*Preliminary version, only for comments*

"Regional integration
has become an important policy dilemma
that is to be addressed by economists,
policy makers and politicians"(NRB, 2005: 2)

# Trends in Financial Market Development in South Asia

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## Introduction

The South Asian Association for Regional Cooperation (SAARC) is a very young regional cooperation project compared with similar arrangements in Africa, Asia or Latin America; with one fifth of world's population it comprises more inhabitants than any other integration project; furthermore, around 50 per cent of the world's poor are living in South Asia. SAARC Member Staates are relatively divers in terms of absolute population, GDP per capita, or geographical extension.[2] There is a disparity across countries, but also a disparity of living conditions and societal well-being within countries. Therefore, South Asian countries are increasingly promoting inclusive growth.

Increasing societal well-being and in particular reducing poverty is highly depended on the success of financial sector reforms and the maintenance of financial sector stability. Financial market instability –whether due to domestic market failures or due to external shocks and contagion– can cause a deep economic slump and destruction of financial wealth. From that perspective, it is of utmost priority for South Asian countries to maintain and advance the regulatory and institutional framework that facilitate financial sector development and enhance financial sector stability.

In the following, an overview of the financial sector of the South Asian countries will be presented; however, the paper will focus on some elementary characteristics and identify common features in the credit markets, debt markets and stock markets; thus, it is rather selective than comprehensive. This is followed by a discussion of challenges which are to be tackled by the next generation of reforms. A third section highlights the main initiatives to foster regional monetary and financial cooperation in East Asia; in addition, the rationale for promoting regional cooperation between South Asian countries is outlined. Final remarks sum up the main findings.

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[2] Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka founded SAARC in 1985, which has its headquarter in Kathmandu; Afghanistan became a member only in April 2007. With regard to macroeconomic disparities across countries see table 7-8 and figure 3-8.

## Features of financial sector development in South Asia

*Financial market reforms in South Asia*

Many South Asian countries have undertaken financial market reforms already since the beginning of the 1990s, while others embarked on such a process only recently (table 1). The starting point of reform is not the only difference; South Asian countries have also followed slightly different approaches of reform. One approach stresses the improvement of both the financial sector's efficiency and the allocation of domestic savings. Within that approach liberalization and deregulation have been "core pillars of the reform measures" (Akhtar, 2006:1). Foreign competition would diminish rents of domestic financial institutions, in particular banks, and thus reduce intermediation costs; in addition, the range of available financial products and services would be extended. Another important element of this reform approach is the privatisation of state-owned banks; in many developing countries private ownership has outstripped public banks in terms of profitability and efficiency. Thus, some South Asian governments are increasingly divesting from public banks, encouraging domestic private banks or foreign banks to purchase public bank assets.

Another approach accentuates the maintenance of financial stability. The more sophisticated financial markets are and the more actors participate in financial market activities the easier might risk be spread throughout institutions and spill over to the real sector. Therefore this approach recommends only a gradual introduction of financial sector reforms dependent on the risk management capacities of regulatory and supervisory institutions. "A key consideration in the choice of pace and sequencing has been the management of volatility in financial markets and implications for the conduct of monetary operations." (Mohan, 2007: 21). Furthermore, this approach prefers to restructure and if necessary also re-capitalise public banks to immediate privatisation. "In order to develop the capacity to reach out to all sections of the community, BB has adopted several measures through implementing financial sector reforms and adopting new policies that include, among others, restructuring of S[tate]B[ank]s, establishing a well-functioning secondary market for all types of bonds and securities, and opening up the financial sector to global level by ensuring proper financial regulation and supervision" (BB, 2008: 88; see also Reddy, 2006).

Considering different starting points, different speeds and different approaches to reform it will come to no surprise that SAARC countries display different levels of financial market development both across countries and across divers segments of financial markets in each country. In the following an overview of the financial sector of the South Asian countries will be given; however, it will focus on some elementary characteristics and identify common features; thus, it is rather selective than comprehensive. The first segment targeted by financial market reforms in all South Asian countries had been the banking sector which therefore is in all countries the most advanced financial market sub-sector while bond and equity markets are in the majority of SAARC member States in their infancy.

*Banking system*

With the exception of Afghanistan the financial system in South Asia is dominated by the banking system in terms of assets, or finance of private households and domestic companies; major financial institutions are banks. In case of Afghanistan the almost non-existent credit portfolio of banks is explained by a lack of basic commercial law which

makes it too risky for banks to offer credit to the private sector (IMF, 2008a: 16ff); accordingly the Afghan financial sector comprises besides a few banks many non-bank financial institutions, e.g. foreign exchange dealers, money service providers and micro finance institutions (IMF, 2008b, Da Afghanistan Bank, 2007).

On average financial soundness indicators improved significantly in all South Asian countries as a result of restructuring and re-capitalisation of state banks, aggressive write-downs of bad loans and improved supervision. Capital adequacy ratios comply with Basel I and some SAARC Member States are busily preparing the implementation of Basel II (table 1), e.g. the introduction of the standardized approach and in a second step enabling both the supervisory authorities and banks to manage own risk estimation systems as is required within the internal ratings based approach. Banking systems in the majority of the South Asian countries even display higher capital adequacy ratios than required according to national and international regulations. The share of non-performing loans in total loans has been continuously reduced; Bangladesh, Nepal and Pakistan impressively slashed this ratio from high levels of 35 per cent (2000), 30 per cent (2001) and 22 per cent (2002) to only 14 per cent for the former two countries and less than 10 per cent in case of the latter in 2006 (BB 2008: 54; IMF, 2008c: 2ff). Four of the SAARC countries are even realizing non-performing loan ratios of around 5 per cent which is comparable with advanced countries, e.g. with Germany whose ratio oscillated between 3.4 and 5.2 per cent during the last 10 years (IMF, 2008d). Moreover, the profitability in terms of return on equity is equivalent to emerging market economies' average with Pakistan's banking system displaying clearly an outstanding profit rate (table 1).

Credit growth has accelerated sharply during the last three years; while at the turn of the century credit annually grew in the range of 5 to 20 per cent, meanwhile it has increased to 15 to 30 per cent which surpasses real GDP growth for all South Asian countries (figure 1, table 7). Robust credit growth in South Asia might reflect a catching-up process from a relatively low initial level of financial development substantially rising the credit-to-GDP ratio, thus indicating a financial deepening (table 2 and 3); another reason might be the persistent high real GDP growth itself which enables a broader segment of the population to access the formal financial system of which it was excluded until recently. High credit growth, however, also raises concerns that and asset quality might suffer. Bank lending in South Asia is highly concentrated in terms of sectoral distribution of the loans; loans to sectors which are very sensitive to business cycles have been expanding at an even higher path than average credit; this applies to consumption loans and in particular credits to finance housing, property and construction.

In some South Asian countries the rise in housing and construction loans has been accompanied by a strong rise in property prices. Excessive credit growth and rising property prices might fuel inflation (figure 5), cause an asset price bubble and result in a notorious boom-bust cycle. Rising property prices encourages both borrowers and banks to use real assets as collateral also for non-housing loans. Thus, in case of property price corrections credit institutions face the risk of a sharp deterioration of their assets via an increased default of housing and non-housing borrowers and a decline in value of the collateral. As it is not perfectly transparent how much risk the balance sheets of credit institutions entail, central banks have increased their monitoring of these specific loan categories. Some South Asian central banks already implemented specific prudential measures to mitigate potential risk, imposed a general provision on all loans and increased the risk weights attached to loans secured by real estate collateral (CBSL, 2007: 11f; RBI, 2007a: 39). Moreover, even if asset quality of some South Asian banking systems seems

to be resilient to asset price corrections large exposures to single borrowers might entail credit concentration risk and require narrower limits (IMF, 2007a; IMF 2008c).

Intermediation costs are relatively high in South Asia; the State Bank of Pakistan even qualifies those prevailing in the Pakistani financial system as ”extraordinary banking spreads” (SBP, 2007: 48), although lending-deposit spreads are lower than in most other SAARC Member States (table 4). On first sight high interest rate spreads are surprising because they seem to be in contrast to international experience. During periods of financial repression banks often face high overhead costs and at the same realize considerable rents which are both financed by widening interest rate spreads; with the implementation of financial market reforms, however, which are enhancing national and international competition these inefficiencies tend to decline and administrative capacities are expected to rise. Thus, declining intermediation costs are considered to be a direct result of financial market reforms.

South Asian central banks and regulatory authorities discuss various factors which could be responsible for the continually high interest rates spreads even after reform; one factor might be a lack of competition, in particular by those segments of the financial system which offer alternatives to the classical loan to raise capital for investments, e.g. the corporate debt market (SBP, 2007: Chap.1). Another explanation for high intermediation costs could be the ratio of non-performing loans, which prevent high lending rates to come down (BB, 2008: Chap 3); although ratios have declined significantly, they have not been falling sufficiently yet to depress lending rates.

Instead of indicating inefficiencies, high lending rates and therefore high intermediation costs might also reflect a perception of higher risk and weak financial intermediation (BB, 2008: Chap. 3). Besides financing actual expenses the interest rate spread covers credit risks attached to the loan portfolio and the cost of funding for banks. Some banks dispose only over limited capacity to assess credit risk and therefore apply a rather conservative lending rate policy. Moreover, the introduction of new financial products and services might render some banks more cautious as long as no long-term track record exists, e.g. in case of so-called easy credit schemes or the provision of credits cards to broader segments of the population which have been responsible for the strong growth in consumption credits in some South Asian countries (CBSL, 2007: 5ff, RBI, 2007a: 39). On the other hand cost of short-term funding for banks comprise both spot and future interest rates; rising inflationary pressures or concerns about the maintenance of macroeconomic stability might translate into an upward pressure on lending rates. Taken all these factors together – efficiency gains and higher risk perception - banks seem to behave rational when they make provisions and tend to keep up lending rates; this applies in particular to banks which cannot get rid off their loan portfolio from time to time due to a lack of structured products.

The persistence and extent of abundant liquidity in South Asian banking systems could support the argument of risk perception as a cause for high intermediation costs.[3] A traditional line of argument is that banks hold more cash and capital than is required by national and international standards because of the lack of domestic alternative investment opportunities to which the abundant liquidity could be channelled. Some South Asian countries have made tremendous progress both in the supply of more sophisticated

[3] For the diagnosis of excess liquidity see BB, 2008: 79, CBSL 2007: 34; IMF, 2007b: 12; NRB, 2007: 41ff, RMB, 2008: 4; RBI, 2007a: 12ff; SBP, 2007:51. Excess liquidity in some countries is due to unsterilized inflows in form of aid, concessional grants and loans or remittances.

financial products and highly liquid financial markets. However, even if bond and equity markets were not sufficiently advanced, the liquidity could be channelled to the interbank market. In most of the South Asian countries, however, the level of activity on the interbank market is low and interbank claims constitute only a very small share of bank assets. Reasons put forward for the absence of robust interbank market activities could be of a very concrete nature in the sense that banks would be willing to unfold activities on the interbank market, but were hampered, e.g. due to a lack of adequate collateral or deficiencies in the payment systems so that they have to keep high and costly reserves to avoid liquidity shortfalls (Saxena, 2007).

Another explanation for the reluctance to channel excess liquidity on the interbank market is based on the notion of uncertainty. Banks' uncertainty could refer to potential risks in the balance sheets of other banks and would therefore be based on a lack of information; in some countries borrowing on the interbank market is perceived not so much as a way to optimise liquidity provision but rather as an expression of bad cash flow management (BB 2008: 79); if such a view is dominant interbank market activities might be characterized by adverse selection in a sense that actually only banks with a bad cash flow management would fall back on interbank market borrowings. Thus, the curious situation could arise that although there is more than sufficient liquidity within the banking system, the interbank market is short of liquidity; and while individual banks which rely on that market to meet their funding requirements face liquidity risks, the central bank has simultaneously "to mop up excess liquidity" (BB, 2008: 79) of the banking system to reach monetary policy targets like a specific level of exchange rate or inflation rate. Moreover, the narrowness of the interbank market might then provoke volatile interbank rates, give contradictory signals to market participants and increase uncertainty.

Uncertainty could also be more of a general nature in times when the financial system is not yet mature and financial environment is changing more fundamentally and more rapidly than in advanced financial markets, including the appearance of new competitors, implementation of laws and regulations, new market infrastructure and the establishment of supervisory authorities. As a result of this uncertainty banks might keep excess liquidity as a buffer. Thus, risk perception and uncertainty might give rise to high intermediation costs eating up efficiency gains and result in a persistent preference for liquidity; from the point of view of a single bank this is a prudential behaviour in a rapidly changing environment, from the point of view of monetary authorities, however, it is problematic as excess liquidity tends to reduce the transmission speed and degree of monetary policy.

The efficiency of monetary policy is also reduced by the lack of economic and financial inclusiveness. Since the beginning of the 1980s extreme poverty in South Asia has significantly fallen from over 50 per cent to around 30 per cent, however around half of the Asian poor still live in SAARC member States. The financial system is accordingly biased; only a minority of the South Asian population has access to the formal financial system; the poor are financially excluded and depend on money traders in the informal sector where prudential laws, consumer protection and transparency are absent. Some countries have already started several initiatives on financial inclusion and have introduced new instruments, e.g. smart cards, general purpose credit cards or so-called no-frills accounts with low or even no charges or developed financial inclusion programmes.[4]

[4] See for instance CBSL, 2008: 15; RBI, 2008a: RBI, 2008b, Chap VII, 40; RBI, 2007a: 27ff; for details on the Financial Inclusion Programme (FIP) of the SPB see on its specific website:

Channelling remittances which are very significant for some South Asian countries (figure 6) might also be an innovative instrument to increase financial inclusion and at the same time monitor capital inflows.

*Bond and equity markets*

The development of local currency bond markets has been of particular interest to policy makers and monetary authorities of South Asian countries in recent years, which was motivated mainly by three evolutions: the distressing experience of collapsing banking systems in their neighbouring countries during the East Asian crisis; the successful implementation of first generation financial market reforms in the banking sector allowing a shift of regulatory attention to other segments; and the persistent high GDP growth and the consecutively high financing needs for infrastructure projects. Bond markets are considered as a major alternate source of funding to governments and non-financial corporations which should decrease the reliance on traditional loans and the attached roll-over risk. Increasing trading on bond markets set incentives to reduce banks' intermediation costs, concentration risk and credit risk; in addition, it gradually removes maturity mismatch in banks' portfolios. Deeper financial markets and more sophisticated financial products should result in better diversification of risk and increased shock absorption potential.

Between 1999 and 2005 total outstanding volume of domestic bonds increased in particular in India, while it declined in Nepal and Pakistan (table 5). Sri Lanka displays the highest ratio of bonds to GDP of all SAARC member States; however, the ratio has reached its peak already in 2002 and is declining ever since. Key market infrastructure, e.g. real time settlement systems and central depository systems are available only in some South Asian countries. South Asian security markets are dominated by government bonds, including capital notes in Afghanistan, short-term T-bills as major financial assets in the bond market in Bangladesh and Nepal, and mid to long-term local currency bonds in India, Pakistan and Sri Lanka. Non-marketable securities are in some countries still sizeable and marketable instruments have to be developed.[5] On average corporate debt markets are very thin and only slowly developing. Outstanding corporate bonds in SAARC member States except India are equivalent to less than one per cent of GDP; in India corporate bond volume amounts to 5 per cent of GDP. Financial institutions constitute the main investor group of securities, including central banks, credit institutions, mutual and pension funds, and insurance companies. Apart of central banks which use government securities in open market activities, the majority of the other investors follow a buy-and-hold strategy. Both the issuer and investor base of primary markets are very limited; accordingly secondary bond markets are not liquid with the notable exception of India.[6] Thus, on average South Asian bond markets are still in their infancy.

There are several impediments to the development of local bond markets which are mutually enforcing. One of them is the limited domestic investor base; for that reason some South Asian countries opened domestic bond markets to foreign investors. Another restricting factor is the lack of liquid secondary markets; absence of liquid second markets

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http://www.sbp.org.pk/MFD/FIP/about.htm. To the rationale of government interventions to broaden access to financial services see Claessens (2005): 24ff.

[5] Non-marketable securities comprise in Bhutan and Maldives RMA bills and MMA certificates of deposit respectively (IMF, 2007b:14 and MMA, 2007: 26).

[6] For a detailed discussion of the Indian bond market see Asian Bond Monitor, 2008: 53-82.

implies absence of investors who do not follow a buy-and-hold strategy; investors who are permanently optimising their portfolio according returns, maturities, risks and liquidity requirements necessarily rely on high market turnover. Price opaqueness further increases the risk attached to bond purchases; price transparency in form of a sovereign yield curve would require governments to issue regularly marketable securities over all maturities, even in the absence of financing needs and at the cost of over funding (Hameed, 2006: 14ff; McCauley, 2008: 136). In addition, the existence of a sovereign yield curve would facilitate the development of a corporate yield curve as the former serves as benchmark and lower limit for the latter.

Like bond markets capital markets are also expected to be a good alternative to mobilize savings, provide finance for business and state-owned enterprises. Indeed, South Asian equity markets are rallying strongly; since 2001 market capitalization has steadily increased by at least 140 per cent in Bangladesh at the lower end and more than 400 per cent in Pakistan at the upper end (figure 2). In particular in Pakistan equity financing gained much momentum and is meanwhile more relevant for the private sector than in other emerging Asian, Central European or Latin American countries (Hameed, 2006: 11). Rising asset prices are partly responsible for the jump in market capitalisation. While in Bangladesh and Sri Lanka stock prices augmented only gradually, India's and Pakistan's stock prices sky-rocketed; the local stock price index in India and Pakistan multiplied by 5 and 10 respectively between 2001 and 2007 with an annual maximum of 48 per cent in India (2006) and 81 per cent in Pakistan (2003) (table 6). From time to time strong corrections of stock prices have interrupted the rise in stock prices in all South Asian countries. Thus, strong stock price performance is accompanied by a considerable degree of volatility even in countries which have not completely liberalised capital accounts; due to limited market capitalization and low market turn-over even small portfolio flows may result in high asset price volatility. In addition, there is a concentration of trading and liquidity in few sub-sectors; e.g. banks and non-bank financial institutions which account for a major share in stock market capitalization as well as turnover in South Asian countries (CBSL, 2007: 40f; NRB, 2007: 50ff; SBP, 2007: 99). Although current exposure of financial institutions to the equity market in form of direct investment in shares constitutes no threat to the financial system, the nexus between stock market development and financial institutions gives rise to some concerns.

In sum, South Asian financial systems have undergone tremendous change within the last two decades. "Domestic financial and capital market reforms have made the financial sector sound and healthy. In Sri Lanka and Pakistan the strides made are quite advanced. India is slowly and gradually opening up to foreign competition and introducing new legislation to improve the performance of the banks and upgrade the quality of assets. Bangladesh has begun the process more recently but is committed to moving forward in the same direction. But directed credit and credit ceilings, administered and subsidised interest rates, have gradually given way to market-based allocation of credit and determination of prices." (Husain, 2004: 2).[7] Notwithstanding disparities across countries the banking system is the most advanced and still the most important segment of South Asian financial markets. While for most SAARC member States bond and equity markets are in their infancy, some countries have already fairly advanced public and private security markets as well as capital markets. e.g. Pakistan, Sri Lanka - or India: "It is quite apparent that there exists well-functioning, deep, liquid, and well-integrated markets for

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[7] Similarly, priority lending was phased out in Nepal until the end of 2007; for a brief overview of directed lending in Bangladesh, India, Nepal and Pakistan, see Atreya, 2005: 45.

bonds, currency and derivates in India, contrary to what is often asserted." (Mohan, 2007: 12).

### The unfinished agenda

One major challenge to be tackled by the next generation of reforms is the lack of inclusiveness of the economic and financial system. Broadening financial access is important for several reasons, e.g. reducing lending costs for the socially deprived and most vulnerable parts of the population and thereby supporting pro-poor growth policies. Expanding access to the formal financial system for the poor also benefits macroeconomic policy; the efficiency of monetary and fiscal policy will increase due to higher financial intermediation and a broader tax base. In addition, the process of financial inclusion will support institution building by banks due to the establishment of relationship banking which -if successful- will finally lift up both borrowers and lenders. However, there might exist a trade-off between profitability and inclusiveness at the beginning which policy and regulatory responses should take into account.

The pro-cyclicality of South Asian financial systems constitutes another challenge for policy makers, supervisory authorities and regulators. Pro-cyclicality as such is a normal feature of banking activities; in the course of an upturn banks tend to loose credit standards and thus accumulate lower quality assets in their portfolios which will only be revealed in the downturn. South Asian financial systems, however, are particular cycle-sensitive due to a combination of several factors, e.g. persistent high growth of private sector credit and substantial credit concentration in terms of collateral, borrowers and sectors; in addition, liquidity risk and interest rate risk are crowded in banks portfolios because alternative sources of funding outside banks or opportunities for securitization of credits are still limited; moreover, there is a high correlation between credit growth and asset prices, in particular real estate prices. All these factors expose *banks as creditors* to considerable write-downs in the course of an asset price slump.

The "overall lack of financial sector diversification" (Akhtar, 2008: 2) has been identified as one of the major risks to the South Asian financial system. Diversification of risks would imply to distribute risks over several market participants beyond banks and make use of a variety of financial products beyond credits. Accordingly, high expectations are attached to the development of local bond and equity markets. However, as long as banks and other financial institutions associated with them dominate these markets, risk diversification can only be limited; shares and bonds are rather complementary than substitutive for loans and in particular corporate bonds have sometimes the status of "quasi-loans" (Report 2005: 72). Though considerable progress with regard to the establishment of bond and equity markets has been achieved, risks still remain in the portfolio of banks. *Banks also as direct investors* might therefore suffer considerable blows as a consequence of asset price corrections.

An increased diversification of risks would further imply the introduction of rather sophisticated financial instruments, e.g. risk transfer instruments like securitization and hedging. In an ideal world risk transfer instruments transform risk into certain slices and transfer them separately from the underlying asset to different investors according their preferences with regard to profitability, liquidity, risk aversion and maturity. The attractiveness of these financial innovations is that a certain risk on the one hand and the capacity to exactly deal with this risk on the other hand seems to be perfectly matched by

highly specialised financial institutions which offer highly sophisticated financial instruments based on complex risk management and risk assessment systems. Such a broader risk dispersion is often associated with a reduced risk perception by market participants. From an aggregate point of view, however, risk might not have been necessarily reduced, but simply shifted around across divers financial institutions thereby in worst case increasing systemic and correlation risk exposures. “The transfer of risk to unknown counterparties could create concentration of risk exposures, within or outside the regulated financial sector. There is also more uncertainty about where exactly risk lies, and some uncertainty about whether risk has been fully transferred” (Mminele, 2008: 6).

Thus, independent of what kind of reform approach countries have been following and what exactly gave the impetus for reform, the next generation of reforms will have to focus more than ever on the risks to financial market stability. With only shallow linkages between different segments of the financial system, in particular the interbank market, South Asian financial sectors have been relatively resilient to regional or global shocks; however, with increasing openness and integration of financial markets issues of spill-over and potential cross-border contagion become more pressing and financial market stability more hazardous.

Another task for policy makers, supervisory authorities and regulators will be to fill in the regulatory black boxes, e.g. relating to micro finance, Islamic financial institutions or rating agencies. For some of these issues international best practices and key benchmarks have existed until recently; however, with the current financial melt-down in mature countries these perceived best practices are fundamentally questioned and have to be redefined. For other topics there is no international best practice established yet. In any case, one of the lessons of the financial market turmoil consist in adjusting regulation according to the criteria “instil simplicity” (Hannoun, 2008: 11) with regard to both financial instruments and supervisory methods.

Furthermore, the growing regulatory coverage of the financial sector might be combined with a process of streamlining the domestic financial market architecture. After the implementation of several reform generations it might be important to re-establish coherence between regulations of certain sectors as well as between various regulating agencies and institutions; in particular an evaluation whether there exists a mingling of tasks and functions between policy makers, supervisory authorities and regulators and whether the original division of labour is still up to date can bring about more transparency and scope for action which might be needed in the future.

## Regional financial and monetary cooperation in South and South-East Asia

The East Asian crisis proved to be a watershed with regard to financial and monetary cooperation in Asia. “It is useful to recall that the acute sense of interdependence aroused by the financial “contagion” in 1997 convinced the Asian economies of the importance of economic cooperation, one that reflected their common interests and priorities as well as strengthened their voice in the global arena” (Reddy, 2005: 901). In particular in the ASEAN+3 context intensified cooperation in financial and monetary issues resulted in the most prominent network of swap arrangement as well as the most sophisticated endeavour to deepen regional bond markets. But also SAARC member States intensified their integration ambitions and founded SAARCFINANCE; a forum of central bank governors and representatives of ministry of finances with the explicit tasks to strengthen

cooperation on macroeconomic policies and harmonization of financial market regulation as well as to evolve common strategies in international forum (Paudel, 2005: 37ff).

*Foreign exchange pooling*

In December 1997 ASEAN member countries initiated a process of cooperation on monetary and financial issues with their major partners in South-East Asia China, Japan, and the Republic of Korea which culminated into the formalization of the ASEAN+3 group in 1999. In May 2000 ASEAN+3 countries launched the Chiang Mai Initiative (CMI); the CMI is geared both to crisis management and crisis prevention by providing participating countries with international financial liquidity through its two major pillars the expanded ASEAN Swap Arrangement and the bilateral Swap network. The original ASEAN Swap Arrangement was introduced by the five founding ASEAN members already back in 1977 and was targeted to dampen temporary liquidity shortages (Wang and Anderson, 2002: 90). In May 2000, the ASEAN Swap Arrangement was expanded to all member countries and the available fund was increased from the initial amount of equivalent $200 million to $1 billion.[8] Five years later in April 2005, the ASEAN Swap Arrangement was raised once again from $1 billion to $2 billion (Ministry of Finance Japan, 2007). In case of liquidity problems central banks of member countries are entitled to swap their own currencies against international key currencies, e.g. dollar, euro and yen, for a period of up to six months (with one possible prolongation of another six months) and to an amount of maximum twice their commitment under the expanded ASEAN Swap Arrangement (Rajan, 2006: p.5; Wang and Anderson, 2002: 90).

The second pillar of the CMI consists of a network of bilateral swap arrangements among 8 ASEAN+3 member countries. As of July 2007 six one-way and ten two-way bilateral swap arrangements with a total amount of equivalent $83 billion have been concluded of which 80 per cent alone are provided by China, Japan and the Republic of Korea. Of the total amount agreed upon in the swap arrangements around 50 per cent are in local currency (Ministry of Finance Japan, 2007). However, participating countries have immediate access only up to a maximum of 20 per cent of the facility and *on consent* by swap-providing countries (Park, 2006: 251; Rajan, 2006: 5); for any more drawings above that threshold IMF approval is required.

The CMI which is targeted to prevent systemic failure incorporates that financial instability is not restricted to one country. However, the amount of emergency finance provided by the CMI and under the bilateral swap arrangements is relatively limited taking into account both capital outflows under speculative attacks and the financial needs during the crisis. As of December 1996 the most crisis-prone countries Indonesia, Republic of Korea and Thailand disposed over $90 billion of foreign exchange reserves of which $30 billion alone were injected in the foreign exchange market in 1997 while the financial rescue package for these three countries amounted to $ 111.7 billion (Park, 2006: 235). Moreover, only a fraction of the CMI foreign exchange is eligible for individual countries; e.g. for Indonesia, the Republic of Korea and Thailand access to liquidity under the CMI is limited to an amount of $12 billion, $29 billion, and $9 billion respectively of which only 20 per cent is free of conditionality. Thus, some observers recommend to increase emergency finance by ten times the current size and to transform the bilateral

[8] Six countries (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand) have committed each $150 million; the remaining $100 million are shared among Viet Nam ($60 million), Myanmar ($20 million), Cambodia ($15 million) and the Lao People's Democratic Republic ($5 million) (Wang and Andersen 2002, p. 91); see also UNCTAD, 2007:124ff.

1nature of swap arrangements into a centralized order to facilitate a joint effective and prompt reaction if required in the future (Institute for International Monetary Affairs, 2005: 44). Others see the main contribution of the CMI in its symbolic value "in as much as it can signal the markets a regional commitment to supporting any member country's currency that is under speculative pressures" (Reddy, 2005: 901).

Meanwhile the CMI is evolving into a multilateral agreement; in their Kyoto Meeting of May 2007 and again in the Madrid Meeting of May 2008, the finance ministers of the 13 countries agreed to advance progressively towards a common reserve pooling arrangement which should be based on a single agreement (Joint Ministerial Statement of the 11th ASEAN+3 Finance Ministers' Meeting, 4 May 2008). However, a multilateralisation of foreign exchange requires a multilateralisation of surveillance; ASEAN+3 countries decided that the Economic Review and Policy Dialogue framework shall be linked with the CMI so that some monitoring of the economic and financial situation of member countries can be exercised.[9]

This raises the question of the division of labour with the IMF. On the one hand, liquidity provided by the CMI is perceived to be only a complement to already existing international arrangements, in particular from the IMF. Insofar the CMI can be characterized as unique as the role of the IMF as the major player in monitoring and surveillance is preserved which is not the case in all other existing emergency finance arrangements like within the European Monetary System or the Common Monetary Area in Southern Africa. On the other hand not only that the financial support of the IMF for the crisis-afflicted countries had been assessed as too low, too late and too lopsided, the CMI is developing a surveillance mechanism which has the potential to stand on its own and be rather independent from the IMF.

*Asian bond market development*

The ASEAN+3 Finance Ministers launched the Asian Bond Markets Initiative (ABMI) in 2003; the ABMI is targeted to develop more liquid primary and secondary bond markets and to recycle Asian external surplus into financing of investment within Asia. To these ends ABMI activities intend to address in particular issues of market infrastructure and of crowding-in a broader variety of issuers and investors into the national and regional bond markets. Six working groups have been established to work out studies and several recommendations to improve bond markets, e.g. increased issuance of local currency bonds, improved capacity of local credit rating agencies or reduced foreign exchange settlement risk to cross-border flows.[10] One of the major accomplishments of the ABMI initiative are local currency bonds issued by the Asian Development Bank (ADB) on several Asian bond markets with maturities of up to ten years. The ADB issuance of local currency bonds which are simultaneously traded in six Asian bond markets is expected to induce cross-border activities and reduce price differentials.

[9] For ambivalences attached to current surveillance mechanism within CMI see Park and Wyplosz, (2008): 79ff.

[10] The working groups (WG) are the following: WG1 Creating New securitized Debt Instruments, WG2 Credit guarantee and Investment Mechanisms, WG3 foreign Exchange Transactions and Settlement Issues, WG4 Rating Systems; another two Wgs were established on technical assistance coordination and on issuance of bonds denominated in local currencies by multilateral development banks, foreign government agencies and Asian multinational corporation has been concluded. See http://asianbondsonline.adb.org/regional/asean_plus_three_asian_bond_market_initiatives/overview.php.

2The activities by ASEAN+3 were complemented by the Executives' Meeting of East Asia-Pacific Central Banks group (EMEAP), which was established already back in 1991 to deepen and strengthen cooperation between its members (EMEAP, 2003).[11] During its initial phase EMEAP was characterized by a consultation process on an informal basis. However, with increasing regional interdependence EMEAP began to formalize its structure by introducing three permanent working and study groups, e.g. the Working Group on Financial Markets which prepared the grounds for the formation of the Asian Bond Fund. In June 2003 EMEAP finally launched the first Asian Bond Fund and created a second Asian Bond Fund already in December 2004 (Park et.al., 2006: 276). EMEAP members created the Asian Bond Funds (ABFs) with the objectives to deepen national and regional bond markets so as to reduce dependence of Asian borrowers on short-term bank financing (EMEAP Working Group on Financial Markets 2006: 1). Short-term bank financing for long-term investment incurs several risks for both market participants and systemic stability as the East Asian crisis 1997/1998 had impressively shown; the cut off from bank financing through the rejection of roll-overs resulted in illiquidity by major corporations which triggered off chain reactions by other credit institutions thereby driving a good part of both the company sector and the banking sector into insolvency.

EMEAP members pooled $1 billion and $2 billion of their foreign exchange reserves for ABF 1 and ABF 2 respectively to be invested in sovereign and quasi-sovereign bonds issued by eight EMEAP countries.[12] The design of ABF1 and ABF2 differs decisively in three points. First, while ABF1 is used to buy bonds denominated in dollar, ABF2 is invested in bonds denominated in local currencies of the eight EMEAP countries. With the local currency denomination another major weakness, currency mismatch between assets and liabilities displayed during the crisis, shall be reduced. A second difference concerns the participation of other market actors in the funding. In contrast to ABF1 which is limited to EMEAP members only, ABF2 has been opened up to public and private investors after April 2005; thus depending on how much funding ABF2 is able to attract from other sources in the future it could be able to display a leverage effect with direct impacts on national and regional bond markets. According to EMEAP the design of ABF2 with passively managed eight single-market funds and one parent pan-Asian fund investing in bond markets of the eight recipient countries is suitable to each of the three target groups of local, regional and international investors (EMEAP Working Group on Financial Markets, 2006: 1ff). The third difference relates to the conception of the two funds; while ABF1 constituted a trial run to prepare the ground for ABF2, the latter had been mainly designed to reveal infrastructure weaknesses and to identify market barriers under real conditions. Therefore, ABF2 is expected to play a catalytic role for the development of regional bond markets by inducing central bankers and policy authorities to improve market infrastructure and harmonize national regulations of financial markets, e.g. facilitation of fund listings, construction of benchmark indices, facilitation of cross-border flows.[13] BIS Investment Pool, the BIS investment vehicle, was appointed to be the manager of ABF1 and administrator of ABF2, which is managed by private investment corporations. For transparency adherents the appointment of BIS Investment Pool has the

[11] To EMAP belong: the following central banks and monetary authorities: Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, Bank of Korea, and Bank of Thailand.

[12] See EMEAP Working Group on Financial Markets, 2006: 1f; Ma and Remolona, 2005. 84ff. Australia, Japan and New Zealand have been excluded as recipient countries.

[13] See EMEAP Working Group on Financial Markets, 2006: 24-30; Ma and Remolona, 2006: 85; Park et.al., 2006: 278ff; Reserve Bank of Australia, 2005: 14f.

advantage that EMEAP member claims qualify as international reserve assets (EMEAP Working Group on Financial Markets, 2006: 14ff).

The ABF Pan Asia Bond Index Fund (PAIF) which constitutes the Asian parent fund of the Asian Bond Fund Initiative by EMEAP members has reached its target, to realize investment returns that correspond to those of the underlying benchmark (Interim Financial Statement, 2007:2). The benchmark consists of an index for local currency bonds issued by selected public institutions of eight EMEAP member countries and is compiled with the objective to provide price transparency on and between local bond markets of member countries. If average profitability corresponds to the benchmark, then the parent fund might be attractive enough for crowding-in private investors and thus broaden demand for local currency bonds.

The level of financial market integration in terms of increasing regional cross-border flows is still limited: "In comparison with the developed markets, there is little evidence of cross-country market integration in Asia – the Asian capital market is a collection of distinct national entities, where the relatively more developed economies are starting to integrate well with the more advanced economies, but are still hesitant to seek the same level of integration with one another" (SBP, 2007: 47; see also UNCTAD, 2007: 129f).

However, some progress in developing local bond markets as a pre-step for regional bond markets can be stated. The absolute amount of local currency bonds outstanding for ASEAN5+3 countries has been more than doubled within the last 10 years (AsianBondsOnline 2008). But, it is still the public sector in ASEAN5+3 countries which has mainly augmented its share of outstanding bonds in GDP, followed by financial sector institutions; compared with pre-crisis level in 1996 an increase in local currency bonds by the non-financial corporate sector can only be stated for few countries, e.g. Republic of Korea and Thailand. Though traded amount on primary local currency bond markets has steadily increased in volume, liquidity of these financial instruments is still low and corporate bonds are in fact illiquid (Asian Bond Monitor 2007: 11f). Domestic creditors active on primary bond markets within ASEAN5+3 comprise financial institutions and government agencies which like in South Asia follow a buy-and-hold investment strategy. Further reasons for the illiquid corporate bonds entail market opaqueness with regard to prices due to lacking reporting requirements or limited flow of timely information about issuers. Thus, secondary corporate bond markets are neither deep nor broad, yet.

Empirical evidence on broadening and deepening regional financial markets is far from being unambiguous. With regard to financial deepening measured as the share of bank loans, outstanding bonds and equity to GDP ASEAN5+3 countries are on average out performers in comparison to Eastern Europe and Latin America, in particular in banking and equity markets. Furthermore, the pace of financial deepening by ASEAN5+3 countries since 1995 has been more accelerated than by their counterparts in Eastern Europe and Latin America. However, if it is correct, that cross-border portfolio investment provides a good measure of regional financial links (Cowen et.al, 2006: 13) then regional financial integration within ASEAN and ASEAN+3 is just right at the outset.

*Regional financial and monetary cooperation in South Asia*

Financial and monetary cooperation in South Asia is at an early stage; "South Asia is a latecomer to the concept of regional cooperation." (Nag, 2007a: 3). SAARC was founded in 1985 and SAARCFINACE only established in 1998. SAARCFINANCE, the forum for

central bank governors and secretaries of finance ministers, has been very active in recent years. Considerable efforts have been made to prepare the ground for a regional payments system; in particular the Central Bank of Sri Lanka has been committed in promoting the SAARC Payments Initiative and establishing its Secretariat in Sri Lanka (CBSL, 2008: 26). The SAARC Payments Initiative was launched in 2007 and has the objective to implement a region-wide payments system for cross-border flows by 2015 (Siriwardhane, 2008:11ff). When and where necessary the SAARC Payments Initiative will harmonize domestic payments and settlement systems and it has to define a regional approach to cross-border payments. In 2001, the South Asian Insurance Regulators' Forum (SAIRF) was established which shall provide a framework for discussions on the harmonization of legislative approaches and financial reporting systems (IBSL, 2007: 12). Exchange and training of staff of central banks, ministries of finance and regulatory authorities is an important activity within both frameworks (SAARCFINANCE, 2007).

Regional integration is very limited, in particular in comparison to East Asia. Intraregional trade does not exceed 5 per cent of the region's total trade (UNCTAD. 2007: 98) and cross-border capital flows are negligible. "South Asia is one of the least integrated regions in the world (Atreya, 2005: 47). Thus, the question arises whether it is not premature to discuss anything beyond increasing trade integration. Several papers discuss whether SAARC member States are prime candidates for regional monetary and financial cooperation at this stage of development and level of cross-border flows.[14] Some base their evaluation on traditional optimum currency area-criteria (e.g. Makay 2005, 2001; Jayasuriya 2003); with the low level of real integration shocks are asymmetric or have asymmetric impacts; accordingly it is concluded that South Asian countries are not optimal candidates for monetary and financial integration now.

Although real interdependence makes financial and monetary cooperation seem politically more feasible and legitimate, it is not an indispensable prerequisite. In the era of financial globalisation the major source of instability derives from the capital account and not the current account; thus exchange-rate volatility rather than factor mobility enforces financial and economic adjustment (Fritz and Metzger, 2006: 9ff). Moreover, Asian experience shows that instability of the financial system cannot necessarily limited to a single country; in contrast, once triggered off it might spill-over and contagion might result in a deep economic crisis and destruction of financial wealth, even if countries display sound fundamentals. Contagion even seems to have a regional bias; actually, it does not require strong real or monetary linkages between the affected countries. What is important for the phenomenon of contagion to occur is the perception of international investors that certain selected countries share similar risks and that similar uncertainties are attached to them. This perception is sufficient to cause herding behaviour and strong U-turns of capital flows. Therefore, the low level of real integration between SAARC countries is not a shield against symmetric external financial shocks or contagion.

The financial systems of the more developed SAARC member States India, Pakistan, and Sri Lanka which together make up more than 90 per cent of the regions' GDP,[15] have gradually become more prone to extra-regional shocks due to the declining fragmentation of their domestic financial markets and increasing openness vis-à-vis the rest of the world.

[14] For instance Chandra and Kumar, 2008; Nag, 2007b; Maskay; 2005; Saxena and Baig, 2004, Jayasuriya et.al., 2003; Maskay 2001.

[15] According to the World Bank list of economies Bhutan and the Maldives are also classified as lower middle income countries (as of July 2008); however, their share in regional GDP is less than one per cent each; see Chandra and Kumar (2008): 20.

Thus, on many occasions all three central banks have emphasized that the maintenance of financial stability and the monitoring of all factors which could result in a build-up of systemic risk to the financial system are top priorities. The experiences with the East Asian crisis and the Subprime crisis give an impressive testimony that no common coherent response of several countries in times of systemic crisis is possible without formal cooperation. The lack of formal cooperation before and during a crisis limits the scope for both crisis prevention and crisis management. Thus, in the absence of a comprehensive multilateral mechanism regional monetary arrangements might be adequate to deal with the vagaries of the global financial markets, albeit only if they are established in times when they are not needed.

Another rational for in particular closer financial cooperation between regional partners is the presence of original sin and its deliberate balance sheet effects on the portfolio of debtors. Many developing countries are not able to raise loans or issue bonds with a long-term maturity denominated in their own currency; this leaves private and public sector agents of developing countries with the options either to take up only short-term debt in domestic currency or to enter foreign currency denominated debt (Eichengreen, Hausmann, Panizza 2005a). For instance, the government of Sri Lanka has succeeded to issue a debut international bond with an amount of 500 million US dollars and a maturity of five years despite a very difficult international environment in October 2007; the inaugural bond issue was also remarkable because it was oversubscribed by three times and it was voted the best sovereign bond of the year (CBSL, 2008: 8f); on the other hand, the bond has a middle-term maturity and is denominated in a foreign currency which exposes Sri Lanka to maturity and currency mismatch. The government of Sri Lanka has opted to issue an international bond in foreign currency to finance public infrastructure taking into consideration the limitations of the domestic market, e.g. small investor base, the risk of inflationary pressures and in particular the restricted market size.

Empirical evidence has shown that country size in terms of GDP is the key determinant of a country's ability to issue sufficient local currency denominated debt at home and abroad (Eichengreen, Hausmann, Panizza 2005b, 2007). Thus, in the absence of a monetary union which would automatically expand the size of the economic area, a high level of financial market integration might provide some kind of redemption from original sin. In that respect raising loans and issuing bonds in local currency by public entities on the domestic and regional markets can indeed play a catalytic role to evolve more and more diversified financial instruments available on the domestic financial markets. A deepening in financial markets can induce an expansion in trading of regional currencies and thereby reduce vulnerabilities of economic agents to exchange risks. All this, however, would require to improve and to strengthen regional monetary and financial cooperation between SAARC member States.

The high financing needs for big infrastructure projects in each of the SAARC member States and for cross-border projects emphasizes once more the relevance to develop regional financial markets and the use of local currencies in intra-regional activities. In that respect the initiatives of the Asian Development Bank (ADB) are highly welcome; the ADB is the first regional development bank that both in its function as a borrower and as a lender strengthens local and regional financial markets by using instruments denominated in local currency. With the explicit aim to reduce currency mismatches in its developing member countries and to support local capital market development the ADB has

introduced its local currency loan product;[16] it has offered local currency loans since 2003 initially only to selected private borrowers, and after expressing increasing interest since 2005 also to public sector entities. Furthermore, the ADB has issued bonds in local currency of developing member countries on local financial markets; with the Indian rupee bond issuance in 2004 the ADB launched its first local currency bond on the domestic market of a borrowing member.[17]

India is increasingly open for integration and cooperation with the rest of Asia, in particular South-East Asia which is characterized by a high political dynamic in recent years. Actually, India's *Look East Policy* began already back in 1992, though it experienced an upswing since the East Asian crisis. Since 2005 India has an observer status in the East Asia Summits. Moreover, following the CMI arrangement India and Japan concluded a bilateral currency swap agreement in April 2008 which will provide each country with $3 billion to support their currencies in case of a speculative attack. In addition, the Bank of Japan and the Reserve Bank of India will have working level meetings to examine each others macroeconomic conditions. Although the Reserve Bank of India does not participate in the Asian Bond Fund Initiative yet, the Indian Government already committed up to $1 billion to ABF2 (RBI, 2007b: 305).

Due to its pure economic size India could take the lead in revitalizing SAARC itself (Chandra and Kumar, 2008: 17; Nag, 2007a: 3) and might have a key role within SAARC when it comes to monetary and financial cooperation within a broader pan-Asian area; India produces 80 per cent of the regional GDP and in terms of the outstanding amount, the debt markets of India are third in Asia after Japan and the Republic of Korea in 2007. India's tight links with East Asia even give it the opportunity to bring to the fore South Asian positions into several forum and policy dialogue frameworks in Asia. However, relations between India and some South Asian neighbours have not always been free of tensions. "There are causes of concern as at times India is criticized for having a big brotherly attitude by other members." (Ranjan, Jain and Mukherjee, 2007: 105).

Therefore, SAARC member States might rather enforce a twin track approach; strengthen regional cooperation within South Asia and at the same time seek enhanced cooperation with East Asia (Chandra and Kumar, 2008: 2). The opening of the South Asian cooperation process to other regional powers like China, Japan and Republic of Korea, which enjoy an observer status within SAARC,[18] could re-balance relations within SAARC and at the same time reduce pressure on India. Enhanced cooperation with East Asia requires SAARC countries to develop common approaches and to advance their institutional framework; a good starting point of building closer relations between SAARC and ASEAN+3 would be the establishment of a formal SAARC finance ministers' process similar to that within ASEAN+3 (Nag, 2007a: 4).

[16] See www.adb.org/Bond-Investors/bp-local.asp for the role of the ADB as a borrower in local currencies of member States markets and http://www.adb.org/Finance/lclp.asp for its role as a lender in local currencies.

[17] This issuance was followed by similar transactions in Singapore, Hong Kong, Malaysia, Thailand, Philippines and China. See also http://www.adb.org/Documents/News/2004/nr2004017.asp.

[18] In addition Australia, the European Union, Iran, Mauritius Myanmar, and the United States of America have become observers.

## Conclusion

South Asian financial markets have undergone tremendous change within the last two decades. While the banking sectors' depth has increased, its soundness improved significantly and banking services and products have become more sophisticated; on the other hand, the bond and stock markets are still in their infancy. South Asian financial markets also pose several challenges to policy makers, monetary authorities and regulators, e.g. its high pro-cyclicality, its lack of diversification, or the existence of regulatory black boxes and the necessity to streamline domestic financial market architecture.

South Asian regional financial and monetary integration is at its outset. On the other hand, East Asia embarked on a process to establish the most prominent swap arrangement and the most sophisticated endeavour to deepen regional bond markets. Though empirical evidence on broadening and deepening of regional financial markets is not definite, the East Asian initiatives seem to be accompanied by some success. They have been well received by market participants and an acceleration of the pace of deepening of regional financial markets could already be stated. Moreover, East Asian countries extended already existing bilateral swap arrangements in terms of liquidity provided and are on their way to transform bilateral emergency financing into a regional multilateral arrangement. Although the crucial test whether these arrangements stand firm speculative attacks and sudden U-turns of capital flows has not yet been taken both initiatives are considered as highly supportive for the functioning of an effective regional mutual mechanism.

The East Asian experience and initiatives display several lessons. First, no common coherent response of several countries in times of systemic crisis is possible without formal cooperation Thus, a formal framework for regional monetary cooperation has to be established in times free of crisis. Second, there is a role for state intervention to increase both supply and demand for local currency bonds. To play this role adequately regional financial cooperation has to provide regional regulations and infrastructure to facilitate cross-border flows.

Given the wide experiences of East Asian countries with regional cooperation and the brittle relations between some South Asian countries, SAARC member States might benefit most from a twin track approach: Enhanced mutual cooperation by developing common approaches and advancing the regional institutional framework while simultaneously promote regional cooperation with East Asia, in particular ASEAN+3.

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**Table 1 SAARC: General information**

| | Afghanistan | Bangladesh | Bhutan | India | Maledives | Nepal | Pakistan | Sri Lanka~ |
|---|---|---|---|---|---|---|---|---|
| Currency | afghani | taka | ngultrum | Indian rupee | rufiyaa | Nepalese rupee | Pakistan rupee | Sri Lanka rupee |
| Exchange rate system | managed float | managed float | peg (Indian rupee) | managed float | peg (US$) | peg (Indian rupee) | managed float | managed float |
| Foreign currency deposits | X | X | | | X | X | X | X |
| Financial Sector Reform (Start) | | 1992 | | 1991 | | 2000 | 1990 | 1977 / 2000 |
| Basel II (start of implmentation) | | 2009 | | Apr-07 | | FY 2007/2008 | Jan-08 | Jan-08 |
| Deposit insurance (introduction) | implicit | 1984 | implicit | 1962 | implicit | implicit | implicit | 1987 (voluntary) |
| | | | | | | | | |
| Total assets of banking system* (a) | 15** | 58*** | ... | | ... | 81** | 52.5** | 79.1*** |
| Construction in total loans# (a) | na | | 35*** | | 6*** | 60** (i) | | 16.4 |
| NPL to total loans (a) | 1** | 14** | 5*** | 2.8** | | 10** | 8.3*** | 5.4 |
| CAR - Total capital ratio# (a) | 32** | 8*** | 17*** | 12.3** | | 11***** | 13.3*** | 12.6 |
| Return on equity# (a) | na | 13.8** | 16.5*** | 12.7*** | | | 31** | 17 |
| | | | | | | | | |
| Short-term external debt* (b) | 0.13 | 1.90 | 1.70 | 1.31 | 10.05 | 0.91 | 0.97 | 3.17 |
| Total external debt* (b) | 21.09 | 33.15 | 75.73 | 16.79 | 49.54 | 38.14 | 28.31 | 42.45 |
| Current Account Balance* (c) | 0.03 | -0.45 | 9.52 | -3.07 | -35.70 | 0.50 | -6.89 | -5.73 |
| Workers remittances* (b) | .. | 8.77 | .. | 2.79 | 0.24 | 16.26 | 4.04 | 8.71 |
| CPI (2000=100) (b) | 180.77 | 159.61 | 137.33 | 144.38 | 125.19 | 146.74 | 159.12 | 221.03 |
| | | | | | | | | |
| Population (b) | 26.70 | 155.99 | 0.65 | 1109.81 | 0.30 | 27.64 | 159.00 | 19.89 |
| Life expectancy (b) | 43 | 64 | 65 | 64 | 68 | 63 | 65 | 75 |
| HDI rank (d) | ... | 140 | 133 | 128 | 100 | 142 | 136 | 99 |

Sources: a: various national sources; b: World Bank, World Development Indicators, Online statistical database, August 2008; c: IMF, World Economic Outlook Database, April 2008; d: of 177 countries; Human Development Report 2007/2008;.
* per cent of GDP; # per cent

**Table 2 SAARC: Domestic credit**
*(Per cent of GDP)*

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|
| Afghanistan | ... | ... | ... | ... | ... | ... | ... | ... | ... | 0.23 |
| Bangladesh | 28.87 | 30.57 | 33.03 | 45.99 | 48.03 | 47.11 | 49.08 | 51.77 | 54.72 | 55.22 |
| Bhutan | 2.67 | ... | 2.90 | 6.26 | 10.94 | 11.49 | 17.77 | 14.70 | 12.95 | 12.38 |
| India | 48.00 | 50.66 | 53.69 | 55.80 | 60.04 | 59.27 | 61.56 | 62.41 | 65.78 | ... |
| Maldives | 32.45 | 32.13 | 34.79 | 39.97 | 41.72 | 36.29 | 42.80 | 72.04 | 81.92 | 102.94 |
| Nepal | 36.50 | 38.21 | 40.30 | 42.99 | 46.14 | 46.62 | 48.24 | 49.32 | 50.30 | 0.00 |
| Pakistan | 42.32 | 40.41 | 41.60 | 37.74 | 36.65 | 37.06 | 41.05 | 43.90 | 43.03 | 45.74 |
| Sri Lanka | 36.62 | 39.16 | 43.75 | 45.43 | 43.69 | 42.14 | 44.61 | 45.24 | 49.43 | 48.52 |

Source: IMF, International Financial Statistics Online Database, August 2008, IMF, World Economic Outlook Database, April 2008.

**Table 3 SAARC: Domestic credit to the private sector**
*(Per cent of total domestic credit)*

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|
| Afghanistan | ... | ... | ... | ... | ... | ... | ... | ... | -246.20 | 3328.29 |
| Bangladesh | 76.74 | 74.09 | 72.17 | 58.15 | 59.77 | 60.77 | 61.96 | 61.57 | 62.20 | 63.98 |
| Bhutan | 364.25 | -632.74 | 300.88 | 153.57 | 104.74 | 117.15 | 89.19 | 121.64 | 162.26 | 177.82 |
| India | 51.48 | 52.59 | 54.41 | 53.20 | 55.74 | 55.82 | 61.77 | 67.52 | 71.00 | ... |
| Maldives | 60.76 | 58.47 | 55.04 | 59.75 | 61.58 | 69.97 | 83.40 | 79.18 | 86.15 | 88.42 |
| Nepal | 73.14 | 70.39 | 70.89 | 68.63 | 65.98 | 68.63 | 70.87 | 71.84 | 74.86 | ... |
| Pakistan | 48.81 | 51.85 | 53.69 | 57.70 | 59.14 | 66.36 | 70.01 | 65.25 | 67.28 | 64.36 |
| Sri Lanka | 78.43 | 74.71 | 65.91 | 61.87 | 65.42 | 71.03 | 70.72 | 75.40 | 72.08 | 73.87 |

Source: IMF, International Financial Statistics Online Database, August 2008.

**Table 4 SAARC: Interest rate spreads**
*(Percentage points)*

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|
| AFG | ... | ... | ... | ... | ... | ... | ... | ... | 12.95 | 12.76 |
| AFG (FC) | ... | ... | ... | ... | ... | ... | ... | ... | 13.99 | 9.12 |
| BGD | 5.58 | 5.38 | 6.94 | 7.34 | 7.83 | 8.18 | 7.64 | 5.91 | 6.22 | 6.82 |
| BTN | 7.75 | 7.75 | 7.75 | 8.25 | 8.25 | 10.00 | 10.50 | 9.50 | 9.50 | 9.50 |
| IND# | ... | ... | ... | ... | ... | ... | ... | 5.25-7.5 | 4.75-7.5 | 5.0-9.75 |
| MDV | 8.20 | 5.57 | 6.13 | 6.03 | 6.04 | 6.50 | 6.50 | 6.50 | 6.50 | 6.50 |
| MDV (FC) | ... | ... | ... | ... | ... | ... | 6.75 | 6.50 | 6.50 | 6.50 |
| NPL | 5.08 | 4.02 | 3.50 | 2.92 | ... | ... | 5.85 | 5.88 | 5.75 | 5.75 |
| PAK* | 5.40 | 5.00 | 4.70 | 5.10 | 4.50 | 3.80 | 3.50 | 5.10 | 5.20 | ... |
| LKA | 5.46 | 5.61 | 6.99 | 8.38 | 3.95 | 4.34 | 4.40 | 5.13 | 6.05 | 8.00 |

Source: IMF, International Financial Statistics Online Database, August 2008, except * SBP (2007) and # RBI (2008a, public banks only).
Spreads: lending rates minus deposit rates
FC: foreign currency

**Table 5 SAARC: Outstanding domestic bonds**
*(per cent of GDP)*

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|
| Bangladesh | 1.3 | 1.5 | 1.7 | 1.9 | 1.4 | 1.5 | 1.4 |
| India | 22.7 | 26.0 | 27.5 | 30.5 | 33.6 | 34.7 | 34.8 |
| Nepal | 14.5 | 13.1 | 12.1 | 11.8 | 10.9 | 10.0 | 9.8 |
| Pakistan | 47.2 | 40.9 | 38.9 | 37.8 | 36.7 | 33.0 | 30.9 |
| Sri Lanka | 49.3 | 53.9 | 58.1 | 60.1 | 58.0 | 56.4 | 53.6 |

Source: Mu (2007).

**Table 6 SAARC: Annual change in composite stock price index**
*(local index, in per cent)*

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| BAN | 15.26 | 15.71 | 20.28 | 2.43 | 68.41 | 19.45 | -10.90 | 48.24 |
| IND | 19.69 | -31.35 | -1.04 | 29.02 | 42.85 | 36.79 | 48.20 | 32.96 |
| PAK | 34.19 | -14.97 | 47.50 | 81.58 | 54.77 | 52.39 | 32.53 | 24.20 |
| LKA | -10.95 | -6.68 | 56.45 | 41.79 | 35.44 | 46.29 | 17.21 | 12.29 |

Source: ADB Asia Regional Information Center (ARIC) Indicators online statistical database, August 2008.

**Table7 SAARC: Real GDP growth**
*(annual change in per cent)*

| | YR1998 | YR1999 | YR2000 | YR2001 | YR2002 | YR2003 | YR2004 | YR2005 | YR2006 |
|---|---|---|---|---|---|---|---|---|---|
| AFG | .. | .. | .. | .. | .. | 15.67 | 7.99 | 14.00 | 5.34 |
| BGD | 5.23 | 4.87 | 5.94 | 5.27 | 4.42 | 5.26 | 6.27 | 5.96 | 6.63 |
| BTN | 5.82 | 7.86 | 7.20 | 6.79 | 10.91 | 7.21 | 6.84 | 7.02 | 8.47 |
| IND | 6.19 | 7.39 | 4.04 | 5.21 | 3.73 | 8.39 | 8.33 | 9.23 | 9.20 |
| MDV | 9.30 | 7.78 | 4.39 | 3.26 | 6.08 | 9.24 | 11.45 | -5.09 | 23.53 |
| NPL | 2.94 | 4.50 | 6.10 | 5.63 | 0.12 | 3.95 | 4.68 | 3.12 | 2.80 |
| PAK | 2.55 | 3.66 | 4.26 | 1.98 | 3.22 | 4.85 | 7.37 | 7.67 | 6.92 |
| LKA | 4.70 | 4.30 | 6.00 | -1.55 | 3.96 | 6.02 | 5.45 | 6.03 | 7.35 |

Source: World Bank, World Development Indicators, Online statistical database, August 2008.

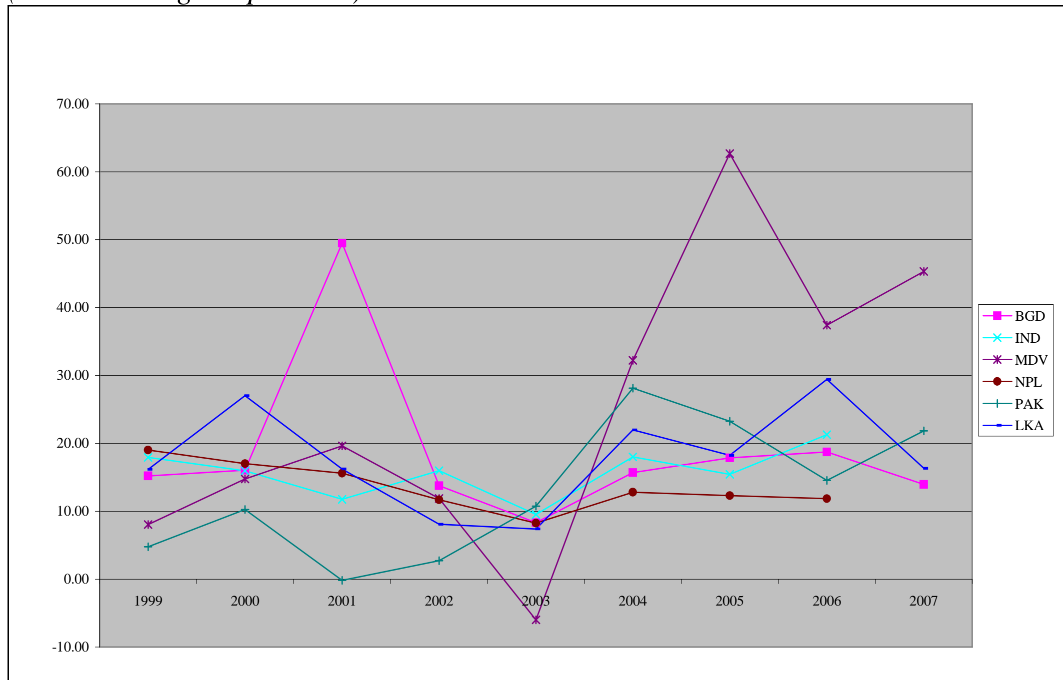
**Table 8 SAARC: Current account balance**

*(per cent of GDP)*

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| Afghanistan, Rep. of. | n/a | n/a | -3.7 | -10.3 | -4.9 | -2.8 | -6.3 | -0.8 |
| Bangladesh | -1.4 | -0.9 | 0.3 | 0.3 | -0.3 | 0.0 | 1.2 | 0.5 |
| Bhutan | -9.7 | -9.0 | -12.0 | -13.3 | -10.3 | -26.1 | -3.1 | 8.8 |
| India | -1.0 | 0.3 | 1.4 | 1.5 | 0.1 | -1.3 | -1.1 | -1.8 |
| Maldives | -8.2 | -9.4 | -5.6 | -4.6 | -16.5 | -35.8 | -40.7 | -45.0 |
| Nepal | 2.7 | 4.2 | 3.9 | 2.2 | 2.7 | 2.0 | 2.2 | 0.6 |
| Pakistan | -0.3 | 0.5 | 3.9 | 4.9 | 1.8 | -1.4 | -3.9 | -4.9 |
| Sri Lanka | -6.5 | -1.1 | -1.4 | -0.4 | -3.2 | -2.8 | -5.0 | -4.6 |

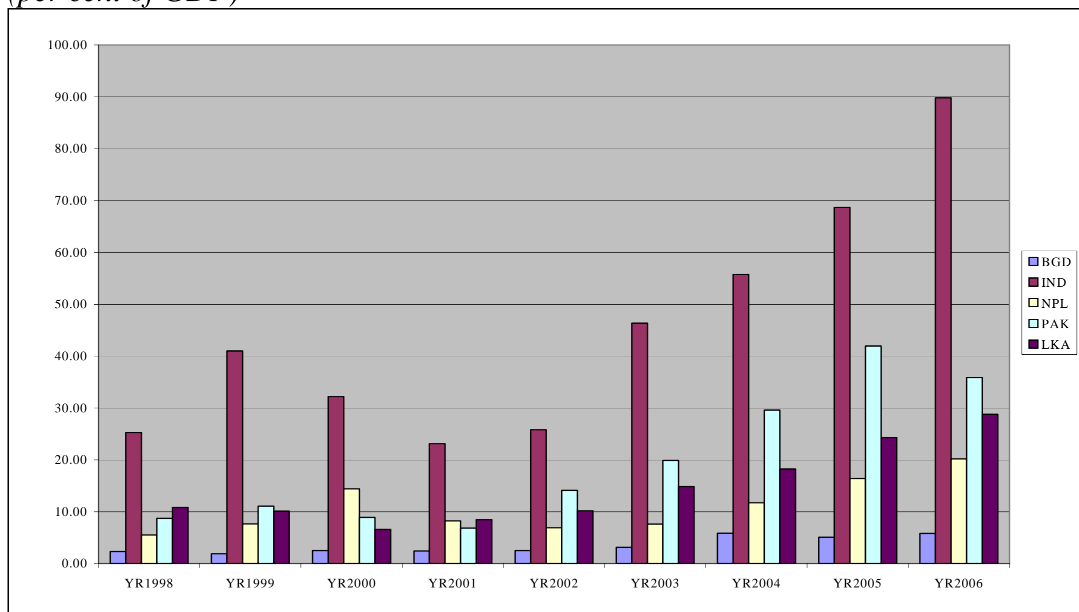
Source: IMF, World Economic Outlook Database, April 2008.

**Figure 1 SAARC: Domestic credit growth**
*(annual change in per cent)*



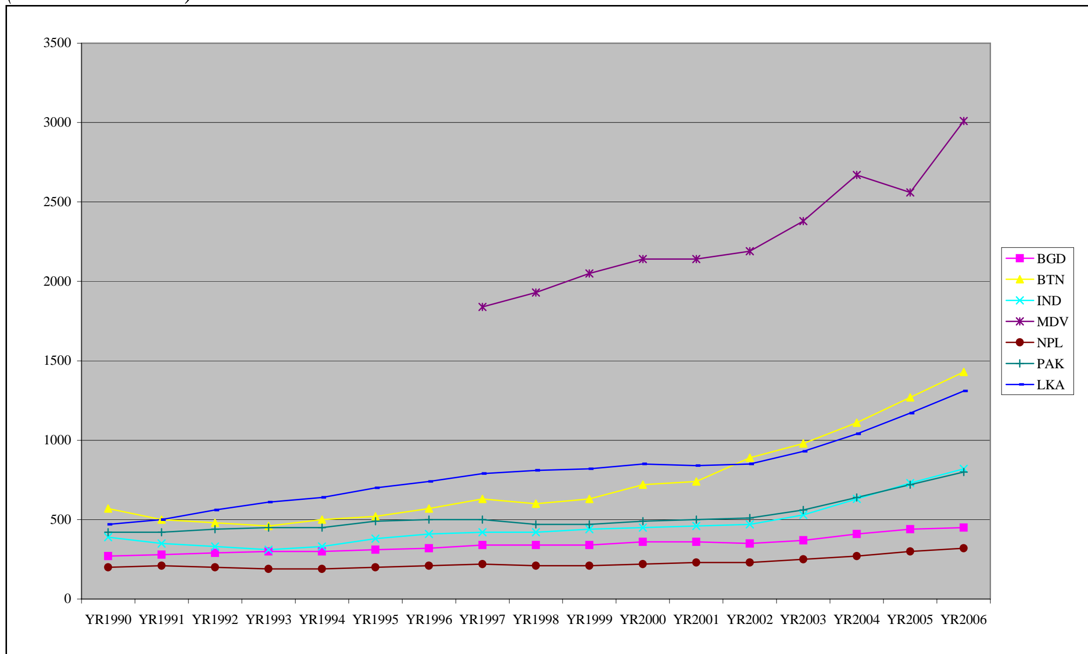

Source: IMF, International Financial Statistics Online Database, August 2008.

**Figure 2 SAARC: Market capitalisation of listed companies**
*(per cent of GDP)*



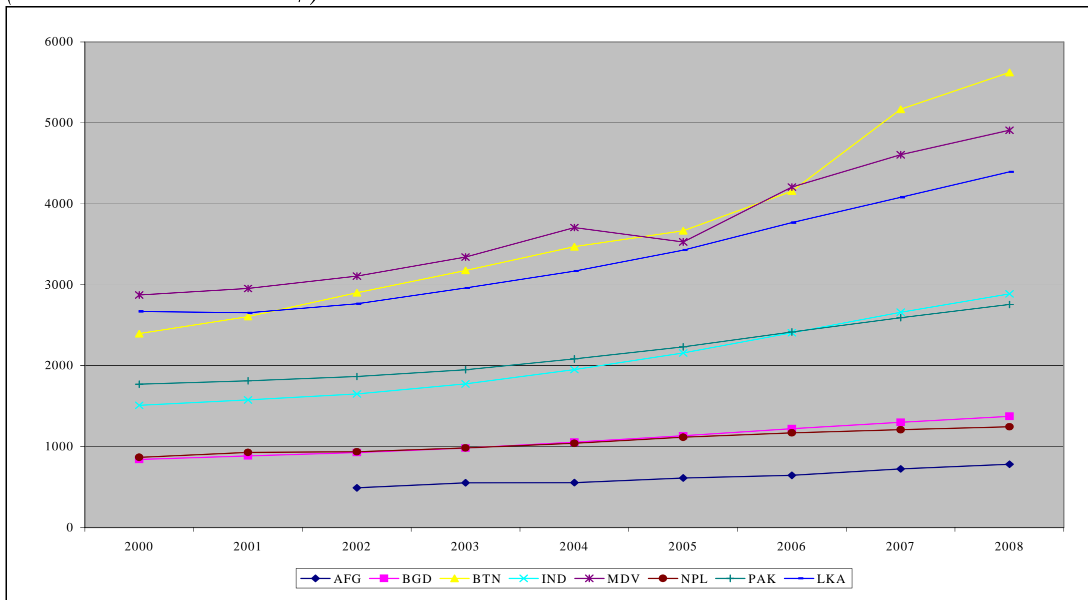

Source: World Bank, World Development Indicators, Online statistical database, August 2008.

**Figure 3 SAARC: GNI per capita**
*(Atlas method)*




Source: World Bank, World Development Indicators, Online statistical database, August 2008.

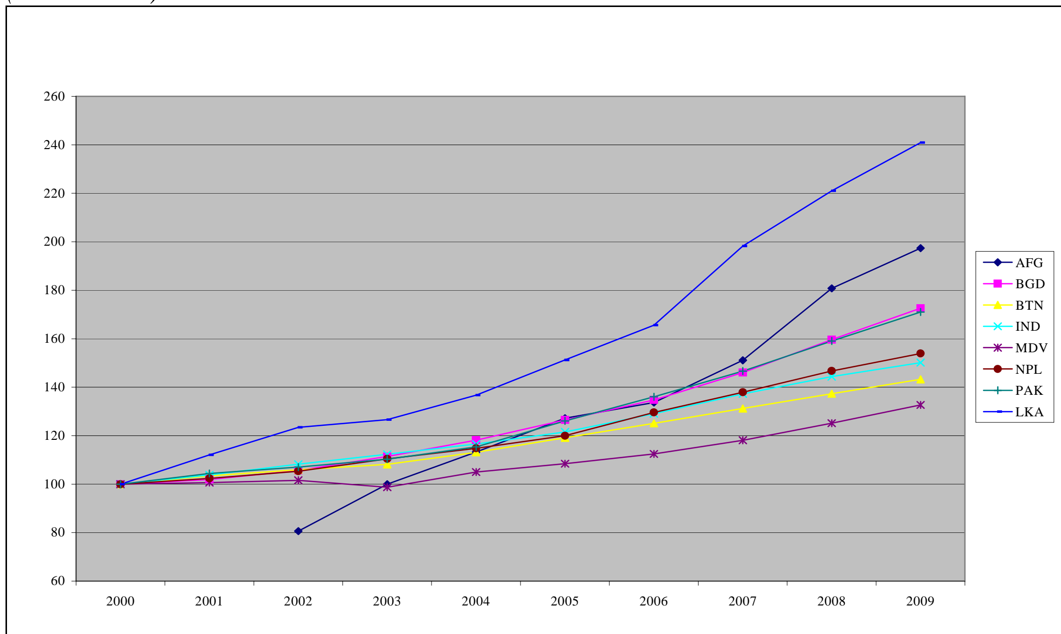
**Figure 4 SAARC: GDP per capita (PPP)**
*(current international $)*




Source: IMF, World Economic Outlook database, April 2008.

## Figure 5 SAARC: Average Consumer Prices

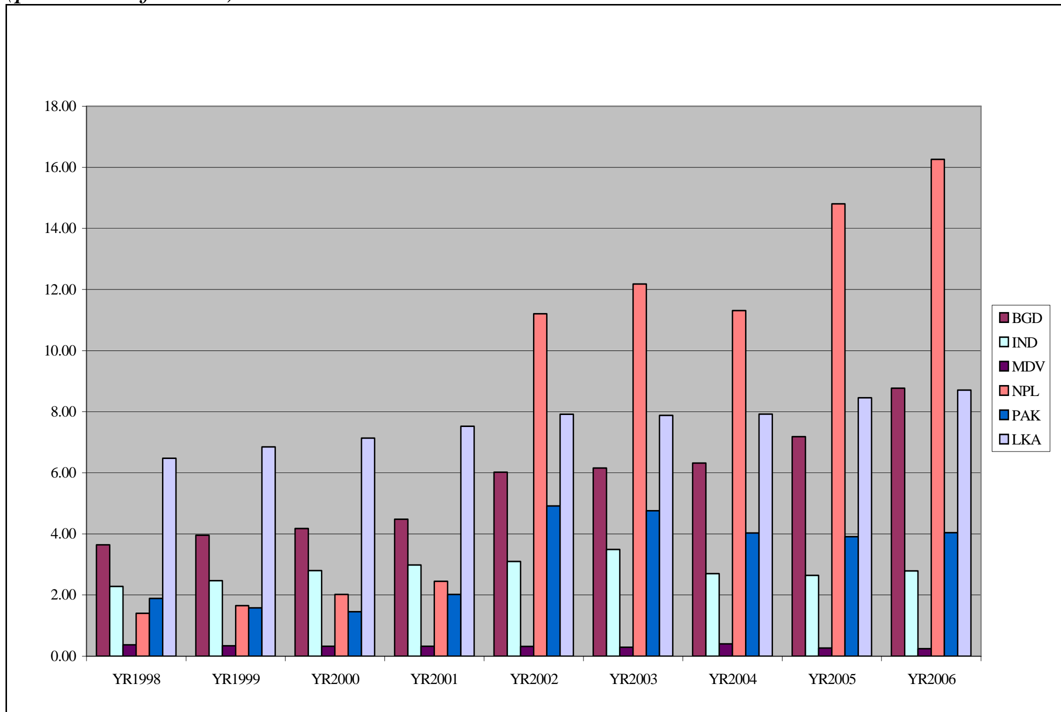
*(2000=100)*




Source: IMF, World Economic Outlook database, April 2008.

## Figure 6 SAARC: Workers' remittances

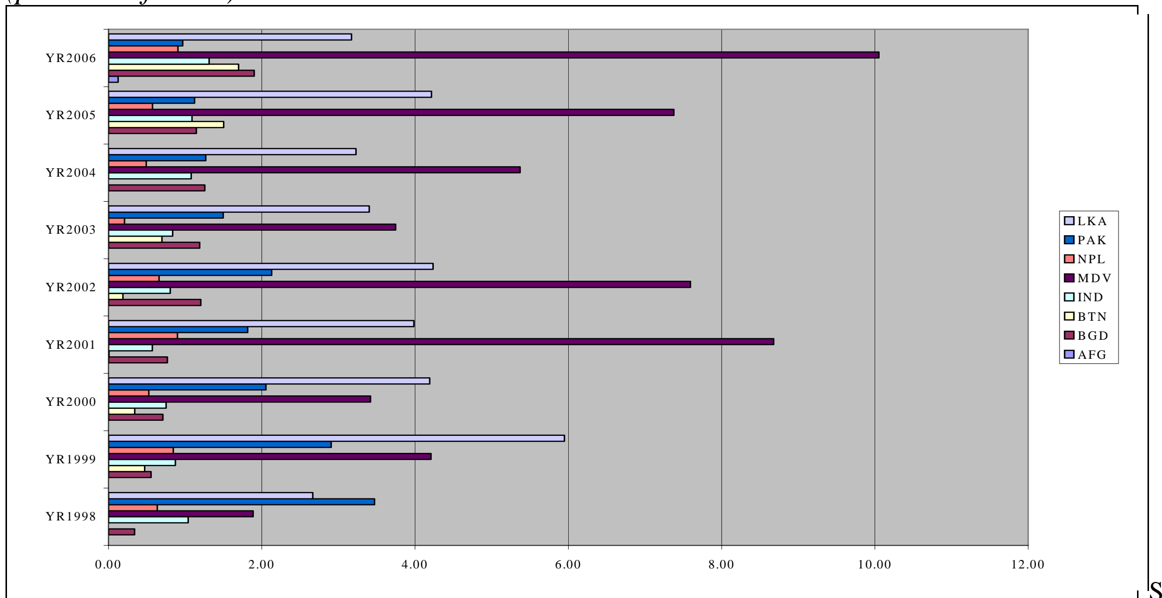
*(per cent of GDP)*




Source: World Bank, World Development Indicators, Online statistical database, August 2008.

## Figure 7 SAARC: Short-term external debt

*(per cent of GDP)*

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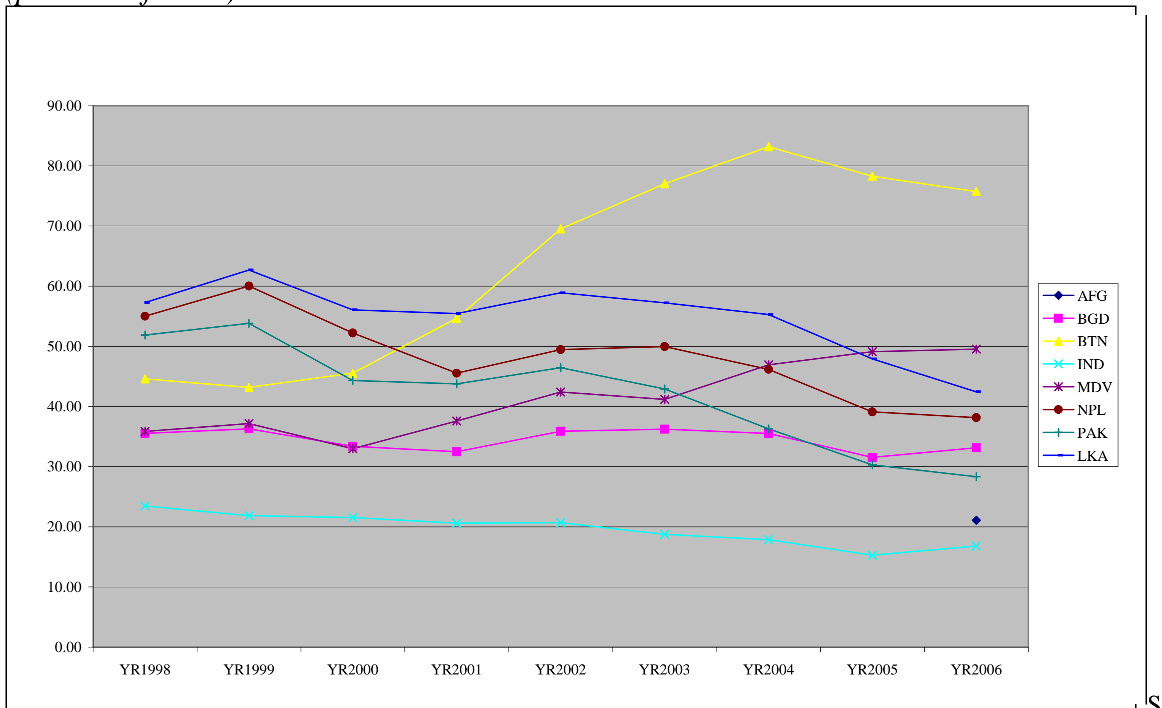
ource: World Bank, World Development Indicators, Online statistical database, August 2008.

## Figure 8 SAARC. Total external debt

*(per cent of GDP)*

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ource: World Bank, World Development Indicators, Online statistical database, August 2008.