CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

Foreign exchange is the means of payment for international transaction. It is made up of convertible currencies that are generally accepted for the settlement of international trade and other external obligation. Just like every other commodity, a market is established which works more like any other market having a supply curve, a demand curve and an equilibrium price and quantity. There are also conditions which are held constant (creteris paribus). When these conditions change, the curve shift and there is a change in the equilibrium price quantity. This market for currencies is known as the foreign exchange market.

The foreign exchange market according to the central bank of Nigeria is the medium of interaction between the sellers and buyers of foreign exchange. The seller of foreign exchange constitutes the supply while the buyers of foreign exchange constitutes its demand. The supply of foreign exchange is derived from oil exports, non-oil export, expenditure of foreign tourist in Nigeria, capital repatriation by Nigerians resident abroad etc.

The demand for foreign exchange on the other hand consist of payments for imports, financial commitments to international organizations, external debt service obligations etc.

Before 1958, when the central bank was established and the enactment of the exchange control act of 1962, foreign exchange was earned by the private sectors and held in balances abroad by commercial banks which acted as agents for local exporters. Another feature of this period was that agriculture exports contributed the bulk of foreign exchange receipts. The fact that the British pound sterling was at par with the Nigerian pound sterling with easy convertibility delayed the establishment of an active foreign exchange market.

However by 1958, when the central bank was established and subsequent centralization of foreign exchange authority. In banks, the need for a local foreign exchange market is paramount. Other factors that led to the evolution of the foreign exchange market in Nigeria include:

The changing pattern of international trade institutional changes in the economy. structural shift in production, etc.

By the early 1970’s, the official exchange receipt was enhanced following the sharp rise in prices and demand for crude oil exports which had by now displaced agricultural exports. The foreign exchange market experienced a boom during this period and there became a need for the management of foreign exchange resources. However, it was not until 1982 that comprehensive exchange controls were applied.

The exchange control system failed to evolve an appropriate mechanism for foreign exchange allocation. This led to the development of a dual exchange rate system, comprising of the first and second tier foreign exchange market which was adopted in September 1986. The first tier was managed while the second tier was subjected to market forces. Not only has there been a metamorphosis of the institutional frame work from second tier foreign exchange market (SFEM) to foreign exchange market (FEM) to inter bank foreign exchange market (IFEM) to Autonomous Foreign Exchange market (AFEM) etc, there have been frequent changes in operational guidelines and procedures. Various pricing methods, marginal and weighted average exchange rates determinations and the Dutch Auction System (DAS) among other have also been adopted.

All those aimed at ensuring more efficient allocation and utilization of scarce foreign exchange resources, to enhance the flow of capital into the country, stimulates domestic industrial production, promote export, increase revenue to the government, help reschedule our foreign debt at more profitable terms etc.

When there are fluctuations in foreign exchange rates, various economic activities are usually affected such as the purchasing power, balance of payment, prices of goods and services, import structure, export earning, government revenue, external reserves among others.

These prevailing instability in exchange rates and its effects on various economic variables, will be the areas of concentration of the research work.

1.2. STATEMENT OF THE PROBLEM

Since September 1986, when the market determined exchange rate system was introduced via the second tier foreign exchange market, the naira exchange rate has exhibited the features of continuous depreciation and instability.

This instability and continued depreciation of the naira in the foreign exchange market has resulted in declines in the standard of living of the populace, increased cost of production which also leads to cost push inflation. It has also tended to undermine the international competitiveness of non-oil exports and make planning and projections difficult at both micro and macro levels of the economy. A good number of small and medium scale enterprises have been strangled out as a result of low dollar/ naira exchange rate and so many other problems resulting from fluctuations in exchange rates can also be identified.

This movement of the exchange rate along the path of depreciation since 1986 has raised a lot of questions on the impact of exchange rate policies on the Nigerian economy.

1.3 OBJECTIVES OF THE STUDY

Objectives of the study

- To find out the impact of exchange rate fluctuation on economic growth of Nigeria.
- To examine the nature of the relationship between exchange rate fluctuations and economic growth in Nigeria.
- To offer some recommendations based on the findings of the study.

1.4 FORMULATION OF HYPOTHESES

For meaningful findings, conclusions and recommendations, a set of testable hypothesis based on available data will be necessary. In the course of this research work, the following hypothesis would be tested.

Hi: Exchange rate fluctuations has no significant impact on Nigeria Economy.

Hi: Exchange rate fluctuations has significant impact on Nigeria Economy.

1.5 SIGNIFICANCE OF THE STUDY

The study would identify the strengths and weakness of exchange rate policy and management, identify those economic variables that are mostly affected by instability in exchange rate and provide the general public with the awareness on the foreign exchange transaction and its impact on the economy.

The various findings of this would enable the government and financial authorizes to device, modify and adopt a better foreign exchange transaction for the economy.

1.6 SCOPE AND LIMITATION OF THE STUDY

Although there are many economic variables that operate within the Nigerian economy, this research work is limited to the study of the effect of fluctuation in exchange rate on the following economic variables.

- Purchasing power
- Importation

The scope of this research work is also limited to the period between 1986-2011.

This study was also faced with certain constraints such as limited time frame with which to collect all necessary data.

1.7 DEFINITION OF TERMS :

1. **Foreign Exchange**

Foreign exchange is a means of payment for international transactions. It is made up of currencies of other countries that are freely acceptable in settling international transactions.

2. **Foreign exchange market :**

This is a medium of interaction among buyers and sellers of foreign- exchange with a view of negotiating acceptable prices for settling international transaction.

Exchange rate – This is the price of one currency in terms of another

SEMI- Second tier foreign exchange market. Under this system the exchange rate is largely determined by market forces.

AFEM – Autonomous foreign exchange market. This exchange rate under this system are being determined essentially through market forces.

IFEM – Inter bank foreign exchange market.

Dutch auction system (DAS) – this is a method of exchange rate determination through action where the bidders pay last bid rate that clears the market.

Dual exchange rate regime- This situation exist when two exchange rates are in existence in an economy.

Marginal pricing method: This is the method in which bid rates are arranged in a descending order of magnitude. The last bid rate at which available foreign exchange is exhausted (marginal rate) is the applicable exchange rate.

Exchange control – This is a foreign exchange arrangement in which the government purchase all incoming foreign exchange and is the only source from which foreign exchange can be purchased legally.

THE EFFECT OF EXCHANGE RATE FLUCTUATIONS ON THE NIGERIA ECONOMY