

Economic Policy's Critical Role for Shaping ESG Outcomes in Emerging Markets

EMERGING MARKETS DEBT TEAM | INVESTMENT INSIGHT | 2023

- While the foundational factors behind improvements in environmental, social and governance (ESG) considerations are seldom investigated at the country level, the evidence demonstrates a clear relationship between the orientation of economic policy and ESG outcomes.
- In this paper, we present research to show that in countries where economic freedom improves or worsens, we see corresponding changes in ESG outcomes and sovereign debt performance, a finding that is key to shaping our approach to ESG integration.
- Morgan Stanley Investment Management's Emerging Markets Debt team integrates quantitative and qualitative research to forecast the direction of change for ESG factors that we believe to be material, with the aim of holding high-conviction positions in ESG-improving countries.
- We engage sovereign issuers in the areas where we have developed a specialised skillset, where we can credibly advocate for ESG policy changes that can benefit both our investors and the sovereign, such as improving the rule of law, transparency, regulatory efficiency, market functioning and openness.

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Country-Level ESG

In the world of investment management, the emergence of environmental, social and governance factors represents a paradigm shift. While ESG inclusion has become more mainstream for investors in corporate securities, particularly for equities, integrating ESG considerations into the investment process is comparatively newer for sovereign emerging markets debt (EMD) investors, where the analysis focuses on countries, rather than corporations.

ESG factors can be observed at the country level across a number of areas. For instance, certain countries suffer from pollution or a lack of access to potable water. Others have a high incidence of child labor or low literacy rates, both social metrics. And corrupt legal systems, which affect governance standards, have historically been a challenge for many emerging economies. Investment managers integrating an ESG approach must focus on such factors and their materiality.

However, looking beyond these individual issues reveals a deeper question, which, in our view, is rarely asked: Specifically, what drives the large difference in ESG outcomes at the country level? Furthermore, what can we do as investors to help enable ESG improvements? While seldom discussed, there is a wealth of evidence to show that changes in economic policy act as a principal determinant to changes in ESG outcomes. Likewise, economic policy orientation drives investment outcomes in emerging markets debt.

In this paper, we present academic evidence as well as our own analysis of the data to demonstrate this relationship. That improvements in economic policy can usher in better ESG and investment outcomes is a key factor that structures our approach to ESG integration, which we discuss in subsequent sections.

Understanding Economic Freedom

We believe that measures of economic policy are best encapsulated by the Fraser Institute's Economic Freedom of the World (EFW) Index data set, which represents the most comprehensive framework for understanding economic freedom. The EFW Index, which has been core to our own analysis, has also been key to the research of several academic studies in the area of ESG outcomes.

The EFW Index reports nearly 50 measures of each country's economic institutions and policy environment.¹ Countries are scored on a scale from 1 to 10, with 10 equating to higher and 1 equating to lower levels of economic freedom.

Each metric is assigned to one of six areas:

- **SIZE OF GOVERNMENT:** Extent to which a country relies on the political process rather than the free-market to allocate capital, labor, goods and services.
- **LEGAL SYSTEM AND PROPERTY RIGHTS:** Scope of the rule of law, security of property rights, and the existence of an independent, unbiased judiciary.
- **SOUND MONEY:** Existence of policies and institutions that lead to low and stable rates of inflation and the allowable use of alternative currencies.
- **FREEDOM TO TRADE INTERNATIONALLY:** Extent of tariffs, efficiencies of customs, a convertible currency and controls on the movement of physical and human capital.
- **REGULATION:** Markets, not governments, determine prices and whether regulatory activities retard entry into business and increase the cost of producing products.

- **GENDER DISPARITY:** A composite index that employs 17 variables to measure legal discrimination against women.

Economic Policy and the Environment

While arguing that a higher level of economic freedom corresponds to better ESG outcomes may appear to be a bold claim, there is a wealth of academic evidence to support the relationship. For instance, an early study by S.W. Norton finds that countries with stronger property rights (as measured by the property rights component of the EFW Index) benefited from higher environmental quality, whereas weaker property rights corresponded to poorer environmental quality.²

The above finding covers the broad environmental picture, but circumscribing the analysis to niche areas of economic policy and environmental spheres yields additional insights. For instance, Norton also finds, in the same study, that in countries with strong property rights, approximately 90% of the population has access to potable water; whereas only some 60% has access when property rights are weaker.

Other research shows that countries with governments that play a relatively small role in the economy experience lower CO₂ emissions per capita.³ In contrast, larger government interference in free markets burdened countries with higher CO₂ emissions. The same study finds that CO₂ emissions were lower in countries where there was increased use of markets and increased freedom to trade internationally.

Lastly, another study finds that after controlling for the effects of factors such as economic growth and political institutions, countries with a high level of economic freedom have had lower concentrations of particulate matter in

¹ Gwartney, Hall, and Lawson. Economic freedom of the world: 2022 annual report. The Fraser Institute, 2022.

² Norton, S.W. (1998). "Property rights, the environment, and economic well-being." *Who owns the Environment*, 37-54.

³ Carlsson, F., & Lundstrom, S. (2001). "Political and economic freedom and the environment: The case of CO₂ emissions." Department of Economics, University of Gothenburg.

the atmosphere.⁴ We believe the study demonstrates that economic freedom empowers those affected by pollution to confront polluters because of the stronger property rights and legal systems.

Overall, the evidence suggests that environmental quality is higher not in spite of greater economic freedom, but precisely because of it.

Social Improvement and Economic Freedom

An analysis of how economic freedom correlates to key social and governance indicators at the country level draws out the positive relationship between ESG and economic freedom more clearly. In *Display 1*, we have split countries into groups with the top-ranked countries for economic freedom represented by the upper quintiles, where 1st quintile represents the most economically free and the 5th quintile the least.

The top quintile has lower rates of infant mortality, poverty and child labor participation—all key social indicators. Across these indicators, outcomes become poorer as we move from the top to bottom quintiles. Not surprisingly, the United Nations Human Development Index, a composite measure of life expectancy, educational attainment and standard of living favored by development economists, shows the same trend.

A more extensive composite data set, also from the United Nations, can be found in the organization's annual report on Sustainable Development Goals (SDGs).⁵ The SDGs are an action plan tracking 17 specific areas that fit neatly within an ESG framework. This is particularly the case for environmental and social factors, as the SDGs focus on areas such as poverty alleviation and equality on the social side and access to clean water and fighting climate change on

DISPLAY 1 Higher Economic Freedom Corresponds to Better ESG Outcomes

	ESG FACTOR	ECONOMIC FREEDOM OF THE WORLD INDEX BY QUINTILE				
		5TH	4TH	3RD	2ND	1ST
UN Sustainable Development Goals Score	E, S, G	57.6	62.3	68.0	71.8	77.1
Environmental Performance Index	E	35.4	34.4	40.1	49.3	56.4
Infant Mortality Rate (per 1,000 Live Births)	S	36.3	32.7	16.4	9.8	5.2
Poverty Gap at \$2.15 a day (2017 PPP) (%)*	S	27.95	2.25	2.46	3.61	0.82
Human Development Indicator	S	0.59	0.63	0.74	0.81	0.88
Child Labor**	S	18.4	17.3	14.3	8.4	3.2
Corruption Perception Index Score	G	26.8	35.1	42.2	50.5	66.3
Voice and Accountability	G	-0.90	-0.41	-0.25	0.28	0.94

* Poverty gap data from 2019.

** Percentage of children 5-17 years olds involved in child labor. Data for 2013-2021.

Sources: Emerging Markets Debt team, Morgan Stanley Investment Management, November 2022; Gwartney, Hall, and Lawson. Economic freedom of the world: 2022 annual report, The Fraser Institute, 2022; World Bank, World Development Indicators, 2022; United Nations Development Program, Human Development Report 2021-22, September 2022; United Nations, Sustainable Development Goals Report 2022. Transparency International, Corruption Perceptions Index, 2022. World Bank, Worldwide Governance Indicators, 2022. Yale University, Environmental Performance Index, 2022.

the environmental side. As we can see in *Display 1*, the most economically free countries are those that are closest to meeting the goals, for which there is a 2030 target date.

Governance

Good policymaking and effective governance are essential for ushering in societal and environmental improvements. Therefore, the G factor receives plentiful attention from researchers, with investigations into the relationship between economic freedom and governance being comparatively robust among the ESG factors.

In one noteworthy study investigating governance, researchers test a model of how country characteristics, such as legal protections for minority investors

and levels of economic and financial development, influence firms' costs and benefits in implementing measures to improve their own governance and transparency.⁶ They find that country characteristics explain much more of the variance in corporate governance than observable firm characteristics, by a multiple of 2 to 18. The findings imply that ESG advocacy should largely be focused at the country, not the corporate, level.

Lastly, in *Display 1*, we would note that the top quintile of economically free countries scores higher than peers when it comes to perceived corruption, an indicator of better governance. Likewise, the top quartile receives a better score for perceived participation in the democratic process and the expression of rights (e.g.,

⁴ Herzog, I. & Wood, J. (2014). "Economic Freedom and Air Quality," Fraser Institute.

⁵ The content of this publication has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States. See <https://www.un.org/sustainabledevelopment/sustainable-development-goals> for more details on the Sustainable Development Goals.

⁶ Doidge, C., Karolyi, G. A., & Stulz, R. M. (2007). "Why do countries matter so much for corporate governance?" *Journal of Financial Economics*, 86(1), 1-39.

freedom of expression) in the Voice and Accountability section of the World Bank’s Worldwide Governance Indicators.

ESG, Economic Policy and Bond Performance

We believe investing in countries that improve their levels of economic freedom and, by result, improve their ESG factors’ leads to beneficial investment outcomes as the country’s risk premium declines. We can see how the level of economic freedom has corresponded to changes in spreads and bond ratings in *Display 2*. In the left-hand chart, we see that countries ranked in the bottom quartile of the EFW Index, which is representative of emerging markets, stand to benefit from a compression in sovereign spreads by implementing policies that strengthen and reinforce economic freedom; vice versa, countries implementing policies that diminish economic freedom stand to see a widening in their sovereign bond spreads.

In addition to the potential for superior investment outcomes, societies in countries that improve their governance can also benefit from less poverty, less infant mortality, less child labor, less gender inequality and less corruption. In our view, this alignment of positive investment and ESG outcomes explains why countries starting from a low ESG base on the path to improvement should not be excluded from consideration for investment.

ESG Integration*

In keeping with our focus on the direction of change in economic freedom when evaluating countries for investment, we likewise focus on the trajectory in ESG factors—as opposed to the absolute level. Accordingly, we generally try to avoid negative screens and usually only exclude the most severe social violators that do not demonstrate an improving trajectory.⁷ We prefer to cast the widest net possible for our investment universe, which, in practice, means incorporating

every emerging economy with a capital market and regulatory framework that allows investment. We believe that maintaining a healthy capital market in these countries helps increase transparency and provides us, investors, a window for engaging with their policymakers.

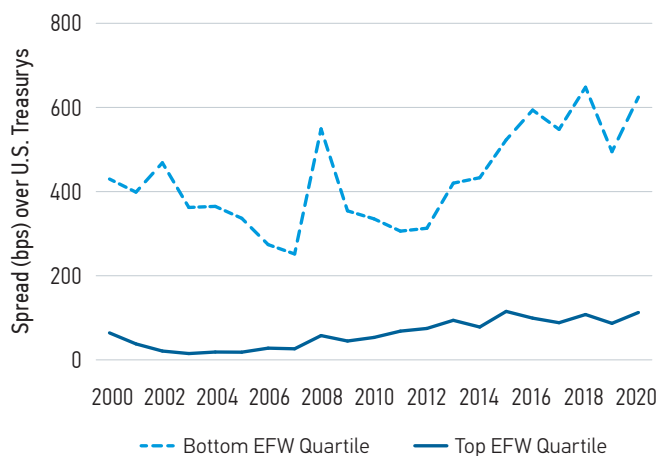
The starting point for a given country is assessing the current ESG situation, which is integral to our standard research process. For this, we employ two primary tools, a quantitative model and proprietary research.

Quantitative Considerations

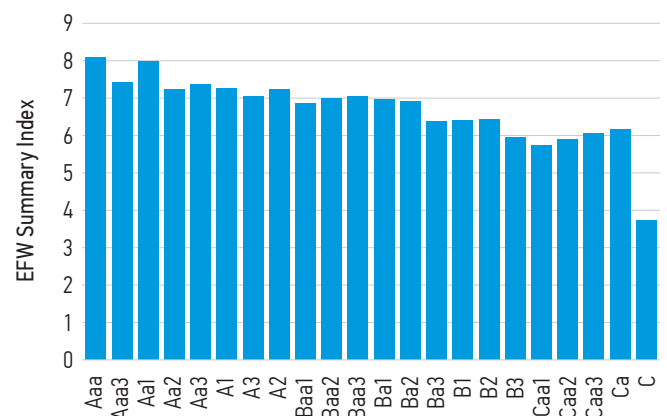
The Emerging Markets Debt team’s quantitative model relies upon third-party, publicly available data for the 110 emerging economies in the investment universe. Incorporating this publicly available information provides insight into how the market might view a given country’s ESG situation and, therefore,

DISPLAY 2
Economic Freedom and Bond Performance

Sovereign Bond Spread



Economic Freedom and Moody’s Credit Ratings



Note: The spreads are provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** Analysis covers 2,325 bonds from 135 countries over 2000-2020.

Sources: Morgan Stanley Investment Management, Damodaran. Country Risk Premiums. (<http://pages.stern.nyu.edu/~adamodar>), Stern School of Business, New York University; Gwartney, Hall, and Lawson. Economic freedom of the world: 2022 annual report (forthcoming). The Fraser Institute, 2022.

⁷ This approach does not apply to Article 8 UCITS and SICAV vehicles managed by the Emerging Markets Debt team.

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serves as useful baseline of comparison for our own proprietary research and analysis.

Modeling ESG factors also has limitations, however. As such, we do not view this information alone as material for investment. Three key reasons are behind this view, discussed below.

ISOMORPHIC MIMICRY. Data sets can be right in a de jure sense, but be de facto wrong. Academics have investigated this phenomenon at the country level, where it is known as isomorphic mimicry.⁸ For example, a country may have environmental protection laws in place that mask failures in practice. Thus, the country could earn a strong score from a third party based on environmental legislation that is incongruent with practices on the ground. As investors, we discover where gaps exist through proprietary, primary research, which often involves in-country visits.

CROSS-COUNTRY COMPARISONS. While we possess the analytical breadth to look across the whole of the EMD universe, no one country ever exhibits average ESG scoring, which complicates model weightings by factor. Deviation at the country level is simply too significant, with E, S and G always figuring more or less prominently for one emerging economy or another. Such variation explains our emphasis on a country's direction of change over cross-country comparisons and absolute ESG scores.

STATIONARY DATA. Public data suffers from stationary and transitory issues. For instance, data is lagged and may be heavily influenced by watershed events, such as natural disasters or adverse weather conditions. Simply put, a hurricane, earthquake or attempted coup d'état may have been a significant issue for a country last year, but not this year. Even when public data is of the utmost standard, good data alone does not guarantee good decisions. For

these reasons, the model is a touchstone, integral to a total mosaic approach but subordinated to the proprietary research and analysis undertaken by our team of specialist emerging markets research associates and portfolio managers.

Adding Value Through Proprietary Research

In our view, the Emerging Markets Debt team's proprietary research and analysis is the greatest source of added value when considering countries for investment. ESG research and analysis is firmly embedded into this process. In this way, the Emerging Markets Debt team dedicates its resources to research that deepens understanding of ESG factors for a given country. Portfolio managers are supported by a group of research associates who focus strictly on country political and economic analysis.

IRIS. The team's proprietary IRIS system captures, categorizes and caches daily news by country around the clock. The research associates utilize this system when preparing the regional team's daily news meeting.

COUNTRY REPORTS. We investigate ESG developments of our coverage universe on a daily basis and report them in aggregate via a quarterly Fundamental Country Analysis. The quarterly report captures the material ESG issues affecting each country, the individual E, S and G scores, the overall ESG score and, most importantly, forecasts for changes in ESG factors by country, discussed below.

COUNTRY VISITS. The purpose of the daily regional team meetings is to identify countries that require further investigation via country visits. Team members use research trips to gain further insights into the issues that are most important to the population, and how government officials, opposition political parties, university

professors, political scientists, journalists, private sector leaders and any another voice with a perspective consider the interaction between the population and politicians. The team prefers in-country trips, but we have quickly become adept in making virtual trips since the advent of COVID-19.

DIRECTION OF CHANGE. The team's country analysis aims to identify countries where the associated risk premium is likely to decline or increase due to changes in the direction of economic policy and local ESG factors. Economies can be prone to unpredictable developments, such as political events, social unrest or natural disasters. While no one can perfectly foresee the future, the breadth and depth of our research capabilities mean that we often track risk factors that can move from a dormant to active state. Close monitoring allows us to quickly assimilate risk developments into our analysis in order to better understand their potential materiality.

RANKING. We assess ESG factors and forecast improvement/deterioration on a five-step scale of “- -” to “+ +,” which then feeds into a proprietary model to rank countries within their intra-income groups by their overall ESG standing and across the individual E, S and G pillars. We see the improvement or deterioration as a critical piece of the overall mosaic that influences the investment decision-making process. In *Display 3*, we provide an example of Uzbekistan, a country with ESG levels at or below global averages, but where our proprietary country research indicates a likelihood of significant improvement in ESG factors.

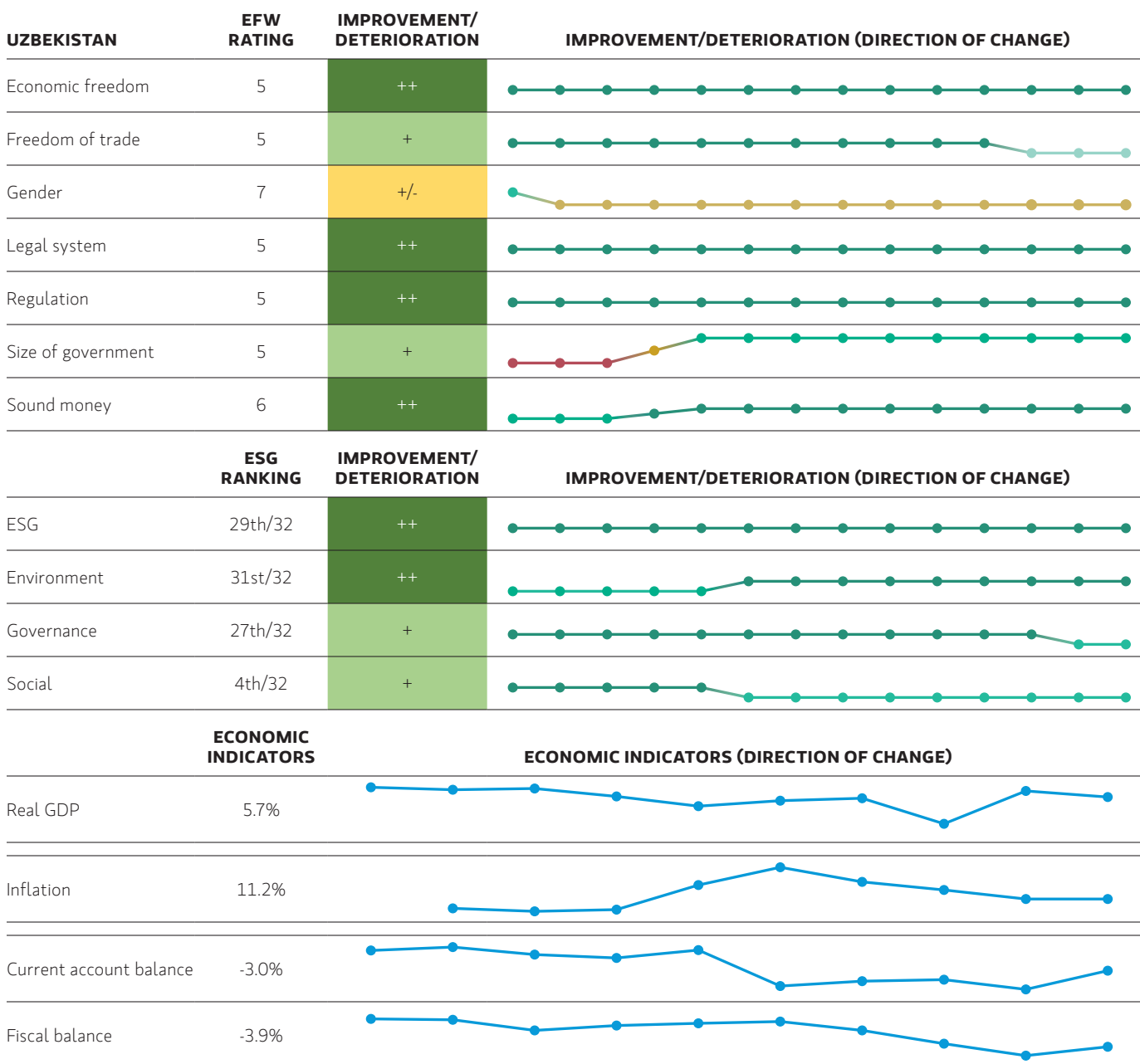
ESG in the Portfolio*

Investment decisions based on forecasted ESG and political/policy developments, the pricing of associated risks (currency, interest rates, credit) and composition of

⁸ Building State Capability: Evidence, Analysis, Action. Andrews, Matt, Pritchett, Lant and Woolcock, Michael. Oxford University Press, Oxford, U.K., 2017.

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DISPLAY 3
Country Case Study



This is provided for illustrative purposes only and should not be deemed as a recommendation to buy or sell the securities in the country shown above. * Direction of Change improvements for the EFW ratings and ESG assessments are illustrated by rising green (+) and dark green (++) lines, whereas yellow lines denote unchanged (+/-) trends and deterioration (-) is illustrated by orange lines. ESG ratings are relative and subjective and are not absolute standards of quality. Ratings apply only to portfolio holdings and do not remove the risk of loss. Source: Morgan Stanley Investment Management, IMF, Government of Uzbekistan. As at December 31, 2022.

the existing portfolio. As the Emerging Markets Debt team focuses on direction of change, oftentimes the highest conviction holdings are issued by countries with

weaker ESG metrics where we expect to see significant policy improvement. Risk premiums tend to be higher for such issuers, which can offer attractive compensation

when risk levels and spreads fall in line with ESG improvements. Accordingly, these ESG improvers often comprise the largest portion of the risk budget.

Importantly, we do not consider broad portfolio measurements of ESG scores, either in absolute terms or compared to a benchmark, to be relevant. The scores reflect base-level ESG assessments, whereas a country's path ahead and direction of change is vastly more significant.

In terms of the individual ESG factors, governance is the principal risk held in our portfolios. At a strategy level, we are not, broadly speaking, attempting to mitigate these risks, rather we aim to take risk in a number of meaningful ESG "improvers" and do all we can to facilitate a reduction of those countries' risk premia by engaging sovereign issuers.

Engagement*

In our experience, investors in emerging markets debt are confronted by a host of considerations when undertaking ESG engagement at the country level. Where can we credibly engage to have the greatest potential impact? How receptive are policymakers to outside advice? How can our engagement impact be measured?

Simply, we engage in areas where we have recognized expertise, focusing where we know we can have meaningful impact on both investment and ESG outcomes. By focusing on the areas where our investment team is most competent and by leveraging the expertise of ESG specialists, we can credibly advocate for beneficial ESG policy changes that can benefit both our investors and the country.

Accordingly, the team's engagement efforts are typically focused on improving rule of law, transparency, regulatory efficiency, market functioning and openness, as well as on countries' climate transition and social development agendas, especially when backed by sustainable financing plans. And while we believe these factors do influence a country's risk premium,

it is challenging to measure the precise impact, as the influence can be indirect, and governments are often reluctant to attribute the merit of a specific policy change to foreign investors.

In practice, engagement takes a two-pronged approach.

SYSTEMATIC ENGAGEMENT. We believe this universal approach applies to all markets in a uniform and consistent manner. As an example, we use a proprietary index to analyze each country's data transparency according to a variety of metrics, including the frequency, timeliness and level of detail available for data published by the ministry of finance and central bank.⁹ We update country scores frequently as part of our fundamental country analysis. We also use similar techniques for securities trading best practices to help identify areas for credible engagements, where we can advocate for policy improvement in each country's capital market infrastructure.

TARGETED ENGAGEMENT. A bespoke approach that leverages engagement opportunities to discuss specific E, S or G issues more in-depth. Over the course of its multiyear history, the team has developed an extensive network of government officials, policy decision-makers, thought leaders, local business executives, think tanks and academics with whom they regularly engage in conversation. Through the cultivation of these relationships, we identify specific ESG issues as they arise, and advocate for policy change in the areas where we are credible experts.

Morgan Stanley Investment Management's Emerging Markets Debt team has carried out engagements with a number of countries. Data and transparency, an area recognized by the United Nations as vital to the SDGs in its 2021 report, is one

such area.¹⁰ Whether that be engaging to discuss language accessibility and the release of standard budget information, such as we have done in Hungary and Romania, or data dissemination, such as we have done with Benin, our activities here have been extensive.

Conclusion

In our view, any well-conceived approach to ESG investing cannot ignore the critical question of how ESG improvements can manifest at the country level. We believe the evidence shows that changes in the level of economic freedom are a principal determinant of positive ESG outcomes and improved investment performance. Therefore, we seek to identify countries on the brink of structural change and the foundational factors that drive salutary and material ESG outcomes.

The Emerging Markets Debt team at Morgan Stanley Investment Management integrates quantitative and qualitative research and analysis to forecast the direction of change in ESG factors, with the aim of holding high-conviction positions in ESG improvers.

We engage in the areas where we are most competent, where we can credibly advocate for beneficial ESG policy changes that benefit both our investors and the sovereign, such as improving the rule of law, transparency, regulatory efficiency, market functioning and openness.

Ultimately, we do not believe asset owners have to sacrifice on their investment or value-based goals when allocating to emerging markets debt. As we have shown, a consistent and complementary approach, in which fundamental and ESG analysis go hand in hand, can offer potential rewards not solely for asset owners but for emerging markets countries as well.

⁹ Tan, P., Thornton, E. and Stocker, M. (2021). "Economic Transparency means a creditworthy sovereign." Eaton Vance.

¹⁰ United Nations (2021). "Investing in data to save lives and build back better," Sustainable Development Goals Report 2021.

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There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Investments in **foreign instruments** or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. In **emerging or frontier countries**, these risks may be more significant. **ESG Strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. Investors should be aware that this strategy may be subject to additional risks, which should be carefully considered prior to any investment decision.

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