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GLOBAL ECONOMIC RESEARCH

SOVEREIGN ESG INSIGHTS

MARCH 2021

Editor: Markus Schneider

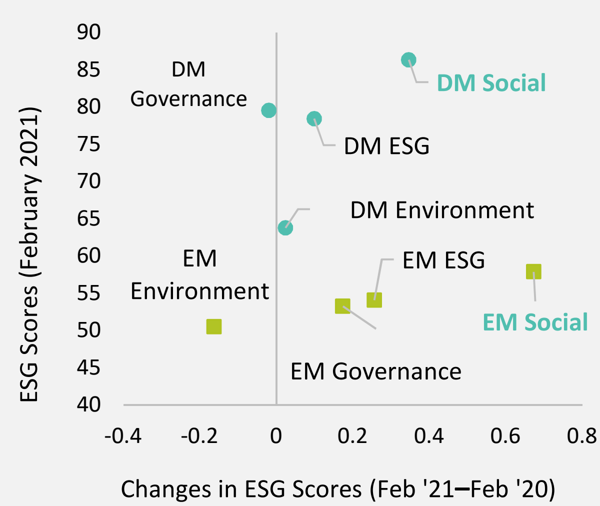
ESG IN THE TIME OF COVID-19 AND BEYOND

This quarterly publication focuses on the impact of the COVID-19 crisis on environmental, social and governance (ESG) dynamics—in particular social (S) indicators. While the pandemic is likely to be negative near term, it has the potential to act as a positive catalyst for ESG developments medium term. We look at several topics in detail:

+ **Latest ESG trends**—Updates of our ESG data point toward improving dynamics over the course of 2020 in both developed markets (DM) and emerging markets (EM), mostly driven by advances in social indicators. This is a welcome and positive development, yet it's uncertain if these gains can be sustained. We recognize that one of the main challenges of ESG data is their lagged nature, which complicates real-time analysis of ESG trends across countries and regions, particularly in the context of the COVID-19 crisis.

+ **COVID-19 and its impact on ESG**—The pandemic is expected to exacerbate societal inequalities and vulnerabilities. The net impact on social indicators as well as aggregate ESG scores is likely to be negative near term. The negative effect on income, health and gender inequality will vary significantly across countries and regions. Those suffering from pre-existing vulnerabilities ahead of the crisis, as well as those with weaker social safety nets and governance structures, could be hurt more severely medium term. Governments' vaccination success will be an important determinant of the scope for economic recovery and thus improvement of social conditions going forward.

DM & EM ESG Scores & One-Year Changes



Source: AB

+ **ESG beyond the pandemic**—The crisis can be a trigger for positive ESG changes by exposing deficiencies in health care systems, social inequality and environmental sustainability as well as the need for future investment in these areas. In the wake of the pandemic, there are indications that governments will also put a greater focus on redistribution policies to address social inequalities, with the European Union (EU) Next Generation Fund and aspects of planned US fiscal and monetary policy being cases in point. Aside from carrying economic costs (including higher fiscal deficits), the success of governments in addressing ESG concerns will depend on effective policy implementation.

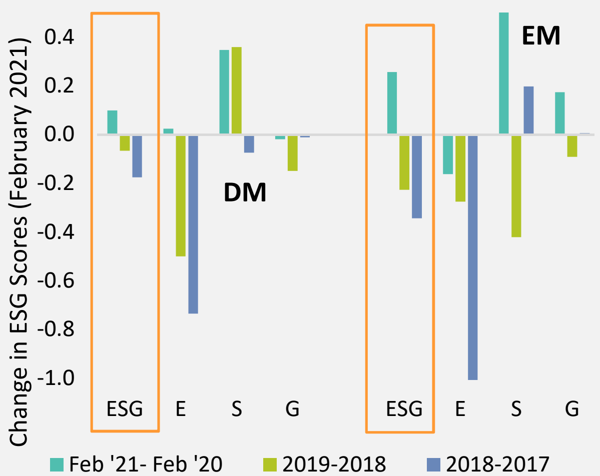
+ **Latest trends in sustainable issuance**— Governments' increasing focus on environmental and social policies has also been reflected in significant increases in sustainable finance issuance (bonds and loans) over the past year, supported by strong investor appetite for ESG-linked investment products. While social bond issuance is still comparatively small, it has been one of the fastest-growing segments of sustainable financing, focusing on funding new and existing projects with positive social outcomes such as improving food security, and access to education and healthcare.

ESG Data Improved in 2020, but Is This Sustainable?

Updates of our latest ESG data paint a positive picture for global ESG dynamics. Aggregate ESG indicators for both EM and DM improved over the course of 2020, representing the first full-year increases observed over the past three years. Granted, both developed- and emerging-market ESG scores continued their cumulative decline since 2017, mostly driven by environmental scores, as well as governance in developed markets. That said, 2020 developments are encouraging and point toward improving momentum, at least ahead of the COVID-19 pandemic.

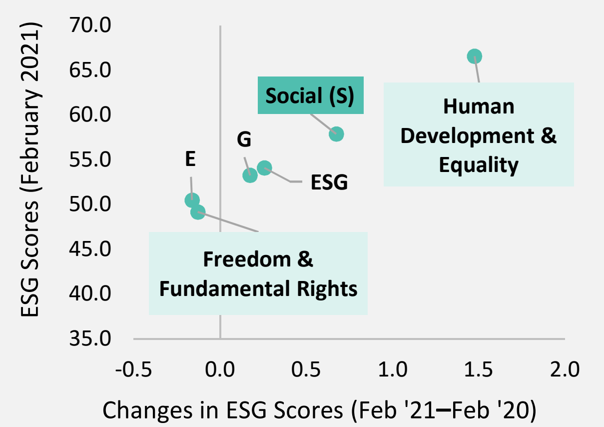
We saw noticeable divergences between the two main subcomponents of our social scores, namely Freedom & Fundamental Rights and Human Development & Equality. It was really the latter category—mostly measuring aspects of inequality and social vulnerabilities—that saw increases during 2020. This was especially true in emerging markets, both on an aggregate level and across individual regions.

Changes in DM & EM ESG Scores



Source: AB

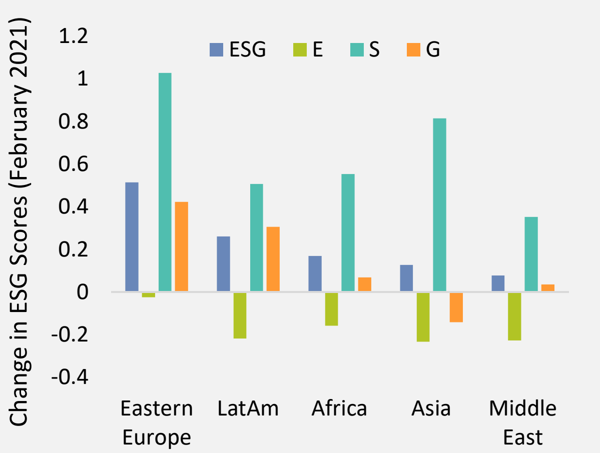
EM ESG Scores, Social Subcomponents & One-Year Changes



Source: AB

When looking at the changes over the past year more closely, the gains appear to be broad-based: aside from DM, all four major EM regions (comprising a universe of 89 countries) have seen an upturn in their aggregate ESG scores. Notably, as shown in the chart below, social indicators saw consistent increases across regions and constituted the main drivers for improved overall ESG scores, offsetting ongoing declines in environmental that we still observe in several EM regions.

One-Year Changes in EM ESG Scores



Source: AB

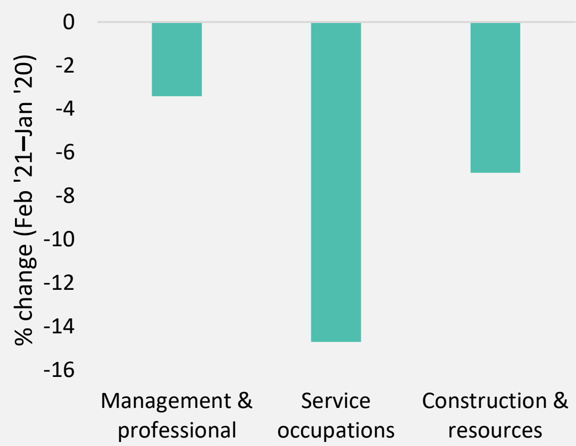
Taking a step back from latest data trends, we recognize that ESG scores likely lag real-time dynamics on the ground, especially in the context of the COVID-19 crisis. As highlighted in the introduction, the pandemic likely impaired social scores, and it remains uncertain whether the gains observed—especially within social indicators—can be preserved beyond 2020.

In the next section, we look closer at some of the possible channels through which the pandemic may have impacted social indicators. Again, the extent and duration of the negative impact will vary across regions and countries, and some channels will be more important for certain countries than others, in terms of both causing social vulnerabilities and actually being reflected in their respective ESG scores further down the line.

Those suffering from pre-existing social inequalities and vulnerabilities ahead of the crisis, as well as those with weaker social safety nets and governance structures, may be impacted more severely medium term.

Labor & Income Inequality: The pandemic has exacerbated social inequalities and vulnerabilities through numerous channels, whether income-, health- or gender-related. Labor force (and thus potentially income) inequality has been a particular focus: lower-skilled, lower-paid workers have been hit harder by the pandemic-related recession, because they're more likely to work in the worst-affected sectors (hospitality and retail), and less likely to be able to work from home during lockdowns. Also, a higher proportion of low-skilled workers are more likely employed in services, increasing potential exposure to COVID-19 infections that can harm health, earnings and job security. This narrative suggests a compelling case for at least a temporary rise in intra-country income inequality during and immediately after the COVID-19 crisis.

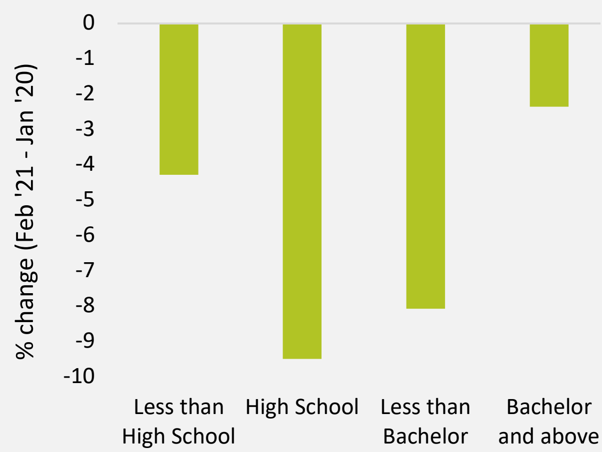
Change in US Employment by Sectors



Source: US Bureau of Labor Statistics, AB

US employment data don't apply to all countries, but they do provide significant detail and help us visualize the labor-market inequalities highlighted earlier. Service-sector occupations have experienced much larger employment changes since the pandemic's onset, with workers who have lower educational and skill levels significantly worse affected. US employment data also suggest a noticeable disparity across ethnic and gender groups (see chart at bottom of page). On an aggregate level, there doesn't seem to be a big difference in employment changes between male and female workers, but across ethnic groups, Black or African American as well as Hispanic or Latina female workers have seen the largest employment decreases. These cohorts also have some of the lowest median average wages in the US economy. We look at cross-country data on female employment in more detail below.

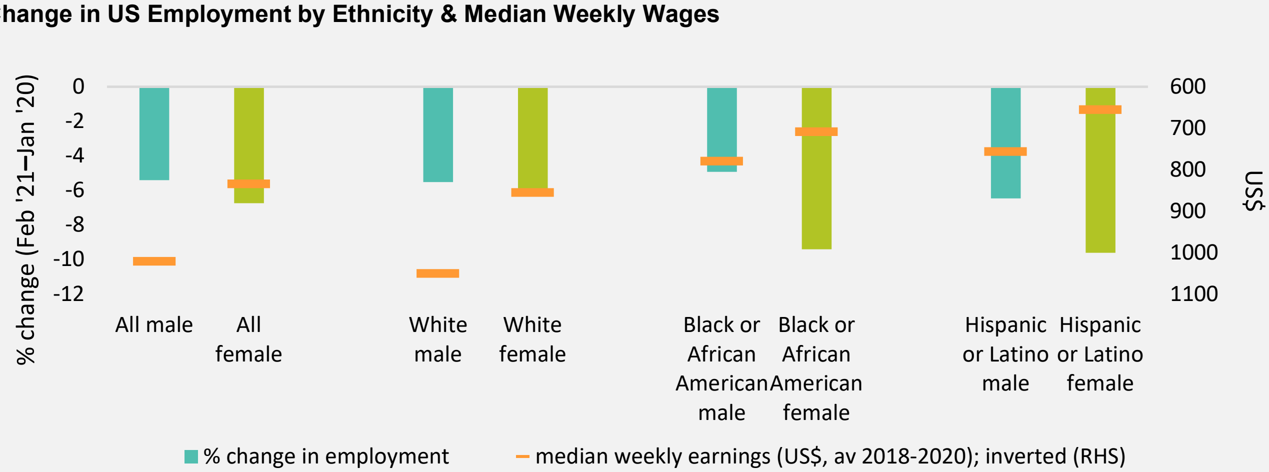
Change in US Employment by Education



Source: US Bureau of Labor Statistics, AB

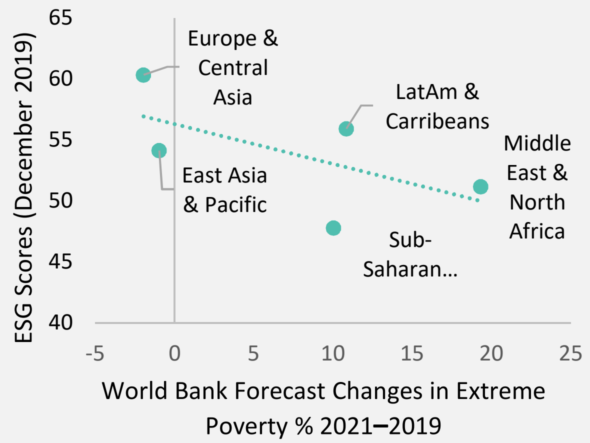
Income Inequality *Across* Countries: A running debate among academics and policymakers is how the pandemic has changed income inequality gaps *between* high- and low-income countries. Economist Angus Deaton (*COVID-19 and global income inequality*, January 2021) points out that low-income countries appear to have recorded lower COVID-19 deaths per capita. At the same time, estimated lost GDP per capita between 2019 and 2020 across countries was strongly correlated with COVID-19 casualties, suggesting that income inequality (as measured by GDP per capita) between high- and low-income countries may have decreased because of the pandemic. However, Deaton's analysis only holds when analyzing high- and low-income

Change in US Employment by Ethnicity & Median Weekly Wages



Source: US Bureau of Labor Statistics, AB countries on a unit basis, as opposed to weighted by population. When countries are population-weighted, income inequality has increased, mostly because China is now considered an upper-middle income country that has performed well, both in terms of COVID-19 fatalities and economic growth since the outbreak of the pandemic.

Regional EM ESG Score and Extreme Poverty



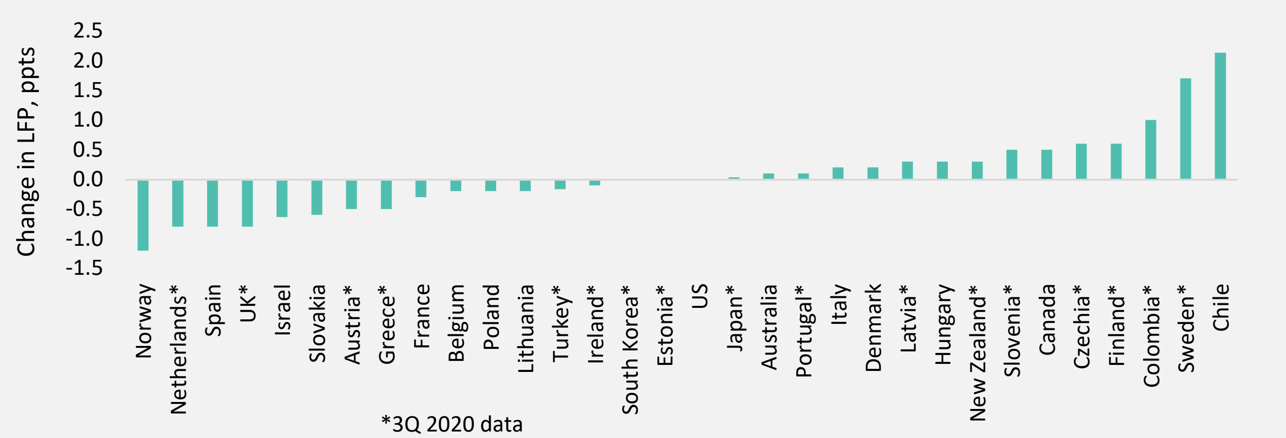
Source: World Bank, WB

Rising Levels of Poverty: A more extreme form of income inequality among low-income countries is the expected significant rise in poverty in the absence of social safety nets. To this point, the World Bank (2021) estimates that the number of people in extreme poverty (living on less than $1.90 per day) rose by 88 million in 2020 under its base-case scenario—the first annual increase in more than 20 years. According to its estimates, around 50% of the world's extreme poor are concentrated in five countries (India, Nigeria, Democratic Republic of the Congo, Ethiopia and Bangladesh). These nations also have among the lowest Human Development & Equality scores in our ESG universe. As shown in the chart to the left, there's an expected negative correlation between World Bank forecasts of changes in extreme poverty in 2020–2021 and ESG scores. This relationship highlights that—among other factors—regions and countries with weaker social, as well as governance and environmental, dynamics have from the outset been at risk of rising poverty during the pandemic. Concerns around "vaccine nationalism"—high-income countries hoarding supply—may hinder a recovery in growth and poverty levels in lower-income countries.

Gender Inequality: As already touched on in the case of the US, a further aspect to consider is that the pandemic risks aggravating gender inequality in the labor market. The Peterson Institute of International Economics (PIIE, December 2020) argues that—while not uniform across countries—there's evidence that lower-paid female workers have potentially been more adversely impacted by the closures of sectors such as retail stores, restaurants, and the hotel and hospitality business. "Normal" recessions in the past had a heavier impact on procyclical sectors (construction and manufacturing), which have higher rates of male employment. School closures and associated parenting responsibilities may have exacerbated pressures on female employment in 2020–2021. The extent and duration of the negative impact on lower-paid female workers have differed from country to country and been mitigated somewhat by social measures such as furlough schemes or childcare subsidies (especially in developed markets). Measuring the gap between male and female labor force participation (LFP) is another way of looking at potential emerging pressures between male and female employment, with a widening gap suggesting that female employment has suffered relatively more during a given time period.

LFP data for 2020 covering all nations in the Organisation for Economic Co-operation and Development (OECD) show a wide dispersion in changes since the end of 2019, highlighting that there is no uniform trend across countries between male-female LFP gaps for which we have comparable data (see chart below). Chile, Sweden and Colombia, and to a lesser extent Finland, Czechia, Canada and Slovenia, registered more noticeable increases in male-female LFP gaps over the course of 2020. In contrast, Norway, the Netherlands, Spain and the UK actually saw decreases. PIIE highlight that government support packages

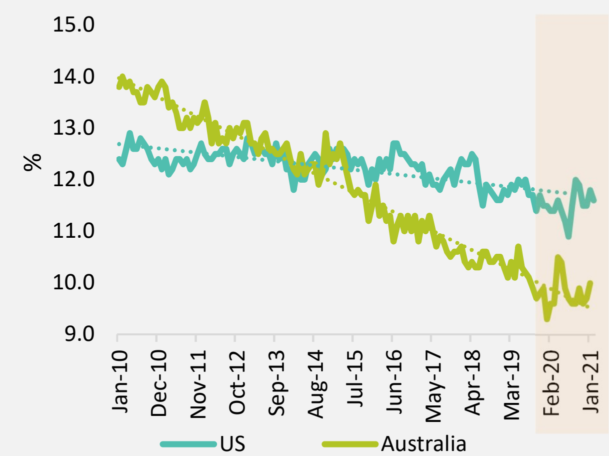
Change in OECD Male-Female Labor Force Participation (LFP) Gap (4Q or 3Q 2020–4Q 2019, %)



Source: OECD Labor Statistics, AB

(furlough schemes, tax cuts and childcare subsidies) have helped keep female workers in the labor force, at least during 2020—the expiration of furlough schemes may still change dynamics going forward.

Gap Between Male-Female Labor Force Participation

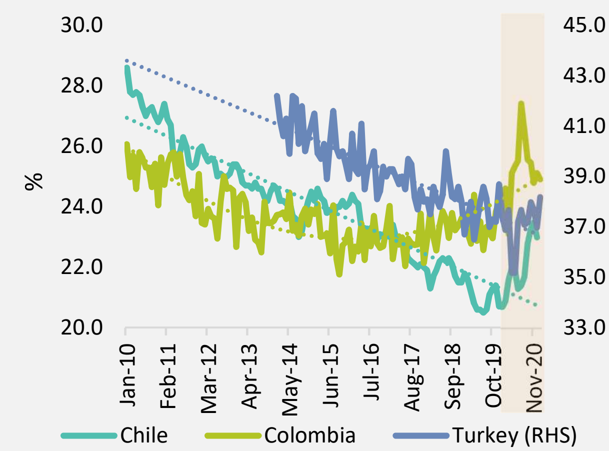


Source: OECD Labor Statistics, AB

The reality is that for most countries—at least in developed markets—gender inequality in the labor market may not have suffered significantly on *an aggregate basis* from the pandemic. When looking at the latest data through February 2021, the US male-female LFP gap has deteriorated slightly but still shows no meaningful deviation from the longer-term trend (although, as discussed above, there may be significant gender disparities *within* ethnic groups). Similar dynamics apply to Australia: the gap between male and female LFP initially spiked but then recovered quickly, partly because the Australian government has been quick to subsidize childcare.

On the other side of the spectrum, dynamics may have to be monitored more closely in some emerging markets, such as Chile and Colombia. In Chile, especially, we see a more meaningful divergence from longer-term trends; the lack of extensive furlough schemes or social security measures could be one explanation. Elsewhere, Turkey's male-female LFP gap improved in the early phases of the COVID-19 pandemic but has deteriorated since third quarter 2020 and may be starting to diverge from longer-term trends.

Gap Between Male-Female Labor Force Participation



Source: OECD Labor Statistics, AB

In conclusion, the pandemic has impacted social inequalities and vulnerabilities through a variety of channels, especially income- and gender-related. But this has not fundamentally altered our aggregate assessment of sovereign ESG risks. First, the impact will likely be felt more severely amongst sovereigns with underlying social and governance vulnerabilities going into the crisis. Second, we do consider developments on a country-by-country basis and make qualitative adjustments to ESG scores as we see fit. It will also matter how governments adjust (social) policy in reaction to the Covid-19 crisis, which could mitigate the negative impact. As discussed in the next section, governments in a number of countries are making active policy changes to address inequalities resulting from the Covid-19 crisis. More generally, the pandemic can be viewed as a catalyst for positive ESG change, which has also been increasingly reflected in sustainable finance flows.

ESG and Sustainable Finance Beyond the Pandemic

Governments have addressed the immediate economic and social impacts of the COVID-19 crisis with significant fiscal and monetary policy stimulus. As shown above, furlough schemes and childcare subsidies have helped to mitigate the labor-market impact, especially in developed markets. Going forward, there are indications that both DM and EM governments have started to look beyond the short term at how to remedy underlying social inequalities and environmental concerns. These pressures were already evident before the crisis, and the pandemic is now acting as a trigger to accelerate policy changes to address them. This should ultimately be a positive for global ESG dynamics.

In developed markets, the EU's €750 billion Next Generation Fund—born out of the pandemic—is a case in point. It envisages spending around 37% of the funds on the green transition, 20% on digital innovations and the rest on reducing social and territorial inequality, boosting economic cohesion, improving crisis-preparedness and investing in education. Also, the EU's €1 trillion Green Deal, established in late 2019, is receiving a major legislative boost during the pandemic through the Sustainable Finance Directive Regulation (SFDR) and the EU taxonomy. The latter two aim to establish standardized disclosure rules for investment activities that are defined as sustainable and aligned with climate-change mitigation.

In the US, debates among policymakers indicate that part of fiscal and monetary policy stimulus will be guided by inequality. The Biden Administration's $1.9 trillion American Rescue Plan has a focus on supporting low-income households through spending on childcare and education. Also, the US Federal Reserve highlighted, in its February 2021 monetary policy report, that low-income households have borne the brunt of pandemic job losses, which may delay a monetary policy response to the crisis. A greater focus on support for low-income households will likely entail redistribution to address ethnic income inequalities as well as gender income disparities within certain ethnic groups.

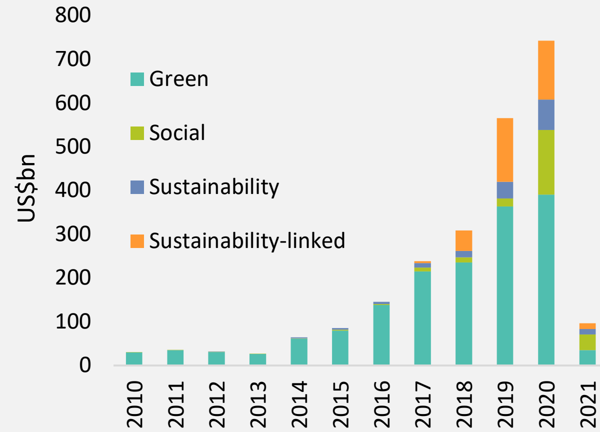
In terms of green initiatives, President Biden's series of executive orders and the US return to the Paris agreement signal the administration's renewed focus on countering climate change. The latter is aligned with stimulus and job creation, as President Biden highlighted himself by saying, "when I think of climate change, I think of jobs." He argued that "millions of Americans will be able to get jobs through modernizing our water systems, transportation, our energy infrastructure—to withstand the impacts of extreme climate."

There are signs of a similar shift among certain emerging-market governments, too. For instance, the Colombian government recently identified specific objectives through a planning exercise to address the uneven effects of the COVID-19 crisis on the population. Government programs across the Márquez administration will prioritize: 1) the rapid creation of around two million jobs; 2) fostering clean and sustainable growth; 3) increased attention to vulnerable populations; 4) support for rural development and peace; and 5) health improvement programs. Moreover, the government recently announced the regularization of close to 1.9 million Venezuelan migrants, a policy that will allow them to enter the labor force and access social services. In the case of Chile, the government launched a new framework that adds social categories, including those that have been crucial in supporting the population most affected by COVID-19, to its existing Green Bond framework. The program delineates the use of proceeds, the evaluation and selection of the projects' process, the management of proceeds and the reporting process after the issuance of the instruments.

At this juncture, it's difficult to quantify the effect of these initiatives on social and environmental aspects, much less on specific ESG indicators. Also, the jury is out on the speed and effectiveness of government policy implementation. Yet, it's becoming clear that there is increased impetus for change on a political level to improve social and environmental sustainability.

Governments' increasing focus on environmental and social policies has also been reflected in continued significant increases in sustainable finance issuance (bonds and loans) over the past year, supported by strong investor appetite for ESG-linked investment products. Total sustainable issuance in the combined corporate and sovereign space increased to US$742 billion in 2020 (see chart below), rising by another 31% following record growth rates in 2019. Moody's estimates that sustainable bonds accounted for about 5.5% of total global bond issuance in 2020, up from 4.5% in 2019.

Global Sustainable Issuance (Sovereign-Related and Corporate, USD Billion)

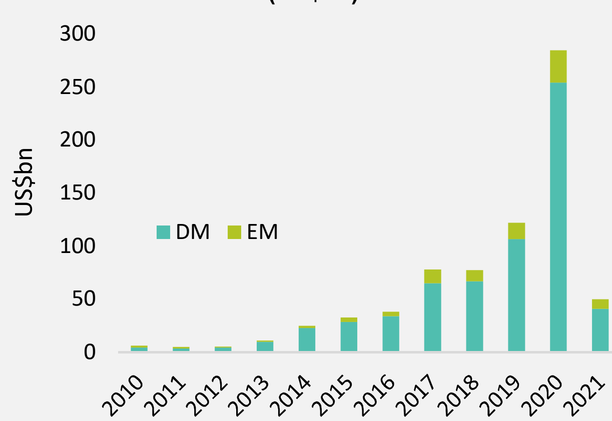


Source: Bloomberg, AB

Sovereign-related sustainable issuance (US$284.5 billion in 2020) continued to account for less than half of total issuance, and for now, developed markets (DM) account for the large majority of sustainable issuance (see chart below), though issuance is also gaining momentum within emerging markets, albeit from a low base.

With respect to terminology, social bond proceeds are geared toward social objectives including basic infrastructure, essential services and affordable housing, while sustainability bond proceeds are deployed in eligible green and social projects. We've seen the fastest issuance growth rates in the sovereign space, especially within DM, and particularly for social and sustainability-related financing.

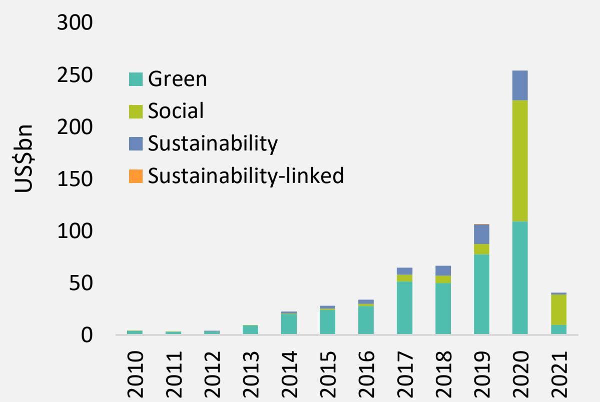
Global Sovereign, Municipal & Supranational Sustainable Issuance (US$bn)



Source: Bloomberg, AB

Within DM, Europe accounted for more than 80% of sustainable finance in 2020, and supranational institutions such as the EU and government agencies such as France's Caisse d'Amortissement de la Dette Sociale have become prominent social bond issuers. The EU issued an additional US$46.7 billion through its Support to mitigate Unemployment Risks in an Emergency (SURE) financing program in fourth quarter 2020 alone. Financing for the EU's Next Generation Fund will also likely support sustainable issuance over the medium term.

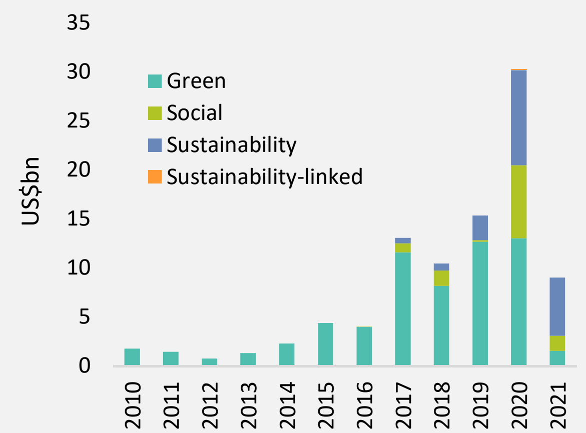
DM Sovereign, Municipal & Supranational Sustainable Issuance (USD Billion)



Source: Bloomberg, AB

While still smaller in scope, EM sustainable issuance also increased in 2020: green bond issuance remained relatively stable, but the amount of social and sustainability issuance rose by a factor of nearly six. In 2021 to date, social and sustainability issuance have made up the lion's share, already reaching 43% of 2020 issuance. These figures for DM and EM clearly highlight that governments' focus on sustainable financing—in particular with regard to social and sustainability—are gaining momentum. This progress has been supported by strong investor appetite for ESG-focused investment products, which is expected to remain a key theme throughout 2021 and most likely beyond. Importantly, quality over quantity will continue to matter, and attempts of "greenwashing" issuances will have to be monitored carefully.

EM Sovereign, Municipal & Supranational Sustainable Issuance (USD Billion)



Source: Bloomberg, AB

AB ESG SCORES: February 2021

Country	Latest Score ESG	E	S	G	Country	Latest Score ESG	E	S	G
Norway	88.6	83.1	92.2	88.7	Belarus	56.4	62.0	58.9	52.7
Finland	88.0	81.6	90.6	89.0	Jordan	56.4	51.6	52.6	60.5
Denmark	87.9	76.7	92.3	89.8	Qatar	55.9	65.5	61.7	48.7
Sweden	84.6	81.0	89.5	83.2	Kuwait	55.4	63.2	58.1	50.8
Switzerland	84.5	72.2	92.5	84.6	Belize	55.3	48.0	65.7	51.9
Netherlands	82.5	67.1	90.3	84.0	Brazil	55.1	57.9	56.3	53.3
New Zealand	82.3	59.1	88.5	87.9	Kazakhstan	54.6	49.1	58.9	54.3
Germany	80.8	66.6	87.0	82.9	Paraguay	54.5	65.5	60.3	46.6
Estonia	80.7	72.0	88.0	79.8	Sri Lanka	54.2	53.2	55.2	54.0
Austria	79.9	70.0	86.7	79.7	Oman	53.7	43.5	53.2	58.0
Ireland	79.3	67.7	90.7	77.1	Bahrain	53.4	64.4	48.5	52.0
UK	79.1	67.0	82.6	81.8	Peru	53.1	39.1	60.8	54.0
Australia	78.8	53.6	86.6	84.3	Ukraine	52.8	53.0	57.5	49.9
Belgium	78.6	69.0	86.6	77.6	Senegal	52.7	51.0	53.0	53.2
Canada	78.1	57.1	87.3	81.1	Morocco	52.4	49.8	49.9	55.0
Singapore	77.9	67.5	78.5	81.8	China	52.0	44.7	55.0	53.1
Czechia	75.1	66.6	85.6	72.2	Colombia	51.4	45.0	52.0	53.6
France	74.9	63.9	82.7	74.5	Thailand	51.2	39.2	52.0	55.6
Uruguay	74.0	73.8	80.4	70.3	Dom Rep	50.9	40.8	61.0	48.9
Portugal	72.9	62.5	84.9	69.8	Indonesia	50.6	33.2	52.8	56.2
Spain	72.8	59.2	83.3	72.0	Ecuador	50.1	37.8	59.8	49.2
Japan	72.2	36.5	86.6	77.9	Russia	48.8	44.0	48.2	51.1
Latvia	72.1	68.3	83.8	66.5	Philippines	48.4	31.7	50.9	53.6
Lithuania	72.0	69.6	87.9	63.4	Uzbekistan	48.3	40.1	50.9	50.0
Slovenia	71.6	59.3	85.2	68.4	Mexico	48.3	38.3	51.8	50.2
Bahamas	71.3	52.6	89.0	68.3	Guatemala	48.1	44.7	47.1	50.1
US	70.3	43.4	74.7	78.3	Kenya	48.1	52.1	42.7	49.8
Slovakia	69.3	61.4	85.0	63.1	Rwanda	47.8	60.8	34.8	50.3
Barbados	69.1	51.7	90.8	63.0	Azerbaijan	47.6	45.9	40.0	52.8
South Korea	68.8	42.3	84.1	70.3	Zambia	47.5	63.1	47.0	41.6
Italy	68.3	53.4	80.8	66.8	Turkey	47.4	39.9	47.3	50.5
Costa Rica	67.9	49.6	77.7	69.4	India	47.3	26.0	49.5	54.6
Poland	67.3	61.6	78.0	63.1	Tanzania	46.8	55.4	43.8	45.2
Chile	65.6	45.7	76.2	67.3	Honduras	46.1	43.5	47.3	46.5
Romania	65.3	54.7	73.2	64.8	Saudi Arabia	46.0	54.5	42.1	45.0
Croatia	64.4	53.4	77.3	61.1	Papua N. G.	45.9	38.8	53.2	44.3
Greece	62.6	48.9	76.4	59.9	El Salvador	45.8	33.1	55.9	44.9
UAE	62.2	49.2	63.2	66.9	Ethiopia	44.8	57.6	34.3	46.0
Israel	62.0	53.7	74.8	57.7	Lebanon	44.8	46.2	51.7	40.1
Georgia	61.5	50.9	61.9	65.6	Côte d'Ivoire	44.8	56.5	41.7	41.9
Hungary	60.7	55.9	71.4	56.2	Nigeria	43.9	61.7	36.8	41.1
Jamaica	59.7	45.9	70.0	59.1	Angola	42.7	55.0	38.7	40.2
Argentina	59.5	52.6	71.7	54.9	Bolivia	42.2	48.4	53.8	32.8
Malaysia	59.4	46.5	64.0	61.8	Tajikistan	42.0	43.2	33.4	46.7
Mongolia	58.6	55.5	69.2	53.4	Egypt	41.8	47.3	36.8	42.7
Ghana	57.6	54.7	59.6	57.6	Pakistan	40.5	32.1	36.4	46.4
South Africa	57.3	42.8	58.9	62.2	Bangladesh	39.8	23.7	38.7	46.9
Suriname	57.0	53.2	72.8	49.0	Cameroon	37.7	58.3	30.1	34.1
Tunisia	56.7	51.9	64.0	54.3	Congo	35.8	53.8	33.4	30.0
Panama	56.7	43.7	69.9	53.9	Iraq	34.7	37.5	34.0	34.0
Serbia	56.5	50.4	65.3	53.6	Venezuela	31.4	43.6	40.3	21.2

Source: AB

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