



Financial Forces

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A currency joke: "What's the exchange rate between the British pound, the U.S. dollar and the Russian ruble?
—One pound of rubles equals a U.S. dollar."

—Brad Templeton, <http://www.templetons.com/brad/>

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U.S. Consumers Credited with Saving the World from Recession

The U.S. consumers have been like Atlas recently, carrying the world on its shoulders. So suggests Christopher Swann in a recent article in the *Financial Times* (of London). The spending of Americans has been relentless, compared to that of Europeans and Asians, despite serious stock market dips, rising unemployment, terrorism, and war. A wide range of economists suggests that this spending has been an important factor in averting a deep world recession.

U.S. consumers have increased their spending in every quarter from the end of 1991 to the present. In fact, after discounting inflation, consumer spending rose by 55 percent. This is compared to a 23 percent increase in the euro zone and a 16 percent increase in Japan.

Can this marathon of consumption continue? That is the question, the *Financial Times* suggests, for economists now. The answer lies in the U.S. labor market, whose growth has been sluggish, even in a growing economy. Earnings growth in the year leading up to January 2004 was at only 2 percent, with an inflation rate at 1.9 during the same period. Job creation rates have also been low.

The U.S. government appears committed to averting a recession. The Federal Reserve has been active, the most proactive of the world's central banks. Tax cuts have also been fortunately timed. They led to a 6.9 percent increase in consumption in the third quarter of 2003. According to Nariman Behravesh, chief economist at Global Insight, an economic consultancy, "Policymakers have been shoveling money into people's pockets in an effort to keep them spending." Auto companies have also gone to the market with great deals that give incentives to buy.

Despite the negative economic indicators, the housing market's rising value has given Americans a sense of wealth, and equity-based loans have given consumers a way to access some of their equity without selling. The cash raised through these equity-based loans is estimated at \$775 billion for last year, 2003. "Credit has been democratized," observes Brian Nottage, an economist at Economy.com. He points out that there is a very relaxed attitude toward credit, with the young and people with low incomes able to leverage against their future earnings. Bankruptcy is also far less stigmatized in the United States than in Europe. Ten years ago, nine households in 1,000 declared bankruptcy. The rate now is 15 in every 1,000.

Source: Christopher Swann, "Carefree Spenders Take Care of World Economy," *Financial Times*, February 10, 2004, p. 7.

CONCEPT PREVIEWS

After reading this chapter, you should be able to:

realize that money can be made—and lost—in the foreign exchange (Fx) markets

understand Fx quotations, including cross rates

recognize currency exchange risks

understand currency exchange controls

understand how financial forces such as balance of payments, tariffs, taxes, inflation, fiscal and monetary policies, and differing accounting practices affect business

explain sovereign debt, its causes, and some of its possible solutions

recognize that a new small business in a developing country might be a better credit risk than the government in a developing country

sovereign debt

Debt of the govern-
ment of a sovereign
nation

The uncontrollable financial forces that we will discuss include: foreign currency exchange risks, national balances of payment, taxation, tariffs, national monetary and fiscal policies, inflation, and national business accounting rules. *Uncontrollable* means that these financial forces originate outside the business enterprise. It does not mean that the financial management of a company is helpless in the face of these uncontrollable financial forces.

We will look at what causes exchange rates to change and at how governments sometimes intervene in foreign exchange markets. We will emphasize the importance for management of remaining aware of balance-of-payments developments, exchange rate forecasts, inflation forecasts, government fiscal and monetary policies, and other financial forces. And at the end of the chapter, we will look at **sovereign debt**.

Fluctuating Currency Values

In Chapters 4 and 5, we spoke of the European Monetary System, which has created a European central bank and a single currency (the euro), and we learned there is powerful opposition in the three non-euro-zone EU countries (Denmark, Sweden, United Kingdom) to giving up their own currencies as well as yielding their sovereignty to the powers of the EU central bank. After a slow start, the euro has been successful.

Outside the EU, there are no comparable efforts by countries to tie major currency values to each other or to integrate monetary systems. Most currencies in the world are free to fluctuate against each other. You will recall that the Bretton Woods conference (discussed in Chapter 5) established fixed exchange rates. That system was eliminated in 1971 and replaced with freely floating exchange rates. Although central banks occasionally intervene in the foreign exchange markets by buying and selling large amounts of a currency, for the most part major currencies fluctuate freely against each other. These fluctuations may be quite large. Financial managers must understand how to protect against losses or optimize gains from such fluctuations. Another level of currency exchange risk is encountered when a nation suspends or limits convertibility of its currency, and managers must try to minimize or avoid losses resulting from large holdings of inconvertible and otherwise less useful currencies.

In the United States, the symbol \$ generally refers to U.S. dollars. One must be careful, as the \$ symbol is also used elsewhere in the world to denote local currencies. For example, Australia, Canada, and New Zealand call the local currency the dollar and use the \$ symbol to refer to the local currency, as do Singapore, Taiwan, and Zimbabwe. The same is true in Hong Kong. And Mexico, which calls its currency the peso, uses the \$ symbol to denote the Mexican peso.

When you want to convert one currency into another currency, you might first look for the value of the currency you have in terms of the one you want. You can find international currency exchange quotations in business publications such as *The Wall Street Journal* and the *Financial Times* and in the business section of most major newspapers. Xenon Laboratories, Inc., has developed what it calls the Universal Currency Converter, which allows you to see exchange rates on the Internet at www.xe.com/ucc.

Foreign Exchange Quotations

Foreign exchange quotations—the price of one currency expressed in terms of another—can be confusing until you have examined how they are reported. In the world's currency exchange markets, the U.S. dollar (US\$) is the common unit being exchanged for other currencies. Recent research shows that from 1998 to 2001, the U.S. dollar was on one side of around 90 percent of the foreign exchange transactions.¹ Even if a holder of Japanese yen (¥) wants British pounds (£), the trade, particularly if it involves a large amount, usually will be to buy US\$ with the ¥ and then to buy £s with the US\$. The reasons for this procedure are historical and practical.

The international monetary system established at Bretton Woods just before the end of World War II set the value of the US\$ in terms of gold at \$35 per ounce. The values of all the other major currencies were then stated in terms of the US\$. For example, the yen was worth

0.28 of a U.S. cent, the French franc (Ff) was worth 18 cents, the German mark (DM) was worth 27 cents, and the British pound (£) was worth \$2.40. In other words, the US\$ was established as the keystone currency at the center of the world's monetary system. Bretton Woods selected the US\$ as the cornerstone because the US\$ was viewed as the strongest, most stable currency and the United States economy was in the best position to lead the rest of the world out of the economic problems caused by World War II. (At the time of Bretton Woods in 1945, France's official currency was the franc and Germany's was the mark. Both countries now use the euro as their official currency.)

The practical reasons for the continuing central position of the US\$ involve the functions it performs in the world. It is the main **central reserve asset** of many countries. It is the most used **vehicle currency** and **intervention currency**.

Liberia, Panama, and El Salvador use the US\$ as their official currency, and Israel uses it as a parallel currency to the shekel. It has been a preferred medium of exchange and store of value in Poland and many other countries in Eastern Europe and elsewhere. (Store of value means that people view the US\$ as a good currency to hold to protect their assets. The US\$ is viewed as a better store of value than are many currencies because of the desire to protect assets from erosion due to instability of other currencies.) Ecuador, for example, in the year 2000, adopted the US\$ as its currency. After a six-month transition period, the US\$ replaced the local Ecuadorian currency, the sucre. The decision by the Ecuadorian government to dollarize the Ecuadorian economy came as a surprise to many people both within Ecuador and abroad, even though Ecuador had experienced recession and inflation. In 1999, the sucre lost two-thirds of its value and the economy shrank by 7.5 percent. These economic problems convinced the Ecuadorian government to replace the sucre with the US\$.² Even though many in Ecuador lament the loss of the local currency, most recognize that acceptance of the dollar was necessary to ensure financial security.

The US\$ is in demand worldwide for several reasons, including its **safe haven** aspect and its universal acceptance in most countries. Even if U.S. interest rates and investment opportunities were less attractive, many would still feel that money is safe in American securities or property. Inflation in the United States has been brought to a low level, and the country's political risk is low. It is seen as less likely than others to be invaded or to have its government collapse. One problem with universal use of U.S. dollars is the increased opportunity for counterfeiting. This is especially true in certain countries.

At an April 2004 congressional hearing, Secret Service Deputy Assistant Director Bruce Townsend, who has responsibility for investigations of counterfeiting and other financial crimes, testified that U.S. and other law enforcement agencies seized about \$63 million in counterfeit U.S. currency in 2003. Approximately \$10.7 million of this was seized in the United States, while more than \$31 million was seized in Colombia.³ Investigations of counterfeiting used to be a part of the Treasury Department and were moved to the Department of Homeland Security in March 2003.

Although Colombia is the single largest producer of counterfeit U.S. currency, cooperation between U.S. and Colombian authorities has been successful. Townsend reported a 37 percent reduction in Colombian-produced counterfeit currency passed in the United States (\$15.3 million passed in 2002; \$9.6 million in 2003). Townsend also cited Bulgaria as one of the countries where counterfeiting is on the increase.

To appreciate the scope of the potential problem, it may help to know that around \$670 billion in genuine U.S. currency is currently in circulation in the United States and an amount as much as two-thirds of that, known as Eurodollars, is circulated overseas, according to the same Secret Service report.

Exchange Rates

Figure 11.1 is the listing of currency trading from *The Wall Street Journal* for the two business days preceding Tuesday, August 3, 2004. The top part of Figure 11.1 is "Key Currency Cross Rates," which is discussed below. The other part of Figure 11.1 is "Exchange Rates." You will notice in Figure 11.1 that there is no entry for the 12 individual euro-zone countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain) as they all use the euro as their official currency.

central reserve asset

Asset, usually currency, held by a government's central bank

vehicle currency

A currency used as a vehicle for international trade or investment

intervention currency

A currency used by a country to intervene in the foreign currency exchange markets (e.g., using some of its U.S. dollar reserve to buy—and thus strengthen—its own currency)

safe haven

In reference to the U.S. dollar, a political concept based on the belief that the United States is less likely than most countries to have communist government or to be subjected to a military coup or revolution

FIGURE 11.1 Foreign Exchange Quotations

Key Currency Cross Rates								Late New York Trading Monday, August 2, 2004							
	Dollar	Euro	Pound	SFranc	Peso	Yen	CdnDir								
Canada	1.3319	1.6024	2.4349	1.0418	.116874	.01203	...								
Japan	110.68	133.16	202.34	86.574	9.709	...	83.099								
Mexico	11.3999	13.7152	20.840	8.9170	...	.10300	8.5591								
Switzerland	1.2784	1.5381	2.3371	...	.11215	.01155	.9599								
U.K.	.54700	.6581	...	.4279	.04798	.00494	.41070								
Euro	.83120	...	1.5195	.65015	.07291	.00751	.62405								
U.S.	...	1.2031	1.8281	.78220	.08772	.00904	.75080								

Exchange Rates		August 2, 2004							
The foreign exchange mid-range rates below apply to trading among banks in amounts of \$1 million and more, as quoted at 4 p.m. Eastern time by Reuters and other sources. Retail transactions provide fewer units of foreign currency per dollar.									
Country	U.S. \$ EQUIVALENT		CURRENCY PER U.S. \$		Country	U.S. \$ EQUIVALENT		CURRENCY PER U.S. \$	
	Mon	Fri	Mon	Fri		Mon	Fri	Mon	Fri
Argentina (Peso)-y	.3348	.3355	2.9869	2.9806	New Zealand (Dollar)	.6420	.6357	1.5576	1.5731
Australia (Dollar)	.7044	.7020	1.4196	1.4245	Norway (Krone)	.1425	.1425	7.0175	7.0175
Bahrain (Dinar)	2.6524	2.6525	.3770	.3770	Pakistan (Rupee)	.01710	.01713	58.480	58.377
Brazil (Real)	.3282	.3292	3.0469	3.0377	Peru (new Sol)	.2934	.2926	3.4083	3.4176
Canada (Dollar)	.7508	.7523	1.3319	1.3293	Philippines (Peso)	.01791	.01786	55.835	55.991
1-month forward	.7504	.7520	1.3326	1.3298	Poland (Zloty)	.2737	.2750	3.6536	3.6364
3-months forward	.7499	.7514	1.3335	1.3308	Russia (Ruble)-a	.03432	.03436	29.138	29.104
6-months forward	.7492	.7507	1.3348	1.3321	Saudi Arabia (Riyal)	.2666	.2667	3.7509	3.7495
Chile (Peso)	.001558	.001553	641.85	643.92	Singapore (Dollar)	.5827	.5819	1.7161	1.7185
China (Renminbi)	.1208	.1208	8.2781	8.2781	Slovak Rep. (Koruna)	.03000	.02998	33.333	33.356
Colombia (Peso)	.0003837	.0003827	2606.20	2613.01	South Africa (Rand)	.1579	.1596	6.3331	6.2657
Czech. Rep. (Koruna)					South Korea (Won)	.0008587	.0008573	1164.55	1166.45
Commercial rate	.03802	.03796	26.302	26.344	Sweden (Krona)	.1305	.1303	7.6628	7.6746
Denmark (Krone)	.1618	.1617	6.1805	6.1843	Switzerland (Franc)	.7822	.7806	1.2784	1.2811
Ecuador (US Dollar)	1.0000	1.0000	1.0000	1.0000	1-month forward	.7829	.7814	1.2773	1.2798
Egypt (Pound)-y	.1612	.1610	6.2050	6.2116	3-months forward	.7844	.7829	1.2749	1.2773
Hong Kong (Dollar)	.1282	.1282	7.8003	7.8003	6-months forward	.7869	.7853	1.2708	1.2734
Hungary (Forint)	.004821	.004843	2.0743	2.0648	Taiwan (Dollar)	.02946	.02942	33.944	33.991
India (Rupee)	.02161	.02157	46.275	46.361	Thailand (Baht)	.02420	.02421	41.322	41.305
Indonesia (Rupiah)	.0001094	.0001094	9141	9141	Turkey (Lira)	.0000068	.0000068	1470588	1470588
Israel (Shekel)	.2212	.2215	4.5208	4.5147	U.K. (Pound)	1.8281	1.8211	.5470	.5491
Japan (Yen)	.009035	.008993	110.68	111.20	1-month forward	1.8226	1.8160	.5487	.5507
1-month forward	.009048	.009005	110.52	111.05	3-months forward	1.8133	1.8064	.5515	.5536
3-months forward	.009074	.009032	110.21	110.72	6-months forward	1.7998	1.7930	.5556	.5577
6-months forward	.009124	.009082	109.60	110.11	United Arab (Dirham)	.2723	.2723	3.6724	3.6724
Jordan (Dinar)	1.4104	1.4104	.7090	.7090	Uruguay (Peso)				
Kuwait (Dinar)	3.3920	3.3929	.2948	.2947	Financial	.03400	.03400	29.412	29.412
Lebanon (Pound)	.0006606	.0006605	1513.78	1514.00	Venezuela (Bolívar)	.000521	.000521	1919.39	1919.39
Malaysia (Ringgit)-b	.2632	.2632	3.7994	3.7994					
Malta (Lira)	2.8354	2.8321	.3527	.3531	SDR	1.4609	1.4578	.6845	.6860
Mexico (Peso)					Euro	1.2031	1.2024	.8312	.8317
Floating rate	.0877	.0876	11.3999	11.4155					

Special Drawing Rights (SDR) are based on exchange rates for the U.S., British, and Japanese currencies. Source: International Monetary Fund.

a-Russian Central Bank rate. b-Government rate. y-Floating rate.

Source: From *The Wall Street Journal*, August 3, 2004. Copyright © 2004 by Dow Jones & Co., Inc. Reproduced with permission of Dow Jones & Co., Inc. via Copyright Clearance Center.

The Exchange Rates part of Figure 11.1 shows the US\$ equivalent rate and the currency per US\$ rate. The US\$ equivalent rate is the cost in U.S. dollars of one unit of another currency. For example, Figure 11.1 (Exchange Rates) shows that the price (indicated as the US\$ equivalent rate) of Switzerland's currency, the franc, on Monday, August 2, 2004, was .7822. This means that one Swiss franc cost US\$.7822, or about 78 cents. For another example, look at the Japanese yen, which is quoted at .009035. Each yen costs that fraction of a dollar, less than one cent. This does not mean that prices are inexpensive in Japan. In fact, quite the con-

trary, Japan is an expensive market for dollar-based consumers. An example of a currency that costs more than a U.S. dollar is the British pound listed under U.K., at \$1.828, meaning one pound can be purchased for \$1.83.

We have looked at the cost of foreign currency in U.S. dollars. The currency per US\$ rate, on the other hand, is the price of one U.S. dollar in another currency. The currency per US\$ rate of the Australian dollar for Monday, August 2, 2004, was 1.4196. That means one US\$ cost about 1.42 Australian dollars.

Depending on what transaction is occurring, it may be necessary to convert from the US\$ equivalent rate to the currency per US\$ rate. By using the reciprocal of the US\$ equivalent rate, one can reach the currency per US\$ rate, and vice versa:

$$\frac{1}{\text{US\$ equivalent rate}} = \text{currency per US\$ rate}$$

$$\frac{1}{\text{currency per US\$ rate}} = \text{US\$ equivalent rate}$$

There is more to be learned from reading the exchange rates quotes. Using the Exchange Rates of Figure 11.1, you will see that exchange rates for the preceding Friday are also given. Comparing the two prices tells you whether the currency is weakening or strengthening.

Spot Rates The **spot rate** is the exchange rate between two currencies for their immediate trade for delivery within two days. The rate on the same line as the name of the country is the spot rate. You will note in the Exchange Rates in Figure 11.1 that the spot rate for Swiss francs was .7822 for Monday.

Forward Rates The **forward rate** is the cost today for a commitment to buy or sell an agreed amount of a currency at a fixed, future date. The commitment is a forward contract, and for frequently traded currencies such contracts are usually available on a 30-, 60-, 90-, or 180-day basis. You may be able to negotiate with banks for different time periods or for contracts in other currencies.

In the Exchange Rates in Figure 11.1, look under Switzerland and refer to the Swiss franc one-month forward rate quotation. For Monday, August 2, 2004, it was .7829. Compare that rate with the spot rate of .7822, and you will see that it would cost more in US\$ to buy a Swiss franc for delivery in one month than for delivery today. The Swiss franc is said to be **trading at a premium** in the one-month forward market. Look then at the three-month and six-month rate quotations, and you see that on Monday, the Swiss franc cost .7844 and .7869, respectively, for three-month and six-month delivery. These prices are also *more* expensive, or stronger, and so the Swiss franc is trading at a *premium* in all the reported forward periods. Conversely, if a currency's forward rate quotes are *less* expensive, or weaker, than the spot rate, the currency is said to be **trading at a discount** in the forward markets.

Whether there is a premium or a discount and its size depend on the expectations of the world financial community, businesses, individuals, and governments about what the future will bring. These expectations factor in such considerations as supply and demand forecasts for the two currencies, relative inflation in the two countries, relative productivity and unit labor cost changes, expected election results or other political developments, and expected government fiscal, monetary, and currency exchange market actions.

So Many Yen, So Few Pounds

Look again at the Exchange Rates in Figure 11.1, and you will see that it took about 111 yen to buy 1 US\$, whereas less than 1 pound was enough for a dollar. Glancing up and down the column, you find that an Indonesian rupiah holder would need over 9,141 rupiahs for US\$1 and that holders of each of the other currencies quoted require a different number. It might seem that the fewer units of a currency required to buy a dollar, the “harder” or better that currency is compared to the others, but as we have seen before, that is not necessarily correct. (Look at Japan, for example.) Outside of controlled economies, supply and demand forces in the foreign exchange markets for the most part today set the price of currencies. As

spot rate

The exchange rate between two currencies for delivery within two business days

forward rate

The exchange rate between two currencies for delivery in the future, commonly 30, 60, 90, or 180 days

trading at a premium

When a currency's forward rate quotes are stronger than spot

trading at a discount

When a currency's forward rate quotes are weaker than spot

mentioned before, in 1945, currencies of the world’s major trading countries were set in value relative to the US\$. Those exchange rates were the rates in the markets at that time. Since then, and particularly since 1973, the relative values of currencies and the ease of their convertibility have been set by the market forces, which are influenced by many factors including trade policies of governments, monetary and fiscal policies such as decisions on taxation and interest rates, and by uncontrollable forces including world events, inflation, and unemployment. *Monetary policies* control the amount of money in circulation, whether it is growing, and, if so, at what pace. *Fiscal policies* address the collecting and spending of money by governments. What kinds of taxes at what rates? On what and in what amounts does the government spend money?

Values of currencies in terms of each other do not remain fixed, but change, sometimes rapidly, as the currencies are traded in the world’s financial centers. What happens in the Tokyo foreign exchange market affects the London and New York markets.

An international traveler will need currencies for use in the countries in which that traveler is visiting. Often credit cards and automatic teller machine (ATM) cards can be used instead of the local currency. Use of credit cards can be expensive, though, as credit card companies generally charge a foreign transaction fee that can be as high as 2 or 3 percent of the total amount of the purchase.



Bid and Ask Prices When travelers or businesses contact a bank or an exchange agency to buy or sell a currency, they find a bid price and an asked price. The bid is the lower and it is the dealer’s offer to buy from you. The quotation for the Swiss franc may be .78 bid and .82 asked. If the customer has francs to sell, the bank or agency is bidding—offering—78 cents (U.S. pennies) for each franc. If the customer wants to buy francs, the bank or agency is asking 82 cents, a higher price. The difference provides a margin for the bank or agency. The rates listed in financial publications, such as those shown in *The Wall Street Journal* (Figure 11.1), are for customers buying large quantities, usually US\$1 million or more. The rates charged to small customers are much less favorable to the customer. Banks intend to make a profit in currency transactions.

Remember that when discussing exchange rates, we need to be clear about what currency we are using and what currency (a commodity) we are buying. Again, novices sometimes mix up their perspectives, which is easy to do because the terms used to describe market fluctuations are mirror images (hard and soft, strong and weak, dear and cheap).

Cross Rates

In addition to the US\$, currencies of other developed countries are also important in world transactions and are becoming more important. This is particularly true of the Japanese yen (¥) and the EU euro (€). Many expect the euro to become as frequently used as the dollar. Although most large currency exchanges go through the US\$, it is possible to find exchange rates for trading directly between non-US\$ currencies. These rates are called **cross rates**. See the Key Currency Cross Rates in Figure 11.1 for an example of the quotes for cross rates from *The Wall Street Journal*.

cross rates

Currency exchange rates directly between non-US\$ currencies; usually determined by comparing the US\$ exchange rates of the other currencies

Fluctuating Exchange Rates Create Risk

When your activities involve more than one country, usually you must deal with more than one currency. For example, a U.S. company exporting to Switzerland will, in most cases, want to receive US\$. If credit is involved, payment is not made when the goods are delivered, and one of the parties will have a currency exchange risk. If the Swiss importer agrees to pay Swiss francs, then the U.S. exporter bears a risk that the value of the Swiss franc will fall and thus the Swiss francs will buy fewer US\$ when received than they would have at the earlier goods delivery date. On the other hand, if the Swiss importer agrees to pay in US\$ at a future time, then the importer bears that risk (see Figure 11.2.)

Company financial managers have strategies for dealing with this type of risk, presented in Chapter 20. Another potential hazard for a company is that a country in which it has assets may institute currency exchange controls.



FIGURE 11.2 Currency Exchange Risk

February 1 Suppose:	Goods delivery date exchange rate US\$1 = 1.78 Swiss francs Whichever party bore the currency exchange risk, neither gained or lost.	August 1	Payment date exchange rate US\$1 = 1.78 Swiss francs
Suppose:	US\$1 = 1.78 Swiss francs Whichever party bore the currency exchange risk lost. It now requires 1.80 Swiss francs to buy the US\$1, which could have been bought for 1.78 Swiss francs at the time the goods were delivered.		US\$1 = 1.80 Swiss francs
Suppose:	US\$1 = 1.78 Swiss francs Whichever party bore the currency exchange risk gained. It now requires only 1.76 Swiss francs to buy the US\$1, which would have cost 1.78 Swiss francs at the time the goods were delivered.		US\$1 = 1.76 Swiss francs

Note: Parties agree to payment in US\$.

Are Foreign Exchange Markets Truly Competitive?

Foreign currency markets come under criticism for their lack of competition. An article in *The Wall Street Journal* stated, “Currency trading is the largest and least regulated market in the world, a Wild West of global capitalism where more than \$1.2 trillion changes hands each day. Unlike major stock and commodities markets, the foreign-exchange market, or FX, operates with virtually no government or regulatory oversight.”⁴

Currency Exchange Controls

Currency exchange controls limit or prohibit the legal use of a country’s currency in international transactions. Typically, the value of the currency is arbitrarily fixed at a rate higher than its value in the free market, and it is decreed that all purchases or sales of other currencies be made through a government agency. A black market inevitably springs up, but it is of little use to a finance manager, who wants to abide by the laws of a country in which the company is operating. In addition, the black market is rarely able to accommodate transactions of the size involved in a multinational business.

Thus, the company must pay more than the free market rate if the government grants permission to buy foreign currency. If permission is not granted or if the cost of foreign currency is uneconomically high, the blocked currency can be used only within the country. This usually presents problems of finding suitable products and investments within the country. When faced with blocked currency in the former Soviet Union, Pepsi once bought an oil tanker in Russia and filled it with vodka, all paid for with blocked currency and all for export.

Official rates for currencies are considered currency exchange controls. When you see the notation “official rate” next to a currency rate quotation, you know that the country has currency exchange controls. The currency exchange controls discussed here are a result of some governmental action.

People will go to remarkable extremes to get blocked money out of exchange-controlled countries. In New Delhi, the local manager of a major international airline gave a case of Scotch to a government official. Shortly thereafter, the agency for which that official worked granted the airline permission to use blocked rupees to buy almost US\$20 million and transfer them to the airline’s home country. This was an extreme method of converting blocked currencies to convertible currencies. It was also illegal. Most financial managers do not resort to such methods, but they can take legal steps to protect their firms from the adverse effects of currency exchange controls.

currency exchange controls

Government controls that limit the legal uses of a currency in international transactions



Employees wait for customers at a currency exchange, licensed by the Bank of Bangladesh, in Dhaka. Some countries set "official rates" for currency and decree that all purchases or sales of other currencies be made through a government agency.

Shawkat Khan/AFP/Getty Images



relevance
for managers

Controls differ greatly from country to country and even within a country, depending on the type of transaction. In general, the relatively rich developed countries have few or no currency exchange controls. They are a minority of the world's countries, though, and thus the great majority of countries do impose exchange controls. Many developing countries, though, such as Mexico, have reduced or eliminated currency exchange controls in order to encourage foreign investment. The international business manager must carefully study whether currency exchange controls exist both before and while doing business in any country.

Balance of Payments

Balance of payments (BOP) was discussed in some detail in Chapter 5, and we mention it here as a major financial force. The state of a nation's BOP tells observant management much about the state of that country's economy. If the BOP is slipping into deficit, the government is probably considering possible measures to correct or suppress that deficit. Management should be alert for either currency devaluation or restrictive monetary or fiscal policies to induce deflation. Another possibility is that currency or trade controls may be coming.

With foresight, the firm's management can adjust to the changing government policies or at least soften their impact. On the export side, the company may start shopping for **export incentives**—government incentives to make exporting easier or more profitable. Lower-cost capital may be available if the company can demonstrate that exports will be increased. Governments worldwide generally encourage exports as exports are viewed as positive for the economy. Therefore, some governments provide lower-cost capital if exports can be increased by doing so. One of the most common export incentives is the financing of exports by a government agency that offers foreign buyers lower interest rates than they could get from other money sources. Sometimes the agency's loans are accompanied by an aid grant, which need not be repaid.

Countries that levy value-added taxes are permitted by World Trade Organization (WTO) rules to rebate the value-added taxes to exporters, which makes the exports less expensive and thus more competitive.

export incentives

Tax breaks, lower-cost financing, foreign aid, or other advantages that governments give to encourage businesses to export and foreign customers to buy goods and services

When firms are engaged in tough competition for major export contracts, their home governments may intervene to assist them. Often, the potential customer is a foreign government agency, and thus intervention may involve contact with the customer's decision makers by their counterparts in the home government.

Other Financial Forces Affecting International Business

Tariffs or Duties

In addition to currency exchange rates and BOP, a number of other financial forces affect international business. These are discussed in the following section. The words *tariffs* and *duties* are used interchangeably. They are taxes, usually on imported goods. They can be high or low, and it is of great importance to business to minimize them. They are discussed in Chapter 3 and as one of the legal forces in Chapter 10, but they can certainly be classified as financial forces and therefore should be mentioned in this chapter.

The European Union (EU) and the other group of nations discussed in Chapter 4 have lowered or abolished tariffs on trade among member-countries. Such developments add new dimensions to the decision-making processes of companies located outside the groupings. Lower tariffs are one of several factors that a country would consider when deciding whether to join a group of nations, but they would not be the only factor.

Taxation

Since much international business is conducted by companies operating in a corporate form, we are concerned with tariffs paid by and taxes levied on corporations. The point may be made that corporations don't pay taxes; they only collect them. In the end, people pay taxes.⁵ The taxes may be collected from customers in higher prices, from employees in lower wages, from stockholders in lower dividends or capital gains, or from suppliers in smaller orders. However, even though corporations act as tax collectors, rather than bearing the ultimate burden, it is very much in their best interest to minimize taxes. If a corporation can achieve a lower tax burden than its competitors, it can lower prices to its customers or generate higher revenue with which to pay higher wages and dividends. The price of its stock tends to rise, and it can be a better customer for the suppliers of its components and raw materials.

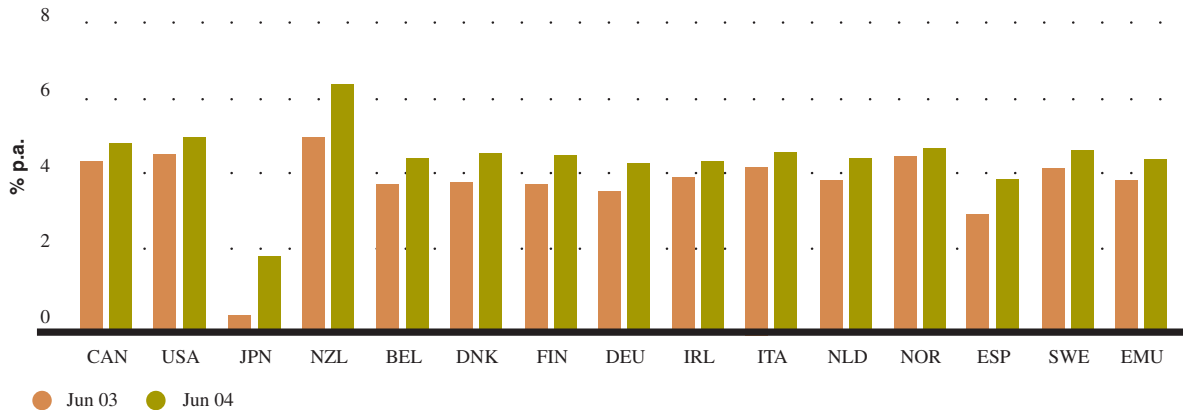
International companies have to be concerned about more taxes because they deal with more countries. It is fundamentally important that international companies understand tax laws in all countries in which they operate and how those tax laws relate to tax laws in other countries. This additional tax burden can create large amounts of financial risk, but it can also be an opportunity for a company to save money if it engages in proper tax planning.

Different Taxes in Different Countries In almost every country, income tax is the biggest revenue earner for governments. Then there are sales or value-added taxes on goods or services, capital gains taxes, property taxes, and social security taxes. A company must carefully study the tax laws of each country in which it operates. This subject is dealt with further in Chapter 10, and in Chapter 20 we shall see how financial managers can sometimes use different tax regimes and other measures to lower their taxes legally.

Inflation

Inflation is a trend of rising prices caused by demand exceeding supply. The phenomenon of increasing prices for almost everything over a period of time is familiar. Contagious inflation was probably the major cause of the end of the unprecedented world economic boom that lasted from the end of World War II in 1945 until 1973. As prices of internationally traded goods rose due to a combination of rising demand and increased money supplies in all the developing countries, inflation fever spread from one developing country to another.⁶ At one time, some thought that inflation was a problem limited to developing countries and that developed countries need not worry about it. The United States experienced problems with inflation in the 1970s.

FIGURE 11.3 Long-Term Interest Rates



Source: OECD, *Main Economic Indicators*, July 2004 (www.oecd.org).

Inflation's Effects on Interest Rates Inflation is clearly a financial force, external to companies, that finance managers must deal with as best they can. Almost every company must borrow money occasionally, and the inflation rate determines the real cost of borrowing. Real interest rates are found by subtracting inflation from the nominal interest rates. Figure 11.3 shows long-term interest rates in selected OECD countries. Table 11.1 illustrates inflation rates for countries in the Organization for Economic Cooperation and Development (OECD).

Monetary and Fiscal Policies Affect Inflation Nations may conduct their monetary and fiscal policies in ways that cause an increase or decrease in inflation. Successful policies have two common characteristics: (1) they remove artificial economic controls, such as wage and price controls, and (2) they apply fiscal and monetary restraint. The restraint includes lower taxes and slower growth in the nation's money supply.⁷

Japan and the United States have had relatively good records in keeping inflation down in recent years. Most Latin American countries have inflation troubles. From 1970 into the 1990s, the worst inflation in Latin America occurred in Bolivia in 1985 at a rate of 11,750 percent a year. That far outstripped Brazil, in second place with 3,118 percent in 1990 and 9.3 percent in 2003. In a dramatic turnaround, Bolivia slashed its inflation to only 7.9 percent in 1996 and further slashed it 2 percent in 2003. Chile is another Latin American economic success story, decreasing inflation from 505 percent in 1974 to 7.4 percent in 1996 and 1.1 percent in 2003, while increasing per capita income substantially. Argentina reduced inflation from 3,080 percent in 1989 to 3.7 percent in 2003 while achieving a slight increase in per capita income; Mexico brought down inflation from 132 percent in 1988 to 34.4 percent in 1996, although Mexico's per capita income also came down⁸ then, and 4 percent in 2003.

By contrast, the United States is now in a period of relatively low inflation. In the 1970s and early 1980s, the United States had a period of relatively high inflation with inflation rates reaching around 20 percent.

Importance of Inflation to Business Even within a single country, inflation is of concern to management. High inflation rates make capital expenditure planning more difficult. For example, management may allocate US\$1 million for a plant and be forced to pay much more to complete construction because of the effects of inflation.

Should management raise capital, and if so, should this be done through equity or debt? Increasing inflation rates encourage borrowing (debt) because the loan will be repaid with cheaper money. But high inflation rates bring high interest rates and may discourage lending. Potential lenders may fear that even with high interest rates, the amount repaid plus in-

TABLE 11.1 Summary of Inflation

	Ten-Year Averages											
	1986–95	1996–2005	1996	1997	1998	1999	2000	2001	2002	2003	2004*	2005*
Advanced Economies	3.4	1.5	1.9	1.7	1.3	0.9	1.4	1.8	1.5	1.3	1.4	1.4
United States	2.8	1.8	1.9	1.7	1.1	1.4	2.2	2.4	1.5	1.6	2.1	1.7
Euro area		1.8	2.9	−0.1	1.2	1.7	1.4	2.4	2.5	2.1	1.9	1.9
Japan ¹	1.2	−1.3	−0.8	0.3	−0.1	−1.5	−2.0	−1.5	−1.2	−2.5	−2.4	−1.4
Other advanced economies	4.8	2.0	3.2	2.6	1.9	1.1	2.0	2.0	1.7	1.9	1.5	1.8
Consumer Prices:												
Advanced Economies	3.6	1.8	2.4	2.0	1.5	1.4	2.1	2.1	1.5	1.8	1.7	1.7
United States	3.5	2.4	2.9	2.3	1.5	2.2	3.4	2.8	1.6	2.3	2.3	2.2
Euro area ²		1.8	2.2	1.6	1.1	1.1	2.0	2.4	2.3	2.1	1.7	1.6
Japan ¹	1.4	−0.1	—	1.7	0.6	−0.3	−0.9	−0.8	−0.9	−0.2	−0.4	−0.1
Other advanced economies	4.7	2.0	2.9	2.2	2.2	1.2	1.8	2.1	1.7	1.8	1.7	2.0
Other Emerging Market and Developing Countries												
Regional Groups	58.0	8.8	18.1	11.6	11.4	10.4	7.3	6.8	6.0	6.1	5.7	5.0
Africa	27.4	12.2	28.2	13.5	10.2	11.5	13.0	11.8	9.6	10.3	8.6	6.7
Central and Eastern Europe	59.2	21.7	37.3	52.0	33.0	23.3	23.0	19.6	14.8	9.2	6.9	5.5
Commonwealth of Independent States		24.4	55.7	18.0	24.0	69.6	24.5	20.4	13.8	12.1	10.3	8.8
Developing Asia	11.2	4.0	8.2	4.9	7.8	2.5	1.9	2.7	2.0	2.7	4.0	3.6
Middle East	17.7	9.5	14.4	11.0	10.5	11.0	8.5	7.1	7.5	8.6	8.9	8.1
Western Hemisphere	194.7	9.0	19.5	11.5	8.5	7.2	6.6	6.0	8.9	10.6	6.2	5.6
Memorandum:												
Median Inflation Rate												
Advanced economies	3.6	1.9	2.2	1.8	1.6	1.4	2.6	2.5	2.1	2.2	1.4	1.8
Other emerging market and developing countries	10.0	5.1	8.8	7.0	6.2	4.1	4.2	4.9	3.3	4.6	4.0	3.5

¹Annual data are calculated from seasonally adjusted quarterly data.

²Based on Eurostat's harmonized index of consumer prices.

*est.

Source: *OECD Statistical Appendix*, 2004.

terest would be worth less than the amount lent. Even if a lender can obtain an interest rate of 25 percent, if the rate of inflation is 100 percent, the lender will lose money. Instead of lending, the money holder may buy something that is expected to increase in value, thereby further fueling inflation.

Lenders have begun to use variable interest rates, which rise or fall with inflation, to shift the financial risk to the borrower. Of course, that risk requires the borrower to be much more careful about borrowing. The original rate and any future changes are based on a reference interest rate, such as the U.S. prime rate or the London Interbank Offer Rate (LIBOR).

Inflation and the International Company Inflation affects international business, with the complication that inflation rates differ in different countries. For this reason, the management of an international company must try to forecast the rates for each of the countries in which it is active. The comparative inflation rates will affect the comparative currency values as the currencies of high-inflation countries weaken against the currencies of countries with lower inflation rates. Management will try to minimize holdings of the weaker currencies.

Higher inflation rates cause the cost of the goods and services produced in a country to rise, and thus the goods and services become less competitive. The company's affiliate in that country finds it more difficult to sell its products in export, as do all other producers there. Such conditions tend to cause balance of payments (BOP) deficits, and management must be alert to changes in government policies to attempt to correct these deficits. Such changes could include more restrictive fiscal or monetary policies, currency controls, export incentives, and import obstacles.

Relative inflation rates affect where the international company raises and invests capital. Interest rates tend to be higher where inflation is higher, and high inflation discourages new investment for all the reasons we have seen.

Accounting Practices

Accounting practices vary widely from country to country. When dealing with its foreign subsidiaries, an international company must be prepared to use the accounting practices of the subsidiary's host country. It must then translate these practices into home country practices so that home country investors, creditors, and government regulators understand them. Accounting practices are financial forces, which is why we include the topic here, and legal forces, as well (Chapter 10). In Chapter 20 we shall examine some of management's solutions to these divergent accounting practices.

The United States follows the standards from the Financial Accounting Standards Board (FASB), which establishes Generally Accepted Accounting Principles (GAAP) in the United States, while the rest of the world generally follows the International Accounting Standards Board (IASB), which is based in London. Both regulators agree they should try to converge to reach the highest accounting standards and progress is being made in this direction. One improvement is that FASB standards are viewed as rule-based while IASB standards are principle-based.⁹ An article in the *Financial Times* stated, "The IASB wants globally harmonized financial reporting rules—steady convergence between its rules and those of FASB is a significant part of that strategy."¹⁰

International Banking

International banking facilitates international trade and investment. Their services include money transfers, currency exchange, letters of credit—which are now offered online, and other trade financing vehicles.

With increased globalization, international banking faces many challenges, including that of reducing its role in money laundering and the transfer of illicit funds to support terrorism. On the opportunity side, one of the requirements of WTO membership is that member-countries must open their banking systems to foreigners. China, which joined the WTO in 2001, made many changes to join the WTO including the promise to open its banking system. This change is especially noticeable in the banking relationship between China and Hong Kong.

In Japan, cultural differences often make it difficult for foreign businesses to conduct business. The only large U.S.-owned bank in Japan, Shinsei Bank, has had problems adjusting since its purchase by a U.S. investment firm in 2000. Part of the problem is not simple xenophobia, but the fact that Japanese banks "operate according to an unwritten quasi-moral code that requires them to support companies and their employees even at the expense of profitability." These "social responsibilities" are a clear distinction between Japanese and Western banks.¹¹

Islamic banks also operate on different assumptions than do Western banks. One Islamic value is the proscription of excessive profit. Profit without risk is considered to be excessive, and at the core of Islamic banking is the requirement that investors share in the risk of the business. Therefore, interest is understood to be a riskless profit and not allowed. Islamic bankers take equity positions in the businesses they finance, and share either in the successes or failures of these businesses.

TABLE 11.2 Household Saving Rates (percent of disposable household income)

	1986	1988	1990	1992	1994	1996	1998	2000	2002	2004
Net Savings										
Australia	10.3	7.0	9.3	5.7	5.8	5.8	1.9	2.9	−0.4	−2.3
Austria	12.3	11.9	14.0	12.0	11.8	9.9	8.4	8.4	8.2	8.5
Canada	13.4	12.3	13.0	13.0	9.5	7.0	4.9	4.6	4.2	2.1
Finland	1.7	−1.0	1.8	10.0	1.9	0.4	0.4	−1.4	−0.2	1.2
France	8.1	6.9	7.8	9.7	9.8	10.0	10.8	11.0	12.1	11.1
Germany	12.8	13.2	13.9	13.0	11.6	10.8	10.3	9.8	10.6	11.1
Japan	16.3	13.0	13.9	14.2	12.6	9.8	11.0	9.5	6.4	6.4
Korea	20.0	25.1	22.0	22.8	19.4	15.9	23.0	11.0	6.8	11.0
Netherlands	14.8	13.4	17.5	16.1	14.3	13.0	12.9	6.8	8.6	12.5
New Zealand	0.7	3.3	0.7	0.8	−3.1	−2.5	−4.1	−3.9	−5.5	−6.5
United States	8.2	7.3	7.0	7.7	4.8	4.0	4.3	2.3	2.3	2.0

Source: OECD. www.oecd.org (September 19, 2004).

Household Savings

Household savings is important because it allows for creation of capital for new investment. When people save money, banks and other lenders have more money for loans. Savings as a percentage of disposable income is a good measure of the savings rate in a country. Traditionally, the United States, which is a consumer-driven economy, has a low savings rate, while Asian countries, which have cultures that encourage savings, have high savings rates. Note the recent high rates in France and Germany. Table 11.2 shows dramatically the differences among country savings rates.

Sovereign Debt: Countries Went Bust

During the lending binge by banks to developing countries in the 1970s, the head of a major bank said, “Countries don’t go bust.” That statement was proved wrong, and a new and ominous financial force hit international business: sovereign debt. Contrary to many expectations, a number of developing countries found themselves unable to pay even the interest, much less the principal, on their debts. The sovereign debt crisis for Poland occurred in 1981; for Mexico, Brazil, Argentina, and others it occurred in 1982 and later.

We examined this matter earlier from the point of view of the International Monetary Fund (IMF) and the Bank for International Settlements (BIS). As was discussed, the IMF took the lead role in resolving these crises as they arose, and the BIS made bridge loans while the IMF was preparing to act.

Because these crises were so important and still affect international business, we will discuss some of the background in this chapter. Also, we suggest some possible solutions.

Causes of Increasing Indebtedness in Developing Countries

The immediate causes of the growing debts in developing countries were the jumps in oil prices (crude oil represents an average of 16 percent of the merchandise imports of the nonoil developing countries). In 1973–74, oil prices quadrupled; they then doubled in 1979–80, and that increase from a higher base represented an even larger increase in absolute terms than the 1973–74 rise. They are presently on the rise again.

Those oil price increases made the already severe inflation that much worse, and the combination brought on a worldwide recession. The resulting drop in prices of primary

nonoil commodities, which accounts for 45 percent of developing country (excluding Mexico and OPEC developing countries) exports, was a serious blow to the economies of developing countries and their ability to pay their heavy debts. Drops in oil prices beginning in 1981 hurt Mexico and the OPEC developing countries.

After the 1979–80 oil price jump, interest rates increased. That increase affected all new loans and the many existing loans that carried variable rather than fixed interest rates. Every 1 percent increase in US\$ interest rates cost developing countries some US\$2.5 billion more a year in interest payments.

On top of all that, the US\$ began to strengthen in value in the foreign exchange markets during 1980. It continued up into 1985 and had gained over 80 percent by March 1985. Developing countries borrow mainly in dollars but export in many currencies, so the rise in the value of the US\$ created new burdens. Developing countries had to earn that much more in hard currencies to pay the US\$ debts.

Debt Problem Solutions

The IMF, the BIS, national central banks, and commercial banks have been scrambling for solutions.

Short-Term Solutions The short-term answers have included rescheduling of debts for countries that were unable to pay as they came due. But renegotiations are becoming more and more difficult. The BIS, the commercial banks, and the central banks are reluctant to come up with more money, and the IMF's resources are limited.

The debtor countries balk at the stringent austerity programs being insisted on by the IMF. The economic growth of some developing countries has halted because they must use new money they receive from exports or loans to repay debt rather than to support productive investments. Social unrest, including rioting, has broken out in several countries, notably Venezuela, Argentina, and Brazil.

The debtor developing countries are in desperate straits, but the developed countries are also being damaged. As the debtor countries use their hard currency to repay debts, they do not buy goods and services from the developed countries. As a result, the developed countries have lost billions of dollars of export business and thousands of jobs.

The debtor developing countries can reduce their debts only by exporting more than they import and thus running balance of payments (BOP) surpluses. Some of the debtor developing countries have been able to run BOP surpluses and make debt payments. These surpluses, however, have been achieved as much by cutting imports as by expanding exports, and that has slowed or stopped economic development in the debtor countries and also hurt exports from countries that had been suppliers before the imports were curtailed.

Most of the debtor developing countries have needed more money from private banks and international agencies and have been lent more. This has caused the debt burdens of these countries to increase at the same time their economic development has been progressing slowly, a process that cannot be sustained.

Long-Term Solutions The debt renegotiations accompanied by stringent austerity were part of the first phase of the world's efforts to solve the debt problems. This phase led to declines in living standards in debtor countries and curtailed economic growth and exports.

The second phase saw a growing awareness that short-term adjustment policies would not do the job alone. The problem for developing countries was not the outstanding debt per se but the economic policies the countries followed and the cultural and attitudinal barriers they faced.

Recognizing this, the Baker Plan called for market-oriented strategies to encourage growth and bring inflation under control. Measures were needed to rebuild confidence in, and lure flight capital and new investment back to, debtor countries.¹²

WORLDVIEW



Gauging Generosity

Which rich countries do most to help poor countries?

Judged by their rhetoric, rich countries are falling over themselves to help the world's poorest. The current multilateral round of trade negotiations is called the Doha Development Round, because it is meant specifically to help poor countries. Jacques Chirac, host of his June's G7 summit, wants to focus the meeting on exports to Africa, trade concessions, and new efforts to stabilize commodity prices. George Bush, who in 2002 proposed a 50 percent increase in America's aid budget over three years, this year offered to triple spending to combat AIDS in Africa.

Promises aside, which rich countries actually have policies that help the poor? The traditional gauge of a country's commitment to development is foreign aid. Total aid flows rose in 2002, by 4.8 percent after inflation. America is the biggest donor in absolute terms, but the stingiest relative to the size of its economy, spending only 0.12 percent of its GDP. Denmark,

Norway, and the Netherlands were the most generous. Each gave more than 0.8 percent of their national income. However, aid is not the only, or even the best, measure of help. Trade policy is crucial: shutting out their exports is a sure way of condemning the poor to remain poor. Liberal immigration policies can also help, because migrant workers' remittances support their home economies.

A new index drawn up by the Center for Global Development (CGD), a Washington think tank, with *Foreign Policy* magazine, attempts to rank 21 rich countries by averaging their scores in six development-related policies: aid, trade, the environment, migration, investment, and peacekeeping. The Netherlands, says the CGD, comes top (see table and, for more details, www.cgdev.org). Norway, although a generous aid donor, ranks only tenth, mainly because of its protectionist trade policies. America scores well on trade but badly on everything else, and so is ranked second-bottom, above only Japan.

Source: *The Economist*, May 1, 2003. © 2003 The Economist Newspaper Group Inc. Reprinted by permission. Further reproduction prohibited. www.economist.com

Helping Hands: Commitment to Development Index Scores*

	Aid	Trade	Environment	Investment	Migration	Peacekeeping	Average
Netherlands	6.9	7.0	5.7	6.1	4.5	3.5	5.6
Denmark	9.0	6.8	5.0	1.0	4.4	7.1	5.5
Portugal	2.2	6.9	5.1	9.0	1.0	6.8	5.2
New Zealand	1.7	7.2	3.4	2.3	9.0	6.9	5.1
Switzerland	3.3	4.0	7.2	6.3	9.0	0.1	5.0
Germany	2.1	6.8	6.0	1.4	8.1	3.8	4.7
Spain	2.4	6.8	6.0	8.2	1.8	2.9	4.7
Sweden	7.0	6.9	6.1	1.8	3.9	1.3	4.5
Austria	2.8	6.8	5.4	2.6	6.5	2.6	4.4
Norway	6.6	1.0	2.8	3.5	4.6	7.4	4.3
Britain	3.0	6.9	5.0	3.4	3.1	3.6	4.2
Belgium	3.5	6.7	4.5	1.4	4.5	3.5	4.0
Greece	1.5	6.7	4.6	0.0	1.6	9.0	3.9
France	3.1	6.8	4.9	1.7	0.8	5.2	3.8
Ireland	2.6	6.6	1.6	2.3	4.5	3.7	3.6
Italy	1.4	7.0	5.3	1.5	1.1	5.3	3.6
Finland	3.0	6.8	5.4	1.7	1.3	2.9	3.5
Canada	1.7	6.6	1.7	2.1	6.1	2.4	3.4
Australia	1.7	7.2	1.8	1.6	3.7	2.8	3.2
United States	0.8	7.7	1.0	2.0	2.3	1.5	2.6
Japan	1.2	4.6	4.0	2.8	1.5	0.5	2.4

*Minimum 0, maximum 9.

Source: Centre for Global Development.



A Vietnamese woman sells coconuts and waits for business outside a local Internet center in Ho Chi Minh City (the former Saigon), Vietnam. Vietnam is one of the countries included in the World Bank's debt relief initiative for Heavily Indebted Poor Countries (HIPC).

Paula Bronstein/Getty Images

The Baker Plan was followed by the Brady Plan, which built on its predecessor and made debt relief conditional on a debtor country's pursuit of an IMF-approved economic adjustment program. The plan called on private banks for more money backed by funds from the IMF, the World Bank, and developed country governments.

Brady debt relief is provided through three mechanisms: (1) the exchange of old debt for new at a discount, (2) the exchange of old debt for new at a lower interest rate, and (3) the buying back of debt from creditor banks at a discount.¹³ The most recent World Bank debt relief initiative for Heavily Indebted Poor Countries (HIPC) appears to be making solid headway on this problem. Figure 11.4 lists nations whose debt is affected by this initiative.

Growing Developing Country Debt Market The third mechanism has resulted in debtor countries buying their own debt and retiring it. The creditor banks have also sold debt of developing countries and countries in transition* to other banks and investors, resulting in a large secondary debt market. The debts are in several instrument forms, including loans, Brady bonds, corporate and non-Brady sovereign bonds, local market instruments, options, and warrants on debt.

Even as the Latin American debt market has flourished, developing country debt traders have begun to focus on Eastern Europe. The list of major players reflects how important the financial community feels the Eastern European market will be. They include Morgan Grenfell, Indosuez, Salomon Brothers, Merrill Lynch, Chase Manhattan, J. P. Morgan, Chemical, and Continental Bank of London.

So far, debts of Russia and Poland are the most traded of the Eastern European countries, with some Bulgarian issues thrown in. One banker describes the other Eastern European countries as “flies on the back of the elephant.” Strangely enough, Latin American money has been going into Russia as investors seek yield and capital appreciation, demonstrating how small a financial world it has become.¹⁴

*“Countries in transition” refers to countries in Central and Eastern Europe and elsewhere that are in transition from centrally controlled to market economics.

FIGURE 11.4 Grouping of HIPCs under the Enhanced HIPC Initiative: Status as of September 2003

Heavily Indebted Poor Countries					
Angola*	Congo, Dem. Rep.*	Honduras	Mozambique	Somalia*	
Benin	Congo, Rep. of*	Kenya	Myanmar*	Sudan*	
Bolivia	Cote d'Ivoire	Lao P.D.R.	Nicaragua	Tanzania	
Burkina Faso	Ethiopia	Liberia*	Niger	Togo	
Burundi*	The Gambia	Madagascar	Rwanda*	Uganda	
Cameroon	Ghana	Malawi	Sao Tome and Principe	Vietnam	
Central African Republic*	Guinea	Mali	Senegal	Yemen	
Chad	Guinea-Bissau*	Mauritania	Sierra Leone*	Zambia	
Comoros	Guyana				

HIPC Relief Approved at Decision Point (27)			Decision Point Not Yet Reached (11)	(Potentially) Sustainable Cases (4)	
Benin	Guinea	Nicaragua	Burundi	Lao P.D.R.	Angola
Bolivia	Guinea-Bissau	Niger	Central African Rep	Liberia	Kenya
Burkina Faso	Guyana	Rwanda	Comoros	Myanmar	Vietnam
Cameroon	Honduras	Sao Tome and Principe	Congo, Rep. of	Somalia	Yemen
Chad	Madagascar	Senegal	Cote d'Ivoire	Sudan	
Congo, Dem. Rep.	Malawi	Sierra Leone		Togo	
Ethiopia	Mali	Tanzania			
The Gambia	Mauritania	Uganda			
Ghana	Mozambique	Zambia			

Sources: HIPC documents; and IMF and World Bank staff estimates; www.worldbank.org (August 3, 2004). Copyright © 20004 by World Bank. Reproduced with permission of World Bank via Copyright Clearance Center.

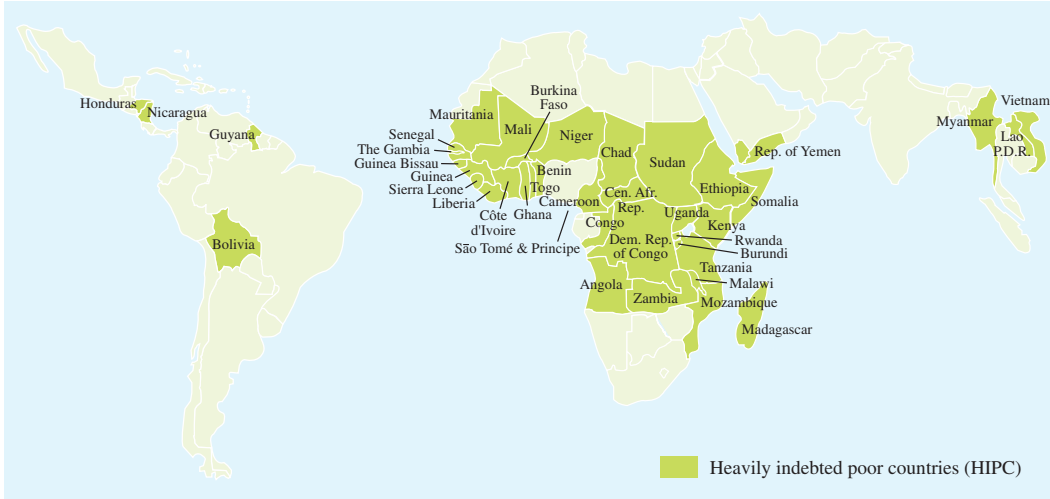
Some Positive Developments The Paris Club, which is an informal group of 19 Western creditor governments who find solutions to payment difficulties, forgave half of Poland's debt. That is a reduction of some \$17.5 billion. The United States forgave Egyptian debt as an expression of thanks for Egypt's support in the first U.S. war against Iraq. More recently, the World Bank, the IMF, and the Paris Club approved a plan to relieve the massive debt load of some of the world's most heavily indebted poor countries (HIPCs). As a whole, HIPCs have a debt-to-export ratio of over 500 percent, more than three times as high as the average for all developing countries. Assistance for such countries can certainly be defended on a humanitarian basis, and tying relief to economic reforms encourages them to take steps toward improving their economic performance.

Figure 11.5 is a world map showing the location of HIPCs. Most are in sub-Saharan Africa. Figure 11.6 includes a chart showing HIPC debt from 1983 to 2004. At the current rate, HIPCs will never get out of debt because they constantly increase their long-term debt at high interest rates and, at the same time, are dependent on essential imports (such as fuel).

Some poor countries have been forced to shortchange health, education, and other pressing development needs so they can keep making loan payments to the IMF, World Bank, and other international lenders. Given the growth of the AIDS pandemic, such cutbacks are exactly the opposite of what is needed. Many creditor countries, including the United States, are funding massive debt-forgiveness programs. We note that much of this debt was initially incurred by bankers in these developed countries, some of whom, it may be alleged, acted irresponsibly in granting loans and then layering bridging loans atop them, even though the bankers knew the loans could not be repaid.

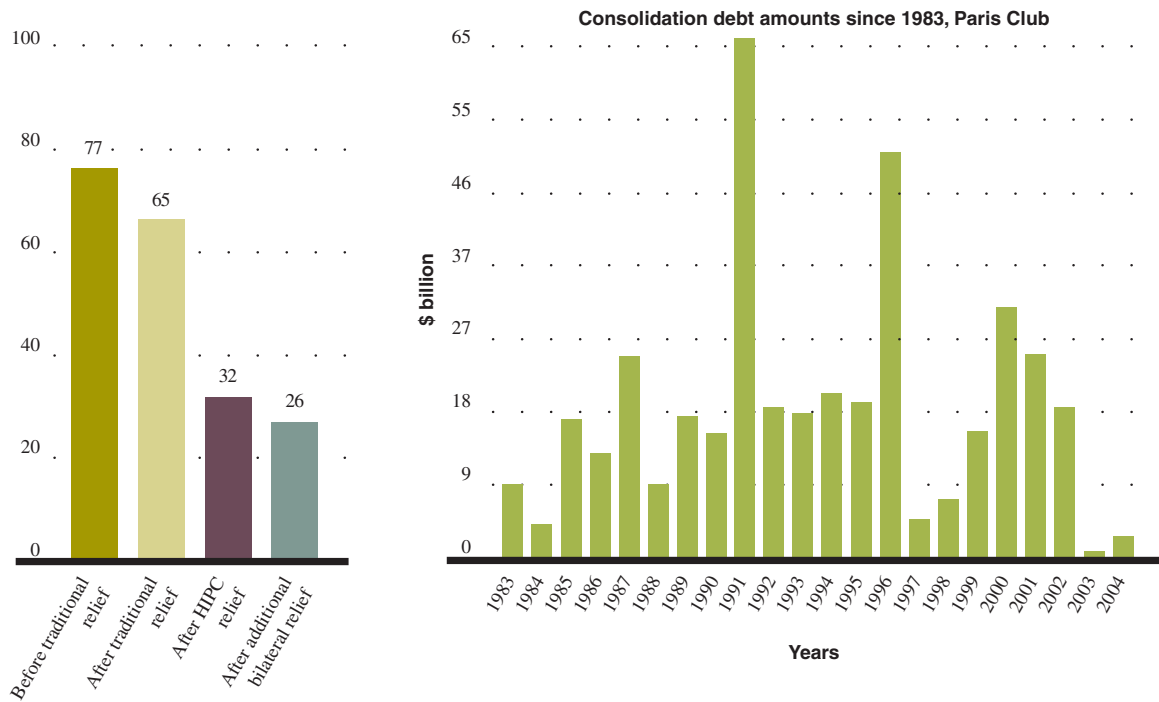
Of 38 countries considered in greatest need of relief, 27 qualified for a total of about \$50 billion in debt write-downs. So far, 13 have successfully completed the program. The latest graduates, announced with considerable fanfare in recent days, are Ethiopia, which received

FIGURE 11.5 HIPC Debt



Source: World Bank Group, 2000.

FIGURE 11.6 HIPC Debt Reduction Net Present Value of Debt



Source: www.IMF.org

Source: IMF Independent Evaluation Office, 2002.

\$3.3 billion in relief; Senegal, which received \$850 million; and Niger, which got \$1.2 billion. The 27 participating countries will reduce their total debt loads by two-thirds by the time they complete the HIPC process, World Bank officials say. Already, their payments have been cut by about a third, or \$1.3 billion a year.¹⁵

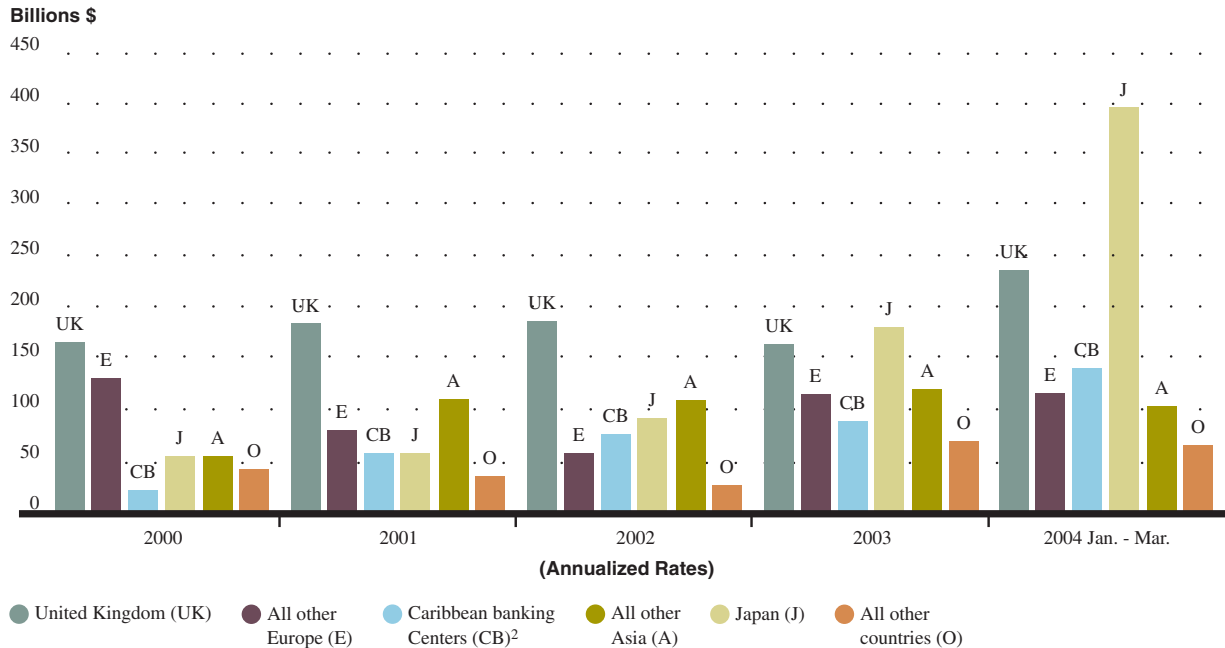
Longer-Term Solutions A number of cures to the debt crisis have been suggested by economists, bankers, and development scholars. We will list a few.

1. Borrowing developing countries should pursue policies that ensure that new money they obtain is used for economic growth rather than for consumption, capital flight, or overambitious government schemes or armaments.
2. Borrowing countries should build up reserves in good years to enable them to withstand the fluctuations in commodity export prices that are inevitable.
3. Developed countries must open their markets to exports from borrowing countries even though that means competition with some industries in these borrowing countries.
4. The IMF and other creditors must not try to enforce austerity measures that may be too stringent to borrowing countries. Social unrest and trade contraction must be avoided or at least minimized.
5. The IMF, the World Bank, and other agencies that aid borrowing countries must be assured of sufficient funding so that they can take long-term views.
6. Parts of the huge external debts of the borrowing countries must be changed to types of equity. These changes could be ownership interests in projects being developed or shares of export earnings. Other parts of the debts should be lengthened in maturity, with interest rate ceilings applied. A novel use for sovereign debt was arranged by the debtor country Senegal and a Dutch organization, The Netherlands UNICEF Committee. The Dutch organization bought \$24 million of Senegalese foreign debt and converted it into projects for women and children in that African nation. Child immunization and education of the street children of Dakar are two of the projects. Since begun by Senegal, similar “debt for children” swaps have benefited children in Madagascar, Jamaica, and the Philippines.
7. The borrowing countries must relax their restrictions on foreign investments and on repatriation of profits from existing investments. They must encourage new money from foreign private sources—nonbank sources—because the banks are now overcommitted with existing loans to borrowing countries and are not likely prospects for new, economic growth money.
8. Blame for the debt crises belongs to several parties. The borrowing countries borrowed more than they could productively invest, and much of the borrowed money was wasted at home or sent abroad for the personal accounts of corrupt political leaders. The lending banks in the developed countries were encouraged to lend by their governments because the governments were thus relieved to that extent of foreign aid demands by the borrowing countries. The banks must also bear a share of the blame; they made limited inquiries regarding the uses of the borrowed money or the soundness of the projects in which the money would be invested. They failed to get collateral to secure the loans, and one reason they were so casual was that the loans were almost always to governments or guaranteed by governments.

The United States in Debt?

After 70 years as the world’s leading creditor, the United States is said by some to have become the world’s biggest debtor, a situation that causes them to forecast adverse effects for America. Before looking at some of those effects, we should define the debt, see how it

FIGURE 11.7 Net Purchases of Long-Term Domestic U.S. Securities by Foreigners, Selected Countries¹



¹The data present aggregate net purchases for 2000 through the first quarter of 2004. The figures show that foreigners' annual net purchases (gross purchases minus gross sales) of U.S. securities have maintained an extremely high level since 2000. Annual net foreign purchases of U.S. securities first surpassed \$100 billion in 1993. In 2003, net acquisitions (including stock swaps) of U.S. securities totaled a record \$746 billion. Net acquisitions in the first quarter of 2004 were even stronger at \$270 billion.

²Includes Bahamas, Bermuda, British West Indies, Cayman Islands, Netherlands Antilles, and Panama. Beginning January 2001, Cayman Islands replaced British West Indies in reporting format.

Source: U.S. Department of the Treasury, www.treas.gov (2004).

differs from the debts of developing countries, and put its growth into perspective with the growth rates of other OECD countries.

net negative international investment position
The U.S. Commerce Department's description of what is commonly called the U.S. international debt

U.S. Debt Defined Conceptually, the U.S. foreign debt—what the Department of Commerce calls a **net negative international investment position**—is the difference between the value of overseas assets owned by Americans and the value of U.S. assets owned by foreigners. These assets consist of commercial bank deposits, foreign exchange holdings, corporate securities, real estate, physical plant, and other direct investments. The popular press calls the difference *debt*, but the Commerce phrase, *net negative investment position*, is more accurate. One reason is the differences between U.S. debt and debt in developing countries.

Figure 11.7 shows U.S. securities purchased by foreigners in 2000 through the first quarter of 2004. Table 11.3 shows the countries that are major foreign holders of U.S. Treasury securities. Japan, Taiwan and the United Kingdom together account for over one-half of all foreign holders of Treasury securities.

Additional Differences between U.S. Debt and Developing Country Debt Even though the United States has a large foreign debt, there are significant differences between United States debt and developing country debt. First, over \$300 billion of the U.S. foreign-owned assets are obligations of the U.S. Treasury or U.S. corporations that are traded daily in world financial markets. Their worth, unlike the face value of a developing country debt, is subject to constant change.

Second, U.S. foreign assets are often measured at book value, which results in an estimated undervaluation of up to \$200 billion. Book value is the cost when bought, which may

TABLE 11.3 Major Foreign Holders of Treasury Securities (in billions of dollars)

Country	Holdings at End of Period			
	2004 May	2004 Feb	2003 Nov	2003 July
Japan	668.1	614.6	532.1	463.1
Mainland China	164.1	153.8	152.9	150.7
United Kingdom	113.2	101.5	75.1	75.8
Caribbean Banking Center	72.2	59.8	47.5	54.3
Korea	58.7	57.0	63.4	59.6
Taiwan	57.3	55.7	50.9	45.1
Hong Kong	52.7	53.1	47.3	42.0
Germany	49.7	45.9	45.9	44.6
Switzerland	49.3	48.2	46.7	42.0
OPEC	48.4	43.7	45.5	42.1
Mexico	41.7	33.6	31.5	30.5
Canada	33.0	28.3	20.1	20.1
Singapore	26.4	25.7	22.6	24.2
Luxembourg	25.6	27.7	25.9	26.2
Ireland	19.2	15.8	15.5	13.4
Israel	18.0	14.1	11.9	13.1
Italy	16.1	14.9	17.3	16.4
India	15.9	13.3	16.1	11.3
Turkey	15.7	14.2	15.5	15.3
Belgium	13.7	12.9	15.2	12.5
Netherlands	13.6	12.6	14.2	18.8
Brazil	12.9	11.3	11.2	11.7
Sweden	11.5	10.6	9.3	11.1
France	11.0	12.3	20.4	19.5
Thailand	10.9	15.3	12.7	15.2
Spain	10.4	9.6	12.9	17.7
Australia	7.3	12.6	10.9	9.9
All Other	118.1	114.2	119.0	117.4
Grand Totals	1754.7	1632.3	1509.5	1423.6

Source: Department of the Treasury/Federal Reserve Board, www.treas.gov/tic.mfh.txt (July 16, 2004).

have been years ago, less depreciation. Inflation alone would result in prices much higher than book value if the assets were sold today.

Third, U.S. assets abroad reportedly earn more in interest and dividend per dollar of investment than foreign holdings earn in America.

Fourth, the most distinctive characteristic of the U.S. foreign debt is its denomination in US\$. In theory, this implies that the United States could discharge its foreign obligations at any time by printing the needed number of US\$. The developing countries, whose debt is not denominated in their own currencies, do not have that power.

The difference between the value of foreign-owned assets in the United States and the value of U.S.-owned assets abroad has increased significantly in recent years. The dollars people in the United States paid foreigners for imported cars, oil, and other products have been used to buy U.S. investments such as Treasury securities and corporate bonds.

mini M N E

>>Third World Debt That Is Almost Always Paid in Full

You think it would be utter folly to lend money to a developing country. So how about a new small business such as a vegetable stand in a developing country?

U.S. development organizations are finding that some of the world's poorest entrepreneurs repay their debts at rates approaching 100 percent. To encourage grassroots private business in Latin America, Asia, and Africa, these organizations are expanding programs that already lend thousands of these small entrepreneurs amounts ranging from \$50 to several hundred dollars.

Tiny businesses in developing countries commonly repay these "microloans" faithfully because of community pressure and the security of a favorable credit rating. Microloans rescue them from the clutches of loan sharks—microloans typically charge the prevailing commercial loan rate—and let them borrow again in hard times. The money helps them start or expand their businesses—selling vegetables, sewing, repairing shoes, making furniture, and the like—and boosts their local economies.

Their repayment performance shines when compared with that of many sovereign nations. It also looks good compared with a default rate of 5.4 percent among U.S. recipients of federally guaranteed student loans.

Though microlending has been around for years, it is now booming. With the decline of communism, U.S. development groups believe they are exporting free market economics to tiny businesses that can fuel growth in the developing world.

"Micro-enterprise lending is the hottest thing in development since the Green Revolution. Everybody does it," says ACCION International spokesperson Gabriela Romanow. The Green Revolution sent farm output surging in many poor nations.

Romanow cites the case of Aaron Aguilar, an unemployed factory worker in Monterrey, Mexico, who borrowed \$100 to buy clay and glazes for making figurines with his wife in their backyard. In six years, the

couple took out and repaid five loans and built their business to 18 full-time employees.

Sometimes borrowers have to struggle against setbacks that might seem weird in a developed nation. One group of women in Cameroon received \$100 from Trickle Up to start a rabbit-breeding business, but the rabbit ate her offspring, recalls Mildred Leet, cofounder of the U.S. agency. Undaunted, the women switched to chickens and made enough money selling eggs to branch out into tomatoes and tailoring, ultimately opening two shops, Leet says.

Some commercial banks in developing countries are taking note of poor entrepreneurs' repayment rates. ACCION persuaded family-owned Multi Credit Bank of Panama City, Panama, to start making microloans two months ago. Isaac Btesh, a director and son of the founder, says the bank has lent \$80,000 to 100 people so far on 60-day, rotating lines of credit—with a 100 percent repayment rate. "When we got in touch with ACCION, we were incredulous," Btesh says. "We couldn't believe their figures. But everything they said is true."

Poverty lending has such promise that Multi Credit plans to make it the bank's number one activity, ahead of trade financing, consumer loans, and merchant loans, the official adds.

**Average Loan: Latin America—\$554;
Africa—\$414; U.S.—\$5,491**

ACCION, a Cambridge, Massachusetts-based nonprofit international development group and a leader in the U.S. microloan movement, says it plans to increase its microlending this year to \$1.175 billion from \$37.8 million in 1990 and \$9.8 million five years earlier. The payback rate is 97 percent.

CARE, New York, perhaps the world's largest private international development group, says small economic activity development—primarily microlending—is its fastest-growing portfolio. "There's energy and creativity out there, people bootstrapping who aren't waiting for the next handout," says Larry Frankel of CARE.

Summary

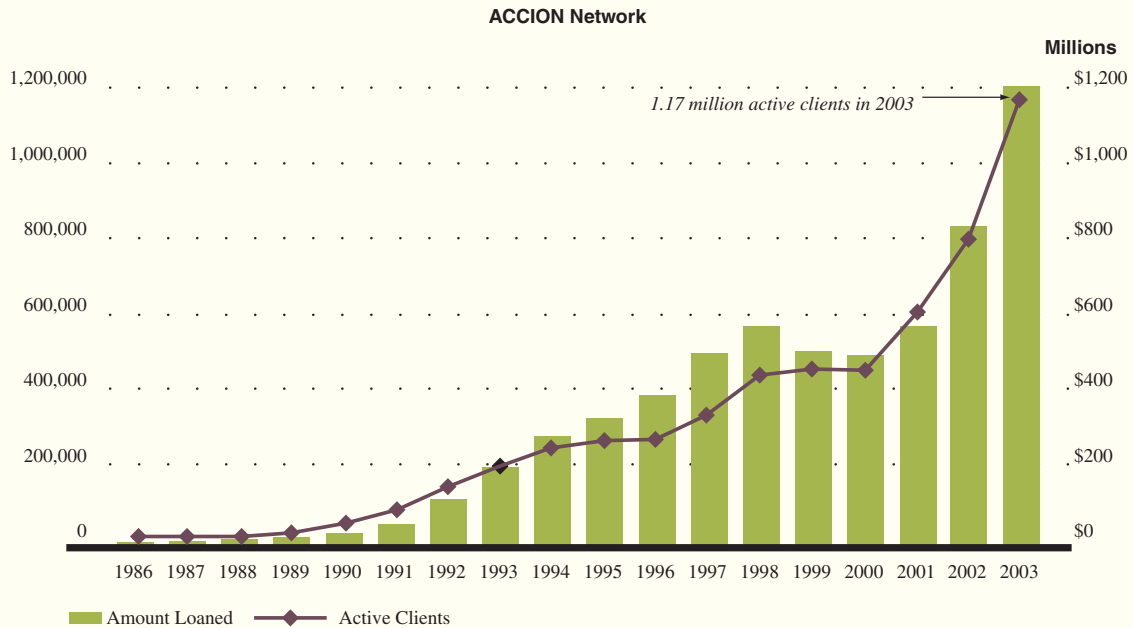
Realize that money can be made—and lost—in the foreign exchange (Fx) markets.

The foreign exchange (Fx) markets are worldwide and collectively involve more money than any other market. On most days, you can trade money 24 hours somewhere in the world. As a result, there are ample opportunities for buying and selling foreign currency.

Understand Fx quotations, including cross rates.

Fx information can be found in financial publications such as *The Wall Street Journal*, the *Financial Times*, and the financial section of major newspapers. *The Wall Street Journal* lists major currencies in terms of their trades with the US\$. The spot rate (for delivery in two business days) is reported for all currencies. For the more heavily traded currencies, 30-, 90-, and

Microlending at One Development Agency, ACCION International



Trickle Up makes thousands of \$100 loans annually, in two installments of \$50 each to small groups of individuals. "We feel private enterprise is the way to help the poor," says Mildred Robbins Leet, who founded Trickle Up with her husband in 1979. The group started in Dominica and are active in China, Laos, Vietnam, and Namibia. They are also active in Latin America, other Asian countries, and in the United States.

Betsy Campbell, economic development manager of Westport, Connecticut-based Save the Children, says her group underwent a shift in the 1980s "from being primarily a charitable organization" to being one oriented toward helping profit-making activities. She says microlending to individuals in 20 nations is rising sharply,

with more than \$3 million in circulation at the moment. Repayment rates in most nations exceed 90 percent. "These people value access to credit so highly that default isn't really a problem," she says.

Some banks in developing countries, notably in Asia, have been making microloans for years. Grameen Rural Bank of Bangladesh is considered a pioneer.

Source: Brent Bowers, *The Wall Street Journal*, June 7, 1991, p. B2; The Inter-American Development Bank, April 1997, p. 3; www.trickleup.org; ACCION.org; CNN, "Default Rate for Student Loans," September 17, 2003, www.CNN.com (August, 2004).

180-day forward rates are reported. Cross rates are exchange rates for trading directly between non-US\$ currencies.

Recognize currency exchange risks.

Currency exchange risk may occur whenever payment is required in another currency. The currency exchange risk is borne by whoever is to receive a foreign currency or is to pay a foreign currency in the future.

Understand currency exchange controls.

Many developing countries have instituted a system of currency exchange controls, which restrict the use of local and foreign currencies. Developing countries often have far less hard (convertible) currencies than they need. They therefore ration them. Anyone wanting hard currencies may have to apply to a government agency, specifying how much is wanted and the use to which it will be put.

Understand how financial forces such as balance of payments, tariffs, taxes, inflation, fiscal and monetary policies, and differing accounting practices affect business.

Business managers must be prepared to react to financial forces that can affect the business. These include balance-of-payments deficits, tariffs and other taxes, inflation, and fiscal or monetary policies of the host government. Accounting policies and practices differ from country to country, so businesses must conform to host country rules and translate the resulting numbers for them to be understood by people in the home country.

Explain sovereign debt, its causes, and some of its possible solutions.

Sovereign debt is the debt of a government. Commercial and investment banks are in the business of lending money or

underwriting bonds through which governments borrow money. As governments receive the borrowed money, corruption and inefficiency can arise, so that a lot of the money does not benefit the country or its people. Some of the debt is repaid, but much is rescheduled or swapped for assets or other uses.

Recognize that a new small business in a developing country might be a better credit risk than the government in a developing country.

Some of the best credit risks in developing countries are the small business entrepreneurs.

Key Words

sovereign debt (p. 326)

central reserve asset (p. 327)

vehicle currency (p. 327)

intervention currency (p. 327)

safe haven (p. 327)

spot rate (p. 329)

forward rate (p. 329)

trading at a premium (p. 329)

trading at a discount (p. 329)

cross rates (p. 330)

currency exchange controls (p. 331)

export incentives (p. 332)

net negative international investment position (p. 344)

Questions

1. In a U.S. financial paper, you see the quotation: "Norway (krone) U.S.\$ equiv. .1308." What does that mean?
2. What is the difference between spot and forward currency rates? Why would someone be interested in buying a currency at the forward currency rate?
3. What does it mean when a currency is said to be trading at a premium to the US\$ in the forward market?
4. If you agree to pay a certain amount of foreign currency to someone in six months, which of you bears the currency fluctuation risk? Explain.
5. What are currency exchange controls? Why are they imposed? What effect do they have in the country imposing them and elsewhere?
6. What is the importance of the balance of payments (BOP) to private companies?
7. What are some ways in which inflation affects business decisions?
8. What is the developing country debt market, and why did it develop?
9. What are microloans and why do they work?
10. What are the differences between developing country debt and the net negative international investment position of the United States?

Use the globalEDGE™ site to complete the following exercises:

1. You are assigned the duty of ensuring the availability of 100,000 yen for the payment that is scheduled for next month. Considering that your company possesses only U.S. dollars, identify the spot and forward exchange rates. What are the factors that affect your decision of utilizing spot versus forward exchange rates? Which one would you choose? How many dollars do you have to spend to acquire the amount of yen required?
2. As an entrepreneur, you are interested in expanding your business to either Poland or Portugal. As part of your initial analysis, you would like to know how much investment is needed to go to these markets. In order to get a rough number, you hire a consulting firm to do initial investment analysis. The consulting firm provides you a short report about how much money is needed for both countries. The numbers provided are: one million zloty (Poland's currency) and 45 million escudo (Portugal's currency). To make a clear comparison, you need to convert these currencies to U.S. dollars. Do the conversion and suggest where to invest.

Minicase 11.1

Management Faces a BOP Deficit

You are the chief executive officer of a multinational's subsidiary in a developing host country. The subsidiary has been in business for about eight years, making electric motors for the host country's domestic market, with mediocre financial results. Before you left the home country a month ago, you were told to make the subsidiary profitable or consider closing it.

After a month in the host country, you have discovered that it is running a worsening balance of payments (BOP) deficit and that the government officials are very concerned about the situation. They are considering various measures to stanch or reverse the deficit flow.

What measures might they adopt? Given that you would prefer to keep the subsidiary open, since it employs locals and contributes to the country's economy in other ways also, can you think of some ways your company might profit from or at least minimize the damage of these potential measures?