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Successful Adaptive Strategies of MNC's in Transition Economies of Central and Eastern Europe

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Roxana Wright

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Committee Approval:

Dr. Massood Samii Professor of International Business	Signature (Chairman)	12/05/05 Date
Dr. Philip Fellman Professor of International Business	Signature	12/05/05 Date
Dr. Bülent Aybar Professor of International Business	Signature	12/05/05 Date
Dr. Yusaf Akbar Professor of International Business	Signature	12/05/05 Date

UMI Number: 3303371

Roxana Wright

SUCCESSFUL ADAPTIVE STRATEGIES OF MNCs IN TRANSITION ECONOMIES OF CENTRAL AND EASTERN EUROPE

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ABSTRACT

The dissertation's purpose is the analysis of multinational corporations' (MNCs) strategies in Central and Eastern Europe (CEE). The region is currently going thru a process of change from planned to market-based economy and institutions that is characterized by a high level of complexity. The research analyzes the patterns of adaptation of multinationals' subsidiaries to this complex environment and presents a comprehensive discussion of successful approaches and strategic limitations. The context of transition is evaluated thru the analysis of initial conditions, internal structures and factors determining the evolution towards market, and, finally, external forces influencing transition outcomes. The companies' responses to the environment are classified as complexity absorption strategies and complexity reduction strategies. The findings suggest that winners evolve and develop not only as environmental forces allow them, but also thru their own products and ideas. Successful companies have a strong strategic theme, 'a simple rules logic', are flexible and quick. Unsuccessful companies have two or more weak strategic themes at entry and develop new ones locally. They follow a 'problem solving logic', learn little from the past and are slow to anticipate the future. The contribution to the field consists of an all-inclusive evaluation of MNCs strategies in the transition environments of CEE, with the discovery of patterns of successful adaptation. The dissertation builds an integrative theoretical framework that treats organizations as interpretative and learning systems with vast applicability for research as well as pragmatic approaches to strategy.

TABLE OF CONTENTS

INTRODUCTION

The transition economies of Central and Eastern Europe (CEE) pose unique challenges due to their volatile economic and political environment. Successful pursuit of markets in transition economies may require MNCs to fundamentally rethink their business models. The dissertation illustrates how MNCs can cope with these unique challenges and unlock the profit potential in transition economies of CEE. The purpose of the dissertation is the analysis of MNCs strategies in Central and Eastern Europe. It is noted that companies develop strategies to cope with resilient components of the idiosyncratic transition environment in the form of embedding into local environment or drawing advantages from regional deficiencies. Firms also develop strategies to react to the dynamic components of the environment: they actively pursue knowledge acquisition and local knowledge activation, and become involved in building and/or improving value chains. These strategies are emerging within a business model that allows for local responsiveness. The requirements for successful implementation of these strategies reflect a medium degree of local autonomy and loose integration into the corporate structures. Finally, for companies operating in CEE, complementary specialization allows for rearrangement of tasks and combination of resources across the entire company network.

An environment of rapid shifts in benefits such as the transition to market creates opportunities for companies to establish new advantages in the market, but as the environment continues to change, these new advantages are themselves vulnerable to attack. Opportunities attract other firms who strive to match, leapfrog or neutralize the advantages of the incumbents. The radical change of the transition process requires companies to change their routines, and reconsider their relationships with suppliers and customers, as well as their attitudes and value systems. Organizations in transition economies in CEE evolve with the environment and go thru changes that reflect responses to policies and new competitive environments.

Sustaining advantages requires effective interaction with the competitive and economic environment- building the firm's resources and position while preventing competitors and new regulation from eroding them. The creation of advantages and their sustenance is an iterative process. To sustain and renew advantages in dynamic environments managers need to understand how advantages are created and how they are eroded. To contribute to this understanding, the dissertation ties the processes of transition in the CEE countries with the dimensions of successful strategy formulation and implementation. The foreign investors' strategies in the first years of transition have evolved into different actions that reflect a change in strategic motivation, value chain organization, and degree of responsiveness.

In general, an organization's focus should be on the long-term potential of strategies and continual readjustment to changing circumstances. Companies use many context-specific resources and capabilities to develop flexible and, at the same time, sustainable strategies. A contribution of the dissertation is providing a conceptual framework that assists investors in adapting their strategies to transition economy contexts, and, more generally, to dynamic and complex environments. In order to obtain a comprehensive perspective on multinational firm's strategies in CEE, the dissertation reviews background papers and data that appraise the evolution of institutional and economic environment of the CEE economies. The analysis of the transition environment presented assists in creating an integrative view that draws together different strands of strategy theory and brings public policy into perspective.

The outcome of the dissertation is the discovery of strategies that make for successful adaptation to the environment of transition from planned to market economy. The research analyzes various patterns of adaptive strategies to the transition environment and investigates learning behavior of the MNC in a dynamic manner that takes into consideration the unique characteristics of the transition economies of Central and Eastern Europe.

Research has noted (Meyer, 2000) that transition economies of CEE provide a laboratory for gaining insights on how businesses evolve during radical organizational change and on how institutions shape corporate behavior, which may reveal aspects that are less observable in mature market economies. The findings of the dissertation as well as the integrative approach bring a relevant contribution to the international strategy literature, in the context of transition economies and beyond. The objective is to conduct an analysis of firm strategies for CEE markets that helps build a theory on how companies successfully adapt to these business environments. The statistical analysis based on available data provides an understanding of the potential causal relationship between outcomes of various strategies and performance outcomes, as well as the extent to which companies use certain strategies to deal with the complexity of the transition environments. Analyzing organizational strategy in a dynamic and longitudinal manner is as valuable as the discovery of causal relationships and statistical reporting, and, as such, exploratory analysis is also used.

Dissertation Structure: The first chapter bridges across theories of international business to provide an integrative theoretical framework for the research. The organizations are treated as interpretative and adaptive systems that have to match the complexity of their environments. The following chapter emphasizes on the unique features of Central and Eastern European economies and the transition context, and brings arguments for the choice of region. The analysis also includes a discussion of path dependency as an explanation for various transition paths, a characterization of the transition process and a review of transition paths in countries of Central and Eastern Europe, as well as an evaluation of external influences. The second part of the literature review discusses and evaluates the existent literature regarding MNCs strategies in Central and Eastern Europe and concludes on the incorporation of some of the findings in the research questions presented in a subsequent chapter. The research hypotheses presented in the third chapter are complemented with a discussion of the choice of firms and appropriate performance outcomes. Chapter four is a presentation of the methodology, variable definition and measurement, including measures of research design robustness and degree of generalizability. Chapter five includes the application of statistical methodology and the analysis of five case studies of multinationals' subsidiaries. The last chapter refers to a detailed discussion of the findings, future research agenda and final remarks on the research applicability and limitations.

CHAPTER 1 THEORETICAL FOUNDATION: BUILDING AN INTEGRATIVE FRAMEWORK FOR MNCs STRATEGIES IN CEE

Foreign direct investment (FDI) is an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy by an enterprise resident in another economy (UNCTAD, 1999). Many foreign direct investments are carried out by transnational corporations (TNCs); others are undertaken by companies operating at various levels of firm internationalization. The Uppsala model of firm internationalization (Johanson and Wiedersheim-Paul, 1975, Johanson and Vahlne, 1977), that is concordant with the product life cycle theory (Vernon 1966, 1971), explains the market-driven investments; other FDI triggers are resources availability (human, material, financial) and global competition.

The literature on FDI in Central and Eastern Europe builds upon a tradition of studies on entry strategies and internationalization of firm's activities, beginning in the 1960s with the work of Vernon (1966) and Hymer (1976). Later on, emphasis in the literature was put on the non- equity inter-firm co-operative agreements and the relationship between market structure and mode of entry within the framework of Buckley and Casson (1981). Subsequently, Dunning's eclectic approach (1992) stated that the propensity of enterprises to engage in international production would depend on three main factors: ownership specific advantages, locational advantages, and internalization advantages referring primarily to Williamson's transaction costs theory (Williamson, 1981).

Constructs of international business, such as Hymer's market imperfections and Buckley and Cason's internalization theory, have maintained that firms maximize profits in a world of imperfect markets. Hymer's thesis explains foreign investments as a means for maintaining and expanding the company's monopoly power in foreign markets.
In contrast, the internalization theory emphasizes on the ability to innovate as the crucial firm-specific advantage that leads to internalization across international boundaries.

When intermediate product markets are imperfect, there is an incentive for companies to bypass them by creating internal markets. The ability to internalize markets is related to the presence of intangible assets (such as technological and marketing capabilities). The operationalization of the construct has previously investigated mainly the firm and industry-specific factors (i.e. firm or industry's research and development and advertising intensity). The market imperfections theory states that firms constantly seek market opportunities and their decision to invest overseas is explained as a strategy to capitalize on certain capabilities not shared by competitors in foreign countries (Hymer, 1970). This theory argues that increasing market power is the ultimate goal of the MNE and foreign direct investment is one means of achieving that goal. Although the theories of *market power and internalization* are distinctive frameworks of international production, the two approaches may overlap if the MNCs integrate their business internationally (internalize) in order to increase market power (internalization for market-power reasons, Akbar, 2003). Research (Doh et al, 2004) supports the idea that *internalization* is most effective in environments with intermediate risk levels. For countries with high risk settings, the potential dangers to any investment are too high to consider, whereas in low-risk settings, internalization benefits are not enough to justify ownership (as the company does not have to protect its intangibles in an environment of low risk of opportunism). Countries with monopoly features attract higher shares of private investment, as the investors may attain more advantageous positions as early entrants.

Expanding the internalization framework, Henisz (2003) draws attention to the fact that a micro analytic perspective identifies the *ability to manage institutional idiosyncrasies* as firm-level capability akin to research or advertising that can drive internalization across national borders and thereby internationalization. In the transition environments, internalizing a wider range of managerial capabilities may include the ability to interact with institutional environments that differ from those of the home country, the ability to protect against the 'grabbing hand' of governments or the ability to secure favorable exemptions from or changes to existing policy (Boddewyn and Brewer, 1994).

Recent research (Safarian, 2003) discusses the fact that the international business research agenda has changed and moved away from the internalization and OLI approach. The recent emphasis is on volatility of the environment for international business and the need to develop flexibility in resource allocation in order to cope with it. The challenge to MNCs is both to develop networks and to compete successfully as they coordinate a global system. This remark is all the more valid when carrying out research in the transition economies of CEE. In a book that would find direct applicability to these environments, Stopford and Strange (1991) argue that the conventional frameworks of analysis fail to deal adequately with the contemporary dynamism of change, as they do not take into account sufficiently the structural changes in political economy, or the highly differentiated conditions of individual states. The interaction between governments seeking structural change with the help of foreign investments and local support, and foreign investors seeking more accommodating policies, is an important dimension to consider. According to Stopford and Strange (1991), in the explicit bargaining between host governments and foreign enterprises, before the 1980s, corporations were seeking tax breaks and low cost labor, whereas recent experience shows that neither can compensate for complicated administrative policies, government intervention, and barriers to efficient operations. The authors note that multinationals have not merely reacted to change in their external environments, but many have actively sought to create new, *internal sources of advantages*. As they jockey for position, firms have made investments in "competitive innovation".

The research agenda recognizes today the need to view organizations as entities embedded within and co-evolving with their environment. Successful agents employ strategies that differentiate them from their competitors, and in doing so, they show adaptive and feedback features. Accounting for these considerations, the investigation draws on evolutionary theory concepts and builds an integrative framework. There seems to be a renewed interest in this approach, as reflected in current published research pieces that tackle the field of business theory more innovatively (Caldart and Ricart, 2004) in developing a framework of corporate strategy in turbulent environments characterized by high level of dynamism, complexity and uncertainty. For business theory, this shows a theoretical quest for an understanding of the dynamic process behind observed change (Nelson, 1995). The theory now recognizes the fact that *subsidiaries can play an* *important part in the development of the MNC's firm-specific advantage* (Birkinshaw & Hood, 1998).

One of the essential features of the evolutionary theory of the firm is the consideration of *companies as heterogeneous agents*. Accounting for the heterogeneity of firms (in terms of distinctiveness of resources and associated capabilities, strategies and expectations) is an important facet considered only recently in business theory. A few modeling techniques have been applied with the assumption of heterogeneous agents. Models such as agent-based modeling capture the agent behaviors realistically, with few assumptions, and maintaining a degree of agent heterogeneity which is more reflective of actual markets. Agent based models are an alternative approach that models social life as interactions among adaptive agents who influence one another in response to the influence they receive. Such models show how exchanges generate diffusion of information and emergence of norms (Macy and Willer, 2002).

A core concept of the evolutionary theory is that of routines as "organizational memory" of the firm (Nelson and Winter, 1981). The search for competitive advantage encompasses changes in the firms' routines: if firms are sufficiently profitable they attempt to maintain their routines and do no "searching" at all. As such, agents attempt to gain a given "aspiration level" rather than optimize. They are explorers and creators, rather than strict maximizers, and display reactive and purposeful behaviors. This approach recognizes the notion that *competitive strategy requires both the exploitation of existing internal and external firm-specific capabilities, and also the development of new capabilities, which is a facet considered in the dissertation.*

In a landmark article, Kogut and Zander (1993) have developed an *evolutionary perspective on the multinational enterprise*, drawing on the evolutionary theory of the firm (Nelson and Winter, 1982). These authors have argued that the internalization theory, with its emphasis on the minimization of transaction costs, fails to consider foreign entry's potential to create value. Internalization theory focuses on individual transactions, whereas strategic decisions cannot be divorced from the broader context encompassing the firm's past, the firm's future and the social context within which knowledge is developed, exploited and transferred. One of the authors' most interesting insights on TCE's weaknesses is that the MNE's superiority in transferring knowledge results from previous investments that permit the development of routines for dealing with problems of difficult "teachability" of the know-how to be transferred abroad. Inferring upon this framework would suggest that a firm's expansion into a country is an expression of the evolutionary acquisition and recombination of knowledge. In its more advanced evolution, this process alters the global knowledge of the firm and may result in its transformation towards a network of subsidiaries characterized by significant cross-border transfer of learning (Kogut and Zander, 1993).

In the constantly changing environment of the transition economies, the framework described here fits well, as it allows for an accurate discovery of firm strategy and learning, with less restrictive assumptions and a more dynamic view on business processes. This broader perspective accommodates the responses of firms to changed market conditions and economic growth, and acknowledges stochastic elements in the determination of decisions and their outcomes (Nelson and Winter, 1982). The perspective used here gives a more realistic description of events and a practical characterization of MNCs' behaviors in the idiosyncratic transitional environment. *The central analytic concern is the viability or profitability of firms with different strategies and exchanges with the environment.* The process of change in Central and Eastern European countries (as an environment undergoing continuing evolution itself) is constantly "tossing up" new "externalities" that firms need to react to with a diversity of strategies.

New theory developments are broadening the equilibrium approach of conventional economics by turning to the question of how actions, strategies, or expectations might react to, or endogenously change with, aggregate patterns. Agents acting in environments with high level of complexity display inductive behavior, recognizing patterns and constantly updating hypotheses as more information about the environment becomes apparent (Arthur, 1994). The world characterized by these aspects is evolutionary and also co-evolutionary, where agents survive by competing and adapting within the environment- it is an adaptive complex system.

Applied to business theory, the idea of adaptation to the business environment implies *accumulated wisdom from a firm's experience across time.* Although the concept would suggest a "positive" adaptation that increases performance over time (learning effects), it is however possible that, in most uncertain environments, agents with limited discriminatory power cannot predict whether a modification will turn out to be good or bad. The uncertainty arising from imperfect foresight and complexity results in agents displaying "satisficing" behaviors, but not literally maximizing. The role of competition is that successful firms will tend to expand, and the less successful firms will tend to wither away.

The process of organizational adaptation can be conceptualized as a search process on a strategic "landscape" (Levinthal, 1997). The concepts of search and landscape closely parallel the concept of seeking sustainable competitive advantage (Porter, 1997). The landscape metaphor applied to business implies that strategic settings are continually evolving in response to the actions of other firms, suppliers, staff, etc. the existence of dynamic, deforming landscapes mean that firms cannot continue for a long time to exploit their capabilities for a long time, as there is no guarantee that current locations of "high fitness" will remain unchanged over time. The difficulty of search on a landscape is often a function of the ruggedness of the landscape. Intuitively, a rugged landscape is one with multiple local maxima. The more rugged the strategic landscape facing an organization, the less viable the management choice perspective becomes (Levinthal, 1997). In this context, history matters (there is path-dependence) in terms of defining the current location of an organization on a landscape and also for defining the nature of the landscape itself. The problem of adaptation strategies in rugged landscapes can be reframed as a familiar dilemma: how to get the benefits of exploration without losing the advantage of exploiting existing knowledge (Caldart and Ricart, 2004). This dilemma is explored in the dissertation, with regards to the strategies of multinational corporations in CEE, and is at the crux of the hypotheses investigated.

The transition to market can be viewed as a typical process characterized by out-of-equilibrium dynamics. The "complicatedness" of the environment generates inductive behavior on the part of economic agents. The accuracy with which we are capable of recognizing patterns and ways in which agents constantly update their hypotheses about the market is at the center of the analytical pursuit. Finding a response to the questions investigated by the dissertation means finding *regularities in the MNCs' behaviors*, and in what they do in order to survive and more so, be profitable.

The theoretical arguments for the hypotheses are presented below. The issue of whether and how firms adapt to their environments has been central to organizational theory. In the case of multinational corporations, the investigation of the relative success of various geographical subsidiaries in different environments represents an interesting research avenue. The adaptive capability of the firm depends on the density of the network of relationships. Hierarchical organizations are less adaptive as they allow only a limited number of strategies. Organizations with more diverse linkages in their network are considered more adaptive.

As regards the learning itself as an adaptive process at all levels of the firm, it is important to note that it takes place thru "routines" in which inferences about past successes and failures are embedded. The successful adaptation of the firm depends greatly on the quality of the learning process. Learning along the wrong path leads to "competency traps'. Learning is also a human activity and, as such, it could be inaccurate and idiosyncratic. In the context of the MNC, local autonomous learning may be beneficial to the entire corporation or not (e.g. local experimentation may sometimes be dangerous to the MNC's survival). The blend of responsiveness and integration in various tasks drives the need for autonomous localized learning.

Modis (1998) argues that under conditions of natural competition, the transition from occupancy by the old to the new follows an S-shaped pattern that is predictable. The growth steps are punctuated by periods of chaos, and the evolution process itself is the result of symbiosis and cooperation creating order, and mutations and competition thriving on chaos. Under this framework, firms that opt for strategies that create options (rather than strategies that are profitable but cut off choices) may be more successful in their adaptation. It would seem that organizations face a need to balance the need to innovate with the need to remain stable and ordered. Going too far in the need for innovation results in loose structures and processes that obscure responsibilities and communication ("chaos trap" or "error catastrophe"- Kauffman, 1993). Searching for tight structures leads to inflexibility and predictability ("bureaucratic trap" or "complexity catastrophe"- Kauffman, 1993). Low interdependence among company's parts seems to be best suited for flexibility, while higher levels of interaction lowers the effectiveness of organizational level change (Kauffman, 1993). Adaptive organizations develop flexible internal structures that optimize learning. Kauffman (1993) suggests that flatter, decentralized organizations might be more flexible and carry an overall competitive advantage. Breaking up an organization in optimizing, interacting and communicating parts may also be beneficial. There is however a limit in the number of simultaneous changes an interacting system can tolerate before "freezing up", as there is a limit on the amount of information that an organization can effectively handle (Lissack, 1997).

A valuable theoretical approach focuses on the highlights of different frames, rather than their limitations. One of the main contributions of the dissertation is an integrative view across frameworks. The concept of co-evolution could be the integrative paradigm across the frameworks. Rather than adapting to an unyielding environment, the firms co-evolve. The outcome of this process could be a stable equilibrium, but one that does not originate from assumptions of common knowledge and mutual rationality. The co-evolutionary framework highlights a race to adapt (Day and Reibenstein, The Wharton School, 2004). The firms that first recognize and take advantage of an opportunity in the environment may adapt better. A superior strategy or capability may yield a defensible competitive advantage, at least until another actor's adaptation changes the environment once again. An integrative view is able to describe complex strategic decisions without limitations of strong assumptions. Nevertheless, it sacrifices the power of mathematical inference that makes the economic framework appealing.

The integrative framework used in the dissertation suggests that a firm's profitability and success depends on its adaptation to the local environment, and its creation of internal "diversity". Acting in the transition context of CEE requires MNCs to adopt an active strategy that creates solutions for the local context as well as global capabilities. The essence of transition is the continual change that also impacts performance criteria. The environment in Central and Eastern Europe has been evolving over the past decade and a half. To achieve competitiveness after the first stages of transitions, firms had to change their resource configurations, their capabilities, and sometimes even organizational structures. The transition requires firms to modify their routines (ways of using resources) in an evolutionary process that is interdependent with the processes of knowledge generation and organizational learning. Successful operation demands that strategies generate options for future development and retain options to deal with atypical circumstances. Transition has the potential of creating variety and mutations emerging from the recombination of inherited forms with emerging ones. Companies thus have to balance generating alternatives on one hand, and allowing them to develop, on the other.

Conclusions and Implications

The discussion above presents a theoretical perspective on the multinational corporation and its strategies, and argues the appropriateness of various views for MNCs' subsidiaries in the CEE region. The dissertation treats *organizations as adaptive systems that have to match the complexity of their environments.* Companies, as human organizations, can not only be viewed as adaptive systems, but also as *interpretative systems.* As such, companies adapt to the complexity as their decision-makers perceive and interpret it rather than to any objectively established standard. The consideration of the firm as an interpretative system is reflected in the methodology and in the assumption of "pattern matching" behaviors. The transition process in CEE can be characterized by a high degree of complexity. The concepts reviewed above are incorporated in the analysis of two types of strategies that companies employ to handle complexity. The first category is reduction, translated into strategies that attempt to reduce complexity by bringing it under apparent control. The second is absorption, defined here as activities of participation in local relational systems (enlisting local support, co-opting those that can anticipate and influence change, etc.). The dissertation examines the evidence of the extent to which MNC subsidiaries use such strategies in CEE and their impact on performance. The discussion presented in this chapter offers a theoretical framework for the research hypotheses. The current state of knowledge is included in the literature review. The theoretical framework and the literature review are complementary in supporting the validity of the research questions.

CHAPTER 2 REVIEW OF LITERATURE

2.1 LITERATURE REVIEW PART I: THE TRANSITION CONTEXT IN CENTRAL AND EASTERN EUROPE

2.1.1 Introduction

Transition versus Transformation

Studies of the transition process have approached it from a variety of views, most of which can be classified as "transition" and "transformation" theories. The analysis below presents explanations of each of the two models and the extent of their applicability as theoretical foundation of the dissertation. The "transition" approach is typically associated with neoliberal and neoclassical economic interpretations. The "transformation" approach brings interpretations stemming from evolutionary and institutional economics, network analysis and economic embededness, as well as Marxist political economy and regulation theory (Pavlinek, 2002).

The transition process could be characterized in terms of the revolutions and political changes that have signaled the end of the centrally-planned party-state system, the economic reform, and, thirdly the impact of reform. The 1989-1991 marked revolutionary changes in political structures brought by worsening economic situations, popular dissatisfaction and increased divisions within the communist leaderships. The reforms' challenges rose from a socialist heritage characterized by obsolete production structures and industries, low productivity, over-employment, low levels of technical infrastructure and dependence on CEE and Soviet markets. The reform has been a process of marketization: liberalization of prices, opening of markets, privatization and structural reform, as well as a process of globalization/internationalization led by liberalization of foreign trade and accession to international structures.

Reform in the post-socialist states of Central and Eastern Europe has been analyzed mostly in the early 1990s thru a transition view[1] -a notion of transition to capitalism that implies a single point of departure- command economy and single outcome- market capitalism- also known as "transitology[2]". Under this view, new institutions could simply be imposed after a total collapse of state socialism. This perspective suggests that reformers faced a blank slate, and to some extent, all CEE countries are undifferentiated. The idea of blank slate raised numerous questions from researchers, as it underestimated the complexity of circumstances. The simple and linear change representing a clean break from the communist past was unable to explain the complexities of political, economic, social and cultural change, and to take into account geographical variability and scale. This framework failed to acknowledge the divergent national and regional pathways.

An alternative view[3] argued that countries in the CEE experienced transformations that are not simply the result of an imposed design: there are numerous approaches to reform, shifts in political powers; there are different reform needs, and various inherited political and social institutions that influence the course of reform. This approach accounts for the observed emergence of the new political and economic system thru a gradual and organic process. Based on an evolutionary view, the transformation framework stresses the similarities between developments after 1989-1990 and the previous state socialist system, while allowing for a multitude of outcomes- "plurality of transitions" (Stark, 1992).

The theoretical foundations of economic transformations in CEE find their roots in a number of notional strands which are reviewed as follows. The orthodox economic view of markets and investment determinants considers the market to be an abstraction (Marx, 1906, Hymer, 1976, Meyer, 1998)[4]. In the case of the CEE economies, this perspective stipulates that markets will emerge spontaneously when the party-state intervention is abolished and the self-interested economic actors are free to exchange and maximize utility. Investing firms search for the highest return opportunities with

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[1] Lipton and Sach, 1990.
[2] Pavlinek, 2002.
[3] Stark, 1992.
[4] Bandelj, N. (2004), Institutional Foundations of Economic Transformations in Central and Eastern Europe (1990-2000), Center for the Study of Democracy, University of California, Irvine, Paper No. 04-14.

minimum costs, and engage in transactions that depend primarily on economic prosperity and stabilization

While the traditional economic approach isolates markets from the intervention of states, economic sociology and political economy view markets and states as strongly related, emphasizing the role of states in structuring markets and creating capitalism. The role of state in the transition countries is to constitute, rather than constrain, economies, provide property rights, governance structures (laws and informal institutional practices that define relations of competition, cooperation and organization), and rules of exchange (Evans, 1995, Bartlett, 1997). States can play various roles in the countries' industrial transformation that range within two extremes: predatory states that extract but don't provide anything of value in return, and developmental states that promote industrial progress. The transformation in CEE requires states to negotiate between simultaneous processes of privatization, democratization, and globalization. Literature[5] suggests that the state can be involved in the transition process by setting an example as a market leader. Having a legitimate actor such as the state is crucial for the restructuring of markets. This perspective views markets as sets of mutually aware actors observing each other and reacting to each others' actions. The role-model position of the state is that of an institutional entrepreneur that advocates new foundations at a time when private actors are only beginning to affirm themselves. This view is based on institutional embeddedness of markets. The path-dependence institutional perspective asserts the role of the state, but also the role of pre-existing institutional arrangements in creating path-dependent contexts for future economic action (Stark, 1992). A more detailed discussion on path dependency is presented in a separate section of the dissertation. Some authors (Bandelj, 2004) note that the effect of past institutions is elusive because they enable actors to serve as resources and use available institutional material to innovate in the future.

Two major approaches toward the study of post-communist transformation related to Marxist political economy have been recognized: the neo-Marxist transition from state to private capitalism thesis and the Marxist approaches based upon class analysis and

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[5] Bandelj, N. (2004), Institutional Foundations of Economic Transformations in Central and Eastern Europe (1990-2000), Center for the Study of Democracy, University of California, Irvine, Paper No. 04-14.

production processes. According to Pavlinek's review (2002), the first framework sees the CEE countries before the collapse of communism as "state capitalist", where the class exploitation of workers was only altered by communism (and not eliminated). The transition process is characterized by a number of oscillations between state capitalism and private capitalism. Because this view does not account for any radical changes in class structures, production of surplus value or social relations, it is similar to a neoliberal framework and could be included in the "transitology" approaches (transition rather than transformation). In contrast, the Marxist analysis of production processes suggests that transition towards capitalism involves major transformations of the social relations of production. Recent interpretations of this approach suggest that in some cases, such as Russia, transition has occurred without transformation (the development of merchant capitalism), which could also be a transitory period for other CEE countries.

Regulation theory has studied the CEE evolution as transformation of the state socialist development model into a new development model based on interconnected changes in the regime of accumulation, mode of regulation, labor process model and hegemonic bloc. This framework provides for flexible and dynamic understanding of the economic development trajectories of various countries in CEE. The dissertation incorporates this framework loosely in the discussion regarding the role of state and regulatory institutions.

The dissertation adopts the "transformation" view. The framework allows for distinctive starting points, and various courses of reform that also validate differences in final outcomes. The literature explored in the review of transition as well as the author's subsequent findings reveal the following aspects suggesting that the "transformation" framework reflects more reliably the realities of change from command to market-based economy:

- The path dependence discussion as well as findings on the relative importance of initial conditions suggest that there are strong interactions between past and present structures.
- The transition characterization concludes on the complexity of the environment, thus recognizing the lack of linearity of the modernization and democratization process.

- The reform paths show great variability across the region, and consequently shape the emergence of market institutions[6].
- The analysis of outside influences on the transition process suggests that some of the changes observed in the region are not necessarily path-dependent. Reform paths have been decisively affected by trade liberalization, processes of integration into European structures, presence of foreign multinational companies and international organizations.
- Companies in CEE operate thru a combination of market and state socialist relationships (there has not been a clean break from social and economic interactions dating back in communist times).

The "transformation" view on transition adopted by the dissertation is incorporated also in hypotheses formulation. The shaping of economies by gradual and diverse evolutionary processes leads in some cases to the development of successful enterprises. The economic change and the companies' adaptive strategies to change are viewed to be such that a regressive process is possible (as opposed to continual progress towards a perfectly functional market-based system and progressively better adaptation of companies). The hypotheses consider multinationals as adaptive and interpretative systems that accumulate and incorporate knowledge, repair inefficiencies and embed themselves into the environment, which reflects a network approach consistent with the "transformation" view.

The "adaptive" view assumed in the dissertation acknowledges the continual transformation of certain aspects of the environment, and the fact that business organizations need to cope with the volatility and pace of reforms. The embededness hypothesis proclaims just one of the responses to the uncertainty of rugged fitness landscapes, where dislocations can be anticipated but are unpredictable in their specific contours. In fact, all questions included in the research reflect the need to reduce uncertainty. Among the types of uncertainties[7] that are significant in the context of the present research are institutional uncertainties. Empirical observations show that these types of uncertainties – referring to formalized regulations and normative expectations

[6] This reflects the idea of "plurality of transitions", as described by Stark, 1992.
[7] Stark and Vedres, 2001 provide a detailed analysis of the environmental uncertainties and "corporate hedging" in their discussion regarding hybrid forms of ownership.

about behaviors of other actors- were higher in a first stage of transition (roughly until 1995), as the increased number of regulations raised questions regarding their applicability and enforcement and brought by expectations of more rules in similar and/or different domains. Another type of uncertainty- political- also characterized the transition transformations throughout (radical changes in governments, alteration of government's view on foreign investment, etc.). Finally, market uncertainties (obtaining access to resources, ability to find customers) are also essential in shaping the multinational companies' strategies. It is possible that strategic responses such as vertical integration thru ownership or close development of channel members are an example of various pathways (what Stark and Vedres, 2001 call "enterprise pathways as changes in firms' network positions").

The strategic responses presented in the dissertation are also the result of managing a series of economic risks and uncertainties that were found to influence FDI in the region to various extents. Perceived risk was found[8] to be inversely related to geographic and psychic distance (a history of involvement in trade during socialist times may have offset company risk perception thru familiarity). This finding was more valid at the beginning of transformation; however, it may still have an impact on some MNCs' strategies considered here, such as allowing for a medium degree of local autonomy and integrating subsidiaries loosely into corporate structures, so as to enhance learning capabilities (increase familiarity with the environment). The evolutionary nature of market and institution- building environment and its complexity can be argued for the entire CEE region. Even for the countries in CEE that are now part of the European Union, concerns persist[9] in the areas of re-nationalization and privatization (Hungary), administrative obstacles to entrepreneurship (Czech Republic), high unemployment and deficits (Poland), and general structural reforms.

Unique Features of CEE

There are numerous arguments in favor of using Central and Eastern Europe (CEE) region as the focus of the dissertation. The transition to market is akin to a natural

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[8] Johansen, 2001.
[9] European Bank for Reconstruction and Development, as quoted in BBC News Online, various.

experiment on how markets are born and how strategy evolves. CEE countries are in a process of *transformation* from different degrees of centrally planned economies to a market oriented economy. The goal of transition is not a static notion of free market economy, but an open-ended adaptation to a world which is itself in flux of transformation. The outcome of transformations in CEE is expected to be a set of different forms of capitalisms interconnected into a Western European system (Deacon, 2000). The transition environment has been characterized by the literature as highly volatile due to frequent changes in institutions and industrial structure. Transition economies have institutional frameworks that may require different ways of interacting with business partners and authorities as a foundation for business transactions. Among the unique features of CEE markets is the fact that informal institutions differ greatly from those of Western market economies, such as wide-spread traditional value systems (including collectivist, particularist, family-oriented values, and religion). Markets - especially for capital and skilled labor – are often thin or illiquid and inhibited by numerous market failures (Meyer et al, 2004). Due to the idiosyncratic nature of the CEE markets, multinational firms operating in these transition economies face particular problems that may require unique solutions. However, the transition process and its idiosyncrasies not only generate challenges for MNCs, but also give rise to opportunities. Understanding the responses to these challenges and opportunities has benefits beyond the transition context, as it builds an operational view on strategy in dynamic and complex environments.

Besides the complex economic environment, the social infrastructure of the CEE countries also contributes to their distinctiveness. Social contracts and social institutions may dominate, such that successfully operating in this business environment requires a capability to understand and appreciate the benefits of the existing social infrastructure (Hart and London, 2004). Firms without a capacity to create social value or to become locally embedded in the social infrastructure may struggle to overcome their liability of foreignness. A related implication (which has been observed in emerging markets, but not specifically in transition economies) is that traditional partners may lack relevant experience, whereas non-profit organizations and other socially oriented institutions can play an important role in business development.

The Central and Eastern European markets and the MNCs' strategies in these countries could not be discussed without considering the *growing integration of some countries in the region with the European Union.* About 60% of the region's FDI stock has been historically held by MNCs based in countries of the EU (UNCTAD, 2000). The EU has established strict criteria that aspiring members need in order to join. The economic environment, as well as the advantages that MNCs seek in Central and Eastern Europe, are likely to change as these countries' integration to the EU advances (Tihanyi and Roath, 2002). The institutions of regional integration include EU-conform regulations, enforcement of property rights, free flow of products and resources, specific anti-inflation measures, promotion of economic growth and local competition, and a prudent fiscal policy. The institutional change that is required to fulfill the criteria for membership in the EU is an important element of transition. The CEE markets are in various positions to catch up with the economic environment of the European Union, but even for those countries aspiring to integrate, many remain burdened with unprofitable state-run enterprises, poor corporate governance and socialist era welfare programs. EU accession is not yet a panacea for these countries, and *institutional idiosyncrasies* are likely to persist in the years to come. Finally, *governments* in CEE play one of the most vital roles in relation to the strategic options that are available to MNCs. Governments and policies they set have a direct impact, for example, on taxes, interest rates, incorporation laws, ownership rights, repatriation of profits, and antitrust laws.

The clarification of the CEE context provides the basis for discerning the strategies that work best in the region. The analysis of MNCs' strategies in CEE would not be possible without understanding the idiosyncratic nature of the transition process. The general characterization of the CEE environment presented above draws on the common features of the region. However, the transformation has been following various paths in the CEE countries and may ultimately bring significant differences in the long-term outlook of these economies. This differentiation may prove critical for the MNCs operating in the region as regards their long term strategies.

2.1.2 Characterization of the Transition Process

The post 1989 period is defined as a period of change in the underlying long-run trends in Central and Eastern Europe. The break from communism and planned economy was marked by drastic and ongoing severance from the soviet-type economy characterized by nine features (Ericsson, 1991): hierarchical structure of authority, centralized economic planning, commitment to maximal resource utilization, formal rationing, rigid price control, lack of true money, lack of legal alternatives to assigned economic relationships, arbitrary control by superiors of norms and indices of plan assignments, and incentives geared towards meeting plan targets. Economic growth had been an imperative of the socialist system that favored accumulation instead of technological and organizational change. The extensive growth strategy achieved by rapid industrialization worked well until the 1960s. After that, the leadership channeled resources to the development of military technology. The emergence of advanced technological innovations in the West has contributed to the demise of socialism. The reasons behind the failure of socialism in Central and Eastern Europe have been identified by research (Campos and Coricelli, 2002) as low productivity rates, rigidities in economic structure, absence of capital markets in a regime of "capital hunger", lack of capital mobility, and lack of technological progress. Although the dissertation is focused on the transition economies of Central and Eastern Europe, other countries are going thru the same process in other regions of the world. Among these countries are the rest of the NIS countries, Mongolia, China, Vietnam, Algeria, Cambodia, the Lao People's Democratic Republic, Nicaragua, the People's Democratic Republic of Korea, and Tanzania.

The transition from centrally-planned to a market-based economy has raised a series of issues which are briefly reviewed and incorporated in this chapter. Literature has recognized the fact that the implementation of good policy by the governments of countries in transition is only partly effective in successful transition. The other component is history and geography, shaping the inherited structure of the economy, its administrative and institutional capacity, and political system (The World Bank, World Development Report, 1996). Finally, the transformation of the CEE economies occurs under the influence of external forces, such as foreign investors and international institutions. The characterization of the transition process is presented here on three dimensions: *initial conditions effects on transition path and their relative impact, elements internal to the transition process itself linked to economic and institutional transformation*, and, finally, *external forces influencing transition.* Table 1 presents the three dimensions with their mechanisms and explanations.

Table 1: The Transition Process and Factors Affecting It

	Mechanism/Explanation	*Elements*
INITIAL CONDITIONS	Path Dependence	✓ Initial level of development and economic distortions ✓ Policy induced distortions (black market, trade dependence, repressed inflation) ✓ Initial level of development ✓ Natural richness
INTERNAL FACTORS DETERMINING TRANSITION PATHS	Reform Goals, Means and Limitations Transformation	✓ Macroeconomic stabilization progress ✓ Sectoral reallocations ✓ Property and bankruptcy law development ✓ State ownership reduction ✓ Variety in transition indicators
EXTERNAL FORCES	Positive Reinforcement Convergence	✓ FDI- reinforcing liberalization and institutional reform ✓ Economic integration and EU accession (adoption of W. European laws and institutions, stabilization) ✓ Outside influences: IMF, etc.

Source: Author's own.

The purpose of transition, the evolution towards market, can be described as an iterative process of sequential improvement (although the dimensions of transition are affected by a series of factors that may not necessarily lead to improvement, but rather deterioration). A mathematical illustration of the evolution process, as considered in the dissertation, is presented as follows:

$$X_{n+1}^{i} = X_{n}^{i} + \frac{1}{w+n}\left[q_{n}^{i}(X_{n}) - X_{n}^{i}\right] + \frac{1}{w+n}\mu_{n}^{i}(X_{n}) + f_{y}\left[\left(\frac{1}{w+n}\mu_{n}^{i}(X_{n})\right)/Y_{n}^{WE}\right]$$

where

$X_n = (X_n^1, X_n^2, ..., X_n^N)$ is a vector of economic and institutional features (1 to N) at time n (after n iterations).

{q} is a sequence of functions mapping features into probabilities of improvement towards market at time n.

b_1 is the vector of initial conditions.

$$w = \sum_i b_1^i$$

Improvements towards market follow the dynamics:

$$b_{n+1} = b_n^i + \beta_n^i(X_n), \textit{where the random variable } \beta_n^i(X) = \begin{matrix} 1, \textit{with probability } q_n^i(X) \\ 0, \textit{with probability } 1 - q_n^i(X) \end{matrix}$$

$$\mu_n^i(X_n) = \beta_n^i(X_n) - q_n^i(X_n)$$

f_y is a factor determining the rate of convergence towards western features of market economy; could be expressed as an exponential function

$f_y = e^{c(n-1)}$, *where c* is a convergence factor.

The mathematical expression reflecting the evolution towards market structures includes a "driving part"(the first two terms at the right of the equation above) that takes into consideration path dependence (role of initial conditions), a perturbational part (the middle term at the right of the equation) that considers the internal factors affecting improvements towards market, and, finally (the last term at the right of the equation) a measure of external influences (mainly FDI and EU accession/agreements), including a factor determining the rate of convergence towards Western features of market economies.

An accurate *characterization of the transition process* in the CEE region has to take into account the heterogeneity of starting points and historical events that have marked the beginning and advancement of the countries' change process from planned economy to capitalism. In general, the historical dimension is an essential part of understanding the dynamics of history in a society. Initial conditions in the system are of decisive importance when determining the "next step". The institutional system has advanced through long evolutionary developments and short revolutionary episodes. Among the CEE states, Slovenia, Croatia, the Czech and Slovak Republics and Hungary were among the countries with modest structural distortions. Preliminary comparisons between successful reformers (Poland, Hungary and the Czech Republic) and less advanced market economies of CEE provides support to the view that the differences in restructuring, effective competition and economic performance are related to policy factors (the development of credit and technical assistance programs) and non-policy factors ('path dependence'). Development does not converge towards a stable solution, it is not fortuitous or deterministic.

According to the World Bank Report (2000) the transition process in CEE started with a sharp decline in GDP followed by recovery. The onset of transition was accompanied by severe shocks, also tied to the disruption in institutional and technological links, supply of inputs and delivery of outputs. The financial crises of the 1990s, such as Mexico, East Asia, and Russia, also contributed to delaying or interrupting the recovery of output. War and civil struggles in Moldova in 1992, and in FYR Macedonia in 1991–94 had a negative impact on infrastructure development and reforms needed for successful transition. The transition recession is considered now to have ended, as all countries in the region have recorded growth after 2000. The recovery has varied greatly across countries: for example, Bulgaria and Romania had about two years of output decline after the initial recovery, Albania had returned to recession after the 1997 financial crisis. Most of the countries in the region have been affected to various degrees by the Russian crisis in 1998. It would appear that the recovery of output benefited from foreign investment as a source of capital and new technology and also as a signal of confidence in the transition progress.

Research (World Bank, 2000) has found that initial conditions explain more differences across countries during the initial period of output decline (1990–94) than over the subsequent years of transition. The shift from planned to market economies has been a transformation of unprecedented scale that included macroeconomic stabilization, price and trade liberalization, imposition of hard budget constraints on banks and enterprises, enabling private sector development, reform of the tax system and restructuring of public expenditure, legal and judicial reform and reform of public sector institutions. Initial *distortions* in the economy- including severe repressed inflation or high black market exchange rates and absence of pretransition policy reforms—are most closely associated with lower performance during the first years of transition. Initial *institutions* and presence or absence of "market memory" (number of years under socialism) were found to be strongly correlated to variations in subsequent performance. However, while initial conditions had a greater impact on the initial collapse of output than on the subsequent recovery, the impact of policies became stronger as transition progressed.

In the first 10 years of transition, countries in CEE displayed some common trends but also significant variations. Several features at the start of transition may have affected economic performance over the past decade: geography (such as endowment of natural resources and proximity to Western markets), years spent under central planning, and nature of economic development under socialism (such as the extent of over-industrialization, military output, and repressed inflation). Central planning left behind a legacy of grave difficulties for market-oriented reform. The lack of relationships with suppliers arose as part of the deep recessions that the transition economies experienced in the early 1990s, when the disappearance of the central planners greatly disrupted production.

The transition economies have significantly different histories, reflected in their institutional and legal traditions. Since the fall of communism, they have followed various political paths, have experimented with privatization and have had different levels of success in building an institutional environment indicative of a market economy. Not all communist countries were centrally planned in the Soviet-type mould. Yugoslavia - which has since turned into five successor states of Slovenia, Croatia, Serbia and Montenegro, Macedonia, and Bosnia -had adopted its own lighter form of economic planning in 1952. In these countries, consumer preferences were allowed to guide production decisions at least to a limited extent, so that the inconsistency between the pattern of domestic demand and the structure of supply was less serious. Countries in the former Soviet bloc varied significantly in their degree of openness to international trade. A few countries were virtually autarchic; for example, in 1989 Albania exported only 5 percent of GDP and Romania only 12 percent, which are exceedingly low trade shares for small economies in the middle of Europe. Other countries exported a larger share of GDP, but mostly within the CMEA trading arrangement between Soviet bloc economies.

The countries that are now part of the European Union had relatively high levels of trade, at least by the standards of transition economies, and exported mainly to developed Western economies. These differences in trade clearly reflect the extent of market interconnectedness, but also reveal something about the levels of competition in these economies and their exposure to market-oriented business practices.

The patterns of reform followed by transition countries in CEE fall within two contrasting approaches: a rapid, all-out program of quick reform or a partial, phased reform. The two paths of reform have not been followed at their extreme by any country in the region. The initial macroeconomic conditions may have impacted policy choices: policymakers in most CEE countries were not able to assure control over the economy in its partially-reformed state, which could explain why early attempts at partial reform had failed to raise efficiency, particularly in the countries of the ex Soviet Union. The role of different political heritages could not be ignored: citizens' loyalties toward pre-transition regimes varied greatly. As reviewed below, legacies of democracy and markets remained strong in some countries. Geography made a difference: countries closer to Western Europe had been exposed to European political norms and culture. Although in most CEE countries the transition start was marked by a "political breakthrough", some countries followed a different pattern- Ukraine's first government, for example, focused on asserting national identity, rather than reform. Some countries started with a more favorable economic situation, reflected in lower inflationary pressures, less dependence on the CMEA system, and a more favorable position to develop new trade links. Countries also differed in their level of development, industrialization and income. These conditions are reviewed in more details below, however, separating the contributions of initial conditions, history in general and geography is extremely difficult (World Development Report, 1996).

A very general characterization of the transition progress in CEE identifies the following patterns: all countries have taken steps to reform the economy, institutions and legal framework, but the extent and coherence of reform vary. There are also varying degree of banking system reform. Most governments have redefined their role to meet the needs of market economy, but the decentralization has sometimes created confusion over the roles of national and local governments. Exports and services are the major engines of growth in transition economies. Some countries in the CEE have been successful in expanding exports (particularly countries that have fostered close relationships with the European Union). Exports from countries with more open trade regimes declined less with the initial disintegration of the CMEA. In NIS countries that have continued state trading arrangements and export controls, the contribution of exports to growth has been less significant. Stabilization policy has followed different paths across the region, and the policies to contain inflation and impose hard budget constraints have been largely influenced by initial conditions, as mentioned earlier. The World Bank (1996) has delineated a first stage of transition in which significant monetary expansion has occurred after freeing prices and the start of liberalization, which meant high inflation. Incomplete price reforms and a process of catching up to world price levels, as well as foreign capital inflows at a later reform stage have put, in most cases, additional pressures on the prices. The government's response to inter-enterprise arrears has had an impact on financial discipline- In Romania and Russia, for example, the government implemented centralized netting-out of arrears between firms, a decision that may have led to an inflationary net expansion of credit.

The patterns of ownership resulted from the shift to non-state forms of enterprises have been less than optimal in most countries in CEE and has resulted in too dispersed ownership as a consequence of mass-privatization programs, or too concentrated ownership in entities that failed to exercise effective monitoring. Deficient legal institutions led to a shortage of institutions that limited the scope of privatization transactions. Most countries have developed early bankruptcy and competition laws following US models (Ukraine, Albania) or West European models (Russia or acceding countries to the EU), but their effectiveness varies greatly.

The Central and Eastern European transition process as well as the MNCs' strategies in these countries could not be discussed without considering the *growing integration with the European Union.* About 60% of the region's FDI stock has been historically held by MNCs based in countries of the EU (UNCTAD, 2000). The EU has established strict criteria that aspiring EU-members need in order to join. The institutions of regional integration include EU-conform regulations, enforcement of property rights, free flow of products and resources, specific anti-inflation measures, promotion of economic growth and local competition, and a prudent fiscal policy. The institutional change that is required to fulfill the criteria for membership in the EU is an important element of transition in the life of a number of CEE countries.

Finally, the CEE region evolves under the influence of various international institutions involved in institutional and infrastructure development. The foreign direct investment inflows have also encouraged governments to improve the general business environment, establish property rights and commercial legislation. At the theoretical level, there is a reasonable agreement that MNCs can play a leading role as agents of change, mainly by stimulating innovation thru linkages and spillovers (positive externalities). Nevertheless, the magnitude and the sign of the effects on local industries and economy may vary in relation to the characteristics of countries, the strategies followed by MNCs and the features of industries in which foreign firms operate. The following discussion presents a more detailed analysis on how the initial conditions, the internal and the external factors have been shaping transition.

2.1.3 Transition Process Initial Conditions Analysis

The extent to which transition can be considered a common process depends on the relative strength of the common legacy of communism versus country-specific factors. Central and Eastern European countries differed significantly in their initial conditions. Despite a common legacy of planning, the transition economies of Central and Eastern Europe started out under different circumstances in terms of initial level of development, macroeconomic distortions, integration into the trading system of the socialist countries, and extent of prior reforms.

Analysis of Initial Conditions

The relative importance of initial conditions at the start of the transition in 1989-1990 can be evaluated in establishing the weights of factors that may have had an impact on the subsequent progress of each country. Among the most important factors are the amount of liberalization pursued before transition and the degree of market mechanisms manifestation before the transition began. Several countries introduced some (relatively small) piecemeal reforms prior to 1990 and gave more independence to managers of state-owned enterprises. Although such uncommitted reforms may have had some negative impact, the literature acknowledges (Campos and Coricelli, 2002) that countries experiencing some market mechanisms may have been positioned better along the path of transition to a market economy, due to the relatively increased familiarity with market oriented decision-making of managers and authorities, and the existence of a better platform for liberalizing prices after the break from the centrally-planned system. Other initial conditions, such as existence of significant distortions in the economy, and institutional inheritance from the communist regime were found to constrain the reform progress and adversely affect the output performance.

The existent literature[10] acknowledged that there is a correlation between output performance and reforms after 1990 and initial conditions. In assessing the role of initial conditions in a comprehensive manner, the dissertation uses principal components analysis to isolate the factors that comprise the most important initial conditions. Drawing on earlier literature on transition (EBRD, 1999; De Melo et al, 1997) the dissertation identifies a number of variables that characterize the initial conditions of selected economies of Central and Eastern Europe prior to their shift towards market-oriented development. Whereas previous studies have included a large number of variables in the initial analysis and all the world's transition economies, the analysis here incorporates only variables that apply to the CEE countries. Also, variables are observed in 1990 consistently across countries as opposed to previous literature that have used a varying time span, needed in order to include Asian and other countries in transition.

The information on each variable considered in assessing the relative importance of initial conditions is presented in Table 2.

[10] Campos and Coricelli, 2002; De Melo et al, 1997; Fidrmuc and Tichit, 2004; Child and Tse, 2001.

Table 2. Central and East European Economies: Initial Level of Development and Economic Distortions

Country	Per capita GNP at PPP USD 1989	Avg. % Growth 1985-1989	Non-CMEA in Total Exports 1990	Repressed Inflation[11] 1987-90	Trade Dependence 1990 (%)	Industry Distortion	Urbanization (% of population) in 1990	Natural Resources	Black Market Premium	Years under Central Planning
Non-EU Countries										
Albania	1400	3.6	0.54	4.3	6.6	0.37	37	0	434	47
Bosnia Herzegovina	n/a	n/a	n/a	n/a	n/a			0		
Bulgaria	5000	2.7	0.41	18	16.1	0.59	68	0	921	43
Croatia	6171	0.2	n/a	12	6.0	0.35	62	0	27	46
FYR Macedonia	3394	0.2	n/a	12	6.0	0.43	59	0	27	
Romania	3470	-0.8	0.72	16.8	3.7	0.59	53	1	728	42
Belarus	7010	5.2	0.11	25.7	41.0	0.49	66	0	1828	72
Moldova	4670	5.7	0.08	25.7	28.9	0.37	47	0	1828	51
Russia	7720	3.2	0.36	25.7	11.1	0.48	74	2	1828	74
Ukraine	5680	2.4	0.18	25.7	23.8	0.44	67	1	1828	74
Other FSU Transition Countries										
Armenia	5530	2.7	0.03	25.7	25.6	0.55	68	0	1828	71
Azerbaijan	4620	0.8	0.08	25.7	29.8	0.44	54	3	1828	70
Georgia	5590	2.7	0.09	25.7	24.8	0.43	56	2	1828	70
Kazakhstan	5130	2.4	0.11	25.7	20.8	0.34	57	3	1828	71
Kyrgyzstan	3180	4.3	0.03	25.7	27.7	0.40	38	0	1828	71
Tajikistan	3010	3.2	0.18	25.7	31.0	0.34	32	0	1828	71
Turkmenistan	4230	1.9	0.04	25.7	33.0	0.34	45	3	1828	71
Uzbekistan	2740	3.9	0.11	25.7	25.5	0.33	41	2	1828	71
Countries in EU										
Czech Rep	8600	1.6	0.41	-7.1	6.0	0.58	65	1	185	42
Hungary	6810	1.6	0.51	-7.1	13.7	0.36	62	1	46.7	42
Poland	5150	2.8	0.50	13.6	8.4	0.52	62	1	277	41
Slovak Rep	7600	1.6	0.32	-7.1	6.0	0.59	57	1	185	42

[11] The indicator of repressed inflation is the increase in deflated wages less the change in real GDP from 1987 thru 1990.

Slovenia	9200	-0.4	0.58	12	4.0	0.44	62	1	27	46
Estonia	8900	5.2	0.06	25.7	30.2	0.44	72	0	1828	51
Latvia	8590	5.2	0.05	25.7	36.7	0.45	71	0	1828	51
Lithuania	6430	3.5	0.09	25.7	40.9	0.45	68	0	1828	51

Source: The World Bank, IFC, and various estimates Melo et al (1997)

The first variable reflects a measure of purchasing power parity in income levels, with the lowest value corresponding to per capita GNP at PPP USD of 1,400 for Albania. The second variable reflects the average growth in each country at the end of 1980s. The pattern of economic growth during the communist system favored accumulation and rapid industrialization. The pattern of growth in the CEE after communism shows marked differences among countries, for which various explanations have been forwarded that are beyond the scope of the dissertation. Growth in the earlier stages of socialist accumulation is higher and countries found themselves at different stages at the beginning of transition. The more mature countries were experiencing low growth or stagnation, whereas poorer countries were still benefiting from higher growth.

Earlier literature has found a predominance of non-CMEA portion of trade in creating a vector of significant initial conditions (Campos and Coricelli, 2002) which justifies the inclusion of the proportion of non-CMEA exports in total exports in the analysis. The importance of repressed inflation, in the form of monetary overhang, is reflected in data compiled by the World Bank (World Development Report, 1992). The indicator of repressed inflation used here represents the increase in deflated wages less the change in real GDP from 1987 thru 1990. The trade dependence variable has been introduced to reflect the desire of authorities to create a regionally interdependent communist economy. The breakdown of the CMEA and the collapse of the USSR caused remarkable disruption in the international trade.

Over-industrialization was a common phenomenon in the CEE region before 1990. The variable included in the analysis follows studies[12] that have used a measure of industrial distortion as the difference between actual share of industry in GDP and a predicted share. Urbanization is used as a proxy for level of development, with a cross-country distribution that closely mirrors income levels. The richness of natural resources

[12] De Melo et al, 1997.

is also introduced as a variable. Previous research[13] has found that resource rich countries have to surmount production and logistical problems before realizing their resources' potential. In some cases, the availability of potentially exportable energy resources may permit governments to delay reform. An essential measure of economic distortion is the black market exchange rate premium introduced as a variable here. A high black market exchange premium is an indicator of expectations of depreciation and/or foreign exchange rationing, and can be stimulating the diversion of resources from the official to the informal sector. A final variable has been introduced to asses the strength of inheritance of communism. The years under central planning reflect the ability of societies to understand and deal with the transition process and the inertia engendered by a history of communist rule.

The preamble to the principal components analysis shows high correlations between the variables taken into consideration and a Bartlett's test that grants the use of the method for assessing the relative importance of initial conditions. The results of the analysis for the entire group of countries in the region (as presented in Table 3) reveals three vectors that explain most of the variance in the original data. The first component attributes a large negative weight to the proportion of non-CMEA exports in total exports and large positive weights to initial policy-induced distortions (mainly black market premium, trade dependence, and repressed inflation). The second vector emphasizes the relative importance of the initial level of development, whereas the third component focuses on the natural richness of the environment of each country at the beginning of the transition process. The results of the analysis are compiled in the Table 3 below.

[13] De Melo et al, 1997.

Table 3. Relative Importance of Initial Conditions Affecting Transition Using Principal Components Analysis

Variables	*Component*		
	1	2	3
GNP	-0.129	0.785	0.323
GROWTH	0.618	0.377	-0.551
NONCMEA	-0.888	-0.231	-0.005
REPINFL	0.854	0.009	0.148
TRDEP	0.871	0.287	-0.009
INDDIST	-0.580	0.496	0.111
URBANIZ	-0.232	0.849	0.377
RES	0.008	-0.452	0.819
BMKT	0.954	0.132	0.131
COMM	0.808	-0.177	0.372

Source: Author's own.

Variable definitions:
GNP= per capita GNP at PPP USD, 1989
GROWTH= average percentage growth 1985-1989
NONCMEA= non-CMEA in total exports, 1989
REPINFL= repressed inflation, 1987-1990
TRDEP= trade dependence percentage, 1990
INDDIST= industry distortion, 1989
URBANIZ= percentage of population living in urban areas, 1990
RES= natural resources, evaluated as poor "0", moderate "1", or rich "2"
BMKT= black market premium, 1989
COMM= years under central planning communist system.

The same analysis has been applied only to the countries that are not integrated in the European Union but have made relatively significant progress in transition, excluding some FSU countries. The results show that 80% of the variance is explained by only two vectors. The first component is similar to the first vector of extended analysis and reflects the importance of policy-induced distortions and communist inheritance. The second factor emphasizes the importance of natural resources. As noted in other parts of the dissertation, the importance of initial conditions affecting the transition process is undisputable. The results of the analysis on the relative importance of selected initial conditions show that for the entire region the conditions can be clustered as initial distortions, level of development, and, natural richness. For the selected countries scrutinized further in the dissertation, the principal components analysis reflects the large importance of initial economic distortions induced by the policies pursued during communism on one hand, and the existence of natural resources, on the other hand.

Path Dependency as an Explanation for Various Transition Paths in CEE

The critical role for timing and sequencing of reform and restructuring in each of the CEE countries has been stressed in theories drawing upon path dependency (such as Stark, 1992). Path dependency builds upon theories of historical institutionalism, an approach that claims that choices formed when an institution is being formed, or when a policy is formulated, have a constraining effect into the future (Peters, 2000). The task of developing a new institutional system from scratch has attracted considerable attention, especially from international actors, who considered the CEE region as a testing ground for several new policies (Deacon, 1997). Path dependency is a valid, at least partial, explanation for various transition paths in CEE.

Almost all research on post-socialist transformation recognizes some form of path-dependency (Bandelj, 2004). Economic institutionalists argue that previously existing institutions, formal and informal, constrain the range of institutional alternatives from which actors (i.e. governments) choose, locking them into certain courses of action which may be difficult to reverse. Existing institutions also set a range of acceptable options that are available to policy makers. The dissertation states that institutions can persist even when the initial conditions that created them change substantially, that is, even after the break-up of the socialist system. Social organization of the economy may also have path dependent influence on particular economic processes because structural features cement shared cultural understandings of how economic activity should be conducted and what kind of economic processes are considered legitimate.

In terms of FDI, the structure of the economy (and the expansion of certain industries and sectors) developed during the socialist period may make certain host economies in CEE more or less attractive to foreign investors. Path dependency may explain the reform pace that influenced the transition by the place of market-based activity in socialist economies. In closed political regimes in pre-1989 Central and Eastern Europe, there was formally no private ownership, but in practice some private sector activity was present. If pre-existing institutional arrangements influence the economic activity in the future, then we can explain why the countries with greater openness to market-based activity during the socialist times had the highest levels of liberalization in subsequent years.

Comparing indicators for the countries that are now part of the European Union with those of other CEE countries shows the various growth paths. Besides the initial (at the beginning of transition) degree of liberalization, the structure of the economy and sectoral development may have also played a role. According to readily available data at the end of the 1990s (UN ECE, Economic Survey of Europe, 2000, No.2/3) the real gross industry output surpassed 1989 level only in Poland and Hungary. In three Central European countries (Czech Republic, Slovakia and Slovenia) industry output reached above three-quarters of the 1989 level. In all other CEE countries industry outputs are about half or less of the previous levels. This decline of industry is partly the result of the inherited 'oversized' industry sector, characteristic to most socialist economies. The decline is also explained (Radosevic, 2001) by various reform paths: deindustrialization, tertiarization and deagrarization (mainly in Central Europe), and re-agrarization in other CEE countries (as in Bulgaria, Romania, CIS countries).

2.1.4 Internal Forces Affecting the Transition Process

The systemic change during transition can be viewed as a list of stylized factors. Table 4 presents the planned system's features and their counterparts in changes occurring during transition. The stylized facts reflect the general change process of transition and they do not account for country differences.

Table 4. The Transition from Centrally-Planned to Market-Based Mechanisms

	Common Legacy	*Changes Occurring during Transition*	*Complete Transition*
Macroeconomic balances	Macrobalance by direct control	Macroeconomic destabilization	No erratic changes in GDP. Inflation and unemployment are under control.
Economic, political and decision-making	Coordination thru plans	Output declines resulting from disruption in the coordinating mechanism	Private interests direct changes in the society. Rational decisions can be made.
Private ownership	Little private ownership	Output gains from private ownership and private sector growth	Rights are effectively protected by a court of law.
Relative prices	Distorted relative prices	Microeconomic and sectoral reallocations	Market mechanisms are mostly able to prevent shortages/surpluses.

Adapted from: De Melo at al, 1996, From Plan to Market, The World Bank, Transition Economics Divisions.

The literature on transition in CEE (Campos and Coricelli, 2002) acknowledges the initial collapse in output, sometimes translated in persistent depression, after the fall of the planned system. Observers have explained the collapse by a fall in consumer demand, "trade implosion" as a result of the break up of the old system of production and exchange, or as a "transformational" recession, related to the overall transformation of the economic system. The "transformational" perspective stresses the importance of institutional factors in the transition path, and views the transition as a large scale institutional change. **Appendix 1** attached shows annual freedom scores in selected transition economies in CEE, 1972- 2003. Today it is possible to tell which countries have progressed further in the transition towards a market economy. The institutional dimensions of governance (the executive, the bureaucracy, the rule of law, the character of the policy-making process and the civil society) change over time. Although path dependency would suggest limits in the feasibility space for policy choices, the institutions of CEE are by no means immutable or unchangeable.

The essence of economic transformation from plan to market[14] is the replacement of one set of institutions governing economic activity by another. The Western market economies have built their institutions over decades, varying as a result of different historical evolution and underlying cultures, and supported by strong and impartial states. The path dependency of institutional frameworks led to a variety of "business systems" that differ among USA, Asia and West Europe. For the last decade and a half, countries in Central and Eastern Europe have been building their institutions under strong outside influence. Policy choices made during the period of radical change around 1990 created institutions and established distribution of power. In many countries, the weak legal framework permitted opportunistic behavior, rent shifting, bribery and corruption. In some countries, vested interests have been created that did not benefit from further reform.

The investigation of the transition process has to consider not only the economic conditions of each particular country, but also the specific culture, geographical conditions and distribution of power among social groups. The society's dynamic relationships between institutional, production, value and social system undergo a substantial transformation during transition from a centrally-planned economy (Mygind, 1994). The most important change takes place in the institutional system, which on the political level means a redistribution of power in central and local governments. On the economic level the transition from plan to market includes liberalization- decentralization of decision and information, liberalization of prices, international trade, banking system, etc.- and it implies a new legislative framework for the operation of private enterprises and a new incentive structure.

[14] The conditions to be met for a country to be called a market economy can be summarized as follows:

	EU Criteria	*US Dept. of Commerce Criteria*
Market-determined prices	Minor state interference	Wage rates are established by the labor market
Control of resources	No undue state control over resources and production. Transparent and non-discriminatory law	State ownership of resources is minimal
Accounting standards	International standards are followed	
Property rights	Transparent and effective property law Insolvent firms are forced into bankruptcy	
Exchange rates	Exchange rates are not fixed	Currency is convertible
Foreign investment		There is potential for foreign investment

Source: Author's own.

The analysis above suggests that the interaction between the subsystems of a society in transition may be defined by positive feedbacks where the stability in the social system creates support for institutional change, which in turn leads to clear rules for political institutions and a consistent economic policy in the area of stabilization, liberalization and privatization. Such a policy impacts positively the production system, and there is an incentive for the continuation of transition supported by the value system as well. Progress towards stabilization improves a country's rating from international institutions and increases the foreign investors' confidence, generating an inflow of capital and entrepreneurship which contributes to further advancement on the transition path. However, it is also possible that an unstable and conflicted social system, where the competence of newly established institutions is unclear, leads to an inconsistent and unbalanced policy. Such a policy does not convince the agents in the market and does not surpass "critical mass" to make the agents behave on market signals. Investors refrain from capital injection, and continue to use "unconventional" methods of maintaining an acceptable profitability level, with negative effects on the production system. The *vicious circle* continues as the value system does not support change and the economy is set back further by restriction to trade, unrealistic expectations and decreased confidence from the rest of the world (Mygind, 1994, and Mygind, 1996).

The main purpose of transition was to introduce markets as more efficient coordination mechanisms. Yet, the old economic system disintegrated before the institutions supporting a market economy were in place. The absence of systems providing information and legal enforcement allowed for opportunistic behavior which in turn increased transaction costs. The lack of informal institutions such as routines, knowledge and procedures provoked market failures at the start of the transition process that continued to persist to various degrees. The weaknesses of market institutions and the constraints on internalizing transactions (such as limited foreign ownership rights) led to the use of alternative exchange mechanisms through *informal networks* which connected firms to authorities.

An important aspect of the transition process is the role of the state. The governments in CEE are still highly involved in building an infrastructure that enforces contracts, guarantees property rights and provides public services like education, healthcare, and social security. The state's role is to build an effective regulatory framework. In absence of a predictable, transparent and accountable state, structural reforms are delayed and unregulated agents in various sectors may run activities that are incompatible with public interest and long term economic growth. In the presence of incomplete information on the nature of policymaking, structural policies may be time-inconsistent, and private agents may suffer utility losses from unfulfilled expectations with reforms.

Researchers[15] suggest that communism is an example of how too much order and control brought the system to an end by taking away its capability to innovate and adapt. The lack of competition reduced the ability of the communist economy to adapt to new conditions. The alternative system, democracy based on free market requires a "loose" environment that ensures competition. But there is also a need for regulations to maintain competition. Free market economies are complex systems characterized by global structure and local randomness. Competition is the source of local randomness while regulation maintains the global structure. The nature of the free market economy reflects thus a need for uncertainty that ensures growth and adaptability. Because totalitarian economies offered a high level of certainty but little opportunity, the citizens and governments in countries making the transition to free market may not be prepared to live with the uncertainty that is required to make the market mechanism work. As a complex system, the economy is characterized by a loosely connected, decentralized web. It is "chance" (randomness) that keeps the system from becoming too rigid and allows it to search for many possible solutions. The rules governing the system are themselves adaptable and keep the system from becoming chaotic. The element of chance is key in understanding how complex systems are stable and adaptive. In researching adaptive behaviors of the agents acting in such environment, it makes sense to look at equilibrium as a dynamic process in which the global or typical characteristics are stable, but the details are ever changing.

In the 1990s, the institutional environments were unstable and rapidly changing, but the process took longer than most reform scenarios predicted (Meyer, 2000). The distinctiveness of the CEE business systems still limits the transferability of multinational

[15] Peters, 1999.

firms' strategies and organizational concepts. The fact that the MNCs' strategies in transition economies differ from the ones in other regions of the world is apparent in the literature (Meyer, 2000). Corporate strategies in these economies can be explained only by incorporating the institutional context in the analysis. For the local institutions and firms, the evolutionary transformation and resource re-configuration requires the acquisition of new capabilities, developed from existing ones in combination with imported know-how. From an investing MNC perspective, research has suggested (Meyer, 2000) that foreign acquirers risk losing valuable local capabilities if they concentrate on the transfer of their established best practices and neglect development of variety by fostering indigenous capabilities.

A Review of Transition Paths in Central and Eastern Europe

Transition is a process of structural change in which many fundamental relationships determining how post-communist economies work change as well (Fidrmuc and Tichit, 2004). The reform in former socialist countries of CEE has recorded various results: while some countries resumed growth after a few years of a transformational recession, others experienced severe declines with little subsequent recovery. In general, Central European countries returned to positive growth 2 or 3 years after the beginning of transition whereas the former Soviet Union (FSU) countries experienced prolonged periods of economic decline (4-5 years or even longer). The evolution of the countries according to their progress towards a market economy is very heterogeneous and does not monotonically depend on time, suggesting that the factors governing growth are indeed sensitive to the progress in implementing reforms.

The transition economies of CEE make a particularly good laboratory for *understanding the dynamics of market evolution* and for evaluating the impact of alternative policy frameworks. It is useful to distinguish two elements in microeconomic transition: the restructuring of existing activities and the reallocation of resources. Restructuring entails enhanced performance within existing firms through changes in objectives, incentives and constraints on managers and results from ownership changes. Improvements depend on the resulting ownership structure, the legal and institutional arrangements for corporate governance and the nature and performance of the capital market. Reallocation of resources depends more broadly on whether the market structure is competitive and on the rules and institutions affecting entry, exit, bankruptcy and competitive interactions between incumbents, as well as trade regime and government policy. The tables below show recent progress of selected CEE countries towards market economy.

Table 5. Transition to Market Economy Progress Ratings, 2000

Country	*Privatization Score*	*Macroeconomic Policy*	*Microeconomic Policy*	*Economic Liberalization*
Albania	4.00	5.00	4.50	4.50
Belarus	6.00	6.25	6.50	6.25
Bosnia	5.00	5.50	6.25	5.58
Bulgaria	3.75	3.50	4.00	3.75
Croatia	3.75	3.50	3.75	3.67
Czech Rep.	1.75	2.00	2.00	1.92
Hungary	1.50	2.00	1.75	1.75
Macedonia	4.00	4.75	5.00	4.58
Moldova	3.50	4.25	4.25	4.00
Poland	2.00	1.50	1.50	1.67
Romania	4.00	4.00	4.50	4.17
Russia	3.75	4.75	4.50	4.33
Ukraine	4.50	4.50	4.75	4.58
Yugoslavia	5.00	5.50	5.50	5.33
Slovakia	3.00	3.25	3.50	3.25
Slovenia	2.25	2.00	2.00	2.08
Estonia	1.75	2.00	2.00	1.92
Latvia	2.50	2.50	2.50	2.50
Lithuania	2.50	3.25	2.75	2.83

Table 6. Transition to Market Economy Progress Ratings, 2003

Country	*Privatization Score*	*Macroeconomic Policy*	*Microeconomic Policy*	*Economic Liberalization*
Albania	3.25	4.00	4.00	3.75
Belarus	6.00	6.25	6.50	6.25
Bosnia	5.00	5.50	5.50	5.33
Bulgaria	3.00	3.00	3.75	3.25
Croatia	3.25	3.50	3.75	3.50
Czech Rep.	1.75	2.25	2.25	2.08
Hungary	1.50	2.50	2.00	2.00
Macedonia	4.25	4.75	5.00	4.67
Moldova	4.00	4.50	4.25	4.00
Poland	2.25	2.00	1.50	1.92
Romania	3.75	3.75	4.25	3.92
Russia	3.50	3.75	4.50	3.92

Ukraine	4.25	4.50	4.50	4.42
Yugoslavia	4.75	5.25	5.00	5.00
Slovakia	2.00	2.50	2.50	3.92
Slovenia	2.50	2.00	2.00	2.17
Estonia	1.75	2.00	2.00	1.92
Latvia	2.50	2.25	2.25	2.33
Lithuania	2.25	2.75	2.25	2.42

Ratings and scores are based on a scale form 1 to 7, with 1 representing the highest level and 7 representing the lowest level of economic development.

Source: The Freedom House, Nations in Transit 1999-2003 Ratings

For most of the CEE countries, it has been noted (Boskhov, 2002) that the foundations of the market economy have been built, but the inefficient functioning of some market institutions (e.g. ineffective judiciary system and police, state bureaucracy, corruption, etc.) may undermine the confidence of the public and its support for market reforms. The relationship between the speed of reform and economic growth in the CEE transition economies has been the subject of controversy. Some economists argued for advancing reforms in all areas as fast as possible; others criticized such a strategy as imposing unnecessarily high costs. Privatization has been key in the transition from plan to market. Rapid privatization early in the transition aimed to get the state out of enterprise management, and to create a broad constituency for reforms. Privatization was a way of imposing hard budget constraints and promoting restructuring. It was also a method of creating demand for stronger property rights and institutions of corporate governance, thus contributing to private sector development. All transition economies in the CEE region had thousands of state-owned small business and service units that were the first to be privatized by simple methods. As the size of the SOEs to be privatized increased, so did the complexity of privatization. The table below presents the various privatization methods that dominated in the countries under consideration.

Table 7. Methods of Privatization

Country/ Privatization Method	*Direct Sales*	*Vouchers*	*Management-employee buyout*
Albania	n.a.	Secondary	Primary
Bosnia and Herzegovina	Secondary	Primary	n.a.
Bulgaria	Primary	Secondary	n.a.
Croatia	n.a.	Secondary	Primary
FYR Macedonia	Secondary	n.a.	Primary
Romania	Secondary	n.a.	Primary
Belarus	n.a.	Secondary	Primary
Moldova	Secondary	Primary	n.a.
Russia	Secondary	Primary	n.a.
Ukraine	Secondary	n.a.	Primary
Czech Rep.	Secondary	Primary	n.a.
Estonia	Primary	Secondary	n.a.
Hungary	Primary	Secondary	n.a.
Latvia	Primary	Secondary	n.a.
Lithuania	Secondary	Primary	n.a.
Poland	Primary	n.a.	Secondary
Slovakia	Primary	Secondary	n.a.
Slovenia	Secondary	n.a.	Primary

Source: European Bank for Reconstruction and Development

According to the European Bank for Reconstruction and Development, the reforms needed for successful transition could be grouped in two stages. The first stage reform consists of liberalization of prices, external trade and foreign currency, privatization of small-scale units, and the establishment of key commercial laws. The second stage reforms consist of large-scale privatizations, enterprise restructuring and reforms in infrastructure. In general, much of the first stage reforms focus on liberalizing the economy from government intervention, whereas second stage reforms concentrate on developing a more efficient government in enforcing the rules for a vibrant market economy. Most of the CEE countries have largely completed the first stage of reforms (Bosnia-Herzegovina and Yugoslavia may be exceptions) and embarked on second stage reforms. The most notable economic reform progress has been recorded in 2000, but has declined in 2001 partly due to the deterioration in the global economy. Of all transition countries, important gains since the 2001 are evident in Yugoslavia, Bulgaria, Croatia and Russia. The discussion of the transition progress in each country reviews the extent of economic restructuring and progress in economic reforms. Although the transition progress varies among countries, the private sector shares in the economies (as a rough approximation of restructuring) have increased significantly from 12% in 1990 to an approximate average of 60% currently (the smallest private sector is found in Belarus). The CEE countries that are now part of the European Union have recorded a significant progress in transition and have relatively higher democratic and economic freedoms. Macroeconomic indicators for the EU countries in Central Europe show various proportions of private sector share in the GDP- between 55% in Slovenia and 80% in Czech Republic and Hungary in 2000. The section below provides a more detailed account of similarities and differences among CEE countries, emphasizing the importance of historical events and development path. The review of transition progress in the countries considered in the dissertation finds a great variability in the nature and speed of reform. The tables below present a set of key indicators as an overview of economic development and freedom in the region. A more complete illustration of CEE macroeconomic indicators is presented in **Appendix 2**.

Table 8. Macroeconomic Indicators: Recent Evolution in Selected CEE Countries

Country	**GDP (current $, bn)**			**GDP Growth (annual %)**			**FDI (net inflows, current $**		**Current Account Balance in % of GDP (ratio)**				**Inflation annual % change (%)**			
	1999	*2002*	*2003*	*1999*	*2002*	*2003*	*1999*	*2002*	*1999*	*2002*	*2004*	*2005 est.*	*1999*	*2002*	*2004*	*2005 est.*
Albania	3.4	4.8	6.1	10.1	4.7	6.0	41.2	135.0	-3.9	-6.5	-5.5	-5.2	0.4	5.2	3.4	3.0
Belarus	12.1	14.3	17.5	3.4	4.7	6.8	444.0	247.1	-1.6	-2.6	-3.6	-3.5	293.7	42.6	19.5	17.4
Bosnia and Herzegovina	4.7	5.6	7.0	9.6	3.9	3.5	176.8	293.4	-9.3	- 22.1	-19	-18.2	2.9	0.3	0.9	1.7
Bulgaria	13	15.6	19.9	2.3	4.9	4.3	806.1	599.7	-5.0	-5.3	-8.7	-8.3	2.6	5.8	6.3	3.6
Croatia	19.9	22.8	28.3	-0.9	5.2	4.3	1.5 bn	960.5	-7.0	-8.4	-5.8	-5.2	4.1	2.3	2.5	3.5
Macedonia	3.7	3.8	4.7	4.3	0.9	3.1	32.7	77.2	-0.9	-8.5	-7.7	-6.3	-2.0	2.4	2.0	3.0
Moldova	1.2	1.7	2.0	-3.4	7.8	6.3	37.9	110.8	-6.0	-6.0	-6.6	-6.3	39.3	5.3	10.7	5.8
Romania	35.6	45.7	60.4	-1.2	4.3	7.6	1.0 bn	1.1 bn	-4.1	-3.4	-5.2	-5.3	45.8	22.5	11.5	7.2
Russia	195.6	345.6	433.5	6.4	4.7	7.3	3.3 bn	3.0 bn	11.3	8.9	9.9	7.8	85.7	15.8	10.3	8.9
Ukraine	31.6	42.4	49.5	-0.2	5.2	9.4	496.0	693.0	2.6	7.5	10.2	4.1	22.7	0.8	8.3	8.1
Yugoslavia	9.8	15.7	1.2	- 18.1	4.0	3.0	112.0	475.0	-7.5	-8.8	-9.6	-8.5	42.1	21.2	7.9	6.9

Sources: The World Bank, Country Data, www.worldbank.org/data/countrydata/countrydata.html; IMF, World Economic and Financial Surveys, World Economic Outlook Database, www.imf.org/external/pubs/ft/weo/2004/02/data/index.htm

Table 9. Current Transition Indicators in Selected CEE Countries

Country	The transition recession- cumulative output decline (%)	Index of Economic Freedom, 2005 (interval score: free 1-1.99, mostly free 2-2.99, mostly unfree 3-3.99, repressed 4-5)	EBRD transition indicator rating at the end of 1990s (1 least progress, 4+ most progress)	Private Sector Share of GDP at the end of the 1990s (%)	Democratic Freedoms (rating 1 to 5)
Albania	33	2-2.99	1.3	75	2.8
Belarus	35	3-3.99	1.6	20	1.4
Bosnia and Herzegovina	n.a	n.a	n.a	40	2.4
Bulgaria	16	2-2.99	2.9	70	3.4
Croatia	36	3-3.99	2.5	60	3.3
Macedonia	n.a	2-2.99	1.4	60	2.7
Moldova	63	3-3.99	2.2	50	2.7
Romania	21	3-3.99	2.3	60	3.2
Russia	40	3-3.99	2.4	70	2.3
Ukraine	59	3-3.99	1.7	60	2.4
Yugoslavia	n.a	n.a	n.a	40	3.0

Sources: The World Bank (2004); The Heritage Foundation www.heritage.org/research/features/index/countries.cfm; EBRD (2000); William Davidson Institute (2000) www.wdi.bus.umich.edu; Freedom House- Nations in Transit (2002)

The transformation from centrally planned economies to market economies has resulted in a group of countries approaching the finish line, while other countries have been languishing at various points along the path. Some Central and Eastern European economies are already highly integrated into the European Union's structures, while many economies in the Commonwealth of Independent States (CIS), including Russia, have recorded uneven progress. The transition economies have not performed as well as many had expected. Economic performance has varied widely, with the Central European countries of Poland, Slovenia, Hungary, Slovakia, and the Czech Republic generally performing better than the Baltic states of Estonia, Latvia and Lithuania and the Balkan states of Bulgaria and Romania, which in turn performed better than Russia, Ukraine, and other countries in the Commonwealth of Independent States.

The Central European countries except for the Czech Republic have generated sustained economic growth since early to mid-1990s. However, only in Poland has the rate of growth been sufficient to start closing the relative income gap with the advanced OECD economies back towards its initial 1989 level. By 2001, every transition economy had an even larger relative income gap with the advanced economies than had existed in 1989. The Czech Republic is one of the most stable countries in the region. Recent growth in 2000-2004 was supported by exports to the EU, primarily to Germany, and a strong recovery of foreign and domestic investment. The accession to the EU has a good potential to give further impetus and direction to structural reform, intensified restructuring among large enterprises, and improvements in the financial sector. The country should also benefit from available EU funds. Estonia, another new member to the European Union, has also recorded significant progress in transition, and might be in a good position to take advantage of strong industries, such as electronics and telecommunications. Together with the Czech Republic, Hungary holds the highest rating among the Central European transition economies; however, ratings agencies have expressed concerns over Hungary's unsustainable budget and current account deficits. Lithuania is the Baltic state that has conducted the most trade with Russia, and has slowly rebounded from the 1998 Russian financial crisis. Latvia's transitional economy recovered from the 1998 Russian financial crisis largely due to the government's budget stringency and a gradual reorientation of exports toward EU countries. Among the recent concerns is the illicit activity on the part of Latvian banks. Poland has pursued a policy of economic liberalization throughout the 1990s and is considered a success story among transition economies, although concerns persist regarding high unemployment, a deficient agricultural sector and stalled restructuring of "sensitive sectors" (e.g., coal, steel, railroads, and energy). Another successful transition country, Slovakia, has made good progress recently in macroeconomic stabilization and structural reform, with major privatizations nearly complete and above expectations economic growth. Slovenia has historical ties to Western Europe that allows for a GDP per capita substantially higher than that of other transitioning economies of Central Europe. Although the country has recorded good economic growth recently, further measures to curb inflation and corruption are still needed.

The Balkan States of Macedonia, Bulgaria and Romania differ in many historical and political aspects, but display a strong similarity in many economical variables such as population, physical capital, initial wealth and macroeconomic variables. Bulgaria is the closest to the EU states, Romania has significantly higher natural resources, and Macedonia is a landlocked country with a bigger agriculture sector and therefore less industrialized. It is also a new country that belonged in the past to a country with more economic and democratic freedom.

Prior to 2001, Macedonia – the only exception in the Yugoslav pattern of violent conflict- was a success story in conflict prevention and a typical case of transition towards democracy. The year 2001 however, has marked a decline in both trends. The leadership's commitment to economic reform, free trade and regional integration was undermined by the ethnic Albanian insurgency. Growth barely recovered in 2002. The grey economy is estimated at around 40 percent of GDP.

In Bulgaria and Romania, lack of adequate political support for the reforms marked the initial years of reform for both countries. No substantial progress in structural reforms materialized in any of the countries until 1997.The inherent problems of transition coupled with long-delayed reforms and adverse effects of the Yugoslav crisis. In Bulgaria, the policies conducted by the former communist party in the first seven years of transition (with the exception of 11 months in 1991-1992) had negative effects on the economy. The 1996 crisis led to a 10% drop in GDP, inflation that exceeded 300 percent and a budget deficit that soared to 13 percent of GDP. A USD 300 million stand-by agreement negotiated with the IMF at the end of 2001 has supported government's efforts to overcome high rates of poverty and unemployment.

The 1989 Romanian revolution was the most violent of all changes of regime in post-communist countries. Romania has started transition without external financial obligations. The transition process in Romania resembled that of Bulgaria in that two major phases can be observed. The first is associated with the rule of former communist parties in the period 1990-1996 and is characterized by inefficient fiscal policies and slow pace of privatization. The second period, after 1997 is characterized by accelerating reforms launched by opposition governments. The country entered in a recession period from which it emerged in 2000 due to strong demand in EU export markets. An IMF stand-by agreement signed in 2001 has been accompanied by slow but palpable gains in privatization, deficit reduction and curbing of inflation. Romania is gradually moving to strengthen tax administration and enhance transparency. In spite of the progress, a rapidly changing legal framework continues to undermine investor confidence (Political Risk Service, Country Analysis 2004). Romania is moving ahead with EU-compatible legislation in its quest to join the EU. Overall, the fact that Romania and Bulgaria have been preparing for EU accession (in the second round) may have had a positive impact on reform, as discussed in a separate section.

Albania displays the lowest levels of initial wealth, development and infrastructure. Until the beginning of 1991, for more than forty years, Albania was described throughout the literature as the poorest country in Europe, however very little has been published concerning the country. During 1985-1990 there were some weak attempts to decentralize decision-making. In 1990, a "new economic mechanism" was adopted. Some modest microeconomic reforms were made, that were intended to decentralize and liberalize the management of enterprises. Under conditions of serious macro imbalance and lack of price flexibility, these measures aggravated the financial situation, creating a big distortion on the supply response of the economy. Albania entered a crisis in 1995-1996. Peculiarities of the economic transition in Albania are strongly determined by political and social components. The initial political instability and lack of democratic tradition set their marks on the Albanian transition.

In the NIS region, Russia, Ukraine, Moldova, and Belarus are a heterogeneous group. The similarities regard industrialization (with the exception of Moldova), population variables, initial wealth and most infrastructure variables. But there are unique features that differentiate these countries as well. Russia for example, is considerably larger than the other countries and is different along many political dimensions and its recent history. Moldova is less industrialized, and has lower economic development and initial wealth.

Many of the differences in initial conditions at the time of the break from command economy tended to disfavor the former Soviet Union, and left an especially difficult legacy for the Newly Independent States. The Soviet economy had especially inflexible and extensive central planning, relatively low openness to western trade, and a market-unfriendly legal system. In addition, the Soviet economy was much larger and more complex, in the sense of degree of vertical integration, than most countries of Central and

Eastern Europe. Thus, the removal of central planning left a larger gap, which was a factor in the deeper and more sustained output decline in Russia and the NIS in the 1990s. Macroeconomic imbalances were particularly severe in the Soviet Union, which meant that the extent of bottled-up purchasing power was very large, and the black economy was deeply entrenched.

The largest and most powerful of the group, Russia, practiced central planning far longer than any other country. The soviet society had a militaristic style and orientation. Despite Russia's seemingly aggressive movement toward a market economy, growth rates have apparently remained non-positive throughout the 90s. Reforms were shaped by political instability and power struggles among constituencies and lacked a consistent strategy. Instrumental in propelling Russia towards capitalism was the fact that a substantial part of the ruling elite became capitalists. By the mid-to late-1990s Russia had freed most prices, privatized a large fraction of state firms and brought inflation under control. Despite this, official numbers imply that Russia has suffered a major and protracted output decline during the 90s and it is still struggling to overcome economical and institutional distortions. Despite continuing growth since 2001, remaining structural and economic problems have restrained FDI and reform. Russia has recorded high growth in 2003 and 2004, partly due to the relatively cheap currency and strong oil export earnings.

At the start of transition, Ukraine had the highest share of large-scale industrial enterprises and was the second largest (after Russia) industrial producer in per capita terms among the CIS countries. Shortly after independence in 1991, the government liberalized most prices and erected a legal framework for privatization, but widespread resistance to reform within the government and the legislature soon stalled the efforts. Despite over a decade of transition, institutional climate in Ukraine remains unfavorable (one of the main challenges is the high level of corruption). The lack of progress in institutions and administrative reform has marked a history of slow and unsustainable growth. Outside institutions (particularly the IMF) have encouraged Ukraine to speed up the reform. GDP in 2000 showed a strong export-based growth of 6% and industrial production recorded a significant increase. During the past couple of years, Ukraine largely completed its small-scale privatization program while the large-scale privatization reached its target for privatization revenues for the first time since the transition started. A number of legislative developments furthered the reform in 2004, such as the reduction in corporate and personal income tax.

After seven decades as a constituent republic of the USSR, Belarus attained its independence in 1991. It has retained closer political and economic ties to Russia than any other of the former Soviet republics. Belarus and Russia signed a treaty on a two-state union in 1999 envisioning greater integration. In comparison to other CIS countries, Belarus has been relatively successful as regards GDP growth, but it remains one of the least reformed of the transition economies. The slow progress in structural reforms, including the unsupportive business environment remains the main challenge. More than a third of the enterprises are loss-making. Some progress has been achieved in the relative control on inflation since the 1995 chosen path of "market socialism".

The extent of Moldova's economic collapse exceeded that of all other former Soviet republics following the breakup of the Soviet Union. This reflected not only dislocation related to the secession of Transniestria shortly after independence, but also the unusually severe terms-of-trade shock suffered by Moldova at that time. During communist era, Moldova had sent its agriculture-related output to markets throughout the Soviet Union and had received subsidized energy imports in return. This arrangement collapsed spectacularly with independence, resulting in a scale of decline much larger for Moldova than for most of the former Soviet Union countries. By the mid-1990s, Moldova's policymakers had successfully tackled a number of first-generation reforms, such as freeing up the vast majority of prices and liberalizing domestic trade. The reform progress determined positive growth since 2000. Despite the relatively strong economic growth, Moldova still ranks as one of the poorest countries in Europe. Privatization is proceeding slowly and official lending from the IMF and the World Bank has come to a halt, whilst the government is in arrears on some of its debt obligations. Moldova became the first former Soviet state to elect a communist president in 2001.

In contrast to the Soviet Union, Yugoslavia had considerable market features since the 1960s. The supply of goods was sufficient, production was consumer oriented, and Yugoslav industrial products well-positioned on the Western markets. Growth was very high until the end of the 1970s while the 1980s were characterized by tough stabilization policies and low growth. The problems were partly caused by the particular form of ownership that existed in the country and partly by the lack of coordination resulted from the increased tensions between the individual republics. Thus, Yugoslavia was not dominated too much by planning problems; it was rather a question of poor central governance.

Bosnia and Herzegovina was one of the lower income republics of the former Socialist Federal Republic of Yugoslavia (SFRY). Unlike other centrally-planned economies, the economic system of SFRY was based on market socialism and self-management. Enterprises were socially owned, with assets owned by societies at large and formally run by worker councils. In principal, key enterprise decisions were made by workers (however, in practice decision-making was in the hands of management, which was formally selected by worker councils and tacitly confirmed by the political system). The economic system was decentralized, allowing some competition in the product market but generally restricting competition and mobility in the labor and financial markets. Commercial banks were the only source of institutional capital, and bank credit was the only form of financing for enterprises. Bosnia and Herzegovina's prewar governance and economic management structures disintegrated with the war. The framework laid out in the Dayton-Paris Peace Agreement implied substantial changes to the country's legislative and policy-making institutions – and virtual re-creation of Bosnia and Herzegovina's economic management structures. According to a Donor Report (1999), the recovery after the war seems to be fragile in this country. There have been modest achievements over the last three years in building and strengthening institutions and initiating the policy reforms of transition. The 1992-1995 war had a devastating impact on the economy and people of Bosnia and Herzegovina. By the end of 1995, output had fallen to just 10-30 percent of the prewar level. GDP had collapsed to about 20 percent of its prewar level. Destruction of physical capital caused much of the contraction, but the war also disrupted trade channels, halted nascent economic reforms, and left pervasive rifts in government, institutions, and laws. Output recovered in 1996-1999 at high percentage rates from a low base, but output growth slowed during 2000. The black market is believed to have a large share (Political Risk Yearbook, Country Analysis 2004). Implementation of privatization has been slow and local entities only reluctantly support national-level institutions. The country receives substantial amounts of reconstruction assistance and humanitarian aid from the international community.

Finally, Croatia differs from other CEE countries in that the transition process started (e.g. price liberalization) while the country was still part of former Yugoslavia. Although Croatia won its independence in 1991, the war and occupation overshadowed economic issues in the first part of transition. In the second stage (starting in 1994) however, it increasingly resembled other advanced countries in transition. The economic reforms suffer from the effects of coalition politics and public resistance, particularly from the trade unions.

Mechanisms of Change and Sensitive Dependence on Initial Conditions

The basic premise of the dissertation is that existing institutions and the action of governments have a major influence on national economic performance and decision-making of economic agents. For countries that are more advanced towards a market economy and more integrated within the European Union the mechanisms of change revolve around the harmonization with EU institutions and the advantageous positioning in Europe in terms of competitive advantages and value added activities. Many of these former socialist countries have liberalized their capital and labor markets. Other countries such as the Balkan states and Latvia continue to maintain a stronger state bureaucracy well after the collapse of central planning. Governments have however relinquished their coordinating power in the economy to a great extent. As these countries are also in advanced stages of becoming integrated in the EU structures, policies are guided towards harmonization and macroeconomic internationalization thru Western European industrial links. For countries less advanced in transition, strategic coordination from governments is still prevailing. It could be argued that some of these countries are still bounded by initial distortions in economic coordination and level of development, as well as inefficiencies in political markets.

Despite a general growth trend, individual country trajectories show a variety of paths, differing in the timing of significant reform implementation and initial increase in FDI inflows, although some regularities have been pointed out across the region. Countries with low initial distortions have overcome liberalization difficulties more promptly, whereas countries with less favorable conditions at the end of the communist years have taken longer to adopt momentous reforms. Hungary, for example, had the most noticeable increase in FDI inflows immediately after 1989 as the country proceeded quicker in liberalizing the economy. Like Hungary, Czech Republic and Estonia recorded relatively high foreign investments early in transition, but unlike in Hungary, FDI inflows have not leveled off later on. It is not until towards the end of the 1990s that the Balkan States and the former CIS countries adopt a fluent reform strategy and begin recording noteworthy investment flows.

Although the beginning of coherent transformation macroeconomic policies and openness to foreign investments and Western European structures marks a break from initial distortions, it is difficult to asses to what extent countries in CEE have overcome these distortions and made a break from past institutions. The dissertation takes the view of transition as transformation- most of trajectories in transition observed in the region are the result of rearrangements, reconfigurations, and re-combinations that yield the current conditions. But although the dissertation advocates for path-dependency, it should be noted that the mechanism does not condemn the CEE economies and the economic agents acting within them to simple repetition or retrogression. Rather than rigorously locking economies into certain paths, initial conditions leave a mark on the creation of future institutions.

Based on the previous discussion, it is noted that some of the current institutions and mechanisms of change are a great departure from past institutions and initial conditions. New systems guiding the progress of some CEE countries have evolved from old social and economic organization. Whereas in more advanced markets the government's role has changed and the EU integration have a consequential effect on progress, in less advanced countries the state still exerts a constraining and constitutive influence on the economy.

The transition experience so far shows that stabilization and structural reforms are related to exchange systems, taxation, and state-owned enterprise reform. While the entire region has progressed, the countries that were closer to the benchmarks of market economy early on in transition have advanced more in subsequent years. Countries that have been more successful in implementing policy reforms have also been more successful in implementing structural and institutional reforms. The slow development of institutions in some countries might have been due to the increased difficulty of developing institutions requiring changes in societal norms. It would be expected that policy reforms eventually change the incentives for the actors in an economy and contribute to the evolution of rules and institutions that are a better fit for economies and societies advancing in transition. Aoki (2001) notes that "only institutional arrangements that are mutually consistent and/or reinforcing may be viable and sustainable in an economy. [..] It can be through the guidance of a particular, symbolic system presented in the transition process and recognized as 'prominent' or 'salient' (among the many possible) that agents' new strategic choices are induced to be coordinated. As agents' choices equilibrate, the guiding symbolic system becomes consistent with, and reconfirmed by, their experiences. It can then serve as their summary representations and thus it becomes established as an institution. The point is that some symbolic system precedes the evolution of a new equilibrium and then is accepted by all through their experiences."

The development of most industries in CEE depends on the effective private ownership of enterprises. Reforms in ownership rights and openness to foreign investments have led to further restructuring. Decisions such as privatization strategies and creating opportunities to participate in regional networks have shaped the level of transformation in each country in the region. The progress in transformation is thus related to the quality of the institutional environment that facilitates the functioning of private enterprises.

To summarize the review of progress in the region and the prevailing mechanisms of change it is noted that in slow reformers such as Belarus and Ukraine which started transition from a high level of distortions, the transformation process is in incipient stages, with governments highly represented in enterprises and as coordinating agents. Although these countries benefit from involvement of international institutions, they have few Western European links. The same apprehensive approach to reform and restricted incentives for EU integration can be noted for other countries (Russia, Moldova) however the liberalization of prices and external trade have been aided by a relatively higher (although at low levels compared to other countries in the region) though fluctuating FDI flows. Other parts of the region such as the Balkans and Central Europe have had a mix of quality in initial conditions but have amended largely the government's role and are focused on the continuation and refining of market institutions. The main driver for change in intermediate reformers has been the liberalization of the banking system. Most countries advanced in transition still suffer from an incoherent competition policy and lack of flexibility in labor and capital markets. The "pull" of the EU integration is strong for acceding countries, whereas the integration has slowed down the reform effects for the countries that have succeeded to join the EU. Arguably as a result of initial high distortions and disjointed reforms some countries have advanced very slowly in transition. Countries of Central Europe have remained in front from the beginning of transition, while the Balkans and some of the Northern CEE countries (Lithuania, Latvia and Estonia have been perhaps most affected by the Russian crisis) have been slowly closing the gap. The process of transformation in CEE is related to reforms that not only mark a change from state-controlled economies but sustain and reinforce change over time.

Conclusions: A Typology of CEE Transition Countries

A typology of the CEE countries can be generated based on the following dimensions: initial conditions as identified by the initial level of development and economic distortions, level of reform, foreign investment pattern and, finally, recent developments and trends. The first two categories of countries are highly integrated in Western European structures.

A Typology of CEE Transition Countries:

Advanced reformers, medium to high initial development, medium to low initial distortions, no pattern in FDI inflows, recent decrease in investments: Czech Republic, Hungary, Poland, Slovakia, Slovenia.

High intermediate reformers, mixed initial conditions, fluctuating FDI pattern with an increase recently, significant advances in reform and good FDI potential in recent years: Bulgaria, Estonia, Lithuania, Latvia, Romania.

Low intermediate reformers, medium initial level of development and high distortions, fluctuating FDI pattern, recent slow advances in reform: Albania, Russia, Kyrgyzstan, Moldova, Kazakhstan.

Slow reformers, medium initial development and high initial distortions, still in early stages of reform: Uzbekistan, Belarus, Ukraine, Turkmenistan.

Affected by war: Croatia, Macedonia, Armenia, Georgia, Azerbaijan, Tajikistan.

Source: Author's own.

The overview of the transition progress in the region is an essential part of the dissertation. The research purpose here is the analysis of strategies of multinational firms operating in the CEE countries. One facet of the study is the exploration of the specific features of the business context with respect to their implications for enterprises in the region. The research pursued here contributes to the understanding of the functioning of business in transition and the interaction between firms and their environments. The review above shows that the process of building institutions in transition took longer and was more complex than most reform scenarios envisaged at the beginning of transition. The literature and data available on the CEE environment argue for a high degree of complexity. The process of transition shows that firms cannot base their decisions on present institutions, which are unstable and sometimes inconsistent with long-term policy. The distinctiveness of the CEE business environment may limit significantly the applicability of Western-based strategies and organizational concepts.

2.1.5 External Factors Impacting the Transition Process

Economic Integration and EU Accession Effects on CEE

Despite the unfavorable external economic climate, the transition countries of CEE display a reasonably good growth performance. The region as a whole now expands more rapidly than the EU; it is also catching up in terms of productivity. Russia continues to cash in on high revenues from energy exports and its GDP growth is accelerating while investments recover. Interestingly, in countries seeking accession to the EU, the integration process has been an essential element in their transition, as it provided governments with additional legitimacy in the adoption of western European laws and institutions and acted as an important stabilizing factor (EBRD, 2002). Recent research (Gros and Suhrcke, 2000) shows that countries that are now part of EU are closer to complete the transition. There have been important differences in how fast each transitional country has turned around (Table 10). According to EBRD (various Transition Reports and Annual Reports), the CEE countries that are now part of the European Union were the first to show positive growth. Whereas a weighed average for Central and Eastern Europe including the Baltic Countries shows that the 1989 level is passed in 2000 (EBRD 2000), the differences between the CEE countries are evident- the 2000 production level for Russia is 61% and for Ukraine it is only 38% of the 1989 level, whereas the CEE countries that are now part of the European Union have caught up.

Table 10. Growth in GDP 1989-2000

Country	*1989*	*2000*	*2000 (1989=100)*
Albania	9.8	7.0	102
Belarus	8.0	2.0	82
Bulgaria	0.5	4.0	70
Croatia	-1.6	3.5	81
Czech Rep.	1.4	2.0	95
Estonia	8.1	5.0	80
Hungary	0.7	6.0	105
Latvia	6.8	4.5	63
Lithuania	1.5	2.2	64
Poland	0.2	5.0	128
Romania	-5.8	1.5	76
Russia	0.0	6.5	61
Slovak Rep.	1.4	2.0	103
Slovenia	-1.8	5.1	114
Ukraine	4.0	3.0	38

Source: EBRD (2000).

The set of regulations concerning internal trade within the European Union and other social and economic aspects of European life is called the “acquis communautaire”. Under the terms of enlargement, the CEE[16] countries that aspire to become part of the European Union are required to adopt the entire “acquis” prior to accession. But some countries have negotiated “transition periods” during which they are allowed to gradually implement all the relevant regulations. The “acquis” is divided into 31 chapters and includes regulations governing free movement of goods, freedom of movement for persons, and free movement of capital. It provides for common competition, transport, and agricultural policies. There are chapters dealing with the monetary union, industrial policy, education and training, consumer protection, justice, customs, etc.

For the CEE countries that are new member states of the EU, on May 1st 2004 the “acquis communautaire” became the law. In order to make this happen, a decade of intense preparations on both sides was necessary and it will certainly take another decade before the full consequences of this enlargement will be felt (Gros and Turmann, 2004). Enlargement should thus be viewed as a process, and not a single event taking place on one day. The same should be applicable for the countries that are now going thru the EU accession process. The economic gap between the EU and the candidate countries (Bulgaria, Romania) is significant: living standards, as measured by GDP per capita at PPP, are less than one third of the level prevailing in the former EU-15 – and about half of the average level in the new Member States. Catching up with the rest of Europe in terms of income levels and productivity will thus be a long-term process. The integration process appears to have had a positive impact on the transition progress of the newly accepted members. According to Forbes (2005)[17], in economic terms, the new EU members had an increase of 5 per cent last year, from 3.7 per cent in 2003, and a forecasted increase of more than 4 per cent in 2005 - more than twice the rate of the EU 15. In the last year, about €1.3 billion EU funds has been paid to the 10 new member states for infrastructure modernization, research, promoting enterprise, environmental protection, tourism, training, democracy building and innovation.

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[16] The new EU member states since 2004 are Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia. Candidate countries to the EU are Bulgaria, Romania and Turkey.

[17] Forbes, 2005, Global Strategic Analysis: Economic Outlook For Central Europe, Baltic States in 2005, available at http://www.forbes.com/business/2005/02/01/cz_0201oafullsegments7and8_CEE-8.html.

Among the structural challenges that the CEE countries considering EU admission face are the high unemployment, a weak judicial system, corruption, hampering administrative procedures, weak implementation of competition policy, deficiencies in bankruptcy legislation and procedures, and the persistence of state-owned loss-making enterprises. The candidate countries have suffered from severe economic and financial crises over the past decade. They have also experienced periods of high inflation at some stage over the past six to seven years. However, each country, with the backing of international programs, has enjoyed recoveries. Although the EU admission criteria includes the correction of some structural imbalances, the candidate countries have made limited progress in real convergence towards the EU, and catching up in terms of income and productivity levels remains a major challenge.

EU candidate countries are implementing policies to manage a number of existing imbalances. In Bulgaria, the policy mix of sound fiscal policy and structural reform supporting the Currency Board Arrangement (CBA) has resulted in an increased rate of growth, low inflation and a declining unemployment rate in the last two years. In Romania, despite considerable reductions since 2001, inflation is relatively high, but on a decreasing path. Further progress has been made to bring down the barriers to market entry and exit. The EU is directly involved in monitoring some of the institutions essential to the market economy, and in the integration of these countries in the multilateral trading system. Trade openness in the candidate countries is generally high. Trade with the EU represents more than half of their trade and has been expanding strongly.

The enlargement process of the EU is changing the business environment under which firms operate in prospective Member States. The removal of barriers to the flow of goods, services, capital and labor provides new market opportunities, increases competition in domestic markets, and facilitates access to new sources for inputs. Research carried out by the European Commission in 2003 stated that the adoption of the "acquis communautaire" ensures, on the one hand, improvement of the business environment and, on the other hand, leads to significant corrections in areas like emissions, waste management, product safety, working conditions, etc.

In some fields adaptation is already completed in candidate countries, whereas in the most difficult areas (e.g. environmental regulations) there are transitional provisions postponing adjustments for a few years after accession. Although the process of taking over the "acquis" is a gradual one, it poses a formidable challenge for candidate countries and the firms operating there as it implies a continuous change of the legal and institutional framework.

Integration measures to the EU include removal of barriers to trade in goods which have already been widely reduced between EU and the candidate countries; the elimination of restrictions to capital transactions (although the candidate countries have widely liberalized the conditions for capital movements already in the run-up to accession, in particular as far as foreign direct investments (FDI) are concerned- these conditions refer to, for example, the protection of foreign ownership, the permission to repatriate profits and capital, and the equal treatment of foreign and domestic investors); freedom to provide services and freedom of establishment; free movement of labor (however, these rights do not yet apply between present EU Member States and candidate countries). The accession process and the anticipated developments (European Commission, 2003) should result in a reduction of transaction costs and the harmonization of product standards and legislation that could lead to economies of scale. The extension of the internal market and the euro area should also lead to transactions cost savings, as well as welfare benefits of between 2.5% and 4.5% of EU GDP (Gros and Turmann, 2004).

Some contributions to the literature on the EU accession benefits are not as optimistic (Tupy, 2003). Researchers recognize that accession to the EU is neither a necessary nor a sufficient condition for economic growth, but rather the combined effects of market access and economic liberalization, not EU membership, optimize economic growth. This literature deems the EU membership trade arrangements a way of limiting the CEE countries' comparative advantages. Accession members may also be disadvantaged by future EU initiatives, such as harmonization of taxes, which could further reduce their competitiveness. The accession of the rest of the CEE countries into the EU also raises the issue of whether 'East' - 'West' industrial networks will be a factor that improves the growth prospects of the enlarged EU or whether they will deepen the differences in levels of development and undermine the prospects for cohesion in Europe (Radosevic, 2002).

As regards the relevant effects that the CEE integration into the EU may have on the business environment, analysts (Dyker, 2001) suggest that the process of trade liberalization between the CEE countries and the EU started with the accession talks and will not change significantly in the year of accession to the Union. As regards scale and competition effects, the enlargement could have positive or negative effects. All the CEE economies are weighed down by problems of inflation and/or balance of payments deficits. Accession to the EU should offer an opportunity to resolve these problems. However, in the absence of well-considered national policies such effects may be severely limited.

The transition from socialism to capitalism in Central and Eastern Europe is both a political and economic process. The reintegration of CEE into Europe is one of the most important aspects in some of these countries' transformation. Current research (Dyker, 2001) analyzes the relationship between foreign direct investment flows and their effects on one hand, and the EU integration process, on the other. Some findings (Bevan and Estrin, 2001) suggest that countries excluded from the EU, typically because of poor progress in transition, will receive lower levels of FDI, which will further limit their transition progress. The implications are an increasing concentration of FDI into the more successful transition economies, and increasing differentiation in per capita income within the region linked with the inclusion or exclusion from the EU. This literature suggests that prospective EU membership could be an important determinant of FDI in transition economies. FDI is an important aspect of the transition process itself, and therefore of the business environment for investing firms. The literature finds that more MNCs are enticed to invest in a CEE country when there is a viable potential for the country to increase its ties with the EU. The same literature has found that the process has the potential to be self-reinforcing by improving the country's credit rating and thus further stimulating foreign investment flows.

It is also mentioned by research (Dyker, 2001) that failures on the part of the acceding states to build up social capability through public education and R&D systems in the run-up to accession may make it increasingly difficult for companies to implement investments satisfactorily. This thread of literature is based on previous research on the CEE countries that have recently been accepted to the EU. Research (Hamar, 2002) based on local managers' opinions shows that the MNCs owned by institutional investors and MNCs involved in low-tech production or food processing anticipate deteriorating conditions, while other subsidiaries expect increasing competition on the domestic markets and abroad. Limited observations show advantages of a larger market, decreasing bureaucratic barriers, the simplification of trade and custom regulations. In general, firms do not see major barriers in preparation for EU accession, and some may not have a strategy for preparation to the EU expansion.

Lack of capital and lack of information about the changing conditions in relation to EU accession are the main obstacles that subsidiaries may face in adopting a successful strategy that takes into account EU integration.

Membership to the European Union will most likely not solve all CEE countries' problems overnight. But it will provide a substantial guarantee of political stability that should have a positive effect on the existing investments and should be an encouragement for MNCs willing to take advantage of the CEE potential. The accession criteria will likely control for the stability of the national policies and analysts acknowledge that the EU admission process will decrease the risk premia of operating in CEE, which should allow the MNC affiliates to stay or become profitable.

Latest data shows that whereas Western Europe is confronted with economic stagnation, political confusion and terrorism, in the eight Central European countries that joined the EU in May 2004 there is a steady economic growth of over 5% (The Economist, July 16-22, 2005). However, further expansion may be less enthusiastic- Bulgaria and Romania have been slow in implementing reform and their accession may be postponed one year to 2008. The next wave of European countries- Bosnia, Croatia, Albania, Macedonia and Serbia have receding chances of joining, whereas EU is said to currently discourage Ukraine's membership. The defeat of the EU constitution in the referendums in France and the Netherlands may signal an unfavorable attitude towards undermining competition from the East. Romania seemed to have fallen behind the schedule for EU membership in all areas: justice, external affairs, environment, and agriculture, according to declarations made by the prime minister at the end of July, 2005

(Gandul No. 75). If going according to schedule, the Central European Bank expects Romania to adopt the euro between 2010 and 2014 (Business Review, Vol. 11 No. 29). Although the EU integration is based vastly on the harmonization of significant areas of legislation, a departure from harmonization is seen even in the CEE countries that are now part of the EU. For example, in countries such as Poland, Slovakia and Estonia, there is extensive use of contractual arrangements for workers which bypass the EU requirements for overtime pay, holiday time, sick days, etc. Analysts see these countries as evolving more towards an 'American' model, characterized by low taxes, weak labor unions and low social contributions, proving a need for 'flexibility' in the EU labor market reglementations.

Transition and Foreign Direct Investment

The inflows of FDI to the region match the improvements in political stability and transition progress (the Vienna Institute for International Economic Studies, 2002). FDI inflow was generally low before 1997, before some of the countries (mainly Romania and Croatia) changed policy and started to attract more investors. Moldova, Albania, Bosnia and Herzegovina received higher amounts only since 2000 and Yugoslavia received significant inflows since 2001. Nevertheless, the overall amount of FDI has been small compared to the size of the countries. Insufficient regulation and control and an unclear institutional setting are among the barriers to productive activity of FDI. The table below offers a historical review of the FDI flows in the region.

Table 11. Foreign direct investment inflow in Central and Eastern Europe (end-of-year balance, USD millions)

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Croatia	13	102	110	109	486	347	835	1445	1086	1325	970
Albania	20	45	65	89	97	42	45	51	141	204	153
Bulgaria	41	40	105	98	138	507	537	789	1003	641	800
Bosnia & Herz.	n/a	n/a	n/a	n/a	0	740	113	112	25	165	300
FYR Macedonia	n/a	n/a	19	9	11	16	118	32	176	442	na
Romania	73	87	341	419	263	1215	2031	1041	1040	1137	1200
CIS	135	642	1079	3445	4400	5780	5463	4651	2152	4168	6221
Czech Rep.	72	654	869	2562	1428	1300	3718	6324	4986	4916	4900
Hungary	311	2339	1147	4453	2275	2173	2036	1970	1649	2443	2115
Poland	89	1715	1875	3659	4498	4908	6365	7270	9342	8000	7852
Slovakia	na	179	273	258	358	220	684	390	2075	1475	1362
Slovenia	4	113	128	177	194	375	248	181	175	441	463

Source: Transition Report 2002, Hunya (2002) based on National Bank of respective countries.

The investment rates in the CEE region were around 20 percent of GDP in the 1990s although countries such as the Czech and Slovak Republics maintained relatively higher levels of investment. Until 1997, Hungary was the only transition economy receiving a significant flow of foreign direct investment. By 1998, major foreign investments took place to the Czech Republic, Poland and Slovakia, although many countries of Eastern Europe remain unattractive to investors. The rate of foreign direct investment appears to have been related to proximity and accession process to the European Union, stability of the country's political, economic and legal environment, and availability of attractive privatization projects in the country.

The FDI in the region has been generally privatization-driven, with a relatively low level of Greenfield investment. Comparatively, Croatia, Romania and Bulgaria pursue a slow but straightforward privatization policy that may be successful in attracting FDI in the years to come. Low wages in Bulgaria and Romania attracted export-oriented

Greenfield investments. Countries of the Western Balkans (Albania, Bosnia and Herzegovina, Macedonia and Yugoslavia) have progressed very slowly towards structural reform and stability. A brief account of the existing FDI in these countries shows that more than half of the capital account inflow is attributed to FDI, but no major Greenfield investments are expected in the following years (except for a few confined to the oil sector) in the absence of significant reform. Bosnia and Herzegovina is still dealing with harmonization of administrative and legal structure. In Bulgaria, the government has made some efforts to step up the pace of privatization in 2000-2002, but the FDI inflow has recently slowed down. FDI in Croatia has been mostly directed towards large privatization deals over recent years, and has benefited from a reduction in corporate taxes and plans for energy and telecom liberalization. Macedonia is still suffering from the civil upheaval in 2001, which has increased the risk of doing business in the country considerably. FDI in Romania is driven by the sale of SOEs to foreign investors and increasing Greenfield investment of medium-size firms along the Western border. In Yugoslavia, the first year of transition in Serbia, 2001, was characterized by macroeconomic stability, international integration and weak supply side response. In Montenegro, voucher privatization has ended, but the results were not as expected. In Russia, irregularities and lack of transparency in the privatizations of the mid-1990s led to limited foreign participation to key sectors, but foreigners have participated to subsequent oil and gas sector privatization auctions. During 2002-2003, FDI inflows into Russia have declined, but, according to UNCTAD (2004) foreign investors have recently renewed their interest in the natural resources of the Russian Federation.

FDI flows to Central and Eastern Europe registered a decrease in 2003, similar to the global trend of declining inflows (UNCTAD, 2004). The decrease in FDI to CEE was somewhat unexpected. According to the World Investment Report for 2003, the newly accepted countries to the EU have not diverted FDI flows from the old members of the EU, but rather the accession eight (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia) actually saw their FDI inflows get smaller, from $23 billion in 2002 to $11 billion in 2003. The decline is explained by the end of privatization in the Czech Republic and Slovakia. For other transition countries in CEE pursuing privatization, FDI opportunities should increase. For these countries, including

Bulgaria and Romania (currently negotiating their entry into the EU) – FDI inflows rose from $8.6 billion in 2002 to $9.5 billion in 2003, representing an increase in their share of total FDI inflows from 28% in 2002 to 45% in 2003. During the period 2001-2003, the Republic of Moldova, the Former Yugoslav Republic of Macedonia and Serbia and Montenegro were the region's leaders in terms of ratio of FDI to gross fixed capital formation. The great potential of CEE countries and the expected growth of FDI in the region bring a *strong argument for the timing of the dissertation*. Finally, UNCTAD (2004) observes a shift of FDI towards services, which can be noticed in CEE countries as well. Most countries have liberalized their services foreign investment regimes, which have made larger inflows possible, especially in industries previously closed to foreign entry, such as utilities. In general, the countries of CEE outside the CIS are characterized by substantial FDI penetration in infrastructure services (e.g. banking, telecommunications, water, electricity). This development is currently expanding to other services sectors. The trend justifies the inclusion of services and information technology as areas of investigation.

2.2 LITERATURE REVIEW PART II: MNCs STRATEGIES IN CENTRAL AND EASTERN EUROPE

After the abrupt opening of the markets in CEE, foreign firms were quick to enter them, as is illustrated by the acceleration of FDI in the region and the reorientation in the pattern of international trade. As shown in a previous section, the businesses operating in the region face a distinct institutional environment which pre-determines their strategic opportunities. The existing international business research regarding FDI has approached transition economies by testing the validity of general theories and by exploring specific features of the business context and their implications for businesses operating in the region.

Much of the existing research regarding MNC entry and operation in transition markets has focused on the incentives used by host governments to attract foreign investment (Doh, Teegen and Mudambi, 2004), the characteristics of the agreements negotiated by MNCs entering these markets (Sethi and Guisinger, 2003), the outcomes that foreign direct investment may have on transition economies (Brouthers, Werner and Wilkinson, 1996; Agmon, 2003), and the impact of these investments on corporate performance (Buck, et al. 2003). Recent studies have noted that the entry of MNCs might encourage the development of some industries, but it can also hasten the disintegration of others.

As discussed previously, foreign direct investment inflows in Central and Eastern European transition economies have generally played a strategic role in restructuring and developing new businesses, in integrating economies to the world economy, and in introducing technology, know-how and management skills. Major investments by foreign companies have made significant contributions to the creation of modern business technology in the CEE (Dyker, 2001). In some key industry sectors, such as automobile manufacturing, the MNCs have allowed for the transfer of hard technology and the formation of supply networks. However, in less advanced countries in CEE, foreign investors have allowed for only insufficient amount of R&D and have generated low or inexistent spillovers. The role of foreign investments may have been overemphasized (in studies and EBRD reports cited in a previous section) as regards their positive impact on successful progress thru transition in CEE. Pavlinek (2004) notes that the arguments supporting benefits of FDI on economic growth and development are widely accepted but have never been proven for the CEE countries. Some of the acquisitions made by MNCs in this region have been followed by downsizing of production and labor, as well as disinvestment, which may prove to be significant in generating long-term social costs and new forms of local dependency on foreign capital and external control of local economies. Direct economic benefits, such as capital formation, employment, trade and positive impact on the balance of payments may only be temporary. The FDI's effect in terms of increased competition and restructuring may have been limited due to concentration and sectoral specialization. Integration of CEE subsidiaries into the networks of the multinationals (discussed more extensively below) makes these affiliates vulnerable to international economic fluctuations. In the case of low-cost seeking investments, the economic benefits may be limited to the creation of low-skilled jobs and increased exports. Stability of the investment in a situation of labor costs increase may be key in generating positive effects on the economy. This section provides a discussion of the strategies mentioned above and more from the MNCs' point of view. The discussion below reviews the literature on the MNC entry and strategy in the CEE region and takes on the company's perspective on its operation in a transition environment with important entry and transaction costs.

In spite of the significant entry and transaction costs, foreign investors would appear to favor direct investment with full control of local assets allowing them to attain more easily their different objectives: market share, cost reduction, integration of local units in the global or regional strategy of the company (UNCTAD, 2002). For Western firms, their presence in Central and Eastern Europe is often related to a strategy of penetration and conquest of new markets (horizontal integration), or reallocation of resources to benefit from advantages in terms of factors costs (vertical integration). A large portion of multinationals have chosen to acquire majority shares in local companies if property rights allowed it. For local companies, acquisition by foreign buyers appears, at best, as a possibility to access the world market, and at worst, a means to avoid bankruptcy.

Multinational firms entering CEE expected considerable long-term growth of demand and a significant increase in the middle-class income (Meyer, 2000). The entry in

CEE may have been a strategic move that allowed MNCs to sustain and enhance their global position. Many companies may have invested in the region in order to prevent rivals' challenges or the emergence of competitors. The early entry into new markets was an opportunity for firms to build competitive advantage and secure market shares. The markets in CEE may have also represented a chance for price discrimination. In industries with major network externalities (e.g. consulting, financial services) presence in the region may be necessary to offer coverage for global customers. In a trend that started in the mid 1990s, governments in CEE are opening underdeveloped sectors of industry (such as telecommunications, power generation and distribution, transportation infrastructure) to foreign investors. These sectors require, in most cases, significant upgrading. The infrastructure development may have also attracted manufacturers of equipment. Factor cost oriented FDI has picked up since the early 1990s, as MNCs became aware of the CEE comparative advantages in intermediate technical skills, and relatively low labor costs. Economic policy may have strengthened this advantage thru an effective undervaluation of exchange rates. The combination of low cost, educated labor with MNCs' managerial know-how and capital has been one of the goals of MNCs entering the CEE region. Low factor costs attracted also small enterprises from neighboring countries who exploited the cost differential thru outward processing. Relocation of production has been important in industries like textiles, clothing, and furniture. Low productivity, lack of infrastructure and suitable local providers of quality supplies, are still deterrents to cost-seeking investors in some countries in the region.

Thus, MNCs entering the CEE region have been guided by market-seeking (or expanding) motivation, aiming to supply the local CEE market area with existing products more effectively than might have been feasible through trade. Alternatively, low-cost local inputs (Dunning's location advantages) have determined an efficiency-seeking motivation for multinationals using their CEE operations to provide an export platform for supply in other markets. According to Manea and Pearce (2004), international corporations also display "knowledge-seeking" behavior in using skill- and technology-based local attributes to sustain the materialization of higher-value-added product development activity in subsidiaries in CEE. The knowledge seeking motivation could be related to developing products that target the market of that host country and other CEE markets, taking advantage of growing familiarity with supply networks and bargaining processes.

As regards the literature on FDI sourced in the European Union, it is noted (Lemoine, 1998) that since 1989, trade relations between the EU and Central-Eastern Europe have intensified, and the surge in trade flows has been accompanied by the establishment and strengthening of cooperative links between Western and Eastern industries. Western firms have extended their production networks towards Central and Eastern Europe, which have become part of their internationalization strategy. This strategy has responded to objectives mentioned earlier: to improve price competitiveness and to take advantage of potential markets. In the early phase of liberalization, the first objective prevailed and industrial cooperation took the form mainly of subcontracting production to Central and East European firms. Later, foreign direct investment has become a more important component of Western firm's strategies in CEE. FDI flows to CEE should remain substantial in the years to come, as an important share of these investments is now accounted for by reinvested earnings and follow up with previous projects.

The FDI originated in the EU represents the majority of FDI in CEE. European firms have reacted differently to the opening up of these transitional economies to international trade and investments. For example, the major share of German foreign direct investment has been directed to manufacturing industry, and especially to the engineering sectors, contributing to the expansion of exports. French firms have been much less involved in trade and investment with CEE countries than German and Italian firms. One reason for the low trade intensity with Central and Eastern Europe may be that French trade relations with its neighbor countries outside the EU have kept a strong traditional orientation towards the Mediterranean countries. According to EBRD (Transition Reports, various years), the development of institutional reforms did not totally reduce uncertainty, nor opportunistic behaviour, not to mention corruption in the region. According to these reports, the country-risk level explains the weak penetration of FDI in lagging countries, even if at the micro-economic level, this risk may be compensated with first-mover advantages which can durably prevent the entry of followers, notably when first-mover acquires at once a significant percentage of market shares.

Among the first entrants to the region were multinationals in industries with world-wide oligopolistic structures, which pursued *first-mover advantages*, such as brand recognition, control of distribution channels and preferential access to local suppliers and governments. The early entrants may have been able to *influence* the local regulatory environment in their favor. Case evidence suggests that some first-movers failed to realize their expected benefits, and second-movers sometimes built larger market share or more profitable operations (Bridgewater et al, 1995). Early entrants in CEE may have been able to influence the local regulatory environment to their advantage (Meyer, 2000). It has been argued (Williams, 1997) that in certain circumstances, foreign firms may have obtained an unfair advantage in subsidies or government incentives, carrying out low level value added activities with strategic decisions being made by a distant parent organization.

The entry in the CEE region poses challenges such as poor business environment and partner choice that may lead to significant sunk costs. Moreover, brand recognition and loyalty are low, as consumers experiment with new products. Later entrants could benefit from local governments' learning process and may also take advantage of the lessons learnt from the first-movers' successes and failures. A combination of both advantages have been pursued by investors building the market early but delaying high level of commitment while becoming familiar with the local environment and waiting for risks to subside.

It is posited (Meyer, 2001) that host country institutions in transition economies have an impact on the choice of market entry of multinational corporations, and that the process of change from a centrally planned system to a market economy generates an institutional framework that is only partially reformed, and therefore inconsistent and unstable. Foreign companies need to adapt their strategies to local institutions and reduce exposure to highly imperfect markets. Recent research (Meyer, 2001) argues that the establishment of market-based institutions reduces but does not eliminate the high transaction costs in CEE, as rapidly changing institutions generate inconsistency between requirements of different institutions and uncertainty over future institutional changes.

Lobbying as well as other modes of pressuring the local policy-makers to adopt favorable legislation are forms of *political risk management* practiced frequently by MNCs in transition economies (Moran, 1998). Kobrin, (1987) finds that the characteristics of the MNCs that invest in transition economies determine the extent to which these corporations have bargaining power in the negotiation with the host government. Bargaining power of the MNCs depends on what resources the firm brings to the internationalization process, as well as the host country capabilities, and the level of competition.

Central and Eastern Europe has provided an excellent laboratory to study international business entry (Brouthers et al, 1998, Pye, 1998). Initially, entrants preferred modes with low exposure to country risk, especially contracting and exporting. Many firms moved quickly along the internationalization process, some using full ownership as their first entry mode (Czinkota et al, 1997). Contractual modes were particularly important before legal constraints have been fully removed and when investment risks were perceived to be high. In the early 1990s, a joint-venture was the only legally permissible mode to establish a direct investment, but the patterns have been rapidly changing, with a massive shift towards fully-owned affiliates. The JVs were thus "transitory alliances" as means of implementing acquisitions in the region's institutional context. Many acquisitions in the privatization process occurred in a "staggered" pattern. The newly acquired businesses were joint-ventures but, in most cases, the foreign partner had full management control and was preparing the company for full foreign ownership (Meyer, 2000). These temporary forms of ownership allowed governments to have some control over firms' restructuring process, while allowing the foreign investor to become familiar with and gain access to local institutions and networks.

A considerable number of foreign companies entered CEE thru acquisition of local firms during privation programs. Full acquisition of a privatized firm requires extensive negotiations with various governmental authorities as well as, in some cases, the management. The acquirers become involve in the enterprises' transformation and face some constraints in their privatization contracts. As the restructuring requires considerable investment, sometimes higher than the initial value, these acquisitions have been termed as "brownfield" investments (Meyer and Estrin, 1999). Such investments may be attractive where the company accesses valuable human capital, technological skills, and local networks. Meyer and Estrin (1999) find that brownfield investors reported fewer bureaucratic obstacles. These investors however bypassed the benefits of Greenfield investment, which allows a clean start for implementing strategy. The share of Greenfield investment in CEE is increasing, in contrast to worldwide tendency (Meyer, 2000).

Research acknowledges[18] that international entry in CEE requires country-specific expertise. It is possible that the internationalization of MNCs is co-evolving with the internationalization of their national business environment. Firms may benefit in their internationalization process by shared knowledge on CEE countries' culture, business and languages through media coverage, education, and personal contacts. Knowledge-based resources such as expertise specific to the foreign country, knowledge on local markets, business practices and institutional conditions are crucial for international business. This 'country-specific knowledge' may reside in the firm itself, in its national business environment, or in its business networks. The entry process of MNCs in a CEE country may thus be influenced by existence of other subsidiaries in the region and extent of knowledge networks. As reviewed in other sections of the dissertation, many MNCs have entered locations in CEE thru joint-ventures or brownfield investments and have extended their commitments as regulations or other local conditions allowed it. As these firms have learned about the environment they became more willing to take on commitments in other CEE countries. According to research from Uppsala School, as firms accumulate experiential knowledge they follow a path of gradual deepening of their commitment in foreign markets. This internationalization process (Johanson and Vahlne 1977, 1990) occurs for each entry into a new market. Country-specific expertise is arguably of particular importance in transition economies. Johanson and Vahlne's internationalization model suggests a gradual and continuous deepening of international commitments. Similarly, "networks of knowledge" that firms built in the CEE evolve evolutionary, with gradual changes as well as possible radical change in reaction to extraordinary situations. According to Meyer (2000), "disturbances in the wider business

[18] Meyer et al, (2000), National Internationalization Processes: SME on the Way to Eastern Europe, CEES, Working Paper No. 37.

environment can trigger revolutionary changes in the focal firm's corporate strategy such as foreign entry. The influence of events in the network on firms' entry decisions thus adds a chaotic element to internationalization processes, providing a less deterministic perspective on entry behavior". The network theory explains the sometimes observed pattern of MNCs in choosing their CEE markets. A company that already has subsidiaries in the CEE chooses entry in other countries in the region depending on new relationships established with other CEE firms and organizations. The internationalization can be explained as the result of an experimental learning-commitment mechanism which also applies to network relationships. Research performed at the end of the nineties (Nieminen, 1999) concluded that foreign companies expanding into Visegrad countries considered to be more stable preferred high commitment operating modes such as wholly owned subsidiaries. MNCs entering CIS countries favored low commitment modes since the markets were more unstable and risky. The discussion above suggests that more recently MNCs establish higher levels of commitments in slow reformer countries or countries that have limited ties to the European Union, if they already own operations in other CEE countries and have an established network in the region.

The relative importance of resources that MNCs seek in the CEE markets may depend on the entry mode. It can be assumed that whereas both Greenfield and JV firms' success depends primarily on technological know-how, acquisitions and partial acquisitions depend primarily on brand names. Meyer and Estrin (2004) show that for new projects (Greenfield and Joint Ventures) it is very important to introduce new technology to the markets and to have a good managerial staff in the initial phase of the operation, while for an acquisition or partial acquisition investment, the most important resource is an existing brand and distribution network. The type of resources sought in CEE countries is also expected to be a function of the corporate strategy. Market-oriented investors might seek licenses and marketing-related assets. Industry-specific technology that is competitive on international stage may have attracted foreign investors aiming to build an export base in CEE. Theoretical considerations suggest that corporate performance will be best when firms have freely chosen their entry mode in accordance with resource and transaction cost decisions.

Recent research reviewing FDI data in the last decade (Radosevic, 2001) found that technology intensive electrical machinery and car production are the main targets for FDI in CEE, while textiles, clothing, and leather sectors are less internationalized by FDI than other fields. Foreign investors seemed to prefer activities with relatively stable domestic markets, such as food, beverages and tobacco industries, particularly at the beginning of transition. The literature suggests that there is a predominance of market seeking FDI, whereas factor cost considerations are secondary. The type of FDI varies significantly - advanced economies in transition have a higher share of export oriented FDI projects, subsidiaries are more integrated into MNCs and are more likely to be wholly owned.

Research finds (Kinoshita and Campos, 2003, Bevan and Estrin, 2000) that the most important determinants of FDI location in transition economies are institutions and agglomeration economies, availability of natural resources and labor cost. Bureaucracy is found to be a deterrent to foreign investors. It would appear that foreign investors prefer transition economies that are more open to trade and have fewer restrictions on FDI as the destinations of their investments. Some authors (Bevan and Estrin, 2000) suggest that countries excluded from the EU will receive lower level of FDI, which will further limit their relative transition progress. CEE countries are still in the process of establishing the legal infrastructure (Dezutter, 1997), challenging the foreign firms to cope with new and changing regulations, often drafted without considering the full implications. Among the problems of the economic environment in CEE are also the inefficient banking system and tax regime and the persistent inflation.

The main purpose of transition was to introduce markets as more efficient coordination mechanisms. However, as institutions were not in place, the process led to abuse by insiders and very slow restructuring of enterprises. The lack of information led to market failure. Weak institutions led to increased transaction costs. The resulting effects on MNCs are a lack of information on potential partners, unclear regulatory frameworks, inexperienced bureaucracy and weak enforcement of property rights, which may have compelled firms to opt for intermediate mechanisms of exchange thru informal networks that connect firms to government, banks and other enterprises (Meyer, 2000). The MNCs in capital goods industries have been noted to pursue a strategy of strong relations in the local environment (Radosevic, 2001), as the success of their investments depends on close connections with large customers.

Some authors have developed some typologies of strategies (Bridgewater et al, 1995). By distinguishing entrants according to their strategic investment motives and the speed of resource commitment, they observe some interesting classifications. Many investors are *client-followers* in that they enter CEE to serve existent customers. Their investment decisions are linked to the strategies of their customers (automotive industry, financial sector, bottling and packaging) (Meyer, 2000). In other areas (such as oil and gas industry) with high upfront costs, investors have *cooperated* intensely with governments and local monopolies. Investment consortia between major multinationals are common both to share the high risk and to negotiate with authorities. As noted earlier, for the firms that have obtained access to market thru acquisitions of privatized firms, governments often continue to be indirectly involved thru minority shareholding. At the same time, governments may support privatized firms by securing financing, guarantee procurement, tax breaks, restrictions on import competition, etc.

The successful development of network relationships is a key factor determining firm performance during transition (Meyer, 1998). Research has noted that as local suppliers in the CEE are weak, foreign investors can coerce them into their sourcing strategy by fostering joint-ventures and takeovers. This seems to follow a worldwide trend of closer business relationships, with integrated supply-chain management, complex exchange relationships, high degree of interdependence and longer term contracts. Research suggests (Meyer, 1998) that some successful investing firms in CEE have created their own business networks and that flagship MNCs have created dependent clusters. Studies (Peng and Heath, 1996) have suggested that enterprises in post-socialist economies do not follow a market or a hierarchy strategy for growth, but rather a strategy of building networks as strategic alliances to facilitate economic exchanges. As mentioned previously, recent research (Radosevic, 2004) suggests that alliances in CEE are transitional forms towards wholly owned subsidiaries. In many consumer industries, alliances are initial steps in a strategy of taking over the domestic company and its distribution network. Most often, it is not the production capacity or technology that matter here, but the market share[19].

Studies (Dyker, 2001, Pavlinek, 2004) notice that foreign investors in some of the CEE countries rarely use local firms as first-tier suppliers in their supply networks (i.e. suppliers who collaborate actively with the main firm on the design and production of complex components). Some first-tier suppliers are joint ventures between MNCs and local firms situated in the host country. Other MNCs develop no or only few linkages with local firms because they find it difficult to acquire the supplies at the required level of sophistication or quality.

Studies carried out recently (Kaminski and Smarzynska, 2001) suggest the potential benefits of becoming part of global production and distribution networks. Various research (such as Uhlenbruck, 2004) explains the expansion of MNCs to Central and Eastern Europe thru acquisitions as a way to facilitate regional market entry, establishing access to distribution networks, knowledge of customers and market conditions throughout the region. The MNEs exploit and possibly enhance these regional advantages at the subsidiary level, thus using FDI in transition economies of CEE in order to develop (rather than only exploit) intangible assets that might contribute to the headquarters' knowledge and managerial capabilities. Theoretical studies of FDI emphasize the importance of the ownership advantages and suggest that firms undertaking FDI are endowed with greater intangible assets than domestic firms. Numerous empirical studies have confirmed this by showing that MNCs are usually more technology-intensive and advertising-intensive than firms that do not engage in FDI (Dunning, 2003). Studies applied to CEE however (Meyer, 1998) show that technology-intensity is not a determinant of a firm's direct investment and that (Smarzynska, 1999) foreign firms with low, rather than high, R&D intensity were more likely to undertake

[19] In telecoms, transitory alliances are the usual way to enter the market. In car assembly, joint ventures based on existing facilities have also served as a transitional form towards majority foreign ownership. Hungary is a good example of a country where legal restrictions on the proportion of shares that foreigners were allowed to buy in the early stages of privatization forced many foreign companies into part-ownership. However it has been reported that they exerted full control and developed the companies as their own, preparing for the next phase of privatization with the aim of acquiring more shares and possibly full ownership. As soon as legal obstacles are removed, foreign involvement turns into outright acquisition, securing full control over business. For example, in Poland, the share of joint ventures in overall foreign investment fell from 56% in 1989 to 31% in 1991 and then to 0.4% in 1993, closely following the pace of privatization.

FDI in transition economies in the early 1990s. Most MNCs operating in the CEE region have used one of the following three strategies for innovation (Shah, 2002): 'innovate local' strategy that recognizes the differences between Central and East European countries and Western European countries, 'trickle down' strategy which considers that global brands or services formulated for advanced markets will appeal to the CEE consumer or an 'incubate/use as a test bed' strategy for which CEE is a lower cost environment where a test market failure does not have the potentially disastrous consequences as a failed market test in Western Europe.

According to research done in a limited number of Central European countries (Shah, 2002), most successful companies have adopted the "portfolio" approach as a means of securing market share. Rather than entering a CEE market with a single product or service, a portfolio of products and services within the category was introduced. The breadth of the portfolio has clear distinct positioning in the low cost, premium and super-premium categories. The approach acts as a tactical barrier to entry for potential competitors such as distributor own brands and retailers. Acquiring a local brand in order to gain a foothold into the market has been most successful. Many of the first entrants in CEE have pursued highly standardized marketing strategies in CEE, with very limited adaptation, such as in labeling or package design. However, such strategies provided decreasing profits and market shares after the initial success (Wright and Drouart, 2002). In other cases, investors discontinued an acquired local brand but re-introduced it later on as they realized a loss (Meyer and Estrin, 1998). The major challenges in marketing a product in CEE are the fragmented distribution channels, with a large proportion of small retailers, which suggests a need for high distribution intensity and multiple marketing partners (Meyer, 2000).

A recent study performed by EBRD[20] shows that firms acting in Central and Eastern Europe both under-report actual sales to tax authorities and bribe tax authorities. Albania is among the countries facing the most severe problem of tax evasion. Firms also report paying at least some bribes in almost all countries in this region (Albania,

[20] Fries et al, The 2002 Business Environment and Enterprise Performance Survey: Results From a Survey of 6,100 Firms, (Based on The EBRD and World Bank implemented jointly the 2002 and 1999 rounds of the Business Environment and Enterprise Performance Survey (BEEPS)). Working paper No. 84 Prepared in November 2003, available at
http://www.ebrd.com/pubs/econ/workingp/84.pdf

Bulgaria, FYR Macedonia, Moldova, Romania, Russia, and Ukraine). The report analyzes the phenomenon of "state capture" referring to actions of firms to influence the formulation of laws, regulations, decrees and other government policies to their own advantage though illicit or non-transparent means. The EBRD report shows that those firms that engage in state capture in CEE have significantly higher investment rates that those that do not. At the same time, those firms that report being affected by state capture have slightly lower rates of productivity and sales growth than do other firms. MNC performance was also found (Fries et al, 2003) to be influenced by country-level factors such as growth in aggregate demand and quality of the business environment. Several firm-level factors are associated with enterprise performance such as *firm origin and ownership* (privatized firms versus Greenfield investment; full foreign ownership versus other combinations). It has been suggested that an important determinant of firm growth in transition countries is trade orientation of firms. Konings and Xavier (2002) found that foreign firms that were involved in foreign trade and were potentially more capital intensive, grew the fastest. Research has found (Gielens and Dekimpe, 2004) that in some sectors (particularly, retail) the presence of home rivals reduces the perceived market uncertainty, as firms with similar backgrounds appear to be successful. This may explain the national clusters that emerged in the early stages of the internationalization.

For acquired firms in CEE (Lieb-Doczy and Meyer, 2000), it was found that efficiency is higher in cases where acquirers provided more *autonomy* to local decision-makers and research units, and did not focus on downsizing and imposing headquarters' norms. This would suggest that local knowledge may be an important resource for the MNC. Firms performed better in cases where they allowed for some degree of managerial autonomy and access to complementary resources.

Literature noted that for most of the transition economies, one of the key resources that MNCs have been seeking is inexpensive labor. Research (Bevan and Estrin, 2001) has noted however that firms only prefer low wage locations if the reduced labor cost is not compensated by lower labor productivity, or an overvalued currency. Thus, it would seem that the CEE markets' attraction lies in labor that is relatively inexpensive *and also* productive.

The MNCs' most successful competitive strategies have altered throughout the transition process. After the abandonment of central planning and state ownership of industry there was a blurred differentiation between competitive industries with high potential and the rest. The industries and firms that emerged from this first stage have asserted their initial competitive status through possession of firm-level capability and are poised to ensure competitive sustainability in a second phase. Whereas at the beginning of the transition process MNCs have taken advantage of pent-up demand and lack of competition, as the economy moves into sustainable development, the benefits for MNCs come from the generation of defendable competitive advantage. There are potential dynamic interdependencies between the evolving needs and capacities of CEE economies and the competitive strategies of MNCs: in the relatively unstructured institutional environment in early transition, foreign companies may have seen the satisfying the unmet demand as a basis for profit growth. As economies evolve towards more stability and economic progress, the operations that are fully positioned to evaluate and react to these conditions should be expected to perform better.

Manea and Pearce (2004) find that technology is the core of dynamic processes. MNCs' subsidiaries move from being users of existing technologies to increasingly autonomous generators of new technologies and competitive competences. Local MNC subsidiaries start out with responsiveness to the local market or cost competitiveness of standardized local inputs and evolve towards the activation of distinctive local technology and tacit knowledge.

The basis for firm performance and evolution are resources such as knowledge, capabilities (processes/routines of the firm) and firm-specific assets. The development of dynamic capabilities allows companies to develop new resources and to take advantage of new opportunities. The outcome of organizational learning is an enhancement of intangible resources and an increase in possible strategies that a firm can employ (Uhlenbruck et al, 2000). Recent studies (Dezutter, 1997) present some evidence of the fact that local subsidiaries are good learning models from this perspective. Examples of successful strategies in CEE (Yoruk, 2001) show that MNCs have actively played a role in enhancing relationships and upgrading local suppliers and partners' knowledge. Along with internalization within the corporation, some companies have been externalizing knowledge via local channels in the host countries. Some successful MNCs subsidiaries are independent in terms of maintenance and allocation of resources, but have maintained a constant exchange of information with the parent.

Research found (Uhlenbruck, 2003) that MNCs' global acquisition and regional business experience contribute to the subsidiary's growth in CEE. However, cultural differences moderate the impact, and sometimes, even eliminate the ability of the MNC to create or make use of valuable resources. These findings suggest that cultural distance reduces the ability of the corporation to develop and exploit location-specific resources. The cultural characteristics of MNCs, such as aversion to risk, have an impact on amount, form and location of investment. Research[21] analyzing the factors affecting investments in the CEE region found that while host market size remains important, geographical and cultural distance lose their significance at higher levels of FDI. Uhlenbruck (2004) finds that cultural differences between home and host country significantly reduce the potential of region-specific resources for future growth. For companies that merge with local firms and companies that acquire local firms, preservation and exploitation of target resources presents a significant concern. Cultural distance reduces the capacity of the MNCs to learn from their experiences in the CEE countries. Uhlenbruck (2004) shows that capabilities associated with the acquisition experience of the MNCs are valuable, independent of cultural differences, implying that some capabilities are effective independent of cultural context. Although international and regional experience may compensate for negative cultural distance effects, this depends also on the size of the distance. Firm's learning is less effective in an environment where cultural differences are larger. MNCs learn more from prior experiences in CEE if their home country is culturally closer to these countries. Uhlenbruck (2004) also notes that cultural distance may deter the transfer of knowledge between the acquiring MNC and the target company in CEE: "The MNC may consider some information of a given body of knowledge more pertinent than the foreign subsidiary, which may therefore disregard some of the knowledge the MNC attempts to transfer. Different learning styles, which are also culturally dependent may have similar effects. Thus, [..] cultural distance hinders both the

[21] Demekas et al. (2005), FDI in Southeastern Europe- How Can Policies Help?, IMF Working Paper No. 05/110.

development of MNE capabilities based on its prior experience in the region and the transfer of such capabilities to the acquired subsidiary". Following the same logic would suggest that cultural distance may also weaken the growth of local subsidiaries, as significant differences may exist in management's interpretation of historical and contextual information.

The convergence of institutions to those of Western Europe reduces psychic distance and facilitates international business in CEE (Meyer, 2001). According to this research, "lower psychic distance reduces the need to invest in information, to train local staff and to adapt management processes to the local environment. This affects all forms of businesses, but to different degrees. The costs of psychic distance arise at least in part from the institutional setting. Notably, lack of familiarity with institutions increases establishment costs, and thus discourages complex operations and wholly-owned subsidiaries." Meyer's research (2001) supports the hypothesis that entrants originating from countries with lower distance proximity to transition economies in CEE are more likely to establish wholly-owned subsidiaries. He shows that German firms are more likely to choose wholly-owned subsidiaries relative to British firms. Proximity and familiarity facilitate German entry into the CEE region without dependence on local partners.

The economic environment, as well as the advantages that MNCs seek in Central and East European countries, are likely to change as these countries' integration continues (Tihanyi and Roath, 2002). The institutions of regional integration include EU-conform regulations, enforcement of property rights, free flow of products and resources, specific anti-inflation measures, promotion of economic growth and local competition, and a prudent fiscal policy. Although some of these institutions are similar to general market development, they require high levels of government involvement. The literature recognizes that the decrease in risk premia associated with the EU integration may be questionable, as certain countries will fail to build up the social capability and R&D systems, making it increasingly difficult for companies to implement investments (Dyker, 2001). Nevertheless, although integration in the EU may not solve the countries' individual problems, it could provide a substantial guarantee of political stability and an incremental cut in risk premia.

Conclusions

Management research has long been concerned with the concept of strategic adaptation. The literature states that successful firms cope with environmental change by adapting the organizational strategy and structure to new conditions (Chakravarthy, 1982). Successful enterprises are thought to display a high level of organizational adaptability. The study of business in transition economies offers opportunities to generate insights and build theoretical frameworks for international business, not only limited to transition, but also in general. "The transition economies provide a laboratory for business; and insights gained here will contribute to the discourse on global economy in the 21st century. Research challenges include questions on how business evolves during radical organizational change, and how institutions shape corporate behavior. Scholars may venture more inductive research and develop new concepts and frameworks relevant beyond the region. In the 1990s, research focused on issues that were specific to the start of transition and opening to international business. Research needs to move on, from privatization to new entrepreneurial businesses, from entry strategies to operations strategies, and from negotiating acquisitions to managing subsidiaries. Yet this research needs to consider the business context that [..] has developed specific institutional characteristics that are likely to persist for the next decades" (Meyer, 2000).

The analysis of MNCs strategies from this perspective is the goal of the dissertation. The research draws from the strands of literature presented in this chapter and adds to it by creating a coherent perspective on the actual strategies that multinational corporations pursue in the transition markets of Central and Eastern Europe. The hypotheses tested concern the ways in which MNCs eliminate inefficiencies in the value chain, how regional and local strategies of MNCs fit into overall corporate strategy, and, finally, the ways in which companies respond and adapt to the transition environment. The results reveal features of successful strategies in dynamic environments, with inferences that expand beyond the geographical and analytical boundaries of the dissertation.

CHAPTER 3 RESEARCH QUESTIONS AND HYPOTHESES

3.1 Introduction

An environment of rapid shifts in advantages such as the transition to market can create opportunities for companies to establish new advantages in the market, but as the environment continues to change, these new advantages are themselves vulnerable to attack. Opportunities attract other firms who strive to match, leapfrog or neutralize the advantages of the incumbents. Sustaining advantages requires effective interaction with competitive and economic environment- building the firm's resources and position while preventing competitors and new regulation from eroding them. Public sector policies can create and help sustain competitive advantages for firms, or can undermine and even destroy advantages. Sometimes policy shifts may appear to managers to be random and capricious, although clear patterns of policy changes can be identified. Some of the literature reviewed in the previous chapter suggests that there is a policy window that portrays opportunities for action on given initiatives. Such opportunities present themselves and stay open for only short periods. The firms that achieve dynamic advantage among multiple players are those that are first to recognize that a policy window has opened. Increasing awareness of public policy might thus be a priority for MNCs in CEE. From a competition perspective, some MNCs in Central and Eastern Europe may still benefit from significant first-mover advantages and market power, but others are already facing increasing competition from emerging local firms or other foreign entrants.

The dissertation asserts that MNCs that strive in these markets are the ones that are actively maintaining and renewing their advantages. Sustainability of advantages is a matter of degree. Most advantages are transitory because they can be readily duplicated. Some advantages may erode because they are gained at high costs, exacerbated by expensive and inflexible labor contracts. Advantages erosion can furthermore occur under external pressure or the arrival of outside competitors who can transfer well-honed assets and capabilities from related markets. In order to develop sustainable advantages or at least slow the erosion of advantages, MNCs need to focus on developing assets and/or capabilities that are valuable, durable, and non-duplicable (Day and Reibstein, 2004).

Successful MNCs operating in CEE are proactive and flexible in their strategy formulation and implementation, anticipating policy changes and continually focusing on the capability to grow and evolve with the market. This implies that MNC's success depends on how well the corporation establishes and defends its advantages. Successful firms find ways to limit the impact of institutions that are set or slow changing, take opportunities to turn deficiencies into advantages and actively acquire and incorporate local knowledge into their operations. It is expected[22] that business strategies that rely on leveraging the strengths of the existing market environment outperform those that focus on overcoming weaknesses. The best adaptation strategies that are tested include developing relationships with non-traditional partners, co-inventing custom solutions, and building local capacity. The main hypotheses are presented in a conceptual framework that incorporates dynamic interactions of various functional components and exhibits the logic and focus of the research, as presented in Figure 1 which has also been reproduced in a graphical presentation in **Appendix 3**.

3.2 Research Hypotheses Formulation

The dissertation treats organizations as adaptive systems that have to match the complexity of their environments. The review of context in CEE has concluded on the complexity of the transition process. The analysis of CEE countries going thru this process indicates that transition is not deterministic in nature, but involves an interplay between a field of forces operating at different system levels. The inability to apply a simple linear model of transition means that multinational firms need new tools to function in dynamic and complex environments. The challenge for their managers is how to model complexity and analyze the implications. The dissertation assists academics and managers in meeting this challenge.

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[22] London and Hart, 2004.

To handle complexity, we assert that two major strategic responses are available to firms operating in these environments. The first is reduction, translated into strategies that attempt to reduce complexity by bringing it under apparent control. The second option is absorption, defined here as activities of participation in local relational systems (enlisting local support, co-opting those that can anticipate and influence change, etc.). The dissertation examines the empirical evidence of the impact of such strategies on the firm performance. Each of the hypotheses considers that the complexity reduction and absorption strategies lead to increased performance. The alternative hypotheses have been added to suggest that these strategies could increase transaction costs, engage the foreign firm in a greater level of variance that it is familiar with, which may limit its ability to relate its policies and practices in CEE countries to its worldwide system. The research thus explores the possibility that these strategies may have a negative impact on performance outcomes. The hypotheses are complemented by the investigation of potential explanations for either alternative. The strategies analyzed below are divided into two categories, as follows:

Complexity reduction strategies:

- vertical integration and/or value chain development
- combining existing business models with localized strategies
- medium degree of autonomy and integration
- complementary specialization.

Complexity absorption strategies:

- active knowledge acquisition, processing and incorporation
- gaining from imperfect market structures/ benefiting from and enhancing imperfect competition
- embedding in the social and political environment
- matching local deficiencies with core businesses.

The strategies investigated here also provide a comprehensive image of the MNC strategy and the factors shaping it as suggested in Figure 1.

Figure 1. Shaping MNCs Strategy in Transition Environments of CEE

Social, Political and Regulatory Environment
Embedding into local environment
Regional deficiencies as advantages

Market Structures
Taking advantage of market imperfection

Resources and Capabilities
Active knowledge acquisition
Activation of local knowledge

Organizational Structure, Values and Culture
Medium degree of autonomy and loose integration
Complementary specialization

Business Models
Local responsiveness

Value Chain Organization
Cooperative strategies

Strategic Fit, Performance Outcomes

Source: Author's own.

The dissertation analyzes the above strategies as a complete investigation of business models and strategies of multinationals in Central and Eastern Europe. The most essential aspects of strategy are treated formally in the hypotheses detailed in this section. The motivation(s) of the foreign firms operating in the region may be the starting point of defining the strategies and the validity of alternative models. Pursuing in parallel *market seeking, low cost and knowledge seeking strategies* might lead to good performance for companies in CEE, because it allows for strategic rearrangement of tasks and combination of resources across the company network. Research (Pavlinek, 2004) shows that some companies are already moving production from more advanced CEE countries to cheaper locations due to rising production costs. Simply pursuing a low cost seeking strategy may not be feasible in the long run. Opportunities to combine cost advantages with the skills advantages of local employees may result in good and sustainable performance. In strategic terms this can be described as complementary specialization-cost cutting by strategic rearrangement of all tasks and functions within the value chain[23]. Some CEE countries however are behind as regards the new shift towards more knowledge and service based business. Although we would expect companies to benefit from the combination of low costs and localized resources and knowledge, this may not be a sustainable strategy for all firms.

Hypothesis 1: Primary value-chain organization

H1: Vertical integration has a positive impact on the success of CEE operations.

H0: Vertical integration does not necessarily lead to successful operation in CEE.

Successful MNCs achieve vertical integration thru ownership or by building a network of alliances that eliminates inefficiencies in the value chain (cooperation). Eliminating inefficiencies may also mean that MNCs need to be actively developing the capabilities of their local network of suppliers and distributors. We expect that the successful MNC adopts the role of a strategic bridge among organizations that are having difficulties cooperating, thus eliminating inefficient practices in the value chain. Competitive advantage in CEE may be less based on the protection of pre-existing proprietary technology and intellectual property and more on the development of trust, social capital, and permeable boundaries. Literature suggests that strong relationships with suppliers and distributors are key. Sharing knowledge, and supporting suppliers and distributors help build efficiency. The literature has shown that the dominant mode of growth in CEE countries is based on networking and foreign acquisitions. It is plausible that vertical integration is the mode that generates success. For firms that are unable to integrate vertically, e.g. due to insufficient financial or other resources, building a vertical network may be the available alternative. Local/regional integration in national industry systems should also increase the company's long term prospective. Becoming involved in building the national industry system may prove the basis for a sustainable operation. A case study of a French MNC (Yoruk, 2001) has shown that the company has been successfully supporting its suppliers to reach the level of quality required by its operations. In a study of marketing obstacles in a number of CEE countries, Batra (1996)

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[23] Kurz and Wittke, 1998.

has found that MNCs have been at the vanguard of creating and improving distribution networks at the beginning of transition.

There are however challenges in actively building values chains and this strategy may have not been in fact successful. Companies seeking to create or expand a distribution network would encounter difficulties in locating and evaluating distributors, in controlling and motivating them- it is thus possible that some MNCs may have made poor or expensive decisions. It is also probable that the distribution systems in transition economies in CEE have not achieved their potential cost-efficiency. The large number of outlets and channels, combined with high segmentation, are obstacles to realizing economies of scale. The literature (Dyker, 2001, Pavlinek, 2004) has noted that foreign investors in some of the CEE countries rarely use local firms as first-tier suppliers in their supply networks and develop no or only few linkages with local firms because they find it difficult to acquire the supplies at the required level of sophistication or quality. Research (Radosevic, 2004) has interpreted the predominance of vertical alliances as being driven by unexploited market opportunities and cost differential rather than displacement of competition. We would then expect that as competition intensifies, horizontal expansion and alliances will become more prevalent. Vertical integration may not necessarily have a positive impact on performance.

Hypothesis 2: Degree of autonomy and corporate integration

H1: Medium degree of autonomy and loose integration with the corporation lead to successful operation in CEE.

H0: Successful operation in CEE is not aided by a medium degree of autonomy and loose corporate integration.

Successful corporations operating in CEE allow for a medium degree of autonomy of their local ventures and a loose integration with the rest of the operations. A medium level of autonomy is essential for a successful local operation: allowing subsidiaries to test strategy/new products and engage in endogenous learning. MNCs may gain from providing subsidiaries with autonomy and refraining from imposing world-wide practices and short-term efficiency targets. A more loosely integrated affiliate has access to the resources of the MNC and local managerial freedom to generate diversity and enhance the corporation's global capabilities. However, diversity and high degrees of adaptation generate high coordination costs and may result in a continual search within unrelated capabilities. The successful MNC needs to balance the trade-off. A time line may also be associated with the relation between performance and level of autonomy (high autonomy in the beginning creates only medium-term success).

Retaining and developing context sensitivity and diversity have been shown to be (Lieb-Doczy and Meyer, 2000) valuable for the MNC. From an evolutionary perspective, permitting for a variety of managerial practices and organizational structures gives the company a long-term benefit of more options and a greater pool of capabilities. In the idiosyncratic transition environment, loose integration with the headquarters may permit for two-way learning and thus enhance the MNC's global capabilities. Allowing a local operation to develop capabilities and solutions in the transition context would require a reasonable degree of autonomy, but also access to resources for developing these capabilities.

Literature has suggested (Meyer, 2000) that foreign acquirers risk losing valuable local capabilities if they concentrate on the transfer of their established best practice and neglect development of variety by fostering indigenous capabilities. Rigid integration of internal routines may increase allocative efficiency, but MNCs may yield more long-term benefits if they allow for some degree of autonomy in local managerial practice, organizational arrangements and technology. Many local practices may initially be perceived to be inferior, yet they may be better adapted to the environment. Experimentation may be needed to develop new managerial practices that correspond to the local cultural values and resources. New practices developed locally may outperform the established ones. As a caveat, loose integration with the rest of the corporation could sabotage consistency in the MNC's overall strategy, and ultimately have a negative effect on performance.

Hypothesis 3: Local capability development

H1: Successful MNC subsidiaries pursue active knowledge acquisition and incorporation.

H0: Corporate level capabilities are sufficient in successful operation in CEE.

Successful MNCs may pursue active knowledge acquisition, as well as knowledge processing and incorporation into their operations thru specific learning outcomes. MNCs that follow a strategy of using their firm-level capabilities and strong market positions were successful at the beginning of transition. Active generation and development of competitive advantages may be essential in current and future successful operations in CEE. Success may be related to putting together capabilities that build on activation of distinctive local knowledge or technology. Research (Radosevic, 2004) has found that companies that have acquired essential knowledge about the local environment and clients are in a better position in bargaining with foreign partners. It would thus appear that knowledge of local market can be effectively traded for technology access. Alternatively, given the fact that local managerial know-how and marketing capabilities are somewhat limited in CEE, MNCs may benefit largely by applying their firm-level capabilities.

Successful operation in the transition environments of CEE may imply the use of existing business models and familiar strategy when the MNCs pursue wealthy markets, and localized strategies for poor markets. Global strategy researchers[24] have suggested that, in pursuing top-of-the-pyramid markets in emerging economies, MNCs can rely on proven capabilities to incrementally adapt existing business models and a familiar subsidiary strategy based on controlling resources, extracting knowledge, and leveraging economies of scale and scope. When operating in CEE, it might be more appropriate to develop separate strategies for the wealthy rising class and the poor customers. From a marketing strategy perspective, the emphasis on global brands and products with little adaptation to local demand, distribution structures and cultures, may actually be detrimental in the long term. Although the introduction of global brands may initially take advantage of pent-up demand, the medium and long-run benefits of such strategy are uncertain.

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[24] Ibidem 22.

Hypothesis 4: Embedding into the local environment

H1: Successful MNCs follow a strategy of embedding their organizations into the local environment.

H0: Establishing close relationships with governments and communities is not related to the success of CEE subsidiaries.

Creating close relations with banks and local governments, lobbying and pursuing reputation building tactics (playing an active role as a good citizen in the community) are part of an embedding strategy that many MNCs are following in the CEE region. Networking with government is important and high bargaining power helps. However, the local embedding may only be a support strategy of diminishing limitations while taking full advantage of opportunities, and may only have an insignificant impact on performance.

Previous literature has identified incidences of insufficient adaptation to local characteristics (Lieb-Doczy and Meyer, 2000) in several spheres of management, such as managerial training designed at headquarters and not adapted to the local cultures and conditions, marketing strategies emphasizing global brands with little adaptation to local demand, distribution structures and cultures. Procurement strategies failed in cases where internal input production was closed without considering the capabilities of alternative local suppliers. The MNCs' success in CEE transition economies depends on creating a coherent long-term strategy. The formulation of a coherent strategy is related to effectively identifying capabilities and key success factors. The concept of "strategic assets" (Day and Reibstein, 2004) has been defined in the strategy literature as a subset of resources and capabilities that is subject to market failures, it is non-tradable, it overlaps with strategic industry factors, it is scarce, firm-specific, unknown ex-ante, and forms the basis for the firm's competitive strategy. Strategic assets may include technology base, brand awareness, reputation, costs, etc. Along with exploring MNCs' strategies in CEE and identifying the most successful ones, the dissertation also investigates key resources that contribute to a coherent strategy. The choice between the two complexity management strategies considered here may be contingent on the key resources and their sources for the local operation (e.g. complexity absorption strategies may be more appropriate for companies that do not posses good technological, brand advantages or financial advantages).

Finally, for selected industries, it is possible that firms that match their core business with local deficiencies are in a good position to operate a successful subsidiary. An illustration of this informally treated hypothesis is the fact that infrastructure modernization projects in CEE have provided great opportunities for MNCs as demand for equipment in restructuring plants, infrastructure, etc. increased. As the countries evolve towards functioning market economies and local development improves, matching local deficiencies may however become irrelevant.

3.3 Choice of Firms Operating in CEE

For the purpose of the investigation a few selection criteria identify a relevant sample. The focus is on subsidiaries in technology and information technology, consumer goods, transport, metallurgy and infrastructure companies. These areas are among the sectors with most foreign investment in the CEE, they are rapidly growing sectors in the region, and are largely affected by reforms. The selection allows for comparisons across industries and has the benefit of contrasting evidence across successful and unsuccessful companies. These areas encompass some of the most successful companies, but also among the largest loss-making firms in their respective economies (Political Risk Services, Investment Climate, 2004, Romanian Business Digest, 2004). Only investment projects with foreign equity of over $1 million are selected. UNCTAD (2004) observes a shift of FDI towards services, which can be noticed in CEE countries as well. Most countries have liberalized their services FDI regimes, which has made larger inflows possible, especially in industries previously closed to foreign entry, such as utilities. In general, the countries of CEE outside the CIS are characterized by substantial FDI penetration in infrastructure services (e.g. banking, telecommunications, water, electricity). This trend justifies the inclusion of services and IT as areas of investigation in this research. Literature suggests (Radosevic and Rozeik, 2005), that the value creation potential of CEE as a global automotive location has not yet been fully exploited. According to this recent research, finding the patterns of successful strategies of MNC subsidiaries in this sector could bring a significant contribution. The automotive industry in the region is concentrated in Central Europe (Czech Republic, Slovakia, Hungary, Slovenia, and Poland) with vast benefits as regards clustering of supplier network. Potential discovery of clustering in other countries of the CEE and cross-country patterns are possible and could further complement the discussion on the link between business environment and company strategy. Therefore, MNCs subsidiaries in the automotive industry are included in the present analysis.

3.4 Performance Outcomes

Four criteria can be chosen to reflect performance: productivity, profitability, revenue growth and domestic market share. The most popular indicators of a successful strategy are market share and profitability. They are closely related at any given point in time, although the reasons for the correlation have been hotly disputed.

Each measure has limitations. It may be dangerous to extend the interpretation of market share from an indication of past performance to a predictor of future advantages. Dominance of a market in which competitive forces are evolving rapidly is no guarantee of future advantage. Current profitability is the reward from past advantages after the current outlays needed to sustain or enhance future advantages have been made. When the environment is turbulent it may be a misleading indicator. The objectives of the business may also distort the signals that current profitability sends about the strength of the competitive position. Above-average reported profits may be extracted by harvesting the business and cutting investments in the sources of future advantages. Research (Day and Reibstein, 2004) claims that it is most accurate to think of both market share and profitability as manifestations of superior capabilities, assets, and strategic direction. Other performance measures that have been used extensively in literature are investment rate (particularly relevant for evaluating foreign investment sustainability), return on equity, employment growth, export share, etc.

The dissertation uses two measures of company performance: numerical measures of *profitability* (profits and profits as percentage of sales and productivity as revenues per employee are used also in the discussion), which are easy to use in investigating possible correlations between variables, and a qualitative evaluation of performance which classifies companies as *successful or unsuccessful*. As noted here, a combination of measures in evaluating the firms' performance is appropriate for evaluating firms in CEE, and a qualitative investigation on three dimensions provides an assessment of successful or unsuccessful operations. The research defines a successful company as an organization that fulfills the following conditions:

- *it generates positive profits:* although we would expect profitability to be a sign of success, there are other factors that need to be taken into consideration- in some cases, losses may be temporal and due to exogenous factors, productive enterprises may show losses and transfer their profits elsewhere, etc. A company may also generate positive profits occasionally, while being a loss-maker on average. Calculating an average profit across time may have its limitations due to lack of reliable deflators.
- *it has an output that is not excessively volatile* (although possibly fluctuating in response to market conditions, demand, etc.): we would expect that a successful firm shows stable performance not only in terms of profits, but also in terms of output. A highly volatile nominal output may be a sign of instability.
- *it invests into fixed assets and has a long-term strategy at the foreign location that reflects a sustainable position in the market:* a qualitative interpretation is necessary for each company case- a firm may not invest because it has spare capacity, it accumulates money for a large project, purchases other firms' equity, etc.

CHAPTER 4 METHODOLOGY

4.1 Data and Methodology

The dissertation treats subsidiaries of MNCs in selected CEE countries as the unit of analysis. The sections below present a description of sampling design, data sources, variables definitions and methodology, followed by evaluation tools for research design robustness and generalizability. The research identifies MNCs' subsidiaries in CEE between 1990 and 2004. As justified previously, the choice of firms is restricted to technology and information technology companies, consumer goods, transport, metallurgy and infrastructure companies. Sources for identifying firms that fit the selection criteria are local agencies for foreign investors/investment, foreign investors' council, local privatization agencies, country statistical office, foreign chambers of commerce, as well as databases such Kompass database.

Although data on the variables considered in this analysis is available from secondary sources (on a somewhat limited basis), the dissertation attempted to employ a *questionnaire* mailed to MNC executives (previous research, Uhlenbruck, 2004, has addressed with surveys CEOs, CFOs and the vice presidents for corporate development, considered to be most able in providing valid information about strategic actions, resource allocation decisions, and characteristics of their organizations). Problems of limited responses (very small sample), non-response bias and response reliability made this methodology impractical. Overcoming these obstacles required using *secondary data sources.* The dissertation also includes *original case studies* as a parallel method of investigation. The findings of the case studies significantly improve the research and help build a theory on foreign companies' strategies in Central and Eastern Europe. This method has the advantage of granting a more dynamic view on strategies.

Variable Definition and Measurement

For statistical investigation, a number of variables have been employed as quantitative and qualitative measures of the aspects considered in the hypotheses. The choice of scale fits criteria used in literature, as described below. Due to the limited nature of data availability on the variables specified in the model, a combination of a variety of sources has been used. The sources for data used in statistical analysis include: Thomson Gale Business and Company Resource Center, Mergent Online International Company Data, and Kompass USA. Additional information was obtained from The American Chamber of Commerce in Central and Eastern Europe- thru Mr. Elias Wexler, representative in New York, USA; Arisinvest- Romanian institution promoting foreign direct investment- thru Mr. Alexandru Mitroi, representative; AVAS- Romanian Institution for the Valorification of State-owned Assets, thru Mr. Viorel Dinu, representative, and the Romanian Chamber of Commerce and Industry, thru Mr. Adrian Grecescu.

The main source of data for this research is Kompass Database. Kompass provides business information mainly for the international commercial and industrial community. Information collected using this database includes company information, profile and financial data. This database is particularly useful as it reveals CEE subsidiaries' associations with local organizations, a list of the MNC's subsidiaries and their activities, a comprehensive history of the subsidiary, a description of operations owned in the primary value chain as well as a complete financial profile and a discussion of the local activities/operations. Business and Company Resource Center is an integrated resource with company profiles, brand information, rankings, investment reports, company histories, chronologies and periodicals. The information on companies (MNCs' subsidiaries) located in CEE countries provided by this source includes addresses and contact information, a complete classification by NAISC codes, annual sales and profits, number of employees, productivity, and company management and profile. Mergent Online provides Internet-based access to a global company database including business description, history, property, subsidiaries, officers and directors, as well as financial statements of subsidiaries in CEE countries. The International Annual Reports module is integrated into the International Company Data module, Mergent's global company database. The coverage includes subsidiary contact information, company profile, primary NAISC classification, business summary, and financial highlights.

The variables considered in the descriptive and inferential statistics methodology are: success as the dependent variable; vertical integration, level of adaptation, strategic motivation, degree of autonomy, degree of knowledge acquisition, market structure, level of local embedding, degree of matching local deficiencies, and a series of control variables. Performance outcomes were measured two ways: profitability (for discussion only) and a binary variable (used in the statistical model) assessed on three conditions: positive profits, output that is not volatile, and continuous investment in fixed assets: 1- a company fulfills the three conditions, 0-the company does not fulfill all three conditions. The choice of "success" variable's measures is detailed in the hypotheses description section.

In order to assess vertical integration a measure is obtained by enumerating the different stages in the value chain in which a firm is involved. Similar to measures used in literature[25] on corporate integration, the dissertation uses the number of stages "owned" by a firm in the value chain. Such a measure is already provided in the Kompass database or is obtained from information on industry codes/activities from the other databases used. The variable for level of adaptation is used to asses the degree to which each company uses an existing business model at the CEE location. The dissertation uses a scale from 1 to 5. Literature[26] suggests this approach or a collapsed classification. The categorical variable denoting level of adaptation reflects the evidence regarding the presence of local management, brands, and local business model (1-low, 5-high). "Product profiles" are obtained from the Kompass database for each company. The level of local customization and use of local business model have been inferred from the historical information on company's decisions regarding acquisitions, expansions and introduction of local brands as they appear after subsidiaries listing in the Kompass

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[25] Acemoglu et al (2004), Vertical Integration and Technology: Theory and Evidence, Working Paper, MIT.
Barrera-Rey, F. (1995), The Effects of Vertical Integration on Oil Company Performance, Working Paper 21, Oxford Institute for Energy Studies.

[26] Ogunmokun, G. and Janine Wong (2004), Determinants of Marketing Adaptation/Globalization Practices of Australian Exporting Firms, World Review of Science, Technology and Sustainable Development, Vol. 1, No 1, pp. 81- 92.

company profile. For example, companies like Synergon, Fortis Bank, Vodafone, Matsushita, have a level of adaptation of "1" as most of them use standard business models, products, global brands and have headquarters' management solutions. A level of "2" shows some weak local adaptation, usually with the use of some distribution systems, etc. but reliance on corporate brands and a replicated business model (IVAX, EGIS Pharmaceuticals, Solvay, Ahold). A medium level of adaptation ("3"-such as for the local subsidiaries of Pliva, Agros, Elbasan Steel, PWC, Dero-Lever) shows some local management, the development or use of adapted distribution systems, some local products and brands. A higher level of adaptation ("4") has been assigned for companies that have most elements of adaptation but also some standardized features- OTP Bank, for example, uses an establish business model and foreign management, but offers pension and treasury services that fit the local environment. Softbank offers custom solutions products but uses a standardized business model. The highest level of adaptation ("5") is assigned for companies with local distributions, brands, products, completely customized products, such as Prazske Pivovary, PVT, Petrobrazi.

The qualitative variable measuring strategic motivation assesses the degree of market seeking, efficiency seeking and knowledge seeking, as well as the use of a "hybrid" combination of any strategic motivations. The formulation of this variable follows recent research discussing motivations of MNCs in Romania[27] . The scores for this variable are as follows: 1-market seeking dominating strategic motivation, 2-efficiency seeking, 3- knowledge seeking, and 4-hybrid.

Degree of autonomy and integration rates the level of autonomy of the local subsidiary on a scale from 1 to 5. This measure is supported by literature[28] noting that other measures based on mathematical formulations do not account for the strong correlation of autonomy to other concepts, such as centralization. Autonomy is defined here as the degree to which local subsidiaries may make significant decisions without the consent of the parent company. Each company's profile has been analyzed for evidence of presence and control from headquarters, location of decisions and level of free local

[27]Manea and Pearce, 2004.

[28] Brock, D. (2003), Autonomy of Individuals and Organizations: Towards a Strategy Research Agenda, International Journal of Business and Economics, Vol. 2, No.1, p. 57-73.

experimentation. The sources of information are secondary (due to the lack of primary data) and as described in the statistical model specification, data and results. The operationalization of the variable is based on the researcher's interpretation of the evidence. A low level of autonomy corresponds to "1"- the "Company Profile" available in the three main databases used notes the names and background of mostly foreign managers from headquarters, description of company's recent decisions and tactics reflects the direction set mainly from the parent company. The opposite situation corresponds to a high level of autonomy-"5". A moderate level of autonomy-"3", reflects a situation where some of the decisions are made locally, but many are still made by the parent. The allocation of values for the categorical variable is based on judgment of information available. For example, low level of autonomy ("1") appears for some of the local subsidiaries of NKT Cables, Quartz, Eironvega, where all management is foreign, there is no indication of local decision-making or activities that go beyond the corporation's main strategy. Companies like IVAX, ComArch, Polifarb and Kraft use some local management, although the autonomy is still low ("2"). A combination can be observed for Saint-Gobain, PCW, Robert-Bosch- these CEE subsidiaries make some local decisions (such as organizing events, changing suppliers/distributors-"3"). Higher levels of autonomy ("4") are observed for firms such as A/S Alpro, Holcim, where management is local and decisions follow strategies pre-acquisition, local management is present in negotiations with governments, distributors, and in takeovers. A level of "5" is assigned for companies in which there appear to be no implication or contribution from the parent, even though the business model has been transplanted directly from the parent companies (e.g. for Volksbank and some Ernst and Young subsidiaries, local management appears to set the strategic direction and there is no apparent coordination from parent).

The knowledge acquisition variable is assessed qualitatively from direct or indirect information. Studies[29] suggest a number of key concepts that test whether knowledge is acquired within an organization, which were used in conceptualizing this variable in the application of methodology. Local capability development is measured

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[29] Blackman, D. and Henderson, S. (2003), Does A Learning Organization Facilitate Knowledge Acquisition and Transfer?, EJROT, Vol.7, No.2.

thru a qualitative variable assessing the knowledge acquisition of each subsidiary. Evidence for the scoring of this variable from 1-low to 5-high is provided by the proliferation of internal and external media for relenting information, activities to seek out information, or the acquisition of local operations with the purpose of developing further products or innovation with a high level of local unique content. Evidence regarding know-how development and R&D capabilities has also been considered for the scores used for this variable. The evidence is only partly available from the databases used. Kompass gives a comprehensive list of activities and centers for each company at location. Business and Company Resource Center gives similar information. For subsidiaries evaluated from Mergent Online however, the information was evaluated from the local subsidiaries' websites. Most subsidiaries with low level ("1") such as Sony Poland and NSK Steering simply apply their corporate capabilities without any evidence of formal knowledge acquisition or application. Societe Generale, Bekaert and Lafarge acknowledge that their local businesses are built upon already-developed capabilities ("2"). A medium level of capability development ("3"- Aker, US Steel) is observed for subsidiaries that took over existent operations and have kept or developed further some of the R&D, local know-how incorporating products, etc. High level of local capability development is recorded for companies that have centers for development and coordination of knowledge and capabilities (such as 3M, Citibank- "4"), or sections of their firms that specialize in local capability development and also application (such as Microsoft, DeloitteTouche, PWC- "5").

As regards market structure- the measure used frequently to determine the market concentration is the Herfindahl index, equal to the sum of the squared market shares of the firms in an industry. The limited nature of data available for the region compels us to consider an alterative measure- the number of companies at the three digit level of industry codes (NAISC codes). For measuring local embedness the dissertation considers a dummy variable taking the value 1 if there is evidence of local embedding and 0 otherwise. The level of local embedness has been assessed from evidence of each company's representation in lobbying, governmental or local networks, etc. Most of the information has been gathered from the websites of foreign investors' councils (main lobbying organizations in CEE countries), local development agencies (representing foreign investors), international chambers of commerce and various organizations working close to regional and national governments which include lists and activities of member companies[30]. A score of 1 for embedness is attributed to companies that are members of one or more distinct organizations and/or whose managers are executives, members of the board, or active coordinators of such institutions. A score of "0" is assigned to subsidiaries that appear not to be represented in any of the organizations found for the country where the company operates. For example, companies such as ING, Allied Deals and AMC are present in almost all organizations representing investors in the countries where they operate ("1"), whereas other subsidiaries such as TAIR, Stomil, Billa and Kodak could not be found as members of any local organizations ("0"). Informal relationships with governments and governmental institutions are impossible to assess. A more detailed discussion of such relationships is therefore discussed in the case studies.

Finally, the level of local deficiencies matching reflects a measure of the ability of the firm to match shortcomings in infrastructure, financial systems, etc. The level of matching local deficiencies has been assessed from the "Activity" portion of the company profile in the Kompass database or the "Object of Activity" and the list of industry codes as presented in the other two main databases used. Matching local deficiencies is evaluated as involvement in urban and infrastructure development, information and communications networks, etc. For example, Metrostav, EZ, Exbud (level "5") match urban development, electric distribution or infrastructure development needs. Other subsidiaries such as PVT A/S and Skanka match IT or construction needs ("4"). A medium level ("3") is noted for example for ING subsidiaries that are currently involved in pension management. Companies like Gedeon Richter, Metal Usti and Lucent Technology met needs in their specific industries ("2").

A number of control variables have been included in the analysis. To acknowledge that it is possible for European firms to benefit from costs advantages

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[30] The information on the categorical variables used in the model have been partially obtained or verified from the following sources: the American Chambers of Commerce in CEE, the British Chambers of Commerce in CEE, the Association for Foreign Investments in Czech Rep., the Association of Foreign Investors in Albania, the Foreign Investors Council in Romania, the Lithuanian Development Agency, the Foreign Investors Council in Bosnia and Herzegovina, the Bulgarian International Business Association, and the "Invest in Estonia" Organization.

related to their proximity to the CEE region, European firms are identified with a dummy variable coded 1 (multinational enterprises from the European Union), US firms are coded 2, and firms from other regions are coded 3. Finally, it was expected that outcomes vary by industry, and therefore, industry effects are controlled via industry dummies. Another control variable- size of local subsidiary, measured as number of employees- is also included in the model.

The evidence used for the qualitative variables employed for statistical generalization is reviewed again in the application of the logistic model. It is noted that the assessment on categorical variables is based on the author's interpretation of evidence from secondary data. The evaluation may thus be somewhat subjective. The lack of primary data characteristic to the CEE region and the nature of the variables considered justify the use of these variables. It is acknowledged however that the interpretation and use of secondary sources for assigning values to the qualitative variables raises reliability issues which are recognized limitations of the statistical methodology.

Methodology Description

The comparative empirical results provide information on the distribution of foreign affiliates by the dimensions considered in the hypotheses, as well as cross-companies evaluation of the most important sources for success. The analysis of secondary data on the variables employs an investigation of variables allocations (percentages) in relation to successful versus unsuccessful companies, and an interpretation of descriptive statistical measures. The analysis includes measures of correlation between performance and each of the variables considered (parametric and non-parametric). Upon completing the measures of correlations as descriptive statistics, the research employs inferential statistical tests in order to evaluate hypotheses concerning the correlation coefficient (the inferential test used here is the z-test[31]). The Pearson *correlation* coefficient reveals whether there are strong associations between the variables. Similar methodology has been used with survey obtained data (Uhlenbruck,

[31] We can test to determine whether a relationship exists between the variables. The hypotheses to be tested are: H0: the population coefficient of correlation is equal to zero, H1: the population coefficient of correlation is not equal to zero. The test statistic for testing $\rho_s = 0$ when n>30 is $z = r_s\sqrt{n-1}$.

2004). The nature of the data and its scale (some of the variables are categorical) make it precarious to assume that the distribution of the variables would be normal. To avoid making strong assumptions, a non-parametric technique is employed in measuring whether a relationship exists between the company performance and the variables considered -Spearman Rank Correlation Coefficient. The technique has been recommended[32] in situations where the data is not interval/ratio or the researcher has reason to believe that one or more assumptions underlying the Pearson product-moment correlation coefficient have been saliently violated. The Spearman correlation determines the degree to which a monotonic relationship exists between variables- a monotonic increasing relationship associated with positive correlation or a monotonic decreasing relationship associated with negative correlation. It is important to note that correlation does not imply causation. Although it is possible that when a strong correlation exists one variable may, in fact, cause the other variable, the information employed in computing correlations does not allow the researcher to draw such a conclusion.

The data obtained from statistical sources for the variables considered is used further to address the hypotheses presented in the dissertation. The statistical methodology used for testing the hypotheses is *logistic regression.* This technique has the advantage of being more flexible than other procedures: it has no assumptions about the distributions of the predictor variables, that do not have to be normally distributed, linearly related or of equal variance. Particularly useful for the present analysis is the fact that logistic regression predictors can be any mix of continuous, discrete and dichotomous variables. The technique emphasizes the probability of a particular outcome for each case. In this instance, it evaluates the probability that a given subsidiary is successful given the pattern of strategies. The predictor variables include quantitative/qualitative aspects of strategies that are directly observable. This methodology allows for testing relationships and prediction of outcome -can a company performance be predicted from its value-chain organization, regional strategy, strategic motivation, degree of autonomy, local capability development, market structure, local embeddeness and core businesses. The results show the relative predictive value of each

[32] Sheskin, D. (2000), Handbook of Parametric and Nonparametric Statistical Procedures, 2nd Ed., Chapman and Hall, Boca Raton.

variable and whether some variables increase or decrease the probability of success. Additionally, the outcome demonstrates the strength of association between performance outcome and the set of predictors.

The variables included in the logistic model are as defined in the previous section. The nature of the relationship between the outcome and independent variables is the conditional mean E(Y/x1, x2, ...). The outcome variable reflects dichotomous data, and so $0 \leq E(Y/x1, x2, ...) \leq 1$. The change in the conditional mean per unit change in the independent variable(s) follows an *S-shape pattern*. The choice of the logistic model is flexible and easy to use from a mathematical point of view and it also lends itself to a "biologically" meaningful interpretation, which is related to the theoretical perspective considered in the dissertation. The specific form of the logistic regression model used is as follows:

$$\pi(x) = \frac{e^{\beta_0 + \sum \beta_i x_i}}{1 + e^{\beta_0 + \sum \beta_i x_i}}, \qquad \text{where } \pi(x) = E(Y/x1, x2, ...) \text{ or } P(Y = 1/x) = \pi(x)$$

The logit transformation in terms of $\pi(x)$ is defined as follows:

$$g(x) = \ln\left[\frac{\pi(x)}{1 - \pi(x)}\right]$$

Fitting the logistic model entails expressing the contribution to the likelihood function thru the term $\xi(x_i) = \pi(x_i)^{y_i}[1 - \pi(x_i)]^{1-y_i}$.

The likelihood function is obtained as $l(\beta) = \prod \xi(x_i)$. The log likelihood is defined as $\ln[l(\beta)]$. The log likelihood and the likelihood ratio test are used to check for the significance of the addition of each term to the model. The Wald test is used to verify the significance of coefficients. Upon obtaining a model that contains the essential variables, possible interactions in the model are investigated. Literature[33] has identified the logistic regression model as a remarkably flexible model. Unless we are dealing with a set of data where most of the probabilities are extremely small or extremely large, or the fit is extremely poor in an identifiable systematic manner, it is unlikely that any alternative model will provide a better fit.

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[33] Hosmer, D. and Lemeshow, S. (1989), Applied Logistic Regression, Wiley and Sons.

To conclude, the descriptive and inferential analysis of data provides us with a quantitative and qualitative assessment of the hypotheses forwarded in this research, and grants findings on the following aspects:

- comparative information on the distribution of foreign affiliates according to the dimensions considered in the research questions,
- an assessment of potential correlation between performance outcome and the various strategic aspects,
- an evaluation of the probability that a given subsidiary is successful given the pattern of strategic responses evaluated in the predictor variables,
- an assessment of relative predictive value of each variable,
- an appraisal of strength of association between performance outcome and the set of predictors considers, and ultimately,
- an evaluation of whether a company performance can be predicted from its value-chain organization, regional strategy, strategic motivation, degree of autonomy, local capability development, market structure, local embeddeness and core businesses.

To test and refine the findings the dissertation also uses *case studies*. The analysis based on original case studies allows for triangulation among sources of data: survey data collection and analysis, interviews with MNC managers and the exploration of archival material, and strengthens the reliability of the findings. Researchers (Eisenhardt, 1989) have noted that exploratory research strategy is most useful for exploring implicit assumptions and examining new relationships, abstract concepts, and operational definitions. The objective for the present research is to conduct an analysis of firm strategies for CEE markets that would help build a theory on how companies successfully adapt to these business environments, for which case study research is an appropriate and strong complement.

As a research strategy, the case study is used in many situations to contribute to knowledge in understanding complex social phenomena. The case study method allows the researcher to "retain the holistic and meaningful characteristics of real life events" (Yin, 2003). The use of multiple case studies permits for multiple "experiments" from which conclusions are drawn thru "analytic generalization". Replication can be claimed if the empirical results of the case studies support the developed theory. The process of inductive theory is highly iterative and tightly linked to data (Eisenhardt, 1989). The goal and nature of the study, investigating firm strategy, also makes a good argument for a choice of methodology that avoids oversimplification and firm heterogeneity assumptions. The process of building theory from the case studies includes (adapted from Eisenhadt, 1989) the following steps:

- *Getting started*- defining the research question(s) and constructs: the initial definition of the research question is important for the theory building. The research questions presented in the hypotheses' section specify the reference to the extant literature and identify important variables.
- *Selecting the cases*- theoretical sampling. Although some of the cases may be "random", they are selected thru theoretical sampling and replicate or extend the emergent theory.
- *Crafting instruments and protocols*- combining quantitative and qualitative data and multiple collection methods. The combination of data types is highly synergistic. Qualitative evidence corroborates and provides a different view of quantitative findings.
- *Entering the field*- overlapping data collection and analysis. A key feature of theory-building case research is the freedom to make adjustments during the data collection process.
- *Analyzing data- pattern matching*- cross-case comparisons allow for the unique patterns of each case to emerge.
- *Shaping hypotheses*- evaluating the evidence supporting constructs. This is an iterative process that compares systematically the emergent frame with the evidence from each case in order to show how well or poorly it fits with case data.
- *Enfolding literature*- comparing similar and conflicting literature. Relating the findings to similar literature increases internal validity, wider generalizability and higher conceptual level, while opposing literature offers an opportunity to investigate additional explanations, and show falsifiability.

- *Reaching closure*- choosing a limited number of cases and stopping the iteration process when the incremental improvement to the theory is minimal ensures closure.

The selection of cases is based on similar predictions of results or contrasting results due to predictable reasons. The sampling is theoretical, rather than statistical (Eisenhardt, 1989). Some of the empirical cases that do not fit into the established framework are used to bring valuable modifications to the theory. The research design is built around the research questions presented in the hypotheses. The outcomes of the research are used to sharpen the constructs. The verification is similar to statistical hypothesis testing, but uses replication logic and it is iterative. Results that do not confirm the expectations provide an opportunity to refine and extend the theory. The findings reveal a complete and coherent theory of firm strategy that is readily testable and empirically valid. The popularity and frequency of case studies has increased recently. The acceptance of case studies as a viable research tool has reemerged as a meaningful technique that has 'face-value credibility'. Case study is an ideal methodology when a holistic, in-depth investigation is needed. Whether the study is experimental or quasi-experimental, the data collection and analysis methods are known to hide some details. Case studies, on the other hand, are designed to bring out the details from the viewpoint of participants by using multiple sources of data. Case studies are multi-perspective analyses. This means that the researcher considers not just the voice and perspective of the actors, but also of relevant groups of actors and the interaction between them.

Among the main issues of the methodology is that the evidence must follow convincingly and allow the reader to determine the basis upon which any generalization(s) are being advanced. Among the major issues relating to generalizability are the conceptually clear representation of the issues to be analyzed and conducting the research in a manner that is consistent with the principles of trustworthiness to ensure internal and external validity. The issue of generalization has appeared in the literature with regularity. It is a frequent criticism of case study research that the results are not widely applicable in real life. Yin in particular refuted that criticism by presenting a well constructed explanation of the difference between analytic generalization and statistical generalization: "In analytic generalization, previously developed theory is used as a template against which to compare the empirical results of the case study" (Yin, 1984). The inappropriate manner of generalizing assumes that some sample of cases has been drawn from a larger universe of cases. Thus the incorrect terminology such as "small sample" arises, as though a single-case study were a single respondent. Multiple-case studies follow replication logic. This is not to be confused with sampling logic, where a selection is made out of a population. Case study methodology uses each individual case as a "whole" study, in which facts are gathered from various sources and conclusions are drawn on those facts.

4.2 Research Design Robustness and Generalizability

Four tests are commonly used to establish the quality of social science methods and are used also in the dissertation. The criteria for judging the quality of research design is presented succinctly as follows:

- *Construct validity:* establishing correct operational measures for the concepts being studied. This criterion is ensured by the use of multiple sources of evidence- questionnaire, databases, archival records, interviews, direct observations, etc. and establishing a chain of evidence. The dissertation develops a sufficiently operational set of measures, as well as relatively more subjective judgments in data collection and interpretation.
- *Internal validity:* differentiating clear relationships from spurious ones. The research uses pattern matching, builds on explanations drawn from international business theory and existent literature, and addresses rival explanations for the observed phenomena.
- *External validity:* establishing the domain to which the study's findings can be generalized. This research design uses parallel methods that test the findings thru different techniques and using different sources. The secondary data research relies on statistical generalization, whereas case studies rely on analytical generalization, striving to generalize a particular set of results to the broader theory. To ensure that the findings are generalizable, the dissertation concludes on the value of findings for managers and researchers analyzing business in dynamic contexts.

- *Reliability:* demonstrating that the operations of the study can be repeated with the same results. To minimize the errors and biases, the dissertation breaks down the phases of research and steps in reaching the findings.

The four tests are considered relevant in judging the quality of this research design, and the various tactics articulated for each test occur in various stages of the research. The logic of the complete research design is presented graphically in Figure 2.

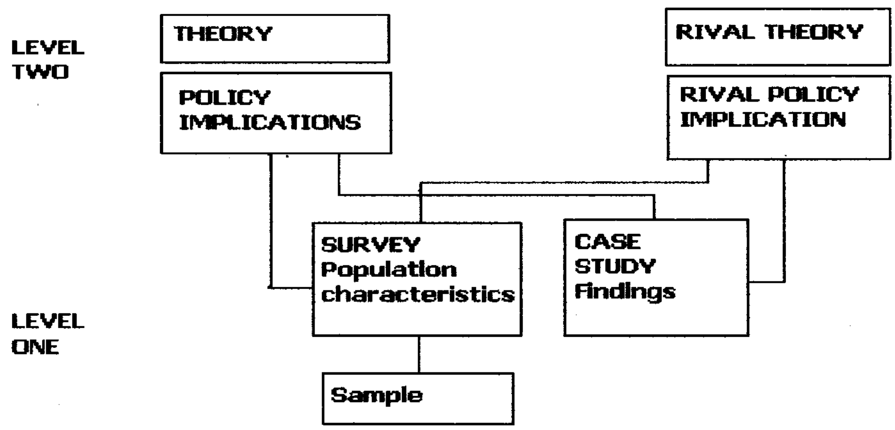


Figure 2. Making Inferences: Research Design for Statistical and Analytical Generalization

Adapted from Cosmos Corporation and Yin (2003)

The strength of the findings is enhanced by the conscious combination of qualitative research methods and straightforward statistical methods. The complete research design relies on the development of a theoretical framework that relies on level one inference (statistical generalization, where the inferences are made on the basis of data collected about a sample) as well as level two inference (analytic generalization, in which the developed theory is used as a template with which to compare the empirical results of the case studies). The research developed on this structure makes it likely that the findings reveal a complete and coherent theory of firm strategy that is replicable and empirically convincing.

CHAPTER 5 RESEARCH FINDINGS

5.1 Statistical Model Specification, Data and Results

A logistic regression model has been used for statistical generalization. The resulting inferences are based on data for subsidiaries of multinational corporations operating in the Central and Eastern European region. The sample of subsidiaries respects the criteria described in the methodology section. Data for a total of 570 companies, subsidiaries of multinational corporations, has been compiled on the variables presented in the methodology description. From these companies, 542 had complete information-this sample has been used for further investigation and in comparative models. The distribution of companies across countries and industries is presented in the table below. The number of companies in various countries across the region generally reflects the amount of FDI existent in each of these countries, although there were some limitations due to availability of data. The representation is reasonably close to expected proportions from the literature review among manufacturing and services industries.

Table 12. Companies Representation in the Sample by Industry and Country

Companies Representation by Industry		*Companies Representation by Country*	
Industry	***% of MNC subsidiaries***	***Country***	***% of MNC subsidiaries***
Manufacturing, high technology	29	Albania	1
Manufacturing low technology	19	Belarus	1
Construction	3	Bosnia and Herzegovina	Less than 1%
Retail, food, beverages, tobacco	2	Bulgaria	6
Retail, IT	3	Croatia	3
Retail, pharmaceuticals and other	2	Czech Rep.	22
Wholesale, food, beverages, tobacco	2	Hungary	5

Wholesale, IT, equipment, cars	6	Estonia	5
Wholesale pharmaceuticals and other	4	Latvia	3
Banking, insurance, accounting, administrative management	23	Lithuania	2
Utilities generation and distribution	2	Macedonia	Less than 1%
Telecom	2	Moldova	Less than 1%
Hotels, transportation, other	3	Poland	25
Total	100	Romania	8
		Russia	5
		Serbia and Montenegro	Less than 1%
		Slovakia	8
		Slovenia	2
		Ukraine	2

Source: Author's own.

The MNCs subsidiaries included in the analysis represent successful as well as unsuccessful companies in approximately equal numbers. The average revenues across the sample are of USD 2,160,000, with an average number of 1,700 employees. The majority of the firms come from the European Union. Most companies do not have an integrated value chain (thru ownership) in each respective country where they are operating. The parametric descriptive statistics show there is significant positive correlation (sig. below 10% in a 2 tails test) between the success measure and the level of local embedding, and between the success measure and the industry. Non-parametric correlation measures (Kendall's Tau and Spearman's Rho) are also significant and positive between the success variable and the local embedding variable and also between the success variable and the industry. Non-parametric correlations are significant and negative between success and size variables. As noted in the research methodology section, the correlations between variables do not grant any conclusion of causal relationships or impact on probability of success. A logistic regression has been used for statistical generalization.

The model used for statistical analysis is formulated as follows:

$$\pi(x) = E(y) = \frac{e^u}{1+e^u}$$

$$where \quad y = "success" = S$$

$$u = \beta_o + \beta_1 VI + \beta_2 AD + \beta_3 AI + \beta_4 SM + \beta_5 LC + \beta_6 MS + \beta_7 EM + \beta_8 LD + \beta_9 RE + \beta_{10} SZ + \beta_{11} IN$$

$$\log odds$$

$$\ln(\frac{\hat{S}}{1-\hat{S}}) = \beta_o + \beta_1 VI + \beta_2 AD + \beta_3 AI + \beta_4 SM + \beta_5 LC + \beta_6 MS + \beta_7 EM + \beta_8 LD + \beta_9 RE + \beta_{10} SZ + \beta_{11} IN$$

Probability of success can be calculated:

$$p(S) = \frac{e^{\beta_o + \beta_1 VI + \beta_2 AD + \beta_3 AI + \beta_4 SM + \beta_5 LC + \beta_6 MS + \beta_7 EM + \beta_8 LD + \beta_9 RE + \beta_{10} SZ + \beta_{11} IN}}{1 + e^{\beta_o + \beta_1 VI + \beta_2 AD + \beta_3 AI + \beta_4 SM + \beta_5 LC + \beta_6 MS + \beta_7 EM + \beta_8 LD + \beta_9 RE + \beta_{10} SZ + \beta_{11} IN}}$$

Where:

S- measure of success: 1-yes, 0-no (at least one of the conditions for success is not met). A discussion of the conditions considered for successful operation is presented in detail in the methodology description section. Income after tax in equivalent US dollars has been used as profitability measures. The success measure also includes the volatility of output and investment in fixed assets.

VI- number of stages in the value chain in which the company is involved.

AD- level of adaptation (1-low to 5-high).

SM- strategic motivation: 1-market seeking, 2-efficiency seeking, 3-knowledge seeking, 4-hybrid motivation.

AI- level of autonomy and integration (1-low, 5-high).

LC- local capability development (1-low, 5-high).

MS- market structure: number of local companies at the 3 digit level of NAISC industry code.

EM- local embedness (0,1).

LD- matching local deficiencies (1-5).

RE- regional effects: 1-EU, 2-US, 3-Other.

SZ- size: number of employees.

IN- industry: 1-manufacturing, high tech; 2-manufacturing, low tech; 3-construction; 4-retail food, beverages, tobacco; 5-retail IT, equipment; 6-retail pharmaceutical and other; 7-wholesale food, beverages, tobacco; 8-wholesale IT, equipment; 9-wholesale pharmaceutical and other; 10-banking, insurance, accounting, administrative management; 11-utilities generation and distribution; 12-telecom; 13-hotels, transportation, farming.

A review of the evidence considered for the values of categorical variables is presented below:

Table 13. Nature of Evidence for Categorical Variables

Variable	*Evidence*
AD- level of adaptation	Presence of local mgmt, local distribution systems, products, brands, etc. Local research. Level of customization. Nature of business model.
AI- level of autonomy and integration	Presence and control of/from headquarter management. Location of decisions. Level of local experimentation.
LC- local capability development	Level of knowledge acquisition, strategic/tactics iterations. Involvement in information searching/information providing organizations.
EM- local embedness	Contacts with private and public sectors or active involvement in an organization that facilitates contacts. Contacts with Government and international bodies such as: IMF, World Bank, EBRD, OECD, and OSCE. Membership in governmental sponsored organizations. Evidence of efforts to create and to perfect the investment climate in the form of on-target suggestions, proposals, or specific solutions leading to improvements in quality of legislation and administrative procedures. Evidence of social and business networking. Proposals and submissions to the local authorities.
LD- matching local deficiencies	Involvement in urban development, construction and utilities modernization and building, responsiveness to local information technology and financial needs, active involvement in the development of banking system and other infrastructure development. Active involvement in creating improvements in business climate and needs of other companies.

Source: Author's own

Results and Interpretation

The statistical results for the complete model (570 observations, with 29 missing cases representing 5.1% of the data) are not significantly different from the model that included only the sample for which all information was available (542 companies, with no missing cases). For this model, results show no inordinately large parameter estimates or standard errors, which means that there is no reason to suspect a problem with outcome groups perfectly predicted by any variable. There is also no indication of violation of the linearity in the logit for the model proposed. The results show no problem with convergence, nor are the standard errors for parameters exceedingly large. No multicollinearity is evident, although there is some correlation between the level of adaptation variable and local capability development variable. No outliers were found.

A test of the full model with all predictors against a constant-only model was statistically reliable, with a chi-square of 31.129 with low significance (0.01), showing statistical significance at 1% level. This indicates that the predictors, as a set, reliably distinguish between successful and unsuccessful firms. The variance in level of success accounted for is small, however, with Nagelkerke R square and Cox and Snell R square values low. Prediction of success is reasonable, with an overall success rate of 61 percent. More specifically, the value of chi-square as a measure of improvement due to the introduction of the independent variables (likelihood ratio as a measure of goodness of fit) and its low p value show that the outcome might be predicted from the set of variables considered. From the two measures of strength of association (low values for Nagelkerke R square and Cox and Snell R square), we cannot conclude on a strong association between the outcome and the variables. The log likelihood high value may also be an indication of imperfect fit. However, Tabachnick and Fidell (2001) suggest that for large samples, differences between models might have no practical importance. For large samples, classification might be good (as is the case here) even though the model deviates from a perfect model. The authors conclude that a statistical difference between a fitted model and the observed frequencies may not indicate a poor model with large samples. The analyst should thus keep in mind both the effects of sample size and the way the test works while interpreting the results.

The classification has a cut-off probability criterion of 0.5, and the 61% is reasonable, as a method of assessing the success of the model. The classification evaluates the ability to predict correctly the outcome category for cases for which the outcome is known. The only way to improve the overall accuracy of classification is to find a better set of predictors. The classification is reported for various models however, and no significant contribution to the correct percentage seemed to be added by other models. A more complete discussion is presented below, along with reports for these alternative models. Selected results for the logistic regression run with no missing cases are included below.

Table 14. Summary of Results for Logistic Model

Summary of Tests/Results			
Omnibus Tests of Model Coefficients	Chi-square= 31.126	Sig.= 0.001	
Measures of Strength of Association	Cox and Snell R-Square= 0.056	Nagelkerke R-Square= 0.075	
Classification	Overall Percentage= 60.900	Cut Value= 0.500	
Variables in the Equation	Coefficient	Wald	Sig.
VI	-0.052	0.173	0.677
AD	0.179	1.929	0.165
SM	0.044	0.384	0.535
AI	0.098	1.329	0.249
LC	-0.078	0.298	0.585
MS	0.012	1.692	0.193
EM	0.129	0.349	0.555
LD	0.018	0.018	0.893
RE	-0.009	0.003	0.956
SZ	0.000	0.018	0.895
IN	0.114	22.475	0.000

Source: Author's own.

Based on the original model, the results show (Wald test) that three variables have an impact on the probability of success: level of adaptation (AD), market structure (MS), and industry (IN) at the 20% level of significance. Only the industry variable is significant at less than 1% significance level. These findings suggest that higher levels of local adaptation as reflected in use of local brands, supply system, local management personnel, business models, etc. increase the probability of success for a multinational subsidiary in the CEE region. More competition in the market also increases the probability of success. The findings regarding industry show that companies operating services have a higher probability of success. The high significance level for the adaptation and market structure variables should be noted. Although these variables could be interpreted to have some impact on success, the set probability of making a Type I error is high (20%). The part of the distribution that remains under the curve for the known population but is beyond critical value in the region of rejections is large. Only at this set probability are the two variables significant and the interpretation above is valid. Such high potential for a Type I error cautions against the limitations of the statistical findings regarding the adaptation and market structure impact on success of CEE subsidiaries.

Because some level of correlation between AD (level of adaptation) and LC (local capability development) was found, a model from which the AD variable was removed was run. The results are similar to the original model, as regards goodness of fit and classification. The MS and IN variables were again the only significant ones. Alternative models were run with the inclusion of interaction terms. The model with the interaction variable AI x LC is comparable in findings. Same is valid for the model with the AI x AD interaction term included, the model with AD x LC interaction term, and the one with the EM x AD term. The model with the EM x LD interaction term shows slightly better goodness of fit and classification. The same is found for the model including the interaction term EM x LC. Stepwise conditional, likelihood ratio and Wald procedures were used, forward stepwise as well as backward stepwise. The stepwise procedure supports the findings. The model run with the entire sample including the missing cases shows slightly better goodness of fit and classification, but the variables found significant in their impact on the probability of success are the same as in the results for the model run excluding missing cases. Reduced models (various combinations of explanatory variables) show low practicality.

Results based on statistical inference show evidence for the alternative Hypothesis 1 ('Vertical integration does not necessarily lead to successful operation in CEE').

Although it was suggested that successful MNCs operating in Central and Eastern Europe may use vertical integration to eliminate inefficiencies in the value chain, bridging across activities may not necessarily increase the probability of success. It must be noted, however, that the result discussed here is based on vertical integration thru ownership. In fact, the case study analysis shows subsequently that sharing and developing knowledge, and supporting suppliers and distributors (financially, thru management know-how, etc.) do help to build efficiency and that integration in national and regional industry systems is part of some companies' long term strategy in becoming successful in the CEE region. As noted in the review of literature on this issue, successfully supporting suppliers to reach the level of quality required by their operations, as well as other ways of creating and improving distribution networks have proven to increase the abilities of foreign subsidiaries and the opportunities for profit at the beginning of transition. We must consider however, that the capabilities of local suppliers, distributors, and other members of the value chain have evolved significantly in recent years. The finding that a company's level of integration may not affect the probability of success could be related to the fact that foreign firms do not have to "internalize' different levels of operations, as local alternatives have similar potential. On the other hand, in countries and industries where supply and distribution systems are not developed satisfactorily, challenges in actively building an integrated value chain have not been successful, due to high costs, administrative blockages and a lack of experience/ability in creating a local or regional value chain. One of the case studies presented in the dissertation (Balli Trading Ltd.) is illustrative in this sense.

The statistical findings support Hypothesis 2 –medium degree of autonomy and loose integration with the corporation lead to successful operation in CEE.
This result suggests that an intermediate level of autonomy is essential for a successful local operation, in that it lets subsidiaries test strategy and try different local tactics, allowing for endogenous learning processes to take place. A more loosely integrated affiliate has access to the resources of the MNC and local managerial freedom to generate diversity and enhance the corporation's global capabilities. As discussed previously in hypothesis definition, retaining and developing context sensitivity and diversity can be

valuable for the MNC. From an evolutionary perspective, permitting for a variety of managerial practices and organizational structures gives the company a long-term benefit of more options and a greater pool of capabilities. In the idiosyncratic transition environment, loose integration with the headquarters may permit for two-way learning and thus enhance the MNC's global capabilities. Allowing a local operation to develop capabilities and solutions in the transition context requires a reasonable degree of autonomy, but also access to resources for developing these capabilities. There is evidence (presented in the case studies analysis) that experimentation may be needed to develop new managerial practices that correspond to the local values and resources which outperform the established ones.

The results of the model presented here in regards to Hypothesis 3 advocate that multinational corporations do not necessarily increase their probability of successful operation in CEE countries by developing subsidiary level capabilities. The analytical results suggest also that firms pursue knowledge acquisition to a lesser degree now than at the beginning of transition; they tend to do so at the regional level more than at a national level and, in the majority of cases, the parent firm capabilities are the ones that have an impact on profitability. The literature had suggested that active generation and development of competitive advantages thru knowledge incorporation may be essential in current and future successful operations in CEE. Although it is conceivable that companies that have acquired essential knowledge about the local environment and clients are in a better position, the ability to acquire the local knowledge may come from the general ability of the multinational to process knowledge. Case studies discussed in another section found that some successful subsidiaries' managers consider the potential for local know-how and capabilities as limited and insufficient in CEE and they are drawing success by either applying capabilities developed regionally or "forcing" firm-level capabilities. We find thus that MNCs in CEE can rely on proven capabilities and a familiar strategy based on controlling resources, extracting knowledge, and leveraging economies of scale and scope.

Although networking, establishing connections with national and local governments, and other behaviors of embedding in the local environment are considered by previous literature as essential for success in CEE, the findings here suggest that establishing close relationships with governments and communities is not related to the success of CEE subsidiaries (findings relating to Hypothesis 4). Creating close relations with banks and local governments, lobbying and pursuing reputation building tactics (playing an active role as a good citizen in the community) are part of an embedding strategy that many MNCs have followed in the CEE region. However, the local embedding may only be a support strategy of diminishing limitations while taking full advantage of opportunities, and may only have an insignificant impact on performance on its own.

Analysis presented in previous sections of the dissertation has shown evidence of MNCs actively blocking entry and take other actions to protect their positions in the market. For example, most multinationals and foreign companies taking over utilities such as in the telecom industry have negotiated privatization contracts that guaranteed their monopoly on the market for a number of years. But as FDI flows to these countries continued and the number of players in the market has unavoidably increased, companies pursuing competitive strategies are shown to be more successful in the CEE. Such strategies contribute to the sustainability of operations and increase the probability of success, as shown in the results presented here.

The level of adaptation is found to have a significant impact on the probability of success. High adaptation as regards local mgmt, local distribution systems, local products and brands appears to be key in operating winner subsidiaries. Finally, one of the control variables (industry) is noteworthy in its impact on success. Conversations with industry regulators, managers and representatives of foreign chambers of commerce have consented on the high profitability in the services sectors. In fact, the representative of the American Chamber of Commerce for CEE noted that most US multinationals are services companies, as the success expectation in the manufacturing sector is very low. The results presented support this expectation. The findings show no evidence to suggest that success may be related to strategic motivation of MNCs operating in the CEE region or to the capability of the firm to match local deficiencies.

Conclusions

Using statistical generalization, it can be inferred that strategies of complexity reduction are most effective in increasing the probability of success of a foreign subsidiary in Central and Eastern Europe. The findings suggest low impact of complexity absorption strategies, which may reflect the fact that thriving operations in countries in this region do not attempt to "absorb" the environment, but, rather, they anticipate change and convergence towards features of fully functioning market structures and institutions, adapt to the local customer and reduce the perceived complexity of the setting. Although they may use localized strategies, they draw from strong multinational and headquarters capabilities. They also find a trade-off between high levels of local autonomy which encourage experimentation (with possible loss of consistency, and continuous testing of unsuccessful strategic avenues) and low levels of autonomy hindering learning and potential synergy feedback.

The services sector is more conducive to success. Competitive markets are usually the most dynamic and provide more incentives for strategies that generate sustainable advantages. The results of this analysis show the evolution of winning strategies in CEE in recent years. As the markets progress, competition increases and consumers become more sophisticated, companies need the backing of strong capabilities, high responsiveness to the market, and an adequate level of autonomy that allows for flexibility but does not promote wasteful iterations on losing strategies.

5.2 A Discussion of the Evidence by Country, Industry, Profitability and Individual Strategies

The analysis of the representation of firms ***by country*** shows that the MNCs subsidiaries in Hungary have the best productivity. Most companies do not have integrated value chains, at least not thru ownership. The strategic motivation seems to be predominantly market seeking or hybrid. Firms have various degrees of adaptation and autonomy, as well as local capability development. Competition varies widely by country and by industry. The level of local deficiency matching is low and most MNCs present in the CEE region come from the European Union. A brief analysis of each country is presented below.

Table 15. MNCs' Approaches in Selected Countries in CEE

Estonia
Companies successful and unsuccessful are both reasonably represented. The industry of preference is accounting, auditing and administrative services. It would appear that subsidiaries have only 1 or 2 operations in the value chain. Most companies have a high level of adaptation and have a market seeking motivation. The subsidiaries benefit from a medium degree of autonomy from the parent firm and a medium level of local capability development. The competition is relatively low in the majority of sectors. There is little evidence from the information that the companies have opportunities to match local deficiencies or get involved in local embedding.

Hungary
The banking sector records a relatively higher level of interest. Size and revenues for MNCs subsidiaries are large, and the majority of companies are successful. They are not integrated, have a high level of adaptation and a combination of strategic motivations. The level of autonomy from the parent is relatively high, and most companies engage in developing local capabilities. Industries are reasonably competitive. Companies do not seem to prefer matching local deficiencies or local embedding.

Poland
Most MNCs' subsidiaries in the sample are in retail and wholesale industry and are of medium to large size. Examples of successful and unsuccessful companies exist. They do not have an integrated value chain thru ownership, and have a relatively low level of adaptation, and are market-seeking. The level of autonomy is relatively high but the degree of building local capabilities is relatively low. Industries are competitive, and companies do not match deficiencies or embed.

Romania
The majority of companies in Romania are large, non-integrated and with low adaptation levels. They follow a combination of strategic motivations, and are highly integrated within their parents. Companies pursue local capability development to a medium degree, and industries are competitive.

Slovakia
Most subsidiaries are operating in the industrial and auto manufacturing sectors, and are medium to large. There is almost an even distribution among successful and unsuccessful firms. Most MNCs are not integrated, pursue a low level of adaptation, a combination of strategic motivations and develop local capabilities, and are not integrated strongly within the parent firms.

Albania
Firms in Albania are relatively successful and the majority have taken over large industrial manufacturing SOEs. They pursue market seeking strategies; do not have integrated value chains, and pursue medium levels of adaptation. The integration with the parent is high, and the local capability development is medium. The competition is low and some companies are involved in local embedding activities.

Belarus
Firms in Belarus are large, involved predominantly in industrial manufacturing, have high levels of adaptation, pursue market seeking for the CEE region and have a high level of autonomy and local capability development. The competition is very low. There is no evidence of matching local deficiencies or embedding.

Bulgaria
The majority of foreign subsidiaries is involved in the banking sector, has low levels of adaptation, pursues market seeking and has low levels of autonomy. The industries are competitive and companies are involved in activities of local embedding.

Russia
Companies in Russia are predominantly involved in light manufacturing and the oil sector, own only one activity in the value chain, have medium degree of adaptation, pursue a multitude of strategic motivations and have low autonomy. There is little evidence of local capability development, competition is generally low and the majority of firms are embedding into the environment.

Ukraine
The administration management is the main industry attracting foreign companies in Ukraine pursuing their clients. They are predominantly successful, have high levels of adaptation and medium autonomy. They develop local capabilities and are generally not involved in local embedding.

Slovenia
Slovenian subsidiaries are predominantly in the manufacturing sector (industrial and auto), have high levels of adaptation, follow a hybrid strategic motivation, have high level of autonomy which allows them to develop local capabilities.

Latvia
Subsidiaries are predominantly in the manufacturing sector (industrial and auto), have high levels of adaptation and are market seeking. They are highly integrated within the parent, but develop some local capabilities. The competition is low and there is evidence of local embedding.

Lithuania
Like in Russia, most MNCs are present in the light manufacturing industries. They have high levels of adaptation, high autonomy, and a combination of strategic motivations. There is evidence of low local capability development, embedding and local deficiencies matching. Competition is relatively low.

Croatia
MNCs in Croatia are relatively smaller. The predominant industry is auto manufacturing. Companies have a medium degree of adaptation, have multiple motivations, high autonomy, and face low competition.

Czech Republic
The predominant industry choice is the auto industry for a combination of strategic motivations. Companies have low autonomy and are relatively smaller. The competition is high and firms develop local capabilities.

The sample included only a limited number of companies from Bosnia and Herzegovina, Macedonia, Moldova and Serbia and Montenegro, due to data availability. No inferences could be drawn from this data.

Source: Author's own.

Revisiting the proposed typology of countries in the region, we can conclude that MNCs subsidiaries in the ***advanced reformers*** that have the most developed market mechanisms and institutions (Czech Republic, Hungary, Poland, Slovakia, Slovenia) are operating in a variety of industries, with predominance on banking, retail/wholesale, industrial and auto manufacturing. They have various productivity levels and degrees of adaptation. Most companies pursue a combination of market-seeking, efficiency-seeking

and knowledge-seeking motivation, have high autonomy, and face high competition. Most companies do not pursue local embedding. Companies in ***high-intermediate reformer*** countries with significant advances in reform and good FDI potential in recent years (Bulgaria, Estonia, Lithuania, Latvia, Romania) are equally involved in industrial manufacturing and financial services, and have varying levels of productivity, adaptation, autonomy and strategic motivations. Competition varies widely by country and industry. Companies in Bulgaria and Latvia appear to be more embedded in the local environment. The somewhat more limited information on MNCs subsidiaries in the ***low intermediate reformers*** with recent slow advances in reform (Albania, Russia, and Moldova) shows that the level of autonomy is relatively low, companies face low competition, and most of them pursue local embedding. Companies in the ***slow reformers*** that are still in early stages of reform (Belarus, Ukraine) have mostly market-seeking strategic motivation and high levels of adaptation, medium autonomy, and face very low competition.
There is very little information on subsidiaries in countries ***affected by war*** (Croatia, Macedonia) on the aspects considered by this study, and it would seem that companies enter these countries from various reasons.
There appears to be no pattern that differentiates very large subsidiaries from the rest.

As regards companies by ***industries***, the following three areas have been considered for further investigation: manufacturing, high tech; banking and financial services; and retail and wholesale of IT, high tech industrial equipment and automotive. Firms in manufacturing of high technology incorporating products are present in almost all countries, with preponderance towards advanced reformers and high-intermediate reformer countries. Most of them have positive profits, although we don't find that most of them are successful by the criteria considered here. They show a medium degree of adaptation, and have a combination of market-seeking, efficiency-seeking and knowledge-seeking motivations. They seem to have high autonomy from parents, and pursue a medium degree of local capability development. The sector is competitive. Companies do not embed in the environment in an evident manner.

Companies in banking and financial services industries are highly profitable, and have high levels of productivity. The majority of foreign subsidiaries are successful in the financial sector, show medium levels of adaptation, a combination of strategic motivations, are highly integrated within their parents, and have a medium degree of local capability development. The sector is highly competitive, and there is some evidence of local embeddness. There is a relatively strong presence of MNCs subsidiaries in this sector in almost all countries. Companies operating in the retail and wholesale of IT, high technology equipment, and automotive are concentrated again in the advanced reformer countries and high-intermediate reformers. Profitability varies. They show lower levels of adaptation than companies in other sectors. The main strategic motivation is market-seeking. They benefit from relatively high autonomy. Companies do not seem to be actively involved in developing local capabilities. The sector has very high competition. There is no evidence of significant local embedding for these firms.

A sample of firms with ***negative profits*** has been selected. The companies in this sample represent various industries. The large majority do not fulfill the other two criteria of success (output that is not unjustifiably fluctuating and fixed assets investments). A relatively high number of companies have an integrated value chain (they own two or more businesses in their value chain), and show high levels of adaptation and local capability development. Some firms match well local deficiencies. In fact, these subsidiaries follow strategies which should ensure them positive profits and success, according to the existent literature. The results of the statistical model and case studies presented in subsequent sections of this research may bring insights on these issues.

A number of companies with significant presence in the CEE region have been selected for further analysis. One of these companies, ***ING***, has positive profits and is successful with its commercial banking branches. The pension fund small branch in Bulgaria is not yet successful and has negative profits. The company has a medium degree of adaptation, medium degree of integration, and various levels of local capability development. ***IBM*** is present in all advanced reformer countries, yet only its largest wholesale operation in Poland seems to be successful. This subsidiary faces the most intense competition. ***Volkswagen*** is present with auto and parts manufacturing operations in a competitive industry. It has low levels of adaptation, more of its operations are motivated by efficiency, and the level of autonomy of its subsidiaries is low. The local capability development is low, similar to the level of embedness. Volkswagen's operations in the CEE are successful. In contrast, ***Daewoo*** is not successful in the CEE.

Most of its operations are very large, show low levels of adaptation, have very low autonomy from the parent, and medium level of local capability development. There is some evidence that these subsidiaries are involved in embedding with national and local governments. The local firms are diversified, with operations such as industrial truck, tractor, trailer, and stacker machinery manufacturing, audio and video equipment manufacturing, ship building and repairing, and automobile manufacturing. ***Siemens*** is present in the CEE region with operations in various fields, such as miscellaneous electrical equipment and component manufacturing, radio and television broadcasting and wireless communications equipment manufacturing, motor and generator manufacturing, motor vehicle parts manufacturing, electronic parts and equipment merchant wholesalers, electrical apparatus and equipment, wiring supplies, and related equipment merchant wholesalers, non-depository credit intermediation, office administrative services, custom computer programming services and computer systems design services. The subsidiaries in which the company is successful are electronic parts and equipment merchant wholesalers, turbine and turbine generator set unit manufacturing, motor vehicle parts manufacturing, non-depository credit intermediation, and office administrative services. In these areas, the firms are not integrated, and have a predominantly market seeking motivation.

As regards the choice of strategies of ***MNCs across various industries***, we observe that most companies follow very similar approaches regardless of their industry. For Daimler Chrysler, for example, the information on the variables is the same for the wholesale subsidiary and credit intermediation. Saint Gobain follows the same strategies for its chemical product manufacturing and abrasive product manufacturing. Siemens has almost identical strategies across turbine and turbine generator set unit manufacturing, non-depository credit intermediation, office administrative services, and computer systems design services.

Conclusions

For more advanced countries on the transition path, companies do not use local embedding. In countries with less developed market institutions and unclear potential, there is more evidence of MNC embedding. Where companies have fewer options to rely on market mechanisms, they attempt to absorb the local environment thru networking with governments. This could also show that although at the beginning of transition embedding was a predominant and successful strategy, as the transition progresses, companies find no incentives to network with local governments and organizations. Companies in advanced and intermediate reformers pursue a variety of strategic motivations, whereas companies in slow reformers operate mostly under a market-seeking motivation. Subsidiaries in countries with advanced reforms have more autonomy. For intermediate reformer's investors the autonomy given to their subsidiaries vary, with mixed results. Most subsidiaries in less reformed CEE countries have low autonomy.

The common feature of unsuccessful subsidiaries is the fact that they are vertically integrated thru ownership in their respective countries. A larger proportion of these firms match local deficiencies. It is possible that such companies have a less flexible strategy and entered the region following opportunities that arose due to the low level of development of the infrastructure. They have not realized their expected potential. It would appear that companies that are diversified are not particularly successful, particularly if the diversification was prompted by opportunities to take over large SOEs with good potential but had no fit with the MNCs' core competency. For companies that are successful, most support activities are not successful; however they may contribute to building a sustainable advantage in a country to the extent to which they are maintaining the firm's main competencies.

A non-integrated value chain is more prevalent for successful firms. These subsidiaries are either integrated in a regional or global value chain, or have strong networks with local firms. There are relatively lower observed levels of capability development for firms that are successful. It would thus appear that all firms need in order to be successful in CEE are strong firm-level capabilities. Strategic motivation is irrelevant as long as it is part of a consistent strategy. A good fit of the CEE strategy with the MNC's strategy seems to be paramount.

Banking and financial sector offers most profitability. According to Merrill Lynch, the industry has had a record of high growth in the past years. The future also promises high profits thru rapid growth of retail financial services.

Firms in manufacturing high tech have high degrees of autonomy, are in competitive industries, but are not successful. It would appear that they have an opportunity to experiment more. However, some may experiment without a clear direction. In general, firms use similar approaches in all industries with widely varying results. This would suggest that most companies who operate in various distinct industries should adapt to each industry.

An analysis by home country shows that MNCs originated in the European Union and the United States invest at a variety of locations in the CEE region, whereas MNCs from other regions (other than EU and US) tend to concentrate in advanced reformer and high intermediate reformer countries in the CEE. MNCs from Asia or the CEE itself are also less successful than their rivals from the EU and US. There is a clear demarcation as regards strategic motivation depending on the country of origin: most EU MNCs operate in Central and Eastern Europe with a hybrid motivation, US companies are in the region with a market seeking motivation, whereas MNCs from other locations invest in the region with an efficiency seeking motivation. The level of integration of subsidiaries of MNCs from other locations than the EU and US is very high. EU and US MNCs' subsidiaries appear to have more autonomy. MNCs from other regions than US and EU are operating in more competitive sectors. We observe that most US companies are in the banking, accounting and administrative management, whereas most companies from other regions than US and EU invest in the high tech manufacturing sector. Finally, US companies are more likely to match local deficiencies in the CEE country were they operate.

Finally, a number of 460 questionnaires have been sent to subsidiaries of MNCs across the CEE region. Of these questionnaires, only four were returned with complete information. From a brief review of the responses, it is evident that the unsuccessful company overstates the problems of the transition environment, considering them a crucial negative influence on its operations. The management of successful companies has a more 'optimistic' perception of the environment, and detects improvements. The same observation has been made by the author while conducting the local case studies. One company deems its success as the result of the expansion of access to its sales network. The other two successful companies notice that the improvement in the transition environment has been important to the increase in sales and profitability.

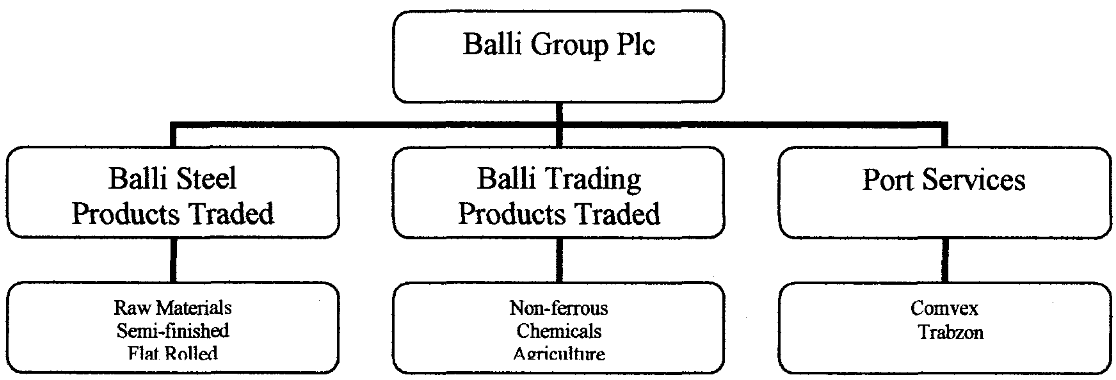
None of the companies are vertically integrated. However we note that the successful subsidiaries built on strong partners and cooperation, whereas the unsuccessful firm is auditing its suppliers, with a rather more 'adversarial' approach. Companies have varied portfolios of brands/products in terms of local, regional and global. The successful companies note the relative importance of high brand recognition. The strategic motivations are combinations- three out of the four note knowledge seeking as an important facet of the strategy. The availability and price of raw materials are noted as the one consistent important local input. There are various degrees of autonomy: whereas successful companies have a medium level, the unsuccessful company has a low level of local autonomy. Strong support from parent is important for success. The unsuccessful company has the highest level of embedding. This subsidiary also networks intensely with the government, whereas the other firms network with other organizations and local companies. Lobbying seems to be more effective (in terms of actual success) when pursued thru organizations of companies or industries, rather than directly with the government. In terms of success factors, the unsuccessful company is the only one not having strong regional or global brands. We can conclude thus that the successful companies have strong corporate (parent) level capabilities which support CEE operations. An established network of suppliers and distributors based on cooperation is conducive to profitable business. A more detached approach to government relationships might be advisable.

5.3 Analysis of Case Studies

5.3.1 Balli Plc[34]- Unsuccessfully Trading Options for Potential Leadership

Company Background

Balli is a large privately owned independent commodity trader, headquartered in the UK with a global network of offices totaling over 2000 employees and consolidating sales at the beginning of 2000s of about USD 1 bn. The portfolio of trading activities is illustrated below.



Source: Balli Plc. Company Materials.

The company specializes in trading primary, industrial and consumer commodities, including steel, non-ferrous metals, chemicals and agricultural products. Balli Group attempted to take advantage of the strong metal industries in the 2000s, and increasing demand in China and other emerging regions of the world, and considered aluminum as one of the strongest performers. Balli Group had been one of the leading providers of value added services to the global steel community through Balli Steel Plc and its various subsidiaries. Balli Trading Limited, the specialist trader in Balli Group Plc, is engaged in the trading of non-ferrous metals, specialty chemicals and agricultural products in selected regions of the world. It also provides office solutions through its subsidiary, Balrox Limited. Balli Port Services, an operator of ports and terminals in and around the Black Sea, has invested in Comvex, the second largest bulk terminal in Europe. It was also responsible for the development and management of the Free Trade Zone in the Port of Trabzon in Turkey. The Group's expansion strategy has included

[34] The main contact person for the information obtained for this case study is Mr. Gabriel Seitan, Financial Manager, Bucharest Representative Office, 35 Str. Polona, Apt. 5, Bucharest 010492, Romania.

acquisition of competitors and taking advantage of privatization opportunities in Europe, and at its peak had a total of net assets in excess of USD 90 million. In Romania, in the early 1990s, Balli established a representative office in the capital Bucharest, an aluminum subsidiary close to the Black Sea and a terminal at the Black Sea in Constanta (Comvex SA).

Company Overall Strategy

Headquartered in the United Kingdom and using a global network of over 60 offices, the Group had annual sales of USD 1.4 bn. and was shipping 7.5 mil tons in early 2000s. Balli Group unified across its subsidiaries with a common vision, allocating resources across its network. The five operating companies and their respective subsidiaries reports thru independent boards. Thru Balli Steel Plc, Balli Trading Limited, Balli Petrochemicals Limited and Balli Resources Limited the group is trading steel, raw materials, petrochemicals, non-ferous metals, agricultural goods and petroleum products. The ports of Comvex and Trabzon controlled by Balli Ports and Terminals plc provide the trading entities with infrastructure support in a region of special importance for the group.

The largest operating subsidiary, Ballli Steel Plc owns 100% equity of two other companies. Other subsidiaries include Sidex International Plc, a join-venture with a Romanian steel mill, an equity interest in MAG SA, a leading Italian distributor of steel products and WeBco International LLC, a joint venture with Weirton Steel of the US. Balli Trading's activities cover trade finance, processing, marketing and distribution of agricultural products, non-ferrous metals, chemicals and office equipment. Its main strength is an established long term relationship with suppliers. Balli Petrochemicals is a global trader and distributor of petrochemical products. It has provided trade financing facilities to producers in the Middle East and Europe and has assured supplies under long term contracts. Balli Resources is a relatively new subsidiary focusing on developing a number of petroleum industry opportunities in the Middle East. An operator of ports and terminals in and around the Black Sea, Balli Ports and Terminals has invested in Comvex (Romania), the second largest bulk terminal in Europe. Balli Group Plc is a member of a group of companies which are related thru the interests of the Alaghband Foundation.

These companies include alumina, aluminum metal and rolling mills, steel service centers, flexible film packaging solutions textile fabrics, office solutions business, a publishing business, a bank, an insurance company and a mobile telephone communications company. According to the company's management, the main strength of the group is IT and management information systems used in effectively controlling the global trading network.

In 1990, Balli traded 1 million tons of steel, and expanded into processing ore and smelting aluminum. Among purchases was 67 percent of Tulcea, Romania-based aluminum ore processor Alum SA for an undisclosed price. Balli took an option to buy a stake in Slatina, Romania-based Alro SA, a state-owned company that was the biggest aluminum smelter in Eastern Europe.

By 2000, Balli had more than $2 billion a year in revenue. The steel industry was consolidating after more than 30 U.S. companies, including Bethlehem, Pennsylvania-based Bethlehem Steel Corp. and Cleveland-based LTV Corp., sought bankruptcy protection from 1997 through 2002 because of falling prices and rising labor costs. Balli considered 'getting big' as its only sustainable strategy. Dusseldorf-based E.ON AG, Germany's largest utility, was looking to sell assets, including the steel trader Kloeckner, which had 10,000 employees worldwide. Viag AG, a Munich-based energy producer, had bought Kloeckner from Deutsche Bank in 1989. When Viag merged with fellow energy provider Veba AG to form E.ON in 2000, the combined company considered selling assets. Balli bought the company's steel-trading arm in 2000 for 380 million euros, and a year later, E.ON accepted Balli's takeover offer of 278 million euros in cash and 800 million euros of assumed debt. Balli chose WestLB as its bank because it had offered to provide further loans backed by Kloeckner's cash flow. Immediately after taking over Kloeckner, the Alaghbands, the founding family, sold properties and pulled together assets from several of the Balli units, including aluminum smelters, the port operator on the Black Sea and an Iranian steel distributor.

Following disputes within the company, Balli Group Plc was accused by its partner, WestLB, of unlawfully removing 120 million euros from Kloeckner in order to expand its other operations including those in Romania. Alaghband lost the company and at least 100 million euros that he had invested to buy it. Balli blamed 'nationalism' and hinted to the fact that foreign buyers can be stymied by cultural differences, employee resistance and laws and procedures that vary from country to country. Leveraged buyouts such as Alaghband's acquisition of Kloeckner and his wish to control the company raised issues such as the application of Germany's codetermination law, mandating that employees make up one-third to one-half of the supervisory board that approves major corporate decisions. German regulations governing the structure of corporations also thwarted Alaghband. In an Aktiengesellschaft, or AG stock corporation, such as Kloeckner, even majority shareholders such as Alaghband have little leverage over the Vorstand, or management board, which reviews corporate strategy. Owning Kloeckner was part of the company's strategy to create a trading and distribution empire and the loss of Klockner meant the need of a clear change in strategy for Balli.

Balli in Romania

The Romanian aluminum industry with its 4 factories- Alum Tulcea, Alor Oradea, Alro Slatina and Alprom Slatina- is currently dominated by Russian companies. The first company in the industry to be sold was Alor Oradea to Russki Aluminium 1998, but was subsequently closed as unprofitable. Three of the factories are owned by the same integrated company which is currently said to be profitable (Cotidianul, 2/8/05). The profitability resulting from owning interdependent companies in the industry is tied to the fact that in order to obtain aluminum a firm needs alumina and the selling of 'processed' aluminum is the most profitable. This is why Balli aimed to own the three segments of the value chain.

After obtaining a majority share in Alum Tulcea, Balli took an option to buy a stake in Alro Slatina. The privatization of Alro Slatina, the biggest producer of aluminum in Eastern Europe has been controversial and consisted in the gradual purchase of stock on the Romanian stock market by the American company Marco International. After Alro, Marco took over Alprom. Marco fought to take over Alum Tulcea from Balli as their profitability depended on the alumina produced at Alum, but gave up and decided to use imports. As Balli was facing problems in Europe with Klockner, the company saw its sources of financing Alum Tulcea drain and eventually sold it to Russian based Rinko, thru an off-shore company- the transaction seemed bizarre for the Romanian media and public. Sources (Cotidianu, 2/8/05) maintain the behind Marco International is the same main shareholder as Rinko's.

Strategy Analysis

Balli established its representative office in Bucharest in 1991. Balli Romania is a wholly owned subsidiary of Balli Group Plc and has 1,500 employees. The firm is financed in totality from the London headquarters and makes no decisions locally. The company started with what was considered a competitive and aggressive strategy and intended to be a powerful player in the aluminum industry in Europe. After an initial strong expansion, as the company lost the bid for Alro Slatina and is facing problems in Western Europe (the loss of Klockner, the death of the main owner, etc.), Balli considers its Romanian operation a failure. Management believes that the problems in Romania were compounded with the repeated changes in the government and accounting system. Balli Romania used to be profitable in the 1990s thru early 2000. In the mid 1990s it was listed among the first 10 most successful companies in Romania. At that time, the company considered expansion in telecommunications, came third in bidding for a GSM license, but did not win. It later obtained a mobile telephony license, but had to sell it (the license went to Zapp Company, Romania) as it was not profitable. As expansion continued at the end of 1990s and 2000, the strategy became unclear with the entrance of competitors (Ispat Mittall and Marco). The high incentives (among these, a three year profit tax exemption for Mittall) offered by the government put the already large rival companies at a net advantage. After a period of drastic cost cuts (changing location to a lower cost one, firing employees, etc.), Balli Romania is currently selling out its operations. The uncertainty of the environment and the unstable legal regulations were considered by the firm's management as the main obstacles to the subsidiary's adaptation. The concession offered to the entrants changed the competitive landscape in a radical manner. The company's local representatives note that because the strategy was 'consolidated' at headquarters, it lacked local flexibility and was slow to react to changes that might have been predictable.

According to the company's representatives, Balli Plc made all attempts to adapt to the local environment- it hired knowledgeable local managers, it worked closely with

Romanian institutions, such as the Competition Registry, AVAS (the new Romanian privatization and post-privatization monitoring agency) and reporting institutions. It also engaged in some forms of local embedding, such as membership in the British Chamber of Commerce, and 'Fundatia Margareta' (a philanthropic organization). As the company became unprofitable, it struggled to meet the expectations negotiated in the investment plan with the Romanian Authority for State Assets Recovery (AVAS), and it is currently involved in a law suit with this institution. Balli's local management asserted that the high uncertainty of the Romanian environment played an essential role in the failure of the company. Management saw no positive effects from the harmonization of Romanian laws to EU legislation, as the perception of continual change increases uncertainty. A discussion of the findings on the hypotheses of adaptation is presented below:

Hypothesis 1: *Primary value-chain organization: the company's strategy for success was based mainly on ownership of a vertically integrated operation. The nature of the industry suggests that such a strategy had the best profitability potential. The company failed to achieve vertical integration thru ownership, however, it would be impossible to generalize on a relationship between level of integration and success, as the case study reveals an inflexible strategy at the location with very few options.*

Hypothesis 2: *Degree of autonomy and corporate integration: there is some evidence to suggest that the successful or unsuccessful operation in a CEE country is related to the degree of autonomy and integration in the corporation. Balli Romania represents a case of very low local autonomy and very high integration with the group. Local management representatives do in fact blame the failure of the company on the lack of flexibility in this approach.*

Hypothesis 3: *Local capability development: this case study illustrates a company that used to be successful at the beginning by using its firm-level capabilities. However, as the local subsidiary failed to generate and develop competitive advantages, it lost its potential. There is thus evidence to suggest that success is related to putting together capabilities that build on the activation of distinctive local knowledge.*

Hypothesis 4: *Embedding into the local environment: it could be argued that establishing close relationships with the government would have changed Balli's outcome in Romania. We could find some support for the hypothesis that successful MNCs follow a strategy of embedding their organizations into the local environment.*

Conclusions

Balli entered Romania seeking the opportunity for a highly profitable monopoly in the aluminum industry. The strategy was based on owning the alumina needed for obtaining aluminum, the aluminum manufacturing operation and the logistics for distribution. An integrated operation was essential for its success. Balli took over the alumina operation (Alum Tulcea) and the docking space with shipping rights (thru Comvex SA), but failed to acquire the aluminum producer (Alro Slatina). Balli's strategy in Romania depended largely on control over all main stages in the value chain. A combination of local events (changes in privatization rules, the entrance of stronger players) and financial and governance problems at the headquarters made such control impossible. It would seem that the company chose a strategy that shut off all options from the beginning. The local subsidiary's strategy could not be completely assessed without the review of the company's overall strategy. Balli Group attempted to take advantage of the strong metal industries in the 2000s and increasing demand, and considered aluminum as one of the stronger performer. Balli considered 'getting big' as its only sustainable strategy. The Group's expansion strategy has included acquisition of its competitors and privatization opportunities in Europe. The loss of one of its main operations in Europe meant the need of a clear change in strategy for Balli, which unfortunately never occurred.

5.3.2 ABN AMRO[35]- Banking On Corporate Level Capabilities

Company Background

ABN AMRO is an international bank with European roots strongly supported by an international wholesale business. The company's declared strategy is that of leveraging advantages as a group. The main customer segments are consumer and commercial clients, wholesale clients and private clients and asset management, with a strategic focus on the mid-market segment. ABN AMRO's history is going back to 1824 and the bank ranks 11th in Europe and 20th in the world with over 3,000 branches in more than 60 countries, a staff of more than 97,000 and total assets of EUR 855.7 billion (as of June 2005).

Company Overall Strategy

ABN AMRO's management notes that the bank's strategy is built through Strategic Business Units (SBUs), each responsible for managing a distinct client segment or product segment, while also sharing expertise and operational capabilities across the group. The SBUs are based on the client segments. Consumer & Commercial Clients SBU serves almost 20 million consumer clients and clients in the small and medium-sized enterprises sector worldwide. ABN AMRO is among the leading players in these segments in its three home markets (the US Midwest, Brazil and the Netherlands) while targeting other high-growth regions through its New Growth Markets Business Unit. Wholesale Clients unit provides integrated corporate and investment banking solutions to more than 10,000 corporate, institutional and public sector clients in nearly 50 countries. Private Clients provides private banking services to wealthy individuals and families, and has EUR 115 billion assets under administration as of year-end 2004. Asset Management is operating from over 20 locations worldwide and managing EUR 161 billion worth of assets for private investors and institutional clients. Finally, the last three SBUs are Transaction Banking Group (covering all payments and trade in the bank for the retail, private clients, commercial and wholesale markets), Group Shared Services, which was established to create cost savings through consolidation and standardization, and Group

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[35] The main contact persons for information on this study were Mrs. Hilde Borjean (ABN AMRO Brussels) Mrs. Ena Badeanu (Country Head, Romania) and Mr. Gabriel Colea (HR Officer, Romanian), 2E World Trade Center Bucharest, 10 Montreal Square, Bucharest, Romania.

Functions, which is facilitating the implementation of Managing Board policy throughout the bank, standard and policy setting, and sharing expertise with all SBUs.

ABN AMRO in Romania

ABN AMRO Bank (Romania) S.A., is a subsidiary of ABN AMRO Bank N.V. which started its operation in November 1995. Although the bank caters for individual customers more recently, its main activity represents corporate banking in the sectors of consumer industry, automotive, energy, telecom, IT, financial institutions and public sector. The bank is present thru its subsidiaries in 15 cities in Romania and builds its image around the 'Dutch way of doing business'- informal and personal. ABN AMRO has introduced what they consider to be 'innovative' products for the Romanian markets, such as 'real-time' interest and exchange rate information access and online transactions on the monetary and foreign exchange markets for large companies (in February, 2005).

ABN operates in a relatively competitive market. In 2004, the industry was dominated by Banca Comerciala Romana (26% of entire market share), which is currently open for privatization and for which ABN AMRO has submitted a bid. The following banks in ranking are BRD Groupe Société Générale (with a declining 13%), Raiffeisen (a climbing 9.2%), Casa de Economii si Consemnatiuni (CEC) (5.9%), ING, ABN Amro (ranked 6th), followed by, in order, HVB Bank, Banc Post, Alpha Bank, and Banca Transilvania. During last year, it would appear (Capital, 5/12/05) that the leaders were followed closely by the other banks, particularly Raiffeisen Bank. However, ABN AMRO has fallen behind from the previous year. To respond to this situation, ABN AMRO is planning a strong offensive on the retail market and to open new affiliates and introduce new products and technology, etc. in the consumer banking domain, such as internet-banking, phone-banking and mobile-banking. Also, the bank is planning to create its own ATM system and extend its mortgage loans offers. ABN has introduced a few new products very recently which reflect the bank's strategy to expand its consumer retail division, such as unit-link saving schemes for individual customers, however the two new planned subsidiaries in Romania have been postponed. In June 2005 the management at ABN AMRO Romania has been replaced, but the new president (Peter Weiss, ex-president of ABN AMRO Greece) did not express a clear vision for the future.

One of the new developments which may affect the banking industry and its profitability is the limitation of credits guaranteed by the government. Banks such as ABN AMRO, Deutsche Bank, ING, Citibank and HVB used to give out large guaranteed loans to companies in the energy sector. Currently, the amounts are reduced with about 80% of the total value of previous loans. ABN AMRO had in 2004 given out over 120 million euros with the government's guarantee to gas distributions companies. As large local SOEs are transferred to international groups such as E.ON (Germany), Gaz de France or Enel (Italy), and the efficiency of energy producers is on an increase, there is an even further limitation of such loans.

The competition in the banking industry is likely to intensify, as new banks look to raise their Romanian presence. For example, the National Bank of Greece (the main shareholder of Banca Romaneasca) has established an aggressive business plan for growth for the next three years (Business Review, Vol. 11 No. 29). The bank intends to extend its market share thru 'organic growth' as well as taking over another local bank. Romania is one of the highest growth markets in the portfolio. High demand for credit cards, mortgages and consumer loans in CEE in general, and to a lesser extent in Romania, means that retail banking is catching up with corporate business as the main driver of financial activity in the region. Strong underlying economic growth and the high potential in retail and corporate banking suggest that foreign banks will expand further in the region (FT, 7/14/05) mainly thru takeovers of local banks still available and consolidation among big foreign banks already present.

ABN AMRO and analysts in the field consider the success in the Romanian banking industry as being related to a dynamic approach, innovation, as well as a wide-spread network of subsidiaries. This may be the reason why certain foreign banks are getting closer to the two large banks leading the market in terms of market share. Raiffeisen Bank and HVB Bank, as well as the Romanian Transilvania Bank have progressed in a spectacular fashion since 2001. Other international banks such as Citibank and ABN AMRO have lost ground. The explanation of this evolution may be the fact that the most successful three banks (Raiffeisen Bank, HVB Bank and Banca Transilvania) have not neglected the retail segment: Raiffeisen has been highly involved with financial services for individuals and small firms, and HVB has been offering high quality corporate services. Citibank and ABN AMRO haven't operated on the retail market, except very recently and with initiatives that are still to prove their success. The competition on mortgage products and consumer loans is very tight. Banks introduce new products rapidly in order to attract customers and take advantage of the latest surge in demand for such products. According to Bank Austria Creditanstalt, the trends in Romania are similar to the trends in the banking industry in CEE. Across the region, the most dynamic markets are in Romania and Bulgaria, followed by Croatia and Hungary. The same analysts predict a fast closing of the gap between EU and CEE as regards financial services, and a strong increase in consumer loans and mortgages in the CEE in the next ten years.

Strategy Analysis

ABN AMRO entered Romania in 1995 with a wholly owned subsidiary (100% equity) and currently has 440 employees. The main strategic motivation has been market seeking and the strong potential of the banking sector in CEE. The management acknowledged that although the bank has not established itself as a leader in any field it has provided high quality services for corporations and aims for an increasing market share in consumer banking. According to company's representatives, the Romanian subsidiary has followed closely the established strategy from the beginning of its operation. ABN AMRO is organized around what the management calls a 'stable but not conservative nucleus' that is currently pursuing expansion in emerging markets.

The subsidiary's management considers the bank to be a success on the Romanian market and notes that although the presence of affiliates across the country is not very high, they are profitable and are staying within the benchmark established at entry. They are also tying the success of the bank to the high potential of the local banking industry, with high interest credits, high demand, and an increasing number of client firms entering the market. Although the management is optimistic in their views about the current and future position of the bank, the author notes that the subsidiary has been slow to react to a huge increase in retail banking services and mortgage and consumer loans. Whereas the more successful banks have been offering competitive products in these areas, ABN

AMRO is still focused on corporate banking and has only timidly launched other products. As a result, the bank has fallen in terms of market share recently. The firm continues to rely heavily on expanding corporate services in Romania.

ABN AMRO Romania has a diversified portfolio of products, with various levels of local adaptation. Compared to other banks in the country, however, the number of products is low. The management notes that one of the strengths of the bank has been the introduction of new, innovative products on the Romanian market. It is possible however, that although the company is successful, it has not realized its full potential as it was slow to predict and react to changes in demand and competitive environment.

The company is highly centralized, with very low autonomy for the CEE subsidiaries. In fact, even the departments within ABN AMRO Romania report directly to the headquarters in Amsterdam. It is apparent that local management has only a general view of the country strategy, and various departments are uncertain as to how their objectives fit with the local strategy. Among the noted strengths are brand name, (especially with clients from the European Union operating in Romania), and personnel training and incentives. The training is organized within each department and management training takes place in Amsterdam. Among the benefits that middle and top management receive are preferential interest rates or no-interest loans, no commissions for bank transactions, and a private health plan. About 25% of the middle and top managers at the Romanian subsidiary are foreign. According to the local representatives, the bank does not have any relations with other banks or companies and is not involved in networking. It is however building its network of affiliates and contributing to other affiliates activities, exchanging employees, etc. The strategy tends to be implemented from headquarters, with a step-by-step approach on each country subsidiary, and then on each local affiliate. ABN AMRO Romania is involved in some embedding activities- it collaborates closely to the National Bank in drafting new legislation, is a member of the Romanian Association for Banks and is an active member of the Chamber of Commerce. The subsidiary also has organized a series of social programs, charity events (building houses in a disadvantaged area, Radauti, donations for orphanages, supporting financially sports activities at orphanages, donations to support recently flooded areas of the country, etc.). The bank is also actively involved in lobbying and is member of the Romanian Foreign Investors Council.

The key success factors that management acknowledges are the high quality of products, the skills of employees and the strong corporate culture based on the four principles: respect, integrity, teamwork, and professionalism. The strategy of the Romanian subsidiary has not changed from the beginning, except for minor adjustments to the initial strategy. According to the bank's representatives, there is no emergent strategy in CEE. The company has pursued a strategy of adaptation to the clients of CEE first and only secondarily adaptation to the environment. For its corporate products, the representatives consider 'stability' as essential. For the retail consumer products, the bank aims predominantly to target busy, high income customers.

Hypothesis 1: *Primary value-chain organization: given the nature of the banking sector, the company has an integrated value chain. The collaboration among subsidiaries in CEE is high and sometimes the value chains are interconnected. It is possible that this has a positive impact on the success of their operation.*

Hypothesis 2: *Degree of autonomy and corporate integration: the subsidiaries in CEE have very low autonomy and are highly integrated into the corporate structure. The management and strategy formulation and control are highly centralized. Although the bank has been successful in Romania, there is however some indication that it has not realized its full potential due to low endogenous learning. It would appear that local management has had no freedom to generate diversity and long-term benefits of more options and a greater pool of capabilities. ABN AMRO may have lost valuable local capabilities by concentrating on the transfer of their established best practice. As its market share is declining in Romania, it may become apparent that more autonomy and a more flexible strategy would have allowed it to be more proactive to developments in demand and local environment.*

Hypothesis 3: *Local capability development: ABN AMRO has pursued some knowledge acquisition in CEE, and has used that in the step-by-step implementation of innovative* *products across the region. However, in Romania, it has been slow in the active generation and development of competitive advantages. Firm-level capabilities are considered essential for success in CEE. The bank's representatives note that the subsidiaries in CEE fulfill their expectations.*

Hypothesis 4: *Embedding into the local environment: the bank's success in Romania is tied to embedding into the environment. The subsidiary has close relationships with local and national governments and is involved in reviewing new banking legislation.*

Conclusions

ABN AMRO's overall strategy is built partially on cost savings through consolidation and standardization, and a unifying, pre-established approach. Its Romanian subsidiary is a success which could be associated with nature and high growth of the industry, vertical integration, and local embedding. Although the bank has followed very closely the strategy established at entry and has fulfilled the headquarters' expectation of profit, it could be argued that it has not realized its full potential in Romania. Its reaction to a change in demand has been slow and uncertain. It would appear that the company has plans for an offensive to the rivals' actions, but the implementation of these plans is still unclear. The subsidiary has been slow to respond to a huge increase in retail banking services and mortgage and consumer loans. Whereas the more successful banks have been offering competitive products in these areas, ABN AMRO is still focused on corporate banking and has only timidly launched its other products. As a result, the bank has fallen in terms of market share recently. The company is highly centralized, with very low autonomy for the CEE subsidiaries and low endogenous learning. More autonomy and a more flexible strategy might allow it to be more proactive to developments in demand and local environment.

5.3.3 KPMG[36]- An Audit of Regional Learning

Company Background

KPMG is the global network of professional services firms of KPMG International. KPMG is a provider of audit, tax and advisory services. The company offers advisory services and has seen the CEE region and Romania as a clear opportunity.

Company Overall Strategy

As a professional company, KPMG's strategy is to build a broad knowledge base at various locations and industries and use it profitably across its affiliates. Besides its audit and tax services, KPMG offers risk advisory, financial advisory services such as corporate finance and transaction services, and corporate recovery. KPMG is present in 148 countries and has nearly 100,000 employees.

KPMG in Romania

According to the management, KPMG in Romania uses its international pool of skills, methods and know-how, benefiting from a 'balanced' multinational network which allows for cross-border advisory capabilities. One of the bases for the company's success in Romania has been the sustained staff training both locally and in International Training Centers. KPMG has been involved as an advisor for the privatization of SOEs, and it is currently anticipating EU accession effects in all its counseling. Although management interviewed has talked enthusiastically about the company success in advising on privatization matters, KPMG has not been able to secure advisory deals lately (for example, the company did not meet the pre-qualifying requirements to become involved in the large Romgaz privatization). In CEE, the company is highly involved in all organizations for lobbying, and local legislation development and overseeing. KPMG's senior partner, Victor Kevehazi is one of the directors of the Romanian Foreign Investors' Council.

[36] The main contact person for gathering information for this case is Mr. Victor Kevehazi, Senior Partner, KMPG Romania Srl, Central Business Park, 133 Calea Serban Voda, Bucharest, Romania.

Strategy Analysis

KPMG entered Romania in 1994 and currently has around 500 employees. The strategic motivation at entry was market seeking- following clients and servicing local clients (local companies, NGOs, 'new money', and governmental). The subsidiary was set up by KPMG France. It has subsequently been taken over by the regional practice (KPMG CEE). The country founder has built on the knowledge of operation in CEE. The company was not profitable while the local professional skills were developed. The subsidiary is integrated into its CEE network thru a partnership agreement and shares into the knowledge and learning effects of other operations in the region. An example is the introduction of the International Accounting Standards to Romania. KPMG in this country had no experience in working with these standards and has benefited greatly from shared information from other affiliates in the region (especially KPMG Poland).

According to the senior partner, the company is currently successful and has good profitability. Large foreign investors in Romania, such as Citi Group, Lukoil, Nestle, Elite, Brau and Interbrew are among their clients, as well as the Romanian National Bank, CEC and Electrica. Management describes the headquarters as 'well established and stable' (board members in the CEE headquarters are the senior partners in all countries), and the local operation as 'dynamic'. Interestingly however, the senior partner was unsure of future expansion in Romania. It would seem that the country founder is currently realizing his highest expectations and is ready to retire as the company enters a stage a lower growth and profitability. As a professional organization, it remains to be seen how this will affect its future.

KPMG is highly involved in embedding- the firm is working with the Ministry of Finance in drafting improvements to the accounting law, partners with a number of NGOs, and is a member of the British Chamber of Commerce as well as the French Chamber of Commerce. KPMG is also active in lobby groups and a tax committee recommending developments in taxation. Some of the firm's efforts have been however stifled, as certain laws, for example, bypassed the review of the 'Social Council' on which KPMG is a member and have become official. Embedding has become part of the firm's organizational culture- charity donations and sponsoring activities for schools-such activities are not publicized and are shared only internally. The firm is also funding the construction of a new highway (along with other French subsidiaries).

KPMG has been profitable in the last few years, as the economy improved and its recognition increased. According to management, this permitted the firm to charge 'fees for quality' which allowed it to be profitable. The senior partner noted that the firm needed to acquire knowledge before it could be profitable. The key success factor is currently considered to be knowledge. From the interviews, it became apparent that the management sees the strength as 'internal' to the company, and associates the weaknesses to the environment. It was noted that the unclear tax environment, changing laws and instances of jeopardized ownership by unclear law application and enforcement are the main reasons why more foreign investors might decide against operations in Romania. The main obstacles to the firm's activities in Romania are a step back in the law of private consultation and the 'ever-changing' taxation. The key success factors are management know-how and human capital.

Certain technical and professional aspects of the firm's strategy are driven by the local market. KPMG Romania is choosing local projects that fit the perspective at the regional CEE headquarters. The marketing, IT, and communications are highly centralized. The regional operations share some mutual expenses and subsidize each other. The local business controls the marketing to local clients and training of its employees. The senior partner noted that about 5% of the revenues are used for training every year, which he considers a necessary cost in building a professional organization. Top management has been trained in other CEE operations. Trainers from other affiliates are sometimes brought in for lower level training.

KMPG Romania does not believe that adaptation to local culture is important. They noted that the firm is keeping the pace with legal requirements; however it uses no adaptation to the local customs. As a side note, the partners at KPMG showed no appreciation for the local culture.

KPMG builds on a strong regional expertise. A team from Hungary has provided assistance for the management of the newly introduced 'effective interest rates' for banks in Romania, and the Polish affiliate has assisted in sharing anti-money laundering techniques.

The firm faces high local competition (main competitor is Pricewater Coopers). Among the obstacles, the senior partner noted that most of tenders for clients are not required to prove evidence of quality. KPMG positions the firm's services as high price, high quality, and high professionalism ('more for more'). In certain instances this positioning is not optimal in CEE. The partners also note that their competitors are more willing to accept 'high risk' clients.

The key success factors in Romania are, according to the country founder, managerial know-how and reputation. The main strength is being part of a strong CEE network of affiliates. KPMG is expanding in terms of number of clients and employees, however, management alluded to the fact that the firm has current good knowledge of the environment which may not be valid in the future as Romania advances towards EU membership. The author is unable to identify the extent to which knowledge will actually be shared across the CEE region after EU's second enlargement, and whether that will allow the Romanian affiliate to make the transition as the environment evolves. The country founder has no long term strategy for the firm as he is unsure that the firm will be able to follow (profitably) the 'steps' that Romania is taking towards a functioning market economy, a stable environment and becomes part of the European Union.

Hypothesis 1: *Primary value-chain organization: the nature of the organization and the implementation at the location makes KPMG a vertically integrated successful business.*

Hypothesis 2: *Degree of autonomy and corporate integration: although certain technical, professional aspects of the firm's strategy are driven by the local market, KPMG Romania is choosing local projects that fit the perspective at the regional CEE headquarters and marketing, IT, and communications are highly centralized. The regional CEE operations also share some mutual expenses and subsidize each other. KPMG Romania has a medium degree of autonomy for short term objectives and obtaining and managing contracts. It would seem that the long term strategy is established regionally. The Romanian subsidiary is not able to test strategy or new products.*

Hypothesis 3: *Local capability development: the Romanian business has not built significant local capability, but it has rather used capability developed regionally. The firm 'waited' for the environment to become conducive to their business model and has applied 'best practices' established for the CEE region. As knowledge sharing across the region is considered the main element of success, we note that it is the pursuit of active knowledge acquisition and incorporation across the region that makes for successful operation in each country of the CEE.*

Hypothesis 4: *Embedding into the local environment: KPMG is highly involved in embedding thru close relationships with the Ministry of Finance, the British Chamber of Commerce, the French Chamber of Commerce, the 'Social Council', and various local NGOs.*

Conclusions

KPMG in Romania uses its regional pool of skills, methods and know-how, and benefits in its success from a 'balanced' network across the CEE region which allows for cross-border advisory capabilities. It would appear that it is this shared knowledge that allows KPMG to be successful. The company is highly involved in all organizations for lobbying, and local legislation development and overseeing.

KPMG positioning as high price, high quality, and high professionalism is not always optimal in CEE, but the firm has been successful in recent years. The author notes that the local management was 'patient' in building recognition and waiting for the environment to become more conducive to its operation. The local firm has however no long-term strategy.

5.3.4 Carrefour[37]- Selling Vision for Unexpected Success

Company Background

Carrefour is the leading retailer in Europe and the second largest worldwide, with more than 11,000 stores in 31 countries. The store formats are hypermarkets, supermarkets and hard discount stores, with consolidated sales of about EUR 90.681 annually (including VAT) and 430 000 employees. The breakdown of consolidated net sales by geographic region (as of 12/31/2004) of the total of 72 668 mil euros was 7% Asia, 6.5% Americas, 37.8% Europe, and 49.2% France. By format, the breakdown of consolidated net sales is 15.7% Others, 8.1% Hard discount, 18.3% Supermarkets, and 57.9% Hypermarkets. Carrefour is active in all types of retail distribution, primarily food retailing. The Carrefour hypermarkets offer a wide range of food and non-food products with an average of 70,000 items. The supermarkets, Champion, GS, Norte, Gb and Marinopoulos offer a wide selection of mostly food products, and the Hard discounters such as Dia, Ed and Minipreço stock 800 food products, at low prices, in small stores with half of the products sold under the Dia brand name. Convenience stores include Shopi, Marché Plus, 8 à Huit and Di per Di chains of stores. Cash-and-carry and food service outlets are designed to meet the needs of restaurant and food industry professionals.

Company Overall Strategy

Carrefour is rapidly expanding the three business lines abroad: hypermarkets, supermarkets and hard discount stores. Its strategy consists of building group market share in each country by expanding the type of retailing best suited to the local market and by taking advantage of the way the three formats complement one another. The year 2004 marked a new stage in the group's strategy, with the start of the rationalization of business portfolio and the strengthening of its financial position.

The major source of growth of Carrefour Group is international, based on common trends shared by various countries. This international growth strategy is based on multi-format approach for flexibility and responsiveness; adoption of a common global strategy; and

[37] The main contact person for this case study is Mr. Nicolae Danciu, Head Office Romania, Development Manager, Hiproma Carrefour SA, 2 Tudor Vladimirescu St., Otopeni, Jud. Ilfov, Romania.

the achievement of strict profitability targets. Management believes success will come from 'sharing synergies', such as the development of Spanish textiles in Argentina, Brazil and Greece. Additionally, in 2004 there were efforts on price cuts, and expansion of loyalty programs. Carrefour identified as one of its main priorities the improvement of profitability of its international operations. The Group decided to sell off assets that were insufficiently profitable or not strategic for EUR 1 bn. As a result, for example, the Group sold off its operation in Chile, country in which Carrefour had a market share of barely 2.5% while the three main competitors held more than 40%.

In 2004, the sustained organic growth continued, with almost one new hypermarket opened per week; almost two new supermarkets opened per week; and over ten hard discount stores opened per week. In total, 914 stores were opened, of which 793 were outside France. Rolled out in every country in 2004, in hypermarkets, supermarkets and convenience stores, the "No. 1" brand represents global sales of EUR 1.2 bn. In many countries, the "No. 1" introduction scored well. For example, in Korea, although "No. 1" was only introduced in the 1st half of 2004, its percentage in sales made with mass consumption products exceeded 9% at the end of 2004. Negotiated at the European level, the "Carrefour International Products" are sold in more than 10 countries. Mass purchasing makes it possible to save on the purchase price and reduce the sale price. On non-food and for the purchasing of assets, a common electronic auction (reverse bidding) marketplace named GNX, enables individual countries to benefit from the power of the Group and significantly reduce the building costs for a new store. The Group favors the tactical acquisition of assets when they are less costly than the construction of new stores. The acquisition in Poland of 12 Hypernova hypermarkets from Ahold is a good example. In recent years, Carrefour gained market share in its 3 main countries in the area of operation. The total growth from 2003 to 2004 was 11%. However, the year 2004 remained marked by low consumption in Latin America, in spite of a slight recovery in Argentina, Brazil and Colombia.

Franchising is a development model that has performed well for the Group. Carrefour franchises are becoming increasingly multi-format. This started with the hard discount format in 2004 in France, Coop Atlantique. In France, 14 franchisees of another chain joined Carrefour in 2004. One of Carrefour's main partners is Hyparlo SA. Hyparlo's principal activity is the retail of food, non food products and basic consumables through a chain of hypermarkets. The Group is operating under a franchise Carrefour SA and has a presence in France (12 hypermarkets), Italy (2 hypermarkets) and Romania (first hypermarket opened in 2001).

Carrefour in Romania

When Carrefour planned its entry into Romania it saw an opportunity to exploit the country with few western-style shops. Its first store outside Bucharest was an unexpected success. Although Carrefour intended to open more stores, it found that there weren't enough skilled managers in Romania, and initially used expatriate managers or sent potential managers to France for training. As this proved expensive, Carrefour persuaded the French D'Auvergne Clermont University to make its management and administration diploma course available at the Bucharest Economics Academy, in a newly established French-Romanian Institute. The diploma is identical to the one in France, although students spend an additional 10 hours a week learning aspects of the Romanian business system. At the end of the course, which is taught in French, the Romanian students graduate with the same qualification as their French counterparts. Other French companies in Romania, such as Renault, KPMG and Societe Generale, are using the Institute.

The four hypermarkets operated by Carrefour in Romania have recorded a significant increase in sales (of about 83% as compared to last year, when only three stores were open). According to declarations made in 'Ziarul Financiar' No. 1683, Hyparlo will use these results to cover some of its French operations. The four hypermarkets in Romania represent 28% of Hyparlo's business. The competition in the sector is high, but dominated by Metro (Carrefour's main competitor) and Selgros. Besides these hypermarkets, there are also 20 supermarkets operating in Romania (Mega Image, Billa, La Fourmi, and XXL Mega Discount). As price is one of the main criteria on which Romanian consumers choose products, most large retailers have introduced their own brands at low prices. Over half of the revenues at Metro International (Metro Cash and Carry) are the result of selling their 26 own brands, such as Aro and Cali. The other two players, Selgros and Cora do not yet own brands in their portfolio, but have exclusive rights over the retail of certain brands and have plans for introducing their own brands. Most of the own brands (97% for Carrefour) are for Romanian products.

Although the competition is likely to intensify (Metro intends to open another store by the end of the year, as well as open new 'Real' stores; Auchan will also enter the Romanian market in the next couple of years), Carrefour's management estimates a 50% increase in sales for 2006. Carrefour follows an expansion strategy of two stores being open every year until 20 hypermarkets will be present in Bucharest and other cities of over 300,000 people (in 2006, Carrefour plans to open three new hypermarkets in Bucharest- Baneasa, Constanta and Cluj). The entire investment will be situated around half a billion euro. At present, 120 million euros have been invested.

According to AC Nielsen, approximately 33% of urban population in Romania shops in supermarkets and hypermarkets, with Carrefour holding a share of about 1/3 of this market. Carrefour and its main competitor, Metro, record high growth in Romania and other CEE countries where they are present, offsetting their low performance in the European domestic markets, France and Germany. The majority of their sales are now generated outside their markets, where consumer confidence has decreased and the retail industry is weak. Intense competition and poor economic growth in France and Germany make for the two toughest retail environments in Europe. The Romanian operations seem to be doing well in revenues, with a significant increase in the first quarter of 2005- over 60% more than in the first quarter of 2004. This increase is partially due to the appreciation of the local currency.

Strategy Analysis

Carrefour started the implementation in Romania six years ago thru its main franchisee- Hyparlo Group. Hyparlo holds franchises for around 12 Carrefour stores in France. The Romanian operation started as a joint venture between Carrefour and Hyparlo named Hiproma. On January 1st, 2005 Hyparlo bought 100% equity in Hiproma. Carrefour holds a controlling share of the Hyparlo Group. The Romanian operation currently has over 2500 employees and is the leader in the Romanian retail sector, the larger employer in Romania and the largest investor in the country. Presently, there are 4 stores in Bucharest and Brasov, with a 5th to be open in Ploiesti. The firm intends to open about 2 stores per year until it reaches a number of 20 stores total planned for Romania.

The company received incentives from the government and had strong bargaining power at its entry due to size and an 'established' business model. According to the management, the government has seen Carrefour's entry as positive for the Romanian economy in general, as it increased competition and it created opportunities for Romanian manufacturers. Currently, the firm receives no help from the government. As regards the company's success, the representatives note that it is 'a success story in Romania, on other areas than profitability'. It might be too early to assess the potential for profit at this relatively new location. The management was optimistic about the future of the local economy and remarked about significant progress as regards legislation and general administration which had positive impact on the company's operations.

The company runs its own logistics in Romania to a great extent and also works with a local company, but only a small fraction of logistics is outsourced. Carrefour Romania has contracts with a series of local producers and it runs a small operation of bread making. The firm is not involved in its suppliers' operations, but has long term contracts with them. The collaboration with other companies in the value chain is strictly 'contractual'. The author notes that due to the firm's position on the market and strong networking with pertinent institutions, most producers are 'captive' to Carrefour. Although this firm does not have 'ownership control' of other operations in the value chain, it is a value chain captain with considerable influence. Its strong network of suppliers has overcome the extensive floods which affected about 1/3 of the country' territory.

The overall strategy is that of expansion. The management noted that the market reviews previous to entry were 'skeptical', and that the local operation has been 'unbelievably successful' compared to the expectations. The business model seems to be working at the location and is one of the key success factors: price discounts, great variety of offerings, and extensive use of Romanian products (over 97% of products in the stores are made in Romania). The firm has introduced innovation in the sector, such as accepting credit cards, making deliveries, and using test banks. It is also the first large retailer of fresh poultry and fish (previously only found in Romania at farmers' markets).

The local operation has considerable autonomy in making decisions regarding its operations. The long term strategy has to be approved by the parent. The local representatives considered the high level of 'knowledge' sharing from its headquarters as one of the main strengths. The group organizes frequent seminars for sharing information on developments in accounting, legislation, etc. Only 0.01% of high and middle management is comprised of foreign (French) employees. The local employees are trained at the Romanian Institute for Management established in collaboration with a Romanian university and the Claremont Institute in France. Most promotions occur internally and the company praises itself on building a strong corporate culture based on employee empowerment. The company is highly adapted to the Romanian demand and it uses a vast majority of Romanian products and brands.

Carrefour Hiproma Romania is continuously building reputation and name recognition by sponsoring various events. The management admitted that the company is paying 'independent' news sources in order to have favorable exposure. It would seem that most French enterprises are involved in such activities, as the interviews with KPMG and Renault revealed. The firm is also a member of the French Chamber of Commerce and the Retailers Association of Romania. The company communicates with the Ministry of Agriculture for decisions regarding produce classifications and quality assessment of agricultural products. There is also involvement with the Ministry for Small and Medium Size Enterprises. Carrefour Hiproma Romania has the highest observed level of embedness- what the management calls 'total integration in the local community' includes strong networking with other French companies operating in Romania, strong relations with financial publications (for example, Carrefour 'contributes' to the Romanian Financial Times in order to have positive information published at least once a week), participation to local seminars, networking with local authorities and various organizations, such as the Consumer Protection Agency. The firm is also a contributor for the Romanian Campaign for Quality Increase, various charities, research foundations, schools, etc. In order to obtain the real estate for its new store in the city of Ploiesti, Carrefour has to develop the road and the infrastructure at that location.

Carrefour Romania has very close relationships with Carrefour operations in Poland, Turkey, Spain, Italy and Greece. As the management predicts an increase in the competition in the sector, it already has plans for counteracting rivals' moves. Management ranks the key success factors of the Romanian operation as follows: company's discount policy, human capital, product variety and the use of Romanian brands, the network of suppliers, the introduction of new products (the retailer was the first to introduce LCD and HD TV sets, MP3 players, and digital cameras) and innovative post-sale services. The representatives note that the retail sector has very good potential in Romania at the moment. The characteristics of the industry are noted as an important determinant of success. Carrefour Romania has a long term strategy in place that goes beyond 2020.

Hypothesis 1: *Primary value-chain organization: there is strong evidence that vertical integration has a positive impact on the success of operations. Carrefour Romania has a strong network of suppliers and its own distribution and logistics, which are seen as essential for the company's long term outlook.*

Hypothesis 2: *Degree of autonomy and corporate integration: although the local operation needs approval for changes in long term strategy and is currently using corporate funding, it has a medium degree of autonomy that allows for testing new products and brands. The company has retained and developed significant context sensitivity.*

Hypothesis 3: *Local capability development: the case brings evidence that successful MNC subsidiaries pursue active knowledge acquisition and incorporation. Although it is recognized that the size and industry may be important determinants of success for this firm, we note a high degree of active knowledge acquisition, as well as knowledge processing and incorporation into their operations thru specific learning outcomes.*

Hypothesis 4: *Embedding into the local environment: the company has the highest observed level of embedness- what managers call 'total integration in the local community', supporting the hypothesis of a relation between success and embedding in CEE.*

Conclusions

The case study illustrates an example of a market seeking investment with unexpected success in CEE. The local operation is the result of expansion strategy and fits perfectly with the overall firm strategy. It is also a case that brings confirming evidence for all hypotheses forwarded. It must be noted however, that the retailer benefits largely from its size and the high growth of the local industry. From all the studies reviewed, it is the only one where local representatives have a clear vision of the company's future environment and strategy and a clear set of objectives.

5.3.5 Adaptive Strategies in CEE of Microsoft Corporation[38]

Company Background

Founded in 1975, Microsoft is the worldwide leader in software, services and Internet technologies for personal computers and servers. Microsoft Corporation develops and manufactures a wide range of software, including desktop and network operating systems, server applications for client-server environments, desktop business applications and office applications for users, online programs and games, Internet and development tools. Microsoft products are sold in more than 80 countries worldwide, and are adapted to more than 45 languages. Microsoft's overall business structure is organized around its seven core business units: Windows Client, including the Microsoft® Windows® XP desktop operating system, Windows 2000, and Windows Embedded operating system; Information Worker, including Microsoft Office, Microsoft Publisher, Microsoft Visio®, Microsoft Project, and other stand-alone desktop applications; Microsoft Business Solutions, encompassing Great Plains and Navision business process applications, and bCentral™ business services; Server and Tools, including the Microsoft Windows Server System™ integrated server software, software developer tools, and MSDN®; Mobile and Embedded Devices, featuring mobile devices including the Windows Powered Pocket PC, the Mobile Explorer micro browser, and the Windows Powered Smartphone software platform; MSN, including the MSN® network, MSN Internet Access, MSNTV, MSN Hotmail® and other Web-based services; Home and Entertainment, including Microsoft

[38] Some of the information used for this case study was provided by Jan Muehlfeit, President of Microsoft Europe, the Middle East and Africa (EMEA), V. Apetrei, Investors Relations Microsoft Romania and O. Artopolescu, Director Microsoft Romania.

Xbox®, consumer hardware and software, online games, and our TV platform. Microsoft's background and its overall strategy are beyond the purpose of the dissertation. The research concentrates on the four formal hypotheses and analyzes the adaptive strategies of the company for each of the clusters set forth in the typology of CEE countries.

Among recent developments in strategy, Microsoft has been involved in high-profile antitrust cases in the US and the EU and has waged a quiet campaign to change its image from that of monopolist to good corporate citizen[39]. Microsoft has been creating a new public sector organization charged with engaging and influencing governments' technology buying decisions and has begun appointing regional and national chief technology officers (CTOs) to head its efforts. It broke out the public sector as one of its key business verticals early this year, and has ramped up investment in education, training and community projects. Microsoft has created a portal for governments to provision technology from itself and its partners, and is teaming with Accenture Ltd. to develop software and services packages for European governments in areas like e-government and public safety. The move is partially necessary for Microsoft as it wants to find future success in the crucial public sector market, which is being increasingly wooed by Linux providers. The size, scale and market access provided by government contracts is also a main impetus for a changing public sector strategy, especially in emerging markets in Central and Eastern Europe. The opportunities are large, as the 10 new members of the EU may bring e-government and modernization mandates along with considerable EU funds.

Microsoft also started a new program[40] to make the underlying code for its Windows operating system available to several governments and governmental agencies. The software company has first signed agreements with the Russian government and NATO to allow them to review for free the underlying programming instructions that Microsoft has long guarded as secret intellectual property. Microsoft is following such a strategy as government agencies in Japan, France, Germany, China and the United States

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[39] Pruitt, S., IDG News, London, 2005.

[40] 2003-01-20, International ICTD News, CNN: Microsoft To Share Windows Secret Code, Tech Giant Attempts To Woo Governments, available at http://www.cnn.com/2003/TECH/biztech/01/15/microsoft.code.ap/index.html

are considering competitors' software, including open-source Linux-based systems. Unlike Microsoft's proprietary software, the underlying code for open-source code software can be downloaded free, improved and redistributed.

Common Aspects of Strategy Across CEE

At the beginning of 2000s, Microsoft has penetrated Central and Eastern Europe, to take advantage of the high potential growth and increased research investments in the region. European Union has mandated IT investments for member countries and aspiring members. Microsoft's reasons for investment in the region are a larger profit base as well as access to vital new technology. In Romania, for instance, Microsoft has taken over the antivirus software of a local company, GeCAD Software. The program, known as "RAV," had been popular with Linux users. The deal not only helped Microsoft expand its Romanian operations, but it also helped counteract a dangerous rival and acquire locally- developed intellectual assets.

Allowing various governments to review the source code for Windows has helped the software giant win new contracts with several countries including CEE. Worldwide government contracts represent a large portion of the company's earnings, which justifies Microsoft's strategy to introduce Government Software Program.

In 2003 Microsoft has increased its activities in EU-candidate countries in CEE (such as Romania and Bulgaria), and also in countries with at least uncertain ties to the EU, like Serbia and Macedonia. Among the main challenges that Microsoft faces in the CEE are the use of already licensed software by governments and the wide-spread piracy.

The markets in CEE vary. Countries that started further behind or were delayed on the path to globalized IT are still based largely on hardware, while more modern regions have made the transition to software and services[41]. Romania, for example, one of the Eastern European countries that is quickly transitioning to software and services, has more than 2,000 software development firms. Because of the uncertain environment, many Eastern developers have concentrated on security systems, with favorable international attention. The Romanian company Softwin SRL, for example, has

[41] Halperin, D., 2003, Worlds in Transition: IT in Eastern Europe, available at www.TechNewsWorld.com (ECT News Network).

developed antivirus software called BitDefender that has won first prize at the European IST Awards. Security as well as other IT areas are innovations in the CEE countries in which Microsoft is tapping in. Microsoft is successful in CEE, although in a couple of countries where it has just entered, the company is not yet profitable. Microsoft has recorded a steady increase in revenue and is building on a medium to long term strategy for the region.

Hypothesis 1: Primary value-chain organization

Microsoft uses vertical integration thru strong relationships with its partners. It is actively involved in developing the competences of its partners and sharing pre-built solutions. The company offers 'partner learning centers' and additional training programs and events for companies in the IT that are not among the partners. The certification programs for its chain partners include 'Microsoft Certified Partner' offering support and resources to local firms supplying technologies; the new 'Microsoft – Commercial Partner'; and 'Empower Program' for small local firms developing software. For its local partners, Microsoft uses uniform criteria and a comprehensive support system. Microsoft notes that its vertical integration allows it to optimally connect clients with suppliers- 'response management thru partner'. Microsoft also offers a series of licenses to local suppliers, such as the OEM System Builder. The services and support offered to these suppliers are extensive.

Hypothesis 2: Degree of autonomy and corporate integration

Microsoft uses highly standardized methodologies for implementing its general strategies. The local subsidiaries have a medium degree of autonomy. Although there are common marketing approaches, suppliers and distributors' licensing criteria, etc., local companies are able to respond to various extents to local competitors' actions, organize and participate in events, select management, develop localized training techniques, etc.

Hypothesis 3: Local capability development

According to Microsoft management, the company pursues a high level of knowledge acquisition and incorporation. As noted earlier, a new program for the CEE is the Shared Source Initiative (SSI), allowing customers, partners, and academic institutions in the region to review some of the source code. The approach is designed to help partners build customized applications and check the security of their systems.

Hypothesis 4: Embedding into the local environment

Microsoft uses a strong strategy of embedding, establishing close relationships with governments, participating to the development of e-government and e-procurement initiatives, organizing community events, etc. These initiatives are presented in more detail for the countries chosen for further analysis.

Microsoft in Advanced Reformers: Hungary, Poland

Hypothesis 1: Primary value-chain organization

Microsoft uses the integrated value chain described in the common strategy in its operations in advanced reformer countries in the CEE.

Hypothesis 2: Degree of autonomy and corporate integration

The local subsidiaries in the advanced reformer countries in CEE have a medium degree of autonomy and are loosely integrated in the corporation, as described in the previous section.

Hypothesis 3: Local capability development

It was noted previously that Microsoft is involved in high level local capability development. An example is the Microsoft-Compaq Test Laboratory[42] in Hungary, surveying the opportunities of NET technology and testing software products based on this technology. The laboratory is available to all local clients and partners. Microsoft also chose Hungary for a new software service center[43]. The company has widened its products portfolio[44] in these countries to serve better the small business sector, such as the ERP management enhancing software.

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[42] This information is obtained from Microsoft Hungary's managing director Péter Vityi, thru the American Chamber of Commerce in Hungary.

[43] IT and Communications Minister's declaration available at http://bink.nu/Article2664.bink.

[44] Bill Gates' declaration during meeting with the Polish president, available at http://bink.nu/Article3258.bink

Hypothesis 4: Embedding into the local environment

The high level of local embedness in CEE is evident in Microsoft's networking with local governments in establishing common initiatives. An example is the Polish Ministry of Economy and Labor's use of Captaris Workflow to create an information portal based on Microsoft Content Management Server. The information portal serves as a single gateway for a wide range of Internet users to access the ministry's information and knowledge base, as well as information about the European Union Structural Fund. The project was completed in February 2005. Another program, Microsoft's Government Security Program (GSP) was launched in January 2003, and enables participating governments and international public organizations to gain controlled access to the source code of Microsoft's Windows operating system and to additional technical information necessary to examine, assess and improve the state of security of their Microsoft Windows platforms. In advanced reformers, as well as other CEE countries, Microsoft is involved in activities of spreading IT in schools[45].

Microsoft in High Intermediate Reformers: Romania, Bulgaria

Microsoft has recorded among the highest success at high intermediate reformer locations, however there are variations. Microsoft Romania is among the most successful operation in CEE. In the first half of 2004, the company has grown 16% from 2004, with a growth rate of 56% from the start of business in 1996. The largest revenue growth has been recorded by the Microsoft Business Solutions.

Hypothesis 1: Primary value-chain organization

Microsoft Romania is actively developing a strong and close value chain. The company is using a network of licensed and/or certified suppliers, retail distributors, OEM distributors, etc.

Hypothesis 2: Degree of autonomy and corporate integration

The local subsidiaries in the high-intermediate reformer countries in CEE have a medium degree of autonomy and are loosely integrated in the corporation.

[45] 2003 Polish Embassy Bulletin, Bill Gates Meets Polish Leaders, available at http://www.polandembassy.org/News/Biuletyny_news/p2003-10-16.htm

Hypothesis 3: Local capability development

Microsoft Romania's management is currently in charge of the newly formed Microsoft South-East Europe. The subsidiary has worked closely with other local firms in consulting, utilities, financial services, telecommunications and media, in order to increase its local capabilities. The company has projects that develop local content, such as the Government Gateway, and the partnership with two local prominent banks (Bancpost and Banca Comerciala). Microsoft Business Solutions has developed a localized version of Navision 3.60 as an integrated solution for management.

Over 100 locally-developed software applications have been attested by Veritest, the global organization that tests software on Microsoft platform. From this respect, Microsoft Romania's local capabilities development is ahead that of Microsoft in Poland, Czech Republic and Hungary. As mentioned earlier, Microsoft Romania has acquired the intellectual and the antivirus technological assets of the local GeCAD Software Srl. Microsoft's acquisition of GeCAD's technology will help secure customers within and outside the CEE by providing antivirus solutions for Microsoft products and services. In addition to developing new solutions, Microsoft will use the GeCAD engineering expertise and technology to enhance the Windows platform and extend support for third-party antivirus vendors.

Hypothesis 4: Embedding into the local environment

The strategies and success of Microsoft's local embedding vary among these countries. For example, members of the Bulgarian government and the Internet Society have sent allegations to the Competition Protection Commission (CPC) that Microsoft Bulgaria and Microsoft Corporation of the US have violated the Competition Protection Act with the construction of the web portal for the Bulgarian government e-gateway. The site is designed and constructed by Microsoft Bulgaria. In order to access the services on it, users are forced to have the operation system Microsoft Windows[46].

Evidence of embedding are the sponsoring of local students at educational international competitions ("Partners thru Education"); the introduction of the GESCO management system for higher education institutions; the sponsoring of the Windows Embedded Student Challenge; the organization of various events for sharing IT advances

[46] Government declarations are available at http://www.socialrights.org/spip/article617.html

(such as Business Intelligence and the Independent Software Vendors Seminar in 2004, etc). Microsoft Romania has been active in protecting its intellectual assets such as Developer (in 2004 Microsoft Romania sued two local companies, SC Mega Tech 2001 SRL and SC General Marketing Serv SRL for illegal use of intellectual property). Although the embedding activities are more 'aggressive' in Romania, such activities are present in all other countries in this cluster. For example, in Bulgaria, Microsoft promotes IT education development in schools[47], partnering with the Minister of Labor and Social Policies, the Minister of Education and Science and the ICT Development Agency. The Bulgarian government and Microsoft have a contract from 2002 for the provision of software to the state administration. As part of this agreement, Microsoft Bulgaria will provide about 1,000,000 US dollars to build a national network for the training of 30,000 civil servants in computer skills[48].

Microsoft in Low Intermediate Reformers: Russia

Russia might be emerging as a prime opportunity for high-tech companies as it is positioned at the center for technology development and outsourcing. Notable IT investments in Russia include the antivirus specialist Kaspersky Labs and Sea Launch, a Russian-Ukrainian-Norwegian-U.S. joint venture that launches rockets from a platform on the equator for commercial satellite deployment. Several venture capitalists have begun to place IT investments in the country recently.

Among its operations in low intermediate CEE reformers, Microsoft Russia has had disappointing results. In the year 1999, the total sales in Russia and the CIS states dropped 38% from the start of business[49]. Microsoft Russia supports Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Although the company dominated the Russian

[47] American Chamber of Commerce in Bulgaria to Help Develop IT Education in Bulgaria, available at http://www.amcham.bg/cgi-bin/e-cms/vis/vis.pl?n=000010&p=0003

[48] Government declarations available at http://www.government.bg/English/Priorities/Administration/2002-06-14/671.html

[49] Humphreys, B. (September 23, 1999), Microsoft Russia Sees Sales Fall 38%, Moscow Times, available at http://www.themoscowtimes.com/stories/1999/09/23/036.html

market since 2000[50] and sales have increased substantially, the subsidiaries are not successful in terms of profitability.

Hypothesis 1: Primary value-chain organization

The company uses the same system of licensing and certifying suppliers of software as it does in the high and intermediate reformer countries in the CEE and builds close networks of distributors. However, in low intermediate reformers, the number of such partners is much lower.

Hypothesis 2: Degree of autonomy and corporate integration

The Russian office has slightly lower level of autonomy as compared to the subsidiaries in advanced and intermediate reformer markets in CEE. However, the local firm organizes its own networking events with local governments, education institutions, etc. Managers are local.

Hypothesis 3: Local capability development

Microsoft Russia is pursuing local capability development recently and is nurturing partnerships for research and development. An example is the use of the local Data Art's R&D center for developing new and optimizing existing client relationship management systems[51]. Microsoft has also released a low-price version of Windows in Russia in an effort to wean consumers off pirated software and Linux. Windows comes preloaded on authorized PCs. Microsoft does not sell the software separately in stores in this region[52].

Hypothesis 4: Embedding into the local environment

Same as it did in the high and intermediate reformer countries in CEE, Microsoft had provided the programming code of its Windows operating system to the Russian government. Russia was the first country, after the US, to be given the source code as part of the software giant's new Government Security Program.

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[50] SpyLOG: Microsoft Dominates Russian Market (Nov. 2000) available at http://www.nua.net/surveys/index.cgi?f=VS&art_id=905356184&rel=true

[51] Information available on the DataArt website at http://www.dataart.com/company/press-center

[52] Information on the limited version of Windows is available at http://www.pcworld.com/news/article/0,aid,117942,00.asp

Microsoft in Slow Reformers: Belarus, Ukraine

Microsoft sales in Ukraine grew 81% in 2003, which is a recent success given the slow growth of the company in this cluster of countries[53].

Hypothesis 1: Primary value-chain organization

The company uses the same system of licensing and certifying suppliers of software as in the high and intermediate reformer countries in the CEE and builds close networks of distributors. However, in slow reformers, the number of such partners is much lower. For example, BelSoft is the only certified partner in Belarus.

Hypothesis 2: Degree of autonomy and corporate integration

Microsoft Ukraine has, like the Russian office, slightly lower level of autonomy as compared to the subsidiaries in advanced and intermediate reformer markets in CEE. There are however clear local initiatives on the part of the management.

Hypothesis 3: Local capability development

Microsoft Ukraine has been developing local capability development, particularly recently. The company partnered with local UNA Corporation to build a new antivirus program. Ukraine agreed to acquire 120,000 licenses for Microsoft Windows and 120,000 licenses for Microsoft Office by the end of 2006[54].

Hypothesis 4: Embedding into the local environment

Microsoft is pursuing embedding into the Ukrainian environment and has close relations with national authorities. The Ukrainian government, at Microsoft's request, has launched an anti-piracy campaign in 2002; however the company was forced to stop taking legal measures on computer clubs and Internet cafes, which used unlicensed Microsoft software, as they were unable to buy copyrighted versions. In an arrangement between the Ukrainian government and Microsoft, the government institutions are granted licenses for the Microsoft software that they are already using for the 2005-2007 period under preferential pricing conditions.

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[53] Excerpt from USDOC Export Assistance Center documents, also available at http://strategis.ic.gc.ca/epic/internet/inimr-ri.nsf/en/gr121591e.html

[54] Information available at http://business.newsforge.com/business/05/06/20/2057245.shtml?tid=110&tid=132

The Association of Ukrainian Banks (AUB) and Microsoft Ukraine have agreed on the start of a three-year program for the banking sector aimed at licensing of Microsoft software products. The program offers better licensing terms than standard corporate ones[55]. Similar actions can be seen in Belarus[56]- Microsoft's CIS operation started a project to modernize the corporate server system of the National Bank of Belarus in 2002. The firm plans to renew both corporate network hardware and install Microsoft Windows 2000 on all bank servers, along with Microsoft Exchange Server 2000, SQL Server 2000 and ISA Server 2000.

Microsoft in Transition CEE Countries Affected by War: Croatia, Macedonia

In 2003, Microsoft entered Macedonia with interests in "strategic partnerships" with the government, and cracking down on unlicensed software[57]. The fundamental goal for Microsoft in Macedonia (and neighboring Serbia, where it started operations recently) is introducing "e-government solutions." This office supports the markets of FYRO Macedonia, Albania, and Kosovo.

Hypothesis 1: Primary value-chain organization

Microsoft in these countries follows the same vertical integration thru close relationships and networking. In Macedonia, the company uses Assistance for Software Developers Program[58]. Although still small, the Independent Software Vendor (ISV) Development Center provides the infrastructure and resources to help software developers create innovative new products and services and bring them to market.

Hypothesis 2: Degree of autonomy and corporate integration

Microsoft in these countries has lower level of autonomy but there are some local initiatives on the part of the management. All management is local.

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[55] Ukrainian News, Ukraine Now Website available at http://www.ukrnow.com/content/view/5248/40/
[56] Doroshevich, M., 31/05/2002, Microsoft Signs Deal With National Bank Of Belarus available at http://www.e-belarus.org/news/200205311.html
[57] Macedonia: Quietly, Microsoft Arrives In Macedonia (Updated), available at http://www.balkanalysis.com/modules.php?name=News&file=article&sid=144
[58] Information available at http://www.usembassy.hr/usaid/whatsnew-developers.htm

Hypothesis 3: Local capability development

There is some local capability development in the countries affected by war. As mentioned above, the Independent Software Vendor (ISV) Development Center provides the infrastructure and resources to help software developers create innovative new products and services at the location.

According to the 2003 agreement between Microsoft and the Macedonian government, Microsoft employs its standard method of localization in Macedonia, which includes control by domestic language experts.

Hypothesis 4: Embedding into the local environment

There are some actions of local embedding, although the extent is much less than in the other countries. Microsoft has partnered with USAID in a program for the development of Croatia's Information Communication Technology (ICT) industry. Microsoft is also a partner and a sponsor of a joint project initiated by the Ministry of Culture of the Republic of Croatia and the Open Society Institute-Croatia that aims at pooling available information resources on Croatian culture[59].

In 2003, the Government of the Republic of Macedonia signed a contract for Strategic Partnership with the Microsoft Corporation, which includes strengthening of legal protections on intellectual property, complete legalization of the software used by the Government, and Microsoft's investment of USD 6 mil in the country, thru localization of their products into Macedonian and Albanian language, and transfer of technological and business know-how to 20 chosen Macedonian companies. Government employees will be allowed to use the workplace software at home, and Microsoft will donate 6,200 more licenses to educational institutions.

Conclusions

The evolution of strategy for Microsoft in CEE shows gradual entry and establishment in the advanced reformer countries and high intermediate reformers followed by entry into the slow reformers and the countries affected by war. Microsoft is counting on future success in the crucial public sector market. The size, scale and market access provided by government contracts is a main impetus for a changing public sector

[59] The portal is available at http://www.culturenet.hr/v1/english/about.asp

strategy in CEE, which offers significant opportunities. European Union has mandated IT investments for member countries and aspiring members. Microsoft has extended operations in the EU member countries, in EU-candidate countries in CEE (such as Romania and Bulgaria), and also, more recently, in countries with uncertain ties to the EU, like Serbia and Macedonia. It would appear that the reasons for its investment in the region are a larger profit base as well as access to vital new technology. The markets in CEE vary. Countries that started further behind or were delayed on the path to globalized IT are still based largely on hardware, while more modern regions have made the transition to software and services. The latter group of countries offers great capability development opportunities.

Microsoft uses vertical integration thru strong relationships with its partners. It is also actively involved in developing the competences of its partners and sharing pre-built solutions. Although the integration efforts are clear in all CEE countries, the number of partners vary, with higher numbers in the countries that have a more advanced IT sector. In general, Microsoft's subsidiaries have a medium degree of autonomy, but the autonomy varies across countries. In slow reformer and countries affected by war, there are lower levels of autonomy. The company follows high level of knowledge acquisition and incorporation and a strong strategy of embedding, establishing close relationships with governments and participating in the development of e-government and e-procurement initiatives. Microsoft does not appear to have significant emergent strategies in the CEE. The empirical findings show that the company has a clear and established strategy for the region, which is consistent at all locations, although the tactics might be different. This case study across CEE typology of countries strongly supports all main hypotheses.

5.3.6 A Different Perspective: A Governmental Institution's View on MNCs Investing in CEE

The 'Authority for State Assets Recovery'[60] (AVAS) is a Romanian institution that is currently selling the remaining state-owned assets and monitors post-privatizations. The institution has completed contracts and negotiated terms with a number of multinationals and has a unique perspective on what these companies pursue in Romania. During interviews with employees of AVAS they asserted that, although the institution sets sometimes strict technical, environmental, cleanup and working capital requirements, these terms are sometimes not respected after a sale and often foreign firms bid higher than they can afford for local companies. This makes for complicated renegotiations post-privatization.

The stages in AVAS privatization are as follows: letters of intention from firms, privatization announcement from AVAS, paperwork completion, privatization committee decision, and negotiating the contract. After further consideration, the author found the process as cumbersome and intimidating. Companies that have excellent prospects and good offers are not qualifying as they do not complete all paperwork in the exact required format. For example, in the biggest privatization currently taking place in Romania, BCR (Banca Comerciala), Citigroup was disqualified due to incomplete paperwork. Citigroup had however the strongest offer.

It was noted that some firms are not seriously considering developing successful operations in Romania. AVAS faces a difficult task as remaining state owned enterprises are the ones with high debts, firms in agriculture, research companies or companies that need to be liquidated. The more difficult privatizations are those of research institutes, as their only valuable assets are the fixed assets. AVAS is not the only organization involved in privatization. OSPI (Oficiul de Stat pentru Participatii in Industrie) is representing the Minister of Industry and is in charge of privatization and regulation of utilities and communications. Other Ministries (such as the Minister of Health) are involved in privatization of SOEs in their field. Sometimes AVAS acts as a liaison between firms and other organizations involved in privatization. The level of

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[60] The main contact person for AVAS was Mr. Viorel Dinu, Counselor to the President, Authority for State Assets Recovery, Government of Romania, 50 Cpt. Av. Alex. Serbanescu St., Bucharest 1, Romania.

relationships that AVAS maintains with companies is supposed to be limited to administrative and monitoring relations. Post-privatization seems to be a large fraction of AVAS' activities. This organization will have its activity terminated as privatization and post-privatization administration are complete. AVAS was founded to signal the end of privatization and to efficiently expedite remaining privatizations and administer post-privatization. Interviewed firms consider that AVAS delays activities as its employees (state servants with relatively high wages and benefits) do not want to lose their positions.

AVAS is seen as an institution dominated by members of the governing party as well as the Hungarian minority representative party. As such, AVAS has taken controversial decisions- such as the latest decision to name one of the sons of a prominent member of the latter as director of one of the largest SOEs in the paper processing industry- Celrom. AVAS has a history of intervening strongly in the management of existing SOEs with radical resolutions, changing entire top and middle management on 'political' criteria, etc. AVAS is currently involved in the privatization of CEC, BCR and the state-owned electric company (Electrica SA). AVAS has taken over or discarded some companies' high debts, taxes, and penalties which are being transformed in state-issued titles on the local market by the Ministry of Finance. Electrica SA's privatization has so far gone smoothly, with Enel and E.ON taking over parts of the company according to location. E.ON is integrating the Southern and Eastern division of the company into its Czech operation.

The counselors at AVAS noted during interviews that adaptation to the local environment is a fundamental requirement for successful operation in CEE. Part of this adaptation is flexibility to changes. For example, AVAS used to negotiate with companies the level of debts to be taken over by the governmental institutions. All facilities of this nature have been recently halted, partly because of legislative requirements imposed by the European Union. The AVAS representatives would advise MNCs' subsidiaries not to use global business models, but rather regional and local models. Local capability development was also considered as an essential factor for success. The main aspects of the local environment that affect multinationals' decisions to invest in Romania were noted as the 'continuously changing legislation'. The observed dominating motivation of MNCs is market-seeking. The representatives of AVAs do not consider embedding in the local environment important for success. The representatives could not comment on extent of vertical integration and degree of autonomy from parent firms.

5.3.7 A Recent Trend in Value Chain Organization: Business Process Outsourcing in Central and Eastern Europe

Evidence suggests[61] that many of the companies that invested in the CEE region are deepening their presence by using and supporting local suppliers. There is also a trend towards investments in business services as EU-established MNCs locate various functions in CEE, from invoicing to advanced research and development. Although the CEE outsourcing wave is not as big as those in India or China, it is significant, especially for EU-based companies. Most of the outsourcing occurs in high and intermediate reformer countries (the countries in the EU and the accessing countries).
Accenture is one of the companies which have established outsourcing activities in CEE. The company also runs outsourcing centers as businesses earning revenues for other MNCs. Other examples are Capgemini and IBM. Some MNCs are outsourcing their own internal services to new in-house centers, such as Lufthansa, Citigroup, Deutsche Post, and General Electric. The choice of outsourcing in the CEE is motivated by the relatively low cost skilled labor, but also by cultural understanding within Europe, and geographic proximity. The trend of outsourcing shows a solid increase, with Romania, Bulgaria and Russia as new attractive locations. Business Process Outsourcing has grown 4.5% in 2004. According to Gartner Research, most companies use outsourcing for transaction-intensive processes (payroll, card processing and claims processing) as well as enterprise processes such as human resources, finance, accounting and procurement. It would thus appear that relatively more companies outsource their support activities in the value chain.

Poland is among the world's 10 most attractive offshore outsourcing locations, according to a recent report from business consultancy AT Kearney[62]. Czech Republic

[61] Financial Times Report - Investing In Eastern & Central Europe, September 2004.
[62] As reported by Polish News Company, Polish News Bulletin, July 6, 2004.

and Hungary also have excellent potential for further expansion of MNCs wishing to shift work to counterparts in CEE. Recent developments[63] show the great potential that other countries have in outsourcing. TechTeam Global, a worldwide provider of information technology and business process outsourcing support services, bought Akela Informatique SRL, the premier provider of custom software solutions and off-shore development center outsourcing services headquartered in Bucharest, Romania. In addition to providing software product design services, Akela supplies application development, migration, implementation, and maintenance support for its more than 200 clients in Romania, France, the United Kingdom, Switzerland, Belgium, Italy, Sweden and the United States. Founded in 1998, Akela also implements human resource information systems, integrated management systems, and document management systems, and has been a Microsoft Certified Partner since 2000.

The main determinants of outsourcing location choice are competitive infrastructure costs, a stable business environment and a strong education system. Financial Services leads other industries, accounting for 34% of outsourcing deals globally. This sector also leads the adoption of BPO within Europe- with 46% of deals in 2004[64] and 68% by value.

Industry analysis of outsourcing suggests that this trend will take longer to come to its full potential in Europe. A recent Forrester report[65] shows that growth until 2004 has been suppressed by poor economic growth in Europe's major economies, and there was a surge in pent-up demand in late 2004 and early 2005. According to this report, as a share of European IT services spending, outsourcing would grow from 29 percent in 2002 to 43 percent in 2008. Gartner Dataquest, in an analysis of market trends in outsourcing of business processes, forecasts a compound annual growth rate of 9.6 percent of outsourcing in Europe between 2002 and 2007.

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[63] PR Newswire US, October 3, 2005, TechTeam Global Announces Acquisition of Akela Informatique SRL in Bucharest, Romania; download thru Lexis Nexis.
[64] M2 Communications Ltd, M2 PRESSWIRE, July 23, 2004 download thru Lexis Nexis.
[65] As reviewed in European Affairs, Spring 2004, European Perspectives, P. Riddell, Anger Over Outsourcing Is Less Strong in Europe.

A.T. Kearney notes[66] that most US companies have operations in CEE countries such as the Czech Republic, Romania and Slovakia as "offshoring" (proprietary facilities), rather than "outsourcing" to a local company. The main obstacle that US companies find to outsourcing in CEE is a gradual loss in competitive advantage as labor costs increase. The investment in service centers designed to carry out work for clients in the EU and beyond is a new element. The relocation of sophisticated business services seems to become an important aspect of globalization for Europe. For companies that carry out business process outsourcing for others in Poland, Czech Republic and Hungary - including Capgemini, Accenture, IBM- the Central European services centers fit into global networks, which usually also include India and China. For example, Capgemini runs outsourcing bases in Bangalore (India), Guangzhou (China), Toronto (Canada) and Dallas (US) as well as Krakow. It is noted that simpler jobs such as data processing are carried out in China while more complex tasks involving client contact are performed closer to the customer. The networks frequently serve European- based clients but have global links as well. For example, one Texan utility company using Capgemini divides its account management functions between Dallas, Krakow and Bangalore.

[66] Quote in Wall Street Journal. (Eastern edition). New York, N.Y.: Sep 8, 2004, S. Covel, Eastern Europe Stakes Its Claim As Just the Right Site for Growth.

CHAPTER 6 DISCUSSION OF FINDINGS AND CONCLUSIONS

The dissertation is built upon a theoretical framework assuming that companies develop consistent routines and behaviors in order to adapt to the environmental complexity at the location where they operate. The dynamic environment in Central and Eastern Europe may serve as an incubator for new and innovative strategies with global applicability. The large scale development of a market in each of the countries in the CEE region is a rare opportunity for building a theory of winning and losing patterns of adaptation to a complex environment. The multinationals' strategies in this region may provide a view into new frameworks that ensure success. Whereas some firms' logics and patterns of adaptation impact performance positively, others limit options and create perceptual blind spots that restrict the ability to adapt to the environment. The results of the research reveal patterns followed by successful companies in Central and Eastern Europe, with valuable findings for academics as well as managers. Explanations of the impact of various tactics and routines are provided. The outcome is a comprehensive and realistic analysis of organizational adaptation to complex environments.

Strategic Themes and Governing Logics of Adaptation

As presented in the table below, it can be inferred upon statistical and analytical generalization that there seems to be a relatively clear demarcation of adaptation patterns for multinational companies that are successful in Central and Eastern Europe and the multinationals that are unsuccessful at this location. Successful companies start with a strong strategic theme and add new features as they acquire knowledge of the local environment. They benefit from robust capabilities that the MNCs already have as well as entrenched routines of learning and knowledge possession. Successful companies are flexible and maintain a limited number of strategic options open and are quick to divest peripheral projects. They evolve from proficient enterprises into proactive as they become capable to incorporate acquired local knowledge in a strategy of "flexible preemption" of the environment. Unsuccessful subsidiaries start with a broader set of strategic themes and options and build their strategy "at location". They rationalize their experiences with the environment and attempt to prevent and solve perceived problems, as a measure of protection. They start with a "thin" strategy and endeavor to build a substantial strategy that fits the environment and its opportunities. These unsuccessful companies' strategy is one of "environmental rationalization".

Figure 3. MNCs' Strategies and Their Adaptation Performance Strategy

STRATEGY	**"FLEXIBLE PREEMPTION": PROFICIENT TO PROACTIVE** ONE STRONG STRATEGIC THEME WITH NEW ELEMENTS ADDED IN TIME LOGIC OF SIMPLE RULES AND A BOUNDED OPTIONS SET	**"ENVIRONMENTAL RATIONALIZATION": THIN TO SUBSTANTIAL** TWO OR MORE BROAD STRATEGIC THEMES WITH TACTICS REFINED AT LOCATION LOGIC OF PROBLEM SOLVING
ADAPTATION PERFORMANCE	**SUCCESSFUL**	**UNSUCCESSFUL**

Source: Author's own.

A general conclusion is that winners evolve and develop not only as environmental forces allow them, but also thru their own products and ideas. Successful companies have a strong strategic theme that they follow from entry and to which they add new elements in time. They have 'a simple rules logic', are flexible and quick. Unsuccessful companies have two or more weak strategic themes at entry and develop new ones locally. They follow a 'problem solving logic', learn little from the past and are slow to anticipate the immediate future.

Strategies of Adaptation to Complex Environments

The general observations regarding strategy and dominant logic of successful and unsuccessful companies ties into the patterns of value chain approach, degree of autonomy, local capability development and local embedness. The table below shows the main observed patterns, and is followed by a discussion of the concluding findings for the hypotheses advanced in the dissertation.

Figure 4. Strategies of Adaptation for Successful and Unsuccessful Companies

Level of success/ Hypotheses	*Strategies of Successful Companies in CEE*	*Strategies of Unsuccessful Companies in CEE*
Value Chain Integration	**PRAGMATIC FORMALIZATION** Value Chain Integration thru Cooperation with Partners, Suppliers and Distributors, with "As-Needed" Formalization	**DEFENSIVE FORMALIZATION** Integration thru Ownership or Highly Formalized Relationships in the Value Chain
Degree of Autonomy	**FLEXIBLE CENTRALIZATION** Medium Autonomy from Parent in a Centralized but Flexible Structure	**COMMITTED CENTRALIZATION** Low autonomy and Persistent Engagement from Parent or **ENDLESS ITERATIONS** High Autonomy and Continual Iterations on Losing Structures and Pursuits
Local Capability Development	**CAPABILITIES RECOMBINATION** Strong Initial Capabilities and Dynamic Capability Built on Parent Level Competencies	**CAPABILITY EMERGENCE** Incremental Capabilities Built on Unsure Overall Competencies Unrelated Capability Development
Embedding in the Environment	**EFFICIENT AND DIVERSE EMDEDDING** Establishing Non-redundant Contacts in a Network with Permeable Boundaries	**HIGH LEVEL EMBEDDING** Establishing Strong Ties to Governments and Governmental Institutions "Relationship Trap"

Source: Author's own.

Hypothesis 1 Discussion: Value Chain Management

The research finds that value chain integration is in fact a matter of formalization of relationships with suppliers and distributors. The level of integration varies and is sometimes related to the nature of the industry or local channel development. The formalization reasoning is what differentiates successful from unsuccessful companies. Successful subsidiaries have cooperative-type relationships with other members in the value chain and formalize these relationships on an "as needed" basis for practical or legal reasons. They are more inclined to work on common solutions and share information. Unsuccessful subsidiaries have a defensive approach in their relationships with other members of the value chain. They control, audit, and formalize relationships as much as possible. These companies are more protective of their knowledge and view contracts as an enforceable way of doing business.

Hypothesis 2 Discussion: Degree of Autonomy

Successful subsidiaries in CEE have a medium degree of autonomy or are somewhat centralized organizations. Most companies in this category find a balance between centralization and flexibility. They have formalized routines for key processes, and some standardization of their operations. Subsidiaries have freedom to experiment with an accepted option set and innovate, but are discouraged to pursue projects with high risks and/or low performance. Two opposite characteristics can be observed for the unsuccessful subsidiaries. They either have high autonomy and pursue various and often unrelated opportunities in the environment, or they have very low autonomy, and are centralized and committed to a strategy defined at the inception. Both types of unsuccessful companies are persistent in their choices. The subsidiaries with high autonomy constantly try new things while persevering in developing the existing choices. They iterate on strategies that do not work. The subsidiaries with low autonomy are persistent in their commitment to the initial strategies.

Hypothesis 3 Discussion: Local Capability Development

Successful companies are observed to develop dynamic capabilities that reconfigure the main competencies to address the changing environment. They mostly start with a strong set of firm-level capabilities and re-combine or expand capabilities as the environment allows or requires. These successful businesses align resources and integrate locally-developed capabilities with existing ones and overall strategy. In the case of unsuccessful companies, two patterns could be observed. Some companies start with somewhat weak firm level capabilities developed elsewhere and cultivate CEE capabilities close to existing ones. They engage in "local searches" that provide them with knowledge close to what they already know. Local searches result in inertia and path-dependent behavior that limits options and strategic alternatives. A restricted search area is limiting the subsidiary's potential. A second pattern of unsuccessful adaptation is that of companies that start similarly with a weak set of capabilities and then take 'long jumps' in their searches. The subsidiaries in this category take on projects that are unrelated with their activities or pursue plans that do not fit into overall objectives. They look for new opportunities that may give them an "edge" in unrelated industries, and are involved in an exaggerated search to increase strategic options and diversity in their operations and structures. As opposed to the first category of unsuccessful enterprises engaging in projects close to their knowledge, this second group of unsuccessful subsidiaries takes on tasks that are a great departure from the knowledge base. Although such a strategy provides them with a diverse set of options, most of them do not have the ability to incorporate the new knowledge and fledgling capabilities into their core competencies.

The need for strong firm level capabilities for MNCs entering the CEE region suggests that successful companies benefit from existing and repeated routines and patterns of learning in building organizational capabilities. They already have patterns of active knowledge acquisition and incorporation and routines that can be replicated at different locations to recombine capabilities and integrate new ones with existing knowledge. Across the CEE these organizational processes and routines become more refined and reliable thru repeated application. For successful companies, local capabilities are not an achieved stage of knowledge possession that allows for "normal" operation, but rather drivers and outcomes of a continuous process of adaptation.

To the contrary, unsuccessful companies work towards the emergence of local capabilities that might have the potential to be a major source of innovation. As most of them have somewhat "timid" applications of their capabilities, the companies' management anticipates that the new opportunities in CEE will grant strong local capabilities development that are sometimes a departure from the firm's existent position and strategy. They count on the emergence of strong and established (versus dynamic) local capabilities, but do not have the background of organizational innovativeness to nurture them. It is possible that emerging capabilities are influenced by path-dependent effects. Weak initial capabilities and unsure knowledge incorporation matter in the emergence of new capabilities. It is possible that some firms in this situation may "catch up" thru intensive capability-building efforts and establishment of knowledge incorporating routines. Such "investments in learning" could be worth making although benefits may not occur instantly.

Hypothesis 4 Discussion: Embedding in the Local Environment

A characteristic of networking for the successful firms is that of "efficiency". These companies invest mostly in relationships that provide non-redundant contacts in their industry, location and country. This might suggest that it is diversity rather than intensity of embedding that leads to successful operation in CEE. Maintaining relationships with various partners, business organizations, local and national governmental institutions and governments may be costly and difficult. Relationships with entities that directly impact operations may lead to better performance. Pursuing effective networking that is closely related to the business and its outcomes avoids the intricacy of a complex network of relationships.

The findings suggest that successful companies are building contacts with other firms and organizations in the field, as well as local non-profit entities, rather than governments and their various institutions, as the unsuccessful companies do. This might be explained by the fact that governments in CEE are somewhat fickle, with changing and sometimes conflicting partialities. They could add to the risk of operations. Close relationships with governments may also insulate companies from learning to adapt and prevent them from making innovative "searches".

The case studies suggest that successful firms strike a balance between size of their network of contacts and the diversity that it entails. A well diversified but bounded network provides sufficient access to new information and enough possibilities to affect mechanisms of change (e.g. amendments in legislation, new privatizations, etc.). A large network of contacts may provide the same information and similar opportunities but at a higher cost to the firm. It became clear that some of the unsuccessful firms (such as Balli and Daewoo, for example) as well as other companies that have fallen behind their competitors in recent years have strong ties with high-level authorities and largely ignore other information search patterns. This inertia may produce a "relationship trap" that acts as a disincentive for pursuing other contacts and isolates a firm from searching outside the tight boundaries of the existing social network.

The pattern is observed not only for an unsuccessful company's external networking (embedding into the local external environment) but also for its "internal" networking with members of the value chain. It is noted in the discussion of the previous hypothesis that peripheral subsidiaries seek formalized relationships with their partners based on established norms. The existence of these strong norms limits a company's options and prevents it from innovating and searching for better alternatives. Any deviation from established norms has a negative impact on the operations that most unsuccessful firms find hard if not impossible to overcome.

Dissertation Conclusions

The dissertation investigates MNCs' strategies to cope with resilient components of the idiosyncratic transition environments in CEE (such as embedding and drawing advantages from regional deficiencies) as well as strategies to react to dynamic components of the environment (such as knowledge acquisition and building or improving value chains). The research argues the appropriateness of a business model that allows for local responsiveness and relates successful implementation of strategies to local autonomy and combination of resources across company network. The theoretical foundation brings an integrative view across three main areas: internalization, the evolutionary perspective of the multinational enterprise and organizational adaptation. The dynamic environment in the region is viewed as an incubator for new and innovative strategies. The assumption is that of "accumulated wisdom" at the location, however the adaptive strategies are viewed to be either positive (successful adaptation) or negative as a result of complexity and imperfect foresight.

The characterization of the transition context in CEE is the starting point of the analysis. The dissertation adopts the view of transition as "transformation", a process with distinctive starting points, various courses of progress and significant differences in final outcomes. The uniqueness of the economic and social environment in the region is argued as an result of frequent changes in institutions and industrial structures, wide-spread traditional value systems, the existence of thin or illiquid capital and labor markets, growing integration with the European Union and the persistent role of governments. The mechanisms of transition are classified as path dependence on initial conditions such as level of development and economic distortions, transformation in sectoral reallocations and macroeconomic stabilization, reinforcement from foreign investments and convergence towards West European structures. These mechanisms are argued to be present in various extents across the region.

A thorough review of the existent literature shows previous research focus on governmental incentives, entry modes and their impact on performance, as well as more recent focus on multinational companies' motivations, significance of first mover advantages and transaction costs, importance of networking and companies' performance and growth in CEE. The literature review identifies the areas of research lacking in focus or consistency, such as the current effects of strategies of networking, optimal autonomy level, degree and nature of knowledge acquisition and local embedding. These strategies are investigated in the dissertation within a framework that analyzes the major responses to complexity in CEE from two perspectives: strategies that attempt to reduce complexity by bringing it under apparent control (complexity reduction strategies) and strategies of participation in local relational systems (complexity absorption strategies). Four formal hypotheses consider that both types of strategies lead to increased performance of the MNCs' subsidiaries in CEE and alternative hypotheses suggest how these strategies could increase transaction costs and level of variance in companies' practices, thus leading to lower performance. The formal hypotheses investigate vertical integration as a positive impact on adaptation performance, a medium degree of autonomy as part of a successful company's approach, the pursuit of knowledge acquisition and incorporation as a positive impact on success and the fact that successful MNCs follow a strategy of local embedding. The methodology is based on a two-level research design and statistical and analytical generalization. The descriptive and inferential statistics using a logistic model show that vertical integration does not necessarily lead to successful operation in the CEE region, whereas a medium degree of autonomy does. One of the main statistical findings is that MNCs do not necessarily increase their probability of success by developing subsidiary-level capabilities, but rather can rely effectively on proven capabilities and a familiar strategy. Establishing close relations with governments is not related to success. The statistical analysis and review of data concludes that where companies have fewer options to rely on market mechanisms, they attempt to absorb the local environment. Diversified companies are not successful, particularly if the diversification was prompted by opportunities to take over large state-owned enterprises with good potential but that had no fit with the MNC's core competencies.

Strategies of complexity reduction are most effective in increasing the probability of success of a foreign subsidiary in Central and Eastern Europe. Thriving operations in the region do not attempt to "absorb" the environment, but anticipate change and convergence towards features of fully functioning market structures and institutions, adapt to the local customer and reduce the perceived complexity of the setting. Although they may use localized strategies, they draw from strong multinational and headquarters capabilities. They also find a trade-off between high levels of local autonomy which encourage experimentation (with possible loss of consistency, and continuous testing of unsuccessful strategic avenues) and low levels of autonomy hindering learning and potential synergy feedback.

For analytical generalization, the dissertation includes five case studies. Balli Romania Plc represents a case of very low autonomy and very high integration with the group, resulting in lack of flexibility. It is also an example of strategy that shuts off all options from the beginning. ABN AMRO Romania is a success, related mainly to strong corporate-level capabilities and a strategy of environmental embedding. Some evidence of low endogenous learning raise issues regarding the local subsidiary's future potential for success. KPMG Romania's case shows the benefits of a long-term approach established regionally and the strategy of "waiting" for the environment to become conducive to the business model and the company's best practices. The pursuit of knowledge acquisition and incorporation on a regional rather than country scale is noted to be the element of success for this company. The case of Carrefour Romania strongly supports all hypotheses, with a series of observations on the particulars that make a difference for successful adaptation. Microsoft Corporation's strategies across the CEE region also support the hypotheses. The company doesn't appear to have significant emergent strategies, but rather a consistent regional strategy with different tactics at different locations.

The deeper analysis of data and the case studies add valuable dimensions to the statistical findings, and bring explanations for the observed patterns of adaptation. It is found that value chain integration is a matter of formalization of relationships with suppliers and distributors. Whereas successful subsidiaries work with other members of the value chain on common solutions, the unsuccessful companies control, audit and formalize relationships. Although most successful subsidiaries are somewhat centralized, they have enough autonomy to learn and experiment. These local affiliates benefit from some formalized routines and procedures and work with a bounded set of strategic options. Too much autonomy or strict control from the headquarters decreases the probability of success: companies either pursue a variety of unrelated opportunities or remain highly integrated with the parent. None of these situations allows for proactive and efficient adaptation. Local capability development is highly dependent on the established routines of knowledge acquisition and recombination. Firms that already have experience in developing a limited set of strong capabilities are more likely to succeed in the CEE region. Inertia and path-dependence on previous capabilities do not allow local subsidiaries to achieve their full potential. For the companies pursuing a wide variety of local capabilities, the investments in learning may pay off if they incorporate such capabilities in a coherent strategy at the location. One of the main findings is that of "efficiency" of the network of business partners in CEE. The same applies for a company's external networking with governments and other institutions. The intensity of embedding is found to be not as important as its diversity. An optimal number of linkages in a network of non-redundant contacts is essential for success. The evaluation of positive patterns of adaptation reveals that most successful MNCs start with strong global or regional capabilities and strategies leveraged across the CEE. These companies add new "localized" features and tactics as they learn about the local environment. A flexible structure and incorporation with the parent allows these subsidiaries to quickly become proactive or even preempt progress in transition and new institutions. These winners of adaptation develop and evolve with the use of their own continuously cultivated assets.

Final Remarks and Future Research Agenda

The literature on international business and strategy can be greatly extended thru the lens of various perspectives. The theoretical background used in the dissertation defines organizations as entities that learn, evolve and adapt to their environment. The relatively dynamic environment in Central and Eastern Europe makes for an appropriate experimental design in which strategists and academics can study and evaluate common patterns and principles that shape behaviors of companies. The main contribution of the research presented here is that of a clear demarcation of what consists successful adaptation to the environment. The approaches analyzed represent patterns of solutions. As a general and final conclusion we observe that strategies that perform best are those that are based on decisive action ensuring high quality learning and responsiveness. Diversity and efficiencies of relationships in a company's internal and external network are essential. Leveraging strong global and regional capabilities and the knowledge acquisition experience of the firm are prerequisites for success.

One of the limitations of the research presented in the dissertation is the subjective nature of the testimony-based material used. The case studies in particular, as well as some of the statistical results' discussions are based on information shared during open-ended interviews with representatives of companies or other organizations. The information is thus drawing on direct personal memory and experience of each individual, and reflects his or her own views and interpretations as a reflection upon strategic choices and macroeconomic events. The direct experience of the individual is likely influenced by the specific context of the organization, his or her position in the organization and personal goals. The subjectivity of the positions on sensitive issues limits the interpretation of the findings. A few shortcomings have been noted in the statistical findings. The results show high probability for Type I error for two of the variables found significant. The model itself has low measures of strength of association. Although a potential explanation is offered, this may be an indication of an incomplete model.

The limitations of the research presented here are related to the limited access to information and the accuracy of shared information from primary sources. The statistical methodology is based on qualitative data that is drawn from existing evidence. The quality of the data and the results depends on the quality and sometimes the interpretation of this evidence. The statistical results have limitations due to their general nature. The companies included represented as many heterogeneous agents across which the generalization occurred. The case studies improved this aspect vastly. They also revealed sensitivity of strategies to industries, countries, etc. The discussion has controlled for some of these factors in an attempt to identify the commonalities across companies' approaches. The extent to which this has been achieved impacts the quality of the findings. There may also be better models for assessing the dynamic nature of adaptation and co-evolution. The author has remained true to the framework and hypotheses advanced at the beginning of the research, thus setting restrictions to the interpretation of the findings. Although the research design meets the criteria of robustness, alternative interpretations and more integrated findings could be obtained from a new perspective.

The future research agenda could be expanded to other transition economies, also as an opportunity to test the validity of the framework in a different region with a similar environment. A comparable model may be applicable to MNCs' subsidiaries operating in dynamic environments in general. The discussion of data included in the dissertation includes references to distinctive patterns of adaptation for companies from various home countries. The model can be developed to include explanations related to cultural and psychic distance. Future research can focus exclusively on multinationals from a particular country, with potential findings' justifications drawing upon specific relationships between home and host country. The present research reaches across industries and generalizes on overall strategies. Industry-specific subsets of strategies can improve the accuracy of the findings and add essential details. As countries in Central and Eastern Europe progress in transition and multinational subsidiaries become established in the region, future investigation can emphasize on the requirements to build sustainable advantage. The findings suggest that some companies with a "diversified" portfolio of knowledge and strategic options might be in a position to catch up from an inferior position. It would be interesting to see whether such cases exist or can be predicted in the near future. Transition towards market structures in the region may also mean a transition in companies' strategies- from using their firm-level capabilities to developing firm-level practices of incorporating new capabilities and local innovations.

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GLOSSARY

Accession. The process of adding a country to an international agreement, such as the GATT, WTO, EU, or NAFTA.

Accession country. A country that is waiting to become a member of the EU.

Black market. An illegal trading arrangement in which buyers and sellers do business at a price higher than the legally imposed price ceiling.

BPO. Business Process Outsourcing. See Outsourcing.

Brown field investment. FDI that involves the purchase of an existing plant or firm, rather then construction of a new plant.

Business model. A description of the operations of a business including the components of the business, the functions of the business, and the revenues and expenses that the business generates.

Capitalism. An economic system in which capital is mostly owned by private individuals and corporations. Contrasts with communism.

CBA. Currency Board Arrangement. Arrangement under which a country fixes its exchange rate and maintains 100 percent backing of its money supply with foreign exchange.

CEE. Central and Eastern Europe. See Transition economies.

CEFTA. Central European Free Trade Agreement. A free trade agreement initiated in 1993 among the Czech Republic, Hungary, Poland, Slovakia, and Slovenia, now also including Bulgaria and Romania. Its purpose was in part to reverse the bias against trade among these neighboring countries that had developed during the process of transition.

Central European Bank. The central bank for Europe's single currency, the euro.

CIS. Commonwealth of Independent States. An organization formed in 1991 of the nations that had been part of the USSR.

CMEA. Council for Mutual Economic Assistance.

COMECON. Council for Mutual Economic Assistance. Council for Mutual Economic Assistance An international organization formed in 1956 among the Soviet Union and other Communist countries to coordinate economic development and trade. It was disbanded in 1991.

Communism. An economic system in which capital is owned by private government. Contrasts with capitalism.

Corruption. Dishonest or partial behavior on the part of a government official or employee, such as a customs or procurement officer. Also actions by others intended to induce such behavior, such as bribery or blackmail.

Deregulation. The lessening or complete removal of government regulations on an industry, especially concerning the price that firms are allowed to charge and leaving price to be determined by market forces.

EBRD. European Bank for Reconstruction and Development. Established in 1991 when communism ended. EBRD uses the tools of investment to help build market economies and democracies in 27 countries of CEE and East Asia.

EU. European Union A group of European countries that have chosen to integrate many of their economic activities, including forming a customs union and harmonizing many of their rules and regulations. Preceded by EEC and EC. As of May 1, 2004, the EU had 25 member countries.

Externality. An effect of one economic agent's actions on another, such that one agent's decisions make another better or worse off by changing their utility or cost. Beneficial effects are positive externalities; harmful ones are negative externalities.

FDI. Foreign Direct Investment. A flow of lending to, or purchase of ownership in, a foreign enterprise that is largely owned by residents of the investing country. Direct investment implies full or partial control of the enterprise and, usually, physical presence by foreign firms or individuals in the host country.

FSU. Former Soviet Union countries.

GDP. Gross domestic product. The total value of new goods and services produced in a given year within the borders of a country, regardless of by whom.

GNP. Gross national product. The total value of new goods and services produced in a given year by a country's domestically owned factors of production, regardless of where.

Green field investment. FDI that involves construction of a new plant, rather then the purchase of an existing plant or firm.

Grey economy. Legal activities whose participants fail to pay tax or comply with regulations.

IMF. International Monetary Fund. An organization formed originally to help countries to stabilize exchange rates, but today pursuing a broader agenda of financial stability and assistance.

Institutional investor. Entity with large amounts to invest, such as investment companies, mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds.

Intangible asset. An asset that is not physical in nature.

Internalize. To cause, usually by a tax or subsidy, an external cost or benefit of someone's actions to be experienced by them directly, so that they will take it into account in their decisions.

Internalization. One of the three pillars of the OLI paradigm for understanding FDI and the formation of multinational enterprises, this refers to the advantage that a firm derives from keeping multiple activities within the same organization.

JV. Joint venture. An undertaking by two parties for a specific purpose and duration, taking any of several legal forms.

Lobby. A group of people usually representing a particular interest, who seek to influence policies, legislation or gain support for its cause.

Maastricht Treaty. The 1991 treaty among members of the EU to work toward a monetary union, or common currency. This ultimately resulted in adoption of the euro in 1999.

Macroeconomic policy. Any policy intended to influence the behavior of important macroeconomic variables, especially unemployment and inflation. Macroeconomic policies include monetary and fiscal policies, but also such things as price controls and incentives for economic growth.

Market. 1. The interaction between supply and demand to determine the market price and corresponding quantity bought and sold. 2. The determination of economic allocations by decentralized, voluntary interactions among those who wish to buy and sell, responding to freely determined market prices.

Market economy. A country in which most economic decisions are left up to individual consumers and firms interacting through markets. Contrasts with central planning and non-market economy.

Market failure. Any market imperfection, but especially the complete absence of a market due to incomplete or asymmetric information.

Market imperfection. Any departure from the ideal benchmark of perfect competition, due to externalities, taxes, market power, etc.

Market mechanism. The process by which a market solves a problem allocating resources, especially that of deciding how much of a good or service should be produced, but other such problems as well.

Market structure. The way that suppliers and demanders in an industry interact to determine price and quantity. There are four main idealized market structures that have been used in trade theory: perfect competition, monopoly, oligopoly, and monopolistic competition.

Market power 1. Ability of a firm or other market participant to influence price by varying the amount that it chooses to buy or sell. 2. Ability of a country to influence world prices by altering its trade policies.

MNC. Multinational Corporation. A corporation that operates in two or more countries. Since it is headquartered in only one country but has production or marketing facilities in others, it is the result of previous FDI.

MNE. Multinational Enterprise. A firm, usually a corporation, that operates in two or more countries. In practice the term is used interchangeably with multinational corporation.

NIS. Newly Independent States. Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldova, Ukraine, Uzbekistan.

OECD. Organization for Economic Co-operation and Development. An international organization of developed countries that "provides governments a setting in which to discuss, develop and perfect economic and social policy."

OLI Paradigm. A framework for analyzing the decision to engage in FDI, based on three kinds of advantage that FDI may provide in comparison to exports: Ownership, Location, and Internalization. Due to Dunning (1979).

Outsourcing. 1. Performance of a production activity that was previously done inside a firm or plant outside that firm or plant. 2. Manufacture of inputs to a production process, or a part of a process, in another location, especially in another country.

Path dependence. Path-dependence exists when the outcome of a process depends on its past history, on the entire sequence of decisions made by agents and resulting outcomes, and not just on contemporary conditions. A closely related concept is hysteresis, a property of systems (usually physical systems) whose states depend on their immediate history. These principles tell us that "history matters" in understanding social and physical sciences.

Path dependent. The property that where you get to depends on how you got there. That is, if the equilibrium that will ultimately be reached by a system depends on the values of variables taken on away from equilibrium, then the equilibrium is path dependent.

PPP. Purchasing Power Parity. A method of measuring the relative purchasing power of different countries' currencies over the same types of goods and services.

Privatization. Act of converting a publicly operated enterprise into a privately owned and operated entity.

Qualitative. 1. Referring only to the characteristics of something being described, rather than exact numerical measurement. 2. Indicative only of relative sizes or magnitudes, rather than their numerical values. A qualitative comparison would say whether one thing is larger, smaller, or equal to another, without specifying the size of any difference. As opposed to quantitative.

Quantitative. Expressed in numerical values.

R&D. Research and development. The use of resources for the deliberate discovery of new information and ways of doing things, together with the application of that information in inventing new products or processes.

SOE. State-owned enterprise. A firm owned by government.

Socialism. An ideology with the core belief that a society should exist in which popular collectives control the means of power, and therefore the means of production.

SFRY. Socialist Federal Republic of Yugoslavia.

TCE. Transaction cost economics. Theory used to explain a number of different behaviors in "transactions" based on costs involved.

Totalitarian. Of, relating to, being, or imposing a form of government in which the political authority exercises absolute and centralized control over all aspects of life.

Transitology. In political science, is the name for the area that studies the process of change from a political regime to another, mainly from authoritarian regimes to democracies.

Transaction cost. In economics and related disciplines, a cost incurred in making an economic exchange.

Transition. The process of converting from a centrally planned, non-market economy to a market economy.

Transition Economies. Economies in process of adopting market-based mechanisms and institutions. The International Monetary Fund classifies transition economies as follows: Transition economies in Europe and the former Soviet Union: CEE: Albania, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic, Slovenia: Baltics: Estonia, Latvia, Lithuania; CIS: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan; Transition economies in Asia: Cambodia, China, Laos, Vietnam

TNC. Transnational corporation. 1. Same as multinational corporation, though for some reason this term seems to be preferred by those who don't like them. 2. A corporation whose national identity is a matter of convenience only, and that will move its headquarters readily in response to incentives.

UNCTAD. United Nations Conference on Trade and Development. An intergovernmental body established in 1964 within the United Nations, responsible for trade and development. Historically it has often been the international voice of developing countries.

USAID. United States Agency for International Development. Bilateral assistance agency that assists LDCs (Lesser Developed countries) to develop under specific American foreign policy preferences.

USSR. Union of Soviet Socialist Republics. Was a Communist dictatorship formed after the Russian Revolutions. From 1919 until WWII it comprised of 11 republics, the RSFSR, Ukraine, White Russia, Armenia, Azerbaijan, Georgia, Turkmenistan, Uzbekistan, Tajikistan, Kazakhstan and Kirghizia.

Value chain. The sequential set of primary and support activities that an enterprise performs to turn inputs into value-added outputs for its external customers.

VAT. Value Added Tax. A tax levied on the difference between a commodity's price before taxes and its cost of production.

World Bank. A group of five closely associated international institutions providing loans and other development assistance to developing countries. The five institutions are IBRD, IDA, IFC, MIGA, and ICSID.

APPENDIX 1 ANNUAL FREEDOM SCORES FOR SELECTED TRANSITION ECONOMIES IN CEE, 1989-2003

Countries	1989-90			1990-91			1991-92		
Year(s) covered	Nov. 1988-Dec. 1989			1990			1991		
	PR	CL	Status	PR	CL	Status	PR	CL	Status
Albania	7	7	NF	7	6	NF	4	4	PF
Belarus	..	..	..	..	..	..	4	4	PF
Bosnia-Herzegovina	..	..	..	..	..	..	..	..	..
Bulgaria	7	7	NF	3	4	PF	2	3	F
Croatia	..	..	..	..	..	..	3	4	PF
Czech Republic	..	..	..	..	..	..	..	..	..
Czechoslovakia	6	6	NF	2	2	F	2	2	F
Hungary	4	3	PF	2	2	F	2	2	F
Macedonia	..	..	..	..	..	..	..	..	..
Moldova	..	..	..	..	..	..	5	4	PF
Poland	4	3	PF	2	2	F	2	2	F
Romania	7	7	NF	6	5	NF	5	5	PF
Russia	..	..	..	..	..	..	3	3	PF
Serbia and Montenegro	5	4	PF	5	4	PF	6	5	NF
Slovakia	..	..	..	..	..	..	..	..	..
Ukraine	..	..	..	..	..	..	3	3	PF
USSR	6	5	NF	5	4	PF	4	4	PF

Countries	1992-93			1993-94			1994-95		
Year(s) covered	1992			1993			1994		
	PR	CL	Status	PR	CL	Status	PR	CL	Status
Albania	4	3	PF	2	4	PF	3	4	PF
Belarus	4	3	PF	5	4	PF	4	4	PF
Bosnia-Herzegovina	6	6	NF	6	6	NF	6	6	NF
Bulgaria	2	3	F	2	2	F	2	2	F
Croatia	4	4	PF	4	4	PF	4	4	PF
Czech Republic	..	..	..	1	2	F	1	2	F
Czechoslovakia	2	2	F	..	..	..	..	..	..
Hungary	2	2	F	1	2	F	1	2	F
Macedonia	3	4	PF	3	3	PF	4	3	PF
Moldova	5	5	PF	5	5	PF	4	4	PF
Poland	2	2	F	2	2	F	2	2	F
Romania	4	4	PF	4	4	PF	4	3	PF
Russia	3	4	PF	3	4	PF	3	4	PF
Serbia and Montenegro	6	5	PF	6	6	NF	6	6	NF
Slovakia	..	..	..	3	4	PF	2	3	F
Ukraine	3	3	PF	4	4	PF	3	4	PF
USSR	..	..	..	..	..	..	..	..	..

Countries	1995-96			1996-97			1997-98		
Year(s) covered	1995			1996			1997		
	PR	CL	Status	PR	CL	Status	PR	CL	Status
Albania	3	4	PF	4	4	PF	4	4	PF
Belarus	5	5	PF	6	6	NF	6	6	NF
Bosnia-Herzegovina	6	6	NF	5	5	PF	5	5	PF
Bulgaria	2	2	F	2	3	F	2	3	F
Croatia	4	4	PF	4	4	PF	4	4	PF
Czech Republic	1	2	F	1	2	F	1	2	F
Czechoslovakia	..	..	..	..	..	..	..	..	..
Hungary	1	2	F	1	2	F	1	2	F
Macedonia	4	3	PF	4	3	PF	4	3	PF
Moldova	4	4	PF	3	4	PF	3	4	PF
Poland	1	2	F	1	2	F	1	2	F
Romania	4	3	PF	2	3	F	2	2	F
Russia	3	4	PF	3	4	PF	3	4	PF
Serbia and Montenegro	6	6	NF	6	6	NF	6	6	NF
Slovakia	2	3	F	2	4	PF	2	4	PF
Ukraine	3	4	PF	3	4	PF	3	4	PF
USSR	..	..	..	..	..	..	..	..	..

Countries	1998-99			1999-2000			2000-01		
Year(s) covered	1998			1999			2000		
	PR	CL	Status	PR	CL	Status	PR	CL	Status
Albania	4	5	PF	4	5	PF	4	5	PF
Belarus	6	6	NF	6	6	NF	6	6	NF
Bosnia-Herzegovina	5	5	PF	5	5	PF	5	4	PF
Bulgaria	2	3	F	2	3	F	2	3	F
Croatia	4	4	PF	4	4	PF	2	3	F
Czech Republic	1	2	F	1	2	F	1	2	F
Czechoslovakia	..	..	..	..	..	..	..	..	..
Hungary	1	2	F	1	2	F	1	2	F
Macedonia	3	3	PF	3	3	PF	4	3	PF
Moldova	2	4	PF	2	4	PF	2	4	PF
Poland	1	2	F	1	2	F	1	2	F
Romania	2	2	F	2	2	F	2	2	F
Russia	4	4	PF	4	5	PF	5	5	PF
Serbia and Montenegro	6	6	NF	5	5	PF	4	4	PF
Slovakia	2	2	F	1	2	F	1	2	F
Ukraine	3	4	PF	3	4	PF	4	4	PF
USSR	..	..	..	..	..	..	..	..	..

Countries	2001-02			2003			2004		
Year(s) covered	2001			2002			2003		
	PR	CL	Status	PR	CL	Status	PR	CL	Status
Albania	3	4	PF	3	3	PF	3	3	PF
Belarus	6	6	NF	6	6	NF	6	6	NF
Bosnia-Herzegovina	5	4	PF	4	4	PF	4	4	PF
Bulgaria	1	3	F	1	2	F	1	2	F
Croatia	2	2	F	2	2	F	2	2	F
Czech Republic	1	2	F	1	2	F	1	2	F
Czechoslovakia	..	..	..	..	..	..	..	..	..
Hungary	1	2	F	1	2	F	1	2	F
Macedonia	4	4	PF	3	3	PF	3	3	PF
Moldova	2	4	PF	3	4	PF	3	4	PF
Poland	1	2	F	1	2	F	1	2	F
Romania	2	2	F	2	2	F	2	2	F
Russia	5	5	PF	5	5	PF	5	5	PF
Serbia and Montenegro	3	3	PF	3	2	F	3	2	F
Slovakia	1	2	F	1	2	F	1	2	F
Ukraine	4	4	PF	4	4	PF	4	4	PF
USSR	..	..	..	..	..	..	..	..	..

PR stands for "political rights", CL stands for "civil liberties", and "Status" is the freedom status. Political rights and civil liberties are measured on a one-to-seven scale, with one representing the highest degree of freedom and seven the lowest. P, PF and NF, respectively, stand for "free", "partly free", and "not free".

Countries with combined average ratings falling between 3.0 and 5.0 are "partly free", and those between 5.5 and 7.0 are "not free".

Source: The Freedom House, World Country Ratings, 2003.

APPENDIX 2 MACROECONOMIC INDICATORS CENTRAL AND EASTERN EUROPE

Country	*Macroeconomic Indicator*	*1999*	*2000*	*2001*
Albania	Current account balance in percent of GDP	-3.9	-4.4	-3.2
	Gross domestic product, constant prices, annual percent change	10.1	7.3	7.6
	Gross domestic product, current prices (bn)	474.291	530.906	610.417
	Inflation, annual percent change	0.4	0	3.1
B&H	Current account balance in percent of GDP	-9.3	-13.3	-16.7
	Gross domestic product, constant prices, annual percent change	9.6	5.5	4.4
	Gross domestic product, current prices	8.989	10.054	10.959
	Inflation, annual percent change	2.9	5	3.2
Bulgaria	Current account balance in percent of GDP	-5	-5.6	-7.2
	Gross domestic product, constant prices, annual percent change	2.3	5.4	4.1
	Gross domestic product, current prices	23.79	26.753	29.709
	Inflation, annual percent change	2.6	10.4	7.5
Croatia	Current account balance in percent of GDP	-7	-2.5	-3.7
	Gross domestic product, constant prices, annual percent change	-0.9	2.9	4.4
	Gross domestic product, current prices	141.579	152.519	165.639
	Inflation, annual percent change	4.1	6.2	4.9
Czech Rep.	Current account balance in percent of GDP	-2.5	-4.9	-5.4
	Gross domestic product, constant prices, annual percent change	0.5	3.3	2.6
	Gross domestic product, current prices	2060.647	2150.058	2315.255
	Inflation, annual percent change	2.1	3.9	4.8
Estonia	Current account balance in percent of GDP	-4.4	-5.5	-5.6
	Gross domestic product, constant prices, annual percent change	-0.1	7.8	6.4
	Gross domestic product, current prices	81.64	92.717	104.338
	Inflation, annual percent change	3.3	4	5.8
Hungary	Current account balance in percent of GDP	-7.9	-8.7	-6.2
	Gross domestic product, constant prices, annual percent change	4.2	5.2	3.8
	Gross domestic product, current prices	11368.893	13091.621	14849.808
	Inflation, annual percent change	10	9.8	9.2
Latvia	Current account balance in percent of GDP	-9.1	-6.4	-8.9
	Gross domestic product, constant prices, annual percent change	3.3	6.9	8
	Gross domestic product, current prices	4.224	4.686	5.168
	Inflation, annual percent change	2.4	2.6	2.5

Country	*Macroeconomic Indicator*	*1999*	*2000*	*2001*
Lithuania	Current account balance in percent of GDP	-11	-5.9	-4.7
	Gross domestic product, constant prices, annual percent change	-1.7	3.9	6.4
	Gross domestic product, current prices	43.359	45.526	48.379
	Inflation, annual percent change	0.8	1	1.3
Macedonia	Current account balance in percent of GDP	-0.9	-2.1	-6.8
	Gross domestic product, constant prices, annual percent change	4.4	4.5	-4.5
	Gross domestic product, current prices	209.01	236.389	233.841
	Inflation, annual percent change	-2	6.2	5.3
Poland	Current account balance in percent of GDP	-7.6	-6	-2.9
	Gross domestic product, constant prices, annual percent change	4.1	4	1
	Gross domestic product, current prices	652.517	723.886	760.595

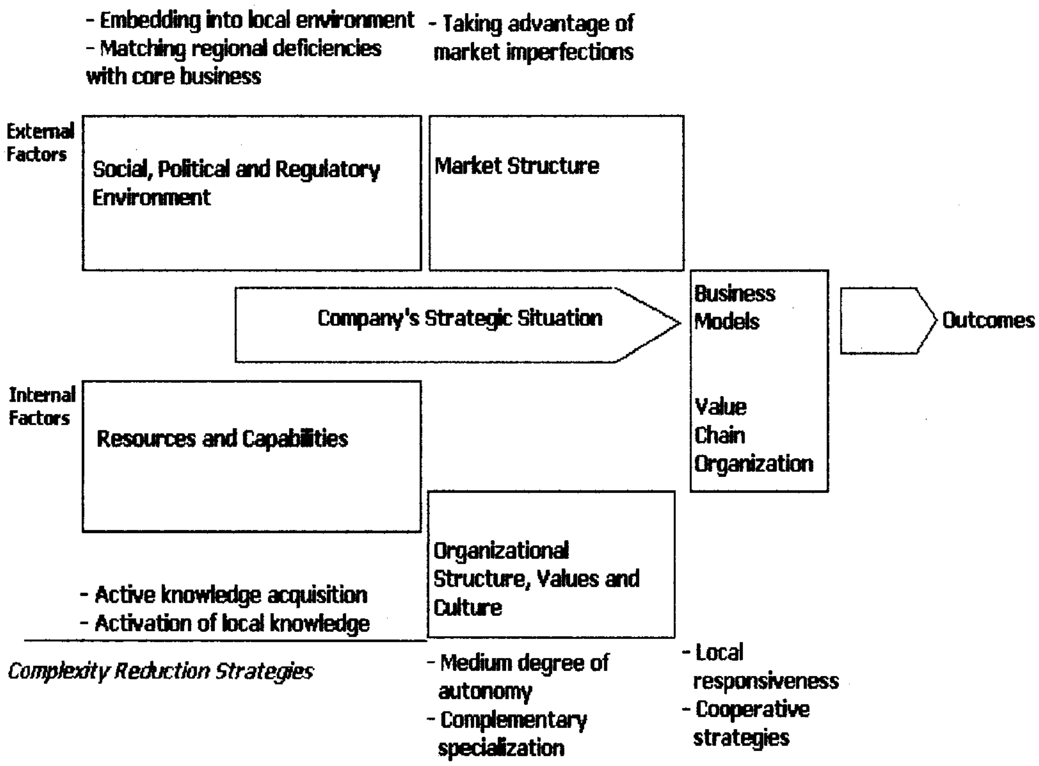
	Inflation, annual percent change	7.3	10.1	5.5
Romania	Current account balance in percent of GDP	-4.1	-3.9	-5.5
	Gross domestic product, constant prices, annual percent change	-1.2	2.1	5.7
	Gross domestic product, current prices	545730.2	803773.1	1167687
	Inflation, annual percent change	45.8	45.7	34.5
Slovak Rep.	Current account balance in percent of GDP	-4.8	-3.5	-8.4
	Gross domestic product, constant prices, annual percent change	1.5	2	3.8
	Gross domestic product, current prices	844.108	934.079	1009.839
	Inflation, annual percent change	10.7	12	7.3
Slovenia	Current account balance in percent of GDP	-3.3	-2.8	0.2
	Gross domestic product, constant prices, annual percent change	5.6	3.9	2.7
	Gross domestic product, current prices	3874.7	4225.3	4761.8
	Inflation, annual percent change	6.2	8.9	8.4

Country	***Macroeconomic Indicator***	***2002***	***2003***	***2004***
Albania	Current account balance in percent of GDP	-6.5	-5.1	-5.5
	Gross domestic product, constant prices, annual percent change	4.7	6	6.2
	Gross domestic product, current prices (bn)	677.674	746.318	836.937
	Inflation, annual percent change	5.2	2.4	3.4
B&H	Current account balance in percent of GDP	-22.1	-19	-19
	Gross domestic product, constant prices, annual percent change	5.5	2.7	5
	Gross domestic product, current prices	11.627	12.062	12.786
	Inflation, annual percent change	0.3	0.2	0.9
Bulgaria	Current account balance in percent of GDP	-5.3	-8.4	-8.7
	Gross domestic product, constant prices, annual percent change	4.9	4.3	5.2
	Gross domestic product, current prices	32.335	34.41	38.046
	Inflation, annual percent change	5.8	2.3	6.3
Croatia	Current account balance in percent of GDP	-8.4	-6.1	-5.8
	Gross domestic product, constant prices, annual percent change	5.2	4.3	3.7
	Gross domestic product, current prices	179.39	193.067	205.747
	Inflation, annual percent change	2.3	1.5	2.5
Czech Rep.	Current account balance in percent of GDP	-5.6	-6.2	-5.5
	Gross domestic product, constant prices, annual percent change	1.5	3.1	3.3
	Gross domestic product, current prices	2414.669	2532.388	2708.031
	Inflation, annual percent change	1.8	0.1	3.2
Estonia	Current account balance in percent of GDP	-10.2	-13.2	-11.2
	Gross domestic product, constant prices, annual percent change	7.2	5.1	5.8
	Gross domestic product, current prices	116.869	125.832	138.162
	Inflation, annual percent change	3.6	1.3	3
Hungary	Current account balance in percent of GDP	-7.2	-8.9	-8.8
	Gross domestic product, constant prices, annual percent change	3.5	2.9	3.5
	Gross domestic product, current prices	16740.42	18573.956	20400.56
	Inflation, annual percent change	5.3	4.7	6.9
Latvia	Current account balance in percent of GDP	-6.5	-8.6	-9.3
	Gross domestic product, constant prices, annual percent change	6.4	7.5	6.5
	Gross domestic product, current prices	5.691	6.322	7.003
	Inflation, annual percent change	1.9	2.9	5.8

Country	*Macroeconomic Indicator*	*2002*	*2003*	*2004*
Lithuania	Current account balance in percent of GDP	-5.2	-6.7	-7.1
	Gross domestic product, constant prices, annual percent change	6.8	9	7
	Gross domestic product, current prices	51.633	55.737	60.7
	Inflation, annual percent change	0.3	-1.2	0.6
Macedonia	Current account balance in percent of GDP	-8.5	-6	-7.7
	Gross domestic product, constant prices, annual percent change	0.9	3.1	4
	Gross domestic product, current prices	243.971	254.372	271.761
	Inflation, annual percent change	2.4	1.2	2
Poland	Current account balance in percent of GDP	-2.6	-1.9	-1.7
	Gross domestic product, constant prices, annual percent change	1.4	3.8	5.8
	Gross domestic product, current prices	781.124	814.698	895.334
	Inflation, annual percent change	1.9	0.8	3.7
Romania	Current account balance in percent of GDP	-3.4	-5.9	-5.2
	Gross domestic product, constant prices, annual percent change	5	4.9	5
	Gross domestic product, current prices	1512616.8	1890778.3	224316C
	Inflation, annual percent change	22.5	15.3	11.5
Slovak Rep.	Current account balance in percent of GDP	-8	-0.9	-2.3
	Gross domestic product, constant prices, annual percent change	4.4	4.2	4.8
	Gross domestic product, current prices	1096.384	1195.812	1302.97
	Inflation, annual percent change	3.3	8.5	7.7
Slovenia	Current account balance in percent of GDP	1.4	0.1	-0.6
	Gross domestic product, constant prices, annual percent change	3.4	2.3	3.9
	Gross domestic product, current prices	5314.5	5726.5	6188.7
	Inflation, annual percent change	7.5	5.6	3.7

Source: International Monetary Fund, World Economic Outlook Database, September 2004
http://www.imf.org/external/pubs/ft/weo/2004/02/data/

APPENDIX 3 (Figure 1)
SHAPING MNCs STRATEGIES IN TRANSITION ECONOMIES OF CEE



Source: Author's own.