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**ECO314 INTERNATIONAL ECONOMICS**

**What is international Finance?**

International finance, sometimes known as international macroeconomics, is the study of monetary interactions between two or more countries, focusing on areas such as foreign direct investment and currency exchange rates.

Some examples of key concepts within international finance are the Mundell–Fleming model, the optimum currency area theory, purchasing power parity, interest rate parity, and the international Fisher effect. Whereas the study of international trade makes use of mostly microeconomic concepts, international finance research investigates predominantly macroeconomic concepts.

The three major components setting international finance apart from its purely domestic counterpart are as follows:

~Foreign exchange and political risks.

~Market imperfections.

~Expanded opportunity sets.

These major dimensions of international finance largely stem from the fact that sovereign nations have the right and power to issue currencies, formulate their own economic policies, impose taxes, and regulate movement of people, goods, and capital across their borders.

**Foreign Exchange Risk:**

Foreign exchange risk (also known as FX risk, exchange rate risk or currency risk) is a financial risk that exists when a financial transaction is denominated in a currency other than the domestic currency of the company. The exchange risk arises when there is a risk of an unfavorable change in exchange rate between the domestic currency and the denominated currency before the date when the transaction is completed.

Foreign exchange risk also exists when the foreign subsidiary of a firm maintains financial statements in a currency other than the domestic currency of the consolidated entity.

Investors and businesses exporting or importing goods and services, or making foreign investments, have an exchange-rate risk but can take steps to manage (i.e. reduce) the risk.

**FEM as a core issue in International Finance:**

The relationship between a nation’s imports and exports and its exchange rate is complicated because there is a constant feedback loop between international trade and the way a country's currency is valued. The exchange rate has an effect on the trade surplus or deficit, which in turn affects the exchange rate, and so on. In general, however, a weaker domestic currency stimulates exports and makes imports more expensive. Conversely, a strong domestic currency hampers exports and makes imports cheaper. For example, consider an electronic component priced at $10 in the U.S. that will be exported to India. Assume the exchange rate is 50 rupees to the U.S. dollar. Neglecting shipping and other transaction costs such as importing duties for now, the $10 electronic component would cost the Indian importer 500 rupees.

2. **How does it affect Balance of payment:**

Balance of Payment it records and summarizes international financial transaction for a specific period. It primarily encircle of three accounts; current account, capital account and reserve account. It also tells us how many goods and services the country has been exporting and importing and whether the country has been borrowing from or lending money to the rest of the world. Balance of payment keeps the complete record of a country trade, net foreign asset, imports and exports of goods, financial transfer and financial capital. The balance of payments is one of the most important statistical statements for any country.

*The market balance of payments refers to the balance of supply and demand for a country’s currency in the foreign-exchange market at a given rate of exchange. If the exchange rate is fixed, the market balance of payments would be in balance only by chance. If it is not in balance and the exchange rate must be maintained, the monetary authorities would have to intervene to achieve balance by buying their own currency with foreign exchange if the home currency were in excess supply or by selling their own currency for foreign exchange if the home currency were in excess demand. If the exchange rate is allowed to float freely, however, the market balance of payments must always balance because the exchange rate is the price which equates the supply and demand for a currency in the foreign-exchange market.*

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: the market 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.

**Issues of Foreign Exchange Management in Nigeria:**

The exchange control system was unable to evolve an appropriate mechanism for foreign exchange allocation in consonance with the goal of internal balance. Over-valuation of the currency under the system was a major obstacle that made the achievement of internal balance difficult. Specifically, the problems with the administration of the exchange control system include inter-alia:

i. Increased dependence on imports;

ii. Depletion of external reserves;

iii. Emergence and encouragement of parallel market activities;

iv. Reduction of competitiveness in export activities;

v. Reduced capital inflow; and

vi. The inability to pay on current basis.

**Factors affecting Foreign Exchange Rate:**:

The operation and management of currency transaction in international market is global and it is influenced by many factors which may weaken a currency in favour of other ones as the other currencies strengthened. Some factors which may affect the exchange rate of a nation’s currency include:

1. 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.

1. 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.
2. 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.
3. 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 their quoted forward contract rates for the currency of that country. For example, if an investor speculates a fall in the value of a currency, and wishes to receive that currency in the future, he will sell the currency forward at the current rate in order to avoid any loss.

**Economic Significance** **of Foreign** **Exchange Reserve** **Management:**:

A nation‟s foreign reserve is a measure of the buoyancy of its domestic economy and its external stock of wealth. As such it is significant to its economic development in the following ways:

1. It confers immense purchasing power and ability of choice and multiple investments opinions

upon the nation, government and citizenry. Most capital goods in developing countries are imported from industrially developed nations. Often times, we are forced to accept what a trading partner is willing to offer on credit terms rather what we would have obtained if we hold ready ocash - or foreign reserve from which to settle obligations arising from such transaction.

2) Enhanced international confidence in domestic economy. The world and international financial institutions rate each economy on its level of external stock of wealth. It is also used as index of the performance of the domestic economy, less developed nations are so called because of their increasing external debt rather than growing external reserves.

3) Influence or the exchange rate of domestic currency. One of the determinants of rate of exchange of domestic currency vis-a-vis other international currencies is its reserves of benchmarking hard currencies such as US Dollar, Japanese Yen, British Pound Sterling. The larger the level of a country‟s reserves, the more likely the upward trend in the rate of exchange of its domestic currency.

4) Balance of payments: Foreign reserves is a major source of settling imbalance in international trade for both visible trade and invisible transactions. Most third world nations continue to carry huge balance of payments deficit thus increasing their external debt because of their meager and dwindling foreign reserve.