

# GREEN MOUNTAINS ARE AS VALUABLE AS GOLD & SILVER MOUNTAINS

President Xi Jinping

Emerging markets and ESG: The challenge,  
the response and the opportunity

# Emerging markets and ESG: The challenge, the response and the opportunity

The carbon-based model of industrialisation is coming to an end. Emerging market governments have the opportunity to become trailblazers for the next era, one where ESG will play a pivotal role. The scale of the task and its urgency has been accelerated by awareness of climate change and its potential to hit the poorest countries the hardest. Strategic Advisor **David Dowsett** argues that the stars are aligning for an upsurge in ESG-related investment in emerging markets.

Emerging markets (EM) have so far replicated the developed world's fossil fuel-driven growth model. The pace of industrialisation in China and India may have been 10 times that of the UK in the 18th century, but the resource-intensive and environmentally destructive nature of growth has been the same.

This growth model has thus far been extremely successful in improving living standards in EM. The growth of the middle class in the developing world has been, and, in my view, will continue to be, the defining feature of the global economic outlook. However, it must be recognised that this global growth model is encountering significant environmental and social constraints.

At an environmental level, although the developing world is not the main culprit regarding the elevated levels of carbon dioxide in our atmosphere, it is most at risk from associated climate change issues.

At a societal level, the next wave of EM growth will only occur if health levels improve, gender imbalances are resolved and demographic change is sensibly managed.

In this article, I will argue that the ESG case for EM is the investment case.

*“Without meaningful improvement in a wide variety of environmental and social goals, progress on the more traditional economic indicators will become impossible.”*

This is a task that needs to be spearheaded by governments within EM. Only they can introduce the wholesale structural reorganisations necessary for economic change. The good news is that many EM governments are already aware of and embracing this challenge. I believe that they can act as trailblazers from which the developed world can learn.

I also believe that environmental and social change can be the most effective catalyst to improved governability. Many of the weakest governance stories in EM are commodity-rich countries that have used resource revenues as an effective weapon for repression.

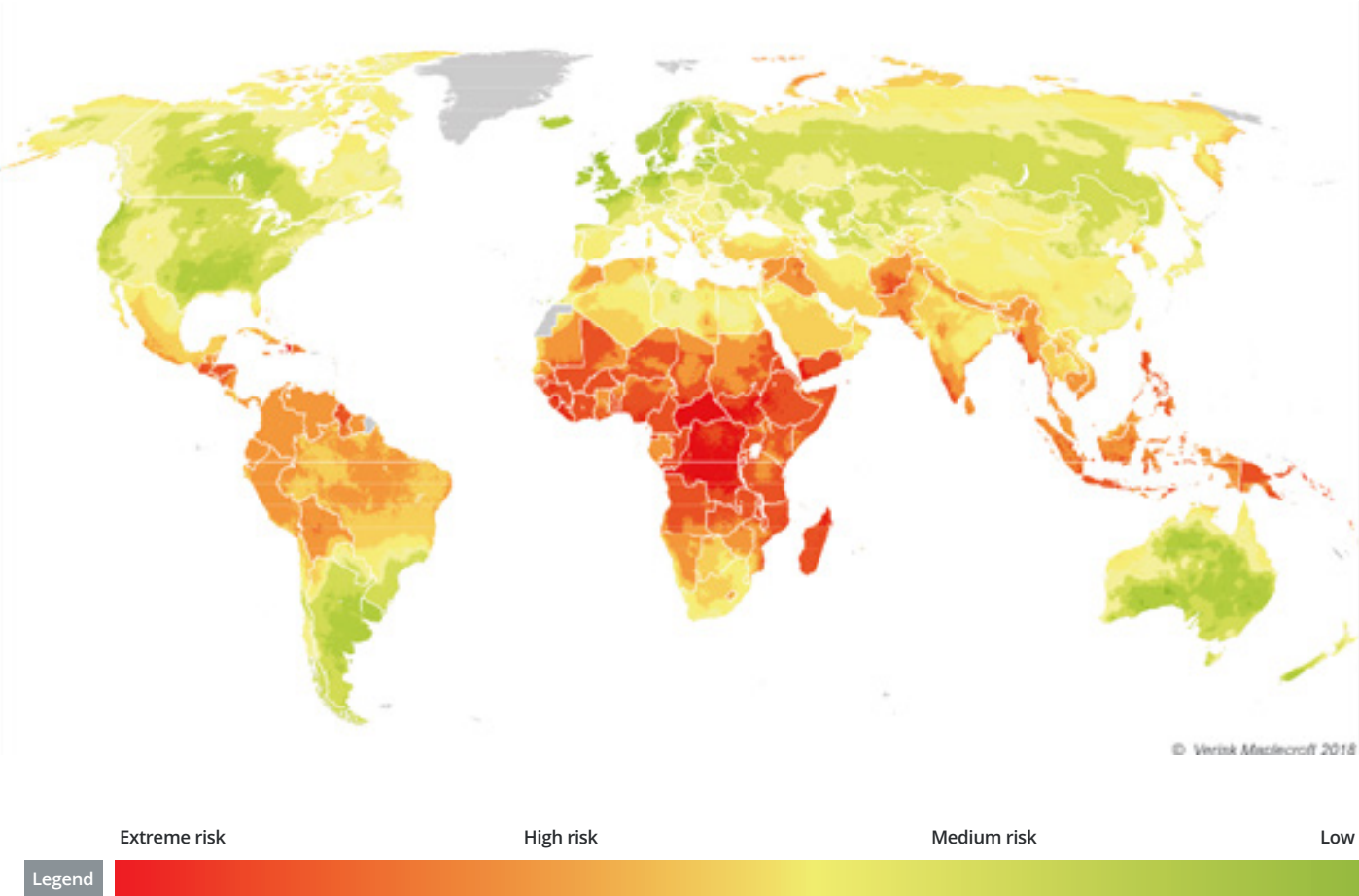


# The environmental threat

Climate change is an emotive topic. In the Western world, disputes about its pace and the severity of the threat are a political football. What seems beyond dispute, however, is that EM is faced with a variety of environmental threats. Some of these have been caused by their own explosive growth experiences

and some are a result of broader atmospheric change. These are now unavoidable and present a direct threat to social cohesion. As Chart 1 shows, the world's poorest are the most at risk with the least resources to protect themselves.

CHART 1: CLIMATE CHANGE VULNERABILITY INDEX



## The five worst-performing countries

Rank	Country	Region	Score	Category
1	Central African Republic	Africa	0.00	Extreme
2	Haiti	Americas	0.15	Extreme
3	DR Congo	Africa	0.25	Extreme
4	South Sudan	Africa	0.37	Extreme
5	Liberia	Africa	0.41	Extreme

## The five best-performing countries

Rank	Country	Region	Score	Category
191	Denmark	Europe	10.00	Low
190	United Kingdom	Europe	9.93	Low
189	Uruguay	Americas	9.93	Low
188	Ireland	Europe	9.91	Low
187	Iceland	Europe	9.85	Low

Source: Verisk Maplecroft, 2018



As a sometime visitor to South Florida, I am well acquainted with the problems that rising sea levels are causing in Miami and the Barrier Islands, but these surely pale into insignificance compared to the challenges faced by a country like Bangladesh. A country of 180 million people in an area about the same size as Iowa faces losing 20% of its land to rising seas by 2050.

There are so many facts one could use to illustrate the environmental challenge that EM faces that it is hard to be selective. Nonetheless, the scale of the problem is critical however you look at it.

## China



In 2015, none of the 300 cities the Chinese monitor for air quality met World Health Organisation standards.



Over the past 25 years, 28,000 Chinese rivers have disappeared.



Beijing is sinking at a rate of four inches per year because of land subsidence.

## Sub-Saharan Africa



Women who don't attend school give birth 6.7 times on average, compared with an average of 3.9 times for those who do.



According to UN estimates, the total African population is set to increase from 1.2 billion in 2015 to 4.5 billion in 2100 on current trends, despite declining crop yields due to soil erosion from overuse.

## Egypt



75% of whose population is under 25 years, may run out of water by 2025.

## Global



A fifth of the world's rice is grown in the Nile, Mekong and Ganges river deltas, all of which are at direct risk of flooding as sea levels rise. This is a direct food security risk for these regions, as well as having global implications.

## India



India is the third-largest economy in the world in PPP terms and yet 160 million people are without access to clean water.

# The environmental response

The good news is that EM are not blind to these problems or idle in their response. In contrast to the developed world, there can be little dispute about the veracity of the threat given the immediacy of the challenge.

## The importance of China

As with many things in the emerging world, it is hard to escape the importance of China when considering environmental change. For China, environmental improvement is a necessity.

As Chart 2 shows, China's initial development was extremely environmentally unbalanced as it ramped up coal consumption and fossil-fuel driven electric power generation on joining the World Trade Organisation in 2001. This has created new risks that, if not properly addressed, threaten continued Communist Party rule. For reasons of both national security and self-preservation, the Communist Party must change tack.

As early as **2013**, it was acknowledged within China that environmental degradation was the most likely source of social unrest. This was about the time the US embassy in Beijing started tweeting air quality levels.

In **2014**, Li Keqiang declared *"war on pollution"*.

In **2018**, President Xi empowered the Ministry of Environment by assigning more weight to the environment than GDP growth when assessing local party cadres for promotion.

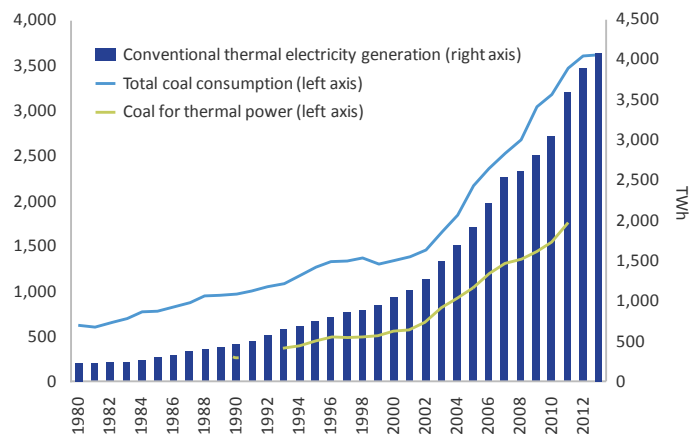
In terms of legislation, in **2009** China passed the law for the promotion of the circular economy, therefore becoming the first country in the world to introduce this concept as part of its national development plan.

## Circular economics

Simply put, a circular economy envisages the interconnectedness of all industrial processes using all the resources (including 'waste') from one section of the process for use in the next, including the final product.

In some ways, it is ironic that China has become a leader in this field given the focus on its annual GDP performance. GDP is a classic linear measurement in which a collection of inputs leads to one output. In the circular economy, the emphasis becomes more on regeneration, using inputs in different ways again and again.

CHART 2: CHINA'S 'BLACK' FACE: BUILD-UP OF THERMAL POWER



Source: Adapted from Mathews and Tan (2013)

China's commitment to the concept was reiterated in the 12th Five Year Plan (2010):

*"The importance of building a resource-saving and environmentally friendly society should be stressed to save energy, reduce greenhouse emissions and actively tackle global climate change. We should develop a circular economy and low carbon technologies."*

This was strong guidance as to the Communist Party's intent. It was accompanied by explicit targets to increase water efficiency and non-fossil fuel usage, as well as ones to decrease CO<sub>2</sub> emissions and those of major pollutants. These targets were both reiterated and measured in the 13th Five Year Plan.

## Do actions speak louder than words?

It is easy to be cynical about such targets. On my travels in Yunnan Province in 2018, I witnessed huge build-ups of rubbish, factories belching out waste into rivers and seemingly unstructured development. Environmental progress in China will be a multi-decade effort. However, significant progress is already occurring.

- China now adds more generating capacity in hydro and renewable energy than through conventional and nuclear power stations.
- Its renewable energy industry is larger than the entire French and German power systems.
- China has five of the world's six-largest solar module manufacturing firms, the largest wind turbine manufacturer and largest lithium ion manufacturer.

Chart 3 shows how energy production will transition to renewables. Renewables should constitute the majority of production by 2022/3.

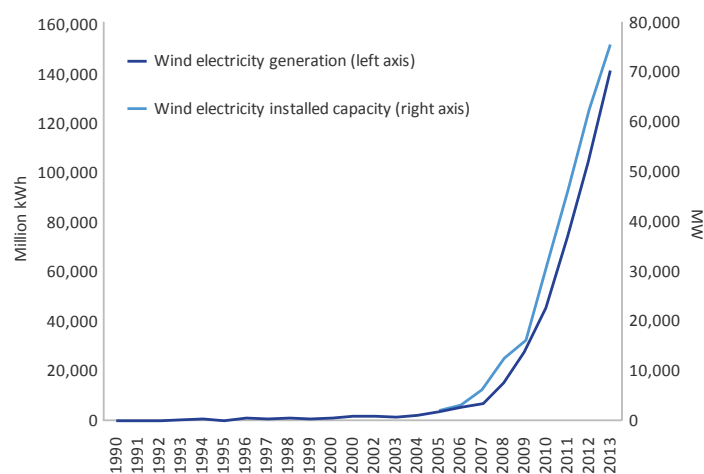
Elsewhere in EM, **South Korea** is coming to the end of its second five-year plan for green growth, which targets government spending of 2% of GDP on green-growth projects. In India, the government has created a Ministry of New and Renewable Energy, and solar production has tripled in the past three years.

In **Brazil**, the election of Jair Bolsonaro poses a threat to the country's commitment to environmental change.

Nevertheless, the issue of Amazonian deforestation has meant that green concerns have long had visibility.

Although subject to some controversy about whether it accelerated deforestation, ethanol production has given Brazil the world's first sustainable biofuels industry. Flex fuel cars make up the vast majority of vehicles sold there. In June 2018, Brazil produced 88% of its energy needs from renewables. This compares with 14% in the US, 27% in the UK and 31% in Germany. The investment needs in Brazil are still large, but the commitment to sustainable sources of energy is likely to outlast the new president.

CHART 3: CHINA'S 'GREEN' FACE: BUILD-UP OF WIND POWER



Source: Adapted from Mathews and Tan (2013)



# The social challenge

## Why do people invest in EM?

The obvious answer is that the return-seeking opportunities in less developed economies more than compensate for the extra risk associated with investing outside one's home market.

For this to be the case there has to be **an assumption of progress**. This progress is normally represented by growth, which in turn raises living standards and earnings potential. In this sense, every EM investment is an investment in the developmental potential of the asset class. It is a belief that common social indicators will improve. Classic social indicators in the ESG literature, such as poverty and social exclusion levels, employment and health indicators and food security, have always been developmental goals for EM countries.

Despite the economic progress made by EM countries over the past 20 years, the social challenge is still immense. It remains the case that:

- There are still roughly a billion people in the world who live on less than USD2 a day. All of them live in EM countries.
- According to World Bank and CIA data, the 80 countries in the world with the worst GINI coefficients (a measure of income inequality) are all EM countries.
- 27.4% of all people who live in Africa are classified as 'food insecure'.

Individual country stories are often heart-breaking. For example:

- In Niger, 75% of the female population between 15 and 24 is illiterate.
- The average Venezuelan has lost 20lb in weight over the past three years.
- Eight million Yemenis currently need emergency food assistance.

## The desire for social progress

The governments of EM countries are aware that social progress is the ultimate determinant of political success.

An interesting starting point when considering the response to the social challenge is the widespread adoption of the UN Sustainable Development Goals (SDG) as benchmarks by which to measure social and environmental progress.

*"Despite the economic progress made by EM countries over the past 20 years, the social challenge is still immense."*

CHART 4: UNITED NATIONS SUSTAINABLE DEVELOPMENT GOALS



Source: United Nations, November 2018

## Investing sustainably

The UN goals are all suitable ESG criteria. When considering which countries to invest in over the long term, I believe these criteria provide as strong a guide as any other. Let's compare these criteria with those we use at BlueBay to assess sovereign creditworthiness.

### UN sustainable development goals

- No poverty
- Zero hunger
- Good health & wellbeing
- Quality education
- Gender equality
- Clean water and sanitation
- Affordable & clean energy
- Decent work & economic growth
- Industry, innovation & infrastructure
- Reduced inequalities
- Sustainable cities and communities
- Responsible consumption & production
- Climate action
- Life below water
- Life on land
- Peace, justice & strong institutions
- Partnership for the goals

### BlueBay's sovereign credit score criteria

- Share of external debt in total (public)
- Reserve in months of imports
- External debt to GDP
- Real GDP growth
- Public deficit to GDP
- Current account change
- Reserves to gross external financing requirement (GEFR) and short-term debt (STD)
- External debt to export
- Public debt change
- Current account to GDP
- External debt change
- USD GDP capita
- Public debt to GDP

Source: United Nations, and BlueBay Asset Management, 2018

The BlueBay criteria are more narrowly focused on assessing ability to pay back sovereign foreign currency debt obligations, but which set of criteria gives you more confidence in the long-term prospects of an EM sovereign?

In this sense, EM investing is ESG investing. Monitoring progress on these variables will give a strong guide as to where to invest. This is what government in EM is for.



Table 5, for example, shows how Nigeria monitors progress towards the UN's first goal. For Africa in particular, where poverty is at its greatest, monitoring progress according to the UN SDG will be crucial to measure ESG success.

TABLE 5: NIGERIA SUSTAINABLE DEVELOPMENT GOALS 2016 REPORT

	Population category	Proportion of population
<b>Goal 1: End poverty in all its forms</b>		
Population below the poverty line	Rural	51.20%
	Urban	69.00%
	National	62.60%
Men, women and children living in poverty in all its dimensions		42.20%
Population living in households with access to basic services (improved sanitation)		60.30%
Population living in households with access to basic services (improved water source)		69.60%
Total government services on essential services by year		21.50%
Government spending to sectors that disproportionately benefit women, the poor and vulnerable groups		13.84%

Source: Nigeria Sustainable Development Goals report, 2016

## Governance: Does the West know best?

Clearly, every country faces different challenges and potential solutions. There are also countries for whom it is hard to make any ESG claims at all.

Russia is a resource-extracting economy that has no discernible environmental strategy and significantly worsening social conditions. Russia is also a very obvious example of the governance challenge in EM.

Good governance has often been framed according to Western metrics. We will have that debate in a second, but it is clear that the answer to the governance debate does not lie in the Russian model. All states act according to their own interests, but Russia will always be penalised for its cynical internal governance and disruptive foreign policy.

I would argue most of the least-defensible EM governance cases involve resource exporters. In traditional style, resource revenues have been used to stifle demands for openness and accountability. Venezuela is currently the most tragic example of this, but clearly not the only one.

Interestingly, if the environmental and social initiatives discussed above succeed in making global growth less resource intensive, then they will also act as a catalyst for good governance. However, the debate about good governance should not be entirely one sided.

### Western bias & exclusivity

At a broader sovereign level, I find the current accepted metrics to judge good governance highly subjective and biased according to Western criteria. EM countries are judged according to Western standards on rule of law, regime stability and institutional strength. While I feel privileged to have grown up in a democracy, I also feel it is legitimate to ask: *"Which country currently demonstrates more institutional strength, the US or China?"*

In the same way as we must accept that the rising economic powers will seek to alter the post-1945 political settlement, we must also be open to the idea that the West does not have exclusive command of what constitutes good governance.

This is particularly pertinent if we accept that today's Western capitalist model seems to be failing the governance challenge of addressing climate change. Our political and economic culture is individualistic and short-termist.

For business, today's capitalism emphasises short-term profit maximisation to meet the next set of quarterly results. The election cycle ranges from two-to-five years in the democratic world. Neither of these cycles are long enough to persevere with the long-term strategic planning and short-term sacrifice necessary to introduce the structural economic change required to meet the environmental challenge.

*"The impetus for this change must come from government. The changes necessary are similar in character to those when a country adopts a 'war economy' mentality – this cannot be driven from the bottom-up."*

## Governance spotlight: The China approach

China, for all its weaknesses and poor starting point, is introducing radical change, aided by a national ethos that emphasises the collective. Surely there can be no greater collective challenge than climate change?

Compare that with the US approach, where the federal government has no coherent strategy and any progress comes piecemeal and from the bottom-up. Is this the kernel of what may become the 'Beijing consensus'?

Perhaps it was no coincidence that after the US withdrew from the Paris Agreement, President Macron's immediate comment was "Now China leads".

The criteria we use to determine good governance are likely to change in forthcoming years, particularly when it comes to environmental and social issues.



## The investment opportunity

ESG considerations will trigger a widespread change in investor behaviour.

Clearly there is both demand for and the supply of capital for environmental and social development.

The supply of capital is coming from internal and external sources. For example, investors in the developed world are increasing their investments in ESG-related instruments for ethical, legal and performance reasons.

Interestingly, the growth of ESG-related investment products is also being spurred by awareness within EM countries. In Brazil, Banco Real issued the Fundo Ethical as far back as 2001. Today, 54% of high net worth investors in Brazil invest sustainably – only 14% do so in the US.

At BlueBay, some of the first investors to ask us about our ESG capabilities were sovereign wealth funds in the Middle East and Asia. Fast-forward to today and ESG scoring methodologies are now a familiar addition to asset management investment processes. A country or a firm's ESG stance is beginning to impact its market pricing.

Eventually, it will be hard, and economically irrational, for any firm or country not to want to improve their ESG criteria. Explicitly screened ESG mandates will grow, but BlueBay's preferred methodology now includes ESG screening for all investment opportunities for all mandates.

Every potential investment is assigned a fundamental ESG rating, which is an absolute assessment of its ESG profile. It is also given an ESG score, which denotes whether there is an actual investment opportunity relative to market pricing as a result of ESG considerations.

At the moment, correlations between the rating and score are not uniform, but it is easy to imagine a closer linkage between the two as ESG considerations become a more accepted benchmark.

As discussed earlier, sustainability can become an equally important investment consideration as GDP growth or free cash flow generation as mindsets change and economic incentives are adjusted. In this sense, all issuers and investors will be more guided by ESG considerations. The concept is broadening beyond specific mandates.

This change in investment behaviour will ultimately mirror changes in the way we live our lives. Over 75% of us recycle our rubbish and yet only 40% currently think about investing sustainably. This gap will surely close. This change in investor behaviour will also reflect a much greater awareness of and activism around ESG issues from the millennials compared to the baby boomers.

*"JP Morgan expect investments measured against their ESG-compliant EM bond indices to increase from USD800 million in 2018 to as much as USD20 billion by the end of 2019."*

## Green bonds: The next fixed income asset class?

New but growing quickly, the green bond market, which began in 2014, is estimated to have reached USD400 billion at the end of 2018. The bulk of this issuance has come from developed markets, but EM sovereigns and corporates are playing a leading and imaginative role.

In 2018, Poland issued a sovereign green bond of EUR1 billion, specifically depositing all proceeds in a green cash account. Indonesia issued the first green sovereign sukuk (Islamic bond). Hong Kong filed shelf for a sovereign green bond programme totalling USD12.7 billion. Meanwhile, Nigeria became the first African sovereign to issue a green bond.

The Nigerian issuance is interesting, as it is specifically earmarked for the 'energising education', 'renewable energy micro-utilities' and the 'afforestation' programmes.

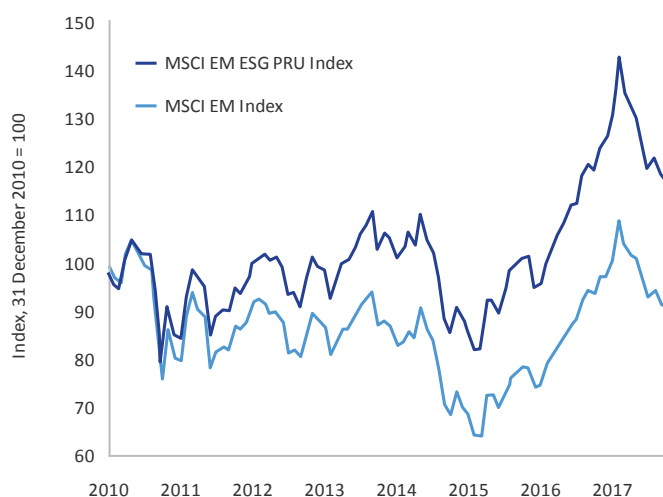
A regrettable consequence of corruption throughout EM has been that financing and aid aimed at improving the life of citizens has not always reached its intended target. Green bonds have a use of proceeds that is more narrowly defined than regular issuance.

Of course, as issuance increases it will be necessary to approach investing with the requisite scepticism and analysis. The more fashionable green bonds become, the more chance there is of abuse of the concept. There will be some issuance that is labelled as green bond issuance even though the eventual destination of the funds is hard to demonstrate.

However, in EM this risk is present on a lot of existing issuance. Proceeds from green bonds are more likely to be tied to a specific use of funds than a regular sovereign or corporate bond issue. In Africa in particular, it is easy to imagine the creative use of green bonds to help with many of the social challenges the continent faces.

The influence of EM sovereigns to determine wider climate strategy is also evident through the issuance from state banks, such as China Development Bank and BNDES in Brazil. BNDES issued a USD1 billion green bond in 2017, through which they have funded 87 operations in the wind power sector alone.

CHART 6: EM MSCI (USD) INDICES – AN ESG RETURN 'EDGE'



Source: Bloomberg, as at 19 November 2018

State-bank support has and will continue to encourage EM corporates to explore the green bond space. Xinjiang Goldwind, a Chinese wind turbine manufacturer, issued the first green perpetual bond in 2016. Malaysian solar projects have been active in the green sukuk space. In the climate-aligned bond space (four-times larger than pure green bonds), 27% of all issuance is denominated in renminbi.

The obvious prerequisites for any new financial market to develop are supply, demand and attractive potential return. The requirement for capital is clearly there, investors have an obligation and incentive to invest and, as Chart 6 shows, for more general ESG investing in EM shows, the return profile looks attractive.

*"HSBC estimate the green bond market is likely to reach USD 1 trillion by 2020. EM issuers will play an important part in that growth."*



## Closing thoughts

### **The stars are aligning for a huge upsurge in ESG-related investing in EM**

The case for investing in EM has always had an ESG-related aspect to it. Before EM capital markets existed, most official creditor funding from institutions such as the World Bank was based on conditionality attached to infrastructure, health, and education & poverty alleviation programmes. The scale of the task and its urgency has been accelerated by awareness of the challenge of climate change and its potential to hit the poorest countries the hardest.

### **The old model of carbon-based industrialisation now has to end**

EM governments can be in the vanguard of creating a new economic model, a green capitalism suitable for the 21st century. Beginning with the invention of the steam engine in the 1780s, the process of industrialisation has led to a number of multi-decade investment cycles.

In the last 30 years, investment momentum has been driven by developments in IT and communications powered by the internet and the ever-smaller microprocessor. There is a sense this cycle is coming to an end. The investment case for IT is complicated by concerns about the externalities of an ever-more connected world.

Is it too much to hope that the next investment cycle will be driven by environmental and bio technology? Is this what can power the world to its next leg of more sustainable growth? It is a cause to hope for, for ourselves and the generations to come.







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