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Why It Can Be Economically and Morally Rewarding to Invest in Developing Countries

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1. Economic and moral reasons for investing in developing countries

Economic theory predicts that capital should flow from rich to poor countries, where capital returns are expected to be higher due to their lower capital-labour ratio, when compared to rich countries (see, for example, Chari and Henry, 2002). At the same time, it is amply recognised that developing countries need to supplement their domestic savings with external capital in order to achieve faster economic growth and eradicate poverty, thereby contributing to global stability and prosperity. However, for a variety of reasons - legal and institutional obstacles, market failures, etc. - the share of international private capital flowing to developing countries in total cross-border capital flows has historically been very low - and has declined to even lower levels since the East Asian crisis -, with no prospects of significant change in the near future.

This is an unfortunate outcome. As this paper argues, lending to, and investing in developing countries can be very rewarding both for economic and moral reasons. It will be seen that the economic justification for investing in developing countries is based not just on theory but on recent and solid empirical evidence showing that historically capital invested in developing countries has obtained higher returns than that invested in developed countries. Moreover, according to the evidence, a further strong economic argument for investing in developing countries is that diversifying an international portfolio towards this category of countries reduces risks for a given level of returns, due to the lower correlation levels between returns of developed and developing countries than within developed countries.

Investing in developing countries is morally right as well, as it would be a response to the central concern with poverty in the developing world. Moreover, the moral argument for investing in developing countries goes hand in hand with the economic one. If investing in developing countries contributes to overcoming poverty and promoting global development, the world will become a more equitable, prosperous and secure place to live in. These are concerns and values we all share and thus should aim for.

Thus, along with the economic argument, we take the same moral perspective as the Socially Responsible Investment (SRI) initiative. The SRI initiative has done in the past a fantastic job in successfully placing SRI in international investors' minds and hearts, and making it become part of the mainstream of their asset allocation strategies. But we emphasise that development, already an SRI element, is the major challenge, which will also help contribute to the improvement of labour and environmental practices, issues that are central to SRI.

In what follows, we first present empirical results showing that developing countries' asset returns are, in many instances, higher than asset returns of developed countries, and that assets' correlation between developed and developing countries are systematically lower than between developed countries. The evidence is provided for all major categories of capital – bonds, bank loans and portfolio equities -, and is

drawn from a variety of sources, such as research from the IDS finance team, JP Morgan, Merrill Lynch and the IMF. Having provided the evidence supporting the economic rationale for investing in developing countries, we secondly make the moral case for investing in the developing world. We in particular focus on the desirability of broadening the SRI approach towards the explicit incorporation of developmental goals.

2. Investing in Emerging Market Bonds: The Empirical Case

Investing in Emerging Market bonds can bring high rewards to international investors. Table 1 shows that average annual returns on EM bonds were 15% and 16% over the 1990-March 2003 and 1991-2001 periods, respectively. These levels of returns are extremely good, especially when compared with returns on bonds in mature markets. For Europe as a whole, for example, returns were on average around 5% and in the United States, 7.7%, over the 1991-2001 period.

Table 1. Bonds Returns in Developed Countries and EM

	Annual Return (%)	Standard Deviation (%)
Emerging Markets (average 1991-2001) ¹	16.0	14.0
Emerging Markets (average Dec 1990-Mar 2003) ²	14.8	14.6
Europe ^{3,4} (1991-2001)	5.0	8.9
United States ³ (1991-2001)	7.7	4.0

Sources: Datastream. J.P.Morgan. UBS Global Asset Management. Pension Fund Indicators 2002.

¹ Calculations based on an Emerging Market Debt Index using JP Morgan EMBI returns (1991-1993) and JP Morgan EMBI+ returns (1994-2001).

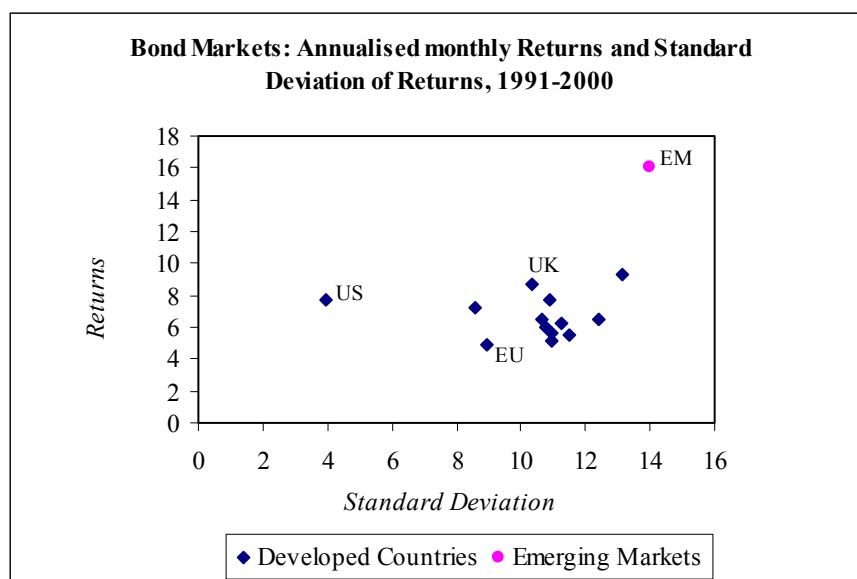
² Calculations by JP Morgan, based on EMB Global Diversified Index.

³ Calculations are based on monthly percentage changes in the JP Morgan Bond Index (Return Index in US dollar).

⁴ Data available from August.

The higher returns on EM bonds vis-à-vis developed country bonds can be clearly visualised in Chart 1.

Chart 1. Bond Markets: Annualised Monthly Returns and Standard Deviation of Returns, 1991-2000.



Source: Kimmis, Gottschalk, Armendariz and Griffith-Jones (2002)

Moreover, in cumulative terms, EM bond returns have been higher than US treasury returns or any other major US market for every year over the past 11 years (see Merrill Lynch, 2003, and Table 2).

Table 2. Cumulative Annualised Returns over the Past 11 Years

Until 28th Feb 2003

%

	1 Year	2 Years	3 Years	4 Years	5 Years	6 Years	7 Years	8 Years	9 Years	10 Years	11 Years
EM Debt	13.6	9.9	11.4	15.9	8.0	8.6	12.3	15.7	11.3	13.6	12.8
US Treasury	11.3	8.8	10.5	8.1	7.8	8.2	7.7	8.2	7.5	7.2	7.7
US Corporate	11.4	9.8	10.7	8.0	7.5	8.1	7.8	8.6	7.8	7.7	8.3
US High Yield	3.4	0.8	1.8	1.6	1.7	3.4	4.5	6.0	5.5	6.3	7.2

Source: Merrill Lynch (2003), page 42, table 23.

It is true that the risk of holding EM bonds is higher (see Chart 1). However, for the purpose of reducing portfolio risk correlation between returns of different assets matters more than the volatility of individual assets.

Calculations made by JP Morgan show that correlation between EM bonds and developed countries' assets is lower than correlation between assets within developed countries - at 0.26 on average against 0.68 over the 1991-2002 period (JP Morgan 2003).² Looking at individual pairs, one can see that while correlation between

emerging market and US Treasury bonds is 0.14, correlation between the Global Bond Index and US Treasury bonds is 0.61. Further evidence is provided in Griffith-Jones et al. (2002), which shows that correlation between countries represented in the Global Bond Index (GBI) and the Emerging Market Bond Index (EMBI) is 0.53, while correlation between developed countries is 0.78.³

According to JP Morgan, diversifying a global balanced portfolio that initially includes only developed countries' assets towards EM bond assets may lead both to higher returns and lower risk. The optimal portfolio composition is reached when the new portfolio composition has 7% of EM assets in its total asset holdings. The Sharpe ratio, which is a measure of risk-adjusted return⁴, increases from 0.32 at the initial position to 0.40 at the optimal position. Beyond that point, returns continue to increase, with just a slight increase in risk. Moreover, adding EM bonds to different types of portfolios, such as the US aggregate portfolio⁵ and the European insurance portfolio, results both in increased returns and Sharpe ratio. The US aggregate portfolio reaches a maximum Sharpe ratio by having 13% of EM assets, and the European insurance portfolio, 18% (JP Morgan, 2003).

3. Returns on EM Debt including bank lending

The calculation of returns and risks for bonds has thus far been based mainly on EM indices and concentrated on a relatively recent period - from the early 1990s onwards. Although this period has been marked by financial crises in the emerging markets, the EM indices may have failed to fully capture the losses investors incurred in crisis times. This is because indices are based on weighted averages of bond values of different countries, but such weights are not fixed. Thus, an EM index tends to underestimate the losses associated with a fall in a country's bond price, as such a fall alone will push down the weight of the country's bond in the index.

An IMF study deals with this issue by calculating the internal rate of returns of EM private debt, using information on debt flows from the World Bank's database (see Klingen, Weder and Zettelmeyer, 2003). Moreover, the study extends the period of analysis back to the early 1970s. Thus, it provides historical rates of returns for EM debt. Since most of EM debt was non-securitised until the late 1980s, the historical estimates on returns include both returns on bonds and bank loans.

² Average of pair correlations of a group of indices that combines both bond and equity indices. These are: EMBIGD, UST, High Grade, High Yield, MBS, GI Agg, GBI and S&P 500.

³ Based on daily data from JPMorgan/Reuters over the 1991-2002 period.

⁴ The exact definition of the Sharpe ratio portfolio is: the ratio of the portfolio's return minus the rate of return of a 'risk-free' asset, to the portfolio's standard deviation.

⁵ The US aggregate portfolio combines US aggregate fixed income (80%) and US equities (20%).

The IMF finds that returns on EM long-term private debt are similar to returns on US 10-year Treasury Bonds (see Table 3). These results include both good and bad times - even the 1980s, years of the debt crisis - as the data covers the 1970-2000 period.

Table 3. Returns on EM Private Debt and US 10-year Treasury Bonds¹
1970-2000 period

	Total long-term debt		Sovereign long-term debt	
	<i>EM²</i>	<i>US 10-year TB</i>	<i>EM²</i>	<i>US 10-year TB</i>
Direct approach	9.3	8.8	9.1	8.9
Indirect approach	8.4	8.8	8.5	9.0

Source: Klingen, Weder and Zettelmeyer (1993).

¹ The direct and indirect approaches differ in that the former draws directly on debt flows information, while the latter draws on information on debt stocks.

2. Only EM countries with secondary market prices in 2000 are included. These are: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Panama, Peru, Venezuela, Indonesia, Korea, Malaysia, Philippines, Thailand, Algeria, Cote d'Ivoire, Jordan, Lebanon, Morocco, Nigeria, Pakistan and Turkey.

When the 1980s are excluded, ex-post EM returns become much higher. As can be seen in Table 4, the calculated sovereign spreads over the US 10-year Treasury Bond - another way of presenting EM returns - are 12% over the 1989-2000 period. Spreads over US Treasury are also quite high - of 6% - even for the 1994-2000 period (thus corroborating results for bonds only, presented above), which was punctuated by many EM financial crises.

Table 4. Sovereign EM Spreads over the US 10-year Treasury Bond¹

1989-2000	12%
1994-2000	6%

Source: Klingen, Weder and Zettelmeyer (1993).

¹ Based on the indirect approach only (see footnote of Table 3 for details), as these are very similar to those based on the direct approach.

Although the analysis shows that ex-post spreads of EM debt above US Treasury over the 1970-2000 period were near 0 (as it includes the years of the debt crisis), still investing in this class of assets would be justified. This is because, according to the IMF results for the 1970-2000 period, the correlation between EM debt returns and that of other assets, e.g., the US stocks and world stocks, is significantly lower than the correlation between returns of developed countries' assets. These results confirm those presented above, thus supporting the view that the risk-return combination makes it indeed rewarding to hold EM debt.

Griffith-Jones, Segoviano and Spratt (2002), focusing on the role of diversification in reducing risks in the financial sector, provide further evidence to support the hypothesis that diversifying the portfolio of loans towards developing countries is conducive to an optimal return-risk combination. The authors show through a battery of statistical tests that correlation between returns on banks' assets of developed and developing countries is lower than between developed countries. Similar results are

obtained for syndicated loans spreads, which is a better indicator of banks' profitability (see Table 5). Moreover, to the extent that loan spreads are an indication of risk, these latter results suggest that the risk arising from loans to banks and corporates based solely in developed countries move closer overtime than risks from loans given to entities from across developed and developing countries.

More generally, Griffith-Jones et al. show that macro variables, such as GDP growth rates, and nominal and real interest rates, hold a much higher degree of correlation among developed countries than between developed and developing countries (see Table 5). This is an important finding, as asset prices at least partially reflect a country's fundamentals and their positions in the business cycle. These findings confirm our hypothesis that assets' prices of developed countries tend to move together over time, or at least much more so than those between developed and developing countries.

Table 5 summarises the main correlation results for all bonds and bank loans, as well as for main macroeconomic indicators. It shows that correlation between developed countries and EM is systematically lower than within developed countries, thus strongly supporting the claim that lending to and investing in developing countries have clear diversification benefits that may well outweigh possible higher risks.

Table 5. Correlation Coefficients for Different Categories of Capital

	Within developed countries	Between developed countries and EM
Bonds/equities (1991-2002) ¹	0.68	0.26
Bonds (1991-2002) ²	0.78	0.53
Bank assets (1988-2001) ²	0.10	-0.08
Syndicated Loans Spreads (1993-2002) ²	0.37	0.14
GDP (1985-2000) ²	0.44	0.02
Short-term nominal interest rate (1985-2000) ²	0.72	0.23
Short-term real interest rate (1985-2000) ²	0.66	0.22

Sources: Table 1; JP Morgan (2003); Griffith-Jones, Segoviano and Spratt (2002).

¹ Drawn from JP Morgan (2003). ² Drawn from Griffith-Jones, Segoviano and Spratt (2002), Table 2.

4. Investing in EM equity assets⁶

The diversification argument can be equally applied to EM equities. Table 6 shows that the correlation between equity returns within developed countries is higher than between developed countries and emerging markets over the period between 1985 and 2002. During this period, the correlation within developed countries was 0.53, while the correlation between developed and emerging market countries was significantly lower at 0.20. The table also shows that over the 1994-2002 time-period correlation between EM equity returns and developed countries' returns went up (due to increased integration of emerging markets with the international capital markets), but that it still remained significantly lower than correlation between equity assets drawn exclusively from developed countries.

⁶ This section draws heavily on Kimmis, Gottschalk, Armendariz and Griffith-Jones (2002).

Table 6. Pearson Correlation Coefficients

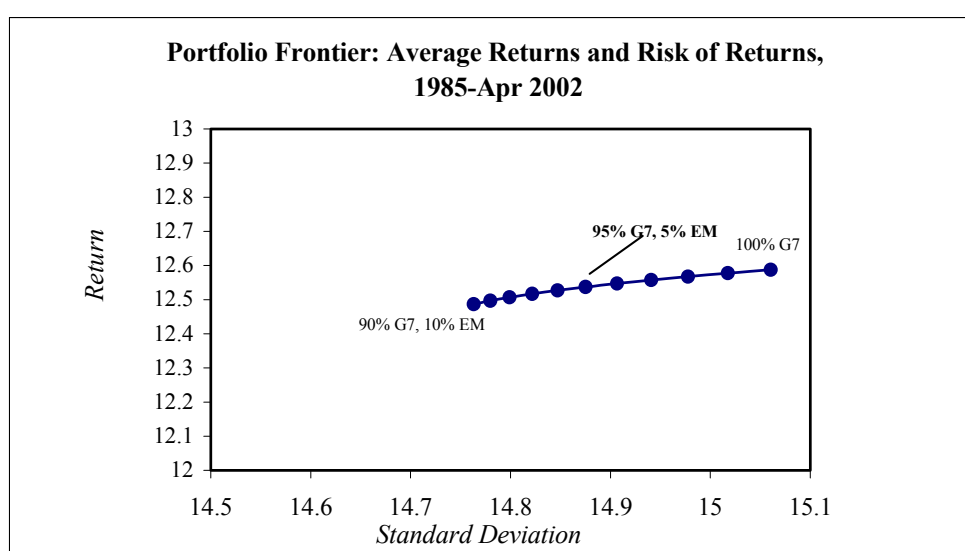
(Based on monthly change in return index)

	Within developed countries	Between developed countries and EM
1985-Apr 2002	0.53	0.20
1994-Apr 2002 ¹	0.57	0.33

Source: Kimmis, Gottschalk, Armendariz and Griffith-Jones (2002), based on data from the International Finance Corporation and Morgan Stanley Capital International. 1. Composite regional indexes are used for EM.

The statistical evidence thus strongly supports the claim that international investors can benefit from diversifying their portfolio through acquiring emerging markets assets, be it bonds or equities, as this can reduce their portfolio risk and even increase returns.

Chart 2. Portfolio Frontier: Average Returns and Risk of Returns, 1985- April 2002



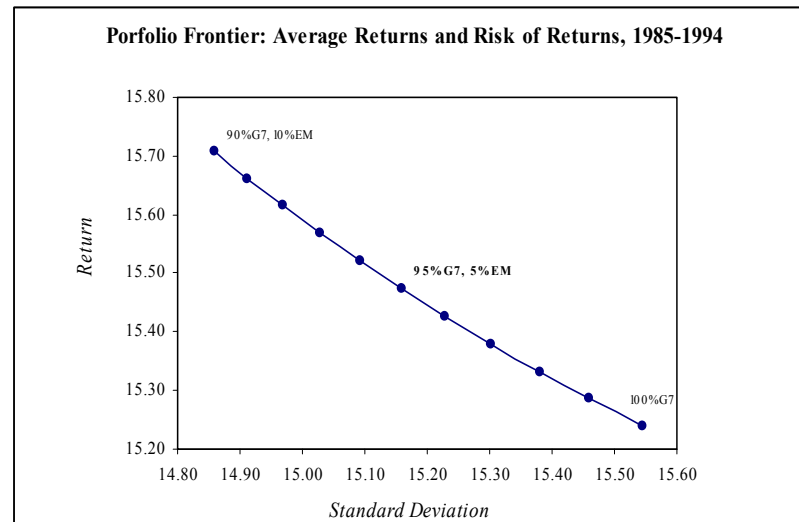
Source: Kimmis, Gottschalk, Armendariz and Griffith-Jones (2002), based data from the International Finance Corporation and Morgan Stanley Capital International.

Chart 2 displays a portfolio frontier along which the portfolio composition moves gradually from a 100% of G-7 countries equity holdings to another of a mix of 90% of G-7 countries' equities and 10% of EM equities. The portfolio frontier shows that, as the portfolio of assets is diversified towards EM asset holdings (moving south-west along the line), portfolio risk falls significantly, together with a slight decline in returns.

However, given that the line is formed by a combination of average returns and risk over the 1985-2002 period, a decline in returns is observed because it includes periods during which EM equity assets suffered from high instability in international financial markets. If appropriate international financial reforms were adopted, the international financial markets could become more stable, and EM countries would have fewer crises and as a consequence be able to generate long-term growth together with higher

returns on its assets, as predicted by the economic theory. Of course, the prospect of stability and faster growth in EM would be enhanced if international investors who are able to commit themselves to long-term investment decided to invest more in these countries. Chart 3, which concentrates on a more stable time-period –1985-1994 -, clearly indicates what portfolio diversification towards EM equity assets can mean for investors, if a more stable future is attained: a portfolio of higher returns combined with lower volatility.

Chart 3. Portfolio Frontier: Average Returns and Risks of Returns, 1985-1994



Source: Kimmis, Gottschalk, Armendariz and Griffith-Jones (2002), based data from the International Finance Corporation and Morgan Stanley Capital International.

The positive combination between higher returns and lower risks reflect the fact that EM equity returns were significantly higher than developed countries' equity returns over the 1989-1994. Even when the late 1990s are included, a few EM like Chile, Mexico and the Philippines beat average G-7 returns (see Table 7).

Table 7. Annualised Monthly Equity Returns

	1985-Apr2002	1985-1994
<i>Selected EM Countries</i>		
Argentina	11.9	32.5
Brazil	11.2	18.3
Chile	25.7	51.7
Mexico	23.1	37.0
Korea	10.1	22.3
Philippines	15.0	47.3
Turkey	11.8	16.3
G7	12.0	15.0

Source: Author's elaboration, based on data from the International Finance Corporation and Morgan Stanley Capital International.

5. The Moral Case for Investing in Developing Countries

We have just seen that there is a strong economic case for channelling capital flows to developing countries. These can take the form of bank lending, and bond and equity flows, as for any of these types of capital an optimal risk-return combination can be achieved.

However, in addition to being economically rewarding, investing in developing countries provides the further benefit of accelerating economic development in the poorer areas of the world, thereby promoting global development. Thus, investing in developing countries is not only justified on economic but also on moral grounds.

The world community is today united around the Millennium Development Goals. These include meeting the following targets by the end of the year 2015: halving extreme poverty, reducing child mortality by two-thirds and achieving universal primary education. According to the Zedillo Report prepared for the Monterrey Financing for Development conference held in Mexico in March 2002, annual external aid flows to developing countries would have to be doubled in order to make the poverty reduction goal a feasible one. Although developed countries expressed the willingness to contribute to the Millennium development goals, they have not transformed such willingness into concrete action in the form of increased financial assistance to developing countries in a major way; the UK, and the US to a certain extent have been exceptions. While continued lobbying for increased aid flows from the developed countries will be important, there may be a role for private investors to contribute to filling the financing gap if they can be convinced to adopt developmentally-friendly investment strategies.

A positive trend in the recent past has been the increasing role moral considerations have played in investment decisions among international investors across the world. The main driver behind this phenomenon has been the Socially Responsible Investment (SRI) initiative. SRI, initially limited mainly to charity foundations and retail specialised SRI funds, has been increasingly adopted by mainstream investment funds. An evidence of this recent trend has been the fact that by 2001 SRI assets reached the level of US\$ 2,7 trillion worldwide (Persaud, 2003).

Investment funds adopting SRI look mainly at the extent to which the companies they are considering investing in are socially, environmentally or ethically responsible, with a focus on their environmental and labour practices (Persaud, 2003). As observed in various reports - see for example Coles and Green (2002) -, SRI is put into effect mainly through negative screening, which means excluding from the asset portfolio those companies whose practices do not meet minimum standards (environmental, labour). Positive screening - consisting of acquiring assets of those companies actively pursuing social and environmental policies- is much less practised. A further approach, encouraged by the UK based *Just Pensions Project* but less practised than negative screening, is positive engagement. This entails influencing companies towards adopting socially responsible policies.

Thus, although the SRI initiative is primarily concerned with social, environmental and ethical issues, and despite the fact that to a certain degree it includes development

elements, its current approach is in some measure narrow, as it does not sufficiently address development issues directly, nor does it encourage investment in developing countries. The predominant practice of negative screening may even harm developing countries, as companies in these countries may face greater difficulties and obstacles to meet funds' SRI benchmarks than their developed country counterparts.⁷ Indeed, standards such as environmental and labour ones are almost by definition lower in developing countries, given their lower development levels and paucity of resources (Williamson, Griffith-Jones and Gottschalk, 2003).

This somewhat narrow approach seems therefore to be at odds with the development philosophy and policies, as to the latter the appropriate course of action should be not to punish countries and companies but to contribute to their improvement. There is therefore a clear need for broadening the SRI initiative so that developing countries and the poor living in these countries can benefit from rather than be (unintentionally) harmed by it. The current negative slant of SRI should be replaced with a positive one, through supporting pro-poor growth and development.

Data reported by Persaud (2003) shows that the most important issue concerning SRI trustees is global development.⁸ The fact that such moral concerns are a top issue among key actors of the international investment community provides strong support for the idea of broadening the SRI approach towards one that explicitly addresses development issues.

Following this line of reasoning, we propose that a *developmentally responsible investment* (DRI) approach could be adopted by investment funds as part of their core investment strategies, in the same way that SRI has taken root among mainstream investment funds and been incorporated into their fund management practices (Robins, 2003). Also, SRI funds should devote an important part of their resources to DRI. A proposal on how the DRI approach could be developed is presented in Annex 1.

The reason that SRI is gaining ground so rapidly among the investment community, it is argued, is that nowadays pursuing such an approach is perceived by investors as not only morally justified but economically sound. An increasingly shared belief is taking hold that companies that are socially and/or environmentally responsible may have their performance enhanced, with a positive impact on their share prices (EIRES and CAF, 2003). This perception has been reinforced by the fact that SRI indices have often outperformed traditional indices in the past (Persaud, 2003).

We have demonstrated above that a DRI approach would be economically equally or even more advantageous, due not only to developing countries' assets having relatively higher historical returns, but also to the diversification benefits it would bring to investment portfolios.

⁷ This point can be illustrated by the case of Californian State pension fund (Calpers), which has recently withdrawn from EM assets on the basis of a negative assessment of EM countries' environmental and labour practices.

⁸ Other issues, such as environmental ones, come further down on trustees' list of concerns (see Persaud, 2003).

Institutional investors, such as pension funds and insurance companies, would have an additional economic incentive for adopting the DRI approach, as it would encourage the undertaking of long-term investment and thus match nicely with their long-term liability structure. A more long-term involvement with developing countries would, in turn, engender a virtuous cycle, as this group of countries would be less subjected to volatile capital flows and boom-bust cycles. As a consequence their long-term growth trend would be higher, with a positive impact on their asset returns.

6. Conclusions

This paper argues that by investing in developing countries the international investment community would be able to achieve an optimum risk-return combination, meet their important moral objective of promoting global development and effectively contribute to eliminating world poverty. In other words, investing in developing countries would be good for investors' financial health, would meet investors' moral concerns and would benefit developing countries.

How much capital would international investors have to channel to developing countries so that their contribution to financing development in the developing world could have meaningful proportions? Just to give an idea of the order of magnitude, according to Persaud (2003), if just 10% of current SRI asset flows were directed to emerging market countries (a sub-set of the developing country universe), the amount of private equity flows to this group of countries would increase very significantly. This increase in flows would certainly contribute towards the reduction of the financing gap that exists to meet the Millennium Development Goals.

How could private capital flows increase and be spread more widely across the developing world? We argue that international investors could invest more and more widely if they broadened the current SRI initiative into a developmentally responsible investment approach, and incorporated it into their core investment strategies. This approach means translating the central moral concern with world development into a pro-active attitude towards development issues and developing countries. The ultimate outcome would be a better, more equitable and safer world for the current and future generations to live in.

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Annex 1. A Proposed Developmentally Responsible Investment (DRI) framework

A possible DRI framework for adoption might be as follows. International investors pursuing DRI could attempt to meet a set of targets. The main one would be to have a developing country asset holding target, to be met over the period of, say, 5 years, after which a natural growth rate would be pursued so that the proportion of developing country asset holding to total asset holding would be kept constant. Investors could opt for: 1) acquiring developing countries' sovereign and corporate bonds and 2) equities of developing countries' companies. Also, banks that are starting to adopt SRI should be encouraged to lend to developing countries. A weight system could be adopted as well.

The target system could be adjusted through asset weighting. For example, bond assets could be weighted according to their maturity. Equities, in turn, could be weighted according to the countries' GDP size, using the PPP definition. These weightings would contribute to reducing volatility.

Investors could also go beyond DRI and adopt the SRI as well. These two approaches would not be in conflict with each other; rather, the SRI could be seen as a step beyond DRI (but contained by it) to be undertaken by those investors willing to have a more active role in promoting development goals. SRI as currently stands would have to be modified, however.

Investors would be encouraged to adopt the positive engagement approach, with less emphasis on prior discrimination regarding a company's degree of commitment to social or environmental policies. Positive engagement would have to be governed by broad rules, which would be based on, and fully consistent with, the Millennium Development Goals. These would for example include encouraging a company to engage itself in the provision of health facilities and primary educational programmes to the local community where it is based.

Thus, our proposal for bringing investors closer to international development goals would be to commit themselves to the adoption of a two step approach: a first one, consisting of the DRI, and a second one, of an improved SRI one, consonant with the international development goals.