International Flow of Funds

2

Chapter Two

Chapter Objectives:

To explain the key components of the balance of payments;

To explain how the international trade flows are influenced by economic factors and other factors;

To explain how the international capital flows are influenced by country characteristics.

Balance of Payments

- The balance of payments is a summary of transactions between domestic and foreign residents for a specific country over a specified period of time.

- Inflows of funds generate credits for the country's balance, while outflows of funds generate debits.

Current Account

- The current account summarizes the flow of funds between one specified country and all other countries due to purchases of goods or services, or the provision of income on financial assets.
- Key components of the current account include the balance of trade, factor income, and transfer payments.

The U.S. Current Account in 2003
(in billions of $)

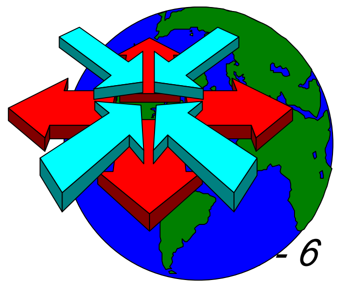
	(1)	U.S. exports of goods	+	$712
+	(2)	U.S. exports of services	+	292
+	(3)	U.S. income receipts	+	275
=	(4)	Total U.S. exports & income receipts	=	$1,279
	(5)	U.S. imports of goods	–	$1,263
+	(6)	U.S. imports of services	–	246
+	(7)	U.S. income payments	–	259
=	(8)	Total U.S. imports & income payments	=	$1,768
	(9)	Net transfers by the U.S.	–	$68
	(10)	Current account balance = (4) – (8) – (9)	–	$557

Capital Account

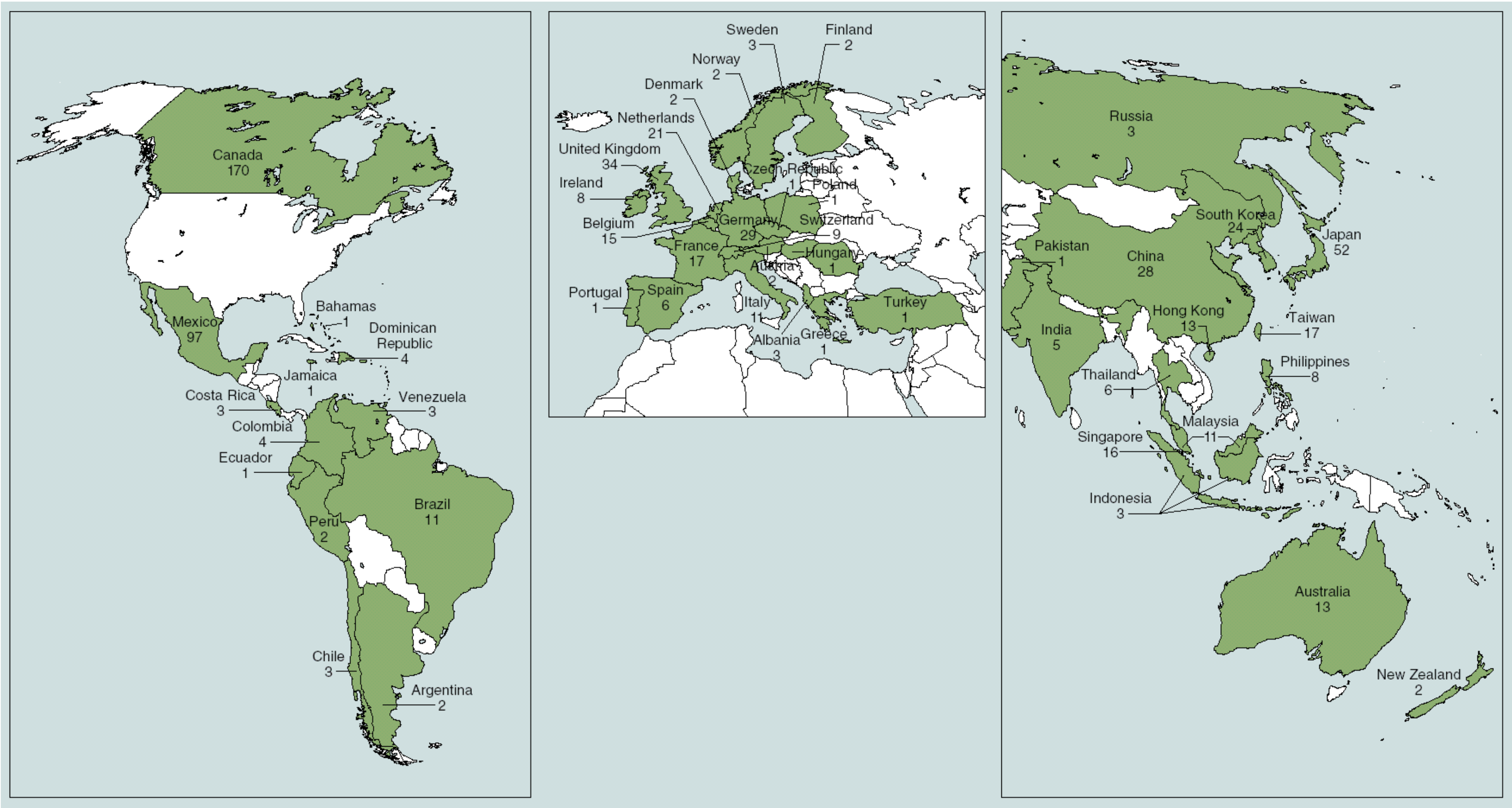
- The capital account summarizes the flow of funds resulting from the sale of assets between one specified country and all other countries.
- The key components of the capital account are direct foreign investment, portfolio investment, and other capital investment.

International Trade Flows

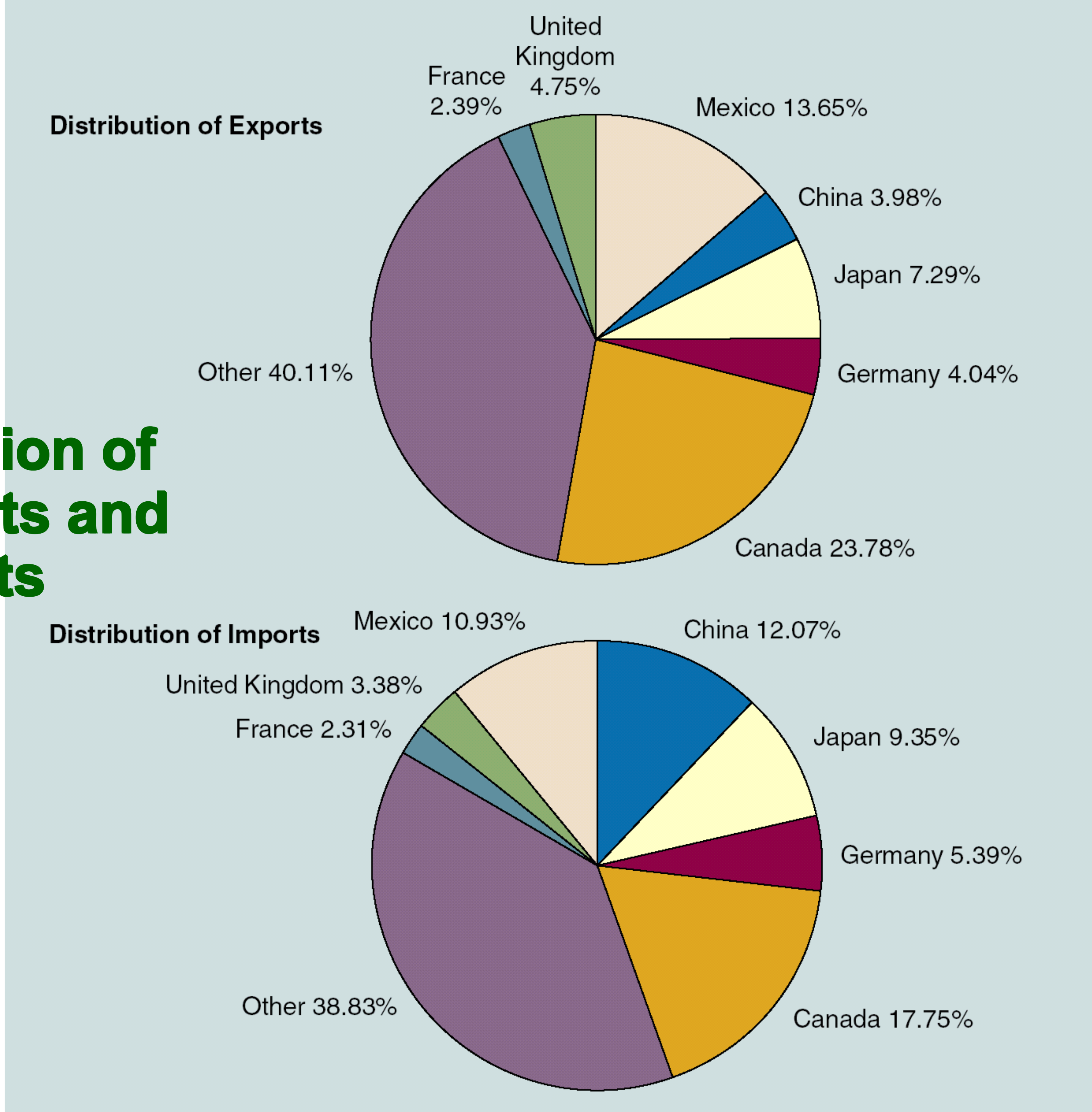
- **Some countries are more dependent on trade than others.**
  - ¤ The trade volume of a European country is typically between 30 – 40% of its GDP, while the trade volume of U.S. (and Japan) is typically between 10 – 20% of its GDP.
- **Nevertheless, the volume of trade has grown over time for most countries.**



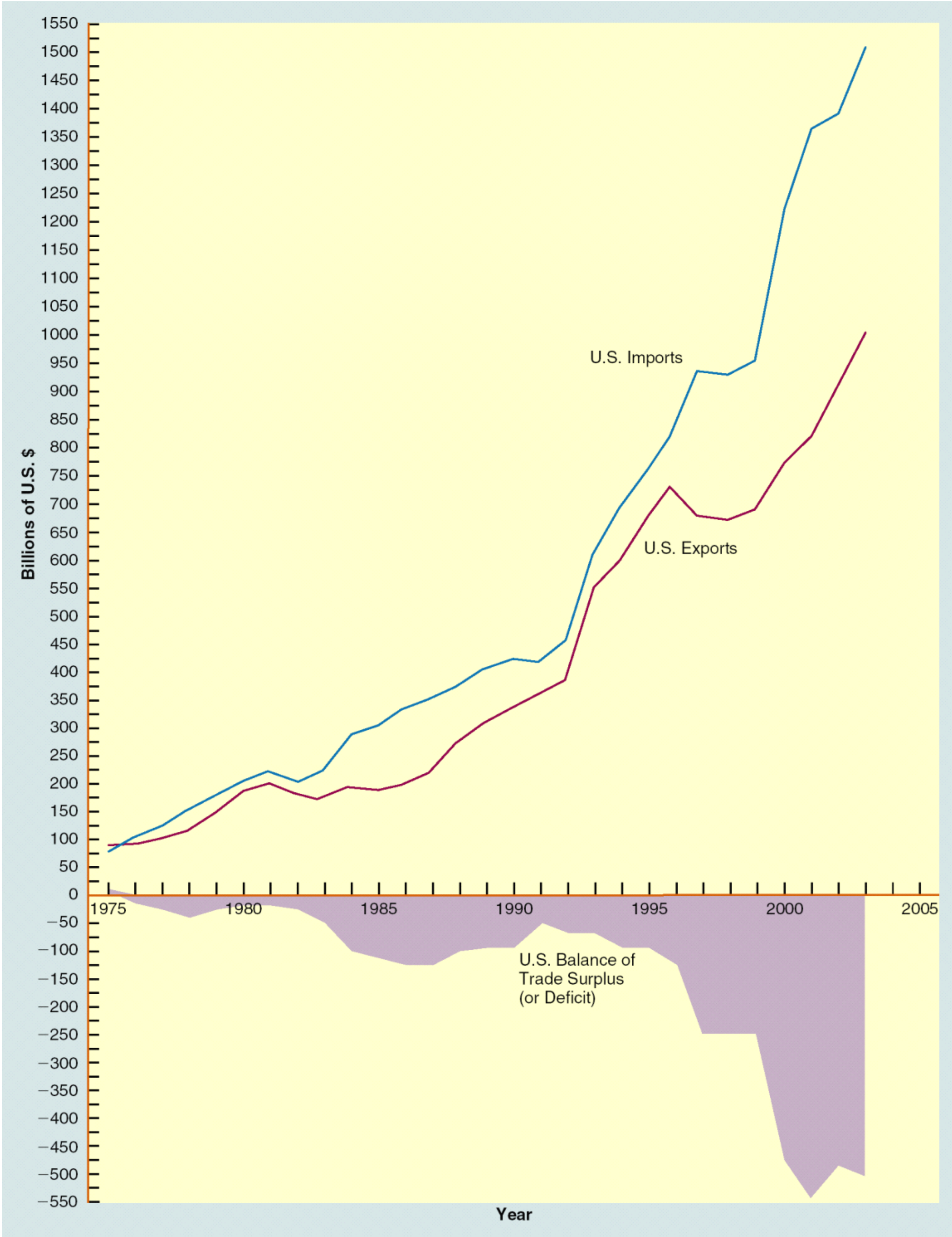
Distribution of U.S. Exports across Countries
(in billions of $)



Distribution of U.S. Exports and Imports



U.S. Balance of Trade Over Time



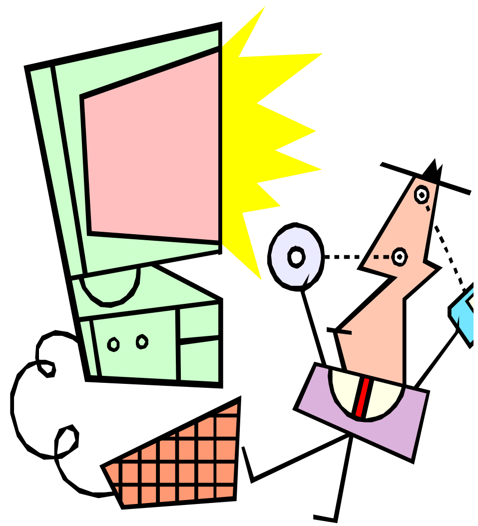
Trade Agreements

- **Many agreements have been made to reduce trade restrictions:**
  - ¤ 1988 U.S. and Canada free trade pact
  - ¤ North American Free Trade Agreement (NAFTA)
  - ¤ General Agreement on Tariffs and Trade (GATT)
  - ¤ Single European Act and the European Union

Trade Disagreements

- **However, even without tariffs and quotas, governments seem always able to find strategies that can give their local firms an edge in exporting:**
  - ¤ different environmental, labor laws
  - ¤ bribes, government subsidies (dumping)
  - ¤ tax breaks for specific industries
  - ¤ exchange rate manipulations

- **Other trade-related issues include:**
  - ¤ the outsourcing of services
  - ¤ the use of trade policies for political reasons
  - ¤ disagreements within the European Union



Factor Affecting International Trade Flows

- **Impact of Inflation**
  - ¤ A relative increase in a country's inflation rate will decrease its current account, as imports increase and exports decrease.
- **Impact of National Income**
  - ¤ A relative increase in a country's income level will decrease its current account, as imports increase.

Factor Affecting International Trade Flows

- **Impact of Government Restrictions**
  - ¤ A government may reduce its country's imports by imposing a tariff on imported goods, or by enforcing a quota.
  - ¤ Some trade restrictions may be imposed on certain products for health and safety reasons.

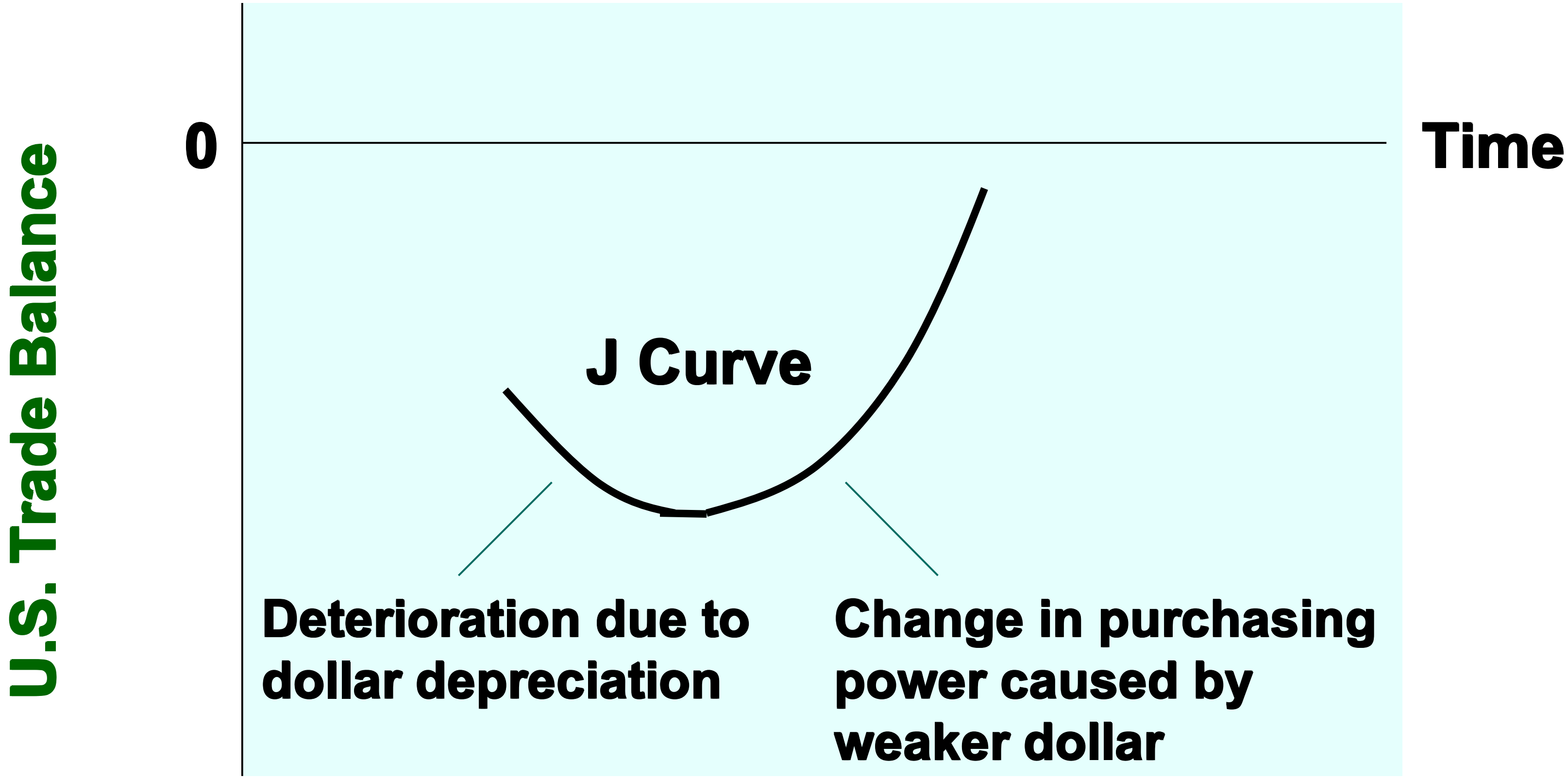
Factor Affecting International Trade Flows

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

Why a Weak Home Currency Is Not a Perfect Solution

- **Counterpricing by competitors**
- **Impact of other weak currencies**
- **Stability of intracompany trade**
  - ¤ Many firms purchase products that are produced by their subsidiaries.
- **Prearranged international transactions**
  - ¤ The lag time between a weaker U.S.$ and increased foreign demand has been estimated to be 18 months or longer.

The J-Curve Effect



Agencies that Facilitate International Flows

- **International Monetary Fund (IMF)**
  - ¤ The IMF encourages internationalization of businesses through surveillance, and financial and technical assistance.
  - ¤ Its compensatory financing facility attempts to reduce the impact of export instability on country economies.
  - ¤ The IMF adopts a quota system, and its financing is measured in special drawing rights (SDRs).

Agencies that Facilitate International Flows

- **World Bank**
  - ¤ This International Bank for Reconstruction and Development makes loans to countries to enhance their economic development.
  - ¤ In particular, its Structural Adjustment Loans (SALs) are intended to enhance a country’s long-term economic growth.
  - ¤ Funds are spread through cofinancing agreements with official aid agencies, export credit agencies, and commercial banks.

Agencies that Facilitate International Flows

- **Multilateral Investment Guarantee Agency**
  - ¤ Established by the World Bank, the MIGA helps develop international trade and investment by offering various forms of political risk insurance.
- **International Development Association**
  - ¤ The IDA extends loans at low interest rates to poor nations that cannot qualify for loans from the World Bank.

Agencies that Facilitate International Flows

- **World Trade Organization**
  - The WTO was established to provide a forum for multilateral trade negotiations and to settle trade disputes related to the GATT accord.
- **International Financial Corporation**
  - The IFC promotes private enterprise within countries through loan provisions and stock purchases.

Agencies that Facilitate International Flows

- **Bank for International Settlements**
  - ¤ The BIS is the "central banks' central bank" and "lender of last resort."
- **Regional development agencies**
  - ¤ Inter-American Development Bank
  - ¤ Asian Development Bank
  - ¤ African Development Bank
  - ¤ European Bank for Reconstruction and Development.