

The Economist

Does Ethical Investment Withhold Capital From Those That Most Need it?

Ethical investors are starting to take a country's income level into account



What does esg stand for? To most people it refers to the environmental, social and governance standards that guide a growing number of ethical investors. But Charlie Robertson of Renaissance Capital, an investment bank, reckons esg risks becoming code for something else: an excuse for investors to put all of their money in Scandinavia.

Prosperous havens rate highly on the criteria esg investors employ. By contrast, the emerging economies that interest Mr Robertson do badly. They are often dirty and corrupt—at least compared with Sweden. Their most liquid companies tend to be national champions or sprawling conglomerates that neglect minority shareholders and jump into bed with the government. Often emerging-market sovereigns default on their duty to protect human rights. Saudi Arabia, for example, will enter msci's emerging-market equity index in June. That will oblige many investors to plough funds into the kingdom, whatever they think of its rulers.

Ethically driven investment can avoid such distastefulness. But a blind adherence to esg criteria, Mr Robertson argues, could skew capital flows towards the most privileged parts of the world. That would make it harder for poorer economies to escape poverty—a failure that could, in turn, inhibit their progress on green, governance and social-justice matters.

Are Mr Robertson's fears justified? Emerging markets do command less weight in stock- and bond-market indices that incorporate ethical criteria. msci's esg Universal index, for example, gives emerging-market shares only a 9% weight. That compares with 11% in the firm's more conventional global-equity index. The gap may not sound big. But it means 18% less money from any investor following the ethical rather than the amoral index.

Mr Robertson argues that ethical investors should instead adopt a kind of economic relativism, judging countries relative to their gdp per person. His team reckon that Chile, Indonesia and Poland are all unusually virtuous given their stage of development. (By contrast, America appears somewhat unethical given its wealth.) Or investors could reward the most improved nations instead of highly rated ones. That would favour emerging markets with room to improve over countries nearer moral perfection.

Mr Robertson may be pushing at an open door. Many esginvestors manage funds that are dedicated either to mature markets or emerging ones, rather than both. They are already implicitly judging countries and companies relative to their peers. msci's index also looks at the trend in ethics scores, as well as their levels.

Foreign capital can also be overrated as a source of growth. Emerging economies benefit from it only after they pass a certain threshold of institutional quality, suggests research by Ayhan Kose and Ashley Taylor of the World Bank and Eswar Prasad of Cornell University. Most of the big emerging markets, including Brazil, Russia, India, and China, fall short of this threshold. If investors' scruples deprive these economies of fickle foreign money, it may be a blessing in disguise. The only thing worse than a dirty, corrupt, ill-run economy is one that is also deeply in hock to foreigners.

This article appeared in the Finance and economics section of the print edition under the headline "Morality play"