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Navigating political risk in multinational business operations

An emerging market perspective

Bachelor’s thesis
In International Business

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The purpose of this bachelor’s thesis is to examine how political risks affect the internationalization of multinational enterprises (MNEs) into emerging market countries. This issue is important as globalization and the increasing amount of foreign direct investments have made emerging market countries even more important for multinational enterprises. Successful business operations in emerging market countries often rely on the management of political risks as those risks are the most crucial risks to be taken into account in emerging markets.

This thesis will cover all the main types of political risks and explain what political risks essentially are. The thesis divides political risks into two main categories: non-violent political risks and violent political risks. These two groups explain the most common ways that political risks appear. Additionally, this thesis will discuss political risk management in the emerging markets. There are three different perspectives on political risk management and those will be explained thoroughly. The perspectives are the institutional view, the resources and capabilities view, and the resource dependence view. All of these perspectives see political risk in different ways and treat political risk in various manners. To give MNEs some concrete ways to manage political risks, this thesis will also discuss three approaches on how political risk can be dealt with. These approaches are the reactive approach, the proactive approach, and the active approach.

The thesis discovers that it is possible to manage political risks even in emerging market countries. MNEs need to be aware of possible risks and understand the environment that they operate in. The management of political risks is crucial especially in emerging markets as in those markets the management of political risk can be the factor that determines if the MNE can invest in the region. This thesis also discovers that there are multiple ways to look at political risk and that some companies see political risks as threats, and some see them as opportunities. In the future political risks need to be considered by MNEs more than before as increasingly more countries becomes emerging market countries with diverse political risks.

Key words: political risk, emerging market, multinational enterprise, risk management

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Tämän tutkielman tarkoituksena on tutkia, miten poliittiset riskit vaikuttavat monikansallisten yritysten kansainvälistymiseen kehittyvien markkinoiden maihin. Tämä kysymys on tärkeä, koska globalisaatio ja ulkomaisten suorien sijoitusten määrän kasvu ovat tehneet kehittyvien markkinoiden maista entistä tärkeämpiä monikansallisille yrityksille. Kehittyvien markkinoiden maissa menestyvä liiketoiminta nojaa usein poliittisten riskien hallintaan, sillä nämä riskit ovat keskeisimpiä kehittyvillä markkinoilla huomioitavia riskejä.

Tämä tutkielma kattaa kaikki poliittisten riskien päätyypit ja selittää, mitä poliittiset riskit olennaisesti ovat. Tutkielma jakaa poliittiset riskit kahteen pääryhmään: ei-väkivaltaiset poliittiset riskit ja väkivaltaiset poliittiset riskit. Nämä kaksi ryhmää selittävät yleisimmät tavat, joilla poliittiset riskit ilmenevät. Lisäksi tutkielmassa käsitellään poliittista riskienhallintaa kehittyvillä markkinoilla. Poliittisesta riskienhallinnasta on kolme erilaista näkökulmaa, jotka selvitetään perusteellisesti. Näkökulmia ovat institutionaalinen näkemys, resurssi- ja kykynäkökulma sekä resurssiriippuvuusnäkökulma. Kaikki nämä näkökulmat näkevät poliittisen riskin eri tavoin ja käsittelevät poliittista riskiä eri tavoin. Jotta monikansalliset yritykset saisivat konkreettisia tapoja hallita poliittisia riskejä, tässä tutkielmassa käsitellään myös kolmea lähestymistapaa siihen, miten poliittisia riskejä voidaan hallita. Nämä lähestymistavat ovat reaktiivinen lähestymistapa, ennakoiva lähestymistapa ja aktiivinen lähestymistapa.

Tutkielmassa todetaan, että poliittisia riskejä on mahdollista hallita myös kehittyvien markkinoiden maissa. Monikansallisten yritysten on oltava tietoisia mahdollisista riskeistä ja ymmärrettävä toimintaympäristöään. Poliittisten riskien hallinta on ratkaisevan tärkeää erityisesti kehittyvillä markkinoilla, sillä näillä markkinoilla poliittisten riskien hallinta voi olla tekijä, joka määrittää, voiko monikansallinen yritys investoida alueelle. Tutkielmassa todetaan myös, että on olemassa useita tapoja tarkastella poliittista riskiä, ja että jotkut yritykset näkevät poliittiset riskit uhkina, ja jotkut näkevät ne taas mahdollisuuksina. Tulevaisuudessa monikansallisten yritysten on otettava poliittiset riskit entistä paremmin huomioon, kun yhä useammista maista tulee kehittyvien markkinoiden maita, joissa on erilaisia poliittisia riskejä.

Avainsanat: poliittinen riski, kehittyvät markkinat, monikansallinen yritys, riskienhallinta

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1 Introduction

The current trend of globalization and foreign direct investments rapid flow has led to the interconnectedness of markets and countries around the world. Multinational enterprises (MNEs) now understand the value of entering markets early, even in areas with recognized risks. This change has enhanced the importance of political risk in today's business environment. As a result, many multinational enterprises nowadays designate significant resources to identifying and effectively managing these risks. (Alon et al. 2006, 2.)

Despite the increasing openness of many emerging markets to multinational enterprises, the significant challenge of political risk resumes as a considerable concern for international business activities (Jakobsen 2010, 1). It is commonly believed that multinational enterprises tend to steer clear of investing in politically risky countries due to the potential for disruptions like unpredictable regulatory conditions, property damage, and threats to safety and life. These disruptions not only result in increased transaction expenses but also create concern regarding future safety and financial concerns. (DeGhetto 2023, 2.) Additionally, the substantial rise in worldwide economic integration, commerce, and capital movement in recent years, connected with increasing political unsettledness and government interference in markets, have generated an atmosphere in where political risk is more significant than ever for MNEs (Bremmer & Keat 2010, 3).

Spar (2009, 206) emphasizes that foreign direct investment is fundamentally political, and that political risks are the primary factor influencing FDI choices. Additionally, Oetzel (2005, 1) and Zhuang et al. (1998, 8) endorse this viewpoint that political risk has a crucial role in shaping firms FDI decisions. Furthermore, it is noted that political risk not only influences investment decisions prior to investment but also continues to impact FDI even afterwards the investment is made (Feinberg & Gupta 2009, 1; Oetzel 2005, 5).

According to Bremmer and Kent (2010, 68) political risk research has more to give when it comes to emerging markets. In emerging market countries, political aspects are just as significant as basic economic aspects for the performance in those markets. In developed industrial countries economics and culture are often separate from politics, however operating business in emerging market countries can require political connections. For instance, in Germany, you most likely won't need political connections to manage a

grocery store. Even though business expertise is essential for profitability, success also depends on navigating the politically influenced economic and regulatory circumstances.

There is no official definition for emerging markets. Nevertheless, emerging markets share some recognizable features. All emerging markets usually have good growth prospects, which at the same time might not always follow through. Likewise, emerging markets typically have possibilities for high rates of return. Another feature is the lack of history in foreign investment and the transition to market economies. Lastly and the most important feature in connection to this thesis is the high level of risk in emerging markets. This thesis focuses on emerging markets due to the region's opportunities with high growth provided that the risks of an emerging market are managed successfully. (Mody 2004, 3.)

According to Ghauri et al. (2012, 4) the BRIC countries, Brazil, Russia, India, and China, which are the four largest emerging market countries globally, contribute to 18% of all global trade and account for approximately 45% of present economic growth. Projections propose that by 2035, the gross domestic product of emerging market countries will rise above that of advanced economies. Besides the BRICs, emerging markets are further categorized into groups like the New Frontier Economies, which include countries such as Colombia, Egypt, Indonesia, Iran, Mexico, Pakistan, Peru, South Africa, and Turkey.

Regardless of the scope and range of influence which political risk can make on MNEs, numerous top executive groups proceed to disregard, evade, and downplay its strategical significance (Bremmer & Keat 2010, 63). Financial and operational types of risk can appear surprisingly and have a large effect on the business arrangements and plan of actions. Nonetheless, the biggest challenge is to process the risks to the organization and the assets involved with unforeseen regime change, policy changes by government or the political unstableness inflicted by terrorism or civilian restlessness. (John & Lawton 2018, 1.)

This topic is significant because in the last few decades, the internationalization of companies in the emerging market has accelerated further. Institutions in the emerging markets are not always supportive of international trade and multinational companies may face problems when trying to export their business to these countries. This is also a relevant issue, because in the last few years the emerging market has been very visible in how they are catching up with the developed countries, for example in their economic

growth. The purpose of my thesis is to identify how political risks affect the internationalization of multinational companies in emerging markets. With the following sub questions, I want to provide information on how companies can prepare for these political risks. The sub questions discussed in this thesis are:

- What are political risks?
- In which ways are political risks visible in emerging markets?
- How can MNEs manage political risks in emerging markets?

The thesis will not concentrate on any specific emerging market country as the aim is to form a general overview of the region. I will use the term emerging markets in this thesis to describe the topic. Some sources have also described the same term with words such as developing markets and developing countries, but this thesis will not use those terms.

The thesis is structured from this forward as follows. The concept of political risk is defined thoroughly in chapter 2.1. In chapter 2.2 the thesis will especially focus on the categorization of non-violent and violent political risks. Chapter 3 will focus on political risk management and different approaches to political risk management. In this chapter the thesis covers three different views on political risk management and how these views are visible in MNEs actions in emerging market countries. Finally, chapter 4 concludes the thesis with a comprehensive summary and conclusions.

2 Understanding political risks in international expansion

2.1 Defining political risk

According to Bremmer and Keat (2010, 5) political risk stands for the likelihood that a specific political action will lead to shifts in economic results. Political risk stands out from natural risks such as different disasters, like earthquakes, disease outbreaks, and droughts. Additionally, political risk differs from economic risks, for example inflation or sovereign credit risk. Political risks are generally more difficult to measure than for example the risk of smoking. Nevertheless, political risks are fundamentally very similar with the other types of risk.

Different terms are often used to explain identical or closely related types of political risk. For instance, terms such as political risk, policy risk, political conflict, political uncertainty, security risk, and economic risk are used to describe the same type of risk. According to John and Lawton (2018, 2) political risk stands for the likelihood that a particular activity or inactivity within the political sphere will result in either positive or negative alterations, consistently or occasionally, in the financial performance of companies in both macro and micro levels. Some studies also refer to political risk as the prospect of a negative change in the governmental regime of a country or in the policies made by that administration (Slangen & van Tulder 2009, 2).

As political risk has a complexity of causes, many potential impacts, and multiple forms that it can take, there is no one definition for the term. Political risk can be any political event that is capable of directly or indirectly shaping the value of an economic asset. Examples of political risks could be a proclamation of war, an act of terrorism, a law that encourages for expropriation of private property, and a modification of the rules for foreign investment. Political risk is often inflicted by governments, rebel groups, nongovernmental organizations, individuals, and any other individual who carries out a political activity. (Bremmer & Keat 2010, 9.) Next, the thesis will cover all the major kinds of political risk. Broadly political risk has been divided into two main categories: non-violent and violent political risks.

2.2 Types of political risk

2.2.1 Non-violent political risks

According to Holburn and Zelner (2010, 1) non-violent political risk refers to the possibility of a government strategically changing policies in a way that directly or indirectly leads to the loss of a company's profits or assets. Given its significant authority within a country, the government can limit or guide the actions of firms and lay out what they can or cannot do while conducting business. There are three primary aspects of non-violent political risks: government type, public corruption, and leadership change (DeGhetto 2023, 1).

Government type stands for whether power is centralized in the hands of a few government leaders or if it is shared broadly and regulated with a democratic system (Delios & Henisz 2003, 3; Flores & Aguilera 2007, 7). In countries with more democratic systems, there is additional supervision and mechanisms like checks-and-balances for leaders of governments, reducing the likelihood of unpredictable and constant policy changes. The political process in such countries tends to be transparent due to the involvement of multiple parties, and there is a reliance on public support through voting, which helps protect the economy and, consequently, companies. (Holmes et al. 2013, 11.) Governments which are democratic, are also further inclined to guarantee a firm protection of property rights, which is crucial for investment and economic growth (Olson 1991, 5).

In regimes with autocratic features, governments tend to be self-contained, maintaining power and resisting replacement due to their centralized authority (Holmes et al. 2013, 11). With power concentrated in the hands of a single government leader, government policies can be changed arbitrarily, posing risks for businesses operating within those environments (Holburn & Zelner 2010, 24). In many emerging markets the government type can have been or still is autocratic, which can and often does cause volatility towards foreign MNEs. However nowadays there are a growing number of emerging market countries with democratic governments.

Some studies have found that MNEs tend to show reduced interest in investing in countries with autocratic regimes (Bilgili et al. 2023, 2). On the other hand, Holmes et al. (2013, 26), Arregle et al. (2013, 17), and Li and Resnick (2003, 30) have discovered a

negative correlation between democratic government structures and foreign investment. These discoveries suggest that multinational enterprises may prefer to invest in countries where power is concentrated because it is perceived as more efficient and less expensive (Inman & Rubinfeld 1997, 19). Instead of navigating the demands of various policymakers with differing viewpoints, MNEs might find it simpler to negotiate with a single leader (Jensen 2003, 8). Additionally, costs, including labour expenses, are usually lower, partly due to wages being managed by central authorities with minimal contribution from the population (Rodrik 1999, 75).

As the emerging market countries all have their own unique features, they also have very diverse political circumstances and various types of governance (Bremmer & Keat 2010, 68). Government types in the emerging market countries can be ones with democratic features or ones with more autocratic features. For example, in emerging market countries like Brazil, India, Mexico, and South Korea, the government type could be described as democratic as they rely on fairly independent political institutions and not on individual leaders or small elites. On the contrary, there are emerging market countries with very autocratic governments. Examples of these could be Saudi Arabia and China as in these countries the government is controlled by a small group of elites. (Bremmer & Keat 2010, 70–71.)

The second aspect of non-violent political risks is public corruption (DeGhetto 2023, 14). Public corruption occurs when political leaders abuse their power for personal gain rather than acting in the best interests of the citizens they represent (Bahoo et al. 2020, 2; Judge et al. 2011, 1). This often includes governments enforcing unofficial charges on multinational enterprises and local organizations. To gain advantages such as government agreements, import or export rights, permits, and licences, firms may be required to pay bribes or provide favours to government officials.

In most cases public corruption is observed in a negative light. It is frequently associated with differing unfavourable consequences, including income inequality, reduced financing for health care and education, economic recessions, minimal entrepreneurial activity, decreased innovation, and lower tax revenues. (Collier 2002, 1; Zhao et al. 2003, 2). There are environments where public corruption has generalized, which means that regulations are not carried out constantly and firms conduct themselves in a biased and unethical way. Instead of following established rules, offering bribes turns into standard

practice and is used to access business opportunities. (DeGhetto 2023, 15.) In nations with corruption, governments regularly operate without transparency in their policies and processes (Tanzi 1998, 33).

In emerging market countries public corruption is often visible in some form. Some emerging market countries have extremely high levels of public corruption, such as Venezuela, Russia, and China, whereas emerging market countries, such as Singapore and Hong Kong, have quite low levels of public corruption. Additionally, public corruption is not only a problem in the emerging markets but also in the advanced economies. However, some of the highest levels of public corruption can be found in some of the emerging market countries and the emerging market countries have had the biggest difficulties in trying to reduce public corruption. (Goncalves et al. 2014, 68–80.)

Multinational enterprises might regularly face uncertainty about when they will be asked to pay bribes. Additionally, they might wonder who will make these demands, the amount expected to be paid illegally, and whether the promised results will actually be fulfilled. (Cuervo-Cazurra 2016, 4.) Furthermore, various countries have regulations like the United States' Foreign Corrupt Practices Act (FCPA) which will restrict companies from engaging in bribery, despite some nations where such actions are fairly common (Cuervo-Cazurra 2006, 4).

The third aspect of non-violent political risks is change in political leadership. Continuous alteration in political leadership can inflict instability related to the country's policies and procedures. (Amore & Corina 2021, 2; Vaaler 2008, 1.) Changes in political parties or regimes can bring up uncertainty related to the continuity or changes in existing laws, which can impact the operations of MNEs (Wang et al. 2021, 2–3). Government authorities have the influence to alter regulations that directly impact MNEs. These officials often lack the sufficient checks on their authority, and they may apply regulations in a contradictory way. Additionally, they often show bias towards certain firms, such as local competitors or those with connections to the government, while potentially disadvantaging others, particularly foreign multinational enterprises, in matters relating to property rights, taxation, and similar areas. (Vaaler 2008, 19–20.)

Similarly, studies have referred to the general unstableness of the government, even outside of election cycles, might create instability for MNEs because they are afraid of potential regime changes (Bailey 2018, 2). Consequently, most studies show that political

elections and instability lead to decreased investments from MNEs (Amore & Corina 2021, 1). This is an issue especially in emerging market countries where the constant change in leadership is much more common than in developed economies (Bremmer & Keat 2010, 76–77).

2.2.2 Violent political risks

The violent political risk refers to risk that causes harm to civilians' life and firm's property (DeGhetto 2024, 2). There has been a great amount of studies that focus on how the violent features of political risks influence MNEs investment decisions. Many countries globally have to endure violence towards their political institutions but still violence is often neglected. According to Hiatt and Sine (2014, 1) the presence or absence of violence and unrest play an important role in moulding the institutional environment. The violent political risk can be divided into two major aspects: armed conflict and terrorism (DeGhetto 2024, 11). Armed conflict and terrorism both have the ability to make an impact on the stability and security of emerging market countries and both of these aspects can harm the interest of MNEs in investing in the country. In these situations, MNEs often have doubts on if their human and physical assets would be safe.

Armed conflict, also referred to as violent conflict, political conflict, political violence, and war, involves militarized confrontations leading to remarkable casualties (Chen 2017, 2). According to Oh and Oetzel (2017, 7) armed conflict refers to the deliberate and ongoing use of physical force resulting in injury, death, or damage of property, typically involving at least 25 battle-related deaths. Frequently in armed conflicts, at least one participant in the incident is the government of the country (Witte et al. 2020, 4). Above all, armed conflict has gained heightened attention due to around 30% of MNEs experiencing challenges linked to armed conflicts, with the risk of losing immense amounts of assets (Dai et al. 2017, 1).

Environments in which armed conflicts take place, there might be casualties among civilians, including employees of multinational enterprises and their partners. Moreover, MNEs and their partners' infrastructure may sustain harm. The destruction of local infrastructure, along with the broader economic and political consequences of armed conflicts, can harm MNEs' competitiveness in the damaged country. (Oh & Oetzel 2017, 3.) Most of research point out that armed conflicts cause a direct decrease in investments of MNEs (Dai et al. 2017; Oh et al. 2021; Oh & Oetzel 2017; Witte et al. 2020). According

to Witte et al. (2020, 9) armed conflicts reduce the likelihood of investment from 2.3 precent to 1.9 precent and additionally diminishes the area’s appeal by 16.5 precent.

At the same time MNEs can opt to invest in countries that face armed conflict and discover ways to operate successfully in the environment. MNEs can gain experience in operating within these areas, and therefore MNEs that have experience of operating in armed conflict areas are more likely to invest in these areas. (Oh & Oetzel 2017, 2; Oh et al. 2021, 1–2.) Multinational enterprises that operate in various markets can more easily invest in more risky areas as they can rely on the other markets (Witte et al. 2017, 9–10). Additionally, some of these zones’ conflicts are not in close proximity with the MNEs assets, above all in large countries (Chen 2017, 2; Dai et al. 2017, 2–3).

Armed conflicts can be a difficult issue especially in emerging market countries. A great example of armed conflict as a political risk for MNEs would be the war that Russia started in Ukraine in 2022. The war has made it harder to invest into Ukraine as there is an active armed conflict. Therefore, Ukraine has not received foreign investments in the time that the country has been attacked by Russia. MNEs are afraid of the physical risk that investment in Ukraine would cause. For instance, purchasing a factory in Ukraine can be dangerous as Russia has been intentionally destroying factories in Ukraine to cause economic harm. Nevertheless, there are MNEs that have continued to invest in Ukraine, one of these being the Carlsberg Group. Almost all MNEs that still operate in Ukraine are companies that have operated in the country for many years before the invasion of Russia. (Culverwell 2024.)

The second aspect of violent political risk is terrorism. Terrorist attacks, unlike prolonged wars, are sudden and momentary events. Examples of these events are the 9/11 attacks in the U.S. or the mosque attacks in New Zealand. These attacks, planned to reach political objectives, are usually committed by non-military groups, differentiating them from conventional armed conflicts. (Czinkota et al. 2010, 3; Dimitrova et al. 2022, 2–3.) Another definition used for terrorism is the organized application of violence, either threatened or executed, to reach political objectives or to pass on a political message by implanting fear, compulsion, or intimidation among particular individuals or the broader population. Terrorism classifies as a political risk because it has a political motive behind it. (Dimitrova et al. 2022, 2.)

Terrorism can present various risks to MNEs, involving harm to employees, damage to infrastructure, disruptions to transportation, psychological harm among shareholders, growing security expenses, and declines in stock prices (Czinkota et al. 2010, 2; Dimitrova et al. 2022, 2–3). Consequently, terrorism in host countries endanger the resources of MNEs and raises transaction prices (Czinkota et al. 2010, 2).

For multinational enterprises terrorism poses a growing threat (Liu & Li 2020, 1). According to Abadie and Gardeazabal (2008, 20) terrorism significantly decreases foreign investment, despite considering other features connected to host country risk. Especially in emerging market countries the threat of terrorism is significant because these countries do not usually have stable institutions and financial markets which might cause over reactions and ineffective applications of the policies and standards initiated by the country's government after the terrorist attack. (Mnasri & Nechi 2016, 2.) In particular terrorism is an enormous issue in the MENA countries which consists of the Middle East and North Africa. These countries can be also seen as emerging markets countries. (Dimitrova et al. 2022, 2.)

Although most research finds that terrorism is seen unfavourably by MNEs, there are studies that do not find terrorism to have a direct and significant negative impact on MNEs' operations. This is the case at least in some industries and in the last few years. (Arif et al. 2020, 8.) Moreover, Oetzel and Oh (2014, 20) note that earlier exposure to terrorism in a specific host country may even lead to increased investments within that country, even though this trend might not extend to other countries that face equivalent terrorism risks.

3 Political risk management in emerging markets

New literature emerged in the 1980s when countries globally opened to foreign investments and embraced market-friendly approaches. This literature challenged traditional views on political risk management, which believed in government authority and described firms as the passive participants in the political environment. (Poynter 1982, 1.) As mentioned in chapter 2 political risk does not always lead to negative results (Jiménez et al. 2014, 1). MNEs can control and decrease political risk by taking an active approach in the political setting and by that persuade governmental decisions (Puck et al. 2013, 9).

Managing political risk demands a flexible and creative viewpoint mixed with demonstrated expertise, according to Bremmer and Keat (2010, 2). John and Lawton (2018, 6) stress the significance of effectively balancing internal and external reliances to be successful in political risk management. Various methods, and perspectives exist to assist MNEs in apprehending and predicting political risk better. In chapter 3.1 the thesis will discuss different perspectives and methods on political risk management. (Bremmer & Keat 2010, 11.) Political risk management is particularly challenging in emerging market countries. Multinational enterprises operating in emerging markets encounter various social and political environments that have quickly developed alongside their economic structures. Additionally, the liberalization of these markets has led to both development and instability, aggravated by international economic crises. The economic advancement experienced in these emerging market countries frequently outpaces the organizational and managerial competences essential to effectively engage with foreign firms. (Ghauri et al. 2012, 1–2.)

3.1 Perspectives to managing political risk

There are three different perspectives on political risk management: the institutional view, the resources and capabilities view, and the resource dependence view. These perspectives influence how firms address political risk, both externally, for example through public policy initiatives, and internally through their corporative impact. External public policy efforts aim to improve the firm's competitive standing by influencing or upholding existing policies, which in turn can affect market performance, financial indicators, and safety of assets. (John & Lawton 2018, 8.) The effectiveness of these

perspectives on political risk management can vary across different national contexts (John & Lawton 2018, 1).

3.1.1 Institutional view

The institutional view on political risk and FDI decisions in international business is widely recognized and firmly established (Dahan et al. 2006, 6). The institutions view considers political risk synonymous with political uncertainty, viewing it as a variable with an uncertain probability. This view acknowledges that political risk poses negative effects on FDI and suggest that it should be avoided. Additionally it agrees that firms have limited control over political risk. (John & Lawton 2018, 8.)

According to John and Lawton (2018, 8) the institutions perspective presumes a one-way connection between foreign firms and their institutional environments. While companies are integrated within their institutional environments, they lack the ability to influence them. Instead, these institutional environments impact firms and their decisions on FDI. Factors such as unclear regulative environments, undeveloped judicial and financial organizations, corruption, and involvement in political conflicts, contribute to heightened political uncertainty. The institutions view entails three different approaches: new institutions economics, new institutional perspectives, and national business systems.

The new institutional economics view advances the political risk management studies by concentrating on how political and regulatory instability alters the decisions of firms. Research in this area primarily examines ways to mitigate the impact of instability in regulatory institutions, and the risks faced by FDI due to changes in the institutional environments of both home and host countries, as well as factors that can moderate these effects. (Cherchye & Verriest 2016, 13.) An example of new institutional economics view could be that Singapore is widely regarded as a top destination for business and trade because of its transparent and steady political and regulatory environment whereas Venezuela's political and regulatory uncertainties further its poor economic prospects. (Doh et al. 2012, 5.)

Most research agrees that risks stemming from uncertainties related to unclear regulatory environments, weak judicial and financial organizations, corruption, and involvement in political conflicts between states expand the expenses involved and consequently dissuade FDI (Chung and Beamish 2005, 5) Nevertheless, certain studies have illustrated

instances where firms are not always deterred by political risk in specific host countries. Firstly, firms might choose less risky entry modes (Delios & Henisz 2003, 9; López-Duarte & Vidal-Suárez 2013, 8). Secondly, firms with prior experience in politically volatile or culturally similar contexts are more inclined to invest in regions with political risks (Kolstad & Wiig 2012, 8; Meschi & Riccio 2008, 15).

Lastly, there are external factors at both industry and country levels that moderate the adverse impacts of political risk on FDI. Political risks pose a greater challenge for industries with heavy regulations, as noted by Desbordes (2007, 9) and García-Canal and Guillén (2008, 2). In the national level, these risks are influenced by factors such as the home country institutions and relations among home and host countries. For example, investment in politically unstable regions might be driven by the desire to evade home country institutional constraints (Witt & Lewin 2007, 1). At the same time, politically risky environments might be appealing due to factors like the host country's economic size, proximity, cultural similarities, governance principles, and cost structures relative to the investor's home country, as suggested by the gravity model (Arregle et al. 2013, 15).

The new institutional perspective (DiMaggio & Powell 1983, 12), otherwise referred to as organizational sociology, focuses especially on the social structures and relationships within societies. It explores how these societal pressures influence organizations and their reactions to political risks. This perspective notifies how social norms and practices impact investment climates and governmental policies. Most significantly this perspective informs how those norms and practises shape the decisions of firms operating in host countries with elevated political risks. (John & Lawton 2018, 11.) An example of the new institutional perspective would be when civil society standards and actions done by non-governmental organizations have an impact on government policies, thus effecting firms' decisions on foreign markets. For example, starting up a factory in Germany includes more costs and time compared to Turkey as a result of greater involvement and influence of civil society. (Doh et al. 2012, 5.)

According to John and Lawton (2018, 11) The new institutional perspective suggests that because firms are deeply connected to their social and institutional surroundings, they face pressures, mimetic, normative and coercive, that drive them to respond similarly to challenges. This often results in a uniformity or similarity among firms within the same

industry. For example, firms might adopt similar strategies for managing political risks in foreign markets by mimicking the actions of their competitors.

Additionally, when contemplating entering a country with significant political risk, a multinational corporation might not always choose a safer, gradual entry strategy in which they establish a joint venture before setting up a wholly owned subsidiary (John & Lawton 2018, 11). Instead, the MNE might choose a wholly owned subsidiary if this mode of entry is generally used by other multinational firms (Guillén 2003, 12). Simultaneously, Xie and Li (2017, 17) and Zheng (2012, 9) argue that in environments with strict regulations and higher likelihood of political risk events like expropriation and forced exit, foreign companies are more inclined to selecting entry modes which have been previously proven successful by other firms in the same market.

The national business systems perspective shares some common aspects with both the new institutional economics and the new institutional theory. It directs attention away from just institutional and social constructions to the distinctions within various national economic systems (Doh et al. 2012, 6). The key idea here is that there are connections among societal institutions and economic and social results, especially regarding non-market aspects like managing political risks (Hotho 2014, 2).

The emphasis is placed on understanding how and why companies with varying institutional backgrounds, for example cultural or regulatory factors, might build up skills to effectively mitigate political risk. Additionally, the national business systems perspective explores how disparities in national institutional organizations influence firms' exposure to political risk and their strategies for managing it. (Salomon and Wu 2012, 22). An example of the national business system perspective is when Chinese companies expanding into Europe are aware of the standardized regulations resulting from EU membership, yet they can leverage the differences present in individual country markets, including variations in tax laws and labor regulations. (Doh et al. 2012, 5).

Additionally, the institutional view has some challenging views. In the new institutional economics, studies argue that firms do not necessarily avoid investing in politically unstable environments, instead, they may opt for less risky entry strategies or target host countries with support or favorable relations from their home country. (López-Duarte & Vidal Suárez 2013, 8; Slangen & van Tulder 2009, 14.) Meanwhile, within the new institutional perspective, firms are seen as lacking a systematic approach to managing

political risk, with their control over such risks being the result of imitative decisions (Rodriguez et al. 2005, 11). In the national business systems perspective, firms may achieve control over political risk by entering countries with similar institutional structures, enabling them to benefit from established approaches to political risk management (Quer et al. 2012, 12).

3.1.2 Resources and capabilities view

The resources and capabilities view of political risk management sees political risk as a source of opportunities (Alon & Herbert 2009, 10; Frynas et al. 2006, 21; Jiménez & Delgado-García 2012, 2). This view puts importance on firms and their internal sources of political risk management. Moreover, this view sees the opportunity to use resources and capabilities in political risk management.

The majority of studies in the resources and capabilities field base their analyses on the resource-based view (Peteraf 1993, 9; Wernerfelt 1984, 1). This view assumes that companies can be understood as collections of political resources and capabilities. Frynas et al. (2006, 4) proposes that political resources, like other types of resources, can be categorized broadly into three groups: physical capital resources (such as a company's nationality indicating the level of protection from its home government), human capital resources (for example managers' experience in communicating with government officials in emerging markets), and organizational capital resources (for instance the relations between a firm's managers and policymakers).

Political capabilities signify a company's ability to effectively utilize its political resources overtime (Holburn & Zelner 2010, 2). For instance, having connections with key policymakers is seen as a resource (Frynas et al. 2006, 4), while the capacity to leverage these connections by understanding the preferences of influential political actors constitutes a political capability (Holburn & Zelner 2010, 3–4). Likewise, having experience in interacting with government officials is considered a human political resource (Frynas et al. 2006, 4). Nonetheless, the capability to use this experience to build relationships with officials and influence policy decisions represents a political capability (Holburn & Zelner 2010, 24).

The resource-based view of political risk management suggests that firms have differing political resources and capabilities, influencing their capability to assess and manage risks

linked with policymaking processes. This view underlines that firms' political resources and capabilities are shaped by their distinct experiences. (Holburn & Zelner 2010, 4; Jiménez et al. 2014, 9.) According to this view, these heterogeneous resources and capabilities play an essential role in establishing firms' permanent competitive advantage and performance (Barney 2001, 8). Critical political resources are seen as vital for accomplishing excellent performance and maintaining competitive advantage since they are valuable, unique, and challenging to repeat (Holburn & Zelner 2010, 5). Successful political strategies and experiences are generally hidden, thus not copied without difficulty (Oetzel & Oh 2014, 5).

However there are some challenging views on the resources and capabilities view. According to García-Canal and Guillén (2008, 13) having political expertise does not always result in decisions favoring entry into markets with political risk. In addition, employing political strategies does not always enhance performance. For instance, Puck et al. (2013, 11) found that in emerging markets, actions like financial incentives and constituency-building do not automatically decrease political risk or create value. At times, they may even cause a competitive disadvantage.

According to John and Lawton (2018, 17) the resources and capabilities view of political risk management offers a micro-view of political risk as it sees political risk through the viewpoint of the firm. Additionally this view challenges the conventional view that political risk always discourages investment, proposing instead that it can introduce opportunities (Jiménez et al. 2014, 1). Hence, firms should not avoid political risk but rather manage it to their advantage (Holburn & Zelner 2010, 24). This view relocates the focus from seeing multinational enterprises as passive objects in dealing with government to perceiving them as proactive managers of political risk (Jiménez & Delgado-García 2012, 7; Jiménez et al. 2014, 9).

3.1.3 Resource dependence view

The resource dependence view examines how MNEs manage political risk by examining their reliance on resources from multiple organizations, including host governments, local partner firms, parent companies and non-governmental organizations. (Holtbrügge et al. 2007, 1.) This view, which is founded on the resource dependence theory, proposes that firms are co-dependent rather than autonomous entities in dealing with political risk. This view assumes that firms are influenced by their external environment, especially political

uncertainty, which can prevent foreign direct investments. (Hillman et al. 2009.) To mitigate this uncertainty, firms try to alter their environments by managing their relationships and focusing on creating more favorable conditions with the political organizations close to them (Arnoldi & Villadsen 2015, 15–16).

The resource dependence view seeks to find out how reliance on external resources influences the impact of political risks. Studies display that when firms count heavily on resources from host partners, they confront greater risks in environments with regulatory uncertainties and low policy credibility. (Liu et al. 2016, 3). In addition, this view examines how managers address political risk by managing these resource dependencies. (Arnoldi & Villadsen 2015, 5; Holtbrügge et al. 2007, 6–7). This view proposes that firms commonly mitigate political risk through two main methods: leveraging bargaining power and engaging stakeholders (John & Lawton 2018, 18).

The first method focuses on bargaining power, which determines the effectiveness of negotiation strategies and helps to achieve wanted results. It analyses the power of bargaining between the firms and host-country entities like governments or partner firms within a mutually dependent relationship. (Inkpen & Beamish 1997, 3.) Bargaining power enhances when the foreign firm controls crucial resources and reduces its reliance on external resources. To the contrary, it declines when the firm loses control over vital resources and becomes more dependent on external sources. (Choudhury & Khanna 2014, 5). Likewise, the bargaining power of host organizations is established by their resource control and dependence. Consequently, negotiations between firms and host organizations contain continuous resource exchanges, where outcomes depend on the resources each party obtains and requires from the other (Inkpen & Beamish 1997, 22).

In contrast, the method of engaging stakeholders relocates the focus from power dynamics in a one-on-one relationship to the complicated web of interdependencies involving multiple actors, known as stakeholders, within the political landscape (Holtbrügge et al. 2007, 3). This method proposes that reliance on important resources and capabilities, and its effect on foreign investment in politically unpredictable contexts, results from interactions with diverse internal and external shareholders who control these resources and capabilities. These stakeholders may consist of governments, national and international non-governmental organizations like Greenpeace, and supranational entities

such as the European Union. (Choudhury and Khanna 2014, 14–15; Holtbrügge et al. 2007, 16.)

According to Liu et al. (2016, 2–5) both the bargaining power method and the stakeholder engagement method can be approached through two main strategies: risk aversion and risk taking. Risk aversion includes avoiding investment in projects with high interdependence, such as in countries where critical resources are tied to politically unsteady governments or unreliable partner firms. This aligns with the institutional view, indicating that political risk prevents foreign investment. At the same time, firms can engage in foreign direct investment with lower interdependence, which allows greater control over critical resources. Achieving lower interdependence includes diminishing ties with resource-controlling entities, like streamlining staff and localizing marketing efforts, and improving internal capabilities such as networking and forming alliances for resource supply. Nevertheless, while risk aversion strategies may diminish political risk, they may also cause missed business opportunities, causing reconsideration of the necessity to decrease political risk. Eventually, firms may need to accept some level of political risk to capitalize on opportunities.

The resource dependence view contributes to the traditional view of political risk from the perspective of how firms rely on external resources. While recognizing the mostly negative impact of political risk on foreign investments, it proposes that firms can diminish political risk through the management of these dependences. In addition, the view advises against only adopting risk-averse strategies without considering possible business opportunities. (Liu et al. 2016, 10).

3.2 Approaches to risk management

Next, I will be discussing three different approaches to political risk management. According to John and Lawton (2018, 20) the different perspectives for political risk management, institutions view, resources and capabilities view, and resource dependence view, all support different approaches. These approaches are called the reactive approach, the proactive approach, and the active approach. The effectiveness of the three approaches can differ depending on the national context. In some emerging market countries where institutional systems are clearly outlined, the reactive approach might serve better. Whereas managers might refrain from embeddedness into institutional systems by choosing the proactive approach in highly volatile contexts. At the same time, the active

approach may be preferred where firms find themselves in a position with resource interdependence with other actors in the political landscape.

3.2.1 Reactive approach

The institutional view supports a reactive approach to management of political risk with MNE investing abroad. With the reactive approach the MNEs lack the ability to influence their political environments, thus leading to a reactive stance where firms react to political risks but are not able to control them. When using the reactive approach, MNEs align with the political environment by complying with regulatory standards. Therefore, political risk management becomes primarily focused on supporting decisions related to market entry and exit. (John & Lawton 2018, 20.)

Decisions based on the reactive approach are deemed more suitable in environments where institutional systems are comparatively well-defined and exhibit uniformity across different regions within a country. Russia and China are prime examples of such environments, as the two countries have relatively strong central government authorities and national institutional systems with considerable homogeneity across regions. (John & Lawton 2018, 20.)

The political risks for a foreign MNE will rely on its adaptation, or embeddedness, into the host institutional systems. For example, in spite of the stably growing importance of local governments, the performance of MNEs in China has been extremely dependent on their relationships to the central government (De Fouloy 2014). Likewise, in Russia, the federal reform strengthened the power of the central government over federal governments by consolidating them into federal districts, with emissaries directly appointed by the president of the Russian Federation (Kordonsky 2016).

3.2.2 Proactive approach

The perspective of resources and capabilities advocates for a proactive stance in managing political risks. Firms seeking to generate value from political risk are likely to take on proactive political approaches. Proactive approaches require internal capabilities such as environmental scanning, and predictive capabilities to anticipate public policy changes and resultant opportunities. This viewpoint suggests that employing a resource-based approach to political risk management is more likely to produce positive outcomes

in environments characterized by high volatility and weak governmental structures, where institutional systems are incoherent or undergoing transitions, such as the decentralization of powers from national governments to lower-level administrative units like states, provinces, and counties. With this viewpoint firms are not able to avoid political risk, but they can also benefit from it. Firms are not necessarily worried with how to evade or decrease political risks whereas, they may use political risks to benefit of opportunities in the non-market and market environments. (John & Lawton 2018, 20.)

Proactive approaches involve influence capabilities that allow a firm to leverage political risk by shaping the non-market environment. This can include redefining norms and setting standards to reshape current legislation. Relying on resources and capabilities, including adaptive capabilities, can be especially effective in volatile contexts, as observed in countries like Venezuela, Ecuador, Nicaragua, and Ukraine (De Villa et al. 2015). Moreover, this approach may prove beneficial for multinational enterprises that operate in the United Kingdom, given the transitions driven by devolution in the institutional systems of Scotland, Wales, and Northern Ireland (O'Neill 2014).

3.2.3 Active approach

The resource dependence view of political risk management promotes an active approach. Taking advantage of the active approach is suitable when there are resources present and dependence relationships between a multinational corporation and other actors within its environment. Organizations may attempt to decrease their political instability by managing external interdependencies. Nevertheless, these attempts might not essentially be successful and may sometimes lead to new patterns of interdependencies. As mentioned previously in chapter 3.1, the resource dependence view consists of two major methods: bargaining power method and the stakeholder engagement method. (John & Lawton 2018, 21.)

According to John and Lawton (2018, 21) the stakeholder engagement method can be useful where there is a decentralized authority due to elements such as federal structure, ethnic and religious division, and historical development. In such situations there is significant variation in norms, behaviors, along with enforcement of regulations across different regions of a country. With countries like this, bargaining of local authorities aids MNEs in their integration into specific regions. For instance in India, each state has its particular institutional organization (Aggarwal 2005). Similarly in Mozambique,

provinces exhibit varying political orientations. Some provinces, particularly those in the center of the country, are subject to more significant authority and control by the political opposition to the central government and the party that is ruling (Beck 2014). MNEs can reduce political risks associated with their investments in these contexts by accruing bargaining power compared to local governments. A failure to reach agreements with local authorities may lead to withdraw of investments. (John & Lawton 2018, 21.)

The active approach can also be beneficial when a multinational corporation has interconnected resource relationships with various stakeholders within the political landscape. When considering investment in a particular sub-national region of a host country, a multinational corporation might not only need to negotiate with the local government of the state, but also take into consideration the concerns of other political stakeholders, such as local communities. (John & Lawton 2018, 21.) For instance, Coca Cola faced challenges when it had to close a bottling plant in Mehdiganj, India due to protests from the local community regarding Coca Cola’s industrial waste discharge and its use of poor groundwater resources. Consequently, the local government cancelled the company’s permission to operate the bottling plant within the area. (The Ecologist 2014.) Likewise, to maintain its gas exploration operations in the Inhaminga, Pande and Temane areas of Mozambique, South African company Sasol engaged with local communities in generating biofuels, for example oil from Jatropha plants. (Borras et al. 2013.)

4 Conclusions

The aim of this thesis was to look into how political risks affect the internalization of multinational enterprises into the emerging markets. The goal of the thesis was to investigate how these political risks can be managed in the emerging market and what kind of approaches there are to do that. This thesis focuses especially on political risks in emerging markets as there has not been research on how political risk in the emerging market affect multinational enterprises. There were three sub-questions aimed to answer the main goal of the thesis comprehensively: “What are political risks?”, “In which ways are political risks visible in emerging markets?”, and “How can MNEs manage political risks in emerging markets?”.

Chapter 2 covered what political risks are and how they can be classified. Political risk was identified as a risk that a political action will cause for companies and usually cause some economic consequences. Political risk was also divided into two bigger categories: non-violent and violent political risks. Non-violent political risks were identified as governments actions that cause a loss of company’s assets. Additionally violent political risks were identified as risks that cause damage to human life or the company’s property. Both of these risks are equally as important, but the violent political risks can cause much more serious harm.

Also the chapter 2. discussed the three different aspects of the non-violent political risks and two different aspects of violent political risks. These aspects are not the only possible political risk options, but they cover the most important features of these risks. The non-violent political risk aspects were government type, public corruption, and leadership change. These aspects were discussed with the focus on emerging markets and this thesis found some clear differences inside the emerging market. In the violent political risks, the aspects were armed conflict and terrorism, which were also examined with a focus on the emerging market. Both armed conflict and terrorism were found to be present in emerging markets, even though these features are showing also in the advanced economies.

Political risk management in the emerging markets was covered in chapter 3. Emerging markets were found to have features that make management of political risks more challenging. For instance, emerging markets often have unstable political environments,

and they lack institutional and managerial competences. These challenges are frequently caused by fast transitions of economic structures. Emerging markets are often dominated by hierarchical political power and a heritage of extensive state intervention in the economy. Chapter 3. also covers the different perspective to political risk management. These are the institutional view, the resource and capabilities view, and the resource dependence view. These perspectives affect how firms look at political risk, both externally and internally. The institutional view sees political risk in a negative light and believes that is should be avoided. This view believes that MNEs have no influence on political risk. The resource and capabilities view believes that political risk can bring new opportunities for the MNE and that the resources and capabilities of the firm determine how those political risks are seen. The resource dependence view sees that political risk is something that MNEs can handle with the reliances that they have on other organizations.

There are three different possible approaches for MNEs on how to handle political risk. These approaches are the reactive approach, the proactive approach, and the active approach. All of these approaches address political risk in varying ways. The reactive approach supports a view that political risk should be addressed by aligning with the regulatory standards in the emerging market that they operate. The proactive approach believes that political risk should be managed by relying on the resources and capabilities that the MNE obtains. Lastly, the active approach supports that political risk should be managed through the dependence relationship it has with different stakeholders. Figure 1 tries to explain the interconnectedness of all the different approaches and perspectives, while also connecting the different types of political risk with it.

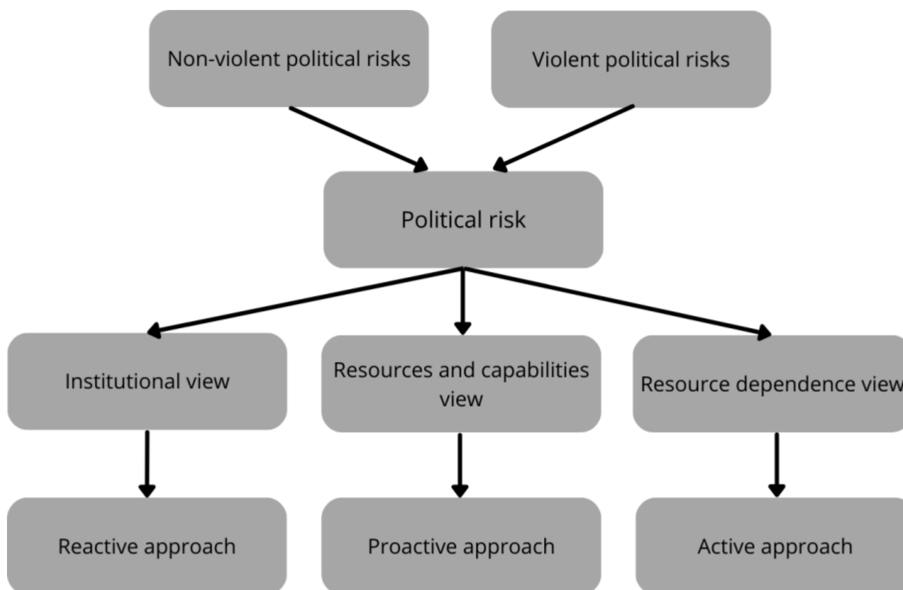

Figure 1 Political risk relationships between different approaches and perspectives

Figure 1 illustrates how the different perspectives on political risk affect the approaches of companies and the whole connectedness of all the topics that were covered in this thesis. The thesis shows that political risks can be managed even in emerging markets. The management of political risks is crucial especially in emerging markets as in those markets the management of political risk can be the factor that determines if the MNE can invest in the region. In the future political risks need to be considered by MNEs more than before as increasingly more countries becomes emerging market countries with diverse political risks.

Previous research on political risk management in the emerging markets is very limited. Likely this lack of focus on emerging market countries is due to the methodological problems that relate to the nature of political activities in these environments. The lack of transparency within the political environment in these economies prevents use of political resources and capabilities affecting foreign outcomes of political risk. Most studies rely on quantitative analyses of secondary data, which can be difficult to obtain in emerging markets. Formal reporting of corporate political activities in these markets is rare, making use of secondary data hard. For future research it would be beneficial to look into the emerging market perspective and focus more thoroughly on specific emerging market countries as they can differ from one another quite dramatically. Also, political risks in the context of how they affect MNEs need to be studied further.

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