The Changing Nature of Doing Business in Transition Economies

Edited by Marin Marinov and Svetla Marinova

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Marin Marinov

and

Svetla Marinova

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Notes on Contributors

Muris Cicic is Professor at the Department of Marketing of the University of Sarajevo in Bosnia and Herzegovina, and Visiting Professor at the University of Podgorica in Montenegro and the University of Shkoder in Albania. His research interests and experience are in marketing in general and consumer behavior in particular with a focus on transition economies.

Stefan Eckert is Professor of International Management at the International Graduate School Zittau in Germany. He conducted research at the Strasbourg Graduate School of Management (IECS). In 2003, Dr Eckert was granted the post-doctoral lecture qualification by the Department of Social and Economic Sciences of the University of Bamberg.

Marian Gorynia is Rector and Professor of Economics of Poznan University of Economics in Poland. He has conducted many research projects and has a number of publications as books, chapters in books and papers in academic journals. His areas of expertise include corporate strategy, internationalization of Polish firms and foreign direct investment strategies in Poland.

Melika Husić-Mehmedović is Assistant Professor and Vice-Dean for Academic Affairs at the School of Economics and Business at the University of Sarajevo in Bosnia and Herzegovina. Areas of professional interest consumer behavior, luxury consumption, fashion marketing, public and media relations.

Valtteri Kaartemo is Lecturer of International Business at the Turku School of Economics, Finland. His research interests are in the areas of internationalization, more specifically in international demand and innovation.

Zoran Krupka is Research Assistant at the Faculty of Economics and Business, University of Zagreb in Croatia. He teaches brand management and international marketing courses. His research interests are international marketing and internationalization.

Jorma Larimo is Professor of Marketing and Head of the Department of Marketing at the University of Vaasa in Finland. His areas of research include the internationalization of small- and medium-sized enterprises, international investments, alliance strategies and performance, and entry and marketing strategies in transition economies.

Kari Liuhto is Professor and Director of the Pan-European Institute at the University of Turku in Finland. His research interests are in economic and business development in the Baltic region and Russia with a special focus on foreign direct investment and cross-border cooperation. He directs the publication of *Baltic Rim Economies Review.*

Marin Marinov is Professor of International Business and Management at the Business School of the University of Gloucestershire in the UK. His research interests are in internationalization, foreign direct investment and international management mostly in the context of emerging market economies.

Svetla Marinova holds a PhD in international business from Copenhagen Business School in Denmark. Her research interests are in international marketing, internationalization of firms, country and firm-specific advantages and outward foreign direct investment of companies from emerging markets.

Ken Morita is Professor at the Faculty of Economics at Hiroshima University, Japan. He has conducted extensive interdisciplinary research, particularly focusing upon commodity futures market and foreign direct investment predominately in transition economies.

Jan Nowak is Professor of Marketing at the Central European University Business School, Hungary. He has conducted research and published in the areas of marketing and international business. Dr Nowak has collaborated with scholars from all over the world and has conducted studies applied to a variety of countries in Europe, North America, Asia and the South Pacific.

Nikolai Ostapenko is Associate Professor at the School of Business and Public Administration of the University of the District of Columbia in the USA. His research focuses on market transformation of the East European economies, changing consumption models, new patterns of consumer behavior, branding strategies, customer education and related issues.

Durdana Ozretic-Dosen is Professor of Marketing at the Faculty of Economics and Business of the University of Zagreb in Croatia. She is national representative at the European Marketing Academy. Her research interests are in marketing in an intercultural cross-border environment in particular in emerging market countries.

Almir Peştek is Doctoral candidate at the Faculty of Economics at the University of Sarajevo in Bosnia and Herzegovina. His research interests are in marketing, marketing research, consumer behavior and management.

Frank Rossmeissl is Head of Strategic Management and Innovation Practice. He holds a Doctoral Degree from the International Graduate School Zittau in Germany. His research focuses on restructuring the competencies of network organizations and the role dynamics of German subsidiaries in Central and Eastern Europe.

Arnold Schuh is Director of the Competence Center for Central and Eastern Europe at Vienna University of Economics and Business Administration in Austria. His primary research areas are marketing and strategic management. Current research and publications focus on international business strategies, marketing in Central and Eastern Europe and the influence of globalization/Europeanization on strategies and structures of multinational corporations.

Vatroslav Skare is a Teaching and Research Assistant at the Faculty of Economics and Business of the University of Zagreb in Croatia. His areas of research interest are product development, service marketing and internet marketing.

Mart Sõrg is Professor of Money and Banking and Head of the Institute of Finance and Accounting at the University of Tartu in Estonia. His research interests and publications are in monetary systems and monetary policies of transition countries, banking system reconstruction and developing and economic education in economies in transition.

Eiko Tomiyama has Masters and Doctoral degrees in Economics from Niigata University in Japan. Her research is focused on emerging market economies investigating strategic marketing issues and the internationalization of small- and medium-sized enterprises. She provides a consulting service for Japanese companies formulating strategies for entering the Russian market.

Liviu Voinea is Senior Lecturer at the National School for Political and Administrative Studies in Bucharest, Romania. He is also Executive Director of the Group of Applied Economics in Bucharest. His research interests are in emerging market economies and changes in the business environment of economies in transition.

Radoslaw Wolniak is Senior Lecturer at the Faculty of Economics of Warsaw University in Poland. His research is in the area of inward and outward foreign direct investment and national competitiveness in the context of Central and Eastern Europe.

Mirela Xheneti is Researcher at the Small Business Research Centre at Kingston University in London in the UK. Her research interests are in entrepreneurship and small business development in post-communist countries and especially the role of institutions and policies in creating a framework for productive entrepreneurial activities.

1
Introduction

Svetla Marinova and Marin Marinov

Business environments vary across the world. Contextual specifics vary from region to region and from country to country. Countries and their environments are distinguished according to a number of indicators. If level of development is applied, it is often associated with per capita income in a particular country in comparison with the world average. Overall a developing country is usually associated with a nation that has a lower level of economic, social, business and technological development than the average in the world and as a result usually has a lower level of material well-being. There is no universally adopted definition of the term developing country. This means that the levels of development in various aspects may differ extensively among developing countries, with some developing countries having similar standards of living as many developed economies.

A number of countries worldwide have a lower degree of industrialization, underdeveloped infrastructure and insufficient capital investment. They do not develop advanced technology, some having educational and literacy problems. Often developing countries are categorized as having different economic needs and interests in business development (Kvint, 2009). Several developing countries, rich in natural endowments, are generally economically better off and have common interests in a healthy world economy that can facilitate local business and economic development (Groose, 2006). Rapidly industrializing economies have strengthened their place in the world business arena, constantly increasing their stakes in the world trading and investment arena (Chen, 2006). Numerous developing countries that are either commodity or product exporters have improved their economic viability, business advancement and living standards significantly in recent years. A considerable number of countries are still mainly agricultural, which has sharply narrowed their business development prospects in the immediate future.

Parallel with developing countries that undergo significant changes, there are *transition economies* (Nur-tegin, 2007) that have been involved in radical business transformation. A transition economy signifies a country which is diminishing to a varying degree the dominant role of the state as a central planner of the economy whilst meanwhile striving to adopt market mechanisms. In the process of their transition, such economies have experienced economic liberalization, privatization of government-owned enterprises and resources, and creation of institutional structures to facilitate economic and business development in the conditions of new realities (Roland, 2000). With the guiding role of the state, this process has so far been applied in China and Vietnam. In the meantime the transition process in the former Soviet Bloc countries in Europe, as well as by many developing countries in different parts of the world (for example, Africa and Latin America) has been applied with limited or at times no state intervention in the process. As the transition economies represent the most dynamically changing countries in the world, the attention of this book is focused on the changing nature of business in them.

The transition process is typically regarded as the changing of existent and creation of new institutions, particularly new entities. Evolutionary or revolutionary change of the role of the state is another key feature, thereby accompanied by the creation of fundamentally different conditions, practices and bodies regulating and facilitating business activities.

The trajectories of transition processes in various countries are idiosyncratic. A number of transition countries have transformed their economies for several decades (for example, China and Hungary), while others are comparatively new adopters of transitional approaches (for instance, Moldova and Serbia). From a political perspective, the transition process was preceded by major disturbances, such as the removal from power of a dictator in Romania or the collapse of a large state and its ideological foundation (valid for the successor countries previously comprising the ex-Soviet Union and to a lesser extent the countries that appeared after the disintegration of former Yugoslavia). In some transition economies the process started without major disarray (for example, in Bulgaria and Hungary). In other transition countries, economic changes have been applied gradually without ideological and government replacement as has been the case in China and Vietnam. Consequently, transition reforms varied in characteristics, goals, scope and scale of development and implementation. Regardless of the specifics of the process, the transition has resulted in changes of the nature of business and its specifics in each particular country. This fact calls for general and detailed attention in revealing the particulars of the changing nature of doing business in transition economies.

Transition in the successive states of the former Soviet Bloc countries, including ex-USSR, is a process that has been implemented in the last 20 years. The corresponding process in Latin America has about 25 years of record. By comparison, the economic transition in China has been a gradual state-led process that started back in 1979 and has had more than 30 years of history.

Since the fall of the Berlin Wall in 1989, there has been an abrupt or gradual departure from the concept of central planning throughout Central and Eastern Europe as well as later on in the former Soviet Union. After the downfall of state socialism in these regions, liberal and decentralized approaches of doing business started to spread. By mid-1990, about 35 per cent of the output of the former Soviet Bloc countries was created by the private sector of the respective national economies, market supply had increased and business environments across the region were in the process of continuous transformation.

The transition processes differed from country to country in content and effectiveness. While all transition economies have faced similar transition problems, important differences have been identified in relation to their economic status at the start of transition and the policies implemented to further and administer the transition process. The national variations influenced the differences in business conditions and economic performance in every particular economy.

The motives behind internationalization of business and success in transition share a lot of similarities (Estrin, 2009). As a result of significant dissimilarities in factor costs, particularly labour, business profits are amplified by transfer of production from developed to transition countries, where the cumulative cost of management and control, transport, trade barriers and so on do not invalidate labour and material cost savings. To facilitate this process, many transition economies have put serious efforts in developing their institutional, legal and policy environment to create better conditions for doing business in them. The liberalized policy environment has been important to many transition economies in allowing them to reorient their business practices to market-based norms. If a close look is taken into the changes of the business environment of transition economies, it can be observed that it has improved progressively in all areas.

Many multinational firms from the developed world have entered transition economies with investment modes of market entry. Developing successful subsidiaries is of key concern to them when pursuing business opportunities in these parts of the world. Thus numerous multinational companies from developed economies have established business processes in transition economies by means of acquisition of local firms (Meyer and Estrin, 2001) only to realize that challenging business conditions are to be addressed appropriately for successful operations. Respective challenges to business activities are stated in international business literature (Bhagat *et al.*, 2002), but they still represent issues requiring constant attention in relation to business practices in transition economies.

This book addresses the changing nature of doing business in transition economies in reference to the above-stated challenges in this transforming part of the world in an attempt to contribute to the clarification of relevant developments in practices of businesses in the restructuring contexts of transition economies.

The transformation processes of the former centrally planned economies towards adoption of market mechanisms coincided in the majority of them with political and economic volatility as well as financial instability. An understanding of the interplay between macro- and micro-environmental factors can shed light on the changing nature of doing business in the contexts of transition economies.

This book provides an insight into the regional and national specifics of the business changing process in transition economies. Chapters 2–6 deal with the regional specifics of business changes in transition economies, whereas Chapters 7–14 refer to the country specifics of transformation.

Chapter 2 addresses the issues of psychic distance of markets in Central and Eastern Europe taken from the perspective of western multinationals creating subsidiaries in the region. The chapter shows how foreign subsidiaries of western multinationals play an important role in the restructuring and transformation of former centrally planned economies in Europe. The authors of the chapter reach the conclusion that competition between "psychic market proximity seeking" subsidiaries of multinationals located in Central and Eastern Europe is going to intensify significantly as the cultural convergence resulting from the process of European integration creates opportunities for further economic restructuring.

Chapter 3 takes an evolutionary game approach to the eastward enlargement of the European Union (EU) and the subsequent foreign direct investment (FDI) inflow into Central European transition economies. The author investigates the EU enlargement as a fundamental factor promoting capital inflow into the region of Central Europe. The chapter concludes that the reasons for the increase of inward FDI into Central Europe interpreted with an evolutionary game approach reflects the increased proportion of diligent workers and the decreased proportion of negligent workers in the transition process of moving towards a more efficient economy.

The challenges to brand strategy of western multinationals in Central and Eastern European transition economies is the topic of Chapter 4. The author tests the notion in international marketing for a natural tendency towards customization in the context of transition economies. The findings of this study supply strong support for the market globalization approach. International brands mainly offered by western consumer goods marketers occupy leading positions in the majority of product categories in the transition countries studied. In particular, in the less culture bound categories, international brands capture more than 50 per cent in all country markets.

Luxury consumption in transition economies is the topic of Chapter 5. The authors investigate the consumption of luxury products in the emerging markets of Balkan countries and the European territory of Russia as they have experienced dramatic transformation in terms of structural consumption and changes in market behaviour. Differences have been identified in the behaviour of luxury items' buyers in the Balkans and European Russia supporting the role of regional contextual specifics.

The authors of Chapter 6 put under scrutiny the growth development of the beer brewing industry in Central and Eastern Europe. There has been a mass influx of capital in the beer brewing industry of the region mostly for the acquisition of existing beer breweries. Market entry into the region was mostly driven by market-seeking motives due to the saturation of western beer markets. The study shows that due to their international managerial experience and financial strength most foreign brewers have performed well in Central and Eastern European markets. There has been a great deal of variability concerning the problems foreign investors have encountered in the region. Some were associated with declining per capita consumption. Furthermore, there have been problems associated with the availability and quality of raw materials, causing an increase in imports and backward industry integration.

Chapter 7 is the first one that deals with the country specifics of business changes focusing on the role and significance of the formation of special economic zones in Russia. The authors deal with the transferability issues of the application of the concept of special economic zones from China to Russia. According to them the problems associated with the creation of technology-innovative special economic zones in Russia are their premature initiation due to a variety of pressures, mostly of a political character.

The changing Russian economy is the focus of Chapter 8 in relation to the export strategy formation of Japanese firms. Russia as a transition economy is interested in the perspective of trade opportunities, and Japan is highly dependent on international trade due to its limited resources and production overcapacity. Based on extensive investigation of trade activities of Japanese firms in Russia, the author concludes that the country's advancing economy has led to increasing interest in the Russian market on the part of Japanese firms. They are actively establishing sales hubs on the Russian market in order to conduct marketing on an ever-increasing scale.

The case of FDI inflow in Poland from the point of view of foreign firms investing in the country is presented in Chapter 9. The purpose of the study is to determine what motivated foreign investors to enter the Polish market, what factors determined the choice of mode of FDI and what patterns emerged in the relationships between the motives and modes of entry. The authors of the chapter reach the following conclusions. Both the within-case and cross-case analyses provided a number of important insights into the motives and ways the analysed foreign subsidiaries were established in Poland. Most of the investing firms were both market- and efficiency-seekers. No firm entered the market to secure only access to local resources.

The changing nature of doing business in Romania is dealt with in Chapter 10. The author presents an analysis of how the business environment in Romania has evolved over time. In order to provide an insight into the transition progress of the country, the development of the business environment, the barriers to its improvement, the support role of the state and the extent to which the macroeconomic changes influenced the business environment are investigated. The competitiveness of the business environment in Romania is put under scrutiny. The author concludes that the Romanian business environment is becoming increasingly friendlier and the country is on the path of economic stability attempting to improve its technology-intensive business standing.

Chapter 11 deals with the subject of celebrity endorsement of brand management in Croatia. The study is exploratory, examining if Croatian consumers recognize brands endorsed by national celebrities. A second purpose of the study is to understand the opinions of customers and their attitudes towards celebrity endorsement as a common and effective marketing practice employed for the purposes of brand management. The study provides evidence that the use of celebrity endorsement in marketing practice in Croatia has an impact on the audience's attention, recognition and probably evaluation of brands. Results are consistent with those of prior research undertaken in developed western market economies.

Chapter 12 provides an institutional perspective of the changing role of the state in the development of entrepreneurship in the transition Albanian economy. Albania is the last country of Southeast Europe where communism collapsed and in the past 20 years has gone through major institutional changes that have significantly affected the development of entrepreneurship. Analysis of the government's role is considered in an institutional perspective, which argues the role of polity in the creation and enforcement of formal institutions. The author has found out that successive Albanian governments have suffered for years from a low level of commitment to market reforms, as well as from the lack of knowledge and resources available to the state to implement what has been required. These features have led to overreliance on donor funding and expertise and to a lack of proper functioning of the institutional infrastructure for entrepreneurship. Lack of motivation, short-term horizons and a lack of capabilities are among the general reasons that have been cited to explain the weak implementation of policies in a transition context.

The tourism industry in Bosnia and Herzegovina with the implementation of e-marketing is the topic of Chapter 13. As tourism business over the Internet is on the increase across the world, the authors of the chapter study the validity of this trend in a transition country. The study brings evidence that tourist companies in Bosnia and Herzegovina use an unplanned, ad hoc approach, and reveals that Bosnia and Herzegovina as a whole is at the beginning of the business transformation process, a process that many developed countries implemented a long time ago.

The process of transformation of the Estonian banking system is explained in Chapter 14 of the book. The transformation of the banking and financial sector in transition economies has become critical for the successful shift from a centrally planned to a market-driven economic system. As a result of the transformation, Estonian banks have entirely based their operations on market principles. Prudent economic management supported by a stable currency and the persistence of the central bank in pursuing the implementation of reforms and the enforcement of all new rules and regulations have become the cornerstone of the success in the banking sector reform. The author has reached the following conclusions. The uncertainties and unpredictability of the environment in transition business contributed to the volatility in the bank management and risk system. These made bank failures and subsequent bank consolidation imminent. Bank regulations and control mechanisms in transition economies evolved and became much tighter than those in the financial sector of most developed economies. The banking sector of a transition economy is open to "invasion" of foreign banks due to the openness of the economy and excessive risk-taking.

Overall the book presents a comprehensive outlook of the processes that have taken place in transition economies and the respective consequences that brought about critical changes in the way business is done in these challenging contexts.

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2
Grading Up or Fading Out?
The Elusive Destiny of Psychic Market Proximity-Seeking Subsidiaries in Central and Eastern Europe

Stefan Eckert and Frank Rossmeissl

Foreign-owned subsidiaries as a driving force of transition and integration processes

Foreign subsidiaries play an important role in the restructuring and transformation of former centrally planned economies. As these foreign entities are embedded in international networks, their existence may lead to cross-border transfer of knowledge, managerial and marketing skills (Manea and Pearce, 2001b) that "promote the diffusion of new technologies through direct linkages or spillovers to domestic firms" (Altomonte and Guagliano, 2001: 4). Such effects should be appreciated as they tend to strengthen the international competitiveness of transition economies. However, the beneficial effects that foreign subsidiaries exert on the competitiveness of the host country depend, among other things, on the role that these subsidiaries have been assigned to perform in the international and sometimes global corporate network.

A multitude of typologies has been created in the international management literature to characterize the spectrum of possible roles of a foreign subsidiary. The most prominent among them is the one suggested by Bartlett and Ghoshal where four different types of subsidiaries are distinguished, that is, contributors, implementers, black holes and strategic leaders (Bartlett and Ghoshal, 1998: 122). Certainly, host countries should be interested in attracting foreign firms, which intend to establish a "strategic leader" subsidiary. They should also try to convince foreign multinationals already present in the host country to upgrade their subsidiaries by transforming them into strategic leaders. From the perspective of multinational firms, however, the decision to transform subsidiaries into strategic leaders should, among other things, depend on the characteristics of the host country.

Since 1990, the business environment in Central and Eastern Europe (CEE) has undergone dramatic and turbulent changes. A common trait of these countries is the fundamental process of change of the former economic and political system, which has been complemented and supported by the process of European enlargement and integration. In this context, an essential question for academic research is how the processes of transformation and integration affect the decision of multinational firms on the future role of subsidiaries in CEE.

European Union accession and the role of foreign subsidiaries

Literature on various roles of subsidiaries in general is well developed. Prominent advocates of this research area are White and Poynter (1984), D'Cruz (1986), Bartlett and Ghoshal (1989), Ghoshal and Nohria (1989), Ferdows (1989), Jarillo and Martinez (1990), Gupta and Govindarajan (1991), Birkinshaw and Morrison (1995), Forsgren and Pedersen (1998), Taggart (1997) and Surlemont (1998).

Although some of the empirical studies on foreign subsidiary roles were country specific, for example, focusing on Spain, Canada and Denmark, little research has been done so far on the issue of how European Union (EU) enlargement affects the role of subsidiaries in the former centrally planned economies of CEE after joining the EU. A recent study of Benito *et al.* (2003) offers some valuable thoughts on this issue. The authors explicitly analyse external, that is, environmental factors – seen as location advantages – by examining the effect of regional, namely EU integration, on the changing role of subsidiaries in Denmark, Finland and Norway. They argue that the external factor "EU membership" has quite a strong influence on the subsidiary's *competence level* and its *scope of activities* as "…the kinds of activity undertaken by the subsidiary and its level of competence are also co-determined by the specific advantages of the host location" (Benito *et al.*, 2003: 444). Through these two dimensions, which characterize a subsidiary's role, Benito *et al.* differentiate various types of subsidiaries (Figure 2.1).

In this context, a subsidiary with few value activities and low level of competencies is called a "single-activity unit" (Benito *et al.*, 2003: 447). An example of such a subsidiary is a sales subsidiary. A subsidiary with the same low level of competence but many value activities

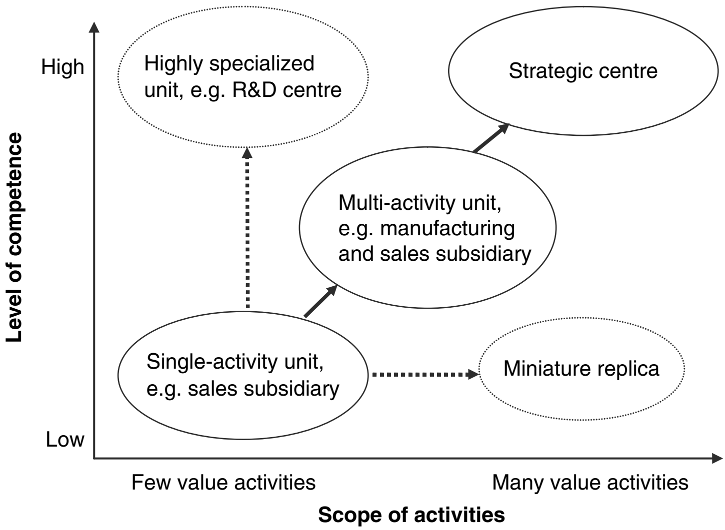

Figure 2.1 Type of subsidiaries
Source: Benito *et al*. (2003: 447).

is called "miniature replica", which obviously follows the term used by White and Poynter in 1984 (Benito *et al.*, 2003: 447). Subsidiaries with a high level of competence and few value activities are defined as "highly specialized units" (Benito *et al.*, 2003: 447). These include research and development (R&D) centres, which are of special value to the multinational enterprise (MNE) due to their unique resources and capabilities. If the scope of activities of this type of subsidiary increases, for example, through rationalization and downgrading of other subsidiaries, they may turn into "strategic centres" (Benito *et al.*, 2003: 447). Benito *et al.* estimate, however, that in practice the greatest number of subsidiaries is to be positioned between the two extremes of each attribute, this way representing a "multi-activity unit" (Benito *et al.*, 2003: 447), for instance, a subsidiary comprising some manufacturing and sales activities.

It could be suggested that an important finding of this study is the significant difference between Norwegian, Danish and Finish subsidiaries of MNEs. The subsidiaries in Denmark and Finland differ from those in Norway when the two aforementioned dimensions are applied. The authors claim that such a difference could be attributed to the EU membership status of Denmark and Finland. They also argue that Norway, as a country without EU membership status, may become less attractive for MNEs because subsidiaries in Norway "scored significantly lower in terms of scope of activities and level of competence" (Benito *et al.*, 2003: 443).

Similarly, one might conclude that subsidiaries in the countries of CEE may become subjects of rationalization and reorganization carried out by MNEs and consequently may be downgraded, that is, their level of competence will (be) decrease(ed) and the scope of activities will (be) narrow(ed) down. On the other hand, foreign subsidiaries in prospective member countries should be expected to develop or be assigned additional competencies and increase the scope of their activities.

Theoretical considerations

The role of a foreign subsidiary comprises expectations concerning future actions of a subsidiary from the perspective of a certain actor or a certain group of stakeholders. Hence, from the viewpoint of different stakeholders, a subsidiary's role may look rather different. The perspective of the parent company is of special interest to management scholars. Therefore, we shall explore the role of foreign subsidiaries from the viewpoint of the parent company. From this perspective, the link between the parent company and the subsidiary can be interpreted as a *means–end relationship*. The subsidiary's mission is defined by the parent company in order to support and backup the implementation of the parents company's strategy and increase the parent company's desired degree of goal attainment.[1]

Our model of a subsidiary's role comprises three dimensions: (1) the *value chain activities* a subsidiary carries out, (2) the *geographical scope* of the respective value chain activities and (3) the *task*, which the subsidiary has to fulfil by carrying out its respective value chain activities for a particular geographical scope. The dimension "value chain activity" can be differentiated into categories like "Research & Development", "Procurement", "Production", "Marketing and Distribution", "Services" and "Supporting Activities" (for example, accounting and controlling, administration and human resource management). By "geographical scope", we understand the geographical responsibility of the subsidiary for the respective value chain activity. The particular characteristics of a subsidiary along this dimension could be classified into categories like national level, regional level or global level. Along the "task" dimension, the parent company's overall intention with regard to the subsidiary is expressed. The properties that a subsidiary has along this dimension could be filed into categories like "cost reducing" or "expanding market share".

The proposed model is based on Porter (1996), D'Cruz (1986), Dunning (1993) and White and Poynter (1984). Porter's work forms the basis for the dimension "value chain activity". The geographical component can also be found in the work of D'Cruz, while Dunning's concept of motives for foreign direct investment (FDI) is used as an operationalization of the task dimension. Like White and Poynter, we also use three dimensions for concept modelling. But unlike White and Poynter, who combine "product scope" with "market scope" and "value added scope" with "market scope" again, we propose to combine every dimension with each other. Certainly, the "dimensions" of the model suggested in this chapter are far from being independent from one another. Some of the theoretical combinations might be empirically less relevant or even irrelevant and the model is – at first sight – less straightforward than, for example, the one of Bartlett and Ghoshal. Nevertheless, by applying this concept an enriched picture of a foreign subsidiary's role might emerge, enabling the researcher to analyse the dynamic evolution of subsidiaries in greater detail.

The establishment or development of a foreign subsidiary primarily depends on the resources it gets or builds up. The upgrading of a foreign subsidiary can be interpreted as the consequence of an investment decision, which should be heavily influenced by the parent company. Dunning introduces a concept that explains the foreign investment decisions of the parent company as being the result of a combination of specific characteristics of a firm and the respective value chain activity, for which the appropriate mode of co-ordination as well as the adequate location have to be chosen. A firm has to have certain *ownership advantages* (strategic resources like intangible assets) and the exploitation of these resources "through an extension of its existing value added chains or the adding of new ones" (Dunning, 1977: 196) should be more profitable than the externalization of these resources through contractual agreements between arm's-length partners (*internalization advantages*). These are necessary conditions for FDI to arise, but they are not sufficient. As a further condition, a place abroad has to have certain *location advantages* versus places at home concerning the value chain activity, which is going to be decided upon. Examples of location advantages, that is, "factor inputs . . . outside . . . [the firm's] home country" (Dunning, 1977: 197), are production costs, transportation costs, governmental regulations, and social natural general conditions.

Based on these considerations the question is, how do transition processes and the integration of Central and Eastern European countries (CEECs) into the EU affect MNEs' decisions to establish a subsidiary (with a certain role) in CEECs; respectively, how do these processes affect MNEs' decisions to alter the role of subsidiaries in CEECs? Given the fact that these processes work mainly on a country level and less on an industry or company level, it seems quite obvious that the implications of these macro processes could influence mainly the location characteristics of certain places. Therefore, the relevant question is: how do transition and integration processes affect the location characteristics of CEECs?

However, the evaluation of these effects on the attractiveness of locations in CEECs cannot be generalized across all types of foreign subsidiaries. Instead, the different tasks foreign subsidiaries are meant to fulfil have to be considered carefully. In this respect, a typology from Dunning seems to offer some help. It differentiates between *market-seeking, efficiency-seeking, resource-seeking and strategic asset-seeking* foreign subsidiaries (Behrmann, 1984; Dunning, 1993; Agarwal, 1996).

In the case of subsidiaries established for reasons of *efficiency seeking*, the relocation of certain value chain activities to places providing lower input costs takes place in order to create or maintain a competitive market position. Through this type of FDI, "MNEs might assist the internationalisation of CEE economies by moving the production of some of their currently most price-sensitive goods to low-cost parts of the region, with these then being mainly exported back to their established (notably Western European) markets" (Manea and Pearce, 2001a: 6). A concern with such an efficiency-seeking activity is that it only remains viable as long as the relatively standardized inputs retain their cost competitiveness. The recent developments in Hungary may illustrate this point: the introduction of minimum wages and salaries in the public and private sector by the government in 2002 led to a nominal increase of 11.5 per cent until March 2003 (in comparison with March 2002) (Schieritz, 2003). Though these changes might further lead to some positive effects such as higher employee motivation and higher labour productivity, such tendencies could inevitably threaten the survival of foreign operations initiated in response to efficiency-enhancing local inputs.

Subsidiaries built for reasons of *resource seeking* form a second category. This kind of foreign investment is undertaken in order to secure or improve the firm's access to certain resources acquired abroad and is directed at reducing the uncertainty that is generated by the geographical spread of the value chain.

Another category of foreign subsidiaries is characterized by Dunning as *strategic asset seeking*. In this category, subsidiaries which are established in order " ... to protect, sustain or advance the global competitive position of the investing company vis-à-vis its major national and international competitors" (Dunning, 1993: 380) are subsumed.

Market-seeking subsidiaries form the last category. Subsidiaries that fall into this group are established in order to improve significantly foreign market proximity. In order to understand how market proximity is affected through foreign subsidiaries, we have to differentiate between foreign subsidiaries established for reasons of physical market proximity and foreign subsidiaries through which the MNE is aiming to reduce psychic market distance, that is, seeking to achieve psychic market proximity.

By physical market proximity, the location of a firm is described in terms of its geographical range to a specific foreign market. This type of market proximity can be achieved by establishing a subsidiary in a foreign market. A high degree of physical market proximity should, for example, be necessary for foreign market activities, where the cost of transportation amounts to a considerable proportion of the total costs of a certain product. Moreover, for certain type of services a high degree of physical market proximity seems to be unavoidable, for example, a lot of foreign subsidiaries in the retail banking sector should be motivated by the desire to achieve physical market proximity.

On the other hand, market seeking foreign subsidiaries may also be built for reasons other than physical market proximity, but rather to realize psychic market proximity. This concept stands for the ability of a firm to communicate effectively with a certain foreign market. Communicating with foreign markets appears to be difficult, since these markets are shaped by actors that differ in their cultural background from the dominant cultural background of decision makers inside the firm. The degree of cultural diversity between the firm and the market has been termed in the literature as "cultural distance". The influence of cultural distance on market entry decisions and market performance has been discussed extensively by international management scholars (for example, Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; Vahlne and Nordström, 1992; Kutschker, 2002). Actors from foreign markets may interpret symbols that the firm transmits into these markets in a way not intended by the firm, for example, Meissner quotes the case of Mitsubishi, which was rather unsuccessful when introducing a car named "Pajero" in Spain due to the Spanish meaning of this name (Meissner, 1997: 8).

One approach to reduce psychic market distance significantly is to establish a subsidiary in a foreign market. Such a reduction of psychic distance results from a higher degree of communication intensity between the firm and the foreign market in the case of a subsidiary compared to other modes of foreign market entry. In this way communication, interactions between the firm and the foreign market processes of learning are stimulated concerning communication with the foreign market on an individual as well as on organizational level (Kumar and Epple, 1997). To sum up, psychic distance market-seeking subsidiaries promote processes of learning that improve the quality of communication between the firm and the foreign market. Thus, these entities could accomplish a higher degree of psychic market proximity than other modes of foreign market entry.

One can argue that the need for psychic market proximity is not equally relevant for all types of business activities. Therefore, not all foreign subsidiaries are established for reasons of increasing psychic market proximity. The psychic market proximity should be of high relevance especially where national or local preferences exert an essential impact on customer decisions as is, for example, the case of the fast-moving consumer goods markets, where understanding and accommodating customer preferences is key to a firm's success in a particular national market. In this sector, the response to the distinctive preferences of the customers is considered to be very important and rapid reaction to changes in customer preferences is seen to be the crucial competitive advantage against competitors.

Tasks of CEE subsidiaries

Empirical data are necessary to enable the assessment of the empirical relevance of different types of subsidiary tasks in the case of CEECs. An overall review of extant research reveals that market-seeking motives clearly dominate as the major force driving FDI into CEE economies. A study of Manea and Pearce (2001b) illustrates the supremacy of this task for CEE subsidiaries (Table 2.1).

Based on Dunning's typology, the authors differentiate between four different kinds of motives for FDI. Apart from market-seeking motives, which were operationalized by the item "to help our MNE group to effectively extend the supply of its established products into the host

Table 2.1 Evaluation of the motives of MNE's subsidiaries in CEE

	Motivation (average response)			
	MS	**ES**	**KS1**	**KS2**
By Industry				
Chemicals	2.71	1.57	1.71	1.57
Electronics	3.00	2.00	1.89	1.67
Mechanical engineering	2.67	2.33	1.33	1.17
Motor vehicles	3.00	2.00	1.33	1.33
Petroleum	3.00	1.50	2.00	1.50
Miscellaneous	2.86	1.71	1.14	1.00
By home region				
Asia	3.00	2.67	1.67	1.67
North America	2.93	1.73	1.53	1.40
Western Europe	2.75	1.88	1.56	1.31
Total	2.85	1.88	1.56	1.38

Source: Manea and Pearce (2001b: 125).

country and other CEE markets" (Manea and Pearce, 2001b: 125) and efficiency-seeking motives, which were defined as "to help improve the competitiveness of our MNE group in supplying existing products to our already established markets" (Manea and Pearce, 2001b: 125), the authors include two other types of FDI, namely knowledge seeking 1 (KS1) and knowledge seeking 2 (KS2).

For KS1, the following item was used: "to use specific local creative assets (for example, local market knowledge, original local technology) available to the subsidiary to develop new products for the host country and other CEE markets" (Manea and Pearce, 2001b: 125). KS2 was defined as "to use important creative assets and talents available to the subsidiary to help develop new products for wider markets (e.g. Western Europe) of the MNE group" (Manea and Pearce, 2001b: 125).

More than 88 per cent of the respondents of the study of Manea and Pearce rated market-seeking motives as the "main" driver of FDI (Manea and Pearce, 2001b: 125). The high relevance of this motive is also strongly underlined by a huge number of other empirical studies, for example, Engelhard and Eckert (1993), Genco *et al.* (1993), EBRD (1994), Engelhard and Eckert (1995), Neudorfer and Bach (1995), OECD (1995), Stankovsky (1995), Lankes and Venables (1996), Altzinger (1997), Kaufmann and Menke (1997), Neudorfer (1997), Pye (1997), Meyer (1998), Witkowska (1999), Bevan and Estrin (2000), Marinov and Marinova (2000), König (2001) and Manea and Pearce (2001a). Even more studies point out the importance of the market-driven motive of Western companies' FDI in Eastern Europe (Altzinger, 1998). Borsos (1995) argued that this was a major motive of companies investing in the Finish-Baltic regions; the findings of Vincentz (1995) were similar for the German-Polish-Czech region; Petrakos (1996) argued the same for the Greek-Bulgarian region; and Altzinger and Maier (1998) suggested the same for the Austrian-Slovakian region.

On the contrary, efficiency-seeking FDI seems – remarkably – to be only of minor importance. Manea and Pearce point out that of the firms they surveyed only 23.5 per cent judged efficiency seeking as the main objective of MNEs when investing in CEE. This finding also appears to be consistent with other empirical studies (Lankes and Venables, 1996).

To sum up, previous findings underline the high empirical relevance of market-seeking motives as a key motive for establishing CEE subsidiaries. Unfortunately, these studies do not differentiate sufficiently in order to identify the empirical relevance of different types of market-seeking motives, that is, the empirical relevance of "psychic market proximity-seeking" subsidiaries versus "physical market proximity-seeking" subsidiaries.

This lack of knowledge seriously impedes adequate forecasts concerning the development of the roles of foreign subsidiaries in CEE. However, there is a good reason to assume that the kind of market proximity that foreign parent companies seek to realize by establishing subsidiaries in CEECs is not only of a physical nature, but that there should exist a considerable number of foreign subsidiaries that are mainly established to achieve cultural proximity. This assumption is underlined by the huge cultural differences that have been prevalent between the Western European countries, from which the largest part of the FDI which flows into the CEE region comes and the formerly state planned CEECs.

Turbulence in the course of the economic and political transition in CEECs did not reduce the psychic distance between foreign firms and the unknown to them CEE markets. Moreover, various strategies of transition adopted by individual CEECs have brought about, among other aspects, separation of previously unified states. An example is the breakdown of Czechoslovakia into the Czech and the Slovak Republics (Savin, 2002). Thus foreign firms needed to serve each local market by a separate local subsidiary in order to increase the psychic proximity. Hence, there is a good reason to assume that among market-seeking subsidiaries in CEECs, there should be a considerable number of subsidiaries created in order to reduce the psychic distance between the investing firms and the CEE markets. Further on empirical findings will be provided that focus on market-seeking foreign subsidiaries.

European integration and CEE markets

Based on these considerations, one has to ask how the processes of transition and European integration affect the relevance of the different categories of market proximity and therefore the relevance of CEE subsidiaries that fall into these differing categories from the viewpoint of the parent company.

For foreign-owned subsidiaries, which aim to improve physical market proximity, no substantial changes are expected. The enlargement of the EU may indeed strengthen the political and economic stability in the CEECs. Foreign subsidiaries that have been established in order to be geographically close to the customers of a firm may therefore be considered less risky than before. Hence, the readiness to transfer more resources and to increase the competencies of such subsidiaries may rise.

In the case of psychic market proximity-seeking FDI, however, effects may be divergent. The transition from the old political and economic system that has taken place in the CEECs since the early 1990s implied profound changes in the everyday life of Central and Eastern Europeans. Throughout the transition period the citizens of the CEECs have been confronted with political and economic instability, changes in the ideological system, social instability and corruption, which did not fit their mental frameworks, which have been developed during the communist era. Since the fall of the iron curtain, they have started to realize that their mental programming did not correspond appropriately with the environment in which they were embedded. Feichtinger and Fink (1999) compared the situation of these societies to the situation of an expatriate. They described the behaviour of people in CEE societies undergoing a fundamental cultural change that resembles the U-curve of cultural adaptation of expatriates living abroad.

The acculturation during the process of the "collective culture shock", as Feichtinger and Fink call the process of collective adaptation to suddenly changing systems, runs through four phases. Figure 2.1 illustrates the theory of the collective culture shock. *Phase one* is characterized by "euphoria" in which illusionary and unrealistic expectations abound (Feichtinger and Fink, 1999: 135). During the communist era, a distorted picture of democracy and market economy emerged. The lack of information led to a misinterpretation of the new system which was interpreted as the ultimate satisfaction of all needs. This exaggerated expectation occurred mainly during the first years after the collapse of communism. The *second phase* is the phase where the culture shock itself appears. Symptoms like "loss of orientation and mental health problems, lack of self-confidence, apathy, passiveness, missing capacity to act and defensive strategies, retreat and retrospective reflections" appear (Feichtinger and Fink, 1999: 136). Correspondingly, confusion, rising uncertainty, missing trust and the wish to re-establish the old system could be observed in the CEECs. In line with this argument, a study of the value systems of Eastern Europeans emphasized that "keeping the national order" was found to be the imperative of greatest importance (Wolf, 1998: 134). After this phase of rising disorientation has reached a certain crisis point, a reorientation is about to happen, where people tend to adapt to the changing environment. In the *third phase*, the mastering and adaptation begins. The forces calling for European integration begin to support the establishing of a market based economic system and a democratic political system and may therefore be interpreted as institutions that stabilize the modification of the mental frameworks of Eastern Europeans towards stronger compatibility with Western European mental frameworks. This cultural convergence is going to be accelerated by increased economical relations, for example, cross-border joint ventures, and by collectively shared norms and values which have seen their manifestation in EU laws and regulations. In *phase four*, by obtaining EU membership the attainment of European standards is realized (Feichtinger and Fink, 1999: 142). On joining the EU, in principle the Acquis Communautaire has applied to all new member states which have equal rights regarding their participation in EU executive bodies and committees. The Acquis Communautaire is the entire body of European laws which are obligatory for all EU member states. This includes all the treaties, regulations and directives passed by the European institutions as well as judgements laid down by the Court of Justice. The new member states should adopt, implement and enforce all the Acquis Communautaire on joining the EU (Stankovsky, 2000). Special EU programmes for enforcing the East–West exchange of students continue to exist and the new member states have been taking part in EU programmes like "Socrates" and "Leonardo da Vinci". The EU enlargement will gradually lead to a political, economic and cultural convergence through standardizing certain norms and an approximation of shared values. This kind of "collective acculturation" (Feichtinger and Fink, 1999: 142) does not only diminish the psychic distance between Central and Eastern Europeans, on the one hand, and Western Europeans, on the other, but is also likely to

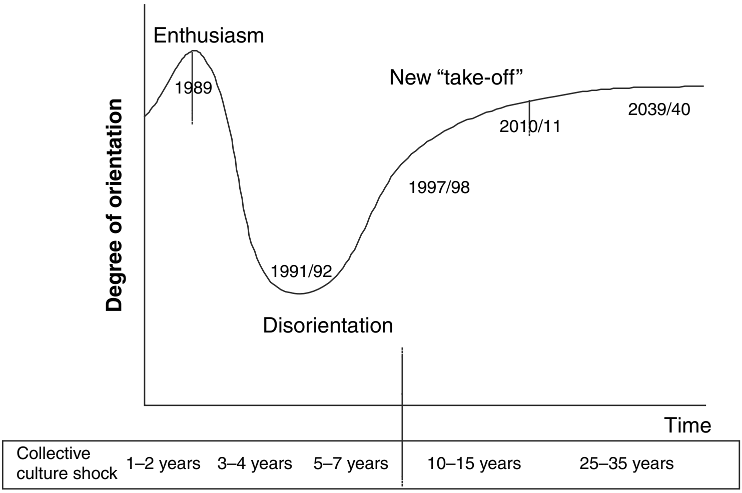

Figure 2.2 Cultural change in CEECs
Source: Feichtinger and Fink (1999: 144).

significantly weaken psychic distance between peoples from different CEEC (Figure 2.2).

Ullmann (2003) reports a study of the Polish Institute for Domestic Trade and Consumption published in 2001 examining the behaviour of young Polish consumers between 7 and 19 years of age: the convergence of buying behaviour – a tendency which erases national differences and promotes the standardization of marketing policies, and which has been hypothesized by scholars like Levitt (1983), Ohmae (1985) and Yip (1994) – was confirmed in the case of young Poles when compared to Western Europeans of the same age. She comes to the conclusion that Polish kids and teenagers are adopting the buying behaviour of Western kids and teenagers. As the study found out, one important determinant is the attribute "known brand" through which young Poles want to express their identification with products from European and global companies.

Consequences for the role of market-seeking CEE subsidiaries

From the viewpoint of Western firms, this collective acculturation taking place in CEECs may therefore lead to a rapid increase in psychic market proximity. A consequence of this development might be that foreign subsidiaries in CEECs are no longer necessary to achieve the required degree of psychic market proximity to the local market. However, another effect might be that by realizing a high degree of psychic market proximity in one CEE country (through a foreign subsidiary), a sufficient degree of psychic market proximity in other CEE countries of even other (Western) European countries can be reached. Therefore, the processes of convergence open up potential opportunities for firms to rearrange the geographic scope of their CEE subsidiaries. Thus MNEs which are running “psychic market proximity-seeking” subsidiaries in CEECs may consider restructuring. In a study of more than 2000 European foreign subsidiaries Schmid and Schurig (2004) question whether and to what extent an MNE’s capabilities can be enhanced by their foreign subsidiary. They suggest that with increasing homogeneity of the environment of an MNE’s subsidiaries, the potential to acquire new capabilities from the local environment declines. This reasoning seems to be perfectly in line with our argument, that is, as national cultures in Western and Eastern Europe converge (towards the Western European culture), the need to be geographically present in the market in order to communicate effectively with the market decreases significantly. Hence, the processes of cultural convergence create opportunities for restructuring and standardization for Western firms and facilitate the establishment of pan-regional strategies, that is, market strategies where the specifics of a local market do not have to be taken into account any longer. Procter & Gamble (P&G) in Hungary is one good example for standardization of customer communication. When launching a new product in Hungary, international copies of television ads from other Western markets are utilized one to one, with only language adaptation. Certainly, one could develop further arguments related to product specificity but homogenizing buyer behaviour patters may certainly lead to more uniformity in the approaches to serving customer needs.

Thus, the fate of many CEE subsidiaries may finally be at a crossroad. During the early stages of economic and political transformation, the business environment in these countries was shaped by an economic system, which still carried the characteristics of its heritage based on state-planning approaches and mechanisms. The level of integration was rudimentary at best between the different CEE markets as well as between individual CEE and Western European markets. In the CEECs, distinct strategies for economic and political transition were chosen (not the least in order to distinguish one country from the others). Furthermore, during the early stage of transition, strong tendencies of separatism could be found in these countries. All these tendencies strongly emphasized the necessity for firms to seek physical presence in a country-specific local market in order to realize a sufficient degree of psychic market proximity.

Consequently, at that time many Western MNEs established local subsidiaries in the CEE markets that may be described as "local centres of transition competence", achieving greater psychic market proximity to turbulent and diverging local Eastern European markets. In many cases, these subsidiaries were run as joint ventures (even after legal restrictions allowed 100 per cent foreign ownership) so that the Western partner could acquire from the local partner the skills and capability in communicating effectively with the local market. However, after these skills were acquired many of the joint ventures were transformed into wholly owned subsidiaries.

Yet, the processes of cultural convergence described above have led to a situation where the benefit of the additional psychic market proximity achieved through setting up a local subsidiary is going to become marginal. Subsidiaries established for this reason might be left in a situation which leads to mass redundancies as cultural changes in CEECs enable Western firms to move to pan-regional strategies for the whole of the CEEC region or even the whole of Europe.

The CEE subsidiaries of Western firms, which have been set up in the first instance for reasons of psychic market proximity may therefore find themselves in a converging context, where they perform similar functions than other subsidiaries of the same network. Consequently, many of these subsidiaries may lose competencies and resources through divestment activities. Thus they will increasingly drift towards the role of implementing units (Bartlett and Ghoshal, 1989) or even get liquidated. Subsequently, some may be replaced by foreign trade activities. Only a few Central European subsidiaries will have the opportunity to profit from these divestment tendencies and emerge from the related restructuring processes as regional leaders (that is, an increase in geographic scope) as has been the case of the Hungarian subsidiary of P&G.

(P&G) in Central Europe

In order to support the practical relevance of our considerations, we are going to base our discussion on the empirical example of P&G operations in CEE as the company has been carrying out radical restructuring activities in this region. The empirical data employed for the illustration of this case have been gathered through personal interviews with executives from the company and through analysing company documents including information material issued by the company as well as information available on the websites of the parent company and its subsidiaries in CEE.

In 1991, P&G opened its first subsidiary in Central Europe with the acquisition of Rakona in Czechoslovakia. Rakona, a reputable and successful Czech manufacturing company established in 1875, was originally a soap-producing plant. New subsidiaries in CEECs were established throughout the same year in Hungary, Poland and Russia. Soon after the break-up of Czechoslovakia in 1993, P&G started operations in Slovakia too. In 1992, Bucharest was chosen as the centre for managing P&G's activities in the Balkan countries. About a year after the signing of the peace treaty between the fighting parties in Former Yugoslavia in late 1995, P&G started activities in Yugoslavia by opening an office in Belgrade. Further offices were opened in the Former Yuogoslav Republic of Macedonia, in Moldavia in 1998, and the Bosnian office was opened in Sarajevo in 1999.

In 1999, this strategy of national fragmentation came to a halt. The Czech, Slovakian, Slovenian, Croatian and Hungarian subsidiaries of P&G were brought together to the regional headquarters in Budapest. Budapest was chosen because of its central location and proximity to Western Europe. The subsidiaries in Slovenia, Croatia and the Czech Republic lost their responsibilities for marketing and finance activities. Country-specific product management in the meantime was carried out from Budapest by managers regardless of their nationality. For instance, a brand manager of Croatian origin was transferred to Budapest and the scope of her geographical responsibilities included five countries – Croatia, Slovenia, Czech Republic, Slovakia and Hungary. Due to cost efficiency reasons, there are plans to replace the expatriates from other CEEs countries by Hungarians in the medium to long term.

The same pattern of "regionalization" can be found for P&G in Poland, the Baltic states and Belorussia. After signing a joint venture agreement with a local Polish company, Poll Ltd, in early 1991 operations began under the name P&G Poll Inc., later changed to P&G Eastern Europe. Following a period of considerable increase in the number of employees, revenues and profits, P&G strengthened its largest plant in Central Eastern Europe that was placed in Warsaw. Between 1997 and 2000, P&G Polska consolidated and integrated the operations that were previously run by subsidiaries in Latvia, Estonia, Lithuania and Belorussia. Similar to P&G in Hungary, the Polish subsidiary profited in terms of developing and enhancing its regional competences and benefitted from additional resources committed to its growth vis-à-vis the losses incurred by the subsidiaries in the Baltic states in view of responsibilities, operational significance and importance in the P&G's European value chain.

Conclusions

The essential conclusions to be drawn from these considerations are twofold. First, competition between "psychic market proximity-seeking" subsidiaries of the same MNE located in Europe is going to intensify significantly as the cultural convergence resulting from the process of European integration creates potential opportunities for restructuring. This concerns not only competition between subsidiaries located in different countries in CEE, but also competition between subsidiaries in CEE and Western Europe, especially from the EU. Second, with the second wave of Eastern enlargement of the EU, and further waves if any, competition between Eastern European countries concerning the development of "psychic market proximity-seeking" subsidiaries located on their territory is likely to increase. For those CEECs where these subsidiaries are important for the national economy in terms of volume and stock of FDI or even considering the number of jobs they provide to the local population, there could be challenging times when the winds of change are going to get rougher.

Note

1. The empirically observable tendency is acknowledged concerning a shift of power towards subsidiaries. However the analogous application of product life cycle to the "life cycle of a subsidiary" suggests that the first impetus to set up the first FDI stems from the parent company.

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3

EU Enlargement and Inward FDI in Central Europe

An Evolutionary Game Approach

Ken Morita

Introduction

Economic forecasts for the new European Union (EU) member countries have generally remained positive following their entry into the EU (Haba, 2004). For example, the Vienna Institute of Comparative Economic Studies (WIIW) has maintained a positive outlook on their economic growth arguing that the GDP growth rate would be consistently between 4 and 9 per cent per annum. A major factor that defines such forecasts is the expectation that foreign direct investment (FDI) to the Central and East European region as a whole will increase. The WIIW expected the total amount of FDI inflow into the eight new EU member countries to reach €15.4 billion in 2004, which was 51 per cent more than in 2003. Thus the entry of the Central and East European countries into the EU has been the major driver for their improved macroeconomic performance and for the substantial rise in FDI inflows (UNCTAD, 2005). This chapter investigates the EU enlargement as a fundamental factor promoting capital inflow into Central Europe using an evolutionary game approach.

Some of the main theories of FDI have been associated with transaction costs, which are discussed in detail by Coase (1937), Williamson (1975) and Williamson and Masten (1999). They are a useful starting point in the analysis that will be supplemented by a reflection on further theoretical developments by Rugman (1980, 1985) and Keohane (1984). Following Keohane's assertion (1984), we could argue that transaction costs are, at least in part, absorbed by international regimes (Dunning, 1979). Moreover, if we consider Rugman's (1980) suggestion that internalization of market transactions by reducing transaction costs could be a determinant of FDI, we could propose that internalization has a similar function to an international regime.[1] Similar to Krasner (1983) and Keohane (1983, 1984), we define international regimes as "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations".[2] Based upon this concept, regime formation indicates a process of establishing principles, norms, rules and decision-making procedures among any parties, which are closely connected with systemic evolution. In other words, it is an approach of an evolutionary game.

The inefficiency of the centrally planned economies has been explained by many social scientists with publications in different disciplines. The use of game theory might be a useful approach to the analysis that can shed light on the recent developments in Central and Eastern Europe (CEE). The research framework exploring the role of institutions and bounded rationality of individual behaviour was developed in the 1970s and 1980s. It has been associated with research on evolutionary biology led by Smith and Price (1973) and Smith (1982). The approach of evolutionary biology was introduced into social science with bounded rationality and was established as the evolutionary game theory.[3] The latter can help researchers in the comparative analysis of economic systems and institutions.[4]

The purpose of the chapter is to investigate the relationship between EU enlargement and the inward FDI in Central Europe based upon the above-mentioned theoretical perspectives of the international regime and evolutionary game theory.

Inward FDI into Central Europe

Overall trends

Table 3.1 shows the inward FDI in Central European economies for the period 1987–2002. According to JETRO (2000), US and European companies have become quite active in their search for investment opportunities in CEE markets, particularly in such industries as automobile and its related industries, finance, telecommunication, aircraft manufacturing and energy, with the objective of strengthening their market positions.[5] EU Eastern enlargement seems to have had positive effects on the FDI movements towards CEE.

Hungary benefited substantially in the first half of the 1990s as the main attraction to foreign buyers were the companies offered for privatization. Hungarian privatization was predominantly led by the

Table 3.1 Flow of inward FDI in Central Europe (USD million)

Country	**1987–1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Bulgaria	34	40	105	90	109	505	537	819	1002	813	479
Czech Republic	533	653	868	2561	1429	1301	3700	6310	4984	5639	9319
Hungary	675	2339	1146	4453	1983	2085	2037	1977	1646	2440	854
Poland	183	1715	1875	3659	4498	4908	6365	7270	9341	5713	4119
Romania	61	94	342	420	265	1229	2031	1041	1025	1157	1106
Slovakia	91	168	245	195	251	177	684	390	1925	1579	4012

Source: United Nations, *World Investment Report* (1999, 2003).

efforts of local government officials and enterprises to find foreign buyers who could either acquire local businesses or be willing to enter into collaborative relationships with the management of Hungarian firms forming joint ventures (Table 3.2).

The privatization in Poland, that is, capital privatization in particular, was delayed due to political conflict. Nevertheless in the second half of the 1990s, Poland became the most attractive country for foreign investors (Morita, 1998) who were motivated by the favourable business climate and the good economic performance of the country.

The Czech Republic has been evaluated as the most efficient economy in Central Europe, together with Slovenia (Table 3.3), which denotes that by the end of 2010 its economy should gain considerable strength and with an EU average at 100 points, it may well be at 75 points, while Greece, Portugal, Hungary and Poland will have 65, 68, 48 and 42 points, respectively.

Table 3.4 shows the structural reform index of 1990–2000, which points out that the Czech Republic and Hungary reached 0.93, and Poland 0.86, in 2000.[6] It also clearly describes that Poland, Hungary

Table 3.2 Methods of privatization

Country	**Sale to outside owners**	**Voucher privatization (equal access)**	**Management–employee buyouts**
Poland	Tertiary	Secondary	Primary
Czech Republic	Secondary	Primary	
Slovakia		Secondary	Primary
Hungary	Primary		

Source: EBRD (1997: 90).

Table 3.3 GDP level (EU average = 100)

Country	1997	2000	2005	2010
Czech Republic	58	62	68	75
Hungary	37	39	43	48
Poland	32	34	38	42
Slovenia	59	63	69	76
Greece	67	67	67	67
Portugal	68	68	68	68
Spain	78	78	78	78

Source: Haba (2004).

and the Czech Republic had much higher index numbers at the beginning of the 1990s than any other transition economies, which indicates that they had created better conditions to receive and absorb inward FDI. It should be noted though that the correlation coefficients between 1991 structural reform index numbers shown in Table 3.4 and inward FDI stocks from 1997 to 2002 as shown in Table 3.5 for eight Central

Table 3.4 Structural reform index

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Bulgaria	0.19	0.62	0.86	0.66	0.63	0.61	0.57	0.67	0.79	0.79	0.85
Czech Republic	0.16	0.79	0.86	0.90	0.88	0.82	0.82	0.82	0.90	0.90	0.93
Estonia	0.20	0.32	0.64	0.81	0.83	0.77	0.78	0.82	0.90	0.93	0.93
Hungary	0.57	0.74	0.78	0.82	0.83	0.82	0.82	0.87	0.93	0.93	0.93
Latvia	0.13	0.29	0.51	0.67	0.71	0.67	0.74	0.74	0.86	0.86	0.82
Lithuania	0.13	0.33	0.55	0.78	0.79	0.71	0.74	0.74	0.82	0.82	0.86
Poland	0.68	0.72	0.82	0.82	0.83	0.79	0.79	0.81	0.86	0.86	0.86
Romania	0.22	0.36	0.45	0.58	0.67	0.65	0.64	0.66	0.76	0.82	0.82
Slovakia	0.16	0.79	0.86	0.83	0.83	0.79	0.79	0.77	0.90	0.90	0.89
EU average	0.27	0.55	0.70	0.76	0.78	0.74	0.74	0.77	0.86	0.87	0.88
Belarus	0.04	0.10	0.20	0.33	0.42	0.50	0.44	0.37	0.37	0.37	0.43
Moldova	0.04	0.10	0.38	0.51	0.54	0.64	0.64	0.64	0.76	0.76	0.75
Russia	0.04	0.10	0.49	0.59	0.67	0.64	0.71	0.72	0.64	0.64	0.64
Ukraine	0.04	0.10	0.23	0.13	0.33	0.54	0.57	0.59	0.65	0.65	0.68
Georgia	0.04	0.22	0.32	0.35	0.33	0.50	0.61	0.66	0.79	0.79	0.79
Armenia	0.04	0.13	0.39	0.42	0.46	0.54	0.61	0.61	0.76	0.76	0.72
Azerbaijan	0.04	0.04	0.25	0.31	0.33	0.40	0.44	0.51	0.61	0.61	0.65
Kazakhstan	0.04	0.14	0.35	0.35	0.42	0.50	0.64	0.66	0.79	0.72	0.71
Kyrgyzstan	0.04	0.04	0.33	0.60	0.71	0.71	0.67	0.70	0.82	0.79	0.79
Tajikistan	0.04	0.11	0.20	0.26	0.42	0.40	0.40	0.39	0.55	0.58	0.61
Turkmenistan	0.04	0.04	0.13	0.16	0.29	0.27	0.27	0.36	0.36	0.36	0.35
Uzbekistan	0.04	0.04	0.26	0.30	0.50	0.57	0.57	0.54	0.57	0.50	0.49
CIS average	0.04	0.10	0.29	0.36	0.45	0.52	0.55	0.56	0.64	0.63	0.63

Source: Aslund and Warner (2004: 233).

Table 3.5 Stock of inward FDI in transition countries (USD million)

Country	1997	1998	1999	2000	2001	2002
Bulgaria	951	1,352	2,403	2,716	3,410	3,889
Czech Republic	9,234	13,457	17,552	21,644	27,092	38,450
Hungary	15,882	18,255	19,299	19,804	23,562	24,416
Poland	16,593	21,722	26,475	34,227	41,031	45,150
Romania	3,617	4,250	5,441	6,480	7,638	8,786
Estonia	1,148	1,822	2,441	2,645	3,160	4,226
Latvia	1,272	1,488	1,795	2,084	2,332	2,723
Lithuania	1,041	1,625	2,063	2,334	2,666	3,981
Slovakia	1,597	2,502	2,817	4,634	6,213	10,225

Source: UNCTAD (1999, 2001, 2003).

Europe and Baltic transition economies, that is, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania[7] were 0.7854, 0.8089, 0.8235, 0.7986, 0.8071 and 0.8208, respectively from 1997 to 2002, all of which are significant at the 0.05 level.

Japan's FDI into CEE[8]

In the following part of the chapter, we shall concentrate our analysis on some of the Japanese FDI into Central Europe. More specifically, we shall examine the investment into Poland considering the 2004 EU accession (Table 3.6).

Japanese investors have considered CEE as a convenient and efficiency generating stepping stone into the market of the EU as well as a gateway to the Russian market. Thus the manufacturing sector in CEE has been targeted by Japanese firms (Marinov et al., 2003). Consequently, at the end of 2003, the number of Japanese FDI into Central Europe was 137, which was an increase by 18 investment projects compared with the

Table 3.6 Japan's outward FDI (USD million)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	34,138	36,025	41,051	50,694	48,019	53,972	407,47	66,694	48,580	31,606
Europe	7,061	7,940	6,230	8,470	7,372	11,204	14,010	25,804	24,406	10,571
3 CEE	4	72	41	82	25	174	103	159	312	136
Asia	6,425	6,637	9,699	12,264	11,614	12,181	6,528	7,162	5,931	6,178

Note: 3 CEE includes Czech Republic, Hungary and Poland.
Source: JETRO.

end of 2002. Of these additional eighteen FDIs, six went to the Czech Republic, five to Poland, five to Hungary, one to Romania and one to Bosnia and Herzegovina. In line with the previous investment interest of Japanese corporations, almost all of the new inward FDI from Japan was targeted at the three Visegrad countries, that is, Poland, Hungary and the Czech Republic.

We have attempted to find out more about the attitudes of Japanese investors in CEE concerning the EU enlargement. Overall, in 2003 the management performance of the firms with Japanese investment in Central Europe improved substantially when compared with the same indicators for 2002. Nevertheless, data from JETRO indicate that Japanese investors perceive a number of major problems that have a negative impact on their firm performance in CEE. These include (1) visa and labour permission issues, (2) financial complexity and exchange rate fluctuation, (3) complicated red-tape procedures, (4) customs duties, (5) difficulties in finding qualified and committed human resources, (6) quality of raw materials and parts, (7) high rate of employee absenteeism and so on.[9] The questionnaire used by JETRO also describes the merits and drawbacks of the EU enlargement for Japanese companies in CEE. More than half or 52.2 per cent of all respondent companies considered that the benefits of EU enlargement overweighed the disadvantages for their business operations in CEE. However, 34.8 per cent thought that there were more drawbacks than benefits and 13.0 per cent perceived that the EU enlargement process had neither positive nor negative impact on their performance in CEE. Among the positive effects of EU enlargement, company managers identified as most important the (1) more simplified trade procedures, (2) more harmonized legal system, (3) more harmonized regulations and (4) market expansion and so on, whereas the drawbacks referred mostly to (1) labour cost increase, (2) greater competition, (3) human capital outflow towards Western Europe, (4) abolition and reduction of favourable treatment for investment and (4) strengthened environmental regulations.[10]

Japan's FDI into CEE (Figure 3.1) has been mostly targeted at the Czech Republic in the first few years of the twenty-first century. A major factor driving this process has been the interest shown by the Czech government in Japanese FDI opportunities and the support system it had put into place to promote the Czech Republic as a favourable destination for the investment of Japanese companies. For example, the Czech government established and actively developed an investment promotion office in Japan, which has been effective in reducing transaction costs.

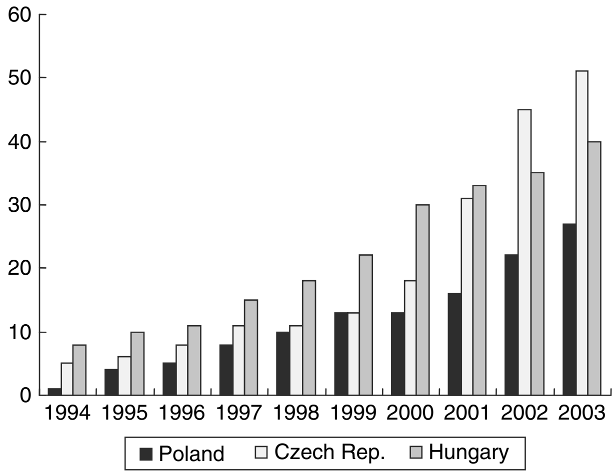

Figure 3.1 Number of Japan's manufacturing FDI in CEE
Source: JETRO (2004: 25).

Japan's FDI to Poland has been lagging behind that towards the Czech Republic and Hungary. Nevertheless, there have been some efforts at government level to promote investment opportunities in Poland with Japanese firms. For example, when the then Japanese prime minister visited Poland in August 2003, he and his Polish counterpart announced a "Joint Statement towards Strategic Partnership between Japan and the Republic of Poland".[11] The statement identified several crucial issues regarding Japan's FDI to Poland which included but were not limited to setting up a "one-stop shop" to deal with all administrative procedures for foreign investment arising from bureaucracy in both countries and establishing a Polish investment promotion office in Japan (McMillan and Morita, 2003). The Japanese delegation also expressed its commitment to extend assistance to the Polish Agency for Information and Foreign Investment (PAIIZ) in attracting FDI by dispatching a Japanese expert for a period of one year. Both sides explained their intentions to support each other in initiatives promoting FDI opportunities. For example, the Japanese side would initiate promotional activities for inward FDI such as "Invest in Japan" and the Polish side would learn from and fully utilize Japan's experience in this regard. Thus the government leadership developed and stood behind a jointly expressed interest in promoting future Japanese FDI into Poland and Polish business interest in Japan. Such government level negotiations, which fall into the category of international regime analysed later in this chapter, are extremely important and powerful mechanisms that can promote FDI and resolve any difficulties and obstacles deterring companies from undertaking FDI.

The evolutionary game theoretical perspective

There have been a variety of models classified as evolutionary game, and here in the second and third sections of this chapter, we investigate a Kübler type model, asserted, for example, by Kübler (2001) and Huck et al. (2001), which is directly based on work of Uno and Inoue (2004).

We start by assuming that (1) we could distinguish the diligent members and the negligent members. In this case, we also assume that the diligent member has his or her own evaluation of being diligent for motivation to work hard (with assumption of the same wage rate[12]) and (2) the proportion of each member is assumed at t period to be, x_t of negligent member and $(1-x_t)$ of diligent member. Also (3) the structure in which each member has a game is assumed as being "trust to numbers", which means that each member could choose the position depending on x_t and $(1-x_t)$.[13]

Based upon the above assumptions, we could build a model thinking about the specifics of the transition process.

The utility of a diligent member is expressed as

$$u^H = w + R - e^H \tag{3.1}$$

Here, w means

$$w = \frac{F(e_1, \ldots, e_n)}{N}$$

where F denotes the production function, and N describes the number of members. R indicates the psychological benefit of diligent members, which is recognized as produced by the mutual cooperation among those with higher will to work, and is expressed as,

$$R = \delta(1 - \alpha)$$

where δ is a parameter showing the worker's subjective sensitivity and it has a uniform distribution $\delta \in [0, 1]$. $(1 - \alpha)$ denotes the proportion of members with the norm of diligence. Needless to say, the higher $(1 - \alpha)$ the higher the will to work, the greater the efficiency. As is easily understood from Equation (3.1), e^H shows disutility with work.

On the other hand, the utility of a negligent member is[14]

$$u^L = w - e^L \tag{3.2}$$

Each member could compare equations (3.1) with (3.2) and choose the optimum decision.

Supposing at t period that the proportion of diligent members is $(1-x_t)$, the proportion of members with higher will to work is indicated as

$$1 - x_t = \begin{cases} 1 - \delta^* = 1 - \dfrac{e^H - e^L}{(1-\alpha)} & \text{if} \quad 0 < e^H - e^L \leq (1-\alpha) \leq 1 \\ 0 & \text{if } (1-\alpha) < e^H - e^L \end{cases} \tag{3.3}$$

where δ^* means the critical parameter at which $(e^H - e^L) - R = 0$ is held.

As far as the long term is concerned, based on Uno and Inoue (2004) it could be assumed that a long-term reputational value of the norm is

$$V = V(1 - x_t)$$

Therefore, the equation to describe the long-term dynamics could be

$$\frac{\partial \alpha}{\partial t} = \lambda \{V(1 - x_t) - (1 - \alpha_t)\} \tag{3.4}$$

where $\lambda \in (0, 1)$ means the adjustment parameter, which indicates the adjustment process to recognize the proportion of diligence and negligence.

In order to recognize the process more clearly, we could specify the reputational value as the following function form:

$$V(1 - x_t) = \begin{cases} 0 & \text{if} & 1 - x_t < 0 \\ 1 - x_t & \text{if} & 0 \leq 1 - x_t \leq 1 \\ 1 & \text{otherwise} & \end{cases} \tag{3.5}$$

Stationary state which is reached after finishing the adjustment process could be achieved when $\partial\alpha/\partial t = 0$. By Equations (3.4) and (3.5), it is when $(1 - \alpha_t) = (1 - x_t)$ and it satisfies the necessary and sufficient condition.

To investigating the nature of equilibrium, we assume $\alpha_t = x_t$ in Equation (3.3), in which we have the following quadratic equation.

$$(\alpha_t)^2 - \alpha_t + (e^H - e^L) = 0$$

Solving the equation leads to stable equilibrium at which the short-term schedule and the long-term schedule intersect. With the stable equilibrium of $(1-\alpha_t^*) = (1-x_t^*)$, the proportion of diligent members is determined.

By rewriting Equation (3.3), we could easily recognize that the short-term schedule is illustrated as concave.[15]

In terms of the long-run equilibrium, because the members who follow the norm become the members who trust diligence and have psychological benefit from higher will to work, the long-run schedule is shown as $\alpha_t = x_t$. It is illustrated by the 45° line in Figure 3.2.

When there are multiple equilibriums in Figure 3.2, the lower intersection could be stable. If the short-term schedule lies above the long-run schedule, that is, $\alpha_t > x_t$, as assumed with the Equations (3.4) and (3.5), α_t decreases which entails a decline of x_t. On the other hand, if the short-term schedule is below the long-term schedule, that is, $\alpha_t < x_t$, both variables α_t and x_t increase. Consequently, the upper intersection is unstable. When the short-term schedule comes into contact with the long-term schedule, the interior solution is also unstable.

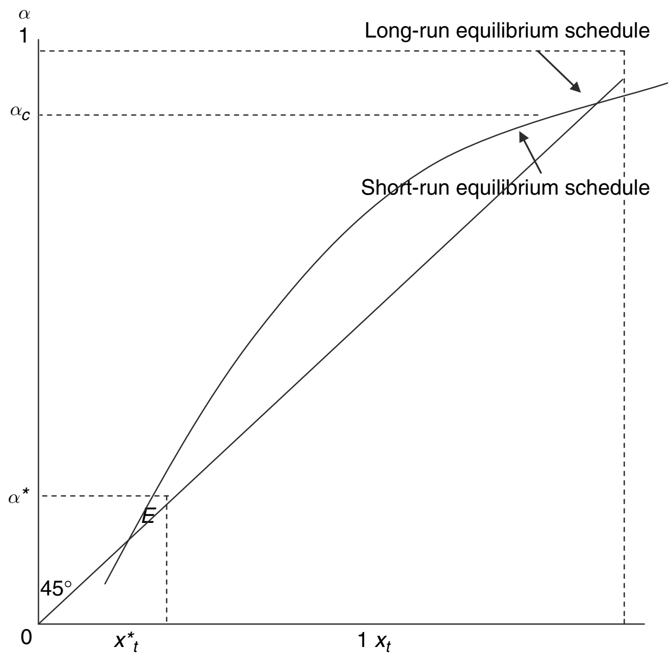

Figure 3.2 Equilibrium in the evolutionary game

Interpretation: why has inward FDI in Central Europe increased?

In the evolutionary game approach, we recognized that the members in a society could be divided into two groups (diligent workers and negligent workers in this chapter) of different maximizing behaviour. We also assumed that each group could be existing in a certain proportion in a stable equilibrium, for example, in this chapter $1-\alpha_t$ and α_t.

What is then the relationship between economic transition (and EU accession) and the evolutionary game?

Starting with Winiecki's idea on the growth of the industrial sector, it can be said that the overgrown industrial sector means "the industrial sector in STEs to be markedly overgrown in comparison with other economies at the same level of economic development".[16] Winiecki explained the reason why the overgrown industrial sector appeared as due to underspecialization.

The underspecialization was due to the behaviour of STEs, which had the tendency to avoid risks by accumulating stocks of workers and materials.

At the initial period *t*, there are $1-\alpha_t$ proportion of diligent workers and α_t proportion of negligent workers. Each worker decides whether he or she is diligent or negligent based upon own individual utility function. It has been widely accepted that motivation to work hard could not be found in the STEs. Therefore it could be considered reasonable under the system described as "underspecialization" and "overgrown industrial sector" for most workers in the STEs to be negligent.

It means that in the STEs almost all workers choose to be negligent (and quite a few workers choose being diligent). We could assume that in STEs the short-run schedule existed at the right and the lower sides of the long-run schedule (Figure 3.3).

If keeping the economy unchanged as presented in Figure 3.3 and the equation of long-run dynamics describes, the economy reaches a corner solution represented by $\left(1-\alpha_t^*\right)=0$, in which all of the members choose to be negligent and the efficiency of the economy becomes extremely low. Therefore, such a situation could be interpreted as of "the distorted world of Soviet-type economies" (Winiecki, 1988: 80).

Economic transition is when the existing economy (as described in Figure 3.3) is transformed into position *E* shown in Figure 3.2. This position represents the economy in a stable equilibrium with a higher proportion of diligent workers, who perform more efficiently. To achieve equilibrium, it might be necessary that workers' utility function

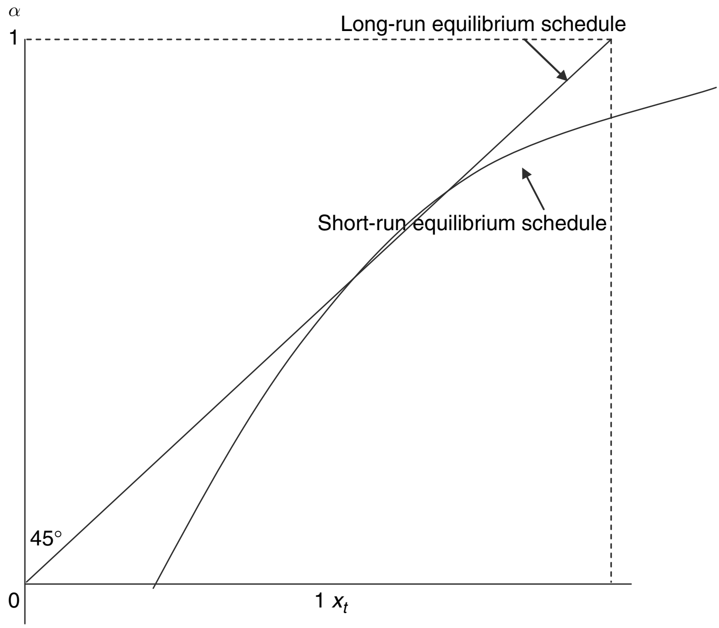

Figure 3.3 Corner solution case

is changed and the evaluation function is also changed, hence the adjustment mechanism indicated by parameter is changed.

An important issue that should be pointed out here in relation to the EU enlargement is a shift of the long-run schedule.[17] This is a parallel shift of the long-run schedule (45° line), which is expressed as the schedule with $\alpha_t = x_t$ to the schedule with $\alpha_t = x_t - \beta(\beta > 0)$. The shift means change that allows having more area of diligence norm in a concerned society, whose shift seems to be connected with the EU enlargement in a long-run perspective. Even if the situation is presented in Figure 3.3, the parallel shift of the 45° line could make the economy reach stable equilibrium with greater proportion of diligent workers. This situation is indicated as *E′* point (Figure 3.4).

Conclusions

This chapter investigates aspects of norm change related to the EU enlargement with an evolutionary game focusing attention on inward FDI in Central Europe.

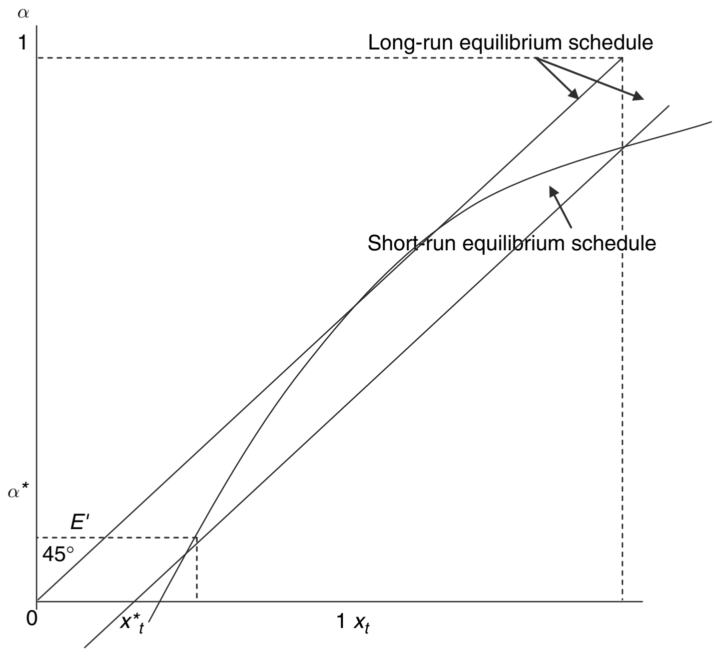

Figure 3.4 Change of norm case

The long-run schedule parallel shift (the parallel shift of the 45° line) means that the new norm established possesses greater area of diligence. Whereas our viewpoint has been focused on the change of norm, the EU enlargement towards Eastern Europe has indispensably caused several serious changes in the eastern part of the new EU. The changes in the investigated economies have brought positive effects for the attraction of inward FDI.

The reasons for the increase of inward FDI into Central Europe could be interpreted with an evolutionary game approach, which reflects the increased proportion of diligent workers and the decreased proportion of negligent workers in the process of moving towards a more efficient economy.[18]

Considering Japan's outward FDI into Central Europe, Japanese firms, being risk averse, have always regarded the region as containing high risk. As EU enlargement progresses the changing norms bring in fairer competition and more transparency among many other changes. Thus in the future the Central European countries would attract more risk averse Japanese firms into the region.

Based on Fehr and Fischbacher (2004) "we still know little about how social norms are formed",[19] it is rather difficult to explain a norm formation or a new norm establishment especially in the context of the changing nature of doing business in transition economies.

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Notes

1. On major theories of FDI and Rugman's maintenance, see, for example, Horaguchi (1992) and Tomiyama (2004). We have no discussion here whether the international regime is established by self-interest or shared interest.
2. See Krasner (1983: 2) and Keohane (1984: 8, 57, etc.).
3. See Okada (1998).
4. See Yoshida (1998).
5. JETRO (2000: 245).
6. On the explanation of the index, see Aslund (2002: 161).
7. Slovakia is excluded here because of the exceptional position at the beginning and the middle of the 1990s.
8. On data analysis related with this section, see, for example, Morita (2005).
9. See JETRO Research Report (2004: 34).
10. See JETRO Research Report (2004: 36–37).
11. It was declared on 19 August 2003. The following text is cited from the Japanese Embassy in Warsaw.
12. This assumption could be easily modified.
13. On the three assumptions, see, for example, Ueda (2004).
14. Needless to say, as the negligent member does not have the psychological benefit, Equation (3.2) has no R.
15. See Uno and Inoue (2004).

16. Winiecki (1988: 78). The abbreviation STEs means Soviet-type economies.
17. It was asserted by Kübler (2001). See also Lessig (1995). I am thankful for the helpful suggestion on this important point of analysis given by Yoshifumi Uno.
18. Needless to say, the change of norm has both cause and effect for inward FDI in Central Europe. As far as the empirical test is concerned, we should have a careful investigation on the statistical relationships between the norm establishment and inward FDI, although we will not do this in the present chapter.
19. Fehr and Fischbacher (2004: 185).

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4

Globalizing Brands?

Brand Strategies of Western Multinational Corporations in Central and Eastern Europe

Arnold Schuh

Introduction

The liberalization of the political and economic systems in Central and Eastern Europe (CEE) since the fall of the Iron Curtain in 1989 has opened a huge new market for foreign firms. In particular, the enormous growth potential of the region prompted a rush into the emerging markets of this region. While the motivation to enter these markets was clearly understood, the choice of the adequate marketing approach turned out to be more complicated. The foreign firms almost faced a "tabula rasa," a regional market that had been isolated from the modern Western marketing and consumption culture for more than four decades. What is the right marketing approach in such a situation? Should the management of the foreign firms opt for a more localized or a more standardized approach in international marketing strategy? Had management followed classic international marketing theory, it would have leaned towards a more localized approach given the huge differential in purchasing power and market development between Western and Eastern Europe. However, the asserted convergence of international consumption patterns and the ongoing portfolio restructuring and brand rationalization efforts by leading players in the saturated consumer goods markets of the world would lead us to expect a more globalized brand strategy in the emerging markets of CEE too (Levitt, 1983; Haden *et al.*, 2004). Does it then make sense to get involved in international marketing program differentiation? A comparison with actual market data representing market shares of local and foreign brands could provide an answer to this controversy. A high and over the years increasing proportion of international vis-à-vis local brands would corroborate the market globalization perspective, while the opposite finding would support the localization perspective. This chapter tries to explore how selected fast-moving consumer goods (FMCG) markets have developed since the economic opening and what market structures have emerged since then. The chapter consists of three sections. First, the strategy dilemma that Western firms face when they plan to market their products in CEE markets is outlined. The arguments for local adaptation are contrasted with those for global standardization. Second, the "market reality" is introduced by presenting the findings of a study comprising market share data for four selected product categories in four countries of the region. Finally, based on the results of the "4 product $\times$ 4 country" study conclusions are drawn with regard to the significance of the globalization philosophy for strategic decision making of multinational corporations (MNCs) in this region.

The strategy dilemma of Western consumer goods firms in CEE

The management of the conflict in international business and marketing strategy development between forces towards unification and integration across national markets and those resulting in fragmentation and localization has always been a central issue in international business research (Buzzell, 1968; Doz, 1980; Douglas and Wind, 1987). In the area of international marketing, scholars show a natural tendency towards customization. The occupation with the customers and their buying behavior as well as with the developments and structures of markets breeds quite understandably an emphasis on demand aspects vis-à-vis supply side considerations and leads to a higher sensitivity towards variances in the consumer behavior in different national markets (De Mooij, 1998). Success in a foreign market, so the credo, results from a good fit between the marketing strategy and the existing local market conditions.

Following this line of thought, looking at some key characteristics of CEE markets and comparing them with the West European market situation reveals a great many differences that could be relevant when considering the transfer of a marketing strategy from Western markets:

- Huge differential in purchasing power: the average GDP per capita (2003), in purchasing power standards, ranges from 29 percent of the EU-25 average in Bulgaria, 30 percent in Romania, 46 percent in Poland, 61 percent in Hungary to 69 percent in the Czech Republic and 77 percent in Slovenia (Eurostat, 2004). Even lower levels can be found in Russia, the Ukraine and Belarus. However, it has to be noted that the gap has been closing slowly but constantly during the last decade. Despite this favorable development, the low purchasing power has led to stagnant demand and, not surprisingly, price has become a decisive factor in buyer behavior (Shama, 1992; Schuh and Holzmüller, 2003).

- Lagging product market development: the average consumption of typical consumer products such a toiletries, soft drinks, confectionary, detergents and household cleansers is still well below Western levels. A lot of product categories did not exist before the transition or only basic product versions had been available. These markets have been built from scratch by the Western entrants who brought new product technologies, packaging and advertising techniques with them.
- Differences in buyers' behavior: under the socialist system the economy was characterized by shortages in supply of goods and particularly services. Consumers had a limited choice of products and had not been able to make informed choices about products or judge prices and quality. Brand awareness is still underdeveloped because most products in the socialist past were sold as generic or local brands. The transition to a market-oriented economy turned the former sellers' market to a buyers' market and brought about a change from a deficit in supply to a deficit in financial resources. Consumers in CEE are faced today with an excessive supply and variety of products but are constrained by their low disposable household incomes. Affordability is a key criterion for selling products to the mass market. Brand loyalty is relatively low and people look for the best value they can get for their money. So it is a difficult task for Western marketers to convince consumers to be willing to pay more for typical value-added features of modern brands like innovativeness, convenience, brand image, design and top quality. Furthermore, the emergence of "buy-national" motives in many markets has caused a stronger consumer loyalty to cheaper local or locally produced brands (Marinov *et al.*, 2001).
- Different competitive situation: while in the early 1990s the pioneers among the foreign firms competed against local firms, today the picture is more multi-faceted. In technology-driven consumer product categories (for example, detergents, cosmetics and body care products) the competition is mainly international, but local producers are major players in the food and beverage sector, where local tastes

and a strong affection for traditional (and cheaper) local brands are challenging the marketing efforts of foreign MNCs.

- Differences in trade structures: fragmented and long distribution channels have been common in CEE. Traditional store formats like general stores, small grocery shops, boutiques, kiosks, street vendors and open markets still dominate the distribution scene in South-Eastern Europe and in Eastern Europe: they represented 91 percent of total grocery retail sales in 2002 in Bulgaria and 86 percent in Romania, while modern store formats like hypermarkets, supermarkets, cash and carry and discounters made up the balance. On the other hand, the more advanced economies in the transition process in Central Europe already showed higher proportions of modern store formats in 2002 (modern/traditional store formats): Poland (50/50), Hungary (52/48) and Czech Republic (57/43). Western retail chains like Metro/Makro, Auchan, Tesco, Billa/Penny, Delhaize and Spar, which entered the region through the acquisition of local retailers and greenfield investments, have been acting as change agents by introducing modern store formats and retail management techniques (Domanski, 2003).

Pointing at these obvious differences in the overall economic development and in the development of product markets in particular, local customization of the marketing strategies in CEE is suggested as the most appropriate approach (Czinkota *et al.*, 1997; Marinov *et al.*, 2001). Marinov *et al.* (2001) doubt the success of standardized strategies for the CEE countries because foreign companies with growing insight and commitment in this region will realize that to be effective they need to address the diversity of cultures by identifying the similarities and differences in the cultural, historical, political and economic environment of these countries. Consequently, a holistic understanding of marketing and cultural diversity is needed and a "contextualized marketing strategy" is even advisable for a standardized marketing approach. Thus, from an extremely local market perspective there are strong arguments in favor of a more responsive international differentiation strategy.

However, an exclusive market-oriented perspective does not suffice to explain strategic decisions in MNCs. Firm-related aspects such as corporate goals and values, the strategic orientation towards internationalization, the organizational structure and configuration of value activities and, of course, profitability and risk considerations have always played a major role in the decision-making process (Doz, 1986; Porter, 1986).

Leading branded goods marketers would rather forgo entering a foreign market than make sacrifices in their product quality or to tarnish the image of their global brands. Furthermore, profit and risk considerations are areas which are often underestimated from a pure marketing point of view. This is well reflected in the currently ongoing rationalization process in the brand portfolios of consumer goods giants such as Unilever, Nestlé or Procter & Gamble and the resulting concentration on core or global flagship brands (Knudsen *et al.*, 1997; Haden *et al.*, 2004). High up-front investments in product development and major adjustments of the product and marketing program for a specific foreign market are rather the exception than the norm. Leveraging existing assets and resources such as brands, product technology and experience in new regional markets is a central consideration for MNCs following a globalization philosophy (Ghemawat, 2003). Major adaptations of the local marketing strategy may happen in a later stage of the market penetration when markets become saturated and management begins to seek new directions for growth and expansion (Douglas and Craig, 1989; DeMooji, 2004).

The balancing of investments and returns as well as the handling of the risks involved is a major concern in all market entry decisions. Strategic decision making in the MNC is the constant search for optimal trade-offs between market-related claims and what is acceptable from an internal perspective – aggravated by an exceptional complexity stemming from the operation in multiple geographic markets with multiple product lines and different constellations of value-added activities (Doz and Prahalad, 1993). Placed in the context of the nowadays prevailing globalization philosophy, the economic and competitive arguments often outweigh demands resulting from differences and peculiarities of local markets (Yip, 1989; Ohmae, 1990; Bryan *et al.*, 1999). The market globalization perspective is built on the assumption that customer needs and interests as well as market structures are becoming increasingly homogeneous worldwide – when compared on an industry level – and that the supposed convergence allows the international standardization of products and marketing elements (Levitt, 1983; Douglas and Wind, 1987; Yip, 1989). In such a global industry, it would be unwise for the management of MNCs to forgo the benefits of a global strategy. Benefits of a (standardized) global strategy are mainly seen in cost savings through the exploitation of economies of scale and the reduction of variety, in an improved quality of products and programs, in enhanced customer preference due to global availability and global recognition, in a coherent brand image and in more rapid diffusion of products (Jain, 1989; Yip, 1989). Although extreme international marketing program standardization – understood as using a common product, price, distribution and promotion program on an international scale – is rare, it has to be noted that MNCs have always had a strong tendency towards standardization of marketing and brand strategies (Buzzell, 1968). The propensity for a global strategy does not rule out adjustments to local market conditions (Schuh, 2000). As the rise of a global consumer culture does not mean that consumers share exactly the same tastes and values, global brands have always to be adapted to local cultures especially in the area of communication (Holt *et al.*, 2004). Further adjustments are often demanded by national regulations (for example, labeling requirements, "localization" of product names) or address important concerns of local consumers (for example, variations in taste, package size and design). Global strategies must not be equaled with a simple concept of globalization, namely a single global product and advertising campaign and isolated, centralized decision making at headquarters and imposed local execution (De Mooij, 1998). Nuanced approaches to global branding that build on the cooperation between all relevant participants from headquarters, local subsidiaries as well as external marketing service providers (for example, marketing research and advertising agencies) and a focus on the international brand-planning process and the following execution of brand-building strategies are regarded as the most effective approaches in a corporate world that is still marked by decentralized cultures and structures (Aaker and Joachimsthaler, 1999).

It is hard to find any arguments why the market globalization process should not affect CEE too. MNCs have a strong interest to increase their presence in these growth regions of the world and in the internationalization of their flagship brands, especially in the emerging markets of CEE, Asia and Latin America (Quelch, 2003). And they are not hindered in their efforts by ideological barriers and legal regulations anymore. Before the collapse of the communist regime CEE countries were isolated from the global (capitalist) economy. The reforming countries of CEE have in the meantime all embarked and made progress on the transition process from a centrally planned to a market economy, which has exposed them to global influences (World Bank, 1996; UNCTAD, 2000; Lewis, 2005). Proponents of the localization approach underestimate the fact that there are several demand side characteristics of CEE markets which are in support of international marketing program standardization: the existence of similar and transnational customer groups as in the West, the appreciation of Western products and lifestyle, the geographic proximity to and growing interdependence with Western Europe and the political and economic integration of Central European and Baltic countries into the European Union (EU) (in the case of South-Eastern Europe the prospect of becoming a member of the EU) are backing the standardization of products and marketing programs (Schuh, 2000).

Given these developments in the region, it is not surprising to find authors that see clear advantages for an internationally more integrated and coordinated approach to the market (Kozminski and Yip, 2000; Schuh and Holzmüller, 2003). Schuh and Holzmüller (2003) distinguish three types of marketing strategies that Western MNCs can choose from when operating in consumer goods markets of the region: the transfer of the Western home market strategy, the multi-tier product and brand strategy and the regional strategy. Transferring the strategy used in Western markets is typical for the entry stage as it is optimal from a cost–risk perspective. Market entry into this new region is regarded as a natural market extension, the core elements of the marketing mix (brand, physical product, packaging design and communicative positioning) remain unchanged, adaptations are limited to peripheral elements such as labeling, package size and promotional activities. When Western MNCs face difficulties in the penetration of markets with their comparably expensive international brands, especially in the more price-sensitive lower end of the market pyramid, they often switch to a so-called multi-tier product and brand strategy, in which local brands are marketed alongside the international brands (Batra, 1997; Schuh, 2000; Schuiling and Kapferer, 2004). Typically such brands have been acquired through the purchase of a local competitor or have been specifically developed for the price-conscious "economy-segment." While the well-known international brands are aimed at the upper segment of the market, the local brands are either catering to the brand loyal consumers by using the strong heritage of the brand or to the "value-for-money" seeking consumers by offering extremely low priced products of a fair quality. Particularly, the incorporation of Western quality and modern image into reasonably priced products is of course very appealing to the mass of CEE households, which are struggling to make ends meet. In order to keep costs of those local brands low, foreign MNCs, which are present in the whole region, turn increasingly to regionalization concepts. The centralized production of products for a group of countries or the whole region allows firms to realize economies of scope and scale, as well as the opportunity to cater to regional preferences and tastes in product composition and design.

Evidence of market globalization in the fast-moving consumer goods markets of CEE

Research design and analyses

The purpose of this study is to examine the dissemination of international brands in a "4 product × 4 country" sample in CEE. A high share of international brands vis-à-vis local brands would indicate an increasing globalization of market structures in CEE. The study includes the following analyses: (a) determination of the level of diffusion of Western brands in selected FMCG markets of CEE, (b) examination of whether the level of economic development of countries and the product character has an impact on the penetration level of international brands.

The data set was provided by the market research agency Fessel-GfK in Vienna, Austria, the latter being the regional headquarters for the region Central and Eastern Europe of the GfK-Group. The market share data were drawn from the national household panels. Four product categories were selected for the study: detergents, toothpastes, carbonated soft drinks and confectionery. They all represent two important "non-food" and "food categories" of the FMCG sector. The country markets chosen were Hungary, Poland, Bulgaria and the Ukraine. The former two countries stand for the more advanced economies in the transition process (which also became members of the EU in May 2004), while the latter two are still lagging in their reform process and economic development (EBRD, 2002). A major limitation stemming from the data base is that comparable market share data across the four countries and four product categories are only available from 1999 onwards. Thus, only two years, 1999 and 2001, are available to determine the extent of diffusion of international brands and changes in the level of diffusion over time.

The national offices of GfK in the four countries conducted the transformation of the raw data into the three brand categories according to our definitions:

- "International brands" are those brands that have their origin abroad and are imported to CEE or are locally manufactured there. The owner of the brand is a foreign firm. As the data showed the majority of the foreign firms was headquartered in Western Europe or the USA.
- "Local brands offered by foreign firms" are those brands that are marketed by foreign firms only in the specific local market. The foreign MNC owns the local brand either directly or through its national

subsidiary. In the case of a joint venture the foreign MNC would hold a majority stake.
- The category "local brands offered by local firms" contains all those brands ("Pure local brands") that are marketed by a predominantly local firm in the national market.

Besides documenting diffusion patterns of international brands, we were also interested in whether differences in the penetration level can be attributed to differences in economic development and product characteristics. The GDP per head is a common indicator for the economic development of a country. When international brands are priced considerably above local brands, then the smaller household budgets set a natural limit to the consumption of those products (Stremersch and Tellis, 2004). Therefore, the higher the GDP per head in a country, the higher the share of international brands is expected to be. In the context of our sample, this means that in the economically more advanced reforming countries in Central Europe, in our sample Hungary and Poland, we assume we will find a higher tendency to adopt international brands than in the lagging economies in South-Eastern Europe (Bulgaria, Ukraine). The relative distances in the economic development of the countries are reflected in the GDP per head figures for 2001 (Bank Austria, CEE Report, No. 3/2002): Hungary €5776, Poland €5100, Bulgaria €1840 and the Ukraine €876.

With regard to the type of product, a higher international brand share is more likely to be observed for non-food products than for food products. The extent of "cultural grounding" is often mentioned as a determining factor for the cross-national transferability of products (Quelch and Hoff, 1986; Jain, 1989). Food products are typically seen as more influenced by local culture and traditions than non-food products (Berekoven, 1978). Occasions of purchase and consumption, taste preferences and the regional origin of the product play a greater role in the buying process (Schuh, 1997).

Findings

In Table 4.1, the market shares of each brand category broken down by products and countries are depicted for the years 1999 and 2001. The total market is composed of the "international brands" (a), "all local brands" (b) and "other" (e), "Other" refers mainly to retail brands which cannot be categorized by country of origin. The "local brands" category (b) is divided into "pure local brands" (c) representing the share of local brands owned by local firms and "foreign-owned local brands" (d). The

Table 4.1 Value-based market shares (2001, 1999) by product category and country

	Value-based market shares 2001 (1999[a])				
	(a)	(b) = (c) + (d)	(c)	(d)	(e)
	International brands[b]	**All local brands**	**Pure local brands**	**Local brands foreign owned**	**Other (private lab.)**
Detergents					
Hungary	50.4 (56.0)	46.3 (43.4)	10.1 (8.7)	36.2 (34.7)	3.3 (0.6)
Poland	58.8 (56.9)	41.2 (43.1)	n.a.	n.a.	–
Bulgaria	89.8 (88.0)	10.2 (12.0)	10.2 (12.0)	0	–
Ukraine	55.0 (43.0)	45.0 (57.0)	n.a.	n.a.	–
Toothpastes					
Hungary	66.4 (72.4)	32,3 (27.2)	3.9 (2.0)	28.4 (25.2)	1.2 (0.4)
Poland	67.2 (69.0)	32.8 (31.0)	n.a.	n.a.	–
Bulgaria	45.2 (56.0)	54.7 (44.0)	54.7 (44.0)	0	–
Ukraine	99.0 (99.0)	1.0 (1.0)	n.a.	n.a.	–
Confectionery					
Hungary	20.1 (21.0)	72.5 (71.2)	12.1 (5.8)	60.4 (65.4)	7.4 (7.7)
Poland	15.6 (13.4)	84.4 (86.6)	n.a.	n.a.	–
Bulgaria	16.5 (11.9)	83.5 (88.1)	23.9 (23.0)	59.6 (65.1)	–
Ukraine	12.0 (11.0)	88.0 (89.0)	n.a.	n.a.	–
Carbonated soft drinks					
Hungary	64.5 (73.6)	24.0 (23.4)	21.5 (17.1)	2.5 (6.3)	11.5 (3.0)
Poland	42.9 (40.1)	57.1 (59.9)	n.a.	n.a.	–
Bulgaria	46.9 (43.7)	53.1 (43.7)	53.1 (56.3)	0	–
Ukraine	9.0 (10.0)	91.0 (90.0)	n.a.	n.a.	–

[a] Figures for the Ukraine refer to 2000.
[b] International brands are defined as imported branded products for the Ukraine. International branded products which are manufactured locally are included in the local brand category.

ownership of some of the local brands could not be determined. The market share figures provide strong evidence that international brands have made considerable inroads into most of the product categories studied in the selected CEE markets. The value-based market shares of international brands in 2001 range for detergents from 50.4 percent (Ukraine) to 89.8 percent (Bulgaria), for toothpastes from 45.2 percent

(Bulgaria) to 99 percent (Ukraine), for confectionery from 13 percent (Ukraine) to 20.1 percent (Hungary) and for carbonated soft drinks from 9 percent (Ukraine) to 64.5 percent (Hungary).

The data also reveal that a continuous market penetration must have happened throughout the 1990s leading to dominant market shares for international brands in many markets at the end of the decade. No clear trend can be noticed for the changes between 1999 and 2001. In Hungary, the shares of international brands were falling in all product categories while in all the other countries figures were still rising (except in the toothpaste market). Furthermore, the figures also show the advent of private labels in Hungary, a new brand category that was not yet present in the other country markets at this time.

In Table 4.2, the major owners of international brands are presented. The majority of international brands in the sample is owned by firms with a Western origin, most of them leading global consumer goods marketers. In Bulgaria and the Ukraine firms from Turkey, Russia and Bulgaria (only in the Ukraine) held noteworthy shares in some of the product categories.

In order to understand the full extent of the market globalization effect a closer look at the ownership is advisable. The confectionery category with a market share of at least 80 percent for local brands in all country markets studied offers an interesting case. The breakdown by ownership reveals that Western firms are the owners of the majority of those local brands. In Hungary, international firms accounted for 67.8 percent of all sales of local brands in 2001. Together with the

Table 4.2 Leading marketers of fast-moving consumer goods (FMCG) in CEE

Product category	**Major international players in FMCG markets in CEE**
Detergents	Henkel (Germany), Procter & Gamble (USA), Unilever (UK/Netherlands), Reckitt Benckiser (UK/Netherlands), Hayat Kimya (Turkey)
Toothpastes	Unilever (UK/Netherlands), Colgate Palmolive (USA), Procter & Gamble (USA), Smithkline Beecham (USA)
Confectionery	Nestlé (Switzerland), Stollwerck (Germany), Ferrero (Italy), Storck (Germany), Kraft Foods (USA), Master Foods (USA)
Carbonated soft drinks	Coca Cola (USA), Pepsi Cola (USA)

20.1 percent share of international brands, this results in a combined market share of 87.9 percent of the Hungarian confectionery market which is under the control of Western firms. In Bulgaria, 59.6 percent of all the local brands belong to non-local firms, leading to a combined market share of 76.1 percent for confectionery brands owned by Western firms. For Poland and the Ukraine, the same analysis was not possible as a breakdown of local brands is not available. But given the strong presence of the global players in the whole CEE region and also across product categories a similar brand structure can be assumed for the other CEE markets too.

Despite the impressive market penetration of international brands in CEE in the last 15 years, differences in the level of diffusion between country markets and product categories are noticeable. No clear evidence can be furnished for the assumption of a strong positive impact of the economic development of a country on the market share of international brands. For the two food categories a positive relationship between GDP per head and international brand share is given, while for detergents and toothpastes the expected positive relationship cannot be found. The expected influence of the cultural grounding dimension on the diffusion of international brands is, on the other hand, supported by the results (Table 4.3). The less culture-bound categories like detergents and toothpastes show significantly higher mean values over the four country markets than the more culture bound categories confectionery and carbonated soft drinks. The lowest share of international brands can be found for confectionery: here local brands dominate in all country markets with at least 80 percent market share.

Table 4.3 Market shares of international brands by cultural grounding category

Cultural grounding category	**Product category**	**Mean value by product category (all four countries)**	**Mean value by cultural grounding category**
Less culture bound products	Detergents	63.53	66.49
	Toothpastes	69.45	
More culture-bound products	Confectionary	16.05	28.44
	Soft drinks	40.83	

Note: Mann–Whitney U test: the difference between the dichotomous categories of cultural grounding is significant at a 5 percent level ($p = 0.003$).

Limitations of the study

Before drawing final conclusions, let us point at the limitations of this study. In order to establish cross-country comparability, only data not earlier than 1999 were available for the study. However, given the particular situation in CEE where Western firms started from scratch to build their local businesses in the 1990s, the data provided are quite revealing and serve the purpose of this study well, namely to examine the extent of diffusion of international brands in CEE. A breakdown of the local brands by ownership was not available in all cases. Due to budgetary reasons, a selection of products and countries had to be made. The choice of the market share of international brands as a measure for market globalization may be regarded as simplistic. The relevance of market share derives from its central role of the purchase in consumers' buying behavior. This decision stands at the end of the consumer's decision process in which alternatives have been evaluated based on past experiences with the brand and competing offerings as well as currently available information at the point of purchase. Situational influences such as the availability of a brand in retail outlets are also included in this decision. A high penetration by international brands in CEE markets is certainly a strong indicator of market globalization although admittedly it cannot be automatically linked with identical buying behavior in various national markets. What would complement the picture are additional data on purchase and usage behavior covering purchase motives and occasions, brand loyalty as well as volume, intensity and frequency of usage (Berekoven, 1978).

Conclusions and discussion

The findings of this study provide a strong evidence for the market globalization thesis. International brands mainly offered by Western consumer goods marketers occupy leading positions in the majority of product categories and countries studied. In particular, in the less culture bound categories such as detergents and toothpastes international brands capture more than 50 percent in all country markets. However, the supremacy of international brands is not a general pattern. In soft drinks and confectionery, local brands dominate the market as a group. Preferences in taste, emotional ties to traditional manufacturers and brands as well as lower prices than for international brands appear to be the main reasons for the higher appeal of local food brands among CEE consumers. Western marketers have shown flexibility in this situation and turned to local brands as the major vehicle to improve their market position. The findings also tell us that a higher level of national wealth does not automatically result in a higher international brand share. Other factors than affordability alone influence the adoption process of Western brands among CEE consumers. Extant literature on cross-national diffusion indicates that besides economic and institutional factors such as the openness of an economy and the distribution of income, national culture, stage of market development, local competition, consumer preferences and the distribution infrastructure affect adoption behavior of local consumers (Yeniyurt and Townsend, 2003; Stremersch and Tellis, 2004).

But where will the convergence of West European and CEE markets end? Will a dominance of global brands and an oligopoly of the two to four global heavyweights in each product market signal the full integration of CEE markets into the global economy? The changes so far observed are well in line with the general industry and market development thesis (Grant, 2002; De Mooij, 2004). In the early penetration phase of a formerly underdeveloped market, the leading players of the industry enter the market and invest heavily to establish new standards of product performance and appearance – often they even create the product category itself. This platform is then used to build the market for their brands. When markets become saturated, competitors increasingly turn to differentiation. In mature industries also, the likelihood rises that new players introduce innovative product and business concepts that can lead to a restructuring and rejuvenating of the industry (Kim and Mauborgne, 1999). In Hungary, the most advanced country market in the sample, the advent of private labels – those are products offered by retail chains under their own label – marks such a turning point. This time it is not the manufacturers who have driven the change but international retail chains. While still at a negligible level in 1999 (with the exception of a 7.7 percent market share in confectionery), the private label value share became a major factor in 2001, especially in the carbonated soft drink market with a share of 11.5 percent and in confectionery with a share of 7.3 percent. This happened across all analyzed product categories at the expense of the brands of the foreign MNCs.

While retail brands have existed in Western Europe since the 1970s (including the private label products offered by discounters), they are a new phenomenon to CEE markets. The ACNielsen study "The power of private label" (2003) shows that the strong growth of private labels is a worldwide phenomenon. The highest shares of private labels can be found in Europe (15 percent of total retail sales) with the highest growth rates in some countries of Central Europe: Poland +115 percent, Czech Republic and Hungary +44 percent. This is the result of the massive internationalization of retail groups in the recent past and of the shift of channel leadership from the manufacturers to the retail groups (Herstein and Gamliel, 2004). After a continuous expansion of their network of stores in the 1990s, local and Western retail chains now use their enhanced bargaining power vis-à-vis the manufacturers to force (weaker) suppliers to produce retail brands for them. A distinction by international or local origin is not possible anymore for this type of brand. Interestingly, the rise of private label products in CEE is another indicator of the parallelism in the development of CEE and Western consumer goods markets albeit with a time lag.

How can this success of Western MNCs in penetrating the CEE market be interpreted? First of all, the findings mirror the high importance Western marketers of consumer goods attach to the CEE region as well as the firms' drive to build their brands in these new markets. The emerging markets of CEE play a central role in corporate growth plans and in the long-term viability of Western MNCs (Kozminski and Yip, 2000; Schuh, 2000). Firms which claim to be global players have no alternative to a strong presence in this region. For West European MNCs, the region is even more important given the geographic proximity and the ongoing economic integration in Europe. The threat of losing ground against global rivals and thus missing out the opportunity to participate in market growth rates that can hardly be found anymore in West European markets are further facts that contributed to the quick and broad market entries in the region and aggressive presence building. Even the less favorable market conditions and the higher country risks of the economies in South-Eastern Europe did not deter them from entering these markets as documented in record high foreign direct investment (FDI) inflows in the recent past (UNCTAD, 2005).

Second, the resource superiority stemming from the unequal distribution of resources and competencies between the foreign MNCs and their local counterparts provides another explanation for the dominance of foreign firms and their brands in CEE markets. Local firms, especially former state-owned ones, have due to their tradition and heritage of operating in a centrally planned economy a disadvantage in terms of their capabilities when competing against Western firms in a now market-driven environment. They lack well-developed skills and accumulated knowledge in core areas of marketing management such as the management of customer relationships, the development and management of products and brands as well as the management of the supply chain (Day, 1994; Srivastava *et al.*, 1999). In contrast, foreign firms originating from Western Europe or the USA have a history of operating in a market economy, which helped to develop and hone these critical skills and, consequently, gives them a potential source of competitive advantage in the host markets in CEE (Fahy *et al.*, 2000). Furthermore, the Western MNCs outperform their local rivals in terms of business assets. They are also financially stronger which allows them to run massively funded advertising and promotion campaigns for their brands and to outspend their local rivals. The Western firms can possibly draw from an existing high brand awareness and strong brand preferences among CEE consumers (for example, for global brands such as Coca Cola, Nivea or Persil). Their integration into a multinational group allows them to make better use of economies of scale and scope by tapping the know-how base of the whole corporate group and by sharing products, product development, production and logistics facilities. The exploitation of these multiple sources of competitive advantage obviously enables them to overcome disadvantages such as less familiarity with local conditions as well as higher market and additional political risks that MNCs typically face when entering a new market.

Third, the findings support extant literature on the predominantly employed marketing strategies of MNCs in CEE, namely globally or regionally integrated strategies and multi-tier brand strategies (Dahm, 1996; Schuh and Holzmüller, 2003). Although the available data set unfortunately does not allow sorting out the proportion of regional brands, the high international brand share provides empirical evidence for the importance of the globalization and regionalization logic in brand strategies of MNCs. When global brands cannot be modified in such a way to reach consumer segments at the lower end of the market, local or regional brands are introduced within a multi-tier concept to accomplish this task. The confectionery market is an outstanding example for this "hidden globalization" in our study where local brands owned by foreign MNCs account for 50 percent of total retail sales. Interestingly, in the economically most advanced Hungarian market you find high proportions of foreign-owned local brands in all other product categories too. Large global marketers like Nestlé, Kraft Foods, Unilever and Procter & Gamble seem to follow the principle "if you cannot beat local competitors, then buy them." In the past years, the multi-tier brand strategy has become a kind of standard strategy for large MNCs in emerging economies where foreign firms are faced with polarized markets or "tiered pyramid structures" (Prahalad and Lieberthal, 1998; Quelch, 2003). It enables them to cover the more price-oriented customer segments that typically account for the majority of the market (in volume terms) and to participate in various market developments that helps to spread the market risk. Neglecting this hidden form of ownership in the analysis of market globalization would result in an understatement of the extent of the globalization effect.

In summary, this study highlights the prominent role of Western MNCs as drivers of the market globalization process. It seems that these firms are not only interested in just a presence in these emerging markets, but they also intend to achieve similar dominant market positions in CEE as in their home markets. Their collective (oligopolistic) parallel behavior leads to the reproduction of their Western home market structures in the emerging markets of the world – a phenomenon already well explained by Knickerbocker in 1973. The closer these emerging markets are in their economic development to the industrialized Western countries – like Hungary and Poland in our sample – the more they mirror the oligopolistic market structures you can already find in Western Europe. The intense competition among Western manufacturers for leading market positions in the region has led, on the one hand, to aggressive market penetration activities in the advanced Central European markets and, on the other hand, has accelerated their market entries into the lagging economies of Eastern and South-Eastern Europe. A market analysis by competitor shows that the detergent, carbonated soft drinks and toothpaste markets of Hungary and Poland in 2001 resembled an oligopolistic structure and are dominated by a few Western firms. In the carbonated soft drink market, the top two global marketers, Coca Cola and Pepsi Cola, accounted for 65 percent of carbonated soft drink sales in Hungary and 42 percent in Poland in 2001. In the detergent market, the top three (Western) marketers held 75 percent of the market in Hungary and 70 percent in Poland. A similar constellation can be found in the toothpaste market in which the top four (Western) competitors captured about 80 percent of the market in Hungary and Poland.

Indeed, this global strategy approach of Western MNCs can also be interpreted as "corporate imperialism" (Prahalad and Lieberthal, 1998; Prahalad, 2005). Business models developed in and for Western markets are imposed on emerging markets under the expectation that these markets will be Westernized in the near future too. The authors call for a new mindset and for the adoption of new business models that move away from the traditional Western thinking. The latter is characterized by the conception of selling Western products to small segments of relatively affluent buyers in these emerging markets and by the hope that a large Western-type middle class will soon emerge. Prahalad (2005) warns of overestimating the extent of Westernization in the emerging markets and suggests using new business models with reconfigured resource bases, redesigned product development processes, lower cost structures and different leadership models to tap the large mass markets successfully. Although they had primarily the big emerging markets in Asia in mind, the concept is also applicable to CEE. The regional and multi-tier strategies employed by Western firms in CEE are examples for this new way of thinking. Western MNCs have also begun to move larger parts of production and research facilities to the region and to establish regional management centers in cities like Warsaw, Prague and Budapest from which they run regional operations and brand strategies (Ferencikova and Schuh, 2003). All that indicates that global strategies are more complex today and that MNCs are constantly being challenged to find new organizational models and strategies in order to be successful in the global marketplace. A final assessment of the effectiveness of the different strategies has yet to come. At least for the moment, the findings of this study support the approximation of CEE market structures to West European ones and the prevalence of the globalization logic in the "going east" strategies of the Western MNCs. This is in sharp contrast to the dominant multi-domestic strategy pattern in Western Europe in the 1950–1980s and the then prevailing localization perspective (Bartlett and Ghoshal, 1989). In order to understand the behavior of MNCs in the emerging markets of CEE and the fundamental changes in market structures there today, the global marketing conception seems to be the more appropriate explanatory framework.

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5
Luxury Consumption in Emerging Markets

Melika Husić-Mehmedović, Nikolai Ostapenko and Muris Cicic

Introduction

The global luxury market, with its huge and widespread appeal and unparalleled glamor, increasingly captivates the attention of academicians and retail business analysts. Even though its relatively flexible boundaries make it difficult to evaluate separately from general consumer market shifts, the luxury goods market is experiencing spectacular structural changes, mostly under the pressure of recent recession-inspired negative consumer sentiment and "guilt" feelings. Additionally, there are serious geographical differences among markets and customers in the global luxury segment that deserve special attention (Dubois and Paternault, 1997). Issues related to the definition of luxury consumption and its structure, motivational drivers and dynamics in the post-socialist consumer fragmented markets of the former Yugoslavia and Soviet Union are the focus of such attention.

In this text, we are trying to explore the elements of a rather unknown territory, meaning the markets for luxury products in emerging markets of Balkan countries and the European territory of Russia. These countries or parts of countries in Europe have experienced dramatic transformation in terms of structural consumption and market behavior in developing attitudes and patterns for luxury goods.

Defining luxury products

Derived from the Latin word *luxuria*, originally meaning "extravagance," later "lust" (as in one of Christianity's seven deadly sins), luxury has long been tarnished by the connotations of excess, lasciviousness and hedonism (White, 2009). It incites greed, desire, envy and anxiety but also provides sumptuous pleasure and a sense of pride. It is a symbol of social status, of being one of the privileged few, as well as a source of aspiration and hope. In the past, the Spartans, Puritans, monks and Amish, as well as socialist and ostensibly communist societies, viewed it as unwise to have luxuries available to only a few before necessities are available to all. For centuries, human beings have satisfied their wants with the possession of beautiful things, and as a result, luxury products have been subjected to intensive discussion and debate. Globalization has led to income growth worldwide, throughout the entire social hierarchy but most impressively among the top social strata (Husic and Cicic, 2009). Nowadays consumers everywhere closely follow this pattern and are willing to offer considerably higher amounts of money in exchange for unique products.

Traditionally, luxury or "status" goods have been defined as goods for which the mere use or display of a particular brand brings prestige to the owner, apart from any specific functional utility of the product itself (Grossman and Sharpiro, 1988). Deeter-Schmelz *et al.* (2000: 48) defined prestige preference as "an individual's preference for shopping in clothing stores where the combination of patron status, store type and atmosphere, merchandise price, quality, branding, and fashion combine to create a particular prestige level." Phau and Prendergast (2000: 127) assume that luxury brands "evoke exclusivity, have a well-known brand identity, enjoy high brand awareness and perceived quality, and retain sales levels and customer loyalty." It is hard to disagree with that.

Motivational drivers for luxury consumption

Many consumers are motivated by a desire to impress others with their ability to pay particularly high prices for prestigious products (Mason, 1981); this form of consumption of luxury goods becomes a pure display of wealth. If luxury products are not priced high, they lose their characteristics of rarity and exclusivity (Dubois and Duquesne, 1993). In many ways, a higher price makes consumers feel superior, one of the elite who can afford these products (Garfein, 1989). A luxury product or service is by definition not available to all and could not be owned by everyone; otherwise, it would not be regarded as a luxury item. A product is not luxurious merely because of its price, however; luxury consumers also rely on the intrinsic product mystery along with its image in the world.

That explains why luxury products are used to arouse certain feelings and affective states in buyers, who derive a sense of personal reward and gratification (Sheth *et al.*, 1991; Westbrook and Oliver, 1991). For consumers in a market economy, possessions serve as a signal or means of communication to others, as a way to create and manage impressions of who they are and what their current status or social position is (Douglas and Isherwood, 1979; Belk, 1985). Consumers who are greatly concerned with their physical appearance and the fashion statements they make are more likely to use different strategies to gain attention from others. An important class of symbols involves association with a prestigious reference group that represents excellence or distinction in an area related to one's self-image (Wicklund and Gollwitzer, 1987). Prestige "has always been designated as constituting a basic symbol of one's social standing or status" (Eisenstadt, 1968). Thus people use status goods as symbols to communicate meaning to their reference peer groups. Hence many consumers acquire luxury goods primarily to satisfy an appetite for symbolic meaning.

In light of the growth in product competition and the globalization of markets, companies now are seeking to further differentiate their product offerings. Invariably many of them attempt to increase the level of added value for their product positioning by adding on the suggestion of "luxury," or specifically choose to position their products as a part of the luxury-goods segment (Vickers and Renand, 2003). As discretionary income increases worldwide and global popular culture promotes immediate self-indulgence and gratification (Dubois and Laurent, 1996) via addressing "societal ego," the desire to seek status and recognition (not only to impress others or oneself) may be becoming more important for the ego (Dubois and Duquesne, 1993).

The most complete overview of the motivational forces for luxury consumption was provided by Vigneron and Johnson (1999). They distinguished five values of prestige consumer behaviors combined with five relevant motivations, and from these identified five different categories of "prestige" consumers. According to the authors' categorization of luxury products, *hedonists* and *perfectionists* are more interested in pleasure derived from the use of luxury products and less interested in price (versus quality), product characteristics and performance. These consumers know what they want and use their own judgment, while price serves only as an "endorsement of quality." The Veblen *snob* and *bandwagon* effects are evident in consumers who perceive price as the most important factor, with a higher price indicating greater prestige. They usually buy rare products and in this way emphasize their elite status (Vigneron and Johnson, 1999).

Motivational forces for luxury consumption were analyzed through the hierarchy scale (Husic, 2006). The research showed that consumer behavior is influenced by social class: not only the one to which the consumer belongs but also the one to which he or she most wishes to belong. Consumers from the lower classes seek the acceptance of the higher classes and therefore copy their consumption patterns to symbolize prestige. Because all people would like to be accepted by their own social class or a higher one, most of them buy products labeled with a brand that will bring them desirable prestige, show their wealth and accord with their desired status in society. The sense of belonging to a social class per se, however, does not have a relevant influence on luxury consumption and cannot be characterized as a driving consumption force (Husic, 2006). Nevertheless, one of the motivational factors for luxury consumption is lifestyle (Husic, 2009). It combines social class with psychographic characteristics and defines the behavior both of the individuals and of the group. Therefore, consumers buy and use luxury products to pursue the lifestyle of their choice.

Luxury industry composition and global fashion centers

Products especially sensitive to social judgment ("display of wealth") are the most visible, and therefore they easily project wealth, status and style to the outside world. They include clothing, fashion apparel and accessories. It is much simpler to stock and handle them than other, bulkier items. According to an Interbrand report (2009), the first 15 places in luxury are traditionally occupied by fashion-designer brand names (Table 5.1).

Luxury always sells in relation to fashion, since those products are never "made," but are created (Dubois and Paternault, 1995). Meanwhile, the brand traditionally outlives the designer. A new trend among luxury designers is merging and acquiring each other's businesses to gain greater market power. Today only three major groups represent luxury in fashion clothing and accessories. They are shown in Table 5.2.

It is well known that French designers represent the majority of the luxury-market labels. Still, the approach they use is completely different from that of their US counterparts, or even of the Italian ones. US designers emerged in the 1970s (Calvin Klein, Tommy Hilfiger and Ralph Lauren among them), defining a more leisure-oriented casual elegance as part of the American lifestyle (Chadha and Husband, 2006). They added a completely new dimension to the fashion equation. It was not just the design or product that was critical; it was the image and lifestyle reflected by the brand. Ralph Lauren created an empire by marketing a luxury lifestyle. The era of mass marketing in luxury

Table 5.1 Strongest luxury brands, 2008

Rank	Brand name	2008 brand value, USD	2008 brand value, euro	Country of origin
1	Louis Vuitton Moët Hennessy (LVMH)	21,602	16,718	France
2	Gucci	8,254	6,388	Italy
3	Chanel	6,355	4,918	France
4	Rolex	4,956	3,836	Switzerland
5	Hermès	4,575	3,541	France
6	Cartier	4,236	3,278	France
7	Tiffany & Co.	4,208	3,257	United States
8	Prada	3,585	2,775	Italy
9	Ferrari	3,527	2,730	Italy
10	Bvlgari	3,330	2,577	Italy
11	Burberry	3,285	2,542	United Kingdom
12	Dior	2,038	1,578	France
13	Patek Philippe	1,105	855	Switzerland
14	Zegna	818	633	Italy
15	Salvatore Ferragamo	722	559	Italy

Source: Interbrand Report (2009).

Table 5.2 The conglomerates behind major luxury brands

LVMH	RICHEMONT	GUCCI
Louis Vuitton	Cartier	Gucci
Christian Dior	Dunhill	Yves Saint Laurent
Fendi	Mont Blanc	Boucheron
Céline	Van Cleef & Arpels	Bottega Veneta
Loewe	Piaget	Sergio Rossi
Donna Karan	Baume & Mercier	Alexander McQueen
Kenzo	Chloé	Stella McCartney
Marc Jacobs	Vacheron Constantin	Balenciaga
Givenchy		

Source: Company websites.

(Nueno and Quelch, 1998) began in the 1990s, when the French tried targeting a wider consumer base. The ingredients had always been there: a tradition of fine craftsmanship with leather products and tailored men's suits, an abundance of excellent-quality materials, modern production and distribution technology, and most importantly, a pop-culture passion for "la dolce vita" (Chadha and Husband, 2006).

While Americans were master marketers, the Italians excelled at creating the right kind of buzz, another powerful tool in spreading the *luxe* culture, mainly through the film industry. It came naturally to them, with numerous flamboyant figures like Gianni Versace creating as much news as his clientèle of princesses, stars and high-society figures. Italian fashion appeal grew rapidly, and today Milan is as much a fashion center as Paris (Chadha and Husband, 2006).

The master move of the luxury fashion industry is the "logofication" of accessories, mainly handbags, by plastering instantly recognizable symbols in a continuous pattern all over the item (Chadha and Husband, 2006). Another interesting concept is the "luxurification" of clothing in fashion. This term refers to the transfer of the label from inside the collar or waistband to the outside: across the chest, down the side, hidden in plain sight in logos, buttons, emblems, initials and other forms of public display. Today you are not what you wear but "who" you are wearing (Twitchell, 2001). At the other end of the spectrum, there is the example of the Hugo Boss company, where the more you pay, the smaller the logo. This obviously sharpens the historical conflict between discreet old money and flashy new money. Consumers who refuse to serve as human billboards will have to compensate the company for the intentional loss of clothing "publicity."

Global luxury consumers and demand for luxury products

Currently, students of the luxury market consumer are investigating a new aspect: guilt. A report by Unity Marketing, an agency that specializes in understanding the mindset of the luxury consumer, shows that the majority of affluent consumers everywhere are changing their shopping behavior in response to the present economic downturn. In particular, they shop less often and more strategically, making lists, taking comparison trips and researching websites like Guilt.com for luxury sample sales (Unitymarketingonline.com). Resilience is still present in the global luxury market, and the unprecedented demand coming from Asian countries, especially emerging China, will ensure its continued existence.

The rich are still getting richer, and there are more of them today than at any other time in history. A recent survey by AC Nielsen ranked the United Arab Emirates (UAE) in the top five countries in terms of consumer purchasing power and luxury consumption of fashion clothing and accessories. By the end of 2010, the luxury-goods sector in Dubai reached more than US$100 billion. UAE luxury expenditures charged on American Express cards rose 27 percent in 2008 alone. Wealth is no longer measured in millions of dollars, because the number of millionaires in the world has grown so greatly. In 2004 there were 8.3 million millionaires in the world (*World Wealth Report*, 2005), of whom 7.5 million lived in the United States and more than 425,000 in Great Britain. The Market Research Report (2002) predicted that in 2009 Europe will have more than 27 million consumers with an annual discretionary income in excess of 50,000 euros. These figures support the importance of the luxury market and its strong tendency to grow in the near future all over the world.

Wealth is not equally distributed, of course. The wealthiest 2 percent own more than half the world's wealth, and this wealth is concentrated in North America, Europe, Japan and Australia (*Oslobođjenje*, 2006). The wealthiest group includes 691 persons from 45 countries around the world, with a combined personal wealth of US$2.2 trillion (Luxury Institute, 2005). As for "new money," a total of 236,000 Chinese and 61,000 Indians became millionaires in 2004 (*World Wealth Report*, 2005). With respect to luxury consumption, 37 percent of luxury goods are purchased in Asia, 35 percent in Europe, 24 percent in the United States and 4 percent in the rest of the world (Chadha and Husband, 2006).

Geographically, much of today's wealth emanates not from the traditional centers of Europe and the United States, but from farther east – Brazil, Russia, India and China (the BRIC countries). The United Kingdom has more millionaires than the United States (*Gulf Marketing Review*, 2008). In China, there is increasing affluence and an impressive number of people interested in luxury. China has become luxury's "Great Wall" of revenue. China's luxury consumption in 2007 reached US$8 billion, accounting for 18 percent of the global total and qualifying the country as the world's largest spender. The new Russians understand luxury as something that has to cost a lot to be worth anything (Caines, 2008). In Tokyo, 94 percent of women in their twenties want to own a Louis Vuitton product, 92 percent would like to have Gucci, 57 percent Prada and 51 percent Chanel (Prasso and Brady, 2003).

The luxury industry is following this trend. In 2008, Hermès presented a Passage to India-inspired spring-summer show, complete with maharajah-style headdresses woven with orange Hermès ribbon, and Balenciaga designer Nicolas Ghesquiere included Chinese-inspired prints in his spring-summer range. In 2008, Gucci rolled out a Russia-themed show for the autumn-winter season, with enough fur and *babushka* carpetbags to appeal to the recession-proof shoppers of the world. In Paris, Lanvin and Givenchy accessorized their collections with satellite-sized costume jewelry attuned to the gilded tastes of Russia and India (Caines, 2008).

Dubai might well be the new *über-luxe* capital of the world. The entire luxury-fantasy metropolis embodies the contemporary hysterical *luxe* craze (White, 2009). In Dubai, there is little evidence of the financial credit crunch that has gripped the globe (*Gulf Marketing Review*, 2008). Although the financial market turmoil is reportedly putting a crimp in the sales of luxury brands in mature markets, there are few signs of this in the Gulf. The affluent consumer in the Gulf countries is resilient. The *grande dame* of the *grandes marques*, Louis Vuitton, is unperturbed. "The Middle East seems to have again demonstrated its resilience and its strong dynamism," observes Damien Vernet, GM Middle East and Africa, LV. "We did not feel the impact of the crisis, either in terms of changing customer profiles or shopping patterns."

There is a strong argument that products cannot be sorted into simple categories of luxury and non-luxury by their appearance or by the intrinsic qualities of the goods themselves. They must be placed into their socioeconomic context (Veblen, 1899). There is also an argument that the socioeconomic context must be defined in the context of a specific country's environment. In this setting, a luxury good is something that is definitely out of the ordinary in terms of daily living needs. For example, BMW, Lexus and Mercedes are considered luxury cars in the United States, Europe and other affluent nations. Any car at all, however, could be considered a luxury in some poor countries because of their economic conditions (Vickers and Renand, 2003).

Even though consumers in different parts of the world buy or wish to buy luxury products for apparently varied reasons, they possess similar values and, regardless of their country of origin, their basic motivational drivers are really the same; only the individual weighing differs (Wiedmann *et al.*, 2007). In a global marketplace, there is no conceivable understanding of luxury that is nationally or regionally bound.

Drivers of regional luxury consumption in the Balkans

An analysis of luxury consumption was conducted in the formerly socialist countries of Bosnia and Herzegovina, Croatia, Serbia and Slovenia, in the Balkan region (Husic, 2009). In this politically troubled and economically challenged region, 26.9 percent of the respondents consume luxury products, according to Dubois and Duquesne (1993). Regardless of the particular economic situation and lifestyle in a respective country, between 20 percent and 30 percent of the population definitely qualify as luxury consumers in the region (Table 5.3).

Table 5.3 Luxury consumers in the Balkan region

Country	Non-luxury consumers	Luxury consumers	Total
Bosnia and Herzegovina	167 (78.77%)	45 (21.23%)	212 (100.00%)
Croatia	122 (60.70%)	79 (39.30%)	201 (100.00%)
Serbia	118 (72.84%)	44 (27.16%)	162 (100.00%)
Slovenia	150 (80.21%)	37 (19.79%)	187 (100.00%)
Total	557 (73.10%)	205 (26.90%)	762 (100.00%)

Source: Research data analysis.

What puzzles many analysts is how a country with a per capita GDP of less than $5000 can be a significant luxury-brand market. The answer lies in an uneven economic development and the presence of a shadow economy. Four Balkan countries, Slovenia, Croatia, Serbia and Bosnia and Herzegovina, were republics of former Yugoslavia. After its dissolution, these four newly established states followed different paths of socioeconomic development.

Luxury consumption is influenced by income, education and age, while gender influence is less significant. It is interesting that income has the same influence as other demographic variables (Husic, 2009). This suggests that luxury consumers do not come exclusively from the upper-income cluster. Motivation for luxury consumption lies in the desired lifestyle orientation: one wishes to pursue a certain lifestyle and therefore buys products associated with the psycho-demographic characteristics of the reference group.

As for the categories of luxury consumers in the Balkan region, we classified them according to the above-mentioned study by Vigneron and Johnson (1999). The majority of luxury consumers in the region are either perfectionists (31 percent) or hedonists (20 percent). The perfectionists are quality-oriented older consumers with higher incomes, mainly from Croatia. The most important features they expect from a product are perfection (quality) and performance. Hedonists enjoy the product they purchase. They are middle-aged and middle-income consumers who want to indulge themselves as a reward for the hard work they do. In the Balkans, therefore, luxury consumption is mainly self-oriented, and the obvious goal of the consumers is to stand apart and not be confused with everyone else (Husic, 2009).

Development of the luxury market is in its initial stage in the Balkan region. From the supply standpoint, there are not many luxury brands present in this market, primarily because of the size of the market. The most developed and economically stable market is Slovenia; however, it is the smallest one, with slightly more than 2 million inhabitants. It is not profitable enough to attract the big international investors and leaders in the luxury industry. On the other hand, the biggest market is Serbia, with approximately 9 million inhabitants, but it also is underdeveloped both socially and economically. The most tempting market for investment in the luxury sector is Croatia, which has the most motivated and most fashionable consumers. Another reason for lack of investment is the geographical position of the Balkans. Proximity to Italy or Austria makes it easy for consumers to travel and shop directly in those famous fashion centers.

From the demand standpoint, this region still struggles with the post-socialist mindset that promotes collectivistic values and equality in consumption. Not surprisingly, consumers feel a strong sense of "luxury shame," and the core value is not to show wealth but to spend modestly. Therefore the only social group willing to display its possessions is the "new money" category. Members of this group quickly acquired wealth during or right after the war in the Balkan region (1991–1995) by using gray-economy opportunities, avoiding payment of taxes, and building new business empires by privatizing or simply exploiting poorly managed public properties as their own. Moreover, the local-celebrity/politician segment is much more strongly represented in luxury consumption than elsewhere in the world. While only 3 percent of the world's rich are considered celebrities and more than 80 percent are entrepreneurs, in the Balkans this ratio is reversed, with more celebrities than business people.

Finally, luxury shopping sprees are not exactly a "feel-good" experience in the Balkans (Urwin and Spanier, 2008). Instability and guilt influence the spending behavior of the population. To boast about your Balenciaga bag or parade your Prada outfit, you need a properly receptive audience, but such behavior is considered distasteful under current economic conditions. Some Balkan countries are struggling more than others with an economic downturn and acute political issues. Slovenia is the only one granted membership in the European Union thus far, and it is economically well ahead of the others. The overall world economic recession is an additional obstacle to luxury consumption in the Balkans.

Though in absolute numbers this market is not currently appealing enough to international luxury retail investors, 26.9 percent of its consumers are luxury-oriented. Consumers in all the Balkan countries share similar histories, languages and lifestyles, and together they represent a lucrative and dynamic consumer market of 20 million people. Finally, there is a defined elite consumer segment that has refined taste and international fashion awareness. Members of this group should not be neglected by luxury brands, as they are the opinion leaders in establishing trends. We predict that the "new money" segment will follow their lead toward luxury with enthusiasm.

Luxury consumption and affluent behavior in European Russia

Luxury consumption and affluent behavior patterns with regard to home, personal and experiential luxuries have been evolving in Russia for a long time. High-end clothing, footwear, leather goods, jewelry and eyewear command an overwhelming 65 percent of the Russian consumer goods market. It is common knowledge that Russians are highly attuned to explicit manifestations of wealth, and they interpret them as an expression of their newly acquired freedom from the political restraints and limitations on travel to Western countries that were common in the past. The pattern has been emphasized in recent years by impressive macroeconomic growth and investment activity, low public debt, positive improvements in the banking and financial systems, the healthy growth of consumption and the unprecedented upward mobility of the upper middle class.

A managing partner of the Accenture consulting group, Richard Wildman, acknowledged at a conference in November 2008 that "consumers from the emerging markets have driven the bulk of [luxury goods] sales in recent years, averaging around 23 percent of the total from 2003 to 2008; in comparison, developed markets were flat or declining. The relative luxury market growth rates for Russia – forecast to grow fourfold by 2015; China, sixthfold from US$2 billion to US$11.2 billion; and in India it is set to jump tenfold" (The Moodie Report, 26 November 2008). The Russian retail sector is supported by attractive commercial rent values, an increasing number of new mall openings and unlimited outsourcing opportunities for products from neighboring India and China. For instance, Russians annually spend US$28.37 per capita on jewelry: about 2.5 times more than Indians (US$11.41 in 2007), who are widely regarded as the world's biggest consumers of gold.

Russia is notoriously known for its exorbitantly priced restaurants, fancy cars and general addiction of the affluent elite to the most expensive merchandise available. Moscow buys over 80 percent of

Russia's luxury goods in a luxury clothing and accessories market estimated at US$4.5 to $9 billion. The other two centers of wealth and luxury consumption in the country are St Petersburg in northwestern Russia and Yekaterinburg in the Urals, where Moscow's successful chains usually proliferate. Russia is home to the world's third-largest concentration of billionaires (after the United States and Germany) and to more than 100,000 millionaires with a combined US$300 billion of cash on hand. Moscow, with its glamorous offerings, is the most expensive city in Europe; more rich people reside there than in New York, according to the Associated Press.

The global economic downturn presented major challenges to the commodity- and energy price-driven Russian economy. Crude oil prices, within a single year, declined from US$150 a barrel (July 2008) to as low as US$40 per barrel (March 2009). The total number of Russia's billionaires was halved in 2009, and the Russian ruble started to fluctuate sporadically again. What is the impact on luxury consumption?

The worsening of the macroeconomic situation in Russia triggered pessimism and confusion in the retail industry, even among Moscow's luxury-store management. Alexander McQueen, Stella McCartney and Lanvin closed their stores less than 18 months after their respective grand openings in Moscow. The sole Vivienne Westwood shop had a notice – "closed for repairs" – taped to the door for some time: less embarrassing than admitting that the firm was "pulling out" of the country. Fancy British stiletto heels, majestic gowns and Italian-made woolen coats first disappeared and then were offered at a 70 percent discount in neighborhood stores fall 2009. The *St. Petersburg Times* predicted that around one-third of the profits normally earned on luxury clothes and accessories might vanish in 2009 (Ferris-Rotman and Pils, 2009).

One symbol of the times was the recent opening in Moscow of an H&M store in the former Alexander McQueen space, in a prime location. Some luxury customers were lured away by this new opportunity. Donatella Versace and Tom Ford have not jetted to Moscow lately to share their amazing plans for operational expansion with enthusiastic crowds, as they did in 2008. Moscow's answer to London's Bond Street, Stoleshnikov Pereulok, buzzed with rumors of crisis-spurred shutdowns. The Russian franchiser Aizel, working for Diane von Furstenberg, Marc Jacobs and Agent Provocateur, admitted that sales dropped by 10 percent spring 2010.

The truth is that the consumer market is just slowing down and shifting modes: bigger discounts for the majority and *über-luxury* for the exclusive few. It takes time to adjust psychologically to the idea of bad times that affect even the wealthiest segment of the most affluent of the non-Western nations. Most of Russia's traditional luxury consumers are presently feeling "guilty yet rich." Things very well might get worse before they get any better. Finally, the Russian rich are Veblenian-effect consumers, in the classification of Vigneron and Johnson (1999). They attach greater importance to price as an indicator of prestige because their primary objective is to impress others. This attitude endures tenaciously. For instance, when the annual Millionaire Fair was held in Moscow in 2006, a diamond-studded cell phone was sold for US$1.27 million (*Herald Tribune*, 2006). Just in case the glitter of the 120 carats of diamonds encrusting the white-gold phone failed to draw customers, there was a plaque declaring, "Certificate of the most expensive mobile phone ever." The world's largest exhibition of luxury goods continued at the Fair in 2007. Customers were eagerly buying US$50 million private jets, Bentleys, penthouses and yachts without remorse.

Very "serious" luxury brands – Chanel and Louis Vuitton – are expanding rapidly in Russia. Chanel is opening a new boutique in Yekaterinburg and seeking more sales opportunities in Moscow, where it already has two stores. Louis Vuitton is also opening a store in the fast-growing city of Yekaterinburg, and the company's further plans include new store openings in the Black Sea resort Sochi, host to the 2014 Winter Olympics, where Christian Dior and Dolce & Gabbana are already situated; the southern city of Rostov-on-Don; and the Samara region on the Volga region. According to *The Economist*, this counter-phenomenon can be explained as follows: "When people have less, they spend what they have on the best quality. Shoppers are going for fewer, more classic items. Vuitton always gains market share in crises" (*The Economist*, 2009). Profits may be lower, but revenues are about the same as in 2008. Vuitton items have never been on sale at a discount anywhere in the world. The price of the ultimate luxury is founded on LV's machine-like discipline, strong manufacturing copied from auto-assembly lines, professionally skilled personnel who set up stores in advantageous locations and, obviously, appealing advertising. LVMH, LV's parent company, counts on emerging markets for 15 percent to 22 percent of its revenue annually (Sharma, 2009).

The recent trend in Russia is to move luxury shops to the fancy *dacha* suburbs of the big cities. The Moscow suburban village of Barvikha, home to members of the business and political elite, including President Putin, accommodates Lamborghini and Ferrari dealerships and Tiffany, Prada, Ralph Lauren and Giorgio Armani shops that are never empty. Though the average Russian earns only US$5000 a year, the so-called "new Russians" still have a healthy appetite for the luxury items available there. They enjoy the opportunity to shop in stores that finally are in proximity to their upscale summer homes. Nick Nelson, an equity strategist at London's UBS, suggested that Russian sales can offset a great deal of lost revenue in the United States and worldwide. Russians are the fourth-largest consumers of luxury goods after the Japanese, Americans and Chinese.

Affluent Russian consumers have the greatest top-of-mind awareness of foreign luxury brands, in comparison with customers in other major emerging markets, China and India. The Russian luxury market is more developed and more European in nature. The following brands are recognized by Russians: Chanel – 39 percent, Giorgio Armani – 37 percent, Dior – 35 percent, Dolce & Gabbana – 29 percent and Versace – 27 percent. The best-known luxury brands in Russia are Versace, Dior, Chanel, Zaitsev/Russia, Yudashkin/Russia and Giorgio Armani. When considering purchases, Russians look above all for high quality (53 percent), good reputation (53 percent) and high fashion (44 percent).

The most popular luxury items in Russia are watches and jewelry, electronics, art and antiques, marine products (yachts, speed boats, marinas and submarines), luxury cars and car accessories (including amphibious vehicles), private jets and helicopters, high-end real estate properties, interior design items and luxury furniture, exclusive spirits and gourmet food, luxury cosmetics, beauty and health products, designer clothes, and luxury travel and leisure opportunities (such as golf). Many well-educated Russians with good management jobs have sufficient financial security and like to buy beautiful things. The Russian mentality historically supports a *carpe diem* attitude, a tendency to spend money madly. Russian *Vogue* suggests that it is now "consumerism time" in Russia. According to the Russian Golf Association, the number of golf courses – 20 in the end of 2009 – soon will double. The majority of them are located on the outskirts of Moscow. The golf market, growing by a remarkable 75 percent a year, was estimated at $1 billion at the end of 2008, and that amount is expected to double by the end of 2009.

The Russian luxury real estate market is growing by a healthy 20 percent per year. Marketed homes are designed with private zoos, golf courses and big aquariums. The most expensive Russian apartment sold in Moscow by the end of 2009 was priced at US$22 million, and the demand for luxury apartments exceeds the supply. Plenty of buyers are willing to pay more than US$100,000 per square meter. New elite construction in downtown Moscow is expected to raise this price to US$40 million per apartment. Newly erected apartments will have indoor swimming pools, enclosed gardens, private yacht piers and up to eight floors per unit, with private elevators for family members. New infill construction and land development in central Moscow is limited, and this boosts demand to an even higher level.

Russia has become the second-largest market for luxury automobiles in Europe after Germany. Most transactions are made in cash and not on credit, as is typical elsewhere. An imported luxury car is a must-have accessory for any successful Russian businessman. Daimler-Benz's latest Mercedes models are the market favorites, and sales jumped 90 percent in 2008. Russia is the third-largest market for company cars, after the United States and the Arab Gulf countries. Rolls-Royce has a lengthy waiting list for the first golden-plated models (some are also encrusted with Swarovski crystals). In 2007, Bentley alone sold 240 cars in the country, and the company plans to double this number by 2013 by operating five dealerships in Moscow, Krasnodar, Yekaterinburg, Novosibirsk and Rostov-on-Don. Bentley expects to make Russia the third-biggest market for the brand in the world, after China and Japan.

Among the truly exotic Russian luxuries is the "Express," a hotel on wheels that travels between Moscow and St Petersburg. It is the first VIP train operated by a state-owned company in Russia. A ticket costs about US$800 per person. It has state-of-the art amenities to accommodate travelers' every wish: air-conditioning, flat-screen TVs, DVDs, appliances and even full showers. The second route, from Moscow to Sochi, is planned to open by the beginning of the 2012 Olympic Games. The demand among business people, tourists and foreign guests lends full support to the project. Another luxury train connects Moscow with Yekaterinburg, Novosibirsk, Irkutsk and Vladivostok: The "Golden Eagle" Trans-Siberian Express, operated by Britain's GW Travel, is a joint project of England and Russia. Passengers travel in great style and enjoy the masterpieces of Russian gourmet cuisine. The floors are heated, and plasma TV sets are in every cabin. A two-week holiday on the "Golden Eagle" costs about US$10,000 per person. But it is the world's longest railway line!

In the luxury timepiece category, the legendary firm Breguet successfully re-entered the Russian market after 200 years of absence. Tsar Alexander I of Russia, Napoleon Bonaparte and Leo Tolstoy all owned Breguet watches. The new store location is right in Red Square. The cheapest item in the store costs US$14,000, and watches from the Imperial Collection are priced up to half a million euros. The watch market is moving toward more distinct, art-oriented, intimate and expensive pieces in the best traditions of the renowned jeweler Fabergé.

The Russian gourmet food market recently welcomed the specialty food chain Globus Gourmet, which operates the first luxury hypermarket in Moscow, as well as France's exclusive grocery chain Hédiard (with 320 stores in more than 30 countries), now owned by Russian billionaire Sergey Pugachev. The average shopper there spends about US$80 per visit. This move triggered great interest among gourmet professionals and connoisseurs in the further development of the luxury food market.

In the high-society gossip market, the Russian "equivalent" of Paris Hilton and the country's most notorious TV personality, Ksenya Sobchak, released a guidebook on "how to marry rich." She and her co-author, Oksana Robsky, stated in the book that there are at least 35 billionaires in Moscow alone. This means that Russia is becoming well accustomed to wealth and glamor in the best traditions of the world's fortunate *crème de la crème*. And this state of affairs seems likely to persist.

All in all, the phenomenon of luxury living is becoming more accepted in Russia, while the gap between "the super-rich" and "the rest" is widening. To support newly acquired social status, the rich "spend richly" and revel in doing so. Luxury brands and exotic, self-gratifying items are seen as a way to entice more and more customers to enjoy a chic, *pas-de-problèmes* existence. This concept of living has great appeal and is positively regarded in the mainstream value system of Russian society. Though the global financial crisis affected the coffers of the rich in a negative way, it did not significantly deter luxury consumers from the pursuit of their exclusive lifestyle. The near-rich had to choose other alternatives. Some of them opted out in favor of discounted consumption; some decided to concentrate more on intellectual versus material life; some simply fell too far and were excluded from the middle-class category for the time being. Meanwhile the show goes on in great style!

Conclusions

Luxury consumption did not come to a halt during the global financial crises of 2008–2010, as many retail analysts expected, but it has changed structurally and incorporates a certain "guilt factor" on the part of consumers. Still, iconic "absolute luxury" consumption again proved resilient in the face of recession. LV, Armani, Hermès and Chanel expanded and did well financially, especially in emerging markets. Mid-level luxury (or "high-fashion luxury") sales (Marc Jacobs, Stella

McCartney, Alexander McQueen, Gucci, Prada, Valentino, Versace, Bvlgari and so on) have dropped, owing to their much greater exposure to the middle-class slowdown as consumers in this category wait for "better times" and new celebrity endorsements. And some department-store "entry-level luxury" items did not do well, moved down-market or were put on sale (Victoria Beckham "dVb" denim, Paris Hilton clothing lines, Jessica Simpson accessories, Just Cavalli and so on).

We did notice differences in behavior of luxury items' buyers in the Balkans and European Russia. However, since that was not the focus of our analysis, we have not explored or elaborated on those differences in this text, and hopefully they will be the topic of further research.

The truly upper-income consumer, however, seems unaffected. Brands such as Burberry and Coach, which grew their business by providing accessible luxury during the boom years, are now in trouble. Old luxury brands that depend on small numbers of very high-ticket sales will continue to prosper. When times are good, everyone loves luxury. But when the going gets tough, only the middle-class consumers cut back or take their custom elsewhere. The top-tier luxury consumers shrug, stick around and keep on spending.

Furthermore, in times of crisis, certain luxury items like jewelry are used as investments or hedges against inflation. With the cost of precious metals – and the perceived inherent value of jewelry – continuing to increase, planned jewelry purchases are most likely to be made now, to avoid further inflation, rather than deferred. Similar consumer behavior is expected in the housing market. As this market is in decline and foreclosure rates are rapidly increasing, prospective buyers with ready cash are expected to look at securing investment properties. Their intention is to buy low, anticipating that in a year or two they can turn a profit and sell high, or at least higher.

The evolution of a significant "guilt" constraint or "luxury shame" among luxury customers has delayed the recovery of the luxury-goods industry. Consumers are less at ease about spending their money than they used to be. It took many marketing strategies to blend purchase with charitable donation (as a percentage of total purchase value or with a discount for donating used items), green living (by paying for environmentally safe products) or even a change in store format (such as temporary luxury "pop-up stores" in non-luxury shopping areas). Some customers permanently moved online to club sites that are accessible by invitation only, such as Guilt.com, GuiltMan.com and ShopItToMe.com, to avoid conspicuous consumption and obtain "sample sale" discounts.

Considering the uniqueness of their market, über-rich consumers will be the last to feel the crisis and the first to overcome it. Furthermore, the current recession, like the previous ones, will create "new rich" who will expand the luxury target market in the years to come.

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6
The Brewing Industry in CEE
Growth and Development

Jorma Larimo, Marin Marinov and Svetla Marinova

Introduction

The brewing industry has recently experienced increasing saturation in mature markets and industry consolidation. Due to the maturity of beer markets in developed economies, the main form of growth of established breweries has become domestic and foreign acquisitions (OECD, 2001). Recently brewing companies have started expansion into the world emerging markets, especially into the buoyant and growing markets of Central and Eastern Europe (CEE) and China.

There exists limited research on internationalization strategies in the brewing industry. Comprehensive studies are rare and outdated (Steele, 1991; Wilson and Gourvish, 1998). CEE internationalization strategies used by Interbrew in the 1990s are studied by Boudewijn (1997), Marinov *et al.* (1997) and Marinov and Marinova (1998, 1999, 2001, 2002). The general trends in the development of the Baltic and Russian beer markets until 2000 are researched by Arnold *et al.* (2000). Marinov and Marinova (1999) have analysed the development strategies of foreign brewing investors in CEE recognizing the role of experiential learning.

The goal of this chapter is to analyse the internationalization strategies of Western brewing companies that have entered CEE beer markets since 1991. The chapter reviews the major trends in the brewing industry in CEE and the investment strategies adopted by foreign companies in the region. The empirical material is based on secondary sources (annual reports, materials provided by the investing companies, journal articles and press releases), and on company visits and interviews with management teams of investing brewers.

Trends in the development of the brewing industry

Beer is the largest volume alcoholic drink in the world. Traditionally brewing markets have had a high degree of localized appeal (Gourvish, 1998). Hence, the industry used to be dominated by local breweries satisfying the demand for good quality beer.

Since the second part of the 1990s, there has been a constant decline in beer consumption patterns in Western Europe and North America, and increasing consumption trends in several emerging markets, especially in China, Russia and Mexico (Kaplan, 2003). While in 2000 the USA ranked first in beer production, in 2003 China became the largest beer maker in the world. The constant increase of beer consumption in Russia and the large opportunities for growth in per capita consumption in China and Russia have strengthened the brewing industries in these countries. Such developments create good opportunities for market penetration of established brewing companies in dynamic markets with high growth potential (Rodwan, 2002).

In the 1990s Anheuser-Busch was the indisputable market leader. However, in the last few years there have been a number of acquisitions, mergers, strategic alliances and joint venture formations among the major players in the industry. For example, a large merger was the one between the Brazilian Brahma and Companhia Cervejeira Antarctica in 1999, which led to the creation of Ambev, the largest beverage company in South America. In 2004 Belgium Interbrew and Brazilian Ambev merged to create the largest brewer in the world, Im-Bev. Other consolidating activities include the merger of Carlsberg and Orkla to form Carlsberg Breweries; the acquisitions of Kronenbourg in 2000 and Hartwall in 2002 by the British Scottish & Newcastle; the acquisition of Miller Brewing by South African Breweries (SAB) in 2002; and the acquisition of Brau AG by Heineken in 2003. Thus, leading breweries have been consolidating operations worldwide to increase competitiveness and strengthen market positions.

Brewers initiated internationalization a couple of centuries ago (Karrenbrock, 1990). For example, Bass exported beer to Russia in 1784. However, the role of foreign investment in the brewing industry was limited until the 1990s. The leading companies worldwide have followed different internationalization strategies. Until the end of the 1990s the leading US brewing companies, namely, Anheuser-Busch, Miller Brewing and Coors, based their operations predominantly in the USA and had an exclusive focus on beer. Their foreign expansion involved licensing agreements covering production, distribution and commercialization activities. The leading Asian breweries, such as the Japanese Kirin, have diversified into other food-related businesses, for example, in functional foods and soft drinks relying on internationalization mainly in Asian countries. The strategy of the leading European breweries was a major focus on beer and extensive international growth through acquisitions. The foreign expansion of West European breweries targeted Europe, including the CEE region as well as other parts of the world. This internationalization approach has recently been adopted by leading Asian and US breweries (Schumacher, 2002). CEE has played significant role in the growth strategies of European breweries. This process has been largely helped by the economic and political changes taking place in the region since 1989.

CEE brewing industry

In the early 1990s the per capita consumption of beer in the Czech Republic was the highest in the world, in the range of 160 litres per capita, while in Hungary it exceeded 100 litres. In Poland, the Baltic States, Russia and the Ukraine the per capita consumption figures were considerably low, in the range of 20–25 litres in Russia and 10–15 litres in the Ukraine. In 1991 Russia was the largest beer producer in CEE in terms of volume, followed by the then Czechoslovakia (Table 6.1). While market size accounted for Russia's large production output, consumption per capita was the most important driver in the Czech Republic.

Before the 1990s Bulgaria, ex-Czechoslovakia and Hungary were the only countries from the CEE region members of the European Brewing Union. They had well-established brewing traditions with

Table 6.1 Beer production, imports, exports and consumption in CEE in 1991 (in thousands of litres)

Country	Beer production	Beer imports	Beer exports	Total consumption
Bulgaria	4,879	6	208	4,677
Ex-Czechoslovakia	22,276	8	1,852	20,432
Hungary	9,570	1,600	2	11,168
Poland	13,633	177	6	13,804
Romania	9,757	258	–	10,016
Russia	32,692	155	16	32,832

Source: UK Breweries Society (1992).

modern technology and production know-how. While Bulgaria and ex-Czechoslovakia were export-oriented, Hungary, Poland, Romania and Russia were with import orientation (Table 6.1). Presently, the Czech Republic is a significant beer exporter, while Bulgarian beer exports have been totally wiped out following the acquisitions by foreign companies. In 1998 beer imports to Russia diminished drastically because of the substantial increase in import taxes. Despite the rapid growth in domestic demand, some Russian companies, such as Baltika and Vena, have intensified export efforts since 2000.

In the 1990s and early 2000s, the beer markets of CEE have followed different development paths. While some markets have been mostly stable (for example, the Czech and Slovakian), others have followed a downward trend in production and consumption patterns (for example, the Hungarian). A third group of markets has been with varied patterns responding to changes in the overall economic conditions that have determined consumer disposable income (for example, the Baltic countries, Bulgaria, Romania and Russia). At the same time, some CEE beer markets have exhibited a relatively steady continuous growth since 1990 (for example, the Polish, Croatian and Slovene). The changes in beer consumption in CEE in the period 1993–2001 are presented in Table 6.2. Currently Russia ranks eighth in the world tables in terms of volume of beer production and Poland ranks fifth in Europe. The two markets have lately indicated growth rates that are higher than the average for the CEE region.

Market entry and market servicing strategies in CEE

One of the most commonly used frameworks for analysing the internationalization of companies is Dunning's eclectic paradigm (Dunning, 1988, 1993). Foreign direct investment (FDI) can be realized as defensive or aggressive. The results of several studies indicate that aggressive investments dominate. FDI motives can be market seeking, resource seeking, efficiency seeking and strategic asset seeking (Dunning, 1993). Market-seeking motives are more common, although certain FDIs in Western Europe and North America are driven by a combination of motives (Dunning, 1993; Marinova *et al.*, 2004).

A number of studies on CEE (for example, Dunning and Rojec, 1994; EBRD Report, 1994; OECD, 1994; Svetlicic and Rojec, 1994; Paliwoda, 1995; Marinov and Marinova, 2001; Marinova *et al.*, 2004) argue that market-seeking motives are the most important FDI motivators, followed by resource-seeking motives.

Table 6.2 Beer consumption in CEE countries in the period 1996–2001

Country	**Per capita consumption in 1996 in l/a (litres per annum)**	**Per capita consumption in 2001 in l/a (litres per annum)**	**Total consumption in 2001 in million litres per annum**
Russia	16.0	43.6	6483.3
Poland	39.0	67.8	2691.7
Czech Republic	157.3	160.8	1640.2
Romania	37.4	56.9	1280.3
Ukraine	n.a.	23.3	1162.5
Hungary	73.0	77.1	778.7
Serbia-Montenegro	n.a.	53.7	569.2
Slovakia	92.0	90.2	487.8
Bulgaria	53.3	51.7	423.9
Croatia	n.a.	85.7	385.7
Belarus	n.a.	23.5	239.7
Lithuania	34.0	62.2	230.1
Slovenia	n.a.	68.3	140.7
Moldova	n.a.	25.1	107.9
Latvia	24.0	43.3	103.9
Estonia	33.0	64.1	89.7
Macedonia	n.a.	33.0	66.2

Source: Brau Beviale, Datamonitor, Drinks Database.

Research on FDI in the brewing industry in CEE indicates that there have been well-founded reasons for the choice of FDI as a main mode of market entry rather than exports or licensing. Generally, there is limited demand for foreign beer brands due to the local nature of the industry and the consumer preference for local brands. Smaller companies have considered joint ventures and/or greenfield investments to tap into the CEE markets (United Nations, 2002). These modes of market entry have been encouraged by low production costs in CEE. For example, the production costs and taxation in Finland and Sweden are much higher than in CEE countries, thus discouraging exports. Restrictive import taxes in some CEE countries, for example, Lithuania, Russia and the Ukraine, have also predetermined the choice of modes of market entry.

Market-seeking motives have been the main drivers for investment in the CEE brewing industry. These are complemented by strategic asset-seeking motives, mainly access to brands owned by local breweries. Efficiency-seeking motives were inspired by low production costs in the region. Investment decisions of smaller breweries acquiring beer companies in CEE have followed the moves of large breweries such as Heineken, Interbrew, SABMiller and Carlsberg. In the case of Nordic brewing investors in CEE, especially the Finnish ones, some specifics in the investment motives can be identified. The initial Nordic investments were motivated mainly by defensive moves. For example, Finnish brewers wanted to benefit from the first mover advantage through investment in the Baltic States and St Petersburg's area to counteract investment moves of large brewers. These investments also created entry barriers for low cost exports from Baltic and Russian production bases to Finland, thus protecting the domestic market from cheaper imports. Market-seeking motives were of secondary importance for Finnish brewing FDI in the first half of the 1990s. However, since the mid-1990s they have become the primary driver for FDIs made by Finnish and Nordic companies in the CEE brewing industry, such as those of Baltic Beverages Holding (BBH) in Russia, the Ukraine and the Baltic countries.

The first companies to invest in CEE in 1991 and 1992 were BBH and Harboe in Estonia; Interbrew, Heineken and SAB in Hungary; and Sinebrychoff in the Baltic countries. When Heineken, Interbrew and SAB started investing in CEE, they were already among the largest brewers in the world. Their expansion in the newly opened CEE markets was supported by significant international experience and financial strength. The then new brewer, BBH, was established in 1991 as a joint venture between the Swedish-Norwegian Pripps Ringnes and Finnish Hartwall breweries (both owning 50 per cent of BBH). BBH was set up with the objective to analyse opportunities for and make investments in CEE countries. The two other pioneers in the CEE market, Finnish Sinebrychoff and Danish Harboe, were small breweries operating almost exclusively in their home markets. By the mid-1990s there were 23 brewing investments in 11 CEE countries. However, it is interesting to note that none of the world's largest breweries originating outside Europe, apart from SAB, had any investments in CEE until 2003. The then independent brewer Miller (USA) did not invest in CEE before its acquisition by SAB (South Africa) in 2002. The brewing company Scottish & Newcastle entered the CEE markets through the acquisition of the Finnish brewery Hartwall in 2002.

The choice of a target country for foreign investment has usually been based on a combination of factors such as market size, future growth potential, cultural and economic distance, and level of political uncertainty. Considering all factors, the markets of Hungary and later the Czech Republic were most attractive in the early 1990s. In the Baltic countries the market size was small, but the psychic distance was low as they were culturally and geographically close to the Nordic states. Thus, Nordic companies such as BBH entered the region to test the opportunities for foreign brewing operations there before moving into Russia where the risks were far greater due to economic and political uncertainty and larger psychic distance. Additionally, the market size and growth potentials in Russia have been substantially more promising than the ones in the Baltic countries. The Nordic company Carlsberg adopted a different strategy in terms of investment location choosing Poland and Croatia as first target countries instead of the Baltic region. Poland was selected because of the large market size, high growth potential and geographical proximity. Croatia represented a test market for Southeast Europe. Previous positive experience from a long-lasting licensing agreement with a Croatian brewing company encouraged Carlsberg to engage in acquiring a local brewer in 1994.

The majority of pioneering investors in the CEE brewing industry were brewing companies that had a long-term growth vision for the region. However, among the early entrants were companies like Nomura Investment Bank (Japan) with short-term investment goals. Several years after Nomura's investment in the Czech brewing industry the investor sold its shares in the Czech breweries.

There have also been soft drinks producers that have diversified their operations investing into the brewing industry in CEE, for example, Bravo International. Their investment strategies were mostly short-term based.

Exports and licensing by foreign companies in the CEE beer markets have been very limited. The characteristics of the brewing industry, the local tax legislation and import duties have encouraged FDI that was not positively correlated with previous experience in the CEE markets as such did not exist. Hence, the internationalization of breweries in CEE offers limited support for the stages theory of internationalization.

While most of the early investments were relatively small in volume, there have been some exceptions such as the 1991 and 1992 acquisitions by Interbrew and SAB in Hungary, and the 1993 investment by Bass in the Czech Republic. Over the years, the value of individual investments increased. For example, the acquisition of Bravo International by Heineken in 2002 exceeded 400 million euros.

About a half of all brewing companies that entered CEE markets limited their commitment to one or two investment deals. However, there are a few that spread investments across a number of companies and countries in the region. For instance, by the end of 2003 BBH had made more than 20 investments in CEE. Other companies that made numerous investments are Interbrew, SABMiller and Heineken. The greatest amount of partly or totally foreign-owned breweries can be found in Russia, about 30 by the end of 2003. Poland also has many foreign-owned brewing operations. Interbrew has the greatest coverage in terms of country presence in CEE. As one of the largest regional investors BBH has, at least so far, avoided entering Central and Southern European markets and has concentrated investments on the Baltic States, Russia, the Ukraine and Kazakhstan.

Investment and ownership strategies

The strategic investment decisions relate to the form of investment and ownership structure of the targeted firm. Concerning the ownership structure the major alternatives are a wholly owned subsidiary (WOS) or a joint venture (JV). According to the transaction cost theory, the choice between full and partial ownership of a foreign company depends on the costs and benefits of sharing its equity compared to those of retaining full ownership (Beamish and Banks, 1987; Hennart, 1988). In Western Europe and North America, WOSs seem to be the preferred alternative, whereas elsewhere JVs are more common (Bell, 1996; Hennart and Larimo, 1998).

WOSs have been the main ownership structure in FDIs in Western Europe, while in CEE acquisitions of former state-owned enterprises (SOEs) have been the main alternative chosen. The governments' strategy was not to transfer full control over the privatized productive assets in one go fearing loss of control over the development of the privatized companies and affected industries, which could cause social dissatisfaction (Marinov *et al.*, 1997). Shares were preserved by governments and given to company management and employees in almost all privatization cases. CEE legislation allowed more investment freedom for foreign companies after the mid-1990s. As economic and political volatility in CEE decreased, the relative share of WOSs augmented (Larimo, 2001). Gradually foreign investors were allowed to purchase the shares held by managers, employees, governments, local investors and financial institutions. Hence, foreign investors have gradually increased their shareholding in CEE breweries. Furthermore, majority ownership at entry has been more common as CEE governments needed cash, while foreign investors aimed at acquiring majority or full control. A good example is BBH, which has increased the original ownership in all its brewing investments in CEE over the years (from an initial 51–60 per cent to 80–95 per cent by the end of 2003). The ownership strategies of the foreign investors in the brewing industry in CEE are presented in Table 6.3.

While some studies on investments in CEE have found out that acquisitions were predominant during the 1990s (Artisien-Maksimenko, 2000), other researchers claim that acquisitions, including "brownfield" investments, and greenfield investments were of equal importance (Estrin *et al.*, 1997; Meyer, 1998; Pye, 1998; Larimo, 2001).

As the results from Table 6.3 indicate, acquisitions have been the prevailing form of investment in the brewing industry in CEE. In fact, no FDI made in the form of greenfield investment could be identified in the brewing industry in the period 1991–1996. There are few greenfield investments made afterwards. The greenfield investment form seems to be more common among malt house FDIs. Based on annual reports and company internal materials, the main motives behind the choice of the acquisition mode of entry in CEE have been the same as in Western Europe, namely, buying market share and local brand(s). Established breweries took the chance of buying productive assets in CEE that were cheap and easy to upgrade but offered them market access, local brands and know-how.

Problems and performance in CEE markets

In the early 1990s, the problems in the CEE brewing industry were mostly stemming from the political, economic and legal restrictions for FDI. For example, the access of foreign investors to privatization deals of SOEs in the Czech Republic was delayed by the implementation of voucher privatization. The possibilities for single investor deals in Poland were limited as the government wanted to attract multiple investors with high financial capabilities. In Russia, the Ukraine, Belarus and other countries from the Commonwealth of Independent States, there was uncertainty related to the local economic, political and legislative development. In addition, CEE governments and management of breweries required potential investors to carry out major restructuring of operations, bring in new production technology, improve product quality and expand export presence. Many of these objectives did not match the motives of the interested foreign investors.

There are still problems with distribution networks and a deficit of good quality raw materials in Russia and the Ukraine. The shortage of quality malt and hops has forced some of the biggest breweries to build their own malt houses. However, investors still face problems with

Table 6.3 Ownership strategies and form of investment in CEE brewing industry

Company	No. of FDIs	Entry Strategy				Form of Investment			
		1990–1996		1997–2003		1990–1996		1997–2003	
		JV	WOS	JV	WOS	Greenfield	Acquisition	Greenfield	Acquisition
BBH	25	Yes	No	Yes	No	No	Yes	Yes	Yes
Interbrew	15	Yes	No	Yes	No	No	Yes	No	Yes
SABMiller	12	Yes	No	Yes	No	No	Yes	No	Yes
BrauUnion	12	Yes	No	Yes	No	No	Yes	No	Yes
Heineken	13	Yes	No	Yes	No	No	Yes	No	Yes
SUN Breweries	10	Yes	No	Yes	No	No	Yes	Yes	Yes
Carlsberg	6	Yes	No	Yes	No	No	Yes	Yes	Yes
Efes	4	No	No	No	Yes	No	No	Yes	No
Olvi	4	Yes	No	Yes	No	No	Yes	No	Yes
Nomura Bank	3	Yes	No	No	No	No	Yes	No	No
Brau und Brunnen	2–4	Yes	No	No	No	No	Yes	No	No
Brewpole	1–3	Yes	No	No	No	No	Yes	No	No
Danish Brewery Group	2	No	Yes	No	No	No	Yes	No	No
Brewinvest	3	Yes	No	Yes	No	No	Yes	No	Yes

Sinebrychoff	1	Yes	No	No	No	No	Yes	No	No
Bass	1	Yes	No	No	No	No	Yes	No	No
Icelandic Business Group	1	No	No	No	Yes	No	No	Yes	No
Grolsch	1	Yes	No	No	No	No	Yes	No	No
Lahden Polttimo	1	No	No	Yes	No	No	No	Yes	No
Groupe Soufflet	1	No	No	Yes	No	No	No	Yes	No
Cyprus-based business group	1	No	No	Yes	No	No	No	Yes	No
New Century Holdings	1	No	No	Yes	No	No	No	Yes	No
Harboes Bryggeri	1	Yes	No	No	No	No	Yes	No	No

supply of inputs. Estimates suggest that only 43 per cent of the demand for malt in Russia can be satisfied with local raw materials, the rest comes from imports (British Embassy, 2001). Therefore, owning malt houses provides brewers with a distinct advantage in the strongly competitive Russian marketplace.

The performance of FDI can be measured using subjective and objective measures. In terms of longevity, there have not been closures of breweries in CEE since 1991. Some breweries only changed their owners. Among the companies that seem to have failed in CEE brewing markets was Bass. The company incurred continuous financial losses in the Czech Republic and had to sell their shares in the acquired breweries. Other examples are Nomura Investment Bank and Grolsch that also sold their shares in CEE breweries. A more common case has been the sale of original CEE investors to other brewers leading to ownership changes. For example, Carlsberg bought the Finnish brewery Sinebrychoff, thus acquiring Vena brewery in Russia. The acquisition of Brau AG by Heineken made the Dutch brewer gain very strong positions in several CEE markets. The performance of the investing brewing companies in CEE in terms of market share is presented in Figure 6.1.

Data from Figure 6.1 indicate that in 2001, BBH and Interbrew were market leaders in three CEE national beer markets, Heineken was market leader in two markets, Brau AG and SAB were market leaders in one CEE country beer market. The dominant role of foreign breweries in the CEE brewing markets is reflected clearly in the fact that the market leader and market challenger in 2001 were foreign companies in the majority of CEE national markets. The joint market share of foreign brewers in CEE was at least 50 per cent in all national markets. Interbrew, Heineken, SABMiller and BBH have been dominating various CEE markets. While in the mid-1990s BBH and SUN Brewing had an almost equal market share in Russia, in the late 1990s SUN Interbrew alliance lost market share. This has provided BBH with the opportunity to acquire competitor market coverage and increase their market share from 19 per cent in 1997 to 32 per cent in 2002. SUN Interbrew has focused attention on growth in the Ukrainian market where it has become the market leader.

Apart from market share, brand sales can be indicative of company performance. For example, Baltika brewery in St Petersburg can be regarded as one of the best performing breweries in CEE as the brand name Baltika has established itself among the best selling beer brands in Europe. The brewery was founded in 1991 and BHH acquired 52.4 per cent of the company in 1993, constantly increasing its share

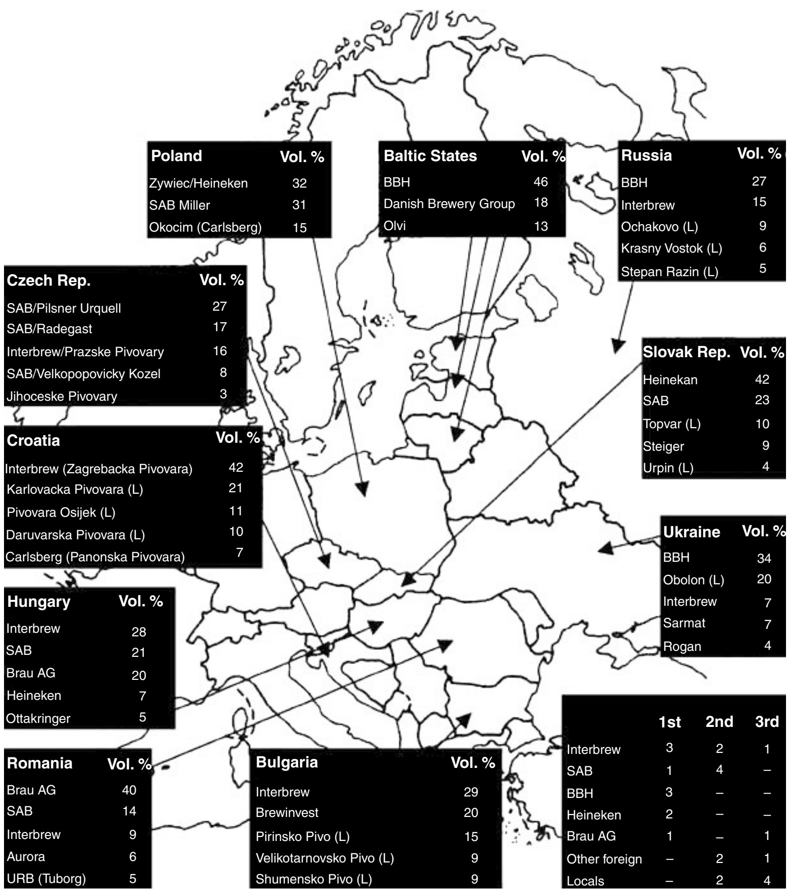

Figure 6.1 Market share of the leading breweries in various CEE markets in 2001
Source: GfK market shares in 2001.

over time. The brand Baltika has become market leader in volume sales in Russia with a market share of 13 per cent in 2002.

The dominant positions of foreign breweries in the CEE markets have made national governments set restrictions on new deals by foreign brewers. Thus, when Carlsberg bought 60 per cent of Orkla and simultaneously received 50 per cent shares in BBH, the latter had to sell the previously acquired Kalnapilis brewery in Lithuania. Similarly, SUN Interbrew divested from the investment in the Crimea brewery to be able to acquire the Rogan brewery in the Ukraine.

There are common features and differences in the strategies applied by the investing brewing companies in CEE. For example, the strategic approaches of BBH and Interbrew have been somewhat different. Initially, BBH adopted a pre-emptive, defensive strategy trying to protect the high value, high priced Nordic beer markets. During its existence BBH has undergone ownership changes, while developing and implementing CEE investment strategies. BBH investment priorities in CEE have largely reflected the strategic priorities of its owners. Presently the investment strategy of BBH in CEE is aggressive and expansionary. By comparison CEE investments of Interbrew have always been dominated by market-seeking motives. The differences in the initial motives did not prevent the two companies from engaging in rapid aggressive internationalization in CEE. Their target country strategy differs substantially. BBH has focused on the Baltic States and Russia, followed by further expansion into the Ukraine and Kazakhstan. Company strategic priority has been to tap into and develop the big Russian and Ukrainian markets benefiting from their huge potential. Interbrew made its first investment in Hungary, gradually expanding into many CEE markets. It entered Russia and the Ukraine via an alliance with the Indian SUN Brewing that had already established operations in both countries. BBH and Interbrew have mainly used partial acquisitions in all their market entries. The evolving legal and economic opportunities have been explored similarly as the two companies gradually increased their shares in the acquired breweries. Currently some of the CEE companies owned by Interbrew operate as WOSs. Both BBH and Inerbrew have attempted to transfer their corporate culture into the CEE entities owned by them. Meanwhile, they have developed local management and marketing expertise, strengthening old and introducing new brands.

Conclusions

Analysing FDI behaviour of investing brewing companies in CEE, it can be concluded that ownership specific advantages of Western companies have been in the possession of strong brands, know-how related to promotion and distribution and economies of scale. There have been significant growth trends in beer production and consumption in a number of CEE countries that encouraged the location of most of the investments in the region. FDI remained the only viable alternative as investing companies wanted to exploit CEE beer markets and wished to get strong footholds in them (Gatling, 1993). Most of the investments in CEE brewing companies made in the period 1991–1996 were partial acquisitions that led in some cases to WOSs. The need for local brand(s) ownership and the lack of regional market knowledge by investors have made acquisitions preferable. The maturity of beer markets in several CEE countries has made greenfield investments inappropriate. There have been a small number of greenfield investments, mainly in malt house creation. It can be expected that acquisitions will be preferred in the future because the demand for new breweries is on the decline, but the need for extension and upgrading of existing ones, especially in the high growth markets, increases.

Due to their international managerial experience and financial strength, most foreign brewers have performed well in CEE. There has been a great deal of variability concerning the problems foreign investors have encountered in CEE. Some were associated with declining per capita consumption. Furthermore, there have been problems associated with the availability and quality of raw materials, causing an increase in imports and backward integration.

There are some limitations to the study. One of them is the limited access to information on FDI in CEE made by breweries like Brewpole and Efes. Furthermore, the study did not address in depth the investment strategies of all brewers. In order to get a better understanding of those, one interesting avenue for future research would be a focus on the marketing strategies of the brewing companies in CEE. This would provide a good insight into the key reasons for the success and failure of brewing companies in the region.

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7
Special Economic Zones in Russia
Can They Lead to an Economic Boom Similar to the Chinese?

Kari Liuhto and Valtteri Kaartemo

Introduction

In the last decade, companies from emerging countries have started to enter global markets at full steam (Fortune, 2009). Firms from the BRIC (Brazil, Russia, India and China) countries have also increasingly engaged in research and development (R&D) activities. As a result of this unprecedented development, 21 companies originating from BRIC countries have taken places among the top 1000 R&D investors in the world (DIUS, 2009). However, the data indicate that the growth of Russian companies does not correlate with the number of companies among the top R&D investors in the world. This suggests that despite the aspirations for increased R&D and the emphasis on a knowledge-based economy, Russian multinationals have mostly remained dependent on natural resources.

When applying the knowledge economy index (KEI), which the World Bank calculates annually, Russia appears to be in the group of countries with medium-low income. The dynamics of KEI for Russia shows that its ranking has been decreasing since 1995 due to a worsening economic incentive regime (currently 127th) and a decrease in some indicators which characterize the educational system. By comparison, China and Brazil have improved their knowledge economy standing since 1995 (Tables 7.1–7.3).

These data confirm that Russia has resources (research personnel in the first place) which are more substantial than in many countries in the world. At the same time the conditions in the economic environment have been worsening. This means that the quality of government regulations, including that of the regulations affecting the innovation

Table 7.1 Countries of origin for top companies in terms of turnover and R&D spending

	Companies in fortune global 500		**Companies in top 1000 R&D investors**	
	2005	**2009**	**2005**	**2009**
Brazil	3	6	3	3
Russia	3	8	2	1
India	5	7	1	12
China	16	37	3	5
Europe*	175	180	294	333
USA	176	140	423	378

*Europe excluding Russia.
Source: DIUS (2009) and Fortune (2009).

Table 7.2 Development of knowledge economy indicators in selected countries

Country	**Year**	**Position in the ranking**	**KEI***	**Economic incentive regime**	**Innovation***	**Education**	**ICT**
Brazil	1995	69	5.23	4.81	5.98	3.95	6.17
	2009	54	5.66	4.31	6.19	6.02	6.13
Russia	1995	58	5.73	2.55	5.64	8.12	6.60
	2009	60	5.55	1.76	6.88	7.19	6.38
India	1995	108	3.56	3.47	3.70	2.56	4.50
	2009	109	3.09	3.50	4.15	2.21	2.49
China	1995	100	3.93	3.24	4.07	3.62	4.77
	2009	81	4.47	3.90	5.44	4.20	4.33
Western Europe	1995	16**	8.95	8.69	9.21	8.66	9.25
	2009	17**	8.76	8.71	9.27	8.29	8.78
USA	1995	2	9.53	9.29	9.55	9.44	9.84
	2009	9	9.02	9.04	9.47	8.74	8.83

*Innovation variables are weighted by population.
**The ranking for Western Europe is calculated based on its KEI points.
Source: World Bank (2009).

sphere, is becoming of crucial importance for the development of the national innovation system.

The comparison among the BRIC countries demonstrates that these countries have chosen different models for their innovation development and that the gap among them is growing. While in 1995 many indicators of patent statistics and publication activity were close for Brazil, China and India, at present China and India are far ahead of Brazil. Russia and India may be characterized as countries in which innovations are based on achievements in the area of fundamental

Table 7.3 Differences between Russian TI-SEZs and Chinese SEZs

SEZ factors	Russia	China
Purpose and administration	Administrative task – economic and political reasoning mixed	Demand from market – economic and political reasoning separated
Specialty	Potential advantages in otherwise non-special regions	Existing advantages in the oasis of the business environment
Impact	Focus on domestic products to domestic market with limited industrial and regional impact	Focus on foreign quality products to foreign markets with wider spillover effects

research, while China and Brazil have based their development mainly on absorption of foreign technologies (Tseng, 2009).

On the one hand, Russia is lacking large science-intensive companies, on the other, it suffers from underdevelopment of innovative small enterprises. Moreover, there is a noticeable trend showing that the number of small innovative companies is even diminishing. Small enterprises are among the key actors in the national innovation system because they may bridge the gap between research organizations and industrial enterprises and thus absorb the risks associated with the first stages of the commercialization process. In Russia, the indicators associated with the dynamics of the development of small innovative enterprises have been negative during the entire post-Soviet period. The decrease in the number of small companies may be explained mostly by the fact that deficiencies in the business and innovation infrastructure concerning taxation, capital and financial markets, as well as administrative barriers, inhibit the emergence of a vibrant sector of small innovative enterprises.

Availability of financial resources for the development of small innovative firms is limited both in terms of volume and variety of sources. The Russian government provides support to small companies in the form of grants on R&D and a number of accompanying activities, including financing of innovation infrastructure. Targeted support of R&D for small companies is not substantial because there is only one government fund which implements such programs which is the Fund for Assistance to Small Innovative Enterprises.

One serious reason for the low demand for innovations (including R&D) from industry lies in the inadequate level of competitiveness and high degree of monopolization of many Russian industries. This has negatively affected the competitiveness of firms. Thus many Russian enterprises have not been in a position to actively participate in government programs which finance R&D. This fact is reflected in the data supplied by the Ministry of Education and Science showing that 90 percent of all R&D projects supported through this Ministry were developed by government research institutes, 4 percent by universities and only 6 percent by private enterprises.

Nevertheless, it is encouraging that the need for the transformation of the Russian economy towards an innovation-driven economy has been recognized and embraced as a key national priority at the very highest level of Russian decision-making. However, the modernization process is not a one-man-job, but it requires the implementation of a systematic, consistent and effective strategy across all sectors of the economy. Moreover such a strategy can only enforce a top-down mechanism of innovation support, which should be complemented by active and efficient involvement at grassroots level, which implies a bottom-up approach inclusive of the business community and scientific powerhouses in Russia. Recently, such a perspective has taken a central position and has been strongly emphasized by President Medvedev.

> In the twenty-first century, our country once again needs to undergo comprehensive modernisation ... Instead of a primitive raw materials economy we will create a smart economy producing unique knowledge, new goods and technology of use to people. (Russian President Dmitry Medvedev in State of the Nation Address, 2009)

Special economic zones

Special economic zones (SEZs) can be seen as one practical tool in the process of economic modernization. They are not a new phenomenon for Russia. The last time they were applied was in the 1990s but this attempt ended up in utter disappointment, as the SEZs became associated with criminal activities and tax evasion. Despite this previous negative experience, four new technology-innovative special economic zones (TI-SEZs) were set up in 2005 in St Petersburg, Dubna, Zelenograd and Tomsk. The objective was to facilitate Russia's transformation from a resource-based economy to a more innovative system (Vedomosti, 2005). These kinds of TI-SEZs focusing on innovation-generation are the first of their kind in the world, although they resemble traditional SEZs.

The history and benefits provided by the Russian SEZs have been covered earlier (for example, Tuominen and Lamminen, 2008; Liuhto, 2009). Therefore, we do not tap into these details. Instead *we study the Russian TI-SEZs in Russia's transformation towards innovation* economy. This is done by comparing the Russian TI-SEZs with the Chinese experience.

We must remember that the TI-SEZs cannot be separated from their context. Only by designing the SEZs according to the special features of the Russian economic environment may they be developed as key forces in the modernization process. Although Russia is different from other countries, it is not unique in terms of its socialist past, legacy of planned-economy or availability of natural resources. Interestingly, these features may all be found among other BRIC countries. Consequently, Russia is not unique in its challenges for the future of innovation development (Grützmann *et al.*, 2009; Kaartemo, 2009). The problems of corruption and administrative inefficiency have also featured in Chinese SEZs but they did not block the success of the firms operating in the SEZs.

Apart from the similarities, there are also a number of differences in the contexts that are spatial (between China and Russia) and temporal (between 1980 and 2010). These differences can be found, for example, in terms of foreign investments[1] and attitude towards entrepreneurship.[2] These must be taken into account in order to appreciate the fact that earlier Chinese success may not be directly transferrable to the Russian context. However, we believe that the Chinese experience has an important political lesson for Russian decision-makers.

The main premise of the chapter is that TI-SEZs might be necessary but not sufficient instruments for the modernization process in Russia (Liuhto and Vahtra, 2009). This means that the purpose of the TI-SEZs must be linked with the aims of the modernization process. In order to enhance the process, they need to contain the "specialty factor," which means that the zones must differ in characteristics from the rest of the economy. Moreover, the impact of the zones must be dispersed throughout the rest of the economy to have a wider influence on the modernization process. Alone, the TI-SEZs would not provide much benefit if their effects are not internalized by the national economy. It is the effective use of the TI-SEZs as instruments of innovation and development which may have an impact on increasing the innovation potential of a national economy in the long term.

Purpose and administration

It is of crucial strategic importance that the government and its institutions should clearly formulate the aims that need to be realized within

SEZs. Only by formulating the aims of the TI-SEZs can it be assessed whether they are the best instruments to reach the intended aims. However, in the case of Russia, it is difficult to understand the concrete goals of the TI-SEZs which could be used as criteria for assessing the performance of the SEZs.

These difficulties lead to the imminent situation that TI-SEZs are under threat of becoming purely a political task. Economic reasoning has mixed with political ideology, which is not a promising platform for innovation development. Although political support is needed for SEZs, it is clear that we should not have a common cell for "purpose and administration" in Table 7.3. However, in the case of Russia, it is a challenging task to analyse them separately.

Administration of SEZs should be designed to be effective and flexible. On the one hand, it should have enough power to influence decision-making in terms of related policy-making. On the other hand, it should have the characteristics of a business venture than of a governmental bureau. The Chinese experience suggests that as much decision-making power as possible should be delegated from governmental agents to private actors. The government should only guarantee that there is enough funding for the development of the zones in the long run, which decreases the risk of investment in SEZs (Knoth, 2000).

It is interesting to note that SEZs were initiated in China "to develop external economic cooperation and technical exchanges and promote the socialist modernisation program" (BFAI, 1986: 95 in Knoth, 2000: 25). In this respect, China was the first country in the world to incorporate SEZs as a means to boost technology transfer and modernization (Bhardwaj, 1993).

The management of the Chinese SEZs has been associated with their administrative and legislative role. For instance, Shenzhen SEZ established its own municipal government in the 1980s and possessed an independent administrative system later in the 1990s. The direct involvement of the government in entrepreneurial decision-making and the regulation of the economic system by bureaucratic institutions were massively reduced, and the whole administration was streamlined (Knoth, 2000). Eventually, Shenzhen became a city of its own, a subordinate to the province of Guangdong (Meng, 2005).

Russia has moved into what seems a different direction. In October 2009, a decision was made to centralize the SEZs' administration from the Federal Agency for Special Economic Zones directly to the Economic Development Ministry in order to improve SEZ administration. Although the earlier independence of RosOEZ remains unclear, this move can be interpreted as a step towards a greater degree of centralization of decision-making and away from decentralization of decision-making. Moreover, it may even be questioned whether TI-SEZs are used in Russia to solve deep structural problems or whether they are used by bureaucrats to cover these issues.

All in all, the purpose of the SEZs should be based on business needs, instead of political motives, be they either federal or regional. In our interviews, we have heard that Russian companies have registered in TI-SEZs as part of a deal for federal funding. The news is worrisome. The TI-SEZs should be based on the needs of the companies, not on reasons associated with obtaining administrative privileges because when the privileges eventually fade away, so will the companies. In other words, the TI-SEZs should provide such value that companies are willing to register there voluntarily with the intent to get involved in innovation and its business application.

Specialization

In Russia, the benefits of the SEZs can be compressed into a more efficient administration, duty-free customs, tax benefits, readily available infrastructure and diminished labor costs.

Considering the role of TI-SEZs in the Russian modernization process, it may firstly be questioned whether the SEZ-related measures are enough to tackle the general problems of the Russian innovation system. Are the TI-SEZs able to overcome the weaknesses in the quality of governance, such as ineffective protection of intellectual property rights, weak enforcement of government regulations, lack of cooperation and coordination, and low level of financial support (Dezhina and Peltola, 2008; Kaartemo *et al.*, 2009)? As TI-SEZs should be based on the idea of providing a better environment for innovation development, the proposed benefits may not be that attractive.

The long history of established universities and research institutes near the TI-SEZs remarkably increases the potential of the TI-SEZs. However, Russia is known for difficulties in the linkage between industry and research institutes, which the zones are not able to solve. As such, this is linked to the idea that the zones cannot create comparative advantage alone but they should enable the leveraging of existing advantages with business initiatives, thus the activities should be mostly based on existing advantages.

In Chinese SEZs, the companies were intially provided with more attractive infrastructure than what was available elsewhere. Later, the interest of companies transformed from the land to industrial issues.

The evolution of Chinese SEZs was not only a result of changes in internal conditions (for example, regional economic development strategy and the free economic zones' (FEZs') unbalanced development) but also due to changes in external conditions (for example, World Trade Organization (WTO) membership in 2001 and wider regional economic integration). The original SEZ preferential policy was gradually transformed to a comprehensive economic and structural advantage program which emphasized the advantages of capital, technology, qualified personnel and a market-oriented economy. Tax holidays, financial subsidies and administrative privileges were reduced and replaced by high-tech and industry-oriented preferential policy. Consequently, the duty-free import of equipment, raw material and semi-finished materials was eventually canceled (Meng, 2005). Interestingly, this is in sharp contrast with the preferences currently provided by the Russian SEZs.

Thus, the benefits of Chinese SEZs were not limited to short-term tax breaks or customs reliefs. Instead, new laws were introduced in the SEZs in order to provide foreign companies with labor productivity which was not available elsewhere in China. For instance, there were changes in contracts and wage systems. Companies became free to hire and fire their employees, and there were significant changes in the wage system which increased labor productivity remarkably. Moreover, other changes such as the introduction of a tender system were introduced first in the SEZs in order to improve cost-efficiency (Wong, 1987). All in all, the incentives of SEZs aimed to make the business environment favorable for foreign companies with first, the possibility to enter the zone quickly using good infrastructure and streamlined administrative regulations, and second, with the possibility for a fast exit ensured by reduced foreign exchange control and unlimited profit repatriation.

It is clear that the initial incentives were not enough for the companies to shift their production to China, as freedom of hiring and firing people was not an exceptional case in the world economy. In fact, investors were willing to invest in SEZs only if they perceived the zones as more attractive than the rest of the country. "It seems that host governments wishing to attract inward FDI should concentrate on the reduction of country risk as their main policy focus, since globalized capital markets enable investors to invest only when combinations of expected return and risk are perceived to be attractive" (Buck *et al.*, 2000: 378).

In China, SEZs were established as part of the "Open Door" policy. SEZs provided foreign companies with privileges and opportunities to invest in the country, which were otherwise close to impossible. In this sense, the SEZs could be seen as oases in the Chinese business environment.

Should SEZs fail in reducing obstacles to investment, only companies which had invested in the country, even without extra incentives, accept the additional benefits of the SEZs (Knoth, 2000). While the level of taxation and labor costs are relatively low in Russia,[3] by international standards these cannot be seen as major reasons to attract foreign investors.

Impact

Should the TI-SEZs be considered as a tool for the modernization of the economy, they need to have a wide impact on the national economy. In other words, it is not enough to have an oasis, as it cannot alone provide fruitful soil for the surrounding desert.

Regional-oriented preferential policy in China led to increasing gaps between the SEZs and other regions. It led to an importation coming from industries with low technology and secured only limited technology transfer. Therefore, the change to cost-oriented and industry-oriented preferential policy was seen as crucial (Meng, 2005). Chinese SEZs were very comprehensive with a wide scope of operations in order to create favorable conditions for business operations. Similarly, the companies were neither only foreign or local; nor private or state-owned. Companies were encouraged to establish various connections with diverse counterparts in order to promote technology transfer and growth through the expanded economic links. Otherwise, the experimentation would have remained limited. The creation of separate growth areas cannot alone generate enough for the modernization of the whole economy. Instead, the sectors with preferential treatment in zones should include all those sectors for which domestic companies have abilities to establish production (Knoth, 2000).

In Russian SEZs, the decision-makers have followed a different approach. They have instead decided which industries would be represented in each zone. This limits operations on the fields in which Russian companies might have a comparative advantage such as the wood processing industry. According to Yuri Zhdanov, ex-director of RosOEZ (Federal Agency for Management of Special Economic Zones), they received plenty of applications related to wood processing at the initiation process of SEZs. These were not regarded as being creative as “the whole country is doing it anyway, without SEZ regime” (Vedomosti, 2005). In China, this was in turn seen as a crucial part that could ensure both horizontal and vertical linkages between companies in the SEZ and in the rest of the economy. Although being in Russia, other companies, such as some service firms, may also operate in the TI-SEZs, but they are excluded from receiving any benefits from the administration. This may be related to a generally common problem in Russia, as innovations are perceived to be associated with advanced science and high-technology by definition.[4] However, one could argue that innovations in the wood processing industry are also important as they can help economic modernization just as innovations in nanotechnology can contribute to economic development. Moreover, the impact of TI-SEZs is not limited only by industry classifications but also in terms of their focus on foreign collaboration.

Chinese SEZs have been supported by their achievements in attracting foreign capital, facilitating export growth, attracting foreign exchange earnings and technology transfer and management methods. The SEZs have had wider spillover effects and they have also led to innovative measures beyond the borders of the SEZs (Wong, 1987).

Russian TI-SEZs seem to be somewhat different from the conventional definition of SEZs "aiming at promoting foreign trade, diversifying the production of exports and overcoming structural balance of payments pressures, importing modern technology and know-how, and improving supply conditions on the domestic market" (Ahrens and Meyer-Baudeck, 1995: 88). Generally, the incentives for foreign investors have been emphasized, and SEZs are seen as the way to overcome the obstacles for foreign investments.

It is interesting to raise the question of how many foreign managers have actually heard that Russian TI-SEZs have been initiated? Based on our survey results in Finland, we found that most foreign technology companies do not even know that TI-SEZs exist in Russia.[5] Russian TI-SEZs are oriented towards domestic companies. For instance, Russian TI-SEZs do not have foreign representative offices which would provide information to potential foreign investors, and the official website information is not easily understood. This domestic orientation may be risky to the future development of the zones. Earlier it has been noted that "only the massive inflow of foreign capital can guarantee the rapid development of such zones" (Knoth, 2000).

Currently, there are no globally recognized foreign companies registered in technology-innovative SEZs. Cooperation with these kinds of companies would provide opportunities for the transfer of knowledge and branding cooperation. It has proved to be successful, for instance, in the development of IBM-Lenovo and in the improved country-of-origin image of the Czech Republic in the field of automotive industry. These are important lessons, as innovations are not only about technological inventions but the commercial success of a product is embedded in the concept of innovation as well.[6]

In order to be able to attract foreign investments, Russia should have a clear economic policy. With recent turmoil within the strategic sectors (Liuhto, 2008, 2009), many companies have become cautious about future developments in Russia before investing heavily in the country. It should also be remembered that other countries are developing their smart economies. Therefore, Russia should analyse its position in today's global economic context and use TI-SEZs with their potential for acting as platforms for economic modernization. This requires a new political will supported by an institutional system for innovation.

Policy lessons

It is good news for Russia that China did not have a well-developed innovation system. Instead, a number of initiatives and actions were targeted at developing the regulative, normative and cultural-cognitive pillars of the innovation system in the country and SEZs were an important part of the development and implementation strategy. Thus it still managed to run SEZs in the modernization process. However, it is not simply enough to automatically transfer the successful Chinese initiatives into the Russian context. Whereas Wong (1989) claims that Chinese SEZs provide a good model for other countries and regions, it is necessary to understand the context of Chinese SEZs before similar strategies are undertaken (Garcia and Lora, 2009).

In order to understand the context of Chinese SEZs, an in-depth analysis of their key success factors should be made. In particular, SEZs should be seen as an integral part of other policies in a transformation economy. Whereas these contextual differences might explain some of the differences between Russian TI-SEZs and Chinese SEZs, an additional analysis of the content- and process-specific institutional and business level entrepreneurship may shed further light on those aspects of the Chinese policy in organizing and managing the SEZs that Russian authorities may find useful.

It has to be remembered that the Chinese success story evolved with a huge price tag and problems associated with the SEZs (Wong, 1987). Therefore, the aims and measures of the zones should be carefully planned in accordance with other economic policies. Defining the purpose of the TI-SEZs in a measurable way is of paramount importance.

Thus Russian policy-makers should analyse whether the implementation of the long-term strategic priorities in the TI-SEZs is directed towards fulfilling the objectives set for the industrial development of the country.

Unlike in China, the aims of the TI-SEZs in Russia are somewhat obscure. Naturally, they are related to facilitating the development of an innovative environment, but it is unclear how the SEZs will help companies in practice. Therefore, it is difficult to assess how the benefits provided support companies to generate innovations.

In the case that innovation development is the priority, the incentives should be first targeted at improving the factors which currently hinder innovation development in Russia. The problems of the Russian innovation system are so deeply rooted that perhaps this would have potentially only marginal impact. The structural problems take a long time to be addressed. Second, the incentives should aim to improve the conditions which hold back foreign companies from investing in Russia. The Chinese developed their SEZs with the help of foreign knowledge and funding. In Russia collaboration with foreigners may be seen as important at the top level of decision-making, but at grassroots level the aim seems to be one of taking best advantage of federal funding. This is the stage where innovations, economic modernization and the importance of foreign collaboration are easily forgotten.

The decision-makers must thoroughly consider the issue of why a foreign company would invest and import its newest technology to Russian TI-SEZs. Traditionally SEZs have been seen as tools to attract foreign firms, but this seems not to be the case in Russia. The current TI-SEZs do not have much to offer foreign companies. With an increasing public sector share in the Russian economy,[7] the TI-SEZs might be developed as safe havens for foreign companies. But this requires explicit commitment to build up trust and confidence in TI-SEZs. Currently, the uncertainty over administration makes it difficult to assess the future of these SEZs. In our opinion, separate legislation for SEZs, which would be foreign firm-friendly by nature, might make the TI-SEZs more attractive for foreign investors. For instance, property rights might be better protected with separate legislation in the TI-SEZs.

The current problems arise from the fact that the Russian TI-SEZs have been born out of political logic instead of economic reasoning. It may be argued that such an approach contradicts the Chinese experience. Should Russia be willing to continue with SEZs, it must develop the zones with bottom-up ideas in order to provide attractive incentives for investors.

Currently, we see that the TI-SEZs will most probably fail in revealing their full potential in terms of economic modernization in the near future.[8] As President Medvedev is demanding explicit results in less than seven years (Interfax, 2009), the prospects for Russian TI-SEZs look gloomy. Most probably the TI-SEZs will not be allocated enough resources for development, and therefore it is unlikely that we will witness an increased role of the TI-SEZs in the strive for Russian modernization.

In the case that the TI-SEZs are considered essential for the modernization of the Russian economy, major reforms will be needed. It is interesting that the same policy recommendations which were given regarding the Chinese SEZs in the late 1980s seem to be valid for the Russian TI-SEZs in 2010 (Wong, 1987):

- Administrative efficiency should be improved and bureaucratic red tape should be avoided.
- The legal system should become more efficient in protecting the interests of foreign investors.
- A greater proportion of production from foreign firms should be allowed to enter the domestic market which would serve as an additional incentive for foreign investors.

China reacted, in the main, to these instructions, and this enhanced the role of SEZs in the process of economic modernization. Russian decision-makers should accordingly define the purpose of the TI-SEZs, respond to the needs of business and ensure the wide economic impact of the activities undertaken in the TI-SEZs. This is the only way in which the TI-SEZs may have a significant role to play in modernizing Russia.

"Go, Russia!" – keeping in mind that building a new reality (modern Russia) requires a comprehensive and profound reform, since, so far, partial reforms in the country have had a tendency to cause only leadership changes.

Executive summary

(1) Special Economic Zones (SEZs) in Russia are not special enough to result in a major foreign direct investment (FDI) inflow to Russia, which is a prerequisite for economic modernization. The SEZs should either offer more benefits to foreign investors or be abolished. No matter which alternative is chosen, the

major policy measures should be directed to improving the immaterial property rights and functioning of the legal system, that is, the improvement of the general investment climate.

(2) The overwhelming concentration on high-tech innovations is a risky innovation policy, since the development costs and possibility of failure is higher than that of low- and medium-tech innovations. Moreover, low- and medium-tech innovations' spillover effects often occur faster than that of high-tech. Therefore, Russia's innovation policy should not only build on high-technology but on the products and services in which the wide population of Russian companies have existing advantages.

(3) Russia's innovation policy is too heavily concentrated on technological advancement. The commercialization of innovations is what matters in the end.

(4) Some 60 percent of the Russian GDP is formed by services, and therefore, service-oriented innovations would create a major economic impact. Currently, service-oriented innovations have been neglected in Russian innovation policy and SEZs.

(5) Without the participation of the world's leading innovation companies, Russia's innovation reform will remain a political exercise. The Skoda case shows that international brand cooperation creates consumer confidence and success stories. Without international brand cooperation, it will take decades before "Made in Russia" stands for high quality. Without foreign participation, Russian natural resources will run out before innovation reform brings tangible changes to the Russian GDP.

(6) Should the Russian innovation reform lean on the military-industrial complex, the participation of leading foreign companies in Russia's innovation reform will remain modest and Western countries will implicitly restrict the inflow of Western high-technolgy to Russia, that is, the era of the neo-CoCom policy will commence.

(7) The innovation activity of the state-run corporations (Rosnano and Russian Technologies) and major private corporations is a necessary but not a sufficient condition to cause major reform in Russia. Therefore, the mobilization of the private sectors' R&D expenditure, particularly among small- and medium-sized enterprises (SMEs), is key to modernizing Russia's natural resource-based economy. In this context, one should bear in mind that companies are not interested in economic modernization but in achieving their own goals. Currently, the private sector (including major

private corporations) accounts for less than 25 percent of the R&D expenditure in Russia.

(8) The innovations have a zero impact on economic modernization in Russia without their wide usage. Therefore, the usage of the available solutions (for instance, a wider usage of computers and the Internet) should be considered as a first step in the modernization and convergence process.

(9) Modernization should not be considered as a government program but as a constant activity in everyday life. The literature clearly reveals that a major change occurs only when there is a real need to change. A chance to change leads only to a modification of existing patterns, that is, free and fair competition is the only democratic way to force the companies to constantly improve their practices. Common wisdom says that without competition there cannot be competitiveness. Therefore, Russia should abolish the obstacles to free competition, including the privileges of oligarchs.

(10) Russia's bureaucracy causes enormous inertia, and Russia's novel ideas at the top of society do not materialize at regional level without breaking the passive change to resistance of the regional administration. The training of regional elites and the nomination of the new change forces is the only way to transform reform at the federal level to reach regional levels. Without corruption-free regional elites, any current reform is doomed to be a superficial politico-administrative exercise.

(11) The implementation of the reform takes decades, and therefore Russia has to dedicate herself for a very long and to some extent to a painful process. One should bear in mind that one cannot implement a major reform without changing anything.

(12) Russia's innovation reform can be compared to car racing. Rosnano, Russian Technologies and innovation-financing institutions are fuel for the car engine, which is formed mainly by the Russian SMEs and large corporations. The research institutions and academia provide the headlights to see a bit further ahead. The political leadership forming the driving team (the driver and the navigator) should have a consensus on the direction they want to steer their vehicle. The driving team can avoid the road blocks ahead created by bureaucracy only by studying the route in advance. However, the driving tandem cannot influence the speed of the competing teams. Unlawful measures result in disqualification and loss of permission to participate in the global race. The Russian population monitors the developments from the back seat,

and possibly changes the driving tandem, if they do not show acceptable results rapidly enough. Even if the future of Russia's modernization is anything but certain, one cannot win without participating in the race. Fortunately, President Medvedev's team has realized this, which gives Russia a chance to succeed.

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The authors acknowledge that this is not the first time that Russia has introduced special economic zones. For instance, Ivan IV of Russia established a special zone for the English in 1555 in the region which is nowadays known as Archangelsk.

Notes

1. In the beginning of the 1980s, the role of SEZs was important as a target for foreign direct investments (FDI) attracting 60 percent of all FDI inflows to China. Later on, FDI flows were directed mostly elsewhere. It was evident that the foreign investors were not only interested in export-processing but they were attracted by the Chinese market (Wong, 1987).

   According to the UNCTAD report in 2009, Russia attracted USD 80 billion in foreign investments in 2008. This is 4 percent of global FDI flows. When China launched the SEZs in the 1980s, the FDI flows to China were at a marginal level – around USD 1 billion. Although the times were different in terms of competition, Chinese SEZs had to compete with other developing regions in Asia (Wong, 1987). However, China benefited from rising labor costs in its neighboring countries, which shifted labor-intensive production to China (Knoth, 2000).

   Moreover, competition was not as strong back then as it is now with almost the whole world open to foreign investors. In addition, Russia's potential is not as tempting as that of China. Many ethnic Chinese residing overseas were willing to invest in China, and most of the FDI flows originated from Hong Kong. With a common language and culture, and family ties it was easy for them to operate in a country without a clear legal framework (Knoth, 2000). Investors were practically waiting at the doorstep to invest in the country, and therefore investment opportunities or SEZss did not need to be promoted as such.

   According to our understanding, Russian emigrant investors are not sharing the same expectations, as they have had the opportunities to invest in Russia for many years. The cultural differences between China and Russia also include the savings rate and investment rate, which have traditionally been higher in China. Due to statistical problems, it is however difficult to compare China in 1980 with Russia in 2010 in these terms.

2. According to the latest surveys, the Russian people have lost their interest in entrepreneurship (Kaartemo, 2009). It has also been found that compared to Russian entrepreneurs the Chinese are more risk-takers (Djankov *et al.*, 2006).
3. The International Labour Organization (ILO) (2010) statistics indicate that the hourly labor cost in manufacturing was around 3 euros in Russia in 2007. This is minimal compared to the labor costs in the European Union and the United States. On the other hand, it may be difficult to compete in labor costs with countries like India and China. Therefore, we see that benefits related to labor costs have, at best, only marginal impact in attracting foreign companies to invest in TI-SEZs. Although tax incentives may provide more attractive benefits to companies, it is unclear whether they may be used for attracting purposeful companies to invest in TI-SEZs. In the best case scenario, major tax breaks bring leading foreign companies to Russia. In the worst case, the tax holidays only repeat the mistake of the 1990s in attracting tax evasion and other criminal activities.
4. "What we need is breakthrough technology" (President Medvedev in Medetsky, 2009).
5. This was found in our survey which was sent to companies located in technology and business parks in Finland in 2009. Top managers from 159 companies responded to the survey indicating that most of them did not know that there are TI-SEZs in Russia. Other findings of the survey are available in Kaartemo *et al.* (2009).
6. In this sense, the allocation of R&D funding to the military-industrial complex further diminishes the possibilities for a wider impact on economic modernization, as commercial success stories and spillover effects may be challenging to find in a closed military innovation system.
7. "The public sector share in the economy has never gone below 40 percent, and during the crisis the state has seen its role increasing of course" (President Medvedev in State of the Nation Address, 2009). "Russia should reduce state and regional authorities' ownership of business to 30 percent or less, from about 50 percent now" (Deputy Prime Minister Kudrin in Gilman, 2009).
8. Chubais has realized that transition typically takes some 20–25 years. "We are moving on to a new stage that is based on innovation development . . . The new stage will take 20–25 years . . . If we do not begin the transition now, we will fall behind developed countries forever" (Anatoly Chubais, Head of Rosnano, 23 January 2010). The Chinese culture and united political system have made it possible to wait for decades to see the implementation of the SEZs to end up with positive spillover effects on the modernization process. Similar patience is now needed from the Russians.

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8
The Changing Russian Economy
Export Channel Strategies of Japanese Companies

Eiko Tomiyama

Introduction

A great number of transition economies around the world are interesting from the perspective of future trade opportunities. Japan is highly dependent on international trade due to its limited resources. This has led to a high level of concentration of multinational companies in relation to the size of the country. Exporting to emerging markets is common practice for a number of Japanese manufacturers. An emerging market is defined as a market that satisfies the following conditions: a rapid pace of economic development, implementation of government policies favoring economic liberalization and adoption of a free-market system (Arnold and Quelch, 1998). The principal impediments in emerging markets appear to be environmental uncertainties and the lack of strong legal frameworks, which have given rise to a significant increase in opportunism and rent-shifting. Emerging markets include transition economies such as Russia and the newly democratized post-communist nations such as China as well as many developing countries (Johansson, 2000).

Russia is a transition economy that was a part of the former Soviet Union. The country is a particularly interesting market for Japanese companies, due to its proximity, size, abundant natural resources and accelerating economic growth. Additionally, the Russian state is becoming more stable both politically and economically. Russia's GDP demonstrated significant economic growth in the period 2000–2009, increasing 5.2 percent on average. Against the background of the stabilization of the political and economic situation under Putin presidency and the shift of the Russian economy towards the adoption of market principles employment rose and personal income improved leading to amplified individual consumption, with a consumption boom taking place particularly in large cities such as Moscow and Saint Petersburg (Volkov, 2004).

At the same time, foreign direct investment (FDI) in Russia has been relatively low considering the size and potential of the economy. According to the United Nations Conference on Trade and Development's (UNCTAD) *World Investment Report 2003*, cumulative FDI in Russia was US$2.26 trillion as of the end of 2002, accounting for just 0.3 percent of total FDI across the globe ($712.24 trillion). Furthermore, according to Goskomstat (State Committee of the Russian Federation on Statistics), FDI in Russia in 2002 was US$26.23 billion, of which Japan accounted for just 5 percent (US$1.35 billion). Thus, it cannot be said that Japanese firms are actively investing in Russia.

However, Japanese firms are actively upgrading their export strategy vis-à-vis Russia (Marinov et al., 2004). Japanese exports to Russia experienced more than 15-fold growths from US$481 million in 1999, reaching US$7326 million in 2009. Despite the threat of worldwide volatility, the remarkable economic growth that has been taking place in Russia lately provides Japanese firms with a sizeable incentive to expand activities in the Russian market. The choice of entry mode depends on the risk a firm is prepared to take and the desired degree of control of international operations (Hill *et al.*, 1990).

The purpose of this chapter is to analyse how Japanese firms changed their modes of market entry, opting for indirect exports or direct exports (via independent intermediaries or via sales subsidiaries). These modes of entry have been selected for the present study due to their frequent use by Japanese exporters in the Russian market. This chapter aims at providing a deeper understanding of the changing entry strategies and modes of market entry used by Japanese firms when entering the Russian market.

The scope of this chapter is limited to studying Japanese firms entering the Russian market, with Russia being chosen as the operating context because the country is one of the largest transition economies in the world. The research outlined in this chapter intends to clarify the following issues:

– To analyse the mode of entry into the Russian market adopted by Japanese firms when they started exporting their products to Russia.
– To investigate how the mode of entry into the Russian market adopted by Japanese firms change during the market penetration stage.

– To study the dynamics in the change of Japanese firms' modes of entry into the Russian market.

Literature review

Due to the economic insecurities in emerging markets that arise from transition-related volatility, many Western firms favor a more traditional approach to these markets, starting with exports and imports (Springer, 1995: 81–82). These strategies are distinguished by the degree of investment and the risk-investment potential.

Most firms conduct their initial internationalization through exporting. Exporting is the simplest way of entering overseas markets, since the level of commitment and risk is minimal whereas the level of investment is low. Exports are divided into indirect and direct exports. Indirect exports involve the use of home country agencies (trading companies) to introduce the product to the foreign market. Direct exports involve the firm itself contacting the overseas buyers, be they independent agents and distributors or the firm's own subsidiaries (Johansson, 2000: 126–127).

Indirect export

The simplest way to manage a firm's export business is to employ external specialists. The advantage of indirect exports is that the firm avoids the overhead costs and administrative burden involved in managing its own export affairs. The disadvantage is that the skills and know-how developed through experiences abroad are accumulated outside the firm, not within it (Johansson, 2000: 134).

Direct export

Direct export has an advantage over indirect exports in terms of the control over operations that it affords to the producer. With direct exports, the firm has a more direct influence over marketing efforts in the foreign market. The firm also learns how to operate abroad. Without involvement in the day-to-day operation of overseas business, the firm will not generate much in-house knowledge (Johansson, 2000: 134–135).

Sales subsidiaries versus independent intermediaries

Firms opting for direct export have to choose between establishing a sales subsidiary and employing independent intermediaries. The latter option involves employing an agent who manages sales and administration and is paid through fees and commissions, and a local distributor who supplies the product to the market and adds a mark-up to the cost. Investing in a wholly owned sales subsidiary is a bigger commitment and requires more resources than the use of independent agents. Where the potential market is large, the firm would generally be better off with more central control of operations, including marketing activities (Johansson, 2000: 135).

Exporting via sales subsidiaries gives the exporter hierarchical control of the whole export operation, including marketing activities. The exporter will therefore normally invest more of its capabilities, both financially and in terms of human resources, in carrying out these operations than in independent export channels. This is thought to lead to a more intensive communication process and higher levels of asset specificity in the relations between the channel intermediary and the exporter, raising the stakes of the latter. Commitment is regarded as a kind of investment. Since the investment, in terms of financial outlays, organizational adaptation and managerial commitment, is generally higher in the case of the sales subsidiary, the exporter is more committed to an integrated channel member than to a non-integrated one. Hierarchical control gives the exporter greater marketing control in sales subsidiary relations than in agency relations (Solberg and Nes, 2002).

Hierarchical control gives rise to a vertical marketing system. This is an organized, structured and unified distribution channel system in which the producer and intermediaries (wholesalers and retailers) work closely together to facilitate the smooth flow of goods and services from producer to end-user. When the export market grows rapidly, exporters shift to a hierarchical structure in order to reduce costs and gain control over their channels (Li, 2002).

Internalization/transaction cost analysis

Decisions on modes of entering foreign markets have been studied by numerous researchers. In particular, since Buckley and Casson's (1976) introduction of the internalization argument based on transaction cost theory, a number of papers have discussed whether or not foreign operations should be integrated (Anderson and Gatignon, 1986; Madhok, 1997). The discussion has largely focused on integrated versus independent foreign business operations. Transaction cost analysis (TCA) predicts that, under the circumstances of high asset specificity and high uncertainty, the exporter will seek to internalize the transaction with the local channel member in order to reduce transaction costs connected to curbing opportunism. Buckley *et al.* (1990) have widened the application of internalization theory to the non-production functions of stocktaking, distribution, generating customers and transport; in this way the work is brought closer to that of channel researchers, who have applied TCA to explain the choice between the internalization of marketing and distribution functions and the employment of external agents and intermediaries (Wheeler *et al.*, 1996). Although TCA has been widely accepted as being powerful in explaining entry modes, it is limited in that it considers only the minimization of costs and not the creation of value (Madhok, 1997).

The issue of investing in their own sales subsidiary, rather than contracting an independent channel intermediary, is critical for many exporters. The resources needed to undertake such investments often exceed internal capabilities. In accordance with the findings of researchers focusing on incremental internationalization (for example, Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; Johanson and Valhne, 1990), consider integrating the next channel member as involving a larger part of the organization and calling for greater management capabilities than is the case with independent modes of entry. In a step-by-step approach the firm first goes through an independent intermediary and then carries out investment by itself at a later stage. This has been demonstrated in a number of cases, even though other arguments (for instance, the need for control) would speak in favor of an integrated model (see Solberg and Nes, 2002).

According to the internalization/TCA model, the foreign manufacturer would move from distributors to sales subsidiaries when it is more economical to internalize transactions. Reasons include the desire to obtain economies of scale, to achieve control through ownership of the channel and to protect knowledge-intensive assets including technology, servicing know-how and transaction-specific knowledge in the sales force. Internalization is possible where the technology is relatively new or specialized and has wide applicability, as well as where the market is large enough to support scale economies and competition is either limited or oligopolistic.

The internationalization model

According to the gradual internationalization process proposed by the Uppsala School (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977), it develops in four stages according to an established chain: no regular export activities; exports via agents; exports via a sales subsidiary; and production via foreign subsidiaries. Existing studies of the internationalization process of firms suggest that they proceed, consistently and gradually, to develop their international activities. This incremental movement through various stages of learning and commitment has undergone substantial scrutiny (see, for example, Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; Cavusgil, 1980; Juul and Walters, 1987; Erramilli and Rao, 1990; Sullivan and Bauerschmidt, 1990). According to this behaviour-based model, the firm would make additional incremental resource commitments as it gained experience from current activities. Comparing the internalization/transaction cost with the internationalization model, there is a fundamental difference between the assumption of rational decision making in the former and the behavioral responses to uncertainty avoidance in the latter.

The critical factors in the internationalization model are lack of knowledge of the foreign market and absence of established relationships with customers and other parties. It is argued that, unless these constraints are included in an assessment of internalization costs and benefits, the internalization/transaction cost paradigm cannot explain the shifts in mode which are demonstrated by the internationalization model. Even if transaction costs are high in the early stages of internationalization, as they might be for technologically complex products, the firm might be unwilling to move beyond agency arrangements because of its lack of knowledge of the market and network relationships (Wheeler *et al.*, 1996).

Newly established firms tend to internationalize rapidly which has led to the development of the new venture internationalization (NVI) theory (Oviatt and McDougall, 1994). These authors provide a framework that explains the phenomenon of rapid internationalization by integrating international business, entrepreneurship and strategic management theory. The new ventures can use hybrid structures such as licensing, franchising or networking as an alternative to internal control and market control over the exchange of resources. They can also use the network structure as a more powerful resource-sharing alternative to internalization that depends upon informal control through trust and moral obligation rather than formal contracts.

The Uppsala model and NVI theory both argue that early internationalization initiates a learning process that enables early accumulation of experiential knowledge in the firm. This process shapes the structures and routines, which support further internationalization.

This chapter focuses on the Uppsala model as it can be applicable to a wide range of firms and foreign activities and is not only focused on exporting by newly established firms. The Uppsala model is also known as the process theory of internationalization (PTI) or the stages model.

Are Japanese firms currently acting in accordance with the internationalization model? Do they vary from it? How do their actions differ? Firstly, if the country whose market is to be entered is stable and demand is anticipated to be strong, companies establish a sales subsidiary at the outset. Secondly, at present Japanese firms build factories in optimal locations around the world; consequently, they do not necessarily establish a local manufacturing subsidiary after establishing a local sales subsidiary. Thirdly, in countries where demand is low, they do not necessarily establish a sales subsidiary, and sales subsidiaries in nearby countries sometimes export goods to the country in question.

Does the internationalization model hold true in the case of the Russian market? There are cases in which it does not. Russia is a vast market and existing demand varies. The fact is that Japanese firms wish to establish sales subsidiaries within Russia. However, due to Russia's "gray" customs system and the impossibility of predicting when Russia's domestic laws will change, they have avoided investing in Russia and establishing sales subsidiaries there. Thus Japanese firm behavior in the Russian market is not in accordance with the internationalization model.

Problems facing companies entering transition countries

When a firm enters international markets there are dissimilarities in the economic, political, legal and cultural environments that act as incentives for, as well as obstacles to, successful expansion. These challenges are especially large in transition economies, like Russia (Johansson, 2000).

First of all, in several transition economies there are problems with economic, political and legal factors such as high interest rates, the rate of exchange, high inflation, an unstable government, excessive bureaucratic power and poor banking and court systems (Bartley and Minor, 1994; Anderson, 1995). Policies initiated have failed to take into consideration a number of constraints which are due to the communist legacy: a highly concentrated and outmoded industrial structure, a lack of adequate financial infrastructure and a sound banking system, not to mention the absence of a functional legal code (Geib and Pfaff, 1999). There are contradictory laws, and a number of laws do not function at all in practice. The unpredictable political and economic environment in which business was conducted in Russia in the 1990s accounted for great uncertainty concerning what constitutes ethical business practice (Groth and Roberts, 2001). Corruption, taking such forms as bribery and extortion, was and to an extent still is common in Russia (Anderson, 1995).

Corruption

Corruption is a serious problem for economies in transition. It retards the development of institutions conducive to economic growth. In this sense, it introduces inertia into transition dynamics. Generally, corruption is a deep-rooted socio-economic problem in developing economies everywhere in the world (Goorha, 2000). As Barnes *et al.* (1997) argue, Russians know that making use of *blat* (Russian word for profitable connections) is wrong, but due to the socio-political climate of the communist system, it continues in the chaos of Russia's emerging capitalist economy. Making use of *blat* has been really pervasive within Russian society as a whole that it could also be considered a norm of the business community, and thus ethical. *Blat* has long been a well-defined norm and accepted as almost inevitable, given the lack of freedom and opportunity under oppressive political regimes (Puffer, 1999). Kuznetsova and Kuznetsov (1999) also argued that there has been no tradition of the law being applied equally and universally. Personal contacts and networking remain a significant factor in determining business success or failure and in engendering corruption in Russia (Kuznetsova and Kuznetsov, 1999: 66).

A particular problem is the fact that Russian customs officers do not treat foreign and Russian firms in the same way during the customs clearance of household electrical appliances. Russian firms bribe the customs officers so that they are charged a lower rate of duty. Radaev, a notable Russian socio-economist, has pointed out that all Russian politicians are involved in this situation and that the problem has not been resolved at all (Radaev, 2002, 2003). Russia's Customs Act was revised in January 2004 and imported cars are now clearing customs in accordance with the official regulations. However, the situation with regard to household electrical appliances remained problematic, and it was the only field in which improvements were yet to be seen.

Taxation and bureaucracy

Tax legislation is contradictory and full of loopholes, and many tax collectors work beyond the law in Russia. Russia has about 200 different levies, most of which hardly reap any revenue but create red tape for businesses. The taxman collects as much as they dare, taking a lot from small enterprises without political connections and little from big, powerful firms. Although there has been an urgent need for root and branch tax reform for years, it has been blocked by influential business people who now pay little or no taxes. An ordinary Russian firm is inspected almost daily by one of the 67 different government agencies engaged in business supervision. These agencies' real interest lies in extorting bribes (Åslund, 1999).

Research method

This study employs a qualitative, longitudinal methodology. Qualitative and longitudinal research offers important benefits. The study used a multiple case comparison design. Comparison of multiple cases provides a variety of viewpoints to check for consistency and agreement, and thus helps to overcome the problem of the absence of reliable strict quantitative data (Ragin, 1987). It should be noted that the generalization of multiple case comparisons is based on an analytical rationale rather than a statistical one. When we discover certain logic and confirm that such logic works in both different and similar contexts, we have reason to believe that the logic is applicable to a wider population (Yin, 1994).

This study uses the Russian market as the research field examining the strategies of 11 Japanese manufacturers in the Russian market. The Russian market has been used as the research setting because the market is one of the most important emerging markets in the world characterized by high contextual velocity. This velocity resulted from inconsistent government policies, uncertain market demand and poorly regulated competition, an overall weak regulatory regime and underdeveloped factor markets. The high contextual velocity in Russia is typical of all emerging markets. A total of 11 cases were examined, with three data sources being used: semi-structured interviews with managers handling the Russian business affairs of Japanese manufacturers, website questionnaires and various secondary sources.

Data analysis has been conducted as follows. In the first stage, within-case data have been analysed. In each individual case a chronology has been developed, focusing on how the exporter initiated and expanded its exports into Russia. Each case has been divided into two stages. The first stage is the market entry stage when the manufacturer's products were introduced to the market. The second stage is the market penetration stage when the manufacturer had operated in the market for about three–five years and had developed a reasonable degree of knowledge about the market. Then the channel structure has been analysed in order to determine whether or not changes took place throughout the two stages observed and the causes of these changes or the reasons for the lack thereof have been identified. In the second stage, cross-case patterns have been developed. Similarities and differences between cases in terms of channel structure patterns have been listed and cases have been categorized into groups based on their similarities and differences.

Results

Four different export channel strategy patterns have emerged from the 11 cases and have been accordingly classified into four groups (Table 8.1).

Similarities and differences between the cases in terms of export channel structure patterns have been listed, with cases being categorized into groups based on these categories. Following the analysis of 11 major Japanese firms, their export marketing channel strategies for the Russian market have been typified as follows.

Pattern A: Use of a local distribution agent in the target country→Use of a local distribution agent: Mitsubishi Heavy Industries and Daikin Industries

Both Mitsubishi Heavy Industries and Daikin Industries use local distribution agents in Russia as a target country for their exports. In this group, manufacturers entered the market by exporting through various agents then continued to use agents at the market penetration stage. With this form of distribution, the firm does not have to invest in fixed capital and can just pay commission to traders who have a local sales network, so exports via a local distribution agent are particularly important for companies that have only just entered a foreign market. The advantage of using a local distribution agent is that the sales network of the local partner can be used.

Pattern B: Use of a trading company (indirect exports)→Establishment of a wholly owned sales subsidiary: Yokogawa Electric, Amada, Honda, Olympus and Komatsu

Unlike representative offices or overseas branches of companies, the local corporations that Yokogawa Electric, Amada, Honda, Olympus and Komatsu established in Russia are incorporated in that country, so they can carry out all necessary activities. Their establishment of sales subsidiaries in Russia can be viewed as the construction of a company-wide vertical marketing system. This is because the head office's wishes can be

Table 8.1 Case study findings

Company	Products in Russian market and their growth	Market entry stage	Market penetration stage
Case 1 Honda Motor Co., Ltd.	Cars and motorcycles Rapid growth in the Russian car market in the future.	Representative office established in Moscow in 1992, with cars being exported to Russia from Japan and the USA via ten Russian designated agents.	Honda established sales subsidiary Honda Motor RUS LLC in 2004, with firm's designated agents becoming authorized dealers. The subsidiary imports automobiles into Russia directly.
Case 2 Amada Co., Ltd.	Machine tools Amada constantly increases its sales to Russia.	Initially Amada's German-based subsidiary Amada GmbH undertook direct sales to Russia. In some areas of Russia, Amada used trading companies as agents to conduct sales, making sales operations more efficient.	The Russian subsidiary of Amada was established in Moscow in 2003 with 100% equity participation by the German subsidiary Amada GmbH. Exports to Russia are manufactured by Amada's French production facilities.
Case 3 Mitsubishi Heavy Industries, Ltd.	Compressors, printing machinery, injection molding machines, machine tools, air conditioners Russia is a key strategic market. The firm has increased sales tenfold in five years.	Representative office established in Moscow. Agents allocated to specific products, such as forklift trucks, generators and machine tools, with products being sold to Russia via these agents.	Mitsubishi Heavy Industries plans to increase the number of agents for machine tools and air conditioners, in order to stimulate demand and serve the market better.
Case 4 Fanuc Ltd.	Robots, factory automation products, injection molding machines, computer numerical control (CNC) technologies	Indirect exports via Mitsui Trading Co. to ex-USSR.	The sales subsidiary, Fanuc Mitsui Automation CIS LLC, was jointly established by Fanuc and Mitsui & Co., Ltd in 2003. This joint

Table 8.1 (Continued)

Company	Products in Russian market and their growth	Market entry stage	Market penetration stage
	The firm focuses on sales of CNC devices and robots.		venture sells and services Fanuc products in the CIS, including Russia. This sales subsidiary imports CNC devices and systems to Russia directly.
Case 5 Yokogawa Electric Corporation	Plant regulation and control systems, industrial instruments, measuring instruments The Russian industry needs innovation, hence demand for purchasing of new technology.	Yokogawa Electric set up a representative office in Moscow, with all export business being conducted via Japanese trading companies engaging in indirect exporting.	The Russian sales subsidiary of Yokogawa Electric was established in 1997, conducting direct imports. The firm also uses ten Russian agents for serving clients far away from Moscow.
Case 6 Komatsu Ltd.	Construction machinery The Russian market is a major focus of attention for Komatsu with main attention on enhancing sales of large-scale equipment and expanding into the provincial areas of Russia.	Sales through Komatsu's representative office in Russia conducted via trading companies.	The Moscow branch of Komatsu CIS was established in 2003. It conducts business via trading companies, which generally handle bulk orders by governments of CIS countries, formerly state-owned businesses and very large companies. The branch of Komatsu CIS also handles the sales and marketing of smaller products aimed at the ordinary consumer market in big Russian cities.

Case 7 Matsushita Electric Industrial Co., Ltd.	Electronic components, consumer electronic goods, home appliances, factory automation equipment, information and communications equipment, household products Russia is one of Matsushita's most important markets around the globe. In 2004, the firm established a market research company in Moscow, resulting in threefold growth of sales in just two years.	Matsushita Electric Industrial's Moscow representative office was established in 1986, with exports to Russia being conducted via trading companies.	In 1997, Matsushita Electric Industrial established sales subsidiary Panasonic CIS Ltd in Finland to sell Panasonic products to the CIS countries. Matsushita strives to establish a Russian sales subsidiary in order to enable it to fine-tune its sales activities. However gray market trade still represents a serious problem.
Case 8 Canon Inc.	Photocopiers, computer peripherals, business systems, cameras, optical products For Canon, Russia is a vast market with very good growth prospects for the future.	In 1975, Canon began exporting its products to the then Soviet Union via trading companies.	In 1995, Canon set up a Moscow branch of its Finnish sales subsidiary, and began direct exports to the former USSR. Later Canon organized its own network of dealers in Russia. Sony considered the Russian environment as risky because of the unpredictability of the legal system. Moreover, if a Moscow-based Canon subsidiary were to import Canon products directly to Russia, without using local distributors, it would be unable to compete with Canon's products imported by independent local distributors.

Table 8.1 (Continued)

Company	Products in Russian market and their growth	Market entry stage	Market penetration stage
Case 9 Ricoh	Photocopiers Russia is one of Ricoh's major markets. Although it experienced some problems, Ricoh was generally positive about its sales prospects when it first entered the Russian market.	Ricoh entered the former Soviet Union in 1984, conducting indirect exports via Sumitomo Shoji Ltd. From 1989, Ricoh began exporting through Mitsui Bussan Ltd, continuing to do business with public corporations of the ex-USSR through Mitsui until 1992. Subsequently, due to the collapse of the state monopoly on foreign trade, Ricoh began to export to the Russian market through Mitsui Bussan Ltd, via a Russian distributor.	In collaboration with Mitsui Bussan Ltd, in 1997 Ricoh established its sales subsidiary Mitsui-Ricoh CIS Ltd. It conducts imports via a Russian distributor, because such distributors bribe customs officers to cut customs duties. However, Ricoh knows that this "special relationship" will not last forever as the legal environment is changing and as the "gray" customs clearance system will be abolished then the sales subsidiary will continue to build its marketing channels.
Case 10 Olympus Corporation	Endoscopes Russia is one of Olympus's major markets.	Olympus formerly exported endoscopes to the ex-USSR via Russian foreign trade companies. In 1992 it established a joint venture with a Russian company for selling endoscopes in the Russian market.	Olympus established its sales subsidiary Olympus Moscow LLC in 1993. It deals with the passage of products through official customs channels. The products are then sold at a fixed price to end-users via Russian agents.
Case 11 Daikin Industries, Ltd.	Air conditioners Russia is a key market for Daikin.	A Russian team was established within Daikin Europe N.V. Daikin has many agents in Russia conducting sales and sales promotion activities.	Daikin sell to Russia via agents, but the firm considers establishing a representative office via a joint venture formation. Daikin Europe N.V. exports to Russia products manufactured by Daikin Thailand via Russian agents importing them through Daikin Europe N.V.

reflected in the local corporation directly and rapidly, and be developed into full-scale marketing activities. With regard to the Russian marketing channel policies of Yokogawa Electric, Amada, Olympus, Komatsu and Honda, in addition to direct channels selling goods to the end-user, they also use distribution agents. This is because they are developing the market using multiple marketing channels in order to reduce transaction costs arising from specific characteristics of the commodity or region.

In this group, manufacturers started exporting via a trading company (indirect exporting). At the market penetration stage, the manufacturers set up their own sales subsidiaries in Russia and began to conduct exports through these. However, in parallel with this approach, they also continue to export via agents. This tends to be the case where distribution in the Russian market takes place through home country agencies (trading companies) or agents in the first instance, and is followed at some stage with the establishment of a sales subsidiary. Relating this progression to theoretical models, the progression from agent/distributor to sales subsidiary is a classic situation, which may be explained by the establishment of a chain approach to internationalization. The development of experiential knowledge of the country market and the willingness to increase commitment to the market encourage the formation of a subsidiary. Motives include a desire to increase market share, to move closer to the customer and to increase control of the channel.

Motives for establishing a subsidiary include gaining access to the "knowledge-intensive assets" held by the agent to facilitate the establishment of an integrated and cost-efficient distribution channel and to implement the parent company's desired marketing strategy (Marinova et al., 2004). Where the costs of running the subsidiary (ownership assets) outweigh the benefits of channel efficiency, ownership may be divested. For a period of time, the benefits of having had a subsidiary will remain due to support provided to the agent/distributor by the former parent. Through the relationships development, therefore, subsidiary influence will persist, an example of the strength of weak ties (Granovetter, 1973), transaction costs will remain low, an example of small numbers bargaining (Williamson, 1975), and the risks and costs of ownership are eliminated.

Pattern C: Use of a trading company (indirect exports)→Establishment of a sales subsidiary as a joint venture with a trading company: Fanuc and Ricoh

Fanuc and Ricoh conducted their exports to Russia via a trading company (Tomiyama et al., 2002) at the market entry stage (indirect exporting). They then established sales subsidiaries as joint ventures with Japanese trading companies at the market penetration stage. By making use of the human resources and networks that trading companies have built up in the Commonwealth of Independent States (CIS) countries over many years, manufacturers can save time and money on investment in gathering information about local markets, forming local sales networks and investing in sales activities. What is more, given the differences in language, customer needs, distribution systems, trade practices and the competition situation in Russia, the investment of a great deal of time and resources is required in order to cultivate specialist human resources with know-how about local sales and the ability to gather information about foreign markets, and to build a local sales network. The trading companies' resources are complementary resources for Fanuc and Ricoh. Furthermore, the establishment of a local corporation in the form of a joint venture enabled the risk to be diversified.

Pattern D: Use of a trading company (indirect exports)→Establishment of an offshore sales subsidiary: Matsushita Electric Industrial and Canon

Both Matsushita Electric Industrial and Canon have established sales subsidiaries in Finland, while also setting up representative offices of those subsidiaries in Moscow. It is possible for local corporations to conduct sales activities in Russia, but Russian laws governing the operations of such corporations are more onerous than those governing representative offices, including laws and regulations relating to the settlement of accounts, cash transfers and tax payments. Fearing that they would be left open to problems arising from the creation of new systems or the actual implementation of rules by the Russian government, both companies avoided establishing companies incorporated in Russia. Were it not for the existence of an unofficial "gray" customs system, both companies would apparently have established sales subsidiaries in Russia and built a vertical marketing system. Taking into consideration Russia's customs system specifics, the construction of a vertical marketing system through the establishment of an offshore sales subsidiary could be described as a Russian-style marketing channel strategy.

In this group, exports started via trading companies (indirect exporting). At the market penetration stage, the manufacturers appointed certain distributors as their exclusive distributors and dealers and they worked together as partners. The manufacturers set up offshore sales subsidiaries in Finland and representative offices thereof in Moscow, and began to export through local distributors and dealers.

There has been no research into distribution and marketing strategies in markets where bribes are paid to customs officials, resulting in cheaper tariffs for local distributors and dealers. We believe that the difference in behavior towards the "rule of law" is an important factor that should be analysed when looking at entry strategies and marketing. Matsushita and Canon use independent distribution channels (Tomiyama, 2004). Of course, at first, when they entered the Russian market, they were constrained by their unfamiliarity with the market. However, even when they came to know the Russian market, they could not use a direct channel strategy, because distributors, who have connections with Russian customs offices, play an important role in the Russian market. Unless Japanese photocopier manufacturers use local distributors, they will be unable to compete with the products imported by independent local distributors.

Findings and analysis

Market entry stage

In all four groups of Japanese export firms identified, exports to Russia started via independent intermediaries (trading companies or agents). Most of the manufacturers complained that partnerships between manufacturers and local distributors were difficult when both parties did not have much information about each other's reputation, integrity and capabilities at the market entry stage.

Exports via an employed sales force were not an option at this stage, while setting up sales subsidiaries in Russia was costly. Japanese manufacturers did not want to be highly committed to the Russian market at a time when they perceived high demand uncertainties and considerable environmental risks. Without country-specific knowledge and customer contacts, manufacturers were almost entirely unable to promote sales.

The results of various studies have indicated that Japanese manufacturers prefer low investment, low commitment and a low control channel structure when they enter the Russian market. That is, each channel member works in their own interest and members have not been committed to each other at first. Without country-specific knowledge, it is difficult for Japanese manufacturers to believe in the integrity and competence of newly emerged Russian distributors and thus they will not commit to any transaction-specific investments in partnerships. In emerging markets, the market mechanism has not yet been established and legal frameworks are weak. Without the market mechanism and strong legal frameworks, Japanese manufacturers cannot protect their transaction-specific investments in partnerships if they are committed to the wrong partners. Such transaction-specific investments include credit, training, product modification and inventory. It is almost impossible for firms to recover these investments if the partnerships fail.

Similarly, a lack of country-specific knowledge makes the hierarchical channel structure disadvantageous. Without country-specific knowledge, it is difficult for Japanese manufacturers to manage the environmental risks and uncertainties and thus they will not invest heavily in establishing sales subsidiaries at the market entry stage. At this stage, Japanese companies were at the indirect export stage and were unable to engage in direct marketing.

Market penetration stage

At this stage, Japanese manufacturers developed reasonable knowledge about the Russian market. With market knowledge, manufacturers had a better perception of the risks and returns involved and therefore became more confident and aggressive, which manifested in a willingness to commit more resources to their operations. Managing frequent market jolts in emerging markets requires well-developed capabilities. Japanese manufacturers may not have these capabilities, which should be country-specific and cannot be transferred between firms (Eriksson *et al.*, 1997). Manufacturers prefer partnerships when a particular distributor possesses distinctive, better and sustainable capabilities, as the former wish to motivate the latter to be committed to their channels. In emerging markets, the economy develops fast and market jolts are frequent. Opportunism can lead to above-average profits. More importantly, a weak legal infrastructure is barely able to punish opportunism and protect the interests of victims. Information asymmetry between exporting manufacturers and resident distributors facilitates such opportunism. Consequently, manufacturers have to choose reliable distributors as their partners.

Market growth can be defined as the increase of demand. When an economy grows rapidly, market demand increases accordingly. Rapid market growth has a number of important implications for Japanese manufacturers. Firstly, rapid market growth justifies investment in expanding the market. Secondly, it leads to promising profits and opportunities and thus makes channel opportunism possible and attractive.

In other words, rapid market growth necessitates a high degree of channel control in order to suppress opportunism. Thirdly, rapid market growth substantially increases transactions across channels and firms have to ensure the smooth coordination of distribution functions. A high degree of control is necessary for fine coordination and adaptation (Li, 2002).

Conclusions

Most Japanese firms see Russia as an extremely attractive market, in terms of its scale and potential for growth. However, there are many risks in emerging markets. Consequently, they have initially learned about the Russian market and gathered information after entering it by means of methods that do not require the investment of a great deal of resources, such as establishing representative offices, undertaking indirect exports via a trading company or selling products through local distribution agents.

After gaining experience of doing business in Russia and becoming accustomed to operating in such a fast-changing and unpredictable economy, Japanese firms have become increasingly comfortable with their Russian operations and with their economic performance and outlook in the Russian market. As a result, many have deepened their commitment to Russia by supplementing their lower-risk strategies with higher-risk ones, such as direct investment.

As a result of Russia's recent rapid economic growth, Japanese firms' export strategy vis-à-vis Russia has shifted towards the establishment of local subsidiaries, which require the investment of large quantities of resources. This takes the form of capital investment in export channels to Russia. The establishment of sales subsidiaries by Japanese firms can be viewed as the true beginning of direct marketing of exports to Russia. Capital investment in export channels is investment in Russia, involving the export of capital, and is distinct from mere exports of goods. The export marketing being developed here is one form of global marketing.

When Japanese companies establish sales subsidiaries in Russia, they often opt to set up wholly owned subsidiaries or split the equity contribution 50–50 with a trading company. The plus side of the wholly owned subsidiary is that the company can control the business completely. All the profits enter the firm, and it can implement its marketing activities as it wishes. The establishment of the wholly owned subsidiary also sends the signal that it has a strong commitment to the local market. Furthermore, it can control its assets in the region, as well as monitoring major changes in the market and the activities of its competitors. In addition, it can react swiftly to market changes, build customer networks and promote better customer service. On the other hand, the establishment of a sales subsidiary with 50 percent ownership by a trading company can disperse risk and allows the use of the trading company's distribution network and web of personal contacts in Russia. Companies that have little commercial ability, know-how or experience in the Russian market tend to opt for this form of sales subsidiary, as do companies that wish to disperse risk through conducting large-scale projects in collaboration with trading companies.

Japanese firms express an active commitment to the Russian market. Companies have to bear the entire risk themselves with wholly owned subsidiaries, and a great deal of corporate resources are required to build a Russian sales hub without the assistance of a third party, including know-how for operating in the relevant market and experience thereof. Moreover, political risks must also be taken into consideration. There is a risk that could be seen as a threat to the cultural and political sovereignty of the host country. Firms opting for a wholly owned subsidiary are prepared to bear the majority of the aforementioned risks involved in setting it up, undertaking direct export marketing and trying to build a vertical marketing system for the Russian market, because they can control the Russian marketing channel in line with the strategy of the company's head office.

Upon entering emerging markets, the less country-specific knowledge a Japanese manufacturer had, the more likely it was that it preferred exports via trading companies or agents to a hierarchical channel structure. At the market penetration stage, Japanese manufacturers developed a reasonable amount of knowledge about Russia's emerging market. With market knowledge, they had a better perception of the risks and returns involved and therefore became more confident and aggressive, which manifested itself in a willingness to commit more resources. Consequently, the hierarchical channel structure is positively associated with market growth and opportunism. The transaction cost paradigm is valid when markets grow fast and partners are inclined to behave opportunistically.

Comparing the dynamics of these market entry strategies with the internationalization process proposed by the Uppsala School (Johanson and Wiedersheim-Paul, 1975; Vahlne and Nordstrom, 1988; Johanson and Vahlne, 1997), it is clear that there are important differences between the West and Russia. The Uppsala model argues that internationalization is the increasing degree of involvement by firms in foreign markets, with implications for both the size of resource commitment and the acquisition of market information (Ali and Mirza, 1996: 52–53). However if the foreign market is not entirely subject to the rule of law, as is the case in Russia, a company may establish an offshore sales subsidiary or set up a sales subsidiary in partnership with a trading company, which has more experience in the market even if the market is a sizeable one.

Implications and recommendations

Managerial implications

What do Russia's healthy economy and the upgrading of its legal system signify for Japanese companies? For Japanese companies, this means that Russia has become one of the most attractive emerging markets together with China and India. With Russia about to join the World Trade organization (WTO), Japanese firms should establish sales hubs in Russia and be proactive in building marketing channels. What, specifically, should they do? For exporters into emerging markets, the selection of the export channel structure is based on a number of factors, including their experience of and competence in managing market shifts, intermediaries' competences, market conditions and their respective strategies in the markets. When Japanese exporters first enter the emerging market of Russia, export via trading companies or agents is a better option than the hierarchical structure. At this stage exporters do not have much information about the Russian market structure and context. Heavy investment associated with the hierarchical structure can be risky in an emerging market, especially when the exporters do not possess the skills to manage the frequent market jolts. At the market entry stage exporters do not have much information about intermediaries' competences and reputation. Commitments to wrong partners can lead to loss of resources, as, in most cases, it is difficult to recover any investment in a partnership if the partnership is terminated after only a short period of time. Consequently, it is better for inexperienced exporters to use trading companies or agents when they first enter an emerging market.

If the market is growing rapidly, exporting through intermediaries can be costly, as exporters have to share profits with their local intermediaries. More importantly, channel control becomes an important issue when the export market grows rapidly and becomes an important market for the exporter. Swift sales increases can make channel monitoring difficult and thus encourage opportunism by local intermediaries.

Therefore, if the export market grows rapidly, it is better for exporters to shift to a hierarchical structure in order to reduce costs and gain control over their channels.

In emerging markets where the market mechanism is not established and legal frameworks are weak, uncertainties and opportunism may prevail. Consequently, exporters should opt for a hierarchical channel structure in their quest to manage uncertainties and suppress opportunism, as employers can impose decisions on their employees and punish opportunistic behavior (Anderson and Coughlan, 1987).

Implications for policy makers

Russia's advancing economy has led to increasing interest in the Russian market on the part of Japanese firms. They are actively establishing sales hubs in order to conduct marketing in the Russian market and some, such as Toyota Motor Corporation and Matsushita Electric Industrial Co., are planning to invest in production in Russia.

Significant improvements have been made to Russia's legal system under the presidencies of Putin and Medvedev. Laws and government ordinances such as the Foreign Investment Law, taxation laws and the Customs Law have been formulated and amended. However, there is a lack of consistency and transparency in the enforcement and operation of these laws. For foreign companies entering the Russian market, this problem is the greatest cause of concern. Russia's laws and statutes must be adapted to the WTO's rules and regulations. Furthermore, unfair treatment, such as the practice of giving preferential treatment to Russian firms and collecting normal customs duties from foreign companies alone, must be abolished. If this were done, along with Russia's accession to the WTO, investment in Russia by foreign companies, such as Japanese companies, would increase further.

Limitations of the study

This study focuses on the approaches used by Japanese firms entering the Russian market and the dynamic changes associated with the process. It was only possible to collect data concerning the experience of 11 firms. In the future, it will be necessary to increase the number of firms in order to make outcome more generalizable. Moreover, surveys should be implemented in the future concerning what characteristics the Russian market has compared with other Central and Eastern European countries, as well as how the strategy of Japanese companies differs from those of firms from other countries such as the USA and the Republic of South Korea.

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9
Investing in a Transition Economy
Motives and Modes of Foreign Direct Investment in Poland

Marian Gorynia, Jan Nowak and Radoslaw Wolniak

Introduction

Foreign direct investment (FDI) has played a pivotal role in the transformation of post-communist economies of Central and Eastern Europe (CEE) for more than a decade. This is especially true for Poland which experienced a phenomenal growth of inward FDI and had, by the year 2000, become the largest recipient of inward investment in the region. Inward FDI can be without doubt considered a salient factor contributing to Poland's transition to a market-led system and, at the same time, leading to a wider and deeper involvement in the ever more complex process of globalization. The results observed and documented so far point to one dominant conclusion that although foreign investors in Poland have often been subject to criticism from Poland's authorities, as well as domestic business circles and other professional, political and social groups, it is clear that the net effects of FDI have been impressive, both in magnitude and scope, and overwhelmingly beneficial to Poland and the international competitiveness of Polish industries and firms. Coupled with a dynamic increase in foreign trade, FDI has not only led to a much greater openness of the Polish economy to the world but has also facilitated Poland's accession to the European Union.

FDI has been mainly undertaken by multinational firms originating from countries such as France, the Netherlands, the USA, Germany, Italy and the UK. Through establishing subsidiaries in the Polish market, these firms have been instrumental in transforming failing state-owned firms into viable operations or creating new enterprises, thus shaking, restructuring, modernizing and generally changing the structure of entire industries. The investment modes used included acquisitions, greenfield investments and joint venture operations. Many factors have influenced the decision to invest and the chosen mode of investment. In turn, FDI motives and modes have had important implications for the subsidiary characteristics and performance.

This chapter investigates the motives for undertaking FDI and the modes of executing this investment using data collected from seven foreign subsidiaries of multinational enterprises. The purpose of the study is to determine what motivated foreign investors to enter the Polish market, what factors determined their choice of mode of FDI, and what patterns emerged in the relationships between the motives and modes.

The first section of the chapter provides an extensive literature review on the subject of FDI motives and modes. The literature review leads to a research methodology section where the authors describe how the data collection and analysis were approached. In the subsequent section, individual cases are outlined and a cross-case analysis is conducted. This is followed by a discussion of results and hypotheses formulation. Subsequently, major implications and lessons both for Poland and foreign investors are presented. The study wraps up by drawing the main conclusions from the case analysis and by providing directions for future research. The Appendix includes an overview analysis of the major trends and the role of FDI in Poland's transition process over the past decade. These trends, although not essential, do provide an important complementary insight and a wider context to the main focus of the study.

Motives and modes of FDI

Motives for FDI

The reasons prompting firms to undertake FDI have inspired and intrigued international business scholars for four decades. They have become part and parcel of various theories and paradigms of international production put forward by such scholars as:

- S.H. Hymer and O.E. Williamson, who laid down the foundation of the theory of internalization/transaction costs, later propagated by P.J. Buckley, M.C. Casson, J.F. Hennart, A.M. Rugman and D.J. Teece (Hymer is also known for his work on the application of an industrial organizational approach to the theory of international production).
- R. Vernon, who developed the product cycle theory of foreign investment, further refined by L.T. Wells.

- R.E. Caves, T. Horst, H. Johnson, S.P. Magee, B. Swedenborg, T.A. Pugel, A.L. Calvet, R.F. Owen, S. Lall, N.S. Siddhathan and N. Kumar, who contributed to the firm-specific (ownership) advantages theory.
- F.T. Knickerbocker, E.M. Graham and E.B. Flowers, who studied extensively firm strategic responses to oligopolistic market situations.
- J.H. Dunning, whose eclectic paradigm, also known as the OLI (ownership, location, internalization) model, provides a holistic explanation of the foreign activities of firms, combining most of the theories and models developed by his predecessors.[1]

Borrowing from an earlier taxonomy developed by Behrman (1972), Dunning (1993, 1998) organized all the numerous motives for FDI and the respective types of multinational enterprise (MNE) activity into the following four groups:

(1) resource seeking;
(2) market seeking;
(3) efficiency seeking; and
(4) strategic asset seeking.

The resource-seeking firms are motivated to invest abroad to acquire specific resources at a lower cost than could be obtained in their home country, if these resources were obtainable at all. Dunning distinguishes three types of resource seekers:

(1) those seeking physical resources (such as raw materials and agricultural products);
(2) those seeking cheap and well-motivated unskilled or semi-skilled labour; and
(3) those seeking technological capacity, management or marketing expertise and organizational skills (Dunning, 1993: 57).

The market seekers are the firms that invest in a particular country or region in order to serve markets in this country or region. Apart from market size and expected market growth, there are four main reasons for which market-seeking firms may undertake foreign investment, namely: (1) a firm's main suppliers or customers may expand overseas and in order to retain its business, the firm needs to follow them; (2) a firm may need to adapt its product to local tastes and specific market requirements, which can only be achieved through market presence in the form of FDI; (3) production and transaction costs of serving a local market from an adjacent facility may be lower than when supplying that market from a distance; and (4) a firm may consider it necessary, as part of its global strategy, to have a physical presence in the leading markets served by its competitors. Unlike other types of foreign direct investors, market-seeking firms tend to treat their foreign affiliates as self-contained business units rather than as part of an integrated chain of value adding activities (Dunning, 1993: 58–59).

The motivation of efficiency-seeking foreign direct investors is to rationalize their production, distribution and marketing activities through common governance of and synergy building among geographically dispersed operations. Such rationalization essentially stems from two sources: (1) the advantages of differences in the cost of factor endowments between countries and (2) the economies of scale and scope (Dunning, 1993: 59–60).

The strategic asset seekers are those firms which engage FDI to promote their strategic objectives – usually that of sustaining or enhancing their international competitiveness. Similarly to the efficiency-seeking firms, the strategic asset seekers aim to capitalize on the advantages of the common ownership of a network of activities and capabilities in diverse environments (Dunning, 1993: 60).

Dunning argues that the former two motives (resource and market seeking) typically characterize initial FDI, while the latter (efficiency and strategic asset seeking) characterize sequential FDI. He also argues that "as strategic asset-acquiring investment has become more important, the locational needs of corporations have shifted from those to do with access to markets, or to natural resources, to those to do with access to knowledge-intensive assets and learning experiences, which augment their existing O specific advantages" (Dunning, 1998: 54).

A version of Dunning's taxonomy of FDI motives can be found in Cantwell (1995), who distinguishes the following three motives for firms' international expansion:

(1) resource seeking;
(2) local market seeking, which usually leads to import substitution; and
(3) firm's international production rationalization (Cantwell, 1995: 303–328).

The first two motives correspond with Dunning's resource- and market-seeking motives. The third one seems to integrate efficiency- and strategic-assets seeking motives.

Some authors (see, for example, Zitta and Powers, 2003) reduce the types of FDI to two groups: market seeking and factor seeking. The latter group encompasses a broad range of specific motivations that include both the search for resources (natural and human) that can contribute to the firm's effective operations in a foreign market and the search for sources of increased competitiveness. In this sense, factor seekers cut across the three types of investors identified by Dunning, that is, resource, efficiency and strategic assets seekers.

In contrast to an abundance of theoretical literature, there appears to be a relative paucity of empirical studies focused on the motives for FDI. During their extensive literature review, the authors of this chapter were able to identify less than a dozen of such empirical studies, a brief summary of which is provided below.

Kim and Kim (1993) surveyed executives of Japanese-owned companies to determine, among other things, their motives for investment in the USA. These authors used 12 motives, which could be allocated between the four groups of motives discussed above, although they did not refer to Dunning's framework, and asked the executives to rate them according to a 5-point scale from "most important to least important". They found that the Japanese had undertaken direct investment mostly to maintain a market position that they initially developed through trade, and to diversify in a huge US market.

Tatoglu and Glaister (1998) considered the location-specific influences that provide motivation for Western multinational corporations (MNCs) engaging in FDI in Turkey. Based on the analysis of a sample of 56 wholly owned subsidiaries and 37 joint ventures, these authors found that the market size, repatriability of profits, the growth of the Turkish economy and government policy towards FDI are the most important location-specific factors motivating Western multinationals to invest in Turkey.

Focusing on transnational management-consulting firms' entry strategies into Thailand, Hussain *et al.* (2001) analysed, among other things, these firms' investment motives. Bases on a survey of 18 firms, which was analysed both quantitatively and qualitatively, the authors found that the most important investment motives were to exploit the existing market opportunities in the host country; to expand markets; to exploit competitive advantage; and to follow the client's international involvement.

Zitta and Powers (2003) researched a sample of 127 foreign companies operating in the USA. These authors used factor- and market-seeking inward FDI as an analytical framework and identified specific motivations that underlie each type of investment behaviour. Their study reports that market-seeking behaviour is motivated by market size, by need for capital and by need for growth. Factor-seeking behaviour is motivated by need for human resources, by stable political climate, by need for capital, by need for profit and by need for technology.

One of the most frequently researched specific motivations to invest abroad is to capitalize on lower labour costs in host countries, which falls into the efficiency-seeking category. Several empirical studies sought a relationship between the labour costs in a given country and the propensity of foreign investors to invest in that country.

Feenstra and Hanson (1997) examined the relationship between the level of wages in Mexico and the level of US investment in that country. They found compelling evidence that the labour costs have significant influence on the level of FDI by US firms in Mexico. A similar study was conducted by Dees (1998) with respect to China, who also found that the lowest labour costs in China among the East Asian countries was a magnet for FDI. However, the study by Mody *et al.* (1999) found that not labour costs but the quality of labour is a decisive factor in making a FDI decision by Japanese firms in Asia. The results of their study highlight the strong Japanese preference for operating in conditions where "human capital is well developed" (Mody *et al.*, 1999: 160).

Three empirical studies identified by the authors of this chapter deal specifically with the motives for FDI in CEE.

The first study, by Ali and Mirza (1996), analyses market entry strategies of UK firms in Poland. Among other things, the authors present UK firms' motives for entering the Polish market. The motives given by the respondents as being the most important for investing in Poland include: to capitalize on Poland's strategic location; to obtain higher profits; to penetrate markets; to pre-empt competitors; and to establish local image. Somewhat unexpectedly, the motive that is often heralded as the most important in descriptive studies of FDI in CEE (for example, Hardy, 1994), the lower labour costs, was in the middle of the ranking scale.

The second study, by Fahy *et al.* (1998), examines the motives and experiences of British firms establishing joint ventures in Hungary. The results of this study reveal that the country's stable economic environment and the potential of its market were the primary reasons why the studied firms invested in Hungary.

The third study, by Marinov and Marinova (1999), explores the motives: of foreign investors to undertake FDI in CEE, of host governments to attract FDI to the country, and of host companies to attract FDI to various privatization schemes and joint venture creation (Dunning and Rojec, 1993). In the foreign investor motives part of their research, these authors find that gaining access to the domestic markets of CEE countries is the most important determinant for investing in the region. Using CEE as a gateway to gain access to other markets in the region is the second most important motive. Thus according to the findings of the Marinov and Marinova's study market-seeking motives dominate among firms investing in the CEE region. Taking advantage of low labour costs – an efficiency-seeking motive – was ranked third, followed by two resource-seeking motives: taking advantage of a skilled labour force and acquiring access to raw material sources.

It is noteworthy that none of the empirical studies reported above explicitly used the four types of FDI proposed by Dunning as a framework, although the individual motives included in these studies seem to represent at least most of the types of FDI. Also, none of the studies reviewed attempted to link the motives to the modes of FDI. The latter finding is surprising; the relationship between motives and modes seems to deserve more attention on the part of international business researchers.

Modes of FDI

The literature on foreign market entry mode is vast.[2] Typically, the modes distinguished and analysed include exporting, licensing agreement, joint venture and wholly owned subsidiary or sole venture (for example, Agarwal and Ramaswami, 1992; Kim and Hwang, 1992; Buckley and Casson, 1998; Osland *et al.*, 2001). However, relatively few studies specifically address the choice between various forms of FDI. Of the latter, some identify and analyse three choices that firms undertaking an FDI have – greenfield investment, acquisition and joint venture (Kogut and Singh, 1988; Woodcock *et al.*, 1994; Nitsch *et al.*, 1996; Bruning *et al.*, 1997; Jermakowicz and Bellas, 1997). Other studies focus on the dichotomous choice between greenfield investment and acquisitions (Caves and Mehra, 1986; Zejan, 1990; Hennart and Park, 1993; Padmanabhan and Cho, 1995; Barkema and Vermeulen, 1998; Gorg, 2000; Matto *et al.*, 2001; Ferret, 2003). Sometimes acquisitions are combined with mergers as a distinct entry mode (for example, Bruning *et al.*, 1997) and joint ventures are included in the greenfield (start-up) investment category (Barkema and Vermeulen, 1998). Finally, there are studies that focus on the determinants of choice between joint ventures and wholly own subsidiaries (Gomes-Casseres, 1990; Shi *et al.*, 2001; Tsai and Cheng, 2002) or between mergers/acquisitions and equity joint ventures (Hennart and Reddy, 1997).

Greenfield investment is typically defined as an investment of a firm that uses its funds to set up an entirely new economic entity by constructing a new facility. Instead, acquisition consists of using the firm's funds to purchase an already existing operation. This is done by acquiring the controlling equity share in a company which previously owned the operation. A cross-border merger occurs when two firms, usually of comparable size, from two different countries, combine their assets and operations to form a new company (UNCTAD, 2000: 99). According to the United Nations Conference on Trade and Development (UNCTAD), only a small percentage of mergers and acquisitions (M&As) are officially classified as mergers (UNCTAD, 2000: 13). A joint venture consists of combining assets in a common and separate organization by two or more firms who share ownership and control over the use and fruits of these assets (for example, Kogut and Singh, 1988: 412; Buckley and Casson, 1998: 545; Gorg, 2000: 165).

Meyer and Estrin (1998, 2001) distinguish a special case of acquisition which they call brownfield investment. Under brownfield investment, the foreign investor initially acquires an existing firm but then almost completely replaces plant, equipment, technology, labour and product assortment of that firm. In this way, the acquired firm undergoes deep restructuring and becomes an almost totally new operation. These authors have found the brownfield investment construct particularly relevant to FDI in CEE.

Below we present a survey of the literature dealing specifically with the determinants of FDI mode choice.

Caves and Mehra (1986) develop a model to explain the choice between greenfield investment and acquisition on the basis of three theoretical considerations (delineated on p. 459). They test this model using a sample of MNEs entering the US market during the years 1974–1980. The independent variables they use fall into two groups: (1) the entrant's corporate organization and (2) the structural features of its product market. The study finds that entrants are more likely to choose acquisitions over greenfield investment when: (a) the initial operation in the US market is large relative to the entrant's operations overseas; (b) the MNE is diversified among countries and product markets; (c) the industry expansion via greenfield investment could lead to the depression of market price; and (d) the entered market is growing very rapidly. The study also finds that the choice between acquisition and greenfield entry is influenced by the co-ordination process of the MNE's overseas activities.

Zejan (1990) also examines the factors which influence the MNE's choice between acquisition and greenfield investment by analysing a sample of Swedish MNEs operating in 35 countries. He examines the influence of market size, market growth and the host country's level of development on the MNE's entry mode decision. The results of Zejan's study suggest that the degree of industrial diversification of the parent company and the host country's per capita income have a positive influence on the propensity for acquisition. The study also shows that the more recent the entry, the greater the probability that acquisition will be chosen as a mode of entry.

Hennart and Park (1993) investigate the factors which determine the choice of Japanese firms investing in the USA between acquisition and greenfield investment. The results of their study suggest that the mode of FDI chosen by Japanese investors is driven both by firm strategies and target market considerations. Japanese MNEs favour greenfield investment when the scale of their operation in the US market is relatively small and when they intend to manufacture in the USA a product they already market at home. Acquisitions, on the other hand, are chosen to enter industries with either very high or very low growth rates, when the investment is large relative to the size of the parent and when entry is into a different industry. Hennart and Park's study leads to a general conclusion that acquisitions are used by investors with weak competitive advantage, while greenfield entry is used by firms possessing strong competitive advantage. At the same time, they find no statistically significant impact on the FDI mode choice of the Japanese investors' previous experience in the US market, its financial situation and its status as a follower in an oligopolistic industry.

In a rather technical paper, Padmanabhan and Cho (1995) tackle the problem of possible multicollinearity and multidimensionality between sets of independent variables typically used in acquisition/greenfield studies. They demonstrate that the problem indeed leads to a loss of significance among variables that may otherwise be significant. They recommend using exploratory factor analysis to identity the critical variables/factors that influence the FDI mode choice.

Barkema and Vermeulen (1998) address the question of how the strategic choice between start-ups (greenfield investments) and acquisitions is influenced by a firm's multinational diversity and product diversity. They test their hypotheses concerning this question on data derived from more than 800 start-ups and acquisitions made in 72 countries by 25 large Dutch multinationals over a period spanning almost three decades. The results of their research indicate that multinational diversity (the diversity of the national markets in which the firm operates) leads to foreign start-ups (greenfield investment) rather than acquisitions. Product diversity, on the other hand, has a curvilinear (an inverted U-shape) effect on the tendency to use start-ups, and this curvilinear effect becomes weaker at higher levels of multinational diversity.

Mattoo *et al.* (2001) investigate the preferences of foreign firms and the host country government for direct entry (greenfield investment) versus acquisition of existing domestic firms, in a situation of costly technology transfer. They find that the trade-off between technology transfer and market competition constitutes a key determinant of these preferences. The results of their study show that high costs of technology transfer lead to acquisitions, whilst low costs of technology transfer motivate foreign investors to choose the greenfield investment mode. The study also identifies the circumstances in which the government and foreign investors' mode choices diverge, and makes recommendations as to how host country welfare can be improved by inducing the foreign firm to choose the socially preferred mode of entry.

Ferret's (2003) study focuses on the relationship between the FDI mode choice (greenfield versus acquisition) and the size of the host country market. The results of this study indicate that firms prefer acquisition when they enter medium-sized markets, whereas they tend to choose greenfield investment when the entered markets are large.

In an economic analysis constrained by a number of simplifying assumptions concerning the market structure, Gorg (2000) shows how different combinations of entry costs and the post-entry competition affect the foreign firm's entry mode choice. Gorg's main conclusion is that the FDI mode choice process is not only influenced by additional costs that a foreign firm has to incur when entering the market, but also by the effects the entry may have on market structure, output produced and market prices. The study reinforces Buckley and Casson's (1998) proposition that market structure is an important determinant of the choice between greenfield investment and acquisition.

The article by Kogut and Singh (1988) relates culture to entry mode choice. The authors formulate two hypotheses, one focusing on the cultural distance between countries, the other on attitudes towards uncertainty avoidance, and test these hypotheses by analysing data on more than 200 entries into the US market by acquisition, greenfield investment and joint venture. Kogut and Singh find empirical support for the hypotheses that cultural distance between home and host countries and national attitudes towards uncertainty avoidance influence the FDI mode choice.

Bruning *et al.* (1997) explore the relationship between several factors instrumental in explaining the mode of entry firms choose when undertaking FDI from Canada into the USA. They consider three competing FDI modes – M&As, joint ventures and subsidiaries (greenfield ventures) – and hypothesize that the entry mode decision is a function of a firm's concern for power, required resource commitment, potential for dissemination risk, and financial concerns related to liquidity and leverage. While using canonical discriminant analysis, these authors measure the validity and strength of the relationship between the three entry modes and the four firm-specific characteristics. The study's main conclusions include: (a) Canadian firms with large existing levels of fixed capital are more likely to enter the USA through the joint venture, rather than through the other two modes; (b) firms concerned with dissemination risk will favour entry by mergers/acquisitions or subsidiaries; and (c) firms facing short-term financial constraints find the joint ventures the least onerous entry mode. The study also highlights strong differences between joint ventures and both M&As and subsidiaries.

In the context of the transaction costs and bargaining power approaches, Gomes-Cassares (1990) develops a framework integrating the two approaches and uses statistical methods in an attempt to estimate the influence of host government restrictive policies on firms' preference vis-à-vis the choice between joint ventures and wholly owned subsidiaries. Gomes-Cassares's study provides some evidence that the firms' preferred ownership structure for a subsidiary, which can be predicted on the basis of transaction costs, is also determined in negotiations between firm and host government. In this process, the relative bargaining power of the parties concerned affects the outcome.

The study of Shi *et al.* (2001) follows Dunnig's eclectic paradigm to investigate foreign market entry strategies of small Hong Kong companies in mainland China. The study integrates strategic, firm-specific, location-specific and transaction-specific factors determining the choice between wholly owned subsidiaries and joint ventures. The results, based on a questionnaire survey and firm interviews, show that the FDI mode choice of the small investors from Hong Kong is determined mainly by strategic and location-specific factors, while firm-specific ownership advantages play a less important role.

Tsai and Cheng's (2002) study analyses the ownership entry decisions made by Taiwanese manufacturing firms that invested in the US market. The modes analysed include full ownership and shared ownership (joint venture), whereas the determinants of the choice used as independent variables are as follows:

– foreign-strategic investment motivation;
– overseas investment environment;
– ownership advantage;
– asset specificity.

The results of their study indicate that Taiwanese manufacturing firms investing in the US market are more likely to choose full ownership over shared ownership for their investment when they

– perceive the risk of operating in the US market as low;
– are strategically motivated to expand market shares in the USA;
– are R&D intensive and have strong manufacturing capability;
– have a high proportion of skill specialists among their employees.

Hennart and Reddy (1997) investigate the determinants of choice between merger/acquisition and greenfield equity joint venture modes of FDI. Their research is based on a sample of Japanese manufacturing entries in the US market. The results of this study show that equity joint ventures are preferred over acquisitions when

– the desired assets are linked to undesired assets (when the US firm owning these assets is large and not divisionalized);
– the Japanese investor has little previous experience in the American market and hence seeks to avoid post-merger integration problems;
– the Japanese investor and the US partner manufacture the same product;
– the industry entered is growing neither very rapidly nor very slowly.

The numerous determinants of FDI mode choice identified in the literature review above can be grouped into the following categories:

- Target market considerations (for example, market size and growth, market structure and competition, level of market development);
- Firm strategy considerations (for example, control, competitive strategy, global co-ordination of firms' activities);
- Firm resources (for example, transferable knowledge, technology, brand name, financial capital);
- Local resource considerations (for example, local human resources, real estate, local firm's assets and networks);
- Costs (for example, transaction costs, costs of acquiring resources, costs of adaptations);
- Risk considerations (for example, risk of information dissemination, financial risk);
- Characteristics of investment (for example, size, capital intensity, compatibility);

- Firm-specific characteristics (for example, firm cost structure, size of parent firm, degree of product diversity, extent of international business experience);
- Host government policies and bargaining power (for example, government preference for specific FDI modes, ownership restrictions);
- Culture (for example, cultural distance between home and host countries, national attitudes).

The identified categories of FDI mode determinants encompass a broad spectrum of possibilities with each category representing potentially numerous individual factors. However, a very limited coverage of host government influences can be observed on the mode decision identified in the reviewed literature (only two studies considered host government ownership preference). And yet, governments can, and often do, influence the FDI mode decision, by either providing incentives or disincentives with respect to the choice of individual modes, depending on these governments' strategic objectives and policies. For example, host governments typically strive to expand the country's industrial capacity and to stimulate local competition, in which case they try to encourage greenfield investment and discourage acquisitions.

Conversely, in Poland, until recently and especially at the beginning of the transition process, it was the policy of consecutive governments in power to privatize state-owned firms by encouraging foreign investors to acquire frequently obsolete and inefficiently managed entities rather than allowing for greenfield investments. This peculiar approach was motivated by a lack of sufficient domestic capital for such privatization undertakings. Presently, many foreign firms are very much interested and vying for investing their equity in quite profitable and well-run Polish companies (especially in the banking and insurance sectors). Thus the Polish market today is available and attractive for both greenfield and acquisition investments.

Research methodology

The literature review of the preceding section serves to provide specific guidelines as to what variables and relationships should be investigated in this study. The analysis focuses firstly on the motives for FDI in Poland. While drawing on Dunning's and Cantwell's taxonomies of FDI motives, the individual motives are divided into three groups: (1) market seeking, (2) resource seeking and (3) efficiency seeking. The literature review shows that these three types of FDI are either explicitly or implicitly widely accepted as a framework for investigating FDI motives.

As for the modes of FDI, this study focuses on the dichotomous choice between greenfield investment and acquisition. This is due to the fact that practically all the firms surveyed were 100 per cent owned by foreign parents. Also, the information collected does not permit an identification of any brownfield operation in the sense defined by Meyer and Estrin. Finally, the central relationship between the motives for FDI and modes of FDI is investigated – a relationship that has been somewhat neglected in international business studies.

Sample and method of data collection

The study is based on data from seven cases of FDI made in Poland in the first half of the 1990s. During that period the Polish economy experienced its most dynamic stage of transformation to a market-led system. All the analysed cases were from the manufacturing industry and consisted of foreign subsidiaries located in the western part of Poland. Six of the seven cases concerned wholly owned subsidiaries. One was technically a joint venture but with such an ownership structure that for all practical purposes it could be treated as a wholly owned subsidiary. Geographical convenience for conducting research was the main rationale for the case selection. Geographical concentration of the sample and the resultant geographical homogeneity allowed for minimization of the influence of the regional differences on the survey responses. On the other hand, some bias cannot be excluded due to the fact that western Poland has always been perceived as the more developed half of the country attracting entrepreneurial and growth-oriented firms. Consequently relatively more firms in this region could have been considered as suitable targets for acquisition by foreign investors. Finally, financial limitations also influenced the scope of this empirical research.

Data were collected by means of personal interviews using a structured questionnaire as a data collection instrument. The interviews were carried out in the first half of the year 2002 in each subsidiary with a member of its management team. The data sets collected were broader in scope than those presented in this chapter. In addition to FDI motives and modes, the questionnaire contained more detailed characteristics of the subsidiaries, their post-investment performance assessment, completeness of the value-added chain managed by the subsidiary, phases of the parent companies' internationalization process in the Polish market, and the level of subsidiary autonomy. Preliminary results of the full-scope study were presented by the authors in 2003 (Gorynia *et al.*, 2003).

Data analysis

Due to the small sample size, the authors could not use any statistical techniques in their analysis of the survey results. Therefore, the research results do not provide grounds for full generalization of conclusions. Instead, qualitative case analysis is employed justifying formulation of some hypotheses. In this sense, the present research is essentially of an exploratory nature.

Several approaches to case-based empirical research can be identified in related literature. Stake (1994) uses an instrumental approach, in which he first describes a case in order to gain some insight into an important problem (Stake, 1994: 237–238). Then he conducts the so-called collective case studies, analysing several cases simultaneously. The cases are selected in such a way that it is easier to understand the main issues and easier to create better theoretical generalizations about a larger number of cases (Huberman and Miles, 1994). Referring to another typology of case studies (Yin, 1993), it can be said that in this research exploratory cases are used in the initial phase. Its aim is a preliminary recognition of a problem and formulation of the main categories and research questions. Later on, explanatory cases are used whose aim is to find out the reasons for different phenomena observed.

More closely, however, the analysis of the present case data partially reflects the procedures of comparative case analysis presented by Ragin (1994) and Eisenhardt (1989). These procedures consist of three steps. Firstly, within-case analysis is conducted for each case. The task of this step is to determine a direction of dependencies between the studied variables in a concrete individual case so that a comparative analysis is possible. The second step is to compare the results of individual cases in order to find cause-effect dependencies between the occurrence or non-occurrence of some variables and the occurrence or non-occurrence of other variables. Next, the results of comparisons between cases are contrasted with the results of theoretical debates, which make it possible to draw some conclusions or hypotheses. In this way, a generalized theoretical model of dependencies can be constructed. This model may later be subject to further empirical research to test its adequacy. In this sense, the results obtained are of preliminary character.

Analysis of cases

Within-case analysis

Table 9.1 presents a summary of the characteristics of each case.

Table 9.1 Summary characteristics of cases

Feature	**Case 1**	**Case 2**	**Case 3**	**Case 4**	**Case 5**	**Case 6**	**Case 7**
1. Product line	Clothes	Lighting equipment	Light clothes	Surgical and dental instruments	Machinery and equipment for glass-making industry	Chocolate products	Plastic pipes and pipe fittings
2. Year of inception	1991	1991	1992	1992	1992	1995	1991
3. Initial investment outlay (USD million)	0.2	23.0	3.6	3.4	7.0	29.0	6.0
4. Investor's country of origin	Italy	Netherlans	Germany	Germany	Germany	Germany	Denmark
5. Entry mode	Greenfield	Acquisition	Acquisition	Acquisition	Greenfield	Greenfield	Acquisition
6. Main motives for FDI	Market and efficiency seeking	Market and efficiency seeking	Efficiency seeking	Market and efficiency seeking	Efficiency seeking	Market and efficiency seeking	Market seeking

Case 1. This subsidiary was established in 1991. It was a greenfield investment. The investor was an Italian company operating in the clothing industry. The following were the most important factors that had led to the selection of the greenfield mode of FDI:

- greenfield costs were estimated to be lower than those of acquisition, because of the possibility to adjust the scale of operation to the anticipated needs of the market;
- difficulties associated with the inherited problems of the acquired firm could be avoided as well as the risk of paying a premium in the case of takeover;
- possibility to freely choose the location of the investment;
- anticipated lower costs of production in the new facility as compared to an acquired firm.

The most important motives for FDI were as follows:

- market seeking – to access, sustain and expand markets in the host country; to overcome import barriers; to expand and improve market position;
- efficiency seeking – lower costs of production and transport, economies of scale and lower wages.

Case 2. The subsidiary was set up in 1991 through acquisition. Its owner is a Dutch investor operating in many branches, including lighting equipment. The main reason justifying acquisition was the opportunity of quick access to the market. The main motive for FDI was the intention to expand and improve the position in the Polish market (market seeking) as well as to cut production costs (efficiency seeking).

Case 3. This subsidiary was established in 1992, also through acquisition. The investor is a German firm operating in the clothing industry. The main motive for takeover was the opportunity to start the venture faster. The main motive for undertaking this FDI was cost efficiency.

Case 4. The next company, and the third case of acquisition, was set up in 1992. Its owner is a German investor operating in the medical instruments sector. The quoted reasons for acquisition (versus greenfield) were an intention to enter the Polish market quickly and to take possession of valuable assets of the acquired firm. The motives for FDI were of a market- and efficiency-seeking nature.

Case 5. This was another greenfield investment subsidiary, founded in 1992 and producing machinery and equipment for the glass-making industry. The reasons for choosing the greenfield mode were a possibility of free choice of location and anticipated lower costs of production in the new plant than in the case of acquisition. The main motive for undertaking this investment was cost efficiency.

Case 6. This case was also a greenfield investment of a German firm, making chocolate products. The greenfield mode was chosen because of anticipated lower costs of production in the new plant and because of the opportunity to freely select its location. Efficiency- and market-seeking motives were of similar importance for making the investment.

Case 7. The last case under consideration was a subsidiary established in 1991 as an acquisition of a local firm by a Danish company making plastic pipes and pipe fittings. The acquisition mode choice was determined by the opportunity to enter the market quickly and to take possession of valuable assets of the acquired firm. The main motive for FDI was of a market-seeking character.

Cross-case analysis

Motives for FDI

Only one of the seven subsidiaries studied can be clearly classified as a market seeker in making the investment. Two firms were clear efficiency seekers. Four firms assigned equally high importance to both market and efficiency factors. No firm indicated resource-seeking factors as a main motive for undertaking the investment, and only two rated these factors as being of low importance, while the other factors (market and efficiency) were given high importance. The lack of "pure" resource seekers may be partly attributed to the fact that a major determinant of FDI in Poland, that is, low labour costs, was bundled in the survey questionnaire together with other predominantly efficiency-oriented factors instead of being positioned in the resource category. Another interesting observation is that, contrary to Dunning's (1993) contention that efficiency-seeking motives are more likely to be present in follow-up investments, all the subsidiaries under study were established by their parent companies as first time investment in Poland.

Entry mode and its determinants

In all three cases where the chosen entry mode was greenfield investment, there was a high degree of unanimity as to the reasons for such a choice. Both the chocolate and clothing manufacturers assigned high importance to the possibility of lowering initial investment outlays through the greenfield approach as compared with acquisition, by a better adjustment of the scale of operations and operations strategy to the requirements and potential of the target market. The third firm, producing equipment for the glass industry, assigned only some importance to this factor. The next group of factors, based on the desire to avoid (a) problems commonly associated with an acquired company and (b) the risk of paying a takeover premium, were ranked as high in importance by all three firms that chose greenfield investment. The subsequent reasons investigated were the possibility of freely choosing the investment location and the expected lower manufacturing costs compared to those usually reported in the acquisition mode. Both these factors were considered by all three greenfield firms as being of high importance.

The Polish government regulations giving preference to greenfield operations and a limited pool of Polish firms suitable for acquisition were ranked as being of little importance also by all of the three greenfield companies. The former reason was weak simply because there have so far been no comprehensive government measures introduced which would explicitly favour greenfield investment. The low ranking of the latter factor indicates that although one could find suitable domestic firms which could be targeted for acquisition, all three companies were firmly convinced that greenfield investment was the superior mode to enter the Polish market.

As for acquisitions, the most important common determinant in all the four cases of this entry mode was the factor of speed in moving into the new market. With the exception of the lighting products firm, the remaining three also attached high importance to the perspective of acquiring valuable assets of the local company such as brand names, distribution networks and market shares. The plastic pipes and fittings company also quoted the desire to avoid possible cultural, legal and managerial problems which might arise in the greenfield mode of entry, but this motive was considered as being of lesser importance. Thus the two dominating determinants of the acquisition entry mode – speed in entering the market and acquiring valuable assets – were quite different from those leading to greenfield investment.

FDI motives versus FDI modes

It is truly difficult to discern a clear and unambiguous relationship between FDI motives and the greenfield investment or acquisition entry modes using the existing case material. There is, however, evidence of two, to a certain degree, distinct trends. Two out of the three cases where the greenfield mode was chosen attached high importance to the market-seeking factors defined in the survey as: securing access to new markets, sustaining and expanding market presence in the host country plus avoiding trade barriers. The second dominant group of motives were efficiency-seeking factors, that is, lower manufacturing and transport costs, lower costs due to economies of scale plus lower labour costs. The chocolate maker mentioned, in addition, other motives such as defence of existing competitive position and creation of a cost-effective supply base, but these factors carried a low importance rating.

Among the four firms that chose the acquisition entry mode, the only common motive was lower costs, as defined above. Three firms gave this motive a high importance rating and only the plastic pipes and fittings firm assigned a low importance mark. The second minimally less common factor was offensive market expansion and improvement of competitive position, thus falling into the market-seeking category of motives. Other factors, such as securing a supply base or defending competitive position, seemed to be incidental. Therefore, within the framework of the existing situation and conditions on the Polish market, the general conclusion points to the greenfield mode as being more suitable for firms which focus on market factors and, at the same time, lower costs. The acquisition mode, on the other hand, will be preferred when the investor is more inclined to act offensively to expand their competitive position, while at the same time being mindful of the need to reduce costs.

Discussion of results and hypotheses

The findings regarding the FDI motives are only partially consistent with the previous empirical studies referred to in the literature review, where market factors assumed higher prominence than efficiency factors. However, these findings seem to be in line with and support the expectations and observations found in the descriptive and qualitative literature dealing with FDI motives in CEE, where the cost-efficiency benefits are singled out as often as market attractiveness of the whole region (for example, Hardy, 1994). Almost a total lack of resource-seeking motives can be, at least partially, explained by the sample composition (only manufacturing companies were studied). The inclusion of companies from the extractive sector, for example, would have probably led to different results in this respect. Hence clearly there is an urgent need for more empirical studies, based on sufficiently large samples of foreign subsidiaries, focused on motives for FDI in CEE. Dunning's classification of FDI motives, as described earlier, could serve as a pertinent organizing framework for such research.

In the relationship between greenfield investment or acquisition and their determinants, the following preferences were identified. The choice of the greenfield investment mode was much more consistently determined across firms than that of acquisition. The firms opting for greenfield investments focused on four groups of determinants:

(1) lower initial investment outlays due to the scale of operations and operations strategy being better adapted to the local market;
(2) avoidance of problems with acquired companies, including the risk of paying a takeover premium;
(3) freedom in choosing a suitable investment location;
(4) expectation of lower manufacturing costs.

The general motives for undertaking FDI in the form of greenfield investment were focused on: (a) market-seeking factors perceived as accessing new markets and then sustaining and/or expanding market presence; and (b) efficiency-seeking factors, mainly through cost reduction. Thus the greenfield investment mode was seen as being more appropriate for firms classified by J.H. Dunning (1993, 1998) as market seekers and efficiency seekers.

Factors affecting acquisition mode demonstrated more variation. Among the many motives quoted for undertaking FDI, only two were common: pursuit of lower costs and offensive expansion and improvement of competitive position. These in turn coincided with and reinforced the two main acquisition determinants: the speed of market entry and the acquisition of such assets as brands and distribution networks plus market shares. Viewed as a summary construct, they came closest to the concept of market and efficiency seekers with more focus being placed on the second category. The importance of efficiency-seeking acquisitions can also be derived from the fact that most of those operations were made within the framework of the privatization process of predominantly mismanaged state-owned companies. This factor differentiates such acquisitions from those made in a mature market economy where the strategic asset-seeking motive often appears to be more prominent.

The findings and their discussion presented above lead to the following research hypotheses that could be tested in future studies on FDI in Poland:

H1: The main motives for undertaking FDI fall into the market-seeking and efficiency-seeking categories.
H2: Factors that determine the choice of greenfield investment are more consistent across firms than those that determine the choice of the acquisition mode.
H3: The greenfield mode is preferred mostly because of the possibility to adjust the scale of operations and strategy to the requirements of the target market.
H4: The acquisition mode is chosen mostly because of the reduced time to enter the market.
H5: There is no clear pattern in the relationship between the motives for and modes of FDI.

Implications and lessons

Apart from Russia and Ukraine, Poland has the largest market in the CEE region. However, despite having a pool of relatively highly qualified labour, Poland has few resources which could be deemed to be attractive to foreign investors. That said, labour is nevertheless perceived by foreign firms as a major factor allowing them to achieve higher levels of efficiency. This labour component contributes to the view emanating from this research that inward FDI in Poland is mainly efficiency-seeking oriented (first) and market oriented (a very close second in line) and practically non-resource oriented. The major implication of such a trend for Poland is the need to introduce economic policy measures reinforcing economic efficiency. The major challenge in this field lies in increasing, for example, the still unsatisfactory level of worker productivity as compared with the average European Union (EU) level.

Efficiency can also be increased by improving various elements of material infrastructure and eliminating bureaucratic red tape – two factors which are most commonly cited as slowing down the FDI process in Poland. In these two areas the central and also local government initiatives are vital to secure the continuing inflow of FDI. Thus the Polish authorities are under pressure to adopt a strategy that will produce palpable results in a relatively short period of time. The time constraint is becoming more and more acute since foreign firms, and especially big

MNCs, have at their disposal more attractive locations in the CEE region itself (like Slovakia, for example, which captured a major investment by the South Korean car manufacturer KIA to the detriment of Poland) as well as in other parts of the world (like China and India).

In the area of efficiency there is also one factor over which the government has little influence and which can contribute to a reduction in FDI flows to Poland. With economic growth and increase in the country's welfare, labour costs inevitably rise decreasing the lower cost motive to invest in Poland. The countervailing force lies in productivity and quality improvements, both of which are still much below the expectations of the foreign investors and the potential of the Polish workforce.

The second motive for inward FDI in Poland has been identified as access to new markets. The recent accession of Poland to the EU as a full member facilitates and strengthens the role of that motive, since the perception of risk due to the unpredictable and/or unstable political and economic environment is now much smaller. Moreover, the market-seeking motive as applied by foreign firms to Poland should be less understood in the sense of being present in the market of the country as such and much more in the framework of entering selected (industry) market segments and/or niches. The latest examples of this niche focus are outsourcing and relocation strategies of MNCs, transferring to Poland services like call centres and accounting (for the whole corporation).

In the strategic choice between greenfield investment and acquisition the first of the two options was found to be in the case of Poland more focused in its determinants and preferred as less problem generating, as well as being better adapted to the local market needs. Such arguments, especially for big MNCs, carry considerable convincing power and indicate a strong strategic option for possible new entrants. Acquisitions, on the other hand, seem to be undergoing a peculiar change. Acquisition through the privatization process of state-owned enterprises is slowly coming to its natural end for the obvious reason of the drying up of the pool of firms commissioned for privatization. However new prospects appear and are associated with firms from the private sector that either are too small and/or lack the necessary resources and expertise to compete successfully with large foreign MNCs or which have already gone bankrupt. In both instances the local Polish firms will usually offer valuable assets, such as knowledge of the market segments or niches in which they operate and ownership of recognized local brands (like in the beer industry).

An additional implication for the acquisition option for local Polish firms lies in the growing need to co-operate and enter into various forms of business alliances if they are to fend off the acquisition attempts by foreign investors. But differences in size and economic power should also not deter Polish firms from contemplating possible alliances with their foreign rivals, although in the long run the risk of an alliance ending in a takeover can never be fully eliminated.

Conclusions and directions for future research

Both the within-case and cross-case analyses have provided a number of important insights into the motives and ways the analysed foreign subsidiaries were established in the Polish market. The studied firms, although concentrated in one region of Poland, represented a broad spectrum of manufacturers, ranging from clothing to medical instruments, to glass-making equipment. Three of them entered the Polish market through greenfield investment and four through acquisition. Most of the investing firms were both market and efficiency seekers. No firm entered the market mainly to secure access to local resources.

Due to the small sample of firms studied and the resultant absence of statistical rigour in the data analysis, the present study could only delineate a number of important relationships between the variables under consideration and thereafter attempt to formulate certain pertinent research hypotheses. These hypotheses can be conceived as general guidelines for stimulating, developing, supporting and directing future research, based on larger and more representative samples of subsidiaries, encompassing a wider cross-section of industries and sectors, thus allowing for the use of statistical analysis and therefore generating more conclusive results. The implications and lessons outlined above also are tentative and should be analysed with caution. At the same time, however, the present study does provide certain leads which might be useful for questionnaire design as to what relationships and issues deserve to be further investigated.

Appendix: FDI in Poland's transition process

The annual inflow of FDI into Poland since the beginning of the transformation process is given in Table 9.2. It reveals an uninterrupted increase in the inflow until 2001.

In 2001 inward FDI witnessed the first fall in over a decade. The magnitude of this fall of −39 per cent calls for attention as to whether this

Table 9.2 FDI inflow into Poland from 1990 to 2001 (in USD million and percentage change over previous year)

	1991		**1992**		**1993**		**1994**		**1995**		**1996**		**1997**		**1998**		**1999**		**2000**		**2001**	
		%		%		%		%		%		%		%		%		%		%		%
FDI inflow	359	307	678	89	1715	153	1875	9	3659	95	4498	23	4908	9	6365	30	7270	14	9342	29	5713	–39

Source: National Bank of Poland (2003) and authors' calculations.

was a signal of a declining trend or whether it was just a consequence of a temporary regional slowdown of economic growth.

It is also interesting to observe the somewhat volatile nature of FDI inflow changes in the period of 1990–2001. A rising rate of growth in the annual value of FDI was usually followed by a smaller increase in the next year but only to give way again to a greater dynamism in the succeeding year. The reasons for such fluctuations are not clear and hard to identify. But the percentage fall in 2001 may indicate that the Polish market may have reached its saturation point for foreign investors as to its general attractiveness. Poland's full membership in the EU in 2004 has indeed generated a new rising wave of inward FDI. An additional challenge in this context is appearing in the form of more intense competition for FDI, coming from the other countries of Eastern Europe which, like Poland, have been in the forefront of the transformation process and have also, together with Poland, joined the EU.

Data pertaining to the role of FDI in Poland relative to other countries in the region of CEE are presented in Table 9.3. Poland ranks first with a 25.8 per cent share of FDI in the said region. Next in line is the Czech Republic with 16.2 per cent, followed by Hungary with 15.3 per cent. It is worth noting that the much larger market of Russia attracted in the year 2000 only 14.8 per cent of the region's total FDI inflow. The role and rank of Poland, however, turns out to be quite different when FDI stock per capita is considered.

The leader is the Czech Republic with USD 2055 per capita, followed by Hungary USD 1984, Estonia USD 1891, Slovenia USD 1411, Croatia USD 1060 and Latvia USD 884. Poland's seventh position, with USD 870, indicates the considerable absorption potential for foreign investment and should be treated as an important motive for intensifying policy measures to attract FDI inflows. Poland's seventh position may also be a result of the bias arising from the fact that Poland's market is much larger than those of the higher ranking countries. One should not forget that Poland's rank is still well above the average of USD 385for the whole region of CEE.

Table 9.4 shows the geographic origin of FDI in Poland. By mid-2002, the largest foreign investor country was France with over USD 11.5 billion invested in Poland. The next largest investor was the USA with over USD 7.9 billion, followed by Germany with over USD 7.4 billion and Holland with almost USD 5 billion. Together investors from these four countries accounted for 51.8 per cent of the total stock of USD 61.6 billion. As for the number of investing firms, the largest group (212) came from Germany, 126 were from the USA, and only 89

Table 9.3 Per capita FDI and FDI percentage spread in Eastern Europe, in 2000

Regions/Countries	**FDI stock per capita in USD**	**Percentage share in total FDI stock**
CEFTA countries	939	70.0
Bulgaria	418	2.6
Czech Republic	2,055	16.2
Poland	**870**	**25.8**
Romania	292	5.0
Slovakia	683	2.8
Slovenia	1,411	2.2
Hungary	1,984	15.3
Baltic countries	951	5.4
Estonia	1,891	2.0
Lithuania	636	1.8
Latvia	884	1.6
European CIS countries	118	19.1
Belarus	124	1.0
Moldova	103	0.3
Russia	133	14.8
Ukraine	78	3.0
Other	296	5.5
Albania	182	0.4
Bosnia and Herzegovina	86	0.3
Croatia	1,060	3.8
Yugoslavia	93	0.7
Macedonia	188	0.3
Central and Eastern Europe total	385	100.0

Source: Kopeć (2002: 170).

from France and 76 from Holland. Jointly, they held a share of 54.7 per cent of the total 920 firms with investment over USD 1 million.

The sectoral spread of FDI in Poland is presented in Table 9.5. Manufacturing is the dominant sector accounting for 40.4 per cent of the stock of FDI over USD 1 million. It is followed by the financial intermediation services with a 23.3 per cent share, trade and repairs with 12.5 per cent and transport, storage and communications with 10.2 per cent. Within the manufacturing sector the dominant industries absorbing FDI were food processing with a 10.3 per cent share and transport equipment with 9.6 per cent. The service industries have overall attracted well over 50 per cent of the total FDI stock in Poland.

The trend to move FDI from manufacturing to the service sector has been observed since the beginning of the transition process in 1990.

Table 9.4 Stock of FDI in Poland by countries of origin as of 30 June 2002

No.	**Country**	**Capital invested (USD million)**	**Investment plans (USD million)**	**Number of companies**
1	France	11,503.0	1,975.5	89
2	USA	7,985.2	2,389.0	126
3	Germany	7,444.57	1,290.86	212
4	The Netherlands	4,976.05	563,7	76
5	Italy	3,701.1	1,272.7	59
6	Great Britain	2,899.1	349.5	40
7	International	2,803.3	913.5	18
8	Sweden	2,653.7	963.8	57
9	Belgium	1,649.05	127.0	23
10	Korea	1,621.8	20.0	4
11	Denmark	1,331.0	241.5	38
12	Russia	1,286.4	301.0	2
13	Ireland	1,039.7	*n.a.*	2
14	Cyprus	911.7	175.0	1
15	Switzerland	904.7	338.5	21
16	Austria	843.4	79.2	41
17	Norway	599.3	173.9	14
18	Japan	598.7	111.0	13
19	Spain	536.2	*n.a.*	9
20	Greece	501.5	4.0	2
21	Portugal	493.1	66.6	4
22	Finland	424.4	122.8	19
23	Canada	205.3	241.5	14
24	Croatia	173.0	16.0	2
25	Turkey	100.1	58.0	4
26	Luxemburg	85.7	10.2	8
27	Australia	67.0	4.0	2
28	Czech Republic	60.7	*n.a.*	4
29	Israel	55.4	120.0	4
30	China	45.0	45.0	2
31	South Africa	35.0	95.5	2
32	Slovenia	35.0	27.0	2
33	Liechtenstein	31.9	27.0	4
34	Taiwan	5.7	200.0	1
35	Hungary	3.5	*n.a*	1
Investments over USD 1 million		57,610.3	12,323.3	920
Estimated investments under USD 1 million		3,990.1		
Total		61,600.4		

Source: PAIZ (2003).

Table 9.5 Stock of FDI in Poland by sectors and industries as of 30 June 2002

Sectors and industries	**FDI stock USD million**	**%**	**Investment plans USD million**
Manufacturing	23,300.2	40.4	5,184.3
Food processing	5,932.7	10.3	619.2
Transport equipment	5,517.1	9.6	827.7
Other non-metal goods	3,241.2	5.6	861.5
Pulp and paper and publishing and printing activities	1,667.1	2.8	285.4
Electrical and optical machinery	1,656.5	2.8	348.0
Chemicals and chemical products	1,613.0	2.7	707.1
Wood and wooden products	1,296.9	2.2	193.2
Rubber and plastics	629.1	1.0	233.2
Metals and metal products	542.5	0.9	691.7
Other products	502.4	0.8	285.5
Other machinery and equipment	436.8	0.7	84.2
Fabrics and textiles	250.3	0.4	47.1
Leather and leather products	14.6	0.0	0.5
Financial intermediation	13,442.9	23.3	143.5
Trade and repairs	7,176.2	12.5	1,019.8
Transport, storage and communications	5,872.0	10.2	478.9
Construction	2,818.4	4.9	1,062.7
Community, social and personal services	1,769.1	3.1	586.0
Power, gas and water supply	1,663.6	2.9	1,746.5
Real estate and business activities	707.6	1.2	1,836.1
Hotels and restaurants	597.0	1.0	242.2
Mining and quarrying	218.5	0.4	7.0
Agriculture	44.8	0.1	16.3
Investments over USD 1 million	57,610.3	100.0	12,323.3
Estimated investments under 1 million USD	3,990.1		
Total FDI in Poland	61,600.4		

Source: PAIZ (2003) and authors' calculations.

In 1996 FDI inflow into manufacturing still had a 53.3 per cent share, but in 2000 it dropped to a mere 22.3 per cent. Between these two years, however, the share of transport and communications rose from 0.3 per cent to 36.6 per cent and the share of financial intermediation went up from 17.9 per cent to 21.1 per cent (Przystupa, 2002). These developments have positively contributed to reinforce Poland's transition to a mature, developed economy.

Table 9.6 provides an interesting insight into the profiles of the 20 largest foreign investors in Poland at the end of 2001. France Telecom,

Table 9.6 Largest foreign investors in Poland by 31 December 2001

	Investor	**FDI in USD million**	**Planned FDI in USD million**	**Country of origin**	**Sector/industry**
1.	France Telecom	3199.4		France	Telecommunications
2.	Fiat	1698.8		Italy	Car manufacture, banking and insurance
3.	Daewoo	1552.3		South Korea	Car manufacture, electronic equipment, construction and insurance
4.	HVB	1358.0		Germany	Banking
5.	Citibank	1300.0		USA	Banking
6.	RAO Gazprom	1283.8	301.0	Russia	Construction
7.	Vivendi	1204.2		France	Telecommunications
8.	United Pan-Europe Communications	1200.0	100.0	Netherlands	Mass media
9.	UniCredito Italiano	1108.5		Italy	Banking
10.	Metro AG	1000.0	71.6	Germany	Retail trade
11.	EBRD	955.0		International financial institution	Banking, capital investments
12.	Casino	923.0		France	Retail trade
13.	Kronospan Holings Ltd.	911.7		Cyprus	Wood processing
14.	General Motors Corporation	800.0		USA	Car manufacture

Table 9.6 (Continued)

	Investor	FDI in USD million	Planned FDI in USD million	Country of origin	Sector/industry
15.	Allied Irish Bank Plc	746.7		Ireland	Banking
16.	KBC Bank	704.0		Belgium	Banking, insurance
17.	Carrefour	703.7	169.4	France	Retail trade
18.	ING Group NV	677.0		Holland	Banking, insurance
19.	Enterprise Investors	630.0		USA	Capital investments
20.	Eureko BV	601.4		international	Insurance

Source: Durka (2002).

a new investor dating from 2000, is ranked first with an investment far surpassing that made by the remaining firms. The country mix is varied but generally reflects the composition of the largest investor countries as seen in Table 9.4, that is, France, the USA and Germany. What is noteworthy though is the high sixth rank of Gazprom from Russia, portending possible further inflow of FDI from that country. Firms from four service industries are prevalent: telecommunications, banking, insurance and retail trade (hypermarket chains). The manufacturing sector is represented by car producers and a wood processing firm from Cyprus. The holding nature of the Cypriot firm coupled with the tax haven status of that country may indicate that the real origin of the investor may be different.

Notes

1. A summary of the works of the authors mentioned in this paragraph, as well as a detailed description of the eclectic paradigm are provided in Dunning (1993: Chapter 4). Other works of Dunning, where he presents the eclectic paradigm and its extensions and application include Dunning (1980, 1981, 1988, 1998, 2001). Alternative reviews of the theories of FDI can be found, for example, in Buckley (1993) and Hennart (2001). An interesting modification of Dunning's OLI model can be found in Guisinger (2001).
2. A list of publications dealing with the choice of entry mode would be too long to present within the length limits of this chapter. The most visible authors who have written on this subject matter include S. Agarwal and S.N. Ramaswami, E. Anderson and H. Gatignon, W.C. Kim and P. Hwang, P.J. Buckley and M.C. Casson, and Brouthers *et al*.

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10
Kissing the Frog
The Changing Nature of Doing Business in Romania

Liviu Voinea

Dynamics of the economic reform

Reforms in Romania had to be initiated under lack of political pluralism, no articulate union pressure prior to 1989,[1] and lack of openness and transparency. In economic terms, the system was plagued by a structural strain (Daianu, 1998) characterized by severe resource misallocation. This misallocation was so extensive, that the economy has suffered from its energy-intensiveness for many years after the start of the reforms. Moreover, almost all productive assets were state owned and private property was non-existent. Furthermore, at the start of the transition process the Romanian economy suffered from the attempt of the communist regime to repay all foreign debt ahead of schedule. Consequently, in 1989, Romania had no foreign debt, but it was all at the expense of domestic consumption and technology upgrading. Given the magnitude of the required resource reallocation following liberalization (strain), and all against the backdrop of structural rigidities, disorganization (Blanchard and Kremer, 1997) and scarce domestic resources imports played a major role in the ailing Romanian economy. Thus imports boomed immediately after the fall of the communist regime. This was coupled with a sharp decline in technologically redundant exports and the collapse of the common market of the former communist states COMECON in 1990. The economic basis for reforms in Romania was therefore very weak, and many economists consider that this poor legacy led to a path-dependency explaining why Romania still lags behind the front-runner transition economies (Daianu and Voinea, 2003).

Nevertheless, since the fall of the communist regime, Romania has witnessed wide-ranging and large-scale political, economic and social transformations. The political turnaround occurred mostly in 1990–1991, while the major turning point in economic terms was in 1999 when the country was invited to start negotiations for European Union (EU) accession. Eventually the latter led to EU membership in 2007. The economic evolution was marked by an alternation of recession and growth episodes (1990–1992 and 1997–1999, respectively, and 1993–1996 and 2000–ongoing).

According to the World Bank taxonomy (World Bank, 2000), there are two groups of reforms for a transition economy. The first one aims at changing the rules of the game and includes changing the ownership structure mostly via privatization, trade and price liberalization, and institutional development. The second group of reforms aims at creating more economic actors who are required to play by the new rules and includes changing the structure of competition, cutting the budgetary deficit, and creating a sound and competitive banking system. By this taxonomy, Romania has advanced considerably, yet some of the issues pertaining to the first group of reforms are not fully implemented as yet. An example of such reforms that still await full implementation is the full liberalization of energy prices. Institutional fragility has also added pressure on the success of reforms because many market institutions are new (such as the Competition Council or the National Securities Commission) to the system and therefore they have to gain more experience, establish their credibility and fully enforce their role (Figure 10.1).

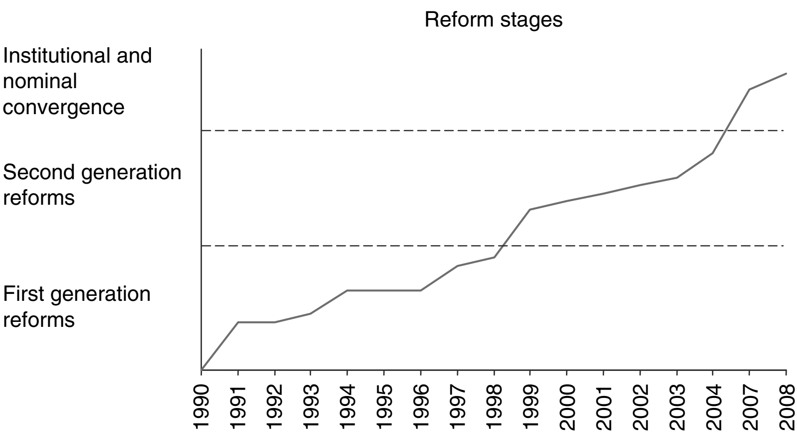

Figure 10.1 Reform stages in the Romanian economy

The European Bank for Reconstruction and Development (EBRD) uses a slightly different distinction of reform stages. By this approach, the first phase of reforms or so-called initial reforms cover small-scale privatization, price liberalization, trade and foreign exchange liberalization. The second phase encompasses institutional reforms, large-scale privatization, governance and enterprise restructuring, competition policy, banking and financial sector restructuring, and creation of appropriate infrastructure. By this taxonomy (Falcetti *et al.*, 2003), Romania has progressed better in the initial reforms, but it is still rather underperforming (compared to Central European economies such as the Czech Republic) in terms of the institutional reform.

A number of reforms have been carried out systematically and persistently although often these have been at a high social cost. Among the most important initial reforms, one can mention the internal currency convertibility (Article VIII of the International Monetary Fund (IMF) status) that was reached in March 1998, marking the full convertibility of the current account. The opening of the current account was gradual, and it recorded episodes of massive price liberalization in November 1991, May 1992, July 1995 and February 1997, as well as trade liberalization. In 1993 Romania signed the EU Association Agreement; in 1995 the country gained World Trade Organization (WTO) membership; and in 1997 it became a member of CEFTA (Central European Free Trade Agreement). The opening of the capital account has also been gradual: inward foreign direct investment (FDI) was liberalized; a structured programme of capital account opening over a four-year period was initiated in 2001. Table 10.1 presents a chronological synthesis of the most important reforms during the transition period in the Romanian economy.

In 2003 the private sector of the economy contributed two-thirds to the country's GDP, and persistent efforts aimed to reduce the state-owned sector that still controlled about half of the total assets in the economy. One of the key problems of the transition period was the existence of an informal sector that reached approximately 30 per cent of GDP by some estimates. It was fuelled by the reduced income of the population, cross-border purchase of goods for domestic sales and the poor ability of the state to identify illegal business operations and collect taxes.

Under pressure from various stakeholders, the government has often resorted to a disruptive, that is, stop-and-go reform policy. The first five IMF stand-by agreements signed after 1989 were not completed; only the sixth one was successfully completed as late as 2003. No less than 14 different laws dealt with the foreign investment

Table 10.1 Chronology of major reforms

Year	Reforms
1990	Reforming the political system, first free elections held; first price liberalization.
1991	New Constitution; privatization law (first in a series of numerous laws on privatizations); company law; banking legislation.
1992	State trading monopoly abolished; small-scale privatization begins; major price liberalization.
1993	EU Association Agreement signed; new fiscal legislation (VAT introduced); State Ownership Fund established as main privatization agency; five Private Ownership Funds also created.
1994	National Securities Commission established, T-bills market initiated.
1995	Bucharest Stock Exchange begins trading; WTO membership; restitution law; bankruptcy law; voucher privatization programme.
1996	Competition law; over-the-counter market established.
1997	Exchange rate unified; first sovereign eurobond; large-scale privatization commenced; enterprise liquidation programme begins; law on reorganization of utilities; major price liberalization; CEFTA membership.
1998	Full domestic convertibility of the local currency; energy law; new banking legislation; largest state-owned bank closed down.
1999	Local public finance law; corporate and income tax reform (global income tax introduced); severe fiscal and balance of payments adjustments; first state bank privatized; largest car producer privatized.
2000	EU negotiations begin; starts the process of adoption of the acquis communautaire; pension system reform.
2001	New privatization agency created; programme for liberalization of utilities prices adopted; the programme of capital account opening started (ended in 2006); largest steel maker privatized.
2002	New legislation reforming trading on the secondary market; new fiscal legislation (VAT and profit taxes modified, fewer exceptions allowed); a plan of measures to improve business environment adopted (reducing market entry barriers and supporting small enterprises); new agency for foreign investments created.
2003	Sunshine law adopted (transparency in government decisions); substantial progress in EU negotiations (22 chapters provisionally closed); largest bank privatized.
2004	New fiscal code (replacing all previous fiscal legislation); EU negotiations are completed.
2005	Flat tax rate is introduced; EU accession treaty is signed.

regime in the first 14 years of transition often accompanied by frequent changes of fiscal legislation. Privatization of most manufacturing companies was completed, but many privatization contracts went back to court, under suspicion of violation. The macroeconomic evolution in the transition period is perhaps best described by the changes in the inflation rate (EBRD, 2002) with its ups and downs. It took Romania about 15 years to reach a lower inflation rate (Table 10.2).

The first "transformational recession" (Daianu, 2000), 1990–1992, occurred by default; initial conditions mattered most compared to other economies in transition. The second recession (1997–1999) was provoked by poor macroeconomic conduct and inconsistent reform policies in the previous period. The first episode of growth in 1993–1996 ended up fuelling inflation as it was based on the surge in net domestic assets. Reforms were conducted by the concept of social justice implying the concept of giving plants back to people (Management and Employees Buy Outs or MEBO) or to working people in general via mass privatization. The second episode of growth that started in 2000 is based on an increase in net foreign assets, and reforms are mainly driven by the process of convergence to the EU. The role of foreign institutions has been a major determinant for the success of the reforms. In the absence of a properly defined and managed national reform programme, the reform programmes of the IMF and the requirements for EU accession became an "anchor" which prevented reforms from being detoured.

Objective of the analysis and research approach

This analysis will attempt to address the question of how the business environment in Romania has evolved over time. In order to be able to provide greater detail, we shall explore the progress made in developing the business environment, the barriers to its improvement, the support role of the state and the extent to which the macroeconomic changes influenced the business environment. Last but not least, we shall try to place the competitiveness of the business environment in Romania in an international context.

To do this we shall base our analysis on Porter's diamond. This is considered a standard method for benchmarking competitiveness, and the business environment is all about competitiveness after all. The

Table 10.2 Key macroeconomic indicators for Romania, 1990–2004

	90	**91**	**92**	**93**	**94**	**95**	**96**	**97**	**98**	**99**	**00**	**01**	**02**	**03**	**04**
GDP real growth	−5.6	−12.9	−8.8	1.5	3.9	7.1	3.9	−6.6	−5.4	−3.2	1.6	5.3	4.9	4.9	8.3
Inflation Dec./Dec.	37.7	222.8	199	295	61.7	27.8	57	151	40.6	51.4	40.7	30.3	17.8	14.1	9.3
Unemployment	–	3	8.2	10.4	10.9	9.5	6.6	8.8	10.3	11.5	10.5	8.6	8.1	7.6	7.2
Current account deficit/GDP	8.5	3.5	8	4.5	1.4	5	7.2	6.7	7.5	3.8	4	6.1	3.4	5.6	7.3
Budget deficit/GDP	0.4	1.9	4.4	2.6	4.2	4.1	5	3.6	2.8	2.5	3.6	3.1	3.1	2.7	1.5
Total foreign debt/GDP	0.9	5.3	12.6	12.7	15.1	15.4	20	22.4	24.4	24.6	26.6	30.2	32	54	33

Source: Adapted from NBR statistics.

four sides of Porter's microeconomic competitiveness are addressed in detail:

(1) Factor conditions; the focus is on assessing the infrastructure (physical, administrative) and the capital market.
(2) Demand conditions; the focus is on local customers and government consumption.
(3) Related and supporting industries; the focus is on local availability of components and parts and it goes further, to discuss the specificity of Romanian foreign trade and the role of FDI in technology transfer.
(4) Context for firm strategy and rivalry; the focus is more on competition aspects, including privatization methods, market entry and exit.

This approach is supported by the triangulation method, which means blending of quantitative and qualitative data analysis. Some business environment indicators are taken from the Global Competitiveness Report data base; other indicators, especially those on foreign trade and foreign capital flows (Buch and Piazolo, 2000), are based on national and international statistics.

Figure 10.2 illustrates the main characteristics of the microeconomic business environment in Romania using a Porter-type of diamond to describe it.

In the category of factor (input) conditions, Romania still underperforms on aspects linked to physical and administrative infrastructure, and the laws on intellectual property protection are yet to be fully implemented. Capital resources are thin, and financial intermediation is again acknowledged as an important problem. The only competitive input condition is its human resources that are well above the world average in terms of education, skills and qualification, and even above those in some other transition economies.

The demand conditions are quite relaxed, in the sense that demanding regulatory standards, environmental and accounting legislation are not fully implemented, while consumers are not very sophisticated. A possible explanation is the limited domestic absorptive capacity, given the relatively low wages. However, as certain income groups are being differentiated, the level of sophistication is increasing for the upper income segments and the surge in sales of luxury cars and mobile telecommunication operators point towards such a process.

The related and supporting industries reflect a significant local availability of components and parts, although the local supplier quality is

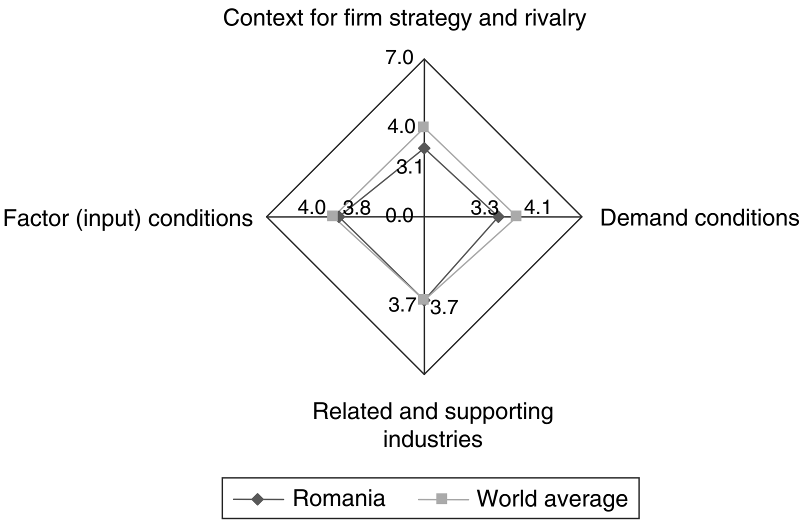

Figure 10.2 The microeconomic business environment
Source: Based on World Economic Forum (2004) *Global Competitiveness Report 2003–2004*, with reference to Porter's framework (2003).

not very high. These attributes explain, to a certain extent, the fact that the local industry is mainly based on assembling operations (parts and components for machines and equipment, or some assembling operations in clothing and footwear), and that the products exported by the local industry usually compete in the low market segments.

The context for firm strategy and rivalry is dominated by the lack of effectiveness of the competition policy. State aid still prevents many state-owned companies from exiting the market, while the poor implementation of the anti-trust regulations creates market entry barriers for potential newcomers. Corruption also adds to the problem, as well as the rather confrontational nature of the labour-employer relations.

Henceforth these aspects will be addressed in more detail.

Findings

Factor (input) conditions

Infrastructure

The main obstacles to business are shown in Figure 10.3. Poor infrastructure is one of them, but red tape and corruption are far more important.

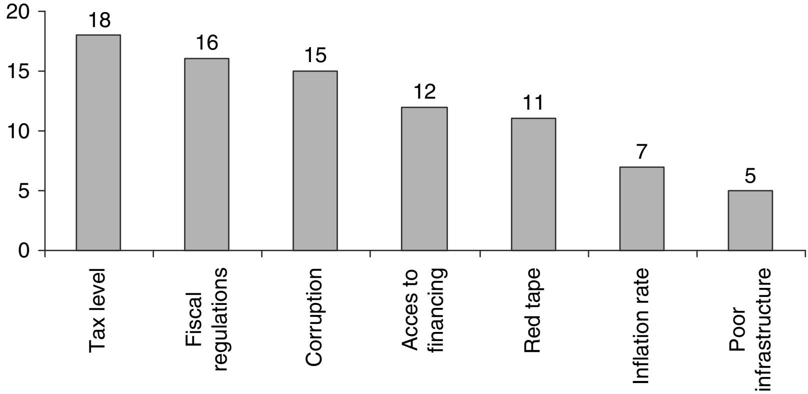

Figure 10.3 Main obstacles to business, survey results (percentage of total)
Source: World Economic Forum (2004), *Global Competitiveness Report 2004–2005*.

The inflation rate has steadily diminished as a barrier to business, but the fiscal burden still remains important. A new fiscal code, introducing the flat tax rate in 2005, has simplified taxation, but other related aspects, such as the tax collection rate and the stability of fiscal regulations, are still to be addressed.

Infrastructure investments have ranked high on the public agenda, in view of the EU accession. Physical infrastructure has been continuously improved using EU structural funds but also at the expense of larger budget deficits.

The financial sector

The Romanian financial system is based on the banking sector, which holds more than 95 per cent of the total assets in the system. The banking sector witnessed a series of major failures during the1990s, which diminished its credibility. All bank crises in Romania stemmed from fraudulent activities of shareholders and/or managers. Fraud risk, spurred by the sub-optimal performance of the judiciary, continued to be one of the direst threats to the supervisory authority. The banking system has been cleaned up in recent years, but its strength has yet to be tested over a longer period of time, while the capital account opening has certainly challenged its stability.

Following the series of bank failures in the second half of the 1990s, current prudential regulations are based on best practices. The regulations in this field, though incomplete, are in line with EU norms and regulations. The National Bank of Romania (NBR) implemented the final regulations issued by the Basle Committee in 2002. Results were fast to appear, that is, the ratio of non-performing loans to total assets in the banking sector was cut from 14.5 per cent at the end of 1998 to 0.2 per cent at the end of 2003; the solvability ratio (capital adequacy) surged from 10.2 per cent in 1998 to 19.9 per cent in 2003 (well above the 12 per cent benchmark).

Furthermore, foreign capital is dominant in the banking sector. Foreign capital ownership in the total banking capital rose to 58.7 per cent in 2002 versus 35.8 per cent at year-end of 1998. The decreasing share of state-owned banks seriously restricted the scope of resource misallocation through the banking channels. Moreover, in 2003, the largest bank in the system, Romanian Commercial Bank, was also privatized, which increased foreign ownership in the banking sector to 90 per cent. Banking concentration in Romania is fairly high – the five biggest banks hold more than two-thirds of total assets and loans and three-quarters of the T-Bills portfolio, a common feature in many transition economies.

However, when compared to other transition economies, the Romanian financial sector is still underperforming, primarily in terms of financial intermediation and insufficient development of non-banking financial markets. This underdevelopment proved to be an asset in the late 1990s, when it insulated the Romanian banking system from the shock waves of the Asian and Russian crises.

The main flaw of the banking system is the poor banking intermediation, which constitutes a constraint to exchange rate and monetary policy conduct amid large capital inflows. The 2004 share of broad money in GDP (the level of monetization) was 25 per cent, and it has hovered around this figure for most of the transition years. Low monetization of the economy renders even small capital inflows to have a significant impact on broad money. An upsurge in capital inflows, following the capital account liberalization and spurred by the interest differential, may easily surpass the speed of re-monetization, resulting in increasingly higher sterilization costs (around 1 per cent of GDP in 2001 and 2002). Total sterilization efforts amounted to 10 per cent of GDP in 2004.

Non-governmental domestic credit has also been historically low, at less than 10 per cent of GDP for most of the transition years. The spread between active and passive interest rates is not helpful, as it stays rather constant, despite both rates going down impressively in the last years; the active rate decreased from 63.7 per cent at year-end of 1997 to

25.4 per cent at the end of 2003, and the passive rate decreased from 51.6 per cent at the end of 1997 to 10.8 per cent at the end of 2003. When the domestic credit nevertheless spurred in 2003 to 15 per cent of GDP, the NBR was fast to intervene to stop a balance of payments damaging consumption spree.

The array of available financial instruments is relatively small and, accordingly, they are less effective. Inter-bank deposits, including deposits taken by the central bank, hold the largest share of the inter-bank market. The NBR lacks its own intervention instruments and the market of government securities has some weaknesses. The capital market is very small both in terms of share in total domestic financial assets, and in terms of regional development. The capital market was subjected to new regulations in 2002, aimed at increasing liquidity and decreasing captive shareholders. The main effect of this was an avalanche of de-listings. Despite these weaknesses in various aspects linked to the operation of the financial sector, the NBR pressed ahead with the liberalization of the capital account, paying little interest to the differentiation between short-term and long-term capital flows, and between inflows and outflows.

Demand

Local customers

Voinea and Simionescu (2005) ran an econometric test, based on the results of a questionnaire applied to a representative sample of 170 Romanian industrial firms, aimed at identifying the determinants of domestic and foreign competitiveness. Some indirect conclusions can be drawn from the finding regarding the sophistication of local customers. Data show that for domestic competitiveness the only research and development (R&D) variable which counts is the introduction of new methods of distribution. The fact that new products or new processes failed to be statistically significant for domestic competitiveness may suggest that the nature of competition on the domestic market has been altered. Competition is on distribution, not on innovation; new products do not change the competitive position. A likely explanation is that market entry barriers, which are still high, limit competition in the domestic market. This result fits the theoretical framework developed by Voinea in 2003, stating that various market power inducements granted in transition economies transform location advantages into ownership advantages, therefore diminishing the incentives for technological transfer and R&D.

Government consumption

We refer here to the way in which government consumption may affect the business environment (Dunning and Narula, 1998), namely, the phenomenon of state capture. Government consumption through captured firms is not a healthy kind of consumption, and it alters the business environment. State capture refers to the fact that firms might influence the rules of the game, including legislation, laws and public procurement. The captive state has been a widespread phenomenon in transition economies (Table 10.3). This refers to the share of firms as a percentage of total firms, but the figures would have been higher if turnover of captor firms is accounted for. Fries *et al*. (2003) found a positive correlation between firms engaging in state capture and their average investment and real revenue growth rates. State capture has an important impact on government consumption via public procurement. This is particularly valid in transition economies, where public procurement for infrastructure works is frequent.

Related and supporting industries

FDI penetration and impact on manufacturing

In the structure of foreign capital inflows to Romania, official flows from multilateral creditors were dominant in the first years of transition (1990–1995), portfolio and short- and medium-term foreign private debt boomed later (1996–1997), while foreign remittances became dominant after 2000 as a share in net foreign capital inflows. FDI was prevalent

Table 10.3 Extent of state capture

Country	Proportion of captor firms	Proportion of firms affected by capture
Albania	12.4	44.7
Bulgaria	10.0	45.6
Croatia	11.2	22.5
Czech Republic	2.6	22.8
Estonia	6.5	8.2
Hungary	6.0	11.2
Poland	3.6	16.6
Romania	4.7	24.3
Slovak Republic	4.7	27.1

Source: Fries *et al*. (2003).

only in 1998 and 1999, when the volume of speculative flows was net negative.[2]

FDI was very modest in the first transition years given the administrative barriers, the soft budget constraints to local firms acting as competitors of potential foreign investors, the substitution of market-seeking FDI by imports in the context of trade liberalization, and the initial prevalence of privatization methods that were scarce in foreign inflows due to the MEBO and voucher-type mass privatization.

Cumulative FDI inflows in Romania in the 1990–2003 period total 10 billion dollars. FDI inflows increased substantially since 1997, when altogether 9 billion dollars were accumulated. FDI inflows to GDP ratio in 1997–2003 ranged between 2.6 per cent and 4.9 per cent; FDI stock to GDP ratio was 20 per cent in 2003. Most of FDI[3] is concentrated in industry (44.4 per cent), followed by wholesale trade (14.4 per cent), services (17.0 per cent), transport (7.4 per cent), retail trade (5.8 per cent), construction (4.5 per cent), agriculture (3.6 per cent) and tourism (3.1 per cent).

Dunning's L advantages, a mix of infrastructure, resources, labour force skills and costs, large technological advantage of the foreign investor, fiscal policy and so on), deriving from the principles of economies of scale and scope, have been triggers for foreign investors looking to invest in Romania. In addition to cheap labour, a large domestic market and the country joining the EU, which has led to greater institutional convergence, brought into the country an increasing number of investors. As argued above, the possibility to conclude special deals with the government added to the L advantages. In fact, market power inducements granted in the privatization process turned potential dynamic ownership advantages stemming from innovation and technology into static advantages, derived from market entry barriers to other investors.

The process of international relocation that substituted to a large extent international expansion, especially in oligopolistic industries, has also been instrumental in determining the growth of FDI flows to Romania. It is worth mentioning here that foreign investments in transition economies tend in fact to concentrate in sectors with international markets dominated by large oligopolistic firms (Kogut, 1996), in industries such as auto manufacturing, food processing, tobacco and cement. In Romania, these industries are already dominated by foreign capital.

As far as manufacturing is concerned, foreign-controlled enterprises accounted for more than one-third of the share capital, 34.8 per cent in

2001, compared to only 4 per cent in 1995, one-quarter of the employees, and 43.9 per-cent of exports (Hunya, 2003). Voinea (2003) shows that FDI share in manufacturing industry turnover grew from 5 per cent in 1995 and 11 per cent in 1998 to 29 per cent in 2001. The following sectors have recorded an above average foreign capital contribution: food industry (DA); non-metallic mineral products (DI); metallurgy (DJ); machines and equipment (DK); electrical and optical equipment (DL); means of transportation (DM). As for other sectors such as textiles and clothing (DB), footwear (DC) and furniture (DN) – which account on aggregate for more than 55 per cent of Romanian exports to the EU – the lower FDI presence is outbalanced by the wide-scale use of subcontracting practices through intermediaries. Voinea (2003) also found a positive correlation between the level of foreign capital penetration in the Romanian manufacturing sector and the productivity gains in the same sector.

Manufacturing sectors with above average foreign capital penetration also recorded above average productivity level rise, that is, they had relative productivity gains. Another study (Damijan *et al.*, 2002), pointing in the same direction, found that foreign ownership contributed to the average growth rate of firms of 1.1 per cent – the highest level among EU candidate countries at the time of the study.

However, the explanatory power of the independent variable "foreign penetration" (shown in Figure 10.4), proxied by the FDI share in each manufacturing sector's turnover, is nevertheless limited in explaining the evolution of the dependent variable "productivity gains".

One possible explanation refers to the issue of causality, that is, foreign firms might tend to establish themselves in industrial sectors with high productivity levels. In the period analysed, 1995–2003, four of the six sectors with relative productivity gains in Romania also obtained relative productivity gains in most of the other transition economies.

Another possible explanation is that some sectors might have been underdeveloped or underperforming before the FDI penetration, but this was not primarily due to lack of FDI. The economic structure inherited from the communist regime misallocated resources and some industrial sectors were overstaffed with employees. One way to obtain productivity gains was to lay off employees, and this practice took place irrespective of the nature of the capital (local or foreign). The number of employees went down in 2001 compared with 1995 by 3.6 per cent in the food industry, by 13.8 per cent in metallurgy, by 23.1 per cent in mechanical machines and equipment and by 3.8 per cent

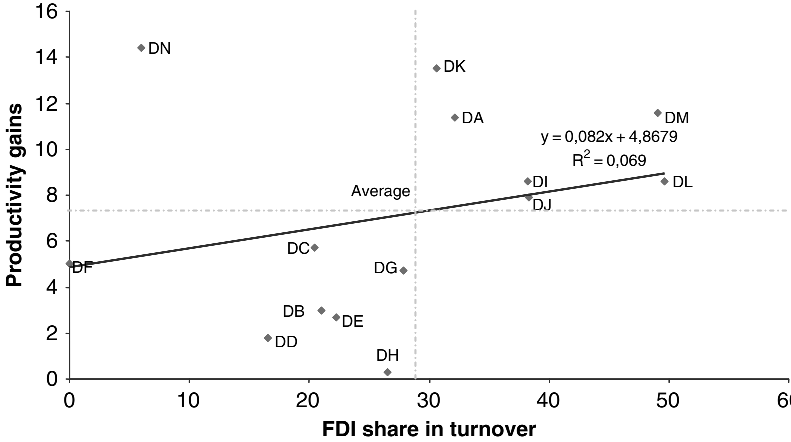

Figure 10.4 FDI penetration (2001) and productivity dynamics (2001 compared with 1995) (percentage, by manufacturing sectors)
Source: Voinea (2003).

in the electrical equipment industry. When calculating productivity gains based on value added, a stronger correlation with foreign ownership is found (Smarzynska, 2002). However, the latter data cover only the period 1996–2000 and make no distinction between various manufacturing sectors.

Productivity gains were also recorded in sectors that had below average foreign penetration, yet they depended on foreign demand and/or capital. As mentioned before, subcontracting replaced the need for FDI in sectors such as textiles and clothing, leather and footwear, or furniture. More than two-thirds of Romanian exports in the textile and clothing industry are done under lohn agreements.

Finally, the level of FDI penetration may not be the perfect tool to analyse the FDI impact in a transition economy, as one suit does not fit all foreign investors. Recent international literature goes in the direction of conceptualizing strikingly different empirical observations, arguing that foreign ownership in itself is not a determinant of the performance gaps between foreign and local firms; instead, the multinationality of firms turns out to be more important.

Regarding the net effect of FDI expansion or relocation and domestic firms' reorganization, theory predicts that labour productivity gains will in the long run translate into wage increases, price cuts, and a consequent increase in demand and therefore an increase in the demand for labour. However, this may be valid only for well-established markets and growing sectors.

In transition economies, Romania included, productivity gains do not translate automatically into welfare gains for a number of reasons. First, wages increase by only a portion of productivity gains, as low unit labour costs are a very significant aspect of competitiveness, more important than innovation, for example. This is in particular true for efficiency-seeking FDI as opposed to market-seeking FDI, but also for local firms trying to survive. In the Romanian manufacturing industry, unit labour costs more than halved in 2002 compared with 1998 (Voinea, 2003). Second, prices were initially below world market levels and the Balassa-Samuelson model predicts price increases going hand in hand with economic progress, that is, catching-up taking place. Third, recession cycles, exchange rate depreciation and episodes of increased fiscality – to mention just a few of the determinants – have not encouraged domestic consumption. Furthermore, an increase in domestic consumption does not mean that it will automatically lead to an an increase in domestic employment; quite the contrary, an increase in foreign employment may be stimulated if the local demand for current consumption goods is met primarily from imports, which is the case in Romania.

Specialization in foreign trade

The trade openness index has surged from 43 per cent in 1993 and 55 per cent in 1999 to 74 per cent in 2003. Trade increased with other EU countries, the volume of trade between the EU and Romania skyrocketing from less than US$4 billion in the early 1990s to more than €20 billion one decade later. Trade creation with the EU has also been accompanied by a learning process, reflected in the improved export/import coverage ratio from 62 per cent in 1992 to 90 per cent in 2003. The clothing industry is the largest exporter from Romania and accounts for 25 per cent of all exports, followed by the machines and equipment sector. The latter is also the largest importer industry accounting for 28 per cent of all imports, followed by the textile industry. Exports of these two industries are in fact dependent on intra-industry productive inputs from imports, and most of the exports are made under various loan or licensing agreements. The sectors with above average foreign capital penetration appear on the winning side of the Romanian foreign trade, as they both record improved performance and increased specialization. Food industry, machines and

	IIT upward	IIT downward
RCA upward	• Food industry including beveages and tobacco (gr.IV) • Mineral products (gr.V) • Machines and equipment (gr.XVI) • Means of transportation (gr.XVII) • Optical, medical instrumental (gr.XVIII)	• Unprocessed wood (gr.IX)
RCA downward	• Vegetable products (gr.II)* • Pulp, paper (gr.X) • Cement, glass (gr.XIII) • Metal products (gr.XV) • Furniture (gr.XX)*	• Animal products (gr.I) • Animal, vegetable oils (gr.III) • Chemical products (gr.VI) • Production of rubber plastic (gr.VII) • Leather, furs (gr.VIII) • Textiles and clothing (gr.XI) • Footwear (gr.XII)

Figure 10.5 Performance and specialization in Romanian foreign trade by product group, SITC-2 classification, 2001 vis-à-vis 1993
Source: Voinea (2002).

equipment, and transportation means show both upward trends and revealed comparative advantages (RCA)[4] and intra-industry trade (IIT),[5] while metallurgy also shows upward IIT (Figure 10.5).

The increase in specialization reflected by IIT says little by itself on whether this intensification of the IIT coincides with local production integration in the international production networks.

One of the first attempts to answer this question was by Kaminski and Ng (2005) who employed 1998 data and discovered that 52 out of the 60 best-performing Romanian export products do not have a double RCA (for exports and imports alike). He interpreted this result in the sense that the respective products were only assembled in Romania. Recent data (Caetano *et al.*, 2002) show that Romania has the lowest share of intermediary goods imports among all new EU member countries, while standing on more comparable terms with them when exports of intermediary goods are concerned. The extremely large spread between the exports and the imports of intermediary goods appears therefore as an indicator of the lack of integration of Romanian products into the international production and distribution networks. The name of the game is fragmentation, that is, assembly operations with low value added, rather than integration. Nevertheless, one should mention that other patterns of Romanian foreign trade match the trends observed in other new EU member states, concerning a lower share of primary goods in the export portfolio, an increasing share of intermediary goods exports and imports, an increasing share of capital goods exports and imports and a decreasing share of consumption goods imports. All these dynamics are not misguided, but they seem to have a lower intensity in the case of Romania.

The trend of Romania's foreign trade in the past decade was to trade more vertically differentiated goods, that is, cheap, low quality products remain predominant (Ciupagea *et al.*, 2002). If we consider price as a proxy for quality, then two-thirds of Romania's exports are of inferior quality; competition is on price, not on innovation. One can see, however, a slight increase in superior quality exports based on a higher value added. Nevertheless, the foreign trade structure yet remains, from the price–quality perspective, one of the most unbalanced among the new EU member states (Table 10.4).

The vertical specialization on lower quality/lower price products in the Romanian foreign trade is typical across most industrial sectors. In metallurgy, even after being acquired by a large foreign investor, SIDEX has maintained its production orientation towards flat products, which are considered of lower quality and less value added than the long products. In the auto industry, Renault, the buyer of carmaker Dacia, transfers technology and stimulates innovation with the aim of producing a new Dacia model for emerging markets only, hence inferior in quality to the Renault models sold in the Western markets. In the clothing industry, Romanian products compete on products with medium to low unit values (Cojanu *et al.*, 2003).

Context for firm strategy and rivalry

Ownership changes: privatization

Law 58/1991 set the framework for privatization by creating two institutional tools: (1) the State Ownership Fund, a public institution administering the state's stakeholdings representing 70 per cent of the share capital of all companies subject to privatization; (2) five regional Private Ownership Funds, organized as joint stock companies, administering the remaining 30 per cent of the share capital of all companies subject to privatization; this 30 per cent was to be freely distributed to

Table 10.4 Exports classification by price–quality ranges (percentage of total exports)

	1993			2000		
	Inferior (low technology)	**Medium**	**Superior (high technology)**	**Inferior (low technology)**	**Medium**	**Superior (high technology)**
Romania	78.3	8.9	12.5	63.7	16.4	19.7
Hungary	52.4	23.5	23.9	41.1	30.2	28.9
Poland	73.6	18.1	8.1	59.8	22.6	17.5
Czech Rep.	70.6	16.1	13.0	61.1	21.9	16.9
Bulgaria	62.9	21.2	12.8	44.3	46.4	9.1
Slovakia	73.8	15.9	8.9	50.5	36.9	12.6
Greece	28.9	35.3	30.2	34.0	38.8	25.2
Spain	47.4	34.9	14.7	46.1	34.6	18.3

Source: Caetano *et al*. (2002).

the population, split into millions of vouchers with an equal nominal value.

Despite numerous changes in the privatization-related legislation, these two institutions have made their mark on the privatization process ever since. The State Ownership Fund, initially designed to function for no more than seven years, prolonged its activity and was renamed in 2001 as the Agency for Privatization and Administration of State Stakeholdings (APAPS). From a portfolio of over 7000 state companies in 1993, less than 400 of them remained to be privatized by the end of 2002. The Private Ownership Funds were later (1996) transformed into Financial Investment Societies and currently represent major players on the Bucharest Stock Exchange.

Privatization has usually been seen as a cure for state-owned companies' lack of efficiency, and for the central budget's lack of funds. Privatization creates better conditions for restructuring, frequently via improved corporate governance and capital inflows. Yet, as a number of cases in Romania show, privatization is not a success story *ipso facto*, due to a number of reasons. These include but are not limited to unfriendly market conditions, unfair competition, union pressures, compensatory mechanisms unfamiliar to the new owners, or just because the new owner is unable to change the loss-making characteristics of the privatized company and execute the necessary investment and restructuring programme.

Historically, the main methods of privatization employed were as follows:

- *MEBO* – Management and Employees Buy Outs, which prevailed in the period 1993–1996 with a peak in 1994. The first serious privatization effort pursued nationwide had a big shortcoming in that it did not provide significant capital inflows. At the time of privatization, this was somehow normal, given the scarcity of indigenous capital. It proved to be less normal in the later stages, when the new owners, in most cases managers, tried to prevent employees from trading their shares. Intruders were kept at a distance – but so were potential capital inflows. Even when it was possible to trade shares, the outsiders were reluctant to invest in companies with significant insider ownership as the firms were also operating in an environment with underdeveloped corporate law and disclosure rules.
- *Vouchers* – the Mass Privatisation Programme (mainly 1995) was a voucher type of asset distribution. A problem stemmed precisely from the "too little and too many" feature of the programme – lack of earnings for the government, and lack of incentives for the shareholders.

Corporate governance problems appeared as a result of the diffusion of control within the privatized companies; this, however, stimulated trade with vouchers on the black market.

- *Direct sales* became predominant in the period 1996–1998 and accounted for 68.7 per cent of all privatization deals in 1996 and 81.6 per cent in 1997, and for 65.8 per cent of large privatization deals in 1998. The prevalence of direct sales in 1997 and 1998 was probably linked to the "hunger" for foreign exchange the country faced in those years. A large part of the privatization-related FDI stock was accumulated in 1997–1999, when direct sales represented by far the most prevalent method. Foreign-controlled enterprises were the main beneficiaries of this method, as they had the best bargaining capabilities due to their regional/global reach. Direct sales presuppose a phase of direct negotiation with a selected investor; in the process of negotiation, various market power inducements are likely to be granted by the state to the investor. Fears have been expressed that inherent competition problems appear in the post-privatization stage, deterring potential capital inflows from other investors. A subsidy lessens the net cost disadvantage of multinational production, therefore decreasing the magnitude of innovations under FDI (Glass and Saggi, 2002); positive discrimination is such a subsidy. The so-called "golden share" retained by the state has sometimes accompanied the direct sales method, but this practice has been dropped, as it contravenes the provisions of EC C220/1997. The controlling golden shares have been transformed into normal shares.
- *Auctions* (used on a wider scale since 1998) were intended to eliminate disputes over the privatization price, as it had to be the best price offered, not the absolutely best price. However, the method runs the risk of receiving offers that may prove politically unacceptable; the lack of a uniform method of evaluation also runs the risk of subjectivism.
- Privatization through *capital market channels* had relatively modest results, in line with the modest performance of the Romanian capital market institutions. Indicating the slow privatization prospects through the Bucharest Stock Exchange, there were cases when typical portfolio investors acquired the majority stake in a listed company, mainly in order to protect their initial lower investment, either from poor management in the absence of privatization or from another investor that wouldn't like strong minority stakeholders.

Out of the aggregated FDI stock in the Romanian economy, about half came as a result of privatization deals (49 per cent). Privatization revenues have dropped in recent years as a share of GDP from 1.8 per cent in 1998 to 0.2 per cent in 2002 both by decreasing the number of deals concluded (from over 1000 per year between 1997 and 1999 to slightly above 100 per year in 2001 and 2002), and by expanding GDP. This does not mean that privatization is over; some key assets in the economy are still under the administration of the *regies autonomes* and national companies; also some large companies were under the administration of other authorities as of end-2004. The most successful privatization to date is SIDEX, the largest steel maker in CEE and also the largest black hole of the Romanian economy, sold in 2001 to the Indian-British LNM Group. An analysis of this privatization (Voinea and Dancau, 2003) suggests that such a success story cannot be replicated unless a mix of conditions exists. They include a commodity type of industry or at least an industry with an appetite for consolidation, an existing demand for a company's products, and an investor with a global reach and a focus on emerging markets.

Market entry and market exit

Severe market failures similar to those in the early stages of transition in Romania may increase the desire to correct the failure by regulating market entry. The temptation should be resisted (World Bank, 2004) because the cost of government inefficiency may outweigh the benefits of stricter regulation. Usually, cumbersome entry regulation is associated with less private investment, higher consumer prices, greater administrative corruption and a larger informal economy.

Romania seems to be in a favourable position in this regard as the time, number of procedures and cost of starting a business are generally lower than those in other transition economies (Tables 10.5 and 10.6).

However, this seemingly favourable position is a recent phenomenon as there have been initiatives for improving the business environment by introducing the "one stop shop" for registering a new business and the silent consent procedure in approving registration. The proportion of newly registered companies in the trade register has increased from 6 per cent in 2001 to 8 per cent in 2002 and 9 per cent in the first half of 2003, but this might also be explained by the improved macroeconomic conditions and the rising rates of gross domestic fixed capital formation.

Nevertheless, the effectiveness of these measures is still debated. For example, the World Economic Forum (*Global Competitiveness Report 2003–2004*) has a strikingly different assessment of start-up indicators for Romania than the World Bank. For the same year, 2002, the World Economic Forum counted nine procedures, 48 days and US$543 needed to start a business. By contrast, the World Bank came up with six

Table 10.5 Business indicators (2002)

	Number of procedures	**Time (days)**	**Cost (USD)**	**Cost (% of income per capita)**	**Minimum capital (% of income per capita**
Romania	6	27	217	11.7	3.3
Other transition economies					
Bulgaria	10	30	148	8.3	134.4
Croatia	13	50	843	18.2	50.7
Czech Rep.	10	88	648	11.7	110
Hungary	5	65	3,396	64.3	220.3
Latvia	7	11	513	14.7	93
Poland	12	31	925	20.3	21.4
Russia	12	29	200	9.3	29.8
Slovak Rep.	10	98	401	10.2	111.8
Selected EU economies					
Finland	4	33	739	3.1	32
France	10	53	663	3.0	32.1
Germany	9	45	1,341	5.9	103.8
Greece	16	45	8,115	69.6	145.3
Italy	9	123	4,565	24.1	49.6
Portugal	11	95	1,360	12.5	43.4
Spain	11	115	2,366	16.4	19.6
UK	6	18	264	1	0.0

Source: Adapted from World Bank (2004), *Doing Business in 2004*.

procedures, 27 days and US$217. Both estimates are based on local surveys. Consequently, the only rational conclusion is that the business environment is still not uniform, and market entry barriers persist.

Market entry barriers are often coupled with market exit barriers. An econometric study by Claessens and Klapper (2002) found a negative and significant correlation between the time needed to start a business and the frequency of bankruptcy cases. Countries with formal or informal market entry barriers have a lower rate of firms going bankrupt. One explanation could be a natural selection process as only firms capable of surviving usually manage to overcome high market entry barriers. Another possible explanation could be that market entry barriers keep artificially alive the loss-making companies already operating in the market. However, the explanation most likely valid for

Table 10.6 Business indicators (2004)

	Time (years)	Cost (% assets)	Creditors' priority[a]	Efficient outcome achieved[b]	Goals of insolvency index[c]
Romania	3.2	8	3	0	39
Other transition economies					
Bulgaria	3.8	18	1	0	48
Croatia	3.1	18	1	0	50
Czech Rep.	92	38	2	0	42
Hungary	2	38	2	0	38
Latvia	1.2	4	1	1	92
Poland	1.5	18	2	1	70
Russia	1.5	4	2	0	58
Slovak Rep.	4.8	18	1	1	71
Selected EU economies					
Finland	0.9	1	1	1	99
France	2.4	18	2	0	43
Germany	1.2	8	1	0	61
Greece	2.2	8	2	0	42
Italy	1.3	18	2	0	46
Portugal	2.6	8	3	1	66
Spain	1.5	8	3	1	68
UK	1	8	1	1	86

Notes:
[a] Creditors get paid: 1 first; 2 after workers; 3 after workers and state budget.
[b] Efficient outcome: 1 achieved: the insolvency process results in either foreclosure or liquidation with a going-concern sale or in a successful rehabilitation maintaining the business; 0 not achieved.
[c] Goals of efficiency index is the simple average of the other four indicators: 0 minimum efficiency; 100 maximum efficiency.
Source: World Bank (2004), *Doing Business in 2004*, based on a survey of a representative number of law and consulting firms in each country.

transition economies, Romania included, is that both procedures, for market entry and market exit, require an effective public sector, which transition economies have not been able to develop yet.

In the period 1997–2002, about 40,000 bankruptcy cases were brought to court in Romania, which meant an annual average of 6700 cases, or less than 1 per cent of all registered companies. This low figure is similar to data reported for Southern EU countries such as Italy, Greece, Spain and Portugal, and is also similar to Poland which has inherited comparable structural strains from the communist past. Claessens and Klapper (2002) also found out that the higher the GDP per capita, the higher the frequency of bankruptcies as a higher level of development implies a higher efficiency of the judicial system and availability of more sophisticated financial instruments. Equally the lower frequency of bankruptcies may be related to the prohibitive cost of bankruptcy procedures to small firms.

These findings are also being validated by Romania's experience with low frequency of bankruptcy cases. As the level of GDP per capita is not high, the operating financial instruments are not very sophisticated, and most registered firms are small- and medium-sized enterprises (SMEs).

As far as the law on bankruptcy is concerned, legislation in Romania is similar to the French one, that is, creditors are paid after employees (like in France, Italy and Greece) and after the state budget as well (like in Spain and Portugal). The low efficiency of both the procedure and the outcome (comparable to that in some French-based legislation systems such as those in France or Greece, and to that in some transition economies like Bulgaria, Hungary and the Czech Republic; see Daianu *et al.*, 2004) demonstrates not only the need for a change in legislation, but also the fact that other related aspects – such as strong institutions, professional judges and administrators – are not functioning well. Changes in legislation in 2004 favoured liquidation and creditors instead of reorganization, but the other related aspects are more difficult to change in the short run.

State aid

The competition policy has proved to be not very effective. Its first pillar, the anti-trust policy, came under fire for a number of disputed acquisitions (privatizations), which was detrimental to competition in the post-privatization phase. The case of the cement industry is one example. Moreover, the second pillar of the competition policy, that is, state aid, creates even greater concern. This is mostly due to the fact that state aid has increased, while it should really be offered in exceptional cases only. The share of rescue and restructuring aid as a percentage of total state aid grew between 1998 and 2001 from 17.4 per cent to 44.6 per cent. Such dynamics suggest that bankruptcy in the Romanian economy is not only of an individual nature, but it also has a systemic determinant. Hence, it needs a systemic repair mechanism, such as rescue and restructuring aid. The share of debt rescheduling and writing off penalties in total state aid also increased from 10 per cent in 1998 to 38 per cent in 2001, which may indicate incapacity to pay off past debts.

In addition, proactive state aid, such as the aid for research and development or professional training, is negligible as the percentage of the total state aid. Efforts to deal with these challenges have been consistently implemented by the Romanian government in view of the requirements for EU membership and the EU competition policy (Tables 10.7 and 10.8).

Table 10.7 State aid characteristics, comparison between Romania and the EU

	Romania	**EU 15**
Per cent of GDP, yearly average 1998–2001	4.5	1
Trend 1998–2001, total aid	Increasing	Decreasing
Trend 1998–2001, aid for manufacturing, absolute volume/number of employees	Increasing	Decreasing
Priority objectives (excluding agriculture)	Sectoral	Horizontal
As part of horizontal objectives, greatest weight represented by:	Rescue-restructuring	SMEs and research and development

Table 10.8 Microeconomic business environment – a scoreboard

	Romania	**World average**
Factor (input) conditions	**3.8**	**4.0**
Physical infrastructure	**3.8**	**4.2**
Overall infrastructure quality	2.7	3.9
Railroad infrastructure	3.4	3.1
Port infrastructure quality	4.0	3.9
Air infrastructure	4.1	4.5
Electricity supply	3.8	4.6
Telecommunications	4.6	5.2
Administrative infrastructure	**3.3**	**4.1**
Judicial independence	2.4	4.0
Administrative burden for start-ups	2.8	4.1
Extent of bureaucratic red tape	4.8	4.3
Human resources	**4.9**	**4.0**
Quality of management schools	3.9	4.2
Quality of public schools	4.9	3.8
Quality of math and science education	5.9	4.1
Technology infrastructure	**3.7**	**4.0**
Availability of scientists and engineers	5.5	4.7
Quality of scientific research institutions	3.6	4.0

University/industry research collaboration	2.9	3.3
Intellectual property protection	2.8	3.8
Capital resources	**3.3**	**3.8**
Financial market sophistication	2.7	4.0
Venture capital availability	2.9	3.2
Ease of access to loans	3.2	3.2
Local equity market access	4.3	4.6
Demand conditions	**3.3**	**4.1**
Buyer sophistication	3.2	3.9
Consumer adoption of latest products	3.6	4.5
Government procurement of advanced technology products	2.9	3.6
Presence of demanding regulatory standards	3.2	4.2
Laws relating to information technology	3.6	3.7
Stringency of environmental legislation	2.9	4.0
Strength of auditing and accounting standards	3.7	4.8
Related and supporting industries	**3.7**	**3.7**
Local supplier quality	3.5	4.3
State of cluster development	3.2	3.2
Local availability of process machinery	3.3	2.8
Local availability of specialized research and training services	4.3	4.1
Local supplier quantity	4.4	4.7
Local availability of components and parts	3.5	3.2
Context for firm strategy and rivalry	**3.1**	**4.0**
incentives	**2.8**	**3.8**
Extent of distortive government subsidies	2.0	3.4
Favouritism in decisions of government officials	2.0	3.3
Cooperation in labour–employer relations	3.8	4.5
Efficiency of corporate boards	3.5	4.5
Subsidies and tax credits for firm level R&D	2.9	3.1
Competition	**3.3**	**4.2**
Hidden trade barrier liberalization	3.3	4.5
Intensity of local competition	3.6	4.7
Extent of locally based competitors	3.9	4.2
Effectiveness of anti-trust policy	3.1	4.0
Decentralization of corporate activity	3.2	3.9
Cost of other firms' illegal/unfair activities	2.5	3.9

Note: From 1 – worst, least developed to 7 – best, most developed. For the extent of distorting government subsidies, 1 means "keeping dying industries artificially alive"; for cooperation in labour-employer relations, 1 means confrontational; for efficiency of corporate boards, 1 means boards are dominated by management; for hidden trade barriers, 1 means these barriers are a big problem; for costs of other firms' illegal activities, 1 means big costs.
Source: Adapted from World Economic Forum (2004), *Global Competitiveness Report, 2003–2004.*

Lessons and conclusions

Romania has advanced considerably in terms of designing and implementing thorough systemic political and economic reforms, yet some of the issues pertaining to these reforms have not been fully implemented. Institutional fragility has also added pressure on the success of reforms. Many market institutions are new to the system, for example, the Competition Council or the National Securities Commission, and therefore they lack long-term experience that will allow them to establish greater social credibility and enforce their role.

Macroeconomic reforms were initially triggered by external actors such as the IMF, EU and the World Bank, which set difficult targets but prevented reforms from being detoured too much. Foreign financing of reforms has evolved from emergency, official and compensatory (debt creating) in the period 1990–1996 to project-driven, increasingly private and autonomous (non-debt creating). Progress is now visible, in terms of steady economic growth, decreasing inflation and cautious budgetary policy. The financial sector is becoming sounder, but the low level of intermediation remains a delicate issue.

The context of firm strategy and rivalry is dominated by issues in competition policy related to state aid and anti-trust regulations that still create some market entry barriers for potential newcomers. A major competitive positive input condition is the quality of the human resources.

Privatization has been systematically pursued, and it has been almost concluded in the manufacturing sector and the banking sector. Privatization has taken place at an extremely high social cost, but it has been recognized as a major lever for economic development and growth. Market entry and market exit barriers are interconnected, but serious steps have been taken to address problems in this area.

Romania is in a positive position of inward FDI, while outward FDI is almost negligible. The location advantages play an important role and fiscal incentives are designed to compensate for the problems in infrastructure. To a certain extent, market power inducements constitute an ownership advantage for the foreign investor, diminishing the need for innovation-driven ownership advantages. Foreign companies also contribute to some vertical integration into labour-intensive low technology sectors.

Applying Porter's stages of economic development, Romania has been moving from a factor-driven economy to an investment-driven economy. Low cost, highly qualified labour is the dominant source of competitive advantage and exports. Firms produce goods designed in other, more advanced economies (assembling operations). Technology is mainly assimilated through imports and FDI which are often inter-related. Vertical specialization is dominant in intra-industry trade, which means that competition is on price, not on innovation. Nevertheless, competition is improving, and FDI has been accumulating to reach more than one-fifth of GDP.

All in all, the Romanian business environment is becoming increasingly friendly, and the country is on the path of economic stability trying to improve its technology-intensive business standing.

Notes

1. The few episodes of workers' protests were nipped in the bud (Petrosani, 1977; Brasov, 1987).
2. Incidentally, they were again predominant in 2004, but only as a result of some large privatization deals. The sale of Petrom alone represented half of the €4 billion recorded in that year.
3. These data reflect shares in total FDI stock by the end of 2001 (Romanian Chamber of Commerce, 2002).
4. Comparative advantage is calculated using the formula:

$$ACRi = \ln [(xi/mi)/(X/M)]$$

where *xi* and *mi* represent exports and imports, respectively, from product group *i*, while *X* and *M* are total exports and total imports, respectively. In this understanding, a product has RCA if its coverage ratio exceeds the average foreign trade coverage ratio.
5. Intra-industry index, known as the Grubel-Lloyd index, is calculated using the formula:

$$IITi = 1 - [(xi - mi)/(xi + mi)]$$

The same meanings as above apply. This index may take values from 0 to 1; the closer to 1, the higher the specialization. The level of disaggregation employed here (two figures product groups) may determine higher IIT values; such an effect is, however, non-discriminating among product groups.

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11
Celebrity Endorsement in Brand Management in Croatia

Durdana Ozretic-Dosen, Vatroslav Skare and Zoran Krupka

Introduction

A number of studies have investigated the impact of celebrity endorsers on consumers' attitudes towards brands and on their purchase intentions. Despite the existence of extensive marketing literature and a growing use of celebrity endorsement in Croatia, little is known about how Croatian consumers react to celebrities in advertisements. Moreover, there is scarce knowledge about consumer opinion of or attitudes towards a celebrity endorsement strategy. This study represents preliminary, exploratory efforts to examine whether Croatian consumers recognize brands endorsed by national celebrities and to understand their opinions of and attitudes towards celebrity endorsement as a common and effective marketing practice employed for the purposes of brand management.

Literature review

Considerable evidence has been accumulated in the social sciences and in marketing about celebrity endorsement as a specific way in which meaning can be transferred to brands. McCracken (1989) defines the celebrity endorser as any individual who enjoys public recognition and who uses this recognition on behalf of a consumer good by appearing with it in an advertisement. As stated by Till and Shimp (1998), practitioners hope the positive feeling of their target audience towards a chosen celebrity will transfer to the endorsed brand or will otherwise enhance the standing of a brand. Erdogan and Baker (1999) report on managers' reasons for utilizing celebrity endorsement, awareness or attention getting, celebrity values define and refresh the brand image, celebrity adds new dimensions to the brand image, instant credibility or aspiration, PR coverage, desperate for ideas, convincing clients. Daneshvary and Schwer (2000) state how endorsers of brands take on many forms including identifiable people, unidentifiables (for example, typical consumers), corporations or organizations and inanimate figures (for example, cartoon characters), but the public attention has mainly focused on endorsements of identifiable people, more often referred to as celebrities.

According to Keller (1993), the desired outcome of the use of celebrity endorsement is a strong and positive link between the brand and the celebrity as a means of enhancing the respective brand equity. If used appropriately, Till (1998) suggests, celebrity endorsement can serve a valuable role in developing brand equity and enhancing a brand's competitive position. Mennon *et al.* (2001) report that consumers generally feel celebrities to be more attractive than non-celebrities, which may draw initial attention to the brand, but their findings also provide support to the consumers' view that celebrities are willing to endorse almost any product or service if the fee is right. Agrawal and Kamakura (1995) have found that the use of celebrity endorsement can have a beneficial effect on stock price.

As reported by Goldsmith *et al.* (2000), promotion activities are important means by which celebrities can be associated with a brand in a coordinated fashion. Erdogan *et al.* (2001) claim how because of their high profile, celebrities may help advertisements stand out from surrounding clutter, thus improving their communicative ability. Successful and unsuccessful marketing campaigns using celebrity endorsement abound. Yilmaz and Ersavaş (2005) report that the most widely used celebrities are sports figures, actors or other type of entertainers. According to Seno and Lukas (2007), celebrity endorsement roles can take the form of the celebrity as an expert, as a spokesperson associated with a product in a long-term capacity or as an aspirational figure with no particular knowledge of or relationship with the product.

Till and Busler (1998) state that potential endorsers could reflect a range of images, and brands may be able to create and/or reinforce an image as, for example, suave, tough, rebellious or sexy by associating themselves with the corresponding individuals as endorsers. Hsu and McDonald (2002) argue that depending on the characteristics of a brand, celebrities' personality and lifestyle meanings can be important qualities in determining the celebrities' congruity with the brand. According to Miciak and Shanklin (1994), in order to be successful celebrity endorsement should meet five baseline criteria that require trustworthiness:

they should be readily recognizable by the target audience; affordability; at little risk for negative publicity; and appropriateness matched with the intended audience. Also, Langmeyer and Shank (1994) stress that the celebrity's image, reputation and values are relevant to the brand she or he endorses and the notion that the match between endorser and product/service will have an effect (positive or negative) on the celebrity and the product/service she or he endorses is, by now, an accepted truism.

Kahle and Homer (1985) point out that physical attractiveness has been an important topic of research in social science and most studies have shown that a physically attractive source facilitates attitude change. Tripp *et al.* (1994) have found that a celebrity who is endorsing multiple products has a reduced credibility and likeability. Farell *et al.* (2000) argue that the professional success of celebrity endorsement, if publicized by the endorsed product's firm, improved consumer brand evaluations of the endorsed product. Dasgupta (2008) reports on cases where celebrity endorsement overshadowed brand-building performance and states that it is critical for marketing professionals to remember that it is a celebrity who is endorsing a product, and not vice versa.

Till (1998) claims how celebrity endorsements will be more effective when used consistently over time to increase the strength of the link between the celebrity and the endorsed brand. According to Silvera and Austad (2004), the effectiveness of celebrity endorsement is dynamic, dependent on the celebrity, the product and perhaps even on the societal conditions at the time and place where the advertisement is shown.

Research design and methodology

Sample, research instrument and procedure

A convenience sample of 584 respondents was used, consisting of three different groups of respondents regarding their current occupation: undergraduate students (297), marketing professionals (107) and other respondents with different occupations (180).

A highly structured questionnaire was used, consisting of 17 questions, out of which two were open and 15 closed; four of 17 questions related to demographics. The questionnaire consisted of two parts: in the first one, 11 national celebrities (sports and entertainment spokespersons) and 25 brands were listed. Respondents were asked to match a celebrity endorser with the respective endorsed brands on the basis of brand name recognition from the given list of brands. In the second part, a question consisting of ten statements was constituted with the help of existing literature – this part of the instrument was designed in line with the propositions made by Bruner *et al.* (2005) that were originally developed by Erdogan *et al.* (2001). Respondents gave their answers according to a five items Likert-type scale ranging from "extremely unimportant" to "extremely important". Respondents were asked to rate the relative importance of ten criteria, as shown in Table 11.1.

Data were analysed by means of *Statistica v7*. Different methods and techniques were applied, including mean values, standard deviation, t-test and one way ANOVA.

Hypothesis

In the present study, based on the preceding theoretical background, three hypotheses are set:

H1: The level of recognition of brands endorsed by Croatian celebrity endorsers are high and differ according to the profession of a celebrity.

H2: As perceived by Croatian consumers, celebrity credibility and celebrity-target audience match are the most important individual celebrity characteristics for successful brand endorsements.

H3: The importance of individual celebrity characteristics for successful brand endorsement significantly differs based on demographics (gender, education and occupation).

Results and discussion of findings

In terms of the demographics of all 584 respondents, 375 (64.21 per cent) were female and 209 (35.79 per cent) male. Of all respondents, 351 (60.1 per cent) were under 26 years old, 137 respondents (23.46 per cent) were between the ages of 26 and 35, 40 (6.85 per cent) were between 36 and 45 years old, 35 (5.99 per cent) were between 46 and 55 years old and 21 respondents (3.6 per cent) were over 56 years old. Most of the respondents (327, 55.99 per cent) hold a high school degree, while 196 (33.56 per cent) hold an undergraduate or graduate degree and 57 (9.76 per cent) hold a college degree; 4 (0.69 per cent) hold no degree.

Table 11.1 Mean scores of criteria and differences in attitudes regarding gender

Rank	Criteria	Mean*	Standard deviation	Mean*		*t*-test
				Female ($N = 375$)	Male ($N = 209$)	
1.	Celebrity credibility	4.073630	1.029441	4.104000	4.019139	0.3400
2.	Celebrity and audience match	3.946918	1.874883	4.005333	3.842105	0.3136
3.	Stage of celebrity's life cycle	3.666096	1.071680	3.688000	3.626794	0.5086
4.	Whether celebrity is a brand user	3.638699	1.260813	3.690667	3.545455	0.1824
5.	Celebrity's physical attractiveness	3.618151	1.037652	3.618667	3.617225	0.9872
6.	Practice of celebrity endorsing several brands	3.606164	1.222913	3.701333	3.435407	0.0116**
7.	Controversial behaviour	3.568493	1.148689	3.618667	3.478469	0.1576
8.	Celebrity and product match	3.537671	0.984968	3.608000	3.411483	0.0208**
9.	Celebrity's profession	3.303082	1.200247	3.376000	3.172249	0.0491**
10.	Risk of celebrity overshadowing brand	3.159247	1.144897	3.221333	3.047847	0.0792***

Note: * Five item Likert-type scale: 1 extremely unimportant, 5 extremely important; ** significant at $p < 0.05$; *** significant at $p < 0.1$.

Hypothesis testing

Respondents have recognized the brands endorsed by Croatian celebrities rather well. Results show that the most recognized brands are those endorsed by the famous Croatian athletes Janica Kostelić (skier, celebrity endorser for water brand Jamnica, recognized by 89.56 per cent of the respondents), and Blanka Vlašić (high jumper; celebrity endorser for water brand Studena, recognized by 84.42 per cent of the respondents). Possible reasons are their great popularity, the match between celebrity and product category and the considerable volume of advertising of brand owners. The appearance of Oliver Dragojević, a very popular singer in campaigns of a hypermarket chain, has very high recognition – 80.82 per cent. Severina Vučković, a female singer, is one of the most popular (and most controversial) persons in the Croatian entertainment business; it is not surprising that a high percentage of the respondents (47.26 per cent) still associate her with a yoghurt brand she used to endorse although that was not a recent endorsement engagement. To conclude, the hypothesis H1 is confirmed.

Table 11.1 shows mean scores for the importance of celebrity characteristics in rank order, and mean scores for the importance of celebrity characteristics according to gender. Respondents find all of the mentioned criteria important or rather important when choosing a brand endorser. The most important criteria are the celebrity's credibility, the match between celebrity and audience and the stage of the celebrity's life cycle. That is consistent with some previously reported results in early studies on celebrity endorsement from developed market economies (McCracken, 1989; Langmeyer and Walker, 1991; Erdogan *et al.*, 2001). If a particular celebrity is a brand user, the celebrity's physical attractiveness and the practice of a celebrity endorsing several brands are also important issues. Controversial behaviour and celebrity and product match gained a rather high importance score too. The celebrity's profession and the risk of a celebrity overshadowing a brand seem to be the least important criteria. There is a need for further data analysis that will identify the underlying characteristics of celebrity endorsement which are important to Croatian consumers. This can be done by means of factor analysis and thus will enable the identification of the main issues. Future research may examine whether the importance of criteria depends on product type, the brand's existing meaning and marketing position, and a country's culture. Nevertheless, hypothesis H2 is confirmed.

Studies report differences regarding gender in the attitudes towards celebrity endorsement. For instance, Kahle and Homer (1985) found that women rather than men would be likely purchasers of an endorsed product, but Daneshvary and Schwer's (2000) findings were not in line with the aforementioned. Results for Croatian consumers show significant differences between women and men in the following cases: when the celebrity is endorsing several brands, in the case of celebrity and product match and concerning the celebrity's profession (all significant at $p < 0.05$). In all three cases, female respondents find these criteria to be more important. One further criterion shows significant differences at $p < 0.1$ and that is the risk of a celebrity overshadowing a brand as it is also more important for female than male respondents. For the remaining six criteria, no significant differences were found. It can be concluded that gender influences the respondents' attitudes towards the importance of the characteristics of celebrity endorsement to some extent. Further investigation is needed into the criteria that are of different importance to female and male respondents.

Further analysis reveals that attitudes towards a celebrity as endorser differ among three groups of the respondents based on their occupation. Results are shown in Table 11.2. Finally, Table 11.3 presents differences in attitudes towards celebrities' characteristics as endorsers among four groups of the respondents according to their level of education.

Results show significant differences between respondents with different levels of education for the following criteria: celebrity credibility, stage of celebrity's life cycle, celebrity's physical attractiveness and controversial behaviour. Since attitudes of the respondents on the importance of individual celebrity characteristics for successful brand endorsements significantly differ on occupation and only to some extent on gender and education, hypothesis H3 can be only partially confirmed.

Limitations

This study is limited due to the type and size of the sample. Findings are not to be generalized across the entire population and all celebrity endorsement for brands in the Croatian market. A larger and more diverse sample would improve the generalizability of the results while also expanding their breadth and enriching their depth. Although the instrument was designed as suggested by previous research, the psychometric properties (scale reliability and validity) require further examination and additional improvements. Therefore, findings may best be applied as a snapshot of the actual situation and as a challenge for further research.

Table 11.2 Differences in attitudes regarding occupation

Rank	Criteria	Mean*			ANOVA
		Undergraduate students (*N* = 297)	**Marketing professionals (*N* = 107)**	**Other respondents (*N* = 180)**	
1.	Celebrity credibility	4.070707	4.448598	3.855556	0.0000**
2.	Celebrity and audience match	4.010101	4.196262	3.694444	0.0639***
3.	Stage of celebrity's life cycle	3.676768	4.009346	3.444444	0.0001**
4.	Whether celebrity is a brand user	3.673401	3.943925	3.400000	0.0015**
5.	Celebrity's physical attractiveness	3.811448	3.261682	3.511111	0.0000**
6.	Practice of celebrity endorsing several brands	3.767677	3.766355	3.244444	0.0000**
7.	Controversial behaviour	3.686869	3.542056	3.388889	0.0220**
8.	Celebrity and product match	3.589226	3.710280	3.350000	0.0048**
9.	Celebrity's profession	3.390572	3.467290	3.061111	0.0041**
10.	Risk of celebrity overshadowing brand	3.350168	3.289720	2.766667	0.0000**

Note: * Five item Likert-type scale: 1 extremely unimportant, 5 extremely important; ** significant at $p < 0.05$; *** significant at $p < 0.1$

Table 11.3 Differences in attitudes regarding education

Rank	Criteria	Mean*				ANOVA
		Undergraduate & graduate ($N = 196$)	**College ($N = 57$)**	**High school ($N = 327$)**	**No degree ($N = 4$)**	
1.	Celebrity credibility	4.244898	4.052632	3.990826	2.750000	0.0025**
2.	Celebrity and audience match	4.056122	3.789474	3.923547	2.750000	0.4330
3.	Stage of celebrity's life cycle	3.862245	3.578947	3.571865	3.000000	0.0114**
4.	Whether celebrity is a brand user	3.637755	3.578947	3.660550	2.750000	0.5303
5.	Celebrity's physical attractiveness	3.433673	3.596491	3.733945	3.500000	0.0157**
6.	Practice of celebrity endorsing several brands	3.556122	3.456140	3.666667	3.250000	0.5083
7.	Controversial behaviour	3.545918	3.368421	3.633028	2.250000	0.0434**
8.	Celebrity and product match	3.602041	3.508772	3.507645	3.250000	0.6761
9.	Celebrity's profession	3.438776	3.263158	3.229358	3.250000	0.2834
10.	Risk of celebrity overshadowing brand	3.081633	2.964912	3.235474	3.500000	0.2266

Note: * Five item Likert-type scale: 1 extremely unimportant, 5 extremely important; ** significant at $p < 0.05$; *** significant at $p < 0.1$.

Conclusions

The research described in this chapter has found supporting evidence that the use of celebrity endorsement in marketing practice in Croatia has an impact on the audience's attention, recognition and probably evaluation of brands. Results are consistent with those of prior research undertaken in more developed, Western market economies. To conclude, although findings are limited in their range of applicability, this research provides valuable insights into the characteristics of celebrity endorsement that Croatian consumers view positively. Moreover, the research findings may provide interesting and important information for Croatian marketing professionals in agencies and companies which are striving to find the "right" celebrity endorsement for their clients' or own brands. More research is needed to explore the relationships between the characteristics of celebrity endorsement that are important both to consumers and managers.

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12
An Institutional Perspective
The Changing Role of the State in Entrepreneurship Development in Post-Communist Albania

Mirela Xheneti

Introduction

Entrepreneurship has been identified as one of the main driving forces of economic development (Thurik and Wennekers, 2004) and as omnipresent in a society. Entrepreneurship is not "the particular feature of a particular social group . . . (but) it is inherent in every action and burdens every actor" (Mises, 1949: 252). It does not require an extensive analysis of documents to understand that the stake placed by national governments and international organizations such as the European Union (EU) or Organization for Economic Cooperation and Development (OECD) on entrepreneurship is very high. The versatility of the concept (its different definitions) and also the different manifestations of entrepreneurship (in very different types of enterprises, that is, ranging from a one person retail shop to a high-tech small company) have facilitated its use as an idealized economic subject in policy documents and government agendas according to the priorities of national governments or international organizations such as the EU (Dannreuther, 2007).

In the community of discourses about entrepreneurship development, the EU has contributed increasingly by making explicit the stake it places on the small and medium-sized enterprise (SME) sector and entrepreneurship, as a key to the creation of an internationally competitive Europe. The significance of the issue is supported by the fact that more than 99 per cent of European businesses are SMEs.

It has also been recognized that "entrepreneurship is not a synonym for virtuousness . . . it cannot always be relied upon to promote the interests of the society" (Baumol, 1993: 11). Baumol (1990) was amongst the first scholars to make a distinction between productive, unproductive and destructive forms of entrepreneurship, pointing out that policy has an important role to play by altering the structure of payoffs under the framework of social norms and attitudes in a particular context. In this context, if an economy is not growing, it is not because entrepreneurship is missing, but because the incentives for entrepreneurial activity that are present in that context may be inadequate.

Post-communist economies have provided interesting case studies of these different forms of entrepreneurship and the (in)efficiency of governments in channelling resources into productive uses (Perren and Jennings, 2005). Twenty years after the collapse of communism, it is a good time to look at the role of the government in creating the basic framework conditions for entrepreneurship and private business development. This chapter looks at the role of government in relation to entrepreneurship development in post-communist Albania. Albania is the last country where communism collapsed and in the past 20 years has gone through major institutional changes that have affected the development of entrepreneurship. Analysis of the government's role is considered in an institutionalist perspective, which argues the role of polity in the creation and enforcement of formal institutions (Karlsson and Karlsson, 2002). Qualitative and quantitative data from the author's own research in 2004 and 2009 are used to explore the role of public policy in entrepreneurship development. The qualitative research refers to an in-depth qualitative analysis of: (i) Government of Albania (GoA) policy documents (GoA, 2001, 2007, 2008a, 2008b) and international organizations' reports (OECD, 2005; OECD and EC, 2007, 2009); and (ii) interviews with 13 policy-makers, business associations and donor organizations that influence enterprise policy in Albania. The quantitative research refers to a survey of 110 manufacturing entrepreneurial ventures in 2004.

In the first section of the chapter, an outline of transitional approaches and institutional theories is presented together with the role of public policy concerning entrepreneurship and small business development. In the second section, an overview of Albania is presented highlighting the main features of her transition. In the third section the main features of public policy influencing entrepreneurship development are discussed taking an historical perspective in highlighting the institutional change in the country and the ways in which it has influenced the nature of entrepreneurship and business development.

The chapter concludes with some general features of doing business in post-communist Albania and implications for entrepreneurship theories and transition studies.

Institutional theories and entrepreneurship development

At the beginning of the transition period, the phrase "transition to a market economy" was widely used in references to the post-communist transformation, by regarding it as a passage from central planning to a market-based economy. The economic sphere was overly emphasized at the beginning of transition because transition was considered as an exercise of getting property rights and prices right in the market. This neo-classical view was static and frictionless, institution-less and culture-less and thus its explanatory value was limited. It neglected the fact that the economic performance of a country was very much affected by the success or failure of its institutions. The main agreement at the beginning of transition was that its core aim was the allocation of resources from the state to the private sector, which would ensure greater efficiency and faster growth (Blanchard, 1997; Kolodko, 2000). In addition, there was an agreement that the objectives of transition were to include: the introduction of flexible relative prices, macroeconomic stabilization, and the provision of incentives to firms through the privatization of the economy and new entry, and also the design of an adequate institutional framework (Roland, 2000). Nevertheless, many disagreements emerged in relation to the particular paths pursued to fulfil these objectives in terms of the sequencing and the speed of reforms.

The post-communist transition to a market economy followed two approaches. The shock therapy, as mainly identified with the Washington Consensus view of transition, considered a radical liberalization of prices, stabilization and privatization, so as to take advantage of the "window of opportunity" (Balcerowitz, 1995) or the institutional vacuum created, as the main policies. These policies were to be implemented as soon as possible, in order to avoid a potential reversal and asset stripping of state-owned enterprises. The Washington Consensus, however, has been criticized for considering transition as just a technical problem with too much focus on liberalization and privatization, and on simple advice policies that did not reach deep down in the societies of these countries (Kolodko, 2000). Shock therapy supporters believed that only market forces could lead to functional institutions and they advocated passive policies in institutional design based on the ideas of the invisible hand of the market or voluntary designs.

This approach was influenced by strong ideological reasons, and any chance for the state to get involved or be more active was dismissed due to fears of a return to communism. The Western advisers considered these policies to be more efficient, faster, controllable and that would simultaneously lead to a change in institutions. In this regard, the informal institutions in terms of norms and culture as well as the knowledge available in these societies were not taken into account or it was thought they would adjust immediately to the new game. The stock of knowledge people in post-communist societies possessed was less than sufficient to interpret the new and complex phenomena that the systemic change entailed. Also, the right balance between capitalist values, such as individualism and self-interest, and civic values was not taken into account (Marangos, 2002). The cruel reality is that the self-interest and individualism encouraged by the market without any particular institutions to ensure that civil values remained unspoiled resulted in non-cohesive societies, as is often the case in post-communist countries today (Bateman, 2000, 2010; Marangos, 2002). Because the market forces at the time were weak, they led to the creation of big market failures and contributed to economic decline, higher figures of unemployment, increased poverty, social inequalities and widespread corruption (Kolodko, 2000; Sokol, 2001; Marangos, 2002). Moreover, no efforts were made to ensure the policy process was effective, efficient and accountable (Ekiert and Hanson, 2003).

The other approach to transition, adopted by the gradualists, saw the development of proper institutions as a prerequisite for the creation of a functioning market economy. According to gradualists, the institutional structure was crucial in ensuring the channelling of resources to sustainable and equitable long-term growth. Gradualists considered the market not to be the per se of reforms in post-communist economies. To them, the institutions that would make the market functional were the Achilles' heel (Svejnar, 2002). According to gradualists, proper attention should have been given to the legacies of the past and how they might have influenced people's behaviour. With the collapse of communism, the formal institutions of communism may have been dismantled, but the old social institutions such as ways of behaving, norms and practices were still available and people adapted their behaviours to the new environment not "on the ruins of communism" but "with the ruins of communism" (Stark, 1996). In this sense, rather than talking about transition from one point to the other, it makes more sense to speak about transformation. It is not as important to develop new and sophisticated formal institutions as much as it is important that the institutional structure is consistent with the country's history, culture and traditions. Moreover, gradualists saw an important role for the state in the process of institution building. They emphasized a *transition by design* that is more comprehensive and requires the state to be an architect in the process, and also requires a better knowledge of the contexts where the design is taking place. Obviously, this decision needs the commitment of the governments towards institution building. In countries where the rules were very different from the ones introduced in the post-socialist period, it usually required a more active role for the state in order for the new behaviours and the enforcement of new regulations to become possible.

These approaches to transition affected the way entrepreneurship and small business developed in post-communist countries. Since the beginning of transition, post-communist economies embraced the view that entrepreneurship had system transformation capacities (Xheneti, 2006). Entrepreneurs have been perceived for a long time as carrying the values of hard work, self-reliance and determination that support the capitalist order, and upon which the prosperity of this system is based. Thus, the emergence of the private sector as an agent of change in "achieving the norms, values and rules of conduct" was considered to be crucial to the performance of the market economy and, therefore, in promoting the freedom of individuals through their free choices in post-communist economies (Brezinski and Fritsch, 1996; Scase, 1997). Another important reason for the encouragement of entrepreneurship and SMEs was the unbalanced structure of entrepreneurial organizations with a focus on big firms as functional to the central planning, but abnormal to a market economy (Chilosi, 2001; Smallbone and Welter, 2001a). The shift towards a more balanced economic structure was accompanied by large dismissals, which the private small business sector was expected to absorb. Moreover, SMEs could introduce more flexible production processes and a wider range of products to consumers considering the inflexibility of production processes inherited from central planning (Smallbone and Welter, 2001b).

However, the "privatization from below" (Winiecki, 2001; Boettke and Leeson, 2002) or bottom-up transformation (Brezinski and Fritsch, 1996), which refers to the creation of enabling conditions for entrepreneurship, thus fostering the *de novo* private sector, did not receive proper attention. The bottom-up transformation that occurred in some of the countries in transition, like Poland or Hungary, initially was spontaneous. The private sector in all post-communist countries emerged pretty quickly with large numbers of SMEs established that made up for a large share of the private sector in these countries. However, its contribution was not very satisfactory for a long time even though in many countries the SME sector accounted for a large share of the private sector. The evidence of transition also showed that many new firms were created mostly in the trade and services sector, which is quite worrying in terms of sustainable development (Arzeni, 1996; Scase, 1997; Bateman, 2000; Hallberg, 2000).

The value placed on entrepreneurship is also an important element in ensuring the supply of entrepreneurship in post-communist countries. Generally speaking, an entrepreneurial culture is made up of the sets of beliefs, attitudes and norms that underpin a successful role model in a society. This culture needs to be embedded at all levels in order for entrepreneurship and small businesses to have a respectable place in a society (Gibb, 1996). In this respect, the social appeal of being an entrepreneur and then becoming wealthier, exerting power and having feelings of achievement should have been part of the payoffs for entrepreneurship in societies where the only business culture previously existent was what Bateman (1997) calls the bureaucratic-administrative business culture, which encouraged neither entrepreneurship and innovation nor constructive and efficient entrepreneurial activities. Moreover, considering the legacy of the past, entrepreneurs in many transition economies have been mainly associated with speculators or exploiters that made use of the economies of shortage at the time and were part of the black market. The situation is not much different nowadays in many of the post-communist contexts, where entrepreneurship is still associated with tax evasion, corruption, criminality and other non-compliant behaviour.

Only in the later stages of transition has there been a more organized approach towards entrepreneurship and SMEs, with almost all post-communist governments developing strategies and stating objectives for the development of the small business sector which points towards the role of the state in designing the appropriate institutional framework for entrepreneurship and private sector development. In this respect, institutions have attracted increasing attention from those seeking to understand the features of the post-communist transformation and entrepreneurial behaviour in particular. According to institutional theory, institutions are constraints that guide human interaction (North, 1990). They not only provide a framework for human interaction but also define what kind of behaviour is acceptable. According to North (1990, 1997), institutions are made up of formal constraints such as rules, laws and constitutions whose aim is to facilitate political or economic exchange; but also informal constraints such as norms of behaviour, conventions and self-imposed codes of conduct. These "come from the socially transmitted information and are part of the heritage we call culture" (North, 1994: 37) and their enforcement characteristics. Informal rules underlie and sometimes complement or substitute the formal ones (North, 1994); and they reflect the old ethos, the hand of the past or the carriers of the history (Pejovich, 1999).

One prominent example of formal institutions through which the government influences entrepreneurship is property rights and the rule of law. The most important function of systems of property rights is to implement the optimal combinations between productive and unproductive entrepreneurial activities that translate into positive sum-games in a country (Baumol, 1990; Foss and Foss, 2000). Also, while entrepreneurship is associated with the creativity and commitment of individuals, an efficient system of property rights ensures that the economic actors feel they can enter certain transactions. In addition, the rule of law gives entrepreneurs a certain level of security that their business activity will not be stolen, extorted or damaged. The state can also influence entrepreneurial behaviour through the creation of an efficient business regulatory framework and consistent policies that will lower barriers to entry into business (administrative procedures), leaving less scope for the discretionary use of policies by public administrators, which has been a problem in many post-communist economies, such as South East European countries and Russia (cf. Bartlett *et al.*, 2002; Broadman *et al.*, 2004).

Sometimes, informal institutions are adopted because the formal rules are inefficient and individuals find it is less costly to make informal arrangements than depend on the formal rules (Feige, 1997; Pejovich, 1999; Smallbone and Welter, 2003). A history of use of discretionary power, and inconsistencies in formal rules and policies after the collapse of communism have contributed to the prevailing features of exchange in many of these countries: namely, corruption and the emergence of shadow economies (Clague, 1997; Broadman *et al.*, 2004; Karklins, 2005). At the same time, Feige (1997) refers to informal norms, such as corruption or personal networks, as being beneficial in countries where compliance with formal rules is very costly. However, he argues that while this activity may reduce transaction costs, it can also harm the social fabric by jeopardizing the principle of the rule of law, making long-term change even more difficult (p. 26).

The inefficiency of formal institutions may discourage some entrepreneurs from pursuing their ideas in the market and may also lead to adverse *selection* by entrepreneurs in the market. According to Chilosi (2001), because of the above-mentioned difficulties in conducting business in such conditions, the most successful entrepreneurs are those that are more effective in bribing and/or getting along with politicians and bureaucrats. This situation creates rent-seeking entrepreneurship which may harm forms of productive entrepreneurship that will contribute more to economic growth. Furthermore, as entrepreneurs spend time dealing with the inefficiencies of the system, in such conditions resources that could be utilized for productive uses are diverted into unproductive uses, thus harming sustainable entrepreneurship in contexts where entrepreneurship is already fragile and not well accepted in society (Smallbone and Welter, 2006).

Whilst formal institutions are the outcome of designated policies, informal ones emerge spontaneously through a process of problem solving (Mantzavinos, 2001). Informal institutions are embedded in a web of social norms, networks and trust in a society and are informally enforced as a byproduct of ongoing social relationships. Whether a combination of formal and informal institutions creates a framework for productive entrepreneurship in the society can be very much dependent on the credibility of the government, in terms of the design and operation of institutions, since this will affect their legitimacy and increase the rate of their adoption in post-communist economies.

A brief overview of post-communist Albania

Albania was the last country to witness the collapse of communism at the beginning of the 1990s. For more than four decades, Albania had been one of the least known and least accessible countries in the world. Under self-imposed isolation, it was ruled by an authoritarian regime that adhered strictly to Marxist ideology and Stalinist practices in one of the most far-reaching experiments in socialist orthodoxy (Pasha *et al.*, 2003). Albania's economic model was based on three principles: (i) complete reliance on central planning; (ii) rejection of private ownership of means of production, and (iii) the idealization of national self-reliance as a guiding tenet of economic policy, which gave a central role to the pursuit of economic autarky. A constitutional ban on external credit, aid and investment, adopted in 1976, culminated in the complete financial isolation of Albania in the 1980s, with the inevitable consequence of the collapse of its economic system at the beginning of the 1990s (Pasha *et al.*, 2003).

Albania's transition has been difficult and characterized by many crises and recoveries. In the first years of transition, inflation peaked at 237 per cent annually, while GDP decreased by 50 per cent a year between 1990 and 1992 (Muco, 2001). Although the institutions of communism were dismantled, new institutions were not created or adopted quickly enough to cope with the shock of transition. Economic reform in Albania mainly followed the neo-liberal approach in line with the Washington Consensus. In the first phase of its transition, Albania successfully pursued most of the policies recommended by the World Bank and the International Monetary Fund (IMF), and achieved macroeconomic stability. By 1993, the growth of GDP was positive, and the budget deficit decreased from 31 per cent in 1993 to 6 per cent in 1995 (Muco, 2001). The restrictive monetary policy of the Bank of Albania kept inflation under control. Small-scale privatization was almost finished in 1995. The success of the Albanian transition was judged by these macroeconomic indicators.

But in 1997, Albania was hit by a very severe crisis accompanied by social and political instability. Whilst the common wisdom has been that the collapse of the fraudulent pyramid schemes led to the Albanian crisis, Vaughan-Whitehead (1999) and Clunies-Ross and Sudar (1998) argue that the real reasons for the crisis were the collapse of industrial activity during transition, the slow development of the trade and services sector, the weak regulatory and legal system, the shallow banking system, which led to the development of an informal credit market, and the lack of a sense of individual responsibility that was a direct inheritance from the past reliance on the state for all aspects of life.

This crisis put a considerable number of enterprises out of business, and encouraged many investors to leave the country for personal security reasons. The war in Kosovo in 1999 had a further negative impact on the fragile Albanian economy as a considerable amount of public and private resources were redirected towards the care of over half a million refugees that entered the country (EBRD, 1999). In the years following these two shocks, the country experienced steady progress with the rate of per capita GDP growth at a steady 7–8 per cent annually. By the end of 2000, GDP had returned to its 1989 level, although it should be recognized that this was extremely low. Since 2000, per capita GDP growth has been in the range of 5–7 per cent annually, although this fell by 2.1 per cent in 2009 as a result of the global economic crisis. Unemployment has also been persistently problematic in Albania with figures reaching 12–13 per cent in the last couple of years.

Successive Albanian governments have been slow to establish a consolidated democracy in which the rule of law and law enforcement are the norm rather than the exception. Nevertheless, many important reforms have been undertaken, including the reform of public administration and involvement in various initiatives such as the Stability Pact for South Eastern Europe, which has encouraged regional cooperation. Albania became a member of the World Trade Organization in 2000, and has signed Free Trade Agreements with the other countries in the region. It also signed a Stabilization and Association Agreement with the EU at the beginning of 2006, and applied for the status of EU candidate country in 2009.

The private sector has shown great flexibility throughout the transition period, even though it might have contributed more to economic development under stable conditions. It is important to remember that the private sector was non-existent during the communist period in Albania. It developed through a combination of entry of new firms after the liberalization, and the privatization of state-owned enterprises. The privatization of services and small shops took place rapidly, and had a positive effect in supplying the population with goods and services. This opened the way for the privatization of large enterprises, which continued until early 2000. The result was that since 2003, the private sector in Albania accounted for about 75 per cent of GDP and over 80 per cent of employment (EBRD, 2009).

As Table 12.1 shows, 93 per cent of the Albanian enterprises are micro-enterprises employing less than five employees. Only 39 per cent of enterprises were created before 2003. According to the Albanian Institute of Statistics, the enterprise birth rate has increased almost every year, reaching a peak of 19 per cent in 2008. This high rate of growth may be explained by the facilitation of business start-up procedures. According to the World Bank's publication *Doing Business 2009*, Albania was one of the top reformers in 2007–2008 in terms of start-up

Table 12.1 Active enterprises by size and year of creation

	Size of enterprise				
Year of creation	**1–4**	**5–9**	**10–49**	**50+**	**Total**
2008	19,248	196	79	15	19,538
2007	12,616	502	394	42	13,554
2006	12,992	348	169	34	13,543
2005	8,434	294	250	139	9,117
2004	8,125	383	138	22	8,668
until 2003	35,991	2,076	1,773	490	40,330
Total	97,406	3,799	2,803	742	104,750

Source: Albanian Institute of Statistics (2009), http://www.instat.gov.al.

procedures, leaving far behind all countries in the South East European region except for the Former Yugoslav Republic of Macedonia. Another feature of the Albanian economy throughout the years of transition has been the creation of very small businesses, mostly in trade and services, reflecting the relatively low barriers to entry in those sectors. According to the Albanian Institute of Statistics, 84 per cent of the overall number of enterprises operate in the services sector.

Institutional deficiencies, characterized by an unfavourable business environment, high levels of corruption and a weak regulatory framework, have been recognized as significant barriers to entrepreneurship development throughout the transition period. Informal businesses are widespread, hindering fair competition and adversely affecting the business environment. Building an appropriate institutional framework to support a market economy is a necessary condition to facilitate continued transition. Whilst market-oriented reforms such as privatization, liberalization and stabilization programmes were initiated in the early 1990s, and followed by measures to improve the business environment, including strengthening public administration and law enforcement, tackling corruption and infrastructure development (EBRD, 1999–2009), problems remain concerning respect for the rule of law, organized crime and corruption, the judicial system, central and local state capacity, regulation and in encouraging a civil society that was highly restricted under communism (CEC, 2004, 2008, 2009; OECD, 2005). Assessments of policy-making have also identified problems such as its authoritarianism, with few non-governmental actors involved (Bogdani and Loughlin, 2007), limited state capacity, lack of ministerial coordination and inappropriate use of public consultation (SIGMA, 2008, 2009). Nevertheless, in recent years the Albanian government has been praised by the European Commission and World Bank for implementing a series of important policy reforms towards improving the business environment especially in the areas of business registration, online access for small businesses and export support programmes as discussed in next section.

Institutional framework for entrepreneurship and SME development

A multi-level institutional analysis is used, based on the framework used by Smallbone and Welter (2001b), who argue that entrepreneurship development depends upon the creation of institutions and organizations at three levels: macro, meso and micro. The macro level is concerned with the design and creation of national institutions and organizations that are responsible for SME policy. The meso level is concentrated on the efforts that governments undertake to create a legal and regulatory framework that is conducive to business growth. At the micro level, the role of the state is first, to create the conditions in which a network of business support organizations can develop; and second, to develop a governance framework (OECD, 2004a) which enables policy actions to be shaped by regional needs. From this perspective, the main policy concern at this level should be the ability of the state to design a business support and governance system that will effectively meet the needs of businesses at local and national levels. Such a multi-level analysis is needed to give a complete picture of the SME policy design and implementation, based on the view that SME development requires an appropriate set of institutions and organizations, with effective cross-linkages between the different levels of policy-making.

Macro level

The development of institutions at the macro level has gone through several important changes in the past ten years. Whilst the initial contribution of SMEs to economic growth in Albania has been mainly a result of the spontaneous efforts of people to create enterprises in order to escape unemployment, from 2001 the GoA has been more active towards formulating SME policy and creating the corresponding institutions to carry it out. In addition, the endorsement of the EU SME Charter[1] in 2003 has added a whole new dimension to the way policy is formulated and implemented in Albania.

In policy terms, the main responsibility for SME development is under the Ministry of Economy, Trade and Energy (MoETE). The main policy actors are the Department of Business Promotion in the MoETE, and Albinvest. The Department develops strategies and programmes to improve the legal and institutional framework for SME development, and analyses and monitors policies to improve the business climate, based on the best practices and experience of countries in the region.[2] Albinvest acts as an SME policy implementation unit, as administrator of government and donor funds and as monitor/coordinator of SME support programmes. The first steps towards a more systematic approach towards enterprise policy development were taken only in 2001 when the GoA published national strategies (GoA, 2001). Under this strategy, the SME Law No. 8957 of October 2002 was adopted to regulate the definition of SMEs, providing the legal framework for SME government support and the creation of a development agency for SMEs. The contents of the strategy spelled out the commitment of the state towards start-ups and existing businesses in manufacturing. During interviews with officials of the SME Agency, undertaken in 2004, it was reported that the "strategy is not an operational programme where the activities are expressed in financial terms". As a result, the Agency itself, which had a very small budget and not enough staff, needed first, to design action plans and second, make them known to the donor community. A further strategy was introduced in 2007 (GoA, 2007). The 2007 strategy aims to develop and support SMEs by

- promoting an entrepreneurship culture through introducing entrepreneurship education in school curricula;
- improving the business climate through reforming the regulatory framework and providing business support;
- developing businesses with internationalization potential through training and support, technology and innovation promotion; and
- increasing SME financing through credit guarantee funds and micro credit.

Entrepreneurship policy and the steps for encouraging the development of entrepreneurial attitudes in the society is one of the pillars of the current SME strategy. Before Albania joined the EU SME Charter, there was no reference in the GoA's documents to an entrepreneurship policy implying some confusion between entrepreneurship and business policy, or otherwise, implying a neglected area. The lack of entrepreneurship policy in many countries has been associated with the main belief that altering the characteristics of a society takes a long time. Thus, the public policies role in changing human orientations and preferences about business is insignificant in the short term (Baumol, 1990). However, in the Albanian context, the old prejudices about entrepreneurship as lacking productive activity during communism are still present and are reflected in the attitudes of many state officials towards small businesses. Despite this, the GoA did not consider a policy on entrepreneurship until 2007 mainly because of the feedback on the implementation of the EU Charter for SMEs. Up to 2007, only the provision of some training programmes for business start-ups were mentioned in the SME strategy.

The strategic programme for the period 2007–2009 placed some emphasis on entrepreneurship culture and more specifically on its introduction into formal and vocational education and in training sessions with entrepreneurs, although nothing specific has been achieved, as yet, with regard to this objective. According to the interviewees, there is an intention to develop national training curricula and to bring entrepreneurship into high school and universities as part of their curricula but this has been difficult because it needs the coordination of three ministries: the MoETE, the Ministry of Labour and the Ministry of Education. One of the policy-makers at MoETE that worked for the formulation of the SME development strategy mentions:

> The lack of information puts in doubt the government's real belief in entrepreneurship policies and suggests that its decisions are taken mainly to fulfil EU conditionality, or otherwise to respond to the discursive emphasis of the EU. The former argument is further emphasised by a statement in the strategy according to which "countries aspiring towards EU membership should consider entrepreneurship projects with extra curriculum activities for the youth". (GoA, 2007: 22)
>
> This is another indication of the adoption of entrepreneurship culture in response to EU conditionality.

Interviews with public officials in 2004 and 2009 showed that the government's attitude was very often to be that of an initiator and designer of strategies and policies with little efforts in their implementation and even less in the fulfilment of the stated objectives and targets. Another reason for the poor implementation of policies is the lack of human and financial resources.

Meso level

The explicit aims of government policy for entrepreneurship and SMEs are typically to increase the competitiveness of the business sector, in order for it to prosper and contribute to employment growth. Achieving this requires a regulatory framework that will enable businesses to feel confident about investing and developing their business ideas. The design of regulations in Albania has for many years been a monopoly of government structures with no or little inclusion of other actors in the process. Since this process has suffered from a lack of knowledge about SME concerns, they have not been taken into account in the regulatory and legal framework. Survey data revealed that laws have continuously changed and have not been very clear in their aims. Businesses reported that during the time they have been in operation, they have had to deal with unexpected changes in rules, laws or policies that have affected their businesses. In this context, only 33 per cent of businesses responded that these changes have been predictable which suggests that these formal institutions do not reduce uncertainty, which is one of the functions of the institutional framework. Moreover, the survey revealed that businesses do not seem to have a voice in the decisions taken by the government.

Thirteen per cent of businesses think that the government "always" or "mostly" ensures that the business community is informed about changes in legislation or policies. The figures enterprises report are low when they are asked if there is any voice for the business community or the associations they are represented by, in designing laws and policies that will affect businesses. As shown in Table 12.2, only 5 per cent of businesses think that their concerns are taken into consideration "mostly" or "frequently".

The unpredictability and instability of regulations are characteristic of a low-quality regulatory framework that fails to encourage compliant behaviour, thereby affecting the credibility of the government, which is important if institutional change is to be achieved. In addition, poor specification of regulations has created space for corruption because regulations can be interpreted subjectively and implemented to favour

Table 12.2 Government – business information flow

	Always (%)	**Mostly** (%)	**Frequently** (%)	**Sometimes** (%)	**Seldom** (%)	**Never** (%)
Governments have ensured to inform the businesses affected by new rules or policies.	3	10	7	17	39	24
Businesses are not only informed about changes in laws or policies that affect the business operation but their concerns voiced directly by them or business associations are taken into account.	0	1	4	25	30	40

or penalize certain groups. The inadequate regulatory framework has influenced the decisions of many entrepreneurs to enter the informal economy, which is one of the most developed forms of unproductive entrepreneurial activity in Albania. Although the reliability of data on Albania has always been an issue, a study was published by the OECD Investment Compact in December 2004 (OECD, 2004b) on the informal economy in the country. The study estimated that, excluding agricultural activities, the size of the informal economy represented 23.4 per cent of GDP at market prices in 2002.

The inequalities of wealth during transition have also created the means to pay bribes, and the inequalities of power have created the means to extort them. The 2004 questionnaire data show that businesses in Albania have to make additional extra payments to public officials in order to get things done and 66 per cent of the enterprises consider this as being common in their day-to-day activities. Similarly, 82 per cent of the businesses respond that this payment ensures that the service gets done, as shown in the answers of enterprises about the frequency of the activity referred in the statements given to them (Table 12.3).

While during communism corruption was a centralized phenomenon, in post-communist Albania in order to get things done one has to bribe the entire chain. It seems as if everybody wants to have "a piece of the cake" and moral values are disregarded considering the circumstances. According to businesses in the sample, all the officials are the same; their personal interests have become business interests and so, in order to get things done businesses have to bribe them all. In this context, this process of bribing the whole chain has become very costly. One entrepreneur in Korca said:

Table 12.3 Additional payments

This is true	Always (%)	Mostly (%)	Frequently (%)	Sometimes (%)	Seldom (%)	Never (%)
"It is common for firms in my line of business to have to pay additional payments to get things done."	15.5	18.2	26.4	23.6	10.9	5.5
"The additional payment ensures the delivery of service as agreed."	17.3	24.5	40	11.8	2.7	2.7

> I can't pass my goods through the customs unless I pay each of the customs' inspectors individually. They say that it is better to pay them than to stay there for a whole week and to pay for accommodation, food etc.

The uncertainty and instability that has characterized transition in most post-communist countries have contributed to the short-term horizons of the individuals. This has been most notable in the public administration due to the lack of clear responsibilities and motivation as mentioned previously. This situation has created certain attitudes in public officials that "today's goose is seen more clearly than tomorrows' golden eggs". Thus, as they see themselves as being only temporarily in a job, they try to use their position as an opportunity to gain personal benefits. Moreover, businesses report that from the time they have started their business operation, the difficulties in dealing with government officials have increased. Fifty-one per cent of businesses in the sample say that difficulties dealing with them have increased.

Table 12.4 shows that amongst enterprises established before 1996, there is a higher percentage of businesses that report that difficulties with government officials have increased (59 per cent) compared to the respondents from the group of enterprises created after 1996 (40 per cent). One possible explanation can be related to the range of

Table 12.4 Difficulties in dealing with government officials by the year of start-up

	Start-up year					
	Before 1996		**After 1996**		**Total**	
	Count	**Percentage (%)**	**Count**	**Percentage**	**Count**	**Percentage (%)**
Difficulties with government officials (Major problem)	38	59.4	17	39.5	55	51.4
Difficulties with government officials (Not a problem)	26	40.6	26	60.5	52	48.6
Total	64	100	43	100	107	100

Note: Results are significant at 0.05 level (Chi square tests).

laws and regulations introduced after 1996 that have not been accompanied by the right and clear responsibilities of public officials, which can be reflected in the public's administration attitudes towards businesses. Thus, to take only one example, the fiscal legislation that is a large concern of enterprises in Albania contributes to this problem, as it gives much power to the Tax Directorate, in terms of developing fiscal policies instead of only implementing them. In this way, a conflict of interests is created. This finding can explain the rather lengthy comments of entrepreneurs regarding the arbitrariness and arrogance of customs or tax authorities. One entrepreneur in Elbasan mentions:

> I am not able to pay tax inspectors a monthly salary as many of my competitors do, so that they won't disturb me with controls or that notify me when other inspectors are coming over.

All these features make businesses very cynical towards not only the state structures but also the new rules of the game. They have contributed to the creation of mischief, distrust and inequality of opportunities. When businesses were asked whether they would use the opportunities presented to them in avoiding different regulations, very few responded that they would do this "seldom" or "never". Answers to these questions might be taken cautiously due to the sensitive nature of the question. However, it is interesting to see that businesses have a higher incentive in cheating on profit (44 per cent) or social security taxes (46 per cent) than cheating on any other type of regulations, which highlights the problems that existed with the fiscal legislation in Albania (Figure 12.1).

Moreover, due to the legacies of the communist period, entrepreneurs in transition economies are greatly associated with speculators. The rising social inequalities in a society where people shared communistic values and feelings of security have also contributed in viewing entrepreneurs through immoral lenses. Entrepreneurs themselves do not think that immorality or regulations evasion are the norms for business success, although they do accept that Albanian businesses do not have a high moral attitude.

As can be seen in the answers above, 54 per cent of Albanian businesses in the sample agree that the moral attitude of Albanian entrepreneurs is low. Table 12.5 also shows that the number of businesses that are at some sort of agreement with the statement is the same when the question is asked for the year of the survey and for five years ago. What seems to differ is that the number of businesses that fully

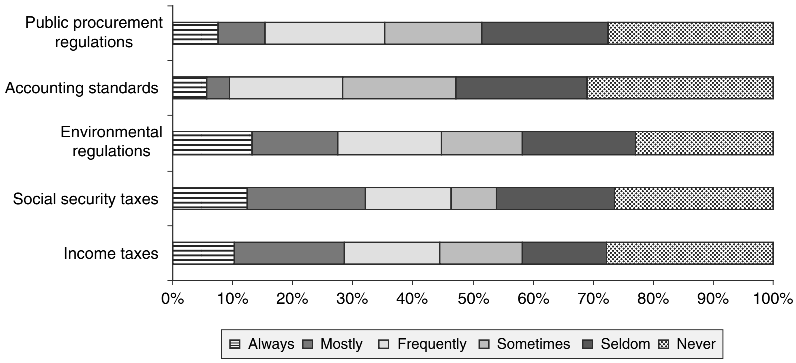

Figure 12.1 Commonality of exploiting opportunities to cheat on formal regulations

Table 12.5 Attitude towards formal institutions

"The moral attitude of Albanian businesses towards formal institutions is low,"	**Fully agree (%)**	**Agree in most cases (%)**	**Tend to agree (%)**	**Tend to disagree (%)**	**Disagree in most cases (%)**	**Strongly disagree (%)**
Current year (2004)	12	11	31	30	15	1
Five years ago	19	13	24	28	15	1

agree with the statement has dropped, which could be a positive sign that businesses see a difference in the way they operate.

Over the years, some steps towards the improvement of the regulatory framework in Albania were taken first, in response to a study conducted by FIAS (2003) on "*Removing Administrative Barriers to Investment*" and most recently, to the evaluations of the EU SME Charter conducted by the EU and OECD. The first evaluation of Albania's progress towards implementing the SME Charter emphasized poor performance across all ten Charter's dimensions (OECD and EC, 2009). The evaluation reported an institutional and legal framework underpinning SME policy that was largely reliant on ad hoc intervention and pilot projects, and in need of clear objectives. The 2009 evaluation rated Albania's policy performance as "remarkable" because implementation improved on all ten

Charter dimensions, particularly company registration and regulatory reform (OECD and EC, 2009).

As a consequence of the regulatory reforms undertaken, Albania has improved its position in the World Bank *Doing Business* national rankings in recent years. Albania's ranking was 82nd out of 183 countries for the 2010 report, having risen from 86th (2009) and 135th in 2008. Specifically, Albania was rated very highly in terms of "getting credit" and "protecting investors" (ranked 15th in both in 2010). There have also been recent changes in income tax and bankruptcy laws (EBRD, 1999–2009). One important example is the establishment of the National Business Registration Centre in 2007, as recommended by the Small Business for Europe Act. This has reduced the time required to register a business from eight days to just one and at lower cost. As one policy-maker stated:

> ... the centre has also 32 branches around the country so that a business does not have to travel all the way to Tirana in order to register its business activity. The number of steps to set up a business has been reduced too. The National Registration Centre plays the role of a one stop shop because the identification number that is given to a business when registering is passed to the Tax Office, Social Contributions Office, Employment Office. This is also seen as a way to reduce the amount of contact between businesses and the public administration which intends to reduce the levels of corruption. (Policy-maker 1, 2009)

The above discussion shows that the regulatory framework in Albania, whilst being characterized for a long time by various deficiencies in terms of both content and enforcement of regulations, has recently started to improve allowing more scope for productive entrepreneurial activities. However, a common view in Albania has been that market competition is based on good connections with political actors rather than on creativity, innovativeness, boldness and alertness to productive opportunities that characterize productive entrepreneurs. In one interview with a business association, it was mentioned rather pessimistically that:

> I don't think the ability to compete in the market is important because the market does not have any rules. To contraband there is no need for any specialisation apart from having good connections with politicians at high levels of power in order not to have difficulties

> with the customs. However good you are in a field you can't compete or manufacture in Albania. This is a problem that all businesses are facing.

Nevertheless, the continuing integration of Albania into the EU has created new challenges and opportunities for businesses as stated by a policy-maker:

> Things have changed; initially there were only small businesses, type of kiosk businesses, after 1997 with the boost in the construction sector, energy, large enterprises were created. Then, after 2000 many businesses were created by emigrants that returned and had some capital and new skills. The opening of regional markets, the removal of tariffs, means that one cannot compete any more with political connections but you need professional people to work with and this is a bit difficult because businesses operate very often on the basis of trust rather than professionalism. We have some training programmes on how to operate in EU markets. Only some selective companies that we think have more potential to go international participate in these training programmes.

Micro level

At the micro level, the business support infrastructure is supposed to play an important role in introducing businesses to new technologies and innovations and encouraging business linkages among themselves and with other relevant organizations. The intensification of the competition from domestic and foreign enterprises and increased consumer demands mean that enterprises need to increase their capabilities.

Figure 12.2 shows what business services respondents consider as needed to improve their business performance. For each of the business service alternatives, over 50 per cent of the businesses respond that they are "very important" and "important" services in improving their business performance. Nevertheless, marketing and sales advice (75 per cent) and information (58 per cent) are the most important services that businesses view as necessary to improve their business performance.

Information is among the most demanded business services and has also been considered as a serious barrier to enterprise operations. The Albanian manufacturing sector is weak and obsolete and is in need of fresh investments and introduction of new technologies. Nevertheless, the chart in Figure 12.3 shows that entrepreneurs find it difficult to collect information on product technology that will improve their

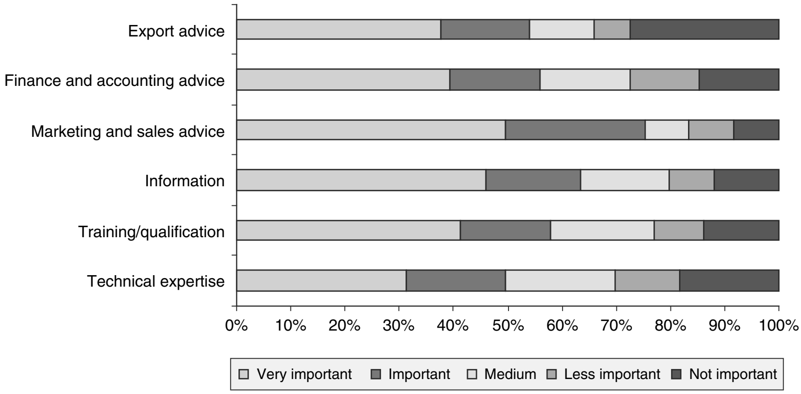

Figure 12.2 Business services that are most needed in the Albanian context

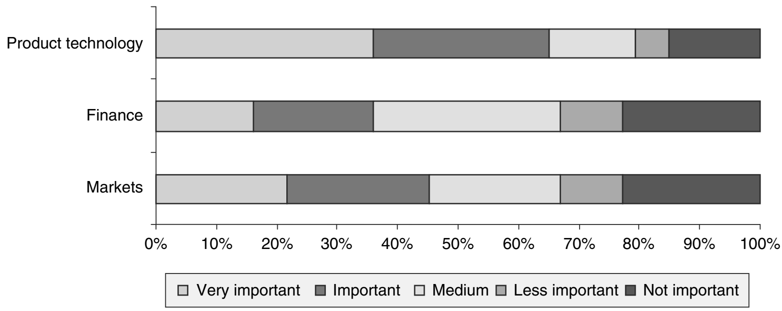

Figure 12.3 Information related barriers by an enterprise perspective

business performance and also make them more competitive in local and regional markets. Sixty-five per cent of the enterprises report that they lack information on product technology and 45 per cent of them consider the lack of information on markets as a "very important" and "*important*" constraint to their business operations (Figure 12.3).

However, although businesses recognize the need for various business services, when asked if they use business support structures to receive these services 61 out of 110 enterprises in the sample report that they do not use their services. Only 28 enterprises respond that they use these services "often" or "sometimes". The relatively infrequent use of business support infrastructure, despite the expressed need for the services they can offer, appears to be a contradiction. However, this finding can be linked to the quality of the services provided, how in tune they

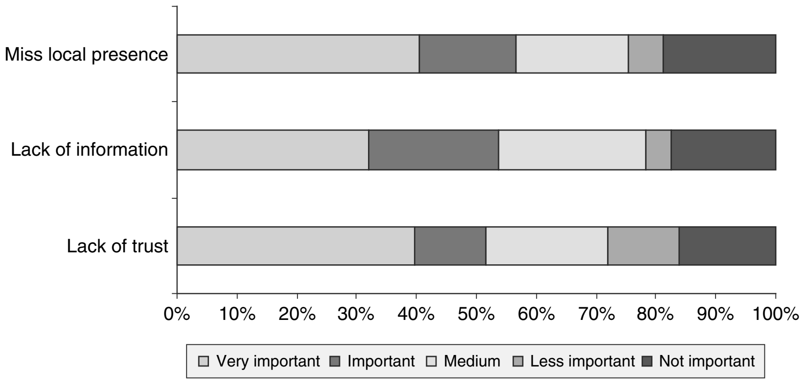

Figure 12.4 Reasons for not using services by business support structures

are with businesses' needs and also in terms of issues of trust. Eighty-seven per cent of businesses that use business support services consider them to be "helpful" and "quite helpful". Those that do not use business support structures' services do it for the reasons outlined in Figure 12.4.

Although the answers for each of the alternatives concerning the use of the business support infrastructure do not differ very much from each other, businesses report that they do not use business services mainly because they lack local presence in the areas these enterprises operate in. Many studies report that the business support infrastructure is located in the main cities. However, my data do not support the argument that businesses will make more use of the business support infrastructure if they are located in the main cities. Businesses selected for the survey are all operating in areas where the research development associations (RDAs) have their offices. This situation suggests other reasons for this hesitation of businesses to use the services offered by the business support infrastructure. The issue of information appears as another reason for this hesitation: 53.6 per cent of businesses considered lack of information as being a "very important" or "important" reason they do not use any business services. Lack of trust is another reason not to use business support structures' services. The fact that more than 50 per cent of businesses report "lack of trust" as a "very important" and "important" reason is an indicator of the lack of legitimacy attached to the government and its structures.

To complement the above discussion, entrepreneurs were asked to report their perceptions on the extent the business support infrastructure has been a burden on their business operations. The same concern

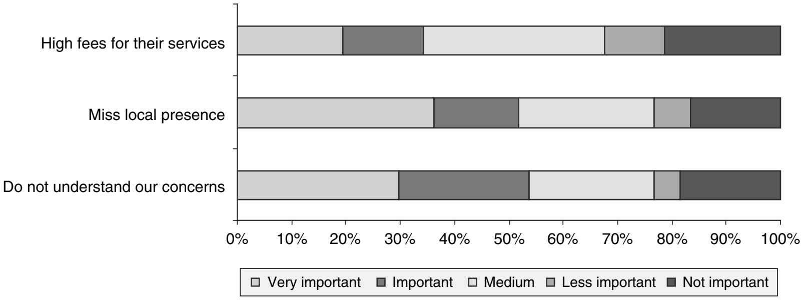

Figure 12.5 Business support infrastructure barriers

about the lack of local presence is also reported in this question. Fifty-two per cent of businesses report that this presence is a "very important" or "important" barrier in improving their growth prospect (Figure 12.5).

While high services charge is not a main issue for enterprises, the quality of the services offered to them seems to be the most important concern. Fifty-four per cent of enterprises in the sample do not think that business support structures really understand their concerns. This finding adds to the discussions about the standardization of business services and the lack of the individual entrepreneur's perspective in the process. From an enterprise perspective, knowledge accumulation is not being well facilitated by the support infrastructure that is currently in place. Although businesses recognized a need for various types of business services, they think that the business support structures miss local presence and also do not understand their concerns. A major difficulty that enterprises expressed was the lack of information on product technology and markets. Enterprises' perceptions are a first indicator about the problems that exist with regard to the support structures that are in place.

From a historical policy perspective, at the micro level, during the period up to 2000, a number of ad hoc SME measures or programmes were developed, which created numerous problems of coordination of SME policy actions. Assistance to Albanian businesses has been mainly achieved through donor programmes, which for many years have operated in their micro worlds that are part of a wider system about which they have limited knowledge (Perren *et al.*, 2001, cited in Xheneti, 2006). Recently, Albinvest has been involved in bridging these micro worlds through coordinating donor efforts. Moreover, as noticed in Xheneti (2005), business providers in Albania have suffered weak capacities and skills that have also been reflected in the kinds of assistance offered to businesses. First, all the enterprises in Albania have often been considered as sharing the characteristics of the group they are included in, the broadly defined SME sector, and second, no differentiation has been made between different areas or localities which have different potential for SME development. Moreover, no differentiation is made between different sectoral activities considering that SME needs vary with the type of industry or sectoral activity they are operating.

The promotion of exports and competitiveness of businesses is one of the priorities of the GoA. Sporadic programmes funded by various donors, mainly the United States Agency for International Development (USAID), have been operating in these two fields for many years. However, programmes have ended, donor priorities have changed and little continuity of these programmes was achieved. As a representative of a business support organization mentions:

> Some projects . . . like the EDEM [Enterprise Development and Export Market] project was very ambitious at the beginning in its aims to create regional clusters but then it only concentrated in some sectors and there was no cluster aspect to it. Those that win projects are very ambitious whilst writing projects but then they realise that it does not work in practice because of the difficulties of the business environment.

For the first time, during the transition period, a governmental fund has been set up to support export companies. As policy-makers agree, it is a small fund (only 63 businesses have benefited till the end of 2009), but they hope it will create the basis for increasing the capacities of Albinvest (the managing body) to apply for larger funds with international organizations in the future, suggesting once again that the GoA does not have the necessary resources to implement small business support programmes.

Conclusions

The aim of this chapter was to highlight the adapting role of the state in the economy (and society) to the major multi-dimensional transformation that post-communist countries have undergone. The chapter looked at the distinctive case of Albania and used data from both qualitative and quantitative research in 2004 and 2009. Post-communist states have faced the challenge of changing their role in the economy, from planner of resource allocation, price setter, owner and financier of enterprise activity through subsidies and transfers, to regulator and facilitator of private enterprise activity, with all that involves (Xheneti and Smallbone, 2008). Despite the shared common socialist heritage, experience in this regard has varied considerably between post-communist countries because they have taken diverse paths of development, partly shaped by their pre-communist histories and experiences of communism as well as the decisions of political elites after 1989 (Dimitrova-Grajzl *et al.*, 2010).

The difficulties of the fragile Albanian democracy in establishing and enforcing the rule of law and in the full implementation of reforms reflect, among other reasons, the legacy of a short tradition of statehood. The Albanian government has suffered for years from a low level of commitment to market reforms, as well as from the lack of knowledge and resources available to the state to implement what is required. These features have led to over-reliance on donor funding and expertise and to the lack of proper functioning of the institutional infrastructure for entrepreneurship. Lack of motivation, short-term horizons and a lack of capabilities are among the general reasons that have been cited to explain the weak implementation of policies in a transition context. In the case of Albania, the majority of the laws that are introduced in the country is not followed by implementation regulations and operational guidelines that would outline the responsibilities of the administration, restrict the space for discretionary use of power and compensate for lack of transparency and accountability (for similar examples, see Smallbone and Welter (2010) for the case of Belarus and Estonia).

One important boost to creating the necessary reforms for entrepreneurship and SME development has been the strengthening of the EU membership prospects. As shown in this chapter, the Albanian endorsement of the EU SME Charter, together with the evaluations of the Charter dimensions implementation have given a new impetus to entrepreneurship and small business policy development. Nevertheless, the social and economic transformation Albania has undergone has still not enabled overcoming the legacy of hierarchical vertical structures and the involvement and appreciation of the role of all the stakeholders (enterprises included) in the policy process. The chapter, by taking a historical perspective in the role of the government in shaping entrepreneurial opportunities and behaviour, shows how processes of institutional transformation influence the features of entrepreneurship over time emphasizing the embeddedness of entrepreneurship behaviour in a specific social context (Davidsson, 2003; Baker *et al.*, 2005; Smallbone and Welter, 2006).

More specifically, changes in the social, legal and economical institutional structures operating in a specific social context influence the forms and outcomes of entrepreneurial behaviour. Whilst these countries integrate more into the EU and as a result face a different set of challenges and opportunities, the government takes a more important role as the designer and enforcer of formal institutions which influence the extent to which entrepreneurship develops and the relative scope for productive or unproductive entrepreneurial activities.

Notes

1. See http://ec.europa.eu/enterprise/policies/sme/best-practices/charter/ (accessed on 23 December 2010). It includes a package of policy measures in ten areas: education and training for entrepreneurship; cheaper and faster start-ups; better legislation and regulation; availability of skills; improving online access; more out of the single market; taxation and financial matters; strengthen the technological capacity of small enterprises; successful e-models and top-class small business support; develop stronger, more effective representation of small enterprises interests at union and national level.
2. http://www.mete.gov.al/mat.php?idm= 732&l= e (accessed on 23 December 2010).

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13

E-marketing Strategies in Emerging Markets

Tourism Industry in Bosnia and Herzegovina

Almir Peştek and Muris Cicic

Introduction

In the twenty-first century, the tourism industry has been strongly influenced by information and communications technology (ICT) growth, which in turn affected the change in the marketing strategies of companies involved in this industry. The Internet and other ICT have created new interesting and innovative ways for providing value to clients. The question arises as to how companies can use the advantages of new technologies (Yeshin, 2000).

E-marketing is the traditional marketing that uses information technology, though with certain changes (Strauss *et al.*, 2006). The Internet and other technologies do not change the fundamental marketing principles, but rather affect the traditional marketing in three ways. Firstly, they increase the efficiency of the established marketing functions. Secondly, e-marketing technologies transform many marketing strategies. Thirdly, they have fundamentally changed consumer behaviour by shifting power from companies to users (Strauss *et al.*, 2006).

As in other industries, marketing in tourism is facing opportunities and challenges due to the continued growth and evolution of the Internet and technology. Tourism is extremely suitable for clarifying the nature of changes due to the development of ICT in service industries. ICT forces companies to find new ways of market expansion, of attracting and retaining customers by adjusting their products and services according to their needs, and of restructuring their business strategy in order to gain competitive advantage. This affects each business aspect, since it changes both internal processes and external relations, and modifies and restructures entire sectors of the economy (Timmers, 1998; Porter, 2001; Wirtz, 2001). The Internet is one of the main drivers of these new developments since it provides new resources and possibilities of doing business. It is a perfect platform on which the travel and tourism industry can offer information on its products to customers across the worlds, in a direct way, with minimum cost and in the shortest time possible.

Which are the basic influences of Internet use on the tourism industry? The Internet offers much available information on prices, products and opportunities. Internet efficiency was increased by the number of "infomediaries", which offer easier access to information, development of "shopbots", which compare prices or select websites according to various selection criteria. A simple assessment of the effects of Internet use would lead to the conclusion of a decrease in information asymmetry in the market, and trends towards the emergence of a market with pure and perfect competition. Presently, the competitive value is found in information.

Impact of information and communication technologies on tourism

With about 11 per cent of the total employment across the world (Longhi, 2008), tourism is often described as the first industry in the world. This economic power of tourism, related to a strong growth potential, brought about strong competitive processes and significant industry reorganization. Tourism must be treated as an information-intensive industry (Poon, 1993; Schertler, 1995; Sheldon, 1997; Inkpen, 1998). Schertler (1995) defines tourism as an information business, since for tourism as a service industry information is one of the most important quality parameters that supports operations. There are few other fields where generating, collecting, processing, using and communicating information is so important for daily business such as tourism. It also transforms chain values and relations within the tourism and travel industry.

Hyper-competitive industries such as tourism are characterized by fast technological changes, comparatively easy entry and exit, uncertain consumer demand and brief periods of competitive advantage (Bogner and Barr, 2000). Intensity of competition in such industries requires fast and timely delivery of innovative solutions, while digital networks can service, allow and improve this process. ICT has introduced a revolution into the tourism industry (Buhalis, 1998; Wade and Raffour, 2000). Tourism was among the first to adopt the Internet revolution, and at present a vast majority of tourism companies have to a great extent digitalized their business processes.

Tourism business over the Internet is on the increase across the world. Online sales of travel and tourist services have definitely become the leading B2C sector on the Internet. Internet activities in tourism make up 30 per cent of activities in US tourism, while 50 per cent of transactions closed in e-commerce are associated with tourism (Longhi, 2008). According to Eurostat (2009), the most popular category of products and services bought online in the EU-27 are travel and vacation (14 per cent of all purchases).

Eurobarometer (2009) describes the following trends:

- In 2008, 67 per cent of EU citizens travelled and spent at least a night outside their home, 58 per cent went on holiday. It is normal that 50 per cent of citizens travel every year.
- Fifty-six per cent of those who travel organize the entire trip by themselves.
- Europeans prefer non-institutional sources of holiday information: 57 per cent use social networks.
- The Internet is the most significant non-personal source of information for holiday planning and for these purposes is used by 38 per cent of Europeans.
- Newspapers, TV and radio are the least used sources for gathering information.

These indicators are confirmed by the World Trade Organization (WTO, 2008) as well. Besides the Internet (38 per cent), Europeans also use information provided by tourist agencies (23 per cent), friends (18 per cent), travel agents' guides or catalogues (8 per cent each), magazines, airlines, local tourist representatives or newspapers (2 per cent each), as well as advertising country's tourism representatives, TV or tourism fairs (1 per cent each). The WTO also shows that the significance of Internet searches in less mature markets is more significant than personal recommendation.

According to Global Travel (2007), 61 per cent of package tour customers consult online tools for browsing before purchasing a package, either online or offline. User-generated content (UGC) and collaboration are becoming an increasingly important source of information. Travellers are increasingly consulting other Internet users (instead of information by professionals and tourist organizations) and in this way they encourage marketers to use this resource. Thus, power is now in customers' hands. Thanks to search engines, consumers can compare travel options and get a general picture of the supply. Actually, the possibility to compare destinations, hotels, locations and so on is becoming more significant than the price of travel itself.

According to the WTO (2008) the value of the online tourism market in 2006 amounted to about USD 80 billion in the USA, USD 49 billion in Europe and USD 20 billion in the Asia/Pacific region.

According to PhoCusWright (2007), the European online market in 2007 made up 27 per cent of the total market, while in the USA this level was achieved as early as in 2004 (Table 13.1).

According to Marcussen (2008), online package sales in the European market increased by 24 per cent in the 2006–2007 period, reaching 49.4 billion euros, which makes up 19.4 per cent of the entire market (39.7 billion euros or 16 per cent in 2006). The growth rate for the period 1998–2009 is shown in Table 13.2.

Table 13.1 Share of online travel in Europe and USA, 1999–2007 (percentage of the total market)

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Europe	n.a.	n.a.	n.a.	4	6	9	14	20	27
USA	4	7	7	14	21	25	29	34	38

Source: PhoCusWright (2006), taken from Global Travel (2007).

Table 13.2 Trends in the European online tourism market

Year	**Market value, billion euros**	**Value of Internet sales, billion euros**	**% of total market**	**% increase**
1998	200	0.2	0.1	NA
1999	212	0.8	0.4	257
2000	227	2.5	1.1	216
2001	223	5.0	2.3	99
2002	221	8.9	4.0	77
2003	215	13.9	6.5	56
2004	220	20.8	9.5	50
2005	235	30.2	12.9	45
2006	247	39.7	16.1	31
2007	254	49.4	19.4	24
2008	260	58.4	22.5	18
2009	266	69.9	25.2	15

In most cases, developing countries do not benefit from the possibilities offered by the new tourism (UNCTAD, 2004). World tourism is mainly focused on rich countries. Most information on tourism opportunities of developing countries is being generated, updated and published by leading international service providers based in the developed countries. With their apparently better technological position, these service providers therefore gain most sales and absorb the greater part of profits. For example, over 85 per cent of the total tourism industry profit generated in the African countries has come back to firms in the developed countries. The situation is not much better in the Caribbean (80 per cent) or Asia (7 per cent in Thailand and 40 per cent in India). What can be done in order to turn this trend around? One possibility for the developing countries (including Bosnia and Herzegovina) is to use the advantages of new opportunities through ICT branding and promote their own tourism industry. Unlimited and cheap access to the global market, information and networks is therefore essential. In order to achieve this, it is necessary that local small and medium-sized businesses in the tourism industry become more involved in global ICT networks, as well as in the development of local ICT policies for the sector. E-marketing in tourism (within e-tourism) can help developing countries in using tourism potentials and opportunities and, if conducted efficiently, it can provide better control over their own tourism industry and far greater benefits for their tourist companies.

Use of e-marketing in tourism

At present, use of e-marketing and ICT in tourism transforms rules of competition in two basic ways:

(1) by decreasing information asymmetry, and
(2) by eliminating and changing intermediaries, which particularly affect the tourism industry and industry reconfiguration (Longhi, 2008).

In their use of e-marketing, organizations undergo a few evolutionary stages (Chaffey *et al.*, 2006), from websites for one-way communication, which are sometimes called brochure sites (since they list products and prices) to websites offering two-way communication and sale transactions. Nowadays, Web 2.0 (collaborative possibilities) is also added to this group. Websites can then evolve even further, into a system of e-business where the website is only the hub of all processes.

E-marketing planning implies planning in the context of the e-environment of e-business. The e-marketing plan is based on traditional marketing disciplines and planning techniques adjusted to the digital media environment, which is then coupled with new techniques of digital marketing communications.

One of the crucial parts of e-strategy includes the development of dynamic dialogue and, eventually, the full utilization of the integrated database potential. Therefore e-strategies include the following:

- Clear goals (what a company wants to achieve online).
- Target markets, positioning and propositions.
- The optimum mix of tactical e-tools (website, banner ads and so on).
- Evolution stage.
- Online marketing mix.
- Dynamic and continuous dialogue with customers.
- Integrated database.

This should also be complemented with the measurement of activity success. Success results are measured based on detailed goals embedded in the general goals and strategy. Use of relevant metrics is considered crucial for measuring performances (Inan, 2002). Measuring performance helps organizations to improve their tactical and strategic decision-making, since it shows the efficiency of planning and operating strategies and processes. Use of e-metrics can optimize online business and identify opportunities for further investment, since it provides more accurate estimates of the company's return on investment (ROI). The obtained feedback and insights in online campaigns allow organizations to compare and integrate online and offline marketing performances, and make a decision on the desirable marketing mix that maximizes profit for the company (Ranganathan *et al.*, 2004) Finally, it allows establishment of the rate of online content refreshment and thus minimizes the cost of website maintenance in terms of money and time.

At present, many companies make a mistake in developing their e-marketing strategies, since they immediately move to the development of tactical e-tools (website), without first agreeing upon the clearly defined goals and an efficient strategy. Theory and practice show that the basic prerequisites for using e-marketing in a company are

- Existence of a clearly defined strategy at a company level.
- Existence of the marketing function within the company.

- Domination of the marketing function in the development, implementation and monitoring of e-marketing results.
- Existence of a database and building customer relations.

The Internet is a very powerful tool, with momentary results and great reach, but it is by no means a replacement for traditional marketing strategies. The Internet is thus only one element of a well-defined tourist companies' marketing strategy.

Law and Leung (2002) recognize the trend for organizations to have a website with much information, most of which is poorly organized, outdated or incorrect. Views on websites frequently remain somewhere in the domain of advertising (Corigliano and Baggio, 2004), and tourism companies do not manage to gain benefits such as an increased sales volumes and improved reputation (Law and Leung, 2002). Gianforte (2003) claims that an improvement of customer experience using a website may lead to at least 33 per cent increase in sales. A good website design must satisfy customer needs for information and transaction possibilities (Heldal *et al.*, 2004). Effective websites require continuous assessment, careful management and frequent changes, as well as innovation (Reichheld and Schefter, 2000; Albert *et al.*, 2004).

Morrison *et al.* (1999) recognize the following multi-dimensional critical factors for online success (Table 13.3).

Table 13.4 shows the expected characteristics of tourism websites that lead to repeated visit.

Tourism in Bosnia and Herzegovina

Estimates from the Travel and Tourism Council report (WTTC, 2007) show that almost 12 per cent of the Bosnia and Herzegovina's economy is related to tourism and travel, with over 100,000 jobs (1 per each 10.5 jobs) generated in this sector, and that it makes up a fifth of Bosnia and Herzegovina's exports.

Bosnia and Herzegovina has excellent potential for the development of

- cultural tourism
- mountain tourism
- healthcare tourism
- coastal tourism
- religious tourism
- rural tourism
- adventure tourism.

Table 13.3 Critical success factors

Perspective	Critical success factors
Technical	– link up datedness – effective use of HTML – reciprocal connection between hyperlinks – registration with search tools – short download time – traffic tracking and analysis
Marketing	– approach in positioning – segmentation and targeting – market research and database marketing – relationship marketing – partnership – service tangibility – marketing assessment
Internal	– simple maintenance – timing of maintenance and additions – maintenance skills
Consumer	– attractiveness – availability and bookings – content and organization – information accuracy – interaction – particular client groups' needs – reply verification and speed – security – user friendliness

Source: Morrison *et al*. (1999).

Table 13.4 Expected characteristics of tourism websites that lead to repeated visit

Website characteristics	%
Possibility to check availability and prices of flights, hotels, rent-a-car agencies	55
Destination information	50
Promotion and rewards	50
Travel information and announcements	22
Chat/forum for providing and reading travel information	13
Personalization possibility	11
Newsletter	10

Source: Burst Media (2007), taken from WTO (2008).

In line with the tourist definition, foreign tourist arrivals to Bosnia and Herzegovina can be classified into the following categories (King and Čar, 2008):

- Holiday tourists: they come to Bosnia and Herzegovina on summer holiday, cultural and winter-mountain tourism. They also include regional tourists, from Central and Southeast Europe who travel by land and tourists from Western Europe and beyond. This group also includes one-day tourists who are an important category for Bosnia and Herzegovina bearing in mind the proximity of Mostar and other Herzegovinian sites to the Croatian Adriatic coast.
- Business tourists: this category pertains to individual business travel and activities by governments and donors, including regional and overseas travellers. They mainly come to the six biggest Bosnia and Herzegovina cities, and stay in hotels and motels.
- Religious tourists: visitors to Međugorje.
- Tourists from the diaspora: Bosnia and Herzegovina is one of the countries that register the greatest impact of this category worldwide, due to the extremely high emigration rates during and after the war.

Over the last years, tourism in the country has been characterized by permanent growth of tourists and bed-nights as shown in Table 13.5.

Recent years also registered an increase in accommodation facilities. However, there is a significant over-capacity of tourism facilities, which can partly be explained by an ad hoc approach in tourism development (Peştek and Čičić, 2010b). The rate of capacity utilization in Europe amounts to 65.7 per cent (Deloitte, 2009), while in Bosnia and Herzegovina it is 34.8 per cent only (Table 13.6).

A total of 206 travel agencies are registered as a combination of travel agents and intermediaries. Tourist packages are typically offered for destinations outside the coutry, while the number of tourist agencies involved in inbound tourism is limited (VTKBiH, 2007).

The greatest number of visits and bed-nights involves tourists from surrounding countries (Table 13.7).

What is concerning is the very short average tourists' stay (about two days in 2008) as shown in Table 13.8.

Bosnia and Herzegovina cannot boast about the speed and quality of adopting new technologies and knowledge. The causes are many, from those at the micro level (company) to reasons at the macro level (state). There is no systemic framework that would stimulate development, education and improvement of the environment. Only in 2009 was

Table 13.5 Number of tourists in Bosnia and Herzegovina, 1997–2008

Year	Federation B-H		RS		Brčko District		Total B-H	
	Tourists	Bed-nights	Tourists	Bed-nights	Tourists	Bed-nights	Tourists	Bed-nights
1997	160,000	41,500	108,009	362,243	–	–	268,009	777,243
1998	189,000	453,000	148,175	437,736	–	–	337,175	890,736
1999	199,301	474,327	168,375	473,705	–	–	267,676	948,032
2000	221,418	511,048	169,720	440,760	–	–	391,138	951,808
2001	184,193	415,584	146,133	359,890	–	–	330,326	775,474
2002	214,640	505,772	151,838	384,187	–	–	366,478	899,959
2003	228,378	509,540	152,441	391,995	–	–	380,819	901,35
2004	258,430	562,254	151,280	407,749	–	–	417,694	1,009,410
2005	276,912	596,685	150,526	397,976	9,778	22,722	434,216	1,017,383
2006	294,541	661,113	191,934	489,441	12,769	26,898	499,244	1,177,452
2007	347,320	750,789	222,729	561,995	13,693	23,375	583,742	1,336,159
2008	354,773	744,484	241,145	625,842	14,899	26,159	610,817	1,396,485

Source: Statistics Agency of Bosnia-Herzegovina (2009).

Table 13.6 Accommodation capacities in Bosnia and Herzegovina per types of facility, 2009

Type of facility	Facilities	Accommodation units	
		Rooms	Beds
Total	383	11,333	23,523
Hotels	182	8,759	18,127
Motels	103	1,316	2,749
Boarding-houses and B&Bs	63	751	1,558
Households	14	98	219
Workers' resorts	21	409	870

Source: Statistics Agency of Bosnia-Herzegovina (2009).

Table 13.7 Top ten countries tourists come from

Country	Number of arrivals	Number of bed-nights
Serbia	60,481	142,811
Croatia	53,512	108,233
Slovenia	36,596	68,493
Germany	17,201	35,493
Italy	16,090	31,826
Austria	12,163	21,920
Turkey	12,091	31,081
Poland	12,041	36,776
France	9,576	25,881
Montenegro	8,129	21,123

Source: Statistics Agency of Bosnia-Herzegovina (2009).

Table 13.8 Average tourists' stay in Bosnia and Herzegovina (in days)

Year	Total	Local	Foreign
2007	2.3	2.3	2.3
2008	2.3	2.3	2.3

Source: Statistics Agency of Bosnia-Herzegovina (2009).

the Strategy of Tourism Development in the Federation of Bosnia and Herzegovina for the period 2008–2028 developed, while in Republika Srpska this strategy is still in the process of development. Therefore, it is not surprising that Bosnia and Herzegovina's position and competitiveness is very poor on a global scale, which can particularly be seen through the travel and tourism competitiveness index shown in Table 13.9. The low competitiveness, with no positive change vis-à-vis 2008, is obvious. Bosnia and Herzegovina is ranked in the lower group of countries, with somewhat satisfactory ranking only in the following fields: security, health and hygiene, tourism infrastructure, ICT infrastructure and availability of skilled labour. Compared to other countries in the region, this position is rather weak with Croatia ranked 34th, Slovenia 35th and Montenegro 52nd.

Table 13.10 reveals details of Bosnia and Herzegovina's competitiveness indices.

Table 13.9 Travel and tourism index of Bosnia and Herzegovina's competitiveness, 2009

Parameter	**Ranking (out of 133)**	**Rating (1–7)**
Index 2009	107	3.4
Index 2008	105	3.4
Travel and tourism regulatory framework	96	4.1
Rules and regulations	119	4.1
Environmental sustainability	115	3.9
Security	57	5.3
Health and hygiene	56	5.0
Travel and tourism prioritizing	126	3.0
Travel and tourism business environment and infrastructure	93	3.0
Air transportation infrastructure	130	1.9
Land transportation infrastructure	126	2.2
Tourism infrastructure	57	3.7
ICT infrastructure	66	2.9
Travel and tourism price competitiveness	100	4.2
Travel and tourism human, cultural and natural resources	124	3.3
Human resources	109	4.4
education and training	124	3.1
availability of skilled labour	30	5.7
Travel and tourism affinities	92	4.5
Natural resources	123	2.2
Cultural resources	81	1.9

Source: World Economic Forum (2009).

Table 13.10 Details of travel and tourism Bosnia and Herzegovina competitiveness indices, 2009

Competitiveness element	**Ranking (out of 133)**
1. Rules and regulations	
presence of foreign ownership	100
property rights	121
effect on foreign direct investment	127
visa requirements	78
openness to agreements on air services	73
government policies' transparency	129
time needed to start a business	115
cost of starting a business	96
2. Environmental sustainability	
power of environmental regulations	130
implementation of environmental regulations	127
sustainability of travel and tourism industry development	129
CO_2 emissions	70
ratification of agreements on environment	127
endangered species	39
3. Security	
cost of business focusing on terrorism	23
reliability of police protection	110
cost of business focusing on crime and violence	70
traffic accidents	15
4. Health and hygiene	
number of physicians	70
access to advanced sanitary facilities	46
access to advanced drinking water	38
hospital beds	57
5. Travel and tourism prioritizing	
government priorities to travel and tourism industry	111
government travel and tourism expenditures	117
branding and marketing efficiency	125
Travel and tourism fair presence	98
6. Air transportation infrastructure	
quality of air transportation infrastructure	131
available sites per kilometre/domestic	100
available sites per kilometre/foreign	129
departures per 1000 persons	87
airports density	59
number of operating airlines	113
international airline transportation network	130
7. Road transportation infrastructure	
road quality	130
quality of railway infrastructure	103

quality of ports infrastructure	133
quality of underground transportation network	96
roads density	55
8. Tourism infrastructure	
hotel rooms	70
presence of major "car rental" agencies	1
ATM acceptance of credit card	74
9. ICT infrastructure	
ratio of business Internet use	91
Internet users	55
telephone lines	52
broadband Internet subscribers	67
mobile telephony subscribers	83
10. Price competition in travel and tourism industry	
airport taxes and costs	110
purchasing power standard	59
ratio and effect of taxes	111
fuel prices	104
hotel prices indices	–
11. Human resources	
number of persons with primary education	–
number of persons with secondary education	109
education system quality	92
local availability of research and training services	126
ratio of training staff	125
employment and dismissal practices	20
ease of employing foreigners	76
HIV presence	1
HIV/AIDS effect on business	26
life expectancy	42
12. Affinity for travel and tourism	
tourist openness	48
local population's conduct towards foreigners	98
expansion of recommended travel	117
13. Natural resources	
number of "Natural world heritage" sites	74
protected areas	124
quality of natural surroundings	71
total of known species	104
14. Cultural resources	
number of "Cultural world heritage" sites	82
sports stadiums	36
number of international trade fairs and exhibitions	83
creative industries' exports	86

Source: World Econmic Forum (2009).

It is also interesting to inspect the overall picture of the country's competitiveness on a global scale. In the World Economic Forum's Report on global competitiveness of 2007, it is ranked 89th out of 125 reviewed countries. Compared to the report for 2006, when Bosnia and Herzegovina was ranked 88th out of 117 countries, it can be claimed that it had not made substantial progress. In the business competitiveness index it ranked 96th out of 121 countries (101st in 2006). With respect to the global competitiveness index, it is the last but one country in Southeast Europe, with Albania being the last.

E-marketing strategies in the tourism sector of Bosnia and Herzegovina

The tourism market in Bosnia and Herzegovina cannot be considered separate from global developments and trends. Although the country possesses certain specifics due to the environment (particularly war events and state organization), companies in the tourism industry are still forced to adopt and use practices that have long been used across the world.

This begs a logical question pertaining to the willingness and possibilities of using the Internet and e-marketing by the management of tourist companies and their ability to keep pace with contemporary market trends. Although many marketers highlight the importance of having a company's website, there has been comparatively little research into how this medium fits the overall marketing strategy of tourism companies, that is, into the way in which the Internet and ICT are perceived and used as marketing tools in the companies themselves. Besides, there is limited reliable secondary data in this field.

As of recently, shifts have been registered in the development of e-marketing strategies and, through the Internet development, of tourism destinations' portals, owing to the international institutions, for instance, the International Finance Corporation (IFC) in partnership with Worldhotel-link.com and through the support to the development of www.sarajevo-travel.ba and www.mostar-travel.ba. The number of such booking engines that allow accommodation bookings over the Internet is limited, and the same applies to the back-office functions, search engine optimization (SEO) advertising and result tracking. Over a year of this project's existence, a total of 70 tourist service providers were included in the database. The number of stand-alone applications,

Figure 13.1 www.sarajevo-travel.ba portal
Source: http://www.sarajevo-travel.ba

that is, tourism service providers' independent websites is also on the increase (Figure 13.1).

To illustrate the current conditions in the use of e-marketing in hotel companies and tourist agencies in Bosnia and Herzegovina, we may use the research conducted on a sample of 206 units (63 tourist agencies and 143 hotels/hostels) in 2009. The research attempted to present the application of concepts defined in works by Bush *et al*. (1998), Chaffey *et al*. (2006), Čičić *et al*. (2000), Tihi *et al*. (2008) and Michopoulou and Buhalis (2008). The research was aimed at learning about the application of e-marketing through the perspective of companies' chief executive officers (CEOs) and marketing managers, and more particularly:

- The perception and ways of using the Internet and ICT as marketing tools.
- Development and implementation of e-marketing strategies.
- The ways of measuring e-marketing strategies' efficiency.

According to these research findings (Peştek, 2009), 159 companies from the analysed sample of 206 companies (77 per cent) have a website of their own. Out of them 47 companies currently do not have a website and 31 (66 per cent) plan to develop one in the future. Table 13.11 presents the main findings of the research.

Evidence of the tourism industry hyper-competitiveness and a need for e-marketing strategies can be found in the companies' assessment that a website is presently considered a necessity in the modern tourism business. Without e-marketing, it is difficult to keep pace with competition and market demands. This should be kept in mind particularly since at present, power is on the customer's side. Besides, e-marketing is considered part of the company's overall marketing strategy.

Companies believe that use of marketing helps them to internationalize business and increase their image. Furthermore, e-marketing significantly contributes to the company's overall success and they are satisfied with the ROI.

Due to the significantly high ratings for the implementation of criteria that express the significance of the Internet and website within the company business, it can be deduced that the observed companies attach a high significance to the Internet and website and intensively use them as a necessary and important part of the marketing strategy in their business.

About 52 per cent of the observed companies have a developed strategic plan (for 3–5 years or longer). Fifty-five per cent have a developed marketing plan, and 38.99 per cent of the companies from the sample have a website and have also developed a strategic and marketing plan. In 76 per cent of cases, the company's general manager makes the decision on using the Internet, and this prevails in the sample. This can be explained by the concentration of functions in small and medium-sized enterprises (SMEs), which make up the majority of the tourism companies in Bosnia and Herzegovina.

According to the above analysed criteria, companies that have a strategic or marketing plan are more successful than the group of companies that do not have such plans. Besides, companies that have a strategic or marketing plan and that have an organized marketing office (about 39 per cent of the observed companies) are more successful than the other companies.

In the future, companies plan to intensify activities related to e-marketing and expect e-marketing to have a favourable effect on their competitive position. According to the research findings, some 50 per cent of companies have registered a 20 per cent rate of growth of total revenue and revenue from Internet activities compared to previous years. Based on the average growth rate, a similar trend in growth of

Table 13.11 Descriptive statistics parameters for the observed samples

Criterion	**Group**	***N***	**Average rating**	**Standard deviation**	**Error in average estimate**
Internet is part of our marketing strategy	Hotel/hostel	106	4.538	0.928	0.090
	Tourist agency	53	4.566	0.747	0.103
Having a website is a must in our business	Hotel/hostel	106	4.576	0.936	0.091
	Tourist agency	53	4.623	0.904	0.124
When hiring new staff, we take into account the knowledge necessary for Internet use	Hotel/hostel	106	4.038	1.352	0.131
	Tourist agency	53	4.604	0.817	0.112
We change the website content based on the analysis of website usage	Hotel/hostel	106	3.887	1.319	0.128
	Tourist agency	53	4.132	1.038	0.143
We change the website content based on the analysis of website usage	Hotel/hostel	106	4.189	1.220	0.118
	Tourist agency	53	4.453	0.889	0.122
Clients are able to register for receiving a newsletter	Hotel/hostel	105	3.229	1.619	0.158
	Tourist agency	53	4.283	1.215	0.167
Clients are able to post comments on the website	Hotel/hostel	104	3.740	1.539	0.151
	Tourist agency	53	4.038	1.441	0.198
Clients are able to communicate with other website users	Hotel/hostel	106	3.274	1.607	0.156
	Tourist agency	52	3.712	1.500	0.208
Clients are able to adjust pages to their needs	Hotel/hostel	106	3.066	1.469	0.143
	Tourist agency	53	3.509	1.449	0.199
We build a community with our clients via the website	Hotel/hostel	106	3.632	1.389	0.135
	Tourist agency	52	3.750	1.100	0.153
Clients are able to assess an offer or comment on it on the website	Hotel/hostel	106	3.802	1.552	0.151
	Tourist agency	53	4.132	1.210	0.166
We know our website clients by their name, last name or user name	Hotel/hostel	106	4.085	1.408	0.137
	Tourist agency	53	4.151	1.150	0.158

Table 13.11 (Continued)

Criterion	**Group**	***N***	**Average rating**	**Standard deviation**	**Error in average estimate**
Link to our website can be found in well-known directories or on other websites	Hotel/hostel	104	3.952	1.403	0.138
	Tourist agency	52	4.077	1.169	0.162
Our website directs the client to other useful web pages – links	Hotel/hostel	105	3.448	1.605	0.157
	Tourist agency	53	4.076	1.269	0.174
We monitor clients' needs and send them e-mail offers adjusted to their needs	Hotel/hostel	106	4.028	1.390	0.135
	Tourist agency	52	4.346	1.046	0.145
We have a database with users' e-mail addresses	Hotel/hostel	106	4.226	1.297	0.126
	Tourist agency	53	4.377	1.130	0.155
We permanently monitor results of our web page usage	Hotel/hostel	105	4.219	1.109	0.108
	Tourist agency	53	4.321	0.936	0.129
We use the website for investigating potential clients' needs	Hotel/hostel	106	4.104	1.195	0.116
	Tourist agency	53	4.396	1.025	0.141
We use the website for investigating the existing clients' satisfaction	Hotel/hostel	106	4.000	1.280	0.124
	Tourist agency	53	4.472	0.823	0.113
On our website, we also provide useful information on the environment (city, country, other tourist offers, weather forecast, foreign exchange list, logistic information etc.)	Hotel/hostel	105	3.810	1.582	0.154
	Tourist agency	53	3.660	1.556	0.214
Marketing over the Internet significantly contributes to the overall success of our marketing efforts	Hotel/hostel	106	4.274	1.100	0.107
	Tourist agency	53	4.547	0.867	0.119
We are satisfied with the return on investment in Internet marketing	Hotel/hostel	106	4.340	1.068	0.104
	Tourist agency	53	4.415	0.929	0.128
Internet marketing leads to the increase in our image	Hotel/hostel	106	4.651	0.718	0.070
	Tourist agency	53	4.660	0.783	0.108
Internet marketing leads to the internationalization of our business	Hotel/hostel	105	4.657	0.782	0.076
	Tourist agency	53	4.679	0.728	0.100

We continuously measure effects of website usage	Hotel/hostel	105	4.229	1.085	0.106
	Tourist agency	53	4.566	0.888	0.122
We have clearly defined parameters for measuring effects of website usage	Hotel/hostel	105	4.191	1.210	0.118
	Tourist agency	53	4.528	0.912	0.125
We know what is the return on our investment in Internet marketing	Hotel/hostel	105	3.886	1.332	0.130
	Tourist agency	52	4.115	1.149	0.159
Results of the website usage help us better adjust to the market	Hotel/hostel	105	4.305	1.093	0.107
	Tourist agency	52	4.539	0.828	0.115
We know what visitors to the site do on our site	Hotel/hostel	106	4.217	1.203	0.117
	Tourist agency	53	4.321	1.173	0.161
We know what proportion of visitors convert into clients	Hotel/hostel	106	4.311	1.116	0.108
	Tourist agency	53	4.453	0.972	0.134
We know what proportion of clients return to our website	Hotel/hostel	106	4.208	1.209	0.117
	Tourist agency	52	4.385	1.069	0.148
Investment in Internet marketing reduces our investment in other media	Hotel/hostel	105	3.971	1.326	0.129
	Tourist agency	53	4.208	1.166	0.160
We plan to increase activities related to Internet marketing in the next year	Hotel/hostel	105	4.238	1.131	0.110
	Tourist agency	51	4.373	0.979	0.137
Internet marketing provides my company with competitive advantage	Hotel/hostel	105	4.505	0.932	0.091
	Tourist agency	53	4.453	0.845	0.116

total income and income from Internet activities can be observed compared to 2006 and 2007. Besides, more activities were registered in 2007 compared to 2006.

E-mail communication is the prevailing e-marketing activity. Activities related to building communities, website customization, personalization and interaction on websites are less present and developed. These are critical activities and it is necessary to work on developing this e-marketing segment in the future, since customers like and want their personal communication created according to their desires, in the case of both e-mail and personalized websites.

Company websites can mostly be found in the known databases or directories. Besides, websites include useful data on the environment, which is very important from the aspect of developing a destination and related synergy effects. It also increases ranking on the browsers, and ultimately increases effectiveness.

Companies have developed elements of tracking results (e-metrics) and they have also developed customer databases. Companies believe that results of website use tracking allow greater flexibility and improve the quality of their overall marketing efforts. Websites are also a tool for examining clients' needs and satisfaction, as well as for content adjustment to customer needs. It is an excellent opportunity to gain competitive advantage by developing an integrated customer relationship management (CRM) system that adds value to customer expectations, brings them closer to the company, listens to them, gathers data and provide services according to their needs.

About 43 per cent of companies measure the effect of marketing over the website based on the number of online reservations. Some 39 per cent of companies use the number of visits to the website to measure the effects of marketing over the website, 13 per cent measure the effects through income and only 3 per cent by ROI.

As an important fact, companies point out that e-marketing provides a sustainable competitive advantage to the company.

Concluding remarks

Changes in the tourism industry are dramatic and fast and affect both the distribution channels and the kind of tourism service provider that can effectively attract customers via that channel and connect to them effectively. Owing to the dynamic online demand and fast changes in consumer behaviour, the Internet creates a completely new dynamic environment. Competitive dynamics created by the Internet lead to dramatic shifts in the strategic position of each player in the entire tourism industry.

It can be claimed that Bosnia and Herzegovina is at the beginning of the business transformation process, which many developed countries started a long time ago. However, if more is done on developing the macro-environmental conditions and industry integration, we believe that the country can easily catch up and improve its position.

In a great number of cases, application of e-marketing strategies is at an initial stage (Peştek and Čičić, 2010a) – through informational websites and e-mail use, mostly without transaction systems, links between front-office and back-office, and use of Web 2.0 technologies.

It is evident that companies in Bosnia and Herzegovina generally use an unplanned, ad hoc approach, which is incomparable with marketing practice. Companies make mistakes since they decide for the development of tactical e-tools (websites) without a clearly defined strategy.

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14
Transformation of the Estonian Banking System
From Uncertainty to Stability

Mart Sõrg

Introduction

The transformation of the banking and financial sector in transition economies has become critical for the successful shift from centrally planned to market-driven economic systems. Such reforms led to the creation of financial markets, which are essential for market transactions. The development of the financial sector has been one of the most difficult areas of reform since at the start of transition financial institutions and markets were limited or non-existent (Fries and Taci, 2001). Financial sector reforms are not easy to accomplish in a turbulent environment. This is even more so considering the high speed of economic and social transformation as well as the length, severity and effects of the economic and financial crises experienced in the course of the transition process. Adding to the complexity of the reform process has been the lack of risk management experience in the banking sector and the numerous changes in banking regulations.

Reforms in the Estonian banking sector started in 1988, three years before restoring the political independence of the country in August 1991.The first period of development of the new banking system ended with a banking crisis. The latter started in the autumn of 1992 and reduced the number of operating banks almost by half. The second period of banking reform was interrupted by a new banking crisis in 1998. It brought about mergers of existing banks, bankruptcy and eventually led to the arrival of foreign banks which were perceived as strategic investors by the government. Following the crisis only five banks and one branch office of a foreign bank remained operational.

The banking crises compelled the Bank of Estonia to initiate a programme of measures for the improvement of the banking regulations and supervision. The Estonian Parliament (*Riigikogu*) passed several new Acts concerning the financial sector. The Credit Institutions Acts were passed in 1994 and in 1999. Since January 2002 financial sector supervisory functions and responsibilities have been concentrated and integrated into a single Financial Supervision Authority.

To date the transformation of the Estonian banking system has been completed. The banks have entirely based their operations on market principles. Prudent economic management supported by a stable currency and the persistence of the central bank in pursuing the implementation of reforms and the enforcement of all new rules and regulations have become the cornerstone of the success in the banking sector reform.

The first banking reconstruction period 1988–1992

Reform of the banking system in the former USSR started in 1988. Three big USSR state-owned banks were reorganized into the central bank and five specialized banks. In the same year, a bill was passed to allow the establishment of cooperative and commercial banks. At that time, Estonia had a major political priority which could be supported by the transformation of its banking system. That was the aspiration to gain political and economic independence from Russia. As a result Estonia pioneered the implementation of reform policies and processes in the banking system of the USSR. In September 1988, the first commercial bank in the Soviet Union, Tartu Kommertspank (Tartu Commercial Bank), was established. Shareholders of the bank were Estonian state-owned enterprises.

The fixed capital needed for the establishment of a commercial bank had to be 5 million Soviet rubles, which was rather impossible for smaller investors. To assist with the process of raising the necessary amount of capital Tartu Kommertspank gave several groups of shareholders permission to establish branch offices. Formally these were branches of the Tartu Commercial Bank, but actually they were independent in their banking policies. These branches could become formally independent if and when they managed to raise the required share capital. Such actions helped to speed up the formation of an alternative banking structure to the state-owned banks in Estonia.

Consequently, the separation from the economic space of the USSR and the transition from a socialist command economy to a market-based one went hand in hand, which caused a deep economic crisis in Estonia and the other Baltic states. Although facing unprecedented difficulties and obstacles, the Baltic countries engaged in painful but systemic and comprehensive economic restructuring. Consequently, as old economic networks collapsed and new ones were not yet in place, production output fell dramatically over several years. The economies were hit by hyperinflation. In several years' time, the volume of gross output decreased by more than 10 per cent; in the period 1990–1994 Lithuanian GDP dropped by almost 60 per cent and prices increased 250 times (Table 14.1). Under such difficult conditions, it would have been impossible for any banks to sustain normality in the management of credit, interest rate and exchange rate risks.

The hyperinflation in 1991 reduced the real value of the obligatory initial capital of the commercial banks several times. Now businessmen who had made money with intermediation of government property had an opportunity to establish their own banks to pump supplementary resources into their business. A boom in mushrooming banks followed in the first half of 1992 when 21 new commercial banks were issued an operational licence. Prior to the currency reform, the number of banks was very high for the size of the economy. At the end of 1992, the total number of commercial banks was 41 but most of them were relatively small. The banks were also small with respect to the number of shareholders, for example, 11 banks had less than ten shareholders and amongst them there were two banks that had only one shareholder.

At the time of the centrally planned economic system, the banking sector had been doing little more than allocating funds to various economic sectors and individual companies following a top-down approach

Table 14.1 GDP and inflation in the Baltic states

	Estonia	**Latvia**	**Lithuania**
GDP % change in volume cf. 1990	−6.5	2.9	−6.9
1991	−13.6	−10.4	−13.1
1992	−14.2	−34.9	−37.7
1993	−8.5	−14.9	−24.2
1994	−2.7	−0.6	1.7
GDP collapse 1990-1994 (%)	31.0	52	58
Output collapse 1990-1994 (%)	60.0	64	67
Total price increase 1990-1994 (%)	8,100	4,600	24,600

Source: *Nordic Economic Outlook and the Baltics* (1996).

of resource allocation. Consequently, when the transformation process began, the banking sector was characterized by parameters such as:

- Almost non-existent competition.
- Lack of customer orientation.
- Low degree of management know-how and insufficient technical equipment.
- Poor loan culture and risk awareness (Stepic, 2002).

Another major reason for the weakness of the banking system in Estonia and other Baltic states at the time was the extremely limited capacity of resources in the sector. The Bank of Estonia can certainly be blamed for issuing banking licences too easily, determining rather low demands on equity capital requirements and tolerating the low level of professional skills and competencies of bank managers, but even critics of its behaviour have not been able to point to alternatives. These changes effectively supported Estonia in achieving economic independence from Russia. This could only happen by establishing a banking system based on national private capital to counterbalance the USSR state-owned banking system governed by Moscow. Beyond any doubt at the time of these major changes the human and financial capital resources outside the USSR banking system were limited. Therefore every initiative and capital investment was welcomed in the banking sector. It should also be noted that the low wages made the recruitment of highly qualified banking staff from overseas unthinkable.

On 28 December 1989, the Supreme Council of Estonian Soviet Republic passed the Banking Law. It defined the functions of commercial and cooperative banks, the principles of bank operations, the role of the Bank of Estonia, and the rules governing property collateral and creditor protection. The minimum share capital requirement for commercial banks was 5 million roubles and for cooperative banks 2 million roubles. However, cooperative banks were not established in Estonia.

The law specified capital-asset ratios for commercial and cooperative banks at 1:20 and 1:12, respectively. Household deposits could not exceed 100 per cent of the capital for commercial banks or 50 per cent for cooperative banks. The ratio of liquid assets to short-term liabilities must exceed 30 per cent for banks providing cashier services or 15 per cent for other banks. The ratio of long-term assets to capital plus long-term liabilities (over 12 months) could not exceed 100 per cent. The law did not request provisions against doubtful loans and did not clearly define the rules on disclosure of financial information for supervisory bodies of banks (Estonia, 1993).

The Bank of Estonia was re-established in January 1990. During the first years of operation, it developed its staff, created the normative basis for performance of the banking system and established itself as the country's central bank. The local branch of the central bank of the Soviet Union State Bank practically stopped the supervision of the banks on the territory of Estonia in 1988. However, in order to strengthen its position in the initial years after its establishment the Bank of Estonia would allow the commercial banks to do things prohibited by Moscow rather than try to reprimand them. For that reason, the banking system began its development without the restrictions and supervision usually imposed by the central bank.

In addition to the inability of the central bank to administer the banking system efficiently, the weakness of the central bank was exacerbated by the lack of Estonian own currency and the lack of market trust in the inflationary rouble. Therefore the banks dealt with traditional banking operations modestly and were more interested in businesses promising good profit. Before the currency reform in June 1992, the loan interest income of the commercial banks was only 5.3 per cent of total returns.

Table 14.2 shows that the banks had corrected their strategy for profit earnings in the second half of 1992. The share of currency exchange fees increased significantly in comparison with exchange rate margins. The reason for this was the currency reform that started on 20 June 1992. It established the Estonian kroon (EEK) as the legal tender with a fixed exchange rate. As the exchange rate against the Deutschmark was stable (8:1), the currency risk remained only with respect to the currencies that were not pegged to the Deutschmark. Thanks to the fixed exchange rate, inflation quickly started to decline. However, income and turnover from currency exchange declined significantly after the currency reform. This had to be compensated and the solution was found in activating the credit activities. As the economic crisis had reached its worst point in 1992, this was a very risky undertaking. Therefore, the interest rate was high. For some banks, the turn from currency exchange business to granting loans was too abrupt; they became illiquid and collapsed. Unfortunately, these included some banks that were perceived as trustworthy by the public. At that time, the system of deposit insurance had not been initiated and due to the principles of the currency board agreement, the Bank of Estonia had limited options to restructure the banks. Consequently, many people and firms lost their savings either partially or completely.

Table 14.2 Income and expenses of Estonian commercial banks in 1992 (EEK million)

	1992 total	1992	
		First half of the year	**Second half of the year**
Total income	1492	605	887
Including:			
Interest income	454	32	422
Exchange rate margin	677	460	217
Commission income	352	92	260
Other fees	9	21	−12
Total costs	1399	572	827
Including:			
Interest expense	85	11	74
Management costs	165	19	146
Exchange rate margin	702	461	241
Commission expenses	249	17	232
Other expenses	198	64	134
Profit of the financial year before taxes	93	33	60
Receipt expenses (%)	93.8	94.5	93.2

Source: Sõrg (1995).

We could argue that the banking crisis was imminent, because the reforms coincided with the systemic changes in the monetary and economic system; hence, it happened in conditions of a deep economic recession and hyperinflation. Under such exceptionally difficult circumstances, even the well-established banking systems of developed countries, that strictly follow banking principles, would not have been able to avoid a crisis.

In order to limit the amount of cash in circulation, the Board of the Bank of Estonia set up a reserve requirement for commercial banks. This ratio was to increase gradually from the initially effective 10–15 per cent by 1 December 1992. The Currency Reform Committee with its decree of 17 June 1992 had invalidated all bank operating licences starting from 1 July. Effectively, it allowed the Bank of Estonia to extend the old operating licences of commercial banks until 1 January 1993. Thus Bank of Estonia could nullify the right of operation of all banks that had not actually started their operations, and forced the others to put their business activities in line with the new requirements.

Subsequently, by 1994 the number of commercial banks decreased more than twice due to bankruptcies and mergers. The pressure of the crisis was felt badly by the large commercial banks. The crisis had much in common with the banking crises in the Nordic countries. Skår (1995) has also found that the bank crisis in Norway eventually turned out to be a crisis of the large banks. Kjellman (1994) has also reached the same conclusions in research on the bank crisis in Finland (1994). The support of the Bank of Estonia and the government did not manage to prevent the collapse of all large banks, not to mention the smaller ones. After the first banking crisis, the share of state-owned banks increased significantly.

On 15 August 1994, the Bank of Estonia imposed a moratorium on the Social Bank of Estonia, which had been holding the position of Estonia's largest bank from the beginning of 1993 until the spring of 1994. With the help of the central bank's liquidity aid and crisis management programme, the bank restored operations within a month, but in May 1995 the central bank was forced to revoke the bank's licence. The collapse of the Social Bank of Estonia gave the Bank of Estonia a fresh impetus to improve banking supervision and prudential ratios.

The case of the Social Bank of Estonia had a significant impact on the Credit Institutions Act, which was enforced at the beginning of 1995. Some analysts even reproached the authors of the Act for basing it on a single case. Indeed, this may well be true. Raimund Hagelberg, who was involved in the drafting of the Act admits: "Since the preparations and the birth of the Act greatly overlapped with significant events in putting banking into order and occurred at the time when the problems arising from the activities of Tartu Commercial Bank, Social Bank of Estonia and others were being handled, it was oriented towards more extensive firmness in setting requirements for the activities of banks" (Zirnask, 2002: 17).

As to prudential ratios, the principle changes concerned credit risk ratios that the Bank of Estonia supplemented only two weeks after the moratorium imposed on the Social Bank of Estonia. Banks had to comply with the following regulations:

1. The overall amount of big loans, that is, accounting for more than 10 per cent of the bank's equity capital, could not exceed the equity capital more than eight times (that is, the total of big loans/equity capital $<$ 800 per cent remained unchanged).
2. The total value of loans, guarantees, letters of guarantee and so on issued to one client could not exceed 50 per cent of the bank's equity

capital (that is, the total indebtedness of one customer/equity capital <50 per cent was changed). According to the new regulation, the total debt obligation of one customer or related customers could not exceed 25 per cent of the equity capital of the credit institution.

3. Subordinate institutions of a credit institution, the parent company of a credit institution and other subordinate units of the parent company were not allowed to have debt liabilities to the credit institution related to them through ownership totalling more than the sum that corresponded to 20 per cent of the equity capital of such a credit institution.
4. The managers of a credit institution, other employees and credit institution shareholders representing 5 per cent or more of the paid-in capital or votes, and also companies related to them cannot have debt liabilities to that credit institution that exceed 20 per cent of the equity capital of the credit institution.

To put it in a nutshell, commercial banks could not grant big loans to their staff and owners any longer. Moreover, the possibility to grant big loans to persons not directly related to the bank decreased (Zirnask, 2002).

Developments in information technology, the proliferation of financial markets, the blurring distinction between banking and non-banking financial institutions and the continuous barrage of new product innovations have fundamentally changed the landscape of financial services (Boot, 2001). Therefore the banks had to confront new risks and also new temptations. It became clear that society could not accept that banks developed and implemented risk management systems by themselves. It was important that there existed supervision of these systems on behalf of the state and the market.

Figure 14.1 illustrates the principle of risk management in banking. A consensus was reached in Estonia that the state had to lay down a legal framework for banking, establish public institutions for financial supervision and guarantee that corrective measures were employed when necessary. To protect depositors and ensure the trustworthiness of the monetary system, the legal framework had to secure fair competition in the market and prevent excessive risk taking.

The tasks of the state were not confined to the above only. Its initiatives had to include establishing good banking practices and guaranteeing sufficient competition. Thus state authorities had to make sure that there were enough participants in the market and that the financial market was transparent. Politicians and financial experts agreed that

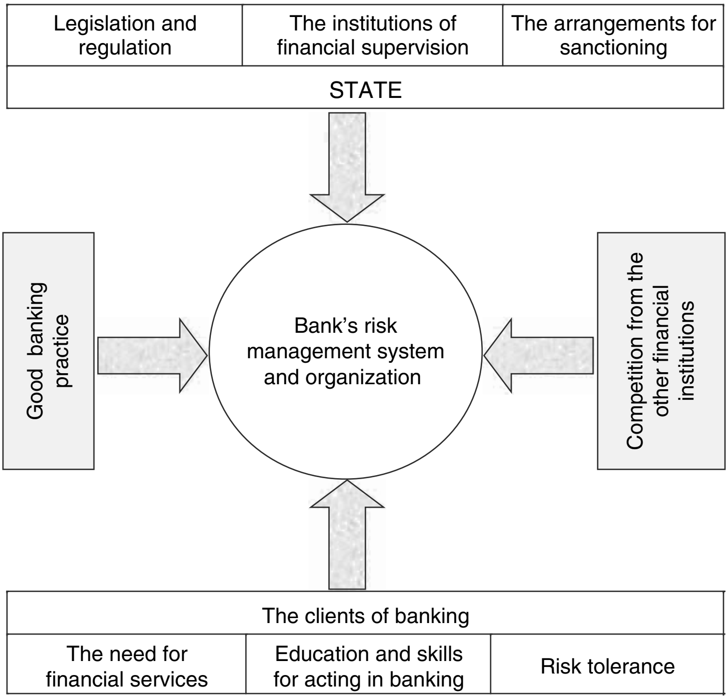

Figure 14.1 The risk management framework in banking

it was in the banks' own interest to build up reliable risk management systems and improve them continuously as the market developed or deficiencies occurred. It was also necessary to have shareholders' supervision, internal audit, rules for transactions as well as an employee training and motivation system that aimed to achieve better quality of risk management.

The investigation of the banking crises in different countries has in most cases led to the finding that risk management systems did not conform to the needs. For example, Caprio and Klingebiel (1996) present three reasons why banking crises have occurred. These include:

1. Large macroeconomic shocks (hyperinflation and economic recession).
2. Missing and inaccurate legislation (loans, collaterals).
3. Big mistakes made by banks in risk management (excessive optimism).

The main reasons behind the Nordic banking crises of the 1990s were the rapid growth of credit volume and liberalization of banking legislation in the 1980s (Koskenkylä, 1995). Such studies show that the success of individual banks and banking as a whole depend on a prudent system of risk management and the actions taken by the banks in risk management.

Analysis of the banking crises in developed and transition countries shows that the crisis roots in transition countries are similar if not the same. Due to the deep economic crisis, caused by a fundamental shift in the economy, credit risk became one of the triggers of banking crises. When the banking market was in a stage of formation, the state became the only real saviour of the banks and depositors in trouble, and the policy of re-capitalizing weak banks led to the re-nationalization of banks along with increased financial risks to the governments (Borish *et al.*, 1995).

Banking transformation in the period 1993–1998

In April 1993, the Bank of Estonia was alarmed by the striking banking crisis and announced a stabilization period in banking. Bank licences were frozen. The central bank designed a schedule for the gradual increase in the minimum share capital of existing banks to ECU 5 million. During the whole stabilization period only one new licence was issued to Preatoni Pank on 23 September 1999.

The schedule for the gradual increase of share capital left the small commercial banks some hope to survive. However, the bankruptcy of the Social Bank of Estonia, which was the biggest bank in the state, put extra pressure on the banking system. In response to the collapse, the Board of the Bank of Estonia tightened the prudential ratios and placed extra demands on equity capital (Table 14.3).

Thus, by 1 January 1996 a bank, whose share capital was EEK 15 million, had to have equity capital of EEK 50 million. The demands on the growth of the equity capital forced the small banks to merge at the end of 1995 and the beginning of 1996.

The above-mentioned activities of the Bank of Estonia, which followed the advice of foreign experts, have been widely criticized. For example, Vello Vensel, Professor of Statistics at Tallinn Technical University, has written: "Forcing the consolidation of the banking sector by gradually increasing the demands on equity capital to the level required in the EU can be regarded as a false solution to the Estonian banking problem by Bank of Estonia . . . The continuous raising of demands on

Table 14.3 Minimum capital requirements for Estonian commercial banks (EEK million)

Year	Minimum share capital		Minimum equity capital[b]
	For operating banks[a]	For granting licence	
1994	6	15	–
1995	15	25	–
1996	25	35	50
1997	35	35	60
1998	35	35	75

Note:
[a] As at 1 April.
[b] As at 1 January; before 1996 banks did not have this requirement.
Source: Board of Eesti Pank decisions.

capital made small banks lose the ground under their feet as their main task was to provide additional capital by all means, ignoring the related risks. The development of the banks in Estonia was retarded; otherwise it would have forced ineffective small banks to leave the market themselves" (Vensel, 1998).

The central bank and government tried to support mergers financially. For instance, when the Industrial Bank of Estonia, which was not able to survive alone, merged with the Estonian Savings Bank, the Bank of Estonia guaranteed the bad loans of EEK 90.6 million and sold to the shareholders of the Industrial Bank its shares in the Savings Bank (1 million shares) at a nominal price, that is, three times lower than the market price. At the beginning of 1997 when the Union Bank of Estonia merged with the North Estonian Bank whose shareholders were the government and the Bank of Estonia, the latter two wrote off their share capital and gave the Union Bank a guarantee on the scale of all doubtful loans in the North Estonian Bank loan portfolio. The Land Bank of Estonia, which was established by the merger of four banks at the beginning of 1996 and consequently suffered a major setback, was helped by the state-owned Fund, created for crediting agriculture and rural life in Estonia. It contributed EEK 25 million to the share capital of the Land Bank (approximately 10 per cent of the Fund).

Bank mergers pushed the rise of assets in the banking sector. Table 14.4 shows that since 1994 this rise has increased at a progressive rate. In 1997, the rate of increase was 76.8 per cent, while in the previous three years this indicator was about 50 per cent a year. Due to

Table 14.4 Growth of assets of the commercial banks in Estonia, 1994–1998

Year	Number of banks	Bank assets (EEK billion)	Assets per bank (EEK billion)
1994	24	10,067	419
1995	18	14,857	825
1996	13	21,902	1, 685
1997	11	38,755	3, 523
1998	6	40,994	6, 832

Source: Author's calculations based on Bank of Estonia data.

such a rapid growth, the Estonian banks became the biggest banks by assets in the Baltics.

At the beginning of 1996, banks had accumulated most of the national financial resources. They played a vital role in the privatization of state-owned assets as the Privatization Agency required all interested applicants to have bank guarantees in addition to a business plan. Thus executive boards and owners of Estonian banks had ambitious objectives to raise profits and expand banking operations into neighbouring regions.

Consequently, banks became highly profitable. In 1997, the return on equity (ROE) was 34.9 per cent. This success led to infighting in which some bank executives ousted the owners who shared part of the profit. For example, the managers of the Estonian Investment Bank managed to do so and benefited from a profit per employee equivalent to EEK 1 million. In the autumn of 1997 when the shareholders of the Investment Bank intended to sell their shares to the German Schleswig-Holstein Landesbank, the top executives threatened to hand in a collective resignation. As a result of their action the bank was sold to them for EEK 310 million although the offer of the foreign investor was much higher. The top executives borrowed the necessary money from the Union Bank of Estonia. Similarly, the executives of the Tallinn Bank forced the Chairman of the Supervisory Board and major shareholder in the bank G. Sammelselg to leave. Following his departure they raised money from the Estonian Investment Bank in order to acquire the shares of the ousted chairman. Thus senior bank managers took risks that allowed them to alter the ownership structure of Estonian banks.

In their desire to expand, commercial banks diversified by investing into unrelated businesses. For instance, at the end of 1997 the Land

Bank of Estonia owned seven related companies, which dealt with property, leasing and investing, and with anything else but banking such as hotels, processing agricultural products, broadcasting and so on. Several credit institutions have high equity in quite a long list of subordinate establishments and related companies. For example, the Union Bank of Estonia mentions 11 subordinate establishments and 18 related companies in its report on 1 October 1997. In this respect it appears that Estonian banks have become very much like other European banks. In many countries in continental Europe, control and finance are institution-based, but banks and other financial institutions are major shareholders in non-financial corporations in which they perform an active supervisory and managerial role (Pradham, 1995).

Estonian banks have also expanded to the markets in the East, where the interest rates and possible profitability were high. Besides buying local banks, Estonian banks made their way into the securities markets. The first boom of establishing independent investment funds in Estonia was in 1994–1995. The collapse of such funds in 1995 did not bring people to the streets as happened in Albania, but decreased the popularity of these institutions. This created an opportunity for the banks and they set up their own investment funds. At the end of 1997, the total assets of the investment funds managed by credit institutions accounted for 94 per cent of all investment funds. Moreover, bank-owned subsidiary companies controlled more than EEK 2 billion of the private portfolios of securities. In 1997, the rapid rise in prices in the local securities market and the Eastward expansion of local investment funds increased their assets more than four times compared with the end of 1996.

At the beginning of 1997, the index of Tallinn Stock Exchange (TALSE) was 160 points and rose rapidly to reach 493 points by the end of August 1997. The nominal share price was EEK 10. By comparison, the share prices of the banks were in the range of EEK 200–300 (Table 14.5). The banks were pushing the market, as the five banks that were listed in the main list provided 60 per cent of the market capitalization. Riding on the market bubble, the banks forgot that global capital flows combined with instantaneous worldwide communications increased the threat of international contagion of financial markets under the impact of global panics and worldwide swings from irrational exuberance to groundless despondency (Transition Report, 2001).

As Estonian banks took high financial risks to get high profits, at the end of 1997 the fall of share prices had a substantial negative impact on them. Although the consolidated profit and loss accounts showed that profits grew by about 90 per cent compared with the previous year,

Table 14.5 Bank share price dynamics on Tallinn Stock Exchange 1997 (EEK)

Bank	**31 December 1996**	**Highest price 1997**	**Lowest price after stock market crash**	**Change in price due to stock market crash**	**31 December 1997**
Hansapank	161	257	70	177	140
Eesti Ühispank	29	179	61	118	59
Eesti Hoiupank	69	315	70	245	166
Tallinna Pank	56	143	35	108	40
Eesti Forekspank	122	285	40	245	115
EVEA Pank	27	33	13	20	16

Source: *Sinu Kroon* (1998).

profits from financial investments had decreased dramatically by EEK 50 million (Table 14.6). Several banks accrued massive losses, whereas all banks had losses from off-balance liabilities.

When in the autumn of 1997 the economic environment became more unstable, the excessive expansion of securities and loan portfolios, lop-sided orientation towards the Russian market, lending short-time

Table 14.6 Estonian commercial banks' profit account (EEK million)

	1996	**1997**	**1998**
Interest income	1722.9	2658.5	3085.3
Interest expense	697.0	1217.2	1693.9
Net interest profit	1026.0	1441.3	1391.4
Income from financial investments	166.4	117.2	21.3
Commission income	449.4	799.1	699.3
Commission expense	132.7	250.8	227.7
Net profit on financial operations	371.4	715.1	−235.1
Administrative expenses	1027.1	1244.0	1069.0
Net other income and expenses	−289.3	−509.0	−1309.3
Profit before taxation	564.1	1068.9	−501.4
Income tax expenses	50.2	104.6	−2.9
Profit on reporting period	513.9	963.1	−498.5

Source: Author's calculations based on Bank of Estonia data.

cheap foreign resources as long-time credits and other mistakes of the banks began to generate losses to the extent of the previously high profits. The Savings Bank of Estonia and Tallinn Bank managed to merge with stronger banks. Others, such as the Land Bank of Estonia, Estonian Foreksbank, Estonian Investment Bank, EVEA Bank and ERA-Bank did not realize the severity of the crisis. The Estonian Investment Bank and Foreksbank were saved by the central bank, but the others joined the list of the failed banks in Estonia.

The banking crisis in 1998–1999 differed from the previous one by the fact that the Swedish banks SE Banken and Swedbank bought the two major Estonian banks, that is, the Hansabank and the Union Bank of Estonia. Those banks had merged with other ailing banks to increase their market share to 50 and 30 per cent, respectively, in order to increase their attractiveness to potential investors. The small banks of Estonia also looked desperately for partners, but their market share was small and they were unable to attract foreign investors. The foreign ownership of banks in Estonia improved their stability and performance, which was also the case in other Central and Eastern European (CEE) countries (Hasan and Morton, 2003; Naalborg, 2003; Bonin *et al*., 2004).

The indirect reason for the second banking crisis was the rapid growth of bank assets, caused by factors that had weakened the banks. Similarly, in other transition countries the much faster growth in the banking sector compared with the other economic sectors had weakened the banking sector and increased its vulnerability. Dmitriyev *et al.* (1998: 38) describes the development of the banking sector in Russia as follows: "The peculiar nature of the current Russian banking system has been linked inseparably with the very rapid growth of banks that took place during 1987–1995." It could be argued that at least some of the reasons for the 1998 banking crisis in Russia could also be associated with the rapid growth of banks in previous years.

Banking since 1999

The two bank crises in Estonia drove the banks with a bad risk management system out of business. Only those with efficient and effective operations survived. Big and small banks realized that their fate was determined by market conditions and performance indicators. The central bank could not and would not always act as a saviour while foreign banks would take steps cautiously based on their commercial interest.

Mergers and bankruptcies enabled bank managers to experience first-hand the sad consequences of underestimating risk. They realized that market pressure could lead to firm failure and severe job losses. The causes for banking crises may differ, but cautious risk assessment and prudent investment operations can help banks survive the destructive power of market forces. The central bank of Estonia has been much criticized for the slow recognition of its paramount regulatory role in safeguarding public interest and ensuring bank stability in the long run.

Reporting and prudential ratios adopted in the second half of 1999 differ substantially from those that were in place in 1993. Complex calculations for considering off-balance-sheet liabilities, securities portfolios and other risks of commercial banks became the norm. The new Credit Institutions Act amended and supplemented the chapters on accounting, reporting and supervision with the aim to guarantee the reliability of credit institutions and ensure protection of customer interest. To date banks in Estonia follow more stringent rules than those in the European Union (EU). For example, if the cooperative capital of a bank is required to be at least EUR 1 million in the EU and Finland (Koskenkylä, 2003), for Estonian cooperative banks this requirement stands at EUR 5 million. The reserve requirement for commercial banks is 13 per cent, which is much higher than in any new EU member country. Stricter rules refer also to the classification of loans and savings. Bank inspections are carried out more often than in the EU countries (Baltaca and Volkova, 2004).

As a result of the transformation of the financial landscape in Estonia, financial supervisory institutions in the banking, insurance and securities market were integrated. There is a strict supervision of the risk management systems of Estonian banks. Consequently, the banking sector has evolved to become much stronger with a greater ability to withstand threats arising from internal environmental actors. Moreover, the ability of the Estonian banking sector to resist foreign shocks has become significantly higher than in 1997–1998.

The operations of the Financial Supervisory Authority (FSA) are regulated by the FSA Act and detailed in ten other Acts governing the operations of financial sector enterprises (Table 14.7).

After the second banking crisis assets started to increase rapidly (Tables 14.8–14.10). At the beginning of 2004, the sum of bank assets was over 100 billion EEK. This asset accumulation strengthened the profitability and efficiency of the banking sector. Regardless, capitalization has remained strong, being supported by consistently good profitability.

The number of banks in Estonia has not changed much since 2004. At the end of 2003, over 85 per cent of the share capital of banks

Table 14.7 Laws guiding the activities of the Financial Supervisory Authority

Title of Act	**Effective (since)**
Financial Supervision Authority Act	1 June 2001
Credit Institutions Act	1 July 1999
Insurance Activities Act	1 August 2000
Insurance Act[a]	1 January 1993
Motor Third Party Liability Insurance Act	1 June 2001
Investment Funds Act	19 May 1997
Funded Pensions Act	1 October 2001
Securities Market Act	1 January 2002
Estonian Central Register for Securities Act	1 January 2001
Deposit Guarantee Fund Act[b]	23 May 1998
Guarantee Fund Act	1 July 2002
Money Laundering Prevention Act	1 July 1999

Note:
[a] Repealed on 1 July 2002.
[b] Repealed on 1 July 2002.
Source: Estonian Financial Supervision Authority Yearbook (2002, 2003).

Table 14.8 Growth indicators of commercial banks in Estonia, 1998–2003

Year	**Number of operating banks***	**Total assets by the end of the year (billion EEK)**	**GDP (current prices in billion EEK)**	**Banks assets (% of GDP)**
1998	6	41.0	73.5	55.8
1999	7	47.1	76.3	61.7
2000	7	57.8	87.4	66.3
2001	7	68.4	97.9	70.8
2002	7	81.7	108.0	76.9
2003	7	98.6	116.2	84.9

Note: * including branches of foreign banks.
Source: Author's calculations based on Bank of Estonia data.

belonged to foreign owners. The share of Hansabank and the Union Bank of Estonia amounted to 83 per cent of the total assets in this sector. All Estonian banks have aimed to introduce up-to-date banking services and customer service has become an important ingredient of bank image-building efforts.

After 1998, the profits in the Estonian banking sector have stabilized (Table 14.11).

Table 14.9 Some indicators of the Estonian financial sector development

Indicator	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Number of commercial banks	13	11	6	7	7	7	7	7
Number of private banks	12	11	5	6	7	7	7	7
Number of foreign banks	1	1	2	2	4	4	4	4
Concentration index C3 (%)	58.8	69.7	93	92.4	91.1	91.1	90.4	90.3
Concentration index C5 (%)	74.7	83.4	99.4	98.9	98.8	98.9	99.1	99.2
Banks' total assets (€ million)	1,467	2,594	2,620	3,008	3,695	4,372	5,221	6,314
Total assets/GDP (%)	40.0	59.7	52.7	57.7	62.4	65.6	69.9	78.5
Foreign ownership in share capital (%)	33.4	44.2	60.7	61.6	83.6	85.4	86.7	85.7
Major foreign ownership in total assets (%)	2.6	2.3	90.2	89.8	97.4	97.5	97.5	97.5
Private credit by banks (€ million)	788	1,362	1,527	1,704	2,189	2,601	3,194	4,420
Private credits by banks/GDP (%)	21.5	31.3	30.7	32.7	36.9	39.0	42.8	55.0
Leasing & factoring portfolio (€ million)	110	315	399	433	644	893	1,232	1,491
Leasing and factoring/GDP (%)	3	7	8	8	11	13	16	19
Debt market capitalization (€ million)	150	258	235	204	231	279	211	185
Debt market capitalization/GDP (%)	4	6	5	4	4	5	3	2
Stock market capitalization (€ million)	508	837	531	1,913	2,095	1,999	4,570	5,565
Stock market capitalization/GDP (%)	13.9	19.3	10.7	36.7	35.4	30.0	61.2	69.2
Stock exchange capitalization (€ million)	672	804	506	1,788	1,923	1,665	2,315	3,005
Stock exchange capitalization/GDP (%)	18	18	10	34	32	25	31	37
Insurance gross collected premiums (€ million)	53	70	81	83	98	112	134	168
Gross collected premiums/GDP (%)	1.4	1.6	1.6	1.6	1.7	1.7	1.8	2.1
Investment funds' assets (€ million)	31	97	23	73	95	193	280	464
Investment funds' assets/GDP (%)	0.8	2.2	0.5	1.4	1.6	2.9	3.7	5.8
Total financial assets (€ million)	1,318	2,458	2,912	5,550	6,727	7,748	11,551	14,108
Total financial assets/GDP (%)	36	57	59	106	114	116	155	175
Total private credit (€ million)			1,902	2,106	2,777	3,395	4,308	5,835
Total private credit/GDP (%)			38	40	47	51	58	73
GDP (€ million)	3,664	4,348	4,973	5,218	5,926	6,668	7,469	8,042

Source: Bank of Estonia.

Table 14.10 EBRD rating* of banking sector reform

Country	1992	1994	1996	1998	2000	2001	2002
Azerbaijan	1.0	1.0	2.0	2.0	2.0	2.3	2.3
Belarus	1.0	1.0	1.0	1.0	1.0	1.0	1.7
Bosnia and Herzegovina	1.0	1.0	1.0	2.3	2.3	2.3	2.3
Bulgaria	1.7	2.0	2.0	2.7	3.0	3.0	3.3
Croatia	1.0	2.7	2.7	2.7	3.3	3.3	3.7
Czech Republic	3.0	3.0	3.0	3.0	3.3	3.7	3.7
Estonia	2.0	3.0	3.0	3.3	3.7	3.7	3.7
FR Yugoslavia	1.0	1.0	1.0	1.0	1.0	1.0	2.3
FYR Macedonia	1.0	2.0	3.0	3.0	3.0	3.0	3.0
Georgia	1.0	1.0	2.0	2.3	2.3	2.3	2.3
Hungary	2.0	3.0	3.0	4.0	4.0	4.0	4.0
Kazakhstan	1.0	1.0	2.0	2.3	2.3	2.7	2.7
Kyrgyzstan	1.0	2.0	2.0	2.7	2.3	2.3	2.3
Latvia	2.0	3.0	3.0	2.7	3.0	3.3	3.7
Lithuania	1.0	2.0	3.0	3.0	3.0	3.0	3.0
Moldova	1.0	2.0	2.0	2.3	2.3	2.3	2.3
Poland	2.0	3.0	3.0	3.3	3.3	3.3	3.3
Romania	1.0	2.0	3.0	2.3	2.7	2.7	2.7
Russia	1.0	1.7	3.0	1.7	1.7	1.7	2.0
Slovak Republic	2.7	2.7	2.7	2.7	3.0	3.3	3.3
Slovenia	2.0	3.0	3.0	3.0	3.3	3.3	3.3
Tajikistan	1.0	1.0	1.0	1.0	1.o	1.0	1.7
Turkmenistan	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Ukraine	1.0	1.0	2.0	2.0	2.0	2.0	2.0
Uzbekistan	1.0	1.0	1.7	1.7	1.7	1.7	1.7

Note: *The transition indicators scores are from 1 to 4 with a 0.3 decimal points added or subtracted for + and – ratings that were first introduced.
Source: Transition Report (2003).

Table 14.11 Key efficiency ratios in Estonian banking (percentage)

	Solo banks				Consolidated group 2003	Euro area 50 largest banks 2002
	2000	2001	2002	2003		
Cost to income ratio	72.49	52.36	61.58	53.01	52.0	72.0
Return on assets	1.18	2.66	1.55	1.70	2.2	0.3
Return on equity	8.04	20.71	11.91	14.15	20.1	6.0
Net interest margin	4.26	3.89	3.59	2.91	–	–
Spread	4.05	3.69	3.44	2.78	3.9	–

Source: Author's calculations based on Bank of Estonia data.

Banking has become one of the most profitable business areas that have supported the development of the national economy. It has also been instrumental in achieving the aspirations of Estonians for political and economic independence from Russia. Moreover, the banking sector has ensured that the country can cope with external pressures such as the current economic crisis and is well on course towards the adoption of the euro in 2011.

Conclusions

Estonian commercial banks were established not long ago. Nevertheless, only few banks have remained from over 50 banks licensed by the Estonian central bank at the initial stages of transition. The development of commercial banking in Estonia shares some commonalities with the initiation and growth of commercial banking in other transition countries. Some of these can be summarized as follows:

1. Banks seemed to have pulled the savings of people accumulated during the years of communism. Following the collapse of the ex-USSR and the subsequent political and economic instability, savers turned towards the banking institution as a most reliable safeguard for long-term savings. The assets of the banks have grown much faster than the national GDP. The main reasons are the high inflation rate and the aggressive expansionist development strategy of banks. The tough competition in the banking sector has reduced substantially the number of operating banks over time by means of liquidation, consolidation and foreign direct investment (FDI) acquisitions following the move of Swedish and Finnish companies into Estonia. The rapid growth of bank assets required the development of a management system, supported by a prudent risk management system. New products and services have been carefully developed to meet customer needs safeguarding confidence in the banking system. In all transition economies, the development of new management and risk systems was not able to keep pace with the needs. The uncertainties and unpredictability of the transition business environment contributed to the volatility in the bank management and risk system. These made bank failures and subsequent bank consolidation imminent.
2. The banking crisis forced the central bank to improve regulation and supervision over all commercial and investment banks. These regulation and control mechanisms evolved and became much tighter

than those in the financial sector of many developed economies. The laws supporting the development of banking have evolved over a short time span to reach and surpass the Western European standards. Eventually, only banking institutions that could operate on a par with their well-established European counterparts could survive.

3. The banking sector of a transition economy is open to the "invasion" of foreign banks due to the openness of the economy and excessive risk taking. Banking crises have driven the value of domestic banks down, which has made them attractive targets to foreign commercial banks. Local shareholders currently hold shares in banks with a marginal market share. Thus most of the banking sector has fallen under the control of foreign banks, which has increased the exposure of local firms and savers to the effects of international financial and economic calamities. However, in the case of Estonia, local banks have mostly become part of other Scandinavian banks that have been overall more cautious, conservative and risk averse in their investment and speculative transactions. This has had a positive effect on the Estonian banking sector as it has emerged from the current financial crisis stronger and relatively untarnished. We may well find out that the effects might be somewhat different in countries where bank FDI acquisitions have been made by Greek or Hungarian banks.
4. A transition economy can single out quickly and ruthlessly a limited number of prosperous banks. It can also displace from the market numerous weaker banks that cannot handle risk and lack a proper risk management system. Only the most ambitious banks have managed to embrace difficult changes and become modern and internationally competitive financial institutions. The transformation of the banking sector has had a major contribution to Estonia's position as the most "Westernized" of the three Baltic Republics (Koźimiński and Yip, 2000).

Although one in every 133 companies in Estonia went bankrupt in 2009 and the banks in Estonia lost a total of EEK 4.7 billion as a result of the financial and economic crises, the banking sector in Estonia has stabilized and the country will join the Eurozone in 2011. As more than 90 per cent of the Estonian banking sector is controlled by Swedbank, SEB, Nordea and Den Danske Bank the close cooperation with the Nordic countries in the area of crisis management has become of paramount importance. Moreover, a Memorandum of Understanding signed with the Swedish central bank has specified practical issues of possible actions by both countries' central banks. Coordination in the supervision of cross-border financial groups has also been strengthened, as some supervisory responsibilities fall with the home country's supervisory authority, while others rest with the Estonian authorities.

To conclude, unlike the recent actions of some governments in saving the ailing banks by pouring huge amounts of public money into them, the banking sector in Estonia and in transition economies has emerged painfully. It has followed the market dynamics, which has caused many of the unfit banks to collapse. In addition, the central banks following the advice of key Western and US economists have mostly stayed away from saving ill-performing banks. Such an approach to development of the banking system has certainly had substantial social and economic costs, but equally, it has strengthened the performance and regulation of the banks. It has also helped to develop and implement a rigorous and highly demanding risk management system where speculative risk has been under strict control.

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