



## Evaluation Information Brief

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# Lessons from the Asian Development Bank's Responses to Financial Crises

Independent Evaluation Department  
**Asian Development Bank**

## ABBREVIATIONS

ADB	–	Asian Development Bank
DMC	–	developing member country
IBRA	–	Indonesian Bank Restructuring Agency
IED	–	Independent Evaluation Department
IFI	–	international financial institution
KAMCO	–	Korean Asset Management Company
Lao PDR	–	Lao People's Democratic Republic
OCR	–	ordinary capital resources
TA	–	technical assistance
TAMCO	–	Thai Asset Management Company

## NOTE

In this brief "\$" refers to US dollars.

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## Executive Summary

The Asian Development Bank's (ADB) past crisis assistance has generally been effective in helping restore investor confidence in affected developing member countries (DMCs) through a combination of liquidity and policy support. Reform programs were implemented over a comparatively short time under difficult circumstances. Assistance was most useful when accompanied by crisis-related policy dialogue with due attention to government priorities and implementation capacity. Although it was often difficult at the outset to determine the full extent and nature of support needed, ADB's responsiveness and flexibility helped meet rapidly evolving client requirements. Despite the different origins and transmission mechanisms of the current global crisis, a number of the lessons identified below in conjunction with past ADB crisis assistance might be relevant for the design and implementation of crisis responses.

- Previous crisis support was mainly in the form of quick-disbursing funds to augment foreign exchange reserves and liquidity, and to supplement budgetary resources. This worked well in maintaining and restoring investor confidence. More importantly, policy-based lending helped demonstrate commitment to longer term structural adjustment. Policy dialogue on issues with a causal relationship to the crisis was more successful.
- It is likely that support for countercyclical investment programs will feature in ADB's assistance for the current crisis. Timely implementation will be important for the effectiveness of such assistance.
- Support for maintaining access of the poor to social services (mainly health and education) and for maintaining the quality of such services was generally effective, provided that established or uncomplicated programs and delivery channels were used.
- Temporary market-based credit support sought to prevent viable enterprises from failing for lack of access to working capital and trade finance. However, utilization of such assistance stayed considerably below expectations due to interest and exchange rate developments and the availability of alternative funds.
- During a crisis, vital decisions often have to be made in the absence of full information, under rapidly deteriorating conditions and under substantial pressures from stakeholders. There is often a trade-off between finding the best solution, speed, and political acceptability.
- The potential for systemic problems in the financial sector needs to be identified early and addressed credibly and decisively to restore confidence. The fiscal impact of liquidity support and government guarantees needs to be carefully considered.
- Liquidity support and government assistance for failing financial institutions need to be guided by a comprehensive, transparent, credible, and well-communicated strategy that clearly spells out the basic principles.
- The restructuring of financial institutions needs to consider long-term sector efficiency and innovation, and linkages with real sector reforms/restructuring and the overall macroeconomic environment.
- Aid coordination may not be easy but is vital for crisis support.

## A. Context

1. The current global financial and economic crisis originated primarily outside Asia. Only a few developing member countries (DMCs) have been directly exposed to subprime mortgage debt and failing foreign financial institutions, or have built up large short-term external debt positions that make them more vulnerable to external shocks, particularly in the presence of other macroeconomic problems. Nevertheless, most DMCs have been affected by (i) a reversal of foreign portfolio investment and liquidity constraints in international funding markets, which has been reducing liquidity in domestic banking systems and corporate access to funding and foreign currency, including trade finance, and increased interest rates; and (ii) a decline in export markets and remittances. This has been having knock-on effects on economic growth, corporate and banking sector performance, fiscal revenues, and employment. Reforms implemented since the 1997 Asian financial crisis have been largely successful and have contributed to increased financial system stability and resilience in many DMCs. While systemic banking sector failures are not likely in most DMCs, collapses of banks and other financial institutions might occur in countries with continuing structural issues. Any slowdown in economic growth with rising unemployment and reductions in education and health-related expenditures due to shortfalls in fiscal revenues will translate into increases in poverty levels. DMC governments and central banks, through fiscal stimulus programs and interest rate reductions, have been seeking to encourage domestic consumption to replace export demand. Countries might require external liquidity support to weather the crisis or budgetary support to implement countercyclical stimulus and social expenditure programs. DMCs with structural problems will also need support for broader sector reforms that can restore confidence.

2. Proposed Asian Development Bank (ADB) responses<sup>1</sup> to the current crisis, accordingly, include (i) the provision of fast-disbursing budget support to eligible DMCs to meet their short-term liquidity requirements; (ii) the provision of short-term finance and capital to vulnerable banking systems; (iii) financial and technical assistance to support sector reforms/adjustment; (iv) expansion of support for public investment programs in the social and infrastructure sectors, including through increases in ADB's funding share in investment projects and the mobilization of additional cofinancing; (v) support for social safety nets; (vi) trade finance facilities; and (vii) an expansion of guarantees to foreign banks and/or private investors.

3. The current crisis differs in many aspects from previous crises experienced by DMCs, not only in terms of its causes, but also with regard to impact and possible resolution strategies. For example, in lieu of the tight monetary and fiscal policies implemented during the 1997 Asian currency cum banking crisis, authorities are seeking to combat the impact of the current global crisis through interest rate reductions and increases in government spending and fiscal stimulus programs. Domestic consumption is being encouraged, as export expansion is not a viable option in the medium term. Nevertheless, relevant lessons can be drawn from ADB assistance provided during the Asian financial crisis to Indonesia, the Republic of Korea (henceforth Korea), and Thailand, and to a much lesser extent from ADB responses to DMCs experiencing fiscal and balance of payments problems, including India in the aftermath of the 1990 Gulf crisis, when ADB provided quick disbursing loans; Pakistan during 2000, when ADB provided policy-based support for industry and trade sector reforms, and a trade finance facility; as well as countries experiencing a general banking crisis, particularly Mongolia during 1996 and 1998, which ADB sought to address through financial sector program loans.

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<sup>1</sup> ADB. 2009. *Global Financial Crisis and Proposed ADB Response*. Manila, and ADB. 2009. *The Global Economic Crisis: Challenges for Developing Asia and ADB's Response*. Manila.

4. The 1997 crisis was caused by (i) structural problems of domestic financial and corporate systems that facilitated asset bubbles and large inflows of unhedged short-term foreign currency borrowings, and (ii) a currency/capital account crisis that ensued after slowdowns in economic growth reversed capital inflows and currencies of countries with high current account deficits and overvalued exchange rates came under speculative attack. Government responses then focused on (i) addressing structural problems through bank and corporate restructuring, improvements in corporate and financial governance, and the development of capital markets; and (ii) stabilizing the economy through monetary and fiscal tightening, and export-led growth. ADB support sought to assist DMCs with structural reforms through policy-based lending, the provision of liquidity support, and the mitigation of social impacts through budgetary/project support and policy conditionality related to transfer payments and social expenditure budgets (in Indonesia and Thailand). In Thailand, ADB also provided a trade finance facility to help enterprises overcome problems in accessing export finance.

5. This paper draws on lessons identified in conjunction with previous ADB crisis support in various evaluation studies undertaken by the Independent Evaluation Department (IED) and project/program completion reports prepared by regional departments, which are listed in the appendix. This analysis has been supplemented and updated by IED staff to enhance relevance to the current crisis.

## **B. Relevant Lessons Related to Specific Issues**

### **1. Increased Lending**

6. In response to the Asian financial crisis, ADB restarted its lending in the Republic of Korea, and substantially increased lending volumes in Indonesia and Thailand. In total, \$7.1 billion in crisis support was approved for these three countries, of which \$5.4 billion was disbursed under various program loan tranches between December 1997 and January 1999. Program loans were frontloaded to ensure that liquidity/balance of payment support was readily available when most needed to help avoid a further deterioration of economic conditions. Despite these large lending volumes, IED found no evidence that ADB's emergency lending during the Asian financial crisis crowded out ordinary capital resources (OCR) lending to other DMCs in the period following the crisis, although it might have increased OCR loan charges for all borrowers.

### **2. Financial Sector Support**

7. Unlike in the United States, where the crisis will likely lead to a demise of stand-alone investment banking and the originate-to-distribute banking model, the structure of most DMC financial systems, with their predominance of traditional commercial banking, is not going to change fundamentally in the immediate future. Also, financial instruments that facilitated high leverage and funding mismatch in the more developed countries, such as collateralized debt obligations, structured investment vehicles and credit products, and asset-backed commercial paper, and have not been introduced yet in the majority of DMCs, given their stage of financial sector development, and there has been significantly less reliance on wholesale funding and credit enhancements. Nevertheless, the impact of tighter liquidity and reduced economic growth is likely going to affect asset quality in DMC financial institutions, particularly in countries that had experienced rapid credit growth and considerable risk-taking in recent years. Also, looking ahead, there will likely be changes in the way financial markets are regulated worldwide, which will affect financial market regulation in DMCs.

### a. Dealing with Liquidity Constraints and Failing Financial Institutions

8. While it is unlikely that the current global crisis will result in systemic failures of DMC banking systems, in some cases there might be need for crisis containment, restructuring, and reform. Experience gained during the Asian financial and other banking crises can be helpful in this regard. ADB supported the restructuring of banking systems in Indonesia, Republic of Korea, and Mongolia as well as the restructuring of merchant banks in Korea and of finance companies in Thailand. ADB also assisted in the restructuring of state banks in a number of other DMCs under noncrisis conditions.

9. **Potential for systemic problems needs to be identified and addressed early, credibly, and decisively to restore confidence, taking into consideration longer term fiscal impact.** Experience indicates the need to act quickly and decisively on deteriorating financial sector conditions. Initial crisis estimates generally turned out to be too optimistic and often led decision-makers to postpone inevitable interventions. Liquidity problems can turn into solvency problems if left unaddressed. Central bank liquidity support is usually the first line of defense, particularly in situations when banks are experiencing liquidity problems due to deteriorating macroeconomic conditions rather than solvency problems. However, indiscriminate and unlimited liquidity support in the absence of adequate banking supervision increases the potential for more loss-incurring transactions and causes delays in addressing underlying structural problems, as experience in Indonesia has shown.

10. Similar considerations apply to the provision of blanket guarantees.<sup>2</sup> Blanket guarantees increased the potential for moral hazard, particularly in the absence of complementary measures such as interest rate caps. Also, the trade-off between short-term confidence-building measures and longer term fiscal impact has to be carefully assessed.<sup>3</sup> Timing is critical. In Indonesia, the initial closure of 16 banks in the absence of full depositor protection in a volatile macroeconomic environment contributed to loss of confidence in the system.<sup>4</sup> However, even the subsequent introduction of a blanket guarantee, while slowing down deposit withdrawals, did not prevent further bank runs that appeared to be, at least in part, politically motivated. As in Indonesia, there is some evidence from Thailand that blanket guarantees were not fully effective in preventing a migration of deposits from private sector banks to perceived low-risk banks, including state banks. In the case of Indonesia, this trend was stopped only after a comprehensive bank restructuring and recapitalization plan was announced.<sup>5</sup>

11. During a crisis, vital decisions often have to be made in the absence of full information, under rapidly deteriorating conditions, and under substantial pressures from stakeholders. There is often a trade-off between finding the best solution, speed, and political acceptability. Nevertheless, it is important to try to distinguish between deeply insolvent, nonviable banks, which need to be closed down as soon as possible, and salvageable banks. Depending on the quality of available information, international-standard audits based on in-depth portfolio reviews might have to be conducted to identify the depth and nature of problems, enable decision-makers to take actions, and ensure fairness in the treatment of private institutions, although it

<sup>2</sup> The provision of blanket guarantees was not advocated by ADB, but implemented by Indonesia, Korea, and Thailand.

<sup>3</sup> International evidence on the usefulness of guarantees for all bank liabilities in minimizing the economic fallout associated with a banking crisis is inconclusive.

<sup>4</sup> ADB was not involved in this decision.

<sup>5</sup> ADB. 2004. *Presentation on Challenges for Deposit Insurers Post-Banking Crisis: Experience in Asia (with focus on Indonesia, Malaysia, Thailand)*. Manila.

needs to be recognized that such audits/assessments tend to take a conservative view on asset quality under uncertain conditions.

12. Government and central bank actions need to be guided by a comprehensive, transparent, credible, and well-communicated agreed-upon strategy that clearly spells out basic principles of liquidity support and government assistance. Although resolution strategies in Indonesia, Republic of Korea, and Thailand were based on similar principles—i.e., the closure of nonviable financial institutions and the transfer of their assets and liabilities to stronger private institutions under purchase and assumption agreements or government-owned bridge institutions; remedial action plans for undercapitalized but solvent banks; and the recapitalization of insolvent but viable institutions—outcomes were different, which is in part explained by how these strategies were timed, implemented, and communicated. Experience in Indonesia shows that ad hoc, intermittent support increases instability. Markets only settled upon the announcement of a comprehensive resolution and recapitalization strategy based on uniform and transparent criteria after much delay, mainly due to political constraints. In Thailand, the closure of finance companies, which accounted for more than 10% of financial sector assets, in the absence of state guarantees for their liabilities and designated bridge institutions to take over their performing assets, resulted in substantial follow-on effects for the financial system. By comparison, the Republic of Korea developed comprehensive resolution strategies for commercial and merchant banks in a timely fashion, which addressed the concerns of depositors and other creditors. Implementation of these strategies was also facilitated by the comparatively smaller number of financial institutions. However, the case of Korea shows that even with successful initial restructuring, there might be need for further restructuring, particularly if the economy continues to deteriorate. Managing a systemic banking crisis is a complex process that can take several years and needs to take into consideration overall macroeconomic conditions.

13. **Bank restructuring needs to consider long-term sector efficiency and innovation.** Any bank restructuring in the wake of a systemic failure should seek to maintain some private sector interest in the running of the banking system to the extent feasible and defensible, particularly with regard to banks whose financial condition has deteriorated due to systemic failure rather than imprudent practices. In Indonesia, where state banks already accounted for a large share of banking sector assets prior to the crisis, maintaining some private sector ownership and interest in the system despite widespread insolvency, together with measures to promote foreign strategic investment, reduced the need for government funds and management resources, and helped speed up recovery. The share of private sector banks in the system now exceeds precrisis levels. During the financial restructuring process in Korea, bank mergers and foreign investment were also actively encouraged to improve the long-term efficiency of the financial system. Large-scale nationalizations, if unavoidable, should be as short-term as possible. ADB evaluation results for the Lao People's Democratic Republic (Lao PDR) and Mongolia confirm international experience, which is that the restructuring of state banks is difficult, as state-owned financial institutions can be pressured to provide loans for government programs, projects, and enterprises that would not merit financing on purely commercial considerations.<sup>6</sup> Where restructuring under government ownership has worked, factors and conditions associated with success included strong incentives for proper governance and management, including operational autonomy and performance-based management contracts and remuneration, and competition from private sector entities on a level playing field. Government commitment to ensuring the transparency and effective governance of the bank

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<sup>6</sup> International audits conducted during the crisis in Indonesia found that state banks had substantially higher levels of nonperforming loans than private sector banks.

restructuring process is essential. When recapitalizing banks, it is important that the downside is as clearly established as possible with the help of portfolio reviews and stress testing. Incomplete recapitalizations and/or recapitalizations without appropriate management incentives usually lead to additional recapitalization needs in the future, as ADB experience with recapitalization programs in India, Lao PDR, and Mongolia showed. Finally, it needs to be recognized that political economy factors that contributed to structural sector problems are likely to affect the implementation of crisis responses as well.

**14. Choose appropriate debt/asset restructuring mechanisms.** The transfer of nonperforming loans to asset management companies was an integral part of past financial sector restructuring efforts. ADB supported the establishment of central asset management and restructuring agencies in its policy dialogue. ADB-financed advisory services for the capacity development of the Korean Asset Management Company (KAMCO) were effective and contributed to an estimated recovery rate of 55% of the book value of transferred assets. By comparison, recovery rates of the Indonesian Bank Restructuring Agency (IBRA) and the Thai Asset Management Company (TAMCO) were 28% and 49%, respectively, although cash recoveries, in the case of TAMCO, were considerably lower. The relative success of KAMCO is attributed not only to the better economic environment in which it was operating, but also to its use of a variety of disposition strategies that considered the different characteristics of the assumed assets and their obtainment of as many purchase bids as possible.<sup>7</sup> Better governance structures might have also accounted for differences in performance. IBRA was subject to considerable political pressures. One of the lessons gained is that whoever is assigned responsibility for debt restructurings needs to have adequate capacity and incentives. Political will to recognize losses and create a transparent resolution process with accountability and proper governance is essential for success. Debt recovery by financial institutions can be problematic if debt recovery frameworks are not functional, or if there are no effective out-of-court settlement mechanisms. ADB policy dialogue during the Asian crisis also promoted improvements in the legal framework for debt recovery. However, although bankruptcy legislation was amended several times in Thailand, it is still perceived by investors as overly debtor friendly. New bankruptcy legislation in Indonesia is largely in line with international standards, but bankruptcy decisions are deemed to be influenced by political and other considerations due to continuing deficiencies in judicial enforcement. Only in 2006 did Korea finally approve creditor-friendly bankruptcy laws. According to World Bank estimates, by 2003 out-of court debt restructurings as a share of total debt ranged from 48% in Thailand and 56% in Indonesia to 95% in Korea.

**15. Consider linkages between real and financial sectors.** The success of banking sector reforms is often dependent on reforms elsewhere in the economy, such as in the corporate sector. For example, in Korea, the government's willingness to allow ailing chaebols to fail, and its commitment to tackling weaknesses in the corporate sector were essential for the success of the financial sector reforms.

#### **b. Provision of Credit Facilities**

**16. Assess effective demand.** During severe credit crunches, temporary market-based credit support, particularly for working capital, may be necessary to prevent viable enterprises from failing for lack of liquidity. However, externally funded financial intermediation loans might not necessarily be useful in addressing such credit needs. ADB experience in Thailand showed

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<sup>7</sup> Federal Reserve Bank of San Francisco. 2008. *Asian Asset Management Companies in Retrospect in Asia Focus, September 2008*. San Francisco.

that volatile macroeconomic conditions and associated interest and exchange rate changes rendered foreign currency-denominated funding unattractive. Also, credit discipline might be impacted by government interventions. Subloan repayments under a credit line that was processed during the financial crisis in Thailand to support rural enterprises were subsequently affected by a general 3-year government moratorium on debt repayments to ameliorate rural indebtedness due to the crisis. Also, the intermediation capacity of participating institutions tends to decline during a financial crisis due to increasing levels of nonperforming loans, risk-averse behavior, and changing priorities of management.

### **c. Trade Finance Facilities**

17. **Respond quickly to changing market conditions.** ADB facilities and guarantees provided in Pakistan and Thailand under crisis conditions to enhance the availability of trade finance have been less than successful, with utilization staying significantly below expectations, mainly because market conditions changed substantially between the processing and implementation of ADB assistance.<sup>8</sup> Timing is crucial, and processing requirements and project design should recognize that external support might be required only for short periods. Soon after the facilities became effective, monetary conditions eased, banking sector liquidity increased, and domestic interest rates fell below the funding costs associated with ADB financing. As with other financial intermediation facilities, demand has to be carefully assessed, taking into consideration all major risk factors, including the availability of alternative sources of funds and potentially adverse interest and exchange rate developments. Limited flexibility in repricing ADB's relending rate contributed to a lack of demand. While market-based pricing is necessary, care needs to be taken not to discourage private sector mechanisms once the liquidity situation improves. The announcement of the \$1 billion export financing facility by ADB and its cofinanciers helped restore investor confidence in Thailand's financial market, signaling that country's return to the international financial market. However, the large size of the facility increased the probability of out-of-line actions by one of the 68 cofinanciers and slowed down implementation. In a crisis period, a series of small-scale syndicated facilities, which can be replicated if successful, might be more effective than large-scale ones, as they can safeguard against out-of-line actions by individual cofinanciers and facilitate agreement on the adjustment of terms in response to volatile market developments. Another lesson is that ADB guarantee coverage for trade finance facilities should be chosen to adequately address market failure.

### **d. Assistance for Capital Market Development**

18. ADB's financial sector crisis support in Thailand focused on capital market development, and sector support in other crisis-affected countries included smaller related components. Emerging capital markets get quickly affected when economic performance deteriorates and portfolio investment inflows reverse. In turn, declining share values also affect the ability of companies to finance themselves through the market and the value of financial institutions' holdings in listed shares. Evaluation findings indicate that there are no quick fixes for declining markets.<sup>9</sup> Also, assistance for capital market development was most effective when it was part of a longer term engagement, integrated with government reform initiatives that were supported by all relevant stakeholders, and guided by long-term strategies that linked capital market

<sup>8</sup> Although both facilities were processed within 3 months, loan effectiveness was delayed by another 3 months due to documentation issues.

<sup>9</sup> Measures that can help increase market capitalization within a short time, e.g., the removal of investment restrictions, tax measures, and the divestment of state enterprises, are not very effective during a crisis scenario. Also, the timing of state divestments needs to be considered in conjunction with fiscal revenue targets.

reforms to overall financial system development; reform of the overall enabling environment; and, in the case of bond markets, fiscal and debt management frameworks. Nevertheless, there are a number of assistance areas that merit special attention during a crisis.

19. **Consider the impact of a crisis on bond market development.** Countries with well functioning and liquid local bond markets are likely to cope better with shocks and the risks stemming from a protracted global credit crisis. Accordingly, ADB intensified its support for the development of regional bond markets after the Asian financial crisis. However, although ADB crisis interventions in Korea and Thailand included support for bond market development, ADB, perhaps understandably at the time, did not anticipate large government bond issues in conjunction with financial sector recapitalization, and therefore did not provide any assistance on related issues. In Indonesia, which did not issue any government bonds prior to the crisis, ADB assumed that bond market development would emerge from the development of mortgage-backed securitization and provided related support, which was unsuccessful, given prevailing market conditions and deficiencies in the underlying legal framework.

20. **Consider support for the development of domestic institutional investors.** Although foreign portfolio investment has generally been good for domestic market development efforts and is likely to return in the medium term, a crisis might reinforce the need to develop the domestic institutional investor base. In Indonesia, Korea, and Thailand, ADB had substantial policy dialogue and provided technical assistance (TA) to initiate pension reform or improve the regulation and supervision of pension funds and insurance companies. While efforts in Korea and Thailand led to some expansion of institutional investment, ADB assistance in Indonesia has been ineffective in expanding the role of institutional investors in capital markets. IED's review of the effectiveness of related support in other DMCs found that improvements in the regulatory framework for pension funds and insurance companies and a liberalization of investment restrictions did not necessarily translate into more capital market investment, which was mainly due to the noncommercial orientation of large state institutions and their role as captive investors. Future efforts need to focus more on strengthening the governance and asset management skills of public institutions while facilitating market growth of private pension and investment funds and insurance companies and the development of related supervisory capacity. These measures will also facilitate strengthening and wider reforms of social security systems in the region, which will help reduce high savings rates and increase domestic consumption.

#### e. **Strengthening Financial Sector Regulation**

21. **Strengthen regulation and prudential requirements for financial institutions in line with systemic risk and exposure to retail clients.** A lot of progress has been made since the last financial crisis in strengthening the legal and regulatory framework for financial market operations. However, evaluation findings indicate that to be effective and sustainable, assistance for the development of legislation and regulations needs to be complemented by support for enforcement capacity through policy dialogue on the independence and resources of regulators, the development of improved incentives and governance mechanisms for (self) regulatory and judicial bodies, the use of meaningful benchmarks including progress towards international standards, and adequate resources and surveillance systems for regulators, all of which requires considerable time and political commitment, as well as sustained advisory services and training. International standards are going to be upgraded in light of the current crisis and will likely involve strengthening of capital requirements and risk management practices, particularly with regard to liquidity risk, structured products, off-balance sheet exposures, and firm wide-risks; new valuation requirements for illiquid assets; a rethinking in the

use and regulation of credit rating agencies; countercyclical prudential regulation; and the regulation of hedge funds and over-the-counter markets. Evaluation findings show that regulatory and supervision approaches and the introduction of new instruments need to be tailored to suit market-specific conditions and the risk management capabilities of financial institutions and their supervisors. For example, a number of countries that ADB helped prepare for the implementation of Basel II are now experiencing financial distress, indicating the need to ensure that basic risk management approaches are in place before diverting regulatory capacity to more complex approaches.

22. **Remove potential for regulatory arbitrage.** Regulatory weaknesses and potential for arbitrage contributed to systemic problems in Korea and Thailand, where less regulated financial institutions like finance companies and merchant banks, through financing obtained from other financial institutions, engaged in imprudent lending practices. However, only in Korea did policy dialogue include the establishment of a consolidated regulatory structure to facilitate regulatory harmonization and reduce the potential for arbitrage. Stricter regulation of Korean merchant bank activities and tightened prudential norms resulted in a significant reduction of their share in financial services. In Indonesia, ADB subsequently supported the establishment of an integrated financial sector regulator. Implementation has been delayed due to lack of widespread political support, in part because, unlike in Korea, regulatory arbitrage had not been contributing to the emergence of the 1997 crisis.

### 3. Measures to Cushion Social Impact

23. **Focus on crisis impact, not general sector reforms.** ADB, recognizing the potential impact that the Asian financial crisis might have on the poor, provided two social sector-related sector development projects and one program loan for Indonesia and Thailand, not only to mitigate the social effects of the crisis, but also to support the implementation of structural reforms. However, the implementation of longer term general health and education sector reforms under the crisis support programs took rather long and was comparatively less successful, mainly due to resource constraints and diversion of attention to more pressing issues during the crisis, which affected both reform design and implementation. By comparison, support for policy measures and/or investment components that aimed at maintaining access of the poor to social services (mainly health and education) and maintaining the quality of such services was more relevant at the time, and effective.

24. **Use simple or established delivery channels to the extent possible.** The use of established programs or uncomplicated delivery channels was more successful than other approaches. For example, maintaining school enrollment and education quality through the provision of scholarships to junior secondary school students and block grants to junior secondary and primary schools in Indonesia was highly effective. By comparison, supplementary feeding programs and support for street children were less successful due to their complexity and to institutional capacity issues, although they eventually achieved positive impacts. Programs that bypassed a number of units and levels of the bureaucracy to ensure direct and expeditious support to providers and beneficiaries were most effective. In the case of Indonesia, it was decided to forego traditional government fund release channels for the potentially more efficient block grant system, which worked very well for the transfer of education benefits, although use of this new mechanism was more problematic in the health sector, where recipient organizations had lower capacity. The use of the postal system to make payments directly to beneficiaries was subsequently utilized under other government programs.

#### 4. Fiscal Stimulus Programs

25. ADB does not have any evaluation evidence with regard to the effectiveness of fiscal responses to financial crises. World Bank research<sup>10</sup> indicates that for most developing countries, expansionary fiscal policy has not been an effective tool for responding to economic downturns in the past, and it recommends that countercyclical measures consider long-term development objectives. As a result, it is recommended that fiscal policy response to a crisis should be either reversible or likely to yield long-term productivity gains.

26. **Carefully consider the usefulness of new investment projects as countercyclical measures.** ADB can play a useful role in ensuring and increasing the availability of additional financing for public investment programs, at a time when it is becoming more expensive for governments to finance themselves in the market and fiscal resources are strained. However, ADB support for new infrastructure investments is unlikely to provide much economic stimulus in the short-term, given the comparatively long time before disbursements commence.<sup>11</sup> Also, to be an effective countercyclical measure, the timing and level of disbursements need to be predictable. Project implementation can be further complicated if counterpart capacity is affected by budget cuts. For example, the implementation of investment projects or of components attached to some of the sector development programs implemented during the 1997 crisis lagged considerably due to reduced counterpart funds and capacity. While ADB's proposed reduction in government financing contributions to project costs will help projects get financed despite temporary fiscal constraints, additional measures are likely to be needed to enhance absorptive capacity, speed up investments, and enhance their overall impact. These measures include the selection of infrastructure project proposals according to their readiness and potential economic impact, adequate budget allocations for the executing agency, and mechanisms that facilitate refinancing of existing infrastructure projects in line with underlying cash flows.

#### C. General Lessons for Crisis Support

27. **Choose appropriate assistance instruments and focus.** Previous crisis support was mainly in the form of quick-disbursing funds to augment foreign exchange reserves and liquidity, and to supplement budgetary resources. This worked well in restoring investor confidence. More importantly, policy-based lending under these program loans helped demonstrate commitment to longer term structural adjustment. Regardless of whether support for structural reforms is provided as part of, in parallel with, or in sequence with liquidity support, there should be some causal relationship with the crisis and its resolution to ensure that sufficient attention is given by political decision makers, particularly if substantial policy reforms and legal changes are involved. During the 1997 crisis, ADB sought to include issues in its policy dialogue that were not directly relevant to the crisis and its resolution, e.g., the establishment of anti-money laundering regimes, decentralization, or general social sector reforms, which were not always government priorities, and as a result program disbursements were delayed or not fully implemented. Stabilization objectives can be frustrated when disbursements are linked to longer term structural reforms. Policy dialogue on crisis-relevant issues was generally more successful.

<sup>10</sup> World Bank. 2008. Luis Servén and Aart Kray. *Fiscal Policy Responses to the Current Financial Crisis: Issues for Developing Countries*. Washington D.C.

<sup>11</sup> There is a substantial time lag between loan approval and effectiveness (taking about 7.5 months for infrastructure projects approved during 2007), and between effectiveness and the start of construction. Delays in project implementation are the rule, rather than the exception, for ADB's sovereign lending operations. Average project delays have historically been around almost 2 years, this means almost 40% of the intended project duration of almost 5 years on average.

Crises are characterized by uncertainties, data constraints, and urgently needed action. Such conditions are unsuitable for negotiating reform programs with a longer term perspective, which need to be preceded by in-depth policy research and dialogue, assessment of implementation capacities, stakeholder participation, and nurturing of ownership. A crisis environment could prevent meaningful consultations.

28. **Adequate problem diagnosis is essential, but difficult.** In undertaking policy-based lending, especially under the intense pressures of a crisis, it is essential to have in place and to be able to build upon extensive country and sector knowledge in the design of a program. Diagnosis has an essential role to play in shaping program design. Under crisis conditions, this tends to be more challenging, given the urgency of required policy responses and rapidly changing conditions. Readily available TA funds and special fast-track consultant recruitment modalities for diagnostic assessments can help, as can flexibility in program conditionality, e.g., by focusing more on results. It is important for program design and choice of focus to reflect an appreciation of institutional requirements and constraints in implementing reforms, which can be substantial.

29. **Country ownership is essential.** Care should be taken in using crises as windows of opportunity for change. A crisis generally creates conditions for change, and an opportunity to introduce needed reforms. However, unless the necessary political buy-in is in place or can be built up, the reform process might cease when the crisis does. Although most ADB-supported reforms were eventually implemented without any major policy reversals, general acceptance of the need for change or full commitment to underlying reform principles was sometimes lacking. For example, in Indonesia, continuing governance problems threatened to undermine the bank restructuring program. In Korea and Thailand, there have been continued discussions about the role of foreign investors in corporate and financial sector restructurings. While external assistance can do only so much to address political economy issues, particularly in the short term, it should, nevertheless, be mindful that such factors exist, and consider them in the design of reform support. Even in a crisis scenario, agreement on politically contentious reforms is easier to obtain, if decision makers in government have sufficient analytical evidence to defend their actions. This usually requires ready access to substantial TA resources, which were provided under TA loans in the cases of Indonesia and Korea. Also, experience gained during the 1997 crisis, when formulaic approaches were often promoted by IFIs in affected countries, indicates that a range of policy options should be considered whenever possible and appropriate to facilitate acceptance.

30. **Adequate implementation assistance and field presence throughout crisis support can improve results.** Crisis assistance calls for continuous and intensive involvement of ADB with implementing agencies, both in the pre-approval and post-approval phases. Lack of adequate involvement in post-approval stages affects the implementation and effectiveness of crisis assistance. Given the complexity and sensitivity of fundamental policy reforms, maintaining an effective field presence is important, especially under conditions of uncertainty and change. ADB involved senior staff in the processing of crisis support and established extended missions in the affected countries to help implement its crisis support. This facilitated policy dialogue with the government and other IFIs, implementation support, resolution of contentious issues, and ADB's understanding of country conditions and political constraints. However, the missions were not as effective as anticipated due to resource constraints and lack of clarity about their roles and responsibilities vis-à-vis the role of headquarters divisions.

31. **IFI assistance needs to be well coordinated.** During crisis situations, effective coordination among IFIs and sharing of information in a transparent manner are needed to

insure that external aid programs are consistent and comprehensive and do not overlap or work at cross purposes. Except in Thailand, where ADB essentially limited its policy dialogue to capital market and social sector development issues, coordination with the International Monetary Fund and the World Bank in other countries, where ADB also addressed financial and corporate restructuring issues, was sometimes challenging at both the design and implementation stages. Particularly in Indonesia, there were initial differences on policy issues (especially with regard to the role of Bank Indonesia vis-à-vis the need for a separate bank restructuring agency), which affected the timing of program approval, as well as weaknesses in inter-IFI communication and information sharing. In Korea, there was some overlap in TA provided by ADB and the World Bank. In all cases, however, a working partnership evolved, facilitated by an effective division of labor. ADB's involvement probably facilitated policy dialogue on politically difficult issues.

## RELEVANT EVALUATION STUDIES

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