The COVID-19 pandemic quickly produced the largest global economic emergency in more than a century. In 2020, economic activity contracted in 93 percent of countries, the world economy shrank by about 3.5 percent, and global poverty increased for the first time in a generation. Governments responded rapidly with fiscal, monetary, and financial policies that alleviated the worst short-term financial and economic impacts of the crisis. Yet the world must still contend with the significant mid- to long-term financial and economic risks caused by, or exacerbated by, the pandemic and the immediate government responses needed to mitigate its effects.

World Development Report 2022: Finance for an Equitable Recovery examines the central role of finance in the economic recovery from COVID-19. Based on an in-depth look at the consequences of the crisis most likely to affect low- and middle-income economies, it advocates a set of policies and measures to mitigate the financial risks stemming from the pandemic—risks that may become more acute as stimulus measures are withdrawn at both the domestic and global levels. The overriding goal is to direct countries toward approaches that can support a swift, equitable recovery. Those approaches include transparent management of nonperforming loans, insolvency reforms to allow borrowers in distress to discharge debts, innovations to improve credit risk visibility and enable continued delivery of credit, and methods to establish sustainable levels of government debt.
Contents

v Foreword
vii Preface

1 Overview

1 Introduction

3 The economic impacts of the pandemic
3 Interconnected financial risks
5 Increased inequality within and between countries

6 The economic policy response to the pandemic: Swift but with large variation across countries

8 Resolving financial risks: A prerequisite for an equitable recovery
9 Policy area 1: Managing and reducing loan distress
11 Policy area 2: Improving the legal insolvency framework
13 Policy area 3: Ensuring continued access to finance
16 Policy area 4: Managing higher levels of sovereign debt

20 Conclusion

21 Notes

22 References

This new World Development Report focuses on the interrelated economic risks that households, businesses, financial institutions, and governments worldwide are facing as a consequence of the COVID-19 crisis. The Report offers new insights from research on the interconnectedness of balance sheets and the potential spillover effects across sectors. It also offers policy recommendations based on these insights. Specifically, it addresses the question of how to reduce the financial risks stemming from the extraordinary policies adopted in response to the COVID-19 crisis while supporting an equitable recovery.

The unfolding COVID-19 pandemic has already led to millions of deaths, job losses, business failures, and school closings, triggering the most encompassing economic crisis in almost a century. Poverty rates have soared and inequality has widened both across and within countries. Disadvantaged groups that had limited financial resilience to begin with and workers with lower levels of education—especially younger ones and women—have been disproportionately affected.

The response by governments has included a combination of cash transfers to households, credit guarantees for firms, easier liquidity conditions, repayment grace periods for much of the private sector, and accounting and regulatory forbearance for many financial institutions. Although these actions have helped to partially mitigate the economic and social consequences of the pandemic, they have also resulted in elevated risks, including public overindebtedness, increased financial fragility, and a general erosion in transparency. Emerging economies have been left with very limited fiscal space, and they will be made even more vulnerable by the impending normalization of monetary policy in advanced economies.

This Report highlights several priority areas for action.

First is the need for early detection of significant financial risks. Because the balance sheets of households, firms, financial sector institutions, and governments are tightly interrelated, risks may be hidden. The share of nonperforming loans has generally remained below what was feared at the beginning of the crisis. But this could be due to forbearance policies that delayed debt repayments and relaxed accounting standards. Firm surveys in emerging economies reveal that many businesses expect to be in payment arrears in the coming months, and so private debt could suddenly become public debt, as in many past crises.

The interdependence of economic policies across countries matters as well. Public debt has reached unprecedented levels. As monetary policy tightens in advanced economies, interest rates will need to increase in emerging economies as well, and their currencies will likely depreciate. Higher interest rates make debt service more expensive, reinforcing the trend of recent years, and weaker currencies make debt service more burdensome relative to the size of the economy. Liquidity problems could suddenly morph into solvency problems.

The corporate–government nexus is another potential source of contingent liabilities and hidden debt. State-owned utilities have been asked to delay increases in tariffs and...
accept arrears in bill collection. Concessions and public-private partnerships have faced dramatic declines in revenue. Sooner or later, the losses could end up on the budget. Meanwhile, borrowing from foreign state-owned enterprises often escapes the surveillance of debt management agencies. These contingent liabilities and parastatal loans can raise significant financial risks in low-income and some emerging market countries.

Second is the need for proactive management of distressed assets. In the absence of effective resolution mechanisms for private sector debt, balance sheet problems last much longer than they should, with loan evergreening keeping “zombie” firms alive and undermining the strength of the recovery. Formal insolvency mechanisms need to be strengthened and alternative dispute resolution systems facilitated. Revamped legal mechanisms can promote debt forgiveness and help protect the long-term reputation of former debtors.

Early detection of risks and proactive management may also reduce the risks associated with the servicing of sovereign debt. Reprofiling allows moving to longer maturities and smoothing out debt-related payments. And the time for it is now, while international interest rates are still low and accessing global financial markets is still an option. Debt management can also help hedge against exchange rate volatility and currency weakness.

The biggest challenge is sovereign debt restructuring. The absence of a predictable, orderly, and rapid process for sovereign debt restructuring is costly, dampening recovery prospects and creating uncertainty. The historical track record shows that the longer the debt restructuring process takes, the larger the “haircut” creditors experience. For debtor countries, delay presents major setbacks to growth, poverty alleviation, and development. Unfortunately, negotiations on debt restructuring for the poorest countries under the G20 Common Framework are currently stalled.

Finally, it is critical to work toward broad-based access to finance. Low-income households are more likely to smooth out their consumption if they can save and borrow. Small businesses are better able to invest and create jobs if they have access to credit. Digital finance can play a critical role in enabling access to finance and fostering new economic opportunities.

Emerging economies need to rebuild their buffers and avoid sacrificing the accumulation of capital—both physical and human—along the way. The path chosen for fiscal consolidation is critically important in this respect. The composition of government spending affects economic growth, and more buoyant economic activity is critical to achieve development goals and debt sustainability in the longer term.

As for advanced economies, they should carefully unwind the extraordinary stimulus policies and avoid creating global turbulence. While reducing the balance sheets of their central banks, they should also rebalance their composition toward shorter-term assets because short-term interest rates matter more for the small and medium enterprises that constitute the backbone of global supply chains.

This new edition of the World Development Report charts a road map to tackle the financial vulnerabilities created by the COVID-19 crisis. The World Bank Group will continue to work tirelessly to assist client countries in these efforts.

David Malpass
President
The World Bank Group
Preface

In the midst of exceptional uncertainty, policy makers around the globe are grappling with the delicate task of scaling back the economic support measures put in place during the early stages of the COVID-19 pandemic while encouraging creation of the conditions needed to restore economic activity and growth.

One significant challenge is the lack of transparency—created or reinforced by the pandemic and (unintentionally) exacerbated by policy actions—about the risks in the balance sheets of the private and public sectors. What we do know is that the pandemic-induced recession of 2020 led to the largest single-year surge in global debt in decades. Before the pandemic, private debts were already at record highs in many advanced economies and emerging economies, leaving many households and firms poorly prepared to withstand an adverse income shock. Many governments were also facing record-high levels of debt prior to the pandemic, and many more significantly increased their debt burdens to fund vital response policies. In 2020, the average total debt burden of low- and middle-income countries increased by roughly 9 percentage points of the gross domestic product, compared with an average annual increase of 1.9 percentage points over the previous decade. Fifty-one countries (including 44 emerging economies) experienced a downgrade in their sovereign debt credit rating.

What we do not yet know, however, is the extent to which governments and private debtors are harboring hidden risks with the potential to stymie economic recovery. In particular, increased complexity and opacity in sovereign debt markets (as to who holds the debt and under what terms) often make it difficult to assess the full extent of risks in government balance sheets. On the private side, common elements of pandemic response programs, such as moratoria on bank loans, general forbearance policies, and a marked relaxation in financial reporting requirements, have made it difficult to determine whether debtors are facing short-term liquidity challenges or whether their incomes have been permanently affected. For both, the risk is insolvency on a scale and scope that are difficult to gauge in advance.

Within the context of uncertainty, the world is confronting the daunting challenge of continuing to navigate a global pandemic, while managing and reducing financial risks across household, business, financial, and government sectors. Problems in one area can and do reverberate across entire economies through mutually reinforcing channels that connect the financial health of all sectors. What at first blush appears to be an isolated disruption in one sector can very quickly spill over to the rest of the economy. For example, if households and firms are under financial stress, the financial sector faces a higher risk of loan defaults and is less willing or able to provide credit and support economic recovery.
As the financial position of the public sector deteriorates as a result of higher sovereign debt and lower tax revenue, many governments find that they are less able to support economic activity.

Policies that facilitate the early detection and swift resolution of economic and financial fragilities can make all the difference between an economic recovery that is robust and one that falters—or, worse, one that delays recovery altogether. Starting with an in-depth assessment of the severest and most regressive financial and economic impacts of the pandemic, this World Development Report puts forward a focused, actionable policy agenda that countries can adopt to cope with some of the harmful and potentially lasting economic effects of the pandemic. Some of these policies seek to reduce opacity in credit markets, for example, by ensuring that banks report accurate, timely indicators of loan quality or by increasing transparency around the scale and terms of sovereign debt. Other initiatives aim to accelerate the resolution of debt distress through improved insolvency proceedings for companies and individuals, and proactive efforts to reprofile or restructure sovereign debt.

Because there is no one-size-fits-all approach to economic recovery, the appropriate policy mix depends critically on prevailing conditions and policy capacity. Few if any governments have the resources and political leeway to tackle simultaneously all of the challenges they face as the pandemic recedes. Countries will need to prioritize. The potential for policy to contribute to a lasting, inclusive recovery will depend on the ability of governments, working in partnership with international financial institutions and other development professionals, to muster the political will for swift action.

Carmen M. Reinhart

Senior Vice President and Chief Economist

The World Bank Group
Overview

Introduction

In 2020, as communities around the world were struggling to contain the spread of COVID-19 (coronavirus) and manage the health and human costs of the pandemic, governments implemented a wide range of crisis response policies to mitigate the worst social and economic impacts of the pandemic.

The mobility restrictions, lockdowns, and other public health measures necessary to address the pandemic rapidly produced the largest global economic crisis in more than a century. This was compounded by a drop in demand as the pandemic affected consumer behavior. Economic activity contracted in 2020 in about 90 percent of countries, exceeding the number of countries seeing such declines during two world wars, the Great Depression of the 1930s, the emerging economy debt crises of the 1980s, and the 2007–09 global financial crisis (figure O.1). In 2020, the first year of the COVID-19 pandemic, the global economy shrank by approximately 3 percent, and global poverty increased for the first time in a generation.

To limit the impact of the crisis on households and businesses, governments enacted a swift and encompassing policy response that used a combination of fiscal, monetary, and financial sector policies. The case of India, which like many other countries enacted a large emergency response to the first wave of the pandemic, offers an example of a decisive policy response that used a wide range of policy instruments to mitigate the worst immediate effects of the crisis. When the pandemic first erupted in India in March 2020, the government declared a two-month national lockdown that closed businesses and sent workers home. The lockdown halted all manner of economic activity, and incomes fell in tandem. Small businesses and low-income workers in urban areas and the informal sector were the most severely affected.

The first measure adopted by the Indian government was a fiscal stimulus package that amounted to nearly 10 percent of the gross domestic product (GDP) and included direct support for poor households. Monetary policy reduced interest rates and eased lending conditions for banks and nonbank financial institutions. Financial sector policies were also part of the support plan; India instituted a debt repayment moratorium for households and firms that ultimately lasted six months. In addition, the Indian government introduced a large credit guarantee scheme aimed at ensuring that small and microenterprises would continue to have access to credit.

India’s response to the economic crisis was similar to that of many other countries. The strategy recognized that the sectors of its economy—households and businesses, financial institutions, and governments—are interconnected. A large shock to one sector can generate spillover risks that destabilize the economy at large if not addressed promptly and in an integrated manner. As the pandemic rolled on, producing multiple waves of infection, many countries extended relief measures beyond their original timeline. Although these policies have helped limit the worst economic outcomes of the pandemic in the short run, they also bring challenges—such as increased public and private debt burdens—that need to be addressed soon to ensure an equitable economic recovery.
As the economic effects of the pandemic continue, policy makers aim to strike a balance between providing enough support to mitigate the human costs of the crisis, while limiting the longer-term financial and macroeconomic risks that could emerge from higher debt levels resulting from the crisis. These risks are likely to arise more quickly in emerging economies and especially in low-income countries, where the public and private debt-carrying capacity is much lower than in advanced economies, and where economic conditions were, in many cases, challenging even before the pandemic.4

The evidence available so far suggests that the economic effects of the pandemic will be more persistent and severer for emerging economies. For example, after the collapse in per capita incomes across the globe in 2020 (figure O.1), 40 percent of advanced economies recovered and exceeded their 2019 output level in 2021. The comparable share of countries achieving per capita income in 2021 that surpassed their 2019 output is far lower for middle-income countries, at 27 percent, and lower still for low-income countries, at 21 percent, pointing to a slower recovery in poorer countries.5

This World Development Report examines the central role of finance in the recovery from what has been called a once-in-a-century crisis and charts pathways toward a robust and equitable recovery. Achieving an “equitable recovery” means that all adults, including vulnerable groups such as poor adults, women, and small businesses, are able to recover from losses of jobs, incomes, human capital, and assets.4 COVID-19 has widened inequality both within and across countries. Addressing financial risks is important to ensure that governments and financial institutions can support the recovery, including through investments in public services, such as health care and education. It is also critical that households and firms do not lose access to financial services that can strengthen resilience to economic shocks, including the loss of income and the unanticipated expenses many are incurring during the pandemic. Success in addressing these risks will help limit the damage to sustainable development outcomes and support an equitable recovery. This Report incorporates new research, data collected throughout the crisis, as well as country case studies to document the immediate financial and economic impacts of the pandemic, the government

Figure O.1 Economic impact of COVID-19 in historical perspective


Note: The figure shows the percentage of countries experiencing negative growth in their per capita gross domestic product (GDP) from 1901 to 2021. Data are as of October 21, 2021.
responses, and the risks that have materialized or are imminent. These risks include an increase in nonperforming loans and financial sector distress; a lack of options for households and businesses to discharge debts incurred during the pandemic through formal insolvency; tighter access to credit; and elevated levels of sovereign debt. With the goal of directing countries toward options that can support an equitable recovery, this Report then highlights policies that respond to some of the adverse impacts of the crisis and mitigate spillovers of financial risks.

The economic impacts of the pandemic

Interconnected financial risks

Although household and business incomes were most directly affected by the crisis, the consequences of this large shock have repercussions for the entire economy through numerous mutually reinforcing channels that connect the financial health of households and firms, financial institutions, and governments (see figure O.2). Because of this interconnection, elevated financial risks in one sector can easily spill over and destabilize the wider economy if left unchecked. When households and firms are under financial stress, the financial sector faces a higher risk of loan defaults and is less able to provide credit. Similarly, when the financial position of the public sector deteriorates, for example, as a result of higher debt and debt service, its ability to support households and firms may weaken.

However, this relationship is not deterministic. Well-designed fiscal, monetary, and financial sector policies can counteract and reduce these intertwined risks, and help transform the links between sectors of the economy from a vicious “doom loop” into a virtuous cycle (see figure O.3).

Figure O.2 Conceptual framework: Interconnected balance sheet risks

<table>
<thead>
<tr>
<th>Precrisis</th>
<th>COVID-19 pandemic</th>
<th>Crisis recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governments and central banks</td>
<td>Financial sector</td>
<td>Households and firms</td>
</tr>
</tbody>
</table>

Source: WDR 2022 team.

Note: The figure shows the links between the main sectors of an economy through which risks in one sector can affect the wider economy.
One example of policies that can make a critical difference are those targeting the link between the financial health of households, businesses, and the financial sector. In response to lockdowns and mobility restrictions necessary to contain the virus, many governments supported borrowers through direct cash transfers and financial policy tools, including debt moratoria and credit guarantees. As the crisis unfolded, these policies provided much-needed support to households and small businesses and helped avert a wave of insolvencies and loan defaults, which could have threatened the stability of the financial sector. Looking ahead, ensuring that debt burdens for households and businesses are sustainable and that there is continued access to credit is essential for an equitable recovery.

Similarly, governments, central banks, and regulators also used policy tools to assist financial institutions and prevent financial sector risks from spilling over to other parts of the economy. In many countries, central banks lowered interest rates, injected liquidity into the market, broadened access to refinancing facilities, and reduced provisioning requirements. These measures enabled banks and other institutions to continue to offer financing to households and businesses. Like many other central banks, the Central Reserve Bank of Peru, for example, injected liquidity into the banking system through government-backed repurchase (repo) agreements, which reduced the interest rate on new credit. Central banks also made unprecedented use of unconventional monetary policy tools such as asset purchase programs. Twenty-seven emerging economies adopted such programs for the first time in response to the COVID-19 crisis. These measures were aimed at preventing a liquidity crisis and safeguarding financial stability. However, debt moratoria and the provision of additional liquidity for the financial sector do not change the underlying economic conditions of borrowers. The risks now embedded in bank balance sheets will have to be addressed to ensure that the financial sector is well capitalized going into the recovery phase and is able to fulfill its role of providing credit to finance consumption and investment.

The crisis response will also need to include policies that address the risks arising from high levels of sovereign debt to ensure that governments preserve their ability to effectively support the recovery. The support measures adopted to mitigate the immediate impact of the pandemic on households and businesses required new government spending at a time when many governments were already

---

**Figure 0.3 Conceptual framework: Vicious and virtuous cycles**

- **a. Vicious cycle**
  - Lower tax revenue
  - Bank instability
  - Restricted access to credit
  - Declining fiscal support
  - NPLs and corporate insolvencies
  - Unfavorable bond markets

- **b. Virtuous cycle**
  - Higher tax revenue
  - Stable banks
  - Improved loan performance
  - Favorable bond markets
  - Improved credit supply
  - Stronger fiscal support

---

*Source: WDR 2022 team, based on Schnabel (2021).*

*Note: NPLs = nonperforming loans.*
burdened by elevated levels of public debt. High debt levels reduce a government’s ability to support the recovery through direct support of households and firms. They also reduce a government’s ability to invest in public goods and social safety nets that can reduce the impact of economic crises on poverty and inequality. Managing and reducing high levels of sovereign debt are therefore an important condition for an equitable recovery.

It is also important to recognize that COVID-19 is a crisis within a larger crisis arising from the escalating impacts of climate change on lives and economies. Preserving the ability of governments to invest in the transition to a green economy will be critical to counteract the inequitable impacts of climate change.

**Increased inequality within and between countries**

The economic impact of the pandemic has been highly unequal within and between countries. As the COVID-19 crisis unfolded in 2020, it became clear that many households and firms were ill-prepared to withstand an income shock of the length and scale of the pandemic. In 2020, more than 50 percent of households globally were not able to sustain basic consumption for more than three months in the event of income losses, while the cash reserves of the average business would cover fewer than 51 days of expenses.8

Within countries, the crisis disproportionately affected disadvantaged groups. In 2020, in 70 percent of countries the incidence of temporary unemployment was higher for workers who had completed only primary education.9 Income losses were similarly larger among youth, women, the self-employed, and casual workers with lower levels of education.10 Women, in particular, were affected by income and employment losses because they were more likely to be employed in sectors most affected by lockdown and social distancing measures, and they bore the brunt of the rising family care needs associated, for example, with the closures of childcare centers and schools. According to high-frequency phone survey data collected by the World Bank, in the initial phase of the pandemic, up to July 2020, 42 percent of women lost their jobs, compared with 31 percent of men, further underscoring the unequal impacts of the crisis by gender.11

The pattern of the crisis having a higher impact on disadvantaged groups applies to both emerging and advanced economies.12 Early evidence from a number of emerging economies points to significant increases in within-country inequality.13 It also reveals that initial disparities in job losses did not decline as lockdown and social distancing measures were relaxed. Those who suffered larger initial losses—women, younger workers, urban workers, and those with low levels of formal education—recovered more slowly than their counterparts or were not able to substantially reverse the initial disparities in losses.14 Not surprisingly, with average incomes contracting and the effects concentrated among the less well-off, the available global data suggest that the pandemic has had a substantial impact on global poverty.15

Similar patterns emerge for businesses. Smaller firms, informal businesses, and those with more limited access to the formal credit market were harder-hit by income losses stemming from the pandemic. Larger firms entered the crisis with the ability to cover expenses for up to 65 days, compared with 59 days for medium-size firms and 53 and 50 days for small firms and microenterprises, respectively. Moreover, micro-, small, and medium-size enterprises were overrepresented in the sectors most affected by the crisis, such as accommodation and food services, retail, and personal services. These businesses were more likely to suffer from supply chain disruptions that limited their access to inventory or supplies. Emerging data from surveys also indicate that affected businesses had to contend with longer payment terms or payment delays from buyers, including the public sector.16

These indicators are particularly alarming because in many emerging economies small and informal businesses account for a large share of total economic activity and employment. It is, for example,
estimated that the informal economy accounts for about 34 percent of GDP in Latin America and Sub-Saharan Africa and 28 percent of GDP in South Asia. In India, more than 80 percent of the total labor force is employed in the informal sector. The survival of small and informal businesses therefore has a direct impact on the broader economy.

The pandemic also exposed and worsened preexisting fragilities in the financial sector. Similar to that of households and governments, the resilience of banks and financial institutions at the onset of the pandemic varied widely across countries. Some countries that were heavily affected by the 2007–09 global financial crisis had initiated meaningful financial sector reforms in response and ensured that their banking systems were well capitalized. In some countries, such as Ghana, reforms also strengthened regulation and capitalization of the microfinance and nonbank sector. As a result, the financial sector in these countries was better able to weather the strains of the pandemic.

Many emerging economies, however, had failed to address financial sector fragilities in the years prior to the crisis, which compounded the problems of chronically low levels of financial intermediation and credit in the private sector. As a result, the financial sectors of these countries were ill-prepared for a crisis of the magnitude of the COVID-19 recession, which further reduced their ability to finance consumption and productive investment through the recovery.

The economic policy response to the pandemic: Swift but with large variation across countries

There were also marked inequalities in the crisis response across countries, which reflect differences in the resources and policy tools available to governments. As the pandemic intensified in 2020, the size and scope of government support programs varied widely. Many low-income countries struggled to mobilize the resources necessary to fight the immediate effects of the pandemic, or had to take on significant new debt to finance the crisis response. Half of the low-income countries eligible for the Group of Twenty (G20) Debt Service Suspension Initiative (DSSI), for example, were already in debt distress or close to debt distress prior to the pandemic. During the first year of the pandemic, the debt stock of these countries increased from 54 percent to 61 percent of GDP, further limiting their ability to respond to the possibility of a drawn-out recovery. While these debt levels are low by the standards of advanced economies, which have a much higher debt carrying capacity, they have been associated with the onset of debt crises in low-income countries.

Figure O.4 shows the stark variation across countries in the scale of the fiscal response to the pandemic. The magnitude of the fiscal response as a share of GDP was almost uniformly large by any historic metric in high-income countries and uniformly small or nonexistent in low-income countries. In middle-income countries, the fiscal response varied significantly, reflecting marked differences in the ability and willingness of governments to mobilize fiscal resources and spend on support programs.

In many cases, fiscal emergency measures were supported by large monetary policy interventions. Several emerging economy central banks, for example, used unconventional monetary policies such as asset purchase programs for the first time in history. These programs supported the fiscal response and provided liquidity at a time it was most urgently needed. However, the capacity of central banks to support the crisis response in this manner varied dramatically, so that these policy tools were both more widely used and more effective in higher-middle-income countries that had deeper capital markets and a more sophisticated financial sector. By contrast, in most low-income countries governments were constrained in their response to the crisis because monetary policy was not able to play a similarly supportive role.

The initial impact of the pandemic translated into rising inequality across countries in large measure because of the constraints many governments faced in assisting households and businesses. Although
poverty increased globally, nearly all of those who have slipped into extreme poverty (measured as the number of people living on less than $1.90 a day) as a result of the crisis live in lower-middle- and low-income countries.24

In addition to the scale of the policy response, there has also been wide variation in the combination of policy tools that countries have used to fight the immediate economic effects of the pandemic. This is illustrated by figure O.5, which shows the percentage of countries within country income groups that adopted different types of fiscal, monetary, and financial sector policy measures. The figure highlights some differences in the policy mix that are explained by resource constraints, as well as some differences that are explained by differences in the nature of economic risks faced by different countries. High-income and upper-middle-income economies, for example, made much more extensive use of financial sector policies, such as debt moratoria, given that financial institutions in these countries are much more exposed to household and small business loans, whose credit risk was severely affected by the pandemic.

Figure O.5 also highlights that the immediate response to the pandemic included a number of policy tools that were either untested in emerging economies or altogether unprecedented at this scale. One example are the extensive debt repayment moratoria and freezes on credit reporting that were enacted in many countries around the world. Although these programs have played an important role in mitigating the short-term liquidity issues faced by households and businesses, they did not necessarily address the future ability to repay, and had the unintended consequence of hiding loan losses, thereby creating a new problem: lack of transparency about credit risk and the true health of the financial sector.


Note: The figure reports, as a percentage of GDP, the total fiscal support, calculated as the sum of “above-the-line measures” that affect government revenue and expenditures and the subtotal of liquidity support measures. Data are as of September 27, 2021.
The impact of the COVID-19 economic crisis has created unprecedented financial risks that will force governments, regulators, and financial institutions to pursue short-term stabilization policies and longer-term structural policies to steer their economies toward a sustained and equitable recovery. Traveling this path will require timely action in four policy areas:

1. Managing and reducing loan distress
2. Improving the legal insolvency framework
3. Ensuring continued access to finance
4. Managing increased levels of sovereign debt.
Policy area 1: Managing and reducing loan distress

In many countries, the crisis response has included large-scale debt relief measures, such as debt moratoria and freezes on credit reporting. Many of these policies have no historical precedent; it is therefore difficult to predict their longer-term impacts on the credit market. As governments wind down such support policies for borrowers, lenders should expect to see increases in nonperforming loans (NPLs) of varying magnitudes across countries and sectors. Because many countries have relaxed the rules defining an NPL during the crisis, policy makers now face the challenge of interpreting increasingly opaque balance sheets. Banks’ incentives to underplay the true extent of exposure to problem loans will likely increase as moratoria end, other support measures are phased out, and the impact of the pandemic becomes clearer. If not countered by strong bank governance, robust regulatory definitions of NPLs, and careful bank supervision, hidden NPLs can create significant discrepancies between reported asset quality figures and the underlying economic realities. A lack of NPL transparency can stand in the way of a timely identification of potential banking system stress, weaken trust in the financial sector, and lead to reductions in investment and lending, which can hinder an equitable postpandemic recovery.

Banks do have processes to manage NPLs in the normal course of business, but the scale and complexity of the possible increase resulting from the COVID-19 crisis could strain that capacity. This may, in turn, fuel a credit crunch, even in countries with sound financial institutions and, at worst, destabilize the financial sector. Banks confronting a decline in loan quality that severely affects capital tend to limit lending, and those reductions typically hit low-income households and small businesses the hardest. In this way, sharply rising NPLs can give rise to a negative feedback loop between deteriorating financial sector performance and weakening real economic activity, which can also exacerbate economic inequality.

Therefore, managing the risk posed by opacity about rising NPLs should be a priority to enable early and clear diagnosis of emerging financial stress and thus facilitate resolution of the problem, while recognizing that the degrees of stress and capacity to absorb higher NPLs differ across countries (figure O.6).

Microfinance institutions (MFIs) face similar challenges and so warrant the same attention from policy makers. Low-income households and micro-, small, and medium enterprises (MSMEs) in developing economies generally rely on MFIs instead of conventional banks for financial services. Although MFIs have so far weathered the pandemic better than initially expected, the challenges they face in refinancing their own debt and in pressures on their asset quality—which so far have been relatively stable in part because of government support—may increase as moratoria are fully lifted and loans begin to come due.

Figure O.6 Capacity of banking systems to absorb increases in nonperforming loans, by country income group

Source: WDR 2022 team, based on Feyen and Mare (2021).
Note: The figure reports the percentage point increase in the nonperforming loan (NPL) ratio at the country level that wipes out capital buffers for banks representing at least 20 percent of banking system assets (see Feyen and Mare 2021). Higher values denote higher capacity to absorb NPL increases. The country distribution of the percentage point increase in the nonperforming loan ratio is shown across country income groups. The underlying bank-level data are from up to July 2021. Dots are values falling outside the whisker range.
Past crises have revealed that without a swift, comprehensive policy response, loan quality issues are likely to persist and worsen over time, as epitomized by the typical increase in loans to “zombie firms”—that is, loans to weak businesses that have little or no prospect of returning to health and fully paying off their debts. Continued extension and rolling over of loans to such firms (also known as evergreening) stifles economic growth by absorbing capital that would be better directed to loans for businesses with high productivity and growth potential.

Some financial institutions may be unable to cope with rising NPLs and will require recapitalization or resolution. If left unaddressed, rising NPLs can set the stage for systemic banking crises, which are associated with severe and prolonged recessions and consequent effects on poverty and inequality. A prompt comprehensive response is therefore critical to preserving the financial sector’s ability to support an equitable recovery and avoid mounting losses for the financial system. A strategy that supports timely identification and management of NPLs is necessary. The key elements of such a strategy are transparency, loan resolution, and problem bank resolution.

Improving transparency and supervision and reducing incentives for mismeasurement

An important first step is to establish enforceable rules and incentives that support transparency about the true state of banking assets. Assessing asset quality during the pandemic is complex because of the great uncertainty about economic prospects and the extent and persistence of income losses. The widespread use of debt moratoria and other support measures for borrowers has made it even more difficult for banks to assess the true repayment capacity of both existing and prospective borrowers. Indeed, debt moratoria and other support measures have reduced the comparability of NPL metrics across time both in countries and among countries.

Accurate and timely indicators of loan quality are essential to gauge the overall health of the financial sector and the ability of banks to absorb credit losses that may materialize in the near future. The use of internationally agreed definitions of NPLs is critical for monitoring and assessing banks’ asset quality in a consistent manner. The easing of regulatory definitions obscures banks’ true asset quality challenges and should be avoided.

Robust regulatory definitions should be underpinned by effective banking supervision. Banking supervisors, responsible for enforcing these regulatory definitions, must ensure that banks comply with prudential rules in an increasingly challenging environment. As pressure on the asset quality of banks increases, they increasingly are susceptible to incentives to step up efforts to disguise the extent of their difficulties in an attempt to avoid a supervisory or market response. Faced with these incentives, some banks may exploit regulatory loopholes or engage in questionable practices such as evergreening loans or transferring loans off balance sheets to present an overly optimistic picture of asset quality, which, in turn, can make a banking supervisor’s job significantly more difficult.

Resolving troubled loans through regulatory interventions

Governments and banking supervisors can use various interventions to encourage banks to step up efforts to resolve troubled loans. To manage rising volumes of bad debt, they can require banks to adopt appropriate processes and dedicate sufficient resources to recovering past-due loans. Bank business models, organizational structure, strategy, and internal resources must all reflect a coherent approach to managing rising NPLs, including setting up dedicated internal workout units and devising methodologies to assess borrower viability.

Banks hold primary responsibility for managing distressed loans. Public interventions may be necessary as well, however, if problem loans jeopardize a banking system’s capacity to finance the real
economy or threaten the stability of the financial system. Individual bank-level strategies may not be sufficient when the increase in NPLs is systemwide, as would be expected after a pandemic. Public policy interventions, such as national NPL resolution strategies for coordinating NPL resolution efforts across stakeholders in the economy, can play a useful role in accelerating the reduction of bad debts. For example, the government of Serbia established a national NPL working group in May 2015 after the banking sector NPL ratio rose to 23.5 percent after the global financial crisis. The working group, which included participants from the public and private sectors, developed and implemented a comprehensive strategy for reducing NPLs, which contributed to a fall in the NPL ratio to a historic low of 3.7 percent in December 2020.

In response to sharp systemic increases in NPL volumes, some countries have established public asset management companies (AMCs) or a systemwide “bad bank” to manage problem loans removed from bank balance sheets. Such a step can help to restore public confidence in the banking sector and prevent unnecessary fire sales. For example, in response to earlier crises, public AMCs were created in Malaysia and Spain in conjunction with publicly funded bank recapitalization schemes to overcome capital space constraints that otherwise would have hindered efforts to recognize the full extent of banks’ exposure to problem loans. The case for and effectiveness of public AMCs depend on a country’s circumstances and on the soundness of the overall design. This is an area in which emerging economies have in practice often experienced challenges.

Dealing with problem banks
When banks are unable to absorb the additional financial stress from the pandemic and develop a viable recovery plan, authorities must be able to deploy a robust set of early intervention measures to turn around ailing banks and resolve failing ones. Measures for dealing with failing banks should include a legal regime that sets bank failures apart from the general insolvency framework and gives authorities more policy options and greater powers to allocate losses to shareholders and uninsured liability holders, thereby protecting depositors while shielding taxpayers against financial sector losses.

Authorities responsible for handling troubled banks should always prioritize solutions led and funded by the private sector, building to the extent possible on the financial buffers of troubled financial entities. The use of public money to resolve a crisis should be a last resort, deployed after private sector solutions have been fully exhausted and only to remedy an acute and demonstrable threat to financial stability.

Policy area 2: Improving the legal insolvency framework
Many households and businesses are struggling with unsustainable debts as a result of the pandemic. Insolvency proceedings can be an effective mechanism to help reduce excessive levels of private debt. However, a sudden increase in loan defaults and bankruptcies resulting from the crisis (figure O.7) poses a significant challenge for the capacity of insolvency frameworks to resolve bankruptcies in a timely manner, even in advanced economies with strong institutions. This challenge stems, in part, from the complexity of court-led insolvency processes. According to World Bank data, resolution of a corporate bankruptcy case in the average country takes more than two years. Complex liquidations can take even longer, even in well-functioning judicial systems.

For countries with weak insolvency frameworks, retaining the status quo creates the risk that more drastic and costlier action will be needed if NPLs and insolvency filings increase. The absence of effective legal mechanisms to declare bankruptcy or resolve creditor-debtor disputes invites political interference in the credit market in the form of debt relief mandated by the government because such
action becomes the only alternative for resolving unsustainable debts. Indeed, emerging economies have made extensive use of politicized debt forgiveness programs. In the past, such programs have often damaged credit discipline and the ability of creditworthy borrowers to obtain loans in the long run. Even in economies that have effective insolvency laws, debt resolution can be inhibited by a slow, overburdened judicial system with insufficient resources to manage the legal and procedural complexity of the issues.

Improving the institutional capacity to manage insolvency is critical for equitable economic recovery for several reasons. First, when households and businesses are saddled with unsustainable debts, consumption, job creation, and productive investment are suppressed. Second, the longer the time needed to resolve a bankruptcy case, the larger are the losses to creditors. Third, higher creditor losses reduce the availability of credit in the economy and raise its cost. Finally, the longer the bankruptcy process, the more time overindebted “zombie” firms have to absorb resources that could support equitable economic recovery if they were redeployed to more productive firms.

In the aftermath of the COVID-19 crisis, the availability and efficiency of bankruptcy systems will determine how quickly unsustainable debt burdens can be reduced and, consequently, how quickly recovery can be achieved. Studies reveal that improvements in insolvency frameworks are associated with greater access to credit, faster creditor recovery, stronger job preservation, higher productivity, and lower failure rates for small businesses. Cost-reducing reforms can also create the right conditions for nonviable firms to file for liquidation, thereby freeing up resources that could be redirected toward more productive firms with better growth prospects.

The following reforms can help to ease COVID-19 debt distress and facilitate an equitable economic recovery. These reforms can be taken up by economies at varying stages of development, with varying degrees of sophistication in their existing insolvency laws, and at varying levels of institutional capacity, and have been shown to be effective by evidence from numerous countries.
Strengthening formal insolvency mechanisms
A strong formal insolvency law regime defines the rights and behaviors needed for orderly in-court and out-of-court workouts. A well-designed system includes incentives to motivate creditors and debtors to cooperate in the resolution process. Other tenets of a strong system are predictable creditor seniority rules that define the order in which debts are repaid; timely resolution, which creates a positive feedback loop motivating all actors to engage in out-of-court workouts; and adequate expertise in the complexities of bankruptcy law. Finally, early warning tools for the detection of business distress hold great promise to assist in the early identification of debtors in financial difficulty before this difficulty escalates to the point of insolvency.

Facilitating alternative dispute resolution systems
Alternative dispute resolution (ADR) frameworks can provide quicker and cheaper resolution of disputes than the formal court system, while retaining some of the rigor that courts provide. In an ADR process, the debtor and creditor engage directly. The process can be mediated by a third party; resolutions are contractually binding; and participants can maintain confidentiality. Variations of ADR processes include degrees of court involvement. Significant creditor buy-in and cohesion are needed in the ADR process because creditors unwilling to make concessions can bring the process to a halt. Active communications by regulators with the private sector, or legal mechanisms to prevent minority creditors from obstructing progress on a restructuring deal, are two methods that can help address the challenges associated with creditor cohesion.

Establishing accessible in-court and out-of-court procedures for small businesses
Small and medium-size businesses are less well capitalized than large businesses and frequently lack the resources and expertise to effectively understand and use complex, costly insolvency systems. Exacerbating these structural problems, the pandemic has hit small businesses harder than large businesses. Because of these factors, dedicated reforms are needed to design insolvency systems that cater to small and medium-size businesses. Such reforms include increasing the efficiency of debt restructuring for viable firms by simplifying legal processes, allowing debtors to maintain control of their businesses when possible, making fresh financing available, and using out-of-court proceedings to keep costs down. With these reforms, policy makers can help facilitate the survival of viable but illiquid firms and the swift exit of nonviable firms.

Promoting debt forgiveness and long-term reputational protection for former debtors
Job losses, reduced operations, and declining sales stemming from the COVID-19 pandemic have pushed many historically creditworthy individuals and entrepreneurs into delinquency. For small businesses, which are often financed at least in part by debt personally guaranteed by the entrepreneur, business failures can have severe adverse consequences. Because many of these borrowers have been devastated through no fault of their own, courts should try to quickly resolve no-income, no-asset cases, and the law should provide a mechanism for discharge and a fresh start for natural person entrepreneurs. High costs (such as court filing fees) and barriers to access (such as overly burdensome or confusing procedures) should be reduced or eliminated for personal bankruptcy, in particular for no-income, no-asset cases.

Policy area 3: Ensuring continued access to finance
Many households and small businesses are at risk of losing access to formal finance because of multiple factors stemming from the pandemic. Although most lenders have not seen massive pandemic-related
liquidity challenges, they anticipate a rise in NPLs, and their ability to extend new loans is constrained by the ongoing economic disruption and the transparency issues discussed earlier. In these circumstances, lenders tend to issue less new credit, and the new credit they do issue goes to better-off borrowers. A review of quarterly central bank surveys on credit conditions in both advanced and emerging economies finds that the majority of economies for which surveys were available experienced several quarters of tightening credit standards after the onset of the crisis (see figure O.8). In periods of tighter credit, the most vulnerable borrowers, including small businesses and low-income households that lack physical collateral or a sufficiently long credit history, tend to be the first cut off from credit.

It is difficult to estimate how long it will take countries to fully recover from the pandemic and its economic repercussions. Because of uncertainty about the economic recovery and the financial health of prospective borrowers, financial institutions find it challenging to assess risk—a prerequisite for credit underwriting. Debt moratoria and freezes on credit reporting, while important for addressing the immediate impacts of the shock, have made it harder for banks to distinguish borrowers experiencing temporary liquidity problems from those that are truly insolvent. As for low-income households and small businesses, their credit risk is difficult to assess even in normal times because they usually lack a credit history and audited financial statements. The widespread disruption of business activity

Figure O.8 Quarterly trends in credit conditions, by country income group, 2018–21

Source: WDR 2022 team calculations, based on data from survey reports by the central banks of 38 countries published or accessed as of December 15, 2021: Albania, Argentina, Austria, Belgium, Canada, Chile, Cyprus, Czech Republic, Estonia, France, Germany, Ghana, Greece, Hungary, India, Indonesia, Ireland, Italy, Japan, Latvia, Lithuania, Mexico, the Netherlands, North Macedonia, the Philippines, Poland, Portugal, Romania, the Russian Federation, Serbia, Spain, Thailand, Turkey, Uganda, Ukraine, the United Kingdom, the United States, and Zambia.

Note: The figure shows the net percentage of countries in which banks reported a change in overall credit conditions in quarterly central bank loan officer or credit condition surveys. The net percentage is the difference between the share of countries that report an overall easing in credit conditions and the share of countries that report an overall tightening of credit conditions relative to the previous quarter. A negative net percentage value indicates an overall tightening of credit conditions in the sample of countries covered. For Chile, Japan, Mexico, Poland, Russia, the United States, and Zambia, the overall credit conditions are estimated from an index of reported credit conditions in business and consumer segments.
and livelihoods has made assessment even more difficult. Banks and nonbank lenders therefore react by tightening credit and reallocating lending—where possible—to observably lower-risk borrowers. Lending innovations that incorporate new approaches for risk measurement and product design can counter this tendency. The accelerated digital adoption that occurred during the pandemic, coupled with the ongoing digital transformation of financial services and financial infrastructure (in a context of consumer and sector protection) could enable those innovations and help lenders better navigate COVID-19–related uncertainty to continue issuing credit.

**Mitigating risk by improving visibility and recourse**

The pandemic has made it more difficult to assess the credit risk of potential borrowers and limited lenders’ recourse when a borrower defaults. New data and technologies can be used to update existing risk models and increase visibility into a borrower's ability to repay. For example, Konfío—a digital MSME lender that leverages electronic invoices and other alternative data to supplement traditional credit information—adapted its credit algorithm in the early months of the pandemic to integrate granular data on the impacts of COVID-19 on small firms in Mexico. It then doubled its monthly loan disbursements during the pandemic. Other strategies to enhance visibility include temporarily reducing loan tenors and leveraging digital channels to gather high-frequency current transactional data. The use of digital channels can also lower delivery costs to reach small businesses and households more effectively.

Adapting loan product design and product selection can improve recourse in the event the borrower does not repay. Products that allow borrowers to pledge movable assets as collateral or that offer lenders less traditional forms of recourse, such as liens on future cash flows, can help offset the impacts of the pandemic on traditional collateral. Working capital financing that occurs within a supply chain or is embedded in the workflow of a commercial transaction links credit to an existing commercial relationship, as well as to an underlying economic activity and its associated data. Forms of embedded finance are expanding into payments, lending, insurance, and other product areas in various contexts, including e-commerce, logistics, order and inventory management, and other digital platforms. These and other forms of contextual lending provide both better visibility into the financial prospects of the borrower and additional recourse—for example, through automatic repayments from the borrower’s revenue through the platform.

**Supporting new lending by insuring credit risk**

Insuring against loss can help to restore credit growth when sufficient visibility and recourse cannot be achieved using the innovations just described. Credit guarantees give lenders recourse to the guarantor in case of default by the borrower. These instruments may be offered by governments, development banks, or donors to promote lending to priority segments where there are market failures in financing such as small businesses. Guarantees have been a component of pandemic responses in advanced countries and several emerging economies, and partial guarantee schemes may continue to play an important role in the recovery. For example, in Burkina Faso the World Bank helped the government set up a credit guarantee scheme focused on restructured and working capital loans for small and medium enterprises struggling from the COVID-19 crisis, but with potential for long-term profitability. Such programs must be carefully designed to be sustainable. As economic conditions improve, guarantors and their partner lenders can progressively narrow eligibility to the sectors or customer segments that continue to be most in need, and guarantee programs can be leveraged to reduce the risk associated with longer-term investments to support priorities such as job creation and financial flows to low-carbon activities.
Adopting policies to facilitate access and manage risks
Financial innovation has the potential to support responsible delivery of financial services, but unsupervised financial innovation can pose risks for both consumers and financial stability and integrity. Governments and regulators must modernize their policy frameworks to balance the sometimes conflicting imperatives of encouraging responsible innovation while also protecting customers and the financial sector’s stability and integrity. Updated regulatory and supervisory approaches should seek to recognize and enable entry into the market of new providers, introduction of new products, and innovations in the use of data and analytics; enhance consumer protection policies and rules around what finance providers can and cannot offer; and facilitate collaboration between regulators and the government authorities overseeing different aspects of digital and embedded finance, as well as competition and market conduct, to prevent regulatory gaps between agencies with overlapping authority. Policies should support modernization of financial infrastructure to facilitate operational resilience and access, including both “hard” infrastructure related to telecommunications networks, payment networks, data centers, credit bureaus, and collateral registries, and “soft” infrastructure around the policies and procedures that dictate standards, access, and rules of engagement. These government policy responses to support digital transformation can help foster a more robust, innovative, and inclusive financial sector.

Policy area 4: Managing higher levels of sovereign debt
The pandemic has led to a dramatic increase in sovereign debt. As shown in figure O.9, the average total debt burdens among low- and middle-income countries increased by roughly 9 percentage points of GDP during the first year of the pandemic, 2019–20, compared with an average increase of 1.9 percentage points over the previous decade. Although interest payments in high-income economies have been trending lower in recent years and account, on average, for a little over 1 percentage point of GDP, they have been climbing steadily in low- and middle-income economies. Debt distress—that is, when a country is not able to fulfill its financial obligations—poses significant social costs. One study finds that every year that a country remains in default reduces GDP growth by 1.0–1.5 percentage points. During the pandemic, governments accumulated debt to finance current expenditures, but it came at the cost of limiting their ability to spend in the future, including on public goods such as education and public health. Underinvestment in these services can worsen inequality and human development outcomes. High debt and lack of spending flexibility also limit the capacity of governments to cope with future shocks. Moreover, because governments are often the lender of last resort, private sector debts can quickly become public debt if financial and economic stability is threatened in an economic crisis and public assistance is required. Protecting the ability of the government to invest in public goods, to act in a countercyclical manner, and to enable the central bank to deliver on its unique role as the lender of last resort is a central goal of managing sovereign debt.

Managing sovereign debt to free up resources for the recovery
Countries at high risk of debt distress can pursue several policy options to make payment obligations more manageable. The feasibility of these options is shaped by the specifics of the case, including the extent of a country’s access to private capital markets, the composition of the debt and creditors, and the debtor country’s ability and willingness to negotiate and undertake necessary reforms. The options include modifications of the structure of liabilities and schedule of future payments through negotiations with creditors and the effective use of refinancing tools (debt reprofiling). Proactive debt management can reduce the risk of default and free up the fiscal resources needed to support an equitable economic recovery.

A reprofiling operation could be helpful when a country has multiple loans to be repaid in the same year. The country could issue new debt with a longer or a more even maturity profile. Debt reprofiling
operations can also help address currency risk, which often adds to debt sustainability concerns. In this case, instead of changing the maturity of the existing debt, the debt reprofiling operation retires the existing debt denominated in one (more expensive or volatile) currency by issuing new debt in another (less expensive or more stable) currency.

Countries facing elevated default risk also have the option of initiating preemptive negotiations with their creditors to reach debt restructuring. This option particularly benefits from transparency around the terms and ownership of the debt. Minimizing the chances of holdouts is important to ensure a speedy resolution. Some evidence shows that a preemptive restructuring is resolved faster than a post-default restructuring, leads to a shorter exclusion of the country from global capital markets, and is associated with a smaller loss in output.44

Resolving debt distress
Once a government is in debt distress, the options to treat the problem are more limited and the urgency is greater. A primary tool at this stage is debt restructuring coupled with a medium-term fiscal and economic reform plan. Use of this tool requires prompt recognition of the extent of the problem, coordination with and among creditors, and an understanding by all parties that restructuring is the first step toward debt sustainability. International financial institutions such as the World Bank and the International Monetary Fund (IMF) play an important role in the debt restructuring process for emerging economies by providing the debt sustainability analyses needed to fully understand the problem and often offering the financing to make the deal viable.

A swift, deep restructuring agreement allows a faster and more sustained recovery.45 The historical track record, however, reveals that resolution of sovereign debt distress is often delayed for years. Even when a country enters negotiations with its creditors, multiple rounds of debt restructuring are often needed for it to emerge from debt distress (see figure O.10). The Democratic Republic of Congo, Jamaica, and Nigeria each had to negotiate seven debt restructuring deals before resolving their debt situations.
Figure O.10  Sovereign debt restructuring and time spent in default, selected countries, 1975–2000

Source: WDR 2022 team, based on Cruces and Trebesch (2013); Farah-Yacoub, Graf von Luckner, and Reinhart (2021); Meyer, Reinhart, and Trebesch (2019); Reinhart and Rogoff (2009).

Note: The figure shows a timeline of sovereign defaults and debt restructuring from 1975 to 2000. The figure excludes countries covered by the International Development Association (IDA) and the Heavily Indebted Poor Countries (HIPC) Initiative.
Restructuring sovereign debt may have become more complex. The creditor community now has a higher share of nontraditional lenders (such as investment companies, bondholders, and official creditors who are not members of the Paris Club). Domestic sources of financing have also increased. Potential off-balance sheet and often unrecorded public sector borrowing from state-owned enterprises and special-purpose vehicles has also trended higher. Collectively, these developments reduce transparency and may complicate the coordination between creditors.

In emerging economies, reducing sovereign debt (particularly external debt) has often required debt restructuring, but governments have also pursued fiscal consolidation (lower expenditures, higher taxes, or both) to improve government revenue, fiscal balances, and debt servicing capacity.

Other ways to reduce domestic currency–denominated debt have included liquidation through inflation or financial repression. Although these approaches have often delivered debt reduction, they frequently come with extremely high social and economic costs that can aggravate poverty and inequality. Inflation is a regressive tax, which would compound the already highly regressive effects of the COVID-19 crisis.

Looking ahead—improving transparency and reducing coordination problems
The surge in sovereign debt during the COVID-19 crisis highlights the need for strategies that can facilitate effective debt management, debt negotiation, and access to capital markets over the longer term. Three broad initiatives stand out: greater debt transparency, contractual innovation, and tax policy and administration reforms.

Effective, forward-looking debt management requires comprehensive disclosure of claims against the government and the full terms of the contracts that govern this debt. Recent debt events have highlighted the problem of “hidden” or undisclosed debt and the possibility of legal disputes about the lack of authority of government and quasi-government entities to enter into debt contracts. Transparency on amounts owed and the contracts themselves does not guarantee a speedy restructuring, but it certainly sets the stage for a more rapid recognition of debt sustainability problems, thereby improving surveillance, and a more favorable entry point for negotiations among the debtors and creditors and the creditors themselves.

Contractual innovations, for their part, can help overcome coordination problems and speed up the resolution of sovereign debt restructuring. These innovations include collective action clauses (CACs), which could lead to faster resolution; state-contingent debt contracts that insure the borrower against disaster risk; and legal reforms that address problematic enforcement practices against states. These innovations offer a positive way forward for new debt contracts. However, they have a more limited role in dealing with debts that require restructuring because state-contingent contracts account for a small share of the outstanding debt contracts of emerging markets. Contracts that include enhanced CACs account for only about half of outstanding contracts.

A well-developed tax policy and administration are essential for debt sustainability. Higher tax revenue arises principally from long-term investments in tax capacity and from structural changes in countries’ economies. Taxing wealth through property, income, and capital gains taxes is an underused revenue generation strategy in most emerging economies that would also mitigate the adverse impacts of the COVID-19 crisis on poverty and inequality. Revenue mobilization strategies should also strengthen incentives for businesses to formalize.

As governments pursue changes to manage their debt and promote pro-recovery practices, it is important that they recognize that the COVID-19 pandemic is a crisis within a crisis because of the ongoing impacts of climate change on countries and their economies. Governments’ plans to rebuild should place the need for green investments front and center. One promising avenue is issuing sovereign
green and social bonds. Pioneering governments are beginning to pave the way for similar debt issuances by the private sector. In 2017, Nigeria became the first African country to issue a sovereign green bond, which was followed by the first green corporate issuance from Access Bank. In 2019, Chile became the first green sovereign bond issuer in Latin America, followed by Banco de Chile, which issued a green bond to raise funds for renewable energy projects. These types of green investments will need to grow as a share of the recovering economy.

Conclusion

The COVID-19 pandemic and the unprecedented worldwide public health crisis it unleashed led to millions of deaths, job losses, business failures, and school closings. The ensuing economic and social disruption both exposed and exacerbated existing economic fragilities, especially in emerging economies, where poverty rates soared and inequality worsened.

Addressing the interrelated economic risks produced by the crisis is a prerequisite for a sustained and equitable recovery. This will require prompt recognition of balance sheet problems, as well as active management of the economic and financial risks. In an ideal situation, governments would implement relevant policies to address each of the risks highlighted by the crisis: financial instability; overindebtedness among households and businesses; reduced access to credit; and rising sovereign debt. However, few if any governments have the resources and political leeway to tackle all of these challenges at once. Countries will have to prioritize the most important policy actions needed. For many low-income countries, tackling unsustainable sovereign debt will be the first priority. Middle-income countries whose financial sectors are more exposed to corporate and household debt may, in contrast, need to focus on policies supporting financial stability.

Although this Report concentrates on the key domestic financial and economic risks produced by the pandemic, a country’s recovery prospects will also be shaped by events in the global economy. One example is fluctuations in the price of primary commodities, which are an important source of revenue for many emerging economies. Another example is exchange rate and interest rate risks, which could emerge as economic activity in advanced economies recovers and stimulus programs are withdrawn, resulting in central banks tightening global liquidity and raising interest rates. These global developments expose households, firms, and governments in emerging economies to financial risks. A carefully chosen policy mix must therefore take into account both domestic and global threats to an equitable recovery.

At the same time, the necessity to address the risks created by the pandemic offers an immense opportunity to accelerate the shift toward a more efficient and sustainable world economy. Climate change is a major source of neglected risk in the world economy. Failure to manage these risks will result in the continued mispricing of assets, capital misallocation, and a vicious cycle in which devastating climate disasters are compounded by spikes in financial instability. The financial sector can help activate a virtuous cycle by recognizing and pricing climate risks, so that capital flows toward more sustainable firms and industries. In the aftermath of the COVID-19 pandemic, governments have an opportunity to support the financial sector’s ability to perform this role by, for example, mandating risk disclosures and phasing out any preferential tax, auditing, and regulatory policies for environmentally unsustainable industries.

The COVID-19 pandemic is possibly the largest shock to the global economy in over a century. As fiscal, monetary, and financial stimulus programs are withdrawn, new policy challenges will emerge at both the domestic and global levels. Early diagnosis of the economic effects of the crisis and decisive policy action to remedy these fault lines are needed to sustain an equitable recovery. There is no room for policy complacency.
Notes

1. Global real GDP growth in 2020 is estimated at –3.1 percent in the International Monetary Fund’s World Economic Outlook (IMF 2021c) and –3.5 percent in the World Bank’s Global Economic Prospects (World Bank 2021a).
2. For more details, see Mahler et al. (2021).
6. This definition builds on the broader definition of equitable development in World Bank (2005), but it is adapted to the context of the COVID-19 pandemic.
7. Fratto et al. (2021); IMF (2021b).
9. The difference in the rate of work stoppage between low- and high-educated workers was found to be statistically significant in 23 percent of the countries. For more details, see Kugler et al. (2021).
12. Adams-Prassl et al. 2020; Chetty et al. (2020); Crossley, Fisher, and Low (2021)
15. Because of a lack of comprehensive data on many countries, the estimates at the global level assume there are no changes in inequality. Lakner et al. (2020) and Yonzan et al. (2020) estimate the impact of COVID-19 on global poverty using a range of assumptions on inequality within countries.
17. Medina and Schneider (2019).
24. Ferreira et al. (2021) and Mahler et al. (2021), building on these poverty estimates, estimate a measure of additional poverty years induced by COVID-19. They assume, conservatively, that poverty stemming from the pandemic lasts for one year and show that additional poverty years have a strong downward-sloping relationship with GDP per capita.
25. This observation assumes that the definition of a non-performing loan has remained constant throughout the pandemic. NPLs, as defined by the Basel Committee on Banking Supervision (BCBS 2017), are those loans with lower credit quality in terms of delinquency status (unpaid for a certain period of time) or unlikeliness of repayment.
27. BCBS (2017).
33. Fonseca and Van Doornik (2020).
34. Lim and Hahn (2003); Neira (2017).
40. Kose et al. (2021).
42. Baldacci, de Mello, and Inchauste (2002); Furceri and Zdienicka (2012); Ravallion and Chen (2009).
44. Asonuma and Trebesch (2016).
45. Reinhart and Trebesch (2016).
46. The Paris Club, a standing committee of official creditor countries formed in 1956, has been instrumental in the majority of sovereign debt restructurings since its creation.
47. See Reinhart, Reinhart, and Rogoff (2015).
48. A collective action clause (CAC) is an article in bond contracts establishing rules in case of restructuring. In particular, if a majority of bondholders agrees to debt restructuring, that agreement becomes legally binding for all bondholders, including those who voted against the restructuring.
49. IMF (2020).
54. Bolton et al. (2020); Carney (2015); Fender et al. (2020).
References


Contents of the
World Development Report 2022:
Finance for an Equitable Recovery

Foreword
Preface
Acknowledgments
Abbreviations

Overview

Introduction

Chapter 1: Emerging risks to the recovery
Spotlight 1.1: Financial inclusion and financial resilience

Chapter 2: Resolving bank asset distress
Spotlight 2.1: Strengthening the regulation and supervision of microfinance institutions

Chapter 3: Restructuring firm and household debt
Spotlight 3.1: Supporting microfinance to sustain small businesses

Chapter 4: Lending during the recovery and beyond
Spotlight 4.1: Public credit guarantee schemes

Chapter 5: Managing sovereign debt
Spotlight 5.1: Greening capital markets: Sovereign sustainable bonds

Chapter 6: Policy priorities for the recovery
ECO-AUDIT

Environmental Benefits Statement

The World Bank Group is committed to reducing its environmental footprint. In support of this commitment, we leverage electronic publishing options and print-on-demand technology, which is located in regional hubs worldwide. Together, these initiatives enable print runs to be lowered and shipping distances decreased, resulting in reduced paper consumption, chemical use, greenhouse gas emissions, and waste.

We follow the recommended standards for paper use set by the Green Press Initiative. The majority of our books are printed on Forest Stewardship Council (FSC)–certified paper, with nearly all containing 50–100 percent recycled content. The recycled fiber in our book paper is either unbleached or bleached using totally chlorine-free (TCF), processed chlorine–free (PCF), or enhanced elemental chlorine-free (EECF) processes.

More information about the Bank’s environmental philosophy can be found at http://www.worldbank.org/corporateresponsibility.
The COVID-19 pandemic triggered the largest global economic crisis in more than a century. In 2020, economic activity contracted in 90 percent of countries, the world economy shrank by about 3 percent, and global poverty increased for the first time in a generation. Governments responded rapidly with fiscal, monetary, and financial policies that alleviated the worst immediate economic impacts of the crisis. Yet the world must still contend with the significant longer-term financial and economic risks caused by, or exacerbated by, the pandemic and the government responses needed to mitigate its effects.

World Development Report 2022: Finance for an Equitable Recovery examines the central role of finance in the economic recovery from COVID-19. Based on an in-depth look at the consequences of the crisis most likely to affect low- and middle-income economies, it advocates a set of policies and measures to mitigate the interconnected economic risks stemming from the pandemic—risks that may become more acute as stimulus measures are withdrawn at both the domestic and global levels. Those policies include the efficient and transparent management of nonperforming loans to mitigate threats to financial stability, insolvency reforms to allow for the orderly reduction of unsustainable debts, innovations in risk management and lending models to ensure continued access to credit for households and businesses, and improvements in sovereign debt management to preserve the ability of governments to support an equitable recovery.