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## Currency risk and microcredit interest rates

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### ABSTRACT

Foreign currency debt provides additional access to capital and offers funds in favorable and flexible terms to microfinance institutions (MFIs). Yet, we find that the use of foreign currency debt, on average, leads to higher microcredit interest rates. We also find that MFIs operating in countries with pegged exchange rate regimes and profit MFIs are better able to mitigate foreign currency risk. The results of the paper suggest that local currency debt is a better option for MFIs if the goal is to provide microcredit at lower interest rates.

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### 1. Introduction

Microfinance has long been considered as a tool for sustainable development and evolved rapidly to become a global industry. Since its inception, donations and subsidies have been the main source of funding for microfinance institutions (MFIs). Lately, however, the concern to maintain their development objectives and financial sustainability has motivated many MFIs to turn to international capital markets where most of the foreign debt is denominated in foreign currency. Many MFIs are not familiar with foreign currency risk as they belong to a relatively new industry that witnesses an enormous growth and is still exploring the best practices in doing business. Additionally, MFIs are particularly vulnerable to foreign currency risk since they mostly operate in developing countries where the risks of devaluation, convertibility, and transfer of currencies are high. Unless it is well managed, the foreign currency risk is expected to be priced into microcredit interest rates; the most controversial aspect of microfinance.

The issue of the microcredit interest rates has been the most debated in the modern move of microfinance. Advocates of microfinance regularly assert that operating costs of providing microcredit are inherently high. These high microcredit interest rates are inevitable if MFIs look for covering high costs, seek independence from donors, and aim to achieve financial sustainability.<sup>1</sup> Opponents argue that the microfinance move exploits poor borrowers through excessive microcredit interest rates. The little bargaining power of the poor and the increasing commercialization movement could mean higher microcredit interest rates

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<sup>1</sup> MFIs face high administrative and personnel costs. Lending a given amount in many small loans costs more than lending it in few large loans and because microfinance involves labor-intensive operation, personnel costs are notably high as well. Interest charged on loans is the main source of income for MFIs and, because MFIs incur considerable costs, the interest rates are similarly high. In addition, many MFIs are socially oriented and operate in remote areas where it costs more to serve. Microcredit interest rates need to be high if MFIs were to continue and operate independently from donors.

which raises fundamental concerns on the social and development missions of microfinance. The debate and research on what “high is high” and what “fair is fair” does not seem to end soon; [Hudon and Ashta \(2013\)](#). When asking “how high is high?” it becomes imperative to reserve judgment long enough to examine the factors that determine microcredit interest rates.

Several empirical studies have identified many contributing components in the determination of interest rates charged by MFIs. The most important component is the cost structure ([Rosenberg et al., 2009](#); [Gonzalez, 2010a, b](#); [Mersland and Strøm, 2012](#); [D’espallier et al., 2012](#); [Roberts, 2013](#)). Other major components include the gender of borrowers ([D’espallier et al., 2012](#)), the profit status of the MFI ([Roberts, 2013](#)), the competition ([McIntosh and Wydick, 2005](#); [Cull et al., 2009b](#); [Cull et al., 2015](#)), and the country specific macroeconomic and macro-institutional elements ([Hartarska, 2005](#); [Ahlin et al., 2011](#)). The empirical literature has overlooked the impact of foreign currency risk on microcredit interest rates. While there exists many discussion papers on the nature and management of foreign exchange risk ([Holden and Holden, 2004](#); [Crabb, 2004](#); [Cavazos, 2004](#); [Fernando, 2005](#); [Featherston et al., 2006](#); [Littlefield and Kneiding, 2009](#); [Apar and Reille, 2010](#); [Abrams and Prieur, 2011](#)), there is no empirical work that examine the impact of foreign exchange risk on the MFIs’ financial indicators such as microcredit interest rates. An exception is [Al-Azzam and Mimouni \(2016\)](#) who use data on 481 MFIs from 73 countries for the years 2003–2010 and find that microcredit borrowers pay higher interest rates in countries with floating exchange rate regimes. The current paper is different in that it attempts to investigate several unanswered research questions. First, do MFIs that operate in countries with floating exchange rate regimes charge higher microcredit interest rates? Second, do MFIs that rely heavily on foreign currency debt charge higher microcredit interest rates? Third, do MFIs that rely on foreign currency debt but operate in countries with different exchange rate regimes charge different microcredit interest rates? Fourth, does the profit orientation of an MFI have any consequences on foreign currency risk? This paper is the first to empirically tackle these questions.

Using data from the MIX Market, International Monetary Fund, and the World Bank for the years 2003–2014, this paper documents new interesting results. First, MFIs operating in countries with floating exchange rate regimes tend to charge higher microcredit interest rates. Second, MFIs with more reliance on foreign currency debt charge higher microcredit interest rates only in countries with floating exchange rate regimes. Third, profit MFIs seem to be less susceptible to foreign currency risk. These results stress the need for local monetary authorities and policymakers to assist MFIs overcoming foreign exchange risk if the goal is to provide the poor with microcredit at lower interest rates.

The rest of the paper is organized as the following. [Section 2](#) states the hypotheses of this study. [Section 3](#) describes the data and the variables used in the paper. [Section 4](#) discusses the estimation techniques and [Section 5](#) discusses the empirical results. [Section 6](#) reports the robustness tests implemented and clarifies the caveats of the study. Finally, [Section 7](#) concludes and offers some policy implications.

## 2. Hypotheses

We would like to emphasize that there is no well-developed theoretical or empirical works that address the questions of this paper directly. Nevertheless, there are many empirical papers that model microcredit interest rates. Among many others, well known empirical models that use similar data to ours include [Ahlin et al. \(2011\)](#), [Mersland and Strøm \(2009\)](#), [Roberts \(2013\)](#), and [D’Espallier et al. \(2011\)](#). We extend these empirical models by introducing the impact of foreign exchange risk on microcredit interest rates.

Foreign currency debt has been a key driver in the expansion of the microfinance industry. It brings numerous advantages to MFIs by providing capital that might not be available domestically. The growth of the microfinance industry and the donors’ pressure to achieve financial sustainability have caused many MFIs to fund their growth through different channels including the international capital markets. According to [El-Zoghbi et al. \(2011\)](#) and as of December 2009, the cross-border funds to MFIs surpassed 21 billion US dollars. The foreign currency debt helps mobilize domestic funds and attracts future equity investors. In

**Table 1**  
Types of foreign currency borrowings.

Name	Subtype	Definition
Development Finance Institution	None	Financial institutions owned by a government or governments and that raise private capital to finance projects with development objectives
Government	Multi- and bilateral	Bilateral or multilateral aid agencies, owned by governments
Government	Development Programs	Government or other public program with development objectives.
Government	Government Agency/Program	The administration, departments, or agencies of any sovereign entity
Government	Regulator	A domestic central bank
Financial Institution	Commercial bank	Bank or other regulated financial institution where private entities are majority shareholders
Financial Institutions	Cooperative Society	Financial institution owned by its members, not external shareholders
Financial Institutions	Public Bank	Bank or other regulated financial institution where the government is a majority stakeholder
Fund	None	Professionally managed type of collective investment scheme that pools money from many investors
Other	Private Cooperation	Registered legal entities. The category does not include governments, non-profits, funds or financial institutions.
Other	Individuals	A person or persons
Other	NGO	Non-government organization
Other	Foundation	A non-profit corporation or other non-profit entity

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