EXECUTIVE SUMMARY

MASTER THESIS: Dollarization vs. Foreign Exchange Risk in the Bolivian Microfinance Industry

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The international financial market is predominantly denominated in hard currencies and the majority of MFIs receivables are denominated in local currency, thousands of MFIs face the problem of currency mismatch and therefore foreign currency risk that can be very costly and translate in huge losses endangering the MFIs sustained growth.

When MFIs lend in hard currency, they pass the forex risk to the client, who have to gather more money every time to repay their loans. This transmission of the foreign exchange (forex) risk is less harmful in partially dollarized economies and is naturally hedged against forex risk in completely dollarized economies when the loans are in dollars.

Is in this extent that mechanisms for hedging such exposure are clearly required. While forex risk hedging is by no means a new concept at an international level, it might be for many MFIs that have not yet started to develop mechanism of protection for the potential risk they face when lending in a foreign currency. In cases like the Bolivian, it might be possible that there is no real need of hedging the risk provided the fact of the dollarization.

The main objective of present thesis is to determine the actual level of dollarization in the Bolivian economy, in the local financial system and in the Microfinance industry to be able to determine the portion of foreign exchange risk not mitigated naturally through the dollarization.

The hypothesis is: if there is a high level of dollarization in the economy, it exists then a natural hedge against forex risk. Then, if the results of measuring the percentage of dollarization of the economy show an almost complete dollarization we would be able to assume that there are no hedging instruments or mechanisms needed to defend microfinance institutions and their clientele from the risk. However, if the level of dollarization is not as high as described in past papers it would be assumed that dollarization is only a partial natural hedge and an investigation will be done to determine what mechanisms are used by the Bolivian nowadays to mitigate the forex risk.

The level of dollarization was determined, concluding that the economy is not as dollarized (90%) as it has been for the past 30 years. The economy nowadays is dollarized at a 60%. This supposes that there is a greater gap trough which the foreign exchange rate could affect the economy in general and the microfinance industry in particular.

It is not of the interest of this thesis to side towards dollarization or the contrary, the de-dollarization ("bolivianization") of the Bolivian economy. There are several arguments in favor and against of each one of them, however this will not be covered in the present paper.

Although almost all the literature reviewed for the purpose of this thesis agrees on the importance of hedging against forex risk for microfinance, no evidence has been found in Bolivia of instruments being used by Bolivian MFIs in Bolivia, although one example was found of a Bolivian MFI operating in Argentina.

This lack of application of financial instruments to hedge the forex risk has been explained throughout the thesis as a consequence of the underdevelopment of the financial market and the almost non-existent supply of the hedging mechanisms.

Nevertheless, the Bolivian expert practitioners who have been interviewed for the sake of this thesis have shown awareness regarding the negative impacts that the forex can have in the performance of the MFIs they lead. Moreover, they have shared information regarding the mechanisms applied inside each MFIs and have openly declared their concerns regarding the unavailability and cost of international well known hedging instruments in general and the ones designed for microfinance specifically.

The descriptive statistics have also shown that the microfinance sector is more dollarized that the rest of the financial system, result that has been attributed to the large amounts of money received by the sector in hard currency, to the previous preference of the client to borrow and deposit in hard currency and for the purposes of facilitating the matching of currencies on an accounting and managerial level inside each MFI.

It has been found that the mechanism used by Bolivian MFIs to hedge the foreign exchange risk is the matching of currencies. And although the Bolivian regulatory entity stipulates that hedging must be done one way or another, the decision on how to hedge and the proportion of portfolio of credit and deposits to be hedged is done within each MFI following its own business plans.