

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

Factors Affecting International Trade Flows

- Cost of Labor
- Inflation
- National Income
- Credit Conditions
- Government Policies
- Exchange Rates
- Interaction of Factors

International Capital Flows

- Factors Affecting Direct Foreign Investment
- 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
- International Development Association
- Bank for International Settlements
- OECD
- Regional Development Agencies

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. When necessary, 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 on a country in an effort to change its human rights policies, that country will retaliate. As a consequence, 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.

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 domestic 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.

b. How is the IMF involved in international trade?

ANSWER: The IMF is 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.

- 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, French beverage firms, and 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.

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. The 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.

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%? By 40%? 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 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 (assuming 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?

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 that invoice for 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 Ketrax 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 Ketrax.
- b. Savanta could consider establishing an arrangement with a specific business in Ketrax 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 potentially affect British demand for the footballs 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).