**NAME: UWEJEYAN ANNIRE**

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**DEPARTMENT: ECONOMICS**

**COURSE CODE: ECO 314 (INTERNATIONAL ECONOMICS II)**

1. **Foreign exchange management (FEM) is the core issues in International Finance. Discuss.**

As you know, money is anything that is accepted as a medium of exchange. In most of the world, people accept pieces of paper imprinted with pictures of national heroes or local wonders of nature as money. But in each nation, they accept different pieces of paper.

This means that if someone in the United States wants to buy something from someone in, say, Nigeria, she must first exchange her local currency—dollars—for the currency accepted in Nigeria—naira. This currency conversion occurs at an exchange rate.

The exchange rate—the price of one nation's currency in terms of another nation's—is a central concept in international finance. Virtually any nation's currency can be converted into the currency of any other nation, thanks to exchange rates and the foreign exchange market. For instance, let's say the current exchange rate between the U.S. dollar and the Nigerian naira is $1 to 360 naira. This means that $1 will buy 360 naira and that 360 naira will buy $1. (I am ignoring transaction costs, such as the commission charged by the bank or foreign exchange broker who does the currency conversion.)

The foreign exchange market includes the importers, exporters, banks, brokers, traders, and organizations involved in currency conversion. The FX or FOREX market, as it is called, is not a physical place—though many participants work in offices and on trading floors—but rather the entire network of participants in the market.

Importers and exporters need foreign currency in order to complete transactions. Banks and brokers maintain inventories of foreign exchange, that is, various currencies, and convert currencies as a service to customers. Traders and speculators make (or lose) money on the movement of foreign exchange rates As you will see, central banks also play a role in the foreign exchange market.

1b) **How does this affect the Balance of Payment (BoP) of your home country?**

Changes in exchange rate have direct effect on demand and supply of goods, investment, employment as well as distribution of income and wealth. When Nigeria started recording huge balance of payments deficits and very low level of foreign reserve in the 1980s, it was felt that a depreciation of the naira would relieve pressures on the balance of payments. Consequently, the naira was devalued. The irony of this policy instrument is that our foreign trade structure did not satisfy the condition for a successful balance of payment policy. The country’s foreign structure is characterized by export of crude petroleum and agricultural produce whose prices are predetermined in the world market and low import and export price elasticity’s of demand. Obadan and Nwobike (1991) opine that some countries with a weak balance of payments position adopt multiple exchange rate systems as an alternative to devaluation, which is viewed as too costly from a political or social perspective. They emphasize that a rationalized and properly administered dual exchange rate system can be very helpful to developing countries for ensuring the satisfaction of basic needs, ensuring fixed and balance of payments viability and general resource mobilization.

1. **Explicitly show the issues in FEM using your home country as case study.**

There was a major change (the first) in 1962 that unpegged the Nigerian pound from the pound sterling. The change, through the 1962 Act, defined the Nigerian pound in terms of gold, which meant that Nigeria could at any time decide on whatever adjustments needed to be made in the official rate between her currency and other currencies including the pound sterling. This, of course, was supposed to send strong signals to the international community that Nigeria, as an independent nation, was free to make decisions on her own. The wisdom of the action was later justified when in 1967 the pound sterling was devalued without any effects on the Nigerian pound. The second major change occurred in 1973 when the Nigerian currency was 'decimalized and changed from the pound to the naira. This time, seemingly forgetting fee wisdom of autonomy, it was fixed to the US dollar. When the dollar was devalued m 1973, the value of the naira depreciated. The depreciation persisted due to the persistence in the depreciation of the dollar. Consequently, at the end of 1973, the Nigeria government decided to discontinue any direct relationship between the naira either the pound sterling or the US dollar. This led in 1974/75 to the policy of progressive appreciation of the naira. This policy -was greatly enhanced by the oil boom.