https://www.ft.com/content/4a915716-39dc-11e5-8613-07d16aad2152

Emerging markets: Redrawing the world map

The term has become obsolete, say critics, as developing markets overtake developed ones in some areas

James Kynge and Jonathan Wheatley AUGUST 3 2015Print this page110

When Matteo Ricci, the Italian 16th century Jesuit missionary, travelled to China to win converts to his faith, he found that his European maps, which showed China relegated to the cartographical margins, failed to endear him to his hosts. So he redrew them. The resulting world map of 1602 placed China at its centre, an accommodation that is said to have helped him win influence among the Middle Kingdom's elite.

Ricci's revisions were made on woodcuts and paper. Now, commentators say, it is the world's mental map that is in dire need of an overhaul, particularly when it comes to the practice of categorising countries as "emerging" or "developed" markets.

The current economic hierarchy, which places emerging nations at the periphery and developed markets at the core of world affairs, no longer accurately describes a world in which EM countries contribute a bigger share to global gross domestic product than their developed counterparts, when measured by purchasing power parity. Nor does the capacious category, which lumps together countries of such diverse economic strengths as China and the Czech Republic, serve to illuminate crucially different realities between these nations.

"The EM term has outgrown its usefulness," says Michael Power, strategist at Investec, a fund management company. "The term today embraces big and small, developed and under-developed, industrialised and agrarian, manufacturing and commodity-based, rich and poor, deficit runners and surplus runners, and I could go on," he adds. At issue are not merely the niceties of symmetry and order. Emerging markets is one of the most powerful definitions in the world, with an estimated $10.3tn invested in emerging financial markets via an alphabet soup of equity and bond indices. But these indices embrace such a collection of incongruous assets, that they misdirect investors and potentially reduce returns to pension funds, insurance companies and other financial institutions.

As emerging markets overtake developed ones in some areas the FT investigates whether it is time to coin a new phrase for the developing powers

The term also forms one of the organising principles for global databases and an analytical starting point for those seeking insights into economic, environmental, social and other trends that shape the world. But this, commentators say, generates flawed perceptions and fuzzy arguments that impact on the efficiency of global governance.

“As an asset class, EM equities are nearly finished,” says John Paul Smith at Ecstrat, an investment consultancy. “The old paradigm is dead.”

Already, some commentators are proposing alternatives to the definition, seeking to identify ordering principles and shared dynamics among clusters of developing countries. This, they hope, will allow institutions, companies and multilateral organisations to assess more accurately the balance of risk and opportunity in large parts of the world.

What’s in a name?

At its inception, “emerging market” was not designed as a definition with specific criteria. Antoine van Agtmael, then an economist at the International Financial Corporation, the private sector arm of the World Bank, coined it as a marketing catchphrase in the 1980s.

What is the alternative?

Matrix offers new perspective

Michael Power argues that any static grouping, such as Brics, inevitably loses relevance over time and that a more dynamic system is needed.

The attraction was clear: it sounded aspirational. Countries previously known by monikers such as “less developed” or “third world” were suddenly imbued with the promise that they might be on a journey towards something better.

Since the 1980s, the stunning success of the term has spawned several attempts to nail down a set of commonly recognised characteristics — with the unintended consequence that different organisations such as the International Monetary Fund, the UN and financial index providers such as MSCI, JPMorgan and FTSE use a clutter of conflicting criteria to categorise emerging markets.

Adding to the confusion, the term is sometimes used to describe equity, bond or currency markets in developing countries and sometimes to describe the countries themselves. Different criteria make a world of difference. The MSCI equity index identifies 23 emerging markets countries and puts 28 into a "frontier emerging markets" category. The IMF, by contrast, defines 152 "emerging and developing economies".

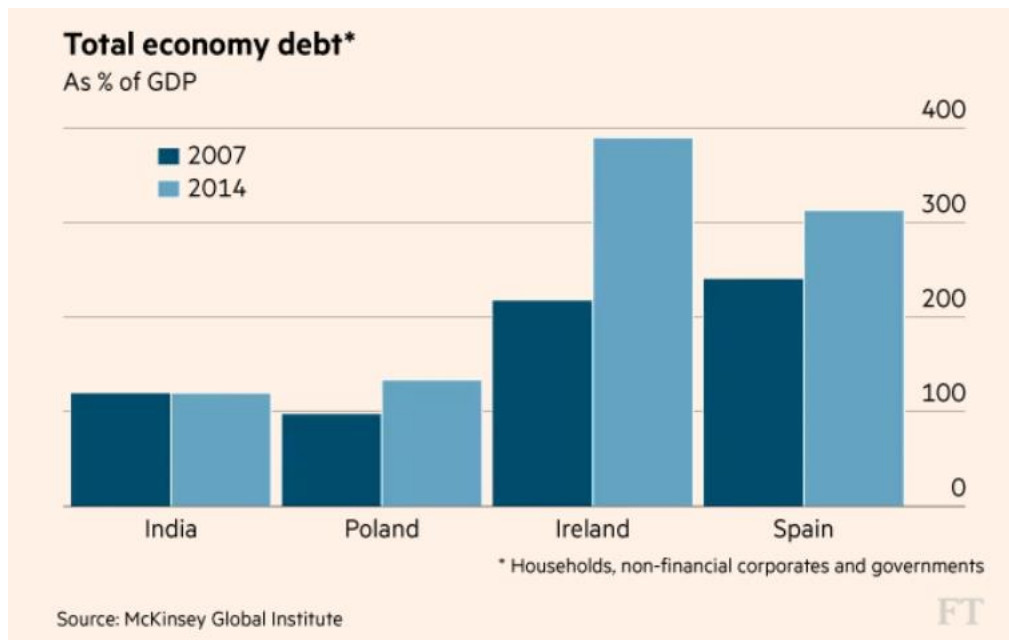
Even accepting prevailing classifications, it is often unclear why one country has been awarded emerging status while another merits a developed tag. Chile has a bigger economy, a bigger population, less debt and lower unemployment than Portugal but is classed as emerging, whereas the European nation remains part of the developed world. Similarly, on a per-capita income basis, Qatar, Saudi Arabia and South Korea are wealthier than several developed countries, but are still consigned to the emerging camp.

We are interested to gauge the views of Financial Times readers in this important debate on whether it is time — or not — to redefine the way we look at the investment world. We therefore invite you to answer the following three questions and undertake to publish the results.

Such judgments often depend on the classifier. Providers of financial indices look at issues such as the freedom with which international investors can access the stocks and bonds of a particular country. Others such as the IMF consider questions about the diversity of a country's economy, in terms of how many products they import and export. Increasingly, the sense that emerging nations take their lead in global affairs from the so-called developed world is also under examination. In some senses, emerging economies already wield power. When calculated by purchasing power parity, which takes account of exchange rate changes, developed countries account for only 43 per cent of global GDP, down from 54 per cent in 2004.

Developed markets are also weaker, in aggregate, when it comes to the size of their foreign exchange reserves, the huge stashes of money that accumulate when a country notches up

trade surpluses and attracts foreign direct investment. Developed markets hold $3.97tn, compared with $7.52tn for developing countries, according to IMF data.

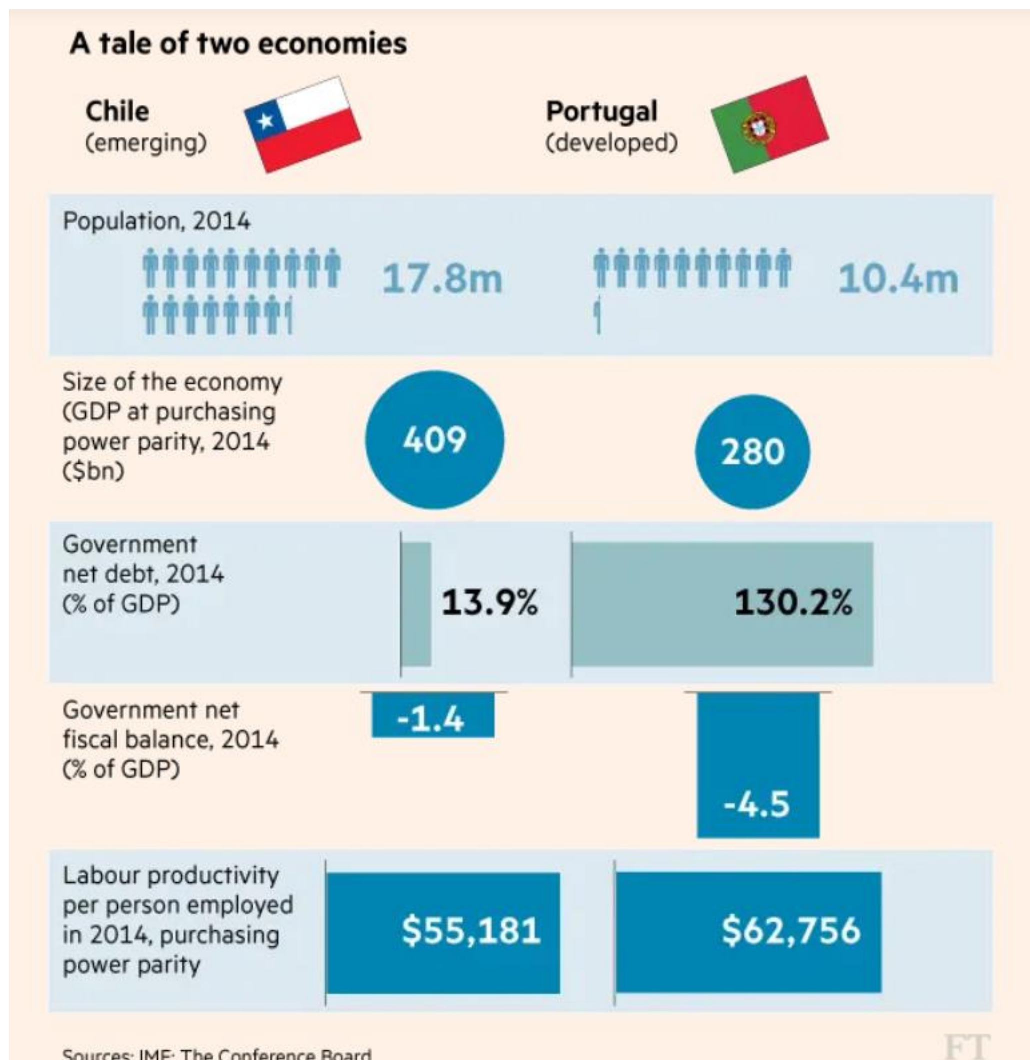


This leads to the curious situation in which emerging nations, which need to invest their reserves in large liquid debt markets, have ended up bankrolling years of deficit-financed excess in large developed countries. China, for instance, was the biggest foreign buyer of US Treasury debt for six years until early 2015.

But aside from the various ways in which the EM tail appears to be wagging the developed dog, the broad inclusion of scores of countries glosses over crucial differences between emerging nations, misleading observers to construe equivalence where none exists.

Sree Ramaswamy, senior fellow at McKinsey Global Institute, says that key determinants of a country's economic dynamism and resilience often come down to "economic structure, industry dynamics, corporate landscape and role of government or social and political make-up"."When it comes to these indicators, the differences between emerging markets outweigh their similarities," Mr Ramaswamy argues.

"For instance, capital investment makes up 20 per cent of GDP in Mexico, but 45 per cent in China. Household consumption makes up 50 per cent of GDP in South Korea but 70 per cent in Turkey," he adds. "The populations of China and India are similar in size but their demographic trends are very different. So is the corporate landscape; 60 per cent of Latin America's corporate revenue is held by family controlled firms but in India it is 50 per cent and in China 30 per cent."



China breaks the mould

To many, the problem of how to classify China highlights the emerging market dilemma. In PPP terms, China is already the world's largest economy and yet it is still classified as emerging. The country has a literacy rate of 96 per cent, more high-speed rail track than all other countries combined and more college students than any other country.

Its near $8tn stock market is the world's second largest after the US and its $5.5tn domestic bond market ranks third in the world after those of the US and Japan. Nevertheless, its domestic equities, not counting those listed in Hong Kong, and its bonds feature only marginally in the MSCI EM Index and JPMorgan EMBI+, the world's leading equity and bond indices.

As a result much of the investment opportunity and risk that Chinese assets represent remains largely sequestered from global investors. In June, MSCI decided not to include China's A-share stock market into the index because of governance concerns.

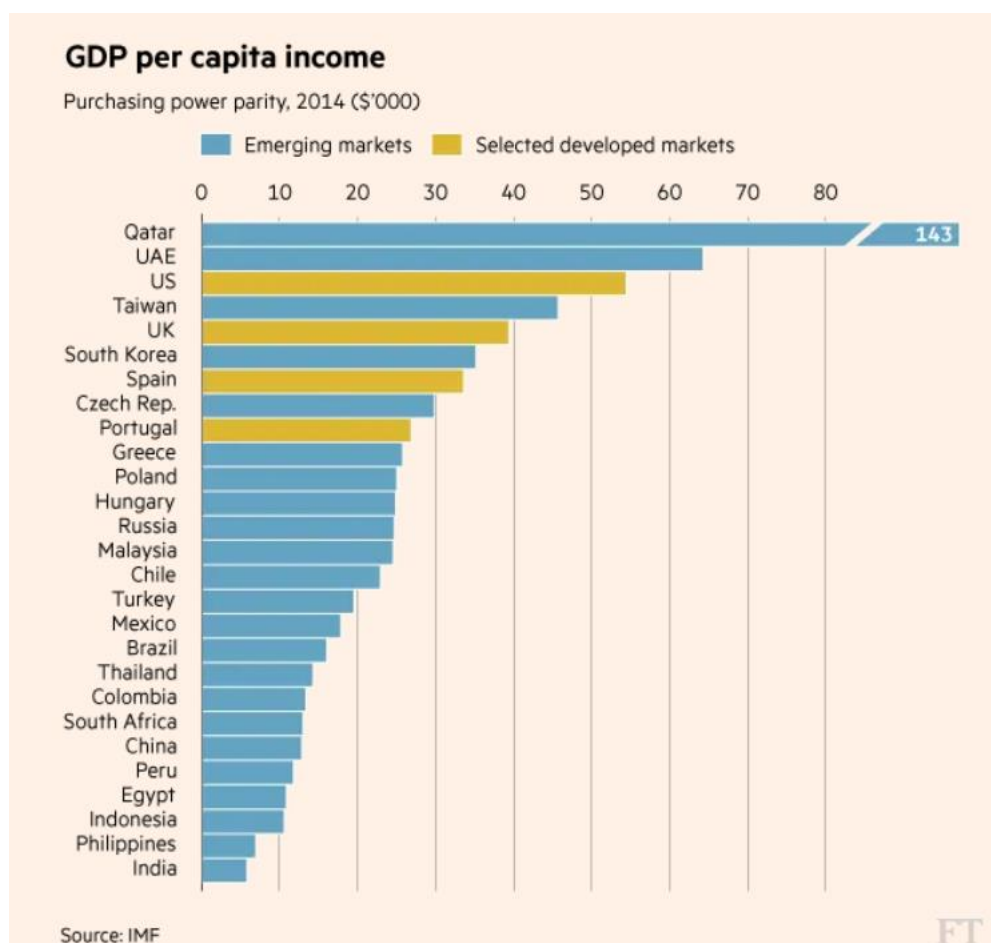
What is an emerging market?

The term began as a euphemism for the pejorative-sounding "third world" but, as the FT argues, "emerging market" now stands for a haphazard collection of countries.

Inclusion in an index may sound like a relatively minor detail but, in fact, such indices pack an enormous financial clout. The competence of fund managers is assessed by their ability, or failure, to generate returns that exceed those of the dominant index in their asset class. This results in an industry-wide tendency to buy stocks or bonds that are included in an index, thus reducing the risk that a fund manager will egregiously underperform it.

Inducting even a mere slice of the huge Chinese stock and bond markets into emerging market indices would create a financial earthquake, effectively forcing fund managers with ambitions to match an index's performance into loading up on Chinese assets.

Peter Marber, fund manager at Loomis Sayles, echoes a widely held view that China's size may break the emerging market mould.



"China is so enormous that if it goes [fully] into EM indices it will dwarf everything, so it is required to treat China as a separate category," he says. But if China stands outside such indices, the case for India to be treated as separate may also harden, hastening the disintegration of emerging market indices.

As it is, Mr Marber says, emerging market indices mix investment assets that range from "garbage" to high quality, rendering investors unable to properly assess risk and dissuading them from investing.

These contradictions threaten to consign the term emerging markets to the dustbin. But if it follows the likes of “third world” into virtual extinction, its passage will raise the question of what, if anything, should replace it.