NAME: BADEMOSI MOYINOLUWA

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QUESTION

1. Foreign exchange management [FEM]is the core issue in international finance. Discuss

* How does this affect the balance of payment [BOP] of your home country?

ANSWER

Foreign exchange is a means of affecting payment for international transactions. It can be acquired by a country through;

1. The export of goods and services
2. Direct investment inflow
3. Drawdown on external loans
4. Aids and grants and it can be expended to settle international obligations.

When foreign exchange expenditure is lower than foreign exchange receipts, the surplus is added to reserves

These reserves which are also savings from foreign exchange.

External reserves also known as international reserves, foreign reserves or foreign exchange reserves, have been defined by the IMF (2009)as:

…those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in foreign exchange markets to affect the currency exchange rate, and for other related purposes(such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing).

* Foreign Exchange Management since 1986

Government introduced the structural adjustment programme (SAP). The programme was aimed at making structural changes in the entire economy amongst these were legal and institutional reforms as well as the deregulation of the foreign exchange rate. Thus, the flexible exchange rate was introduced in 1986 under the SAP, the main objectives of foreign exchange policy were to: i) Preserve the value of the domestic currency

ii) Maintain favorable external balance

iii) To determine the realistic exchange rate for naira.

* The floating of the exchange rate led to the introduction of 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 of 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.
* Various basic framework of market determination of the naira exchange rate, different methods were applied, and same adjustments were 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 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.
* (AFEM) Autonomous foreign exchange market was caused by the reversal of policy in 1995 that led to ‘guided deregulation’.
* The 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

International finance is the study of monetary interactions that transpire between two or more countries. International finance focuses on areas such as foreign direct investment and currency exchange rates. International finance is an important tool to find the exchange rates, compare inflation rates, get an idea about investing in international debt securities, ascertain the economic status of other countries and judge the foreign markets. It can as well be known as international macro-economic which is a section of financial economics that deals with the monetary interactions that occur between two or more countries.

International finance is an essential aspect of trade transaction of any given country, without international trade assessment of a given country, a country will not be honored in the global market. By engaging in international finance, it will reduce global poverty, improve people’s living standard conditions, it will support sustainable economic growth, social and institutional development and to enhance regional cooperation and integration.

However, the component of international financial environment is

* + foreign exchange market in which money denominated in one currency is purchased and sold with money denominated in another currency for instance naira currency (#) and us dollars ($).

Currency convertibility: is the ease in which a country’s currency can be converted into gold or another currency.

International monetary system: is a set of internationally agreed rules, conventions and supporting institutions that facilitates international trade, cross border investment and generally the reallocation of capital between nation states.

International financial markets: it can be a wide set of rules and institutions where assets are traded between agents in surplus and agents in deficit and where institutions lay down the rules.

Balance of payments: is a statement which records all the monetary transactions made between residents of a country and the rest of the world during any given periods.

The core issues of international finance have been extensively enumerated as thus:

* Dealings with massive capital in flows
* Sequencing of domestic and external financial liberation
* Regional financial arrangement
* Financial innovation and regulations
* Bank risk management

But these issues are all brought out from the main issues which are the foreign exchange risk and political risk.

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

Foreign exchange risk occurs when the economy is not stable or when the value of an investment fluctuates (volatility of exchange rate) to changes in currency’s exchange rate. When a domestic currency appreciates against a foreign currency, profit or returns earned in the foreign country will decrease after being exchanged back to the domestic currency. due to the somewhat volatile nature of the exchange rate, it can be quite difficult to protect against this kind of risk, which can harm sales and revenue. For example, assume a U.S. car company receives a majority of its business in Nigeria. If the Nigerian naira depreciates against the U.S. dollar, any naira denominated profits the company receives from its Nigerian operations will yield fewer U.S. dollars compared to before the naira’s depreciation. Foreign exchange risk typically affects businesses that export and/ or import their products, services, and supplies. when the economy is not stable the foreign exchange finance will be affected negatively, and this will sweep the depletion reserve.

b) Balance of payments

is a statement which records all the monetary transactions made between residents of a country and the rest of the world during any given periods. Also balance of payments is known as balance of international payment of the country is the record of all economic transaction between the resident of the country and the rest of the world in a particular period of time (a quarter of a year). These transactions are made by individual, firms and government bodies.

Thus the balance of payments involves both visible and non-visible transactions of the country (Nigeria).

Balance of payments difficulties may develop slowly over time and can result from developments such as a progressive loss of key export markets, high and rising import dependency, declining capital inflows, rising foreign debt, unsustainable current account deficits, sustained currency overvaluation and banking sector weaknesses. These difficulties can become acute where foreign loans become inaccessible and international reserves fall to such a low level that they cannot cope with import and export fluctuations or reductions in net capital inflow.

Foreign exchange in Nigeria determines balance of payments position and its fluctuation steadily affect the balance of payment in Nigeria. Therefore, there is a need for export diversification, since the prospects of traditional agricultural export products in the world market are no bright.

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

A handful of problems are still identified with foreign exchange operations in Nigeria these issues include

i) 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, and importation of foreign goods or raw materials which can all be gotten from materials in Nigeria. For instance, the governor of central bank of Nigeria gov. Godwin emefiele announced to the country the prohibition / embargo on 42 items that can be produced locally

ii) Inadequate inflow of foreign exchange

Nigeria being a monolithic economic base. We rely heavily on oil as our major source of foreign exchange earnings whereby our larger buyer U.S. has developed their own oil shake oil due to this the demand for our crude oil declined ,some Africa countries like angola, ghana, chad etc. has developed their own crude oil which have made demand for our crude oil to be low and this had adverse effect on our reserve

iii) government policy inconsistency

The unnecessary foreign borrowings by government over the years. most of the repayment of the loans will be done from our merger forex earnings and we pay interest at very high rates thereby eroding foreign reserves the more. 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.

iv) 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 or payment with our trading partners.

v) Problem of finding sectorial allocation of foreign exchange in the foreign exchange market and the naira is not a convertible currency and so it clings to the apron-string of one/more of the major currencies

vi) financial and fiscal indiscipline

our borders are penetrable, 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