Evaluation Lessons of a Global Financial Crisis for Asia and ADB

As Asia and the Pacific recovers from the 2008–2009 global financial crisis, the distress engulfing European economies is stoking fears of a new storm battering the region’s exports and restricting financial resource flows. Concerned about a crisis governments in Asia are preparing their defenses and might seek financial support and policy advice from ADB. This brief discusses the potential risks to Asia from a crisis in Europe, and lessons from evaluation on crisis response support provided by ADB and other international financial institutions.

The Impact and Risks of a Crisis in Europe
The impact of 2008–2009 global financial crisis on Asia was much lighter than feared. But the fallout from a crisis triggered by a country exiting the eurozone, while not a high probability, could be more significant. Such an event could change perceptions about the commitment of other countries to the euro. And this in turn could severely reduce economic growth in Europe and increase uncertainty on global financial markets that could encourage a flight of capital to US dollars. This study contends that the ongoing slowdown in the Asian economies would be severely aggravated by a crisis in Europe. Indeed, countries might find it harder to cope with a sharp economic downturn in Europe than with a prolonged slowdown. At least the latter scenario would provide Asia’s exporters some time to find alternative markets.

Just as in the 2008–2009 global financial and economic crisis, trade would be the main route of transmission. Bangladesh, Sri Lanka, Thailand, and Viet Nam are seen as particularly vulnerable due to their larger dependence on European markets. But even for the less dependent, the risks of a full-blown economic crisis in Europe are not negligible. Risks would also be high for mineral exporters if an ensuing global recession cut commodity prices. Here, Armenia, Azerbaijan, Georgia, Kazakhstan, Mongolia and Papua New Guinea would be vulnerable. As would tourism and remittance-dependent economies such as Cambodia, the Kyrgyz Republic, Mongolia, Tajikistan, Thailand, Timor-Leste, Viet Nam and some of the small island economies of ADB’s Pacific developing member countries.

The impact on the financial sectors of several Asian countries could be significant if there were a flight of credit and capital and a marked drop in exports. While low foreign ownership and thin exposure to eurozone bonds would likely shield banking systems in Asia’s emerging markets, the recent increase in European banks’ exposure to financial institutions in the region’s developing economies could heighten vulnerabilities if lending to Asia is cut. The impact on poverty in the region is likely to be moderate overall, but could be quite severe on more vulnerable small countries, and directly affected and vulnerable groups in larger countries.

Crisis Preparedness and Response of Developing Countries
The extent to which a crisis in Europe would reverberate onto ADB’s developing member countries depends not only on their vulnerabilities, but also on the strength of their institutions, monetary and fiscal policy regimes, the health of financial sectors, and the strength of social safety nets.

Macroeconomic and financial sector policies in Asia have improved since the 1997 Asian financial crisis, bolstering the region’s ability to cope with future emergencies. Even during the global slowdown of 2008–2009, Asia managed respectable economic growth, despite sharp decline in exports. The flexibility of exchange rates has improved in major Asian economies, particularly in the past few years. Consequently, most emerging economies in the region now have competitive exchange rates. Asian countries have also slowed the transition to open capital accounts, thereby insulating their exchange rates and economies from volatile
capital flows. Most countries in the region have built up substantial foreign exchange reserves. Regulation of the banking and corporate sectors has improved, and risk-weighted capital adequacy ratios have increased in most countries. What is more, the short-term external borrowing that generated substantial currency and maturity mismatches in the 1990s have been reduced, and asset diversification has helped reduce financial market risk. Even so, there remains considerable scope for strengthening Asia’s financial systems, particularly in transition countries in Central Asia.

On the economic front, inflation in most economies had been contained since the Asian financial crisis. As the global crisis unfolded, several Asian countries cut policy rates sharply in the second half of 2008 to ease liquidity. Pressure on consumer prices did emerge in some countries, but inflation rates by early 2012 had eased to pre-crisis levels. Thus, some countries have the scope for easing liquidity in the event of another financial crisis—and might consider easing cash-reserve ratios and interest rates to encourage bank lending to stimulate their economies.

Fiscal deficits have fallen in much of the Asian region, providing the space to mount credible expansionary fiscal responses to the 2008–2009 crisis (see Table 1). Although many countries in the region have the fiscal latitude to pursue expansionary policies in the event of a crisis in Europe, the high level of government deficits present a dilemma for policymakers in Asia. High deficits could undermine confidence, while a significant fiscal contraction at this point could worsen the impact of negative shocks from the global economy. This puts a premium on macroeconomic sustainability and the quality of public expenditure in countercyclical fiscal packages. To safeguard development goals, countercyclical spending should be reversible, especially for consumption-type spending, and yield productivity gains in investment expenditure on human and physical capital.

A high degree of international cooperation across regions and within Asia was the hallmark of the response to the 2008–2009 global financial crisis. A similar coordinated effort will be needed to stem any serious contagion from a European crisis. Asian countries will be expected to participate in such an effort. One potential area of cooperation would be to push for greater international cooperation on corporate and banking sector regulation to accommodate emerging Asia’s needs. Collective action by Asia’s developing countries could reduce the impact of a global crisis on the region. The rapid growth of Asia’s larger emerging economies and greater financial integration underlines the importance of, and potential for, the region to play a larger role in helping prevent global crises.

The eurozone crisis has vividly highlighted the dangers inherent in fixed exchange rate systems among disparate economies. Compared to Europe, Asian countries are far more diverse in their income levels, financial systems, and legal and political structures. Such diversity imposes severe limitations on treaties and institutional arrangements to promote monetary integration. The volatile global environment underlines the merit of Asian countries retaining exchange rate flexibility and independent monetary policies.

### Lessons on Responses to Crises for ADB and Developing Countries

Evaluations of the responses to the 2008–2009 global financial crisis by ADB and other international financial institutions provide valuable lessons. Box 1 highlights how the future responses by developing countries, ADB and international financial institutions, and the evaluation community could be more effective.

#### Country-level Support

**Stay prepared to respond to crises.** Developing Asia coped well with the recent global crisis, mainly because it was better prepared by learning crucial lessons from the Asian financial crisis. This time around, countries had adequate fiscal space, pursued rational exchange rate policies, and improved banking sector regulation. ADB was also better prepared institutionally, with improved staff knowledge, and quick disbursing instruments. ADB was, however, somewhat handicapped because the needed capital headroom was

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### Table 1: Government stimulus 2005–2011 (average annual government deficit (% of GDP)

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<tr>
<td>Severely affected</td>
<td>-0.1</td>
<td>-2.2</td>
<td>-4.3</td>
<td>-3.8</td>
<td>-4.6</td>
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<td>Moderately affected</td>
<td>-1.7</td>
<td>-2.9</td>
<td>-4.7</td>
<td>-3.7</td>
<td>-3.4</td>
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<tr>
<td>Least affected</td>
<td>-0.4</td>
<td>-0.4</td>
<td>-1.2</td>
<td>-1.5</td>
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<tr>
<td>High income</td>
<td>-1.7</td>
<td>-1.3</td>
<td>-6.5</td>
<td>-5.9</td>
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GDP = gross domestic product; regional averages are GDP weighted

Source: World Bank data
not available in a timely manner. The management and shareholders of international financial institutions need to be aware of the additional resource needs of crisis response operations and the trade-off between the goals of maximizing resource flows to developing countries during normal times and maintaining sufficient capital headroom so that lending can be ramped up during a crisis.

**Countercyclical fiscal policy—focus on sustainability and timely impact.** A successful countercyclical fiscal policy needs to focus on three important factors—macroeconomic sustainability, quality of spending, and timeliness. Both ADB and its developing member countries need to pay attention to whether the fiscal expansion required to respond to a crisis is consistent with macroeconomic stability over the medium-term. The quality of spending is critical. Incremental public spending that supports consumption should be reversible, and investment expenditures should focus on ongoing investment projects with high short-term employment impacts. Relying on capital-intensive investment projects with long startup periods can delay the impact of stimulus packages. In contrast, supporting labor-intensive investments, enhanced maintenance of existing infrastructure, and scaling up social protection expenditure can all help in infusing liquidity into the system faster and have more immediate impacts.

**Build and nurture reliable and strong social protection systems during non-crisis periods.** Social protection systems are vital for coping with crises, and well-functioning systems can be scaled up or down as needed. Reliable social protection systems mean that governments can reach out effectively to the vulnerable and disburse assistance fast. However, the performances of many existing safety net programs are being undermined by poor targeting, waste, and other forms of leakage due to mismanagement. Given the time needed to set up effective social protection systems, it is essential to address these issues before rather than after a crisis. ADB, in coordination with other agencies, could help developing member countries build comprehensive and well-targeted social protection systems that factor in budget constraints, administrative feasibility, and political economy considerations.

**Focus on keeping the financial sector efficient and strong.** Countries in Asia made considerable progress in reforming and strengthening their financial sectors. However, financial sectors in some developing countries, and particularly in Central Asia’s transition economies, need further strengthening. While a crisis in Europe is unlikely to trigger banking crises in Asia, it could create stress points which need to be anticipated and carefully managed. ADB and other international financial institutions can provide advisory and policy-based support to Asian financial institutions. Evaluation shows that crisis assistance can be delivered faster if support is built on existing relationships with institutions already familiar with the policies and procedures of international financial institutions.

**Trade finance supported by international financial institutions can play an important role during crises.** Trade finance played a prominent role in the response of ADB and other international financial institutions to the 2008–2009 global financial crisis—and the size of trade finance programs have since been enhanced significantly in most of these institutions. Evaluations found these programs to be relevant because trade finance dried up during the crisis. The programs were responsive to the needs of developing countries, because a significant part of the support went to the ones that were worst hit and most in need, with Bangladesh, Nepal, Pakistan, Sri Lanka, and Viet Nam receiving 90% of ADB’s trade finance support during that time. Evaluation studies found that the high due-diligence standards of the trade finance programs also raised the standards of operational efficiency, disclosure, and procedures.
governance of issuing banks. However, the impact of trade finance programs in terms of their additionality, possible crowding out of private sector resources, pricing, profitability, and appropriate scaling-up during crises and scaling-back afterwards needs to be evaluated. This could be done jointly with the other international financial institutions involved in trade finance programs with common features to benefit from mutual learning.

**ADB’s Institutional Preparedness**

In-depth country and sector knowledge is a prerequisite for mounting an effective crisis response program. ADB and other international financial institutions will benefit from improving coordination of resources and knowledge sharing. This and the presence of so-called “silo behavior” (behavior based on a narrow-minded view on policy) could weaken the crisis response of international financial institutions and aggravate the difficulties involved in learning from macroeconomic and financial developments and cross-country experiences.

**Partnership approach to crisis response will be more effective.** Compared to the Asian financial crisis, coordination among international financial institutions within Asia and in other regions, was better during the 2008–2009 crisis. An effective division of labor among these institutions based on each one’s comparative advantages and expertise, and with good communication and information sharing, would significantly improve the planning and execution of crisis support.

**Timely availability of adequate resources is critical for effective crisis response.** ADB’s capacity to respond to a crisis depends on the availability of capital to support a rapid increase in lending. But this may result in a trade-off between crisis response operations and its normal lending operations unless its risk-bearing capacity is augmented. Allocation of resources for crisis response and normal operations is a strategic issue for ADB’s shareholders and its Board to consider in determining the level of support. A better assessment of the vulnerabilities of developing countries to economic and financial crises, and their ability to deal with them, could improve the targeting of ADB support to those most in need during a crisis.

**Choice of instruments matters for effective response.** The timely disbursement of resources and ensuring positive net resource transfers are critical for an effective crisis response. Typical slow-disbursing investment lending would therefore be inapt for crisis-support. Regular high-quality policy-based quick disbursing loans are appropriate for crisis support, but they tend to exhaust the capital headroom over longer periods. Special crisis response vehicles, such as ADB’s countercyclical support facility and special program lending facility are appropriate instruments during crises as they have shorter repayment periods and offer greater flexibility to institutions for designing support. Crisis-response instruments also minimize the trade-off with normal lending. Such instruments must also meet the special crisis-related loan financing needs of poorer countries eligible for ADB support on concessional terms.

**Surveillance is key to a timely crisis response.** Effective surveillance provides vital early warnings on impending shocks to financial systems and helps develop crisis responses. However, surveillance is a complex business. It needs to be managed professionally and, crucially, be devoid of political and ideological influences. To be effective, surveillance must provide timely information on looming problems to ADB’s management and policymakers.

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**Written by Joanne Salop and Vankina Tulasidhar under the guidance of Vinod Thomas, Director General, Independent Evaluation.**

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**Learning Lessons** is a synthesis of key evaluative lessons drawn from the experience of ADB operations and non-ADB sources. Lessons presented in this brief are not prescriptive, and users are advised to carefully review these lessons in the context of country, sector, and thematic conditions.

**Contact Us**

Independent Evaluation Department
Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4100
Fax +63 2 636 2161
www.adb.org/evaluation
evaluation@adb.org