Emerging market essay

Finance, Market

This chapter will expose the students on potential risks faced by firms that are doing or currently planning to enter an emerging market. This chapter will detail each and every element of political, economic and legal risk. Discussions on how to reduce the impact of risks are also discussed at the end of the chapter. After studying this chapter, students should be able to:

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Describe political, economic and legal risks of doing business in an emerging market. 2. Analyses which risks are the most probably to happen in different emerging arrest countries. 3. Classified each emerging market based on the level of risks. 4. Describe the action that can help mitigate the effect of risks. Political volatility; economic volatility; legal risks; corruption; expropriation risk; risk mitigation. 3. The nature of risks Even though previous chapter's discussions on the current trend in emerging markets highlight many good opportunities for Multinational Firms (Macs) to explore, there are also a risks and challenges that firms will encounter. Among the most significant risks are political volatility, economic policy volatility and also legal risks. Firms entering emerging markets must understand the risks and take necessary action to mitigate the effect of those particular risks. 3. Political volatility Despite the demonstration and free market orientation process among emerging market countries, some of them particularly the one that Just achieved independence, is having an election, or governs by corrupt individual or political party are susceptible to political risks. Multinational companies that invest in this volatile country are exposed to risks such as military coups, civil war, mass labor tribes, violencestreet protest, or erratic

changes in government policy and industry regulations that pose a threat to foreign investment.

Among the political risks associated with emerging markets are: chapter 3 emerging market By Hanna-zinnia Although the barrier to trade in most emerging markets have fall, and most of these countries are now enjoying greater stability and experiencing steady growth, these emerging markets remain vulnerable to political risks that usually started inside the country itself and was largely beyond the control of investors. Extreme nationalism ND religious fundamentalism as evidence in countries like Indonesia, Pakistan and India further contribute to the problem.

Different in ideology and oppression from the current government also contributes to political volatility. Russia for example is still having an uncertain future direction as politics is unpredictable due to ongoing power struggles between reformers and the old-line communists. If the political clout could not be solved peacefully, then there is a potential for a civil war. Sir Lang is an example of a country that has been experiencing a civil war. There is a power useless between the two ethnic groups, the Ginghams that currently forms the government of the country and the Tamil.

Tamil guerrillas are fighting for and independent Tamil state. There has been an intense fighting since 1994 with more than 70, 000 people have been killed in the war. 3. 2. 1 Corruption and cronyism Another serious issue associated with emerging markets is corruption and cronyism. Corruption refers to dishonest or fraudulent conduct by those in power, typically

involving bribery or the abuse of a position of trust for dishonest gain. Most emerging markets in fact are always associated with corruption.

Brazil for example suffers lost of unbelievable SUDS 60 billion to corruption and fraud in connection with government and social programs between the periods of 1990 to 1994 [1]. Even Malaysia is having the same problem as reported by the Auditor General on the issue of very serious leakages in government agencies expenditure. SecondFinanceMinister has made a media statement dated October 26, 2009 that the government billions of dollars lost due to leakages that involved in purchasing and procurement at the extreme pricing and do not meet the specifications and standards.

Local swapper, The STAR on October 26, 2009 also reported that this leakage resulted in losses between ARM 14-28 billion over a period of one year. Cronyism refers to the appointment of relatives and friends to positions of authority, without proper regard to their qualifications or an individual who was able to exploit connections with the government or private officers to gain wealth and economic position. In Philippine, cronies controlled key sectors, including the sugar and coconut industries and media, and got state loans, lucrative contracts and concessions under the 31 -year-rule of

Ferdinand Marco's who was ousted in 1986. In Thailand, Thai politicians depend heavily on business support during election. Patronage politics, particularly in the countryside, boosts both political spending and the cronyism mentality of asking favors from the powerful. The prostitution and drugs trade has also corrupted many officials and police force of the country

[2]. 3. 2. 3 Fight against drug cartel Another problem that has an impact on political aspect of emerging countries fight against drug cartel.

In recent years, the Mexico drug cartels have waged increasingly violent battles with one another as well as with theMexicangovernment. Upon taking office in December 2006, Mexican President Feline Cauldron deployed thousands of federal troops in an aggressive crackdown on drug-related violence. Yet death tolls continue to rise. There were more than 2, 500 drug-related deaths in 2007, and the yearly toll rose to more than 4, 000 by the end of 2008.

Murders and street gun battles are only part of a more entrenched problem that includes corrupt police forces and a lackluster Judiciary [3]. 3. 2. 4 Territorial claim and possible war In some region, there is a tense relationship between emerging countries with its neighboring country due to multiple territorial claims among countries. If a peaceful solution could not be reached through peaceful negotiations, there will be potential for war between these nations. This is evidence at the Sprat's Islands at South China Sea.

The area consists of more than 100 small islands or reefs, surrounded by rich fishing area and potentially by gas and oil deposits. They are claimed in their entirety by China, Taiwan, and Vietnam, while portions are claimed by Malaysia and the Philippines. About 45 islands are occupied by relatively small numbers of military forces from China, Malaysia, the Philippines, Taiwan, and Vietnam. Brunet has established a fishing zone that overlaps a southern reef but has not made any formal claim.

In June 2011, the tense situation in Sprat's Islands amplify as the Philippines complains that Chinese ships offloaded building materials and erected marker posts on reefs to the west of its island of Palatal, within Manila's exclusive economic zone. Political volatility is hard to quantify due to broad characteristics of each emerging markets. What the managers could do is to anticipate upcoming changes in the political aspect of the nation and formulate timely, successful strategies in the face of sudden changes and uncertainty.

This is critical because political situation will have a direct impact on investment, decision-making, and corporate performance. Every market has it risks so businesses need to ensure that the risk worth the return they will get from the investment. 3. 2. 5 Social Unrest The current people uprising in emerging market countries of the Middle East such as Egypt, Jordan and Bahrain cause a growing concerns among investors who has already invest or thinking of investing into emerging markets.

One of the factors that increase the possibility of social unrest is an increase infoodand fuel price due to depleted resources and inflation. The high price of food is thought to have been one of the catalysts of the unrest in Tunisia, which led to the ousting of Zinc al-Abiding Ben All as president in January 2011. Other reason that makes people revolt includes corrupt leader and government, change in tax, economic and fiscal policy that affect daily life, UN-fair election, high unemployment etc.

Figure 2 shows the level of lattice and social risk of every country, based on a report produced by the Royal bank of Canada in 2011. Among the

emerging market countries, China, Egypt, Indonesia and Saudi Arabia is listed as high risk countries, together with Colombia. India, Russia, South Africa, Jordan and Turkey are among the medium risk countries while Mexico, Bahrain and Thailand are considered as moderate. Other emerging countries with low political and social risks according to this report. 3. 3 Economic volatility The second major risks associated with emerging markets are the level of economic volatility.

Economic growth may be high, but crises are frequent, as the Asian crisis of 1997 demonstrated. Emerging countries' economies are highly volatile due to frequent changes in institutions, industry structure and the macro-economy. Both the political and economy actually have a huge impact on one another, and firms can anticipate risks in the future if any of them become volatile. Among the element that brought economic volatility includes currency risks, expropriation risks, and foreign debt crisis. 3. 3. Currency risks Although there is an increasing trend towards liberation's of international payment ND transfers, there is still a concern among businesses that there could be a change in policy. Even emerging market countries have the tendency to influence the exchange rates. In some cases, the government will try to peg it's currency to a single currency such as a US dollar to stop aggressive drop in the country's currency value especially during financial crisis. Figure 2 shows how the exchange rate of Asian countries dropped significantly during the Asian financial crisis.

The Koala Lump Stock Exchange (KEELS) had lost more than 50% from above 1, 200 to fewer than 600, and the ringing had lost 50% of TTS value,

falling from above 2. 50 to under 4. 57 on Can 23, 1998) to the dollar. The then premier, Tune Dry. Mathis Mohammad imposed strict capital controls and introduced a 3. 80 peg of Malaysian ringing against the US dollar. 3. 3. 2 Expropriation risk One of the economic policy related concern among the investors was " expropriation risk", which refers to the possibility that host governments would seize all foreign- owned assets.

This risk however has largely disappeared. Stronger international law and the symbiotic nature of growth in emerging and developed economies reduced set seizures to nearly zero during the sass. A 2009 survey by the Multilateral Investment Guarantee Agency and the Economist Intelligence Unit found that multinational enterprises considered breach of contract, restrictions on the transfer and convertibility of profits, civil disturbance, governmentfailureto honor guarantees, and regulatory restrictions all to be more significant risks than the potential seizure of assets [4].

Emerging market countries policy of attracting foreign investment into their country foreign investors should be wary of any change in political and economic situation, getter with regulatory uncertainty can make the expropriation action possible. Even in the communist country like China, the government has never confiscate any foreign assets since 1978 when the country officially launched its so-called 'open door' policy, unless the asset in question specifically compromises China's national security. 3. 3. Foreign debt crisis Foreign debt crisis is external debt incurred by governments of emerging markets generally in quantities beyond the governments' political ability to repay. " Unplayable debt" is a term used to describe external debt

when the interest on the debt exceeds hat the country's politicians think they can collect from taxpayers, based on the nation's gross domestic product, thus preventing the debt from ever being repaid [5]. Emerging market countries have traditionally borrowed from the developed nations to support their economies.

In the sass such borrowing became quite heavy among certain developing countries, and their external debt expanded at a very rapid, unsustainable rate. The result was an international financial crisis. Most of the time, government with high level of debt will have to re-vamp its financial policy to accommodate debt payment. Countries such as Mexico and Brazil declared that they could not keep up with the schedule of interest and principal payments, causing severe reactions in the financial world.

Cooperating with creditor nations and the MIFF, these countries were able to reschedule their debts and delay payments to remove financial pressure. But the underlying problem is not really solved as developing countries were saddled with staggering debts that totaled more than $800 billion in the mid-sass. The large debts created huge problems for the developing countries and for the banks that faced the risk of substantial losses on heir loan portfolios. Such debts increased the difficulty of finding funds to finance development.

In addition, the need to acquire foreign currencies to service the debt contributed to a rapid depreciation of the currencies and to rapid inflation in Mexico, Brazil, and a number of other developing nations. Even emerging market in Asia such as Malaysia, Philippines, Indonesia, Pakistan, India etc.

As shown in Figure 4, also facing a serious problem with foreign debt. The wide fluctuations in the price of oil were one of the factors contributing to the debt problem. When the price of oil SSE rapidly in the sass, most countries felt unable to reduce their oil consumption quickly.

In order to pay for expensive oil imports, many went deeply into debt. They borrowed to finance current consumption-? something that could not go on indefinitely. As a major oil importer, Brazil was one of the nations adversely affected by rising oil prices [6]. Figure 3. : Foreign debt among Asian countries 3. 4 Legal risks The possibility of investing in emerging markets by Macs will increase if the legal system in the country is reliable and always give fair decisions. Contract will only be void.

In sass, many South East Asian governments in their effort to attract foreign investors offered contracts that protect investors from risks related to lower than expected demand, currency conversions, exchange rate and political force measure. The Asian financial crisis in 1997 brought those investors' favorable treatment into sharp relief as currency values, share prices, and electricity demand all plummeted. Political officials had to choose between honoring the contracts, at the risk of compromising their own popular support, and renegotiating them in order to maintain that support.

In the end, manycareerminded public officials in Southeast Asia chose to renegotiate or cancel scores of contracts. Even when contracts can be legally enforced, experience shows that inventive politicians can circumvent them, through a wide variety of means other than changing laws [4]. Another example is when foreign investors involved in oil and gas industries in

countries such as Transmitted, Gyrations and Astrakhan, which is a newly independent countries of a former USSR regime.

Even though the contract seems to put them on favorable terms, the possibility that firms will face a breach of contract ND other regulatory problems is high. Another legal issue that always arises is when some emerging market countries have laws that limit the amount of profit firms can take out of the country, which means that company might make a huge amount of profit by doing business in the country but may be prohibited from taking the whole profit back to the home country. 3. Minimizing the risks There are many options available for companies in Minimizing the risks when investing in emerging markets. They are: 3. 3. 1 Thorough political and economic risk analysis Multinational firms should carefully evaluate the emerging market country's political ND economic risks before deciding whether to do business there or not. Nowadays, there are vast indicators, statistics and political analysis paper published and publicly available for review. This is the best source for country's information that can help decision making.

However, there are some emerging market countries that are less transparent and access to accurate economic or industry statistics may not exist at all. In this case, firms might not have the information and expertise to do the analysis by themselves. Then the best option is to, employ a consultant service firm who have the expertise in inducting the analysis. 3. 3. 2 Protect the investment with political risks insurance Political risk

insurance is a type of insurance that can be taken out by businesses, of any size, against political risk.

Political risk insurance is available for several different revolution, insurrection, civil unrest, terrorismor war; Governmental expropriation or confiscation of assets; Governmental frustration or repudiation of contracts; Wrongful calling of letters of credit or similar on-demand guarantees; Business Interruption; and Inconvertibility of foreign currency or the inability to repatriate funds. 3. 3. Involve host country's government in the business Government equity participation either through the relevant government agencies or through Government Related Companies (Glass) can bring a lot of advantage to firm and to the government itself.

This can be done in various ways such as by creating a new Joint venture company with both parties have a percentage of shares in it, or through strategic alliances and consortium. By having the government itself as partner, firms may find it easier to obtain the license, get full support from the government, reduce the risk of expropriation and even improve company's goodwill mongo the people. 3. 3. 4 Have a Joint venture or alliance with local company. The objective of having cooperation with local company is almost similar to having the relationship with the government as discussed previously.

Some other benefit for Macs when they cooperate with local company includes firms can share the knowledge of local company about the trend, taste, preferences andcultureof the local people. Both parties will also share the costs and risks of doing business. At the same time, Macs can benefit the

local company by having a knowledge andtechnologytransfer, besides sharing the experience of Macs. 3. 3. Conduct a proper scenario planning when making the entry decision.

Scenario planning refers to the process of visualizing what future conditions or events are probable, what would be the consequences or effect of it and how to respond to, or benefit from it. For example, when a pharmaceutical company starts to develop a new compound it does not know if these typically very large investments will generate any benefit in the future. So, success is dependent on many factors; internal factors such as the skills and knowledge of researchers and developers, and external influences such as technology trends, demand and price developments.

In order to do that, they have to tap into tacit information that is already available within or outside the company and to convert it into knowledge about possible future scenarios and options the Risks associated with investments into intangibles, especially of investments into the strategy and in the product innovation chain of a company, are much higher than in traditional industrial physical asset type of investments. But on the other hand the upside is often unlimited.

Businesses which are engaged in R&D and continuous product and market innovations must find ways to limit the downside, the risks, and o boost the upside in order to fully leverage their investments and to generate value for investors and other stakeholders. Scenario planning is a very good method to do that and to limit especially large strategic risks. Figure 5 shows finding of a study on what is the best tools to mitigate the effect of risks in four

major emerging markets; Russia, India, China and Brazil (Also called BRIM countries).

The study shows that firm need to use different mitigating strategy in different countries due to the different nature of risks in that particular country.