Chapter 3
Financial Sector Reforms in South Asian Countries

Amir Manzoor
Bahria University, Pakistan

ABSTRACT

Several far-reaching reforms to the financial sector were introduced by South Asian countries in early 1980. The nature and progress of these reforms vary from country to country. These reforms covered a number of areas such as promoting competition in the financial sector, developing payment and settlement systems, and strengthening regulations. So far, these reforms have not only helped South Asian countries to significantly raise domestic savings, attract foreign capital, and raise economic growth rates but also provided greater economic integration of South Asia. This chapter performs a close re-scrutiny of the reforms implemented in South Asian countries. Suggestion for further reforms for building efficient, competitive, and resilient financial sector is also provided.

INTRODUCTION

Several far reaching reforms to the financial sector were introduced by South Asian countries in early 1980. The nature and progress of these reforms vary from country to country. These reforms covered a number of areas such as promoting competition in the financial sector, developing payment and settlement systems, and strengthening regulations. So far, these reforms have not only helped South Asian countries to significantly raise domestic savings, attract foreign capital, and raise economic growth rates but also provided greater economic integration of South Asia.

East Asian financial crisis resulted in providing greater space for these new reforms. Another round of reforms took place in the 1990s. The 2007 financial crisis, which began in the U.S. sub-prime mortgage market, has already prompted a reassessment of financial sector policy making globally to address many of the weaknesses in supervisory, regulatory and prudential frameworks (Berkmen, Gelos, Rennhack, & Walsh, 2009).

The beginning of the current global crisis was associated with complex financial products. South Asian financial sector didn’t have direct exposure to such products. Still the global financial crisis caused
Financial Sector Reforms in South Asian Countries

a considerable slowdown of South Asian economies as a result of contagion effects of global shocks. Some of the significant channels that affected South Asian economies were capital, remittances, credit and international trade. Capital outflow, reduced foreign remittances, dried up international credit markets, and reduced exports have had serious implications for these economies (Griffith-Jones & Ocampo, 2009).

The objective of this chapter is to perform a close re-scrutiny of the reforms implemented in South Asian countries in the context of developments that took place after global financial crisis. The chapter also examines the room for further reforms that might be necessary for building efficient, competitive and resilient financial sector. Such a sector would play a key role in putting South Asian economies to the path of sustainable high growth. According to (World Bank, 2014), India set the pace for regulatory reform in South Asia in 2013/14 India with 20 - the region’s largest reforms during the period. India was followed by Sri Lanka with 16 reforms while three countries - Bangladesh, Nepal, and Pakistan - focused their efforts on adopting modern electronic systems to facilitate business activity. Therefore, many examples, with respect to various reforms, provided in this chapter will be from India as it is expected that other south Asian countries will follow the similar path.

STRENGTHS AND FLAWS OF SOUTH ASIAN FINANCIAL SECTOR

Various strengths of current South Asian financial structure were pivotal in lessening the direct impact of the global financial crisis on South Asia. Some of the notable strengths were healthy reserves, improved export performance and enhanced risk-taking capabilities of financial institutions. These strengths were supported by previous financial reforms. The outlook over the next years for South Asia indicates broad economic stability and a pick-up in growth with potential risks concentrated on the fiscal and structural reform side. Future growth will increasingly depend on strong investment and export performance (Griffith-Jones & Ocampo, 2009).

Exports have recently shown a strong export performance in many South Asian countries, growing in the double digits in several of them. While sales abroad were boosted by favorable tailwinds, such as the depreciation of the Indian rupee in 2013, there are also deeper trends at play. Export diversification by type of product increased, as did the share of emerging markets in total exports. These are manifestations of an increasingly stronger position of the region in global markets (World Bank, 2014). In Bangladesh, A rise in export growth helped to lower the trade deficit, and foreign exchange reserves continued to accumulate despite the 1.6 percent decline in remittance. In Bhutan, Hydropower generation (river-flow dependent) in the first half of 2014 was 2 percent (annualized) down on the same period of 2013 due to weaker rainfall. As a result, export revenues from the sale of electricity declined. In India, the exchange rate has remained stable since last year’s depreciation, which stimulated exports and slowed imports. In Sri Lanka, robust performance of exports contracted the trade deficit for the first half of the year to 4.6 percent of GDP.

Most South Asian countries solidified their foreign reserve positions. Benefitting from strong capital account inflows and a stable and manageable current account balance, India saw its foreign exchange (FX) reserves increase from an estimated US$ 276.4 billion in FY2013/14 to 321.1 billion projected for FY2014/15. Bhutan built up an impressive 17 months of import coverage reserve by June 2014, with the only caveat that 83 percent of them are in convertible currencies while it is mainly Indian rupees which are required for trade settlement and debt service. Nepal continues to maintain extraordinarily high reserve levels, most recently above 10 months of import coverage. Afghanistan’s FX reserves stood slightly