



Introduction

The COVID-19 pandemic sent shock waves through the world economy and triggered the largest global economic crisis seen in more than a century. The economic impacts of the pandemic were especially severe in emerging economies. Global poverty increased for the first time in a generation, and disproportionate income losses among disadvantaged populations led to a dramatic rise in inequality within and across countries. Governments responded at the onset of the pandemic with large economic programs that were successful at mitigating the worst human costs in the short run. However, this emergency response has also exacerbated a number of preexisting economic fragilities that may pose an obstacle to an equitable recovery.

Policy Priorities

The economic response to the pandemic will need to address the following areas in which economic fragilities have been highlighted and worsened by the pandemic:

- **Addressing increased inequality within and between countries** resulting from the highly regressive impacts of the crisis.
- **Managing and reducing the interconnected financial risks created by the pandemic** to prevent spillover effects that can threaten the return to economic growth.
- **Ensuring continued access to finance** to help households and businesses weather economic uncertainty and invest in opportunities.
- **Preserving and restoring market transparency** to enable a prompt recognition of economic risks.

Introduction

The COVID-19 (coronavirus) pandemic triggered a global public health crisis that overwhelmed the health systems of many countries with over 200 million cases and close to 5 million deaths worldwide. The outbreak of the pandemic quickly turned into the largest economic crisis seen in more than a century, as countries enacted unprecedented emergency measures, such as travel bans, mobility restrictions, closure of nonessential businesses, limitations on public gatherings, and mandatory home-based work, that severely affected economic activity. In response, household incomes, business revenue, and employment declined dramatically. Small businesses, low-income households, and vulnerable populations were disproportionately affected, and global poverty increased for the first time in a generation.

The economic crisis stemming from the COVID-19 pandemic stands out in its global scale, scope, and severity. In 2020, economic output contracted in 90 percent of countries, while the world economy contracted by approximately 3 percent.¹ The share of countries experiencing negative output growth as a result of the pandemic surpassed that of both world wars and the Great Depression.

The crisis is also distinct in its highly unusual indiscriminate impacts across the globe. Economic crises in the postwar period have typically hit advanced economies and emerging markets unevenly. For example, despite its designation as the global financial crisis, the 2007–09 financial crisis primarily affected advanced economies, whereas emerging markets, whose economies were supported by robust commodity prices and rapid growth in China, were far less affected. As a result, at the height of the global financial crisis in 2009, output contracted in only 63 percent of countries, and the world economy contracted by 2.2 percent, much less than in the first year of the pandemic.²

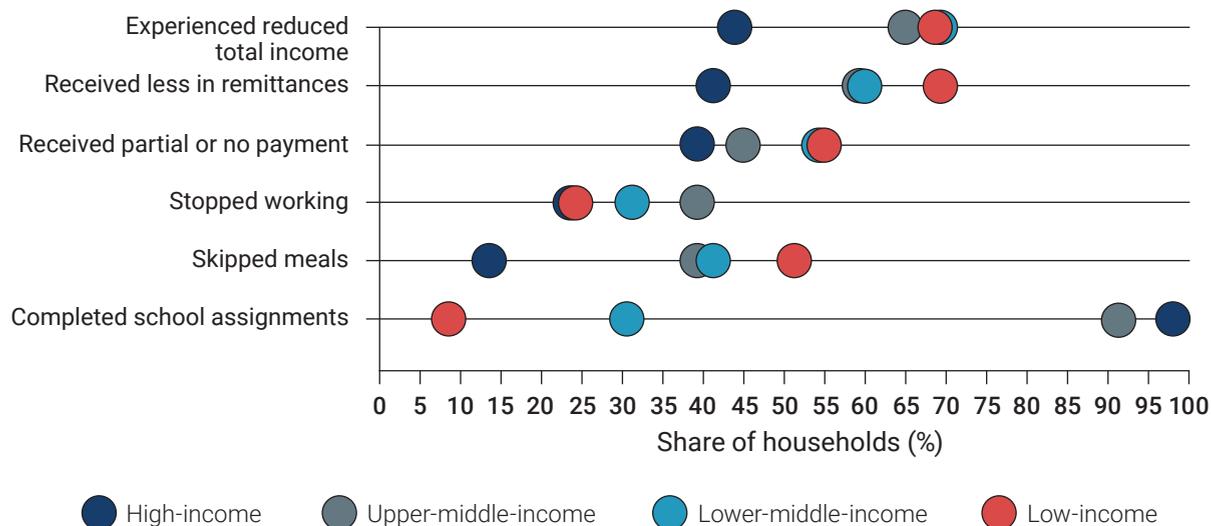
The COVID-19 economic crisis is also unique in its nature and origins. Unlike most crisis episodes in recent decades, the COVID-19 economic crisis did not originate as a financial crisis or as a debt crisis in the public or private sector. Instead, it was the result of a truly exogenous event that generated both an aggregate demand and an aggregate supply shock. By contrast, the economic crises of the 1980s were sparked by government debt and financial crises in emerging markets, and the 2007–09 crisis originated from asset bubbles and financial distress in advanced economies. In most countries, the current crisis therefore does not fit the prototypical pattern in which a long economic expansion is followed by a recession during which borrowers who took out loans in boom times can no longer afford their debt payments. Instead, when the COVID-19 pandemic emerged, most countries had not been experiencing a robust economic expansion. It is not uncommon, however, for one form of crisis to morph into another. Although this economic crisis did not begin as a debt or financial crisis, the large increases in private and public debt incurred from the pandemic could very well turn it into one.³

This introduction explores the short- and medium-term implications of the COVID-19 crisis for emerging economies. It begins by documenting the dramatic immediate impacts of the crisis on households and businesses, which were most immediately affected by income losses arising from the pandemic. It then highlights the unequal economic impacts of the crisis within and between countries and the large government responses to the crisis, which made use of many unprecedented policy tools and was relatively successful at mitigating the worst effects of the crisis in the short run but may create longer-term economic risks that pose obstacles to an equitable recovery.

Impacts on households

Household incomes and employment were severely affected by the COVID-19 crisis and the public health measures adopted to contain the effects of the pandemic. Survey data covering 51 countries reveal that 57 percent of firms reduced employment during the first two quarters of the pandemic, directly affecting

Figure I.1 Impacts of the COVID-19 crisis on households, by country income group



Source: World Bank, COVID-19 Household Monitoring Dashboard, <https://www.worldbank.org/en/data/interactive/2020/11/11/covid-19-high-frequency-monitoring-dashboard>.

Note: The figure shows survey data summarizing the economic impact of the crisis on households. Data are taken from the first wave of surveys, administered between April and July 2020, to ensure comparability across countries.

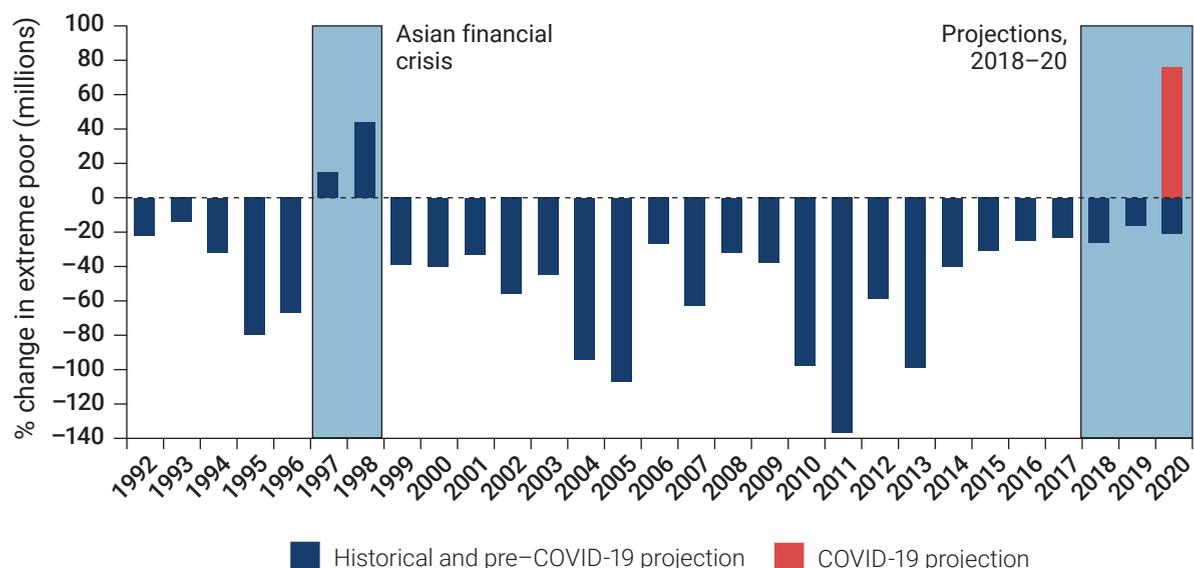
household income.⁴ Similarly, World Bank high-frequency phone surveys⁵ from a sample representative of 1.4 billion adults in 34 low- and middle-income countries found that, on average, more than a third of respondents stopped working because of the pandemic, and 64 percent of households experienced reductions in income.⁶ This employment-income effect was compounded by a steep decline in remittances in those countries. Over 60 percent of households reported receiving less in remittances since the onset of the pandemic (figure 1.1).⁷ The aggregate nature of the economic shock also made it more difficult for low-income households to rely on other risk-sharing mechanisms, such as informal credit and support from social networks.⁸

Rising global poverty

Meanwhile, global poverty increased for the first time in a generation. Figure I.2 shows the annual year-on-year change in the number of poor for the last three decades. In this period, poverty increased only twice: during the Asian financial crisis and the COVID-19 pandemic. The 2007–09 global financial crisis did not lead to an increase in global poverty because its effects were felt primarily in advanced economies, whereas most emerging economies—where the majority of the world’s poor live—remained relatively unaffected. Although the full consequences of the COVID-19 crisis on poverty are still highly uncertain, preliminary estimates suggest that COVID-19 will have a significantly greater negative impact than the Asian financial crisis.⁹

This increase in poverty is likely to persist as unequal access to vaccines and the possibility of future waves of the pandemic pose obstacles to the recovery. Figure I.3 shows the global trend in extreme poverty from 2015 to 2021. For the projected years 2020 and 2021, the bars show the change in the poverty rate if prior trends had continued, compared with the estimated poverty rates adjusted for the impact of the COVID-19 crisis. Whereas before the pandemic 635 million people were projected to live in extreme

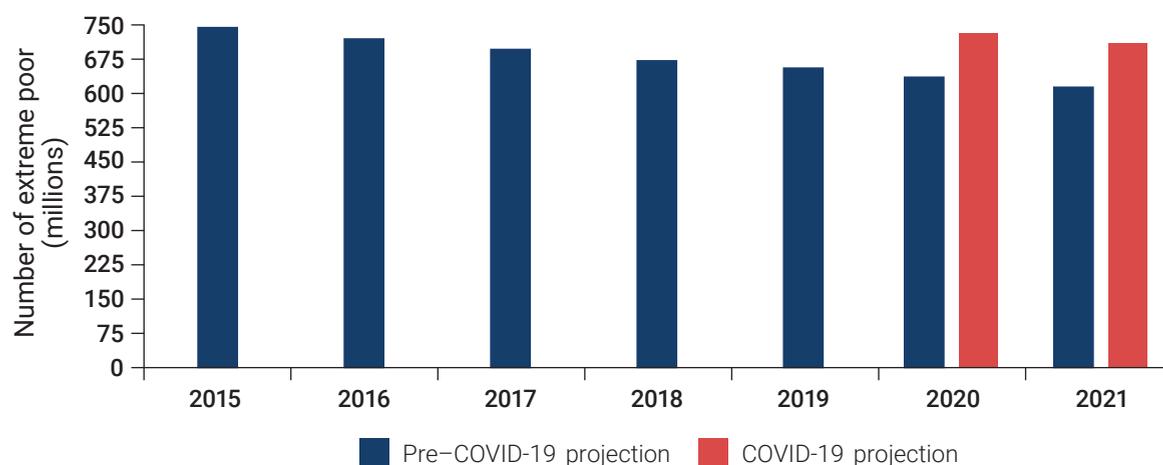
Figure I.2 Global annual change in extreme poor, 1992–2020



Sources: Lakner et al. 2020; Mahler et al. 2021; World Bank, Global Economic Prospects DataBank, <https://databank.worldbank.org/source/global-economic-prospects>; World Bank, PovcalNet (dashboard), <http://iresearch.worldbank.org/PovcalNet/>.

Note: The figure shows the global annual year-on-year change in the number of poor in millions, calculated using the international poverty line of \$1.90 per person per day. Two growth scenarios are considered: “pre-COVID-19” uses the January 2020 *Global Economic Prospects* growth rate forecasts (World Bank 2020a), predating the COVID-19 crisis; “COVID-19” uses the June 2021 *Global Economic Prospects* forecasts (World Bank 2021a).

Figure I.3 Global extreme poverty, 2015–21



Sources: World Bank, Global Economic Prospects DataBank, <https://databank.worldbank.org/source/global-economic-prospects>; World Bank, PovcalNet (dashboard), <http://iresearch.worldbank.org/PovcalNet/>.

Note: Figures are obtained following the approach developed in Lakner et al. (2020) and Mahler et al. (2021). Poverty is defined using the international poverty line of \$1.90 per person per day. The year 2017 is the latest with sufficient population coverage for a global poverty estimate. Subsequent years are projected. Two growth scenarios are considered: “pre-COVID-19” uses the January 2020 *Global Economic Prospects* growth rate forecasts (World Bank 2020a), predating the COVID-19 crisis; “COVID-19” uses the June 2021 *Global Economic Prospects* forecasts (World Bank 2021a).

poverty in 2020, after the onset of the pandemic the projected number of poor increased to 732 million. The COVID-19–induced poor, calculated as the difference in poverty trends with and without COVID-19, are thus estimated to be 97 million in 2020 and 2021. These numbers suggest that COVID-19 set back progress on poverty reduction at the global level by nearly half a decade, making the goal of eliminating extreme poverty by 2030 unattainable. If countries return to their historical average growth rates after 2021, about 7 percent of the global population will live below the international poverty line by 2030, or more than double the target level of 3 percent.¹⁰ Put differently, achieving the target would require all economies to grow at 8 percent per capita per year, which is equivalent to about five times the historical growth rates for Sub-Saharan Africa.

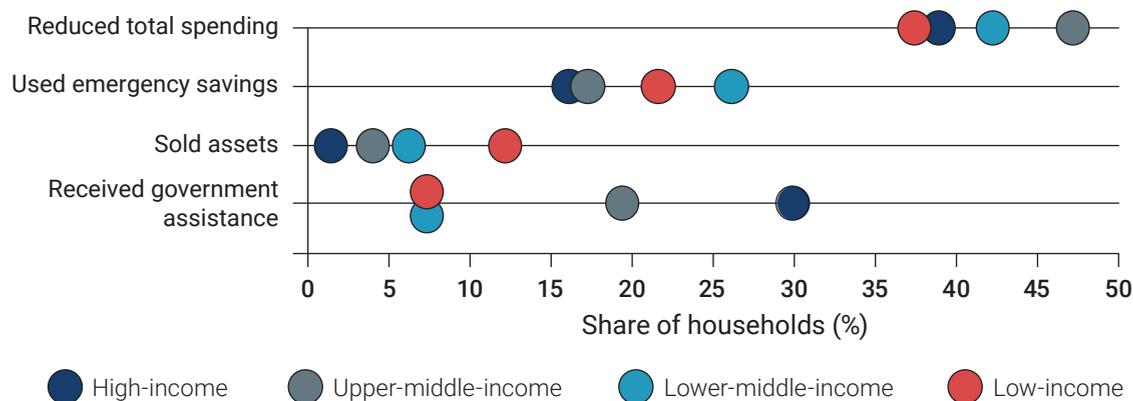
Greater inequality across and within countries

The impact of the crisis on households has been highly regressive across and within countries. Early evidence suggests that 2020 per capita gross domestic product (GDP) declined more in higher-income countries.¹¹ However, these data may not tell the full story.¹² Because many households in low- and middle-income countries work in the informal sector, the impact of the pandemic on them is harder to assess. It is then possible that the impact of the pandemic on those countries is being underestimated. Survey data indicate that the highest share of respondents who stopped working on account of the pandemic was recorded in middle-income countries.¹³ One in five of the pandemic-induced poor in 2021 are estimated to reside in low-income countries (which account for 9 percent of the world population), and over 90 percent of those considered newly poor as a result of the crisis reside in low- or lower-middle-income countries.¹⁴ Between 2019 and 2021, the average income of the bottom 40 percent is estimated to have fallen by 2.2 percent, compared with a 0.5 percent decline in the top 40 percent.¹⁵

Meanwhile, low-income countries experienced a high incidence of income losses and food insecurity, despite having less pronounced disruptions in employment than higher-income countries. Twenty-four percent of households in low-income countries reported work stoppages, compared with 32.3 percent in lower-middle-income countries and 38.7 percent in upper-middle-income countries (figure I.1). This finding stems, in part, from the higher share of the population engaged in agriculture in low-income countries, minimizing the employment effects of lockdown measures. Nonetheless, even among agricultural workers who continued working, many experienced declines in income due to lockdown measures and reduced demand for agricultural products in urban areas. In low- and middle-income countries alike, more than two in three households reported reductions in total income related to the pandemic. More than a third of households in low-income countries and almost half of households in upper-middle-income countries had to reduce their overall consumption. Low- and lower-middle-income countries reported a higher prevalence of food insecurity and of having to resort to coping mechanisms such as selling assets or depleting emergency savings (figure I.4). Such effects of the pandemic increase these countries' vulnerability to shocks that may arise during a protracted recovery and dampen the prospects for an equitable recovery.

The recovery so far has been similarly uneven across countries, with advanced economies faring overall much better than emerging economies.¹⁶ In low-income countries, which face risks to their growth outlook because of unequal access to vaccines and preexisting economic fragilities, GDP growth was forecast to be 2.9 percent in 2021—the second-lowest growth rate (after 2020) in the last 20 years—compared with 5.3 percent in high-income economies.¹⁷ Even if it is assumed that the impact of the pandemic is distributionally neutral, the top 20 percent of the global income distribution was expected to recover around half of its 2020 income losses in 2021, while the bottom 20 percent was expected to lose an additional 5 percent of its income.¹⁸

Figure I.4 Ways in which households coped with income losses from the COVID-19 crisis, by country income group



Source: World Bank, COVID-19 Household Monitoring Dashboard, <https://www.worldbank.org/en/data/interactive/2020/11/11/covid-19-high-frequency-monitoring-dashboard>.

Note: Data from the first wave of surveys, collected between April and July 2020, are used to ensure comparability across countries.

Beyond the immediate impact of the pandemic on incomes and employment, there are also channels through which the crisis is likely to aggravate inequality across countries in the longer term. One such channel is pandemic-related disruptions in access to education. Estimates based on data from 157 countries suggest that the COVID-19 pandemic could lead to a loss of between 0.3 and 0.9 years of schooling, adjusted for quality. Pandemic-related income shocks could force close to 7 million students to drop out of primary and secondary education. And students from the current cohort could face a loss in lifetime earnings equivalent to a 5 percent annual reduction in income.¹⁹ The pandemic has also disproportionately affected female labor force participation, which is another channel through which the crisis aggravates preexisting inequalities.²⁰

Within countries, the crisis has disproportionately affected disadvantaged groups. In 70 percent of countries, the incidence of temporary unemployment was higher²¹ for workers who completed only primary education.²² Income losses were similarly larger among youth, women, the self-employed, and casual workers with lower levels of education.²³ These patterns are consistent with those observed in advanced economies.²⁴ Although the impact of the pandemic on within-country inequality at the global level is not yet known, it seems likely it will increase. The regressive nature of impacts suggests that the impact of the crisis on global poverty is a lower-bound estimate. With a widespread increase in within-country inequality, the crisis would have an even bigger impact on global poverty.²⁵

The COVID-19 economic crisis has also been unique in exacerbating gender inequalities. Analysis of firm-level data from the World Bank’s Enterprise Surveys reveals that women were more likely than men to be laid off after the onset of the pandemic.²⁶ According to phone survey data collected during the first months of the pandemic, 42 percent of women stopped working, either temporarily or permanently, compared with 31 percent of men.²⁷ Women were disproportionately affected by income and employment losses because they were more likely to be employees or owners of firms in the sectors most affected by lockdown and social distancing measures—such as services, hospitality, and retail, where the demand shock was hitting hardest.²⁸ Indeed, women-owned businesses were, on average, more likely to be closed after the onset of the pandemic, especially microbusinesses and businesses in the hospitality industry. Female-led businesses were also less likely to have received public support.²⁹

In addition, women bore the brunt of the higher care needs associated with closures of day-care centers and schools.

Evidence from recent rounds of high-frequency surveys also reveals that the initial disparities in job losses were not reduced with the relaxation of mobility restrictions and other policy measures. Those who suffered larger initial losses—women, younger workers, urban workers, and persons with low levels of formal education—recovered more slowly than their counterparts and were not able to substantially reverse initial disparities in losses.³⁰ By September 2020, men had recovered 49 percent of their initial employment losses, compared with 30 percent of women. Workers in urban areas had recovered only a third of their initial losses, compared with 58 percent of rural workers. Although the employment recovery was slightly faster for younger workers and those without a college education, this was insufficient to significantly reduce the gaps in job losses relative to older and college-educated workers.³¹ Similarly, school closures have been associated with substantial learning losses, particularly for children from low socioeconomic status households. Even with schools reopening, it is not clear whether these children will be able to catch up, thereby exacerbating within-country disparities in the future.

Heightened fragilities on household balance sheets

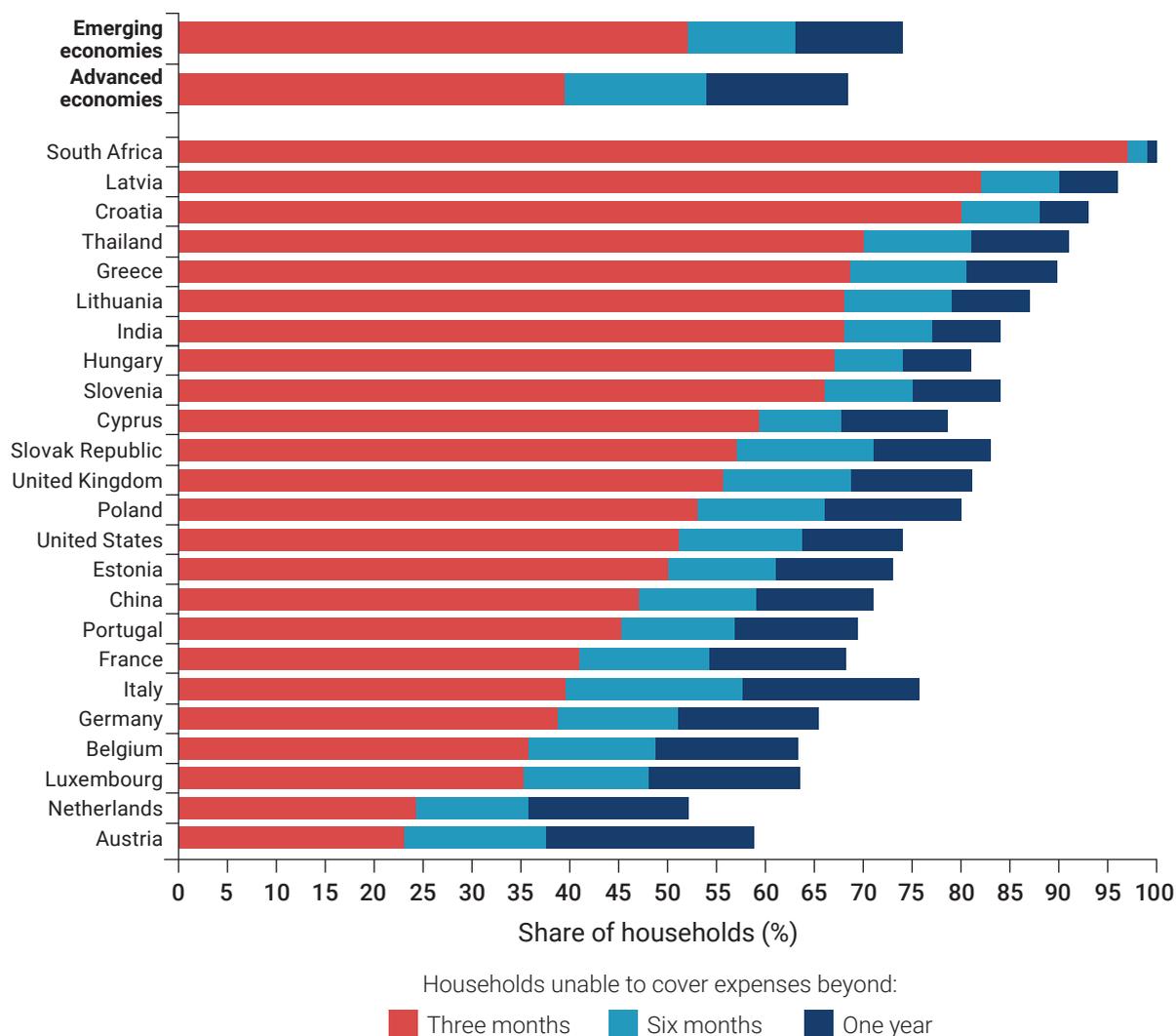
The impacts of income losses sustained during the pandemic were intensified by the fact that many households were already financially stretched at the beginning of the crisis. Although there was significant within-country and cross-country variation in how well households were positioned to cope with income losses, one pattern that is strikingly similar across advanced and emerging economies is that very few households have the resources to weather substantial income losses for more than a few months.³² This pattern underscores the immense value of emergency cash transfers for households facing large, prolonged income losses.

Intuitively, households can accommodate income shocks either by financing consumption with liquid financial assets, such as easily accessible savings, or by reducing expenditures to the bare minimum required for food, essential utilities, housing expenses, and debt repayment. Both coping mechanisms do not rely on external sources of funds such as the state or on credit markets, and they have little bearing on households' future ability to borrow. The definition used in this Report therefore considers a household to be fully “resilient” when, in the face of an income shock, it can sustain consumption in the short to medium term using its own liquid financial assets.

Newly available data on household consumption and asset holdings that are comparable across countries make it possible to quantify the resilience of households to income losses as the ratio of a household's total liquid wealth to its monthly consumption expenditure.³³ This measure has a simple interpretation: conditional on an economic shock resulting in a complete loss of income, it is the number of months that a household can maintain its level of consumption by relying solely on its liquid financial wealth. Figure 1.5 shows the share of households whose resilience to a total income loss falls below three months, six months, and one year for a sample of 24 emerging and advanced economies for which comparable data are available.³⁴ The figure reveals that the percentage of households not able to sustain basic consumption beyond three months is higher in emerging economies (50 percent) than in advanced economies (40 percent). However, the percentage of households that cannot self-sustain beyond one year is practically identical, reaching around 70 percent in both emerging and advanced economies.

The same stress test approach can be used to examine how effectively different crisis response policies counteract income losses and enhance household resilience. Figure 1.6, which shows the results of this exercise, first considers the effect of debt relief programs on household resilience. It reveals that if all household debt repayments³⁵ were paused by law, household resilience would improve only marginally

Figure I.5 Household resilience to income losses, selected emerging and advanced economies

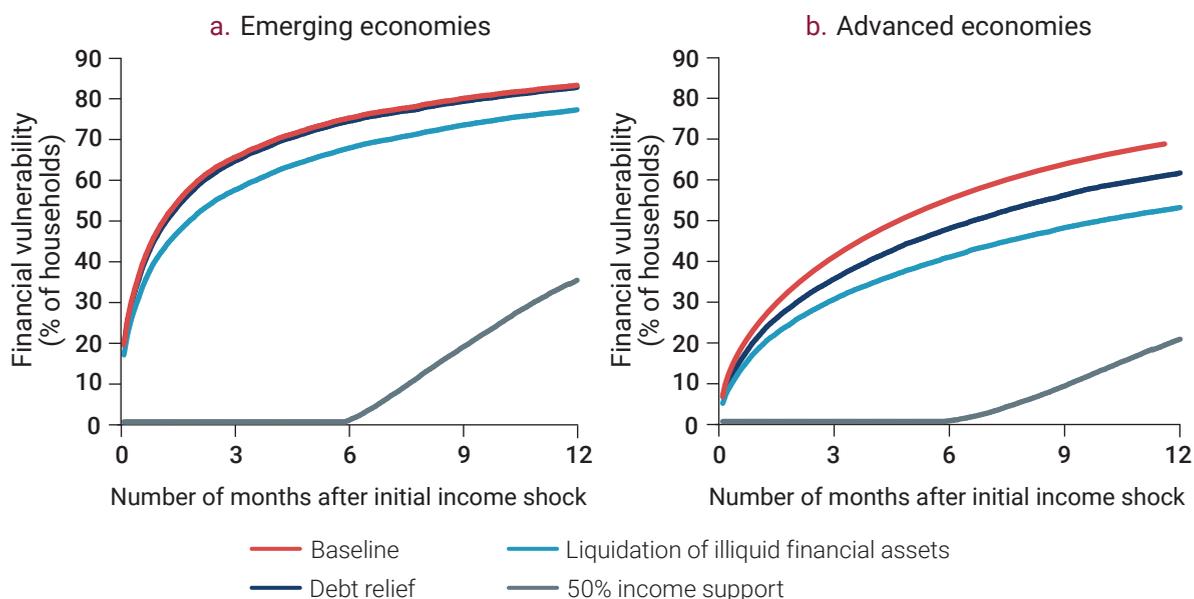


Source: Badarinza et al. 2021.

Note: The figure shows for each economy and economy income group the share of households not able to sustain their baseline consumption with liquid assets for more than three months, six months, and one year in the event of an income loss.

for advanced economies and would be unchanged in emerging economies. Debt relief as a policy tool is largely ineffective because in emerging economies it is mostly the wealthy—and therefore inherently more resilient—households that can access formal credit. This finding also suggests that debt relief may have adverse distributional effects because it benefits primarily wealthier households, while the cost of the policy, through taxation, is borne across the population. Similarly, figure I.6 shows that if households were able to liquidate their *illiquid* financial assets, such as retirement accounts, it would have almost no effect in emerging economies and only short-lived benefits in advanced ones. Roughly 40 percent of advanced economy households would continue to be vulnerable six months after the initial shock. Not surprisingly, a policy instrument that dramatically reduces vulnerability in both emerging and advanced economies is direct income support. Income support replacing 50 percent of regular income brings the

Figure I.6 Impacts of alternative COVID-19 policies and coping strategies at different time horizons, emerging and advanced economies



Source: Badarinza et al. 2021.

Note: The figure shows the impact of alternative support policies and coping strategies—income support, debt relief, and asset liquidation—on household resilience for different time horizons.

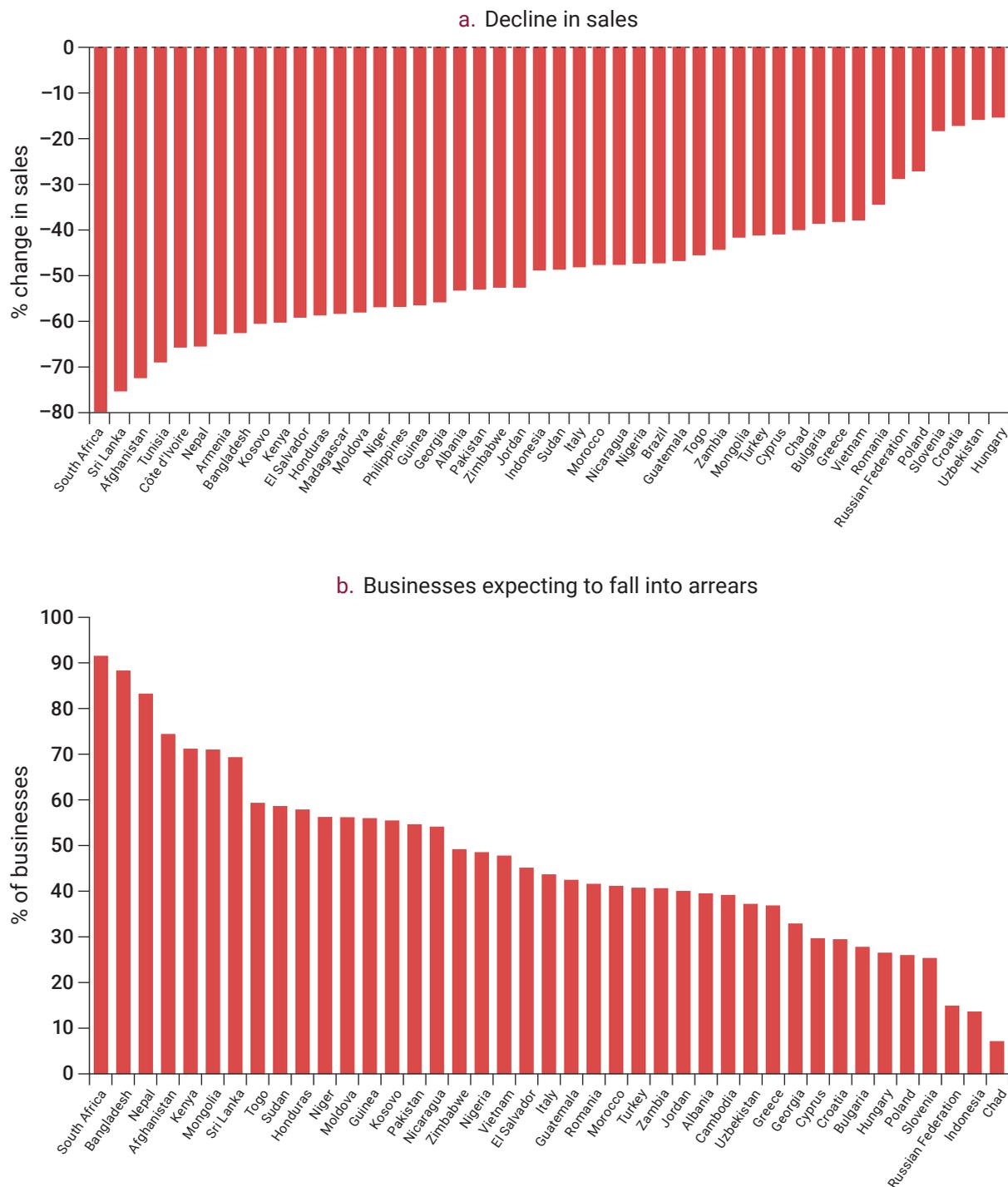
total fraction of vulnerable households to near zero for the first six months in both sets of economies. This finding underscores the immense value of the large cash transfers used worldwide to enable households to weather the immediate impacts of the crisis.

Impacts on firms

Business revenue declined dramatically as a result of lockdowns and other public health measures needed to contain the pandemic. Survey data collected from more than 100,000 businesses worldwide show that, overall, 70 percent of businesses closed at the peak of the first wave of the pandemic,³⁶ and 84 percent of firms reported a drop in revenue. This decline in sales was large in magnitude—on average, firms experienced a 51 percent year-on-year reduction in revenue as a result of the first wave of pandemic-induced mobility restrictions (figure I.7, panel a). Declines in sales and revenues were also persistent—four months after the peak of the pandemic, average revenue was still more than 40 percent lower than in the same period one year earlier. The shock was sufficiently severe and long-lasting to threaten the survival of many firms. In the early stages of the pandemic, 46 percent of firms expected to fall into arrears on their outstanding supplier, wage, or loan payments over the next six months (figure I.7, panel b). The average business reported having cash reserves to cover expenses for less than 51 days. The impacts of business closures and the sharp, persistent decline in business revenue translated into a corresponding reduction in employment, mostly by reducing workers’ hours and requiring furloughs (both paid and unpaid). Permanent layoffs were less common. In total, 57 percent of surveyed firms reduced employment.

The impact of the COVID-19 crisis on businesses varied significantly across countries and sectors. Tourism, retail, and parts of the service sector were more severely affected by public health policies

Figure I.7 Impact of COVID-19 on businesses, selected countries



Source: World Bank, COVID-19 Business Pulse Surveys Dashboard, <https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard>.

Note: The figure shows the average predicted percentage decline in sales (panel a) and share of businesses expecting to fall into arrears (panel b) by country. Estimates are obtained from a linear regression that controls for country, firm size, sector, and distance to the first peak of the pandemic. Data are as of July 31, 2021.

limiting mobility or mandating temporary business closures or capacity restrictions. In addition, international supply chains were disrupted, causing input shortages and price fluctuations that rippled through the global economy and eventually also reached sectors not initially affected by the crisis.

Small and informal businesses most severely affected

The impact of the crisis on businesses, like that on households, was highly regressive. Smaller businesses, informal businesses, and businesses with more limited access to the formal credit market were more severely affected. Smaller firms tend to face greater financial constraints, even in advanced economies. In the United States, for example, the median small business has fewer than 15 days in cash reserves.³⁷ Thus even profitable small businesses can easily fall into arrears and insolvency due to a temporary shock to revenue. The same is true of the impact of the COVID-19 shock on businesses around the world. Larger firms were able 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. More than 50 percent of all small firms expected to fall into arrears within six months of the onset of the crisis, compared with 45 percent of medium-size firms and 36 percent of large firms. Compounding the challenge, small businesses have far more limited access to external finance than larger firms, and thus were much more likely to be pushed into insolvency by the crisis.³⁸

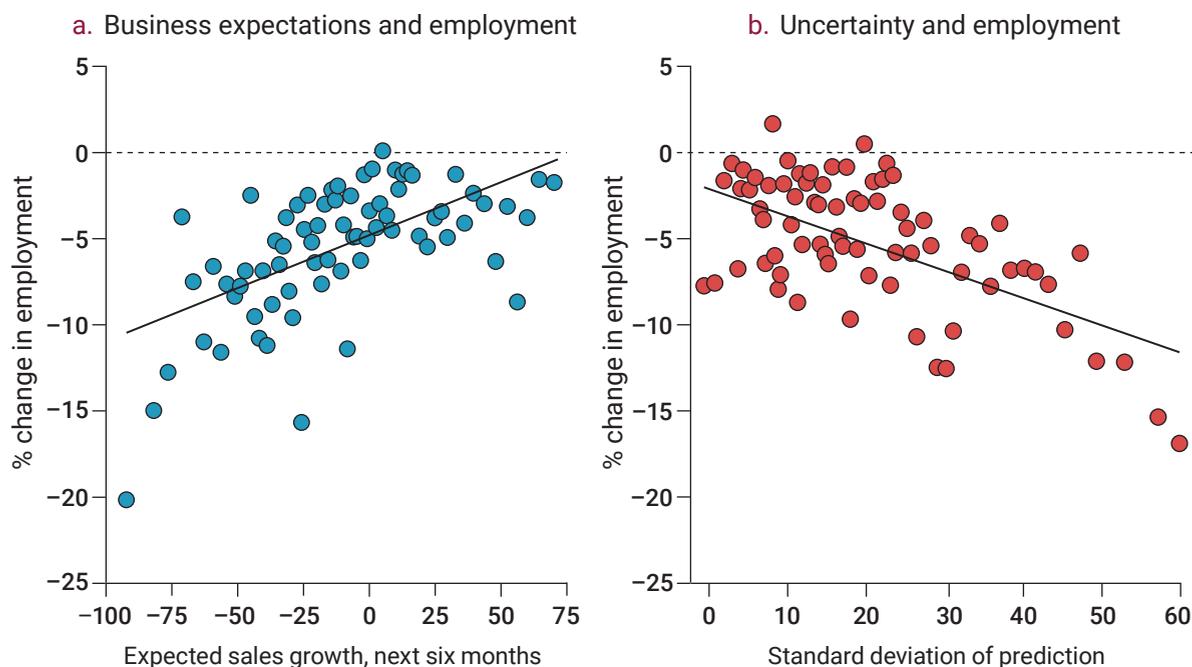
Women-led businesses have been disproportionately affected by the crisis, according to data from the World Bank's COVID-19 Business Pulse Surveys conducted during the first year of the pandemic. Women-owned businesses are, overall, more concentrated in sectors that were harder-hit by lockdowns and mobility restrictions, and even within these sectors women-owned businesses fared worse. Women-owned businesses in the hospitality industry, for example, recorded larger declines in sales revenue than male-led businesses during the same period the previous year (–67.8 percent versus –60.4 percent), were able to cover costs for a shorter period of time (54 days versus 64 days), were more likely to fall into arrears (58 percent versus 51.6 percent), were more likely to reduce work hours (59.6 percent versus 53.7 percent), and had less access to public support (33 percent versus 37 percent).³⁹ Surveys of some 26,000 business owners in over 50 countries with an active Facebook business page also reveal that the strictness of lockdown measures tended to exacerbate gender gaps in temporary business closures.⁴⁰

Businesses relatively more affected by the initial impact of the COVID-19 pandemic were also experiencing greater difficulties recovering in 2021. Comparisons of first-round (May–November 2020) and second-round (November 2020–May 2021) data from the World Bank's COVID-19 Follow-up Surveys in Europe and Central Asia, for example, show that small, young (founded within the last 10 years), and female-owned firms did not see improvements in sales in 2021, in contrast to larger, older, and male-owned firms. Larger firms were also more likely than smaller firms to receive payment deferrals and fiscal relief.

Persistent economic uncertainty hampering business activity

In addition to revenue losses, business activity has been affected by an uncharacteristically large and persistent increase in uncertainty about future business prospects, despite the presence of large support programs. Studies using data from advanced economies show that, because of its unique nature, the COVID-19 pandemic has generated more uncertainty in business sales and profitability expectations than a conventional economic downturn.⁴¹ The World Bank's COVID-19 Business Pulse Surveys collected comparable data on business expectations worldwide and found strikingly similar results. They confirm that greater uncertainty about business prospects is associated with larger firm-level declines

Figure I.8 Economic uncertainty and employment during the COVID-19 crisis



Source: Apedo-Amah et al. 2020, based on World Bank, COVID-19 Business Pulse Surveys Dashboard, <https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard>.

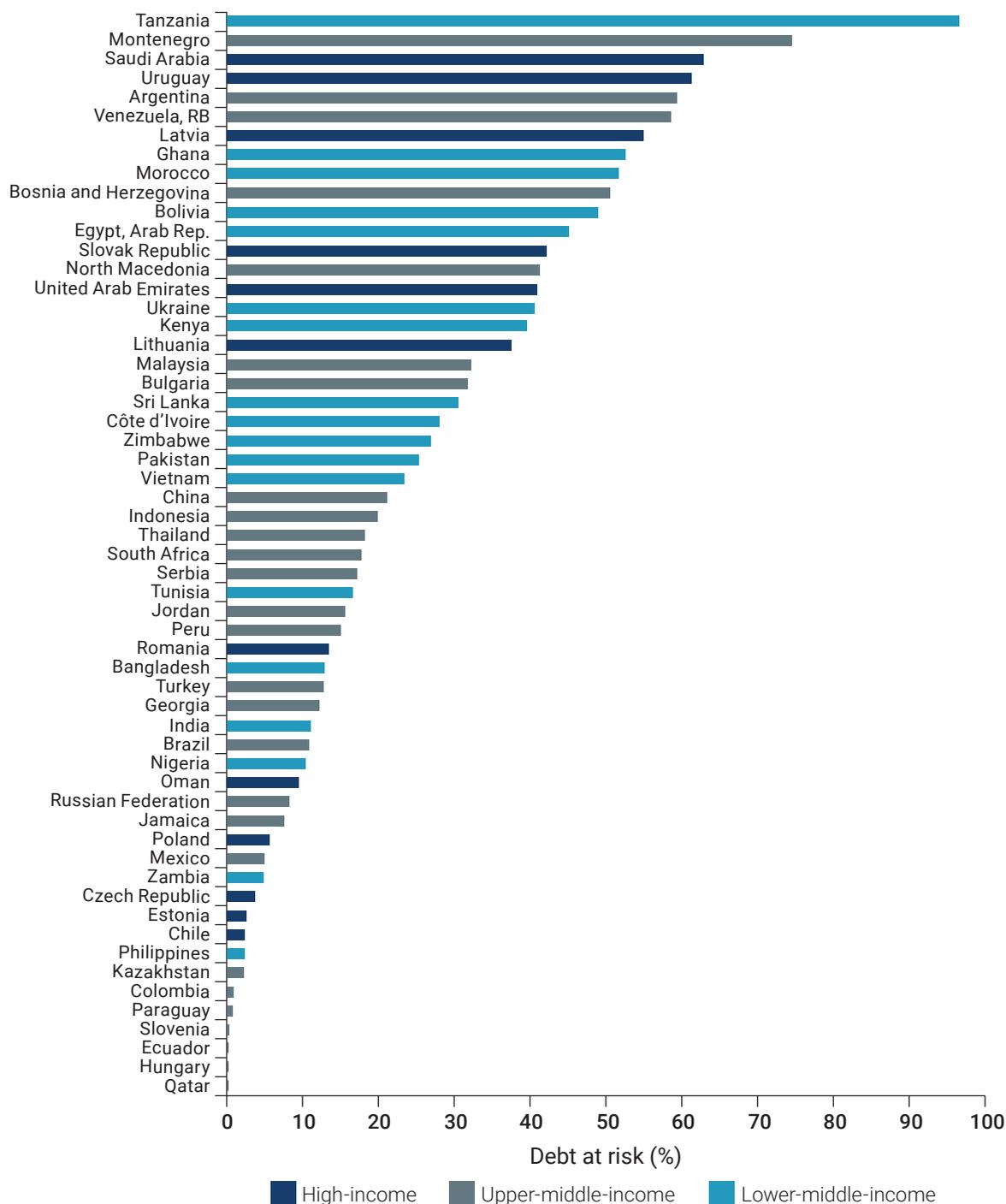
Note: The figure shows the relationship between expected sales growth and changes in employment (panel a) and uncertainty about sales growth and changes in employment (panel b), based on data from the World Bank's COVID-19 Business Pulse Surveys collected during the first two quarters of the pandemic. The analysis first conditions on the variable on the x-axis and then calculates employment changes for businesses in each bin.

in employment (see figure I.8). Even as pandemic-related risks are gradually resolved, prolonged uncertainty about the recovery of business revenue is therefore likely to suppress job creation and investment by businesses, as well as the availability of credit from their lenders in the longer term.

Heightened fragilities on corporate balance sheets

The precrisis period saw a significant buildup of financial risks in the corporate sector, which became increasingly apparent with the onset of the pandemic. This increase in risks was particularly severe in emerging markets, where an extended period of low interest rates globally had contributed to lending booms and dramatically increased leverage ratios in the corporate sector. Prior to the crisis, many firms in emerging markets were already struggling with unsustainable debt burdens and difficulties covering short-term liabilities.⁴² Stress test simulations using precrisis corporate balance sheet data indicate that an economic shock of the size experienced by most emerging from the COVID-19 recession would push a large share of firms in these economies into insolvency (figure I.9).⁴³ Some of the financial risks that have accumulated among emerging market firms have become apparent as a result of the crisis. Troubled assets in the real estate sector of important emerging markets that have come to light recently are one example of how credit-fueled asset bubbles that accumulate during times of high growth can trigger wider economic instability in the event of an unforeseen adverse shock.⁴⁴ This phenomenon is not unique to the current crisis and, in fact, bears many similarities to the asset bubbles and subsequent

Figure I.9 Percentage of corporate debt at risk after a simulated 30 percent shock to earnings, precrisis, selected countries, by income group



Source: WDR 2022 team, based on Feyen, Dancausa, et al. (2020).

Note: The figure reports the distribution across income groups of the fraction of debt of firms in a country considered “at risk” in terms of interest coverage ratio after a simulated 30 percent shock to earnings. The interest coverage ratio captures the ability of a firm to cover interest expenses with current earnings. A higher value indicates higher debt at risk for corporations in a country.

market corrections in previous crises, such as real estate bubbles in advanced economies prior to the global financial crisis.

In emerging economies, corporate solvency risks have been further exacerbated by a sharp increase in dollar-denominated debt over the past decade. Low interest rates in advanced economies over this period tempted firms to take on foreign rather than local currency debt.⁴⁵ Since the beginning of the pandemic, the currencies of many emerging markets have come under pressure. This creates problems for firms that hold significant amounts of foreign currency-denominated debt, which is now more difficult to service because the value of the borrower's local currency revenue has fallen. The exposure to currency risk is likely to become more acute if the recovery proceeds more quickly in advanced economies than in the rest of the world, which will lead to a further weakening of emerging market currencies.

Impacts on the financial sector

In contrast to the immediate large impacts of the COVID-19 crisis on households and firms, the short-term impacts of the crisis on the financial sector were relatively muted because of the large-scale emergency support and forbearance programs for borrowers aimed at preventing a spike in loan defaults.

Moderate initial impacts masking longer-term risks

Although extensive income support and debt forbearance policies have helped to insulate the financial sector from a wave of loan defaults in the short run, few if any countries have the resources to keep these policies in place in the longer term. Therefore, financial institutions around the world are likely to come under significant stress as debt moratoria and other support policies for borrowers are scaled back. In some economies, these risks are already becoming apparent. Loan defaults have been on the rise in India, Kenya, the Philippines, and a growing number of other middle-income countries. These emerging credit risks are also reflected in the worsening outlooks of the main international rating agencies for financial institutions as forbearance policies are lifted.

How well financial sectors around the world are prepared to confront this challenge varies considerably. Some economies that were hard-hit by the global financial crisis of 2007–09 initiated meaningful reforms and ensured that their banking systems were well capitalized. However, given that the global financial crisis affected primarily advanced economies, many emerging economies did not enact such reforms. As a result, their financial sectors are poorly prepared to withstand a crisis of the magnitude of the COVID-19 recession. For example, in emerging economies the average levels of regulatory capital holdings (the risk capital banks are required to hold to protect their balance sheets in the event of loan losses) have remained flat, albeit at a relatively high level, since the global financial crisis.⁴⁶ Moreover, bank debt-to-asset ratios, indicating greater balance sheet risk, have increased for smaller banks generally, as well as for banks located in emerging economies.⁴⁷

In many emerging economies, fragilities in the financial sector are compounded by extensive government ownership of banks, misallocation stemming from government-mandated lending programs, and financial repression policies such as the requirement that domestic financial institutions hold government debt, which links the asset quality of the financial sector to that of the government. In the years leading up to the COVID-19 crisis, the Financial Sector Assessment Program, a joint exercise carried out by the World Bank and the International Monetary Fund, highlighted problems in the resolution of nonperforming loans (especially in Sub-Saharan Africa and Eastern Europe), loan classification and provisioning, and bank exposure to the nonbanking sector.

There has also been significant concern about the rapid expansion of lending by nonbank financial institutions (NBFIs) and their links to the formal banking sector in many emerging markets. According to data from the Financial Stability Board, and using a narrow definition of the sector, in 2020 NBFIs accounted for 14.1 percent of the total financial assets of 29 jurisdictions.⁴⁸ Nonbank lenders often face greater credit risks than banks, but are typically less regulated and can therefore accumulate significant hidden risks that can threaten financial stability. Regulators have become increasingly aware of these risks and have sought to adapt oversight of nonbank lenders.⁴⁹

The short-term government response and its impact on public finances

The COVID-19 crisis triggered an extraordinarily large government response aimed at stabilizing output and protecting incomes in the short run. Governments enacted comprehensive fiscal, monetary, and financial sector policies, many of which included policy tools that were unprecedented at this scale or had not previously been used in emerging economies. Examples include direct income support measures, debt moratoria, and asset purchase programs by central banks. Most economists welcomed the speed and enormous scale of this response, pointing to the unparalleled scale of the economic shock and the lessons learned from past crises in which gradual approaches had proven less effective at stabilizing output and market expectations.⁵⁰

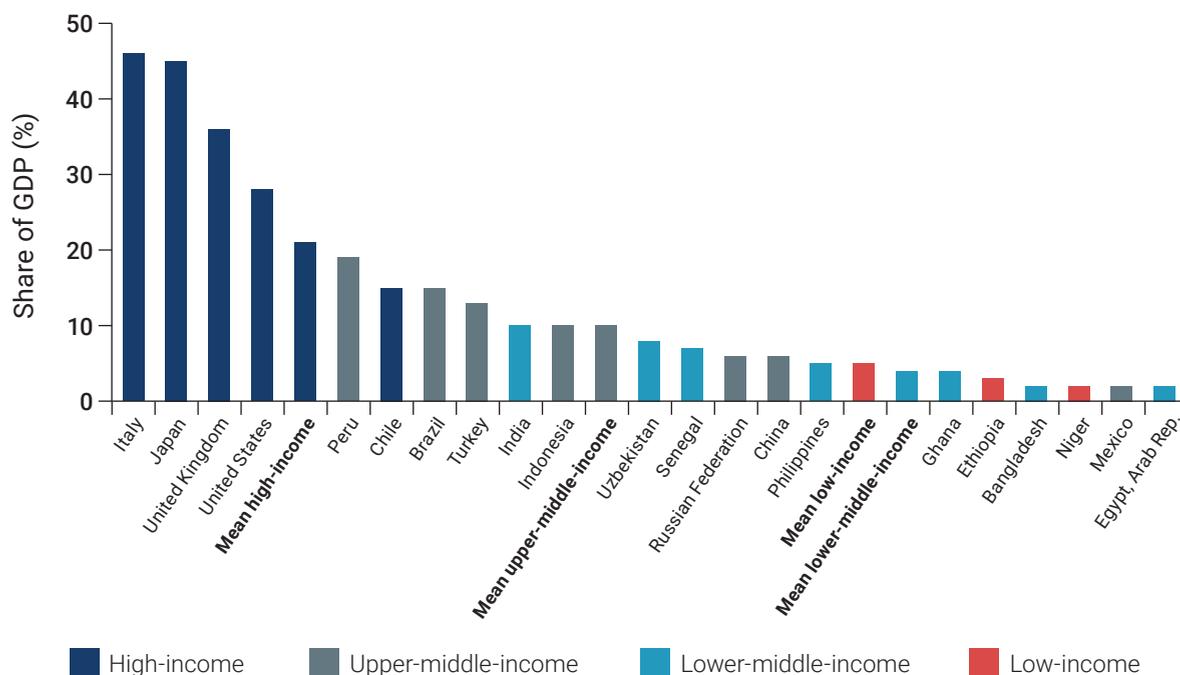
Wide variation in the scale of the policy response

The fiscal policy response to the COVID-19 crisis was swift and substantial. It consisted primarily of direct emergency payments to the households and firms most acutely affected by a sharp drop in incomes and revenue. Many countries conducted countercyclical fiscal policies during the crisis, a first for most emerging economies. The scale of the response, however, varied significantly across countries, depending on the capacity of governments to mobilize resources, as well as institutional capabilities and the availability of social safety nets, as illustrated by figure 1.10. While the extent of the fiscal response was almost uniformly large by any historical measure in high-income countries and uniformly small or nonexistent in low-income countries, there was significant variation in the size of the fiscal responses among middle-income countries. This variation reflects, among other factors, large differences in government debt burdens and the ability to finance the crisis response, as well as differences in the ability of central banks to support government spending through accommodative monetary policy measures. The scale and nature of the fiscal response were also shaped by political economy factors. For example, some recent evidence indicates that less politically polarized governments and societies were able to mobilize more fiscal resources to fight the immediate effects of the pandemic.⁵¹

In addition to rate cuts, central banks used unconventional monetary policy tools such as asset purchase programs to support the crisis response. Although asset purchase programs had previously been used almost exclusively in advanced economies, 27 emerging economies adopted such programs for the first time in response to the COVID-19 crisis.⁵²

In addition to the fiscal and monetary policy response to the crisis, financial regulators around the world also implemented an unprecedented set of measures to prevent financial distress among borrowers and financial institutions. These policies were aimed at maintaining overall financial stability, preserving critical financial market functions, averting preventable insolvencies, and ensuring the continued flow of credit to households and firms. Central banks helped financial institutions maintain liquidity

Figure I.10 Fiscal response to the COVID-19 crisis, selected countries, by income group



Source: WDR 2022 team, based on IMF (2021a). Data from International Monetary Fund, Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic, Fiscal Affairs Department, <https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19>.

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.

through reductions in the policy rate, asset purchase programs, and other interventions intended to quell market turbulence in the early stages of the crisis.

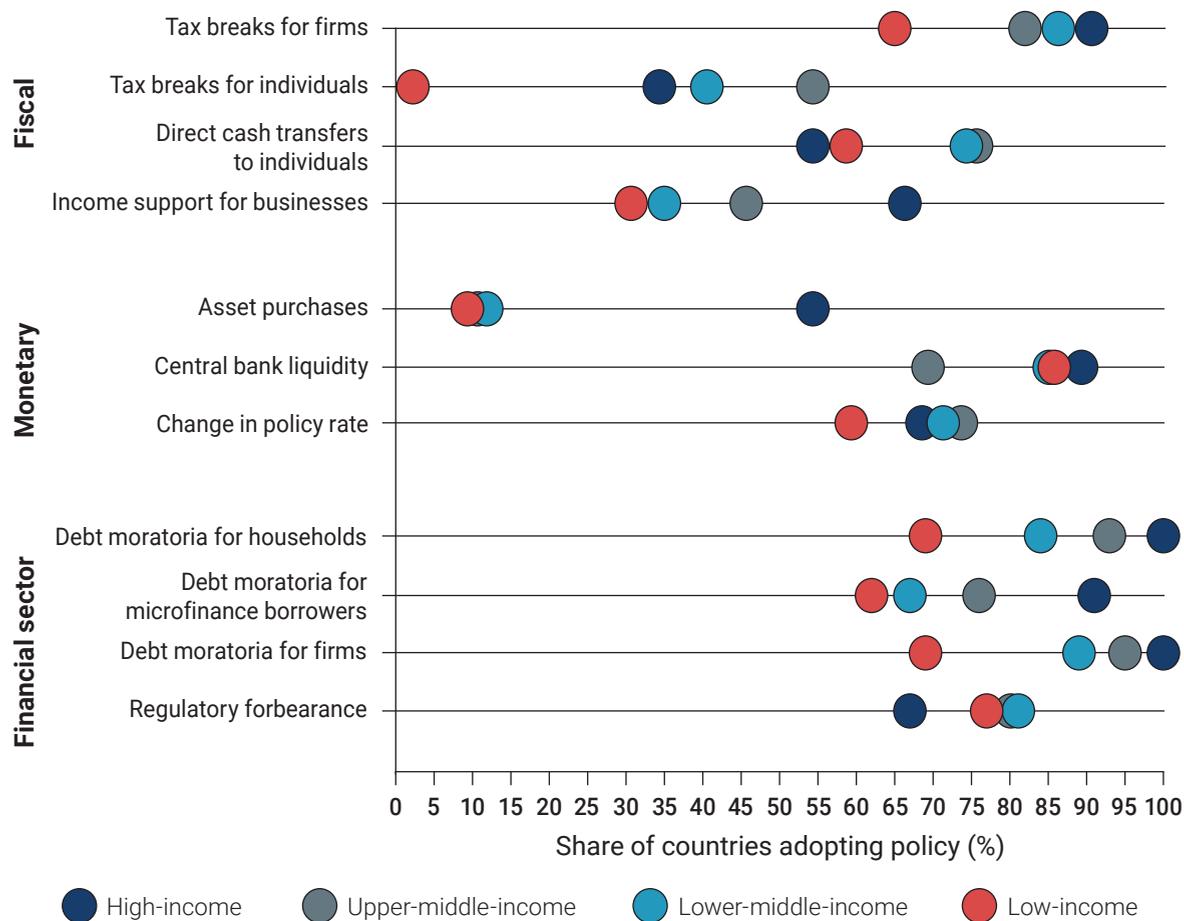
To support borrowers and avert a wave of preventable insolvencies, financial regulators rolled out a variety of temporary debt relief measures for households and businesses, such as debt moratoria and debt restructuring programs. In many countries, these policies ultimately covered a large share of outstanding credit and played an important role in preventing loan defaults among borrowers facing temporary liquidity problems. However, debt moratoria on the scale of those enacted during the pandemic are a largely untested policy, and so far there is very little evidence of their longer-term impacts on borrower behavior and financial stability. One important concern is that, if left in place for too long, debt moratoria can have the unintended effect of masking the true extent of credit risk in the economy and delay rather than prevent the emergence of financial fragilities.

In contrast to previous crises, many countries also implemented so-called regulatory forbearance policies for banks. Regulatory forbearance refers to the relaxation of regulatory requirements and accounting standards in the hope that this will make it easier for lenders to issue new credit. Although some of these policies used the flexibility embedded in existing regulatory frameworks (such as the Basel III regulations), some countries relaxed prudential regulation and accounting standards beyond the emergency measures allowed by these frameworks. This may have created some respite for banks, but could create significant longer-term risks to financial stability. Regulatory forbearance policies reduce bank balance sheet transparency by enabling banks to hide the true extent of their credit risk, delay the

resolution of nonperforming loans, and ultimately weaken the ability of the financial sector to provide financing to creditworthy borrowers during the recovery. Because regulatory forbearance policies can lead to the accumulation of significant hidden credit risks, they can also place further burdens on government finances should government intervention be required to support ailing financial institutions once these risks materialize.

In addition to the scale of the short-term crisis response there was also wide variation in the specific combination of policy tools used by different countries (figure I.11). This variation reflects differences in the ability to mobilize resources as well as different priorities for the crisis response. Low-income countries made relatively greater use of simple cash transfer programs, whereas middle- and high-income economies, whose financial sectors are much more exposed to household and small business debt, made more extensive use of financial sector policies aimed at averting financial sector distress.

Figure I.11 Fiscal, monetary, and financial sector policy responses to the pandemic, by country income group



Source: WDR 2022 team, based on Feyen, Alonso Gispert, et al. (2020); Lacey, Massad, and Utz (2021); World Bank, COVID-19 Finance Sector Related Policy Responses, Version 3, <https://datacatalog.worldbank.org/search/dataset/0037999>.

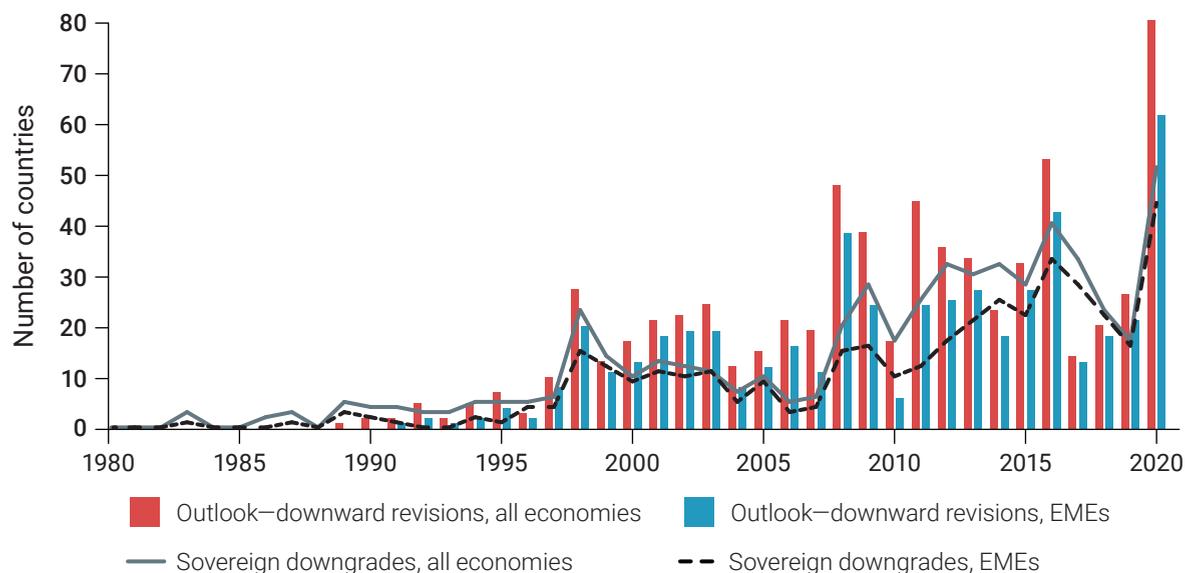
Note: The figure shows the percentage of countries in which each of the listed policies was implemented in response to the pandemic. Data for the financial sector measures are as of June 30, 2021.

A global increase in government debt triggered by the pandemic

The large crisis response, while necessary and effective at mitigating the worst impacts of the crisis in the short run, led to a global increase in government debt that has given rise to renewed concerns about debt sustainability. Government debt levels have been rising steadily over the last decade in many emerging economies, and several suffered downgrades of their sovereign risk rating prior to the crisis (see figure I.12). In 2020, 51 countries—among them, 44 emerging economies—saw their credit ratings deteriorate. Although advanced economies have not been spared, sovereign downgrades are much more consequential for emerging economies, where credit ratings are at or near junk grade, and where the rating of the sovereign has a direct impact on the ratings of state-owned banks and state-owned enterprises. In more extreme cases, where sovereign restructuring becomes necessary—and these have been on the rise as well—banks and domestic investors will take outright losses on their holdings of government securities. Increases in government debt stemming from fiscal responses to the pandemic are therefore especially consequential for low-income countries.

In emerging and advanced economies, the fiscal response to the pandemic was supported by significant monetary policy measures that made unprecedented use of new policy tools (box I.1). Building on lessons from the global financial crisis, central banks lowered interest rates rapidly rather than through a series of gradual rate cuts. Because advanced economy policy rates were low prior to the crisis, emerging economies had more space to lower interest rates, with several central banks cutting rates by 100–200 basis points. Emerging economies were able to undertake especially ambitious monetary policy responses in part because many were at a low point in the business cycle. With output below potential, there was less concern about overheating the economy and spurring capital outflows. Structural reforms enacted since the global financial crisis helped to create additional flexibility.⁵³

Figure I.12 Global sovereign downgrades, 1980–2020



Source: WDR 2022 team, based on Reinhart (2021). Data from Trading Economics, Credit Rating (database), <https://tradingeconomics.com/country-list/rating>.

Note: The figure shows the total number of sovereigns downgraded in a given year for all economies (gray line) and for emerging market economies (dashed black line) for which ratings data could be obtained. Emerging market economies (EMEs) are defined as in the International Monetary Fund's *World Economic Outlook: A Long and Difficult Ascent* (IMF 2020).

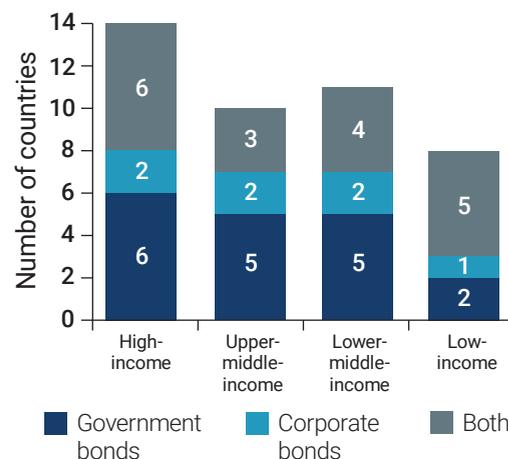
Box I.1 The interplay of fiscal and monetary policy

In response to the pandemic, countries made extensive use of monetary policy to support the large fiscal programs that became necessary to support households and firms. In emerging economies, interest rate cuts were a much more effective tool for stimulating the economy than in advanced economies, where rates had been hovering around the zero lower bound prior to the pandemic. Nonetheless, many emerging economies found themselves constrained in their crisis response because of limited fiscal and monetary policy options arising from high levels of government debt, low policy credibility, or weaker-than-expected effects of rate cuts.

Many economies adopted unconventional monetary policy tools to support the crisis response. The term *unconventional monetary policy* refers to policy instruments that go beyond the traditional regulatory and interest rate-setting powers of a central bank. Examples include asset purchase programs in which the central bank buys government or corporate bonds to inject liquidity into the economy and keep interest rates low; extraordinary liquidity operations, such as the central bank providing the financial sector with liquidity on the condition that it is used to issue new loans; or forward guidance, in which the central bank seeks to influence market expectations to stimulate economic activity.

To mobilize the full set of policy instruments at their disposal, central banks in emerging economies made extensive use of these new monetary policy tools, many for the first time. The most widely used instrument was asset purchase programs (figure BI.1.1), which before the COVID-19 crisis had been used almost exclusively in advanced economies—most notably by the US Federal Reserve Bank and the European Central Bank in the aftermath of the global financial crisis. Where asset purchase programs are aimed at buying government bonds, they increase the demand for longer-term government debt and reduce its cost, which directly supports the government’s ability to finance future spending.

Figure BI.1.1 Asset purchase programs of central banks during the COVID-19 crisis, by country income group



Source: WDR 2022 team, based on Fratto et al. (2021).

Note: The figure shows the number of countries that introduced asset purchase programs in response to the pandemic, by income group, disaggregated by whether the central bank was authorized to purchase government bonds, corporate bonds, or both. Data for the Central Bank of West African States are considered for each individual member state.

In response to the COVID-19 crisis, between March and August 2020, 8 low-income countries, 11 lower-middle-income countries, and 10 upper-middle-income countries initiated asset purchase programs.^a Examples of countries that initiated asset purchase programs include Angola, the Arab Republic of Egypt, Costa Rica, and Uganda. In several countries, adoption of such programs required changes in the laws governing the operations of the central bank. Brazil, for example, changed its constitution to allow the central bank to carry out monetary financing operations, including the direct purchase of government bonds. Thailand’s parliament approved a law to set up a B 400 billion (\$12.3 billion) fund to buy corporate bonds.

(Box continues next page)

Box 1.1 The interplay of fiscal and monetary policy (*continued*)

Although the use of an expanded set of monetary policy tools has been beneficial to the COVID-19 crisis response, it has also increasingly blurred the lines between fiscal and monetary policy and raised the specter of governments trying to influence central banks to accommodate their fiscal needs. In this situation, referred to as “fiscal dominance,” the central bank sacrifices price stability to support the government’s fiscal policy goals. In the past, this practice has led to episodes of high or hyperinflation, which place a disproportionate burden on the poor and pose a significant obstacle to sustained economic growth in many emerging economies and efforts to tackle climate change and inequality.

The greater interdependence between fiscal and monetary policy foreshadowed by the increased use of new monetary policy tools will

a. Fratto et al. (2021).

require improved coordination between fiscal and monetary authorities, as well as safeguards for central bank independence. In response to these emerging challenges, some emerging economies have introduced rules aimed at isolating central banks from political pressure to finance government outside of emergency situations. In Indonesia, for example, the central bank was prohibited from buying government bonds in the primary market. This prohibition was suspended through emergency legislation but only for a limited time (the prohibition on government financing must be reinstated by law in 2023). However, such rules are not always time-consistent, and it remains to be seen whether they can help countries strike the right balance between enabling an effective policy mix and safeguarding central bank independence.

Overall, the swift and decisive policy response to the COVID-19 crisis has mitigated its worst economic impacts in the short run. However, some crisis response measures have also given rise to new risks that may pose an obstacle to an equitable recovery in the longer term. Among these, the most pressing concerns are dramatically increased levels of public and private debt, as well as the significant risk of hidden debts and financial fragilities that will materialize once support and forbearance programs are scaled back. As the immediate effects of the pandemic subside, policy makers face the difficult task of striking the right balance between providing enough support to contain the worst human costs of the crisis, while limiting the longer-term risks that may arise from the crisis response. Given this context, chapter 1 of this Report highlights the mutually reinforcing links between the various sectors of the economy—households, firms, financial institutions, and governments—through which risks in one sector can affect the economy as a whole, and charts policies that can effectively reduce these risks and support an equitable recovery.

Notes

1. Global real GDP growth in 2020 is estimated at –3.1 percent in the International Monetary Fund’s World Economic Outlook (IMF 2021b) and –3.5 percent in the World Bank’s Global Economic Prospects (World Bank 2021a).
2. See World Bank (2011). Also see Reinhart (2020). Although the COVID-19 pandemic evokes a comparison to the 1918 Spanish influenza pandemic, global economic conditions in the two periods are not comparable because of the wartime production under way during World War I as well as the stark differences in health and economic policy responses (Arthi and Parman 2021).
3. Bordo and Meissner (2016); Reinhart and Rogoff (2009).
4. Apedo-Amah et al. (2020).

5. World Bank, COVID-19 High-Frequency Monitoring Dashboard, <https://www.worldbank.org/en/data/interactive/2020/11/11/covid-19-high-frequency-monitoring-dashboard>.
6. Bundervoet, Dávalos, and Garcia (2021).
7. The decline in remittances reported by households is at odds with the aggregate data on remittances flows, which show global flows declining only by 1.6 percent in 2020 with respect to the previous year. This difference stems, in part, from migrants switching from informal (carry) to formal (digital) channels of sending remittances in response to mobility restrictions. Even with these changes in the composition of remittances, formal remittances declined by 10 percent or more in the Europe and Central Asia (ECA) and Sub-Saharan Africa (SSA) Regions and by 8 percent in the East Asia and Pacific (EAP) Region. For more details, see World Bank (2021b).
8. Janssens et al. (2021).
9. Measurements of poverty rely on household surveys, which become available with a lag. Data collection for these surveys has also been affected by COVID-19. To estimate poverty for 2020 and 2021, the most recent household surveys have been extrapolated using growth rates from national accounts. This requires additional assumptions: how much of GDP per capita growth feeds through to household consumption or income recorded in the survey and whether there have been any distributional changes. The nowcasts assume that 85 percent of growth in GDP per capita is passed through to household incomes, following Lakner et al. (2020). This pass-through rate is determined by comparing past growth in national accounts and household surveys in a global sample of comparable surveys. In the baseline estimates, it is assumed that all households grow at the same rate, so there are no distributional changes. See the more detailed discussion that follows on the likely distributional changes arising from COVID-19 in selected countries.
10. Lakner et al. (2020); World Bank (2020c).
11. Deaton (2021).
12. Deaton (2021) finds that inequality between countries, measured as the dispersion in per capita GDP without accounting for population size, decreased in 2020. This is consistent with a larger decline in GDP per capita in higher-income countries. However, Deaton finds that this dispersion increases when countries are weighted by their population. Yonzan, Lakner, and Mahler (2021) also find that population-weighted between-country inequality increased in 2020. Their study draws on distributions from household surveys, which are extrapolated using growth in GDP per capita and weighted by population. Both studies agree that the dispersion between countries in 2020 is highly sensitive to the growth forecasts of China and India. The vintages of the growth data also make a difference. Deaton (2021) compares growth forecasts from the October 2019 and October 2020 editions of World Economic Outlook (IMF 2019, 2020), while Yonzan, Lakner, and Mahler (2021) use growth forecasts from the January 2020 and June 2021 Global Economic Prospects (World Bank 2020a, 2021a).
13. Khamis et al. (2021).
14. Mahler et al. (2021) based on World Bank, Global Economic Prospects DataBank, <https://databank.worldbank.org/source/global-economic-prospects>; World Bank, PovcalNet (dashboard), <http://iresearch.worldbank.org/PovcalNet/>.
15. Yonzan, Lakner, and Mahler (2021).
16. See note 12.
17. World Bank (2021a).
18. Yonzan, Lakner, and Mahler (2021).
19. Azevedo et al. (2020).
20. See de Paz, Gaddis, and Müller (2021).
21. 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).
22. Kugler et al. (2021).
23. Bundervoet, Dávalos, and Garcia (2021).
24. Adams-Prassl et al. (2020); Chetty et al. (2020); Crossley, Fisher, and Low (2021).
25. Because of a lack of comprehensive data for 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 with a range of assumptions on within-country inequality.
26. See de Paz, Gaddis, and Müller (2021).
27. Bundervoet, Dávalos, and Garcia (2021).
28. Goldstein et al. (2020).
29. Torres et al. (2021).
30. Agrawal et al. (2021); de Paz, Gaddis, and Müller (2021); Kugler et al. (2021).
31. Agrawal et al. (2021).
32. Gomes, Haliassos, and Ramadorai (2021); RBI (2017).
33. Badarinza, Balasubramaniam, and Ramadorai (2019). Measuring consumption and asset holdings at the household level is challenging for two reasons: (1) representative surveys often lack sufficiently detailed data on assets and consumption, and (2) where such data are available, they are often difficult to compare across countries. Some recent research has managed to bridge this gap by collating a broad set of household surveys for emerging and advanced economies.
34. Badarinza et al. (2021).
35. Measured in the surveys as part of consumption expenditure, including self-reported exposure to informal loans.
36. World Bank, COVID-19 Business Pulse Surveys Dashboard, <https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard>. Data for the first wave of the survey were collected between April and November 2020.
37. Federal Reserve Bank of New York (2021).
38. Emerging evidence also suggests there is a gender component to the impact on businesses. In response to the pandemic, women-owned businesses closed at a higher rate than those owned by men. See, for example, Goldstein et al. (2020) and Torres et al. (2021).
39. Torres et al. (2021).

40. Goldstein et al. (2020).
41. Altig et al. (2020); Baker et al. (2020).
42. Acharya et al. (2015); Alfaro et al. (2019).
43. Feyen, Dancausa, et al. (2020).
44. Bottelier (2010); Rogoff and Yang (2021).
45. Especially low rates in the United States, as described by Bruno and Shin (2017).
46. World Bank (2020b).
47. Anginer et al. (2021).
48. FSB (2020).
49. India, for example, has introduced a new regulatory framework for nonbank lenders that will come into effect in October 2022. See RBI (2021).
50. For example, see Gopinath (2020) and other essays in Baldwin and Weder di Mauro (2020).
51. Aizenman et al. (2021).
52. IMF (2021b), based on Fratto et al. (2021).
53. Aguilar and Cantú (2020); Arslan, Drehmann, and Hofmann (2020); Cantú et al. (2021).

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