Discussing Emerging Financial Markets:
Relevance of Institutional and Instrumental Characteristics

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Abstract

The paper addresses the scientific and professional perspectives on emerging financial markets' essence and determining features. Characteristic of emerging financial markets requires clarification that determines the research purpose. Within research framework, we suggest to consider emerging market in the broader sense as an emerging financial system. This approach corresponds with the financial development assessment and monitoring methodology. Applying this approach, it is relevant to broadly view the determining features of emerging financial markets including institutional and instrumental characteristics. We find it advisable to supplement the characteristics of emerging financial markets by the following institutional and instrumental features correspondingly: medium level of information transparency, increased country risk, moderate level of operational efficiency; the presence of stock markets, including those with high liquidity instruments; domestic and/or foreign market of state and corporate debt instruments; free and well-developed forex market of major currencies, derivatives market with liquid contracts for currencies and equities. The reported study was funded by RFBR according to the research project №18-010-00085.

Keywords: Financial Markets, Institutional , Instrumental Characteristics

Introduction

Emerging markets has been drawing attention of institutional investors since the late 1980's. A few years earlier the World Bank had coined this term in order to describe a group of 'less developed' markets with a strong potential for growth. In December 1987, MSCI released a new index covering emerging markets – the MSCI Emerging Markets Index; in 1997, S&P joined in with it's the S&P Emerging BMI; in 2000, FTSE launched its Emerging Index. Establishment of these indices reflects the scale of investors commitment to buy this kind of assets, which also corresponds to both soaring commodities prices and unprecedented intensification of international trade. Today, the indices serve as key benchmarks of financial situations in emerging markets and reflect the general view of professional community on their structure and key features.

Originally, the term 'emerging market' described investment-attractive developing countries (Van Agtmael, 2007, p. 4), but later its meaning broadened and included social, technological and economic aspects (Kvint, 2012, p. 255). Interest in emerging markets reached its peak in the period of rehabilitation from the Great Recession. Despite optimistic outlook, emerging markets saw their decline alongside with developed ones, suffering greater losses in comparison to markets of low-

income countries (Jahan & McDonald, 2012). It became obvious that in short-term emerging markets would remain dependent on economic environment in developed countries, and their relation would become cyclic (Derviş, 2012). At present, in the light of flight to quality (Stiglitz & Rashid, 2016) and ambiguous trends in capital investment (Bulatov, 2017), discussion on the character and potential of emerging markets remains relevant.

Challenges of global economy take us back to the definition of investment attractiveness, which can be assessed within different systems of investment management (management of real or financial, direct or portfolio investments, etc). This ambiguity leads to the situation when the term 'emerging market' is unclearly defined. In this research we intend to systematize views on emerging financial market by studying particular features of its institutions and instruments in use. The paper covers the essence and aspects of emerging financial markets, as well as criteria for measuring the level of financial development.

Approaches for Characterizing Emerging Financial Markets

The starting point of this research lies in assumption that not every country with emerging market has emerging financial market. If the list of the former includes as many as 80 countries, the list of the latter comprises around 25 (Lvova et al, 2018b). Furthermore, the assumption that countries with emerging financial market form a separate group characterized by shared attributes is not always present in researches on economy in general and specifically on finance[1]. This assumption is predominant in investment analysis and is clearly visible in methodology of estimating global financial market indices. We suppose that the classifications of countries by the level of financial market development used by MSCI, FTSE Russel, S&P Dow Jones Indices deserve more thorough studies, which may contribute to current discussion about institutions and instruments of emerging financial market.

We believe that methods for characterizing emerging financial market should correspond to the methodology of macro-financial analysis set out in the System of National Accounts (SNA 2008)[2]. Firstly, it promotes more accurate interpretation of basic terms (for example, institutional unit, financial service, financial corporation, financial corporation sector, etc.). Secondly, it will help properly describe a system of features particular to emerging financial market. Third, it will make possible to assess levels of financial market development through the IMF and World Bank indicators used in international financial system monitoring.

Thus, we see financial services (including, services of financial mediation, financial assistance, etc.) as the key aspect of emerging financial market. The broad definition of 'financial services' leads to the institutional interpretation of financial system, which is a system of financial markets, financial institutions, and conditions that ensure their proper functioning (Bodie et al, p. 2). In this respect, a country with emerging financial market is a country with emerging financial system, which implies that its financial markets, as well as market infrastructure and financial institutions, are also at emerging stage. It is worth mentioning that assessment of the financial market development level is rarely restricted to one kind of financial services or one group of financial institutions. Such assessment usually includes estimates of access to finance and financial stability that demonstrate the situation within finance corporations' sector as a whole. As for financial market, its assessment is based not only on its depth and liquidity, but also on indicators of operational efficiency.

It is very important to highlight that SNA based financial market analysis deals with economic rather than administrative territory of a country. Thus, the Mainland China and Taiwan are two separate emerging financial markets. Autonomous territory of Hong Kong is classified as a developed

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[1] Noteworthy, a series of articles about features of monetary policies on emerging markets provide general conclusions based on the analysis of the following countries: the RSA, China, India, Brazil, as well as Serbia and Ghana (Monetary policy, 2010).

[2] This implication was firstly introduced by the authors in paper: (Lvova et al, 2018b).

financial market. Nevertheless, legally speaking, all of these economic territories (as well as Macao) are parts of the People's Republic of China.

Today, countries with emerging financial market form a separate type of investment assets that is drawing considerable attention. Originally, the MSCI Emerging Markets Index included public companies from 10 countries comprising less than 1 percent of world's capitalization (free-float calculation).[3] Today, the number of emerging market countries increased to 26 in the MSCI Index. Now they comprise more than 12% of the world's free-float capitalization, 20% of the global market capitalization, and contributed roughly 40% to the growth of global economic activity (Melas, 2019, p. 30). Contribution of emerging markets to the global GDP is significantly underestimated, and the gap between their total GDP and total stock market capitalization is still growing (Bekaert & Harvey, 2017, p. 4-7).

In case of emerging markets, investors can anticipate not only greater returns, but also greater risks. Investment dynamics in emerging markets are not only dependent on external factors (business cycle phase, key interest rate, US dollar exchange rate), but are also exposed to specific threats (e. g. sanctions against Russia). Moreover, active investment strategies achieve better results in emerging markets, in comparison with developed ones. Hence, when choosing country and sector to invest, it is important to assess financial soundness of its issuers. We will further discuss features of emerging financial market in detail.

Summarizing Key Features of Emerging Financial Markets

According to the framework of macro-financial analysis, emerging financial market countries are assessed in terms of financial depth, efficiency, stability, and access (Lvova et al, 2018b), as well as quality of financial services. These countries also use their follow up position in relation to developed countries to their advantage and show faster growth in comparison to other economic territories. This financial development hierarchy corresponds to the principles of country classifications, which are used for global indices. Within these classifications, financial markets fall into 3 groups: developed markets[4], emerging markets, and frontier markets[5]. By default, other countries form the fourth group of the least developed countries.

Today, the list of countries with emerging financial markets includes the following states: Brazil, Hungary, Greece, Egypt, India, Indonesia, Qatar, China, Columbia, Malaysia, Morocco, Mexico, the United Arab Emirates, Pakistan, Peru, Poland, Russia, Taiwan, Thailand, Turkey, South Korea, Philippines, the Czech Republic, Chile, the Republic of South Africa. This list may vary insignificantly, depending on particular assessment methodology.[6] Each framework is based on its own set of emerging financial market features. The analysis of approaches resulted in the following attributes of emerging financial markets:[7]

1) *Considerable potential for the development of financial system*, which is not accompanied by the symptoms of financial glut. To clarify, according to the ‘too much finance’ hypothesis, positive effect of financial development is limited to some extent, and when a state reaches it, further financial

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[3] This comparison includes large and medium companies in terms of capitalization. World capitalization structure is assessed through the data from the MSCI All Country World Index (MSCI ACWI Index).

[4] It seems curious that despite the differences between classifications, list of financially developed countries remains unchanged. This group is the most stable, though even there one can discover exclusions (e. g. Greece descended to the group of emerging economies after government-debt crisis). As in the case of emerging markets, not all economically developed country can boast developed financial markets (e. g. Baltic states).

[5] For more details on the special features of frontier markets see: (What is the difference, 2012).

[6] In 2017, Morocco and South Korea were excluded from the list in some instances.

[7] It is important to note a review of main approaches to interpreting the term 'emerging market' which includes financial aspects of its functioning. The review can be found in (Mody, 2004).

development fails to benefit economy (Arcand et al, 2015). According to the IMF, medium level of financial development common for countries with emerging markets appears to be the most advantageous for economic growth (Sahay et al, 2015, p. 16). As far as formal estimates go, high potential for financial development can be interpreted in two compatible ways:

– In accordance with fast *growth of financial depth indicators* (including assets volume of deposit and formal financial institutions, total capitalization of stock and bonds market, stock market capitalization, capitalization of particular bond market sectors, etc. These indicators are expressed in relative terms – as shares of GDP).

– In accordance with *sufficiently significant volumes of financial system* (sufficient financial depth, assessed via indicators listed above). Sufficiency here is not strictly determined. Additionally, emerging financial markets differ greatly from each other. Still, the size of the financial market remains one of the most important criteria for assessing its level of development. Market size is determined via stock market parameters (capitalization or the number of listed companies expressed in relative terms as % of GDP). This leads to the role of public companies in classifying countries by the level of financial development (Lvova et al, 2018a; Lvova et al, 2018b). However, this issue is beyond the scope of our research.

2) *Increased financial vulnerability*, which is highly relevant to the Russian financial system, particularly in respect to inner market volatility. It is worth noting that many definitions of emerging financial market include increased volatility and excessive investment risks (Prasad, 2011). Instability and unpredictability of the market are usually based on functional and institutional flaws (Johanson & Johanson, 2004). On the same basis, market turbulence is regarded as a typical feature of emerging market, which only highlights systemic interrelation of these categories.

Additional features of emerging financial market include:

3) *Low or medium level of national wealth* (Rubtsov, 2007, p. 28) (that, however, does not concern emerging markets of the Middle East). At first glance, the level of national wealth does not seem to be directly related to the assessment of financial development. However, the increase in wealth has been proved to impact the model of national financial development: it boosts the role of direct access markets, collective investors and contractual financial institutions while diminishing the role of banks (Sahay et al, 2015, p. 10). Emerging financial markets mostly focus on a bank-based model (Rubtsov, 2007, p. 29).

4) *Sufficient level of liberalization* (e.g., Emerging market, 2016). The feature has ambiguous interpretation. For emerging market countries, it generally means free capital flow (in particular, it leads to increased volatility), which may be related to the origin of the term. In a broader sense, sufficient level of liberalization can be seen as a relatively high degree of economic freedom, but that interpretation does not reflect the specifics of certain emerging financial markets, including the Russian one (Mirkin, 2017, p. 17).

These features of emerging financial markets highlight their functional and institutional aspects. However, they fail to include financial institutions and instruments typical for countries with those markets. We will further consider the approaches that address this issue in practice, and we will use the framework of FTSE Russel for that.

Institutions and Instruments in Emerging Financial Markets

Early approaches to distinguishing financial markets by level of development were mainly based on generalized subjective judgments. As they lacked transparency, it naturally made the work of investors and regulators more complicated. Financial data service providers like FTSE Group (currently known as FTSE Russell) have created the latest, most efficient instruments to evaluate this development. The expansion of the FTSE global index series prompted FTSE to propose a structured framework in 2003 for classifying financial markets. The proposal set out the following guiding principles for market classification: quality of market (the quality of regulation, the dealing

landscape, custody and settlement procedures, and the presence of a derivatives market are all taken into account); materiality (a country needs to be of material size to warrant inclusion in a global benchmark); consistency and predictability (the classification changes are set out through a list of countries considered for promotion and demotion as well as the criteria by which countries are judged); cost limitation (assessment costs should be reasonable and competitive); stability (a new country only joins as an emerging market; and promotion only occurs in response to permanent changes in market status and global acceptance); and market access (international investors should be able to invest and withdraw funds in a timely and secure manner at reasonable cost) (FTSE country classification process, 2015, p. 2).

These principles, as well as client consultation, has resulted into criteria that assess the development of financial markets and classify them as developed, emerging (with further distinction as more or less advanced) or frontier markets. The framework includes qualitative and quantitative criteria. The qualitative criteria are divided into four groups: regulation, custody and settlement, dealing landscape and brokers, and derivatives. Criteria in each group score as “Pass”, “Restricted” (partial failure) or “Not Met”. Quantitative criteria include the rate of national wealth as calculated by the World Bank (2013), the country's credit rating, the size of the market and the number of listed companies.

The analysis of FTSE Russell framework provides us with the following features of emerging financial markets: transparency, including clear and timely trade reporting; moderate country risk, which means no objection or significant restrictions to capital investment (including foreign capital), low rate of void deals, and active state regulation of the market; high operating efficiency and, consequently, reasonable and competitive transaction costs; sufficient competition to ensure high quality custody and broker services; clearing & settlement — T+3 or a smaller settlement date; and sufficient market liquidity to support sizeable investment. These features are generally relevant to direct access markets (financial markets in a narrow sense), but some criteria from the first block (infrastructure and market regulation) are applicable to financial systems in general, as confirmed by our previous observations. We will further elaborate on the features focusing mainly on specifics of financial market:

1) It seems that the first feature requires clarification. In emerging financial markets, abundance of information goes along with significant asymmetry (Darushin et al, 2016), which often drives financial instability (Mishkin, 1999, p. 6). Therefore, we see it more reasonable to use *moderate information transparency* as a benchmark.

2) The criterion of country risk is also worth elaborating. The quantitative criterion of sovereign rating in the FTSE framework serves more illustrative than functional purposes as it does not specify the exact relation between market rating and its type. Moreover, emerging financial markets include countries with both investment and speculative grades of credit worthiness (FTSE country classification process, 2015, p. 6), which does not fully correspond to a moderate country risk mentioned by FTSE. It seems more likely that *the sovereign risk for emerging financial markets is generally elevated*[8].

3) The indicator of operating efficiency should be decreased as well. Despite assessment framework being reasonable, the validity of sufficient liquidity criterion is doubtful as it is not fully applicable to, for example, the Russian market, where liquidity is mainly raised by large companies. Therefore, we need to adjust the third feature as well: what we deal with is a *medium operating efficiency*.

It is worth noting that the framework basically sets requirements to the institutional aspect of markets. As for instrumental criteria, they are quite few. We can only see "free and well-developed" stock and foreign exchange markets, as well as a "developed" derivatives market. The assessment criteria for them, however, are not specified.

[8] Unless the market is developed, a similar allowance is made in assessing risk premiums in investment analysis. See also: (Damodaran, 2016, p. 234).

The framework also ignores that emerging financial markets are heavily dependent on the degree of freedom and development of the *stock market*. Moreover, it lacks criteria for the development of the *debt market*. Emerging financial markets are often greatly dependent on the development of the bond market, including its state segment. As the classification is mainly designed for international investors, it is unreasonable to omit criteria for the foreign exchange market. Though the criteria of investment capital withdrawal is essential for emerging financial markets, a dysfunctional or underdeveloped foreign exchange market will fail to repatriate capital in case of inconvertible national currencies. We believe that the development of the derivatives market plays a specific role in the assessment of emerging financial market. We look at Russian and Chinese derivatives markets to analyze its characteristics (box 1).

Box 1. Special features of Russian and Chinese derivatives markets

China and Russia are members of BRICS — a group of rapidly developing large countries. Their derivatives markets are similar due to late emergence if compared with western developed markets. Both markets started to develop in 1990's and has since gone through many ups and downs. Their circulations are predominantly based on stock market, with over-the-counter stocks having a small share of total trade. For example, in Russia most of the over-the-counter trading goes on Moscow Exchange, which means it can also be regarded as a marketplace trading. The majority of transactions on both derivatives markets are regulated. Weak legislative frameworks is a common disadvantage for Russian and Chinese derivatives markets. As in the case of China, Russia needs structural changes in its legal policy on the derivatives market. In addition, both Chinese and Russian markets have few tradable financial instruments. There are many types of derivatives on Moscow exchange, but only few of them are traded regularly. The latter include currency futures (primarily US dollar to rouble futures) and a number of futures with underlying security.

We will use the data of Moscow exchange to assess value characteristics of the market. In 2016, total value of derivatives amounted to 115 trillion roubles, including 109.5 trillion roubles for futures and 5.5 trillion roubles for options. In China the total value of the market was 195 trillion yuans for the same year. If converted to US dollar at the rate of 31.12.2016, the value of the Russian market amounted to 1.9 trillion dollars, while in China the indicator was 15 times greater and amounted to 28 trillion dollars. The Chinese market also excels in the number of contracts negotiated. Though the number of contracts concluded on Moscow exchange in 2016 was a little lower than 2 billion (world's third biggest derivatives market), the total turnover of 3 Chinese exchanges that are in top ten derivatives markets exceeded 4 billion contracts. In terms of dynamics, the Russian derivatives market is ahead of the Chinese. If we compare futures trading on Moscow exchange, the value of the derivatives market for 2016 increased by 23%, while the same indicator on 4 futures exchanges in China grew by 9.3% in 2016.

The makeup of instruments on the Russian futures market is characterized by a big share of foreign exchange instruments and a small share of commodity futures. Index products are a quite popular derivative as well, while interest rate futures hardly circulate in the market. According to the Financial Stability Department of the Russian Central Bank, the derivatives market has a large number of non-residents. They hold almost a third of all open positions in foreign exchange derivatives. In China forex contracts are traded over-the-counter only, and the country has limitations for non-residents. The main instruments traded on commodity section of the Russian derivatives market include, among others, contracts for Brent Crude. Other contracts, in particular for gold and silver, are not in high demand. Being the largest among all exchanges, the Chinese commodity futures exchange has many various commodity contracts traded on it ranging from soybean meal to steel rebar. The commodity market takes the central role in China, its share being more than 91% of the total value.

The development of the Russian and Chinese derivatives markets is under the state control. Key points in the development of these markets are legal framework, number of contracts traded, infrastructure, financial literacy and derivatives market awareness, and professional training. The central aim of the state policies is creating an efficient market to hedge risks and decrease economic

uncertainty. Meanwhile, the derivatives market should not destabilize the economy.

Designed by the authors on the base of: (The financial system of China, 2018, p. 80-82).

Thus, we suggest adding the following instrumental characteristics to the features of emerging financial markets: the presence of stock markets, including those with high liquidity instruments; domestic and/or foreign market of state and corporate debt instruments; free and well-developed forex market of major currencies, derivatives market with liquid contracts for currencies and equities.

Conclusion

The analysis of emerging financial markets should follow a systemic and consistent approach, which is not always the case. As we can see from guidelines and scholarly works, the assessment framework for financial markets is eclectic. It mainly focuses on features of financial markets (in a narrow sense), though it also includes general conditions and characteristics of financial development. In many cases, emerging financial markets are seen as emerging financial systems. However, the framework does not explain the nature of the relation between the financial market and the financial system.

We see it rational to analyze emerging financial markets through the institutional interpretation of financial systems. This approach highlights that an emerging financial market is an element of an emerging financial system, and the defining features of the latter are high potential for development, increased financial vulnerability, as well as low or medium level of national wealth and high level of liberalization. As for emerging financial market, its institutional and instrumental characteristics include correspondingly: a) medium level of information transparency, increased country risk, moderate level of operational efficiency; b) the presence of stock markets, including those with high liquidity instruments; domestic and/or foreign market of state and corporate debt instruments; free and well-developed forex market of major currencies, derivatives market with liquid contracts for currencies and equities.

Our findings correlate with the results of E. S. Prasad's study (Prasad, 2011, p. 4), in which he argues that countries with an emerging (financial – *authors' note*) market need primarily to develop capital market instruments and major currency derivatives, rather than create sophisticated financial innovations. In conclusion, quantitative criteria without clear-cut points make the assessment of financial development less objective. It is necessary to remember that emerging financial markets are usually heavily dependent on price fluctuations, especially during a downturn. This supports out idea that it is impractical to analyze financial markets by the development of financial system while ignoring key features of those systems.

It should be noted again that systemic and consistent approach towards the analysis of emerging financial markets paves the way for further research, which will complement our results in the two directions: first, providing a more detailed and structured assessment framework for emerging financial systems; and second, analyze features of financial markets and institutes through their pivotal role in the financial service market and incorporate them into the framework.

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