

THE REVERSAL PROBLEM: DEVELOPMENT GOING BACKWARDS

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Credibility of Emerging Markets, Foreign Investors' Risk Perceptions, and Capital Flows

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THE REVERSAL PROBLEM: DEVELOPMENT GOING BACKWARDS

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The Covid-19 pandemic triggered the most synchronous economic downturn in more than a century. Ninety percent of countries posted a decline in real per-capita GDP in 2020, a share that surpassed any other year since 1900, which includes two world wars and the Great Depression of the 1930s.¹ The health crisis pushed an estimated 90 million people into extreme poverty.² We document that, for emerging and developing economies (EMDEs) as a group, the setback in their development markers did not start with the pandemic. Covid-19 deepened and accelerated a troubling trend of economic backsliding that had appeared around half a decade earlier. We call this the Reversal Problem.

In the 21st century, several benign trends emerged in EMDEs: progress on poverty reduction, a narrowing of the gap between rich and poor nations, higher growth rates in per-capita incomes, and a much lower incidence of economic crises. Gender equality gained a stronger footing, and many social indicators improved. Yet a turning point around 2015, marked by the largest decline in commodity prices since the early 1980s, began to chip away at these gains in development. The setback in economic and social conditions was already broadly synchronized when Covid-19 hit the global economy.

1. Holston and Reinhart (2022).

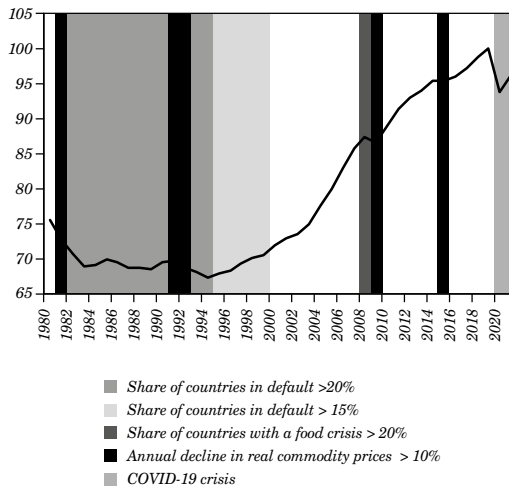
2. Mahler, Daniel Gerszon & Yonzan, Nishant & Lakner, Christoph, 2022. "The Impact of Covid-19 on Global Inequality and Poverty," Policy Research Working Paper Series 10198, The World Bank.

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The Reversal Problem is widespread in terms of geography, though more acute in Africa and other low-income regions. It is also encompassing in that it not only affects economic and social indicators but is potentially politically destabilizing internally and across national borders, as these trends appear to coincide with a setback in democratic values.

We take a step back and review the bonanza years, which roughly span 2000–2015 and followed the calamitous 1980s (and somewhat better 1990s), which marked an earlier *reversal in development* in scores of low- and middle-income countries (figure 1, table 1). We document these trends with an encompassing array of indicators. The commonality in these economic, social, and political indicators is that they follow a distinctive U-shaped pattern, from worse to better and back to worse, indicating that, across many dimensions, EMDEs as a group have been moving from progress to stagnation to reversal.

Figure 1. The Big Picture: Real Per-capita GDP EMDEs Unweighted Average, 1980–2021 Index 2019 = 100



Sources: World Economic Outlook, IMF; Farah and others (2022).

Table 1. Real per-capita GDP

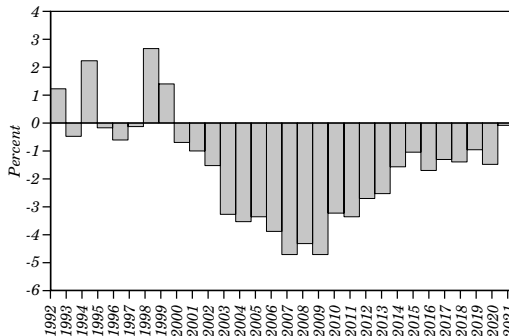
<i>Period</i>	<i>Change</i>	<i>Period</i>	<i>Change</i>
1980–1994	-0.8	2010–2014	2.0
1995–2000	1.2	2015–2019	1.0
2001–2007	2.8	2020–2021	-1.9
2008–2009	0.5		

Source: Authors' calculations.

1. THE BONANZA YEARS

The EMDE debt overhang of the 1980s was ultimately addressed in the early 1990s for middle-income countries by the Brady Plan and, some years later, for the low-income ones through the Heavily Indebted Poor Countries (HIPC) debt relief initiative. The resolution of protracted debt crises paved the way for recovery. For EMDEs, the first decade of the 21st century was one of high growth by historic standards, as growth in per-capita GDP outstripped that of advanced economies (AEs) by a widening margin (figure 2). The share of EMDEs with negative 5-year real GDP growth declined from 40 percent in the early 1990s to less than 10 percent in 2008. Social conditions improved significantly as compared to the previous two decades, with considerable declines in poverty rates and a more equitable income distribution.

Figure 2. Real Per-capita GDP Growth Differential: AEs Less EMDEs, 1992–2021
(in percent)



Source: Authors' calculations and World Economic Outlook, IMF.

Robust economic growth allowed EMDEs to improve their fiscal and external positions and strengthen their financial-sector policy frameworks. The incidence of high inflation and debt and financial crises, which dealt devastating setbacks to growth in many EMDEs from the 1970s to 1990s, saw a significant reduction.³ Subdued inflation allowed central banks to maintain comparatively low policy rates, and rising international reserves strengthened external buffers. EMDE current-account deficits narrowed, on average, from 3.5 percent of GDP in 2001 to 1.2 percent of GDP in 2007. About 70 percent of EMDEs increased their international reserves-to-external-debt ratio by more than 10 percentage points, while one-quarter posted increases of more than 50 percentage points. Many EMDEs faced the 2009 global recession with greater resilience than in the past.

Sustained growth helped reduce global poverty and inequality. The number of countries classified as 'low-income' declined from 66 in 2001 to 31 in 2015. Extreme poverty fell from 30 percent of the global population in 2000 to 10 percent in 2015. Between-country inequality improved, halving the global Gini index between 2000 and 2015. In most EMDEs, within-country inequality also declined. In Latin America, for instance, from 2000 to 2015, more than 50 million people were lifted out of poverty and the middle class swelled to more than a third of the population. Educational gaps were reduced. For example, between 2000 and 2017, in India and Nigeria, rates of secondary attainment increased from 10.9 to 37.2 percent and from 11.5 to 45 percent, respectively.

In sum, the first 15 years of this century is the only period since at least 1950 that has delivered a sustained EMDE outperformance. However, the new prosperity possibly owed less to a lasting shift in EMDE's fundamentals than to sustained favorable external conditions. An important factor was China's rapid investment-led growth, which lifted global commodity prices and fueled the longest commodity boom since the early 19th century. Another engine of growth was the surge in world trade, which as a share of world GDP, rose from less than 40 percent in 1990 to over 60 percent in 2011. Importantly, globalized finance and low interest rates in financial centers incentivized risk-taking; investors sought opportunities in emerging markets. Gross capital inflows to EMDEs excluding foreign direct investment swelled nearly seven-fold (from 1 percent of GDP in 2001 to 6.5 percent in 2007).

3. See Reinhart and Rogoff (2009).

2. THE ONSET OF THE REVERSAL PROBLEM

During 2015–2019, real per-capita GDP growth in EMDEs slowed markedly, averaging one percent or one half the growth rate of the previous five years, and about a third of the 2000–2007 rate (table 1). The economic slowdown was followed by the Covid-19 outbreak. While 2020 was an abysmal year for most countries, preliminary data indicate that 2021 delivered a regressive and uneven rebound. As table 2 highlights, 2021 marked a new peak in per-capita income in more than a third of AEs. By contrast, for middle- and low-income EMDEs, the share of countries at peak per-capita GDP in 2021 is much lower, about 21 percent and 12 percent, respectively. Put differently, between 80 and 90 percent of EMDEs were below their prior per-capita income levels, let alone the levels that would have prevailed had output followed its pre-crisis trend. Mounting evidence suggests that the crisis may have lasting effects on growth through its impact on human capital and income inequality.

The scale and breadth of the economic setback are evident in other macroeconomic variables. The re-emergence of debt problems, particularly in low-income countries, figures prominently in the Reversal Problem. Levels of public indebtedness also follow a distinctive U-shaped pattern (figure 3).

EMDEs managed to weather the 2008–2009 crisis thanks to fiscal buffers and sustained deleveraging during the years leading up to that crisis, but since then, debt and budget deficits have risen steadily, thus denting resilience. The fiscal health of commodity-exporting EMDEs deteriorated sharply since the end of the commodity super-cycle in 2013–2014. The setback in public finances has been mirrored in a reverse-U in the sovereign credit ratings of EMDEs, as the steady improvement in ratings during the high-growth era was replaced by recurrent downgrades (figure 4). While public debt loads were mounting in most EMDEs well before 2019, the pandemic-induced crash in economic activity and government revenues pushed several ‘graduates’ of the Brady and HIPC plans back into debt distress territory.

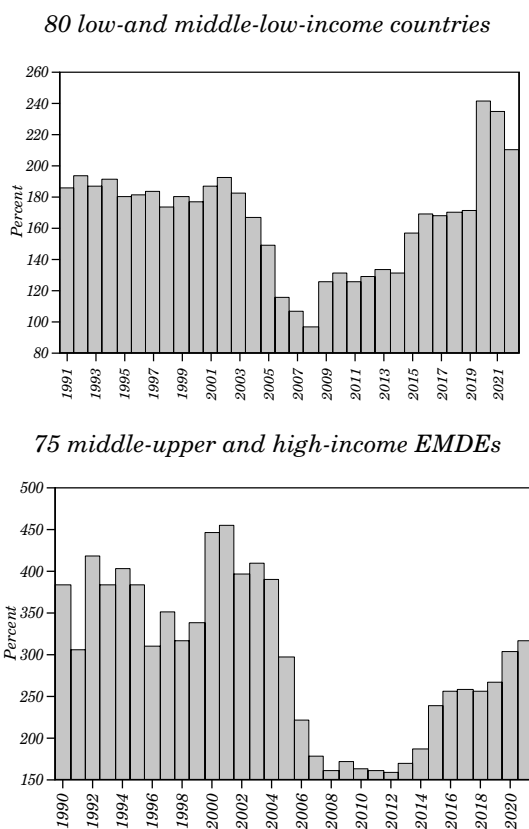
The reversal in inflation is of a more recent vintage and common to AEs. In a manner reminiscent of 2008, although on a lesser scale (to date), food price inflation, with its regressive impacts, has also reemerged. The rekindling of inflationary pressures, even prior to the Russia-Ukraine war, was proving to be more persistent than anticipated by many central banks and will represent a challenge to the relatively new-found central-bank independence in EMDEs.

Table 2. Per-capita GDP, Peak Versus 2021: 1980–2021, 194 Countries

	<i>Advanced economies</i>		<i>Middle-income</i>		<i>Low-income</i>	
	Number of countries	Share (%)	Number of countries	Share (%)	Number of countries	Share (%)
2021 = peak	13	35.1	27	20.6	3	11.5
2021 < peak	24	64.9	104	79.4	23	88.5
Total	37	100	131	100	26	100

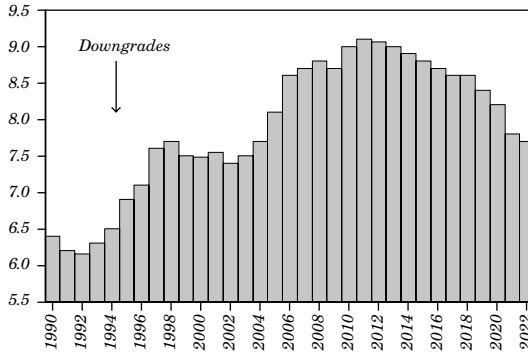
Sources: World Economic Outlook, IMF; and Holston and Reinhart (2022).

Figure 3. General Government Debt-to-Revenue Ratio: EMDEs, 1990–2021
(in percent)



Source: Authors' calculations and World Economic Outlook, IMF.

Figure 4. The Reverse U: Fitch, Institutional Investors, Moody's, and S&P Sovereign Ratings: Average Numeric Score: EMDEs, 1990.1–2022.3



Sources: Authors' calculations based on data from Fitch, Institutional Investors, Moody's, and S&P Sovereign Ratings.

3. THE REVERSAL IN SHARED PROSPERITY

Following two decades of progress in terms of shared prosperity, reductions in poverty reduction have also suffered a marked reversal. The world made extraordinary progress in reducing poverty at the turn of the century. However, the sustained decline in extreme poverty that began in the 1990s was already stalling in the pre-Covid-19 decade. As the health crisis persisted, stalling morphed into outright reversal. According to the World Bank, from 1990 to 2015, extreme global poverty dropped by an average of about 1 percentage point per year, but this pace slowed from 2013 to 2015 to 0.6 percentage point per year before slowing further in the years before Covid-19.

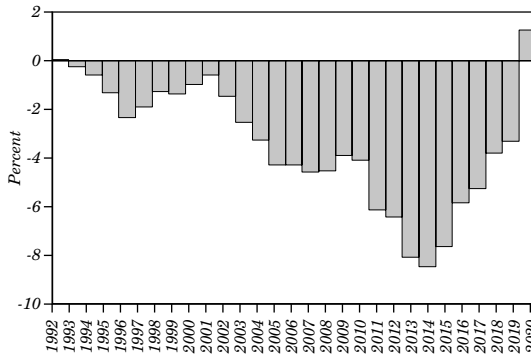
The slowdown in global poverty reduction is partly accounted for by the increasing concentration of extreme poverty in two regions: Sub-Saharan Africa, which has experienced a slower reduction in poverty than any other region, and poverty spikes in the Middle East and North Africa, where extreme-poverty rates nearly doubled between 2015 and 2018, from 3.8 percent to 7.2 percent, spurred by the ongoing conflicts.⁴

The poverty reversal can be gleaned from the share of countries that have higher levels of extreme poverty than the average during the prior 5 years (figure 5). From 1995 to 2008, the share of worsening cases dropped from 42 percent of EMDEs to less than 10, but progress

4. World Bank (2022).

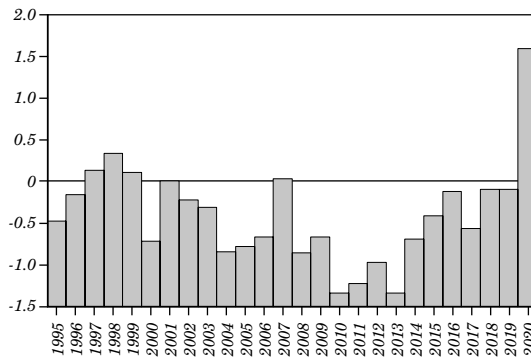
stalled, and the share climbed back to 18 percent in 2019 before surging to almost 42 percent in 2020 amid the pandemic. After the initial Covid-19 impact, extreme poverty has continued to increase. World Bank estimates suggest that the Covid-19-induced extreme poverty is set to rise by 0.9 percentage points and even more in Sub-Saharan Africa.⁵

Figure 5. Annual Change in the Global Poverty Rate, 1992–2020
(moving 5-year average, in percent)



Sources: Authors' calculations based on data from Mahler and others (2022).
Notes: This chart shows the 5-year rolling average of the annual percent change in the global poverty rate (\$1.90 poverty line), using the global distributions in the Poverty and Inequality Portal (PIP) for the historical series and the simulations by Mahler and others (2022).

Figure 6. Income Inequality: Global Gini, 1995–2020
Rolling 5-year Average of Annual Change



Source: Authors' calculations and Mahler and others (2022).
Note: This chart shows the annual percentage change in the global Gini index (5-year moving average), using the global distributions in PIP for the historical series and the simulations conducted by Mahler and others (2022).

5. Cojocaru and others (2022).

The pandemic has been particularly harsh on the urban poor and, notably, women. In many cases, the Covid-19 rise in inequality reinforced trends already in place and clawed back earlier progress. Faster economic growth during 2000–2010 facilitated a decline in within-country income inequality globally, albeit from historically high levels in the 1990s and early 2000s. Income inequality declined in more than 60 percent of EMDEs, as measured by the Gini Index. As with poverty reduction, improvement had stalled in the years prior to the pandemic, when the reversal materialized in earnest. In stark contrast to the Global Financial Crisis of 2008–10, the lagging economic recovery in EMDEs compared with AEs has raised between-country income inequality (table 2 and figure 6). According to the Gini and Theil indices, between-country inequality reverted to the levels of the early 2010s. Within-country income inequality in EMDEs has also increased in 2020 (by about 0.3 points), reversing the steady decline since the 2000s.⁶

4. THE HUMAN CAPITAL REVERSAL

The rise in income inequality is already significant and it is poised to climb further over the medium term. The accumulation of human capital has been severely disrupted in most EMDEs, but the pandemic has had a disproportionate impact on children from low-income households. The long-term consequences of students missing many days of school and some, notably girls, not returning to the classroom cannot be underestimated as a fault line in the development process.

School closures affected 1.6 billion children across the globe,⁷ but lower- and middle-income countries have closed schools for far longer than their higher-income counterparts. In parts of South Asia, Latin America, and Africa, schools have been closed for over 80 weeks. Uganda, which reopened schools in January 2022, topped the charts with 82 weeks of partial or full closure. Recent research suggests that, in Latin America, the likelihood that today's students will complete secondary education has dropped from a regional average of 61 percent to 46 percent (figure 7), but averages mask the striking differences across socioeconomic groups. Although school closures affected all students, their ability to continue learning depended on their parents' income and educational level. Children in disadvantaged households found it difficult, if not impossible, to continue their education at

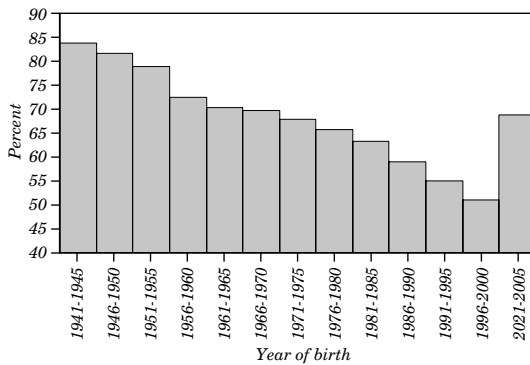
6. Adarov (2022).

7. World Bank (2021a).

home due to a lack of adequate equipment, connectivity, and one-on-one coaching by well-educated parents.⁸ For these children, the odds of completing secondary school may be closer to 32 percent, a level of educational attainment that was last reported for cohorts born in the 1960s.

Covid-19 has also set back the provision of health services in EMDEs. Evidence compiled by the World Health Organization and the World Bank shows that the Covid-19 pandemic is likely to halt two decades of global progress toward Universal Health Coverage.⁹ Many EMDEs had made progress on service coverage and, by 2019, 68 percent of the world's population was covered by essential health services, such as pre- and post-natal care, immunization services, treatment for diseases like HIV, TB, and malaria, and services to diagnose and treat noncommunicable diseases like cancer and diabetes. The pandemic disrupted regular health services and stretched countries' health systems. As a result, for instance, immunization coverage dropped for the first time in ten years, and the incidence of deaths from TB and malaria has increased.

Figure 7. Likelihood that Disadvantaged Children do not Complete Secondary Education: Latin America, 1941–2005



Sources: Neidhöfer and others (2021) based on data from Latinobarometro.

Notes: This chart shows the likelihood that children, whose parents have less than secondary education, will complete secondary education. Unweighted average.

8. World Bank (2021b).

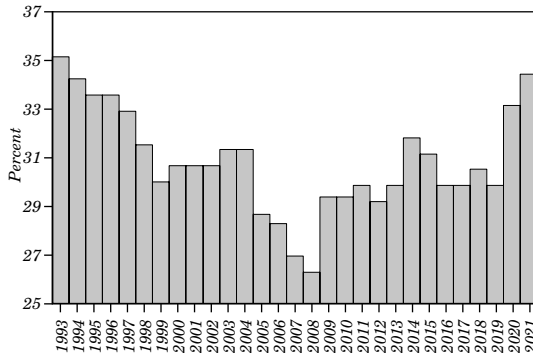
9. World Bank (2021c).

5. POLITICAL REVERSALS

Slower growth, increasing poverty and inequality, and dissatisfaction with the quality of public services, particularly evident in the (mis) management of the pandemic in many EMDEs, are contributing to dissatisfaction with governments and democratic values. According to data collected by *Freedom House*, the share of countries that are ‘not free’ has followed a U-shaped pattern that mimics what we observe in other economic and social indicators.¹⁰ Societies around the world are experiencing radical political fractures that were deemed long gone. These manifestations preceded the pandemic but have spiked in the past two years.

Violent conflicts have increased¹¹ to the highest levels observed over the past three decades, thus affecting both low- and middle-income countries, and there were some 80 million forcibly displaced people worldwide as of the end of 2019, the highest number recorded. Russia’s invasion of Ukraine is adding to those numbers daily (Figure 9).

Figure 8. Share of Countries that are Not Free, 1993–2021



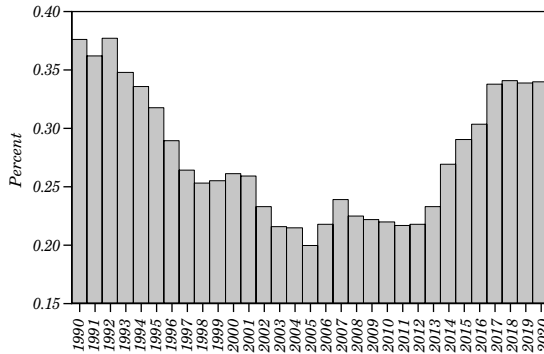
Source: Freedom House.

Note: This chart shows the percentage of 191 countries that have been classified as Not Free by Freedom in the World. For each country and territory, Freedom in the World analyzes the electoral process, political pluralism and participation, the functioning of the government, freedom of expression and belief, associational and organizational rights, the rule of law, and personal autonomy and individual rights.

10. See notes to figure 8.

11. World Bank (2020).

Figure 9. Refugees as a Percentage of World Population, 1990–2021



Source: World Bank World Development Indicators (2022).

6. FINAL THOUGHTS

The Covid-19 crisis has set back many of the development markers where significant progress had been achieved, especially so in the many countries where the economic and social fundamentals had already started to backslide prior to the pandemic. While the setbacks are more acute in low-income countries, the trend is far more encompassing among EMDEs. If the past is any guide, policy reversals often follow closely on the heels of ‘bad times’. Policy reversals, in turn, set the stage for self-reinforcing economic and social setbacks. The international community and the AEs must come to terms with the heightened risks of delaying coordinated assistance replaying the calamitous 1980s. While the extent of the development Reversal Problem described here is not *yet* on the scale development reversals of 40 years ago, there are added new risks posed by climate change that will disproportionately harm EMDEs.

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