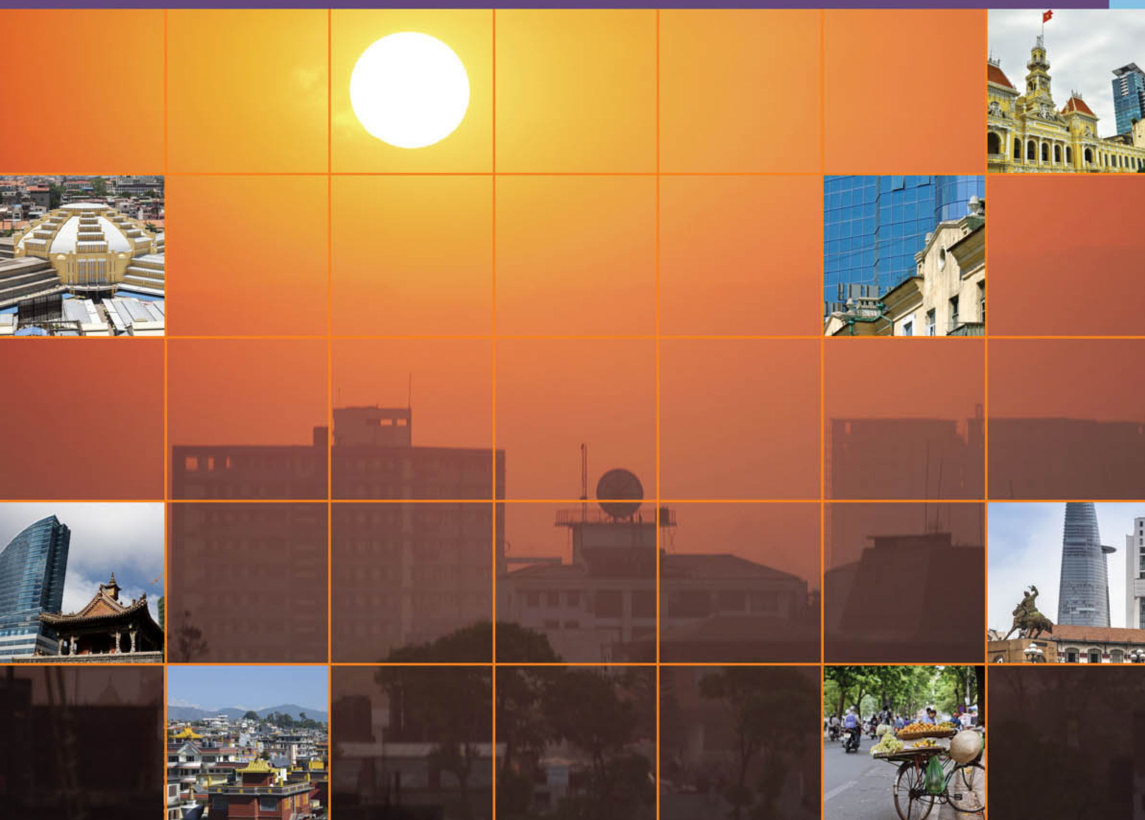
EXCERPT

Frontier and Developing Asia

The Next Generation of Emerging Markets



EDITOR

Alfred Schipke

INTERNATIONAL MONETARY FUND

Note to Readers

This is an excerpt from *Frontier and Developing Asia: The Next Generation of Emerging Markets*.

While emerging markets have played an important role on the global economic stage for some time and are now a major driver of global growth, a new group of fast-growing low-income countries, sometimes referred to as frontier economies, is receiving increased attention and has become the darling of capital markets. The question is whether these countries will become the next generation of emerging markets and what lessons can be learned that might be relevant for other low-income countries that want to grow more rapidly and join the group of frontier economies. Frontier and developing Asia, which includes countries such as Vietnam, Cambodia, and Bangladesh, is located in the world's fastest-growing region and has favorable demographics. Despite their heterogeneity, the countries share a number of common macroeconomic, financial, and structural challenges. The book addresses issues related to economic growth and structural transformation, as well as the risk of a poverty trap and rising income inequality. The book also analyses a number of financial sector and monetary policy framework issues.

The Table of Contents and Chapter 1 are included in this excerpt.

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Frontier and Developing Asia: The Next Generation of Emerging Markets
Edited by Alfred Schipke
ISBN: 978-1-47559-551-2
Pub. Date: February 2015
Formats: Digital; Paperback, 6x9 in.; Approx. 176 pp.
Price: US$25.00

For additional information on this book, please contact:
International Monetary Fund, IMF Publications
P.O. Box 92780, Washington, DC 20090, U.S.A.
Tel: (202) 623-7430 ♦ Fax: (202) 623-7201
Email: publications@imf.org
www.imfbookstore.org

Cover design: IMF Multimedia Services Division

Cataloging-in-Publication Data
Joint Bank-Fund Library

Frontier and Developing Asia: The Next Generation of Emerging Markets / editors: XXX. – Washington, D.C. : International Monetary Fund, [2014].
p. ; cm.
Includes bibliographical references and index.
ISBN: XXX-X-XXXXX-XXX-X (Paper)

XXX

XXXX

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Foreword

For some time now, emerging markets have played an ever-more important role on the global economic stage. Today they account for half of the world's GDP and are a key driver of global growth. At the same time, a new group of countries is getting more and more attention, including from global investors. These are fast-growing low-income countries often referred to as *frontier economies*.

Within Asia, this group includes countries such as Bangladesh, Cambodia, Mongolia, and Vietnam. They are located in the world's fastest-growing region and benefit from favorable population dynamics. Many of these economies face similar macroeconomic and institutional challenges. Will they become the next generation of emerging markets? What are the policy lessons that might be relevant for other low-income countries?

This book addresses these questions, based on our experience of working with Asia's emerging, frontier, and developing economies over many years. We highlight that continued structural transformation and increased emphasis on inclusive growth will be critical to achieve the full potential of these countries. Also, drawing on the success of today's emerging markets, high growth and rapid structural transformation needs to be complemented by increased investment in "soft" infrastructure to avoid crises down the road. In particular, to realize the strong potential of frontier and developing Asia, upgrading of monetary and fiscal policy frameworks and continued strengthening of financial sector regulation and supervision will be critical.

The IMF is contributing to the progress the frontier economies are making through our ongoing policy dialogue, analytical work, and capacity building. I am confident that this book will contribute to this effort and also raise awareness around the globe of the great potential that Asia's frontier economies have to lift their countries to a new level of widely—shared growth and well-being of their citizens.

Christine Lagarde
Managing Director
International Monetary Fund

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Preface

Work on frontier economies is in its infancy and publications on the subject are limited. This book aims to fill part of this void. It relies on cross-country analytical work and draws on experience in today's emerging market economies to provide insights and make recommendations relevant for policymakers, think tanks, and academics.

The book would not have been possible without valuable comments, feedback, and contributions from many economists within and outside the IMF. It also benefited from discussions at the 2013 Joint International Monetary Fund—Japan International Cooperation Agency high-level conference on "Frontier Asia: Economic Transformation and Inclusive Growth in Bangkok."

The authors would like to thank Ranee Sirihorachai for an excellent job keeping the ball in the air—that is, coordinating these many contributions and comments. Special thanks go to Eric Van Zant for editing the manuscript and for Joanne Johnson of the IMF Communications Department, who did her usual outstanding job coordinating production and publication.

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Abbreviations

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CHAPTER 1

The Growing Importance of Frontier and Developing Asia

ALFRED SCHIPKE

Even if a mountain is high, there is always a way to reach the top—and although the way might be full of danger, there is always a way for someone to get through it (Vietnamese proverb).

Frontier economies, in Asia and beyond, are in the spotlight for their potential to achieve and sustain substantial economic and development gains. Emerging market economies have held center stage for years. But as growth in some slows and others face what is frequently called the middle-income trap, this new, "frontier" group is generating considerable interest among development, investment, and academic communities and policymakers.

WHAT ARE FRONTIER ECONOMIES?

Although there is no formal definition, frontier economies are increasingly regarded as a separate group of low-income countries that warrants special attention. Compared with other low-income countries, they tend to be dynamic economies that have experienced rapid growth and, in most cases, demonstrated a fair degree of macroeconomic stability over an extended period of time.[1] Given their strong growth (Figure 1.1), the question arises whether they can become the next generation of emerging market economies and show the way to other low-income countries striving to improve living standards.

Frontier economies include commodity-rich economies, manufacturing exporters, and dynamic low-income countries spanning the globe and ranging from Bangladesh, Cambodia, and Vietnam in Asia to Kenya, Nigeria, and Tanzania in Africa. In some frontier economies, strong growth is linked with efficiency improvements aided by economic liberalization and trade opening, while the resource-rich ones have benefited from strong external demand and high commodity prices. But in a number of these economies, strong growth is also associated with structural transformation and economic diversification.

Global investors are already seeking out some of these countries and more are expected to follow. Some frontier economies—including in Asia—reflect improved macroeconomic fundamentals, which has made them the darlings of

[1] See Zhu (2014) and *World Economic Outlook* (2013).

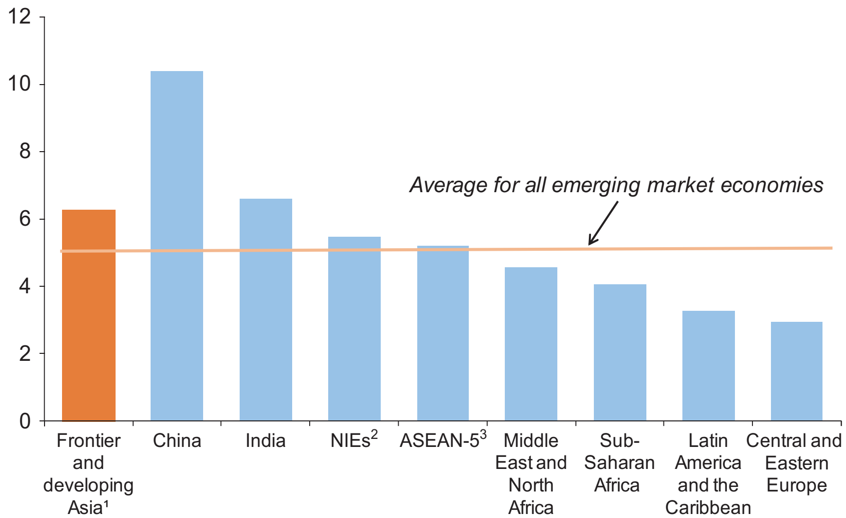

Figure 1.1 Emerging Markets: Real GDP Growth *(Annual percent change, 1990–2010)*

Source: IMF, World Economic Outlook database.
[1] Frontier and developing Asia includes Bangladesh, Bhutan, Cambodia, Lao P.D.R., Maldives, Mongolia, Myanmar, Nepal, Papua New Guinea, Timor Leste, Sri Lanka, and Vietnam.
[2] NIEs refers to the Asian newly industrialized economies, Hong Kong, Singapore, Korea, and Taiwan.
[3] ASEAN-5 refers to Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.

the capital markets and allowed them to issue sovereign bonds and attract increased portfolio inflows. Indeed, a subgroup of frontier economies is already part of a new asset class called *frontier markets* that is distinct from established emerging market economies (Box 1.1). Investor enthusiasm for these frontier markets, however, also reflects a search for yield and unconventional monetary policy in advanced economies that have driven interest rates to historical lows and could present a challenge if the tide were to change.

FRONTIER ASIA: PROSPECTS FOR A BRIGHT FUTURE

More than 350 million people live in frontier and developing Asia.[2] Although these countries face many challenges, they are part of the world's fastest growing region, with favorable demographics. In the following chapters, these countries are referred to collectively as frontier Asia. Indeed, with its recent political and

[2] Frontier and developing Asia—in the following referred to as frontier Asia—includes Bangladesh, Bhutan, Cambodia, Lao P.D.R, Maldives, Mongolia, Myanmar, Nepal, Papua New Guinea, Sri Lanka, Timor-Leste, and Vietnam.

BOX 1.1 What Are Frontier Markets?

While the term ***frontier economy*** is somewhat loosely defined, the term ***frontier market*** reflects a new asset class. Initially, the term was coined by the International Finance Corporation in 1992 to describe developing economies with small but investable financial markets.

A number of financial market indexes now include frontier markets. The Emerging Market Bond Index (EMBI), comprising 54 countries, is the most widely followed index for dollar-denominated debt issued by emerging and frontier market sovereigns. The Next Generation Emerging Market index (NEXGEM) is a subset of the EMBI Global Diversified Index covering exclusively frontier markets. More than 80 percent of this index is rated single-B or lower, with frontier Asia accounting for about 30 percent of the index. The Eurobonds of Mongolia, Sri Lanka, and Vietnam are represented in the NEXGEM (and, by extension, in the EMBI). If Bangladesh were to issue a Eurobond of benchmark size, it would likely be represented in the NEXGEM and investors would view it as a frontier asset.

The Government Bond Index–Emerging Markets is an index of emerging market local-currency-denominated sovereign bonds, but so far there is no index for local currency frontier bond markets, reflecting the infancy of these markets. Indonesia, Malaysia, the Philippines, and Thailand are represented in the Government Bond Index–Emerging Markets.

Citibank and Bank of America Merrill Lynch also have local currency sovereign bond indices, but none of them has many frontier market names.

economic reforms, another important country, Myanmar, has joined this formidable group.

Despite their heterogeneity, many of these frontier economies face several common macroeconomic, financial, and structural challenges. Some of them have benefited from regional supply chains and the diversification of production facilities across the region. This has allowed companies to combine production in emerging markets such as China and Korea with those in Cambodia, Laos, and Vietnam, generating foreign direct investment in these frontier economies. This allows the former to move up the value chain, and benefits the latter.

Not only has frontier Asia as a group grown strongly over a prolonged period, it also performed relatively well throughout the 2007–09 global financial crisis and during the periods of stress in mid-2013 in a number of vulnerable emerging market economies in anticipation of tapering of monetary policy in the United States. Indeed, frontier Asia is expected to remain on a strong growth path.

This is not to say that frontier Asia was unscathed by the financial crisis; many countries in the region still need to rebuild fiscal and external buffers. Furthermore, the more frontier Asia integrates with the global economy, the more it is exposed to shifts in global fortune. Frontier Asia will not only be increasingly vulnerable to developments in advanced economies, but also to slowdowns in the larger emerging market economies to which many frontier Asian countries are linked through trade, foreign direct investment, and remittances.

HOW TO MAINTAIN HIGH GROWTH AND MAKE IT MORE INCLUSIVE

Although frontier economies in Asia and beyond have grown strongly and have started to overcome the "poverty trap," they now face the challenge of ensuring that growth remains strong. A critical element of growth is the ability to continuously reallocate resources from less to more productive uses through changing economic structure. This reallocation and diversification helps boost growth and reduce economic volatility. Compared with other frontier economies in the world, some in Asia have diversified quite successfully, especially their exports. Most diversification has occurred by going into completely new products, although in some countries, such as Vietnam, through quality upgrading as well (see Chapter 3).

Globally in low-income countries, a growth reversal often follows the initial take-off, especially in Africa (see Chapter 4). At times, natural disasters or political conflicts cause these reversals, and in others falling commodity prices or weak institutions may set off the decline. Reforms therefore have to focus on continuous structural transformation and diversification, especially against the backdrop of weaker global growth and commodity prices. The reallocation of resources and quality upgrading needs appropriate policies, and bottlenecks, including weak public infrastructure, must be addressed.

Strong economic growth in frontier economies has been a key driver of poverty reduction, but the benefits have not been shared equally across all segments of society. Millions remain poor, and inequality has risen dramatically in most frontier economies, except Vietnam. As the experiences of a number of emerging market economies demonstrate, both political and macroeconomic stability requires not only strong growth, but also that growth is inclusive (see Chapter 5).

Although no one size fits all, fiscal policies in frontier economies need to focus even more on enhancing social safety nets and increasing spending on health, education, and pensions. Doing this without undermining fiscal sustainability is the main challenge in the medium term. A number of today's emerging market economies provide good examples of how to address inequality through cash transfer programs. India's recent experiences with a large cash transfer program to issue individual identification cards could provide useful insights, as could *Solidario* in Chile and *Opportunidades* in Mexico.

Many segments of society in frontier economies—despite strong credit growth and financial development—still lack access to formal financing, partly reflecting the concentration of credit in a few sectors. Only 30 percent of frontier Asia's population has access to formal financial services, significantly behind the region's established emerging market countries, at about 50 percent (see Chapter 6). Scope is significant for the use of modern financial products, such as cell phone mobile bill payment, and the traditional use of credit cards. Again, frontier Asia trails both emerging market economies and other frontier economies outside the region in both areas. Promoting inclusion by overcoming scale barriers will be critical. The use of mobile technology in some countries, such as Smart Money in the Philippines and M-Pesa in Kenya, provides promising examples of what could work in frontier economies as well.

THE NEED TO INVEST IN "SOFT" INFRASTRUCTURE

High growth has lifted millions out of poverty, but it has also obscured or even worsened weaknesses, making these economies more susceptible to shocks. In contrast to stagnant or slow-growing economies, many Asian frontier economies double in size every 10 years or so, quickly rendering monetary and fiscal policy frameworks obsolete. The same is true for financial sector regulation and supervision. The challenge here is further compounded by rapid structural transformation, which raises the risk that future shocks (including changing global monetary conditions) could reverse progress or even spark a full-blown crisis. As the experiences of today's emerging market economies show, a key challenge for frontier Asia will be to ensure investment in soft infrastructure—that is, constant upgrading of policy frameworks and financial sector regulation and supervision (see Chapter 2).

Frontier Asia's strong growth has gone hand in hand with increased financial sector deepening. In the banking sector, a number of frontier countries, such as Vietnam, are showing credit- and deposit-to-GDP ratios similar to those in emerging market economies, such as and Indonesia, Malaysia, and Thailand. Greater banking sector efficiency, reflected in falling interest margins, has also accompanied financial sector deepening in such countries.

Globally, financial sector deepening is associated with economic growth and poverty reduction and helps reduce output volatility. And more developed financial systems are essential to improving the effectiveness of macroeconomic policies. That said, such deepening can also lead to a buildup of significant risks and misallocation of resources that can undermine stability and growth potential. Taking into account structural characteristics such as economic development, demographics, population density, and other fundamentals, a number of frontier Asian economies already have private-credit-to-GDP ratios exceeding expected values. Recent financial system stresses in some of the countries have highlighted the risk of overly rapid financial sector development. Because regulatory and supervisory reform in frontier Asia has lagged other regions and often remains relatively weak, the risks of a buildup of vulnerabilities and a misallocation of resources are significant (see Chapter 7).

Furthermore, compared with emerging market economies, frontier Asia's financial systems are undiversified and their structure continues to differ significantly. Frontier Asian financial systems remain largely bank based, and in a number of countries, state-owned banks still dominate. The strong presence of large state-owned enterprises in some countries partly explains the difficulties that medium and small firms have in accessing credit.

At the same time, strong links between state-owned banks and enterprises in a number of frontier Asian economies has resulted in lending that is not purely based on commercial considerations. This results in a high number of nonperforming loans and can, of course, undermine financial system stability. To identify these weaknesses and embark on financial sector reforms, Bangladesh, Cambodia, Mongolia, Papua New Guinea, Sri Lanka, and Vietnam have already undertaken IMF Financial Sector Assessment Programs.

As with financial sector supervision and regulation, monetary policy frameworks in many frontier economies have also not kept up with economic development, possibly undermining the ability to deal with shocks. When economies take off, intermediate exchange rate regimes can be appropriate, given evidence that they deliver price stability without sacrificing growth or causing growth volatility. But as frontier Asian economies develop their financial sectors and become more integrated into global capital markets, their monetary policy frameworks will need to be updated and strengthened. And for now, in frontier Asia's more rudimentary frameworks, the first step is to introduce greater operational autonomy for central banks and to widen exchange rate bands. Once the region progresses from monetary targeting to forward-looking policy that makes use of interest rates, more emphasis will be needed to deal with shocks. This will in turn allow countries to pursue more active monetary policy to manage aggregate demand (see Chapter 9).

A NEW ASSET CLASS: FRONTIER MARKETS

As noted, a couple of frontier Asian economies have been able to tap global capital markets with sovereign bonds. Others may follow soon. These *frontier markets* make up a new asset class and are included in global investment indices (see Chapter 8). Compared with established emerging market economies, however, they are considered economically and politically more challenging. The size of their outstanding debt is smaller and they are less liquid, which in turn is reflected in credit ratings several notches below investment grade. Still, nonresident investors have shown interest in a number of domestic bond and equity markets in frontier economies. Although this allows these countries to access foreign savings, improve the allocation of financial resources, and create conditions for better risk sharing, it could make them more vulnerable to sudden stops in capital inflows or even capital outflows.

Investors' search for yield has helped some of the frontier economies access capital markets. The question therefore arises: what will happen with changes in expectations about the unwinding of unconventional monetary policy in the United States or if investors suddenly become more risk averse? Given the small markets and huge information costs, investors are not likely to distinguish among the different frontier markets. They could treat them as one asset class, raising the risk of contagion and implying little discrimination across countries, irrespective of fundamentals. At the same time, given the lack of liquidity, the investor base of frontier markets consists exclusively of more long-term-oriented and real-money investors. This compares with investors in emerging markets, where global bond funds are limited to investment grade investment.

During turmoil in vulnerable emerging market economies around mid-2013, triggered by mere talk of tapering of the Federal Reserve's bond purchases, frontier markets were largely unscathed and less volatile. This reflected not only their improved economic fundamentals, but also that, given the less liquid and smaller nature of frontier markets, they attracted more dedicated investors.

However, as the exposure of frontier markets to the global system increases, so does the risk of a sudden halt in capital inflows or of capital outflows. The appropriate policy response will depend on each country's circumstances and exchange rate regime. But continued pursuit of sound macroeconomic policies and, in some cases, further strengthening fiscal and external policy buffers will be paramount. The experiences of today's emerging market economies suggest that regulation and supervision must keep up with financial sector development to minimize the risk of financial and macroeconomic instability. Many frontier economies need significant upgrading in their supervisory tools and financial regulation, including by providing sufficient resources. Frontier economies also need to address information gaps, such as those in credit registries.

A CHALLENGING PATH

The prospects for many frontier Asian economies to become the next generation of emerging market economies and to join the group of middle-income countries are very good. However, getting there will not be without challenges, and countries will have to avoid complacency and accelerate reforms to unleash their full growth potential, minimize volatility and avoid crises, and move up the value chain, which will be necessary to sustain high growth.

In particular, reforms have to focus on fostering structural transformation and diversification to help sustain high growth. Scope is also significant to make growth more inclusive and to improve safety nets. In the short term, this would require such things as strengthening conditional cash transfer programs and improving access to financing. At the same time, reforms have to focus more on upgrading and strengthening policy frameworks, which have not always kept up with robust growth.

Managing high economic growth is challenging. As well as capacity constraints, the benefits from investments in soft infrastructure are not as tangible as investments in physical infrastructure, are less well understood by the public, and are often deemed less urgent. Upgrading policy frameworks requires more effort to educate the public about the costs of neglect and will require political capital to achieve progress. Failure to upgrade policy frameworks could undo many achievements the next time a domestic or external shock hits. As frontier Asia becomes more globally integrated, policymakers will also have to focus increasingly on how to manage risks and deal with macro challenges and with increased vulnerabilities. Here, yesterday's frontier and today's emerging market economies offer lessons. These include the importance of sequencing reforms, the risk of excess growth and bubbles, and the need for the financial sector regulatory and supervisory capacity to keep up with financial sector deepening and economic growth.

With the right policies, however, frontier economies should be able to realize their full potential and become the next generation of emerging market economies.

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