Credit crunch has always been a dark facet of Nepalese financial system whose frequent haunting breaks all hell loose for the banking and financial institutions. Often we encounter the mention of "credit crunch" when there is not enough money in the bank to lend credit to its clients. Credit crunch arises when deposit creation mismatches with the loan outflow, creating a situation of scarce loanable funds. Being an import based economy, which is heavily dependent on remittance for deposit creation, where big business houses based on importing business control the majority of the banking system, it is an inevitable vice of Nepalese economy to be plagued by credit crunch time and again. The increased usage of informal channels for the purpose of sending remittances and financing imports just to secure arbitrage and evade taxes is not helping in the deposit creation either. Weak regulations incubating the growth of the informal economy coupled with majority of BFIs investment in unproductive sector, majorly real estate has led to unproportioned growth among different GDP contributors. To make the matter worse, the large number of BFIs for a small economy like ours, competing to be the best profiteer is an equal culprit to this notion.

As the primary function of a bank is to extend credit, they first need to create the deposit. If we analyze the sources of deposit for our country, it is usually dependent upon exogenous factors like remittances, government spending, grants, donations, foreign loans rather than endogenous factors. The increased dependency on the external sources of deposit creation led us to the situation of recurring credit crunch. Let's have a look at how our banking industry has been battling with the credit crunch over the past decade.

By 2010 the number of BFIs in our country had increased drastically. With NRB issuing licenses instead of clamping down the BFI's growth, there were over 308 BFIs, including 31 commercial banks, 87 development banks, 80 finance companies, and 21 microfinance institutions. The economic and banking fundamentals of the past decade did not support this unprecedented increase in BFIs. Without a proportional increase in the depositor base and diversification of investment portfolios, the unnatural growth led to cutthroat competition. With the interbank rates exceeding BFIs average lending rates, "B" and "C" class banks found it hard to borrow from "A" class banks. The credit crisis prolonged for years and occurred on a cyclical basis, with only tail events like the 2015 earthquake, when we got massive donations, and the 2016 economic blockade, which barred imports and so preserved our foreign reserves, easing the situation. Realizing the problem of the credit crisis, the central bank through its monetary policy did try to decrease the number of BFIs, but ironically, the very same policy sowed the seed for yet another credit crisis.

In order to reduce the number of BFIs, the central bank had announced an increase in paid-up capital for "A", "B", and "C" class institutions by mid-July 2017 through its monetary policy. The policy did contribute to a reduction in the number of development banks and finance companies, which remained at 40 and 28 respectively. The number of commercial banks, which accounted for about ~88% of total deposits in 2016-17, did not, however, shrink much. Most chose other methods like issuance of right shares and FPOs to raise the capital. This meant that the credit crisis still persisted. In fact, the situation became much worse. Commercial banks were now under immense pressure from the board as well as shareholders to maintain their bottom line intact. Thus, yet again began the tug of war to snatch each other's deposits. The situation became so bad that the Nepal Banker's Association had to call a truce, agreeing to cap the deposit rate. The issue carried on well throughout till the end of 2019 when the central bank decided to intervene and tighten the imports.

Later on, the emergence of COVID and the lockdown was like a déjà vu for the financial sector as yet another tail event helped resolve the credit crisis.

The COVID and its resulting lockdown had halted the economic activity for almost a year, which resulted in credit to amass in the system. But with the opening of the economy, the demand for goods also witnessed robust growth. As our country is import-based, an increase in consumption resulted in a huge surge of imports and our foreign reserves began to deteriorate. Soon after the banking system yet again started facing a credit crisis as the loan demand surged. By mid-July 2021, credit had expanded by 27.8% in a span of one year while deposits grew by 20.6% in the same period. The credit crisis has deteriorated further in the current fiscal year, as by mid-December, while credit had expanded by 10.3%, deposit growth had remained modest at only 1.4%. Due to sluggish deposit growth, BFIs are borrowing heavily from the central bank to meet their short-term credit demands.

Looking back over the last decade, our banking industry has often encountered credit issues. Both the government and the central bank have been unable to permanently address the matter, and it has been temporarily resolved by an outlier event. Cognizant of the fact our economy is significantly reliant on imports; the credit demand has always been high. The root cause for this recurring credit crisis is the unprecedented growth in the number of BFIs without a proportional increase in the deposit base along with robust credit demand which has welcomed an unhealthy competition to maintain their profitability growth. Over the past ten years, our imports (with a higher base) have seen a growth of around 199% while exports have grown by 63% over the same period. The widening trade deficit means foreign reserves have been depleting over the same period. For deposit mobilization, we heavily rely on and are confined to remittance incomes and government spending (which only occurs around the end of the fiscal year). Because there are limited resources accessible for such a large number of players, there will always be a tug of war to grab the biggest piece of the pie.

The credit problem can't be resolved in a year or two, but it will require years of careful planning and until now, all efforts to overcome the recurring problem have been futile. If the issue is to be resolved, the relevant bodies must come up with some unorthodox approaches. First and foremost, the main focus should be on reducing the number of BFIs. Despite the fact that the number of development banks and financing businesses has substantially reduced, the number of commercial banks, which account for the majority of the market share, has not decreased much. The central bank has been encouraging commercial bank mergers, but the effort hasn't yielded much. As the number of participants' declines, the remaining companies will get a larger portion of the market, reducing the rivalry to seize each other's deposits. Other than that, instead of always relying on the central bank, BFIs should also come up with innovative ideas to bring in more deposits.

However, the government is at equal fault for pushing the system into the vicious circle of credit crunch. The government has to play an important role if they are to come up with a permanent solution. By now we all know that speeding up of capital expenditure, which is an integral part of deposit creation normally occurs only towards the end of the fiscal year. Until then, the majority of the money that could be utilized for development works remains stashed in government coffers. There should be a radical change in the systems currently under operation and some robust brainstorming in order to utilize the funds available for capital expenditure from day one. In addition to this, BFIs have been frequently scratching their heads to identify investing in "productive sectors" as mentioned by the government. The investment avenues are limited which is why the BFIs tend to focus more on the sector that generates profit for them, i.e real estate and trading business. At the end of the day, BFIs are also a profit making organization who is liable towards its shareholders, for which they need to remain profitable. The liability of creating other conducive sectors for investment lies in the hand of the government itself and then only we can decrease the dependency on the external sector for deposit creation, thereby giving a remedy to recurring crunch.