Factors Influencing the Slowdown in Private Sector Credit Growth in Nepal

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Abstract

Private sector credit plays a fundamental role in financing investment, expanding businesses, and sustaining economic growth. The existing literature suggests that private sector credit growth is primarily determined by macroeconomic conditions, borrowing costs, banking sector stability, household demand, and the allocation of credit across productive sectors. In Nepal, however, private sector credit growth has remained weak despite periods of lower lending rates, indicating that the slowdown in borrowing is likely driven by the interaction of multiple economic and financial factors rather than the cost of credit alone.

This paper examines the major determinants of private sector credit growth in Nepal using annual data from 2000 to 2024. Specifically, it analyses the role of lending rates, economic growth, non-performing loans, household consumption, and sector-wise credit allocation in explaining changes in private sector borrowing. The empirical findings broadly support the view that private sector credit growth is influenced by these determinants collectively. Among them, GDP growth, Household Consumption and Sector wise credit growth exhibit the strongest relationship with private sector credit growth, while lending rates display the weakest. Overall, the study suggests that Nepal's borrowing trends are best understood through the combined influence of macroeconomic performance, banking sector conditions, household demand, and sectoral lending patterns rather than through any single determinant.

Keywords: Private Sector Credit Growth, Lending Rate, Economic Growth, Non-Performing Loans, Household Consumption, Sector-wise Credit Allocation, Nepal.

Introduction

Private sector credit is widely recognised as one of the key drivers of investment, business expansion, employment generation, and long-term economic growth. In developing economies such as Nepal, where commercial banks remain the primary source of business financing, the availability and growth of private sector credit directly influence the pace of private investment and overall economic activity (Levine, 2005). A well-functioning credit market enables businesses to expand production, improve productivity, and respond to changing market conditions, making private sector credit an important indicator of economic confidence and financial sector development Beck et al., 2000).

The literature suggests that private sector credit growth is determined by a combination of economic, financial, and institutional factors rather than by lending rates alone. Strong economic growth generally increases firms' willingness to invest and borrow, while stable banking conditions encourage financial institutions to extend credit (Bernanke & Gertler, 1995). Conversely, rising non-performing loans increase lending risk and often reduce banks' capacity and willingness to finance new investment. Household demand also plays an important role, as stronger consumption creates incentives for businesses to expand production and seek additional financing. Similarly, the allocation of credit across the primary, secondary, and tertiary sectors reflects the changing structure of the economy and influences overall credit growth (Djankov et al., 2007).

Nepal presents an interesting case. Despite periods of relatively lower lending rates and continued expansion of the banking sector, private sector credit growth has remained uneven in recent years. This suggests that borrowing behaviour cannot be explained solely by the cost of credit but must be understood within a broader economic and financial context. While previous studies have examined individual determinants of credit growth, relatively few have considered how macroeconomic performance, banking sector conditions, household consumption, and sectoral credit allocation interact to shape private sector borrowing in Nepal.

Against this backdrop, this study examines the major determinants of private sector credit growth in Nepal using annual data from 2000 to 2024 obtained from the Nepal Rastra Bank and the World Bank. By analysing weighted average lending rates, GDP growth, non-performing loans, household consumption, and sector-wise credit allocation within a single empirical framework, the study seeks to provide a broader understanding of the factors influencing private sector credit growth and contribute to the ongoing discussion on Nepal's recent borrowing slowdown.

Current Problem

Private sector credit growth in Nepal has weakened despite periods of relatively lower lending rates, raising concerns about the factors constraining borrowing and investment. While lower borrowing costs are generally expected to stimulate credit demand, recent trends suggest that monetary conditions alone have not been sufficient to sustain private sector borrowing. At the same time, fluctuations in economic growth, changes in household consumption, variations in sectoral credit allocation, and concerns regarding the quality of bank assets have coincided with slower credit expansion.

This has raised an important policy and economic concern. Weak private sector credit growth limits the ability of businesses to invest, expand production, and create employment, ultimately affecting overall economic performance. Understanding which factors have played the greatest role in shaping private sector credit growth is therefore essential for explaining Nepal's recent borrowing slowdown. This study examines these determinants using annual data from 2000 to 2024 to identify how macroeconomic conditions, banking sector characteristics, household demand, and sectoral credit allocation collectively influence private sector credit growth in Nepal.

Empirical Findings

The empirical analysis supports the view that private sector credit growth in Nepal is shaped by the combined influence of macroeconomic conditions, banking sector characteristics, household demand, and sectoral credit allocation rather than by a single determinant. The overall regression model is statistically significant, indicating that the selected variables collectively provide a meaningful explanation of changes in private sector credit growth over the study period.

Among the determinants examined, sector-wise credit allocation exhibits the strongest relationship with private sector credit growth, suggesting that the distribution of credit across productive sectors plays an important role in explaining borrowing trends. In contrast, lending rates display the weakest relationship, indicating that lower borrowing costs alone are insufficient to stimulate sustained credit expansion. Economic growth and household consumption maintain positive relationships with private sector credit growth, while non-performing loans exhibit a negative relationship, reflecting the tendency of weaker asset quality to constrain lending activity.

When all determinants are analysed simultaneously, the individual contribution of each variable becomes less distinct, indicating that these factors are closely interconnected. This suggests that changes in private sector credit growth are not driven by one economic or financial factor in isolation, but rather by the interaction of economic performance, household demand, banking sector conditions, and sectoral lending patterns. Overall, the findings reinforce the argument presented in the literature that private sector borrowing is a multidimensional process influenced by several interrelated determinants rather than a single explanatory variable.

Policy Recommendations

1. ***Direct Credit Towards More Productive Sectors***

   The analysis shows how credit is distributed across sectors has a strong impact on private sector credit growth. Instead of encouraging overall credit expansion, Nepal Rastra Bank should publish yearly reports identifying sectors with strong growth potential, good repayment records, and high job creation. Banks should use this information to spread their lending across different sectors and gradually shift more credit towards productive industries, rather than focusing on only a few sectors. This would make the financial system more efficient, reduce risk, and support steady growth in private sector credit.

2. ***Diversify Nepal's Sources of Business Finance***

   Nepal remains heavily dependent on commercial bank lending for business investment. This concentration increases systemic risk and limits financing options during periods of banking sector stress. The government, Securities Board of Nepal (SEBON), and Nepal Rastra Bank should promote alternative financing channels by expanding corporate bond markets, venture capital funds, private equity financing, and SME-focused investment funds.

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