



# EDGE

**Strategic disinformation:  
Russia, Ukraine, and crisis  
communication in the  
digital era**

**The interplay between  
emotions and legitimacy  
in managing the global-  
local tensions**

**From refugee to entre-  
preneurship: motivations  
factors and challenges  
of three women from the  
mena region**

*«Man enjoys living on the edge of his dreams and neglects the real things of the world which are so beautiful. The ignorant and indifferent destroy beautiful things merely by looking at the marble. Things that remake the soul of him who understands them.»*

**AUGUSTE RODIN**

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## FOREWORD

The *EDGE* characterizes the tumultuous state of the world witnessed in the past few years. It exemplifies recent global events that will act as a crucible affecting the shape of our modern society for decades to come. Time to time, from academia to industry, we refer back to these historical [Edge] moments not just because of the cumulative progress we have made, but also because of the impact that these events have had on our shared human experience. Indeed, how far have we come since the steam engines and early applications of electricity?

On the *EDGE*, we stand at another tipping point for society. On the road of the fourth industrial revolution, combinations of rapidly advancing technologies and processes are continuously challenging the shape of society. Our progress is allowing us to conquer diseases, build smarter, travel faster, and connect better. Our ambitions have set our eyes on inhabiting new planets, and more than ever before, we recognize that there is more than just the “human experience” involved. Instead, our species must play a conscious role in protecting a vulnerable planet and all its inhabitants. On the other hand, we continue to face enormous challenges. Despite our collective progress, we have yet to overcome the basic challenges posed by human geography, the archaic international system, human security, and the scourge of war. The bane of climate change and an ever-warming planet, food (in)security, an impending energy crisis, culture wars, misinformation/malinformation and disinformation, the growing chasm between us and our elected representatives, the rising threats to human liberty, and the possibility of new epidemics and pandemics – all threaten to derail us from advancement as a conscientious race.

For creators and problem solvers, the opportunities are galore. Businesses today have even more tools at their disposal to create value for the consumer, in ways that are truly holistic, inclusive, and sustainable. But even that is not enough, because just as we did during the previous tipping points in history, we must once again design our collective future. What business processes will help us tap into resources on moons and comets? How do we balance global integration with local adaptation? What regulations must come into play for ever expanding artificial intelligence? How do we have ethical debates on bioengineering while also advancing the singularity?

At the edge, we can either chose to look down, or look up. Answering these questions is our attempt at looking up.

**Suddha Chakravartti**  
*Editor-in-Chief*

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# TABLE OF CONTENTS

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1.	<b>Strategic Disinformation: Russia, Ukraine, and Crisis Communication in the Digital Era</b> <i>Elisa Paz Pérez</i>	8
2.	<b>The Interplay Between Emotions and Legitimacy in Managing the Global-Local Tensions</b> <i>Eugene Cha &amp; Masahiro Kotosaka</i>	19
3.	<b>Business Ethical Approaches in the Echo of the VW Group's Emission Scandal</b> <i>Ivona Spasovska</i>	48
4.	<b>From Refugee to Entrepreneurship: Motivation Factors and Challenges of three Women from the Mena Region</b> <i>Antonia Koumproglou, Nahed Ahmed &amp; Lynn Mounzer</i>	58
5.	<b>The Rise of the Phd Student "ghostwriter" - Findings From a UK Distance-learning Course</b> <i>Aaron Taylor</i>	79
6.	<b>On the Impact of Thematic ETFs on Index Investing</b> <i>Lorenzo F.P. Merlo</i>	85
7.	<b>Stock Picking Theories and Models: A Review of the Relevant Literature</b> <i>Delini Jayatilaka</i>	110
8.	<b>CSR Development in the Energy Companies Of Azerbaijan: Case-study Of Bp Azerbaijan</b> <i>Nigar Talishinskaya &amp; Konstantinos Biginas</i>	124
9.	<b>Political Economy Of Rmb Internationalization</b> <i>Bora Ly &amp; Romny ly</i>	160

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## STRATEGIC DISINFORMATION: RUSSIA, UKRAINE, AND CRISIS COMMUNICATION IN THE DIGITAL ERA

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*Elisa Paz Pérez*

**ABSTRACT:** *In times of crisis, communication is a critical and sensitive topic that has been analysed to identify and understand the power of media, the use that citizens make of digital channels, and how governments and key agents can use it strategically to resonate with audiences and consolidate important messages. In these past years, crisis communication studies focused on analysing information management during the pandemic, also explaining disinformation and fake news aggravate the situation. This crisis has deepened and extended outside the healthcare dimension now due to the European geopolitical conflict regarding Russia's invasion of Ukraine, which affects the stability of international political relations considerably and concerns citizens worldwide. This context demands a closer analysis of disinformation as warfare, how it is (and has been) articulated in this framework of political crisis, and what elements contribute to the dissemination of fake news. The objective of this paper is to present a critical analysis of how the various levels of disinformation apply in the current situation and to assess how communication theories engage in this context. To do so, this paper examines four aspects of disinformation: (1) as a strategic form of communication, (2) the social impact that it entails domestically and internationally, (3) the role of social media regarding this type of corrupted communication, and (4) measures and proposals to oppose the spread of disinformation.*

**KEYWORDS:** *disinformation, fake news, social media, political communication, crisis communication, Europe, Russia, Ukraine.*

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The power of communication and media in times of crisis has been extensively discussed these past years in relation to the COVID-19 pandemic. Scholars have focused on government-citizen communication, the impact of digital channels and the spread of inaccurate information through these channels, which threatens the overall security of the population.

Currently, the socio-political crisis context has not only persisted, but also intensified and extended to a different dimension due to the escalation of events in the Russian offensive towards Ukraine, and so have the sources and threats of disinformation and fake news. Russia's invasion of Ukraine has key political agents and international institutions on their toes due to both the current and potential implications of a war in European territory close to members of the NATO alliance.

From a communication perspective, scholars and professionals alike are immersed in the study of how the information is disseminated, and the role that journalists, social media, academia, governments, and citizens play in the communication of this political crisis. It is pertinent to acknowledge, though, that in spite of the recent increase of media attention, communication scholars have been studying the Russia-Ukraine conflict with more intensity since 2013, and the impact of Russian disinformation both domestically and internationally regarding this situation specifically. Furthermore, existing literature previous to this context also highlights the (mis)use of communication tools for political purposes in the particular case of Russia and the United States, which can help towards a deeper understanding of the current situation.

Taking this into consideration, this paper aims to analyse how communication and media frameworks, as well as disinformation theory apply to this context, particularly considering the aforementioned extensive literature that exists around information warfare related to the Russian federation, which has been increasingly developing in the past decades, and which now we have the possibility and responsibility to analyse in the recent context of war in Europe.

### **DISINFORMATION, MISINFORMATION & MALINFORMATION**

Interestingly enough, the term “disinformation” seems to be fairly connected to the Russian government, since many scholars link it to the Russian word *dezinformatsiya*, which is a term the KGB used in the 1950s to name a department that was created to dispense propaganda (Mahairas and Dvilyanski, 2018). Nonetheless, this term is translated as “misinformation,” which has a different connotation nowadays. The study of the dissemination of false or inaccurate messages has extended and deepened since the 1950s, and nowadays we distinguish between misinformation, which is defined as inaccurate or misleading content spread without the intention of causing harm; disinformation, which is false information that is shared deliberately, and malinformation, which refers to genuine information shared with the intention of causing harm (e.g.: leaks) (Wardle & Derakhshan, 2017).

It is important to mention that when we talk about disinformation and its frequent association with the Russian Federation, we are not talking about propaganda, although in both cases we discuss information and communication of messages that serve political purposes. An essential element of disinformation as a form of communication is its intention of causing harm based on untruthful facts. Furthermore, it has been argued that Russia is far from being the only country that uses this tactic, and that many governments use disinformation as a part of their communication plan, particularly during presidential campaigns (an example of the study of fake news during presidential campaigns is that of Guess, Nyhan & Reifler (2018)). The focus of this paper, however, is not to contradict these arguments or assess these objects of study because, among other reasons, the use of communication as a weapon during presidential campaigns is usually a domestic conflict in which all three types of information disorders can be found, aiming to destabilize and confront voters; this is, it has a cross-sectional application, limited in time. Rather, this paper focuses on the spread of disinformation (not misinformation or malinformation) during current times of political crisis, of which the Russian Federation is one of the protagonists, and which has frequently been linked with this type of information warfare in a credited (and longitudinal) manner.

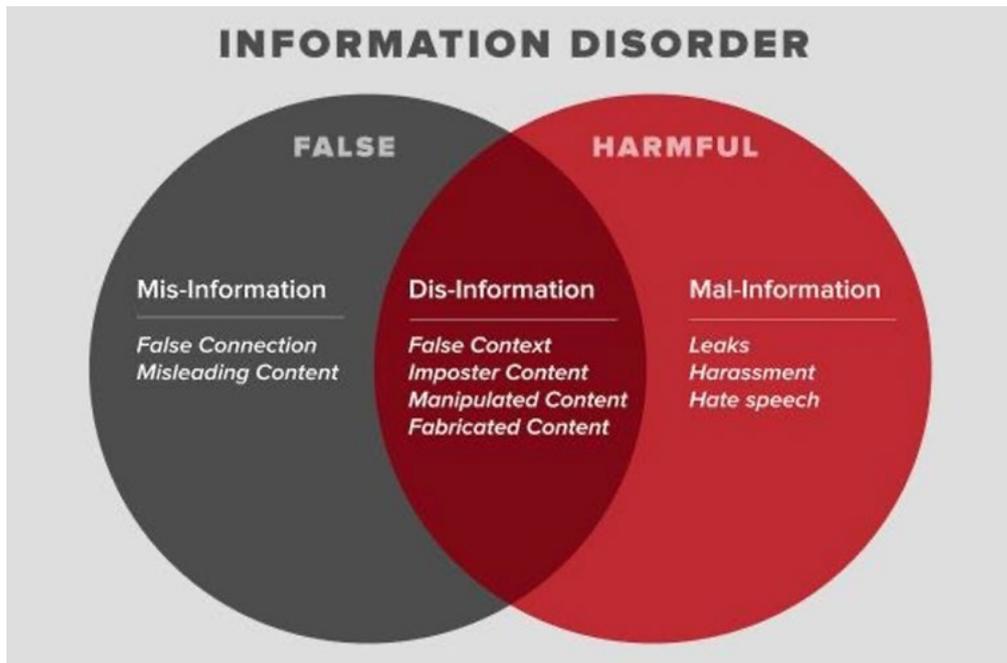


Image 1: Information disorder (Source: Wardle & Derakhshan, 2017)

In times of crisis, and particularly regarding communication and information in times of war, scholarly attention focuses on disinformation on several levels: (1) the strategic dimension and purpose of disinformation, (2) the social impact that it has in public life, (3) the role of social media and other digital methods in the dissemination of disinformation, and (4) disinformation's rapid circulation and the challenges to dismantle it.

In this paper, we assess how these four dimensions of disinformation apply to the disinformation efforts in the context of the current European war conflict.

### **DISINFORMATION AS STRATEGIC COMMUNICATION: INFORMATION WARFARE**

As per the first level, disinformation as a strategic form of communication, it is important to note that Russia's understanding of information warfare is not limited to wartime, as it could be assumed in western European countries, but it is rather conceived as a calculated, broader, complex system of activities extended through time (Čížik, 2017). Some authors argue that in spite of communication being regarded as "soft-power" in diplomatic and international relations (Nye, 1990), Russian attitude towards modern warfare contemplates that (dis)information needs to be used in a longitudinal manner in order to control the narrative morally and psychologically, and to do so in the eyes of both the enemy's civil population and professional armed troops (Bērziņš, 2014).

The goal of these disinformation campaigns is to portray Russia as the victim of western aggressive policies, such as the threatening expansion of NATO. These systemic problems, according to the Kremlin, are the cause of the deterioration in the relations between Russia and the Western states and all its consequences, as they cite in the Foreign Policy Concept of the Russian Federation

published in 2016. Although it is true that geopolitical issues are complex, and each country uses narratives that put them in a positive light, these discourses become disinformation when they seek to damage established structures through the use of untruthful messages, control of media and lack of informative plurality. This type of “soft-power” tactics has not only been used within Russia, but also internationally, and particularly in Ukraine, where pro-Kremlin disinformation campaigns have been a solid part of the Kremlin’s strategic political agenda these past years (Erich & Garner, 2021).

The success of the international propaganda spread during the Ukraine conflict in 2014 has contributed to Russia increasing its efforts towards alternative news, promotion of scepticism towards western public institutions, and propagation of anti-establishment narratives online (Watanabe, 2018), which is done through the choice of key terminology and attracting users to verisimilar stories that enhance the role of Russia as a victim or justice-seeking country, in some cases appealing to conspiracy theories. This is possible due to the elevated level of media control that exists in the country, with independent information outlets being commonly acquired or confronted by the state or state-friendly organisations. In fact, Russian citizens are currently facing an information blackout because many independent journalists have decided to stop working in light of the new regulation criminalizing certain practices that contradict the government’s version of events (Inskeep & Maynes, 2022). Therefore, there are two layers to the Kremlin’s disinformation strategy: the control of the message itself, what is being said, and the control of the media agents responsible of communicating that information.

The strategic control of what news citizens should receive, and in which manner, can be considered a (perverted) version of the agenda-setting theory (McCombs *et al.*, 2014). The Russian Federation is in charge of the messages that audiences are exposed to, gaining dominance over independent outlets, as well as pointing out to what the population should consider important, which they are able to do due to the lack of informative choices that citizens have. Citizens learn about reality and events surrounding them through their own experiences and through mass media channels. Hence, by using disinformation as part of the political strategy, Russia has been able to define what is real and the state of affairs that its citizens are prone to engage with.

## **THE SOCIAL IMPACT OF DISINFORMATION**

This strategic development can only be understood considering the second dimension of the study of disinformation, which is the social impact that it has in public life. As discussed, the choice of terminology helps shaping public opinion. This shows in the efforts of Russia to use the concepts of “special operation” or “peacekeeping mission” to refer to the invasion of Ukraine, particularly domestically, while warning information outlets of the use of “invasion,” “attack” or “declaration of war.” In spite of the relative international success that this strategy may have had in 2013 and 2014, the escalation of events is far from being accepted as a routinary operation by foreign audiences.

The power of disinformation is strictly linked to the social impact it is able to articulate. The objective is to establish a discourse that fragments civic society, disrupts hegemonic narratives, and creates a gap between reality its perception. Media control in Russia remains relevant because it crafts messages that meet the expectations (while shaping them) of their target audience, aiming

to overthrow any genuine discussion about socio-political issues, especially during times of conflict and crisis (Mejias & Vokuev, 2017).

Disinformation efforts have had some impact on foreign audiences, although not to a broad extent, and particularly not at an institutional level. In fact, and particularly since the escalation of violence in Ukraine, the international response has provoked a considerable shift in international politics, such as pivoting traditional and established Swedish and German strategies.

The international social impact has also been mitigated because of how international institutions, and particularly the European Union, have rapidly communicated their position in defence of Ukraine. This has been done in a substantial, solid, and unified form, sending coherent messages to its citizens aligned with the Union's values of democracy, human rights, and cooperation. On the other hand, the images shared by Ukrainian citizens on social media (and shown on international broadcast television) reach users and audiences worldwide, which along with the media attention and the consistent messages that come from known and trusted institutions, make citizens empathise with Ukrainian citizens as victims of the conflict. Negative images boost the mobilization of citizens outside the conflict towards supporting the attacked party in armed combats, and more so if these images are filmed in a first-person perspective (also known as point-of-view or POV shots, much analysed in media studies).

In spite of the vast number of Russian citizens supporting Ukraine and protesting against the war, it is reasonable to argue that the Russian disinformation campaigns have had the most significant impact domestically, since the population still shows significant support towards its government and the invasion of Ukraine (Parker, 2022). This can be explained through the social theory of framing (the *selection* and *salience* of specific information), which results in the definition of problems and causes, the establishment of moral judgement and the suggestion of remedies or solutions (Entman, 1993). Since an essential element of the frames is the culture itself, one can deduct that information warfare is more effective domestically because it is not spread in a context of contestation, since the state has significant control over the broadcast of information.

In fact, the relevance of the cultural agent in this frame is particularly noticeable when assessing the effectiveness of pro-Kremlin disinformation in Ukraine, where Ukrainians with ethnolinguistic ties to Russia were more likely to believe disinformation supporting Russia's discourse in 2019 (Erlich & Garner, 2021). Nonetheless, disinformation about politics, historical experience, or the military is less likely to be believed than that concerning the economy, and since Russia's narrative has inclined towards the former, the disinformation campaign has not helped significantly towards support regarding the military action, which points out to an overestimation of the pro-Russian side and an underestimation of Ukrainian response and resistance to this attack.

It is also important to note the social impact that disinformation has not only in the involved parties, but also internationally, which can be observed, on the one hand, in international news outlets, and, on the other hand and reflecting on the popular discourse, in the realm of social media, where the plurality of disinformation campaigns is palpable.

## **DISINFORMATION AD HOC: SOCIAL MEDIA AND THE DISSEMINATION OF FAKE NEWS**

The digital space and particularly social media have accentuated the threat of disinformation, although it is only fair to acknowledge that these networks also provide users with easy access to fact-checking tools and first-hand information from reliable sources. A good example of this is Ukrainian president Zelenskyy's profiles on social media network, which he uses to address the international community and boost the morale of Ukrainian citizens through a disruptive form of diplomatic communication. The president's selfie videos aim to emphasise the personal and authentic connection with the audience, showing significant contrast with traditional institutional messages from presidents in their office surrounded by institutional symbols. In this case, Zelenskyy becomes the symbol himself.

Social media has granted (or at least contributed to) the success of his messages but, on the other hand, with this notoriety comes a greater risk of disinformation, and, in fact, more than 200 Zelenskyy impersonators on different international (including Russian) social media channels (Suciu, 2022). This is yet another demonstration of how the digital context makes it more difficult to control the information space, since they imply a structural change on how societies inform and converse with themselves, using these sites as new portals of public consciousness (Dornan, 2017).

Social media allows for sharing messages rapidly, and users are likely to do so when these messages have key informational factors such as controversy, relevance, or unexpectedness (Rudat *et al.*, 2014). When it comes to false information, the features of social media sites themselves make it extremely easy for users to share the content that they find appealing to their whole network (and beyond if they have a public account). Using traditional dissemination methods, citizens would be, firstly, less exposed to false information and, even after reading it and accepting it as truthful, they would not be able to spread the news so easily nor to such a number of people synchronously.

The main tactics that are used on social media to spread disinformation is through the control of media, similarly to the strategies used in traditional and broadcast media, which in this case entails manipulation of search ranking, and the use of bots and trolls to directly share information and make it more noticeable among audiences (Tucker *et al.*, 2018). Furthermore, a particular ramification of the disinformation campaigns promoted by Russia that has materialized with a favourable outcome has been that of *whataboutism*. Concerningly, western European audiences have adopted this discourse more easily than what they consider to be fake news from Russia. One of the reasons why they are not aware of it being part the Kremlin's disinformation tactics could be that this practice is not based on false information or fake news *per se*. Rather, this technique aims to discredit the argument someone holds by bringing another issue to discussion, raising a different subject and trying to point out to inconsistency or hypocrisy in someone's speech; which is generally considered to be a form of logical fallacy known as *tu quoque* (*What is 'whataboutism'?*, 2021). This has been studied before in the propaganda techniques of the Soviet Union.

Although this type of disinformation tactic is more difficult to detect, it still intends to deviate attention from the situation in Ukraine and degrade the discussion that portrays Russia as the responsible actor of the current crisis. This shows the extent to which disinformation campaigns

in Russia are elaborated in a diversified manner, not merely relying on dishonest or distorted messages that international audiences could fact-check, but also appealing to analytical reasoning that resonates with committed audiences defending the European concept of democracy and human rights.

Besides the selective exposure of users, which are influenced by agenda-setting and framing theories, the motivation that drives users to spread disinformation and fake news has to do with the gratification felt when sharing something with their online community, seeking social acceptance within the collective opinion, and confirmation and desirability biases (Shu *et al.*, 2020; Domenico *et al.*, 2021).

The fact that many users rely on social media as a primary source of information and how easily one can spread content through these platforms is one of the key reasons for the proliferation of disinformation. Besides, the online environment contributes to the polarization of political views and the rapid spread of information that contribute to these views (due to the confirmation bias), which ultimately affects the quality of public policy and democracies (Tucker *et al.*, 2018).

## **WHAT CAN WE DO? TOOLS TO FIGHT THE DISINFORMATION WARFARE**

Considering the threat that disinformation poses towards democracy and stable public life, it is pertinent to discuss the challenges that disinformation entails in the current context, and what methods are being set to combat it.

From an institutional perspective, there are several points of action being taken. For instance, countries in Europe actively had strong debates regarding switching off Russian television, preventing European citizens to access Russian state-backed media and its narrative. Although there seems to be consensus around not accepting media that are used as an information window structurally organized to publicize messages from the Kremlin, in this protective move experts also recognize the threat that it entails, since this could significantly limit on-the-ground understanding of the country (Kayali & Goujard, 2022). These policies seem to be reciprocated, given that that Moscow also banned German public media Deutsche Welle from reporting and broadcasting in Russia, further emphasising the control over media and using this decision as a form of response.

The restrictive measures approved by the European Union are an institutional reaction to the threat that Russia currently presents to the stability of the region, but they not only seek to have institutional impact, but also a social one. It is rather challenging for the European Union to battle the disinformation campaign by sending opposite messages to Russian citizens due to the previously discussed media control, but these actions are a way of reaching out to the country's population. These sanctions surely put on economic pressure on the Kremlin, but they also require the Russian government to justify to its citizens the effort and instability they will be facing.

Another example is the exclusion of Russia from European cultural events, such as sports competitions or even the Eurovision Song Contest. In spite of these secondary sanctions being

caricaturised on social media, it can be argued that in the particular case of Eurovision, which was created with the intention of reinforcing a European identity after the Second World War, the European Broadcasting Union (EBU) had two choices: letting Russia participate amidst the war conflict, or not; and preventing the country to be represented in this event, aimed at promoting cooperation between European countries, seems to be more in line with the messages being sent from the continent's countries, and the policies being adopted. The strategy is to not only isolate Russia economically and politically, but also at a cultural and social level.

There are also different organizations that are specialized in battling disinformation that are creating specific pages and tools with the aim of containing the spread of these messages, particularly within the European context, such as the European Observatory against Disinformation (EDMO) and SOMA, or the project *EUvsDisinfo*, which was created in 2015 to forecast and address the "Russian Federation's ongoing disinformation campaigns affecting the European Union, its Member States, and countries in the shared neighbourhood" (*About*, n.d.). Other associations and publications with this shared purpose are the *Global Disinformation Index* (GDI) or *First Draft News*, as well as academic and professional events addressing the current situation, such as the Disinformation Summit scheduled to take place in Cambridge (the United Kingdom) in 2023 or the webinar held by the European Communication Research and Education Association (ECREA) just a few weeks ago, titled "The information war: Communication and the Russian invasion of Ukraine".

Journalists and academics are also immersed in battling fake news in the 'post-truth' era, and every scholar analysing this topic is asked to make a contribution in this direction. Recommendations do include fact-checking for journalists and citizens alike, but it is important to revert the lack of trust and scepticism that audiences show towards public and professional institutions (Corner & Ball, 2017). This is, to counterbalance the disinformation war, the active role of citizens is as important as professional efforts, both in general and in the particular case of Russia's invasion of Ukraine.

Usually in times of crisis, citizens seek information more actively, precisely because of the uncertainty that comes with crisis, and although digital information means more flexible access, it is also a noisy and overwhelming environment in which finding credible information might be more challenging than usual. A first step towards avoiding spreading disinformation is the fact that audiences are able to fact-check themselves, which is enabled by organizations as the ones mentioned in this paper. In a more complex manner, being able to identify all the ramifications that disinformation campaigns adopt (such as the *whataboutism* strategy) and not be quick to share highly emotional content which may intend to trigger a viral response are also key steps that audiences should take.

## CONCLUSION

In times of ongoing crisis, disinformation techniques are fuelled by the emotional dimension of the communication of events, and they are nourished by the stronger need that citizens have of receiving information. It is likely that, due to different communication theories, citizens accept

more comfortably information that aligns with their expectations and political views, even when this information is not true or follows a specific narrative that presents reality in a false light to serve a political purpose. During political crises, it is easier that disinformation is spread because due to the urgency of the situation we cannot find real-time *expertise*, but rather, real-time events (more open to interpretation and manipulation) that are shared in the form of videos, pictures, or written messages.

Russia's efforts towards disinformation as part of their communication strategy is considered a form of hybrid warfare that adopts multiple forms and is used throughout multiple channels across time. The social impact has demonstrated to be stronger domestically than it has been internationally, but the *whataboutism* campaign incited by Russia has been more effective among international audiences, who condemn the invasion of Ukraine and might not be aware of how this logical fallacy is one of the branches of the Russian disinformation campaign.

Responsible communication in times of crisis is something that concerns governments, policy-makers, journalists, and scholars, but that should involve citizens to a great extent, particularly those that are users of social media. Highlighting the features and characteristics of Russian disinformation techniques and being suspicious of content that may seem legitimate but has the intention of deviate attention from the main issue may be helpful.

This paper has contributed to existing knowledge about crisis communication and Russian disinformation by analysing four key dimensions of this type of communication considering the current political crisis and relating it to important social and communication theories for further understanding the mechanics and dynamics of the spread of disinformation. Nonetheless, the discussion looks over the four aspects concerning digital disinformation rather than developing in-depth analysis of particular cases of disinformation for each dimension. Future research could contribute to this field of study by analysing specific examples of disinformation on social media and digital outlets. Another potential research that could be developed could focus on the particular study of *whataboutism* as part of the Kremlin's strategy and its success on Western social media regarding the Ukrainian conflict.

Russian deceitful information is being spread every day, and although audiences may be aware of the distorted reality that Russian media and journalists present and the strong surveillance of the government on these activities, there are several layers to these campaigns that must be acknowledged in order to oppose the disinformation and its dissemination, particularly in times of ongoing crisis.

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## THE INTERPLAY BETWEEN EMOTIONS AND LEGITIMACY IN MANAGING THE GLOBAL-LOCAL TENSIONS

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**ABSTRACT:** *Expatriates reside under the paradoxical tension between global integration and local adaptation when the assignment is to implement a global strategy in a local context. This tension triggers complex emotions that expatriates need to regulate to perform. Although the link between the individual-level emotion and the firm-level strategy implementation is of utmost importance in a multinational corporate context, it remains under-researched to date. We therefore investigated what kind of emotions evoke under such tension and how the emotion results in organisation-level outcome. We conducted a 612-day ethnographic study of a new product launch project in a multinational corporation. As a result, we found that the global-local tension evoked mixed emotions among expatriates over time, and those emotions influenced the individual's legitimacy in two phases: legitimacy seeking stage and legitimacy owning stage. These phases reiterated, and the repetitive cycle over time developed an emotional dynamic at organisation-level across the project team. We argue that expatriates' actions and behaviours to regulate mixed emotions evoked by the global-local tension influence the way the individual's legitimacy develops, as they change the interaction and the relationship among the actors. In turn, the individual-level legitimacy influences the organisation-level emotional dynamic and thus the performance.*

**KEYWORDS:** emotions, legitimacy, paradoxical tension.

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Managing dilemma between global integration and local adaptation has been an integral part of MNCs' strategic management (Bartlett & Ghoshal, 1988, 1991; Meyer *et al.*, 2011). Since globalization further evolved (Ghemawat, 2007), complexity of managing MNCs has been increasing. Consequently, modern MNCs need to proactively leverage synergetic relationship between headquarters and local subsidiaries (Cantwell, 2009). MNCs are required to manage increasing interfaces with differences of local contexts in terms of people, culture and infrastructure (Meyer *et al.*, 2011).

A way to understand how MNC manages the tension between global and local is to highlight the role played by expatriates. Expatriates are at the forefront of the tension between global integration and local adaptation (Luo, 2000). They interpret the global strategies and adapt them to local contexts, as they are cognitively closer to local business context than headquarters (Balogun & Johnson, 2004; Gavetti, 2012). These expatriates with multinational experiences reside in certain locations which are different from their own country of origin, hence, they experience

enduring influences from multi-embeddedness with global standard, local adaptation, and their own country of origin.

In this study, we highlight the emotions of expatriates to investigate their impact and relation to MNCs' performance. Scholars argue emotion may build dynamic managerial capabilities (Huy & Zott, 2019), facilitate adaptation to radical change within the organization (Huy, 2002), and contribute top managers' legitimacy (Huy *et al.*, 2014). In fact, expatriates are subject to complex emotions while mediating this tension (Anicich & Hirsh, 2017). As emotions affect cognition and behaviors of individuals at organizations (Elfenbein, 2007), emotions of expatriates at MNC and emotional capabilities of the organization play important role in implementation of global strategy, by affecting relevant decision making areas such as choice of location, entry model, management model etc. (Maitland & Sammartino, 2015).

However, how emotional capabilities of expatriates are related to the MNC's strategy remain under investigation. In particular, we need additional empirical evidence highlighting the mechanism in which emotions of expatriates navigate the implementation of global strategy under paradoxical tension between global and local. Therefore, we investigated the following research questions. How do expatriates navigate the balance between global integration and local adaptation in strategy implementation? And what are the contributions of emotions in this process?

To investigate the research question, we conducted a 612 days long ethnographic study of a new product launch project at a leading MNCs. The empirical setting of the study is the local subsidiary of the one of the world largest multinational food manufacturing companies; considered highly decentralized M-form entity, implementing the strategy to launch globally branded products that are developed as local adaptation to the consumer needs in another local subsidiary. This setting provides the window to observe emotional processes of those managers mediating the tension between alignment with global brand message (transfer of knowledge and technology from the parent company), leverage of product line up developed in the network of other local subsidiaries (sharing of locally developed knowledge within MNC network), and finally deployment of all marketing mixes to the need of consumers in the country where launching local subsidiary is located (local adaptation).

Our findings suggest that 1) expatriates may encounter mixed emotions, which influence the way they interact with others, when they deal with the global-local tension; 2) emotions would influence the way in which expatriates' legitimacy to develop, while the dynamic between emotion and legitimacy development change over time; and 3) emotions would in fact mediate the power and the influence between multiple stakeholders in the process of knowledge and technology transfer under the global-local tension.

We argued the findings advance our understanding of the tension between global HQ and local markets. The expatriates' actions in implementation processes is a source of MNC's sustainable competitive advantage (Peng, 2001), and so understanding of the individual-level emotion should also contribute to organization-level international strategic management (Teece 2014, Ghoshal & Bartlette 1991). The result also revealed the mechanism between emotional processes of expatriates and their legitimacy. While other legitimacy related research focus on social entities and objects

(Huy *et al.*, 2014), we provided animated example of how emotional processes contribute to legitimacy development of human agent in the entity where management of interrelationship between global and local is routinized.

## **LITERATURE REVIEW**

### **Paradoxical tension between global integration and local adaptation**

MNCs are exposed to internal and external complexities in strategy development and execution, caused by multidimensional and heterogeneities of cross boarder conditions. Reflecting this complexity, MNCs which used to pursue their growth and expansion through standardization and integration, look into the opportunity to continue prosperity through balancing with local differentiation. Hence, decision making mechanism of MNCs has evolved from the more headquarters driven bureaucratic and formal to the more networked and informal (Kostova, Marano, & Tallman, 2016), emphasizing the strategic role of local subsidiaries.

However, business initiatives in local subsidiaries require balancing off tensions between global integration and local adaptation (Meyer *et al.*, 2011; Mudambi & Navarra, 2004), as conforming to countless regulations and institutional expectations stemming from global and local contexts where MNCs are embedded is not possible. Hence, MNCs rely on political process to negotiate their status and interest (Kostova *et al.*, 2008) amid such paradoxical tensions.

Powers and influences of actors come to play in the negotiation process. The recent research trend regarding MNCs reflects the increasing importance of actors' role in the management of complexities and heterogeneities embedded in political negotiation processes between global and local decision making, hence, shows greater weight on the role of informal factors such as people management, social networks, compared to their early focus on formal organizational structure and design (Kostova *et al.*, 2016).

While acknowledging great potentials of actors' role in managing tensions between global integration and local adaptation, it is critical to understand micro level process on how actors manage such a paradoxical tension. However, majority of studies are made through organizational level approach and we are still lacking micro level researches that shows how actors in MNC approach to tensions between global vs local (Waldman *et al.* 2019)

### **The roles of expatriates at MNCs**

At micro level, expatriates assume a pivotal role in managing the global – local relationship. Consequently, preceding studies explored the role of expatriates in navigating the dynamic of powers and influencing the interactions between global and locals. Their acts, behaviors are the micro-foundation of the management of the focal tension.

Leveraging experiences both in global and local, coupled with international mindset, expatriates socialize with local managers and create informal networks between headquarters and local

subsidiaries (Harzing, 2001). They are boundary spanners transferring the knowledge not only across intra organizational boundaries separating between global and local and but also with external institutional bodies such as local regulators, stakeholders and customers (Johnson & Duxbury, 2010; Kostova & Roth, 2003). By playing various roles, they become a focal point of communication between global and local. They formulate strategic options and business plans by incorporating multiple yet conflicting views from global and local, and provide rationales, balanced perspective and positive attention from HQ that supports local business initiatives (Conroy & Collings, 2016; Plourde *et al.*, 2014).

As a dynamic managerial capabilities of MNCs (Luo, 2000), expatriates play multiple roles in the process to balance tensions between global integration and local adaptation, in turn, MNCs can achieve high level legitimacy across HQ and subsidiaries, so that they can stay competitive in the market through continuous access to resources and competencies (Kostova *et al.*, 2008). Naturally, juggling multiple roles creates substantial uncertainty and lead to increased feelings of frustration, stress, and anxiety, amid tensions about how to mediate conflicting demands and expectations from different stakeholders in global and local (Anicich & Hirsh, 2017; Floyd & Lane, 2000; Putnam *et al.*, 2016). They are constantly under pressure of conflicting interests and exposed of diverse emotional factors influencing the way they behave.

However, we have relatively little understanding the process of how those emotions influence expatriates' response to tensions between global and local in MNCs and how they navigate powers and influences from stakeholders within this process at the organization.

### **Individual-level emotions to organization-level emotional capabilities**

According to Elfenbein (2007), emotions have impact on attitude, thinking and behaviors through intrapersonal and interpersonal process in organizations. Contradictions inherent in global integration – local adaptation relationship translate into individuals' experiences of tensions and conflicts (LÜScher & Lewis, 2008). Hence, emotions interplay with expatriates' response to organization-level tensions between global integration and local adaptation. The individual-level emotion affects expatriates' cognition, behaviors and attitudes in decision makings and social interaction with stakeholders in HQ and local subsidiaries, thereby influencing the organization-level behaviors and inevitably the performance.

We define emotions as a reaction to affective events and has a range of possible consequences (Frijda, 1988). Affective events are triggered by social interactions and relationship with others and also by economic events and conditions (Elfenbein, 2007). Within organizations, emotions can be defined as two levels: individual and interpersonal. They can be the interpretation from individual appraisal on affective events but are also influence by social interactions which individuals experience (Hassett *et al.*, 2018).

People appraise affective events in relation to their own goals, concern, and their capability to deal with those events. For example, an individual will have positive emotions if he/she appraise the result of the event will be beneficial. If they believe they equip with capabilities and resources enough to deal with the event, they will decide to proactively respond it. Otherwise, they will avoid dealing with such an event.

Reflecting the interest in theoretical and managerial impacts of emotions in organization, various research revealed multi-level emotional dynamics in different empirical settings. As a result, a link between managerial capabilities and emotional processes of managerial roles has been found (Helfat & Peteraf, 2015; Hodgkinson & Healey, 2011; Huy & Zott, 2019). Guo, Huy and Xiao (Guo *et al.* 2017) discussed that MNCs are subject to middle managers' emotion in managing external embed-ness with local political condition.

However, most the link between individual-level emotion and organization-level capabilities are rarely researched, despite the fact that the emotion might contribute significantly to manage the paradoxical tensions between global and local (Conroy & Collings, 2016; Kostova *et al.*, 2008; Putnam *et al.*, 2016; Waldman *et al.*, 2019).

### **The link from emotion to legitimacy**

A way to understand the role of emotion would be to study how emotions contribute to creating and maintaining legitimacy. Legitimacy is defined as "generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs and definitions" (Suchman, 1995; Suddaby *et al.*, 2017). Individuals, as a kind of social entities earn their legitimacy from various sources of judgments. For example, the instrumental model would predict one to be judged as legitimate when they are perceived as promoting the material interests of individuals (Tost, 2011; Tyler, 1997, 2006). On the other, the relational model would predict one to be evaluated as legitimate when the one communicates one's status that affirm social identity (Bitektine, 2011; Tost, 2011; Tyler, 1997, 2006). Individuals may also judge legitimacy based on their moral concern. In case they judge taken-for-granted cultural expectations and norms, they make cognitive judgement that involve the absence of questions or challenges (Suchman, 1995; Tost, 2011).

Legitimacy is a key for MNCs' competitive advantage. As MNCs are competing in complex and heterogenous global environment, they must establish and maintain legitimacy by relying on the actors within the organization who manage internal and external social and political interactions (Kostova *et al.*, 2008; Kostova & Zaheer, 1999). Being legitimate is important also at individual level. Legitimacy exerts influence and power over stakeholders and help gaining voluntary supports from them (Tyler, 2006). Therefore, individual-level legitimacy, especially of expatriates, would mediate the tension between global and local (Kostova & Roth, 2003).

Individual level legitimacy to be developed by interactions between individuals, and the relational perspective implies the importance of emotional management in developing the legitimacy. Stakeholders with social connections develop social bonds with expatriates and internalize values and objectives that expatriates embrace. These mechanisms lead them to value expatriates' opinions and judgement, voluntarily follow their decisions (Tost, 2011; Tyler, 1997, 2006). The emotion would be an influencing factor of legitimacy development, and so would be the capabilities of expatriates to build social relationship with their stakeholders, which lead to organizational-level capabilities.

### **The link among the tension, emotion, and legitimacy**

Expatriates assume a pivotal role in managing the global-local tension in MNCs. While their functional role is well-investigated, how does the emotion of them influence their behaviors and thereby the organizational-level performance remains under-researched. A way to understand would be to investigate what the link between emotion and legitimacy is, because legitimacy is one of the most important factors influencing the performance of individuals managing tensions and conflicts. Therefore, we investigate the following research questions:

1. What kind of emotions are evoked when expatriate encounters the tension between the headquarters and a local operation?
2. How do expatriates legitimize the role in managing tensions between a headquarter and a local operation? And how do emotions play a role?
3. How can individual level emotions contribute to organization level capability?

## **DATA AND METHOD**

### **The data**

To address the research questions, inductive qualitative research method (Eisenhardt, 1989; Gioia *et al.*, 2013; Langley, 1999; Siggelkow, 2007) is applied, as it enables researchers to have deep dive understanding into complex and nascent research arena (Yin, 1994) and to track tensions and emotional response to them over time by exploring individual's day to day activities in MNC (Martin *et al.*, 2017; Putnam *et al.*, 2016).

We conducted longitudinal ethnographic study (Eisenhardt, Graebner, & Sonenshein, 2016), and one of the authors (hereafter CJ) involved in the launch of an anonymous global brand (hereafter "Chocolina") in an anonymous country (hereafter "Kaos") by an anonymous MNCs (hereafter Glo F&B) as a participant observer. The ethnographic study lasted for 612 days and CJ kept record of the progress, as well as the key moments of the project, with a particular attention on actors' emotion and legitimacy development.

We complemented the data taken from the ethnographic study with the information from various sources such as semi-structured interviews, focus group interviews, observation of 197 meetings and kitchen cabinet conversation, and review of 50 projects' strategy and implementation related key documents, and 447 email conversations. The diverse sources of secondary information enabled researchers to involve creative problem solving and imaginative interpretation (Charmaz, 2008).

In particular, we conducted interviews with 6 top and middle managers who hold decision power on business, people move and management of relationship with external parties. To triangulate, we also interviewed 4 team managers and frontline employees. All interviews are recorded and transcribed. These multiple data from various sources will allow us to sense the flow of emotions and to identify its organizational outcome. Through these interviews, first, we understood overview of organizational structure and ways of working and organizational culture broadly. Second, we

gained the access to archival data such as organigrams, official strategy documents (e.g. Market Business Strategy – MBS document) before starting official interaction with interviewees. Third, we reassure confidentiality and anonymity, and align mutual expectation on potential outcomes and benefits from this research (Huber & Power, 1985).

To increase validity of retrospective interviews on emotional dynamics, we utilized the following steps and measures (Miller *et al.*, 1997). First, we applied free report options and asked facts, concrete events, rather than generalized post opinions or beliefs. Second, we interviewed not only expatriates, but also their managers, subordinates and peers for triangulation. As Eisenhardt and Graebner (2007) suggest, information from diverse angles can reduce bias from impression management and retrospective sensemaking. Third, we guaranteed confidentiality and anonymity. Fourth, we included facial expression, vocal tones, body language, movement, touching and physical distance through voice and/or video recording to capture emotional expression in the organizations, as organizations lack “vocal” conversation to discuss emotional experience (Elfenbein 2007). Fifth, we conducted “tandem” interviewing that leverages a co-interviewer’s complementary positioning, to increase accuracy and comprehensiveness of data collection (Huber & Power, 1985).

### **The Method**

To attain underlying insight and mechanism of emotional dynamic, our data analysis goes back and forth between theoretical concept, prominent themes and data collected (Farny *et al.*, 2019).

First, we followed an iterative process (Charmaz, 2008) and inductively searched the focus of the analysis over the course of data collection and analysis (Kaplan, 2011). We explored five different practice breakdowns (see Appendix 1: An overview of the episodes); conflicting moments where expatriates’ emotions and interaction with stakeholders were intensive, to enable the development of theory that capture “logic of practice” (Sandberg & Tsoukas, 2011). For each of the five episodes, we answered various questions that addresses conflict resolution processes. By answering these questions, we uncover underlying processes and mechanism; what emotions expatriates felt, what triggered expatriates’ emotional ups and downs, how they manage emotions, what actions they take and how their emotions led them to act in such way.

To model the dynamic of actions and interactions between expatriates and the rest stakeholders, we applied the narrative and visual mapping strategies on the process data along the key dates and milestones (Langley, 1999). Applying the data analysis methodology suggested by the study of Gioia *et al.*’s (Gioia *et al.*, 2013), we applied two step coding approach to our data analysis stage. Interpretation of insights from ethnographic data and the outcome of the interviews such as quotes, verbatims are codified according to 1<sup>st</sup> order (informant centric) terms – key questions that address steps of conflict resolutions. With the rich sets of emerging theoretical themes, we began mapping those dynamics with the themes such as legitimation, legitimacy judgement, emotional regulation of self and others, and self enhancement mechanism triggered to gain power & influences. Through this rigorous data analytical process, we began establishing the emergent theoretical explanation of how expatriates’ emotions relate to legitimacy over the course of the project, and how they help reconciling the tensions between global and local. Hence, we built into more theoretical 2<sup>nd</sup> frame – 1) emotional management categories developed in studies of Schutte *et al.*’s (Schutte *et al.*, 2009)

and Kaplan *et al.*'s (Kaplan *et al.*, 2014) as emotional states and actions, and 2) legitimacy using the categories developed in the study of Tyler (Tyler, 1997) and Tost (Tost, 2011).

Finally, we have developed our final arguments that focused on the development of the link between individual-level emotion and legitimacy, which changed over the dimension of time, and how did the emotion and legitimacy contributed to defuse the tension between global and local.

## FINDINGS

In this section, after a short explanation of the empirical context, we present our findings on the processes to manage paradoxical tensions carried by expatriates to explain 1) what emotions of expatriates are evoked and evolved under dynamic of tension, 2) how emotional capabilities and social capitals of expatriates contribute to managing tensions between global and local and 3) how legitimacy of expatriates are evolving.

### Empirical context

Glo F&B is the multinational food & beverage company with over 100 years long history. It carries more than 2000 brands, ranging from global and local ones in more than 150 countries worldwide. As it is indicated in its organization principle, Glo F&B embraces and manages the balance between global integration and local adaption, by aligning strategy & implementation through its strategic planning cycle and distinguishing the roles and responsibilities of; 1) Strategic Business Units (SBUs); 2) Zones at the headquarters; 3) and local markets.

SBUs are the organization units holding “strategic leadership” to set the strategic direction on specific business category related topics. Under this strategic leadership role, SBUs develop Global Business Strategy (GBS) for the categories. To deliver GBSs, they develop and manage global product innovation priorities, brand communication guideline and consumer insight framework. Together with the Zones, they also manage the category-specific talent pool.

Zones are the organization units that hold the role of “line management” in given geographic territories divided at continent level. “Line management” refers to driving performance and steering the Line organization with decision-making authority on strategy implementation, target setting, results tracking, resource allocation, talent pool assessment and nominations. They develop the Zone Business Strategy (ZBS) with enhanced focus on zone specific category issues in line with GBS developed by SBUs.

Local markets are subject to multiple forces from local business environment such as local competition, product category trend, and consumer behaviors. Local markets develop market business strategy (MBS) that reflects local specificities and ensure alignment with ZBS. They hold “P&L responsibilities” within a country, delivering business performance to reach financial target through implementation of MBS. Local markets represent the company in the region to the local external stakeholders and comply with internal principles, policies and standards, and external regulations.

The focus of this study was a local market launch project of a brand called Chocolina. Chocolina is the single global brand among various chocolate portfolios of Glo F&B. The brand is now available in over 100 countries. Acknowledging severe competitions among global chocolate brands, Glo F&B's chocolate SBU and the zone APAC (i.e., Asia Pacific) believe in the strategy to focus its investment on expansion and growth of global brand Chocolina and emulate one market's success factor in other following markets.

Chocolina branded products and locally adapted marketing campaign developed in an anonymous developed market (hereafter Nix) are recognized as the best practice by other local markets and the SBU, hence, the local markets who have business of Chocolina brand are highly interested in adopting the practice from market Nix. Hence, the SBU and the zone encourage and even request local markets to launch Chocolina branded product and marketing campaigns developed in market Nix.

Chocolina brand in Market Nix is known for unique campaign message of the brand that resonates local consumers' heart and mind through various local flavors and its unique brand message. Recognizing that Chocolina brand's emotional benefit from its brand positioning and product benefits from its flavor varieties can be attractive also in Market Kaos, John, the head of the business unit in Nix and Greg, the head of Market Kaos agreed to bring Chocolina branded product made in market Nix and launch its communication campaign in the market Kaos.

In market Kaos, the products of brand Chocolina made in Europe, are available, yet the taste of these products was not adapted to local consumers' palate. In addition to that, the brand communication was never made during 20 years of its business since its first distribution. For these reasons, coupled with frequent changes in distribution model, brand Chocolina had been staying as an immaterial sized business in market Kaos, therefore, there is no dedicated resource for this brand.

For this reason, CJ in John's team in market Nix was appointed to lead the project to launch 'made in market Nix' Chocolina branded products with the communication campaign in market Kaos. Born in Kaos and worked in HQ and Nix, CJ, expatriated to country Nix, understands the global strategies and local specificities. He has been exposed to multi-cultural business environment, hence, is considered to have right profile to manage the project orchestrating various directions from multiple stakeholders in global HQ (the SBU and the Zone) and two local markets: Nix and Kaos.

### **Underlying emotional reactions in the dynamic of tensions**

By nature, tensions in decision making situation evoke negative feelings such as stress, anxiety, worries and discomfort. However, from our empirical research, we found that emotions of expatriates toward paradoxical tensions in decision making are mixed and changing over time, as perspective and attitudes toward the tensions are evolved. For example, when CJ first encountered the tension raised in the discussion to adjust the product launch timing right after being appointed as the project lead, he felt positive emotions about it driven by his motivation to success and emotional regulation that redefine tensions as a "part of the game".

*“When I first faced the tension between the global team and the team at Kaos regarding the change of product launch time, I felt very excited. I thought that constant tensions between them are the part of the game. I enjoy having those conflicts to prove that I can manage them well which means I am the right one who is charge.”*

However, once he entered the stage when he needs to solve tension by getting to the conclusion, he started feeling negative emotions.

*“Amid those recurrent tensions, what I had to do is to make progress. To do that, I had to facilitate repetitive several discussions to get to the conclusion. In this process, I became a messenger between the global and Kaos team. I felt very exhausted and disappointed with my role as a project lead. Convincing all those stakeholders with different opinions in two folds were extremely challenging and time consuming.”*

When the product launch was made on time, he described his feelings that came across after dealing with accumulated multiple tensions and maintain himself to stay in the project with this self-enhancement motivation.

*“Facing the tension after the tension, I feel only today that those tensions are finally solved. I had to deal with fear from failure in managing those tensions and this feeling has been endured along the project. Sometimes, I wanted to leave the project. But I wanted to be successful and didn’t want to be the part of the failure. I really try hard to hang on.”*

Our observation concludes us that tensions evoke not only negative emotions but also positive emotions and that emotions can be evolved from positive to negative or from negative to positive over time due to their emotional regulation and motivation for self enhancement.

### **Emotional capabilities and social capitals of expatriates**

In our empirical research, we found that expatriates demonstrated actions and behaviors to regulate those complex and dynamic emotional reactions of their own and others, and that these actions and behaviors ultimately supported the expatriates to build social capital within the organization. For example, when CJ had to engage his boss to support his opinion, even asked him to speak for himself in the meeting to announce new project deadline, he felt disappointed with his role as a project lead as he realized that he couldn’t lead the decision in the direction he wanted and relied on his boss’s authority, knowledge and connection with key people in the organization. However, he didn’t give up and eventually became eager to learn & emulate strengths of his boss to convince Nix org, thinking that these strengths will help him to change this frustrating and disappointing situation

*“I felt very bad about me when I had to rely on my boss’s authority to break through negative reaction from the team. However, looking at how my boss managed the situation, I kept in mind that I want to equip myself with the strengths that my boss demonstrated. I realized that I need more time to get respect from the organization in the beginning and began thinking this project can be a good opportunity to learn his leadership style, knowledge, and skillsets. Next time, I want to rely on my own strengths to convince the team.”*

With the strong desire to turn the situation favorably next time, he used his emotion to understand how his position and status are perceived within the organization and chose to build and maintain motivation under challenging circumstance by reframing the negative event where he was not supported by the stakeholder as a learning opportunity. Another manager Smith whom we interviewed for triangulation stated that maintaining positive view on the conflict between global and local helped him to solve the conflict by keeping his motivation on the project high and separating task conflict from relation conflict.

*“I understand both perspectives from global and local that are often contradicting. When the discussion gets too long without progress, I am agitated and frustrated, of course. However, I see this conflict is basically necessary ‘healthy conflict’ to have better business results. From my experience, the important one is not to avoid conflict and tensions, but to embrace them.....I tried to keep emotion very cool in the intense discussion not to damage relationship with people. Work is work, isn’t it?”*

Supported by self-awareness and motivation, expatriates regulated their own negative emotions by defining the conflict as a positive event to bring better solution in managing the balance between global integration and local adaptation.

CJ also showed his behavior to communicate and listen with stakeholders by having participative discussion before making final decision.

*“Understanding local business contexts is the key to success for my role, and I noticed people who spent long time in this organization tend to get very unhappy when it comes to change, because they are very proud with what they have been doing for long time. Especially, in the beginning of the role, I extremely needed to hear from the team in the local not only to obtain knowledge, but also to show that I am open to listen to them and communicate with them.”*

This participative discussion process which was often referred by expatriates as a conflict solution process was perceived as a fair procedure and expatriates’ openness to stakeholders’ different opinions by stakeholders both in local and global team. One of the project team members, Sarah who worked with CJ said.

*“I was very upset when I heard from him that launching date just has been changed. Cause it cause huge additional work and I got stressed. However, when I saw he kept us in a loop of discussion afterwards, I felt that he tried to listen and be open to us, and everyone’s opinion was counted. I think that’s fair way of working. I felt I am the part of the project at the end.”*

*“In the one of the discussions I joined, I saw him in the challenging situation – being in the middle between global HQ and our local team insisting different opinion from HQ, I felt empathy for him. Although I don’t see him yet as a part of us, I shall say I appreciate his positive attitude toward the project.”*

While he perceived as an outsider due to different cultural background and pursuit of the new project which requires adjustment on existing ways of working that has been perceived as a norm

within local organization, stakeholders in a local subsidiary started sharing positive view on him as his actions and behaviors to regulate emotions of self and others play a role to let the project team members feel their self-worth and respected. Positive feelings that the team members have, moved them to provide voluntary support.

His actions and behaviors to maintain positive attitude under the paradoxical tensions and to care about others' emotions created positive perception around him and the project, leading to sparking commitment of the team to the project he led, and helping him to build social network with the team.

### **Evolution of Expatriates' Legitimacy**

We found that capabilities to manage emotional dynamic along paradoxical tensions and social capitals of expatriates produced organizational outcome; legitimacy that helps them to navigate and solve tensions by engaging stakeholders to provide voluntary support.

Phase 1: At legitimacy seeking stage of expatriates, expatriates seek sources of legitimacy externally in solving conflicts.

Expatriates are often seen as a "outsider" due to nature of their role as a mediator between global and local, and different ethnic origins and nationality. In a word, they are less conformant to cultural expectation and norms in local subsidiaries. Therefore, in the beginning of expatriation, local stakeholders' judgement toward legitimacy of expatriates are at low level, as at the legitimacy formation stage, individuals rely on validity cues and/or conformity to cultural expectation and norms to reach cognitive judgement (Tost, 2011).

In a such circumstance, we observed expatriates seek legitimacy, relying on external judgement contents such as authorities and knowledges of others who hold power, influences and credibility within the organization. For example, William who faced the gap between compliance to global guideline and adaptation of the global process for local needs, engaged his boss to back him up:

*"When I tried to convince the stakeholders with my own judgement and opinions, stakeholders gave objections as my suggestion was always different from theirs. I had to bring my boss to back me up. As a trick, I even give my opinion to him and ask him to speak on behalf of me."*

From triangulation interviews with other expatriate James, we also see that they rely on facts and opinions from influential professional groups and they facilitated participative discussions to accommodate and consolidate others' opinions before formulating final decision:

*"When I landed in this role, I need to understand better various perspectives that bring the balance between what global wants and what local team wants. Before I pursue the decision, I asked my teams who are specialized in each segment of business and skill. According to their professional knowledge, I tried to form the solution."*

By understanding how his position and status within the organization are perceived by stakeholders, CJ applied the approach that first navigates key people who hold power and influence within the organization and engage them to bring support upon conflicts in discussions.

*“I felt that people in the organization feel discomfort when the project requires some adjustment in their current ways of working, which becomes cause of tensions between global and local. I knew I am not the part of them yet and I am not the part of HQ anymore neither, so I was not the best person who should address this directly to them. I had to rely on helps from others and to search for who can provide that help and support me. I observed the group dynamic in meetings and identified so to say ‘key opinion leader’ within the organization. Later on, I could ask them historical background of the existing business initiatives and processes, and they advised me whom to talk to when I was stuck in the issue.”*

His awareness on stakeholders’ emotions and capability to regulate them by approaching key influencers with the attitude as a listener helped him to build interpersonal relationship and brought him supports gradually.

#### Phase 2: Organizations reassess expatriates’ legitimacy

We observed that expatriates’ continuous and consistent actions and behaviors to regulate their emotions and others and tangible success of the business can act as emotional events that triggers stakeholders to reassess judgement toward legitimacy of expatriates by affecting creation and maintenance of their social capital and that expatriates notice this switching moment before they actively utilize legitimacy judgement contents from self.

For example, CJ’s consistent behaviors to communicate and interact with his stakeholders in respectful manner supported release of anxiety and stress spread within the project team.

*“I remember we had unwelcoming news. We had to change lots of existing development because it was declined in the internal review. We were very disappointed and worried of how we can deliver final development on time. He personally explained to me the reason for refusal in detail and gave very specific directions I could immediately follow up. I felt very relieved by his communication to me. He was calm and didn’t blame us.”*

His behavior to contain his emotion internally and rather to focus on tasks to solve the conflict was interpreted as determination and reliability that gave him respect and evoked trust and empathy from the project team members Diana. Diana described:

*“I saw him in the very challenging situation. The distributor in Kaos didn’t want to comply with the company’s process, while Nix team asked CJ to push the distributor to follow our internal order process. He often said, ‘I’m in the middle.’ He must be very frustrated and lonely. If I were him, I would have given up the project. But he has never shown such frustration and tried to see what’s next. I felt sorry for him and positively surprised with his capacity to absorb stress and move on next.”*

His engagement with his own emotions and others supported him to build solid social capital such as trust, credibility, and positive and cooperative relationship with the stakeholders, facilitating the process to make choices or formulate alternative between global integration and local adaptation. Observing his consistent emotional engagement came across as a mental alarm to stakeholders within the organization that triggers to shift their judgement on his legitimacy from positive to negative. We observed in the phase 1 that positive and negative judgement on their legitimacy stay mixed, while in this stage, evaluators actively reassess existing judgement and turning from negative judgement to positive one is accelerated.

The immediate success of the project played as an emotional event driving reassessment on legitimacy of expatriates. Upon sold out of newly launch product in Kaos, stakeholders in Nix and Global described:

*"I knew our brand is strong and the product produced in Nix under this brand is very competitive. However, during the project journey, we were very skeptical about the success, as working with Kaos made us realized that our internal guideline and process are not designed for serving small new market such as Kaos. We had to make lots of adaptation in our approach to make this launch happen. We thought it's not possible to do, while CJ relentlessly tried to convince us. Well now, we see we can do it!"*

In contrary to expectation on the project result, success of the project brought proud and rewards to the organization. Some of the team members even expected the opportunity for job promotion. This success not only boosted self-confidence of CJ, but also positive judgement toward his legitimacy, as stakeholders noticed tangible benefits that this project success brought, such as job promotion, acknowledgement from sr. management in global and local organization and enhanced their feeling of that they and their work are being valued.

When do expatriates notice that their social capital is solid enough to support them within the organization? How can they detect the moment of stronger legitimacy? According to our empirical research, we found that expatriates actively look for the moments of "emotional hook" which signal that they are accepted by the organization. James said:

*"As a mediator, I often have conflicts both with global team and local team. If I support local team's idea, I shall provide reasoning to global team, and vice versa. It can be very lonely position. However, when my team member came to me directly and shared her ideas which sometimes are opposite to mine, I feel they feel safe to talk to me and they feel accepted, especially if she is normally shy person who tends to avoid giving different opinions from others. I feel that I build emotional bonding."*

Affirmative comments that demonstrate agreement to his position or give compliment to his actual performance are interpreted as signal of support.

*"When I took in charge in the role in the beginning, I had a hard time to convince people as often what I wanted is opposite to what they were doing. However, at some point, I see people openly 'agree' with my opinion and show overt verbal comments by saying 'I agree,' 'what James says is right.'"*

*“After the product launching, one of my team members in Nix came to me and said ‘James, thank you for introducing products produced in our country’. I feel they open up to me.”*

Phase 3: at legitimacy owning stage of expatriates, expatriates own the source of legitimacy in solving conflicts.

After expatriates build solid social network and gain respect and supports from the organization, they increasingly rely on the source of legitimacy from self, such as their own perspective, thinking and knowledge to influence more proactively stakeholders and decision direction. Acknowledging that stakeholders are showing trust on him due to his network and achievement, they become further confident in forming their own opinions and drive decision making process beyond facilitating and coordinating it.

Positive judgement on their legitimacy sourced from their inner self, support them to get buy in on their ideas and opinions easily. For example, Smith mentioned:

*“When I landed in the role, I remember I had to consistently defend my opinion by looking for evidences and facts to support. Along the project, I found more people on board as they saw the success and progress in the project. Now, I find myself more confident to drive my opinion and I feel even I became quite assertive in this environment.”*

We also observed that individual’s positive judgement is influenced by acceptance and appreciation from majority of the group on the business success. His stakeholder mentioned:

*“I know now every organization is running after the business opportunity that he opened up. I don’t want to be the only one who don’t follow that trend.”*

Smith also described that success of the project as a lighthouse example of multi-market collaboration.

*“In the beginning, I didn’t feel that project would go well. It costed mostly exception-based adjustments. However, at the end, I felt this new project brought a good example of cross market collaboration that HQ always wanted to demonstrate through their strategy. Now I am much eager to contribute to the project.”*

Positive judgement toward CJ’s legitimacy that are formed at group level, enabled him to drive timely efficient consensus gathering process and gain agreement and approval efficiently, increasing his negotiation power in the process of managing the tension at group level.

For example, interviewee for triangulation described his changing situation.

*“After the success of the project, I noticed my boss didn’t ask several questions anymore to validate my approach. He just gave in his support.”*

## DISCUSSION

### **The role of expatriates in managing the tensions in MNCs**

While MNC may be competing globally, managers and leaders of organizations reside in a certain location, and their embeddedness in that location has an enduring influence on their firms' behaviours (Marquis & Battilana, 2009). Hence, expatriates in MNC who lead strategy implementation in local subsidiaries involving global and local communities as stakeholders, take the role of a mediator who does "telescoping global and local to make a blend." (Robertson, 1995), managing various influences from multiple institutional contexts where organizations are embedded.

According to the research of Marquis and Lounsbury (Marquis & Lounsbury, 2007), members with longer tenure at the organization are more likely to take for granted existing norms and in some cases, to defend them. In contrast, organizational members who have been exposed to greater numbers of different institutional contexts, are less likely to take for granted.

Expatriates in MNC are exposed to the organization which consist mostly of stakeholders who build their career and live their lives only in their home country or in limited geographic scopes. To those stakeholders, practices and processes of organizations that they belong to, are taken for granted. Therefore, expatriates who develop and bring different perspectives between global and local, may encounter conflicts with surrounding stakeholders. Social capital of expatriates is critical to their success in the process of managing tensions between global integration and adaption, and their emotions is catalyst to build social capital.

In such recurrent conflicts raised spontaneously under paradoxical tensions between global and local, we found that expatriates rely on legitimacy to address and solve conflicts as obtaining and maintaining supports from the organization are related to legitimacy, and that emotional capabilities and social capital of expatriates contributed to building legitimacy. We illustrated emotional dynamic under paradoxical tension; explained the micro-mechanism of how expatriates leverage their emotional capabilities and social capitals; and identified evolution of legitimacy as an organizational outcome.

The tension between global integration and local adaption in MNC persist over time and the continuity of situations leaves making choices among strategic options difficult, hence, evokes feelings such as stress, frustration, and angers by nature. However, there has been a challenge to study emotions in tensions because in many cases, tensions are read but the emotions behind them are either unclear or ignored, therefore, majority of previous studies emphasized on the role of rational and treat emotions as a background (Putnam *et al.*, 2016).

In our empirical research, expatriates verbalized a wide range of emotions, mixing positive and negative ones on tensions over the project period. Mixed emotion defined as the simultaneous or sequential experience of at least two different emotional states during the same emotional episode (Rothman & Melwani, 2017) are driven by the motivation for self enhancement such as desire to prove that they deserve to be the part of success (Pfeffer & Fong, 2005), and by regulating negative

emotion such as reframing tension as an opportunity to learn how to deal with challenge in new country (Schutte *et al.*, 2009).

In addition to mixed emotions, we found that emotional reactions of expatriates toward tensions changed over time as the project progressed. This was mainly driven by the fact that their perspective and attitude toward the tension also changed. In our empirical setting, the expatriates got familiar to the business context of the project, built bond with stakeholders and made small wins in conflictive discussions in the project journey, hence, they gain confidence and credibility within the organization. This gradual success, increasing knowledge stock and support from the organization drove those expatriates to interpret tensions; emotional events much positive than when they just kicked off the project (Hassett *et al.*, 2018; Lazarus, 1991; Martin *et al.*, 2017).

### **The emotion and legitimacy evolve around two stages**

How would MNC manage complex emotional dynamic under paradoxical tension? Our study suggests that expatriates' capability to manage mixed emotions and social capital they build are crucial in making decisions under conflicting forces between global integration and local adaptation, as expatriates use emotions in decision making, understand and regulate emotions in self and others (Mayer *et al.*, 2004), and their actions driven by emotions can determine emotional experiences of stakeholders (Kaplan *et al.*, 2014).

Effective emotional functioning of expatriates led to positive competencies and skills that are catalyst to management of decision making under paradoxical tension, such as interpersonal relationship within the organization, strong problem - solving competency, self-motivation under challenge and self-awareness (Bar On, 2006). Leveraging emotional capabilities to acknowledge others' emotion, listen and communicate to their stakeholders in global and local, expatriates evoked empathy, trust and credibility from the organization, leading to building social capital within the organization successfully.

Further, our finding also suggests that emotional capabilities and social capital of expatriates drove changes in legitimacy judgments, as they affect evaluators' emotions, thinking and behaviors that influence interpretation on judgement contents (Elfenbein, 2007; Huy & Zott, 2019; Tost, 2011). We argue that the relation between emotion and legitimacy change over time between two phases: legitimacy seeking stage and legitimacy owning stage.

First, in legitimacy seeking stage, expatriates seek source of legitimacy judgement externally meaning that they are relying on other's opinions and knowledge or on other's authority e.g. their boss. Empirically, in the beginning of landing in the mediator role, they still face cognitive distance from local business context and social dynamic within organization (Powell *et al.*, 2011) and are perceived as a "outsider" or "someone in the middle". Therefore, cognitive legitimacy of expatriates are at low level at this stage (Tost, 2011). They first want to understand local context and seek local power and influence holders. They deliberately focus on facts and opinions coming from externally to bring neutrality in the process of decision making. Recognizing others' perspective and integrating them into his/her own perspective in formulating alternatives that solve tensions can be seen as a behavior that respect stakeholders' identity and self-worth. Similar to the relational

model of legitimacy, this legitimacy seeking behaviors of expatriates develop positive judgement of stakeholders toward legitimacy of expatriates (Tost, 2011; Tyler, 1997, 2006)

Second, in legitimacy owning stage, expatriates leverage sources that he or she own internally to enhance and maintain legitimacy. With social bonds coupled with familiarity in market context, they start feel further confident in forming his own perspective and he can convince stakeholders in absence of questions and challenges. Stakeholders are willing to give supports as “trade off” as reciprocal respect toward respects that expatriates gave in legitimacy seeking stage (Tost, 2011; Tyler, 1997, 2006).

Switching between these two stages, “emotional hook” with stakeholders – the feeling that expatriates are accepted by the groups and connected to them, plays as a signal that allows them to be present, make their own voice, be more proactive in engaging stakeholders, and rely more on own experiences and knowledges. The feeling of bonding gradually emerged within the organization, driven by two forces. One is expatriates’ actions and behaviors for emotional regulation. The other is unexpected success of the project which acted as a mental alarm that triggers stakeholders to reassess legitimacy of the expatriates and eventually to shift their legitimacy judgement from negative to positive (Tost, 2011).

By definition, legitimacy is critical institutional logic on which expatriates rely during their mission in navigating balance between global integration and local adaptation as legitimacy can bring voluntary supports and sense of obligation to support from the group of stakeholders within the organization (Tyler, 2006).

Our empirical research illustrated that individual emotions of expatriates contribute to address and solve tensions at the organization level, building and utilizing their legitimacy. Legitimacy at high level leads to effective consensus development and decision making as it granted stronger convincing and negotiation power to expatriates under political circumstance that requires balance between global and local organizations. It creates group dynamic that is supportive to mediators who try to reconcile tension, leading to effective conflict resolution. The legitimacy also allows the access to information and human resources within the organization that are critical for expatriates to implement strategic initiatives.

## **CONCLUSION**

This study provide an evidence of how expatriates’ social capital, together with emotional capabilities, contribute to managing the tension between integration and adaptation in MNCs as also discussed by Kostova and Roth (2003). We presented an animated detail of how individual level emotion and social capital development lead to organization level emotional capability managing synergetic intra-organizational relationship between global and local. Managing the tension between global and local is the foundation of international strategic management (Bartlett & Ghoshal, 1991; Luo, 2000; Peng, 2001; Teece, 2014). And, we argue that expatriate’s emotion also is an important element for developing sustainable competitive advantage.

In particular, this research advanced our understanding of the dynamic tensions between global and local by exploring how emotional reactions toward management of tensions change over time and by showing actual empirical examples. We illustrated how expatriates address and embrace tensions in the organization through longitudinal inductive study, leveraging access to actual empirical setting to which is usually hard to access for academic research (Martin *et al.*, 2017; Putnam *et al.*, 2016). In addition to temporal and contextual values, our result illuminated understanding on micro-processes of decision making under tensions while the role of tensions in decision makings at micro-level has been underspecified in precedent researches (Waldman *et al.*, 2019).

Secondly, this research provided the avenue to understand the mechanism of the interplay between emotional capabilities of expatriates and legitimacy of actor, while precedent legitimacy related studies (Conroy & Collings, 2016; Huy *et al.*, 2014) focused on social entities at organization level. Our research delivered the micro level animated detail of how emotional regulative behaviors of expatriates supported them to build social bond within organizations, leading to establish and maintain their legitimacy in the routinized tension between global and local at the organization level.

While the interrelationship between emotional process and legitimacy development is an established research topic for entrepreneurial firms, less is known for established firms (Huy & Zott, 2019). Our evidence taken from a large multinational firm with +150 years history informed us how legitimacy is utilized within the established firm in managing internal tensions in making strategic and implementation decision within the organization. As previous research found, we found that emotional regulations would mobilize social capital by facilitating legitimacy.

Further, although integrating emotional foundations to management theory has been progressed for the last 20 years, many researchers addressed the gap in understanding emotional dynamics under paradoxical tension (Ashkanasy *et al.*, 2017; Conroy & Collings, 2016; Huy *et al.*, 2014; Putnam *et al.*, 2016). We observed the micro-processes that shows emotional contribution of individual actors to legitimation of MNCs by mediating power and influences between multiple stakeholders in the process of knowledge and technology transfer under paradoxical tensions.

There are several important considerations to be taken into account for future research. First, in this research didn't make distinction between top managers and middle managers. Likewise, there is no distinction between expatriates from HQ to local subsidiaries, or from local to other local subsidiaries. Future research will benefit from the specific research that study differences among various international cadre groups in terms of the approach to emotional regulation and legitimation.

Further, expatriates' personal characteristics, as well as personal situations, may significantly influence the dynamics. Expatriation is becoming challenging as hard to manage careers for individual who pursue dual careers, and expats' emotions conflicts in work environment (Harzing, 2001). How such emotions aroused in their personal life circle in dual career can affect their performance in MNCs provide new avenue of research (Putnam *et al.*, 2016). Further research can highlight how personal aspect of expatriates can influence their behaviors of emotional regulation and legitimation process.

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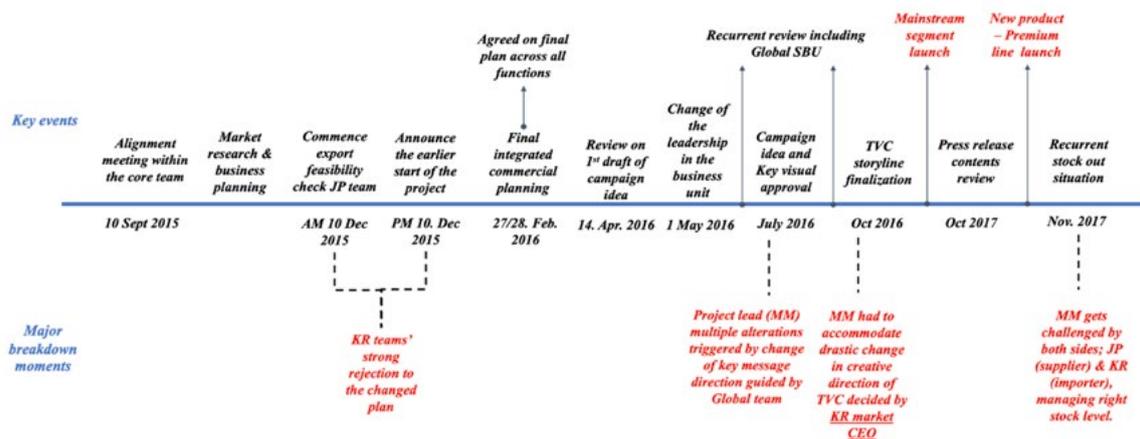
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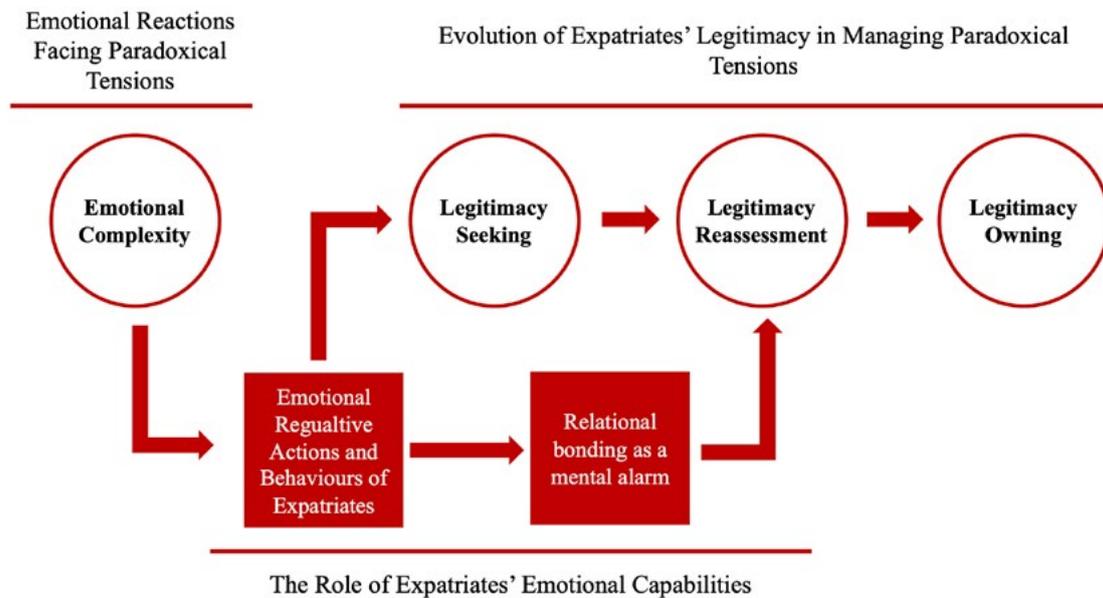
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## APPENDIXES

### APPENDIX 1: Timeline of Episodes



**APPENDIX 2:  
Integrative Mechanism of Interplay between Emotional Capabilities  
& Legitimacy in Global – Local Tensions**



**TABLE 1.  
Overview of Five Episodes Where Intense Emotions Aroused**

Episodes where intense emotions evoked.	How CJ managed and/or solve conflicts?	What emotions CJ felt and how he managed them?
<p><b><u>Episode 1: Informing change of the launching date, after the initial kickoff meeting</u></b>                      In the initial meeting, HQ, NIX and Kaos agreed on the launched date. However, upon Greg’s request, launch date became advanced by 4 months causing emergent production plan to change in NIX and increase of workload in Kaos. CJ announced the change yet faced huge objection from the team in NIX and Kaos.</p>	<p>He reiterated the change of the launch timing as a request from the CEO of Kaos. Later on, John who was in the meeting with CJ, started backing him up by addressing the mutual benefit of NIX, Kaos and HQ. Finally, the team in NIX and Kaos decided to cooperate upon the new project timeline.</p>	<p>CJ <b>frustrated</b> with that had to rely on John’s in-group connection and his knowledge &amp; previous experience and Greg’s superiority in hierarchy. CJ started feeling <b>disappointment</b> with a project lead role as he realized that he couldn’t actually LEAD the decision in the direction he wanted. On the other hand, CJ felt <b>eager to learn &amp; emulate John’s strengths</b> to convince stakeholders.</p>

<p><b><u>Episode 2: Managing the approval process of Campaign Idea and Key Visual</u></b></p> <p>CJ developed 1<sup>st</sup> draft of the campaign idea as per the discussion with John. However, upon the arrival of new BU head James, he was asked to redevelop the idea with focus on product benefits, while the previous version focus on emotional benefit; dilemma between product benefit focus communication which would become similar to global guideline, and emotional benefit focus communication locally adapted and was in line with initial intention.</p>	<p>Despite his dilemma, CJ decided to revise existing development, as he knew that James and HQ are the final approver. He realized this was unpopular decision for Kaos, however, explained to them with the argument of alignment with the global brand guideline. He increased travel to Kaos, to have frequent meetings with the team there. This increased awareness on challenges the team faced from day to day operation.</p>	<p>He got confused with the dilemma he faced, felt lonely as he didn't have feeling of ultimate support from his stakeholders. However, he put aside his negative feelings for the moment and looked for solutions to work better with Kaos team, thinking that "how to complete this project on time in a right way". CJ spent more time with Kaos team to explain why HQ &amp; James addressed different view coming from global alignment.</p>
<p><b><u>Episode 3: Managing TVC storyline alignment</u></b></p> <p>CJ went through recurrent review processes with key stakeholders; Kaos commercial team, James and HQ. HQ &amp; James accepted a lot the TVC storyline in line with the campaign idea which they approved previously. However, this time, Harry, Kaos org CEO, final reviewer whom CJ thought would give blanket approval, turned out to make a drastic changer for the whole story development made so far.</p>	<p>CJ accommodated the drastic change decided by Kaos CEO, upon the final approval stage. <b>No one, even HQ and James, didn't challenge him</b> upon his position as CEO. The agency who initially told CJ further adjustment is not possible, decided to bear the decision from HQ.</p>	<p>Knowing Harry is CEO, CJ didn't give objection to the change and <b>decided to move on. He put his negative emotions behind</b> and started to regroup the meeting to discuss what he and project members would need to do to accommodate the change that Harry wants in the given timeline before the launch. He communicated to the team rationally Harry's decision and message toward the current development of TVC storyline.</p>

<p><b><u>Episode 4: Launching the brands and products</u></b>                  Upon the launch of the products, Kaos team got the sales data from the distributors that shows offtake of products skyrocketed beyond initial sales forecast. This event was signal of the big success of the launch.</p>	<p>Stakeholders who were opposite to CJ came to him and congratulate him. People who were skeptical about the project started reevaluating the value and meaning of the project, as it seems the initial result was going very well.</p>	<p>CJ felt <b>rewarded as he felt more connected</b> to the project and to the related stakeholders. He sensed that his role is <b>better understood</b>, and he <b>can influence</b> people on what they need to do and follow. He felt <b>more comfortable</b> to give his own opinion with firm voice, compared to the beginning of the project.</p>
<p><b><u>Episode 5: Managing recurrent stock out situations</u></b>                  Upon the big gift season, the products were sold way beyond the forecasted amount. The distributor in Korea wanted urgent delivery of short qty as they don't like to have overstock in case. However, NIX asked Kaos distributor to follow the strict process NIX has been complying with for many years, however, Kaos distributor as a small family business could not comply with.</p>	<p>CJ asked supply chain director to bring emergency solution, addressing that we should not miss this seasonal opportunity. Recognizing CJ's contribution along the project evolution and considering this stock out as the signal of business success in Kaos, he acted on quickly pushing their team to bring emergency solution at exceptional base. CJ promised to organize the meeting between Kaos and NIX supply team to bring mutual understanding and alternative solution.</p>	<p>NIX team and Kaos importer looked for <b>CJ's help as a focal point</b> of communication and they expected CJ to explain their difficulty to the each other's party. He was <b>overwhelmed by</b> the amount of conflicts he should solve or address, but, <b>finally happy to see</b> that people naturally come to him to discuss the business. He felt <b>more confident</b> to deal with various stakeholders, as he understood better what to expect from them along the project experience.</p>

TABLE 2. Data Structure

First Order Categories	Second Order Categories	Aggregated Theme
Don't give up the project facing challenge, because he didn't want to be the part of the failure and wanted to prove his self-worth.	Self enhancement	Emotional regulation
Often felt both negative and positive feelings under managing conflicts.	Mixed emotions	Emotional complexity
Put negative emotions behind and rather look for solutions to break through the challenges that caused negative emotions.	Actions to modify the situation	Emotional regulation
Reframed challenges coming under the process to manage tensions, as his learning opportunity.	Change his perspective on the event	Emotional regulation
Increased the number of the visits to Kaos, to have much frequent face to face conversation with Kaos team members.	Open and frequent communication	Emotional regulation
Stakeholders who observed expatriates experiencing challenges from various stakeholders, started feeling empathy for expatriates.	Emotional display that influences other's behaviors	Emotional regulation
Acknowledged key opinion leaders within the group and approached to them one by one for individual talk, facing disagreement from stakeholders,	Interpersonal interaction and communication in respectful manner	Emotional regulation
Organized often participative discussion meetings to hear other opinions from the stakeholders.	Ensure procedural fairness / Relational judgement	Legitimacy
Relied on power of authority of his boss, to convince stakeholders who don't agree with the new timeline.	Cognitive judgement	Legitimacy
Local stakeholders considered the expat as an outsider in the beginning of the project.	Cognitive Judgement	Legitimacy

The expat to become a focal point to whom two conflicting parties want to talk for addressing their challenges in managing stocks.	Instrumental / Relational Judgement	Legitimacy
Send out email communication to Sr. management that communicates efforts and supports from the project team members.	Instrumental / Relational Judgement	Legitimacy
Upon the project success, stakeholders who used be to skeptical about the project, overtly showed their support. They often mentioned they want to be the part of the success.	Instrumental Judgment	Legitimacy

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## BUSINESS ETHICAL APPROACHES IN THE ECHO OF THE VW GROUP'S EMISSION SCANDAL

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*Ivona Spasovska*

**ABSTRACT:** *Volkswagen (VW) Group is one of the largest automobile manufacturing corporations worldwide. The taint of the emissions scandal in 2015 affected main involved parties including stakeholders, human capital, senior managers, and the group's hierarchy in the global marketplace. This paper provides an overview of the corporate social responsibility disgrace. It focuses on the factors that impacted the occurrence of the situation, and the consequences that followed the shock at different levels of operation. A review of secondary data was used to present an interpretative analysis. The theory of utilitarianism is the major ethical approach employed to support the data analysis, along with the teleological ethical approach. The paper concludes that VW Group experienced a regeneration due to the scandal's echo that contributed to a set of revisited business strategies, and corporate strategies in functional areas. The impermissible character of the deceitful behavior led to an internal shakeup and that has been ongoing.*

**KEYWORDS:** automobile industry, corporate ethics, scandal, regeneration.

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Automobile manufacturers are among the most powerful and influential companies in the world today. Volkswagen (VW Group) is one such company. With headquarters in Wolfsburg of Germany, Volkswagen represents one of the largest automotive manufacturing corporations in the world, with vehicles sold all over the globe (Volkswagen, 2021). From the top luxury class occupied by Bentley, Bugatti, and Lamborghini models to the bottom class occupied by Skoda, Seat, and Volkswagen, the company brands span a wide range of vehicle classes. In 2015, VW Group merged with a modern example of a corporate scandal (Volkswagen, 2021). The EPA (Environmental Protection Agency) revealed that Volkswagen cheated on carbon emissions (Hotten, 2015). Moreover, the International Council on Clean Transportation conducted Tests on Volkswagen vehicles, using BMW cars as a comparison, where they concluded that Volkswagen cheated with 584,000 diesel cars in the United States by emitting up to 40 times the permissible NOx (Nitrogen Oxide) fumes (Tophan, 2015). Figure 1 exhibits the maximum and minimum NOx emission statistics recorded in a laboratory by the German Transport Ministry, with VW leading the pack (European Court of Auditors, 2019). However, the degree of robustness of the corporate governance structure and ethics are called into question as a result of these fraudulent events. Volkswagen was able to manipulate emission scores by using a device that reduced the engine's performance when the car was put through its paces (Tophan, 2015). It is computer software that can detect when the car is being tested, rather than a physical device. Carbon emissions

are significant because they determine whether or not a vehicle can be sold in certain jurisdictions, such as the United States. From an ethical standpoint, Volkswagen not only deceived people into taking false carbon emissions tests but also outlined the bigger picture in terms of various stakeholder effects.

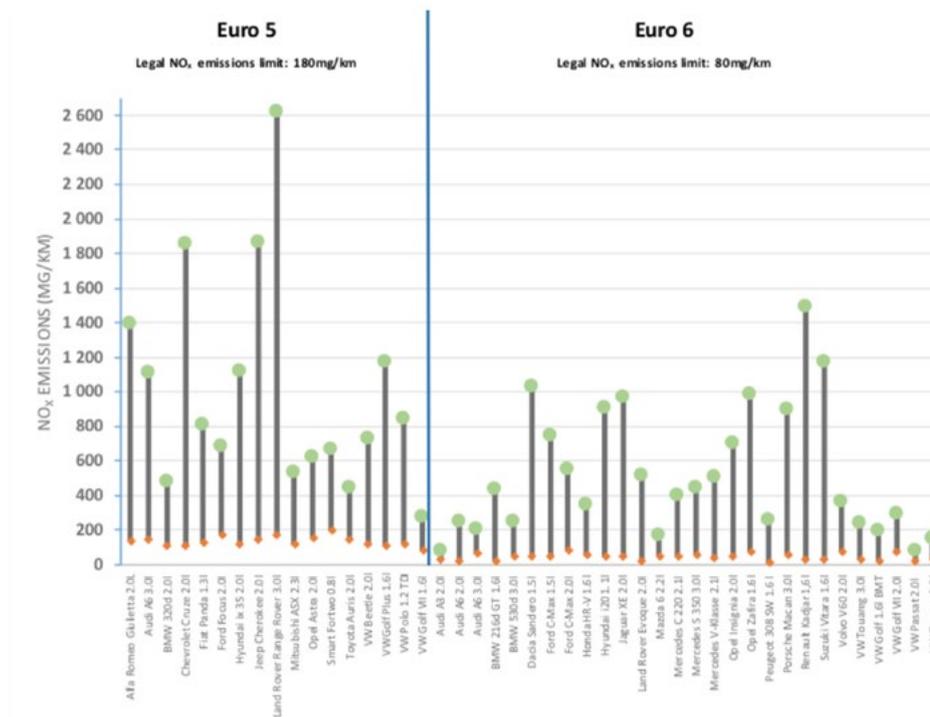


Figure 1. Maximum and minimum NOx emissions by vehicle (European Court of Auditors, 2019).

### ETHICAL ISSUES AND VALUES APPRAISED IN VW EMISSION SCANDAL

A group of scientists from West Virginia University conducted road testing on diesel cars (Glinton, 2015). Additionally, the international council on clean Transportation was engaged to conduct research and tests on diesel cars. According to the International Council on Clean Transportation, Volkswagen was accused of installing a cheat device in their cars (Hotten, 2015). The VW corporation utilized defeating software, allowing them to make adjustments to the emissions control system’s functionality (Hashimoto, 2015). Furthermore, senior executives ignored not just corporate regulations, but also fundamental moral and legal principles that they perceived as impediments to making a rapid profit. Technology for automobiles required for the US market existed, and the Volkswagen Group, like its competitors BMW and Mercedes, had a choice in the US market, but the company chose to mislead. Volkswagen grossly underestimated the amount they would have to pay in penalties, legal costs, recalls, compensations, and, most importantly, the loss of trust, reputation, and consumer confidence by deciding to save the estimated \$4.8 billion that licensing this technology would have cost them (Tophan, 2015). Moreover, Volkswagen

violated the key principles of ethical business behavior, including legality, honesty, the prohibition of damage, integrity, and fairness. However, accepting higher-than-declared hazardous emissions, resulting in greater pollution levels from over 600,000 diesel engine automobiles depicts in Figure 2 by brand, the senior management of the company was fully aware that they were endangering people’s health, creating environmental damage, and disobeying federal law ( US Justice, 2018). The company put their profit over the customers and society, their actions put the whole society at risk since the scientist proved that this unethical act of Volkswagen could’ve caused 1200 premature deaths in Europe and 60 premature deaths in the USA (Chu, 2017). Furthermore, the controversy went against the moral concept of non - maleficence, which states that one should not intentionally damage others. According to the rules of fairness, the corporation did not play fairly in any manner, since they deceived their consumers by fabricating a cheat device for their vehicles and, more crucially, they broke the law, all for higher revenue. Volkswagen has marketed its diesel cars as one of the most environmentally friendly and fuel-efficient vehicles on the market, yet their actions call this “statement” into question and jeopardize the company’s credibility because they behaved contrary to their promises. Furthermore, the Volkswagen Group’s emissions scandal involved countries other than the United States, figure 3 shows the number of Volkswagen diesel vehicles equipped with emissions-manipulating software as of October 2015 (Carlier, 2015). The number of diesel vehicles loaded with software designed to evade pollution controls is subdivided by country in this data. As of October 2015, Volkswagen had admitted that the scandal had touched around 11 million vehicles globally, with 2.8 million of those delivered to German customers (Carlier, 2015).

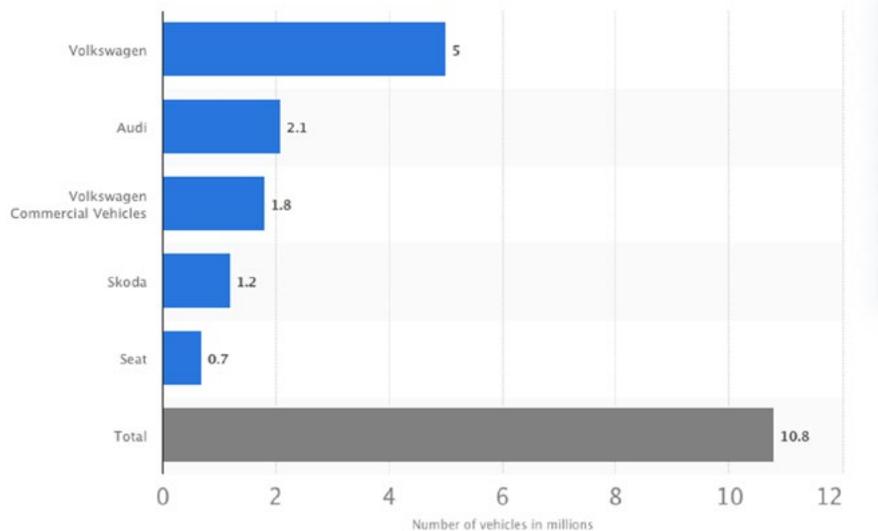


Figure 2. As of September 30, 2015, the number of Volkswagen diesel vehicles fitted with emissions-manipulating software was subdivided by brand (Carlier, 2015).

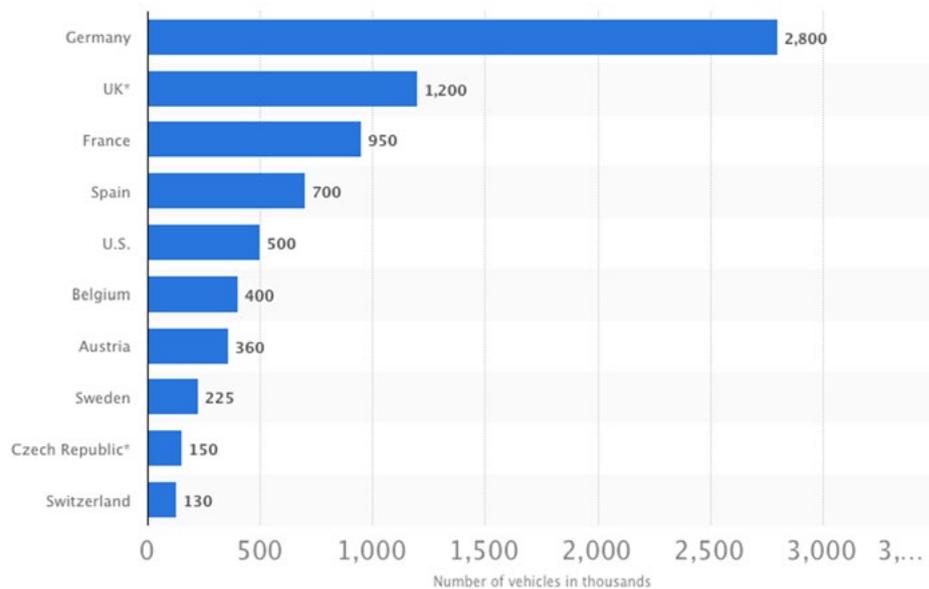


Figure 3. Several Volkswagen diesel vehicles are equipped with emissions-manipulating software as of October 2, 2015, by country (Carlier, 2015).

## ENVIRONMENTAL, LEGAL AND POLITICAL FACTORS INVOLVED IN VW CASE

A multitude of legal, environmental, and economic concerns contributed to the uproar. Volkswagen sought to increase its low market share in the United States as part of its goal to become the world's largest vehicle maker. VW engineers were fully aware that the newly built diesel engine would no longer fulfill the stricter pollution rules in the United States. Furthermore, senior management and engineers were unable to discover a technological solution to develop diesel engines that met US emissions criteria within the company's timeframe and budget, thus the Volkswagen Group opted to cheat on emissions tests in 2005 (Hotten, 2015). In 2015, it was revealed that the number of managers, technicians, and engineers involved in the "VW emission scandal" is high. There have been several levers in this controversy. According to the EPA, each car contains approximately one hundred (100) million lines of code whereas, in the case of Volkswagen, the defeat device was hidden among millions of codes that are extremely difficult to detect ( McGrath, 2016). However, An intriguing truth is that Volkswagen engineers discovered a way to fulfill pollution requirements after a specific period, but they opted to keep manipulating rather than use the legal approach (Tophan, 2015). The company's peculiar corporate culture is another important aspect contributing to Volkswagen's dishonesty. Moreover, Volkswagen has a compliance culture, with employees expected to obey the regulations. The corporation has a dictatorial history rather than a democratic work environment (Welle, 2016). As a result, Volkswagen employees were forced to make a difficult decision if they wanted to preserve their employment. Some individuals feel that the Volkswagen crisis arose as a consequence of profit maximization, while others believe that Volkswagen's culture and techniques are at the basis of the deceit. Numerous environmental and health issues have been highlighted as a result of the large volumes of nitrogen oxide discharged into the air. According to the Environmental Protection Agency, nitrogen oxide causes smog,

acid rain, degradation of water quality, pediatric asthma, respiratory diseases, and early mortality (Manisalidis *et al.*, 2020). Nevertheless, there was undeniably a financial and economic impact on this organization. Volkswagen had to cope with a flurry of legal and public relations offices throughout the world, as well as international rules and laws. As a result of their immoral actions, Volkswagen’s stock has collapsed 20% after the scandal was revealed Figure 4 (Makortoff, 2015).



Figure 4. Volkswagen’s annual closing share prices from FY 2013 to FY 2021, by type (Carlier, 2022).

### STAKEHOLDERS INVOLVED IN VOLKSWAGEN SCANDAL

Parties involved in the emissions controversy are customers, employees, dealers, shareholders, the environment, various automobile manufacturers, Volkswagen’s executives, and board members, as well as the authorities and the courts. All parties were impacted in quite a few ways as inventory marketplace fluctuations, environmental concerns, and tarnished reputations. There’s no denying that automakers are continuously struggling with competition, trying to get an advantage over their competition through searching for extra green and powerful manufacturing and overall performance methods, in addition to modern processes to live beforehand of the competition. Stakeholder pastimes in the VW emission scandal are divided into 3 categories: internal (board, senior control, managers, and employees), connections (shareholders/traders, clients, suppliers, consultants, and competition), and external, together with authorities, neighborhood communities, foyer groups, and media groups. The decision to fake emission records during inspections was taken to create a misconception of the automobile’s efficiency, which might entice clients at the same time as additionally enhancing the organization’s brand value. According to the stakeholder theory, Volkswagen corporation took into consideration the pastimes of traders to generate short-term profits. The company’s risky decision involves misleading stakeholders, particularly consumers who buy cars under the impression that they emit minimal emissions with the purchased vehicles, and the government, which has established norms and standards surrounding vehicle emissions. The outcome was a 20% decline in VW’s stock price, which has had a huge impact on stockholders (Makortoff, 2015). The Volkswagen Group must face total penalties of \$25 billion for its actions (Parloff, 2018). The majority of the

company's top-level board members were fired, including the CEO, allowing the company to move ahead with a new management team.

## **ETHICAL THEORIES**

### **Teleological Theory**

The teleological theory focuses on the effects of an action to see if it is moral at the moment (Meval, 2018). When applied to Volkswagen, the teleological ethical approach takes away the act of "cheating" and determines the event's immorality based on the results. Volkswagen's activities have had a severe impact, resulting in significant pollution that is more than 40 times what they have documented on a worldwide scale. There are three different types of teleological theories; Utilitarianism, Eudaimonism, and Ethical egoism (Meval, 2018). The subject of the paper will be utilitarianism and ethical egoism. When this method is used for observing the Volkswagen emission scandal, the act of deceiving emissions testers is immediately classified as unethical due to the numerous negative implications it has on a huge number of innocent people. Given the seriousness of the adverse repercussions caused by "Dieselgate" – ranging from premature deaths due to excessive emissions to enormous losses for various stakeholders and the abandonment of sustainability principles – we can conclude that deceiving emissions tests is unquestionably unethical business practice (Codruta, 2017).

### **Utilitarianism**

Utilitarianism is concerned with the consequences of an activity and its outcomes for the greater good (O'Dwyer, 2016). Moreover, Volkswagen's decision to cheat on emissions tests was taken on a utilitarian basis because the shareholder's wealth was maximized. The end consequences, in this case, were unfavorable, the maximum happiness gained was overridden when the scandal exposed serious pollution and effects. Despite understanding what they were doing was wrong, they designed software to fool the system. Following the utilitarianism act, punishment is allowed. Following the scandal, VW saw a decline in inventory charge and revenue as a result of class-action litigation. Higher-performance automobiles would undoubtedly appeal to the general public, and good sales would benefit all employees. VW might use this strategy to align their behavior with their principles. Another concern with utilitarianism is that VW would have to deal with their reconciliation. It does not address the severity of the minority's health issues because it is a theory without any socio-political convictions or sympathies for certain groups of people (O'Dwyer, 2016). Claiming that EU regulations on emissions testing give them greater leeway to manipulate the statistics isn't a valid explanation for polluting the air at 40 times the rate that they report while only caring about defending their economic interests (O'Dwyer, 2016). A utilitarian viewpoint would be advantageous to the VW Group board of directors, but it would be an insufficient reason for the media, government regulators, and, most crucially, consumers (O'Dwyer, 2016).

### **Ethical Egoism**

Ethical egoism, on the other hand, is concerned with actions that have a benefit to the party who initiated the action and thus can be considered ethical (Shaver, 2019). Furthermore, ethical egoism

maintains that everyone should act in their self-interest, the main argument for ethical egoism is pursuing self-beneficial interests. This is the most relevant theoretical approach to Volkswagen's situation (Shaver, 2019). When the corporation was deceived on emissions testing for financial reasons, it was operating in its own best interests, enhancing the wealth of its directors and shareholders.

### **Deontology**

Deontology is a normative theory that focuses on the moral action itself, the individual's decision (or a company's decision in this case) (Breux, 2019). The act of "cheating" on the emissions test triggers the deontological approach. Cheating is regarded as an immoral and consequently unethical behavior according to the deontological philosophy. This perspective, on the other hand, ignores the reality that the action was conducted to create wealth and obtain a competitive edge over other automobile companies. Furthermore, suggesting that cheating on environmental tests is wrong from a deontological stance is not ethically right (Breux, 2019). Volkswagen likewise violated its moral obligation by acting in a way that the moral law forbids.

### **Absolutism and Relativism**

Absolutists represent rigid ethical decisions, whereas relativists represent further flexibility. Absolutists would claim that, in the case of Volkswagen, lying is morally reprehensible conduct (Osmundsen, 2018). Volkswagen's actions, on the other hand, maybe justified by a relativist with a smidgeon of moral egoism as necessary for the company's aggressive edge, performance, and economic prudence.

## **CONCLUSION**

Volkswagen group's actions were ethically wrong. Through their products, goods, and services, every business and organization should contribute to the general good. Furthermore, Volkswagen as a prominent global firm should have encouraged ethical behavior by proving that society's well-being and health come before profit; yet, Volkswagen's immoral conduct landed the company in a major ethical dilemma and badly harmed its reputation. Smog, acid rain, degradation of water quality, childhood asthma, respiratory diseases, and early mortality are all caused by nitrogen oxides, demonstrating that VW endangered the entire society. According to MIT experts, "fake" clean diesel automobiles would cause 1200 early deaths in Europe (Jacobs & Kalbers, 2019). Many shareholders filed a lawsuit against the firm in a German court, claiming compensation for the company's stock price loss as a result of the company's emissions test cheating controversy at the time (Clark, 2016). Employees in the Volkswagen group were also impacted, as 204 workers were sacked for violating company policies (Rauwald, 2019). In terms of legislation and modifications to legislation, the EU has enacted a new law to prevent a repetition of the Volkswagen Group's diesel emissions debacle (European Court of Auditors, 2019). The European testing procedure for vehicles is also being intensively investigated as a result of the VW emission gas scandal (European Court of Auditors, 2019). Germany sought to develop an environmentally friendly living environment following the Volkswagens crisis. Additionally, all of the company's

new investments have been made to create environmentally-friendly vehicles. Disregarding the environment is one of the most reliable ways for a company's brand to be tarnished. Despite making a large profit between 2009 and 2015, the corporation lost much more when the incident was resolved. The most destructive element of the pollution issue is how it destroyed Volkswagen's reputation as a reliable automaker. Even if the law is lacking, the virtue ethics approach assists the organization's management in protecting and respecting human rights. In this scenario, ethical theories are relevant. The use of teleological and deontological approaches, as well as utilitarianism and ethical egoism, assisted in observing the case based on the definitions of ethical theories and studying all sides to grasp what VW was doing for so many years.

## FUTURE OUTLOOK

Following the Volkswagen emissions scandal in 2015, the Volkswagen Group is a very different organization in terms of how they function and act. Volkswagen announced its desire to become an environmental role model in 2016, a model firm that provides transportation for everyone across the world while limiting its environmental impact, on its sustainability page (Crider, 2020). A few of Volkswagen's ostensibly green projects are natural gas ventures, as well as Electric cars (Crider, 2020). Furthermore, VW is not only outselling Toyota and GM in terms of volume, but it is also increasing profitability and investing more in new technologies than any of its competitors, with group CEO Matthias Müller stating that by 2025, the company will spend €20 billion on electrification (Mcgee, 2019). Additionally, The number of top managers are reporting directly to Matthias Müller, the company's CEO, and several fresh faces have been brought in. Volkswagen has made significant changes to its senior management team to save money and modify its culture (Gruddick, 2015).

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## FROM REFUGEE TO ENTREPRENEURSHIP: MOTIVATION FACTORS AND CHALLENGES OF THREE WOMEN FROM THE MENA REGION

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*Antonia Koumproglou, Nahed Ahmed & Lynn Mounzer*

**ABSTRACT:** *The global refugee crisis has prompted mass displacement and significant global socio-economic implications as migrants' journey within and beyond local borders. In addition to the institutional and legal frameworks that must be navigated, forcibly displaced migrants need to renegotiate their professional and personal identities and assume new roles in their host countries (Burnett, 2013). This paper focuses on the lived experiences of women refugee entrepreneurs from the Middle East North Africa (MENA) region, not because refugee production is by any means particular to the region; this is however a region that has historically witnessed large-scale forced population movements. In the past fifteen years, the UN High Commission on Refugees reported more than 16 million refugees from the Middle East region (UNHCR, 2021). The wars and failed states in the region keep forcing citizens to seek refuge in other countries. The refugee experience is generally understood to be one of marginalisation and poverty. One of the main challenges is labour market integration due to discrimination and exclusion. These factors push refugees toward self-employment as a means to integrate into society and avoid difficulties such as the language barrier and credentials recognition (Lazarczyk-Bilal & Glinka, 2021). Over and above that, women refugees are potentially subject to further subordination, sexual harassment, vulnerability, and disadvantage (Pittaway & Pittaway, 2004) and other gender-based biases (Pittaway & Pittaway, 2004). Despite all these obstacles, many women refugees demonstrate entrepreneurial success. This paper depicts the unique entrepreneurial journeys of three women refugees from the MENA region to better understand their motives and factors that drove them towards entrepreneurship. Our intention is to recount and help re-imagine women refugee stories as stories of perseverance, self-reliance and success; The paper explores through a detailed narrative inquiry the different enablers and challenges the women face during their entrepreneurial journey. The journeys of these women across different continents are then compared and gleaned out for their distinct attributes and the lessons we can learn from them.*

**KEYWORDS:** women entrepreneurship, gender and entrepreneurship, entrepreneurial characteristics, refugee entrepreneurship.

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*“Women are now rising in powerful ways to solve very major problems in the Middle East”*

Christopher Schroeder, Entrepreneur and Author of *Startup Rising*

Global migration is an important key factor of the twenty-first century and has become a matter of great interest economically, politically, socially, and culturally (Freiling & Harima, 2019; Baranik *et al.*, 2018). As if it engaged constructively with their host country and fostered personal resilience (Huq, and Venugopal, 2021). Despite most academic research on migrant entrepreneurship combining immigrants and refugees, the circumstances, and experiences of each are distinctly different (Shneikat & Alrawadieh, 2019, Baranik *et al.*, 2018; Freiling & Harima, 2019; Heilbrunn & Iannone, 2020). Refugees leave their homes for the purpose of personal safety.

Before we dive deep into the topic, we first need to define the term “refugee.” There is an existing debate among scholars over the definition of refugee, it mostly relates to gender. They ask the question who is considered a refugee? Are women subjected to female genital mutilation (FGM) considered refugees? Or are people from the LGBTQ+ community who face persecution in their countries? Usually, in these cases, countries decide on a case-by-case basis whether the person should be considered a refugee or be granted asylum.

The United Nations High Commissioner for Refugees UNHCR provides a primary and universal definition of refugees as “*people who have fled war, violence, conflict or persecution and have crossed an international border to find safety in another country*” (UNHCR, n.d.). We cannot define the word without referring to the core definition contained in the 1951 United Nations Convention Relating to the Status of Refugees and its 1967 Protocol Relating to the Status of Refugees, which define a refugee as “*an individual owing to a well-founded fear of being persecuted for reasons of race, religion, nationality, membership of a particular social group or political opinion, is outside the country of his nationality, and is unable or — unwilling to avail himself of the protection of that country*” (UNHCR, 2010).

Since every region around the world is affected – whether produce or receive – refugees, the topic is of global concern. There are 7.9 billion people on earth and 84 million of them are forcibly displaced due to violence, insecurity, and climate change (Worldometer, 2022). According to UNHCR (2018) *Figures at a Glance*, conflict or persecution causes the forcible displacement of nearly one person every two seconds; Out of the displaced people, 26.6 million are refugees and more than half of them (68 percent) are from five countries: Syria (6.8 million), Venezuela (4.1 million), Afghanistan (2.6 million), South Sudan (2.2 million), and Myanmar (1.1 million) (UNHCR, 2021). As for where they ended, 3.7 million refugees are in Turkey, 1.7 million in Colombia, 1.5 million in Uganda, 1.4 million in Pakistan, and 1.2 million in Germany. In other words, 85 percent of the world’s refugees are hosted in developing countries (UNHCR, 2021). Note that the four million Palestinian refugees are not included in these statistics since they are counted by the United Nations Relief and Works Agency (UNRWA, n.d.).

The refugee crisis in the Middle East and North Africa (MENA) region has reached extreme heights, calling for a decisive and stronger political response from the international community. According to IDMC's latest report (2021), between 2010 and 2019 conflict in the region caused 2.9 million new displacements a year on average. Recent conflicts across the Middle East, including in Iraq, Syria and Yemen, have triggered an additional mass displacement of people, with millions fleeing violence and instability. In 2019, the highest number of refugees and internally displaced persons in the region were from Syria at about 12.8 million (Statista, 2022). Within the region, Syria, Libya and Iraq have been suffering from conflict and humanitarian crises. As of April 2017, more than five million Syrian refugees were registered in Egypt, Iraq, Jordan, Lebanon, Turkey and across North Africa. At least half of all Syrian refugees are children; more than 300,000 were born as refugees (Friends of Europe, 2017). One of the most concerning situations anywhere in the world is that of Lebanon, where one in five people is a refugee. COVID-19 has compounded suffering in a country already in deep crisis.

So, what can be done to address the refugee crisis? First, inclusion of refugees in the host country until repatriation or another durable solution is found is critical. Some refugees will not and cannot go home. They have particular needs and vulnerabilities that must be addressed through third country solutions. This means access to schools, health care, and other social services that are critical to more than mere survival. These services must in turn be appropriately resourced by the international community and international financial institutions (IFIs). Host communities must see a "refugee dividend" through investments that are made in these communities. Governments, universities, and the private sector should unite forces and provide the means for expanding refugee participation in education, employment, and entrepreneurship.

Refugees bring skills and a drive and determination to succeed, but also face significant restrictions on access to housing, employment, and social services (Bloch & Schuster, 2002). Our own intention with this article is to shed light on the importance of policies and initiatives that challenge our attitudes and beliefs about refugees as an important element for successful integration. A better and more objective understanding of the entire refugee pathway, from displacement, transnational cross-border movements to resettlement in new countries, is paramount. We maintain that refugee identity should be further analyzed and considered to be an important process towards self-discovery and self-determination, ever-changing, ever-negotiated and always reformulated. It is this identity construction we need to delve into as an important process and enabler for developing a sense of free will and self-efficacy, forming a secure perception of self, and finally for positive new interactions with socio-economic and political actors upon resettlement in the host country. It is through this newfound understanding and language used to describe and analyze the refugee experience-especially that of women refugees-that we will begin to overcome and shed the mainstream portrayals of refugees as helpless victims or dependable outsiders. We need to renegotiate and reconceptualize the physical and social spaces that refugees inhabit and in which refugee identities are shaped.

## **THE REFUGEE EXPERIENCE: AN EXPERIENCE OF DISPLACEMENT**

The refugee experience is generally understood to be one of marginalization and poverty. Leaving their homes, properties, source of income, and even family members are often an unplanned

decision (Shneikat & Alrawadieh, 2019; Baranik *et al.*, 2018; Freiling & Harima, 2019; Selvamalar, 2010; Almohammad *et al.*, 2021; Cifci & ATSIZ, 2021). Forced into abandoning their homelands to escape inhospitable conditions: conflict and violence, whatever paths their journeys take- even seemingly short-lived, uncomplicated, and uneventful ones- their forcible displacement has a multitude of deleterious effects on them psychologically, mentally, economically and physically, before, during, and, possibly, for years afterward. The statistics are sobering and represent immense human suffering. Worldwide, the number of forcibly displaced people has reached the highest levels on record (UNHCR, 2016).

Forcible displacement due to conflict or violence leaves women and children extremely vulnerable; Resettlement is a long-term process that affects all refugees, but women and children are particularly vulnerable. Women refugees are particularly vulnerable to experiencing displacement, prejudice, and marginalization. They are more likely to be subject to further subordination, vulnerability, and disadvantage because of their gender (Pittaway & Pittaway, 2004). They face high risk of persistent discriminatory norms, limited access to livelihoods and multidimensional poverty. This reflects broader labor market segregation by gender around the world, compounded by language barriers, lower literacy rates, unpaid care responsibilities, and gender norms that limit refugee women's prospects. However, women are also often limited in their ability to access labor markets in the host community not least due to care responsibilities, and often also due to lack of formal documentation for work and security concerns, unfamiliarity with language and limited networks, which are especially important where the informal sector is the main source of jobs.

It becomes apparent that women refugees' self-reliance needs to be enhanced as well as their sense of belongingness by helping them build their personal, social and material assets. Although assistance offered by higher power groups is often welcomed by those with less power or status, it depends on the nature of, and motivations for, the help. When higher status groups offer dependency help, providing solutions rather than supporting the recipient to build their own solutions, the assistance can be perceived as reinforcing the inequality between groups (Nadler & Chernyak-Hai, 2014).

## **THE IMPACT OF DISPLACEMENT ON REFUGEE IDENTITIES**

Forced resettlement, leaving one's roots, and adapting to a new region can all affect feelings of identity and belonging (Hiruy, 2009). Galbally (1978) using a multiculturalism approach, defined resettlement as a complex process of adjusting to a new environment following migration. As displaced people are on the move across transnational borders in search of a new place they can call home, they construct, negotiate, and navigate new emerging identities. While their physical bodies move through space and time, their discursive identities too continuously move and change across time and space. The refugee identity can be better understood as a "moving identity", continuously shifting and is forever reconceptualized as the physical body internalizes new experiences and their multidimensional impact. Refugees thus undergo a complicated process of identity reformulation as a result of displacement (Griffiths, 2001).

Refugee identities are thus complex and formed not only by internal feelings, beliefs, ethnic and cultural traditions, but also by external factors, such as resettlement practices, forced migrant

policies, cultural traditions, and the economic, political and social conditions of the new host country (Hein, 1993; Holt 2007). Refugee identities are grappling with transition and resistance in that limited space available for self-determination and dialectic transformation. Many times, in the rhetorics of displacement, the narrative representation of displaced identities include stories of *othering*, which somehow dehumanize the actual lived experiences of those displaced. In refugee studies, labeling can have the effect of creating an 'us' and 'them' rhetoric. By designating an identifying mark can essentially create and/or compound the feeling of being an 'other'. Scholars often mention the 'us' and 'them' aspect, being the 'other' or feeling as outsiders in both their country of origin and destination country as impacting identity (Eide, 2007, O'Neill, & Spybey, 2003; Papastergiadis, 2006; Parker & Brassett, 2005, Robinson & Rubio, 2007; Zetter, 2007). Refugees are a part of and also excluded from both their country of origin and host country (Zetter, 2007). The label of refugee is influential not only for defining and categorizing people but also critically affects the process of identity reformulation. Such a label reflects the 'need to manage globalized processes and patterns of migration and forced migration in particular' (Zetter, 2007: 174). A person who was formerly a citizen of one country is now a 'refugee' in another, which can (and often does) have a profound effect on that person's identity.

According to scholars, one of the main influences of a refugee's evolving identity is place (Brun, 2001; Griffiths, 2001; Holt, 2007; Parker and Brassett, 2005). This influence is partially due to the existing legal infrastructure in the destination country; While some scholars have argued that people and place have a deep and lasting natural bond (Hernández *et al.*, 2007; Hiruy, 2009), others have advocated a de-territorialized notion of identity, which argues that a robust identity can exist without a strong attachment to place (Lambo, 2012). This is because displacement and experiences of trauma and violence can complicate feelings of identity. This is especially true among women, as displacement often leads to shifts in gendered roles and responsibilities that result in women becoming the heads of their households (Amnesty International, 2019).

## **ENTREPRENEURSHIP AND REFUGEES**

Entrepreneurship among refugees has received little attention compared to other economic elements such as labor force participation and they are researched under immigrants. However, the complex nature of refugee entrepreneurs stipulates studying them in-depth independently of other groups. For instance, under normal circumstances, entrepreneurship is a difficult path to take. Successful entrepreneurs necessitate social networks, access to finance, the right skills, and an enabling environment. Refugee entrepreneurs lack several of these elements where they: May or may not speak the language of the host country, have little or no knowledge of the social dynamics and have little or no network or funding opportunities. Therefore, succeeding as a refugee entrepreneur, functioning in an irregular environment and conditions, should be celebrated and explored.

Refugees also add pressure on the host country's infrastructure and resources causing wide socio-economic challenges. For a fragile economy, this can cause major economic and political destabilization. Nevertheless, refugees tend to make a long-term investment in the host countries and build roots and communities (New American Economy, 2017). They also contribute to the host country's economy as earners, taxpayers, and consumers. For example, refugees in the Zaatari

camp in Jordan – the world’s largest camp for Syrian refugees – created more than 3,000 informal businesses, generating \$13 million a month (PBS, 2016). Likewise, in 2019, the number of refugee entrepreneurs in the United States US was 185,827 with a total business income of five billion dollars yearly (New American Economy, 2022). Despite the severe impact of refugee crises on countries, it is important to acknowledge the contribution of refugees to economic development and the country’s enrichment.

### **The New Rhetoric of Refugee Entrepreneurship**

The movement of people across the world’s borders can on the other hand boost global productivity and drive economic growth (Woetzel *et al.*, 2016; Almohammad *et al.*, 2021; Barth & Zalkat, 2021). The stories of such refugee realities are beginning to be told quietly and forcefully. But what is rare is the narrative about the opening up of possible new frontiers of creativity, new opportunities, the painfully difficult act of resource mobilization and the crystallization of economic hope and social dignity that entrepreneurship can bring to bear on the lives of people who have been denied of every possible possession in their flight from abject danger (Freiling & Harima, 2019). Self-employment is one of the options for newcomers who may have been excluded from the labour market or finding jobs due to language barriers, low wages, and difficulty getting a work permit (Shneikat & Alrawadieh, 2019; Freiling & Harima, 2019; Almohammad *et al.*, 2021).

### **Social and economic integration**

Social inclusion via entrepreneurship ensures equality between individuals, facilitates access to employment and also helps the refugees accept their situation in a new and unfamiliar host country (Shneikat, and Alrawadieh, 2019; Freiling, and Harima, 2019; Almohammad, Durrah, and Ahmed, 2021; Cifci, and ATSIZ, 2021). Opportunities to start their businesses in the host countries that had given to refugee entrepreneurs are limited compared to immigrant entrepreneurs. (Shneikat, and Alrawadieh, 2019; Almohammad, Durrah, and Ahmed, 2021). Women are opening businesses of their own in record numbers, signifying that women-owned businesses represent a noticeable percentage of all businesses. Even though there is a clear indication that women are joining the mainstream of entrepreneurship, there are still obstacles or barriers facing both current and prospective women entrepreneurs (Nxopo, and Iwu, 2015).

## **ENTREPRENEURSHIP MOTIVATIONAL FACTORS AND BARRIERS AMONG REFUGEES**

### **The Motivational factors**

The literature on female entrepreneurship indicates various factors drive entrepreneurial motivation. Motivational factors for refugee entrepreneurs have been classified into the pull and push factors; Push factors are related to personal (including a marriage break-up or being passed over for promotion) or external factors such as difficulty to find jobs in the market and financial need, while pull factors such as recognizing an opportunity are those that attract people to start a business (Shneikat, and Alrawadieh, 2019; Kirkwood, 2009; Cho, Moon, and Bounkhong,

2019; Zgheib, 2018; van Kooy, 2016; Robichaud, Cachon, and Haq, 2010; Mehtap, and Al-Saidi, 2019; Barth, and Zalkat, 2021). Nevertheless, self-employment gives them at least the hope to bolster their development and get back on a more prosperous path (Freiling, and Harima, 2019; Robichaud, Cachon, and Haq, 2010).

Some authors said that motivational factors for choosing the hospitality industry were Survivability, Desire for independence, Availability of resources, Limited access to the labor market, Family caregiving responsibilities and Reasonable starting costs (Shneikat, and Alrawadieh, 2019; Fong et al. 2007; Cifci, and ATSI, 2021).

Needs to settle and ensure a source of income become challenging and often traumatic. The need to survive in an unfamiliar environment had been a key motivational factor to start a business (Shneikat, and Alrawadieh, 2019; Cho, Moon, and Bounkhong, 2019; Fong et al. 2007; Cifci, and ATSI, 2021).

The literature found that motivational factors for choosing the hospitality industry were Survivability, Desire for independence, Availability of resources, Limited access to the labour market, and Reasonable starting costs (Shneikat, and Alrawadieh, 2019; Cifci, and ATSI, 2021). Needs to settle and ensure a source of income becomes challenging and often traumatic. The need to survive in an unfamiliar environment had been a key motivational factor to start a business (Shneikat, and Alrawadieh, 2019). Family-related factors were one of the most important reasons for becoming an entrepreneur among women (Cho, Moon, and Bounkhong, 2019)

In the push-pull factors that motivate women to pursue entrepreneurship, the desire for independence is a key motivational factor for starting a venture (i.e., autonomy and being own boss), self-fulfillment and extra income (Shneikat, and Alrawadieh, 2019; Kirkwood, 2009; Cho, Moon, and Bounkhong, 2019; Zgheib, 2018; van Kooy, 2016)

Having the experience, knowledge and financial capital plays an important role in the decision to start a business (Shneikat, and Alrawadieh, 2019; Kirkwood, 2009). In particular, refugees relied on their personal savings from their previous jobs or businesses in their home country (Shneikat, and Alrawadieh, 2019; Kirkwood, 2009).

The access to business guidance, training, consultancy services, outside support and mentorship, and instructions that governmental and non-governmental organizations provide was an important initial motivation (Barth, and Zalkat, 2021; Fong et al. 2007).

## **THE BARRIERS THAT REFUGEES FACE**

### **Language skills and recognized qualifications**

The refugees and other newcomers face some challenges which limit the process of integration into the host society. Such as lack of language skills and/or recognised qualifications (Johnson et al. 2004; Wauters, and Lambrecht, 2008; Uriyo, 2018; Fong et al. 2007). Insufficient English language and lower attainment at school and performance in the labor market inhibit their access to the labor

market (Johnson et al. 2004; Huq, and Venugopal, 2021; van Kooy, 2016; Freiling, and Harima, 2019; Selvamalar, 2010; Woetzel, Madgavkar, and Rifai, 2016; Bristol-Faulhammer, 2017). lack of knowledge of the system. This includes, for example, how to find accommodation and lack of familiarity with the school system or the role of General practitioners (Johnson et al. 2004; Huq, and Venugopal, 2021; Freiling, and Harima, 2019; Selvamalar, 2010; Wauters, and Lambrecht, 2008).

Refugee women's obstacles may be further compounded due to the intersectionality of race, ethnicity and gender, and the context for enacting their entrepreneurship (Huq, and Venugopal, 2021; van Kooy, 2016; Baranik, et al. 2018; Nyabvudzi, and Chinyamurindi, 2019).

### **Uncertainty**

Refugees experience substantial uncertainty over their status in host countries and cumulative disadvantage. Long waiting periods are demanded by the process of seeking asylum, as do long periods of unemployment, undermining "psychological readiness for work" and leading to the high prevalence of mental disorders (Huq, and Venugopal, 2021; Selvamalar, 2010; Barth, and Zalkat, 2021; Heilbrunn, and Iannone, 2020; Cifci, and ATSIZ, 2021).

Unstable labor market conditions create specific difficulties for women, the young and the elderly (Huq, and Venugopal, 2021; Freiling, and Harima, 2019; Selvamalar, 2010; Woetzel, Madgavkar, and Rifai, 2016; Fong et al. 2007; Cifci, and ATSIZ, 2021).

While the fact that "the vast majority of the world's refugees live in forgetfulness, unable to return home yet lacking the rights needed to successfully integrate into their host states" creates considerable obstacles for refugees, such are not adequately reflected in self-reliance ideology (Huq, and Venugopal, 2021; Freiling, and Harima, 2019; Heilbrunn, and Iannone, 2020)

### **Identity and self**

Identity work can be "highly relevant" to refugee entrepreneurs in shaping not only their self-identity but also the role they play in the entrepreneurial process within the social milieu they find themselves (Huq, and Venugopal, 2021; Baranik, et al. 2018; Bristol-Faulhammer, 2017; Fong et al. 2007).

### **Resilience**

Resilience depends on individual, relational, community, cultural and contextual factors. Effects are cumulative rather than traceable to single occurrences. Resilience and recovery are the results of combinations of factors working together to aid the process as a cumulative whole, a fact that belies attempts to attribute resilience to any single cause like entrepreneurship (Huq, and Venugopal, 2021; Heilbrunn, and Iannone, 2020).

Such challenges tend to stimulate resilience as refugees must often rely on their own personal agency and underlying entrepreneurial cognitions and personality factors to unlock their adaptive capacities and entrepreneurial spirit. In this context, displaced women's entrepreneurship represents a form of defiance and economic resistance – one that arises as displaced women entrepreneurs defy their contextual embeddedness including male domination, authority,

institutional norms, and barriers, rather than succumbing to them (Huq, and Venugopal, 2021; Bristol-Faulhammer, 2017; Fong et al. 2007).

### **Financial resources**

The availability of financial resources to start entrepreneurship is one of the most important challenges facing refugee women. For that, they tend to rely more on personal savings, friends, and family, rather than formal financial channels for funding (Mehtap, and Al-Saidi, 2019; Wauters, and Lambrecht, 2008; Heilbrunn, and Iannone, 2020; Bristol-Faulhammer, 2017; Fong et al. 2007). A person who wants to set up his or her own business also needs a certain amount of money to invest. Refugees have often left all their assets behind (Wauters, and Lambrecht, 2008). Refugees often cannot provide the capital guarantee required by banks if they tend to get loans. In addition to solid business proposals, collateral, and good credit scores required to obtain a bank loan (Wauters, and Lambrecht, 2008; Bristol-Faulhammer, 2017; Fong et al. 2007).

### **Institutional and Societal Environment**

Legal barriers, restrictions and routines are particularly hard for refugees to overcome, as they are new to the system and unfamiliar with the customs and the institutions in charge (Wauters, and Lambrecht, 2008; Bristol-Faulhammer, 2017; Fong et al. 2007). Contacts with the external environment are not always easy (Wauters, and Lambrecht, 2008; Bristol-Faulhammer, 2017; Fong et al. 2007).

## **STORY ONE**

### **Mona from different moving to Restaurant owner**

When Mona asked about her motivations to start a business said, over my life, I went through different stages of moving. I was born in Yemen until my father and mother immigrated from Yemen to Saudi Arabia due to the political disputes taking place in Yemen, and my father's family was excluded from the south of Yemen to the north of Yemen as well. The south of Yemen to the north were two separate regions at that time. After that, all my father's family members immigrated to different countries. I got married after finishing high school, I did not have the opportunity to get a university degree. My ex-husband, our kids and I moved from Saudi Arabia to Austria for some years until we settled in the United Kingdom in 2017 then due to family quarrels we had divorced. Mona looks closely and says York is a touristic, ancient, and archaeological city, always crowded with tourists and visitors, and there are no Yemeni restaurants.

I am a skilled cook, I learned to cook Yemeni dishes from my mother and grandmothers. I have a dream to have a restaurant with an Arabic theme and decoration that serves Yemeni dishes and run it with my sons. When I was in Austria, I sold Yemeni dishes online by Instagram, but when I moved to settle in the United Kingdom, I started selling Yemeni dishes to my colleagues at the English language institute, and then I decided to have my own restaurant. Mona proudly said that seeing people satisfied and happy with what I serve makes me happy and very motivated.

Customers are very impressed with Yemeni food and the restaurant atmosphere. For me, cooking is a beautiful portrait which I love to be creative in taste and look of it". She mentioned that "I am a single mum of five, in my forties, we are living together, and we have many living expenses. I had no choice rather than overcome the divorce trauma, so I went to the English Language Institute. I had to learn it in order to understand the law in my rights as a divorced woman, there I had gotten the opportunity to promote Yemeni dishes to my Gulf colleagues once again. perseverance and determination to succeed was the main motivator for me. Mona confirmed that the desire for independence is considered a key motivation for entrepreneurship, I worked hard to have a restaurant, and run it with my sons. I used to work in commerce since I was 25 and run businesses everywhere I lived. I preferred to work on my own instead of working for somebody. She said that I have a good experience in cooking; since I was young my mother and grandmothers taught me various Yemeni dishes, salads, and desserts. I have been very skilled and loved to dazzle others with what I cooked. I used to sell Yemeni dishes online on Instagram when I was in Austria. I have some savings from the inheritance that I had gotten after my father's death, in addition to the government grant during the first lockdown in 2020, should think well about how to invest this money in a profitable business.

### *Mona's Challenges*

Mona said about the difficulties that she went through "I'm in my late forties, just holding a high school certificate. Language is at the top of the barriers. I felt as if I was blind because I do not know English, so I went to the Language Institute to learn it. I want to know everything that is going on around me, what are my rights and what my duties are".

She also mentioned some organizations have given me a helping hand to overcome my ordeal such as IDAS<sup>1</sup> has provided me with psychological support and advice on the rights of a woman after divorce. The Jobcentre offered me a group of courses on running a business. I Involved myself in a group of courses on running a business which was conducted by the Jobcentre. I also obtained professional cookery certificates which allowed me to obtain the necessary licenses to open a restaurant.

It took a year of effort to get the new location of the restaurant, I had great difficulty getting it some of it was objections in the rental due to the Arabic restaurant idea or the lack of trust as my Arab origins. After I got it and it was prepared well for work. A few days before its opening, it was attacked by unknown people and completely damaged and lots of equipment had stolen. The restoration took several months and cost a huge of money. Getting financing is a very important and very difficult matter. she has some savings from the inheritance that I had gotten after my father's death, in addition to the government grant during the first lockdown in 2020. After the restaurant devastating incident, my children, Tom, and Zaineb had set up a GoFundMe page to help raise funds to cover the cost of the restaurant's repair. "The local community, the institutions, the neighbouring projects, and the supervisors of York University, have donated to support me. But it was not enough to restore the restaurant, so I got a loan from the bank". With great love, satisfaction and gratitude to the local community, Mona concluded her interview by saying "Peace and love' overcome hate – as vandalized York restaurant finally opens".

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1. IDAS is the largest specialist charity in Yorkshire supporting people affected by domestic abuse and sexual violence. <https://www.idas.org.uk/>

## STORY TWO

### Lara and the Jasmine Foundation

The eleven years Syrian civil war produced about 6.8 million refugees and displaced 6.7 million internally (Reid, 2021). The war created the world's largest refugee and displacement crisis of our time and forced millions of Syrians to relocate and leave their lives behind them. Nowadays, most Syrian refugees are in Turkey (3.7 million), followed by Lebanon (844,000) and Jordan (670,000). These are the official numbers of registered refugees only whereas Jordan counted 1.3 million Syrian refugees and Lebanon claims to have 1.5 million (Karasapan, 2022). Jordan has the second-highest share of refugees relative to its population in the world – around 89 refugees per 1,000 inhabitants (TrustLaw and the Tent Partnership for Refugees, Jones Day, Latham & Watkins LLP, Ozalp Law Firm, and Winston & Strawn LLP, 2021). As the Syria crisis dragged on, Syrians had no choice but to integrate into and contribute to the Jordanian communities. While in theory refugees in Jordan can set up their own businesses, they still face significant obstacles from sectoral restrictions to difficult registration conditions. Despite the capabilities and skills of Syrian refugees, the Jordanian government did not create a straightforward or easy registration process for Syrian businesses (JIF, 2018). For instance, one of the business registration requirements is having a Jordanian partner. Irregardless, many of the Syrian business owners moved their businesses to Jordan creating job opportunities and improving the local economy. Between 2011 and 2021, Jordan had around 3,004 registered companies with at least one Syrian partner (Bayram, 2021).

In the meantime, female entrepreneurs face additional obstacles like social restrictions, and cultural and institutional challenges (Bayram, 2021). When trying to run home-based businesses, Syrian women experience ad hoc restrictions from landlords which makes everything more challenging (JIF, 2018). Consequently, to better understand the condition of Syrian women refugee entrepreneurs in Jordan, I talked to Lara Shahin founder of Jasmine Foundation in Jordan.

#### *The Story*

During the Syrian war, Lara and her family fled to Jordan. They thought the war will last a couple of months before they can go back to their family and live in Syria. As months turned into years, the family realized they had to settle in Jordan and find ways to subsist. Consequently, Lara took on the duty of care for her family who includes her mother, father, and little sister thereby she started looking for a job within her skill set. Despite holding a Diploma in Business Administration and working for years as an office manager and accounting field manager in Syria, Lara was not able to find a job. This was mainly due to the Jordanian law that allowed Syrian refugees to work only in specific sectors: Agriculture, construction and manufacturing. Another reason was the existing high unemployment rate in Jordan 13 percent in 2011 (O'Neill, 2022) that kept increasing till it reached 25 percent in 2021 with only 14 percent of women labor force participation – one of the lowest in the world (World Bank, 2021). Additionally, Lara faced discrimination and other hardships when looking for a job opportunity. She mentioned being exploited and assaulted several times mainly because she was both a woman and a refugee. These challenges drove her to consider two options: Either leaving Jordan and her family for a more inclusive country or starting

her own business. She chose the latter and established the Jasmine Foundation for the Economic Empowerment of Women, also known as Jasmine House. The inspiration behind Jasmine House came from Lara's direct community. Since Syrian women were known for their crafting skills and homemade natural products, Lara decided to turn these skills into a business. Jasmine House was formed to provide Syrian women refugees in Jordan with work opportunities by benefiting from the skills they already had (crafts and natural product making). She then put her previous managerial experience in Syria into action and started a business.

As for the initial investment, Lara relied on a small fund from her family which allowed her to buy two machines and rent a small shop. First, she hired women who previously owned factories in Syria manufacturing the same products. These women fled Syria after their factories were destroyed. Then she trained other women in crafts and production. At the same time, Lara adapted the products to the local market preference and started selling them. At the moment, the foundation has around 100 Syrian women working from home and in the office, creating a family and community sense around the product and the shop. The foundation expanded their employees circle and started working with Jordanian and Palestinian women, who face the same challenges as Syrian women. This exchange of expertise and knowledge among women created products that suit everyone's tastes and needs. The first challenge Lara faced was business registration. In 2015, Jordanian laws mandated that foreigners needed minimum deposits of 50,000 Jordanian dinar JOD (around US\$70,500) in a Jordanian bank and a Jordanian partner in order to register a business. These requirements were beyond exorbitant and impossible for Lara. The inability to register the business prohibited her from promoting her products thusly she could not sell them products in the Jordanian market. That did not dissuade Lara, instead she relied on her connections and word of mouth to sell the products to friends, family and the surrounding community. During that time, she realized that her target customers were not Jordanians per se, but the foreigners living in Jordan who appreciated handmade products. She then targeted her products and services (soap making classes) to foreigners and succeeded. Around that time, Jasmine Foundation was getting attention from the media and NGOs especially since very few Syrian women refugees were starting businesses. The media exposure led to business growth and gave them a share of the market. However, this attention did not go without repercussion. The government learned about Lara's unregistered business and shut them down in 2017. Coincidentally, Lara was participating in workshops and roundtables provided by the World Bank. The objective of these gatherings was to collect and understand refugees' problems and challenges. The World Bank then published a report on the importance of Syrian refugees' businesses alongside recommendations for how Jordan can be inclusive. By the end of 2017, the Jordanian government issued a law allowing Syrian refugees to register a business with a small capital and a Jordanian partner. In that case, if the company capital was 10,000 JOD, they only needed 5,000 JOD in the bank. In 2018, Jasmine Foundation registration was completed, and Lara was back into business. In the interim, Lara was witnessing violence happening around her especially with Syrian women. She recognized the need to share the story of other women and the need to highlight gender-based violence (GBV) that is going on around her. Therefore, she extended her business from crafting and product making and added workshops and training to empower women and decrease GBV. For the first campaign under the name of "Al Najiyat" or the survivors, Lara collaborated with HEAL organization for funding and support. Lara identifies Syrian women refugees as the survivors of all sorts of violence, so she concentrated the

campaign on reducing violence against them. With the success of the campaign, the foundation turned it into a continuous program that empowers and invests in women by training them in making crochet and natural products and also selling them.

### *The Funding*

In 2018, Lara received her first loan. At that time, Jasmine House was still very small. She was approached by the Near East Council of Churches Committee for Refugee Work after hearing about her business from different people. The council credited Lara around 20,000 euros to help her grow the business. The terms of the loan payment were not bad where she must pay 10 percent of the revenue every 3 months. Lara considers a bad step since it was a long-term commitment, she is obligated to repay for the next 6 to 7 years. Additionally, in 2019, Jasmine Foundation received an EU grant for small businesses. With this grant, Lara was able to pay for a website where she is currently selling her products.

### *The Challenge*

Lara's journey is complicated and challenging. She faced extra obstacles just for being a woman and a refugee. Her main and constant challenge is governmental limitations on Syrian refugees. These limitations make it hard, sometimes impossible, to get work permits for her Syrian employees. The Jordanian government only gives permits to Syrian refugees for agriculture or cleaning jobs. Businesses are expected to hire Jordanian people even though, as in the case of Lara, the nationals don't have the right skills. Lara keeps hiring people without registering them and risks getting ticketed. After getting a ticket, Lara should go to court and ends up paying around 800 USD fine for every unregistered employee (which she's happy to pay for her employees). Another obstacle that is also unbending is social and cultural norms. Jordanian society doesn't view woman entrepreneurs positively, so they hinder their entrance in any possible way. According to Lara, these limitations are mostly applicable outside of Amman – the capital of Jordan – where rural areas and the suburbs are less accepting of women working in the first place. Unfortunately, Lara works closely with suppliers from rural towns to acquire the raw materials. Wherefore, she gets harassed by the suppliers, but she ignores them for the sake of her business. Lara also faced abuse by government workers. She recalls one incident where a government employee harassed her at her shop after learning the business was not registered. He assumed that a woman refugee with an unregistered business is good prey since she will be too afraid to speak out. He was wrong. Lara filed a complaint against him. As per Lara, Jordan does not tolerate harassment. After the worker was questioned, Lara was asked to drop the charges (and she did) declaring that the worker was humiliated enough. The following year, Lara was invited to Brussel for a conference on Syrian women refugees' conditions in the workplace. During her session, Lara mentioned harassment as the main challenge Syrian women face at work and shared several stories. Her contribution did not go so well with the Jordanian ambassador. The latter contacted the Jordanian government in distress. After learning what happened, Lara was scared to go back to Jordan, fearing any repercussions. She directly visited the UN women manager in the EU office in Brussels and shared her story. The manager reassured her that nothing will happen to Lara and asked her to contact her if she ever feels threatened or was interrogated. As was foreseeable, once Lara landed in Jordan, she was escorted to the office of the secret service for questioning. The Jordanian government

apparently does not like to be blamed for the problem. That is when Lara shared her intentions with the officials. She was not blaming anyone but just highlighting the problem Syrian women face hoping for solutions. Unlike the constraints from the Jordanian society, Lara mentioned the extreme support she received from the Syrian community in Jordan where they consider her shop as a mini Damascus. The shop made them feel at home.

### *The Motivation and Success*

Despite all the hurdles Lara faced, she was determined to keep moving forward. She didn't receive any help or support from the Jordanian government or even local NGOs. Lara conveys that her success comes from the relationships she developed. She credits her success to the relations she builds with different organizations and people who kept her going and helped the foundation grow.

Through her connections, Lara met with the United Mission for Relief and Development (UMR) in 2020. One month before the pandemic, Lara signed a contract with them. This contract saved Jasmine Foundation. With the slowing business during the lockdown, Lara could not pay the shop. However, the contract with UMR allowed Jasmine Foundation to use its offices for free. It was the only way she could have kept the operation running. As the founder, Lara created a sense of family and belonging in her organization. Her family supported her every step of the way, especially her mom who took workshops on how to make soap and added the product to the list. Her mother also trains visitors from Airbnb experience and others interested in learning how to make soap at home. Jasmine House is now on Airbnb experiences where people can learn how to make soap. This increased sales and awareness of the company. Jasmine House is also on the Jordanian Ministry of Tourism's list of recommended tourist destination destinations, the only Syrian company among 45 Jordanian craft businesses.

Alongside relationships and reputation, Lara recognizes the importance of flexibility and adaptability in business. She believes for a business to succeed, owners should adjust the strategy to adapt to the market condition and demand. The pandemic was a great example. Jasmine Foundation relied on offline business and training, but for the foundation to survive, Lara had to shift work online. She then started a website and shifted the sales strategy.

## **STORY THREE**

### **Mali from Libya developing self-agency through The Melissa Network Program**

#### *The Melissa Network*

The Melissa Network is an organization for migrant and refugee women in Greece. Founded in 2014 with grassroots-based participation, it counts members from over 45 countries. It provides a platform for networking, capacity building and advocacy and runs an innovative integration program supporting refugee women and children. At the Melissa Network it is strongly believed that refugee women need to be aware of the successful women entrepreneurs as role examples to increase their self-confidence; 2) trainers and business advisors need innovative and adapted

methodologies to transfer entrepreneurship skills to refugee women from ethnic minorities taking into consideration the cultural barriers; 3) women and trainers/business advisors need to have easy access to open educational resources in order to empower themselves according to their needs and their interests. The project aims at increasing the employment of refugee women providing them the knowledge, practical skills and counselling necessary for engaging the social enterprise world.

### *The Story*

Mali is a 29-year-old woman from Libya, who has been living in Athens with her family for the last four years. When she came to Greece, she had no money and felt depressed and helpless. There is a clear sense of loss she has experienced which she communicates very expressively in her impassionate interview. When she joined the Melissa Network, she took up painting and photography as a means of “escaping reality”. She mentioned that “she had lost herself” and the network helped her acquire a newfound sense of self and purpose in life. It was there she decided to set up her own food stall at the Ritsona refugee camp, an hour north of Athens, Greece to sell fresh, organic food as she used to make homemade food in her homeland. Ritsona is a temporary residence for about 750 refugees from countries such as Iraq and Afghanistan awaiting asylum in Europe. Businesses bring routine and community to those who have made the perilous journey to Greece, fleeing persecution and war. As Mali’s business grew and she was able to provide for her family, her confidence and desire to contribute to her community. “Running a successful business made me feel worthy again. As refugees, it is vital for us to feel part of a community again, a sense of belonging that we lose when we leave our native countries. Providing necessary items to my community also gives me a sense of usefulness.”

### *A tale of refugee resilience and agility*

Refugees from North Africa have to embark a highly perilous journey, having to cross the Mediterranean Sea. Mali recounts “I didn’t want to get into the water. It was too risky. I thought the journey wouldn’t finish and I’d die.” But despite experiencing the perilous journey at sea, she said she would do it again if she had to because living in Libya was “hell” and this was the only way out. Registered refugees and asylum seekers receive a stipend funded by the European Commission that ranges from €90 for a single person in catered accommodation to €550 for a family of seven or more in self-catered accommodation. Ritsona’s entrepreneurs reinvest this. Despite the adversities, research has shown that refugee entrepreneurs are disproportionately entrepreneurial and economically diverse. Nadina Christopoulou, the director, and co-founder of the Melissa Network tells me: “The idea behind this was to be able to provide a safe space [in Greece] for them to pick up the thread of the work they have been doing for so long, and to start thinking again about the potential of what they can do. To also avoid the fragmentation that the diaspora entails.” Social and labour integration is so important for refugee women to become self-reliant and independent. Key efforts by local and central authorities, the private sector and refugees themselves are vital towards employment and entrepreneurship. State-provided accommodation and cash assistance painfully exposes the lack of support many of these people have had to become self-sufficient. Hundreds of refugees are homeless, with no language skills or necessary documents, and no clue of what to do. The COVID-19 outbreak further

exacerbated existing difficulties related to the integration process of refugees and asylum-seekers who were not in the formal labour market and were therefore excluded from expanded social protection measures in response to the pandemic in Greece. Refugee and asylum-seeking women face increased challenges in integrating and should be understood as a *specific group requiring particular attention* – their strengths and needs need to be taken into account in any strategy seeking to improve integration outcomes. Comprising one third of all asylum-seekers and refugees in Greece today, their socio-economic inclusion is of vital importance and should be mainstreamed throughout all interventions.

## CONCLUSION

The current media platforms present refugees as the problem and tend to forget mentioning the hardships they go through. It's time to focus on the resilience these refugees present and their ability to innovate despite displacement. Some refugees moved their businesses abroad others achieved their dreams of starting one. Being a refugee means having lost more things than just your home country. Many refugees have lost family, their homes, businesses and wealth that they have struggled so hard to build. Despite their hardships, these refugee entrepreneurs showed exceptional resilience, and their entrepreneurial spirit allowed them to thrive and create opportunities for themselves and their community. This also goes against the stereotypes that want refugees are idly waiting for humanitarian agencies to take care of them. Recent OECD evidence shows that it takes longer for refugee women to gain a foothold in the labour market compared with refugee men. When employed, refugee women are frequently in part-time positions.

Although entrepreneurship for many refugees is about surviving, it should be shifted into thriving. Despite the cultural and governmental limitations, female refugee entrepreneurs have excelled. There is potential for them to grow and innovate even more if provided with a fair environment and the right support. Having an inclusive environment can yield substantial social and economic benefit. Policy makers and startups are both responsible for creating an enabling environment for refugees. Policy makers should issue new laws that support refugee entrepreneurs, women specifically, and reduce procedures time and cost. There should also be proper training programs that teach refugees business creation from ideation to execution. These programs could also provide business and financial solutions that help women refugee entrepreneurs scale their businesses. On the cultural level, highlighting the achievement and contribution of women refugee entrepreneurs will create better social acceptance and encouragement.

Many EU Member States lack policies specifically concerning female migrants. Out of the 32 responding governments (27 Member States, 4 Belgian regions and Norway), only 7 have such policies in place. A 2018 report by the EU Fundamental Rights Agency (FRA) underlined that across the EU, there is little evidence of action plans and strategies with a particular focus on migrant women or gender issues. There is however a steady progress towards empowerment of female refugees as well as their labour market integration. At the first ever European Business Summit on Refugee Women in November 2021 for example, 24 companies, including Accenture, adidas, Barilla, BNP Paribas, H&M group, L'Oreal, and Sodexo have collectively pledged to mentor 1,200 refugee women over the next three years — including recently arrived Afghan women — on

practical skills like CV writing, interviewing, and networking to improve their chances of landing decent jobs or advancing their careers.

Integration initiatives should target:

**Education in general:** Universities should offer refugees and asylum seekers the opportunity to participate in a variety of university courses and organise ad-hoc trainings for critical, employability skills.

**Language skills:** These initiatives usually focus on the acquisition and improvement of language skills. This is often combined with citizenship courses or activities to foster social integration in general.

**Educational programs assisting with childcare:** Other promising initiatives combine the language needs of migrant women with their child care duties as mothers

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## THE RISE OF THE PHD STUDENT “GHOSTWRITER” - FINDINGS FROM A UK DISTANCE-LEARNING COURSE

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*Aaron Taylor*

**ABSTRACT:** *This study has investigated how and in what ways a number of active PhD students are writing assignments on behalf of online distance-learning students. The rationale behind the decision of PhD students to participate is revealed along with the process in securing writing contracts and the particular services that are offered. The mitigation of risk and the strategies employed by ghostwriters are also explored in this study. It was discovered that a number of PhD students were motivated by financial gain with only one respondent feeling any remorse for their actions. Solutions are provided for universities to combat contract cheating and include reassessing anonymous marking policies, designing more authentic assessments and utilizing stylometry.*

**KEYWORDS:** PhD students, UK; online-distance learning, ghostwriters.

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The increase in the popularity of online learning has provided new revenue streams for universities and has afforded greater flexibility to students (Markova *et al.*, 2017). Many commentators have heralded this development as unprecedented and spectacular (Holbeck & Hartman, 2018). However, the rapid development of online delivery has brought with it a number of associated issues. One of the main challenges is arguably understanding whether a student's work is actually their own (Bretag *et al.*, 2019; Amigud & Lancaster, 2020). Whereas it is possible to ascertain knowledge and understanding through interaction in face to face classes, it is more complex to do so in an online environment where a student may feel uncomfortable being on camera. It can also be challenging to effectively track those who do not regularly participate in asynchronous and synchronous activities (Kong *et al.*, 2017). This situation has resulted in academic management and educators losing confidence in the authenticity of the assignments they receive (Mellar *et al.*, 2018) with “ghostwriters” becoming ever more commonplace in higher education (Awdry & Newton, 2019). Interventions such as marker training (Dawson & Sutherland-Smith, 2019), learner analytics (Trezise *et al.*, 2019), stylometry (Juola, 2017; Ison, 2020) and the design of more authentic assessments (Ellis *et al.*, 2020) have taken place in some institutions, although contract cheating in higher education remains a serious issue that is often challenging to detect (Newton, 2018; Lucky *et al.*, 2019). These issues have resulted in unscrupulous individuals taking advantage of the situation.

“Essays mills” are well-known in this regard although more recently, active PhD students have become more involved in the process of contract cheating (Medway *et al.*, 2018). This case study

explores the motivations and actions of 5 current PhD students who all agreed to participate in this research on the proviso that they were given anonymity and their identities were coded. The demographics of each PhD student is found below:

Code	Gender	Age	Length of time PhD student
PhD Student A	Female	25	1 year
PhD Student B	Male	25	1 year
PhD Student C	Male	24	1 year
PhD Student D	Male	26	2 years
PhD Student E	Female	23	8 months

These respondents were interviewed on Microsoft Teams over the course of 3 months, from August 2020 to November 2020. An interpretivist qualitative approach was adopted in order to generate rich, deep and descriptive data (Bell *et al.*, 2018). Each respondent was interviewed using the same set of interview questions, focusing on two distinct themes; exploring how and why they participate in contract cheating. The interviewees were known to each other and occasionally worked together when writing assignments for students. They were led by PhD Student D who directly recruited the others. The PhD students are all part of the same faculty in the same university. This university is different to that of the author of this article.

### **CHEATING IN DISTANCE-LEARNING CLASSES**

Interestingly, it has been discovered that students are more likely to cheat in a distance-learning environment (Newton, 2018; Kong *et al.*, 2019). This is primarily because students who choose to cheat perceive it is easier to do so online (Mellar *et al.*, 2018). The ability to be less visible as discussed above, arguably makes it less straightforward to be identified. The increasing use of anonymous marking is another factor that has made it difficult to understand if a student's submission is their own (Hinton & Higson, 2017). These issues are compounded by tight marking deadlines, sometimes of only a week (Fernández-Toro & Duensing, 2020), that has made it extremely challenging for academics to understand if any form of academic misconduct has taken place (Medway *et al.*, 2018).

As former students who are often invited to mark assessments, PhD students are fully aware of this situation and are in a position to take advantage. The vast majority of PhD students naturally do not partake in contract cheating although those that do so share common motivations. The rationale for getting involved and the process that takes place from tender to payment is shared in two sections below – why and how do they do it.

### Why do they do it?

Unsurprisingly, each respondent was open that they were motivated by financial gain. None of the respondents were sponsored for their PhDs and each had to pay their own fees and had other expenses. This compelled them to become involved in contract cheating. For instance, PhD Student D stated:

*“It’s quite a lucrative gig. I can make £150 in a few hours if the topic is straightforward. I used to work in the local supermarket but quit after I learned I could make a lot more money and more quickly.”*

PhD Student A confirmed that *“the money is too good to turn down. When I started, I felt a little bit guilty but after a while you don’t think about it. If I don’t do it, someone else will”*.

PhD Student E (who was 23 years old) similarly stated that she thought it was difficult to get the same amount of money in other work. She said *“at my age and in my financial situation, this is easy money. I don’t feel good about doing it, but I don’t really have another choice”*.

The theme of guilt was also mentioned by PhD student B who said he felt *“ashamed”* of being involved in contract cheating and when he was a student and was repulsed at his fellow students who paid others to do their work. However, as in the case of PhD Students D, A and E, he felt the money that was offered for the work that he was required to do which he termed as *“simple”*, made his decision easier.

PhD Student C confirmed that he had accrued substantial debt since becoming a student and was working as a ghostwriter to pay this off. Interestingly, PhD Student C was the only respondent who said they would like to stop contracting cheating as soon as possible. He confirmed he would quit as soon as he had paid off the money he owed.

On average, each ghostwriter was able to make approximately £1,500 per month.

It was also revealed that the PhD students were confident they would not be caught and could quite easily *“beat the system”* as affirmed by PhD Student E. This was because they all had previous experience as students in the same university and were well aware of the basic systems in place designed to mitigate cheating. The main *“danger”* was that academics marking the work would see articulate, native-level discourse and become suspicious that this was not written by the student that submitted. PhD Student C said he was adept at *“dumbing down”* what he wrote and purposely made punctuation and grammatical errors so as not to arouse suspicion. Each PhD student was sure that they could circumvent any form of suspicion and pass off their work as belonging to others.

### How do they do it?

The group of PhD students led by PhD Student D had a sophisticated system in place that enabled them to attract, personalize and achieve the grade the student asked for. PhD Student D explained this concept as the ‘APP approach’ (Attract, Personalize, Pass). PhD Student D explained this strategy had gradually evolved and was deemed to be most successful in luring *“clients”*. When

PhD Student D first started the operation, he used to bid for work on contract cheating websites. However, he found this to be onerous and overly competitive. Therefore, he reformulated his marketing strategy and each PhD Student took it in turn to market their business outside of the university library by distributing flyers and business cards. Both of these documents included pseudonyms and generic email addresses so they could not be traced. By taking it in turn, they were able to reduce the possibility of being identified. Additionally, as they had access to the internal email directory, they were able to send introductory emails to distance-learning students offering “*writing services*” and “*assignment help*”. Many students misunderstood these emails and believed they were related to study skills support from the university. When students responded to the email, they were assured they would be guaranteed a pass (or grade they desired) in any subject for an agreed fee. The fee was dependent on the level (undergraduate was less expensive), the word count and the level of personalization. Students were promised that they would be able to receive the grade they asked for, with the finalized assignment completed by a specific date. PhD Student D purposely recruited two non-native colleagues (PhD Student B and PhD Student E) in order to make the style of writing more authentic and akin to non-native speakers. A typical price was £150 for 2,000 words with 12,000 words dissertations being £450. Students were also offered a discount if they bought more than one assignment. Once a fee was agreed, students were asked to provide the ghostwriter with the assessment brief and student ID and password to the LMS. PhD Student D thought this was useful in order to have a better understanding of the forum discussions that have taken place. This access was also seen as useful in group-based assessments and reflective work where the ghostwriters were able to tailor their work accordingly. Depending on the complexity of the subject, there was usually a 72 hours turnaround. The student was then asked if they would like anything further included. Once this was finalized, the fee was paid, and the student submits.

### **ADVICE FOR UNIVERSITIES ON REDUCING ONLINE CHEATING**

Although this is naturally a challenging situation to overcome, there are nevertheless a number of suggestions that could be considered. The main difficulty arguably surrounds the issue of identifying authenticity. As each PhD student confessed, it was much more straightforward to escape detection due to anonymous marking. Although this form of marking is argued as beneficial in reducing potential academic bias regarding gender and ethnicity as discussed above, it nevertheless acts as a barrier in ascertaining academic integrity. It is therefore suggested that anonymous marking policies should be reassessed, and students submit using their actual names. Unless a student utilizes a ghostwriter for every assignment, it will therefore be easier to identify if writing standards differ, even if a non-native ghostwriter is employed. Focusing on student stylometry is contended as a useful recommendation in this regard (Juola, 2017; Ison, 2020). For those that are suspected, it is recommended that a *viva voce* is also implemented to ascertain authenticity. Adopting appropriate assessment design is further suggested. Creating authentic assessments where students are required to actively participate in tasks then reflect upon their delivery and performance may be another way of reducing the input of ghostwriters.

## CONCLUSION

It should be acknowledged that these are the stories of 5 PhD students who have chosen to engage in contracting cheating, primarily for financial gain. Although this does raise concerns regarding ethical behaviour, particularly from those who should be effectively representing their institution, the vast majority of PhD students do not participate in such activity. Nonetheless, it is surprising at the ease in which these individuals are able to avoid detection and “beat the system” as put by PhD Student D. Abandoning anonymous marking, adopting student stylometry as best practice and designing authentic assessments can all be used to reduce contract cheating in distance learning students.

It is vital that all universities do their utmost to prevent contract cheating from occurring, otherwise those that graduate will do so without the requisite knowledge, skills and abilities. This in turn has larger repercussions for the credibility of distance learning and society in general.

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## ON THE IMPACT OF THEMATIC ETFs ON INDEX INVESTING

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*Lorenzo F.P. Merlo*

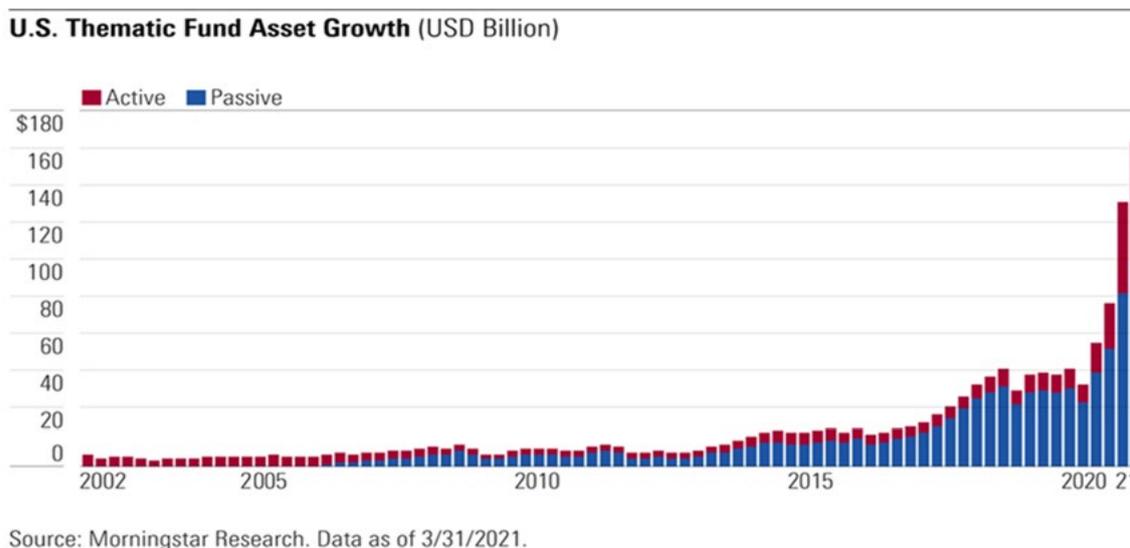
**ABSTRACT:** *Thematic strategies have gained a lot of traction and popularity since the world economy faced an impactful macro event. Investment managers emphasize that some sectors affected positively by the change in business conditions could generate greater returns (alphas) than the broader market (beta). Exchange-traded funds (ETFs) and other index products have become the instrument of choice for betting rapidly on the outperformance of these sectors over the aggregated market. The euphoric demand for US-based equity ETFs is continuing to outpace its supply as the inflow curve has steepen in 2021. The exponential growth of thematic investing feeds further investors' appetite for ETFs. We examine here whether the recent rise of thematic ETF trading is coherent and in line with the rationale behind index investment strategies as originally envisioned. The investigation relies on a survey directed to retail investors and a cross-analysis of a set of thematic ETFs against a traditional ETF. This paper questions the continuity of the fast-paced growth in US-based equity ETF trading. The results gathered here suggest that the development and the rationale of thematic ETF trading is deteriorating the reliability of index investing altogether. These risks are transparently presented here to savers. We intend to verify at which point investors can confidently rely on these "hot" equity products.*

**KEYWORDS:** thematic ETFs, index investing, underlying index, alpha JEL.

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The ETF industry crossed a milestone as it reached the \$10 trillion mark back in 2020 (Financial Times, 2020). With asset under management (AUM) of \$421 billion, the SPDR S&P500 ETF Trust (SPY) is the world's largest ETF as of 2021. SPY precedes Blackrock's counterpart, the iShares Core S&P500 ETF (IVV), which reported \$326 billion in AUM in the same year. Taken together, they represent 10% of the total amount of AUM for US-based ETFs (Statista, 2021). These figures exclude the dollar amount of option trading. US-based equity ETFs dominate the global ETF market. The two largest ETFs are part of the traditional broad market index-tracking spectrum. New strategies such as thematic, leveraged, and smart-beta strategies have generated a wide range of specialized ETFs. These trends mark the shift of the traditional passive investing to the "aggressive passive" and active investing within the ETF spectrum. The recent flood into thematic funds has further expanded the ETF spectrum and spurred heightened demand for US equities. Morningstar data illustrated in figure 1.1 shows that AUM of US thematic funds has grown from around \$50 billion in 2019 to over \$160 billion during the third quarter of 2021 (Morningstar, 2021). In this paper, the outstanding growth is subject to closer study. The amount of AUM is still below \$200 billion and represent a minor allocation in the overall ETF

spectrum. If the pace in inflows continues, thematic ETFs could rapidly take a substantial place in the ETF spectrum. Thematic investing has never been more popular and “in vogue” than in the aftermath of the “Great Lockdown.”



**Figure 1.1.** The asset growth of US active (red) and passive (blue) thematic funds in billions of USD (2002-2021).

In 2016, ETFs have outgrown index mutual funds worldwide in terms of AUM. Given the inflows in the first half of 2021, the total value is set to break yet another record by year’s end by reaching the bar of \$12 trillion. At this time, ETFs represent roughly 60% of the total global value linked to index investing and will presumably continue to outgrow its sibling. Whereas index funds typically fill the need for buy and hold investors, ETFs have found more appeal among intraday traders worldwide. The development of specialized ETFs such as thematic, sectoral, and leveraged ETFs has also increased the propensity to execute numerous intraday trades on a high-frequency basis. They can easily shift from one sector to the other in a short-time interval via the high liquidity of large and frequently traded ETFs. This trading behavior often leads ETFs and their options to have higher trading volumes than their underlying securities. The phenomenon is being repeatedly observed in US stock markets and it ultimately led to greater noise and volatility associated with ETF trading (Ben-David *et al.*, 2014).

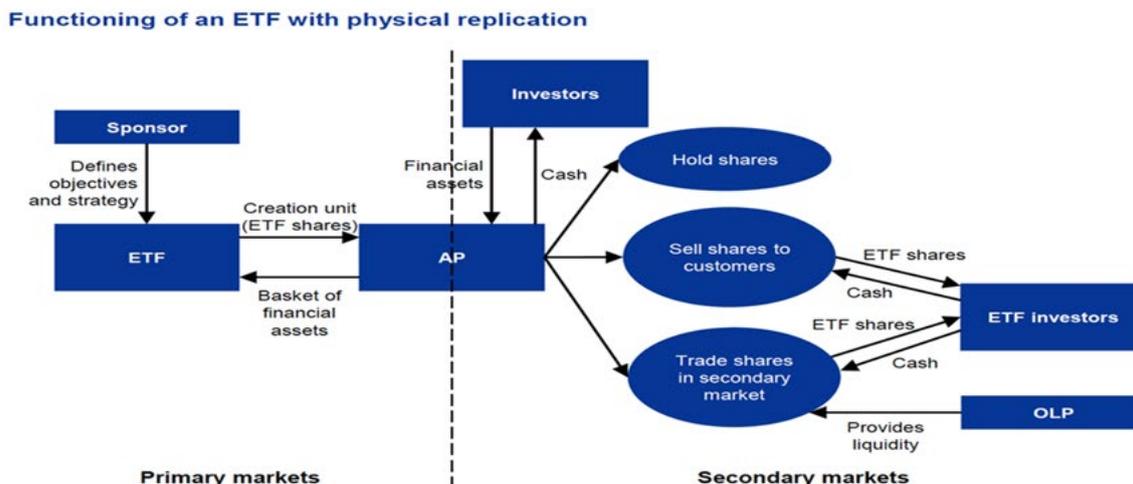
Before introducing new financial products into the market, regulative frameworks must be elaborated and approved by the competent authorities. Failing to do so can lead to financial disasters as exemplified in the case of collateral debt obligations in 2008. Index investing was implemented under the Investment Company Act of 1940 by the Securities Exchange Commission (SEC) and thereby any ETF or index fund must be registered. Financial regulatory bodies and authorities such as the SEC in the US or the European Securities and Market Authority (ESMA) in Europe have continued to put under scrutiny the current trends that have fueled the rapid pace. They have evaluated on several occasions the impact of ETF trading on macro stability and systemic risk (European Systemic Risk Board, 2019).

This research paper aims to investigate the recent development of US-based thematic ETFs. The study reveals that thematic ETFs are in contradiction with the initial rationale of index investing. Many factors and amplification mechanisms feed the appetite of ETF trading (e.g., low-cost investment vehicle, diversification, ease to invest...). Lately, an outstanding trend in ETF trading consists of building thematic stock indices, a composite of individual stocks around a specific (mega)theme such as sustainability, energy, or technology. These equity products are used to generate so-called alphas, an excess return over benchmarks such as the S&P500. Naturally, as investors seek higher yields in an extremely low interest rate environment, these products are in high demand. This paper meets the following four objectives:

1. An examination of ETFs as an investment vehicle
2. An assessment of the latest trends in US-based equity ETF trading
3. An evaluation of inconsistencies in thematic ETF design and trading
4. A comparison of primary research with secondary research outcomes

## LITERATURE REVIEW

ETFs are a type of closed-end investment fund that is listed and traded on a stock exchange. ETFs are mostly index-tracking as they seek to replicate the performance of an underlying index. Their direct link to an underlying makes them a derivative. The physical replication method widely dominates the index investing universe, especially in the US. The other being the synthetic replication has mostly been seen in European and Asian markets. The tracking of an underlying using physical replication requires the issuer to buy and hold all securities that compose the index whereas the synthetic replication relies on a set of complex swap agreements (Karlou, 2012). In simpler words, synthetic ETFs are much riskier (Federal Reserve, 2017). This paper leaves out synthetic ETFs. The physical replication method implicates a special intermediation known as the creation/redemption process (CRP). The ETF physical model involves a set of interactions among market participants. These interactions are illustrated in figure 2.1. The authorized participant (AP) is at the core of the ETF model and appears as a bridge that maintains the continuity of the ETF market. ETFs emanate in a primary market as do stocks. Once the ETF units/shares are created, they will be sold in the secondary market to investors. There are three main attributes for any ETF: the NAV (fund's total assets minus any liability divided by the ETF shares/units outstanding); the tracking error (the difference between the ETF percentage change and the underlying percentage change) and the implied liquidity (the forward liquidity of the ETF given the liquidity of the underlying). These attributes should be reviewed carefully as we define here the product in its entirety.



Sources: own calculations, based on Autorité des marchés financiers (2017), Investment Company Institute (2015 and 2018) and Lettau and Madhavan (2018).  
 Notes: AP refers to Authorized Participants and OLP to Official Liquidity Providers. Creation units can also be delivered to the AP in exchange for cash.

**Figure 2.1.** Functioning of an ETF with physical replication model.

The shares are traded directly on electronic stock exchanges (e.g., NASDAQ, NYSE, BATS). The units do not return into the hands of the fund manager as it is the case for mutual funds. Brokerage firms will facilitate the transaction for end users to buy and sell ETFs. Additionally, the electronic trading system and automation has further facilitated the trading of financial products and reduced transaction costs as well as spreads between ask/bid prices (Patterson, 2018). Index-tracking removes the decision-making process of fund managers for portfolio construction and rotation. Traditional ETFs have low fees due to passive management; allows market transparency via historical indices, price discovery and information and most importantly are tax efficient as there are less taxable transactions and a lower capital gain tax levied on ETFs. The low management fees and tax efficiency have been considered until now as the strongest drivers of the asset allocation shift towards ETFs.

The buying and selling of ETFs involves two processes: namely the so-called creation/redemption process (CRP) that occurs between AP and ETF sponsors/issuers and the buy/sell process between liquidity providers, AP, and end holders. The first process consists of a set of transactions between the ETF sponsor/issuer and the authorized participants (AP) and occurs in the primary market. The AP, usually a large investment bank (e.g., Goldman Sachs) or market maker (e.g., Citadel Securities) will sell the matching securities within the underlying index to the ETF issuer to hold. The issuer then creates a defined number of shares based on the total market value of said securities. The creation of shares requires buying more of the underlying from an AP whereas the redemption requires selling. The CRP is at the essence of the pricing mechanisms of ETFs (Abner, 2016). It allows to keep the NAV, de facto the ETF price, always close to the value of the underlying. The CRP remains imperfect even if the AP relies on high-frequency trading to align the ETF price with the NAV. A tracking error often occurs in which the ETF change does not match exactly the change in the underlying. The direct buying and selling pressure on ETFs can deviate its price from the fair NAV. This leads ETFs to be mispriced at premiums or discounts (Engle *et al.*, 2002). High-frequency traders including APs consistently exploit these statistical arbitrage opportunities to gain fair and often riskless profits. Their activity eventually allows ETFs to move back to fair values. High-frequency trading has been

therefore defended as a useful market mechanism to ensure the correct pricing of ETFs (Jain *et al.* 2021). It will be argued here that thematic ETFs do not fit the requirements to assure a smooth and continuous CRP to reduce tracking errors and mispricing.

The issuer of an ETF does not incur risk as it shifts to the holder once the ETF units are sold. It only stores the basket of securities on behalf of the ETF holder. The two largest ETFs issuer Blackrock and Vanguard Group rely on the end holder to market their products. Once the issuer chooses an underlying from a third-party index provider, it relies on an AP to buy and sell the components in the secondary market to build the intended ETF. The second main process in the replication model consist of the buying/selling of these units in the secondary market. Here, another party comes into play: namely the liquidity provider. It is a market participant, usually also an AP or a market maker, who trades ETFs to fulfill orders for their own set of institutional clients or to provide additional hedging to their trading activities. These orders will raise the trading volume of ETFs and assure ease of access to buyers.

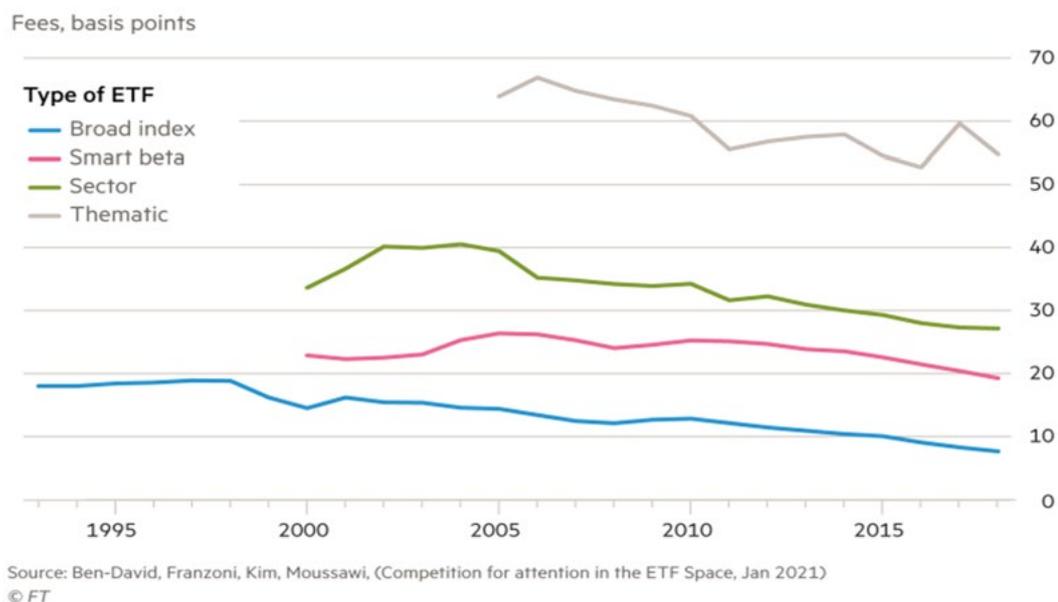
Financial markets will match counterparties with opposing views, buyers, and sellers, at an agreed market price. ETFs are traded on exchanges through the bid/ask mechanism and involves both brokers and dealers to deliver the units to end users. This floating mechanism grants ETFs much higher liquidity than index funds or mutual funds. Yet, ETFs differ in many ways from stocks (Abner, 2016). The quoted price at any time of an ETF should be equal to its NAV. The NAV is calculated by taking the market value of all assets, usually the basket of securities held by the issuer, minus any liabilities that the issuer has incurred to create the shares and finally divided by the total outstanding shares or units. This calculation allows the market to price the ETF at any time (Engle *et al.*, 2002). As pointed out above, the pricing mechanism leaves a margin of error on the ETF fair price.

Given the pricing mechanism of ETFs there can be several inconsistencies that arise from it (Petjisto, 2016). The NAV does not always match exactly the market value of the underlying index. This difference is referred to as the tracking error. Another resides in the liquidity of the underlying. To match the ETF price to the value of the underlying, the ETF constituents must be traded rapidly to continuously assure the match. Any potential investor should understand the implied liquidity attribute. The implied liquidity does not represent the ETF liquidity per se. The former represents the forward-looking trading volume permissible by the ability to create new tradable units based on the liquidity of the underlying. The daily trading volume used as a liquidity measure for stocks does not reflect the actual ETF liquidity (Abner, 2016). The liquidity of the underlying holdings will also impact the future liquidity of ETFs. It is important to measure how quickly the CRP can be carried out to match the NAV with the underlying. The slower the higher the tracking error as bottlenecks can occur for buying and selling the underlying constituents. As a result of lower liquidity in the underlying, the performance of the ETF does not replicate the performance in the underlying. It was demonstrated that active ETFs tracking specialized indices have greater tracking errors than broad market ETFs (Rompotis, 2009).

These issues partially caused two flash crashes in the US stock markets (Abner, 2016). One of these events occurred on May 2010 on the floor of the NYSE and triggered a new regulatory framework in ETF trading. Major stock indices fell instantly in a matter of 15 minutes by more than 5%. Investigation by the SEC concluded that ETF trading was the cause of the flash crash. It was later

revealed that the lack of visibility in the underlying caused ETF mispricing and increased tracking errors. This generated a major sell-off by liquidity providers. Records showed that market orders at that moment were 4 times the average market orders at the time on the NSYE. Ultimately, these market orders were filled rapidly and resulted automatically in a crash. The SEC issued new regulatory policies to prevent ETF trading to cause another flash crash. Ironically, these policies resulted in a more severe flash crash on August 2015 (Abner, 2016). The passive approach of financial authorities leaves the door open to unexpected volatility and market turmoil. ETF products have a complexity due to their derivatives-like behavior that requires daily monitoring. The deregulation of financial derivatives undoubtedly made the markets a riskier place (Rajan, 2005). We urge financial authorities to take closer scrutiny at thematic indices. A failure of these products could result in massive losses to end holders.

ETFs reduced costs for both the issuers and investors as transaction and trading costs are lower. Sponsors will have lower operating costs for maintaining, balancing, and rotating the underlying portfolios. Their role is minimized as they delegate the composition of said portfolios. There is an intense competition among ETF issuers to reduce fees. Cheap funds usually raise more money. The cheapest US stock ETFs have expense ratios around 0.03% per year (e.g., VOO, IVV). With thematic ETFs, the story is quite different. Their expense ratio is much higher compared to their older siblings. Even smart-beta and sector funds have much lower expense ratios. As shown in figure 2.2, a large gap separates broad market funds and thematic ETFs. The gap in 2019 was around 40 basis point or 0.4%. The higher cost of thematic funds does not prevent their popularity. ETFs were praised for their low cost, yet issuers have been able to market thematic ETFs through their unique feature, namely a bespoke underlying composed of promising stocks. Given the risk-adjusted performance of broad ETFs against specialized ETFs, these costs are entirely unjustified (Ben-David *et al.*, 2021). Any holder should be aware of these costs. A meager 0.5% expense ratio would reduce a \$10,000 initial investment with a compound rate of 10% by -\$6,116 after 20 years.



**Figure 2.2.** Average expense ratios by type of ETF in basis points from 1993 to 2019.

## The Making of the Underlying

The first step in the ETF model is to define the underlying. They are constructed by so-called index providers. The largest is the S&P Dow Jones with more than 130'000 administrated financial indices (incl. real estate, stock, bonds). Other large index providers include Morgan Stanley Capital International (MSCI), FTSE, Bloomberg, and Russell. ETF issuers pay a license fee for using the underlying in their investment strategy. Globally, index providers earned \$4.1bn in revenue last year, up 9.7% from 2019 (Financial Times, 2021).

The underlying is constructed under predefined rules (Karlow, 2012). These rules include among others the following: index universe selection (e.g., size, sector, style, geographic, factor), the number of assets and the criteria of asset selection (e.g., liquidity, earnings, consistent financial reports...). Asset selection of thematic ETFs seems to be arbitrary as holdings from one ETF to another within the same theme differ. By studying the methodology of Solactive electronic gaming index, we discovered that index construction is indeed arbitrary and unregulated. The provider chooses a set of 20 companies on basis of highest market capitalization in the e-gaming sector (Solactive, 2016). It delimits which company are eligible to be part of this sector. Their criteria for the selection pool states no precise rule to determine the eligibility of a company to be part of a sector or not. These observations suggest that the guideline used by Solactive for its index construction seems relatively arbitrary. On their website, they offer a service for custom indices. They propose to create a “modified version of an existing index or a sophisticated multi-asset solution” and add to the offering “send us the details and we’ll find a way to set up a new index that will cover your needs.” This sounds alarming as it seems there are little or no constraint for index providers to create an underlying for clients.

Index providers have a vital role in the process of ETF construction yet hidden in figure 2.1. They continuously define the investment strategy. At its essence, index-based investment schemes were based on broad market indices such as the S&P500 and the NASDAQ 100. These indices provided respectively by the S&P Dow Jones and the Nasdaq include numerous so-called blue chips. The blue chips components of these indices represent the most sound and stable companies in the entire stock market. They usually show low volatility over time especially in a period of market turmoil. These components allow to smoothen out noise and anomalies that can be seen in some highly speculative stocks. The S&P500 represents the most widely used index for index-tracking products. More than \$2 trillion of AUM is linked daily to this index via various funds and derivatives (Bloomberg, 2021). ETFs alone directly tracking the index have a combined AUM of \$1 trillion. By adding the fourth world’s largest ETF, namely the Vanguard S&P500 ETF with \$277 billion in AUM, we observe the massive amount of money that is parked by investors into S&P500 tracking ETFs. These amounts exclude the market value in option trading. Index providers will compute and update their indices in various forms. The frequency of updating varies also but is relatively short for most. The Dow Jones Industrial Average (DJIA) is the oldest broad stock market index in US history. The S&P500 previously known as the S&P Composite is the second one. Those indices have a long track record and have stricter rules than thematic indices when it comes to its constituents.

Index-based investment schemes became more specialized to suit better investors’ new investment objectives and risk appetite. Thematic ETFs are based on such an index construction approach.

They best exemplify the new development of a special-purpose index. These bespoke indices have become more subjective and suit the taste for a particular breed of investors. The notable paper published by Virginia University in 2021 called “*Advisers by Another Name*” has raised the flag on the role that index providers have in the financial world. In this paper, it is fiercely argued that index providers are considered as unregulated data publishers rather than regulated investment advisers (Mahoney *et al.*, 2021). In their view, they should be registered as investment advisers. This would be a crucial step forward to limit the arbitrary index construction and prevent the downside of indexation across individual securities. The lack of scrutiny of index construction poses a potential threat to investors. There seems to be enough empirical evidence of higher correlations across stocks caused by indexation (Da & Shive, 2016). The increasing stock correlation (stocks tend to move in tandem if correlation moves closer to 1) consistently raise systemic risk (European Systemic Risk Board, 2019). The correlation between individual stocks across the ETF basket as well as the induced correlation due to indexation should be reviewed before construction of an underlying. Higher correlation between constituents could reduce the diversification effect praised firsthand by investment advisers. The argument that providers ought to be more regulated remains widely open.

The lucrative business model of unregulated index construction led to a paradox in US and global stock markets. We count today more stock market indices than actual publicly listed stocks. Alone in the US, there are roughly 4000 exchange-listed companies and more than 5000 stock market indices. As a result, some US stocks are subject to noise caused by the indexation (Ben-David *et al.*, 2015) Many individual stocks especially blue chips will be part of several indices at the same time. The CRP leads to a rise in the demand for these indexed hyped-up stocks. Stocks such as Microsoft or Apple will be in high demand for new ETF customers linked to overweightness and frequency of appearance. A rise in demand for ETF shares feeds back in the demand for the individual stocks that compose the underlying (Financial Times, 2021). Using Shiller’s principles and amplification mechanics in speculative asset prices described below, the euphoric demand impacts the price advancement of the underlying constituents (Shiller, 2014). The US stock market valuation will be highly inflated and supported by the growing inflows into index-tracking products. Research on the impact of index investing on equity valuation seems to point out that ETF trading consistently feeds back into the biggest bull market in history and supports the latest high valuation (Financial Times, 2021).

Passive investment strategies are not as passive as their name suggest. In the first order, the construction of index models and their constant updating depending on the weighting mechanisms require active decisions. Index investing reduced as far as possible the role of asset managers, but the activeness to administrate a passive fund remains high nevertheless (Easley *et al.*, 2021). The activeness of asset management is especially high for any thematic or other specialized product. The rising demand for these products raises the need to actively manage the underlying due to its specialization and more arbitral construction rules. It results in higher transaction and trading costs. The license fee on thematic indices is much higher than those on broad market indices (Financial Times, 2021). As revenues rise in the industry, the incentive to create new bespoke indices rises as well. Yet not all indices are created equally. Many similar thematic ETFs have different holdings. This will inevitably impact the performance after fees as well as the ETF implied liquidity. The vital role of index providers should not be overlooked. Many underlying indices are

not suited for the design of an ETF. The development of thematic ETFs raises concern about certain indices built with no other intention than for marketing and ETF trading. All these studies call again for a new regulatory framework for ETF trading.

### **The Rationale Behind Index Investing**

The introduction of ETFs led to the advent of index investing. This investment strategy can be traced back to the late John C. Bogle, founder of the Vanguard Group. He was the pioneer in index investing and revolutionized it with his index fund. In his 2007 book *“The Little Book of Common-Sense Investing”*, he outlined the core idea of index investing: there is almost no way to beat the market in the long run. Instead, he ingeniously realized that holding a broad stock market fund will eventually yield reasonable and safe returns over the long-term. His strategy minimizes risk to market risk, removes any noise or short-term volatility from a portfolio and reduces trading costs. It also reduces the resources, labor and time needed to pick the “big winners.” These stocks might outperform the market today but could entail higher downturn risk as the market goes sideways and the mean regression law takes over (Bogle, 2007).

Bogle’s ideas are shared by a fellow great investment fund manager, namely Benjamin Graham also known as the father of value investing. In their view, the average investor who lacks in time, knowledge, and expertise to understand the value of a security should always choose a defensive approach for investing. And this does not only apply to individual investors. Graham admitted in the 1970s that most investment managers will ultimately fall behind market returns. The famous “Mr. Market is always right” statement was coined by Graham himself. The process that led to these revolutionary ideas is fundamental to understand the rationale behind index investing. Bogle has come to criticize ETF trading and warned against the inconsistencies that emanate from it. In his interviews and books, he praised the practice of investing in broad market indices through index funds yet seems to warn against its publicly listed counterpart. We quote his words in 2015 as follow: “I freely concede that the ETF is the greatest marketing innovation of the 21st century. But is the ETF a great innovation that serves investors? I strongly doubt it. In my experience [...] I have learnt to beware of investment “products,” especially when they are “new” and even more when they are “hot.”” Ironically, his company became as of today the world’s second largest ETF provider preceded only by Blackrock.

John C. Bogle and Burton G. Malkiel argued early that actively managed portfolios would eventually fall behind their respective benchmarks. Almost five decades later, it seems that their intuition foresaw the latest “poor” performance of active funds. The odds of beating the market have dwindled and retail investors seem to be better off holding an index fund. They introduced the practice of index investing to give retail investors an opportunity to participate at low cost in markets without the fuss on the trading floor of Wall Street. With a lack of financial expertise and resources, an individual will take the shortcut, opt for the most accommodating option, and leave the fuss to financial experts. This is the strongest economic narrative that drives the psychology of the average investors to rely on passive management. They choose the less costly and less time-consuming alternative as a heuristic reaction (Kahneman & Tversky, 1979). Given the low volatility of broad stock market indices, risk averse and neutral investors are naturally attracted to traditional ETFs. The adoption of index investing is amplified by the storytelling about its

prowess. The strong inflows into passive investment vehicles show that there could be widespread contagion of these narratives.

The storytelling among popular figures such as Warren Buffet, “the Oracle of Omaha,” on the miracles of index investing explains one of the drivers. They insist that the best way to invest is to passively wait that the market to sort out the noise. This narrative has become common sense today. The rationale for passive management spreads across institutional investors as well. The adoption of financial products among end users undergoes a complex process. Yet, it involves similar processes as for any other good or service. Among them, the decision of economic agents is influenced by the attractiveness of the narrative as well as the adoption rate within their social circle (Shiller, 2020). Therefore, to understand the popularity of index investing, it requires an examination of the narratives around index-tracking products. Little of them may be aware that it took more than a century to build them.

The argument in favor of index investing lies foremost within the unpredictability of future short-term swings in speculative asset prices such as stocks. Instead of screening for winners and losers every day, the average investor should patiently wait for the market, namely the masses of participants, to sort it out for them. Due to speculation, mispricing can occur, and higher volatility takes place even on a broad scale. The market consensus can be utterly misplaced thus exposing the passive approach which is highly correlated with market performance. In his 2020 revised book “*A Random Walk Down Wall Street*”, Malkiel affirms that: “The market eventually corrects any irrationality-albeit in its own slow, inexorable fashion. Anomalies can crop up [...]. But eventually, true value is recognized by the market [...]” Malkiel and Bogle both recommend a market portfolio to minimize risk.

A stock market is a complex system in which numerous participants interact with each other every second through lightning-fast computer systems. It remains a place where people interact even in a digital place. Today, algorithmic traders, also known as high-frequency traders, are part of the equation too. Not only human traders are part of the marketplace, but also automated machines that are programmed by humans. Algorithms can be biased as much as any human trader and their participation will influence prices as much as any other market participant. A given price can be defined as the current consensus value at which participants are willing to bid (buy) or/and to ask (sell). As history has shown, market prices can deviate from ultimate values to which they regress. Speculative crazes have been source in the past of various financial disasters as bubbles boost and burst. These events can be traced back to amplification mechanisms and positive feedback loops which explain the process of speculative asset bubbles (Shiller, 2014).

Shiller listed a couple of factors and amplification mechanisms that feeds the demand for stocks thus resulting in ever-growing higher stock prices. Index investing was conceived to protect investors against the misdeeds of speculators. The storytelling of how index investing safeguards investors’ capital against speculative crazes appears as a strong and commonly accepted narrative. Due to the ties to an underlying, this type of investment strategy remains threatened by mispricing, bubbles, and the madness of markets. Diversification might not suffice to smooth out the wide swings caused by manias and speculative crazes. Many elements highlighted here suggest that index investing has found itself under the claws of frenzied speculative behaviors.

Any investor face two main obstacles to generate alphas: portfolio selection optimization and market inefficiency. The sole purpose of active management is to achieve alphas. Traditional index strategies generate de facto alphas of zero (beta). The new strategies such as thematic or smart beta will de facto actively seek alphas. Seeking information in stock markets can be time consuming, costly and a real head-scratcher. Yet, valuable information gives an advantage to beat the market. Institutional investors, often dubbed “smart money,” will more often than not outperform retail investors, considered as “dumb money.” Their access to information as well as their load of resources and technological prowess should give them an edge to track better winners and losers. Retail investors are far better off holding a cheap ETF or index fund rather than screening for latest information. As lockdowns were implemented, consumer behaviors radically changed. The time spent at home opened the way to new “investment ventures.” A new breed of investors emerged. Suddenly, a substantial portion of savers begun to invest at their own expense and account. The ease to invest in our digitalized world propelled the stay-at-home economy to take part in financial markets. Investors worldwide can easily and rapidly buy a US-based thematic ETF and pursue investments at their own benefits (or losses). The latest and heavy shift towards ETFs even by institutional investors have now flooded markets with “dumb money.” Most participants are today on autopilot and parking massive amount of money into cheap passive ETFs. This created two classes of market participants: the active traders and the sleepy investors. As ETFs have taken a huge place in our financial markets, we have gone asleep at the wheel (Financial Times, 2021).

By holding an autopilot market portfolio, investors are mainly exposed to systemic risk as firm-specific risk is nullified through diversification. This rationale takes root in the modern portfolio theory (MPT) developed by Harry Markowitz in his 1952 paper. The MPT states that there is a portfolio that yields the best risk/return profile (highest return for lowest standard deviation). This profile would translate quantitatively as the highest Sharpe ratio achievable. This optimal portfolio represents the market portfolio. Malkiel, Bogle, and later Buffet all preconized to hold the market portfolio embodied by a broad market index fund. Yet, the selection of such a fund is an entirely different story. Not all traditional ETFs perform equally, less so thematic ETFs. Due to transaction costs and other hidden fees average investors should carefully choose an ETF (Bhattacharya *et al.*, 2012). Thematic ETFs face a greater portfolio optimization issue in terms of the risk/return trade-off as they do not mimic closely the market portfolio (Methling *et al.*, 2018). The rise in smart-beta and thematic strategies is linked to the belief that fund managers can achieve a better risk/return profile than the market portfolio (Malkiel, 2020). This will be subject to testing in the second part of this paper.

There is undeniable evidence that passively managed portfolios have consistently outperformed actively managed portfolios in the last decade (Financial Times, 2021). This was partly due to the high expense ratios that eat into the returns. In the current low to near-zero interest rate environment, the chase for higher yields and the increasing risk-taking led market participants towards riskier assets such as equity and other high yielding asset classes (e.g., cryptocurrency, non-fungible tokens...). Investors are attracted to the high yields quoted on thematic ETFs but are taking on more risk. The conceptualization of index investing certainly allows investors to reduce the excessive costs for participating in stock markets with minimizing their risk exposure as well as to set aside the time-consuming research. This remains to be proven for the more specialized and costly ETFs studied here.

Index investing faces a problematic downturn: namely market inefficiency. The debate on whether financial markets are efficient and whether prices reflect at any given time all the available information remains widely open. Two schools of thoughts stand against each other. On one side, there are the market efficiency proponents led by notorious Eugene Fama from the University of Chicago. On the other, there are the behavioral economists personified by influential Robert Shiller and Richard H. Thaler. As the academic community widely recognized both theories, Fama and Shiller were awarded the Nobel Prize of Economics in 2013 for their groundbreaking empirical analysis on asset pricing (Fama, 2013; Shiller, 2013). We turn our view to Paul Samuelson who lies somewhere between those two. Samuelson said that “the stock market behaves micro efficiently but is macro inefficient.” The dictum was empirically tested and seems to hold true under certain conditions (Jung & Shiller, 2006). This suggests that broad market indices face a downturn as inefficiency is more pronounced across a large set of individual stocks. The efficient market hypothesis (EMH) developed by Fama should be more accurate to individual stocks compared to the aggregated stock market.

The price behavior of speculative assets is often defined as random, continuous, and independent. The earliest works were conducted in Paris by Jules Regnault in 1863 and Louis Bachelier in 1900. Both concluded that future price movements were unpredictable by nature because they are caused by unrelated past events and by unexpected future events. These events can still be measured by the law of probabilities and stochastic processes inaccurate as they may be. Bachelier’s doctorate thesis, supervised by Henri Poincaré, is considered as a pioneering advancement in mathematical finance and viewed as the “quant revolution.” He used a Brownian motion model to describe the static state of government bond prices at a given time. Thus, was born the seed of the random walk hypothesis of speculative asset prices. In the 1960s, Mandelbrot showed plenty evidence disclaiming the probability theories used in many widely accepted models such as the Black-Scholes option pricing model (Mandelbrot, 1963; Mandelbrot 2008). In Mandelbrot’s research, any model should consider the non-continuity (jump processes) and the long-term memory (Hurst exponent) of stock prices.

As shown by mathematical finance, behavioral finance and lately by narrative economics, stock markets can be better grasped by cross-searching and collecting data from various fields of study. The concept of consilience is important for the progress of any discipline. For instance, the random walk hypothesis in finance took its roots in botany. The discovery of this bizarre pattern is accredited to the botanist Robert Brown to whom the Brownian motion was dedicated. Another instance of consilience is the 2002 Nobel Prize of Economics awarded to psychologist Daniel Kahneman. He was able to show that uncertainty affects rational judgement and decision-making thus leading to behavioral biases in the marketplace. It is well to mention yet another consilience undergone by brilliant mathematician Benoit Mandelbrot. He used fractal geometry to describe the (mis)behaviors of our financial markets (Mandelbrot, 2008). It seems plausible that the improvement of ETF trading requires further consilience. Gaining better understanding on how stock markets behave will add to our knowledge on ETF trading and its inherent riskiness.

### **The Rise of Thematic and Active ETFs**

The most marked trend in ETF trading is currently the rise of active ETFs over passive ETFs such as embodied by Cathie Wood’s Ark Investment flagships. As shown in figure 1.1 above,

actively managed funds have indeed found robust growth in AUM in the thematic funds category. These ETFs are actively managed thus coming at higher costs. For instance, Goldman Sachs just recently issued three additional actively managed thematic ETFs centered around health care, discretionary consumption, and real estate. The expense ratio is set to 0.75%. Compared to the 0.03% charged by the Vanguard S&P500 ETF (VOO), these thematic funds will eat away a large slice of the pie. Thematic and active ETFs entail also higher risk than traditional ETFs. In their attempt to achieve alphas through thematic strategies, investors take on more firm-specific risk thus moving up on the risk/return line.

The recent phenomenon consistently observed in the ETF landscape is seemingly moving investors away from the initial rationale of index investing. Actively managed ETFs are not index-tracking products as their holdings are not based on an underlying. They have seen more inflows than their passive siblings in Q2 of 2021 (Bloomberg, 2021). The investment rationale behind the rise in active ETFs is centered around thematic strategies which are extremely popular and lucrative products. By creating ETF portfolios focused on growth and disruptive sectors or industries such as financial technology, space, sustainable energy or other mega-themes, managers claim that they will surf a wave of upcoming trends on which some businesses can strive on more than the rest thus achieving alphas.

Managers must be able to determine which megatrend will generate the greatest hype to capitalize on strong price advancements. Businesses related to those trends will see highest earnings growth thus a greater stock price advancement (Burniske, 2016). By issuing some thematic ETFs, fund managers turn to index providers to supply them with a bespoke underlying. Instead of picking the winning individual stocks, they rely heavily on index providers. After deciphering the winning megatrend, the fund manager collaborates with an index provider to establish a set of stocks that capture best the wave. This is for instance the case for the Global X Lithium and Battery Tech ETF (LIT) which collaborates with Solactive to establish such underlying. This naturally raises concerns as the index providers have almost no constraints to supply a given underlying. The rise in thematic investment in the ETF world has spurred a growing number of indices that might include very risky stocks. Fueled by frenzy behaviors of a new breed of investors and so-called meme stocks, thematic ETFs could entail in their holdings a time ticking bomb.

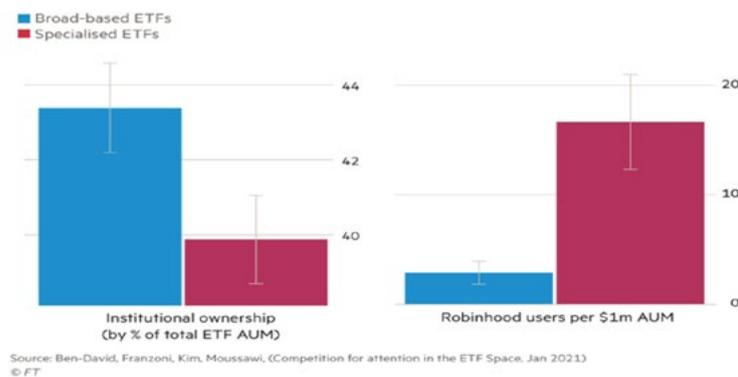
It was argued by academics that the world of passive portfolio management is more active than supposed to (Easley *et al.*, 2021). In their paper "*The Active World of Passive Investing*," they created an activeness index that demonstrates that ETFs are far more actively managed than its siblings. The launch of new ETFs and the liquidation of old ones reflect both the demand and supply curve. 200 new equity ETF were launched in first half 2021 with 51 in June (etf.com, 2021). Most are actively managed with thematic strategies as their underlying. These ETFs are alpha-seeking US equity products. They are solely purposed to outperform the broader market and especially traditional ETFs. The phenomenon that more active ETFs than passive ones were launched in the post-pandemic era reinforces the shift of traditional index funds to more complex and active ETFs by investors (Morningstar, 2021). The shift towards aggressive passive and active ETFs can eventually degrade alphas as was the case for mutual funds in the 1970s (Easley *et al.*, 2021). The evidence shows that holders should understand the implication of their shift towards actively managed and specialized equity products.

The most recent trend in ETF trading is the introduction of cryptocurrencies-based futures ETFs (Bloomberg, 2021). The ProShares Bitcoin Strategy (BITO) launched in October 2021 is the first ETF linked to bitcoin. It recorded already a whopping \$1.3 billion in AUM in mid-November 2021 (Bloomberg, 2021). These newest types of ETFs do not require the actual holding of the cryptocurrencies by the ETF issuer because they are cash settled on basis of bitcoin futures. There is currently a lot of discussion on the first introduction of a spot ETF for cryptocurrencies. A spot ETF would work as a physical ETF. The issuer holds the cryptocurrencies composing the underlying on behalf of ETF investors. As cryptocurrencies continue to surge in price, more investors are interested to get some exposure. Thematic ETFs with stocks linked with the tokens have recently experienced extraordinarily strong inflows. Some of them such as the Amplify Transformational Data Sharing ETF (BLOK) recently reached an all-time high with \$50 million net flows in November 2021 (Bloomberg, 2021). This trend implicates that countless new cryptocurrencies-related indices will be created solely for ETF trading. The concern regarding index construction by third parties and its unregulated practice grows by the day. How far can index providers go to supply ETF issuer with a bespoke underlying?

### METHODOLOGY

We now concentrate on a set of primary data gathered via a survey and a cross-analysis of thematic and traditional ETFs. Both inputs will help us evaluate the sustainability of the rise in thematic investing and to test its viability given the rationale of index investing. We wandered through the world of index construction and studied their masters. We exposed the complexity of stock markets that ultimately affects ETF trading. We explored the trends in active and thematic ETFs. We finally confront the findings in the secondary research.

The first input is to analyze the demand-side and what factors are at the origin of rising demand. Using a survey, we highlight some behavioral patterns around ETFs. Retail investors are a valuable group to survey as their number has increased in the last two years. They have been subject to a lot of attention in the financial news as meme stocks and other related events have shaken the US stock market. Most importantly, they rely more on thematic ETFs compared to institutional investors (Ben-David *et al.*, 2021). According to figure 3.1, we can see the dominance of thematic ETFs in comparison to broad ETFs in the portfolio of an average Robinhood retail user. Thematic ETFs experience a real hype among retail investors.



**Figure 3.1.** Percentage of total ETF AUM for broad-based and specialized ETFs among institutional and Robinhood (e-trading platform) retail users in 2021.

The second input is to verify empirically whether thematic ETFs can de facto generate alphas and fulfil their rationale. Generating systematically alphas over time would allow thematic ETFs to maintain their popularity and attractiveness. We also intend to verify whether thematic ETFs can move to a better point in the risk/return profile compared to the market portfolio. We use three ETFs which have no common holdings and seek to capture three different megatrends. This cross-analysis should give a better insight into why investors are flowing vast amount of money into the chosen ETFs. The megatrend surfed by ETF manager remains the marketing tool used for attracting new clients. We selected three different thematic ETFs which recorded high net flows (inflows-outflows) in 2021. Popular thematic ETFs were chosen for this empirical test. Each one will be cross compared with the SPY. The cross-analysis entails the 1-year performance after counting for fees, the Sharpe ratio, the Treynor ratio, Jensen's alpha, and the tracking error. All ratios are computed on a yearly basis.

## **DATA ANALYSIS**

### **Survey Analysis**

The survey generated a sample size of 79 responders. Most responders, namely 36%, are aged between 30-44; 25% were aged between 18-29 years old and 28% between 45-60. Most responders reside in the US. 30.5% of respondents earned an annual income of \$25,000-\$49,999. The survey starts with the question whether the responder holds any thematic ETF in her portfolio or not. This gives us a head start if participants are exposed to any thematic strategy. We found that 31.7% of the responders hold a thematic ETF in their portfolio. One third of the responders rely on these equity products to grow their savings over time. It is a sizable portion in our sample yet not the majority.

It follows with an evaluation of the investment objective and gives us an insight into the investment rationale. The results show that most voted "Long-term saving growth" with a 61% approval rate. The second highest rate was around 30% for both "Medium-term profit utilization" and "Income Generation". The objective "Short-term day trading profits" had a 14.6% approval rate. Responders seem to passively invest over a long-time horizon instead of actively trading. We showed above that thematic ETFs have a rather short- or medium-term investment approach. In fact, the rationale disclosed above hints to the fact that these specialized ETFs are used to surf a trend or megatrend that can change rapidly over time. Megatrends can reverse. As the hype dwindles around these theme-based stocks, thematic ETF holders would be exposed to rapid loses if there is a trend reversal. The fact that responders pursue the objective of "Long-term saving growth" partially contradicts the rationale behind thematic investing but remains perfectly aligned with traditional index investing. There is plenty evidence that the short-term volatility of financial markets strongly affects thematic strategies. Whereas traditional index investing was created against said volatility, thematic ETFs entail greater risk exposure and might not survive a period of high volatility. Taking a long-term approach seems to be ill-advised for thematic holders. We cannot stress this element enough. Question 2 highlights a fundamental contradiction with thematic investing.

Question 3 reinforces further the contradiction in thematic investing. In fact, 20.3% of responders answered favorably to whether their pension savings entail any thematic ETF. Risk-averse savers

should be wary of financial advisors who recommend thematic ETFs. Retirement plans should rely on a risk-averse long-term investment strategy. Therefore, thematic strategies raise contradiction within the investment approach and horizon of pension savings as they do not suit the investment objective.

The two next question analyzes closer if the investor relied on external advice and if such advice influenced her behavior or investment decision. We turn our attention to whether the respondent received any recommendation to buy a thematic ETF and if she had any prior knowledge of thematic strategies before recommendation. 16.5% of respondents received positive recommendation while 83.5% were not aware of thematic ETFs prior to the financial advice. We further observed that 76% of responders are unaware about thematic ETFs prior to any recommendation. The popularity of thematic ETFs has taking off since mid-2020 and is therefore a relatively recent phenomenon. This might explain why only few respondents were aware of these specialized equity products prior to recommendation by experts. The narratives of the prowess of thematic strategies have not yet reached the population at large. Eventually, the growth in AUM could accelerate further once the narratives spreads on a larger scale.

From question 6 to 12, we intend to capture the sentiment and confidence of investors. Question 6 measures the overall sentiment of respondents towards thematic ETFs by asking if they feel confident or not about holding thematic ETFs. We intend to evaluate the reliability of these products as a viable investment vehicle depending on responders' confidence. This question could also evaluate if there are any overconfidence bias that affects investors' decision and feeds into the exponential growth in thematic investing. We found that 67% of responders do not feel confident about holding a thematic ETF while 33% are confident about their portfolio exposure to thematic strategies. It seems that responders are wary about the riskiness of these products or simply unaware of their existence. This question would be extremely relevant with a greater sample size as it would answer whether the growth can be associated with an overconfidence bias. It still gives us an idea on what forces feed into the growth.

The next two questions (7 and 8) have been based on a recent Bloomberg article which stated that investors have in the past been influenced by catchy ticker symbols to make an investment decision. This phenomenon is partly retraced in the survey's result. We evaluate here whether investors' behavior was influenced by a fund's catchy name. We seek to analyze as in question 6 psychological factors that influenced buying patterns. Thematic ETFs have been marketed in a brilliant way and their appealing ticker symbol has been one of the marketing tools used to attract a large amount of AUM. In question 7, we proposed an optional question directed to the 25 respondents who do hold a thematic ETF by mentioning their ticker symbol. We then ask in question 8 whether the ticker symbol (including stocks) gave them confidence in anyway. 23% of the respondents gave a positive response. Investors under rational behavior should remain indifferent towards ticker symbols. However, our study reflects that it could influence an investment decision. Most respondents have not been influenced by a marketing tool commonly used on Wall Street. In no way does the ticker symbol affect the performance. Yet, it seems to continue to affect somehow the choice of investors as it did in the past. Our findings suggest that there is a possibility to influence buying patterns via catchy fund names (e.g., MEME, MOON, HERO, LIT, or UFO).

As we move to the next questions, we analyze further the confidence of investors as well as the investment decision-making process. In question 9, we turn our attention to their knowledge regarding the underlying. We can contrast the results of question 8 and 9. The former shows an irrational behavior pattern whereas the latter shows a rational one. Both questions portray a fair insight into which elements or factors influence respondents. Any fundamentalist or value investor will be extremely wary of the underlying as it defines the ETF ultimate performance. She would evaluate each individual holding and its respective weight on the overall portfolio before buying the ETF. With 77.2% of negative responses, investors transgress a fundamental investment rule: know what you invest in. From the responses, it seems that marketing is so successful and powerful that investors feel no need to proceed to any due diligence. Only 22.8% of respondents were fully aware of the underlying. Holders could be adversely affected by some holdings in their ETF portfolio without realizing why. These results are quite worrisome and are truly relevant for our study. Responders seem to underestimate the impact of the individual holdings on the preservation of their capital.

Once we evaluated the due diligence and fundamentalist approach of the investor regarding the underlying, we ask respondents in question 10 what theme they feel most confident about. This continues to evaluate the sentiment that investors have regarding thematic strategies but instead of looking at the ETF we turn our view to the broader theme in which many ETFs are focused in. From the results gathered here, most responders feel that blockchain technology has the greatest growth potential soon. Blockchain-based ETFs have shown great interest among investors at time of writing. The \$1.6 billion net flows of one of these ETF, namely Amplify Transformational Data Sharing ETF (BLOK), reflects how strong the hype is around these theme-based ETFs. The confidence emanates from a belief that some stocks located in a disruptive or innovative sector will yield higher returns. Gaining insight into which theme is most appealing gives us another evidence why thematic strategies are growing in the ETF spectrum.

As we gathered result on confidence and sentiment indicators, we have some evidence on how thematic strategies gained such recent outstanding traction in the ETF landscape. With the next question, we intend to verify if the appetite for thematic ETFs can remain strong moving forward. Question 10 ask if respondents would consider buying more thematic ETFs. 42% intend to do so. Evidence suggests that thematic ETFs are still in demand and growing. There seems to be a high probability that growth in terms of AUM will continue if performance holds.

Finally, the survey directly confronts responders to the main rationale of thematic investing. The last question relies on a qualitative approach and evaluates the confidence respondents have regarding the ability of thematic ETFs to outperform the overall stock market. Most respondents believe or are not sure that thematic ETFs can. Hence, this belief contradicts the core rationale.

The analysis of the results suggests that retail investors have a relatively low confidence in thematic investing. All questions of the survey directly confronted the secondary data collected in the first part. Long-term saving growth seems not to be aligned with the design and rationale of thematic strategies. The absence of due diligence shows the lack of information gathered by investors to make a rational investment decision. We did not discover an overconfidence bias among our responders as expected, yet we observed other behavioral biases that misled investors

to buy thematic ETFs. The rationale behind thematic ETFs is contradicted by our results. Most responders do not believe in the ability of these products to generate alphas. Findings in the secondary research have revealed a couple of inconsistencies in the design and trading of thematic ETFs. The survey has reinforced the findings in the first part of this paper. Thematic ETFs incur heightened risk to holders. The product is often misunderstood by holders and could thus lead to unexpected losses. We go further in our research by back testing whether thematic ETFs can outperform the market portfolio and thereby verify the rationale.

## CROSS-ANALYSIS

### Global X Lithium & Battery Tech ETF (LIT)

The Global X Lithium & Battery Tech ETF is issued by Global X. The fund accumulated a net flow of \$2.37 billion in 2021. It has a total expense ratio of 0.75%. The ETF intends to capitalize on the megatrend of sustainable energy as well as the growth of electrical vehicles worldwide. The fund reached a cumulative performance (YTD) of 47.9%. The Sharpe ratio is 0.72 which shows a promising risk/return profile. Furthermore, its high Treynor ratio of 9.86 which captures the return per unit of systemic risk suggest a great diversification and low firm-specific risk. The fund in terms of return per unit of risk is close to the SPY. It suggests a fair ability to generate high returns with minimum risk. It generated alpha of 4.59%. A downside of the fund can be found in LIT's extremely high tracking error. The ratios and metrics reflect that the product is well designed and verifies the rationale. If some funds continue to achieve alphas, thematic ETFs will continue to experience strong inflows.

	LIT	SPY
<b>1-Year Cumulative Performance</b>	<b>113.15%</b>	<b>42.75%</b>
<b>Sharpe Ratio</b>	<b>0.72</b>	<b>0.78</b>
<b>Treynor Ratio</b>	<b>9.86</b>	<b>2.96</b>
<b>Jensen's Alpha</b>	<b>4.59</b>	<b>0</b>
<b>Tracking Error</b>	<b>6.7</b>	<b>0.01</b>

### First Trust NASDAQ Cybersecurity ETF (CIBR)

The First Trust NASDAQ Cybersecurity ETF accumulated a net flow of \$1.7 billion. The accelerated digitalization increased the threat of cyber-attacks. Cybersecurity services are therefore in higher demand and the fund seeks to capitalize on increasing revenues of these companies. It has a total expense ratio of 0.6%. The 1Y cumulative performance was recorded at 62.2%. The Sharpe ratio

is 0.62 which is relatively fair compared to the market portfolio. The Treynor ratio is 3.26 and relatively close to the SPY suggesting low firm-specific risk. It succeeded to generate alphas and therefore does verify the rationale.

	<b>CIBR</b>	<b>SPY</b>
<b>1-Year Cumulative Performance</b>	<b>62.2%</b>	<b>42.75%</b>
<b>Sharpe Ratio</b>	<b>0.62</b>	<b>0.78</b>
<b>Treynor Ratio</b>	<b>3.26</b>	<b>2.96</b>
<b>Jensen's Alpha</b>	<b>0.15</b>	<b>0</b>
<b>Tracking Error</b>	<b>3.27</b>	<b>0.01</b>

### **ARK Genomic Revolution ETF (ARKG)**

The ARK Genomic Revolution ETF is one of the flagships of ARK Investment. The actively managed fund accumulated a net flow of \$1.6 billion since January 2021. It has a total expense ratio of 0.75% way above average. The pandemic has centered medical stocks in the center of attention. Stocks within this theme have performed strongly and often outperformed the market in 2020 and 2021. The fund returned 15.5% on a 1-year basis. The fund performed poorly compared to the SPY which returned net of fees 42.75% in the same period. The Sharpe ratio for ARKG is 0.11 which is relatively low. Compared to the 0.78 ratio of the SPY, ARKG is a risky ETF. In fact, the low Treynor ratio of 1.87 suggest that the fund entail a relatively high firm-specific risk. It failed to generate alphas in 2021 and therefore does not verify its purpose. ARKG's tracking error is extremely high as we observe for any active ETF. Overall, ARKG diverges greatly from the original rationale of index investing. The failure of some thematic funds to generate alphas can cause the loss of appeal in thematic strategies altogether and thus reduce the growth in AUM over time.

	<b>ARKG</b>	<b>SPY</b>
<b>1-Year Cumulative Performance</b>	<b>15.5%</b>	<b>42.75%</b>
<b>Sharpe Ratio</b>	<b>0.11</b>	<b>0.78</b>
<b>Treynor Ratio</b>	<b>1.87</b>	<b>2.96</b>
<b>Jensen's Alpha</b>	<b>-0.62</b>	<b>NA</b>
<b>Tracking Error</b>	<b>7.77</b>	<b>0.01</b>

## CONCLUSION

The exponential growth of thematic ETFs has spurred a new cycle in ETF trading. The latest trends mark the radical shift of the traditional passive investing to the “aggressive passive” and active investing within the ETF spectrum. With fast-growing AUM, thematic funds have reinforced the hype around the practice of index investing. It has been proven that thematic ETFs are not in line and in some instances in contradiction with the rationale of index investing. The “aggressive passive” and active approach of index investing exposed here has raised a red flag about the process and the practice that undermines the creation and trading of these specialized ETFs.

The arbitrary and customized creation method for the underlying has facilitated the unencumbered growth. Providers are supplying issuers with bespoke indices and cash in generous fees in exchange. Specialized ETFs are marketed best to end holders with promising expected returns thus spurring a wave of new thematic ETF launches. The riskiness of the underlying is misunderstood by some holders as shown by our findings. The lower liquidity in the underlying adversely affects the performance of the ETFs. Active and specialized ETFs have greater tracking errors than traditional ETFs. Our cross-analysis has reinforced this fact. The low implied liquidity caused by low liquidity in the underlying reduces the swiftness of the CRP thus creating bottlenecks to match the NAV change with the underlying change. The underlying requires a high level of liquidity to increase implied liquidity and reduce the tracking error.

The arbitrary creation of the underlying ought to be more monitored by financial authorities. In this paper, we join authors Mahoney and Robertson in the wake-up call for a new regulatory framework in index construction and administration to ETF sponsors. This would be a crucial step forward to limit the unregulated index construction and prevent the downside of indexation across individual securities. Several underlying should be reviewed more closely before being issued for the design of an ETF. The consideration of diversification, asset correlation as well as liquidity is fundamental to create a reliable and sound ETF model. The lower diversification of the underlying in thematic ETFs contradicts the rationale behind index investing. Compared to traditional ETFs which track historical and vast indices, thematic ETFs track recent and narrow indices with a low diversification effect. It makes them far riskier than index-tracking equity products were intended to be. The development of thematic and actively managed ETFs also raises concern for long-term savers due to the high expense ratios quoted on these equity products. They seem more suited to high-frequency traders who can rapidly shift from one trend to another without incurring the annual expense ratios.

Initially, index investing was created to reduce short-term volatility, minimize risk on the long-term, allow for a high diversification effect and are cheap. These characteristics are all contradicted by thematic ETFs. The underlying has high asset correlation thus reducing the diversification effect. Management fees have increased, and the higher expense ratios affect mostly the buy and hold investors. Issuers rely on their low price to market their product or on high expected yields to justify higher prices. The costly thematic ETFs should deliver excess returns (alphas). This is not always verified. The offer remains extremely tempting in a low- and negative bond yield environment. But these offering come at higher cost as well as higher risk. According to our primary data, some investors are mainly seeking “Long-term saving growth”. Yet, high expense

ratios would considerably reduce their realized returns over the long-term. We recommend that any investor should reevaluate the allocation for thematic equity products in their long-term portfolio to reduce such adversity. For long-term exposure, traditional ETFs fit much better investors' expectation. Our results conclude that thematic ETFs are better suited for short- and medium- term trading.

The lack of knowledge regarding the underlying holdings suggests limited due diligence among investors. Herd behaviors in markets generally support exponential price movements. As investors chase higher yields in this unprecedented low- and negative yield environment, they are naturally drawn in herds towards these promising ETFs. With the appropriate underlying and management, these ETFs could eventually beat the market as shown by two of the ETFs studied above. The rise in thematic and actively managed funds prove that investors are convinced that managers should be able to generate alphas by exploiting anomalies caused by the recent macro event that shook global markets on a deep level. Investors should remain cautious as they add thematic ETFs in their portfolio and proceed firsthand to due diligence.

ETFs have a high complexity due to their derivatives-like behavior. Portfolio indexation could induce an unexpected market turmoil as exemplified in the two flash crashes. The immense and growing amount set on autopilot would be adversely affected by such an event. With the rise in thematic ETFs, the number of index-tracking equity products grows rapidly by the day thus accentuating the global exposure to indexation. We conclude that thematic ETFs became more risky than necessary in their quest to achieve alphas. The unequal creation of thematic ETFs due to differing underlying induced a gap for any thematic investor to choose properly among a vast pool of offering. The competition in ETF space has become too fierce. Under these conditions, issuers add risky index-tracking products to the ETF spectrum. The reliability of index investing is, in our view, distorted by thematic strategies. To reduce said distortion, ETF models should align closer to the initial rationale of index investing. Thematic ETFs such as the two studied here have the potential to extract alphas from these challenging market and economic conditions. Yet, ETF sponsors charge unjustified high fees for them. Further research on the making of bespoke underlying indices could be extremely useful to evaluate the riskiness of the recent flood of thematic ETFs in our financial markets. For our final say, we believe that the coming monetary tightening and interest rate hikes by the Federal Reserve will adversely impact the inflows into US thematic ETFs and new launches. They rely too much on the chase of higher yields and risk-taking which will be reversed in a growing interest rate environment and during economic contraction.

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# STOCK PICKING THEORIES AND MODELS: A REVIEW OF THE RELEVANT LITERATURE

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**ABSTRACT:** *This research paper is a literature review of the relevant Stock Picking Theories and Models involved in selecting stocks to invest in the (public) stock markets and categorizes the Theories and Models into the following five themes: Modern Portfolio Theory (MPT) (Markowitz, 1952); Capital Asset Pricing Model (CAPM) (1961-1965); CAPM+ Models including Fama French Three Factor Model; Asset Pricing, Data Mining, Momentum, and other Indicators Models; and the Behavioral Science and the psychology of stock market participants and stakeholders. This literature review also provides a critical analysis of the Theories and highlights current debates. It identifies a gap in the knowledge of the Stock Picking Theories, specifically on the lack of consideration of how ‘Disruption and Innovation’ impacts the Stocking Picking Theories and Models and how it may be incorporated into future models. It recommends ‘Disruption and Innovation’ as a future avenue for Stock Picking research and the development of new theories and models.*

**KEYWORDS:** **disruption and innovation, Fama French 3 Factor Model, stock picking theories and models, Capital Asset Pricing Model (CAPM), behavioral science.**

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**T**his research paper is a literature review of the relevant Stock Picking<sup>1</sup> Theories<sup>2</sup> and Models involved in selecting stocks<sup>3</sup> to invest in the (public) stock markets<sup>4</sup>.

The Financial Markets<sup>5</sup> and Investment Theories<sup>6</sup> involved in picking stocks are considered the hallmark of modern economic theory and thought culminating in Fama, Hansen and Shiller

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1. Stock Picking – A method to pick or select a company to invest in the public stock markets. Used interchangeably with share investing or investing in a firm or other investment assets or financial assets

2. Theories – Used interchangeably with Models and are ideas or models – both quantitative and/or qualitative method to model a hypothesis or financial economic theory or model to pick and select stocks or to manage a basket or group of stocks, often called a portfolio (of stocks). Theories are also used to model or manage a portfolio of stocks/shares/firms or a deliberate grouping of shares

3. Stocks – are a unit of a company or firm where anyone can own a piece of; usually listed on public markets where anyone can buy or sell the shares daily. Used interchangeably with Shares of a company. Owners of the stocks are called share holders, stock owners or investors

4. Stock Market – an exchange or market where companies are listed, enabling investors to buy or sell stock. Examples include the New York Stock Exchange (NYSE), or NASDAQ in the US stock markets

5. Financial Markets – Used interchangeably with the public stock market, capital markets, public commodities markets, bond, or credit markets – where various kinds of public financial related assets are traded daily on various exchanges. Examples are US stocks markets are the New York Stock Exchange, NASDAQ stock market, Chicago Board of Trade (Commodities Market including Futures (purchases of a commodity).

6. Investment Theories – Used interchangeably with Financial Markets Economic Theories, Stock Picking Theories and Models

receiving the Nobel Prize for Economic Sciences in 2013 for advancing Financial Markets economic theory, in particular, “for their empirical analysis of asset prices” (Nobel Prize, 2021). The relevant Stock Picking Theories have evolved chronologically from John Maynard Keynes’ *‘animal spirits’* in the 1930s to Henry Markowitz’s Modern Portfolio Theory (MPT) in the 1950s and to the Capital Asset Pricing Model (CAPM) in the 1960s. CAPM has become the bedrock on which all financial markets economic theories and therefore where all Stock Picking Theories and Models are built upon or are derived from (Markowitz, 1952; Dempsey, 2016).

From CAPM, the Stock Picking theories have further evolved into the Fama French Model (1993) that utilizes CAPM with three additional factors, to the Asset Pricing Model approach using other factors such as Momentum that deploys Data Mining to discover other relevant quantitative factors or indicators. From CAPM related models, the Stock Picking theories have evolved into Behavioral Sciences/Finance theories involving the psychology of stock market participants and stakeholders. Besides a chronological approach, it is more relevant and logical for the Stock Picking Theories to be categorized thematically as many of the theories have evolved iteratively over several decades as follows:

1. Modern Portfolio Theory (MPT) (Markowitz, 1952)
2. Capital Asset Pricing Model (CAPM) (1962)
3. CAPM+ Models including Fama French Three Factor Model
4. Asset Pricing, Data Mining, Momentum, and other Indicators Models
5. Behavioral Science/Economics/Finance Models

### **RESEARCH TITLE, TOPIC, AND APPROACH**

This section consists of the main research title and topic, ‘Stock Picking Theories and Models: A Review of the Relevant Literature,’ with the following detailed research questions:

**RQ1:** What are the relevant Stock Picking Theories and Models from the literature review:

- What are the major themes and how have they evolved over time?
- How are these Stock Picking Theories and Models used in selecting public companies to invest in on the Stock Market?
- How are these Stock Picking Models used in managing these stock investments and a portfolio of stocks?

**RQ2:** What are the critical analyses of Stock Picking Theories and Models – debates and critiques?

**RQ3:** What are the observed existing gaps in the knowledge of the relevant Stock Picking Theories and Models literature and what are potential areas of future research?

#### **Approach: How the Search for relevant literature was conducted?**

The research was conducted using online EBSCO database, Google Scholar and Google online searches using the following search terms:

Stocking Picking Theories and Models  
 Securities and Investment Analysis  
 Nobel Prize for Economics Sciences

The online database search found primary and secondary sources located in:

Academic research papers in academic journals  
 Academic books and business books  
 Business articles located in business magazines, newspapers, and websites  
 Case studies located in academic journals and business magazines  
 Business video content including business reports and interviews from CNBC and Bloomberg business TV Channels  
 Financial definition and dictionary websites, and the official online website of the Nobel Prize ([nobelprize.org](http://nobelprize.org)) that cites primary sources – articles and books of Nobel Prize winners for Economic Sciences

## **SUMMARY OF STOCK PICKING THEORIES**

Thomas Kuhn (1962), the scientific philosopher, considers a theory as a ‘world view’ that explores and explains a model and not a hypothesis to be confirmed (Dempsey, 2016). Using the concept of a Theory and Model interchangeably, the utility of any model is that it enables us to organize our perceptions, insights, experiences and provides a framework to recognize patterns that are repeatable (*Ibid*). So, when observations no longer match a pattern, then the model breaks down and one progresses to a newer more useful model (*Ibid*), enabling the evolution of a Theory or Model. Hence, as Thomas Kuhn (1962) postulated, the usefulness of a model or theory is that it organizes observations into patterns that allow us to create a conceptual framework as ‘a way of seeing the world’ (*Ibid*).

Considering above, the research of the literature review of the relevant Stock Picking Theories and Models can be divided into following five major themes:

1. Modern Portfolio Theory (MPT) (Markowitz, 1952)
2. Capital Asset Pricing Model (CAPM) (1961-1965)
3. CAPM+ Model related models including Fama French Model (1993)
4. Asset Pricing, Data Mining, Momentum & other Indicators (1993)
5. Behavioral Science and the psychology of stock market participants and stakeholders

### **Theme 1: Modern Portfolio Theory (MPT)**

Modern Portfolio Theory (MPT) is considered the seminal and foundation economic theory in finance and investment which demonstrates that diversification of an investment portfolio can be created to produce the same investment total return with less risk to the investor. (Essential Economics, 2004).

Markowitz published his theory, 'Portfolio Selection,' in the Journal of Finance (Markowitz, 1952). Harry Markowitz, Merton Miller, and William Sharpe were awarded the 1990 Nobel Prize in Economic Sciences for "their pioneering work on the theory of financial economics", and Markowitz "for having developed the theory of portfolio choice" (Nobel Prize, 2021). MPT is based on the premise that financial markets are efficient, with the theory used to analyze risk versus return in allocating investment capital; for example, in allocating funds in a basket of stocks to invest for a portfolio. This theory is used to explain the complex nature of the capital markets and how one uses asset allocation principles to manage an expected return as it relates to market related risk (Bank Investment Consultant, 2006). In addition, Markowitz in 1952 suggested a mean-variance theoretical analysis for the selection of investment portfolios which has resulted in the birth and growth of a new industry of index funds (French, 2016) and later ETFs (Exchange Traded Funds) which are index funds listed on the stock exchange.

### **Theme 2: Capital Asset Pricing Model (CAPM) (1961-1965)**

The Capital Asset Pricing Model (CAPM) is defined as an economic finance model that portrays an idealized "relationship between the expected return and risk of investing" in an asset or stock (Corporate Finance Institute, 2022). It is universally used in financial markets to price an asset taking into consideration the cost of capital, expected investment returns and risk of investing in those assets (*Ibid*). The underlying theory of Capital Asset Pricing Model is that when one invests in a broad portfolio of stocks, the winners outperform the losers. So, in a basket of stocks the risk of losing one's initial capital is significantly reduced, enabling an adequate return on the investment. That is not having all of one's eggs in a basket or not investing in a single stock or in a small group stock that are not sufficiently diversified (Dempsey, 2016). CAPM was built by several different US academics in the 1960s – Jack Treynor (1961, 1962), William Sharpe (1964), John Lintner (1965), and Jan Mossin (1966) – all who worked independently and built upon each other's work and the early research of Harry Markowitz (1952) MPT and diversification (*Ibid*). Later William Sharpe was awarded the 1990 Nobel Prize for Economic Sciences "for his contributions to the theory of price formation for financial assets, the so-called, *Capital Asset Pricing Model (CAPM)*" along with Markowitz and Miller for related contributions ([Nobel Prize](#), 2021).

Below are the various evolutions of the CAPM and other works in support of it:

*Mehrling & Brown (2005)*

In the book, *Fisher Black and the Revolutionary Idea of Finance*, Mehrling & Brown (2005) retells the evolution of modern finance theory from the efficient markets hypothesis, which is the idea that markets prices react to new information (weak, semi-strong or strong) rapidly and is the most tested model in social science, to the development of CAPM as the "revolutionary idea" that runs through finance theory (Dempsey, 2016).

*Black, Jensen & Scholes (1972)*

Fischer Black, Michael Jensen, & Myron Scholes (1972) developed the first analytical method and successful test of the CAPM, and this method is still used to test asset pricing models today. They

developed a double-pass regression method to apply to the asset pricing data to achieve testable predictions. (Dempsey, 2016).

### **Theme 3: CAPM+ Models including Fama French Three Factor Model**

This section documents the various permutations and evolutions of the financial economic theories developed by Nobel laureate Eugene Fama singularly, and together with Kenneth French which builds upon the CAPM to become the CAPM+ and Fama French Three Factor Models.

#### *Fama French Model (1973)*

The Fama French (1973) Model is considered as the CAPM's first methodologically satisfactory test and is still widely used in academia to test any type of asset pricing model (Dempsey, 2016).

#### *Fama and French Three-Factor (1988, 1992, 1996)*

The Fama and French Three-Factor Model (1992) is built upon the CAPM by adding the size of a firm and the value of a firm as risk indicators to the market risk factor of CAPM. This model demonstrates the outperformance of value and small-cap stocks over the general market over the long term (Fama & French, 1988). The Fama and French Three-Factor Model consists of the CAPM and three additional indicators - the size of the firm, its book value, and excess return of the market it operates in (*Ibid*). In 1992, rather than discard the CAPM as it was not working well, Eugene Fama and Kenneth French improved upon this model by adding two additional variables in addition to the concept of beta, and thus the Fama French three-factor model was born. This model is now regarded as superseding the CAPM.

#### *Jensen (1978), Modigliani & Miller (1958), Fama (1976)*

Michael Jensen (1978) claimed that the 'efficient market hypothesis' in economics has the most solid empirical evidence and includes all the most timely and available information at any one time embedded within the price of a stock, so it is impossible to make consistent economic profits by trading stocks (Modigliani & Miller, 1958; Fama, 1976; Dempsey, 2016).

### **Theme 4: Asset Pricing, Data Mining, Momentum, and other Factors Indicators**

This section highlights a further evolution of Stocking Picking Theories and Models through the lens of Asset Pricing models using technology and data mining techniques to discover relevant and useful financial factors or indicators in picking stocks such as Momentum.

#### *Jegadeesh & Titman (1993) – Momentum*

Jegadeesh & Titman (1993) discovered that there is 3 to 12 months momentum effect for past returns resulting in the research of other variables on a stock performance (Dempsey, 2016).

*Chordia & Shivakumar (2002), Grinblatt & Moskowitz (2004) – Momentum*

Chordia & Shivakumar (2002) demonstrated that in the United States momentum is explained by the business cycle; of which Grinblatt & Moskowitz (2004) discovered similar findings. (Dempsey, 2016). Griffin, Ji, and Martin (2003) and Rouwenhorst (1998) reported evidence of momentum internationally (*Ibid*).

*Heston & Sadka (2008) - Winners and Momentum*

Heston & Sadka (2008) demonstrated that based on momentum the same winners continue to outperform the same loser over the following period (Dempsey, 2016). Hong, Lim, and Stein (2000) demonstrated a negative momentum effect on analyst coverage and a firm's size (*Ibid*).

DeBondt & Thaler (1985, 1987) discovered for a 6-to-12-month momentum timeframe there was evidence of under and out performance and long-term reversal in a stock over a 3-to-5-year period (*Ibid*).

*Fama & French (2008) - Momentum*

Fama and French (2008) suggested that the momentum effect needs to be incorporated into asset pricing models, with consideration for the momentum effect across different firm sizes (Dempsey, 2016).

*Cooper, Gulen & Shiller (2008) – Growth, Accruals, Stock Issues*

Cooper, Gulen, and Schiller (2008) demonstrated that predicted returns are related to growth in assets (Dempsey, 2016). Fama and French (2008) have reported that a cross-section of returns are associated with accruals and stock issues (*Ibid*).

*Haugen & Baker (1996) – Return on Equity (ROE), Price Earnings (PE), Past Returns, Trading Volume*

Haugen and Baker (1996) determined that the strongest expected returns are associated with past returns, trading volume, and accounting ratios of return on equity and price/earnings ratios (Dempsey, 2016).

*Cochrane (2005) – Asset Pricing*

John Cochrane (2005) states that asset pricing factor models are more likely the convention than asset pricing risk and return models (Dempsey, 2016).

*Amihud & Mendelson (1986) – Stock Liquidity*

Amihud and Mendelson (1986) discovered that stock liquidity is related to asset returns (Dempsey, 2016).

*Subrahmanyam (2010) - Asset Pricing and Data Mining*

Through data mining related to asset pricing, Subrahmanyam (2010) discovered over fifty indicators and variables to predict stock return (Dempsey, 2016).

*Cochrane (2005) – Data Mining*

Cochrane (2005) advises caution in coming to definitive conclusions because of the complexity and difficulty of measuring and analyzing statistical meaning over many years. He questions why academics are not researching the relationship between the business cycle of the real economy and bank credit policies and how each may impact the other (Dempsey, 2016). His observations are that academics are rewarded for short term work in authoring papers and achieving citations and not for long-term studying and thinking of complex financial economic issues. Hence, the mining of data to find statistically relevant and significant indicators that could be frequently cited by other academics (*Ibid*).

*Shiller (2010) - Bubbles, Price Movement*

Shiller (2010) states that the possibility of price movements and how bubbles are formed in the financial markets is not related to information, as many asset pricing models hypothesize. For example, he was quoted in *The Economist* that the creation of the CRSP database which many economists utilize is leading them to believe financial markets and investing has become scientific (Dempsey, 2016). Instead, he states that it is more about the vulnerabilities in economies and financial markets related to history, and how institutions and laws work together to create or exacerbate vulnerabilities, as demonstrated by the global financial crisis of 2008 which many economists did not see it coming as they were measuring the financial markets and not studying long term history as a significant predictor of financial crises (*Ibid*).

*Fama and French - Sharpe Ratio and Interest Rates*

Brennan, Wang, and Xia (2004) using the Fama and French 25 portfolios reported that both the Sharpe ratio and the real interest rate are associated with the expected returns of assets in equilibrium (Dempsey, 2016).

*Liquidity Impacting Asset Returns*

Chordia, Roll, Subrahmanyam (2002, 2008) and Chordia, Sarkar, Subrahmanyam (2005) determined that Liquidity is a crucial factor in impacting asset returns (Dempsey, 2016).

**Theme 5: Behavioral Science/Finance/Economics**

Behavioral Science or Behavioral Finance is defined as “the cognitive factors and emotional issues that impact the decision-making process of individuals, groups, and organizations, including overconfidence, cognitive dissonance, regret theory, and prospect theory” (Ricciardi & Simon, 2000). Hence, investors often make irrational decisions when picking stocks or when buying or

selling them; and therefore, are not rational investors as hypothesized by the efficient market model such as CAPM. This section documents three key thought leaders and their Theories and Models espousing Behavioral Science.

*John Maynard Keynes - Animal Spirits*

John Maynard Keynes' (1936) *The General Theory of Employment, Interest and Money* is believed to be the foundation of modern behavioral finance by economist Marcelo De Cecco (Bhasin, 2014; Wasik, 2014). Keynes, a giant in economics who proposed the Keynesian economic theory was also a phenomenally successful stock market investor where he made his personal fortune, so he knew something about how markets in work in practice. Besides being an investor who managed his own money, and that of King's College, Cambridge University, Keynes provided financial advice to Winston Churchill and Franklin D. Roosevelt (Dempsey, 2016).

Keynes coined the famous term '*animal spirits*' to describe the behavior of market participants and this term is often used today to characterize 'market sentiment and crowd psychology' (Keynes, 1936; Dempsey, 2016) and thus is really the foundation for behavioral science. Keynes' main tenet was that market participants are not evaluating stocks or the market on its fundamental values but are trying to assess and anticipate "what average opinion expects the average opinion to be" and how market sentiment and market psychology play a role in producing tipping points and booms and busts market cycles (Keynes, 1936; Dempsey, 2016).

*Shiller (1981) - Behavior Science – Variability and Efficient Market Theory*

Shiller (1981) hypothesized that crowd psychology and behavioral considerations are likely to explain the process of price determination than the efficient market theory because there is a lot of variability in stock market price fluctuations (Shiller, 1981; Dempsey, 2016).

*Putnam (1979) – Practice is Primary*

Putnam view is that there is no separation between science and behavioral science, therefore 'practice is primary' (Putnam, 1979; Dempsey, 2016). Putnam argues that 'practice is primary' and that our ideas or theories or models are not the goal but there to guide us in our practice so we may test our ideas by applying them and then judging to see if they are correct and if we have succeeded or failed. Thus, "failure to see the importance of practice leads directly to failure to see the importance of success" (Dempsey, 2016).

## **CRITICAL ANALYSIS OF STOCK PICKING THEORIES – DEBATES, OBSERVED GAPS IN KNOWLEDGE AND FUTURE RESEARCH**

### **Critical Analysis of Stock Picking Theories and Models - Debates and Critiques**

#### **Critique and Debates of the CAPM**

*Douglas (1969)*

Douglas' (1969) empirical studies confirmed as early as in the late 1960s that there were factors contradicting the CAPM. Most notably that average (realized) stock return is associated with the variance of its return over time and not to its covariance of market index of returns (Dempsey, 2016).

*Lo & Mueller (2010) Empirical Research*

Lo and Mueller (2010) demonstrated that any challenge to the orthodoxy of the efficient market theory and the CAPM was discounted until the early 1990s, whereby papers reporting and discovering data often being rejected by the top economics and finance journals, sometimes without being reviewed by independent referees (Lo & Mueller, 2010; Dempsey, 2016). For years, Lo and Mueller reported that there was a belief that it was possible to build predictive and quantitative scientific and physics like financial models and economic systems by economists and financial analysts (Dempsey, 2016).

*Dempsey (2013) Balancing Risk and Return*

Dempsey (2013) view is that "we must seek to understand markets on their own terms and not our own" and not rely on models that are not working well to price assets in the market and capture the real risk-return. This results in unmeaningful models that undermine the discipline and study of asset pricing.

*Dempsey (2016)*

Dempsey (2016) argues that facts do not support the CAPM nor the hypothesis that it is rational and can be studied in a scientific manner (Dempsey, 2016). He suggested that early researchers in asset pricing thought that the rationality and the integrity of the market was based on their ability to monitor and price risk (*Ibid*). However, they have often been proven wrong as markets have acted with irrational exuberance and significant uncertainty and unpredictability. For example the mispricing of US housing risk that resulted in the Great Financial Recession of 2008 with the collapse of Bear Sterns, a storied Wall Street firm, and more recently the irrational exuberance of the rise of pandemic stocks of 2020 to 2021, resulting in a significant 20% bear market in the US due to unexpected significant inflation, unexpected supply chain issues in the real economy and the unforeseen geo-political ramifications of the invasion of Ukraine by Russia in 2022 with a significant refugees humanity crisis in the heart of Europe. Dempsey notes that the CAPM 'fails as a worthy paradigm' because of a contradiction between its core premise and the 'anomalies' it advances, it does however continue to have academic championing and broad industry acceptance to estimate a company's cost of equity capital (*Ibid*).

*Putnam (1979)*

The issue is not whether the CAPM should be accorded "true" or "false." The CAPM presents a straight-forward principle of additive rationality. Following the scientific philosopher Hilary

Putnam (1979), theories/models are never ultimately “true” or “false”, but, rather, are ultimately “useful” or “not useful” (Putnam, 1979; Dempsey, 2016).

### **Observed Gaps in the existing knowledge – No Disruption and Innovation Stock Picking Theory/Model**

A main observed gap in the theories and models, is that CAPM, and other models, were developed often by studying value stocks or a portfolio of value stocks. More recently, and in the past 20 years or so with the advance of the internet, speed of technology development in silicon chips that are used in every device, and an acceleration in disruptive and innovative accelerating technologies such as the internet, the digital economy, medicine and biotechnology, Growth stocks<sup>7</sup> have consistently outperformed Value stocks<sup>8</sup>.

The rise of the famous FAANG internet stocks of Facebook (now Meta), Apple, Amazon, Netflix, and Google (now called Alphabet), all but one is worth more than a trillion dollars; including Tesla as it advances the electrification of vehicles with the deployment of multiple technologies such as battery, solar, computers, and Artificial Intelligence, are examples of growth companies. In a study of over 18-year period, growth stocks have outperformed value stocks for 14+ years on a buy and hold strategy (Beneda, 2002). The point is that ‘Disruption and Innovation,’ is causing all sorts of unpredictable impacts to the stock market and stocks, other financial markets and the general economy including rapid social, political, and lifestyle changes. Further disruption and innovation are also occurring because of climate change and the once in a 100-year SARS Covid-2 pandemic which is still ongoing since 2019 and are resulting in more tumultuous and volatile impacts to Stock Picking and stocks, specifically Growth stocks.

Many of the Stock Picking Theories and Models do not study or acknowledge this ‘Disruption and Innovation’ phenomena resulting in a gap in the knowledge. What is apparent though is new behaviors have risen – in the retail stock investors and institutional investors in the stock market, giving rise much more to the Behavioral Science Theories. Also, changes in regulatory behavior of the authorities such as the Federal Reserve and other Central Banks pouring in liquidity into the economy and stock/financial markets give rise more to Shiller’s (1981) impact of Liquidity and how it impacts stock picking, stock prices and a rise in a stock’s price. For example, the Federal Reserve quantitative easing strategy of buying US Government Bonds of many billions every month issued by the US government’s Treasury pumps a lot of money and liquidity into the financial system thereby also pumping liquidity into the stock market that will impact the rise of the price of stocks. Another Theory that is relevant during this time is Black Scholes (1974) model on the volatility of stocks and the stock market. During this tumultuous time, the quite extreme swings of the prices of many stocks appear to be in motion as we enter a seismic period of disruption and innovation.

A key proponent of ‘Disruption and Innovation’ thinking is not really an academic but a Market Practitioner, Ms. Cathie Woods of the ARK Investment Management’s Exchange Traded Funds

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7. Growth stocks – stocks with high Price to Earnings (P/E) ratio that grow rapidly over a period of time.

8. Value stocks – stocks with low Price to Earnings (P/E) ratio have high earnings or profitability and consistent performance as a company and often are considered undervalued and are good income paying or dividend stocks.

(ETFs)<sup>9</sup> listed on the US Stock Market. Currently thought of one of the best, if not the best Stock Picker in the US Stock Market. Ms. Woods subscribes to a 'Disruptive Innovation' approach, thesis, or model, where ARK, her firm, "aims to provide broad exposure to disruptive innovation" by picking stocks or public companies to invest in "that will change the way the world works and deliver outsized growth as industries transform" (AK Invest, 2021). Thus, it seems that the CAPM and some of its evolutions, that of the efficient market and the rational investor theory, no longer appears to be useful in picking stocks or managing a stock portfolio.

The MPT may also no longer appear to be useful in picking stocks as while its theory of a diversified portfolio may be useful in managing risk, it does not assist in generating excellent outsized returns for a portfolio as it limits performance of the portfolio. It may be useful in managing volatility and limiting risks and therefore losses, but that approach also substantially limits the ability of the portfolio to produce substantial gains. Most investors these days do not necessarily invest in the stock market to preserve capital but to grow their wealth and require the stocks they pick to either produce a good income in the form of a dividend and or continued growth of its stock price over many years. A diversified portfolio of the MPT may reduce risk and thus volatility but also lose the opportunity to have substantial income and capital gains from the selected stock and stock portfolio.

### **Future Research**

Based on the observed gap of a lack of Stock Picking models or theories as previously mentioned above, it is recommended future research is conducted in developing Stock Picking models based on a "Disruption and Innovation" model or theory. Market Practitioners such as Cathie Woods of ARK Investment Management uses a "Disruptive Innovation" model to pick stocks and stocks portfolios in her listed ARK ETFs on the US stock market.

### **CONCLUSION**

Many of the existing Stock Picking Theories have all been demonstrated to be of much less value in the current and future information environments. The theories all require elapsed time and history to evaluate a stock and assess its potential and risk and can be left behind in today's rapidly moving worldwide microsecond digital information environment. Information about a stock is now democratized. It is instantly available to anyone with a smartphone, anywhere in the world. Investment is also democratized. Anyone with a smartphone can invest in stocks and follow their investment's performance second by second. Small communities of like-minded people can influence a stock price. For example, Reddit and the GameStop incident, where a small group of people rebelled against orthodoxy and directly drove a stock price to extreme irrational highs to prove a point.

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9. ETFs- Exchange Traded Funds are listed portfolio of stocks that may emulate and index such as the S&P 500 or portfolio stocks selected by active fund managers based around a theme or industry, similarly to a mutual fund. ETFs are a group of selected public stocks listed as a group and are often with exceptionally low fees to hold with the ability of investors to buy and sell the ETFs daily or several times a day.

A new “Disruptive and Innovation” environment is taking hold. Machine Learning and Artificial Intelligence and programmed machine trading systems can all pile in on a fluctuation without restraint and thus amplify swings in the stock market and stock prices. The current business environment is not “business as usual.” Any Stock Picking Theory must now consider the field of business a company is in and needs to be cognizant of the future steps needed to alleviate climate change. This may result in a firm without notice being in a sunset industry and becoming a zombie business with no prospects. Governments and government action to alleviate the impact of potential new pandemics has restricted the prospects of many industries and businesses such as travel and tourism and accommodation whilst providing opportunities for companies developing vaccines and drugs, and sanitation products like industrial air cleaners and protective equipment.

A whole series of ‘Disruption and Innovation’ is occurring because of the internet and advances in technology, biotechnology, medicines, climate change, the SARS Covid-2 pandemic and the democratization of finance and investing; bringing unprecedented and accelerated social, political and lifestyle changes to the planet. A new theory and methodology are required to embrace the current and future disruption and innovation and needs to be derived from elements of the existing Stock Picking Theories and Models.

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## CSR DEVELOPMENT IN THE ENERGY COMPANIES OF AZERBAIJAN: CASE-STUDY OF BP AZERBAIJAN

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*Nigar Talishinskaya & Konstantinos Biginas*

**ABSTRACT:** *As a modern concept, Corporate Social Responsibility (CSR) is constantly changing as a business idea and acquiring different definitions. Although there is an abundance of literature regarding the theory, history, and application of CSR, there is also a lack of material when it comes to specific case studies in Azerbaijan. This research fills the gap in the literature by providing an examination of BP's CSR strategies in Azerbaijan. The study aims to answer the following question: "What is the level of BP's CSR development in Azerbaijan? - by utilizing primary and secondary information sources. Using such data collection tools as questionnaires, interviews as well as thoroughly analyzing corporate reports, allows the study to increase the validity and reliability of the research. The case study approach ensures a focus on one specific topic, and the study's separation into units of analysis creates a structured methodology. According to the findings, BP's CSR strategy in Azerbaijan is developed to an adequate level in line with international standards on the environmental, social, and ethical responsibility of businesses. This research study contributes to the existing literature by demonstrating BP's CSR efforts and disclosures in Azerbaijan.*

**KEYWORDS:** corporate social responsibility, Azerbaijan, energy, strategy, BP.

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The main purpose of this study is to assess the level of Corporate Social Responsibility (CSR) development in the energy sector of Azerbaijan. By focusing on one certain foreign oil and gas company operating in Azerbaijan (BP), the study will aim to develop a case study. In this way, the essence of the research study will be to determine the extent to which the chosen energy company invests its resources in CSR and point out any limitations in developing CSR in Azerbaijan's energy sector.

### BACKGROUND

The first few sections of this research study provide a general introduction to several CSR frameworks in theory and practice as well as the historical background of CSR. All the existing information sources focus on the fact that the corporate world is transforming, and businesses are faced with the need to adapt to the rapidly changing environment. Today, one of the essential elements of business enterprises around the world is CSR. Aside from being considered as a modern business practice and often even a prerequisite for a successful company, it is also more than just

that. Businesses have CSR at the heart of their operations, as they are not standalone entities without any connection or regard to the external but are tied to and affected by the environment in which they operate. There is no universal way to define CSR because it is an extremely dynamic idea and has been subject to change every few decades. However, the most common definition was coined as “the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society” (Bowen, 1953 quoted by Mapelli *et al.*, 2016).

To demonstrate how dynamic and flexible the concept of CSR is, it would be beneficial to bring into attention the changing definitions and terminology over the years. The first scholar to ever mention and discuss Corporate Social Responsibility was H.R Bowen in his book “Social responsibilities of the businessman” of 1953, which consequently gave him the acclaim of the “father” of CSR (Hossain, et al., 2014). Back then, CSR was only starting to emerge as a business practice and was not accepted in the wider corporate world. The turning point for this emergence was the understanding that businesses from now on must conform to “business morality.” In other words, companies must think not only of their own benefit but also the benefit that society can get from their operations. Moreover, in this regard businesspeople are viewed primarily as servants of society that must acknowledge external values and place them at the same level as the internal company values. CSR is synonymous with such terms as “public responsibility,” “corporate morality,” and “social obligations” (Bowen, 2013).

After the initial introduction of CSR by Bowen, the understanding of CSR started to change rapidly, and new contributions were made by scholars. Firstly, the notion of “public responsibility” was separately presented by Preston and Post. They tried to stress the importance of accountability and sustainable management directed at the overall public (Melé, 2009). This contribution highlighted that all businesses are influenced by society, in fact, both can mutually affect each other (Hopkins, 2012). For instance, an oil and gas company may invest in its machinery for exploration and production of oil, however, it contaminates water and air throughout the process. These types of thoughts gave sufficient ground for re-thinking the role of businesses. Furthermore, scholars like Ackerman, Bauer, and Sethi focused on businesses addressing and meeting social needs and coined the term “corporate responsiveness” (Ackerman & Bauer, 1976, cited in Melé, 2009). In the 1980s, CSR obtained a slightly different theme as scholars and businesses alike started to emphasize the role of corporate social performance, so this gave CSR an element of measurement. For example, one of the studies that stood out significantly was carried out by Wood and Corchran in 1984, where they were able to measure the effect of CSR on the financial efficiency of the company through the incorporation of the reputation index (Gheribi, 2017).

There is a plethora of various theories attempting to explain CSR, but for the purpose of this paper, only the most popular and prominent approaches will be discussed. To start with, Klonoski has differentiated between three paradigms of CSR. The first one is tied to “fundamentalism” and states that businesses are inherently just legal entities seeking to maximize profit; the second one emphasizes the moral responsibility of the businesses and the third theory is rooted in ethical and political sciences and highlights the social aspect of the corporation’s operations (Klonoski, 1991, cited in Melé, 2009).

Furthermore, there is a study conducted by Windsor in 2006 that proposed three main approaches to CSR:

1. corporate citizenship established on the grounds of political science theories
2. economic responsibility theory promotes accumulation of assets with minimum public policy, and
3. ethical responsibility theory implies a firm commitment to the altruistic duties of the company (Melé, 2009).

Another crucial theory explaining CSR in businesses is the legitimacy theory. It is centered on the notion that companies always try to be perceived by the public as responsible and operating within the social norms, as well as continuously meeting the demands and expectations of society (Deegan, 2009, cited in Fernando & Lawrence, 2014). This theory may be especially relevant for the energy industry. For instance, by carrying out community development projects, maintaining an environmentally friendly or “green” corporate culture, and organizing charity events, the companies can strengthen their legitimacy in the eyes of the public. Whereas, information about scandals and major accidents may be disseminated through popular media and create a bad reputation, which will inevitably decrease the legitimacy of the company (Fernando & Lawrence, 2014).



Figure 1. Carroll's pyramid model of corporate social responsibility (Carroll, 1991)

The theoretic framework that will be specifically used in this study (displayed above) was established in 1979 by A.B Carroll who was the first one who suggested the term “corporate social performance” and conducted a comprehensive analysis of drivers, principles, and philosophy of CSR (Melé, 2009). He proposed that the CSR is the obligation of businesses to the society and it must encompass Carroll suggested that an entire range of obligations that business has to society must embody legal, ethical, economic, and philanthropic realms, which make up the “Pyramid of Corporate Social Responsibility” (Carroll, 1991, cited in Melé, 2009).

When it comes to the energy industry, the concept of CSR is extremely crucial. The global energy demand is increasing, and the energy business, as one of the most impactful on societal and environmental wellness, is furthermore pressured to develop its CSR strategies and invest in

sustainability (Stjepcevic & Siksnelyte, 2017: 22). In Azerbaijan, the energy sector is a crucial part of the economy: oil and gas account for 90% of the country's exports and its crude oil production comprises 37.5 million tones including natural gas liquids as of 2019 (IEA, 2020). Moreover, as of January 2021, Azerbaijan's crude oil reserves were estimated at 7 billion barrels (U.S Energy Information Administration, 2021).

### **Why BP?**

As stated before, the purpose of the study is to determine the level of CSR development in the oil and gas sector of Azerbaijan. Considering that Azerbaijan is abundant in its hydrocarbon resources, many oil and gas companies are operating in the country. These include governmental and transnational energy companies, such as the State Oil Company of the Azerbaijan Republic, BP, Total, Chevron, Statoil, Exxon, and Lukoil. So, why is it that for the matter of this study the chosen company of choice is BP? The answer has its roots in the history of BP's presence in Azerbaijan's energy sector. BP has first entered Azerbaijan in 1992, and for the past three decades it has been operating the most important oil and gas projects in the country: Azeri-Chirag-Gunashli, Shah Deniz, Baku-Tbilisi-Ceyhan pipeline, South Caucasus pipeline. During this period, BP has significantly contributed to the growth of the economy, provided substantial revenue, helped create new trade links with the rest of the world, invested in capacity-building and educational development, supported rural areas, and committed itself to sustainable development (BP, 2021). Being one of the first foreign energy companies to arrive in Azerbaijan and having a long history of operation in the country, BP makes a fitting example of CSR development in the country.

### **Significance and relevance**

The significance of this study will be measured in the research gap that it aims to fill. There have been studies on CSR strategies of specific energy companies (including BP) in Azerbaijan, however, they have been carried out by measuring CSR development purely according to theoretical frameworks. This study will aim to determine the development of BP's CSR in Azerbaijan through theory and in practice. This will allow gaining more insight into the company's CSR strategies, compare it with the existing literature of the company's approaches.

### **Aims and Objectives**

Considering that the oil and gas industry takes up a prevalent role in Azerbaijan, it is important to establish whether the energy companies, both transnational and governmental, develop their CSR in accordance with international standards and thus, determine the level of CSR development in this sector. Businesses involved in such asset-heavy industries with significant impact on the region that they operate in are responsible to give back to the communities and raise their public responsiveness.

The Research Question for this study is:

*What is the level of BP's CSR development in Azerbaijan?*

The Research Objectives of this study will be the following:

- to examine the development of CSR in BP Azerbaijan,
- to investigate the corresponding drivers behind CSR strategies and their impact on the society and environment,
- to compare the findings with the existing literature of theory

The initial hypothesis is the following:

H1: *BP has developed its CSR strategies in Azerbaijan to an adequate level*

### **Limitations to the study**

It is crucial to point out some of the limitations that can affect the study. Firstly, the COVID-19 pandemic has shifted how companies operate on a day-to-day basis. Many firms still have remote or hybrid work regime, which allows workers to be flexible. However, in the context of this research, the pandemic poses a barrier to the carrying out of the study. It may create difficulties in logistics, coordinating meetings for the interviews, and gathering the necessary information. Secondly, the time frame for this study is short (three to four months) and that can be a limitation to the study as well. Lastly, it is important to mention that the topic of this research study implies that there may be inaccessibility of some portions of data due to insufficient reporting, privacy, or lack of transparency.

## **LITERATURE REVIEW**

### **Types of CSR**

Building a socially responsible business has become a top priority for many firms. Companies develop their CSR to positively contribute to the external environment and help local communities. There is not one single correct way to develop CSR, but there are four common types of CSR and directions that it may take: environmental efforts, philanthropy, ethical labor practices, and volunteering (Schooley, 2021).

### **Environmental Corporate Responsibility**

The first type of CSR is the environmental responsibility of companies, which is also known as environmental stewardship. It is one of the most popular types of CSR practiced by businesses. These types of initiatives imply that a company has the responsibility to act in the most environmentally sustainable way that it can. Undoubtedly, there are a plethora of ways that a company can ensure corporate environmental responsibility. According to Tim Stobierski, an author of Harvard Business School, three main action words are associated with environmental efforts: 1) to increase recycling and the use of recycled materials, sustainable resources, the development of renewable energy sources such as water, wind, and solar energy; 2) to reduce greenhouse gas emissions, pollution, the utilization of plastic and the overall level of waste; 3) to prevent an environmental crisis and negative climate change impacts (Stobierski, 2021).

According to the works of Paul Shrivastava, it is a matter of utter importance for companies to integrate the logic of environmental sustainability into their culture and operations to ensure efficiency. High rates of consumerism and unsustainable production can lead to a significant ecological crisis, and that is why corporations must take part in reducing this crisis by encouraging ecologically friendly consumption, production, and promotion patterns (Rehak, 1992, cited in Shrivastava, 1995). The author stresses that many corporations do not prefer the eco-friendly way of carrying out their operations because it is not cost-efficient. Moreover, stakeholders, such as consumers and organizations themselves, have become used to the traditional non-sustainable way of doing things. However, the author highlights that integrating environmental responsibility into company culture can be beneficial. Firstly, businesses can reduce operating costs through the utilization of ecological efficiency. For example, preservation of water and energy, waste management, and recycling of materials. Secondly, maintaining ecologically sustainable practices can distinguish the company in their industry. In this way, a business can gain a competitive advantage by being a first mover in the market, improving its reputational image, and establishing legitimacy (Shrivastava, 1995).

Another study conducted by Simpson et al., has brought forward important findings that demonstrated the perceptions of businesses (SMEs in particular) towards creating competitive advantage through CSR. According to the study, 60% of companies considered environmental efforts to be beneficial for the final product and overall effectiveness. Nevertheless, most businesses were not able to gain a competitive advantage from environmental responsibility. Furthermore, these companies did not regard environmental accountability to be a worthy investment, and more than that, the companies were unqualified to utilize those environmental improvements in their further corporate practices (Simpson, et al., 2004). In addition, the research concluded that small enterprises do not want to adopt ecological improvements because they perceive them to be too costly without professional help, which is also expensive (Sarkis, 2001, cited in Simpson *et al.*, 2004).

A question that remains at the center of the debate is the following: does the market value environmental accountability? Theoretical background can answer this question through the stakeholder theory that suggests a positive relationship between the use of eco-friendly corporate practices and profitability (Wahba, 2007). This assumption is proven by some practical examples such as a positive correlation between cost-effectiveness and waste management (Spicer, 1978, cited in Wahba, 2007), better financial records following corporate environmental efforts (Klassen & McLaughlin, 1996, cited in Wahba, 2007) as well as higher market value in case of fulfilling environmental laws (Dowell *et al.*, 2000, cited in Wahba, 2007). The results of the research study showcased the following: eco-friendly practices within businesses have become more than altruistic behavior, but a real way to improve long-term financial performance and create a positive corporate image (Wahba, 2007).

### **Philanthropy**

The second type of CSR is the philanthropic responsibility of businesses. This refers to businesses' dedication to positively contributing to the world and making it a better place. Companies do it through gratuitously donating portions of their profits to important causes in their sphere of

operations or completely different causes. Moreover, some businesses even create their own charities and trusts to collect funds to give back to the society that they function in (Stobierski, 2021).

Corporate philanthropy implies that businesses engage in giving resources to the external environment without expecting any compensation and completely of their free will. Three main pursuits of strategic corporate philanthropy have been identified as emotional, rational, and economic (Adamonienė & Astromskienė, 2010). Philanthropic responsibility is widely recognized by companies as essential. But not many businesses can achieve effectiveness through philanthropy, as many of them simply do not yield the output proportionate to the input that they bring in. This occurs due to a lack of a cohesive philanthropic strategy that businesses can implement, and as a result, it brings executives to misinterpret philanthropic practices as unprofitable and useless. To gain more insight into managerial opportunities in this sphere, businesses must differentiate between two major approaches in corporate philanthropy: market orientation and competence orientation (Bruch & Walter, 2005).

Businesses that adopt the market orientation strategy tend to prioritize the interests of important stakeholders, such as consumers, investors, employees, governing organizations, at the center of their philanthropic activities. The logic behind this approach is the expectation to gain a competitive advantage in the form of improved sales, promotion, and popularity. One outstanding example of this type of philanthropic responsibility is Deutsche Lufthansa AG that implements community involvement programs. On the other hand, the competence orientation strategy allows companies to focus on the internal environment of the firm and align their philanthropic practices with their core business areas. For instance, McKinsey & Co. regularly organize charitable projects with free consulting services to various organizations. The downside of this strategy is its inability to always coincide with stakeholder interests (Bruch & Walter, 2005).

### **Ethical Responsibility**

The third type of CSR is the ethical responsibility of companies. It refers to the corporate obligations of businesses to hold ethics and fairness in high regard. Companies with highly developed ethical corporate responsibility prioritize just treatment of all employees, customers, suppliers, and investors. For example, companies can ensure ethical operations by refusing to use materials or products made through child labor or slavery, as well as aim to utilize only products bought and sold under free trade agreements. Businesses may enhance ethical practices by raising their minimum wages to a higher level if the existing one is insufficient for the adequate life of their employees (Stobierski, 2021).

Business ethics is an important part of the corporate world. It is defined as principles and standards guiding the company to differentiate between morally right and wrong in their business operations (Boone and Kurtz, 2005, cited in Jalil, et al., 2010). It is important to note that companies with strong ethical standards enjoy more employee and customer loyalty. Moreover, building organizational goodwill through ethical practices allows companies to establish beneficial longstanding relations with different stakeholders, from investors and governing agencies to consumers and suppliers (Jalil, et al., 2010).

## Volunteering

The last type of CSR is volunteering efforts, which is an incredibly important business responsibility in today's corporate world. The concept of corporate volunteerism is often defined as the company's engagement in active, voluntary, and unpaid work outside of designated work hours (or during work hours). This type of CSR is usually a partnership with non-profit organizations or charity projects to bring value to the external environment (Lorenz *et al.*, 2012).

A study conducted by Dreesbach-Bundy and Scheck concluded that corporate volunteerism is a new notion in the business world and has been significantly maturing during the past decade. Its scope is limited so far, but extensive research about the topic showed that corporate volunteerism is employee-oriented and centered around non-profit and non-governmental organizations (Dreesbach-Bundy & Scheck, 2017). Moreover, corporate volunteering should be aligned with the values and interests of employees, in which case it will increase employee work engagement and cultivate a volunteering corporate climate. For instance, companies can implement the P-E (person-environment fit) strategy during the recruitment process to maximize the gains from volunteering. This will allow for the company to correctly identify each employee's strengths and match them with volunteering activities in accordance. It is also highly crucial to incite employee volunteering behavior by giving timely feedback in appraisals and being generous with rewards that highlight employees' volunteering experiences and efforts (Zhang *et al.*, 2021).

## Measurement of Corporate Social Performance

Since this study is concerned with the level of CSR development, it is important to pinpoint how to measure the level of CSR in a company (Lindgreen & Swaen, 2010). Measurement of CSR is quite a challenging task because of the fluidity and ambiguity of the concept. CSR is multidimensional and can focus on a variety of different spheres from environmental protection and ethical labor laws to volunteering programs and charity (Rondinelli & Berry, 2000, cited in Lindgreen & Swaen, 2010).

## Categories of CSR Measurement

One of the first major studies on CSR measurement was conducted by Ullmann in 1985 and is still relevant up to this day. By analyzing 31 business cases of 1970-1980s, the author pinpointed three main categories of measurement (Wood, 2010). The first measure is "economic performance," for which the indicators would be the price/earnings ratio, growth in earnings per share, operating earnings/sales, operating earnings/assets, stockholder returns, excess market valuation, net profit margin, net income, median return on equity and other important economic pointers that assess corporate financial performance. The second one is "social disclosure," and it refers to transparency and voluntary corporate reporting with sufficient and truthful information about the company's CSR activities. Moreover, since 1973 this measurement category also includes pollution reporting such as CDP (formerly known as Carbon Disclosure Project) rankings if the company operates in an according sector. Lastly, the third CSR measurement category was identified as "social performance" that can be effectively evaluated through Moskowitz's reputation index, corporate social disclosure, surveys, the company's own vision and mission, CEP's (Council on Economic

Priorities) pollution indexes, and other ways which demonstrate the company's dedication to CSR (Ullmann, 1985).

Agle and Kelley have conducted further research on the topic of CSR measurement based on information collected from political action committee's (PAC) campaigns and United Way. Their main argument focused on the assumption that CSR measurement should involve all three of Wood's areas of expertise: processes, principles, and outcomes (Wood, 2010). The authors support Wood's suggestion that CSR is not merely an addition to the corporate culture or a separate concept existing outside of businesses, which serves the function of improving corporate financial performance (Wood, 1991). Agle and Kelley have made a significant contribution to the definition of CSR by ensuring the validity of measurement and thoroughly studying such business cases as PAC campaigns and United Way. For instance, they have found out that some employees at PAC and United Way were forcibly made to contribute to the organizations' CSR projects. On the one hand, this allows for the companies to fulfill their CSR objectives and create satisfactory corporate responsibility reports. On the other hand, however, it creates questions as to what extent is this type of CSR legitimate. No coercion to make corporate responsibility efforts by employees (or any other stakeholder) should be considered as socially responsible behavior because it undermines employee morality and free will (Agle & Kelley, 2001). These observations once again demonstrate the intricacy of CSR measurement and the complexity of the concept.

Sometimes CSR measurement cannot be categorized into principles, processes, and outcomes. To demonstrate some CSR studies that use different indicators, it is useful to bring some empirical examples. For instance, Stanwick and Stanwick analyzed environmental disclosures through the company's self-report and objective data (Stanwick & Stanwick, 2006). Similarly, such CSR variables like social reports, annual reports, and environmental disclosures were measured by company self-report. Such information sources like Compustat Tapes for years 1979-1984 and Directory of Corporate Affiliations helped categorize data into such domains as corporate social responsiveness, corporate social responsibility, and the company's standpoint on certain social issues (Lerner & Fryxell, 1988). Although this study is comparatively old, it made a great contribution to CSR measurement studies and shows how far research methods have come.

### **CSR Ratings and Databases: KLD, ESG**

Then, some CSR studies have analyzed KLD ratings, Stiller's Ethical Performance Scorecard (EPS), Canadian Social Investment Database (CSID) ratings, ARESE ratings, Vigeo ratings (Europe) all through third-party assessments (Wood, 2010). In one study conducted by Chatterji et al., the authors attempted to check whether corporate social performance transparency can be measured through KLD ratings. The KLD analytics provide some of the oldest and valid data about the environmental and social responsibility activities of businesses. The results showcased that KLD ratings were successful at analyzing the company's past corporate performance: past high pollution levels led to high total environmental concerns (regulatory issues, emission levels, hazardous waste). However, KLD ratings do a poorer job at forecasting future pollution and emission levels. The latter finding made the authors conclude that such social ratings like KLD may not provide sufficient transparency in terms of CSR (Chaterjee *et al.*, 2009).

The ESG (environmental, social, and governance) criteria are used by some investors who are conscious of corporate social performance and sustainability. It has become particularly popular in 2020 and is widely used as a standard of reference when screening investment opportunities. Firstly, the environmental criteria showcase the company's energy use, pollution, waste, toxic emissions, animal protection, preservation of natural resources, and compliance with governmental regulations about the environment. Secondly, social criteria analyze whether a company maintains fair wage levels, encourages diversity, and respects human rights, and sustains ethical practices. And finally, the governance criteria inform investors and other stakeholders if the company participates in any illegal practices, has corruption, or interferes with transparency. For instance, such companies like JPMorgan Chase, Goldman Sachs, and Wells Fargo all continuously review their ESG criteria in their annual CSR reports (Scott & Courage, 2021).

### Readability of CSR Reports

Furthermore, the effectiveness of CSR measurement also depends on the readability of CSR reports. One study was conducted by Wang et al., to investigate the link between the readability of corporate CSR reports and CSR performance. The authors utilized data from KLD analytics as well as the ESG database. They have made a significant finding that the companies with outstanding CSR achievements usually adopt simple language and sentence structure in their CSR reports. This is made to effectively reveal good CSR performance to the public and highlight the stronger sides of the company. On the other hand, those companies which had unfortunate CSR experiences and poor results tend to use complex language and difficult words in their reports to conceal the true meaning of information and lessen the negative reaction of the public (Wang *et al.*, 2017).

Another important finding about the readability of CSR reports is the following: environmental performance of businesses has a lesser impact on readability than the social performance of businesses. This is mainly because environmental performance standards, such as ISO 14000 and ISO 9000, provide managers with standardized formats, structure, and content. For instance, the ISO 14001 sets up clear criteria and practical requirements that companies must fulfill to establish an effective environmental management system (Jong, et al., 2014). This certification allows for more rigid standards of corporate environmental performance disclosure, and it makes CSR reports more truthful and transparent. In other words, certified environmental performance standards make it more difficult for companies to manipulate information and to decrease the readability of their CSR reports (Wang *et al.*, 2017).

From the perspective of investors, looking for suitable investment opportunities, CSR measurement is extremely crucial. They look for high corporate sustainability and corporate social performance (CSP). A study by Artiach, et al., used the Dow Jones Sustainability Index (DJSI) to rate the companies according to their corporate social performance and choose the leading ones. Their analysis of these firms' statistics and CSR reports made them conclude that there is a strong link between the size of the company and levels of CSP. In other words, the bigger the size of the firm the higher CSP they demonstrate. More than that, the authors observed that global CSP leaders are usually the biggest companies in their respective sectors. This link is explained by stronger scrutiny of third parties, such as regulatory agencies, financial organizations, and other important stakeholders, towards the big companies' CSR activities. Additionally, the study revealed that

companies with higher levels of CSP are prone to make more profits. Though, it is important to mention that this conclusion is only based on profitability measured by return on equity (ROE), not return on assets (ROA) (Artiach, *et al.*, 2010).

### **CSR in BP**

BP is one of the global leaders in CSR and sustainability. Ever since the 2000s, it was rated as “best practice leader in CSR” among 122 other companies (CSR Wire, 2001). The company is dedicated to CSR projects by developing alternative energy sources, investing in social issues, taking concrete steps to fight against climate change, and promoting ethical labor practices. But at the same time, BP has also been involved in serious accidents that were inconsistent with their pledge to CSR (Dudovskiy, 2012).

For several years, BP has been known as an environmentally committed company with a grave approach towards corporate and environmental sustainability. It has made serious attempts at differentiating strategies to stand out amongst other energy companies as the most environmentally conscious. For instance, in 2000 BP has adopted a new name, “Beyond Petroleum” in place of the older “British Petroleum”. Moreover, the company’s new logo of green and yellow sunflower signified solar power, highlighted BP’s environmental ambitions, as well as established the “Helios” identity. These were all major parts of BP’s rebranding towards an environmentally aware business that was committed towards CSR. The cost of the PR campaign and marketing activities of this rebranding process constituted around \$200 million for BP (Mejri & Wolf, 2013).

### **Deepwater Horizon Oil Spill**

One of the biggest accidents associated with BP is the Deepwater Horizon Oil Spill of 2010 that happened in the Gulf of Mexico. It is known as the largest oil spill in U.S waters. According to the U.S Geological Survey and the interagency independent scientists, there were around 30,000-65,000 barrels of oil per day spilling into the ocean and contaminating the waters (U.S Department of Energy, 2010). As a result of the crisis, there have been 11 fatalities, many injured and 10,000 people have become temporarily unemployed. Following the oil spill, the U.S government led by Barack Obama issued compensation worth \$20 million for BP to pay out to cover the damages (King, 2010).

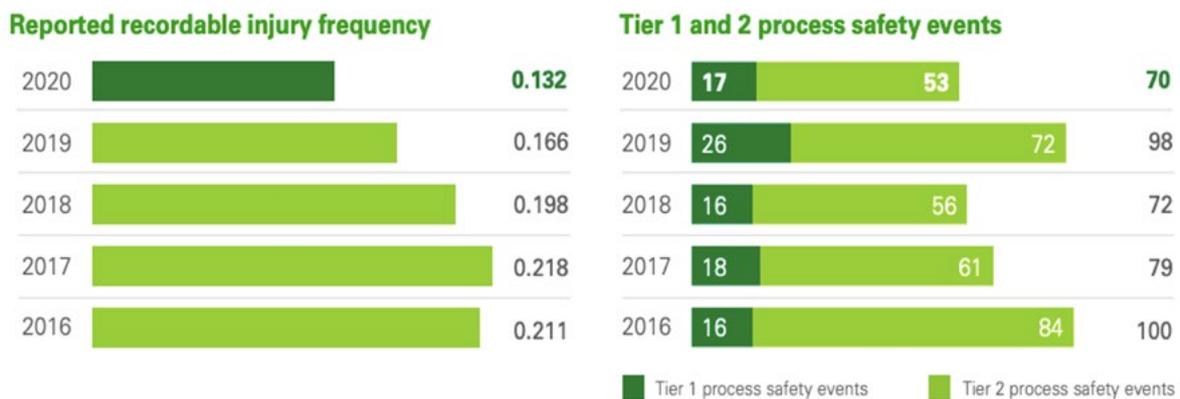
The overall territory of the polluted shoreline in the Gulf of Mexico constituted 1,770 km. The oil spill has made the area’s economic future seem bleak: it has driven down the tourism rate significantly and negatively affected many prevalent industries, such as fishing and farming. BP actively took part in the clean-up efforts for years, however much of the oil either washed ashore and seeped into the ground or compiled in tidal zones, which made it extremely difficult for the logistical departments to remove it and clean up from polluted areas. On the other side, sometimes attempting to remove the toxic waste from the waters and the onshore regions could further harm the ecosystem (Pallardy, 2021).

BP’s CSR report following the biggest oil spill in U.S history provided some safety disclosures. For instance, following the last critical accident in BP’s Texas refinery in 2005, the company has

established an Independent Safety Review Panel and appointed an Independent Expert who oversaw the developments made by the Panel towards safer and more reliable operations. But the important takeaway from BP’s CSR report then was the fact that the company admitted to some faulty safety regulations and low safety records. Furthermore, BP’s report emphasized its recognition of the huge responsibility that the company has, given the effect that its operations can have on the external environment. Nevertheless, most often these types of reports by influential multinational companies are seen as more as “self-promotion” and not “self-reflection” (Mobus, 2012). Therefore, given the voluntary and “self-report” nature of companies’ (including BP’s) CSR information disclosure, it is important to have a third-party observation. The Commission Report analyzed BP’s CSR report post the 2011 Gulf of Mexico oil spill and acknowledged the company’s pledge for sustainable, safe, and reliable operations. But it has been highlighted that BP’s commitment to improving safety practices across its sectors of operation is mostly focused on individual safety not safety in processes (CR, 2011, cited in Mobus, 2012).

**ESG criteria in BP**

As outlined at the beginning of this literature review, there are four main types of CSR approaches that are the most popular and are upheld among global CSR leaders. And the same categories are analyzed by the ESG criteria. BP has set unveiled its goals to be a net-zero company by 2050, in other words, to fully cut down on emissions by that time. The company has ambitions to reinvent the conception of energy and help the world move towards sustainability. According to BP’s ESG Investor Pack, the company has spent \$750 million on low carbon investment in 2020 and achieved a 16% reduction in operational emissions compared to 2019.



**Figure 2.** Foundations of our sustainability frame (BP, 2021)

Moreover, has made considerable progress in reducing methane levels by improving methane intensity by 0.14%. BP also encouraged JVs to set their own methane reduction goals and committed to working under the Methane Guiding Principles (BP, 2021). In addition, BP highlights its serious approach to safety by demonstrating the statistics which demonstrate a lesser number of injuries and more process safety events compared to other years.

When it comes to BP’s social criteria of CSR, the company makes it clear that they have clear approaches towards vulnerable groups, minority groups, human rights such as freedom of speech,

water and sanitation, and land rights. BP implements these commitments in practice through a systemic application of labor rights, regular assessments of policy compliance. On another note, BP's statistics show that the overall percentage of women in leadership has increased in 2020 compared to past years. As of March 2021, there were 42% women among the board of directors and 31% women on executive teams.

As at 31 March 2021	Female %
Board directors	42
Executive team	31
Group leaders	29
All employees	39

**Figure 3.** Workforce by gender (BP, 2021)

Lastly, in terms of transparency of reporting BP is striving to be an industry leader in the authenticity of its disclosures. The company collaborates with TCFD (Task Force on Climate Related Financial Disclosures) and significantly increased its TCFD disclosures in 2020. Furthermore, BP's close partnership with SASB (Sustainability Accounting Standards Board) allows the company to use their standards for oil and gas to develop pragmatic reports for all stakeholders. To disclose valuable information about BP's ESG criteria, the company engages with such ESG ratings agencies as MSCI, CDP (to resume reporting in 2021), and Sustainalytics (BP, 2021). Overall, BP aspires to provide investors and other stakeholders with useful information on ESG criteria that discloses the company's commitment to sustainability. BP's ESG datasheet is presented in an online format and is easily accessible with the assistance of the HSE charting tool (BP, 2020).

## CONCLUSION

There have been considerable efforts by researchers to study the phenomenon of CSR and provide valid and reliable study results. However, the concept of CSR is still comparatively new, and it is developing every day. Therefore, it is essential to consider that CSR cannot be studied solely from one theoretical perspective or framework (McWilliams, et al., 2006). Moreover, the measurement standards for CSR are not formatted across all countries and businesses which makes it more difficult to come to correct conclusions about corporate social performance through their CSR reports. From the literature reviewed above, it can be concluded that BP is making considerable steps towards sustainability although it has experienced serious unfortunate accidents when it comes to its safety practices. Nevertheless, the company is committed to developing its ESG standards and works on improving the transparency of CSR reports with the help of ESG ratings agencies. This study will further contribute to filling the gap in the literature by providing more primary and secondary information to analyze BP's CSR in Azerbaijan.

## **METHODOLOGY**

### **Literature Review**

This study has outlined some existing literature about the theory of CSR, its application in practice, and CSR reporting techniques. The review also demonstrated BP's long-term history with CSR not only in Azerbaijan but in the world, as it is a multinational company. All information was obtained through academic articles, books, journals, reports, and blogs. These sources were accessed with the assistance of such platforms as Google Scholar, Scirus, and databases like EBSCO and ProQuest. These sources were free in their majority, however some required payment. It is important to note that all sources were chosen with objectivity, reliability, and validity in mind. In other words, all authors were credited scholars and academic articles were peer-reviewed. Moreover, to ensure the relevance of the information about the topic of CSR the selected literature was from all regions of the world. In addition, it is also crucial to point out that CSR is a contemporary business concept, but it has a rich history of development. Therefore, the reviewed literature also included sources from earlier years.

Nevertheless, the existing literature is insufficient for a thorough analysis of CSR development in BP Azerbaijan. To provide a suitable framework for analysis, the research will include both primary and secondary findings. Interviews and questionnaires with BP representatives will allow for a more in-depth data collection, whereas reports and other sources will provide the raw data that can be further analyzed. These two methods in combination will complement each other and increase the validity of the study. In addition, the review of literature assisted in choosing this methodology style because it demonstrated the existing separation into CSR components, such as environmental, social, and ethical responsibility of businesses. This, in turn, allowed the methodology to have units of analysis and specific criteria to measure CSR in BP Azerbaijan.

### **Research Philosophy: Pragmatism**

As mentioned above, Saunder's research onion is a useful tool to describe research methodology and have a clearer view of the overall methodology framework. The first important layer to "unpeel" is the philosophy of the research. It is crucial to first identify it because as the research progresses, the knowledge about the chosen research philosophy will provide steppingstones and a foundation to build upon. This research is driven by pragmatism, where there is no specific research philosophy. In this regard, pragmatism is all about the involvement of the researchers and the interpretation of the information, where the goal is to approach the study with maximum practicality (Saunders *et al.*, 2019). Moreover, pragmatism's roots in practicality allow one to effectively measure and evaluate performance in organizational settings (Kelly & Cordeiro, 2020).

### **Approach: Deductive Reasoning**

The second layer of the "research onion" is the approach that is chosen for theory development. In this study, the approach will be focused on deductive reasoning. It is most often used if researchers start with an already existing theory or a framework in mind, then the strategy is used to test that theory or build upon it. Moreover, it implies that the study generalizes from the general to the

specific. In this regard, deduction is used to test and evaluate hypotheses that have been assumed by the study (Saunders *et al.*, 2019). Furthermore, it is important to mention that if deductive reasoning is used as the theory development approach, then there must be a tentative hunch, premise, or an idea that further data collection is supposed to reject or corroborate (Blaikie, 2010, cited in Saunders *et al.*, 2019).

Nevertheless, the nature of the research topic entails that both primary and secondary information gathered about the CSR development of BP Azerbaijan can be particular to this specific case. Therefore, it would be incorrect to limit the study solely to the deductive approach.

### **Strategy: Case Study**

This research will be following the strategy of a case study, as it will be examining the CSR strategy and development of a specific oil and gas company, BP in Azerbaijan. Case studies are often characterized as having a qualitative method and holistic nature. Moreover, case studies follow a data-gathering technique that is based in a real-life context. And most importantly, case studies examine the features of a single example, event, or phenomenon (Gerring, 2007). In recent years, the way that case studies are being utilized as research methods has changed drastically. Most notably, case studies are more frequently integrated into research frameworks that are both qualitative and quantitative. Furthermore, case studies emphasize process-tracing, where research examines and describes processes within and among organizations. Case study strategy stands out in its way of gathering and analyzing information because it makes use of accessible documents, voluntary observations, and interviews (Swanborn, 2010). Similarly, this research study will also follow these techniques and more will be explained in the data collection section.

Case studies allow the research to be approached not just from one perspective, but through multiple perspectives. However, one point that is essential to remember is that case studies should not be examining broad topics, extensive research questions, and numerous objectives at the same time. Scholars have made it clear in their suggestions that case studies are more effective when limited to by certain boundaries. For instance, these limitations can represent definition, time and place, activity, and context (Baxter & Jack, 2008). Moreover, case studies are often presented in a bad light because it is impossible to generalize based on one single phenomenon. However, it depends on the sampling technique and the overall research method. It is crucial to highlight that generalization and extensive applicability should not be prioritized over specific instances (Flyvbjerg, 2006).

### **Case Study Design**

It has been argued that case studies must include certain components that are essential to their research design. The following features are imperative for a case study:

- its research questions
- its hypotheses
- its units of analysis (if there are any)
- the linkage between the hypotheses and the findings
- criteria for evaluating the data (Yin, 2002).

Whereas the hypothesis and research questions have already been mentioned before (they will be further noted in later sections), it is critical to also point out the units of analysis of this research. The focus of the investigation is CSR development in BP Azerbaijan; however, it has been covered by the literature review that CSR is a broad, flexible concept that has many constituents. Therefore, it is important to introduce units of analysis to narrow down the study from the broader “CSR” into several CSR components. In this way, it allows for more accuracy and structure in the research process.

The first unit of analysis is “*environmental efforts of BP*,” which examines the company’s accountability when it comes to the environment. This category focuses on ecological projects, investment in recycling, waste management, and reduction of emissions, as well as budget for environmental programs. As mentioned in the literature review, environmental responsibility is one of the key factors of BP’s CSR worldwide. The second unit of analysis is “*philanthropy and social projects in BP*” and this unit targets the company’s initiatives regarding social programs and volunteering, charity funds, and participation in various philanthropical projects. This allows for the research study to identify whether the company has this prioritized and on its agenda. Lastly, the third unit of analysis is “*ethical responsibility*,” which delves into BP’s ethical practices both inside and outside the company, as well as the attention towards transparency, corruption policies, and human rights. It is important to mention that these units of analysis additionally focus on the attitudes and behavior patterns when it comes to each of them because it is important to remember about the human factor even when it comes to corporate responsibility.

### **Time Horizon: Cross-Sectional**

Another important layer of Saunder’s “research onion” is the time horizon that the study will cover. This study will employ a cross-sectional method of research, where the information gathered about a particular topic reflects the situation at one single point in time (Olsen & St. George, 2004). This contrasts with longitudinal studies, where the study examines a given situation over time. A cross-sectional study is an observational investigation that is the least complex among other study designs because of the lower costs. These types of studies can be descriptive or analytical. On the other side, cross-sectional studies have some disadvantages such as their inability to effectively establish causality and their tendency to have selection and information bias (Pandis, 2014).

Considering the research objectives of this study it can be said that the cross-sectional method is the most suitable. The study aims to examine the CSR strategy of BP at a given point time, not investigate its history of CSR development since the beginning of its operation in Azerbaijan. Moreover, the shortage of time and other practical aspects of conducting this research pose as significant reasons for this choice of study design.

### **Methodological Choice: Mixed**

The mixed choice method for carrying out a research study is getting increasingly more popular in the academic world. In the mixed-method approach, the research involves the integration of both quantitative and qualitative methods of data collection and analysis. The choice of this method is justified through the combined effect of these two research approaches.

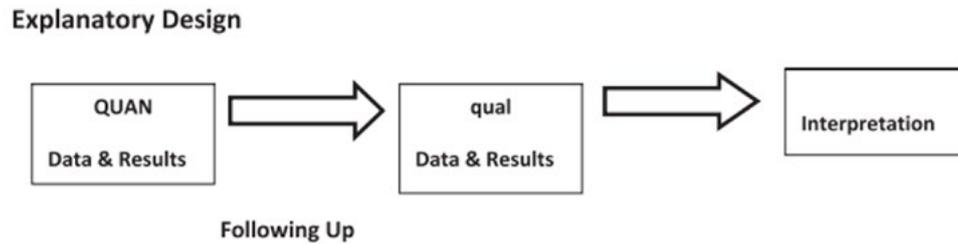
This research study utilizes the mixed-method approach and therefore divides the process into two phases. The study utilizes the quantitative method to gain data on the units of analysis (environmental efforts, social projects, and philanthropy, ethical responsibility) and the qualitative method in addition to strengthen the methodological approach and to complete the information gathered with the quantitative method. It is important to mention that the nature of the research study and its topic implies the prevalence of qualitative methods. This is mainly because CSR can be quantified in a limited way, however, there are major ways in which CSR can be quantitatively reflected.

To expand more on the mixed choice method, it is important to outline that this research study has two phases: (1) the quantitative method involving data collection instruments as questionnaires distributed to the employees of BP Azerbaijan as well as the official reports of the company on its CSR activities, followed by (2) the qualitative method involving an interview with a BP representative knowledgeable in the field of company's CSR strategy and activities. Whereas the first phase allows gathering raw data and quantifiable information to build a foundation on, the second phase further complements by gaining insight on specific topics and acquiring more comprehensive answers.

According to scholars, mixing qualitative and quantitative methods is thought of as an innovative way to solve complex social problems. There are sequential models of a research study in which one method follows the other. For instance, a qualitative method of data collection may precede the quantitative method to lay the foundation and gain valuable insights. Conversely, the quantitative method at the earlier stages may assist the researcher in identifying important sample representatives from which to collect qualitative data. In addition, the mixed method is considered as one of the most efficient ones because of its ability to address various parts of a complex problem with the most suitable approaches (Irwin, 2008).

As a methodological approach, the mixed method has a separate philosophy that guides its data collection and data analysis process by combining quantitative and qualitative methods. This method stands out because of its practicality and usage of various perspectives. Moreover, it is highly evident that the mixed method approach provides more comprehensive findings than a mono-choice method would. In other words, both quantitative and qualitative approaches have their strengths and weaknesses, but in the mixed approach these two complement each other and cancel out each other's shortcomings. As a result, the mixed strategy provides the study with answers that would not be achieved with a single methodological approach (Sadan, 2014).

To this study, a sequential explanatory mixed-method design will be adopted (see Figure 5 below). This type of method completely coincides with the "two phases" strategy described earlier in the chapter. Firstly, the quantitative method will explore the relationship between two variables and gain data. Then, the qualitative data collection process will be used to explore the information obtained in the first stage through a qualitative interview or observations. The reasoning behind the sequential explanatory mixed-method approach is that the qualitative approach can further explain the quantitative information and provide more in-depth findings (Sadan, 2014).



**Figure 5.** Sequential Explanatory Mixed Method (Sadan, 2014)

There are numerous advantages of the mixed-method approach, which are all rooted in the fact that it allows the study to be investigated with all accessible tools and with maximum pragmatism. These advantages include the following aspects:

- Elevated level of data interpretation (increased significance)
- Optimized samples
- Increased applicability of data collection instruments
- Integrity of treatment (Collins *et al.*, 2006, cited in Sadan, 2014)

The following hypothesis was formulated for this research study:

H1: *BP has developed its CSR strategies in Azerbaijan to an adequate level*

### **Data Collection: Quantitative**

The first stage of data collection followed the quantitative method. This method was further divided into two parts: (1) primary data collection and (2) secondary data collection. The first stage involved questionnaires that were digitally distributed to a group of BP employees in Azerbaijan. These questionnaires were in line with the research objectives of this study and aimed to gain information about the CSR development of the company. The sample consisted of 20 BP employees in Azerbaijan. Moreover, the sampling method followed the snowball sampling technique. At the first stage, a representative of the entire population was selected and given the link to the online survey. Then, at the second stage, the selected BP employee chose other participants, and they further distributed the survey to others. In other words, this method allowed for total non-probability in sampling.

Secondly, it was important to analyze BP's reports to acquire statistics and raw data about the company's activities. The analysis of reports is important they are critical sources of information, which can provide the study with valuable conclusions. It can be inferred that conducting questionnaires (primary) and analyzing BP's reports at the same time can allow the study to draw parallels and compare information between these two data collection stages.

The quantitative method is defined as a "research strategy that emphasizes quantification in the collection and analysis of data" (Bryman, 2012). This method assists the research to answer the how many/much, to what extent questions. An advantage of quantitative methodology is that its

findings can be generalized to a bigger sample or a population, because of the random sampling technique (Carr, 1994). Moreover, this method has a prevalent feature of measuring the relationship between two variables, and that is the focus of the research question. However, it is also crucial to note down the disadvantage of the quantitative method. It gathers, analyzes, and interprets quantifiable data, but it leaves out the common meanings of the phenomenon that is being researched. In other words, the quantitative method misses deeper context and nuances that are vital for a comprehensive understanding of the topic (Rahman, 2017).

The questions in the survey (see Appendix) were grouped according to the research objectives of this study. They were categorized with the consideration of units of analysis and aimed to focus on the following aspects: CSR development (including challenges), environmental CSR, business ethics, social responsibility.

### **Data Collection: Qualitative**

The second method used for this study is qualitative data collection, which is utilized at the second stage. It involves an interview with a BP representative knowledgeable in the company's CSR strategy. The interview was aimed at gaining a deeper understanding of CSR of BP in Azerbaijan, as well as the overall attitudes and behaviors that influence CSR development in the company. In this way, the interview built on the information gained from the questionnaires and allowed the research to have more extensive findings on the topic. It is important to emphasize that the qualitative data collection method also includes the analysis of reports because the company's CSR reports include both quantitative and qualitative information.

The qualitative method of research prioritizes the human experience and delves deep into people's minds. It can be said that this method holds abstract ideas and meanings in higher regard than objective facts. When it comes to the major objectives of qualitative research, most literature sources agree that they are the following: to better comprehend human experiences, to develop empathetic skills, utilizing interviews, focus groups, or other qualitative data collection tools as ways to access the "minds" of the people (Silverman, 2020). Furthermore, the qualitative method is also known as the interpretive approach because it interprets situations and actions according to the meanings that people give to them. It is a constructivist method of thinking about phenomena. However, to be successful at this type of methodology it is vital to be adaptable, open-minded, and compassionate (Hennink *et al.*, 2020). Moreover, the essence of qualitative methods lays in the fact that the researcher is an integral part of the process. In contrast, the quantitative method separates the researcher from the data collection and analysis process and minimizes their role to provide an objective study. Here comes the concept of reflexivity, where the researcher acknowledges their place in the research process and realizes that it is unfeasible to achieve complete disengagement with information (Horsburgh, 2003: 308).

In the case of this research study, qualitative methods have a key role. Firstly, an interview with a CSR specialist from BP will allow the study to have more insights into the meanings that BP employees may put into the company's CSR strategies, as well as identify the internal attitudes and opinions. As mentioned before, an interview can reveal bigger meanings and information that may be concealed from quantitative methods. The findings obtained from the interview will be

integrated with the data from questionnaires. Secondly, the analysis of reports can also count as a qualitative approach. This is mainly because the company's official reports contain both quantitative and qualitative information. It is important to emphasize that BP's CSR reports (as well as other reports) play a paramount role in this research because they are the official sources about CSR activities with accurate data.

### **Validity, Reliability, Generalizability**

Considering that this research has a case study design, there are certain features of it that need to be highlighted. Firstly, this research has high internal validity. It means that the study has established a credible cause-effect link between two variables and ensured the trustworthiness of findings (Cuncic, 2021). Moreover, high internal validity in this study is achieved through multiple sources of data and a more complete comprehension of information (Karlsson, 2016). Nevertheless, the external validity of the case study is lower because the transferability of the results is also low. In other words, the study results cannot be as effectively applied in other circumstances and that leads to low generalizability. Lower external validity is linked to the representatives of the sample, which may not reflect the whole picture. However, it is important to remember that generalizability is not as prioritized in this case because this research is a case study, and the results pertain to a specific company of one country. Lastly, the reliability of this study is ensured through the consistent use of research techniques and analysis.

### **Research Ethics**

This research study ensures full anonymity and confidentiality of all participants who answered the survey questions or took part in the interview. The questionnaires were formulated on an online Google Forms platform and did not require the participants to indicate their names or positions at the firm. Moreover, the name or job position of the interviewee was kept confidential and was not mentioned at any point in the study. Consent of all respondents was obtained to use their answers in the study.

## **FINDINGS & ANALYSIS**

### **Introduction**

This chapter describes the findings acquired from questionnaires and an interview. In addition, this section also analyzes the findings from BP's reports. With the assistance of questionnaires, it was feasible to inspect the internal attitudes and knowledge about CSR in the company, whereas the interview added on to the finding and provided more depth to the quantitative survey answers. Lastly, the official reports of BP were indispensable to a valid and reliable research study because they provided accurate data and statistics. The main goal of this chapter is to utilize the information gathered from primary and secondary sources to examine the development of CSR in BP Azerbaijan.

To make the findings more structured, they have been categorized according to units of analysis. As mentioned earlier in the study, the units of analysis are the following: environmental efforts,

philanthropy, and social projects in BP, and ethical responsibility. It is crucial to highlight that the separation into units of analysis was necessary to be able to measure CSR according to its criteria and components, as well as be more specific. In addition, the findings were collected in a way that allowed to answer the research question and test the initial hypothesis formulated at the beginning of the study.

### **CSR Development and Awareness**

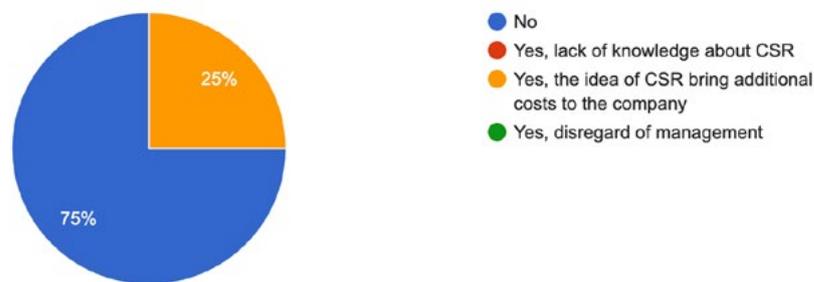
To have an approximate picture of the overall awareness about CSR in the company, the survey asked several questions. These questions aimed to answer the question of whether CSR is a sufficiently popular concept at the company. Firstly, all 20 respondents indicated that BP has a CSR (or Sustainability) Program and that they are aware of it. In addition, all respondents also indicated that this program provides the necessary metrics for the measurement of CSR performance. Indeed, the interview findings also reveal that BP has a clear CSR program from year to year, which is outlined in all company documents, agendas, and reports. Moreover, this CSR program lays out the sustainability goals for the next years in terms of SMART goals. These goals are meant to be specific, measurable, attainable, realistic, and time bound. With the help of CSR programs, the company management can shape the operations and set measurable objectives that are to be achieved in a certain period. It is crucial to add that these goals also include the metrics for measurement. BP utilizes ESG criteria for CSR measurement and their metrics for reporting. The company ensures that its ESG reports are in open access, where anyone can open the charts with comprehensive data on all CSR subtopics. To assist the understanding of BP's sustainability performance, the company allows the reader to access the HSE (health, safety, environment) charting tool that presents information in a readable manner (BP, 2021).

Inasmuch both the survey and the interview asked the respondents about the metrics for measurement of CSR performance, and all respondents indicated that these metrics are extensively used for CSR measurement. As mentioned in the literature review BP was supposed to re-start their collaboration with the CDP rating agency, which is a charity organization responsible for disclosing corporate information for various stakeholders. According to the interview findings, BP certainly resumed their reporting to CDP to ensure transparency in their sustainability performance reports. For instance, in July 2021 BP has handed in a climate change survey and its digital copies are easily available for download for everyone on BP's official site. However, CDP's full report and assessment on BP's CSR performance in 2021 will be posted online at the end of the year. Therefore, it can be concluded that the company heavily invests in its CSR reporting, metrics, and accessibility of CSR-related information.

Next, the survey asked the respondents whether there is a CSR or sustainability officer at BP to assess the employees' knowledge of the topic. As a result, 19 out of 20 people answer the question with "yes" meaning that they confirm the existence of a CSR officer at the company. Whereas one person indicated that they have no sufficient information about the topic and therefore do not know about the existence of a CSR officer at BP. The study's interview participant (who wished to stay anonymous) confirmed that there is a CSR officer in their company, whose job position is called "chief sustainability officer." This person is responsible for coordinating the company's CSR activities and upholding the accountability culture inside the firm.

Moreover, one of the most important findings of the questionnaire was related to employee attitudes and opinions about obstacles to CSR development at BP. The results demonstrate that 75% of surveyed employees are confident that there are no obstacles to a more effective CSR strategy at their company. However, 25% of respondents said that there is an obstacle to CSR development in BP and it is the belief that CSR adds to the costs of the company. In other words, most of the surveyed employees believe that the company is doing its maximum in reaching CSR effectiveness and there are no potential limitations to a more effective CSR strategy that the company faces.

In your opinion, are there any obstacles to a more effective CSR development at your company? If yes, what are they?  
20 responses



**Figure 6.** Survey Findings: Obstacles to CSR

Nevertheless, it is crucial to pinpoint the belief among some employees that CSR brings additional costs to the company, which can act as a barrier to CSR development. This finding coincides with the literature sources reviewed previously, where it is claimed that many businesses do not prefer “green” operations because of their lack of cost-efficiency. Numerous empirical studies prove otherwise, in fact, 92% of studies claim that CSR leads to a net financial profit (Margolis *et al.*, 2009). And although there are considerable costs in carrying out certain CSR practices, the overall short-term and long-term gains outweigh the losses made initially. Most importantly, CSR may be costly, but it creates the necessary shareholder value, which is so vital for companies like BP.

Lastly, the questionnaire findings showcase employee assessments of the corporate efforts made towards the enhancement of CSR and CSR awareness among all worker levels. The results demonstrate that 55% of the respondents “strongly agree” with the statement that their company arranges special sessions to improve CSR understanding among employees. Moreover, 35%, which constitutes 7 people, indicated that they “agree” with the beforementioned statement. Whereas two people revealed that they “neither agree nor disagree” with the statement. No one from the respondents disagreed with the claim that BP organizes events and programs to increase employee understanding of CSR and its importance.

The company organizes sessions to enhance the understandings of CSR among employees.  
20 responses

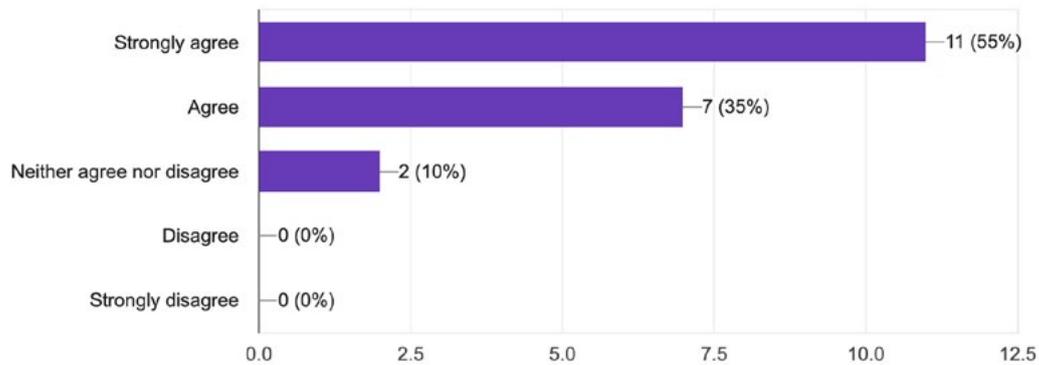


Figure 7. Survey Findings: CSR sessions

The interview findings reiterate the survey results and provide some more depth to the quantitative results obtained there. The interview respondent confirmed that the company organizes meetings to discuss CSR programs and shape the corporate CSR strategy. However, the participant specifically pointed out that the effectiveness of enhancing CSR knowledge among employees of the company is not tied to separate sessions, but the integration of CSR as a topic in all meetings. According to various sources, an effective CSR strategy is linked to internal responsiveness inside the company. In other words, it is crucial to establish trust in the workplace, gain the support of the employees and be inclusive. Responding to the values of employees plays a significant role in building a CSR strategy that is inclusive and reflects the beliefs of the company. For instance, it is feasible to form employee committees or nominate representatives for participation in CSR planning meetings (Mindell, 2021).

### Environmental Efforts

Analyzing the survey results, the study presumes that BP significantly invests in its environmental CSR efforts. For instance, one of the most important indicators of environmental accountability in a company is the regular completion of environmental audits. The questionnaire asked the respondents whether BP performed regular environmental audits to identify the company’s environmental performance and employees’ knowledge of the topic. As seen in the pie chart below, which tracks and showcases all answers to the question, 65% of the respondents answered with “yes, the company performs internal audits”. The rest of the findings gathered from this survey question demonstrate answers focused on “yes, the company performs both internal and external audits.” Overall, the findings separated between two claims: BP performs internal environmental audits, BP performs both internal and external audits. The benefit of environmental audits is that they allow the company to monitor compliance with environmental regulations and laws, make necessary changes in their operations and improve transparency in environmental reports. Although environmental audits are not mandatory, conducting them internally can assist the company in building a more trustworthy image in the eyes of the shareholders. Therefore, it is considered that environmental audits increase the overall financial performance and market value of a company (Lee *et al.*, 2017).

Does the company perform regular environmental audits?

20 responses

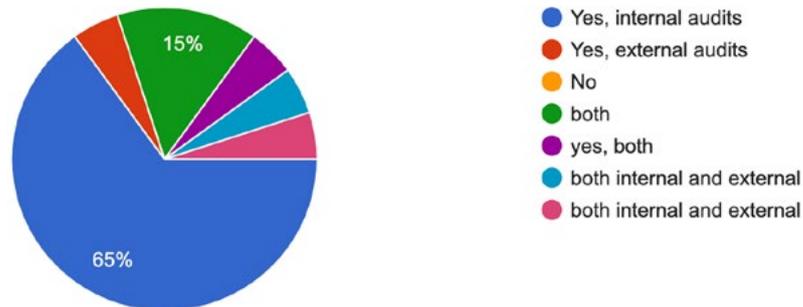


Figure 8. Survey Findings: Environmental Audits

According to BP AGT (Azerbaijan – Georgia – Turkey) reports, the company has special Environmental Management Systems (EMS) that coordinate monitoring and reviewing environmental and social issues in the accordance with the regional laws. In this regard, environmental audits are major components of EMS. The AGT Region together with the oil and gas operators have specific tools and systems in check to audit environmental performance. Moreover, joint auditing checks are also plausible if the circumstances require so, and this is where external auditing plays a significant role. Furthermore, it is crucial to mention the Environmental Monitoring Program (EMP) that is set up by BP AGT Region and designated to keep up with a 10-year schedule ahead. This allows the program to keep track of important data and establish a credible picture of the company’s environmental performance while identifying potential areas of concern (BP, 2013). As suggested by the literature review, such environmental performance standards as ISO14001 establish crucial criteria for maintaining an effective EMS and Compliance Management System (CMS). These inspections allow for timely detection of problems and their eradication. Since 2019, BP Azerbaijan has widened its area of environmental certification further to newly established sites such as Shah Deniz 2 part of the Sangachal Terminal, Shah Deniz Bravo Platforms, and the South Caucasus Pipeline Expansion Project (SCPX) gas export channel.

Another essential part of BP’s environmental efforts is its low carbon agenda. The analysis of BP’s official reports concludes that the company has made serious steps towards decreasing its ecological footprint and developing renewable energy sources. BP has launched several programs such as “Keep Advancing” and “Meeting the Dual Challenge,” established a “Reduce-Improve-Create” operating and management framework, launched the Advancing Low Carbon accreditation program. Official statistics showcase that BP’s methane intensity in 2019 was 0.03% compared to the external target of 0.2%, which shows the company’s dedication to achieving environmental objectives. Moreover, the total reduction in greenhouse gas emissions comprised 37.67 thousand tonnes, which is significantly less than the year before. However, BP’s self-report explains this number by the launch of new facilities in the Shah Deniz 2 project that began operating in the middle of 2018 (BP Azerbaijan, 2019). This reduction in methane intensity completely corresponds

with the literature review findings that BP has set specific goals to cut down on methane emissions and work under Methane Guiding Principles under the ESG framework.

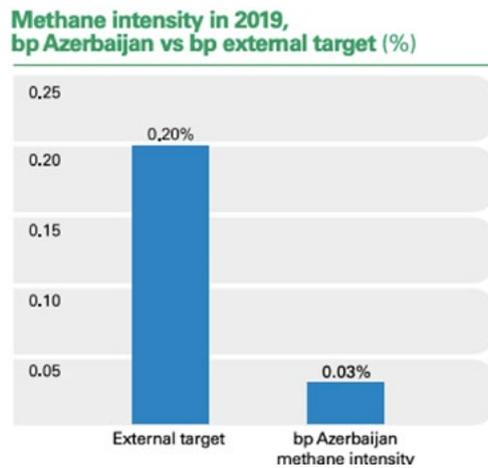


Figure 9. BP Methane Intensity 2019

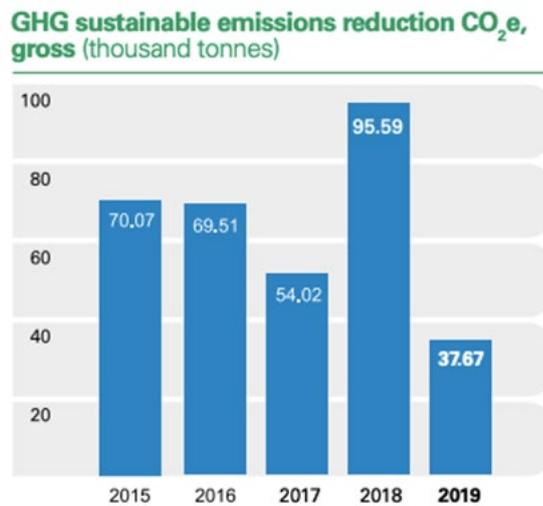


Figure 10. GHG Emissions

### Reduction 2019

In the following year of 2020, BP Azerbaijan has further improved its environmental performance and decreased its methane intensity to 0.02%. Additionally, the company’s official CSR reports state that the total GHG emissions reduction in 2020 comprised 84.48 thousand tonnes, which is a dramatic change compared with the previous year (BP, 2020). These numbers demonstrate that BP Azerbaijan is building its operations based on the Net Zero Agenda and taking meaningful steps to make it feasible. However, the number shown down below are significant for the environment eventually, especially when considering the oil and gas sector in which the company functions in.

Indicator	2020*
Flaring, gross** (thousand tonnes)	112.27
Greenhouse gas emissions, gross (thousand tonnes)	3,141.30
GHG sustainable emissions reduction, gross (thousand tonnes)	84.48
Methane, gross (thousand tonnes)	2.86
Methane intensity	0.02%
Total carbon dioxide (CO <sub>2</sub> ), gross (thousand tonnes)	3,069.83
Energy consumption:	
fuel gas (thousand tonnes)	986.35
Diesel (thousand tonnes)	31.58
electricity import (megawatt hours)	16,929
*For the year ended 31 December 2020.	
**Gross numbers are for all bp-operated production sharing agreements in total and include co-venturers' shares.	

**Figure 11.** Annual Emissions Report for BP Azerbaijan (BP, 2020)

### Social Projects and Philanthropy

The survey findings regarding the social and philanthropic aspects of BP's CSR strategy are concentrated on a few key replies. Firstly, the questionnaire distributed among employees aimed to obtain answers to the following question: does BP participate in any voluntary social projects? All 20 respondents indicated that BP does participate in such projects. BP's CSR report for the first half of 2021 shows that the company has spent a total of 901 thousand dollars on social initiatives, 488 thousand dollars of which were carried out together with other co-venturers (such as SOCAR) in shared projects (BP, 2021). Examples of such social projects include "Build Your Future," where BP assisted children from disadvantaged families with access to higher education. BP Azerbaijan together with its co-venturers in the ACG (Azeri-Chirag-Gunashli), BTC (Baku-Tbilisi-Ceyhan), Shah Deniz, South Caucasus Pipeline projects has been working on the "Build Your Future" program for the last five years. The main goals of the program were to support talented youth, contribute to access higher education, and build a sustainable future for many families. In the scope of this project, BP has sponsored tutoring and training sessions for 11<sup>th</sup> graders from 400 families in the Yevlakh, Garadagh, Kurdamir Agdash regions (BP, 2021). Furthermore, BP (on behalf of its co-venturers in Azerbaijan) social initiatives in 2021 carried out the "Sweet Gold" project, which benefited 530 community members in the regions along the BP-operated pipelines. Throughout this project, the beneficiaries received intensive training, consultancy, and professional equipment for beekeeping and farming. Other prominent projects in the first half of 2021 cover skill-building for women in rural areas, capacity building in the IT and computer sciences sector, and improving infrastructure for impoverished communities (BP, 2021).

**Social spend in Azerbaijan**  
(\$ thousand disbursed)

bp and co-venturers in bp-operated projects	488
bp100%	413
<b>Total</b>	<b>901</b>

Figure 12. BP’s Social Initiatives Expenditures 1H 2021 (BP, 2021)

Another prominent finding from the distributed questionnaire was obtained on the topic of BP’s social initiatives. The answers acquired showcase employees’ attitudes and opinions on the effort that BP makes towards ensuring equal rights, appropriate working conditions, wages, and benefits, as well as protection against discrimination based on race, gender, religion, or ethnicity. The findings demonstrate that all 20 respondents strongly agree that their company ensures full protection of human rights and non-discrimination. Furthermore, 16 and 4 employees strongly agree and agree respectively with the statement that the company provides satisfactory working conditions for them. And lastly, 13 and 7 people strongly agree and agree respectively with the statement that BP enforces appropriate policies to ensure adequate wages and benefits.

This information coincides with the insights gained from the interview, which shed light on the fact that BP organizes regular townhall meetings to listen to employee concerns, established an employee forum, and arranges employee engagement events. In addition, BP invests in local capacity building and enterprise development programs, aids business growth, and strengthens the economy in Azerbaijan.

The company has established policies for the following social issues and is committed to enforcing them:

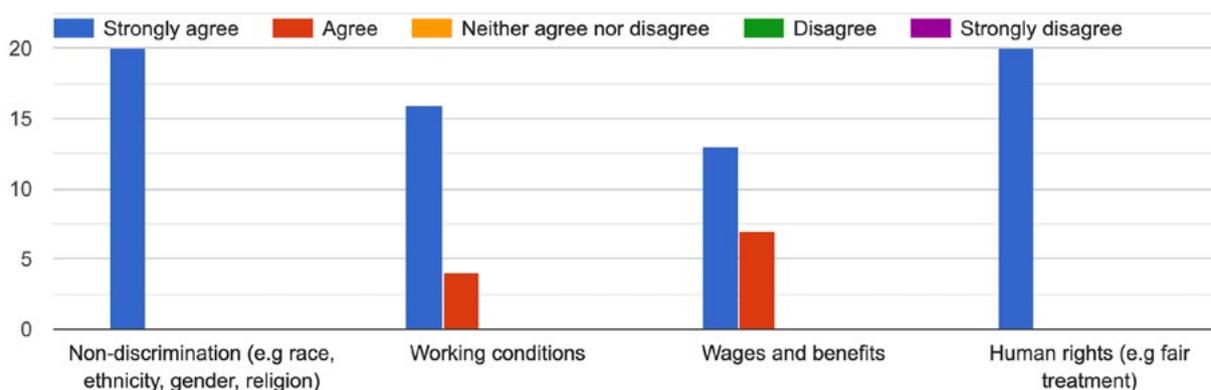


Figure 13. Survey Findings: Social Issues

### Ethical Responsibility

Analyzing the survey results, it can be concluded that all 20 respondents claimed that there are formal policy standards for ethics in BP. The ethical code of conduct in BP is based on the values of the company, which are the following: respect, excellence, safety, courage, one team. These values are the guiding principles for BP’s management principles in recruitment, performance appraisals, promotion, and other management processes. As stated in BP’s sustainability reports, the company is also committed to safeguarding the ethical code of conduct regarding anti-corruption and bribery policies. BP’s code of conduct, which is enforced in every part of the world that the company operates in, forbids corruption and bribery. The company strengthens its ethical responsibility by arranging anti-corruption training regularly, assessing potential risks, reporting, and eradicating them through risk reduction plans (BP, 2020). The interview findings further elaborate on this information by disclosing that BP organizes regular anti-bribery compliance audits inside the firm to monitor its performance.

Furthermore, questionnaire results showcase that the employee respondents in the majority, namely 80%, strongly agree that BP is dedicated to creating an amicable corporate culture and increasing employee satisfaction through rewards and recognition of achievements. Whereas 20% responded with “agree” with the beforementioned statement. It can be presumed that employees recognize BP’s efforts to develop corporate ethical responsibility.

The company is dedicated to creating an amicable corporate culture and increasing job satisfaction through recognition of employee achievements, compensations, and rewards.  
20 responses

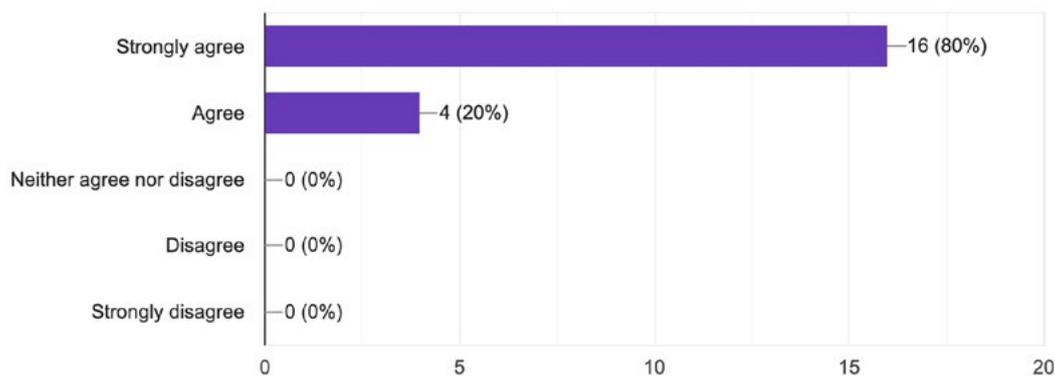


Figure 14. Survey Results: Business Ethics

The examination of BP’s CSR reports in Azerbaijan provides some insights into the ethical aspects of corporate accountability of the company. BP organizes special away days and award ceremonies for employees to recognize achievements and provide an atmosphere for effective networking. Moreover, BP states that it prioritizes the health and well-being of all employees. Therefore, they have launched innovative programs aimed at improving the work-life balance among workers. For instance, such initiatives include shortened work hours on Fridays every week, as well as professional development days (BP Azerbaijan, 2019). The findings and analysis regarding the ethical

responsibility of BP in Azerbaijan are comparable to the literature review. The similarities are in the following factors: BP maintains an adequate living wage for all employees; BP implements regular policy compliance audits to ensure equal and just treatment of all employees regardless of race, ethnicity, religion, or gender; BP increases employee loyalty by enforcing strong ethical standards.

## CONCLUSION

This study has carried out extensive research among different information sources and has met its main research objectives. Firstly, the study has examined the development of CSR in BP Azerbaijan by analyzing the company's various sustainability strategies. Through such data collection tools like questionnaires and interviews, the study was able to gather primary information about BP's CSR culture, CSR awareness, and the attitudes of employees. In addition, the use of BP's official reports allowed the study to compare primary findings with statistics, as well as provide more insights into the acquired data and elaborate on numbers. Moreover, the study was separated into units of analysis, which allowed to have a more narrow and specific view on CSR as a concept. This was implemented on purpose to increase the validity and reliability of the study. The units of analysis were categorized under environmental efforts, social projects and philanthropy, and ethical responsibility in BP's CSR strategy.

The research question posed for this study has been answered by providing data on the main components of CSR, analyzing primary and secondary findings, and examining them in accordance with international CSR standards and ratings. Based on the research findings and analysis it can be concluded that the initial hypothesis proposed in the first chapter of the study can be accepted, and BP has developed its CSR strategies in Azerbaijan to an adequate level. The acceptance of this hypothesis directly answers the research question and indicates the level and extent of CSR development in the company, which was the purpose of the study. Moreover, the research objectives posed in this study focused on the assessment of CSR and sustainability practices in BP Azerbaijan, investigating the company's CSR strategies and their impacts on the society, environment as well as internal corporate climate. These objectives guided the literature review and choice of methodology to obtain relevant findings. As a result of the whole research process, the research objectives have been accomplished and it can be seen in the findings section through the analysis of primary results and their comparison with the existing literature review. The investigation of the company's CSR strategies was done through the research and examination of practices that BP implements, revealed through surveys and the interview. As for the last research objective, the inspection of the relationship between BP's CSR strategies and their impact, the statistics reported in the official CSR disclosures played a significant role and provided an accurate picture of the company's accountability practices and achievements.

The main findings of the research conclude that BP's environmental efforts are sufficiently developed to meet international environmental standards and regulations. The successful development of environmental accountability is further highlighted by the company's collaboration with rating agencies, such as CDP, and their shared efforts to disclose information about environmental performance with maximum transparency for all stakeholders. Furthermore, BP's social initiatives and philanthropy are reflected in numbers, considering the budget it has allocated

for social projects in the first half of 2021. BP's philanthropic projects in Azerbaijan have benefited thousands of people in need ranging from rural women to children in impoverished families with no access to proper education, led to local capacity-building, enterprise development, and overall strengthening of the economy. And lastly, the ethical responsibility of the company is reflected in its code of conduct, corporate values, and formal policy standards that are all enforced through timely audits, townhall meetings, and employee forums. The company has standard procedures set in place for ensuring equal rights, adequate working conditions, and non-discrimination among all levels of management.

Further research can be focused on comparative studies, where the CSR strategy of one specific foreign company is compared with its strategy and practices in another country of the same region. The analysis could highlight the similarities and differences in the results achieved as well as the approach to sustainability depending on geographical location, culture, society, and other factors. Another suggestion for further research includes the integration of only one unit of analysis, such as the environmental accountability of BP in Azerbaijan. By enabling a case-study, the research could narrow down the research question and objectives and systematically analyze a company's impact on the environment in the country of operation.

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## POLITICAL ECONOMY OF RMB INTERNATIONALIZATION

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*Bora Ly & Romny ly*

**ABSTRACT:** *The paper intends to address why the Chinese government seeks to accelerate the process of RMB internationalization. It is based on official data, international agency datasets, and academic publications. The concept of International Political Economy (IPE) is used in this study as its broader theoretical framework can provide a better understanding of the more complex problem of RMB internationalization. Several aspects of the processes will be introduced and analyzed, including infrastructure construction, clearance, Belt and Road Initiative (BRI), Asian Infrastructure Investment Bank (AIIB), and RMB-denominated Commodities. This work employs a qualitative approach to exemplify the problem formulation. Ultimately, the authors will summarize their thoughts to verify the formulated problem and share other perspectives based on some new international perspectives.*

**KEYWORDS:** AIIB, BRI, China, international political economy, RMB internationalization.

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The People's Bank of China (PBC) was officially established in late 1948, concurrently with the birth of the Renminbi (RMB). Gold bonds and silver bonds were no longer circulated since the PBC only traded currencies issued by liberated zones. China has begun a new era in its financial history with the advent of the RMB, which was set for the first time during the country's liberation. The turbulent history of currency flow in ancient China formed a strong foundation for the liberation war in the country. Liberation occurred in 1949 at Guangzhou, Shanghai, Tianjin, Xiamen, and other ports. Keeping in line with government policy, PBC determines and reports the exchange license prices according to local needs, based on the Tianjin port exchange rate. Chinese RMB (old currency) to the US dollar exchange rate was 80 Chinese RMB (old currency) on January 18, 1949. After February 1973, the dollar devalued a second time. Therefore, the following major western countries need not maintain a fixed exchange rate. The international monetary system has also undergone periods of volatility. There is instability in international financial markets because of floating exchange rates. Efforts to minimize damage to the Chinese economy due to inflation, exports, and unfair competition have converted the RMB from a US dollar to a basket of currencies. This work considers the RMB exchange rate against several currencies relevant to Chinese foreign policy.

A reasonable period of cross-border trade settlements and peripheral development began in 2009 under the RMB. RMB internationalization will be formally implemented after the specific situation has been analyzed. According to government regulations or laws, the Central Bank

Digital Currency (CBDC) is a digital version of banknotes. A variety of breakthroughs have been announced in the past few years as China has operated its own CBDC, digital currency, and electronic payment system (DC/EP). According to Xu (2020), the digital currency of China has launched a pilot program in the initial application scenario in Suzhou in Xiangcheng district. It could also significantly affect multi-dimensional economic relations, such as bi-multilateral exchanges, direct investment, cross-border circulation, and so forth.

Despite the RMB playing an increasingly significant role in cross-border transactions, it is still restricted to transactions between foreign companies in China and their parent companies in neighboring countries. This situation opens a wide range of internationalization possibilities for the RMB. In addition to facilitating RMB internationalization, China has launched several pilot schemes for international trade arbitration, currency swap arrangements, and other financial markets. Nonetheless, domestic and external factors remain a challenging factors. The dollar has lost some of its sways but remains the world's dominant currency. In contrast to the rise of the Euro, the RMB is far from the global influence of the Euro. As a result of the global financial crisis in 2008, all nations took steps to prevent a similar catastrophe from occurring again for the next 12 years. Amid the epidemic, the GDP growth of the global economy declined; a new cycle of financial crises was inevitable.

This study aims to discuss possible approaches to overcoming the challenges and providing RMB internationalization with a promising future. Hence, "why does the Chinese government accelerate the RMB internationalization process?" The primary approach for this study is a qualitative method, which documentary analysis and the supported fundamental analysis of economic data sources. The following is the structure of the paper. The first section will briefly review the three perspectives in international political economy theory (IPE): economic liberalism, mercantilism, and structuralism. A subsequent section will describe the history of RMB internationalization, including overall developments and policy adjustments. There will then be a variety of simultaneous processes such as international use, infrastructure building (for payments or clearance), BRI and AIIB, RMB inclusion in SDR, RMB-denominated commodities, the offshore market for RMBs, and RMB digitalization. Finally, this paper will review the posed problem and explain the concept based on the context of the Coronavirus pandemic.

## **INTERNATIONAL POLITICAL ECONOMY (IPE)**

There are three perspectives in IPE: economic liberalism, mercantilism, and structuralism. The viewpoints reflect the relationships between a range of actors and institutions. The stark contrast between these perspectives is subjective and influenced by institutional practice, making it difficult to see how they are related. IPE blends various viewpoints to offer a more comprehensive overview. The flexibility of its study makes it more attractive than other disciplines. That flexibility has always been reflected in social science interpretations of human behavior. Currently, the IPE represents the attempt by political philosophers to return to studying human social interaction before it was separated into separate fields.

There are various levels of analysis used by IPE researchers – the global level, interstate level, state level, and individual level. Although the classification is clearly defined, applying multiple

approaches and combinations with four structures gives the process greater variety. Susan Strange's four structures, such as "production and trade; money and finance; security; and knowledge and technology," are also commonly applied in related analyzes (Balaam & Dillman, 2015: 15). The structure of production and trade is the question of "who produces what, for whom, and what terms lie at the heart of the international political economy. Making things and then selling them in world markets [a global-level process] earns countries and their industries huge sums of money, which ultimately can quite easily shift the global distribution of wealth and power" (Balaam & Dillman, 2015: 15). Finance and monetary policies are among the most abstract forms of international relations; they define who can access money, under what conditions, and how they will be allocated. In this regard, "money is often viewed as a means, not an end in itself. Money generates an obligation between people or states. International money flows [a global level factor] pay for trade and serve as financial investment in a factory or a farm in another country. Financial bargains also reflect rules and obligations, as money moves from one nation to another in the form of loans that must be repaid" (Balaam & Dillman, 2015: 16). Human beings primarily want to feel safe from outside threats and activities. At the international level, the security structure contains "those persons, states, international organizations, and NGOs that provide safety for all people everywhere" (Balaam & Dillman, 2015: 16). Furthermore, knowledge and technology represent a rich and influential resource for those who use them effectively. Thus, "the spread of information and communications technology [a global level factor] has fueled industrialization in emerging countries and empowered citizens living under authoritarian regimes, as seen during the Arab Spring" (Balaam & Dillman, 2015: 16).

In this study, most issues are presented internationally in a liberal way. At the international level, mercantilism is mainly used to explore the root causes of the incident between states. The structural approach explains how nations transform their policies to obtain growth (primarily economic). At the individual level, Trump may be more relevant as an example today than Merkel in the textbook (Balaam & Dillman, 2015).

### **LIBERAL PERSPECTIVE**

Economics liberals (also known as neoliberals) believe the state should play a limited, if not restricted, role in society and the economy. This would explain a growing contradiction between orthodox economic liberals (OELs), who are adamant about free markets and free trade, and heterodox interventionist liberals (HILs), who support more state regulation and trade protection. In recent years, HILs have begun to stress that markets function best when embedded in (connected to) society. The government intervenes to resolve problems that markets alone cannot solve. It is widely acknowledged that markets are the source of many of these problems. A continuing focus of HILs is that markets work better if they are rooted in (related to) society. The state intervenes when concerns arise beyond the scope of market action.

In many cases, the market causes these problems itself. The importance of Keynes was that he used the uncertainty to describe the economy -- not rational expectations -- and advocated management that served the interests of society over the interests of the wealthy. As a result of the crisis, the HILs claimed that states would intervene to preserve capitalism and the financial

system. It is interesting to note that some OELs agreed. For example, in a Financial Times piece titled “The Seeds of Its Own Destruction,” the OEL Martin Wolf acknowledges that “the era of financial liberalization has ended and that the state can be expected to play a more significant role in rescuing banks and adopting other interventionist measures” (Balaam & Dillman, 2015: 46).

According to Balaam and Dillman (2015), the most often discussed HIL proposals are: “spend more to grow the economy, without worrying about inflation. [...] create more jobs; invest more in new technology for energy and transportation, infrastructure, education, and health care; impose tougher regulations on banks related to derivatives, deposit requirements, pay, and bonuses; break up big banks to increase competition; better manage globalization, but without stopping it” (p. 46). Because of these factors and others, OELs favor a free-market characterized predominantly by *laissez-faire*, with a few less active reform measures. Furthermore, Balaam & Dillman (2015) propose to “limit government support for banks, infrastructure projects, and social welfare programs; decrease regulation of many parts of the economy; cut taxes of the wealthy and middle class to stimulate economic growth; foster more globalization, which is good for the United States and the world” (p. 49).

### **MERCANTILIST PERSPECTIVE**

The mercantilist system is the oldest and most psychologically integrated of the three forms within the IPE. Wealth and power are essential for maintaining and ensuring stability and freedom. Realists emphasize a greater variety of physical challenges, whereas mercantilists emphasize economic challenges in a country. Both realists and mercantilists advocate using military and financial measures to avoid war.

The primary purpose of mercantilism is to protect citizens and governments. Secondly, mercantilism provides ample evidence that states have always controlled markets. Such demands cannot benefit if the state cannot embrace, sustain, and handle them. Additionally, their pursuit of liberal economic aims includes opening markets and promoting free trade if these priorities align with national interests. In addition, despite what economic liberals suggest, globalization has not reduced the capacity of states to protect themselves. Internationalization, however, has exacerbated national insecurities by creating tensions and conflicts. Finally, mercantilists claim that states struggle with the recent financial crisis and other global issues. The philosophy of *laissez-faire* became politically ineffective during the 1930s due to pressures on the state to reach more voters and have higher standards. The Keynesian economist offered a more positive view of how developed nations would rebuild their economies. Keynes believed that recessions and depressions could last long despite frequent economic collapse. Therefore, it was crucial for states to improve the national economy by increasing employment, improving social impact on unemployment, and restoring confidence in the capitalist system for the people to be less inclined to follow authoritarian leaders. After World War II, Keynesian ideas shaped Bretton Woods institutions, namely, GATT, IMF, and World Bank. There is also an argument on the economic liberals that the US and its allies created a new international political and economic order (without the Soviet Union and China), with different goals. It is on this basis that the GATT was established.

The IMF has eradicated currency discrimination. World Bank programs have helped Europe recover from the war and the least developed countries (LDCs). Additionally, US leaders noted that a gradual opening of foreign markets would prevent the mercantilist wars that ravaged states under US leadership before World War II. Political economist Robert Gilpin argued that states had difficulty choosing correct countermeasures without understanding their intentions. A mercantilist can either be aggressive or benevolent. In the first activity, nations use more aggressive measures to extend their power geographically and/or politically and economically to areas generally considered adequately secured at the expense of other countries. Beneficial mercantilism, on the other hand, is defensive since “it attempts to protect the economy against untoward economic and political forces” (Balaam & Dillman, 2015: 64). It is more challenging to distinguish the two in an environment where the difference is more of a question than a kind of difference.

There are two specific neo-mercantilist policies: industrial, infrastructural, and strategic resources. The first aim is to encourage industrialization and constructing infrastructures. At the same time, the latter focuses on the scramble of (rare) resources, which could be part of a nation’s energy security. For instance, the US is categorized into the latter category. Foreign investments in some countries are restricted in less obvious ways, typically to protect their independence and sovereignty. For example, the government can limit foreign shares in domestic firms (e.g., oil companies) or prohibit foreign investment in strategic industries such as natural resource exploration, energy generation, banks, and media. In addition, foreigners often complicate real estate acquisition for constructing factories or accumulating office space. These policies also provide an edge for domestic businesses or discourage foreigners from influencing the economic sector by pressuring them to cooperate with the local industry.

In addition, neo-mercantilists assume that state-to-state relations are not always symmetrical. It appears that suppliers of essential resources and commodities, such as oil, see their reliance on others as a positive factor that boosts their security and power. There may be situations in which the relatively high cost of oil and supplier threats of cutting it off to client states threaten national security due to dependency or vulnerability to a supplier of such energy. There are also rare earth resources that are competing for national attention. There have also been tensions between China and some partner countries because of rare earth. In an ideal world, a nation-state would survive economically and politically only by self-sufficiency in raw materials.

Over the years, mercantilist concepts have developed and adapted themselves to changing circumstances in the IPE. A realist or mercantilist would observe that states can also engage in economic activities to generate a greater yield of wealth and power, whether legally or illegally. A significant reason for the emergence of economic and broader national security concerns was the end of the Cold War in 1990. The world is not ready for mercantilists and realists to rule for long today. There should be a more inclusive approach to the invisible hand since HILs agree with mercantilists.

## **WORLD SYSTEM AND STRUCTURALISM**

Structuralism is rooted in Karl Marx, but it involves many activists and scholars today. Most structuralists acknowledge that the present capitalist system is unfair and exploitative but agree

it can be transformed into one that fairly distributes economic output. Marxists view it as a great tragedy that capitalists exploit workers and use their beliefs to neglect or ignore the exploitation. “Marx’s four main contributions to IPE—the definition of class, class conflict and the exploitation of workers, control of the state, and ideological manipulation”— are separated from “his theory of history, which predicted the inevitable collapse of capitalism and its replacement with socialism (and ultimately communism)” (Balaam & Dillman, 2015: 97).

Neo-imperialism describes a subtler, younger form of imperialism, affirmed after the US and other industrialized nations ended the Vietnam War in 1975. Other critics blame multinational corporations for exploitation and natural resource extraction and seeking cheap labor in developing countries. Furthermore, dependence theory is a structuralist perspective that focuses on the links between the core and peripheral countries while simultaneously highlighting the constraints imposed by the peripheral countries. Instead, they criticize a progressive liberal interpretation of free trade and deregulation that leads to exploitation, inequality, unemployment, and poverty in power imbalances between capitalists and employees and between wealthy and poor.

Global monetary and financial systems remain shaky and uncertain at present. There has been an increasing decline in the importance of the IMF and the World Bank in currency exchange supervision and lending. It is common to assume that trade surplus economies will avoid maintaining sizeable foreign exchange reserves as a self-assurance against the need for IMF loans from some OELs and HILs. As a result, China, Japan, and Saudi Arabia would increase domestic consumption and spending in their currencies.

In the seventies, the social historian and sociologist Immanuel Wallerstein first developed the world system theory. Then, in the 1950s and 1960s, Wallerstein became the critical reaction to the first modernization theory (Chirot & Hall, 1982). In its original definition developed by Wallerstein (1974), a world system is “a multicultural territorial division of labor in which the production and exchange of basic goods and raw materials is necessary for the everyday life of its inhabitants” (p. 347).

It is also a macro-sociological perspective that seeks to explain the dynamics of the “capitalist world economy” as a “total social system” (Martínez-Vela, 2001: 1). A world-system is what Wallerstein refers to as a “world economy” embedded in the market, rather than a political center, in which two or more regions are interdependent on resources such as food, fuel, and security, and two or more polities compete for dominance indefinitely without the emergence of a single-center (Goldfrank, 2000).

A few concepts appear to highlight the political side of the world system. For example, national states are variables within it. The class powers utilize the strong core states to achieve their goals (Martínez-Vela, 2001). According to Martínez-Vela (2011), imperialism is about “the domination of weak peripheral regions by strong core states” (p. 4). Hegemony is about “the existence of one core state temporarily outstripping the rest” (p. 4). Hegemonic powers uphold “a stable balance of power and enforce free trade as long as it is to their advantage” (p. 4). Also, it is the interregional and international division of labor, based on the principles of core, semi-peripheral and peripheral countries (Martínez-Vela, 2001). They are geographically and economically distinct,

characterized by labor-intensive and capital-intensive production, respectively (Goldfrank, 2000). Core-periphery relationships are structural. Between the core and the periphery, semi-peripheral countries have a combination of different activities and institutions (Skocpol, 1977). Globalization has increased, and there has been a rapid expansion of the world economy from the Netherlands, UK, and US. Despite being a semi-peripheral state and a significant power, China poses certain contradictions in theory.

### **THE RMB INTERNATIONALIZATION IN A NUTSHELL**

The Chinese government has pushed to internationalize its currency in the aftermath of the global financial crisis in 2008. For this purpose, the authorities of China initiated and expanded its hallmark pilot program for the cross-border trade transaction settlement of RMB in these years to cover entire China, enabling the currency to perform international trade functions such as “Unit of Account” and “Medium of Exchange” (Frankel, 2012). As a result, the RMB became an international currency widely used for international trade, finance, funding, and as a reserve currency for foreign reserves (Ly, 2020). As a result, the RMB has become an international currency. The RMB cycle is making the currency more and more valuable internationally (Ly, 2020). As a result of the current global currency system, the RMB needs to go through a long and challenging process to become one of the major international currencies. The financial crisis of 2008 shook up the global currency system, which is dominated by the dollar. According to Ly (2020), global investor confidence in the US dollar was greatly affected by the Federal Reserve’s quantitative easing policy (QE) and the financial crisis, resulting in RMB internationalization. US financial resources create trade deficits. US economic contribution is roughly one-fifth, but trade has decreased to 10% (Ly, 2020). US dollars constitute approximately two-thirds of official global reserves and are the only super currency. A market deficit to sustain the US dollar’s superposition will only lead to problems like problems with US dollar stocks, issues with the dollar asset bubble, the extension of the subprime mortgage crisis transforming into a global crisis, and problems with US domestic monetary policies spilling over into the global economy.

The rapid growth of international trade and investment strengthens the position of the RMB in the global market. Increasingly, countries are adopting the RMB as a cross-border currency and price benchmark. Equally, China has entered into trade swap agreements with over 30 countries (Ly, 2020). In addition, RMBs are growing in size and distribution outside of China due to the frontier exchange, national monetary coordination, RMB foreign direct investment, and the Hong Kong offshore RMB hub.

### **INTERNATIONAL USE OF THE RMB**

Intergovernmental organizations have listed RMB as an international reserve currency. The scale of RMB reserves reached USD 202.79 billion based on IMF COFER data, representing 1.89 percent of total foreign reserves for designated currencies by the end of the 4th quarter of 2018, and ranking sixth and above 1.62 percent of AUD and 1.84 percent of CAD, which had been the highest level since the IMF publish RMB reserve assets in 2016 (PBC, 2019). As a result of

the internationalization of the RMB, more than 60 central banks and monetary authorities have RMBs as foreign exchange reserves (Ly, 2020).

Despite the growth of the RMB, its share in global reserve currencies remains too low. Following the latest data released by the IMF, global foreign reserve assets totaled USD 10.73 trillion at the end of Q4 2018. USD assets covered 61.7 percent, declining for three quarters (PBC, 2019). The EURO amounted to 20.7 percent of the global official foreign reserve assets as of the end of the fourth quarter of 2018, which was the highest level since the fourth quarter of 2014. Simultaneously, the JPY and the Pound assets accounted for 5.2 percent and 4.4 percent of the global official foreign reserve assets (PBC, 2019).

### **USING RMB IN NEIGHBORING COUNTRIES**

Cross-border RMB transactions between China and its neighboring countries totaled RMB 3.1 trillion in 2018, with a year-on-year increase of 46.3 percent, exceeding the average increase rate (PBC, 2019). Accordingly, RMB settlements under the current account reached RMB 1.1 trillion, increasing 13 percent yearly. Moreover, cross-border RMB direct investment settlements amounted to RMB 282.8 billion, rising 68.1 percent annually. Therefore, cross-border RMB settlement accounted for over 40 percent of total cross-border RMB settlement (PBC, 2019).

Among them, cross-border RMB settlements with Nepal surged ninefold year on year, Belarus increased sevenfold, and thirteen nations including Singapore, South Korea, Russia, and Thailand increased by more than 50% year on year. Fifteen international central banks, including Singapore, South Korea, Russia, and Cambodia, have incorporated RMB assets in their foreign exchange reserves (PBC, 2019). China has established clearing arrangements for RMBs in six neighboring countries, local currency settlement agreements with nine neighboring countries, including Vietnam and Kazakhstan, and contracts for local currency swap agreements with central banks or monetary authorities in fourteen neighboring countries, including Mongolia and Japan. Regional trading of RMB against Thai Baht was extended to the national interbank exchange market in February 2018. In addition, a direct quotation and position squaring mechanism was launched in September for RMB against Kazakhstani Tenge and the first batch of overseas banks joining regional trade in the interbank foreign exchange market. Thus, the RMB trading system against Kazakhstan Tenge was initially established based on the bank-counter listing and supported by regional trading on the foreign exchange market of the interbank (PBC, 2019).

Additionally, China initiated the “Port Interconnection Information Service Platform” and the “China (Xinjiang)-Silk Road Currency Regional Trading Information Platform” in 2018, and the implementation and completion of the bank account service platform for overseas border residents, which encouraged border residents to participate in border trade (PBC, 2019, p. 82).

### **MULTINATIONALS EMBRACE RMB FOR CROSS-BORDER TRANSACTIONS**

China has been an essential player in the global layout of multinational enterprises since its national strength is comprehensive. For instance, According to PBC (2019), “eighty-three of the top five

hundred companies globally had set up regional headquarters in Shanghai to undertake various functions such as fund management, procurement, sales and settlements in China” (p. 85). The total value of cross-border RMB transactions made by multinational firms in Shanghai reached RMB 174.2 billion in 2018, comprising 54 percent of their total cross-border receipts and payments in RMB and foreign currency (PBC, 2019). It was the first time that cross-border RMB settlements exceeded foreign exchange settlements. Among them were twenty firms with a share of RMB cross-border receipts and payments exceeding 90 percent. It is reported that many multinational firms are considering settling all their cross-border Chinese business in RMB (PBC, 2019).

The cross-border RMB economy has brought tangible benefits to multinational firms. The first benefit is the avoidance of exchange rate risks and exchange costs. Secondly, operational costs in the supply chain were reduced, allowing upstream and downstream firms to focus on their core competencies. Third, the efficiency of cross-border fund settlement was facilitated. Fourth, the discourse of the regional headquarters of international corporations in China should be enhanced. Therefore, many multinationals in China actively pushed their parent companies to use RMB for Chinese-related businesses and hand over their global RMB assets for centralizing operations to domestic firms (PBC, 2019).

RMB exchange rates have fluctuated since 2018. However, multinationals have not reduced their cross-border use of RMB, indicating that they rely on cross-border RMB settlements in certain respects. Therefore, it is clear that cross-border RMB policies will not change, and the current business environment will endure. Further, they wish to enhance the free accessibility of the RMB and to improve policy convenience (PBC, 2019).

## **MARKETS EMBRACED PANDA BONDS**

Global investors have become increasingly interested in Panda Bond due to China’s two-way opening of its financial markets in 2018. The issuers have expanded further as a result, and the issuance scale has risen substantially. Panda Bonds issued by non-financial companies increased the most in 2018. According to PBC (2019), at the end of 2018, sixteen corporations gave 36 Panda Bonds worth RMB 62.7 billion, a 191.6 percent increase over the previous year. In addition, a total of RMB 5.5 billion in Panda Bonds have been issued by the Philippines, the United Arab Emirates, and Hungary (PBC, 2019).

Similarly, five countries have issued eight sovereign Panda Bonds — Canada, Hungary, Poland, Philippines, South Korea, and the United Arab Emirates. At the end of 2018, there was a total issuance of almost RMB 16.5 billion (PBC, 2019). In addition, four financial institutions, including MUFG Bank, Mizuho Bank, ABC International, and BOCGI, issued four Panda bonds with the total issuance of RMB 6.5 billion. The size of non-financial bond issuance was the highest in 2018, accounting for 84 percent, while the bond issuance of financial institutions and foreign governments was 8.7 percent and 7.3 percent, respectively (PBC, 2019).

With the development of the Panda Bond market, the enthusiasm of investment institutions had been steadily increased. In 2018, the institutions involved in the Panda Bond investment

expanded, and rural commercial banks and urban commercial banks gradually participated. The investment scale of domestic foreign commercial banks, including HSBC (China), MUFJ (China), and Mizuho (China), had dramatically increased. In 2018, total investments of foreign commercial banks surpassed RMB 1.3 billion, which was three times as figure as in 2017. In addition, foreign investors have raised their enthusiasm. Foreign investors had subscribed to many Panda Bond in recent years. In issuance cases for Canada, Hungary, and the Philippines, the subscription of foreign investors accounted for 55 percent, 73 percent, and 88 percent, respectively, including sovereign wealth funds and foreign central banks. As a result, Panda Bond has played a significant role in the Chinese bond market with foreign issuers and investors (PBC, 2019).

In September 2018, “the Interim Rules for the Administration of Bond Issuances by Overseas Institutions on China’s Interbank Bond Market (PBC and MOF Public Announcement [2018] No.16)” were jointly released in September 2018 by the PBC and by the MOF, which comprehensively standardize the bond issuance processes of four types of China financial institutions, including issuance approval, registration, custody, settlement process (PBC, 2019, p. 91). Having the rules in place was critical for a sound and standardized market for Panda Bonds. In addition, increasing RMB internationalization and opening the market would lead to more opportunities for Panda Bond (PBC, 2019).

Furthermore, Bloomberg announced its inclusion in the April 2019 Bloomberg Barclay Global Composite Index of Chinese government bonds and policy bank bonds in March 2018. Similarly, Bloomberg officially included Chinese bonds in their index in April 2019, and RMB bonds became the fourth currency component of the index after the USD, EUR, and JPY, which was the first time that RMB bonds appeared on the three major international bond indices (PBC, 2019). As a result, China has strengthened its global monetary and financial structures.

## **RMB CROSS-BORDER INTERBANK PAYMENTS**

In 2012, the PBC began the RMB Cross-Border Interbank Payment System (CIPS). In these years, the role of CIPS has been continuously strengthened, the number of participants has increased, and business volumes have expanded. Participants have widely recognized the effectiveness of clearing and settlement. In October 2015, CIPS (Phase I) was introduced to provide real-time gross settlement support for payment businesses, such as payment forwarders and financial institutions, which meet the settlement needs of cross-border RMB companies, investment, and finance in major time regions worldwide (PBC, 2016). CIPS has met the settlement criteria for Bond Connect following its official launch in July 2017. Through Hong Kong, CIPS connected China to various economic markets and promoted delivery-versus-payment (DVP), which covers spot trading, bonding, and buying mainland bonds, satisfying the needs of foreign investors wanting to invest in mainland bonds without having to change their businesses (PBC, 2018).

CIPS (phase II) was launched in May 2018, and the deferred net settlement (DNS) model was introduced. Also, the operating hours had been extended from 5×12 to 5×24+4 hours, covering the working hours of all financial markets in every time zone around the globe (PBC, 2018). As a result, as of May 2018, “the RMB Cross-border Interbank Payment System (CIPS) had thirty-one

direct participants and seven hundred and twenty-four indirect participants, covering six continents, eighty-seven countries, and regions” (PBC, 2018, p. 76).

The CIPS settled 1.44 million of total payments in 2018, which amounted to RMB 26.45 trillion, with a year-on-year increase of 14.6 percent and 81.7 percent, respectively. The typical daily reached 5,724 payments accounted for RMB 105 billion, among which the customer remittance business reached 1.07 million settlements, accounting for RMB 4.63 trillion. The financial institution remittance business got 0.36 million payments, which accounted for RMB 21.24 trillion. The bilateral trade amounted to RMB 575.8 billion, and the batch business reached 15,000 costs, which accounted for RMB 57 million (PBC, 2019).

In 2018, the CIPS accomplished 7,478 in the Bond Connect funds settlement payments, which accounted for RMB 893.1 billion. From the perspective of bond trading, overseas institutions paid bond purchases amounted to RMB 559.8 billion and paid the bond sale, which accounted for RMB 333.3 billion. From a domestic custodian institution’s standpoint, China Central Depository & Clearing Co., Ltd. settled 4,721 payments of custody funds, which accounted for RMB 441.4 billion. In addition, Shanghai Clearing House paid 2,757 fees of custody funds with a balance of RMB 451.6 billion (PBC, 2019).

## **CROSS-BORDER PAYMENT FOR RMB**

To support the development of the trans-border RMB pilot program, the PBC launched the RMB Cross-border Payment Management Information System (RCPMIS) in July 2009. RCPMIS was the only national information management system in China that monitored cross-border RMB payments. RCPMIS has continually tailored its performance to meet business development needs since its conception. Following several improvements and reconstructions, business information, flow information, and stock information on cross-border RMB, receipts and payments were incorporated into the system. Additionally, the PBC has upgraded its statistical and reporting functions to accommodate its needs for cross-border settlement analysis, tracking, evaluation, and macro-control decision-making. As of 2018, a total of 424 incorporated banks and clearing banks in Hong Kong and Macau linked to RCPMIS, with 69,000,249 active users and over 33.78 million retrieved data and information (PBC, 2019).

## **OPERATING CROSS-BORDER TRANSPORT OF RMB BANKNOTES**

Transporting RMB banknotes across international borders has continued to increase in volume since 2009. The significance of cross-border banknote transportation grew from RMB 10.9 billion in 2009 to RMB 117.1 billion in 2018, with an average annual growth rate of 28.9 percent. Transport of RMB banknotes before 2009 mainly took place in Hong Kong, Macao, Taiwan, Mongolia, Vietnam, and other areas. A clearing bank in Hong Kong, which had been in operation with the Bank of China (Hong Kong) since 2010, provides a channel of supply and backflow of offshore RMB banknotes that is gradually being extended internationally. The banks used three modes of cross-border RMB banknotes: overseas depository vault, overseas clearing bank, and correspondent bank. Furthermore,

the secondary market for overseas RMB banknotes was continuing to grow. By improving the overseas RMB clearing mechanism, transportation, and deposit and withdrawal environments, it became increasingly convenient to obtain RMB banknotes abroad (PCB, 2019).

## **BRI AND AIIB**

In 2013, China announced its international growth strategy, which asserted its position as a vehicle for global economic growth. It was eventually incorporated into the Communist Party reform blueprint as one of three illustrated governance initiatives for 2020 (Huang, 2016). Furthermore, BRI comprises over 150 countries and organizations that account for approximately 70 percent of the global population and over 50 percent of global GDP (Jizhong *et al.*, 2020). As part of the BRI, China invests in building critical infrastructure, including ports, airports, highways, railways, pipelines, and power stations (Tao & Zhong, 2018). In addition, the program facilitates international transactions that benefit China and its participating nations in terms of national infrastructure development, economic growth, and human well-being (Tao & Zhong, 2018).

AIIB has achieved something that its Asian competitors, the Asian Development Bank, have not achieved through the BRI's multilateral funding mechanism. The AIIB was officially launched on January 16, 2016. The legal framework of the bank is one of the joint International Financial Institutions (IFIs). The IFIs and Multilateral Development Banks (MDBs) are intergovernmental organizations (IGOs). So, it should not be confused with NDB, a state bank that aims to promote development at its border. By the end of 2019, the ADB had 68 members, a steady surge from the 31 members in its founding year of 1966; whereas by the end of the fiscal year of 2019, there were already 102 approved members in the AIIB, a surge from the 57 founding members at the start of 2016 (ADB, n.d.; AIIB, 2020). Present AIIB membership also comes from other non-regional nations, including Germany, France, and the United Kingdom. Occupying 26.6 percent of votes, China is the biggest holder of the AIIB. The institution's outlook is primarily to promote sustainable economic development in Asia and "promote regional cooperation and partnership in addressing development challenges by working closely with other multilateral and bilateral development institutions" (AIIB, 2015).

As a result of the BRI and AIIB initiatives, China will achieve economic and diplomatic strategic goals (Cai, 2018). Despite its importance to the Chinese economy and its geopolitical impact throughout Asia and the world, the AIIB is dependent on the supply chain's safety, which implies a need for international trust and support (Zha, 2015). The Chinese are not seeking hegemony (Ly, 2020). Nonetheless, it recognizes the importance of equitable global production and its role in reaching that goal. China is exactly what is revered as an embodiment of the "Chinese dreams." The BRI, AIIB, and NDB initiatives reflect its long-term strategy as the emerging global hegemon, frustrated with world economic governance, where its presence in current multilateral institutions such as the ADB, IMF, and WB does not meet its economic powers as the world's second-largest economy and largest trading nation.

Both AIIB and BRI intend to expand the feature of storing RMB values. As a result of improved economic cooperation, the RMB is more likely to be included in the international reserves of

Asian countries, thus contributing to the swap agreement. Additionally, it will promote the global status of the RMB and encourage its internationalization. The RMB also serves as a private-sector financial asset for storing value internationally.

The AIIB will also stimulate the internationalization of the RMB in the private sector. According to Ly (2020), it is estimated that USD 1.7 trillion annually will be required to sustain the growth momentum in Asia. Businesses must double their infrastructure investment by 2020 from 63 trillion dollars to 250 trillion dollars (Ly, 2020). Government reforms could bridge up to 40 percent of the infrastructural gap in Asia, with the rest being undertaken by the private sector (ADB, 2017). A large-scale fundraising effort is required since AIIB cannot fill such a wide gap, so Chinese domestic investors will have a chance to invest internationally (Ly, 2020).

The AIIB and BRI will extend their RMB pricing capabilities. The development of AIIB will facilitate the building of infrastructure in Asia. As a result, Chinese companies are actively building their networks. In the long run, it will make China and BRI countries more economically connected and increase transboundary investment and trade (Ly, 2020). It is crucial to reduce US dollar dependence and lower currency risks to encourage cross-border business. Therefore, there is an excellent chance for RMB to become the price and settlement currency of the BRI region (Ly, 2020).

The rise of China destabilizing the second periphery is challenging the US order of the world. Since the BRI was launched, the Western media has increasingly highlighted Chinese debt-trap diplomacy. One notable example is the principal port of Hambantota, a small fishing town in southern Sri Lanka, which the Exim Bank of China developed. Because the government of Sri Lanka could not repay its debt, it was leased to a Chinese state-owned enterprise (SOE) for 99 years in 2017. Although the Chinese authorities announced that the port was used exclusively for commercial, the US, India, and Japan have expressed concerns that China could use it as a naval base (Aneez & Sirilal, 2018). The rise of China could influence the world order led by the West. In a nutshell, it indicates the transition of China from rule-follower to rule-maker, but it is not sufficiently precise. The development of each nation depends on its reasons, and all countries are concerned that others have too much power. However, China is poised to rise peacefully. According to Zheng Bijian, “the only choice for China under the current international situation is to rise peacefully, namely, to develop by taking advantage of the peaceful international environment, and at the same time to maintain world peace through its development” (Medeiros, 2004).

## **THE INCLUSION INTO SDR OF RMB**

The Executive Board of the International Monetary Fund (IMF) agreed in November 2015 to include RMB with a weight of 10.92 percent, only a third behind USD and the Euro in the Special Drawing Right (SDR) currency basket (Kennedy, 2015). According to PBC (2019), the size of RMB reserves in Currency Composition of Official Foreign Exchange Reserves (COFER) of the IMF amounted to USD 90.78 billion in the fourth quarter of 2016, which was the first time for the IMF released RMB reserves information. By the end of the fourth quarter of 2018, the RMB reserves

in COFER had reached USD 202.79 billion, representing 1.89 percent of the total and ranking 6th among significant reserve currencies (PBC, 2019).

The Chinese economy is already the largest trading partner and foreign investor in many countries, with substantial RMB demand. Therefore, the inclusion of the RMB into the SDR led to many countries including it in their foreign exchange reserves (International Monetary Institute of the RUC, 2019). Additionally, the renminbi's inclusion in the SDR will enhance the appeal of bilateral currency swaps. These swaps reflect the international status of emerging-market economies.

Furthermore, including the RMB in the basket would benefit both China and the world. The improvement of the representation and appeal of SDRs themselves and the perfection of the international monetary system is not enough to acknowledge Chinese reform and opening. It is well-established that the global currency structure is fragile, heavily reliant on a single sovereign currency. An international financial crisis erupted in 2008 when the international monetary system became enormously overly dependent on dollars. The RMB joining the SDR may give rise to the situation of a "three-legged" Dollar, Euro, and RMB system, contributing to the diversification of the international monetary system and increasing financial stability around the world. Also, it would elevate the status of the RMB among mainstream currencies.

### **RMB-DENOMINATED COMMODITIES**

The size of the market has continuously expanded since listing INE crude oil futures. According to the PBC (2019), in February 2019, the cumulative trade volume (unilateral, same below) reached 34.18 million hands, with an accumulated value of almost RMB 16 trillion, averaging 22,000 hands a day. It was reported that INE crude oil futures averaged a higher trading volume than Oman crude oil futures on Dubai Mercantile Exchange. As a result, it became the third-largest crude oil futures trade in the world, behind WTI crude oil futures in the US and BRENT oil futures in the UK (PBC, 2019). Currently, 52 international intermediaries in Hong Kong, Singapore, Britain, South Korea, and Japan have registered with the INE crude oil futures exchange. The steady development of the INE crude oil future has expected a gradual increase in foreign traders' number and level of participation.

Chinese crude oil futures, denominated and settled in RMB, are officially listed on the Shanghai International Energy Exchange (INE). A Shanghai Futures Exchange affiliate and foreign traders were introduced in March 2018. Trading varieties were medium-sour, primarily crude oil, including seven deliverables crude oil such as Dubai crude oil, Upper Zakum crude oil, Oman crude oil, Qatar marine oil, Yemen Masila crude oil, and Iraqi Basra light and domestic Shengli crude oil. The trading volume was 1,000 barrels/hand, and the trading hours were mainly 9:00-11:30, 13:30-15:00, and 21:00-2:30 (the next day). For the time being, the delivery method was spot delivery, and the transaction arrangement was net price transaction and bonded delivery. The net price transaction applies to the valuation minus tariffs and VAT. The related delivery is a physical delivery based on a bonded oil depot. Therefore, INE crude oil futures trading was temporarily exempted from VAT (PBC, 2019).

## **GLOBAL RMB FOREIGN EXCHANGE TRADING**

In 2018, worldwide RMB foreign exchange trade increased. According to data released in April 2016 by the Bank for International Settlements (BIS), RMB ranked 8th among the world's most active currencies trading and 1st among emerging market currencies (PBC, 2019). The worldwide average daily trading volume of RMB rose from USD 120 billion in 2013 to USD 202 billion, while the global foreign-exchange market share of RMB trading volumes increased from 2 percent in 2013 to 4 percent. RMB trading was mainly a result of RMB trading with USD, which accounts for 95 percent of the total trading amount of RMB against all foreign currencies.

According to SWIFT figures, RMB was one of the most active foreign exchange markets. RMB foreign exchange trading volumes rank among the top four offshore markets in the UK, Hong Kong, US, and Singapore, which account for over 80 percent of total RMB offshore foreign exchange trading. Also, an open interest turnover for RMB futures exceeded 30,000 against USD, and 5,625 contracts for options of RMB against USD as of December 2018 (PBC, 2019).

## **BILATERAL LOCAL CURRENCY SWAP**

The international financial crisis in 2008 led to severe liquidity difficulties for the global financial system, and some trading and investment partners required liquidity support. As a result, the PBC had signed bilateral local currency swap agreements with central banks or monetary authorities in 38 countries and regions with a cumulative volume of RMB 3.7 trillion since 2008 and were accepted by the State Council. By facilitating trade and investment between related countries and territories, local currency swap arrangements have played an essential role in maintaining financial stability and promoting the global use of the RMB. The total amount of RMB 3.48 billion has been agreed upon in thirty valid agreements as of the end of 2018 (PBC, 2019).

## **RMB CLEARING ARRANGEMENT**

The State Committee had approved the PBC to arrange personal RMB business in 2003 and 2004 for banks in Hong Kong and Macau regions and authorized Bank of China (Hong Kong) and Macau Branch of Bank of China to act as RMB clearing banks in Hong Kong and Macau regions respectively. The pilot program for cross-border trade settlement of RMBs was initiated in 2009, and the business scope of RMB clearing banks in the Hong Kong and Macau regions was extended.

The PBC signed an MOU with foreign central banks or monetary authorities to meet the development of the overseas RMB markets. It also expanded the two-way opening of financial markets, created RMB clearing arrangements in twenty-five nations and regions, and authorized twenty-five local banks to act as RMB clearing banks, including twenty-four Chinese-funded banks and one foreign-funded bank. Overseas RMB clearing banks cover Hong Kong, Macao, Taiwan, Southeast Asia, Europe, North and South America, Oceania, the Middle East, and Africa (PBC, 2019).

## DIGITALIZATION OF THE RMB

Digital currency and electronic payment instruments (DC/EP) are virtually the same as paper bills and are nothing more than digital forms. Since 2014, the central bank has considered legalizing digital currencies. In the words of Mu Changchun, chief of the Digital Currency Research Institute at the China Central Bank, the study of digital currency (DC/EP) has been ongoing for five years since 2014, and a report will be issued soon (Shen & Zhang, 2019). However, he did not give a date. According to reports, the PBC is nearing issuing its digital currency. Working together with private firms, it “has completed development of the sovereign digital currency’s basic function and is now drafting relevant laws to pave the way for its circulation” (Helms, 2020, para. 3). The central bank released a statement that DC/EP will apply a two-tier system to legitimate issuers in both central banks and financial institutions (Helms, 2020). In order to minimize the impact on monetary policy, the currency will replace M0, the amount of cash in circulation, rather than M2, the country’s broadest measure of money supply that includes savings and time deposits (Shen & Zhang, 2019).

As a result, timing is critical for issuing central bank digital currency (DC/EP). Because “as more central banks around the world are cutting interest rates to zero or even entering negative territory to release liquidity into the market amid the coronavirus (Covid-19) pandemic, China should accelerate the launch of its digital currency” (Helms, 2020). Therefore, it can be argued that China, as one of the largest economies in the world, is the first to introduce the DC/EP, so the impact of the digital economy on the world is somewhat close to being dominant, shaking the current monetary hegemony of the dollar using the BRI framework.

The digitalization of fiat money exemplifies the liberal perspective. Promoting inclusive finance is a goal all countries should strive onward. Additionally, digital currencies offer numerous advantages, such as reducing banking industry costs, promoting financial growth through sharing, and preventing money laundering and terrorism. Globally, the Bank for International Settlements (BIS) reports that around a third of central banks are now creating their digital currencies (Barontini & Holden, 2019). However, some countries do not in favor of D/CP. For example, Japan believes a closer US-Japan partnership is necessary to curb China’s digital currency (Takeo *et al.*, 2020).

Furthermore, Nakayama, a prominent member of the ruling party who drafted the proposals, stated that “we sense the digital yuan is a challenge to the existing global reserve currency system and currency hegemony [...] without the US, we cannot counter China’s efforts to challenge the existing reserve currency and international settlement system” (Takeo *et al.*, 2020). Despite advanced technology, global realism still plays a crucial role in competitiveness. As a result, approximately one-third of the countries are looking to enhance their information technology capabilities.

Furthermore, global financial markets are experiencing a black swan event due to the outbreak of COVID-19. Certain economic circles encourage Chinese, Singaporeans, and other financial markets of better-off economies during such a crisis. Conversely, some economies have declined dramatically in the short run, such as the US stock index. Therefore, if China can take advantage of the preemptive opportunity to launch a digital currency, its internationalization will be accelerated substantially.

## CONCLUSION

Besides internationalizing the RMB itself, China has launched several new initiatives like the BRI, CIPS, and AIIB. These approaches enhance the use of the RMB and provide a support structure to facilitate its usefulness once the RMB has been internationalized. In addition, China has made the RMB a primary international currency. Reaching this goal would allow the Chinese government to be more able to pursue difficult domestic reforms.

The internationalization of RMB would primarily boost China's economic power development. The recent progress in RMB internationalization is noteworthy from a macro standpoint. However, it still has a long way to go before it becomes a primary international reserve currency. RMBs are not used as widely in cross-border trade with neighboring nations, and their global impact is minimal. However, RMB influence has steadily grown and is expected to grow.

Nevertheless, it is not competitive with a stable international currency such as the US dollar or the Euro in the short run. The use of the central bank's digital currency may be an option for improving RMB internationalization. Chinese policy does not aim to build a monetary hegemony but to enhance the role of the RMB in balancing their economic influence. Economic factors drove the internationalization of the RMB. As a Chinese saying, "Where water flows, a channel will form" (shu dào qú chéng) (Chan, 2015). Over the last decade, the RMB internationalization role has been primarily reflected in international payment and settlement, and the way forward is to create RMB as a freely usable currency. First, PBC should insist on the market orientation principle, regularly remove restrictions on cross-border RMB usage, and explore ways to promote a higher level of trade and investment support under the pilot program. Second, the PBC should actively encourage the two-way expansion of the domestic financial market and make it possible for international investors to use RMB to invest in domestic bonds and stocks. Third, PBC should guide a healthy offshore RMB market expansion, increase RMB independence, and foster constructive relationships and deep integration between onshore and offshore markets. Fourthly, the PBC should improve macro-prudential regulation and work well on counter-cyclical adjustments to mitigate cross-border capital flow risks. Contemporary China, as one of the largest economies in the world, is influenced by global economies, so its response to the growth of the world economy is significant. Chinese economic growth, an essential member of the emerging markets, has been a powerful driver of the world economy. Moreover, China helps others optimize their market structure and stimulates their economies, particularly semi-peripheral and peripheral countries. There may also be opportunities to internationalize the RMB given the Covid-19 pandemic and the digitalization of sovereign currencies. China ranked among the top nations containing Coronavirus outbreaks in early May, particularly considering its large population and territory. Conversely, the US is the country most affected by the outbreak. Additionally, the Sino-US trade war is currently in full swing. Chinese companies are involved in the pharmaceutical industry and consistently export masks, protective clothing, and other anti-epidemic tools.

In addition, if China is the first to issue digital fiat money, it could significantly influence the world market. Additionally, China will leverage innovative clearing technology owned by the governments of the developed countries to attract semi-periphery and periphery countries to its global financial network. In addition, it will draw the attention of transnational corporations. Although RMB

internationalization is far off, there is a greater sense of anticipation in the new era. Thus, China will use the window of opportunity to expand the influence and use of the RMB abroad.

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then we have the power to turn Earth back into Earth.”*

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