Monetary Policy

FY 2079/80

"Better Late Than Never"

Himalayan Capital

A Wholly Owned Subsidiary of Himalayan Bank Limited

A. Current Overview

1. International Outlook

- Global economy is expected to expand by 3.60 percent in 2022 AD, mainly due to the Russia-Ukraine conflict which has led to commodity price increases and aggravated an economic situation which underlined by supply chain disruptions after opening up post the COVID-19 pandemic. Consequently, Advanced, and Emerging Markets and Developing Economies are projected to expand by 3.0 percent and 3.8 respectively, down from the expansions of 5.20 and 6.80 percent in 2021 AD.
- War-induced commodity price increases and broadening price pressures have led to 2022 inflation projections of 5.70 percent in advanced economies and 8.7 percent in emerging market and developing economies. The respective economies had experienced an average inflation of 1.50 and 5.10 percent in the last decade.
- In order to control the rampant inflation, central banks across the world have implemented tight monetary policies and have made provisions to increase interest rates.

Implications: The global economy has been plagued by inflation issues following the end of the COVID-19 pandemic in its current iteration due problems observed in the supply chains of key commodities which had pushed prices upwards. This situation was further exacerbated by the Russia-Ukraine conflict which besides pushing oil price higher also cause a scarcity of commodities such as grain. In order to control the rampant inflation, central banks have been adopting tighter monetary policies.

2. Overall Economic Status

- Nepal's economy is expected to grow at 5.84 percent in Fiscal Year (FY) 78/79 compared to a growth of 4.25 percent in the FY 77/78. However, with the trade deficit increasing and the Foreign Exchange Reserves Depleting, control on credit expansion will make GDP growth above a certain threshold difficult.
- Ratio of Gross Domestic Savings to Gross Domestic Products is at 9.27 percent compared to 7.71 percent in the previous Fiscal Year. Similarly, Ratio of Gross National Savings to Gross Domestic Products is at 31.95 percent compared to 33.30 percent in the previous Fiscal Year.
- Consumer Price Inflation (CPI) for the month of Jestha was 8.56 percent in a year-on-year basis. With the annual inflation over the first eleven months of the fiscal year at 6.09 percent, the inflation should fall within the targets set for the fiscal year.
- Recurrent Expenditure in FY 78/79 is projected at 961.47 Arba, Capital Expenditure at 216.37 Arba, Financial Management Expenses at 118.40 Arba and Tax Collection at 1,067.96 Arba. All the revenue and expenditure metrices except for capital expenditure have increased this fiscal year as opposed to a decrease in major metrices in the previous fiscal.
- Exports have increased by 53.30 percent to reach 185.84 Arba, and imports have increased by 27.50 percent to reach 1,763.22 Arba.*
- Balance of Payment and Current Accounts have both deteriorated to end at BOP Deficit of 269.81 Arba, and Current Account Deficit of 595.73 Arba.*
- Remittance Inflow has increased by 3.80 percent to stay at Rs 904.18 Arba. *
- Foreign Exchange Reserves In Dollar Terms has decreased 2.3 Arba USD to Reach9.45 Arba USD which is enough to cover merchandise and service imports for 6.37 months

*Data is for eleven months of the fiscal year.

Implications: Increased imports coupled with a shortfall in remittance growth have led to significant pressure on the nation's external accounts. This has led to problems in the deposit creation cycle and ultimately credit creation through BFIs. A reduction in the nation's foreign exchange reserves has been experienced due to higher fund outflow than inflow and could prove to be problematic if allowed to deplete even further.

Similarly, the tiring state of government finances may be a problem as the government will need to source significant external debt to fund additional capital expenditure projects and drive the development agenda forward as the increased foreign borrowing will require servicing continuously. A growing proportion of recurrent expenditure to total expenditure is worrisome as always.

3. Financial Sector

- Deposits Mobilization of BFIs has increased by 5.70 percent while credit to private sectors has increased by 13.5 percent. The total deposit collected by BFIs stand at NPR 266 Arba versus a credit outlay of NPR 553 Arba to the private sector resulting in a credit crunch within the nation as additional credit growth would require the sourcing of new deposits.
- NPA of Class "A", "B", and "C" BFIs were 1.32, 1.49, and 7.00 percent at the end of nine months of the fiscal year as opposed to 1.41, 1.30, and 6.19 percent at the start of the fiscal year.
- Number of branches of BFIs has increased by 845 in the fiscal year while population served per branch of BFI has gone down from 2,844 to 2,532 .

*Data is for eleven months of the fiscal year.

Implications: Owing to greater fund outflow from the country compared to fund inflows, deposit creation was poor during the fiscal year and while credit disbursement was carried out at the start of the fiscal year from the existing deposit surplus, credit growth also stopped after a period as regulatory ceiling (credit to deposit ratio) was reached due to deposit growing very slowly.

4. Securities and Stocks

- NEPSE index has decreased from 2,883.41 points to 2,009.46 points during the FY while Market Capitalization reached NPR 2,869.34 Arba from NPR 4,010.96 Arba, a decrease of 28.46 percent during the FY.
- A total of 8 BFIs (7 Commercial Banks, and 1 Development Bank) were permitted by SEBON to issue Debentures worth 11.28 Arba in the market this fiscal year.

Implications: NEPSE index was in a period of correction throughout the fiscal year as liquidity issues and increasing interest rates combined to create a selling-mood in the market leading to a decline in the local bourse.

B. Review of Monetary Policy 2078/79

1. Monetary Management

- Money Supply has grown by 9.00 percent* which is half the limit of 18.00 percent set for the current fiscal year.
- Private Sector credit has grown by 16.00 percent which is 3.00 percent less that the limit of 19.00 percent set for the current fiscal year.
- Weighted Average Interbank Lending Rate was 7.00 percent at the end of the fiscal year.
- The weighted average 91-Day treasury Bills rate was 10.66 percent at the end of the fiscal year.
- The average base rate for commercial banks was 9.39 percent compared to 6.66 percent last year. Similarly, weighted average cost of deposits and weighted average cost of credit were 7.34 and 11.54 percent compared to 4.72 and 8.46 percent last year*.

*Data is for eleven months of the fiscal year.

Implications: Money Supply and Credit Growth both became stifled due to the low rate of deposit mobilization which has served to push rates upwards as the demand for money and its limited supply caused all participants to offer greater rates for available funds

2. Sectoral Credit

- Commercial Banks have availed 12.28 and 5.51 percent of total loans in agriculture and energy sector in line with the set target of 12.00 and below the target of 6.00 percent.*
- Commercial Banks have availed 9.85 percent of their total loans in MSME sector which are individually below NPR 1 Crore well below the set target of 11.00 percent as of the end of the fiscal year. *
- Development Bank have availed 26.62 percent of their total loan portfolio in priority sector lending for (MSME, Agriculture, Energy and Tourism Sectors) against a target of 17 percent while Finance Companies have availed 21.92 percent of their total loan portfolio in these sectors against a target of 12 percent.*

*Data is for eleven months of the fiscal year.

Implications: Commercial banks are having trouble meeting their priority sector lending targets in energy and MSME sector which might lead to issue of debentures linked with/sales of credit portfolios by institutions that have such portfolios in excess of NRB requirements.

3. Subsidized and Restructured Loans

- Total of NPR 115.68 Arba of loans have been approved for restructuring for 24,305 creditors impacted by COVID-19.
- A total of 1,47,147 are being facilitated through subsidized loans worth NPR 215.91 Arba funded by the governments interest allowance discount scheme.
- NPR 1.15 Billion of Business Continuity loans provided to MSMEs and Tourism Industries for payment of staff benefits.*

*Data is for eleven months of the fiscal year

Implications: Amount of Restructured Loans have been decreasing as NRB looks to curtail facilities provided to mitigate the impact to businesses from the COVID-19 pandemic as the economy is now open.

4. Review of Regulatory and Supervisory Provisions

- Credit to Deposit Ratios for BFIs have been maintained at 86.22 percent against the maximum allowable limit of 90 percent at the end of the FY.
- Deprived Sector Lending of BFIs was at 7.88 percent of their total loan portfolio.

Implications: BFIs are adhering to NRB guidelines on deprived sector lending and CD Ratio.

C. Monetary Policy 2079/80

1. Economic and Monetary Goals.

- Inflation is expected to be limited at around 7.00 percent compared to target of 7.00 percent previous fiscal year.
- Foreign Reserves to cover up to 7 months of imports of merchandise and services will be maintained similar to previous fiscal year.
- Money Supply will be limited to within 12.00 percent and private sector credit growth will be limited to within 12.60 percent.

Implications: Monetary Policy Targets are in line with the fiscal policy.

2. Operating Target and Instruments

- The existing standing liquidity facility (SLF) rate as the upper bound of the IRC (Interest Rate Corridor) has been increased to 8.5 percent , repo rate as the policy rate has been increased to 7 percent and the deposit collection rate as the lower bound has been increased to 5.5 percent.

- In the event of interbank lending rate fluctuating from the policy rate by 2 percent Repo/Reverse Repo Auctions to be initiated. In the event the interbank lending rate fall below the policy rate by greater than 3 percent, Deposit Auction to be initiated.
- SLF Facility that can be availed by a BFI in a week pegged at 1 percent of their local currency deposits at the end of last week for a maximum period of 5 days backed by set of securities as prescribed by the central bank.
- Lender of Last Resort (LOLR) facility to be provided to BFIs at a premium of 2 percent(attributable as penal rate) from their requested bank rate.
- Cash Reserve Ratio to increase to 4 percent.
- Statutory Liquidity Ratio (SLR) has been increased for BFIs which is now 12 percent for Commercial Banks, and 10 percent for Development Banks and Finance Companies.

Implications: All policy rates have seen upwards revisions aimed at increasing interest rates and discouraging imports and thus controlling the inflation. SLF facilities have been pegged at 1 percent of Local Deposits to prevent BFIs from availing arbitrage benefits when subscribing to treasury bills.

3. Financial Sector Improvement

- Provisions made to facilitate economic recovery following the COVID-19 pandemic will be reevaluated.
- Counter Cyclical Capital Buffer to be implemented from 2080 Asar End for BFIs.
- Class "A" and Class "D" BFIs merging with/acquiring BFIs within their own segments to be allowed to avail facilities under merger and acquisition promotion scheme given their unified operations are started by 2079 Poush End.
- Continuity of provision for BFIs to include debentures in the calculation of CD Ratio up to 2080 Asar End.

- Provision for ensuring full insurance coverage for credit amount while insuring the collateral provided for credit acquisition.
- BFIs cannot charge penalty for businesses availing credit less than NPR 5 Crores in case of payment of principal and interest for Asar End 2079 by Ashwin End 2079.
- Provision to differentiate interest rates charged to productive and business sector creditors. BFIs to be able to charge only a 2 percent premium for loans up to NPR 2 Crore availed to productive sector such as agriculture, and animal husbandry, export-oriented industries and productive industries using only local raw materials .
- Provision for the Ratio of Credit to Collateral to be set at a maximum 30% and 40% of Fair market Value respectively of collateral situated within Kathmandu valley and outside Kathmandu valley for the purpose of disbursing overdraft without stated purpose, personal overdrafts, loan against securities, and loan against property.
- Provision to encourage merger between Nepal Infrastructure Bank and other FIs investing in infrastructure sector.
- Single Obliger Limit for Margin Lending has been revised to NPR 12 Crore for an individual across any number of BFIs as opposed to previous provision of NPR 12 Crore in total and a maximum of NPR 4 Crore per BFI. Limits on margin lending to be removed after implementation of margin lending through stockbrokers.
- Risk weight for loans against securities up to NPR 25 Lakhs to be apportioned at 100 percent of the loan portfolio while that for loans above NPR 25 Lakhs to be apportioned at 150 percent of the loan portfolio.
- Provision to facilitate the establishment of a second-tier regulatory body to regulate activities of financial cooperatives and non-government organizations involved in financing activities.

Implications: The monetary policy for the fiscal year intends to regularize the pre-planned activities of the central bank which had to be postponed due to the COVID-19 pandemic. The introduction of the counter cyclical buffer will thus begin from the start of the next fiscal year to improve the capital adequacy of BFIs and improve their long-term stability and strength.

Similarly, the policy also allows for concessions so as to facilitate the smooth implementation of its current policies which is observed by the allowance to count debentures in the calculation of CD Ratio for the FY allowing BFIs more time to regularize their operation and mitigate any negative short-term consequences that may arise from the implementation of the policy.

Similarly, the central bank also looks to be widening the access to credit to include small creditors and provide credit to institutions that are operating productive industries and reduce concentration in a limited number of large creditors mostly involved in the trading of goods. Suspension of penal charge for interest non repayment for businesses availing credit less than NPR 5 Crores, different interest rates on credit for non-productive and productive sectors, a premium of just 2 percent for loans up to NPR 2 Crore to the productive sectors, and risk weight of 100 percent for loans against securities up to NPR 25 Lakhs are all indicative of this policy decisions.

Similarly, the debt to collateral ratio being downward revised for overdrafts and other specific types of credits shows an effort on the part of the central bank to control non-productive credit that is being used for arbitrage in land dealings which is sure to affect the real estate industry of the country further. This is in line with the central bank's policy of facilitating the establishment of a second-tier regulator so as to better regulate sectors such as co-operatives and ensure credit delivery to productive sectors.

Finally, the policy regarding removing the per institution limit of 4 Crores for margin lending while keeping the 12 Crore limit for overall system until margin lending is done through stockbrokers shows a move towards a more liberal attitude to the stock market but is also wary of the central banks efforts to reduce the control of major groups overall the entire economy.

4. Foreign Exchange Management

- Provision for card-to card remittance inflow to the country to reduce costs of remitting and ease of access to banking service for remitters.

- Continuity to provision of requiring cash margins while availing letter of credit services through BFIs.
- Provision to increase due diligence requirements for BFIs before issuing draft and LC's
- Provision to initiate study to establish a USD/NPR swap window for hedging foreign currency risks.

Implications: Efforts from central bank to promote remittance through formal channel continues while discouraging the leveraging of BFIs for growing import related businesses. Establishing a swap window can help attract FDIs as well.

5. Refinancing and Subsidized Loans

- Continuation of refinancing for productive industries sectors such as agriculture, MSME, export-oriented industries and recovering industries affected by COVID-19 pandemic. The total refinancing available to be restructured to be equal to size of the refinancing fund by the end of FY 2080/81
- Study to ascertain feasibility of alternative mechanisms such as Peer-to-Peer lending and Crowdfunding for startup funding.

Implications: Provisions to gradually reduce the funds for refinancing while not affecting the recovery of affected businesses. Study on alternate funding mechanisms can also help attract smaller FDIs to the country.

6. Microfinance Sector.

- BFIs can only charge a maximum of 2 percent as premium on base rate to Microfinance companies for wholesale lending under deprived sector lending.
- Microfinance companies can issue debentures up to the size of their capital funds to be used as source.

Implications: Reduction in costs of borrowing for microfinance companies without changing their maximum credit rate limit to minimize the impact of growing interest rates on their profitability. Issuing debentures can help source additional funds for mobilizing in the market.

7. Payment Systems.

- NRB Act, and BAFIA to be amended to move towards fully digital banking operations in BFIs.
- Provisions to allow for merger and acquisition of payment system operators/providers and allowing them to source FDIs to be reevaluated.
- Provisions for settlement of payment card issues by Nepali BFIs to be done in Nepal itself and the bonds/collateral intended for the settlement to be issued in Nepali currency itself.

Implications: Regulatory provisions enabling a digital banking system will help reduce costs and enable broader access while also reducing cost of service delivery and reception. Mergers among PSP's and PSO's can enable better synergy and ensure a larger capital base to grow business more rapidly.

8. Financial Literacy and Financial Inclusion

- Financial Inclusion Index to be initiated to measure the actual reach and impact of banking services within the country.
- Financial Literacy Framework, 2022 to be enacted to improve financial literacy among the populace. Lobbying to include financial literacy as a subject in the curriculum of schools.

Implications: Actually, measuring how the strategy of service expansion has affected service availability for citizens will help NRB understand what strategy will yield the best results in terms of financial inclusions and what changes can be made to improve this. Introduction of financial literacy in the school syllabus will not only help educate children about proper financial planning and behavior but also help set a foundation for good financial decisions in the future.

9. Overall

The monetary policy for this fiscal year is primarily oriented towards controlling the high credit growth in the economy which is intended to slow import growth and maintain sustainable national accounts. For this the policy has leaned into increasing of policy rates so that any money borrowed for consumption has a high servicing requirement. This combined with a cash margin requirement for using LCs for imports means that it is now more costly for importers to import consumables. Combined with CD requirements which are causing a shortfall of credit for importing is requiring the importers to use their own money for importing, this is sure to lead to an increase in the cost of consumables which is intended to discourage their high usage. This combined with continuation of provision for blockade on investment of certain non-productive items is intended to curb the flow of money out of the country for imports and allow for deposit creation within the country.

Similarly, the policy is also geared towards controlling the overinflation in various asset segments of the country. The provision of decreasing the ratio of debt amount to collateral to just 30% of Fair Market Value within Kathmandu Valley and 40% elsewhere for overdraft and loans of personal nature is intended to reduce the exposure of banking sector in the already inflated Nepali real estate market and prevent price from ballooning even further. This is also intended to control credit flow towards non-productive sectors as well. Similarly, the removal of only the single institution cap of NPR 4 Crore for Margin lending and low risk weight for margin lending below 25 Lakhs are intended to reduce the impact of major players activities on the market and ensure the stock market grow in a sustainable manner.

Finally, the policy continues with iterative upgrades and continuation of policy initiatives intended to stabilize the economy, improve the functioning of the financial sector, and ensure accessibility of financial services to its citizens while also undertaking policy measures that will help lift the country out of its current predicament. In this regard, the policy provides the appropriate mechanism for the needs of today.

However, as a tight monetary policy affects overall credit creation, there will be a marked risk of economic slowdown which can affect the profitability of businesses leading to an increase in the non-performance of banking assets. Similarly, as treasury bills rates have now reached up to 14% post monetary policy, a continuation of such high returns on low-risk assets will also entice BFIs to invest in these low-risk instruments as opposed to disbursing riskier loans which is also sure to affect credit creation which in turn will affect private enterprises stability and solvency.

Especially, in a country like Nepal where the ratio of credit to GDP is quite high, and where major business ventures are backed by credit, the inability to source credit will not only derail expansion plans for businesses but also affect their cash flows if problems occur within their supply chain. This can have a trickle up effect wherein problems observed by smaller actors across a company's supply chain due to inability to source credit in order to manage their operations can add up quickly leading to issues of increased inventories, and high receivables to the main producer/actor. This will then have a trickle-down effect to the companies' suppliers leading to problems across the system as credit-based funds will not be immediately available to address the issues.

As most of the credit in the country is backed by real-estate, problems in debt servicing by enterprise and businesses can affect the real estate market, pushing supply upwards and prices downwards in the event that BFIs need to foreclose large amounts of collateral. Any such movement is sure to affect the overall performance of the financial sector by increasing the systemic risk within the system.

Thus, there is a need for the central bank to continuously monitor how the policy is affecting the economy in regular intervals (every month) so as to ensure that the policy does not produce unintended effects and to roll-back policy measures in case problems with the sustainability of enterprises is observed.

The monetary policy brough forth by the central bank is also not unique in the global sense as central banks the world over are enacting tighter policies to control inflation which has helped grow the demand for the US Dollar. Consequently, global stock markets have also observed periods of retracement owing to limited money supply as a result of regulatory intervention which had pushed rates higher. In this regard, with money supply tight, and interest rates expected to remain high for the time being Nepal's stock market should also see periods of high volatility in days to come.