



January 2009

Global Financial Crisis and Proposed ADB Response

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AfDB	–	African Development Bank
DMC	–	developing member country
EBRD	–	European Bank for Reconstruction and Development
GCI	–	general capital increase
IADB	–	Inter-American Development Bank
IFC	–	International Finance Corporation
IFI	–	international financial institution
IMF	–	International Monetary Fund
OCR	–	ordinary capital resources
PRC	–	People's Republic of China
PRGF	–	poverty reduction and growth facility

NOTE

In this report, "\$" refers to US dollars.

Director General	K. Sakai, Strategy and Policy Department (SPD)
Team leader	A. Pio, Director, Operations Planning and Coordination Division, SPD
Team member	V. Reppelin-Hill, Senior Planning and Policy Specialist, SPD

CONTENTS

	Page
I. IMPACT OF THE CRISIS ON ADB'S DEVELOPING MEMBER COUNTRIES	1
II. INTERNATIONAL FINANCIAL INSTITUTIONS' ROLE IN CRISIS RESPONSE	3
III. ADB'S REPOSENSE TO THE CRISIS	4
A. Regional Response	4
B. Country Support	4
IV. CONCLUSION	6
 APPENDIX	
Other International Financial Institutions' Response to the Crisis	7

I. IMPACT OF THE CRISIS ON ADB'S DEVELOPING MEMBER COUNTRIES

1. The global economy is experiencing a major downturn. A global financial crisis has caused economic activity to stall and dimmed the outlook for global growth. While the severity and duration of the crisis are still unclear, the major industrial countries are already in or close to recession and the global slowdown is expected to be deeper and much more prolonged than previously anticipated. As the deepening financial crisis intensifies its grip on the global economy, Asian economies have begun to feel its effects.¹ The recently revised 2009 forecasts of the Asian Development Bank (ADB) for aggregate gross domestic product growth in developing Asia are 3 percentage points lower than growth in 2007, and 1 percentage point lower than in 2008.²

2. As deleveraging continues in global financial markets, capital flows to the region have reversed, causing sharp swings in Asian market asset prices. Asian equities have been particularly hard hit, with the region's major stock market indexes dropping between 20% and 60% in September and October 2008 as foreign investors repositioned their investment portfolios. Net equity outflows for eight economies in Asia are estimated to have totaled about \$72 billion from January to November 2008,³ contributing to sharp depreciations of many of the region's currencies. Should foreign banks further liquidate holdings of Asian assets as part of the deleveraging process, Asia's domestic asset prices, exchange rates, and external reserves could come under further pressure. The drop in global financial markets has also flowed through to Pacific countries via a loss on offshore investments held in official trusts and superannuation funds.

3. With risk aversion rising, offshore funding conditions have deteriorated substantially. Many East Asian economies have experienced difficulties in obtaining dollar funding, including funding for trade finance, and have seen a sharp rise in external borrowing costs. Sovereign credit spreads for selected ADB developing member countries (DMCs) have increased two- to fourfold, in some cases to as much as 3,000 basis points over comparable United States treasury securities. While spreads have narrowed in recent weeks, they remain significantly higher than before the crisis. Liquidity and pricing strains in international funding markets are being transmitted to local credit markets. Pricing for domestic bank loans in some economies is already showing signs of stress. Tighter credit is reducing private investment, at a time when the region continues to require substantial investment to finance priority development needs. This poses a considerable threat to developing Asia's long-term growth potential and ability to reduce poverty.

4. Instability spread through financial channels is being amplified by a deceleration of economic activity. Trade links between Asia and major industrial economies are substantial, with Europe, Japan, and the United States accounting for more than 60% of final demand for

¹ For more detailed discussion of the global crisis and its impact on Asia, see James, William E. et al. 2008. The US Financial Crisis, Global Financial Turmoil, and Developing Asia: Is the Era of High Growth at an End? In *ADB Economics Working Paper Series*. No. 139. Manila (December). Available: <http://www.adb.org/Documents/Working-Papers/2008/Economics-WP139.pdf>

² Growth in developing Asia is expected to fall to 5.8% in 2009, from an estimated 6.9% in 2008 and 9% in 2007. Developing Asia refers to the 44 DMCs of ADB. Economic growth in the People's Republic of China (PRC) and India, which account for a large portion of the growth estimate, has already slowed significantly. In the PRC, gross domestic product growth is expected to slow to 8.2% in 2009, down from 11.9% in 2007 and 9.5% expected in 2008. Growth projections for India were revised downward to 7% for 2008 and 6.5% for 2009, compared with 9% (actual) in 2007.

³ These were: Hong Kong, China; Indonesia, Republic of Korea; Malaysia; Philippines; Taipei, China; Thailand; and Viet Nam. See ADB. 2008. *Asia Economic Monitor*. Manila.

Asian exports.⁴ With the world's developed economies slipping into recession, the region's exports are suffering. Net exports in some more industrialized regional economies have already dipped into negative territory. The ripple effects of a global recession are also beginning to show in the region's current account balances through tourism receipts and remittances. Overseas remittances are an important source of income and, more importantly during a crisis, a supply of foreign exchange for many of the regions' economies, particularly the Philippines and Viet Nam. For example, growth in remittances slowed to 3.3% year-on-year in October in the Philippines, after gains of 16.9% in September and a high of 30.0% in June. Pacific DMCs rely heavily on tourism and remittances and are therefore highly exposed to a further deceleration of the global economy.

5. There are some positive factors in the present situation. The rapid fall in energy and commodity prices caused by the declining demand has temporarily tamed inflationary pressures. A number of countries have attempted to contain the effect of the global economic slump and financial crisis through monetary policy (liquidity injections and interest rate cuts), fiscal policy (fiscal stimulus packages on the expenditure or revenue side), and financial policy (deposit guarantees and bailouts). Asia is more resilient to external shocks than it was a decade ago for several reasons: (i) many countries have better external positions and larger internal reserves; (ii) the region's financial institutions have had less exposure to the United States subprime mortgages and structured credit products than those in other parts of the world; and (iii) in most Asian economies, improvements have been made to financial regulation and to macroeconomic management since the 1997/1998 financial crisis.

6. Nevertheless, the overall situation is cause for significant concern. Coming on the heels of the food and fuel price shock, the global financial crisis could significantly set back the fight against poverty. Sharply tighter credit conditions and weaker growth are likely to cut into government revenues and governments' ability to invest in infrastructure and to meet education, health, and gender goals. The poor are likely to be hit hardest. The 1997/1998 crisis nearly doubled the poverty rates in some DMCs.⁵ ADB estimates that, if growth in 2009 and 2010 turns out to be one percentage point less than the growth in 2008 for 24 Asian countries, about 21 million people who would otherwise have been freed from poverty will remain mired in it.⁶ These complex economic challenges require coordinated action at global, regional, and country levels. As developing country budgets adjust to a new fiscal reality, careful management will be necessary to protect long-run investments in infrastructure and social development, avoid unnecessary cuts in essential public expenditures, and restore high-quality economic growth over the longer term. These are all critical steps to maintain progress toward achieving the Millennium Development Goals. It is critical that aid flows be maintained, and commitments honored and supplemented where necessary. Data from members of the Development Assistance Committee of the Organisation for Economic Co-Operation and Development shows that total net official development assistance worldwide reached \$103.5 billion in 2007. This is modest in comparison with the sums already spent or planned to address the financial crisis in developed countries.

⁴ ADB. 2007. *Uncoupling Asia: Myth and Reality*. In *Asian Development Outlook*. Manila.

⁵ National poverty level estimates rose from 15% in 1997 to a peak of 33% by the end of 1998 in Indonesia. In the Republic of Korea, poverty incidence went from 3.0% in the last quarter of 1997 to 7.5% in the last quarter of 1998. See ADB. 2008. *Review of the Asian Development Bank's Ordinary Capital Resource Requirements*. Manila.

⁶ Staff estimate by ADB's Economics and Research Department.

II. INTERNATIONAL FINANCIAL INSTITUTIONS' ROLE IN CRISIS RESPONSE

7. The November 2008 meetings of leaders and representatives of the Group of Twenty (G-20) economies⁷ made important advances toward reestablishing financial stability, supporting global growth, and ensuring that adequate official flows (including aid) are mobilized and delivered. Crucially, the G-20 recognized the important role of the major international financial institutions (IFIs) in achieving these goals and underlined the need to ensure that they have adequate resources to meet the challenge. IFIs can help their DMCs face the challenges brought about by the crisis in the following ways.

- (i) **Stabilizing financial and private sectors.** IFIs can be part of a coordinated and rapid program of action to avert the collapse of the banking and private sectors in developing countries. IFIs can offer advisory services to help countries prepare for and respond to financial sector crises, assess vulnerability, and strengthen policy and regulatory frameworks. IFIs can also provide short-term finance (including trade finance) and provide capital to vulnerable banking systems (either directly through private sector operations or indirectly via government programs supporting bank recapitalization). IFIs can also support developing countries by providing guarantees to foreign banks and/or private investors to encourage them back to emerging markets.
- (ii) **Managing fiscal challenges.** Through budget support, IFIs can help partner countries finance their deficits and adjust their expenditure and revenue policies to take account of the priorities and pressures emerging from the crisis (in particular ensuring that fiscal adjustment takes into account the needs of the poor). Such work can be supplemented by technical assistance to help strengthen management, transparency, and accountability in public finances to ensure that scarce resources are used efficiently.
- (iii) **Securing long-term development.** One of the most important roles for IFIs over the coming years will be to help developing countries minimize disruption to ongoing development programs and projects. This includes helping governments to prioritize their own resources and ensure sustained external financing of ongoing and planned development projects and programs. Given the increased pressures on governments' own resources and the importance of fiscal stimulus, IFIs may in some cases need to support additional programs and projects in infrastructure and human development.

8. IFIs are responding by providing policy advice and balance-of-payments support, increasing lending levels, and supporting recapitalization of banks and the expansion of trade financing facilities. The appendix provides a brief overview of the specific measures that individual IFIs have taken in response to the crisis. The next section focuses on ADB's response.

⁷ Argentina, Australia, Brazil, Canada, PRC, European Union, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russian Federation, Saudi Arabia, South Africa, Turkey, United Kingdom, and United States.

III. ADB'S RESPONSE TO THE CRISIS

9. The shortfall in internal and external financing in ADB DMCs to support development expenditure related to ADB operations can be estimated in the order of at least \$7.4 billion (\$5.6 billion, excluding the larger countries such as the People's Republic of China and India). The shortfall includes counterpart funds that may no longer be available due to declining fiscal revenues, cofinancing and financing for ADB-supported or related development projects for which private and donor funding has dried up or become uncertain, budget support for fiscal stimulus through development expenditures, support for trade financing, and some budget support for countries unable to access domestic or international debt markets at a viable cost because of the financial crisis. Some countries have already approached ADB for support. Others may soon follow.

10. The international community and the G-20 have urged multilateral development banks to work to sustain the momentum of infrastructure investment for development in low-income countries, and to ensure that—where severe market disruptions have limited access to the financing needed for fiscal stimulus—arrangements are in place to support countries with a good track record and sound policies.⁸ ADB intends to assist its DMCs to cushion the social impact of the economic crisis, and to complement the role played by other IFIs through support for (i) public investment programs in infrastructure and social sectors; (ii) trade financing facilitation; and (iii) where ADB is already engaged in the financial sector, policy-based advice and support to address weaknesses in financial systems. Where required, ADB will participate in emergency response programs in coordination with other IFIs, including the International Monetary Fund and the World Bank. In addition to direct support at the country level, ADB proposes to strengthen monitoring and support for regional approaches to the crisis.

A. Regional Response

11. To support the development of a coordinated regional response, ADB has strengthened national monitoring and surveillance, and is working closely with the existing regional arrangements—such as the Association of Southeast Asian Nations (ASEAN), ASEAN+3, and the East Asian Summit—to strengthen economic surveillance and monitoring at regional, subregional, and country levels. ADB has already initiated a joint donor effort in the Pacific to assist economic monitoring and policy dialogue.

B. Country Support

12. At the country level, direct support will be provided through policy dialogue and ADB operations, funded through both the Asian Development Fund (ADF) and ordinary capital resources (OCR). Technical assistance and program lending operations are being prepared to support the development, consolidation, and regulation of financial markets. Their policy-based components will also help address requirements for quick-disbursing assistance. Some flexibility in applying program lending ceilings may be required under the circumstances. Project lending operations will aim to sustain planned levels of development expenditure by (i) increasing ADB's

⁸ See (i) G-20. 2008. *Communiqué: Meeting of Ministers and Governors*. Sao Paulo (8–9 November). Available: <http://www.fazenda.gov.br/portugues/documentos/2008/novembro/Communiqué-November-2008-Brazil.pdf>; and (ii) G-20. 2008. *Declaration of the Summit on Financial Markets and the World Economy*. Washington, DC (15 November). Available: <http://www.fazenda.gov.br/portugues/documentos/2008/novembro/G20-SUMMIT-LEADERS-DECLARATION-2008-11-15.pdf>. The G-20 also committed to review the adequacy of the resources of multilateral development banks and to stand ready to increase them where necessary.

share when project financing is threatened by a shortfall in counterpart funds; and (ii) replacing, or supporting through guarantee operations, alternative project financing sources that are no longer available as a result of the crisis. Finally, ADB has taken action to expand its support for trade financing, to ensure that trade flows are not impeded. Since the situation in each member country is different, and ADB resources are limited, the response needs to be tailored to the requirements of specific countries and country groups.

1. Borrowers from the Asian Development Fund

13. Annual ADF lending and grants to the poorest DMCs will be on average 30% higher during the ADF X period than during 2005–2008, as a result of the substantial replenishment finalized in May 2008. However, the precise value of the commitment authority has become more volatile due to exchange rate fluctuations. Close monitoring of the amount will be needed. Requests for crisis-related assistance have been received from ADF recipients in Central, South, and East Asia and processing of financing is underway. When required, ADB proposes to make use of the flexibility to front-load resources within the first biennium of ADF X so that requests for assistance and levels of operations in 2009 are sustained. As a result, the overall ADF lending and grant level in 2009 is expected to total approximately \$3.1 billion,⁹ against an annual average (based on the revised performance-based allocation) of \$2.6 billion. Depending on the evolution of the economic situation, ADB may need to respond to further requests from ADF recipients through even more aggressive front-loading of their 2-year program. ADF regulations allow countries to use 62.5% of their biennial allocation in a given year, with greater flexibility for smaller countries and programs; therefore, under current policies, ADF lending and grants in 2009 could be expanded to \$3.4 billion.

14. Front-loading may not necessarily affect future ADF lending and grant levels if exchange rate adjustments result in an increase in future commitment authority. If not, and if the general economic situation in 2009 and 2010 requires significantly higher levels of support, ADB will discuss with donors whether some ADF resources can be advanced from the second to the first biennium. ADB will report on the situation at the first ADF X donors' meeting that will take place in conjunction with the May 2009 Bali Annual Meeting of the ADB Board of Governors, and more thoroughly during the midterm ADF X review planned for 2010.

2. Borrowers from Ordinary Capital Resources

15. To respond to the needs of borrowers from ordinary capital resources, ADB proposes a three-pronged approach to promptly provide \$5 billion–\$6 billion of additional resources through: (i) an increase in lending in 2009 of about \$2 billion; (ii) an expansion of the guarantee program to about \$2.1 billion; and (iii) aggressive mobilization of cofinancing to leverage at least \$1 billion–\$2 billion from other development partners and commercial sources.

16. The \$2 billion increase in OCR lending would aim to replace internal or external funding shortfalls, and in some cases to provide quick-disbursing assistance to support reforms aimed at stabilizing the economy. ADB may also need to consider increasing its share of financing for ongoing projects, in cases where a shortage of counterpart funds due to the crisis threatens implementation progress. Allocation of these funds will be in addition to the lending program outlined in the work program and budget framework,¹⁰ and will be prioritized by Management based on the outcome of discussions with the affected countries. Following approval of a new

⁹ This amount includes \$267 million of projects whose approval was deferred from December 2008 to early 2009.

¹⁰ ADB. 2008. *Work Program and Budget Framework 2009–2011*. Manila.

lending limitation policy by the ADB Board of Directors on 15 December 2008,¹¹ the constraint to this approach comes from the borrowing headroom. The \$2 billion increase in OCR lending in 2009 will result in a corresponding significant reduction in the OCR lending level in 2010 unless the resolution on the proposed general capital increase (GCI) is effected by mid-2009. Such increase in 2009 OCR lending, however, is needed for ADB to play a meaningful role in responding to the crisis. To avoid the reduction in the lending level in 2010, and allow planning of future operations, timely resolution of the proposed GCI will be critical.

17. The new lending limitation policy (footnote 10) also modifies the treatment of guarantees for headroom purposes,¹² allowing a more efficient utilization of ADB's capital. Guarantees will allow ADB to support trade financing and leverage nonsovereign financial flows to its DMCs. ADB is prepared to increase these operations significantly, and initially proposes to allocate about \$2 billion for this purpose, and to reassess this allocation based on the market response. The first step will be a proposal to expand the successful trade finance facilitation program, which has been active since 2004, from the present amount of \$150 million to as much as \$1 billion.¹³

18. ADB will mobilize additional programmatic cofinancing. Arrangements with the Islamic Development Bank, the Japan Bank for International Cooperation, the Republic of Korea, and regional export-import banks have already been developed. In addition, ADB is pursuing framework agreements with interested counterparties, covering both trade financing guarantees and infrastructure financing. The objective is to mobilize at least \$1 billion–\$2 billion of additional resources, and possibly significantly in excess of this amount.

IV. CONCLUSION

19. ADB plans to respond to its DMCs' requests and to the mandate from the international community by increasing its role in regional cooperation and increasing 2009 levels of operations, in spite of the present resource constraints. Depending on the evolution of the crisis, these measures may need to be augmented during or extended beyond 2009. This requires that ADB be equipped with the resources needed to perform its role, possibly by altering the scheduling of ADF utilization, and especially through timely consideration of the GCI.

¹¹ ADB. 2008. *Review of the Asian Development Bank's Lending Limitation*. Manila.

¹² Guarantees are calculated against headroom for the amount and in the year in which they become callable. Previously, the net present value was counted against headroom in the year of approval.

¹³ The trade finance facilitation program currently covers nine countries (Afghanistan, Azerbaijan, Bangladesh, Cambodia, Nepal, Pakistan, Sri Lanka, Tajikistan, and Viet Nam) and there are plans to expand it to five more countries in 2009. With a total maximum exposure limit of \$150 million per transaction, the program has been instrumental in supporting over 1,000 trade transactions representing over \$500 million in trade.

OTHER INTERNATIONAL FINANCIAL INSTITUTIONS' RESPONSE TO THE CRISIS

A. World Bank Group

1. The International Bank for Reconstruction and Development has indicated that it is prepared to make new commitments of up to \$100 billion over the next 3 years, and to almost triple 2008 lending to more than \$35.0 billion (compared with \$13.5 billion in 2007) to meet additional demand from developing country partners. On 9 December 2008, the World Bank announced the creation of a \$2 billion International Development Association (IDA) Financial Crisis Response Fast-Track Facility to speed up grants and long-term, interest-free loans to help the world's poorest countries cope with the impact of the global financial crisis. The facility will utilize IDA 15 funds and finance expenditures to maintain economic stability and sustain growth, address volatility, and protect the poor, through funding for infrastructure services, education, and health and social safety nets. The World Bank will also provide technical analysis and advice to help countries respond to potential difficulties in banking systems.

2. The International Finance Corporation (IFC) is planning to expand support to the private sector through the following initiatives, to be implemented over a 3-year period: (i) a doubling of the Global Trade Finance Program to \$3.0 billion and the issuance of up to \$18 billion in guarantees for short-term trade finance, benefiting participating banks based in 66 countries; (ii) the launch of a global equity fund to recapitalize distressed banks, with \$1 billion provided by the IFC and \$2 billion by Japan; (iii) the creation of an infrastructure crisis facility, to provide roll-over financing to help recapitalize existing, viable, privately-funded infrastructure projects facing financial distress, with \$300 million provided by IFC and \$1.5 billion from other sources; and (iv) a refocusing of advisory services programs on banking for small and medium-sized enterprises, leasing, microfinance, housing, investment policy and promotion, and business operation and regulation for an estimated financing of \$40 million.

3. The Multilateral Investment Guarantee Agency is providing guarantees to foreign banks to help inject liquidity and bolster confidence in the financial systems of the Russian Federation and Ukraine. Similar guarantees are expected for countries in eastern Europe and Africa.

B. Inter-American Development Bank

4. The Inter-American Development Bank (IADB) plans to accelerate loans to finance projects and enhance social programs and to approve up to a record \$12 billion in 2009 (compared with about \$10 billion in 2008). IADB is also setting up a new quick-disbursing \$6 billion liquidity facility, the Liquidity Program for Growth Sustainability, to help Latin American and Caribbean economies sustain growth. The aim is to make funds available to domestic firms via commercial banks that may face temporary difficulties accessing foreign and inter-bank credit lines as a result of the financial crisis. If the facility is fully utilized, the resulting flow of committed funds to Latin America and the Caribbean would amount to about \$18 billion in the course of 2009, an almost 80% increase in IADB lending to the region.

C. European Bank for Reconstruction and Development

5. The European Bank for Reconstruction and Development (EBRD) board of directors approved the 2009 business plan and budget on 10 December 2008. This allows for a 20% increase in EBRD's annual lending volume, from approximately \$6 billion in 2008 to up to \$7 billion in 2009, in response to the severe impact of the global economic crisis on central and

eastern Europe. The increase will be financed from EBRD's reserves. The extra investments in 2009 will be spread across EBRD's countries of operations, with a special focus on the western Balkans and less developed countries in the Caucasus and Central Asia. The EBRD's response will initially focus on the banking sectors in countries where EBRD invests to ensure that financing flows continue, in particular to small and medium-sized enterprises. EBRD will also extend its support to the broader corporate sector. The crisis response package also includes an expansion of EBRD's Trade Facilitation Programme, and intensified engagement with existing clients and with governments to address key policy issues.

D. African Development Bank

6. On 12 November 2008, the African Development Bank (AfDB) hosted a conference of African finance ministers and central bank governors to discuss the impact of and approaches to the global financial crisis on the continent. Government representatives committed to expanding economic reforms and agreed to strengthen the regulation and oversight of financial systems, continue harmonization of fiscal and monetary policies, carry out more effective mobilization of domestic revenues, and deepen African capital markets.

7. AfDB expects that the crisis will increase the demand on its services and products, particularly from its private sector window. To deal with this expected surge in demand, AfDB will (i) be more selective, to balance responsiveness with financial prudence by focusing predominantly on infrastructure, the financial sector (especially long-term and trade finance), and large-scale extraction and refining operations; (ii) intensify portfolio oversight to sustain projects where possible; and (iii) intensify partnership with other international financial institutions active in the region.

E. International Monetary Fund

8. The International Monetary Fund (IMF) is helping countries affected by the crisis with policy advice and balance-of-payment support. The IMF has about \$200 billion available for immediate lending and can draw on an additional \$50 billion through special standing borrowing arrangements. In response to the crisis, the IMF has streamlined its conditions by focusing on essential actions for resolving a country's immediate economic difficulty. It has recently announced loans to Hungary, Iceland, Pakistan,¹ and Ukraine, and is engaged in discussions with several other countries. It has emphasized its readiness to act quickly through emergency financing procedures, which are faster than a normal IMF lending program.

9. In addition, modifications to the exogenous shocks facility were approved in September 2008. This facility provides policy support and financial assistance to low-income countries facing exogenous shocks if they are eligible for the poverty reduction and growth facility (PRGF) but do not have a PRGF program in place. Financing terms are equivalent to a PRGF arrangement and more concessional than under other IMF emergency lending facilities. Under the enhanced facility, the IMF board approved on 10 December 2008 an 18-month, SDR66.6 million (about \$100 million) program for the Kyrgyz Republic, to address spillovers from the global financial crisis and provide targeted protection to the poor.

¹ The Pakistan program (totaling \$7.6 billion) was approved in November 2008 under the IMF's fast-track emergency financing mechanism procedures. The 23-month standby loan will enable the Government to implement a stabilization program that envisages a significant tightening of fiscal and monetary policies to bring down inflation and reduce the external current account deficit to more sustainable levels. Upon IMF board approval, an amount equivalent to SDR2.067 billion (about \$3.1 billion) became immediately available, with the remaining amount to be phased in, subject to quarterly reviews.