## 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 overindebtedness, increased financial fragility, and a general erosion in transparency. Emerging economies have been left with very limited fiscal space, and they will be made even more vulnerable by the impending normalization of monetary policy in advanced economies.

This Report highlights several priority areas for action.

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

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

The corporate-government nexus is another potential source of contingent liabilities and hidden debt. State-owned utilities have been asked to delay increases in tariffs and

accept arrears in bill collection. Concessions and public-private partnerships have faced dramatic declines in revenue. Sooner or later, the losses could end up on the budget. Meanwhile, borrowing from foreign state-owned enterprises often escapes the surveillance of debt management agencies. These contingent liabilities and parastatal loans can raise significant financial risks in low-income and some emerging market countries.

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

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

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

Finally, it is critical to work toward broad-based access to finance. Low-income house-holds 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.

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