



Frontier Markets: A World of Opportunities

Tomás Guerrero Blanco

Research Assistant
ESADEgeo Center for Global Economy and Geopolitics

Frontier Markets: A World of Opportunities

Tomás Guerrero Blanco

Research Assistant
ESADEEgeo Center for Global Economy and Geopolitics

March 2013

Abstract

- ✦ The emergence of *frontier markets* is speeding up the global economic rebalance.
- ✦ No longer do the highest economic growth rates belong exclusively to the BRICS countries. Lesser known economies, such as Nigeria and Vietnam, are key players in global economic growth and are expected to continue to be so for several decades¹.
- ✦ The economic growth that frontier markets are undergoing is still due to the combination of low labour costs and abundant natural resources.
- ✦ To avoid excessive commodity dependence and guarantee sustainable growth over time, the governments of these countries have opted for creating sovereign wealth funds and tech hubs.
- ✦ Spain could take advantage of the opportunity that frontier markets represent, just as it once did with the Latin American market.

Introduction

When Farida Khambata, an Indian economist at the International Finance Corporation (IFC), coined the term frontier markets (FM) to describe countries at an earlier stage of economic development than emerging markets (but holding the same potential), the vast majority of states belonging to this set of countries were characterised by their instability, restricted market accessibility and low liquidity. At best, they represented a future opportunity.

Nowadays, after a marked improvement in their fundamentals, the 37 frontier markets included in the main financial indices (see **Table 1**) are synonymous with economic growth (see **Figure 1**) and low debt levels (see **Figure 2**).

¹ Forecasts taken from [World in 2050: The BRICs and beyond: prospects, challenges and opportunities](#), PwC, 2013.

TABLE 1. LIST OF FRONTIER MARKETS BY INDEX AND WEIGHTING

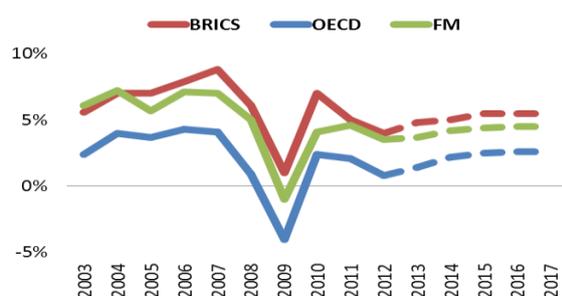
Country	S&P BMI	MSCI FMI	FTSE F50	Country	S&P BMI	MSCI FMI	FTSE F50
Argentina	5.4%	2.9%	7.8%	Mauritius	1.7%	0.9%	3.7%
Bahrain	2	0.6	0.4	Namibia	0.2	-	-
Bangladesh	1.3	2.5	5.1	Nigeria	9.8	12.8	21.1
Botswana	0.6	-	-	Oman	2.3	3.4	6.6
Bulgaria	0.2	0.1	-	Pakistan	3.8	4.2	-
Ivory Coast	0.5	-	-	Panama	3.3	-	-
Croatia	1.4	2.1	2.4	Qatar	13.4	14.2	24.6
Cyprus	0.6	-	-	Romania	1	1.1	4.3
Ecuador	0.6	-	-	Serbia	-	0.2	-
Estonia	0.4	0.4	0.9	Slovakia	0.4	-	-
Ghana	0.3	-	-	Slovenia	1.5	1.9	3.6
Jamaica	0.7	-	-	Sri Lanka	1.9	2	3.7
Jordan	3.7	0.9	1.7	T and T *	1.2	-	-
Kazakhstan	5.2	3.6	-	Tunisia	1	0.8	2
Kenya	1.8	2.9	8.4	Ukraine	1.5	0.3	-
Kuwait	19.5	27	-	UAE	6.8	10.2	-
Latvia	0.1	-	-	Vietnam	3	2.4	3.4
Lebanon	2.5	2.4	-	Zambia	0.3	-	-
Lithuania	0.3	0.5	0.6	Total: 37			

* Trinidad and Tobago.

Note: The initials of the indices in Table 1 are: S&P Frontier Broad Markets Index, MSCI Frontier Markets Index and FTSE Frontier 50 Index.

Source: Standard & Poor's, FTSE and Thomson Reuters Datastream.

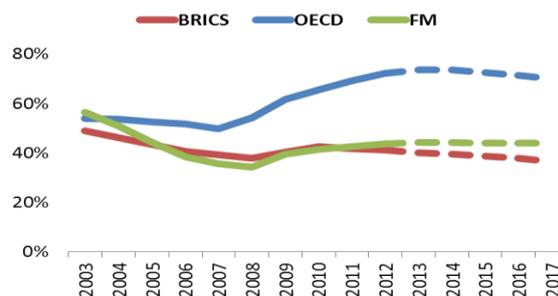
FIGURE 1. ECONOMIC GROWTH*



*GDP at constant prices.

Source: FMI.

FIGURE 2. PUBLIC DEBT TO GDP RATIO

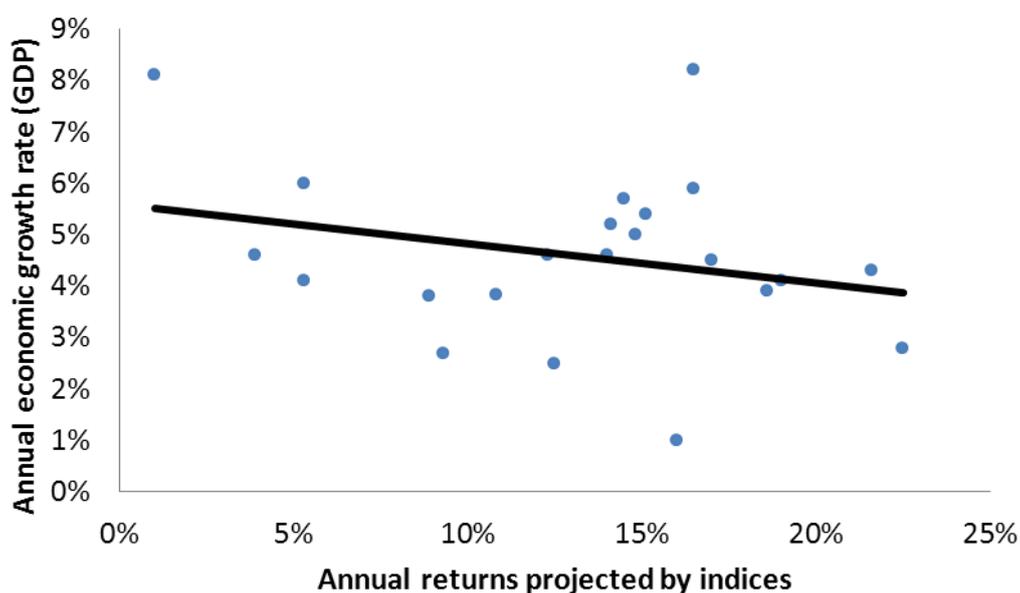


Nowadays, the economic and financial development of the frontier markets is monitored chiefly by financial entities which maintain a series of specialised indices in this sector. However, there is clearly room for improvement for these indices, which are tremendously popular among today's investors². The two most significant deficiencies they have are the following:

² Index weightings assigned to each country and sector are not properly justified and do not correspond with the actual performance of their economies.

- a) The omission of macroeconomic and institutional variables, which prevents the economic and financial performance of frontier markets from being recorded objectively. The Argentinean government's recent nationalisation of Repsol's subsidiary YPF highlights the need to start incorporating institutional and macroeconomic variables when putting together these indices. Only then will they be able to project returns in keeping with the true risks these countries present.
- b) The lack of relationship between the real economic growth of these economies and the returns forecast by these indices (see **Figure 3**).

FIGURE 3. ECONOMIC GROWTH VS FINANCIAL RETURNS



Note: Data for the period January 2000 to September 2012.
Source: Thomson Reuters Datastream.

Although what has been described above continues to paint a picture of frontier markets that is closer to that of a future challenge than a present opportunity, I now aim to explain some of the most important phenomena taking place in these markets, and show the opportunities these countries currently represent for Spain.

Frontier market sovereign wealth funds

Not only did the 2007 financial implosion, which came into focus with the fall of Lehman Brothers in 2008, provoke the collapse of the global banking system and the start of the financial crisis we continue to suffer from today, it also contributed to the arrival on the world scene of the giants of state capitalism: sovereign wealth funds³.

³ Term coined in 2005 by Andrew Rozanov in [Who Holds the Wealth of the Nations?](#)

In the first few years of the crisis, the emergence of these new stakeholders caused a certain amount of confusion among the main governments of the OECD economies, the strongest sufferers in the global recession. However, this perception, which led the main media to classify sovereign funds as barbaric and invasive, gradually changed over the course of time.⁴ The providential intervention of these new actors in the US bank bailout was a decisive factor in the change of perception, upgrading sovereign wealth funds to the category of white knights of capitalism (see **Table 2**).

TABLE 2. SOVEREIGN WEALTH FUND INVESTMENT IN US BANKS*

Sovereign Fund	Bank	Value (\$M)	Date
Abu Dhabi Investment Authority	CitiGroup	7,500	November 2007
China Investment Corporation	Morgan Stanley	5,600	December 2007
Temasek Holdings	Merrill Lynch	4,400	December 2007
Government of Singapore Investment Corporation (GIC)	CitiGroup	6,880	January 2008
Kuwait Investment Authority	Merrill Lynch	3,000	January 2008
Korea Investment Corporation	CitiGroup	2,000	January 2008
Temasek Holdings	Merrill Lynch	2,000	January 2008
Government of Singapore Investment Corporation (GIC)	Merrill Lynch	600	February 2008

* Period 2007-2008.

Source: 2012 Sovereign Wealth Funds Report, Invest in Spain/ICEX, KPMG and ESADE Business School, 2012

In the vast majority of cases, these state investment vehicles, whose risk tolerance is higher than that of traditional Central Banks, have originated in countries with abundant natural resources as a tool to achieve five main objectives:

- a) To obtain long-term profits from current account surpluses arising from the exploitation of natural resources.
- b) To reduce inflationary pressure stemming from the budget surplus.
- c) To avoid the effects of the so-called “*Dutch disease*”, the loss of competitiveness of other sectors in the economy (with respect to the extractive export industries) as a result of the appreciation of the national currency.
- d) To diversify and restructure the country’s economy, investing in high-tech industry and knowledge-intensive services⁵.

⁴ Rolando Avendaño y Javier Santiso, "Are sovereign wealth funds political biased? A comparison with mutual funds" in Karl Sauvant, dir., *Sovereign investment: Concerns and policy reactions*, Oxford, Oxford University Press, 2012, pp. 221-257.

⁵ In this respect, Javier Santiso advocates the creation of strategic sovereign wealth funds that develop cutting-edge sectors in new technologies [Fondos Soberanos Latinos](#)

- e) To develop a model of inter-generational solidarity that allows the generations to come to enjoy the wealth that finite natural resources are bringing to present-day generations.

At present, there are over 70 sovereign wealth funds worldwide, and the current trend suggests this number will continue to grow in the next few years⁶. In 2012, sovereign wealth funds in frontier markets gained special relevance, for two main reasons described below.

A first factor is the significant number of sovereign wealth funds recently being launched in frontier markets, and specifically in Africa⁷. On the basis of the Monitor Company Group (2008) definition of sovereign wealth funds⁸ (which would exclude funds controlled by the Central Bank, such as the Botswana Pula Fund, funds that restrict their investments to national markets, such as the Investment Corporation of Dubai, funds used as stabilisation funds, such as the Ghana Stabilization Fund, and public companies with large investment portfolios, such as Sonangol), frontier markets are home to 14 sovereign wealth funds, the vast majority in the United Arab Emirates.

Secondly, the frontier markets' sovereign wealth funds have gained in significance due to the sheer volume of managed assets, which already exceeds \$1 trillion (see **Table 3**), and the size of operations being carried out, such as the arrangement the Abu Dhabi Investment Authority is set to conclude with the Royal Bank of Scotland to acquire 42 Marriott hotels for almost \$992 million⁹.

⁶ The ESADEgeo Sovereign Wealth Fund Report suggested that a total of 21 countries were considering the possibility of setting up a sovereign wealth fund in 2012.

⁷ Capapé (2012) forecast 12 new SWFs in Africa in the next few years. A new SWF has recently been launched in Angola: the Fundo Soberano de Angola (FSDEA).

⁸ The five criteria needed for a sovereign wealth fund to be considered as such are: a) to be owned exclusively by a sovereign government; b) to comply with the characteristics of an investment fund, not to those of a state-owned company; c) to invest nationally and internationally in risk assets; d) for the investment to seek commercial returns; e) it is not a pension fund with obligations in this respect.

⁹ [Abu Dhabi Fund Said Close to Buying RBS's 42 Marriott Hotels](#)

TABLE 3. FRONTIER MARKET SOVEREIGN WEALTH FUNDS

Sovereign Fund	Managed assets (\$b)	Country	Year founded
Abu Dhabi Investment Authority	450	UAE	1976
Kuwait Investment Authority	290	Kuwait	1953
Qatar Investment Authority	135	Qatar	2005
Mubadala Development Company	65.3	UAE	2002
International Petroleum Investment Company	49	UAE	2000
Kazakhstan National Fund	41.6	Kazakhstan	2000
Bahrain Mumtalakat Holding	11.1	Bahrain	2006
Emirates Investment Authority	10	UAE	2007
Abu Dhabi Investment Council	10	UAE	1999
Heritage and Stabilization Fund	4.3	Trinidad and Tobago	2000
Mauritius Sovereign Wealth Fund	3	Mauritius	2010
Ras Al Khaimah Investment Authority	2	UAE	2005
State Capital Investment Corporation	0.6	Vietnam	2006
Oman Investment Fund	N/A	Oman	2006

Note: Data February 2013

Source: Compiled by author based on the SWFs' annual reports.

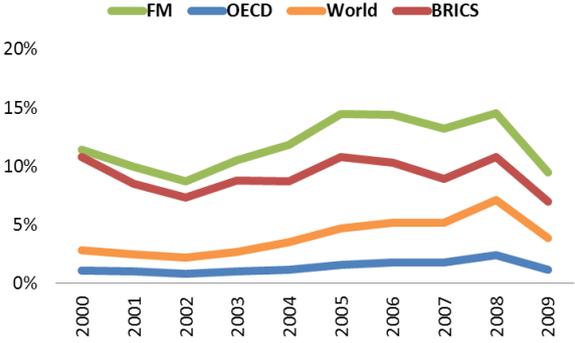
Frontier markets as tech hubs?

On the one hand, frontier markets have used sovereign wealth funds to develop an inter-generational model that enables future generations to enjoy the benefits that the currently abundant raw materials are producing for people today. Yet, at the same time, a series of investments have been initiated which aim to promote and stimulate the development of technology sectors and innovation-intensive industries.

By implementing these economic policies, reinforced in recent years in the face of what appears to be the end of the sustained increase in the price of raw materials, the frontier market governments are pursuing two seemingly fundamental goals in order to guarantee long-term economic growth. Firstly, they aim to reduce the dependence of their economies on the exploitation of raw materials. Secondly, they are attempting to lay the foundations for the transition from an extractive economy, based on the export of commodities and manufactured goods, to an innovation economy, based on the intensive use of knowledge in the production and development of the transformational industry and services sector.

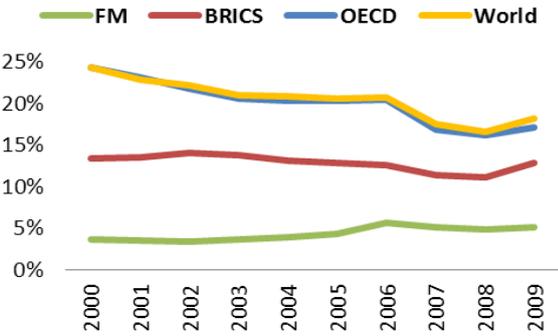
This transition is still at an embryonic stage, far from actually becoming a reality. Proof of this is that the variables that ought to record the change in the production model continue to project an image of frontier markets more in keeping with that of extractive economies than that of the innovation economies which characterize the OECD countries. The most recent data provided by the World Bank leave no room for doubt: in 2009¹⁰, the average total revenue derived from the

FIGURE 4. REVENUE FROM NATURAL RESOURCES*



* Total revenue derived from the exploitation of natural resources as a percentage of the GDP.
Source: World Development Indicators, World Bank.

FIGURE 5. HIGH-TECH EXPORTS^



^ Exports of high-tech goods as a percentage of the total of manufactured goods exports.
Source: World Development Indicators, World Bank.

exploitation of natural resources as a percentage of GDP was 9.5% in frontier markets, as opposed to 6.8% in the BRICS, 3.9% in the world and 1.2% in OECD economies (see **Figure 4**). Similarly, in the same year, the average volume of manufactured goods exports was 5.20% in the frontier markets, as opposed to 12.88% in the BRICS, 17.12% in the OECD economies, and 18.29% in the world (see **Figure 5**).

In light of these figures, we can safely assert that frontier markets continue to be eminently extractive economies. Nevertheless, recent events suggest this trend is shifting. Since approximately 2010, some frontier market governments have been adopting measures which give grounds for optimism and lead us to believe that an innovation economy, which can prevent mid- and long-term economic stagnation, is drawing progressively closer. In this process, two frontier markets (one from Africa and the other from the Middle East) appear to have taken the lead.

1. Kenya: From iHub to Silicon Savannah

A little over two years ago, and thanks to funding by Hivos and Omidyar Network, we saw the rise in Nairobi of what would be the first tech hub in Kenya: iHub. Since then, iHub, which started out offering free internet access and specialist forums for entrepreneurs, has been expanding continuously, becoming a benchmark for tech hubs in Africa; it has over 10,000 members, over 150 incubated companies, and the backing of multinationals such as Intel, Google and Samsung.

¹⁰ The last year with data for all the frontier markets currently included in the indices covered in this report.

iHub turned out to be only the beginning of things to come, since as a result of its creation, a series of publicly and privately funded areas were set up with the aim of deepening Kenya's commitment to upgrade its production sector. As a result of this public-private cooperation, several successful projects saw the light, such as the startup incubator, NaiLab, and the research and entrepreneurship institute, @ilabAfrica, inaugurated in 2011, followed by the startup accelerator, 88mph, in 2012, and the proposal to build a technology city which has been dubbed Africa's Silicon Valley: *Silicon Savannah*.

This technology city project, planned to be carried out in four phases, the last of which is expected to be completed in 2030, will be built on a 2,000-hectare site in the city of Konza (a settlement 160 km from Nairobi). To do so, almost \$14,500 million will be mobilised, of which only 5% will be provided by the government led by President Mwai Kibaki¹¹. The Kenyan government hopes this ambitious project will convert the country into a benchmark for the production and distribution of technological components in Africa, creating two hundred thousand jobs in the ICT sector, and positioning Kenya as a tech hub of world renown.

2. Jordan: Making a virtue out of necessity

Not only was the Arab Spring, which brought about the downfall of the vast majority of Maghreb's dictators¹², the result of the citizens' revolution, but it was also the triumph of a revolution begun years before, which silently paved the way for the wave of protests to spread at breakneck speed: the technological revolution.

If it is basically private initiatives that have promoted and provided funding for the construction of the centres in Kenya; in Jordan it was the institutions of the Hashemite Kingdom that decided to transform their capital, Amman, into a benchmark tech hub for the Arab world and, therefore, into the main Pan-Arab competitor of Israel's tech hub, Silicon Wadi.

Contrary to what one might think, the technology epicentre of the Arab world originate from the development and globalisation of cities such as Doha, Riyadh or Abu Dhabi – catalysts for progress in the Middle East and the main magnets for FDI – but from decisions made by Jordan's King Abdullah II to re-launch his country's economy, which is characterized by its lack of natural resources and strong energy dependence.

It would appear these decisions are succeeding: the latest International Telecommunication Union data indicate that Jordan currently hosts three quarters of all Arabic content online. Moreover, the Queen Rania Center for Entrepreneurship (QRCE), launched in 2004, and the

¹¹ Private funding will make up the remainder of the financing.

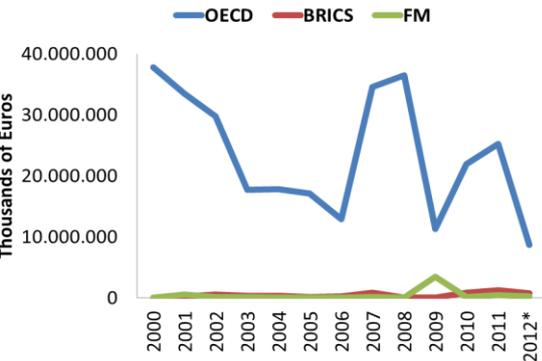
¹² In Jordan, the wave of protests did not topple the monarchy. It only managed to have modest political reforms introduced.

startup accelerator Oasis500, launched in 2010 and located on a site that was built to be the headquarters of the Jordanian Army, indicate that Yahoo’s acquisition of the Jordan-based startup, Maktoob, for \$80 million will likely not be the last.

Frontier markets: An opportunity for Spain?

The latest figures offered by the Ministry of Economy and Competitiveness on foreign investment in Spain and Spanish investment abroad paint an uncertain picture of Spain; a picture that does not bode well: Spain remains mired in recession¹³.

FIGURE 6. FOREIGN INVESTMENT IN SPAIN



* Up to September 2012.
Source: Compiled by author based on data from DataInVex.

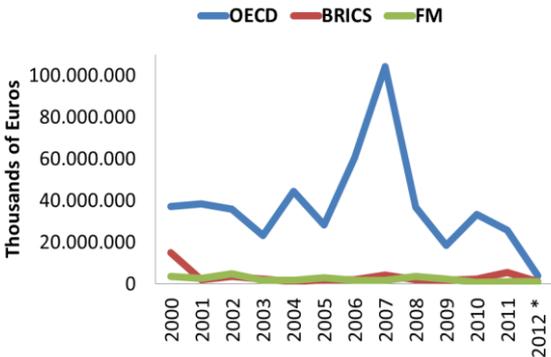
The breakdown of these disheartening figures, which record a drop of over 50% in foreign investment in Spain in 2012, and over 63% in Spanish investment abroad compared to the same period in 2011¹⁴, clearly show the delicate situation of the country, as well as the opportunity that frontier markets represent.

Foreign investment flows in Spain in the last twelve years are a clear example of this opportunity, revealing that the frontier markets’ investment in Spain is long-standing. Since

2000, there have been numerous years in which frontier market investment in Spain has been greater than investment from the all-powerful BRICS. In fact, in 2009, when OECD investment in Spain plummeted and BRICS investment suffered, frontier market investment reached an all-time high of €3 billion gross (See **Figure 6**). In 2012, frontier market investment was lower than BRICS investment, but still extremely close; this is hardly insignificant if the size of these markets is taken into account.

The statistics on Spanish investment abroad reveal two trends. Firstly, Spanish investment in OECD economies has fallen sharply due to the crisis. Secondly, these figures reveal that,

FIGURE 7. SPANISH INVESTMENT ABROAD



* Up to September 2012.
Source: Compiled by author based on data from DataInVex.

¹³ ESADE’s 2013 Economic Report predicts a one-percentage-point contraction of the Spanish economy and an increase in unemployment, which will reach rates over 25%.

¹⁴ All the data related to investment in 2012 in this section only cover up to the third quarter of said year.

on the one hand, Spanish investment in BRICS and frontier market economies has been practically unaffected by the crisis; on the other hand, Spanish investment in frontier markets has remained at similar levels to those for BRICS since 2001 (see **Figure 7**).

The 2012 figures, which did not cover Spanish investment in Colombia¹⁵ and Saudi Arabia¹⁶ as both countries had been reclassified as emerging economies, confirmed this trend. Frontier markets were established as an attractive destination for Spanish investment; to the point that, if we add Spanish investment in Colombia and Saudi Arabia in 2012 to investments made in the frontier markets recognised by the different financial indices (see **Figure 8**) for that same period, the total investment is greater than the investment in the BRICS (see **Figure 9**).

FIGURE 8. SPANISH INVESTMENT IN FRONTIER MARKETS

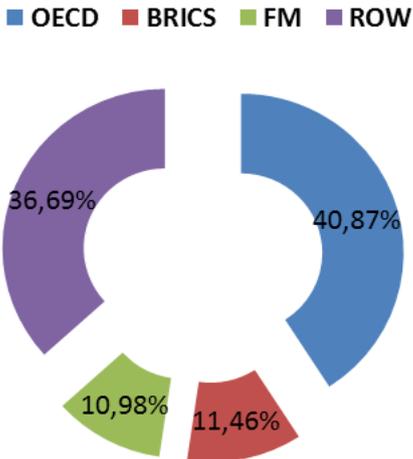
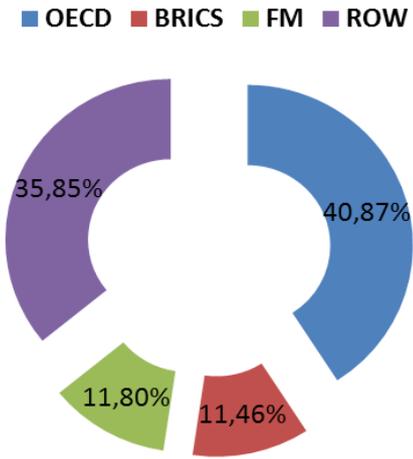


FIGURE 9. SPANISH INVESTMENT IN FM, INCLUDING COLOMBIA AND SAUDI ARABIA



Note: Data for 2012 (January-September).
 Source: Compiled by author based on data from DataInVex.

Against a backdrop of uncertainty, investing in frontier markets, which entail greater levels of risk as opposed to the traditionally “safe” OECD economies, may seem *a priori* counterintuitive. But the fact is that beyond the underlying explanation of the risk-return trade-off, figures reveal that these high levels of risk – the sole preserve of the frontier markets until the outbreak of the financial crisis – have become globalised.

In this context, frontier markets represent an excellent opportunity for Spain, which unavoidably obliges us to rethink our commercial strategy and look beyond the BRICS.

¹⁵ [Colombia to be Reclassified as an Emerging Market](#)
¹⁶ The upgrading of Saudi Arabia to the category of emerging markets is just a matter of months. [MSCI Reintroduces Coverage of Saudi Arabian Stock Market](#)

For further information on ESADEgeo's Position
Papers, please feel free to contact:

Marie Vandendriessche

ESADEgeo Center for Global Economy and Geopolitics
Av. Pedralbes 60-62, 08034 Barcelona, Spain
+34 934 95 21 46

marie.vandendriessche@esade.edu

www.esadegeo.com

<http://twitter.com/ESADEgeo>