

FOREWORD

We are pleased to present the fourth issue of the *South Asia Economic Report* (SAER), a series of reports on economic and development issues in South Asia. Each SAER provides an update on South Asia's economy and examines an important development issue. The theme of the fourth SAER is "South Asia's Financial Sector: Recent Developments and Challenges."

SAERs present findings based on reviews and analyses of relevant development issues, with a particular focus on policy reforms across South Asia, targeting policy makers in the region. The theme of the first SAER, published in October 2006, was "Banking, Governance, and the Investment Climate." The second, issued in June 2007, featured "Social Sectors in Transition: Accelerating Inclusive Growth and Human Development" and covered education and health. The theme of the third SAER, issued in December 2007, was "Foreign Direct Investment in South Asia."

This SAER assesses the recent performance and development of South Asia's financial sector against the backdrop of a deteriorating outlook for the region. It presents an overview of current developments in South Asia's financial and capital markets and then surveys developments and identifies issues in each of the region's eight financial markets. For each country, issues that need to be addressed to advance market development are identified, and policy recommendations aimed at developing a robust financial system to support sustainable economic growth are provided.

South Asia's economic growth has been strong, driven by a buoyant services sector and solid investment demand. To sustain high growth, countries in the region must increase savings and investment through financial deepening or financial development. Enhancing saving rates through financial development is crucial, particularly considering the expected declines in remittances and foreign direct investments as well as possible liquidity squeezes from global financial turmoil. Financial development can also contribute to poverty reduction by expanding financial services and increasing the poor's access to and use of these services.

Recent years have seen South Asian countries embark on development of their financial markets through financial liberalization and banking sector and capital market reform. Although liberalization and reform have led to the deepening of domestic financial markets in the region, challenges remain, including the lack of legal foundations for financial services and commercial transactions, the failure to apply best practices in regulation and supervision of financial institutions and markets, and limited outreach of the formal finance sector.

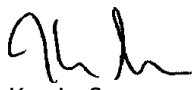
Policy recommendations, which have particular poignancy given the effects of the global financial turmoil, are provided to address these challenges and to deepen and develop South Asia's financial markets

further, thereby helping them accelerate economic growth and alleviate poverty. These recommendations include (i) prudent fiscal policies; (ii) strengthening the legal foundation and government infrastructure; (iii) lifting nonprudential restrictions; (iv) reforming and privatizing state-owned financial institutions; (v) removing remaining capital account restrictions; (vi) improving the quality and application of accounting standards; (vii) bringing the legal framework and prudential standards for the finance sector fully in line with international best practices; (viii) building policy development and supervisory capacity, particularly in nonbank sectors such as insurance and pensions; (ix) establishing an appropriate legal framework for microfinance; and (x) supporting credit bureau development.

We hope that this SAER will help all stakeholders—especially policy makers—appreciate important global and regional trends and take effective, proactive steps to capitalize on opportunities and to mitigate risks through the development of financial and capital markets. This SAER also aims to provide background information on these markets for further in-depth analyses.

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