NPL-INTEREST RATE DEBATE

Missing the cause for the symptoms

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THE stock of non-performing loans (NPLs) is increasing in both public and private banks. This is raising the threat to financial stability, impairing financial intermediation and damaging the resilience of the banking sector to shocks, thus increasing systemic risk. NPLs are also associated with higher funding costs and a lower supply of credit. However, the recent hot debate in Bangladesh has centred on whether high NPLs are a cause or a consequence of high lending rates.

Those identifying NPLs as the cause argue that the link between NPLs and lending rates is driven by higher risk premia with higher NPL stocks passed on to borrowers. Default risk is an essential component of loan pricing. Those identifying NPLs as the consequence argue that high lending interest rates enlarge the debt burden of borrowers eventually causing loan defaults.

The focus on the lending rate-NPL nexus has crowded out attention to the impact of NPL on credit volume. NPLs affect banks' lending volume through losses caused by loan provisioning against the NPL stock. Increases in provisioning leads to a reduction in capital via the profit and loss statement. NPLs also erode bank's liquidity leading to depletion in their capacity to lend. Banks thus react to a high stock of NPLs by restricting loan supply.

In an economic system where everything depends on everything else, this debate may sound a bit like the blind men and an elephant parable. Each blind man feels a different part of the elephant's body and describes the elephant based on their limited touch of the animal. The parable shows how our individual perceptions or "mental models" can lead to far less than full truth.

The NPL, lending rate and loan volume issue can be settled just the same way the Rajah settles it in the parable. "The elephant is a big animal," he said. "Each man touched only one part. You must put all the parts together to find out what an elephant is like."

To discover the whole truth about the relationship between NPLs, interest rate and credit growth, we must put all these together by looking at what the data says.

What do we look for in the data? Granger predictability is a way to investigate "causality" between two variables in a time series. The method seeks to find patterns of correlation in empirical data. Technically, it is a method for determining whether one time series is useful in forecasting another. What one can uncover is whether a particular variable consistently comes before another in the time series.

Since predictability is a central feature of "causal" attribution, causality could be tested by measuring the ability to predict the future values of a time series (lending rates or credit growth) using prior values of another time series (NPLs) or vice versa. This does not necessarily imply true causality, only conditional dependence, that is, the probability of one event (say rise in NPL) given the occurrence of another event (rise in lending rate).

Both quarterly (from December 2013 to September 2019) and annual (from 1997 to 2018) data on NPLs and the bank lending rates suggest there is no clear-cut relation between gross NPLs and lending rates. There is no evidence of Granger predictability either way—from lending rate to gross NPL or from gross NPL to lending rate. However, there is fairly strong relationship between gross NPL and growth of credit to the private sector with predictability running from NPL to credit growth and not vice versa.

The impact of NPLs on credit growth is fairly large. Simple regression analysis based on quarterly data suggests that a 1 percent increase in gross NPLs reduces private sector credit growth by 0.47 percentage points. Similar regression further suggests that one percentage point decrease in credit growth increases lending rate by 0.34 percentage points.

Deterioration of the credit risk caused by rising NPLs reduces growth in the supply of loanable funds. High default risk and the difficulty of assessing the soundness of each debtor in a default-friendly system generate adverse selection and loan aversion (preferences to avoid losing compared to gaining the equivalent amount) among banks. NPLs, as a source of anticipated future losses, have the same impact on lending policies as actual capital shortfall. There is an abundance of evidence in the related literature suggesting capital corrosion entail cuts in bank lending. Not only that NPLs decrease the supply of loanable funds and banks may even shift the composition of their borrower portfolio towards riskier borrowers who can be charged higher risk premia. Both contribute to increasing lending rates.

There is no shortcut to getting to the root of the problem. Measures to reduce interest rate by administrative fiat cannot dent the NPL problem when interest rate has no predictable effect on the NPLs. The reason is simple. It only touches the symptom, not the root cause. High NPL is also a symptom of deeper malaise in the market for bank loans. The issue is not whether NPL causes high interest rate or high interest rate causes NPLs. The issue is what corporate and regulatory failures in banking governance keeps both interest rates and NPLs high?

The legal and judicial framework and banks' governance structures determine the circumstances under which macro-prudential policy can be effectively enforced. When bankers expect the enforcement of collateral and the outcome of insolvency proceedings to be lengthy, costly and variable from case to case, they incorporate this into their pricing decision. This keeps lending rates high and credit availability restrained. With borrowers aware that the collateral will not be easily and quickly enforced, the incentive to pay their loans in time is feeble. This keeps NPLs high. The absence of resolute action in these two areas is antithetical to ensuring the resilience of banks and preserving their capacity to finance the economy.

The author is an economist.

STAR/FILE

The Bangladesh Bank headquarters is seen in Dhaka.

Trade turbulence pushes airline profits lower

AFP, *Geneva*

Global trade tensions have sent airline profits into a descent, the industry's trade association said Wednesday, and while profitablity is expected to rebound next year it will unlikely match the level hit in 2018.

The global airline industry is expected to earn $25.9 billion (23.4 billion euros) in 2019, down 14 percent from the $30 billion in net profits it recorded last year.

The figure is also considerably lower than the $28 billion in net profits that IATA forecast for the industry in June, and more than a quarter less than its original 2019 forecast last December.

"Slowing economic growth, trade wars, geopolitical tensions and social unrest, plus continuing uncertainty over Brexit all came together to create a tougher than anticipated business environment for airlines," said IATA chief Alexandre de Juniac. Restructuring and cost-cutting nevertheless helped the airline industry extend its streak of profitability to 10 years, and 2019 should prove to be the bottom of the economic cycle, he added.

IATA expects airlines' net profits to rise to $29.3 billion in 2020, helped by an expected rebound in global trade growth and dip in fuel prices. Demand for air travel is also expected to grow by 4.1 percent, down marginally from 2019, and below historical trends.

Meanwhile airline capacity is forecast to accelerate to 4.7 percent, up from 3.5 percent this year.

"The big question for 2020 is how capacity will develop, particularly when, as expected, the grounded 737 MAX aircraft return to service and delayed deliveries arrive," de Juniac noted.

Germany fines steelmakers 646m euros for price fixing

AFP, *Frankfurt Am Main*

Germany's antitrust watchdog on Thursday said it had issued a 646-million euro ($720 million) fine against three steel manufacturers and three individuals for fixing prices for plate steel.

The Federal Cartel Office said Germany's Thyssenkrupp Steel Europe, Salzgitter-owned Ilsenburger Grobblech and Austria's Voestalpine Grobblech had admitted to the accusations and accepted the penalties.

At regular meetings between 2002 and 2016, representatives from the companies "agreed on the most important price supplements and surcharges for specific quarto plates in Germany," Andreas Mundt, president of the cartel office, said in a statement.

According to the competition body, the add-on prices agreed by the steel producers "accounted for around 20-25 percent of the total price of quarto plates" over the period.

Quarto plates are hot-rolled flat steel products used in shipbuilding, bridges, wind turbines and pipelines.

A fourth company, Dillinger Huettenwerke, was also involved in the cartel but escaped punishment because it was the first to cooperate with the investigation.

Voestalpine Grobblech likewise cooperated with Germany's Federal Cartel Office, and saw its fine reduced accordingly.

Why Saudi is listing its crown jewel

AFP, *Dubai*

SAUDI oil giant Aramco's valuation soared to $1.88 trillion on Wednesday as it hit the domestic stock exchange after the world's largest initial public offering.

The kingdom sold 1.5 percent of the company, three billion shares worth $25.6 billion, to fund its "Vision 2030" plan to wean the economy away from oil.

But why is Saudi Arabia, which has reaped trillions of dollars from its vast energy deposits, selling off a piece of its economic crown jewel? - Isn't Saudi Arabia wealthy already? - Despite its almost unimaginable oil wealth, Saudi Arabia's finances have sagged along with the price of crude, causing its budget deficit to balloon.

It still has around $500 billion in fiscal reserves run by the country's central bank and some $250 billion managed by the public investment fund (PIF), the kingdom's main investment vehicle.

"It's a fact that Saudi Arabia is gradually running out of money," General David Petraeus, who is currently chair of the KKR Global Institute, said in a November television interview in Abu Dhabi.

"The bottom line is that they need the money, they need that outside investment that is crucial to delivering 'Vision 2030'." Another factor could be young ruler Crown Prince Mohammed bin Salman's desire to "have a flashy project to show he is reforming the country", said Hossein Askari, a professor of international business at George Washington University.

Pressing ahead with the Aramco listing, despite it falling short of a hoped-for $2 trillion valuation, is more about "following through with a political statement by the crown prince", said Karen Young from the American Enterprise Institute.

"It is about making a debut to the international investor community, and to legitimise the state to a global audience of peers." - How will the funds be used? - Since Prince Mohammed came to power, Saudi Arabia has unveiled plans for a series of "giga projects" that will soak up tens of billions of dollars, but also hopefully bring investment and thousands of jobs.

Those visions include the Red Sea Project, to be built across an archipelago of 90 islands off the Saudi port city of Jeddah, and stretch into nearby deserts and mountains.

NEOM, a $500 billion futuristic mega city, is planned on the northern Red Sea coast, complete with flying taxis and talking robots.

And last year, construction of the Qiddiya "entertainment city" was launched near Riyadh, with the blueprints including high-end theme parks, motor sport facilities and a safari area.

Saudi Arabia was hit by high levels of capital outflow in 2017 -- the year that Prince Mohammed spearheaded an anti-corruption campaign that led to the arrest of hundreds of princes and businessmen.

The shock move cemented his rule, but also made international investors nervous.

"The regional political risk climate, Saudi foreign policy choices and repression of political dissent have all likely dampened investor sentiment," Young told AFP.

REUTERS/FILE

Amin H Nasser, president and CEO of Aramco, attends the official ceremony marking the debut of Saudi Aramco's initial public offering on the Riyadh's stock market, Saudi Arabia on Wednesday.

Protest-free Macau to win financial policy rewards from China

REUTERS, *Macau/Hong Kong*

CHINESE President Xi Jinping will visit Macau next week to announce a raft of new policies aimed at diversifying the city's casino-dependent economy into a financial center, according to over a dozen interviews with officials and corporate executives.

The move is seen by officials and executives in Macau as a reward for having avoided the anti-government protests that have gripped nearby Hong Kong over the past six months.

The policies include the establishment of a yuan-denominated stock exchange and the acceleration of a renminbi settlement center already in the works, as well as the allocation of land for Macau to develop in neighboring mainland China, they said.

While there has been speculation about the proposals in recent months, the fact they have been officially approved has not previously been reported.

"The financial industry used to be an idea that we reserved for Hong Kong," said one Chinese official who requested anonymity. "We used to give all the favorable policies to Hong Kong. But now we want to diversify it."

Xi's trip to mark the 20th anniversary of Macau's return to China comes as the central government has praised the city for upholding the "one country, two systems" framework that governs both Hong Kong and Macau.

In contrast, China has condemned anti-government protests in Hong Kong and accused demonstrators in the financial center of undermining national stability.

China's Hong Kong and Macau Affairs Office did not respond to requests for comment.

Beijing has instructed state-owned banks and enterprises to help set up infrastructure in Macau to aid financial diversification, four sources familiar with the matter told Reuters.

Two officials who helped develop the Shanghai stock exchange moved to the territory this year to help establish its yuan-based stock exchange, one of the sources said.

Chinese officials, and bankers in Hong Kong, say the push to develop financial infrastructure in Macau is part of a plan to avoid any major market disruption in Hong Kong that could impact Chinese businesses.

The idea is not for Macau to replace or undermine Hong Kong but for China to have a contingency plan in case the situation in Hong Kong worsens, they said.

"Xi Jinping has made very clear that he wants a diversified Macau economy," said another Chinese official who declined to be identified. The future focus will be on tourism and finance, to make it a center to host international meetings like Singapore."

Macau's new exchange will initially be focused on bond trading to encourage local and Chinese companies to issue debt in the city, according to a Chinese official familiar with the matter.

The exchange will also focus on start-ups and target companies from Portuguese-speaking countries, ensuring it does not directly compete with bourses in Hong Kong or in the southern Chinese city of Shenzhen, according to six Macau executives and Chinese officials. Macau was a Portuguese colony until it was handed to China in 1999.

An announcement that Macau will join the Beijing-backed Asian Infrastructure Investment Bank is also expected during Xi's visit, two Chinese officials said.

Xi is expected to announce policies to further integrate Macau with mainland cities in the Greater Bay Area, the region around the Pearl River Delta that also includes Hong Kong, according to Chinese officials and Macau executives.

As part of that effort, Macau will be allocated more land on the mainland island of Hengqin to develop in areas such as education and healthcare, they said.

Macau's casino operators, which have been hit by slowing economic growth, the Sino-US trade war and a weakening Chinese yuan, are also looking at development opportunities in Hengqin, casino executives said.

The economic slowdown in China has added to pressure on Macau to diversify its economy from the casino industry, which accounts for more than 80 percent of government revenues.

"We plan to work with the Macau government to launch programs that encourage next-generation entrepreneurs to start businesses in Hengqin," said Lawrence Ho, chief executive of Melco Resorts, which runs three casino resorts in Macau.

Sands China, another casino operator, said it was looking at setting up a training academy in Hengqin.

Beijing has previously allocated Macau portions of land on the former oyster farming island, which lies just across the water from its casinos, including land for Macau University's campus which opened in 2013.

While the new initiatives were not explicitly linked to toeing the official line, Chinese officials have repeatedly praised Macau for setting an example in maintaining national security and adhering to the central government's requirements.

"This is the candy that Hong Kong did not want," said Larry So, a political commentator and retired Macau university professor. "It is a gift for Macau, for Macau being a good boy."

In recent weeks, Xi has said at several gatherings of senior government officials that it is crucial to find ways to implement the "Macau model" in Hong Kong, two people familiar with the discussions said, on condition of anonymity.

"President Xi Jinping spoke highly of the practice of one country, two systems with Macau characteristics. This is an encouragement and a spur," Macau's chief executive, Fernando Chui, said at a meeting with Chinese officials in Beijing on Dec. 3, according to an official transcript.

REUTERS/FILE

Casinos are seen in a general view of Macau, China.