Businesses operating in developing countries and emerging economies face a number of political, economic and social risks. Discuss the nature of these risks and the methods used to assess such entry risks:

International trade barriers, for most, have long fallen. In developed nations, markets are becoming saturated; specific natural resources are often exhausted or non-existent and labour rates and material resources are too costly. Meanwhile, emerging economies such as China, India, or even Brazil are finally opening themselves up to the rest of the world. For businesses, this means a chance to take advantage of opportunities that are too often scarce at home. However, opportunity does not come without risks; foreign countries have different political, economic and social frameworks which all affect MNCs in different ways, especially in developing countries where socio-political and economic grounds may at times remain unstable.

International managers can do very little to prevent the difficulties they face, and have no control over events that may influence those risks. It is therefore in the interest of any international manager not only to understand the different risks they face but also to be aware of the methods used to assess such risks.

Although the question divides risks into three different categories (political, economic and social), it has nevertheless been noted that all risks have political, economical and social implications. Therefore, to avoid confusion, this discursive essay will employ Griffin & Putsay's risk categorisation[1]:

1. Governmental risks: risks that arise out of governmental action and/or influence (including legal and regulatory frameworks…)
2. Non-governmental risks: risks that arise out of non-governmental actions (terrorism, religious conflicts…)

There are a number of governmental risks that international managers have to be aware of. First, a government from a developing country may not provide political/economic and social stability. Many emerging economies may present

[1] Griffin, R. & Pustay, M (1999) International Business, A Managerial Perception, New York, Addison-Wesley.

important risks in relation to the stability of their fundamental legal and political frameworks. Some may still not have an established rule of law, so government's role in business varies because those in control can determine policy with some degree of enforceability. David Holt calls this the "rule of man":

> This situation often results in frail commercial regulations, unpredictable economic policies, and trade agreements subject to the prerogatives and whims of those in power.[2]

This means that a business could arrive in a country, understand, accept and comply with all the current regulations; but the host-government may change policy and suddenly decide that one of these regulations (e.g. import/export taxes) does not fit their ideologies anymore. This regulation may have a direct effect on foreign businesses and thus represent a risk to the flow of its production. Although China has been attracting multinational ventures from all over the world because of its new membership to the WTO and the economic reforms this triggered, the "Economist" still claims that "the risk of political instability will rise sharply in 2003"[3]. Zemin is to hand over the state presidency in March 2003, but will this be done smoothly without directly or indirectly affecting foreign businesses?

Another type of governmental risk that multinational ventures face in emerging economies is government intervention. Although many developing nations will offer attractive incentives (such as favourable tax rate etc.) to attract foreign investment and therefore directly invite multinationals inside the country's borders, governments may change their attitude once commercial activity within the country has consolidated. Governments may start wanting to have control over what the businesses do without necessarily investing in them:

> As governments expand their commercial activities, they also tend to expand regulatory influence over foreign enterprises.[4]

In some cases, government intervention can be subtle, but in others it can be extreme. Holt provides a comprehensive model that exposes the scale of government intervention and its possible actions:

[2] Holt, D. (1998) International Management, New York, The Dryden Press
[3] Economist "The world in 2003"
[4] Holt, D. (1998) International Management , New York, The Dryden Press

Subtle Intervention:		Extreme Intervention:
Licensing	Price Controls	Confiscation
Import Constraints	Content Rules	Expropriation
Export controls	Labour regulations	Domestication or
Specific Levies	Incentives or Penalties	Nationalization
Compliance Rules		Mandated equity
General Regulation of		Required Contract
commerce.		Foreign Taxation

Extreme intervention can represent a direct threat not only to a company's ownership, assets and property rights but also to the physical security of the employees. Confiscation for example, implies the government simply takes over a company's assets and expels foreign managers. No negotiations or effort to reimburse the company for its losses are even considered. The effect of expropriation is the same as confiscation except the business in question would receive compensation and the event does not involve hostile action. Such measures may be taken when, for example, there is a shift in governmental ideology, which would be highly likely in unstable economies.

Other extreme intervention such as mandated equity or foreign taxation all represent ownership and operating risks whereby the company has neither security over its assets nor stability over its costs, which can subsequently cause major disruption in the ongoing operations of the firm.

More subtle intervention such as legal and regulatory intervention may not be as drastic but may exert tremendous pressure on management decisions. The host government, for example, may decide to change labour regulations and impose new mandatory labour benefits legislation, which would increase operating costs for the business. Similarly, government can decide to impose content controls on the products an MNC may produce; they may decide that x% of the components of the finished product has to come from the host-country, meaning it will probably be taxed more heavily when imported into a different country. Price controls can also be threatening to the profitability of a business:

> A foreign company is vulnerable to host-government price mandates for minor expenditures, such as extra fees for entry visas, and major ones, such as costs of factors of production.[5]

More subtle intervention such as imposing specific quotas, levying taxes or imposing constant licensing charges can all represent risks for the profitability of foreign businesses.

Nevertheless, governmental risks do not solely arise out of governmental intervention. Different countries have different legal and regulatory systems and different governments rule differently, with a more or less relaxed approach to enforcing regulations. These differences alone can create risks for businesses who are not used to them. For example, ownership rights and more specifically, intellectual property rights in some countries are not well enforced.

There are treaties that have been signed by countries around the world that protect those rights, but not all countries have signed them. As Putsay remarks, "weak protection for intellectual property rights can have high costs for international businesses"[6]. For example, China is well-known for producing very high quantities of illegal duplications of C.Ds and cassettes. Similarly many music shops in Belgrade – Serbia[7], only sell duplications; businesses wanting to sell their music products in these countries may find it very difficult if in the same market copies of the product can be accessed for a much cheaper price.

So far, it is only the actions of the host-government that have been analysed in terms of the potential risks they could create. However, risks that may affect businesses operating in developing countries can also arise out of the actions of the home government itself. A business wanting to move and operate in emerging economies

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[5] Holt, D. (1998) International Management , New York, The Dryden Press.
[6] Griffin, R. & Pustay, M (1999) International Business, A Managerial Perception, New York, Addison-Wesley.

may not want its labour force to follow which implies job losses at home and other unattractive economic consequences. Consequently, home government may want to discourage businesses from relocating internationally. The home government may then want to impose on its own businesses import/export licenses, taxation, currency restrictions, treaty constraints and other specific domestic laws applicable overseas. These are other economic risks international managers will have to face when relocating. Relations with the home-government can also therefore turn out problematic. However, what may make home government relations more complicated is its relation with the host-government and what this relation implies for businesses. For example, it would be very risky for an American business to operate in Iraq these days; not only would they face possible physical attacks on assets and/or employees, but also boycotts and the like. Mac Donalds recently shut down 75 branches all over the world because of the anti-American feelings spreading internationally due to hostility towards American foreign policies. So political and diplomatic relations between two countries can often determine the relative risk of doing business in one country rather than another.

It has so far been assessed that businesses wanting to operate in emerging economies and developing countries have to face a number of governmental risks, which will affect their overall profitability. Risks originating from governmental instability, government intervention, differences in regulation enforcement, tensions between host and home government or host and other governments. However, there are many other risks that international managers may have to face when relocating in an emerging economy and that don't necessarily have anything to do with direct governmental actions or influence.

Exchange Rates and currency values and their stability or instability are completely beyond government's or business's control. In "International Business", Margaret Woods talks about the effect that the Exchange rate can have on international business:

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[7] ibid

> Coping with variations in the profitability of different national/regional markets and managing the effects of changes in exchange rates can often be detrimental to a company's financial performance.[8]

It would be assumed that companies trading in emerging economies would face even more difficulties in terms of exchange rates as the economic and political uncertainty that characterises a developing country would worsen the volatility of exchange rates. This makes it difficult for businesses to keep control over certain financial aspects of the company (such as risks in cash-flow forecasts, risks in transactions or risks in translations).

Another financial risk that will affect businesses is inflation. High inflation will mean higher operating costs. Argentina, as an emerging economy, is a good example of a hyper-inflationary economy, here again, the "Economist" predicts that as a result, "foreign investors may sell off assets"[9].

Social risks that may affect businesses in emerging economies include kidnappings, terrorist threats and other forms of violence (such as local antagonism). These may have subtle but nevertheless important impacts on firms such as disrupted production, increased security costs, increased managerial costs and as a result, lower productivity and profitability.

Another risk that businesses may face that the host-country is not responsible for is the behaviour of other international business that have operated in the same region and caused damaged in some way. How would the local inhabitants of Bhopal (India) react if an American business decided to relocate there? The Union Curbide explosion in Bhopal in 1984 killed about 2500 people and left 100, 000 people homeless [10], with no significant financial compensation provided. How would the local inhabitant feel towards new foreign factory plants? And how would this understandably hostile environment affect businesses?

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[8] Woods, M. (1995), International Business, London, Chapman &Hall.
[9] The Economist "The world in 2003"
[10] The Chambers Encyclopaedia (2001), Edinburgh, Chambers Harrap Publishers.

Whether risks directly arise out of governmental actions or influence or not, the type and degree of risks associated with internationalisation in emerging economies will depend on certain factors. For example, a business will face different types of risks depending on whether it is in pursuit of resources, markets or cost efficiencies. A company interested in developing new resources may later have problems with intellectual property rights. A business wanting to pursue new markets may find that certain regulations prevent it from selling their product in the host-country. For example, an American based direct sales company called "Amway" started doing business in China, after a year of successful activities, the Chinese government announced a ban on direct selling because this new way of selling had been used for fraudulent purposes[11]. Therefore, a business wanting to sell a product in China using direct selling approaches will be prevented from doing so and therefore limit the firm's activities. Finally, a business relocating because it wants to limit its overall costs may realise when arriving in the host-country that because it created job losses at home, the home-government has decided to impose currency restrictions or the like.

To conclude the first part of this essay, two main types of risks have been identified. Governmental risks comprises risks such as government instability; government intervention; differences in regulation enforcement; restrictions coming from home governments; restrictions coming from tension between home and host government. Non-governmental risks have included risks such as: losses to exchange rate' volatility; high inflationary economies; terrorism and other MNCs impact on the host-region.

However, exposing the nature of political, economic and social risk is not enough for international managers who are looking to operate in emerging economies. What is also important is to expose the methods used to assess those risks so that decisions for locations and entry modes can be made as confidently as possible.

Although managers doing business in most countries encounter similar issues, specific risk factors differ for each company, industry and host country. Therefore,

[11] Hill, C. (2003), International Business, New York, The McGraw-Hill Irwin.

observers have developed many different models of risk but each have their own limitations and none have been judged completely reliable.

Holt identified three main types of methods used to assess entry risks: intuitive assessment method, advisory assessment method and analytical assessment methods.

Whether a company relies on individual subjective judgement or employs sophisticated means of risk assessment, managers ultimately rate the risk of doing business abroad based on their personal perceptions. So the first step of a general intuitive method would consist of the company executives having a structured dialogue with its foreign managers during which a discussion on the most important risks the company would have to face would take place. This first analysis will result in basic conclusions; for example, the company may want to divide countries into basic categories such as “very high risk”, or “high opportunity”. The second step would consist of considering the risks according to the different entry modes (licensing, franchising, turnkey projects, joint ventures etc.) and markets available. Here the categories would become increasingly complicated so many companies actually adopt risk-preference strategies that would match desired opportunities with acceptable levels of risk exposure and rank countries with, for example, letters. So while Iraq and Zimbabwe would be given the letter Z, Brazil or China may be given the letters E or F. This ranking method may be supplemented by internal surveys among the company’s foreign managers and international executives, or by various types of consultants.

However, this method has its limits. Judgement may partly rely on foreign manager’s perception and their advice may not be completely reliable. While they may be able to give useful advice about general risk factors from their own experience, they may not appreciate the overall SWOT of the company since they only have an understanding of their own activities. Secondly, local managers may be informed about operating risks and the like but they rarely appreciate the general political and economic affairs of the host-country.

This is one of the reasons why few international companies solely rely on intuitive methods; indeed most will also refer to established risk-rating services, consulting reports or government advisory services. For example, in the US, although the government generally does not intervene with business actvities (if compared to Japan for example) the US State Department will provide businesses with extensive advisory services such as country-specific commercial guidelines. The drawbacks with government services is that much information is provided but it is not tailored to specific industries and nor is it conclusive, so companies would have to interpret the figures themselves and draw appropriate conclusions.

Similarly, large businesses can refer to fee-based advisory services and contract with consulting organisations such as *Euromoney*, which publishes an index of country risk ratings based on six criteria (economic performance, political risk, debt indicators, default record, credit rating and access to international finance). The result is a numerical rank-ordered list of approximatively 170 countries and territories; the lowest possible risk would earn the country 100 points and the highest would result in a score of zero. So while Switzerland would earn 95 points, Iraq would earn under 20.

The "Economist" publishes similar country ratings through its "International Country Risk Guide". There are consultancy agencies such as *PriceWaterhouseCoopers*, *Dataquest* and *Chase Econometrics*. However, all these methods of assessment, again, do not come without their limitations. Most of these services measure political risk in economic and financial terms but they never seem to agree on common patterns of analysis, which means different agency's conclusions will vary considerably making the overall judgement problematic. Similarly, some agencies will rely on few variables, while others will find as many as 200 to base their ratings on.

As mentioned above, businesses may refer to advisory services including fee-based consulting agencies; but these in turn will refer and use objective analytical assessment methods. There are three mainstream risk-assessment techniques: "The Economist model", "The BERI model" and "The PRS model". "The Economist model" ranks a country's risk based on a 100-point scale in which a high score indicates high risk (opposite to *Euromoney*). This analysis evaluates risks in three broad categories: Economic variable (falling GDP per person, high inflation raw materials as a percentage of export etc.); Political variables (bad neighbours, authoritarianism, illegitimacy etc.) and social variables (corruption, Islamic fundamentalism etc.).

Although this method seems to be comprehensive in the way that it also deals with social variables and not only the economic and political variables, it is still unreliable. It implies that authoritarianism, thus a lack of democracy, can be threatening to businesses, but there are many countries that are not democratic but still have had few civil difficulties (such as monarchies in the Middle East or Southeast Asia). Similarly, taking "Islamic fundamentalism" as a social variable is not consistent; it is obvious that fundamentalists exist in every religion and every country; one business operating in America could be suspicious of its minority of fundamentalist Mormons or Catholics. This model does actually present prejudiced variables and therefore should be used with caution.

Another model that consulting agencies may use is "Business Environmental Risk Intelligence (BERI) Model". This analytical assessment method produces a figure called the "Political Risk Index", which again, is based on a composite score from ratings by global experts on ten variables mainly divided into three categories: Internal Causes of Political Risk (factionalisation of the political spectrum, social conditions such as wealth distribution, organisation and strength of forces for a radical left government…); External Causes of Political Risk (dependence on and importance to a hostile major power…); and Symptoms of Political Risks (strikes, street violence, overall instability). This study includes data for 100 countries and the rating is based on an assigned score 0 (maximum risk) to 7 (no risk).

Although this method has been judged as a better model than the Economist, it still presents weaknesses. One could criticise it for not addressing more social and cultural issues and that it does not use extensive economic or financial data that could be important for investment decisions.

Finally, the third mainstream risk-assessment method used by agencies to advise international managers is the Political Risk Services (PRS) Index. This method differs completely from the Economist and BERI indexes. This index evaluates probabilities of loss due to political risk rather than generating absolute scaled indexes like the Economist or BERI models. It has 12 variables such as "political turmoil probability", " Equity restrictions", "Exchange controls", "Tariff imposition" etc. The variables are mainly political and financial. In addition, these indexes provide 18-month and five-year political forecasts for as many as 100 countries. The subscribed organisation would also receive a monthly report actually tailored specifically for that company's industry. So it could be assumed that, as opposed to the previous two models, this one can be used by companies without having to also seek professional consultants to interpret the figures for them.

Again, this model is limited in the way that it does not include social and cultural variables. Besides, forecasts as long as five years ahead inevitably rely on considerable speculations and thus should be treated with caution.

All three assessment methods (intuitive, advisory and analytical) all have their advantages and drawbacks. However, a combination of these may then constitute the best available technique for political, economic and social risk assessment and it is important that business appreciate this combination instead of relying solely on only one method.

It is clear that businesses have very little control of the risks they face when operating in unstable, emerging economies. Governmental and non-governmental risks can affect business in both extreme or in subtle ways. Government intervention whether coming from the host-country, home country or a third party inevitably disrupt the activities of a business and ultimately its profitability. Economic uncertainty also means little control over exchange rates and thus many aspects of the financial activities of a business. Terrorism and local hostility can reach such extremes that a business is forced to close down. It is evident that businesses have to face risks where there is opportunity, there is always a danger of failure. However, it is also important to consider the other side of the coin, businesses may be affected by their environment, but likewise, their environment will be equally affected by the businesses themselves. Therefore, opportunity does not only come with risks but also with responsibilities; and the first responsibility businesses have is to make sure that their choice of location and the entry risks associated with that location have been effectively assessed beforehand. This means understanding different means of risk-assessment and appreciating their limits. Businesses should not assess risks purely intuitively, they should also seek informed advice; and this advice should be based on reliable risk-assessment models that are up-to-date and unbiased. Only then, when a business has explored every risk involved associated with its new venture, is a business responsible. Even though it will not be in control of the risks it faces, at least it would have envisaged them and assumed its responsibility and approached the new opportunity with its eyes open.