A World Bank Group Flagship Report

WORLD DEVELOPMENT REPORT 2022

# FINANCE FOR AN EQUITABLE RECOVERY

## Policy Priorities

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# 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.

# 1 Emerging risks to the recovery

*The immediate economic effects of the COVID-19 pandemic were felt most acutely by households and firms, which experienced dramatic income losses. Financial risks resulting from these income losses can ultimately affect the entire economy through multiple, mutually reinforcing links that connect the financial health of households, firms, the financial sector, and government. Because of this interconnection, elevated financial risks in one sector can spill over and destabilize the economy as a whole. For example, income losses among businesses and households can create spillover risks for the financial and public sectors through rising loan defaults and reduced tax revenue. Similarly, the governments of many emerging economies were already heavily indebted before the pandemic and further increased borrowing to finance their crisis response. These relationships between sectors of an economy are not, however, deterministic. Well-designed fiscal, monetary, and financial sector policies can counteract and reduce these risks over time to support an equitable recovery.*

## Policy Priorities

The pandemic has increased economic risks for households, firms, financial institutions, and governments. Counteracting these risks to ensure an equitable recovery will require policy action in the following areas:

- **Recognizing and resolving asset distress in the financial sector** as support measures for households and firms are scaled back before economic activity has fully recovered.
- **Supporting insolvent households and businesses** that are unable to resolve their debts in countries with limited or no formal insolvency mechanisms.
- **Ensuring continued access to finance** in the face of tightening lending standards resulting from increased economic uncertainty and greater opacity about the true financial health of borrowers.
- **Managing and reducing high levels of government debt,** especially in countries that entered the pandemic with a high risk of debt distress.

# 2

# Resolving bank asset distress

*Debt moratoria, loan forbearance, and the relaxation of classification and provisioning rules during the COVID-19 crisis have created a lack of transparency about the health of bank balance sheets, particularly in the recognition of nonperforming loans (NPLs). Although not yet visible in reported asset quality indicators, rising borrower distress is likely to translate into rising NPL levels. If left unaddressed, high levels could reduce overall lending volumes and affect the financial sector's capacity to support economic activity. Such an outcome can be particularly harmful to small businesses and lower-income households. To reduce these risks, banks should identify and report problem loans accurately and manage revealed exposures while under strong supervisory oversight.*

## Policy Priorities

The pandemic and the related government policies have reduced the transparency of bank balance sheets. For banking sectors vulnerable to rapid increases in NPLs, the following timely corrective policies to preserve financial stability will help to support the continued provision of credit:

- **Ensuring clear, consistent practices for reporting on asset quality,** enforced by effective supervision and with strong incentives to encourage speed and transparency.
- **Developing the capacity to manage nonperforming loans** to avoid a rapid increase in bad loans impairing the capacity of banks to finance the real economy.
- **Dealing with problem banks swiftly** to prevent broad distress in the financial system, misallocation of financial resources, and failure in the provision of credit.

# 3 Restructuring firm and household debt

*The COVID-19–induced economic crisis and the temporary government measures intended to protect firms and households from bankruptcy have created unprecedented opacity about the financial health of households and businesses. Some borrowers are temporarily short on liquid assets, while others are facing longer-term structural difficulties and should exit the market. The challenge, then, is sorting the illiquid from the insolvent. Historically, court-led bankruptcy systems have performed this sorting function, and so these systems are scrutinized in times of financial crisis. Effective insolvency systems can help to quickly resolve high levels of debt distress to prevent collapse of the financial sector without relying on costlier forms of policy intervention. Reforms to strengthen bankruptcy systems also improve the underlying economic conditions and so are critical to an equitable recovery. This chapter lays out a blueprint for bankruptcy reforms that will help governments manage high levels of debt distress while laying the groundwork for economic recovery.*

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Countries can mitigate the risk of an onslaught of insolvent households and businesses by investing in four policy reforms:

- **Strengthening formal insolvency mechanisms** so that the rules that define the rights and behaviors of debtors and creditors are in place, giving each an incentive to negotiate and come to an agreement, whether in court or out of court.
- **Facilitating alternative dispute resolution systems such as conciliation and mediation** to enable faster and cheaper resolution of disputes than in the formal court system, but with some of the rigor that courts provide.
- **Establishing accessible and inexpensive in-court and out-of-court debt resolution procedures for micro-, small, and medium enterprises** to facilitate the recapitalization of viable but illiquid firms and the swift, efficient market exit of nonviable firms. Rules designed for small entities can help resolve their debts more quickly and cheaply with less burden on the judicial system than requiring the same rules regardless of firm size.
- **Promoting debt forgiveness and discharge of natural person debtors** so that solo entrepreneurs and individuals unable to pay their debts—through no fault of their own—can be discharged of those debts and more quickly move on from them, avoiding the stigma and loss of productivity that come from long-term debt distress.

# 4 Lending during the recovery and beyond

*The ongoing impact of the COVID-19 crisis on business performance and household incomes could inhibit new lending because of increased credit risk. Risk can be mitigated by better visibility into borrower viability and improved recourse in the event of default. Reassessing credit models to take into account the "new normal," as well as innovations in digital finance that leverage alternative data and tailor loans to the borrower and the lending environment, can help keep credit flowing. Regulatory frameworks that enable innovation can support credit in the recovery while ensuring consumer and market protections.*

## Policy Priorities

Mitigating the environment of uncertainty and the lack of transparency that are making the traditional approaches to measuring risk less effective calls for the following measures:

- **Creating an enabling environment to leverage alternative data.** Lenders should look to adapt underwriting approaches, with support from supervisory model validation and regulatory frameworks that open access to data while ensuring privacy and consumer protection.
- **Embracing innovations in product design and embedded finance** that tailor loans to customer and market conditions or link credit to underlying business transactions to increase visibility and improve recourse.
- **Providing well-tuned guarantee programs** where needed to bridge the gap between lenders' risk aversion and the role of credit as a driver of an equitable recovery.
- **Advancing the regulatory framework and financial infrastructure** to support innovation; adjust the regulatory perimeter; provide clear, effective, and enforceable consumer and market protections; and facilitate digital payments, information exchange, and asset registration.

# 5 Managing sovereign debt

*Governments around the world mobilized enormous resources to pay for the COVID-19 pandemic response. Many emerging economies, already heavily indebted at the outset of the crisis, took on additional debt to support households and firms. During 2020, this led to an increase in the total debt burden for low- and middle-income countries of 9 percentage points of gross domestic product (GDP), compared with an average annual increase of 1.9 percentage points over the previous decade. Managing and reducing elevated levels of sovereign debt improve the ability of governments to continue providing support through the recovery, especially to low-income households and small businesses, which is key to ensure an equitable recovery. However, coordination between debtors and creditors has become more difficult than in previous crises because of the greater number of creditors and the higher participation of commercial and nontraditional creditors in the market for sovereign debt.*

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Governments can take proactive policy approaches to mitigating the risks posed by high levels of sovereign debt to an equitable recovery:

- **Governments at high risk of debt distress can pursue proactive debt management approaches** with creditors through, for example, debt reprofiling, which replaces existing debts with new debt with a different currency or maturity profile.
- **Governments in debt distress must coordinate with creditors to restructure debt.** Effective restructuring requires the prompt and comprehensive recognition of debts, coordination with and among creditors, and a medium-term plan of reforms needed to achieve debt sustainability.
- **Governments and their creditors can benefit from improvements in sovereign debt transparency,** which requires comprehensive disclosure of claims against the government and terms of the contracts that govern the debt.
- **Contractual innovations can help overcome coordination problems and speed up the resolution of unsustainable debts,** but they are not a universal cure.
- **Well-developed tax policy and investments in tax administration can support debt sustainability in the longer run** by increasing the government's ability to mobilize revenue.

# 6 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.

The COVID-19 pandemic triggered the largest global economic crisis in more than a century. In 2020, economic activity contracted in 90 percent of countries, the world economy shrank by about 3 percent, and global poverty increased for the first time in a generation. Governments responded rapidly with fiscal, monetary, and financial policies that alleviated the worst immediate economic impacts of the crisis. Yet the world must still contend with the significant longer-term financial and economic risks caused by, or exacerbated by, the pandemic and the government responses needed to mitigate its effects.

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

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