When Are Emerging Markets No Longer 'Emerging'?

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The term 'emerging markets' is now more than 25 years old and has come to define wide swaths of the world undergoing rapid economic change. Dozens of countries fall under the label even though they are evolving at their own pace and with their own twists on economic development.

Now, as many emerging markets show signs of a strong and growing middle-class population, observers wonder whether the term has lost some of its meaning. Initially, the phrase applied to fast-growing economies in Asia and was used in Eastern Europe after the fall of the Berlin Wall. As global interest in market-driven economies grew, investors began to look toward Latin America for emerging markets and eventually at countries such as Indonesia, Thailand, China, India and Russia.

"Once you start to put so many countries in the same category, the category loses meaning," says Wharton management professor Mauro Guillen. "While South Korea, Singapore and Taiwan share characteristics, once you put them in a bucket with India, Mexico, Argentina, Indonesia and Poland, it's no longer meaningful. The term 'emerging markets' has become a victim of its own success."

Wharton management professor Gerald McDermott agrees the definition is muddy, but the intent behind the phrase remains the same. "People started using it more loosely, and as more countries fell under the rubric, it lost a little bit of its original meaning," he says. "I think it continues to convey a reality that we're not talking about the developing world at one end or the developed world at the other. We're talking about countries with great promise and great potential. They're growing, but they're still not there."

Looking Down on the 'Third World'

Antoine W. van Agtmael was deputy director of the capital markets department of the World Bank's International Finance Corp. (IFC) when he coined the phrase "emerging markets" during an investor conference in Thailand in 1981.

Van Agtmael recalls that back then, Thailand was grouped with other poor countries that were known as the "Third World." He felt that name was discouraging investors from putting funds to work in Thailand and other poor countries with development potential.

"People looked down upon the 'Third World.' It sounded so distasteful. I thought people with that feeling would never invest," he says. "I had lived in Thailand and I knew it was better than people thought. I felt we had to use a more uplifting term." Initially, the definition applied to stock markets in countries with a cutoff of $10,000 in income per capita. Those specific numerical references soon faded. The term "emerging markets" came to be synonymous with "emerging economies" and no longer relied on income or other statistical measures.

According to Wharton faculty, the most important element in defining an emerging economy poised for growth is the strength of its economic and political institutions, such as the rule of law, regulatory controls and enforcement of contracts.

Philip Nichols, Wharton professor of legal studies and business ethics, says a numbers-based definition is less meaningful than an understanding of the way in which business is done in a country. Emerging economies, he adds, are in places that are changing from a system based on informal relationships to a more formal system with rules that are transparent and apply equally to all participants in the market. "We used to use numbers like income or market liquidity [to define these markets], but that was worthless. Those kinds of definitions don't tell you what is really going on."

The Cold War triggered a global reexamination of financial systems, not only in the former Soviet Union but around the world, Nichols says. Planned economies in Latin America failed and a new generation of Chinese leaders introduced economic reforms. "It's amazing that so many different places were coalescing on this one change at the same time."

McDermott notes that following the collapse of the Soviet Union, the degree and speed of the transfer of assets from government to the private sector was key to defining the characteristics of emerging markets. However, that led to problems on either end of the privatization spectrum. "Many of the measures were related to how much of the economy was in private hands. [These measures] weren't very helpful," he says. "Those who didn't change were bad and those who changed really fast also blew up."

McDermott has done research into development patterns in Eastern Europe and Latin America and found that differences in economic progress can be linked to what he calls "transnational integration regimes," such as membership in the European Union or participation in NAFTA. These systems have different characteristics which may offer better insights into the potential for economies to join the club of developed nations, which is generally thought of as the members of the Organization for Economic Co-Operation and Development (OECD).

A More Sophisticated Approach

According to Wharton management professor Witold Henisz, emerging economies recently have begun to revise their approach to the global economy, particularly as resource-rich nations gain clout with today's booming commodity markets. They are still willing to integrate with international markets and will allow foreigners in to help build their economic infrastructure, but are demanding a greater share of the benefits. Unlike earlier periods of Colonialism, these countries are not claiming to be exploited. The approach is now more sophisticated, he says.

"The countries are saying, ’We’re still going to work with you, but we will do it on our terms.’ It’s more like the U.S. [style of approaching other countries]," says Henisz. "They’re working to play by the same rules as we do."

Henisz cautions there is not a single moment when countries "emerge." "It’s not a zero-one switch. The forces we’re talking about that make a country different are shades of gray," he says. "There is no force in Russia or Brazil that doesn’t exist in the U.S. It’s just a question of the impact they have and how the institutions of the country moderate uncertainties."

While enormous attention has been paid to rapid growth in India and China, those two countries are nowhere near ready to graduate from the emerging camp, according to Wharton faculty and analysts. While India and China both enjoy pockets of glittering prosperity, national wealth is unevenly distributed and most of the population in these countries lives in poverty.

Wharton management professor Marshall Meyer says many Chinese cities seem to be as sophisticated as any in Europe or North America, but rural areas of China remain desperately poor. Household income is 10 times higher in urban coastal cities, like Shanghai, compared to rural inland provinces, he notes. "Has China graduated?" asks Meyer. "If you look at capital formation and fixed asset investment, it looks that way. If you look at disposable income in households, it doesn’t."

Nichols, too, says India and China are not ready to move up from emerging status. He explains that as an outsider, he would be completely comfortable entering a contract in Singapore, but not India or China. "If I were to do business in India or China, I would be really careful that I establish the rules, rather than just relying on institutions that say they are open to strangers," says Nichols. "China is definitely moving toward formally-run institutions and the same is true of India. But you would be pretty foolish to just rely on a contract, although India is farther along than China."

Countries that make it into the top rungs of economic progress can slip backwards, too. Guillen notes that in the first part of the 20th century, Argentina was one of the richest nations in the world. After decades of Peronist rule and decline, Argentina became a star in the 1990s march toward privatization, only to stumble into a financial crisis in 2001. With a well-educated population and wealth of resources, Guillen says, "Argentina is one of the biggest mysteries."

Lebanon is another example. In the 1960s, it was considered to be the Switzerland of the Middle East, with strong trade and high per capita incomes before it descended into Civil War, never to recover its economic place in the world.

"There are many examples of African countries that were doing reasonably okay and then got into trouble," adds Guillen.

Forever Emerging?

Even with their weaknesses, emerging economies are clearly a rung up the economic ladder from many other countries, including most of sub-Saharan Africa, Central America, Haiti and the Dominican Republic, along with Bangladesh and Myanmar, Guillen says.

At the same time, some countries seem to have gotten solidly stuck in the emerging markets category. Guillen points to South Korea, where per capita income is $20,000 -- well above most countries in Latin American and South and East Asia. More important, the economy has transformed from a heavy industrial base to a strong focus on knowledge and technology. "One thing that intrigues me is these countries seem to be emerging forever," he says. "It’s about time we think of South Korea as a fully developed economy."

Guillen is careful to emphasize that there is no one path to economic prosperity. "All countries start in different positions. If they succeed, they do so in different ways," he says.

Bert van der Vaart, CEO of Small Enterprise Assistance Funds, a global investment firm providing capital and support to 29 emerging markets, says the sector is increasingly recognized as an investment class that should command 5% to 15% of total assets. "Growth in these countries is likely to be trending positively and in excess of the OECD average. In a sense, these economies are ’catching up.’ At some level, whether we add the adjective ’investment-worthy’ to ’emerging markets’ could be surplus."

His definition excludes a number of poorer countries whose governments are not willing to adopt true market reforms, or where the ruling elite are doing well enough that they do not care about attracting a broad range of private investment. Zimbabwe, for example, despite all its human and physical resources, falls short of being an "emerging market," van der Vaart says.

More than a quarter century after he christened the term "emerging markets," van Agtmael, now CEO of Emerging Markets Management in Arlington, Va., which manages $20 billion in institutional investment, says he has seen tremendous change. "We are in the midst of a huge shift in the global economy toward emerging markets, as many are no longer poor, but are becoming middle class. The emerging markets consumer is becoming increasingly important, infrastructure spending in emerging markets now exceeds that in the U.S. or Europe, and a steadily larger group of companies is becoming world class."

According to van Agtmael, in the next 10 years there will be one billion more consumers in emerging markets, and in 25 years the economies of these countries will surpass the combined economies of the developed countries.

In recent years, Goldman Sachs has contributed to the economic name game. In 2001, the firm began calling Brazil, Russia, India and China the "BRIC" countries and forecast that by 2010, they would make up more than 10% of global GDP. By 2007, they already accounted for 15%. Then in 2005, Goldman Sachs introduced another moniker, the Next Eleven (N-11), identifying another set of populous countries with the potential to have an impact on the global economy, similar to the BRIC nations. The N-11 are Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and

Vietnam.

Van Agtmael says he has heard some new terms -- "middle-income emerging markets" or "graduating emerging markets" -- tossed around to describe countries moving up the continuum. "Now most investors simply realize there’s money to be made in these markets -- not just the portfolio investors, but also major corporations. The name is now less important than the fact that people recognize this is a part of the world that is no longer a backwater and no longer peripheral, but an increasingly important part of the world."

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