

Impact of Interest Rates on Loan Default: Experience from a Developing Country

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Persistent industrial loan defaults and massive loan loss have become a regular feature in developing countries. Despite application of conventional remedial measures, loan loss continued to haunt the banks and development finance institutions (DFIs) since mid-1980s. This paper tests this hypothesis that loan default is associated with high interest rates. The evidence collected from 89 industrial firms in Bangladesh supported this hypothesis. This suggests that interest rates policy should be rationalized to increase the repayment ability of the borrowers which would reduce persistent loan defaults in developing countries.

JEL Codes: F34, G21 and G24

1. Introduction

Persistent loan defaults has become an order of the day in developing countries. There has been hardly any bank or development financial institutions (DFI) in developing which has not experienced persistent loan default. This is evidenced by the under-capitalization and illiquidity of 160 DFIs in 33 developing countries (Hoque 2004, World Bank 1993: and Calomiris and Himmelberg, 1993).

2. Literature Review

Theoretically, loan defaults occur when borrowers are not willing and or able to repay loans (Hoque 2004). This paper focuses on the borrowers' ability to repay loans. Among the many factors, high interest rates is the most important one which influences borrowers' ability to repay loans. It widely reported (that high interest rates has devastating effect on investment and growth of an economy though McKinnon (1973) and Shaw (1973) underscored the important of higher real interest rates during inflationary pressure to promote savings and investment in financially repressed economies. Rittenburg (1991) found that too high interest rates was detrimental to investment and growth.

3. The Methodology and Model

In order to test our hypothesis, we have conducted an empirical study and we have covered 89 firms financed by the Bangladesh Shilpa Bank (BSB) between 1985 and 2005.

We first consider 3 models in our analysis. All 3 models composed of same set of independent variables but with different dependent variables.

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4. The findings

The World Bank (1995) mentioned that a Bangladeshi bank assuming 40 percent of loans to be non-performing required a spread of 20 percent between lending rates and the bank's costs of funds just to break-even.

5. Summary and Conclusions

The banks and DFIs in developing countries such as the Bangladesh Shilpa bank (BSB) have been ravaged by persistence loan default and loan loss since mid-1980s.

End Notes

References

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Appendix