

# 1. INTRODUCTION

This issue of the *South Asia Economic Report* assesses the recent performance and outlook for South Asia's financial sector against the backdrop of a deteriorating outlook for the region. Countries in South Asia have diverse financial sector, from Afghanistan, which is still rebuilding basics after decades of conflict, to India, which has all the elements of a modern financial system.

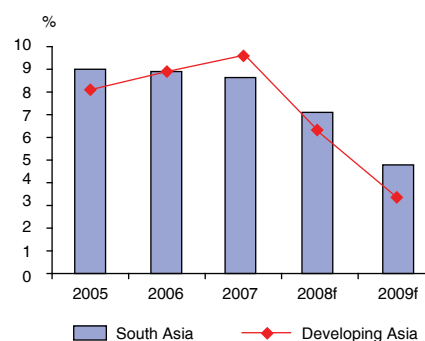
Common themes throughout the region are ongoing reforms to enhance legal foundations for financial services and commercial transactions, and evolution toward best practices in the regulation and supervision of financial institutions and markets. All countries have a legacy of significant state ownership and direct government intervention in their financial sector, which generally remains prevalent today. Progress to date in financial sector reform and the extent of the outstanding development agenda are major determinants of resiliency as South Asia's economies face decelerating growth.

Economic performance in developing Asia is slackening following an annual gross domestic product (GDP) expansion of 9.5% in 2007, the highest growth in the last two decades (Figure 1). South Asia's performance will follow the same trend, with GDP growth moderating to 4.8% in 2009. The anticipated deceleration is linked to the global economic slowdown brought about by the weakening of the world's major economies, particularly the European Union, Japan, and United States. Inflationary pressures experienced until mid-2008—caused by rising food and oil prices—also are expected to slow growth in developing Asia.

The outlook for South Asia is subject to considerable downside risks arising from rapidly deteriorating expectations for the world's major economies. As prospects dim in Europe, Japan, and the United States, South Asia's economies face potential declines in exports and remittances, which, in turn, will dampen domestic consumption. Foreign direct investment is likely to decrease, and banks and corporations in South Asia that have tapped international financial markets are being negatively affected by the global tightening of liquidity.

The still-unfolding global financial turmoil is highlighting underlying weaknesses in the world's financial sector. South Asia's banking systems were largely insulated from the immediate causes of turmoil in 2008, having no direct exposure to United States subprime assets, limited exposure to complex financial instruments, and generally liquid banks with a high proportion of funding by domestic deposits. Decelerating growth, however, is bringing into sharp focus the risks of homegrown credit bubbles in Bhutan, Maldives, Nepal, and Sri Lanka. Nonbank financial institutions throughout the region are emerging as key concerns for two reasons: (i) those dependent on wholesale funding are facing liquidity shortages, and (ii) those raising deposits from the public (which is common in South Asia) are generally subject

**Figure 1: Gross Domestic Product Growth in Developing Asia and South Asia**  
(% annual change)



f = forecast.

Source: ADB. 2009. *Asian Development Outlook 2009*.

to a less stringent prudential regime than are banks. South Asia's capital market performance has largely tracked global stock market trends, illustrating that markets remain highly correlated despite earlier hypotheses of decoupling.

Weak loan-loss provisioning standards—common in the region—may result in an overly optimistic view of banking systems' resiliency throughout South Asia. In many South Asian countries, the continued prevalence of state-owned institutions is a double-edged sword. Government ownership can help maintain confidence and ensure stability, but at the same time, state-owned institutions have tended to be inefficient and susceptible to political influence, often incurring large losses ultimately borne by taxpayers. Furthermore, they are not good at developing innovative products and effective leveraging of resources.

The balance of this report explores these issues for individual countries and the region as a whole. Section 2 begins with an overview of the region's financial sector, comparing and contrasting their structures, performance, and levels of development. The section continues with an assessment of financial stability, followed by commentary on the infrastructure for financial services and outreach of the formal financial sector. It concludes with a summary of key finance sector reform issues for the region. Section 3 supplements this crosscutting analysis with a brief overview of key issues, structure, outreach, and the reform agenda for each South Asian country.