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**ASSIGNMENT.** (QUESTION)

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

1b) How does this affect Balance Of Payment of your home country?

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

**Answer.**

**1.)** International finance, also 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. 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. Increased globalization has magnified the importance of international finance.

Foreign exchange is essential to coordinate global business. Foreign exchange management is associated with currency transactions designed to meet and receive overseas payments. Beyond these transactions, foreign exchange management requires you to understand the relevant factors that influence currency values. From that point, you may execute the proper strategy to manage risks and improve potential earnings. Foreign exchange management begins with trading currencies to exchange goods and services overseas. International businesses convert overseas profits back into their domestic currency to spend at home. Meanwhile, consumers exchange domestic currency for foreign banknotes to buy overseas goods. These transactions occur within the foreign exchange markets, where networks of private individuals, banks and organized financial exchanges provide the infrastructure to trade international banknotes.

Foreign exchange rates describe valuations for domestic currency, which describe the economic and political standing of your home nation. Low exchange rates may signal recession and political instability. Alternatively, strong exchange rates often serve as an indicator of favourable commercial conditions for a particular country. Exchange rates directly impact international trade. Low exchange rates support tourism and the export economy. At that point, domestic goods become less expensive for foreign buyers. Domestic consumers, however, prefer higher exchange rates. Consumers then have more purchasing power to spend on imported goods. Foreign exchange occurs at rates that are associated with currency valuations. Foreign exchange rates describe the amount of one currency that must be given up to receive one unit of another currency, and they tend to parallel the political and economic environment of a particular country. For example, domestic foreign exchange rates appreciate when the economy is strong and the currency is in high demand to buy the nation’s stocks and real estate. Conversely, currency values fall amidst political and social instability.

Effective foreign exchange management requires you to preserve purchasing power by staying current on any events affecting rates and operating accordingly. You will exploit the buying power of high exchange rates to acquire overseas goods. Alternatively, low exchange rates are an opportunity to boost overseas sales, as your wares become relatively cheaper overseas.

The exchange rate; the price of one nation's currency in terms of another nation's - is a central concept in international finance. Virtually any nation's currency can be converted into the currency of any other nation, thanks to exchange rates and the *foreign exchange market*. For instance, let's say the current exchange rate between the U.S. dollar and the Mexican peso is $1 to 10 pesos. This means that $1 will buy 10 pesos and that 10 pesos will buy $1. Another example of an exchange rate, consider a recent rate at which U.S. dollars (US$) could be exchanged for Canadian dollars (C$): US$0.65 per C$1. This implies that a Canadian dollar can be purchased for US$0.65 and conversely, a U.S. dollar can be purchased for C$1.54 (or 1/0.65). These current rates are also called spot rates. The level of international trade is a relevant indicator of economic growth worldwide. Foreign exchangemarkets facilitate this trade by providing a resource where currencies from all nations can be bought and sold. While there is a heavy volume of foreign exchange between some countries, such as the United States and Canada, other countries with little international trade may have only intermittent need for such transactions. Current exchange rates of one country's currency versus another are determined by supply and demand for these currencies. Importers and exporters need foreign currency in order to complete transactions. Banks and brokers maintain inventories of foreign exchange, that is, various currencies, and convert currencies as a service to customers. Traders and speculators make (or lose) money on the movement of foreign exchange rates. As you will see, central banks also play a role in the foreign exchange market.

**Types of Exchange Rates**

Foreign currency exchange rates have historically been determined in three different ways:

* Fixed rates
* Floating (or flexible) rates
* Managed rates

With a fixed exchange rate, the value of the currency is determined by the nation's central bank and held in place by central bank actions, mainly the purchase and sale of the currency. Another way to fix exchange rates, which has been used by the United States and other nations in the past, is to tie currencies to the gold standard. If all the currencies in the exchange rate system have a value pegged to gold, it is a simple matter to convert the currencies to one another according to their value in gold.

Floating exchange rates are determined by the market forces of supply and demand. We will examine these forces in this section. Essentially, if demand for a currency increases, the value of that currency in terms of other currencies increases. If demand for the currency decreases, then the value of the currency decreases.

Managed exchange rates are influenced by nations' central banks, but are not targeted to a fixed rate. In practice, the system of managed rates that we have today operates through the forces of supply and demand *and* are influenced by central banks. So we now have a mix of floating and managed rates, which is called managed float.

**Exchange Rate Risk.**

Since forecasts of future inflation rates, interest rates, and government actions are uncertain, exchange rates are also uncertain. This means that an investment that will pay its return in units of a foreign currency has an uncertain return in the home currency. For example, suppose an investor in A bought a security B for 100 B. This one-year investment has a guaranteed return of 10 B, or 10 percent. If the exchange rate remains at a constant 2 B per I A over the life of the investment, the investor must initially commit 50 A to exchange for 100 B to make the investment. After one year, the 110 B returned (including the 10 B in interest) is exchanged for 55 A. The profit of 5 A on an investment of 50A represents a 10 percent return to the investor from A. As another example, suppose an importer in country A purchases a quantity of goods from an exporter in country B and agrees to pay 1,000 B in 90 days. The importer is now obligated to make a foreign exchange transaction and must purchase the units of B's currency at the exchange rate that prevails in 90 days. Since that rate is likely to be different from the current rate, the importer is exposed to exchange rate risk. One common method for reducing this exposure is to enter into a forward **contract**to buy B's currency. A forward contract is an agreement to trade currencies at a specified date in the future at an exchange rate determined today.

**Foreign Exchange Control:**

Foreign Exchange Control is a method of state intervention in the imports and exports of the country, so that the adverse balance of payments may be corrected”. Here the government restricts the free play of inflow and outflow of capital and the exchange rate of currencies.

 According to crowther “When the Government of a country intervenes directly or indirectly in international payments and undertakes the authority of purchase and sale of foreign currencies it is called Foreign Exchange Control”. Also, According to Haberler “Foreign Exchange Control in the state regulation excluding the free play of economic forces for the Foreign Exchange Market”. The Government regulates the Foreign Exchange dealings by Consideration of national needs. The objectives of Exchange Control are thereby as follows:

1. Correcting Balance of Payments: The main purpose of exchange control is to restore the balance of payments equilibrium, by allowing the imports only when they are necessary in the interest of the country and thus limiting the demands for foreign exchange up to the available resources. Sometimes the country devalues its currency so that it may export more to get more foreign currency.

2. To Protect Domestic Industries: The Government in order to protect the domestic trade and industries from foreign competitions, resort to exchange control. It induces the domestic industries to produce and export more with a view to restrict imports of goods.

3. To Maintain an Overvalued Rate of Exchange: This is the principal object of exchange control. When the Government feels that the rate of exchange is not at a particular level, it intervenes in maintaining the rate of exchange at that level. For this purpose the Government maintains a fund, may be called Exchange Equalization Fund to peg the rate of exchange when the rate of particular currency goes up, the Government start selling that particular currency in the open market and thus the rate of that currency falls because of increased supply.

4. To Prevent Flight of Capital: When the domestic capital starts flying out of the country, the Government may check its exports through exchange control.

5. Policy of Differentiation: The Government may adopt the policy of differentiation by exercising exchange control. If the Government may allow international trade with some countries by releasing the required foreign currency the Government may restrict the trade import and exports with some other countries by not releasing the foreign currency.

**1b.)** Balance Of Payments (BOP) is The balance of payments of a country is a systematic record of all economic transactions between the residents of one country and residents of foreign countries during a given period of time. Balance of Payments is also a record of a country’s transactions with the rest of the world. It shows the receipts from trade. It consists of the current and financial account.

**Current account**

This is a record of all payments for trade in goods and services plus income flow it is divided into four parts. It records transactions relating to export and import of goods, services, unilateral transfers and international incomes. Thus, balance on current account is the value of exports minus the value of imports, adjusted for international incomes and net transfers. The export and import of goods are called visible items whereas invisible items include shipping, banking, insurance, gifts.

* Balance of trade in goods (visibles)
* Balance of trade in services (invisibles) e.g. tourism, insurance.
* Net income flows. Primary income flows (wages and investment income)
* Net current transfers. Secondary income flows (e.g. government transfers to UN, EU)

**2. Financial account**

This is a record of all transactions for financial investment. It can also record all international economic transactions relating to change in assets-both financial and physical. It is a record of short term and long term capital transactions, both private and official. It includes:

* Direct investment. This is net investment from abroad. For example, if a UK firm built a factory in Japan it would be a debit item on UK financial account)
* Portfolio investment. These are financial flows, such as the purchase of bonds, gilts or saving in banks. They include
* short-term monetary flows known as “hot money flows” to take advantage of exchange rate changes, e.g. foreign investor saving money in a UK bank to take advantage of better interest rates – will be a credit item on financial account

**3. Capital Account**

This refers to the transfer of funds associated with buying fixed assets such as land.

**4. Balancing Item**

In practice when the statistics are compiled there are likely to be errors, therefore, the balancing item allows for these statistical discrepancies.

The exchange rate affects the prices at which a country trades with the rest of the world and is integral to open economy analysis and policy formulation. In the Bretton Woods era, exchange rates were fixed in terms of the US dollar. Today however, national governments can choose from a number of alternative exchange rate arrangements, ranging from independently floating to fixed. The ongoing debate over fixed versus floating exchange rates involves issues such as whether currency speculation is stabilizing or destabilizing and whether central banks possess superior economic knowledge. Decisions taken by national governments to float their exchange rates and abolish exchange controls are often inevitable in light of the increased integration of international capital markets.

The balance of trade influences currency exchange rates through its effect on the supply and demand for foreign exchange. When a country's trade account does not net to zero; that is, when exports are not equal to imports, there is relatively more supply or demand for a country's currency, which influences the price of that currency on the world market. Currency exchange rates are quoted as relative values; the price of one currency is described in terms of another. These relative values are influenced by the demand for currency, which is in turn influenced by trade. If a country exports more than it imports, there is a high demand for its goods, and thus, for its currency. The economics of supply and demand dictate that when demand is high, prices rise and the currency appreciates in value. In contrast, if a country imports more than it exports, there is relatively less demand for its currency, so prices should decline. In the case of currency, it depreciates or loses value.

**Factors affecting the balance of payments**

A current account deficit could be caused by factors such as.

1. The rate of consumer spending on imports. For example, during an economic boom, there will be increased spending and this will cause a deficit on the current account.
2. International competitiveness. If a country experiences higher inflation than its competitors, exports will be less competitive leading to lower demand.
3. Exchange rate. If the exchange rate is overvalued, it makes exports relatively more expensive leading to a deterioration in the current account.
4. Structure of economy: deindustrialisation can harm the export sector.

**Balance of payments equilibrium**

Balance of payments equilibrium occurs when induced balance of payments transactions---those engineered by the government to influence the nominal exchange rate---are zero. This implies that autonomous receipts from exports and the sale of securities abroad equal autonomous payments for imports and the purchase of securities from foreign residents. Since changes in the stock of official reserves of foreign exchange are the method used by the authorities to fix or otherwise manipulate the exchange rate, balance of payments equilibrium requires that the stock of foreign exchange reserves be constant.

A deficit on the current account is balanced by a surplus on the financial account.

* Financial Account:

. Direct Investment (FDI)

. Portfolio Investment ( Bonds, Savings, Equities )

A country is using capital inflows to finance consumption of imports and investment.

* Current Account:

. Trade in goods

. Trade in services

. Investment incomes

. Transfer payments

Causes of deficit in the Balance of Payments

* Fall In Export Demand
* Growth Of Population
* Change in foreign Exchange Rate
* Huge International Borrowings
* Developmental Expenditures
* Demonstration Effect

The appreciation in the exchange rate would make exports less competitive and imports more competitive therefore with fewer exports and more imports there would be a deficit on the current account.

Disequilibrium In Balance Of Payment: A disequilibrium in the balance of payments may appear either as a surplus or as a deficit. A Surplus in the BOP occurs when Total Receipts exceeds Total Payments. Thus, BOP= CREDIT>DEBIT. A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus, BOP= CREDIT<DEBIT

Measures To Correct Disequilibrium in the Balance Of Payment:

* Monetary measures Exchange Rate Depreciation By reducing the value of the domestic currency, government can correct the disequilibrium in the BoP in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country. Devaluation devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.
* Deflation is the reduction in the quantity of money to reduce prices and incomes. In the domestic market, when the currency is deflated, there is a decrease in the income of the people. This puts curb on consumption and government can increase exports and earn more foreign exchange. Exchange Control All exporters are directed by the monetary authority to surrender their foreign exchange earnings, and the total available foreign exchange is rationed among the licensed importers. The license-holder can import any good but amount if fixed by monetary authority.

Measures To Correct Disequilibrium in the Balance Of Payment:

1. Non- Monetary measures . Export Promotion To control export promotions the country may adopt measures to stimulate exports like:
* Export duties may be reduced to boost exports.
* Cash assistance, subsidies can be given to exporters to increase exports.
* Goods meant for exports can be exempted from all types of taxes.

Import Substitutes Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

1. Import Control Import may be kept in check through the adoption of a wide variety of measures like quotas and tariffs. Under the quota system, the government fixes the maximum quantity of goods and services that can be imported during a particular time period.

**2.)** There is scarcely any country that lives in absolute autarky in this globalised world. The economics of all the countries of the world are linked directly or indirectly through asset or/and goods in the markets. This linkage is made possible through trade and foreign exchange. The price of foreign currencies in terms of a local currency (i.e. foreign exchange) is therefore important to the understanding of the growth trajectory of all countries of the world. The consequences of substantial misalignments of exchange rates can lead to output contraction and extensive economic hardship. Moreover, there is reasonably strong evidence that the alignment of exchange rates has a critical influence on the rate of growth of per capital output in low income countries (Isard, 2007). Nigeria, like many other low income open economics of the world, has adopted the two main exchange rate regimes for the purpose of gaining internal and external balance.

Amidst complex economic development problems (broadly, summarized under huge external and internal debts, chronic fiscal deficit and serious economic decline, reflecting in stagflation pressure despite abundant primary resources), there is the general consensus in Nigeria that the primary goal of current macroeconomic policy is to put the economy back on a path of sustainable, non -inflationary and self reliant growth of output, employment and income. In this regard, this primary goal is subsequently reinforced by the general assumption that price and exchange rate stability are necessary for the growth of output, employment and income.

This assumption is couched under the awareness that price and exchange rate instability are injurious to existing producers, new investors and consumers alike as they introduce uncertainty which discourages long-term commitments without which sustained self-reliant growth of output, employment and income will be difficult to achieve. In recognition of the foregoing, both the monetary and fiscal authorities have usually aimed at the attainment of price and exchange rate stability. In this regard, while the monetary authorities in Nigeria constantly search for the optimal quantity of money and interest rate, that would support stable prices and exchange rate, the fiscal authorities on their part constantly look for the constellation of government

revenues and expenditure that will attain the same objective all in a bid to foster economic growth and development. Given the foregoing, it is conventional to assign the goal of price and exchange rate stability primarily to monetary authorities. Thus, over the years, the primary goal of monetary policy in Nigeria always relates to that of the achievement of price and exchange rate stability, enunciated by the Central Bank of Nigeria (CBN) in its various issues of Monetary, Credit, Foreign Trade and Exchange Policy Guidelines.

It has already been stated that money is a common denominator in which the rate relative values of goods and services can be expressed.  Throughout history any community which form itself into a nation for the purpose of self-government immediately introduces its own distinctive unit of account-monetary unit of account (legal tender). In the words of Endel (2013) in the international realm no legal tender exist vales must be measured, accounts kept and payments made by conversion of one currency not another, this conversion process is known as foreign exchange.Foreign exchange can be acquired by a country through the export of goods and services, direct investment inflows, aids and grants.  When foreign exchange receipts, the surplus is added to reserves.  These reserves which are also savings from foreign exchange transactions are held by the authorities to finance short falls in foreign receipts and to safeguard the international value of the domestic currency.

When there is disequilibrum in the foreign exchange market which is caused by in adequate supply of foreign exchange reserves, pressure may be exerted on foreign exchange reserves.  If the reserves are not adequate, it will deteriorate into balance of payments problems, hence the  need to manage a nation’s foreign exchange resources so as to reduce the adverse effect of foreign exchange volatility. The management of foreign exchange resources is further informed by the need to set an appropriate cleaning price in the foreign exchange market. Therefore the act of foreign exchange management in a conscious attempt to harness foreign exchange resources, deploy them to service the economy so as to prevent the economy from experiencing shocks due to foreign exchange volatility.“The practice of managing the foreign exchange resources has therefore evolved broadly in line with the globalization and liberalization of economics and financial markets”.  (Anifowose, 2017)

**STATEMENT OF THE PROBLEM**

The primary objective of foreign exchange management is to reduce foreign exchange instability and its adverse effect on the economy. Despite government efforts to achieve this objective through the central bank of Nigeria (CBN), foreign exchange (monitoring and miscellaneous provisions) Decree No promulgated in 1995 and the introduction of the use of forms  A and 19 in 1996, a handful of problems are still identified with foreign exchange operations in Nigeria.  These problems include

(i)    Inadequate inflow of foreign exchange

(ii)   Continuous depreciation in the value of the Naira

(iii)   Balance of payment problems

(iv)   Problem of finding Sectorial allocation of foreign exchange in the foreign exchange market