EFFECTS OF EXCHANGE RATE VOLATILITY ON TRADE BALANCE OF UGANDA (1991 – 2005)

BY

James Wokadala
BSc(QE) Mak

A DISSERTATION SUBMITTED IN PARTIAL FULLFILMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF SCIENCE IN QUANTITATIVE ECONOMICS DEGREE OF MAKERERE UNIVERSITY

AUGUST 2007

ABSTRACT

The primary objective of this study was to determine the effect of exchange rate volatility on trade balance of Uganda for the period 1991 – 2005. The specific objectives were to evaluate the effects of exchange rate volatility and other policy variables on trade balance and to analyze the dynamics of adjustment process on trade balance.

The study employed Augmented Dickey Fuller test to establish the order of integration of the variables, the Johansen Maximum Likelihood ratio test to establish the cointegrating relationships and the number of cointegrating equations among variables in the trade balance model system. The Vector Autoregressive Correction model was used to examine dynamic relationships among variables. The exchange rate volatility, real exchange rate, terms of trade, direct investment, government expenditure, private consumption and lending interest rate were used as the long run determinants of trade balance.

The results revealed that;

Trade balance is insensitive to permanent changes in exchange rate volatility and lending interest rate but highly depend on private consumption, government expenditure, direct investment, real exchange rate and terms of trade in the long run. In addition, exchange rate volatility and lending interest rate were found to be contractionary in the short run because residents have high affinity for imports and demand tends to be inelastic. The results also revealed that government expenditure and direct investment were expansionary both in the short run and long run because they increase on the value of trade balance. Finally, real exchange rate depreciation has a contractionary effect on trade balance in the long run, but there is no presence of J-curve effect.

It is recommended that there is need to increase the production of tradable and non-tradable goods and services that can sufficiently satisfy local demand and also be exported, encouraging direct investment through creating an enabling environment such as political stability, proper infrastructure and provision of trade incentives to both local and foreign direct investors should be a matter of priority. Besides, there should be affordable micro-finance facilities vis-à-vis lending interest rates to help local investors establish small and medium enterprises.