ETLA The Research Institute of the Finnish Economy

Julianna Borsos-Torstila

THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT OPERATIONS OF FINNISH MNCs IN TRANSITION ECONOMIES 1990-1995

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ABSTRACT: The research analyses the manufacturing foreign direct investment (FDI) operations of Finnish MNCs in transition economies in 1990-1995 with particular focus on regional differences. The research first sought to reveal the determining factors of these FDIs at the operational level by examining the strategic choices made in relation to the reviewed FDI operation elements: ownership arrangements, form of investment, type of investment and value-added activities. The FDI-preceding operations in these target markets were also reviewed to assess their impact on FDI strategy. The analysis was then extended to cover market, institutional and production factors. Home country and global factors were also taken into account. An explanatory model is presented based on the findings of this thesis. The results indicate that the factors leading to manufacturing FDI operations and affecting them also after the initial start-up stage are closely associated with the extent and duration of liberalisation and economic progress in transition economies. These FDIs were particularly affected by initial conditions in the target markets. This helps to account for the relatively high level of investment by the reviewed firms in 1990-1995 within the most progressed Visegrád region, particularly in Poland and Hungary, and in the small market of Estonia. It also explains the differences between determinants in the Visegrád, Baltic and Russian markets. At the operational level, factors affecting specifically ownership arrangements were identified as crucial determinants, which initially have triggerred these FDIs. Throughout the region, market factors play a central role. The fundamental reason behind the need or preference to rely on hierarchical rather than arm's length operations, lies on the one hand in both the perceived market imperfections and in the lack of experience or knowledge of the market.

KEY WORDS: FDI, Finnish MNCs, operation modes, market-, institutional and production-specific determinants, transition economies, the Baltic States, Visegrád countries, Russia.

TIIVISTELMÄ: Tutkimuksessa tarkastellaan suomalaisten suuryritysten Euroopan siirtymätalouksiin tehtyjen suorien tuotannollisten sijoitusten määrääviä tekijöitä. Tutkimuksessa on analysoitu ilmiötä toisaalta operaatio-tasolla, jolla tarkoitetaan omistusjärjestelyjä, sijoitusmuotoa ja -tyyppiä sekä lisäarvotoimintoja. Toisaalta on myös tarkasteltu yleisempiä ulkoisia tekijöitä, joita ovat markkina-, instituutio- ja tuotannontekijät. Keskeisin tutkimustulos on, että siirtymätalousvaihe kullakin kohdealueella määrää pitkälle sen, kuinka paljon suoria sijoituksia suuntautuu alueelle. Operaatiotasolla nimenomaan omistusjärjestelyihin liittyvät vapausasteet vaikuttavat vahvasti suorien sijoitusten suuntautumiseen. Markkinatekijät ovat lähes poikkeuksetta suorien sijoitusten suurin houkutin markkinasta riippumatta. Itse toimintamuotoon, eli suoraan sijoitukseen johtavat pääsääntöisesti havaitut markkinaepätäydellisyydet ja toisaalta yritysten itsensä kokemattomuus. Tutkimuksessa on kehitelty mallia, jonka avulla voidaan edistää suorien sijoitusten määräävien tekijöiden seurantaa ja ymmärtämistä.

AVAINSANAT: Suorat ulkomaiset sijoitukset, suuryritykset, markkina-, instituutio- ja tuotantokohtaiset määräävät tekijät, siirtymätalousmaat, Baltia, Visegrád-maat, Venäjä

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February 1999

Julianna Borsos-Torstila

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1 INTRODUCTION

1.1 Background to the Study

Direct investment operations in transition economies as a research topic is currently of particular interest with new opportunities for Nordic and other companies emerging after the opening up of nearby Eastern markets and as European integration develops rapidly. Since 1989, all of the former European centrally planned economies have embarked on a path of transition in order to establish market-based systems. The majority of the countries involved in this process have actively attracted foreign direct investments (FDI) due to their urgent capital and technology needs and to expectations related to FDI as a powerful catalyst for economic change. As a result, FDI in the form of acquisitions and greenfields has become the dominant operation mode for foreign multinational companies (MNCs) in the region, and it is a key vehicle in the European regional strategies of these firms. In the case of Finnish MNCs, this development seems to have further accelerated the pace of their internationalisation.

However, the phenomenon of FDI is still unknown in both theory and practice, in the sense that FDIs grew explosively in the 1980s and research on the topic has expanded simultaneously. As a result, theoretical explanations of FDI are many-faceted and differ across various economic schools. There is no unanimously accepted FDI theory due to the diversity of theoretical explanations. Empirical studies on FDI strategies do not usually concentrate on certain types of industries, nor have there been many references at all to the FDI strategies of firms from, for instance, small and open economies. The emergence of a new region for FDI, ie. Central and Eastern Europe, poses new demands on existing theories and on empirical studies, as theory building has been based on examinations of either developed or developing countries, and empirical research concerning Eastern Europe has traditionally focused on East-West trade issues. During the course of this study (1996-1997), Nordic research on Eastern Europe was mostly empirical by nature and undertaken in Finland, and it focused on emerging network structures, macroeconomic transition issues, industrial policy, regional integration and entrepreneurial adaptation. This trend in research has continued. Common to all of these studies is their geographical focus either on the Baltic States or Russia, whereas the

present study also covers other Eastern European countries (ie. the Czech Republic, Hungary, Poland and Slovakia) and deals with the whole region, thereby permitting comparative analyses and the identification of differences within the whole transition region. Furthermore, no distinction has been made between firms of different sizes in those few studies that do deal with FDI operation modes in the Visegrád countries, Russia or the Baltics. It seems, then, that research on the FDI strategies of Nordic firms and on factors influencing these FDI operations since the opening up of Eastern Europe has not been the focus of consistent research.

In seeking to assess the recent and likely development of the FDI strategies of Finnish MNCs in transition economies, companies already involved in FDI in that area would appear to be uniquely placed to provide an indication of the nature and direction of FDI strategies and the impact of host country determinants on them. Therefore, the objective of this thesis is to analyse the FDI operations made by Finnish MNCs in Eastern Europe in the period of 1990-1995. The aim is to concentrate on how the various host country, transition specific, factors have determined these FDI operations. Thus the present study contributes to the limited amount of research into the Eastern European FDIs of Finnish MNCs first by providing a detailed analysis of Finnish MNCs' FDI operations in the context of the FDI-preceeding operations, the form of investment, the type of investment, the ownership arrangements of the investment, and the value added activities involved in the investment projects. Second, the study provides an analysis of the region-specific FDI determinants by aiming at identifying key characteristics in the transition area. A distinction is made between the Baltic, Visegrád and Russian markets/regions. This study is a first attempt to identify regional (referred as 'blockwise' differences in this study) differences in FDI determinants within the transition area. In addition, the study differs from more 'traditional' FDI research, which has relied on purely quantitative macroeconomic data. The fact that this study relies on information provided by actual agents, i.e. managers of the MNCs reviewed, brings yet new aspects to FDI research. Finally, the study examines existing theories in order to assess their applicability in describing and explaining the FDI strategies of Finnish MNCs in Eastern Europe during the period 1990-1995.

1.2 Objectives and Limitations of the Study

The study seeks to analyse *how* Finnish multinational companies have undertaken direct investments in Central-East Europe and Russia and which *transition-specific factors* have *determined* these FDI operations in the early 1990s from a corporate perspective. Thus, special emphasis is placed on the examination of FDI operations in a transitional environment. Hence, the research problem addressed in this study centres on what kind of foreign direct investment strategies Finnish MNCs have undertaken in Eastern Europe during the early years of transition. The research problem is followed by two specific research questions: what are the transition- specific determinants of FDIs of Finnish MNCs? Given the FDI operations of Finnish MNCs, how do the regional factors in transition countries affect these FDI operations? To answer these questions, the objectives for the present study are set as follows:

1. To analyse the FDI operations and strategic choices related to, e.g., the form and type of investment and value-added activities, etc. of Finnish MNCs during the early years of transition, ie. in the period 1990-1995.

2. To analyse the host market determinants of these FDIs in a regionwise perspective and to identify transition-specific characteristics

3. To examine existing theories to determine their applicability for describing and explaining FDI strategies in transition economies.

The first objective is sought by looking at the various elements of FDI strategy, here defined as covering four elements: previous operations, the form of investment, the type of investment, and the ownership arrangements of the investment. The first element, 'previous operations', comprises both previous modes of operation in the host country and the other modes of operation used in conjunction with the FDI mode of operation. The former reveals the degree and role of previous experience in the market and the initial reason for undertaking a FDI in the first place, while the latter indicates whether FDI also necessitates supporting operation modes. The second element, 'the form of investment', refers to entry strategies related to FDI operations, ie. to the fundamental choice between acquisition and greenfield. The third factor, called 'the type of investment', allows a distinction between a horizontal, vertical, concentric or conglomerate investment, which is necessary due to, for example, the fact that different

types of investment are affected by different locational factors. The latter also applies to the fourth element, ie. 'the ownership arrangements', as the choice between a wholly-owned company and a joint venture is often dependent on locational factors such as the legislative environment.

The second objective, analysing the host country determinants, is sought by examining the market, insitutional and production factors affecting the location of manufacturing subsidiaries. By doing so, emphasis is put on identifying transition-specific determinants in a blockwise perspective (groups of markets).

The above objectives lead us to the characteristics and future pattern of FDI strategies of Finnish MNCs in Central and Eastern Europe. In the context of the above cited objectives, the thesis then considers theoretical issues regarding the applicability of existing theories to the case of Western FDIs flowing to Central and Eastern Europe since the beginning of the transition period in the region. Internalisation theory, the internationalisation model and the location theory, among others, are examined to determine their applicability in describing and explaining Finnish industrial MNCs' direct investment operations in Central and Eastern Europe in the period *1990-1995*. Hence, objective 3 is achieved by a theoretical discussion based on the results of the study and on antecedent literature on FDI.

In this study, the decision to undertake FDI is taken as given, in the sense that the analysis focuses on exogenous factors and does not cover the behavioral and organisational determinants and the actual decision process *within* the firm. The study is limited to internationally involved large multinational Finnish firms which own and control production facilities outside the country in which they are based. The selected Central and Eastern host countries are the Baltic States (Estonia, Latvia and Lithuania), the 'Visegrád' countries (Hungary, Poland, the Czech republic and Slovakia), and Russia. Other Central and Eastern European countries have been excluded, due to non-existent FDIs by Finnish companies in these countries (such as Bulgaria, Romania and Slovenia) in the period reviewed.

1.3 Position of the Study

The problem with most of the FDI theories and models is that hardly any of them are able to explain all kinds of FDI (Agarwal 1980, Pitelis and Sugden 1991) and they are based on FDIs made either in developed or developing countries. The emergence of transition economies therefore poses new demands on the existing theories and models. While much of the previous theoretical work and the accepted concepts offer some aid in certain aspects of interpreting FDI strategies in Eastern Europe, they are inevitably partial. Therefore, the empirical results of this study enable further theoretical development pertaining to foreign direct investment operations in Eastern Europe.

The majority of earlier empirical studies on Nordic FDIs in Eastern Europe mainly concerned Finnish joint ventures in the former Soviet Union and the perceived emerging opportunities at that time (see Nieminen (ed.) 1991, Hansén and Kivikari 1989, Kallio 1990). Only a few studies concerning FDIs in other Eastern European countries exist (e.g., Tiusanen 1990). This is due to the fact that research in the late 1980s traditionally focused on Finnish-Soviet trade issues related to macroeconomic analysis and to the bilateral trading system (see, for instance, Tolonen 1987, Alho et al. 1986, Hirvensalo 1979, Hemmilä 1983).

At the time the theoretical and empirical data for this study were gathered (autumn 1996 and spring 1997), recent Finnish empirical studies focused, as previously, on the Baltic and Russian markets, whereas other Eastern European countries received less emphasis. These studies covered a wide range of issues such as the emerging network structures (Salmi 1995, Törnroos 1995), transition issues (Lainela & Sutela 1994), entrepreneurial adaptation based on a managerial learning process both from the host country point of view and the foreign investor point of view (Liuhto 1992 and 1993, Nieminen 1994), as well as industrial policy issues and regional integration in the Baltic Rim (Hyvärinen & Borsos 1994; Hyvärinen & Hernesniemi 1995; Borsos & Erkkilä 1995a). Research on Finnish FDI strategies and other operation modes in Eastern Europe was and still is scarce, with the exceptions of Laurila (1993 and 1994) and Hirvensalo (1993 and 1996) and the FIBO studies (e.g., Hussi & Puolakka 1995). In the other Nordic countries, particularly in Sweden, research on institutional issues and on this topic has attracted

more attention (see, for instance, Eliasson et al. 1994, Vahlne et al., 1993). However, research on foreign business operations in Eastern Europe has been very scarce in Norway and Denmark. Contrary to the Finnish studies, the Swedish, Danish and Norwegian studies also include other Baltic States and the Visegrád countries and also analyse firms of different sizes.

Thus the present study contributes to the limited amount of research into the Eastern European investment operations of Finnish companies by providing an explorative analysis of the FDI strategues of Finnish MNCs in the region. Furthermore, many studies on FDI strategies in general and on Western investments in Eastern Europe cover relatively few factors related to the subject, often analysing corporate motives or locational determinants alone and separately. Outward operation forms have to a great extent been studied on a more general level, and certain operation forms such as licensing have attracted considerable interest among scholars, whereas in-depth research on one specific operation form, such as the FDI form of operation, has not been the focus of consistent research. (except for the specific case of joint ventures in developing countries).

1.4 Definition of Concepts

The concepts are briefly defined below, to clarify how they are used and understood in this study.

Foreign Direct Investment (FDI)

In this study, foreign direct investments (FDIs) are defined as manufacturing investments in which the multinational firms included in the study have acquired a substantial and lasting controlling interest in a foreign firm or have set up a subsidiary (i.e., greenfield investment) in a foreign country. The direct investor's purpose is to exert a significant degree of influence on the management of the enterprise resident in the other economy. Direct investment involves both the initial transaction between the two entities and all subsequent transactions between them and among affiliated enterprises,

both incorporated and unincorporated.[1] Thus, the direct investment may be undertaken in the form of acquisition or a greenfield operation and the new units may be either wholly-owned or controlled under partnership.

One must further note that FDI is a distinctive form of international capital flow for two reasons. First, the capital involved in direct investment is entrepreneurial or risk-bearing by nature. Second, FDI is strongly industry-specific. FDI does not only finance the construction of plant and equipment, but - in its entrepreneurial role and irrespective of the type of entry- there is always one production factor transferred from the parent company to the foreign subsidiary: knowledge. Furthermore, its economically significant traits arise from the transfer of capital from an industry in the home country to the same industry in the host country (Caves and Jones, 1985).

The terms *'subsidiary'* and *'foreign direct investment'* are used interchangeably, which is appropriate in this specific study, as the focus is on direct investment operations and their determinants and on the interlinkages between corporate FDI strategies and FDI home / host country determinants. As specified in the methodological chapter, the study focuses on manufacturing FDIs.

Multinational Company (MNC)

In this study, multinational company (MNC) refers to the selected largest Finnish industrial firms with direct manufacturing investments in Central and Eastern Europe. The selection is based on turnover, worldwide sales and employment. All of the companies are also engaged in other international operations and a majority meets the Harvard Business School criterion of multinationality, i.e., at least six subsidiaries abroad. However, two features should be taken into account when analysing any Nordic firm. First, the largest Nordic companies are small compared with large companies from other countries such as the U.S. due for example to the smallness of their markets. Second, the internationalisation of Finnish firms started in the 1960s and accelerated markedly in the 1980s, which is very late by international standards.

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[1]Based on the OECD Detailed Benchmark Definition of Foreign Direct Investment (OECD 1992).

(Foreign) direct investment strategy

In this study, FDI strategy refers to the firms' *choices* related to previous operations, the form of investment, the type of investment, the ownership arrangements of the investment and to the value-added activities involved in the investment.

Central and Eastern Europe

The following Central and Eastern European countries (CEECs) are included in this study: the *Visegrád countries*, ie., the Czech Republic, Hungary, Poland, and Slovakia; the *Baltic States*, ie. Estonia, Latvia and Lithuania; and Russia. In this study the abbreviation CEECs and the concept 'Eastern Europe' refers to these particular countries except in chapter 4. The term CEEC usually covers a larger number of countries including Bulgaria, Romania and Slovenia, in addition to the above groups of countries (except for Russia, which is usually not included among the CEECs).

Transition (economy)

After the transformation of the economic, social and political systems of Eastern European countries that was set in motion by the revolutions of 1989, the countries of Central and Eastern Europe have broken with the old socialist system. In fact, 'what has occurred is not reform, it is a complete rejection of one model and its substitution with another', as Senior Nello (1991) points out. This transformation is often referred to as '*transition*', which has become a widely used concept describing the progressive and irreversable move towards political pluralism and parliamentary democracy, private enterprise, and a market economy open to international trade and investment.

This transition process, which has taken place in Central and Eastern European countries since 1989 in the Visegrád countries and 1991 in the Baltic countries, has been based on two propositions: first, the market is necessary to organize production and exchange, and second, *private ownership* is necessary to motivate economic agents (see, eg., EBRD 1994; Eliasson 1994; Estrin 1994). All Central-East European countries have followed a broadly similar path of transformation. Three basic phenomena which were common to all of those countries could be identified in the early 1990s: (i) They were all engaged in the process of implementing comprehensive reform-cum-stabilization programmes (although the designs of the programmes and the degree of implementation

differed considerably); (ii) they all experienced radical structural industrial output changes ; and (iii) the early results of reforms in the majority of countries was generally worse than was initially anticipated. Furthermore, the transformation was made harder by major inherited problems: macroeconomic imbalances, deep distortions of prices, equally distorted behavioural patterns of managers, workers, and consumers, and a capital stock inappropriate to domestic and foreign demand, to current Western technological possibilities, and to environmental protection. In this study, the concepts of transition economies or transition countries and Central-East European countries are used interchangeably.

1. 5 Design of the Study

The introduction establishes the scope and objectives of the study. Chapter 2 describes the research methodology of the empirical part of the study. This section also discusses problems associated with research on direct investment operations and the current knowledge on such operations both internationally and in Finland. The research strategy is presented including an elaboration of the questionnaire and interview frameworks. The questionnaire, which also served as a guideline for interviews, is provided in appendix 1. Appendix 2 presents other questions posed during the interviews. The chapter also discusses the reliability and validity criteria of the study.

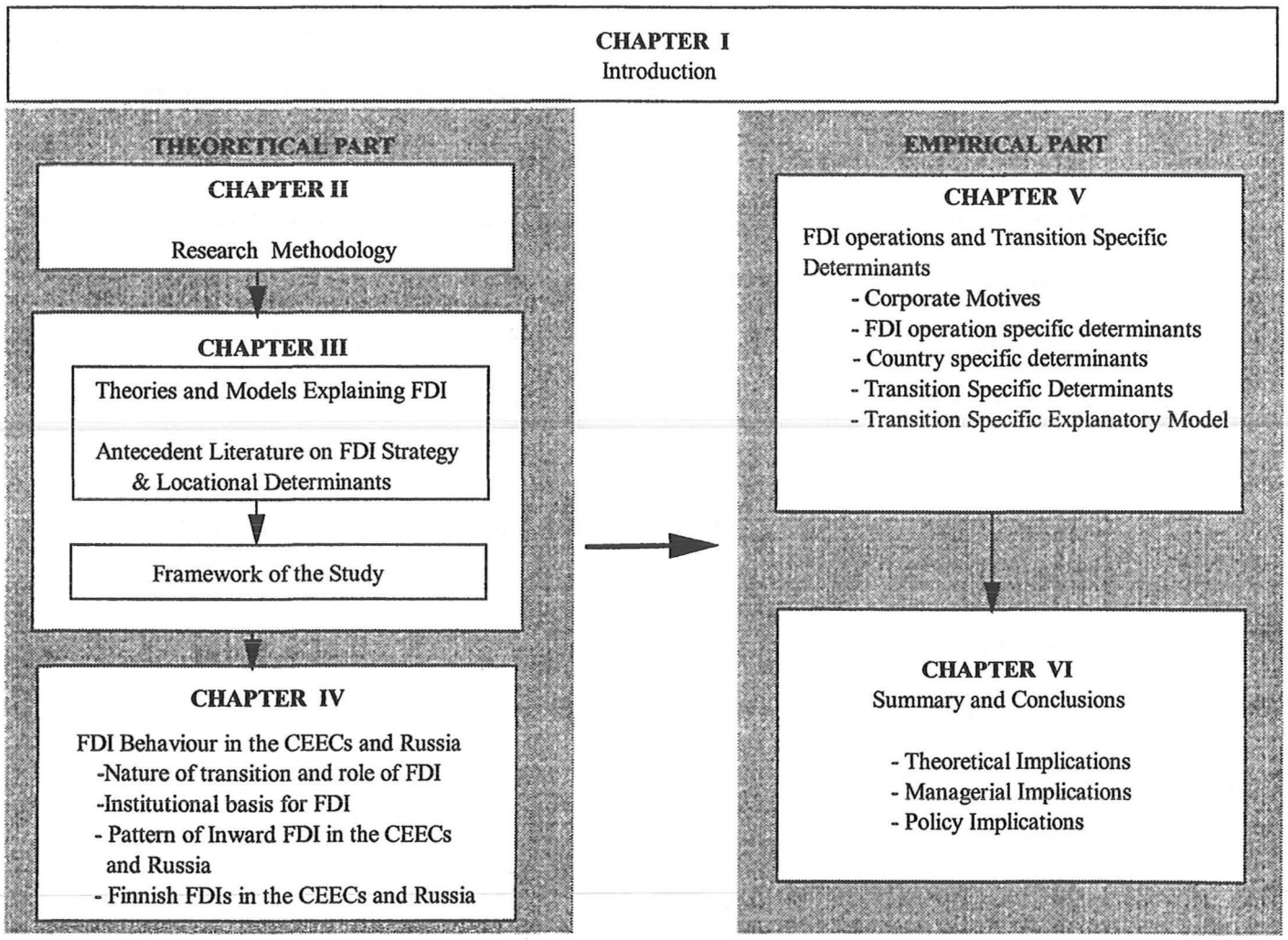
Chapter 3 provides an in-depth presentation and analysis of the development of the various theories and models that have evolved around the phenomenon of direct investment operation. The field is large and one of this study's major task was to compile a comprehensive framework for studying such operations. Key concepts are discussed and the chapter further includes an overview on empirical findings related to FDI determinants.

Chapter 4 discusses the major characteristics of transition and the differences between various transition economies, with the objective of offering an understanding of the uniqueness of such a change. In addition, the chapter provides an overview of the institutional basis for FDI as well as the key developments in foreign direct investment operations in transition economies in 1990-1995. These issues are discussed both from

the point of view of the home country Finland and from the point of view of the target markets. This chapter, together with the theoretical framework, provides the foundation for the empirical part.

Chapter 5 discusses the empirical findings. Firstly, the operation-specific determinants are discussed, followed by an analysis of country-specific determinants in a blockwise (i.e. Baltic markets, Visegrád and Russian markets) comparative perspective. A more in-depth discussion on transition specific determinants is then provided, which is the basis for the proposed explanatory model. The last chapter offers a synthesis of the consequent managerial, theoretical and policy implications, in addition to a summary.

Figure 1 Structure of the Study



2. RESEARCH METHODOLOGY

This chapter describes and justifies the methodological choices of the study. It will show that this study is a first attempt to make a qualitative analysis of the factors determining foreign direct investment operations. This has allowed a detailed analysis of FDI operations, based on information received by the respondent managers. The strength of the study lies in the pool of information based on real life observations and decisions made by investor-managers themselves. Hence, a comparative research perspective has been adopted, as it allows identifying diversity existing across a moderate number of cases in a comprehensive manner, though in not as much detail as in most qualitative research (for example single-case research), but more detailed than in 'purely' quantitative research. Qualitative research enables recognition of linkages between events and activities and exploration of managers' interpretations of the agents producing such connections, which is highly difficult in quantitative research.

2.1 Problems Related to the Analysis of Foreign Direct Investments

Data on FDIs are incomplete and inaccurate due to the fact that countries apply different statistical and data collection methods even though general guidelines have been set by the OECD, for instance. The OECD Detailed Benchmark Definition of Foreign Direct Investment (OECD 1992) provides definitions not only for FDI, but also for FDI-related activities. According to the OECD Benchmark definition, foreign direct investment refers to an investment involving a long-term interest by a foreign investor from a given (home) country in a firm (entity) in another (host) country. The direct investor aims at exerting a significant degree of influence on the management of that host country's firm. Control is therefore central. Direct investment does not only involve the initial transaction between the two firms, but also all subsequent transactions between them and among other affiliated firms. The latter include both incorporated and unincorporated ones. A foreign direct investor may in turn be either an individual, a group of individuals, an incorporated or unincorporated public or private firm, a group of them, or a government, having a subsidiary in a country other than the home country of the investor or home countries of investors. Furthermore, a minimum of 10 per cent of the ordinary shares or voting power in the host firm is required, before the investment

can be considered as direct. These criteria are also applied by the Central Bank of Finland.

FDI data are either based on balance of payments or on information provided by firms to the central banks, although such data are aggregate and several measurement problems arise. Firstly, balance of payments data cover only capital flows and secondly, firm data entail exchange rate and accounting problems. Additional obstacles are faced in transition economies due to deficiencies and distortions in previous statistical methods. New techniques have been adopted only recently, though current FDI statistics are non-reliable, because they lack satisfactory coverage. Many of the transition economies provide data on registered FDI, which are based on FDI projects that have been approved or registered by enterprise registers, investment agencies or other authorities. Thus, an FDI project may only be in a stage of being planned and presented as a potential project to the host country when it is registered. This was a major problem particularly in the early years of transition, in 1990-1994 for instance in the Baltic countries, where the number of realised projects was low compared with the planned ones. Furthermore, cross-country comparison was limited due to the widely differing FDI registration methods in transition economies. Some statistics included only joint ventures, excluding wholly foreign-owned firms. In contrast of the possibility to registering a 'planned FDI project' in e.g. Lithuania or Romania, countries such as the Czech Republic and Hungary registered FDI projects (and inflows) only after payment of the statutory capital and with the cash inflow recorded for the balance of payments. Estonia followed the latter model as well, after problems related the registration of 'planned' projects were recognised. In addition, the availability of tax advantages allocated to joint ventures may have induced joint venture registrations (with low actual investments) for instance in Russia.

Moreover, FDI data may still today refer to foreign equity contribution, total equity, in-kind contributions or loan capital, including either only one of these elements or a combination of two or more of them. The described FDI data problems were still present in the course of this study and this is still a problem in the case of many countries. As a result, aggregate data are available but they often do not allow for a thorough analysis at the firm level.

2.2 Existing Data and Methodological Aspects

In Finland, to provide at least some more specific firm-level information on direct investments in Central and Eastern Europe, several databases based on surveys have been set up. The Bank of Finland (BOF) made its first enquiry in 1991, covering 320 operative joint ventures in the former Soviet Union at the end of March 1991. This survey was repeated in 1993 and 1995, the former providing information on 382 operative firms with Finnish ownership and the latter providing data on 562 operative subsidiaries (by 345 firms) with Finnish ownership in the CIS, the Baltics and to some extent in the CEECs (see Laurila and Hirvensalo 1996, 22-24).

This survey provides information on the distribution of FDIs by economic sector and geographic area, on the volume of these investments, on the performance of firms with different size, on the ownership structure and data on the financing of operations. Another major database has been set up by the Pro Baltica Forum (Association), based in Finland and Germany. This database covers major investments in the Baltics and includes basic information on the industry, turnover, employees and sales. It is a list of major operative firms in the Baltics.

The Research Institute of the Finnish Economy (ETLA) also set up a database including data on the trade and FDI operations of 126 firms in the Baltics and the CIS in spring 1996 (number of subdidiaries unknown, see Piispanen 1996). This database includes information on the initial trade and FDI motives, on the distribution of FDIs by economic sector and geographic area, on the volume of these investments, on the performance of firms, on the ownership structure and data on the financing of operations, on the major obstacles to increasing operations in the region and on future economic prospects in the region. The study aimed at comparing the Baltics with Russia as trade and FDI target countries.

Furthermore, a major survey has been carried out at the Helsinki School of Economics and Business Administration within the FIBO (Finland's International Business Operations) programme (see Hussi and Puolakka, FIBO, 1995), which covers 1192 operative Finnish foreign subsidiaries in Central and Eastern Europe. This study is so far

the most complete on Finnish operations in Central and Eastern Europe. The study contains information on the economic and geographic distribution of the subsidiaries, on various business operations carried out in the subsidiaries, on the ownership structure and to some extent on their turnover and number of employees.

Table 1 Research Aspects of Studies on Central and Eastern Europe, 1990-1995

Study	Data source	Coverage	Comments
In Finland			
Surveys by: # BOF (Laurila & Hirvensalo 1996)	Questionnaire, BoP data	562 operative subsidiaries	Initial motives not investigated; covers the Baltics and the CIS; performance differences between SMEs and large firms
FIBO (Hussi & Puolakka 1995)	Questionnaire,journalistic sources, other secondary sources	721 operative subsidiaries	Does not include initial motives; no distinction between firms of different sizes; whole region covered, no analysis on regional characteristics
ETLA (Piispanen 1996)	Questionnaire and secondary sources	126 (parent) firms	No major difference made between firms of different size; covers the CIS and the Baltics; future trends in both trade and FDI
Case studies*	Interviews and secondary sources	1 or usually < 10 firms	Aspects unrelated or slightly related to FDI; results specific to the given firm(s)
Abroad*			
Macrroeconomic studies on FDI determinants	Balance of payments data on inward or outward FDI	All flows reported in BoP statistics	Econometric studies using BoP data; no distinction between different industries nor firms of different size.
Case studies	Interviews and secondary sources	1 to ten firms	FDI related, but specific to the given firm(s).
Surveys	Questionnaires	100 to less than 1000 firms	Most surveys on German, American, British and Austrian firms; typically cover Central Europe and sometimes Russia. No in-depth study on FDI strategy, though some aspects covered.

**For an overview, see chapter 3 on antecedent empirical research in the field. # Pro Baltica Forum is not included, as it provides a list of firms with a few key indicators on these firms. The studies by Laurila & Hirvensalo and Piispanen were conducted in 1995, but published in 1996, therefore they are included.*

The above factors affected the methodological choices of this study. This study focuses on large MNCs, while previous surveys do not make a distinction between large, medium-sized and small firms in their overall analysis (the BOF study makes a distinction between the performance of SMEs and large firms). Nor do they cover in-depth data on FDI-related decisions, i.e. the form of investment, ownership arrangements, type of investment, home and host country determinants of FDI, and the industry-specific features affecting this FDI strategy. Previous studies cover certain features of certain operation modes either related to trade or subsidiary operations. Furthermore, several studies do not investigate the initial motives for starting operations

in Eastern Europe. Naturally, the objectives of these studies were different and did not specifically aim at obtaining such information. Table 1 presents the major research characteristics of studies related to FDIs both in Finland and abroad from the point of view of this study (see also chapter 3 on the literature review). The table reviews the prevailing situation, when this study was started in late spring 1996.

2.3 Methodology and Analysis of Data

The need to undertake a study covering manufacturing FDIs by large Finnish MNCs arose from the fundamental observation that SMEs and large firms differ in their FDI strategies. For instance, when the current study was started (in spring 1996), a first glance at the geographical distribution of Finnish-owned subsidiaries in Central and Eastern Europe indicated that large firms were operating in Central East Europe, while SMEs operated in the nearby eastern regions, particularly in Estonia and in nearby regions of Russia (St. Petersburg). The overall allocation of FDIs gave impetus to further study differences in determining factors *within* Eastern Europe, as clearly the timing and volume of FDIs vary considerably within these host markets. Another stimulating reason behind this study was the notion by other studies made in countries in a similar position to Finland, which is situated in the neighbourhood of transition economies, that large MNCs from neighbouring Western countries play an active role in restructuring via their manufacturing FDIs. This is the case with e.g. German and Austrian MNCs. It was therefore considered that Finnish large firms may also play a central role. In addition, manufacturing production is central in Finland, where the 30 largest industrial firms account for 60 per cent of total output and nearly 90 per cent of outward FDIs, which reflects the crucial role of these firms in the economy and its internationalisation (see Ali-Yrkkö & Ylä-Anttila 1996) The perspective is important, as along this internationalisation pattern major concerns have emerged on the relocation of production to Central and Eastern Europe.

As the existing databases could provide only partial information and very little in-depth data on the FDI strategy of large Finnish firms, a separate investigation was initiated. The study is explorative by nature, which allows the examination of the appropriability of existing theories, concepts and empirical generalisations (Ragin 1994) on factors

affecting manufacturing direct investments from a corporate perspective. Due to the small number of large firms having manufacturing FDI operations in transition economies (includes the whole population; see chapter 2.2), the study is based on qualitative analysis and quantitative data are used to describe the main characteristics of choices related to FDI strategies in the transition economies reviewed. The quantitative data were limited to descriptive use, as the small size of this population did not allow the use of cross tabulations of independent and dependent variables or tests on them.[1] *Hence, the strength of this study emerges from information on FDI determinants / affecting factors provided by managers involved in the processes.*

The resulting analysis enables identification of region-specific patterns, interpretation or understanding of the significance of a new phenomenon, (that is transition and its impact on corporate FDI strategies), and advancement of explanatory models/theories (Ragin 1994, 31-52). In fact, the moderate number of firms (16) and their manufacturing subsidiaries (42) is most appropriate for comparative purposes and for identifying different determinants of manufacturing operations in the various markets within the whole transition area covered in this study. The empirical analysis reflects a *comprehensive approach*, where the relevant factors have been identified and subsequently discussed. As Ragin (1994, 33) puts it: '*Comparative research allows identifying diversity that exists across a moderate number of cases in a comprehensive manner, though in not as much detail as in most qualitative research*'. Hence, this study is a first attempt to identify the determinants of FDI qualitatively. Qualitative research enables recognition of linkages between events and activities and exploration of managers' interpretations of the agents producing such connections, which is difficult in quantitative research (Bryman 1988, 100-103). Furthermore, the use of several cases as objects of analysis provides a sufficient and broader basis for greater explanatory power and greater generalisability than in a single case study (Eisenhardt 1989; Yin 1984).

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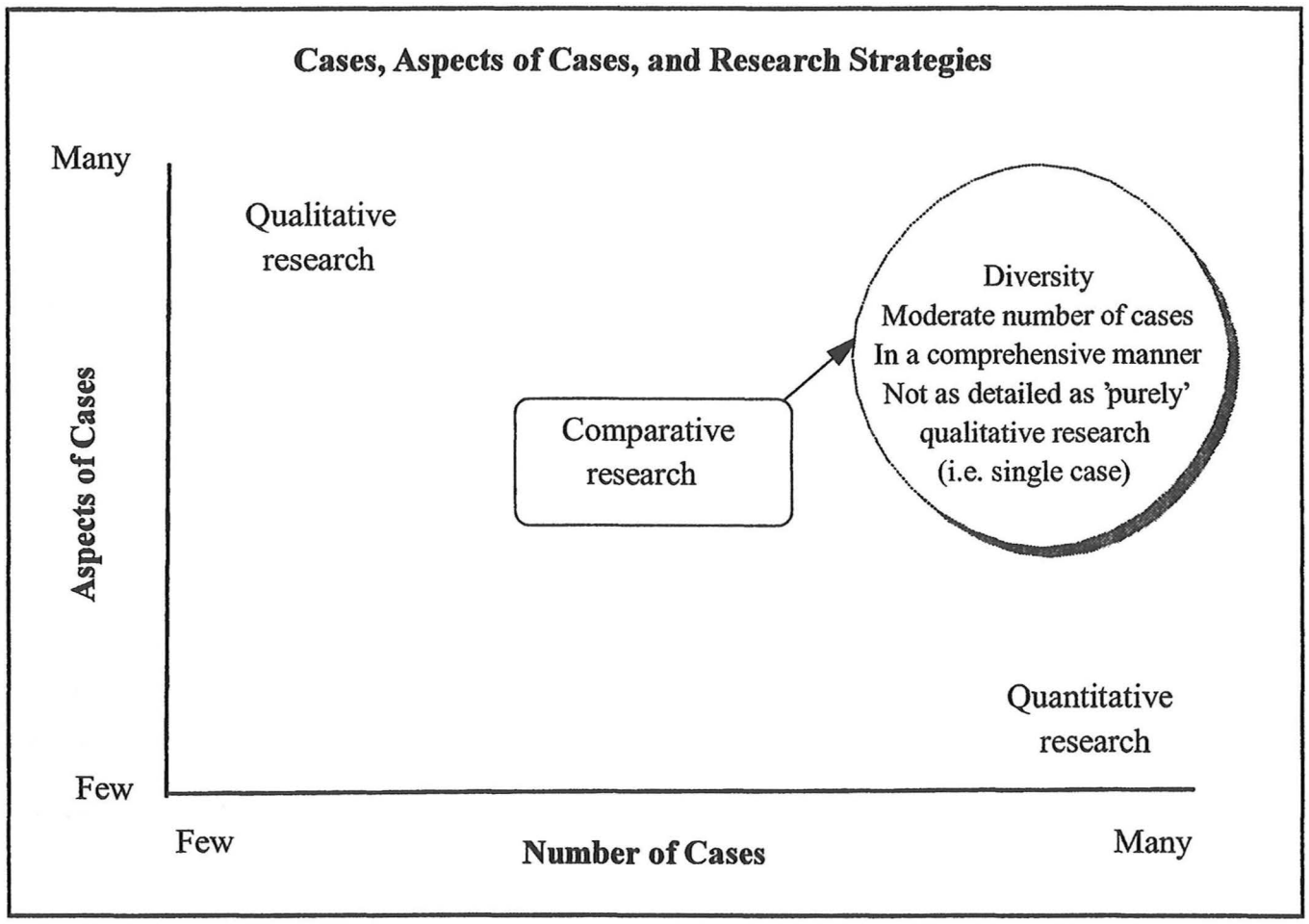
[1] For instance, in the case of Chi-square-tests, the amount of subsidiaries (= 42) turned out to be too limited to fulfill the minimum preconditions and the degree of freedom was too small for obtaining relevant results.

Figure 2 Cases, Aspects of Cases and Research Strategies



Source: Adapted from Ragin 1994.

Identifying the factors to study in order to analyse FDI determinants in transition markets was first based on the literature and second on the information that accumulated in the interviews and in the questionnaire answers. The theoretical discussion provided guidance for data collection and a strategy for analysing the data. The empirical analysis in turn was based on an interpretative perspective, i.e. entirely on information given by the interviewed persons or received in the questionnaire answers (see chapter 2.4). As a comprehensive research approach was adopted, the trade-off that arises is the one related to the number and depth of the presented results. This study has followed the guidelines of Yin (1981), who proposes organisation of *the interpretation of results around the substantive topics*. These substantive topics arose from the interviews and questionnaire data and they were analysed in the empirical chapter, leaving aside the less relevant ones.

The internal and external variables are shown in the summary of the framework of this study. The reviewed firms were classified into four different groups according to their industrial orientation. This classification used by the OECD has been used only to

facilitate identifying firms or groups of firms, where needed, as single firms could not be mentioned by name:

Resource intensive firms	Food, beverages, tobacco (ISIC 31), wood products (ISIC 34), petroleum refining (ISIC 353+354), non-metallic mineral products (ISIC 36), non ferrous metals (ISIC 372)
Labour intensive firms	Textiles, apparel and leather (ISIC 32), fabrication of metal products (ISIC 381), other manufacturing (ISIC 39)
Knowledge intensive firms	Non-electrical machinery (ISIC 382-3825), electrical machinery (ISIC 383-3832), communications equipment and semi-conductors (ISIC 3832), aerospace (ISIC 3845), computers (ISIC 3825), pharmaceuticals (ISIC 3522), scientific instruments (ISIC 385)
Scale intensive firms	Paper and printing (ISIC 33), chemicals excl. drugs (ISIC 351+352-3522), rubber and plastics (ISIC 355+356), iron and steel (ISIC 371), shipbuilding (ISIC 3841), motor vehicles (3843), other transport (ISIC 3842+3844+3849)

2.4 Questionnaire Development and Organisation of Data Collection

The study is based on information gathered through a questionnaire and via interviews in all of the Finnish large firms having undertaken manufacturing FDIs after the reopening of Central and Eastern European countries. The questionnaire best served the need to acquire factual data on the value and volume of direct investments, their geographical and sectoral distribution, information on the whole FDI strategy, as defined in the literature review of this study. Interviews, mainly telephone interviews, followed the same structure as the questionnaire, but they were also used to complement data received through the questionnaire.

The questionnaire was proved appropriate, as the key respondents were not able to answer all of the questions without searching for necessary data. In addition, many of the key respondents were spending a significant amount of time abroad. The latter was a major reason for conducting the complementary interviews by phone. Furthermore, as the required data concerned such a broad range of direct investment activities, several persons in each firm were involved in providing the information. However, only key FDI project leaders answered questions related to the evaluation of the business

environment and future operations. Additional information was acquired from annual reports, archival sources, newspapers, and the above-mentioned databases of ETLA (including the ETLA database on the 30 largest Finnish firms) and FIBO[2]. These particularly provided information on FDI operations in other regions than the Central East European region, which allowed for comparative assessment.

2.4.1 Questionnaire Development

The questionnaire was designed on the basis of empirical and theoretical literature on FDI and on previous experience to gather the most relevant elements to be analysed. This took place in January 1996. The questionnaire language was Finnish and all of the respondents were Finnish natives. The questionnaire was presented to other scholars experienced with questionnaire designs and surveys. A major emphasis on the clarity of the questions and concepts was made by using simple language and by posing carefully worded questions to avoid ambiguity and to increase the reliability of the answers. The questionnaire was then pre-tested in February 1996 by sending it to three firms (included in this study) that had agreed to co-operate in the development of the questionnaire. Major changes were subsequently made both in the wording of questions, the order of questions and in the contents, i.e. a few questions were omitted due to the low probability of obtaining such data. Furthermore, a notion of confidentiality was added to the cover letter, as all of the pilot firms underlined the strategic nature of the information requested.

Strong criticism was made on the length of the questionnaire and on the amount of data requested, but no major changes were made in that respect, as the initial objective of this study was to acquire unique data. In addition, as the total number of firms having manufacturing FDIs in Central and Eastern Europe turned out to be rather modest (i.e. 20, see the following section), the author aimed at establishing personal contacts with these firms to ensure their participation by closely monitoring and helping in the process of data collection for the study.

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[2] Database updated on a continuous basis at the Helsinki School of Economics and under the copyright of Reijo Luostarinen.

The questionnaire consists first of (questions 1-3 in form A and questions 1-4 and 7 in form B) background information on the firm and its FDI activities in the region since 1990 (or earlier, if possible) to 1995 (number of manufacturing units, industry, year of establishment, ownership/control share in case of joint venture, regional distribution, number of employees, turnover and value of investments). Second, similar information was requested on FDI operations at the regional level (in addition to the CEECs and Russia: EU, NAFTA, Asia, South America, Others) for comparative purposes and country determinant analysis (questions5-6, 8-9). Third, other operation modes and value-added activities of these firms in the CEECs and Russia were investigated to find out the extent of activities and the status of the subsidiary units (to find out, for instance, whether only production takes place or whether other activities such as R&D, finance, purchasing, etc. exist in the given unit). Previous business operations, including divestments, were also investigated in the third part (questions 10-24).

Hence, all of the above questions provide detailed information on the FDI strategy of the firms. The fourth part includes questions related to motives as well as to home and host country market, cost and production factors affecting FDI projects of these firms (questions 26-29). Finally, the competitive situation (question 30), obstacles to business operations (questions 31-32) and future trends in business operations and in the macroeconomic development of the transition economies are investigated.

The questionnaire consists of factual questions in the form of accurate data inquiries (1-9, 14-19, 24, 26, 27), multiple choice questions (10, 20-22, 34), dichotomous questions (11,22, 23), and open-ended questions (3, 12, 13, 23, 25, 35). In addition, opinion and motivation questions were posed in the form of Likert scaling (26-33). Moser and Kalton (1996, 315) argue that such questions are factual by nature, if they provide the information the questions seek. The use of the Likert scale was appropriate for this study, because it enabled measurement of, e.g., the impact of various host country factors on corporate FDI operations.

2.4.2 Organisation of Data Collection

The largest industrial Finnish firms that have made manufacturing direct investments in Central and Eastern Europe, including the Baltic States (i.e. Estonia, latvia or Lithuania), Russia and the Visegrad countries (i.e. the Czech Republic, Hungary, Poland and Slovakia) after the re-opening of these economies were selected from the 65 largest firms. The size of the firm was defined according to turnover and worldwide employment. All of the firms are also multinationals, as defined by their number of manufacturing subsidiaries abroad, which exceeded the minimum of 6 subsidiaries per firm (Harvard definition of multinationality) when the study was started. In this study, a firm is defined as a financial entity encompassing several business engagements which legally are within the control span of one ownership group. A firm is industrial, if more than 50 per cent of its total employment is within conventional mining or manufacturing. Only Finnish large multinational firms are included in the study, i.e. large foreign-owned firms based in Finland are excluded. However, only one firm that otherwise met the requirements set for the population of this study was excluded for this reason (ABB).

The first steps in identifying large firms with direct manufacturing investments in Central and Eastern Europe were taken in late autumn 1995 and early 1996 by listing large firms that were known to have FDI operations in Central and Eastern Europe (either based on journalistic sources or previous studies made by the author) and by complementing this list with the FIBO subsidiary database of 1995. In February - March 1996, the 65 largest firms, as listed in the ETLA database in terms of turnover and employment (data of 1995), were each contacted to verify whether they did or did not have direct manufacturing investments in Central and Eastern Europe. This process was time-consuming, as the right person to provide appropriate information had to be found in each firm. Including firms that were not previously listed was appropriate, as operations in general in that region are dynamic and subject to rapid changes.

The choice of the 65 largest firms as measured by turnover is based on the fact that these firms would satisfy both the size and the multinationality criteria. The turnover of the 66th largest firm (which does not have any business operations in Eastern Europe) is

only 4.7 per cent of the largest firm's turnover included in this study. Furthermore, an overview made of the 200 largest firms (again, as measured by turnover in 1995) revealed that among these firms, those with manufacturing FDIs in Eastern Europe are among the 65 largest firms. In the following rankings, from 68 to 200, only 12 firms were found to have manufacturing FDIs in Eastern Europe. Their relative turnover is even lower than that of the above 66th firm's turnover and all of them have only 2 to 3 subsidiaries abroad[3]. Thus, limiting the scope of the study to the 65 largest firms ensures meeting the requirements of the study and also the homogenousity and comparability of the data.

As a result of this first contact round, it turned out that 1 firm in the FIBO list had already divested and 2 firms did not have manufacturing FDIs in the region at all. One firm had sold its subsidiaries in Estonia and St. Petersburg in the winter of 1995-1996 as an outcome of restructuring and two firms had merged into one concern. Three 'new' firms, which were not presented in any previous databases, were added to the database of this study, as they turned out to have manufacturing FDIs in the region. Thus, the first contact round provided altogether a list of 18 firms with manufacturing FDIs in the above-listed countries of Central and Eastern Europe, reflecting the situation of March 1996. All of the investments have been made after the reopening up of these economies, i.e. in 1989-1995. The key persons knowing about manufacturing investments in the CEECs and Russia in these firms were then informed of this study and asked to participate in the questionnaire survey.

After the first contact round, these questionnaires were sent in late February to the key persons identified during the first contact process. These key persons were contacted 3 weeks later to verify that the questionnaire had been received and that the firms were still willing to participate in the survey. Five firms answered to the questionnaire immediately, while the rest answered during spring 1996, the last one answering in mid-June. The same key people were contacted regularly during the process, to ensure the

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[3]Turnovers in the group of the 65 largest firms vary between FIM 43 335 million and FIM 1 784 million, while the turnovers of the firms included in the study vary between FIM 36 810 million and FIM 2 320 million. Those of the remaining 135 firms vary between FIM 1 743 - 486 million and the figures vary between FIM 1 721-514 million in the case of the 12 firms with FDIs in the CEECs and Russia within this group.

participation of the firms and to encourage them to participate despite the large amount of data required. The contacts enabled discussing problems and clarifying some questions. Complementary data were requested by phone at the same time (such as annual reports and other information related to the questions). In the case of five firms, the questionnaire had to be resent to other key persons in subsidiaries in Finland and abroad. On average, each firm was contacted 6 times during spring 1996. Finally, only two firms refused to participate due to the strategic content of the information and due to the amount of work it would require. Furthermore, these firms announced that their FDI operations in the region were not significant yet. Thus, this study covers, in practice, the whole population of the largest Finnish firms with manufacturing direct investments in the CEECs and Russia with its 16 firms.

2.4.3 Reliability and Validity of Results

The data obtained via the questionnaire can be considered as reliable for three reasons: Firstly, accessibility of the required information to the respondent(s) was verified at all stages of empirical data collection; secondly, cognition by the respondent(s) of what is required was assured; thirdly, motivation to give accurate information was increased by the establishment of close personal relationships with the respondent(s) and by agreeing on the confidentiality of the obtained data. Furthermore, the use of a questionnaire enabled obtaining detailed data on corporate FDI strategies and determinants better than a survey interview, due to the large amount of required data and due to the number of firms (16). Thorough interviews aiming at obtaining the same data would have inevitably entailed several 3 to 4 meetings lasting 3 to 4 hours per firm, due to the accuracy of data needed. This assessment is based on a pilot interview made in one of the included firms. Finally, the reliability of results was increased by the fact that this study covers all of the largest multinational Finnish firms with manufacturing direct investments in the CEECs and Russia in 1990-1995.

The results provided by the Likert squale can be considered reliable, as it is a useful technique (with such a small amount of analysis targets) enabling measurement of firm-specific perceptions on host country determinants of their direct investments in the CEECs and Russia and the impact of these determinants on corporate FDI strategies. As

indicated previously (see table 1), macroeconomic studies provide vague results on these determinants, due to the unreliability of balance of payments data (on which most of the studies have relied) and the treatment of all FDIs as one homogenous group. The latter poses serious problems, as FDI determinants are different for firms originating from different industries and the size of the firm may affect strategies to a considerable extent. Furthermore, all of the scales include a large number of homogenous items, which increases reliability (Moser and Kalton 1996, 355).

As both the scale questions, and in fact the whole questionnaire, were constructed on the basis of existing literature considerations, the types and degrees of association between the scale and other variables should provide valid results, which is supported by adequate correlations. All in all, the accurate process of data collection in this study should also ensure the validity of the results.

2.4.4 Key Characteristics of the Firms

The 16 firms performing manufacturing FDI operations in transition economies all operate in the Central East European countries (CEECs) and / or Russia. As this information was obtained during the two first rounds of enquiry, the questionnaire was modified to enable focusing on the regions where the firms operate. Table 2 presents the regional distribution of subsidiaries in transition economies.

Table 2 Firms by Industrial Orientation in the CEECs and Russia

Industrial orientation	Firms	Number of subsidiaries in CEECs & Russia	Regional distribution of subsidiaries			
			Baltics	Russia	Visegrad	
Resource intensive	6	14	7	3	4	
Labour intensive	6	14	4	5	5	
Knowledge intensive	1	2	-	-	2	
Scale intensive	3	12	5	2	5	
Total	16	42	16	10	16	

The average number of manufacturing subsidiaries in Eastern Europe varies between 1 and 3. In addition, all of the investor firms have established their manufacturing

subsidiaries in the period 1989-1995. The whole population consists of highly internationalised firms with at least 6 subsidiaries abroad. As table 3 indicates, the share of CEEC and Russian markets as targets for manufacturing is modest, with the exception of the first group of investor firms. EU markets, in fact, are the dominant target for manufacturing FDIs. The same applies to employment figures (see table 4) and global sales.

Table 3 Global Distribution of Manufacturing Subsidiaries

Industrial orientation	Firms	CEECs &Russia	EU	NAFTA	South America	Asia	Others	Share of CEECs & Russia
Resource intensive	6	14	40	19	-	12	4	15.7 %
Labour intensive	6	14	142	41	-	11	21	6.1 %
Knowledge intens.	1	2	18	3	-	6	1	6.7 %
Scale intensive	3	12	124	20	3	9	7*	6.9 %
Total	16	42	324	83	3	38	33	8 %

**Out of which 3 subsidiaries are in Africa. Otherwise all subsidiaries in this category are situated elsewhere in Europe. Source of data for EU, NAFTA, South America, Asia and others, except for knowledge intensive category: Luostairinen/ FIBO 1995.*

The reported value of FDIs made by the firms reviewed amounts to some FIM 120 million, which represents 26 per cent of all outward FDI flows to transition economies in 1995 (FIM 459 million; including also other than manufacturing FDIs and re-invested earnings). This figure is indicative by nature, as firms are reluctant to publish such data and evaluation methods vary significantly both within firms (among various FDI projects in different units) and between firms.

Table 4 Global Distribution of Employees in 1996

Industrial orientation	Firms	CEECs & Russia	Total Employment	Employment abroad	Share of CEECs & Russia (of total)
Resource intensive	6	1 918	38 356	12 748	5 %
Labour intensive	6	1 592	48 713	26 689	3.3 %
Knowledge intens.	1	77	31 948	13 390	0.2 %
Scale intensive	3	382	65 601	9433*	0.6 %
Total	16	3969	184 618	62 260	6.4 %

**One firm did not provide such information.*

3. CONCEPTUAL FRAMEWORK FOR FDI OPERATIONS AND DETERMINANTS

This chapter provides an in-depth presentation and analysis of the development of the various theories and models that have evolved around the phenomenon of direct investment operation. The field is large and one of this study's major task was to compile a comprehensive framework for studying such operations. Key concepts that were perceived relevant are discussed and the chapter further includes an overview on empirical findings related to determinants and factors affecting FDI operations. This chapter also enabled framing the research questions and provided the broad parameters of the empirical section. This review represents the knowledge of the phenomenon existing when this study was started in spring 1996. The review starts with a broad presentation of the various research schools within the field and the evolution of various FDI theories and models. This background section may overlap with the following sections, which proceed to more in-depth discussion of the most relevant FDI-related theories and models.The discussion ends with a summary leading to the analytical framework of the study.

3.1 Background to Theories and Models Explaining FDI

There is a large diversity in the theoretical explanations of international production or the FDI motives and determinants due to, among other things, the different levels of analysis. Cantwell (1991, 17)[1] mentions three of them: 1. *macroeconomic*, i.e., examining broad national and international trends; 2. *mesoeconomic*, i.e., considering the interaction between firms at an industry level; and 3. *microeconomic*, i.e., looking at the FDIs and international growth of individual firms. Studies conducted at the first level of analysis are often heavily based on theories of trade, location and the balance of payments and exchange rate effects. The second relates to industrial economics, game theory and the theory of innovation, whereas microeconomic analysis is derived from the theory of the firm. It is important to make a distinction between these different approaches, as what may be an exogenous variable in one may be endogenous in another (Dunning 1993, 67). As a whole, it can be said that there is no unanimously accepted FDI or internationalisation theory due to the diversity of theoretical explanations (Larimo 1993). Rather, the use of particular theories often reflects the issues addressed

[1]Cantwell's article 'A Survey of Theories of International Production' (1991) in Pitelis & Sugden (eds., 1991) is one of the most comprehensive overviews on the literature. The different levels of analysis have been identified by other scholars as well, such as Luostarinen (1970).

and the questions asked (Cantwell 1991, 17). Caves (1971) further argues that different explanations are needed for different kinds of FDI. The following classification by Agarwal (1980, 739-773; see also Pitelis and Sugden 1991)[2] of FDI-related theories and empirical studies well reflects the diversity of explanations for FDI. These approaches share one common feature, nearly all of them are primarily related to outward foreign investment:

Table 5 Classification of FDI-Related Theories

I Theories Based on Perfect Markets • Differential Rate of Return Theory • Portfolio Theory • Output and Market Size Theory	**III Theories on the Propensity to Invest** • Liquidity Theory • Currency Area Theory • Other Determinant Variables
II Theories Based on Imperfect Markets • Behavioural Theory • Product Cycle Theory • Oligopolistic Reactions Theory • Internalisation Theory	**IV Determinants of the Inflow of FDI**** • Locations theory • Economic geography

***Modified and adapted by the author.*
Source: Gathered by the author and based on Agarwal (1980), Pitelis & Sugden (1991).

The most recent theories have been developed through attempts to synthesize past theories, emphasizing the behavior of firms and industries rather than countries. The rationale goes as follows: A firm operating in a foreign country faces certain additional costs in comparison with a local competitor. These are due to institutional, legal, cultural and linguistic differences, the lack of knowledge of local markets, and the increased expense in terms of the communications and misunderstandings of operating at a distance.

Therefore, for foreign direct investment to prove profitable, the foreign firm is assumed to have some advantages not shared by its local competitors. These advantages are, at least in part, *specific to the firm* and readily transferable within the firm and across distance. Such firm-specific or ownership advantages are not, however, seen as a sufficient condition for FDI, even though they are a necessary condition (Buckley & Casson 1976; Caves 1971; Swedenborg 1979). These knowledge-based, firm-specific assets of the firm may be embodied in the human capital of the firm's employees, copyrights or trademarks, patents or other exclusive technical knowledge, or simply in

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[2]The Marxist and dependencia schools of thought are not included by Agarwal, due to the domination of ideological argumentation and due to the fact that these explanations for FDI, particularly the latter one, are more concerned with the consequences of FDI. All of the explanations are here refered to as 'theories', even though they have varying degrees of power to explain FDI.

more intangible assets such as management, marketing, 'know how' in general or even the reputation of the firm.

The necessity of proprietary assets is based on empirical evidence on the microeconomic characteristics of FDI. According to empirical findings, high-tech or R&D intensive firms have a higher propensity to engage in foreign production (see for recent Nordic results, e.g. Braunerhjelm, Heum & Ylä-Anttila 1996, Swedenborg 1982 and 1989). Similarly, industries where output is characterized by high R&D, marketing expenditures, scientific and technical workers, and also by product newness, complexity and differentiation, have been found to comprise a larger proportion of MNCs. Hence, multinationality at a more general level is connected to a high ratio of the intangible assets of the firm to its total market value (Markusen 1995). Such firms tend to choose the FDI mode of operation in foreign markets, since the exploitation of firm-specific assets might be eroded in traditional trade arrangements, such as exports, or other non-equity modes of outward operation, such as licensing. Therefore, foreign subsidiaries are established in order to internalize production, ie. to ensure possession of and control over the firm's own firm-specific advantages.

The argument here is that firms grow and expand their operations internationally due to a lack of markets for firm-specific assets, ie. The markets for key intermediate products such as human capital, knowledge, management expertise, and the like, are considered imperfect (Buckley & Casson 1976; Casson 1979; Dunning 1977 and 1993). This *Internalisation theory*, as originally advanced by Hymer (1976) in an international context, then expanded by Buckley and Casson (1976) and later by several other scholars[3], is one of the predominating explanations of FDI. Another strand of internalization theory has also developed around the transaction costs approach, initiated by Coase (1937) and later developed by, e.g., Williamson (1975, 1981 and 1985) and Hennart (1982). Here, the efficiency achieved through economies of transaction costs in the internalization process play a more central role in the explanation of FDI (see following sections, where this is clarified).

To further understand why the FDI mode of operation has been chosen over other alternatives (such as exporting or licensing), the locational factors must often be taken into consideration in addition to the previously mentioned firm-specific advantages. Such locational factors include relative costs of production, market characteristics, trade

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[3]Such as McManus (1972), Dunning (1977 and 1988) and Swedenborg (1979). For a thorough reappraisal of the literature on the internalisation theory see Rugman (1980). Casson (1979) also presents a large number of scholars that have influenced the development of this theory.

barriers, and the like. (see Caves 1971, Dunning 1981 and 1993, Hood & Young 1984, Swedenborg 1979). This is the starting point for the most recent theories and models explaining FDI and internationalisation.

One of the best-known syntheses of past theories, ie., the eclectic paradigm (Dunning 1981) - drawing on firm-specific attributes (or 'ownership' advantages), locational advantages and internalization advantages - helps in understanding the internationalization processes and corporate investment strategies as they might apply to Eastern Europe, even though it sets several operational limitations due to the growing complexity of the variables used in the paradigm (Helleiner 1989; Melin 1992). However, the eclectic paradigm does not refer to the motives of a firm investing abroad; it merely postulates the preconditions to be fulfilled (Agarwal 1985). Thus, the paradigm indicates which strategy is the most effective once the motivation is given (Schmidt 1995, 16).

More recently, some scholars have stressed the sufficiency of strategic advantages alone to trigger FDI (see Jacquemin 1989; and Stehn 1992). For instance, Jacquemin (1989) argues that there are two types of locational advantages that are narrowly linked to each other: Firstly, there are the traditional locational advantages based on cost considerations, e.g., costs of inputs and transaction costs. Secondly, there is the strategic locational advantage, which is more relevant and which motivates firms to undertake FDIs. The basic assumption is that firms make FDIs to increase/defend their market power; their strategic behavior can, for instance, take the form of showing their long-term commitment to be established into a given geographical market. Here, the search for reducing transaction costs and the search for market power are not two independent motivations for FDI. FDI can be more profitable than other modes of operation, if specific assets exist (physical, locational, informational and human). Their existence may then give rise to market imperfection, which makes FDI 'a credible strategy of controlling a market' (Jacquemin 1989, 507).

In general, firm-specific strategic motives are divided into four main types of considerations which act as a basis for undertaking FDIs and which are not mutually exclusive (Behrman 1981): (1) market seekers, (2) raw material seekers, (3) production efficiency seekers, and (4) knowledge seekers.

Corporations that are market seekers primarily seek better opportunities to enter and expand within markets. This type of seekers produce in foreign markets either to satisfy local demand or to export to third markets. Companiues tend to undertake FDIs when

markets are closed or access is restricted. Several studies analysing motives for making FDIs have concluded that market-related factors are the dominant ones[4]. Access to technology has also been identified as a dominating motive.

Raw material seekers extract raw materials wherever they are available, either for export or for further processing and sale in the host country. Raw material resources are mainly based on mineral, oceanographic or agricultural advantages; thus for example firms in the oil, forest, plantation or mining industries fall into this category. Production efficiency seekers manufacture in countries where one or more of the factors of production are underpriced relative to their productivity. Thus, the aim is to obtain the most economic sources of production by having affiliates in various markets that are highly specialized in product lines or components and by exchanging production. Finally, knowledge seekers make FDIs to obtain access to managerial or technology expertize.

As opposed to Jacquemin's argumentation, locational theory - which seeks to explain why firms concentrate into certain *geographically* well-defined areas - finds the rationale for FDI from advantages accruing to the pooling of factors with specific skills, the possibility to support production of non-traded inputs and information spill-overs (Braunerhjelm & Svensson 1994). However, some scholars would put emphasis on 'pecuniary' externalities which are related to demand and supply linkages (Krugman 1991). For instance, low transportation costs coupled with a large manufacturing sector and economies of scale foster concentration of production, and vice versa. In the case of Eastern Europe, the fact that this agglomeration process is a self perpetuating process (see Wheeler & Mody 1992)[5], makes this agglomeration theory valuable, as 'a minor regional advantage could turn into a substantial clustering of specialized industrial activity' (Braunerhjelm & Svensson 1994). Therefore, the locational factors that might affect Nordic MNCs' FDI strategies are also observed in this study.

While the above explanations for international production are relatively static by nature, the Nordic internationalisation models of Luostarinen (1970 and 1979), Johanson & Wiedersheim-Paul (1975) and Johanson & Vahlne (1977)[6] describe the

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[4]See, for instance, Davis 1987; Hedlund and Kverneland 1984.

[5]They report that in the case of the wealthiest industrial economies two general agglomeration variables - foreign investment and industrialization (followed by market size) - seem to influence strongly the distribution of FDI. In the developing countries, the quality of the infrastructure and labor costs are dominant determinants, followed by existing FDI.

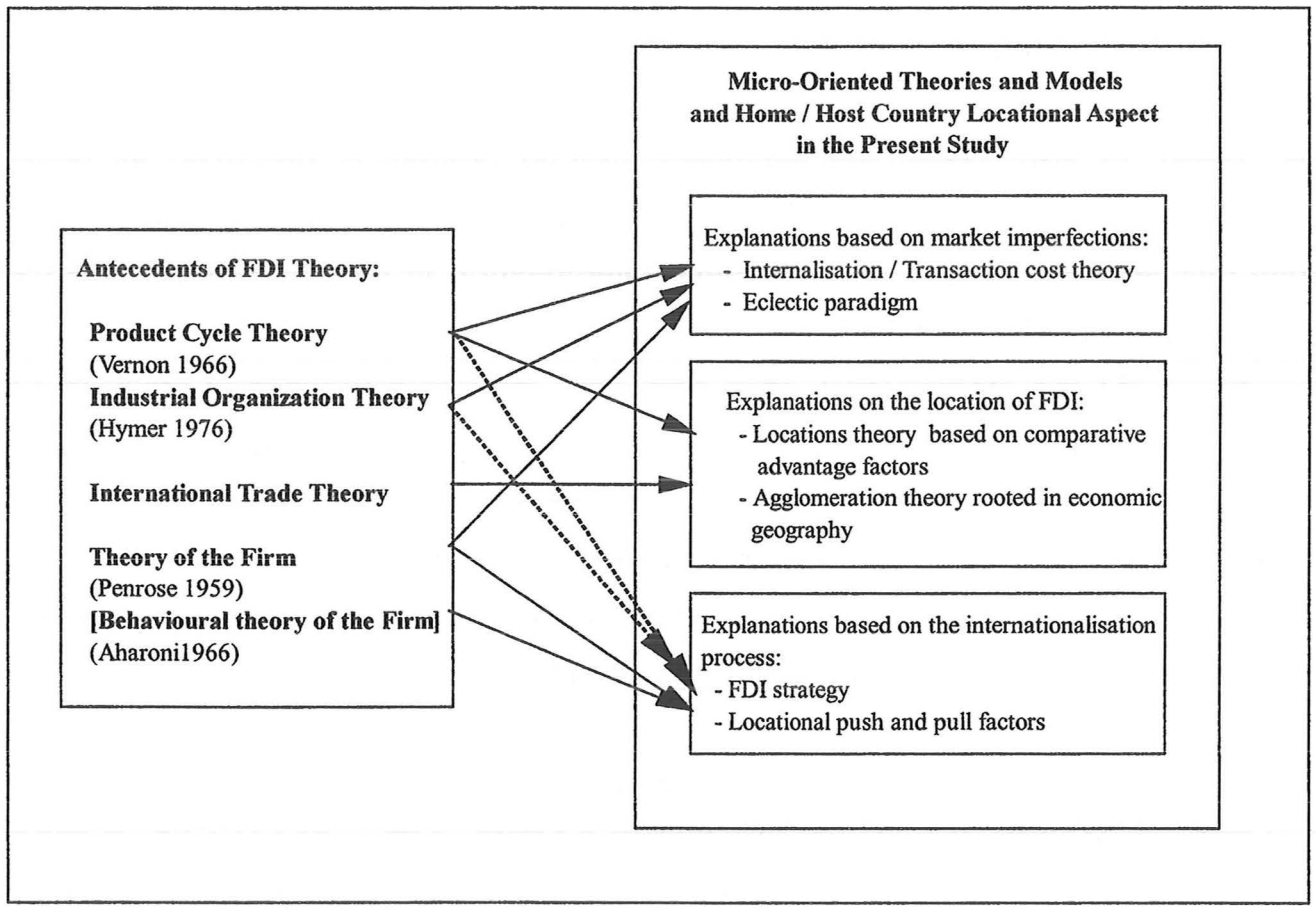
[6] These Swedish models are also refered to as 'the Uppsala model'.

internationalisation process as a gradual development taking place in distinct stages and over a relatively long period of time (Melin 1992, 102). The models of Luostarinen (1970) and Johanson & Vahlne (1977) are centered around a target country stages pattern. In addition, Luostarinen has developed a firm level stages model (1970, 1994, 1995, 1996). In both cases, the internationalisation process is described as being sequential from the initial export activities to the setting up of foreign production units, though this sequence differs in the dynamic interpretation in the two models (see the following chapter). The emphasis is nevertheless on market knowledge and market commitment. At the market level, each firm goes through a number of steps in its internationalisation path based on the firm's gradual acquisition, integration and use of knowledge on foreign markets and operations (Johansson 1977, 23-32). In Luostarinen's firm level stages pattern, rigidity towards international expansion decreases and firms shift to a more mature stage of international business, as they acquire more experience and information about internationalisation (Luostarinen 1979).

The Uppsala model is said to be most appropriate for firms that are at a relatively young stage of internationalization due to the fact that MNCs with extensive international experience have greater freedom in the choice of entry mode and seem to increase their commitments on the market in large steps (see Root 1987; Hedlund & Kverneland 1983; Luostarinen/UN-Wider 1994). The larger a firm is, the more likely it is to resort to FDI rather than licensing or exports. This is due to the larger stock of accumulated knowledge and experience with the foreign market, managerial skills, and/or capital (see, for instance, Jeon 1992).

Given the current economic stage of transition economies, this model is useful from the strategic point of view; ie. in analysing the link between certain investment entry mode patterns and corporate strategies on the one hand, and their relation to the current economic position of the Eastern European countries (locational factors) on the other hand. It is from this perspective that this dynamic model is discussed in this study.

Figure 3 Theories and Models Explaining FDI in a Corporate FDI Strategy and Locational Choice Perspective



Compiled by the author. For a thorough overview of the antecedents of FDI theory, see Pitelis & Sugden 1991. The behavioral theory of the firm is in brackets, because it is not covered in this study.

In the following sections, all the above presented theories and models are discussed in the context of this study. The analysis provides an examination of the characteristics of and relationship between the different *micro-oriented FDI approaches* as well as some propositions in regard of how these theories and models serve the empirical part of the study. The static and micro-oriented FDI theories and models are first examined and they have been grouped under the heading of theories based on market imperfections. This examination excludes the behavioral theories (see Aharoni 1966) of FDI, due to the fact that in this study the decision process to undertake a FDI is taken as given. Following the same logic, the subchapter on the dynamic models of internationalisation is dealt with from the point of view of FDI strategies as stipulated in this study; ie. the learning process *per se* and other behavioral aspects of these models are not central in this examination. These aspects would also be difficult to take into account, as the transition period started only recently and the period of observation would thus be too short. The aim is to look at the models' internationalisation factors which are related to FDI strategies in the context of the present study.

The two other sections discuss on the one hand the host country determinants of FDI from the locations theory perspective and on the other hand the eclectic paradigm. This

analysis of various FDI-related theories and models is followed by a discussion on the antecedent empirical literature from the same perspective. The framework model of the study, which is based on the preceding theoretical and empirical literature, is then presented. We will come back to the theoretical and empirical implications of the transition-specific environment in conclusions.

3.2 Theories Based on Market Imperfections

Theories explaining FDI by market imperfections have their roots in the industrial organization approach, which can be considered as a response to the deficiences encountered in the classical assumption of perfectly competitive markets. The need for an industrial organization approach emerged from the fundamental observation by Hymer (1976[7]) that the orthodox theory of international trade did not explain the foreign operations of MNCs, and that the critical associating link between capital flows and international operations of firms was missing. Moreover, the two-way flows of FDI between countries, and particularly between countries with similar factor proportions could not be explained (Cantwell 1991, 18).

According to the theory of industrial organization, the internationalisation of firms emerges as a result of interdependencies between firms in different countries due to, firstly, *market imperfections* caused by oligopolistic rivalry or bilateral monopoly, and, secondly, to *firm-specific advantages* which erect certain barriers to entry in a given industry for firms not possessing such proprietary assets (Liansheng 1992). In other words, according to Hymer (1976), internationalisation is a sum of exogenous market imperfections on the international market *and* the individual firms' potential ability to generate market imperfections endogenously by possessing firm-specific advantages. In order to remove competition in the cases of oligopolistic rivalry or of bilateral monopoly, firms resort to horizontal integration in both cases. In addition, the possession of firm-specific advantages encourages firms to exploit their monopolistic asset power globally, as these advantages enable firms to overcome barriers to international operations. FDI occurs, then, as a result of these international operations, given that the benefits of internationalisation more than offset the costs of overcoming barriers to international operations.

The key distinction between the industrial organization and internalisation theory is that in the former case, firm-specific i.e. endogenous advantages are critical, whereas in the

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[7] Published only in 1976, but this is often refered to 1960 (in the literature), when an unpublished paper appeared.

latter case, the exogenous factors to the firm are a critical force for international expansion and FDI (Cantwell 1991). Consequently, internalisation theorists have tended to treat firm-specific advantages as given. In the Hymerian theory, the endogenous generation of favourable market imperfections precedes the elimination of exogenous market imperfections, and presumes the possession of firm-specific advantages in the first place (Liansheng 1992, 30). Hence, once favourable market imperfections are generated through firm-specific advantages, barriers to internationalisation can be overcome. Later extensions to the industrial organization approach (e.g. Kindleberger 1969; Caves 1971 and 1974) all emphasize the significance of firm-specific advantages in internationalisation. However, the current interpretation of the Hymerian theory within the industrial organization approach exclusively emphasizes the role of firms' creation of market imperfection and the generation of monopoly power endogenously through firm-specific advantages. The internalization approach has developed through another interpretation of the Hymerian approach, which emphasizes the exogenous market imperfections, as indicated in the following chapter.

As the present study does not aim at analysing the *endogenous growth* of the firms included in the sample, it is beyond the scope of this study to analyse endogenous internationalisation factors, here stipulated as the generation and development of firm-specific advantages, from the industrial organization point of view. However, the study does make a distinction between *different types* of firms, according to their industrial orientation (see chapter on methodology), in order to take into account the possible effects of type-related factors on FDI strategies in the transition economies.

3.2.1 The Internalization Approach and the Transaction Cost Theory

As mentioned in chapter 2.1, internalisation theory serves to determine the reasons for the foreign production and sales of an MNC, whose activities take place in response to imperfections in the goods and factor markets (Rugman 1980). Hence, internalisation scholars think that the markets for key intermediate products such as human capital, knowledge, information, marketing and management expertise are imperfect (see, e.g. Buckley & Casson 1976; Casson 1979; Dunning 1977).

Hymer (1976) demonstrated that firms relying on internalisation could achieve market advantages through the acquisition of factor inputs at a lower cost than rivals, through better distribution and marketing channels, through monopoly advantage in information, research, knowledge or some other aspect of the production process, and/or if the firm has a differentiated product. Internalization can occur in responce to any type of

externality or distortion in the goods or factor markets, due to the need to operate efficiently and to prevent dissipation of firm-specific knowledge or other type of advantage (Rugman 1980). Buckley and Casson (1976, 37-39) consider explicitly various forms of market failure, which include incomplete markets, natural and bilateral monopolies, buyer uncertainty due to asymmetric information and government interventions. They conclude that external market failures are a necessary condition for internalization to take place. Significant time lags and transaction costs are caused by the need to link different activities through these markets. Therefore, firms find it more beneficial to replace these external markets by their own internal markets for these products (Agarwal 1980), and this internalisation of markets across countries leads to FDI. Some scholars, such as Rugman (1981 and 1985) and Hennart (1995) consider internalisation as a sufficient explanation for FDI and, hence, for the existence of MNCs. Some more strategic aspects of internalisation have been incorporated into this 'classical' explanation by Buckley (1990), Buckley and Casson (1985). They observe that internalisation incentives arise from strategic positioning, i.e. rather than deriving internalisation incentives from market failure, they define it as a strategic motivation that may lead to internalisation, and, thus to FDI.

The notion by Casson (1984) that it is necessary to distinguish between the internalization of an imperfect market and the internalization of an externality deserves due condideration. The former entails the replacement of an existing market (i.e. an arm's-length contractual relationship) with a hierarchical governance structure (i.e. a firm). This is the case when the transaction costs related to arm's-length contractual exchange are too high due to market imperfections. The internalization of an externality, in turn, takes place when the necessary market for the transaction is non-existent. These are the two aspects from which the firm is viewed in the common strand of internalization literature (e.g. Coase 1937, Hymer 1968, Buckley and Casson 1976). Thus, internalization emerges due to the avoidance of market failures (i.e. imperfect markets and externalities), whereas the transaction cost approach, as discussed below, emphasizes the economies of transaction as the major motivation for internalization. In this approach, FDI occurs as a response to increased transaction costs economies, which, recall, include opportunity and moral hazard costs.

In the framework proposed by Williamson (1975, 1981, 1985) transaction costs occur when a product is transferred across sequential stages of a production process under alternative governance structures. The most critical dimension in this transaction is asset specificity. In addition, transaction cost economics maintains that costs occur due to the combined ramification of the latter coupled with bounded rationality and opportunism.

When these attributes are joined, Williamson (1987, 30-32) refers to 'the world of governance', in which firms seek to 'organize transactions so as to economize on bounded rationality while simultaneously safeguarding them against the hazards of opportunism'. Two other factors affect the nature of these transactions, namely, uncertainty related to the completion of the contract and the frequency of these transactions. Hence, incentives for other operation modes than FDI through vertical integration become weaker as transactions become progressively more idiosyncratic, due to the less transferable nature of both human and physical assets which become more specialised to a single use (Williamson 1987, 78). In this way, vertical integration brings the liberty to make adaptations in a sequential way and a presumption of joint profit maximization brought by single ownership. Furthermore, adjustments are implemented at whatever frequency in order to maximize the joint gain to the transaction. (Williamson 1987, 68-84) Thus, *efficiency* through proper matching of governance structures to the attributes of transactions is the central advantage of bypassing intermediate markets in the Williamsonian framework.

The static approach of the transaction costs theory has as well attracted scholars adopting a more dynamic and strategic view. Langlois (1992 and 1995) shows that internalisation is a superior institutional arrangement for coordinating systemic change, i.e. the capabilities of the firm determine these transaction forms rather than market failure. Others (Kogut and Zander 1993 and 1995) explain internalisation by the determining role of transfer of tacit knowledge and argue that the creation, building-up and transfer of such knowledge determines the evolutionary expansion of firms across national boundaries. Thus, internalisation is needed for this type of transfer rather than for overcoming market failures.

Internalisation and transaction costs theorists have indeed been more concerned with the phenomenon of vertical integration than horizontal integration. Vertical investment occurs when a firm establishes a subsidiary to perform the next stage forward, or the next stage backward, in the manufacturing and sale of its product. The critical difference between horizontally and vertically integrated firms used to lie in the country specific endowments, such as input prices, raw materials or specific other resources, which the vertically integrated firms seek to exploit in an optimal fashion (see e.g. Buckley and Casson 1976, Kravis and Lipsey 1982) and which is now rather a phenomenon associated with FDIs made between developed and developing countries.

Vertical FDI in an industry is associated with reduced risk via decreased uncertainty related to the supply of the upstream good and the need for information by the

downstream firm (Arrow 1975). Likewise, Williamson (1985) underlines the role of asset specificity in transaction costs, leading to vertical integration. Lundgren (1990) indicates that 'in general vertical integration can be a useful tool to establish property rights to knowledge and to avoid the losses of successive monopolies', but underlines also the temporary, cyclical character of vertical integration in knowledge intensive industries. This is due to institutional changes that may take place over time, i.e. the integration may be dissolved, the parties engaged in the integration may shift or the coalition can be broadened, according to the parties' need to develop, protect and absorb knowledge (Lundgren 1990, 131). Caves (1971) concludes that FDI is a result of vertically integrated firms' efforts to avoid oligopolistic uncertainty and create barriers to the entry of new rivals, whereas horizontal expansion to produce the same good in foreign markets as in the home country involves, according to Caves, the critical element of product differentiation and the extension of the firm's monopoly advantage into world markets.

However, despite the different views on the role of product differentiation and horizontal integration vs. information and knowledge advantages occurring under vertical integration, several scholars stress the essence of all types of integration in internalisation (i.e. Rugman 1980 and Hennart 1990, 96). The following table illustrates different types of MNCs resulting from the internalization of various types of markets.

Table 6 The Transaction Cost Theory of the Multinational Company

Type of MNC	Market internalized
1a) Horizontal integration by R&D-intensive firms	**1a)** Technological and managerial know-how
1b) Horizontal integration by 'goodwill'-intensive firms	**1b)** Reputation; managerial skills in quality control and marketing
2a) Vertical integration into distribution	**2a)** Distribution and marketing services
2b) Vertical integration into raw materials and components	**2b)** Raw materials and components

Modified from Hennart (1990). Note that the MNC may also internalize various markets simultaneously, which is often the case.

Throughout the evolution of this literature, several studies have sought to isolate, refine and empirically test the various sources of the elusive internalization advantage (Denekamp 1995, 494). A large number of empirical studies have shown the direct relationship between the level of FDI and proxies such as the R&D intensity (which is the most common), the advertising-sales ratio, among others (cf. Braunerhjelm, Heum & Ylä-Anttila 1996; Grubaugh 1987; Horst 1972; Swedenborg 1989; Yu 1990), due to the

difficulty to discern empirically where the ownership advantage ends and where the internalisation advantage starts.

As the preceding discussion shows, what is not certain in the literature of internalisation is whether the motive for bypassing the market is its inefficiency in terms of relatively high transaction costs and longer time lags or anything else (Agarwal 1980, 754). While Hymer (1970, 443) postulates that FDI allows not only for the effective transfer of tangible and intangible assets, but also for restraining competition between firms of different nations, Williamson (1987, 292) argues that it is the efficiency factor that counts from the transaction costs perspective. He finds two reasons: firstly, oligopolistic purposes can be achieved by portfolio investment together with a limited degree of management involvement to segregate markets, and, secondly, the significance of competitive restraints would manifest in large FDIs undertaken by firms in industries associated with less rapid technical progress. Scholars stressing the strategic approach to FDI, in turn, consider internalisation as both and simultaneously reducing transaction costs and increasing market power (Jacquemin 1989, Smith 1987). In contrast, Dunning (1977 and 1993) explains FDI by three necessary factors, namely, ownership, locational and internalisation factors. In fact, the transaction costs approach has been criticized for being too static and for not taking into account *changes* in the environment (Ciborra 1992). In addition to the previously mentioned attempts to analyse internalisation from a more dynamic perspective, the Nordic stages model has been developed in order to explain internationalisation. These aspects are now discussed in the following sections.

The initial absence of strong competitors in the CEECs and Russia and the concomitant market power of large parent multinational firms from Western industrialised countries has made it relatively easy for firms to make FDIs in these economies, after their re-orientation towards a market-based economic system involving openness to international investments and trade. The internalisation / transaction costs approach is later introduced into the analytical framework of this study (see last chapter of the theoretical part), which is based on the observation that several market imperfections in terms of internalisation and transaction costs approaches seem to exist in the transition economies (see chapter 4). These imperfections (particularly resulting from industry structure and the lack of certain markets needed in transactions) may well have caused the bypassing of external markets by internalisation.

3.2.2 The Oligopolistic Reaction and the Strategic Approach to FDI

Some scholars have analysed FDIs from an oligopolistic reaction perspective[1] (Knickerbocker 1973; Graham 1975), which presumes risk-minimizing corporate behaviour where firms seek to reduce the perceived competitive threats of other members of their oligopolistic industries. Knickerbocker (1973) emphasizes a 'follow the leader' hypothesis in his observation of manufacturing FDIs by American MNCs. According to him, increased industrial concentration causes increased oligopolistic reaction in the field of FDI (except at very high levels) and profitability is positively correlated to entry concentration. Furthermore, the latter is negatively correlated with product diversity. Tests by Flowers (1975), Yu and Ito (1988) and by Li and Guisinger (1992) support Knickerbocker's findings, whereas Graham's (1975, 1978) 'exchange of threats' hypothesis is based on the central observation that firms finding their indigenous markets invaded by a foreign competitor reciprocate by entering the rival's home market and thus threaten the monopolistic position of that rival. In a later extension, Graham (1985) argues that cross investment further accelerates new product development, whereby collusion is less likely.

These hypotheses are, however, problematic, as they fail to explain the reason for an initial foreign investment made by one of the members of the oligopoly, to which the other members react. Furthermore, put in Agarwal's (1980, 753) argueable words on Knickerbocker's reasoning 'the process of FDI as a function of oligopolistic reaction is self limiting since the initial FDI and the responding FDI tend to reduce the industrial concentration in the respective host countries...With increasing FDI from (several) countries, competition has increased in many industries....A follow up conclusion from Knickerbocker's hypothesis that this should lead to a decrease in total FDI flows, is not visible yet...'. Nevertheless, the oligopolistic reaction approach offers a valuable insight into the study of FDI strategies in transition economies due to the specific business environment associated with the still partial transformation towards a market-market oriented system.

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[1]The concept of defensive investment was first postulated by Lamfalussy (1961) for domestic investment, as reported by Rugman (1980).

Most recently, the game theoretic literature in industrial organisation has also provided a strategic approach to FDI (Tirole 1989) and adopts an explanation where FDI is not considered as simply based on interactions between agents taking comparative advantages as exogenously given (Konings 1996, 7). In contrast, the need for the MNC to increase and maintain its market power plays a more important strategic role, which is explained in the game theoretic framework by the long-run deterring effect of threats caused by the specificity and sunk nature of FDI (Dixit 1980). In this model, the interplay between the sunk cost of entering a new market and the expected severity of price competition are important, i.e. the MNC can deter entry by other competitors.

Jacquemin (1989) and Smith (1987) further elaborate this proposition by indicating that FDI can replace exports even in the absence of trade barriers, due to the irreversible and long-term nature of the locational choice, which simultaneously reduces transaction costs and increases market power through a commitment of sunk costs. Jacquemin (1989, 507) stresses that the search for reducing transaction costs and the search for market power are not two independent motivations of FDI. FDI can be more profitable than other modes of operation, if specific assets exist (physical, locational, informational and human). Their existence, in turn, give rise to market imperfection which makes FDI 'a credible strategy of controlling a market'. Several other scholars underline the significance of purely strategic factors encouraging FDI (e.g. Bagwell and Staiger 1989; Horstman and Markusen 1990; Smith 1987).

The strategic reasons behind Finnish FDIs abroad mainly through acquisitions and in firms in the same industries (Kinnunen 1990) can be considered at least partially critical due to the evident motivation to maintain and increase market power (Haaparanta 1990, 13). Moreover, the literature of oligopolistic reaction, first mover advantage, learning process, and action for increasing rival costs seems to be relevant with regard to strategic FDIs (see, e.g., Jacquemin 1987; Motta 1994; Veuglers 1995). For instance, Veuglers (1995) shows how firms internationalize as a reaction to indigenous competitors' potential FDIs, which can incur competitive disadvantages in their home country.

The described critical interaction between the degree of price competition in the product market and the sunk costs associated with FDI, renders this approach valid due to the fact that price competition is at an early phase in transition economies and they are short of (cheap) capital (Konings 1996). Furthermore, market entry conditions in the region seem to attract strategic FDIs rather than FDIs determined by traditional comparative advantage factors, such as natural resources, cheap labour force, and the like (see, e.g., Baldwin 1994; Borsos 1995; Meyer 1995; Piispanen 1996). Therefore, this study also considers the 'new' strategic approach[2] of FDI, to investigate the FDI strategies of Finnish MNCs in the CEECs and Russia.

3.3 Theory of Location and Economic Geography

From the corporate point of view, the FDI may originate from three control-based objectives, i.e. FDI may be export-oriented, market development-induced or government-initiated (Reuber 1973, 73-81). While the first one does not involve targeting the host country's market at all, the second and the third render the host country locational factors vital issues for the investing company. Because the market development-type of investment aims at servicing a whole new market and /or integrating operations horizontally, and profits are not usually realised in the short- term, thus involving a long-term relationship with the host country, host country specific considerations become vital. Reuber refers to government subsidies in the case of the third motivation, but one must understand the concept in a broader sense, i.e. in the general treatment of FDIs in the context of investment-related policies and institutions. To understand the locational FDI advantages, disadvantages as well as the locational determinants associated with transition economies, the locational aspect of FDI is discussed below and then incorporated into the analytical framework of this study.

The location of FDI has been analysed on the basis of two main strands in the literature. Economic theory suggests that the location of production is determined by traditional sources of comparative advantage such as relative wages, market size and economic growth (see, e.g., Kravis and Lipsey 1982; Petrochilos 1989; Veugelers 1991) as well as transport costs (Vernon

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[2]As called by Konings (1996).

1966, Aliber 1970, Hirsch 1976). Barriers to trade (tariffs) are also shown to affect the location of FDI (see, e.g., Caves 1982, 40-43; Culem 1988). For instance, FDIs made by Finnish and Swedish firms increased dramatically in the late 1980s and early 1990s, which has been explained by the need to secure presence within the EU (see Swedenborg 1982 and Kinnunen 1990).

The second strand of literature is rooted in economic geography and is based on the pioneering work of Englander (1926) and Palander (1935). It emphasises the significance of agglomeration economies in the location of production, i.e. the advantages arising from co-locating different economic units. For instance, Wheeler and Mody (1992) found that such country agglomeration factors as the quality of infrastructure, the degree of industrialisation and the level of inward FDI were major FDI determinants in the case of US investors. Furthermore, the availability of specialized service suppliers, skilled labour and the development of industrial clusters may as well attract FDIs into certain well-defined areas (Porter 1990; see also Braunerhjelm and Svensson 1994). Wheeler and Mody (1992) further underline the self perpetuating nature of this agglomeration process, where a minor regional advantage can attract a substantial amount of specialised industrial activity (Arthur 1986).

Empirical evidence would show that both traditional comparative advantage factors and 'agglomeration factors' influence the location of FDIs. However, factor costs seem to play a less important determining role in the location of FDI than previously thought (see, e.g., Brainard 1993); a result which has also emerged in recent research on transition economies (see, e.g., Wang and Swain 1995). Instead, geographical proximity, market size and the degree of openness affect positively the distribution of FDIs (Kravis and Lipsey 1982; Veugelers 1991) and some scholars have even found that high wages in a host country eventually attract MNCs (Swedenborg 1982), as they might reflect high productivity. Internationalisation models, in turn, have incorporated institutional and risk factors (i.e. the eclectic paradigm; Dunning 1980 and 1993), as well as physical, cultural and economic distance (Luostarinen 1970, 1979 and Hörnell, Vahlne and Wiedersheim-Paul 1972), which affect the location of international production (see following chapters).

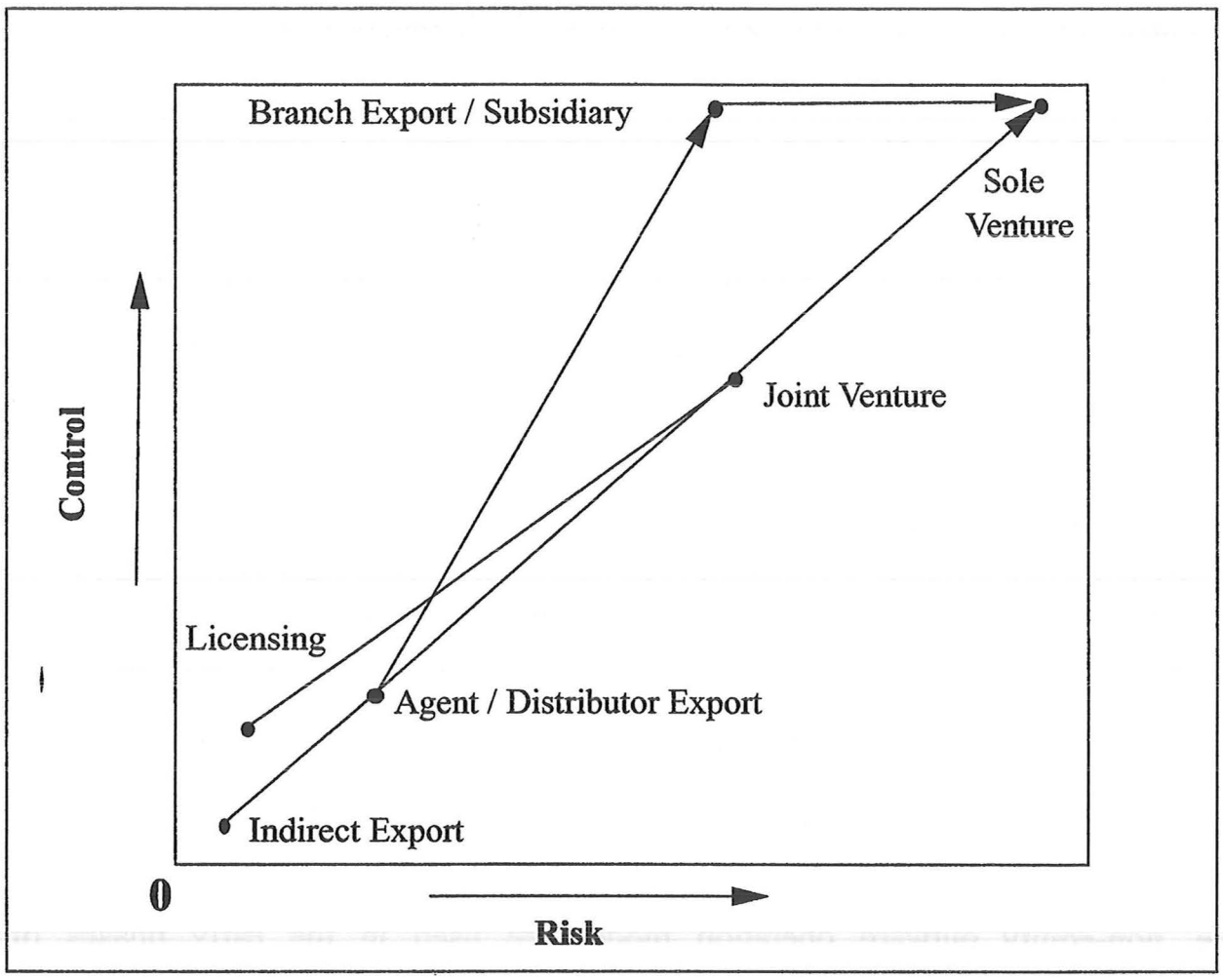
3.4 Nordic Internationalisation Models and FDI

Nordic literature on the internationalisation strategy of the firm emphasises the incremental and sequential nature of both the export process and the foreign direct investment process (see, eg. Luostarinen 1970 and 1979; Johanson & Vahlne 1977; Johanson and Wiedersheim-Paul 1975) The Uppsala model focuses mainly on internal factors affecting internationalisation (Vahlne and Nordström 1993), while Luostarinen's model has evolved since the 1970s to the late 1990s and focuses both on internal and external factors affecting internationalisation. and build on the behavioural theory of the firm developed by Cyert and March (1963), Aharoni (1966) as well as the growth theory of the firm by Penrose (1959). Other contributors to the stages model of internationalisation are Bilkey and Tesar (1977), Cavusgil and Nevin (1981), Cunningham and Homse (1982).

According to this internationalisation model, firms acquire experience in a culturally and economically close market one before moving further afield: they do not enter all major markets at the outset. This incremental strategy would allow the firms to benefit from experience acquired during the early stages of expansion and avoid larger risks. Entry modes are also chosen according to their risk containment, which usually refers to the degree of ownership, ie. non-equity outward operation modes are used in the early phases of internationalisation in a given market and ownership degree increases as the operation mode(s) develop(s) towards financially riskier modes of operation. Firms are also assumed to enter markets successively at an increasing distance from the home country, not only in terms of physical distance but also in terms of differences in economic development, culture, political system, and so on. Luostarinen (1979) refers to so-called physical, cultural, and economic distances which, together, are referred to as the 'business distance'. In the literature related to the internationalisation model of other Nordic scholars, only cultural and geographical parameters are used and they are referred to as 'psychic distance'. Thus, firms first enter markets they know best, which, hence are 'closer' than to more 'distant' markets, which are entered at a later stage. The following figure illustrates the described

internationalisation process which is largely based on case study results (e.g. Johanson and Vahlne 1977) and surveys (Luostarinen 1979)[3].

Figure 4 Evolution of Entry Modes According to the Stages Model of Internationalisation



Source: Root 1982, 20.

Internationalisation is influenced by the availability of resources and by perceived uncertainty (Luostarinen 1979; Welch and Luostarinen 1988; Johanson & Vahlne 1977) . The latter is due to two factors; firstly, to a lack of knowledge about a specific foreign market, including the institutional settings and business culture, and secondly, to a lack of knowledge on how to run a given business operation in an unfamiliar environment. Learning through experience plays a central role in acquiring knowledge in both situations. Foreign direct investment takes place gradually as a result of accumulated knowledge and accumulated alternatives.

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[3] Several surveys on the internationalisation process of Finnish firms have been conducted by Luostarinen within the FIBO Programme on a regular basis (in 1976, 1983, 1990 and 1997).

Luostarinen (1979) underlines the influential role of lateral rigidity between the stages in the decision process, meaning that the mode choice is confined by the limited perception of alternatives and selective search. In contrast, the Swedish, so-called 'Uppsala Model', views internationalisation as the consequence of a process of stepwise adjustments to changing conditions within the firm and its environment (Johanson and Vahlne 1977, 24). Here, it is the environment and the lack of market knowledge that pose both problems and opportunities, leading to the incremental process of internationalisation. While the Uppsala model distinguishes between 'state' (market commitment and market knowledge) and 'change' (commitment decisions and the performance of current activities) aspects of internationalisation (Johanson and Vahlne 1977, 26-27), Luostarinen (1970, 1979, 109-111) further elaborates his behavioural model of rigidity by identifying four categories of various types of outward international operations according to a combination of functional and investment classifications. Direct investment is here separated into two categories. Namely, into direct investment marketing operations and direct investment production operations.

The propensity to undertake FDIs and the size of the firm correlate so that small firms often take a more cautious approach to international expansion than large firms, due to the given level of resources needed in a given operation (Welch and Luostarinen 1988). As previously discussed, the Uppsala stages model is considered as primarily suitable for firms at an early stage of internationalisation (Forsgren 1989; Luostarinen and Welch 1990). Moreover, the relative importance of psychic and business distance seems to have decreased since the 1970s. Several scholars have also pointed out to the fact that firms move faster in this internationalisation path and may by-pass some stages of the model (Nordström 1991; Engelhard and Eckert 1993; Luostarinen / UN-Wider 1994). Furthermore, Melin (1992, 104) argues that the Nordic internationalisation models do not pay much attention to the acquisition type of FDI. However, and in contrast to other theories, attempts to identify various types of FDIs have been made. As a result, Hentola and Luostarinen (1995) find 22 different subsidiary / FDI (including also non-manufacturing FDIs) types. The Nordic stages model scholars have also sought to identify the external reasons behind internationalisation. In the case of Finnish firms, both home and host country factors are presented as well as the consequent company-specific advantages. The home country factors consist of domestic

'push' factors, such as the smallness, openness and peripheral location of markets, while the latter, i.e. host country factors, refers to the largeness and openness of host country markets (Luostarinen 1994). In more recent models (Luostarinen 1995), global factors have been added.

3.5 The Eclectic Approach

The 'eclectic paradigm' (Dunning 1977 and later extensions in 1981, 1988 and 1993), a synthesis of previous micro- and macroeconomic explanations for FDI, seeks to explain international production and FDI determinants principally by hypothesising that a firm will engage in FDI if three conditions are satisfied: Firstly, it possesses net ownership (e.g., firm-specific) advantages vis-à-vis firms of other nationalities in serving particular markets and they take the form of the possession of intangible assets. Secondly, assuming the first condition is satisfied, it must be more beneficial to the company possessing these advantages to internalise them through an extension of its own activities rather than externalise them through licensing and similar contracts with independent firms. Finally, if the first and the second conditions are satisfied, it must be profitable for the firm to utilise these advantages in conjunction with at least some factor inputs (including natural resources) located outside its home country; otherwise foreign markets would be served entirely by exports and domestic markets by domestic production.

The greater the ownership or firm-specific advantages, the more incentive the firm has to exploit these itself. Thus, the probability of a particular country to engage in international investment depends on whether its own firms possess such advantages. Furthermore, the extent to which FDIs are undertaken also depends on the country's locational features compared with those of other countries. Moreover, *the direct investment alternative will be chosen where locational advantages favour a foreign rather than a domestic production base* (Dunning 1993). For instance, it can be argued that in the case of Finnish companies, the change in the locational (including political change) configuration of the neighbouring Eastern transition economies has triggered Finnish firms' direct investments to that region. The following table summarises the conditions underlying these choices.

Route of servicing market	Ownership	Internalisation	Location
FDI	Yes	Yes	Yes
Export/import	Yes	No	No
Contractual arrangement	Yes	No	No

The eclectic paradigm and the internalisation theory are similar in the postulation that the existence of firm-specific or ownership advantages and country-specific or location advantages are not themselves sufficient to explain the decision to expand abroad. The firm must have some advantage gained through the internalisation of foreign activities before FDI can take place. There is, however, a conceptual difference in the two approaches: According to Dunning (1977 and 1993), each of the three advantages are distinct conditions and they must be satisfied for FDI to occur, while the internalisation approach (see, e.g., Rugman 1980) emphasises the existence of the internalisation advantage and the ownership and location advantages are considered as embodied in the firm's production function.

Many of the elements of the previously presented FDI explanations; i.e., the internalisation and transaction cost approaches, the oligopolistic and strategic approaches, the theories of location and agglomeration and the internationalisation model; are to be found in Dunning's (1981) model, but under different concepts. Dunning (1993, 88) further incorporates the three conditions into a country level investment development path (see Porter 1995), which identifies several stages of development a country may pass through and, accordingly, inward and outward FDI levels and characteristics vary according to the 'economic state' of both the home and the host country. As Dunning's paradigm consists of building blocks from other theories and models, which have been overviewed here, this study does not separately look at the paradigm's suitability for explaining FDIs in Eastern Europe. This is also due to the fact that empirical verification of the paradigm has been considered impossible. In effect, the paradigm has faced considerable criticism, as it sets several operational/empirical limitations due to the complexity of the variables used in the paradigm (Helleiner 1989; Melin 1992). In addition, the eclectic paradigm does not refer to the motives of a firm investing abroad; instead, it merely postulates the preconditions to be fulfilled (Agarwal 1985). Thus the paradigm allows one to conclude which strategy is the most effective once the motivation is given (Schmidt 1995, 16).

3.6 Antecedent Empirical Literature on FDI Strategy and Determinants: Results and East European Context

Empirical research on FDIs has focused on FDIs made either in developed or developing countries. The emergence of transition economies therefore poses new demands on empirical work related to FDI determinants and other characteristics, which is still very scarce in the case of transition economies. Until now, research has mainly focused on macroeconomic issues related to the restructuring of transition economies and less on microeconomic aspects of FDIs. This is clearly due to a lack of detailed sector-specific data and incomplete or even distorted time series data, as indicated in chapter 2.

The majority of earlier empirical studies on Nordic FDIs in Eastern Europe mainly concern Finnish joint ventures in the former Soviet Union and the perceived emerging opportunities at that time (see Nieminen, ed., 1991, Hansén and Kivikari 1989, Kallio 1990). Only few studies concerning FDIs in other Eastern European countries are to be found (e.g. Tiusanen 1990, and studies produced in the FIBO programme). This is due to the fact that research in the late 1980s traditionally focused on Finnish-Soviet trade issues related to macroeconomic analysis and to the bilateral trading system (see, for instance, Tolonen 1987, Alho et al. 1986, Hirvensalo 1979, Hemmilä 1983).

The more recent Finnish empirical studies[1] focus, as previously, on the Baltic and Russian market, whereas other Eastern European countries are given less, if any, emphasis. These studies cover a wide range of issues, such as the emerging network structures (Salmi 1995, Törnroos 1995), transition issues (Lainela and Sutela 1994), entrepreneurial adaptation based on a managerial learning process both from the host country point of view and the foreign investor point of view (Liuhto 1994, Nieminen 1994), as well as industrial policy issues and regional integration in the Baltic Rim (Hyvärinen and Borsos 1994; Hyvärinen and Hernesniemi 1995; Borsos and Erkkilä 1995a). Research on Finnish FDI strategies and other operation modes in Eastern Europe is scarce, with a few exceptions (Laurila 1993 and 1994; Hirvensalo 1993; Hussi and

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[1]Situation when writing the theoretical framework of this study in late 1996 and in the spring of 1997.

Puolakka 1995; Hirvensalo and Laurila 1996). In the other Nordic countries, particularly in Sweden, research on institutional issues and on this topic has attracted more attention recently (see, for instance, Vahlne et al., 1993; Eliasson et al. 1994). However, research on foreign business operations in Eastern Europe has been very scarce in Norway and Denmark. Contrary to the Finnish studies, the Swedish, Danish and Norwegian studies also include other Baltic States and the Visegrád countries.

The majority of research undertaken elsewhere constitutes of surveys[2], which typically cover the Visegrád countries and concerns FDIs made by British, German, Austrian and American firms. Furthermore, this literature is heavily empirical and covers relatively few factors related to the subject, often analysing corporate motives or the macroeconomic determinants of FDI. As to the actual FDI strategy in transition economies, the joint venture mode of operation and entry through privatisation have been a major research topic. This chapter provides an overview on antecedent empirical research on the various FDI related characteristics/elements, here referred to as FDI strategy, both in general and when possible in the case of transition economies.

3.6.1 Operations Preceding FDI

As presented in chapter 3.4, some researchers would view the internationalisation of the firm as a stepwise process of operations from no operations at all to exports, sales subsidiary and manufacturing subsidiary (see chapter 3.6; Luostarinen 1970 and 1979; Johanson and Vahlne 1977). Several studies confirm that firms typically operate in some form before making a manufacturing investment abroad. Not all firms follow a firm level nor country level stages pattern. This is the case of, e.g., Belgian (Van den Bulcke 1986), Danish (Schultz and Westergaard 1987), Finnish (Björkman 1991; Larimo 1993), and Swedish (Lindvall 1991) firms. However, there is a difference between more distant (business distance) countries, i.e. firms are more likely to use other operation modes before making a manufacturing FDI, due to higher perceived risks. Furthermore, a firm

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[2]See EBRD 1994, table 9.4. for a list of syrveys. Meyer (1995) provides a short list of surveys concerning mainly German and other Western FDIs in the CEECs as well.

well-experienced in FDI operations will most probably undertake an FDI without prior operations in a specific host country.[3] Moreover, Hedlund and Kverneland (1983) suggest that establishment and growth strategies on foreign markets are changing towards more direct and rapid entry modes than those implied by the Uppsala internationalisation model. In another study, Hedlund and Kverneland (1985) end up with opposing results to the internationalisation model, i.e. manufacturing investments have been made without previous operations in the same host country. A study by Larimo (1993) suggests that the behaviour of Finnish firms (operating in OECD countries) seems to have changed over time. Namely, it indicates that SMEs are more likely than large firms to make an FDI without previous operations in the host country, and, in addition, FDIs made by firms with broad FDI experience are more often preceded by extensive operations in the host country than FDIs made by less experienced firms.

Hirvensalo's (1993, 55-58) study on Finnish operations in the former USSR from 1976 to 1991 is by far one of the very few studies which analyse the development of Western operations in a former CMEA country (the former USSR) from the viewpoint of the firm level stages model. According to the results, the pattern of a stepwise development of operations mainly describes the process of internationalisation of the firm in market economies, due to strict restrictions in the former USSR. However, her observations seemed to show that 'new' operations, i.e. those undertaken after reforms were realised in the former USSR in the early 1990s, would follow a more similar pattern. Namely, operations would first develop in the Eastern nearby areas, such as in Estonia, following the proposition of 'business distance'. This seems indeed to have happened (Borsos 1994, Hussi and Puolakka 1995, Laurila and Hirvensalo 1996), as indicated by the large trade and FDI flows in Estonia, the nearby regions of Russia and other Baltic States. In addition, Hirvensalo (1993) found that Finnish SMEs located in Estonia typically had only export experiences before undertaking their manufacturing FDIs, while large firms followed a more stepwise and thus a less risky operations strategy. In contrast, according to a few case studies (Vahlne et al. 1993), a stepwise pattern would seem to apply to

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[3]See Luostarinen and Welch 1990 for an analysis of factors causing deviations in firms' internationalisation behaviour. See also Turnbull 1987, where the Uppsala model is criticised.

Swedish SMEs. Until now and to the writer's knowledge, no additional in-depth studies have been undertaken to give support to a stepwise development of operations in transition economies, including a distinction between large firms and SMEs.

3.6.2 Form of Investment

Several studies analyse the basic choice related to the form of investment, i.e. acquisition versus greenfield decisions (e.g. Andersson and Svensson 1994; Caves and Mehra 1986; Hennart and Park 1993, Svensson 1995; Zejan 1990), some of which further attempt to identify differences between various types of firms, for instance according to the knowledge intensity of the firm (e.g. Davidson 1982; Fölster and Nyberg 1993; Svensson 1996). A very common result of these studies is that high R&D intensity should encourage greenfield investment. The nature of the industry is considered to affect the choice between acquisition and greenfield, i.e. particularly in the case of resource-based industries where the most plausible way to access resources is to make an acquisition, often in the form of a joint venture (see Hennart 1991, Gomes-Casseres 1989 and 1990). The latter seems to hold in the case of German and British firms operating in the Visegrád countries (Meyer 1996).

Some have concluded that firms with a large and diversified portfolio of already established subsidiaries are more likely to make greenfield investments (Dubin 1976; Stopford 1976) and that previous presence in the market and a large plant size of the investing firm increase the probability of acquisitions (Andersson and Svensson 1995; Svensson 1995; Zejan 1990). Furthermore, in addition to previous experience, 'psychic distance' (Johanson and Wiedersheim-Paul 1975, Luostarinen 1979) affects the choice between acquisition and greenfield investment so that firms with distant origins prefer acquisition due to a higher perception of risks and fewer external sources of learning. This can be seen in the behaviour of American firms investing in Eastern Europe, where they have prefered the acquisition mode of entry.

Only a few studies have included additional market characteristics of entry such as market size, market growth and the host country's level of development (Caves and Mehra 1984; Zejan 1990; Larimo 1996). The latter finding has been associated with studies on FDIs from developed to developing countries, which have indicated that a large majority of these investments were made on a greenfield basis (see, e.g., Radetzki 1980, Larimo and Nieminen 1989, for the case of Swedish and Finnish firms). Larimo and Nieminen (1989, 22) indicate several reasons for this pattern among Finnish firms. Namely, the choice of greenfield investment is primarily due to the perceived limited opportunities of acquiring suitable and economically healthy local firms. Secondly, the difficulties between the investing firm and local firms in terms of technology, work and employment patterns and in marketing techniques form an obstacle to an acquisition type of investment. The growth in manufacturing greenfield investments as an entry mode in Eastern Europe[4] has been explained with similar reasons, but no in-depth analyses have been made (see Borsos 1995).

According to Hennart et al. (1995, 7), acquisitions differ from greenfield entries in three main ways, which imply costs and advantages that are contingent on characteristics related to the target industry, the investing parent firm and the host country. Firstly, acquisitions are associated with lower risk and costs than a greenfield investment, since acquiring a local firm provides access to valuable knowledge of the foreign market and an established brand name (see Caves 1982). Due to this advantage, competition with shareholders and other potential entrants will raise the acquisition price and reduce the expected rate of return from a takeover. Thus, the acquisition mode involves lower return, but is less risky than greenfield investment. Secondly, acquisition is viewed in the literature as a faster entry mode than greenfield, as the latter entails building a subsidiary from scratch (Caves 1982). The previously presented oligopolistic and strategic approaches provide the theoretical rationale for this observation, i.e. investors speed up their foreign entries in order to maintain their relative market power. Thirdly, greenfields usually entail the expansion of total supply, while acquisitions do not necessarily involve

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[4]Observed recently with differences across host and home countries. See Svetlicic 1994a, Rojec and Jermakowicz 1995.

increasing production. This third aspect brings into consideration the impact of concentration and the rate of growth in the target market (Hennart et al. 1995, 7).

3.6.3 Ownership Strategy

In addition to the form of investment, ownership arrangements are a critical element of the FDI strategy (e.g. Buckley 1987). This involves the choice between a wholly owned subsidiary (WOS) or a joint venture (JV), followed by the choice between majority, equal and minority ownership. However, the latter choice is complicated by the fact that in many JVs, the division of ownership is not equivalent to the division of control. Hence, minority ownership may provide a larger degree of control in some situations (Schaan 1988). In practice, this seems to be common in the CEECs and Russia (UN 1994). Furthermore, JVs in general show high rates of failure, due to multiple ownership, cultural differences, various conflicts between partners and the like (see, e.g. Beamish 1988; Gomes-Casseres 1987; Hennart, Kim and Zeng 1996). East-West joint ventures have similarly been characterised by problems arising from cultural and managerial differences (see, e.g., Hansén and Kivikari 1989; Liuhto 1991). The actual relationship between the degree of ownership and form of entry seems to be irrelevant, i.e. the ownership level of the subsidiary has no impact on the choice between entry through acquisition or greenfield investment (see, e.g., Hennart and Park 1993).

WOSs are associated with high R&D intensity of the investing firm, but most of the studies have not indicated any significant relationship (see, e.g., Stopford and Wells 1972; Kogut and Singh 1985; Hennart 1991; Larimo 1993). Swedish firms are an exception (Swedenborg 1979). However, it is the transfer of technology content and the need to secure and control that tacit knowledge being transferred that seem to affect positively the propensity to rely on a WOS arrangement (see Larimo 1987; Luostarinen and Svärd 1982; Sanna-Randacio 1990). The nature of the industry in which the investing firm operates further influences the choice between a WOS and a JV so that the latter ownership arrangement is more preferred in resource-based industries than in non-resource-based indutries (see Gomes-Casseres 1989 and 1990; Hennart 1991). This

seems to be the case for British and German firms in the CEECs, as reported by Meyer (1996), who finds that the need for complementary inputs apparently offsets the post-(JV-)acquisition costs involved in restructuring and integrating the acquired firm. The same study further reveals that R&D intensity is also associated with WOSs in the CEECs. R&D-intensive firms would also abstain in particular from acquisitions in the ongoing privatisation process in the CEECs (Meyer and Estrin 1996).

The choice between a WOS and a JV is determined by various factors. In general, WOSs are preferred over JVs in developed countries (see, e.g. Larimo 1993, in the case of Finnish firms), while JVs are predominant in developing countries regardless of whether or not the JV mode is a prerequisite for foreign investors to enter developing markets (Beamish 1987). JVs in developed vs. developing economies also differ in the patterns of ownership degrees: equal equity ventures are a rare ownership arrangement in developing countries, where minority ownership is the most common JV arrangement. Furthermore, motives are also different; i.e. the JV ownership arrangement is mainly triggered by host government policies in developing countries, while skills are the predominant motive behind JVs in developed countries (Larimo and Mäkelä 1995).

Recently, as FDI restrictions have been liberalised in many developing countries, partners' knowledge of the local market, investment climate, business culture, etc., has come to play a more central motive behind JVs in developing countries (Larimo and Mäkelä 1995). JV acquisition in general can be considered a vehicle to acquire the complementary intputs/knowledge (including brand names and distribution networks) necessary for a rapid market entry, which is particularly crucial in industries (such as the consumer goods industries) where first mover advantages can be significant (Stopford and Wells 1972). Similarly, industries with fast growth rates in the host economy due to short term profit opportunities and participation in a growing market are associated with the need for firms to make rapid market entries (Hennart 1991). Some early observations of FDI behaviour in the CEECs make these arguments valuable in the transition economies, where JVs and acquisitions were used soon after the reopening of the economies to achieve quick entry into these markets (Gatling 1993, OECD 1994).

'Psychic distance' and experience are other factors affecting ownership arrangements, i.e. firms without international experience would choose the JV mode in order to learn about the local environment while minimising risk exposure. The same applies to firms from culturally, geographically and economically distant countries, as they face obstacles and they have fewer external sources of learning and the risks are considered high (Luostarinen 1979). Firms make incrementally stronger commitments along various dimensions, for example, in terms of ownership. (Johanson and Vahlne 1990). Finally, WOSs are often preferred when the sales of the foreign unit are export oriented, while a target market orientation favours JVs due to the need for local knowledge and local reputation (see, e.g. Gomes-Casseres 1989; Sanna-Randaccio 1990; Hennart 1991).

Recent surveys report a dramatic change towards wholly owned subsidiaries in the CEECs and Russia (Duvvuri et al. 1995, Laurila and Hirvensalo 1996, Möllering et al. 1994). This is partly due to the changing institutional conditions, and partly to the need to control fully greenfield investments, reflecting a change in the business environment (as in the previously discussed case of increasing greenfield operations). As later indicated in chapter 4, 100 percent foreign ownership has been allowed only recently in the CEECs and Russia. In the former countries, generally no majority foreign owned firms were permitted before 1989 and in Russia, the 1992 legislation allowed for the first time full ownership by foreign investors as well as all existing juridical ownership forms. Investments by foreign firms were allowed previously, but only in the form of joint venture and minority ownership, Hungary being the pioneering host country for such investments since 1972. Other countries followed later in the 1980s, such as Russia in 1987, but these operations faced severe constraints and general economic and political conditions did not foster inward foreign investments in these countries until the late 1980s and early 1990s.

Hence, the joint venture mode was the only feasible form of investment operation in the former CMEA countries (Borsos 1994, Hunya 1996, Laurila 1994, OECD 1994, Senior Nello 1991). This should be taken into account while analysing changes in the investment form and ownership patterns related to FDIs in transition economies. The Nordic model

of incremental involvement receives support, but it has been strongly influenced by this specific business environment. In addition, many firms (particularly the large ones) move into the Eastern European markets very quickly; some even established wholly-owned firms as their first activity in the region (Ali and Mirza 1996).

3.6.4 Type of Investment

Chapter 3.2.1 discussed the characteristics of vertical vs. horizontal investments in an internalisation / transaction costs context. Vertical investments are investments made in same industry, but in a another stage of the production or the distribution network. A horizontal investment is a replication of the investing firm's activities, i.e. the foreign unit produces the same goods with the same methods and serves the same customers. In addition, a distinction is made according to the 'status' of the foreign affiliate, i.e. whether a concentric investment is involved or a conglomerate investment. Here, the performance of value-added activities such as manufacturing, R&D, logistics, sales, determine the nature of the foreign affiliate. In a conglomerate investment, the foreign unit does not perform at all the same activities than the investing firm in terms of production, technology, logistics, customers. The concentric type on investment involves either serving the same market segment (customers) with different production methods and R&D from the investing firm's, or the latter are similar but the market segment is different. As can be seen from this classification, vertical and horizontal investments are related to the investing firm's industry or market segment, while concentric and conglomerate investments are unrelated. This distinction between the four types of investments is widely used in the international business literature.

A multiple case study on Finnish subsidiaries in Estonia (Borsos 1994) showed that the specific transition environment may have triggered a different pattern in corporate choices related to the type of investment. While related investments are the most common type of investment in FDIs made in Western industrialised countries (see, e.g., Björkman 1991; Buckley 1981; Larimo 1987 and 1993), unrelated investments may play a more central role in a transition environment due to, among others, regulations related

to privatization, or deficiences in the market. Furthermore, some firms have been forced, at least in the early phase of transition, to undertake vertical investments in addition to their horizontal investments, because of the lack of an efficient distribution network (particularly in the case of transport networks).

Economic, geographic and cultural distance as well as experience are crucial determinants, i.e. unrelated investments are more probable in familiar markets in terms of 'psychic' distance and among firms with broader previous FDI experience. In addition, large firms are likelier to undertake unrelated investments than smaller firms, due to the more financial and management resource demanding nature of unrelated investments. Surprisingly, the nature of the industry in which the investing firm operates does not seem to affect the choice of the type of investment (See Larimo 1993, 47-53) Research related to the four types of investment is scarce, except for the phenomenon of vertical and horizontal investment (see chapter 3.2.1).

3.6.5 Host Country Determinants of FDI

There is a large body of research made on the host country determinants of the location of FDI. In the literature, these determinants are usually host country instution-, market- and production-specific. The following discussion is based on this distinction between different host country determinants, that are not mutually exclusive and are external to the firm.[5]

Institutional factors consist of the political, economic and sociocultural nature and system of the host country. Government policies and regulations are considered the most important factors affecting FDI, and within this framework political risk and legislation play a crucial role. From an economic standpoint, political risk refers to uncertainty over property rights. This refers to expropriation risk, restricted repratiation of the firm's stream of income, or constraints on the way firms use their property. Political risk

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[5]Root (1982) classifies external factors influencing the FDI strategy into market, production and environmental factors.

encompasses government actions ranging from expropriation to a major change in laws affecting, for instance tax rates or restricting competition through narrowing the rights of private companies. However, there is no unanimity yet as to what exactly constitutes political risk and how to measure it. Although various measures and models have been used, the operationalisation of the concept has proved difficult and thus studies measuring political risk are partial (see Agarwal 1980). Thunell (1977) further suggests that the degree of political risk emerging from political instability in a given host country for FDI varies according to the origin of that FDI and according to the industry involved (Thunell 1977). Furthermore, Agarwal (1980) underlines the impact of guarantees available for most firms in developed economies against a political risk.

Nevertheless, political risk is generally found to be a major deterrent of FDI in survey-based studies (see, e.g., Aharoni 1966; Root 1978), while econometric studies do not support this result. This is partly due to the above mentioned measurement and definition problems. Instead, economic factors predominate (see, e.g., Nigh 1985; Schneider and Frey 1985). In contrast to these results, Wang and Swain (1995, 375) conclude in their econometric study on FDI determinants in Hungary and China that political stability plays a crucial role in FDIs, i.e. foreign investors prefer political stability and a free market system (see also Schmidt 1995). Furthermore, they underline the decisive nature of the economic environment and particularly of the market size in attracting FDIs, once the necessary legislation has progressed.

Other studies, also, stress the importance of the overall institutional framework for FDIs, instead of stressing the particular role of political stability or of incentives specifically set to attract FDIs. In the transition economies commitment to systemic transformation and policies ensuring macroeconomic stability, infrastructural development and the establishment of a market-oriented legal framework are key factors in attracting FDIs (Borsos and Erkkilä 1995b; World Bank 1996). A number of studies suggest that countries that have adopted liberal trade regimes[6],particularly in regions with wider free trade agreements seem be more attractive in terms of inward FDI (Hufbauer et al. 1994).

In the case of the CEECs, some scholars would question the current benefits brought by the Europe Agreements signed with the EU. Baldwin (1994) points out that the 'hub-and-spoke' nature of these agreements has a deterring effect on FDIs in the region.

Offering fiscal incentives for foreign investors are still a common policy in several developing countries, while most of the European transition economies have given up special incentives for foreign investors (Borsos and Erkkilä 1995b; EBRD 1994). In fact, fiscal incentives are considered as costly and ineffective (Agarwal et al. 1995), and surveys show that they are not considered to be important among investors in the CEECs and Russia (see, e.g., EBRD 1994, Piispanen 1996). The same applies to FDIs made in Western industrialised countries, where openness, including transparency, is becoming an increasingly important determinant (Li and Guisinger 1992)[7]. In contrast, incentives seem to determine FDIs in developing countries (Lecraw 1991), ans also in the less developed regions of the EU.

Privatisation has been a major determinant in transition economies, attracting 60 per cent of all FDIs in the region (UN 1995).[8] A recent econometric study on the determinants of FDI in Central Europe by OECD countries lends support to this finding (Lansbury et al. 1996). However, one must note that such a major impact of privatisation is related to the restructuring of these economies and to the first years of transition. Thus the determining factor of privatization is only temporary. This is reflected in global privatisation trends: in other regions of the world, privatisation plays a minor role in attracting FDIs (see UN 1995).

Market-related determinants of FDI are unanimously considered the most significant. The size and the growth of the host market are determining factors not only in Western industrialised countries (Behrman 1962), but also in developing countries (see, e.g.,

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[6]As measured by the ratio of total trade to GDP

[7]Trade barriers in the form of tariffs and non tariff-barriers can also trigger FDI, if it is the only way to access a given market. See Horst 1972, Young 1978 and Moore 1993 on the effect of tariff barriers on FDI.

[8]The broad literature on privatization is not presented here, as the aim is to focus on privatization factors from the point of view of the investing firm. For an overview, see Dunning and Rojec 1993, Estrin 1994, Hunya 1992, OECD 1995.

Reuber et al. 1973[9]; Lecraw 1991) and as early surveys indicate, in transition countries as well (e.g. Gatling 1993, Wang 1993, EBRD 1994, OECD 1994, Borsos 1995, Schmidt 1995, Piispanen 1996, Venables 1996). The latter is strongly associated with the catch up demand to Western consumption levels and the expectation of sustained economic growth (ECE 1995, Piispanen 1996). Many investors followed a 'wait and see' strategy through minor investments in very early phases of transition, to establish presence and tap the markets as soon as political and economic risks decreased and/or as soon as they were be more familiar with the markets (Hirvensalo 1993, Marton 1993, Borsos 1994, Laurila 1994, EBRD 1994) In Russia, this is still a common strategy, as the large amount of representative affiliates indicates (Hirvensalo and Laurila 1996, Piispanen 1996). Furthermore, the competitive structure of the transition economies, i.e. lack of competition, the availability of acquisition targets (through privatization) at relatively low prices, etc., enabled easy access to the markets after the undertaken reforms. The Hungarian and Estonian food industries faced such an FDI pattern (Kiss 1995, Von Hertzen and Borsos 1994).

Several empirical studies suggest that such host market factors as economic (Teece 1977, Luostarinen 1979), cultural (Johanson and Vahlne 1975, Luostarinen 1979, Davidson 1980, Veugelers 1991) and geographic distance (Luostarinen 1979, Kravis and Lipsey 1982, Yu 1990, Veugelers 1991) further determine foreign direct investment. Geographical and cultural distance have been the main focus of these studies (Benito and Gripsrud 1995). The main rationale is that firms tend to undertake FDIs first in culturally, economically and geographically similar countries. As experience and knowledge accumulates, this 'psychic' distance shortens and FDIs are undertaken in less similar markets. This would explain why firms from Finland have tended to undertake their first foreign investment in Sweden (Luostarinen 1979) or US firms in Canada (Davidson 1980).

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[9]In their study on FDI inflows in developing countries was correlated with the size of the market (as meadured by GDP), but not with market (GDP) growth.

Benito and Gripsrud (1995, 46-47) point out that there are three explanations for this pattern. Firstly, nearby markets are targeted first, because a newly developed product is likelier to meet similar demand in countries that are economically and culturally similar to the home country. Secondly, psychic closeness makes it easier to manage the foreign unit and, in the early internationalisation phase or in the case of a small company, problems related to co-ordinating foreign activities are alleviated. Thirdly, psychically close markets are less uncertain, because the knowledge needed does not differ substantially.

Host country production factors are more central in the neo-classical explanations of FDI determinants. Comparative advantages of factor costs tend to dominate both popular and scientific debate, especially in connection with developing and transition economies. FDI is considered an attempt by the profit maximising MNC to minimise production or marketing costs (Dunning 1981). In this framework, particularly low labour costs would enhance foreign production. However, the evidence from survey-based studies on the role of low wages in developing countries is weak (Agarwal 1980, Larimo and Mäkelä 1995). Contrary to expectations, surveys on the motives behind FDIs in transition economies conclude with a similar result (OECD 1994, Borsos 1995, Meyer 1995, Piispanen 1996). Certain industries such as textiles, clothing and furniture, however, are associated with relocation and the strong role of low production costs in the host economies (OECD 1995, Borsos 1995). The only few econometric studies analysing FDI determinants in Hungary (Wang and Swain 1995) and OECD FDI determinants in Central Europe (Lansbury et al. 1996) end up with different results. The former finds a weak impact of wages on FDI and the latter finds a significant effect from relative labour costs and an indicator of research intensity. The role of other production factors has also been studied to some extent in the transition economies. The same surveys have revealed that infrastructure was a major obstacle to FDI in the early phases of transition, but is currently of less concern in the CEECs. Natural resources, as a whole, have attracted relatively little FDIs and are also a non-existent determinant of FDI in transition economies (ECE 1995, Piispanen 1996) with some exceptions in Russia.

3.7 Summary of the Analytical Framework of the Study

Several theories and models explain the emergence of FDI, from either the macroeconomic or the microeconomic perspective, or both. Those providing at least partially a microeconomic basis for the analysis of FDI have been reviewed in this chapter, i.e. the internalisation and transaction costs theory, the oligopolistic and strategic approaches, the theory of location and the economic geography perspective on location, and the internationalisation and eclectic models. Some empirical results of studies using one or more of these theories as a basis for analysing FDI strategy and factors affecting this strategy particularly in the case of large firms (as this study centres around large firms) were also presented. Table 7 summarises the various characteristics of the FDI explanations reviewed. As can be seen, many of these are overlapping and refer, in many aspects, to similar phenomena.

For instance, while transaction costs theory refers to opportunism, oligopolistic reaction refers to threats in the environment, which actually could be two sides of the same coin. Uncertainty in the form of lack of knowledge and experience at the firm and country level seems to emerge as the most common element in all of the approaches presented. Furthermore, the most striking common feature is the role of firm-specific knowledge. Others include the nature of industry, market size and growth, proximity, and market failures in general. Luostarinen's (1979) internationalisation model is the only explanation stressing home country factors (smallness and openness of the home market) as determining internationalisation in the first place. This, clearly, is due to the fact that other theories and models have evolved around the internationalisation of firms originating from larger economies, typically the U.S., while the Nordic model is associated with the peripheral, small and open economies of Sweden and Finland.

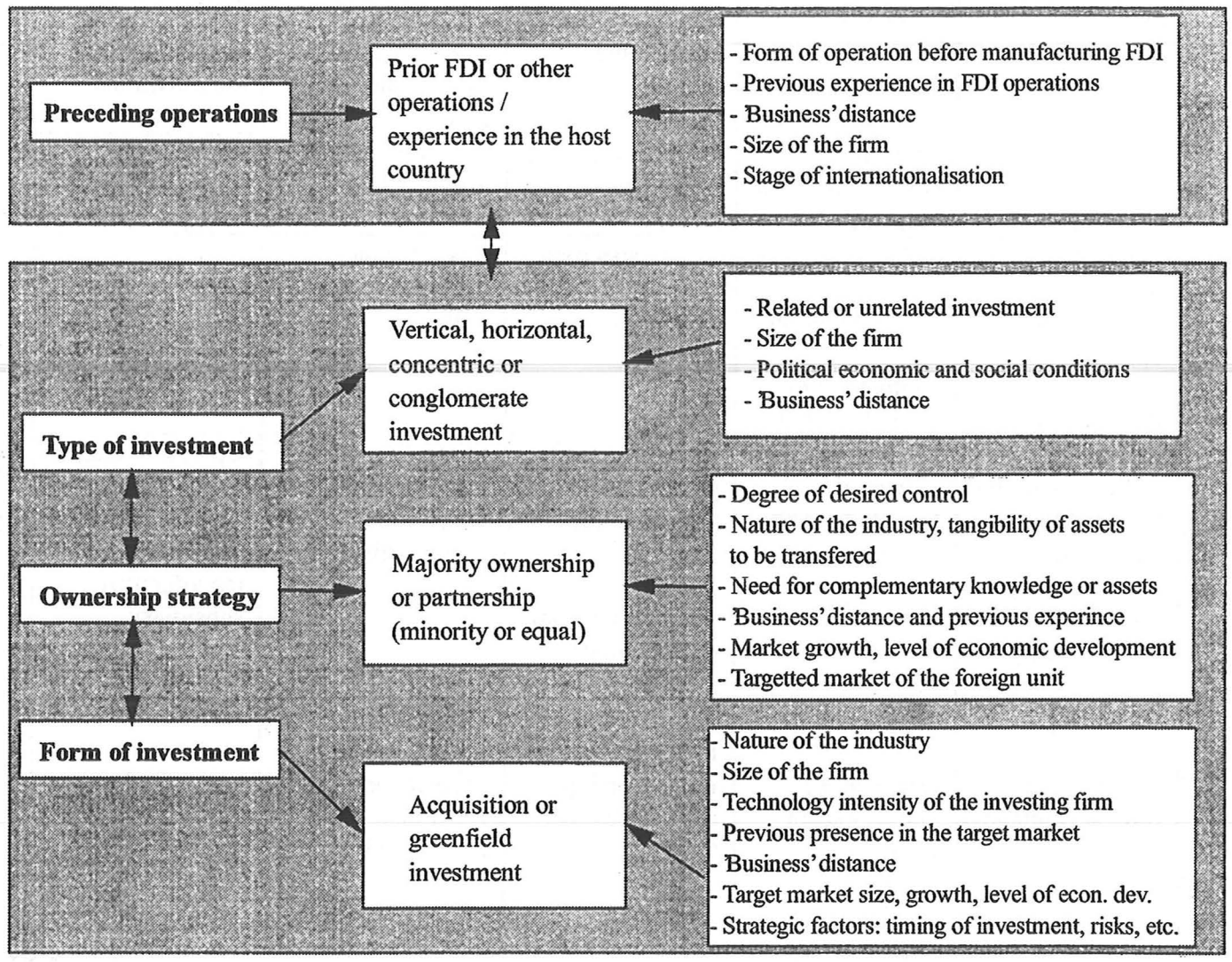
Table 7 Factors Leading to FDI in the Reviewed Theoretical Literature

	Explanatory factors:			Implications	
	Major factor leading to FDI	Environment characterised by	Firm /product characteristics	FDI rationale:	FDI entry modes
INT	Market failures	Market imperfections, i.e. lack of relevant market	Intangible knowledge	Creation or replacement of market through internalisation	-Vertical and / or horizontal integration - Greenfield
TC	Economies of transaction, need for efficiency	Market imperfections, Uncertainty - Opportunism - Bounded rationality	Asset specificity Information content	Matching of governance structures to the attributes of transactions, i.e. internalisation	- Vertical integration specifically, but also horizontal integration - Greenfield
OR	Competitive threats posed by other firms	-Increased concentration -Increased inward FDI	Oligopolistic industries	- 'Follow the leader' - 'Exchange of threats', i.e. entering the rival's home market	Vertical and / or horizontal investment -acquisitions
STR	The need to maintain and increase market power	- Market imperfections - Price competition	Specific assets, specificity and sunk nature of FDI	- same as in OR, - 'First mover advantage', - increasing rival costs	Vertical and / or horizontal investment -Acquisitions
TL	Country-specific comparative advantages	- Varying factor costs in different locations	Stage in life cycle of the product	Resource or cost oriented FDI	- Vertical integration - Acquisitions
EG	- Geographic proximity, market size, openness - agglomeration factors	<- Not specified - Accumulation of agglomeration-related attributes	<- Not specified -Technology-intensity	Resource and market oriented FDIs	- Not specified
NOR	-Changing conditions in the firm and the environment - Smallness and openness of home country	Uncertainty, due to lack of knowledge and experience	- Lateral rigidity, state and change aspects in the firm - stage of internationalization, firm and product level	- Step by step market entry according to psychic distance	Operation chain: No operations abroad- exports-sales subsidiary-manufacturing subsidiary
ECL	Ownership, locational and internalisation (OLI)advantages	-Market imperfections -Same as all above, except NOR -Distortions in regulatory envir.	Tangible and intangible assets, i.e. ownership advantages (Oa & Ot)	-Internalisation, as in INT and TC. - Others, except NOR also considered.	Includes all means mentioned above

Abbreviations: INT: internalisation theory; TC: transaction cost theory; OR: oligopolistic reaction approach; STR: strategic approach; TL: theory of location; EG: economic geography; NOR: Nordic internationalisation model; ECL: eclectic model

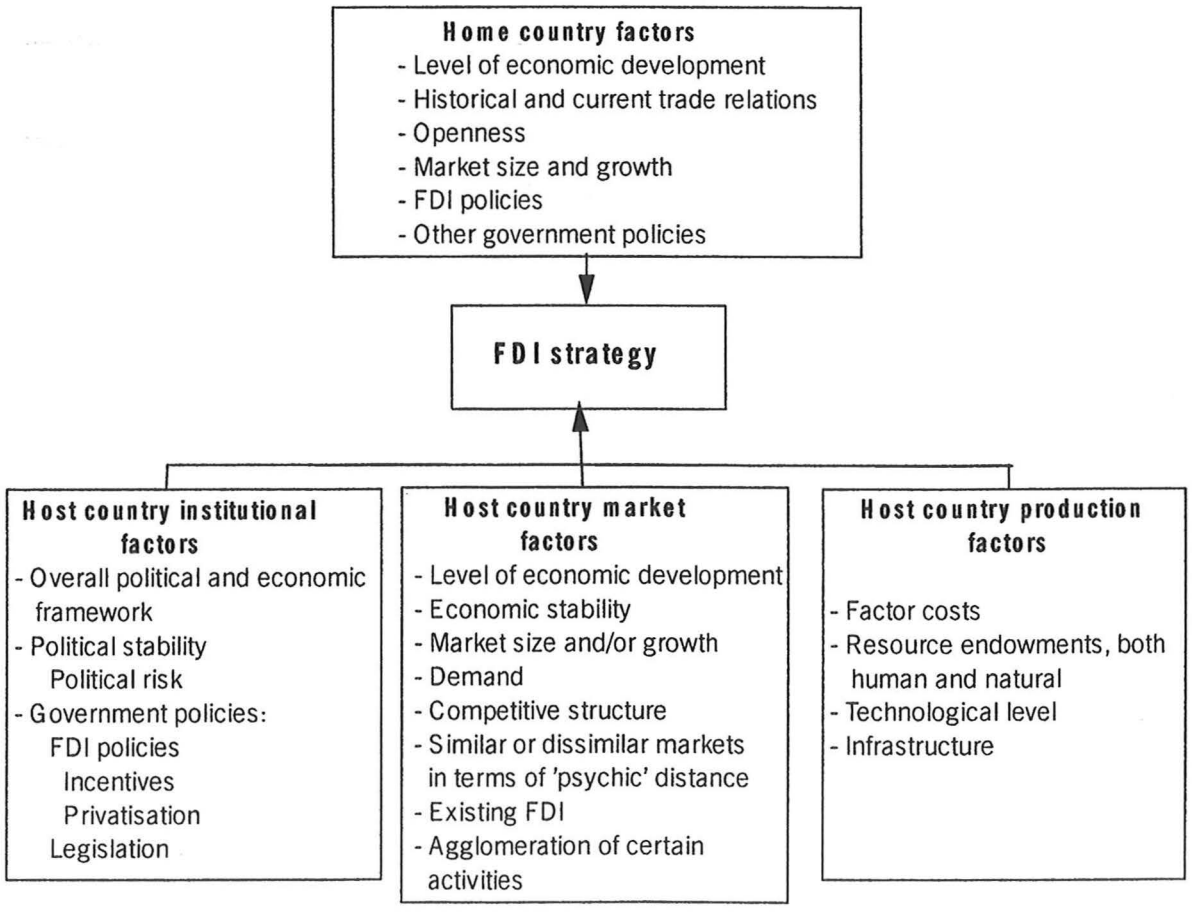
Both the theoretical and empirical literature provide a framework for the various elements related to FDI operation strategy (internal factors) and the factors affecting (external factors) this strategy. The elements of FDI strategy are shown and summarised in the adjacent figure. The empirical data collected for the purposes of this study are analysed first by focusing on the four elements of the framework (figure 5) in addition to value-added activities, then in a broader context, including the institutional, market and production factors that affect such FDI strategies in transition economies (see figure 6). As the pilot interview indicated that the home country determinants play a relatively less important role than host country determinants, these aspects are analysed simultaneously with the analysis of host country determinants.

Figure 5 Elements of FDI operation and firm-specific determining factors



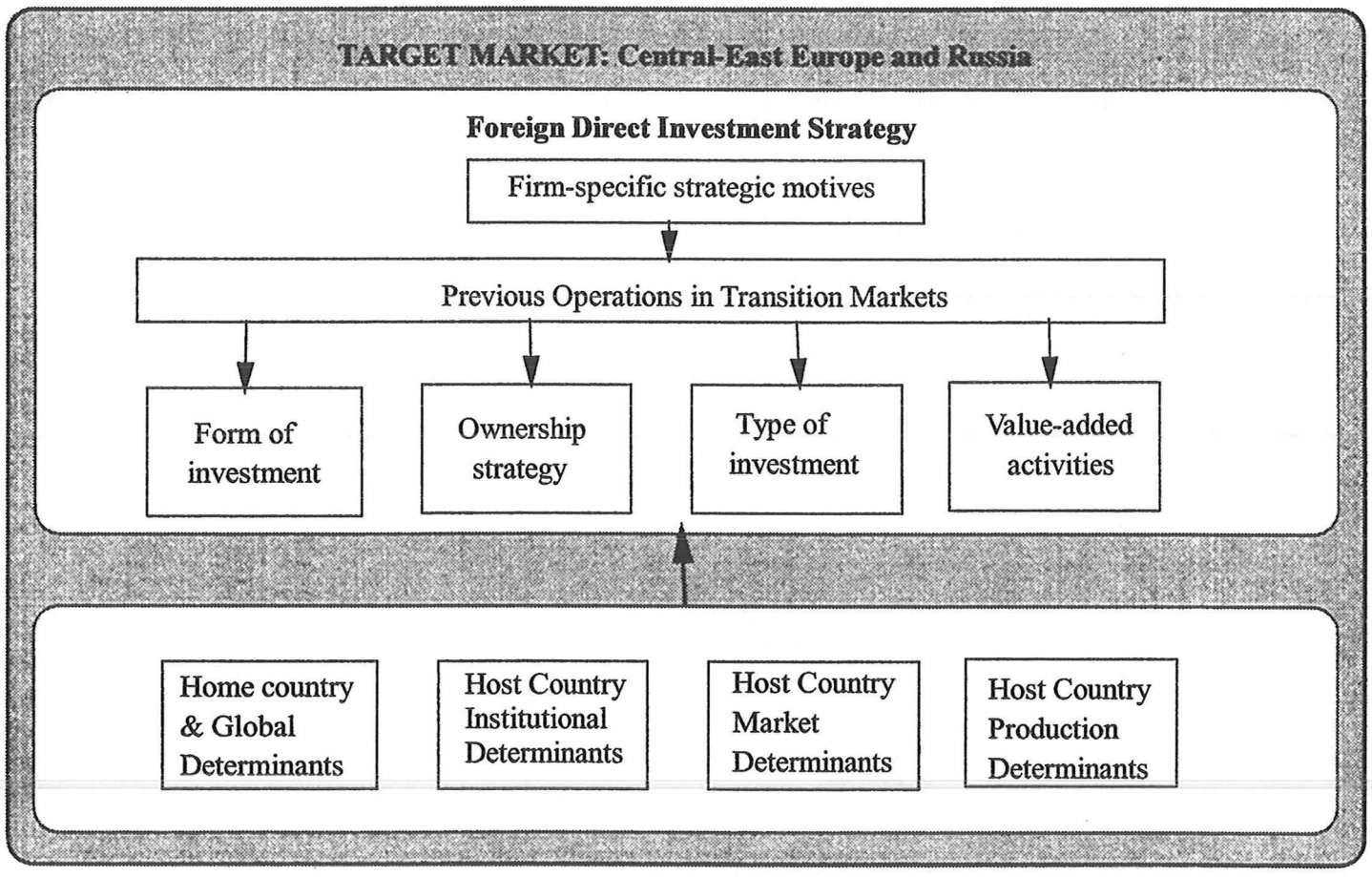
The literature on home and host country determinants was also reviewed. A large body of these empirical studies analyse FDI determinants at the country level, but as the previous analysis on FDI strategy related literature indicates, locational factors strikingly affect corporate behaviour. These country level studies were reviewed in order to cover also those locational factors that did not appear in the FDI strategy literature. For instance, political stability or existing FDIs in the host country are variables missing from the FDI strategy literature, i.e. their direct impact on the form and type of investment or on ownership arrangements has not received due consideration. However, one can assume that such factors may affect FDI strategies in the transition economies. Therefore, the most common home and host country determinants/factors are included in the analytical framework of the study. These are presented below.

Figure 6 Home and Host Country Factors Affecting FDI Operations



The FDI strategy of the reviewed Finnish MNCs and factors affecting their strategies in transition economies will be analysed according to the following framework of the study, presented in figure 7.

Figure 7 Framework of the Study: the Elements of Finnish MNCs' FDI Operations and Determining Factors in the CEECs and Russia



This theoretical framework has been developed on the basis of the preceding in-depth analysis of existing theoretical models and explanations for foreign direct investment operations and empirical results. As the former discussion has indicated, FDI as a research topic is multifaceted, it has been studied from various angles by different economic schools and the empirical results are as diverse as the theoretical explanations. To facilitate both theoretical and empirical understanding of the phenomenon, the above clear and logical framework has been constructed. The empirical analysis of this study will provide an elaborated model based on this framework and explaining the FDI operations covered in this study. The analysis looks systematically at factors emerging from the literature and the collected data, according to the chosen methodology (see chapter 2).

4 FOREIGN DIRECT INVESTMENTS IN CENTRAL-EAST EUROPE AND RUSSIA

4.1 Main features of Transition and the Role of FDI

4.1.1 The Nature of Transition

The transition markets covered in this study, i.e. the Baltic countries, the Visegrád countries and Russia, embarked on the complex process of economic transformation towards a market based system and greater international integration in the late 1980s (the Visegrád countries) and early 1990s (the Baltic States and Russia). All of these countries were previously linked to each other through trade within the Council for Mutual Economic Assistance (CMEA), but they were autarkic and international trade was more or less limited to the members of the CMEA. The starting point for transition in these countries was far from monolithic, particularly when comparing the Visegrád countries with the former Soviet Union (FSU) countries. The Visegrád countries had already initiated some reforms in the late 1960s, while the Baltic economies were still subject to tight control by the Soviet Union. This was reflected in transition progresses in the period 1990-1995 so that the Visegrád countries were able to stabilise their economies earlier than the Baltics and Russia. In general, transition countries that had progressed further in their reforms (due to an early start, fast progress or both) experienced a more stable macroeconomic environment by 1994 and benefited from a more favourable change in real output than the slower starters or slower reformers (Brenton et al. 1997). In such countries, inflation was lower and less volatile and positive growth had typically been achieved by 1994. Social indicators, namely infant and under-5 mortality rates, were also better in the faster reformers (ibid.).

The weaknesses of the centrally planned system had emerged by the late 1960s, but freely available Western credits in the early 1970s enabled eastern imports to continue. In addition, the Soviet Union benefited from the oil price increases of 1973 and 1979. As a result, reform was postponed (Senior Nello 1991, World Bank 1993). By the 1980s, credits became more difficult to obtain and at that time the republics of the former Soviet Union (FSU) and Central East European countries (CEECs) were

increasingly dependent on Western imports for technology. A huge lack of monetary discipline in the FSU and CEECs (public debt over 40% of GDP in 1989, according to the World Bank[1]) and the fall in energy prices in 1986-1991 caused serious problems to the Soviet Union. The inefficiencies of central planning involving an unbalanced industrial structure emphasizing the role of heavy industry and an almost complete lack of or lagging of comsumer goods production became more and more evident with time. The Soviet economy started to decelerate since the 1960s from a growth rate of 7% p.a. to 5% in the 1970s and to some 2% in the 1980s, while it contracted in 1990 (World Bank 1997, 2). Other Eastern European countries followed this pattern of development. Gorbachev's policy of Glasnost permitted the initiation of the urgently needed changes. This later led to the complete rejection of the centrally planned system in 1989 in Poland, Hungary and the former Czechoslovakia, followed by other surrounding CEECs. The Baltic States obtained re-independence in 1991, as a result of a similar rejection.

The transition process of these economies has been longer and deeper than expected. The following definition of transition well reflects the profound nature of change associated with the shift from a centrally planned to a market oriented economy:

> *'The long-term goal of transition is the same as that of economic reforms elsewhere: to build a thriving market economy capable of delivering long-term growth in living standards. What distinguishes transition from reforms in other countries is the systemic change involved: reform must penetrate to the fundamental rules of the game, to the institutions that shape behaviour and guide organisations. This makes it a profound social transition as well as an economic one. Similar changes have been needed in many other countries, and the transition experience is therefore of interest to them as well, but most of their reform programmes pale in comparison to the scale and intensity of the transition from plan to market'* [2]

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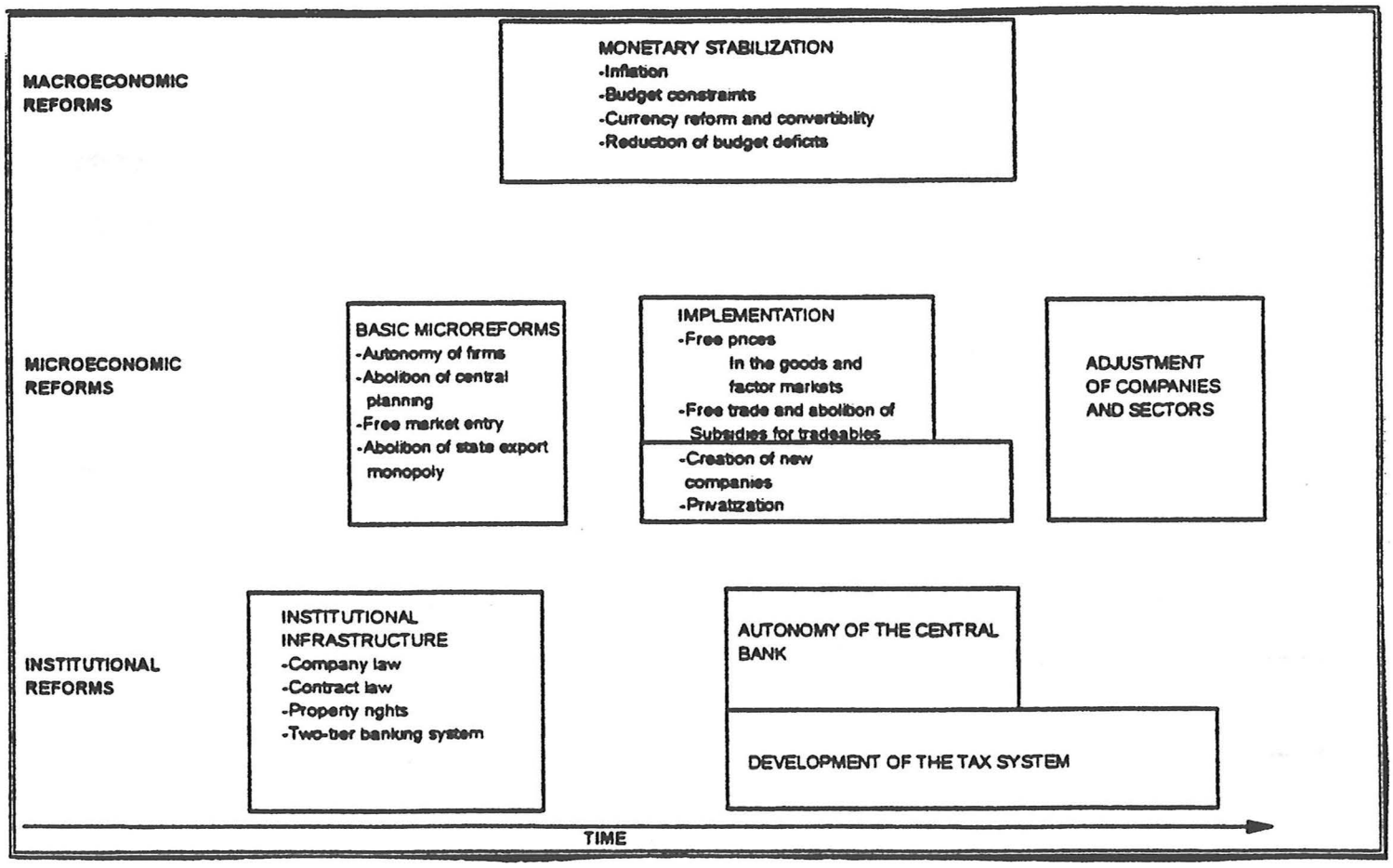
[1]World Bank, country study on Estonia, 1993.
[2]World Development Report 1996, 'From Plan to Market', p.1, World Bank, 1996.

The initial reform programmes consisted of varying combinations of stabilisation measures, institutional reforms and structural policies, including privatisation. Monetary and fiscal restraints were aimed at reducing inflation, restoring financial equilibrium, and setting the stage for a stable macroeconomic environment. Liberalisation efforts were particularly directed towards trade and capital flows in order to create a stronger private sector, which previously was almost non-existent. The following figure indicates key reforms involved in the transition process, as identified by Genberg (1991).

Figure 8 Key Reforms in Transition Economies



The early transition years, 1989-1993, were characterised by a massive contraction in output and recession. Output and employment declined to levels well below those preceding transition. The cumulative fall of gross industrial output was larger, by more than a half, than the fall of GDP. By 1993, it exceeded 50% in the countries most severely hit, i.e. Bulgaria, Romania, Russia, Ukraine and the Baltic States. The recession was surprisingly deep, widespread and persistent, while the adjustment at the supply side was weaker than expected. Attempts to explain this L-shaped behaviour of output instead of the expected U-shaped pattern would point to the inherently slow, but

necessary restructuring, while the majority of the previous output became unsustainable (see Hare and Hughes 1991; Winiecki 1991).

By 1995, most of the CEE countries and the NIS were essentially market economies with open trade, currency convertibility, and liberal policies towards new entry and private business. However, transition was still incomplete, which was reflected in indirect obstacles to enterprise operations, mainly emerging from inconsistencies and loopholes in the legislation, but also from various other areas of reform.

Enterprise restructuring and privatisation

Transition was also slower than expected due to the fact that not all market-based criteria were strictly applied. This would have led to a dramatic closure of plants and companies and to the large-scale dismissal of workers in a very short period of time. At the same time, large inflows would have been needed to create new capacities and re-allocate some of the existing capacities. Hence, the early years of transition were characterised by the following features (Landesmann 1993):

- Companies which would not otherwise (in a market-based system) be viable continued to operate and the subsequent losses were borne by banks or the government
- Specific linkages between companies or between companies and public-sector bodies were maintained although they should have been broken off
- As a result, enterprise behaviour changed slowly, but gradually in such areas as inventory behaviour, employment, output flexibility, orientation of sales and sales efforts towards different markets and determinants of investments, scrapping of capital goods.

One of the key features of transition and enterprise behaviour particularly in Russia, but also in other transition economies, was the rapid accumulation of inter-enterprise arrears since the dissolution of the FSU. By mid-1992, these amounted to 21% of GDP in gross terms. In an attempt to solve this problem, various countries - except the Baltics - carried through netting operations in the second half of 1992 and early 1993. These

operations, nevertheless, fell short of the needs, as they were accompanied by bailouts of the net debtors. This led to expectations of further bailouts and the re-emergence of inter-enterprise arrears (Citrin 1995, 14). Starting from mid-1993 to the end of 1994, some countries such as the Baltic States were able to alleviate the problem of inter-enterprise arrears, while countries such as Russia, Turkmenistan, Ukraine, Belarus and Kazakstan were struggling with increasing problems resulting from the rise in energy prices towards world market levels. This situation worsened by the end of 1995, as a result of added pressures for credits and subsidies to energy enterprises. This seriously impeded stabilisation efforts and complicated interstate relations with energy-importing states in the region (ibid.).

In addition, privatisation turned out to be a difficult task. In effect, few enterprises - except those that had been sold to foreign investors - embarked on strategic restructuring. According to Estrin et al. (1995) and Brada (1995), problems endured particularly in the domains of innovation and marketing, due to the scarcity of relevant managerial capabilities. The role of privatisation was to introduce efficient corporate governance and additional sources of funding for enterprises. Moreover, it was considered a major feature of political transformation.

Broadly considered, two different privatisation strategies were followed: one based on the free distribution of state assets to the public, and the other on a case-by-case 'commercial' approach (ECE 1995). The actual privatisation methods and the timing of privatisation were determined by political forces and interest groups (see Estrin 1994, World Bank 1996). Though privatisation methods varied across the region, small firms were generally privatised first through direct sales or auctions, while the privatisation of large firms was subject to the two methods mentioned above.

The free distribution of assets was a fast method, but it turned out to be inefficient in terms of restructuring. Ownership remained in the hands of passive owners due to the fact that ownership was too dispersed or due to the management's (which in this case remained unchanged) inability to undertake major changes. For instance, the results of voucher privatisation (where ownership was transferred to individuals) in the Czech

Republic indicated the crucial role of efficient governance and the inflow of new capital. Though privatisation in the country had led to a situation where more than half of its industry had been privatised in less than three years, enterprise behaviour had not changed markedly due to the large number of new owners (ECE 1995). Similarly, mass privatisation in 1994 through vouchers created mostly insider ownership in Russia. Though the actual transfer of ownership away from the state was rapid, effective governance and new capital were missing.

The second privatisation method, i.e. the commercial method, is time-consuming, but corporate governance is immediately established, coupled with additional financing and the implementation of the necessary adjustments, as a result of sales to new owners. In Hungary, early privatisation took the form of spontaneous privatisation with insiders taking control of the firms, while large-scale privatisation was mainly undertaken via sales to foreign investors. Estonia followed the German Treuhand model, while Polish privatisation was still at the end of 1995 seriously delayed by political conflicts. It was based on a voucher scheme providing investment funds a central role. Overall privatisation was difficult to implement, due to the unattractiveness of the firms from the point of view of foreign investors. The firms were often too large, the majority of the production capacity was outdated and the companies were generally overstaffed.

In addition to firm-specific peculiarities, transition was characterised by persistent inflation, considerable structural unemployment, major problems in the banking sector, and a lower amount of FDI flows than initially expected in the years of 1990-1995. A clear change in these respects took place when GDP growth was achieved in a number of countries in 1994, and trade was clearly reoriented towards the EU.

Reorientation of trade and its significance to Finnish markets

In the 1980s, most of the countries of Eastern Europe and the former Soviet Union enjoyed a surplus in their merchandise trade. Since 1990, one country after another moved into deficit as trade liberalisation and the transformation process advanced, resulting in trade deficits in all of the Visegrád and Baltic economies by 1995. In

contrast, Russia outstandingly enjoyed a large and ever-rising surplus during the same period, while about half of the CIS countries maintained trade surpluses.

Trade in the transition economies changed dramatically after the collapse of the CMEA. The one-way trade of the Baltic States and the Visegrád countries with the former Soviet Union changed into rapidly expanding trade with the EU. By the end of 1995, at least 50% of these countries' foreign trade took place with the EU. In contrast to the EU's importance from the eastern point of view, the CEECs occupied only a minimal, but increasing, share in the EU's total foreign trade, as the adjacent table indicates.

Table 8 Share of CEECs in EU Foreign Trade, 1990-94.

CEEC-10	1990	1991	1992	1993	1994
Exports	3,5	4,1	5,1	7,3	6,6
Imports	3,0	3,3	4,0	4,9	5,6

Source: IMF 1996.

Within the EU, Germany and Finland became significant single trade partner countries for transition countries. Considering Finland's position, it is worthwhile noting a rapid development in trade activities in the whole Baltic Rim. For instance, Germany, Finland and Sweden had by 1995 become the most important trade partners for the Eastern Baltic Rim countries with their absorption of some 40, 27 and 20 per cent of total Estonian, Latvian and Lithuanian exports, respectively. The three Baltics' trade with Russia remained stagnant in value and declining in volume (see tables 7 and 8). Only Latvia experienced a notable increase of 20 per cent in its exports to Russia in the first three quarters of 1995.

It is only in the course of 1995 that *trade among European transition economies* increased significantly. Romania was the only country to record a further decline in the value of exports to other transition economies, while Poland registered the highest trade growth with former CMEA partners with exports and imports rising by 40 and 34 per

Table 9 Foreign Trade by Direction in the CEECs and Russia

	Exports			Imports		
	Value	Growth rates		Value	Growth rates	
	1994	1994	1995	1994	1994	1995
Estonia						
World	1307	62.6	44.5	1660	85.5	55.8
Baltic States	178	80.1	29.5	67	34.3	33.3
CIS	394	61.8	15.1	339	75.0	43.8
Eastern Europe	21	3.4	65.3	30	136.2	64.6
Western Europe	653	65.0	64.2	1070	94.8	63.7
Developing countries	19	-14.5	65.1	48	128.5	56.2
Latvia						
World	1020	-2.0	33.9	1250	30.1	40.1
Baltic States	80	29.3	34.3	117	-8.6	68.4
CIS	422	-11.4	14.7	378	4.3	29.1
Eastern Europe	29	-38.2	36.6	46	139.8	41.9
Western Europe	408	19.3	62.5	516	93.2	89.6
Developing countries	57	-35.3	-55.5	127	-22.6	-82.3
Lithuania						
World	2031	1.9	12.7	2348	3.0	7.7
Baltic States	223	14.1	3.0	102	97.9	47.0
CIS	949	-16.6	-6.5	1179	-23.3	-20.1
Eastern Europe	148	-21.3	-1.7	179	102.8	16.7
Western Europe	631	54.9	54.8	803	50.4	43.2
Developing countries	48	144.0	-1.1	26	-0.3	65.4
Russian Federation						
World	49.3	8.4	30.6	28.3	5.2	19.4
Baltic States	1.7	26.4	32.5	0.7	-17.4	53.2
Transition economies*	10.9	-14.9	32.5	5.4	-15.8	12.2
Eastern Europe	5.3	-19.5**	44.9	2.8	-16.6**	16.7
Developed market econom.	32.9	21.7	20.3	19.9	20.2	20.4
Developing countries	5.5	0.4	87.9	3.0	-4.5	26.1
Poland	Trade bal.			Tr. bal./95		
World	-4.3	21.6	34.4	-3.9	15.2	36.0
Transition economies	-0.9	25.6	51.1	-0.9	22.3	53.7
Developed market econom.	-3.2	22.0	35.4	-2.6	13.5	33.4
Developing countries	-0.2	13.0	-1.3	-0.5	17.2	25.1
Hungary						
World	-3.9	20.4	20.2	-2.6	15.6	6.3
Transition economies	-1.0	5.6	26.7	-0.6	-7.5	6.5
Developed market econom.	-2.6	29.7	15.9	-2.0	25.5	6.0
Developing countries	-0.3	-12.1	52.4	-0.1	25.0	8.5
Czech Republic						
World	-0.7	8.3	19.2	-3.8	14.6	39.5
Transition economies	-	11.4	28.1	-0.5	8.3	48.2
Developed market econom.	-1.1	19.6	19.7	-3.3	21.7	40.6
Developing countries	0.2	-3.9	-2.0	-	24.1	29.8
Slovakia						
World	0.1	23.5	27.8	0.1	4.2	28.5
Transition economies	-0.5	14.6	39.2	-0.5	0.2	27.1
Developed market econom.	-	50.0	33.2	-	25.9	33.9
Developing countries	0.1	19.7	6.6	-	17.7	47.0

*Trade Balances in billion dollars for the Visegrád countries. *Excluding former Yugoslavia. **Trade with all former CMEA countries. For the Baltic States trade values of January-September in millions of dollars and growth rates January-September over same period of 1994. Source: Compiled from ECE 1996.*

cent, respectively, in volume terms[3]. The latter included the CIS countries and the Baltic States. Hence, trade between the transition economies, and particularly between those of the Baltic Rim (except with Russia) and other transition economies, increased considerably in both value and volume, the latter having risen by an estimated 18 to 20 per cent in 1995 (ECE 1996). This growth in intra-regional trade shows the re-establishment of industrial links and a recovery of domestic demand. Hence, the mutual trade of the Baltic States increased in the three first quarters of 1995 to a value of some $300- $400 million, which accounts for the same share as in the past few years or some 6 to 10 per cent of their total trade.

Previously, trade between the three Baltics seemed to suffer from poor implementation and 'political' barriers to trade, as reported in Lainela & Sutela (1994). However, these figures showed that progress was being made towards a working Baltic Free Trade Area and towards the establishment of a Baltic customs union following principles compatible with the Europe Agreements. In contrast, trade arrangements with the CIS and particularly with Russia faced several serious difficulties due to the delays in the ratification of the agreements by Russia.

The Estonian-Russian agreement signed in late 1992 remained unratified in 1995, while Lithuania's agreement was not ratified until late 1995. In practice, both direct and indirect barriers to trade set by the Russian Federation were hampering normal practices in Baltic-Russian trade in the form of excise duties, special levies, VAT, and the various certificates required on a sometimes unclear basis.

In 1995, import followed the same country pattern than in export activities with Austria, Finland and Germany being the most important single EU trade partners. Finland, Germany and Sweden were again the most important Western partners with respective shares of 16, 14 and 6 per cent of the Baltics' total imports, respectively, while the total share for Western countries was 58 per cent. Imports from Eastern Europe were of

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[3]Polish Statistical Office, 1996.

relative importance only for Lithuania. All in all, as the table below reveals, the Baltic Rim countries experienced a significant boost in the currently freer intra-regional trade within the Baltic Rim region, leading to higher growth in intra-regional trade than in trade with the rest of the world (Hernesniemi 1996). Trade within the CEFTA region followed a similar pattern of development.

Table 10 Growth and Shares of Trade between Baltic Rim Countries, 1994

	Trade growth (%) of the Baltic Rim				Share (%) of Baltic Rim in total foreign trade#	
	1994		1995*			
	Imports	Exports	Imports	Exports	Imports	Exports
Russia	34,6	20,3	24,7	12,8	24.6	17.7
Estonia	85,1	60,3	44,8	42,5	72.9	76.3
Latvia	58,7	27,2	58,3	61,5	65.4	59.3
Lithuania	51,5	11,4	22,2	14,4	69.3	61.5
Poland	15,0	24,1	19,4	33,0	42.3	49.6
Germany	20,9	22,6	15,8	25,6	9.2	8.2
Denmark	17,0	16,9	22,0	17,6	39.7	38.1
Sweden	13,9	12,5	..	..	34.7	27.7
Finland	23,0	35,5	32,3	26,6	39.5	37.6
Baltic Rim	24,4	19,5	21,0	20,6	17.7	15.7
All countries	13,6	14,9	16,4	18,8		

**The 1995 figures have been obtained by transforming the year's first 5-10 months to an annual basis. Fluctuations in growth during the year may distort the growth figures. # Figures for 1994.*
Source: compiled from Hernesniemi 1996, p. 4 and 7.

Characteristic to all of the exports from the European transition economies to the EU was their concentration on a relatively narrow range of industrial products, including goods intensive in unskilled labour (textiles, clothing, footwear, wood products), goods that use relatively large amounts of human capital and small amounts of physical capital (machinery and equipment, steel products and chemicals) and goods with low capital intensity combined with modest amounts of human capital (foodstuff). As a result of improved performance in sectors where subcontracting and production activities with foreign involvement were significant, exports of electronics parts, machinery and equipment assembly, textiles and clothing, and wood products to the EU gained momentum. Poland was a particularly important exporter of crude materials and minerals, but also of coal, iron, steel and non-ferrous metals to the EU. Russia, in turn, mainly exported oil, natural gas and refined metals to the EU, whereas exports from the EU consisted of machinery and vehicles.

Transit trade became important for the Baltic countries in the reviewed period. Transit trade played an important role particularly in Latvia's foreign trade. This reflects the geographical position between Eastern and Western Europe. Goods that were subject to such transit trade included mainly mineral products and base metals. Trade between the three Baltics consisted mainly of mineral and chemical products as well as to a more modest degree of foodstuff, machinery and equipment, while their trade with the CIS consisted of the same products, but the share of foodstuff, mineral products, machinery and equipment was more significant. These patterns confirm that the Baltic countries' production structures resemble each other and that they trade to a great extent in the same category of goods with each other and the CIS.

From Finland's point of view, the trade potential was highly under-utilised (see Borsos and Erkkilä 1995; Borsos-Torstila 1996). Potential trends in these studies showed the significant welfare effects of freer trade in the region, given that trade barriers could be eliminated. In such a case, intra-regional trade could grow by about 80 per cent. It also seemed that historical, cultural and linguistic ties played an important role, as it seemed easier for firms in the region to penetrate the new transition markets, which was reflected in the high share of Western Baltic Rim investors in the Eastern Baltic Rim and in the substantial excess of the realised trade over the potential trade, such as in the case of Finland and Sweden. The trading potential among the three Baltic States, in turn, was surprisingly modest, with more intense actual trade than predicted potential trade. Hence, the various multilateral and bilateral trading arrangements within the Baltic Rim seem to have had a positive effect on the 1990-1995 developments in both trade and FDI (see chapter on the institutional basis for FDI).

4.1.2 The Role of FDI in Transition Economies

Foreign investment was soon after the abolition of the former socialist system in Eastern Europe considered as the most potent catalyst for the indispensable transformation process. Initial expectations were very high. Foreign direct investment in the form of joint ventures, acquisitions and greenfields were seen as offering access to capital that

might otherwise be unavailable. After decades of high, but misdirected capital accumulation, the early transition phase was characterised by under-investment. New investments were needed in order to restructure existing capacities, the development of public sector infrastructure, and the resumption of economic growth. It was further realised that international funds could fill the gap only partly. Therefore, foreign capital was sought to be attracted.

Many studies have indicated, as shown in the following overview, that foreign direct investments can act as a powerful catalyst for economic change. They offer financial resources, technology, management, a new business culture or management and marketing techniques, and access to foreign markets. These factors can help in developing the private sector, which was neglected under the socialist system.

Some of the main host country benefits of FDI are considered to result from the inflows of new technology to subsidiaries of multinational companies (MNCs), since these flows create a potential for technology spillovers to the host country's local firms (see, e.g., Caves 1974; Blomström 1989; Kokko 1994). Furthermore, FDI is seen as an important vehicle for the transfer of technology, contributing relatively more to economic growth than domestic investment. However, a higher productivity of FDI requires a minimum threshold stock of human capital in the host country (Borensztein et al. 1995). Hence, the same technology that has worked successfully in a given country may completely fail in another environment unless the host country and its firms possess adequate prerequisites to adopt, use and maintain new technology. In this respect, expectations were positive in the former socialist countries, as technical know-how formed the core of educational programmes and great effort was put into research. In addition to high human capital, successful transfer of technology requires an appropriate socio-economic environment with a sufficient material and non-material infrastructure (Myllyntaus 1992). This was one of the objectives of the transition economies in seeking to make their economies fully market-oriented ones.

The technological benefits of FDI emerge due to the fact that MNCs, which are major foreign direct investors, are identified with a high ratio of knowledge-based, firm-specific assets. Moreover, empirical evidence shows that a country's industry tends to have a greater proportion of MNCs when the output of that industry is characterised by R&D, marketing expenditures, scientific and technical workers, product newness and complexity, and product differentiation (Markusen 1995, 174). Technology transfer from mother companies to affiliates, then, does not only include flows of management, engineering, marketing, and financial services, which are based on human capital, but also other firm-specific assets, such as patents and trademarks.

At the country level, the above MNC characteristics emerge in the same way, ie. foreign direct investment and MNCs are associated with the similarity of countries. That is, MNCs are more important between countries that are relatively similar in size, per capita income, and relative factor endowments (see Markusen 1995). This may explain why a greater bulk of FDI activities takes place among the industrialised countries and not between the developed and developing countries (see UN 1995). However, the role of FDI in developing and emerging economies seems to be more crucial, particularly when it comes to technology diffusion and economic growth (see World Bank 1993; Wang 1990). Therefore, the technological capacities of a transition country and its firms may be crucial in achieving a market-based competitive economy.

In addition to the technological benefits of FDI (either through transfer or upgrading of indigenous technological capability, or both), foreign firms can, via their FDIs, benefit host country economies in a number of ways (Dunning 1993), such as: (1) By bringing financial resources to fill the gap between desired investment and locally mobilised capital; (2) by providing new trade links and increased foreign exchange earnings; (3) through the transfer of management techniques and training programmes; (4) through overall economic effects (e.g. the overall tax revenue, employment effects, etc.) and increasing competition as well as other spillover effects (Kokko 1994). In transition countries, the role of FDI is not only limited to the ones described above, but also to the strong overall need to rapidly re-orient the economy towards a market-based system and

even to secure independence on the new European political map (Rumpunen 1995). Industrial transformation in Central and Eastern Europe has centred around two key elements, privatisation and capacity restructuring with emphasis on the former. It was the urgent need for capital necessary in industrial restructuring that was the initial motive behind new policies allowing foreign investment in the former socialist countries (Senior Nello 1991). Other motives were closely associated with the above FDI benefits.

It is widely agreed that FDI has already contributed significantly to institutional development in Central and Eastern Europe. For instance, legislative changes have evolved around FDI-specific regulatory needs. Furthermore, technical assistance programmes by multilateral organisations (such as the World Bank, IMF, EBRD) and the European Commission, in which FDI projects are also involved in most cases, are strictly connected to the commitment of these economies to pursue a market-based, democratic system. The transition economies have benefited from FDI primarily through new linkages with Western firms, through the contribution to creating a corporate business culture and increased competition brought by entry (McMillan 1993, Borsos 1994, UN 1995, Kogut 1996).

Benefits brought by the transfer of technology, management and marketing knowledge, financial resources, etc. are underlined in the transition economics literature as well (see, e.g., McMillan 1993, OECD 1994, Berg et al. 1996). For instance, an UNCTAD report (1995) reveals that foreign owned companies in Eastern Europe generally show higher productivity and higher sales than their domestic rivals. Figures for Hungary would show that foreign firms achieved double the productivity rate of domestic firms in 1993. In addition, sales growth rates in foreign owned firms were 47%, while the corresponding figure for domestic firms was 3.5%. A similar, though not as large of a gap between foreign and domestic firms, occurred in the Czech Republic as well. In Estonia, the output of foreign owned firms increased by 105%, while domestic firms were able to achieve a growth rate of 28% in 1993. In addition, export developments are shown to have been highly affected by FDIs at least in Hungary, Estonia and Poland (OECD 1995, UNCTAD 1995, Borsos and Erkkilä 1996, Hunya 1996). In Hungary,

foreign owned firms generated 50% of export revenues in 1993. The increase in exports that year was solely generated by foreign owned firms (32%), while exports by domestic firms actually declined the during the same year by 13%. In Poland, foreign owned firms' exports rose from more than 6% of total exports in 1991 to 16.4% in 1993. A major part of imports was also absorbed by foreign owned firms in the Visegrád countries.

Hunya (1996) reports higher R&D spending in foreign owned firms than in indigenous firms in Hungary. Studies on R&D activities in foreign vs. domestic firms in other transition countries are not available. Some authors would question the role of FDI in upgrading host country technological capacities, due to the strategic behaviour of MNCs, which often entails the centralisation of R&D activities usually situated in the home or main markets of the parent firm and not in the locally acquired foreign unit (see Papánek 1995).

Other drawbacks in FDI activities have emerged. One of the recognised dangers of large inflows of foreign capital into countries in transition is that they may not only reduce domestic savings but actually become a substitute for efforts to mobilise domestic resources for investment, with damaging effects when foreign investors withdraw their funds (Borsos and Erkkilä 1995b). Therefore, the rapid development of domestic financial resources/instruments for the domestic companies is crucial. Furthermore, problems may arise from the market power of the foreign firm and its ability to use this power in acquiring unusually high profits and in transferring it to its foreign shareholders (Simai 1995). This power may also involve the negotiation of more than favourable conditions, for instance through the protection of their locally produced goods (EBRD 1994, Simai 1995). Large foreign companies have also been able to crowd out local competitors, for instance in the Hungarian industries (Nachum 1996) and the foodstuff industry in Estonia (Borsos 1994).

The employment-creation effects of FDI, apart from those stemming from greenfield investments, have been overshadowed by employment-reduction effects related to the

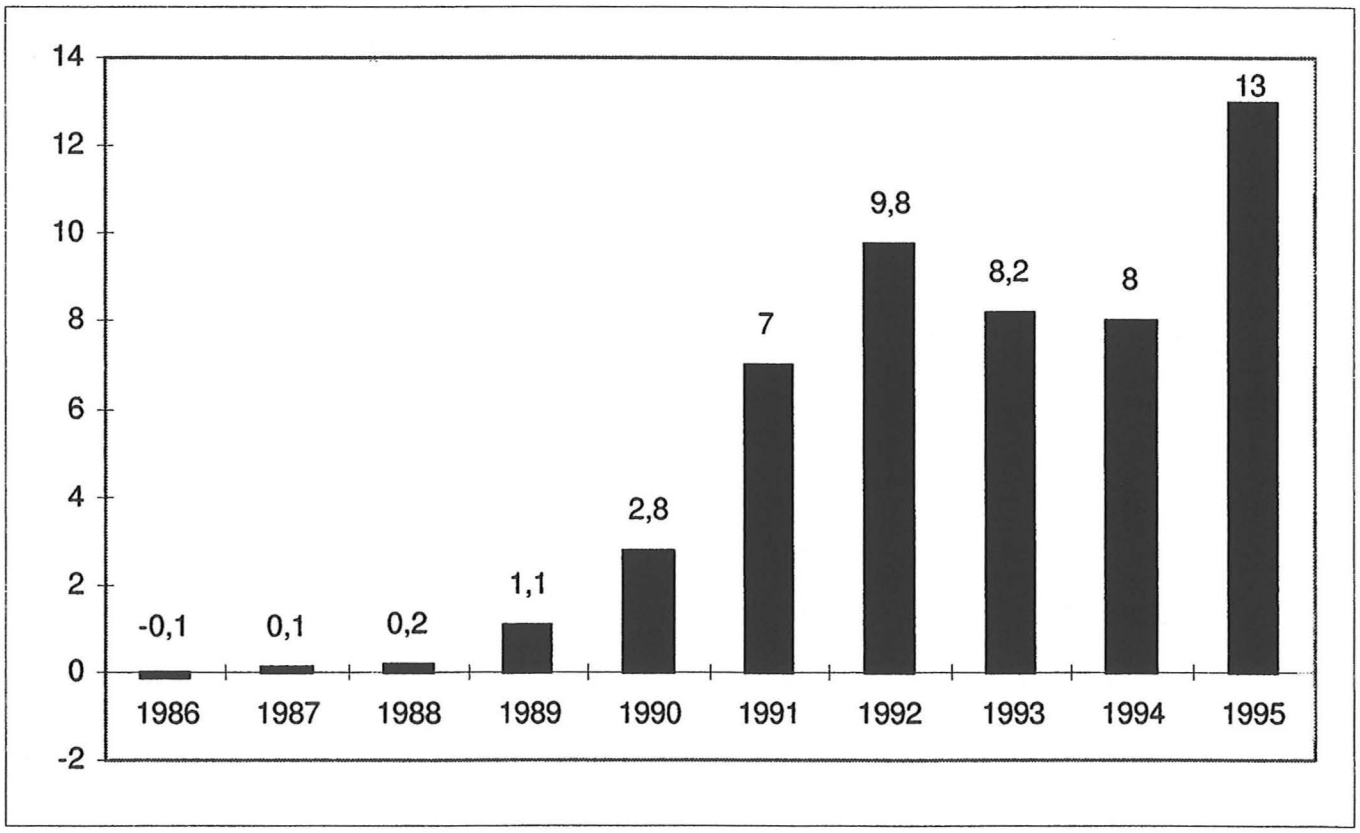
modernisation of privatised state companies in the majority of transition countries. Nevertheless, several studies have indicated that foreign investors have been able to increase productivity and re-establish profitability in these companies more efficiently than domestically owned firms (see UN 1995, 113; World Bank 1996, 63). Furthermore, foreign investors have invested heavily in technical and management training for their local labour force, including local suppliers, and foreign firms have also tended to export a larger share of their output than domestically-owned firms in transition economies (Borsos 1994, Borsos and Erkkilä 1995a, UN 1995, OECD 1995, Stankovsky 1995).

Finally, the level of existing FDI seems to play an important role in attracting long-term investments and additional investments (see Wang and Swain 1996). Some degree of FDI 'clustering' can be identified in Hungary and Estonia, for instance, reflecting the credibility of transition policies in these economies.

4.2 Inward Foreign Direct Investments in the CEECs and Russia in 1990-1995

Since 1989, all of the former European centrally planned economies have embarked on the path of transition to establish market-oriented economies. The majority of the countries opened up their economies to FDI. These policies were initially triggered by the capital and technology needs and by the expectations related to FDI as a powerful catalyst for economic change (see chapter 4.1). Expectations were further reinforced by international organisations which since the beginning of transition have provided financial and technical assistance, particularly to FDI projects. The European Union's Phare and Tacis Programmes have played a key role in this respect.

Figure 9 Net FDI inflows into Eastern Europe, % of total inflows into developing countries



Source: World Debt Tables 1995/1996, World Bank.

Though investment flows have increased rapidly from an almost zero base, the overall volume of FDIs in Eastern Europe falls dramatically short of the external capital required for a rapid increase in living standards and the overall development of these economies. The fact that FDI into Eastern Europe accounted for about 8% of all FDI flows in developing countries in 1993 and 1994, and 13% in 1995, reflects the modest performance of FDI in the region. Figure 9 shows this development since the early

opening up to FDIs took place. Nonetheless, driven by both waves of privatisation and by economic recovery in some countries, the first years of the 1990s saw a sharp increase in the flow of foreign direct investment to European transition economies.

Table 11 **Net Foreign direct Investment Flows in Selected Transition Economies, 1990-1995** (Millions of dollars)

	1990	1991	1992	1993	1994	1995	FDI flow per capita 1995	FDI flow/GDP 1995, %	FDI stock per capita 1995
Baltic States:									
Estonia			58	160	225	205	138	8.8	420
Latvia			43	49	279	180	87	6.3	227
Lithuania			8	31	31	73	11	1.0	30
Russia	-400	-100	-112	682	637	2017	6	0.3	35
Visegrád Countries:									
Czech Rep.	120	511	947	517*	862*	2562	242	6.9	569
Hungary	311	1459	1471	2328	1146	4453	431	10.7	1107
Poland	10	117	284	580	542	1134	29	1.2	71
Slovakia	18	82	100	134*	170*	157	34	1.4	132

** Excluding flows between the Czech Republic and Slovakia. The Czech Republic reported a net inflow of $577 million and a net outflow of $93 million with Slovakia in 1993 and 1994, respectively.*
Source: ECE 1996 and 1997.

The bulk of FDI inflows has, however, been heavily concentrated in a few countries. According to balance of payments data, the flow of FDI jumped from nearly non-existent investments still in 1989 to some USD 7 billion in 1993. Stagnating in 1994, the amount soared to a record USD 12 billion in 1995, while cumulative FDI inflows reached $31 billion by the end of 1995. Of this, three quarters were invested in Eastern Europe, slightly over 4% in the Baltics and 21% in European CIS countries (including Russia, see appendix 2). By the beginning of 1995, an estimated 173000 firms[1] could be connected to FDI projects (Stankovsky 1996, 112). The average size of foreign affiliates, however, was small, the average foreign investment in equity capital being

[1]However, the ratio of operational to registered FDI projects is very low in, e.g., the Baltic States, where the share of unoperating registered firms is estimated to vary between 30 to 50 per cent. The highest ratio was recorded in Hungary (80%). Due to inaccuracy and measurement problems (see chapter 2), this chapter does not include an analysis on the number of foreign owned firms and related issues.

USD 260 000 in 1994 (UN 1994). By the end of 1995, the region accounted for 5% of world FDI inflows compared with only 1% in 1991 (UN 1996, 64).

Privatisations in several countries in the last months of 1995 increased the full year total considerably and the differences between the CEECs, Russia and the CIS as FDI host countries accentuated further. The bulk of increase was centralised in two countries, i.e. Hungary and the Czech Republic with an inflow of USD 4.5 billion and USD 2.5 billion in 1995, respectively. More than three quarters of the total cumulative inflows have been invested in Eastern Europe[2] and over one third in Hungary alone during 1990-1995, as table 11 indicates. During the reviewed period, Estonia was the only former Soviet Union country able to attract a relatively large amount of foreign investments.

Within the region covered by this study, Hungary and the Czech Republic account for the largest share of the increase of FDI. Poland doubled its FDI inflows in 1995, which could be explained by the improving macroeconomic environment and the normalisation of relations with foreign creditors (the London Club) towards the end of 1994. Russia, in turn, received total inflows of USD 1.4 billion, which was, however, overshadowed by continuous capital flights and increasing investments abroad. As a result, Russia was the most important single transition country to invest abroad, which could also be seen in the increasing role of Russian FDIs within the Eastern Baltic Rim countries.

Flows into Latvia and Lithuania remained modest during the period reviewed. Hungary, the Czech Republic, Estonia and Latvia were the only transition countries able to attract FDIs amounting to around 5 per cent of GDP or more (see previous table), which is high by international standards. Finland and its Nordic neighbours have typically had significantly larger outward FDI flows than inward flows.

All in all, the reviewed period can be divided into two phases as regards FDI in the CEECs and Russia: (1) The first phase, which lasted from 1989 to 1993 in the Visegrád

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[2] Albania, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, the FYR of Macedonia.

countries and from 1991 to 1994 in the Baltics, while Russia is still in this phase, was characterised by the difficult launching and implementation of transition reforms. This specifically included convincing foreign investors of decreasing political and economic risk and of the irreversibility of the chosen policies. The principal task was to advance with privatisation, in order to restructure and create a functioning enterprise sector. FDI was clearly linked to privatisation. (2) The second phase, which took place in 1994-1995 in the case of both the Visegrád and the Baltic countries, was characterised by decreased uncertainty and increased stability. FDI became less privatisation-driven (18% in 1994 in the CEE economies) and greenfield investments gained more momentum, particularly in Hungary and Poland[3].

Both phase 1 and phase 2 were characterised by the 'sensitivity' of FDI in the sense that it has, firstly, strongly reacted to changed conditions in main investor countries (i.e. the drop in 1994 FDIs, when main investor countries such as Germany were hit by recession). Secondly, it has reacted to changes in privatisation processes in the sense that once the most attractive or profitable investment opportunities were exploited, FDI declined slightly in 1994, while another increase could be seen in 1995 during the privatisation of 'strategic' firms in the Visegrád countries. A similar tendency could be seen in Estonia starting from 1996, while Latvia and Lithuania are expected to follow their neighbour sometime in 1998 or 1999.

Thirdly, those post socialist countries that have advanced most in their market-oriented transition and price stabilisation have been able to attract significantly larger amounts of FDI (see also EBRD survey results, EBRD 1995, 85-86). Country-specific FDI inflows clearly picked up once GDP growth became positive[4]. Thus FDI has clearly flowed first to the 'FDI pioneering' countries, which first liberalised their FDI policies and whose economic performance had improved and where policy reversals regarding the role of the private sector seemed unlikely. In addition, the increase in non-privatisation-related

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[3]The share of greenfield investments of the total FDI funds announced or actually invested, or both, accounted for less than 10% before 1993 (Robinson 1993).
[4]With the exception of Slovakia, due to unclear FDI policies and the smallness of the market in terms of GDP and GDP per capita.

FDI inflows in the Visegrád countries seems to have taken off in response to the positive growth performance of these economies[5].

4.2.1 Source Countries for FDI in the CEECs and Russia in 1990-1995

European Union countries have been the major source countries of FDI in the CEECs since the start of transition. By the end of 1995, the EU accounted for around three quarters of the FDI stock in Hungary and Bulgaria, two thirds of the FDI stock in the Czech Republic, Poland, Slovakia and Slovenia, and slightly over 50% of the stock in the Baltic States (UN 1996). The Russian Federation made an exception in this structure, with Switzerland and the USA representing slightly over 50% of the Russian inward FDI stock in 1995[6].

The largest single investor country was Germany during the reviewed period in Central-East Europe, with the exceptions of Finland (in Estonia), Denmark (in Latvia), Austria (in Slovakia and Slovenia), and Korea (in Rumania). The maximum relative values achieved by US firms in the region were slightly below 20% (in Poland, Hungary and the Czech Republic). In general, USA, Canadian and British investor firms seem to have been more evenly spread across the whole region of Eastern Europe. Hence, they have played a relatively more important role in the CIS than in the CEECs. In addition, firms from these countries are mostly large multinational firms, which typically invest in few but large FDI projects. This is the case for American firms, particularly in Poland and Russia, while the most important British projects are in telecommunications projects in the Baltics and oil exploration in Russia.

Asian investors turn out to have been modestly represented in the market, which is surprising recalling that they have been dominant investors since the surge of worldwide FDI in the 1980s. Contributions by Japanese firms stood at a marginal 2% (concentrated in Hungary) by the end of 1995 (IMF Economic Bulletin, 1997). In addition to this and

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[5]Naturally, other factors such as market size, the regulatory framework and political stability, have also affected this outcome.
[6]Based on national statistics.

significant Korean FDI projects in Slovakia and Poland, no other South East Asian firms were present with significant investments in 1990-1995.

Table 12 Cross Country Ranking of Investor Countries within the CEECs and Russia, January 1996 (total cumulated flows).

	Estonia	**Latvia**	**Lithuania**	**Poland**	**Russia**	**Czech Republic**	**Hungary**	**Slova-kia**
Denmark		4	5	11		11		
Finland	1	10			10			
Germany	7	3	2	2	3	1	2	2
Norway								
Sweden	2	5	4	10	8			6
Estonia		11						
Latvia			13					
Lithuania								
Poland		6	10					
Russia	3	1	8				6	
Others:	Ireland, 5		Ireland, 6			Belg.,4	Belg.,10	CR, 3
Austria			9	8		5	1	1
Canada		7	7		7			9
France				4	4	3	5	5
Italy		9		3	5	8	8	8
Switzerland							9	10
Netherlands				5	6	7	4	7
UK	6	8	3	6	2	6	7	
USA	4	2	1	1	1	2	3	4

Sources: National statistical offices, investment agencies and Russian Ministry of Economics.

In addition to the investor perceptions of country risk (social stability, macroeconomic stabilisation, privatisation, etc.), the pattern reveals that proximity to countries that are the source of FDI matters, both in geographical and cultural terms. The Czech Republic, Estonia, Hungary, the Slovak Republic and Slovenia share borders and a historical background with countries where much of their inward FDI originates. These countries are notably Finland, Germany, Italy, and Austria, respectively. This also explains the large amount of FDI made by SMEs from these countries. Marginal SMEs threatened by structural change in their home countries may save their industry-specific assets by transferring their operations to neighbouring transition economies and by relocating their overall operations (Borsos 1995). The role of proximity is in general more straightforward in the number of FDI projects than in terms of capital contributions, as proximity plays a more central role for SMEs than in the case of large investor firms (Meyer 1995, 311).

Moreover, the FDI pattern in the CEECs and to some extent in Russia, reflects the structure of these economies' international trade since the start of transition (see chapter 4.1). The European Union is the most important trade partner for all of the CEECs and Russia, reflecting intra-firm trade flows between EU parent firms and their subsidiaries in the region and the emerging significance of these markets as a production base for exports to the EU (see, e.g. ECE 1996, OECD 1996, Borsos and Erkkilä 1995). Both trade and FDI patterns seem to confirm the clustering of the CEECs, particularly in the case of the Visegrád countries, around the EU.

4.2.2 Sectoral Distribution of FDI in the CEECs and Russia in 1990-1995

The FDI/value added ratios in table 4 show the relative importance of FDI related to the size of certain transition economies covered in this study. FDI penetration is considerable in the case of Estonia (22.8), which comes second after Hungary (26..3, respectively), followed by Latvia (12.8), Slovenia (12.0), and the Czech Republic (10.5). As the table indicates, Poland achieves a surprisingly low ratio, whereas the Russian score is not startling. Following the same pattern throughout the 1990s, manufacturing and particularly engineering, chemicals and food processing have attracted the majority of FDI inflows in the 'FDI pioneering' countries such as Hungary, Poland and Estonia, while the share of services is relatively high in 'FDI latecomer' countries, such as Latvia, Romania, Slovakia (the Czech Republic having attracted the most important industrial FDIs).[7]

This may be due to the regional strategies of large MNCs establishing their manufacturing operations in one location, from where operations other than manufacturing are governed in transition countries penetrated thereafter. Large direct investments in services or low-technology industries also reflect the uncertain business conditions, as these investments can be withdrawn quickly and capital is not tied up. Such business conditions prevent optimal allocation of FDIs and they may thus have

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[7]Note that these figures are onyl indicative, due to comparability problems mainly cused by loopholes registration methods and by different industrial classification schemes (including changes in individual countries during the reviewed period).

significant long-term effects, as a country's economy may follow a growth path marked by undeveloped technology and low capital.

Table 13 Sectoral breakdown of FDI stocks/value added ratios of selected industries in the CEECs and Russia, January 1995

	Industry					
	Food processing	**Chemicals**	**Metals**	**Engineering**	**Light industry**	**Total, % share of all FDIs**
			Sectoral breakdown of FDI			
Estonia	8.7	27.9	0.8	2.5	2.1	52.2
Latvia	11.9	1.0	0.9	3.3	2.7	24.9
Czech	9.3	5.7	..	27.5	..	...
Hung.	16.3	6.5	3.1	13.2	6.0	49.9
Poland	18.3	10.0	4.0	6.8	2.7	64.1
Slovak.	2.1	17.7	1.8	19.5	2.3	47.0
Russia	2.6	19.3	2.3	24.1	1.3	65.5
			FDI/ Value added ratios			
Estonia	13.8	217.5	17.5	16.5	12.8	31.1
Latvia	14.9	4.4	8.9	8.1	10.9	9.4
Czech	10.5	13.0	..	38.6	..	..
Hung.	56.8	27.5	28.2	69.6	90.3	41.3
Poland	7.9	10.4	5.5	6.7	3.6	6.1
Slovak	1.8	12.4	1.2	16.6	4.8	6.2
Russia	0.7	9.6	0.4	4.2	0.9	2.3

	Others, (continued)			
	Construction	**Transport and communications**	**Services**	**Total**
		Sectoral breakdown of FDI		
Estonia	0.5	9.9	36.3	100.0
Latvia	1.4	31.6	41.3	100.0
Czech	12.7	..	16.4	..
Hung.	4.7	8.2	35.5	100.0
Poland	3.3	4.1	28.2	100.0
Slovak.	1.4	0.5	50.9	100.0
Russia	8.5	3.2	28.8	100.0
		FDI/ Value added ratios		
Estonia	1.3	14.0	23.0	22.8
Latvia	2.2	14.8	17.2	12.8
Czech	19.1	..	3.8	10.5
Hung.	18.0	20.3	18.4	26.3
Poland	1.8	2.1	3.5	4.5
Slovak.	1.0	0.2	6.4	5.2
Russia	0.9	0.4	1.1	1.4

Source: ECE 1996, and same as in table 3. Lithuanian data not available.

All in all, manufacturing has attracted half or more of foreign capital and the share of services has grown steadily involving typically a larger number of small projects, while agriculture and mining have played a minor role. There is a clear difference between

SMEs and large firms as to the sectoral breakdown of their FDIs. Namely, operations other than manufacturing investments attract SMEs. These main trends have held over the reviewed period, though single large FDI projects can affect the overall record. FDIs in the Czech (Volkswagen/Skoda), Hungarian (Audi, Opel, Suzuki, Ford) and Polish (Fiat/FSM) automobile industries are examples of this phenomenon. Though factor cost advantages are clear, these figures would indicate that low cost manufacturing by foreign investors has not gained as much momentum as expected or commonly thought during the early years of transition. This can be seen in the low share of textile or electronics industries. In addition, Russian data would show that it is the only country in addition to other CIS countries to take advantage of natural resource endowments. Western data on the sectoral breakdown of their outward FDI in Eastern Europe confirm the central role of manufacturing, but often the structure of these FDIs does not correspond to national comparative advantages. This is the case, for instance, with Finnish FDIs. Industries such as the foodstuff or building materials industry that were not yet internationalised, expanded rapidly after the opening up of the Eastern neighbouring markets (see Borsos 1994 and 1995).

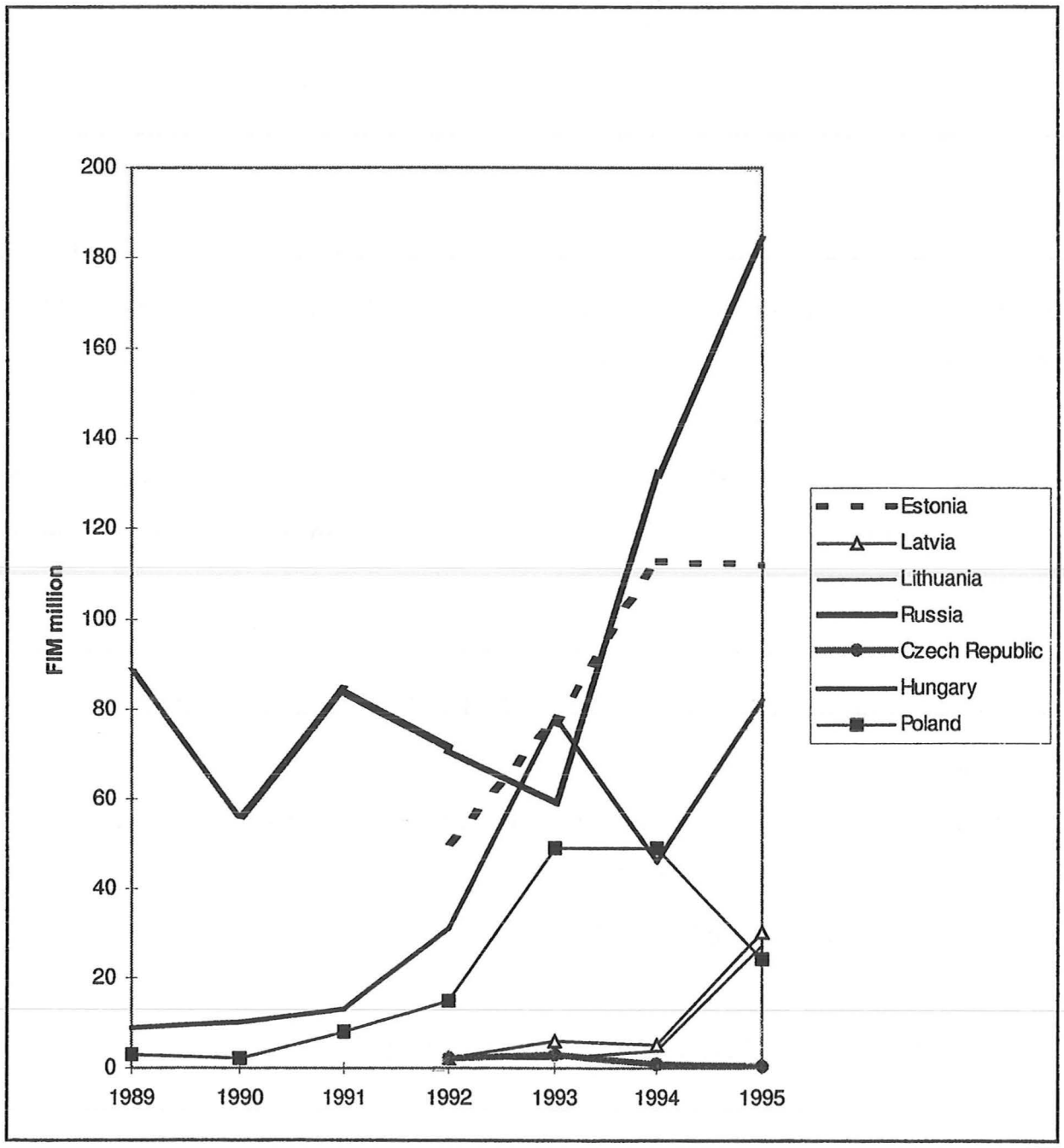
Though both the FDI data and the estimates of the branch allocation of industrial value added are approximations, these indicators do reflect comparative advantage in countries and sectors with high FDI penetration. Such countries and sectors would seem to be relatively well endowed with capital of superior quality, which are important potential sources of future growth due to the implied embodied productivity gains. (ECE 1996, 71) It is, however, clear that as these economies catch-up and factor costs rise, they become more and more vulnerable to international competition and may face the need to move towards higher value-added products in their manufacturing activities. This further requires FDIs oriented to such industries.

4.3 Finnish FDIs in the CEECs and Russia in 1990-1995

Finnish FDIs have followed the same tendencies as FDIs in a global perspective, i.e. most FDI has taken place with industrialised countries, not with developing countries. In the first half of the 1990s, the major target markets of Finnish FDIs were the EU (some

70%[8]), North America (25%), while the rest constituted of outward investments to other non-EU European countries (including Eastern Europe) and third world countries. Though the Finnish outward FDI stock in Eastern Europe was still modest by the end of 1995 with a share of less than 2% of the total outward stock, the tendency which emerges from central bank figures is one of rapid growth in 1990-1995. This was reflected in the gradually increasing outflows of FDIs into Eastern Europe, which can be seen in figure 10.

Figure 10 Net capital outflows from Finland to Eastern Europe, 1989-95



Source: Bank of Finland, 1996

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[8]Including former EFTA countries that became EU members

Capital flows from Finland to Eastern Europe increased from a modest level in 1988 to a cumulative stock value reaching some FIM 1.5 billion by the end of 1995. Both in terms of flows and measured by the number of companies with Finnish ownership, Estonia and Russia were the largest recipients of Finnish direct investments in eastern Europe (see Borsos, 1995) in the reviewed period. According to Laurila and Hirvensalo (1996, 7), some 40% of Finnish owned firms operated in Estonia and 33% in Russia in 1994. The remaining 25% operated in other eastern European countries. In Russia, the majority (60%) operated in St. Petersburg or regions close to the Finnish border, while a quarter operated in Moscow (ibid.). In Estonia, the capital area attracted most of these firms.

As the previous chapter indicated, the role of Finnish investors from the point of view of the Eastern European receiver countries was modest, with the marked exception of Estonia. In Estonia, Finnish investors have played a major role in the economy through significant shares in total exports (see Borsos, 1994). The cumulative share of Finnish FDIs amounted to some 30% of total FDIs by the end of 1995 (Estonian Investment Agency, 1996). According to Eastern European national sources of information, the sectoral distribution of Finnish FDIs in Eastern Europe followed the same pattern than FDIs from other home countries. This was the case when measured by the value of investments. When measured by the number of firms, the pattern was different. Namely, most of the Finnish owned firms operated in the service sector (estimates ranging from 50 to 60%) in Eastern Europe (see Hussi and Puolakka 1995; Laurila and Hirvensalo 1996), followed by manufacturing. Another peculiarity characterised Finnish investments: while other investors were heavily present in the Russian energy and construction sectors, Finnish investor firms were not present at all by 1994 (Laurila and Hirvensalo, 1996).

Finally, while the 30 largest Finnish companies commanded a lion's share (80%) of FDI outflows in the first half of the 1990s (see Ylä-Anttila and Ali-Yrkkö, 1997), FDI outflows to Eastern Europe were by and large originating from SME investments (Laurila 1995; Laurila and Hirvensalo 1996).

4.4 Regulatory Framework for FDI in the CEECs and Russia

4.4.1 Background

Most Eastern European countries were trying to reform their economic system during the 1980s, but failed to do so. One of the key reforms was specifically concerning foreign investment. Namely, entrepreneurial commitment was formerly restricted to joint ventures which until 1989 were by and large the sole organisational form under which direct foreign investment was allowed in the former CMEA[9]countries. Laws permitting the establishment of joint ventures with foreign capital were first introduced as early as 1971 (Rumania), 1972 (Hungary) and 1976 (Poland). These measures did not lead to any substantial flows of foreign investment, as foreign participation was generally limited to minority shares and the legal and economic environment of a centrally planned economy did not offer an attractive business environment. A privately owned and independently managed foreign firm could not be easily incorporated after all (McMillan, 1992).

However, the central role of East-West joint ventures in promoting economic restructuring and especially in encouraging foreign trade, appeared in repeated policy statements of Central-East European countries. After the fundamental changes in their political systems these countries' governments strived to create the necessary laws between 1986 and 1988 in order to offer a proper business environment to foreign investors. (Senior Nello, 1991) The former Soviet Union also went through a period of major changes in its policies in the second half of the 1980s, when first Perestroika and then the Glasnost policies where adopted. This allowed the introduction of laws permitting foreign investments in 1987. As a result, general economic and political conditions fostered investment in Central and Eastern Europe with Hungary acting as a

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[9]The Council for Mutual Economic Assistance was founded in 1949, as a political response to the Marshall Plan. It became active after the signing of the Treaty of Rome, establishing the European Community in 1957. The CMEA included countries from Africa, Asia, Europe and Latin America. Full members included the Soviet Union, Bulgaria, Czechoslovakia, the German Democratic Republic (GDR), Hungary, Poland and Rumania. These countries endorsed the CMEA's charter and thereby expressed their willingness to subscribe to the purposes and means of the CMEA as an organisation entrusted with the promotion of, in effect, socialist economic integration. (Van Brabant 1989; Senior Nello 1991).

pioneer by embarking first on its transition programme in 1988. It was only after the political upheaval in 1989 that the proper prerequisites for FDI were established in the former Central-East European socialist countries. This included the full remove of restrictions and obstacles on foreign ownership and allowing majority ownership. The Baltic States followed in 1991, after regaining their independence. The task of adopting and implementing a new FDI regime has been easier to Central-East European countries than to Russia, as the former countries adopted extensive market-oriented legislation of German and French type already in the inter-war period.

As regards FDI regulation, the move from an arbitrary bureaucratic approach to a market-based rules-oriented system was a key step accomplished by most of the Central-East European countries by 1991. This process of FDI liberalisation was enforced by privatisation needs. All of the Central East European countries and Russia further offered generous (tax) incentives to foreign investors at the start of their transition, but by 1993 some of the Visegrád countries and Estonia abolished such favourable incentives. Russia has kept favouring foreign investors and incentives were applied in special cases in many of the Central-East European countries still after 1993. The adjacent table indicates the 1993 situation.

Table 14 FDI Incentives in Selected CEECs and Russia in 1993

	Investment incentives			**Tax incentives**			
Country	Tax	Customs	Free econ. zones	Profit	Payroll	Dividend	Retained earnings
Czech Republic	no	yes	no	no	no	no	no
Estonia	no	yes	no	no	no	no	no
Hungary	yes	no	yes	no	no	no	yes
Latvia	yes	yes	no	yes	no	no	yes
Lithuania	yes	no	no	yes	-	yes	no
Poland	yes	yes	yes	yes	no	no	yes
Russia	yes	yes	yes	yes	no	no	no
Slovakia	yes	yes	yes	yes	yes	yes	yes

By 1994, FDI was more or less unregulated in the Visegrád countries and the Baltic States, apart from registration requirements and some restrictions on foreign participation in 'strategic' industries (such as the defense industry), while Russia posed and still poses obstacles on foreign investment (as of 1997). All of the CEECs have

further signed agreements on the mutual protection of foreign investment with most of the OECD countries.

4.4.2 Institutional basis for FDI and Trade in Transition Economies

Finland and Finnish companies are bound in their trade activities with transition economies to trade agreements made between the EU and the transition countries. FDI activities, in contrast, have not been subject to such multilateral agreements, though Europe Agreements (EAs) and the Partnership and Cooperation Agreement (PCA) include provisions for direct investments between the EU and the transition countries (see table 15). However, many informal and formal agreements aiming at the promotion of FDI activities between Finland and transition economies have taken place at both the national and regional levels. The PCA signed (but not ratified until 1995) with Russia and the EAs with the CEECs provide for political dialogue and conditions for freedom of establishment of firms, of cross-border trade in services and of capital and employee movements, as well as of goods trade.

As Russia was suffering from considerable capital flight, monetary and reserve problems, in the reviewed period, the country was granted the option to impose restrictions where appropriate after notifying the EU. In the PCA, MFN status applied only to greenfield investments, and national treatment could be granted to the operations of subsidiaries of firms from the EU or Russia, whereas MFN status was granted to branches of EU or Russian companies (see European Commission 1994; Pautola 1996, 10). At the corporate level, technical, financial and training assistance was supported by the EU through the Phare Programme in the Baltic and Visegrád countries, and through the Tacis Programme in Russia and the CIS countries.

The establishment of the necessary legal, institutional and regulatory framework required in a market-oriented economy has mostly evolved and been constructed around FDI-related legislation, which indicates the perceived significance of inward FDI as a mode of acquiring additional capital, managerial and technological capacity to transition countries. All of the transition economies used to offer generous tax incentives to

foreign investors, but they were gradually eliminated by the end of 1995, and those that stayed in force concerned FDIs made in the early 1990s. Tax incentives were still in use for 'nationally' useful and exploitable projects, such as infrastructural investments, except in Estonia, where all kinds of tax incentives had been abolished. Russia in turn, was still on the road for tax and other generous incentives in 1995, in order to attract additional FDIs. In general, the Baltics and Visegrád countries could be considered as meeting the requirements related to FDI set in their Europe Agreements (see appendix 1), and the harmonization of FDI legislation towards that of the EU advanced rapidly, particularly in the latter half of the reviewed period, though with difficulties in the implementation of new laws.

Ownership of land became the cornerstone of FDI legislation in Latvia, Lithuania and Russia, where foreign firms were still not allowed to own land in the period 1990-1995. Instead, leasing was allowed, but the situation was confused in Russia. In Poland, an appropriate permit was required to own land. The Baltics and Visegrád countries guaranteed the protection of foreign investment as stipulated in their foreign investment laws. These countries had signed bilateral agreements securing the promotion and reciprocal protection of investments with most of the OECD countries. Russia had signed the PCA, which included provisions for FDI, but bilateral agreements were concluded with only a few Western countries. In the case of Finland, agreements signed with the former Soviet Union (FSU) were in force on Russia's request, but they did not correspond totally to the same contents of the 'new' agreements.

Economic cooperation between the EU and the transition economies was and still is based on Europe Agreements, which are preferential agreements aiming at establishing a close, long-term association between the EU and individual CEECs leading, at the final stage, to EU membership. These agreements, which also cover the harmonisation of legislation, financial, political and cultural cooperation, were signed with the three Baltic States in June 1995. Estonia had no protectionist measures, and thus no transition period was required to abolish restrictions contradicting EU rules.[10] However, a gradual shift toward free trade between the EU and the Baltics began already on January 1,

1995, when a free-trade agreement was signed. The signed agreements established free trade in industrial products, with the exception of sensitive products such as textile and clothing products and certain agricultural products which are subject to quotas. Estonia made a total exception from all parties having signed the EA, as it granted free access to all EU exports, including agricultural exports. The Visegrád countries signed their EAs in 1991, and they went into force in 1994. According to this agreement, a free trade area was aimed at being implemented within ten years. All of the EAs provided for the establishment of an Association Council which supervises the implementation of the EAs and has the power to take decisions in specific cases. The agreements signed with the Baltics also contain provisions on co-operation in the prevention of illegal activities.[11] The preparation of the CEECs for EU membership was supported within the framework of the Phare Programme.

In addition, the three Baltic States institutionalised their trade relations in the form of the so-called Baltic Free Trade Area, an agreement that went into effect in April 1994. It provided free trade of industrial products, but not agricultural products. Again, Estonia granted free access to all products from other Baltic States. Latvia and Lithuania were given transitional periods, during which their tariffs were to be successively reduced, in order to adjust their industries. In practice, the agreement has not worked very well, and trade *between* the Baltics remained modest in 1995 and 1996. Other CEECs, mainly the then so-called Visegrád countries participated in the Central European Free Trade Agreement (CEFTA), which went into effect on March 1, 1993. The agreement is a framework agreement, aiming at completely free trade, originally planned to be implemented fully by the year 2001, but in 1994 the countries agreed to move up the timetable. The barriers on industrial goods were aimed to be abolished by January 1, 1998. In 1995, CEFTA applied to trade in manufacturing goods and only partially to agricultural goods. By the end of 1995, Slovenia had already made decisions to enter CEFTA, and several other countries such as Romania, Bulgaria and Lithuania were also planning to join the CEFTA.

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[10]See The Baltic Review 1995.
[11]For further details on the Europe Agreements, see European Commission 1995a.

The role of CEFTA could be considered as important in many respects: Firstly, its task from the EU's perspective was to hasten the development of the countries making them fit for membership. Secondly, after a transition period starting in the beginning of 1998, it would constitute a genuine free trade zone. Finally, and thirdly, it would make the countries familiar with the ground rules of free trade (Hernesniemi 1996, 33). Furthermore, it can be considered as central in enhancing trade flows also in the reverse direction, i.e. from transition economies to other such countries and regions other than the EU. Also, this may enhance FDI in the same way, and increasing FDI from transition countries to the EU, which was minimal still in 1995 (see for statistics, UN 1996).

Economic co-operation between the EU countries and Russia, in turn, was based on the Partnership and Co-operation Agreement (PCA). The PCA presumes neither the establishment of an association between the EU and Russia, nor future membership in the EU. Nevertheless, this agreement was the broadest and the most far-reaching one ever concluded between Russia and any Western country or organisation.[12] Technically, the 1989 Trade and Co-operation Agreement with the former Soviet Union offering Most Favoured Nation Status (MFN) for tariffs and duties and dialogue through a Joint Committee still constituted the formal framework for EU-Russian relations in the reviewed period 1990-1995 (Pautola 1996). However, the PCA was more ambitious and even included the establishment of a free trade area between the EU and Russia[13].

As the PCA had not been ratified yet by the European Parliament and the EU member countries by the end of 1995, it was the Interim Agreement, meant to bring into force the central articles on trade and investment of the PCA into force, which governed trade activities between the EU and Russia since February 1996. The PCA, and hence the Interim Agreement, provided MFN status to both parties with regard to tariffs. The EU committed itself to removing quotas on imports from Russia, apart from certain

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[12]For details, see European Commission, Agreement on Partnership and Cooperation between the EU and Russia, Corfu 1994; European Commission 1995b. See also Borsos & Erkkilä 1995a and 1995b; Borko 1996.

[13]Foreseen by article 3; whether the conditions for opening such negotiations exist will be decided in 1998.

sensitive products, and Russia abstained from discriminating exports of the EU. However, Russia could apply quantitative restrictions on EU imports in exceptional circumstances, i.e. provided the imports originating in the EU gave rise to particular difficulties in certain sectors of the Russian economy[14]. Any such restrictions were defined as temporary, and import tariffs were to be reduced gradually.

In practice, Russia applied a tariff of 12 to 14 per cent on average on imports from the Nordic and other EU countries in the latter half of the reviewed period (1994 and 1995), and higher tariffs on certain goods such as luxury articles. The corresponding rate for the EU was less than 1 per cent. In addition to tariffs, there were various other charges on imports to Russia, e.g. value added and excise taxes. Also, a variety of charges were imposed for short periods and they were subject to monitoring on a case by case basis. These practices were often not well known by Western counterparts, which significantly hampered trade. The interest of EU countries in concluding free trade agreements with transition countries lies not only in the critical political causes, but also on the considerable long-run commercial and scientific potential (particularly in Russia), despite the wide-range pessimism about the pace and effectiveness of economic restructuring in Russia and some other transition countries.[15] The main objective of the EAs and the PCA was to gradually integrate the transition countries into the European economic co-operation scheme, and eventually to the international economic co-operation scheme through, e.g., WTO membership. One must note that the EU became Russia's main trade and FDI partner by the end of 1995, as it was also for the other transition countries covered in this study. Taking the point vice versa showed a minimal share of transition countries in EU's overall external trade and inward FDIs, as the chapter on the nature of transition indicates.

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[14]The PCA allows Russia the option of protectionist measures or adjustment periods of 3 to 5 years based on structural problems.

[15]See more on the contents and goals of the PCA in Borsos & Erkkilä 1995a and Pautola 1996.

Table 15

Provisions Related to Investments in Europe Agreements and in Partnership and Co-operation Agreements

Provisions	Europe Agreements	Partnership and co-operation Agreements	
		with Russia	with Others
1. Establishment of enterprises and professionals	NT reciprocal but to be introduced asymmetrically.	MFN for companies only. For financial services, NT with exceptions.	EU offers MFN. NIS offer best of MFN/NT, with some exceptions (Bel, Mol, Ukr), some of which are transitional.
2. Operations of enterprises and professionals	NT reciprocal but to be introduced asymmetrically.	EU offers NT for subsidiaries with some exceptions. MFN for branches. Russia offers best of MFN/NT.	EU offers NT for companies and MFN for branches, with some exceptions. NIS offer best of MFN/NT.
3. Capital transfers in respect to investments	To be fully liberalized, including also repatriation of profits and transfer of dividends.	To be fully liberalized, including also rapatriation of profits and transfer of dividends. Russia may maintain during a transitional period restrictions on outward investment.	Liberalization of capital movements for FDI including repatriation of assets and profits.
4. Protection of intellectual, industrial and commercial property	CEC to provide same level of protection and subscribe to international agreements.	Russia expected to provide same level of protection and subscribe to international agreements.	Expected to provide same level of protection and subscribe to international agreements.
5. Competition rules, including state aids	Similar to EU rules.	Disciplines inspired from EU rules, but less strict than EA rules	Ukr, Bel, Mold: right to intervene and obtain information; non-discrimination regarding marketing and public procurement rules within 4 years. Kaz, Kyr: right to intervene where trade affected.
6. Law in all areas having impact on agreements	Approximate.	Gradual approximation	Gradual approximation.
7. Industrial standards and certification	Co-operation (PHARE)	Co-operation (TACIS)	Co-operation (TACIS)
8. Investment promotion • Improve legal framework • Conclude investment protection agreements	Co-operation (PHARE)	Co-operation (TACIS)	Co-operation (TACIS)
9. Market access	Free trade in industrial goods, introduced asymmetrically.	MFN for goods and for selected services	MFN for trade in goods (Bel: for selected services)

EA = Europe Agreement; NT = National Treatment; MFN = Most Favoured Nation treatment; CEC = Central European Countries; EA = Poland, Hungary, Czech Republic, Slovakia, Romania, Bulgaria, negotiations with Baltics are ongoing, and are expected with Slovania. Partnership and co-operation agreements signed with Russia, Ukraine and Moldova; Kazakhstan, Kyrgyzstan and Belarus are expected to sign the agreement soon.
Source: European Commission, March 1, 1995, com(95)42.

5 FDI OPERATIONS AND TRANSITION-SPECIFIC DETERMINANTS

This chapter discusses the empirical results of the collected data. Firstly, the operation-specific determinants are discussed, followed by an analysis of country-specific determinants in a regional (i.e. Baltic markets, Visegrád and Russian markets) comparative perspective. A more in-depth discussion on transition specific determinants is then provided, which is the basis for the proposed explanatory model.

5.1 Previous Operations in the Baltic, Visegrád and Russian Markets and Emergence of FDI Entry

The entry patterns of the 16 firms covered in this study is relatively similar. Operating at arm's length has preceded the establishment of 39 (out of 42) manufacturing subsidiaries in the CEECs and Russia. The first business operations of 14 MNCs in the region started in the form of exports either well before the transition period or a few years after the initial opening up of the East. While one firm started with both imports and exports, another firm in the building materials and construction industry started with only import activities already in 1910 (in Latvia). This firm then entered the Russian market in 1950 through exports. Only three other firms started operations in the period 1950-1970, all in the former Soviet Union. Two of these firms are in the foodstuff industry and one in the metals industry. The next wave of entries took place in the early 1980s by four firms, three of which entered through exports and one directly through a sales subsidiary. The rest of the firms (7) have entered transition economies more recently, i.e. during the early 1990s. Up to four of these firms started their operations by establishing manufacturing subsidiaries, while others started by exporting.

Firms that consider themselves 'labour intensive' were already the most active before the transition period, particularly in the first half of the 1980s. The FSU (including the present Baltic States) and Hungary were their principal target markets. All of the entries made in the 1990s were in either the Visegrád region (Poland and Hungary being the target markets) or the Baltic States region (Estonia being the main target). Thus, after the dissolution of the FSU, a clear change in the orientation of first entries took place.

Table 16 First Business Entry: Operation Mode, Target Market and Year of Penetration in Eastern Europe Prior to Transition

		First target market			
Firms covered in the study, N=16, Code	First entry	FSU, market*	Visegrad	Other	Year of penetration
1	Manuf. subs.			Estonia	1993
2	Exports	Russia			1950
3	Exports				na
4	Manuf. subs.		Poland		1993
5	Exports	Russia			1970
6	Exports		Pol & Hun	Estonia	1993
7	Exports		Pol & Hun		1992
8	Exports	Balt & Rus			1980
9	Imp. & exp.	Russia			1960
10	Imports			Latvia	1910
11	Exports		Hungary		1985
12	Sales subs.	Russia			1981
13	Exports			Baltics	1992
14	Manuf.subs.	Russia			1988
15	Exports		Poland		1990
16	Manuf.subs.		Hungary		1991

** Market according to current country territories*

According to respondents, the reason to the avoidance of operations other than exports prior to transition lies in the environmental factors and above all the legislative environment, which did not allow majority foreign ownership. Moreover, even when some degree of ownership was allowed in the 1970s (Hungary, Poland and Romania), it was still considered as severely restricted, as it allowed only involvement in joint ventures. This partnership signified that the foreign partner would have to co-operate with a host government, as firms were state-owned in the CMEA countries. One of the interviewees who was involved in an earlier attempt to form a joint venture commented as follows:

> *'The potential partner firm was faceless, as government officials were to be addressed in any approaches concerning joint venture interests....enquiries alone resulted in a rather bureaucratic way of treatment...operative independence seemed to be unreachable and the possible future partnership then seemed to be difficult to establish due to a lack of bargaining power in matters of control and management....in addition, there were no guarantees of their long-term commitment to this partnership'*

Differences in the business culture posed a major obstacle, which was considered difficult to overcome with a minority ownership arrangement via a joint venture, regardless of the market in question (the current Visegrád countries or the FSU). Furthermore, overall economic and political risks were considered as too high for

such partnerships or even with optional operation modes, such as licensing. Contractual arrangements, such as licensing, were considered unattractive due to limited protection of patents and/or unclear proceedings in the event of conflicts of interest in contractual operations. This was considered as a more serious problem in the FSU than in Central-East Europe.

Thus, the use of other than export operations was very limited or almost non-existent prior to transition, due to primarily restrictions on foreign ownership but also due to the perceived economic and political risks. As soon as FDIs involving majority ownership were allowed along the opening up of the current Visegrád countries, all of the MNCs included in this study established so-called FDI project monitoring units to investigate the various manufacturing options and prepare for the establishment of a manufacturing subsidiary. Attitudes were, however, conservative, due to a new and sudden turn in the economic systems of these countries.

> *'Such manufacturing projects were surrounded by great uncertainty in 1989 and 1990...uncertainty over the sustainability of the new system, both politically and economically...now (as of March 1996) no one would doubt the irreversibility of such measures, both in the Visegrád countries and the Baltics.'*

As table 16 indicated, besides the three firms that established directly manufacturing subsidiaries, all of the firms had some kind of operations before making the reviewed manufacturing FDI projects. Two firms even had import operations as first entry modes. However, as shown in the following table, the majority of firms later moved directly from export operations to manufacturing operations. Only 7 manufacturing subsidiaries of 5 MNCs in the whole region of Eastern Europe were preceded by sales and / or marketing subsidiaries, which were located in other markets. In the case of the reviewed firms the unexpectedly occurred political and economic changes affected considerably the investment behaviour of firms.

The straightforward 'jump' to direct manufacturing operations was often explained by the need to benefit from that change as soon as possible. The distribution of these FDIs reflects high risk perceptions or uncertainty avoidance, as the majority of FDI projects were first undertaken in the 'pioneering' transition countries of the Visegrád region, i.e. in Poland and Hungary, and in Estonia (3 subsidiaries), the only market

formerly belonging to the Soviet Union viewed as 'safer' for first manufacturing entry. These manufacturing subsidiaries were established between the years 1991-1993, i.e. a period when the Baltic States were already considerable FDI target markets for SMEs (starting in 1992). The majority of the Baltic subsidiaries of these MNCs were established in the period 1993-1995, while most of the Russian subsidiaries were also established in the period 1993-1995. Thus, it is surprising that these large firms – which commanded more extensive financial, human and other resources than SMEs - chose to invest in the less risky, but physically and culturally more distant countries or regions, i.e. in the Visegrád region (particularly Poland). On the other hand, these countries offered larger markets than the Baltic countries.

Table 17 Previous Operations to the FDIs of Finnish MNCs in Eastern Europe after First Entry (only modes actually reported are mentioned here)

		In the same market			Other
Group of countries	No. of manufacturing subsidiaries, n =42	Exports	Manufac. FDI	Sales subsidiary	markets
Baltics	16	13	1	-	2*
Russia	10	8	2	-	-
Visegrád	16	11	2	-	1**,2#, (2***)
By type of firms					
Resource-intensive	6	12	-	-	2
Labour-intensive	6	9	4	-	1
Knowledge-intens.	1	1	1	-	-
Scale-intensive	3	10	-	-	2

**1 preceded by a representative office and 1 by another manufacturing subsidiary in another Baltic country*

*** Preceded by sales subsidiaries in each country covered in this study, except for Slovakia , of the same MNC owning this FDI unit in Poland.*

**** Preceded by 1 divested sales subsidiary and 2 sold manufacturing FDIs in Russia, all of which were in a different industry. The firm now operates only in the electronics industry.*

 # These FDIs based in Poland were preceded by a manufacturing FDI in Hungary

Nevertheless, a clear pattern can be identified in the FDI strategy of these firms. Firstly, FDI operations in the Visegrád region started with operations in Hungary and Poland in 1991. Poland was the dominant target for FDIs during the first surge of FDIs and it remained the host market for 80 per cent of the subsidiaries located in the Visegrád region at the end of the period reviewed. Secondly, investments made in Russia were with almost no exception preceded by (different types of) subsidiary operations in the Baltics, usually in Estonia. Thirdly, FDIs made in other Baltic States were also preceded by FDIs made in Estonia.

The springboard position of Estonia to the Russian market was considered important for the following reasons: Estonia was considered as more stable in economic and political terms than Russia prior to 1994, and therefore subsidiary operations in Estonia would be less risky. Subsidiaries operating in Estonian markets would further serve as bridgeheads to other Baltic markets, in addition to their role as export bases for the EU markets. The experiences gained in Estonia were viewed as critical for entering Russian markets at an appropriate moment and anticipating the market's eventual economic take-off. This appropriate moment was referred to as the '*diminishing of uncertainties to a meaningful degree*', i.e. signs of a definite trend towards a functioning market economy in Russia, of a significant increase in the purchasing power of consumers and firms (as FDIs in Russia were considered host market-oriented ones) and an overall stabilising of the economy (including criminality). Moreover, some managers underlined the crucial role of the results of parliamentary and presidential elections in 1995 and 1996, respectively.

Country specific knowledge seems to play an important role, as the firms have invested in those countries with which they also have traded (exports) most actively prior to the FDI projects, with the exception of Russia. Country-specific experience brought by these export operations is considerable, as export activities have lasted from 4 to even 12 years in 10 MNCs (on average, 6 years in Poland, 5 years in Hungary, 7 years in Russia and 1 to 3 years in the remaining markets). Five of the reviewed MNCs had some kind of trade activities already in the early 1970s, which then had no trade until again in the 1980s or early 1990s. In those few cases where the FDI project (2) was preceded by an earlier FDI in the same host country, the average length of prior manufacturing was 2 years. Otherwise the MNCs have established their production subsidiaries in different countries of the region, which gives support to the significance of experience gained in other transition markets.

Previous trading with the former Soviet Union was of strategic importance for half of the included firms, i.e. 2 resource oriented firms, 4 labour intensive firms and 2 scale intensive firms. The special trading arrangements between Finland and the FSU provided these large firms significant long-term trading contracts. Since the dissolution of the FSU, trade has dropped drastically and many of the former trade

partner have disappeared. 12 of the MNCs announce that they have partly had to start from scratch in re-creating new trade strategies and networks in Russia. As a result of the collapse of former inter-linkages, the market is now considered as 'one among others'. Only 3 firms (resource-oriented firms) benefited significantly from trade agreements between Finland and the European CMEA countries. These firms are still trading in the same countries, but the volume is half of that prior to transition. Thus, previous trade patterns both with the FSU and the European CMEA countries were somewhat distorted and artificial by nature, which affected the business operations behaviour of these large firms. In the case of these MNCs, transition has brought 'normal' trade and other business operations into consideration. All of the Eastern markets are now considered as drastically different from the pre-transition period for one basic reason: Private firms (clients) and the end-users are now dictating 'the rules of the game'.

To sum up, as discussed in the literature chapter (3.6.1), empirical studies on the internationalisation of firms from small and open economies indicate that firms typically operate in some form before making a manufacturing FDI in a given host country (e.g. Schultz and Westergaard 1987; Lindvall 1991; Larimo 1993). These studies mainly concerned international operations in OECD countries. As shown above, the reviewed MNCs' FDI behaviour in transition economies follows the same pattern: the reviewed MNCs have had extensive export operations (as measured by the number of years) before the FDI in the same host country. However, due to a restricted operating environment prior to transition (see also Hirvensalo 1993) and due to rapid changes soon after the adoption of transitionary measures, these firms did not follow a step-wise entry path, as proposed by the internationalisation model. On the contrary, the use of other operation modes was very limited prior to the FDI, with the exception of the most recent manufacturing FDIs in Russia (in 1994). According to this pattern, the adoption of a market-based economic system in all countries of Eastern Europe triggered these FDIs, particularly in Central Europe. Thus, the sudden and unexpected change in the business environment stimulated a more direct entry mode in the first place.

However, recently started business operations (as of 1996 and first quarter of 1997) elsewhere in the region, particularly in Russia, may follow a more traditional path, as all of the reviewed firms announce that they plan to make manufacturing investments once their sales and marketing subsidiaries provide the necessary basis for the establishment of a manufacturing FDI. Hence, the firms are currently following a rather cautious entry pattern in those Eastern markets, where they plan to establish manufacturing units, particularly in Russia.

In terms of previous extensive export operations, experience gained in the same market has played a major role as a determinant for the location of the reviewed FDIs. In addition, the until now accumulated experience and knowledge in current markets would seem to affect operations in other transition markets in the near future. In this respect, both the Uppsala (e.g. Johanson and Vahlne 1977) and the Finnish (Luostarinen 1979) internationalisation model apply. Nonetheless, while these models propose that firms would first undertake manufacturing FDIs in culturally, physically and economically closer countries, the FDIs reviewed in this study were first made in the culturally and physically more distant countries of Central-East Europe (2/3 of the FDIs made during the first half of 1990-1995 and 60 per cent of the investment value), followed by investments made elsewhere in the region, (particularly in the physically and culturally close Estonia) in the latter half of the observation period. Thus, countries that embarked on the transition phase in the first wave and that have advanced more rapidly in their transition have attracted the major bulk of the firms' investments both in terms of the invested amount and number of subsidiaries.

5.2 Direct Investment Production Operations-Specific Determinants in the Baltic, Visegrád and Russian Markets

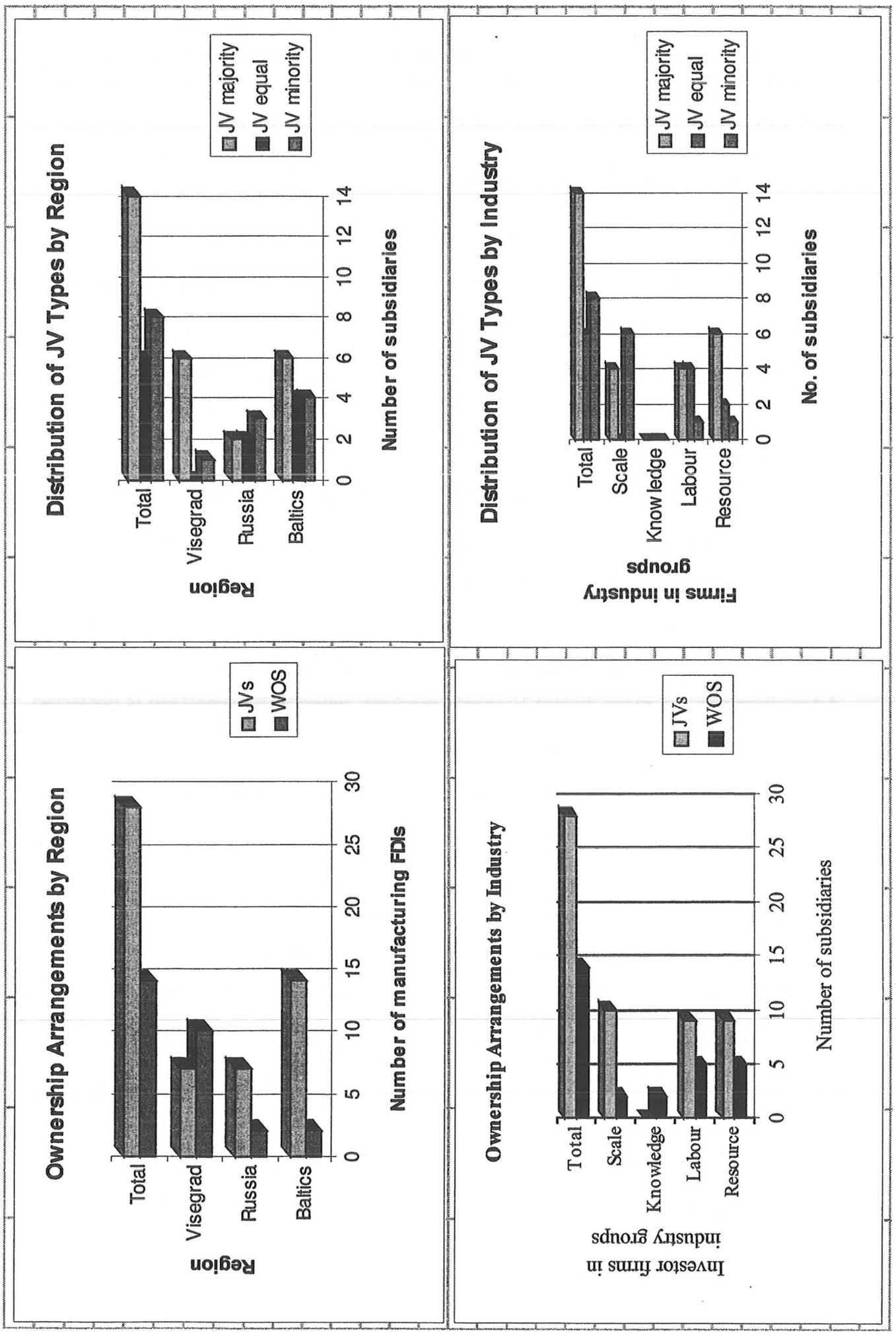
5.2.1 Ownership Strategy

As discussed previously (in chapter 3.6.3), ownership arrangements are a critical element of FDI strategy. In the CEECs, foreign ownership was first allowed by Hungary in 1972, followed by other Central European countries in the early 1980s and the former Soviet Union in 1987 (see chapter 4). However, operations were limited to JV operations with minority foreign ownership. Total foreign ownership

has been allowed only since the start of the transition programmes, i.e. since 1989 in Central Europe (Hungary, Poland and the former Czechoslovakia), in 1991 in the Baltics and since 1992 in Russia. Even though wholly owned foreign firms were allowed to operate in these countries, the early 1990s saw a boom of JV establishments. Since 1993, a marked change towards wholly owned subsidiaries in the CEECs and Russia has taken place. Former JVs have been either divested or changed into 100 per cent foreign owned firms, as is the case of a few of the reviewed firms as well. As figure 11 shows, the share of wholly owned subsidiaries is slightly half that of JVs, which is surprising regarding that these same MNCs in general prefer total ownership in other markets. The majority of these subsidiaries have been established very recently, in the period 1993-1995, except for two subsidiaries established in 1991 and 1992. This would confirm the overall pattern, i.e. the more recent the establishment of the subsidiary in a transition market, the likelier it is for it to be a wholly owned subsidiary. Full ownership is clearly preferred in more distant target markets, i.e. the Visegrád countries. The interviewed managers explain their preference for total ownership firstly by the relatively well advanced reform process in the Visegrád countries, secondly by the various problems faced by other firms (either competitors or firms in other industries) in their JV partnerships, and thirdly by the difficulty of finding an appropriate partner/acquisition target. These are crucial determinants in the more distant Visegrád markets, where full ownership is preferred. Furthermore, some of these firms' general policy is in the favour of total ownership, regardless of the FDI target region, due to the need to secure and control the involved tacit knowledge.

One third of the reviewed wholly owned subsidiaries have been preceded by JVs either in the same host market or elsewhere in the transition region. Both negative experiences with these JVs and the difficulty of finding suitable partners (including existing production facilities) have affected the choice. Thus, there is a shortage of potential complementary assets. Particularly the subsidiaries situated in the Baltic States seek to rapidly cover the market. This has first been achieved by either buying out potential competitors or by forming a partnership with a major market leader. This pattern is typical to resource oriented investor firms. The later established WOSs enforce their current position in the region. Hence, one of the major driving forces in

Figure 11 **Ownership Arrangements in the Reviewed Firms and Regional Characteristics**



the resource industries (particularly in the foodstuff industry) is to keep other large foreign competitors out of the Baltic markets so that Finnish markets could not be easily penetrated by cheaper products once trade barriers in such goods decrease significantly.

Another noteworthy point is that all of the wholly owned subsidiaries are totally or partly export oriented, which is associated with the higher propensity to choose total ownership. In this situation, the investor does not necessarily need complementary assets provided by a partner in the target market. In addition, as these investments are recent, related and supporting services needed for the setting up of as well as for developing and maintaining the activities of a wholly owned subsidiary are relatively well available in the Central European countries (where the majority of wholly owned subsidiaries are situated). These are mainly provided by firms in related and supporting industries / services which are foreign firms that have followed their customers to the region, but also newly established local firms have become important suppliers of such activities. Thus, the significantly larger share of wholly owned subsidiaries in the Visegrád markets does not only reflect the better advancement in restructuring (which is, naturally, partly due to an earlier started transition), but also the better availability of supporting and related services/industries. The high R&D intensity and/or the central role of tacit knowledge of those non-resource oriented investor firms who have pursued a total ownership policy in Eastern Europe additionally explains this behaviour; i.e. there is an ultimate need to secure and control that tacit knowledge.

Both non-JV investors and JV investors pointed to the difficult task of finding effective partners with whom to embark on a joint investment project. Firstly, firms that existed in the former centrally planned system and that are now being privatised have immense structural difficulties in being able to adapt to market forces. Therefore, they are not attractive JV acquisition targets (see 5.2.3 for a further discussion on this). Secondly, entrepreneurial activity in both the CEECs and the former USSR was suppressed under central planning and is still - from the viewpoint of these investors - not widespread in the region. According to investors, entrepreneurial activity seems to have developed at a faster pace along market

oriented principles in Central Europe. Nevertheless, establishing a JV with a newly established local firm or already heavily restructured privatised firm (or part of it), is considered as equally problematic due to this lack of entrepreneurial knowledge.

Thirdly, the Western partner's contribution to the partnership consists of a major bulk of the needed physical and financial capital. Part of the costs could in the early phases of transition be compensated by the generous tax advantages granted for foreign investors. However, these beneficial tax advantages were abolished soon after the first signs of their inefficency in attracting FDI and due to the lost budget revenues. This happened first in Hungary, in 1993, followed by other CEECs. Currently, only Russia still grants special tax treatment. The scarce availability of external financial resources (banks, international organisations, etc.) further renders the role of the foreign partner as a generator of capital even more crucial. The combined impact of these various problems faced by both potential and actual JV investors well explains the fact that all of the previously made divestments made by the investor firms included in this study were unsuccessful JVs. The reviewed firms would typically start with a joint venture and either divest or gradually become a wholly-owned unit in the covered markets. JVs have become unpopular also among many Eastern European entrepreneurs, who consider foreign investors as profit-seeking.

What, then, are the advantages gained through JVs? As the previous table indicates, two thirds of the reviewed FDIs are joint ventures. Almost all of the JV investors are resource and labour oriented or scale intensive firms, who are seeking complementary local assets. The interviews point to three motives determining their JV choice: (a) access to raw materials and partner's property, (b) access to local business contacts (distribution networks, customers), (c) acquiring knowledge on the local product preferences (content, legislative aspects, other product features). However, a major initial reason to the large amount of JV entries specifically in the Baltics and Russia is related to economic risks and legal constraints. Four of the resource oriented firms (in the foodstuff industry) are particularly dependent on their partners to get access to local markets and due to the local nature of their operations, i.e. they need to process inputs at the source of their raw materials and/or they are dependent on local inputs as

transportation costs are high and international trade in their goods is constrained by trade barriers.

One firm, which is in the building materials industry, follows a general policy of risk diversification through JVs in the whole region of Eastern Europe in order to improve overall risk exposure. In addition, this firm has chosen the equal ownership option in all of its JV subsidiaries. Two of the firms (one in the foodstuff sector and one in the metal industry) having established JVs also have other foreign partners, in addition to the local partner(s). In addition, one firm in the energy sector has formed both of its JVs in the Baltics with foreign partners. Even though this firm would benefit from having a local partner due to the nature of the industry, no local partners have been included in the partnership. All foreign partners in the reviewed JVs are, with the exception of one investor firm having a partner from Germany, from other Nordic countries. Their JVs located in Eastern Europe are considered as a testing ground for future potential co-operation in other markets. However, the main motive lies in their objective to minimise risks, too, and to acquire knowledge on the market. The risk factor is of primary importance in the energy JV, as a considerable amount of capital is tied up to the project.

An overall consensus exists upon the fact that the JV mode of operation enables maintaining a better local 'image', which is crucial in their industries, which are dependent on local labour force, raw materials, good relationships with suppliers, customers and, above all, authorities. This set of image factors is considered as a more crucial determinant in the Baltic and Russian markets than in the Visegrád markets. In practice, the degree of ownership does not always reflect the degree of real control in joint ventures. Investor firms having made an equal ownership JV arrangement underline the fact that, eventually, they exercise a larger degree of control over management and marketing issues. Moreover, the Western partners have an unusually large bargaining power in the JVs' decision making regardless of their ownership arrangements. This has been a deliberate choice by the partners involved, who seem to be able to achieve their objectives in this alliance.

To conclude, ownership strategies have strongly been determined by external factors such as legal constraints and economic risks, which is reflected in the gradual shift from JV entries to wholly owned subsidiaries along with gradual advancements in reforms. Thus, the more recent the establishment of the subsidiary in a transition market, the likelier it is for it to be a wholly owned subsidiary. While the majority of WOSs are very recent, most of the JVs have been established soon after the re-opening up of the transition markets, when JVs received preferential treatment in many respects (property, taxation, other legal aspects) and when the establishment of WOSs was still partly restricted. In addition, all of these JV entries have been made into fast growing industries, mainly into resource and labour intensive industries, and are either motivated by the need to secure home markets or to participate in growing markets. In either case, the role of complementary assets brought by JV acquisitions is crucial. Thus, in contrast to other empirical results, the business environment is the primary determinant in ownership strategies in transition markets (which are largely affected by the reform measures), while corporate motives and the need for complementary assets are secondary determinants[1]. These findings would indicate that government policies have a considerable triggering effect, likewise in many developing countries (see Larimo and Mäkelä 1995).

Despite the recent preference for WOSs, the JV arrangement is still dominant, particularly in Russia due to higher risk perception, and no significant ownership re-arrangements are foreseen regarding these JVs in the medium term. Full ownership is significantly more common in the more distant target markets, i.e. the Visegrád countries, than in Russia or the Baltic States, which form the mirror figures of the preference for JVs. In the case of these JVs, regardless of the industrial orientation, the post acquisition costs of integrating the new firm into their global organisation are considered as too high. This refers as well to anticipated frictions between partners. Therefore, these investor firms also prefer greenfield investments (see chapter 5.2.3). Hence, unlike FDIs made in other markets, it seems that the degree of ownership can affect the form of entry in transition markets (cf. Hennart and Park 1993).

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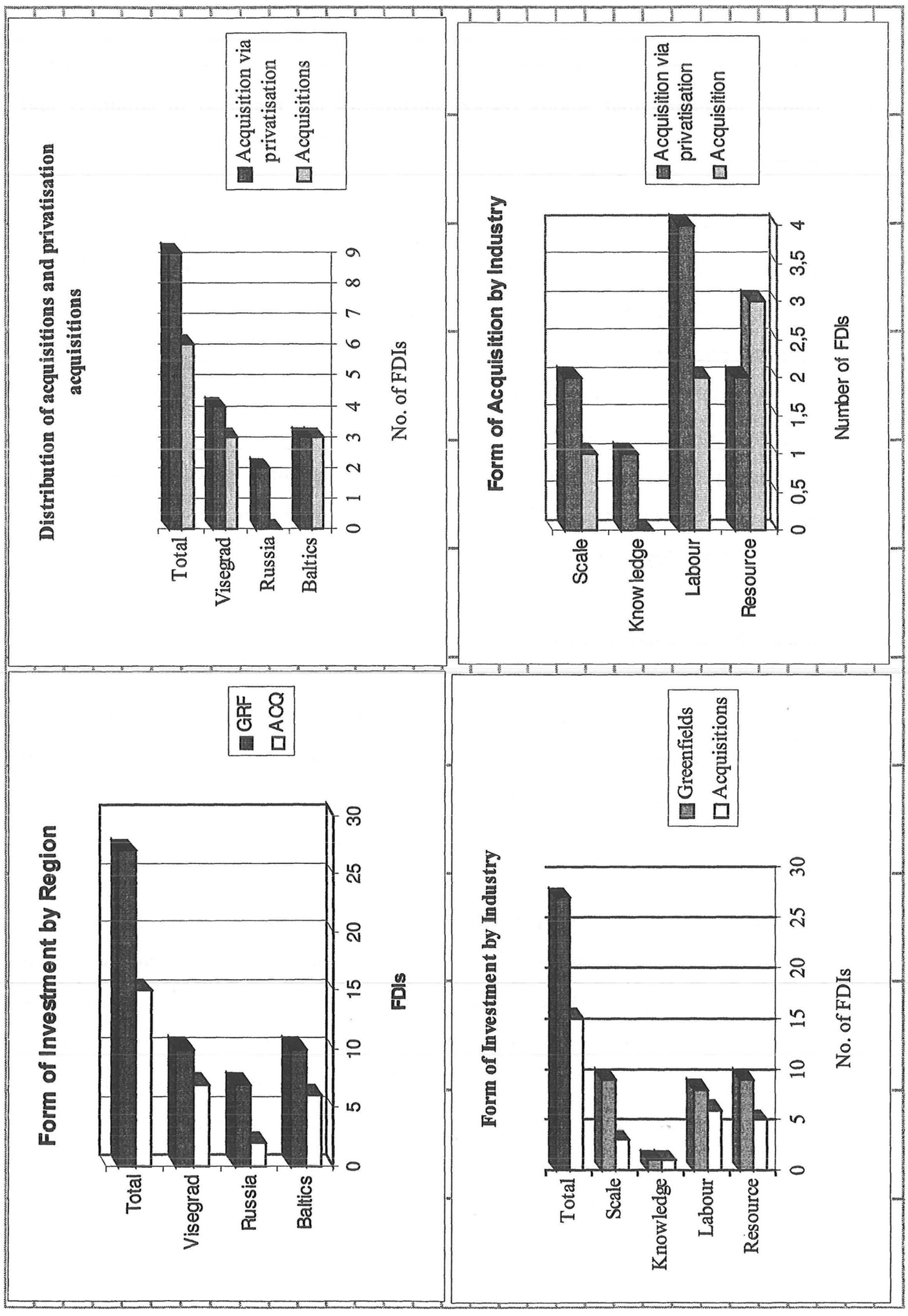
[1]See, e.g., Stopford and Wells 1972, on first mover advantages and Hennart 1991, on the determinants of market entries

Furthermore, the Visegrád markets are considered as more mature and as catching-up EU economies more rapidly than Baltic and Russian ones, implying that the business environment is already significantly in favour of wholly owned subsidiaries. Thus, in Luostarinen's (1979) terms, the economic distance is a major determinant, while cultural and geographic distance have a neutral impact. I.e., in contrast to other studies indicating that wholly owned subsidiaries are preferred in culturally and geographically closer markets (e.g. Luostarinen 1979), this study indicates that economic development is a major determinant (as the majority of WOSs are located in culturally and geographically more distant markets). Experience, in turn, plays a central role in those wholly owned subsidiaries, which are located in the Baltics or Russia, as they have either been preceded by JVs in the same home markets (either divested earlier or gradually changed into WOSs) or in other transition markets. Finally, industry orientation of the reviewed Finnish firms has a minor impact on the propensity to rely on WOSs in transition economies, in contrast to a more important relationship found in FDIs made elsewhere (see, e.g., Sanna-Randacio1990, Hennart 1991) and even in the case of FDIs made in the Visegrád markets by German and British firms (Meyer 1996).

5.2.2 Form of Investment

In addition to ownership arrangements, the decisions related to the form of investment are critical, particularly in transition economies which have sought to attract FDIs through their privatisation programmes. However, privatisation has not been a major determinant of the form of investment in the case of the investor firms included in this study. As figure 12 reveals, only one third of the subsidiaries have been established through acquisitions. A large majority of these are found in the CEECs, particularly in Poland and Estonia. While acquisitions made in the Baltics and Russia are very recent (made in the latter half of the reviewed period 1990-1995), many of the acquisitions (5 out of 7) made in Central Europe have taken place in the early phases of transition (i.e. 1989-1992). Poland and Hungary were then and still are the two countries, which managers consider as offering the most potential acquisition targets. A large amount of acquisitions were made by labour and resource intensive firms. This reflects the development in transition, i.e. the most attractive acquisition targets are typically

Figure 12 **Form of Investment in the Reviewed Firms and Regional Characteristics**



found in the labour and resource intensive sectors instead of technology intensive ones. The more technology intensive sectors and production opportunities in particularly electronics components are considered as more and more attractive by the interviewed managers, but the greenfield form of investment would be the chosen mode of entry. All of the acquisitions are further associated with a high share of exports (85 per cent) in the subsidiaries. In fact, the goods produced in these subsidiaries are either intermediate goods for the parent firms or components and end products exported to other than host country target markets.

Less than one fourth of the reviewed FDIs (i.e. 9 FDIs) were made in the form of privatisation acquisition, while 6 subsidiaries followed a 'traditional' acquisition procedure, i.e. the acquired firms were already privatised and had operated on market based principles on average 2 to even 4 years before the acquisition (see the following table). None of these subsidiaries were situated in Russia. All of the acquisitions made via privatisation shared two common features: Firstly, these FDIs were made either in nearby regions, i.e. particularly in Estonia and to some extent in the nearest regions of Russia, or in the pioneering transition economies of Poland and Hungary. Secondly, their intensity of technology is low. Thus, proximity and knowledge of the markets (Estonia) or significant advancement in transition (Poland and Hungary) as well as lower restructuring costs (as compared to industries with higher technology intensity) play a central role.

As to the general attitude towards privatisation acquisition, investors emphasise the complexity of not only integrating a formerly state-owned firm, but also the difficult and expensive task to undertake radical restructuring. The latter has been constrained by the host governments which have tied up acquisitions with strict limits to personnel restructuring. Typically, layoffs have been allowed only gradually over a period of several years. Interviews revealed that the most restrictive conditions are found in Russia, while the less restrictive ones are found in Poland. Otherwise all of the covered markets are considered as homogenous in this respect, though privatisation methods vary greatly across countries (see chapter 4).

Another reason to the minimal amount of privatisation acquisitions is simply in the lack of 'sufficiently attractive targets'. The unwillingness to acquire state-owned firms is further strengthened by the fact that former linkages (both forward and backward linkages) have totally or at least partly disappeared. Finally, the usual advantage of buying market shares and established brand names through acquisitions is not considered as important in transition markets, as the value of local brand names was low at the early stages of transition. On the contrary, Western imports and brand names attracted Eastern customers. Some changes have taken place in this respect, but they have not affected the operations of the firms included in this study.

Therefore, while the acquisition form of investment is usually associated with rapid entry to new markets, a readily available brand name and customer base, a readily available organisation, and with an overall cheaper option than greenfield investment, acquisitions in transition economies turn out to be excessively expensive and disadvantageous due to the above mentioned factors. The acquisition process is further complicated and lengthened by the involvement of several negotiation parties, such as several government agencies, former managers and employees. In Russia, unclear hierarchies between regions and the central authorities accentuate this situation. Thus, the evidence would suggest that privatisation acquisitions are not determined by the same factors that determine other international acquisitions.

Thus, the overall investment pattern in terms of the forms of investments is in favour of greenfield investments in transition economies, while the same investor firms prefer the acquisition form of investment in their other target markets. The preference of greenfield investments is also clearly connected to the degree of ownership in the subsidiaries, i.e. 12 of the 14 wholly owned subsidiaries and 11 of the 14 majority owned JVs are greenfield investments. The transition specific business environment and the need to secure full control over the manufacturing process are considered as the primary strategic reasons to these choices, regardless of the industry. The latter relates to the fact that these investments have been made in core industries of the investing firms. furthermore, the need to penetrate rapidly growing markets, which are still characterised by low capacity in certain sectors and certain markets (the Baltics and Russia), is crucially influencing the preference for greenfield investments, due to

the previously discussed obstacles to acquisitions. Interviews further revealed that significant differences in corporate culture and particularly the lack of market based management, marketing and production practices turn out to be a third determining factor.

However, along the observation period, the Visegrád markets and Estonia have moved into a position viewed as culturally and economically closer to these investors' (home) markets, while the other Baltic markets and Russia are considered as culturally and economically more distant. This change in the perceived business distance is triggered by accumulated firm specific experience in the Visegrád and Estonian markets. Several investors underlined that once a given market in regional terms (Visegrád, Baltics or Russia) was familiar through one or two subsidiaries (including all types of subsidiaries) in a country located in that market, and given the business environment, there was no need to choose the acquisition form of investment for the sole purpose of obtaining market related know how. Russia forms an exception in that FDI strategies in this target country are considered separately from other FDI operations elsewhere in the transition economies, due to a significantly higher risk perception and due to a relatively different socio-economic environment. Thus, Russia differs in terms of market conditions, i.e. experiences acquired in other transition economies do not affect the form of investment choices in Russia (see also 5.3 on transition specific determinants).

To sum up, the pattern of FDI entry modes in transition markets differs to a large extent from the one recorded elsewhere, both in terms of industry specific behaviour and in terms of psychic distance (cf. 3.6.2). Moreover, economic risk perceptions and the limited opportunities of acquiring local firms on market based conditions (obstacles set by privatisation schemes and differences in corporate practices) are considered as higher than in any other markets where the reviewed firms operate through FDI. Therefore, full control is seeked through the greenfield form of investment. Most strikingly, as experiences accumulate, greenfield investments become significantly more popular in transition markets, while it is the acquisition form that dominates as a result of accumulated knowledge in developed markets, due to the advantages brought by rapid entry and market coverage (see Caves 1982;

Hennart et al. 1995). Hence, achieving relative market power in transition markets is not determined by the same forces than in these same investor firms' other markets.

5.2.3 Type of Investment

FDIs can be grouped into horizontal and vertical investments, which are related to the investing firm's industry or market segment, and further into concentric and conglomerate investments, which are unrelated investments (see chapter 3.6.4). However, FDIs may share several of these features. As table 18 indicates, FDI projects by the reviewed MNCs in the Baltics, Visegrád countries and Russia are mainly related horizontal investments, of which some share features of a concentric investment (in parentheses). Operating in a familiar industry rather than in an unrelated industry is preferred, which is, in general, typical for Finnish firms (see, e.g. Björkman 1991, Larimo 1993). However, the relative share of unrelated investments in Eastern Europe is lower than in any other FDIs made in these MNCs' major target countries, as pointed out by the majority of interview respondents. This reflects the higher risks perceived in transition countries. Thus, perceived risks are not only related to the uncertainties associated with the unfamiliarity of unrelated industries or host market segments, but also to the transition specific uncertainties.

Only one (backward) vertical investment is found in the group of knowledge intensive firms. The amount of vertical investments could have been larger, especially among the resource and labour intensive firms, due to the vast opportunities of exploitable transition specific endowments (cheap raw materials, input prices, etc.), particularly in Russia. Apparently, large MNCs have not sought to take advantage of such resources, but to extend their advantageous (monopolistic) position based on product differentiation into transition markets. Furthermore, investing firms all realise that advantages gained through vertical integration are only temporary in the transition countries. The internalised factors are, thus, associated with technological and managerial know-how and / or reputation as well as managerial skills in quality control and marketing. In this sense, the transition markets are viewed as any other developed markets having long-term potential. The difference is that FDIs made in the CEECs and Russia are not expected to be profitable yet.

Table 18 Types of FDIs in the CEECs and Russia

		Related investment		Unrelated	
Group of firms	No. of manufacturing subsidiaries, n =42	Horizontal investment	Vertical investment	Conglo-merate	Concentric
Baltics	16	15	-	1	(3)
Russia	11	10	-	1	(1)
Visegrad	15	14	1	-	(5)
By type of firms					
Resource intensive	14	14	-	-	(2)
Labour intensive	14	14	-	-	(6)
Knowledge intens.	2	1	1	-	(1)
Scale intensive	12	10	-	2	-

Based on interviews and annual reports.

Though the number of vertical investments is minimal, all of the firms operating in the Baltic States and Russia pointed out that they are actively participating in the cooperation schemes aiming at restructuring and modernising backward and forward linkages in the given industries. This mainly takes place through contributing to training programmes. The active role of these firms in such 'informal' vertical activities is reflected also in the large amount of units established specifically to tackle problems related to backward and forward linkages (see, e.g., number of logistical units in the following table). The involvement of firms was most intense at the early stages of the FDI, sometimes already during the planning of the project, but usually problems were faced soon after the initial FDI was made. Within backward activities, which were of importance to resource and labour intensive firms, factors such as the possibility of disruptions to supplies, unreliability of product quality, the failure to keep to delivery dates and unacceptable price hikes were the most problematic ones. Other firms (in group 3 and 4) undertook their backward activities either in the home country or globally.

Within forward activities, the distribution channels formed a crucial problem in the early years of transition in the Baltics and Russia. This concerned 4 resource intensive firms (all in the foodstuff industry with 7 manufacturing subsidiaries in the Baltics and Russia), 3 labour intensive firms (2 firms in the metals industry with 3 manufacturing subsidiaries and 1 firm in the building materials industry with 4

manufacturing subsidiaries) and 1 scale-intensive firm with 3 manufacturing subsidiaries in the Baltics and Russia. Even though less than half (6) of these units were acquisitions, all of the manufacturing units faced the same problem, due to the nearly total dissolution of former distribution networks.

Investments made in the Visegrád markets have not followed the above described pattern; i.e. 'indirect' vertical involvement was not common in the early phases of the FDI. As indicated in chapter 4, the Visegrad countries have longer traditions in entrepreneurship and they were able to perform business operations even during the Soviet era. Therefore, the needed business networks were partly existing in the early 1990s , even though some of them disappeared after the dissolution of the FSU. As a result, the basis for the formation of new backward and forward linkages was more solid and indigenous firms have been able to undertake many of the operations. Hence, MNCs have not been involved in indirect vertical activities to the same extent as in the Baltic and Russian markets.

As the previous table reveals, 9 manufacturing subsidiaries share features of concentric investments, all of which are 'marketing' concentric investments (i.e. the FDI units serve the same or similar groups of customers via the same channels as the parent, while different production methods and R&D technology are used). All of the 9 marketing concentric investments are in manufacturing subsidiaries that have become part of the parents through acquisitions, meaning that the different production methods and / or technology are - at least partly - originating from the acquired unit. However, 8 units, i.e. excluding the knowledge intensive unit, serve local markets and they are using local resources (due to cost considerations and transport distances). As these two factors are essential in the activities of these resource and labour intensive subsidiaries, production in transition markets has not been adapted completely to the same production methods applied in their Western markets. Hence, in these industries the produced goods are local by nature, and therefore marketing concentric investment features are found.

To conclude, these results would indicate that the strategic choices of large MNCs between the various types on investments in transition countries differ as compared to

similar choices made by the same MNCs in other markets as well as by other large firms in other foreign markets. The horizontal type of investment is dominant in transition economies, likewise other studies have indicated it is in other markets as well (e.g. Buckley 1981). Studies on Finnish firms have indicated that the share of horizontal investments is relatively higher than in firms of other nationalities (see Larimo 1993, 240), which may explain the overall preference for horizontal investments in the case of transition markets, as well. However, uncertainty avoidance is also a significant determinant in all of the investing firms, as managers point out that: (a) Transition economies have opened up only recently, i.e. the business environment is new; and (b) the relative share of related investments is higher than in any other markets where these firms have made FDIs. Furthermore, as described above, several transition specific peculiarities emerge in the markets belonging previously to the FSU, i.e. an unusually high degree of involvement in vertical activities, due to the initial inexistence of certain services / functions provided by other firms or due to a lack of knowledge.

All of the investments that shared features of a concentric type were FDIs made through acquisitions, which is also a common association in studies concerning FDIs made in other markets (see Larimo 1993, 240). However, we can identify a dominance of marketing concentric investments in all of the transition markets. Overall, patterns of choices related to the types of investment do not differ within industries nor within transition markets.

5.2.4 Value added activities

This section discusses the value added activities the subsidiaries perform, the intangible and tangible flows between the parent firms and affiliates, as well as the business orientation of the subsidiaries, in order to see the long-term role of the affiliates situated in transition economies. We will also look at other business operations taking place simultaneously. The degree of the investing firms' commitment to transition markets and the latter's position in these firms' global strategies is reflected in the extent to which value addded activities are performed in the subsidiaries.

The following table presents the distribution of various value added activities performed in the reviewed subsidiaries. Altogether, 6 firms (one resource-intensive firm, 2 labour-intensive firms, one knowledge-intensive firm, and 2 scale-intensive firms) announced having only production activities in their subsidiaries. Only one of these 6 firms serves other than target markets. In their case, the value-added activities are all centralised in the parent firms. Respondents underlined the importance of information flows, which initially encouraged the centralisation of these activities, particularly those of R&D, marketing, and the like. The key factor affecting this decision was the availability and quality of the most important non-traded input, i.e. skilled labour. Five of these firms have established their subsidiaries recently. Value added activities are therefore mostly carried out in the parent firm (see also figure 7). In the longer run, according to the intervieved managers, the scale of value added activities will be enlarged in the subsidiaries. However, this would take place to the extent that economies of common governance are optimised. R&D activities form an exception, as they are tightly monitored by the parent firm and expected to remain centralised. The sequence of development in organising value-added activities in the region was markedly caused by a lack of knowledge and contacts as the following statements by two respondents show:

> *'Whatever the market we would never directly start operating with the whole range of (value-added) activities.... Certain activities, such as R&D, are centralised in the parent firm because of the need to control that particular activity both in terms of quality and the sensitivity of the embodied knowledge... In addition, our knowledge of the local labour force, support services and other parties involved (in Eastern Europe) is limited, therefore we first need to see what happens during the first year of operation.'*

> *'Local marketing units are needed, of course, as we are targeting the local market (the foodstuff industry)...But it took time to build the set of activities, as everything had to be started from scratch and it was difficult to find the most talented employees...First we wanted to tightly monitor the flows of information and other intangible knowledge, but the subsidiary (in the Visegrád region) is fairly independent now. Estonia was an exception, as it is so close both culturally and geographically. Therefore, a lot of these activities are centralised and only actual production is purely local...'*

All of the manufacturing subsidiaries additionally take advantage of services provided by their parent firms' other sales subsidiaries either located in the same host market or elsewhere in the same 'block of countries', i.e. the Visegrád and Baltic markets or

Russia. Part of the sales of the goods produced in the reviewed production subsidiaries are sold via these other sales subsidiaries. All of the firms included in this study have sales subsidiaries either in the CEECs and in Russia or both. Altogether, 46 sales subsidiaries are reported. While the reviewed MNCs' manufacturing FDI operations in other markets, such as in the EU or NAFTA, are usually accompanied with other contractual modes of operations, such as licensing, subcontracting, turnkey projects, and the like, FDI projects in these transition economies are associated with very few contractual operations.

Subcontracting forms an exception, with 6 firms undertaking such activities[2]. Subcontracting was also considered the 'easiest' contractual mode in terms of commitment (by all parties involved) and flexibility in the transition markets. These activities were, however, modest by volume and temporary by nature. Several of the respondent managers viewed subcontracting as a useful strategic vehicle for developing networks as well as obtaining additional experience with either a new product or a new market or both simultaneously and information particularly on the more turbulent Russian markets. The latter were still considered as risky and too uncertain for manufacturing direct investment operations, for which reason commitment to production activities were limited to subcontracting arrangements allowing flexibility and reaction to possible changes in the operating environment. The Estonian subcontracting activities were typically supplementary to home country operations, while the Visegrád subcontracting operations were mainly oriented towards supporting other operations (subsidiaries) located there.

Table 19 Value-Added Activities Performed in the Subsidiaries

Group of markets	No. of manufacturing subsidiaries, n =42	Sales unit	Marke-ting unit	Purcha-sing unit	Fi-nance unit	R&D	Pro-ject unit	Logi stics	Prope rty
Baltics	16	7	8	2	-	-	1	4	1
Russia	10	5	6	2	-	-	-	3	-
Visegrád	16	5	5	2	1	1	1	3	-
Total	42	17	19	6	1	1	2	10	1

[2] In Estonia, Poland, the Czech Republic, Hungary and Russia.

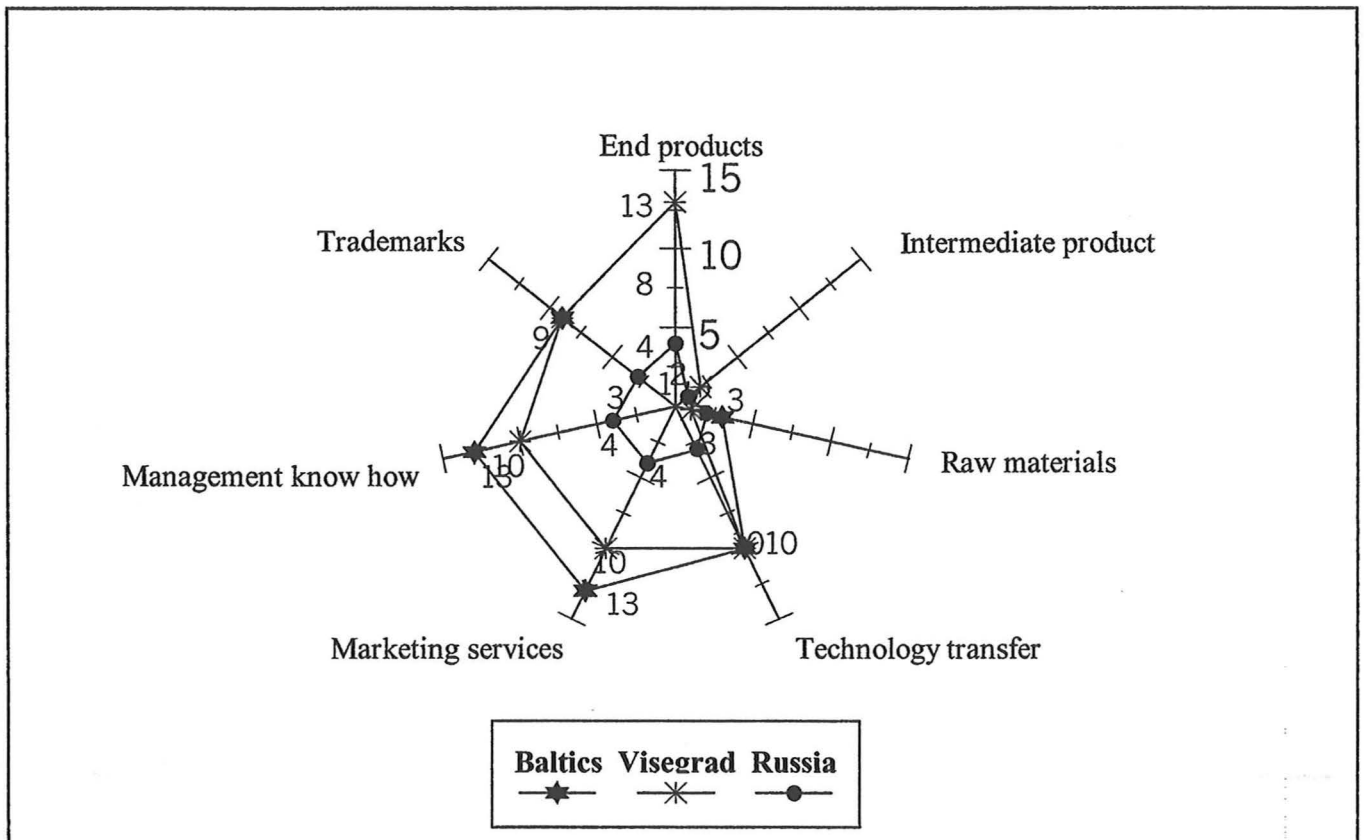
Separate purchasing units are found in six of the subsidiaries. All of their parent firms consider them indispensable, due to their dependence on the availability and cost of raw materials, parts, components and intermediate goods. The activities of purchasing units are considered as crucial in minimising uncertainties in the supplies of these goods. Regardless of the investor firm's industrial background and regardless of the host market, a key function of the purchases units is to solve problems related to quality and shortages. Both are considered as crucial issues in Eastern Europe, which accentuates the significance of long-term functioning relationships with local suppliers.

Marketing activities are also tightly controlled by the parent firms, but all of the investor firms have also realised the necessity to perform locally such activities in order to, firstly, accumulate knowledge on the East European markets and, secondly, to closely follow developments in these rapidly changing markets. Here, the interviewed managers often refered to the dynamism of and rapid changes in these markets, which required continous following up. All of the target markets were considered as significantly different from those the investors were used to (i.e. Western Europe), except for the Estonian market, and different from each other as well. This signified that marketing units in any of the Visegrád markets could not provide support to other units located in the Baltic or Russian markets. Hence, the majority of the firms have established both marketing and sales units in order to promote their products and to ensure the creation and maintenance of close relationships with customers and distributors in their given Eastern European markets.

Figure 13 reflects the dependence of subsidiaries on the investing parent firms, which provide marketing services, management know how, brand names and technology. The role of subsidiaries, in turn, focuses on providing information on local markets for their parent firms. The latter is crucial in 15 of the 16 investor firms, including 28 subsidiaries and particularly in those countries where the relative number of affiliates is large, i.e. in Poland, Estonia and Russia. The only firm not reporting the use of its subsidiaries as information sources, merely uses its two subsidiaries as producers of intermediate products for its global and home markets. Thus the flows between parent firms and subsidiaries situated in transition economies consist of a considerable

amount of mainly intangible, but also tangible assets provided by parent firms, while subsidiaries contribute significantly to the accumulation of transition specific market knowledge for the parent firms.

Figure 13 Investor Firms' Contributions to Subsidiaries



The strong concentration on Eastern European markets materialises in the sales orientation of the subsidiaries, as the majority, i.e. 79 per cent (33 subsidiaries of which 14 serve EU markets simultaneously), allocate their business operations to the Eastern European region. This is illustrated in the adjacent table. Surprisingly, four of the few subsidiaries that target only the host country markets are situated in the Baltic countries, which each provide very small markets. A closer enquiry revealed that these subsidiaries have not operated very long (i.e. established in 1994 and 1995). They operate in industry sectors which are restricted to national boundaries (at least currently in the Baltics, such as the production of energy and many of foodstuffs) and they are planning to expand eastwards once intra-Baltic and Russian trade and particularly non-trade barriers in these goods are removed. Though each Baltic economy is small, each market has specific characteristics due to cultural, linguistic and historical differences. Therefore, according to managers, it is necessary to

consider each market separately in terms of marketing. However, product characteristics such as standards are rather similar in Eastern Europe, which facilitates serving a larger market area than solely the host market.

Table 20 Sales Orientation of Subsidiaries

Investor firms' manufacturing subsidiaries in:	No. of FDIs, n =42	Eastern Europe	Host country only	EU (excluding home country)	Home country	Both Eastern Europe and EU	Both home and other EU
Baltics	16	3	4	1	1**	6	1
Russia	10	3	3			3 (2")	1
Visegrad	16	3			5**	2*+3	3

**One subsidiary serving mainly EU markets (20% in Eastern Europe). **Serve the parent firm only. "Only 20-30% of sales of both subsidiaries in Eastern Europe.*
Note: None of the subsidiaries' sales were oriented to other international markets, such as Asia, NAFTA or S-America.

Otherwise, a regional strategy emerges from the pattern of subsidiary operations in transition economies and from managers' perceptions. A clear distinction can be made between the Visegrád markets on the one hand and the Baltic and Russian markets on the other hand. Subsidiaries situated in a given Visegrád country either target the whole region and/or some EU markets as well, whereas Baltic subsidiaries target other Baltic and often Russian markets, as well . However, almost one third of Baltic subsidiaries serve EU markets simultaneously, regardless of the industrial orientation of the investing firm.

Trade opportunities provided by the so-called Europe Agreements signed between the EU and the CEECs clearly attract both investors whose CEEC subsidiaries already trade with EU countries and those investors whose subsidiaries are not trading with the EU yet. Knowledge and scale intensive firms are particularly interested in performing certain activities supporting their global operations in the transition markets, in which case the production of, e.g., intermediate products would be attractive. However, it is acknowledged that while trade is and will gradually be liberalised as stipulated in the Europe Agreements, production and other costs in the CEECs will also increase gradually up to a point where the benefits may not exceed significantly returns on the invested capital. Thus, the CEECs are expected, in the longer run, to catch up relatively well with EU Economies in terms of production costs. Exploitable cost advantages for the performance of a certain stage of production

are considered as more significant in the long term in Russia. However, such opportunities are overshadowed by several local and international (i.e. trade barriers) obstacles.

To sum up, the range of value-added activities undertaken in the reviewed subsidiaries mainly consist of marketing and sales activities, while very few units performing functions such as R&D, financial operations, purchasing, are reported. No country-specific or regional differences are identified within Eastern Europe in this respect. This high rate of centralisation of functions is partly due to the sudden stimulus to FDI arising from new opportunities that emerged after the collapse of the former central planning system, partly due to the relatively young age of the subsidiaries (i.e. most of the subsidiaries have been established in 1993-1995). The former factor refers to both the inability of firms to quickly introduce all functions in the production subsidiaries as well as to the unwillingness to commit the whole range of resources to activities object to a highly uncertain environment. Furthermore, all of the reviewed large firms follow a strategy of gradually increasing commitment in terms of performed functions. Thus, the most crucial value added activities are first established (i.e. marketing and sales units), followed by functions established gradually over a longer period and via the accumulation of market knowledge. Activities, which are typically centralised in large firms such R&D form an exception.

All in all, the subsidiaries situated in transition economies are highly dependent on their parent firms, which is also seen in the intense tangible and intangible flows from parent firms to their affiliates. Likewise, other studies have indicated (see Hirvensalo 1996), this study suggests that the subsidiaries located in Eastern Europe are also used as crucial sources of information of these markets.

Unlike manufacturing FDI operations in other international markets, firms operating in transition countries do not use the whole range of other (contractual) modes in conjunction with their manufacturing FDIs. Subcontracting in Russia is the only exception. A general unwillingness to either expand the current production activities of the subsidiaries or establish new manufacturing subsidiaries prevails in Russia due to the perceived political risks and economic turbulence. In this situation,

subcontracting is considered as a mode allowing the firms to flexibly react to the differences found in the Russian market. Should there be significant positive changes reducing political and economic risks, the firms can subsequently exploit new opportunities more rapidly by extending their current subcontracting activities and / or take into consideration the option of establishing a manufacturing subsidiary. Subcontracting is further preferred over licensing because it allows more control of the outcome of the production process.

The overall pattern, which emerges from this study, is one with an almost non-existent use of contractual modes by investor firms in conjunction with the manufacturing FDI throughout Eastern Europe. However, the numerous sales subsidiaries situated in the region play a central role in providing supporting services in addition to the services provided by parent firms.

The overall pattern emerging from the business orientation of subsidiaries indicates that likewise manufacturing FDIs elsewhere, FDIs in the transition countries are heavily market-oriented (79 per cent). However, this market-orientation has to be understood in a broader sense, as nearly 60 per cent of these subsidiaries are not only covering the host market, but also the other surrounding transition markets. Resource and labour intensive investor firms are clearly more oriented towards serving Eastern European markets than other firms, which use many of their affiliates as export bases (either to the home country or other EU countries). The economies of the Baltic States are typically used as export bases both to Russia, the Visegrád countries and EU countries, due to their small markets. These findings coincide with other empirical findings both in transition economies and in OECD countries (see, e.g., Larimo 1993, McMillan 1993, Meyer 1996).

5.3 Region-Specific Determinants in the Baltic, Visegrád and Russian Business Environment

This chapter analyses region-specific factors affecting the reviewed foreign direct investment operations in the covered transition area: the Baltic markets, the Visegrád markets and Russia. While the previous chapter (5.2.) analyses specific factors affecting choices related to the elements of FDI strategy, this chapter focuses on identifying those market, institutional and production factors affecting FDI operations at a regional level that have not been discussed in the element-specific analysis of FDI operations. Hence, this chapter is complementary to the previous chapter and the analysis therefore focuses on the more general external regional market, institutional and production factors affecting FDI entry and operations. The discussion specifically focuses on the most important market, institutional and production factors that have been identified by the respondent companies. This analysis is proceeded by discussing these region-specific factors in order of importance, as they emerged in the collected empirical data. The methodological chapter describes how this analysis was conducted.

5.3.1 Market Factors

5.3.1.1 Market size and growth

The most frequently cited primary factor that led the companies to establish a manufacturing subsidiary in the region was related to high expectations of future market growth and eventual take-off of Eastern transition economies. Table 21 shows how significant these factors were considered, when asked to rank factors according to their degree of importance in various regions among the transition countries. Most of the managers interviewed had not expected short-term profits. The initial aim, in some cases regardless of the profitability of the direct investment operation, was to seek a permanent presence in the new market and establish customer loyalty. Thus, a long term view was adopted in each transition market. As table 21 indicates, future market growth and potential play a particularly central role in Russia, while the need for presence, to follow competitors and the presence of other foreign investors have an equally central role with market potential in the Visegrád markets.

Table 21 **Importance of various market factors determining FDIs in transition markets** *Average grade, from 1 to 5 (1= very important, 5= less significant)*

	Baltics	Russia	Visegrád
Size of the target market	4,2	1,4	2,8
Large growth potential	2,5	1,5	2,0
Access to neighbouring markets	3,7	3,6	3,5
Access to Russian markets	2,6	-	4,7
Potential EU membership	2,1	-	1,8
Need to be near customer, need for presence	1,2	1,3	1,0
Barriers to trade	4,4	3,2	3,6
Indirect barriers to trade	4,0	2,5	4,5
Need to secure parent firm's market share	2,5	3,2	2,5
Need to follow competitors, leaders	3,7	3,8	2,1
Existing foreign investors in the market	2,0	2,0	1,8
Need to promote exports	2,3	2,5	2,1
Part of corporate regional strategy	1,3	1,6	1,0
Smallness of Finnish markets	2,7	2,9	1,3
Slower growth in Finnish markets	3,1	3,5	2,1

Though the size of the host market and potential growth primarily dictated the choice of the host market at a more general level, attractiveness brought by the proximity of the Baltic markets played a more important role along with improving political and economic conditions for those firms that had established production subsidiaries in this region. In the case of the Baltic markets, the managers interviewed underlined that it was clear that their (the Baltic markets) proximity to Russian markets was also a key determinant. The Baltics were a '*testing ground*' and a market where these firms could wait for a change in the perceived Russian FDI-deterring investment climate. Politico-economic tensions were considered problematic, while the enormous future potential was seen as evident. This way, a foothold was established not only by covering the Baltic States, but by ensuring some kind of extension to the large Russian market.

The FDI entry pattern of the firms (see chapter 5.2) closely followed economic growth developments in the region covered, reflecting the significance of market growth and size. The Visegrád region of some 80 million people was the number one target for these FDIs since the beginning of transition. Positive growth in most of these CEECs in 1993-1995

followed a sharp contraction in the early 1990s, coinciding with the initiation in much of the region of market-oriented reform and the break up of the former socialist trading block, the CMEA. The Baltics saw positive developments in economic growth starting in 1995. GDP in Eastern Europe (including the non-Visegrád countries) and the Baltics as a whole grew in real terms by a remarkable 5% in 1995. Growth rates of 6% to 7% were recorded in Poland and the Slovak Republic, while the Czech Republic and Estonia saw real GDP expand by 4% to 5%. Other CEECs and Baltic countries also experienced positive growth but at more modest rates. Hungary and Latvia were affected by severe fiscal adjustment, leading to a slowdown in growth in both economies from 2% to 3% in 1994 to 1%-2% in 1995. In contrast, real GDP fell during 1990-1995 in Russia; this is also apparent in the behaviour of FDIs made by the MNCs reviewed.

Table 22 **Economic Growth in the Baltic, Visegrád and Russian Markets, 1990-1995** (GDP, %-growth)

Country	1990	1991	1992	1993	1994	1995	Five-year projections by respondents*
Estonia	-8.1	-11.0	-14.2	-8.5	-2.7	3.2	+++
Latvia	2.9	-8.3	-35	-16	0.6	-1.6	++
Lithuania	-5.0	-13.4	-37.7	-24.2	1.0	3.1	+
Czech Rep.	-0.4	-14.2	-6.4	-0.9	2.6	4.8	++
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	+++
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	+++
Slovakia	-2.5	-14.6	-6.5	-4.1	4.8	7.4	+
Russia**	na	-13.0	-14.5	-8.7	-12.6	-4.0	+

* - Negative growth prospects, + Slightly positive, ++ positive growth prospects, +++ Very good prospects, all of the markets compared with each other; ** Real GDP, for other countries GDP at constant prices.

Economic growth in 1996 varied considerably throughout the CEECs and the CIS, but still met investors' expectations. The Visegrád countries maintained a fairly high average growth rate of 5 per cent and the Baltic States experienced solid recovery with a 3.4 per cent growth rate. In contrast, Russia continued its difficult path towards a market based economy as the country's long decline in GDP did not contract (-6 per cent), while many of the other members of the CIS made recoveries. The interviewed managers expected

Russia's continuous GDP decline to be brought to an end in 1997, depending on whether the problems related to arrears could be dealt with in a non-inflationary way.

As table 21 indicates, investors in all of the three regions viewed their FDI operations as part of general corporate *regional strategy*, which was fortified by the overall growth prospects in the whole transition area covered. Both the interviews and a more detailed observation of the answers to the questionnaire, however, suggest that only FDIs made in certain countries and certain cities were concerned by the regional strategy -factor affecting the FDI operations. In Estonia, Poland and the Russian cities close to Finland, this factor had a strong impact together with growth prospects. Typically, once Estonia was successfully entered at the very beginning of transition, the two other Baltic markets were entered at the latter half of the reviewed period and they were included in the regional market strategy.

The market size and growth factor also had a *push-effect* in the case of the Visegrád markets. As these markets were entered first soon after the opening up of Eastern Europe (see chapter 5.1), the reviewed FDIs were also greatly influenced by the ongoing serious Finnish recession in the early 1990's and by the lack of expansion opportunities once the Finnish market was covered. As the interview discussions showed in chapter 5.2, industries such as foodstuff and building materials saw for the first time, an opportunity to internationalise rapidly with low costs and few transportation problems as a result of proximity.

5.3.1.2 Overall economic environment

The fundamental socio-economic developments also played a role in the location of the direct investment production operations of the reviewed MNCs. In addition to market size and growth and political risks (see next section 5.3.2), factors that emerged as important in affecting the location of production subsidiaries were the trend in inflation and crime (including corruption), as shown in table 23. The financial system was not mentioned. On the one hand, this was partly due to the fact that almost all of the financial transactions were handled by the parent company in the home country. On the other hand, this was partly due to the fact that many of the Western banks had penetrated the Visegrád markets,

i.e. the markets the reviewed MNCs had first entered in the earliest phase of transition. In the Baltics, Estonia was the first target of FDIs by these MNCs. There, too, the financial system was not considered problematic for production operations, as the country had liberalised capital flows from the start of transition. This enabled the use of instruments and banking services in the home country of the parent companies. By the time the other Baltic markets (very few) were entered, the financial system there had already improved and capital flows liberalised. In addition, foreign banks had already entered the market. As such, the banking crises of the Baltics did not affect these FDIs, though the crises were serious (see chapter 4). Investors were confident in the ability of Baltic governments to control the situation, as actions aiming at consolidating and restructuring the sector were radical particularly in Latvia. In contrast, the lack of confidence in the Russian financial system was accentuated with the serious liquidity crisis that emerged in August 1995. As a result, overnight inter-bank interest rates rose above an annualised level of 1000%.

Table 23 Market factors considered to be obstacles to manufacturing FDI in the business climate of transition economies
Average grade, from 1 to 5, 1=significant obstacle, 5= not significant

	Baltics	Russia	Visegrád
Taxation	4,8	1,8	4,9
Product norms and certificates	4,7	1,3	5,0
Inflation	4,1	2,2	3,0
Stability of currency and its convertibility	4,1	1,4	4,7
Economic instability	4,1	1,2	4,5
Functioning banking sector	4,0	3,1	4,8
Availability of funding resources	4,9	2,9	5,0
Sales and distribution channels	3,3	3,1	4,3
Availability of support services	4,0	1,8	4,5
Crime	3,1	1,2	4,3

Significant progress had been achieved throughout the transition region in efforts to control inflation. This was considered as important by investors because of the influence of '*improved predictability of market and cost conditions*'. By the end of 1995, no Visegrád and Baltic country was suffering from annual inflation of more than 40%. Moreover, inflation fell to single digit levels in the Czech Republic and in Slovakia. Table

23 indicates that inflation was actually considered as less an obstacle than elsewhere. The interviews revealed that the adoption of a currency board system in each of the Baltic countries turned out to be a positive factor in creating an investor friendly climate. The commitment to achieve tight fiscal and monetary policies within the framework of a currency board was considered as a stabilising factor leading persistently to lower inflation and more stable financial markets. However, the Visegrád market was considered as the best achiever in terms of low inflation, while the Baltic situation was still disappointingly high during the reviewed period, particularly in Estonia. In contrast, Russian inflation was declining, though the respondents still considered it to be at an '*unacceptable*' level. It decreased from more than 800% in 1993 to about 130% in 1995.

According to investor firms, the vigorous *stabilisation programs* were the key issue. They paved the way for declining inflation and a resumption of growth as reforms gradually took hold in the most successful countries. These assessments indicated that whilst undertaking their production FDIs, 'homeworks' were relatively well done in the sense that a close look at the surrounding operating environment was made. Not only in terms of potential growth but in terms of overall stability. *The more radical the economic reforms, the more they signalled long-term commitment to sustained market-oriented policies and to the willingness of providing an adequate investment climate for foreign participants.* In their opinion, this had specifically taken place in Poland, Hungary, the Czech Republic and in Estonia (though timing was different), where political change had been more rapid and fundamental - but still without social unrest - than in other transition countries. The degree of criminality and more particularly corruption, however, emerged as influencing factors to the extent that the less the market was *known* (as perceived by the investors) as having such problems, the more favourable the investment climate was considered as appropriate for FDI. The Visegrád would in this respect be graded as least problematic, the Baltics next with Estonia standing out of the group as clearly most preferred, while Russia was viewed as most insecure. The interviews reflect the same feature as table 23, i.e. investors faced several obstacles in the Russian markets, while the Visegrád and Baltic markets as a whole were graded almost similarly as 'non-problematic'.

5.3.1.3 Competitive factors

The managers interviewed stressed that the presence of the international competitors of the MNCs reviewed were significant in triggering action, once the market potential was realised. The impact of a competitor's FDI operations on these MNCs' operations was manyfold: firstly, the presence of competitors in transition markets had a strong impact on the reviewed MNCs' need to follow the leaders, i.e. to participate in this race for presence in new, large and growing markets. This 'wave' of reaction particularly concerned the Visegrád countries. Secondly, the location of competitor MNCs' production subsidiaries was viewed as a signal of a given market's suitability for such operations. Once a major competitor was known to have established successfully operations in the market, the reviewed investors would translate this into a factor encouraging FDI entry. Thirdly, competitors' presence in a given market provided strategic encouragement by sparing - to some extent - the smaller and less experienced Finnish MNCs from the demanding work of market research and preparation. Furthermore, they provided a playing field in which the legal conditions improved and stabilised more rapidly in the wake of the competitor MNCs. This was particularly the case with Poland and Hungary. Their bargaining power was considered a match for most governments, particularly in smaller countries.

As a result of the above cited factors, the presence of major international players attracted additional investors and added to the FDI attractiveness. It was also realised, however, that competition would be fierce even in these new markets, as '*every major player*' was present. In a way, though it was clear that local firms would not be able to compete, these markets were considered as more demanding than for instance EU markets, due to the existence of 'normal' competition and because of the exceptional and turbulent conditions in which they had to operate. This combination of factors determining the competitive environment in transition economies might also explain why so relatively few Finnish MNCs were present in the region in the early 1990s.

Hence, the presence of major international MNCs was an important consideration for investors, which is reflected in their entry pattern: these firms first established production subsidiaries in the Visegrád markets (particularly in Poland and Hungary) in 1990-1993, then to the Baltics (with a major concentration in Estonia) during the period 1993-1995,

while still by the end of the covered period, i.e. in 1995, Russia suffered from both the lack of FDI inflows and the lack of confidence needed for attracting foreign investors.

For some of the firms in certain industries, such as the building materials industry or the foodstuff industry, the reasons behind their production FDI entries is to be found in the strategy *to buy potential competitors*, though these products are difficult or expensive to transport and their product characteristics are local by nature. The aim was to protect existing markets and preclude rivals or potential rivals from gaining new markets. Hence, some market expansion takes place in the form of extended (Finnish) home markets, particularly in the Baltics and the nearby Russian regions. These investor firms also followed a regional strategy (see subchapter 5.3.1.1) Nevertheless, the MNCs concerned were notably operating in such industries that had not internationalised (at least to any large degree in Finland) by the end of the 1980s. The opening up of the nearby transition economies, i.e. the Baltics and Russia, to FDI offered that opportunity to these firms.

5.3.2 Institutional Factors

5.3.2.1 Political Risk

A major source of political risk was caused by unclear definitions of what is permitted and not permitted. Hence, unclear legislation was viewed as the most critical factor inhibiting an even greater optimisation of FDI. Deficiencies broke down into systemic problems, which stemmed from a legacy of fifty years of central planning. The difficulties mainly arose from loopholes in the legislation and the fast implementation of new laws with some changing the previously passed, while those (dating from the previous regime) that had not been changed were in force as long as the new ones were missing. Investors faced political risks even when the laws existed, due to the varying interpretations and to implementation practices, which had not had time to develop. The fact that specifically the Baltics and the Visegrád countries were among the few formerly planned economies that could fall back upon a legal Germanic-French tradition from a not too distant past (see chapter 4) was a crucial facilitating factor. Investors would rank the Visegrád countries slightly ahead of the Baltics in their legal achievements during their early years of transition.

Table 24 **Institutional factors determining the location of manufacturing subsidiaries in transition economies**
Average grade, from 1 to 5, (1=Very important, 5=Less significant)

	Baltics	Russia	Visegrád
Political stability	2,2	1,1	3,1
Legislation favourable for FDIs	1,3	1,0	1,2
Ownership restrictions (property)	3,0	1,2	3,1
Customs tariffs and related regulations	4,8	4,1	3,2
Privatisation	4,2	4,9	3,0
Positive attitude towards foreign investors	2,2	4,3	1,1
International agreements on investment protection	1,3	1,0	2,2
Investment incentives	3,9	2,9	4,7
Trade agreements with the EU	1,4	3,1	2,5
Support by international organisations	4,5	4,1	4,9

It turned out that the difference in legislative backgrounds between the cited countries and Russia (as was the case with the CIS as well) was seen as huge and it was considered as a major FDI deterring factor in Russia. Overall institutional deficiencies were by far considered the most serious ones in Russia. Everyday operations were hampered by the unclear power relations between regions and central government and by the ever-changing fiscal treatment of foreign owned firms. Most of the interviewed investors adopted a 'Wait and see' attitude due to the '*chronically*' unstable political and economic situation in Russia, which was also reflected in the survey (see table 24, below). Therefore, those firms that were operating there were not as committed (in terms of investment value and volume) to the market as in the Baltic and Visegrád markets. The interview outcome indicated that those firms that were not operating via manufacturing operations in Russia yet, concentrated on the development of Baltic operations through which they further acquired more experience and knowledge on the neighbouring Russian market. This indicates that the Baltic markets provided a foundation for potential FDIs to Russia. At the time the interviews were conducted, potential FDIs to Russia were said to be highly dependent on the outcome of the 1996 presidential elections.

In addition, a slow bureaucratic administration and unclear and vague ownership schemes hampered efficient operations and on a long-term horizon, particularly in Russia, and to a

less significant degree in all of the countries concerned. The resulting lack of clarity and uncertainty made investors think that '*anything was allowed*'. Enquiries on other political risks revealed that expropriation risks were considered 'to exist' in Russia, but not at all in the Visegrád and Baltic host markets. Some degree of uncertainty emerged during the first year of transition in the Baltic markets, which then changed into complete confidence in the irreversibility of the chosen political path towards a market economy.

5.3.2.2 Institutional Basis for Trade

According to the respondents, the whole period 1990-1995 suffered from a marked absence of a strong and clear commitment to open markets among the reviewed countries, despite the new trade arrangements agreed upon in 1992 among the Visegrád countries and in 1993 among the Baltic States (see chapter 3). The existence of trade barriers not only between the reviewed transition economies and the EU, but also particularly within and between the Baltic, Visegrád and Russian markets was puzzling. Trade procedures in Russia were deemed '*unnecessarily complicated and unclear*' even though several agreements had been signed between Russia and the EU (see chapter 3). Trade between the Baltics and Russia also suffered from unusually high Russian tariffs on Baltic products, especially for products manufactured in Estonia, which faced tariffs double those of its two Baltic neighbours. The latter had a major impact on the sales orientation of the subsidiaries of the MNCs reviewed in this study, as shown in chapter 5.2. Furthermore, Russian treatment involved peculiarities, as described in a comment by a respondent:

> *'...We (the investing company) faced export incentives of unprecedented nature... For instance, any company situated in Estonia and with at least 50% of its employees of Russian origin could be granted preferential treatment in tariffs when exporting to Russia... '*

Within the Baltic region, the so-called Baltic Free Trade Agreement (see chapter 3), turned out to be problematic in practice. The fact that by 1995 intra-Baltic trade was low, around 7-9%, well reflects the malfunctioning of the agreement. Though it was agreed that it would enter into force in April 1994, it was fully enforced only in late 1996. Similarly, the Central European Free Trade Agreement (CEFTA, signed in 1992 and in force since 1993) signed between the Visegrád countries was not implemented directly by all of the

countries and in all products, but it was still viewed as more useful than the Baltic agreement and as impeding normal commercial practices to a lesser degree. By the end of 1995, the CEFTA seemed to provide considerable advantages to those interviewed investor firms whose subsidiaries were servicing the whole region. All of the respondents were enthusiastic about plans to lower trade barriers between the CEFTA and Baltic countries, as this would enable taking advantage of a wider unified market. Namely, as the majority of the subsidiaries were oriented towards local host markets or surrounding transition markets, such an arrangement would have increased the possibility to supply several Eastern European markets from manufacturing, servicing or storage facilities located in one country in the region.

Though not favourable enough in the initial phase, the Europe Agreements (EAs) signed between the EU and the Visegrád and Baltic countries provided a '*safe basis*', as investors were fully aware of the final goal of these agreements: to liberalise trade completely at the final stage. In this sense, the Russian market could be considered as isolated, as terms of trade were less favourable both with the EU and the Baltics. On the other hand, these FDIs in Russia were clearly fully locally oriented (host market oriented), while the attractiveness of the small Baltic markets would in the long term be dependent on developments in their trade relations with EU and/or CEFTA countries and Russia (see tables 24 and 21). Thus, the anticipation of future more favourable trade arrangements played a key role in the case of Baltic FDIs, while the Visegrád subsidiaries were less dependent on such developments, due to the large size of these markets and an already functioning 'trade block' in the region. From the point of view of these investors, the EAs then provided an additional, but not a necessary advantage. The eventual liberalisation of trade between the EU and the CEFTA countries was viewed as providing further flexibility and possibilities to deepen the integration of various activities within the region and in the EU. In the longer run, this would increase competitiveness vis-à-vis American and Asian competitors and would also imply reorganisation of European production operations involving relocation as well.

5.3.2.3 FDI Treatment

The importance of guaranteeing profit repatriation was emphasised as a pre-condition for all of the investors. The importance of streamlining regulations and making them simpler was stressed. Not the least important, some participants emphasised the significance of establishing credible dispute settlement procedures, with clear rights for foreign investors to sue in impartial courts.

FDI incentives, concessions and fiscal privileges (for details, see chapter 4) did not play a significant role in the establishment of these MNCs' production subsidiaries in the Visegrád, Baltic and Russian markets, as shown by table 24. Nor did the various sources of financial grants and technical support offered by international and national organisations for investment projects specifically allocated to the transition economies attract any of the investors' interest, regardless of the host market. Several of the interviewed managers said that the materialisation of their FDI projects would be least dependent on any such factor and that 'purely strategic corporate objectives' were dictating the establishment of the subsidiaries. However, if easily available, they would provide an additional advantage. One manager in a foodstuff company remarked:

> *'...of course such incentives would not be available in Finland. But their existence did not affect the final decision to establish a manufacturing subsidiary. It was good news to learn about such an advantage (0 profit taxes during the first 3 years) ... Nevertheless, the advantage was much less significant than the total financial and other resources we allocated to this project, the outcome of which was uncertain in terms of profitability, results in management, technical and marketing training. And above all, whether the product would become 'domestic' and accepted played a critical role.'*

It was generally thought that SMEs would seek to take advantage of such programmes more actively. In addition, the involvement of international organisations, such as the EBRD, was seen as complicating and prolonging the whole process and as decreasing flexibility. It was generally known that acquiring funds from these organisation was difficult. Subsidies granted on a case-by-case basis, in contrast had a manifold reception. For instance, one respondent thought that the use of subsidies for attracting foreign investors by some governments in the very beginning of transition could be characterised as unfair and it distorted competition, though these measures did not affect the reviewed

MNCs as the benefiting firms where foreign (non-Finnish) MNCs that operated in different industries. However, 'supra-normal power' gained by large MNCs was acknowledged.

5.3.3 Production Factors

5.3.3.1 Factor costs

Factor costs, more specifically low wages, were generally expected to be a major FDI attracting force in addition to the availability of technically skilled labour in the transition economies soon after their opening up. The respondents of this study, however, underlined that exploiting cross-country differences in factor costs is of more central importance only in certain types of industries, typically in labour-intensive industries and lower value added products, such as textiles. In addition, such exploitation is beneficial only for shorter-term investments. For instance, certain types of operations, such as subcontracting, would benefit from such advantages. As the interviewed investors were interested in creating a permanent presence, it was argued that *factor costs could not be a primary determinant.*

Low cost production factors fell much further down the list of priorities. It was commonly acknowledged that rapid development towards a market economy and the sharp increase in wages would render low factor costs only a temporary benefit. Russia was considered as an exception, as it was generally thought that this advantage would last longer there than in any of the other European transition economies. Nevertheless, these investors were not even seeking to benefit from that situation either, as e.g. political and economic instability overshadowed the benefits of low cost. The following comment describes the actual opinions on the role of the cost factors in transition economies and their impact on the location of manufacturing subsidiaries:

> *'The cost advantage can be exploited only for some years to come (in the Visegrád and the Baltics), as economic development shows strong signs of catching-up more rapidly than expected at least in the case of wages...the cost advantage is in this sense likelier to be exploitable in Russia for at least two decades... and even there, the infrastructural deficiencies pose problems and decrease to some extent the benefits brought by low factor costs.'*

The following remark by a respondent in a knowledge intensive firm was pertinent:

> *'..Cheap labour is not an important factor for us, it is only an additional advantage...we do consider an acceptable cost level to be important, though... access to the local (Hungarian and forthcoming Polish) and surrounding transition markets, acquiring and accumulation of local market knowledge as well as the availability of skilled labour together are a set of primary factors that affected the choice of our production subsidiaries'*

Two groups of firms did benefit from the low cost advantages, but the role of these advantages was said to be non-existent unless combined with other primary benefits. These were the foodstuff and building materials companies They benefited from low cost advantages to the extent that their internationalisation, which had started as a result of the opening up of nearby new and growing markets (the Baltics and nearby Russian regions), was greatly facilitated and enhanced by this additional advantage. Namely, it decreased uncertainty related to perceived internationalisation risks and increased the willingness to invest in these markets. Typically, these firms first entered the culturally and physically closest Estonian market via a production subsidiary and then expanded to other Baltic countries or Russian markets either through other FDIs or exports (which was often the case with the Russian market). Thus, the low cost factor affected marginally FDIs made by 5 MNCs covered in this study, which had altogether 7 manufacturing subsidiaries in the Baltic markets and 5 subsidiaries in Russia.

Table 25 Production factors determining the location of manufacturing subsidiaries in transition economies

Average grade, from 1 to 5, (1=very important, 5= Less significant)

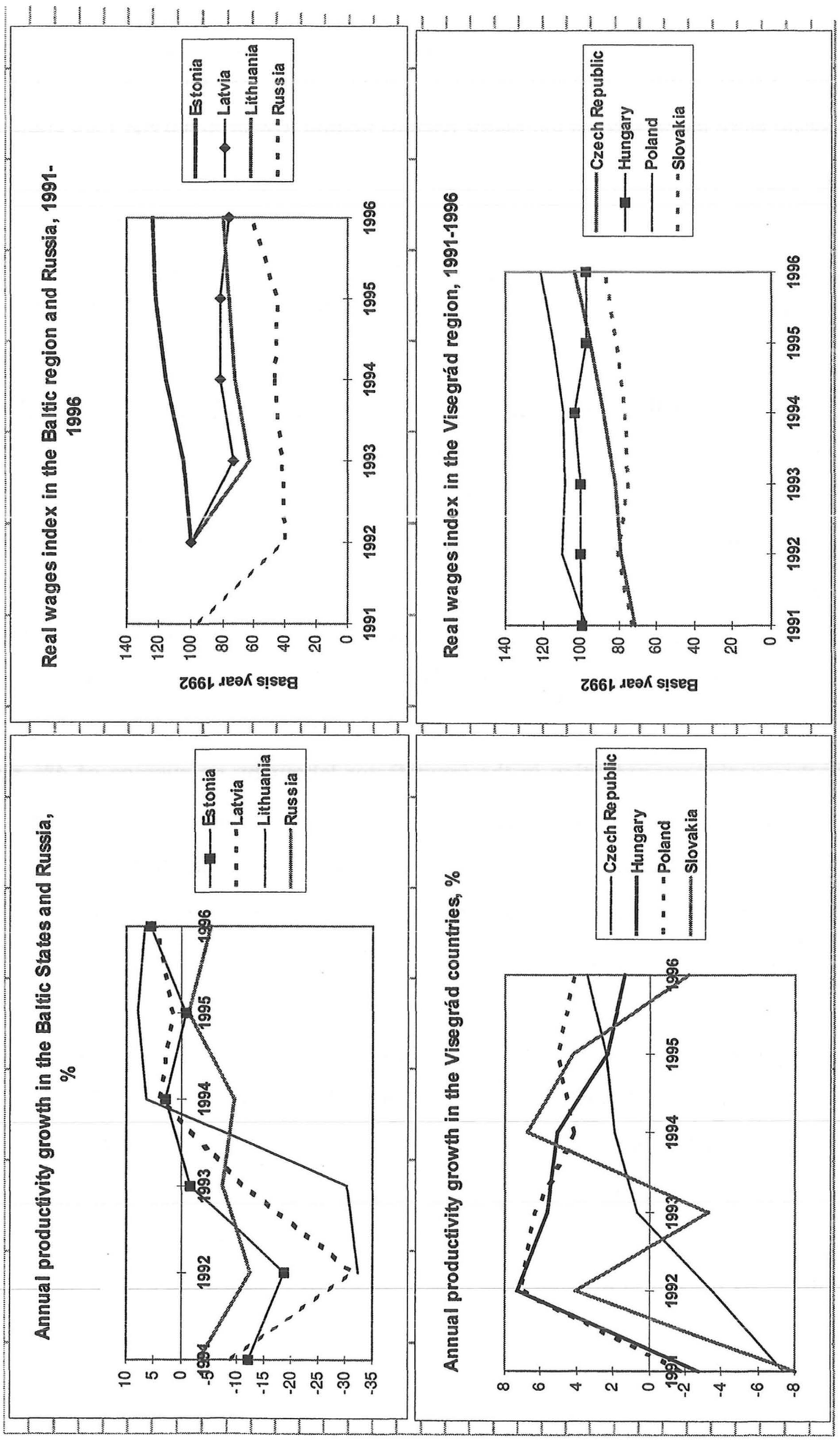
	Baltics	Russia	Visegrád
Well educated labour force	1,3	2,1	2,2
Availability of labour force	2,2	1,1	2,3
Low wages	4,1	4,0	4,6
Low production costs	3,9	3	4,7
High technological level in the target market	2,6	2,5	2,4
Availability of raw materials	2,2	2,1	4,2
Low transport costs	3,5	3,1	4,8
Quality of infrastructure	1,1	2,2	1,3

All of the managers pointed to *the significance of productivity,* which was far from being at the Western European level. Though remarkable achievements were made, productivity was still seen as poor, particularly in the Baltics and Russia at the end of the reviewed period. Poor infrastructure, outdated physical capital stock, overstaffing and lower working morale were mentioned as the major reasons behind low productivity (see chapter 3 for a description on the previous production systems).

In the Visegrád and Baltic countries the economic and social reforms were initially associated with sharp increases in unit labour costs, with the exceptions of the Czech Republic and Russia, where unit costs fell in early stages of transition. The following figures on the development of the wage levels as well as productivity in the Visegrád, Baltic and Russian markets re-enforce the respondents' perceptions. In general, an increase in productivity was seen as having only a temporary impact on the situation, as it was commonly expected to be broadly matched by a further rise in wages or by an appreciating exchange rate. In terms of productivity achievements, the FDIs of these MNCs seem to have followed the most advanced transition economies. Namely, the most important host countries for their FDIs, i.e. Poland and Hungary, also achieved the highest productivity gains in Eastern Europe by the end of the reviewed period. Hungary owed its good position to the continuous reduction in the input factor labour by an average of 4% p.a. since 1991. In addition, the country benefited greatly from the devaluation of the HUF. In contrast, Poland experienced a deterioration in its competitiveness, due to strong upward pressure on the PLZ. This situation was accentuated in 1995, when a revaluation of the currency caused a 19% deterioration in its competitive position that year.

Unit labour costs were lower in the Baltics, where they rose more or less in parallel during the reviewed period. The Estonian currency experienced the highest (real) appreciation, accelerated by its peg to the DEM in 1993-94. Productivity losses have been by far the greatest in Russia, where unit labour costs have been almost entirely determined by nominal wage increases and exchange rate fluctuations. Until 1992, wage increases were more than offset by the fall in the exchange rate, after which stabilisation policy was more successful in controlling exchange rates and annual wage increases.

Figure 14: Real Wages Index and Annual Productivity Growth in the Visegrád, Baltic and Russian Markets, 1990-1995



5.3.3.2 Human resources and technological endowments

The general labour qualification in technical skills, though difficult to measure, was considered as very high. Due to a shorter period of socialism in the Visegrád and the Baltics vs. Russia, the labour force was seen as more easily adaptable to new production methods and principles, management and marketing as well as quality requirements with the help of training. The Visegrád markets had a headstart compared to the Baltics and Russia, as they had started with the liberalisation of entrepreneurship via experiments already during socialism with Hungary pioneering in the 1960s. In addition to market factors, human capital endowments and the historical background affected strongly, according to managers, the choice of the location of production subsidiaries in Eastern Europe after the initial decision to invest in the region. As a result, the Visegrád countries, more specifically Poland and Hungary, became more attractive in these terms at the time the entry decisions were made. By the end of 1995, the Baltics were already considered as more competitive in these terms compared to the Visegrád, but Estonia was clearly at a preferential position within the Baltic region.

5.3.3.3 Other production factors in a long term perspective

Some of the firms (the resource oriented and scale intensive ones) considered long-run location-specific production factors as strategically important for their production FDIs at the time of investment and all of the firms considered them as even more central in terms of the *availability of production factors* (including human resource) and in terms of future developments regarding the *institutional basis for international trade*. The gradually widening trade arrangements between the Visegrád and the EU markets were seen as offering the opportunity to centralize certain production activities according to the availability and quality of production factors, which would bring advantages of economies of scale or/and localisation economies (all firms in a single industry at that location reduce costs because of shared production factors).

For those firms that operated in Russia, the availability of natural and human resources played a more determining role as a locational factor. The exploitability of Russian natural resources, however, posed problems particularly to firms in the metal, forest and building materials industries during the whole reviewed period. A so-called law on production

sharing was anticipated in 1995, but it finally became operational in January 1996. This law allows an investor to enter into a contract with the state, which grants it exploitation rights for a particular geographical area together with an exemption from all present and future taxes other than those defined in the contract. The state, in turn, receives a pre-determined percentage of the production after the investor has recouped his investment costs. This law was seen as an important advancement facilitating production operations by these MNCs in the longer run. It was yet unclear how efficiently each state would implement this law, as experience had already shown the unclear relationship in decision-making between the central government and regions (states).

The trade developments related to the Baltic markets were said to be crucial, as their smallness forced each of the companies to carefully consider their strategic role. During the reviewed period, the Baltic production factors and the business environment were clearly more attractive than those of Russia, which enabled using them as bridgeheads to Russian markets. However, once the Russian market would stabilise their role as a host to the production subsidiaries would change. They would be likelier to serve either the Visegrád markets or the EU in addition to serving the Baltic markets.

5.3.4 Other Factors

5.3.4.1 Home country factors

Though secondary to the previously reviewed determinants of the MNCs covered in this study, home country conditions did affect the East European operations of firms in the building materials and foodstuff industry. As mentioned earlier, FDIs by these firms were triggered by the new situation in neighbouring former Soviet Union countries in particular. Their own home market had already reached a maximum level of market coverage, both in terms of market shares and in terms of firm size. The opening up of the ex-socialist countries offered an opportunity to expand, as the domestic market was 'saturated' from their point of view. In addition, it was feared that a larger international competitor would try to penetrate the Finnish market by first entering the Baltic markets (seealso table 22), thus increasing rivalry in the domestic market. Entry was further facilitated by the fact that the products were partly already known in the Baltics, particularly in Estonia, were Finnish

advertising programmes on television could be seen even during the centrally planned system. One of the foodstuff firms had operated in the Baltics already before World War II. Hence proximity and historical factors played a major role, in addition to the domestic (leading position in the home market), firm specific (size) and competitive (foreign threat) factors.

Home country trade arrangement also had an impact on FDIs made to the Visegrád countries, as some of the former CMEA trade arrangement were exceptionally in force still after the collapse of the CMEA. This supported to some degree production operations, as re-exports and some of the intermediate products flowing between the parent company and the subsidiary were treated according to preferential arrangements. However, this advantage ceased to exist in 1992.

5.4 Discussion on Findings: Transition Specific Determinants

The previous chapters have indicated in many ways that the determinants of the choice of a hierarchy rather than an external market leading to FDI are closely associated with the extent and duration of liberalisation and economic developments in transition economies. The manufacturing FDIs made by the firms covered in this study are particularly affected by initial conditions in the Visegrád, Baltic and Russian markets. This helps to account for the relatively high level of investment by the reviewed firms in 1990-1995 within the Visegrád region, particularly in Poland and Hungary, and in the small market of Estonia. It also explains the differences between determinants in the Visegrád, Baltic and Russian markets. We will first discuss the findings concerning firm-specific and FDI project-specific determinants, and then present an analysis of country-specific determinants. A model is then proposed to explain transition specific determinants in a regional context (i.e. Baltics vs. Visegrád vs. Russia).

5.4.1 Firm Specific Perceptions and Reaction to Region-Specific Differences

5.4.1.1 Determinants of FDI Entry

The operations of the MNCs reviewed show that in terms of the initial motives behind FDIs, those made in Eastern Europe do not different from their other FDIs. The conscious motivation behind their entry into the Baltic, the Visegrád and Russian markets was the prospect of establishing a presence in a new expanding market. Expectations were, however, not high in the short term as most of the investors - regardless of the target transition market and regardless of the industry - knew the operations would be profitable only after a few years after establishment.

Looking at the initial motives at a more in-depth glance, we find that FDIs in Eastern Europe do differ from FDIs made elsewhere by these same firms. The overall pattern of entry shows a high degree of prudence, which was reflected in the entry strategies. This shows that these investors were also very passive, especially those that first entered the more advanced transition countries (i.e. the Visegrád countries). In fact, the interviews and the questionnaire results indicate that strategic motives were associated with the

above-mentioned initial motive. As the analysis on the FDI operation-specific determinants (chapter 5.2) indicated, investments were more of a reactive nature, i.e. FDI motives were related to the need to follow the leader (either from the same home market or a foreign competitor) or to gain first mover advantage. In a few industries, such as the foodstuff and construction industries, we could further identify the need to buy out potential competitors pointing to an 'exchange of threats' situation. Hence, the need to maintain and increase market power led to FDIs in Eastern Europe. The choice of FDI as an entry, i.e. a penetration mode then, was more or less dictated by the perceived market imperfections (see the following chapter for region-specific imperfections) and the asset specificity and information content of FDI.

The home country factors played a secondary role affecting the decision to undertake FDI operations. As all of the reviewed firms were large MNCs, the smallness and the openness of the home market cannot be seen as a major factor. This factor had initially affected the internationalisation of the reviewed firms already earlier. In contrast, past trade linkages and certain specific trade arrangements between Finland and the former CMEA countries provided a partly still beneficial basis for FDI in the Visegrád markets. In addition, while a major part of the former networks created by these firms and the FSU collapsed and disappeared, many of the former networks in the Visegrád countries were left. Within the FSU, Estonia was a clear exception in many terms. As a result of tight former commercial, cultural and other historical relations, the country became the number one target for Finnish manufacturing FDI within the FSU region. Thus, former trade links and networks enhanced the ability to make manufacturing FDIs in these markets.

In almost every aspect of the foreign direct investment components (ownership, form and type of investment as well as to some extent the distribution of value-added activities in the subsidiaries), experience and knowledge brought by previous operations played a key role in determining the location and the breath of FDI operations in the Baltic, Visegrád and Russian markets. Uncertainty brought by the lack of experience and knowledge was unrelated to the level of internationalisation of the reviewed firms, as they all were already large multinationals.

Uncertainty was related to a lack of experience in and knowledge of these markets. At the firm level, rigidity towards potentially high risks in the region led in the majority of the MNCs to an entry pattern reflecting unusually high risk avoidance. Firstly, the market entry pattern of the reviewed firms can be seen as unusually rigid, due to the fact that a large number of Finnish SMEs with considerably less significant resources than the reviewed MNCs entered riskier transition markets more rapidly and at an earlier phase than the reviewed MNCs. Similarly, foreign competitor MNCs have entered the markets more rapidly and with more significant resources in relative terms. Secondly, previous operations did determine FDIs, but only in a region-wise (as defined in this study) pattern; i.e. typically, a manufacturing FDI would be preceded by exports or/and another FDI operation *within the same* transition block (Baltic, Visegrád or Russia) and rarely *across* different blocks. A few exceptions occurred. For instance, several investors that were already operating in the Baltic region considered their Baltic subsidiaries as bridgeheads to the Russian market. However, only a few FDI projects in Russia were preceded by operations in the Baltics. Moreover, the Russian market was perceived as too risky to penetrate, although Russian FDI projects were planned to follow these Baltic operations.

As a result of this FDI operation pattern, most of the reviewed FDIs were initially made into the Visegrád markets (Poland and Hungary specifically) with the exception of Estonia within the FSU. In addition, the timing of the reviewed FDIs points to more active investment during or after 1992 in the region as a whole. This pattern indicates that uncertainty and risk avoidance overcrowded even geographical distance, which explains the initial absence in Latvia, Lithuania and Russia. In the second half of the period, this situation changed along with advancements in transition in these countries. Hence, the country-specific factors and particularly those related to economic policies and liberalisation significantly determined the entry pattern, which is discussed in chapter 5.4.2.

5.4.1.2 Firm-specific Determinants of Internalisation

The interviews and questionnaire results would point to several considerations behind the need to internalise production operations rather than operating at arm's length. These can

be identified as market imperfections, firstly characterised by the lack of a relevant market as proposed by the internalisation theory, and secondly characterised by high transaction costs (caused by opportunity and moral hazard costs) as proposed by the transaction cost theory (see page 33) and more specifically the Williamsonian framework. Due to the characteristics of transition, all of the firms seem to have been forced to adjust themselves to the business environment by creating or replacing the market through FDI, i.e. through internalising these activities, which brings them under the direct ownership and control of the firm. The preference for greenfield operations in the second phase of the covered period alone reflects the difficulties encountered in these markets, recalling that the reviewed MNCs have preferred FDIs through acquisitions in non-transition markets. In addition, the reviewed JV forms of FDIs also reflect the need to control operations, as majority ownership was generally preferred and both the equal and minority JV arrangements in fact led to a dominant role of the foreign owner. Hence, these JV operations fulfilled the characteristics of actual internalisation.

Intra-firm integration through FDI turned out to be evident for these companies to avoid problems related to risk sharing and transaction costs. In addition, the conditions in which they had to operate in each transition country fostered this choice. In all of the manufacturing subsidiary operations, a considerable amount of diverse information flows made it impossible to construct contracts which make interaction at arm's length identical to interaction internalised within a firm. Thus, the need to control these mostly intangible flows seems to have been a key factor leading to FDI operations. These factors further strongly affected the choice of the form of investment (i.e. between the greenfield and acquisition form). The reviewed data shows that FDI brought a harmonisation of interests, but only in the case of greenfield operations. While previous studies on FDIs in other than transition markets and antecedent theories suggest that through acquisitions investors can utilise synergetic effects with the special assets of an already established local firm, the reviewed MNCs considered the transition markets as exceptional in this respect. The need to restructure heavily the local firm, the difficult task of adjusting a firm previously operating within a centrally planned scheme to the activities and needs of the foreign firm and the fact that the negotiating party was a government, rendered the acquisition alternative unattractive. Hence, the preference for greenfield investments was

dictated by transition-specific supply and demand factors and firm-specific uncertainty caused by this. As a result, the reviewed firms preferred to exploit their specific endowments via greenfield operations.

In a region-specific perspective, market imperfections perceived by the investor companies reviewed vary across markets. Different ownership conditions have led to different internalisation strategies. Factors such as the degree of economic liberalisation, political risk and overall achievements in transition have played a central role in ownership strategies, which can be seen as a higher propensity to engage in wholly owned subsidiaries in the more advanced transition economies of the Visegrád region in the reviewed period and as a larger amount of joint ventures in Russia, the other extreme. In addition, the sales orientation of the Baltic and Russian subsidiaries - which are mostly locally oriented with Baltic subsidiaries serving surrounding transition markets as well - has encouraged the joint venture mode of operation, due to the need to secure a 'local image'.

Internalisation is markedly determined by gradual advancements in reforms. Recall that the majority of WOSs are very recent (established during the latter half of the period reviewed) and most of the JVs have been established soon after the re-opening up of the transition markets, when JVs received preferential treatment in many respects and when the establishment of WOSs was still partly restricted. In addition, all of these JV entries have been made into fast growing industries, mainly into resource- and labour-intensive industries, and are either motivated by the need to secure home markets (especially in the Baltic markets) or to participate in growing markets (the whole reviewed area). In either case, the role of complementary assets brought by JV acquisitions is crucial. Thus, the more recent the establishment of the subsidiary in a transition market, the likelier it is for it to be a wholly owned subsidiary.

Hence, economic liberalisation seems to be a primary determinant in ownership strategies in the transition markets of the Visegrád and the Baltic regions, while corporate motives and the need for complementary assets are secondary determinants. Clearly, in the case of the reviewed FDIs, particularly legislative changes have initially triggered FDIs.

Internalisation in Russia is additionally determined by political risk and higher economic risk than in any other of the reviewed markets. These factors considerably affected the ownership strategies of the reviewed investors.

In general, the type of investment choices seem to be characterised by uncertainty and risk avoidance throughout the market area; i.e. most of the investments were related, horizontal investments. Problems rooted in the former system or transition-specific peculiarities in forward or backward activities and the overall disappearance of former linkages within these activities led to indirect vertical involvement, but not to actual vertical investments. In addition, the internalised activities were those where intangible knowledge (such as R&D, marketing, quality control) plays a core role. Though centralisation of such activities is usual in FDI operations in other markets as well, our results show that this pattern was more common in the transition markets. However, MNCs operating in the more advanced transition economies also planned to expand such operations also into the given markets. Hence, a gradual change would take place along with longer presence in the market, i.e. increased experience and local knowledge. A key factor supporting such a development was the availability of a highly educated labour force.

The above discussion shows that internalisation seems to be highly sensitive to two elements: Firstly, to the degree of advancement in transition and secondly to the degree of firm-specific experience in the market. Furthermore, be it a technology intensive firm or not, the information content is considered as so valuable in each investor MNC that internalisation, i.e. FDI emerged as the solution to this sensitivity. This sensitivity may also have a deterring effect on potential investments, thus explaining the lower attractiveness of more turbulent[1] markets as perceived by the reviewed investors in Russia. Internalising the operation brings efficiency through economies of transaction, due to the existence of these transition-specific market failures.

To sum up, regardless of the target market reviewed in this study, firms have considered the establishment of their manufacturing subsidiaries (i.e. the internalisation of

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[1]A concept used by Hirvensalo 1996.

production and certain transactions) in transition economies as a less costly alternative than relying on an external market due to the existence of market imperfections. Such market imperfections leading to internalisation are related to costs or benefits associated with uncertainties in external market transactions and costs, the complete lack of the relevant market, imperfections in markets for knowledge (e.g. bargaining power, supply services, uncertainty over price developments, product quality, etc.), and government policies. Moreover, the key factor determining firm-specific internalisation decisions is control throughout the markets covered.

5.4.2 Market, Institutional and Production factors Determining FDI Operations

Likewise firm-specific determinants, the determining impact of the market, institutional and production factors changed over time and with achievements in transition. This pattern divides the reviewed countries into three identifiable country groups, here defined as regions or 'blocs', in a distinct order (see chapter 5.3): 1) the Visegrád, 2) the Baltic and 3) the Russian markets.

The results of this study would indicate that potential market growth and size have had a decisive role in determining the FDIs reviewed, depending nevertheless primarily on the development of transitional stabilisation programmes. Even in the case of the small Baltic markets, growth has been a key determinant, while size has to be implicitly understood as the size of the host market together with the surrounding transition markets (other Baltics and / or Russia). The attractiveness of the Baltic markets, particularly that of Estonia, has further been fostered by their proximity. This pattern is valid for both locally oriented subsidiaries and export-oriented subsidiaries, as the latter ones eventually covered other neighbouring transition markets as well.

Moreover, market factors rank first together with institutional factors so significantly in the whole reviewed transition region that these overcrowd production factor benefits, with the very few exceptions in certain industries (foodstuff and building materials) having production subsidiaries located in the Baltic and Russian market area. Production factors seem to have the least determining impact on FDI, whatever the location of the

production subsidiary. This holds over time, regardless of achievements in transition. In particular, the benefits brought by low wages seemed to be seriously eroded by low productivity and political instability. The latter two elements also overshadowed the fact that the agglomeration of human and technological endowments in the whole covered area was considered as significant. This was particularly the case with the Russian market.

Table 26 **Factors viewed as most FDI determining by the reviewed firms; ranked by respondents from 1 to 4 (1=most important),**
average grades counted from separate country ratings by respondents

	Baltics	Visegrád	Russia
Market factors	1,2	1,1	1,4
Production factors	3,7	4,0	2,6
Istitutional factors	1,8	2,0	1,6
Other factors	3,1	3,4	3,9

The amount of existing or the 'clusterisation' of FDI seems to have a marked impact in determining the location of the reviewed production subsidiaries in transition economies. The overall amount of existing FDIs in the host market and the presence of major competitors had a triggering effect, and may together with advancement in reforms explain the preference for the Visegrád market bloc. This was particularly seen in the entry order of the reviewed firms, especially in Poland, Hungary and in the second half of the reviewed period in Estonia. The longer term plans of investors further point to an increasing role of the agglomeration of certain activities within the covered area.

The regulatory environment, particularly that related to FDI legislation and ownership, as well as political stability are the two dominating institutional factors that have determined the reviewed FDIs. In the Russian market, the interviews indicated that institutional determinants of FDI played a more important role than market factors in the reviewed firms, though the former table based on the questionnaire would show a slightly more important role for the market factors. Political instability, in turn, clearly deterred potential FDIs, as shown by the 'wait and see' strategy of investors already present in the Baltics and watching the Russian market therefrom during the reviewed period. In

addition, the regulatory framework and criminality were clearly more FDI deterring than in any other markets reviewed.

In contrast, a historical background of an existing European legal tradition worked in favour of the attractiveness of the Visegrád and Baltic markets. The difference between the latter two blocs lies in the more advanced and more rapid legislative and ownership changes in the Visegrád block, which have been more difficult to achieve in the Baltics. The task of converting the whole socio-economic system towards a market-oriented one has been more difficult than in the Visegrád bloc, due to the different sovereign basis, i.e. the Baltics were *de facto* part of the former Soviet Union. Furthermore, the observed FDI behaviour would show a reaction to the *timing* of privatisation programmes, not the form of privatisation, regardless of the market. Privatisation proceedings, in turn, were likewise heavily dependent on the initial conditions, thus reflecting a similar bloc-wise pattern. Privatisation as such, however, did not attract the reviewed investors in any of the blocs due to common problems emerging from systemic weaknesses in the formerly state-owned firms in these markets.

A third important institutional factor determining the FDIs reviewed, is the existence of historically strong trade linkages and the developing trade arrangements particularly between the EU and the reviewed markets. The former trade linkages between Finland and the CMEA countries and later bilateral and also Europe agreements have encouraged the establishment of production subsidiaries throughout the reviewed region. The sales orientation of the subsidiaries towards EU markets reflects the importance of the existence of the Europe Agreements, which also include guarantees of investment protection and openness to FDI. Moreover, the prospect of accession to the EU has had a strong effect in the Visegrád markets. Hence, while traditional trade theorists emphasise the role of trade barriers as FDI determinants, these results do not support such assumptions. The overall transition market factors have offset such an impact. FDI incentives are another factor which has proved insignificant in the European transition economies.

5.4.3 Transition-Specific Determinants of FDI Operations in an Explanatory Model

The preceding discussion shows that manufacturing FDI determinants differ to some degree within the European transition region, particularly due to a varying pace of advancement in reforms. In addition, there are several common determinants, regardless of the block within the covered region, i.e. the Visegrád, Baltic and Russian markets. The findings also show that explanations are multifaceted, and that a set of various existing concepts help understanding the reviewed FDI operations. While it is clear that the findings are limited to certain types of firms (i.e. large Finnish MNCs) and to certain types of FDIs (manufacturing), they provide a basis of understanding the nature of transition and its impact on FDI operations. The findings also show that such operations in transition economies are characterised by different determinants as compared to FDIs made in developed or developing countries.

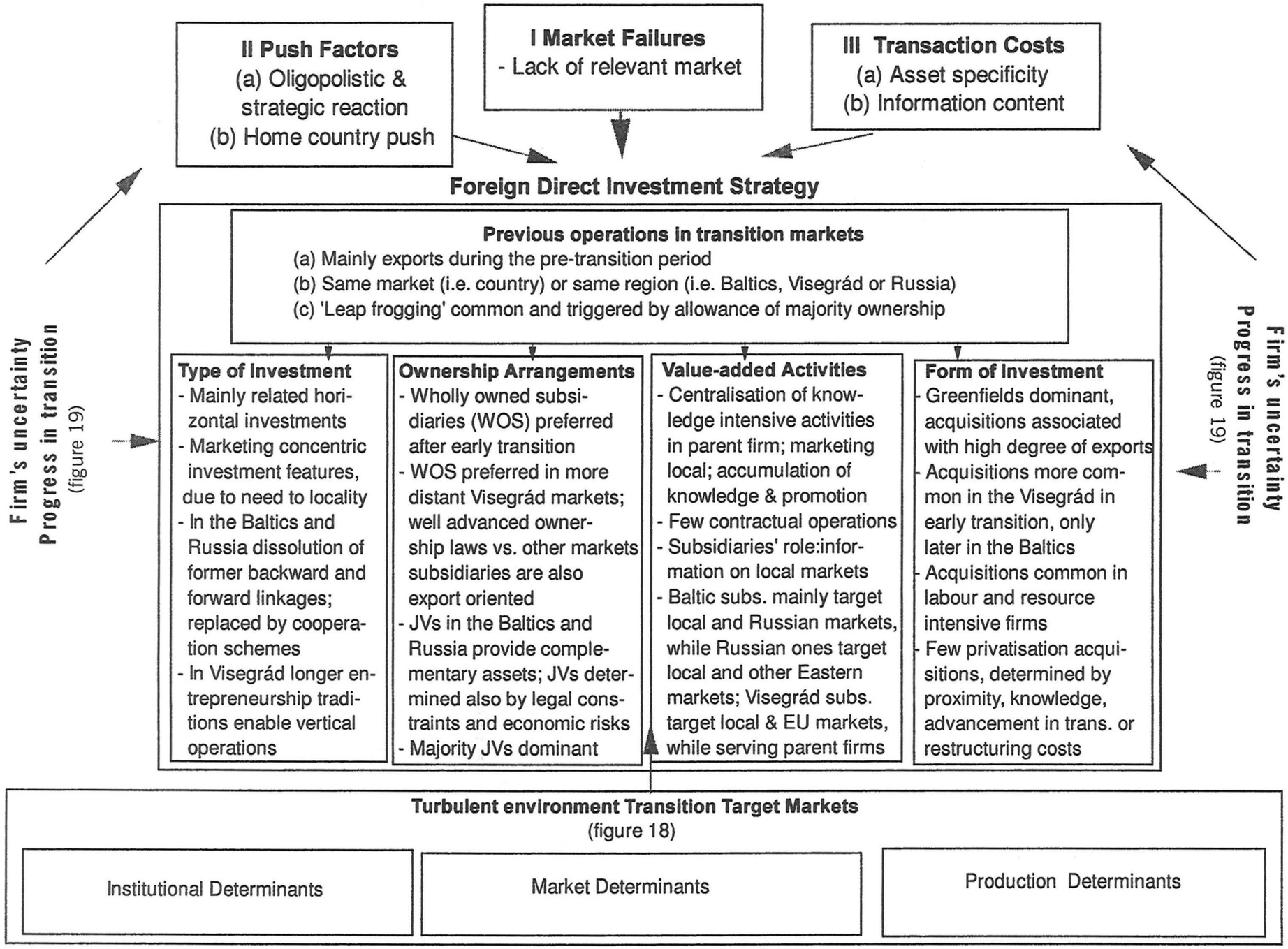
While opportunity-oriented market factors (the need to be present in growing markets) affect the initial entry decision to the transition markets, internalisation leading to FDI can be explained by three factors. These apply to each block, i.e. the Visegrád, Baltic and Russian market. According to the findings, market failures in the form of a lack of a relevant market primarily cause the need to internalise production activities rather than using arm's length operations. The existence of transaction costs support this behaviour, due to uncertainty and the need for efficiency. This uncertainty is of two types. First, uncertainty is caused by the lack of experience in the market and the lack of knowledge on the market. Second, uncertainty in a transaction cost context occurs in the form of opportunity and moral hazard costs in a turbulent transition environment. The two types of uncertainty arise from the asset specificity and the information content. In a turbulent environment investors consider control over their own production as a primary objective. This is fortified by the fact that many of the investor firms can be considered relatively R&D intensive (see Ali-Yrkkö and Ylä-Anttila on R&D intensity of large Finnish firms, 1996) by international standards, and their competitiveness is dependent on intangible knowledge. In addition, considering the target market, the investor firms were in a unique position where product superiority was automatic by nature. I.e. local competition was initially non-existent and was only emerging from foreign competitors present in the

same market. However, market imperfections and the need to secure control over intangible assets forced to rely on FDI, in order not to create a potential local competitor and to avoid transaction costs.

In addition to market imperfections, push factors affect the FDI decision. This particularly refers to investor firms' strategic need to increase and/or defend their market power. Moreover, the findings show that push factors alone do not lead to FDI. They are connected to the existence of market failures and transaction costs, which together lead to FDI in transition economies. The strategic need to follow the leading investor firms or to gain first mover advantage has a triggering effect on the final decision to internalise manufacturing operations. Differences within the reviewed transition markets arise when analysing the country specific determinants as perceived by the reviewed firms. All of these determinants are markedly influenced by the overall advancement in the transition process, which causes the division between certain groups of countries. These can be identified as the Visegrád market, the Baltic market and the Russian market. The determinants of FDI operations are in the first place distinctively determined by previous operations either in the same country or the same block, reflecting also the importance of uncertainty in terms of the degree of experience and knowledge. The key decisions related to the elements of FDI operations, i.e. type of investment, ownership arrangements, form of investment and value-added activities, are in turn determined by both firm specific internalisation factors and region(/bloc-)-specific factors. The latter are commonly characterised by the dominant role of market and institutional factors, while production factors play a minor role. More specifically, factors such as market size and growth, the degree of liberalisation and the agglomeration of certain activities, determine the location of FDI, given the level of advancement of transition.

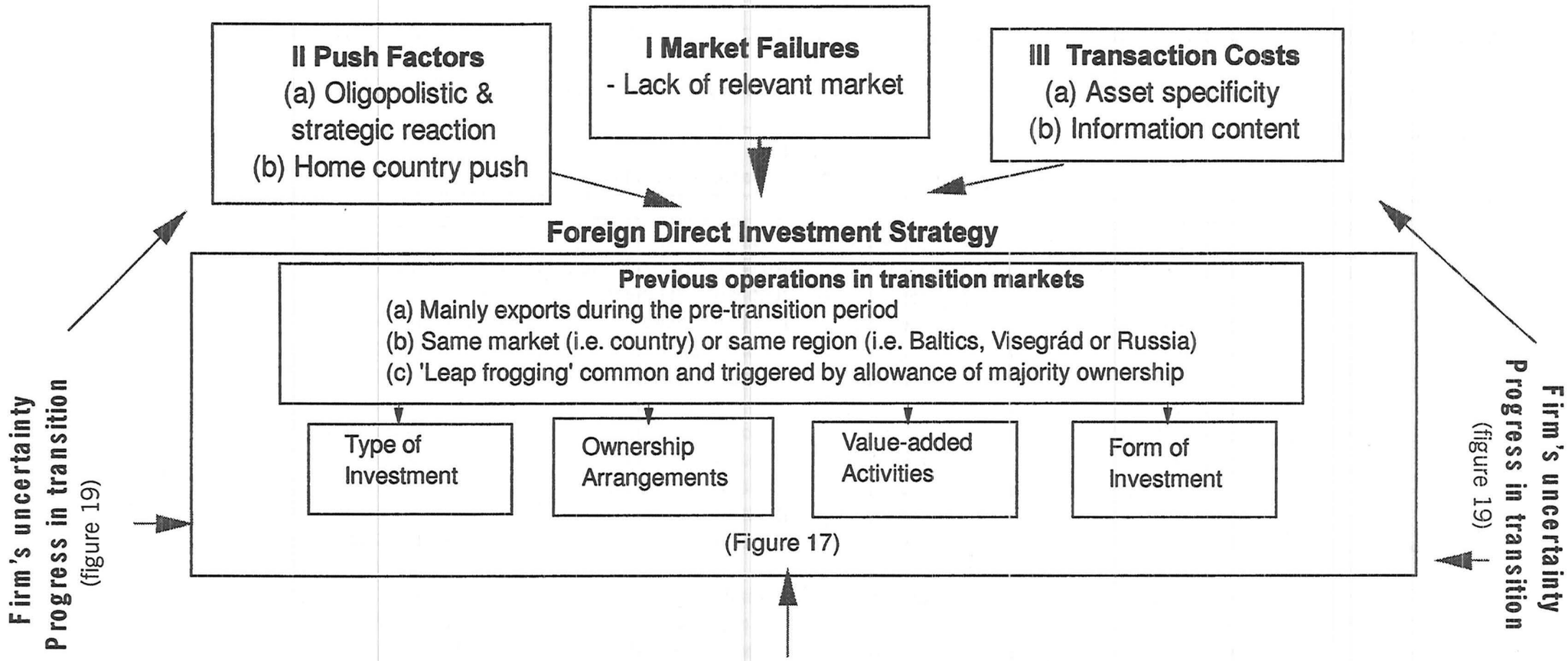
The following figures present the findings of this study on the determinants of manufacturing FDIs. These figures reflect the discussion set in the whole of chapter 5.4. An explanatory model is presented in chapter 6

Figure 15 Factors leading to and determining manufacturing FDI in transition markets



I, II and III show the order of importance (I = most important)

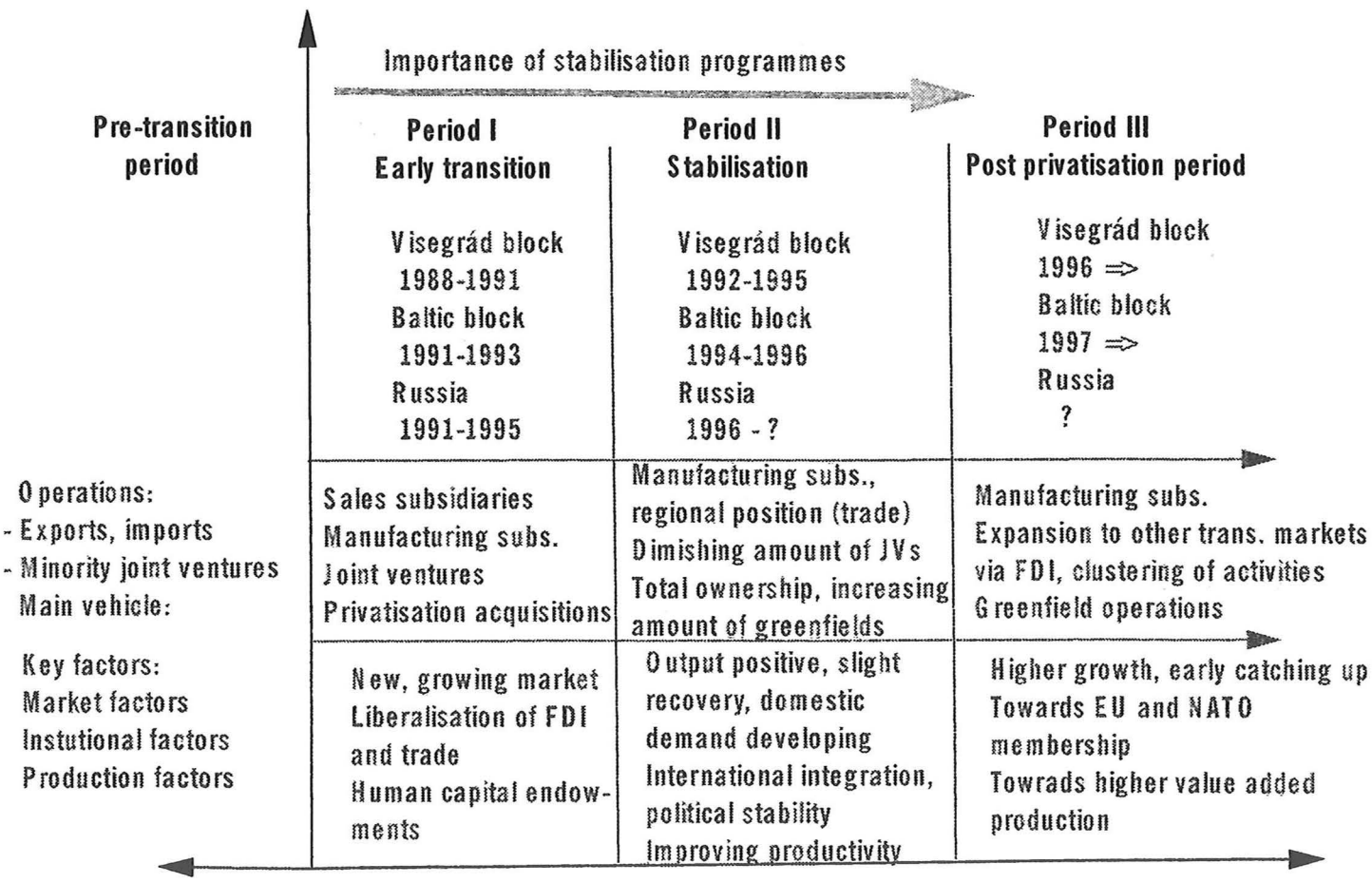
Figure 16 Factors leading to and determining manufacturing FDI in transition markets (continued)



I, II and III show the order of importance (I = most important)

As the findings indicated, the location of manufacturing subsidiaries within the reviewed market area is highly dependent on developments in the transition process. This translated into larger engagements at every level of the FDI operation along the degree of advancement in the target block markets. This would indicate the dynamic nature of both FDI and transition. Hence, while manufacturing FDI as such is the riskiest form of operation in a foreign market, the form of operation itself evolves in a sequential order from a less committed degree of operation to a more committed operation. This process, in turn, involves increasing investments along with transition progresses taking place in the target market. Thus, risks decrease due to the progress made in stabilisation programmes and declining turbulence of the business environment, which reduces uncertainty in terms of firm specific experience and knowledge. This is the dynamism involved in the previously exhibited figure and presented below.

Figure 17 Dynamic dimension of FDI operations in transition economies



The explanatory model presented in Chapter 6 and derived from this three-part presentation explaining the determinants of manufacturing FDIs made in transition economies by the firms reviewed in this study provides a flexible framework of analysis. It includes the key factors found to affect the operation strategy in the reviewed market area from the firms' viewpoint and in a region-wise perspective. It also includes a dynamic dimension, as this factor turned out to be central in the developments of the reviewed operations. The theoretical, managerial and policy implications of this study's results are discussed in the following chapter.

6 SUMMARY AND CONCLUSIONS

This final chapter first summarises the results of the present study in relation to the research problem and research objectives (section 6.1). Section 6.2 discusses the theoretical implications of the thesis, and it ends with a presentation of an explanatory model for FDI operations and their region-specific determinants in transition economies. Section 6.3 examines the managerial implications of the study, while section 6.4 aims at highlighting some policy implications. Sections 6.2, 6.3 and 6.4 also include proposals for further research

6.1 Summary of the Study

The research problem of the study was addressed as follows: What kind of foreign direct investment strategies have Finnish MNCs undertaken in Eastern Europe in the first five years of transition (1990-1995)? This research problem was followed by two specific sub-problems: What are the transition-specific FDI determinants of Finnish MNCs? Given these FDI operations, how do the region-specific / bloc-wise factors among transition countries affect these operations?

Answers were sought to these questions by analysing 1) the FDI operations and strategic choices related to the elements of FDI operation, i.e. ownership arrangements, the form and type of investment, and the value-added activities of Finnish MNCs, 2) the host market factors affecting these FDI operations by identifying transition specific determinants in a regional (comparative) perspective, and 3) the existing theories to determine their applicability for describing and explaining FDI strategies in transition economies. The latter is discussed in the following section, while the results related to 1) and 2) are discussed below.

The findings related to the first and second objectives (chapters 5.1 - 5.3) of the previous chapters have indicated in many ways that the factors leading to manufacturing FDI are closely associated with the extent and duration of liberalisation and economic developments in transition economies. These FDIs are particularly affected by initial conditions in the

Visegrád, Baltic and Russian markets. This helps to account for the relatively high level of investment by the reviewed firms in 1990-1995 within the Visegrád region, particularly in Poland and Hungary, and in the small market of Estonia. It also explains the differences between determinants in the Visegrád, Baltic and Russian markets. We can identify two levels at which FDI operations are affected: first the operational level, at which the investor companies are able to react to regional differences by adopting the strategies best suited to a given market, and second, the region-specific market, institutional and production level, which are given.

At the operational or firm-specific level, the empirical analysis showed that specific factors affecting FDI penetration behaviour and the consequent need to rely on FDI rather than arm's length operations were identified.

The FDI penetration or entry pattern shows a high degree of prudence, which was reflected in the entry strategies. Initial motives were strategic by nature. Investments were more of a reactive nature; FDI motives were related to the need to follow the leader or to gain first mover advantage. In a few industries, the need to buy out potential competitors pointing to an 'exchange of threats' situation led to FDIs particularly in the Baltic markets. The need to maintain and increase market power was clearly a leading motive. The choice of FDI as a penetration mode was more or less dictated by the perceived market imperfections and the asset specificity and information content of FDI.

The home-country factors played a secondary role affecting the decision to undertake FDI operations. However, past trade linkages and certain specific trade arrangements between Finland and the former CMEA countries still provided a partly beneficial basis for FDI in the Visegrád markets and in Estonia which was part of the FSU.

In almost every aspect of the foreign direct investment strategy components (ownership, form and type of investment and to some extent the distribution of value-added activities in the subsidiaries), experience and knowledge brought by previous operations played a key

role in determining the location and the breath of FDI operations in the Baltic, Visegrád and Russian markets. At the firm level, rigidity towards potentially high risks in the region led in most of the MNCs to an entry pattern reflecting unusually high risk avoidance. Previous operations determined FDIs in a region-wise pattern; i.e. typically, a manufacturing FDI would be preceded by exports or/and another FDI operation *within the same* transition region or block (Baltic, Visegrád or Russia) and rarely *across* different blocks. A few exceptions occurred.

As a result of this FDI operation pattern, most of the FDIs reviewed were initially made into the Visegrád markets (Poland and Hungary specifically) with the exception of Estonia in the FSU. In addition, the timing of the FDIs reviewed points to more active investment actions during or after 1992 in the region as a whole. This pattern indicates that uncertainty and risk avoidance offset even geographical distance, which explains the initial absence in Latvia, Lithuania and Russia. In the second half of the period reviewed, this situation changed along with progress in transition in these countries.

The study identifies the need to internalise production operations via FDI as being related to market imperfections. These are firstly characterised by the lack of a relevant market and secondly by high transaction costs (caused by opportunity and moral hazard costs). Due to the characteristics of transition, all of the firms seem to have been forced to adjust themselves to the transitional business environment by creating or replacing the market through FDI, that is by internalising these activities, to bring them under the control of the firm and to avoid problems related to risk sharing and transaction costs. The preference for greenfield operations in the second half of the period reflects the difficulties encountered in these markets. Moreover, the need to control intangible flows seems to have been a key factor leading to FDI operations.

These factors further strongly affected the choice of the form of investment (between the greenfield and acquisition form) in all of the markets reviewed. The need to restructure heavily the local firm, the difficult task of adjusting a firm previously operating within a

centrally planned scheme to the activities and needs of the foreign firm and the fact that the negotiating party was a government, rendered the acquisition alternative unattractive. Hence, the preference for greenfield investments was dictated by transition-specific supply and demand factors and firm-specific uncertainty caused by it. As a result, the firms reviewed preferred to exploit their specific endowments via greenfield operations.

Market imperfections vary across markets. Different ownership conditions have led to different FDI strategies. Factors such as the degree of economic liberalisation, political risk and overall achievements in transition have played a central role in ownership strategies, which can be seen as a higher propensity to engage in wholly owned subsidiaries in the more advanced transition economies of the Visegrád region and as a larger number of joint ventures in Russia, the other extreme. FDI is markedly determined by gradual advancements in reforms. For instance, economic liberalisation seems to be a primary determinant in ownership strategies in the transition markets of the Visegrád and the Baltic regions, while corporate motives and the need for complementary assets are secondary determinants. Clearly, in the case of the reviewed FDIs, legislative changes in particular have initially triggered FDIs. Internalisation in Russia is also determined by a political risk and a higher economic risk than in any other of the markets reviewed. These factors considerably affected the ownership strategies of the investors.

In general, the type of investment choices seem to be characterised by uncertainty and risk avoidance throughout the market area; i.e. the majority of the investments were related, horizontal investments. In addition, the internalised activities were those where intangible knowledge plays a core role. Though centralisation of such activities is usual in FDI operations in other markets as well, the study shows that this pattern was more common in the transition markets.

Hence it seems that FDI operations are highly sensitive to two elements: firstly, to the degree of advancement in transition and secondly to the degree of firm-specific experience in the market. Furthermore, be it a technology intensive firm or not, the information content

is considered as so valuable in each investor MNC that internalisation, i.e. FDI, emerged as the solution to this sensitivity. This sensitivity may also have a deterring effect on potential investments, thus explaining the lower attractiveness of more turbulent markets as perceived by the reviewed investors in Russia. Internalising the operation brings efficiency through economies of transaction, due to the existence of these transition-specific market failures.

The impact of the market, institutional and production factors changed over time and with achievements in transition, as did the factors affecting operational FDI choices. Potential market growth and size seem to have had a decisive role in determining the reviewed FDIs, depending nevertheless primarily on the development of transitional stabilisation programmes. Even in the case of the small Baltic markets, growth has been a key determinant, while size has to be implicitly understood as the size of the host market together with the surrounding transition markets (other Baltics and / or Russia). The attractiveness of the Baltic markets, particularly that of Estonia, has further been fostered by their proximity.

Together with institutional factors, market factors rank first so significantly throughout the reviewed transition region that these offset production factor benefits, with the very few exceptions in certain industries. Production factors seem to have the least determining impact on FDI, whatever the location of the production subsidiary, due to low productivity and political instability. The latter two elements also overshadowed the fact that the agglomeration of human and technological endowments in the market area covered was considered significant. This was particularly the case with the Russian market.

The total number of existing FDIs in the host market and the presence of major competitors had a triggering effect and may together with advancement in reforms explain the initial preference for the Visegrád market block. This was particularly seen in the entry order of the reviewed firms. Both the regulatory environment and political stability are the two dominating institutional factors that have determined the FDIs reviewed. In the Russian

market, institutional determinants of FDI played a more important role than market factors in the firms reviewed. Political instability clearly deterred potential FDIs. In contrast, the historical background of an existing European legal tradition increased the attractiveness of the Visegrád and Baltic markets.

Furthermore, the observed FDI behaviour would show a reaction to the *timing* of privatisation programmes, not the form of privatisation, regardless of the market. Privatisation proceedings, in turn, were likewise heavily dependent on the initial conditions, thus reflecting a similar blockwise pattern. Privatisation as such, however, did not attract the reviewed investors in any of the blocs/regions, due to common problems emerging from systemic weaknesses in the formerly state-owned firms in these markets. A third important institutional factor determining the FDIs reviewed, is the existence of historically strong trade linkages and the developing trade arrangements particularly between the EU and the reviewed markets. The sales orientation of the subsidiaries towards EU markets reflects the importance of the existence of the Europe Agreements, which also include guarantees of investment protection and openness to FDI. Moreover, the prospect of accession to the EU has had a strong effect in the Visegrád markets. Hence, while traditional trade theorists emphasize the role of trade barriers as FDI determinants, these results do not support such assumptions. The overall transition market factors have offset such an impact. FDI incentives are another factor, that turned out to be insignificant in the European transition economies.

6.2 Theoretical implications

This study was a first attempt to analyse factors affecting the location of manufacturing subsidiaries or manufacturing FDIs with empiria being neither very large (i.e. more than 100 investor firms) nor very narrow-scoped (i.e. one or a few cases). Though this was caused by the fact that surprisingly few Finnish MNCs had made manufacturing FDIs in transition economies in the period 1990-1995, it turned out to be an interesting starting point in terms of research methods. As the methodological chapter clarifies, most of the studies have been conducted empirically either by means of econometric models with the

empiria covering a large number of firms or amount of investment data, or with case research methods covering one or a few firms.

This study has offered a possibility to provide a still different theoretical outcome by relying on comparative and qualitative methods enabling analysis of a 'medium-sized' group of firms (16) and number of subsidiaries (42) and assessing information received by actual agents, i.e. managers.

Thus the study adds to the knowledge of foreign direct investment operations in a comparative context. The latter is noteworthy in the sense that comparative studies covering such operations and the transition markets are few in numbers. In addition, FDI operations as a research topic are important due to the fact that Finnish MNCs (see introduction) were when this study began and still are major outward investors. During the covered period 1990-1995, the 30 largest Finnish MNCs alone were behind a majority of outward FDIs, peaking at around 80% in 1995. When considering specifically manufacturing FDIs, these firms are even more significant investors. Yet, little was known about similar operations in transition economies. One of the first results that emerged after the collection of empirical data in fact showed that the subject was worth studying, as the number of manufacturing FDIs turned out to be modest during that period. In addition, preliminary testing interviews indicated a different pattern of FDI behaviour. Hence the study posed both methodological and empirical challenges. Finally, as most of the existing theories are based on studies concerning manufacturing FDIs (see literature overview), the empiria of the current study could be used by taking advantage of existing models and theories and enabled identifying transition-specific features in manufacturing FDI determinants.

The findings indicate that concepts developed in market economies are useful in analysing FDI operations in formerly planned economies. Though the existing models and theories have been based on FDIs made either in developed or developing countries, not in transition economies, they do provide building blocks for analysing FDI operations in transition markets. These countries have undertaken the task of converting their former economic

systems into a market-oriented one, a conversion that is unknown in history. Therefore, the business environment is unique, and as the results show, many of the solutions related to manufacturing FDI in the reviewed firms have been tied to the specific nature of that transitionary environment.

The theoretical overview turned out to be useful for identifying the characteristics of the operations reviewed. The model developed on the basis of the empirical results in chapter 5.4 and in section 6.2. provides an insight into understanding FDI operations in a transitionary environment by looking first at the operational level of the investor firm (ownership arrangements, form of investment, type of investment and value-added activities), then at the regional level (market factors, institutional factors and production factors). The model allows examination of factors which are under the control of the firm at the operational level and regional factors affecting these operational choices. The regional level in the model allows examination of the factors which are given to the investor firm and which affect their FDI operations.

Sections 5.4.1 - 5.4.2 discuss from a theoretical/conceptual perspective the study's firm specific regional FDI choices and factors affecting these choices and the given regional factors affecting FDI operations at the market, institutional and production levels. This discussion and the preceding empirical analysis throughout chapter 5 show that factors affecting / determining manufacturing FDIs differ to some degree within the European transition region, particularly due to a varying pace in reform. In addition, there are several common factors affecting these operations, regardless of the region, i.e. the Visegrád, Baltic and Russian markets. The findings also show that explanations are multifaceted, and none of the existing theoretical frameworks *alone* can explain the results of this study. While it is clear that the findings are limited to certain types of firms (i.e. large Finnish MNCs) and to certain types of FDIs (manufacturing), they provide a basis for understanding the nature of transition and its impact on FDI operations.

While opportunity-oriented market factors (the need to be present in growing markets) affect the initial entry decision to the transition markets, three factors explain the need to rely on internalisation leading to FDI. These apply to each region, i.e. the Visegrád, Baltic and Russian market. According to the findings, market failures in the form of a lack of a relevant market primarily cause the need to internalise production activities rather than using arm's length operations. The existence of transaction costs support this behaviour, due to uncertainty and the need for efficiency. Uncertainty is of two types: firstly, uncertainty is caused by the lack of experience in the market and the lack of knowledge on the market. Secondly, uncertainty in a transaction cost context occurs in the form of opportunity and moral hazard costs in a turbulent transition environment. The two types of uncertainty arise from the asset specificity and the information content of the products of these companies. Therefore, in a turbulent environment investors consider control over their own production as a primary objective. This is fortified by the fact that many of the investor firms can be considered relatively R&D-intensive by international standards and their competitiveness is dependent on intangible knowledge. In addition, considering the target market, the investor firms were in a unique position where product superiority was automatic by nature. Local competition was initially non-existent and emerged only from foreign competitors present in the same market. However, market imperfections and the need to secure control over intangible assets forced reliance on FDI, so as not to create a potential local competitor and to avoid transaction costs.

In addition to market imperfections, push factors affect the FDI decision. This particularly refers to the strategic need of investor firms to increase and/or defend their market power. In the case of the firms reviewed, push factors alone do not lead to FDI. They are connected to the existence of market failures and transaction costs, which together lead to FDI in transition economies. The strategic need to follow the leading investor firms or to gain first mover advantage has a triggering effect on the final decision to internalise manufacturing operations.

Differences within the reviewed transition markets arise when analysing the region specific factors affecting the reviewed FDI operations. The role of these factors is markedly influenced by the overall advancement in the transition process, which causes the division between the Visegrád market, the Baltic market and the Russian market. The FDI operations are initially distinctively determined by previous operations either in the same country or the same region, reflecting also the importance of uncertainty. The key decisions related to the elements of FDI operations are in turn determined by both firm specific internalisation factors and region or block-specific factors. The latter are commonly characterised by the dominant role of market and institutional factors, while production factors play a minor role. More specifically, factors such as market size and growth, the degree of liberalisation and the agglomeration of certain activities, determine the location of FDI, given the level of advancement of transition.

Hence the internalisation and transaction cost models provided useful partial explanations for this study. Their explanatory power in this study arose from the assumption that market imperfections initially guide FDI operations, which in this study was reflected in their existence in transition economies. These then led to the choice of FDI rather than operating at arm's length. The results would also point to the lack of explanatory power in the case of the older traditions of theory schools, such as those based on comparative advantages and traditional trade theory. As world trade and FDI have become extremely liberalised, so is the case with FDI policies in transition economies. In contrast, the newer theories emphasising the importance of strategic factors (need to follow competitors, need to secure presence and expand) and agglomeration factors (i.e. the number of existing FDIs in the target market or the potential future concentration of certain activities in a target market) in economics and partly rooted in economic geography and also the dynamic model of internationalisation rooted in international business provide a set of theoretical frameworks enabling understanding factors affecting the reviewed manufacturing FDIs.

Uncertainty as a concept emerged as an important factor affecting the FDIs reviewed in two senses: firstly, as uncertainty caused by the firm-specific lack of knowledge of the target

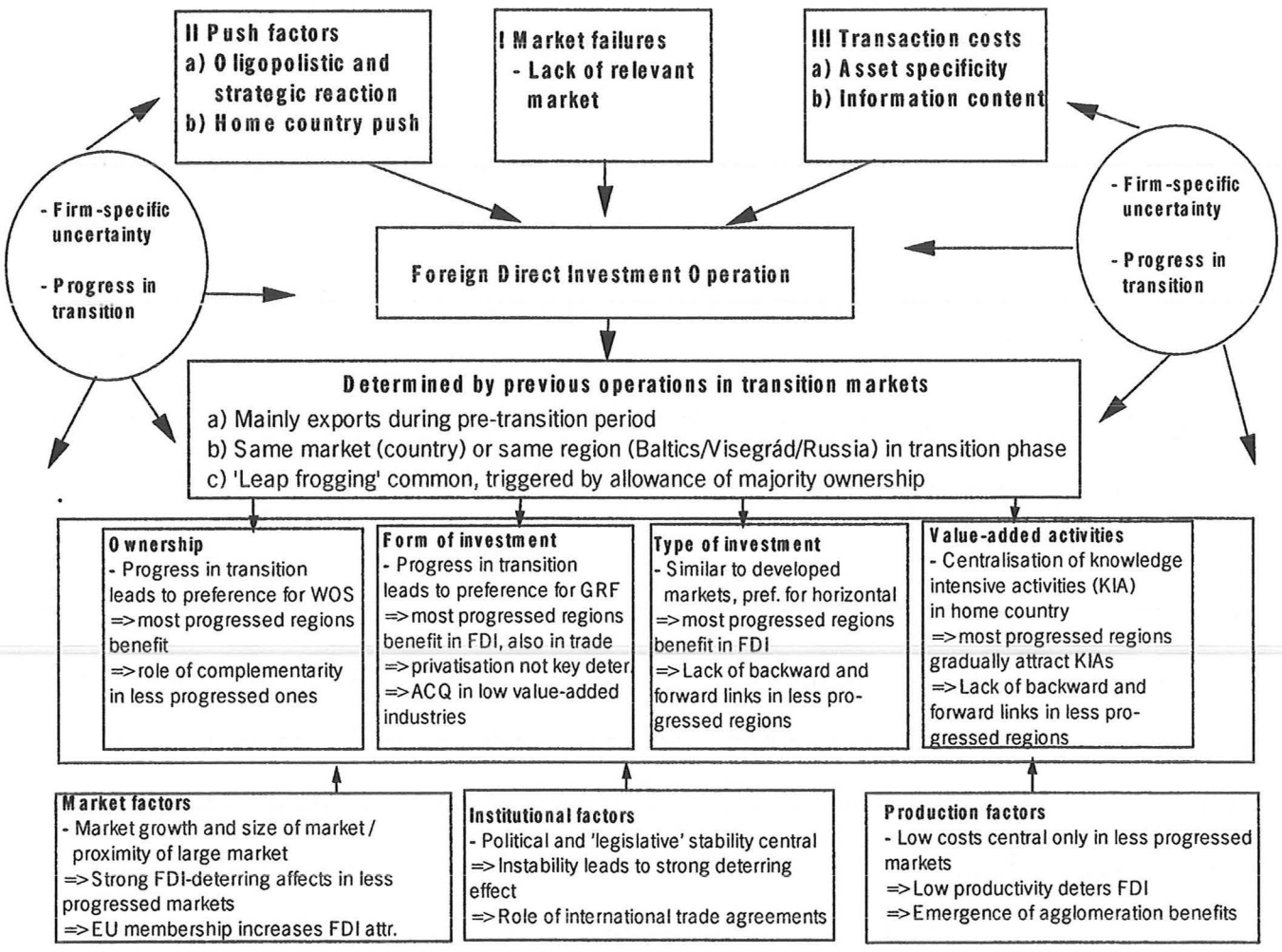
market and experience in the market and secondly as uncertainty caused by external factors. Because the transitional environment is highly characterised by turbulence, where such uncertainties occur, these are important factors determining the various choices related to FDI operations (i.e. the type and form of investment, the value added activities and ownership arrangements).

Hence using existing concepts provided by 'Western' models is appropriate, but the use of actual theories turns out to be most appropriate in a flexible framework considering a wider range of different existing explanations. For instance, explaining FDIs made in transition economies only by using the theory of location which underlines the significance of country specific comparative advantages would probably have led us to believe that low production costs are a major determinant. This study, however, strongly indicated that these are not perceived as a significant determinant, due to low productivity. Using various FDI models and theories also enabled identifying the nature of transition and the role of progress in determining the scope of the reviewed FDI activities. This dynamism might have gone unnoticed without such an approach.

The model aiming at explaining the determinants of manufacturing FDIs made in transition economies provides a flexible framework of analysis based on the results of the study. Naturally, it is better to apply it to large companies than to SMEs. As mentioned at the beginning of the empirical analysis, Finnish MNCs differ greatly in their FDI strategies in transition markets, which could already be seen in the different entry pattern into these same markets. Further research would be needed to develop this model into one that considers firms that differ by size and other resources as well. Methodologically, the analytical framework is as well flexible, as it allows the use of both qualitative and quantitative methods. Moreover, it may point to features or factors that may be difficult to measure, such as uncertainty in this study. Finally, the model is also appropriate to the circumstances of research , research related to FDI in transition economies suffered from the lack of information and distortions in statistical data. Even in developed economies FDI data are weak and provide only partial information on flows, sector-specific breakdowns

and other details (see methodological chapter). This study provides a number of research objects (42 manufacturing subsidiaries by 16 firms) that is large enough to permit the identification of general features of FDI still coupled with firm-level information on these operations. This enabled overcome problems related to the weak availability and quality of the data.

Figure 18 Explanatory model for FDI Operations in Transition Markets



6.3 Managerial Implications

Several key conclusions can be made on the basis of the findings of the study. Firstly, it seems that uncertainty emerging from, on the one hand, a lack of experience and knowledge, and on the other hand, from the transitional business environment, dictates FDI operations from the planning to the establishment of the subsidiary and for several years after establishment. This may impede efficient operation due to a continuous lack of willingness to increase local commitment by widening the scope of operations and the amount of available resources. This may also indicate that preparations for full-scale operations at the local level were inadequate. It seems that companies operating in the transition economies have had difficulties in identifying properly political and other business risks. Tools and corporate procedures enabling identifying risks and opportunities in the target market need to be developed. Traditional political risk analyses might not suffice for this purpose. The need for this is reflected in the obvious lack of understanding transition, as many of the investors seemed to be surprised essentially by the lack of some institutions or weakly functioning ones, by problems faced in privatised companies and their restructuring, and the like. Preparations should include a longer period of 'groundfield testing' in the target market.

Both pre-investment and post establishment problems seem to indicate a lack of sufficient training and preparedness. Uncertainty would be most efficiently reduced by efforts to allocate resources into training not only to the local labour force, but also for the home country labour force located both in the actual home country and in the host country. Overall issues related to human resources are crucial in the implementation of FDI projects.

Another important factor emerging from this study is the central role of efforts to be local in any operations and actions in order to carry through the establishment of manufacturing subsidiaries. This may help to a large extent in the case of privatisation acquisitions, where government authorities are involved in negotiations. Politically, some of the privatised firms are considered as important, which may complicate the foreign buyer's position. Here

too, knowledge and ability to deal with such FDI obstacles are enhanced with in-depth pre-investment analysis.

The comparative nature of this study further revealed how different the Baltic, Visegrád and Russian markets are and, consequently, how critical it is for investors to take this into account. A set of strategies should be considered depending on the main 'orientation' of the manufacturing subsidiaries in the host market, i.e. whether the investment is made to exploit domestic supply shortfalls, to use it as an export base, or to invest in high vs. low technology industries.

The fast development of the reviewed markets also pose challenges, as production circumstances change to a large extent as the standard of living rises and the markets are becoming more and more market-oriented ones. Competition becomes more intense and the lead provided by the initial privileged position brought by size and former market power may erode as local and other firms catch up faster. While transition is advancing, industrial structures change rapidly, and investors must be prepared to adjust. In addition, the planned EU membership of the Baltic States and the Visegrád countries may significantly affect, e.g., the current inter- and intra-trade arrangements within these MNCs. Furthermore, specialisation in the longer term may also lead to the agglomeration of certain activities in certain well specified areas, meaning that the investor firms may have to adjust again by relocating some activities or reorganising current activities.

6.4 Policy Implications

The study points to several policy implications both for home and host countries. Firstly, such a home country as Finland, which is located nearby transition economies is likely to experience an accelerated pace of specialisation. Production is located more and more according to a set of locational factors affecting their competitiveness, as the investment plans of the firms reviewed indicated. In addition, after the accomplishment of the current study, several of the reviewed firms have enlarged their operations in the target markets, and the tendency is towards the centralisation of certain activities into certain locations in transition markets. This may also involve the relocation of certain types of activities. This tendency forces to consider industrial strategies that correspond to firm-specific FDI strategies and to the changing determinants of manufacturing investment.

The study further indicates that a functioning institutional basis for trade has played a major initial role in determining the location of manufacturing subsidiaries. As these subsidiaries perform a large amount of exporting and at least part of this has generated additional export opportunities for the parent companies located in Finland, policies aiming at deepening European integration and the involvement of transition economies in pan-European trade arrangements would make it possible to sustain and increase trade flows between Finland and these markets. As the reviewed firms are all major Finnish exporters in addition to being major foreign investors, such efforts would bring benefits for the Finnish economy as a whole. Furthermore, full advantage of the trade potential between Finland and the transition economies is still not being taken (see Widgrén & Erkkilä 1997; Kaitila & Widgrén 1998).

Contrary to what was expected in the early phases of transition, the role of special incentives for foreign investors and to some degree the role of privatisation in attracting FDIs turned out to be insignificant in this study. In target markets such as Hungary, such incentives were abolished soon after the first few years of transition, as a result of their ineffectiveness and the emergence of drawbacks (misinterpretation or even illegal use of such advantages by foreign investors, and lost tax revenues). This study points to the fact

that other factors determine the location of production subsidiaries in the first place, at least in the case of large, long-term investments made by MNCs. Clearly, the overall low corporate taxation rates and low wage-related taxation have been facilitating factors for foreign investment, but not determining ones.

The study shows the importance of the availability of a well-educated labour force and, more specifically, the central role of its productivity. Hence, transition countries willing to attract additional FDIs should not base their strategies on the low production costs, but on human and technical endowments as well as to their geographical position. The latter applies specifically to the small Baltic markets, which the reviewed firms consider as possessing a competitive position between East and West. Specifically, these markets have played a major role in firms having used them as a testing ground before establishing manufacturing subsidiaries in the Russian market.

Hence the Baltic markets have enjoyed a more stable institutional, political and overall more stable business environment than Russia, which has provided them a head start in attracting additional FDIs. Still currently, several foreign firms seem to operate in Russia via the Baltic markets. This is a factor that could realistically lead to additional benefits, if taken into account in FDI policies. This includes providing a sound institutional basis for Baltic - Russian trade, which originates from these FDI activities.

In terms of transition progress, the study shows that the Visegrád markets seem to be 'mature', signifying that traditional methods of attracting FDIs are becoming exhausted as the privatisation process comes to an end and because of the rapidly developing business environment. This leads these countries in a situation where more and more FDIs have to be greenfield FDIs by nature and where the country-specific endowments have to be upgraded to attract additional investments. Additional investments are needed because domestic saving and domestic investments are still not significant. The attributes of specialisation in these countries should be identified in order to support such production activities. This also involves supporting further development in upgrading domestic production and even

creating the needed environment for higher value-added production. In the longer run, catching up signifies that these markets will be competing for the same FDI inflows as other European countries. This will require industrial policies taking this inevitable development into consideration. The clusterisation of certain activities in these markets should be seen as an opportunity that will benefit the entire economy through spillover effects. Last but not least, the study shows that problems brought by loopholes in the legislative environment and other bureaucratic hurdles have been considered major impediments to FDI in the area reviewed of the Baltic and Visegrád markets and to the greatest extent in the Russian market. The issue lies in the more general framework of FDI policies, their systematic functioning and implementation and the respect for the rule of law.

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Translation of the questionnaire

(see the original attached copy in finnish):

The questionnaire was accompanied by a letter asking to kindly participate in this enquiry. The questionnaire was also accompanied by a front page including instructions to filling up the questionnaire (including, e.g., a definition of concepts, codes for industries and the like).

- Part A is an enquiry for basic information on the firm:

- Name and address
- Contact person for this study
- Main industry of the firm
- The main products of the firm

- Part B is the actual questionnaire:

1. Please list the names, number, industrial code, year of establishment and ownership sh a-re (%-share of shares and voting power) of your subsidiaries having manufacturing pr o-duction activities in the listed countries (Estonia, Latvia, Lithuania, Poland, Czech Repu b-lic, Slovakia, Hungary, Russia, other East European countries?)

2. If ownership is less than 100%, please give the following information: a) country where the subsidiary is located, b) the name of the subsidiary, c) ownership share of other o w-ners, d) the home country of the latter

3. Have you had other owners previously in your subsidiaries? If yes, in which ones (question 1), when and why has joint ownership been dissolved?

4. Please write in the table the development of turnover and personnel in each subsidiary in 1990-1995 or since the subsidiaries have been established (the countries are listed in the table)

5. Please write in the table the amount of personnel by region (EU, NAFTA, Asia, South America and others except Eastern Europe) in your manufacturing subsidiaries in 1990-1995 or since the subsidiaries have been established.

6. Please, state the 5 most important manufacturing subsidiaries/units according to perso n-nel in 1990-1995 or since establishment (anywhere in the world)

7. Please, give the value of investments (in millions of FIM) in manufacturing subsidiaries located in the CEECs and Russia or elsewhere in Eastern Europe (1990-1995 or since establishment)

8. Please, give the value of investments in manufacturing subsidiaries by region in 1990-1995 or since establishment (EU, other Europe, NAFTA, Asia, South America and others except Eastern Europe)

9. Please state the 5 most important manufacturing subsidiaries in terms of investments (anywhere in the world) in 1990-1995 or since establishment

10. What other business operations does the fimr have in the CEECs and Russia? Tick in (Exports, imports, subcontracting, sales subsidiary or representative office, licensing, turnkey projects, management contracts, others?)

11. What support activities are performed in the subsidiaries in the Baltics, the Visegrád countries and Russia? Tick in, yes and no, : Sales unit, marketing unit, finance unit, R&D unit, project unit, property unit, logistics unit (transport, stocking), others (specify)?

12. Have some business operations or support activities been ceased? If yes, which operations and why?

13. Have some manufacturing subsidiaries been disinvested or are planning to disinvest any of the existing ones? If yes, why?

14. When has the firm started to operate in the CEECs and Russia? (year by country)
15. With which operation(s) (alternatives in question 10)?

16. Please give the value of exports by the manufacturing subsidiaries in Eastern Europe in 1990-1995 (by country)

17.Please, assess the amount (in %-share) of internal exports out of total exports originating from eastern European subsidiaries in 1990-1995 (by country)

18. Please give the value of imports by the manufacturing subsidiaries in Eastern Europe in 1990-1995 (by country)

19. Please, assess the amount (in %-share) of internal imports out of total imports originating from eastern European subsidiaries in 1990-1995 (by country)

20. What support services or activities does the parent company perform for the subsidiary: intermediate products, end products, raw materials, technology transfer, marketing services, management know how, right to use trade mark, others? (by country)

21. What support services or activities do the subsidiaries perform for the parent company: intermediate products, end products, raw materials, technology transfer, marketing services, market know how, right to use trade mark, others? (by country)

22. Establishment of subsidiary: Acquisition or greenfield investment? tick in : country, subsidiary, acquisition, greenfield, through privatisation or not?

23.have any of the subsidiaries been acquired through a merger? If yes, mention the country and the name of the subsidiary

24.Sales orientation of the CEECs and Russian subsidiaries: %-share: Finland, EU, other Europe, Nafta, South America, Asia, others?, please give the share of Finland.

25. If the subsidiaries do not serve local markets, why is it so?

26. Distribution of regional value-added and its value by region (Finland, EU, excl. Finland, Eastern Europe, Asia, NAFTA, South-America, others? [the majority of the respoendent firms did not answer this question]

27. Give the value and distribution (Finland vs. abroad) of R&D costs in 1990-1995

28. Which of the following market factors have been important when choosing the location for the manufacturing FDI? Assess on a scale of 1 to 5 (1=very important factor; 5= not important) (see page 10 of the finnish questionnaire and alternatives) for each country (Estonia, Latvia, Lithuania, Poland, Slovakia, Czech Republic, Hungary, Russia)

29. Which of the following production factors have been important when choosing the locat i-on for the manufacturing FDI? Assess on a scale of 1 to 5 (1=very important factor; 5= not important) (see page 11 of the finnish questionnaire and alternatives) for each country (Estonia, Latvia, Lithuania, Poland, Slovakia, Czech Republic, Hungary, Russia)

30. Which of the following institutional factors have been important when choosing the loc a-tion for the manufacturing FDI? Assess on a scale of 1 to 5 (1=very important factor; 5= not important) (see page 12 of the finnish questionnaire and alternatives) for each country (Estonia, Latvia, Lithuania, Poland, Slovakia, Czech Republic, Hungary, Russia)

31. Rank market, production and institutional factors (& others?) in order of importance from 1 to 4, in terms of significance when doing the FDI? (in each country)

32. If you would invest noe in the CEECs and Russia, which of the following factors would affect in choosing the host country?

33. Assess the role of the following competitive factors on the FDI manufacturing operations in each country

34. How large an importance have the following factors had on your FDI operations? (=the role of Finnish authorities, industrial and trade organisations, international organisations, EU membership, Finland's gateway position, others?)

35. Assess the conditions (obstacles) for your FDI operations on a scale of 1 to 5 (1= signif i-cant obstacle, 5= not a significant obstacle)

36. Assess future developments in the region in which you operate (Baltics, Visegrád and Russia) (1= disagree fully, 5= fully agree with opinion)

37. How do you expect your FDI operations to develop by the year 2000? Choose form the following alternatives by region (Baltics, Visegrád and Russia): will decrease, same as currently, grow less than 50%, grow by 50%-100%, grow by more than 100%

SUOMALAISTEN SUURYRITYSTEN SUORAT SIJOITUKSET KESKI- JA ITÄ-EUROOPPAAN 1990 - 1995

ELINKEINOELÄMÄN TUTKIMUSLAITOS, ETLA
Lönnrotinkatu 4 B, 00120 Helsinki
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Fax: (90) 601 753
Yhteyshenkilö:
Tutkija Julianna Borsos-Torstila
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Lomakkeet tulisi palauttaa ETLAan 30.5.1996 mennessä.
Vastausten liitteeksi olisi hyvä lähettää yhtiön vuosikertomus vuodelta 1995.

A-lomake: Yrityksen taustatiedot

Ks. lomakkeen täyttöohjeet.

1. Yrityksen nimi ja osoite:

   _____

   _____

2. Yhteyshenkilö:_____

   Puh: _____Suoraan:_____

   Fax:_____

3. Yrityksen / konserniin kuuluvien yritysten päätoimiala:

   Koodi:_____(ks. ohjeet)

4. Yrityksen / konsernin tärkeimmät tuotteet:

   _____

   _____

   _____

OHJEET KYSELYLOMAKKEEN TÄYTTÄMISEEN

A-lomake:

3. Yrityksen **päätoimialalla** tarkoitetaan sitä toimialaa, jolta yritys saa vähintään 60% liikevaihdostaan.

Toimialojen koodit ovat:

01 Kaivostoiminta
02 Elintarviketeollisuus
03 TeVaNaKe
04 Huonekaluteollisuus
05 Metsäteollisuus
06 Kemia ja muovi
07 Metalliteollisuus
08 Koneet ja laitteet
09 Sähkö- ja elektroniikkateollisuus
10 Tietotekniikka
11 Telekommunikaatio
12 Energiantuotanto
13 Kuljetusvälineet, laivanrakennus
14 Rakennus, rakennusaineteollisuus
15 Moniala
16 Muu, mitä_____

Lyhenteet:

KIE-maat:	Tässä tutkimuksessa: Eesti, Latvia, Liettua, Unkari, Puola, Tsekki ja Slovakia
Baltia:	Eesti, Latvia ja Liettua
Visegrad-maat:	Unkari, Puola, Tsekki ja Slovakia
Itä-Eurooppa:	KIE, Venäjä ja kaikki muut Itä-Euroopan maat.

B-lomake:

1. Tytäryhtiöiden omat koodit (samat kuin yllä). Jos tiedot eivät mahdu tietylle maalle varattuun tilaan, yliviivaa ne maat, joissa ei ole toimintaa ja kirjoita siihen tilaan.

4. Liikevaihto markoissa tai dollareissa, valuuttayksikkö merkittävä selvästi.

5. EU ja NAFTA -Alueilla käsitetään tässä kyselyssä seuraavaa:

EU: EU-maat nykyisen kokoonpanon mukaan eli Suomi, Ruotsi ja Itävalta mukaanlukien (EU 15). Jos ette pysty antamaan vuotta 1995 edeltäviä tietoja tämän ryhmittelyn mukaan, antakaa Suomen, Ruotsin ja Itävallan tiedot erikseen ja EU 12 -maat omana ryhmänään.

NAFTA: USA + Mexico

7. Kaikki investoinnit: Rakennukset, kiinteistöt, koneet, laitteet ja koulutusinvestoinnit.

8. Sama, mutta alueittaiset summat

22. Uusinvestoinnilla tarkoitetaan itse perustettua yritystä / tuotantolaitosta.

24. Mainitkaa erikseen KIE-maissa ja Venäjällä olevien eri tytäryhtiöiden oman viennin alueittainen suuntatuminen. Jatkakaa kääntöpuolelle, jos ei mahdu.

28. Epäsuorilla esteillä tarkoitetaan muita kuin muodollisia kaupan esteitä, esim. epäviralliset maksut, vaikea markkinoille pääsy kilpailijoiden vahvan aseman vuoksi, jne.

B: Liiketoiminta Keski- ja Itä-Euroopassa sekä Venäjällä

Antakaa seuraavat tytäryksikkötiedot:

1. Konsernin <u>tuotannollista</u> toimintaa harjoittavien tytäryhtiöiden nimet, lukumäärä (tytlkm), toimiala, perustamisvuosi, omistusosuus prosentteina (äänivallasta ja osakkeista) seuraavissa kohdemaissa:

Maa	Tytäryksiköiden nimet	Tytlkm	Toimiala (koodi)	Perustamis-vuosi	Omistus, % ääni	Omistus, % osake
Eesti						
Latvia						
Liettua						
Puola						
Tsekki						
Slovakia						
Unkari						
Venäjä						
Muita maita:* _____ _____ _____						

* Muita Itä-Euroopan maita

2. Jos omistusosuus jää alle 100%:n, antakaa muiden omistajayritysten osuudet osakkeista ja alkuperämaat:

Maa, jossa tytäryhtiö sijaitsee	Tytäryhtiön nimi	Muiden omistaja-yritysten osuudet	Omistajayritysten alkuperämaa

3. Onko muita omistajayrityksiä aiemmin ollut? Missä tytäryhtiö(i)ssä, milloin ja miksi yhteisomistus päättynyt?

_____

_____

_____

4. Konsernin <u>tuotannollista</u> toimintaa harjoittavien tytäryhtiöiden liikevaihdon kehitys ja henkilöstön lukumäärä vuosina 1990-1995 tai perustamisesta lähtien KIE-maissa ja Venäjällä

Maa	Tytäryhti-öiden lkm	1990	1991	1992	1993	1994	1995
Eesti Liikev. Hlöstö							
Latvia Liikev Hlöstö							
Liettua Liikev. Hlöstö							
Puola Liikev. Hlöstö							
Tsekki Liikev. Hlöstö							
Slovakia Liikev. Hlöstö							
Unkari Liikev. Hlöstö							
Venäjä Liikev. Hlöstö							
Muita Itä-Euroo-pan maita: _____ _____							

5. Konsernin <u>tuotannollista</u> toimintaa harjoittavien yksiköiden henkilöstön lukumäärä vuosina 1990-1995 tai perustamisesta lähtien <u>alueittain</u>

		Henkilöstön lukumäärä					
Alue	**Yks. lkm**	1990	1991	1992	1993	1994	1995
EU							
NAFTA							
Aasia							
Etelä-Amerikka							
Muu, pl. Itä-Eurooppa							

6. Konsernin <u>tuotannollista</u> toimintaa harjoittavien yksiköiden maittainen (Suomen lisäksi 5 merkittävintä maata kaikista maailman yksiköistä) **henkilöstön lukumäärä vuosina 1990-1995 tai perustamisesta lähtien**

Maa	1990	1991	1992	1993	1994	1995
Suomi						

7. Konsernin investoinnit (milj. markkoina) <u>tuotannollista</u> toimintaa harjoittaviin tytäryhtiöihin 1990-1995 tai perustamisesta lähtien KIE-maissa ja Venäjällä

Maa	1990	1991	1992	1993	1994	1995
Eesti						
Latvia						
Liettua						
Puola						
Tsekki						
Slovakia						
Unkari						
Venäjä						
Muu Itä-Eurooppa yhteensä:						

8. Konsernin aluekohtaiset investoinnit (milj. markkoina) <u>tuotannollista</u> toimintaa harjoittaviin tytäryhtiöihin 1990-1995 tai perustamisesta lähtien

Alue	1990	1991	1992	1993	1994	1995
EU						
Muu Eurooppa						
NAFTA						
Etelä-Amerikka						
Aasia						
Muut, pl. Itä-E.						

9. Konsernin maittaiset (Suomen lisäksi 5 tärkeintä kaikista maailmalle tehdyistä investoinneista) **investoinnit (milj. markkoina) tuotannollista toimintaa harjoittaviin yksiköihin 1990-1995 tai perustamisesta lähtien**

Maa	1990	1991	1992	1993	1994	1995
Suomi						

10. Mitä muita liiketoimintoja konsernilla on KIE-maissa ja Venäjällä? Rasti oikeaan vaihtoehtoon:

	Eesti	Latvia	Liettua	Puola	Tsekki	Slovakia	Unkari	Venäjä
Vientiä								
Tuontia								
Alihankintatoimintaa								
Myyntiyksikkö /lkm*								
Lisenssitoimintaa								
'Avaimet käteen' - projekteja								
'Management contract'								
Muita, _____ _____								

*Myyntiin keskittyvä tytäryhtiö /-edustusto; lukumäärä mainittava.

11. Mitä tukitoimintoja KIE-maiden ja Venäjän tytäryhtiössä suoritetaan? Rasti ruutuun:

Yksikkö	Kyllä	Ei
Myyntiyksikkö (MY)		
Ostoyksikkö (OS)		
Markkinointiyksikkö (MA)		
Rahoitusyksikkö (RA)		
Tutkimus- ja kehitysyksikkö (TK)		
Projektiyksikkö (PR)		
Kiinteistönomistusyksikkö (KI)		
Kuljetusyksikkö (KU)		
Varastointiyksikkö (VR)		
Muu, mitä ?		

PR= perustettu määräajaksi projektin toteutusta varten
KU= kuljetustoimintaa tai -järjestelyjä hoitava yksikkö
VR= varastorakennus

12. Onko joitain toimintoja lakkautettu KIE-maissa tai Venäjällä? Mitä toimintoja, milloin ja miksi (ks. kys. 11)?_____
_____
_____

13. Onko joitain tuotantoyksiköitä lakkautettu aiemmin tai ollaanko lakkauttamassa? Milloin ja miksi?_____

_____

_____

14. Milloin (vuosi) konserni on käynnistänyt liiketoimintansa KIE-maissa ja Venäjällä?

Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä

15. Millä toiminnalla tai toiminnoilla konserni tuolloin aloitti? (sijoitus vai jokin yllä olevista vaihtoehdoista, ks. kysymys 10):

Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä

16. Vienti (milj. markkoina) vuosina 1990-1995:

	Eesti	**Latvia**	**Liettua**	**Puola**	**Slovakia**	**Tsekki**	**Unkari**	**Venäjä**	**Muualle***
1990									
1991									
1992									
1993									
1994									
1995									

*Muualle Itä-Eurooppaan, yhteensä.

17. Arvioikaa sisäisen viennin (emoyhtiön ja tytäryhtiön välisen viennin) **osuus koko Itä-Euroopan viennistä prosentteina:**

	Eesti	**Latvia**	**Liettua**	**Puola**	**Slovakia**	**Tsekki**	**Unkari**	**Venäjä**	**Muualle***
1990									
1991									
1992									
1993									
1994									
1995									

* Muualle Itä-Eurrooppaan

18. Tuonti (milj. markkoina) vuosina 1990-1995:

	Eesti	**Latvia**	**Liettua**	**Puola**	**Slovakia**	**Tsekki**	**Unkari**	**Venäjä**	**Muualta***
1990									
1991									
1992									
1993									
1994									
1995									

* Muualta Itä-Euroopasta

19. Arvioikaa sisäisen tuonnin (emoyhtiön ja tytäryhtiön välisen tuonnin) **osuus koko Itä-Euroopan tuonnista prosentteina:**

	Eesti	**Latvia**	**Liettua**	**Puola**	**Slovakia**	**Tsekki**	**Unkari**	**Venäjä**	**Muualta***
1990									
1991									
1992									
1993									
1994									
1995									

*Muualta Itä-Euroopasta.

20. Mitä emoyhtiö tarjoaa KIE-maiden ja Venäjän tytäryhtiöille? Rasti ruutuun:

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
Lopputuotteita								
Välituotteita								
Raaka-aineita								
Teknologian siirtoa								
Markkinointipalveluja								
Management know-how'ta								
Tavaramerkin käyttöoikeuden								
Muuta:								

21. Mitä KIE-maiden ja Venäjän tytäryhtiöt tarjoavat emoyhtiölle? Rasti ruutuun:

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
Lopputuotteita								
Välituotteita								
Raaka-aineita								
Teknologiaa								
Tietoa paikallisista markkinoista								
Muuta:								

22. Perustamistapa: Yritysosto vai uusinvestointi? Rasti ruutuun:

Maa	Tytäryhtiö	Yritysosto	Uus-investointi	Kuuluuko ostettu yritys yksityistämisohjelmaan Kyllä Ei

Maat kirjoitettavava taulukkoon, samat maat kuin edellisessä kysymyksessä.

23. Onko tytäryksiköitä tullut yrityksen haltuun fuusion kautta? Jos on, nimeä tytäryksikkö ja maa:

_____

_____

24. Tytäryhtiön / -yhtiöiden oman viennin suuntautuminen prosentteina kokonaisviennistä: (ks. kys. 22)

Tytäryhtiö 1	**%**	**Tytäryhtiö 2, %**	**Tytäryhtiö 3, %**	**Tytäryhtiö 4, %**
EU	____	____	____	____
Itä-Eurooppa	____	____	____	____
NAFTA	____	____	____	____
Etelä-Amerikka	____	____	____	____
Aasia	____	____	____	____
Muu?_____	____	____	____	____
(Suomen osuus)	____	____	____	____

25. Miksi KIE-maiden ja Venäjän tytäryhtiö(t) ei(vät) palvele (jos ei palvele kuin vähän tai ei ollenkaan) paikallisia markkinoita?

_____

_____

_____

26. Konsernin alueittainen jalostusarvo ja sen jakautuminen

	1990	1991	1992	1993	1994	1995
Suomi						
EU, pl. Suomi						
Itä-Eurooppa						
Aasia						
NAFTA						
Etelä-Amerikka						
Muu						

27. Konsernin tutkimus- ja kehitystoiminnan kustannukset Suomessa ja ulkomailla

	1990	1991	1992	1993	1994	1995
T&K - menot yhteensä						
- Suomessa						
- Ulkomailla						

28. Millä seuraavista <u>markkinatekijöistä</u> on ollut merkitystä maan valinnassa suoraa sijoitusta tehdessä? Arvioikaa seuraavista tekijöistä asteikolla 1-5 (1= merkittävä tekijä, 5= ei lainkaan merkittävä tekijä)

Markkinatekijät	**Eesti**	**Latvia**	**Liettua**	**Puola**	**Slovakia**	**Tsekki**	**Unkari**	**Venäjä**
Markkinoiden koko	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Markkinoiden hyvät kasvunäkymät	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Pääsy alueen muiden maiden markkinoille	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Pääsy Venäjän markkinoille	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tarve olla lähellä asiakasta	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muiden kilpailijoiden läsnäolo markkinoilla	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kaupan esteet	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Epäsuorat kaupan esteet	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Emoyhtiön markkina-osuuden ylläpitäminen	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Emoyhtiön viennin edistäminen	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Osana yhtiön aluestrategiaa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Maiden mahdollinen EU-jäsenyys	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Hyviä yritysosto-kohteita	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Suomen pienet markkinat	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Hidastunut talouskasvu Suomessa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

29. Millä seuraavista tuotantotekijöistä on ollut merkitystä maan valinnassa suoraa sijoitusta tehdessä? Arvioikaa seuraavista tekijöistä asteikolla 1-5 (1= merkittävä tekijä, 5= ei lainkaan merkittävä tekijä)

Kustannustekijät	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
Työvoiman hyvä saatavuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Hyvin koulutettu työvoima	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Alhaisemmat työvoimakustannukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Alhaisemmat muut tuotantokustannukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Alhaisemmat kuljetuskustannukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Raaka-aineiden hyvä saatavuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Halvemmat raaka-aineet	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Ulkomaisille yrityksille tarjotut vero- ym. edut	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
EU:n ja kv-järjestöjen rahoittamat projektit	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Alhaisempi verotus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Yleensäkin matala kustannustaso	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Valuutan vakaus ja vaihtokelpoisuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Hyvät tuotto-odotukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kohdemaan korkea teknologinen taso								
Suuret riskit	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

Muu, mikä

30. Millä seuraavista institutionaalisista tekijöistä on ollut merkitystä maan valinnassa suoraa sijoitusta tehdessä? Arvioikaa seuraavista tekijöistä asteikolla 1-5 (1= merkittävä tekijä, 5= ei lainkaan merkittävä tekijä)

Investointi-ilmapiiri	**Eesti**	**Latvia**	**Liettua**	**Puola**	**Slovakia**	**Tsekki**	**Unkari**	**Venäjä**
Poliittinen vakaus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Taloudellinen vakaus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Ulkomaisille sijoituksil-le suopea lainsäädäntö	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Omistusosuuteen liittyvät rajoitukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Maanomistukseen liittyvät rajoitukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Yksityistäminen	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Myönteinen suhtautumi -nen ulkom. sijoituksiin	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kohdealue tunnetaan hyvin yrityksessä	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Suhteellisen hyvä infrastruktuuri	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
EU:n sopimukset KIE-maiden kanssa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
KIE-maiden solmimat investointisuoja-sopimukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Olemassaolevat ulkomaiset sijoitukset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muuta, mitä? _____	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

31. Millä tekijällä on ollut eniten merkitystä sijoituksen kannalta? Asettakaa seuraavat tekijät tärkeysjärjestykseen (1-4):

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
Markkinatekijä								
Tuotantotekijä								
Institutionaaliset tekijät								
Muu, mikä?								

32. Arvioikaa seuraavia kilpailuolosuhteita kuvaavia väittämiä asteikolla 1-5 (1= täysin eri mieltä, 5 = täysin samaa mieltä)

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kilpailu on erittäin kovaa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Jatkossa kilpailu tulee vielä kiristymään entisestään	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Ulkomaiset yritykset ovat merkittävimmät kilpailijat	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Paikalliset yritykset ovat merkittävimmät kilpailijat	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Vero- ja tullimaksuja kiertävät yritykset ovat merkittävä ongelma	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muu, mikä?	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

33. Arvioikaa seuraavia kilpailuolosuhteita kuvaavia väittämiä asteikolla 1-5 (1= täysin eri mieltä, 5 = täysin samaa mieltä)

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kilpailu on erittäin kovaa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Jatkossa kilpailu tulee vielä kiristymään entisestään	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Ulkomaiset yritykset ovat merkittävimmät kilpailijat	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Paikalliset yritykset ovat merkittävimmät kilpailijat	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Vero- ja tullimaksuja kiertävät yritykset ovat merkittävä ongelma	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muu, mikä?	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

34. Kuinka suuri merkitys seuraavilla tekijöillä on yrityksenne toiminnan kannalta (1= merkittävä haitta, 5= merkittävä hyöty)

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
Suomalaisten viranomaisten toiminnan merkitys	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Teollisuuden- ja idänkaup-pajärjestöjen merkitys	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kansainvälisten järjestöjen merkitys	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
EU-jäsenyyden merkitys	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Suomen gateway-asema	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muu, mikä?	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

35. Minkälaiset ovat KIE-maiden olosuhteet yritystoiminnan kannalta? Arvioikaa seuraavia tekijöitä asteikolla 1-5
(1= merkittävä yritystoiminnan este, 5= ei lainkaan este yritystoiminnalle)

	Eesti	Latvia	Liettua	Puola	Slovakia	Tsekki	Unkari	Venäjä
Poliittinen ympäristö	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Lainsäädännön selkeys ja yritysystävällisyys	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Lakien ja määräysten soveltaminen käytännössä	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tullimaksut ja määräykset	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Verotuskäytäntö	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tuotenormit ja sertifiointi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Viranomaisten toiminta	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Ostovoima	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Talouden vakaus, inflaatio	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tietoliikenneyhteydet	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Liikenne- ja kuljetusyhteydet	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Pankkiyhteyksien toimivuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Rahoitusjärjestelyt	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Myynti- ja jakelukanavat	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Toimi- ja varastotilojen saatavuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Luotettavien yhteistyö-kumppaneiden löytäminen	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tukipalveluiden saatavuus (verotuksessa, kirjanpidossa ym.)	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Työvoiman saatavuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kulttuurierot	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Turvallisuustilanne (rikollisuus)	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Alueen kustannustaso	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muutosten ennakoitavuus	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Myyntikatteet	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muu, mikä?	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

36. Arvioikaa seuraavaksi alueen kehitystrendejä yrityksenne näkökulmasta. (1= täysin eri mieltä, 5= täysin samaa mieltä)

	Visegrad - maat	Baltia	Venäjä
Kuluttajien ostovoima kasvaa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Alue kehittyy merkittävämmäksi markkina-alueeksi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tuotanto siirtyy yhä suuremmassa määrin Itä-Eurooppaan	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Painopiste siirtyy työvaltaisilta aloilta korkeampaan teknologiaan	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Poliittinen epävarmuus vähenee	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Talous kehittyy ja vakautuu	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kauppa EU:n ja alueen välillä tulee kasvamaan merkittävästi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kaupan esteet alueella tulevat alentumaan merkittävästi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Lainsäädäntö selkeytyy ja kehittyy yritysystävällisemmäksi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Viranomaisten toiminta kehittyy selkeämmäksi ja yritysystävällisemmäksi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Verotus ja muut maksut selkeytyvät	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tullin toiminta kehittyy johdonmukaisemmaksi	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Tietoliikenneyhteydet kehittyvät	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Liikenneyhteydet kehittyvät	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kustannustaso säilyy edullisena	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Työvoimakustannukset pysyvät kurissa	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Pankkiyhteydet kehittyvät	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Rahoituksen saatavuus paranee	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Myynti- ja jakelukanavat kehittyvät	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Kilpailu ei enää merkittävästi kiristy	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Myyntikatteet kehittyvät suotuisasti	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Rikollisuus vähenee	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5
Muu, mikä?	1 2 3 4 5	1 2 3 4 5	1 2 3 4 5

34. Miten odotatte liiketoiminnan kehittyvän vuoteen 2000 mennessä? Ympyröikää sopivin vaihtoehto.

Visegrad-maat	Vähenee	Säilyy ennallaan	Kasvaa alle 50 %	50 - 100 %	Yli 100 %
Baltia	Vähenee	Säilyy ennallaan	Kasvaa alle 50 %	50 - 100 %	Yli 100 %
Venäjä	Vähenee	Säilyy ennallaan	Kasvaa alle 50 %	50 - 100 %	Yli 100 %