International Financial Management 13th edition Madura Solutions Manual

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Chapter 2

International Flow of Funds

Lecture Outline

Balance of Payments
- Current Account
- Financial Account
- Capital Account

Growth in International Trade
- Events That Increased Trade Volume
- Impact of Outsourcing on Trade
- Trade Volume Among Countries
- Trend in U.S.Balance of Trade

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- Inflation
- National Income
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- Exchange Rates
- Interaction of Factors

International Capital Flows
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- Factors Affecting International Portfolio Investment
- Impact of International Capital Flows

Agencies that Facilitate International Flows
- International Monetary Fund
- World Bank
- World Trade Organizations
- International Finance Corporation
- Internatiaonal Development Association
- Bank for International Settlements
- OECD
- Regional Development Agencies

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Chapter Theme

This chapter provides an overview of the international environment surrounding MNCs. The chapter is macro-oriented in that it discusses international payments and the flow of funds. This macro discussion is useful information for an MNC since the MNC can be affected by changes in a country's flow of funds.

Topics to Stimulate Class Discussion

1. Is a current account deficit something to worry about?

2. If a government wants to correct a current account deficit, why can't it simply enforce restrictions on imports?

3. Why don't exchange rates always adjust to correct current account deficits?

POINT/COUNTER-POINT:
Should Trade Restrictions be Used to Influence Human Rights Issues?

POINT: Yes. Some countries do not protect human rights in the same manner as the U.S. At times, the U.S. should threaten to restrict U.S. imports from or investment in a country if it does not correct human rights violations. The U.S. should use its large international trade and investment as leverage to ensure that human rights violations do not occur. Other countries with a history of human rights violations are more likely to honor human rights if their economic conditions are threatened.

COUNTER-POINT: No. International trade and human rights are two separate issues. International trade should not be used as the weapon to enforce human rights. Firms engaged in international trade should not be penalized by the human rights violations of a government. If the U.S. imposes trade restrictions to enforce human rights, the country will retaliate. Thus, the U.S. firms that export to that foreign country will be adversely affected. By imposing trade sanctions, the U.S. government is indirectly penalizing the MNCs that are attempting to conduct business in specific foreign countries. Trade sanctions cannot solve every difference in the beliefs or morals between the more developed countries and the developing countries. By restricting trade, the U.S. will slow down the economic progress of developing countries.

WHO IS CORRECT? Use the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

ANSWER: There is no perfect solution, but the tradeoff should be recognized. When trade is used as the means to correct human rights problems, those firms that initiated their business in other countries could suffer major losses. These firms may argue that they are mistreated by such restrictions, and that the country of concern will not necessarily improve its human rights record even with the restrictions. Yet, if the U.S. ignores the human rights issue, it will be criticized for being too capitalistic, and unwilling to help solve social problems in the world.

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Answers to End of Chapter Questions

1. Balance of Payments.

a. What are the main components of the current account?

ANSWER: The current account balance is composed of (1) the balance of trade, (2) the net amount of payments of interest to foreign investors and from foreign investment, (3) payments from international tourism, and (4) private gifts and grants.

b. What are the main components of the financial account?

ANSWER: The **financial account** measures the flow of funds between countries that are due to: (1) direct foreign investment, (2) portfolio investment, and (3) other capital investment.

2. Inflation Effect on Trade.

a. How would a relatively high home inflation rate affect the home country's current account, other things being equal?

ANSWER: A high inflation rate tends to increase imports and decrease exports, thereby increasing the current account deficit, other things equal.

b. Is a negative current account harmful to a country? Discuss.

ANSWER: This question is intended to encourage opinions and does not have a perfect solution. A negative current account is thought to reflect lost jobs in a country, which is unfavorable. Yet, the foreign importing reflects strong competition from foreign producers, which may keep prices (inflation) low.

3. Government Restrictions. How can government restrictions affect international payments among countries?

ANSWER: Governments can place tariffs or quotas on imports to restrict imports. They can also place taxes on income from foreign securities, thereby discouraging investors from purchasing foreign securities. If they loosen restrictions, they can encourage international payments among countries.

4. IMF.

a. What are some of the major objectives of the IMF?

ANSWER: Major IMF objectives are to (1) promote cooperation among countries on international monetary issues, (2) promote stability in exchange rates, (3) provide temporary funds to member countries attempting to correct imbalances of international payments, (4) promote free mobility of capital funds across countries, and (5) promote free trade.

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b. How is the IMF involved in international trade?

ANSWER: The IMF in involved in international trade because it attempts to stabilize international payments, and trade represents a significant portion of the international payments.

5. **Exchange Rate Effect on Trade Balance.** Would the U.S. balance of trade deficit be larger or smaller if the dollar depreciates against all currencies, versus depreciating against some currencies but appreciated against others? Explain.

ANSWER: If the dollar weakens against all currencies, the U.S. balance of trade deficit will likely be smaller. Some U.S. importers would have more seriously considered purchasing their goods in the U.S. if most or all currencies simultaneously strengthened against the dollar. Conversely, if some currencies weaken against the dollar, the U.S. importers may have simply shifted their importing from one foreign country to another.

6. **Demand for Exports.** A relatively small U.S. balance of trade deficit is commonly attributed to a strong demand for U.S. exports. What do you think is the underlying reason for the strong demand for U.S. exports?

ANSWER: The strong demand for U.S. exports is commonly attributed to strong foreign economies or to a weak dollar.

7. **Impact on International Trade.** Why do you think international trade volume has increased over time? In general, how are inefficient firms affected by the reduction in trade restrictions among countries and the continuous increase in international trade?

ANSWER: International trade volume has increased because of the reduction in trade restrictions over time. It may have also increased for many other reasons, such as increased information flow (via Internet etc.) between firms in different countries. Inefficient firms are adversely affected if they have to face tougher competition from foreign firms as a result of a reduction in trade restrictions.

8. **Effects of the Euro.** Explain how the existence of the euro may affect U.S. international trade.

ANSWER: The euro allowed for a single currency among many European countries. It could encourage firms in those countries to trade among each other since there is no exchange rate risk. This would possibly cause them to trade less with the U.S.

The euro can increase trade within Europe because it eliminates the need for several European countries to exchange currencies when trading with each other.

9. **Currency Effects.** When South Korea's export growth stalled, some South Korean firms suggested that South Korea's primary export problem was the weakness in the Japanese yen. How would you interpret this statement?

ANSWER: One of South Korea's primary competitors in exporting is Japan, which produces and exports many of the same types of products to the same countries. When the Japanese yen is weak, some importers switch to Japanese products in place of South Korean products. For this reason, it is often suggested that South Korea's primary export problem is weakness in the Japanese yen.

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10. Effects of Tariffs. Assume a simple world in which the U.S. exports soft drinks and beer to France and imports wine from France. If the U.S. imposes large tariffs on the French wine, explain the likely impact on the values of the U.S. beverage firms, U.S. wine producers, the French beverage firms, and the French wine producers.

ANSWER: The U.S. wine producers benefit from the U.S. tariffs, while the French wine producers are adversely affected. The French government would likely retaliate by imposing tariffs on the U.S. beverage firms, which would adversely affect their value. The French beverage firms would benefit.

Advanced Questions

11. Free Trade. There has been considerable momentum to reduce or remove trade barriers in an effort to achieve "free trade." Yet, one disgruntled executive of an exporting firm stated, "Free trade is not conceivable; we are always at the mercy of the exchange rate. Any country can use this mechanism to impose trade barriers." What does this statement mean?

ANSWER: This statement implies that even if there were no explicit barriers, a government could attempt to manipulate exchange rates to a level that would effectively reduce foreign competition. For example, a U.S. firm may be discouraged from attempting to export to Japan if the value of the dollar is very high against the yen. The prices of the U.S. goods from the Japanese perspective are too high because of the strong dollar. The reverse situation could also be possible in which a Japanese exporting firm is priced out of the U.S. market because of a strong yen (weak dollar). [Answer is based on opinion.]

12. International Investments. U.S.-based MNCs commonly invest in foreign securities.

a. Assume that the dollar is presently weak and is expected to strengthen over time. How will these expectations affect the tendency of U.S. investors to invest in foreign securities?

ANSWER: The expectations of a strong dollar would discourage U.S. investors from investing abroad. If the dollar is relatively weak now, U.S. investors need more dollars to make purchase foreign currency (when investing). If the dollar strengthens over their investment horizon, they will exchange the foreign currency (as the investment is liquidated) into dollars at a less favorable exchange rate than the exchange rate at which they converted dollars into the foreign currency. That is, the exchange rate effect would reduce the yield that they earn on their investment.

b. Explain how low U.S. interest rates can affect the tendency of U.S.-based MNCs to invest abroad.

ANSWER: Low U.S. interest rates can encourage U.S.-based MNCs to invest abroad, as investors seek higher returns on their investment than they can earn in the U.S.

c. In general terms, what is the attraction of foreign investments to U.S. investors?

ANSWER: The main attraction is potentially higher returns. The international stocks can outperform U.S. stocks, and international bonds can outperform U.S. bonds. However, there is no guarantee that the returns on international investments will be so favorable. Some investors may also pursue international investments to diversify their investment portfolio, which can possibly reduce risk.

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13. Exchange Rate Effects on Trade.

a. Explain why a stronger dollar could enlarge the U.S. balance of trade deficit. Explain why a weaker dollar could affect the U.S. balance of trade deficit.

ANSWER: A stronger dollar makes U.S. exports more expensive to importers and may reduce imports. It makes U.S. imports cheap and may increase U.S. imports. A weaker home currency increases the prices of imports purchased by the home country and reduces the prices paid by foreign businesses for the home country's exports. This should cause a decrease in the home country's demand for imports and an increase in the foreign demand for the home country's exports, and therefore increase the current account. However, this relationship can be distorted by other factors.

b. It is sometimes suggested that a floating exchange rate will adjust to reduce or eliminate any current account deficit. Explain why this adjustment would occur.

ANSWER: A current account deficit reflects a net sale of the home currency in exchange for other currencies. This places downward pressure on that home currency's value. If the currency weakens, it will reduce the home demand for foreign goods (since goods will now be more expensive), and will increase the home export volume (since exports will appear cheaper to foreign countries).

c. Why does the exchange rate not always adjust to a current account deficit?

ANSWER: In some cases, the home currency will remain strong even though a current account deficit exists, since other factors (such as international capital flows) can offset the forces placed on the currency by the current account.

14. Impact of Government Policies on Trade. Governments of many countries enact policies that can have a major impact on international trade flows.

a. Explain how governments might give their local firms a competitive advantage in the international trade arena.

ANSWER: Some governments offer subsidies to their domestic firms so that those firms can produce products at a lower cost than their global competitors. They may also have very limited environment and child labor restrictions, which allows local firms to produce at a low cost.

b. Why might different tax laws on corporate income across countries allow firms from some countries to have a competitive advantage in the international trade arena?

ANSWER: When a government imposes lower corporate tax rates, firms may be able to charge lower prices for their products and still make a profit.

c. If a country imposes lower corporate income tax rates, does that provide an unfair advantage?

ANSWER: Lower tax rates should not be viewed as unfair, unless the government only allows its exporting firms such a tax advantage.

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15. **China - U.S. Balance of Trade.** There is an ongoing debate between the U.S. and China regarding whether the Chinese yuan's value should be revalued upward. The cost of labor in China is substantially lower than that in the U.S.

    a. Would the U.S. balance of trade deficit in China be eliminated if the yuan was revalued upward by 20%? Or by 40%? Or by 80%?

    ANSWER: This is an open question without a perfect answer. Yet, it should at least make students realize that a small increase in the value of the yuan is not going to make Chinese products more expensive than U.S. products in labor-intensive industries, given that Chinese wages may be less than one-tenth of U.S. wages in these industries.

    b. If the yuan was revalued to the extent that it substantially reduced the U.S. demand for Chinese products, would this shift the U.S. demand toward the U.S. or toward other countries where wage rates are relatively low? In other words, would the correction of the U.S. balance of trade deficit have a major impact on U.S. productivity and jobs?

    ANSWER: To the extent that there are decent substitute products in other low wage countries, it seems likely that U.S. consumers would just shift their demand toward the products in these countries. If so, a correction in the U.S. balance of trade deficit with China would shift jobs to other low-wage countries rather than to the U.S.

CRITICAL THINKING

Cause and Effects of International Trade Conflict Conduct an online search of the terms "international trade conflict" and also insert the prevailing month and year. You will likely see that an international trade conflict exists at the time that you conduct your search. Review the online articles on a recent conflict. Write a short essay to summarize the source of the conflict, and whether there one country's trade barriers represents retaliation due to actions by the other country. Describe the types of MNCs that are most likely to suffer from the trade conflict.

ANSWER:
This question enables students to recognize the different types of reasons that can cause governments to impose new international trade barriers. In many cases, the government is using the barriers as a form of protest against a political situation, or in retaliation for barriers imposed by another government.

Solution to Continuing Case Problem: Blades, Inc.

1. How could a higher level of inflation in Thailand affect Blades (assume U.S. inflation remains constant)?

   ANSWER: A high level of inflation in Thailand relative to the United States could affect Blades favorably. Generally, if a country's inflation rate increases relative to the countries with which it trades, consumers and corporations within the country will most likely purchase more goods overseas, as local goods become more expensive. Consequently, Blades' sales to Thailand may increase.

2. How could competition from firms in Thailand and from U.S. firms conducting business in Thailand affect Blades?

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ANSWER: Blades would be favorably affected relative to Thai roller blade manufacturers and relative to other U.S. roller blade manufacturers with operations in Thailand. Both groups of firms will likely be forced to raise their prices if they want to maintain the same profit margin should inflation in Thailand increase. This is especially true if both groups of firms source their supplies directly from Thailand, so that the prices of these supplies are subject to the higher inflation in Thailand. Conversely, Blades' cost of goods sold incurred in Thailand is relatively small. Consequently, costs will not be subject to the higher level of inflation in Thailand to a great extent and Blades will probably not have to raise its prices to the same extent as Thai roller blade manufacturers or U.S. manufacturers with operations in Thailand.

3. How could a decreasing level of national income in Thailand affect Blades?

   ANSWER: At first glance, it would appear that a decreasing level of national income in Thailand could hurt Blades financially, as Thai consumers will have less money to spend. Furthermore, this effect may be magnified because Blades manufactures a leisure product, which is probably one of the first products Thai consumers will stop buying. The arrangement Blades has with its primary Thai importer mitigates this effect somewhat, since the latter has committed himself to the purchase of a certain number of "Speedos" annually. Nevertheless, the importer may not offer to renew this arrangement in excess of the original three years if the Thai economy does not improve.

4. How could a continued depreciation of the Thai baht affect Blades? How would it affect Blades' relative to U.S. exporters invoicing their roller blades in U.S. dollars?

   ANSWER: A continued depreciation of the Thai baht would hurt Blades, especially because the firm invoices its roller blades in baht. A continued depreciation of the baht means that the baht-denominated revenue in Thailand will convert to fewer U.S. dollars. Blades also has some expenses in baht, but this amount is less than the revenue denominated in baht.

   Although Blades would be hurt by a depreciating baht because its exports are denominated in baht, the demand for Blades' products may increase relative to that of its U.S. competitors exporting to Thailand. This is because most of the U.S. firms exporting roller blades to Thailand invoice their products in U.S. dollars. If the baht depreciates, Thai importers will have to convert more baht to dollars in order to pay for the dollar-denominated exports.

5. If Blades increases its business in Thailand and experiences serious financial problems, are there any international agencies that the company could approach for loans or other financial assistance?

   ANSWER: An agency extending direct loans to corporations involved in international trade is the International Financial Corporation (IFC). Besides extending loans, the IFC may also purchase stock in a corporation, thereby becoming part owner.

Solution to Supplemental Case: Savanta Company

a. Savanta's business could be adversely affected because its imports from Ketraz may be prevented by the U.S. government due to violations of child labor laws. Even if the U.S. government does not impose restrictions, consumers in the U.S. may no longer purchase the jewelry produced by Savanta as a form of protest against the child labor violations in Ketraz.

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b. Savanta could consider establishing an arrangement with a specific business in Ketraz that has an excellent reputation for treatment of its employees (including the avoidance of child labor). Alternatively, it may establish its own subsidiary in Ketraz to obtain the stones and produce them there. This would allow it to have full control over the employment.

c. The U.S. government could impose restrictions on all imports from Ketraz due to violations of child labor laws, even if Savanta could prove that its imports are not contributing to the violations. Alternatively, if Savanta establishes a subsidiary in Ketraz and the U.S. government does not impose restrictions, Savanta's strategy would likely shift its labor from the U.S. to Ketraz. Thus, it may have to lay off U.S. workers as a result, which could cause some U.S. consumers to stop buying jewelry from Savanta as a form of protest against the layoffs.

Small Business Dilemma

Identifying Factors That Will Affect the Foreign Demand at the Sports Exports Company

Identify the factors that affect the current account balance between the U.S. and the U.K. Explain how each factor may possibly affect the British demand for the footballs that are produced by the Sports Exports Company.

ANSWER:

1. High inflation in the U.K. could cause a shift in the demand for U.S. products instead of British products. However, at this time there is not a British producer of footballs, so that high British inflation will not cause an increase in the demand for U.S.-produced footballs.

2. High national income in the U.K. could increase the amount of spending by British consumers, and would therefore cause an increase in the demand for footballs produced by the Sports Exports Company. A lower national income in the U.K. would have the opposite effect.

3. Government restrictions could be imposed by the British government on goods (such as the footballs) exported by U.S. firms. However, footballs are not likely to be targeted by the British government as a product that should be subject to restrictions.

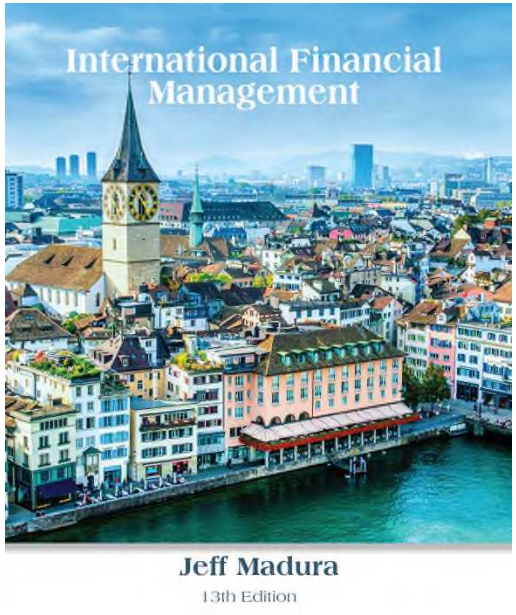
4. The exchange rate of the British pound will change over time. However, since the Sports Exports Company is willing to accept pounds when it sells footballs to the distributor, the distributor does not have to convert the pounds into dollars. Therefore, the British demand for footballs is not affected by changes in the value of the pound (unless this causes the Sports Exports Company to change the price it charges for the footballs someday).

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2 International Flow of Funds

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.

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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.

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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.

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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 (interest and dividend payments) received by investors on foreign investments in financial assets (securities).
- **Secondary Income**
  - Represents aid, grants, and gifts from one country to another.

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Balance of Payments (4 of 6)

Current Account (cont.)

- **Examples of payment entries**
  - Exhibit 2.1.
- **Actual current account balance**
  - Exhibit 2.2.

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Exhibit 2.1 Examples of Current Account Transactions

INTERNATIONAL *TRADE* TRANSACTION	U.S. CASH FLOW POSITION	ENTRY ON U.S. BALANCE-OF-PAYMENTS ACCOUNT
J.C. Penney 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
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
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
A Mexican company that borrowed dollars from a bank based in the United States sends an interest payment to that bank.	U.S. cash inflow	Credit
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 outflow	Debit
Switzerland provides a grant to U.S. scientists to work on cancer research.	U.S. cash inflow	Credit

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Exhibit 2.2 Summary of Current Account in the year 2014 (billions of $)

	COMPONENT OF CURRENT ACCOUNT	VALUE IN BILLIONS OF DOLLARS FOR 2014
(1)	U.S. receipts for merchandise exports	+$1,635
(2)	U.S. payments for merchandise imports	−$2,372
(3) = (1)−(2)	U.S. net receipts for merchandise	−$737
(4)	U.S. receipts for service exports	+$710
(5)	U.S. payments for service imports	−$478
(6) = (4)−(5)	U.S. net service receipts	+$232
(7)	U.S. receipts due to primary income	+$819
(8)	U.S. payments of primary income	−$601
(9) = (7)−(8)	U.S. net primary income receipts	+$218
(10)	U.S. receipts due to secondary income	+$125
(11)	U.S. payments of secondary income	−$249
(12) = (10)−(11)	U.S. net secondary income receipts	−$124
(13) = (3) + (6) + (9) + (12)	U.S. current account balance	−$411

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Balance of Payments (5 of 6)

Capital Account

- Originally included the financial account.
- Includes the value of financial assets transferred across country borders by people who move to a different country.
- Includes patents and trademarks.
- Relatively minor(in terms of dollar amounts) to financial account.

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Balance of Payments (6 of 6)

Financial Account

- **Direct foreign investment**

  Investments in fixed assets in foreign countries.

- **Portfolio investment**

  Transactions involving long term financial assets (such as stocks and bonds) between countries that do not affect the transfer of control.

- **Other capital investment**

  Transactions involving short-term financial assets (such as money market securities) between countries.

- **Errors and omissions and reserves**

  Measurement errors can occur when attempting to measure the value of funds transferred into or out of a country.

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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.

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Growth in International Trade (2 of 6)

Events That Increased Trade Volume (cont.)

- **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.

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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.

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Growth in International Trade (4 of 6)

Impact of Outsourcing on Trade (cont.)

- **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.

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Growth in International Trade (5 of 6)

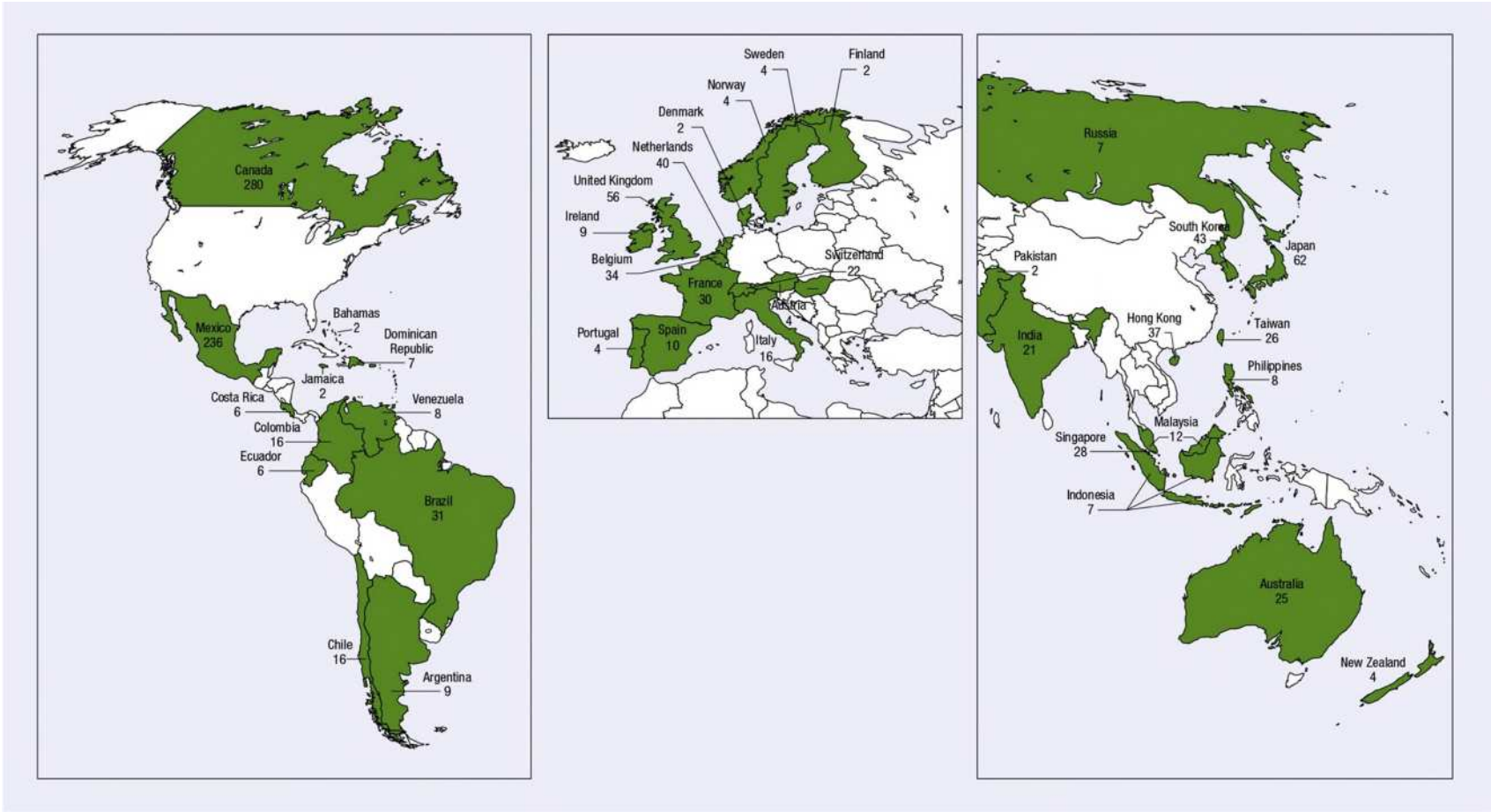
Trade Volume Among Countries

- 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 2.3 and 2.4)
  - 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.

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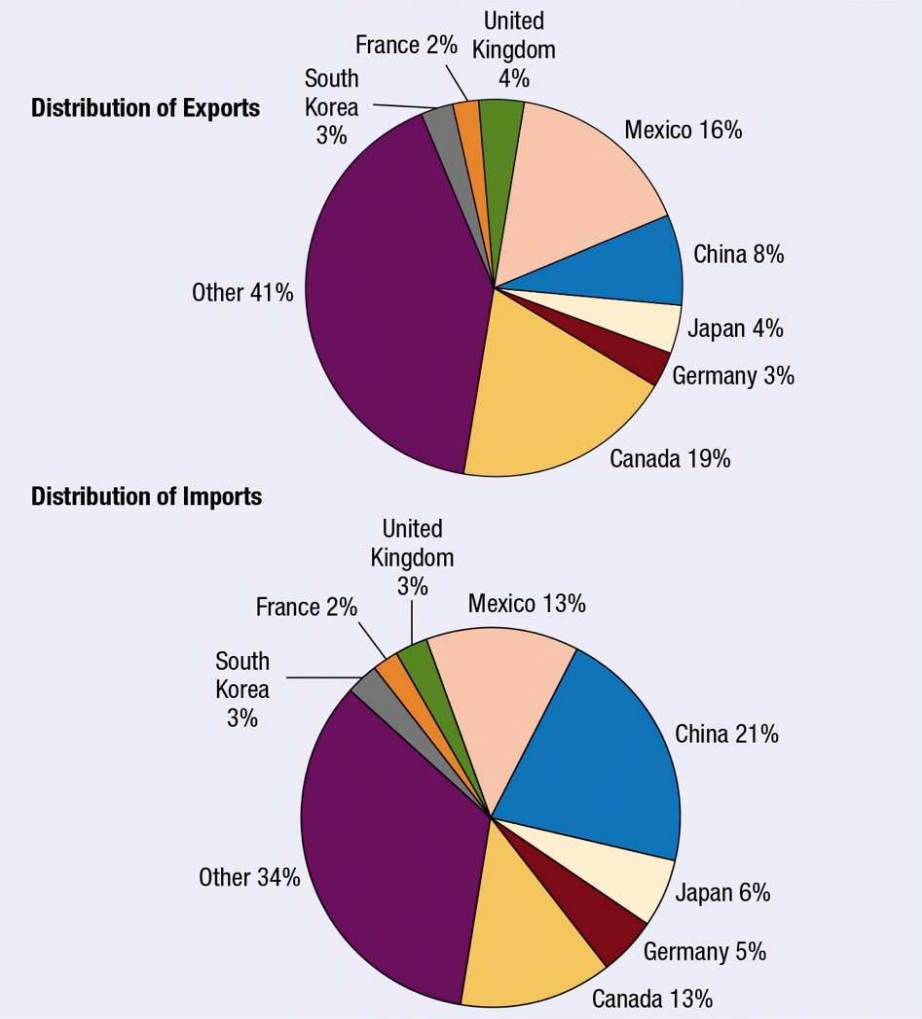
Exhibit 2.3 Distributions of U.S. Exports by Country (2015, billions of $)



Source: U.S. Census Bureau, 2016.

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Exhibit 2.4 Distribution of U.S. Exports and Imports by Country (2015)



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Growth in International Trade (6 of 6)

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

- The quarterly trend in the U.S. balance of trade is shown in Exhibit 2.5.
- Much of the U.S. trade deficit is due to a trade imbalance with just two countries: China and Japan.
- In recent years, the U.S. annual balance-of-trade deficit with China has exceeded $300 billion.

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



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Factors Affecting International Trade Flows (1 of 9)

Cost of Labor: 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.

Credit Conditions: Tend to tighten when economic conditions weaken, causing banks to be less willing to extend financing to MNCs

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Factors Affecting International Trade Flows (2 of 9)

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

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Factors Affecting International Trade Flows (3 of 9)

Impact of Government Policies (cont.)

- **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.

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Factors Affecting International Trade Flows (4 of 9)

Impact of Government Policies (cont.)

- **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.

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Factors Affecting International Trade Flows (5 of 9)

Impact of Government Policies (cont.)

- **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.

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Factors Affecting International Trade Flows (6 of 9)

Impact of Government Policies (cont.)

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

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Factors Affecting International Trade Flows (7 of 9)

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.

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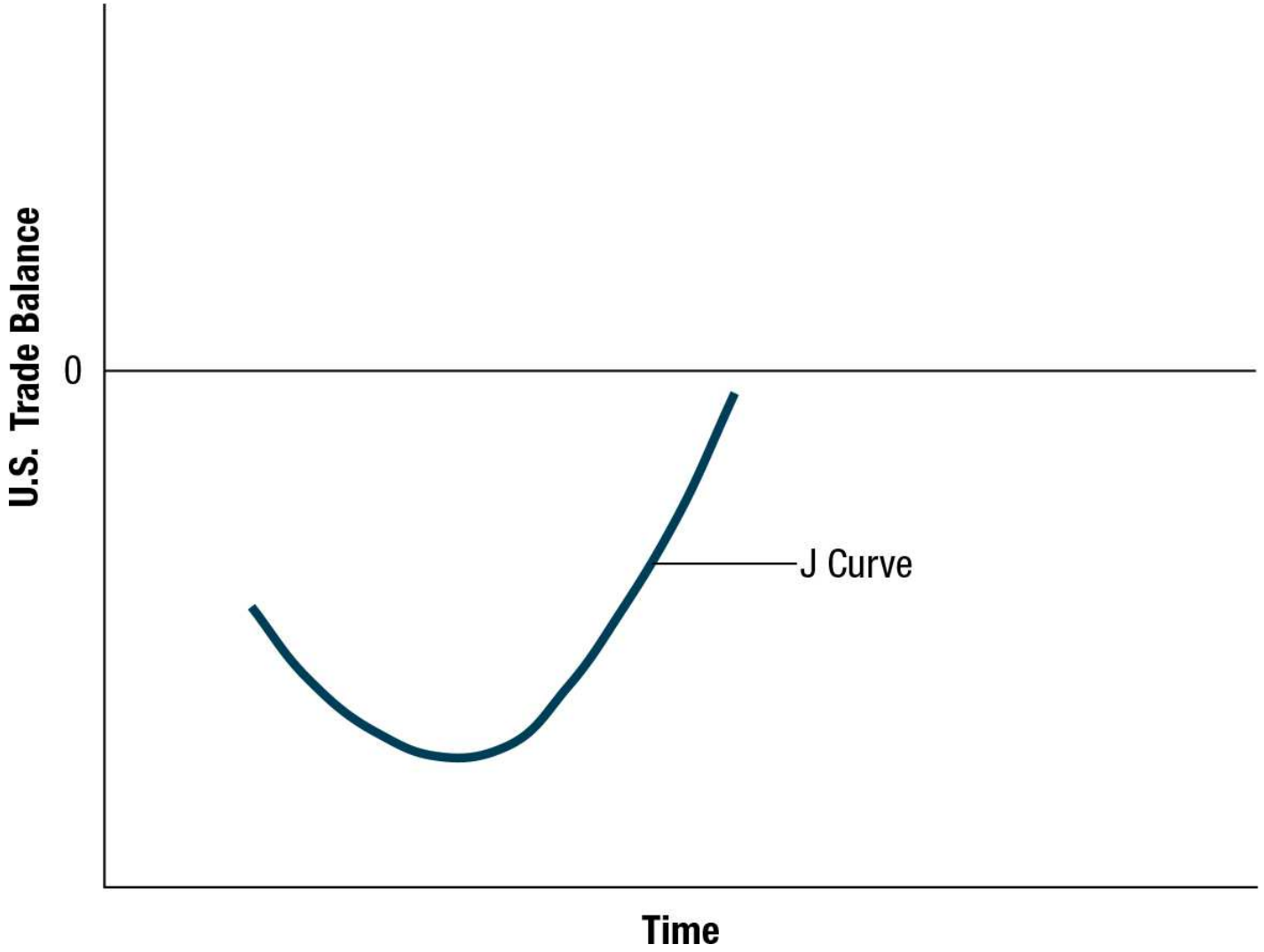
Factors Affecting International Trade Flows (8 of 9)

Exchange Rates (cont.)

- **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.

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Exhibit 2.6 J-Curve Effect



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Factors Affecting International Trade Flows (9 of 9)

Exchange Rates (cont.)

- **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.

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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**
  - DFI is stimulated by new business opportunities associated with privatization.
  - Managers of privately owned businesses are motivated to ensure profitability, further stimulating DFI.

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International Capital Flows (2 of 4)

Factors Affecting Direct Foreign Investment (Cont.)

- **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.

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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.

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International Capital Flows (4 of 4)

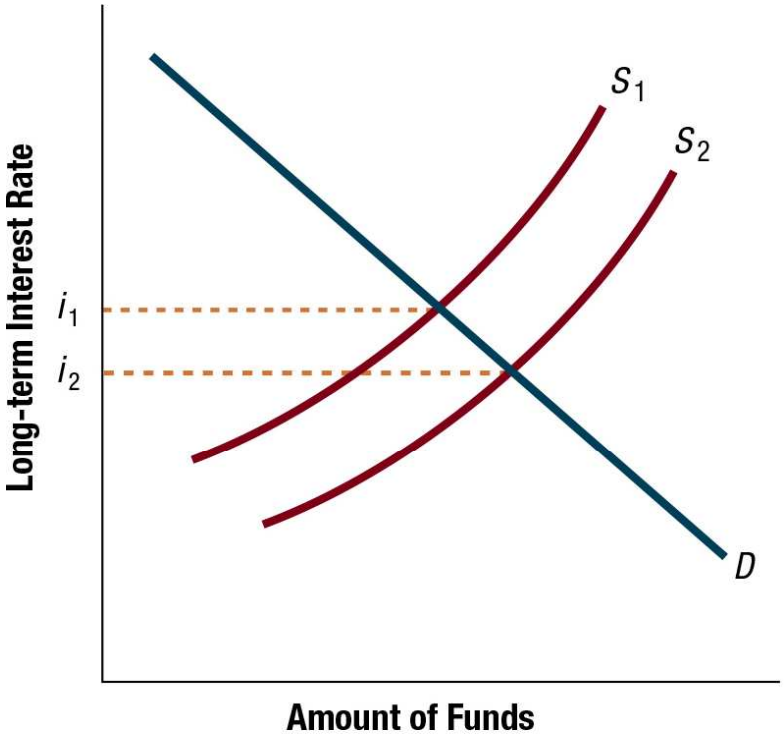
Impact of International Capital Flows (Exhibit 2.7)

- 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.

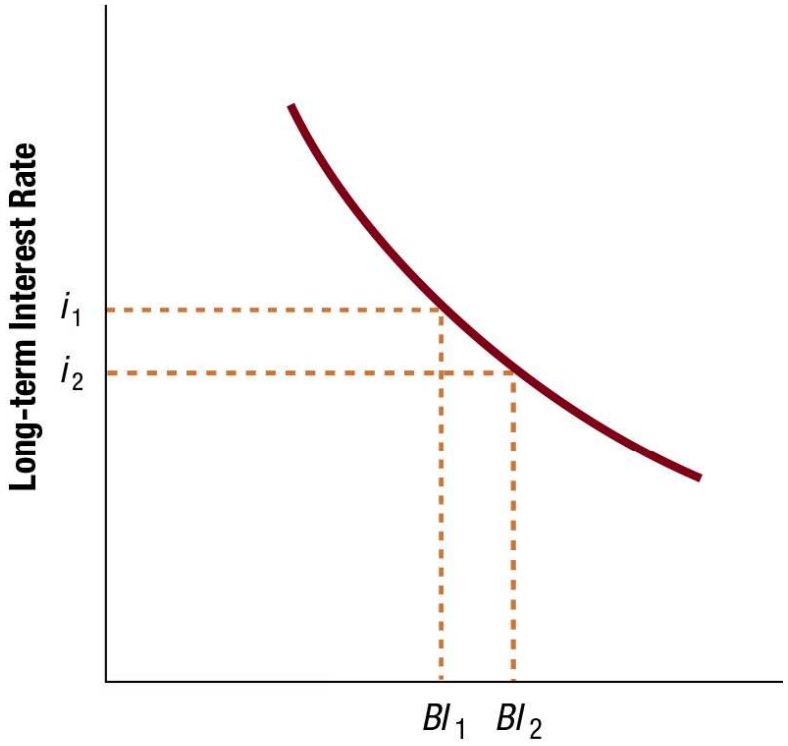
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Exhibit 2.7 Impact of the International Flow of Funds on U.S. Interest Rates and Business Investment



S_1 includes only domestic funds
S_2 includes domestic and foreign funds supplied to the United States



Amount of Business Investment in the United States

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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)

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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

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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.

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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.

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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."**

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Agencies that Facilitate International Flows (6 of 7)

Organization for Economic Cooperation and Development (OECD)

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.

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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.

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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).

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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.

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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.

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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.

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