

# STUDY UNIT SEVEN

## INTERNATIONAL TRADE

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This study unit is the last of three related to the economic environment of a business and its industry. The primary emphasis of this study unit is on how international trade affects the economy and individual firms.

### 7.1 ADVANTAGES OF INTERNATIONAL TRADE

1. The laws of supply and demand affect imports and exports in the same way that they affect domestic goods. For example, a cutback in petroleum production in a single Middle Eastern country can raise the world price of oil.
  - a. The term **net exports** refers to the amount of a country's exports minus its imports. Conversely, a nation can have **net imports** if its imports exceed its exports.
2. **Terms of trade (the exchange ratio)** is the ratio of a country's export price index to its import price index, multiplied by 100.
  - a. **EXAMPLE:** A simple illustration uses two countries and two products.
    - 1) Kenya's entire exports for the year consist of \$800,000 worth of coffee to Spain, and Spain's entire exports consist of \$1,000,000 worth of concrete to Kenya.
    - 2) Kenya's terms of trade are thus 80 [ $(\$800,000 \div \$1,000,000) \times 100$ ]. Spain's terms of trade are 125 [ $(\$1,000,000 \div \$800,000) \times 100$ ].
  - b. When the ratio falls, a country is said to have deteriorating terms of trade. When the ratio is less than 100, the country is an overall loser in terms of world trade.
3. **Countries vary greatly in their efficiency** in producing certain goods because of the immobility of resources. This variation can be largely attributed to differences from country to country in the following five factors:
  - a. Climatic and geographical conditions
  - b. Human capacities
  - c. Supply and type of capital accumulation
  - d. Proportions of resources
  - e. Political and social climates
4. Given these differences, it is clear that countries can **mutually benefit from trade**.
  - a. The greatest advantage from trade is obtained **when each nation specializes** in producing what it can produce most efficiently or, more precisely, least inefficiently.
    - 1) If nations specialize and then exchange with others, **more is produced and consumed** than if each nation tries to be self-sufficient.
  - b. We know that specialization of labor is beneficial for individuals; the same principle applies to nations.

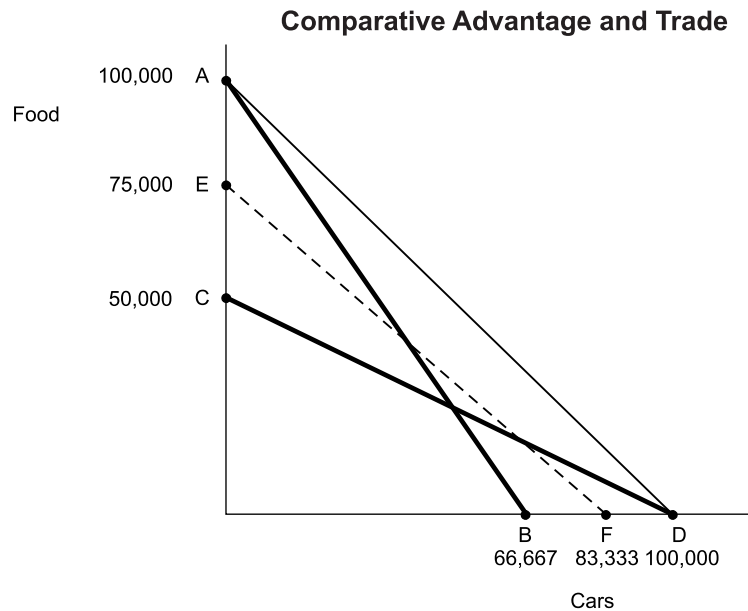
5. The explanatory mechanism for this phenomenon is **comparative advantage**, a term coined by the English economist David Ricardo (1772-1823). This principle is based on **relative opportunity costs**.

- a. EXAMPLE: The following table displays the comparative costs of production for two countries and products. Assume the two countries produce and consume only these two products and that labor is the only input.

	U.S.	Japan
Food (1 bushel)	1 hour	2 hours
Cars (1 car)	1.5 hours	1 hour

- 1) If the two countries specialize, **both will be better off**. There will be an increase in total output if the U.S. uses its resources to grow food and Japan uses its resources to produce cars (given a fixed amount of inputs).
  - a) Total output will be maximized when each nation specializes in the products in which it has the **lower opportunity cost**, that is, a comparative advantage.
- 2) The U.S. has an opportunity cost for 1 bushel of food of  $2/3$  of a car ( $1 \div 1.5$ ). The Japanese opportunity cost for 1 bushel of food is 2 cars ( $2 \div 1$ ).
- 3) At the same time, the U.S. opportunity cost for 1 car is 1.5 bushels of food ( $1.5 \div 1$ ). The Japanese opportunity cost for 1 car is .5 of a bushel of food ( $1 \div 2$ ).
- 4) Accordingly, the U.S. has the lower opportunity cost for food production ( $2/3$  car to 2 cars) and the Japanese have the lower opportunity cost for car production (.5 bushels to 1.5 bushels).
  - a) For 100,000 units of labor input, the U.S. economy can produce either 100,000 bushels of food or 66,667 cars. If the labor input is divided equally, however, the U.S. economy can produce 50,000 bushels of food and 33,333 cars.
  - b) At the same time, if the Japanese economy divides its efforts equally, input of 100,000 units of labor can produce 25,000 bushels of food and 50,000 cars.
  - c) In the absence of world trade, therefore, the two economies together can produce 75,000 bushels of food ( $50,000 + 25,000$ ) and 83,333 cars ( $33,333 + 50,000$ ).
- 5) But if each country concentrates on the product in which it has a comparative advantage, the total production will be 100,000 bushels of food (all produced in the U.S.) and 100,000 cars (all produced in Japan).

- b. This phenomenon can be represented graphically by plotting the production possibilities curves for the two countries:



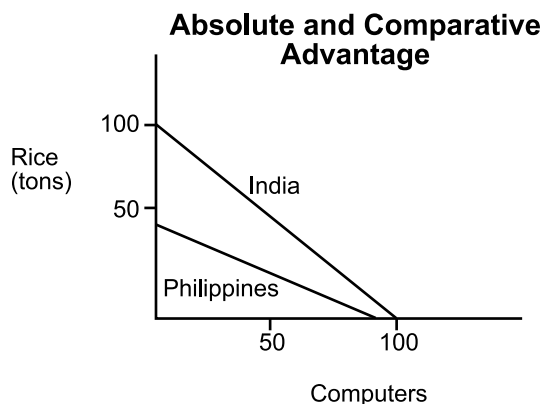
- 1) The individual production possibilities frontier for the U.S. is line AB and that for Japan is line CD. If both countries devote half of their resources to each product and there is no international trade, total production will be along line EF.
  - 2) However, if the two countries specialize and engage in trade, the new production possibilities curve is line AD, which is superior to any of the other curves.
- c. In this example, the U.S. has an **absolute** advantage with respect to food production (because the price of food is lower in the U.S.), and Japan has an absolute advantage in car production.
- 1) Along with its absolute advantage, the U.S. has a **comparative** advantage in food production [because its opportunity cost for food production (cars forgone) is lower than Japan's]. Similarly, Japan has a comparative advantage in car production because Japan's opportunity cost for car production (food forgone) is lower.
  - 2) Thus, each country has both an absolute and a comparative advantage in a particular product.
  - 3) **Comparative advantage** is initially a comparison of costs in one country. It determines what that country produces most efficiently. The result of this analysis is a determination of opportunity costs. Thus, no matter what the costs may be elsewhere, the U.S. will always have a comparative advantage in the production of food rather than cars. Similarly, Japan has a comparative advantage in the production of cars as opposed to food.
  - 4) **Absolute advantage** compares the costs of inputs between countries. Thus, a given country might have an absolute advantage with respect to every product compared with a specific other country.
  - 5) In the previous example, Japan would continue to have a comparative advantage with respect to cars even if its costs were 1.6. In that case, the U.S. would have an absolute advantage (1.5 is less than 1.6). Nevertheless, trade is still beneficial because the opportunity costs of car production are 1.5 bushels of food in the U.S. but only 0.8 bushels of food in Japan. Only if both countries have identical opportunity costs would trade not be beneficial.

6. The principle of comparative advantage is so powerful, it even applies when one country has an **absolute advantage in both products**.

- a. EXAMPLE: Assume India and the Philippines can produce the following products with one year of labor and that labor is the only input to these outputs:

	India	Philippines
Rice (tons)	100	40
Computers	100	90

- b. In this example, India has an absolute advantage in the production of **both** products, i.e., it is able to produce more of each output with the same amount of input. However, the Philippines still has a comparative advantage over India in one of the products.
- 1) India is 2.5 times as efficient as the Philippines at producing rice ( $100 \div 40$ ), but only 1.1 times as efficient at producing computers ( $100 \div 90$ ).
  - 2) If the Philippines devoted a year of labor to rice, world output of rice would only increase by 40 tons. But if the country devoted that same year of labor to computers, world computer output would increase by 90.
- c. The production possibilities frontiers for these two countries and these two products for a single year of labor can be depicted as follows (if these curves were for total national output, they would be much farther apart because the greater population of India means more labor hours are available in that country):



- 1) The slope of India's curve is 1 ( $100 \div 100$ ), meaning that India gains one computer by trading off one ton of rice. However, the slope of the Philippines' curve is only .44 ( $40 \div 90$ ), meaning that the Philippines only has to trade off .44 tons of rice to gain one computer.
  - 2) Thus, the Philippines' comparative advantage stems from the fact that its **opportunity cost is lower** than that of India for computers with respect to rice.
- d. If the two countries specialize and engage in trade, the world has more of both food and computers. Thus, specialization and trade **enhance world output without changing total inputs**.
- 1) Moreover, the greater abundance of affordable goods means that workers in **both countries** experience higher real wages.

7. A nation will **export** goods in which it has a **comparative advantage** and **import** goods in which it has a **comparative disadvantage**.
- a. Developing countries exporting primarily raw materials are dependent on vibrant economies in developed (importing) countries.
  - b. Even when one country is technologically superior in all industries, one of the industries will go out of business when free trade takes place.
    - 1) Therefore, **technological superiority is no guarantee** of continuing operation in a case of free trade. A country must have a comparative advantage in the production of a good, not necessarily an absolute advantage, to guarantee continuing production when free trade exists.
    - 2) Thus, the superior technology in developed countries is no indication that developing countries cannot compete in international trade.
  - c. A high-wage country with a comparative advantage for a product will see that product survive even though the laborers in the developing country have lower wages.
    - 1) Thus, a **knowledge of wage rates is not sufficient information** to determine which country's industry would decline under free trade. In other words, a domestic industry may not decline simply because foreign firms pay their workers lower wages.
  - d. If a country has only two factors of production (labor and capital) and a relative abundance of capital, it will tend to export capital-intensive goods and import labor-intensive goods. Thus, factors of production and the varying efficiency in producing goods determine which products a country will export and import.
    - 1) Capital-intensive goods are those requiring a high level of investment, e.g., oil refining.
    - 2) Labor-intensive goods are those requiring a high level of labor, e.g., manufacture of fashion clothes.
  - e. For nations to receive the full advantages of international specialization and exchange, free trade must be allowed among **all** countries.
    - 1) Trade barriers cause resources to be **misallocated** in the country that established the barrier because inputs are used to produce products that could be produced more economically in other countries.
    - 2) As a result, products that could be efficiently produced in that country are not produced. In the other countries where the product was originally being produced economically, there is an oversupply of the product and the domestic price is driven down, resulting in efficient producers going out of business.

## 7.2 TRADE BARRIERS

1. Even though individuals (on the whole) are best off under free trade, **governments** often establish policies designed to **interfere** in the workings of the marketplace.
  - a. In fact, until economists such as Adam Smith and David Ricardo gave life to the free-trade movement in the late 18th and early 19th centuries, it was the **policy** of governments around the world to **actively impede trade**.
  - b. The belief was that exports were to be promoted and imports discouraged in all cases because exports led people in other countries to owe domestic producers money. This theory went by the name of **mercantilism**. Certain aspects of mercantilism survive in modern protectionist practices.
2. **Protectionism** is any measure taken by a government to protect domestic producers. Protectionism takes many forms.
  - a. **Tariffs** are consumption taxes designed to restrict imports, e.g., a tax on German beer. Governments raise tariffs to discourage consumption of imported products.
    - 1) The agreements reached during the Uruguay Round (1986-1994) of negotiations specified the rules for levying antidumping tariffs. Most cases hinge on the definition of “cost.”
    - 2) In the U.S., the Secretary of the Treasury must first determine that a class of foreign merchandise is being sold in the U.S. at less than its fair value.
  - b. **Import quotas** set fixed limits on different products, e.g., French wine.
    - 1) In the short run, import quotas will help a country’s balance of payments position by increasing domestic employment, but the prices of the products produced will also increase.
    - 2) An **embargo** is a total ban on some kinds of imports. It is an extreme form of the import quota.
  - c. **Domestic content rules** require that at least a portion of any imported product be constructed from parts manufactured in the importing nation.
    - 1) This rule is sometimes used by capital-intensive nations. Parts can be produced using idle capacity and then sent to a labor-intensive country for final assembly.
  - d. **Voluntary export restrictions** are agreements entered into by exporters to reduce the number of products made available in a foreign country in an attempt to avoid official sanctions.
    - 1) These restrictions can be counterproductive. Because the supply of the product desired by consumers in the importing country is held artificially low, the exporter sometimes can charge a price high enough to earn profits greater than normal.
  - e. A **trigger price mechanism** automatically imposes a tariff barrier against unfairly cheap imports by levying a duty (tariff) on all imports below a particular reference price (the price that “triggers” the tariff).
  - f. **Antidumping rules** prevent foreign producers from “dumping” excess goods on the domestic market at less than cost to squeeze out competitors and gain control of the market.
  - g. **Exchange controls** limit foreign currency transactions and set exchange rates. The purpose is to limit the ability of a firm selling in a country to repatriate its earnings.
  - h. **Export subsidies** are payments by the government to producers in certain industries in an attempt to increase exports.
    - 1) A government may impose “countervailing duties” on imported goods if those goods were produced in a foreign country with the aid of a governmental subsidy.

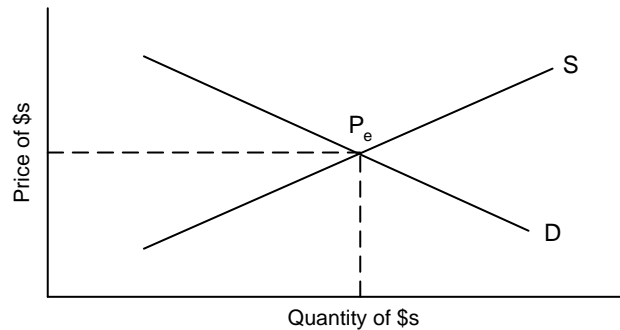
- i. **Special tax benefits to exporters** are an indirect form of export subsidy. The best U.S. examples were Foreign Sales Corporations (FSCs). They were entities located in U.S. possessions or in countries with tax information exchange agreements with the U.S. FSCs received an exemption of about 15% of qualified export income. However, after the World Trade Organization (WTO) ruled them to be illegal, the legislation creating them was repealed.
  - j. The **Export Trading Company Act of 1982** permits competitors to form export trading companies without regard to U.S. antitrust legislation.
  - k. Certain exports may require **licenses**. For example, sales of technology with military applications are limited by western nations that are members of the Coordinating Committee for Multilateral Export Controls. The related U.S. legislation is the Export Administration Act of 1979.
3. The **economic effects of tariffs and quotas** can be summarized as follows:
- a. **Workers** are shifted from relatively efficient export industries into **less efficient** protected industries. **Real wages decline** as a result, as does total world output.
  - b. Under a **tariff**, the excess paid by the customer for an imported good goes into **government coffers** where it can be spent on domestic concerns.
    - 1) Under a **quota**, prices are also driven up (by the induced shortage), but the excess goes to the **exporter** in the foreign country.
  - c. A **tariff** is laid on all importers equally; thus, the more efficient ones will still be able to set their **prices lower** than the less efficient ones.
    - 1) An import **quota**, on the other hand, does not affect foreign importers equally and import licenses can be assigned as much for **political favoritism** as on any other grounds.
4. A major reason for trade restrictions is that the costs of competition are direct and concentrated (people lose jobs and firms go out of business), but benefits of unrestricted trade are less noticeable and occur in the future (lower prices, higher wages, more jobs in export industries).
- a. Special-interest groups are strong and well organized, and they lobby effectively, getting legislation passed that is harmful to free trade.
  - b. **Economic integration** is the joining of the markets from two or more nations into a free-trade zone. Examples of economic blocs of trading nations are the European Union and the North American Free Trade Agreement (NAFTA). Generally, the trading bloc provides trading incentives to member nations and discriminates against nonmember nations.

### 7.3 FOREIGN CURRENCY RATES AND MARKETS

- 1. For international trade to occur, the two currencies involved must be easily converted at some prevailing exchange rate. The **exchange rate** is the price of one country's currency in terms of another country's currency.
  - a. Currency appreciates when it can buy more units of another currency.
  - b. Currency depreciates when it can purchase fewer units of another currency.
  - c. In other words, depreciation in country A's currency is an appreciation of the currency of country B.

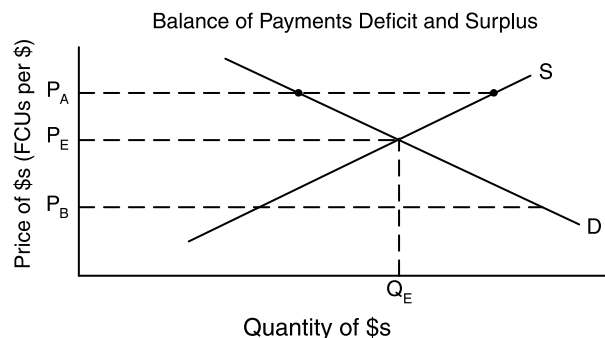
## 2. Exchange Rate Determination

- a. Equilibrium exchange rates in floating markets are determined by the supply of, and demand for, the currencies.



The equilibrium rate of  $P_e$  will prevail in the market. No surplus (or deficit) occurs at  $P_e$ .

- 1) Demand for currencies comes from international trade in goods and services, investor global trading (e.g., an American buys a French stock or bond), and international corporate activity.
  - 2) Supply of currencies comes from reversing these transactions.
- b. **Fixed exchange rates** are set by some outside force (e.g., the government). One traditional method of establishing rates is to require that currencies be convertible to specified amounts of gold.
- 1) An exchange rate set too high (in foreign currency units per dollar) tends to create a deficit U.S. balance of payments. This deficit must be financed by drawing down foreign reserves or by borrowing from the central banks of the foreign countries. This effect is short-term because, at some time, the country will deplete its foreign reserves.
    - a) A major reason for a country's devaluation is to improve its balance of payments.
    - b) As an alternative to drawing down its reserves, a country might change its trade policies or implement exchange controls or exchange rationing. Many developing countries use currency exchange rationing to avoid a deficit balance of payments.
  - 2) An exchange rate set too low (in foreign currency units per dollar) tends to create a surplus U.S. balance of payments. In this case, surplus reserves build up. At some time, the country will not want any greater reserve balances and will have to raise the value of its currency.



- 3) At exchange rate A ( $P_A$  foreign currency units per dollar), a greater quantity of dollars is supplied by U.S. interests than demanded by foreign interests (i.e., U.S. imports exceed exports). The result is a trade deficit. At exchange rate B, a smaller quantity of dollars is supplied by U.S. interests than demanded by foreign interests (i.e., U.S. exports exceed imports). The result is a trade surplus.



- c. A **managed float** is the current method of exchange rate determination.
- 1) Supply and demand forces primarily guide exchange rates.
  - 2) During periods of extreme fluctuation in the value of a nation's currency, intervention by governments or central banks may occur to maintain fairly stable exchange rates.
  - 3) Floating rates permit adjustments to eliminate balance of payments deficits or surpluses. For example, if the U.S. has a deficit in its trade with country X, the U.S. dollar will depreciate relative to country X's currency. This adjustment should decrease imports from, and increase exports to, country X.
3. Floating exchange rates may fluctuate differently in the long, medium, and short term.
- a. **Long-term exchange rates** are dictated by the purchasing-power parity theorem.
- 1) In the long run, real prices should be the same worldwide (net of government taxes or trade barriers and transportation costs) for a given good. Exchange rates will adjust until purchasing-power parity is achieved. In other words, relative price levels determine exchange rates. In the real world, exchange rates do not perfectly reflect purchasing-power parity, but relative price levels are clearly important determinants of those rates.
- b. **Medium-term exchange rates** are dictated by the economic activity in a country.
- 1) When the U.S. is in a recession, spending on imports (as well as domestic goods) will decrease. This reduced spending on imports shifts the supply curve for dollars to the left, causing the equilibrium value of the dollar to increase (assuming the demand for dollars is constant); that is, at any given exchange rate, the supply to foreigners is less.
  - 2) If more goods are exported because of an increased preference for U.S. goods, the demand curve for dollars shifts to the right, causing upward pressure on the value of the dollar.
  - 3) An increase in imports or a decrease in exports will have effects opposite to those described in b.1) above.
- c. **Short-term exchange rates** are dictated by **interest rates**. Big corporations and banks invest their large reserves of cash where the real interest rate is highest. A rise in the real interest rate in a country will lead to an appreciation of the currency because it will be demanded for investment at the higher real interest rate, thereby shifting the demand curve to the right (outward).
- 1) The reverse holds true for a decline in real interest rates because that currency will be sold as investors move their money out of the country.
  - 2) However, the interplay of interest rates and inflation must also be considered. Inflation of a currency relative to a second currency causes the first currency to depreciate relative to the second. Moreover, nominal interest rates increase when inflation rates are expected to increase. The effect on exchange rates of inflation reflected in nominal interest rates is expressed by the **interest-rate parity theorem**. The ratio of the current forward and spot exchange rates (expressed in units of foreign currency per dollar) equals the ratio of one plus the current nominal foreign rate to one plus the current nominal domestic rate.

$$\frac{\text{Forward exchange rate}}{\text{Spot exchange rate}} = \frac{1 + \text{Foreign interest rate}}{1 + \text{Domestic interest rate}}$$

For example, if the current nominal foreign interest rate increases, the forward rate in terms of units of the foreign currency per dollar will increase. Hence, that currency will trade at a discount in the forward market.

#### 4. Effective Interest Rate on a Foreign Currency Loan

- a. EXAMPLE: A U.S. company takes out a one-year, 12,000,000 peso loan at 6.5% to pay a Mexican supplier. After a year, the U.S. company repays the loan with interest but, in the meantime, the peso has experienced a slight appreciation. Thus, the company's effective rate on the loan is higher than the stated rate, calculated as follows:

		Times: Conversion Rate	Equals: Equivalent USD
Amount borrowed	12,000,000 Pesos	0.0921496	\$1,105,795
Times: stated rate	6.5%		
Equals: interest charged	780,000 Pesos		
Total repayment	<u>12,780,000</u> Pesos	0.0940000	<u>1,201,320</u>
Difference			<u>\$ 95,525</u>
<b>Effective rate:</b>			
Difference ÷ amount borrowed = (\$95,525 ÷ \$1,105,795)			<b>8.64%</b>

#### 5. Interaction in Foreign Currency Markets

- a. The **spot rate** is the exchange rate paid for immediate delivery of a currency.
- b. The **forward exchange rate** is the future price of the currency.
- 1) If the forward rate in foreign currency units per dollar is greater than the spot rate, the dollar is selling at a premium.
  - 2) If the spot rate in foreign currency units per dollar is greater than the forward rate, the dollar is selling at a discount.
  - 3) The annual effect in the forward market equals

$$\frac{\text{Forward market rate (FC)} - \text{Spot rate (FC)}}{\text{Spot rate (FC)}} \times \text{Number of forward periods in a year}$$

- a) FC means that the amount is denominated in foreign currency.
  - b) For example, if there is a 1% premium in a 30-day forward market, the annual premium is 12%.
- c. The **discount or premium** is related to the difference between the nominal interest rates paid by foreign and domestic banks (differences in interest rates are largely related to differences in expected inflation).
- 1) When the foreign nominal interest rate is lower than the domestic nominal rate, the forward foreign currency sells at a premium. If this were not true, investors would borrow at the lower interest rate, invest at the higher rate, and buy a forward contract for the principal and interest.
  - 2) If the foreign nominal rate exceeds the domestic nominal rate, the forward foreign currency sells at a discount.
- d. A foreign currency will depreciate or appreciate relative to the dollar at a rate equivalent to the amount by which its inflation rate exceeds or is less than the dollar's inflation rate (everything else constant).
- 1) EXAMPLE: If the inflation rate in U.K. is 12% and the inflation rate in the U.S. is 10%, the dollar should appreciate by 2%.
- e. Borrowing in a country with the lowest nominal rate may result in an exchange rate loss if the borrower's currency depreciates relative to the lender's.
- 1) Foreign currency exchange rates equalize inflation rates.

## 6. Avoidance of Exchange Rate Risk in Foreign Currency Markets

- a. The firm may **hedge** its risk by purchasing or selling forward exchange contracts.
  - 1) A firm may buy or sell forward contracts to cover liabilities or receivables, respectively, denominated in a foreign currency.
  - 2) Any gain or loss on the foreign payables or receivables because of changes in exchange rates is offset by the loss or gain on the forward contract.
- b. The firm may choose to **minimize receivables and liabilities** denominated in foreign currencies.
- c. Maintaining a monetary **balance between receivables and payables** denominated in a particular foreign currency avoids a net receivable or net liability position in that currency. Monetary items are those with fixed cash flows.
  - 1) A firm may attempt to achieve a net monetary debtor (creditor) position in countries with currencies expected to depreciate (appreciate).
  - 2) Large multinational corporations have established multinational netting centers as special departments to attempt to achieve balance between foreign receivables and payables.
    - a) They also enter into foreign currency futures contracts when necessary to achieve balance.
- d. Another means of managing exchange rate risk is by the use of **trigger pricing**. Under trigger pricing, foreign funds are supplied at an indexed price but with an option to convert to a futures-based fixed price when a specified basis differential exists between the two prices.
- e. A firm may seek to minimize its exchange-rate risk by diversification. If it has transactions in both strong and weak currencies, the effects of changes in rates may be offsetting.
- f. A **speculative forward contract** does not hedge any exposure to foreign currency fluctuations; it creates the exposure.

## 7. Analysis of Foreign Investments

- a. A company planning a foreign investment can either purchase the stock of a foreign corporation or make a **direct foreign investment**. A direct foreign investment involves buying equipment and buildings for a new company.
  - 1) The advantages of a direct foreign investment include
    - a) Lower taxes in the foreign nation
    - b) Annual depreciation allowances for the amount invested
    - c) Access to foreign capital sources
  - 2) Disadvantages include
    - a) Bureaucratic hurdles (e.g., documentation, licensing) required specifically of foreign investors
    - b) Risk of expropriation or loss to violent change of government
    - c) Local laws designed to protect domestic firms
    - d) Limitations on remittances to investor country
- b. Relevant cash flows are the dividends and possible future sales price of the investment paid to the investor. To this extent, traditional capital budgeting techniques can be used.

- c. **Cost of capital** for foreign projects is higher because of
    - 1) Exchange-rate risk
    - 2) Sovereignty (or political) risk arising from possible expropriation (or other restrictions), with net losses to the parent company
    - 3) Laws requiring financing from certain sources, such as majority ownership of foreign subsidiaries by locals
    - 4) The risk that contentious tax issues may arise
  - d. Foreign operations are more difficult to manage than domestic operations.
8. Foreign investments are funded by
- a. Parent company resources
  - b. Common stock sales in the foreign country
  - c. Bond sales in the foreign country
  - d. Borrowing in world financial markets

## 7.4 BALANCE OF PAYMENTS

1. The balance of payments is an economic measure that includes all international payments made by one nation to another, including those for imports, exports, investments, unilateral transfers, and capital movements. The principal accounts are the current account and the **capital account**.
- a. The **current account** records
    - 1) Exports (credits) and imports (debits) of goods
      - a) The **balance of trade** is the difference between total exports and total imports of goods.
      - b) A **trade deficit** occurs when a country imports more goods than it exports.
    - 2) Exports (credits) and imports (debits) of services
      - a) The **balance on goods and services** is the difference between total exports and total imports of goods and services.
    - 3) Interest and dividends received on investments abroad (credits) and interest and dividends paid on foreign investments in the U.S. (debits)
    - 4) Net unilateral transfers, e.g., foreign aid, pension payments, and remittance to relatives (credits or debits, depending on whether the flow is into or out of the U.S., respectively)
    - 5) The balance on the current account
  - b. The **capital account** records capital flows resulting from the purchase and sale of fixed or financial assets.
    - 1) Inflows of foreign capital (credits) are effectively exports of stocks and bonds and therefore result in inflows of foreign currencies.
    - 2) Outflows of capital (debits) use up supplies of foreign currencies.
    - 3) A capital account surplus therefore indicates that inflows exceeded outflows.
  - c. The **balance of payments deficit or surplus** is the net of the current and capital account balances.

- d. The **official reserves account** records transactions involving the central bank and its official reserve assets, such as gold and foreign currency.
- 1) Also among a central bank's reserves are **special drawing rights** (SDRs). They are accounting entries established by the **International Monetary Fund**. The IMF is a banking organization that helps to manage international transactions by holding currency reserves and making loans to central banks.
    - a) Another important international financial institution is the **World Bank**, established to provide credit for development purposes to underdeveloped countries.
- e. EXAMPLE (in billions):

<b>Current account:</b>		
Exports of goods	\$1,272	
Imports of goods	(1,996)	
<b>Balance of trade</b>		<b>\$(724)</b>
Exports of services	\$ 380	
Imports of services	(322)	58
<b>Balance on goods and services</b>		<b>\$(666)</b>
Net investment income		1
Net transfers		(83)
<b>Balance on current account</b>		<b>\$(748)</b>
<b>Capital account:</b>		
Capital inflows	\$1,293	
Capital outflows	(1,216)	
<b>Balance on capital account</b>		<b>77</b>
<b>Balance of payments</b>		<b>\$(671)</b>
Official reserves account		671
<b>Net</b>		<b>\$ 0</b>

- f. The references to debits and credits treat the balance of payments account as if it were a revenue or expense account. In other words, a debit is similar to an expense in that it is unfavorable for the country's balance of payments position.
- 1) EXAMPLE: A debit (such as an import) is undesirable because it contributes to an unfavorable balance of payments. The U.S. has an unfavorable balance of payments when payments by the U.S. to foreign countries exceed the payments made from foreign countries to the U.S. It is also unfavorable because foreign currency reserves held by the U.S. must be given up to correct the imbalance.
  - 2) A credit in the balance of payments account is desirable (exports, for instance) because foreigners will be paying more to the U.S. than the U.S. is paying out. Thus, the foreign currency reserves available to the U.S. increase.
- g. In addition to decreasing the reserves of foreign currencies held by the U.S., an unfavorable balance of payments can also affect the domestic economy.
- 1) EXAMPLE: An excess of imports can cause an unfavorable balance of payments. At the same time, consumers may not be buying domestic products, which may result in domestic layoffs and production cutbacks. These in turn will mean less investment opportunity domestically, and investors will begin sending their investment dollars overseas. The flow of capital overseas compounds the balance of payments problem because investing in a foreign country is essentially the same as importing a product (i.e., the investor is importing foreign stocks and bonds).

- 2) Steps to correct an unfavorable balance of payments:
  - a) Establish **import quotas**.
    - i) One country's unfavorable balance of payments may be caused by another nation's import quotas. For example, if the U.S. has a continuing unfavorable balance of payments with Japan, it might be possible to encourage Japan to remove the trade barriers set up to keep U.S. electronics products out. The removal of Japan's trade restrictions would help the U.S. balance of payments (but might result in an unfavorable balance of payments for Japan).
  - b) Provide **export incentives**.
    - i) **EXAMPLE:** The tax law provisions for Domestic International Sales Corporations (DISCs) and Foreign Sales Corporations (FSCs) permitted exporters to postpone or avoid income taxes on export-related income as long as that income is reinvested in export-related assets. Provisions for FSCs were enacted in 1985 to replace DISCs because the latter were criticized as illegal export subsidiaries. FSCs were ruled illegal by the WTO, and the FSC rules were repealed as of September 30, 2000.
  - c) **Develop substitutes** for products currently being imported.
    - i) **EXAMPLE:** The U.S. has tried to develop substitutes for or local sources of oil.
- 3) An automatic correction results when a debtor nation's monetary unit declines relative to that of a creditor nation. For example, the huge U.S. trade deficit with China is attributable in part to the artificially low valuation of the yuan that results from its being pegged to the U.S. dollar.
- h. A balance of payments deficit (imbalance) must be equalized by shipments of goods or reductions in reserves.
  - 1) Gifts and grants also are used.
- i. In the 1980s, the U.S. became the nation with the largest foreign debt. The reasons include the following:
  - 1) Federal budget deficits financed by foreigners
  - 2) Growth in the economy that attracted foreign investors
  - 3) High real interest rates
  - 4) A strengthened dollar in the early 1980s that encouraged imports
  - 5) The shift from a manufacturing to a service economy
  - 6) A decrease in exports of agricultural goods
- j. The following are the actual or potential effects of the U.S.'s debt:
  - 1) An increase in the percentage of the GDP used for debt service
  - 2) Reduced reserves leading to a devalued dollar, inflation, and increased exports
  - 3) A decline in net imports and improvement in the trade balance
  - 4) Increased savings as a result of economic uncertainty
  - 5) Increased pressure for trade protectionism
  - 6) Potentially high interest rates to curtail inflation and tighten the money supply, with the consequent incentive for foreign investment