The Rise of Africa's "Frontier" Markets

A number of sub-Saharan countries are beginning to attract investors to their financial markets

Downtown highrises in Dar es Salaam, Tanzania.

David C. L. Nellor

SEVERAL African countries, with developing financial markets that are likely to attract institutional financial investors, are promising candidates to become part of a second generation of "emerging market" countries.

The same crucial developments that presaged the arrival of institutional financial investors in emerging markets in the 1980s are taking place in parts of sub-Saharan Africa today—growth is taking off, the private sector is the key driver of that growth, and financial markets are opening up (see box). The global environment has played a key role. The search for yield, triggered by significant global financial market liquidity, has encouraged investors to expand their horizons.

But the new generation faces a more complex, more integrated global environment than did emerging markets of a quarter century ago. Then, institutional investors accessed emerging economies largely through equity markets and, in some cases, foreign currency debt issues. Today, these investments are but a part of the picture. Investors are immersed in a wide range of financial activities, including domestic bond and foreign exchange market instruments. Financial technology is more complex too.

Financial markets gradually became more sophisticated and complex over the past 25 years. Today, however, financial technology is transferred to African emerging markets more or less simultaneously as it is developed in sophisticated markets—although lack of market depth and infrastructure does inhibit its application.

That means that the second-generation emerging markets in Africa face significant immediate challenges to which their predecessors could adapt over a quarter century. For one, maintaining financial sector stability will be challenging. With most of the financial flows intermediated through domestic banking systems, Africa's central banks have to strengthen considerably their supervisory capacity to manage the sophisticated financial activity that has emerged almost overnight. At the same time, policymakers have less scope to manage these activities. For instance, prudential-based approaches to manage capital flows, such as taxes on short-term flows, can be bypassed more easily because of the availability of derivative transactions that were not used in emerging markets a generation ago.

This article identifies sub-Saharan African countries, beyond South Africa, that offer institutional investors the prospect of good returns and a means to diversify risk through investments in financial markets. It recognizes how the changed global environment affects policy and raises issues investors are thinking about as they move into these markets.

Who coined the term?

The International Finance Corporation coined the term "emerging market" in 1980 to refer to developing countries with stock markets that were beginning to demonstrate the features of the mature stock markets in industrial countries. Emerging markets—which afford the opportunity to participate in economies through financial investments—have been identified in all regions of the world. In Africa, only South Africa so far has been seen as an emerging market (see "Emerging Markets Emerge" on p. 54 of this issue).

Identifying emerging markets

The compilers of emerging market indices decide whether a country is an emerging market by assessing the nature and sophistication of the stock market in relation to the degree of development of the economy. Recently, Standard & Poor's—which in 2000 took over the emerging market financial indices from the International Finance Corporation (IFC)—has used the term "frontier markets" to describe countries with markets that are smaller and less liquid than those in the more advanced emerging markets. Many of the emerging markets in the 1980s might have been called frontier markets under today's classification.

The term emerging markets is used here to identify countries in sub-Saharan Africa that have financial markets and attract investor interest. The broader usage of the term emerging market in this article suggests that a positive response to several questions helps establish membership in the emerging markets group:

- Has there been a takeoff in growth?
- Is that growth led by the private sector, and has public policy embraced market-led growth?
- Are there financial markets in which to invest?

Eight sub-Saharan countries that meet these criteria and are headed toward emerging market status are benchmarked against the founding members of the Association of Southeast Asian Nations (ASEAN), which were among the early emerging markets identified by the IFC.

A growth takeoff

Emerging markets are attractive to investors because they offer rates of return that are high relative to mature markets and offer opportunities for investors to diversify risk. High GDP growth signals that there are opportunities for investors to "buy" into the country's overall prospects or seek out opportunities by identifying undervaluation in specific sectors. Growth prospects in emerging market countries are likely to be based on technological catch-up, significant output gaps, young populations, and faster population growth than in mature markets. The processes that bring about growth may differ by country, but a track record of solid growth is common to emerging markets. The potential for risk diversification might arise at the country level when growth trends are not synchronized with mature market economies.

Attitudes toward Africa's growth prospects are influenced by Asia's experience of export-led growth. Analysts argue that export-led growth is critical if African countries are to sustain high growth and ask whether there is scope for export-led growth, particularly in the nonresource sector. Although the export-led growth model might not be as viable today as when growth was taking off in the first-generation emerging markets, Africa has potential for significant growth through import substitution and intraregional trade, as well as through traditional export markets.

Two tests could be used to determine which countries have reasonable prospects of establishing the preconditions for growth—one for resource-rich and one for resource-scarce countries.

Africa's resource-rich countries have a poor long-term track record for macroeconomic performance. When commodity prices were high—particularly for oil—governments spent more than their economies could absorb and exchange rates strengthened and choked off their nonresource sectors. But when commodity prices fell, the nonresource sectors failed to revive. The recent boom in commodity prices offers a laboratory experiment on growth prospects for African resource producers. How are they coping with the macroeconomic stress imposed by sustained high commodity prices? The high prices of resources in recent years have no doubt contributed to higher growth rates, but this could be a false signal; growth in these countries could again deteriorate when commodity prices turn down—the well-known resource curse.

One way to assess the prospects for these countries is to examine how they are performing today, compared with previous episodes of high commodity prices. Is there anything to suggest that this time their performance after the boom could be different? The best emerging market prospects would be resource producers that have installed sound economic institutions to avoid the boom-bust cycle of the past. Take the case of Nigeria. Since the current oil boom started in 2004, its economic performance has been far better than in previous booms in 1974–78, 1979–83, and 1990–94—whether measuring non-oil growth or inflation (see Chart 1).

The key to this good performance is that fiscal policy has been set with an eye on the ability of the economy to absorb the domestic demand consequences of spending booming oil revenues. Use of a budget oil-price rule, which allowed spending of oil revenues in line with absorptive capacity and saving oil revenues above this budget price, was effective in breaking the link between growing oil prices and budgetary outlays that led to booms and busts in the past. If this fiscal rule can be sustained, the prospects for ongoing growth are strong.

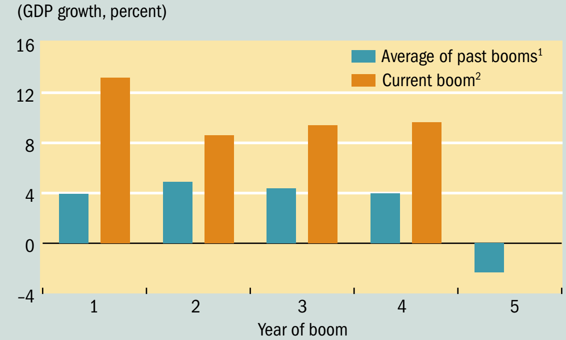
Africa's resource-scarce countries have also had to deal with macroeconomic stress: the significantly higher commodity

Chart 1

Handling the boom in Nigeria

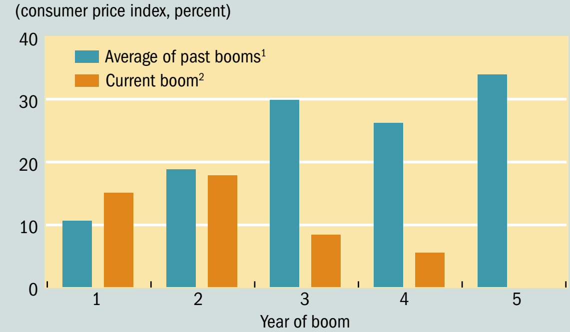
During the first four years of the current boom, Nigeria's non-oil GDP has grown much faster than it did in earlier cycles . . .

(GDP growth, percent)



. . . while consumer prices have risen much more slowly.

(consumer price index, percent)



Sources: Nigerian authorities; and IMF staff.
[1]The previous booms were in 1974–78, 1979–83, and 1990–94.
[2]The current boom began in 2004.

prices they must pay. Which countries have nevertheless performed well? Some countries have seen high prices for their own commodities offset the high oil prices they must pay, but certainly not all. An ability to sustain growth demonstrates not only economic resilience but also a break from the past.

Growth can be looked at against terms-of-trade developments (see Chart 2). Several countries whose terms of trade turned negative—that is, the overall prices of their exports fell relative to imports—nonetheless have recorded solid growth. This is because their better policy frameworks have helped them adjust to the higher import prices. Also, because they have built significantly higher international reserves, the countries have had a cushion while this adjustment is taking place. While recognizing that policy challenges are mounting, the track record so far signals both better policies and an economic flexibility that augurs well for growth prospects.

Private sector–led growth

Successful emerging market countries feature the private sector as the engine of growth, irrespective of their form of economic organization. Institutional investors want to have confidence that policy will continue to support private sector development and that private property rights will be protected; here they share the interests of foreign direct investors. Africa generally fares poorly in measures of the attractiveness of the business environment, and this makes the continent a less attractive destination for investors. Stronger performance in this area is likely to be well rewarded with additional investment.

The first-generation emerging markets used policy actions to help establish them as emerging markets, and some African countries are doing likewise. Indonesia, for example, offered an extensive range of tax breaks as one indicator of its interest in investment. By the early 1980s, having established its credentials, it eliminated these benefits and adopted a conventional tax structure while continuing to sustain its competitiveness through its macroeconomic policy. In Africa today, Mozambique, which came out of a lengthy conflict, has restored private sector confidence by such actions as providing attractive fiscal arrangements for mega projects, including the massive Mozal aluminum operation. Having demonstrated a track record of strong economic performance and respect for private sector rights, Mozambique is establishing a balanced tax environment that, along with macroeconomic stability, makes it an increasingly attractive investment destination.

Investing in financial markets

Only recently have Africa's financial markets attracted significant interest from institutional investors. Just as first-generation emerging markets welcomed institutional investors to their equity markets, African countries are doing so now. African equity market capitalization was about 20 percent of GDP in 2005, comparable to the level reached by ASEAN in the late 1980s. By 2007, Africa's equity market capitalization had surged to over 60 percent of GDP. Africa's domestic bond markets are attracting interest in a way not seen in first-generation emerging markets. Trading of domestic and foreign debt in the international markets has accelerated rapidly. Emerging Markets Traders Association data show that trading in Africa's debt markets (excluding South Africa) more than tripled in 2007, reaching about $12 billion (see Chart 3).

Nigeria, as the largest country in this group, dominates the trade. During 2005–06, Nigeria received Paris Club debt relief and bought back much of the remainder of its external debt. Since then, trade in Nigerian debt has been mainly in domestic issues. Nigerian debt trading ranked 21st globally at the end of 2007; this is equal to or exceeds many first-generation emerging markets. Using a variety of investment vehicles, Nigeria's banks raised about $12 billion in capital over 2006–07, much of it from offshore investors.

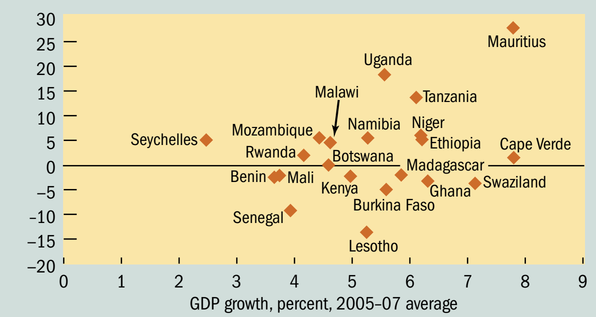
The criteria for an emerging market set out here—growth, private sector–led growth, and investible markets—can be identified in eight sub-Saharan African countries: Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda, and Zambia.

Chart 2

Growing during adversity

Several sub-Saharan African countries whose terms of trade[1] turned negative have still recorded solid growth.

(terms of trade, 2005–07 average)



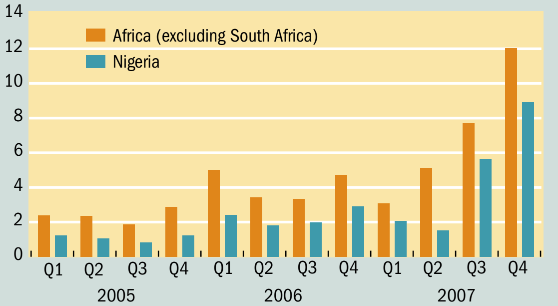
Source: IMF, *World Economic Outlook* (April 2008).
Note: Fragile states, oil-exporting countries, Zimbabwe, and South Africa are not included.
[1]Terms of trade measures the overall prices of a country's exports relative to imports.

Chart 3

Debt trading booms

Foreign trading in Africa's debt markets more than tripled in 2007, reaching about $12 billion, with Nigeria dominating.

(billion dollars)



Source: Emerging Markets Traders Association.

Together these countries account for about 40 percent of the region's population outside South Africa and almost one-half of its GDP.

The new frontier and the old

This group of African countries compares favorably with the ASEAN countries of 1980 (see table). ASEAN was already experiencing strong economic growth in 1980 but, in many other areas, the ASEAN countries looked quite different than they do today—and the African candidates perhaps have lower vulnerability and greater economic stability than the ASEAN countries had in 1980. Growth in sub-Saharan Africa is strong, as it was in Asia. Unlike the high ASEAN inflation in the 1980s, inflation in Africa is single digit. High international reserves and low debt-to-GDP ratios—the result, among other things, of debt relief—characterize the African countries relative to the ASEAN countries of 1980. Government, however, comprises a larger share of the African countries than it did in the ASEAN countries.

Measuring up

Emerging markets in sub-Saharan Africa (SSA) today compare favorably with the first-generation emerging markets.

	ASEAN[1]	Select SSA[2]
	1980	2007
GDP (annual growth, percent)	7.5	6.9
Inflation (annual CPI, percent)	16.5	7.3
Financial depth[3]	28.9	29.1
Size of government[4]	11.0	22.1
International reserves[5]	3.1	9.4
Debt[6]	27.0	12.0
Foreign direct investment[6]	1.3	4.8
Portfolio inflows[6]	0.1	0.3

Source: IMF, *World Economic Outlook* (April 2008).
[1]Indonesia, Malaysia, the Philippines, Thailand, and Singapore.
[2]Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda, and Zambia.
[3]Money supply as a percentage of GDP.
[4]Government expenditures as a percentage of GDP.
[5]As a percentage of the following year's imports.
[6]As a percentage of GDP.

The macroeconomic policy challenges for the African markets are similar to those faced by the ASEAN countries in the 1980s. African markets tend to use monetary aggregates as the basis for achieving inflation goals, supported by a managed float exchange rate policy. With financial liberalization and other structural changes, the stability of money demand and relationships between monetary aggregates and inflation becomes problematic. As questions arise about their credibility, central banks look for more effective ways to meet their needs. In Africa today, a goal of some central banks is to move to inflation targeting. Some ASEAN countries adopted inflation targeting for much the same reasons, but not until after the Asian financial crisis of the late 1990s.

Because market participants seek to exploit differences in market valuations, it is crucial that investment destination countries meet market tests for consistency of policy. The experience of the ASEAN countries during the 1990s Asian crisis shows that artificial exchange rate stability along with independent monetary policy encourages destabilizing short-term investment flows. Investors perceive a stable exchange rate (or a one-sided risk to appreciation in the oil economies) and look to benefit from interest rate differentials; this so-called carry trade characterized Asia in the late 1980s and 1990s and is already moving into Africa. The fear of letting exchange rates float (which allows this carry trade) is driven by concern that exchange rate volatility will complicate business planning and, in the oil economies, that a currency that rises and falls with oil prices will be a permanent drag on non-oil growth and employment. A tension between macroeconomic stability and permitting exchange rate flexibility is likely to become even more evident as countries target inflation.

Complex financial instruments are already being introduced in African financial markets. These markets have not had the opportunity to mature gradually in the way that their predecessor emerging markets did in the 1980s. In 1980, investors in equity markets generally followed a conventional buy-and-hold strategy—portfolio flows were relatively long term and sovereign debt issues were traded in global financial market centers. In contrast, institutional investors are entering Africa's markets through a variety of instruments—equity and local currency fixed income, as well as in both physical and derivative instruments. The technology transfer from emerging markets elsewhere into Africa's nascent emerging markets is limited only by market depth and regulatory and market infrastructure.

African central banks must give adequate weight to financial sector stability against a tradition in the region that has long focused on financial sector development. The banking system is the main conduit through which foreign inflows are intermediated, and so bank capital and risk management practices must be monitored carefully. However, the challenges for central banks go well beyond assessing the capacity of the capital base of a commercial bank to absorb the kinds of shocks that lead to more nonperforming loans. Links between various parts of the financial markets, such as banks and the stock markets, must be assessed, as must the foreign exchange market implications of macroeconomic-driven shifts in bank balance sheets. The learning curve for central banks today in terms of implementing effective risk-based and consolidated supervision is much steeper than for the first-generation emerging markets. And, for some first-generation emerging markets, such as the ASEAN countries during the 1990s Asian crisis, this proved to be a challenging task.

A tremendous opportunity

The rise of some African countries to emerging market status gives them a tremendous economic opportunity. Access to capital markets is a key ingredient to high and sustainable private sector–led growth, and this access had long seemed out of reach for Africa; it is now a reality. Evidence is already mounting that financial flows are being translated into growth in financial intermediation in these countries. To help ensure sustained growth, the countries must ensure that macroeconomic policy and capital account prudential policies are tailored to avoid the traps of volatile short-term flows, and that supervision promotes financial sector stability and effective intermediation. ■

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