Unit VII: The Global Economy

Topic 1: International Trade: Comparative & Absolute Advantage (Module 4)
Topic 2: International Finance: Balance of Payments (Module 41)
Topic 3: International Finance: Exchange Rates (Modules 42-45)

"An open economy interacts with the rest of the world both through the goods market and the financial markets, and it is important to understand how a country's transactions with the rest of the world are recorded in the balance of payments accounts.
Students should understand the meaning of trade balance, the distinction between the current account balance and the capital account balance, and the implications for the foreign exchange market.

The course should also focus on the foreign exchange market and examine how the equilibrium exchange rate is determined. Students should understand how market forces and public policy affect currency demand and currency supply in the foreign exchange markets and lead to currency appreciation or depreciation. How capital flows affect exchange rates, and how appreciation or depreciation of a currency affects a country's net exports should be an integral part of the presentation. Having learned the mechanics of the foreign exchange markets, students should then understand how changes in net exports and capital flows affect financial and goods markets.

It is important to examine the effects of trade restrictions, how the international payments system hinders or facilitates trade, how domestic policy actions affect international finance and trade, and how international exchange rates affect domestic policy goals."

(http://apcentral.collegeboard.com/apc/public/repository/ap08_economics_coursedesc.pdf)

Topics Covered:

VII. Open Economy: International Trade and Finance (10-15%)

- A. Balance of payments accounts
  1. Balance of trade
  2. Current account
  3. Capital account
- B. Foreign exchange market
  1. Demand for and supply of foreign exchange
  2. Exchange rate determination
  3. Currency appreciation and depreciation
- C. Net exports and capital flows
- D. Links to financial and goods markets

Topic 1: International Trade: Absolute & Comparative Advantage
Krugman Module 4

Objectives:

1. Describe the patterns and trends in international trade
2. Explain why nations engage in international trade and why trade benefits all nations
3. Assess the difference between Absolute Advantage and Comparative Advantage
4. Calculate Comparative Advantage and Terms of Trade between two nations.

Key Terms:

Absolute Advantage	Comparative Advantage
Terms of Trade	Specialization
Tariff	Quota

Key Conceptual Questions:

1. Discuss the relationship between comparative advantage and absolute advantage
2. Use the production possibilities curve to demonstrate gains from trade
3. Calculate the terms of trade between two trading nations
4. Explain the effects of a tariff and a quota on domestic consumers, domestic producers, and the domestic government

Topic 2: International Finance: Balance of Payments
Krugman Module 41

Objectives:

1. Explain how U.S. exports create a demand for dollars and a supply of foreign exchange, and how U.S. imports create a derived demand for foreign exchange and a supply of dollars.
2. Explain and identify the various components of the balance of payments.
3. Identify trade and balance of payments deficits or surpluses when given appropriate data.
4. Explain how a nation finances a "deficit" and what it does with a "surplus."

Key Terms:

Balance of Payments	Current Account
Capital & Financial Account	Trade Deficit
Trade Surplus	Net Investment Income
Net Transfers	Capital Inflow and Outflow

Key Conceptual Questions:

1. Define the balance of payment accounts, the current account, the capital account, and the financial account
2. Explain trade deficits and trade surpluses

Topic 3: International Finance: Foreign Exchange Rates
Krugman Modules 42-45

Objectives:

1. Explain how exchange rates are determined in a flexible system.
2. Describe the causes and two effects of a trade deficit.
3. Describe the difference between fixed exchange rates and floating exchange rates.

Key terms:

Appreciation of Currency	Depreciation of Currency
Equilibrium Exchange Rate	Real Exchange Rate
Purchasing Power Parity	Exchange Rate Regime
Flexible/Floating Exchange Rate System	Fixed Exchange Rate System

Key Conceptual Questions:

1. Explain the role of the foreign exchange market
2. Define currency appreciation and currency depreciation
3. Discuss the relationship between the exchange rate and the quantity of dollars demanded
4. Explain how a change in the US interest rate differential or in the expected future exchange rates changes the demand for dollars
5. Discuss the relationship between the exchange rate and the quantity of dollars supplied
6. Explain how a change in the US interest rate differential or in expected future exchange rate changes the supply of dollars
7. Illustrate equilibrium in the foreign exchange market and show how the demand for dollars or supply of dollars changes the exchange rate
8. State how the Fed intervenes in the foreign exchange market