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Emerging Markets: A Fuzzy Concept and some Key Identifiers

Dr. Rahel Falk, researcher at the WU Competence Center for Emerging Markets & CEE, on the identifying criteria of Emerging Markets

1. Introduction

The notion of "Emerging Markets" dates back to the early 1980s when Antoine van Agtmael, then the deputy director of the capital markets department of the World Bank's International Finance Corporation (IFC), coined the term in order to raise private investment funds for developing countries with high growth potential. At that time investors indiscriminately ignored developing countries, then known as the "Third World", a place rather known for charity and aid than for business. Due to extensive research and travelling van Agtmael knew better and he felt that the vast ignorance of profitable business opportunities outside the Western World was mainly due to arrogance (van Agtmael, 2010). Accordingly, he made up a new concept that would hopefully appeal more to international investors by separating the wheat from the chaff.

The concept itself and even more so the countries it addressed proved to be highly successful in economic terms throughout the past decades. While the total emerging and developing world accounted for only a little bit more than one third of global GDP (based on purchasing power parities) in 1980, the share comes close to 60% today. In the same period, the seven members of the club of major advanced countries (G7)[1] experienced a decline from more than half to only 30% of world GDP. At the turn of the millennium the two groups had realized equal shares (International Monetary Fund, 2016). The unequal number of countries included in these sets – seven as opposed to 152 – sure enough puts such evidence into perspective, but the trends are clear. There is no more room for arrogance. In view of saturated markets with declining growth performance, today's investors are highly aware of market potential beyond well-established business locations.

Another reason for the ongoing popularity of the fuzzy catch-all term might be that the traditional Western perspective on the path of economic development has been extremely challenged as well. In the old days, mainly agrarian economies of the Western hemisphere had started to build up large-scale manufacturing following the Industrial Revolution from the mid 19ths century onwards. More than a century later we have been witnessing the transition to knowledge-intensive service economies. The story of gradual transformation following a linear trajectory (as revealed not least in the numbering of sectors: agrarian/primary sector, manufacturing/secondary sector and services/third sector) is quite

[1] G7: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States

different nowadays. To not lose track on developments in different parts of the world it is convenient to just put them all under an umbrella term, emerging being the common denominator.

Irrespective of its wide use ever since, the concept of Emerging Markets lacks a clear-cut, formal definition. Instead, researchers loosely refer to “advanced developing countries” and “countries or markets that are not well established economically and financially, but are making progress in that direction”, as Aizenman (2008) introduces his corresponding contribution to The New Palgrave Dictionary of Economics.

2. Methodic Approach to EM-Identification

The main problem for identifying Emerging Markets is that the very centre of reference – “development” along with its antipodes at the lower and upper end – is dynamic by definition and can therefore only be assessed in relative terms. (Nielsen, 2011) argues most convincingly that it is far from obvious where to draw the line between developed and developing. More importantly, any such classification system would struggle with general acceptance for it inevitably involved judgements. Four important implications result from this discussion. Firstly, development is a multifaceted concept that, secondly, involves value judgements. Thirdly, due to its dynamic nature, it is impossible to come up with fixed benchmarks, nor, finally, with universally valid country lists.

While there is no general consent on what constitutes the critical state of “emergence”, the case of least development is well-defined by the United Nation’s (UN) definition of Least developed countries (LDC) (see UN Committee for Development Policy, 2015, Chapter 3, page 41 ff.). On the other hand side, the International Monetary Fund (IMF) classifies countries into just two broad groups, viz. 39 “advanced economies” versus 152 “emerging and developing economies” – acknowledging that this classification is not based on strict criteria and just serves as a useful approach to organize data in a “reasonably meaningful” way (IMF 2016, Statistical Appendix, p. 205 ff.).

A pragmatic approach to EM-identification would start from the IMF-list of 152 “non advanced economies”, subtract the least developed countries as identified by the UN and apply the criteria for “financial and economic progress” to the rest. Both of above classifications rely on measures of income and external economic relations. Furthermore, a country overcomes the status of least development and potentially qualifies as an Emerging Economy when it proves more stability in socio-economic and financial terms.

The following sections will discuss the issues of human, economic and financial progress and hence “emergence” and motivate some key indicators by which development can be assessed. The table in the appendix provides for details on data sources and definitions of all indicators.

3. Identifying Progress

3.1 Human Development

Income

Income measures provide information on the overall level of resources available to a country. The World Bank classifies countries into four broad income groups, viz. low, high, lower- and upper-middle income countries, and it adjusts the prevailing limits every year. At present (i.e. calendar year 2015, fiscal year 2017) a country falls into the low-income group if it realises purchasing power parity-adjusted GNI per capita of less than US-$ 1,026 a year. If the three-year average is below this inclusion threshold, the UN classifies a country as "least developed". Furthermore, the income-only graduation threshold – the country moves to a higher level of development even if it meets none of the two other criteria for advancement – is set at twice the normal graduation threshold, which is 20 per cent above the inclusion threshold. Hence, by the income measure alone, a country would not fall into the LDC-class anymore if it realized GNI per capital above 1,026*1.2*2= 2,462 US-$. High-income countries are those with annual GNI per capita of more than US-$12,475, again evaluated at purchasing power parities (PPP). All countries the IMF identifies as "advanced economies" prove to be high-income countries. Emerging Markets are located somewhere between these upper and lower benchmark.

Per-capital income is a good starting point for assessing the average standard of living within a country, yet the distribution of income may be highly unequal, leaving too many in dreadful poverty. More importantly, income is a means to human development and not the end.

Health & Education

To shift the former focus of development economics from monetary measures of national income accounting to people-centered policies, a group of economists around Nobel laureate Amartya Sen designed the Human Development Index (HDI) as a simple composite measure based only on per capital GNI, knowledge and health measures (see section II in Fukuda-Parr and Kumar, 2009). The indicator thus explicitly addresses the spending priorities and whether growth in income translates into actually better outcomes of people's health and education.

Good health is not only an integral part of human well-being, but it also improves individual educational achievements and eventually spurs economic productivity, both directly, as well as indirectly through the positive effects of skilled (educated) labour. Ban Ki-moon, former Secretary-General of the UN, put it metaphorically in stating that "healthy societies and healthy markets go hand in hand". In the HDI, the health dimension is assessed by life expectancy at birth, while the knowledge dimension is measured by mean of years of schooling for adults aged 25 years and more, as well as by expected years of schooling for children of school entering age.

3.2 Economic Development

Economic performance

Economic activity is most commonly measured in terms of gross domestic product (GDP), i.e. the market value of all final goods and services a country produces within its borders in a given period. To make GDP figures comparable across countries, GDP is converted into international dollars using purchasing power parity rates and divided by population. Higher levels thereof reflect higher levels of economic performance (but, again, not necessarily higher levels of economic well-being). Emerging Markets are characterised by both distinctively lower absolute levels of per-capita GDP as compared to established markets, as well as notably higher growth rates of GDP as compared to (other) developing countries. Furthermore, GDP performance of Emerging Markets is typically subject to heavy fluctuations which can be directly traced back to the economic (and financial) structure.

Economic Structure

Within the GDP framework only goods and services produced for sale are measured and hence contribute to economic growth, while anything produced for own use or barter does not. On this account a country's economic structure is highly essential and any shift of activity from the informal economy to registered enterprises contributes to growth. It comes as little surprise that exceptionally fast growth in GDP often result from heavy industrialization when larger numbers of people leave the subsistence economy – mainly in agriculture – to find better paid jobs in urban manufacturing. Measures for a country's economic structure include the (relative) size of its agricultural, manufacturing and service sector as identified by the sectoral shares in total value added. The size of the informal sector is usually proxied by informal employment in total non-agricultural employment.

3.3 Financial Development

The financial sector comprises all "institutions, instruments, and the regulatory frameworks that permit transactions to be made by … extending credit" . It is instrumental in mobilizing and pooling savings, producing reliable information about investment, optimizing the allocation of capital/funds, as well as facilitating and encouraging the inflows of foreign capital.

A large body of both theoretical and empirical literature shows that financial sector development is not just an outcome of growth, but well-developed financial institutions and markets are catalysts for socio-economic progress (Levine, 2005; World Bank, 2015, 2014, 2012). New industrial undertakings require funds to finance initial fixed capital expenditure and working capital needs, individuals invest in education, save for retirement and insure against risk and governments need to finance health and basic infrastructure.

The World Bank has developed a relatively simple framework to assess countries' states of financial development that builds on four dimensions – financial depth, access, efficiency and stability – each of which is measured with respect to financial institutions and financial markets.

Financial Depth

Financial depth aims to capture the size of the financial sector relative to the economy. From a number of available empirical measures two stand out. First, total credit issued to the private (real) sector by domestic banks as a measure for the size of financial institutions. Second, it has been observed that the trading of ownership claims on firms is closely linked to the state of economic development. Hence, a comprehensive measure for the size of a country's financial markets is given by the sum of stock market capitalization and outstanding domestic private debt securities (size of bond markets), both measured as a ratio to GDP.

Financial Access

Financial inclusion means that all firm and individual can take advantage of the benefits produced by the financial system and are given full access to credit, insurance and banking – provided they are "bankable", i.e. they generate (future) income high enough to serve their loans. Access indicators differentiate between the supply-side and the demand-side. Proxies that have received much attention in the literature refer to the number of branches or ATMs per capita (provision of financial services) and the proportion of adults with an account at a bank or mobile-money provider (use of financial services).

Financial Efficiency & Stability

On the part of creditors the claim for financial access calls for clear and transparent criteria for initial project appraisal, as well as careful monitoring practices to evaluate the risk profile of existing projects and loan portfolios, as well as the debtors' entrepreneurial abilities. Good screening and monitoring standards are usually provided by credit reporting institutions which offer valuable information on the (prospective) client's credit-worthiness and the probability of default. Sound risk management in the above sense reduces default risk and thereby it contribute to the stability and efficiency of the financial system. In competitive credit markets the interest on credit will fall and thereby benefit the clients.

4. Subset and Related Concepts

As explained in the first section, the rationale behind the concept of Emerging Markets ultimately follows the logics of branding. A new term popped up to make advanced developing countries more attractive for private investment. It still works as a strategic device to better market a group of countries that shared some distinctive features with respect to human, economic and financial development making international private sector investments both promising, but also risky. Incidentally, the set of targeted countries had until then been distinguished as NICs, an acronym for "newly industrialized countries", an expression that is more technical in nature and thereby lacks the special investor appeal. The same applies to the similar and widely used term of "rapidly industrializing countries".

Growing numbers of Emerging Markets increase the heterogeneity within the set, while at the same time leading former members leave as their performance converges to the ones' of advanced countries. They may also just move to higher levels of economic and financial development and otherwise differ completely from democratic market economies that for a long time served as the prototype of socio-economic progress. Anyway, the simultaneity of diverging and converging forces clearly puts the umbrella term into question and calls for a stronger focussing with regard to the identifying criteria (Meyer and Peng, 2016).

Against this background, major international think tanks such as the Organisation for Economic Development (OECD) or the IMF are keen in providing analyses on, as well as policy advice to Emerging Markets, but they do not further elaborate on the identifying criteria. Others, most prominently providers of financial (services and) information, take the opposite route and have been further refining the initial concept. Refinements differentiate the broad class of Emerging Markets with respect to their state of development, size and geographical location.

In the early 1990s it was again an IFC economist who took the initiative to introduce so-called Frontier Markets, a subset of Emerging Markets with the distinguishing feature of relatively low market capitalization and low liquidity. As compared to "regular" Emerging Markets, equity markets in frontier economies are either distinctively smaller and/or at an infant state and hence (international) investors find it more risky, more difficult and more expensive to do business in. Needless to say, the idea of frontier economies relates to upcoming prospective business opportunities. In a similar way the Future Seven ("F-7") or the Next Eleven ("N-11") countries have been identified by Goldman Sachs economists as promising future candidates for high growth potential.

Otherwise metaphorical labelling of EM subgroups shows some preference for all kind of wild, energetic and aggressive animal, alluding to the particularly vibrant economic activity of the respective set of countries. The original Four Asian Tigers (synonymously Four Asian Dragons) of Hong Kong, Singapore, Taiwan and South Korea have progressed to well-established business hubs long ago. Subsequently, the wild-animal label has been passed on to the Tiger Cub Economies (Indonesia, Malaysia, Thailand and the Philippines), the Baltic states ("Baltic Tigers"), or the Pacific Pumas (Chile, Colombia, Mexico, Peru).

Last but not least, the use of acronyms enjoys much popularity for branding some subset of Emerging Markets. The list of well-established acronyms includes in alphabetical order the BRIC countries (Brazil, Russia, India and China), the BRICS (BRIC plus South-Africa), CIVETS, MINT, MIST, and VISTA and probably many more to come; the creativity

The collapse of the centrally-planned economies in Eastern Europe and the Soviet Union in the late 1980s marked the start of academic research in what soon came to be known as transition economies, i.e. countries adopting a series of institutional reforms to transform entire economic systems from the former planning mode to new types of market-based coordination. Interestingly, China and Vietnam are usually referred to as Emerging and not Transition Economies though they certainly do meet the identification criteria for both of these concepts (Piepenbrink and Nurmammadov, 2015, p. 2109). In general, the concept of Transition Economies implicitly embodies some kind of geographical connotation. The reverse, however, does certainly not apply (anymore). Poland, for instance, is located in Eastern Europe, has gone through transition and is now clearly outperforming Greece in in terms of economic development.

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