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Financial Frontier Markets:

Challenges and opportunities for entrepreneurial development cooperation

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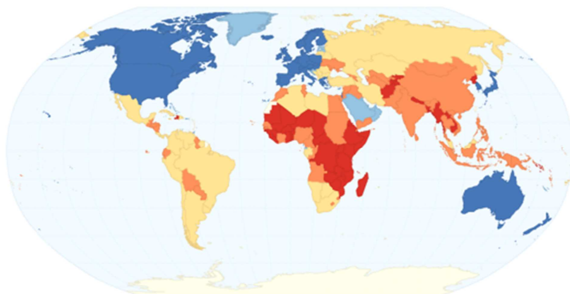
Financial frontier markets are capital markets, which are characterised by a smaller market capitalisation than transition countries. They are mainly located in high-risk countries and low-income countries. Rating agencies frequently rate high-risk countries as speculative asset class, due to high to very high convertibility, transferability and risk of sovereign default. There is a strong correlation with countries in the low-income category which is defined by the World Bank. The term, "low-income countries (LICs)" refers to countries with a maximum per capita income of USD 995 p.a. The country category with access to International Development Assistance (IDA) concessionary loans is a more encompassing definition for low-income countries. These are economies with a per capita income of up to USD 1,165 p.a.; 57 countries fall into this category, of which 32 are in Africa.

Fig. 1: Countries by income categories

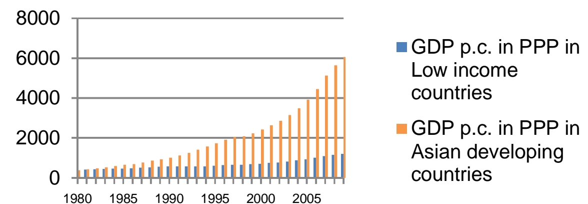


Low-income (dark red); Lower-middle income (orange); Upper-middle income (yellow); High-income, non-OECD (light blue); High-income, OECD (dark blue). Source: World Bank.

Classification by income does not take into account socio-economic factors and therefore does not automatically give the full picture on the development status of a country. Nevertheless, this group of countries has significant overlaps with the so-called "least-developed countries" (LDCs) – a UN categorisation. Due to a lack of accurate data on individual low-income countries (LICs), data from the LIC group of countries will be used in the context of this paper and data from LDCs will be used as a proxy for measuring millennium development goals.

The economic position of financial frontier markets is, at present, better than it has been for around three decades. Whilst year-to-year growth between 1990 and 2000 amounted to 3.5%, between 2000 and 2008 the figure was almost 6%. However growth in low-income countries was substantially lower than in regional peers (see fig. 2).

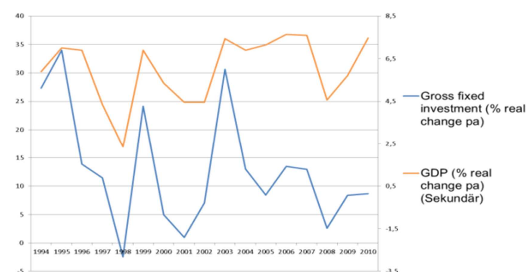
Fig. 2: Gross national income in USD per capita (1980 - 2008)



Source: World Bank, author's illustration.

The benefits of the constant high growth, particularly between 2000 and 2008, are not distributed evenly between the individual countries, i.e. between Asian and African financial frontier markets, nor between commodity and other exporters of agricultural products and industry. In the boom period, economic growth in these markets was generally not accompanied by the development of productive capacities or by improved efficiency. On the whole, it can be observed that investments in low-income countries have made a considerable contribution to economic growth (see fig. 3). On the other hand this trend cannot be affirmed for the inflow of funds from official development aid (ODA). In fact a negative trend is to be observed here, which could imply the crowding out of private investors by public ones.

Fig. 3: Correlation between BIP growth and gross capital expenditure (1984 - 2010)



Source: EIU, IMF, author's calculations.

Despite improved global macro-economic framework conditions, low-income countries still face enormous challenges. Deficits can be observed in the real economy as well as in the financial sector. Development bottlenecks in the real sector are diverse in nature. Particular challenges are the availability of infrastructure, the low diversification level of the economies and often a high dependency on natural resources within the export structure. On the financial markets, we can observe that the access to financial services remains difficult for local companies, despite stable inflows

of foreign capital. These development bottlenecks are aggravated by socio-economic factors: a constant high level of poverty goes hand in hand with low level access to health and education services. These are hurdles for qualitative growth, i.e. the building up of productive capacities and the creation of employment opportunities.

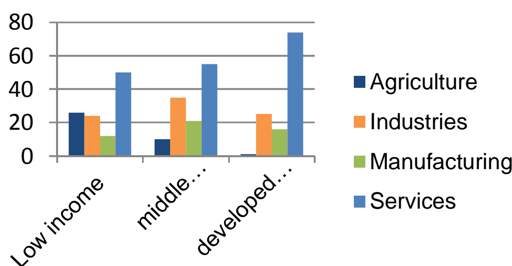
Socio-economic challenges

Even following an economic boom phase and despite a reduction of relative poverty ratios, a large proportion of the population in low-income countries still lives in extreme **poverty**. In 2007, 53% of the world's population lived in extreme poverty (USD 1.25 limit, 78% under the USD 2 limit), whereby the proportion of extreme poverty in African LDCs (59%) is considerable higher than in Asian ones (41%). Despite considerable ODA inflows of funds in the areas of **education** and **health**, the access to services did not increase proportionally. In low-income countries health expenditure is only 50% of that in developed economies. In these countries 36% of total health investments are from private expenditure, compared to 83% in low-income countries. Whilst progress has been made in the areas of tuberculosis, access to clean drinking water and malnourishment, the infection rates of HIV/AIDS have risen in relative terms. 2.3% of the population in low-income countries are infected (1990: 2.1%). Despite a lack of data in the area of education, barriers to increasing productive capacities are apparent. Only 41% of relevant age groups in low-income countries enter secondary education; only 6% reach tertiary education (compared to developed countries: 100% and 69%, respectively).

Real economy

The economic structures in low-income countries are still characterised to a large extent by the **primary sector**, which makes up a quarter of economic output (for developed countries: 1%) the proportion of manufacturing industry only increased by 1% during the economic boom phase (see fig. 4).

Fig. 4: Income structure in %



Source: World Bank, author's illustration.

Between 2000 and 2007 the proportion of oil and other primary **raw materials** exports grew by over 50% against the overall export volume. The additional income, which was generated by the sharp rise in the crude oil price in 2008, was beneficial to the crude oil economy in the individual states, but did not lead to a significant diversification of the economy. The import of machines and other plant equipment, a key influencing factor for technological progress and capital accumulation, increased only marginally. Investments were neither made in the field of infrastructure nor in job creation for the future. At the same time countries without oil reserves in particular have been negatively affected by the higher oil price, which has led to a drop in economic output and higher food prices. For economies reliant on the export of raw materials and agricultural products, the increasing volatility of raw material and food prices are having an increasingly destabilising effect on the balance of payments.

The export-orientated growth model with its focus on raw material/commodity exports and comparative low productivity in the primary sector, has led to a decline in the primary sector's contribution to GDP. Increasing population growth means leads to a focus of the population towards urban centres rather than in agriculture and increasingly; the reason being a lack of jobs in the manufacturing and service industries in rural areas. Accordingly the rural population has fallen by almost 10% during the last two decades. The phenomenon of insufficient structural change is aggravated by a lack of technological progress and only a slight rise in production, which is all linked to the classical dutch disease.

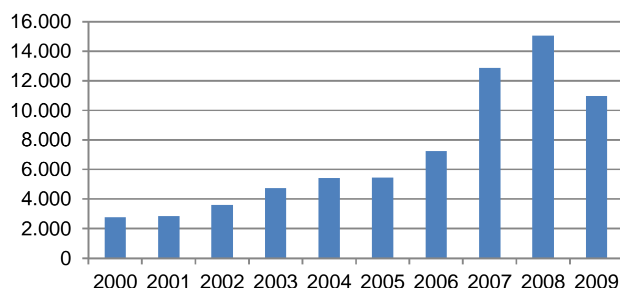
Entrepreneurial development cooperation can make a contribution to building up productive capacities through the promotion of investments which lead to employment opportunities in the area of agriculture as well as in manufacturing industry and through indirect promotion of local small and medium-sized enterprises by the financial sector. These are essential for increasing income and consumption of private households. Above and beyond growth effects, investments by German or European partners within the entrepreneurial development cooperation can bring about increased efficiency, in agricultural and oil-exporting economies, through technology and know-how transfer. As well as contributing to the Economic Value Added, private sector promotion can help to ensure that environmental and social standards are met and also boost distributional effects, for example in the context of multi-stakeholder initiatives e.g. the Extracting Industry Transparency Initiative (EITI).

In addition to the export structures listed, a lack of the building up of **Infrastructure** is one of the greatest challenges. In this context, it is not all about building large infrastructural capacities, but rather adapting these to economic structures and growth and preparing them for the future. Whilst low-income countries have experienced huge investments over the last decade, especially in the area of telecommunications, energy will be a focus are in the future with a rise in capacity and efficiency: even considering the very low levels of consumption, transmission and distribution losses amount to 13%. It can be observed here that the use of renewable energy has not increased proportionally (increase of 6% since 1990) with general energy consumption (increase by 63% in the same period). Investment opportunities carrying high developmental impact await private investors. This applies also to the water sector. Particularly in rural areas, this is an area suffering low investment; the building up of waste water and waste management infrastructure is one of the main infrastructure bottlenecks, especially in emering urban areas.

Financial market

The historically pathological level of indebtedness in low-income-countries has dropped sharply, mainly due to the international initiatives on debt cancellation such as the "Heavily Indebted Poor Countries Initiative" and "Multilateral Debt Relief Initiative", which have had a stabilising effect on state budgets. We have witnessed a considerable rise in private inflows of capital - albeit these flowed primarily into LDCs with large amounts of natural resources and were generally lower than overall ODA inflows (see fig. 5).

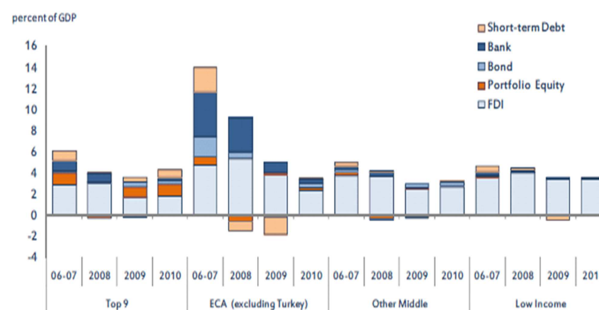
Fig. 5: Inflows of capital in low-income countries in USD millions



Source: World Bank, author's illustration.

A continual growth of inflows of foreign capital can be observed in low-income countries, whereby remittance transfers in particular, have made a significant improvement to the balance of payments of some financial frontier markets e.g. Bangladesh, Nepal and Lesotho. This is in contrast to developed and transition countries. The positive trend also continued after the financial crisis: following a decrease in inflows of capital by 40% in 2009, in 2010 an increase of 16% amounting to USD 410bn was recorded. A general observation is that inflows of capital in low-income countries are often characterised by foreign direct investment and are therefore more stable than in transition countries (see fig. 6).

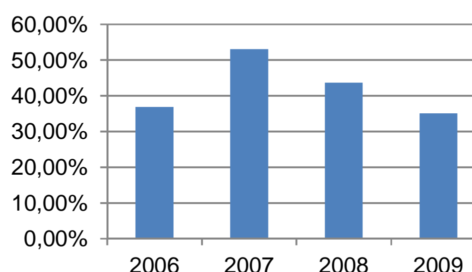
Fig. 6: Inflows of capital in low-income countries and selected transition countries



Source: World Bank.

The low proportion of short-term foreign inflows of capital in the financial and capital market, as well as the lack of trust in local financial institutions, means very modest levels of saving. This translates in a low proportion of local credit allocation in the economic output. Consequently local companies are hampered by insufficient access to capital. Local financial markets have as yet, not completely recovered from the financial crisis: the proportion of loans from local banks only adds up to 35% of overall income, before the crisis this figure was over 50%.

Fig. 7: Provision of loans through local financial institutions

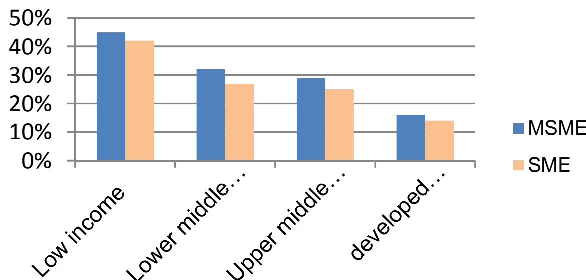


Source: World Bank, author's illustration.

This leads to a shortage of access to financial services, in particular for small and medium-sized enterprises: 40% of all local SMEs regard this as a significant bottleneck to sustainable growth (compare with fig. 8). The basis for this development bottleneck is, however, not only a lack of liquidity on the local banking market. In the context of an

adjustment towards Basel II principles, which are also increasingly relevant for low-income countries, the ability of local institutions to bear risks also plays a role. Entrepreneurial cooperation is not only able to provide capital through indirect financing solutions for local SMEs, but also contributes to organic growth in the sense of strengthening the risk-bearing ability through investments in financial institutions. And that primarily in areas which are believed to be high-risk, such as SME and agribusiness.

Fig. 8: Proportion of companies, who mention access to financial services as being a significant development bottleneck, in %



Source: Klein, author's illustration.

Financial frontier countries as a market opportunity

Ultimately financial frontier markets are not purely countries challenged by having to build a functioning market economy. According to growth forecasts strong rates of growth are expected, especially in financial frontier markets in 2012. Double-digit growth rates are anticipated particularly for raw material/commodity-based export economies, including Niger (15.4%), Iraq (12.6%) and Angola (10.5%).

In fact the challenges outlined above could be opportunities for international investors to consider these countries as lucrative markets. High population growth offers markets with high growth rates, particularly in urban areas. Indeed in this context increasing investments from multinational companies are anticipated. The banking sector belongs to the fastest growing sectors, with an annual predicted growth rate of over 6%, as does education with nearly 5% and health with 4.2%.

At the same time, we have witnessed an improving macroeconomic environment for private investors, certainly due to the very high overall inflows of ODA in the area of institutional technical consulting. Seven of the ten top performers of the current Doing Business Rankings are low-income and/or high-risk countries. Until these changes can translate into improved ratings and a higher level of attractiveness for private investors, the entrepreneurial development cooperation can play an important role in highlighting and mobilising capital, which will reveal how the challenges mentioned can actually become opportunities.

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