**NAME: UGWO VANESSA ANULI.**

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**COURSE: ECO 314.**

**COURSE TITLE: INTERNATIONAL ECONOMICS II.**

**QUESTION: FOREIGN EXCHANGE MANAGEMENT IS A CORE ISSUE IN INTERNATIONAL FINANCE. DISCUSS.**

**2. HOW DOES THIS AFFECT THE BALANCE OF PAYMENT IN THE COUNTRY?**

**3. EXPLICITLY SHOW THE ISSUES IN FEM USING YOUR HOME COUNTRY AS CASE STUDY.**

**ANSWERS.**

1a. Foreign exchange management is a very big issue in the Nigerian economy, it has passed four stages, which are:

* Fixed parity solely with the British pound and sterling and the US dollar (1959-1985).
* Adoption of the second- tier foreign exchange market (SFEM) 1986-1994.
* Introduction of the autonomous foreign exchange market (AFEM) 1995-1999.
* Introduction to the inter-bank foreign exchange market (IFEM) 2000-2010.

FEM is a major issue because it affects the central bank because it is the major supplier of fund for the market. The expansionary fiscal operations of the demand of individuals still inflict the efforts of the apex bank. This issue has continued to persist even with the great penalty involved. Monitoring has continued to be a little difficult as incomplete data hold sway.

The determination of foreign exchange rate in Nigeria has traversed two main mechanisms, the fixed and flexible. Nigeria practiced fixed exchange rate system from independence in 1960 up to 1986, which meant that the value of the local currency in foreign currencies was administratively fixed by the CBN.

Before the 1986, importers and exporters of non-oil commodities were required to get appropriate licences from the ministry of commerce before they could undergo foreign exchange market. But it has been modified since that time. Now, the exchange rate policy in Nigeria is to preserve the value of the domestic currency, maintain a favourable external reserves position and ensure external balance without compromising the need for internal balance and the overall goal of macroeconomic stability.

FEM in Nigeria has been an issue and continues to be an issue that touches on the very foundation of the economy since the movement of the naira/dollar exchange rate is the most important single factor influence prices output and employment. As said before, in 1986 was based mainly on the exchange control act of 1962. About 1991, the world oil market from where the bulk of the nation and foreign exchange was earned started to collapse as a result of the sharp decline in the demand for crude oil.

Theoretically speaking, it can be written as :

**LnYt= β0+β1LnEXCR+β2LnEXPT+β3LnINF+β4LnIMP+β5LnFDI+µ**

With:

Y= Economic growth

EXCR= Exchange rate.

EXPT= Volume of export

INF=Inflation

IMP= Volume of Import

FDI= Foreign Direct investment.

**1b.**

The balance of payment does not affect the exchange market but the exchange market will affect the BOP because when the trade is made, it is recorded in the current account portion of the balance of payment. The exchange rate can actually have a huge impact on the BOP position. The exchange rate depreciation can lead to the improved balance of payment (BOP) if the fiscal discipline is imposed. Also if there is consistent lack of appropriate expenditure control policies due to centralization of power In the government cause balance of payment deficit in Nigeria.

There should be judicious use of credit and available foreign exchange.

Exchange rate policies should be imposed as well along with fiscal and monetary instruments to get meaningful results. We recommend monitoring machineries to be best set up in place to ensure that the rules are being followed.

When there is a deficit in the balance of payment, the country will have a weak exchange rate position. There will be increase in the demand for foreign exchange relative to the supply there of because more payment have to be made than receipts of payments from abroad.

Also it can cause fluctuations in the exchange rates between its currency and foreign currencies. And the reverse is also true, a fluctuation in relative currency strength can alter the balance of payment. This conflicting exchange rate policy contributed to the fluctuating and unstable nature of the naira and this failure made various industrial sectors of the economy to face the challenge of exchange rate fluctuation (Enekwe, Ordu, Nwoha, 2013). Oladipupo and Onotaniyohowo (2011) observed that fluctuation in the exchange rate had a ripple effect on other macro-economic variables in the economy such as the level of inflation, unemployment rate, interest rate and money supply. Fluctuation in exchange rate also affects the demand and supply of goods in the economy, investment opportunities, level of employment as well as the distribution of income and wealth, (Oladipupo and Onotaniyohowo, 2011). Oladipupo and Onotaniyohowo (2011) observed that fluctuation in the exchange rate had a ripple effect on other macro-economic variables in the economy such as the level of inflation, unemployment rate, interest rate and money supply. Fluctuation in exchange rate also affects the demand and supply of goods in the economy, investment opportunities, level of employment as well as the distribution of income and wealth, (Oladipupo and Onotaniyohowo, 2011).

**2.**

The exchange rate changes very often; it moves from minute to minute, hour to hour and day to day under a floating exchange rate regime. When there are large swings in the exchange rate over a period of time, the exchange rate is considered volatile. Thus, exchange rate volatility is a measure of the degree or frequency by which the price of the foreign exchange changes over time. The larger the magnitude of the price change, or the more speedily it changes over a period, the more volatile the

exchange rate is. If the price increases or falls with very wide margins over a period, it shows that the exchange rate is unstable or volatile and the foreign exchange market is said to be experiencing volatility.

Volatility causes panic in the foreign exchange market because the users and traders of foreign exchange are uncertain of what to expect in the market on a daily basis. Some of the users most affected by exchange rate volatility are investors and international traders. They could lose money if the exchange rate falls below their expectations. In either situation, the monetary authority or central bank can intervene to control exchange rate volatility and avoid panic in the foreign exchange market. Conversely, investor stand to gain if the exchange rate is above their expectation.

Exchange rate misalignment refers to the deviation of the exchange rate from its equilibrium or benchmark level. In simple term, an exchange rate is misaligned when it deviates from the underlying exchange rate that would have prevailed if the economy was simultaneously in internal and external balance (equilibrium). Internal balance means the economy is operating at full employment and at full capacity output, while external balance means a country has a sustainable current account position given its desired capital position. Misalignment can either make the exchange rate to be 6

undervalued or overvalued. An exchange rate is “undervalued” if it is below the equilibrium value, and “overvalued” if it is above the equilibrium value. Misalignments generally influence economic behavior and external competitiveness of the country.

This are some issues that the Nigerian foreign exchange management faces. But with recent policies, they have been able to reduce the issues but everything with an advantage will surely have a disadvantage. In a floating exchange rate regime, the increase or decrease in exchange rate is an interaction between how much foreign exchange is available to the market (supply) and how much of the foreign exchange is required by users (demand). Thus, market forces of supply and demand determine the value of the exchange rate. There are times, when less domestic currency is required to buy a foreign currency. When this happens, the domestic currency is said to have appreciated, while the foreign currency has depreciated. Currency appreciation is, therefore, the rise in the value of a country's currency relative to one or more foreign reference currency or currencies. On the other hand, when more domestic currency is required to buy a foreign currency in any period, the domestic currency is said to have depreciated, while the foreign currency has appreciated. Thus, currency depreciation simply means the fall in value of a country's currency in relation to one or more foreign reference currency or currencies.