

The Basics of Foreign Trade and Exchange

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Growing Trade, Shrinking World

Americans drive cars made in Germany, use VCR's made in Japan and wear clothing made in China. Japanese watch American movies, Egyptians drink American cola and Swedes jog in American running shoes. The world economy is more integrated than ever before.

What is international trade?

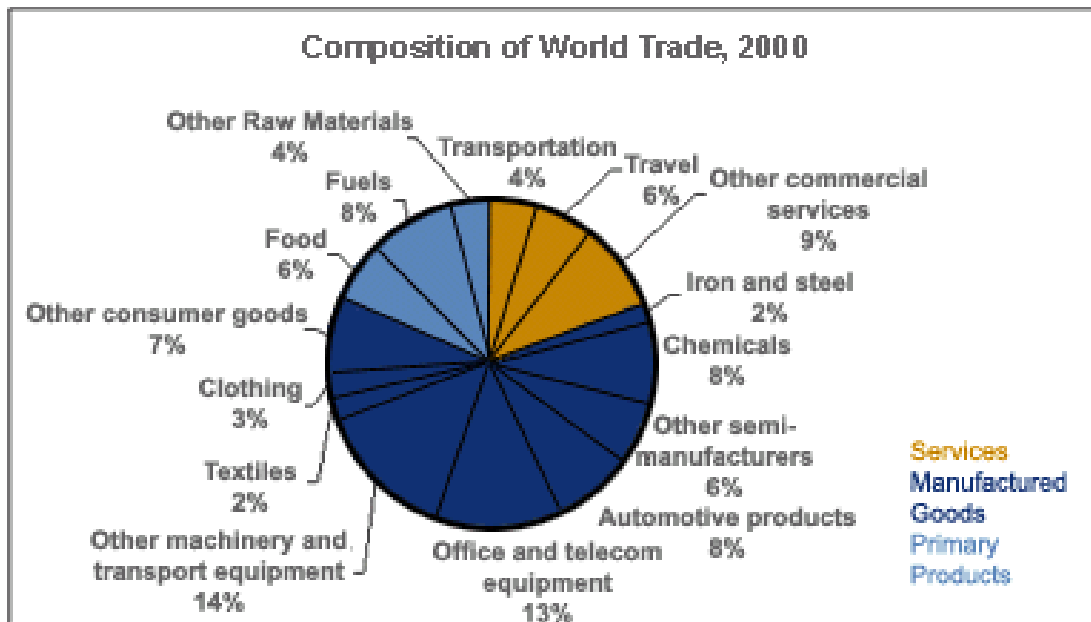
International trade shapes our everyday lives and the world we live in. Nearly every time we make a purchase we are participating in the global economy. Products and their components come to our store shelves from all over the world.

International trade is the system by which countries exchange goods and services. Countries trade with each other to obtain things that are better quality, less expensive or simply different from what is

produced at home.

Goods and services that a country buys from another country are called **imports**, and goods and services that are sold to other countries are called **exports**. Trade mostly takes place between companies. However, governments and individuals frequently buy and sell goods internationally.

World Trade is Diverse



Most international trade consists of the purchase and sale of industrial equipment, consumer goods, oil and agricultural products. Services such as banking, insurance, transportation, telecommunications, engineering and tourism accounted for one-fifth of world exports in 2000.

WORLD EXPORTS ARE UP SHARPLY

Since the end of World War II, there has been a rapid increase in international trade.

- In 1950, total world merchandise exports amounted to \$58 billion
- In 2000, exports were \$6.3 trillion, over a 100-fold increase

More information on [world trade statistics](#).

Trade: Important for economic well being

With the increase in volume, trade has become very important to the economic well-being of many countries. In early 1960s, the United States bought less than \$1 billion of foreign cars and parts. By 2001, this figure had increased to *more* than \$189 billion.

Financial ties between United States and the rest of the world have grown significantly over time:

- Number of foreign banking offices operating in the United States rose from fewer than 40 to over 600 at present.
- Amount of **foreign direct investment** (FDI) was \$158 billion in 2001.
- Gross transactions of long-term U.S. government securities by foreigners rose from \$144 billion in 1978 to over \$9.1 trillion in 2000.

Foreign direct investment is the amount of money individuals invest in companies, assets and real estate of another country.

The cost of international transportation and communication has fallen drastically, resulting in greater integration among the economies of the world. Because of this **interdependence**, economic trends and conditions in one country can strongly affect prices, wages, employment and production in other countries. Events in Tokyo, London and Mexico City have a direct effect on the everyday life of people in the U.S., just as the impact of events in New York, Washington and Chicago is felt around the globe.

If stocks on the New York Stock Exchange plummet in value, the news is transmitted instantly worldwide, and stock prices all over the world might change. This means that countries have to work together more closely and rely on each other for prosperity.

For data on [FDI](#) in the U.S.

Trade: Why do it?

International trade occurs because individuals, businesses and governments in one country want to buy goods and services produced in another country.

- Trade provides people with a greater selection of goods and services to choose from.
- Often these goods are available at prices lower than those in the domestic economy.

Benefits of Trade

Specialization and Its Benefits

To become wealthier, countries want to use their resources—land, labor, capital and entrepreneurship—in the most efficient manner. However, there are differences among countries in the quantity, quality and cost of these resources. The advantages that a country may have, vary:

- abundant minerals
- climate suited to agriculture
- well trained labor force
- new innovative ideas
- highly developed infrastructure like good roads, telecommunications system, etc.

Instead of trying to produce everything by themselves, countries often concentrate on producing things that they can produce most efficiently. They then trade those for other goods and services. In doing so, both the country and the world become wealthier. Learn more about the theory of [specialization and trade](#).

Specialization and Trade

Two economies, Cottonland and Woodland, have the same resources and produce both cloth and furniture.

Cottonland

- Without trade, produces
 - 8 bales of cloth
 - 4 pieces of furniture

Woodland

- Without trade, produces
 - 4 bales of cloth
 - 8 pieces of furniture

- Total production 12 units
- Time taken to produce
 - 1 bale of cloth – 1 hour
 - 1 piece of furniture – 2 hours
- With trade
 - 16 bales of cloth
 - 0 pieces of furniture
 - Total production 16

- Total production 12 units
- Time taken to produce
 - 1 bale of cloth – 2 hours
 - 1 piece of furniture – 1 hour
- With trade
 - 0 bales of cloth
 - 16 pieces of furniture
 - Total production

Since Cottonland is more efficient in cloth production, it can double its cloth output to 16 bales a day by transferring all its resources to that industry. By doing so Cottonland will eliminate the furniture industry. However, it can trade the surplus cloth for furniture.

Similarly, Woodland can direct all its resources to the production of furniture and produce 16 pieces of furniture. Although its cloth industry will suffer it can trade the surplus pieces of furniture for cloth bales.

Through specialization and trade, the supply of goods in both economies increases, which brings the prices down, making them more affordable.

Trade also provides a wider variety of goods to consumers: cars from Japan, salmon from Scandinavia, bananas from South America, are just a few.

Most industrialized countries can produce just about anything they want. For instance, the U.S.:

- | | |
|---|---|
| • could conceivably devote all its resources to the production of tropical fruits. | ➔ such reallocation of resources makes no economic sense. |
| • could compensate for the unsuitable weather by building hothouses, developing irrigation techniques and retraining workers. | ➔ the resources that are directed towards the tropical fruit industry could be used more efficiently elsewhere. |
| • would never have to import tropical fruit again. | ➔ countries achieve greater total wealth by devoting resources to their most productive industries. |

Law of Comparative Advantage

Even if a country can produce everything more efficiently than another country, there is still scope for trade. A country can maximize its wealth by putting its resources into its most competitive industries, regardless of whether other countries are more competitive in those industries. This is called the [law of comparative advantage](#).

Law of Comparative Advantage

Suppose Cottonland produces both cloth and furniture better than Woodland:

	<i>Cottonland</i>	<i>Woodland</i>
Bales of cloth per day	10	2
Pieces of furniture per day	05	3

Cottonland has an ***absolute advantage***—is more efficient—in the production of both cloth and furniture. However to achieve greater wealth, each country should specialize in the item in which it enjoys greatest advantage among all the products it produces—***comparative advantage***.

In terms of ***opportunity cost***, or the cost of not transferring resources, Cottonland is twice as efficient in producing cloth as furniture.

Opportunity Cost

Cottonland	1 piece of furniture = 2 bales of cloth
Woodland	1 piece of furniture = 2/3 bales of cloth

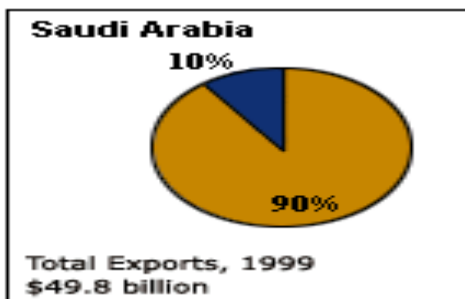
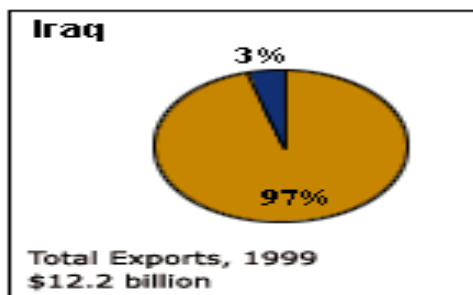
Since Woodland's opportunity cost for producing furniture is less than Cottonland's, it makes economic sense for Woodland to focus on furniture. Cottonland should continue producing cloth and trade for Woodland's furniture. Whereas, Woodland should concentrate on furniture and trade it for cloth with Cottonland. Channeling resources into the most productive enterprise in each country will result in more products to trade.

Benefits of Diversification

Even though it makes economic sense to allocate resources to the most productive industries, no country wants to rely on only a few products. This makes the country vulnerable to changes in the world economy, such as recession, new trade laws and treaties, and new technologies.

A country that relies too heavily on one product is especially susceptible to market forces. If demand suddenly drops or if a cheaper alternative becomes available, the economy of that country could be damaged.

Many Middle East countries that are largely dependent on their oil exports see their economic fortunes rise and fall in tandem with the oil market.



The degree to which countries specialize is influenced by that country's ***terms of trade***—i.e. the relative prices of a country's imports and exports. It is most advantageous to have declining import prices compared with the prices of exports. Exchange rates and productivity differences affect the terms of trade more than any other factors.

By developing a diversified economy, a country can make sure that even if some industries are suffering, other, more competitive industries will keep the economy relatively healthy. The United States is competitive in finance, entertainment, aerospace, industrial equipment, pharmaceuticals and communications, among others.

Competitiveness

Competitiveness is used to describe the relative productivity of companies and industries. If one company can produce better products at lower prices than another, it is said to be more competitive. This is a matter of concern for governments, since it is difficult for uncompetitive industries to survive.

In the long run, competitiveness depends on:

- a country's natural resources,
- its stock of machinery and equipment, and
- the skills of its workers in creating goods and services that people want to buy.

Natural resources are predetermined and must be used efficiently, but a country's infrastructure and its workers' skills have to be developed over time. The ability of a society to do this effectively determines whether it can remain competitive in the global economy.

Economies of Scale

The law of comparative advantage says that a country can become more competitive by directing its resources to its most efficient industries. This enables a country to achieve **economies of scale**—increasing its output in a particular industry so that its costs per unit decrease. Such lower-cost goods are more in demand in international markets.

Certain industries that require heavy research and development or capital expenditures cannot be competitive unless they can spread the costs over many units. If a sophisticated weapons industry knows that it has access to foreign markets and could export, it may increase the scale of its manufacturing operations and become more efficient and competitive in the international markets.

Other factors affecting a country's trade competitiveness can be complex.

- Sometimes it is difficult to move resources from one industry to another—it would cost a great deal of money to turn a shoe factory into a car factory.
- Governments often attempt to restrict or encourage international trade to achieve domestic economic goals—increasing employment in certain industries, or maintaining economic independence.

Knowledge-Intensive Products Contributed to a U.S. Export Boom

From 1986 to 2001 there was an enormous boom in U.S. exports, especially in manufactured goods. Exports went up from \$227 billion to \$731 billion. One of the driving forces behind the increase in exports was the success of U.S. companies in selling "knowledge-intensive" manufactured goods to other industrialized countries.

The value of knowledge-intensive products depends on the skills that went into producing them, rather than the actual cost of the components. For example, while producing a new compact disc, the expenses of paying the artist, advertising, marketing and legal and other fees far outweigh the actual cost of the physical disc.

Production of such knowledge-intensive goods relies more on a well-educated and skilled workforce than on natural resources. A number of products fit this description, from computer software to custom-built aircraft engine parts. Such products are produced for specific market niches and substitutes are not easy to come by.

These knowledge-intensive products are becoming a major force in international trade and a source of wealth for economies well positioned to compete in those markets.



More data on [U.S. exports](#).

Free Trade vs. Protectionism

All governments regulate foreign trade. The extent to which they do so is a matter of great controversy and debate. The news is full of reports of various groups protesting about:

- new trade agreements,
- adverse effects of trade on domestic industry, and
- dilution of the environmental and labor standards, especially in the developing economies.

Free trade proponents stand for an open trading system with few limitations and little government involvement. Advocates of **protectionism** believe that governments must take action to regulate trade and subsidize industries to protect their domestic economy.

Although the amount of government involvement in trade varies from country to country and product to product, overall barriers to trade have been lowered since World War II. All governments practice protectionism to some extent. The debate is over how many, or how few, such measures should be used to reach the country's long-term macroeconomic goals.

Completely free trade would:

- deliver the most goods and services at the lowest possible cost;
- provide consumers the freedom to buy from whomever produces the goods and services most efficiently; and
- result in competition for domestic industries which may lead to unemployment and slower growth at the least efficient companies.

If cars can be produced more efficiently in another country and consumers are free to buy them from anywhere, the domestic auto industry will lose business and may ask for government protection by limiting imports of lower-cost cars.

Arguments for protection

There are many arguments forwarded by advocates of protectionism:

- ***Cheap labor:*** Less developed countries have a natural cost advantage as labor costs in those economies are low. They can produce goods less expensively than developed economies and their goods are more competitive in international markets.
- ***Infant industries:*** Protectionists argue that infant, or new, industries must be protected to give them time to grow and become strong enough to compete internationally, especially industries that may provide a firm foundation for future growth, e.g. computers and telecommunications. However, critics point out that some of these infant industries never "grow up."
- ***National security concerns:*** Any industry crucial to national security, such as producers of military hardware, should be protected. That way the nation will not have to depend on outside suppliers during political or military crises.
- ***Diversification of the economy:*** If a country channels all its resources into a few industries, no matter how internationally competitive those industries are, it runs the risk of becoming too dependent on them. Keeping weaker industries competitive through protection may help in diversifying the nation's economy.
- ***Lowering environmental standards:*** In the rush to meet the world demand for their exports, some countries may compromise on critical environmental standards. This is particularly true for less developed countries that do not have well defined environmental protection laws in place.

Methods of Protection

Governments use a variety of tools to manage their countries' international trade positions.

- ***Tariffs:*** Tariffs are taxes on imports. Tariffs make the item more expensive for consumers, thereby reducing the demand.

Learn more about [tariffs](#).

Tariffs

Suppose there is a U.S company and a foreign company producing widgets:

	Cost to produce
U.S.- made widget	\$1.00
Foreign-made widget	\$0.75

The American widget factory will find it difficult to stay competitive under this scenario. Now, if the U.S. were to impose a tariff of 60 percent:

	New cost to U.S consumers
U.S.-made widget	\$1.00
Foreign-made widget	$\$1.20 = [(0.75 \times .60) + 0.75]$

If consumers base their purchases only on price, the demand for the foreign widget would fall and the U.S. widget industry would prosper.

If no tariff were imposed, as under free trade, Americans would have saved money by buying the cheaper foreign widget. The U.S. widget

industry would either have to become more efficient in order to compete with the less expensive imported products or face extinction.

Tariffs need not push the price of an import above the price of its domestic counterpart. They should be just high enough to reduce the price differential between the import and the domestic good. Tariffs are usually levied as a percentage of the value of the import, although sometimes a flat rate may be charged.

- **Import Quotas:** Governments sometimes restrict the sale of foreign goods by imposing import quotas. These limit the quantity of foreign goods that can be imported and help domestic producers by limiting the share of the market that can be taken by foreigners.
- **Voluntary restraints:** Sometimes governments negotiate agreements whereby a country agrees to voluntarily limit its export of a certain product. Japan voluntarily limited its export of cars to the United States in 1992 to 1.65 million cars per year.

With tariffs, it is the importing country that stands to gain through increases in the tax revenue. However, in case of quantitative restraints, the exporting country gains as the price of the imported good rises.

Both import quotas and voluntary restraints thwart the functioning of the free market. The quantity of goods remains constant while the price changes, instead of demand and supply determining both quantity and price.

- **Subsidies:** Another way to achieve the goals of protectionism is to make the domestic industry more competitive. Subsidies, which are grants by the government to an industry, can accomplish this. Subsidies can be:
 - Direct—outright payments
 - Indirect—special tax breaks or incentives, buying of surplus goods, providing low-interest loans or guaranteeing private loans.

For example, the United States subsidizes the sugar and dairy industries, among others.

- **Trade ban:** Sometimes governments ban trade with certain countries for political reasons—during times of war or political crises. Governments also ban import of certain products to protect domestic industries. For instance, Japan bans importation of rice to protect its domestic rice industry.
- **Imposing standards:** Health, environmental and safety standards often vary from country to country. These may act as a barrier to free trade and a tool of protectionism. For example, the European Union has very stringent health and safety standards that goods have to meet in order to be imported.
- **Others:** Apart from the legal restrictions there may be other less formal obstacles that impede trade. Cultural factors are one such obstacle.

Arguments for Free Trade

The debate about how free a trading system should be is an old one, with positions and arguments evolving over time. U.S. free-trade advocates typically argue that consumers benefit from freer trade and forward many reasons in support of their theory:

- Free trade and the resulting foreign competition forces U.S. companies to keep prices low.
- Consumers have a larger variety of goods and services to choose from in open markets.
- Domestic companies have to modernize plants, production techniques and technologies to keep

themselves competitive.

- Any kind of protectionist measures, like tariffs, often bring about retaliatory actions from foreign governments, which may restrict the sale of U.S. goods in their markets. This may result in inflation and unemployment in the U.S. as the export industries suffer and prices of imports rise.
- An open trading system creates a better climate for investment and entrepreneurship than one in which there is fear of governments cutting off access to certain markets.
- The cost of protection often outweighs the benefits. [Learn more](#).

Protectionist Measures: The Costs Involved

Suppose the United States placed a tariff on imported wrenches that were less expensive than domestic wrenches. There would be four basic costs to the economy:

- wrench-buyers will have to pay more for their protected U.S.-made wrenches than they would have for the imported wrenches;
- jobs will be lost at retail and shipping companies that import foreign-made wrenches;
- jobs will be lost in any domestic industries that suffer from retaliatory tariffs; and
- the extra cost of the wrenches gets passed on to whatever products and services use these wrenches.

These costs will have to be weighed against the number of jobs the tariff would save to get a true picture of the impact of the tariff.

Measures of Trade

Balance of trade and balance of payments are two of the statistics most widely used to measure a country's international trade position.

Balance of trade is the difference between a nation's exports and imports of both goods and services.

Balance of payments gives a complete summary of all economic transactions that involve money flowing into or from a country.

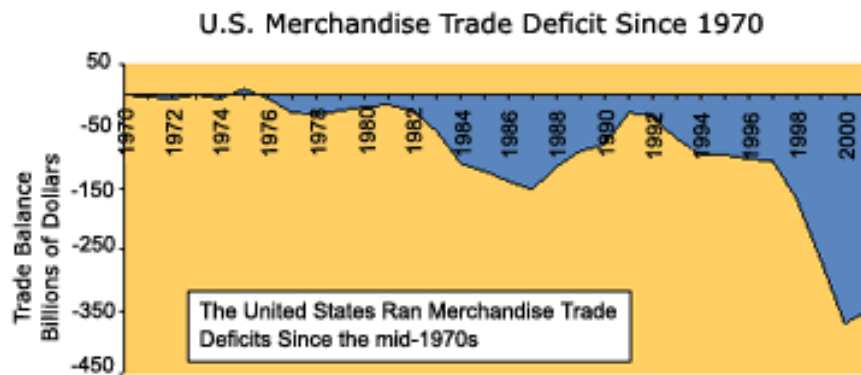
Exports are the value of goods and services sold abroad over any specific period of time.

Imports are the value of goods and services purchased from foreign countries over a specific period of time.

A "favorable" balance of trade, or **trade surplus**, occurs when exports exceed imports. A "negative" balance, or **trade deficit**, occurs when the imports surpass exports.

From the mid-1970s through 2001, the United States ran persistent trade deficits. Economists disagree as to what effect these deficits had on the economy, but they allowed:

- foreigners to accumulate U.S. dollars from U.S. import payments; and
- facilitated the purchase of U.S. goods, services and assets, such as real estate and companies, by



foreigners.

The balance of trade alone does not give the whole picture. The detailed record of all economic transactions between a country and the rest of the world is called the **balance of payments**. This includes trade in:

- goods and services; and
- financial and non-financial assets

The balance of payments is separated into two main accounts:

- **Current account**—records transactions that involve the export or import of goods and services and interest payments. The entire merchandise trade balance is contained in this account.
- **Capital account**—records transactions that involve the purchase or sale of assets or investments, like companies, stocks, bonds, bank accounts, real estate and factories.

If you buy an automobile made by a factory in Germany, the transaction will be recorded in the current account. However, if you buy the automobile factory or stock in the automobile factory, the transaction will be a part of the capital account.

Table 1: U.S. International Transactions, 2001
(Billions of dollars)

	Credits	Debits
Current account		
1. Exports	1,298.3	
Of which:		
Merchandise	720.8	
Investment income received	293.8	
Other services	283.7	
2. Imports		1,665.3
Of which:		
Merchandise		1,147.4
Investment income paid		312.9
Other services		204.9
3. Net unilateral transfers		50.5
<i>Balance on current account</i>		417.5
[(1)+(2)+(3)]		

Capital Account

4. U.S. assets held abroad		439.6
Of which:		
Official reserve assets	4.9	434.7
Other assets		
5. Foreign assets held in U.S.	895.5	
Of which:		
Official reserve assets	6.1	
Other assets	889.4	
<i>Balance on capital account</i>	455.9	
[(4)+(5)]		38.4
Statistical discrepancy		
[sum of (1) through (5)]		

Source: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. International Transactions Accounts Data. Totals may differ due to rounding.

Every international transaction automatically enters the balance of payments twice, once as a credit and once as a debit, resulting in two equal and opposite entries. A transaction that involves money flowing into the country is recorded as a *balance of payment credit* and anything that draws money out of the country is a *balance of payment debit*.

For example, if you buy a camera from a Japanese company, XYZ Inc., and pay by check, your purchase results in the following two entries in the balance of payments statements:

	Credit	Debit
Current account		
Camera purchase (U.S. import)		\$1,000
Capital account		
Sale of bank deposit (U.S. asset export)	\$1,000	

Your payment to buy a good (the camera) from a foreign company is recorded as a *debit* in the U.S. *current account*. Let's say XYZ Inc. deposits the check in their account at ABC Bank in New York. This means, XYZ Inc. has purchased, and ABC Bank has sold, a U.S. asset (a bank deposit) worth \$1,000—and the transaction will appear as a *credit* in the U.S. *capital account*.

This system of double-entry bookkeeping tries to ensure that the current and capital accounts are balanced. However, due to accounting conventions and differences in the recorded values of transactions, this does not always happen. Accounting for these differences, called *statistical discrepancies*, makes possible the following fundamental identity of the balance of payment accounts:

$$\text{Current account} + \text{Capital account} + \text{Statistical discrepancy} = 0$$

CURRENT ACCOUNT

The current account consists of four sub accounts:

- *Merchandise* trade consists of all raw materials and manufactured goods bought, sold, or given away. Since early 1990s, the merchandise trade account has been combined with services to determine the "balance of trade."
- *Services* include tourism, transportation, engineering, and business services, such as law, management consulting, and accounting. Fees from patents and copyrights on new technology, software, books, and movies also are recorded in the service category.
- *Income receipts* record investment incomes made up of interest and dividend payments and earnings of domestic owned firms operating abroad.
- *Unilateral transfers* are payments that do not correspond to the purchase of any good, service or asset. These usually take the form of international aid, gifts, or worker remittances from abroad.

Table 2: Calculating the balance on the current account

(Refer to Table 1 above)

Current Account:		Billions of dollars	
	Exports		1,298.3
+	Imports	(-)	1,665.3
+	Net unilateral transfers (inflows minus outflows)	(-)	00050.5
	Balance on current account	(-)	\$417.5 (1)

CAPITAL ACCOUNT

The capital account measures the difference between sales of assets to foreigners and purchases of assets located abroad.

- *U.S.-owned assets abroad* are divided into official reserve assets, government assets, and private assets. These assets include gold, foreign currencies, foreign securities, reserve position in the International Monetary Fund, U.S. credits and other long-term assets, direct foreign investment, and U.S. claims reported by U.S. banks.
- *Foreign-owned assets in the United States* are divided into foreign official assets and other foreign assets in the United States. These assets include U.S. government, agency, and corporate securities; direct investment; U.S. currency, and U.S. liabilities reported by U.S. banks.

Table 3: Calculating the balance on the capital account

(Refer to Table 1 above)

Capital Account:		Billions of dollars	
	Purchase of assets abroad (U.S. owned assets abroad)	(-)	439.6
+	Sales of assets to foreigners (foreign-owned assets in U.S.)		895.5
	Balance on the capital account	(2)	\$455.9

BALANCE OF PAYMENT DEFICIT AND SURPLUS

In theory, the current account should balance with the capital account. The sum of the balance of payments statements should be zero. Therefore, when a country buys more goods and services than it sells (a current account deficit), it must finance the difference by borrowing, or by selling more capital assets than it buys (a capital account surplus). A persistent current account deficit amounts to exchanging capital assets for goods and services. Large trade deficits mean that a country is borrowing from abroad and it appears as an inflow of foreign capital in the balance of payments.

The accounts do not exactly offset each other, due to statistical discrepancies, accounting conventions, and exchange rate movements that change the recorded value of transactions.

Calculating Statistical Discrepancy on the Balance of Payment

Accounts

(Refer to Table 2 and Table 3 above)

If (1) and (2) are not equal, the difference (with the sign changed) is attributed to statistical discrepancies.

- $(-417.5 + 455.9 = 38.4$

Thus *statistical discrepancies* were (-) **\$38.4** billion for 2001.

2001 U.S. BALANCE OF PAYMENTS

In 2001, the U.S imported goods and services worth \$1,352 billion, while its exports were only \$1,004 billion. And with net unilateral transfers of \$50.5 billion, the deficit on the current account amounted to \$417 billion. To cover this deficit, the United States required a capital inflow of the same amount. That means net borrowings or net sales of assets to foreigners of the same magnitude.

In the same period, the capital account registered an increase of \$439 billion in U.S assets located abroad and a \$895 billion increase in foreign assets held in the U.S. giving us a surplus balance of \$456 billion.

The difference, of approximately \$39 billion, was attributed to statistical discrepancy, leaving a zero balance in the balance of payment statement.

More information on the U.S foreign trade statistics may be accessed on the Department of Commerce, Bureau of Economic Analysis [web site](#).

BALANCE OF PAYMENTS AND INTEREST RATES

The balance of payments is influenced by many factors, including the financial and economic climate of other countries. If the U.S banks are offering higher interest rates for deposits than banks abroad, foreign funds will flow into the United States. Conversely, if interest rates are higher abroad, U.S. investors will choose to invest their money abroad.

<i>Interest rate in</i> <i>U.S.</i>	<i>Interest rate</i> <i>abroad</i>	<i>Fund flows</i> Into the	<i>U.S.Capital</i> <i>Account</i>
High	Low	U.S.	Improves
Low	High	Abroad	Weakens

Statistics Can Have Different Interpretations

Interpretations of trade statistics sometimes can differ sharply, depending on the questions being asked. The U.S. trade deficit has been viewed as good, bad, irrelevant, overstated, understated and illusory.

For example, a company that exports goods to the United States will view the deficit as a sign of a healthy U.S. market. On the other hand, a U.S. based trade union may consider the deficit a sign that domestic industries are unable to compete in the world markets.

In a global economy that is measured in trillions of dollars, not every transaction is going to be reported accurately. Statistics for many types of transactions rely heavily on estimates made by statisticians, and even the best estimates are sometimes incorrect. This can produce a skewed measurement of what is actually happening in the economy.

Measuring imports and exports

Imports: U.S. importers file tax documents with the U.S. Customs Service describing the type and value of imported goods. These reports are processed and tabulated to arrive at the overall level of U.S. imports. Inaccurate reports, delays in processing data, and smuggling can affect their value.

Exports: There is no tax on exports, so to collect information, the U.S. Department of Commerce developed a form called the Shippers' Export Declaration (SED) form, which is filled out when goods are sent overseas. These are tallied to arrive at export totals.

Access more data on [U.S. trade](#).

The Bretton Woods Agreements Act of 1945 requires the publication of balance of payments information. The statistics are generally reliable although the collection process is often difficult, especially in case of data on travel, services, direct foreign investment and financial transactions.

Sometimes it is difficult to classify a good as an import or an export. Trade is usually tabulated on the basis of national origin rather than national ownership. If a product is shipped from the U.S. to Germany, it is considered a U.S. export and a German import. It makes no difference whether a foreign company owns the U.S. factory or if it is a U.S. firm in Germany that imports the product.

If a U.S. company owns a plant in Brazil and sells a product to a Japanese company in Canada, the transaction is recorded as a Canadian import and a Brazilian export.

It is also difficult to assign a value to goods. To compare the exports of two countries in a given year, it is necessary to convert the figures

Foreign Currency Exchange

Foreign Exchange Market: What is it?

To buy foreign goods or services, or to invest in other countries, companies and individuals may need to first buy the currency of the country with which they are doing business. Generally, exporters prefer to be paid in their country's currency or in U.S. dollars, which are accepted all over the world.

When Canadians buy oil from Saudi Arabia they may pay in U.S. dollars and not in Canadian dollars or Saudi dinars, even though the United States is not involved in the transaction.

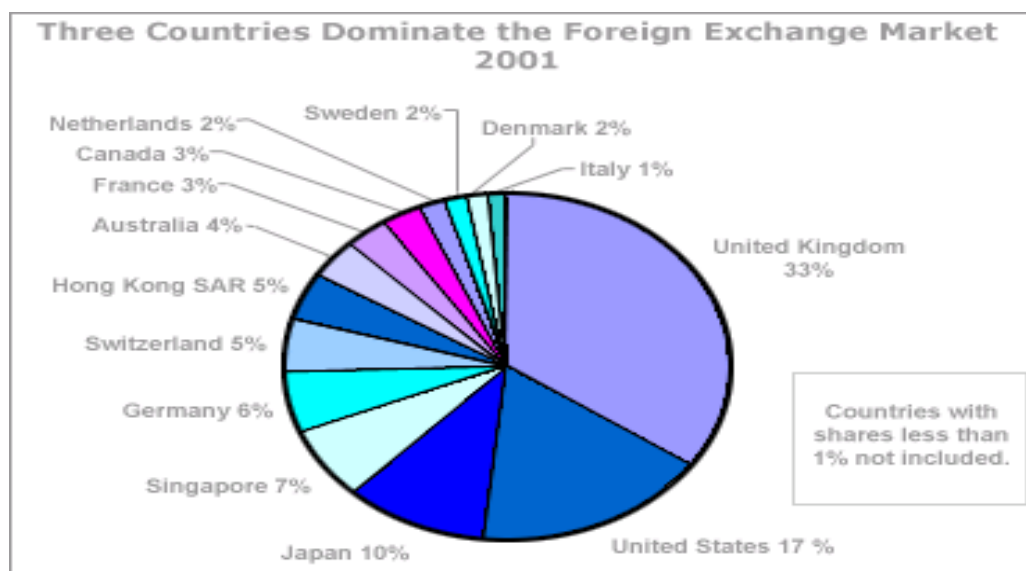
The **foreign exchange market**, or the "FX" market, is where the buying and selling of different currencies takes place. The price of one currency in terms of another is called an **exchange rate**.

The market itself is actually a worldwide network of traders, connected by telephone lines and computer screens—there is no central headquarters. There are three main centers of trading, which handle the majority of all FX transactions—United Kingdom, United States, and Japan.

Transactions in Singapore, Switzerland, Hong Kong, Germany, France and Australia account for most of the remaining transactions in the market. Trading goes on 24 hours a day: at 8 a.m. the exchange market is first opening in London, while the trading day is ending in Singapore and Hong Kong. At 1 p.m. in London, the New York market opens for business and later in the afternoon the traders in San Francisco can also conduct business. As the market closes in San Francisco, the Singapore and Hong Kong markets are starting their day.

The FX market is fast paced, volatile and enormous—it is the largest market in the world. In 2001 on average, an estimated \$1,210 billion was traded each day—roughly equivalent to every person in the world trading \$195 each day.

More statistics on the [foreign exchange market](#).



Foreign Exchange Market Participants

There are four types of market participants—banks, brokers, customers, and central banks.

- **Banks** and other financial institutions are the biggest participants. They earn profits by buying and selling currencies from and to each other. Roughly two-thirds of all FX transactions involve banks dealing directly with each other.
- **Brokers** act as intermediaries between banks. Dealers call them to find out where they can get the best price for currencies. Such arrangements are beneficial since they afford anonymity to the buyer/seller. Brokers earn profit by charging a commission on the transactions they arrange.
- **Customers**, mainly large companies, require foreign currency in the course of doing business or making investments. Some even have their own trading desks if their requirements are large. Other types of customers are individuals who buy foreign exchange to travel abroad or make purchases in foreign countries.
- **Central banks**, which act on behalf of their governments, sometimes participate in the FX market to influence the value of their currencies.

With more than \$1.2 trillion changing hands every day, the activity of these participants affects the value of every dollar, pound, yen or euro.

The participants in the FX market trade for a variety of reasons:

- to earn short-term profits from fluctuations in exchange rates,
- to protect themselves from loss due to changes in exchange rates, and
- to acquire the foreign currency necessary to buy goods and services from other countries.

Foreign Exchange Rates

Most common contact with foreign exchange occurs when we travel or buy things in other countries.

Suppose a U.S. tourist travelling in London wants to buy a sweater.
Price tag is 100 pounds.

Current exchange rate		Price of sweater in dollars
\$1.45 to £1		$100 \times 1.45 = \$145.00$
\$1.30 to £1	Pound falls	$100 \times 1.30 = \$130.00$
\$1.60 to £1	Pound rises	$100 \times 1.60 = \$160.00$

Thus, small changes in exchange rates may not seem significant. But when billions of dollars are traded, even a hundredth of a percentage point change in exchange rates becomes important.

Stronger US dollar implies	1. U.S. can buy foreign goods more cheaply	➔	Cost of purchasing foreign goods falls
	2. Foreigners find U.S. goods more expensive and demand falls	➔	Does not help firms that produce for exports
Weaker U.S. dollar implies	1. Foreigners buy more U.S. goods	➔	Helps firms that rely on exports
	2. Foreign goods become more expensive	➔	Demand for imports falls

It would seem logical that if the dollar **weakens**, the trade balance will improve, as exports would rise. However, this does not always happen. U.S. trade balance usually worsens for a few months.

The **J-curve** explains why the trade position does not improve soon after the weakening of a currency. Most import/export orders are taken months in advance. Immediately after a currency's value drops, the volume of imports remains about the same, but the prices in terms of the home currency rise. On the other hand, the value of the domestic exports remains the same, and the difference in values worsens the trade balance until the imports and exports adjust to the new exchange rates.

Exchange rates are an important consideration when making international investment decisions. The money invested overseas incurs an exchange rate risk.

When an investor decides to "cash out," or bring his money home, any gains could be magnified or wiped out depending on the change in the exchange rates in the interim. Thus, changes in exchange rates can have many repercussions on an economy:

- affects the prices of imported goods
- affects the overall level of price and wage inflation
- influences tourism patterns
- may influence consumers' buying decisions and investors' long-term commitments.

Determination of Foreign Exchange Rates

Exchange rates respond directly to all sorts of events, both tangible and psychological—

- business cycles;
- balance of payment statistics;
- political developments;
- new tax laws;
- stock market news;
- inflationary expectations;
- international investment patterns;
- and government and central bank policies among others.

At the heart of this complex market are the same forces of demand and supply that determine the prices of goods and services in any free market. If at any given rate, the demand for a currency is greater than its supply, its price will rise. If supply exceeds demand, the price will fall.

The supply of a nation's currency is influenced by that nation's monetary authority, (usually its central bank), consistent with the amount of spending taking place in the economy. Government and central banks closely monitor economic activity to keep money supply at a level appropriate to achieve their economic goals.

Too much money ➔ inflation ➔ value of money
declines ➔ prices rise

Too little money ➔ sluggish economic
growth ➔ rising unemployment

Monetary authorities must decide whether economic conditions call for a larger or smaller increase in the money supply.

Sources for currency demand on the FX market:

- The currency of a growing economy with relative price stability and a wide variety of competitive goods and services will be more in demand than that of a country in political turmoil, with high inflation and few marketable exports.
- Money will flow to wherever it can get the highest return with the least risk. If a nation's financial instruments, such as stocks and bonds, offer relatively high rates of return at relatively low risk, foreigners will demand its currency to invest in them.
- FX traders speculate within the market about how different events will move the exchange rates. For example:
 - News of political instability in other countries drives up demand for U.S. dollars as investors are looking for a "safe haven" for their money.
 - A country's interest rates rise and its currency appreciates as foreign investors seek higher returns than they can get in their own countries.
 - Developing nations undertaking successful economic reforms may experience currency appreciation as foreign investors seek new opportunities.

Foreign Currency Trading

"Yoshi, it's Maria in New York. May I have a price on twenty cable." *Yoshi it's Maria in New York. I am interested in either buying or selling 20 million British pounds."*

"Sure. One seventy-five, twenty-thirty." *"Sure I will buy them from you at 1.7520 dollars to each pound or sell them to you at 1.7530 dollars to each pound."*

"Mine twenty." *"I'd like to buy them from you at 1.7530 dollars to each pound."*

"All right. At 1.7530, I sell you twenty million pounds." *"All right. I sell you 20 million pounds at 1.7530 dollars per pound."*

"Done." *"The deal is confirmed at 1.7530."*

"What do you think about the Japanese yen? It's up 100 pips." *"Is there any information you can share with me about the fact that the Japanese yen has risen one-one hundredth of a yen against the U.S. dollar in the past hour?"*

"I saw that. A few German banks have been buying steadily all day...." *"Yes, German banks have been buying the Japanese yen all day, causing the price to rise a little...."*

Traders in the foreign exchange market make thousands of trades daily, buying and selling currencies while

exchanging market information. The \$1.2 trillion that is traded everyday may be used for varied purposes:

- for the import and export needs of companies and individuals
- for direct foreign investment
- to profit from the short-term fluctuations in exchange rates
- to manage existing positions or
- to purchase foreign financial instruments

In the volatile FX market, traders constantly try to predict the behavior of other market participants. If they correctly anticipate their opponents' strategies, they can act first and beat the competition.

Traders make money by purchasing currency and selling it later at a higher price, or, anticipating the market is heading down, selling at a high price and buying back at a lower price later.

Trader ***purchases*** a lot of currency → ***long*** on the currency (e.g. long dollar, long yen)

Trader ***sells*** a lot of a currency → ***short*** on the currency (e.g. short sterling)

To predict the movements of currencies, traders often try to determine whether the currency's price reflects its fundamental value in terms of current economic conditions. Examining inflation, interest rates, and the relative strength of the country's economy helps them make a determination.

Currency underpriced → price will go ***up***

Currency overpriced → price will go ***down***

CURRENCY TRADING BETWEEN BANKS

Banks are a major force in the FX market and employ a large number of traders. Trading between banks is done in two ways—through a broker or directly with each other.

Brokers: If a U.S. bank trades with another bank, a FX broker may be used as an intermediary. The broker arranges the transaction, matching the buyer and seller without ever taking a position and charges a commission to both the buyer and seller. About a third of transactions are arranged in this way.

Direct: Mostly banks deal with each other directly. A trader "makes a market" for another by quoting a **two-way** price i.e. he is willing to buy or sell the currency. The difference between the two price quotes (the **spread**) is usually no more than 10 **pips**, or hundredths, of a currency unit.

Most currencies are quoted in terms of how many units of that currency would equal \$1. However, the British pound, New Zealand dollar, Australian dollar, Irish punt and the Euro are quoted in terms of how many U.S. dollars would equal one unit of those currencies.

The currencies of the world's large, industrialized economies, or ***hard currencies***, are always in demand and are actively traded. In terms of trading volumes, the FX market is dominated by four currencies: the U.S. dollar, the euro, the Japanese yen and the British pound. Together these account for over 80 percent of the market.

It is not always easy to find a market for all currencies. The demand for currencies of less developed countries, ***soft currencies***, is a lot less than for the hard currencies. Weak demand internationally along with exchange controls may make these currencies difficult to convert.

Types of Transactions

There are different types of FX transactions:

- I. **Spot transactions:** This type of transaction accounts for almost a third of all FX market transactions. Two parties agree on an exchange rate and trade currencies at that rate.

Spot Transaction: How it works

- A trader calls another trader and asks for a price of a currency, say British pounds.

This expresses only a potential interest in a deal, without the caller saying whether he wants to buy or sell.

- The second trader provides the first trader with prices for both buying and selling (two-way price).
- When the traders agree to do business, one will send pounds and the other will send dollars.

By convention the payment is actually made two days later, but next day settlements are used as well.

Although spot transactions are popular, they leave the currency buyer exposed to some potentially dangerous financial risks. Exchange rate fluctuations can effectively raise or lower prices and can be a financial planning ordeal for companies and individuals.

Exchange Risks in Spot Transactions

Suppose a U.S. company orders machine tools from a company in Japan.

- Tools will be ready in six months and will cost 120 million yen.
- At the time of the order, the yen is trading at 120 to a dollar.
- U.S. company budgets \$1 million in Japanese yen to be paid when it receives the tools ($120,000,000 \text{ yen} \div 120 \text{ yen per dollar} = \$1,000,000$)

There is no guarantee that the rate will remain the same six months later.

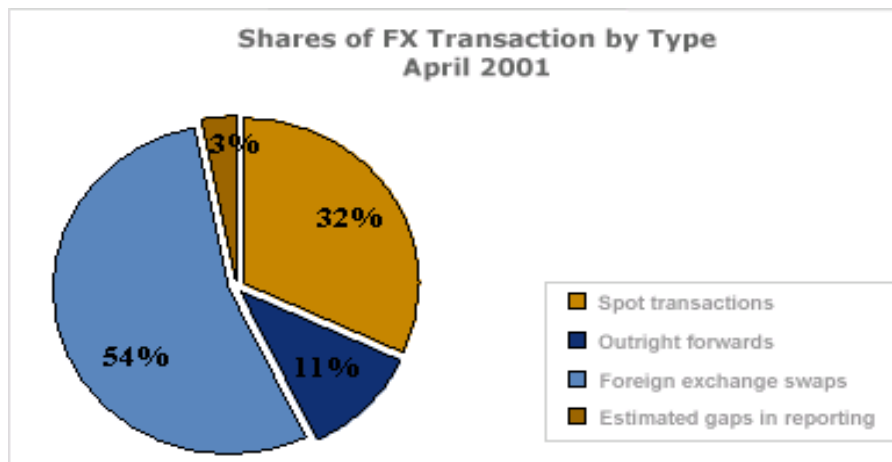
Suppose the **rate drops** to 100 yen per dollar:

- Cost in U.S. dollars would increase ($120,000,000 \div 100 = \$1,200,000$) by \$200,000.

Conversely, if the **rate goes up** to 140 yen to a dollar:

- Cost in U.S. dollars would decrease ($120,000,000 \div 140 = \$857,142.86$) by over \$142,000

One alternative for a company is to pay for the foreign good right away to avoid the exchange rate risk. But no one wants to part with money any sooner than necessary—if the company does pay the money in advance, it loses six months' interest and risks losing out on a favorable change in exchange rates.



II. **Forward transaction:** One way to deal with the FX risk is to engage in a forward transaction. In this transaction, money does not actually change hands until some agreed upon future date. A buyer and seller agree on an exchange rate for any date in the future and the transaction occurs on that date, regardless of what the market rates are then. The date can be a few days, months or years in the future.

- *Futures:* Foreign currency futures are forward transactions with standard contract sizes and maturity dates — for example, 500,000 British pounds for next November at an agreed rate. These contracts are traded on a separate exchange set up for that purpose.
- *Swap:* The most common type of forward transaction is the currency swap. In a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date.

In all of these transactions, market rates might change. However, the buyer and seller are locked into a contract at a fixed price that cannot be affected by any changes in the market rates. These tools allow the market participants to plan more safely, since they know in advance what their FX will cost. It also allows them to avoid an immediate outlay of cash.

Swap Transaction: How it works

Suppose a U.S. company needs 15 million Japanese yen for a three-month investment in Japan.

- It may agree to a rate of 150 yen to a dollar and swap \$100,000 with a company willing to swap 15 million yen for three months.
- After three months, the U.S. company returns the 15 million yen to the other company and gets back \$100,000, with adjustments made for interest rate differentials

III. **Options:** To address the lack of flexibility in forward transactions, the foreign currency option was developed. An option is similar to a forward transaction. It gives its owner the right to buy or sell a specified amount of foreign currency at a specified price at any time up to a specified expiration date.

For a price, a market participant can buy the right, but not the obligation, to buy or sell a currency at a fixed price on or before an agreed upon future date. The agreed upon price is called the **strike price**.

Depending on which—the option rate or the current market rate—is more favorable, the owner may exercise the option or let the option lapse, choosing instead to buy/sell currency in the market. This type of transaction allows the owner more flexibility than a swap or futures contract.

Option to **buy** currency → **Call option**

Option to **sell** currency → **Put option**

Get more information of different types of FX [transactions](#).

Option: How it works

Suppose a trader purchases a six-month call on one million euros at 0.88 U.S. dollars to a euro.

- During the six months the trader can either purchase the euros at the 0.88 rate, or purchase them at the market rate.
- Option can be sold and resold many times before the expiration date.
- Options serve as an insurance policy against the market moving in an unfavorable direction.

Floating and Fixed Exchange Rates

The FX market was not always quick to respond to changing events. For most of the 20th century, the exchange rates were **fixed**, or kept constant, according to the amount of gold for which they could be exchanged. This was called the [gold-exchange standard](#).

Gold-Exchange Standard

Under this system, the value of all currencies was fixed in terms of how much gold for which they could be exchanged.

For example, if one ounce of gold was worth 12 British pounds or 35 U.S. dollars, the exchange rate between dollars and pounds would remain constant at just under three to one.

There were many advantages of the gold-exchange system:

- It served as a common measure of value.
- It helped keep inflation in check by keeping money supply in the gold-exchange standard economies fairly stable.
- Long-term planning was easier as rate changes were infrequent.

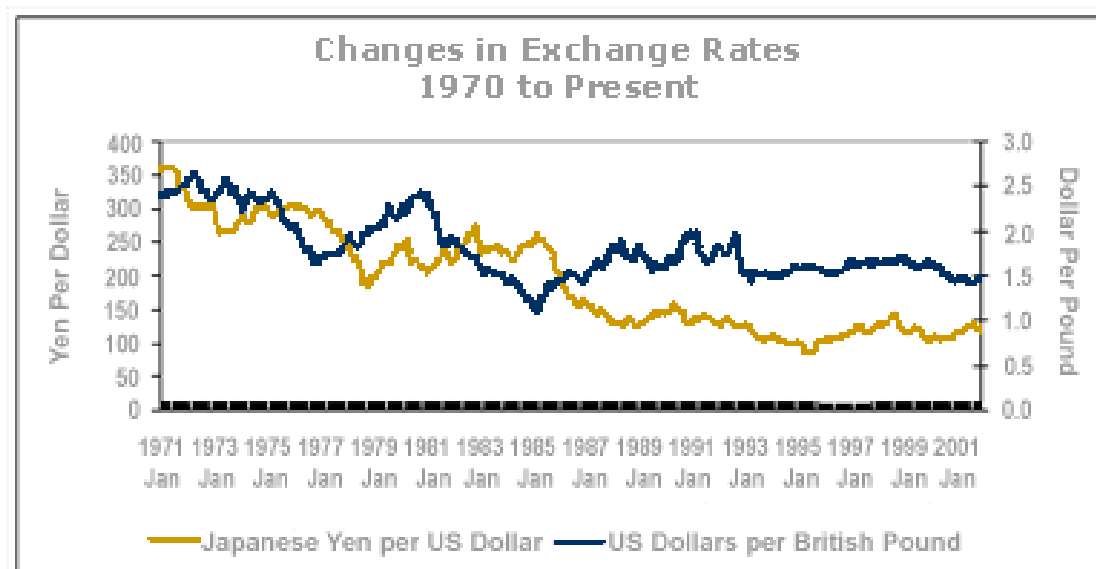
This system was put in place in 1944, when the leaders of allied nations met at **Bretton Woods**, New Hampshire, to set up a stable economic structure out of the chaos of World War II. The U.S. dollar was fixed at \$35 per ounce of gold and all other currencies were expressed in terms of dollars.

The Bretton Woods system began to weaken in the 1960s, when foreigners accumulated large amounts of U.S. dollars from post World War II aid and sales of their exports in the United States. There were concerns as to whether the U.S. had enough gold to redeem all the dollars.

With reserves of gold falling steadily, the situation could not be sustained and the U.S. decided to abandon this system. In 1971, President Nixon announced that U.S. dollars would no longer be convertible into gold. By 1973, this action led to the system of floating exchange rates that exist today. Currently, currencies rise and fall in value according to the forces of demand and supply.

After the abandonment of the gold-exchange standard, the foreign exchange market went from a relatively unimportant financial specialty to the forefront of international economics.

Under another system, the **gold standard**, U.S. households and businesses could exchange their dollars for gold. This practice was abandoned in 1933 during the Great Depression to allow freer expansion of money supply. However, foreign governments were still able to exchange their dollars for gold until 1971, when the United States terminated the gold-exchange standard entirely.



Role of Central Banks

Despite the size and importance of the foreign exchange market, it remains largely unregulated. There is no international organization that supervises it, nor any institution that sets rules. However, since the advent of the flexible exchange rate system in 1973, governments and central banks, such as the Federal Reserve System in the United States, occasionally intervene to maintain stability in the FX market.

There is no standard definition of instability or a disorderly market—circumstance must be evaluated on a case-by-case basis. Sharp rapid fluctuations of exchange rates and traders' reluctance to be ready to either buy or sell currencies (maintaining a "two-way" market) may be signs of disorderly market.

To restore stability, the central banks often work together. However, a country taking a conservative view on intervention would act only in response to unusual circumstances that require immediate action, like political unrest or natural disasters. Most monetary authorities would be less likely to intervene to counteract the fundamental forces that drive FX markets, such as trade patterns, interest rate differentials and capital flows.

Intervention

The U.S. Treasury has the overall responsibility for managing the U.S. government's foreign currency holdings. It works closely with the Federal Reserve to regulate the dollar's position in the FX markets. If the Treasury feels that there is a need to weaken or strengthen the dollar, it instructs the Federal Reserve Bank of New York to intervene in the FX market as Treasury's agent.

The Federal Reserve Bank of New York buys dollars and sells foreign currency to support the value of the dollar. The Fed also sells dollars and buys foreign currency to try and exert downward pressure on the price of the dollar.

The transactions in the intervention are small compared to the total volume of trading in the FX market and these actions do not shift the balance of supply and demand immediately. Instead, intervention is used as a device to signal a desired exchange rate movement and affect the behavior of investors in the FX market.

The frequency of intervention in the FX markets by the U.S. monetary authorities has reduced tremendously over the last decade. The Federal Reserve Bank of New York intervened only once since 1995.

Central banks in other countries have similar concerns about their currencies and sometimes intervene in the FX markets as well. Usually, intervention operations are undertaken in coordination with other central banks.

Most of the Federal Reserve Bank of New York's activities in the foreign exchange market are for far less dramatic purposes than to influence exchange rates. The New York Fed often intervenes in the FX market as an agent for other central banks and international organizations to execute transactions related to flows of international capital.

Learn more about the Federal Reserve Bank's role in the [FX market](#).

Some countries have special arrangements with other countries to help them keep their currencies stable. Many less developed countries have their soft currencies pegged to hard currencies, so their value rises and falls simultaneously with the stronger currency. Some peg, or target, their currency to a basket of hard currencies, the average of a group of selected currencies.

Countries that are part of the European Union (EU) had pegged their currencies to the euro. There were formulas set for converting from the euro to the currency of each member nation. However, since January 2002, all currencies that were part of the Economic and Monetary System of the EU ceased to exist.

Intervention in the FX market is not the only way monetary authorities can affect the value of their countries' currencies. Central banks can also affect foreign exchange rates indirectly by influencing interest rates.

Higher interest rates →	Value of currency goes up	→	Investors want to buy currency to invest at high rates
German interest rate 8%	U.S. interest rate 3%	→	Demand for German mark goes up

Concerns about Eurocurrency

An important side effect of the increase of international economic activity over the past few decades has been the creation and growth of the **Eurocurrency market**. This is the name given to any bank deposits in any country held in a different country's currency, like U.S. dollars in a British bank. A great deal of foreign exchange market activity involves the transfer of Eurocurrency deposits.

Eurocurrency, especially eurodollars (approximately two-thirds of Eurocurrency are U.S. dollars) are a source of concern to central banks and regulators because they are "stateless money"—subject to very little regulation. Rules governing currency and bank deposits—such as taxes, restrictions on capital movements and exchange controls—do not apply to the currency in the Eurocurrency markets.

Banks around the world use the Eurocurrency market to move and store funds more profitably than they could in many countries. This poses a problem for countries attempting to regulate capital flows.

International trade and foreign exchange cannot be viewed as two separate economic processes. The two are intimately connected on many levels. Increased trade and investment has brought the FX markets to their present level. Together, trade and foreign exchange affect peoples' living standards and livelihoods all over the world.

Working across Borders

Many large companies are "multinational" in that they have branches and subsidiaries all over the world. By some estimates, intra-firm trade, or trade between branches of the same company in different countries, accounts for 40 percent of U.S. exports.

Many companies buy and sell goods overseas and others form partnerships with foreign companies so that cooperation replaces competition. This has a profound effect on how companies operate in the global marketplace. Businesses around the world work side-by-side to produce and market products, thereby reducing the economic risks of global production and marketing.

For instance, there may be a running shoe company:

- headquartered in the United States,
- financed by a Japanese bank,
- buying rubber from Indonesia and leather from Spain,
- manufacturing in Mexico,
- employing a U.S. company for the legal and accounting work,
- and a British firm to handle all its advertising and marketing.

Multinational companies shift resources from one country to another to maximize profits and productivity.

The running shoes may be sold all over the world. If a shoe is shipped from San Francisco to Indonesia, it is simply a U.S. export. However, if Indonesia imposes a tariff on the shoe, it harms more than just the U.S. exporter; all businesses around the world that were involved in the process are affected, including Indonesia's own rubber exports. With globalization, it is increasingly difficult for governments to target trade policies effectively.

To remain competitive, individuals, companies, and governments all must adapt to the changing global marketplace.

Business practices vary from country to country and may require new approaches to making profits. In the United States, a signed contract is considered all but sacrosanct; in the Far East, southern Europe and the Middle East, the spirit of the agreement can sometimes matter more than the letter.

The "get down to business" approach that the U.S. and German businesses usually favor may be considered brusque or harsh in Japan or Korea. Even small details of business behavior—whether or not to look someone in the eye, tone of voice, exchange of gifts—vary significantly from country to country.

International Organizations and Trade Issues

As trade becomes more and more important to economic well being, international organizations have been formed to facilitate cooperation on trade issues.

The **World Trade Organization** (WTO), established on January 1, 1995, is the only global international organization dealing with the rules of trade between nations. It was created by the Uruguay Round of negotiations over a 14-year period and has 144 member countries (as of January 2002).

At the heart of the WTO are the various agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. These agreements cover a range of topics:

- reductions in tariffs;
- fairer competition in agricultural trade;
- textiles trade;
- trade in services;
- protection and enforcement of intellectual property;
- issues related to anti-dumping, export subsidies, and safeguards; and
- other non-tariff barriers.

The goal of the WTO is to help producers of goods and services, exporters, and importers conduct their business. The agreements have three main objectives:

- to help trade flow as freely as possible,
- to achieve further liberalization gradually through negotiation, and
- to set up an impartial means of settling disputes.

To learn more about the activities of the [WTO](#).

Another organization, the **International Monetary Fund** (IMF), was founded at the United Nations Monetary and Financial Conference at Bretton Woods in 1944. The IMF is an international organization of 183 member countries, established to:

- promote international monetary cooperation, exchange stability, and orderly exchange arrangements;
- facilitate the expansion and balanced growth of international trade,;
- foster economic growth and high levels of employment; and
- provide temporary financial assistance to countries to help ease balance of payments adjustment.

The purpose of the IMF has remained unchanged but its operations — which involve surveillance, financial assistance, and technical assistance — have developed to meet the changing needs of its member countries in an evolving world economy. Learn more about the [IMF](#).

A related organization, the **World Bank**, was founded in 1944 with the primary focus of helping the poorest people and the poorest countries. Its mission is to fight poverty for lasting results and to help people help themselves and their environment by providing resources, sharing knowledge, building capacity, and forging partnerships in the public and private sectors. Learn more about the [World Bank](#).

The **Bank for International Settlements** (BIS) in Basel, Switzerland, is an international organization that

fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability.

The BIS functions as:

- a forum for international monetary and financial cooperation;
- a bank for central banks, providing a broad range of financial services;
- a center for monetary and economic research, contributing to a better understanding of international financial markets and the interaction of national monetary and financial policies; and
- an agent or trustee, facilitating the implementation of various international financial agreements.

The Basel Committee on International Banking Supervision, a committee of the BIS that consists of representatives of some of the world's largest countries, meets to establish uniform financial and performance guidelines for commercial banks around the world. Learn more about the working of the [BIS](#).

The **Group of Seven**, or G7, was created in 1975 with the objective of setting up a forum, at the highest decisional level and having formalities reduced to a minimum, in which to discuss important macroeconomic and monetary issues. The group was established with the intent of filling the gap created in the management of the monetary system following the breakdown of the Bretten Woods agreement in 1971.

The G-7 consists of the leaders of the United States, Germany, Japan, France, Great Britain, Canada, and Italy. The Birmingham Summit in 1998 marked Russia's official entry in the Group and the creation of the **G8**. Among other things the Group discusses

- economic issues
- trade relations
- foreign exchange markets

While economic issues still dominate the G8 meetings, discussions on environmental issues and arms control have been included in recent years. Learn more about [G7](#).

A major change in the economic structures in recent years has been the creation of the **European Union** (EU). It is the result of a process of cooperation and integration that began in 1951 between six countries (Belgium, Germany, France, Italy, Luxembourg and the Netherlands).

After nearly fifty years, and four waves of accessions, the EU today has fifteen Member States.

One of the main objectives of the EU is to promote economic and social progress. Towards this end, Member States established the single market in 1993 and the single currency was launched in 1999. The completion of the EU's internal "single market" boosted intra-EU trade, which represents two-thirds of the total EU Member States' trade.

Suppliers of goods, services and investment from outside the EU have benefited from the single market program, just as much as people and companies within the EU. The EU has been busy consolidating its single market. Traders at home and overseas can market their goods in the EU based on one set of rules. The single market experience may include valuable elements for the multilateral system of the future. Learn more about the [European common market](#).

Other nations have moved to build free-trade zones and common markets as well. Under the **North American Free Trade Agreement** (NAFTA), the United States, Canada and Mexico have agreed to

eliminate barriers to trade and to facilitate the cross-border movement of goods and services. The agreement also aims to promote conditions of fair competition in the free trade area and to substantially increase investment opportunities. Learn more about [NAFTA](#).

Many smaller "**trade blocs**" are developing all over the world, in North Africa, South East Asia, different parts of Latin America, Eastern Europe and the Middle East. Over the last 50 years more than 100 regional economic agreements have been created.

A **trade bloc** refers to a regional arrangement among countries that have established formal mechanisms for cooperation on trade issues. The term does not necessarily imply a protectionist stance with respect to nonmember countries, although it is sometimes used in this way.

Trade blocs commonly include six types of arrangements: *economic union*, *common market*, *customs union*, *free trade area*, *preferential arrangement*, and *regional cooperation organization*.

A possible problem is that competing trade blocs will adopt protectionist policies and slow worldwide economic growth by restricting trade among groups of nations. However, rapid proliferation of trade blocs and free-trade zones has occurred because countries want the benefits of increased trade that accompany lower trade barriers.

The WTO has created a committee to study regional groups and to assess whether they are consistent with WTO rules. The committee is also examining how regional arrangements might affect the multilateral trading system, and what kind of relationship they might have.

Useful Web Links

U.S. related:

U.S. Department of Treasury: Capital Movements Bulletin:

<http://www.fms.treas.gov/bulletin/b21.pdf>

U.S. Department of Commerce: Export Portal:

<http://www.export.gov/docTSFrameset.html>

White House: Economic Statistics Briefing Room:

<http://www.whitehouse.gov/fsbr/international.html>

Census Bureau: Foreign Trade Statistics:

<http://www.census.gov/>

<http://www.census.gov/foreign-trade/www/>

Bureau of Economic Analysis:

<http://www.bea.doc.gov/bea/di1.htm>

Federal Reserve Board: Research and Data:

<http://www.federalreserve.gov/rnd.htm>

Federal Reserve Board: Flow of Funds Data:

<http://www.federalreserve.gov/releases/Z1/Current/Coded/coded.pdf>

International Sites:

World Bank:

<http://www.worldbank.org/>

http://www1.worldbank.org/wbiep/trade/services_data.htm#Flows

Bank of International Settlements:

<http://www.bis.org/>

European Union:

http://europa.eu.int/index_en.htm

G-7 Home page:

http://www.g7-2001.org/en/frames_c.htm

OECD National Accounts:

<http://www.oecd.org/std/nahome.htm>

World Trade Organization:

<http://www.wto.org/>

http://www.wto.org/english/res_e/statis_e/technotes_e.htm

General Agreement on Trade and Tariff (GATT):

<http://gatt.org/>

North American Free Trade Agreement (NAFTA):

<http://www.nafta-sec-alena.org/>

International Monetary Fund:

<http://www.imf.org/>

International Finance Corporation:

<http://www.ifc.org/>