RBC Global Asset Management

# Emerging markets and climate transition: progress, challenges and opportunities

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**"The success or failure of EM will have a significant impact on the ability of the world to reach net-zero emissions by 2050."**

**Almost a year ago, we wrote about emerging markets ("EM") being the key piece in the climate puzzle. By this we meant that whilst developed markets have historically been the main contributor to climate change, EM markets will account for most of the increase in greenhouse gas ("GHG") emissions going forward. As such, the success or failure of EM will have a significant impact on the ability of the world to reach net-zero emissions by 2050, and therefore avoid the worst effects of climate change.**

What is becoming increasingly clear is that climate solutions for EM cannot come fast enough. There is no time for complacency, with an approaching perfect storm of diminishing global liquidity, elevated funding costs and the over-leveraged balance sheets of many EM issuers.

EM countries are certainly feeling the sense of urgency. The devastating floods in Pakistan, and drought-induced famine in Uganda in 2022 are but a few of many likely climate-related natural disasters affecting EM countries, where the capacity to cope is limited. Unfortunately, it is precisely some of the most climate-vulnerable countries that are also facing the most acute debt distress – such as Sri Lanka and Zambia. Here, whilst focusing on the restructuring of past debts is certainly necessary, it is solving only half of the problem. What these countries really require are new engines of economic growth to allow them to carry more (not less) debt, on a sustainable basis. On top of this, with the help of the international community, they need to invest in climate mitigation and adaptation projects to protect their populations from the adverse effects of climate change.

## Progress so far

Despite the overwhelming nature of the challenge, combined with a hostile external market environment, EM countries are continuing to push ahead with their green agendas:

1. **Climate change commitments – scaling up ambitions:** one indication of progress amongst EM countries is the growing ambition of their Nationally Determined Contributions (“NDC”)[1]. More than 15 EM countries have submitted a new NDC target since the start of 2022. Most of these commitments, whilst more ambitious than previous NDCs on paper, are still leading to increased emissions and are not yet compatible with the Paris Agreement’s objectives[2]. However, EM countries are not alone in this respect. Whilst more ambition is needed, it is noteworthy that EM countries continue to dominate the group of countries with an ‘almost sufficient’ NDC target, as defined by the Climate Action Tracker initiative.

   More importantly, last year, Uruguay led the way in creating a direct link between the fulfilment of its NDC commitment and debt financing cost, via the first ever sovereign ‘step-up, step-down’ sustainability-linked bond[3]. This was a significant achievement. Creating this structure was only possible through lengthy engagement with market stakeholders, producing a ground-breaking symmetrical coupon structure whilst engaging the United Nations Framework Convention on Climate Change to act as an external verifier. It also shortened the publishing timeline of the country’s GHG data publication from three and a half years to only 15 months.

   By linking the voluntary NDC commitments to a penalty for non-compliance, Uruguay is piloting a new mechanism to motivate countries to follow up on their climate commitments, while making these targets more immune to political cycles. Such a step also recognises the reality that many EM countries – more than most DM countries – lack the domestic funds needed to meet their NDC goals. Other countries, including developed ones, may do well to follow their example and link future financing programmes to their national climate goals.

### Figure 1: Climate Action Tracker

| Critically insufficient | Highly insufficient | Insufficient | Almost sufficient | 1.5°C Paris Agreement Compatible |
|---|---|---|---|---|
| Iran (Islamic Republic of) | Argentina | Australia | Bhutan | |
| Mexico | Canada | Brazil | Costa Rica | |
| Russian Federation | China | Chile | Ethiopia | |
| Singapore | Egypt | Columbia | Kenya | |
| Thailand | India | EU | Morocco | |
| Turkey | Indonesia | Germany | Nepal | |
| Vietnam | New Zealand | Japan | Nigeria | |
| | Saudi Arabia | Kazakhstan | Norway | |
| | South Korea | Peru | The Gambia | |
| | | Philippines | United Kingdom | |
| | | South Africa | | |
| | | Switzerland | | |
| | | UAE | | |
| | | USA | | |

Source: www.climateactiontracker.org.

2. **Green taxonomies – prioritising low carbon economic activities:** whilst many are aware of the EU’s work on developing a green taxonomy (a dictionary describing which economic activities are considered green and sustainable), it’s been perhaps less widely reported that EM countries have also been developing and (in some cases) launching their own green taxonomies as well. These frameworks are important as they mobilise investments in domestic economies to line up behind a country’s own climate transition priorities and environmentally friendly projects.

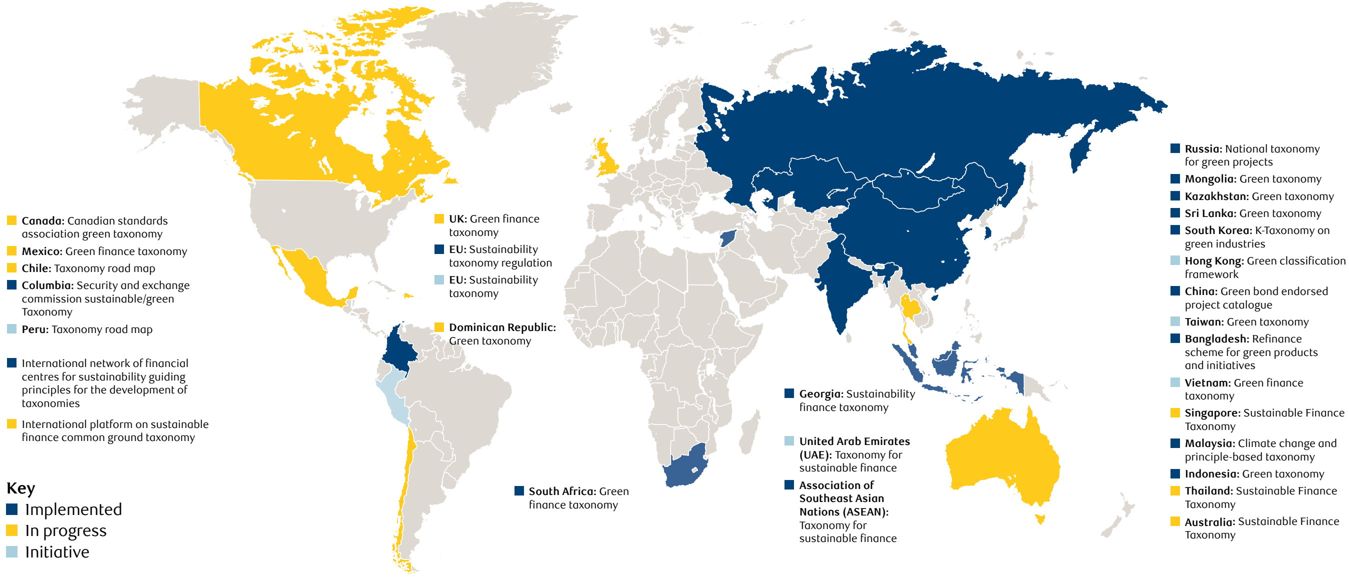
   They can provide helpful signposting to which future economic activities will be supported by government policies, which in turn provides visibility and certainty for the private sector and investors to plan for their own futures. In doing so, they can allow countries to scale up sustainable financing in a systematic and orderly fashion. Many countries’ green taxonomies reflect the unique challenges that individual countries are facing, and although these frameworks might not be perfect, they are a much-needed starting point, and we fully expect them to dynamically evolve over time.

[1] NDCs are non-binding, self-defined national climate pledges (i.e. short to medium-term targets) under the UN Paris Agreement, which detail what a country will do to meet the global goal to pursue 1.5°C, adapt to climate impacts and ensure sufficient financing to support these efforts. They are required to be updated every five years with increasingly higher ambition, based on each country’s capabilities and capacities.

[2] According to Climate Action, as at September 2023, although Climate Watch data highlights improvements across a range of categories for 10 of these updates. Source: NDC Enhancement Tracker (climatewatchdata.org).

[3] Uruguay’s Sovereign Sustainability-Linked Bonds (SSLB) (mef.gub.uy).

### Figure 2: Overview of green taxonomies and their various stage of development

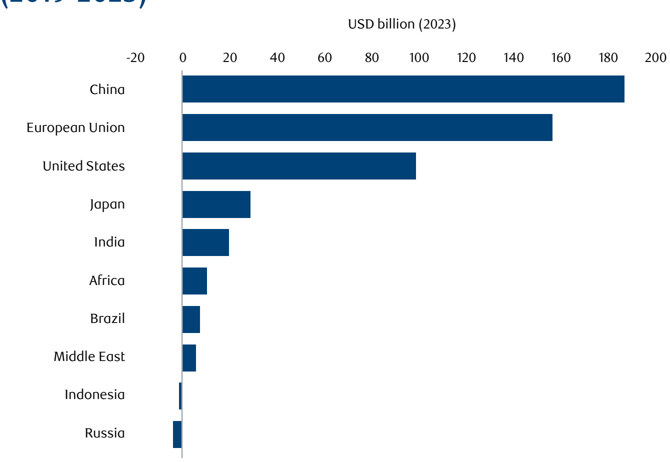



Source: Green Taxonomies Around the World: Where Do We Stand? (ECOFACT).

3. **Investments in alternative energy – renewable energy and green hydrogen**: with the ever-increasing need for energy production, given fast population growth and the growing importance of energy security following Russia's invasion of Ukraine, EM countries are stepping up their efforts to reduce reliance on fossil fuels and increase capacity in clean and renewable energy. The overall financing required to unlock the full potential for renewable energy in EM falls short by roughly USD1.1 trillion per year (a recent World Investment Report for 2023 showed that developing countries need renewable energy investments of about USD1.7 trillion every year, relative to an inflow of USD544 billion)[4]. However, countries with access to funds, China in particular, are not wasting any time directing investment into this rapidly-growing industry, followed by India and Brazil, according to the Emerging Markets Investors Alliance ("EMIA").

   Green hydrogen, generated from renewable sources, has also been an area of focus for EM countries in the past year – many are well positioned given the low cost of hybrid solar PV and onshore wind systems required to compete in this fast-evolving sector. Based on Bank of America's estimates, green hydrogen has the potential to become a USD1 trillion market by 2050, with the wide range of potential applications growing eight times from current levels. Countries in the Middle East, with high levels of national savings and strong borrowing potential, are particularly well positioned to benefit, given the significant investment needed to develop these capabilities.

### Figure 3: Increase in annual clean energy investment in selected countries and regions (2019-2023)



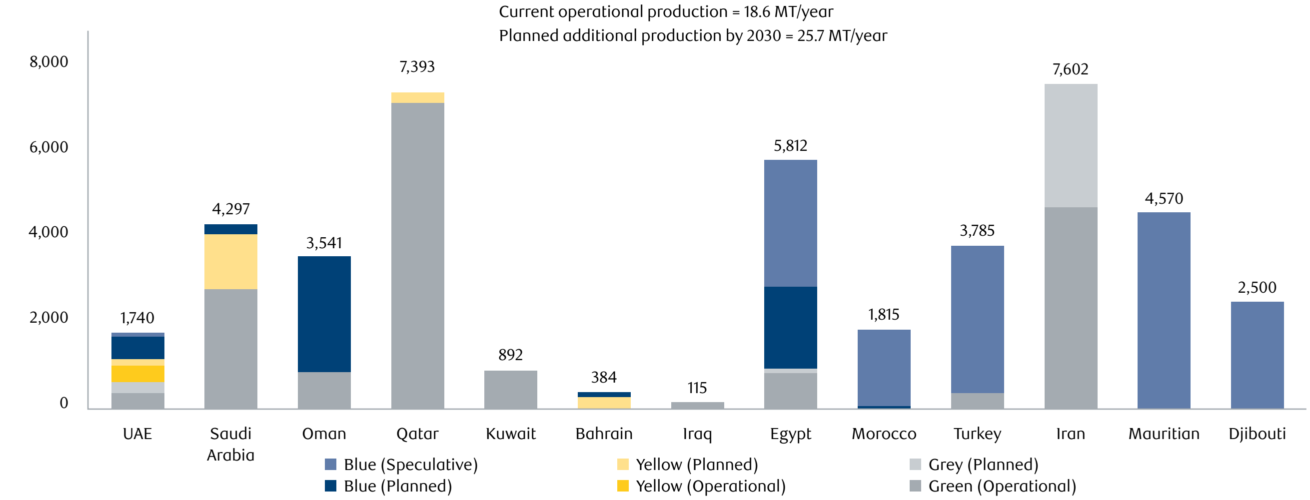

Source: Overview and key findings – World Energy Investment 2023 (iea.org).

What is becoming apparent, however, is the marked regional differences in EM's capability to attract investments into clean energy. The least developed countries, as well as small island developing states, are finding it particularly challenging to attract investments, as highlighted in a report by UNCTAD, which calls for urgent support. Whilst organisations such as the International Energy Agency, World Bank and World Economic Forum are launching programmes to mobilise investment into clean energy[5], structures to help leverage private capital are also essential for tackling the problem.

[4] World Investment Report 2023 | UNCTAD.
[5] Mobilizing investment for clean energy in emerging economies (weforum.org).

## Figure 4: Middle East hydrogen production by 2030 (dedicated & non-dedicated hydrogen projects)

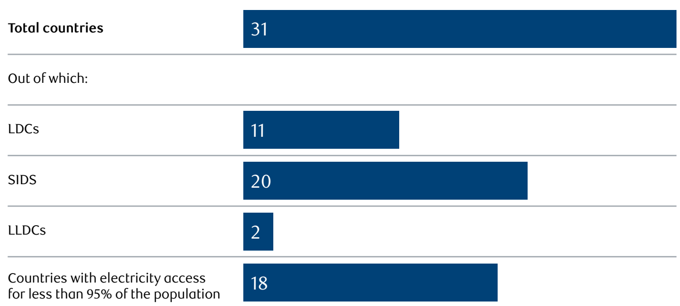
### Circa 7 million tonnes of planned firm capacity is expected to come online by 2030




Source: BofA, as at May 2023.

## Figure 5: Developing economies lack international renewable energy projects

### Number of developing countries without a large international investment project in renewables since 2015 (total and per country category)




Source: UN UNCTAD. Note: LDCs = least developed countries, LLDC = landlocked developing countries, SIDS = small island developing states.

4. **Sustainable financing – new innovative instruments and resilience of flows into positive ESG initiatives:** given challenges ahead, stakeholders, including multinationals, market participants and sovereign issuers have been ramping up efforts to develop innovative financial instruments to channel funding into much-needed projects within EM, all at a time when the tide has turned and capital is flowing out. The recent Wilton Park conference, which RBC BlueBay helped to organise in September 2023 and which explored options for debt restructuring for EM in debt distress[6], is a good example of a private-public sector initiative to brainstorm creative solutions.

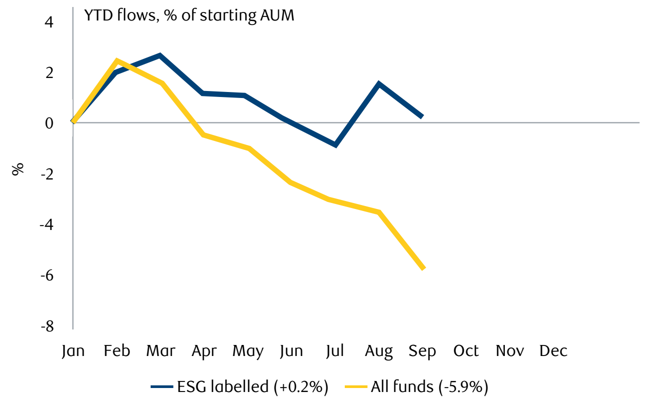
Positively, whilst we have seen net outflows so far this year from EM credit funds, ESG fund flows have remained positive, showing that despite tightening liquidity, investors are willing to commit funds to activities they believe are important for future sustainability and resilience.

We have seen ongoing issuance of EM sovereign 'use-of-proceed' ("UoP") bonds, which are debt instruments that fund pre-defined projects with ESG benefits, with green bonds (i.e. funding environmental projects) still making up the majority of new ESG bond issues. Social bond (i.e. funding social projects) issuance re-accelerated slightly from the post-Covid 2022 dip, although it is still taking up a smaller share of EM sovereign ESG issuance, third after sustainability bonds[7] (i.e. funding a mix of environmental and social projects). Regionally, we have seen recent acceleration of green issuance from the Middle East – a trend we expect to remain firmly in place in the years to come, with more countries (such as Oman) currently working on their sustainable finance frameworks.

Finally, we have been positively encouraged by improvements in the quality of recently-introduced UoP frameworks, such as the latest Brazilian one[8], with more sovereign issuers acknowledging the importance of transparency and additionality, limiting lookback periods to current budgets and trying to target areas with the greatest need for improvement (such as deforestation, in the case of Brazil).

[6] Emerging markets in debt distress: exploring options for debt restructuring (wiltonpark.org).
[7] research.hsbc.com.
[8] Brazil announces first issuance of sustainable bonds (Planalto.gov.br).

**Figure 6: EM credit fund flows**




Source: EPFR, Barclays Research, as at November 2023.

We have also seen the sustainability-linked bond ("SLB") framework (debt financing issued with specific ESG performance targets that contain contain key performance indicators), which was limited to the corporate world until last year, start to be utilised by sovereigns. At that time, Chile successfully launched the first ever SLB[9] using a step-up coupon structure, with the aforementioned Uruguay issuance following shortly afterwards. Presently, with USD216 billion outstanding issuance globally[10] the SLB market remains the smallest part of the ESG-labelled bond universe. Yet, we believe it remains an area to watch. These structures present an interesting new instrument for countries that might not have enough projects for UoP bonds but still want to attract ESG-minded capital. They could also serve as a powerful tool in holding countries accountable for meeting their ESG commitments in general, and not just the NDCs.This was something Chile showed with its SLB bond launched earlier this year, targeting social KPIs.

Finally, we have also seen the growth of the so-called 'debt-for-nature' swaps, most recently completed by Gabon[11] and Ecuador[12]. These rather complex transactions allow sovereign borrowers to exchange some of their debt for cheaper funding, usually boosted by credit enhancements, in return for channelled future funding into projects connected to nature conservancy/environmentally friendly causes. These instruments take a long time to complete and currently lack scalability as they are appropriate in very unique circumstances (i.e. for heavily indebted countries). However, we believe they will remain part of the solution for many smaller sovereigns with high biodiversity endowments and limited access to funding.

## Challenges remain and the stakes are high, but the opportunities are also compelling

Whilst there have been many positive developments over the last year, significantly more capital needs to be channelled into EM countries to fulfil their climate transition objectives. The financial industry can play a critical role, by directing this capital into EM countries. For this to be possible, public resources such as those provided by the World Bank, the IMF and other developmental institutions will be instrumental. Likewise, funding via country-led initiatives, such as the Just Energy Transition Partnerships for South Africa, Indonesia or Vietnam, needs to be broadened out, further leveraged and scaled up. ESG-labelled issuance structures also need to be enhanced to become better fit for purpose when it comes to lending to low- and middle-income countries, which often lack the capacity to develop and monitor these frameworks, such that investors are comfortable that the funds are reaching the desired projects. Credit enhancements with the help of the developed world and international institutions can also allow for concessional rates of new funding. Equally as important, present restructuring processes should be used as an opportunity to design solutions for emerging countries coming out of debt distress to attract new capital into well-defined projects and boost their growth prospects.

**"These investments have some of the greatest potential to generate positive impact and real-world outcomes for us all."**

Ultimately, as we have highlighted previously, the world cannot transition without EM being taken along on the journey. At a time when many investors are discouraged from investing into EM and capital is flowing out of the regions, it is the moment to recognise that, in fact, these investments have some of the greatest potential to generate positive impact and real-world outcomes for us all. So it's time for the world to stop thinking of EM countries as a burden, and instead see them as a key enabler in the low carbon transition.

9 Sustainability-linked bonds (hacienda.cl).
10 HSBC, as at 10 July 2023.
11 The nature conservancy announces debt conversion in Gabon (nature.org).
12 Ecuador completes world's largest debt-for-nature conversion with IDB and DFC support (iadb.org).

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