ESG in emerging market debt: A look at human capital

August 2023

Introduction

As investors in sovereign fixed income, we are naturally interested in factors that impact the long-term growth potential of EM countries, including human capital.

In this paper we take a closer look at what human capital is, why it matters and the ways in which government policymakers can best utilise the stock of available human capital.

What is human capital?

Using the World Bank definition, human capital refers to the health, knowledge and skills that people accumulate over their lives.[1] Human capital allows individuals, as well as nations, to be more productive and to realise economic potential. Beyond its impact on poverty reduction, human capital is associated with higher income per capita for sovereigns and greater cohesion in societies.

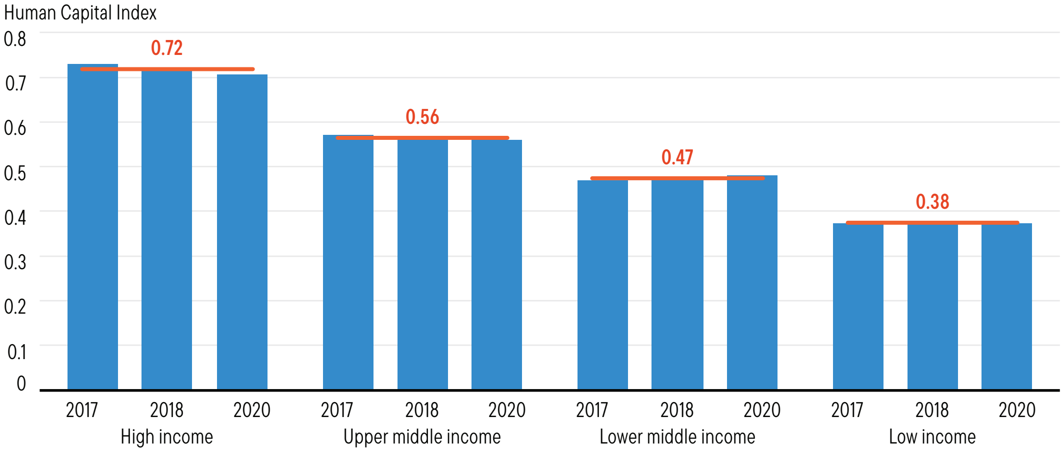
The World Bank Human Capital Index (HCI)[2] has been a helpful tool in facilitating our assessment of the quality of human capital for the countries in emerging markets that we invest in and is therefore referenced frequently in this paper. In principle, the HCI quantifies the future productivity potential of a country's workforce based on the present level of education and health of its children. The HCI methodology is based on the premise that for children to grow up and become economically productive members of society, she needs to 1) survive, 2) be healthy, and 3) receive a good quality education. As a result, nations that invest in evidence-based health and education initiatives are likely to reap long-term productivity gains.[3]

Why does human capital matter to us as sovereign investors?

Aside from the obvious societal benefits of increased health and education, human capital is also associated with higher sovereign growth and increased income per capita. Lower-income countries with greater human capital have been shown to ultimately grow faster than comparable countries with weaker levels of human capital. Variation in economic growth across countries is strongly related to the quality of educational outcomes, as measured by the cognitive skill of a population.[4] Research examining the channel through which human capital and growth are related concludes that the transmission is through an increase in labour force productivity. Specifically, better-skilled people are more productive in performing tasks and in utilising technology and innovating. It is certainly intuitive that a

Exhibit 1: Human Capital Index by Income Group

As of August 2023



Sources: World Bank, FT Fixed Income Research.

better-educated, healthier workforce is a more productive workforce, and this aligns with our experience assessing the business climate across emerging markets. Ultimately this is relevant to us because higher growth, all other things being equal, improves a sovereign's ability to sustain debt.

Human capital is also associated with reduced income inequality and lower crime. Income inequality is a relevant consideration at the sovereign investment level given the extent to which political risk drives emerging market spreads.[5] In some cases, large fluctuations in income inequality and/or significant changes in poverty rates have been precursors to political regime change with knock-on ramifications for sovereign borrowing costs. A memorable example is the dramatic 2019 presidential election outcome in Argentina, which followed a sharp rise in poverty rates in the country.[6] Hence, for policymakers, investing in human capital not only pays direct benefits but may also indirectly serve to increase political stability over the long term.

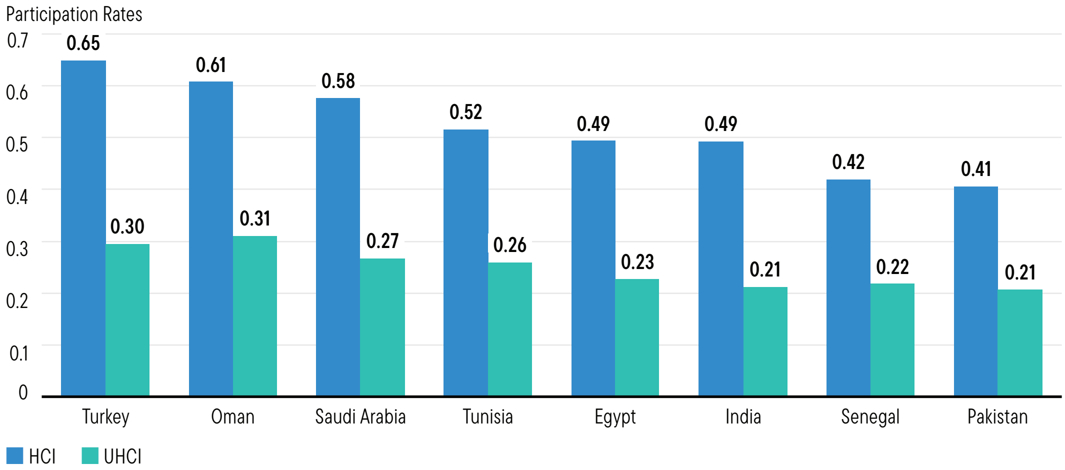
Realising the potential of human capital

The ability of a country to realise the productive capacity of its labour force will hinge on two factors: whether labour force participants ultimately get employed and, also importantly, whether they are employed in jobs that fully utilise their skills. Our fundamental investment process examines how broader policies and features of a sovereign work to either help or hinder the "utilisation" of human capital.[7] For example, we look at the extent to which macroeconomic and regulatory settings create a prosperous private-sector business environment with adequate employment opportunities.

One factor that has a major impact on the extent to which a country utilises its human capital is the degree to which women are participating in the labour force, something we track for countries we invest in. It is intuitive that output for countries with low female labour-force participation will be lower than for comparable countries with more women in the workforce, by the pure mathematics of individuals working times marginal output. This dynamic was observed in a 2020 paper by the World Bank that produced a utilisation-adjusted HCI (UHCI).[8] The UHCI is an extension of the HCI, in that it measures the future productivity of a country considering the extent of human capital and the extent to which human capital is currently utilised. In the UHCI, countries with very low levels of female labour-force participation stood out as having low levels of human-capital utilisation. The UHCI also showed that female human capital is persistently underutilised relative to male human capital globally.

Exhibit 2: HCI Versus UHCI for Countries with Low Female Labour-Participation Rates

As of August 2023



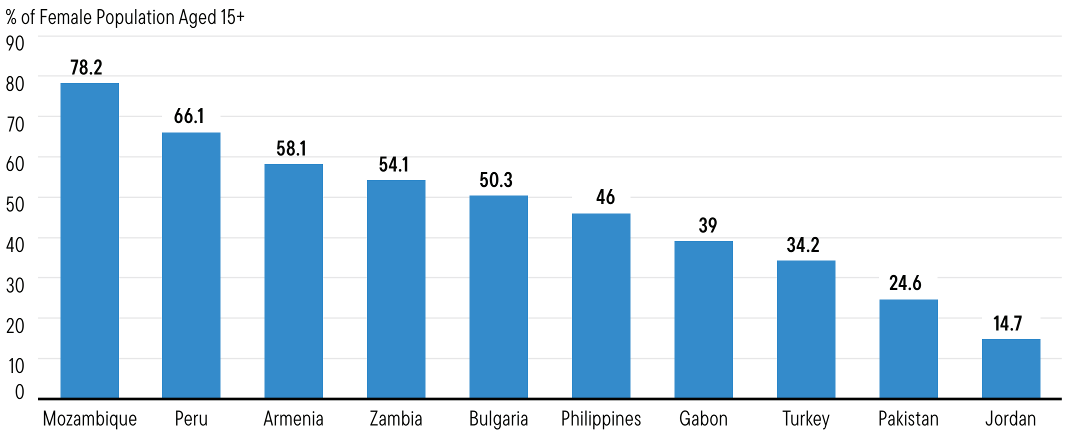
Sources: World Bank, FT Fixed Income Research.

ESG sovereign engagement in action: Jordan—on better utilising female human capital

In April 2023, the Franklin Emerging Market Debt Opportunities (EMDO) team communicated with the Jordanian Ministry of Finance and engaged on government reforms designed to increase female economic participation. Jordan stands out as a country with a high level of female human capital relative to peers, but despite this, has an exceptionally low level of female labour-force participation. While cultural and social norms play a role in this, there are also practical factors that have hindered women's ability to participate in the workforce. It was encouraging during our engagement that government representatives were familiar with diagnostic work around the reasons for low female participation. These included a lack of affordable and safe transportation, safety concerns in the workplace and availability of affordable childcare. We see evidence that the government is working to improve conditions for women at work, including by introducing, and now enforcing, specific labour laws designed to increase the provision of childcare in workplaces.[9] Following World Bank assistance on the topic, the Jordanian government has increased sexual-harassment prevention regulation within the workforce and also increased punishments for offenders and their employers. Future engagement goals include encouraging the government to publicise a specific and suitably ambitious target for female labour participation.

Exhibit 3: Female Labour-Force Participation—Emerging Markets Subset

As of August 2023



Source: World Bank, International Labour Organization. "ILO Modelled Estimates and Projections database (ILOEST)" ILOSTAT. ilostat.ilo.org/data. Data current as of 2022.

Case study: Vietnam—high human capital associated with foreign direct investment (FDI) and improved stock of external savings

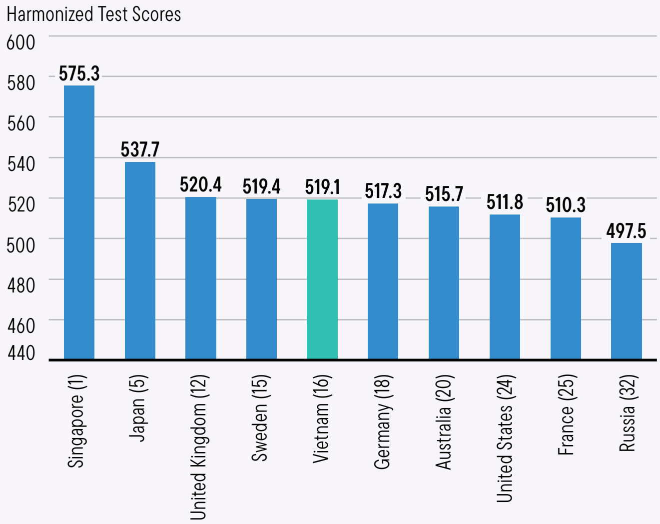
Within our emerging market investment universe, Vietnam stands out as having human-capital levels that far exceed its lower-middle-income peers. The educational attainment of children in Vietnam is truly exceptional and is comparable with those in high-income developed market nations.[10] The component of the HCI that measures "harmonised test scores" amongst children shows Vietnam outperforming Australia, France, Germany and Switzerland.

Importantly, the education system in Vietnam is also relatively equitable, meaning children from poorer parts of the country also perform well by global standards.[11] It is beyond the scope of this paper to delve deeply into the reasons for this performance, but the system by which the government incentivises and holds teachers accountable in Vietnam is consistently cited as a driver of such performance. Teachers are assessed regularly and teachers who take roles in less popular rural postings are paid more. The system differs from that seen in many other developing countries, where education systems have been designed to serve a small, elite segment of the population and where a lack of appropriate management of teachers can lead to high rates of absenteeism and low-quality outcomes.

Vietnam's well-educated, low-cost workforce is paying dividends in the form of FDI that exceeds the average for countries at a similar income level. FDI, in turn, has allowed the country to grow its export base, access a stable source of external financing, build external buffers, and increase its resiliency to economic shocks. Strong external liquidity has been a source of ratings upgrade momentum for Vietnam and has contributed to a significant reduction in sovereign borrowing costs, relative to similar income peers. Moreover, this positive trajectory is reflected in a changing employment landscape for the country. Since 2013, the share of Vietnam's employment in low-skill jobs has steadily fallen, while medium-skill and high-skill jobs have increased. Vietnam now has a tremendous opportunity to better utilise its human capital and increase per-capita income by encouraging more growth in sectors that provide high-skilled employment opportunities.

Exhibit 4: Vietnam Stands Out in Educational Attainment

As of August 2023



Sources: World Bank, FT Fixed Income Research.

Case study: Nigeria—weak human capital contributes to low growth

According to the World Bank HCI, Nigeria ranks lowest among lower middle-income countries and ranks well below the Sub-Saharan Africa (SSA) region's average with an HCI of 0.36. According to the HCI methodology, Nigerian children born today will be only 36% as productive when they grow up as they could be if they enjoyed complete education and full health.[12]

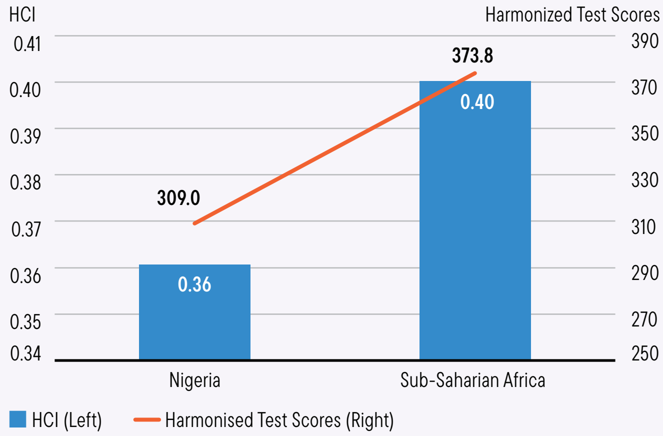
Despite Nigeria's longstanding commitment to universal basic education, the country faces a daunting challenge with one of the highest numbers of out-of-school children globally. Children in Nigeria are expected to complete 10.2 years of education by age 18, which is above the regional average. However, because they learn relatively little, their years in school are the equivalent of just 4.2 years, meaning six years are lost due to the poor quality of the education. One reason for this is the financing of public education, where states are mandated to partly fund primary education without sufficient oversight, leading to consistent underspending on education in the country.

Nigeria also compares poorly when it comes to health, with only 66% of 15-year-olds surviving beyond age 60. Twelve out of 100 children in the country don't make it past five years. A lack of social protection can also necessitate the adoption of dangerous coping strategies, including reducing education and scaling back food consumption, which have further negative long-term impacts on human capital. There is evidence that weak human capital has had a significant long-term impact on economic growth in Nigeria and has also contributed to high poverty levels. Growth levels in Nigeria have consistently lagged those in SSA, with the 10-year annual average nearly 1% lower. Sluggish growth has contributed to downward pressure on Nigeria's credit rating and higher sovereign borrowing costs as a result.

Nigeria has over 220 million inhabitants. It's the seventh-largest country in the world by population and is set to become the third largest by 2050. This demographic trajectory presents Nigeria with a tremendous opportunity to increase its economic competitiveness. Investing in health and education is crucial for Nigeria to enhance human capital, create better opportunities for its citizens.[13] A better business environment, underpinned by a large, healthy and well-educated labour force, could boost economic growth and ultimately increase the debt-carrying capacity of the country.

Exhibit 5: Nigeria's HCI Ranks Well Below the Sub-Saharan Africa Region

As of August 2023



Sources: World Bank, FT Fixed Income Research.

Human capital: an investment in the future

There are many heartening examples of what a targeted government commitment and investment in human capital can deliver. In recent years, a major commitment by the Rwandan government to reduce childhood stunting has yielded significant health dividends, thanks in part to a World Bank-designed programme. Across the globe, Albania's launch of a National Education Strategy back in 2004 prompted one of the biggest improvements in child-learning outcomes, with harmonised test scores increasing markedly from 2009 to now.[14]

Governments today have a choice to invest in their populations and pave the way for a brighter economic future. Health, education and gender policy play a critical role in improving citizens' quality of life, enhancing economic competitiveness and boosting future growth. Reform priorities vary by country, and we strongly encourage governments to engage with credible multilateral institutions for evidence-based policy advice. Prudent economic policymaking allows sovereigns the fiscal space to invest in quality education and vocational training, to address barriers to women's economic participation and to improve health outcomes for children.

Contributors

Nicholas Hardingham, CFA
Portfolio Manager
Franklin Templeton Fixed Income

Stephanie Ouwendijk, CFA
Portfolio Manager, Research Analyst
Franklin Templeton Fixed Income

Robert Nelson, CFA
Portfolio Manager, Research Analyst
Franklin Templeton Fixed Income

Joanna Woods, CFA
Portfolio Manager, Research Analyst
Franklin Templeton Fixed Income

Carlos Ortiz
Research Analyst
Franklin Templeton Fixed Income

Jamie Altmann
Research Analyst
Franklin Templeton Fixed Income

Endnotes

1. Source: World Bank, The Human Capital Project.
2. The Human Capital Index (HCI) measures the amount of human capital that children born today can expect to attain by age 18, given the risks of poor health and poor education that prevail in the country where they live.
3. Source: Barro, Robert J. "Economic Growth in a Cross Section of Countries". The Quarterly Journal of Economics, Vol. 106, No. 2. (May 1991), pp. 407–443. Education is used here as a proxy measure for human capital.
4. Source: Égert, B., C. de la Maisonneuve and D. Turner (2022). "A new macroeconomic measure of human capital exploiting PISA and PIAAC: Linking education policies to productivity", OECD Economics Department Working Papers, No. 1709, OECD Publishing, Paris, https://doi.org/10.1787/a1046e2e-en.
5. Source: Lee, J.-W., and Lee, H. "Income inequality, human capital accumulation, and economic growth: Evidence from a panel of Asian economies". ADBI Working Paper 810. Asian Development Bank Institute, 2018.
6. Source: Reuters, "Argentina's Peronists sweep back into power as Macri ousted", October 2019.
7. Source: Pennings, S. "The Utilization-adjusted Human Capital Index (UHCI)". World Bank Development Economics, Development Research Group, Policy Research Working Paper 9375, 2020.
8. Source: World Bank, The Human Capital Index 2020 Update: Human Capital in the Time of COVID-19, 2020.
9. Source: International Labour Organization, The Ministry of Labour and SADAQA consolidate cooperation towards a more ambitious agenda on childcare in Jordan, 2017.
10. Source: Green, D and Boyden, J. "What Can Vietnam's excellent schools teach us about education quality and equality". Oxfam, October 2013.
11. Source: Yang, J and Tran, ATB. "Connecting Vietnam's youth to high-skilled jobs: What does it take?" World Bank. 2022. Note: low, medium, and high skill jobs as defined by the International Labour Organization.
12. Source: The World Bank, "Deep Structural Reforms Guided by Evidence Are Urgently Needed to Lift Millions of Nigerians Out of Poverty, says new World Bank Report", March 2022.
13. Source: Keji, S.A. Human capital and economic growth in Nigeria. Futur Bus J 7, 49 (2021). https://doi.org/10.1186/s43093-021-00095-4.
14. Source: The World Bank, "Amid the Pandemic, Human Capital Gains in Albania can be Sustained by Expanded and Better Targeted Investment in Education, and Health Care", September 2020.

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