International business is facilitated by markets that allow for the flow of funds between countries. The transactions arising from international business cause money flows from one country to another. The balance of payments is a measure of international money flows and is discussed in this chapter.

Financial managers of MNCs monitor the balance of payments so that they can determine how the flow of international transactions is changing over time. The balance of payments can indicate the volume of transactions between specific countries and may even signal potential shifts in specific exchange rates.

The specific objectives of this chapter are to:
- explain the key components of the balance of payments, and
- 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. The words “all transactions” can be somewhat misleading because some transactions may be estimated. The transactions are recorded using double-entry bookkeeping. That is, each transaction is recorded as both a credit and a debit. Thus, total credits and debits for a country’s balance of payments will be identical in aggregate; however, for any subset of the balance-of-payments statement, there may be a deficit or surplus position. A balance-of-payments statement can be broken down into various components. Those that receive the most attention are the current account and the capital account. The current account represents a summary of 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. The capital account represents a summary of the flow of funds resulting from the sale of assets between one specified country and all other countries over a specified period of time. Transactions that reflect inflows of funds generate positive numbers (credits) for the country’s balance, while transactions that reflect outflows of funds generate negative numbers (debts) for the country’s balance.

**Current Account**

A key component of the current account is the balance of trade, which is simply the difference between merchandise exports and merchandise imports. Merchandise exports and imports represent tangible products, such as computers and clothing, that are transported between countries. A deficit in the balance of trade reflects a greater value of imported goods than exported goods. Conversely, a surplus reflects a greater value of exported goods than imported goods.

A second component of the current account is service exports and imports. Service exports and imports represent services, such as legal, insurance, and consulting services provided for customers based in other countries. Service exports by the United States result in an inflow of funds to the United States, while service imports by the United States result in an outflow of funds.

A third component of the current account is factor income, which represents income (interest and dividend payments) received by investors on foreign investments in financial assets (securities). Thus, factor income received by U.S. investors reflects an inflow of funds into the United States. Factor income paid by the United States reflects an outflow of funds from the United States.

A fourth component of the current account is transfer payments, which represent aid, grants, and gifts from one country to another. Factor income, transfer payments, and other payments are lumped together as “International Income Transactions” in Exhibit 2.1, which shows several examples of transactions that would be reflected in the current account.

Notice in the exhibit that every transaction that generates a U.S. cash inflow (exports and income receipts by the United States) represents a credit to the current account, while every transaction that generates a U.S. cash outflow (imports and income payments by the United States) represents a debit to the current account. Therefore, a large current account deficit indicates that the United States is sending more cash abroad to buy goods and services or to pay income than it is receiving for those same reasons.

The U.S. current account balance in the year 2000 is summarized in Exhibit 2.2. Notice that the exports of goods were valued at $773 billion, while imports of goods by the United States were valued at $1,223 billion. Therefore, the United States balance of trade in the year 2000 was:

\[
\begin{array}{c|c}
\text{Exports of goods} & \$773 \text{ billion} \\
- \text{Imports of goods} & -1,223 \text{ billion} \\
\hline
\text{Balance of trade} & -450 \text{ billion}
\end{array}
\]

Total U.S. exports of goods and services and income receipts amounted to $1,414 billion, while total U.S. imports of goods and services and income payments amounted to $1,733 billion. The bottom of the exhibit shows that net transfers
Exhibit 2.1
Examples of Current Account Transactions

<table>
<thead>
<tr>
<th>International Trade Transaction</th>
<th>U.S. Cash Flow Position</th>
<th>Entry on U.S. Balance-of-Payments Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>J.C. Penney purchases stereos produced in Indonesia that it will sell in its U.S. retail stores.</td>
<td>U.S. cash outflow</td>
<td>Debit</td>
</tr>
<tr>
<td>Individuals in the U.S. purchase CDs over the Internet from a firm based in China.</td>
<td>U.S. cash outflow</td>
<td>Debit</td>
</tr>
<tr>
<td>The Mexican government pays a U.S. consulting firm for consulting services provided by the firm.</td>
<td>U.S. cash inflow</td>
<td>Credit</td>
</tr>
<tr>
<td>IBM headquarters in the U.S. purchases computer chips from Singapore that it uses in assembling computers.</td>
<td>U.S. cash outflow</td>
<td>Debit</td>
</tr>
<tr>
<td>A university book store in Ireland purchases textbooks produced by a U.S. publishing company.</td>
<td>U.S. cash inflow</td>
<td>Credit</td>
</tr>
<tr>
<td>U.S. tourists purchase jewelry in Budapest, Hungary.</td>
<td>U.S. cash outflow</td>
<td>Debit</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A U.S. investor receives a dividend payment from a French firm in which she purchased stock.</td>
<td>U.S. cash inflow</td>
<td>Credit</td>
</tr>
<tr>
<td>The U.S. Treasury sends an interest payment to a German insurance company that purchased U.S. Treasury bonds one year ago.</td>
<td>U.S. cash outflow</td>
<td>Debit</td>
</tr>
<tr>
<td>A Mexican company that borrowed dollars from a bank based in the U.S. sends an interest payment to that bank.</td>
<td>U.S. cash inflow</td>
<td>Credit</td>
</tr>
</tbody>
</table>

(which include grants and gifts provided to other countries) were –$52 billion. The negative number for net transfers represents a cash outflow from the United States.

Exhibit 2.2 shows that the current account balance can be derived as the difference between total U.S. exports and income receipts (line 4) and the total U.S. imports and income payments (line 8), with an adjustment for net transfer payments (line 9). This is logical, since the total U.S. exports and income receipts represent U.S. cash inflows while the total U.S. imports and income payments and the net transfers represent U.S. cash outflows. The current account balance of $371 billion means that the United States spent $371 billion more on trade, income, and transfer payments than it received in the year 2000.
Capital Account

The key components of the capital account are direct foreign investment, portfolio investment, and other capital investment. Direct foreign investment represents the investment in fixed assets in foreign countries that can be used to conduct business operations. Examples of direct foreign investment include a firm’s acquisition of a foreign company, its construction of a new manufacturing plant, or its expansion of an existing plant in a foreign country.

Portfolio investment represents transactions involving long-term financial assets (such as stocks and bonds) between countries that do not affect the transfer of control. Thus, a purchase of Heineken (Netherlands) stock by a U.S. investor is classified as portfolio investment because it represents a purchase of foreign financial assets without changing control of the company. If a U.S. firm purchased all of Heineken’s stock in an acquisition, this transaction would result in a transfer of control and therefore would be classified as direct foreign investment instead of portfolio investment.

Financial Markets Perspective

Impact of Portfolio Investment on MNCs

Portfolio investment has an indirect effect on MNCs because it can affect interest rates and also affects the values of securities that are issued by MNCs. Consider that financial institutions in various countries commonly invest in bonds issued in the United States, thereby creating a flow of funds into the United States. In particular, Japanese financial institutions purchase a large portion of Treasury bonds and bonds issued by U.S. firms. Consequently, long-term interest rates in the United States are not as high as they would be without this portfolio investment by other countries. This portfolio investment is also important to U.S. firms that fund projects by issuing bonds or obtaining long-term loans in the United States, because it means that they can obtain the funds at a lower cost. Therefore, they may be able to pursue more value-enhancing projects.
A third component of the capital account consists of other capital investment, which represents transactions involving short-term financial assets (such as money market securities) between countries. In general, direct foreign investment measures the expansion of firms' foreign operations, whereas portfolio investment and other capital investment measure the net flow of funds due to financial asset transactions between individual or institutional investors.

Exhibit 2.3 summarizes the U.S. capital account for the year 2000. Notice that foreign investment in the United States during 2000 was valued at $753 billion, while net U.S. investment in foreign countries was valued at $430 billion. Therefore, the United States experienced a large net inflow of cash as a result of foreign investment. Overall, the United States had large net cash outflows due to trade and income transactions with foreign countries and large net cash inflows due to investment transactions with foreign countries.

**Exhibit 2.3**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value (in billions of $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct foreign investment in the U.S.</td>
<td>$276</td>
</tr>
<tr>
<td>+ Portfolio investment in the U.S.</td>
<td>$477</td>
</tr>
<tr>
<td><strong>Total foreign investment in the U.S.</strong></td>
<td><strong>$753</strong></td>
</tr>
<tr>
<td>U.S. direct foreign investment by the U.S.</td>
<td>$151</td>
</tr>
<tr>
<td>+ Portfolio investment by the U.S.</td>
<td>$279</td>
</tr>
<tr>
<td><strong>Total foreign investment by the U.S.</strong></td>
<td><strong>$430</strong></td>
</tr>
</tbody>
</table>

**INTERNATIONAL TRADE FLOWS**

Canada, France, Germany, and other European countries rely more heavily on trade than the United States does. Canada's trade volume of exports and imports per year is valued at more than 50 percent of its annual gross domestic product (GDP). The trade volume of European countries is typically between 30 and 40 percent of their respective GDPs. The trade volume of the United States and Japan is typically between 10 and 20 percent of their respective GDPs. Nevertheless, for all countries, the volume of trade has grown over time.

**Distribution of U.S. Exports**

The distribution of U.S. exports among countries during 2001 is shown in Exhibit 2.4. The amounts of U.S. exports are rounded to the nearest billion. For example, exports to Canada were valued at $179 billion.

The distribution of U.S. exports by region, shown in Exhibit 2.5 provides more insight on the relative importance of specific regions as targets for U.S. exports. The Pacific Rim countries account for about 26 percent of all U.S. exports. Western Europe accounts for 23 percent of all U.S. exports, while Eastern Europe accounts for only 1 percent. Canada purchases more U.S. exports (23 percent of the total) than any other single country.
Exhibit 2.4
Distribution of Export Markets for U.S. Firms (in billions of $)

The distribution of U.S. imports is shown in Exhibit 2.6. One-third of all U.S. imports comes from the Pacific Rim countries. Another 20 percent comes from Western Europe, while 19 percent comes from Canada. Among the Pacific Rim countries, China, in particular, has become a key source of U.S. imports; U.S. imports from China exceed those from any other country in Asia or Europe.

South American and Central American countries (excluding Mexico) account for 6 percent of U.S. imports. Imports from Mexico account for 11 percent.

Updated Trade Conditions An update of the current account balance and international trade balance is provided at http://www.whitehouse.gov/fsbr/international.html.
The trends for U.S. exports, U.S. imports, and the U.S. balance of trade are shown in Exhibit 2.7. Notice that the value of U.S. exports and U.S. imports has grown substantially over time. Since 1976, the value of U.S. imports has exceeded the value of U.S. exports, causing a balance of trade deficit. Much of the trade deficit is due to a trade imbalance with two countries. The United States has had an annual trade deficit of about $60 billion with Japan and an annual trade deficit of about $34 billion with China. If the trade with these two countries becomes more balanced over time, the overall trade deficit of the United States will likely be reduced.

**HTTP:// USING THE WEB**

**U.S. Balance of Trade with Each Country** The U.S. balance of trade with each individual country is updated monthly and provided at [http://www.census.gov/foreign-trade/www/index.html](http://www.census.gov/foreign-trade/www/index.html). Click on Balance with U.S., and then click on a specific country. The balance of trade with the country you specify is shown for several recent months.

**Exhibit 2.7**

U.S. Balance of Trade over Time
**U.S. Balance of Trade in Aggregate**  
The trend of the U.S. balance of trade in aggregate is provided at [http://www.census.gov/foreign-trade/www/index.html](http://www.census.gov/foreign-trade/www/index.html). Click on U.S. International Trade in Goods and Services. There are several links here to additional details about the U.S. balance of trade.

**Recent Changes in North American Trade**

In January 1988, the United States and Canada agreed to a free trade pact, which was initiated in January 1989 and was completely phased in by 1998. As a result of this agreement, trade barriers on numerous products were reduced. The trade pact resulted in increased competition within various industries. Some firms that had focused exclusively on domestic business were encouraged to consider exporting or importing as the barriers were removed.

In 1993, the North American Free Trade Agreement (NAFTA) was enacted, removing numerous restrictions on trade between Canada, Mexico, and the United States. The agreement was an extension of the 1989 treaty that reduced trade barriers between the United States and Canada. The three countries involved in NAFTA have combined production similar to that of the European Union and a larger population. NAFTA also removed some restrictions on direct foreign investment in Mexico. Before the agreement, most direct foreign investment in Mexico was restricted to the so-called maquiladoras located near the U.S. border.

The enactment of NAFTA caused a heated debate in the early 1990s. Opponents argued that the agreement would reduce the number of U.S. jobs as a result of lower labor costs in Mexico. Its proponents argued that instead there would be a redistribution of U.S. jobs; although low-skilled jobs would be transferred to Mexico, some high-skilled jobs would be created as a result of increased trade with Mexico. They also suggested that a portion of the income earned in Mexico as a result of NAFTA would be spent on U.S. goods.

Some were also concerned that the United States would need massive retraining programs to allow for the redistribution of U.S. jobs. The U.S. government was running budget deficits during the years of the debate over NAFTA, and some of its opponents argued that any government-sponsored programs would further increase the U.S. budget deficit.

Opponents of NAFTA also feared that environmental standards would not be enforced in Mexico, which would give Mexico an extra advantage beyond its labor cost advantage. NAFTA’s proponents countered that the agreement could enhance Mexico’s economy and help finance the environmental expenditures there.

A related concern was that Mexico’s safety and health laws for workers and child labor laws were less stringent than U.S. laws and that these differences would give Mexico an extra cost advantage. Again, a counterargument was that Mexico might upgrade its laws if its economy improved.

The effects of NAFTA are only beginning to be realized. As usually occurs when trade barriers are removed, those firms that were prevented by the barriers from pursuing international business have been favorably affected. Conversely, those firms that were protected by the barriers have been adversely affected. For many firms, the effects depend on how those firms respond to the reduced barriers. Some firms that face more competition are working to become more efficient or considering diversifying into other industries in which they can compete more effectively.
In 2001, trade negotiations were initiated for a free trade area of the Americas, which would include all South American countries and some countries in the Caribbean Sea. It would involve 34 countries that generate an annual GDP of $11 trillion. The existing tariffs would be phased out over the next 10 years.

Recent Changes in European Trade

Since the Single European Act was implemented to remove explicit and implicit barriers to trade, exports and imports between European countries have increased. The shift to free enterprise in the former East Germany and other countries in Eastern Europe has also contributed to the growth of trade because consumers in these countries now have more freedom to purchase imported goods. As time passes and private enterprise evolves in Eastern Europe, firms based there are developing some comparative advantages.

The single currency system in Europe is also encouraging trade between European countries because it allows a single currency (the euro) to be used for trade among many European countries. Thus, the advent of the euro has eliminated the need to convert currencies and the exchange rate risk associated with trade between the participating countries.

Trade Agreements around the World

International trade has grown in response to trade agreements among countries. Some of the best-known free trade areas are shown in Exhibit 2.8. Many trade agreements specify reductions in trade barriers, while others specify free trade between the countries in the group.

In December 1993, a General Agreement on Tariffs and Trade (GATT) accord among 117 countries called for lower tariffs around the world. The accord resulted from the so-called Uruguay Round of trade negotiations that had begun seven years earlier. The provisions of the accord reduced some tariffs by 30 percent on average and removed other tariffs over a five- to ten-year period. Existing tariffs were not reduced in some protected industries. In general, more progress was made on reducing tariffs in manufacturing industries than in service industries. Many of the large MNCs that had subsidiaries in numerous countries were affected less by the accord because they already had been producing their goods in the foreign markets they served and therefore had circumvented the tariffs. The accord was a major boost to exporting firms that had previously been subject to tariffs.

As described earlier, discussions have begun on a potential free-trade agreement among the United States and all Latin American countries, which would create the largest free-trade zone in the world. The agreement is not likely to be completed for many years, but the initial discussions at least show that the countries are willing to consider free trade throughout the Americas.

Friction Surrounding Trade Agreements. Trade agreements are sometimes broken when one country is harmed by another country's actions. For example one country may engage in dumping, or the exporting of products to other countries at prices below cost. Some governments have been accused of creating local jobs by producing goods and dumping them. Another situation that can threaten a trade agreement is copyright piracy, which occurs when a country allows local people to violate
Exhibit 2.8
Trade Agreements Around the World
Factors Affecting International Trade Flows

Because international trade can significantly affect a country’s economy, it is important to identify and monitor the factors that influence it. The most influential factors are

- Inflation
- National income
- Government restrictions
- Exchange rates

Impact of Inflation

If a country’s inflation rate increases relative to the countries with which it trades, its current account would be expected to decrease, other things being equal. Consumers and corporations in that country will most likely purchase more goods overseas (due to high local inflation), while the country’s exports to other countries will decline.

Impact of National Income

If a country’s income level (national income) increases by a higher percentage than those of other countries, its current account is expected to decrease, other things being equal. As the real income level (adjusted for inflation) rises, so does...
consumption of goods. A percentage of that increase in consumption will most likely reflect an increased demand for foreign goods.

Example

The removal of the Iron Curtain boosted Europe's economy in late 1989 and in 1990, which led to an increase in national income in Europe. Consequently, there was an increase in the demand for U.S. goods, which improved the U.S. balance of trade with Europe.

Just as an increase in national income can increase the demand for imports, a reduction in national income may result in the reduction in the demand for imports.

Example

During the 1997–1998 Asian crisis, the national income of Asian countries declined, causing a decline in the Asian demand for products imported from countries in other regions of the world. Thus, the amount of exports sold by the United States and some other countries to Asian countries declined as a result of the Asian crisis.

Impact of Government Restrictions

A country's government can prevent or discourage imports from other countries. By imposing such restrictions, the government disrupts trade flows. Among the most commonly used trade restrictions are tariffs and quotas.

HTTP:// USING THE WEB

Import Controls Information about import controls for each country is provided at http://biz.yahoo.com/itc50/. Click on any country listed, and then click on Trade Regulations. Review the import controls set by that country's government.

http://
Dr. Ed Yardeni's Economics Network at www.yardeni.com reviews international political and economic events, discusses their possible global impact, and presents economic and political analyses of major economies. Various national and international economic and financial market charts are also available.

Tariffs and Quotas. If a country's government imposes a tax on imported goods (often referred to as a tariff), the prices of foreign goods to consumers are effectively increased. Tariffs imposed by the U.S. government are on average lower than those imposed by other governments. Some industries, however, are more highly protected by tariffs than others. American apparel products and farm products have historically received more protection against foreign competition as a result of high tariffs on related imports.

Tariffs differ significantly among countries. For example, the United States recently charged a tariff of 13.5 cents per case of foreign beer, while Canada charged 24 cents per case, most European countries charged $2.93 per case, and China charged $14.64 per case. In general, higher tariffs will increase a country's current account balance, unless other governments retaliate as often happens.

HTTP:// USING THE WEB

In addition to tariffs, a government can reduce its country’s imports by enforcing a **quota**, or a maximum limit that can be imported. Quotas have been commonly applied to a variety of goods imported by the United States and other countries.

**HTTP:// USING THE WEB**

**Import Restrictions** General information about import restrictions for each country is provided at [http://www.usatrade.gov/website/ccg.nsf](http://www.usatrade.gov/website/ccg.nsf). Click on a specific country, and then click on Trade Regulations, Customs, and Standards.

**Other Types of Restrictions.** Some trade restrictions may be imposed on products for health and safety reasons.

**Example**

In 2001, an outbreak of foot-and-mouth disease occurred in the United Kingdom and eventually spread to several other European countries. This disease can spread by direct or indirect contact with infected animals. The U.S. government imposed trade restrictions on some products produced in the United Kingdom for health reasons. Consequently, U.K. exports to the United States declined abruptly.

This example illustrates how uncontrollable factors besides inflation, national income, tariffs and quotas, and exchange rates can affect the balance of trade between two countries.

**Response to Potential Trade Barriers**

Given its large volume of international business, Nike closely monitors any existing or potential trade barriers. In 1997, the European Commission imposed anti-dumping taxes on some shoes imported from China and Indonesia. Nike produces some shoes in these countries and then ships them to Europe for sale in European countries. Although the taxes were not aimed at athletic shoes, Nike was prepared to shift some of its shoe production to other countries if its athletic shoes were subjected to the European anti-dumping taxes.

**Discussion:** Why would Nike produce shoes in Indonesia to be sold in Europe? If anti-dumping taxes had been imposed, how could Nike have shifted its production so that it would not be subject to such taxes? Describe in general terms why it could be costly to shift production.

**Impact on Jobs.** Trade restrictions may save jobs, but only at a cost. A study by the Institute for International Economics estimated the cost per job saved to be $705,000 for the U.S. automobile industry and $1 million for the specialty steel industry. Furthermore, trade restrictions tend to benefit some industries at the expense of others, as other countries retaliate by imposing their own trade restrictions.

**HTTP:// USING THE WEB**

**Trade Sanctions** An update of sanctions imposed by the U.S. government on specific countries is provided at [http://www.treas.gov/ofac](http://www.treas.gov/ofac).
Impact of Exchange Rates

Each country's currency is valued in terms of other currencies through the use of exchange rates, so that currencies can be exchanged to facilitate international transactions. The values of most currencies can fluctuate over time because of market and government forces (as discussed in detail in Chapter 4). If a country’s currency begins to rise in value against other currencies, its current account balance should decrease, other things being equal. As the currency strengthens, goods exported by that country will become more expensive to the importing countries. As a consequence, the demand for such goods will decrease.

Example

A tennis racket that sells in the United States for $100 will require a payment of C$125 by the Canadian importer if the Canadian dollar is valued at C$1 = $.80. If C$1 = $.70, it would require a payment of C$143, which might discourage the Canadian demand for U.S. tennis rackets. A strong local currency is expected to reduce the current account balance if the traded goods are price-elastic (sensitive to price changes).

Using the tennis racket example above, consider the possible effects if currencies of several countries depreciate simultaneously against the dollar (the dollar strengthens). The U.S. balance of trade can decline substantially.

Example

During the 1997–1998 Asian crisis, the exchange rates of Asian currencies declined substantially against the dollar, which caused the prices of Asian products to decline from the perspective of the United States and many other countries. Consequently, the demand for Asian products increased and sometimes replaced the demand for products of other countries. For example, the weakness of the Thai baht during this period caused an increase in the global demand for fish from Thailand and a decline in the demand for similar products from the United States (Seattle).

Just as a strong dollar is expected to cause a lower (or more negative) U.S. balance of trade as explained above, a weak dollar is expected to cause a higher balance of trade. The dollar’s weakness lowers the price paid for U.S. goods by foreign customers and can lead to an increase in the demand for U.S. products. A weak dollar also tends to increase the dollar price paid for foreign goods and thus reduces the U.S. demand for foreign goods.

Interaction of Factors

Because the factors that affect the balance of trade interact, their simultaneous influence on the balance of trade is complex. For example, as a high U.S. inflation rate reduces the current account, it places downward pressure on the value of the dollar (as discussed in detail in Chapter 4). Since a weaker dollar can improve the current account, it may partially offset the impact of inflation on the current account.
**Correcting a Balance of Trade Deficit**

By reconsidering some of the factors that affect the balance of trade, it is possible to develop some common methods for correcting a deficit. Any policy that will increase foreign demand for the country's goods and services will improve its balance of trade position. Foreign demand may increase if export prices become more attractive. This can occur when the country's inflation is low or when its currency's value is reduced, thereby making the prices cheaper from a foreign perspective.

A floating exchange rate could possibly correct any international trade imbalances in the following way. A deficit in a country's balance of trade suggests that the country is spending more funds on foreign products than it is receiving from exports to foreign countries. Because it is selling its currency (to buy foreign goods) in greater volume than the foreign demand for its currency, the value of its currency should decrease. This decrease in value should encourage more foreign demand for its goods in the future.

While this theory seems rational, it does not always work as just described. It is possible that, instead, a country's currency will remain stable or appreciate even when it has a balance of trade deficit.

### Example

During the year 2000, the United States experienced a large balance of trade deficit, which should have placed downward pressure on the value of the dollar. Yet, during this same period, there was substantial investment in dollar-denominated securities by foreign investors. This foreign demand for the dollar placed upward pressure on its value, thereby offsetting the downward pressure caused by the trade imbalance. Consequently, a country cannot always rely on currency movements to correct a trade deficit.

### Why a Weak Home Currency Is Not a Perfect Solution

Even if a country's home currency weakens, its balance of trade will not necessarily improve for the following reasons.

**Counterpricing by Competitors.** When a country's currency weakens, its prices became more attractive to foreign customers, and many foreign companies lower their prices to remain competitive with the country's firms.

**Impact of Other Weak Currencies.** The currency does not necessarily weaken against all currencies at the same time.

### Example

When the dollar weakens in Europe, the dollar's exchange rates with the currencies of Hong Kong, Singapore, South Korea, and Taiwan may remain more stable. As some U.S. firms terminate their demand for supplies produced in European countries, they tend to increase their demand for goods produced in Asian countries. Consequently, the dollar's weakness in European countries causes a change in international trade behavior but does not eliminate the U.S. trade deficit.

**Prearranged International Transactions.** Many international trade transactions are prearranged and cannot be immediately adjusted. Thus, non-U.S. importing...
companies may be attracted to U.S. firms as a result of a weaker dollar but cannot immediately sever their relationships with suppliers from other countries. Over time, they may begin to take advantage of the weaker dollar by purchasing U.S. imports, if they believe that the weakness will continue. The lag time between the dollar’s weakness and the non-U.S. firms’ increased demand for U.S. products has sometimes been estimated to be 18 months or even longer.

The U.S. balance of trade may actually deteriorate in the short run as a result of dollar depreciation. It only improves when U.S. and non-U.S. importers respond to the change in purchasing power that is caused by the weaker dollar. This pattern is called the **J-curve effect**, and it is illustrated in Exhibit 2.9. The further decline in the trade balance before a reversal creates a trend that can look like the letter J.

**Intercompany Trade.** A fourth reason why a weak currency will not always improve a country’s balance of trade is that importers and exporters that are under the same ownership have unique relationships. Many firms purchase products that are produced by their subsidiaries in what is referred to as **intracompany trade**. This type of trade makes up more than 50 percent of all international trade. The trade between the two parties will normally continue regardless of exchange rate movements. Thus, the impact of exchange rate movements on intracompany trade patterns is limited.
INTERNATIONAL CAPITAL FLOWS

Capital flows usually represent direct foreign investment or portfolio investment. The direct foreign investment (DFI) positions by U.S. firms and by non-U.S. firms in the United States are illustrated in Exhibit 2.10. The DFI positions inside and outside the United States have risen substantially over time, an indication of increasing globalization. Both DFI positions level off during recessionary periods (such as in the early 1980s and in the early 1990s) but increase during periods of strong economic growth.

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Exhibit 2.10
Comparative Direct Foreign Investment Positions

Source: Survey of Current Business.
Exhibit 2.11
Distribution of DFI by U.S. Firms (in billions of $)
**Distribution of DFI by U.S. Firms**

The distribution of DFI by U.S. firms is illustrated in Exhibit 2.11. The United Kingdom and Canada are the biggest targets. The DFI by U.S. firms in Latin American and Asian countries has increased substantially as these countries have opened their markets to U.S. firms. Exhibit 2.12 summarizes the distribution of DFI by U.S. firms among large regions. Notice that Europe receives more than 50 percent of all DFI by U.S. firms. Another 30 percent of DFI is focused on Latin America and Canada, while 16 percent is concentrated in the Asia and Pacific region.

**Distribution of DFI in the United States**

Just as U.S. firms have used DFI to enter markets outside the United States, non-U.S. firms have penetrated the U.S. market. Much of the DFI in the United States comes from the United Kingdom, Japan, the Netherlands, Germany, and Canada. Seagram, Food Lion, and some other foreign-owned MNCs generate more than half of their revenue from the United States. Many well-known firms that operate in the United States are owned by foreign companies, including Shell Oil (Netherlands), Burger King (United Kingdom), Citgo Petroleum (Venezuela), Canon (Japan), and Fireman’s Fund (Germany). Many other firms operating in the United States are partially owned by foreign companies, including MCI Communications (United Kingdom), Universal Studios (Canada), and Northwest Airlines (Netherlands). While U.S.-based MNCs consider expanding in other countries, they must also compete with foreign firms in the United States.

**Factors Affecting DFI**

Many U.S.-based MNCs have recently increased their DFI in foreign countries. For example, ExxonMobil, IBM, and Hewlett-Packard have at least 50 percent of their assets in foreign countries.
Capital flows resulting from DFI change whenever conditions in a country change the desire of firms to conduct business operations there. Some of the more common factors that could affect a country’s appeal for DFI are identified here.

Changes in Restrictions. Restrictions on DFI were lowered in many Eastern European countries during the mid-1990s and in Asian countries following the Asian crisis in the late 1990s. These changes allowed more DFI in these countries.

HTTP:// USING THE WEB

DFI Regulations Information about regulations on direct foreign investment in each country is provided at http://biz.yahoo.com/ifc/. Click on any country listed, then click on Foreign Regulations, and then click on Incoming Direct Investment. Review the restrictions set by that country's government.

Globalization continues to increase in response to reductions in tariffs and other barriers imposed by governments. For example, when PepsiCo, Inc., owner of KFC, Pizza Hut, and Taco Bell (subsequently spun off to Tricon Global Restaurants), the company entered various markets in the Caribbean and Asia that were previously restricted, in pursuit of its goal to be in any country where people desire chicken, pizza, or tacos. Many U.S.-based MNCs, including Bausch & Lomb, Colgate-Palmolive, and General Electric, have been penetrating less developed countries such as Argentina, Chile, Mexico, India, China, and Hungary. New opportunities in these countries have arisen from the removal of government barriers.

Privatization. Direct foreign investment has also been stimulated by the move toward free enterprise, as several national governments have sold some of their operations to corporations and other investors. This privatization has already taken place in some Latin American countries such as Brazil and Mexico, in Eastern European countries such as Poland and Hungary, and in such Caribbean territories as the Virgin Islands. Privatization allows for greater international business as foreign firms can acquire operations sold by national governments.

Governments’ reasons for privatization vary. Privatization was used in Chile to prevent a few investors from controlling all the shares and in France to prevent a possible reversion to a more nationalized economy. In the United Kingdom, privatization was promoted to spread stock ownership across investors, which allowed more people to have a direct stake in the success of British industry.

The primary reason that the market value of a firm may increase in response to privatization is the anticipated improvement in managerial efficiency. Managers in a privately owned firm can focus on the goal of maximizing shareholder wealth, whereas in a state-owned business, the state must consider the economic and social ramifications of any business decision. Also, managers of a privately owned enterprise are more motivated to ensure profitability because their careers may depend on it. For these reasons, privatized firms will search for local and global opportunities that could enhance their value. The trend toward privatization will undoubtedly create a more competitive global marketplace.

Potential Economic Growth. Countries that have more potential economic growth are more likely to attract DFI because firms recognize that they may be able to
capitalize on that growth by establishing more business there. During the Asian crisis, expected economic growth was reduced, which limited the desire of MNCs to expand in that region (even though they were subject to fewer restrictions when acquiring Asian companies).

**Tax Rates.** Countries that impose relatively low tax rates on corporate earnings are more likely to attract DFI. Firms estimate the after-tax cash flows that they would expect to earn when assessing the feasibility of DFI.

**Exchange Rates.** Firms typically prefer to direct DFI to countries where the local currency is strengthening against their own. Under these conditions, they can invest funds to establish their operations in a country while that country’s currency is relatively cheap (weak). Then, earnings from the new operations can periodically be converted back to the firm’s currency at a more favorable exchange rate.

**Factors Affecting International Portfolio Investment**

The desire by individual or institutional investors to direct international portfolio investment to a specific country is influenced by the following factors.

**Tax Rates on Interest or Dividends.** Investors normally prefer to invest in a country where the taxes on interest or dividend income from investments are relatively low. Investors assess their potential after-tax earnings from investments in foreign securities.

**Interest Rates.** Portfolio investment can also be affected by interest rates. Money tends to flow to countries with high interest rates, as long as the local currencies are not expected to weaken.

**Exchange Rates.** If a country’s home currency is expected to strengthen, foreign investors may be willing to invest in the country’s securities to benefit from the currency movement. Conversely, if a country’s home currency is expected to weaken, foreign investors may decide to purchase securities in other countries.

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**HTTP:// USING THE WEB**

**Capital Flow Regulations.** Information about regulations on capital flows to each country is provided at [http://biz.yahoo.com/ifc/](http://biz.yahoo.com/ifc/). Click on any country listed, then click on Foreign Regulations, and then click on Incoming Portfolio Investment. Review the restrictions set by that country’s government.

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**Agencies That Facilitate International Flows**

A variety of agencies have been established to facilitate international trade and financial transactions. These agencies often represent a collection of nations. A description of some of the more important agencies follows.
International Monetary Fund

The United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, in July 1944, was called to develop a structured international monetary system. As a result of this conference, the International Monetary Fund (IMF) was formed. The major objectives of the IMF, as set by its charter, 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. It is clear from these objectives that the IMF’s goals encourage increased internationalization of business.

Before 1973, when exchange rates were maintained within tight boundaries, the IMF concentrated on removing currency exchange restrictions and ensuring currency convertibility, with the goal of encouraging international trade. With the inception of floating exchange rates in 1973 and the onset of the 1974–1975 recession, the IMF became concerned that countries would attempt to reduce their respective currency values as a means of stimulating exports and reducing imports. Consequently, the IMF offered financing arrangements to countries experiencing large balance of trade deficits.

During the international debt crisis that erupted in August 1982, the IMF provided financing to many of the countries experiencing debt-repayment difficulties. The IMF worked with each country individually to develop and implement policies that would improve its balance of trade positions.

One of the key duties of the IMF is its compensatory financing facility (CFF), which attempts to reduce the impact of export instability on country economies. Although it is available to all IMF members, this facility is mainly used by developing countries. A country experiencing financial problems due to reduced export earnings must demonstrate that the reduction is temporary and beyond its control. In addition, it must be willing to work with the IMF in resolving the problem.

Each member country of the IMF is assigned a quota based on a variety of factors reflecting that country’s economic status. Members are required to pay this assigned quota. The amount of funds that each member can borrow from the IMF depends on its particular quota.

The financing by the IMF is measured in special drawing rights (SDRs). The SDR is not a currency but simply a unit of account. It is an international reserve asset created by the IMF and allocated to member countries to supplement currency reserves. The SDR’s value fluctuates in accordance with the value of major currencies.

The IMF played an active role in attempting to reduce the adverse effects of the Asian crisis. In 1997 and 1998, it provided funding to various Asian countries in exchange for promises from the respective governments to take specific actions intended to improve economic conditions. Though the IMF had good intentions, its funding efforts were not always successful. For example, the IMF agreed to $43 billion for Indonesia. The negotiations were tense, as the IMF demanded that President Suharto break up some of the monopolies run by his friends and family members and close some weak banks. Citizens of Indonesia interpreted the bank closures as a banking crisis and began to withdraw their deposits from all banks. In January 1998, the IMF demanded many types of economic reform, and Suharto agreed to them. The reforms may have been overly ambitious, however, and Suharto
failed to institute them. The IMF agreed to renegotiate the terms in March 1998 in a continuing effort to rescue Indonesia, but this effort signaled that a country did not have to meet the terms of its agreement to obtain funding. A new agreement was completed in April, and the IMF resumed its payments to support a bailout of Indonesia. In May 1998, Suharto abruptly discontinued subsidies for gasoline and food, which led to riots. Suharto blamed the riots on the IMF and on foreign investors who wanted to acquire assets in Indonesia at depressed prices.

**World Bank**

The *International Bank for Reconstruction and Development (IBRD)*, also referred to as the *World Bank*, was established in 1944. Its primary objective is to make loans to countries to enhance economic development. For example, the World Bank recently extended a loan to Mexico for about $4 billion over a 10-year period for environmental projects to facilitate industrial development near the U.S. border. Its main source of funds is the sale of bonds and other debt instruments to private investors and governments. The World Bank has a profit-oriented philosophy. Therefore, its loans are not subsidized but are extended at market rates to governments (and their agencies) that are likely to repay them.

A key aspect of the World Bank’s mission is the *Structural Adjustment Loan (SAL)*, established in 1980. The SALs are intended to enhance a country’s long-term economic growth. For example, SALs have been provided to Turkey and to some less developed countries that are attempting to improve their balance of trade.

Because the World Bank provides only a small portion of the financing needed by developing countries, it attempts to spread its funds by entering into cofinancing agreements. Cofinancing is performed in the following ways:

- **Official aid agencies.** Development agencies may join the World Bank in financing development projects in low-income countries.
- **Export credit agencies.** The World Bank cofinances some capital-intensive projects that are also financed through export credit agencies.
- **Commercial banks.** The World Bank has joined with commercial banks to provide financing for private-sector development. In recent years, more than 350 banks from all over the world have participated in cofinancing, including Bank of America, J.P. Morgan Chase & Co., and Citigroup.

The World Bank recently established the *Multilateral Investment Guarantee Agency (MIGA)*, which offers various forms of political risk insurance. This is an additional means (along with its SALs) by which the World Bank can encourage the development of international trade and investment.

The World Bank is one of the largest borrowers in the world; its borrowings have amounted to the equivalent of $70 billion. Its loans are well diversified among numerous currencies and countries. It has received the highest credit rating (AAA) possible.

**World Trade Organization**

The *World Trade Organization (WTO)* was created as a result of the Uruguay Round of trade negotiations that led to the GATT accord in 1993. This organization was established to provide a forum for multilateral trade negotiations and to
settle trade disputes related to the GATT accord. It began its operations in 1995 with 81 member countries, and more countries have joined since then. Member countries are given voting rights that are used to make judgments about trade disputes and other issues.

International Financial Corporation

In 1956 the International Financial Corporation (IFC) was established to promote private enterprise within countries. Composed of a number of member nations, the IFC works to promote economic development through the private rather than the government sector. It not only provides loans to corporations but also purchases stock, thereby becoming part owner in some cases rather than just a creditor. The IFC typically provides 10 to 15 percent of the necessary funds in the private enterprise projects in which it invests, and the remainder of the project must be financed through other sources. Thus, the IFC acts as a catalyst, as opposed to a sole supporter, for private enterprise development projects. It traditionally has obtained financing from the World Bank but can borrow in the international financial markets.

International Development Association

The International Development Association (IDA) was created in 1960 with country development objectives somewhat similar to those of the World Bank. Its loan policy is more appropriate for less prosperous nations, however. The IDA extends loans at low interest rates to poor nations that cannot qualify for loans from the World Bank.

Bank for International Settlements

The Bank for International Settlements (BIS) attempts to facilitate cooperation among countries with regard to international transactions. It also provides assistance to countries experiencing a financial crisis. The BIS is sometimes referred to as the “central banks’ central bank” or the “lender of last resort.” It played an important role in supporting some of the less developed countries during the international debt crisis in the early and mid-1980s. It commonly provides financing for central banks in Latin American and Eastern European countries.

Regional Development Agencies

Several other agencies have more regional (as opposed to global) objectives relating to economic development. These include, for example, the Inter-American Development Bank (focusing on the needs of Latin America), the Asian Development Bank (established to enhance social and economic development in Asia), and the African Development Bank (focusing on development in African countries).

In 1990, the European Bank for Reconstruction and Development was created to help the Eastern European countries adjust from communism to capitalism. Twelve Western European countries hold a 51 percent interest, while Eastern European countries hold a 13.5 percent interest. The United States is the
biggest shareholder, with a 10 percent interest. There are 40 member countries in aggregate.

**How International Trade Affects an MNC’s Value**

An MNC’s value can be affected by international trade as shown in Exhibit 2.13. The cash flows (and therefore the value) of an MNC’s subsidiaries that export to a specific country are typically expected to increase in response to a higher inflation rate (causing local substitutes to be more expensive) or a higher national income (which increases the level of spending) in that country. The expected cash flows of the MNC’s subsidiaries that export or import may increase as a result of country trade agreements that reduce tariffs or other trade barriers. The expected cash flows of some subsidiaries may be reduced if they now face increased competition from foreign exporters as a result of trade agreements.

Cash flows to a U.S.-based MNC that occur in the form of payments for exports manufactured in the United States are expected to increase as a result of a weaker dollar because the demand for its dollar-denominated exports should increase. However, cash flows of U.S.-based importers may be reduced by a weaker dollar because it will take more dollars (increased cash outflows) to purchase the imports. A stronger dollar will have the opposite effects on cash flows of U.S.-based MNCs involved in international trade.

**Exhibit 2.13**

Impact of International Trade on an MNC’s Value

\[
V = \sum_{t=1}^{n} \left[ \frac{E(CF_{i,t}) \times E(ER_{i,t})}{(1+k)^t} \right]
\]

- \(V\) = value of the U.S.-based MNC
- \(E(CF_{i,t})\) = expected cash flows denominated in currency \(j\) to be received by the U.S. parent in period \(t\)
- \(E(ER_{i,t})\) = 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 U.S. parent company
- \(m\) = number of currencies
- \(n\) = number of periods

- National Income in Foreign Countries
- Inflation in Foreign Countries
- Exchange Rate Movements
- Trade Agreements
SUMMARY

The key components of the balance of payments are the current account and the capital account. The current account is a broad measure of the country's international trade balance. The capital account is a measure of the country's long-term and short-term capital investments, including direct foreign investment and investment in securities (portfolio investment).

A country's international trade flows are affected by inflation, national income, government restrictions, and exchange rates. High inflation, a high national income, low or no restrictions on imports, and a strong local currency tend to result in a strong demand for imports and a current account deficit. Although some countries attempt to correct current account deficits by reducing the value of their currencies, this strategy is not always successful.

A country's international capital flows are affected by any factors that influence direct foreign investment or portfolio investment. Direct foreign investment tends to occur in those countries that have no restrictions and much potential for economic growth. Portfolio investment tends to occur in those countries where taxes are not excessive, where interest rates are high, and where the local currencies are not expected to weaken.

SELF TEST

(Answers are provided in Appendix A at the back of the text.)

1. Briefly explain how changes in various economic factors affect the U.S. current account balance.

2. Explain why U.S. tariffs may change the composition of U.S. exports but will not necessarily reduce a U.S. balance of trade deficit.

3. Explain how the Asian crisis affected trade between the United States and Asia.

QUESTIONS AND APPLICATIONS

1. What is the current account generally composed of?

2. What is the capital account generally composed of?

3. Explain why a strong dollar could enlarge the U.S. balance of trade deficit.

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

5. How would a weakening home currency affect the home country's current account, other things being equal?

6. How can government restrictions affect international payments among countries?

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

8. More than 500 U.S. firms have developed offices or factories in China. Many other U.S. firms have become exporters to China in recent years. However, the U.S. government has periodically threatened to restrict business between the United States and China until China improves its human rights record. The U.S. Chamber of Commerce has estimated that heavy restrictions of U.S.-China business could cause layoffs of 150,000 U.S. workers. Should the United States use trade restrictions as a means of encouraging improvements in human rights in some countries? If so, how will this affect U.S. firms that are considering business in less developed countries?

9. It is sometimes suggested that a floating exchange rate will adjust to reduce or elimi-
nate any current account deficit. Explain why this adjustment would occur. Why does the exchange rate not always adjust to a current account deficit?

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

11. In some periods, the dollar substantially depreciated, but the U.S. demand for particular foreign imports was not significantly affected. Explain why.

12. If a U.S. importer is charged higher prices for its imported supplies, what will influence its decision to switch to a U.S. supplier?

13. In some periods, the dollar depreciated against some major currencies but not against others. Would the U.S. balance of trade deficit been larger or smaller if the dollar depreciated against all currencies? Explain.

14. 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?

15. 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?

16. In recent years 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 implicit trade barriers.” What does this statement mean?

17. Explain how the existence of the euro could affect U.S. international trade.

18. In recent years many U.S.-based MNCs have increased their investments in foreign securities, which are not as susceptible to negative shocks in the U.S. market. Also, when MNCs believe that U.S. securities are overvalued, they can pursue non-U.S. securities that are driven by a different market. Moreover, in periods of low U.S. interest rates, U.S. corporations tend to seek investments in foreign securities. In general, the flow of funds into foreign countries tends to decline when U.S. investors anticipate a strong dollar.

a. Explain how expectations of a strong dollar can affect the tendency of U.S. investors to invest abroad.

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

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

Impact of 9/11/01

19. Why do you think international trade volume could be reduced as a result of the terrorist attacks on the United States on September 11, 2001? Are there any products for which international trade may increase?

Internet Application

20. The website address of the Bureau of Economic Analysis is: www.bea.doc.gov.

a. Use this website to assess recent trends in exporting and importing by United States firms. How has the balance of trade changed over the last 12 months?

b. Offer possible reasons for this change in the balance of trade.

Running Your Own MNC

This exercise can be found on the Student CD-ROM.
Ben Holt, chief financial officer (CFO) of Blades, Inc., has decided to counteract the decreasing demand for “Speedos” roller blades by exporting this product to Thailand. Furthermore, due to the low cost of rubber and plastic in Southeast Asia, Holt has decided to import some of the components needed to manufacture “Speedos” from Thailand. Holt feels that importing rubber and plastic components from Thailand will provide Blades with a cost advantage (the components imported from Thailand are about 20 percent cheaper than similar components in the United States). Currently, approximately $20 million, or 10 percent, of Blades’ sales are contributed by its sales in Thailand. Only about 4 percent of Blades’ cost of goods sold is attributable to rubber and plastic imported from Thailand.

Blades faces little competition in Thailand from other U.S. roller blades manufacturers. Those competitors that export roller blades to Thailand invoice their exports in U.S. dollars. Currently, Blades follows a policy of invoicing in Thai baht (Thailand’s currency). Ben Holt felt that this strategy would give Blades a competitive advantage, since Thai importers can plan more easily when they do not have to worry about paying differing amounts due to currency fluctuations. Furthermore, Blades’ primary customer in Thailand (a retail store) has committed itself to purchasing a certain amount of “Speedos” annually if Blades will invoice in baht for a period of three years. Blades’ purchases of components from Thai exporters are currently invoiced in Thai baht.

Ben Holt is rather content with current arrangements and believes the lack of competitors in Thailand, the quality of Blades’ products, and its approach to pricing will ensure Blades’ position in the Thai roller blade market in the future. Holt also feels that Thai importers will prefer Blades over its competitors because Blades invoices in Thai baht.

You, Blades’ financial analyst, have doubts as to Blades’ “guaranteed” future success. Although you believe Blades’ strategy for its Thai sales and imports is sound, you are concerned about current expectations for the Thai economy. Current forecasts indicate a high level of anticipated inflation, a decreasing level of national income, and a continued depreciation of the Thai baht. In your opinion, all of these future developments could affect Blades financially given the company’s current arrangements with its suppliers and with the Thai importers. Both Thai consumers and firms might adjust their spending habits should certain developments occur.

In the past, you have had difficulty convincing Ben Holt that problems could arise in Thailand. Consequently, you have developed a list of questions for yourself, which you plan to present to the company’s CFO after you have answered them. Your questions are listed here:

1. How could a higher level of inflation in Thailand affect Blades (assume U.S. inflation remains constant)?
2. How could competition both from firms in Thailand and from U.S. firms conducting business in Thailand affect Blades?
3. How could a decreasing level of national income in Thailand affect Blades?
4. How could a continued depreciation of the Thai baht affect Blades? How would it affect Blades relative to U.S. exporters invoicing their roller blades in U.S. dollars?
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?
Identifying Factors That Will Affect the Foreign Demand at the Sports Exports Company

Recall from Chapter 1 that Jim Logan planned to pursue his dream of establishing his own business (called the Sports Exports Company) of exporting footballs to one or more foreign markets. Jim has decided to initially pursue the market in the United Kingdom because British citizens appear to have some interest in football as a possible hobby, and no other firm has capitalized on this idea in the United Kingdom. (The sporting goods shops in the United Kingdom do not sell footballs but might be willing to sell them.) Jim has contacted one sporting goods distributor that has agreed to purchase footballs on a monthly basis and distribute (sell) them to sporting goods stores throughout the United Kingdom. The distributor’s demand for footballs is ultimately influenced by the demand for footballs by British citizens who shop in British sporting goods stores. The Sports Exports Company will receive British pounds when it sells the footballs to the distributor and will then convert the pounds into dollars. Jim recognizes that products (such as the footballs his firm will produce) exported from U.S. firms to foreign countries can be affected by various factors.

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