SOLUTIONS MANUAL

Chapter 2

International Flow of Funds

Lecture Outline

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How Trade Affects an MNC's Value

Chapter Theme

This chapter provides an overview of the international environment surrounding MNCs. The chapter is macro-oriented in that it discusses international payments on a country-by-country basis. This macro discussion is useful information for an MNC since the MNC can be affected by changes in a country's current account and capital account positions.

Topics to Stimulate Class Discussion

1. Is a current account deficit something to worry about?

2. If a government wants to correct a current account deficit, why can't it simply enforce restrictions on imports?

3. Why don't exchange rates always adjust to correct current account deficits?

POINT/COUNTER-POINT: Should Trade Restrictions be Used to Influence Human Rights Issues?

POINT: Yes. Some countries do not protect human rights in the same manner as the U.S. At times, the U.S. should threaten to restrict U.S. imports from or investment in a country if it does not correct human rights violations. The U.S. should use its large international trade and investment as leverage to ensure that human rights violations do not occur. Other countries with a history of human rights violations are more likely to honor human rights if their economic conditions are threatened.

COUNTER-POINT: No. International trade and human rights are two separate issues. International trade should not be used as the weapon to enforce human rights. Firms engaged in international trade should not be penalized by the human rights violations of a government. If the U.S. imposes trade restrictions to enforce human rights, the country will retaliate. Thus, the U.S. firms that export to that foreign country will be adversely affected. By imposing trade sanctions, the U.S. government is indirectly penalizing the MNCs that are attempting to conduct business in specific foreign countries. Trade sanctions cannot solve every difference in the beliefs or morals between the more developed countries and the developing countries. By restricting trade, the U.S. will slow down the economic progress of developing countries.

WHO IS CORRECT? Use the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

ANSWER: There is no perfect solution, but the tradeoff should be recognized. When trade is used as the means to correct human rights problems, those firms that initiated their business in other countries could suffer major losses. These firms may argue that they are mistreated by such restrictions, and that the country of concern will not necessarily improve its human rights record even with the restrictions. Yet, if the U.S. ignores the human rights issue, it will be criticized for being too capitalistic, and unwilling to help solve social problems in the world.

Answers to End of Chapter Questions

1. **Effects of Tariffs.** Assume a simple world in which the U.S. exports soft drinks and beer to France and imports wine from France. If the U.S. imposes large tariffs on the French wine, explain the likely impact on the values of the U.S. beverage firms, U.S. wine producers, the French beverage firms, and the French wine producers.

   ANSWER: The U.S. wine producers benefit from the U.S. tariffs, while the French wine producers are adversely affected. The French government would likely retaliate by imposing tariffs on the U.S. beverage firms, which would adversely affect their value. The French beverage firms would benefit.

2. **IMF.**

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

   ANSWER: Major IMF objectives are to (1) promote cooperation among countries on international monetary issues, (2) promote stability in exchange rates, (3) provide temporary funds to member countries attempting to correct imbalances of international payments, (4) promote free mobility of capital funds across countries, and (5) promote free trade.

   b. How is the IMF involved in international trade?

   ANSWER: The IMF in involved in international trade because it attempts to stabilize international payments, and trade represents a significant portion of the international payments.

3. **Currency Effects.** When South Korea’s export growth stalled, some South Korean firms suggested that South Korea’s primary export problem was the weakness in the Japanese yen. How would you interpret this statement?

   ANSWER: One of South Korea’s primary competitors in exporting is Japan, which produces and exports many of the same types of products to the same countries. When the Japanese yen is weak, some importers switch to Japanese products in place of South Korean products. For this reason, it is often suggested that South Korea’s primary export problem is weakness in the Japanese yen.

4. **Exchange Rate Effect on Trade Balance.** Would the U.S. balance of trade deficit be larger or smaller if the dollar depreciates against all currencies, versus depreciating against some currencies but appreciated against others? Explain.

   ANSWER: If the dollar weakens against all currencies, the U.S. balance of trade deficit will likely be smaller. Some U.S. importers would have more seriously considered purchasing their goods in the U.S. if most or all currencies simultaneously strengthened against the dollar. Conversely, if some currencies weaken against the dollar, the U.S. importers may have simply shifted their importing from one foreign country to another.

5. **Impact on International Trade.** Why do you think international trade volume has increased over time? In general, how are inefficient firms affected by the reduction in trade restrictions among countries and the continuous increase in international trade?

ANSWER. International trade volume has increased because of the reduction in trade restrictions over time. It may have also increased for many other reasons, such as increased information flow (via Internet etc.) between firms in different countries. Inefficient firms are adversely affected if they have to face tougher competition from foreign firms as a result of a reduction in trade restrictions.

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

   ANSWER: Governments can place tariffs or quotas on imports to restrict imports. They can also place taxes on income from foreign securities, thereby discouraging investors from purchasing foreign securities. If they loosen restrictions, they can encourage international payments among countries.

7. **Effects of the Euro.** Explain how the existence of the euro may affect U.S. international trade.

   ANSWER: The euro allowed for a single currency among many European countries. It could encourage firms in those countries to trade among each other since there is no exchange rate risk. This would possibly cause them to trade less with the U.S.

   The euro can increase trade within Europe because it eliminates the need for several European countries to exchange currencies when trading with each other.

8. **Inflation Effect on Trade.**

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

   ANSWER: A high inflation rate tends to increase imports and decrease exports, thereby increasing the current account deficit, other things equal.

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

   ANSWER: This question is intended to encourage opinions and does not have a perfect solution. A negative current account is thought to reflect lost jobs in a country, which is unfavorable. Yet, the foreign importing reflects strong competition from foreign producers, which may keep prices (inflation) low.

9. **Demand for Exports.** A relatively small U.S. balance of trade deficit is commonly attributed to a strong demand for U.S. exports. What do you think is the underlying reason for the strong demand for U.S. exports?

   ANSWER: The strong demand for U.S. exports is commonly attributed to strong foreign economies or to a weak dollar.

10. **Balance of Payments.**

    a. Of what is the current account generally composed?

    ANSWER: The current account balance is composed of (1) the balance of trade, (2) the net amount of payments of interest to foreign investors and from foreign investment, (3) payments from international tourism, and (4) private gifts and grants.

b. Of what is the capital account generally composed?

ANSWER: The capital account is composed of all capital investments made between countries, including both direct foreign investment and purchases of securities with maturities exceeding one year.

Advanced Questions

11. International Investments. U.S.-based MNCs commonly invest in foreign securities.

a. Assume that the dollar is presently weak and is expected to strengthen over time. How will these expectations affect the tendency of U.S. investors to invest in foreign securities?

ANSWER:
The expectations of a strong dollar would discourage U.S. investors from investing abroad. If the dollar is relatively weak now, U.S. investors need more dollars to make purchase foreign currency (when investing). If the dollar strengthens over their investment horizon, they will exchange the foreign currency (as the investment is liquidated) into dollars at a less favorable exchange rate than the exchange rate at which they converted dollars into the foreign currency. That is, the exchange rate effect would reduce the yield that they earn on their investment.

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

ANSWER: Low U.S. interest rates can encourage U.S.-based MNCs to invest abroad, as investors seek higher returns on their investment than they can earn in the U.S.

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

ANSWER: The main attraction is potentially higher returns. The international stocks can outperform U.S. stocks, and international bonds can outperform U.S. bonds. However, there is no guarantee that the returns on international investments will be so favorable. Some investors may also pursue international investments to diversify their investment portfolio, which can possibly reduce risk.

12. Exchange Rate Effects on Trade.

a. Explain why a stronger dollar could enlarge the U.S. balance of trade deficit. Explain why a weaker dollar could affect the U.S. balance of trade deficit.

ANSWER: A stronger dollar makes U.S. exports more expensive to importers and may reduce imports. It makes U.S. imports cheap and may increase U.S. imports. A weaker home currency increases the prices of imports purchased by the home country and reduces the prices paid by foreign businesses for the home country's exports. This should cause a decrease in the home country's demand for imports and an increase in the foreign demand for the home country's exports, and therefore increase the current account. However, this relationship can be distorted by other factors.

b. It is sometimes suggested that a floating exchange rate will adjust to reduce or eliminate any current account deficit. Explain why this adjustment would occur.

ANSWER: A current account deficit reflects a net sale of the home currency in exchange for other currencies. This places downward pressure on that home currency's value. If the currency weakens, it will reduce the home demand for foreign goods (since goods will now be more expensive), and will increase the home export volume (since exports will appear cheaper to foreign countries).

c. Why does the exchange rate not always adjust to a current account deficit?

ANSWER:
In some cases, the home currency will remain strong even though a current account deficit exists, since other factors (such as international capital flows) can offset the forces placed on the currency by the current account.

13. Free Trade. There has been considerable momentum to reduce or remove trade barriers in an effort to achieve "free trade." Yet, one disgruntled executive of an exporting firm stated, "Free trade is not conceivable; we are always at the mercy of the exchange rate. Any country can use this mechanism to impose trade barriers." What does this statement mean?
ANSWER: This statement implies that even if there were no explicit barriers, a government could attempt to manipulate exchange rates to a level that would effectively reduce foreign competition. For example, a U.S. firm may be discouraged from attempting to export to Japan if the value of the dollar is very high against the yen. The prices of the U.S. goods from the Japanese perspective are too high because of the strong dollar. The reverse situation could also be possible in which a Japanese exporting firm is priced out of the U.S. market because of a strong yen (weak dollar). [Answer is based on opinion.]

Solution to Continuing Case Problem: Blades, Inc.

1. How could a higher level of inflation in Thailand affect Blades (assume U.S. inflation remains constant)?

ANSWER: A high level of inflation in Thailand relative to the United States could affect Blades favorably. Generally, if a country's inflation rate increases relative to the countries with which it trades, consumers and corporations within the country will most likely purchase more goods overseas, as local goods become more expensive. Consequently, Blades' sales to Thailand may increase.

2. How could competition from firms in Thailand and from U.S. firms conducting business in Thailand affect Blades?

ANSWER: Blades would be favorably affected relative to Thai roller blade manufacturers and relative to other U.S. roller blade manufacturers with operations in Thailand. Both groups of firms will likely be forced to raise their prices if they want to maintain the same profit margin should inflation in Thailand increase. This is especially true if both groups of firms source their supplies directly from Thailand, so that the prices of these supplies are subject to the higher inflation in Thailand. Conversely, Blades' cost of goods sold incurred in Thailand is relatively small. Consequently, costs will not be subject to the higher level of inflation in Thailand to a great extent and Blades will probably not have to raise its prices to the same extent as Thai roller blade manufacturers or U.S. manufacturers with operations in Thailand.

3. How could a decreasing level of national income in Thailand affect Blades?

ANSWER: At first glance, it would appear that a decreasing level of national income in Thailand could hurt Blades financially, as Thai consumers will have less money to spend. Furthermore, this effect may be magnified because Blades manufactures a leisure product, which is probably one of the first products Thai consumers will stop buying. The arrangement Blades has with its primary Thai importer mitigates this effect somewhat, since the latter has committed himself to the purchase of a certain number of "Speedos" annually. Nevertheless, the importer may not offer to renew this arrangement in excess of the original three years if the Thai economy does not improve.

4. How could a continued depreciation of the Thai baht affect Blades? How would it affect Blades' relative to U.S. exporters invoicing their roller blades in U.S. dollars?

   ANSWER: A continued depreciation of the Thai baht would hurt Blades, especially because the firm invoices its roller blades in baht. A continued depreciation of the baht means that the baht-denominated revenue in Thailand will convert to fewer U.S. dollars. Blades also has some expenses in baht, but this amount is less than the revenue denominated in baht.

   Although Blades would be hurt by a depreciating baht because its exports are denominated in baht, the demand for Blades' products may increase relative to that of its U.S. competitors exporting to Thailand. This is because most of the U.S. firms exporting roller blades to Thailand invoice their products in U.S. dollars. If the baht depreciates, Thai importers will have to convert more baht to dollars in order to pay for the dollar-denominated exports.

5. If Blades increases its business in Thailand and experiences serious financial problems, are there any international agencies that the company could approach for loans or other financial assistance?

   ANSWER: An agency extending direct loans to corporations involved in international trade is the International Financial Corporation (IFC). Besides extending loans, the IFC may also purchase stock in a corporation, thereby becoming part owner.

Solution to Supplemental Case: Maple Leaf Paper Company

This case reflects the actual experience of a Canadian exporting firm (although the name and industry have been changed) to the free-trade agreement on January 2, 1989. The appreciation in Canadian dollars (resulting from the agreement) offset the tariff, so that the firm was no better off with the free-trade agreement. The case shows that the effects of free trade are not always so obvious and may differ across firms.

a. While the tariff allowed for a 12 percent decline in price, the U.S. clients will have to pay more dollars to obtain Canadian dollars in the future, based on the forecast of the exchange rate. The exchange rate is expected to rise by 13.15 percent. Given that the 12 percent tariff is removed along with the exchange rate movement, the net effect will be an increase in price to U.S. clients of about one percent. Based on the relationship between the price and U.S. demand, the U.S. demand for Maple Leaf paper should decline 3 percent in response to the one percent increase in price. This implies a U.S. demand of 174,600 rolls of paper per year.
   In Canada, the 20 percent increase in demand (provided in the case) implies an annual demand of 24,000 rolls. Therefore, the total demand for Maple Leaf paper should be around 198,600 rolls, which is slightly less than the total demand in the past.

b. The precise forecast is not as important as the general concept here. What seemed to be a favorable event does not benefit Maple Leaf. While the free-trade agreement allows for the removal of tariffs, it causes a shift in international trade flows, which places upward pressure on the Canadian dollar's value. The appreciation of the Canadian dollar is expected to overwhelm the effect of removing the tariff, forcing the price in U.S. dollars to rise.

c. The U.S. exporting firm is not directly affected by the removal of the tariff on Canadian exports, but would benefit from the appreciation of the Canadian dollar.

Small Business Dilemma

Identifying Factors That Will Affect the Foreign Demand at the Sports Exports Company

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

ANSWER:

1. High inflation in the U.K. could cause a shift in the demand for U.S. products instead of British products. However, at this time there is not a British producer of footballs, so that high British inflation will not cause an increase in the demand for U.S.-produced footballs.

2. High national income in the U.K. could increase the amount of spending by British consumers, and would therefore cause an increase in the demand for footballs produced by the Sports Exports Company. A lower national income in the U.K. would have the opposite effect.

3. Government restrictions could be imposed by the British government on goods (such as the footballs) exported by U.S. firms. However, footballs are not likely to be targeted by the British government as a product that should be subject to restrictions.

4. The exchange rate of the British pound will change over time. However, since the Sports Exports Company is willing to accept pounds when it sells footballs to the distributor, the distributor does not have to convert the pounds into dollars. Therefore, the British demand for footballs is not affected by changes in the value of the pound (unless this causes the Sports Exports Company to change the price it charges for the footballs someday).