The Implications of a Global Financial Crisis for Asia and the ADB: Lessons from Evaluation
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NOTES

Note: In this report, “$” refers to US dollars.

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<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<td>ADF</td>
<td>Asian Development Fund</td>
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<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>CSF</td>
<td>Countercyclical Support Facility</td>
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<tr>
<td>DMC</td>
<td>developing member country</td>
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<td>DPO</td>
<td>development policy operation</td>
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<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>EvD</td>
<td>Evaluation Department, EBRD</td>
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<tr>
<td>FIL</td>
<td>financial intermediary loan</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GTFP</td>
<td>Global Trade and Finance Program</td>
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<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IED</td>
<td>Independent Evaluation Department, ADB</td>
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<td>IEG</td>
<td>Independent Evaluation Group, World Bank</td>
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<td>IEO</td>
<td>Independent Evaluation Office, IMF</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IFI</td>
<td>international financial institution</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>MDB</td>
<td>multilateral development bank</td>
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<td>OCR</td>
<td>ordinary capital resources</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
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<tr>
<td>SBPL</td>
<td>Special Policy-Based Loan</td>
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<td>SDPL</td>
<td>Special Development Policy Loan</td>
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<td>SME</td>
<td>Small- and medium-sized enterprises</td>
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<tr>
<td>SPL</td>
<td>Special Program Loan</td>
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<tr>
<td>TFP</td>
<td>Trade Finance Program/Programme</td>
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<td>US</td>
<td>United States</td>
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Acknowledgments

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Executive Summary

This report reviews the emerging experience with the economic crisis emanating from the Euro area to draw implications of such situations for Asia and the Asian Development Bank (ADB). It draws on analysis within the ADB, in other international financial institutions (IFIs), and in the research community, with particular attention to the lessons from evaluations of past crises and IFI responses to them.

The evidence suggests that the probability of a major crisis in the Euro-zone over the next 12 months is not insignificant. The most vulnerable European countries can regain competitiveness only while maintaining their euro commitments through a long period of economic stagnation and high unemployment to reduce wages and prices to the levels of the core European countries. Thus, some governments could choose, or be forced by popular protests, to restore competitiveness through exchange rate depreciation, despite dire economic consequences in the short term. One or more countries exiting the euro could result in a sharp recession, and perhaps economic chaos, in Europe as a whole.

The evidence also points to substantial spillover risks to Asia from such a crisis. These spillover risks imply follow-on risks to the broader global economy, as Asia is itself a major driver of international activity. As was the case in the global financial and economic crisis of 2008–2009, the leading edge of such risks is trade. However, there are also considerable risks to the financial sector in several countries, especially once exports decline and external credit and capital begin to flee. Remittances also are vulnerable in those countries that rely heavily on the provision of services to European markets or oil exporters.

The risks vary notably across Asian countries. The countries likely to suffer the largest declines in foreign exchange revenues are those dependent on oil, metals, or minerals (Armenia, Azerbaijan, Georgia, Kazakhstan, Mongolia, and Papua New Guinea) and a few countries that rely heavily on tourism or remittances (Kyrgyz Republic, Tajikistan, and some of the small island economies). Countries where exports to Europe are largest relative to output (Bangladesh, Sri Lanka, Thailand, and Viet Nam) would also see immediate declines in foreign demand. However, the extent to which these countries would be affected more than other open economies would depend on the strength and speed of the crisis impact on other major markets and their degree of participation in supply chains. In economies that are less dependent on Europe and export primarily manufactures or agricultural products (India, Nepal, Pakistan, and Uzbekistan), the risks of a European crisis are considerably lower, although not negligible.
Asian countries can do much to mitigate these risks. For the most part, Asian countries were able to avoid the worst effects of the 2008–2009 crisis because of their current and past policies. Should a new crisis strike—or the current slowdown continue for a prolonged period—more of the same would be needed, especially in severely affected countries, with respect to a continuation of (i) prudent monetary, fiscal, and exchange rate policies; (ii) targeted safety net programs to protect the most vulnerable from adverse impacts; and (iii) improved governance and transparency policies for the financial sector. Strengthened regional and international cooperation would also be important.

ADB and other IFIs can help, building on the lessons from evaluation of their responses to earlier crises, including the East Asian crisis and the 2008–2009 crisis. But a close watch will be needed on global, regional, and country developments so that preventive measures and quick responses can be designed and implemented. Should crisis conditions materialize, ADB would be better positioned to help developing member countries (DMCs) than three and a half years ago because of its 200% capital increase in 2009, its completion of the $12.4 billion Asian Development Fund XI Replenishment earlier this year, and its mainstreaming of the Countercyclical Support Facility (CSF) last year.

Actual events and DMC priorities will determine the shape of any ADB response, including crucially, the actual DMC fiscal, safety net, and financial sector policies that it would support. A key lesson of the evaluations considered in the paper is the critical importance of timely resource transfers. Hence the volume, and even more important for development effectiveness and sustainability, the quality of support provided through quick-disbursing policy-based operations or crisis-response instruments like the CSF would be at a premium. So would be continued engagement with the authorities and other potential clients during noncrisis periods, especially through investments in knowledge, which evaluations show to be the critical determinant of the quality of quick-disbursing operations.

The most resounding lesson of multilateral development bank (MDB) support for DMCs in responding to the 2008–2009 crisis is the importance of good preparation. There is clearly a vital role for continued attention to fiscal balances, whose relative adequacy provided the headroom for the Asian economies to react following the 2008–2009 crisis. Systems in place for the effective use of resources are of particular importance in the face of emerging difficulties concerning resource flows. But the efficacy of early preparation applies equally to the design of effectively targeted safety nets and social protection systems, for which there is increasing demand by authorities, especially in emerging economies, but inadequate investment thus far.

Going forward, ADB should take stock of its overall crisis preparation and response strategy. Such stocktaking would allow for a more thoughtful consideration of some of the underlying issues that have been inadequately addressed under crisis conditions in the past—building on the lessons from evaluation by both the Independent Evaluation Department (IED) and the evaluation units of sister IFIs, given the similar challenges they have faced. Pertinent issues for deeper discussion and debate include the implications of an expanded ADB role in surveillance, as has been suggested as central to an early warning system. In playing such an enhanced surveillance function, the risks that it poses to ADB’s confidential advisor role vis-à-vis DMCs would have to be considered.
Also to be examined are the magnitudes, allocative mechanisms, and modalities with regard to ADB financing under crisis conditions. The rules for allocating ordinary capital resources (OCR) during the 2008–2009 crisis may have been more transparent by virtue of ADB’s proactive use of the CSF for rationing incremental resources, but it remains to be decided what overall share of OCR ADB wants to set aside for crisis response. Scenarios would be useful for highlighting the resources required and the tradeoffs involved both on the financial side and also in the scaling up of the staff’s country knowledge and sectoral and macro expertise so as to be able respond quickly and effectively under crisis conditions. It also would pay to attend to the modalities for strengthening coordination and the division of labor with partners and donors—and internally across departments.

There are also implications for IED. Clearly, there is evaluation interest in the three priority areas of countercyclical fiscal policy, social safety nets, and financial sector management. As IED formulates its work program for the coming years, these issues need to receive prominent attention, given their relevance for ADB’s crisis prevention and response activities. These three priority areas—including greater scrutiny of fiscal sustainability and infrastructure gestation periods—should also receive prominent attention in IED’s outcomes-based evaluation of ADB’s crisis response once more in-depth data about crisis outcomes become available.

Finally, partnerships are important not just for DMCs and ADB but for IED as well. All the main MDBs had trade finance programs in operation as part of their response to the global crisis. These programs are clearly an area in which institutional learning would benefit from joint evaluation by the respective MDB evaluation units. More broadly, there is much to be learned from the findings of other evaluation units’ consideration of relevant topics in relevant contexts. This points to the desirability—and cost-effectiveness—of IED’s joining with its evaluation counterparts in the other MDBs in investing in mechanisms for more systematic sharing of their respective lessons learned with operational staff and others.
1. The global economy has barely recovered from the global economic and financial crisis of 2008–2009, and prospects are clouded by the potential for a deep recession in the euro zone. The most likely scenario remains a small decline in European gross domestic product (GDP) in 2012 followed by recovery over the next few years. But other scenarios are also possible—and none of them are pretty. Prudence dictates that policymakers review their economies’ ability to withstand a deep decline in European, and perhaps global, output—and to consider possible European outcomes ranging from a prolonged slowdown to a full-blown crisis.

2. This paper explores the consequences of such scenarios for developing Asia. It discusses country policy options, including possible enhanced regional and global coordination, and reviews the lessons learned from past evaluations concerning how the multilateral development banks (MDBs), and particularly the Asian Development Bank (ADB), might be able to help. It considers (in five chapters after this introductory one) the potential for a euro crisis and the possible implications for developing Asia; developing Asia’s policy options; the priorities in such circumstances for ADB’s support to its developing member countries (DMCs), based on the lessons learned from evaluation; the emerging institutional issues; and the implications of the paper’s analysis for the medium-term priorities of DMCs, ADB, and the Independent Evaluation Department (IED) itself.
CHAPTER 2

The Potential for a Euro Crisis and the Impact on Asia

3. This chapter explores the potential for a euro crisis or prolonged slowdown in Europe and its effect on developing Asia. It starts with the challenges that euro countries face in deciding whether or not to stay in the euro zone, given the importance of those decisions for broader economic and financial developments. It then turns to the implications for the global economy and for Asia generally. It ends with a discussion of likely impacts on individual country groups.

A. Dimensions of a Possible Crisis

4. The most severe threat to global prosperity may lie in the possibility of default and exit from the euro zone of one or more European economies. The vulnerable euro zone countries (Greece, Ireland, Italy, Portugal, and Spain) confront enormous difficulties in restoring growth and macroeconomic sustainability. The five countries have experienced an appreciation of their real exchange rates of from 6.8% to 16.9% since 2001, when Greece joined the euro zone, and public debt burdens are high (Table 1). Macroeconomic imbalances also reflect a run-up of private sector liabilities: all of these countries (except Italy) experienced a rise in the ratio of total (public plus private) debt to GDP of 70 percentage points or more from 2002 to 2010. And all five countries except Ireland are expected to suffer a decline in GDP this year.1

<table>
<thead>
<tr>
<th>Real Appreciation</th>
<th>Real Effective Exchange Ratea</th>
<th>Debt/GDPb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>16.4</td>
<td>142.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>16.9</td>
<td>96.1</td>
</tr>
<tr>
<td>Italy</td>
<td>6.8</td>
<td>119.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>10.7</td>
<td>83.3</td>
</tr>
<tr>
<td>Spain</td>
<td>13.7</td>
<td>60.1</td>
</tr>
</tbody>
</table>

GDP = gross domestic product.

a Real exchange rate appreciation from first quarter of 2001 to first quarter of 2012.
b Government debt-to-GDP ratio in 2010.


5. The question facing the vulnerable countries is whether staying in or leaving the euro zone would be the least-cost way to restore growth. Current policies essentially rely on deflation in the vulnerable countries to correct the imbalances in real exchange rates within the euro zone. Declines in wages are to be achieved through compressing demand and eliminating social arrangements that promote wage rigidity, in short through recession and worsening the lot of poor workers. The recession required to restore competitiveness would further raise the debt burden relative to GDP. And it is not clear whether policy reform would achieve recovery within some acceptable time frame, whether these countries’ political elites are able to implement the necessary reforms, and whether sufficient finance would be forthcoming to ease the adjustment.

6. However, the consequence of leaving the euro zone could be devastating. The exiting countries could face severance from global financial markets, bank runs, massive bankruptcies due to the higher local currency value of debt denominated in foreign currencies, further economic disruption due to uncertainty over the value of existing contracts, and greater fiscal austerity or monetization of the deficit accompanied by rising inflation. Estimates of the decline in output vary from absolute disaster (Union Bank of Switzerland [UBS] forecasts a decline of 40%–50% in exiting countries’ GDP) to merely severe (International Netherlands Group [ING] and Credit Suisse anticipate that an exiting country would suffer a 7.5%–9.0% reduction in GDP).

7. Historical precedents are of uncertain value in anticipating the likely impact of leaving a monetary union. Most countries that have left currency unions since World War II did not suffer calamitous drops in output. However, this conclusion largely reflects the experience of developing countries before 1980, when global financial integration was limited. Exit from a currency union by a financially integrated, developed country with extensive ties to neighboring countries is likely to be more costly. More recent devaluations from a fixed exchange rate peg have ushered in sharp recessions (from date given to trough), for example Argentina (-15% from January 2001), Iceland (-11% from October 2008), Indonesia (-16.6% from July 1997), Mexico (-15.1% from December 1994), Republic of Korea (-9.1% from December 1997), and Thailand (-13.8% from July 1997).

8. A crisis precipitated by a euro exit would lead to a sharp depreciation of the euro in the short term. One country leaving the monetary union could call into question the commitment of other countries; worsen growth prospects for Europe as a whole; and increase global financial uncertainty, which would encourage a flight to dollars. However, the long-run equilibrium level of the euro would not be greatly changed by the exit of a few small countries. Over time, assuming that no further countries exit, that growth resumes after short-term disruptions from the crisis, and that the strengthening of efforts towards fiscal union results in a more sustainable monetary union, the euro exchange rate would likely strengthen again.

9. Most economic forecasts view a country exiting the euro as a low probability event, given the huge declines in output and economic disruption involved. The Citigroup puts the probability of a vulnerable country leaving the euro at 20%–25%.

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The Economist Intelligence Unit assigns only a 5% probability to Greece leaving on its own, but a 35% chance to a full breakup of the currency union (as the exit of one country would increase the probability of exit for others due to market pressures). The baseline forecasts of the International Monetary Fund (IMF), the World Bank, the Organisation for Economic Co-operation and Development (OECD), and ADB all assume a slowing of European growth to near-stagnation or recession in 2012, but none of these forecasts appear to involve a country exiting the euro. However, as of this writing the euro crisis appears to be deepening, and commentators are increasingly accepting the idea that some countries could leave the euro. In any event, it is important to consider the implications of an alternative scenario in which one or more countries exit the euro. Indeed, the difficulties that authorities face in planning for euro exit (as news of such plans could hasten the crisis by further undermining the credibility of current policies) may well exacerbate the crisis, because authorities are unprepared. Greece and Portugal are the most likely candidates for exit, given their relatively high debt and real exchange rate levels; high government bond yields; and lack of a large, dynamic export sector that could facilitate adjustment.

10. **The timing of a country exiting the euro is equally uncertain.** The Greek debt restructuring and IMF program, coupled with the European Central Bank’s (ECB) lending operations, which have strengthened the liquidity position of European banks (which may make it easier for them to continue to lend to vulnerable countries), have not resolved the underlying crisis but have undoubtedly postponed the day of reckoning. Nevertheless, markets are likely to react very quickly in the advent of adverse political or economic developments, and such reactions could precipitate a crisis at any time.

11. **A euro crisis could develop in various ways.** Driven by popular discontent with austerity policies, a government in one of the vulnerable countries could seek to renegotiate the terms of its bailout program, leading to a break with creditors. A government could feel compelled to print its own currency if a drop in revenues coupled with a loss of market confidence made it impossible to finance minimal levels of government expenditures. Or the loss of deposits in the banks of a vulnerable country could exceed the limit that the ECB is willing to finance, threatening the solvency of the banking system and leading the government to print its own currency to avoid massive bank failures and to limit depositor losses.

12. **Exit from the euro could have severe implications for European and global output.** Other European countries would suffer a precipitous decline in exports as the exiting countries undergo severe recession and exchange rate depreciation. European banks would experience huge losses on their exposure to exiting countries, a potential seizing up of financial transactions, and an overall decline in confidence as investors worry about other countries exiting. Given the large amount of intra-European trade and financial transactions, declines in demand in each country would have cascading effects, exacerbating the Europe-wide recession. A decline in European demand and in United States (US) consumer spending with the fall in the value of financial assets could tip the US into recession, further dampening global growth. In addition, the deterioration of public debt positions in Europe and the US would make it more difficult than during the financial crisis to rely on fiscal expansion to counteract a further drop in private sector demand.

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B. Implications for Developing Asia

13. Multilateral organizations have recently prepared low case scenarios involving a severe recession in Europe. The IMF estimates that a 3.5% reduction in European GDP would reduce US GDP by more than 2% and emerging Asia’s GDP by 1.5%–4%, relative to base case forecasts. The OECD calculates that disorderly sovereign defaults in some euro countries could reduce Europe’s GDP by 3.7% and US GDP by 2.6%. The more serious of the two World Bank low cases, which involves a credit squeeze in some of the larger European countries, results in a 6.0% decline in the GDP of the European Union and a 3.6% fall in GDP in other advanced countries. The most pessimistic scenario provided by ADB envisions a decline in GDP in the euro zone and the US to 2009 troughs.

14. The focus on the potential for a severe crisis should not draw attention from the impact on Asia of a protracted slowdown. Even if no country exits the euro zone, efforts to restore competitiveness through deflation in the vulnerable countries, coupled with continued fiscal restraint in the core countries to meet recent commitments, could imply a long period of slow growth or stagnation in Europe. Prospects are further darkened by weaknesses in European banking systems, which have seen a deterioration in loan quality and credit rating downgrades as a result of the financial crisis and recent economic stagnation. European banks will require further improvements in balance sheets (in part to meet the rise in capital requirements under Basel III) before they can again become robust sources of loans to fuel recovery.7

15. A protracted European slowdown would depress demand for Asian economies’ exports, which could reduce growth. However, Asia would find it easier to cope with an extended slowdown in export demand than a sharp crisis. Exporting firms would have a longer period of time to find alternative markets (including regional and domestic markets), and the probability of a financial crisis driven by a flight to quality would be less. Nevertheless, a protracted European slowdown would severely reduce the potential gains from trade for Asian economies, which would slow development. In turn, given the importance of Asia to the global economy, Asia’s response would be important in determining the global implications of a crisis or a prolonged slowdown (Box 1).

16. First and foremost, a European crisis would reduce developing Asia’s export revenues. As with the financial crisis, trade would be an important channel for transmitting the impact of a European recession to Asia. Developing Asia’s export volumes dropped by 9% in 2009 with the financial crisis, but have since rebounded strongly. However, export growth for most Asian countries remains well below the torrid pace set during the precrisis boom.

17. The countries likely to be most affected by a European recession are important customers for Asia’s exports. Just under a fifth of developing Asia’s exports are bought by Europe. Asian exporters also would suffer from reduced demand from economies hurt by the European recession, most immediately the US (which accounts for 15% of developing Asia’s exports). The Asian economies suffering the largest declines in GDP growth during the financial crisis tended to be the more open economies: In 2010, the developing Asian economies that were hardest hit by the crisis had export-to-GDP ratios averaging almost 40%, the moderately affected countries’ export share was less

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7 For example, a recent survey found that European commercial banks are continuing to tighten credit standards for loans to both firms and households. See the ECB Monthly Bulletin, April 2012.
than a quarter, and the least affected countries’ export share was about a fifth.\(^8\)
Nevertheless, the impact of a euro crisis would probably be less than during the financial crisis, as the share of Asia’s exports going to Europe and the US has declined since 2008.\(^9\)

**Box 1: Developing Asia’s Contribution to the Global Economy**

Developing Asia has become an important source of growth for the global economy. The extraordinarily rapid growth and large size of People’s Republic of China (PRC) and India have dramatically increased the contribution of developing Asia to global demand growth, from 9% in the 1980s to 23% in the 2002–2007 boom, and then to almost 60% in 2008 as global growth slowed (see box figure).

Developing Asia now accounts for 13% of global GDP, and has contributed about 30% of global growth since 2009. The World Bank forecasts that developing Asia’s contribution to growth will rise to 36% over the next 2 years. By contrast, high-income Asian countries’ GDP fell in 2008 and 2009, and their contribution to growth during the recovery (2009–2011) was broadly similar to the experience prior to the crisis.

18. The impact of a global recession originating in Europe would in part depend on the substantial share of Asia’s trade that represents participation in supply chains, where final demand ultimately depends on the advanced economies.\(^10\) The follow-on effects of the crisis and the substantial role of supply chains means that the decline in European demand would be translated quickly throughout Asia, and not be limited to countries with large direct exports to Europe. To illustrate, an analysis of the importance of production chains in trade finds that 59% of exports from developing Asia (including intra-Asian exports for assembly and shipment to other regions) ultimately depends on Europe, the US, and Japan, while these destinations directly purchase only 40% of developing Asia’s exports.\(^11\)

19. Data on the domestic content of exports should be considered when evaluating the regional impact and country distribution of a European crisis. The immediate impact of a decline in exports on GDP in part depends on the extent to which domestic

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\(^9\) Footnote 6, page 5.

\(^10\) Foreign trade statistics are measured in terms of gross receipts. However, for a country participating in a supply chain, a large share of gross export revenues may represent the purchase and re-export of intermediate inputs. Thus the value added involved in exports could be well below total export revenues.

labor and capital are devoted to export production (the share of domestic content of exports in output). Where countries are intensively involved in assembly operations, the domestic content of exports can be much smaller than total export receipts. In the countries with the highest share of exports in GDP (Thailand and Viet Nam), domestic value added accounts for only 60% of gross exports (Figure 1). And in countries with very low exports-to-GDP ratios (South Asia, Indonesia), domestic value added is about 80% of gross exports. The People’s Republic of China’s (PRC) total exports equal 28% of GDP but domestic value added is only 50% of export revenues. As countries develop, it may be desirable for involvement in technologically sophisticated sectors to transition from a focus on assembly operations to manufacture of the entire product. Nevertheless, during the financial crisis the relatively low domestic content of exports of the more open economies is one reason why the huge drop in exports was not accompanied by a greater decline in output in the Asian developing economies.

Figure 1: Share of Domestic Value Added in Export Receipts (percent)

GDP = gross domestic product, PRC = People’s Republic of China.
Notes: Share of domestic value added in exports refers to 2004, exports-to-GDP ratios to 2010.

The data on the domestic content of exports were produced by a group of researchers (see sources cited in Figure 1) and are not available on a reasonably comprehensive basis for more recent years. Exports refer to merchandise, for consistency with domestic content analysis. As a result, export shares may appear smaller than in some other sources. The authors divide the People’s Republic of China’s exports into two sectors, “processing exports,” which include assembly activities integrated into supply chains, and “normal exports,” which are other export activities.

http://www.sciencedirect.com/science/journal/03043878

Note that the issues surrounding high-tech assembly operations sound similar to, but differ from, earlier studies of the importance of developing countries moving to higher value-added export production. That discussion focused on how developing countries could transition from exporting primary goods with minimal processing (and thus low value added) to exporting more sophisticated manufactures that are associated with higher wage levels. The problems with focusing on primary goods exports were seen as declining or highly-variable terms of trade and limited opportunities to move into higher skilled production (see, for example, Federico Bonaglia and Kiichiro Fukasaku, “Export Diversification in Low-Income Countries: An International Challenge after Doha.” OECD Development Centre Working Paper No. 209. http://www.oecd.org/dataoecd/13/28/8322001.PDF). By contrast, participation in supply chains through assembly operations does not expose a country to volatile primary commodity prices and can be a stepping stone to moving into higher skilled production.
20. **As during the financial crisis, the fall in Asian exports could be exacerbated by constraints on trade finance, as funding pressures drive banks to withdraw credit lines, particularly to risky borrowers.** A drying-up of trade finance facilities to Asian developing countries is a real threat, as these countries are likely to be cut off before high-income exporters, while European banks provide most of the dollar-denominated trade finance in Asia. Replacing trade finance sources during a period of international crisis would be difficult, underlining the importance of establishing credit commitments at an early date.

21. **Exporters of energy, metals, and minerals would be particularly affected by the crisis.** When global GDP fell in 2009, energy prices dropped by 32%, metals and minerals prices by 28%, and agricultural prices only modestly, relative to manufactures prices. In general, agricultural prices are less responsive to cyclical conditions than energy and metals, although that is changing as more agricultural land is devoted to biofuels. The most affected countries have, on average, relatively small net trade in each commodity grouping relative to GDP (Figure 2). Countries that were moderately affected by the financial crisis would be likely to enjoy terms of trade gains with the euro crisis, as the prices of their substantial imports of energy, metals, and minerals (almost 6% of GDP) fall compared with the prices of their manufactured exports. The least affected countries could experience a terms of trade decline, which may worsen their position compared to during the financial crisis (in 2007, before the crisis, the size of their net surplus in commodities was smaller relative to GDP).

![Figure 2: Net Gains from Commodity Price Declines Would Have Some Impact During a Crisis](source: World Bank data)

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17 The average data for the most affected countries conceal considerable variation within the group of most affected countries, which includes the Central Asian republics with large net surpluses in oil and some larger countries (e.g., Pakistan, Philippines, Thailand) with large net deficits.
22. **Declines in remittances and tourism would have a major impact in only a few countries.** Declines in remittances and tourism revenues were not a major factor in the financial crisis for developing Asia on average. A recession in Europe and the US, coupled with a fall in oil prices, which would reduce demand for workers in the rich oil exporters, would cut remittance receipts. However, remittance receipts averaged only about 2% of GDP in developing Asia in each of the years from 2006 to 2010, and the changes in remittances to GDP for each of the three country groups was less than 0.5% of GDP in every year. Nevertheless, remittances are important in a few countries, notably some of the Central Asian republics and small island economies, Bangladesh and Sri Lanka, which receive substantial remittances from workers in the Middle East (11% and 8% of GDP, respectively); Philippines (11% of GDP); and Nepal (26%).

23. **Tourism revenues are even less important than remittances for the Asian developing economies on average, and for most countries declines in tourism with the financial crisis were not that significant.** However, tourism revenues did fall by more than 1% of GDP from 2007 to 2009 in Cambodia, Mongolia, Thailand, Timor-Leste, Viet Nam, and a few of the small island economies, as well as in the severely affected countries in total. Again, declines in tourism are not expected to play a major role in reducing foreign exchange earnings for most developing Asian economies in the event of a European crisis.

24. **Financial sector implications are difficult to anticipate.** Sharp withdrawals of bank funding, a drying up of international capital market flows, and reductions in foreign direct investment could exacerbate the impact of a European recession. A fall in capital flows would reflect a global flight to quality, as the deteriorating economic environment, coupled with declines in income and the need to shore up balance sheets, reduce investor demand for all relatively high-risk financial assets, including in developing Asia. This was the experience during the financial crisis: Although the fall of Lehman Brothers and the ensuing crisis revealed severe weaknesses in the US financial system and undoubtedly reduced expectations of the return on investing in the US, yields on US Treasury bills fell and the dollar appreciated, while secondary market spreads on sovereign debt issues from Asia skyrocketed.

25. **Gross flows from international capital markets (international bond issues and equity placements) to developing Asian economies fell from 2.9% of GDP in 2007 to 1.1% in 2008, and have not yet recovered.** Net debt flows from private sources and portfolio equity flows also dropped, although they have more or less recovered since. And net foreign direct investment flows, which typically react more slowly to macroeconomic developments than capital market flows, held at 3.7% of GDP in 2008 and then declined to 2.4% in 2009.

26. **Emerging markets in Asia, which remain relatively high-risk investments, could see increases in the interest rates required to attract new funds, coupled with declines in stock market prices.** Indeed, Asian financial markets are already experiencing some impact from the slowdown in Europe, as European banks have begun selling assets to devote cash to headquarters. Secondary market spreads on the foreign currency government debt of PRC, Indonesia, Malaysia, Philippines and Viet Nam all rose by well over 100 basis points from December 2010 to October 2011, and an index of secondary market bond spreads for developing Asia, while well below late-2008 levels, is almost twice the historically low levels reached before the increase in market turbulence in 2007.

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18 See Bénassy-Quéré et al., op. cit.
27. The potential for a withdrawal of funds has increased, because advanced country investors have built up considerable positions in Asian debt markets since 2009. For example, from the first quarter of 2009 to the second quarter of 2011, foreign investors increased their share of Thailand’s domestic debt market from 3% to 9%, and in Indonesia’s debt market from 15% to 35%. A sudden withdrawal of these holdings, or the anticipation of such withdrawals, to shore up the positions of European and US investors in their domestic markets could reduce confidence and lead to more widespread withdrawals. The IMF also underlines the potential for financial disruptions in Asia if US and European investors are forced to unwind speculative positions they have taken in Asian currency markets. These risks highlight the importance of efforts to increase regional participation in Asian bond markets. Despite efforts to encourage greater intraregional investment under the Asian Bond Markets Initiative, cross-border debt investment as a percentage of the region’s total equaled only 7.2% in 2010, although this does represent a rise from only 4.2% in 2001.

28. Asian banks are in a relatively good position to weather a renewed global crisis, despite some deterioration in asset quality during the financial crisis. Nonperforming loans fell by half or more as a share of total loans in PRC, Indonesia, Philippines, and Thailand from December 2006 to June 2011. Most of the largest banks with home offices in PRC and India and had strong profitability and higher Tier I capital ratios in 2010 than in 2005, and all comfortably met the Basel III guideline of at least 6%. Those countries with relatively high inflation (such as India and Viet Nam) and recent high credit growth (such as PRC) may see greater increases in nonperforming loans if global credit conditions deteriorate.

29. The relatively low level of foreign ownership of Asian emerging market banking systems helps to insulate them from declines in funding due to home country problems. Asian banks do not hold large amounts of euro zone bonds. However, European banks’ exposure to developing Asian financial institutions rose by 41% from September 2009 to September 2011, to 2.9% of domestic credit, which has somewhat increased developing Asia’s vulnerability to a renewed crisis in Europe. It is thus possible that a severe cutback in lending by European banks could raise funding issues for Asian banks. There also is some potential for regional financial disruptions, since European banks account for 161% of Hong Kong, China’s GDP and 83% of Singapore’s. Morgan Stanley anticipates that European banks could withdraw about 3%–5% of Asian banks’ system assets due to increases in capital requirements, funding problems they are experiencing in the wake of the euro zone crisis, and political pressures to safeguard European banks’ domestic lending. On balance, they conclude that a European bank withdrawal from Asian markets would be manageable, but would have some negative impact on funding costs and credit conditions. Asian banks also could be affected because of their exposure to other financial systems hit by the euro zone crisis, and by a general seizing up of financial transactions.

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19 IMF. 2011. Asia Pacific Regional Economic Outlook.
21 Discussed in the IMF’s World Economic Outlook 2011.
24 Data are from Table 9D from the Bank for International Settlements (www.bis.org).
Increases in corporate leverage with the recovery from the financial crisis could exacerbate the impact of a sharp European recession. While comprehensive data are not available, corporate leverage does appear to be rising in some Asian economies, which would increase their vulnerability to a European crisis. The average debt-to-equity ratio in emerging Asia rose by about 30 percentage points from 2007 to 2010, a much faster rate than during the recovery after the 2001 global recession. Nevertheless, the average debt-to-equity ratio remains less than half the heights reached just prior to the East Asian financial crisis.27

The crisis may also represent a financial opportunity. The stronger Asian banks and corporates could take advantage of the depreciation of the euro and sharp declines in European asset prices to acquire European banks (including their Asian branches and subsidiaries) and other firms at low prices. Similarly, Asian banks could inherit much of the business from the withdrawal of European banks’ loans to the region. The appreciation of the dollar that would likely accompany a European recession would increase the real value of Asian reserves, which are largely held in dollars; for example, the euro accounts for only a small share of the PRC’s massive reserves.28 The increase in the purchasing power of Asian reserves would help limit the income losses from the decline in foreign demand, and could spur increased purchases of foreign assets by Asian sovereign wealth funds.

Most and Least Vulnerable Developing Member Countries

The impact of a renewed global crisis on growth in each country would depend critically on the size and composition of trade. Countries dependent on oil, metals, or minerals (Armenia, Azerbaijan, Georgia, Kazakhstan, Mongolia, Papua New Guinea), the prices of which are likely to fall sharply with a global recession, would experience the largest percentage declines in export revenues. Kyrgyz Republic, Tajikistan, and some of the small island economies may also be affected due to their heavy reliance on tourism or remittances, which are likely to decline modestly with the crisis. Countries with the greatest dependence on European markets (in Bangladesh, Sri Lanka, Thailand, and Viet Nam, exports to Europe account for 6%–12% of output) would also see immediate declines in foreign demand. However, the extent to which these countries are affected more than other open economies would depend on the strength and speed of the crisis impact on other major markets, principally the advanced economies outside Europe. Also, for countries heavily involved in supply chains, the data on the share of gross exports going to Europe may understate the importance of Europe in final demand, but overstate the importance of export revenues for GDP (see above).

In economies that are less dependent on Europe and export primarily manufactures or agricultural products, the risks of a European crisis are considerably lower, although not negligible. In India, Nepal, Pakistan, and Uzbekistan exports to Europe account for less than 3% of output, and manufactures and agricultural products, whose prices are likely to improve relative to oil, metals, and minerals, constitute more than three-fourths of total exports. However, some of these countries may be affected by other effects of the crisis: India may be vulnerable to a sharp withdrawal of private lending, while Nepal receives substantial remittances that could decline with the crisis. PRC and Philippines occupy a position between the two groups,

27 IMF. 2011. World Economic Outlook. op. cit.
28 See Huang. op.cit.
as they are relatively open economies with somewhat higher dependence on Europe. The same caveat concerning the role of supply chains, discussed above, applies here. Indonesia is also in a middle position, with some dependence on oil exports but with only limited exports to Europe.

34. **Barring a global financial meltdown, the financial implications of the crisis are likely to affect a limited number of countries.** A few countries (India, Maldives, Mongolia, and Viet Nam) have significant current account deficits financed by private capital flows. Apart from a few island economies, international banks’ claims account for more than a third of domestic credit in Azerbaijan, Indonesia, Philippines, and Sri Lanka.

35. **The impact of a euro crisis on Asia would be intensified by the ongoing slowdown in major Asian economies.** In the PRC, growth slowed by only a little more than a percentage point in 2011, but the principal concern is that the government-directed expansion of bank lending in response to the financial crisis may have weakened the quality of bank portfolios. A European crisis that contributed to a reversal of the boom in the prices of real estate, which is widely used as collateral for bank loans, and reduced the return on bank-funded projects could imperil the solvency of the banking system. In India, a slowing of domestic demand in 2011 reduced GDP growth by 3 percentage points (to 7%), and producer sentiment deteriorated in the second half of the year. A crisis that substantially cuts export demand when the current account deficit is rising (to above 3% of GDP) could severely reduce growth, at least in the absence of a strong policy response. Growth declined more sharply in 2011 in Philippines (by 4 percentage points) and Thailand (almost 6 percentage points), and a severe global crisis could well result in economic stagnation.

36. **The impact of a euro crisis on poverty in the region would likely be moderate, as only some of the countries most likely to be hit by falls in export revenues are relatively poor.** The headcount poverty indices in the exporters of oil, metals, and minerals are below 10%, except in Georgia and Papua New Guinea, and their populations are relatively small. By contrast, poverty rates in the countries where export revenues are least likely to fall sharply range from 18% to 32%, and populations are larger. Thus the most vulnerable countries account for less than 1% of extreme poverty in the region. Since half of the region’s extreme poor live in India, and India’s export vulnerability is relatively limited (although its financial vulnerability is a cause for concern), the share of the region’s poor living in the least vulnerable countries is 60%.

37. **The small share of regional poverty living in the most vulnerable countries does not imply that we should not be concerned with the poverty impact of a global crisis.** Distributional effects can mean that the poor suffer disproportionately in countries that are on average less vulnerable to a crisis. This finding does imply, however, that sound social safety nets in individual countries, coupled with targeted international support to countries with high poverty rates and high vulnerability, could play a significant role in addressing the impact of a global crisis on poverty.

38. **This analysis has focused on each country’s vulnerability to a crisis in terms of the potential impact on foreign exchange revenues.** The ultimate impact on growth and poverty also would depend on these countries’ policy reactions, including the fiscal space that they have available to substitute domestic for foreign demand, and the institutions and procedures in place to aid the poor.
CHAPTER 3
Developing Asia’s Policy Response

39. Developing Asia can and should act—both to avert a possible crisis coming their way and to minimize and mitigate adverse impacts, taking account of where they are in the postglobal crisis response cycle. Importantly, collective action by Asian developing countries could reduce the impact of a global crisis on Asia. At the same time, greater financial integration coupled with rapid growth in large Asian economies underlines the importance of, and potential for, Asia playing a greater role in preventing global crises.

40. The previous chapter focused on country vulnerabilities to a possible crisis in terms of first-round impacts of a major euro-shock. But in the end the impact on growth and poverty would also be determined by the country policy response, including, importantly, countercyclical fiscal policies, social protection and safety-net policies, and financial policies. These topics are discussed in this chapter, along with considerations of global and regional policy coordination, following an initial discussion of developing Asia’s recent policy experience.

A. Developing Asia’s Policy Experience in Recent Years

41. The financial crisis had a more limited impact on developing Asian economies than did the East Asian crisis of 1997–1998. Driven largely by external and internal policy changes, the intervening period was marked by major improvements in Asian economies’ ability to cope with external shocks. One measure of this increased resilience is Asia’s reserve holdings, which, measured by monthly import coverage, just about doubled between end-1996 and end-2007.29

42. Externally, developing Asian economies increased their exchange rate flexibility after 1999—at least until 2004—and reduced their capital account openness. Exchange rate flexibility according to a commonly used index (Figure 3) declined with the global boom, although some analysts argue that in terms of both declared commitments and analysis of data, exchange rate flexibility in the major Asian economies rose from 2000 to 2008.30 More recent statistical analysis of major Asian economies’ exchange rates indicates some movement towards greater flexibility in the past few years.31 At the same time, developing Asian countries also slowed the

29 Including the PRC, the average rose from 5 months of imports to 13 months; excluding the PRC, the average rose from 4 months to 7 months.
transition to open capital accounts in the wake of the East Asian crisis, thereby insulating the exchange rate and the domestic economy from volatile capital flows. Figure 4 charts the course of a commonly used financial openness index, where a lower value of the index indicates less openness, which rose steadily from 1980 to 1996, and then declined sharply through the onset of the global crisis. Even by 2009, the average of the major Asian economies, both high-income and developing, remained significantly lower than its peak in the mid-1990s.

Figure 3: Exchange Rate Flexibility in Asian Economies Increased Following the 1990s Crisis (index of exchange rate flexibility)

Note: Increase indicates greater exchange rate flexibility. Unweighted average of Asian countries with data from 1980, excluding small economies (includes 10 developing countries and 7 high-income countries).

Source: http://web.pdx.edu/~ito/Chinn-Ito_website.htm

Figure 4: Capital Account Liberalization Became Less Popular With the East Asian Crisis (Chinn-Ito index of financial openness)

Note: Unweighted average of Asian economies with data since 1980. Excludes small economies.

Source: http://web.pdx.edu/~ito/chinn-Ito_website.htm
43. These improvements in external policies strengthened Asian economies’ ability to cope with the decline in export demand. This can be seen in the changing relationship between exports and growth in the region. Excluding the two countries most affected by the crisis (Philippines and Thailand), developing Asia’s export and GDP growth rates fell by 4 percentage points in 1998 compared with the average of the previous 5 years (Figure 5). By contrast, in 2008–2009, developing Asia’s export growth rate fell by almost 20 percentage points from the previous 5-year average, but the GDP growth rate fell by only 2 percentage points. And this was despite the fact that exports had in the intervening years become more important in Asian economies (from 18% of GDP in 1998 excluding the most affected countries, to 39% for developing Asia in 2007, although the growing importance of supply chains means that the domestic value added involved in exporting had not increased as much—see Chapter 2).

![Figure 5: Developing Asia's Ability to Cope with Crises has Improved since 1997–1998](image)

Notes: Countries included are developing Asia except Philippines and Thailand in the 1990s crisis, Source: World Bank data.

44. Internally, several Asian economies took measures to improve macroeconomic policies and strengthen corporate governance and financial sector regulation. Between the end of the East Asian crisis and the start of the global crisis, most Asian economies reduced inflation and fiscal deficits, thereby improving the credibility of their policies and positioning themselves to expand when the new crisis struck. The major Asian economies also strengthened their financial sectors after the late 1990s crisis. Nonperforming loans declined substantially as a share of total assets from 1998 to just before the financial crisis in PRC, India, Indonesia, Philippines, and Thailand. Risk-weighted capital adequacy ratios also improved in all of these countries, except the PRC.32 Short-term external borrowing that had generated substantial currency and maturity mismatches in the 1990s was reduced, risk-weighted capital asset ratios were

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raised, while asset diversification has reduced risk. Supervision of banking and corporate sectors improved substantially.

45. Nevertheless, some Asian developing economies still required substantial efforts to achieve more sound financial systems. In Viet Nam, poor transparency made it difficult to estimate the level of nonperforming loans, although early in the last decade the government did substantially reduce nonperforming loans in the state banking sector. Banking systems in the Central Asian republics (Armenia, Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan) remained small, with bank deposits ranging from 9% to 26% of GDP, compared with a third or more in some of the Eastern European transition economies. The Central Asian republics faced significant financial sector weaknesses, with high levels of nonperforming loans (by international standards) in Azerbaijan, Kazakhstan, and Uzbekistan; low levels of provision in Tajikistan; and vulnerability to liquidity problems due to a history of devaluations and bank runs in Armenia.

B. Country Policy Options Going Forward

1. Countercyclical Fiscal Policy

46. Most developing Asian economies have some room for expansionary policies that could offset a renewed decline in external demand. Government debt levels remain low relative to GDP in many Asian economies, but debt exceeds 50% of GDP in India, Mongolia, and Pakistan. Debt has increased substantially in the PRC, but not in many other countries, as a result of the expansionary fiscal policies undertaken since the crisis hit (Figure 6). Many countries retain some fiscal space to undertake expansionary policies, if needed.

47. Also, Asia’s experience with countercyclical policies during the global crisis was positive. A rise in fiscal deficits was nearly universal among the Asian developing economies: By 2009, the average fiscal deficit was more than 4 percentage points of GDP higher than the precrisis average (2005–2007) in the severely affected countries, 3 percentage points higher in the moderately affected countries, and 0.8 percentage points higher in the least affected countries. The rise in deficits reflected declines in revenues and mandated increases in safety net payments as growth slowed, as well as deliberate decisions to raise expenditures and cut taxes.

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33 Lee and Park 2008, op cit.
Developing Asia's Policy Response

48. This widespread use of expansionary policies, in which the high-income Asian economies also participated, was one of the reasons that regional GDP growth fell only moderately during the crisis. Average GDP growth in the countries that were severely affected by the crisis rose from 0.1% in 2009 to 6.5% in 2010, driven by strong recoveries in Philippines and Thailand, and then fell by about half in 2011 (Table 2). GDP in PRC and India, which were only moderately affected by the crisis, rose by about 10% in 2010 before slowing in 2011 to 2.5–3 percentage points lower than the precrisis boom (2002–2007). Growth in the developing countries that were least affected by the crisis exceeded 6% in 2010 and 2011, almost 1 percentage point higher than during the precrisis boom.

Table 2: Asian Growth Rates
(average annual percentage change in real GDP)

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<td>Asian Developing</td>
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<td>8.0</td>
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<td>3.6</td>
<td>0.1</td>
<td>6.5</td>
<td>3.3</td>
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<tr>
<td>Moderately Affected</td>
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<td>8.7</td>
<td>8.5</td>
<td>10.2</td>
<td>8.5</td>
</tr>
<tr>
<td>Least Affected</td>
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<td>6.2</td>
<td>5.0</td>
<td>6.1</td>
<td>6.5</td>
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Source: World Bank data.

49. While many countries retain space for further expansionary policies, current levels of fiscal deficit pose a dilemma for government policy in the context of preparing for a renewed global crisis (Table 3). Continued, large deficits could undermine the confidence gained by the reduction of Asian developing countries’ average fiscal deficit from 4.6% of GDP in 2000 to 0.5% in 2008. On the other hand, a substantial fiscal contraction by many Asian governments could reinforce whatever negative shocks may emanate from the global economy, exacerbating the regional downturn. Fiscal policy takes time to implement and is subject to lags in its effects, so that contractionary policies may be difficult to reverse quickly. On balance, moderate efforts towards fiscal consolidation may be useful—and some governments are already taking measured
steps to unwind the fiscal stimulus—but should not be so large as to undermine the government’s ability to respond in case of a renewed global recession.\(^{38}\) Governments have been understandably reluctant to unwind fiscal stimulus more rapidly, given the anemic recovery in the global economy and the threat of a renewed downturn.

**Table 3: Government Stimulus, 2005–2011**
(average annual government deficit/GDP, in percent)

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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>
</tr>
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<td>Moderately Affected</td>
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<td>-4.7</td>
<td>-3.7</td>
<td>-3.4</td>
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<td>-0.4</td>
<td>-1.2</td>
<td>-1.5</td>
<td>-1.6</td>
</tr>
<tr>
<td>High Income</td>
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<td>-1.3</td>
<td>-6.5</td>
<td>-5.9</td>
<td>-6.4</td>
</tr>
</tbody>
</table>

GDP = gross domestic product.
Note: Regional averages are GDP weighted.
Source: World Bank data.

50. **This dilemma puts a premium on macroeconomic sustainability, and in turn on the quality of public expenditures in countercyclical packages.** World Bank research shows that for most developing countries, expansionary fiscal policy has not been an effective tool for responding to economic downturns in the past. It finds that Asia’s experience during the financial crisis was an important exception, but the potential for prolonged fiscal expansion remains limited. It concludes that governments cannot neglect long-term development objectives in structuring countercyclical programs.\(^{39}\) Thus, the fiscal policy response to a crisis should be either reversible (for example, large-scale consumer subsidies that people may view as permanent income should be avoided) or likely to yield long-term productivity gains (for example, investment in high-return infrastructure or human capital).

2. **Social Protection and Safety Nets**

51. **Expansion of social safety nets and other social protection programs was a key driver of the fiscal outturns shown above.** In contrast to earlier crises, which typically emerged from macroeconomic and financial imbalances within developing countries to which “adjustment” was required, the global crisis was driven by a massive external shock in the advanced economies that required synchronized expansion by almost all countries to prevent a global economic collapse. Rather than belt tightening, belt loosening was called for, including importantly for households—both those below the poverty line and those adversely affected by the slowing of economic growth and employment. The six case study countries of IED’s evaluation of ADB’s crisis response all enacted major safety net programs. This ranged from targeted subsidies and employment guarantee programs in Bangladesh; to tax cuts and unconditional cash transfers to support the poor and near-poor in Indonesia; to social protection programs in the Philippines targeted at the poor, export sector workers, and returning overseas workers.\(^{40}\)

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\(^{38}\) The rise in the average deficit in 2011 in the severely affected countries shown in Table 3 largely reflects the 5 percentage points of GDP increases in Azerbaijan and Cambodia, with most other countries experiencing some improvement in the fiscal balance. The average deficit in the least affected countries also would have fallen sharply, except for large increases in Kyrgyz Republic and Uzbekistan.


52. There is also evidence that the efficiency of spending on such programs improved during the crisis due to better preparation and targeting. The improvement reflects innovations in such programs in recent years, building on the lessons learned in part from previous crises. These include the use of existing structures and the focus on crisis needs. Such programs provide an effective platform for expansion in time of crisis. The prospect of increased global volatility emphasizes the need to have efficient arrangements to support the poor. During the recent, dramatic increase in food prices, countries that had institutions in place that could efficiently target assistance to the poor were well placed to assist vulnerable groups rather than boost poorly targeted and excessively costly consumer subsidies.\(^{41}\) The time to think about how to reach the poor and the vulnerable during a crisis is now, not when the crisis hits.

53. Declines in commodity prices could moderate the impact on some poor groups, particularly in urban areas. The impact of food prices on poverty is complex and highly differentiated among countries and areas within countries. For example, declines in farm prices can benefit the urban poor while lowering incomes among the rural poor. On balance, the World Bank’s Global Monitoring Report concluded that the immediate impact of a decline in food prices is probably to reduce poverty in most poor countries, despite the fact that poverty tends to be higher in rural areas.\(^{42}\) However, over time lower food prices can reduce rural employment and thus the incomes of the poor. Moreover, as the impact of economic cycles on food prices tends to be limited, any short-term amelioration of the poverty impact of a crisis stemming from reduced food prices is likely to be small. Since food prices can be volatile for various reasons, and account for a large share of household expenditures of low-income people, food security should play an important role in social safety net programs.

54. Safeguarding the poor also involves improving policies governing food, both domestically and internationally. On the domestic side, increasing the supply of food through investments in infrastructure, efficient marketing institutions, and agricultural extension services would help stimulate production in rural areas where the bulk of the poor live. Adequate buffer stocks, and for small countries the pooling of stocks through regional cooperation (where ADB and other MDBs can help promote cooperation), can be useful in moderating food price volatility, although in some countries stock programs have been plagued by poor administration, including spoilage due to inadequate storage, politically motivated policies governing release of stocks, and inefficient distribution. Also, recent increases in food prices have encouraged changes in trade restrictions (both export restraints and reductions in tariffs on food products) to increase the supply of food domestically. Such policies, particularly if undertaken by large countries, tend to worsen the food crisis facing other countries, and thus encourage retaliatory responses that degrade the usefulness of the global food trade regime.

55. International food prices rose sharply just before the financial crisis, and after declining in 2009 resumed their upward march. While a European crisis is unlikely to have a major impact on food prices, the implications of a crisis for the poor should spur improvements in food policies. According to the 2012 Global Monitoring Report, “…a dual approach of raising agricultural productivity and earned income, coupled with targeted safety nets, is needed to deal with hunger in South Asia. East Asia presents a different mix of challenges. Thailand and Viet Nam provide over 50% of global rice exports and thus benefit significantly from rising prices; Indonesia and the Philippines


\(^{42}\) This can occur because many poor farmers are actually net food buyers, and the rise in employment as farm incomes increase can take some time. See World Bank 2012, op. cit.
are significant rice importers; and PRC is largely self-sufficient in rice. East Asia needs to maintain production while shifting to more environmentally sustainable processes in the face of increasing land and water scarcity.”

3. Financial Sector Policies

56. The expansion in fiscal deficits during the crisis was accompanied in several countries by an easing of monetary policy and an associated depreciation of the exchange rate. Indeed, several regional policymakers cut policy rates sharply in the second half of 2008 as the financial crisis intensified.43 As a result, inflation rose in some countries in 2008 and has been variable since, but the 12-month percentage changes in consumer price indices (ending in January 2012) in major Asian developing countries are now either roughly at or below both the average prior to the crisis and the 2010 level (Table 4). Most emerging Asian economies have exchange rates not too far out of line with competitiveness conditions.44

Table 4: Inflation is Declining in Major Asian Economies
(percentage change in consumer price index, January to January)

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<td>0</td>
<td>4</td>
<td>3</td>
<td>3</td>
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</tbody>
</table>

Source: World Bank (Global Economic Monitor data).

57. Increased liquidity support would be necessary if another crisis hits, and clearly several countries have some scope for easing. Steps that might be contemplated include the reestablishment of swap facilities with the US Federal Reserve and the ECB, reductions in cash reserve ratios, increased liquidity injections, and changes in repo and reverse repo rates to encourage lending by banks.45 Such measures should provide for a general expansion of available liquidity throughout the economy as global markets tighten. It may also be useful to consider means of targeting credit flows to segments of the economy likely to be particularly affected.

58. Notwithstanding major areas of progress, financial sector policies will require a continued close watch, balancing qualitative measures to strengthen institutions with quantitative responses to cyclical conditions. Stronger capital ratios, low levels of nonperforming loans, and a diversified asset base would help Asian banks weather cuts in funding and a deterioration of asset quality that would accompany a European crisis. Asian economies have made considerable progress in strengthening their financial sector institutions, and further work in this direction would be useful in many countries. However, the lessons of experience suggest that the timing of government efforts to raise bank capital ratios and improve loan quality should be considered carefully in light of their potential to reinforce a downturn in global economic activity.

44 Footnote 23, page 10.
C. International Cooperation—Globally and Regionally

59. The international response to the 2008–2009 crisis featured a high degree of policy coordination among the G-20 countries, including its five Asian members—PRC, India, Indonesia, Japan, and Republic of Korea—which collectively constitute 25% of global GDP. Given the unprecedented strains on the global financial system arising from the Lehman bankruptcy and its aftermath, the coordinated fiscal and monetary expansion that followed stands in marked contrast to the competitive “beggar-my-neighbor” policies that followed the events of 1929 and that contributed to the Great Depression.

60. Should a euro crisis threaten to turn into a repeat of 2008–2009, there will no doubt be renewed calls for global coordination on macroeconomic policies, and Asia would again be asked to participate. It would be in Asia’s interest to do so. Its participation would contribute to a cooperative agreement among the entire G-20. Nonparticipation would preclude an agreement, thereby increasing the probability and/or intensity of a full-blown crisis, which is not in Asia’s interests at all. Asia should also respond positively to requests for support for IMF and international creditor efforts to finance a new round of European bailouts—but only under the right conditions. These would include greater say both on the structure of the European programs and in the management of the Fund. This could be achieved by increasing the share of developing Asia in IMF votes, which currently stands just below 10% (below these countries’ 12.6% share of global GDP).

61. Asia should press for greater international cooperation on corporate and banking regulation to account for the needs of developing economies. Regulation has to strike a balance between encouraging financial innovation and controlling risk, a tradeoff that the recent crisis demonstrated was seriously compromised in the US. Even now, it is unclear whether the advanced countries are willing to take necessary steps to limit the potential impact of speculative transactions. Asian economies need to exploit opportunities for financial innovation. Nevertheless, the greatest beneficiaries of technology that improves the ability to speculate are in industrial countries, while the ensuing crises can create enormous problems for Asia. Thus Asians, and emerging markets in general, may have different perspectives on the need for financial regulation that they should press in international discussions.

62. Enhanced regional cooperation can also play a role, building on the Chiang Mai Initiative, but it is still in its early days. As a platform for the pooling of resources for responding to crises, for the discussion of macroeconomic policies for the purposes of coordination, and for the adoption of measures to support greater trade integration, the Chiang Mai Initiative is extremely valuable. The recent agreement to double the resources available (to $240 billion) and to introduce a crisis prevention facility to provide ex-ante liquidity support should improve the region’s ability to cope with financial crises. In addition, the resources that can be provided in the absence of an IMF program were increased to 30% of a country’s quota, with a view to a further rise to 40% in 2014. The 2011 formation by the Association of Southeast Asian Nations (ASEAN)+3 countries of the Macroeconomic Research Office is a first step towards

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46 See the briefing note on the Chiang Mai Initiative Multilateralization for the G-20 meetings prepared by Jayant Menon of ADB.

47 Most Asian governments are seriously averse to requesting support from the IMF, owing to concern over reducing market confidence and to resentments lingering from IMF policies during the 1997–1998 Asian financial crisis and the 2007 discussions on exchange rate surveillance. Thus Indonesia and Republic of Korea were hard hit by the financial repercussions of the financial crisis, but were unwilling to ask the Fund for support or to borrow from the Chiang Mai Initiative.
putting in place the necessary technical capacity—with inputs from ADB—to evaluate the soundness of members’ economic policies, an essential step towards granting access to Chaing Mai resources without an IMF program. However, the ASEAN Macro Regional Office still lacks the research capacity, human resources, experience, and institutional setup to effectively replace IMF surveillance.48 The vision of a regional facility that can act independently and effectively to provide emergency finance requires further progress in strengthening the surveillance system and, most likely, greater resources (which remain small compared with members’ reserves of some $6 trillion).

63. While regional integration along the lines of the Chiang Mai Initiative can be beneficial, increasing integration through establishing fixed exchange rates and common monetary arrangements would be unwise. The euro crisis has highlighted the dangers inherent in fixed exchange rate systems among disparate economies. With Greece, Ireland, and others deprived of the exchange rate instrument for adjusting their economies, they have had to resort to severe compression of wage and spending levels, with all the adverse consequences those policies entail. Within Asia, countries have much greater differences in income levels, financial systems, legal systems, and political arrangements than do countries within Europe. In such circumstances, treaties and institutional arrangements to limit exchange rate flexibility or promote monetary integration would be premature at best. Today’s more volatile global environment also underlines the importance of retaining the exchange rate and an independent monetary policy.

48 Menon, op cit.
CHAPTER 4

Lessons for ADB
Crisis-Response Support to DMCs

64. ADB can help Asian DMCs respond to a possible new crisis or period of prolonged slowdown emanating from a eurozone shock. Taking into account the lessons learned from evaluation of ADB and other international financial institutions (IFI) responses to past crises—importantly, the East Asian crisis and the recent global crisis—ADB can improve the development effectiveness of its actions. To facilitate such a process of review and deliberation, this chapter distills ten lessons about ADB (and other IFI) support to DMCs found to be most relevant to a possible near-term crisis episode. It also highlights areas where greater evaluation attention is needed to refine the lessons learned to date.

A. Country-Level Preparedness

Lesson #1: Precrisis preparation is the key to effective crisis response at the country level.50

65. The overarching lesson of IFI evaluations of responses to past crises is the critical importance of preparation in terms of staff country knowledge and dialogue in key areas. With preparation, relevant and effective interventions can be fashioned quickly in the face of crisis conditions. Without it, there is a tradeoff in the design—and, in turn, the effectiveness—of crisis support activities between speed on the one hand and quality and relevance on the other. In such circumstances, staff and the authorities will inevitably find themselves scrambling to put something together that will meet—or be seen to meet—the requirements of IFIs for crisis support, quite aside from the fact that the agreed-upon actions may not be the best course of action for the country and may lack the broader country ownership that is essential for sustained success.51

66. The remainder of this chapter elaborates on the preparation issue in terms of the near-term implications for ADB support for DMC policies in the three policy areas highlighted in Chapter 3—countercyclical fiscal, safety net and social protection, and

49 The evaluation units covered by this chapter are those of ADB (IED); the European Bank for Reconstruction and Development (Evaluation Department); the IMF (Independent Evaluation Office); and the World Bank (Independent Evaluation Group).

50 It also is key to the institutional response, and discussed in Chapter 5.

51 This is a lesson highlighted by IED in ADB. 2009. “Lessons from the Asian Development Bank’s Responses to Financial Crises.” June.
The subsequent chapter takes up the medium-term implications for ADB institutional policies and practices.

### B. Countercyclical Fiscal Policy

67. If the last crisis is any guide, future crises will also involve calls for coordinated global or regional expansion, in which DMCs will want to participate to the extent permitted by their fiscal and debt situations. What are the evaluation lessons for ADB and other IFIs for the next time? This section explores the lessons learned in three key areas: (i) macro sustainability, (ii) high-quality public expenditures, and (iii) infrastructure.

**Lesson #2: DMC crisis response programs need to take account of fiscal and debt sustainability risks, and to include an exit strategy from countercyclical expansion to avoid subsequent solvency problems.**

68. A key challenge for DMCs in responding to externally generated crises is the management of fiscal and debt sustainability risks. Of course, some Asian countries have reservoirs of unused fiscal space and international reserves that allow them to expand as needed. But for others in more marginal situations, the risks are high; and for some countries, consolidation is unavoidable and the challenge is to do so while protecting essential social programs and high-return investments. What do the lessons of evaluation say about MDB support for DMC fiscal efforts to respond to the crisis while managing sustainability risks? The quick answer is that the evaluation evidence suggests that MDBs have not always paid adequate attention to the fiscal space and sustainability of the crisis response programs that they have supported. But if the truth be told, neither have evaluations. Going forward, further attention to these issues is needed to learn more.

69. In focusing on these questions, the World Bank’s Independent Evaluation Group (IEG) found that many of the quick-disbursing development policy operations (DPOs) approved by the World Bank during the crisis “…paid insufficient attention to the available space for fiscal stimulus, to the reversibility of stimulus measures, and to forward-looking measures to attain fiscal sustainability.” IEG found that in countries with reasonably sound fiscal positions, the World Bank’s operations “rightly accommodated the countercyclical worsening of the fiscal balance.” But it also found that “a majority of countries receiving fiscal management support emerged from the crisis with weaker fiscal positions,” which it “associated with some weaknesses in the design of fiscal management-focused DPOs” and in some cases with the underestimation of the impact of the crisis on fiscal positions. IEG also identified cases in which the World Bank provided countercyclical financing without policy content related to the crisis in which there were subsequently “noticeable” deteriorations in fiscal positions. IEG found, for example, that “the Poverty Reduction Support Credit and Public Investment Reform Development Policy Loan to Viet Nam provided resources for a stimulus package but did not embody measures to support or guide the package.”

70. The other IFI evaluation units have not yet zeroed in on this topic, which remains an important issue for further evaluation, including by IED. IED’s crisis evaluation, for example, considered whether ADB’s support for countercyclical programs in its six case-study countries was justified by their macro track records and

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53 Footnote 40, page 19.
clear need for additional fiscal resources—without focusing on the sustainability issue per se.

Lesson #3: Reconciling medium-term fiscal sustainability with near-term countercyclicality puts a premium on the quality of public expenditures.

71. Developing countries clearly faced different challenges in managing their crisis response expenditures, in turn with implications for possible IFI support. Those that increased spending, as part of countercyclical stimulus packages, needed to ensure the quality of new spending; those that consolidated fiscal positions needed to protect key spending priorities; and those in between needed to reprioritize to create fiscal space for specific pro-poor and pro-growth priorities. In studying fiscal DPOs for countries in different situations, IEG did not find a systematic approach to World Bank support for expenditure reforms. Some DPOs geared to consolidation focused on budget processes rather than expenditure rationalization, and some DPOs supporting countercyclical stimulus packages “did not pay enough attention to the allocation of higher spending to specific expenditure programs—including for social protection or for public investment with high impact on employment and growth.” IEG did, however, find examples of countries bringing forward future expenditures (Mexico), introducing reversible expenditures (Jordan), and providing a backstop for essential expenditures (Indonesia). Broadly speaking, IEG found that countries were more likely to take measures to support the quality of public expenditures the less fiscal stress they faced.

72. This finding suggests a topic for further exploration by IED in a follow-up evaluation of crisis outcomes. The topic would be to test the relationship between fiscal stress and reprioritization in the Asian context. Given the region’s generally lower fiscal stress levels, the hypothesis would be that the scope for reprioritization in the context of countercyclical expansion should be higher than elsewhere, with consequent positive implications for sustainability.

Lesson #4: The preservation of existing infrastructure assets through operation and maintenance, and the completion of ongoing projects, can have higher short-term crisis response returns than new investments with long gestation periods.

73. MDBs highlighted infrastructure as a pillar of their crisis response strategies; however, they did not always differentiate between major new infrastructure projects, with long gestation periods and large import components, and more labor-intensive infrastructure works, with quick startup capable of providing short-term employment and income gains, possibly in conjunction with social protection programs. Both IED and IEG evaluations addressed the issue of the relevance of infrastructure to country and IFI crisis response strategies, albeit tangentially. This is another issue that might be addressed more explicitly in follow-on evaluations, especially in light of its relevance in assessing the quality of public expenditures, growth prospects, and in turn fiscal and debt sustainability.

(i) IED specifically commented on the limited information on “shovel-ready” labor-intensive projects in DMCs’ crisis response programs, noting that such projects had the potential to become important developmental tools both in a crisis and in noncrisis times, but that “…the presumption that such shovel-ready projects are available in adequate numbers and a suitable state of readiness to scale up their execution at short notice and on the required scale needs to be closely examined.” IED also recognized that just because an infrastructure
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project was designated as “crisis related” did not mean that it was—an Indonesia case study, for example, the Rural Infrastructure Support Project II disbursed only about 10% of its committed amount by end-2010.

(ii) Similarly, IEG, in defining the scope of its Phase II evaluation, excluded infrastructure from in-depth coverage, despite the sector’s accounting for more than a third of the increase in World Bank lending during the period and its inclusion as a pillar of the World Bank’s crisis response. IEG did so because it found that “the majority of infrastructure loans processed during the...period had relatively low crisis relevance...”

C. Social Protection

74. While the analysis of earlier chapters suggests that the countries most likely to be affected by the crisis include only a small share of the region’s people living in absolute poverty, the poverty impact in these countries is likely to be substantial, while even in less-affected countries some poorer groups may be severely affected by the crisis. In addition, social protection may be targeted at assisting workers hit by the crisis, even if they are not the poorest. These two groups—those in absolute poverty, often permanently, with no reserves on which to fall back in the event of an adverse shock; and those in the formal sector, not the poorest segments of the population but adversely affected all the same—have increasingly become the dual targets for crisis-related safety net activities in developing countries. This is especially so for emerging economies, where interest climbed during the global crisis as authorities in those countries sought to cushion adverse impacts with programs included in countercyclical fiscal packages. 54

Lesson #5: Well-targeted social protection programs warrant support as part of crisis response programs. Continued evaluation, however, is needed to ensure their effectiveness, especially taking into account cross-country differences in implementation capacity and resources as between emerging economy DMCs on the one hand and Asian Development Fund (ADF)-eligible DMCs on the other.

75. The evaluation record points to a correlation between preparation and effectiveness of social protection programs. When already in place, safety nets can be scaled up to meet increased needs and then scaled back—at least in principle—as a crisis subsides. When not in place, they can be built, obviously, and designed to meet a variety of objectives and target beneficiaries—from the very poorest groups who may be permanently poor and made more so by the crisis to the temporarily poor suffering from crisis-related dislocations. But building systems with the requisite data and safeguards takes time, expertise, and resources that few authorities are likely to have during a crisis. And even once built, such systems require a continuing commitment of resources and implementation capacity—requirements that may be able to be met in emerging economies but that may not in ADF-eligible DMCs—hence the need for systems that match country conditions.

Lesson #6: Simple delivery mechanisms, relying on existing channels for delivering support, can be helpful—especially in ADF-eligible DMCs with limited implementation capacity—as in school feeding programs.

76. A key evaluation lesson from earlier crises is the importance of a functioning delivery mechanism for quickly responding to a crisis.\footnote{Footnote 51, page. 23} Speedy delivery is clearly important. For humanitarian reasons, time is of the essence in getting assistance to potential beneficiaries. It is also important for macroeconomic reasons. IED and other IFI evaluations have found that established programs and uncomplicated delivery channels have tended to be more successful than other approaches, with Indonesia, for example, succeeding with ADB-financed program benefits delivered through schools in some cases and the postal system in others. Focused on more recent programs, IEG found that World Bank responses during the global financial crisis helped to raise the effectiveness of social protection, but within limits. Given the minimal availability of real-time crisis data, many projects were unable to target crisis-affected vulnerable households with much precision. Instead they had to rely on blunter instruments targeted to larger pools of poor and vulnerable households. Especially among fragile states and other low-income countries, school feeding programs were often relied on—and expanded—given their simplicity and feasibility on the ground. However, as noted by IED, “...the performance of many existing safety net programs is compromised by poor targeting, capture by the nonpoor, waste, and other forms of leakage due to mismanagement. Therefore, earmarking [of IFI-supported]... social safety net programs should be based on an adequate understanding of the schemes' performance to minimize the risk of achieving uncertain or even unintended results...”

Lesson #7: The time to invest in safety net data and delivery mechanisms is during noncrisis periods, even as periods of crisis provide motivation to begin planning such investments.

77. The global financial crisis saw the strong interest of authorities of emerging economies in functioning systems that can track vulnerable populations as an input into the design of targeted social protection interventions. As IED concluded: “If a country has an established social protection program—such as the conditional cash transfer program of Brazil or the employment guarantee program of India—it could be scaled up or down as required. In the presence of such programs, ADB’s crisis support would be more effective and DMCs would become resilient to crises. However, “…deeper knowledge about the operation and performance of such schemes is necessary if ADB is to rely on them in the future. In the medium term, ADB, jointly with other aid agencies, could develop comprehensive, well-targeted social protection systems in the DMCs, keeping in mind a country's vulnerabilities, affordability, and administrative and political economy matters....” The prospect of increased global volatility points to the value of such arrangements. But the time to think about them—and work on them—is before, rather than after, a crisis hits.

D. Financial Sector

78. As set out in Chapter 2, the most likely scenario associated with a possible euro crisis or prolonged downturn is not one of financial meltdown in Asia’s financial centers or in DMCs. Still, there will be repercussions, if only because of Asia’s extensive trade links and the implications of softening there for the corporate sector and in turn for financial institutions. So financial stress cannot be ruled out. Nor can be the
tightening of credit availability to small and medium enterprises or of trade credit lines to local banks, as seen during the last crisis. Possible country policy responses—for which support from ADB and others could be sought—including both financial sector reform measures aimed at improving the soundness and efficiency of financial institutions and targeted liquidity aimed at assisting specific groups, such as small and medium-sized enterprises and exporters.

**Lesson #8: Developing Asia made strides in strengthening financial sectors in the wake of the East Asian crisis. But weaknesses remain, especially in several Central Asian republics and in other countries where assessments of nonperforming assets are limited.**

79. There was limited engagement by ADB and other IFIs in financial sector issues in Asia during the recent crisis, reflecting countries’ improved financial sector situations. These developments—while broadly reassuring about the health of developing Asia’s financial systems—allow no room for complacency. Going forward—should the need arise—ADB (and the other IFIs) have considerable experience in dealing with past systemic and more narrowly confined financial failures, and can help in the context of advice and policy-based support (Box 2). However, efforts will be needed to keep staff up to date with developments in the sector, especially in light of the IEG finding that the effectiveness of the World Bank’s financial sector activities during the crisis depended importantly on its staff engagement before the crisis, especially through advisory activities.

**Lesson #9: For crisis response purposes, MDB-supported credit lines to financial intermediaries need to build on existing relationships with institutions already familiar with MDB policies and procedures; otherwise, startup delays will push disbursements well beyond the crisis period.**

80. The World Bank used credit lines as an instrument of crisis response, looking to channel incremental resources to the private sector and especially to small and medium-sized enterprises (SMEs). Credit lines have been the subject of much study and evaluation over the years, and the lessons learned from such activities with respect to the importance of selection criteria for the financial intermediaries, charges, and financial sustainability via credible credit recovery remain. An additional issue with respect to the use of financial intermediary loans (FILs) as an instrument of crisis response is the speed of effectiveness and disbursement, which in the case of the World Bank turned on the financial institution’s operational familiarity with World Bank

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56 Important exceptions were ADB’s Countercyclical Structural Facility (CSF) support to Kazakhstan and the World Bank’s DPO support to India, both of which were associated with bank recapitalizations from central government resources. Nor was the limited engagement on financial sector issues confined to Asia, as banking stress in developing countries was highly localized during the crisis, concentrated in countries such as Croatia, Hungary, Latvia, and Ukraine. By way of evidence, IEG noted that of 77 crisis-related World Bank financial sector operations, only 7 had components designed to address immediate impairments in financial institutions—and those were in countries subject to the most financial stress. The other 70 financial sector loans addressed crisis-related credit issues and/or structural, medium- to long-term financial sector issues, for the most part in countries with more limited stress.

57 According to J-P. Chauffour and M. Malouche: “The lack of access to affordable trade finance has been particularly detrimental for certain firms (for example, SMEs and new exporters), especially in developing countries with underdeveloped financial systems and weak contractual enforcement systems. SMEs have been more affected than large firms because of a weaker capital base and bargaining power in relation to global buyers and banks. Also, SMEs have been more subject to high increases in the cost of trade finance instruments, with banks being more risk averse and preferring to work with sounder large, multinational firms.” See Trade Finance during the Great Trade Collapse, 2011. Also IEG. World Bank Lending for Lines of Credit. World Bank. 2005.
procedures. Indeed IEG observed that FILs are “by design” slow-disbursing instruments, and for that reason not ideally suited to crisis response.\footnote{World Bank. 2012. The World Bank Group’s Response to the Global Economic Crisis, Phase II.} IEG concluded that FILs to new entities and FILs for infrastructure appeared “particularly unsuited” to scaling up for crisis response situations. Nevertheless, it found that some crisis response FILs did disburse quickly, with the evaluation pointing to familiarity with World Bank policies and procedures (especially for procurement and safeguards as being the decisive factors).

Lesson #10: MDB trade finance programs have proved relevant for scaling up trade credit during a crisis. To avoid crowding out the private sector later, they should be scaled back at the end of the crisis period to market segments with chronic access problems.

Trade finance initiatives were a central plank of MDB crisis response, with each of the five main MDBs taking steps to enhance existing programs or to create new ones.\footnote{For example, as part of its crisis response, the African Development Bank created a Trade Finance Initiative in early 2009 with $500 million in lines of credit for trade finance by African banks and invested another $500 million in the Global Trade Liquidity Program to provide liquidity and risk sharing for African exports and imports. The European Bank for Reconstruction and Development (EBRD) doubled the size of its preexisting Trade Finance Facility in 2009, though the collapse of trade in the region robbed the initiative of funding.} Given the contraction of financial markets during the crisis, even relative to

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**Box 2: Effective Recoveries from Systemic Financial Sector Failure**

While it is highly unlikely that a euro crisis would result in systemic failures of DMC banking systems, in some cases there might be need for crisis containment, restructuring, and reform. ADB supported the restructuring of banking systems in Indonesia, Republic of Korea, and Mongolia as well as the restructuring of merchant banks in Republic of Korea and of finance companies in Thailand. It also supported the restructuring of state banks in a number of other DMCs under noncrisis conditions. A number of lessons emerged from the Asian financial and other banking crises, which are relevant to the challenges ahead:

(i) Early, credible, and decisive actions are critical in identifying and addressing the potential for systemic problems.

(ii) Blanket guarantees need to be handled with extreme caution—given the potential for moral hazard—balancing the benefits of short-term confidence-building measures against longer term fiscal impact.

(iii) Decisions about which banks and other financial institutions are salvageable and which are not need to be made early on, applying seasoned judgment to what will inevitably be a less-than-full-information assessment.

(iv) Whatever financial sector restructuring plan is decided on needs to be implemented consistently and communicated clearly if confidence is to be restored and markets calmed.

(v) Private sector creditors should be brought in to the extent possible—both for their resources and for their incentive framework.

(vi) Whatever debt/asset restructuring mechanism is chosen needs to be endowed with adequate capacity and incentives.

(vii) Expectations need to be managed by recognizing that progress on financial sector reforms will move 
*pai passu* with progress in the corporate sector and elsewhere in the economy.

trade, these programs are generally viewed as successful, at least as measured by commitment volumes.60

(i) IED found ADB’s Trade Finance Program (TFP)—whose exposure limit was increased from $150 million to $1 billion as part of ADB’s crisis response—to be highly relevant, highly responsive, and with satisfactory results, especially in focus countries such as Bangladesh, Nepal, Pakistan, Sri Lanka, and Viet Nam, which together accounted for 90% of the facility’s operations in 2010. It found that the TFP enhanced access in countries where trade credit had been particularly constrained. It also found that the TFP’s due diligence standards had been helpful for issuing banks in both DMCs and money-center confirming banks in setting standards of operational efficiency, disclosure, and governance.

(ii) IEG found that the International Finance Corporation’s (IFC) Global Trade and Finance Program (GTFP), which had been set up in 2005 originally to provide risk mitigation for counterparty bank risk on trade transactions, was likewise highly successful. IEG found that the volume of GTFP transactions more than doubled between fiscal 2008 and 2010, compared with a 20% decline in loan volumes in other IFC programs.

(iii) The exception was the European Bank for Reconstruction and Development (EBRD) Trade Finance Programme, whose limit had been almost doubled to €1.5 billion in February 2009 to allow EBRD to respond to the lack of liquidity in the private trade finance market.61 However, as trade volumes among EBRD clients fell even more than financial availabilities, there was actually reduced demand for the facility throughout much of 2009.

82. Notwithstanding these evaluations’ findings about the relevance of the various programs, a deeper review is warranted to look into aspects of the programs beyond relevance, including additionality, possible crowding out of private sector resources, pricing, profitability, and appropriate scaling up during crises and scaling back afterwards. Given the common feature of the programs, the evaluations might be carried out jointly, under the auspices of the Evaluation Cooperation Group of the MDBs.62

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61 EBRD’s Evaluation Department (EvD) rated the Trade Finance Programme (TFP) as partly successful, with evaluation findings and recommendations provided in four areas: (i) at the strategic level there is no clear linkage between the market constraints and TFP activities. The instrument requires top-down review to align activities more closely with EBRD’s mandate, strategies, and policies. (ii) Control—there is a need to establish a clear matrix of internal authorities and related processes. Environmental policy and practice also require review. (iii) Use of Technical Cooperation funds—this is a unique resource of TFP. A more strategic approach would bring focus to the deployment of Technical Cooperation funds. (iv) Bank handling—a number of good practice issues were raised over transaction handling, and concern was raised about the weak direct trade linkage of cash transactions. See, EBRD. Annual Evaluation Overview Report 2010, 2011.

62 The EvD evaluation of the EBRD TFP—in 2010—was not exclusively focused on crisis response, but was a review of the entire program since the previous evaluation in 2002.
CHAPTER 5

Institutional Issues and Lessons

83. Regardless of the severity of a possible euro crisis, it will surely not be the last to affect the global economy. Beyond managing the risks of a possible immediate crisis, ADB should take advantage of any possible lull in crisis activity to take stock of its overall crisis preparation and response strategy. Such a stocktaking would allow for a deeper discussion and debate on issues touched on in the recent IED evaluation and others, as detailed below, with respect to staff knowledge and sectoral and macro expertise, partnerships and coordination, resource adequacy and allocation across DMCs, crisis instruments and facilities, and early warnings and surveillance. This section aims to contribute to such a stocktaking.

A. Country Knowledge and Sector Expertise

84. The lessons of evaluation show that prior country knowledge and sectoral expertise are for the development effectiveness of crisis response activities. Indeed the dilemma that MDBs have long faced in responding to crises is how to provide untied financial support quickly, but in a manner that goes beyond mere “check-writing”—whether in the context of regular policy-based lending or special crisis instruments—when time is of the essence. Evaluation lessons suggest that an important part of the solution lies in starting the crisis response with a strong endowment of country and sectoral knowledge and specific expertise on which to draw. They highlight the importance of both a good base of relevant knowledge and expertise within the institution and effective sharing of that knowledge and expertise across the institution. This chapter presents the lessons about ADB and other IFI support to DMCs that are relevant to possible near-term crisis scenarios.

Lesson #11: Staff country knowledge and sectoral expertise are critical for development effectiveness, especially in responding to crises when time is of the essence.

85. Both IED and IEG have highlighted the importance of prior knowledge and expertise for the development effectiveness of crisis response activities. IED found that “ADB’s operations departments were ... better prepared than in 1997 to provide operational and knowledge support to DMCs due to greater focus on policy-based operations in areas like public resource management, finance sector, and governance reforms....” In a similar vein, IEG found “that in countries where the [World] Bank had a strong knowledge base..., that base enabled a program to be built. However, where precrisis engagement had waned, including through a fall in lending volumes, knowledge gaps were noted. In these countries specifically, the [World] Bank was
unprepared to help map out actionable forward-looking programs in public finance to address the crisis.”

86. Building on this and related findings in other sectors, IEG concluded that: “In recognition of the value of prior country knowledge and engagement, the [World] Bank Group could consider formalizing commitments to maintain an adequate knowledge base in countries across relevant sectors to maintain crisis readiness. With regard to economic policy and financial sector work, a commitment could be made to undertake core diagnostic work regardless of the lending program. Maintaining a strong knowledge base is an important prerequisite for effective crisis intervention, which strikes an appropriate balance between longer-term development issues and short-term measures of risk and vulnerability.”

Lesson #12: Internal knowledge sharing and coordination must be carried out in a way that does not undermine ADB’s confidential advisor role with DMCs.

87. Both IED and the IMF’s Independent Evaluation Office (IEO) highlighted problems caused by a lack of communication across departmental boundaries within the respective institutions. IED found coordination on macroeconomic monitoring and forecasting, but it concluded that there “… could have been a better two-way flow of information between knowledge departments (which have strong analytical capabilities on macroeconomic and finance sector issues) and the operations departments (whose strength lies in sector-specific issues and country-level monitoring).” IED also reported that operational staff did not much use ADB’s in-house knowledge products, obtaining inputs instead through their own sources such as consultants, technical assistance studies, and outside publications.

88. IEO, in its evaluation of IMF performance in the run-up to the crisis, similarly noted that “staff tend neither to share information nor to seek advice outside of their units.” It concluded that the IMF’s pervasive “silo behavior made it difficult to integrate multilateral with bilateral surveillance, to link macroeconomic and financial developments, and to draw lessons from cross-country experience.” As a result, the risk and vulnerability dots were never connected between the IMF’s multilateral surveillance of the global financial system and its bilateral surveillance of the largest financial centers in the US and elsewhere. Breaking down silos within the institution remains a key challenge for IMF Senior Management, which is pursuing the issue through a variety of mechanisms, designed mainly to raise the profile of and incentives for communications across departmental boundaries.

B. Partnership and Coordination

89. The lessons of evaluation also highlight the importance of sharing knowledge and coordinating more broadly with partners, especially in times of crisis. With respect to partnerships, IED highlighted the importance of effective inter-IFI working partnerships grounded in communications, information sharing, and division of labor based on IFIs’ and other partners’ comparative strengths, with the crisis evaluation calling specifically for ADB to develop a division of labor with partners on safety nets. But clearly an agreed-upon division of labor for developing the knowledge...

64 These problems were not highlighted in the IEG crisis evaluations, but have been studied in a recent evaluation of the World Bank’s matrix system. See World Bank. 2011. The Matrix System at Work: An Evaluation of the World Bank’s Organizational Effectiveness. IEG.
65 IMF. 2010. An Evaluation of IMF Performance in the Run-up to the Global Financial Crisis. IEO.
underpinnings necessary for effective crisis response would be helpful for other sectors as well.

**Lesson #13:** The seeds for effective coordination among IFIs need to be planted before crises strike. Preparation of crisis response plans in country strategies would provide a vehicle for cooperation.

90. One of the most searing lessons of the East Asian crisis was the need for better IFI coordination both before and during crisis response episodes. During the earlier period, there had been outright conflicts between ADB staff on the one hand and IMF and World Bank staff on the other, and also between IMF staff and World Bank staff. As a result, the whole of the IFI response to that crisis was less than the sum of its parts.

91. The evaluation evidence suggests that cooperation was better this time around. By all accounts, ADB and the World Bank partnered well in countries such as Indonesia (and elsewhere), and the IMF and the World Bank partnered well in Europe, Colombia, and Mexico—but interestingly not in parts of ADB territory, where IMF involvement was limited. Indeed, vis-à-vis ADB DMCs, the IMF had new or ongoing programs during the critical 2009–2010 period with DMCs in Central Asia and South Asia, but no programs with DMCs in Southeast Asia or with DMC users of ADB’s Countercyclical Support Facility (CSF).

92. One telling piece of evidence is the absence of IFI coordination as an issue in the IED evaluation. Yes, the evaluation report highlights the need for improved internal coordination as an issue. But on external coordination, the only potentially adverse references are with respect to Bangladesh and Philippines, where there were substantive professional disagreements between ADB and World Bank staff on several issues. Meanwhile, the evaluation specifically cites ADB work without incident in “embedding” its support to Armenia, Georgia, Maldives, and Tajikistan in financing plans that also included IMF stand-by arrangements.

93. Focusing on IMF-World Bank coordination, the IEG Phase I evaluation found concrete evidence of an improvement compared with the East Asian crisis. It concluded that: “[World] Bank-Fund collaboration, which had been a major problem during the East Asian crisis, appears to have been better this time. Indeed, a staff survey on [World] Bank-Fund collaboration review found that 35%–40% of [World] Bank and Fund staff thought that the crisis had improved collaborations, with the remainder reporting no change or no opinion. The improvement appears to have reflected several factors. First, the Fund had moved quite substantially away from setting structural conditionality, removing an important area of tension between the staff of the two institutions. Second, the biggest staff disagreements during the East Asian crisis had been around programs in East Asia; but as noted above, this time there were few such programs.” Finally, the very existence of the survey on World Bank-Fund collaboration and successive task forces and reports on the topic reflect the commitment of Senior World Bank and IMF Management to change, which is another driver of the improvement.66

C. Resource Adequacy

94. To be sure, knowledge and coordination are essential, but so are financial resources. In a very real sense they are the *sine qua non* of the MDB crisis response, as without financial resources DMCs would need to seek support elsewhere. Financial resources are also an important ingredient of development effectiveness, which is maximized when excellent programs can be supported and scaled up with major financial backing. Within this question of the adequacy of resources, two themes have loomed large in MDB crisis evaluations—the management of overall headroom constraints and the allocation of scarce resources across countries, especially between severely affected countries on the one hand and less affected countries on the other. They are discussed in turn below.

*Lesson #14: Unless shareholders are willing to provide separate, incremental, and nonfungible capital for MDB crisis response activities, there are clear tradeoffs between such activities and normal operations.*

95. The IFIs went into the crisis with different resource positions, which translated into different financial capacities to respond. The World Bank’s substantial resources—accumulated during a period of limited borrowing by emerging economies—allowed it to respond forcefully and quickly to client requests; though much of its expansion was related to the crisis, much was not, and its previous excess capital was quickly run down, and needed to be replenished.67 EBRD was short on capital at the outset of the crisis and long on assets in risky banks in Central and Eastern Europe; EvD concluded that, pending a replenishment of capital—which did not come until 2010—EBRD “redefined how it calculated its prudential asset and gearing ratios” to meet its capital requirements and at the same time “relaxed institutional restrictions on its portfolio size in order to deliver its crisis response in 2009.” 68

96. ADB also was short on capital at the start of the crisis, leading IED to conclude that it was unable to translate its knowledge of a looming crisis into an effective operational response because of its resource shortage. IED concluded that going forward: “Institutional readiness to assist in future crises should place emphasis on (i) the need to have capital headroom for contingencies, and (ii) the timeliness of support. There will be a trade-off between ADB’s crisis response operations and its normal operations unless ADB augments its risk-bearing capacity to mount a crisis response when a crisis is imminent.” This trade-off issue was also raised in the IEG evaluations,

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67 World Bank. 2010. The World Bank Group’s Response to the Global Economic Crisis, Phase I. Independent Evaluation Group. As spelled out there: “The [World] Bank would not have been able to respond as it did if it had not been so well positioned financially when the crisis started. The IBRD went into the crisis with an equity-to-loans ratio of 38 percent, compared with a target range of 23–27 percent, which gave it substantial room to expand lending. The IDA15 operational period, which had just become effective on July 1, 2008, had increased available resources for commitments by about 25 percent.” The IEG evaluation went on to say that: “Once international financial markets seized up, demand for IBRD financing surged, even from investment-grade borrowers. The focus quickly shifted from what to do with the “excess” IBRD capital to how to ration it among borrowing member countries and how to increase IBRD capital to support higher lending levels…. It ultimately received (in 2010) a capital increase to partially replenish the huge capital commitments it made during the crisis, though its increase was in relative terms considerably smaller than what the other IFIs and MDBs received—30% for the IBRD compared with 200% each for ADB and the African Development Bank, 70% for the Inter-American Development Bank, and 50% for the EBRD. In terms of absolute amounts, this reflects capital increases of $69 billion for the African Development Bank, $110 billion for ADB, $70 billion for the Inter-American Development Bank, $14 billion for EBRD, $86 billion for the World Bank, and $200 million for IFC.

which highlighted the question of the desirability (or not) of rebuilding the World Bank’s headroom to restore/protect its ability to respond to future crises.

**Lesson #15: MDB rules for allocating concessional resources across DMCs are transparent. For nonconcessional ordinary capital resources (OCR) they are not, but they need to be.**

97. The allocation of MDB resources across their respective DMCs—especially between severely and less affected countries—was a major theme of the IED and IEG evaluations. Both evaluations started from the implied presumption that more severely affected countries should receive relatively more resources, and found what they characterized as important departures from that presumption. According to the IED evaluation, ADB support (measured by commitments to sovereign lending) to the least-affected countries increased by 75% in 2009, while support to the severely affected countries rose by only 41%.69 According to the IEG evaluation, “…the [World] Bank’s crisis response was a large increment of its previous lending, but it was spread across many client countries. Rather than being targeted toward most-affected countries, it tended to follow precrisis lending patterns. This does not mean that the [World] Bank did not increase lending to affected countries. Indeed, some crisis-affected countries received large incremental lending, but so did many less-affected countries….” 70

98. Both evaluations explored the implications of inflexibilities in their concessional windows (ADF and the International Development Association [IDA]) and between their concessional and nonconcessional windows. This said, questions remain concerning the allocation of nonconcessional OCR resources during the crisis—and exactly how such resources were rationed and/or how crisis impact was factored into the allocation at the time. Especially in light of the tradeoffs highlighted in Lesson #14, these questions constitute a topic for further exploration during the proposed stocktaking.

D. Instruments

99. For the MDBs, two closely related issues are relevant for the discussion of instruments, as summarized below. The first relates to dedicated MDB instruments for crisis lending. The second relates to the mix of investment lending and policy-based lending in overall support to sovereign borrowers.71 In both cases, a critical evaluation issue has been the development effectiveness of traditional quick-disbursing policy-based lending and loans made under the CSF. And in both cases, IED and IEG

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69 IED attributed the apparent imbalance in allocational outcomes to several factors, headlining the fact that most severely affected countries were small, ADF-only countries that were subject to the ADF performance-based allocation (PBA) rules and for which there was no ADF crisis response window. To remedy this, IED recommended the creation of a dedicated ADF crisis facility that could be used outside the PBA framework to allow ADB to better serve these small, vulnerable countries. It did not explore alternative explanations for the relatively small increase in lending to severely affected countries, such as by removing from the sample individual country anomalies, such as Pakistan, or the CSF operations.

70 IEG’s Phase I report had concluded that the increase in World Bank lending benefited all country groups, but tended to be greatest for countries that experienced the largest adverse impacts from the crisis. Looking at the 29 countries in the most-affected group, IEG found that disbursements—which it argued were the more relevant measure of crisis response—increased by more than 113% for the entire cohort; compared with 84% for the 36 moderately affected countries and 31% for the 51 least-affected countries. However, IEG’s Phase II evaluation revisited that analysis and found that the correlation between crisis intensity and incremental World Bank lending was not statistically significant, as the lending totals to severely affected countries were dominated by commitments to a few large IBRD borrowers, including Kazakhstan, Mexico, and Turkey.

71 ADB’s terminology for quick-disbursing operations—“policy-based lending”—is adopted throughout this section. In the World Bank, such operations, which were historically termed “adjustment operations,” are now termed “development policy operations.”
highlighted the contribution of country knowledge and sectoral and macro expertise to the development effectiveness of crisis response programs, especially in the context of quick disbursing operations.

**Lesson #16:** For crisis instruments that go beyond country allocation norms, short maturities, as in ADB’s CSF, are essential for preserving headroom. In contrast, the World Bank’s crisis instrument was little used, with large amounts of incremental lending made at normal interest rates and maturities.

100. MDBs’ special crisis lending instruments received prominent attention in the IED and IEG evaluations. Both ADB and the World Bank had adopted special instruments in the wake of the East Asian crisis, providing eligible DMCs with greater access to nonconcessional resources than normal, but at a price in terms of higher charges and a shorter payback period. Both modified and used them during the global crisis—ADB rather substantially and the World Bank much less so.

101. In 2009, ADB launched the CSF as an adaptation of its preexisting Special Program Loan (SPL) introduced in the wake of the East Asian crisis. As compared with the SPL, the CSF was cheaper, had less conditionality, did not require an IMF program or comfort letter, and provided budget support. Access to the CSF was based on three criteria: (i) the adverse impact of the global economic crisis, (ii) planned countercyclical development expenditures for poverty reduction, and (iii) sound macroeconomic management—which IED found to be too broad. In the event, ADB approved five $500 million CSF operations, all of which were fully disbursed by early 2010, and IED rated the operations as relevant, responsive (for the most part, though there were concerns about the speed of disbursements for Indonesia and the 5-year payback schedule for Bangladesh, given its blend status), and useful. Less discussed by IED, but of major strategic importance—especially in light of Lesson #15 and the fact that the bulk of ADB’s incremental lending was through the CSF—was the CSF’s contribution to making more transparent the terms and conditions for accessing incremental resources in a time of crisis.

102. The World Bank, in contrast, both left its basic emergency instrument broadly intact and used it less. It did amend the Special Development Policy Loan’s (SDPL) governing policy to clarify access rules with respect to lending amounts in excess of purely notional levels that may have been set out in the country assistance/partnership strategy when the expectation had been of limited borrowing under a noncrisis scenario. But the World Bank did not really use the SDPL during the crisis—only three loans carrying SDPL terms were approved during the crisis, and they were to countries that had graduated and had been reinstated during the crisis. For the most part, the World Bank relied on regular policy-based lending (DPOs) during the crisis, including the introduction of innovations such as the deferred drawdown option.

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72 The Inter-American Development Bank (IDB) had also adopted such an instrument in 1998 to assist its DMCs such as Argentina and Brazil in the context of financial market disruptions there. In 2008, with the new crisis at hand, IDB renamed the instrument and funded a facility for it—the $6 billion Liquidity Program for Growth Sustainability. The African Development Bank introduced in 2009 a totally new instrument, the Emergency Lending Facility (ELF). The ELF in many ways replicated the original World Bank Special Development Policy Loan—5-year maturity, 3-year grace period and so on—albeit with lower spreads and no commitment fee. Only one operation (for Botswana) was approved under the ELF.

73 The Special Development Policy Loan replaced the Special Structural Adjustment Loan, which had been introduced in 1998 in the wake of the East Asian crisis. It was renamed in 2004 when “development policy lending” replaced “adjustment lending” in the World Bank.
103. IEG concluded that the SDPL had been made “financially unattractive by the [World Bank’s] elastic use of DPOs on regular financing terms for crisis support.” Implicitly referring to the ADB’s CSF, it called for the establishment of new instruments “…involving shorter maturities or a combination of pricing and maturities that encourage early payback, possibly with a countercyclical financing facility, as adopted by other multilateral banks.” The key point here is that, unlike ADB, which imposed a *quid pro quo* of higher interest rates and shorter payback period on increased country borrowing, the World Bank lent large amounts of incremental resources at normal interest rates and payback schedules.

**Lesson #17:** Investment lending typically does not disburse quickly enough to constitute crisis support. Rather it ties up institutional capital both through a long disbursement period and an even longer payback period.

104. Core MDB instruments for sovereign lending remain investment lending and quick-disbursing policy-based lending. Key differences include the applicability (or not) of environmental, social safeguard, procurement, and financial management policies, as well as the timing and profile of disbursements. But importantly, investment and policy-based loans both carry the same financial terms—for both charges and payback periods. As in previous crises, the instrument mix of most MDBs changed during the crisis, in favor of policy-based loans, as DMCs sought incremental liquidity to pay for countercyclical fiscal programs and to offset revenue and foreign exchange shortfalls. Between ADB and the World Bank and other MDBs, however, there was one difference this time around: policy-based lending in ADB did not surge, except when CSF operations are counted in that category, whereas in the World Bank (and the other MDBs) the normal pattern prevailed.

105. According to IED, given the importance in crisis situations of making more resources available, “…the focus of ADB should be on increasing disbursements.” However, beyond that statement and the discussion of the CSF as summarized above, the IED evaluation said little about policy-based lending per se beyond making the observation about its increase in the wake of the East Asian crisis and its synergies with knowledge acquisitions and improvements in the policy dialogue with DMCs (also discussed below)—and by extension improving the quality and development effectiveness of operations.

106. The IEG Phase I evaluation focused much more on policy-based lending and its increasing share relative to investment lending during 2009 and 2010. In line with IEG’s focus on increasing disbursements, it analyzed the relative “velocity” of disbursements from policy-based vs. investment lending for FY2009–2010 commitments. It found that, because of their higher velocity, such operations accounted for 75% of World Bank disbursements during the crisis period, but only 39% of commitments. The evaluation also focused on the quality and development effectiveness of policy-based lending, finding that the availability of relevant analytical work was a decisive determinant of the quality of quick-disbursing policy-based operations and of the

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74 In the World Bank and the Inter-American Development Bank, there was some blurring of the boundaries between investment lending and development policy lending, which was most apparent in quick-disbursing investment lending support for crisis-related social programs in Colombia and Mexico. These developments in lending to emerging economies built on operational policy innovations developed in the context of IDA participation in donor-supported programs in low-income countries—sectorwide approaches (SWAs) used frequently in Sub-Saharan Africa—and applied them to participation in government budget-supported social protection and conditional cash transfer programs that were part of the Colombian and Mexican authorities’ crisis responses.
related policy dialogue on the crisis response—a topic discussed earlier in the context of Lesson #11.

E. Early Warning and Surveillance

107. Several evaluations have explored IFIs’ early warning systems for identifying the risks of crises. In principle, such systems position IFIs to put in place measures to help their members avert adverse crisis impacts and/or to lay the foundations for quick and effective responses. In practice, as some evaluations have shown, such systems have not always worked as intended, providing lessons on some of the pitfalls involved. And, as detailed below, three important lessons about IFI early warning systems and surveillance have emerged from these evaluations.

Lesson #18: Early warning systems and forecasting exercises are important tools for crisis response preparation (inter alia).

108. IED focused on ADB’s work in warning DMCs about the 2007 slowdown in the US economy, noting that the Lehman crash was not predicted by anyone. It highlighted the fact that the Asian Development Outlook 2007 had provided the first warning to Asian countries from an international organization about the risks to them of a US slowdown, while cautioning that “like other multilateral agencies, ADB knowledge departments could not predict—and could not have been expected to provide specific warnings about—the events of September 2008 that precipitated the global economic crisis.” It concluded that surveillance pays off in terms of foreknowledge about pending shocks and crises and recommended that ADB strengthen its macroeconomic and financial sector surveillance and surveillance capacity development to include other regions—such as the Pacific, Central and West Asia, and South Asia—to help DMCs better prepare for and manage future crises.

109. Management accepted this recommendation, which has potentially important systemic implications for the support ADB provides to the Chiang Mai Initiative and for intra-Asian policy coordination going forward. These are important considerations, and the specifics warrant further discussion with the Board before too long, with the overall direction discussed and agreed upon. In going forward on this front, ADB would be well advised to consider the challenges highlighted in the various IEO evaluations of the IMF’s performance on surveillance and in the run-up to the crisis. Those evaluations hold lessons for surveillance activities in other institutions as well, including ADB.75

Lesson #19: IFI forecasting work must be professionally grounded, and free of political and ideological influences.

110. The focus of the IEO evaluation was primarily on the IMF’s precrises forecast and early warning system, as they had operated during the 2004–2007 run-up to the global crisis; IEO did not evaluate the Fund’s actual response to the crisis. The evaluation concluded: “Warning member countries about risks to the global economy and the buildup of vulnerabilities in their own economies is arguably the most important purpose of IMF surveillance. This IEO evaluation found that the IMF fell short in delivering on this key objective in the run-up to the financial and economic crises. During the period 2004–2007, the banner message of IMF surveillance (both bilateral and multilateral) was characterized by overconfidence in the soundness and resiliency

of large financial institutions, and endorsement of financial practices in the main financial centers...."

111. IEO found a broadly similar pattern of IMF overoptimism in earlier evaluations of IMF crisis-related and surveillance work. Such findings emerged in evaluations of programs with Indonesia and Republic of Korea during the East Asian crisis, which highlighted analytical weaknesses, organizational impediments, internal governance problems, and political constraints related to concerns about country relations. These findings and their internal drivers are clearly relevant for ADB as it considers expanding its own surveillance role.

Lesson #20: Management needs to get staff findings about possible adverse developments out as quickly as possible.

112. IEG focused on a considerably later period than did IED, zeroing in on the very narrow window between Lehman’s crash in September 2008 and the World Bank-Fund Annual Meetings in early October 2008. It examined how quickly and by how much the World Bank marked down its global and regional growth forecasts compared with the IMF and other comparators. It found that World Bank staff had scaled back its forecast, but that the staff message did not get out to shareholders and others in a timely manner. IEG attributed the delay to the fact that World Bank Senior Management was preoccupied by a number of other matters at the time and to “organizational fragmentation,” which diminished the organization’s “ability to connect the dots between macroeconomic and financial sector developments.”

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76 See IMF. 2003. Evaluation of the IMF and Capital Account Crises. IEO.
CHAPTER 6

Priority Actions for the Next Five Years

113. This review has highlighted a number of implications for action in the period ahead—by DMCs, by ADB, and by IED itself (Box 3).

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<thead>
<tr>
<th>Box 3: Key Drivers of Effective Crisis Response to External Shocks</th>
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<td>According to the old adage, the three most important factors in real estate are location, location, and location. For crisis response, the evaluation-based adage would emphasize preparation, preparation, and preparation. In the context of the current paper, this translates into preparation by DMCs; preparation by ADB; and preparation by IED, with the specifics summarized below.</td>
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<tr>
<td>(i) For DMCs the key preparation priorities are on ensuring (a) fiscal sustainability through aggressive public expenditure management—both building flexibility into budget processes so that identified expenditures (especially those with large employment effects) can be advanced and others postponed as needed for macro policy purposes and ensuring high quality programs that pay for themselves over time; (b) robust systems for social protection that effectively target vulnerable households; and (c) sufficient capital adequacy in the financial system to counter shock-related stress.</td>
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<td>(ii) For ADB the key preparation priorities are investing in (a) forecasting systems—to position the institution to advise DMCs (and operational colleagues) on the forward risks of external shocks and the need for action; (b) knowledge, resources, and instruments to support the above DMC priorities; and (c) relationships—with clients and partners, so that ADB can act quickly and effectively in its areas of comparative advantage.</td>
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<td>(iii) For IED the key priority is the proactive pursuit of operational learning through timely evaluations of past and ongoing ADB support—both crisis-related and crisis-relevant—and getting the lessons out to DMCs and ADB staff in a timely manner. This priority may require a strategic rebalancing of the IED work program—especially with respect to the mix between project evaluations and more thematic evaluations—given the bearing that crises have on ADB project and portfolio outcomes and the institution’s development effectiveness.</td>
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A. For Developing Member Countries

114. Good policies with respect to macroeconomic stability and socioeconomic well-being remain the best medium-term investment in crisis prevention and management that DMCs can make. Historically, countries with good policies are the best positioned to manage shocks and crises. Homegrown crises are unlikely there, and destabilizing speculation is not likely to be a problem. But such countries may import a crisis, as for
example Mexico did during the global crisis—despite its good policies—given its high exposure to the US economy. Still its good policies kept a very bad situation from becoming worse.

115. A key component of good policies is crisis preparation, which includes policies in three areas:

(i) **For countercyclical fiscal policy, revenue and expenditure planning needs to be done with the risk of crisis in mind.** In the context of multi-year budgets, this means pre-identifying crisis-relevant items (both revenues and expenditures) that can be brought forward if need be to offset adverse effects of export shortfalls on aggregate demand and employment. For maximum crisis response effect, such items would have a strong domestic demand component—to maximize the domestic employment effects and to minimize the degree of import leakages—and either a strong safety-net component or a high rate of return. Increases in expenditures and declines in tax rates should be clearly identifiable as crisis responses and reversible, to limit political pressures for their continuance and to maintain the credibility of fiscal policy over the medium term.

(ii) **For safety nets, the key is to have the necessary information and systems in place that can be scaled up and back as needed, and also laterally to accommodate the particular groups adversely affected by a particular crisis.** Some Asian countries (Indonesia and Philippines, for example) have launched such approaches, as have countries in Latin America (Brazil, Colombia, and Mexico, for example), which include good practice features that DMCs might consider. As noted in Chapter 4, these approaches aim to mitigate crisis impacts on vulnerable groups, and are an extension of earlier social safety net programs in developing countries that tended to focus exclusively on the poorest groups.

(iii) **In the financial sector, notwithstanding much progress in Asian countries in the wake of the East Asian crisis, a close watch continues to be absolutely necessary.** Indeed both crises—the East Asian crisis and the global financial crisis—though inevitable in retrospect, were a surprise when they hit. The financial sectors and economies of East Asian countries in the late 1990s had been thought strong, and the US and United Kingdom financial sectors in 2007 and early 2008 had been thought robust, even models of risk taking and innovation for others. But in both cases, there were large imbalances beneath the surface, reflecting inflated values for financial assets that were not matched by associated real assets. The point here is simply that yes, transparency, governance, and solvency have all improved. But especially in matters concerning the financial sector, things are not always what they seem. So a tight rein by regulators and supervisors remains the prudent course.

116. **Investment in regional and global coordination is an essential investment in crisis prevention and management for DMCs.** ASEAN, the G-20, and the IMF all provide forums for the sharing of knowledge and information, and platforms for discussion. And further investment in the Chiang Mai Initiative warrants DMC support over the coming 5 years. It will promote regional surveillance efforts and also provide a basis for
the periodic synchronization of monetary and fiscal policies in order to internalize possible expansionary externalities.

117. **The key word here is “periodic.”** Effective coordination on crisis prevention and management involves the opening of options through investment in cross-country relationships and surveillance; not the closing of options through rigid commitments that may not be able to withstand market pressures. The European currency union lessons from Greece and some other countries are highly instructive. But they are not new. Similar lessons were learned from Argentina’s rigid link to the US dollar and from the French Community of Africa (Communaute Financiere Africaine) zone’s rigid link to the French franc. Without full economic and political integration, such rigid links between economies almost inevitably fail, as the costs become untenable.

**B. For the Asian Development Bank**

118. **Priorities for DMCs provide a platform for actions by ADB.** But in deciding where and how much to invest in its capacity to support such DMC priorities, ADB needs to take account of its likely resource availability and its comparative advantage vis-à-vis other partners.

119. **For ADB there is a tradeoff between crisis and normal activities—a point made clearly in the IED crisis evaluation.** Operationally, this tradeoff translates into the question for ADB as to how much of its risk-bearing capacity should be set aside from normal lending activities as “insurance” for the funding of crisis-support activities should the need arise. This issue is within the discretion of Management to decide and implement—including through incremental resource mobilization for the Special Policy-Based Loan (SPBL)77 and CSF—as long as ADB’s minimum long-term equity-to-loan ratio of 26% is preserved.78 However, the implied resource split—between crisis response and normal operations—is clearly a strategic issue on which shareholders and the Board will want to engage in the not too distant future. It also will have operational policy implications for how tightly ADB will need to apply the eligibility criteria for the SPBL and CSF, as with less resources available for crisis response activities, greater country selectivity will be unavoidable.

120. **Meanwhile, financing and instruments, while necessary for the development effectiveness of ADB’s crisis response, are not sufficient. Quality is essential too.** And in turn this means precrisis knowledge, which provides the basis for timely, high-quality crisis response activities. The key strategic question here for ADB Management and the Board is in what specific areas of knowledge within the three priority areas discussed above (countercyclical fiscal policy, social safety nets, and financial sector management) to invest—especially in light of parallel engagement by the World Bank in the same areas: How can the division of labor between the two institutions be established to best serve the interest of borrowing countries?

121. **Finally, IED’s crisis evaluation recommended that ADB strengthen its macroeconomic and financial sector surveillance and surveillance capacity development in order to help DMCs better prepare for and manage future crises.** Management accepted this recommendation, which has potentially important systemic implications for the assistance ADB provides to the Chiang Mai Initiative and for intra-Asian policy coordination. In implementing it, Management needs to be mindful of the challenges highlighted in the various IEO evaluations of the IMF’s performance on surveillance—

77 The SPBL—the Special Policy-Based Loan—is the new name for the SPL.

especially with respect to the management of possible relationship tradeoffs between ADB’s role as confidential advisor to individual DMCs and its role in communicating its surveillance findings to regional partners.

C. For the Independent Evaluation Department

122. This paper also has implications for IED itself.

(i) First, there is evaluation interest in the three priority areas of countercyclical fiscal policy, social safety nets, and financial sector management. As IED formulates its work program for the coming years, these issues need to receive prominent attention, given their relevance for ADB’s crisis prevention and response activities.

(ii) Second, real-time evaluations are good—they provide quick feedback on responses and importantly can assess ADB performance against Board-approved policies for accountability purposes. But they are no substitute for in-depth outcome-based evaluations, which can inform reconsiderations of ADB policies and actions and contribute significantly to learning about what works and what does not in different country and crisis situations. When IED carries out its follow-up evaluation of ADB’s crisis response, it should also cover in greater depth for learning purposes some of the considerations raised in this paper with respect to countercyclical fiscal policy (including, for example, fiscal sustainability and infrastructure investments differentiated by time frame), safety nets for crisis-vulnerable groups, and the financial sector.

(iii) Finally, partnerships on evaluation with other MDBs warrant greater consideration going forward. All the main MDBs had trade finance programs in operation as part of their response to the global crisis. These programs are clearly an area in which institutional learning would benefit from joint evaluation by the respective MDB evaluation units, possibly under the auspices of the Evaluation Cooperation Group of the MDBs. More broadly, several of IDB’s evaluations offer lessons for ADB’s work with emerging economies and vice versa; and the same is true for some of the World Bank’s evaluations, with respect to both ADF-eligible and OCR-eligible countries. The many commonalities point to the desirability of IED’s joining with its evaluation counterparts in the other MDBs in investing in mechanisms for more systematic sharing of lessons learned.


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