Quarterly Frontier Markets Recap

Financing Constraints, Institutional Weaknesses a Common Theme

Fitch recently held its annual Global Sovereign Conference series in eight major cities across the globe, this time including a section specifically dedicated to frontier markets, called "The View from the Frontier". At the first two conferences, hosted in Hong Kong and Singapore, Sagarika Chandra discussed the Asian frontier markets Vietnam, Sri Lanka and Pakistan, while at the European conferences, Erich Arispe focused on CIS frontier markets Belarus, Uzbekistan and Ukraine. Finally, in the U.S., Carlos Morales covered the Central American frontier markets Costa Rica, Guatemala and El Salvador. Below are the highlights of all three presentations, complemented with published Fitch research and webcasts.

For **CIS frontier markets** (here we will focus on Uzbekistan and Belarus, as these form part of JP Morgan's updated NEXGEM index), access to external financing remains key, as Uzbekistan grapples with a large current account deficit (7.1% in 2018, versus a 2.5% surplus in 2017) reflecting public investment and Belarus faces high external debt repayments (USD3.1 billion in 2019 alone) and low international reserve coverage (1.9 months of current external payments, compared to the 'B' median of 3.5 months and Uzbekistan's 11.9 months).

Currency risk is high for both countries, as over 90% of their debt is FC-denominated. Additional challenges for **Belarus** ('B'/Stable) include weaker-than-peer GDP growth and high dependence on Russia for trade, investment and external financing, despite progress towards diversification. On the other hand, Belarus exhibits a significant drop in inflation to mid-single-digit figures and lower than 'B' median current account deficits and government debt (although net external debt remains significantly above the peer median), as well as high income per capita and human development indicators relative to its peers. For more information on Belarus' sovereign and banking sectors, please refer to the articles featured in this newsletter, as well as the **Webcast: Fitch on Belarus.**

In many respects, **Uzbekistan's** ('BB-'/Stable) strengths and weaknesses are opposite of those exhibited by Belarus, with still high inflation, low income per capita, weak governance indicators and high commodity dependence representing its main challenges. This is balanced against strong GDP growth (about twice Belarus'), low government debt (20pp of GDP below Belarus') and a robust external balance sheet. In addition to ample reserve coverage, Uzbekistan's external liquidity is among the highest in the 'BB' category, mitigating the risks related to its high current account deficit, financial dollarization and commodity dependence. *More information on Uzbekistan and other CIS frontier markets can be found in the article following this summary.*

We assigned Uzbekistan's rating in December 2018 and affirmed it in May. For more details please refer to the **Webcast: Fitch on Uzbekistan - The Newest EM Sovereign Issuer.**

For **Central American frontier markets**, risks are titled to the downside, as evidenced by the Negative Outlook on Costa Rica (rated 'B+') and Guatemala (rated 'BB'), and the low rating assigned to El Salvador ('B-'/Stable). Common themes in Central America are significant fiscal and financing constraints, as well as ongoing political polarization. Legislative assemblies tend to be atomized across the region, with current administrations enjoying limited legislative support. This leads to uncertainty over budget and financial approvals, with a two-third majority vote in Congress required for external debt issuance in El Salvador and Costa Rica.

Key Sovereign Rating Actions

Sri Lanka Affirmed at 'B'; Outlook Stable

Armenia's USD Bonds 'Rated B+(EXP)'

Suriname's Outlook Revised to Negative; Ratings Affirmed at 'B-'

El Salvador's 2050 USD Bond Rated 'B-'

Iraq Affirmed at 'B-'; Outlook Stable

Angola's Outlook Revised to Negative; Rating Affirmed at 'B'

Webcast

Fitch on Belarus

Jordan First Time Rating and Middle Eastern Sovereign Outlook


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Financing Constraints, Institutional Weaknesses a Common Theme **(continued)**

The latter's recent approval of a USD1.5 billion external bond issuance reduces financing uncertainty this year, but falls short of the initial USD6 billion Eurobond authorization requested for the next six years.

Key fiscal weaknesses throughout the region include high levels of informality and tax evasion, which, coupled with shortcomings in tax collection, have led to low government revenues. This is particularly pronounced in Guatemala, which exhibits one of the narrowest fiscal revenue bases of all rated sovereigns. Low government revenues and high fiscal deficits (particularly in Costa Rica and El Salvador), combined with limited fiscal flexibility (over 90% of Guatemala's total expenditure are ear-marked), have resulted in rising debt burdens. While Guatemala's debt/GDP ratio remains relatively low, interest payments as a percentage of fiscal revenues are high, signaling limited fiscal space.

Other concerns include high crime rates, corruption, governance issues and weak institutions. An outlier in the region is Costa Rica, with stronger governance indicators, but these do not reflect the political polarization that has prevented fiscal reform for a number of years and continues to weigh on external financing authorization. We expect limited reform momentum in the region to improve institutional strengths, at least in the near term. Evidence of this is the decision by Guatemala in September not to renew the mandate of the U.N.-backed International Commission Against Impunity.

On the positive side, Guatemala has been exhibiting broad macroeconomic stability, maintaining one of the highest international liquidity ratios among rating peers and a debt ratio that is less than half the 'BB' median. In El Salvador, macroeconomic stability has been supported by official dollarization since 2001, and social development and governance indicators are higher than its peers'. Costa Rica's economic model centered on high-value-added manufacturing and services has supported FDI and stable economic growth. Its GDP per capita, social development and governance indicators are high relative to similarly-rated peers. For more information, please refer to the articles featured below and the **Podcast: Sovereign Trends in Central America.**

While in **Asia**, Sri Lanka ('B'/Stable) and Pakistan ('B-'/Stable) still face significant challenges, Vietnam ('BB' /Positive) is in a league of its own from a credit perspective, exhibiting an improving track record of macrostability and growth prospects. Vietnam has attracted attention of late for its strong foreign direct investment inflows and influx of manufacturing firms seeking to diversify their production base to avoid US tariffs. Despite being one of the fastest growing countries in the Asia-Pacific region (five-year average GDP growth of 6.6%), Vietnam's inflation has remained below 4%. Vietnam has typically recorded annual current account surpluses since 2011 and its external liquidity ratio is well above the current 'BB' median. However, income per capita is weaker than the 'BB' median (USD2,539 versus USD6,083), and so are its human development and governance indicators.

In **Sri Lanka**, external and fiscal financing constraints have eased after the IMF programme resumption in February and the issuance of USD4.4 billion of sovereign bonds so far this year. As a result, reserve coverage has improved to around 3 months of current external payments, but its external liquidity ratio remains far weaker than the peer median, and high government debt and large interest payments continue to represent a key credit weakness. Tourism is recovering from the April 2019 bombings and the IMF programme has been extended by one year to June 2020, but the upcoming presidential election in November and parliamentary elections in 2020 pose risks of policy slippage and renewed political tensions.

In **Pakistan**, external pressures have eased with recent policy actions and the start of a new IMF programme, but relatively low reserve coverage and high gross financing needs make the country vulnerable to shifts in investor confidence. In addition, fiscal deficits have widened, and elevated government debt coupled with a narrow revenue base make public finances a rating weakness. However, it should be noted that the government's FY20 budget outlines an ambitious consolidation effort. While Pakistan's demographic profile is supportive of growth, security threats and geopolitical tensions negatively affect economic fundamentals. Low income per capita, weak governance indicators and a difficult business environment weigh on the country's credit profile.

This edition of the newsletter reflects JP Morgan's updated NEXGEM index, which includes Uzbekistan (rated by Fitch) and Papua New Guinea (ratings withdrawn in 2010), and eliminates Egypt and Ecuador.

Reform Path and External Financing Drive Frontier Emerging Europe Sovereign Outlook

Reform progress and access to external financing will be key factors for the rating trajectory of frontier emerging Europe sovereigns currently working towards improved stability and a reduced role of the state in their economies. We believe that for Uzbekistan ('BB-'/ Stable), Belarus ('B'/Stable) and Ukraine ('B'/Positive) progress in improving macroeconomic stability, as well as successfully advancing reforms that increase sustainable and balanced growth, will be important for these sovereigns to attract foreign investment and obtain access to external official and market financing to meet debt service payments.

After the 2014-2015 shock caused by lower commodity prices and increased geopolitical tensions, including military conflict in Eastern Ukraine, frontier emerging Europe sovereigns have introduced a policy mix characterized by increasing exchange rate flexibility, reducing inflation and prudent fiscal policies.

Belarus and Ukraine have made significant progress in reducing inflation (not an easy feat as demonstrated by the Argentine experience) with the objective of reaching 5%, while keeping fiscal and current account deficits under control. In the case of Uzbekistan, the reformist government removed foreign exchange controls in September 2017 and aims to lower still double digit inflation (16.5% in August 2019), a process that will likely require improved coordination between monetary policy goals and the financing of state projects and programmes.

Achieving sustainable and balanced growth represents a key policy challenge. As experienced by other emerging markets, improving macroeconomic stability is a necessary but not always sufficient condition to enhance growth prospects. While frontier emerging Europe countries have made progress in improving their business environment, as measured by the World Bank Doing Business survey, the reforms ahead include reducing the role of the state in their economies, strengthening institutions and domestic market mechanisms as well as improving the health and efficiency of the banking sector. A robust sovereign balance sheet, reflected in high reserves and low debt, and strong political commitment provide Uzbekistan with space to move forward with structural reforms, while Ukraine's new government has pledged to work with international partners to tackle long-standing structural constraints weighing on growth.

Increased exchange rate flexibility is a policy enhancement for these countries, as it helps the economy to adjust to changing external conditions while limiting pressures on international reserves. While government debt has come down in Belarus and Ukraine, and it is low in Uzbekistan relative to similarly rated sovereigns, they face high currency risk stemming from the large share of government debt denominated in foreign-currency (with Belarus and Uzbekistan above 90%) as well as relatively high financial dollarization. The large share of public sector banks (between 60% and 83% of total assets) creates the risk of contingent liabilities for sovereigns as well as for an efficient allocation of credit in the economy.

Access to external financing will remain a key component of the frontier emerging Europe sovereigns rating story, but there are differences. Uzbekistan needs to fund an enlarged current account deficit resulting from the removal of FX constraints as part of the economic liberalization process and public investment projects, while Ukraine and Belarus face significant government debt repayments (including external bonds in the case of Ukraine) in 2020-2021. Uzbekistan placed a debut USD1 billion bond in international markets in February 2019. After issuing EUR1 billion in June, Ukraine will likely return to external markets, as it faces USD2.4 billion external bond maturities in 2020-2021. Authorities in Belarus have indicated that they plan to return to international markets in 2020, after forays in 2017 and 2018, and to continuing to diversify financing sources away from Russia.

These countries also have the challenge to increase foreign direct investment, which remains low compared to regional and rating peers. Reforms that address weaker institutional quality in terms of government effectiveness, rule of law and control of corruption could enhance the improvements in terms of business environment and support private investment.

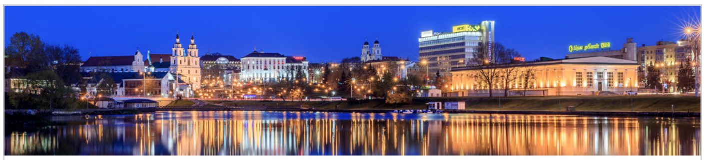
This article was written by Erich Arispe, Senior Director in Fitch's Sovereign Group, and published in the Financial Times' Beyond BRICS forum* on 19 September 2019.

* beyondbrics is a forum on emerging markets for contributors from the worlds of business, finance, politics, academia and the third sector. All views expressed are those of the author(s) and should not be taken as reflecting the views of the Financial Times.

Newsreel

MEA Faces Challenges Issuing LC Debt at Low Cost, Long Tenors

MEA issuers' ability to issue LC debt at low cost or long tenors is constrained by deep-rooted structural challenges, including weaknesses in their institutional framework and policymaking. Consequently, LC market debt tends to have shorter tenors and higher interest rates than FC debt in MEA. The region has also not followed the trend towards an increasing share of LC debt in total government debt that was seen in other EMs in recent years.



Belarusian Banks' Asset Quality is Still Vulnerable

Belarusian banks remain vulnerable to potential macroeconomic stresses, with IFRS 9 disclosures confirming that asset quality is still weak and reserve coverage modest. Asset quality is particularly susceptible to currency depreciation given the high proportion of FC lending (48% at end-1Q19), much of it to weak or poorly hedged borrowers.

EAC Budgets Highlight Development Focus, External Debt Flows

Continued high levels of development expenditure in the East African Community (EAC) budgets highlight a reliance on external debt flows to fund development spending. The budgets contain some measures that could reduce reliance on external funding for development finance, but it is unclear how successful these will be. Continued or renewed increases in debt/GDP are negative rating sensitivities for all three sovereigns.

Vietnam Bank Sector More Vulnerable to Shocks as Leverage Rises

Vietnam's banking system is becoming more susceptible to shocks as household leverage continues to increase, but near-term risk appears limited amid the benign operating environment and strong economic growth. Vietnam's bank credit has increased to an estimated 134% of GDP by end-2018, significantly higher than the 'BB' median of 60% and 'BBB' median of 55%.

Frontier Vision – 3Q19

Consistent with the broader global economic picture, GDP growth is slowing down among frontier emerging market economies according to Fitch's latest Frontier Vision chart pack. In 2Q19 GDP growth rates declined in Armenia, Costa Rica, El Salvador, Georgia, Ghana, Jamaica, Jordan, Kenya, Mongolia, Senegal, and Sri Lanka, with Belize, Honduras and Paraguay seeing negative rates.

Frontier markets are also experiencing further interest rates cuts, particularly: Belarus, Belize, Costa Rica, Cote d'Ivoire, Ghana, Jamaica, Jordan, Namibia, Papua New Guinea, Paraguay, Sri Lanka and Vietnam.

Fitch's Frontier Vision chart pack tracks high frequency macroeconomic data for the 35 countries included in NEXGEM. The charts cover five years of historical data and the choice of data series has been harmonised as far as possible across all countries to facilitate comparisons. The index comprises 35 countries representing Sub-Saharan Africa, Central America, the Caribbean, the Middle East, Europe and Asia. Following the recent change in NEXGEM index composition Papua New Guinea and Uzbekistan replaced Ecuador and Egypt in the chart pack.

Regional Commentary

Europe

Georgia Affirmed at 'BB'; Outlook Stable

Azerbaijan Affirmed at 'BB+'; Outlook Stable

Russia Flight Ban to Weigh on Georgian Growth, Current Account

Armenian Banks' IFRS 9 Loan Impairments in Line with IAS 39

Middle East & Africa

Tunisia's Presidential Election Raises Policy Uncertainty

Kenya Lending Rate Cap Weighs on Bank Earnings and Loan Growth

Recapitalization Exercise Stabilizes Ghana's Banking Sector

Nigeria's Unconventional Policies Aggravate External Vulnerability

Gabon's New Oil & Gas Law Could Support Output

Ghana's Banking Reforms Enhance Sector Loss Absorption Capacity

Nigerian Banking Sector Recovery Still Hampered by Bad Loans

Tunisia's New EUR Notes Assigned Final 'B+' Rating

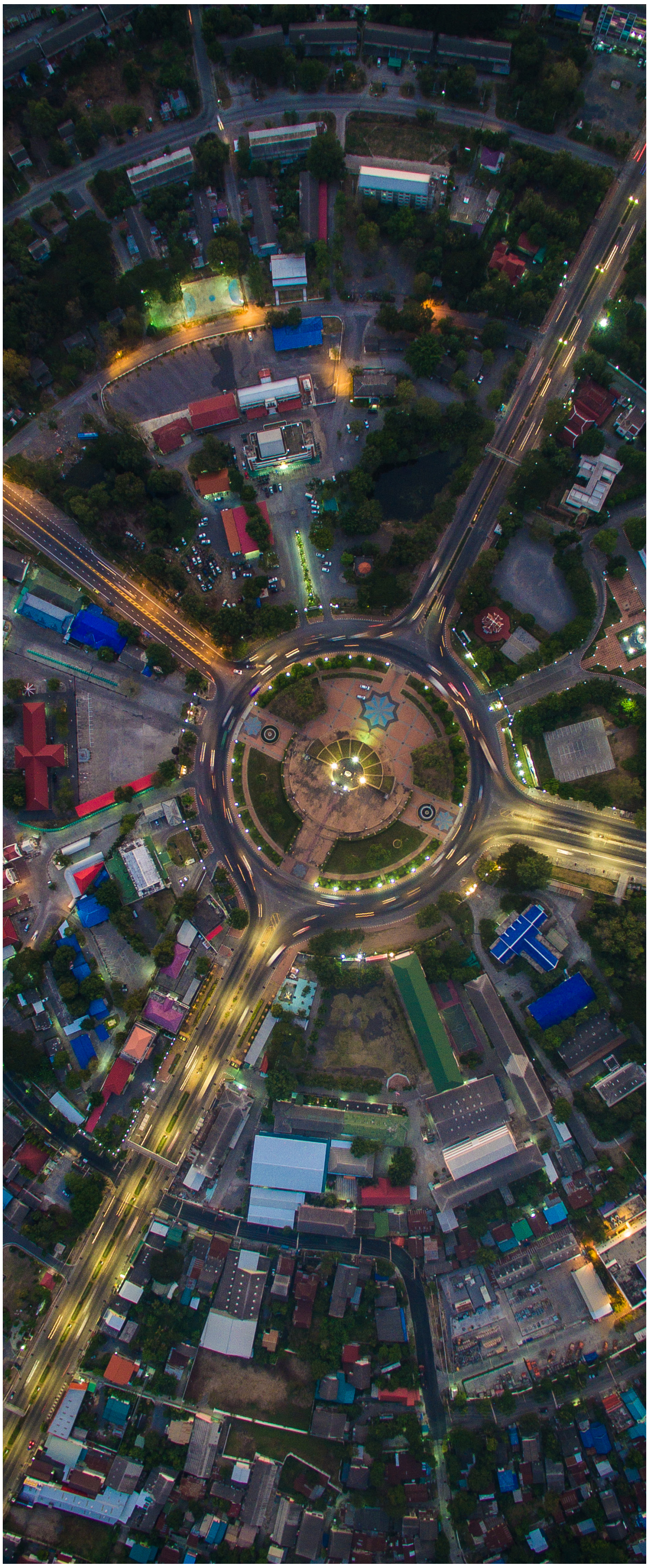
Loan-to-Deposit Requirement Credit-Negative for Nigerian Banks

Latin America & The Caribbean

Costa Rica Debt Approval to Ease Financing Constraints

Asia Pacific

Mongolia Affirmed at 'B'; Outlook Stable



Regional Commentary

Country	Current Ratings	Last Rating Action	Outlook	Rating Action Type
Middle East & Africa				
Angola	B	12-Jul-2019	▼	Affirmation
Cameroon	B	07-Jun-2019	▶	Affitmation
Cote D-Ivoire	B+	07-May-2019	▶	Affirmation
Ethiopia	B	01-Oct-2019	▼	Affirmation
Gabon	B	26-Jun-2019	▶	Affirmation
Ghana	B	11-Oct-2019	▶	Affirmation
Iraq	B-	25-Jul-2019	▶	Affirmation
Jordan	BB-	13-Jun-2019	▶	Publish
Kenya	B+	30-Apr-2019	▶	Affirmation
Mozambique	RD	10-May-2019	-	Affirmation
Namibia	BB	01-Oct-2019	▶	Downgrade
Nigeria	B+	07-Jun-2019	▶	Affirmation
Tunisia	B+	27-Jun-2019	▼	Affirmation
Zambia	CCC	27-Jun-2019	-	Downgrade
Latin America & The Caribbean				
Bolivia	BB-	20-Jun-2019	▼	Affirmation
Costa Rica	B+	15-Jan-2019	▼	Downgrade
El Salvador	B-	11-Jun-2019	▶	Affirmation
Guatemala	BB	11-Apr-2019	▼	Affirmation
Jamaica	B+	31-Jan-2019	▶	Upgrade
Paraguay	BB+	11-Dec-2018	▶	Upgrade
Suriname	B-	21-Aug-2019	▼	Affirmation
Asia				
Mongolia	B	05-Jul-2019	▶	Affirmation
Pakistan	B-	14-Jun-2019	▶	Affirmation
Sri Lanka	B	27-Sep-2019	▶	Affirmation
Vietnam	BB	09-May-2019	▲	Affirmation
Europe				
Armenia	B+	24-May-2019	▲	Affirmation
Azerbaijan	BB+	19-Jul-2019	▶	Affirmation
Belarus	B	28-Jun-2019	▶	Affirmation
Georgia	BB	16-Aug-2019	▶	Affirmation
Uzbekistan	BB-	11-Oct-2019	▶	Affirmation

Legend
▲ (positive), ▶ (stable), or ▼ (negative)
Source: Fitch Ratings

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