INTERNATIONAL BANKING

Nicholas L. Deak
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Foreword

A proverb, wrote Cervantes, is a short sentence based on long experience. The complexities of international finance are not so easily reduced to succinct dictums. So Nicholas Deak and JoAnne Celusak have given us a volume, but one with cogency and based on a life lived on both the back paths and carriageways of multinational commerce.

I welcome this book, as should all who wish to sharpen their understanding of international banking and finance. It is a useful text for the motivated novitiate and the seasoned practitioner alike. Given the ever-shifting mosaic we know as international finance, Mr. Deak and Ms. Celusak have captured a portrait that will endure. An intricate terrain has been charted with wisdom and care.

JOHN F. MCGILLICUDDY
Chairman of the Board
Manufacturers Hanover Corporation

Introduction

With the expansion of American banks abroad and of foreign banks in the United States, and with the related international activities, there is a crying need for a textbook on international banking, which can be used in universities and colleges.

More and more students, on undergraduate and graduate levels, are seeking expertise in the international financial field. A growing number of law schools are providing their students with facilities to expand their legal knowledge and the basis for their future professional activities in this area.

During my classes in international banking at the New York Law School, students called to my attention the need for more up-to-date textbook material to facilitate their studies. The former Dean of the New York Law School, E. Donald Shapiro, and the Associate Dean, Margaret S. Bearn, gave me encouragement to attend to this task.

The greatest incentive, however, to tackle the job of writing this textbook, came from one of my students, JoAnne Celusak, who volunteered to assemble a group of students to cooperate with me in doing research, preparing the material, and making corrections wherever necessary. All the students were in the graduating class of the New York Law School. Their contribution under the leadership of JoAnne Celusak was especially commendable since, in the meantime, they graduated and became engaged in various aspects of the legal profession.

Without JoAnne Celusak and her team, this book could not have been accomplished.

We do not claim completeness; we do not claim perfection. We do believe, however, that this book contains superior material for the ma-

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ture students interested in international banking, international finance, and advanced economics. We feel that professionals, bankers, economists, will find this book valuable and useful to them.

As time goes by, and as new editions might become necessary, we intend to upgrade the book with additional information as it becomes available.

We wish to thank the following individuals for their cooperation and assistance in the preparation of this text: in particular, David Roulston, for his skillful editorial work and helpful contributions, along with Joyce Moffatt, Richard O'Connor, Karin Burke, Brian Platton, Celeste Miller, Simon Kogan, and other New York Law School graduates for their assistance in preparation of the drafts. A special thank you goes to Inez Bruelhmann as well as to Frances Lauder for their extraordinary secretarial skills in producing the final manuscript.

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1

Balance of Payments

The concept of balance of payments is important to understanding the economic forces behind events affecting international banking. Numerous studies have analyzed the intricacies and theories of balance of payments. However, this discussion approaches balance of payments with the purpose of explaining components that have immediate as well as long-term effects upon a nation's currency and banking transactions. Therefore, let us first define the often used term, "balance of payments."

The *balance of payments* of a nation refers to a whole complex of international business and financial transactions involving payments made and received by the residents of one nation to and from the residents of other nations. The measurement of payments is not necessarily restricted to payments made in monetary form. Currently, the United States balance of payment data is officially called "United States International Transactions."

Thus, the balance of payments records economic transactions made during a specific period between residents and nonresidents. It is a complex structure consisting of many tangible and intangible movements of funds. A nation's balance of payments must be carefully monitored and studied since it indicates not only the internal but also the external economic strength of a country. In fact, it would be inaccurate to think of the balance of payments as a disconnected phenomenon that is unrelated to the domestic economy.

It is clear that international economic relationships will affect the balance of payments between the United States and the rest of the world. Moreover, the balance of payments will influence the well-being of a nation. In addition, it has a significant effect upon everyday political,

economic, and monetary decisions. For example, since the United States dollar is so widely used to settle many business transactions here and abroad, the condition of the balance of payments in the United States is of importance to many nations. Similarly, investors turn to balance of payment figures as the key starting point for the study of a nation's economic condition.

In general, a balance of payments surplus indicates a healthy economy that holds enough foreign currency reserves to finance outstanding foreign debt. On the other hand, a balance of payments deficit implies a drain on the economic resources of a nation, which will produce harmful consequences. Causes and effects of these conditions will be examined later in this chapter.

Overall, however, we will see that every act involving some form of payment between a resident and a nonresident will affect the balance of payments. For example, if an individual travels outside the United States, purchases goods manufactured abroad, or sends money to help a friend or relative residing abroad, these acts affect the balance of payments. Other examples include: making a loan to a foreign enterprise, opening a foreign bank account, or purchasing insurance through a foreign company. The list of possibilities is endless since virtually every form of international economic transaction is added to the balance of payments picture.

However, for analytical purposes, a distinction should be made between the various types of transactions that comprise the balance of payments. Therefore, the balance of payments can be subdivided into five major components including:

- Balance of Trade
- Balance of Services
- Balance of Short-Term Capital Movements
- Balance of Long-Term Capital Movements
- Errors and Omissions

By looking at these components individually or in combinations, analysts can determine the areas of economic strength and weakness of a national economy, thereby locating growth and decline in specific domestic and international sectors. Although balance of payments data is a reflection of the past, economic trends may be projected when supplemental information is also considered. It is important to note, however, that the "errors and omissions" component, now officially called "statistical discrepancy," should be seriously taken into consideration by analysts since this category can be substantial and lessen the degree of reliability of the data. In addition to the possibility of a large number of transactions being incorrectly reported or altogether omitted,

about 30% of the United States economy might be underground. This further adds to the unreliability of official balance of payments data. Nevertheless, for reasons to be explained, the true barometer of a nation's balance of payments condition is its currency. That is, we can determine the positiveness or negativeness of the balance of payments through the relative strength or weakness of its currency. If the currency strengthens, we know that the balance of payments is positive. Conversely, if the rate of exchange of a nation's currency weakens versus other countries, we know that the balance of payments of that country is negative at that point in time.

Before examining the various components of the balance of payments in depth, it is useful to understand the basic differences between each of the components and see the manner in which the data is compiled and published by the authorities.

The first subdivision mentioned was the *balance of trade*. This component measures the balance or net between all the merchandise exported and all the merchandise imported into a country during the measuring period. It measures the competitive position of U.S. products. The Customs Service is the agency that processes figures for imports and exports using documents accompanying the goods.

The second subdivision covers *balance of services*. This component includes all expenditures and receipts that are neither connected with the trade of merchandise nor included in the categories of capital movements. Services are often provided between residents of separate nations, such as when tourists travel to see the scenery. Services include payments for franchises and interest on the use of money in a loan transaction. Thus, interest paid or received on the use of funds is considered payment for a service provided and is classified under balance of services. In order to compile these figures, an average expenditure is calculated using a group of questionnaire survey responses, sometimes obtained from tourists returning to the United States. In addition, total receipts and expenditures for various measurable services are also included in the balance of services. However, unlike the balance of trade, figures for the balance of services are not as easily obtainable.

The third subdivision mentioned was *short-term capital movements*. These include financial transactions, namely capital investments with a maturity of generally less than one year. Overall changes in assets and liabilities held are measured. Short-term capital movements can be defined either as a transfer of funds that can be withdrawn at any time in the discretion of the originator or as a transfer of funds for a specific length of time, mostly one year or less. It should be mentioned, however, that a few economists consider three years to be the distinguishing time factor between short- and long-term capital movements. Regarding the computation of capital movement figures, the reporting requirements

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imposed on certain transactions facilitate the collection of data to measure both short- and long-term movements of capital. However, great statistical difficulty is involved in calculating this most important subdivision of balance of payments.

The fourth subdivision, *long-term capital movements,* refers to investments of a more permanent nature, which are not callable or returnable on short notice. Therefore, transactions in assets or liabilities with original maturities of more than twelve months are generally classified as long-term capital movements.

As was mentioned for the short-term capital movement figures, the source of data for long-term transactions is obtained mainly from Department of the Treasury reports that various organizations are required to file. For example, banks, large corporations, and some securities firms must file reports indicating changes in capital movements based on either a transaction or net position. Securities firms make reports on a transaction basis, whereas figures for banks are sometimes estimated using the balances outstanding at the end of the reporting period. Thus, whereas the shift of funds between banking centers may be large in volume, the overall change in capital movements is taken from the net position at the end of the reporting period. It should be mentioned that, in countries having exchange controls, data regarding transfers of funds between residents and nonresidents through the domestic banking system will probably be one of the main sources of balance of payments data.

The fifth and final subdivision in balance of payments is called *errors and omissions.* A statistical discrepancy occurs despite attempts to collect relevant data by means of mandatory reports and other methods. All the movements of funds and payments that statisticians did not measure are entered into the category of errors and omissions. Furthermore, the reliability of balance of payment data is not assured once errors and omissions are tallied. This is due to the fact that it is not known into which category or categories the discrepancy should be placed.

In order to eliminate this inaccuracy, which became very large in 1980–81, a committee was set up to study causes and suggest solutions to the reporting problem. Although adjustments were made in reporting requirements, the problem of a large statistical discrepancy still exists.

Nevertheless, by adding up the positive and negative side of the first four subdivisions of the balance of payments, we would have a good indication of the nation's economic position. This is possible because of the method of recording the balance of payment transactions, known as the *double entry system.* Similar to business accounting, a debit entry shows an increase in assets (or a decrease in liabilities), whereas a credit

entry shows an increase in liabilities (or a decrease in assets). Each transaction within the balance of payments system is shown with two entries, one positive and one negative in real terms.

To illustrate this double entry system, assume that goods (such as trucks) are being exported from country A to country B. Two entries are made to represent the exportation of goods and payment therefore. Namely, since country A now has less goods, a credit (or minus) entry is made in that category. However, a debit (plus) entry must also be made under payments since funds are due for payment of the goods. The opposite entries will be made for country B's balance of payments, since goods are being gained (debit or plus entry) while funds are being reduced (credit or minus entry).

Theoretically, these transactions balance. Thus, the components of the balance of payments of a nation must always balance due to its nature as a double entry system. The ideal balance is known as *balance of payments equilibrium*.

It is important to examine the reality of the total balance of payments system, however. It is likely that the amount of goods exported will not equal the amount of goods imported to a nation. Therefore, the possibility of balance of payment disequilibrium between two or more nations exists. In other words, one country may be exporting more goods to other nations and receiving more funds in payment than others. In this situation, assuming a surplus is created, the balance of trade of the exporting nation will be positive.

Conversely, if foreign claims on a country's currency to pay for imports increase to the point of creating a deficit, the balance of trade will be negative. Although surplus and deficit concepts are more suspect due to the shift from fixed to floating exchange rates, the strength or the weakness of a currency will indicate a balance of payments position. Thereafter, an adjustment mechanism might operate when the demand or supply of a nation's currency is substantially increased so as to alter the exchange rate of a currency. That is, an exchange rate adjustment may occur at some point in time to equalize the purchasing power of the currencies and reduce the balance of payment disequilibrium between the nations. However, as will be examined in the chapter on foreign exchange, a variety of forces continually operate on the value of a currency. Nevertheless, it is important to realize that there is a correlation between the balance of payments and the currency value of a nation.

For example, the value of the dollar outside the United States depends mainly upon our balance of payments. Outside the United States, our currency is a commodity, since it is not legal tender abroad. An excess of any commodity forces prices down. As shown, if the United States balance of payments is negative, it means that more dollars have been spent abroad than were taken in from nonresidents. Therefore, if

the supply of U.S. dollars abroad is greater than the demand, the value of the dollar will decrease.

Until about 1968, the balance of trade of the United States was positive due to the fact that more goods were exported than imported. However, with the exception of one year, the United States balance of trade has remained negative. In addition, the United States balance of payments turned negative in 1982, resulting, years later, in a vast depreciation of the value of the dollar abroad. The reality of the situation is that U.S. residents have to pay higher prices (in terms of U.S. dollars) for foreign goods and services. At the present time there is no indication that our balance of trade will become positive.

It is evident why the individual and combined components of the balance of payments accounts are of such interest to analysts and governmental officials. Let us now look more closely at the various subdivisions of a nation's balance of payments.

The balance of trade can be positive or negative, as it measures the difference between all the merchandise exported and imported into a country. It is a sizable part of the balance of payments, and, in foreign countries especially, balance of trade figures have great importance. However, it should be understood that in the United States the importance of balance of trade is not as great as it is in some other countries. As a general matter, the importance of balance of trade figures can be judged based upon the percentage that exports contribute to GNP amounts. The greater the proportion of exports to GNP totals, the more significant the balance of trade figures will be in ascertaining a particular nation's economic position.

For example, the United States exports less than 10% of its gross national product. This is much less than the proportionate export of some other countries. Some countries export over 30% of their GNP. As a result, the balance of trade of those countries is more crucial and has a greater effect on the balance of payments than in the United States. Nevertheless, the majority of people either mistake balance of trade for the balance of payments or lend greater significance to balance of trade figures than is required. Therefore, news of negative United States balance of trade figures produces more of a reaction than is warranted under the circumstances.

It is also important to look behind the balance of trade figures for additional useful information. For example, an unfavorable deficit in the balance of trade may in the long run be productive if so-called capital goods are being acquired to be utilized to increase future exports or to lessen future dependency on imports. Similarly, one should be aware that, since balances are derived by computing the next excess of debits or credits in merchandise accounts, the possibility of a valuation error is present. All entries are supposed to be recorded on a uniform valuation

basis, which should achieve uniformity in the freight and insurance entries. However, establishing the value of goods shipped and received is not simple. For example, should cost of goods to importers and exporters be the valuation, or should additional costs—such as commissions, insurance premiums, freight and handling charges, and the like—also be included? Detailed sets of rules of the U.S. Customs Service provide valuation guidelines for U.S. trade statistics. Valuation basis is normally FOB (free on board) at the customs frontier of the exporting country for both exports and imports. However, if a country is unable to report imports on this basis, the alternative valuation of CIF (cost, insurance, freight) at the customs frontier of the importing country is also used. For example, the United States, Canada, and Australia value imported goods FOB foreign port of origin. The thorough collection of statistical data through the U.S. Customs Service provides figures reflecting monthly, quarterly, and yearly balances of trade. Nevertheless, the valuation of merchandise is a crucial factor in the accuracy of these statistics. Furthermore, since different nations compile data using different systems of valuation, comparison of those figures is often inconclusive. Finally, it should be mentioned that a special classification is made for military merchandise, which leaves the country but for which no payment is made. Assuming that no payments were made and the shipments are going to be used by our own military abroad, it is not considered a true "export," and it might be added to the errors and omissions category.

Another category that contains a variety of classifications is the balance of services. As was mentioned earlier, expenditures and receipts that are not connected with trade or merchandise and that are not in the category of capital movements are entered in balance of services. Principal areas include shipping services, other transportation, travel, investment income such as interest and dividends, official services and private services such as insurance premiums unrelated to merchandise. In some countries, the balance of services may be a significant category in the balance of payments measurement inasmuch as large amounts of foreign currency earnings are generated by the nation's sale of various services. For example, a country largely dependent on tourist trade will attribute a greater significance to balance of service figures. Additional examples of expenditures that would fall within the balance of services include: expenditures of embassies abroad; payments received for use of patents, royalties, and fees; medical and student expenses; film right payments; supplying know-how and labor; foundation payments supporting universities, educational institutions, hospitals, and churches; expenditures of various American missions; legal fee expenditures; plus many more. An interesting illustration of a balance of service entry is the payment made to the Canadian government for permitting the use of

their territory for the transit of oil by pipeline from Alaska. Since the oil originates in U.S. territory, the royalty paid for the right to transport the oil across Canada is not for import but rather for services. The sum total of these service expenditures will yield the balance of services. Again, this total may be either positive or negative and is another element in the final balance of payments calculation.

This brings us to a discussion of short-term capital movements, which is a most significant factor in a nation's balance of payments. While the officially prepared United States International Transactions groups capital flows into private and governmental capital flows, with remittances and transfers under a separate heading, a clear understanding of the causes and effects of short-term capital flows is still essential. Short-term investments of one year or less create a vast amount of readily movable funds that respond to identifiable catalysts. In particular, the interest rate differentials existing in worldwide money markets are responsible for attracting short-term capital flows. Naturally, costs incurred, such as those involved in conversion of one currency to another and in hedging exchange risks, must be considered when calculating the most favorable investment yield. In addition, market factors, such as perceived risk and stability existing in the country of investment, also play important roles in the choice of location of short-term investments. For example, when the United States devalued its dollar repeatedly and closed the gold window in 1971, many individuals in the United States and abroad lost faith in the monetary policy of the United States government. A huge outflow of short-term capital from the United States to foreign banks occurred in response to the concern that the U.S. dollar would be further depreciated. Thus, we see that a lack of confidence creates a flow of short-term capital, which may assume abnormal proportions.

The most commonly known forms of short-term capital movements include: opening accounts abroad, purchase of foreign securities, or the purchase of certificates of deposit by nonresidents if the maturity is one year or less. Thus, since most certificates of deposit or commercial paper are for three-, six-, or nine-month periods, funds moving out of a country into foreign certificates would be considered short-term. If the certificates of deposit were to be renewed or rolled over so as to extend the total time, the funds would still not be considered long-term. There would be two short-term movements—one for the original duration and one for the renewal period. It should be remembered, however, that the interest resulting from these short-term deposits would be categorized under balance of services.

The free, unrestricted flow of short-term funds into as well as out of the nation has advantages. For example, international trade will be facilitated through the availability of funds for payment. Foreign ex-

change markets will operate more smoothly by having arbitrage channels available for purchase and sale of currency. Finally, the possibility of turning short-term capital movements into long-term investments is better when the international financial market is active.

Difficulties arise, however, when conditions in a nation do not permit the establishment of a free market interest rate. Confidence in the safety of investments and faith in continued free market conditions are vital if a market is to continue to attract short-term funds. Therefore, if foreign governments and foreign enterprises have faith in the U.S. dollar, they will purchase U.S. dollars for deposit in the United States. This flow of funds into the country will improve the U.S. balance of payments. Conversely, if confidence in the monetary system of a nation falters, the resulting withdrawal of short-term funds will weaken the balance of payments. When this outward movement of funds is prompted by loss of market confidence beyond a shift of short-term interest rate levels, the international flow of funds will rapidly become substantial. This phenomenon is known as *flight of capital*. The movement of funds out of a nation due to an international weakening of faith in the currency of that country accounts for a large percentage of short-term capital movement. Therefore, it is a most important factor in a nation's balance of payments.

Many events may prompt the flight of capital. A loss of faith in the economy or the stability of the government may be the cause. Threats of outside aggression or domestic upheavals will invariably prompt residents to seek out more stable conditions and move funds to safer countries, rather than hold a currency exposed to unfavorable pressures. For example, in countries such as Argentina, Brazil, Uruguay, and Israel, those earning money in excess of their daily needs exchange their local money into other currencies in order to preserve their wealth. The added pressure created by flight capital prevents these countries from maintaining a positive balance of payments.

Naturally, in the attempt to alleviate this added pressure on currency, governments seek to prevent flight of capital. Controls on capital movements are frequently enacted in the forms of exchange restrictions discussed in more detail in the chapter on foreign exchange. However, the effectiveness of such controls has not been proven. It is more likely that removal of the cause triggering the flight of capital would stem the outflow of funds more effectively than exchange restrictions.

An example of efforts made to control foreign investment outflows is seen in the United States capital controls introduced in the 1960s. The increasing weakening of the U.S. dollar and continuing deficit in the balance of payments caused by corporate expansion overseas, war expenditures, and capital outflow prompted measures such as the Interest Equalization Tax and the Voluntary Credit Restraint Program. These

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