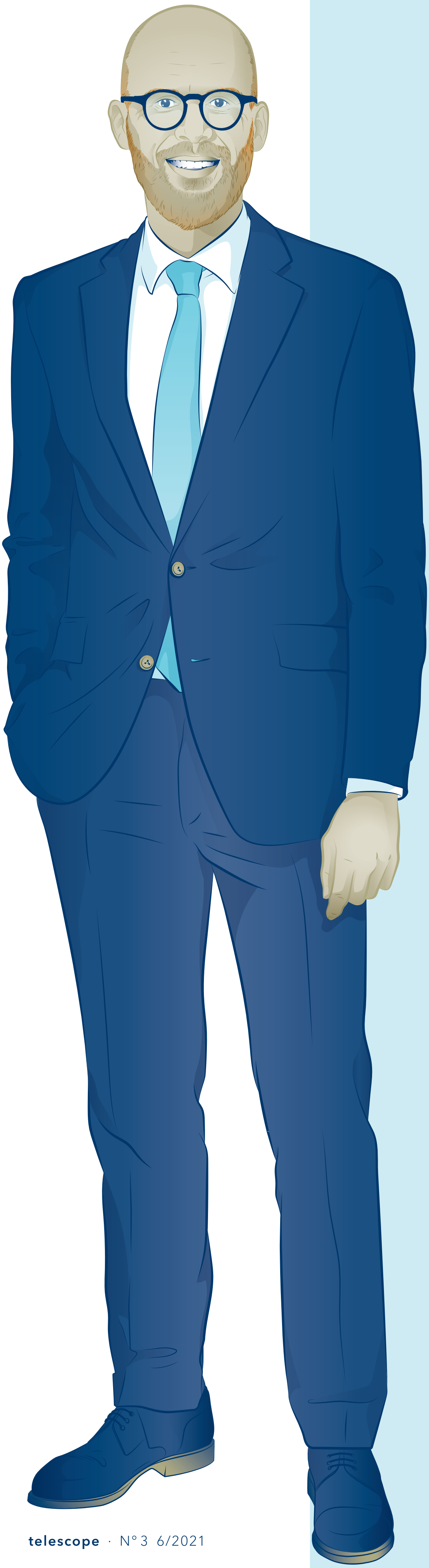
telescope N° 3 6/2021

EMERGING MARKETS REAPPRAISED

After the BRICs craze, other emerging markets are now moving into focus.

VP BANK



A FRESH LOOK

Dear Reader

Twenty years ago the emerging BRIC countries, Brazil, Russia, India and China, were regarded as must-have components of an investment portfolio. But that has changed. The only one of these four which has lived up to expectations – indeed, exceeded them – is China.

This does not mean that investors should turn their backs on emerging markets. Far from it. We believe, however, that this highly diverse group of countries needs to be systematically differentiated. We have therefore drawn up a ranking that compares selected emerging markets in terms of their attractiveness for investors.

The pandemic poses an exceptional challenge for the developing world. The devastating health impact goes hand in hand with economic pain. While developed countries have kept their economies above water by providing unprecedented fiscal and monetary stimulus, many emerging countries have been struggling to stay afloat, as Professor Ricardo Hausmann of Harvard University explains in the interview.

In short, we believe that emerging markets have a firm place in a portfolio, but careful selection is vital.

As always in Telescope, we also include special articles that expand on our core theme. You can read about an entrepreneur who is marketing cleantech solutions in India. And we introduce the new head of the World Trade Organisation, a person uniquely qualified to breathe new life into this Geneva-based institution.

We wish you an enjoyable and informative read.

Dr Felix Brill
Chief Investment Officer

EMERGING MARKETS REAPPRAISED

Emerging markets have grown in importance economically and politically in recent decades. The process has not been without bumps and setbacks, but the trend is set to continue. It is still too early to talk of a post-Covid world, but the global economy is already on a recovery track. Similar phases in the past have been good news for emerging markets. But does this apply to all of them?

Thomas Gitzel and Felix Brill

The decoupling of emerging markets from the advanced economies was a big talking point in the 2000s. For many emerging economies the sky seemed to be the limit. Optimism was focussed especially on the BRIC countries – Brazil, Russia, India and China. This acronym was coined in 2001 by Jim O'Neill, a British economist with the US investment bank Goldman Sachs. He portrayed the BRIC economies as the "bricks" that would become key building blocks of a new global economic order. The term is still in use, but have the hopes pinned on the BRICs been fulfilled? The clear answer is no. While China has exceeded expectations and mutated into a special case (→ page 11), Russia, Brazil and India have been mired in political and economic problems that have prevented them from fully realising their potential.

These inadequacies have been highlighted by the Covid-19 pandemic. Infections in India have reached appalling proportions. Brazil, too, has not handled the crisis well. For a long time, President Jair Bolsonaro closed his eyes to the danger. 2021 will not see a post-Covid dawn in either of these countries. The same is true for many other emerging markets, as Professor Ricardo Hausmann of Harvard University explains in the interview (→ page 17).

What is an emerging market?

The database of the International Monetary Fund (IMF) classifies 156 countries as emerging market and developing economies. This long list stretches from A for Afghanistan to Z for Zimbabwe. Unsurprisingly there is no generally accepted definition of an emerging market economy. In the financial markets this is reflected in the lack of a standard composition for emerging market equity and bond indices.

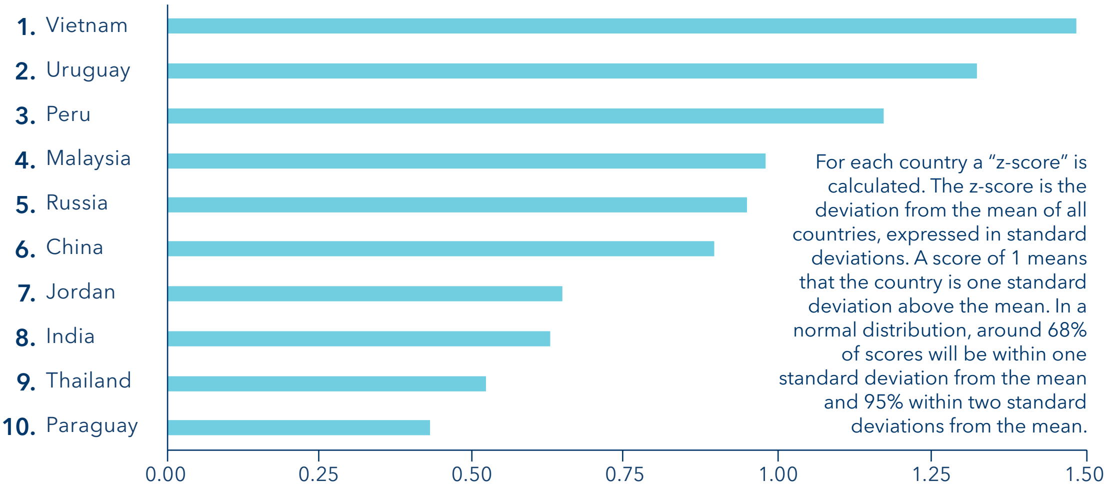
A typical feature of many emerging markets is that they can boast rapid economic growth but fail to achieve a corresponding improvement in the quality of life. Symptoms of this disparity include a low education level, high infant mortality and limited access to electricity and clean water.

Emerging markets supported by global recovery

So, twenty years after the BRICs made their debut, do we now have to talk about decoupling again, this time in a negative sense? Are emerging markets going to be left behind? We believe the answer is no. As we forecast in the last issue of Telescope (December 2020, "Green recovery"), the world economy is at the start of a dynamic period of green growth. Activity has accelerated powerfully over the last six months. The recovery has been especially vigorous in the US, where a highly successful vaccination campaign and huge stimulus programmes (amounting to over 25% of gross domestic product, GDP) are giving a mighty boost to the economy. America's GDP looks set to expand by more than 6% this year. This is also good news for emerging markets. Economic recovery in the developed world has always been a good omen for emerging economies. Moreover, the experience of countries like the US, UK and Israel has shown that the re-opening of the economy in the wake of a successful vaccination roll-out can unleash tremendous positive forces.

Emerging markets cannot be lumped together indiscriminately. They are a very mixed bunch, as was already obvious before the advent of the BRICs. We have therefore set ourselves the task of assessing the relative attractiveness of selected emerging markets in the context of a recovering global economy. Countries must not, of course, be appraised in isolation. We have therefore devised a ranking system

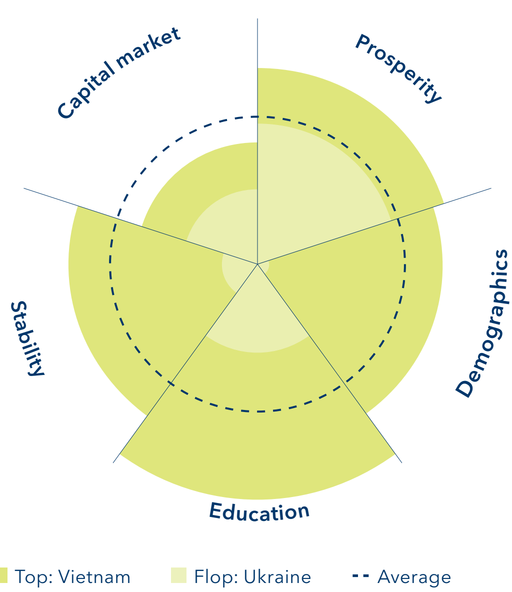
Fig. 1: Top 10 attractive emerging markets



based on five criteria – prosperity, demographics, education, stability and capital market – which are then combined into a single indicator (for details → page 10). In this way, we have compared 28 countries and ranked them on the basis of their attractiveness (for the Top 10 → fig. 1).

Top-ranked country is Vietnam, followed by two that might seem surprising at first glance: Uruguay and Peru. Less surprising are the countries at the bottom of the list: Ukraine in last place, Tunisia second last and Nigeria third from the bottom.

Fig. 2: Huge differences



A comparison of the best and worst countries – Vietnam and Ukraine – is informative. Vietnam scores very highly in almost all categories (→ fig. 2), the exception being "capital market". Ukraine, by contrast, is an "also ran" by every criterion. The differences are sometimes substantial, as a look at the tops and flops in the five categories shows (→ fig. 3).

Rankings do not exist in a vacuum. We have therefore explored the themes that might be determinative in the years ahead in addition to the pandemic and the economic recovery. On this basis we have sorted the countries into three groups:
1) high-powered Asian countries
2) Latin American countries caught in the "middle-income trap"
3) the "fragile five"

These last five countries are or have been characterised by current account deficits, relatively high foreign debt and inadequate foreign exchange reserves. Brazil achieves the unenviable feat of being in both Group 2 and Group 3.

Group 1
Emerging markets in the Association of Southeast Asian Nations (ASEAN)

The star performers are in Asia. The ASEAN countries in our ranking have successfully decoupled from developments in other emerging markets. The top 10 ranked countries include three in this group: Vietnam (rank 1), Malaysia (rank 4) and Thailand (rank 9).

ASEAN members also include Singapore, Myanmar, Laos and Brunei. For all these economies, proximity to China (rank 6 → page 11) is an important factor. ASEAN economies have functioned mainly as suppliers of materials and components for Chinese producers, but the situation is now changing. In future China wants to concentrate on higher quality goods. The main beneficiary of this structural upheaval will be Southeast Asia.

Added to this is a further development. While free trade is under attack in many parts of the world, the Regional Comprehensive Economic Partnership (RCEP) being set up in Asia will be the largest trade bloc in the world. The pact was signed by the ASEAN countries together with China, Japan, South Korea, Australia and New Zealand last November after over nine years of negotiations, and ratification is now in progress. The 15 member countries account for 30% of the world's population, 30% of global GDP and 28% of world trade. Trade barriers within this region have already been largely removed thanks to numerous agreements, but the new trade zone will bring about complete harmonisation. It will be years before product standards are fully unified, but the course has been set for long-term growth. The law of comparative advantage tells us that trade is a generator of prosperity.

> // Southeast Asia has a long future as a global powerhouse. //

Southeast Asia has a long future ahead of it as a global powerhouse. A crucial factor here is education. The ability to make complex products for tomorrow's world requires a good education system. It is no coincidence that top-ranked Vietnam comes second in the education category.

Group 2
Latin American emerging markets in the middle-income trap

The leap from an emerging economy to an advanced one is not easy. Singapore is a rare success story here. Several countries in Latin America find themselves stuck in a halfway house. Examples are Bolivia (rank 19 in our list), Mexico (rank 20), Brazil (rank 22) and Argentina (rank 24). The average annual growth rate in Latin America over the last two decades has been 2.7%, compared with 7.3% in Southeast Asia. That is not enough to get these economies into the advanced nations club.

Once a country drags itself out of poverty, economic growth usually powers ahead. The country becomes a workshop for advanced economies and jumps into the middle-income bracket. But that is when things get difficult. If the country cannot continue to push its income higher, it finds itself caught in the "middle-income trap".

Mexico provides a good example. Low wage costs lured many foreign firms into Mexico, propelling the country into the middle-income bracket. The World Bank defines lower middle-income economies as those with a per capita income of between USD 1,000 and USD 4,000 and upper middle-income economies as those with a per capita income of between USD 4,100 and USD 12,600. Going farther up the ladder and achieving advanced nation status typically requires a capacity for technological innovation. The country must be able to manufacture goods that have a high added value. Mexico's lack of innovativeness has so far stopped it from achieving the breakthrough. Its economy continues to function as an offshore workshop for US and even European firms. There is an exception to every rule, of course. Dubai has successfully concentrated on tourism rather than manufacturing as an engine of economic development.

Unless a country produces high-value-added goods, it will find it difficult to maintain and expand its capital stock, i.e. the plant and machinery necessary for production. The problem will be aggravated if the influx of cheap labour from the agricultural sector dries up. Economic development may then be stopped in its tracks. A sad example is Brazil. The country's inadequate investment in education has stymied technological advance, while economic policy has failed to create a growth-friendly environment. High inflation and high public debt are not a sturdy base for economic advance. The upshot is that Brazil's BRIC ambitions have not been fulfilled.

By contrast, Uruguay (rank 2) has achieved the next step on the development ladder. Per capita income (adjusted for purchasing power) is USD 21,900 at the latest reading. With its population of around 3.5 million, the country is also mounting a successful coronavirus vaccination campaign. It is now among the most vaccinated countries in the world. Thus Uruguay has shown that it is not impossible for a Latin American country to escape the middle-income trap.

Group 3

Five fragile emerging market economies with current account deficits

The "fragile five" countries span several continents. They are India (rank 8), Indonesia (rank 11), South Africa (rank 15), Turkey (rank 18), and Brazil (rank 22). What they have in common is a worrying current account deficit, meaning their current expenditure exceeds their income, and concern about the way it is financed.

A current account deficit is not necessarily a bad thing. It depends how long it lasts and how it is financed. If the offsetting inflow of foreign capital takes the form of direct investments, i.e. money going into new plant and machinery or into new businesses, that is a positive trend. The strengthening of the country's capital stock will generate income in the future, enabling foreign debt to be repaid. But if incoming finance goes mainly into portfolio investments (purchases of bonds, shares etc.), the situation becomes unhealthy. Portfolio investments can be rapidly withdrawn by investors, potentially plunging the country into dire financial straits or even default.

The current account deficits of the "fragile five" are frequently financed by this volatile sort on financial inflow, i.e. investments in securities. The largest component of the current account is typically the trade balance, so a current account deficit is usually due to a deficit in foreign trade. Countries that are rich in natural resources may react by simply increasing or at least stabilising their exports so as to earn urgently needed foreign exchange. Brazil, for example, was able to tackle the previously unhealthy relation between foreign exchange reserves and foreign debt partly by increasing its exports of cattle and other agricultural products. Its agricultural exports have doubled in the last ten years and risen tenfold over the last two decades. These increases have easily outstripped the growth of Brazil's total exports, with the result that the percentage of agricultural products in Brazil's foreign sales has climbed from 7% to 20% in the last twenty years.

This strategy has had devastating consequences for the tropical rain forest of the Amazon basin. Deforestation has accelerated significantly under President Bolsonaro. In Indonesia, too, financial stabilisation goes hand in hand with the destruction of valuable tropical habitats. Thus, welcome improvements in the macroeconomic situation of the "fragile five" are achieved partly at the expense of biodiversity and the climate. Against the background of global sustainability initiatives, investors should not lose sight of this aspect.

// Mexico's lack of innovativeness has stopped it achieving the breakthrough. //

> Some countries will have to be downranked because of the pandemic.

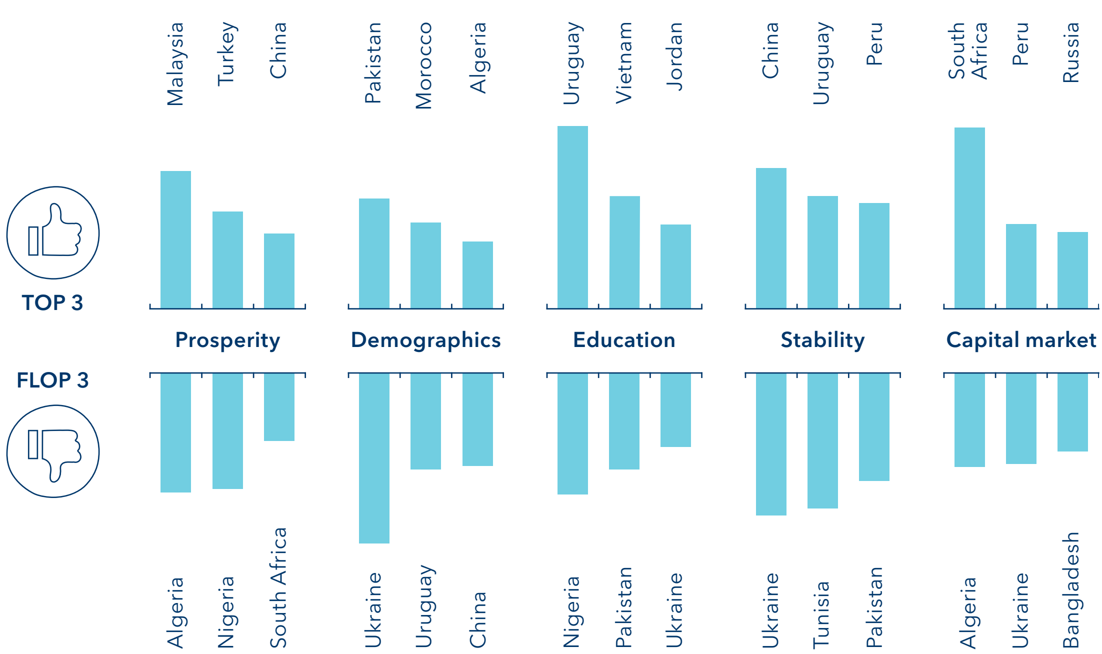
Growing importance

Among these three groups, No. 1 is our favourite. It should be noted that India, too, is interested in joining the Regional Comprehensive Economic Partnership though it does not yet feel ready to sign up. Groups 2 and 3 highlight the fact that emerging markets are a very mixed bunch and can confront investors with decision-making criteria that transcend traditional financial analysis, as we have seen in connection with the agricultural exports of Brazil and Indonesia.

All the countries in our ranking stand to benefit from the green recovery (→ Telescope No. 2, December 2020). The sustainability-oriented expansion unleashed by forward-looking investment programmes in the advanced economies gives emerging nations a new chance to climb further up the development ladder. A big obstacle here is the coronavirus pandemic. Emerging countries lack the financial capacity to launch mammoth programmes to master the pandemic quickly and keep their economies afloat. Depending on infection rates and the vaccine roll-out, some countries in our list will probably have to be downranked.

It is certain, however, that emerging markets will continue to grow in importance in the years ahead. Investors need to recognise this by giving these countries the portfolio weighting they deserve (Investment ideas → page 21). Emerging markets are not all cut from the same cloth. But our ranking process lets us assess almost thirty emerging market countries on a differentiated and comparative basis. That is a good starting point for selection.

Fig. 3: Top and bottom three for each criterion

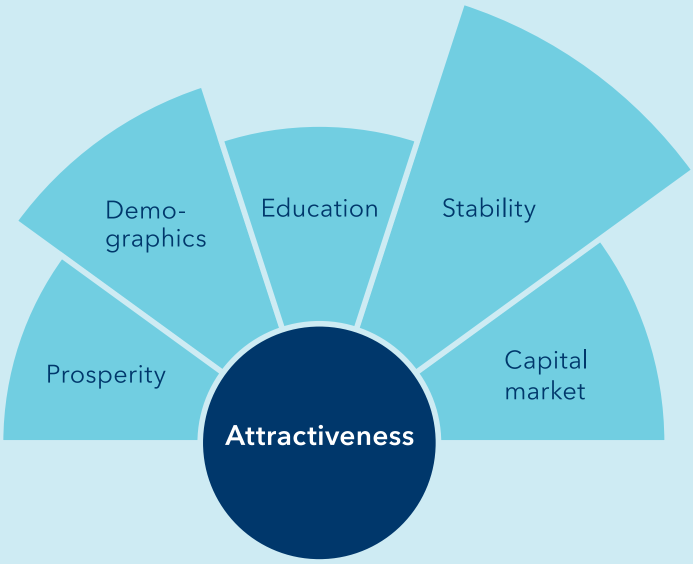


HOW THE RANKING WAS MADE

Felix Brill

Rankings get a lot of attention, but they can be misleading. What does "the world's best tennis player" mean? Are the top ten restaurants on Tripadvisor really the ones I'd like best? Is the "red lantern" rider in the Tour de France really the worst cyclist in the race?

When making a ranking we have to answer three questions:
- What is the aim?
- What criteria should be applied?
- And how are the criteria to be weighted and combined?



The aim

We have drawn up a ranking of emerging markets. These markets can be looked at in many ways, of course. Our standard of comparison is "attractiveness". Which emerging markets will be most attractive for investors in the years ahead?

The criteria

But how is "attractiveness" measured? We have identified five criteria.

1. **Prosperity:** More prosperity typically means more purchasing power for consumers, more investment by businesses and a better infrastructure. We measure prosperity by a country's current gross domestic product (GDP) per capita in US dollars and its growth trend.
2. **Demographics:** As a country's population grows, so does economic demand. The younger the age pyramid, the greater is the future supply of labour. We therefore factor in population growth and the proportion of the population that is below 14 years of age.
3. **Education:** A country's education level is a vital factor in its development potential. We measure education by two indicators: the United Nations' Human Development Index (HDI) and the Innovation Index of TheGlobalEconomy.com.
4. **Stability:** Emerging market crises are a recurrent phenomenon. Political and economic stability is therefore an important factor for investors. We measure stability on the basis of a political stability index and the country's foreign debt as a percentage of GDP.
5. **Capital market:** How big is it? How accessible is it for foreign investors? We measure this by the Capital Account Openness Index and the equity market's turnover as a percentage of GDP.

The calculation

These five criteria have to be reduced to a single overall indicator. For this purpose we calculate the "z-score" (deviation from the mean) for all countries on the basis of each indicator. This enables us to make a ranking per category. We then calculate the average across all five categories to produce the overall ranking.

SPECIAL CASE CHINA

China likes to present itself as an emerging market economy rather than a developed one. But the rest of the world sees things differently. There are five good reasons why China no longer qualifies as a typical emerging market.

Bernd Hartmann

The Chinese government is keen to retain China's status as an emerging market economy. Emerging market status has many advantages. The World Trade Organisation (WTO) grants developing countries longer time periods for implementing trade agreements and allows special treatment for state subsidies. In the field of climate protection, the rules for emerging countries are likewise not as tough as for developed economies. But the fact is that China has become an economic superpower. It competes technologically with the US and is busily expanding its sphere of influence. We explain why China should no longer be regarded as a typical emerging market economy.

1. International financier

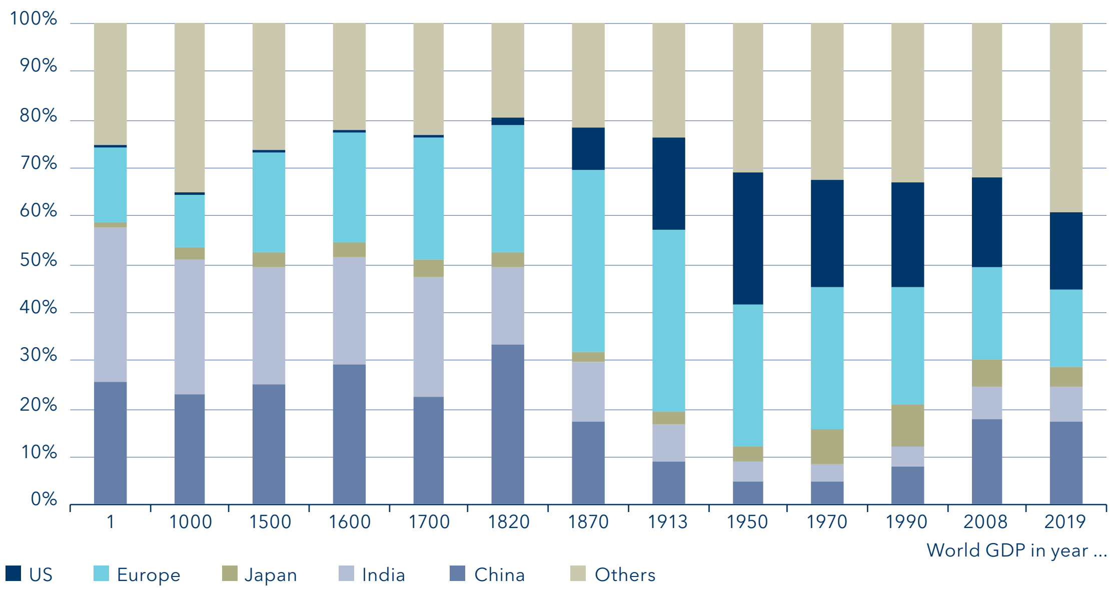
The Organisation for Economic Cooperation and Development (OECD) still lists China as a recipient of development aid. But for the last ten years the flow has been reversed. China pays back more development aid than it receives. As an aid recipient, China does not figure as a donor in OECD statistics, but in fact it is now a major provider of finance. According to an estimate by the Japan International Cooperation Agency (JICA), China was the seventh largest donor country in 2016. But the form and transparency of Chinese aid deviates from OECD standards, reflecting the blurred dividing line between development aid and economic interest. A clear example is Beijing's Belt and Road Initiative – a modern version of the ancient Silk Road trading network. The ostensible aim of providing infrastructure development cannot conceal the project's economic and geopolitical motivation.

Many countries regard China as an attractive provider of finance. It has no colonial past and is generally disinclined to meddle in countries' domestic affairs. Chinese money flows not only into emerging economies but also into the West, usually via Chinese state enterprises. In 2016, for example, the Chinese conglomerate Cosco purchased the Port of Piraeus in Greece. With its "17 + 1" initiative, China promotes business relations with countries in east and southeast Europe by participating in major infrastructure projects. Montenegro's cross-country express highway project is being financed by Chinese money and has landed the country with a huge burden of debt. China is often accused of practicing "debt trap" diplomacy. A study by Harvard University economics professor Carmen Reinhart and two other academics has shown that China is now one of the world's most influential creditors. It is very noticeable that EU members like Hungary and Greece, which enjoy major direct investments from China, regularly veto attempts by the EU to criticise China's record on human rights.

2. Freedom of action

China's freedom of action derives from its economic muscle. Since joining the World Trade Organisation (→ page 16) in 2001 China has enjoyed a growing foreign trade surplus.

China regains its historical strength: regional makeup of global GDP (based on purchasing power)



The ability to export more than it imports, combined with a high saving rate, makes China its own master. The world's most populous country is also an attractive market for foreign companies. All this puts it in a very comfortable position. China is largely free to set the speed with which it opens up its economy and can slow the pace of promised reform when it regards this as necessary. In this cautious balancing act, liberalisation measures are implemented only very carefully. If a crisis strikes, reforms tend to be shelved. In 2015, for example, when a stock market crash triggered massive outflows of Chinese capital, the exits were quickly boarded up and the central bank intervened on the forex markets to manage the renminbi, thereby preventing Chinese goods from becoming more expensive in foreign markets.

This "stop go" policy is intended to ensure that liberalisation only happens in a way that is manageable for businesses and the government. But opposition is growing. Former US President Donald Trump unleashed a trade war with China. His successor Joe Biden will adopt a softer tone but maintain a hard line in practice. Nevertheless, the fact that China's exports to the US are now rising faster than at any time in the last ten years shows how limited the effect of government action is.

3. Technology leader

China carved out huge shares of world markets after joining the WTO, earning the sobriquet "workshop of the world". It initially concentrated on simple but labour-intensive products. Now, however, wage and population trends (→ point 4) mean that China must strive to climb to the next level of development. Nothing is being left to chance; Beijing seeks to modernise the economy on the basis of an active industrial strategy.

The strategic plan "Made in China" aims to reduce dependence on foreign technology and establish China as an industrial power. The emphasis is on ten key industries, ranging from agricultural machinery to biomedicine. The plan covers not just individual activities but the entire supply chain, from research and development to production and computerised control. These are ambitious objectives. China aims to compete in the same league as America's tech giants and Europe's cutting edge industries. In some areas, Chinese companies have already taken the lead, notably in the fields of digital payments, the new 5G mobile phone standard and artificial intelligence for surveillance systems. The EU has come to regard China as a "system rival".

> // China's population will be almost halved by 2100. //

4. Aging population

Amid this economic rivalry, China and the established developed nations have one fatal thing in common: an aging population. Three decades of the one-child policy in China have produced a population in which the over-65s now outnumber the under-35s. The policy was ditched five years ago, but the birth rate has continued to fall. Meanwhile, life expectancy has risen. Academics at the University of Washington in Seattle forecast that China's population will shrink by almost half by the year 2100. The number of working people will fall even more steeply – from around 950 million to 350 million. This is China's Achilles heel. The demographic challenge to economic progress will be felt much earlier in China than in the established developed countries. Also, per capita income in China, at currently around 17,200 US dollars (adjusted for purchasing power), is still far lower than in the US (63,000 dollars).

5. Global muscle

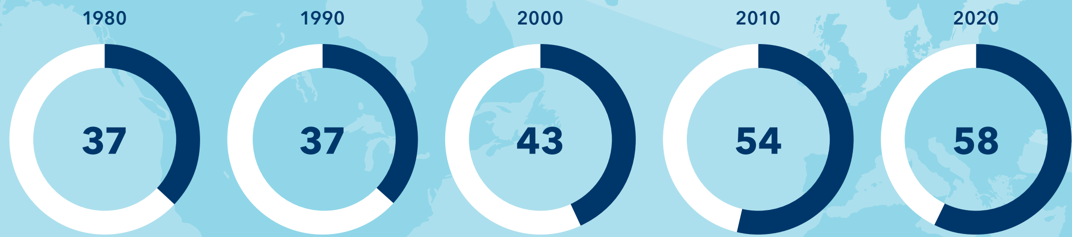
China was for a long time a virtual absentee from the world stage. This situation began to change in the 1980s under Deng Xiaoping, though Deng still wanted China to maintain a fairly low political profile while concentrating on economic development. This reserved posture has been abandoned under President Xi Jinping. China still has a much smaller international presence politically than economically, but Xi has cleverly exploited the gap left by America's withdrawal from international organisations under Donald Trump. China now heads up four of the UNO's 15 specialist agencies. With its Asian Infrastructure Investment Bank, Beijing has created an alternative to the World Bank (dominated by the US and Japan) and the Asian Development Bank. China's power ambitions are underpinned by military spending. By 2049, Beijing intends to have the strongest armed forces in the world. This muscle-flexing posture is on display in the South China Sea, where Chinese action is no longer limited to uninhabited islands. Its navy and air force have been putting on a show of strength close to Taiwanese waters too. But China is also adept at using soft power. During the pandemic it has exported masks and other protective equipment and supplied vaccines to developing countries. This will enhance China's reputation in the developing world, especially as the West has failed to deliver cheap vaccines.

Conclusion

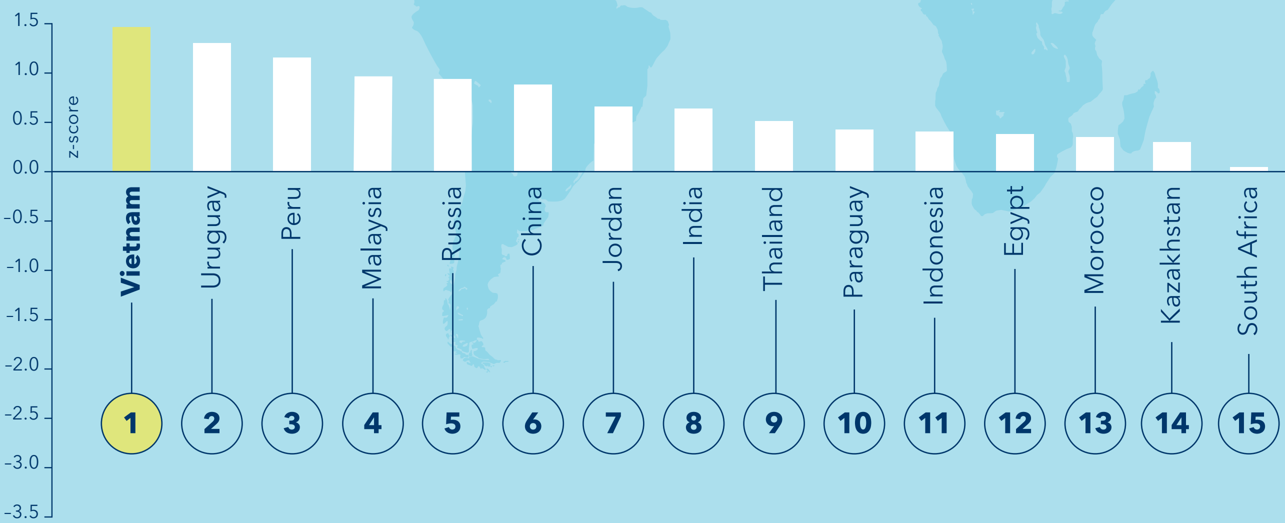
China is striving to regain its historical prominence. This involves not only developing its economic power but also expanding its geopolitical influence. Beijing knows its strengths and is willing to deploy them systematically and position itself in emerging economies as an alternative to the West. At the same time it is committed to a multilateralist approach and the assumption of greater international responsibility. This new self-confidence makes China a partner and competitor in the club of the big powers. On the other hand, the country faces enormous challenges. China is too big and influential for investors to ignore. But it would be a mistake to lump it together with the broad mass of emerging market economies.

THE EMERGING MARKET RANKING AT A GLANCE

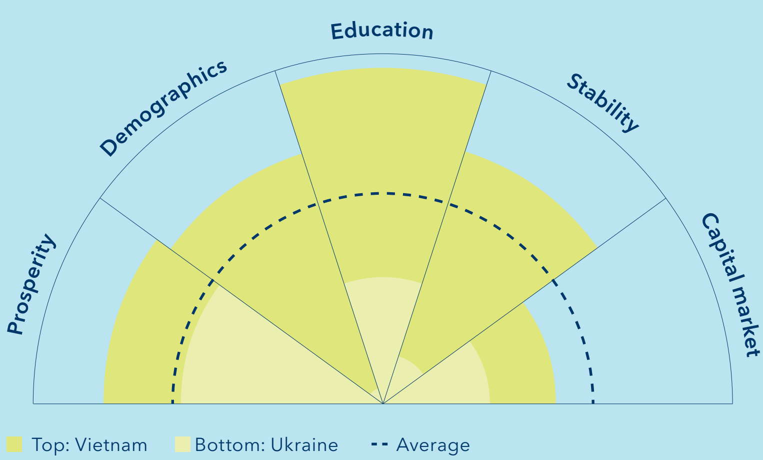
Gross domestic product of emerging markets based on purchasing power parity (share of world total, in %)



Overall ranking



How the top and bottom countries compare in the five ranking categories



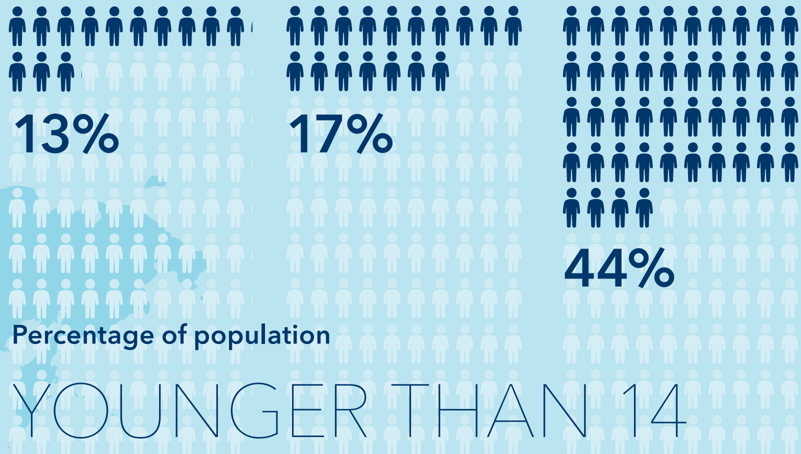
Nigeria has the highest annual **population growth** at

2.6%

In the Ukraine, the population is **shrinking** annually by

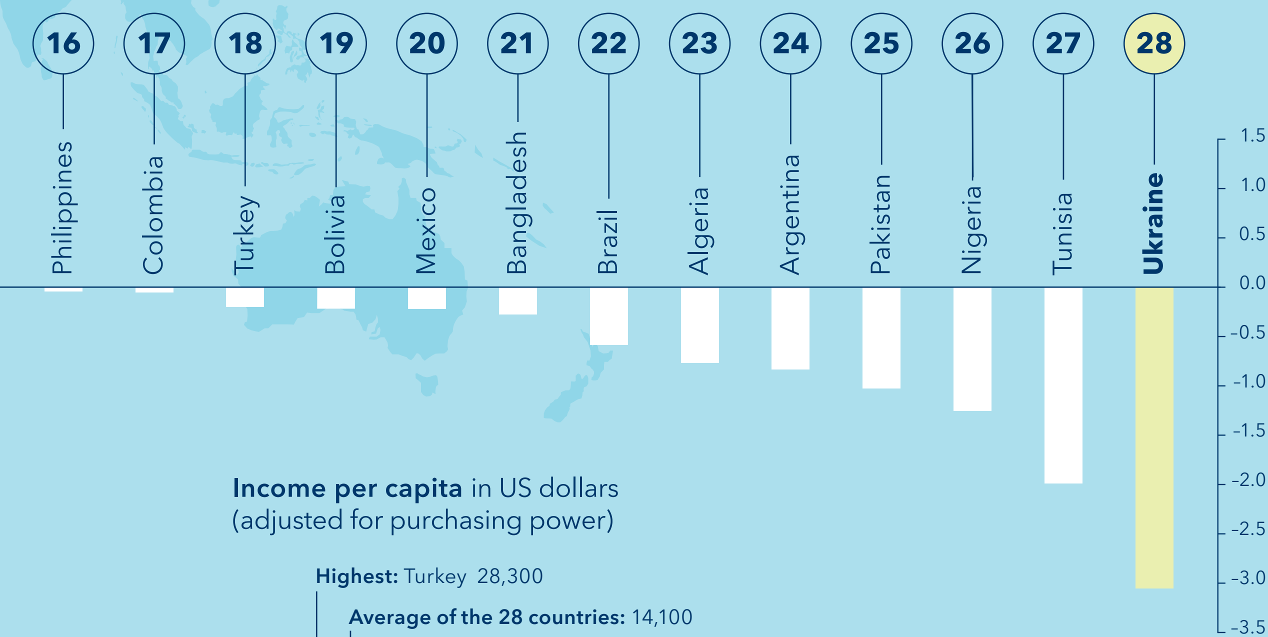
–0.5%

South Africa | **China** | **Morocco**



Percentage of population

YOUNGER THAN 14

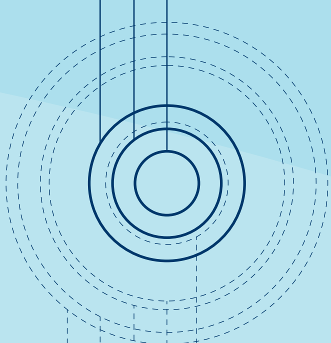


Income per capita in US dollars (adjusted for purchasing power)

Highest: Turkey 28,300

Average of the 28 countries: 14,100

Lowest: Nigeria 5,100



This compares with

China 17,200

US 63,400

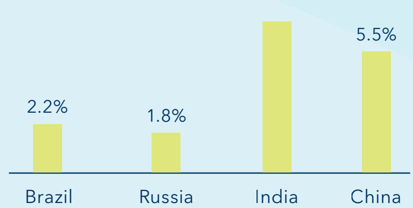
Switzerland 72,900

Singapore 97,100

Luxembourg 118,000

Trend growth India

7.2%



NGOZI OKONJO-IWEALA – A LIFE SPANNING TWO WORLDS

Clifford Padevit

Ngozi Okonjo-Iweala defies easy categorisation. The new Director-General of the Geneva-based World Trade Organisation is uniquely qualified for her international role.

Yes, she is the first woman and first African to head the WTO. But that is not why this 67-year-old Nigerian was chosen.

Ngozi Okonjo-Iweala is a person of extensive international experience. She had a 25-year career at the World Bank as a development economist, rising to the position of Managing Director. She also served two terms as finance minister in her home country Nigeria, where she spearheaded negotiations that led to the cancellation of USD 18 billion of Nigeria's foreign debt in 2005 – no easy task given that Nigeria is a country with rich oil reserves. She was also instrumental in helping Nigeria obtain its first ever sovereign credit rating, a precondition for borrowing on the international capital market.

Okonjo-Iweala bridges north and south in a unique way. She grew up in a country where despots came to power by putsch rather than by election. She admittedly comes from a privileged family. Her father was a traditional ruler, a sort of local prince. But the civil war in the late 1960s brought hunger and illness. "I have lasting memories of children dying around me," she said in an interview.

She moved to the US as a teenager to study at Harvard University, where she graduated magna cum laude, and she subsequently earned her PhD at the Massachusetts Institute of Technology. She started her career at the World Bank in 1982. People who have worked with her say she is friendly, easy to get on with and very hard-working. She says she learned self-discipline from her grandmother, and she herself now has four children and three grandchildren. She has 15 honorary doctorates to her credit and has also been active in the corporate sector, including as Senior Adviser at the investment bank Lazard and as a Member of the Boards of Directors of the UK bank Standard Chartered and Twitter.

These are excellent qualifications for her job at the World Trade Organisation. The WTO was set up to establish a rules-based and liberalised international trade environment. But growing opposition to multilateralism (not only by the US) puts the organisation in a difficult position. The US is still blocking the appointment of new Appellate Body members.

Despite her international reputation, there are those in her home country who view Ngozi Okonjo-Iweala less favourably. As a minister she took steps to reduce the cost and time for unloading goods at ports. That created many enemies. "There are a lot of vested interests … and the way they fight back isn't necessarily nice and neat," she said in 2011. "It is not a game for those with thin skins or weak stomachs."

“THE LIMITED FISCAL SPACE HURTS EMERGING COUNTRIES”

The coronavirus pandemic hits emerging countries more than industrialised ones, says Harvard Professor Ricardo Hausmann. He believes telework will be a big growth opportunity.

Interview: Clifford Padevit

Professor Hausmann, what is the secret sauce for growth in emerging economies?
It is the ability to expand the set of activities that a country is able to implement – in some sense, the set of technologies that a country is able to adopt and adapt to its ecosystem. The world is full of ideas, technologies and production possibilities. Middle-income countries – emerging markets – have not implemented many of them. So their challenge does not require innovation on a global scale pushing the technological frontier. They can advance a lot by just adopting and adapting the stuff that already exists. The challenge is simply to become good at more things, things that the world already knows how to do well, but they don't.

And that is exactly what rich countries did?
Yes. It is amazing how small countries like Austria or even Slovenia are incredibly diversified. And it is amazing how undiversified many emerging countries are.

A key element for expanding the abilities of an economy is know-how. How do you get the know-how to those countries?
The truth is, know-how resides in brains and moves with great difficulty from brain to brain. So it is much easier to move brains than to move know-how into brains. If a country wants to start a new business activity, it has to know how to do it, but typically you don't know how to do the things you don't do. So it is easier if somehow the process gets kickstarted by people who do know because they learned the business somewhere else, like immigrants. So a lot of know-how moves when people do.

What other ways are there?
It can happen by having a foreign company invest in your country or having a domestic company operate abroad, learn things abroad or just acquire a company abroad. And finally we have shown the importance of diasporas. Diasporas mean that there are individuals who know two realities. They can identify technological gaps and business opportunities and play a very important role. Examples are Taiwan, Korea, India, Israel. A diaspora can help a country learn things that the host country of the diaspora is good at. Business travel is also an important way in which knowledge diffuses.

So China has been successful in this regard?
What you want from a foreign company is not just that it operates in your country, but that the technology diffuses. There is a very interesting example of a company in Bangladesh, named Desh Garments. The company was co-founded by Daewoo from Korea in 1978 and took 130 Bangladeshi workers for a six-month training programme to Korea. Within 10 years, about half of these workers had left the company to establish their own companies. And these companies led to a transformation of the export basket of Bangladesh. That's what you want. China has been very focussed on making sure that technology diffuses within the country and not just stays captured in a foreign company.

What will the Covid pandemic change?
I am optimistic that one of the major things happening in the next decade or so is a new configuration of value chains through telework. With Covid we learned that many things that were done in the office could be done from home. But anything that can be done from home can also be done from abroad. Given existing wage differentials between countries, many tasks are going to be relocated. And

many of the obstacles which have been important, like physical remoteness, bad infrastructures, rugged terrains and crossing borders, will become much less relevant for the relocation. This will open growth opportunities that were not there before.

But only for certain sectors, of course.
We looked at tasks that are teleworkable, and the field is huge. I wouldn't underestimate it.

You were early and very vocal about the effect the pandemic will have on emerging countries. More than one year into the pandemic, how are they faring?
There are several issues. From an epidemiological point of view, I'd give the world a C+ or a C in the way it has managed the vaccine issue. Obviously, we did not know which vaccines would work and when we could certify that they worked, but we knew that once we had certified vaccines we needed to produce them in big numbers. I don't think we planned for the level of production that was needed, which would have required licensing many more manufacturing plants. So 2021 and even 2022 are not going to be post-Covid years. They will be Covid years, where activity will be restricted by social distancing. From a macro perspective, the fiscal policy responses adopted in the US, the UK, the European Union, Canada and Singapore have been effective in limiting the contraction and protecting people's welfare. But they have involved massive increases in government spending and big deficits that dwarf the fiscal space in most emerging markets. As a consequence, economic contractions have been much deeper and the welfare costs much more significant. Even the increased fiscal deficits have been caused more by revenue shortfalls than by additional spending.

What about additional borrowing?
Emerging countries fear that if they were to try to borrow, then markets might shut them down. Capital markets were remarkably open last year, not only for the Chiles or the South Africas of this world but also for lower rated countries such as Paraguay, Jordan, Honduras and Albania. But in emerging markets everybody is a bit scared by the unprecedented US fiscal stimulus, which means that the US is on a borrowing binge, and they wonder if there is going to be enough liquidity for the rest. From a policy point of view, the change of tone of the Biden administration in international matters has been important. For example, the issuance of 650 billion Special Drawing Rights may provide countries with extra liquidity to manage things and give a signal to markets that developing countries have external backing. This definitely is positive.

What will the recovery look like in emerging markets?
In post-Covid the recovery will depend on how much structural harm will have been done in terms of lost firms, weakened balance sheets and weakened banking systems. Because firms are going to be short of equity, the shortage of equity is going to limit their ability to borrow. Just pure lax monetary policy is not going to be enough. We need markets to inject equity into firms, but the vehicles to do so are not there. We need financial innovation to achieve this, and it could be very win-win. I am impressed at the speed with which US capital markets are funding special purpose acquisition companies (SPACs). I don't see why these SPACs are not being used to capitalise emerging market firms. They could become a game changer.

CV

Ricardo Hausmann is Director of the Growth Lab at the Center for International Development at Harvard University in the US and Professor of the Practice of International Political Economy at the Harvard Kennedy School. He is from Venezuela, where he was Minister of Planning in the early 1990s. Later he was the first Chief Economist of the Inter-American Development Bank. He is a renowned expert on emerging market issues, and his research interests include growth issues, macroeconomic stability, international finance and the social dimensions of development.

Note: The opinions expressed in this interview may differ from those of VP Bank.

THE SUSTAINABILITY CHALLENGE

Emerging countries have to broaden their economies in order to grow, but they need to do this in a sustainable manner. We take India as an example.

Rashila Kerai

Every tenth human lives in extreme poverty, one in three does not have access to clean water and an estimated 7 million people die every year from air pollution. These are examples of the problems the world wants to solve by 2030, as agreed by UN members and summarised in the 17 global Sustainable Development Goals (SDGs, → below).

Poor and emerging countries face some of the biggest shortfalls relative to these goals, because inequalities in these countries are greater and living standards lower. The UN estimates that achieving the SDGs globally by 2030 will require investments of at least 5 trillion dollars a year. Around two thirds of that will be needed in developing countries to meet needs such as climate change mitigation/adaptation, food security, health, education, and basic infrastructure (transportation, sewers, electricity and telecommunications networks). The task of meeting these needs in emerging markets is enormous and could open up huge investment opportunities. Investing in these regions will facilitate growth while contributing to the achievement of the UN's goals. On top of that, investing in resilient and sustainable infrastructure like water piping or smart electricity grids has the potential to unlock economic development.

Two solutions in one country

India, as an emerging country, faces such challenges. According to the World Bank, one fifth of India's population lives in extreme poverty (less than 1.90 dollars a day), but 80% have mobile phone subscriptions. Like many emerging market countries, India (8th in our ranking, → page 14) leapfrogged traditional landline telephones and invested directly in mobile accessibility, so that mobile services can be offered that are affordable for all. The mass use of mobile phones throughout emerging markets has fostered innovation, for example in mobile payments, enabling people without bank accounts to pay each other digitally, which helps achieving a sub-goal of SDG 8, access to banking. One of the most successful examples is M-Pesa, a mobile banking system launched in Kenya and now operates in ten countries. Mobile technology has helped finding new solutions and scale up its operation.

A comparable trend can be seen when it comes to energy and the transition to renewables. While 90% of the world's population has access to electricity, supply is not always reliable. People in many emerging market countries experience frequent and prolonged power outages. Both businesses and households need access to reliable power, and demand will continue to grow. The spread of e-mobility – vital for improving air quality in cities – is also a driving force here.

Globally only about 17% of power is generated from renewable sources. In India, almost one quarter of installed generation capacity is from renewables. This figure is targeted to reach 40% by 2030. In this way, India should be able to meet growing overall demand, improve reliability and efficiency and bring clean and affordable electricity to areas that do not yet have access. This puts India firmly on the road to SDG 7 ("Affordable and clean energy"). Investing in decentralised power reduces the need for expensive traditional generation and distribution. Power is produced much closer to the end user, so that access to electricity becomes cheaper, particularly in rural areas. The World Economic Forum estimates that smart and connected technologies at the forefront of the electric power grid could create an additional 2.4 trillion dollars of economic value worldwide for businesses and consumers through cost savings from efficiency and revenue from new services.

// Emerging countries face big shortfalls relative to the UN's sustainable development goals. //

Investment yes, but ...

There is no doubt that emerging markets offer attractive opportunities for investing in sustainable infrastructure solutions, but there are problems to consider. The challenges of doing business and investing are greater in emerging markets. This translates directly into higher costs. Considerations include:

- **Political stability:** A stable political environment is essential for economic stability and growth. In our ranking, stability is one of five criteria that make up the overall score. India scores in the top half of emerging countries in terms of economic stability, but is lagging when it comes to political stability.
- **Information gap:** Poor disclosure quality results in misleading, false or insufficient information and makes it harder to arrive at informed investment decisions. Investors are also put off by opaque transaction costs.
- **Repatriation of profits:** It may be relatively easy to bring funds into a country for investment, but it is important to consider the ease of transferring returns back to the home country. India scores at the bottom end in our ranking when it comes to capital market openness. The World Bank's "Ease of Doing Business Index" also shows that India has made improvements over the past few years, but there are some areas where more work is needed, notably taxation, enforcing contracts and protecting minority shareholders.

Investors should be aware of the risks involved when investing in emerging markets. Risks have to be balanced against the investment opportunities that will help emerging markets achieve global sustainability goals. When discussing the hoped-for "green recovery" after the Covid-19 pandemic, the rhetoric in Europe and the US tends to be about "building back better". In emerging economies we can build better from the start.

GETTING EXPOSURE TO EMERGING MARKETS

Bernd Hartmann

01

Appropriate portfolio weighting

Many investors fail to take sufficient account of the increased importance and growth potential of emerging markets. Research shows that these markets currently account for between 6% and 8% of investors' equity holdings. But emerging countries are far more important than that in the world's financial markets and the real economy. Investors should base their equity allocations on market capitalisation. Emerging markets account for 13% of the MSCI indices. In the fixed income sector, emerging market bonds are a rewarding portfolio component in today's low interest rate environment.

02

Chinese bonds

China is too big for investors to ignore. This is generally accepted by equity investors. China now accounts for 37% of the market capitalisation of the MSCI Emerging Markets Index, compared with less than 7% twenty years ago. But Chinese bonds are still being kept at arm's length. Although the Chinese bond market is the second largest in the world, only 3% of it is held by foreigners, compared with 28% foreign ownership of US bonds. The Chinese bond market currently offers a more attractive risk-reward ratio than emerging markets as a whole.

03

Thematic focus

Emerging market investments are no longer driven by the shifting of production into low-wage economies. The "offshoring" of manufacturing processes has certainly helped create prosperity and facilitated the spread of know-how, but growth is now being generated primarily by domestic expansion and regional trade. By focusing on future-oriented themes, investors can exploit emerging economies' potential more effectively than with index-based investments.

04

No (direct) investments in bonds of weak countries

Investors should not invest in government or corporate bonds of countries at the bottom of our ranking, i.e. Argentina, Pakistan, Nigeria, Tunisia and Ukraine. This applies primarily to individual securities. An exposure cannot be avoided in the case of index-tracking investments, but these are so broadly diversified that the lowest-quality component is small. Yields may be attractive, but we expect a persistent structural deficit in terms of credit quality. In the case of local currency bonds, exchange rates will also be a downside factor. The distortions now being caused by the yield famine mean that long-term risks are not being adequately priced in.

PANKAJ AGARWAL

Entrepreneur Pankaj Agarwal helps European companies gain access to the Indian market with cleantech energy solutions.

Clifford Padevit

By 2030, India intends to cover 40% of its energy needs with non-fossil energies. Given the rapidly rising demand for electricity, that is a huge undertaking. But it's one that 57-year-old entrepreneur Pankaj Agarwal can help with. His company assists small and medium-sized enterprises (SMEs) in the Liechtenstein and Rhine Valley region and the surrounding area to market cleantech applications in India.

Without local know-how and a network of contacts, it would be difficult and risky for an SME to move into the Indian market. Agarwal's company Panitek takes care of that. "We are not consultants," he emphasises, "but partners who organise and co-finance market entry and take a stake in the Indian joint venture."

What Agarwal is looking for is cleantech solutions for the efficient generation, distribution and consumption of electricity on a low-emission basis. "We are looking for SMEs with exciting technology applicable to India," he says. For example, he has helped Swiss battery manufacturer Leclanché set up a local operation in India. Agarwal and his team developed the market and the business, and after three years it was possible to merge the Indian operation in a joint venture with the country's largest battery manufacturer.

Agarwal is uniquely qualified for this job. Raised in Kolkata, he graduated from one of the country's leading universities, gained a PhD in chemistry in the US and took a business degree in Rotterdam. He combines a deep knowledge of India with technological expertise, business acumen and a long familiarity with Western modes of thinking. "I always wanted to be an entrepreneur," says Agarwal, who now lives in Liechtenstein. Indeed, one could describe him as a "serial entrepreneur". Back in 2007 he co-founded one of India's first independent producers of electricity from totally renewable energy sources and listed it on the London Stock Exchange.

India needs transformation. Air pollution in India is partly due to its many coal-fired power plants. "India is a big country, but it is poor," says Agarwal. "That means there is no government support for new technologies." So a new application has to pay its way quickly. "If a product is manufactured in a bigger quantity, the cost goes down. This is also a benefit for Western countries, as we have already seen with solar energy."

Agarwal has already built many bridges between Europe and India. Currently he and Panitek have five businesses under development in India, with two more in the pipeline. In this way Panitek contributes imaginatively to a bright and clean future.

My best investment

"When I moved to Liechtenstein about seven years ago, I bought myself a mountain bike."

How did it pay off?
"I really started cycling regularly three years ago, when I found out that I was overweight and had high sugar levels. At the beginning I thought it would be great to cycle from Vaduz up to the castle. For me, coming from Kolkata, where it is completely flat, that was like a dream. Now I can do 1,000 metres uphill. I have never felt fitter in my life. Cycling has also helped me to keep my sanity during the pandemic, because I can get outside and even meet friends."

My worst investment

"When I was a student in the US, I went to a casino for the first time in my life. I gave myself a budget of 50 dollars and gambled it away in about 5 minutes."

What did you learn from that?
"It taught me a big lesson. I don't believe in luck, and I would never buy a lottery ticket. There are no easy ways. You have to do something in order to get something. That means hard work. This experience is also the basis of my mantra: when I invest my own money, for example in a startup, I want to have a say."

GLOBALISATION – CHANGE OF DIRECTION?

Emerging markets are an intrinsic part of today's interlocked world economy. But the pandemic has shown that globalisation also has its drawbacks.

Clifford Padevit

World trade figures speak for themselves. The last fifty years have seen a massive shift towards globalisation. Total exports and imports of goods and services as a percentage of world GDP have more than doubled from 27% in 1970 to 60% just before the pandemic.

There are multiple reasons for this. Trade barriers have been dismantled, making it easier and cheaper to sell goods worldwide. The same goes for foreign direct investments, like building a factory. Secondly, more and more countries have opened up to the rest of the world. The fall of the Iron Curtain freed the whole of eastern Europe, while China has moved into the international trade arena and joined the World Trade Organisation. Thirdly, supply chains have become more diffuse, to the benefit of emerging market economies. Low freight costs and modern means of communication mean that manufacturing processes can be spread over multiple countries. This is evidenced by an analysis carried out by the Bank for International Settlements of the goods traded by developing countries. In 1970 their trade balances were dominated by commodities and food, whereas now industrial products are the predominant component.

Growing risk of contagion

The 2007–2008 financial crisis put a damper on globalisation. In an economically interdependent world, crises can spread more rapidly. As troubles magnify, countries tend to look after number one. But at the G20 summit in 2009, the participating countries declared that they would "refrain from raising new barriers to investment or to trade in goods and services". World trade recovered rapidly. Even so, 2009 remains the peak year for globalisation in terms of international trade as a percentage of world GDP. Then came the trade war unleashed by former US President Donald Trump. His "America first" retreat from multilateralism disrupted supply chains and further weakened the WTO (→ page 16).

The pandemic created a new challenge, disrupting international supply chains and laying bare the dependencies that had arisen. Covid vaccines are a dramatic case in point. Several countries, notably the US and now also India, have forced producers to prioritise the domestic market. In response to these stresses, politicians are now playing with the idea of moving parts of the production process back home to help cushion their countries against external shocks. A new study by economists at the Organisation for Economic Co-operation and Development (OECD) concludes that such action would be ineffective. But politics are politics.

More or less?

It is impossible to say in which direction things will go. Globalisation may spread further, driven by the digital revolution. Harvard economist Ricardo Hausmann (→ page 17) believes that telework will be a crucial factor shaping the coming decade.

On the other hand, the possibility cannot be ruled out that nations or companies will want to bring parts of the production process back home or at least have them nearby. Whichever direction developments take, emerging market economies will play a major role.

YIELDS ARE NOT HURTING EQUITIES YET

Bernd Hartmann

Start-of-year optimism has paid off for investors. Life is still dominated by the pandemic, but large parts of the economy are in action again. Plunging activity seemed to herald even greater economic pain, but this has been warded off by ultra-expansionary central bank policies and massive fiscal relief.

Governments are ready to bolster the recovery further by means of ambitious economic stimulus programmes. At the same time, depleted inventories in the manufacturing sector, combined with consumers' catch-up needs, are resulting in a surge of new orders. Economic prospects for the second half of the year are better than we have seen in a long time.

> // Equities should benefit from positive economic momentum. //

New problems …

The demand bounce is confronting many companies with new challenges. Cutbacks in the production of raw materials, combined with a shortage of empty containers in Asia, have led to bottlenecks in many sectors. This will slow the recovery but not stop it. As these are temporary effects, we do not believe that the resulting rise in producer prices will be passed on directly to consumers.

Even so, central banks will not want to loosen the monetary reins dramatically. It is true that the risks of recession and deflation have receded, and emergency asset purchase programmes will have to be reviewed in the light of reviving economic momentum. But previous episodes have shown how difficult it is to exit from an ultra-expansionary monetary stance. We assume that the Fed will modify its tone during the summer in order to prepare the markets for a course correction. However, raising key interest rates will not be on the agenda for some time to come. The first step will be a gradual unwinding of emergency measures.

… and old challenges

We expect government bond yields to rise further, though the movement is unlikely to be as steep as at the start of the year. We advise investors to maintain a low exposure to interest rate risks. Globally oriented opportunistic bond funds should fare better in this environment.

The economic situation clearly indicates that equities will perform better than bonds. Equity markets currently present an untypical picture. Instead of the usual caution in the early stages of a business upswing, the mood among investors is now one of extreme optimism, not to say euphoria. This, combined with current high valuation ratios, limits the markets' fundamental potential. Nevertheless, equities should benefit from positive economic momentum. We see further potential in selected themes and the European region.

PUBLISHED BY

CIO Office · VP Bank Ltd
Aeulestrasse 6 · 9490 Vaduz
T +423 235 61 73 · F +423 235 76 21
cio-office@vpbank.com

Editorial staff
Dr Felix Brill, Chief Investment Officer
Dr Thomas Gitzel, Chief Economist
Felipe Gomez de Luis, Head of Group Communications & Marketing
Bernd Hartmann, Head of CIO Office
Rashila Kerai, Head of Group Sustainability
Clifford Padevit, Head of Investment Communication
Christina Strutz, Publication Manager

Design and illustrations
Lieu Nguyen, Senior Visual Designer
Katja Schädler, Visual Designer

Translation
Paul Courtney

Publication frequency
Semi-annual

Publication date
10 June 2021

Editorial deadline
28 May 2021

Sources for the ranking and charts
Pages 6, 9, 14–15:
- International Monetary Fund (IMF): GDP per capita, potential growth, Capital Account Openness Index, world GDP
- World Bank: external debt
- UN: Human Development Index (HDI), population below 14 years, population growth
- TheGlobalEconomy: political stability, innovation index, stock market turnover

Page 12: Angus Maddison: The World Economy: Historical Statistics; World Bank: World Development Indicators
Page 19: UN Agenda 2030

Photos
Page 16: © WTO
Page 18: © Christopher Goodney / Bloomberg, Getty Images
Page 22: Close up AG, korner.li

Printed by
BVD Druck+Verlag AG, Schaan

MIX
Paper from responsible sources
FSC® C013308

PRINTED MATTE
CO_2 NEUTRAL
by Swiss Climate
SC2021052704

You decide how **sustainable** your **lifestyle** is. But what about your investment strategy?

In the long term, sustainable companies offer more safety – and more potential. We create transparent criteria that allow you to invest in a manner consistent with your preferences. **vpbank.com/sustainabilityscore**

VP BANK