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ASSIGNMENT

QUESTIONS

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

b) How does this affect the balance of payment (POB) in your home country?

2) Explicitly show the issues in FEM using your home country as case study.

ANSWERS

1. Firstly I will like to define foreign exchange and foreign exchange management.

Foreign exchange is define as an instrument for international payment, the instrument does not only include currencies but cheques, drafts, bank notes etc. which are also order to pay currency ‘spencer 1990’. It is also defined as a convertible and acceptable national currency that is available for international settlement of debt.

Foreign exchange management is therefore defined as the process of limiting a company’s exposure to foreign currency fluctuations. In most cases, it is done by companies that engage in foreign trade.

Foreign exchange management is a major challenge to the monetary authorities and this is evident in the fact that foreign exchange plays a critical role in any country’s development process. For this reason it is important to assess the impact of foreign exchange on the economy regularly so that the development process is sustained. Foreign exchange management is the core issue in international finance because it lies only within the framework of countries engaged in international trade in contract to a closed economy. The need for FEM is underscored by the economic theory of comparative advantage, theory of comparative cost as well as international resources endowment differentials. The main objective of foreign exchange management is to reduce foreign exchange instability and its adverse effect on the economy. Despite all the measures put in place to achieve this objective there are still problems which are restricting this from being fully functional therefore affecting international finance. Issues like inadequate inflow of foreign exchange, continues depreciation in some countries currency value, balance of payments problems and problem of finding sectorial allocation of foreign exchange in the foreign exchange market makes foreign exchange management an issue in international finance cause ne needs to take care of all this to be able to effectively manage their foreign exchange market and reserve which will lead to an improved international finance in that country.

 1b) foreign exchange management deals with foreign exchange rate and foreign exchange rate affects balance of payment in a country.

Balance of payment is defined as the record of all economic transactions between the residents of the country and the rest of the world in a particular period of time.

Foreign exchange and balance o payment are the key factors of a nation’s life. They are also factors to look into when comparing a country's relationship with other nations. These factors directly or indirectly affect a host of other factors which are of severe importance in any nation. Consequently these factors can be seen as essential to the growth and development of the nation. Currently these two factors can be said to have crippled the Nigeria's economy and made life uncomfortable and unbearable for its citizens. These factors have brought the country to a level where growth and development appear to be an illusion.

Currently the nation’s exchange rate has fallen so low due to unfavorable nature of the competing power of the nation’s currency with foreign currencies of the world. Our economy has been trying to resolve the problem of external and internal balance which has materialized in disequilibrium in our balance of payment and causing us a balance of payment deficit.

Much controversy had also been degenerated by the devaluation of our naira (the national currency). Relevant literature and opinion on the issue are of the view that exchange rate policy plays an important role in maintenance of internal and external balance, on the other hands, other writers argued that devaluation is not the best policy for the less developed country because of many diverse results.

Foreign exchange rate had serious implication on balance of payments position during the deregulated than regulated period. This is shown by the higher value of determination of he balance of payments model in the deregulated period. Also, exchange rate, balance of trade, money supply and government expenditure all appeared with the appropriate sign and were statistically significant during the deregulated period than the regulated period.

Foreign exchange rate in Nigeria determines balance of payments position and its fluctuation steadily affect the balance of payments position in Nigeria. Therefore there is a need for export diversification, since the prospects of traditional agricultural export products in the world market are not bright. We hope that the balance of payments position can be improved, if the recommendations made in this study are implemented without compromise.

1. Issues or constraints of foreign exchange management In Nigeria are:
2. Excessive demand

From the inception of a deregulated foreign exchange market in 1986 until now, demand have constantly outweighed the amount supplied to the market. This gap is accounted for by the following:

1. Our undue taste for foreign goods.
2. Over dependence of our industries on foreign inputs.
3. Reliance on oil exports as a source of foreign earnings. crude oil accounts for more than 70% of our foreign earnings,
4. 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-à-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 continuous depreciation of naira exchange rate in the foreign exchange market from 1998 to august 2003 is shown below:

 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.

Exchange rate of US>1 to Naira

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| --- | --- | --- |
| YEAR | IFEM/AFEMN | Parallel market bureau de change N |
| 1998 | 80 | 87.87 |
| 1999 | 97.23 | 99.26 |
| 2000 | 101.65 | 121.50 |
| 2001 | 113.45 | 135.5 |
| 2002 | 112.15 | 135 |
| 2003 | 128.20 | 142 |

1. Government undefined role in forex market

Until the beginning of 1999, government transactions enjoyed a privilege rate of first tier market of N22.00 to US$1 while private sector sourced same fund at almost 400% of first tier rate. This allowed most government officials to obtain he fund at the first tier and sell the same 300% profit in the second tier. After the abolition of first tier, government sells forex at determined exchange rate in the forex market through cbn. Should government through the cbn continue to be a participant or regulator of the forex market in Nigeria?

1. Misallocation of foreign earnings

At the initial stage of SFEM only merchandise trade benefited at the expense of priority sectors in Nigeria. This was addressed by sectorial allocation in 1995. However since the abolition of AFEM, major manufacturers find it difficult to source fund at prevailing rate, consumable goods continues to dominate transactions in the foreign exchange which should had been invested in growth and development promoting ventures continues to be wasted on hotel bills, cheese and importati0n for raw materials, sugar. Milk and textile materials all which could have been manufactured from locally sourced materials here in Nigeria.

1. Bank operating interest

Banks are the major operates at the forex market. But banks operate for profit motives. Even at the much publicized IFEM the exchange rate worsened against the naira because funds obtained by banks from alternative source are not traded it.in the market but other avenues at profit Thus the local currency continues to deprecate in favor of the US dollar.

1. Commoditization of naira-a misguided policy

Commoditization of naira-a misguided policy. The major policy error of SAP is the imposition of IMF conditionality of commoditizing a local currency. This brought naira into market the as if it is a traded commodity. Nowhere in the world that local currency is bided for on daily basis as in Nigeria without a form of regulation. Government role through the central or reserve bank has always been significant in maintaining the value of the local currency. This has not been possible for the managers of our domestic economy.