A World Bank Group Flagship Report

WORLD DEVELOPMENT REPORT 2022

FINANCE FOR AN **EQUITABLE RECOVERY**

WORLD BANK GROUP

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Foreword

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

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

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

This Report highlights several priority areas for action.

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

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

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

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

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

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

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

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

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

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

David Malpass
President
The World Bank Group

Preface

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

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

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

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

As the financial position of the public sector deteriorates as a result of higher sovereign debt and lower tax revenue, many governments find that they are less able to support economic activity.

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

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

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Abbreviations

ADR	alternative dispute resolution
AI	artificial intelligence
AMC	asset management company
AQR	asset quality review
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BNPL	buy now, pay later
BP	Banco Pichincha (Ecuador)
BRSS	Bank Regulation and Supervision Survey
CAC	collective action clause
CBI	Climate Bonds Initiative
CDBP	consolidated distance to break point
CESEE	Central, Eastern, and Southeastern Europe
CG	credit guarantee
CGAP	Consultative Group to Assist the Poor
CIRP	Corporate Insolvency Resolution Process
COVID-19	coronavirus disease 2019
CRILC	Central Repository of Information on Large Credits (India)
CRSP	credit reporting service provider
DE JURE	Data and Evidence for Justice Reform (World Bank project)
DSA	debt sustainability analysis
DSSI	Debt Service Suspension Initiative
EAP	East Asia and Pacific
ECA	Europe and Central Asia
ECB	European Central Bank
ECL	expected credit loss
ECLGS	Emergency Credit Line Guarantee Scheme
EU	European Union
EWT	early warning tool
FMCG	fast-moving consumer good
FSAP	Financial Sector Assessment Program (World Bank/IMF)
FSB	Financial Stability Board
FV	future value
G20	Group of Twenty
GBP	Green Bond Principles
GDP	gross domestic product
GTSF	Global Trade Supplier Finance Program (IFC)
HIPC	Heavily Indebted Poor Countries Initiative (IMF)

IADI	International Association of Deposit Insurers
IBBI	Insolvency and Bankruptcy Board of India
IBC	Insolvency and Bankruptcy Code (India)
ICMA	International Capital Market Association
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
MAS	Monetary Authority of Singapore
MDRI	Multilateral Debt Relief Initiative (IMF)
MENA	Middle East and North Africa
MFB	microfinance bank
MFI	microfinance institution
ML	machine learning
MSEs	micro- and small enterprises
MSMEs	micro-, small, and medium enterprises
NBFI	nonbank financial institution
NBMFC	nonbank microfinance company
NDCs	Nationally Determined Contributions (Paris Agreement)
NPL	nonperforming loan
NPV	net present value
OECD	Organisation for Economic Co-operation and Development
P&A	purchase and assumption
PAYGo	pay-as-you-go
PCGS	public credit guarantee scheme
RBI	Reserve Bank of India
SAR	South Asia Region; special administrative region
SDGs	Sustainable Development Goals
SMEs	small and medium enterprises
SOE	state-owned enterprise
SSA	Sub-Saharan Africa
suptech	supervision technology
UNCITRAL	United Nations Commission on International Trade Law
UTP	unlikely to pay
VAT	value added tax

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