It is Time to Re-define Emerging Markets

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- At Goldman Sachs Asset Management (GSAM) we have decided to adopt the term "Growth Markets" to describe how we view some of the world's most dynamic economies.
- Given the rising importance of some of these economies, we think the traditional Developed/Emerging country divide no longer reflects the fundamental nature of the global economy today.
- We separate out some countries from the traditional Emerging Markets universe—those that are at least 1% of global GDP—and call them "Growth Markets".
- Eight countries currently satisfy this criterion: each of the **BRIC** countries **(Brazil, Russia, India and China)**, as well as the four largest "Next 11" (N-11) countries: **Mexico, Korea, Turkey and Indonesia**.
- These are the economies that are most likely to experience rising productivity coupled with favourable demographics and, therefore, a faster growth rate than the world average going forward.
- Additional characteristics that we implicitly use to distinguish Growth Markets from Emerging Markets include their growth environment, as well as the level of financial development and accessibility to investors.
- Other countries could achieve Growth Market status over time—these include some of the other N-11 countries, namely Nigeria and the Philippines, and possibly Egypt. For now, however, they remain in the Emerging Markets group.

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1. Introduction

This will be the tenth year since the acronym BRIC came into existence. It has become synonymous with the remarkable rise of those four countries—Brazil, Russia, India and China—as well as some others, and their influence on the world economy. It is almost 8 years since GS Global ECS Research first published an outlook to 2050 which suggested that these four economies could collectively be bigger than the US and, along with the US, could become the five biggest in the world based on their likely USD value of gross domestic product.

In 2005, GS introduced the concept of the "Next 11" or the "N-11" as it has become known. This was a simple description to bracket the eleven most populous countries and to see if they, collectively or individually, might have BRIC-like potential.

A few years after the inception of the two acronyms, it is reassuring to see that most of the positive momentum behind the world economy is being driven by the majority of these 15 countries. Their success extends beyond their borders and is affecting the lives of all the world's 6.5 billion citizens. As a result of this, many profound changes are occurring, not least of which is that we are probably seeing the largest and fastest rise of people out of poverty globally in many generations. Therefore, to describe many of these countries as "Emerging Markets" no longer seems appropriate.

2. The Global Power Shift

The transformation of the global economy that we predicted is well under way. We have been surprised by how quickly the changes have actually taken place. GS Global ECS Research original long-term projections published in 2003 underestimated reality. In fact, the BRICs are already dominating the world in a number of ways.

In 2010, China overtook Japan to become the second largest economy in the world, five years earlier than initially predicted. With GDP of around $6.0 trillion, China is now about the same size as the other three BRIC countries combined. Collectively, the BRICs are roughly $11 trillion, which is about 80% of the size of the US. In 2010, the BRICs grew by around 8.5% on average. In 2009, amid the world's worst period of economic performance for decades, the BRIC countries collectively grew by around 5.5%.

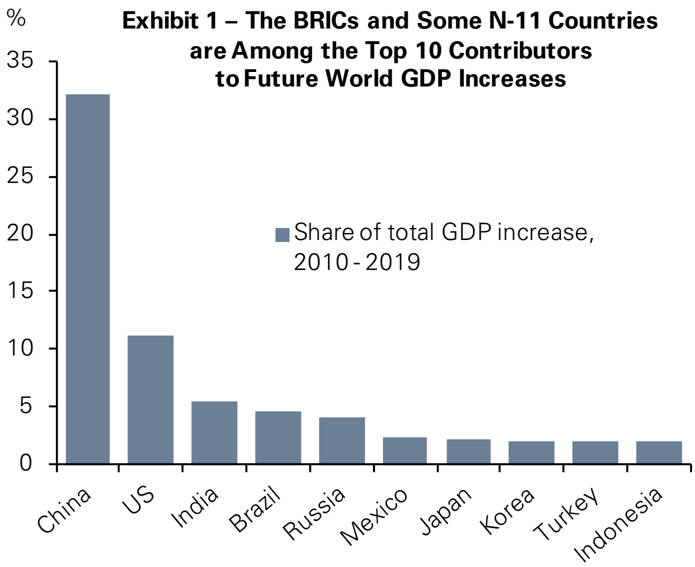
The size of Brazil's economy almost rivals that of Italy. This is something we originally thought could happen only by the mid-2020s. Furthermore, both India and Russia are not far behind. Within the N-11, Indonesia and Turkey are growing at rates that are leading some to argue that they should be part of the BRICs.

At some stage this decade, the four BRIC economies could collectively become as big as the US, and China alone could grow to around two-thirds the size of the US economy.

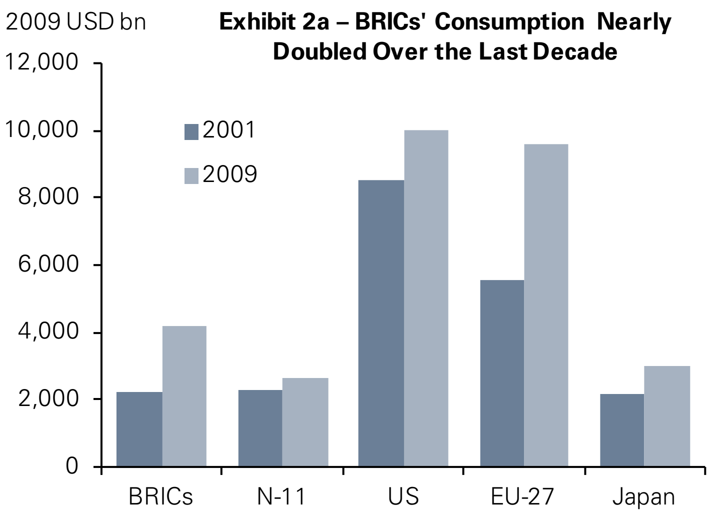
By 2020, the four will be responsible for almost 50% of the increase in global GDP. In addition to the BRICs, the top ten contributors to global GDP growth this decade and beyond could include Korea, Mexico, Turkey and, possibly, Indonesia. These latter four economies, while certainly not as powerful as the BRICs, are increasingly important for the world economy.

Exhibit 1 illustrates where our projections forecast the world's future GDP increases are likely to come from this decade. Among the top ten, only the US remains a consistent driver of growth from within the Developed Markets.

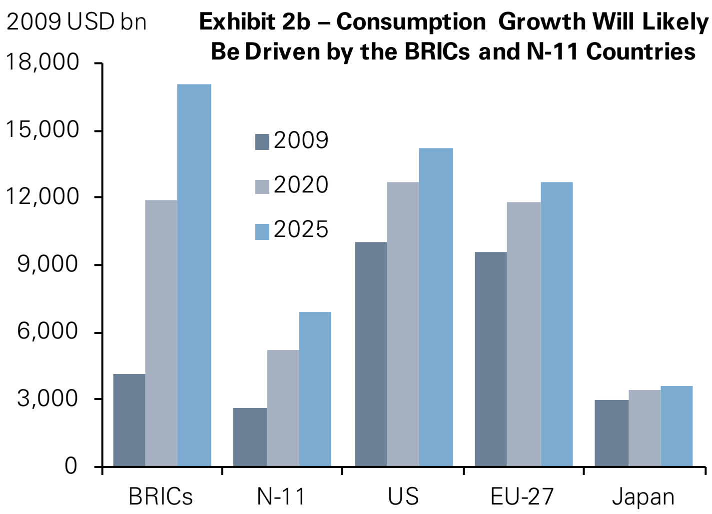
Exhibit 1 – The BRICs and Some N-11 Countries are Among the Top 10 Contributors to Future World GDP Increases



Source: GS Global ECS Research, GSAM calculations



Source: GSAM Strategy Series, 3 Dec 2010



Source: GSAM Strategy Series, 3 Dec 2010

Growth in the BRICs' domestic demand is even more impressive—in 2010 it was close to 10% on average. In China, the consumer is gaining more importance as a driver of growth. The current USD value of the BRIC consumer is over $4 trillion, possibly closer to $5 trillion. The US consumer is worth around $10.5 trillion, more than double the level of the BRIC counterpart. However, given the current pace of ascent, it is possible that the BRIC consumer could become almost as large as the US consumer by the end of this decade, adding around $800 billion on average per year to the world economy over the next 10-15 years.[1] BRICs consumption could quadruple in real terms by 2025. *Exhibits 2 a and b* illustrate the actual change in consumption in the last decade and the potentially dramatic transformation in global consumption patterns over the next 15 years.

With this in mind, is it still legitimate to describe these countries as "Emerging"? And, more generally, how should we think about the phrase "Emerging Markets"?

3. Growth Markets: The Framework

Simply stated, a "Growth Market" should be regarded as one that is likely to have favourable demographics and achieve rising productivity going forward. While this condition is necessary, it is not sufficient, especially when thinking about the concept from business and investing perspectives. It also needs to be an economy with adequate **market size and depth** that allows investors and business sufficient scale and liquidity to not only invest and develop, but also to perhaps exit as and when the decision is appropriate.

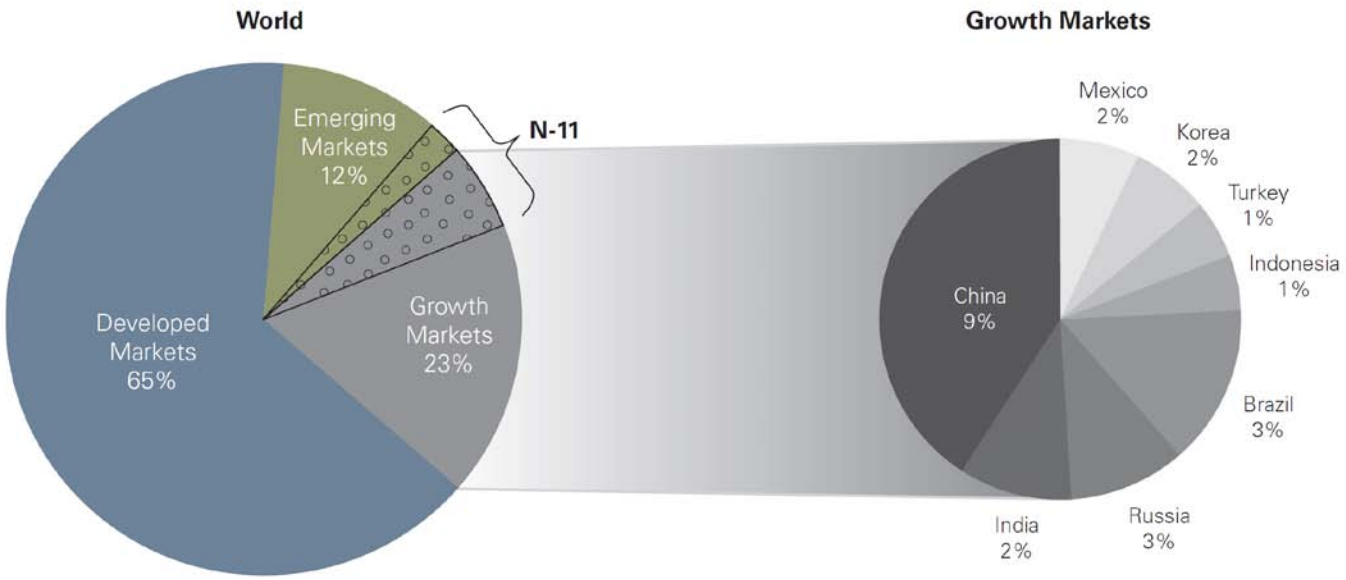
With this framework in mind, we studied more closely the size of some of the BRIC and N-11 economies, their likely growth rates over the next decade and beyond, as well as their productivity performance and attributes. As a result, we decided to **define a Growth Market as any economy outside the Developed World that is at least 1% of current global GDP**. At this threshold, currently around $600 billion, it should be large enough to allow investors and businesses to operate along the same general principles that they operate under in the more advanced economies.

Under this definition, eight countries currently satisfy our criterion for a Growth Market. These countries include each of the BRIC countries (Brazil, Russia, India and China), as well as the four largest N-11 countries: Mexico, Korea, Turkey and Indonesia. All other countries below this GDP threshold outside the Developed World we still refer to as Emerging Markets. *Exhibit 3* illustrates how our definition splits the world into three groups—Developed, Growth and Emerging.

Exhibit 4 illustrates how the 1% share cut-off criterion redefines the traditional Emerging Markets universe. As can be seen, there are other economies that are close to this 1% threshold and, in a sense, the criterion is somewhat arbitrary. Not all Emerging economies have favourable demographics and strong productivity trends. Moreover, many are still very small. For those countries that some might regard as being worthy of the same elevated status, the proof will be in their growth and development. As *Exhibit 5* shows the eight Growth Markets could still be the largest contributors to global GDP in the next decade and beyond.

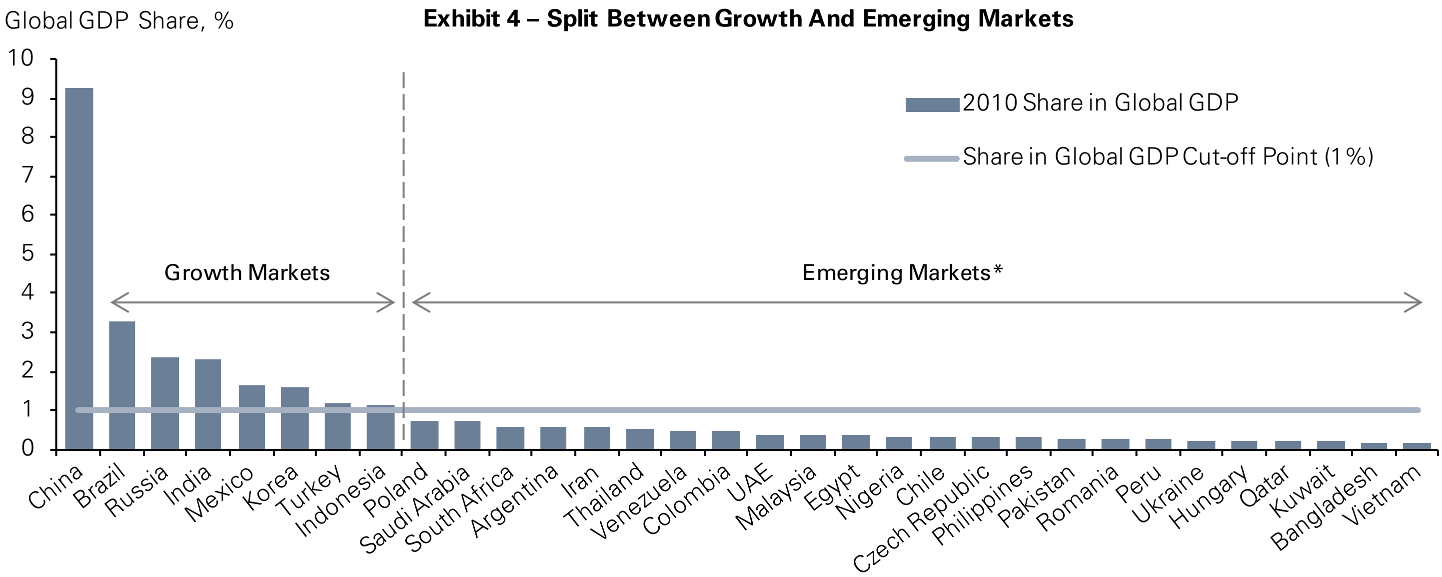
[1] For detailed discussion of the consumption theme see 'The Rise of the BRICs and N-11 Consumer', *GSAM Strategy Series*, 3 December 2010.

Exhibit 3 – Country Classification (2010 GDP Share)



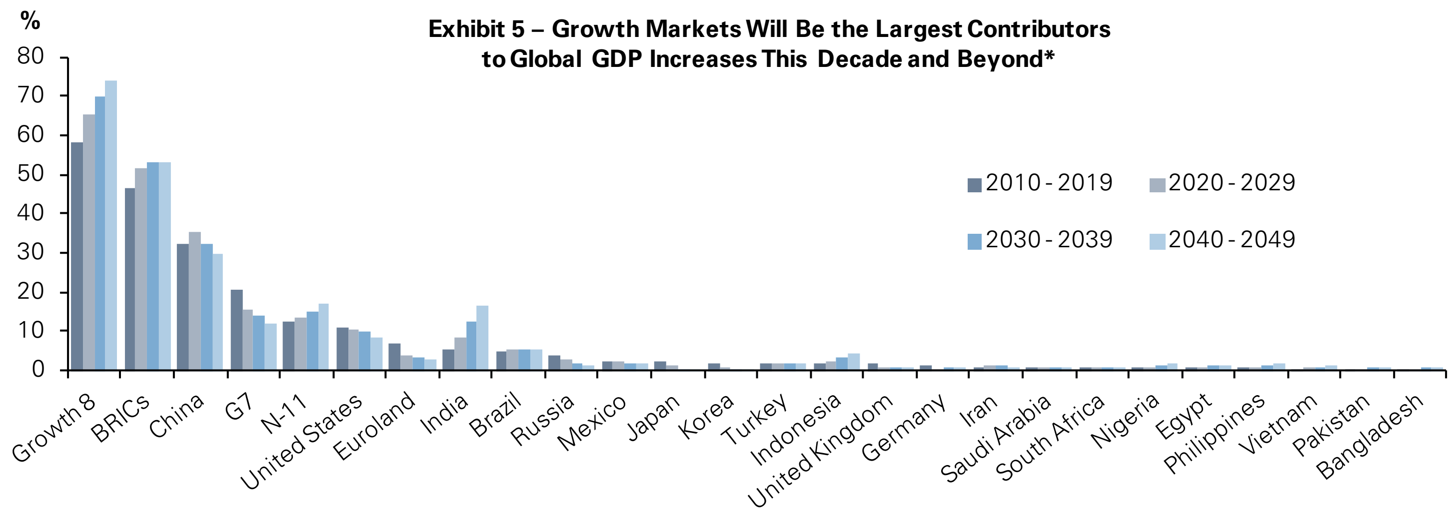
Source: GSAM

Exhibit 4 – Split Between Growth And Emerging Markets



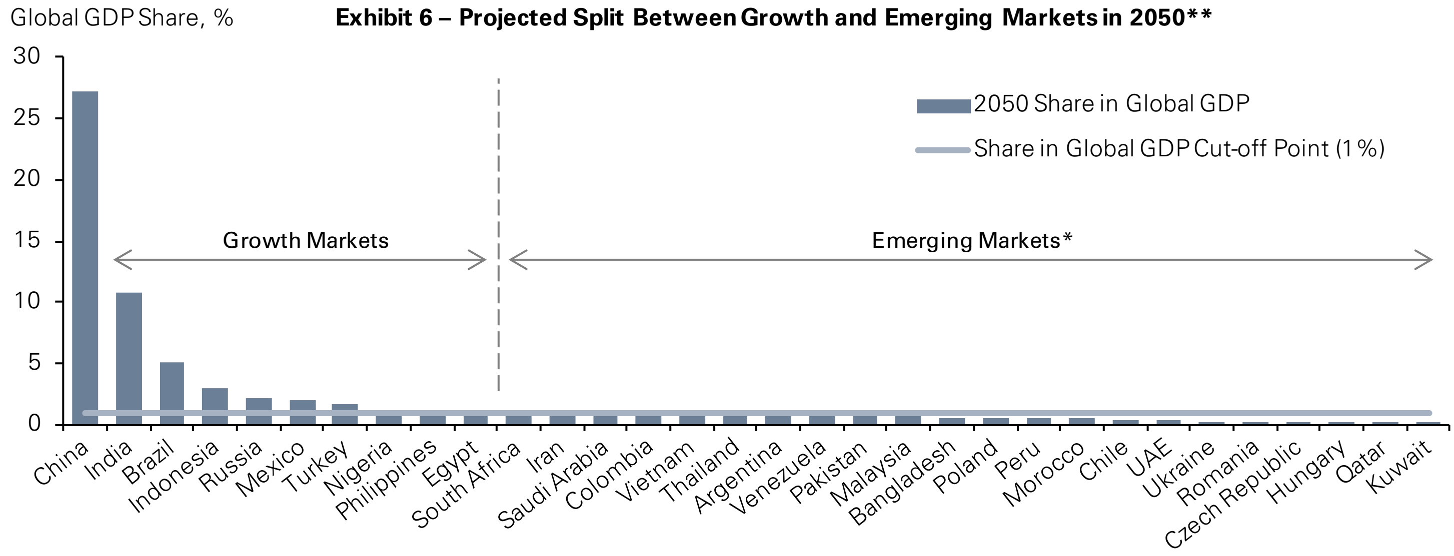
*Up to the smallest N-11. Source: IMF World Economic Outlook 2010, GSAM calculations

Exhibit 5 – Growth Markets Will Be the Largest Contributors to Global GDP Increases This Decade and Beyond*



*Original projections re-based from 2007 to 2010. Source: GS Global ECS Research, GSAM calculations

Exhibit 6 – Projected Split Between Growth and Emerging Markets in 2050**



*Up to the smallest N-11. **Original projections re-based from 2007 to 2010. Source: GS Global ECS Research, GSAM calculations

4. Could the Growth Markets Include More Countries Over Time?

A number of other countries could achieve Growth Market status over time. According to GS Global ECS Research projections shown in *Exhibit 6*, the countries most likely to graduate from the Emerging Market category to the Growth Markets category are currently members of the N-11 group. Specifically, Nigeria and the Philippines could cross this threshold by the mid-2040s, and Egypt is another country that might approach the threshold by 2050.The large, relatively young populations of these countries will be one important factor potentially driving this impressive growth. Productivity will also be key in achieving these projections. Here, government policies ensuring a sustained improvement in growth conditions will be crucial.

Another country that could potentially approach this threshold in the not too distant future is Iran. However, its share of global GDP is projected to peak by the end of the 2030s, reaching 0.95%. Obviously, Iran would need to be governed differently in order for investors to gain access. While more N-11 countries do have the potential to become Growth Markets, it is not likely in the immediate future. It is up to the countries themselves to ensure a continuous rise in productivity and sustainable development. If some economies surprise on the upside, the Growth Markets list might be expanded sooner.

It is worth noting that Korea is no longer in the Growth Markets universe by 2050. Given its currently high level of development, this is not surprising. It is already classified as an advanced economy by the IMF, and some other international institutions also treat it as a developed market. Of course, there is no universal rule that defines the transition to Developed Market status. We still believe that today it is a legitimate Growth Market. As Korea continues to develop and raise its incomes per capita, a natural progression to full Developed Market status in the future is likely.

5. Growth Conditions are Essential for Growth Status

While current GDP share is the only criterion we explicitly use to identify the Growth Markets, there are also other criteria that are implicit in this selection process. The local growth environment is one of them. A sustainable growth path can only be realised when robust growth conditions are in place.

The Growth Environment Score[2] (GES)—calculated every year by GS Global ECS Research for around 180 countries in order to monitor productivity and likely sustainable growth—reveals that the eight Growth Markets do have the essential growth conditions in place. All of them except India are ranked above or in line with the developing countries average, as *Exhibit 7a* illustrates.

The scores of the Growth Markets are still quite diverse. Korea's GES is very high, in line with the developed countries' average, reinforcing its potential to graduate from Growth Markets status and to Developed Market status. India appears to be the weakest, with a below-average GES. While India's share in global GDP is still large enough to be classified as a Growth Market, this low GES provides a significant warning to the country's government as well as investors. To realise its considerable potential, India has to address the weaknesses in its growth conditions in the future.

[2] This is an index containing 13 variables that are critical for sustainable growth. Scores range from 0 to 10, with higher scores reflecting higher productivity or growth. The variables fall into five main categories including macroeconomic conditions, macroeconomic stability, political conditions, human capital and technology.

As *Exhibit 7b* shows, India has made the smallest progress out of all Growth Markets since 1997. Political conditions (in particular stability), macroeconomic conditions (mainly government deficit) and technology (especially computers and internet penetration) all require attention.

Other countries' scores also provide interesting insights. Indonesia, for example, the most recently qualified Growth Market (it just crossed the 1% share threshold in 2010[3]), ranks just below the average. While this level of GES is not too concerning, Indonesia has to improve its growth conditions in the coming years in order to maintain its progress. The country has the second smallest GES change, after India, since 1997. A faster pace of GES improvement would ensure Indonesia delivers good growth and possibly upside surprises to our long-term projections.

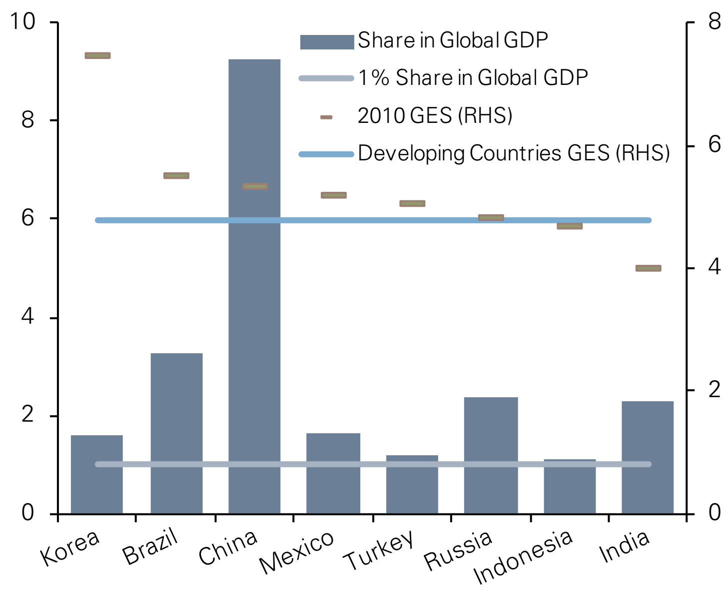
Russia, whose GES is marginally above the average, has seen its GES slip for the past 2 years, despite strong performance since 1997. If Russia does not start to improve its growth environment again in the future, its potential to be in the top five largest economies by 2050 might be threatened.

There are many Emerging Market countries that have significant growth potential, but are still small in size. Indeed, several have higher Growth Environment Scores than our Growth Markets average, particularly some of the Gulf Cooperation Council (GCC) countries. Should they be considered Growth Markets? Our answer is no, because they are too small. While their growth environment scores imply good growth stories and investment opportunities, we believe they will not become large enough to generate meaningful shifts in the global economy and opportunities for investors of the kind that the Growth Markets could deliver.

Many countries have low GES and are also still rather small. We believe they should clearly still be called Emerging Markets. While they may grow significantly, their current environment also makes them somewhat vulnerable to economic or financial market shocks originating within the Developed Markets. To get out of this position, the countries with low GES need to undertake policies that will allow them to grow and decouple from their dependency on the business cycle in the Developed Markets.

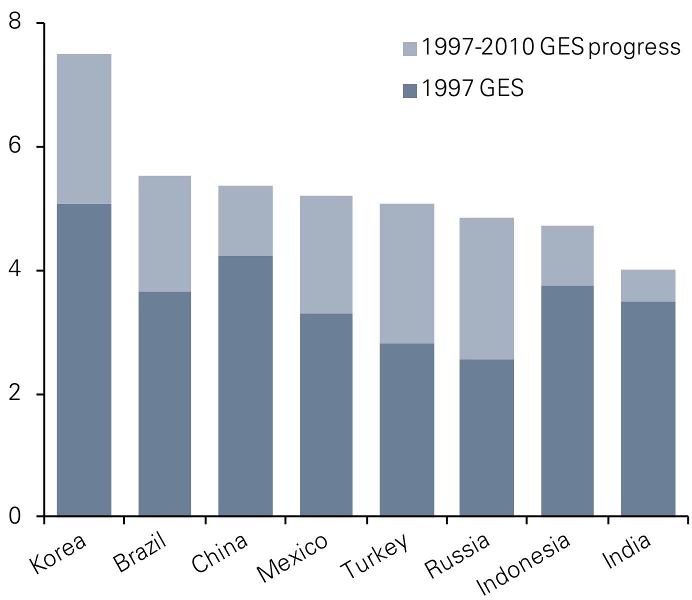
Nigeria is a very interesting case. As we discuss earlier, Nigeria could emerge as a Growth Market within the next 20 years. While its current GES of 3.9 is significantly below the average of the BRIC and N-11 countries, it has already nearly doubled in the last 13 years and, if it maintains this progress, it will graduate from Emerging Market status before 2030. Given that Nigeria accounts for around 20% of Africa's population, this could be an exciting development for the continent.

Exhibit 7a – All Growth Markets' GES Rank Above or in Line with the Developing Average Except India



Source: IMF, GS Global Economics Paper 206, 15 Dec 2010, GSAM calculations

Exhibit 7b – Overall, Growth Market Countries Have Made Progress with Their Growth Conditions



Source: GS Global Economics Paper 206, 15 Dec 2010

[3] According to available data from national sources and forecasts.

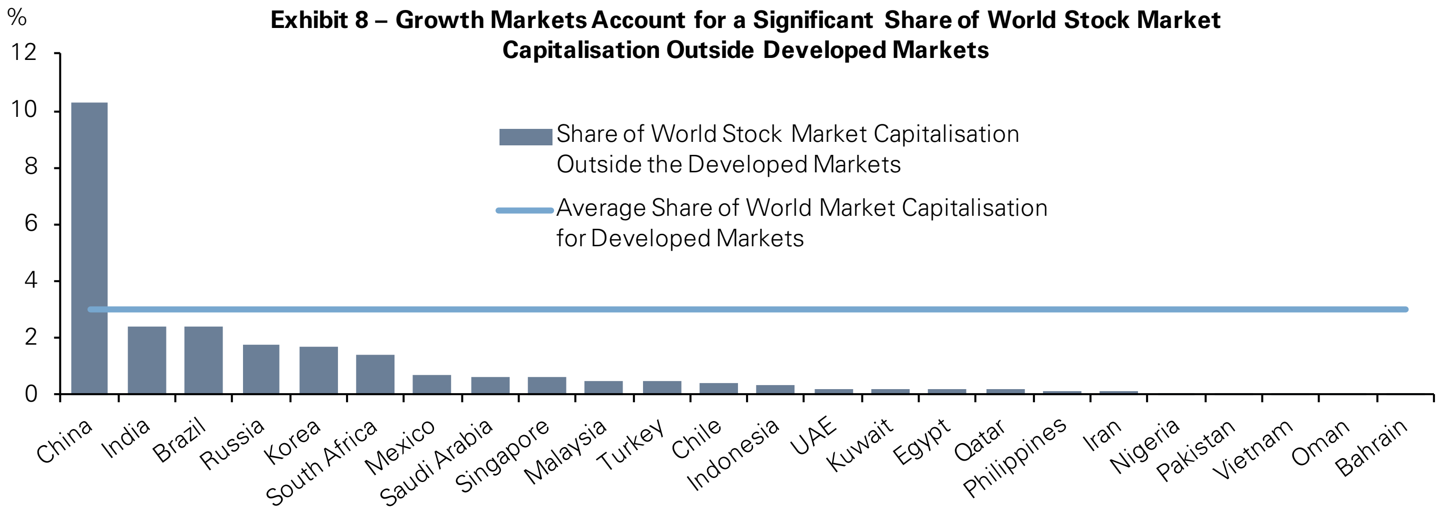
6. Financial Development

An important aspect that should be considered in thinking about the distinction between a Growth and an Emerging Market is the development and accessibility to investors of the country's financial markets. A country with an open, transparent market that is also relatively advanced in terms of financial instruments has a much improved chance of unlocking its potential. Naturally, that country could provide more investment opportunities than a country with a closed and/or under-developed market. In other words, 'investability' goes alongside more general growth conditions.

While there are certain issues and restrictions on investing within the eight Growth Markets, they are, nevertheless, relatively better developed and more accessible than most Emerging Markets. Unless these Emerging Market countries improve the size and depth of their financial markets, their prospects for elevation to Growth Market status could be diminished.

Exhibit 8 below shows one of the simple proxies that can be used to evaluate a country's financial development—its stock market size. The high shares of the Growth Market countries support them being more accessible and better developed investment platforms. On the other hand, the relatively low market size of the GCC countries is one of the reasons why these wealthy nations cannot yet be classified as Developed Markets.

Exhibit 8 – Growth Markets Account for a Significant Share of World Stock Market Capitalisation Outside Developed Markets



Source: Haver Analytics, GSAM calculations

Box: Q&A on Growth Markets Basics

1. **By defining Growth Markets, are you broadening the BRIC concept?**

   No. The BRIC concept remains intact. By defining Growth Markets, we simply identify those countries that have already grown large enough (above 1% of global GDP)—and have the potential to grow even larger—to be important for the global economy in a number of ways. These countries simply no longer fall under the traditional Emerging Markets definition. So the concept of Growth Markets is broader than the BRICs. It includes the BRICs, as well as four other countries (Mexico, Korea, Turkey and Indonesia).

2. **What is the difference between a Growth Market and a BRIC?**

   A Growth Market is an economy which currently accounts for at least 1% of global GDP. A BRIC is an economy which already accounts for more than 1% and has the potential to be at least 3-5% of global GDP in the foreseeable future. The BRICs are a subset of the Growth Markets.

3. **What is the difference between a Growth Market and an N-11 member?**

   The N-11 are the next set of largest population countries beyond the BRICs, which also have potential to grow much larger over the next several decades and have a BRIC-like impact in rivaling the G7. Four of the largest N-11 countries, namely Mexico, Korea, Turkey and Indonesia, meet the Growth Market criterion today. There is an overlap between the Growth Markets and the N-11.

4. **Could there be any more Growth Markets?**

   Of course. A number of countries in the Emerging Market universe could cross the 1% GDP threshold and achieve Growth Market status over time. According to GS Global ECS Research long-term GDP projections, the most likely candidates are Nigeria and the Philippines, which might grow sufficiently large by the mid-2040s. Egypt and Iran could also approach this threshold at some point over the horizon to 2050. See text for more discussion on this.

5. **What defines the transition from a Growth Market to a Developed Market?**

   There is no strict rule that defines the transition from the Growth Market to Developed Market universe. A number of criteria would have to be reached, including robust growth conditions, advanced financial markets as well as high income levels. Given its complexity, this decision will have to be somewhat subjective.

   Korea is a good example. While we still define it as a Growth Market, it would be the first country out of the eight in the group to graduate to Developed Market status. Korea already has robust growth conditions in place, and its financial markets are relatively well developed. In this case, wealth will serve as a legitimate cut-off point. As Korea raises its income per capita further, in line with the developed countries average, we will re-classify it as a Developed Market. However, this categorisation process could be less clear-cut in the case of other Growth Markets.

6. **Can an Emerging Market become Developed without becoming a Growth Market first? How does this transition work?**

   Yes, there can be a direct transition. An Emerging Market does not necessarily have to become large to be classified as Developed. Just like in the case of Growth-to-Developed transition, there are no strict criteria.

   A transition to the Developed group from Emerging status would involve an even more arbitrary decision than a transition from Growth status. This is because Growth Markets, by construction, implicitly assume a certain level of growth conditions and financial market development, so incomes per capita there play a decisive role. The Emerging Market group is much more diverse on these parameters. So defining strict cut-off points is not entirely sensible.

   The Gulf Cooperation Council (GCC) countries are a good example. They are already among the richest countries in the world, but it is difficult to classify them as Developed.

7. **Can a Growth Market slip back to the Emerging group?**

   It can. A Growth country that does not keep improving its growth conditions could drop below the 1% share of global GDP and thus move back to the Emerging Markets group. As highlighted in the text, it is absolutely critical for some countries such as India, Russia and Indonesia to address some of their most pressing issues in the near future.

8. **Doesn't Growth Market status imply that you think these countries will always grow?**

   No. Of course, these countries will experience cycles just like others, but over time their share of global GDP, already above 1% each, is likely to rise.

9. **Why don't we get rid of the Emerging Market name completely?**

   If we could think of a smarter, non-offensive word that simply summarised their status, we would. However, this universe of countries is very diverse. Many are still in the early stages of development and still have the characteristics that led Antoine Van Agtmael to coin them as "Emerging Markets" in the early 1980s in the first place.

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