

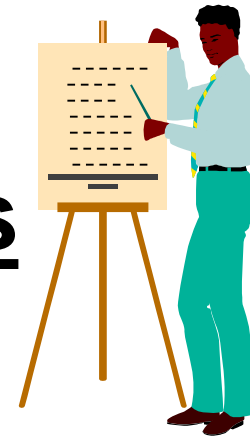
Topic

2

International Flow of Funds



Chapter Objectives



- **To explain the key components of the balance of payments; and**
- **To explain how the international flow of funds is influenced by economic factors and other factors.**

Balance of Payments



- The ***balance of payments*** is a measurement of all transactions between domestic and foreign residents over a specified period of time.
- Each transaction is recorded as both a credit and a debit, i.e. ***double-entry bookkeeping***.
- The transactions are presented in three groups – a ***current account***, a ***capital account***, and a ***financial account***.

Balance of Payments



- The ***current account*** summarizes the flow of funds between one specified country and all other countries due to the purchases of goods or services, the provision of income on financial assets, or unilateral current transfers (e.g. government grants and pensions, private remittances).
- A current account ***deficit*** suggests a greater outflow of funds from the specified country for its ***current*** transactions.

Summary of U.S. International Transactions

(For the Year of 2000 in Millions of Dollars)

Current Account

Exports of goods and services and income receipts	1418568
Goods, balance of payments basis	772210
Services	293492
Income receipts	352866
Imports of goods and services and income receipts	-1809099
Goods, balance of payments basis	-1224417
Services	-217024
Income payments	-367658
Unilateral current transfers, net	-54136
Balance on current account	-444667

Balance of Payments



- The current account is commonly used to assess the *balance of trade*, which is simply the difference between merchandise exports and merchandise imports.

Balance of Payments



- The new ***capital account*** (as defined in the *1993 System of National Accounts* and the fifth edition of IMF's *Balance of Payments Manual*) is adopted by the U.S. in 1999.
- It includes unilateral current transfers that are really shifts in assets, not current income. E.g. debt forgiveness, transfers by immigrants, the sale or purchase of rights to natural resources or patents.

Summary of U.S. International Transactions

(For the Year of 2000 in Millions of Dollars)

Capital Account

Capital account transactions, net	705
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Balance of Payments



- The ***financial account*** (which was called the capital account previously) summarizes the flow of funds resulting from the sale of assets between one specified country and all other countries.
- Assets include official reserves, other government assets, direct foreign investments, investments in securities, etc.

Summary of U.S. International Transactions

(For the Year of 2000 in Millions of Dollars)

Financial Account

U.S.-owned assets abroad, net (increase/financial outflow)	-580952
U.S. official reserve assets, net	-290
Other U.S. Gov't assets, net	-944
U.S. private assets, net	-579718
Foreign-owned assets in the U.S., net (increase/financial inflow)	1024218
Foreign official assets in the U.S., net	37619
Other foreign assets in the U.S., net	986599
Net financial flows	443266
Statistical discrepancy (sum of items in all accounts with sign reversed)	696

Online Application



- The U.S. balance of payments and related data are disseminated by the Bureau of Economic Analysis.

Visit the



at <http://www.bea.doc.gov>.

September 2001

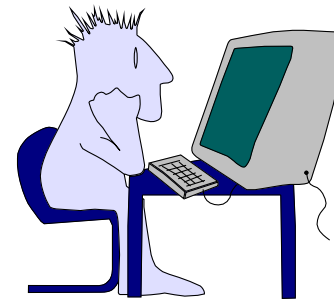
SURVEY OF CURRENT BUSINESS

International Data • D-53

Table F.2.—U.S. International Transactions
[Millions of dollars]

Line	(Credits +; debits -)*	1999	2000	Not seasonally adjusted				Seasonally adjusted			
				2000			2001	2000			2001
				II	III	IV	I*	II	III	IV	I*
Current account											
1	Exports of goods and services and income receipts	1,242,655	1,418,568	355,842	359,403	365,402	353,123	355,075	361,236	362,617	355,906
2	Exports of goods and services	957,353	1,065,702	266,347	270,858	273,621	265,831	265,822	272,497	270,131	269,297
3	Goods, balance of payments basis*	684,553	772,210	193,698	193,488	200,018	193,701	181,558	199,273	196,237	194,942
4	Services*	272,800	293,492	72,649	77,370	73,603	72,130	74,264	73,224	73,894	74,355
5	Transfers under U.S. military agency sales contracts*	15,920	14,060	3,910	3,329	3,420	3,388	3,910	3,329	3,420	3,388

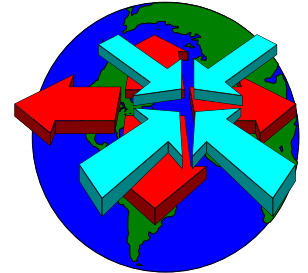
Online Application



- For a snapshot of the latest international trade conditions, visit the White House's Economic Statistics Briefing Room at www.whitehouse.gov/fsbr/international.html.

 <p>CHART: Balance on Current Account, '93-'01</p>	<p>Balance on Current Account</p> <p>In the second quarter of 2001, the U.S. current-account deficit on international transactions decreased to \$106.5 billion.</p>	<p>Previous -\$111.8 1st Quarter 2001 (billions of dollars)</p>	<p>Current -\$106.5 2nd Quarter 2001 (billions of dollars)</p>
<p>Provided by Bureau of Economic Analysis as of September 12, 2001.</p>			
 <p>CHART: Monthly trade balance</p>	<p>U.S. International Trade in Goods and Services</p> <p>The Nation's international deficit in goods and services decreased to \$28.8 billion in July, from \$29.1 billion (revised) in June, as imports decreased more than exports.</p>	<p>Previous -29,1 June 2001 \$ billion</p>	<p>Current -28,8 July 2001 \$ billion</p>
<p>Provided by U.S. Census Bureau as of September 19, 2001.</p>			

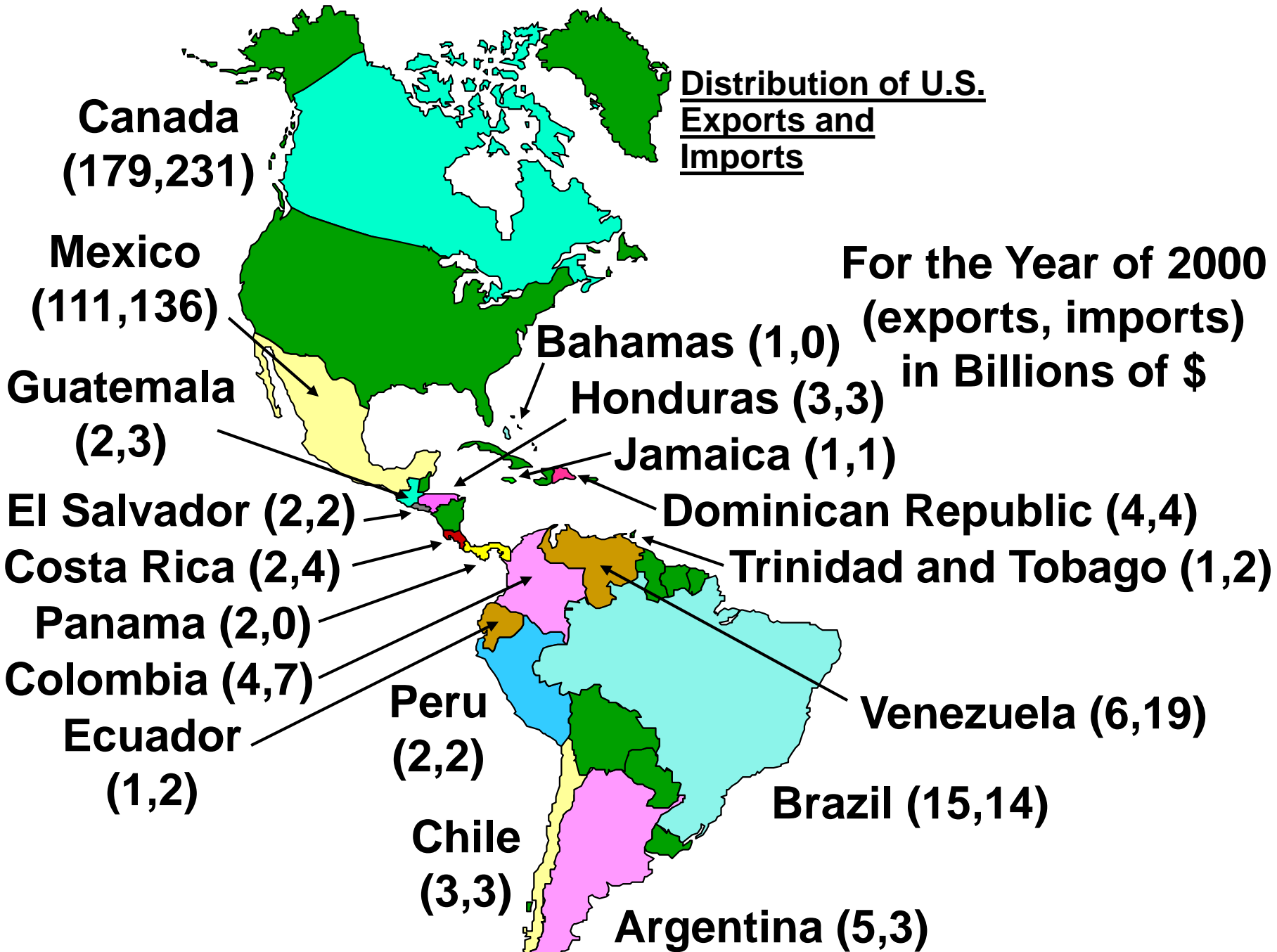
International Trade Flows



- **Different countries rely on trade to different extents.**
- **The trade volume of European countries is typically between 30 – 40% of their respective GDP, while the trade volume of U.S. and Japan is typically between 10 – 20% of their respective GDP.**
- **Nevertheless, the volume of trade has grown over time for most countries.**

Distribution of U.S.
Exports and
Imports

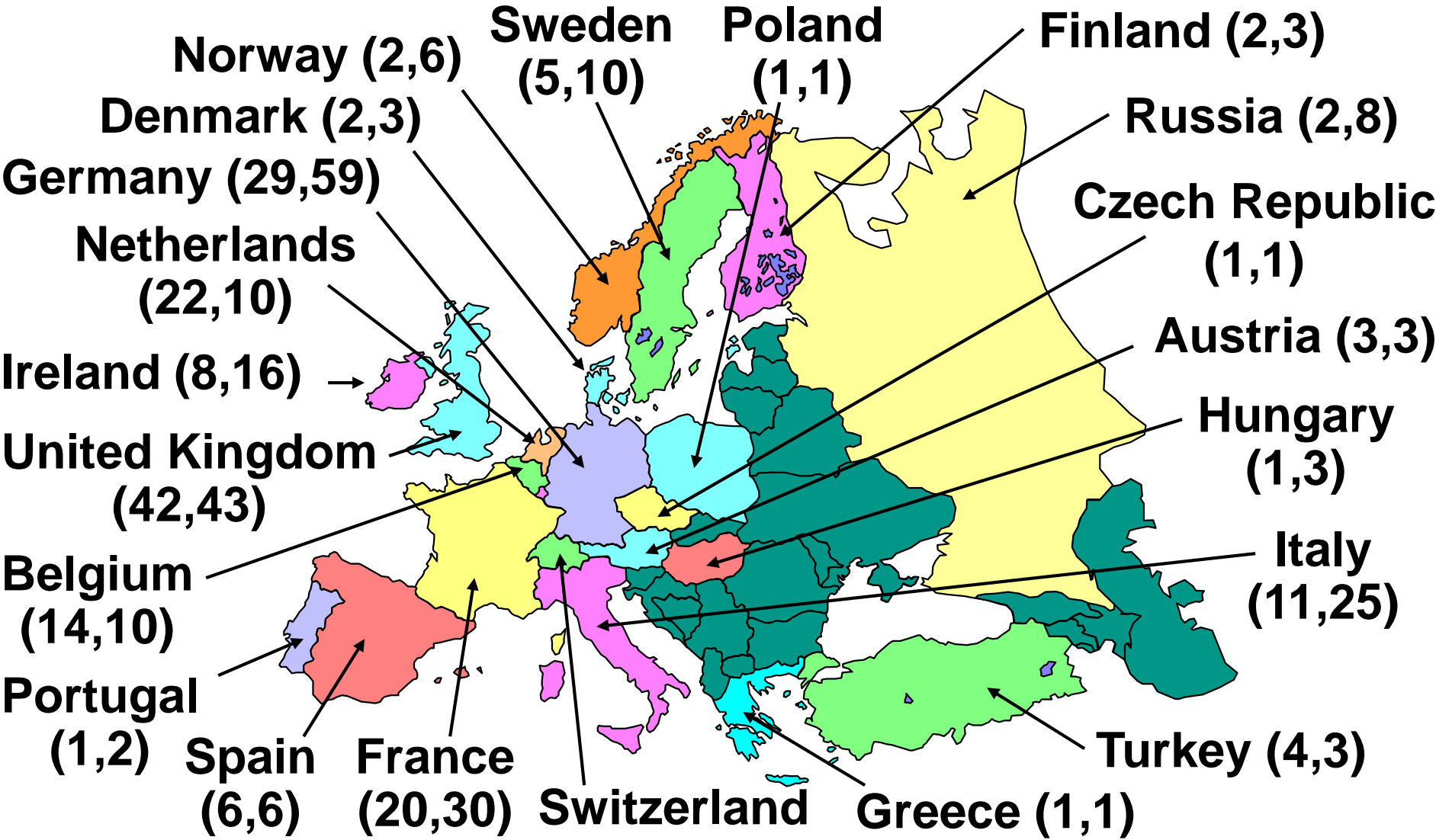
For the Year of 2000
(exports, imports)
in Billions of \$



Source: U.S. Census Bureau

Distribution of U.S. Exports and Imports

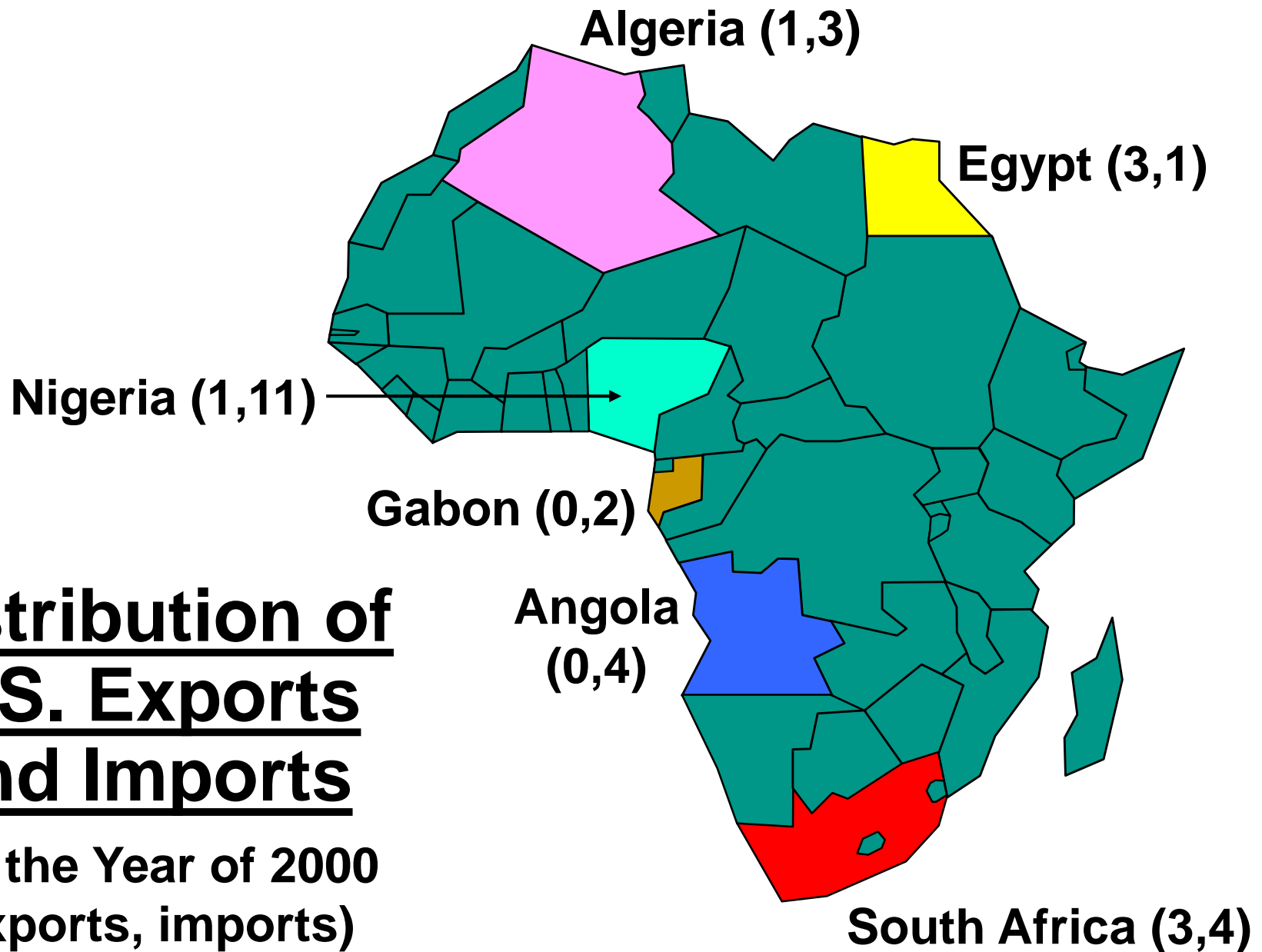
(exports, imports) in Billions of \$ for the Year of 2000

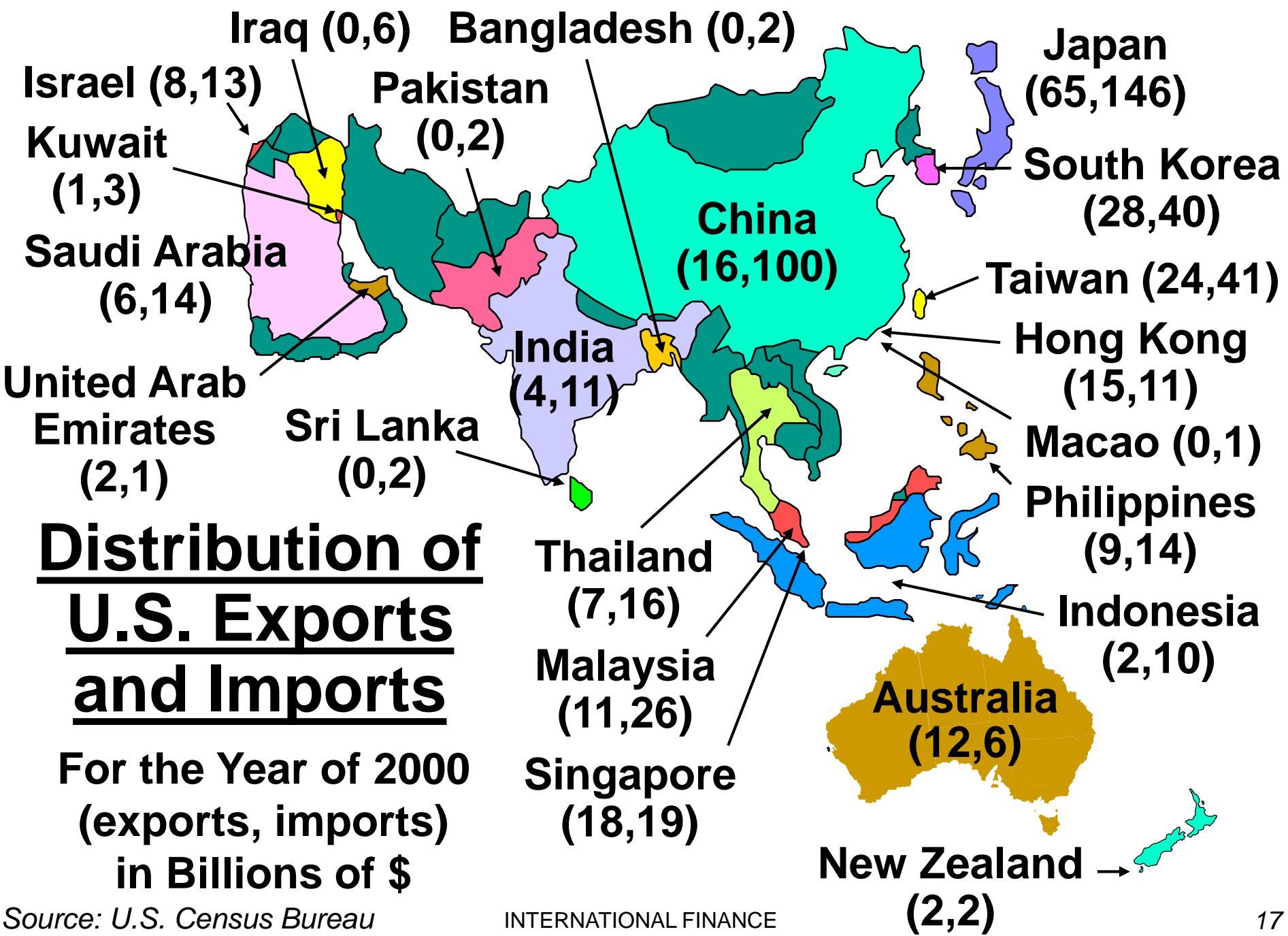


Source: U.S. Census Bureau

Distribution of U.S. Exports and Imports

For the Year of 2000
(exports, imports)
in Billions of \$





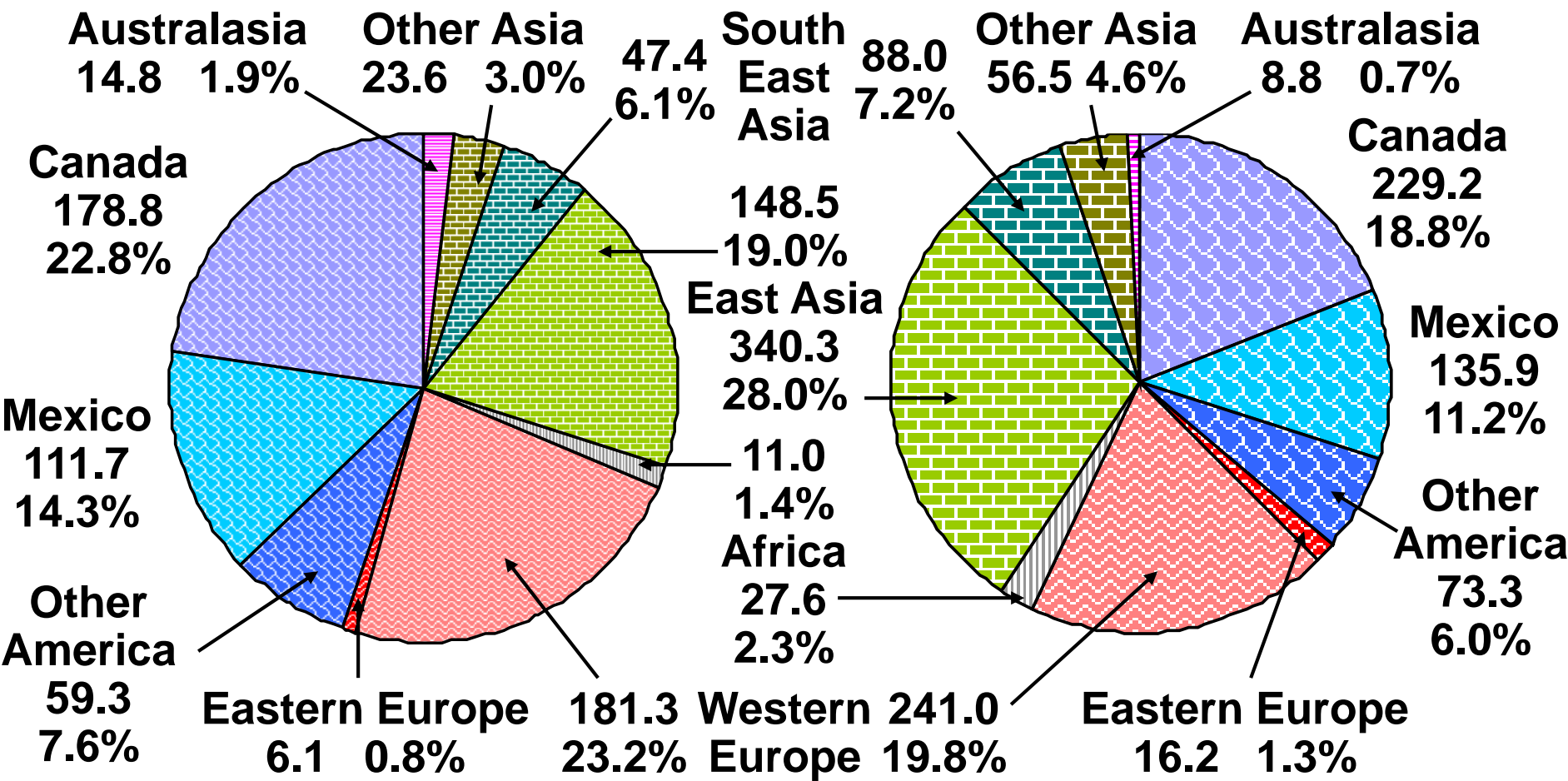
Source: U.S. Census Bureau

Distribution of U.S. Exports and Imports

For the Year of 2000 in Billions of \$

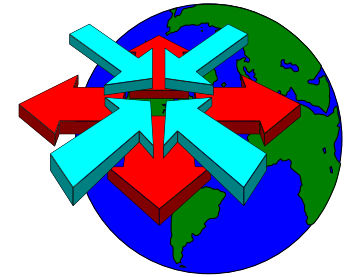
Exports

Imports



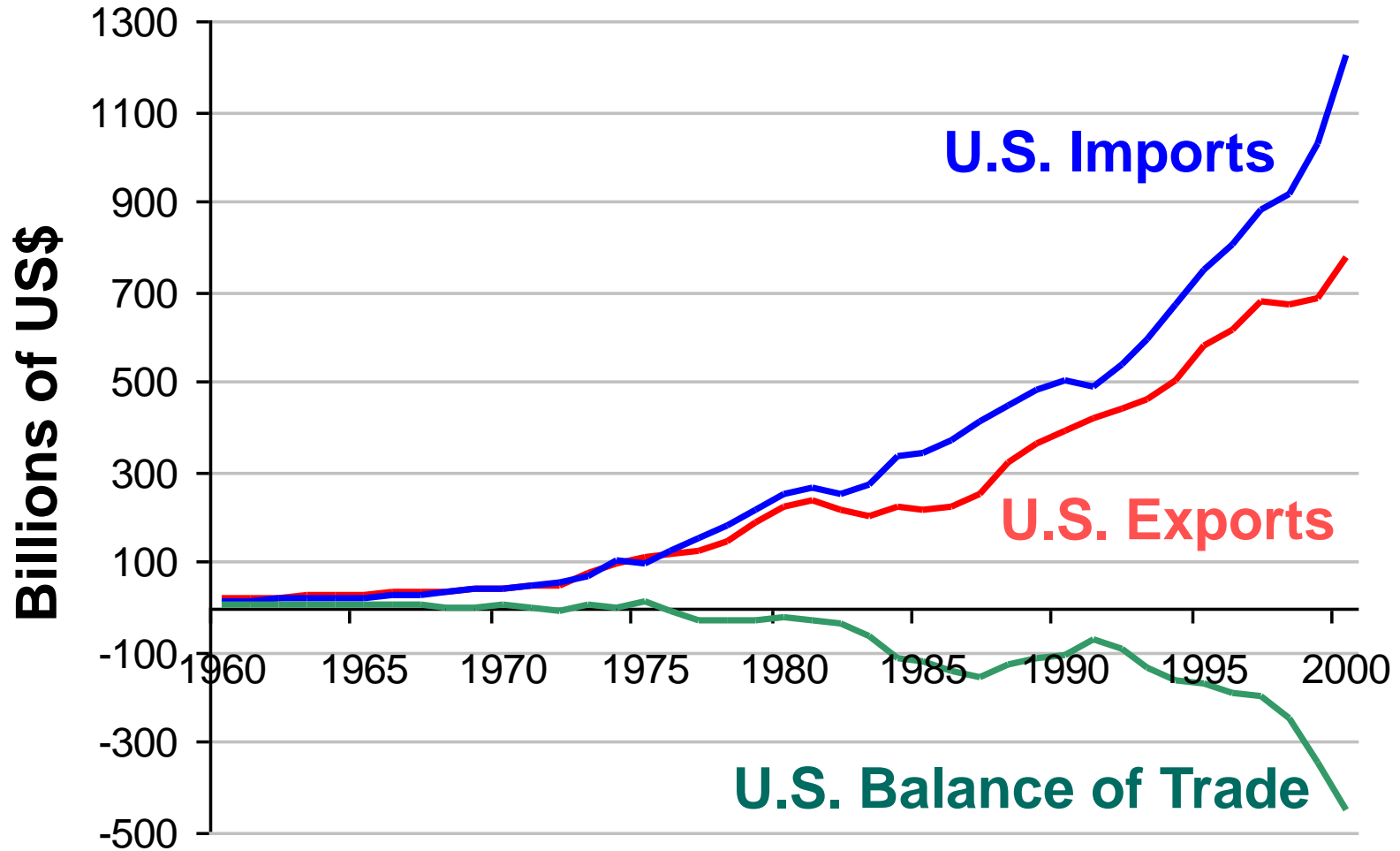
Source: U.S. Office of Trade and Economic Analysis FINANCE

International Trade Flows

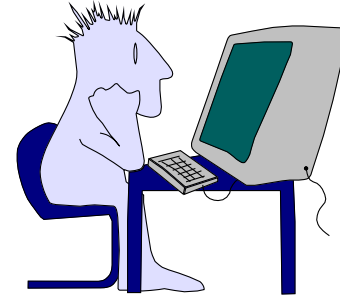


- **In 1975, the U.S. exported \$107.1 billions in goods, and imported \$98.2 billions. Since then, international trade has grown, with U.S. exports and imports of goods valued at \$773.3 and \$1,222.8 billions respectively for the year of 2000.**
- **Since 1976, the value of U.S. imports has exceeded the value of U.S. exports, causing a balance of trade deficit.**

U.S. Balance of Trade Trend

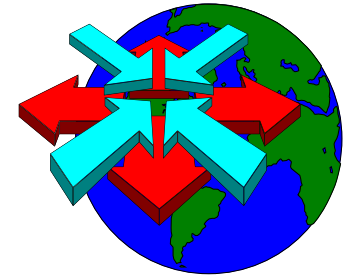


Online Application



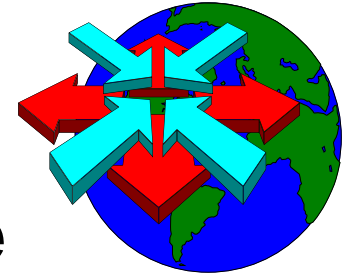
- **For more U.S. trade-related statistics, visit:**
 - α <http://www.census.gov/foreign-trade/www/>
 - α <http://www.ita.doc.gov/td/industry/otea/>
- **For worldwide trade statistics, visit:**
 - α http://www.wto.org/english/res_e/statis_e/statis_e.htm
 - α <http://www.worldbank.org/data/>

International Trade Flows



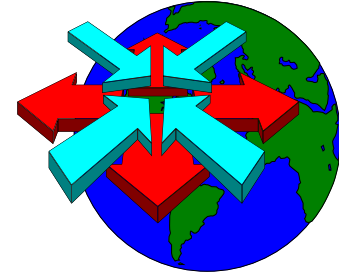
- **Recent Changes in North American Trade**
 - In 1998, a 1989 free trade pact between U.S. and Canada was fully phased in.
 - Passed in 1993, the North American Free Trade Agreement (NAFTA) removes numerous trade restrictions among Canada, Mexico, and the U.S.
 - In 2001, trade negotiations were initiated for a free trade area of the Americas. 34 countries are involved.

International Trade Flows



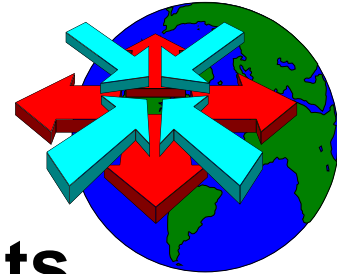
- **Recent Changes in European Trade**
 - The Single European Act of 1987 was implemented to remove explicit and implicit trade barriers among European countries.
 - Consumers in Eastern Europe now have more freedom to purchase imported goods.
 - The single currency system implemented in 1999 eliminated the need to convert currencies among participating countries.

International Trade Flows



- **Trade Agreements Around the World**
 - In 1993, a General Agreement on Tariffs and Trade (GATT) accord calling for lower tariffs was made among 117 countries.
 - Other trade agreements include:
 - Association of Southeast Asian Nations
 - European Community
 - Central American Common Market
 - North American Free Trade Agreement

International Trade Flows



- **Friction Surrounding Trade Agreements**

- Trade agreements are sometimes broken when one country is harmed by another country's actions.
- *Dumping* refers to the exporting of products by one country to other countries at prices below cost.
- Another situation that can break a trade agreement is *copyright piracy*.

Online Application



- **To learn more about the various trade agreements around the world, visit:**
 - http://www1.worldbank.org/wbiep/trade/RI_map.html
 - http://www.worldbank.org/data/wdi2001/pdfs/tab6_5.pdf
 - <http://www.sice.oas.org/tradee.asp>

Factors Affecting International Trade Flows

- **Inflation**

- ⌘ A relative increase in a country's inflation rate will decrease its current account, as imports increase and exports decrease.

- **National Income**

- ⌘ A relative increase in a country's income level will decrease its current account, as imports increase.

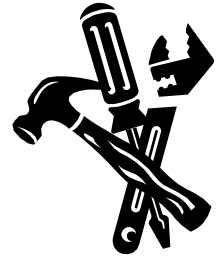
Factors Affecting International Trade Flows

- **Government Restrictions**
 - ⌘ A government may reduce its country's imports by imposing tariffs on imported goods, or by enforcing a quota. Note that other countries may retaliate by imposing their own trade restrictions.
 - ⌘ Sometimes though, trade restrictions may be imposed on certain products for health and safety reasons.

Factors Affecting International Trade Flows

- **Exchange Rates**
 - If a country's currency begins to rise in value, its current account balance will decrease as imports increase and exports decrease.
- **Note that the factors are interactive, such that their simultaneous influence on the balance of trade is a complex one.**

Correcting A Balance of Trade Deficit



- **By reconsidering the factors that affect the balance of trade, some common correction methods can be developed.**
- **For example, a floating exchange rate system may correct a trade imbalance automatically since the trade imbalance will affect the demand and supply of the currencies involved.**

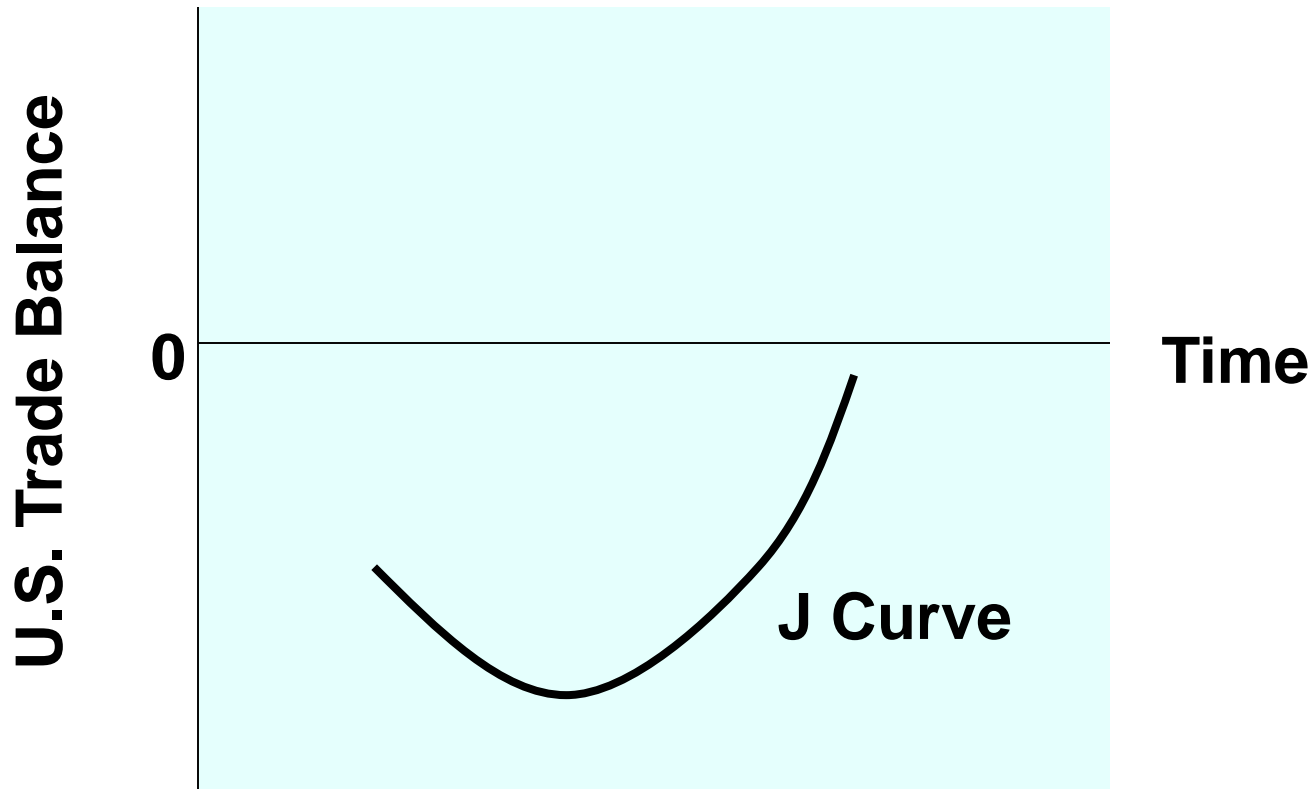
Correcting A Balance of Trade Deficit

- However, a weak home currency may not necessarily improve a trade deficit.

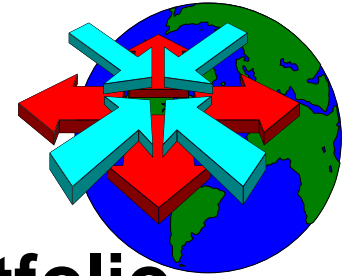


- Foreign companies may lower their prices to maintain their competitiveness.
- Some other currencies may weaken too.
- Many trade transactions are prearranged and cannot be adjusted immediately. This is known as the *J-curve effect*.
- The impact of exchange rate movements on *intra-company trade* is limited.

J-Curve Effect

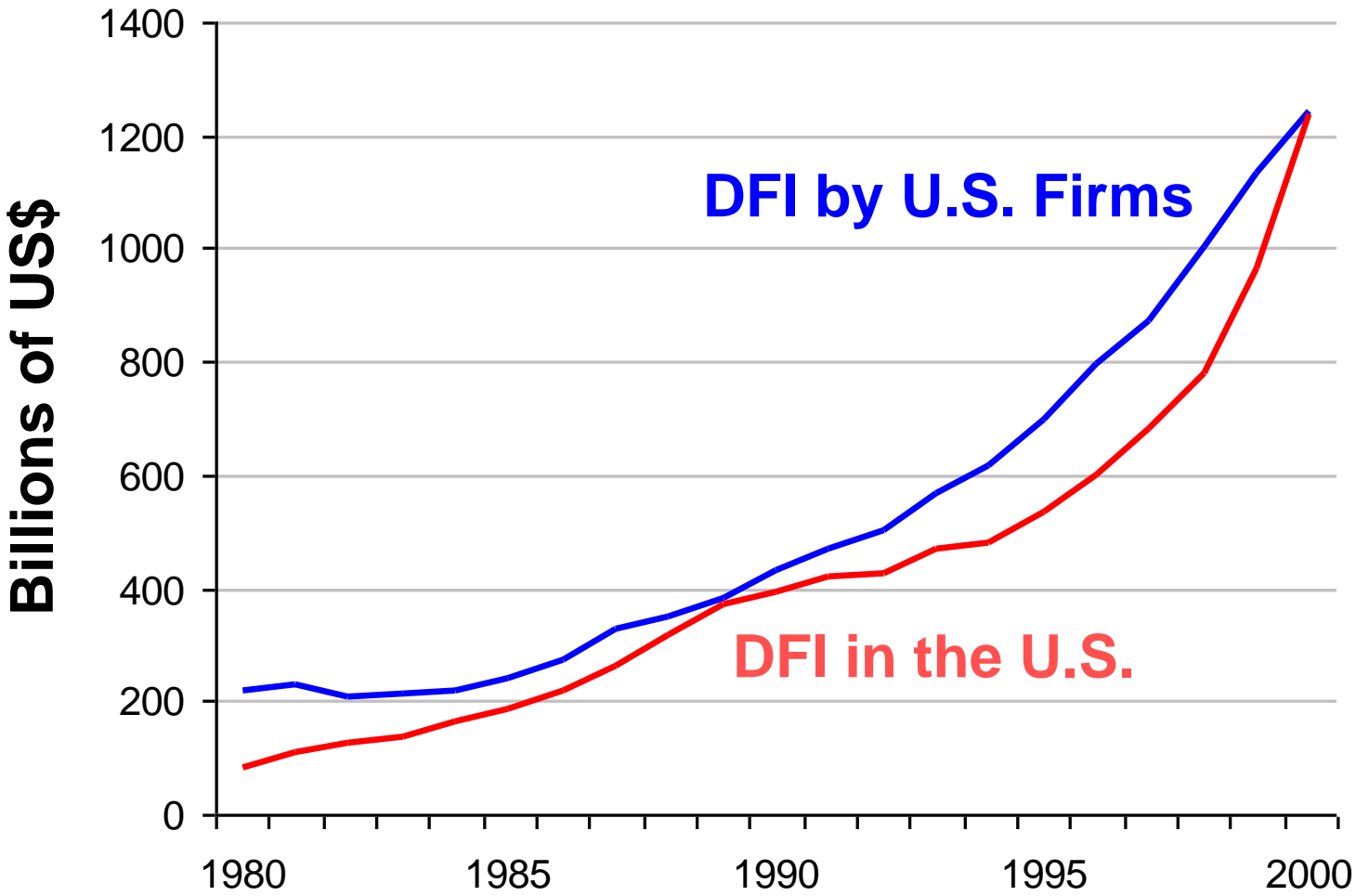


International Capital Flows



- **Capital flows usually represent portfolio investment or direct foreign investment.**
- **The DFI positions inside and outside the U.S. have risen substantially over time, indicating increasing globalization.**
- **In particular, both DFI positions increased during periods of strong economic growth.**

Direct Foreign Investment Positions of the United States on a Historical Cost basis



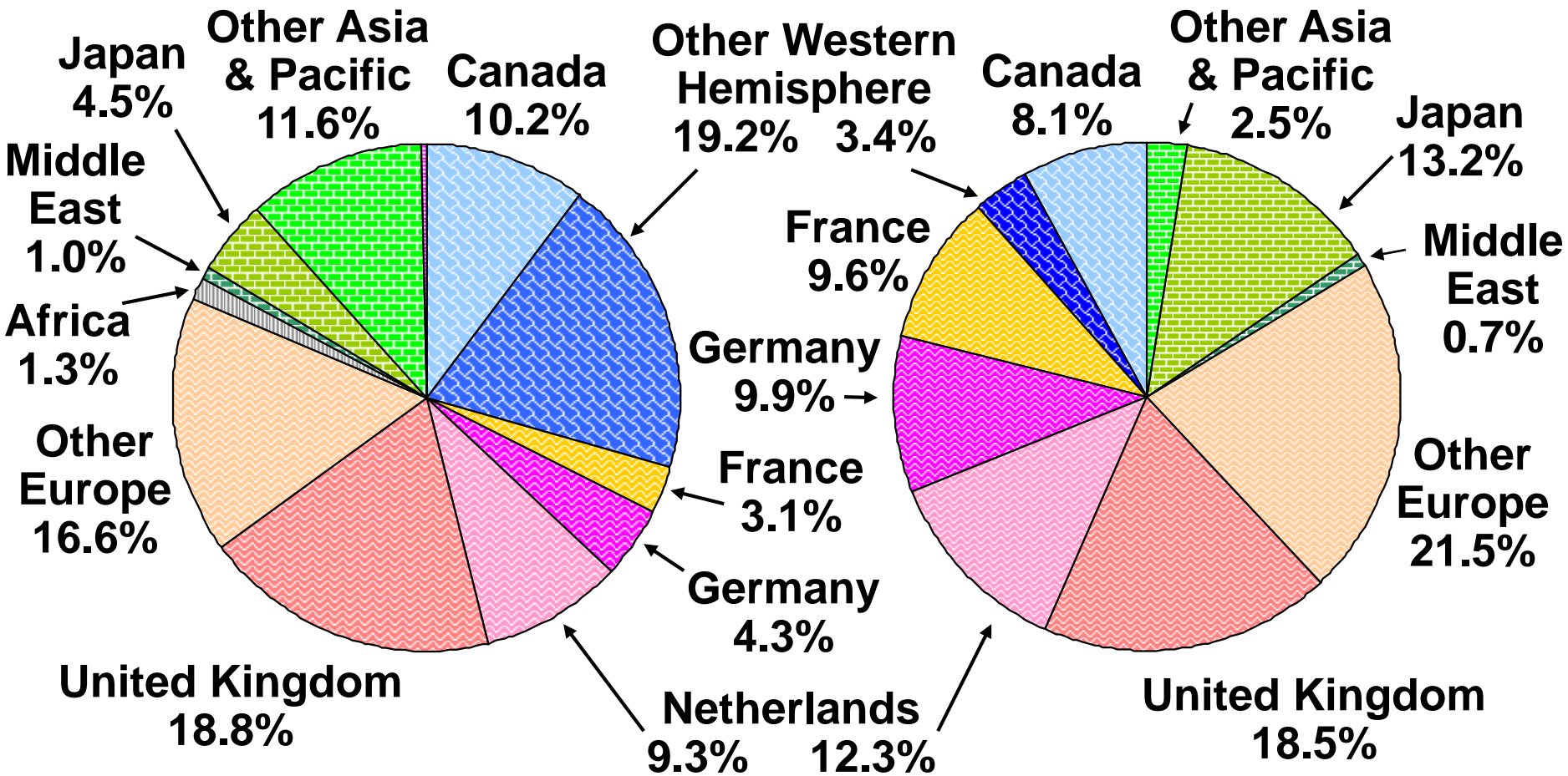
Source: U.S. Bureau of Economic Analysis INTERNATIONAL FINANCE

Distribution of DFI for the U.S.

For the Year of 2000

DFI by U.S. Firms

DFI in the U.S.



Factors Affecting DFI



- **Changes in Restrictions**
 - New opportunities may arise from the removal of government barriers.
- **Privatization**
 - DFI has also been stimulated by the selling of government operations.
- **Potential Economic Growth**
 - Countries with higher potential economic growth are more likely to attract DFI.

Factors Affecting DFI



- **Tax Rates**

- Countries that impose relatively low tax rates on corporate earnings are more likely to attract DFI.

- **Exchange Rates**

- Firms will typically prefer to invest their funds in a country when that country's currency is expected to strengthen.

Factors Affecting International Portfolio Investment



- **Tax Rates on Interest or Dividends**
 - Investors will normally prefer countries where the tax rates are relatively low.
- **Interest Rates**
 - Money tends to flow to countries with high interest rates.
- **Exchange Rates**
 - Foreign investors may be attracted if the local currency is expected to strengthen.

Online Application



- **Which countries should you invest in?**

- α Consult the *Country Commercial Guides* prepared by embassy staff at <http://www.usatrade.gov/website/ccg.nsf/ccghomepage?openform>

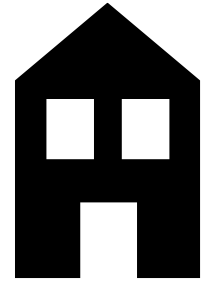


- α Visit the Trade Information Center at <http://www.trade.gov/td/tic/>



- α Visit the Yahoo! International Finance Center at <http://biz.yahoo.com/ifc/>

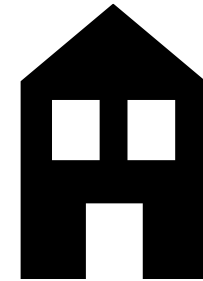
Agencies that Facilitate International Flows



International Monetary Fund (IMF)

- **The IMF is an organization of 183 member countries. Established in 1946, it aims**
 - ⌘ to promote international monetary cooperation and exchange stability;
 - ⌘ to foster economic growth and high levels of employment; and
 - ⌘ to provide temporary financial assistance to help ease imbalances of payments.

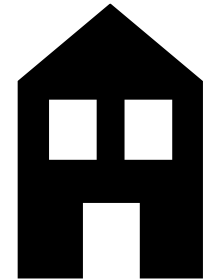
Agencies that Facilitate International Flows



International Monetary Fund (IMF)

- Its operations involve surveillance, and financial and technical assistance.
- In particular, its *compensatory financing facility* attempts to reduce the impact of export instability on country economies.
- The IMF uses a *quota* system, and its unit of account is the *SDR (special drawing right)*.

Agencies that Facilitate International Flows



International Monetary Fund (IMF)

- The weights assigned to the currencies in the SDR basket are as follows:

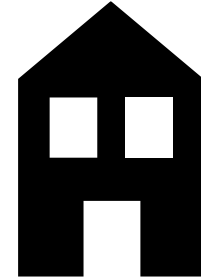
<u>Currency</u>	<u>2001 Revision</u>	<u>1996 Revision</u>
U.S. dollar	45	39
Euro	29	
Deutsche mark		21
French franc		11
Japanese yen	15	18
Pound sterling	11	11

Online Application



- You may learn more about the IMF at <http://www.imf.org>.

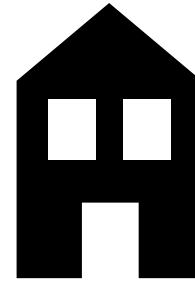
Agencies that Facilitate International Flows



World Bank Group

- **Established in 1944, the Group assists development with the primary focus of helping the poorest people and the poorest countries.**
- **It has 183 member countries, and is composed of five organizations - IBRD, IDA, IFC, MIGA and ICSID.**

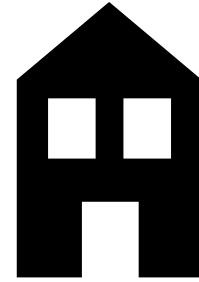
Agencies that Facilitate International Flows



IBRD: International Bank for Reconstruction and Development

- **Better known as the World Bank, the IBRD provides loans and development assistance to middle-income countries and creditworthy poorer countries.**
- **In particular, its *structural adjustment loans* are intended to enhance a country's long-term economic growth.**

Agencies that Facilitate International Flows



IBRD: International Bank for Reconstruction and Development

- The IBRD is not a profit-maximizing organization. Nevertheless, it has earned a net income every year since 1948.
- It may spread its funds by entering into *cofinancing agreements* with official aid agencies, export credit agencies, as well as commercial banks.

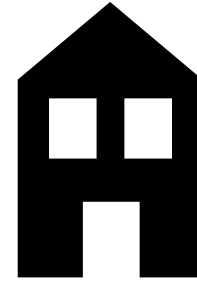
Agencies that Facilitate International Flows



IDA: International Development Association

- **IDA was set up in 1960 as an agency that lends to the very poor developing nations on highly concessional terms.**
- **IDA lends only to those countries that lack the financial ability to borrow from IBRD.**
- **IBRD and IDA are run on the same lines, sharing the same staff, headquarters and project evaluation standards.**

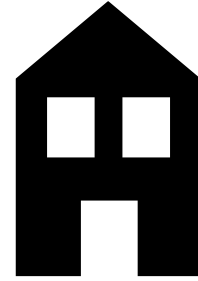
Agencies that Facilitate International Flows



IFC: International Finance Corporation

- **The IFC was set up in 1956 to promote sustainable private sector investment in developing countries, by**
 - financing private sector projects;
 - helping to mobilize financing in the international financial markets; and
 - providing advice and technical assistance to businesses and governments.

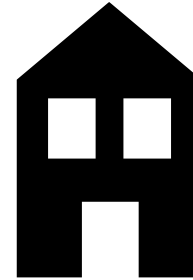
Agencies that Facilitate International Flows



MIGA: Multilateral Investment Guarantee Agency

- **The MIGA was created in 1988 to promote FDI in emerging economies, by**
 - offering political risk insurance to investors and lenders; and
 - helping developing countries attract and retain private investment.

Agencies that Facilitate International Flows



ICSID: International Centre for Settlement of Investment Disputes

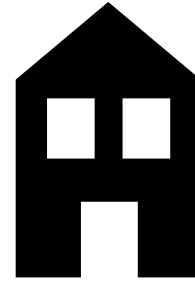
- **The ICSID was created in 1966 to facilitate the settlement of investment disputes between governments and foreign investors, thereby helping to promote increased flows of international investment.**

Online Application



- **To learn more about the World Bank Group and its organizations, visit:**
 - α <http://www.worldbank.org>
 - α <http://www.worldbank.org/ibrd>
 - α <http://www.worldbank.org/ida>
 - α <http://www.ifc.org>
 - α <http://www.miga.org>
 - α <http://www.worldbank.org/icsid>

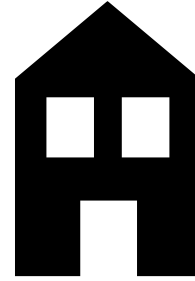
Agencies that Facilitate International Flows



World Trade Organization (WTO)

- Created in 1995, the WTO is the successor to the General Agreement on Tariffs and Trade (GATT).
- It deals with the global rules of trade between nations to ensure that trade flows smoothly, predictably and freely.
- At the heart of the WTO's *multilateral trading system* are its trade agreements.

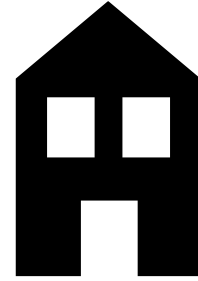
Agencies that Facilitate International Flows



World Trade Organization (WTO)

- **Its functions include:**
 - ⌘ administering WTO trade agreements;
 - ⌘ serving as a forum for trade negotiations;
 - ⌘ handling trade disputes;
 - ⌘ monitoring national trading policies;
 - ⌘ providing technical assistance and training for developing countries; and
 - ⌘ cooperating with other international groups.

Agencies that Facilitate International Flows



Bank for International Settlements (BIS)

- **Set up in 1930, the BIS is an international organization that fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability.**
- **It is the “central banks’ central bank” and “lender of last resort.”**

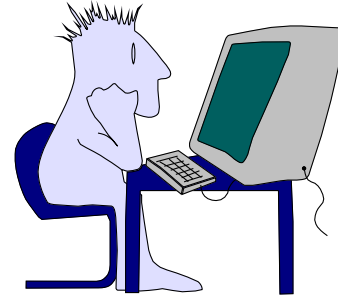
Agencies that Facilitate International Flows



Bank for International Settlements (BIS)

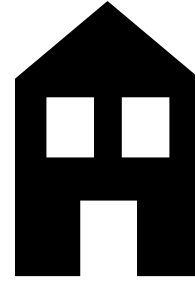
- **The BIS functions as:**
 - a forum for international monetary and financial cooperation;
 - a bank for central banks;
 - a center for monetary and economic research; and
 - an agent or trustee in connection with international financial operations.

Online Application



- To learn more about the WTO and the BIS, visit:
 - α <http://www.wto.org>
 - α <http://www.bis.org>

Agencies that Facilitate International Flows



Regional Development Agencies

- **Agencies with more regional objectives relating to economic development include**
 - ⌘ the Inter-American Development Bank;
 - ⌘ the Asian Development Bank;
 - ⌘ the African Development Bank; and
 - ⌘ the European Bank for Reconstruction and Development.

Online Application



- **Check out the following regional agencies:**
 - Inter-American Development Bank:
<http://www.iadb.org>
 - Asian Development Bank:
<http://www.adb.org>
 - African Development Bank:
<http://www.afdb.org>
 - European Bank for Reconstruction and Development: <http://www.ebrd.com>

Impact of International Trade on an MNC's Value

National Income in Foreign Countries

Inflation in Foreign Countries

Trade Agreements

Exchange Rate Movements

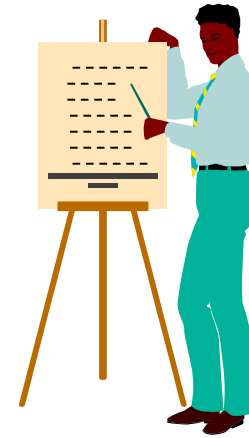
$$\text{Value} = \sum_{t=1}^n \left\{ \frac{\sum_{j=1}^m [E(CF_{j,t}) \times E(ER_{j,t})]}{(1+k)^t} \right\}$$

$E(CF_{j,t})$ = expected cash flows in currency j to be received by the U.S. parent at the end of period t

$E(ER_{j,t})$ = expected exchange rate at which currency j can be converted to dollars at the end of period t

k = weighted average cost of capital of the parent

Chapter Review



- **Balance of Payments**
 - Current, Capital, and Financial Accounts
- **International Trade Flows**
 - Distribution of U.S. Exports and Imports
 - U.S. Balance of Trade Trend
 - Recent Changes in North American and European Trade
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- **Factors Affecting International Trade Flows**
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- **How International Trade Affects an MNC's Value**