Easing the Nepali Liquidity Crisis

During normal conditions, the NRB’s monetary policy is effective in tackling liquidity problems. Some of the solutions that the NRB has been pursuing are: bank mergers, lowering the CRR, lowering the interbank lending rate, and liquidity injection. Maybe NRB’s reluctance in committing itself to lowering the interest rates has something to do with the fact that inflation, which is already very high in Nepal, can spiral out of control if interest rates are too low. A viable solution to the liquidity crisis is that our government should buy the banks, with discretion and proper audit to determine which ones are good bets. The bad ones that seem like they will not survive—even with a government buyout—should be allowed to go bankrupt and exit the market. This would be a win-win situation. The good banks would survive, and the government would make some money during the process. If we do nothing, and hope the free market fixes the problem sooner or later, we risk aggravating the situation. Like the US, our liquidity crisis has also occurred due to the slowdown of our real estate market. We could also face a debt crisis very soon if we do not solve this crisis.

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References


Countries in the west, for example: the US, have tried this approach and have succeeded. There is no reason to doubt its success in Nepal.

5. Conclusion

In my opinion, monetary policy is not a solution to this crisis. Even then, if the NRB is going to keep pursuing the monetary policy anyway, I believe that lowering the interbank lending rate is the exact opposite of what the NRB should be doing. The NRB should actually let the interbank lending rate to increase as—and, up to the point that—the market sees it necessary.

If the interbank lending rate is increased, it will mean that the price that richer banks receive for lending the money to struggling banks will increase. This would mean that despite some of the uncertainty and distrust, a higher interbank lending rate would encourage the banks with surplus money to take a risk and lend some of the money to the struggling banks because the risk could bring higher rewards in interest income. The richer banks will be willing to sell more loans when the price of loans increases. Again, this is basic economics.

If we do nothing, and hope the free market fixes the problem sooner or later, we risk aggravating the situation. We should learn some lessons from the recent debt debacle in the US. The recent US debt crisis was a product of the liquidity crunch that started in and around 2007 after the collapse of the real estate—housing and land—market. The recent downgrading of the US credit status from AAA to AA+ resulted in an immediate 4 percent decline in the US stock market within an hour of that announcement.

Nepal’s economy could also suffer a huge blow if the current liquidity crisis is not contained, and if it brings forth a debt crisis. Like the US, our liquidity crisis has also occurred due to the slowdown of our real estate market. We could also face a debt crisis very soon if we do not solve this crisis. The only good thing going on for us is that credit rating agencies like Moody’s and Standard and Poor’s do not rate Nepal. If they did, we would be in a heap of trouble.
Easing the Nepali Liquidity Crisis

Outline

Executive summary

2. Who solves this liquidity crisis?
3. NRB’s possible solutions
4. Is monetary policy even the best solution?
5. Conclusion

pursued to solve a financial distress⁹. Today’s liquidity crisis in Nepal has the tendency to affect neither the inflation nor the real economy.

Any monetary policy, such as lowering the CRR or lowering the interest rates, has a high probability of aggravating the inflation situation without contributing much to easing the liquidity¹⁰. So, monetary policy is not the intervention that our market needs to solve this crisis. Fiscal policy is a better solution for the current mess. The government could incur expenditure to purchase the debts of these struggling banks. If our government does not have enough cash, it should print money to make the purchases.

Now, in most instances, printing money is not a good idea. If the money were to be spent on consumption, it could aggravate the inflation. But, my suggestion is to spend that printed money not on consumption but on asset purchase i.e. buying the private banks. Therefore, the printed money would be used in stabilizing the balance sheet of the Nepalese banking and financial system.

I am not advocating for changing the size of our financial balance sheet, but simply an alteration to its composition. Unlike consumption expenditure, this will actually count as an asset purchase. Our government should buy the banks, with discretion and proper audit to determine which one are good bets. The bad ones that seem like they will not survive—even with a government buyout—should be allowed to go bankrupt and exit the market.

Once the private banks are purchased and made public, the government can sell the banks back to private buyers when the financial system stabilizes, and the banks become sustainable.

Through such intervention, the government can actually make capital gains on its investment¹¹. This would be a win-win situation. The banks would survive, and the government would make some money during the process.

⁹ Freixas, Martin, Skeie 2009
¹⁰ Business Standard 2011
¹¹ Smullen and Stojanovich 2008
It doesn’t help that the NRs and IRs are pegged, and the two currencies can be converted from one to another very easily. If the peg and easy convertibility could be avoided, lowering the interest rates in Nepal would definitely help ease the liquidity crunch we face today.

Maybe NRB’s reluctance in committing itself to lowering the interest rates has something to do with the fact that inflation, which is already very high in Nepal, can spiral out of control if interest rates are too low. There are a couple of reasons why this is especially worrisome. First, inflation is a self-fulfilling prophecy in the sense that inflationary expectations of people—about what the future inflation could be—contributes to the actual inflation in the future. Second, when NRB implements a monetary policy this quarter to tackle inflation, the results of its effectiveness will not appear until the next quarter or two. So, monitoring inflation is difficult.

Therefore, NRB cannot lower the interest rates without giving the impression of loosening its anti-inflationary stance. It is difficult to convince the market that lower interest rates are being pursued without affecting NRB’s anti-inflationary stance. In fact, lowering any interest rates—conventional open market rates for purchase of short-term government debt by the central bank or the interbank lending rate—is fraught with additional danger. If the rates are lowered so much that it comes close to being zero percent, then we risk turning this liquidity crunch into a “liquidity trap”. The zero percent lower bound that a liquidity trap creates will severely constrain any monetary policy that the NRB wishes to pursue.

In developing countries, the interest rates do not even have to be “zero” percent to result in a liquidity trap. Low interest rates can be damaging to Nepal and turn the liquidity crunch into a liquidity trap. Also, low interest rate in Nepal would mean that there will be capital flight out of Nepal due to reasons like the pegging, easiness in converting NRs to IRs, and the open border between India and Nepal that facilitates illegal currency trade.

4. Is monetary policy even the best solution?

Even if monetary policies could ease the crisis, they should not be pursued. A monetary policy should be pursued only if a financial disturbance has the potential to affect inflation or the real economy. It should not be

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Krugman 2010
If we do nothing, and hope the free market fixes the problem sooner or later, we risk aggravating the situation. The recent US debt crisis was a product of the liquidity crunch that started in and around 2007 after the collapse of the real estate—housing and land—market. Like the US, our liquidity crisis has also occurred due to the slowdown of our real estate market. We could also face a debt crisis very soon if we do not solve this crisis.


Nepalese banking and financial system is going through a crisis phase. The central bank has liquidated a number of banks while urging others to merge. Although Nepal receives remittance money equivalent to almost 30 percent of its GDP, our banks seem to be running out of cash. Our banking and financial system is under a liquidity crisis.

Where is all that remittance money going then? Well, the 2010 National Living Standard Survey’s preliminary finding shows that 79 percent of remittance income coming into Nepal is spent on household consumption. Only 2.4 percent is invested in capital formation activities. And, that is one of the reasons why banks in Nepal are having problems. People are not saving their money in banks; they’re spending it.

Figure 1: Currency holders in Nepal

<table>
<thead>
<tr>
<th>Year</th>
<th>By Public</th>
<th>By Banks</th>
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<tbody>
<tr>
<td>Jan 06</td>
<td>60</td>
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<td>120</td>
</tr>
<tr>
<td>Jan 13</td>
<td>130</td>
<td>130</td>
</tr>
</tbody>
</table>

Source: NRB, NepalEconomy.co.

3.4 Liquidity injection

Any kind of liquidity injection will reduce the severity of the problem but does not solve it. However, NRB has not pursued liquidity injection wholeheartedly. It has injected very little liquidity into the market in a couple of instances. But, the amount injected has been akin to feeding peanuts to a starving elephant.

In addition, the current liquidity injection of NRB is purely an accounting exercise where NRB has credited some of the banks’ accounts. This does not ease the crisis because the real crisis is not in the accounting books. The real crisis is in the actual interbank lending market where money is not being lent to poorer banks by richer banks.

3.5 Interest Rates Manipulation

Lower interest rates will make it easier to borrow money. However, since we are already in a liquidity crunch situation, a lower interest rate may increase the demand, but it’s no good if nobody is willing to supply the money at the lower price.

Also, a lower interest rate would mean that the opportunity cost of keeping the cash in our homes is very low. Therefore, the other real danger of low interest rates is that it encourages the public to keep their cash in their homes instead of keeping it in their bank accounts. They will keep their cash with themselves until they find a proper opportunity for investment that can fetch higher returns.

This hoarding of cash due to low opportunity cost worsens the liquidity crisis because banks will not be able to mobilize all that cash. This hurts the public even more because the cash kept in their homes do not earn any interest. Instead, at the current rate of 8 to 10 percent annual inflation in Nepal, the cash kept at home actually loses its value each passing year by 8 to 10 percent.

The good thing is that NRB has not committed itself to this solution of lowering the interest rates. Maybe NRB’s reluctance in lowering the interest rates stems from the fact that lower interest rates in Nepal would encourage people to send money to India due to high interest rates in India. Their money could earn more interest income in India.

1 Khanal, Prem 2011
I believe that the richer banks in Nepal have enough money to lend to struggling banks in order to ease the liquidity crunch. But, they are not sure that the struggling banks will survive. So, they are not willing to take the risk by lending to them. Figure 4 shows that since July of 2007, there has been almost no change in currency holdings/M1 ratio. The public’s currency holdings as a share of total M1 has remained at around 66 percent while the ratio for the banks has remained steady at around 7.5 percent.

Figure 1 shows the currency holders in Nepal for the last few years. It clearly shows that the Nepalese banks hold petty sums of money when compared to the large sums in the hands of the public. The current crisis in Nepalese banking and financial industries has resulted due to the skepticism of these large public money holders in our banking and financial system. This loss of trust has hurt the banking industry in the form of lower deposits by the public.

However, to put the blame of Nepalese liquidity crisis on the public is foolish. The main culprits of this crisis are the banks themselves. They used to have money in their vaults. In fact, they had so much money that they did not know what to do with it. So, they gave it to anyone who came asking for it.

So, who came asking for it? The land plotting and housing people did. In their bid to collect some quick cash as interest payments, the banks distributed the money without proper documentation and backing. Through reckless lending they created the artificial asset bubble that we have experienced in the last few years.

As long as the asset market was hot, the brokers and the banks were getting richer. But, like all good things, the merry did not last. Housing and land market has cooled off since last year. As a result, the brokers are unable to pay interests on their loans. Therefore, banks now have no money to collect and play with.

Historical data from all over the world will show that liquidity creation right before any liquidity crisis is always high. Figure 2 shows the percentage change in the broad money supply, M2, in Nepal. Money supply had a decreasing trend after the Nepalese economy was liberalized after the democracy in 1990. After 2001, however, the data shows an increasing trend. The increase kept happening right up until the end of 2009, after which the liquidity crisis hit the Nepalese financial system hard.

Figure 4: Currency Holdings


Therefore, technically, the crisis does not actually stem from a shortage of money. There is neither a shortage nor a glut of cash in the Nepalese financial sector. Any crisis in lending and borrowing between banks is clearly a sign of shortage of “willingness”. It shows distrust among the banks themselves. The current liquidity crisis is, therefore, the making of the banks themselves. Hence, the lowering or increasing of the interbank lending rate is not going to help ease the crisis if the confidence level of lenders stays low.

If some bankers and the NRB seem to believe that lowering the interbank lending rate further is going to solve this liquidity crisis, they are forgetting their basic economic theory of demand and supply along with the cost-benefit risk analysis.
Figure 2: Percent change in Broad Money (M2) Supply

Source: Nepal Rastra Bank

Therefore, the Nepalese data also seems to corroborate and confirm the general historical trend of very high liquidity creation right before a liquidity crisis. This suggests that maybe the crisis isn’t really a crisis but a downward adjustment towards the equilibrium steady state.

2. Who solves this liquidity crisis?

Like any financial crisis, the solutions for this mess are carried out by Nepal Rastra Bank (NRB) through its monetary policy. The NRB has been putting some efforts to mitigate the crisis by liquidating some banks and urging others to merge.

During normal conditions, the NRB’s monetary policy is effective in tackling liquidity problems. Most of the bank liquidity is created by large and medium sized banks. A monetary policy, however, does not significantly affect the liquidity creation of large and medium sized banks. Large and medium sized banks have relatively rigid structural compositions when compared to smaller banks that are more flexible in their operational and administrative approaches. Due to such rigidity in their structural compositions, large and medium sized banks are impervious to most monetary policy tightening or loosening. So, loosening the monetary policy by NRB will have insignificant effects in creating liquidity.

Like any other market, the interbank lending is a market where a bank that has “surplus money” sells it to another bank at a price. The price that the borrower pays is the “interest” on that loan. So, like any other market, whether the transaction occurs between the two is determined by the equilibrium of demand and supply.

There are two reasons why the lower interbank lending rate will not help in easing our liquidity crisis.

First, the interbank lending rate is too low at 1.5 percent. Since the interest rate is low, the banks that need money are willing to borrow as much as they can. This is basic economics: when the price for a product is low, demand always increases. However, the main player in this transaction is not the buyer but the lender who has to agree to give the money at that low interest rate.

If the rate is too low, like in the current context, the banks that have surplus money are not willing to loan it to others because the “price” i.e. interest they are earning is very low. So, they don’t feel like selling their product. That is, the buyers and sellers are not agreeing at the low interest rate. So, no transaction is occurring in the interbank lending market.

Second, if the market were not suffering from a crisis, the banks with surplus money would be willing to lend the money even at that lower interest rate. However, the current state of our financial system is such that there is uncertainty over the continued existence of many of these struggling banks and financial institutions.

The skepticism on the part of richer banks is understandable. Think about it from the lender banks’ perspective. Why would a bank that has surplus money lend it to another bank that is undergoing a crisis, and which might not return even the principal amount of the loan let alone the interest?

What if the banks that borrow money go bankrupt anyway? This is why even banks that have money with them are refusing to lend it to others. And, this is making the liquidity crisis in Nepal even worse. The distrust and uncertainty is fanning the flame of liquidity crunch in Nepal.
When a bank does not end up with enough cash to meet its reserve requirements or enough to balance its books, it borrows money from another bank through the interbank lending market. The current liquidity crisis has been severe for banks with the needy ones not being able to secure loans from the richer banks with surplus amount of cash.

The current liquidity crisis started gaining momentum at the end of 2009. Initially, the banks were able to maintain their balance. However, once the crisis started hitting the financial sector really hard with the slowdown of the real estate market, the banks started borrowing from one another. Figure 3 shows that interbank lending started increasing significantly after May of 2010.

However, after November of 2010, the data shows that there has been a severe decline in the interbank lending. This does not mean the liquidity crisis is over. On the contrary, the severe drop in the interbank lending amount suggests that the liquidity crisis got worse in Nepal after November of 2010. Richer banks that had started lending to the needy ones after May of 2010 started losing their confidence on the smaller banks. They started doubting the ability of fellow needy banks to repay the loans. As a result, the interbank lending market has slowed down substantially after November of 2010.

Some bankers, including some in the NRB, believe that lowering the interbank lending rate should help ease the liquidity. On September 15, the NRB lowered the interbank lending rate to 1.5 percent, the lowest in the last decade. The NRB claims that recent rise in commercial bank deposits is due to this lowering interbank lending rate.

These steps by NRB to reduce the interbank lending rate to such a low level, and its claims that low interbank lending rate is propping up commercial bank deposits have no logical explanation. The NRB, in this case, needs to realize that what it is claiming to achieve through low interbank lending rate is false, and is not supported by Economics.

Interbank lending rate is the interest rate that is charged by one bank to another bank when the former lends money to the latter for a short term.

Also, worldwide evidences show that monetary policy during a liquidity crisis becomes weaker in creating liquidity in banks of all sizes, not just the large and medium size banks.

3. NRB’s possible solutions

3.1 Bank mergers

In March, during his presentation of mid-term review on monetary policy, NRB governor Yubraj Khatiwada suggested to the bankers that they should engage in mergers and acquisitions. He posited that the increase in credit interest that had been observed was the result of increase in interest rates on deposits. Therefore, funds for further growth had been difficult to obtain due to the resulting higher costs of obtaining such funds. A merger of banks, the governor believed, would help reduce the costs of operating a financial institution. However, it is a dangerous suggestion.

Like many other economists, the governor believes that a merger or acquisition will result in an institution that is bigger than its individual parts. This bigger institution will experience lower costs due to economies of scope and scale, increase in market power, diversification, and reduced operational expenses. Thus, the perception is that this consolidation will accrue higher gains than the simple sum of gains from two separate institutions.

The perceived gains arise out of the belief that the newer and larger organization is considered to be efficient in allocating resources—human and capital—to maximize the output gains. The same personnel and infrastructure can deliver different services and products. Thus, redundant operating costs will be minimized. The belief is also that the larger bank, with more resources now at disposal, can even offer more products and services than before. In essence, the larger entity could take the best tools and methods from the pre-merger entities to maximize efficiency and capabilities.

However, these perceived gains do not occur, at least not to the extent that is perceived. Research on mergers and consolidations has shown that

\[ \text{Singh 2011} \]

\[ \text{Berger and Bouwman 2010} \]

\[ \text{Greenspan 1998} \]
there is no conclusive evidence of such gains existing in real life\textsuperscript{4}. Hence, the governor’s suggestion to the bankers was based on little factual evidence. While the suggestion might have been genuine and made in earnest, the repercussions could be devastating. In this case, the idea of bank mergers creates risk of underperformance and loss in overall valuation of the banking industry.

3.2 Lower CRR

The Cash Reserve Ratio (CRR) is also called the reserve requirement. It is the minimum reserve that each bank must hold, and is usually a certain percentage of the total deposit in the bank’s vaults. Up until the third week of July this year, the CRR was 5.5 percent. It meant that out of total deposits, the banks would have to save 5.5 percent of total deposits either at the banks’ own vaults or with the central bank.

During the third week of July, the NRB lowered the CRR from 5.5 to 5 percent. According to the NRB, the lower CRR would infuse Rs 3-4 billion into the market and ease the liquidity crunch.

Table 1: Quarterly Cash Reserve Ratio

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<td>2009 January</td>
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However, the fact of the matter is, this was only a charade and was a move to appease the bankers. As the Nepalese fiscal year was drawing to a close, the banks had been reeling due to the liquidity crunch, and were in no position to show a profit to their shareholders. What the NRB’s tactics of lowering the CRR did was to provide the bankers an accounting gimmick that could now free up some cash in order to show profit, however minimum, to their shareholders.

Also, since Statutory Liquidity Ratio (SLR)\textsuperscript{5} at that time was still at 15 percent, the reduction of CRR would not ease the liquidity crunch but would simply alter the composition of liquidity. Any cash that opened up due to lower CRR would simply be invested in acquiring government treasury bills to ensure that SLR remained at 15 percent\textsuperscript{6}. If the NRB was serious about solvency issues, lowering the SLR should have been pursued as it supports credit growth by freeing up more credit.

Therefore, lowering the CRR did not help ease the liquidity crunch because it was a bad tactic by the NRB implemented solely to appease the bankers.

3.3 Lower interbank lending rate

Figure 3: Interbank Lending in Million Rupees


\textsuperscript{4} Berger and Humphrey 1997

\textsuperscript{5} According to Wikipedia, SLR is the amount of liquid assets like cash, precious metals and other approved securities that banks and financial institutions maintain as reserves with the central bank. The main objective of SLR is to restrict the credit in the economy.

\textsuperscript{6} Khanal, Rameshore Prasad 2011