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Department: Economics

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Assignment

1. Foreign exchange management (FEM) is the core issue in international finance. Discuss.

(B). how those this affect the balance of payment (BoP) of your home country

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

ANSWER

1.Exchange rate has strong impact on import, export and current account of any country and hence on GDP or economic growth. Theoretically, if the domestic currency is depreciated, it makes goods cheaper and hence exports increase. Depreciation is used to reduce trade deficit and to balance current account. Imports become expensive that helps to increase local manufacturing. However, if a local manufacturing firm imports raw material, it increases manufacturing cost and therefore domestically produced products become expensive and ultimately it reduces exports. In the case of appreciation, prices of domestically produced products increase and volume of exports will decrease due to high prices. On the other hand, manufacturing firms which import the raw material have an advantage of low cost. Depreciation of currency can lead to economic growth and appreciating can slow down economic growth

1(b). A change in a country's balance of payments can cause fluctuations in the exchange rate between its currency and foreign currencies. The reverse is also true when a fluctuation in relative currency strength can alter the balance of payments. There are two different and interrelated markets at work: for all financial transactions on the international market (balance of payments) and the supply and demand for a specific currency (exchange rate).

These conditions only exist under a free or floating exchange rate regime. The balance of payments does not impact the exchange rate in a fixed-rate system because central banks adjust currency flows to offset the international exchange of funds.

The world has not operated under any single rules-based or fixed exchange-rate system since the end of Bretton Woods in the 1970s.

To explain further, suppose a consumer in France wants to purchase goods from an American company. The American company is not likely to accept euros as payment; it wants U.S. dollars. Somehow the French consumer needs to purchase dollars (ostensibly by selling euros in the forex market) and exchange them for the American product. Today, most of these exchanges are automated through an intermediary so that the individual consumer doesn't have to enter the forex market to make an online purchase. After the trade is made, it is recorded in the current account portion of the balance of payments.

The same holds true for investments, loans, or other capital flows. companies normally do not want foreign currencies to finance their operations, thus their expectation for foreign investors to send them dollars. In this scenario, capital flows between countries show up in the capital account portion of the balance of payments.

As more U.S. dollars are demanded to satisfy the needs of foreign investors or consumers, upward pressure is placed on the price of dollars. Put another way: it costs relatively more to exchange for dollars, in terms of foreign currencies.

The exchange rate for dollars may not rise if other factors are concurrently pushing down the value of dollars. For example, expansionary monetary policy might increase the supply of dollars.

2.i . Price levels and the rate of inflation in a country: If the rate of inflation in country “A” is higher than the rate of inflation in country “B”, country A‟s currency will be losing value relative to country B‟s currency. This means that goods exported from country „A‟ to country „B‟ would be more expensive to buyers in that country and vice-versa. This will definitely increase the demand for country B‟s goods in country „A‟ and consequently increase the demand for country „B‟ currency.

 ii. The balance of payments: If a country has a surplus in her current balance of trade that may experience foreign currency surpluses which in effect will create market pressures for fluctuations in the exchange rate between her currency and other currencies. A surplus in its balance of payment pushes the currency value higher and vice versa.

iii. Interest rate differentials: Interest rates refer to returns an investor would receive by investing either at home or abroad. The decision of an investment in a foreign currency is based on the net yield factor. The investor would therefore be interested in investment in a country where the interest rate is higher than in any other countries. The demand for that country’s currency will definitely push up its currency exchange value.

iv. Confidence and Speculation: The confidence of dealers in the future economic and political position of a particular country based perhaps on speculation, will probably affect