Chapter Objectives

- Explain the key components of the balance of payments.
- Explain the growth in international trade activity over time.
- Explain how international trade flows are influenced by economic and other factors.
- Explain how international capital flows are influenced by country characteristics.
- Introduce the agencies that facilitate the international flow of funds.

Balance of Payments (1 of 6)

Definition:

Summary of transactions between domestic and foreign residents for a specific country over a specified period of time.

Balance of Payments (2 of 6)

Components of the Balance of Payments Statement:

- **Current Account:** summary of flow of funds due to purchases of goods or services or the provision of income on financial assets.
- **Capital Account:** summary of flow of funds resulting from the sale of assets between one specified country and all other countries over a specified period of time.
- **Financial Account:** refers to special types of investment, including DFI and portfolio investment.

Balance of Payments (3 of 6)

Current Account

- **Payments for Goods and Services**
  - Merchandise exports and imports represent tangible products that are transported between countries. Service exports and imports represent tourism and other services. The difference between total exports and imports is referred to as the balance of trade.
- **Primary Income Payments**
  - Represents income earned by MNCs on their direct foreign investment as well as income earned by investors on their portfolio investments.
- **Secondary Income**
  - Represents aid, grants, and gifts from one country to another.

Balance of Payments (4 of 6)

Current Account (continued)

- **Examples of payment entries**
  - Exhibit 2.1. shows several examples of transactions that would be reflected in the current account.
- **Actual *U.S.* current account balance**
  - The U.S. current account balance has been consistently negative since 1992. Since 2011, the quarterly current account balance for the United States has typically exceeded $40 billion per month, which is primarily due to the U.S. balance-of-trade deficit.

Exhibit 2.1 Examples of Current Account Transactions (1 of 3)

International *Trade* Transaction	U.S. Cash Flow Position	Entry On U.S. Balance-Of-Payments Account
Walmart purchases clothing produced in Indonesia that it will sell in its U.S. retail stores.	U.S. cash outflow	Debit
Individuals in the United States purchase leather goods over the Internet from a firm based in Italy.	U.S. cash outflow	Debit
The Mexican government pays a U.S. consulting firm for consulting services provided by the firm.	U.S. cash inflow	Credit
The Home Depot headquarters in the United States purchases lumber from Canada that it uses in assembling kitchen cabinets.	U.S. cash outflow	Debit
A university bookstore in Ireland purchases textbooks produced by a U.S. publishing company.	U.S. cash inflow	Credit

Exhibit 2.1 Examples of Current Account Transactions (2 of 3)

International Primary *Income* Transaction	U.S. Cash Flow Position	Entry On U.S. Balance-Of-Payments Account
A U.S. investor receives a dividend payment from a French firm in which she purchased stock.	U.S. cash inflow	Credit
The U.S. Treasury sends an interest payment to a German insurance company that purchased U.S. Treasury bonds one year ago.	U.S. cash outflow	Debit
Apple's foreign subsidiaries remit earnings to their U.S. parent.	U.S. cash inflow	Credit
U.S.-based Mercedes-Benz subsidiaries remit earnings to their parent (Daimler AG) in Germany.	U.S. cash outflow	Debit

Exhibit 2.1 Examples of Current Account Transactions (3 of 3)

International Secondary *Income* Transaction	U.S. Cash Flow Position	Entry On U.S. Balance-Of-Payments Account
The United States provides aid to Costa Rica in response to a flood in Costa Rica.	U.S. cash inflow	Debit
Switzerland provides a grant to U.S. scientists to work on cancer research.	U.S. cash inflow	Credit

Balance of Payments (5 of 6)

Financial Account

- **Direct foreign investment**
  - Summarizes the new direct foreign investment over a given period.
- **Portfolio investment**
  - Summarizes the new portfolio investment (investment in financial assets such as stocks or bonds) over a given period.
- **Other capital investment**
  - Transactions involving short-term financial assets (such as money market securities) between countries.

Balance of Payments (6 of 6)

Capital Account

- Summarizes the flow of funds between one country and all other countries due to financial assets transferred across country borders by people who move to a different country, or due to sales of patents and trademarks.

Growth in International Trade (1 of 6)

Events That Increased Trade Volume

- **Removal of the Berlin Wall:** Led to reductions in trade barriers in Eastern Europe.
- **Single European Act of 1987:** Improved access to supplies from firms in other European countries.
- **North American Free Trade Agreement (NAFTA):** Allowed U.S. firms to penetrate product and labor markets that previously had not been accessible.
- **General Agreement on Tariffs and Trade (GATT):** Called for the reduction or elimination of trade restrictions on specified imported goods over a 10-year period across 117 countries.

Growth in International Trade (2 of 6)

Events That Increased Trade Volume (continued)

- **The European Union:** Free movement of products, services, and capital among member countries.
- **Inception of Euro:** Avoid exposure to exchange rate risk.
- **Other Trade Agreements:** The United States has established trade agreements with many other countries.

Growth in International Trade (3 of 6)

Impact of Outsourcing on Trade

- **Definition of Outsourcing:** The process of subcontracting to a third party in another country to provide supplies or services that were previously produced internally.
- **Impact of outsourcing:**
  - Increased international trade activity because MNCs now purchase products or services from another country.
  - Lower cost of operations and job creation in countries with low wages.
- **Criticism of outsourcing:**
  - Outsourcing may reduce jobs in the United States.

Growth in International Trade (4 of 6)

Impact of Outsourcing on Trade (continued)

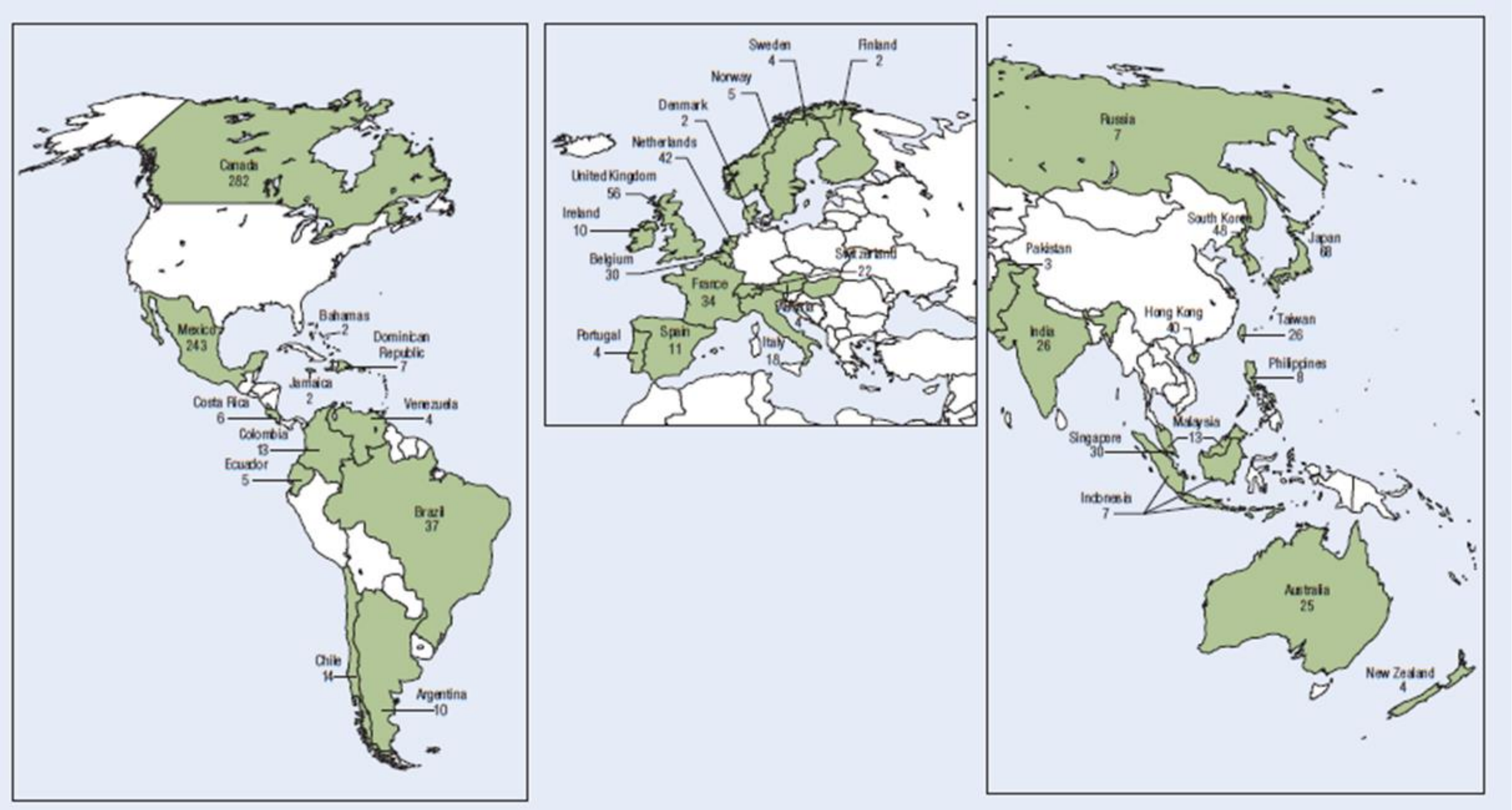
- **Managerial decisions about outsourcing**
  - Managers of a U.S.-based MNC may argue that they create jobs for U.S. workers.
  - Shareholders may suggest that the managers are not maximizing the MNC's value as a result of their commitment to creating U.S. jobs.
  - Managers should consider the potential savings that could occur as a result of outsourcing.
  - Managers must also consider the possible bad publicity or bad morale that could occur among the U.S. workers.

Growth in International Trade (5 of 6)

Trade Volume Among Countries

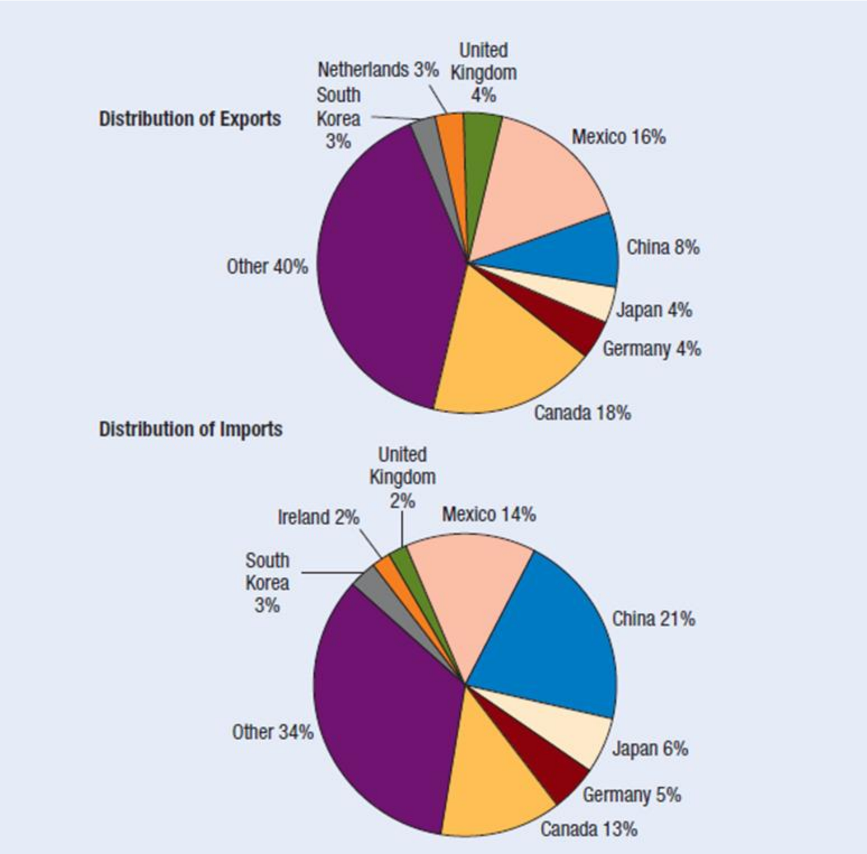
- The annual international trade volume of the United States is between 10 and 20% of its annual GDP.
- **Trade volume between the United States and Other Countries:**
  - About 20% of all U.S. exports are to Canada, while 13% are to Mexico. (Exhibits 2.2 and 2.3)
  - Canada, China, Mexico, and Japan are the key exporters to the United States. Together, they are responsible for more than half of the value of all U.S. imports.

Exhibit 2.3 Distributions of U.S. Exports by Country (2015, billions of $)



Source: U.S. Census Bureau, 2018

Exhibit 2.4 Distribution of U.S. Exports and Imports by Country (2018)



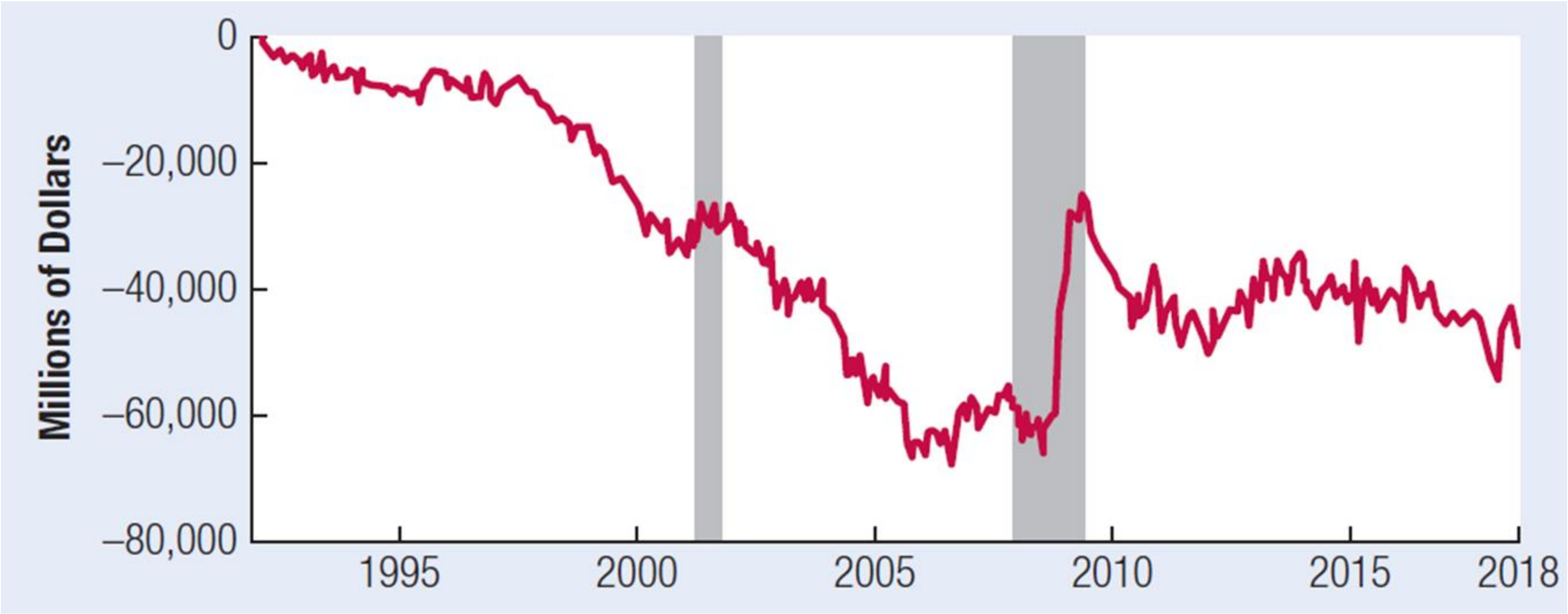
Source: U.S. Census Bureau, 2018

Growth in International Trade (6 of 6)

Trend in U.S. Balance of Trade (Exhibit 2.5)

- During the last decade, the United States has experienced large balance-of-trade deficits, due to strong U.S. demand for imported products that are produced at a lower cost than similar products can be produced in the United States.
- Exhibit 2.4 shows the monthly trend in the U.S. balance of trade.
- The U.S monthly trade deficit has been $40 billion or more per month since 2011.
- Much of the U.S. trade deficit is due to a trade imbalance with just two countries: China and Japan.

Exhibit 2.5 U.S. Balance of Trade Over Time (Quarterly)



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Federal Reserve.

Factors Affecting International Trade Flows (1 of 11)

Since international trade can significantly affect a country's economy, it is important to identify and monitor the factors that influence it. The following factors are the most influential:

- Cost of labor
- Inflation
- National income
- Credit conditions
- Government policies
- Exchange rates

Factors Affecting International Trade Flows (2 of 11)

Cost of Labor:

- The cost of labor varies substantially among countries.
- Firms in countries where labor costs are low commonly have an advantage when competing globally, especially in labor intensive industries.

Inflation:

- Current account decreases if inflation increases relative to trade partners.

National Income:

- Current account decreases if national income increases relative to other countries.

Factors Affecting International Trade Flows (3 of 11)

Credit Conditions:

- When credit conditions become more restrictive, MNCs may reduce their corporate spending and reduce their demand for imported supplies.

Factors Affecting International Trade Flows (4 of 11)

Government Policies: can increase imports through:

- Restrictions on imports
- Subsidies for exporters
- Restrictions on piracy
- Environmental restrictions
- Labor laws
- Business laws
- Tax breaks
- Country trade requirements
- Government ownership or subsidies
- Country security laws
- Policies to punish country governments

Factors Affecting International Trade Flows (5 of 11)

Impact of Government Policies (continued)

- **Restrictions on Imports:** Taxes (tariffs) on imported goods increase prices and limit consumption. Quotas limit the volume of imports.
- **Subsidies for Exporters:** Government subsidies help firms produce at a lower cost than their global competitors.
- **Restrictions on Piracy:** A government can affect international trade flows by its lack of restrictions on piracy.
- **Environmental Restrictions:** Environmental restrictions impose higher costs on local firms, placing them at a global disadvantage compared to firms in other countries that are not subject to the same restrictions.

Factors Affecting International Trade Flows (6 of 11)

Impact of Government Policies (continued)

- **Labor Laws:** Countries with more restrictive laws will incur higher expenses for labor, other factors being equal.
- **Business Laws:** Firms in countries with more restrictive bribery laws may not be able to compete globally in some situations.
- **Tax Breaks:** Though not necessarily a subsidy, still a form of government financial support that might benefit many firms that export products.
- **Country Trade Requirements:** Requiring various forms or obtaining licenses before countries can export to the country (Bureaucracy) is a strong trade barrier.

Factors Affecting International Trade Flows (7 of 11)

Impact of Government Policies (continued)

- **Government Ownership or Subsidies:** Some governments maintain ownership in firms that are major exporters.
- **Country Security Laws:** Governments may impose certain restrictions when national security is a concern, which can affect on trade.
- **Policies to Punish Country Governments:** Many expect countries to restrict imports from countries that:
  - Fail to enforce environmental laws and child labor laws.
  - Initiate war against another country.
  - Are unwilling to participate in a war.

Factors Affecting International Trade Flows (8 of 11)

Impact of Government Policies (continued)

- **Summary of Government Policies:**
  - Every government implements some policies.
  - No formula ensures a completely fair contest for market share.

Factors Affecting International Trade Flows (9 of 11)

Exchange Rates: Current account decreases if currency appreciates relative to other currencies.

- How exchange rates may correct a balance of trade deficit:

  When a home currency is exchanged for a foreign currency to buy foreign goods, then the home currency faces downward pressure, leading to increased foreign demand for the country's products.

- Why exchange rates may not correct a balance of trade deficit:

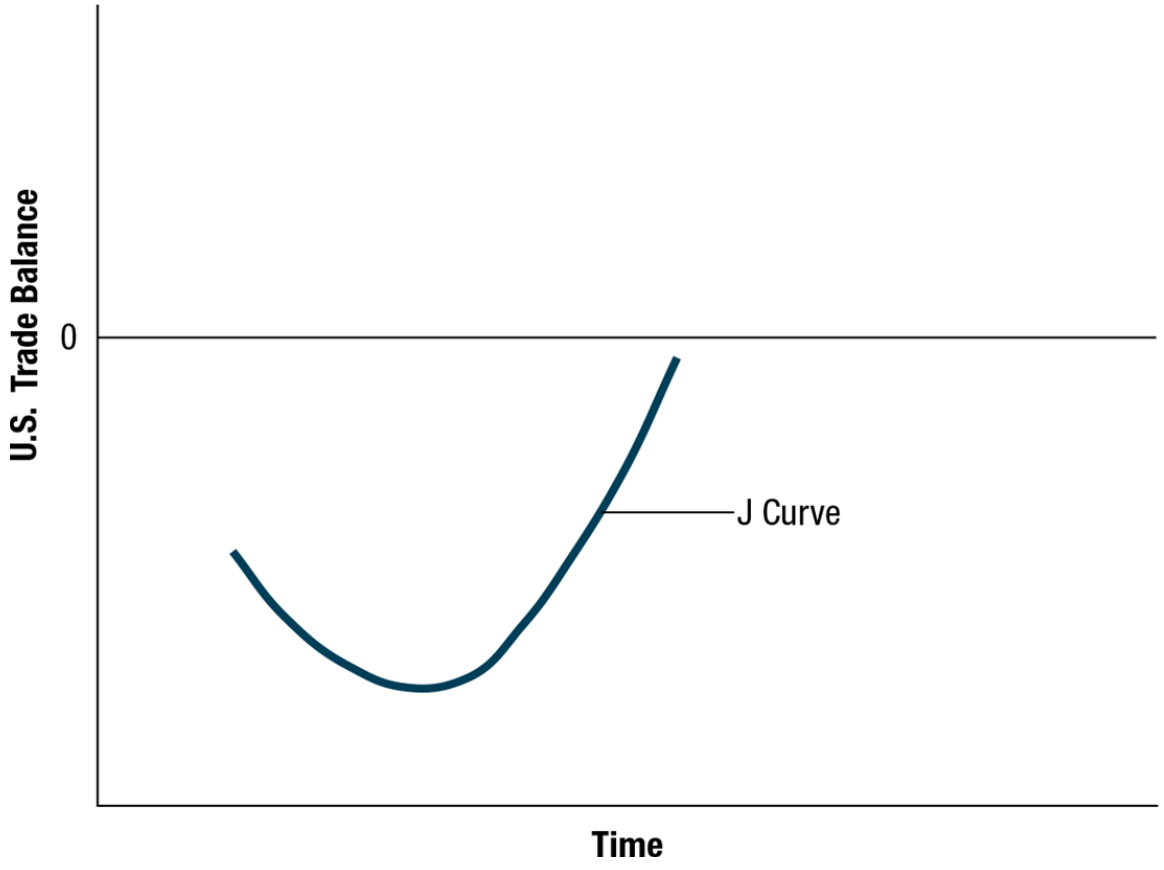
  Exchange rates will not automatically correct any international trade balances when other forces are at work.

Factors Affecting International Trade Flows (10 of 11)

Exchange Rates (continued)

- **Limitations of a Weak Home Currency Solution**
    - Competition: Foreign companies may lower their prices to remain competitive.
    - Impact of other currencies: A country that has balance of trade deficit with many countries is not likely to solve all deficits simultaneously.
    - Prearranged international trade transactions: International transactions cannot be adjusted immediately. The lag is estimated to be 18 months or longer, leading to a J-curve effect. (Exhibit 2.6)
    - Intracompany trade: Many firms purchase products that are produced by their subsidiaries. These transactions are not necessarily affected by currency fluctuations.

Exhibit 2.6 J-Curve Effect



Factors Affecting International Trade Flows (11 of 11)

Exchange Rates (continued)

- **Exchange Rates and International Friction**
  - All governments cannot weaken their home currencies simultaneously.
  - Actions by one government to weaken its currency causes another country's currency to strengthen.
  - Government attempts to influence exchange rates can lead to international disputes.

International Capital Flows (1 of 4)

Factors Affecting Direct Foreign Investment

- **Changes in Restrictions**
  - New opportunities have arisen from the removal of government barriers.
- **Privatization**
  - Privatization policy allows for expansion of international business because foreign firms can acquire operations sold by national governments.
  - The primary reason that the market value of a firm may increase in response to privatization is the anticipated improvement in managerial efficiency.
  - The trend toward privatization will undoubtedly create a more competitive global marketplace.

International Capital Flows (2 of 4)

Factors Affecting Direct Foreign Investment (Continued)

- **Potential Economic Growth**
  - Countries with greater potential for economic growth are more likely to attract DFI.
- **Tax Rates**
  - Countries that impose relatively low tax rates on corporate earnings are more likely to attract DFI.
- **Exchange Rates**
  - Firms typically prefer to pursue DFI in countries where the local currency is expected to strengthen against their own.

International Capital Flows (3 of 4)

Factors Affecting International Portfolio Investment

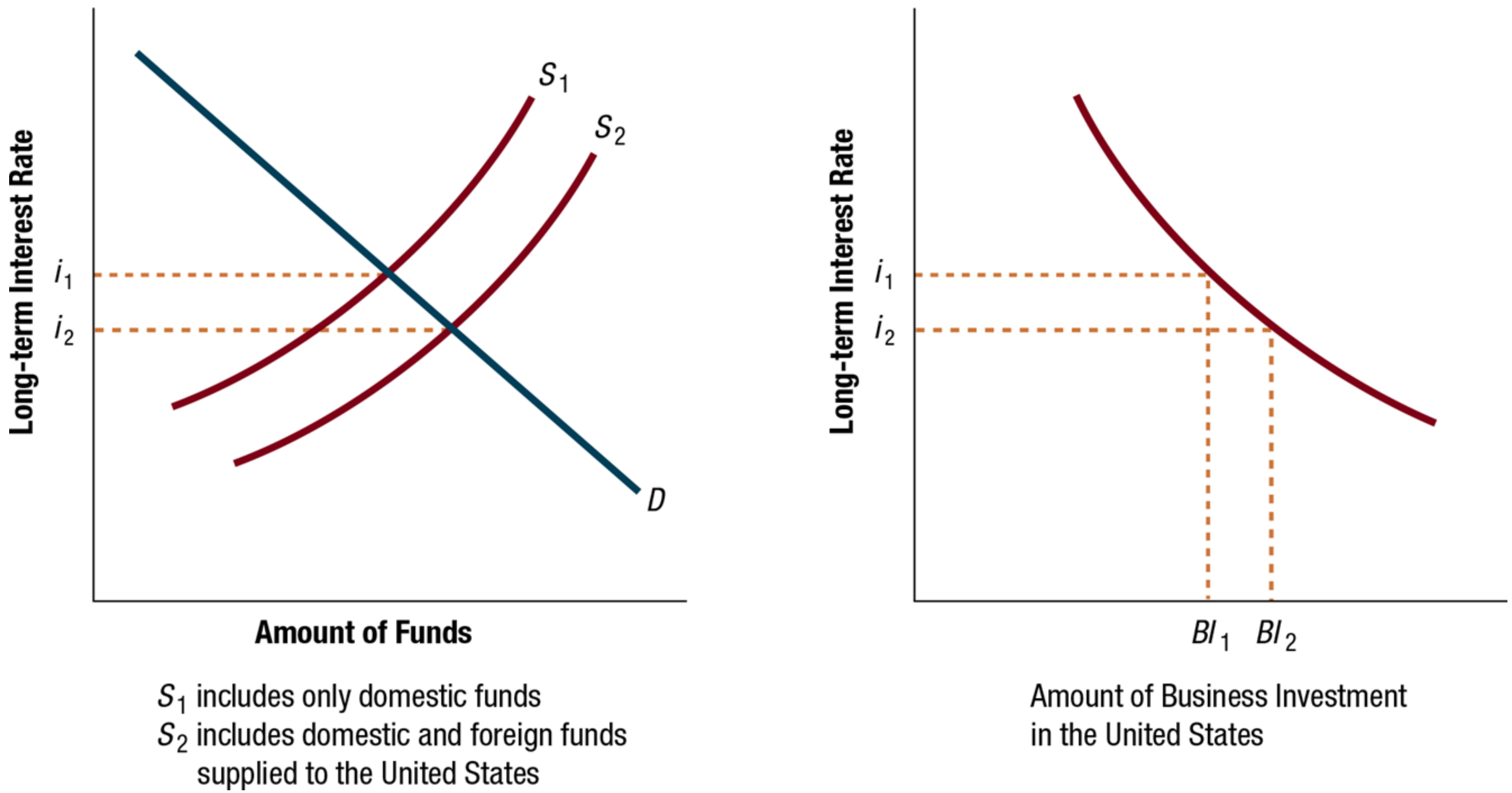
- **Tax Rates on Interest or Dividends**
  - Investors normally prefer to invest in a country where taxes are relatively low.
- **Interest Rates**
  - Money tends to flow to countries with high interest rates, as long as the local currencies are not expected to weaken.
- **Exchange Rates**
  - Investors are attracted to a currency that is expected to strengthen.

International Capital Flows (4 of 4)

Impact of International Capital Flows (Exhibit 2.7)

- The United States relies heavily on foreign investment in:
  - U.S. manufacturing plants, offices, and other buildings.
  - Debt securities issued by U.S. firms.
  - U.S. Treasury debt securities.
- Foreign investors are especially attracted to the U.S. financial markets when the interest rate in their home country is substantially lower than that in the United States.
- **U.S. reliance on foreign funds:** In general, access to international funding has allowed more growth in the U.S. economy over time but has also made the U.S. more reliant on foreign investors.

Exhibit 2.7 Impact of the International Flow of Funds on U.S. Interest Rates and Business Investment



Agencies that Facilitate International Flows (1 of 7)

International Monetary Fund

- Major Objectives of the IMF
  - promote cooperation among countries on international monetary issues,
  - promote stability in exchange rates,
  - provide temporary funds to member countries attempting to correct imbalances of international payments,
  - promote free mobility of capital funds across countries,
  - promote free trade. It is clear from these objectives that the IMF's goals encourage increased internationalization of business.
- Its **compensatory financing facility** (CFF) attempts to reduce the impact of export instability on countries.
- Financing is measured in **special drawing rights** (SDRs)

Agencies that Facilitate International Flows (2 of 7)

World Bank — (International Bank for Reconstruction and Development)

- Major Objective — Make loans to countries to enhance economic development.
- **Structural Adjustment Loans** (SALs) are intended to enhance a country's long-term economic growth.
- Funds are distributed through **cofinancing agreements**:
  - Official aid agencies
  - Export credit agencies
  - Commercial banks

Agencies that Facilitate International Flows (3 of 7)

World Trade Organization (WTO)

- Major Objective — Provide a forum for multilateral trade negotiations and to settle trade disputes related to the GATT accord.
- Member countries are given voting rights that are used to make judgments about trade disputes and other issues.

Agencies that Facilitate International Flows (4 of 7)

International Finance Corporation (IFC)

- Major Objective — promote private enterprise within countries.
- Provides loans to corporations and purchases stock
- It traditionally has obtained financing from the World Bank but can borrow in the international financial markets.

International Development Association (IDA)

- Major Objectives — extends loans at low interest rates to poor nations that cannot qualify for loans from the World Bank.

Agencies that Facilitate International Flows (5 of 7)

Bank for International Settlements (BIS)

- Major Objectives — facilitate cooperation among countries with regard to international transactions.
- Provides assistance to countries experiencing a financial crisis.
- Sometimes referred to as the **“central banks’ central bank”** or the **“lender of last resort.”**

Agencies that Facilitate International Flows (6 of 7)

OECD — Organization for Economic Cooperation and Development

- Major Objective — Facilitate governance in governments and corporations of countries with market economics.
- It has 30 member countries and has relationships with numerous countries.
- Promotes international country relationships that lead to globalization.

Agencies that Facilitate International Flows (7 of 7)

Regional Development Agencies

- Inter-American Development Bank: focusing on the needs of Latin America
- Asian Development Bank: established to enhance social and economic development in Asia
- African Development Bank: focusing on development in African countries
- European Bank for Reconstruction and Development: created in 1990 to help the Eastern European countries adjust from communism to capitalism.

Summary (1 of 4)

- The key components of the balance of payments are the current account and the capital account. The current account is a broad measure of the country's international trade balance. The capital account measures the value of financial and nonfinancial assets transferred across country borders. The financial account consists mainly of payments for direct foreign investment and investment in securities (portfolio investment).

Summary (2 of 4)

- International trade activity has grown over time in response to several government agreements to remove cross-border restrictions. In addition, MNCs have commonly used outsourcing in recent years, subcontracting with a third party in a foreign country for supplies or services they previously produced themselves. Thus, outsourcing is another reason for the increase in international trade activity.

Summary (3 of 4)

- A country's international trade flows are affected by inflation, national income, government restrictions, and exchange rates. High labor costs, high inflation, a high national income, low or no restrictions on imports, and a strong local currency tend to result in a strong demand for imports and a current account deficit. Although some countries attempt to correct current account deficits by reducing the value of their currencies, this strategy is not always successful.

Summary (4 of 4)

- A country’s international capital flows are affected by any factors that influence direct foreign investment or portfolio investment. DFI tends to occur in those countries that have no restrictions and much potential for economic growth. Portfolio investment tends to occur in those countries where taxes are not excessive, where interest rates are high, and where the local currencies are not expected to weaken.
- Several agencies facilitate the international flow of funds by promoting international trade and finance, providing loans to enhance global economic development, settling trade disputes between countries, and promoting global business relationships between countries.