

CASE STUDY



TRUSTAFRICA

Investment Climate & Business Environment Research Fund

TrustAfrica is an independent foundation that strives to secure the conditions for democracy and equitable development throughout the continent.

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Our programs focus on:

- Democracy & Civil Society
- Equitable Development
- African Philanthropy

ICBE Research Fund

In partnership with the International Development Research Centre, we have set up a special fund to support research and advocacy on business and investment in Africa and help ensure that the benefits of economic growth extend to all members of society. Known as the **Investment Climate & Business Environment (ICBE) Research Fund**, it has awarded nearly US\$1.5 million to 53 teams in 16 African countries in its first two rounds of support.

Grant Summary

University of Dar es Salaam

US\$10,000 (2007)

“Foreign currency risk: Awareness and management practices in Tanzania”

Mussa J. Assad Ph.D., principal investigator



Christopher Reardon

Riding the Ups and Downs of Foreign Exchange

For Tanzania’s importers and exporters, limiting exposure to currency fluctuations may spell the difference between failure and success.

Every few months, Amani Simba visits the marine port in Dar es Salaam to take delivery of five large shipping containers. Sent from England, each one typically contains about 150 scratched, dented, or lightly used refrigerators and freezers that will still fetch a good price in East Africa. The cargo and shipping cost roughly £60,000, which Simba, 28, slowly seeks to recoup from local buyers who pay with Tanzanian shillings. Yet as he prepares to place a new order, an inherent risk becomes evident: If the shilling has risen against the pound in recent months, he’s in luck; if it has fallen, he may not have enough cash to pay for his next shipment. What then? He could simply place a smaller order—say, four shipping containers this time—but what if it happens again? With just a few bad rolls of the dice, Simba could be out of business for good.

“These fluctuations pose a serious risk for small and medium enterprises that do a lot of importing or exporting,” says Mussa J. Assad, who conducted a study of foreign currency risk in Tanzania with support from TrustAfrica’s Investment Climate and Business Environment (ICBE) Research Fund. “It’s true you can get quite a lot of windfall if the rates shift in your favor. But if you look at the trend over time, it’s more likely, in a country like ours, to go the other way.”

High Risk, Low Capacity

Assad, a scholar at the University of Dar es Salaam who also chairs the National Board of Accountants and Auditors, traces his research interest back to an article he saw during a visit to Dublin in 1991. Although the Celtic Tiger had yet to stir, he was surprised to learn that Irish firms knew so little about foreign currency risk and how to deal with it. Back home, he observed a similar lack of awareness among small-scale importers and exporters. “These firms are not hugely capitalized,” he says, “so it’s quite important to sustain what capital they have.”

There are many ways to hedge against this risk, from internal techniques like invoicing exports in dollars or Euros to external ones like currency forwards. ▶

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Assad hoped to gauge awareness and use of various hedging methods among small and medium firms that import or export. He gained useful advice on how to structure the study at a 2006 workshop on research methodology and writing grant proposals held in Dar es Salaam by the ICBE Research Fund. After peer reviewers and a pan-African jury named him one of the winners of the grant competition, Assad enlisted two assistants and set to work surveying 50 firms and 103 business students and recent graduates. They also conducted extended interviews with selected participants and analyzed syllabi for relevant business school courses at Mzumbe University and the University of Dar es Salaam.

The researchers documented a high level of awareness of foreign currency risk, but found that few of those surveyed knew how to reduce their exposure and fewer still made use of these methods. As expected, younger respondents were more aware of ways to limit their risk. But to Assad's surprise, those who studied outside Tanzania, which only liberalized exchange rates in the mid-1990s, were not more familiar with these techniques. Among all participants, the most common ways of dealing with the ups and downs of exchange rates were through internal hedging techniques like matching balance sheet assets against liabilities in the same foreign currency or switching to local or regional suppliers. Banks and other financial institutions have done little to help smaller firms. "They don't think the market is there," Assad says, "but the study found otherwise."

Sharing Solutions

Simba, unlike many of his peers, takes some basic precautions to limit his exposure to foreign currency risk. Before his shipping containers leave England, for example, he tops them off with small household items and compressors in hopes of generating enough extra income to offset any unwelcome fluctuations. He sheds more of the risk by selling 80 percent of the cargo to wholesalers upon arrival and promptly converting the income to British pounds. Although some of his investment remains at risk until he can sell the rest of the goods at his retail shop, a process that can take two months, he has secured a preferred customer rate at his bank, saving about 2.5 percent each time he buys foreign currency.

Not bad for a merchant with a secondary education, but Simba could do more. With each shipment, Assad suggests, he might arrange with the bank for a currency forward, essentially locking in the terms to buy sterling at a later date. "They charge a fee," he says, "but you know the cost. There's no uncertainty."

With the right training, entrepreneurs like Simba and Ayubu Said, who imports Japanese auto parts, could build their capacity to manage foreign currency risk—and thereby minimize losses and increase the value of their firms. Assad has begun enlisting bankers and business school leaders in efforts to:

- Raise merchants' awareness of foreign currency risk and hedging techniques;
- Show banks that there is an untapped market for currency risk management products and services geared to small and medium enterprises; and
- Strengthen the content and delivery of business school curricula so that the next generation of entrepreneurs has a better grasp of hedging techniques.

Because so many businesses would benefit from immediate assistance, Assad is also laying the groundwork for a free Saturday clinic where entrepreneurs could meet with financial experts for guidance on real-time concerns. "Practical advice," he says, "can help these firms succeed rather than fail." ■

Read an in-depth report on this research project at www.trustafrica.org/icbe.