**ADEYEMI OLUWATOYIN ELIZABETH.**

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**INTERNATIONAL ECONOMICS.**

**QUESTION 1.**

1. **Foreign exchange management as a core issue in international finance.**

International finance is also referred to as international monetary economics or international macroeconomics. It is the branch of financial economics broadly concerned with monetary and macroeconomic interrelations between two or more countries. International finance examines the dynamics of the global financial system, international monetary system, balance of payments, exchange rates, foreign direct investments, and how these topics relate to international trade.

Sometimes referred to as multinational finance, international finance is additionally concerned with matters of international financial management. Investors and multinational corporations must assess and manage international risks such as political risk and foreign exchange risk, including transaction exposure, economic exposure, and translation exposure.

**Foreign Exchange Management Before 1986**

Before 1986, importers and exporters of non-oil commodities were required to get appropriate licenses from the Federal Ministry of Commerce before they could participate in the foreign exchange market. Generally, import procedures followed the international standard of opening of letters of credit (L/Cs) and subsequent confirmation by correspondent banks abroad. The use of Form 'M' was introduced in 1979 when the Comprehensive Import Supervision Scheme (CISS) was put in place to guard against sharp import practices. The authorization of foreign exchange disbursement was a shared responsibility between the Federal Ministry of Finance and the CBN. The Federal Ministry of Finance had responsibility for public sector applications, while the Bank allocated foreign exchange in respect of private sector applications.  
Increased emphasis was placed on export promotion as a means of reducing pressure on the external sector. The government introduced a number of incentives to boost non-oil exports. These included arrangements for setting up export free zones, concessions to exporters to retain 25 per cent of their export proceeds, the liberalization of export and import licensing procedures and the provision for the establishment of an export credit guarantee and insurance scheme. Exchange control was discarded on September 26, 1986 in order to evolve an exchange rate mechanism that would better reflect the underlining macroeconomic realities.

**Foreign Exchange Management Since 1986**

The Second-tier Foreign Exchange Market (SFEM) came into being on September 26, 1986 when the determination of the Naira exchange rate was made to reflect market forces. The modalities for the management of the Foreign Exchange Market have changed substantially since the introduction of SFEM, in line with the principles of the Structural Adjustment Programme (SAP) which emphasize the market-oriented approach to price determination.

Within the basic framework of market determination of the Naira exchange rate, various methods were applied and some adjustments carried out to fine-tune the system. A transitory dual exchange rate system (first and second-tier) was adopted in September, 1986. On 2nd July 1987, the first and second-tier markets were merged into an enlarged Foreign Exchange Market (FEM). Various pricing methods, such as marginal, weighted average and Dutch system, were adopted. With the introduction of the SFEM, the Federal Ministry of Finance had its allocative powers transferred to the CBN, but it retained approving powers on public sector transactions.

The constant fine-tuning of the market culminated in the complete floating of the naira on March 5, 1992 when the system of pre-determined quotas was discontinued. The unabating pressure on the foreign exchange market resulted in the policy reversal in 1994. The reversal of policy in 1995 to that of "guided deregulation" necessitated the institution of the Autonomous Foreign Exchange Market (AFEM). Apart from the institution of an appropriate mechanism for exchange rate determination, other measures increasingly applied in managing Nigeria's foreign exchange resources included demand management and supply side policies. The CBN and the government have actively fostered the development of institutions such as the Nigerian Export Promotion Council (NEPC) and the Nigerian Export-Import Bank (NEXIM) in the drive to earn more foreign exchange.

AFEM metamorphosed into a daily, two-way quote Inter-Bank Foreign Exchange Market (IFEM) on October 25, 1999. The IFEM is expected to broaden and deepen the foreign exchange market on daily basis and discourage speculative activities.  
**Participants of the foreign exchange market.**

The following participants operate in the Nigeria foreign exchange market:

1. The CBN - This is the regulator of the foreign exchange market as well as the representative of the Federal Government providing the required enabling environment for the market. The major functions of the CBN in the market include, but not limited to, the following:

* Establishing the ground rules of the market. Enforcing the rules governing the allocation of foreign exchange.
* Determining the auction system.
* Enforcing exchange control regulations.
* Providing the foreign exchange for each bidding and ensuring allocation of successful participants.
* Advising the Government on the developments in the market
* Enforcing discipline among erring foreign exchange market participants.

1. Authorized dealers- These are institutions that are authorized to bid for foreign exchange at the CBN’s periodic foreign exchange auction programs and or can buy and sell foreign exchange but cannot participate in the CBN’s biddings. They are equally authorized to sell and buy foreign exchange to and from authorized buyers and autonomous sellers. In Nigeria, the authorized dealers are the Banks and Bureau De Change (BDCs). While the banks can participate in the bidding sessions of the CBN and can engage in money transfer service as well as correspondent banking, the same is not true of the BDCs.
2. Authorized buyers- There are institution that are allowed to buy foreign exchange from holders, but not authorized to sell and cannot participate in the CBN’s foreign exchange bidding programs. Authorized buyer can, however, sell their foreign exchange holdings to the authorized dealers or keep such in foreign currency domiciliary accounts which must be maintained with any of the authorized dealers. Examples of such buyers are Hotels, Tourists centers, Ticketing Companies, individuals, etc.
3. Foreign currency domiciliary account- The introduction of the foreign currency domiciliary account into the nation’s foreign exchange system was aimed at:

* Encouraging Nigerians who have foreign accounts to repatriate and invest same in the Nigerian economy.
* Creating investment opportunities compared to the existing ones in the countries of the foreign currency domiciliation.
* Easing the effects of bottlenecks in the process of applying for foreign exchange in financing the importation of raw materials for exports.

1. Foreign exchange management and balance of payment.

**Foreign exchange management in the period before the structural adjustment programme (1970- June 1986)**

The objectives of foreign exchange management during this period was to harness foreign exchange resources, prevent disequilibrating foreign exchange movements, preserve the nation's foreign exchange reserves and the international value of the domestic currency. During the period, exchange control was the main instrument adopted to manage foreign exchange resources.

The control measures applied derived mainly from the income-absorption approach. As the exchange rate was administratively determined, it was not an active instrument for foreign exchange management. The administration of the exchange rate failed to isolate the economy from the vagaries of international price movements and above all it impossible for independent monetary policy initiatives to be effective.

The basic framework for foreign exchange management was the Exchange Control Act of 1962 which was reinforced by the Economic Stabilization (Temporary Provisions) Act, 1982.\_The 1962 Act made provisions for measures to increase foreign exchange resources, reduce the disbursement of foreign exchange and preserve the- nation's international reserves: Other policies that were adopted were either in pursuance of the objectives of the 1962 Act or meant to reinforce the provisions of the Act. The specific policies that were applied during this period are as follows: trade and exchange controls, export promotion, external reserves diversification, external debt and exchange rate administration. The main ingredients of the policies which are discussed below derive mainly from the expenditure reduction aspect of the income-absorption approach.

1. Trade and Exchange Controls Trade and Exchange controls were meant to manage judiciously available foreign exchange, promote the production and consumption of home-made goods and ensure that foreign exchange reserves are adequate to guarantee balance of payments stability. However, trade and exchange· controls are cumbersome because of the massive policing and complex administrative framework required for a successful operation. Furthermore, control stem is effective in a society when, corruption is resisted, where people are dedicated and leakages are either non-existent or are minimal. The application of trade and exchange controls in Nigeria during the review period were based on the need to tighten them during periods of crises and loosen them during periods of relative ease. This approach appeared to be in conformity with the Federal Minister of Finance assertion at the enactment of the 1962 Act, when he indicated that the act was conceived as a "fire extinguisher” meant to be reactivated at periods of crises. Thus, between 1970 and 1975, controls were liberalized but tightened progressively. between 1976 and 1979. However. a policy of massive trade and exchange liberalization was adopted in 1980 as a result of the relatively comfortable foreign exchange position in the preceding year. The disastrous consequence of this policy led to the dramatic decline in foreign exchange reserves starting from the second half of 1981. This led to the enactment of the Economic Stabilization (Temporary Provisions) Act in April 1982. Control measures were progressively intensified up. to June 1986, in a desperate effort to stem the massive outflow of foreign exchange and create an atmosphere conducive for application of stabilization policies. Trade and exchange controls which required that foreign exchange receipts be centralized in the Central Bank and deliberately attempted for limit the expenditure of the same come under the realm of the income-absorption approach.

2. Export Promotion Since exports constitute a major determinant of foreign exchange inflow, the authorities have tried over: the years to promote them. In addition, the high dependence of the economy on the external sector convinced the authorities that the sustainable path to economic growth lay in the enhancement of exports and the diversification of the export base. Thus, the export promotion council decree 1976 was promulgated to give legal backing to ad-hoc incentives already in place. The decree created the Export Promotion Council and charged it with the promotion of Nigeria's non-oil exports and the diversification of the export base. To further boost the export of Nigeria's scheduled export commodities, the marketing boards were dissolved and replaced with commodity boards in 1977. Federal budget of 1986 also contained proposals for the establishment of export free zones and import duty concessions on export manufacturing. The package of incentives that accompanied the budget proposals included among others, the retention of 25 per cent of export proceeds by exporters, liberalization of import and export licensing procedures and the provision for the establishment of an export credit guarantee and insurance scheme. However, most of the key incentives to promote non-oil exports during the review period were not implemented. Export promotion which was meant to raise the level of export production fits adequately into the income-absorption approach.

3. External Reserves Diversification Essentially, reserves diversification is meant to optimally apportion a nation's reserves assets among various reserve currencies so as to ensure maxim Uni returns and minimum losses in case of fluctuation, while at the same time ensuring that liquidity problems are minimized in daily foreign exchange transactions. Nigeria's foreign exchange reserves which were held in four currencies hitherto, were diversified into nine in 1976 as a result of increased oil receipts. Part of the reserves which were held in sterling were redistributed to other currencies in that year and sterling ceased to be the major component of Nigeria's foreign exchange reserves.

4. External Debt Management Although there was need to fund adequately the reconstruction effort of the Federal Government after the civil war, the compelling need to stem the rate of foreign exchange outflow led to the pegging of outstanding external debts at 1 billion. However, decree number 30 of 1978 raised the ceiling to 5 billion. Before 1982, external debt management did not constitute a major problem for the overall management of foreign exchange resources. With the re-emergence of trade arrears in the year, due to the inability to finance payments on current basis, external debt became the focus of policy. As a result of the continuous build-up of payments arrears and the persistent dwindling of external reserves, two debt refinancing agreements were concluded in 1983. Under the refinancing agreements about $2.1 million worth of arrears were covered. The third refinancing agreement which commenced in November 1984 involved the issuance of promissory notes.

5. Exchange Rate Management During the period under review, the exchange rate of the naira was administratively managed and backed up by control measures. The Nigerian pound was pegged to the British pound sterling before and immediately after the creation of the Central Bank of Nigeria. However, following the generalized floating of the major currencies in 1972, the Nigerian currency was devalued in February, 1973 by 10 per cent in sympathy with the dollar devaluation of that year.

**Foreign exchange management under the structural adjustment programme (July 1986 – 1990)**

The pitfalls of exchange control let to its abandonment. Consequently, a market-based system commenced in July 1986 with the structural Adjustment Programme (SAP). The SAP objectives include, the achievement of balance of payments and fiscal viability, the rationalization of public enterprises through privatization and commercialization, the reduction in the level of unemployment and the attainment of sustained economic growth.

To achieve the objective of balance of payments and fiscal viability, a market determined exchange rate mechanism was put in place, fiscal and monetary policies were tightened to be consistent with the achievement of balance of payments equilibrium. The key element of the SAP is the free market determination of the naira exchange rate through an auction system. Apart from the shift to market-determined exchange rates and exchange control deregulation, other policy measures adopted under the previous system were continued with modifications where necessary to accord with the policy framework of deregulation.

The policies applied during this period were based largely on the income-absorption and monetary approaches. This is because, the policies emphasized increase in domestic output and foreign exchange receipts, curtailment of foreign exchange expenditure, domestic monetary stability and reliance on relative prices in the allocation of scarce foreign exchange resources. In specific terms, the measures adopted can be examined under the following: Exchange Rate Management The framework for foreign exchange management under then dispensation, tire

Foreign Exchange Market (FEM), was conceived as a mechanism for the determination of an appropriate exchange rate for the naira in order to reduce the pressure on foreign exchange resources and stabilize the balance of payments. In effect, the exchange rate mechanism was expected to result in a more rational allocation and utilization of foreign exchange resources and reduce foreign exchange volatility, thus, foreign exchange management less difficult.

The major source of foreign exchange to the market is the Central Bank of Nigeria which incidentally earns most of the nation's foreign exchange from crude petroleum exports. The main users of foreign exchange are the manufacturers who ironically contribute little to the pool of foreign exchange resources. This asymmetry has resulted in continuous pressure on official foreign exchange resources. Since the inception of the market determined system in September 1986, the naira has undergone substantial devaluation. However, the authorities have constantly adjusted the modalities of operating the system to make it more efficient in order to be able to realize the objectives for which it was set up.

Thus, in January 1989 the autonomous market was abolished and the inter-bank foreign exchange market (IFEM) emerge. A set of criteria were used to determine the exchange rate. Due to the persistent decline in the value of the naira, the Bureau de Change was established in 1989 to enlarge the scope of the officially recognized foreign exchange market and make foreign exchange available to small users in a less formal manner. In addition, the Dutch Auction System (DAS) first operated in 1987 but abandoned in 1989 was re-introduced in December 1990. It was meant to check the sharp practices that led to the persistent pressure on the naira. External Debt Management In the area of external debt management, the policy restricting external debt acquisition to only key projects were retained.

A debt conversion programme commenced in 1988 to further reduce the nation's external debt burden. Also, various debt rescheduling agreements have been concluded between Nigeria and the Paris and London Clubs of creditors aimed at restructuring the maturity pattern of debts falling due. The debt rescheduling negotiations are continuing. Export Promotion It was not until 1986 that real efforts were made to tackle the poor performance of the non-oil export sector. Apart from the generous incentives proposed in the Federal budget and the Export (incentives and miscellaneous provisions) Decree of that year, export licensing was abolished. In addition, the commodity boards were scrapped so as to make exports of non-oil commodities more competitive, the foreign domiciliary account scheme became operational and exporters were now allowed to retain 100 per cent of their export proceeds in their domiciliary accounts. To further boost non-oil ·exports, the Central Bank of Nigeria set up a Re-discounting and Refinancing Facility (RRF) in 1987.

Under the scheme, banks that engage in export financing could recoup such funds from the Central Bank at the minimum rediscount rate, thus allowing them a margin over the rates they charge exporters. The depreciation of the exchange rate was also considered as a measure that could boost exports. External Reserves Diversification Nigeria's external reserves were further diversified in 1987. However, the concentration of most of the reserves in dollars, indicated a shift in policy from mere diversification to liquidity. Since most of the nation's external transactions were effected in dollar, the holding of most of the reserves in the currency might have been justified. Nevertheless, the continuous slide of the dollar against other reserve currencies necessitated the shift to the pound sterling between 1989 and 1990 when the share of the dollar in Nigeria's reserves declined from 67.3 to 50.4 per cent with a corresponding rise in the share of the sterling from 21.9 to 425 per cent. Demand Management Policies To guide the foreign exchange market towards an appropriate exchange rate, tight monetary and fiscal policies were embarked upon by the authorities.

Thus in 1989, the Federal government directed its Ministries and Parastatals to transfer their deposits from commercial and merchant banks to the Central Bank. Financial institutions were banned from granting loans on the basis of foreign guarantees. Loans already granted on that basis were recalled. The prescribed ceiling for credit expansion was reduced while cash reserve requirements, liquidity ratios and Central Bank's minimum rediscount rate were raised. In addition, the issuance of stabilization securities commenced in 190 to mop up excess liquidity from the system, and thus reduce the effective demand for foreign exchange

**QUESTION 2.**

**Problems of foreign exchange management in Nigeria.**

**1.** Excessive Demand From the inception of a deregulated foreign exchange market in 1986 until now, demands have constantly outweighed the amount supplied to the market. This gap is accounted for by the following: 1. Our undue taste for foreign goods. ii. Over-dependence of our industries on foreign inputs. iii. Reliance on oil exports as a source of foreign earnings. Crude oil still accounts for more than 70% of our foreign earnings.

**2.** Mismatch in Policy Pursuit The underlying principle of deregulated market is the unhindered operation of price mechanism of demand and supply to establish and moderate the exchange rate. More than usual, the Central Bank of Nigeria had intervened to enforce exchange rate at the market. The reason is to forestall massive depreciation of Naira vis-a-vis other nations‟ currencies. Yet the same intervention continues to weaken the domestic currency and create business opportunity for round-tripping trading by unpatriotic bank officials. The gap between parallel market and CBN rate is a major concern and clear evidence about the defect in our policy on the management of foreign exchange. This has encouraged the plague of round tripping by some fraudulent bank officials in Nigeria. For example, a dealer in August 2003, which sourced the exchange at fore AFEM and sold at parallel market would have made a gain of at least N12.50 per dollar - allowing for a margin of N1 for selling price at N142/USS1 at parallel market. External Debt Services in Nigeria (Milli on US Dollars)

**3.** Imbalance in demand and supply of foreign exchange currencies. This is a major challenge in almost all developing countries. However, our peculiar situation in Nigeria is more acute because we rely heavily on imported goods. This is closely related to the issue of adverse balance of trade and payment with our trading partners.

**4.** Another limitation to our Forex management is due to our monolithic economic base. We rely heavily on oil as our major source of foreign exchange earnings. Before the advent of oil in Nigeria, our economy was doing quite well with Agricultural product such as Cocoa, Rubber, Cotton, Groundnut etc. driving our Forex earnings. This has changed drastically since the discovery of oil, the Agric sector has been neglected and Forex earnings from that sector lost.

**5.** Again, Nigeria has become an import-dependent nation because of our new found sudden wealth in oil. We now import virtually everything, including consumer goods and luxury goods that we can easily do without.

**6.** Another limitation is the inconsistencies in government policies that have hampered progress in industrialization. Most of our industries have collapsed over the years, thereby contributing/compounding our import-dependency.

**7.** Corruption is another challenge or limitation in our Forex management. Most of our leaders prefer to steal our money and keep such in foreign account outside Nigeria. Such monies are not available for the needed developmental projects that could generate employment or even generate further Forex. This reduces the supply end and increases the demand train.

**8.** Unnecessary Foreign borrowings by our governments over the years. Most of the repayment of these loans will be done from our meager Forex earnings and we pay interest at very high rates thereby eroding Foreign Reserves the more.

**9.** Financial and Fiscal indiscipline are another limitation in our Forex market Management. Our borders are porous and a lot of corruption is evident. Goods that are not expected to come into the country find their ways in thereby denying us of revenue and Forex.

**10.** Lack of economic and financial independence from our colonial master. Most of our financial and economic policies are dictated to us by the western world. These policies are designed to weaken our economic and financial sector. Such policies are forced down our throats and these task masters pretend to be doing us some favor. Our leaders and economic advisers condescend to agree with them even when they know that such policies are not in our interest. This is done because of their inherent personal financial gains or some hidden political/economic agenda.

**11.** The Naira is not a convertible currency and so it clings to the apron-string of one/more of the major currencies, e.g. the dollar and or Sterling Pound; any adverse change in the rate of such currencies directly affect the Naira whereas positive change are not reflected in the Naira exchange rate

**RECOMMENDATIONS**

**1.** In view of the economic predicaments of the less developed countries, there is need to pursue appropriate domestic policies equipped to improve the quality and quantity of domestic investment, discourage capital flight and maintain external competitiveness for our products. In the same vein, the terms of new borrowings should be well negotiated and must be used to finance projects whose economic viability is not in doubt and which are capable of generating sufficient foreign exchange required to service the debts and repay as at when due.

**2.** The world economy is tending toward globalization, if Nigeria is to benefit from the gain of this trend, we need to diversify our economic base from monolithic foreign exchange earning commodity that is, crude oil. This has been an integral part of adjustment package of economic development in developing countries. Effort should be made to promote trade in other commodities with other developing countries. Our home industries should be encouraged through incentives to embrace the use of local materials to produce at international standard for favorable competition in foreign markets.

**3.** Investment in the agricultural sector should be encouraged and processing industries established to handle their output such that only processed agricultural products would be produced for export rather than raw- material, which command low price in the international market.

**4.** Additionally, Federal Government should hasten to put into operation the export price adjustment compensation scheme, export performance grants fund, duty draw back suspension scheme, export credit guarantee scheme to stimulate export and enhance more earnings from non-oil exports.

**5.** The Bureau de change scheme should also be allowed to operate if only to marginalize the evils of black-market activities in foreign exchange. However, direct allocation should be emphasized and the CBN should initiate utilization inspection procedure to monitor usage such that raw materials will not be imported in disguise for machinery. Non-productive less priority sector should be at inter-bank or parallel market but priority sector should enjoy the privilege of CBN concession. There is need for the pre-shipment inspection agents and the customs officials to be more up to their responsibilities to forestall dumping, smuggling and other export related malpractices. Modem infrastructure and technology adequate to policing the country’s seaport, air and land routes including the footpaths should be installed for internal security and minimization of foreign exchange leakages through smuggling.

**6.** As the government embarks on market-oriented economic policies, there arise the necessity for a sound, consistent industrial policy to provide conducive atmosphere for industrial development. Situations where the manufacturing sector remains consumer based rather than producer - oriented and in which local industries fail to fully utilize their installed capacity do not augur well for a growth aspiring nation like ours.

**7.** For effective foreign exchange management, availability of adequate statistics is very vital. The more information that are available on resources inflow and outflow particularly as it concerns invisible transactions, the more realistic it will be to formulate effective policy and monitoring techniques to minimize waste and leakages from the hard-earned foreign reserves. The allocation and utilization of foreign exchange resources should focus on growth inducing industries not on importation of items that would yield no productive benefits to the whole economy.