



# Policy priorities for the recovery

*The COVID-19 crisis has given rise to a wide range of new and elevated economic risks, some of which will only become apparent with time. Few governments have the resources and political leeway to tackle all of these challenges at once. Countries will need to identify the risks that pose the most immediate threat to an equitable recovery and prioritize their policy responses. This concluding chapter reviews the most urgent risks and highlights global issues that may arise as countries recover from the economic repercussions of the pandemic at different rates.*

## Policy Priorities

Pursuit of the following priorities can help set countries on the path to a more equitable and sustained economic recovery:

- **Mobilizing resources for the recovery.** In many low-income economies, high levels of sovereign debt pose the most urgent threat to the recovery. Countries facing this scenario can free up resources for the recovery through improved debt management.
- **Safeguarding financial stability.** In middle-income economies, financial sector risks tend to pose a larger threat to the recovery. These countries should focus on identifying and resolving financial sector risks to ensure the continued provision of credit.
- **Scaling back support in a transparent manner.** Support policies should be withdrawn in a predictable manner and scaled back first for the most resilient households and firms to counteract the highly regressive impacts of the COVID-19 crisis.
- **Managing exposure to global economic risks that threaten an equitable recovery.** These include interest rate and currency risks that are likely to arise as advanced economies scale back stimulus policies.
- **Supporting the transition to a green economy.** Economic policies for the recovery should aim to support sustainable growth by facilitating the reallocation of resources to green sectors and business models.

## Introduction

The economic disruption caused by the COVID-19 (coronavirus) pandemic will affect countries for many years to come. As the immediate impacts of the pandemic subside, resource-constrained governments will face the challenge of scaling back support policies in a way that does not threaten the recovery. Because of uneven access to vaccines and economic fragilities predating the pandemic, emerging economies, in particular, face the very real prospect of a slow crisis recovery. Mobilizing the resources needed for proactive management and reduction of financial risks arising from the crisis, as well as for longer-term structural reforms, is essential for a strong and equitable recovery.

This Report has examined the primary financial and economic risks that have been exposed or exacerbated by the pandemic, and it has highlighted concrete steps policy makers can take to address them. In an ideal situation, governments would implement relevant policies for each of the priority areas discussed: financial stability, household and business insolvency, access to credit, and sovereign debt sustainability. However, few if any governments have the resources and political leeway to tackle all of these challenges at once. Countries will have to decide which policy areas to prioritize and how to best allocate scarce resources to support the recovery.

This chapter offers some guidance for doing that within a globally connected economy, taking a thematic perspective on the options and trade-offs available. The chapter emphasizes that the prompt recognition of economic risks is critical for the design of effective policies and highlights how new data and analysis can help evaluate the crisis response and guide evidence-based policy in the future (box 6.1).

### Box 6.1 Evaluating the success of the crisis response: A research agenda

The response to the COVID-19 crisis has included many policy tools never applied in emerging economies or tried on this scale. Examples include large cash transfer programs, debt forbearance, and asset purchase programs. Although it is still too early for a conclusive assessment of these policies, a thorough analysis of the successes and limitations of the crisis response is essential to guide future policy making.

#### Understanding interrelated economic risks

As this *World Development Report* highlights, tracing the economic impact of the crisis response requires understanding the links between the balance sheet risks of households, firms, the financial sector, and the government because policies targeting one sector will have implications for the wider economy. Helping households with government cash transfers, for example, increases pressure on government budgets, but reduces loan defaults and risks to the financial sector. Recapitalizing banks may help them

continue to supply firms with credit, but it may come at the cost of reducing the government's ability to support households and firms directly.

Evaluation of the impacts of the economic crisis and the progress toward an equitable recovery thus requires detailed data on the financial positions of households, firms, the financial sector, and the budgets of national and subnational governments. In some cases, such data are already available. In others, they would have to be collected either from conventional sources, such as nationally representative surveys or administrative data, or from newly available "big data," such as mobile banking and digital payments records. These data are useful not only to conduct a retrospective analysis, but also to offer practical guidance on how to best target support and choose between alternative policy approaches.

The use of microdata on household balance sheets is a good example. As shown in chapter 1, when policy makers have access to comprehensive data on the assets, liabilities, and expenditures of

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## Box 6.1 Evaluating the success of the crisis response: A research agenda (*continued*)

households, they are able to evaluate which types of support policies (income support, debt relief, or improved access to credit) will most effectively strengthen household resilience during a recession. It is also possible to assess how households at different income levels would benefit from each of these policies. However, in most countries standard household surveys do not collect information on household assets that is sufficiently detailed to allow for such an analysis, and, even where such data are available, they are still rarely used to inform policy making.<sup>a</sup>

### **The distributional impacts of the crisis response**

Detailed data on the balance sheets of households, firms, and the financial sector can also be a powerful tool for tracing the distributional implications of the crisis and crisis response. Fiscal support in the form of direct cash transfers has been a lifeline for many households and businesses during the crisis. However, access to these payments typically requires a bank account, and low-income countries in particular have increasingly disbursed payments through mobile money accounts and other digital channels. Although these programs have been very effective at disbursing payments quickly, they also raise concerns that households and businesses without an account may be excluded from such support programs. Combining data on financial inclusion that have become available in recent years with information on household incomes and business revenue can help policy makers assess exactly which households and firms benefit from a given transfer program.<sup>b</sup>

Similarly, government support for the financial sector in the form of bank bailouts and recapitalizations has vastly different implications for inequality, depending on which borrowers are financed by a particular financial institution. In most countries, the currently available data can give researchers and policy makers only an imperfect picture of what share of a bank's lending goes to small and

women-owned businesses and low-income and female-headed households. Where such data are available, policy makers can use them to target support to financial institutions instrumental in lending to those segments of the population most at risk of losing access to credit because of the crisis. Such data can be collected by regulators or the private sector. In some emerging markets such as India, some household and firm surveys also collect information on the banking relationships of respondents. Such data collection efforts should be extended to the nonbank financial sector, which accounts for a growing share of lending in emerging economies. This is a promising direction for future research that could not only provide policy makers with practical guidance, but also examine to what extent support of the financial sector actually helps marginal borrowers to maintain access to credit in a crisis.

### **Transparent government budgets**

The pandemic has also had a profound impact on the financial position of many governments. Evidence from past crises suggests that delays in resolving high levels of sovereign debt are associated with lower spending on public goods and worse health and education outcomes. Transparent data on government budgets can be used in analysis of the mechanisms that explain this link. They can, for example, allow researchers and policy makers to analyze which types of government spending are cut first when governments face debt sustainability issues, the extent of the resulting social costs, and how equally or unequally they are distributed across the population. As for fiscal and financial sector policies, this type of analysis can give policy makers specific guidance on the social cost of budget consolidation and the benefits of prioritizing certain types of social expenditures over others.

Better data on the structure and extent of government debt are also crucially important for the management and efficient resolution of high levels of such debt—a task facing many emerging

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### Box 6.1 Evaluating the success of the crisis response: A research agenda (*continued*)

economies in the years ahead (see chapter 5). One of the most important steps in restructuring sovereign debt is debt reconciliation, which entails reviewing contracts to ascertain the validity of the debt claims. This often time-consuming process could be significantly shortened if more and better transparent debt records are maintained, reducing the time needed for debt restructuring and thereby ensuring a better outcome. Such data could also help researchers to better understand the factors that slow the resolution of sovereign debt, which is associated with severe negative impacts on poverty and inequality.

#### **The role of digitalization in the crisis response**

Finally, the pandemic is arguably the first truly global crisis in the digital age. Digital channels, such as mobile money, have been used extensively to disburse support payments, and digital solutions,

including innovations in financial technology, algorithmic lending, and risk assessment, have offered new paths to improving transparency and supporting the crisis response. But for the more vulnerable and less financially experienced, digitalization of government transfer payments and wages also poses risks of informal fees, financial fraud, and predatory lending. Assessing how effective these innovations have been at channeling government payments to households and firms at the bottom of the income ladder and preventing them from losing access to formal credit requires detailed data. Fortunately, data on digital transactions are easily available. A more challenging task is to combine these data with information from household and firm surveys to enable future research to paint a comprehensive picture of the role of new financial technologies in crisis recovery.

a. See Badarinza, Balasubramaniam, and Ramadorai (2019); Badarinza et al. (2021).

b. See, for example, data from World Bank, Global Findex Database, <https://globalfindex.worldbank.org>.

## Tackling the most urgent sources of risk

One of the main themes running through this Report is that the sectors of an economy are interconnected through multiple mutually reinforcing channels. These links create pathways along which risks in one sector can affect the wider economy. However, well-designed fiscal, monetary, and financial policies can counteract these risks, lead to positive outcomes across multiple areas, and support an equitable recovery.

Using the framework of interrelated risks laid out in this Report, countries that need to make difficult choices about how to prioritize resources for the recovery can identify both the risks confronting their economy and where policy action is likely to be most effective at reducing economic fragilities worsened by the pandemic. The areas in which the risks are the most pronounced and are most likely to be the source of damaging spillovers warrant the most attention. This is not to say that countries with a high degree of risk in one area should ignore the other areas, but rather to emphasize the importance of urgent action in the areas where the threats are highest or where a further accumulation of risks is more likely to create spillover risks for the economy as a whole.

A common scenario in low-income countries is that the formal banking sector primarily serves wealthier, more resilient households and larger, more established businesses, while low-income households and small businesses most severely affected by the pandemic are less likely to have access to bank credit. As a result, the possibility of rising loan defaults is typically a less pressing issue in these countries. Moreover,

borrowers in low-income countries tend to be more reliant on nonbank lenders, such as microfinance institutions, and so those countries might benefit from guidance on regulating and supporting these institutions (as discussed in spotlights 2.1 and 3.1).

Yet in these same countries, deteriorating public finances threaten the ability of the government to support the recovery and pose a risk to the domestic financial sector, which often holds large amounts of sovereign debt.<sup>1</sup> Low-income countries also tend to face greater external threats to an equitable recovery. As high-income countries begin to recover from the crisis, low-income countries that borrow in foreign currency face the risk that their debt payments and import costs will become more expensive as global interest rates rise and their local currencies depreciate. In this scenario, a focus on improved sovereign debt management can help countries manage existing debt burdens and free up resources for the recovery (as discussed in chapter 5).

By contrast, addressing financial sector fragilities is a more pressing policy priority for many middle-income economies. The financial sector in these countries is typically more developed and therefore more exposed to household and small business debt. As outlined in chapter 1, income losses arising from the pandemic have led to a sharp deterioration in the financial health of households and firms, and could trigger a sharp rise in loan defaults. This could, in turn, threaten the capital position of many lenders. Thus, as outlined in chapters 2 and 3 of this Report, regulators in these countries should take steps to improve the resilience of the financial sector, promote greater transparency of bank asset quality, and expedite the restructuring of bad debts.

Overall, middle-income countries also introduced larger and more encompassing fiscal and financial sector policies in response to the pandemic, including cash transfers, debt moratoria for households and firms, and credit guarantee schemes for businesses. In these countries, policy makers need to ensure that support measures are withdrawn in a careful, predictable manner to avert a wave of loan defaults that will threaten financial stability and create contingent liabilities for governments.

## Managing domestic risks to the recovery

### Scaling back the stimulus

In the short term, resource-constrained governments face the challenge of scaling back fiscal support to households and firms without dampening the recovery. In many countries, direct payments to households and firms have served as the main pillar of the crisis response and were designed to protect the livelihoods of economically disadvantaged groups—such as workers in the informal sector and those in unskilled occupations—and the survival of businesses in the sectors most severely affected by the crisis. However, few countries have the resources to maintain these policies in the longer term, and in many cases countries will need to phase out support before economic activity has fully recovered.

As governments withdraw stimulus programs, policy makers must balance equity and efficiency considerations. Support should, for example, be scaled back first for firms that are financially resilient and have access to credit and capital markets that can help bridge temporary liquidity problems. Similarly, for households support should be scaled back first for those that are financially resilient, while support that protects the incomes and livelihoods of vulnerable populations that have been especially hard-hit by income losses stemming from the pandemic should be kept in place until their recovery prospects have materially improved. It is, moreover, essential that the withdrawal of support policies is implemented in a transparent and predictable manner to avoid adding to the economic uncertainty that is already dampening economic activity.

## Managing risks to government budgets

Governments will also need to mobilize new revenue to pay off debts incurred for the crisis response and preserve their ability to support the recovery. The potential return to economic growth during the recovery will help. However, governments must also pursue complementary, longer-term structural policies to increase their revenue base. Most emerging economies, for example, lack the institutional capacity to tax incomes and instead rely primarily on taxing consumption. This approach is highly inefficient—for example, in 2020 Mexico, which relies heavily on consumption taxes, raised only 18 percent of its gross domestic product (GDP) in tax revenue,<sup>2</sup> while countries in the European Union, relying primarily on income taxes, raised 41 percent of GDP in tax revenue.<sup>3</sup> Taxing consumption is also highly inequitable because it places a disproportionate burden on the poor, who spend most of their income on consumption. Taxing wealth through property, income, and capital gains taxes is an underused revenue generation strategy in most emerging economies and could help mitigate the adverse impacts of the COVID-19 crisis on poverty and inequality. Revenue mobilization strategies should also strengthen incentives for businesses to formalize, which brings additional benefits such as improved access to credit.

## Managing risks to financial stability

In many economies, the withdrawal of stimulus programs may also pose a threat to financial stability. Because many support programs will be scaled back before the incomes of households and businesses have fully recovered, regulators and financial institutions should be prepared to address an increase in loan defaults.

Chapters 2 and 3 discuss policies that can counteract these risks and reduce the likelihood of a credit crunch that would disproportionately affect small businesses and low-income households and could weaken the recovery. The policies discussed in chapter 2 focus on managing loan distress and safeguarding financial stability. Those featured in chapter 3 are aimed at improving and establishing a well-functioning legal insolvency framework for households and businesses. Effective policy action in both areas can prevent the risks posed by loan defaults escalating to the point that banks reduce lending. The challenges presented by elevated levels of nonperforming loans require a quick, comprehensive policy response on the three main fronts laid out in chapter 2: (1) improving transparency on banks' exposure to problem assets; (2) developing the operational capacity to address rising volumes of bad loans to ensure the resolute and efficient handling of borrowers considered nonviable; and (3) providing supervisors and bank resolution authorities with the tools they need to deal decisively with distressed banks in a manner that protects taxpayers and ensures the continuity of key financial services. Policies should encourage timely action before nonperforming loans rise to problematic levels. Both regulators and financial institutions should therefore be prepared to address an increase in problem assets as support programs are withdrawn.

An important tool to help resolve high levels of private debts in the economy is a functioning legal insolvency framework (see chapter 3). Because many emerging economies either lack legal or institutional frameworks for debt resolution or suffer from weak implementation or enforcement capacity, they would likely see benefits from concentrating efforts in these areas—notwithstanding the fact that the legal reform process can be lengthy. Even in countries where institutional capacity is limited, small improvements in the bankruptcy code can make a difference. For example, the experience of several emerging economies suggests that reforms that simplify bankruptcy proceedings can improve loan performance and increase the availability of credit.

## Ensuring continued access to credit for households and businesses

Many households and businesses are at acute risk of losing access to formal credit as a result of the COVID-19 crisis. Such a loss could dampen the recovery because access to credit is an important insurance mechanism that strengthens the ability of households and firms to weather economic risks that might arise during an extended recovery (see spotlight 1.1 for a review of the evidence). Credit also finances investment and consumption, which are essential to support the recovery.

The ongoing economic disruptions and persistent economic uncertainty resulting from the pandemic have also increased credit risk and diminished the realizable value of collateral as well as other forms of recourse for lenders. Coupled with the fact that government programs have had the unintended consequence of reducing credit market transparency, many lenders are finding it challenging to accurately measure credit risk and have responded by tightening credit conditions across the board. Innovations in financial technology and lending models can help counteract the resulting contraction in lending and stimulate continued lending to households and firms.

Where lenders have sufficient liquidity but are reducing lending, new financial technologies and lending models—often using alternative data sources to assess creditworthiness—can compensate for the lack of credit information. Similarly, better matching the duration of loan terms to the time horizon over which lenders can assess credit risk can facilitate risk management in times of heightened uncertainty. These advances can partly compensate for reduced credit market transparency and help lenders identify creditworthy borrowers. In situations in which lenders are reluctant to issue new credit because of economic uncertainty, governments and central banks could pursue other options such as partial credit guarantees. In these programs, often provided through state-owned banks, a guarantor (usually the government) absorbs part of the credit risk of loans to specific groups of borrowers. Although such programs require the lender to assume part of the credit risk, they must be implemented selectively (as discussed in spotlight 4.1) because they can distort incentives for lenders to collect payments and borrowers to repay credit. They also carry the risk of creating contingent liabilities for the government if borrowers default.

## Managing interrelated risks across the global economy

Beyond efforts to support the domestic economy, governments must also consider developments in the global economy that could pose a threat to an equitable recovery. Connections forged through global credit markets, international trade, foreign aid, and other areas create interdependencies. These connections have noticeably affected the recovery, perhaps best illustrated by the disruption of vital global supply chains through the temporary shutdown of factories, shipping, warehouses, and other essential infrastructure.

One important global risk is the uneven pace of recovery between advanced and emerging economies. The faster recovery in advanced economies is likely to precipitate an increase in global interest rates, which will expose public and private sector borrowers to refinancing risks and put downward pressure on the currencies of emerging economies. These risks are especially acute for low-income countries with high levels of foreign currency-denominated debt, and they create a dilemma for the central banks of emerging economies. If they do not follow the interest rate hikes in advanced economies, they face the risk of capital outflows and a depreciation of the national currency. However, if they raise interest rates, they risk dampening the domestic economy by exerting pressure on borrowers and increasing the cost of servicing domestic sovereign debt.

In view of these trade-offs, a carefully chosen policy mix that addresses interest rates, exchange rates, and macroprudential policy is crucial. This is especially important in countries with financial sectors

that rely on credit and capital markets for wholesale finance because financial institutions that cannot refinance themselves will have less capacity to supply credit during the recovery. It should also be a high priority in countries where state-owned enterprises account for a significant share of the economy. When state-owned enterprises cannot refinance short-term debt or service foreign currency debt, the risk of contingent liabilities for governments is even higher.

The recovery in emerging economies is also affected by economic growth in the rest of the world, and it could be impeded by slower growth in important emerging markets such as China. In view of China's role as the most important bilateral creditor for emerging economies, a protracted deleveraging of the Chinese banking sector could expose economies that previously borrowed heavily from China to sizable refinancing risks (see chapter 5). Moreover, a slowdown in Chinese economic activity could affect the economic recovery in emerging economies by reducing the global demand for their exports. For example, in 2020 China's share of the total trade of Sub-Saharan Africa was 26 percent, or about equal to the combined shares of the European Union and the United States.<sup>4</sup>

## Seizing the opportunity to build a more sustainable world economy

Recovery from the COVID-19 pandemic will call for far-reaching structural changes in economies around the world. This presents an enormous opportunity to accelerate the transformation to a more efficient and sustainable world economy. The consequences of climate change are already affecting lives and livelihoods in all countries. Although climate change is a global phenomenon, its impacts are felt most severely in low-income countries and low-income communities, where they compound existing vulnerabilities such as lack of access to clean water, low crop yields, food insecurity, and unsafe housing.

Governments and regulators have a variety of policy instruments at their disposal to support this transformation and adapt their economies to the realities of climate change, which is a major source of neglected risk in the world economy.<sup>5</sup> Governments can, for example, use the tax code to incentivize green investments, or central banks and supervisors could mandate higher risk provisioning for loans to sectors engaged in unsustainable activities that contribute to climate risks. Governments and central banks can also provide financing to lenders on preferential terms, conditional on meeting specific sustainability targets. Indeed, many countries have begun to use such regulatory incentives to accelerate the shift to a more sustainable economy. Such policies can have an important impact on the reallocation of financing to green sectors and technologies. In China, for example, green lending targets as well as regulation that incentivizes green lending have shifted bank lending portfolios toward sustainable sectors. Similarly, regulatory incentives can help the financial sector and activate a virtuous cycle by recognizing and pricing climate risks so that capital flows toward more sustainable firms and industries.<sup>6</sup> In the aftermath of the pandemic, governments have a unique opportunity to support the financial sector's ability to perform this role by, for example, mandating risk disclosures and phasing out preferential tax, auditing, and regulatory treatment for unsustainable industries.

## Notes

1. Daehler, Aizenman, and Jinjarak (2020).
2. Data from Organisation for Economic Co-operation and Development, Revenue Statistics 2021—Mexico (database), <https://www.oecd.org/tax/revenue-statistics-mexico.pdf>.
3. Eurostat (2020).
4. Data from International Monetary Fund, DOTS (Direction of Trade Statistics) (dashboard), <https://data.imf.org/?sk=9D6028D4-F14A-464C-A2F2-59B2CD424B85>.
5. See Gennaioli, Shleifer, and Vishny (2012); Stroebel and Wurgler (2021).
6. Carney (2015); Fender et al. (2020).



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