The background of the cover features a blue-tinted image of three people: a woman in the upper left, a young child in the lower center, and an elderly man with a white beard in the lower right. On the left side, there is a semi-transparent financial chart with a grid and a fluctuating line graph. The chart's y-axis is labeled with numerical values: 429085, 426585, 424088, 421588, 419087, 416587, 414088, 411588, 406589, 404090, 808521, 606391, 404260, and 202130. The ADB logo is positioned in the top left corner.

**ADB**

**THE GLOBAL ECONOMIC CRISIS  
CHALLENGES FOR DEVELOPING  
ASIA AND ADB'S RESPONSE**

Asian Development Bank



# **THE GLOBAL ECONOMIC CRISIS CHALLENGES FOR DEVELOPING ASIA AND ADB'S RESPONSE**

April 2009

Asian Development Bank

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Every effort has been made to ensure the accuracy of the data used in this publication. Variations in data in the Asian Development Bank (ADB) publications often result from different publication dates, although differences may also come from the sources and interpretation of data. ADB accepts no responsibility for any consequence of their use.

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In this publication, \$ refers to US dollars.

# CONTENTS

<b>Abbreviations</b>	<b>iv</b>
<b>Acknowledgments</b>	<b>v</b>
<b>Introduction</b>	<b>1</b>
<b>The Crisis in Developing Asia: Evolution and Impact</b>	<b>2</b>
The Financial Sector: Banks Resilient But Stock Markets Not	2
Trade: Main Pathway to Crisis in the Region	3
Capital Flows: A Receding Tide	5
Social Impact: Increasing Vulnerabilities	6
<b>The Response of Developing Asia: Rising to the Challenge</b>	<b>8</b>
<b>Policy Implications</b>	<b>13</b>
Fiscal Policy	14
Monetary Policy and Exchange Rate Management	15
Finance Sector and Trade Policies	16
Social Protection	16
Regional Cooperation	16
<b>ADB's Response to the Crisis</b>	<b>18</b>
Support for the Public Sector	19
Expanding Support for Infrastructure Development	21
Support for the Private Sector	22
Subregional and Region-Wide Initiatives	23
<b>Conclusion</b>	<b>24</b>
<b>References</b>	<b>25</b>

# Abbreviations

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AIFI	–	Asian Infrastructure Financing Initiative
ASEAN	–	Association of Southeast Asian Nations
CGIM	–	credit guarantee and investment mechanism
DMC	–	developing member country
GDP	–	gross domestic product
OCR	–	ordinary capital resources
MDGs	–	Millennium Development Goals
PRC	–	People's Republic of China
SAARC	–	South Asia Association for Regional Cooperation
SMEs	–	small and medium-sized enterprises
TFFP	–	Trade Finance Facilitation Program

## NOTE

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

# Acknowledgments

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# Introduction

This paper provides a brief overview of the evolving economic crisis in developing Asia<sup>1</sup> and the Asian Development Bank's (ADB) response. Section II describes the main drivers of the crisis in the region and the major impacts on ADB's developing member countries (DMCs). The region's crisis response, including actions and reforms already initiated by DMCs, is discussed in

Section III. Section IV examines important policy issues the crisis has raised for developing Asia and summarizes the reforms DMCs should undertake to respond in the short run and to strengthen their resilience to external shocks in the longer term. Section V presents ADB's plan to help its DMCs restore sustained growth and social progress. Section VI concludes the paper.

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<sup>1</sup> Developing Asia refers to ADB's 44 developing member countries and to Brunei Darussalam, which is an unclassified regional member.

# The Crisis in Developing Asia: Evolution and Impact

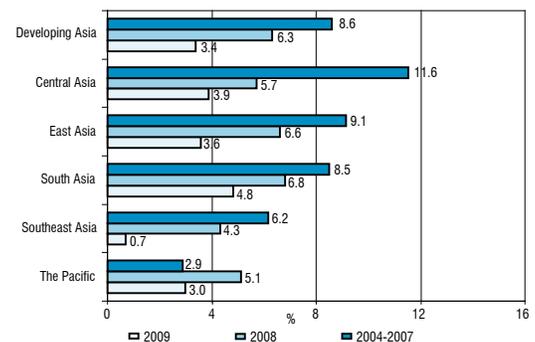
**The global financial crisis presents developing Asia with its most difficult economic challenges in recent times.** Growth rates have fallen sharply and are projected to drop further. Unemployment, deprivation, and financial and fiscal stress have increased and will likely worsen. Poverty reduction and other key development efforts have been knocked off track. As the economic fallout from the financial crisis that began in the United States (US) became worldwide, overall growth in developing Asia tumbled from its impressive peak of 9.5% in 2007 to 6.3% in 2008. In 2009, the Asian Development Outlook sees another steep fall to only 3.4%. Because global financial systems and major economies remain fragile, the recovery could be long and marked by setbacks and further shocks (ADB 2009, World Bank 2009a).

**Today's crisis is broader and deeper than the Asian financial crisis of 1997–1998. It is also more complex.** The Asian financial crisis arose from structural weaknesses in financial and monetary systems at home. This time the damage has come from financial and economic meltdowns in the advanced countries. The US subprime mortgage collapse, shattered confidence in major global financial institutions and instruments, massive deleveraging, crashing equity prices, and frozen credit markets reversed credit and investment flows to Asia, wounded Asian stock prices and exchange rates, and interrupted a decade of record economic expansion and social progress in developing Asia. During the earlier crisis, healthy growth and demand in the developed world helped support Asia's recovery. This time, however, the US, Japan, and Europe—the G3 countries—are in recession and their business confidence and consumption, on which the region has long depended, are in decline.

**For this reason, the crisis has hit export-dependent DMCs the hardest.** Growth in East Asia overall declined from 10.4% in 2007 to 6.6% in 2008. It is forecast to shrink to 3.6% in 2009. This is despite the relatively strong performance of the People's Republic of China (PRC). Growth in Southeast Asia was only 4.3% in 2008, compared with 6.4% in 2007. It may fall to below 1% in 2009. Only countries with limited external linkages defied the Southeast Asian trend. The economies of

South Asia, including India's, were also relatively less affected. They depend less on exports and their growth slowed moderately from 8.6% in 2007 to 6.8% in 2008, although it will likely decline again in 2009. Most of Central Asia's DMCs have been harmed economically by plunging prices for their vital commodity exports and by the recession in the Russian Federation, their main trade and financial partner. The subregion's growth plummeted from 12% in 2007 to 5.7% in 2008, and will likely be only 3.9% in 2009. Against this bleak backdrop, the Pacific subregion's growth of 5.1% in 2008 appears buoyant. But the Pacific DMCs will start feeling the full impact of falling commodity prices and tourism receipts only in 2009. Figure 1 shows the fall in growth by subregion (ADB 2009).

**Figure 1: GDP Growth Rates and Forecasts of Developing Asia**



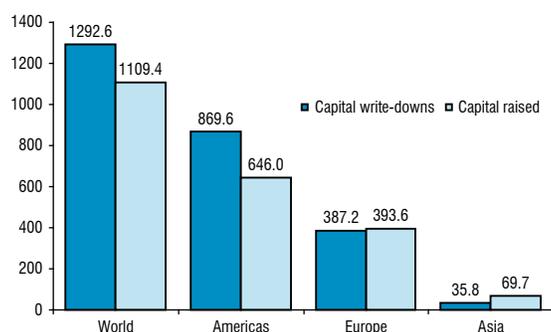
Sources: ADB 2009, ADB staff estimates.

## The Financial Sector: Banks Resilient But Stock Markets Not

**The region's banking sector is a bright spot in a dark economic picture.** Bolstered by reforms following the Asian financial crisis, particularly in East and Southeast Asian countries, the banking sector has been remarkably resistant to global shocks and fears. The region's banks report only miniscule (0.09%) direct exposure to subprime assets. Consequently, Asia's major banks

have faced comparatively less pressure on their balance sheets than the rest of the world's (Figure 2). The capital adequacy ratios of the banks in the region were strengthened after the Asian financial crisis and lending continues to flow more or less normally to the real sector. Overall, interbank interest rates fell in early 2009 from their peak near the end of 2008. But anecdotal evidence suggests that, in their effort to shore up capital adequacy, banks are turning down riskier borrowers, including small and medium-sized enterprises (SMEs). This "flight to quality" could deter innovation. Overall, however, the region has so far been spared the severe credit crunch that has gripped the US and Europe (Adams 2008).

**Figure 2: Crisis Write-Downs and Capital Raised by Major Banks**  
(\$ billions since 1 October 2007)



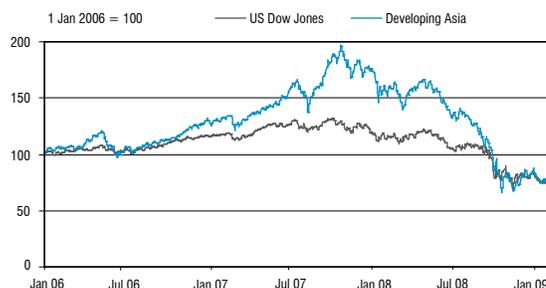
Note: Data as of 3 April 2009.

Source: Bloomberg.

**Stock markets have fallen dramatically as foreign capital has fled.** This deprives DMC economies of a crucial source of external financing. A protracted slump could effectively raise the cost of capital, dampen business and consumer confidence, and reduce financial wealth (Figure 3).

**The longer or deeper the crisis becomes, the greater the risks to the region's finance sector.** Banks may become vulnerable if a prolonged slowdown cuts earnings further and growing corporate and individual bankruptcies force them to set aside more funds for losses and nonperforming loans. A delayed or disorderly resolution of the credit crisis in the developed countries could also undermine financial stability in developing Asia by further shaking investor confidence in financial systems and instruments.

**Figure 3: Equity Prices**



Source: ADB 2009.

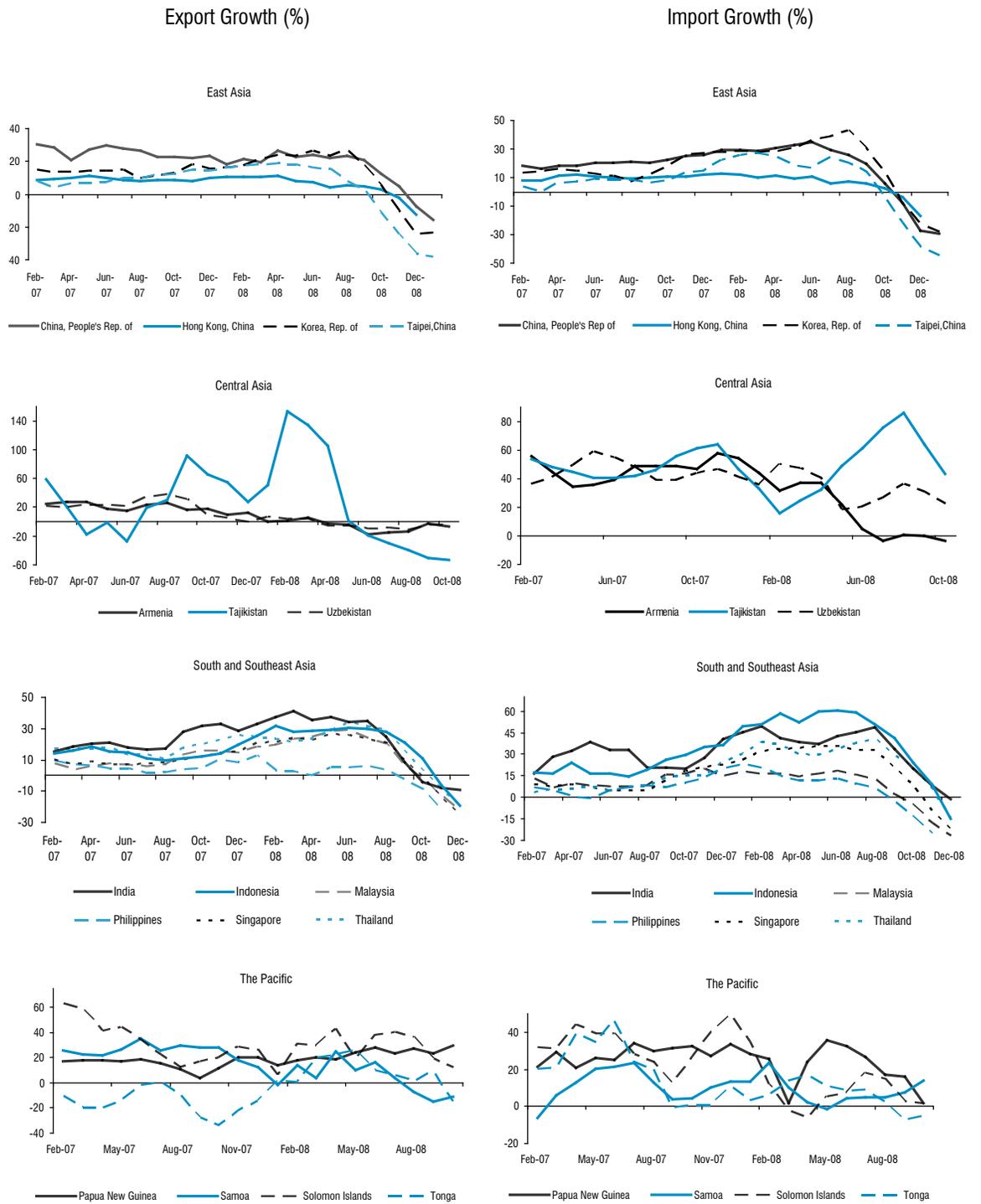
## Trade: Main Pathway to Crisis in the Region

**The global crisis struck developing Asia most forcefully through the collapse in trade and in business and consumer confidence in the G3.** As import demand faded in the advanced economies and their recessions set in, export growth plunged in East and Southeast Asia and South Asia. It was down by about 30% and 10%, respectively, in the two subregions in January 2009 compared with the last quarter of 2008. Electronics exports, closely tied to world income levels, have been particularly hurt, badly weakening export performance in the Republic of Korea; Malaysia; Philippines; Singapore; and Taipei, China. Bangladesh, Cambodia, Indonesia, and Sri Lanka have also suffered as the consumption in G3 markets of their major, labor-intensive export goods like textiles, toys, and footwear has withered. A comparison of recent trade performance between subregions is presented in Figure 4.

**Weakening consumption and investments at home have compounded these imported problems.** Lost export revenues have crimped income and cast a cloud over investment in export manufacturing. Import growth has followed suit. The gloomy global outlook has sapped business confidence across developing Asia.

**Dropping commodity prices have punished exporting DMCs but helped low-income consumers.** As commodity exporters, Indonesia, Papua New Guinea, Timor-Leste, Thailand, Viet Nam, and Malaysia stand to lose significantly. In 2009, for example, exports are projected to decline by 25% in Indonesia, 13% in Malaysia, 18% in Thailand, and 32% in Viet Nam (ADB 2009). The

Figure 4: Recent Trade Performance in Developing Asia



Note: Growth rates refer to 3-month moving average.

Sources: CEIC Data Company, Ltd. database and International Monetary Fund, *International Financial Statistics*.

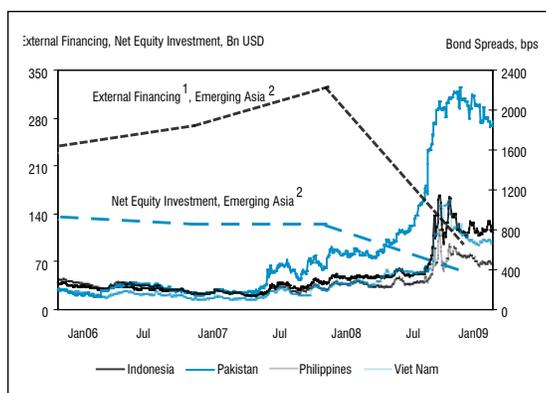
downturn also hits farmers in food-exporting countries, such as Thailand and Viet Nam, and government revenues in oil-exporting DMCs, such as Kazakhstan and Malaysia. However, lower food and oil prices slow inflation and increase the purchasing power of the poor.

## Capital Flows: A Receding Tide

**External financing, a key driver of economic expansion in the DMCs, has been cut back radically.** Developed world investors have withdrawn funds to repair balance sheets at home. The slump in net private flows for both direct and portfolio investment will continue in 2009, according to the Institute of International Finance (Figure 5). The region is also experiencing a

precipitous drop in foreign direct investment, which has deprived it of both finances and new technology (Figure 6). This is a grave problem for countries that have low reserves, like Pakistan, and those that rely on external borrowing to help fund their budget deficits, such as the Philippines and Indonesia. The worldwide flight from financial assets has hiked the risk premium on the dollar-denominated offshore bonds of the DMCs and set back their efforts to finance capital-intensive projects externally (Figure 5). ADB's experience with private sector operations shows that funding for infrastructure projects is fast drying up. Fortunately, domestic capital markets, which still supply the bulk of bond financing in the region, have not yet been affected by the tightened US bond market conditions. Official aid flows also remain unchanged.

**Figure 5: Developing Asia—External Finance Falls and Borrowing Costs Rise**



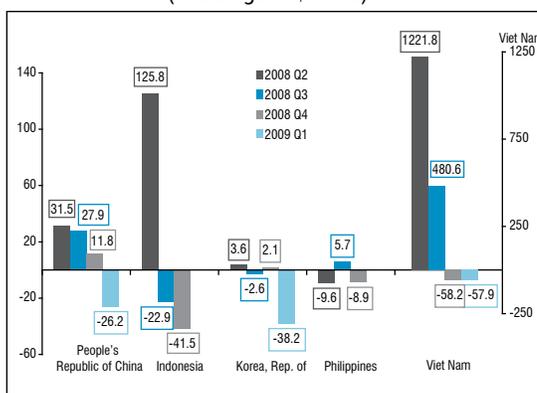
<sup>1</sup> External financing comprises net inflows of loans and equity and use of foreign exchange reserves, less errors and omissions.

<sup>2</sup> Emerging Asia includes the People's Republic of China, India, Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.

Note: The bond spreads are based on JP Morgan's Emerging Markets Bond Index for sovereign bonds.

Sources: Bloomberg and Institute of International Finance.

**Figure 6: Foreign Direct Investments in Selected DMCs**  
(% change in \$ value)



Note: Changes are calculated on year-on-year basis using quarterly data.

Source: ADB staff estimates.

to grow by only 6%–9%, compared with 10%–14% in 2008. The steep declines of 2008 (Figure 7) in most of these countries are likely to continue well into 2009 (ADB 2008c, World Bank 2009).

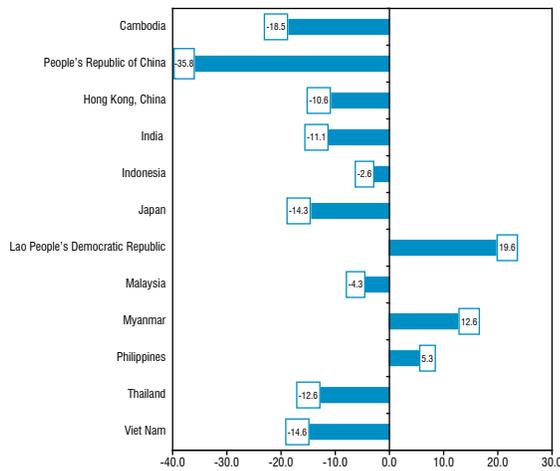
## Declines or slower growth in remittances are damaging economies dependent on their overseas workers—and will likely continue to do so.

Remittances play key roles in capital formation and household survival strategies in much of the region, including India, PRC, Philippines, Bangladesh, and Pakistan, which are 5 of the top 10 remittance recipients in the world. Remittances constituted more than 45% of Tajikistan's GDP in 2007 and are crucial to Nepal. South Asia, where remittances grew by almost 27% in 2008, faces a fall of 4%–7% this year. Remittances from overseas Filipinos are expected

## The region's currencies have depreciated against the US dollar due to weakened payments balances.

Eroding exports and remittances and portfolio outflows are mainly to blame. These have limited gains from falling commodity prices in importing countries and partially offset the potential losses of commodity exporters. In principle, currency depreciation favors exports but weak global demand has so far generally neutralized this potential advantage.

**Figure 7: Change in Remittance Inflows (%)**



Notes: (i) Workers' remittances include migrant transfers. (ii) Comparison is between 2008 and 2007 data; 2008 data are estimates.

Source: World Bank.

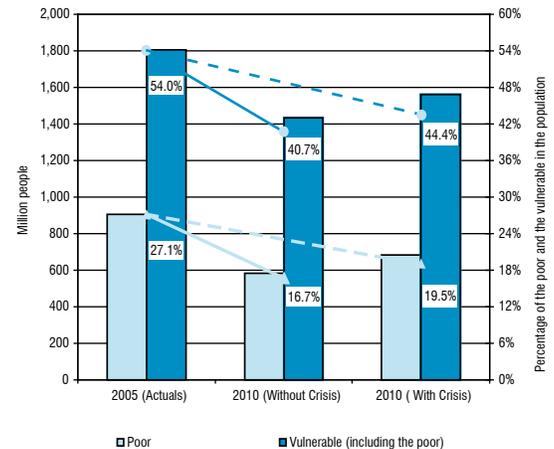
## Social Impact: Increasing Vulnerabilities

**Slowing growth is destroying jobs and driving down wages, consumption, and welfare of DMC households.** Unemployment is up substantially in manufacturing, construction, and services, the sectors greatly exposed to thinning demand abroad and at home. The International Labour Organization (ILO) has warned that this recession may add more than 30 million people to the rolls of the unemployed by the end of 2009 (ILO 2009). This estimate could prove conservative since it may not fully capture the trickle-down impacts through the value chain on downstream industries and services, where job losses more directly affect the extreme poor. Over 20 million workers are reported to have lost their jobs in the PRC alone. Unemployment has also risen markedly in Hong Kong, China; India; Republic of Korea; and Taipei, China. New jobs often require hard-to-get skills and many job seekers stay unemployed. Those who are successful frequently work for less pay or under poor conditions in the informal labor market. Recent retail sales data confirm that falling employment, incomes, and wealth are further dampening consumption.

**Developing Asia's impressive record in poverty reduction is likely to falter.** The region's strong performance has been powered by high growth over long

periods. Now large numbers of newly jobless workers from the region's struggling export industries and laid-off migrant and overseas employees are at risk of descending into absolute poverty. The lost opportunity cost is high as well. An ADB study estimates that more than 60 million individuals who would have been lifted above the extreme income poverty line of \$1.25 per day had the region's high growth continued in 2009 will remain mired in poverty instead. The figure could reach nearly 100 million by the end of 2010. If the impact on the vulnerable (those earning less than \$2 per day) is considered, the number of affected people will rise to 80 million in 2009 and 130 million by 2010 (Figure 8).

**Figure 8: Changes in Poverty and Vulnerability in Asia**



Notes: (i) Based on ADB projections of declines in growth for 2009 and 2010, (ii) Solid lines indicate percentage of the poor and the vulnerable in the population without the crisis, and dotted lines represent those with the crisis.

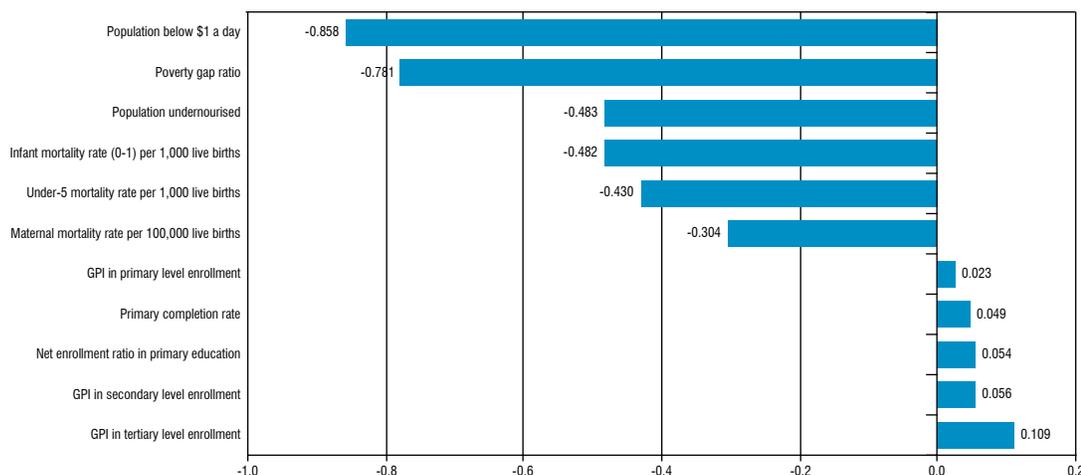
Source: Hasan et al. 2009.

**Women workers are likely to suffer the most as the crisis decimates their jobs and makes them more vulnerable.** Women dominate the low end of global supply chains in labor-intensive, export-oriented sectors, as well as tourism. Women employees outnumber men by between two and five to one in the garment, textile, and electronics industries in Thailand, Philippines, and Viet Nam (ILO 2009a). When layoffs start, they are often the first to lose their jobs. Women also form a large and particularly vulnerable group within the overall body of millions of overseas workers who have lost their jobs and are subject to exploitation and harsh conditions when seeking new ones.

**The crisis is likely to increase child mortality, aggravate hunger and disease, and increase school dropout rates and the odds against attaining the Millennium Development Goals (MDGs).** Fifteen DMCs had fallen seriously behind on the child mortality MDG even before the crisis. Thirteen countries had high or very high maternal mortality rates. Twice as many children were underweight in South Asia than in sub-Saharan Africa and Latin America combined. Diarrheal diseases were the leading killer of children in the region and nearly 2 billion people lacked access to adequate sanitation. These problems will probably worsen. Declining household incomes will force more students to abandon

their education. Experience from earlier crises shows that the children who drop out of school during these times may never return. A recent ADB-supported study in 25 DMCs (UNESCAP-UNDP-ADB 2008) suggests that economic growth directly affects movement on the MDGs and on the goals related to nutrition and health in particular (Figure 9). If these relationships hold, a 3 percentage point drop in the region's GDP growth rate in 2009 will translate into 10 million more undernourished people; 56,000 more deaths of children under 5 years; and 2,000 more mothers dying at childbirth. It also translates into an additional 1-year delay in achieving MDG targets relating to infant mortality and hunger.

**Figure 9: Link between Growth and MDGs in Asia: Elasticities with Respect to Growth**



Note: GPI refers to gender parity improvement in education (the ratio of girls to boys).

Source: UNESCAP-UNDP-ADB 2008.

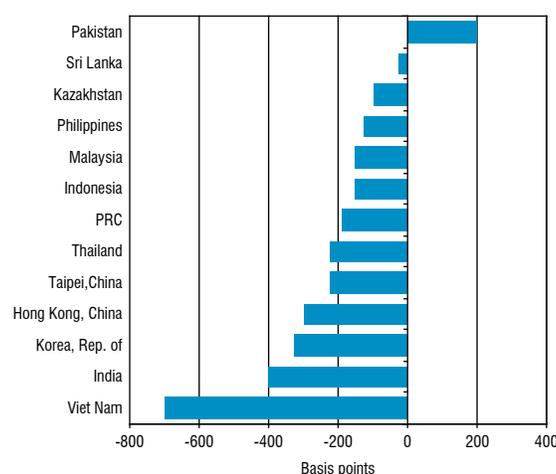
# The Response of Developing Asia: Rising to the Challenge

**Individual DMC responses have ranged from strong to inadequate, depending on how and when the crisis reached them, the nature and intensity of its effects, and their ability to fight back.** East and Southeast Asian governments and central banks moved quickly to expand local demand, spur job creation, and stabilize financial markets, easing monetary policy and implementing large fiscal policy initiatives. DMCs in other subregions have lacked either the need or the fiscal resources to act with the same speed or force. Some countries in the region, particularly those in South Asia, delayed reacting on the assumption that their economies' weak linkages with the US financial system would help protect them from the global storm. But when the financial turmoil expanded to the real G3 economies and then, through global integration, spread to their own, they began to respond (ADB 2008c). Table 1 compares fiscal, financial, and monetary measures taken by selected countries in developing Asia. Box 1 provides an overview of the crisis responses in the PRC and India, the region's two major developing economies.

**In most countries, the first step was to safeguard banking and financial systems, although the speed and intensity of interventions have varied.** Several governments increased deposit insurance coverage and issued blanket guarantees on the liabilities of deposit-taking institutions. This helped head off panic and the potential for bank runs amid global uncertainty and the failure of major US investment banks. By strengthening cooperation mechanisms in developing Asia, including the Chiang Mai Initiative,<sup>2</sup> the PRC, Japan, and Republic of Korea helped shore up public confidence in the safety of the region's savings. If the crisis deepens, more such measures will be needed.

**The balance of risk in most of the region has shifted since mid-September 2008 from rising inflation to slowing growth.** Central banks in most countries have acted to increase liquidity and ease credit and monetary policy. Policy rates and reserve requirement ratios have come down in most DMCs (Figure 10). Governments have also adjusted regulatory guidelines, guaranteed deposits, injected liquidity, and intervened to smooth volatility in foreign exchange markets. To support flagging stock prices, some state-owned enterprises increased their shareholdings in publicly traded companies. These measures, coupled with their sound financial systems, have helped ensure adequate liquidity and kept interbank rates low and stable in most countries.

**Figure 10: Change in Policy Rates  
30 September 2008–16 March 2009**



PRC = People's Republic of China.

Sources: Bloomberg; CEIC Data Company, Ltd., downloaded 17 March 2009.

<sup>2</sup> The Chiang Mai Initiative is a collaboration to create a network of bilateral swap arrangements among ASEAN+3 countries. It was agreed upon after the 1997–1998 Asian financial crisis to manage short-term liquidity problems. In February 2009, ASEAN+3 agreed to increase the fund to \$120 billion from the \$80 billion proposed in 2008.

Table 1: Financial, Monetary and Fiscal Policy Responses—Developing Asia (2008–2010)

Components / Country	East Asia and Southeast Asia										South Asia					Central Asia					The Pacific							
	Cambodia	PRC	Hong Kong, China	Indonesia	Korea, Rep. of	Lao PDR	Malaysia	Mongolia	Philippines	Singapore	Taipei, China	Thailand	Viet Nam	Bangladesh	India	Pakistan	Sri Lanka	Armenia	Azerbaijan	Georgia	Kazakhstan	Kyrgyz Rep.	Tajikistan	Uzbekistan	Fiji Islands	Papua New Guinea	Samoa	Vanuatu
<b>Financial Policy</b>																												
Deposit guarantee	□	□	✓	✓	✓	□	✓	✓	✓	✓	✓	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□
Government stakes in banks	□	✓	□	□	✓	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□
Regulatory forbearance	✓	□	✓	✓	✓	✓	✓	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Stock market intervention	□	✓	□	✓	✓	□	✓	□	□	✓	✓	□	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
<b>Monetary Policy</b>																												
Policy rate	□	✓	✓	✓	✓	□	✓	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Reserve ratio	✓	✓	□	✓	□	□	□	✓	□	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Liquidity injection	□	✓	✓	✓	✓	□	□	□	✓	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□
Exchange rate arrangement	✓	✓	✓	✓	✓	□	✓	✓	✓	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
<b>Expenditure</b>																												
Infrastructure investment	✓	✓	✓	✓	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Support to SMEs and/or farmers	□	✓	✓	✓	✓	□	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Safety nets	✓	✓	✓	✓	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Housing/construction support	□	✓	✓	✓	✓	□	□	□	✓	□	✓	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□
Strategic industries support	✓	✓	□	✓	□	□	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Increase/subsidy in wage	✓	□	□	✓	□	✓	□	□	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Employment generation	□	✓	✓	✓	✓	□	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Other	□	✓	✓	✓	✓	□	□	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
<b>Revenue</b>																												
Corporate income tax incentives	✓	□	□	✓	✓	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Personal income tax incentives	□	□	✓	✓	□	□	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Indirect tax exemptions	✓	✓	✓	✓	✓	□	□	□	✓	□	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Other	□	□	✓	✓	✓	✓	□	□	✓	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□	□

✓ = with policy response; □ = no policy response or data not available.

Lao PDR = Lao People's Democratic Republic; PRC = People's Republic of China; SMEs = small and medium-sized enterprises.

Sources: ADB, 2008, *Asia Economic Monitor, December 2008*; International Monetary Fund, *The State of Public Finances: Outlook and Medium-term Policies After the 2008 Crisis*; OREI staff country write-ups as of 25 March 2009; ADB country consultations; Releases of central banks and ministries of finance; News releases.

### Box 1: Responding to Crisis: The Cases of the People's Republic of China and India

The People's Republic of China (PRC) and India have moved quickly to put financial, monetary, and fiscal measures in place to bolster economic performance and address social costs.

- **Support for capital markets.** The PRC's attention was primarily focused on stabilizing the stock market while India's centered on the liquidity problems faced by nonbanking financial institutions. The PRC eased rules on share buybacks and eliminated the stamp duty on stock purchases. The China Investment Corporation increased its stakes in key banks during the third quarter of 2008 to support banking share prices. India instituted a special repo window for short-term central bank loans to banks for on-lending to nonbanking financial companies (NBFCs), housing finance companies (HFCs), and mutual funds that faced acute liquidity shortages.
- **Support for bank lending.** Both the PRC and India took steps to enlarge liquidity in the banking system. The PRC's bank lending rate has been cut by a total 216 basis points since September 2008. Deposit rates have come down to widen bank margins and encourage depositors to spend. The reserve requirement for small and medium-sized banks has been reduced to 13.5% from 17.5%. India's central bank reduced the cash reserve ratio from 9% to 5% and the statutory liquidity ratio from 25% to 24% of net demand and time liabilities. It increased the refinancing facility to the Small Industries Development Bank of India and the National Housing Bank, both sources of long-term lending.
- **Stabilizing foreign exchange markets.** While the PRC increased the use of the yuan in trade transactions, India took steps to increase the supply of foreign exchange. In December 2008, the PRC began using the yuan in trade with several neighboring territories and has intervened in foreign exchange markets to limit the yuan's appreciation against the US dollar. In India, to ease foreign liquidity, interest rate ceilings on foreign currency nonresident (banks) and nonresident (external) rupee accounts were raised and NBFCs and HFCs were allowed to access foreign borrowing.
- **Support for investment.** The PRC's strong fiscal position allowed it to unveil a CNY4 trillion (about \$600 billion) fiscal stimulus package. It will focus on transport, rural infrastructure, disaster relief, low-income housing, and the environment. The PRC also increased the incentive for investment by reducing borrowing costs. It exempted capital equipment from value added tax (VAT) at the start of 2009. The down payment required for first homes has been cut, along with the mortgage interest rate and the VAT on land sales. India's stimulus package is modest by comparison. It took steps to increase the resources of the India Infrastructure Finance Company Ltd (IFCL), which raises funds for infrastructure investments. The IFCL was authorized to raise Rs400 billion (about \$8 billion) through tax-free bonds to refinance bank lending of longer maturities and support financing of infrastructure projects under public-private partnerships, particularly in the highways and port sectors.
- **Addressing the social impacts.** Both the PRC and India have been concerned with alleviating the social costs of the crisis. The PRC announced in January 2009 that CNY850 billion (about \$125 billion) will be allocated to finance health care reform in 2009–2011. The government also announced a one-time payment to help low-income households—CNY100 (about \$15) in rural areas and CNY150 (about \$22) for urban residents. India's intervention has involved relief on consumption taxes. It reduced the central VAT on all products except petroleum, effective until the end of fiscal year 2008. Excise duty has also been reduced to 10%. These measures are expected to benefit those most affected by job losses and lower incomes.

#### **Fiscal policy has taken center stage in the region but the size and potential effectiveness of stimulus efforts vary widely.**

The budgetary discipline exercised by the newly industrialized economies and many ASEAN countries in recent years has allowed them ample fiscal space to stimulate domestic demand. Countries in other subregions have taken similar steps. Overall, however, the stimulus has been too small to achieve the potential output (Table 2). Even the relatively strong package in the PRC covers only half the output gap. Most stimulus efforts cover much less. These levels of stimulus will

have a weak impact on economic growth and may even be counterproductive. In some DMCs, particularly in South Asia, the problem has been a lack of fiscal space. In some others, absorptive and institutional capacity to manage the stimulus has been a constraint (ADB 2009, Bhaskaran 2009, Loser 2008).

**Public spending, especially on infrastructure, accounts for the bulk of the stimulus packages in most countries.** Tax cuts, primarily in corporate income tax, play a large stimulus role in only a handful of DMCs,

**Table 2: Fiscal Stimulus Plans of Selected DMCs**

Fiscal Stimulus	Countries
More than 5% of GDP	People's Republic of China, Georgia, Kazakhstan, Malaysia, Papua New Guinea, Singapore, Viet Nam
Between 2% and 5% of GDP	Armenia; Hong Kong, China; India; Republic of Korea; Philippines; Taipei, China; Thailand; Uzbekistan
Between 0.5% and 2% of GDP	Bangladesh, Cambodia, Indonesia, Pakistan
Less than 0.5% of GDP	Sri Lanka

Note: Based on announced fiscal stimulus packages of countries where data are available.

including Indonesia and the Philippines. Several DMCs have prioritized expenditures on infrastructure. SMEs and the rural sectors are also prime targets. Many DMCs have increased spending on housing and job creation and some are supporting strategic industries and increasing public sector wages to boost demand. In general, social sector spending has not received much attention. Few countries have yet to take the longer-term view, especially with respect to social protection issues. This calls for spending on lasting improvements in health care and education and for incentives for environment-friendly technologies. The PRC is an exception. Most other countries have been limited by institutional capabilities in planning and operating social safety net programs.

## Regional Initiatives

### **A global crisis ultimately requires a global solution.**

The Group of Twenty (G20) framework provides a global platform for developing and developed countries to jointly consider approaches to overcoming the crisis.<sup>3</sup> In its 2 April London meeting, the G20 resolved to implement tougher financial regulations, clamp down on tax havens, increase lending by multilateral development banks to assist developing countries, support global trade by providing greater access to trade finance, and avoid protectionist policies. The long-term agenda of international policy dialogue includes the reforms in the global financial architecture to avert crises like the

current one. Developing Asia's active participation in global forums for financial reform will ensure that its interests are fully reflected in international decisions on crucial issues.

**The February 2009 decision by ASEAN+3 finance ministers to expedite multilateralization of the Chiang Mai Initiative and expand their commitment to \$120 billion from \$80 billion was an important confidence-building step.**<sup>4</sup> Restrictions on the amount nations can draw from this pool of foreign currency reserves may be eased and rules liberalized. The ministers are also likely to push for an independent regional surveillance unit to provide close, objective monitoring of economic conditions in the subregion and to take preemptive action when necessary. Once the surveillance mechanism is fully functional, the portion of the Chiang Mai Initiative funding not subject to oversight by the International Monetary Fund can be increased significantly above the current limit of 20% (ADB 2009b).

**ASEAN+3 is seeking to expand the local currency bond market, a large, underexploited source of investment and finance for the region.** New steps under the Asian Bond Markets Initiative will promote and improve the legal framework for these bond issues and strengthen the infrastructure for trading on the region's bond markets. ASEAN+3 and ADB are establishing a mechanism to provide credit guarantees for domestic commercial bank loans and bond issuance. The credit

<sup>3</sup> The PRC, India, Indonesia, and Republic of Korea represent developing Asia in the G20 group of nations.

<sup>4</sup> The ASEAN+3 group of countries comprises 10 ASEAN members—Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam—and three non-ASEAN countries: the PRC, Japan, and Republic of Korea. The group's main objective is to enhance economic cooperation between ASEAN and the +3 countries.

guarantee and investment mechanism (CGIM) would provide access to US dollar funding, help limit the reversal of capital flows to the region, and allow commercial banks to continue lending. The CGIM would help reduce refinancing risks in the corporate sector, minimizing the maturity mismatch. Although it would operate initially only in ASEAN+3 countries, the CGIM could provide a template for a similar mechanism for other DMCs.

**Asian countries are acting bilaterally to stabilize currencies.** Indonesia, Malaysia, Korea, and Hong Kong, China have signed multibillion bilateral currency swap agreements with the PRC. In December 2008, the

Republic of Korea and Japan broadened an unconditional won–yen swap facility from \$3 billion to \$20 billion until April 2009. It supplements an existing \$10 billion crisis arrangement. Japan will provide financial guarantees of up to \$1.5 billion to Indonesia for issuing yen-denominated samurai bonds. The central bank governors of the PRC, Japan, and Republic of Korea strengthened monetary and financial policy collaboration in December 2008. Bilateral swap arrangements are being finalized between the central banks of India and Sri Lanka and an emergency credit line of \$100 million was established between the Reserve Bank of India and the Maldives Monetary Authority.

# Policy Implications

**Policy responses by governments in Asia and the Pacific must address the unique challenges and complexities of today's crisis while not forgetting important lessons learned during the Asian financial crisis of 1997–1998.** Several of these remain especially relevant:

- *Quick and transparent policy actions* can preempt considerable hardship and prevent a deeper crisis. Not acknowledging the problem or keeping it hidden, either for political reasons or lack of information, can cause severe damage by delaying necessary action.
- *One solution may not fit all countries.* The extent of the crisis and its underlying drivers vary across the region, as must the policy responses.
- The crisis provides *an opportunity to undertake difficult, long-term policy reforms* that often may not have been politically feasible during normal times. Southeast Asian countries took the opportunity raised by the Asian financial crisis to significantly strengthen their banking and social protection systems.
- The crisis *can disrupt development momentum well into the future.* The crisis led to a significant reduction in investments in infrastructure, especially for operations and maintenance. Even 10 years after the crisis, the precrisis spending levels have not been restored.
- The crisis has an important *human dimension.* Undertaking actions to mitigate the social impact of the crisis and protect investments in human capital is critically important. These measures can help obtain broader support for reforms and can also ensure early recovery and long-term growth. At the same time, neglecting these measures may have a permanently damaging impact on a country's growth potential.
- Ultimately, it is the *restoration of private sector confidence and investments* that will sustain recovery.
- Finally, *regional cooperation*, sharing of information and lessons, and coordinated surveillance are key

elements in an effective response to the crisis. No single country can manage the crisis on its own.

**The region's developing countries need to do more to minimize the impact of the crisis.** Despite some signs that the global crisis is easing, recovery in developing Asia is not expected to be swift. DMCs should take timely action to ensure that it comes as soon as possible and to mitigate long-term damage. No one uniform policy can fit the needs of all countries. Each must tailor its response to the nature and intensity of its particular challenges. However, in the short run, all DMCs should work individually and collectively to

- Restore the three critical global public goods essential to economic growth: market confidence and economic stability, a well-functioning financial system, and an open trading regime.
- Adopt countercyclical policies and programs to compensate for the worldwide collapse in private demand.
- Minimize cutbacks in investments critical to long-term growth and social stability—infrastructure, education, and health programs—despite expected shortfalls in government revenues and private capital flows.
- Protect society's most vulnerable people, the poor and the near-poor, as well as the recent progress in poverty reduction, by supporting existing social safety nets or creating new ones.

**In the long run, developing Asia must rebalance its growth model.** Export-led growth has delivered enormous benefits to the region and will continue to do so when global trade revives. But the current crisis has made the risks of excessive dependence on external demand painfully clear. The large, persistent current account surpluses that emerged after the Asian financial crisis have been unhealthy in other ways, too. The heavy price of aggressive export-oriented growth policies has included welfare costs associated with producing too little for domestic consumption; importing, investing, and consuming too little; and loss of efficiency in the

## Box 2: How to Rebalance Growth in Developing Asia

Developing countries whose output greatly exceeds expenditure can correct this imbalance by altering the production structure and diversifying demand.

In principle, the region's governments can boost domestic demand—and thereby reduce overdependence on external demand—either by encouraging greater consumption or stimulating investment. Empirical research undertaken by ADB (ADB 2009) suggests, however, that expanding domestic consumption is fundamental to achieving more balanced growth in the region. Strengthening social safety net programs will help dampen the precautionary motive for saving and boost domestic consumption. Governments need to improve the climate for investment rather than expand investment itself.

Policies that accelerate the development of the region's financial systems and strengthen domestic competition can channel more of Asia's large savings away from low-yielding foreign government bonds into productive investment within the DMCs. This will help build an output structure that is more welfare oriented, lessen the need for precautionary household saving, and result in greater domestic consumption.

Countries that allow domestic currencies to appreciate to reflect current account surpluses can stimulate consumption through increased imports and reallocation of resources from the export to the domestic sector. This will help increase the production of non-tradable goods.

Supply side policies that promote small and medium-sized enterprises and service industries can boost the economic role of production that caters to domestic demand. Governments can do this by (i) making economies more dynamic—lowering entry barriers facing new firms, for example; (ii) influencing the structure of production, e.g., by adjusting policies that favor manufacturing for exports over goods and services for domestic consumption; and (iii) promoting competition, including the liberalization of key sectors like telecommunications and public utilities.

Finally, by strengthening regional cooperation and integration, ADB's DMCs can build resilience to the additional, perhaps larger, external shocks that may arise as the global crisis unfolds. Concrete steps to expand regional trade will reduce overdependence on demand in the advanced economies. A larger Asian market will allow for economies of scale and help stabilize exchange rates by reducing the demand for G3 currencies. It will also encourage greater specialization and expand the scope for intra-industry trade in differentiated products. Domestic demand expansion and intra-regional trade liberalization can form a mutually reinforcing virtuous circle (ADB 2009, James et al 2008).

allocation of resources. DMCs need to support structural changes in the region's economy that will enable robust future growth and make economies less susceptible to volatility in other financial markets, particularly by raising domestic demand and recycling more of developing Asia's vast savings into investments at home (see Box 2).

are well placed to achieve both goals. Stimulus can be provided through increased spending or through tax cuts, but it should be sizable, timely, and well coordinated. The challenge is to strike a balance between quick demand creation and long-term fiscal sustainability. To target and administer stimulus packages efficiently, many DMCs may need to strengthen their capacities in public expenditure management (OECD 2009).

## Fiscal Policy

**Carefully designed fiscal stimulus can help restore stability and growth.** When properly targeted to meet growth, human development, and sustainability aims, fiscal expansion can generate demand and protect vulnerable groups in the short run, while maintaining investments and progress on long-term development goals. Fiscal space and ability to attract external funding determine a country's scope for action, but several DMCs

**Infrastructure provides the opportunity to raise employment and growth quickly.** Infrastructure investment, which has been long neglected in many DMCs, can create jobs, additional income, and add to aggregate demand. It also bolsters long-term growth potential by adding to the capital stock and enhancing productive capacity. Most developing Asian governments plan to increase infrastructure spending but to obtain the best results they need to prioritize the right kind of projects:

### Box 3: Indonesia's Experience in Social Protection: Turning Crisis into Opportunity

Social protection first became a public policy priority in Indonesia when the government instituted programs to offset the social costs of the Asian financial crisis in the late 1990s. The Social Safety Net Program was introduced in 1998 to cope with the precipitous decline in employment and incomes in the aftermath of the crisis. It had two components: social protection sector development and health and nutrition sector development. The social protection component financed specific interventions for education, health, family planning, nutrition services and support to street children. The health and nutrition component supported policy reforms for safeguarding access of the poor to basic health services and strengthened the management of health services delivery through decentralization. After a decade of implementation experience, social protection is now deeply rooted in Indonesia's social development strategy.

In 2007, the Government of Indonesia expanded its social protection efforts by launching a large pilot for the Conditional Cash Transfer Program, applying two approaches to supporting health and education outcomes. The first targeted poor individual households and the second provided block grants to communities. Now, Indonesia spends 2% of its GDP on social protection.

With its strong base and accumulated know-how, Indonesia is now well positioned to expand its social protection programs to cope with current challenges. Other DMCs may consider replicating the Indonesian example by building or strengthening their social protection systems during the current global crisis.

- Projects should be shovel-ready and implemented without delay. Their impact may be adversely inflationary rather than countercyclical if disbursement comes after the crisis has passed.
- Projects that are labor intensive, create employment, and have a high multiplier effect in local economies should be preferred over more capital-intensive undertakings that have a large import content.
- Operations and maintenance projects for existing infrastructure are not only greatly needed in several DMCs but can also be implemented simply and promptly. They create long-range benefits by lengthening the life of existing assets.
- Strategically targeted infrastructure projects in disadvantaged areas like urban slums can expand domestic demand. They also reduce poverty by providing jobs for people affected by the crisis and directly improve the quality of life in their communities.

**Governments must protect and expand public expenditures in the social sectors.** Crisis-driven fiscal expansion provides a chance to make overdue budget increases for education and health. Public expenditure on health by many DMCs is lower than that in sub-Saharan Africa. High secondary school dropout rates are due to poverty and lead to continued deprivation and the loss of potential human capital for future economic growth. Many DMCs not on track to achieve the MDGs needed to increase their social sector spending even before the crisis hit. That urgent need has now become

more pronounced. Fiscal stimulus packages provide a perfect opportunity (Box 3).

### Monetary Policy and Exchange Rate Management

**Many DMCs have the short-term option of relaxing monetary policy as the first line of defense.** Inflationary pressures have eased and the healthy balance sheets of most financial institutions will allow expansion of loan and investment portfolios. Interest rates can still come down in many countries where they were kept high to combat inflation and currency depreciation. Central banks can help lenders design policies that encourage appropriate high-priority investments—credits for lower- and middle-income housing, for example. Care must be taken not to dilute asset quality. Ill-regulated liquidity expansion could compromise the future financial health of developing Asia.

**Countries need to use reserves judiciously to smooth volatility in difficult foreign exchange markets but resist the temptation to try to set rates.** Domestic currency liquidity is not a problem for most DMCs at present. But massive US dollar outflows have driven down the exchange value of many currencies. Commercial foreign exchange sources have all but disappeared. The illiquidity in the US dollar market could constrain imports and create trade bottlenecks for countries with low reserves. One answer is to arrange more bilateral currency swaps

with regional neighbors that have accumulated large reserves. Several subregional examples already exist. Regional cooperation in exchange reserve management also discourages currency speculators (ADB 2008b, World Bank 2008).

## Finance Sector and Trade Policies

**The Asian finance sector has avoided a credit crisis for now but authorities should further strengthen public confidence, which has been shaken by global events.**

In a fragile environment, even marginal adverse developments in one institution could spread quickly through the market and infect an entire financial system. Regulators can help sustain stability by standing vigilant and not taking the region's relative immunity so far for granted. Policy should concentrate on strengthening transparency, accountability, regulation, and prudential oversight, as well as offsetting the pro-cyclicality of financial systems. Authorities should also reinforce international cooperation in regulation, accelerate reforms to strengthen financial systems, and broaden and deepen financial markets to make them more resilient (Lee and Park 2008).

**Governments must prepare for further challenges to financial stability and market confidence.**

First, crisis management frameworks must be reinforced and readied for possible implementation. Institutions tasked with providing emergency liquidity should be empowered and able to provide adequate assistance quickly. Second, policy makers need to identify the systemically important financial institutions and be able to quickly arrange additional sources of foreign and domestic liquidity support for them so that key economic activities are not disrupted in an emergency. At the same time, however, regulators must ensure that liquidity is not provided to insolvent institutions. Third, policy should concentrate on containing the spillover effects of worsening financial conditions due to slow growth and on the risks this raises for the region's banking systems (ADB 2008b).

**Governments should continue their commitment to free trade.**

Rising unemployment and dimming economic prospects have increased the risk of protectionism, which will prolong the crisis and weaken the recovery. Warning signs include restrictions on foreign workers

and tightening of nontariff barriers in some parts of developing Asia. This is despite DMC commitments to free trade practices. Beggar-thy-neighbor policies may bring short-run employment benefits but also invite retaliation and longer-term pain. By discussing and disarming protectionist impulses, ASEAN and subregional forums can protect long-term growth prospects for all.

## Social Protection

**Governments must help prevent millions of the vulnerable from sliding into poverty.**

Attention to social protection and investments to stimulate internal demand and reduce this vulnerability is imperative during the economic slowdown. Existing informal community-based mechanisms should be strengthened to cope with risks and, where possible, community-based interventions should be encouraged, including social funds, microinsurance, public works programs, conditional cash transfers, and in-kind programs. Income support must be clearly identified as temporary, however, to avoid creating unsustainable fiscal burdens. And it should not dilute regular poverty reduction efforts. Governments must step up real-time monitoring and assessment of human development indicators among low-income groups.

**Help should target migrants and the young now leaving school, as well as address the widening urban-rural divide.**

Infrastructure investments to upgrade low-income housing and neighborhoods can ease the plight of the many vulnerable groups who may join the ranks and swell the slums of the urban poor. Labor-intensive infrastructure investments can give jobs to the newly unemployed who will migrate back to their villages. Looking ahead, governments must readjust policy to encourage viable industries to locate in rural areas.

## Regional Cooperation

**Regional cooperation proved its value during and after the Asian financial crisis and should be strengthened now to prepare for potentially larger shocks ahead.**

These will include the consequences of an abrupt unwinding of global imbalances. ASEAN, the Greater Mekong Subregion,<sup>5</sup> and the Central Asia Regional

<sup>5</sup> The Greater Mekong Subregion comprises Cambodia, PRC, Lao PDR, Myanmar, Thailand, and Viet Nam.

Economic Cooperation<sup>6</sup> have all expanded markets, speeded development, and provided mechanisms for subregional cooperation during economic crisis. The Chiang Mai and Asian bond markets initiatives launched after the Asian financial crisis were win-win regional solutions for countries with often disparate economic interests. They should—and are about to be—strengthened. The current priorities in regional cooperation are

- institutional arrangements for managing the region's savings for better returns and preventing future crises,
- regional financial integration and arrangements for improved monitoring and coordinated regulation of the finance sector,
- development and implementation of early warning systems, and
- research on leading indicators for forecasting impending economic catastrophes.

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<sup>6</sup> The Central Asia Regional Economic Cooperation consists of eight participating countries: Afghanistan, Azerbaijan, PRC (focusing on Xinjiang Uygur Autonomous Region), Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan.

# ADB's Response to the Crisis

**ADB is acting aggressively to help its member countries respond to the crisis.** Given the scale of the challenge and the huge financing needs, ADB will focus on its areas of comparative strength, knowledge, and experience. ADB's crisis-related assistance will largely remain in the core operational areas under its long-term strategic framework 2008–2020 and will ensure that it does not lose sight of the long-term development goals of DMCs (ADB 2008a). ADB's strategy concentrates its operations in sectors that are central to generating employment, stimulating domestic demand, promoting regional cooperation and integration, and boosting investor confidence during the crisis. Led by infrastructure, they also include finance and education. ADB's crisis response will also prioritize these areas.

**ADB will tailor its crisis assistance to the specific circumstances and needs of the region's developing countries.** ADB will effectively augment increased lending with policy advice and regional cooperation support. Simultaneously, it is establishing new modalities and facilities to meet its DMCs' immediate needs. Figure 11 presents ADB's overall approach for responding to the crisis. ADB will closely monitor the crisis as it evolves in the region and make adjustments when needed. It will also regularly monitor and assess the effectiveness of its crisis response. Although attribution and impact will be hard to immediately determine, ADB will establish indicators to measure the progress and results of its support to ensure that ADB financing is additional to, and not a substitute for, governments' own funding. To optimize impact, ADB is collaborating closely with its development partners in the region, as well as the International Monetary Fund and World Bank and regional organizations like ASEAN and SAARC.

**ADB support is being extended to both public and private sectors, with higher levels of concessional and non-concessional lending volume and guarantees planned for the 2009–2010 period.** Recent replenishments of the resources for ADB's lending have

considerably increased its ability to support the region in key crisis-related areas. These replenishments have increased ADB's non-concessional ordinary capital resources (OCR) for lending mainly to middle-income countries and the concessional resources of the Asian Development Fund (ADF), which funds concessional loans and grants to low-income DMCs.

**ADB plans to increase its lending by more than \$10 billion in 2009–2010.** This will bring total ADB assistance for these 2 years to about \$32 billion, compared with about \$22 billion in 2007–2008 (Figure 11). The support will include project investments, quick-disbursing policy-based loans, guarantees, and new initiatives designed to address specific crisis needs. ADB will also expand its support through technical assistance grants for policy analysis and capacity development.

**ADB is proposing a Countercyclical Support Facility<sup>7</sup> of \$3 billion for fast-disbursing crisis assistance and maintaining credit flows to the real economy.** The facility would help offset the diminished external credit available to DMCs, sustain growth, and improve macroeconomic conditions by expanding domestic demand and production, strengthening social protection, facilitating trade, and protecting employment from fresh external shocks. It would also help DMCs address the short-term liquidity crunch and provide fiscal stimulus. In addition, ADB has expanded the Trade Finance Facilitation Program (TFFP) to \$1 billion to maintain and enhance liquidity for trade.

**ADB will accelerate and add to its support for low-income countries in 2009–2010.** The substantial ADF replenishment finalized in May 2008 will on average enable 30% more lending and grants to low-income DMCs in the 2009–2012 ADF X period than in 2005–2008. To meet crisis demand, ADB will front-load ADF X operations, boosting overall lending and grants in 2009 to about \$3.0 billion from the original allocation of \$2.6 billion. A planned \$400 million contribution from

<sup>7</sup> Establishment of the Countercyclical Support Facility is subject to the approval of ADB's Board.

ADB's liquidity reserve<sup>8</sup> will further increase the ADF resource available for 2009 to \$3.4 billion. ADB may intensify front-loading of the 2-year program if crisis needs warrant. To help strengthen the ADF resource position, annual OCR net income transfers will be three times higher during ADF X than during ADF IX.<sup>9</sup>

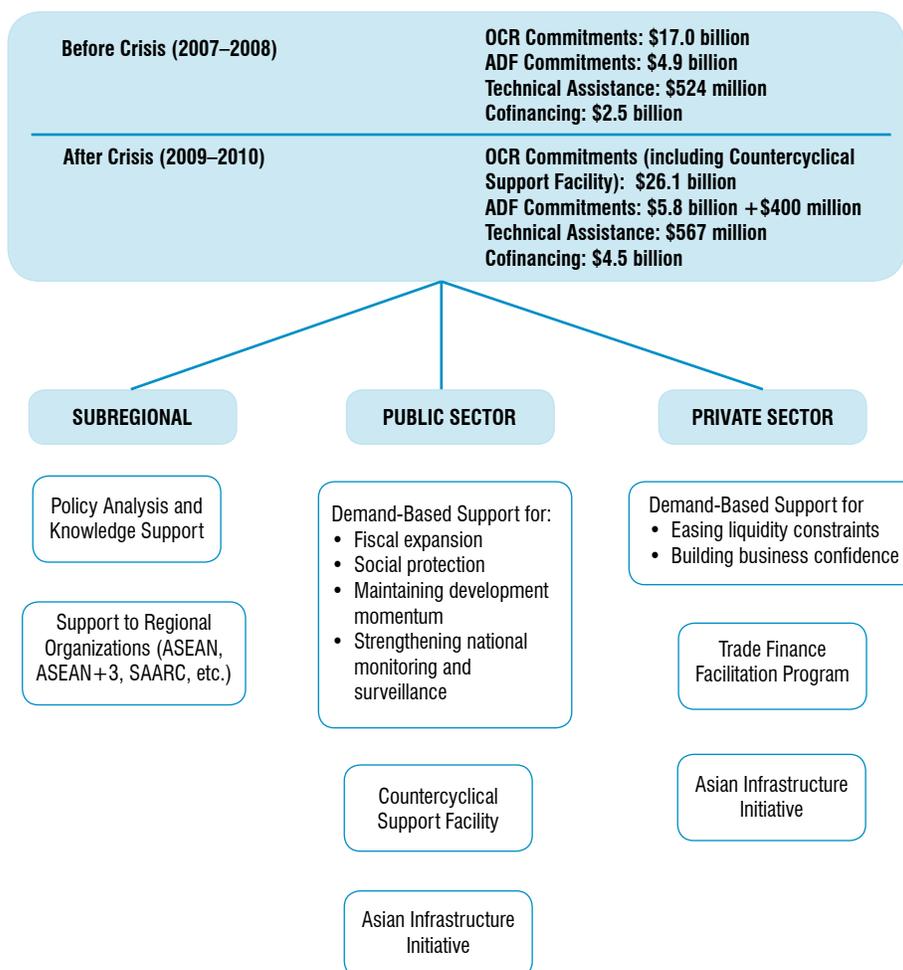
**ADB aims to mobilize close to \$4.5 billion of cofinancing with development partners for its projects in 2009–2010.** This would almost double the resources marshaled through cofinancing in the last 2 years. The risk-mitigating technical and financial features of ADB projects make them attractive investments for bilateral development partners and commercial financiers. ADB is pursuing framework

agreements with interested counterparts, covering both trade financing guarantees and infrastructure financing.

## Support for the Public Sector

**The crisis is changing the public sector priorities of DMCs and ADB will be flexible in meeting these evolving needs.** When necessary, it will modify assistance programs for both regular and supplementary lending to include crisis-related projects. Business processes will be adapted to ensure that ADB assistance is timely and effective. Supporting a combination of investment, policy advice, and capacity development needs, ADB's

Figure 11: ADB's Response to the Crisis



<sup>8</sup> This is subject to the concurrence of ADF donors.

<sup>9</sup> This is subject to ADB's Board of Directors' annual reviews of ADB's capital adequacy and net income outlook, and ADB's Board of Governors' approval of the net income allocation.

public sector operations in the short term will focus on the following:

- **Managing fiscal challenges.** ADB budget support and advice will help DMCs finance deficits and adjust expenditure and revenue policies to meet key crisis challenges and the needs of the poor. This includes ensuring sustained external financing for ongoing and planned development projects and programs. Technical assistance will help analyze and strengthen management, transparency, and accountability in public finance so that scarce resources are efficiently spent. For example, ADB, together with other development partners, is considering extending \$1 billion to the Government of Indonesia for a public expenditure support facility to ease the tightening liquidity situation. ADB has also supported Pakistan's efforts to stabilize its economy (Box 4).

- **Maintaining long-term development momentum.** DMCs must minimize disruption to current development programs and projects during the crisis and helping them do so will be a key responsibility of ADB and its development partners. With government resources contracting and the need growing for fiscal stimulus spending, ADB will support additional infrastructure and human development undertakings to prevent development advances from stalling (Box 5).

#### Box 4: ADB Helps Pakistan Deal with the Crisis

ADB's Accelerating Economic Transformation Program approved in September 2008 with initial funding of \$500 million aimed to help Pakistan deal with the fiscal and social consequences of the spiraling food and fuel prices and the emergence of the global financial crisis during the year. A further \$500 million in assistance for 2009 is to be considered by the Board in June 2009. Designed within the overall framework of the International Monetary Fund stabilization program, this loan will continue the focus on short-term stabilization measures while also helping Pakistan cope with the crisis.

The two loans, including a \$300 million loan on concessional terms, will help Pakistan create social safety nets and resolve a long-standing inter-corporate circular debt problem in the electricity sector. They will also allow the government to maintain essential public expenditures and provide some fiscal stimulus. The program includes measures to strengthen risk management in the finance sector.

ADB has also approved \$300 million in loans, mostly on concessional terms, for economic policy reforms in Balochistan, Punjab, and Sindh provinces. The assistance will help Pakistan manage the current crisis by providing much-needed foreign currency resources, with the equivalent in rupees to be lent on to the three provinces. It will also improve provincial delivery of public services to the poor and the vulnerable at a time when they are needed most.

#### Box 5: India's Infrastructure Finance Company Limited

India's fiscal deficit is expected to reach 6% of gross domestic product in fiscal year 2009 and to continue at that level for the medium term. ADB's long-term funding for large public sector infrastructure projects in the country frees up government resources to be spent on other priorities, including social safety nets.

ADB proposes to finance the second India Infrastructure Project Financing Facility in 2009, which would support the Infrastructure Finance Company Limited, a key public sector institution. The facility would promote public-private partnership projects in the roads, airports, sea ports, power, gas pipelines, and urban infrastructure sectors by catalyzing private sector participation and mobilizing cofinancing from foreign and domestic financial institutions.

India needs to follow this approach if it were to successfully implement its ambitious \$514 billion infrastructure development plan for 2007–2012. The 24 subprojects financed under the first India Infrastructure Project Financing Facility mobilized about \$2.3 billion of equity and debt. Without this new ADB project, the equivalent noncommercial resources would have to be found since long-term commercial sources of financing have virtually dried up.

- **Mitigating adverse social impacts.** ADB will help DMCs ease the social impact of the crisis. ADB will promote the strengthening of social safety nets, rural programs to generate employment, financing for SMEs, and conditional cash transfers to prevent vulnerable people from sliding into poverty (Box 6). ADB will also support post-secondary technical education and vocational training to help absorb unemployed graduates.

### Box 6: Public Expenditure Support for Social Protection

By supporting key public expenditures and counter-cyclical fiscal efforts in crisis-affected DMCs, ADB will work to offset the effects on the poor and the vulnerable of plunging exports, remittances, and capital inflows, as well as of falling government revenues. Examples:

**In Armenia and Tajikistan,** ADB's proposed budget support operations aim to help finance safety nets for the poor, including small-scale public works programs for returning migrant workers.

**In Georgia,** the government has requested ADB for budget support in 2009 to help cope with the evolving global economic crisis, especially for strengthening its social protection system.

**In Nepal,** the proposed Financial Crisis Mitigation and Vulnerability Reduction Program will help fund government efforts to generate employment in rural areas and parts of the economy hurt by falling foreign investment and the loss of tourism and overseas employment.

**In Bangladesh,** ADB is preparing a project for providing inclusive social insurance that will benefit poor households, especially in rural areas.

**In India,** ADB's Mizoram Resource Development Project seeks to strengthen social sector expenditure through improved payments to teachers and health workers and to support the social protection system.

## Expanding Support for Infrastructure Development

**ADB will expand its Asian Infrastructure Financing Initiative (AIFI) and work proactively to arrange additional cofinancing for DMC infrastructure development.** ADB has signed framework cofinancing agreements of \$5.5 billion for 3 years under AIFI.<sup>10</sup> ADB's catalytic role can help attract private sector involvement for several large infrastructure projects now frozen across the region by lack of funds. ADB has established a project preparation and advisory facility within AIFI to prepare a shelf of public, private, and joint venture projects for financing. ADB will coordinate closely with the World Bank's INFRA platform.<sup>11</sup>

**ADB will be flexible in financing identified shovel-ready infrastructure projects.** To deliver stimulus quickly, these projects need to start soon—or already be under way. ADB will consider increasing its share of financing for ongoing infrastructure projects and simplify feasibility analysis and approval processes. It will also examine possibilities for financing infrastructure operations and maintenance, another quick-start option. In private sector operations, ADB will consider financing more than the usual 25% of the cost of high-impact infrastructure projects.

**ADB partnerships will help prepare a crucial project pipeline for private sector involvement in infrastructure.** Because past crises show it takes many years to redevelop infrastructure project pipelines, ADB will provide vital support for project development, partly by accessing funding for project preparation through its participation in the Public Private Infrastructure Advisory Facility (PPIAF).<sup>12</sup> ADB is also developing a partnership with the Private Infrastructure Development Group

<sup>10</sup> These are with the Islamic Development Bank for \$2.0 billion, the Republic of Korea's Ministry of Strategy and Finance for \$0.5 billion; Korea Development Bank for \$0.5 billion; and Korea Export-Import Bank for \$2.5 billion.

<sup>11</sup> The World Bank is launching the Infrastructure Recovery and Assets (INFRA) platform to counter the falloff in infrastructure investment during the crisis. INFRA addresses both public and private sector infrastructure assets.

<sup>12</sup> PPIAF was launched in 1999 as a joint initiative of the governments of Japan and the United Kingdom, working closely with the World Bank. It was built on the World Bank Group's Infrastructure Action Program and designed to reinforce the actions of all participating donors. PPIAF's membership includes bilateral and multilateral development agencies and international financial institutions.

(PIDG)<sup>13</sup> by contributing to their technical assistance fund. These partnerships add to ADB's existing resources for private sector or public-private partnership project development.

## Support for the Private Sector

**ADB is taking steps to rebuild business confidence, provide incentives for private sector investment, and facilitate trade financing.** These private sector initiatives will also deliver short-term finance and capital to vulnerable banking systems, either directly through ADB private sector operations or indirectly via government programs supporting bank recapitalization. ADB is developing a Bank Liquidity Guarantee Program (BLGP) to provide partial credit guarantee cover for short-term borrowings by systemically important banking institutions. ADB may provide initial seed capital to establish a foundation for the BLGP and attract additional cofinancing. At an individual transaction level, ADB may also selectively increase its exposure beyond the current 25% limit to assist infrastructure projects that may otherwise be delayed by the current scarcity of commercial financing. ADB may seek to "warehouse" this additional exposure until it can be sold down to the market, for example, as B-loans.

**ADB's Trade Finance Facilitation Program (TFFP) will provide about \$15 billion by 2013 on a roll-over basis to support trade in the region. The program will use the following three vehicles:**

- A credit guarantee product that provides guarantees to participating (confirming) regional and international banks against the payment of trade obligations issued by approved issuing local banks in DMCs;
- A risk participation agreement product that works like the credit guarantee product but provides risk participation and/or guarantees on a portfolio basis rather than on a transaction-by-transaction basis; and

- A revolving credit product that provides loans to issuing banks for on-lending to private sector exporters and importers to finance trade-related transactions. This product has been used mostly for pre-export finance (Box 7).

### Box 7: Trade Finance Facilitation Program

ADB has expanded its Trade Finance Facilitation Program (TFFP) to \$1 billion, a move that could generate up to \$15 billion in greatly needed trade financing by the end of 2013. The TFFP began operations in 2004 as a \$150 million program and provides direct finance and guarantees for trade transactions in DMCs in conjunction with international and national banks.

The TFFP's expansion comes at a critical time. Many large international banks that traditionally finance DMC trade have retreated from the field to rebuild their capital and reduce risk. The resulting evaporation of commercial trade financing for DMC companies has further aggravated the region's economic downturn. The TFFP will help meet the shortfall.

The TFFP delivers high leverage. Each dollar of TFFP exposure can attract a similar amount of private sector financing. Since the portfolio can roll over twice a year, the \$1 billion program can generate as much as \$3 billion of trade finance annually.

Slower trade growth will also require credit facilities with longer tenures because payments to suppliers may be delayed. ADB has increased the maximum maturity under the program to 3 years from 2 years to boost the trade competitiveness of its DMCs.

By the end of 2008, the TFFP had supported nearly 1,200 international trade transactions in nine DMCs worth over \$578 million. It has suffered no losses or nonperforming loans. The volume of transactions soared by 570% in 2008, on top of a 78% increase in 2007. Currently, 72 international banks and 60 DMC banks are participating and ADB expects the number to rise to 100 by the end of 2009.

<sup>13</sup> PIDG is a coalition of donors for mobilizing private sector investment to help developing countries provide infrastructure vital to boost their economic development and combat poverty. Its current members are the UK Department of International Development, Swiss State Secretariat for Economic Affairs, Netherlands Ministry of Foreign Affairs, Swedish International Development Cooperation Agency, and International Finance Corporation/World Bank.

**ADB is mobilizing additional commercial cofinancing by providing credit enhancements.** As the availability of credit for both project and trade financing in DMCs has tightened, the demand for credit enhancements, including guarantees and political risk insurance, has increased. To respond to the growing demand for credit enhancements, ADB is raising the level of awareness of its guarantee products among its DMCs and potential beneficiaries of these guarantees, which include commercial banks, investors, importers, and exporters. ADB is also exploring ways in which it can mobilize additional guarantee capacity in cooperation with public and private political risk insurers and guarantors, including through reinsurance and its guarantor-of-record structure. ADB credit enhancements will support both sovereign and nonsovereign projects and transactions.

**ADB is facilitating expert discussion and the exchange of ideas among DMCs to produce appropriate policy responses to the crisis.** A symposium of premier economic policy research institutions held by the ADB Institute in March 2009, under the auspices of the Asia Policy Forum, made important crisis policy recommendations to East Asian leaders (ADB 2009b). ADB has intensified its policy guidance to DMCs to help them prepare for emerging financial sector issues, assess their vulnerability, and strengthen policy and regulatory frameworks. ADB also hosted a meeting of the regional technical group of the World Trade Organization's Aid for Trade Initiative in March 2009. The group focused on initiative-related crisis responses. Top policy makers from South Asia discussed their crisis priorities at an ADB-sponsored South Asia Forum. In the Pacific, ADB is playing a leading role in monitoring the crisis, facilitating policy dialogue with key stakeholders, and building surveillance capacity (Box 8).

## Subregional and Region-Wide Initiatives

**ADB's regional initiatives will build institutional capacity and support policy analysis to help countries cope with the crisis.** Many DMCs, particularly small and low-income countries, lack government capacity for sound fiscal planning and management, design, and implementation of social protection systems. They also need help in preparing for greater participation in global trade, once growth recovers. ADB has undertaken and will conduct several studies of crisis effects to inform sound policy planning in the region.

**ADB has helped strengthen economic surveillance and crisis monitoring at the regional, subregional, and national levels.** These efforts have included close work with existing regional arrangements—including ASEAN, ASEAN+3, SAARC, and the East Asian Summit—and are part of ADB's support to help DMCs develop a coordinated regional response to the crisis. ADB is also working with ASEAN+3 on an Asian Bond Markets Initiative to accelerate the establishment of a credit guarantee and investment mechanism. The CGIM would allow access to initial US dollar funding to the participating member countries.

### Box 8: ADB's Pacific Crisis Support Program

ADB is giving its Pacific developing member countries (DMCs) broad, comprehensive help to weather the global crisis. Its Pacific Crisis Support Program has four components:

**Extensive analytic and policy work.** ADB released a policy brief, *Navigating the Global Storm*, in October 2008 that provided an early assessment of the potential effects of the worldwide events on the Pacific. A follow-up brief, *Taking the Helm*, gives the region's governments a policy framework they can use to cope with crisis impacts. A *Pacific Economic Monitor* under preparation will present additional policy responses for Pacific DMCs based on further close analysis of crisis developments (ADB 2008, ADB 2009a).

**Technical assistance.** ADB's Pacific Economic Management Technical Assistance will help economic agencies improve their economic monitoring and analysis systems. It will include innovative modalities to enable governments to overcome long-standing institutional constraints and formulate effective crisis responses on their own.

**Budget support.** ADB's budget support for Pacific governments will cushion the downturn's effects on their revenues and help them sustain essential expenditures, including support for the vulnerable. Budget support for the Cook Islands and Tonga in 2009 is already being prepared. Support is also available for other Pacific DMCs.

**Donor coordination.** ADB has helped coordinate a consultation process aimed at providing a joint response to the global economic crisis by the Pacific's development partners.

# Conclusion

**This crisis will test the resources, policies, and skills of developing Asia's governments and economies.**

The region's record growth and gains against poverty have been derailed by global financial upheaval and advanced world recessions. Its economic fortunes remain inextricably linked with those of the G-3. While the crisis in those nations persists, prospects for developing Asia's recovery will be generally grim. If prolonged or deepened, the crisis raises risks even for the region's so far resilient banking sector. Some DMC governments have countered crisis effects with strong fiscal responses but most have lacked the resources to offset the abrupt fall in incomes and investments. The region's policy makers face difficult and complex challenges. They must provide fiscal and monetary stimuli and private sector incentives without distorting markets. They must also make parallel efforts to strengthen safety nets and to ensure that poverty reduction and other key human development work are not halted or reversed. In the long term, they must rebalance their economies and make them more resistant to global shocks and stresses.

**ADB will support the crisis response of its DMCs aggressively through regular and emergency lending, guarantees, policy advice, regional cooperation, and by mobilizing additional resources.**

ADB proposes to substantially expand its programmed assistance in 2009–2010. A number of new initiatives have already been launched and many are under way. They include a proposed Countercyclical Support Facility, which will provide fast-disbursing budget support to eligible DMCs to meet their short-term liquidity requirements. ADB has also expanded its TFFP to ensure liquidity for trade. If the crisis deepens, ADB will consider ways to enhance its assistance further. ADB aims to help mitigate crisis impacts, maintain momentum in regional development and poverty reduction, hasten recovery, and restore developing Asia to its past levels of dynamic economic growth and social progress.

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## About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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