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What drives a market's promotion to emerging market status?
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How do you define an emerging market? Why is South Korea still deemed an emerging market but Vietnam is not? We look at the factors behind a market's MSCI classification as frontier, emerging or developed.

Emerging markets (EM) have seen ongoing change since the investment grouping became popularised in the late 1980s. To some extent, this is implied in the name, though it is more complex than this.

As an example of this change, the last decade has seen the first Gulf markets classified to EM. This began with the UAE and Qatar in 2014, with Saudi Arabia and Kuwait included in 2019 and 2020 respectively. The last ten years have also witnessed the return and subsequent departure of both Argentina and Pakistan. Meanwhile Russia was removed in 2022. Frontier markets have seen even more significant changes over this period.

This all begs the question, and one which we are often asked: 'How do you define an emerging market (EM)?'. Two other questions that often crop up are: 'Why is South Korea still deemed EM?' and 'Why is Vietnam not an EM?'.

A brief history – where did the term "emerging market" originate?

The term '*emerging market'* was originally coined by the International Finance Corporation (IFC) economist Antonie Van Agtmael in 1981. Part of the World Bank Group, IFC was founded in 1956 with the aim of furthering economic development and the growth of productive private enterprise in member countries. As well as investing with others in private businesses, it also helps to mobilise capital from other investors, and provides macroeconomic advice.

From the early 1980s IFC started to track total return data for ten developing markets it viewed as potentially attractive to investors. As it tried to raise their profile within the investment community, IFC also sought to change their perception. Reference to terms such as *'third world economies'*, a Cold War reference to unaligned nations, was deemed to have negative connotations, and something with a more progressive undertone was needed, que the birth of *emerging markets*. These are the foundations to the EM asset class of today.

The distinction between an emerging equity market and emerging economy

A key point to note is that an EM stock market is not necessarily an EM economy, and vice versa. There is more to this story, and it comes down to the way in which equity market indices are constructed.

As an example, the diagram below illustrates how the MSCI Emerging Market and Frontier Indices (the level below emerging), both include some economies which are defined by the World Bank as High-Income Economies, its highest ranking. South Korea and Taiwan are among the four largest equity markets in the

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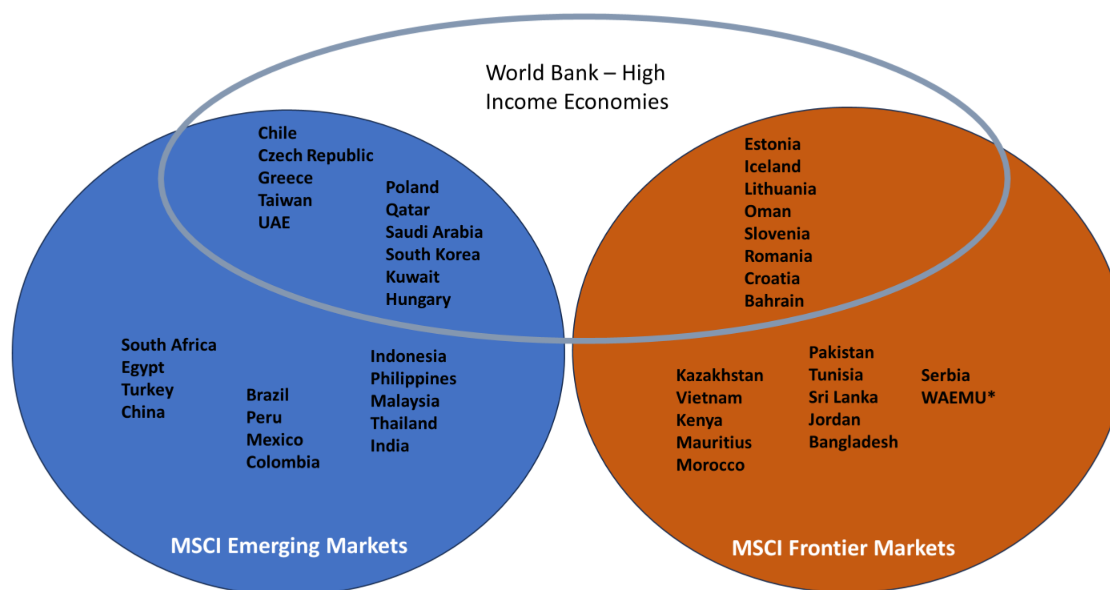
MSCI Emerging Markets Index, accounting for a share of 30%, as at the end of May 2024. And yet both are classed by the World Bank as High-Income Economies.

Emerging equity market does not necessarily equal emerging market economy



**The West African Economic and Monetary Union (WAEMU) consists of the following countries: Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal and Togo. Currently the MSCI WAEMU Indices include securities classified in Senegal, Ivory Coast and Burkina Faso. Source: Schroders, MSCI, World Bank[1], as at 31 May 2024*

So what is index inclusion all about?

There are various EM indices available to international investors today. We focus on MSCI, given its long history and wide use, but FTSE and S&P also have EM indices, albeit their markets differ slightly due to different approaches to building their indices (South Korea and Poland are considered developed markets by FTSE for example)

The way in which MSCI classifies global equity markets is prescriptive[2]. It has three key category groupings, from frontier to EM and developed markets (DM). Equity markets not meeting any of these classifications are classed as standalone. In determining a market's classification, a combination of economic development, equity market size and liquidity, and market accessibility are key. The economic development factor is only used as a requirement for assessment into DM. Markets must have a Gross National Income (GNI) of 25% above the World Bank's High-Income threshold which is currently $13,845 of GNI per capital in 2022.

There are minimum company size requirements, in terms of full market capitalisation and floating market capitalisation, and stock liquidity requirements for each of the three classifications. The requirement increases, moving from frontier to EM and again to DM. A minimum number of companies meeting these size and liquidity requirements is a further hurdle. In frontier the minimum is two, emerging three, rising to five in developed.

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[1] World Bank Country and Lending Groups, June 2024
[2] MSCI MARKET CLASSIFICATION FRAMEWORK, June 2024

This is an issue which has seen certain smaller EM such as Peru come under the microscope of classification review in the past, albeit the market has ultimately retained its status as EM.

Accessibility is still a key factor to understand

It is accessibility which is perhaps the lesser understood factor, and yet arguably the most important, as the assessment is qualitative. This is all about the ease with which international institutional investors can invest and divest from markets. The smoother and less restrictive the process, whilst maintaining robust, efficient and secure operations, the more likely a market is to be classified as DM. The criteria for assessment encompass foreign ownership restrictions to the ease of capital in/outflows, the operational framework, the availability of investment instruments, through to the stability of the institutional framework.

South Korea is a prime example of a market entangled in some of these issues. It meets the economic development factor threshold to classified as developed by a country mile. However, the lack of an offshore currency market, and a short selling ban on all listed stocks (in place until at least March 2025) among other factors are constraints. As a result, South Korea does not appear to meet the grade for developed market classification due to market accessibility issues.

Foreign ownership limits are in place in certain stocks or sectors which may be viewed as strategic. The US for example prohibits foreign investors from holding more than 25% ownership in airlines; but the impact is very limited as passenger airlines represent a tiny share of the MSCI USA. In EM, there are many markets with foreign ownership limits, from China through to India, Thailand and the UAE, which affect more than 10% of the overall market. The impact varies depending on the market and limits do not typically prohibit investment, but can complicate decision making or restrict access to areas of the market at times.

This issue is a notable impediment in Vietnam, along with other challenges (e.g. Vietnam has no offshore FX market and there are constraints on the domestic FX market) which hold it back from potential promotion to EM from frontier.

What does it take to be promoted/demoted from one classification to another?

As we noted at the outset, changes to the MSCI Emerging Markets Index have not been that unusual over the years. The index provider has quarterly reviews, and an annual market classification review each June. It also assesses market accessibility annually[3].

The cyclical process is adopted to aid predictability and normal market functionality. Markets are only considered for upgrade if the change is interpreted as “irreversible”. Even so, changes can be more rapid and taken off-cycle, as with the removal of Russia from its indices in 2022. This followed Russia’s invasion of Ukraine, after which the market became un-investible for many international investors.

Why reclassification can be an opportunity for active strategies

Reclassification has in the past created the opportunity for active investors, who can invest off-benchmark, to make allocation changes as soon as the decision has been announced, and in advance of the actual implementation of this change.

At the market level, the switch from frontier to emerging, for example, can potentially bring the market onto the radar of a wider group of investors. Equally, a market with a large weight in frontier can be tiny in EM, depending on factors such as company market cap, liquidity etc, which may mean it is overlooked in EM. There can be advantages to being a big fish in a small pond, as opposed a small fish in a large pond.

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What does this all mean for investors?

We often emphasise the fact that EM is not a homogenous grouping, given its broad range of economies and equity markets. Understanding the framework behind the EM index is key to explaining this point, and the road on which markets must travel to be reclassified to another grouping.

The underlying drivers of EM index construction and the ongoing evolution bring challenges and complexity, but also opportunity for investors with a long-term flexible approach.

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