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## What Is an Emerging Market Economy? : Acronyms or Attributes

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### **Abstract:**

*It is not clear to anyone exactly what an emerging market economy is but we try to explain it. In this paper, we carry out a literature survey of the acronyms commonly used to describe emerging market economies. After reviewing the acronyms and their origins, we surmise that they are of very little practical significance to businesses. We argue that emerging market economies have a number of common attributes. Moreover, it is these distinguishing attributes rather than the common acronyms, that practicing businessmen need to be aware of if they wish to be successful in emerging market economies.*

### **1. Introduction**

A market economy is one in which prices are generally determined by the forces of demand and supply. Demand and supply are effectively synonyms for consumption and production. Resources are allocated to consumption and production activities based on freely determined prices. A market economy can be contrasted with the opposite extreme of a command economy in which the government determines prices and decides how (and in what quantities) resources should be allocated to production and consumption. Market economies have in-built dynamism that leads to economic growth and wealth creation. An emerging market economy is therefore, an economy that is (or has recently become) market oriented, and is emerging in the sense that it is growing in a noticeable and measurable manner. An emerging market economy is just coming into view.

An emerging market economy should not be confused with an emerging market. They are related concepts but they are not the same. An emerging market is any market that is just being formed or is growing. An emerging market can be in any economy, developed or less developed. In the colloquial sense, the term "emerging market" usually applies to the capital market of an emerging market economy.

Over the past decade, countries that only recently initiated market orientation reforms started recording impressive growth rates. As their growth rates soared, they have captured the interest of everyone from sophisticated investors, to politicians and the general media. Acronyms, of which the most prevalent is BRIC, have been used to describe them. One of the objectives of this paper is to carry out a survey of the common acronyms used to describe emerging market economies. In doing so, we try to decipher whether the acronyms have much meaning or in fact teach us anything about how to conduct business in emerging market economies. We compare what we learn from the acronyms with what we can learn from a detailed set of common attributes of the relevant countries. We find that the list of attributes gives a richer view of opportunities and threats that can emanate from operating businesses in emerging market economies. Foreign direct investors would be better served by acquainting themselves with attributes rather than acronyms.

The rest of the paper is organized as follows. Section 2 goes through the common acronyms and traces their histories. It becomes obvious that the acronyms are of much value in the investment banking industry, and are therefore better suited to portfolio investors than foreign direct investors. Section 3 presents some of the common attributes of emerging market economies. In this, we try to draw out implications of these attributes for businesses. Some of the implications are well known, but some of those that we pinpoint have been overlooked in the international business literature. Section 4 provides concluding remarks.

### **2. The Acronyms**

In the second half of the 20<sup>th</sup> century, economic locations fell into either of three blocks: West, East, or Third World. This was very much based on ideology and international politics. The West comprised the United States, Canada, Western Europe, and in some descriptions, other allies such as Japan. The East was the Soviet Union and Eastern European countries. The third world comprised countries that did not fit into either of the two categories. They were sometimes alternatively called the South (or non-aligned countries). Western countries were typically market economies whilst Eastern countries were centrally planned economies with strong socialist tendencies. The third world was a mix, but more usually heavily dirigiste.

Things started to change significantly in the 1980s. The centrally planned economies started to see the errors in their ways. The Soviet Union collapsed, its constituent states went their separate ways, and each one carried out its own form of market oriented economic reforms. The biggest soviet state, Russia, emerged from its own period of *perestroika* as a large state transitioning to a commodity rich market economy. China was also switching from socialism to something they called "socialism with Chinese characteristics" which

meant they allowed private enterprise and private ownership. The benefits, in terms of economic growth, derived from this meant that they eventually started to refer to themselves by the somewhat oxymoronic term - “socialist market economy”. The third world was also changing. Many third world countries in Asia, Latin America, and Africa had run into debt problems typically brought on by their governments trying to control and fund everything. The result was bail outs by multilateral institutions such as the World Bank and IMF. These institutions never lent money to third world governments without conditionalities that limited the likelihood of recurrence and enhanced the ability to pay back. This translates into setting conditions that required cuts in government spending and carrying out market reforms in their countries. Essentially, third world countries had to change their economic structures, hence the often misunderstood term “Structural Adjustment”. All in all, market oriented economies became pervasive and third world economies started to record economic growth rates higher than they had ever previously experienced.

Prior to this, the economies of the West were the most successful. They were market oriented and the fact that there was a lot of intra-industry trade between them meant that they had become mutually dependent. In the light of this, it made sense for their economic policies to be co-ordinated. The forum at which co-ordinated economic policies were discussed, examined, and decided upon was the G7 meetings held annually. The G7 was the group of seven countries that are the richest in terms of GDP (national income), i.e. United States, Japan, Germany, France, Britain, Canada and Italy. In 1991, the Soviet leader, Mikhail Gorbachev, intent upon seeking financial assistance for his country, made it known that he wished to attend the annual summit. He was, perhaps out of courtesy or pressure, invited to attend. From this point on, the forum became colloquially known as the G7+1, until 1997 when Russia was given formal admittance and it became officially renamed the G8.

### 2.1. BRIC

It is in this context that in 2001, Jim O’Neill, an economist working for Goldman Sachs, came up with the most widely used acronym to date – BRIC (O’Neill, 2001). Most observers reasoned that policy co-ordination by the G7 countries was ideal based on the fact that they constitute a very large share of the world economy. As shown in table 1, the total percentage share of world GDP represented by the G7 countries in 2000 was 70.12%. O’Neill on the other hand, pointed out two fundamental issues that called for a rethink. Firstly, the computations of GDP do not take relative price levels into account. If country GDP is recalculated using exchange rates based on purchasing power parity (i.e. taking relative price levels into consideration), the total share of G7 GDP falls to 49.47%. This is also shown in table 1.

The acronym, BRIC refers to Brazil, Russia, India and China. The shares of world GDP at purchasing power parity for these countries are shown in table 2. It can be seen that they jointly contribute 23.27% to world GDP. The argument therefore is that for proper macroeconomic policy co-ordination, this group that contributes 23.27% of world GDP should be added to the G7. It was no longer reasonable to add only Russia. It is even arguable that even if the computation of GDP was done without reference to purchasing power parity the BRICs would jointly contribute 7.95%, which might even be large enough to warrant inclusion in a policy co-ordination forum. The second point O’Neill makes is that based on the market reforms in the BRIC countries and fairly reasonable growth forecasts, the BRIC share of world GDP will continue to increase over the next few decades while that of the G7 is projected to continue decreasing.

	<b>% Share of World GDP (Year 2000 Dollars)</b>	<b>% Share of World GDP (Year 2000 PPP)</b>
United States of America	33.13	23.98
Japan	15.83	7.99
Germany	6.25	5.01
France	4.29	3.51
United Kingdom	4.71	3.43
Italy	3.58	3.38
Canada	2.33	2.17
<b>TOTAL</b>	<b>70.12</b>	<b>49.47</b>

Table 1: Source: O’Neill (2001)

	<b>% Share of World GDP (Year 2000 Dollars)</b>	<b>% Share of World GDP (Year 2000 PPP)</b>
Brazil	1.96	2.92
Russia	0.82	2.70
India	1.58	5.06
China	3.59	12.59
<b>TOTAL</b>	<b>7.95</b>	<b>23.27</b>

Table 2: Source: O’Neill (2001)

O’Neill wrote that: “Indeed on a PPP basis, China is the 2nd largest economy in the world, India the 4th largest and all four are bigger than Canada. These estimates raise important issues about the transmission of global monetary, fiscal and other economic policies, as

well as the need for general international economic and political co-operation ..... Representation at global economic policy meetings might need to be significantly changed..... A simple comparison between China and Italy serves to illustrate the point. Even on a current GDP basis, the Chinese economy is slightly bigger than Italy, so an expansionary monetary or fiscal policy in China would be likely to have slightly more global impact than similar policies in Italy.”

Hence, the initial grouping of the BRIC countries together was mainly due to the perceived need for better co-ordinated global economic policies. There is no doubt that the BRICs were regarded as emerging market economies, but there was no pretending at the outset that they were the only ones. They were merely the four countries outside the G7 that were deemed to be contributing significantly to world GDP. All four of them could at purchasing power parity claim to be bigger than at least one G7 country.

Any reference to the term BRIC to imply that they are the only emerging market economies would therefore be deviation from the original intent of the individual who coined it. Even the BRIC countries themselves seem to have not fully understood the original meaning of the term. The four countries have formed an association in which they meet annually. They have formed a political block that is supposed to be an alternative center of global political power as opposed to a cooperative alliance for co-ordinated economic policy. In 2010, they even went one step further to invite South Africa to join them thereby expanding the group to five members and changing the name to BRICS<sup>1</sup>. Thankfully, the need for international economic policy co-ordination to involve a larger number of countries is now well appreciated and the premier forum for such issues is the G20 – a group made up of the G7, BRICS, as well as Australia, Saudi Arabia, Turkey, Argentina, Mexico, Indonesia, and South Korea<sup>2, 3</sup>.

One thing about acronyms is that they help to focus attention. Even though the original purpose of the BRIC term is now lost, it has at least woken many people up to the opportunities in these countries. In addition to businesses making direct investments, the investment bankers and portfolio managers are now focused on understanding the best ways of managing risks and returns in these economies. Many investment banks, including Goldman Sachs, now have BRIC mutual funds, for exclusive investments in these countries.

## 2.2. N-11

Not everyone was satisfied with the focus on only Brazil, Russia, India, and China. As a response to the dissenters, Goldman Sachs came up with another acronym. O’Neill et al (2005) argued that although the BRIC countries still stand out, there is another group of eleven countries that can, over the next five decades, contribute substantially to world GDP growth. This group comprising Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey, and Vietnam is termed the next eleven (or N-11 for short). The countries that qualified to join this group had to meet the twin conditions of having high growth rates of GDP and large populations because this is the main criteria that singled out the BRIC countries and propels them to global significance. Population, GDP and GDP growth rates are shown in table 3.

	2005 Population (M)	5 YR Average GDP Growth Rate (2000-2005)	2005 GDP (US\$B)
Bangladesh	144	5.4%	61
Egypt	78	4.0%	91
Indonesia	242	4.6%	272
Iran	68	5.7%	203
Korea	49	5.2%	814
Mexico	106	2.6%	753
Nigeria	129	5.1%	94
Pakistan	162	4.1%	120
Philippines	88	4.7%	98
Turkey	70	4.3%	349
Vietnam	84	7.2%	47

Table 3: Source: O’Neill et al (2005)

There are a few things to note from the table. Other than Mexico, the lowest average growth rate for these countries is 4%. The country with the lowest population is (South) Korea with 49m. Korea and Mexico are special case countries that already have very high GDPs. In spite of Korea’s relatively low population and Mexico’s relatively low growth rate, their current high GDPs mean that they will be highly significant in the near future. The projections done by O’Neill et al (2005) based on these growth rates imply that by 2025 Korea and Mexico will be the ninth and eleventh richest economies in the world in terms of GDP.

<sup>1</sup>Most observers regard the invitation of South Africa to join the BRIC group as evidence that it is now more of a political acronym than a purely economic one. Jim O’Neill himself has pointed out that South Africa’s economy is a quarter the size of Russia (which is the smallest BRIC), and is simply too small to qualify as a member based on economic criteria alone.

<sup>2</sup>These are undoubtedly 20 large economies, but they are not the 20 largest.

<sup>3</sup>These 20 countries are usually referred to as the “G20 Major Economies”, to distinguish it from another group of twenty developing countries called the “G20 Developing Nations”.

All the other countries have both high populations and high growth rates of GDP. The projections of these growth rates into the future imply the following three things. First, the N-11 is unlikely to rival the BRIC countries in economic scale but by 2050 they could, as a group, reach two-thirds the size of the G7. Secondly, there is much diversity within the group of countries and performance would differ between them. For instance, given the projected growth rates, Korea overtakes Italy by 2020, Indonesia overtakes Italy by 2044, and Nigeria overtakes Italy in 2048. Hence, some countries within the N-11 could be important enough to rival current members of the G7. Thirdly, countries like Philippines, Iran, Egypt, Pakistan and Bangladesh grow but are not expected to catch up with the smallest G7 countries<sup>4</sup>.

As was to be expected, Goldman Sachs set up an N-11 equity fund in February 2011. At the end of June 2012, the fund had US\$113 million in assets. The fund has outperformed their BRIC fund gaining more than 12% compared to the BRICs 3.2% gain. The truth is that 75% of the N-11 fund is made up of equities from Mexico, Indonesia, South Korea, and Turkey. These countries make up a subset of the N-11 and go by the acronym, MIST<sup>5,6</sup>.

### 2.3. CIVETS

Again there was displeasure in some quarters regarding the choice of countries included in the N-11. South Africa, on the erroneous assumption that it is the wealthiest country on its continent, has always been a touchy customer. The view from O'Neill et al (2005) was that with a projected annual growth rate of just 3.5% and a population of only 49 million, South Africa simply does not qualify, and cannot be seen as possibly rivaling any of the coming G7 in the coming decades. Nevertheless, the Economist Intelligence Unit (EIU) proposed that South Africa be included in the group of countries that following the BRICs, would play a large part in generating global economic growth in the coming decades. From the point of view of the EIU, South Africa has virtually the same population as South Korea (49 million) and should have been included in the N-11. The same goes for Columbia with a population of 46 million.

In addition, the EIU believes that seven of the N-11 countries should have been excluded. As a result, they propose a new acronym, CIVETS, referring to Columbia, Indonesia, Vietnam, Egypt, Turkey, and South Africa. These six economies are considered the best bet by the EIU because they have favorable macroeconomic indicators including low inflation, low current account deficits, and growth rates above 3%. The stated reasons why individual countries in the N-11 were excluded are summarized in table 4. In a nutshell, the table suggests that only those politically stable diversified economies with good growth prospects should be included in the CIVETS.

The EIUs fresh perspective was given a boost in 2011 when HSBC launched a CIVETS fund for global retail and institutional investors. On closer inspection however, the HSBC CIVETS fund might actually only give qualified support to the CIVETS concept. The press release by HSBC upon launching the fund stated specifically that "The fund, however, also has the ability to invest up to twenty five percent in non-CIVETS nations which have similarly attractive demographics, such as Mexico, Nigeria, the Philippines, Thailand, Malaysia and Saudi Arabia". Thus, in practice, the CIVETS acronym includes at least three of the N-11 countries that the EIU sought to exclude as well as some new additions.

### 2.4. The 7% Club

From the acronyms discussed so far it is obvious that it is debatable what set of countries to include in the group expected to be the movers and shakers following the BRICs. Standard Chartered, a British bank that is heavily present in non-G7 countries argues for a different approach<sup>7</sup>. They reason that the approach should be dynamic, so that the countries included can change as their growth rates change. They propose that the group of countries should be those that have had at least an average growth rate of GDP of 7% over ten years. The 7% rate is chosen because an economy that grows by 7% every year for a decade doubles in size, and after three decades, it will be (almost) twice as large as one growing at 5%<sup>8</sup>. Any country with an average of 7% GDP growth or over qualifies to be part of the 7% club, but it loses its membership whenever its average growth rate falls below that. In the decade to 2008, Standard Chartered says the countries that fit into this club are China, India, Vietnam, Ethiopia, Uganda and Mozambique. With projections, they reasoned that by 2010, Indonesia, Nigeria, Bangladesh and Tanzania would be part of the club. The surprising thing about the analysis was the increasing number of African countries. Large G20 emerging market economies such as Russia, Brazil, Korea, and South Africa are simply unable to make it into the 7% club because they do not have the requisite growth rates<sup>9</sup>.

<sup>4</sup>See also Wilson and Stupnytska (2007).

<sup>5</sup>Because he is "...quite cognizant of not going down in history as being the guy that just constantly created acronyms" Jim O'Neill has been reluctant to allow Asset Managers in Goldman Sachs to set up a separate fund for MISTs. As quoted in Martin (2012).

<sup>6</sup>In spite of Jim O'Neill's reluctance to create more acronyms, he recently threw his weight behind another group touted as MINTs (Mexico, Indonesia, Nigeria and Turkey). This grouping was originally suggested by *Fidelity Investments*. The rationale for such a grouping is however not very clear.

<sup>7</sup>See Calverley (2010).

<sup>8</sup>To see these, consider (i)  $2 = (1.07)^n$ , implies  $n = \frac{\ln 2}{\ln(1.07)} = 10.24$ . (ii) Similarly,  $\frac{(1.07)^{30}}{(1.05)^{30}} = 1.76$ .

<sup>9</sup>There were some other surprising contenders including Azerbaijan, Turkmenistan, Kazakhstan, Tajikistan, Angola, Sudan, Chad, Sierra Leone, Rwanda, and Cambodia. In countries like Angola, Azerbaijan and Turkmenistan, growth is fueled purely by the Oil and Gas industry. Such growth, although typically over 7% is hardly ever sustained for a decade.

Country	Reason For Exclusion From CIVETS
Bangladesh	Simply too poor & given current projections, would still be a low-income country by 2030.
Iran	Its politics and international relations are too unstable.
Korea	Already successful with a high GDP. It is old news for investors.
Mexico	Already successful with a high GDP. It is old news for investors.
Nigeria	Too dependent on commodities – primarily petroleum.
Pakistan	Its security problems are too acute.
Philippines	Weak, unstable, and a perennial under-performer.

Table 4: Reasons for Excluding Certain N-11 Countries.

### 2.5. Eagles & Nests

Another dynamic method of grouping the countries was suggested by the Spanish bank, BBVA<sup>10</sup>. They suggested two groupings viz, EAGLEs and NESTs. EAGLEs stand for Emerging and Growth Leading Economies. To qualify to be an EAGLE, and economy must have projected incremental growth rates higher than the average of the G6 over a decade. The G6 is the G7 minus the USA. NESTs are a second set of countries with incremental projected growth rates lower than the average of the G6 over a decade, but higher than that of the country in the G6 with the lowest projected minimum growth rate (i.e. Italy). The approach is dynamic because countries can move from being EAGLEs to being NESTs as their incremental growth prospects change. NESTs can become EAGLEs if their conditions improve or drop out of consideration altogether if their prospects deteriorate. One example of changing positions is Egypt. It went from being an EAGLE in 2010 to a NEST in 2011, no doubt due to the damage on its growth projections brought on by the chaos of the Arab spring.

The countries that were considered EAGLEs and NESTs in 2011 can be seen in table 5 which categorizes countries under the acronyms within which they fit. The striking thing is that all the BRIC and N-11 countries are either EAGLEs or NESTs. Countries like Poland, Peru, and Ukraine that had not turned up within prior acronyms are now captured as NESTs. The question marks (?) in the table are to signify that *maybe* the relevant countries fall under the marked acronym. Iran qualifies as an EAGLE but BBVA say they were deliberately left out because their international relations and sanctions make investments there difficult to initiate. Similarly, Saudi Arabia, Iraq, and Kazakhstan qualify as NESTs but they were excluded from the final list because a plethora of investment banks regard them as “frontier markets” as opposed to “emerging markets”<sup>11</sup>.

As a consequence of the BBVA classifications, Dow Jones (in collaboration with BBVA) launched two equity indices tied to the EAGLEs. The two indices are called “Dow Jones BBVA EAGLEs” and “Dow Jones BBVA EAGLEs Optimized” each comprising 50 companies from the EAGLE countries. The weight given to each country is dependent on their projected incremental GDP growth over the coming decade. As the EAGLEs concept is dynamic, the companies (and countries) used to calculate the indices can change. BBVA and Dow Jones reset the index constituents in March every year. Portfolio managers who have private clients that desire investments in EAGLEs are able to measure their performance against the indices, because the 50 companies that are used to compute it are usually very liquid stocks listed in the USA or Hong Kong.

It may be tempting to say that in order for a country to be considered an emerging market economy, it has to fit into one of the categories shown in table 5. There is some truth to this. Indonesia is mentioned the most times. It fits within six acronyms. This suggests that there is widespread agreement that it qualifies as an emerging market economy and would contribute significantly to growth in years to come. On the other hand, some countries that surprisingly, do not even get a mention in the table would never accept that they are not emerging (e.g. Venezuela and Lithuania). They might even get some support from the investment management industry itself. Ashmore Investment Management, a fund management firm known for its focus on emerging markets, is unimpressed by all the acronyms. They regard the range of what constitutes an emerging market to be broader. This is evident in the acronym they created: CEMENT – Countries in Emerging Markets Excluded by New Terminology.

What qualifies as an emerging market economy might therefore depend on ones’ perspective or prejudices. BBVA for instance, admits that Saudi Arabia qualifies as a NEST but left it out of the final list. In addition, BBVA says if the Gulf Cooperation Council (GCC), comprising Saudi Arabia, Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates, were regarded as a single country it would definitely qualify as an EAGLE. Real GDP growth in the GCC averaged 6.1% from 2002 to 2011 well above the world average of 3.8%. Needless to say it seems that the acronyms are designed and formulated to aid and simplify the work of fund managers.

<sup>10</sup>BBVA is a bank headquartered in Spain. Like Standard Chartered, it is also active in emerging market economies, but its presence is highly concentrated in Latin America.

<sup>11</sup>The question marks in the CIVETS column of table 5 are because HSBC includes equities from these countries in their CIVETS funds, even though they were not included in the initial description of CIVETS given by the Economist Intelligence Unit.

	G20 (but not G7)	BRIC	N-11	MIST	CIVETS	7% club	EAGLEs 2011	NESTs 2011
Argentina	X							X
Bangladesh			X			X		X
Brazil	X	X					X	
Chile								X
China	X	X				X	X	
Colombia					X			X
Egypt			X		X			X
Ethiopia						X		
India	X	X				X	X	
Indonesia	X		X	X	X	X	X	
Iran			X					
Iraq								?
Kazakhstan								?
Korea (South)	X		X	X			X	
Malaysia					?			X
Mexico	X		X	X	?		X	
Mozambique						X		
Nigeria			X		?	X		X
Pakistan			X					X
Peru								X
Philippines			X		?			X
Poland								X
Russia	X	X					X	
Saudi Arabia	X				?			?
South Africa	X				X			X
Tanzania						X		
Taiwan							X	
Thailand					?			X
Turkey	X		X	X	X		X	
Ukraine								X
Vietnam			X		X	X		X
Uganda						X		

Table 5: Countries and Their Acronyms

Whilst the acronyms help global investment managers, they can be criticized on two grounds. What they do is define a narrow set of countries. They help investment managers define investment policies and explain to clients which countries they would be putting their money in. They help bring focus and make it easy to create indices that serve as benchmarks against performance. The truth though, is that the focus on acronyms lumps together asset classes within and between these countries that have very different risk profiles. One asset manager from BNY Mellon Asset Management, believes that in order to provide a forthright service that gives clients a true picture of what is going on, the common emerging markets moniker should be replaced with, ASTERISCS, which is an acronym for Assets Tied to Economies of Risky Countries. Kozhemiakin (2011) argues that,

“..... high country risk of any kind should be included as an important criterion with any new label. Thinking in terms of ‘assets tied to economies of risky countries’ would prompt investors to put a mental ‘asterisk’ next to a company like Samsung Electronics, because, in addition to being a world-class manufacturer of electronic equipment, it is based in a country like South Korea with high geopolitical risk” pg 3.

Hence, the acronyms do not reflect the true risks involved in the investments. Different investments within a country can also present different risks.

The second criticism of the popular acronyms is that besides the focus they give the investment managers they do not do much else. They are therefore, more appropriate for portfolio investments in emerging market economies than they are for foreign direct investment. Investors who wish to make foreign direct investments and operate businesses in emerging market economies need to know more about the operating environments than mere acronyms. They need to know how those countries differ from what they are accustomed to and how the differences would affect different business functions. What they need to know are the common attributes of emerging market economies.

### 3. The Attributes

The characteristics and distinguishing attributes of emerging market economies all stem from the fact that the economies are in a sense, still transitioning. They used to be command economies but are now trying to base their economies on free market systems. The necessary changes to a market oriented system have not been completed. In many instances the principles governing market economies have neither been fully accepted nor fully digested by local policy makers. From time to time, these economies might take a few steps back after taking major steps towards liberalization. The dynamics of growing economies would always throw up groups of winners and groups of losers. The groups of losers would most likely become interest groups dedicated to policy reversals and desirous of halting the march towards full market systems. A proper examination of these emerging market economies would reveal that some of their industrial sectors have not been fully liberalized. The absence of the full spectrum of necessary changes and the fact that these economies are just starting to record impressive growth rates is what leads to the observed unique attributes.

#### 3.1. Institutional Voids

The most widely accepted characteristic of emerging market economies is the presence of “institutional voids”. Khanna and Palepu (2010), who are regarded as authorities on doing business in emerging market economies, christened this term. Their reasoning can be summarized as follows. In a perfect market system, there are numerous participants, competent intermediaries, well defined laws and full information. There are institutions to ensure that information is reliable, and that laws are properly defined and enforced. Such institutions are absent or not fully developed in emerging market economies, hence the term, institutional voids. In a sense, by this view, all countries have some “emergingness” in them, but the developed countries (such as the G7), have significantly fewer institutional voids than those we would come to regard as emerging market economies.

What this framework implies for doing business is that prior to making a direct investment in an emerging market economy, businesses must identify the institutional voids they would face in their operations and plan how they would fill them. The institutional voids could be in the product market, labor market or capital market. So for instance, the inability to gauge the quality of suppliers is an institutional void in the product market. Khanna, Palepu and Sinha (2005) give, amongst others, the example of McDonalds’ expansion into Russia. The company was unable to find reliable local suppliers. In order to adapt to this void, McDonalds imported cattle from Holland, and potatoes from the USA. Having identified willing farmers, they advanced them money so that they could procure better equipment and seeds. In addition, to setting up its own trucking fleet, McDonalds also sent Russian managers to Canada for a four-month training program. All these activities can be characterized as designed to fill institutional voids. McDonalds was essentially adapting to the requirements of the new environment because in its home country, the common practice was to outsource most of its supply chain.

#### 3.2. Marketing Attributes

Whilst no one can claim the institutional void framework is faulty, it does not at a glance provide people who manage different business functions the characteristics of emerging market economies that they need to know to properly strategize. Take for instance, a marketing manager, who has just been given a job in a high-population N-11 country. He may know he faces institutional voids in the sense that there are an inadequate number of retail shopping outlets or chains to carry his product. If he focuses on the institutional void alone he may give all his attention to seeking innovative ways to get his product to the consumer. There is nothing wrong with this, but he may miss the bigger point which is that N-11 countries have high populations of untapped consumers who probably desire products that can meet lower price points due to their limited financial means. In essence, one important attribute of emerging market economies is that they have a large number of hitherto unreached consumers. Any foreign direct investor should have this in mind.

The nature of emerging market economies throws up a multitude of implications for marketing. The first of these is that there are ample opportunities to profitably engage in Bottom-of-the-Pyramid (BOP) marketing. Prahalad and Hammond (2002) say that a common misconception that businesses have is that the rural dweller in a developing country is too poor to spend money on consumer goods because he is probably spending all his resources on meeting his basic needs. To buttress their point, they give the example of a confectionary introduced into the Indian market by Hindustan Lever, the Indian subsidiary of Unilever. The sweet was made with real sugar and fruit and sold at about a penny per serving. Although this might sound like a marginal business opportunity, the fact is that in about six months the product was the highest selling in the company’s portfolio. Hindustan Lever estimated that sales from the product could generate US\$ 200 million per annum in India. As such, emerging market economies, by virtue of the fact that they have untapped masses present themselves as opportunities for good BOP marketing that can quickly generate profits as well as establish brands in the minds of consumers.

Growth in these economies also implies other opportunities. In an emerging market economy, not only is there an emergent middle class, the middle class is constantly increasing in size and spending power. The middle class therefore presents opportunities for sales growth. In fact, there are opportunities to introduce the middle class in emerging market economies to products consumed by the middle class in developed countries. This applies to a broader range of products than just Big Macs in Moscow. One item researchers have focused on recently is wine. Singh (2008), using qualitative research argues that the consumption of wine in India is now more for pleasure than for prescription. Similarly, Somogyi et al (2011) using qualitative data, found that although there is wine consumption for health purposes linked to traditional Chinese medicine, the new Chinese consumer is significantly influenced by “face and status”. Wine is therefore a symbol of affluence and there is clearly a rising preference for cork-closed wine bottles. Undoubtedly, goods that are consumed by the middle class in developed countries can also be sold to the nascent middle class in emerging market economies.

There is also an emerging “super rich” class. Russia for instance, now has the most billionaires among all European countries, and China has the most billionaires in the Asia-Pacific region<sup>12</sup>. The marketing opportunities this presents is not just for luxury good brand names such as Louis Vuitton or Armani. Nowadays, there are other services that wealthy individuals are desirous of, an example of which is private aviation. The Swiss private aviation company, VistaJet, regards China and Russia as their main markets. In June 2012, VistaJet signed an agreement with a local Russian partner that allowed it to be the only foreign long-range large cabin luxury aircraft operator that flies point-to-point within Russia. The huge demand from Russia prompted VistaJet to set up a permanent base in Moscow. As a result of Russian demand and an earlier similar entry into the Chinese market, VistaJet expects their fleet size to double from 30 aircrafts in 2011 to 60 in 2015. By the middle of 2012, they already had an aircraft order backlog of US\$ 2 billion.

A perhaps less well known attribute that impacts marketing is the so-called country-of-origin effect. This is the idea that the country a product emanates from influences how consumers view the product or view the quality of the product. This is important for direct investors who are offshoring or attempting to benefit from location economies. The literature on country-of-origin effects, although vast, is often ignored in contemporary discussions about emerging market economies<sup>13</sup>. The message is clear - the country in which a product is manufactured can influence quality perceptions of the product and therefore affect purchase decisions. Consumer biases can also turn up e.g. Italian made shoes would always be deemed better than Canadian made shoes. Similarly, consumers in Arab countries are not likely to look favorably on items manufactured in Israel. Knowledge about the country-of-origin effects upon consumer purchase decisions are very important in this time period in which foreign direct investors are locating manufacturing facilities in various emerging market economies. There is evidence that the country-of-origin effect also applies to services, and researchers have also found that in some instances, the (perceived) country-of-brand-origin is more important than country of manufacturing with regards to influencing purchase decisions<sup>14</sup>. All in all, branding and brand management become more important, because even though, the country-of-origin effect changes over time, consumers do have unfavorable perceptions about the quality of products from many emerging market economies.

### 3.3. Infrastructural Deficits

The typical emerging market economy suffers from significant infrastructural deficits. David and Stewart (2010) define infrastructure as a “collective term that refers to all the elements in place (publicly or privately owned goods) to facilitate transportation, communication, and business exchanges. It would therefore include not only transportation and communication elements, but also the existence and quality of public utilities, banking services, and retail distribution channels”<sup>15</sup>. China is a country in which the economy has grown much faster than the infrastructure has kept pace. Their railways are a case in point. China relies on rail for movements of goods within the country and from ports into the hinterland. Due to limited capacity there are frequent delays and bottlenecks. Bangsberg (2004) reports that China only has 45,000 miles of track compared to the 144,000 miles of track found in the USA. The railway infrastructure only satisfies about 60% of demand.

China’s road network on the other hand, is quite good. The same cannot be said of Russia where the “roadlessness” of large parts of the country is captured by the expression “bezdorozhye”. In many other cases, it is not the absence of roads, but their quality that is the issue. Polish roads are amongst the lowest quality in Europe. A large percentage are either unpaved or in poor condition. In India’s main cities, the problem is usually congestion that slows road movements to a grind. Nigeria is legendary for its inability to provide constant and uninterrupted electricity to private and industrial consumers alike. Any foreign direct investor would be well advised to scan the target investment location to ensure that the right infrastructure is in place before committing funds. There would be no point carrying out an export oriented investment in an emerging market economy only to find that its seaports are not large enough to accommodate the bulk carriers that are typically used for the transport of the commodity in question. Infrastructural problems in emerging market economies are a major headache for global supply chain management.

The infrastructural deficits and host country attempts to improve have another implication for businesses. Here we are referring to the pro-cyclicality of fiscal policy in emerging market economies and the effect on the general macro economy. Governments, as happens in G7 countries, are supposed to save during economic booms, and spend during downturns. This helps to smooth out business cycles. The evidence from emerging markets is exactly the opposite<sup>16</sup>. They tend to spend more during booms and less during busts. During economic booms, governments in emerging market economies increase their infrastructural spending and further boost the economy. As boom turns to burst, government infrastructural spending rapidly decelerates thereby worsening downturns. The implication of this for foreign direct investors serving consumers in emerging economies is that they should expect economic downturns to be deeper whenever they occur. The good times are very good, and the bad times are very bad. Businesses in emerging market economies have to learn to save for rainy days and smooth out their own cashflows over business cycles. When it rains, it pours!

<sup>12</sup>Moreno (2010) also says “Moscow has more billionaires than New York”.

<sup>13</sup>See Dinnie (2004) for a survey of the empirical evidence on country-of origin effects.

<sup>14</sup>For a discussion of the country-of-origin effect with regards to services see Javalgi et al (2001). For a study that finds that country-of-brand-origin can be more important than country-of-manufacturing see Dikcius and Stankeviciene (2010).

<sup>15</sup>David and Stewart (2010) page 41.

<sup>16</sup>For empirical evidence to this effect see Talvi and Vegh (2005) as well as Ilzetzki and Vegh (2008).



### 3.4. Corruption

Some economic theorists (such as Alesina et al, 2008) have argued that the pro-cyclicality of fiscal policy in emerging market economies is due to their endemic governmental corruption<sup>17</sup>. Whether this is true or not is immaterial, the point is that most people in business believe that corruption is very high in emerging market economies compared to their G7 counterparts. Corruption is difficult to define but in international business it is characterized by the payment of bribes in order to gain a business advantage or avoid a cost. It is also difficult to measure, so people just fall back on measurements of perceptions of corruption. It however, does not follow that poorer countries are more corrupt than rich ones. Kilani (2010) for instance, compares the Transparency International “Corruption Perception Index” for the Middle East and North Africa (MENA) countries with that of other emerging market economies and finds that all the Gulf Cooperation Countries (GCC) excluding Saudi Arabia are perceived as being less corrupt than Turkey, India, China and Brazil. All the GCC countries including Saudi Arabia are deemed less corrupt than Russia.

A major issue for businesses to realize is that many countries now have extra-territorial laws that can impose penalties on their citizens for corrupt acts carried out abroad. The US Foreign Corrupt Practices Act of 1977 was the first of these. Some other countries have followed. Complying with such laws and having the right compliance programs in place for employees is now an essential requirement for foreign direct investors. The punishments for violations of the extra-territorial laws can be severe and there is substantial reason to avoid falling foul of them. We should also not forget the laws of the host countries. There is probably no emerging market economy in which bribery (or related corrupt practices) can be considered legal. Business managers bribe at their own risk. It is crucial to remember that the measures of corruption are only based on perceptions. Law enforcers in emerging market economies are not going to overlook corrupt practices that contravene their laws. Any business manager that pays bribes in emerging market economies because he has heard that corruption is the order of the day in those countries should be prepared to face the consequences if he is caught. Different countries have differing standards of business ethics but what is regarded as a corrupt practice is very similar across legal regimes.

### 3.5. Laws & Legal Framework

Whilst in the case of corruption the laws of developed countries and emerging countries are similar, there are some other laws that might be surprising to the foreign direct investor. The first sort falls under what could be termed “Affirmative Action”. Malaysia is the premier example of this. In 1971, it launched an intensive affirmative action program called the “New Economic Policy” designed to improve the lot of ethnic Malays who were seen as economically disadvantaged in comparison with the minority ethnic Chinese population. The policy set a 30% ownership target of the economy for the ethnic Malays who were also given preference with regards to government contracts. This meant that foreign investors had to make sure their local partners were ethnic Malays and not ethnic Chinese. In addition 30% of shares in any IPO had to be reserved for ethnic Malays. The policy was officially ended in 1990. It was replaced in 1991 by the “National Development Policy” which, as old wine served in a new bottle, carries on much of the same affirmative action.

A similar law can be found in South Africa. Over there it is called Black Economic Empowerment (BEE) and aims to correct some of the economic injustices resulting from the country’s history of apartheid. Some other emerging market economies have industry specific affirmative action programs that are commonly referred to as “local content laws”. Brazil has gone further than other countries in applying such laws to its oil industry. Companies with significant local content are given preference in bidding rounds for oil concessions. Local content has many elements but can broadly be read to mean ownership by nationals, employment of nationals, and purchase of inputs from local suppliers. In essence, foreign direct investors find that their probability of success is increased by having local partners and local suppliers. Nigeria’s oil and gas industry law operates on similar principles.

In general, the differences in legal regimes between developed and emerging market economies can pose problems for business. Not only does one have to take the differences between common-law and civil-law countries into account, one also has to ensure that the business laws relating to the transaction an investor wishes to engage in are properly defined and actually exist. For transnational project finance, laws relating to the collateral and the enforcement of liens must be in place. Sadly, this is not always the case. In addition,

“... the expertise and experience of local lawyers and judges are sometimes less developed than project sponsors and lenders are accustomed to in industrialized countries. This is not a reflection on the abilities of these lawyers, but rather a reflection of a lack of sophisticated commercial transactions in these countries and a lack of experience with the type of issues in a dispute that arise in them.” Hoffman (1998), pg. 81.

### 3.6. Anti-Dumping

Lyons (2010) and his team of economists at Standard Chartered Bank, argue that starting in 2000, the world is experiencing a third super-cycle. They define a super-cycle as “A period of historically high global growth, lasting a generation or more, driven by increasing trade, high rates of investment, urbanisation and technological innovation, characterised by the emergence of large, new economies, first seen in high catch-up growth rates across the emerging world”. The first super-cycle is supposed to have been from

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<sup>17</sup>The model by Alesina et al (2008) is actually quite elaborate. They reason that voters who cannot observe corruption (or stealing by government officials) simply demand more public goods in good times in order to “starve the Leviathan”. They go on to show, using regressions, how their model fits with the empirical evidence. They show that fiscal policy is only pro-cyclical in non-OECD countries.

1870 until 1913. The second was from 1945 till about 1970. We are in the middle of the third super-cycle and the advent of the emerging market economies is evidence of it.

There are two clear implications for emerging market economies arising from the definition of super-cycles. The first is increasing urbanization. The growing countries can all expect their degree of urbanization to rise. The second is that the super-cycle is driven by increasing trade. An upsurge in international trade is clearly evident in today's world but old protectionist instincts die hard. More and more countries realize the benefits of free trade but political pressure from old inefficient industries may push governments to adopt protectionist measures. In today's climate, transitioning countries that have joined the WTO<sup>18</sup> find that one of the only protectionist instruments they can apply is anti-dumping measures (tariffs). Dumping occurs when a business sells a product at a lower price in a foreign market than it does at home. The WTO allows an importing country to impose anti-dumping duties on such a foreign business if there is injury to an existing domestic competitor. This supposed exception to the principles of free trade has been much abused. The advanced G7 nations were the ones who used to employ anti-dumping measures the most, but now, Prusa (2005) amongst others, finds that per dollar of imports, the new growing economies have filed anti-dumping cases up to 15-20 times more frequently than the traditional users. There are also signs that both the traditional users of anti-dumping measures as well as the new users are unlikely to slow down its' use. Exporters to emerging market economies should be aware that they could face anti-dumping proceedings. The converse is also true. Exporters from emerging market economies should know that they would increasingly face anti-dumping protectionism in advanced countries. The realization of this is critical because in some instances, local firms that are losing market share to a more cost efficient foreign firm would claim the foreign firm is dumping even if it is not. Production efficiencies such as the location economies foreign direct investors often seek in emerging market economies can be interpreted as dumping (even though they are not) when exporting to developed countries. Fighting off anti-dumping charges can be extremely costly in terms of time and legal fees. Businesses should know that it would be neither pleasant nor cheap to prove their innocence.

### 3.7. *Persistent Distortions*

One attribute that stems from the fact that most emerging market economies are transitioning and have not fully imbibed market principles is the fact that their domestic economies would have persistent distortions caused by subsidies of some form or the other. The most prevalent subsidies in emerging market economies are on the consumption of petrol and related fossil fuels. In 2011, 20% of total spending by the Indonesian government was on fuel subsidies. Once subsidies are initiated they come to be viewed as an entitlement and are difficult to remove. Prime Minister Najib Razak of Malaysia likened his country's petrol subsidies to opium. Other countries that spend a lot on fuel subsidies include China, Russia, India, Saudi Arabia, Egypt, Nigeria and Venezuela. Brazil seems to have gone some way towards weaning themselves off the subsidies<sup>19</sup>. Iran has also managed to drastically cut subsidies, but only after an elaborate public awareness campaign to garner support<sup>20</sup>.

In addition to sending the wrong price signals and encouraging excess consumption, these subsidies discourage investments in the oil and gas sectors of emerging market economies. There are two real issues that we can point out to foreign investors in this regard. Firstly, the governments in emerging market economies are now well aware that the subsidies have to go. The sums spent on subsidies are too much and progressively increase as their economies and populations grow. Such expenditure also leaves the governments with little cash to do anything else. As a result, the governments would always try to remove the subsidies. Attempts would be repeated. Governmental support exists but the absent popular support means that there would always be social upheavals related to fuel subsidies. These upheavals would occur from time-to-time, and investors need to accept this as a feature of any emerging market economy they wish to operate in.

Secondly, investors in the oil and gas sector need to be cautious. This applies to both upstream and downstream operations. The populace in these countries does not fully grasp the need for subsidy elimination. They are hell bent on having their energy consumption subsidized. As De Oliveira and Laan (2011) say in relation to Brazilian subsidization, "reforms are fragile" and can be reversed. An investor that is enticed by recent reforms of subsidization regimes or elimination of related price controls may find at some point that he is stuck in the middle of a loss making hydrocarbon venture due to governmental policy reversals brought on by political pressure.

The subsidization of petrol and related fuels is a major difference between emerging market economies and developed economies. In the developed countries petrol is more often taxed. The rationale for taxation usually stems from the fact that petrol and related fuels are derived from crude oil – an exhaustible resource. Theoretic economic analysis teaches that the optimal policy to have regarding an exhaustible resource is one that slows down its consumption, i.e. a tax, not a subsidy.

### 3.8. *Political Risks*

As can be seen, from the discussion on fuel subsidies, foreign direct investors in emerging market economies could face political risks. Bremmer (2005) proposed that an alternative definition of an emerging market economy is "a state in which politics matters as much

<sup>18</sup>The World Trade Organization (WTO) is an organization of nation states whose prime objective is the liberalization of international trade. Most countries are members. Countries that recently transitioned to market economies have sought membership. China joined in December 2001 and Russia only joined in August 2012.

<sup>19</sup> See De Oliveira and Laan (2010) for a review of how Brazil reduced its' fuel subsidies.

<sup>20</sup> In the build-up to subsidy reforms President Ahmedinejad referred to the need to cut subsidies as necessary economic "surgery". Guillaume et al (2011) provide a good summary of the reform process in Iran.

as economics". The flaw in this definition is obvious because even in advanced countries political risk also exists, but it makes a patently clear point that the political risks in the countries regarded as emerging are higher than in the G7. It used to be that the main risk of investing in developing countries was the possibility of expropriation, i.e. a forceful transfer of ownership from private owners to the host country government. Expropriation is not illegal. It can be done due to overriding public interest. The generally accepted international standard is that the owners of expropriated corporations must be compensated adequately and swiftly.

Many observers have pointed out that expropriation is very rare these days<sup>21</sup>. They argue that investors are more at risk from "creeping expropriation". Creeping expropriation refers to acts of governments other than outright seizures such as the passing of laws or administrative policies that essentially strip financial value from the investment. Henisz and Zelner (2010) refer to this as "policy risk" and point out that these risks are actually on the rise. Governments can find inventive ways to circumvent contracts or they can simply make things unworkable. Leon (2009) gives the example of how a NAFTA tribunal found that Mexico had indirectly expropriated the assets of a US investor when a local government refused to give the investor a construction permit, and a state government had decided to set up a conservation area on the same plot of land that Mexico's federal government had given the investor a permit to build and operate a hazardous waste landfill.

Even though it is true that outright seizures are rare, they are not pleasant when they occur. The low *ex ante* probability of having your assets expropriated is of little comfort in the face of the high *ex post* disappointment the rare victim experiences. Both outright and creeping expropriation is higher during periods of financial crisis. Countries that are particularly prone to financial crises therefore present higher risks. A case in point is Argentina. It was accused of numerous acts of creeping expropriation during its 2001/2 currency crisis. More recently, Argentina announced the forceful takeover of YPF, a subsidiary of the Spanish Oil and Gas giant, Repsol. President Christina Fernandez de Kirchner said the takeover signaled a "recovery of sovereignty and the control of a fundamental instrument"<sup>22</sup>. This is an example of outright seizure and expropriation in 2012. It is rare, but it can and does happen.

Any location in which there is high nationalist sentiment is a prime candidate for presenting high expropriation risk. This could be either explicit or creeping expropriation. Foreign investors in the mining industry in countries such as South Africa (and perhaps the Democratic Republic of Congo) should be particularly vigilant. Once an investment is made, the risk exists. The suggested ways to lessen the risk include investing in goodwill, framing the debate with political spin, and occasionally using any political pressure points at the investors' disposal<sup>23</sup>. Ultimately though, these risks are part of the reason why (expected) returns are higher in emerging market economies.

### 3.9. Other Attributes

There is a multiplicity of other attributes of emerging market economies that have been suggested in the literature. The most important ones are the myriad of differences in business cultures that investors would experience and the scarcity of trained managers. Culture is an amorphous concept that businessmen find difficult to wrap their heads around. Those who ignore cultural variations do so at their own peril. The absence of trained and employable managers in emerging market economies is much touted by businessmen. It is true, but often exaggerated. In sum, foreign direct investors have to adapt their operations to the cultures of the new environments and have to evolve strategies to attract competent staff to work for them.

## 4. Conclusion

Emerging market economies are best seen as those countries that have carried out some market reforms and are now recording high rates of growth. Their main attributes are the presence of institutional voids, political risk, persistent economic distortions, a growing middle class, perceived corruption, and the use of anti-dumping duties. It is these features rather than the commonly used acronyms that influence how businesses have to operate in those environments. The acronyms also have their benefits in the sense that they help focus attention on countries and provide simple means with which portfolio managers can explain the geographic locations where investor's money is placed.

It seems reasonable to say that, given the stock tracking indices that are in use, the acronyms are of value to international fund managers and their clients. For foreign direct investors who wish to operate businesses in emerging market economies, we would recommend that they thoroughly acquaint themselves with their defining attributes.

<sup>21</sup>Korbin (1984) and Minor (1994) have compiled data showing that outright seizures have fallen drastically. They were near zero by the mid-1980s.

<sup>22</sup>Quoted in The Washington Post, 26 April, 2012.

<sup>23</sup>These three points are advocated by Henisz and Zelner (2010). They regard them as the current best practice for managing policy risk.

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