

# Chapter 3

## The Effects of Exchange Rate on Export Performance in Tanzania: An Empirical Research for Financial Competition

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### **ABSTRACT**

*The chapter analyzes the effects of exchange rate of Tanzanian shilling on the country's exports performance applying Vector Auto-Regressive (VAR) model covering the sample period from 1993:Q1 to 2016:Q4. Cointegration and causality tests are performed to investigate the short- and long-term relationships between the variables to evaluate the financial competition. The results show that; there is no long-term relationship (cointegration) between exchange rates and exports and between foreign demand and exports. Moreover, the results of causality test show no short-term relationship (causality) between exchange rates and exports and between foreign demand and exports. As the findings suggest, the exchange rate level of Tanzanian shilling (in nominal terms) does not statistic-significantly affect the country's exports performance.*

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## **INTRODUCTION**

While in the last touches of World War II, in 1944, when the world was resuming to normality, an international agreement commonly known as Bretton-Woods Agreement was signed for resetting a way through which countries can exchange their currencies and hence carry out trades between them. This came following the collapse of Gold Standard and the financial chaos in Europe and America (Great Depression of 1930s). Under Bretton-Woods system, countries could trade between them using exchange rates maintained within fixed values, once exchange rates between currencies established, governments were intervening to prevent them from deviating for more than one percent (1%) from the original set level. And most of currencies were pegged to either US Dollar or British Pound. Unfortunately, by 1971 it came to light that the US Dollar to which some of currencies were pegged had been overvalued and hence greatly suppressed its demand i.e. more dollars were in supply than what demanders could afford to buy because of overvaluation. This called for a review of the exchange rate regime and finally US Dollar devalued relative to other currencies, and currencies allowed to vary above the initial allowed interval of 1%, hence, this time currencies could vary up to 2.25 percent (2.25%). This was agreed in a common agreement known as Smithsonian Agreement by major trading countries. Very unfortunate, even after being allowed to vary for up to 2.25% below or above the set level, countries were struggling to keep their currencies within the margins of change. Hence, the fixed exchange rate regime proved failure and by March 1973 officially the world wrote a new history as a starting point of “Flexible Exchange Rate Regime” which is in practice until today. (Madura, 2011) By such a new flexible exchange rate system just set in, officially exchange rates among currencies started to fluctuate in response to prevailing market demand and supply conditions – no longer fixed margins of change. The new system got a quick acceptance among many countries fuelled by globalization move. Countries started liberalizing their economies and the trading among them increased in a vacuum. As a result, the level and variability at which one currency trade against such a free globalized world become of paramount importance to determine the country’s competitiveness in the world business arena. Not alone to governments’ policy makers, exchange rate became of the same importance to rest of actors who use foreign currencies such as investors, individual entities (importers and exporters) and multinational corporations. The fact that exchange rates are now freely adjusting to market conditions, means these stakeholders are not sure of exchange rate movements anymore, so uncertainty set in. The now new worries in the market i.e. uncertainty brought by level as well as frequency of fluctuation of exchange rates became a click to all stakeholders of international business and the same to the world of academia. Many studies so far have been taken but most focusing on effects of exchange rate volatility rather than level. Moreover, they are based on developed countries and recently on BRICS countries as potential power houses of the world, MINT countries and MENA countries. Considering the significance of the proposed topic from both theoretical and practical view, there are very limited studies conducted the impact of exchange rate on exports performance in Tanzania. In this direction, the aim of the study is to analyze the effects of exchange rate of Tanzanian shilling on the country’s exports performance.

### **Foreign Exchange Market in Tanzania**

Tanzania in her present state of the financial and trade regime, went through major three eras. Like many developing countries, SSA countries in particular, exchange rate regimes emerged in a controversial fashion. The country right after independence in 1961 (Mainland Tanzania) entered the first era of

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