High lending rates pose threat to productive sector

One-and-a-half years ago, Bhim Lal Poudel, the owner of Royal Shoe, rapidly expanded business operation, raising the factory's staff strength by around 50 per cent to 225. A critical factor that encouraged Poudel to increase production of shoes was low interest rate on loans.

"Lending rate had fallen to seven per cent per annum. This had drastically reduced my debt servicing cost, enabling me to expand the business," says Poudel, who had acquired around Rs 80 million in credit from a commercial bank some six years ago to set up his shoe factory.

Ironically, the interest rate which had once worked as an incentive for Poudel has now emerged as a disincentive threatening his very existence. This is because the interest on Poudel's loan has spiralled up from seven per cent to 13 per cent. "I'm now forced to pay Rs 4-5 million extra per year in interest cost," says Poudel. "This high debt servicing cost is now eating into my profit."

Poudel has since cut around 75 jobs to make up for the loss. "I'll have to cut more jobs if bank financing continues to become expensive," says Poudel.

Commercial banks have been raising lending rates for the last several months, stating deposits have become expensive due to deceleration in remittance inflow and slow public spending, especially capital spending. This has pushed up lending rates to as high as 22 per cent.

"The capital has become very expensive these days, making it tough for businesses to survive," says Sunil Chitrakar, vice-president of the Federation of Handicraft Associations of Nepal.

The central bank has informally said that it intends to keep deposit rates within a range of seven to eight per cent and lending rates within a range of 12 to 13 per cent this fiscal. Nepal Bankers' Association has already barred commercial banks from offering over eight per cent interest on savings deposits and over 11 per cent interest on fixed deposits. The central bank has given tacit approval to this practice of locking the deposit rates, which, many say, thwarts competition. But it has maintained awkward silence about runaway lending rates. This is hurting the productive sector, which needs large chunks of capital to keep their businesses moving.

“Interest rate on term and working capital loans has now breached the 13 per cent mark and is likely to hit 15 per cent soon,” says Rabin Kumar Shrestha, president of the Footwear Manufacturers Association of Nepal. These rates, according to many, are being raised even without giving prior information to borrowers. “How can entrepreneurs of the productive sector survive in this environment?” questions Shrestha.

The government and the central bank have long been saying more credit should go towards the productive sector to raise domestic production, create jobs, bridge the ever-widening trade deficit and stimulate economic growth. A big portion of banking sector loans is being used to purchase real estate, stocks and cars, considered unproductive areas, as they cannot create jobs continuously.

Nepal needs to create more jobs in the coming days because fewer workers are going abroad for employment.

Around 512,000 workers join the domestic job market every year, according to the Ministry of Finance. Earlier, over 400,000 of these new entrants used to find jobs in overseas labour markets. Now the outflow of Nepali workers has declined, meaning more jobs need to be created in the country. This calls for the need to establish more small and medium enterprises, as they are the biggest job providers in many countries.

“But how can new enterprises be established when the cost of capital is so high and all the profit is taken away by banks?” asks Chitrakar, implying it is safe to bet on real estate and stocks where returns are high.

Unlike other sectors, banks have been making handsome profits year after year. The combined net profit of 28 commercial banks jumped 15.5 per cent to Rs 36.3 billion in the third quarter of this fiscal, according to unaudited financial reports of these financial institutions.

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One of the reasons for uninterrupted profit year after year is the central bank's provision, which allows banks and financial institutions to maintain interest spread of five per cent. This means a bank which has bought deposit at an interest of 11 per cent per annum can sell it in the form of loan at an interest of up to 16 per cent.

The Federation of Nepalese Chambers of Commerce and Industry, the largest private sector body, had earlier called for reduction in interest spread. But nothing has been done. Worse, commercial banks have been breaching the regulatory limit on interest spread since November, central bank report shows. But no action has been taken. All the while, firms that churn out shoes, handicraft items and other goods and services are seeing their profits shrink.

If the government is to entrench a revolution in the productive sector, this problem ought to be addressed. But nothing is likely to happen anytime soon.

Lending rates are likely to remain high for the time being, as Rs 15-16 billion is expected to exit the banking system as early as this week in the form of advance payment for two wide-body aircraft that Nepal Airlines Corporation is purchasing. "This will exert pressure on liquidity of some banks, making it harder to reduce lending rates," Sanima Bank CEO Bhuvan Kumar Dahal said. "But the government's capital expenditure is expected to go up from mid-May, which will enable banks to lower the rates."

Nonetheless, lending rates are unlikely to fall to the range of one-and-a-half years ago, as banks are likely to say their cost of fund has gone up because they have been purchasing deposit at high rates. This will knock the confidence of investors and prevent them from establishing new businesses or expanding existing ones.

"The central bank is not planning to make any intervention for the time being to bring down the lending rates," a senior central bank official said on condition of anonymity. Central bank spokesperson Narayan Prasad Paudel could not be contacted.

Source : The Himalayan Times, 2nd April 2018