



Policy Paper

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Crisis Response of Asian Development Fund— Allocation of Additional Liquidity

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
OCR	–	ordinary capital resources
PBA	–	performance-based allocation
PML	–	prudential minimum liquidity
SDR	–	special drawing right

NOTE

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

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I. INTRODUCTION

1. The purpose of this paper is to seek the approval of the Board of Directors of the Asian Development Bank (ADB) to allocate additional Asian Development Fund (ADF) commitment authority to ADF-only countries to help them respond to the global economic crisis. As of 31 March 2009, about 55% of the outstanding ADF legacy loans had been converted to special drawing rights, reducing the currency risk. As a result, SDR270 million (about \$400 million)¹ from the prudential minimum liquidity (PML) of ADF that was originally provided to cover the currency risks can now be released and added to the ADF commitment authority.

2. The effects of the financial and economic crisis have spread rapidly to Asia and the Pacific, where the economies depend heavily on external demand. While it initially appeared well positioned to weather the global crisis, the region has come under increasing economic strains as the crisis has unfolded. With few policy options available because of their weak revenue bases and limited access to capital markets, Asia's poorer countries are highly vulnerable to global economic shocks.

3. The socioeconomic impact of the global economic crisis is forecast to be severe in poorer countries of Asia and the Pacific. Weaker export demand, lower capital inflows from both foreign direct and portfolio investments, and declining tourist arrivals and remittance inflows will impair not only growth prospects but also social cohesion and political stability of countries that are already vulnerable to these risks. If not managed effectively, including through assistance from development partners such as ADB, the prolonged economic downturn could significantly reverse past gains in achieving sustained growth and reducing poverty in these countries.

4. Given the acute resource constraints of poorer countries, additional liquidity is proposed to be distributed to ADF-only countries, although the performance-based allocation (PBA) policy² envisages that the allocation be made to all ADF countries. The poorer ADF countries are among the most fiscally constrained in responding to the crisis, and they generally do not have access to non-concessional resources including ADB's ordinary capital resources (OCR).³ While limited to ADF-only countries, the allocation of this additional liquidity will be made according to the PBA formula based on 2008 country performance assessment results.

5. In addition, if requested, ADB plans to allow all ADF countries to use 100% of their biennial allocation in 2009 (or 100% front-loading in 2009) in response to the crisis, provided sufficient commitment authority is available at the time of the request. Under the PBA policy, for countries with a biennial allocation of \$40 million or greater, annual approvals are expected to be in a range of 62.5% and 37.5% of the biennial volume.⁴ Allowing 100% front-loading to all ADF countries will provide significant flexibility to ADF countries in helping them respond to the immediate economic challenges of the crisis.

¹ This is valued at the exchange rate as of 31 March 2009.

² ADB. 2001. *Policy on Performance-Based Allocation of Asian Development Fund Resources*. Manila; ADB. 2004. *Review of the Asian Development Bank's Policy on the Performance-based Allocation of Asian Development Fund Resources*. Manila; ADB. 2008. *Refining the Performance-Based Allocation of Asian Development Fund Resources*. Manila.

³ Blend countries have an OCR allocation of about \$6 billion in 2009–2010. In addition, a proposal is being considered to create a \$3 billion facility to provide short-maturity lending to crisis-affected OCR and blend countries. Blend countries are those with access to both ADF and OCR loans. (ADB. 2008. *Review of the 1998 Graduation Policy of the Asian Development Bank*. Manila.)

⁴ ADB. 2004. *Review of the Asian Development Bank's Policy on the Performance-based Allocation of Asian Development Fund Resources*. Manila.

II. ADDITIONAL ADF ASSISTANCE

A. Additional ADF Liquidity

6. Additional ADF resources can help poorer countries in Asia and the Pacific cope with their current and future economic difficulties. The current economic crisis and financing needs for essential crisis management and countercyclical measures further corroborate the need for securing additional ADF resources for Asia's poorer countries. Additional resources can help crisis-afflicted and fiscally stretched countries by providing crucial budget support and funds to finance key projects that promote social sector protection and expand domestic demand under a prolonged economic downturn.

7. Additional liquidity of SDR270 million from the PML framework is available for further assistance. These funds can be released because some ADF borrowers exercised their legacy loan conversion option to SDR,⁵ reducing the required provision for foreign exchange volatility.⁶ Accordingly, SDR270 million—about \$400 million of the original \$750 million earmarked as part of the PML to absorb currency risks on reflows in non-SDR currencies for legacy loans—can be released immediately and added to the commitment authority for ADF X. The remaining balance in the PML is considered adequate to safeguard the ADF's financial integrity.

8. The PML was introduced as a new financial management framework for ADF resources. When the financial framework of the ADF was reviewed in December 2007,⁷ the ADB Board approved a new approach to liquidity management, which included the following:

- (i) Total liquidity will be used to determine the reflow-based commitment authority.
- (ii) The PML will initially be set at 100% of the next year's projected cash flows. It will be reviewed at every replenishment of the ADF⁸ based on financial risks and the volume of operations.

9. A significant portion of the PML is to cover currency risk—specifically, the currency risk of reflows—as most outstanding loans were valued in donors' national currencies at the time of ADB Board approval of the financial framework paper. At the same time, the SDR conversion option for legacy ADF loans has been offered to eligible ADF borrowers since the beginning of 2008 based on the SDR currency management policy paper⁹ and the SDR conversion option paper.¹⁰

⁵ The following countries have signified their agreement to the conversion of their payment obligations under ADF legacy loans into SDR: Bangladesh, Cambodia, Cook Islands, the Federated States of Micronesia, Indonesia, Kiribati, Kyrgyz Republic, Maldives, Mongolia, Nepal, Papua New Guinea, Sri Lanka, the Philippines, Samoa, Tonga, and Uzbekistan.

⁶ For the ninth replenishment of the ADF, donors agreed to a partial use of one-time usable liquidity of SDR1.45 billion. It was further agreed that use of the remaining SDR378 million in usable liquidity shall be discussed at the time of the midterm review. The PML discussed in the paper is separate from this one-time usable liquidity.

⁷ ADB. 2007. *Review of the Financial Framework of the Asian Development Fund*. Manila.

⁸ The ninth and current replenishment covers 4 years from 2009 to 2012.

⁹ ADB. 2005. *Asian Development Fund Currency Management Proposal*. Manila.

¹⁰ ADB. 2007. *Special Drawing Rights Conversion Option for Legacy Asian Development Fund Loans*. Manila.

B. Allocation of Additional Liquidity

10. To limit the allocation of additional ADF liquidity to ADF-only countries, ADF donors' consent was required. The refined PBA policy considered by ADF donors during ADF X replenishment negotiations and approved by the ADB Board in October 2008 governs country allocations. Based on the estimated commitment authority, \$5,368 million¹¹ was allocated to all ADF countries for 2009–2010 according to this policy. Of that commitment authority, 4.5% was earmarked for ADF countries in the Pacific. A total of \$538 million was allocated to 19 subregional projects according to the revised subregional pool criteria. Limiting additional allocations to ADF-only countries would mean an exception to the PBA principle.

11. During the ADF X donors' annual consultation meeting on 3 May 2009 in Bali, Indonesia ADB proposed two options for distributing the additional liquidity:¹²

- (i) Option 1: SDR270 million (about \$400 million) is distributed to all the ADF countries using the 2009–2010 PBA formula.¹³
- (ii) Option 2: SDR270 million (about \$400 million) is distributed to ADF-only countries using a pro-rata approach derived from the 2009–2010 PBA. The Pacific pool of 4.5% is maintained, and distribution is calculated separately for non-Pacific and Pacific countries.¹⁴

12. The following allocation outcomes are expected from each option:

- (i) Under option 1, 66.4% goes to non-Pacific blend borrowers, whereas the allocation to ADF-only borrowers is 27.5% (25.5% for non-Pacific and 2.0% for Pacific countries). The total additional allocation to ADF-only countries compared with the 2009–2010 biennial allocation is 9.3%.
- (ii) Under option 2, non-Pacific ADF-only borrowers are allocated \$335 million, or 30.6% above the 2009–2010 biennial allocation. Pacific countries are allocated \$17 million, or 20.1% above their biennial allocation.

13. ADB proposed option 2 as more appropriate under the current economic and country-specific circumstances, and donors unanimously supported this proposal. The poorer ADF countries are among the most fiscally overstretched in responding to the crisis, and they suffer from their lack of access to non-concessional resources including ADB's OCR, and international and domestic capital markets. Most of these countries are not on track to achieve the Millennium Development Goals. The crisis will make the achievement of the targets even more challenging—and out of reach in some cases. Additional ADF support to these countries could be utilized to augment their efforts to generate local demand and to mitigate the social

¹¹ This includes \$160 million of ADF hard-term facility. To help cover the forgone interest from ADF grants, a separate ADF facility with harder lending terms was established in 2007. (ADB. 2007. *Revising the Framework for Asian Development Fund Grants*. Manila.)

¹² ADB. 2009. *Asian Development Fund Crisis Response*. Discussion paper for ADF X Donors' Annual Consultation. Manila.

¹³ During ADF IX, \$700 million was made available in July 2008. After consultation with donors, the entire amount was distributed using the 2007–2008 PBA formula.

¹⁴ Afghanistan, which receives an exceptional allocation, is not included. Its biennial allocation of \$548 million consists of its PBA formula-based allocation plus a portion of its post-conflict premium, which is calculated based on the proportional increase of ADF operations from ADF IX to ADF X. The subregional allocation is also not considered.

impact of the crisis by providing social safety nets, conditional cash transfers, employment-generating schemes, and other appropriate measures.

III. COUNTRY ALLOCATIONS AND REVISED 2009–2010 PERFORMANCE-BASED ALLOCATION

14. The additional \$400 million will be allocated to ADF-only countries using a pro-rata approach derived from the 2009–2010 PBA. The Pacific pool of 4.5% is maintained, and the distribution is calculated separately for non-Pacific and Pacific countries. Of the \$400 million, non-Pacific countries will be allocated \$334.8 million, or 30.6% above the 2009–2010 biennial allocation. Pacific countries will receive \$16.8 million, or 20.1% above their biennial allocation. The 20% volume discount on the grant portion of country allocation will be maintained and transferred to hard-term ADF facility.¹⁵ As a result, an estimated \$197.8 million will be provided in grants and \$153.8 million in loans.

15. The additional resource distribution raises the total ADF allocation for 2009–2010 from \$5,368 million to \$5,768 million (Appendix). Resources earmarked for subregional projects will remain at \$538 million, and the exceptional country allocation for Afghanistan at \$548.28 million. The remaining ADF resources will be allocated among 27 countries, with the additional \$400 million reserved for 16 ADF-only countries.¹⁶ After taking into account the grant shares and 20% of volume discounts on grant portions, \$203.59 million will be allocated to 12 Pacific countries and \$4,269.87 million to 15 non-Pacific countries. An estimated \$208.56 million of hard-term facility generated from volume discounts on grant portions will be made available to blend countries.

IV. FRONT-LOADING OF 2009–2010 PERFORMANCE-BASED ALLOCATION

16. Given the imminent financing needs of ADF borrowers affected by the crisis, ADB plans to allow up to 100% front-loading for 15 ADF countries¹⁷ with a current annual ceiling of 62.5%, subject to availability of the commitment authority at the time of the request. The 28 ADF countries plan to utilize 58.5% of their biennial allocations in 2009 (table). Of the 28 countries, 5 requested front-loading in 2009 above the ceiling; and, among them, 2 countries¹⁸ requested 100% utilization of their biennial allocations in 2009.

¹⁵ Resources from the volume discount are retained within each operations group and made available for allocation through the hard-term ADF facility at the discretion of the operations group vice president. (ADB. 2007. *Revising the Framework for Asian Development Fund Grants*. Manila.)

¹⁶ Of the 16 ADF-only countries, 8 are from the Pacific: Kiribati, Nauru, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. The other 8 are non-Pacific: Bhutan, Cambodia, Kyrgyz Republic, Lao People's Democratic Republic, Maldives, Mongolia, Nepal, and Tajikistan.

¹⁷ The 15 countries include 7 ADF-only countries (Afghanistan, Cambodia, Kyrgyz Republic, Lao PDR, Mongolia, Nepal, and Tajikistan) and 8 blend countries (Armenia, Bangladesh, Georgia, Pakistan, Papua New Guinea, Sri Lanka, Uzbekistan, and Viet Nam). Other ADF countries are already allowed front-loading of 100% or more.

¹⁸ Armenia and Georgia

Projected Approvals for ADF Loans and Grants
(\$ million)

Country Group	2009–2010 Allocations (A)	Approvals 2009–2010 (B = E + H)	2009				2010		
			Loan (C)	Grant (D)	Total (E = C + D)	(E / A) ^a	Loan (F)	Grant (G)	Total (H = F + G)
Non-Pacific	5,006.4	5,326.2	2,057.1	771.9	2,829.0	56.5%	1,908.7	588.6	2,497.2
ADF-only	1,642.0	1,731.4	245.9	700.5	946.4	57.6%	259.8	525.2	785.0
Blend	2,841.4	3,071.8	1,675.2	0.0	1,675.2	60.4%	1,396.6	0.0	1,396.6
Subregional	523.0	523.0	136.0	71.3	207.3	39.6%	252.3	63.3	315.7
Pacific	201.8	279.7	105.8	72.1	177.9	88.2%	85.5	16.3	101.8
ADF-only	83.8	153.9	40.0	67.1	107.1	127.8%	30.5	16.3	46.8
Blend	103.0	110.8	55.8	0.0	55.8	54.2%	55.0	0.0	55.0
Subregional	15.0	15.0	10.0	5.0	15.0	100.0%	0.0	0.0	0.0
Total	5,208.1	5,605.9	2,162.9	844.0	3,006.9	58.5%	1,994.2	604.9	2,599.0
Projected utilization (as % of allocation)	5,208.1	5,605.9			3,006.9			2,599.0	
		108.4			58.5			49.9	

ADF = Asian Development Fund.

^a Percent utilization includes the \$40.6 million advanced to Georgia in 2008, not reflected in the 2009 projected approval amounts. The allocation amounts exclude \$160 million in hard-term facility. The projected approval amounts also exclude the hard-term facility but include 2008 projects worth \$359 million scheduled for approval in 2009.

Subregional refers to projects financed from the subregional pool.

Source: Asian Development Bank.

17. During the ADF X donors' annual consultation meeting in Bali, donors strongly supported ADB's proposal to allow up to 100% front-loading of the 2009–2010 biennial allocation in response to the crisis. To allow 100% front-loading to all ADF-only countries, up to \$688 million of additional ADF resources will be necessary in 2009. Furthermore, if the coverage is expanded to include 8 blend countries, an additional \$1.2 billion will be needed.

18. The available commitment authority for 2009 is estimated at SDR2.8 billion (or the equivalent of \$4.2 billion),¹⁹ which can allow up to \$1.2 billion of further front-loading.²⁰ Once allocated, the \$400 million of additional commitment authority can also be used for front-loading. However, the ADF allocation was earmarked for specific projects in most cases, and reprogramming or advancing the projects that are planned for approval in the latter half of 2010 is likely to be considered only in exceptional cases by crisis-hit countries. As such, it is expected that overall requests for front-loading will be within the available commitment authority.²¹

19. Management will report to the Board quarterly on the status of front-loading requests of the 2009–2010 biennial allocations and the outcome of the approvals beginning from the second quarter of 2009.

¹⁹ This is valued at the exchange rate as of 31 March 2009.

²⁰ The estimated commitment authority of SDR2.8 billion (\$4.2 billion equivalent) available for 2009 includes the SDR270 million (\$400 million equivalent) from the PML.

²¹ If, within the proposed parameters, demands exceed available commitment authority, priority is to be given to projects with quick-disbursing tranches, with approvals for remaining projects being on a first come basis, subject to Management's approval. (ADB. 2004. *Review of the Asian Development Bank's Policy on the Performance-based Allocation of Asian Development Fund Resources*. Manila)

V. RECOMMENDATION

20. The President recommends that the Board approve distributing \$400 million to ADF-only countries using a pro-rata approach derived from the 2009–2010 PBA.

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