

MITIGATING FINANCIAL RISKS AND ASPECTS TO BE ADDRESSED IN MAKING FOREIGN INVESTMENTS

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Annotation: The globalization of financial markets has led to increased cross-border investments, enabling investors to access new growth opportunities. However, foreign investments are riskier than domestic ones due to factors such as political instability, currency fluctuations, and differing regulatory environments. This thesis will explore these financial risks, propose methods for mitigating them, and highlight the critical factors investors must address when considering foreign investments.

Keywords: Global financial markets, foreign investments, investment risks, financial institutions, risk management tools and tactics.

Introduction

Global financial markets have opened ways for investors to diversify their portfolio and reap the benefits of foreign markets. Technology made the investment process straightforward and dynamic that investors now are able to access different stock markets and do their transactions from any place of the world. International markets are attractive to many investors because they could get more profit than investing only in their home country. Foreign investment opportunities also come with specific risks and in this thesis, we are going to explore foreign investment risks and ways of mitigating them.

The Financial Risks in Foreign Investment

Investors need to consider different risks when making international investments. These risks may range from economic risk of a country, political risk or exchange rate risk and so on. Now let's define different risks investors should assess before entering international financial markets:

Political Risk

Political risk refers to the possibility that political changes or instability in a country could adversely affect an investment. This can include expropriation of assets, changes in tax policy, or sudden shifts in government regulations.

For example, in 2008, the Venezuelan government expropriated several oil companies, including those with foreign investments, causing substantial financial losses. For instance, ExxonMobil's operations in Venezuela were valued at approximately \$1.5 billion, which were seized as part of the nationalization process.

Currency Risk

Currency risk, or exchange rate risk, arises from the fluctuation of currency values. An investor holding foreign assets is exposed to the possibility of the local currency weakening relative to their home currency, which can lead to losses.

Between 2014 and 2016, the Russian ruble lost nearly 50% of its value against the U.S. dollar, significantly affecting the returns of foreign investors in Russian assets. A U.S. investor holding 1 million rubles at the beginning of 2014 would have seen its value drop from \$28,000 to \$14,000 by 2016, assuming the exchange rate was 35 rubles to the dollar initially and 70 rubles to the dollar in 2016.

Market and Liquidity Risk

Market risk refers to the potential for an investment to decline in value due to changes in market conditions, while liquidity risk is the risk that an investor may not be able to sell an asset quickly at a reasonable price. The main driver of market risk are interest rates, foreign exchanges, commodity prices, equity prices.

Regulatory and Legal Risk

Different countries have varying regulations related to foreign investment, taxes, property rights, and repatriation of profits. A change in regulations could impact the profitability or even the viability of an investment.

Interest Rate Risk

Interest rate risk arises from the potential for changes in interest rates that affect the cost of borrowing or the discount rate applied to future cash flows. This risk is particularly important for foreign investments in countries with unstable monetary policies.

Mitigation Strategies for Financial Risks

Risks are inevitable part of any investment. They cannot be eliminated but through careful management they can be mitigated. If the investment were risk free, everyone would be investing in the same stock or bond. In real life if you want to gain high profit, you have to bear high risk. There are some risk management techniques and tools in financial markets to reduce risk exposure of investments.

- Insurance and hedging - to mitigate political risk, investors can purchase political risk insurance from institutions like the Multilateral Investment Guarantee Agency (MIGA) or use hedging strategies such as options and futures contracts to protect against adverse political developments.
- Currency hedging - to protect against currency fluctuations, investors can use hedging instruments such as forward contracts, options, and currency swaps.
- Diversification and asset allocation: diversification across different asset classes, sectors, and geographic regions can help reduce both market and liquidity risks. Allocating investments into a mix of stocks, bonds, real estate, and commodities in different countries can cushion the portfolio from localized risks.
- Regulatory understanding: foreign investors should conduct thorough legal due diligence, including understanding the host country's regulatory environment and property rights protections. Additionally, building strong relationships with local legal advisors and government agencies can help navigate potential legal and regulatory risks.

Investors must conduct detailed research on the economic environment of the foreign country. This includes GDP growth rates, inflation, employment rates, and sector-specific trends.

Before making an investment, investors must carefully weigh the risk against the potential return. Financial models such as the Capital Asset Pricing Model (CAPM) or the Internal Rate of Return (IRR) can assist in this evaluation.

Investing in a foreign country often requires partnering with local firms. Proper vetting of these partners and understanding their governance structures are critical to ensuring compliance and aligning business interests.

Conclusion

Foreign investments hold significant promise for capital growth, but they are fraught with unique risks. Political instability, currency fluctuations, regulatory uncertainty, and market volatility are just a few of the challenges that must be mitigated. By employing a variety of risk mitigation strategies such as hedging, diversification, and thorough due market analysis, investors can reduce the likelihood of adverse outcomes. Furthermore, understanding the key aspects of the local economic, legal, and market environments is essential to ensuring that foreign investments yield optimal returns.

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