ETLA ELINKEINOELÄMÄN TUTKIMUSLAITOS

Inkeri Hirvensalo

STRATEGIC ADAPTATION OF ENTERPRISES TO TURBULENT TRANSITIONARY MARKETS

Operative Strategies of Finnish Firms in Russia and the Baltic States during 1991–95

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ABSTRACT: The study analyzes the behavior of enterprises in the transitional markets of Russia and the Baltic states with the help of a conceptual model of transitional adaptation. It is argued that the behavior of enterprises in the rapidly changing transitional environment is not fundamentally different from behavior in rapidly changing environments in market economies. Therefore a general conceptual framework can be used to describe the behavior in both. The model is applied, first, to describe the behavior of Russian enterprises in the transitionary environment and, secondly, to analyze the strategic adaptation of Finnish companies to the transitionary conditions of Russian and Baltic markets. A comparison is also made between the model of transitional adaptation and the stages model of internationalization and it is argued that internationalization can be regarded as a particular form of transitional adaptation under relatively stable conditions. Consequently, it is argued that the model of transitional adaptation can be used to search for common patterns in the adaptation of international operations under transitionary conditions. It is found, among others, that in the transitionary Russian and Baltic markets wholly owned Finnish subsidiaries are preceded by networking strategies, such as inward-directed subcontracting and joint ventures.

KEY WORDS: strategic adaptation, internationalization, transition economies, Russia, The Baltic countries

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TIIVISTELMÄ: Tutkimuksessa tarkastellaan yritysten käyttäytymistä Venäjän ja Baltian maiden siirtymätaluoksissa käsitteellisen sopeutumista kuvaavan mallin avulla. Tutkimuksen peruslähtökohta on se, että yritysten käyttäytyminen siirtymätalouksisssa ei periaatteessa eroa käyttäytymisestä nopeasti muuttuvissa olosuhteissa, mistä syystä voidaan rakentaa käsitteellinen malli, joka kuvaa käyttäytymistä molemmissa. Mallia sovelletaan tutkimuksessa ensin venäläisten yritysten käyttäytymiseen ja toiseksi suomalaisten yritysten käyttäytymiseen Venäjän ja Baltian maiden markkinoilla. Mallia verrataan lisäksi teoreettiseen malliin yrityksen kansainvälistymiskehityksestä ja todetaan, että kansainvälistymismalli kuvaa yritysten kansainvälistymiseen johtavaa muutoskäyttäytymistä suhteellisen vakaissa markkinaolosuhteissa kun taas tutkimuksessa kehitetty malli kuvaa käyttäytymistä nopeasti muuttuvissa olosuhteissa ja voi sen vuoksi tuoda myös lisävalaistusta yritysten kansainvälistymiskäyttäytymiseen siirtymätalouksissa. Tutkimus osoittaa mm., että Venäjän ja Baltian siirtymätalouksissa suomalaiset yritykset ovat käyttäneet verkostostrategioita, kuten alihankintoja ja yhteisyrityksiä ennen kuin ovat perustaneet tytäryrityksiä, jotka ovat täysin emoyhtiön omistamia.

AVAINSANAT: strateginen sopeutuminen, kansainvälistyminen, siirtymätaloudet, Venäjä, Baltian maat

Preface

This study is the result of a multifaceted experience in East-West banking, teaching and research. Its first seeds were planted in the early 1970's when, after graduation from the Helsinki School of Economics and Business Administration, I started my first job in the Eastern Trade Department of the Bank of Finland. I became involved, among others, in evaluating the potential effects of the abolition of the bilateral clearing payment system between Finland and the USSR and got interested in questions of adaptation to significant institutional changes, such as the bilateral trading system.

During the 1980's I was working as the manager of the Eastern Trade Department in the state owned commercial bank, Postipankki. There my duties included participation in the trade and project finance negotiations with the bank's corporate customers who were trading with the Eastern European countries. As a result I became interested in the various strategic approaches of Finnish companies to the Eastern European planned economies. When, as a result of the perestroika reforms in Russia, the joint venture boom started among Soviet organizations, I also got involved in discussions with both Finnish companies and Soviet banks about various ways of financing Finnish-Soviet joint ventures. This happened at a time, when the Soviet legislation on joint ventures was still being formulated on the basis of those early cases, which made it all the more interesting.

My licentiate thesis, which was accepted at the Helsinki School of Economics in 1993, analyzed the adaptation of Finnish companies mainly to the changes in the Finnish-Soviet bilateral clearing payment system in 1991. This present study is an extension of the licentiate thesis, which, based on quantitative survey data, was not able to answer the questions of strategy formulation and dynamics of strategy development, which I found the most interesting for the continuation of the study. Therefore I chose a different approach, that of case studies, for this study. I also found the case approach very relevant for myself having dealt with companies on a case-by-case basis in the project finance discussions.

The empirical data for this study, the case interviews in Finland, Russia and Estonia, were collected during 1993-95 while I was working both as a visiting researcher at the unit for the Eastern European Economies of the Bank of Finland and as director of the international MBA program at the Helsinki School of Economics and Business Administration. During those years I was also involved in teaching intensive courses on the Russian economy and on Russia and the Baltic states as target markets both in the MBA program of Helsinki School of Economics and at the Renvall Institute of Helsinki University. These and teaching appointments also at the Zelenograd business college in Moscow in 1994-95 focussed my attention to the enormous needs of adaptation within the Russian economy as well as the need for a multifaceted analysis of the adaptation dynamics. On the other hand, I found literature particularly on adaptation of foreign companies to transitionary conditions very scanty.

My research project advanced significantly when, through the international connections of the Helsinki School of Economics and Business Administration it became possible for me to spend the school year of 1995-96 at Indiana University, USA, which is known for its Institute of Russian and East European Studies and faculty with wide research interests in the transition economies. In addition to co-teaching a course on Russian and Eastern European transition economies I had the opportunity to participate, among others, in courses on corporate strategy and to review the relevant literature in order to assess its applicability to the transitionary economies. Moreover, the stay at IU provided me the opportunity to have fruitful discussions on related topics with fellow researchers as well as to concentrate on writing the thesis.

As this study is the result of an extensive process of practical experience, research and teaching, there is also a great number of persons, who over the years have provided invaluable assistance in many different ways as well as insights into the problem of transitional adaptation itself. Among such persons I owe my gratitude, first, to Prof. Reijo Luostarinen, who was most encouraging and supervised and supported the study in an enthusiastic way typical of him. Secondly, I owe my gratitude to Prof. Paul Marer from Indiana University, who with his broad research experience on transition economies offered many invaluable comments on various drafts of the thesis. Thirdly, I am grateful to Prof. Pekka Sutela from Helsinki University, whose way of analyzing the Russian transitionary developments has greatly influenced my thinking, as well.

Among the persons, who have commented on various parts of the study I want to thank Prof. Reuben R. McDaniel, Jr. from the University of Texas at Austin, USA, as well as Prof. John Johnson from Indiana University, who both helped me in understanding some crucial issues in the strategy literature. My thanks are extended also to colleagues at the Unit for Eastern European Economies at the Bank of Finland for discussions and help in many different ways during the tedious process of writing the dissertation.

This study would hardly have been possible without the help of Prof. Veikko Jääskeläinen, at the time Rector of Helsinki School of Economics, who engaged me as director of the International Center and Dean of the MBA program with the explicit requirement that I finish my Ph.D. “within the next couple of years”. He was also instrumental in arranging the financing for the stay at Indiana University. I am grateful to Saastamoisen Säätiö, Liikesivistysrahasto and Helsingin kauppakorkeakoulun tukisäätiö for providing the financing, which ultimately made this study possible.

This study would not have been possible at all without the help and cooperation of the key managers in the three case companies, Director Aaro Ikonen from Valmet, Director Ville Ounaskari from Ahlström and Director Olavi Urvas from Outokumpu. I thank all three of them as well as a number of their colleagues for taking the time and having the interest in discussing their cases with me.

After joining the Research Institute of the Finnish Economy in the fall of 1996 as coordinator of the research on Eastern Europe, I want to thank the institute for providing the opportunity to finalize the study. My thanks go also to John Rogers, who read the text carefully and polished my English.

Last but in no way least, I want to extend my gratitude to my family members, who have survived without the care of a wife and mother and for extended periods of time, which the thesis writing has required. The older daughters Irmeli and Irina, who by 1996 are students of economics and engineering, respectively, seemed to adapt without great difficulties to a mother who was absent both mentally and physically. The youngest daughter Ilona, who shared the year with me at Indiana, often complained that mother was just working, working, and working! In addition to "losing" his wife to writing the dissertation my husband Iiro lost during the critical years also both his beloved mother and sister. While thanking him for standing beside me I am also thinking gratefully of Emo and Liisa. Finally I am grateful to my mother and father who have always stood by and supported their daughter both materially and spiritually.

November 1996

Inkeri Hirvensalo

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1 Introduction

The Russian and Baltic markets, which are in the middle of profound political, structural and economic changes marking the transition from planned to market economies during 1991-95, have provided foreign companies a most turbulent operating environment. They are also a striking example of changes, which companies are facing in many parts of the world in economies of transition and to which they have to adapt their operations if they wish to stay competitive and profitable in those markets. However, the adaptation processes of companies in such circumstances have been studied only to a limited extent.

This study analyzes the behavior of enterprises in the transitional markets of Russia and the Baltic states with the help of a conceptual model of transitional adaptation. The model is built on the basis of the literature on adaptive behavior in rapidly changing environments in general, and in transition economies in particular. It is argued that the behavior of enterprises in the rapidly changing transitional environment is not fundamentally different from behavior in rapidly changing environments in market economies. Therefore a general conceptual framework can be used to describe the behavior in both.

The model is applied, first, to describe the behavior of Russian enterprises in the transitionary environment and, secondly, to analyze the strategic adaptation of Finnish companies to the transitionary conditions of Russian and Baltic markets. However, no direct comparisons are made between the behavior of Russian and Finnish enterprises as they face totally different choices. Most Russian enterprises cannot choose their environment, whereas the Finnish companies can choose to leave the market without significant economic consequences.

A comparison is also made between the model of transitional adaptation and the stages model of internationalization and it is argued that internationalization can be regarded as a particular form of transitional adaptation under relatively stable conditions. Consequently, it is argued that the model of transitional adaptation can be used to search for common patterns in the adaptation of international operations under transitionary conditions. It is hoped that the analysis and the findings will contribute to theory building in the fields of enterprise behavior under transition as well as internationalization and international operations in the transitionary markets.

The study is an extension of a licentiate[1] thesis, which was accepted at the Helsinki School

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[1] A licentiate degree is an academic degree between the Master's and Doctor's degrees in Finland. Often and also in this case the licentiate theses forms the foundations for a doctoral dissertation.

of Economics in 1993. When the first round of interviews among Finnish companies was carried out for the thesis in 1991, it was clear that the risks and uncertainties concerning the path which Russia's reform process would follow constituted a major impediment for the companies in formulating explicit, long-term strategies in that market. Accordingly, the adaptation strategies of the interviewed companies were mostly oriented towards the very short term. However, most of the companies had been operating in the former USSR for more than ten years and considered Russia one of their major foreign markets and very important for them in the long run. Therefore this study also provides a longer term view of the reform process in Russia and analyses the behavior of Russian companies in those circumstances as a frame of reference for the operations of Finnish companies.

One of the major findings of the licentiate thesis was that extensive operational experience in the former USSR market was related to slow adaptation to the changed circumstances in that market. On the other hand, companies with very little previous experience were among those that quickly set up new operations in the emerging market. The findings suggest, on the one hand, that the role of previous experience is less important in such an environment. On the other hand, the slow adaptation of the experienced companies could be a result of a more in-depth analysis of the situation and better understanding of the risks involved than among the less experienced companies. This study, when analyzing the adaptation of operative strategies of the companies over a longer, 5-year span, will also try to analyze the roles of previous experience and learning as well as monitoring the changing environment in the adaptation process.

It was also found that many of the competitive advantages Finnish companies enjoyed within the bilateral clearing arrangement were lost when the system was abolished at the end of 1990. However, in the opinion of the Finnish companies, the marketing know-how, which consisted mainly of understanding of the Russian business culture, continued to be a significant competitive advantage of Finnish companies in the changed markets in 1991. This study attempts to analyze also the cultural features of both Finland and Russia based on international cultural comparisons in order to judge how justified this view of the Finnish companies actually was.

Another major finding of the licentiate thesis was that financial arrangements were a crucial part of the operations in the changed Russian markets. As they were practically excluded from company-level contracts within the bilateral clearing payment arrangement between Finland and the former USSR, the companies had to learn new skills, particularly in providing financing for their Russian customers. Therefore, this study also pays attention to the financial arrangements and their role in the adaptation of operation forms in Russia in greater detail. The financial behavior of the Russian companies in the transitory environment and under hardening budget constraints is also analyzed among the environmental factors of Russian transition.

1.1 Research questions

From the theoretical point of view, the first research question of the study can be formulated as follows: can western economic concepts be used for analyzing enterprise behavior in transition economies? This question, and the affirmative answer as implied above, will be dealt with in chapter 2 in connection with constructing the model of transitional adaptation.

The empirical part of the study in chapters 5 and 6 will try to answer the following three major research questions:

1) What kinds of operations have Finnish companies developed in Russia and the Baltic countries during 1991-95 and how has the turbulent environment influenced the strategies of the companies? This question is related to the particular path of internationalization that the Finnish companies have followed in the Soviet, Russian and Baltic markets. The question can be supplemented by two additional questions:
   - 1 a) Does the pattern of developing operational modes in the transition economies conform to the general internationalization pattern of Finnish companies as developed by Luostarinen?
   - 1 b) Can the strategic behavior of the Finnish companies under such circumstances shed light on the internationalization behavior in general?

2) How does extensive previous experience of operations in the former USSR influence adaptation to the changed circumstances in Russia and the Baltic countries? As indicated above, this question has two parts:
   - 2 a) Does extensive previous experience lead to slow adaptation?
   - 2 b) Does extensive previous experience lead to better understanding of the risks involved in the changing market?

   Since earlier research findings showed that the most relevant aspect of the extensive previous experience of the Finnish companies in the former USSR was understanding Russian business culture, a third related question can be formulated:
   - 2 c) How close or similar are Finnish and Russian business cultures?

3) What is the role of financing in developing new operational forms in Russia and, more specifically, how has the hardening budget constraint of the customers' organizations in the Russian and Baltic markets influenced operations of the Finnish companies?

1.2 Theoretical foundations

The macroeconomic framework of this study is the Russian economy's transition from the centrally planned economic system to a market-oriented system. As transition has taken place almost simultaneously throughout Eastern Europe, theory building concerning transition has so far taken place based on the experiences of those countries where the reform process was introduced somewhat earlier than in Russia. However, there is a large body of literature describing the various characteristics of transition throughout Eastern Europe since 1989, when the economic reforms were introduced in the former G.D.R., Poland, the former Czechoslovakia and Hungary, and the literature particularly on Russian transition, serves as an important frame of reference for this study.

When analyzing the transformation in Eastern Europe Csaba, among others, has concluded that there is no place for a general theory of transformation that could be of universal validity and transferable to any society of the globe. He also notes that due to the multidimensional nature of change, only multidisciplinary attempts may be adequate in addressing it (Csaba 1995, pp. 295-298). On the other hand, Benham et al. found, after reviewing 1494 articles on economics literature concerning issues of transition and reform in Central and Eastern Europe, that the relation of articles dealing with macroeconomic issues to those dealing with microeconomic issues was 5/1. Among the various topics privatization schemes were the most commonly researched issues but very little attention had been paid to institutional changes, information flows or credibility issues (Benham, et al. 1995, pp. 46-49).

The development of trade between Finland and Russia (the former USSR) has been analyzed in the literature mostly also from the macroeconomic point of view. This view was relevant for the foreign trade authorities of both countries as long as trade was conducted under long-term bilateral trade and payment agreements. Since 1990, when the last bilateral trade and payment agreement ended, trade between the two countries has not been governed by intergovernmental framework agreements, which would indicate the quantities and types of goods to be traded. It has been left to the companies.

The macroeconomic studies of bilateral trade between Finland and the former USSR analyzed in great detail the specific features of the bilateral trade and payment framework[2]. Most writers agree that the theories of international trade had only marginal relevance for Finnish-Soviet trade relations, among other reasons, because of fundamental differences in the determination of prices in both countries. Since 1990, with trade carried out in freely convertible currencies in a multilateral setting and with economic reform introduced in

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2 For a detailed account of the literature see Hirvensalo (1993a), pp. 24-29

Russia, those theories would seem more relevant. Due to the very short time period, not many studies have been carried out since 1991. However, the few overviews so far have revealed that the composition of Finnish exports to Russia after 1990 does not correspond to the comparative advantages of Finnish exports in general (Borsos and Erkkilä, 1995, pp 56-59, Kivikari, 1995, p.23). The tentative conclusion from those findings is that the export structure reflecting rapidly changing transitionary conditions on the Russian markets during 1991-94 most likely will not last long.

From the present study's point of view that finding illustrates the nature of the trade between Finland and Russia in the transitionary framework. It is also in line with the finding of the licentiate thesis that Finnish companies had lost many of their competitive advantages, which they used to enjoy under bilateral trade with the former USSR. Consequently, in the changed circumstances, trade flows cannot be easily forecast and the companies have to find new ways of operating to suit the requirements of the rapid changes in the market. Particularly in the field of providing financing for the Russian buyers, Finnish companies had to learn new skills. However, the expectations of the companies in the longer-term were such that exports to the Russian market and operations there will, at some point, again reflect the longer term comparative advantages of Finnish companies. Therefore, short-term expectations were different from long-term expectations, which presented a particular conflict for the companies.

Research on the behavior of Finnish companies within the bilateral trade framework has been more limited and fragmentary than the macroeconomically oriented research. This study will build mainly upon those that have analyzed the development of operation forms in Russia and the strategic adaptation of companies in that market (Korhonen 1984, Hirvensalo 1993, Hussi and Puolakka 1995, and Salmi 1995).

The approach of this study is interdisciplinary with the theoretical foundations built upon three major theoretical or conceptual frameworks of economics and business administration: the theoretical foundations emerging theories concerning the adaptation of enterprises in transitionary economies, the theories concerning the strategic behavior of enterprises, and the models of internationalization of a company. It is hoped that the interdisciplinary approach will help in shedding light and creating new insights into the process of adaptation to transition, which is not a widely researched topic from the microeconomic or management point of view.

1.2.1 Enterprise behavior in transition economies

The first framework of reference for the present study is the rapidly developing literature concerning the behavior of enterprises in the transition economies. The main theme in this literature is to analyze whether enterprises in the transition economies of Eastern Europe respond to stimuli from the emerging markets rather than continue operating as under the planned economy. The early and tentative conclusion from this research is a qualified yes, qualified in the sense that the stimuli are also mixed and it is not easy to determine which stimuli the enterprises are actually responding to. Particularly in Russia, where the economic reforms were started a couple of years later than in Poland, the Czech. Republic and Hungary, enterprises have been found to be slow to change their behavior.

This study will analyze that literature, first, in order to provide a description of enterprise behavior in the Russian environment during 1991-95 and, secondly, to provide a reference basis for the observed patterns of behavior of Finnish companies. More importantly, however, it will be argued that the transition behavior of the Russian companies is not just typical behavior in the specific Russian conditions but represents features of behavior under rapidly changing transitory conditions in general.

1.2.2 Strategic behavior in rapidly changing environments

The second framework of relevance to this study is the literature on the strategic behavior of enterprises and particularly the strategic behavior in rapidly changing environments. The fit between a company's operations and the environment is a crucial factor. Strategies, which are defined as distinct patterns in the behavior of organizations, aim at providing a best possible fit between the organizations and the environment.

The strategy literature suggests that companies have different strategic responses to rapid changes in their environments. Miles and Snow in their well known categorization of business strategies describe "Reactors" as the form of strategy which would be found in companies in transition (Miles and Snow, 1978). Quinn has described logical incrementalism as a way in which companies change their strategies as a response to environmental changes (Quinn, 1980) while Mintzberg has called attention to emergent as opposed to deliberately planned strategies (Mintzberg, 1977, 1989). Inkpen and Choudhury have recently argued that a deliberate strategy of not having a strategy at all would be an appropriate way of coping with rapid changes (Inkpen and Choudhury, 1995). The chaos theory or science of complexity has also challenged the idea of having deliberate strategies as a response to rapid changes. Their recipe for adaptation is to stay “at the edge of chaos” and it emphasizes the significance of informal connections and flexibility in the organization (Gleick, 1987, Wheatley, 1992, Bettis and Prahalad, 1994, Thietart and Forgues, 1995, and Stacey, 1995). The strategy literature also includes a concept which is particularly well suited for the analysis of transitionary market behavior, namely that of dominant logic, introduced by Prahalad and Bettis (Bettis and Prahalad, 1986, 1995). Using the concept of dominant logic and elements of the science of complexity a model of transitional adaptation will be formulated to incorporate the theoretical framework of this study. The model will then be used, first, to analyze the behavior of Russian enterprises and, secondly, to analyze the operations of Finnish companies in transitionary Russia.

The new operations of Finnish companies were mostly various forms of direct investments, which suggests that also the theories of foreign direct investments have relevance for this study. Of the various theories suggested to explain the development of foreign direct investments those that include a strategic approach are closest to the approach of this study. The strategic approach assumes that multinational firms, rather than just basing their decisions on relative cost advantages, aim first to increase their market power when considering foreign direct investments in new markets (Konings, 1995). This assumption coincides with many findings on the motivations of foreign investors in transition economies (EBRD Transition report, 1994, pp. 125-133, Watkins-Mathys and Hill, 1995). However, even if market power were the ultimate goal of foreign investors, the strategic approach would not provide additional insight into the adaptation and learning process of companies, which is the focus of this study.

1.2.3 Internationalization and operations in Russian transition

The models of internationalization refer to a step-wise development path of international operations. This line of research, often identified as the stages theories of internationalization, has been mostly Nordic-based (Johanson and Wiedersheim, 1975, and Johanson and Vahlne, 1977, Luostarinen, 1970, 1979) and initiated in the 1970's.

Luostarinen has created a model for the internationalization of a firm based on Finnish empirical data (Luostarinen, 1979). The model states, in brief, that the involvement of a firm in foreign operations follows a path which starts from less demanding forms of operations and proceeds to other operations in the order of increasing commitment and risk. The path is also influenced by strict adherence to plans, called lateral rigidity, which restricts the companies' perceptions of foreign opportunities in comparison to domestic opportunities. In addition, the internalization path is determined by three operational dimensions: product, operation form, and market. The step-wise path for products starts from goods and services and reaches systems and know-how at the mature state, the path for operation forms starts from indirect exports and reaches direct investments in production operations, and the path for markets starts from geographically, economically and culturally close markets and reaches distant markets only late in the internationalization process. The pattern was found very consistent in the early stages of internationalization but less consistent in the later stages of the process (Luostarinen 1979, pp. 181-195, Hirvensalo 1993, pp. 53-54). Moreover, a distinction is made in the model between inward-oriented, outward-oriented and cooperative forms of operations and the most common step-wise path has been found to follow the route from inward-oriented operations, mainly imports of goods and services, to outward-oriented operations as listed above, and finally to cooperative operations, such as joint ventures or other kinds of strategic alliances (Luostarinen, 1978, 1994).

The internationalization model of Luostarinen is based on the process of accumulating knowledge either through experience or information received in other ways. As a result of the accumulation process, the company's knowledge base concerning international markets and operations increases, which in turn influences the willingness to engage in additional international operations (Luostarinen, 1979, pp. 46-49). Accordingly, companies adopt more advanced forms of international operations after they have first learned to use and become comfortable with less advanced operational forms.

In my licentiate thesis a longitudinal analysis was carried out on the basis of three large consecutive FIBO[3] surveys among Finnish companies which had engaged in foreign operations. The surveys were carried out by Luostarinen and his research teams in 1976, 1983 and 1990 but had not been analyzed from the point of view of operational development in the USSR market before. The surveys were supplemented by a round of structured interviews among 42 Finnish exporting companies in 1991. It was found that the pattern of operational mode development in the former USSR differed from the pattern observed in other markets. Even though the surveys revealed a remarkably high involvement of Finnish companies in trade with the USSR, in one third to almost half of the companies included in the survey[4] the development of operational modes in Russia had been slower than in other markets.

There was also a difference in the observed pattern of operational development. In the former USSR direct-investment forms of operations were started much later than in other markets due to the restrictions imposed upon foreign investments by the USSR. Until 1988

[3] Finnish Internationalization of Foreign Operations Project

[4] The involvement of Finnish companies in trade with the USSR is measured as the share of companies which over the time of the 3 consecutive surveys had engaged in that trade either indirectly through intermediaries or directly.

companies were only able to establish representative offices in Moscow. However, construction project exports had developed at approximately the same pace in the USSR market as in other markets. Consequently the most experienced of Finnish companies in the former USSR markets had gained their experience predominantly from exports of goods, partial or turnkey projects, from participation in the bilateral working groups for scientific and technical cooperation, as well as from monitoring the market through representative offices in Moscow. Mostly the experience had thus been gained from outward-oriented operations, but efforts for creating cooperative operations had also played a special role in the learning process.

Another finding of the surveys revealed that extensive operational experience in the former USSR was related to slow adaptation to the changes in the market whereas some companies with very little previous experience adapted very quickly. Especially in Estonia, which at the time of the surveys belonged to the USSR, companies were “leap-frogging”, not following most of the stages in the common development path, and established subsidiaries very soon after it became possible in 1988, often without any previous experience of foreign operations in that market or of subsidiaries in other foreign markets. This finding, which has been confirmed in a later study (Hussi and Puolakka, 1995) is particularly interesting for several reasons. First, it illustrates the differences of the internationalization path on the level of the target country, on the one hand, and on the level of the firm, on the other hand. In general the pattern of internationalization has been found more consistent on the level of the firm than on the level of the target country (Luostarinen, 1994). The observed behavior of Finnish companies in Estonia clearly breaks the pattern on both levels of analysis. Secondly, it suggests that the dimension of geographic, economic and cultural distance takes precedence over the dimension of operational form in such circumstances. Finally, it suggests that the role of previous experience and learning is less relevant in an environment which is undergoing rapid and fundamental changes.

A third conclusion of the survey found that Finnish companies followed a somewhat different path of operative development in the former USSR than other markets. In particular, they developed non-investment production operations, such as production cooperation and contract manufacturing earlier in relation to direct-investment operations than they did on other markets. This study will pay special attention to the use of such operational modes that exemplify networking strategies in the transitionary markets of Russia. It will also investigate the role of inward-oriented international operations, such as imports and inward-oriented contract manufacturing within the broad pattern of internationalization, which includes inward-oriented, outward-oriented as well as cooperative forms of operations.

A fourth finding of the survey revealed that Finnish companies did not seem to have utilized their experiences in other markets in the development of operational forms in the USSR. The operational forms used in the USSR developed independently of other foreign operations of the companies. This is explained above all by the big differences between the market characteristics of the former USSR and the other markets. Most Finnish companies with extensive experience of operations in the USSR, had set up a special unit in the company headquarters to be responsible for the Soviet market. Such a centralized unit was necessary in order to deal with the monopoly buyers of the former USSR and to provide the Finnish authorities necessary information for negotiating trade protocols on the governmental level. However, the finding also adds a new dimension to the concept of lateral rigidity, which according to the model restricts the internationalization process of companies in general. It draws attention to the rigidities of various units within companies in developing operations in different foreign markets.

The present study aims to contribute to the development of the internationalization models by shedding light on the behavior of companies in the turbulent transitionary markets. Attention will be paid to the role of previous organizational learning in changed and continuously changing circumstances. In the transition economies companies can draw on earlier experience only to a limited extent because it is unlikely that they happen to have experienced similar changes somewhere else. As the leap-frogging suggests earlier experience may not be relevant in such circumstances. However, there is also the possibility that companies underestimate the importance of previous experience as well as the risks involved.

The model of transitional adaptation, used as the theoretical framework for the analysis of this study, differs from the stages theory of internationalization mainly in making a few factors explicit which are implicit in the other model, most notably the role of networking strategies and budget constraints. It is argued that the role of networking strategies, based on operational forms which have been established on the basis of networks rather than markets or hierarchies, is particularly significant in the Russian transitionary conditions. In the internationalization pattern only the cooperative operational forms, such as strategic alliances, are explicitly characterized as network-based. Likewise it is argued that the budget constraints of both Finnish companies and their Russian customers and business partners play a significant role in the transitionary adaptation.

1.3 Key definitions

The names of **Soviet Union** and **USSR** (Union of the Soviet Socialist Republics) are used interchangeably to refer to the former USSR until its disintegration at the end of 1991. **Russia** is used for the **Russian Republic** after the disintegration of the former USSR at the end of 1991. **The Baltic countries** refer to **Estonia, Latvia and Lithuania** both as socialist republics within the former USSR before becoming independent republics in 1991 and as independent countries after 1991.

Strategy refers to business strategy as the **pattern of decisions** in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals, and defines the range of business the company is to pursue, the kind of economic and human organization it is or intends to be, and the nature of the economic and noneconomic contribution it intends to make to its shareholders, employees, customers, and communities (Andrews, 1987, p. 13). In relation to the foreign operations of enterprises a narrower definition of strategy is used and strategy refers more specifically to the pattern of decisions leading to a choice of products, operational modes and geographic markets that a company subscribes to. **Networking strategies** refer to strategies aiming at building long-term relationships to other organizations without using factor markets or hierarchical expansion strategy. Examples of networking strategies include production cooperation, joint ventures, strategic alliances or partnerships (Williamson 1975, Johanson and Mattson 1989, Thorelli 1986).

Defined as a pattern of decisions strategy can either be **built upon formally accepted plans** or it can **emerge without formal plans** as an ad hoc response to the environmental requirements the company faces. In addition, strategy as a pattern of decisions can be **intended** ex ante and either intended or **nonintended** ex post (Mintzberg, 1976, 1989), the latter particularly in rapidly changing environments. The pattern-of-decisions definition of strategy also emphasizes the dynamic nature of strategies, which is an important point of view in this study. Moreover, although this definition was developed to describe business strategies in market economies, it is also broad enough to capture conditions in transition or even planned economies. The adjustment needed for it to apply also in the planned economy environment would be to substitute shareholders by the state. **Dominant logic** refers to the way managers conceptualize their business and make critical resource allocation decisions (Prahalad and Bettis, 1986).

The term **operation** is used for various kinds of marketing or production operations enterprises engage into. When analyzing the behavior of Finnish companies they refer to **outward-oriented, inward-oriented or cooperative foreign operations**, as defined by Luostarinen (Luostarinen, 1979, pp. 105-112). These are divided into four groups depending on, first, whether they are marketing or production operations and, secondly, whether they involve direct investments or not. The most typical operations following Luostarinen's classification (Luostarinen, 1970) are, first, **export operations** which are classified as **non-investment marketing operations**, secondly, **contract manufacturing or subcontracting** which is classified as a **non-investment production operation**, thirdly, **sales subsidiaries** which are classified as **direct-investment marketing operations**, and fourthly,

manufacturing subsidiaries which are classified as **direct-investment production operations**. Reference is also made to **imports**, which in the above terminology are the most common of inward-oriented foreign operations.

Adaptation refers to changes in the adopted strategies. **Transition, transitional** and **transitionary** refer to the change from the former centrally planned economic system to a market-oriented economic system. **Soft budget constraints** under the socialist system refer to the possibility of negotiating administrative pricing, subsidies, credit condition and taxes by using the lobbying power and party connections of the company's managers (Kornai, 1980, pp. 299-322, and 1992, pp. 140-145).

1.4 Organization of the study

After the introduction chapters 2 and 3 lay down the theoretical foundations for the study. Chapter 2 provides the theoretical framework for strategic behavior of enterprises in transition, which is based, first, upon an analysis of the Russian transition strategies identified in the transition literature and, secondly, upon concepts and strategies of change from the strategy literature. The model of transitional adaptation is built using those concepts to provide the theoretical framework for the study. At the end of chapter 2 the model is first applied to the analysis of transition behavior of Russian enterprises.

Chapter 3 provides the theoretical framework for internationalization as well as for cultural comparison between Finland and Russia. A comparison of the model of transitional adaptation and that of internationalization results in the conclusion that the pattern of internationalization is similar to transitional adaptation under stable conditions. A comparison of the Finnish and Russian cultures is carried out in order to judge the potential validity of the adaptation model for Finnish or Russian companies and place the Finnish companies' alleged competitive advantages in understanding the Russian culture into an international perspective.

Chapter 4 provides an overview of the economic environment in Russia and the Baltic countries during 1990-95, as well as of the development of Finnish trade and direct investments into those countries. The description focuses especially on the financial difficulties of the Russian enterprises and the implications of the soft budget constraints inherited from the planned system.

Chapter 5 describes the research methodology and design of the empirical part of the study and provides the case reports of the three case companies, Valmet, Ahlstrom and

Outokumpu. A list of the units of the case companies and persons interviewed during the research process is provided in the appendix 1. The questionnaire used for the survey in 1991 is provided in Hirvensalo (1993a). In 1992 the same questionnaire was used as a guideline for the interviews but only some of the questions were asked and they were also formulated in a more open ended form than in the previous year. The guiding questionnaire is provided in appendix 2.

Chapter 6 analyses the empirical findings of the study in two consecutive parts. The first part covers the strategies of Finnish companies as revealed in the surveys carried out during 1991-92. The second part covers the case studies as revealed in the interviews during 1993-95. The model of transitional adaptation is used as the framework of analysis for both of these periods. Chapter 7 summarizes the findings. The chapter discusses the findings in relation to research questions, draws theoretical implications from them and provides suggestions for future research. Finally it discusses the limitations of the study.

2 Models of strategic behavior of enterprises in transition

This chapter forms the theoretical framework for analyzing the strategic behavior of enterprises in transition. A model of transitional adaptation will be developed using an interdisciplinary approach, which combines concepts of business strategy and the literature analyzing the strategic behavior of enterprises in transition economies and particularly in Russia.

There are two main reasons for starting the analysis, in section 2.1, from studying the behavior of enterprises in transition economies. First, for foreign companies, Russian enterprises are potential customers or business partners, whose behavior is important to understand in order to build profitable long-term business relations. Secondly, it is argued that studying enterprise behavior in the Russian transitional environment which is undergoing thorough and rapid changes will offer insights into the behavior of enterprises in rapidly changing circumstances in general.

Even though they have not been developed specifically for the analysis of transition economies, certain concepts of the western economic literature on business strategies reviewed in section 2.2 are well suited for analyzing the behavior of enterprises in a transitionary environment, which is characterized by blurred ownership structures, soft budget constraints and ambiguous signals from other agents in the economy. Such concepts of particular relevance to this study include above all the dominant logic of the management and networking strategies. It is also argued that the survival behavior of Russian companies is an extreme example of enterprise behavior in rapidly changing circumstances and not typical only of transition from a planned to market economy. Based on the chosen concepts, a model of transitional adaptation is formulated in section 2.3 and applied to the behavior of Russian enterprises identified in the literature in section 2.4. In chapter 6 the model of transitional adaptation will be applied to the Finnish companies' operations in the Russian transitionary markets.

2.1 A review of existing theories of transition strategies in Russia

In the growing literature analyzing the developments in transition economies the behavior of enterprises has received increasing attention. One of the main interests in this literature is directed at analyzing to what extent enterprises have changed their behavior to correspond to the signals of an emerging market economy. While the early accounts detected certain kinds of seemingly unrelated behavior, the more recent analyses have found systematic patterns of behavior described as strategies. As the economic reforms were started earlier in Central Eastern European countries Poland, the Czech Republic, Slovakia and Hungary than in Russia, the early accounts on enterprise behavior deal mostly with changes in these countries after 1989. Reforms in Russia were introduced roughly 2 years later and consequently the literature on Russian enterprise behavior is more scarce and more recent than that covering Central Eastern European countries.

Among the early descriptions an account of the behavior of 9 Polish companies after the "Polish Big Bang", the so-called shock therapy introduction of economic reform, describes the drastic reduction of production, proportionately smaller reduction in employment, growth in interenterprise trade credits and growth in exports of the Polish companies (Gelb et al., 1992). A later and more comprehensive study analyzing case studies conducted throughout Eastern Europe describes similar behavior in greater detail and identifies three broad patterns of behavior which characterize enterprises in the central and east European countries (Carlin et al., 1994, pp. 7, 17).

These three patterns are: 1) restructuring, 2) passive, and 3) ambiguous behavior. In the first category enterprises are undertaking restructuring actions which appear to be broadly consistent with the development of a competitive market economy. In the second category enterprises show minimal organizational and behavioral changes and in the third category active behavior is recorded but it is unclear to which extent it is consistent with the furthering of the market economy reforms. The authors point out, however, that the extent of passivity tends to be under-reported and virtually all enterprises were passive in some respects.

More specifically, the restructuring pattern of behavior detected by the study included decentralization of decision making within the enterprises, splitting of companies into independent units and in fewer cases selling nonproductive assets or closing unsuccessful plants. The most common restructuring measures included setting up marketing departments and changes in production mix or lines. Labor shedding comparable to the fall in output was also recorded but a problem recognized with this development was that the most skilled workers left first because of low state sector wages in comparison to those in privatized companies. Major investments in new capital equipment were only available to enterprises which had accumulated profits. In all these forms of restructuring the study recorded a paucity of such behavior in Russia when compared to Poland, the Czech Republic and Hungary (op. cit. pp. 18-19). This is more likely due to the later introduction of economic reforms in Russia in comparison to the other countries than to the more passive behavior of Russian enterprises.

The passive pattern, in turn, included a lack of or very limited response to changed market conditions. Thus there was little organizational change, little development in the marketing system, and limited employment shedding compared with the fall in output, which all can be considered incompatible with behavior in a market economy. Failure to respond was attributed either to constraints faced by the management in attempting restructuring or low incentives for restructuring in comparison to high incentives for not doing so. The primary constraint on the ability of managers to restructure was the power of workers. Enterprises facing low incentives to restructure included companies in a dominant market position and companies facing soft budget constraints. Both situations offered shelter from financial pressures (op. cit. pp. 28-33). However, as will be discussed later, hard or hardening budget constraints are also likely to diminish the financial possibilities for restructuring, which suggests that from the point of view of initiating change, there exists most likely an optimal point of financial pressure.

The third category of behavior is called ambiguous restructuring, not only because of the motives behind it but because it is not clear whether in the long run the structures that are being formed are going to help or hinder the transition to a market economy. The study identified the following types of ambiguous restructuring: pursuit of market dominance; exploitation of existing non-market contacts with other enterprises, banks, parastatal associations and with government authorities; creation of internal and holding companies, and unproductive use of assets (op. cit. pp. 34-40). As these kinds of behavior can also be found in market economies, although not as widely used as in transition economies, the criteria of helping or hindering the transition to a market economy could be criticized as too limited.

A somewhat similar categorization of restructuring behavior is described by Ernst, Alexeev and Marer (Ernst et al., 1996). They first make a distinction between active and passive adjustment of enterprises noting that passive adjustment involves producing as much as possible with existing resources of items in demand, while drastically cutting production of those no longer in demand. Active adjustment in turn involves developing new products and changing production techniques or substantially increasing the capacity for products that are in demand (op. cit. p. 26). The three main categories of restructuring are described as 1) Strategic restructuring, 2) Defensive restructuring, and 3) Passive restructuring.

Strategic restructuring takes place when an enterprise develops and implements a comprehensive, long-term business strategy in response to a profound necessity or opportunity. Defensive restructuring involves measures aimed primarily at ensuring the enterprise's survival in the short run, such as neglecting investment in order to pay wages or selling assets for the same purpose. Passive restructuring or "asset stripping" as it is also called takes place when an enterprise's assets erode - whether legally or illegally - for personal gain.

The major difference between the two categorizations described above is their focus on time. While Carlin et al. differentiate behaviors according to compatibility with behavior expected in a market economy in general, Ernest et al. pay more attention to the difference between the short-term and long-term consequences of the observed behavior.

As far as Russian enterprise behavior, in particular, is concerned it is characterized by specific features, which could be at least partly attributed to the length of the centrally planned system prevailing in the country in comparison to other Eastern European countries and partly to Russian cultural characteristics. The End of Year Report of Russian Economy 1994 of the Russian Academy of Science offers an analysis of these characteristics (Russian Economy - 1994, p. 177-178). According to the report Russian enterprises are oriented above all towards the survival of the organization as a whole and of the working collective, in particular. Secondly, having lost most state subsidies and protectionist tariffs, the enterprises are finding new sources of protection comparable to earlier soft budget constraints on the level of regional administration. An additional feature of Russian enterprises is the de facto ambiguity of property rights even after most state-owned enterprises have been privatized and a corresponding orientation towards continuing help from the authorities, albeit more at the local level than before. The former powerful governmental ministries, which have turned into various kinds of associations, continue to play a significant role as sources of important economic and business information in an environment which otherwise provides very little reliable micro-level information. Informal contacts between groups of enterprises are also based on a specific kind of managerial code of conduct aimed at ensuring survival of the particular group of enterprises to which the companies belong (op cit. p. 179). Such groups are not necessarily formal organizations but enterprises which have long-standing business relationships with each other.

In addition to the above characterization of Russian enterprise behavior the End of Year report offers a categorization of restructuring strategies. Like the two analyses described above their categorization also has three different groups but instead of categorizing according to market orientation their groups are formed according to their attitude towards the state or other outside interest groups. The groups are: 1) enterprises which passively wait for governmental help in restructuring, 2) enterprises which initiate partial restructuring measures, e.g. establish marketing departments by themselves, but expect governmental or local public sector help to carry out any major restructuring, and 3) enterprises which are looking for a major outside investor to finance restructuring but wish to keep the controlling shares in the hands of the management. The last group of enterprises consists mainly of small or medium-sized enterprises. By far the largest group is the second group of enterprises, which are prone to expect the government to help them out in the restructuring process.

As the previous three studies have mainly highlighted the behavior and adaptation of former state-owned companies in Eastern Europe, the following two offer insights also into the behavior of newly created enterprises, which are less likely to emulate the behavior of old state-owned enterprises. When analyzing the formation of financial industrial groups in Russia, Starodubrovskaja notes how private capital first concentrated in the trade and financial spheres and only later began to diversify into the production sector (Starodubrovskaja 1995, p. 12). However, such diversification has taken place not only in large trade-financial structures but also in medium-sized commercial companies. Starodubrovskaja then identifies two fundamentally different types of structures which are close to financial-industrial groups in character and calls them 1) groups for development and 2) groups for survival.

Groups for development are formed primarily with a specific medium or long-term aim by combining industrial, trade and financial capital. They are oriented towards finding the most effective market strategy and exploiting the most profitable opportunities presented by the market environment. Groups for survival, on the other hand, seek primarily to help the enterprises within the group to survive hard times. Rather than orienting themselves towards market conditions these enterprises are oriented towards maximum isolation from the market by means of close economic links within the group, avoiding loss of control of the enterprises, preventing new financial structures from acquiring ownership of them, maintaining close contacts with official bodies and lobbying to secure benefits, privileges and protection of their market from foreign competition (op. cit. p. 13).

Pistor, Frydman, and Rapaczynski (Pistor et al. 1994) in turn have analyzed the investment strategies and objectives of Russian Voucher Privatization Funds[1], whose by far largest group of owners consists of new private nonfinancial companies. They identified four different kinds of strategies, which in their view appear to go beyond mere divergences of investment strategies, such as the differences among the Western funds that specialize in trading, venture capital, or real estate. Instead they seem to raise the question about the very reason why the funds take part in the whole game in the first place, since some forms of behavior do not seem geared toward profit maximization (op. cit. pp. 19-20).

The four strategies are described as follows. The purpose of the first group, called "managerialists" is to help enterprise managers solidify their control over their enterprises by collecting voucher capital from the citizens and channeling it into investment in certain enterprises, while at the same time using it to maximize the objectives of the enterprise management rather than in the interest of the funds' shareholders. It is assumed that the management of managerialist funds derives some benefits from this strategy which exceed the benefits of profit maximization. Illicit payoffs are not excluded either. The second fund grouping called "rent seekers" pursues profit maximization but views the prospects for the

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[1] Voucher privatization funds are mostly privately owned funds that issued shares of their own and invested the funds first in privatization vouchers and later in the shares of the privatized enterprises.

highest returns in companies receiving subsidies or cheap credits from the state or state-controlled institutions. Both of these strategies involve less adaptation to market conditions than the two other fund groupings, which are geared towards more conventional economic activities. The third grouping called "traders" concentrates on buying and selling securities on the secondary market and focuses on short term cash flow while the fourth grouping, called "restructurers" engages in shareholder activism in trying to increase the value of the companies in their portfolios in the longer run. Of the four groupings the traders were by far the largest. However, in reality the groupings are overlapping and in particular the largest funds seem to incorporate strategies typical to at least those of traders, restructurers and rent seekers. Managerialists were found mostly among the small or medium-sized funds (op. cit. pp. 30-33).

In their studies Starodubrovskaja and Pistor et al. focus not only on the extent the Russian companies orient towards the market, but more specifically to what extent their orientation seems to be in accordance with the profit maximization motive. Both studies identified groups, the survivalists and the managerialists, which apparently pursued goals other than profit maximization whereas the groups of development, restructurers and traders, behaved more according to the profit maximization motive.

Table 1 summarizes the different strategies described above. The strategies in the table are presented in the order of diminishing adaptation, which reveals clear similarities between the categorizations even though the criteria used to formulate them have been different. All identify a market-oriented long-term restructuring strategy even though it may not be widely adopted. All of them, including those which studied both old and newly created enterprises, also identify passive behavior, which is more common than the active restructuring strategy, but the descriptions of the passive behavior vary more according to the criteria used. It is also recognized, particularly by Pistor et al., that there are only few enterprises which adhere to one strategy only. Instead, the real strategies are combinations of the different types identified by the authors.

The use of different strategies at the same time seems in turn a sensible conventional way of hedging against risks inherent in each single strategy, particularly in highly inflationary and unstable conditions of transitionary Russia. Risk spreading is also identified by Prokop (Prokop, 1995, p. 39) as the key factor shaping the emerging conglomerates in Russia. However, when analyzing the financial expansion strategies of financial industrial groups Freinkman also argues that they have virtually no financial strategy at all for two main reasons. First, it is impossible to evaluate the financial position of Russian companies in the turbulent conditions, and secondly, the level of professionalism of the Russian companies is not high enough to carry out a financial evaluation (Freinkman, 1995, p. 60). To the extent that this is true for most of the financial industrial groups, it illustrates the significance of other criteria, e.g. personal contacts of the managers, in evaluating the Russian enterprises.

Table 1. Transition strategies in Russia in the light of five different studies

Focal dimension of each study	Description of strategies in the order of diminishing adaptation		
Orientation towards market[1)]	**Restructuring** spin off subsidiaries product changes new markets	**Passive behavior** soft budget constraints	**Ambiguous behavior** monopolies vertical contacts
Short-term vs. long-term orientation[2)]	**Strategic restructuring** new products new markets	**Defensive restructuring** selling assets	**Passive restructuring** asset stripping
Relationship to state or major investors[3)]	**Looking for outside investors**	**Partial restructuring** help needed for major restructuring	**Passively waiting for governmental help**
Profit maximization[4)]	**Groups for development** seeking most profitable opportunities	**Groups for survival** max. isolation from the market	
Profit maximization[5)]	**Restructurers** increase of portfolio in the long run	**Traders** short-term cash flow	**Rent seekers** lobbyists **Managerialists** entrenched control

Sources:

1) Carlin, Wendy, Van Reenen, John, and Wolfe, Toby (1994) Enterprise restructuring in the transition: an analytical survey of the case study evidence from central and eastern Europe, Working paper No. 14, European Bank for Reconstruction and Development, July 1994
2) Ernest, Maurice, Alexeev, Michael, and Marer, Paul (1995) Transforming the Core; Restructuring Industrial Enterprises in Russia and Central Europe, Westview Press, Boulder, San Francisco, Oxford
3) Russian Economy - 1994; End of year Report, Institute of Economy in Transition, Russian Academy of Sciences, Academy of the National Economy - Government of the Russian Federation
4) Starodubrovskaja, Irina (1995) Financial-industrial Groups: Illusions and Reality, Communist Economies & Economic Transformation, Vol.7, No 1, March 1995, pp. 5-20
5) Pistor, Katharina, Frydman, Roman and Rapaczynski, Andrzej (1994) Investing in Insider-Dominated Firms; A Study of Russian Voucher Privatization Funds, A paper presented at Joint Conference of the World Bank and the Central European University Privatization Project, 15-16 December 1994, Washington DC, Transition Economics Division Policy Research Department, The World Bank

Using the dividing line between survival-oriented behavior and profit maximization, Ickes and Ryterman have argued that the survival-oriented enterprises are unique to the period of transition. According to them such an organization is neither fully socialist nor fully market oriented, because it typically places more emphasis on current cash flow than on the long-run value of their assets (Ickes and Ryterman, 1994, p. 83). Ickes and Ryterman also suggest that a new theory would be needed to explain the behavior of enterprises in transition.

According to Ickes and Ryterman, the contrast between profit maximization and survival orientation is best illustrated by the phenomenon of growing interenterprise payment arrears and the fact that enterprises have continued to ship goods to other enterprises even when the prospects for payment were negligible. This in turn is explained by beliefs held by the enterprise managers about the behavior of other enterprises. When only one enterprise stops paying bills, the adverse consequences for that enterprise are immediate. However, if all enterprises stop paying their bills, they will likely avoid any consequences and under such circumstances the downside risk of not adjusting is low. (op. cit. pp. 91-92).

Ickes and Ryterman supplement their analysis of survival strategies by the following description (op. cit. p. 92):

> The potential for both adjustment and nonadjustment equilibria is a result of the *nonincremental* (original italics) nature of the changes associated with these strategies. Transition creates the potential for significant changes in the economic environment, and hence, to the strategies that agents choose. In such cases, agents cannot take the behavior of others as given. Rather, enterprise directors are forced to take the actions of other enterprises into account, accentuating the role that beliefs play in the strategy that the enterprise director ultimately chooses. In part, the speed at which the set of strategies selected by enterprise directors becomes stable depends on how quickly enterprise directors learn about their best strategy for survival - in particular, how quickly their beliefs are confirmed by actual behavior. This learning process is made all the more complex by the fact that other directors are engaged in a similar effort. This simultaneity of the process adds to noise in the system. When many agents are choosing strategies, the possibility for unexpected outcomes is high...... Given a set of beliefs, one can predict the particular equilibrium that is likely to be obtained.

The development of interenterprise arrears between Russian enterprises will be described in more detail in chapter 3 as part of the environmental description of this study. However, as the hardening budget constraints form a significant factor shaping the behavior of enterprises in transition, the findings of another study on privatization of industrial enterprises in Russia (Clarke, Fairbrother, Borisov and Bizyukov, 1994) are of interest here. Their study of four Russian case companies found four different ways of adapting to privatization. All four benefitted initially from a relatively prosperous financial position and were able to carry out a successful adaptation to market conditions where rising prices made it possible to maintain profitability. However, as their advantages eroded due to increased competition and ensuing hardening budget constraints, all four tended to look outside to secure their future, whether through parallel commercial and financial activities or through re-integration into state economic and political structures, while tending to re-establish traditional relationships in the production sphere. As a result, their distinctiveness in relation to state enterprises was eroded. This observation suggests that hardening budget constraints cannot be considered only stimulants for strategic change. At a certain point they may start inhibiting further change and even cause enterprises to readopt old strategies.

Like Ickes and Ryterman, Ernest et al. also discuss the need for new theoretical concepts for enterprise behavior in transition and note that the survival-oriented enterprises concentrate almost exclusively on the short-run due to a highly uncertain environment (Ernest et. al, 1996, pp. 256-257). They therefore suggest that if the implications of survival orientation can be obtained simply out of the shortness of the planning horizon, the concept of survival appears to be unnecessary. To the extent that the survival-oriented strategy is not caused by shortness of horizon, it, according to Ernest et al., reflects the desire of the enterprise director to safeguard his position. They claim further that in order to save his position the enterprise director is dependent on the support of the workers, which puts certain limits on the management. They conclude, however, that it is probably more reasonable to treat this mutual dependency of managers and workers as a short-term phenomenon rather than an intrinsic feature of Russia's corporate culture.

From the point of view of short-term vs. long-term orientation one can note that the short-term oriented behavior, which places more emphasis on the current cash flow than on the long-run value of assets, is also typical for companies facing drastic changes, like the threat of going bankrupt, even in market economies. In a critical turnaround situation the company does not really have the choice between short-term orientation, which places the emphasis on current cash flow and the long-term value of their assets (e.g. Whitney, 1987). If the company fails to produce enough cash flow in the short-run, the long-run value of their assets will also fall drastically if not disappear entirely. Consequently the main emphasis has to be on short-term survival, which is the precondition for increasing the asset values on long-term. From this point of view it can be argued that the short-term survival orientation is fully in accordance with the concept of profit maximization in the long term. However, from the point of view of Russian corporate culture, which will be discussed more in section 2.5, one could argue that the Russian cultural feature of collective orientation also contributes to the chosen strategies, which aim at survival of the work collective.

Also western management literature has criticized the concept of profit maximization as the main driving force for the behavior of enterprises and their managers. Most notably the notions of bounded rationality, satisficing and limited search introduced by Simon (1940), Cyert and March (1963) incorporate constraints on the aim of profit maximization. Profit maximization as a guiding motivation for companies in transition can also be criticized from the point of view that the concept of profit did not exist within the planned economies for ideological reasons. Therefore it is logical to assume that other motivations, which have been described as predominant motivations of enterprise managers in the planned economies still play a significant role in the transition economies.

Among the set of factors which motivated managers in planned economies, political power was one of the most important ones (e.g. Kornai, 1992). It could be argued that in conditions of limited and unreliable information relationships with power centers continue to be important in determining the behavior of Russian managers even though the monopoly of political power no longer rests with the former Communist Party. In its place other centers of economic power, governmental authorities and increasingly local authorities as well as banks have taken the place of party organs. One could also hypothesize that where the profit motivation plays a more significant role is among newly created private enterprises rather than among the old state-owned and privatized enterprises.

The role of competition is also a significant factor in market economies but was almost totally lacking in the planned economies (Starodubrovskaya, 1994). It is also a concept which is often misunderstood in the transition economies due to lacking information on how limitations of free competition are sanctioned in market economies. It can likewise be argued that it is not realistic in transitionary Russia to expect enterprises to behave according to the ideal especially when there are no effective legal restrictions to sanction forms of cooperation which limit competition between enterprises.

In summary, it is argued that the short-term orientation in transition can also be guided by other goals than profit maximization. For the purposes of the present study the main focus will be on the common set of beliefs or, what it could also be called, the dominant logic (Bettis and Prahalad, 1986, 1995) of the enterprise managers, which can incorporate either profit maximization according to economic theory or preservation of power or a combination of the two supplemented by still other goals. The dominant logic in turn influences the perceived need to change or not to change the enterprise strategies.

In transition economies the dominant logic of enterprises is being shaped by the change from planned to market economy. The major guideline for the companies within the planned economy was the fulfillment of the plan and the strategies of the companies were influenced mainly by the political power structure (Kornai 1992). In transition enterprises orient themselves towards the emerging markets and the dominant logic of the enterprise managers is influenced by their perceptions and interpretations of the ongoing change. The description of Ickes and Ryterman above is an illustrating example of the process through which the dominant logic of Russian managers is changing.

The mutual dependency of managers and workers, as described by Ernest et al. above, draws attention to the role of informal connections in the transitional behavior. Ickes and Ryterman in turn pay attention to the role of soft budget constraints, the simultaneity of the learning process of managers and the fact that enterprise managers are forced to take the actions of other enterprises into account when formulating their strategies. These observations also emphasize the informal connections between managers of different enterprises as well as the systemic characteristics of the strategy formulation process. They also suggest that the adaptation process could be described by a model which includes organizational learning, the belief structure of managers and hardening budget constraints as major elements.

2.2 Concepts and strategies of change and their applicability to enterprises in transition

The following section will provide an account of the major strategies identified in the western strategy literature and a brief analysis of their applicability to enterprise behavior in transition.

From the variety of definitions proposed for business strategy (Schendel and Hofer, 1979, pp. 8-13) the definition of Andrews (Andrews, 1987, p. 13) is used here as the frame of reference. Accordingly corporate strategy is defined as the *pattern of decisions* in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals, and defines the range of business the company is to pursue, the kind of economic and human organization it is or intends to be, and the nature of the economic and noneconomic contribution it intends to make to its shareholders, employees, customers, and communities. Although this definition was developed to define business strategies in market economies, it is broad enough to capture conditions in transition or even planned economies. The only adjustment needed for it to apply also in the planned economy environment would be to substitute shareholders by the state.

Strategy defined as a pattern of decisions incorporates the idea of evolution and change over time. The literature on corporate strategies also views strategies explicitly as a way of adapting to environmental changes. However, most of the strategies in the literature describe behavior in a relatively stable environment, where the changes could be forecast and patterns of behavior were developed over a relatively long period of time. Strategies coping with a turbulent environment have been a much less researched area but an area of growing importance and interest.

Due to the drastic environmental changes in transition economies practically all transition strategies are directed at coping with those changes. A common goal or motivating factor behind strategies of change in market economies is growth, which can no longer be attained by pursuing the initial strategies of the company. In transition, as discussed above, the emphasis is on short-term survival strategies, which may even seem to be in contradiction with profit maximization and also growth in the longer run. However, the above definition of business strategies by Andrews encompasses the goals and qualities of the organization as well as the nature of contribution it intends to make without tying them to any particular goal, which is why it also fits the transitionary conditions.

Growth strategies within market economies have been divided into two basically different kinds of approaches. First, there are generic expansion strategies which utilize unused resources of firms and develop mainly through organizational learning (Penrose, 1959, Chandler, 1962, Cyert & March, 1963). This approach, also called the evolutionary approach, uses strategies within the organizational hierarchy as opposed to using factor markets for expansion (Williamson, 1975, 1985, Thorelli 1986). Secondly, there are growth strategies which depend on the use of markets rather than internal development of operations. Mergers and acquisitions are examples of such strategies.

More recently attention has been paid to a third group of growth strategies, which are not based purely on either market or hierarchy but on a mixture of both. These can be called networking strategies. Peng and Heath (1996) have argued that networking strategies are particularly relevant in transition economies, where there are no unutilized resources to facilitate internal growth, where ownership rights are blurred and where corporate governance tends to follow the old patterns established during the centrally planned system. Salmi (1995) has also argued that evolution of networks rather than change from pure hierarchy to pure market illustrates the transition from plan to market.

In the literature networking is defined as a firm's effort to establish long-term relationships with other firms in order to obtain and sustain a competitive advantage (Johanson & Mattson 1987, Thorelli 1986). The networking approach emphasizes horizontal and informal relationships between organizations as opposed to hierarchical and formal relationships. In the western market economies the network-based relationships between firms take on various forms, such as strategic alliances, joint ventures, hybrid organizations, partnerships, or corporate groups (Johanson & Mattson 1987, Thorelli, 1986). In transition economies networks are generally less visible and take on such forms as old supplier relationships as well as informal relationships with banks and various industrial and semi-governmental organizations, which have developed as a result of the restructuring of the former ministries

(Starodubrovskaya 1994). An example of specific networking agents in the former centrally planned system were expediters (tolkachi), whose primary responsibility was to establish long-run personal relationships with other organizations for the purpose of procuring needed suppliers particularly in emergency situations (Grossman 1977).

Within the framework of internationalization process strategy has been used mainly to describe the choice of product, operational mode or geographic market (Luostarinen 1979) The above definition of business strategy, which describes strategy as a pattern of decisions, also emphasizes the process of strategy formulation. Therefore it also fits into the framework of the internationalization process, which is based on the notion of organizational learning leading to a particular path of internationalization. On the other hand, the stages approach to internationalization includes both the generic expansion of enterprises as well as market-based and networking strategies. Based on the above, particularly the networking aspects of operations in transition economies call for special attention in the adaptation of operation strategies. The similarities and differences between the model of transitional adaptation to be developed in section 2.3 and the model of internationalization will be discussed in more detail in chapter 3.

Strategy defined as a pattern of decisions also implies that there is a decision maker or a group of decision makers in the company, who choose the strategic actions from among several possible alternatives. The group of actors is here defined as the *dominant coalition* (Miles and Snow, 1978) in the company. In transitionary Russia the dominant coalition of the privatized companies is typically represented by the board, which has an average of 6-7 persons (Blasi, 1994, p. 15)[2]. The *strategic choice* emphasizes the view that the environment alone does not determine the behavior of the companies (Child, 1972) and that the dominant coalition has a choice of actions according to their perceptions concerning the environment (Weick, 1977). An alternative view to strategic choice is the so-called *ecology view*, which argues that the choice is determined by the nature of the organization and the environment (Hannan and Freeman, 1977). According to that view competitive selection weeds out those companies, which due to inertia are too slow to adapt. However, these two views need not be fully contradictory, because they could be viewed as two opposite ends of a dimension which depends on the managerial skills, on the one hand, and the degree of freedom that the dominant coalition either has or perceives, on the other hand, when adapting to environmental changes.

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[2] According to Blasi the typical board has 1 outsider (whose affiliation is not revealed by the study), 1 state representative and 4 insiders. In almost all cases the insiders are the general director and functional managers reporting directly to the general manager (Blasi, 1994, pp. 14-15). It can be assumed that the major changes in the combination of dominant coalitions of the Russian companies since the introduction of economic reform are the exclusion of communist party representatives and inclusion of other outsiders, who represent significant investor interests in the companies.

A third view is proposed by Mintzberg, who has introduced the concept of *emerging strategies*, which include the idea of not making explicit choices but letting the strategies evolve as a result of an ongoing process of learning as opposed to the idea of making explicit choices from among two or more alternatives (Mintzberg 1977, 1989). In transitionary conditions the radical, rapid and continuous changes in the environment are likely to emphasize the significance of continuous learning, which supports the fit of emerging strategies to such circumstances. Mintzberg has also distinguished intended, ex ante, strategies from the realized, ex post, strategies as well as from the nonintended but realized strategies.

In the process of organizational learning and adaptation the concept of *dominant logic*, introduced by Bettis and Prahalad (Bettis and Prahalad, 1986, 1995), plays a crucial role and provides additional insight into the dynamics of adaptation. Dominant logic was originally defined as the way in which managers conceptualize the business and make critical resource allocation decisions (Prahalad and Bettis, 1986, p. 490). It can also be viewed as a fundamental aspect of organizational intelligence, which is shaped by learning at the level of strategy, systems, values, expectations and reinforced behaviors (Bettis and Prahalad, 1995, p. 7). This analogy also emphasizes the interactive and mutually interdependent nature of the relationship between strategy and dominant logic. The concept of dominant logic seems particularly well suited for the analysis of enterprise behavior in transition, where companies are facing a major change from planned to market economy which in turn is likely to create a corresponding shift in the prevailing view of doing business among the enterprise managers.

The strategy literature makes a distinction between *corporate level* strategies and *business level* strategies. The corporate level strategies are designed to answer the question of which businesses and markets the company should be in and the business level strategies are designed to answer the question of how the company should conduct the chosen businesses.

The basic ideas behind the corporate level strategies are the financial and age balance of products based on the product life-cycle view. The most widely known of these portfolio strategies is the *Boston Consulting Group matrix*, which divides products into four groups, stars, cash cows, problem children and dogs, depending on the market share of the product and the growth rate of the market. By analyzing their portfolio of products using those dimensions companies can make strategic choices about products that should be developed and products that should be dropped from the portfolio (McNamee, 1985, pp. 138-173).

The BCG matrix offers a dynamic view which can help companies in adapting to changes in the market but which has also been criticized of being too limited as it is based only on two variables, the market share of the product and the growth rate of the market. In its simplicity, however, it probably could provide a useful tool for corporate managers in transitionary conditions where detailed economic data is scarce and unreliable. Due to the required longer-term view of the market development it is questionable, though, to what extent the early restructuring decisions of Russian managers to change the product portfolio and to seek new markets have been guided by the idea of a balanced product portfolio rather than the need to change most of the portfolio and start from those for which there seems to be demand in the short term.

Among the business level strategies Porter's well known generic strategy types, called *cost leadership, differentiation and focus,* which were developed within the industrial organization paradigm and based upon the idea of developing competitive advantages over competitors within an industry, do not specifically focus on the capabilities of the companies to change their strategies rapidly (Porter, 1980). Consequently, companies following any of those strategies are most likely to face great difficulties in adapting to rapid changes in their environment. However, companies pursuing two generic strategies at the same time might have greater flexibility to adapt and therefore also be more competitive in the longer run than companies following just one generic strategy (see Murray, 1988). The danger of "getting stuck in the middle" of two generic strategies and eventually failing because of that, as Porter suggests, is most likely smaller than getting stuck in one strategy when the environment is changing rapidly.

The relevance of Porter's generic strategies in today's transitionary Russia is also questionable, first, because in the planned economy enterprises did not compete with each other and consequently did not intentionally build competitive advantages. Secondly, the cost structure of enterprises was a result of administratively set prices, which the companies could not influence, and thirdly, the portfolio of goods produced was decided by the plan. In transition from plan to market all of these constraints have been lifted but it is unlikely that the enterprises would be able to make a deliberate choice between cost leadership and differentiation in the highly turbulent conditions. Persistent high inflation only would make that very difficult.

The strategies described by Miles and Snow (Miles and Snow, 1978), called *Defender, Prospector and Analyzer* incorporate features of both corporate level and business level strategies according to the distinction between these two level of strategies given above. Classified according to the Miles and Snow typology, all enterprises in the former planned economies would, by definition, be Defenders, because they were producers of a specific, often narrow line of products and were confined to that role by the plan. It can be argued that all of these strategies would most likely also lead the companies to great difficulties in coping with rapid environmental change[3], but especially the Defenders would be likely to miss the signs of change in their environment.

Miles and Snow also describe a fourth strategy, that of *Reactors*, whose pattern of adjustment to the environment is both inconsistent and unstable. Since the Reactor's strategy is typically found in companies in transitionary stages in their strategy formulation process (op. cit. p. 121), it is interesting to look at the reasons why it is described as failing to cope with environmental change. There are three reasons given for that: 1) management fails to articulate a viable organizational strategy; 2) a strategy is articulated but technology, structure and process are not linked to it in an appropriate manner; 3) management adheres to a particular strategy-structure relationship even though it is no longer relevant to environmental conditions (op. cit. pp. 81-82). Accordingly, instead of a strategy to cope with change it could be characterized as an inefficient way of reacting to change. It is described as unstable because if not changed it will cause the company to fail. A precondition for survival then is a successful change of strategy to a more proactive one. Of the above three alternatives causing companies to become Reactors, the third, which describes adherence to a particular strategy-structure relationship even though is no longer relevant, seems to fit the Russian transitionary behavior as described earlier.

Inkpen and Choudhury (Inkpen and Choudhury, 1995) have even argued that the presence of a strategy is perhaps not always true and that there is room for absence of strategy in enterprises. They point out that Porter's "stuck in the middle" and Miles's and Snow's Reactors are really examples of *not having a strategy at all.* They also claim that absence of strategy can be viewed as a transitional phase in a firm's life-cycle. According to them absence of strategy becomes a virtue when it is intentionally used as a constructive ambiguity or a symbol to enhance flexibility and adaptation to environmental changes.

Another, more flexible and dynamic view of corporate strategies and their development than those described above has also gained support. As most of the strategies identified in the literature tended to become rigid and actually hinder the company from adapting when facing radical environmental changes, Quinn introduced a strategy called *logical incrementalism* as a way to cope with environmental changes (Quinn 1980). Similar concepts to incrementalism had earlier been suggested by Lindholm as the science of "muddling through" (Lindholm 1959) and by Mintzberg as emerging strategies (Mintzberg 1977, 1989).

[3] One might argue that the Prospector strategy, which is based on the capability of finding and exploiting new product and market opportunities, would be well tuned to adapting to environmental changes. However, even that strategy can lock the company into developing such products and operations that become failures and not to develop enough capabilities of survival in very rapidly changing environments.

Especially the notion of emerging strategies, as pointed out earlier, includes the idea of not making explicit choices but letting the strategies evolve as a result of an ongoing process of learning whereas the notion of logical incrementalism is based on the idea of making explicit choices from among two or more alternatives.

Quinn developed the concept of incrementalism after studying a number of large multinational companies which had undergone important strategic shifts. Based on his findings he concluded that a synthesis of various behavioral, power-dynamic, and formal analytical approaches rather than analytical systems alone approximate the processes major organizations use in changing their strategies. He also noted that although the processes the companies used appeared to be disjointed or "muddling", they actually embodied a strong internal logic. In addition his analysis also showed that effective strategies tended to emerge from a series of strategic formulation subsystems within the companies and build on each other in an incremental way (Quinn 1980, pp. 16-17).

Quinn also pointed out that when encountering environmental change incrementalism deals actually with the unknowable, not uncertainty, because it involves forces of such great number, strength, and combinatory powers that one cannot predict events in a probabilistic sense (op. cit. p. 56). Therefore it is logical that one proceeds flexibly and experimentally towards specific commitments and makes those commitments as late as possible in order to narrow bands of uncertainty and to benefit from the best available information. According to Quinn incrementalism is a proactive rather than merely reactive change process and therefore unlike the reactor strategy described by Miles and Snow. Therefore it offers a model of behavior that, when skillfully managed, would facilitate adaptation to a changing environment.

However, applied to the transitionary conditions of Russia, incrementalism would probably not provide a sensible strategy, because the market change is so fundamental that enterprises could not build on their earlier experiences. As the name implies, incrementalists tend to take small steps that can be reversed if so needed and not to undertake big changes rapidly until the last possible minute. As such it is probably suitable for companies which have considerable slack resources so that they can survive hard times before their strategy leads them to take sufficient corrective action. In transitionary Russia most of the enterprises also do not have slack resources, even though those that face soft budget constraints could be viewed as such.

Johnson (Johnson, 1988) has also argued that incrementalism can result in a strategic drift as a result of a widening gap between the incrementally adjusted strategic changes and the environmental changes. According to Johnson this can happen when external stimuli are interpreted only in terms of an existing paradigm within the company and when managers believe that they are adapting to a changing environment when in fact they are only adapting to signals which coincide with the paradigm. In such a situation also the remedial solutions are constructed only within the bounds of the paradigm, which also could be described as the dominant logic of the management. This interpretation seems to be more in concordance with the recorded behavior of Russian companies in transition.

More recently introduced strategic concepts include *core competencies* developed by Prahalad and Hamel (Prahalad and Hamel 1990). The concept of core competence is applicable on the corporate level, as the BCG matrix , and it has four key components: 1) Corporate span, within which powerful core competencies support several products or businesses; 2) Temporal dominance, which emphasizes the greater stability of core competencies than that of products; 3) Learning by doing, which emphasizes the view that core competencies are gained and enhanced by collective learning of the organization; 4) Competitive locus, which suggests that competition between enterprises is essentially concerned with the acquisition of skills. Strategies based on the portfolio of core competencies offer a relevant point of view to the transition economies, where the products produced earlier no longer fulfill the requirements of the market, but where the skills of the work force could form the basis for building new competencies. It also offers a dynamic view based on organizational learning in changing circumstances. On the other hand, as the BCG matrix, it requires a longer-term view, evaluation and development of the competencies, which is likely to be difficult without outside help, particularly if the Russian companies wish to develop core competencies which are competitive on the global level.

Most recently the science of complexity, or chaos theories, have suggested an alternative perspective for strategic change processes (Gleick, 1987, Prigorine 1984, Wheatley, 1992, Bettis and Prahalad, 1994, Thietart and Forgues, 1995, Stacey, 1995) based on the view that enterprises are complex nonlinear network feedback systems and behave accordingly. This implies that the behavioral patterns of such complex systems would offer insights into how enterprises change and adjust their behavior. The following account deals with the properties of complex systems using the analogy of Boolean networks and self-organizing systems. Chaos theories include also other concepts which will not be dealt with here.[4]

The perspective of complex systems is concerned with the dynamics of whole systems. Stacey (Stacey 1995) describes a Boolean network as an example of a complex system. The network consists of a number of cells, which are connected to other cells. The cells receive

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[4]The chaos theories also include the concepts of *strange attractors*, which create implicit order within chaos when the apparent random behavior gets "attracted" to a given space and remains within its limits, *bifurcation process*, through which the system moves from one state to another in a discrete way, *scale invariant properties*, which means that the system reproduces at a smaller scale what is observed at a more global level, and *irreversibility of the system*, which means that it is most unlikely that the initial conditions will be reproduced in a reasonable future (Thietart and Forgues, 1995)

inputs from some or all of the other cells as well as send inputs from some or all of the other cells depending on how the network is configured at a given time. In case the cells are light bulbs that are lit through the inputs they receive from other cells, a different pattern of lights is seen depending on the number of connections between the cells. When there are only a few random connections, e.g. when each cell is randomly connected only to two others, the whole system soon settles down into a fixed orderly pattern of stable patches of light. Thus random local rules of behavior can result in emergent order at a global level even though there is nothing in the random individual decision rules (other than the number of them) which determines it.

As a richer pattern of interconnection is established the system becomes more changeable until, when every cell is connected to every other cell, the system becomes random, with patterns of behavior changing so fast that it is difficult to make any sense of them. Thus the system produces simple stable behavior when interconnectivity is sparse and random patterns when connectivity is very rich. However, just before such systems go completely random, at the edge of chaos, another pattern of behavior emerges. That pattern has coherent structures that grow, split apart and recombine in different unpredictable patterns in a never-ending way.

Stacey argues that while the formal reporting structures in an organization have nothing random about the interconnections between persons, the informal organizations are what is to all intents and purposes a Boolean network. The implications of this analogy for organizations suggest, first, that stable organizations are those in which there are relatively few informal connections between people within and across organizational boundaries. Secondly, they suggest that when an organization has an informal system in which there are rich, random patterns of connection, that organization produces a great variety of behavior and becomes changeable. The possibility of emergent changing order out of the rich connectivity is thus dependent on the feedback networks of the system.

According to Stacey human systems are driven by feedback loops, in which free choice, institutional and other environmental constraints are present and the state these systems occupy is the result of their actual histories. The circular feedback nature of choice, action and outcome, which includes both negative and positive feedback loops, also leads to a complex connection between cause and effect. Due to the nonlinearity and positive feedback loops behavior patterns can emerge without being intended and produce unexpected, even counterintuitive results. Due to these properties the results are also very sensitive to the initial conditions, which means that small differences in the initial conditions can lead to significant differences in the outcomes.

What the analogy of the Boolean network does not capture, however, is the nature of human learning as opposed to the connectedness of light bulbs. Stacey points out that inertia in organizations explains why some of them fail and are weeded out by competition. Another way to fail according to him is to come up with an inappropriate outcome for the particular environment. One can argue, however, that the success or ability to come up with an appropriate outcome for the particular environment depends on the ability of the individuals and organizations to learn from the informal connections which they engage in.

Prigorine (Prigorine and Stengers 1984), after observing the behavior of chemical clocks, introduced the concept of *self-organizing systems*, which has become an integral part of the chaos theories. He noted how molecules "communicated" and acted in simultaneous coordination even though there was no identifiable center of command (brain), which would have disseminated such information. When organizations are seen as systems consisting of intelligent actors like human beings, the properties of self-organization can also be attributed to them. Such properties imply fast learning abilities and would be especially valuable in circumstances which require rapid adaptation to environmental changes. The concept of emerging strategy comes close to fulfilling this requirement.

Even though the application of the chaos theories to organizations has not proceeded very far, the perspective of the science of complexity offers several implications for the strategic literature reviewed above, especially for strategies in turbulent circumstances. First, the strategic choice view needs to be supplemented by the nonintended and emerging outcomes of the interactions within the informal networks. Secondly, for an organization to become adaptive and innovative the strategic choice relates to the organizational dynamics, the development of information and communication networks, rather than to specific outcomes of the chosen strategy.

In order to reach that end the organizations should operate in a state of rich informal connectedness, "at the edge of chaos", where long-term outcomes cannot be predicted. In practice this calls for spontaneous self-organization rather than planning and following formal rules and procedures. As Stacey points out this view comes close to the ones of creative destruction and spontaneous self-organization proposed by Schumpeter (Schumpeter, 1934) and Hayek (Hayek, 1948).

The above discussion on strategic concepts and strategies of change can be concluded by arguing that the perspective of the science of complexity offers a framework which incorporates many of the characteristics of the various business strategies identified in the literature. It provides an explanation based on systemic properties of informal networks for the birth of stable patterns of behavior, of which there are many examples in the strategic literature and, among other things, a bridge between the alternative views of strategic choice, on the one hand, and determinism, on the other hand. It also provides an explanation for changing patterns of behavior, which is of particular interest for adaptation in rapidly changing environments. Finally it explains the circumstances, which give rise to chaotic behavior. Supplemented by the notions of dominant logic and organizational learning it also provides a general framework which will be used as a frame of reference for the following analysis of strategic behavior in Russian transition.

2.3 A model of transitional adaptation

This section describes the model of transitional adaptation (depicted in Chart 1), which is based on models of learning and adaptation (Levitt and March, 1988, Weick, 1991, Bettis and Prahalad, 1995) and also incorporates ideas derived from the science of complexity by allowing influences of both environmental data and informal connections to enter the adaptation process. These influences are filtered through the dominant logic prevailing in the enterprise as depicted by Bettis and Prahalad (op. cit.). A distinction from many other adaptation models is that the budget constraints are given an explicit role in this model. This is, first, due to the fact that hardening budget constraints constitute a new constraint for enterprises used to the soft budget constraints under central planning. Secondly, performance, is very hard to evaluate and measure in the rapidly changing transitionary conditions. Thirdly, budget constraints can be considered relevant guidelines for the enterprises especially in adaptation to transitionary conditions in the short run. On the other hand, for foreign enterprises operating on many different markets the budget constraints of those particular units which are operating in the transitionary markets can also be considered a more relevant factor in the short run than the overall performance. In their case the budget constraints also incorporate the view of the management about the size of investment that can be risked in the target market. However, in the longer run performance greatly influences the budget constraints imposed on the units.

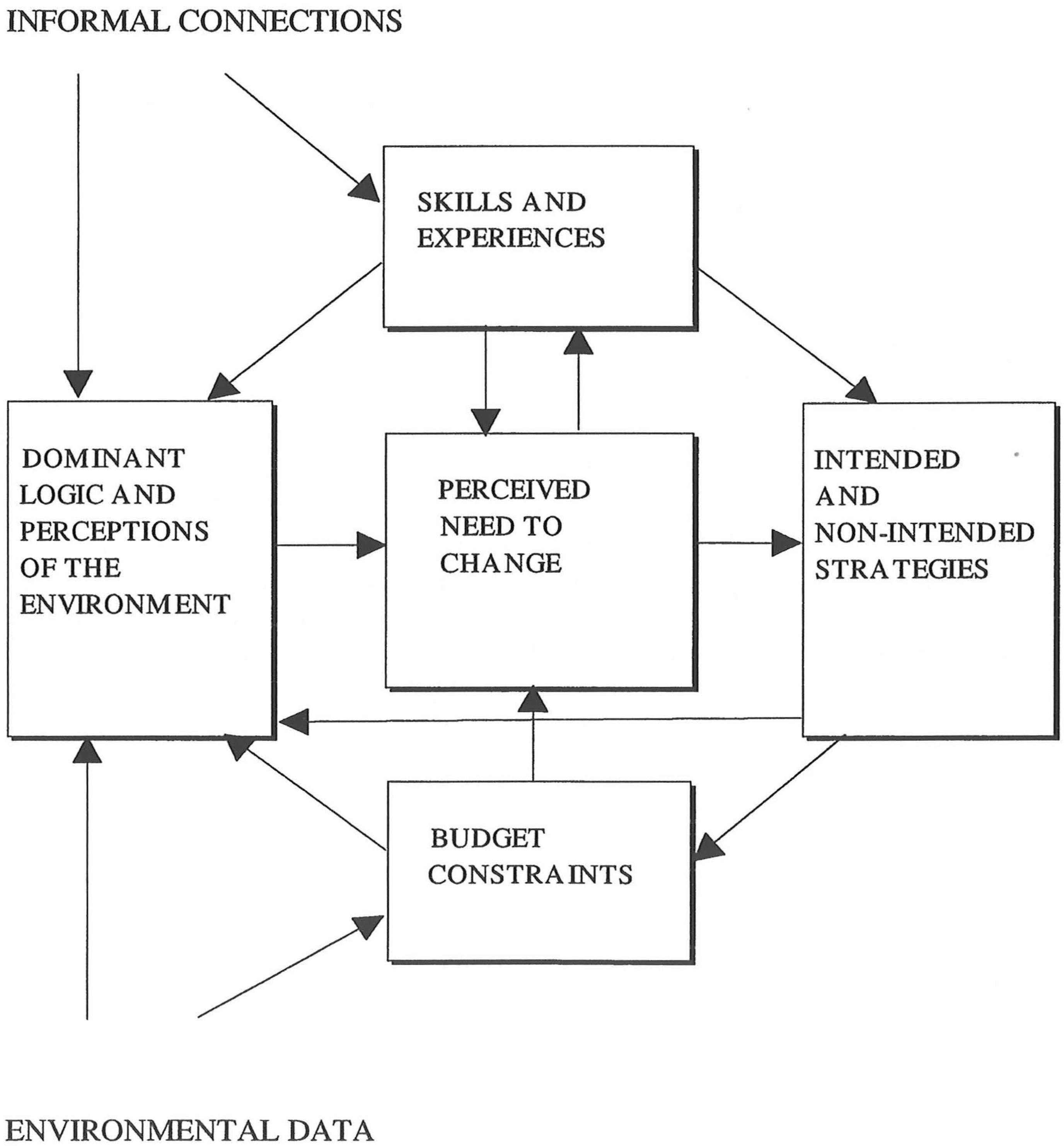
In the model enterprises face three major groups of constraints when making strategic choices:

1) environmental constraints, which here include the connections and interactions with actors outside of the enterprise,
2) constraints that stem from the dominant logic of the enterprise managers, and
3) resource-based constraints, which include both financial and skill-related constraints.

Accordingly the changes of strategy are influenced by these three groups of factors, which are not, however, independent of each other.

As the science of complexity implies and the characterization of dominant logic clearly points out, there is not a one-way causality that ties strategy (and other variables) to the dominant logic. Instead, there is an interactive feedback loop, which in turn suggests that simple linear models that seek to relate one to the other in a simple causal fashion are not likely to be appropriate (Bettis and Prahalad, 1995, p, 7). However, even though it is not possible to ascertain the direction of causality or the magnitude of change in the strategy emerging as a result of the influence of the variables independently or of their interaction, it is possible to gain insight concerning the relationships by studying the process of strategic change in companies.

Chart 1 Model of transitional adaptation



In addition to the three major groups of constraints the analysis includes a concept called *perceived need to change*, which is derived from the idea of dominant logic. Instead of looking at an objectively derived need to change their strategy, companies are limited to the perceptions of their dominant coalition to guide the strategy formation. These perceptions are filtered through the dominant logic within the management. Accordingly, changes in the environment of the company might be interpreted either as changes which bring about a need to change the strategy or as changes which do not spur a need to change the strategy depending on what is the perceived fit or difference between the environment and the dominant logic of the management.

If the dominant logic within the enterprise is very powerful and/or the environmental changes small, no difference between the environment and the dominant logic is noticed and consequently no need for change is perceived. Also if the perceived environmental changes do not make any sense, they are unlikely to bring about a need to change. However, if the dominant logic is weak and/or the environmental change significant as presented in the environmental data and through informal connections, it is more likely that a difference between the dominant logic and the environment is detected and leads to a recognized need to change.

The dynamics of the model are briefly described in the following:

The dominant logic or common intelligence of the enterprises is represented and shaped by the skills and experiences of the people in the organization. If a need to change is born, it will provide an incentive for learning, which in turn will shape the dominant logic. It will also influence the choice of skills that the enterprise seeks to employ. On the other hand, the existing skills and experience filtered through the dominant logic will condition both the learning process and limit the search for new skills to the domain that is visible to the management and which it feels it can control. The learning process in turn is influenced directly by the number of connections that the enterprise has both with the outside world and within the company, so that the greater the connectivity the faster the learning and adaptation.

Budget constraints can be seen to influence this adaptation process in two basically different ways. Kuitunen has, among others, identified two different ways in which slack (or soft budget constraints) influences the innovation process of a company. Within the first, a virtuous circle, organizational slack is likely to prompt paradigm-driven development of technology guided by the overall strategy of the firm. Within the second, an inertial circle, organizational slack is likely to result in maladaptive behavior, which is irrelevant in the particular environmental conditions (Kuitunen, 1993). From the point of view of adaptation to transition it can be assumed that the second kind of inertial circle is more prevalent in the initial stages of transition than the first virtuous circle, because in the turbulent environment enterprises have problems in formulating an overall strategy, which could guide them in the adaptation process. As budget constraints get harder, the reduced slack is likely to prompt environmental scanning, in which the skills and connectivity of the key persons play a significant role.

According to Kuitunen (op. cit.) the slack resources were seen to slow down the adaptation of Finnish companies to the fall in exports to Russia particularly in 1991, whereas the hardening budget constraints after that limited the strategic choices to those which did not require major investments. Soft budget constraints or slack resources seem to be needed in order to finance significant changes in operations, which are in accordance with the main strategies of the company. On the other hand, hard and/or hardening budget constraints are both likely to increase efficiency but also passivity, especially in a situation where environmental changes call for a strategic change.

In the model of transitional adaptation the two main factors described above, 1) perceived need to change, 2) skills and experiences of the enterprises influence the strategies directly. Those strategies can be either intended of emergent. The chosen or emerging strategies influence in turn budget constraints, which can become harder or softer. Budget constraints in turn influence the way the enterprise perceives and interprets the environment and provides the feedback loop to dominant logic.

2.4 Model of transitional adaptation and behavior of Russian enterprises

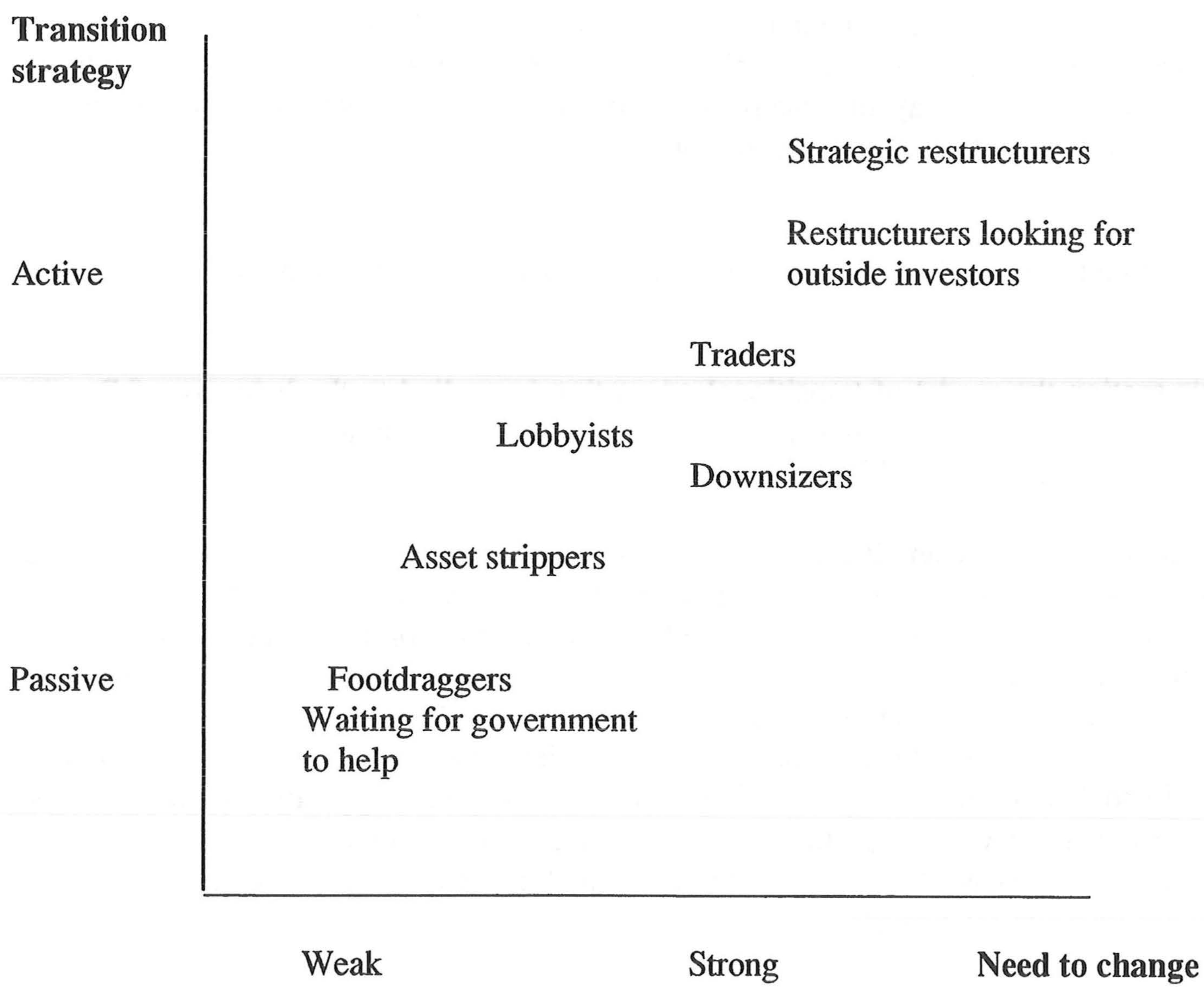
In this section the model of transitional adaptation is applied to the behavior of Russian enterprises as described in the transition literature and to a more limited extent by the Finnish managers interviewed for this study.

In transition economies, and Russia in particular, the changes in the environment have been so spectacular since the beginning of economic reforms in 1989, that they are clearly visible to everyone. However, the perceived need to change behavior accordingly is not equally clear due to different perceptions of the company managers about the dominant logic of the transition economy as opposed to that of their company. While others see the economic changes as irreversible and producing new opportunities which call for a change in behavior, others do not believe in their irreversibility or do not see any new opportunities which would justify changed behavior. A particular reason in Russia for not detecting reasons to change has been the success of enterprises in lobbying for cheap credits and the build-up of interenterprise and tax arrears.

In addition to differences in the perceived need to change there are also differences in the connections, skills and budget constraints of the managers, which in turn cause some companies to be active and others to be passive in introducing change. As pointed out above some active skills have also been channeled to lobbying for continuing soft budget constraints instead of adapting to hard budget constraints.

In chart 2 below enterprises in transition are placed in different theoretical categories according to the level of their perceived need to change and their activity or passivity in adapting to their changed environment as represented in the transition literature reviewed earlier. Being active in turn is defined as engagement in new activities and/or operations whereas being passive is defined as sticking to old routines and/or even diminishing them.

Chart 2 Transition strategies of Russian enterprises



It is further assumed that the level of activity is dependent on three different characteristics of the companies: the skills of the managers (dominant coalition), and the connectivity of the key players to change agents, in other words their level of networking, and the stringency of budget constraints. A low level of activity is the result of low connectivity to the outside (or inside change agents) and/or a low skill level of the managers. A high level of activity is, likewise, the result of high connectivity to change agents and/or a high skill level of the key players. Soft budget constraints or slack are assumed, initially, to keep the level of activities low, whereas hardening budget constraints are assumed to increase the level of activities

The groups are labeled: 1) strategic restructurers and restructurers looking for outside help, 2) traders, 3) lobbyists, 4) asset strippers and downsizers, as well as 5) footdraggers and they represent different hypothetical outcomes of the model of adaptation presented above.

The group of strategic restructurers recognizes the need to change and works actively to produce that change either entirely on their own or trying to identify outside investors who could provide the needed funding. However, they want to keep full control of the companies in their own hands. The group of traders recognizes the need to change, but they are mostly short-term oriented and opportunistic. They have wide connections both to restructurers and footdraggers and utilize the opportunities that open for trading in the restructuring process. Restructurers are also likely to start from trading, which will provide funding for more fundamental restructuring.

The group of lobbyists does not recognize a significant need to change, because it believes in survival by lobbying for soft budget constraints and directs its activities accordingly. Its connections are mainly to enterprises, authorities or politicians which hold the same view. Their strategies aim at defending the status quo in the short or medium term.

The group of downsizers also recognizes the need to change but mainly due to the hardening budget constraints caused by decreasing sales. They downsize production but do not shed labor in proportion to the fall in production. Their passivity is caused by a lack of management skills in the new situation as well as a lack of connections to market-oriented customers or to influential authorities. Their strategies are extremely short-term oriented and inconsistent.

Finally the groups of footdraggers and asset strippers see no need to change, because they believe that the government will have to help them out, anyway. The footdraggers are also passive in working for the enterprise and the asset strippers direct their activities to those that produce personal gains only. Their strategies are also short-term oriented and inconsistent from the enterprise's point of view.

These strategies have much in common with those identified earlier in the transition literature even though the categories differ somewhat reflecting the differences in the dimensions used. Most strategies are short-term oriented, but for example the lobbyists can be considered to be motivated by a longer term view based on the belief in their political clout.

The potential dynamics of that configuration of enterprises can be described as follows: The traders are likely to proceed to restructuring if they are successful enough in collecting the necessary funding for new investments. If not, they are likely to turn into lobbyists because they have a wide contact network which can be used also for that purpose. The lobbyists, if successful, will most likely continue that strategy, but if not, they will probably become traders and potential restructurers because of the wide network they have.

The downsizers in turn are likely to become active lobbyists or passive footdraggers depending on the development of their connections to other actors. It is unlikely, though that they would move directly to trading or restructuring due to their initial low level of connectivity. The footdraggers are likely to become failing companies unless they also resort to lobbying and become successful at it.

For the economy as a whole this dynamic view suggests that the authorities of Russia, both at the federal and local level are in a crucial position to influence the perceptions of enterprises about the need to adapt. If the authorities are consistent in pursuing a tight monetary policy, or if the monetary policy is credible, an increasing number of enterprises will undoubtedly recognize a greater pressure to change. If the monetary policy is too tight, an increasing number of companies will resort to lobbying for the status quo and the political power relations will finally decide which view will prevail. According to the perspective offered by the science of complexity, small changes in initial conditions can cause significant changes over relatively short periods of time due to the complicated positive feedback loops in the system. Such a small change could be the entry of a well trained, resourceful and widely connected person into the network. However, due to the complexity it is not possible to predict the outcomes of such changes.

What are the implications of the model for Russian transitional strategies? First and foremost the implications relate to the informal networks of enterprises in transition. In order to become adaptive the enterprises would have to have a rich network of informal connections, which would bring in new ideas and a spirit of experimenting into the company. It seems that some descriptions of the behavior of new investment funds would fall into this category. However, the evidence so far indicates that most of the enterprises are passive and do not change their behavior readily. This in turn implies either that the informal connections of those enterprises are still scarce or that the learning process conditioned by the dominant logic is very slow. An additional cause reflecting the budget constraints could be that the companies either have no slack resources to increase environmental scanning or due to slack resources or recourse to soft budget constraints can survive without adapting their behavior.

Is there something in the above description that would differ from adaptation strategies in market economies? Could it be argued that the survival behavior of Russian companies is an extreme example of behavior of companies in rapidly changing circumstances and not typical only of the transition from planned to market economy? It has been pointed out above that a peculiarity of the Eastern European and especially the Russian transition has consisted of the soft budget constraints inherited from the centrally planned system. Such practices are not non-existent in market economies but certainly not as prevalent as in Russia. Again according to the logic of complex systems even small initial differences can lead to big differences in the outcomes. Therefore the specific strategies and processes described above may be specific to Russian conditions only. However, the model of adaptation is a more general model, which could serve as a frame of reference in a wider context.

3 Internationalization and cultural comparisons between Finland and Russia: theoretical framework and implications

In this chapter a comparison will be made between the model of internationalization particularly at the mature stage, which fits the situation of the Finnish case companies of this study, and the model of transitional adaptation presented above. It is argued that the step-wise internationalization process can be considered similar to transitional adaptation under relatively stable conditions. Therefore the research questions which relate mostly to the development of international operations in the transitionary markets can also be answered by using the model of transitionary adaptation. It is argued that the model of transitional adaptation can provide insights into behavior which has been found to differ from the general step-wise internationalization path particularly in rapidly changing environments.

Section 3.2 discusses in turn how cultural differences between the Russian western market economies are likely to influence the model of transitional adaptation and looks at cultural differences particularly between Finland and Russia. It is hypothesized that Russian cultural characteristics are likely to enhance collusive behavior and passivity among the Russian enterprises. It is also suggested that the Finns are overconfident in believing that they have a competitive advantage based on understanding the Russian business culture in comparison to other western nations.

3.1 Comparison between the model of internationalization and model of transitional adaptation

The internationalization model of Luostarinen (Luostarinen 1979) is based on the notion of organizational learning and describes internationalization as a strategy of growth in small and open economies. According to the model the internationalization process is conditioned by lateral rigidity, sticking to earlier patterns of behavior, which causes companies to prefer known alternatives to unknown ones and leads the company to a path of logical incremental steps in the process of internationalization. The model implicitly assumes relative stability on the foreign markets where the company expands its operations, because learning from past experiences is only applicable in sufficiently stable markets where those earlier experiences are relevant. Risk aversion and uncertainty avoidance is also one of the guiding behavioral characteristics of the model.

According to the outward-directed internationalization model of Luostarinen firms follow a path from a non-investment type of marketing operations, such as exports of goods and services, to direct investment marketing operations, such as sales subsidiaries, and further to non-investment types of production operations, which are often based on various kinds of cooperation forms with the organizations in the target countries, before entering the most advanced stage of making direct production investments. The inward-directed international operations can also be divided into marketing or production operations which either involve direct investments or do not involve them. Imports of goods or services are the most common inward coming international operations and they represent non-investment marketing operations. Joint ventures with foreign partners operating in Finland represent in turn inward coming direct investment operations. The third category of foreign operations, cooperative operations, are described as strategic alliances.

In an empirical study concerning the internationalization of Finnish family firms Luostarinen and Hellman (Luostarinen and Hellman, 1995) concluded that the most common path of internationalization, not only for family firms but for all firms, started from inward-oriented operations, developed through outward-oriented operations and led finally to cooperative operations. A competing, but less commonly followed path started from outward-directed operations, developed using also inward-directed operations and led to cooperative operations. In only exceptional cases had the internationalization path started from the cooperative operations (op. cit., pp. 14-18).

The international operations as described by the model of internationalization encompasses all three general growth strategies of enterprises, which are hierarchical expansion, expansion through market, and network-based expansion (Williamson 1975, Thorelli 1986). Most of the international operation modes can be categorized according to the mode of establishment either through hierarchy, market or networking. Table 2 provides such a categorization. In the table a distinction is made between the hierarchical and market-based growth strategies, on the one hand, and network-based growth strategies, on the other hand, on the basis of the degree of ownership and control. Accordingly, a wholly owned subsidiary is considered either hierarchical or market-based depending on the establishment basis whereas all joint ventures are considered network-based growth strategies[5].

As the table indicates, most outward-directed operation forms chosen by firms on the path of internationalization can be established either within the hierarchy, on the basis of factor markets or on the basis of networks. However, there are a few operation modes which can only be established on the basis of networking, such as indirect exports and most of the

[5] This categorization combines two approaches, the establishment mode approach and ownership and control approach suggested by Hentola and Luostarinen, 1995.

Table 2. International operation forms according to the mode of establishment

Operation form (outward directed)	Mode of establishment
Non-investment marketing operations	
Indirect exports	Networking
Direct exports	Hierarchy
Service exports	Hierarchy
Know-how exports	Hierarchy
Partial projects	Hierarchy
Direct-investment marketing operations	
Sales promotion subsidiaries	Hierarchy or market
Warehousing units	Hierarchy or market
Service units	Hierarchy or market
Sales subsidiaries	Hierarchy or market
Non-investment production operations	
Licensing	Networking
Franchising	Networking
Contract manufacturing	Networking
Turnkey projects	Hierarchy
Coproduction	Networking
Direct-investment production operations	
Assembling units	Hierarchy or market
Manufacturing units	Hierarchy or market
Portfolio investments	Market

Sources: Luostarinen Reijo (1989), Internationalization of the firm, The Helsinki School of Economics; Hentola Helena and Luostarinen Reijo (1995) Foreign subsidiary: The concept revisited, Helsinki School of Economics and Business Administration, Centre for International Business Research Working Papers Z-4; combination of the forms and modes made by the author non-direct investment operations, such as contract manufacturing or coproduction. Accordingly, the internationalization path of a firm could, in theory, follow either hierarchy, market or networking strategies. For example, a fully hierarchy-based internationalization path would develop from direct exports, through wholly owned sales subsidiaries to wholly owned production units but skip most of the non-investment production operations. A fully market-based path could in turn start from acquisition of a sales agent and lead eventually to acquisition of a production unit and skip all non-investment operations. Finally, a fully network-based path would start from indirect exports, develop through various cooperation forms and lead to marketing and production joint ventures. In reality, however, the internationalization paths are combinations of these three theoretical paths.

The use of market-based mergers or acquisitions is more likely in developed markets, where the markets are transparent enough to allow for evaluation of the assets to be acquired in each case. Moreover, in relatively stable market economies mergers and acquisitions allow firms also to leap over certain stages along the incremental internationalization path, because they provide a shortcut to the long learning process of doing it all by themselves.

As the transitionary economies do not offer developed factor markets, networking strategies are likely to be used particularly in those conditions. The findings of my licentiate thesis analyzing operations of Finnish companies in the planned market of the former USSR also support this view. From the above hypothetical internationalization paths the one based on networking strategies only is also closest to the path followed by Finnish companies in the former USSR.

When the inward-oriented international operations are taken into consideration the role of networking strategies in the former USSR is emphasized even more. Due to the bilateral nature of the trade relations many companies used imports as a way of promoting exports. In addition the bilateral working groups within the framework of scientific and technical cooperation aimed at increasing technology imports from the USSR to Finland. Their efforts led to increased imports of raw materials and components for products which were sold back to the USSR (Hirvensalo, 1993). Even though imports cannot be considered networking strategies as such, they were used in a similar way in the former USSR by Finnish companies.

In the general path of internationalization, as depicted in table 2, the networking strategies are used especially before the firm engages in the most advanced form of foreign operation, direct production investments and suggests that the strategies were used as a form of preparation for the last step. In the former USSR, on the other hand, network-based operations preceded direct marketing investments, whereas in the general pattern of internationalization the direct marketing investments were introduced earlier. This finding also suggests that the networking type of operations are used in conditions where markets are not yet developed enough for more advanced operation modes. It could also be suggested that the networking strategies actually replace generic expansion strategies in such circumstances and cover certain stages in the learning process, which could lead in turn to leapfrogging those stages when the markets have become more developed.

In the general pattern of internationalization the cooperative mode of joint ventures and other strategic alliances most often comes after all outward-directed operation modes. Based on the above it could be expected that in the transitionary Russia joint ventures are also used earlier in relation to the generally used path.

The model of transitionary adaptation uses the concept of markets as networks by including the informal contacts as a variable, which influences the other parts of the model. In addition, applying the concepts of the transitional model presented above to the model of internationalization, the dominant logic of a company incorporates both the informal views of the dominant coalition of managers as well as their formal plans to develop the company. It also incorporates the lateral rigidity, which causes them to stick to their old ways of behavior unless there is sufficient pressure not to do so. Thus the dominant logic at the initial stages of internationalization is constrained to growth on domestic markets due to lateral rigidity and limited knowledge of international operation modes.

The dominant logic applied to the model of internationalization changes and encompasses international operation modes as a result of environmental push (small domestic markets) and pull (growth opportunities abroad) factors and organizational learning as the company engages in more international operations and becomes successful in them. The internationalization process could therefore also be looked upon as a step-wise transition from purely domestic operations to international operation modes of increasing managerial and financial commitment.

At the mature stage of internationalization, when a significant part of the company's sales is accumulated from international operations, the dominant logic of the company incorporates a broad international perspective, which is based on experiences gathered on many different and increasingly distant markets and from many different and increasingly demanding operation modes, some of which have been successful and some of which have been unsuccessful. Depending on the quality of the experience gained and information received through informal connections the dominant logic also has been shaped accordingly.

The internationalization development has most likely also led to increased international connectivity or networking on all levels of the organization and a wider understanding of the international opportunities which are open for the company. As, according to the transitional adaptation based on the science of complexity, the increased connectivity in complex systems leads to innovation and change, it also provides an explanation why at the mature stage the patterns of internationalization are more varied than at the early stages of the internationalization process.

Likewise it also provides one reason for the "leap-frogging" or jumping over certain stages in the step-wise pattern of internationalization, especially in the later stages of the process. Through increased networking companies are able to gather relevant information from the operation modes other companies have used and to build their strategies on those as well. However, as pointed out the science of complexity is not likely to provide the only explanation for leapfrogging major stages at the beginning of the internationalization process. It could also be suggested that in companies with no or very little international experience the dominant logic of the management underestimates the complexities of other markets and overestimates the similarities of foreign operations with domestic operations.

The transitional adaptation model includes budget constraints as explicit variables influencing the adaptation process whereas the model of internationalization treats them implicitly as parts of the formal planning process of the company. In the model of transitional adaptation the role of budget constraints is predominant due to the fact that companies in transition economies are generally facing much harder budget constraints than they did under central planning, when budget constraints were a matter of bargaining with various governmental authorities and banks. Bad performance, as measured by the indicators of the planned economy, did not necessarily lead to tighter budget constraints and an ensuing need to change because of negotiable soft budget constraints. In transition, therefore, the softness or hardness of budget constraints as perceived by the dominant coalition of the company, is a crucial factor influencing the strategic behavior of the companies.

In market economies the budget constraints can also be soft, as pointed out by Kornai (1980, 1992), but the possibilities for bargaining are generally fewer and more limited than they were in the centrally planned economies. However, in market economies the resources of the companies play a bigger role and companies with slack resources actually face softer budget constraints than those that do not have them. Therefore, by analogy, the degree of slack in the organization also influences the perceived need to change and through it the strategies of internationalization.

If, again, the step-wise process of internationalization is considered a process of transitional adaptation, the explicit inclusion of budget constraints or slack in the organization provides a further explanation for inconsistencies in the internationalization pattern at mature stages of the process. Companies, which have been successful in their international operations, may have accumulated slack resources, which in turn has increased the complacency of the dominant coalition and reduced the perceived need to change. Other successful companies may have pursued an aggressive investment policy which has kept the budget constraints very tight and reinforced the need to change as perceived by the management and incorporated in their dominant logic. Unsuccessful companies, in turn, have faced tighter budgetary constraints, which most likely have reinforced the need to change but provided less financial possibilities to carry out the needed changes.

Thus, the performance and its effect on the budget constraints can lead to different patterns of internationalization. The successful companies with tight budget constraints are most likely the ones which develop more varied patterns and might leapfrog certain logical stages due to the pressure of tight budget constraints, which reinforces the perceived need to change.

For companies facing major and rapid environmental changes performance and budgetary constraints are also more significant than for companies planning for growth in relatively stable international markets, because the adaptation needs are generally greater and there is much less time for the companies to accumulate the needed resources.

In summary, the step-wise internationalization process can be seen as a transitional adaptation under relatively stable conditions. Due to increased informal networking as suggested by the science of complexity, and due to differences in performance and budget constraints the internationalization patterns become more varied. which allows for more variation when the companies reach a more mature stage of internationalization. The concluding chapter 7 summarizes the implications of the adaptation process of the Finnish enterprises for the internationalization process.

3.2 Transitional adaptation and cultural characteristics

This section provides a discussion on how Russian cultural characteristics are likely to affect the model of transitional adaptation. It also highlights differences in assumptions behind enterprise behavior that can lead to a different dominant logic in similar environments. Additionally, a comparison will be made between Russian and Finnish cultural characteristics in order to provide a framework for the empirical part of the study.

Culture consists of specific learned norms based on attitudes, values and beliefs in a society (Danielson and Radebaugh, 1994, p.51). Culture has also been defined as the way in which a group of people solves problems (Trompenaars, 1993, p. 7) or as the collective programming of the mind, which distinguishes one group of people from another (Hofstede, 1991, p.5). According to Trompenaars (op. cit. p. 64) the concept of culture incorporates three layers: first, the outer artifacts and products of culture, secondly, norms and values and, finally, basic assumptions about existence. Culture always refers to some average for a group as a whole, never to individuals. Most commonly culture distinguishes one nation from another but cultural differences can and do exist also between regions, between ethnic and language groups, between genders, generations and social classes, as well as between industries and organizations. The following discussion is concerned with specific dimensions of national culture, such as power distance, uncertainty avoidance and individualism used by Hofstede and Trompenaars in their research, and their implications for enterprise behavior.

It has been argued that one of the most difficult legacies which the communist system left among the former centrally planned economies is the mindset of people, which is a concept close to culture as defined above. As all national cultures, also the Russian culture is conditioned by the history of geographic, religious and linguistic connections, which Russians have had during their history. In addition to these the 70-year-long communist rule is often seen as a separate constraint on the behavior of both individuals and organizations. However, in practice it is difficult to distinguish between those cultural characteristics that originate from times before the communist system was imposed upon Russia and those that have developed as a result of the system. For example, a low work ethic is often considered a result of the communist system but in Russia it can have longer roots, as discussed later. Likewise the collectivist and egalitarian characteristics of Russian culture are generally attributed to the socialist system, even though the rulings of the Russian tsars, motivated by the desire to curb the power of potential rivals might have had even more influence on the Russian culture.

Eastern European countries were excluded from comparative international research on national cultures until the end of 1980's when the communist rule ended. Thereafter a few comparative studies on cultural differences have been published but more research is needed in order to replicate the first research findings in this field. Therefore only tentative hypotheses and suggestions can be made based on those findings. However, culture based on attitudes, values and beliefs is known to change very slowly and this is why also new research is likely to reveal cultural characteristics which are relatively stable even in the conditions of transition (e.g. Mason, 1995).

3.2.1 Russian cultural characteristics and the model of transition

In Russia the 70-year communist rule has greatly influenced the business culture but some cultural characteristics date back to times long before the Russian revolution in the beginning of the 20th century. One such fundamental characteristic of the Russian culture and mentality, is the lacking respect for laws and regulations. Pipes offers a description on how the particular Russian circumstances of land ownership dating back to the 15th century created such an attitude long before the Russian revolution. Only the Tsar, who had the authority to order a general repartition of the land every 20-30 years commanded respect. The observance of laws for the peasant invariably represented submission to a force majeure, to the will of someone stronger, not the recognition of some commonly shared principle or interest. Pipes also describes the work ethic of Russians. According to his analysis all work was despicable among the aristocracy. Peasants, on the other hand, considered only manual work respectable whereas landlords, bureaucrats, priests, intellectuals and even industrial workers using machines were considered idlers in their view (Pipes, 1990, pp. 109-120).

Kennan offers in turn a vivid description of how the communist rule relentlessly suppressed every form of private initiative by physically destroying or driving out of the country most of the educated and culturally important elements of the Russian society and trained the people to regard themselves as the helpless and passive wards of the state (Kenyan, 1990). In a similar vein of thought Gasman and Etkind describe how the development of the 'new type of man' - passive, submissive to power and absolutely incapable of living in the conditions of freedom - was for decades one of the main tasks of the Soviet state (Gasman and Etkind, 1992, p. 117). These views of the role of the communist rule are supported by a study concerning differences of personal initiative between East and West Germany (Frese, Kring, Soose and Zempel, 1996). The study found evidence that, as a result of socialization, personal initiative was lower in East than in the West Germany.

In a more general framework Paramonov points out the controversies in the Russian culture, especially in relation to western European influences. Westernizers in the country, most notably represented by Peter the Great, have considered Russia a part of Europe and European culture whereas Slavophiles have viewed Russia and Russian culture as distinct from European culture and opposed all western influences in the country (Paramonov 1996).

In the transitionary Russia cultural traits described above are still predominant among the Russians in the analysis of Sidorenko (Sidorenko, 1994). When analyzing the psychological profile of the Russian entrepreneur she notes the low work ethic in general and low esteem for rich people, who cannot have become rich without engaging in illegalities. She also points out the low respect for law and authorities as well as the expectations that the state should continue to provide them the necessities of life.

Puffer adds to the characterization of Russian managers a description of really hard working individuals, who had to hide their success from the envious collaborators or competitors (Puffer, 1993). Litheness, Welsh and Rosenkrantz in turn pay attention to the fact that, in order to be successful, the Russian managers have to be particularly good at networking (Litheness, Welsh and Rosenkrantz, 1993).

The characteristics of the Russian culture described above, the lack of initiative, lack of respect for laws and for hard work and disrespect of traders are all likely to produce passivity among the managers in the transition from planned to a market economy. Therefore it is not surprising that the most common transition strategies identified in the literature analyzed above were labeled passive. On the other hand, the active and successful managers, which most likely are restructurers, are also not likely to be very visible because they probably hide their success in order to avoid the envy of others. The cultural characteristics also point out the significance of networking in the change process, which emphasizes the system features of the process. With such cultural heritage the Russian transitional conditions offer an excellent environment for analyzing those changes that take place, because there must be exceptionally powerful forces to cause any change to happen and become visible.

The fundamental differences between planned and market economies include different institutions, ownership rights, available information and different freedom of individual actors in the marketplace. In transitionary Russia the institutional change, both of formal organizations and of informal attitudes, beliefs and mores was underway but far from completed. Ownership rights were ambiguous and information on other economic agents was unreliable or not available at all. In addition, cultural characteristics attribute different interpretations to the dimensions of market behavior when compared to American or western European countries.

In such circumstances it is likely, first, that the role of old contact networks between managers is crucial in providing a source of reliable information whereas the role of the new contacts would be less significant. Secondly, the cultural characteristics are likely to be mirrored in the perceptions of the environment and the dominant logic of operating and managing among the managers.

In the previous account of transition strategies behavior was interpreted to correspond to market signals when enterprises restructure their operations, increase or downsize production according to demand, raise or lower prices according to demand or lay off employees when there is not enough work for them. Non-market behavior was exemplified by a lack of response to the changes in demand or other market signals. However, these observed behaviors were also dependent on the beliefs that the actors held about the degree of freedom they had in relation to other actors and about their willingness to use this freedom, which were in turn deeply influenced by the prevailing culture. For example, Russian managers preferred accumulation of receivables with their old customers to diminishing production because they believed in governmental help to solve the financial problems.

3.2.2 Cultural differences between Finland and Russia

In this section an attempt will be made to analyze the cultural differences between Finland and Russia based on recent research on cultural differences between various nations in general and between Finland and Russia in particular.

The internationalization model of Luostarinen includes business distance as an explanatory independent variable. The business distance, as defined in the model, is a composite of physical, cultural and economic distance between the home and target countries but only the cultural dimension will be analyzed in this section. On the other hand, the concept of dominant logic, which shapes enterprise behavior is also, almost by definition, shaped by the cultural features of the environment.

The cultural differences identified between Finland and Russia will also serve as benchmarks when analyzing the adaptation strategies of Finnish companies in transitionary Russia. The survey, which was carried out in 1991 among 42 Finnish companies (see Hirvensalo, 1993, pp 77-87) indicated that the Finnish companies considered their competitive advantages in marketing in the former USSR as crucial after having lost the traditional competitive advantages related to the clearing payment system. Understanding the Russian trading and business culture was the key feature of the competitive advantages in marketing.

After the disintegration of the USSR at the end of 1991 the cultural map of the region also changed. Most notably, the Baltic states gained independence from the USSR. Until these drastic political changes most trade connections were concluded between Finnish companies and Soviet organizations which operated out of Moscow. The cultural ties between Finland and the Baltic countries or other regions of the USSR had only a very limited influence on trade. This is why the competitive advantages related to marketing refer to understanding the Soviet business culture. Even though the Russian business culture had a strong influence on the Soviet business culture, it is likely that the transitionary business culture in Russia as well as in other parts of the former USSR is characterized more by national cultural traits than before.

Already among the first Finnish-Soviet joint ventures, which started operations in 1988-89, there were a significant number of companies operating in Estonia, which suggests that the cultural ties facilitating the engagement in direct investments played a bigger role even under the Soviet rule. In a study on managerial cultures in Soviet-Finnish joint ventures, which included both Finnish-Russian and Finnish-Estonian joint ventures, Liuhto also concluded that the Finnish managerial culture was closer to that of the Estonian managers than to that of the Russian managers in the joint ventures (Liuhto, 1991).

Differences between the Finnish and Russian cultures have not been subject to thorough study. In the few studies that exist Finns are often described as law-abiding and hard-working (Johnson and Moran, 1992, p.47, Kallonen and Ketola, 1996, Lewis, 1996) in comparison to the Russian cultural characteristics of lacking respect for laws and regulations and low work morale. In addition, they are also described as silent, stubborn and lacking in communication skills whereas Russian are described as warm, emotional and caring people. Without probing more deeply into these cultural traits, it can be noted that even a brief review focuses on significant cultural differences between the two countries. On the other hand, recent surveys conducted among Russians show that, particularly in the north-western regions of Russia, Finns are often preferred to representatives of other foreign nationalities as business partners whereas in more distant parts of Russia this is not the case (EVA, 1996).

In an analysis of eight different studies on country clusterings (Ronen and Shenkar, 1985) Finland was placed consistently in the same cluster with the other three Nordic countries, Sweden, Norway and Denmark, and sometimes in a larger North European cluster, which in addition to the Nordic countries also included Germany, Austria and Switzerland. As the former USSR was not included in any of these studies, the similarity of Finnish culture with that of Russia (or Baltic) cultures has not been tested in a wider international context. However, as geography, language and religion were found to be major dimensions of the country clusters, both language and religion separate Finland and Russia, whereas all three dimensions are similar for Finland and Estonia.

The recent international management literature provides additional comparative evidence for cultural differences, which influence the behavior and strategy formulation of enterprises (Hofstede, 1984, 1993, Schneider, 1989, Trompenaars, 1994) and offer the possibility to make direct comparisons between the Russian and Finnish cultural characteristics.

The following table 3 illustrates differences between Finnish and Russian cultures as measured in the research carried out by Hofstede and Trompenaars (Hofstede 1984, 1993, Trompenaars 1994). In Hofstede's research the measurements relating to Russia are estimations, because the original research was not carried out in Russia. However, Bollinger (1994) provides measurements produced by a limited study carried out in Russia in 1989 which used Hofstede's questionnaire. Although there are differences between the estimations and measurements given for Russia, it is, however, clear that they are both significantly different from the measurements for Finland.

Hofstede's power distance refers to the inequality within organizations, which is usually formalized in hierarchical boss-subordinate relationships (Hofstede, 1984, pp. 65-66). His uncertainty avoidance refers to the degree that uncertainty concerning the future is tolerated within the organizations (Op. cit., pp. 110-113). Individualism describes the relationship between the individual and the collectivity which prevails in a given society (Op. cit., p.

Table 3. Cultural differences between Finland and Russia

Cultural dimension	Finland (Scale 0 - 100)		Russia		Difference
Power distance [1)]	33		76*[2)](95)**		43
Uncertainty avoidance [1)]	59		92*[2)](90)**		33
Masculinity/femininity [1)]	26		28*[2)](40)**		2
Individualism [1)]	63		26*[2)](50)**		37
Individualism/collectivism [3)]	42		59		17
average of the scores for:					
1 preference of individual freedom			65		62
2 belief in individual decisions		34		48	
3 group vs. individual responsibility		26		68	
Universalism/particularism [3)]	77		39		38
average of the scores for:					
1 preference for a universalist system over a particular social group		85		42	
2 denial of preferential treatment of a friend when testifying		70		49	
or 3 in a test situation		76		27	
Achievement/ascription [3)]	52		38		14
average of the scores for:					
1 importance of achievement		39		23	
2 importance of family background		65		53	

* measurements based on Hofstede's questionnaire for a small group of Russian managers in 1989
** estimates by Hofstede
Sources:
1) Hofstede, Geert (1984) Culture's Consequences; National Differences in Work-Related Values, Sage Publications, Beverly Hills, and (1993) Cultural constraints in management theories, Academy of Management Executive, 1993 Vol 7 No 1, pp. 81-94
2) Bollinger, Daniel (1994) Les fondements d'un nouveau systeme de management en Russie, Le Courrier des Pays de l'Est, no 392, Septembre 1994, pp. 43-47
3) Trompenaars, Fons (1994) Riding the Waves of Culture; Understanding Diversity in Global Business, Irwin Professional Publishing, Burr Rridge, Illinois New York

148). Masculinity in turn refers to the issue of whether the biological differences between the sexes should or should not have implications for their roles in social activities (Op. cit., p. 176). The concept also refer to the characterization of a society more by tender values and cooperation one usually associates with females or with aggressive and materialistic behavior one usually associates with males.

Out of Trompenaars' seven dimensions of culture measurements, three are available for both Finland and Russia. These are: individualism versus collectivism, which is practically the same as Hofstede's dimension of individualism; universalism versus particularism, which refers to the significance ascribed to relationships and unique situations as opposed to abstract societal codes; and achievement versus ascription, which refers to the difference between the attributed status by birth, kinship, gender or age, and accomplishments.

In comparison to Russia the Finnish culture profile presents itself as low on power distance and uncertainty avoidance and highly individualistic. The Russian culture in turn is particularly high on power distance and uncertainty avoidance and highly collectivist. There is not a big difference between the cultures in the dimension of masculinity/femininity, which implies among other things that both cultures are equally oriented towards collective caring for others. On Trompenaars' scales the Finnish culture is highly universalist and more achievement-oriented than the Russian, which presents itself as particularist (e.g. in tolerating privileges of special groups) and less achievement oriented.

On Trompenaars' scales describing the individualism vs. collectivist dimension the Finns and Russians have approximately the same degree of preference for individual freedom. The Russian scores for the belief in individual decisions vs. group decisions and individual vs. group responsibility are, however, clearly higher than those of the Finns. Trompenaars, when commenting upon the Russian scores, noted that the impact of communist organization on Russian and East European managers had been extremely limited in this respect. It could be argued that the scores probably reflect the great personal responsibility that the Russian managers had to carry in fact when trying to fulfill the plans through networking and informal connections when the formal organizational networks failed to provide them with sufficient amounts of raw materials, for example.

What is the significance of these findings for transitional behavior? One could hypothesize that due to the highly collective and particularist orientation and high uncertainty avoidance Russian managers would tend to seek advice from their previous horizontal networks before changing their behavior significantly. The collective particularist orientation would thus lead to collusive non-market behavior and low tolerance of uncertainty would cause sticking to the old networks and ways of operation. The large power distance would in turn lead to the expectation that the decisions would come from a superior higher up in the organization and

Table 4. Russian and Finnish cultural dimensions in international comparison

	Russia	Finland	Sweden	Germany	France	US	Italy	UK	Austria	Canada	Japan	Belgium
System vs. social group/T	68	62	52	44	36	54	49	50	51	59	36	55
Opting to be left alone/T	53	85	73	87	89	83	77	78	75	95	69	76
Opting for function / personality/T	80	98	89	92	95	92	88	93	94	96	80	95
Universal/particular social group/T	42	86	93	91	68	95	70	90	80	96	67	72
No extra favors to friends/T	49	70	55	62	81	64	67	51	69	67	69	62
No insider tips to friends/T	27	76	59	66	56	83	58	65	53	84	87	56
Opting for individual freedom/T	62	65	64	60	48	79	52	66	56	79	60	59
Believing in individual decisions/T	48	34	45	14	12	40	20	36	27	28	24	27
Individual responsibility/T	68	26	41	43	43	40	38	36	28	41	36	40
Help painting the boss'es house/T	77	79	92	89	78	89	84	92	65	81	83	88
Disagree with company housing/T	22	70	89	75	81	85	75	82	79	77	45	71
Status is most important/T	25	39	46	39	26	55	34	47	20	53	28	27
Family background important/T	53	65	69	65	73	77	64	76	44	76	65	64
Nature can be controlled/T	42	30	21	39	31	38	35	35	18	39	10	30
People can control their own fate/T	35	70	70	82	81	89	65	75	71	83	56	76
Power distance/H	76	33	31	35	68	40	50	35	11	39	54	65
Uncertainty avoidance/H	92	59	29	65	86	46	75	35	70	48	92	94
Masculinity/femininity/H	28	26	5	66	43	62	70	66	79	52	95	54
Individualism/H	26	63	71	67	71	91	76	89	55	80	46	75
Correlation with Russian scores/T-scores		0.182036	0.155653	0.147022	0.160303	0.000975	0.24404	0.147799	0.174333	0.0709	0.244753	0.361994
Order of similarity with the Russian scores		4	7	9	6	11	3	8	5	10	2	1
Correlation with Russian scores/ all scores		0.113641	-0.02051	0.012243	0.264335	-0.2594	0.140629	-0.2156	0.00278	-0.13415	0.243854	0.410656
Order of similarity with Russian scores		5	8	6	2	11	4	10	7	9	3	1
Correlation with Russian scores/ H-scores		0.137843	-0.19538	-0.44889	0.699554	-0.82322	-0.33146	-0.92451	-0.33398	-0.69539	0.194094	0.623167
Order of similarity with Russian scores		4	5	8	1	10	6	11	7	9	3	2

T refers to Trompenaars' scores
H refers to Hofstede's scores

Sources:
1) Hofstede, Geert (1984) Culture's Consequences; National Differences in Work-Related Values, Sage Publications, Beverly Hills, and (1993) Cultural constraints in management theories, Academy of Management Executive, 1993 Vol 7 No 1, pp. 81-94
2) Bollinger, Daniel (1994) Les fondements d'un nouveau systeme de manegement en Russie, Le Courrier des Pays de l'Est, no 392, Septembre 1994, pp. 43-47
3) Trompenaars, Fons (1994) Riding the Waves of Culture; Understanding Diversity in Global Business, Irwin Professional Publishing, Burr Rridge, Illinois, NewYork

thus explain the passivity or inertia which is prevailing in most of the organizations in the absence of the earlier superior authorities.

The Finnish cultural traits of small power distance, universalist orientation, and relatively high tolerance of uncertainty and high individualism would lead to different expectations about the behavior of enterprises in transitional circumstances. It could be hypothesized that the Finns in general would tend to expect more independent decision making from their Russian counterparts than actually takes place. They would likewise tend to expect their Russian counterparts to treat their partners more equally than they actually do. Finally, they would be less inclined to engage in lobbying for governmental help to control the uncertainties in the environment and more confident in dealing with those uncertainties.

In comparison to other nations the Finnish business culture as measured by Hofstede's dimensions seems somewhat closer to the Russian than the culture of most other Western European countries. Table 4 shows the differences in scores between the national culture and that of Russia for 12 countries, which are among the major western trading partners of Russia. Finland ranks fourth among the countries, when they are listed in the order of closest cultural distance to largest distance from the Russian culture as measured by the correlation coefficient between the scores of Russian cultural characteristics and those of the other nations. Ahead of Finland are France, Belgium and Japan and relatively close behind are Italy and (West) Germany. Along Hofstede's dimensions Sweden, the United States, and Great Britain present themselves as culturally the most distant countries with respect to Russia of those listed.

On Trompenaars' dimensions Finland also ranks fourth in the order of closeness to the Russian cultural measurements but after Belgium, Japan and Italy. France ranks only sixth in this comparison. Finland is followed by Austria, France, Sweden and Germany. If both Trompenaars' and Hofstede's scores are lumped together and correlations are calculated for all scores, Finland's ranking falls one step to the fifth place. The ranking falls also if some other countries are added to the comparison. From Europe the scores for the Netherlands would have a higher correlation with those of Russia than Finland. The comparison shows that the results depend, first, on the particular dimensions and, secondly, on the countries which are included in the comparison. Therefore, based on Trompenaars' and Hofstede's research there cannot be a single answer to the questions, which of the western countries is culturally closest to Russia or how close is the Finnish culture to that of Russia.

The cultural differences as described and measured above influence the way enterprises of the countries are carrying out business with enterprises from other countries. More research is, however, needed, first, to replicate these findings and, secondly, to compare the Finnish and Russian cultures to those of the other central Eastern European and Baltic countries, and thirdly, in order to determine the relative significance of each cultural dimension for international business. Above they were all given equal significance.

Moreover, the similarities of culture do not necessarily signify facilitation of trade. In certain circumstances, especially in the recently opened markets, such as the transition economies where enterprises are for the first time able to contact new foreign partners directly, they might even provide an obstacle to trade. Also, understanding a foreign culture is not synonymous to being able to trade with enterprises of that culture. Extensive experience can also lead through trial and error to effective ways of creating cultural synergy in business relationships and competitive advantage in that field.

However, for Finnish companies one tentative conclusion seems warranted. The measured cultural differences seem to suggest that the Finnish companies might be overconfident in estimating their competitive advantages based on cultural understanding of the Russian market. There are other countries, France, Belgium, Italy and Japan, which are all closer to Russia on power distance and uncertainty avoidance. The Finnish cultural peculiarity in relation to Russia seems to be the similar scoring in the dimension of masculinity/femininity axis. One possible way to interpret this is to hypothesize that the Finns are closer to the Russians as individuals whereas the society as a whole is organized in a very different way, which is then reflected in the large differences in the scores for power distance and uncertainty avoidance.

The implications for business would be that the Finns would probably have an easier access to some of the Russian organizations, particularly if they have old connections to such organizations. However, the Finns would be likely to underestimate the role of political power centers and their influence on enterprises.

4 Finland's trade and investments in Russia and the Baltic states, 1990-95

This chapter will set the scene for the analysis in the following chapters by providing background information about the economic environment mainly in Russia with some references to the Baltic countries and about Finland's trade and direct investments in the region.

4.1 Main features of the Russian and Baltic economic reforms

The main tasks of economic reform in the former socialist countries can be described as liberalization, stabilization, privatization and restructuring. Liberalization refers first to the price reforms concerning goods and services but applies also to currency and interest rate policies as well as to foreign trade administration[1]. In Russia most commodity prices were liberalized at the beginning of 1992 and ruble exchange rate became market based in the middle of 1992. Among the Baltic countries Estonia led the reform process by liberalizing most prices already during the years of 1989-1991 and introduced the national currency, the kroon, in June 1992. Latvia and Lithuania followed the Estonian example by liberalizing prices during 1991-92 and introducing currencies of their own during 1992-93[2].

Stabilization as an essential part of the reform process has been more difficult to attain than liberalization. In Russia liberalization of prices was followed by two years of near hyperinflation. In 1992 prices rose by more than 2300 percent and in 1993 about 840 percent. The inflation rate came down to 220 percent in 1994 but only in the second half of 1995 did the inflation rate fall to the level of 1 percent per month. The Baltic countries were more successful in stabilization and managed to curb the inflation to single digit monthly figures by the end of 1993. The introduction of national currencies played a major role in this process by detaching the Baltic economies from the ruble zone. In Russia large budget deficits and the burden of financing all the other CIS countries, which belonged to the ruble zone, made the stabilization of the economy more difficult than in the Baltic countries.

Privatization started in Russia when the parliament passed the privatization program of 1992 and the voucher scheme was introduced in the same year. By the beginning of 1993 all Russian citizens received a 10000 ruble privatization voucher. As opposed to relatively slow stabilization, Russia moved quickly in privatization and by the end of 1994, after the first phase of mass privatization was completed, more than 90 percent of state enterprises, which

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[1] See e.g. Russian Economy - Summer and Autumn 1992

[2] An account of the introduction of Baltic currencies is provided in Lainela, Seija and Sutela, Pekka (1994)

participated in the privatization program had been turned into private hands. Out of all Russian state-owned enterprises the number of privatized enterprises amounted to about 50 percent in the middle of 1995[3]. However, Russian privatization proceeded in a unique way, which can be characterized as insider privatization, as in most cases the majority of the shares were transferred to the previous managers, insiders of the enterprises[4]. The Baltic countries introduced their privatization programs later and particularly privatization of large state-owned companies has proceeded slowly.

The restructuring of the institutions and particularly changes in ways of operation, which were customary in the planned economies, has been the slowest of all the reform processes throughout Eastern Europe. The restructuring of state-owned enterprises and orientation towards market stimuli has often been led by companies which were oriented to export markets rather than serving local customers. Contrary to early expectations privatization has not provided a sufficient stimulus for enterprises to restructure their operations (De Boissieu, Cohen and de Pontbriand, 1995).

4.2 Developments in key sectors of the Russian economy

The following three sections will cover developments of key economic sectors in Russia. Also financial difficulties, accumulation of payment arrears and related behavior of enterprises as well as developments in the sphere of foreign trade will cover developments only in Russia, as Russia was the principal target market among the former USSR countries for the Finnish metal and engineering companies. The development of Baltic countries has had similar but less spectacular characteristics. Among the Baltic countries Estonia became the most attractive target market for Finnish companies. The reform processes in Russia and Estonia differed mostly in the monetary policies carried out in both countries. While Estonia adopted the system of a currency board with tight monetary control, which was widely supported by Estonians and was able to stabilize the economy relatively quickly, Russian authorities had differing views about the proper policy to be followed, which contributed to the persistent high inflation. Also problems in the Estonian banking sector, which culminated in a crisis during the years of 1992-93, were tackled promptly by the monetary authorities. In Russia ouvertures of the banking sector crisis were first felt in 1995[5].

The economic environment in which foreign companies operated in the former USSR and Russia during 1991-95 was characterized by problems of transition, which are well

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[3] Review of the Russian economy - 1994 - and of year report, p. 157 and 1995 half yearly report, p. 111,

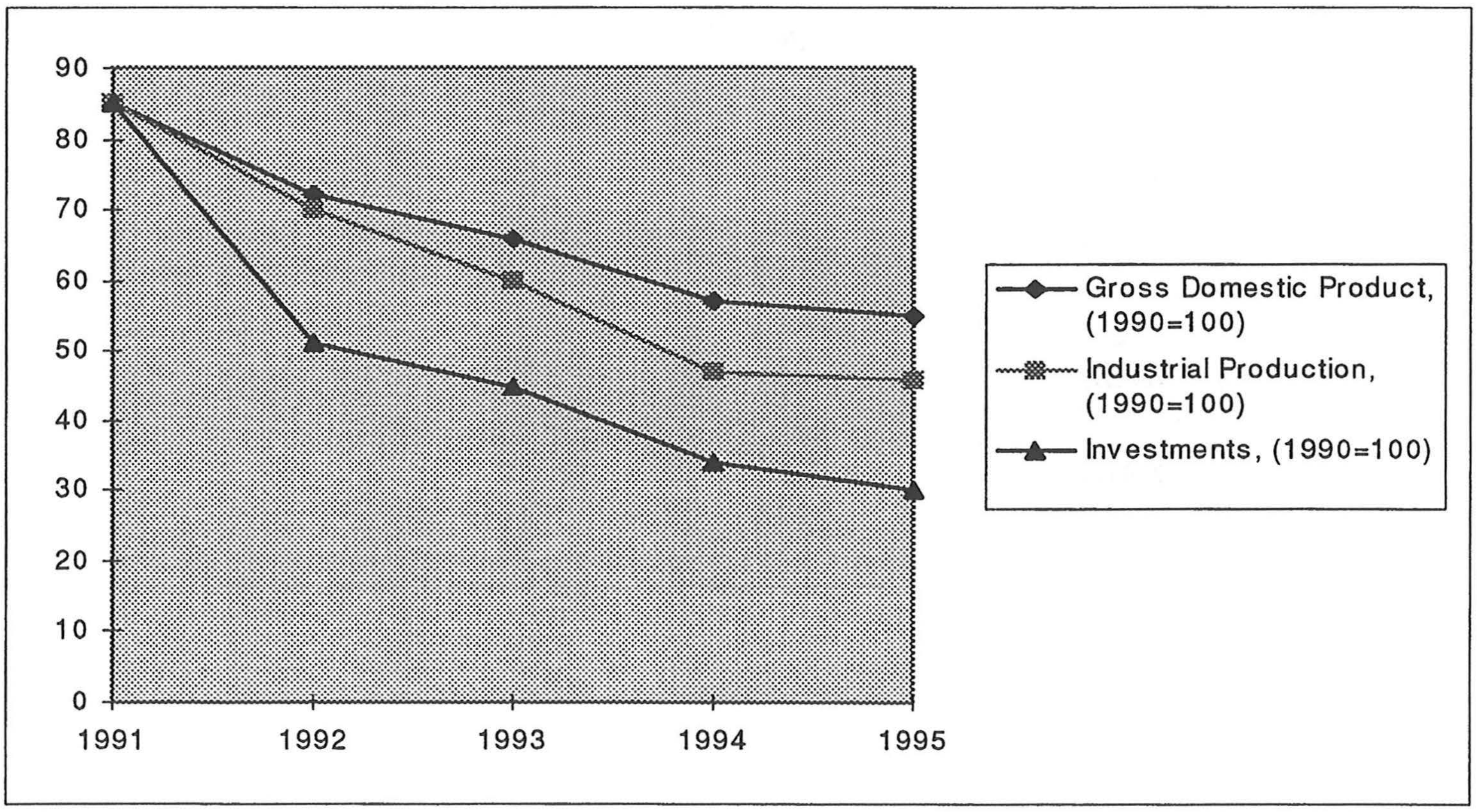
[4] Sutela, Pekka (1994) provides an early analysis of the phenomenom of insider privatization in Russia

[5] 1994 Lainela and Sutela, pp. 31-34 and pp. 90-112

documented by both Russian and western authors[6]. These problems included among other things high inflation following the liberalization of most prices in the beginning of 1992. High inflation was in turn followed by a sharp fall in GDP and increasing financial difficulties throughout the economy. Without trying to cover the economic development in great detail the following brief account aims at analysing the situation particularly in the Russian pulp and paper, engineering and metallurgical industries, which were the major customers of Finnish metal and engineering companies.

Figure 1 illustrates the fall in GDP, industrial production and investments in the Russian economy during the years of 1991-95. According to the revised statistics of Goskomstat and World Bank experts the GDP fell by 45 percent, the industrial production by 54 percent and investments by 70 percent from their level in 1990 by 1995[7].

Figure 1. Indicators of Russian economic development during 1991-95 (Index, 1990=100)



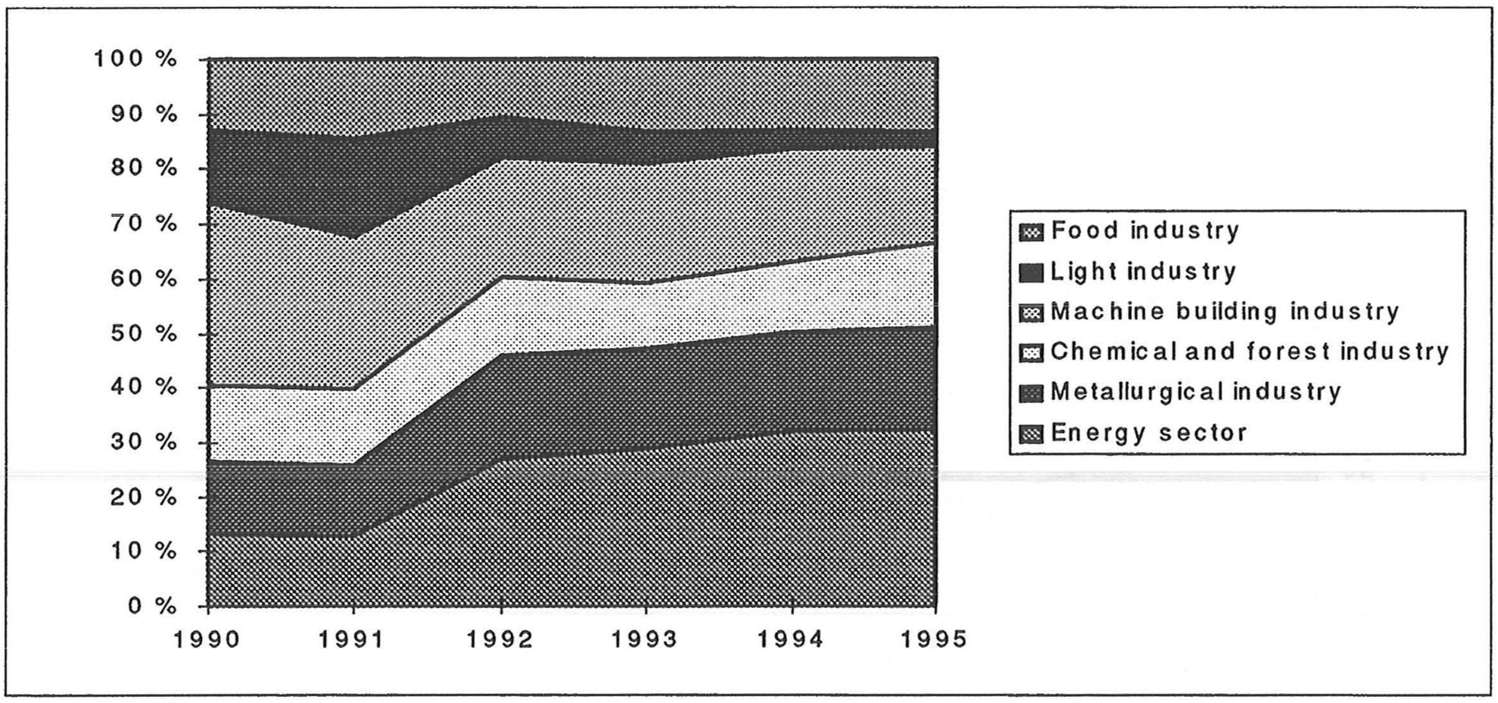
Source: Russian Economic Trends, Vol 3 and 4, 1995-96

[6] See for example the IMF and World Bank reports on Russia as well as Russian Economic Trends and Reviews of the Russian Economy

[7] The initial Goskomstat statistics underestimated the development in the newly created private sector and were revised upwards due to this realization

Simultaneously with the fall in the level of production the structure of industrial production changed reflecting the shifts in the price structure of the goods produced. The most notable change took place in the relative significance of the energy sector. While it was only 12 percent in 1990, the share had reached 28 percent in the first half of 1995[8]. At the same time the share of the machine-building industry decreased from 31 percent to 15 percent and the share of light industry from 12 percent to 2 percent. The position of metallurgical industry and the chemical-forest industry complex changed only little. In the first half of 1995 the former accounted for 16 percent and the latter for 14 percent of the total industrial production. Figure 2 illustrates the structural changes in the Russian industries during 1990-1995.

Figure 2. Structure of Russian industrial production in current prices during 1990-95*, (percent)



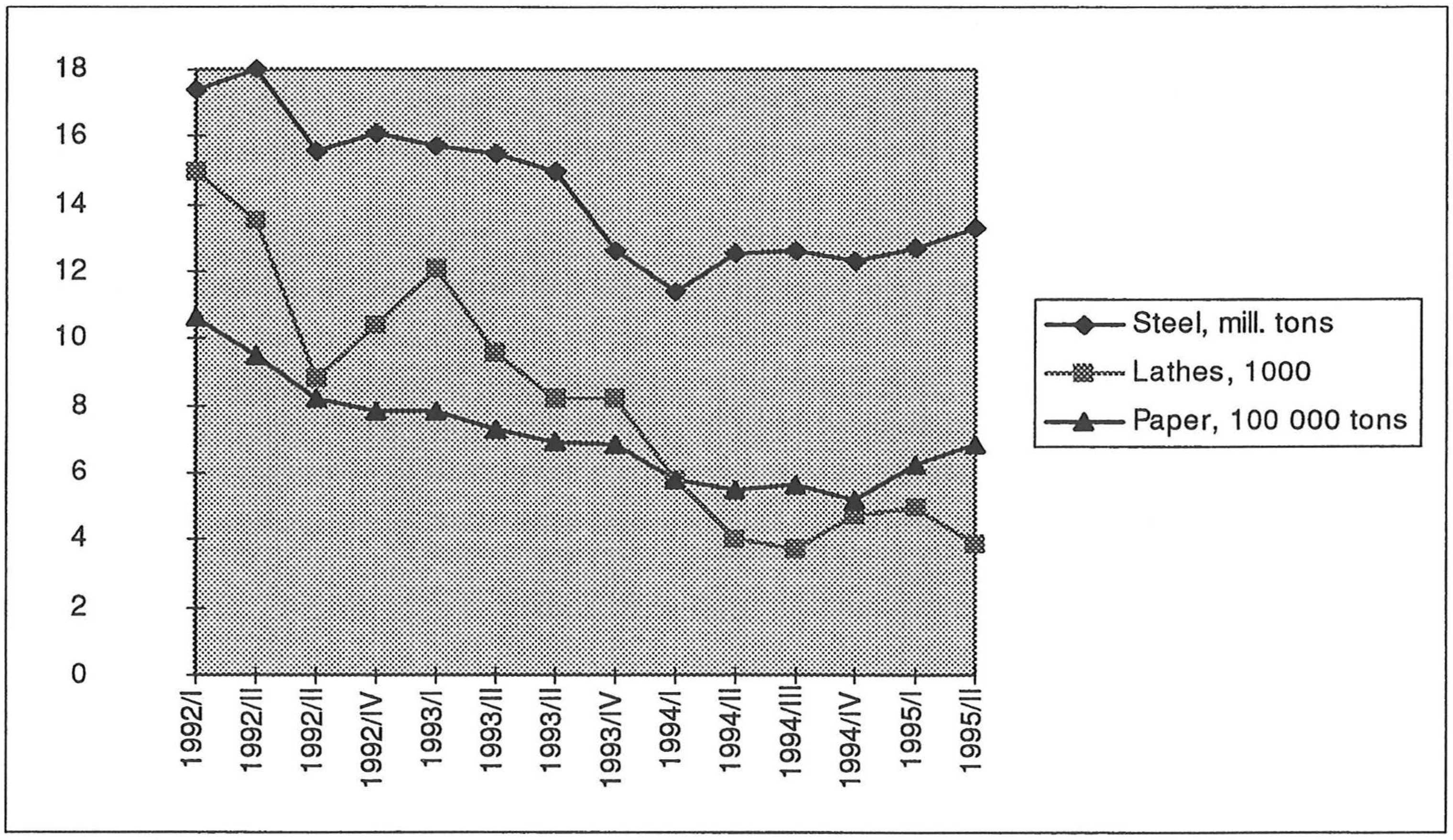
* first half of 1995
Source: Review of the Russian Economy, Vol. 4, 1995, p. 72

Figure 3 gives a more concrete illustration of the real development in the target industries by depicting the production in paper, steel and lathes during 1992-95. The production of paper fell by 43 percent from 350 000 tons per month to 200 000 tons per month from the beginning of 1992 until the beginning of 1995. During the same period the production of steel fell from 5.4 million tons per month to 4.2 million tons per month and the production of lathes from 4.6 million machines per month to only 1.3 million machines per month. However, the production of steel started growing already at the beginning of 1994, the production of lathes

[8] Review of the Russian Economy, Vol. 4, 1995, p. 72.

at the end of 1994 and of paper in the beginning of 1995, which indicates that the bottom of the transitionary recession was reached in these industries.

Figure 3. Indicators of Russian industrial production during 1992-95



Source: Goskomstat statistics

As the Finnish metal and engineering companies were mainly sellers of investment goods, the development of Russian investments deserves here special attention. The share of investments in relation to GDP fell only from 21 percent in 1990 to 15 percent in 1995. However, as the GDP also fell sharply, that measure does not illustrate the drastic fall in the real investments as depicted by figure 1. Moreover, investments in production facilities decreased even more than investments in housing and social infrastructure. While in 1990 the share of production investments was 70 percent, by the beginning of 1995 their share had fallen to 55 percent of all investments[9], which indicates that production investments had actually diminished by not less than 80 percent from 1990.

During 1993-94 the largest capital investments were carried out in the energy sector of the economy. Their share of all investments amounted to 37 percent in 1994, which is more than

[9] Review of the Russian Economy, Vol 2, No 4, 1993 p.149 and Vol 4, No 1, 1995 p.88

the share of the energy sector in the industrial production of the country.[10] At the same time the transportation and communication sectors made 24 percent and agriculture 16 percent of all investments. Metallurgical industry carried out 5 percent and the chemical and forest industries only 2 percent of total investments, which is much less than their share of Russian industrial production. While the investments were highest within the energy sector, also the state investment program for 1994 favored the energy sector, to which a total of 56 percent of the budget funds for investment were directed. However, the machine building industry was the largest recipient, 53 percent, of state credits for investment purposes in 1994. For the metallurgical and chemical and forest industries no budget funds were reserved but their share of the directed credits amounted to 25 percent of the total, which corresponds approximately to their share of the industrial production.

The contents of the state investment program reflect the preferences of the Russian authorities in directing their resources. The target industries of the Finnish companies, pulp and paper industry as well as the metallurgical industry were not among those favoured. However, as both the budget funds and cheap credits from the state diminished greatly since 1992, the role of Russian enterprises' own resources increased and the financial performance of the target industries started to play a crucial role in determining their investment possibilities.

Foreign direct investments in Russia will be dealt with briefly in section 2.4. Here it suffices to note that foreign direct investments only played a marginal role in Russian economic development. Their share of gross fixed investments reached only 0.6 per cent in 1994[11].

4.3 Financial difficulties, payment arrears and behavior of Russian enterprises

The transition from plan to market has brought about increasing financial difficulties throughout the Russian economy. In addition to the drastic fall in production and high inflation, the budget constraints of Russian enterprises became harder as a result of reduced recourse to soft administrative pricing, soft taxation, subsidies and cheap credits. The hardening budget constraints have in turn led to a dramatic growth in payment arrears, particularly interenterprise debts, which in Russia became a much more prolonged problem than it had been in the other Eastern European countries. The accumulation of arrears and related phenomena will be dealt with here in some detail, as it is one of the most conspicuous examples of transitionary behavior of Russian enterprises. Through it, insights on the motivations of Russian entrepreneurs can also be highlighted.

[10] Review of the Russian Economy, Vol. 3, No 2, 1994 p. 147

[11] UN/ECE Economic Bulletin 1995, pp. 99-100

4.3.1 Accumulation of interenterprise arrears

Significant payment arrears started to accumulate in Russian companies in the beginning of 1992 after most of the price controls were lifted. They rose from 40 to 3000 billion rubles in only six months corresponding to about 20 percent of the GDP by June 1992. In July 1992 the Central Bank of Russia ordered the commercial banks to register in "Line 2" all payment arrears of Russian state enterprises in order to carry out a multilateral netting of the arrears. The netting process was concluded in October and, as a result of it, the arrears were reduced to 450-480 billion rubles. After July 1, 1993 the "Line 2" was closed and the interenterprise arrears were no longer recorded in the banking system.

According to Goskomstat statistics the interenterprise arrears (defined as overdue receivables of one industrial enterprise from another[12]) stabilized between July 1992 and May 1993, when they started to grow again. By March 1993 their share as a percentage of the monthly GDP had fallen to 34 percent. After March 1993 they started to grow again also in relative terms and reached the level of 90 percent of the monthly GDP in the end of 1994, where they have stayed since. (See figure 4). In comparison to the yearly GDP the overdue arrears amounted to approximately 9 percent at the end of 1995. During most of 1994 and 1995 the overdue debts of enterprises also grew more rapidly than prices in general, which signifies that the debts also grew in real terms.

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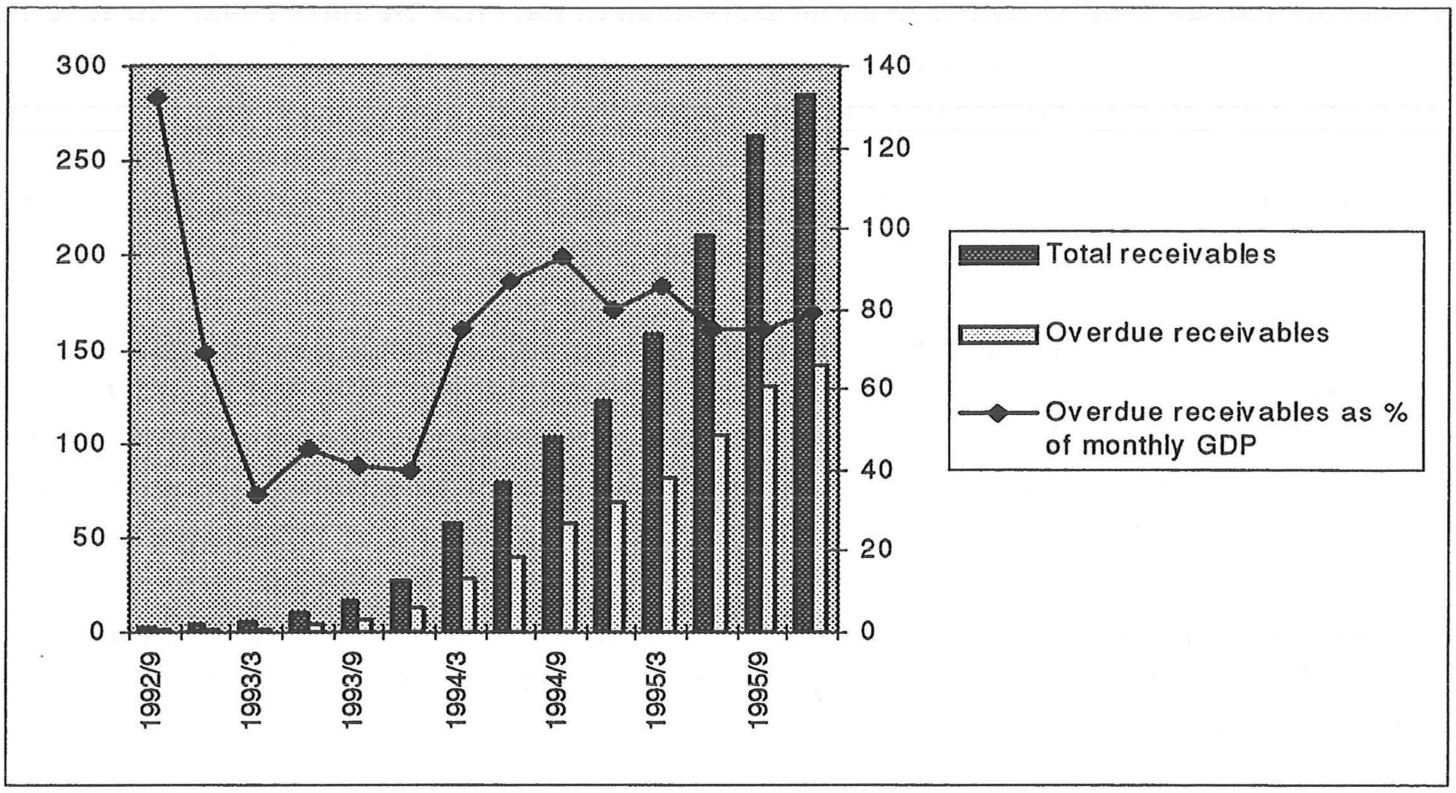
[12] A discussion on the definition and development of payment arrears is provided in Hirvensalo (1995), Payment Arrears and Russian Reforms in Rautava, Jouko (ed) Russia's Financial Markets and the Banking Sector in Transition, Bank of Finland studies A:95

Figure 4. Receivables (total and overdue) of Russian industrial enterprises in 1992-94 (trillions of rubles, left hand scale; % of monthly GDP, right hand scale)



Source: Russian Economic Trends 4/1994, 4/1995

In November 1995 the total overdue indebtedness of Russian industrial enterprises amounted to 157 trillion rubles. Close to one half of this (47.3 %) consisted of overdue accounts payable to the suppliers, roughly a third (35.8 %) consisted of tax arrears and arrears payable to extrabudgetary state funds, and about 5 percent was wage arrears. Especially tax arrears payable to the state grew rapidly from 1994 to 1995. During the fourth quarter of 1995 they amounted to almost three times the monthly taxes due and four times the level reached one year earlier[13]

About 70 percent of industrial enterprises had debts which were overdue and about two thirds of such debts had been overdue for more than three months. The distribution of overdue debts among various sectors in the industry is described in Table 5.

[13] Ekonomitheskij monitoring Rossii, p. 15

Table 5. Overdue enterprise debts to suppliers and the state budget of industrial enterprises in December 1995 (billions of rubles)

	total overdue debts	(%)	debts to state budget*	(%)	debts to suppliers	(%)
Total of debts	**157344**	**100.0**	**56341**	**100.0**	**74426**	**100.0**
Electroenergy	28208	17.9	6719	11.9	18817	25.3
Fuel	44915	28.6	22425	39.8	16064	21.6
Ferrous	11049	7.0	2764	4.9	6372	8.6
Non-ferrous	7060	4.5	2205	3.9	2730	3.7
Chemical and petrochemical	10114	6.4	1750	3.1	6766	9.1
Machine-building and metalworking	28370	18.0	11605	20.6	10988	14.8
Wood, pulp and paper	6474	4.1	2443	4.3	2540	3.4
Construction materials	3629	2.3	1001	1.8	1978	2.7
Light	2682	1.7	945	1.7	1166	1.6
Food	4982	3.2	1510	2.7	2437	3.3

* and extrabudgetary funds
Source: Goskomstat monthly statistics

Within industry the energy sector and machine-building sectors were the most indebted sectors. The energy sector alone accounted for almost one half of the arrears and together with the machine-building industry they accounted for about two thirds of the debts, which share is higher than their share of the total industrial production. The share of ferrous and non-ferrous metallurgical industries as well as of the wood, pulp and paper industries of the overdue debts was in turn somewhat smaller than their share of total industrial production.

The situation in overdue receivables of various sectors of the economy resembles very much that of the overdue debts. The largest receivables were recorded by the industrial enterprises, about two thirds of the total. Within industry the energy sector was also the largest creditor. According to the statistics published by Goskomstat the overdue debts to suppliers amounted to 40 percent more than the total overdue receivables from buyers at the end of 1995. Among the creditors the Russian Ministry of Finance and the local tax authorities had also significant overdue receivables from the fuel industry. Within the energy sector the oil extracting industry alone accounted for 27 percent of the debts to the state budget.

The largest net debts in relation to the total receivables were recorded in the paper and woodworking industries. Significant net debtors were also the fuel industry, within it especially the coal industry, as well as non-ferrous metal and machine-building industries. As the overall position of all industries was that of a net debtor, the situation was the reverse only in the sectors of electroenergy, ferrous metallurgy and construction.

The recorded statistical difference between the overdue payables and receivables of the Russian enterprises has had a growing trend. According to Goskomstat statistics the net position of the enterprises changed from that of a net creditor to that of a net debtor in the summer of 1994. In addition to the obvious reasons of a financial crisis associated with a general production fall the development could be related to the learned behavior under the soft budget constraints. It could be argued that enterprises benefitted from undervaluing their receivables and overvaluing the debts in the expectation that the state will come and bail the indebted companies out.

Additionally it could be argued that in the highly inflationary conditions of the Russian economy the enterprises did have great interest in cashing in their receivables as soon as possible while delaying payment of debts in the expectation that the inflation tax will then be paid by their creditors. How well the enterprises managed to pursue such a strategy depended on how influential they were in relation to other enterprises. As large enterprises generally have more clout than small ones, this may also explain why the powerful energy sector enterprises were the most indebted within the Russian economy.

The energy sector in Russia was also better able than the other sectors to compensate for the lack of financing brought about by interenterprise arrears with export earnings. Export prices of energy were adjusted to the world market price level, which was still higher than the domestic price level. Consequently, it was relatively easy for the companies to compensate for the lost domestic revenues by high export earnings. The energy sector was also in a very powerful position in relation to its suppliers and could use that position to delay payment to its suppliers and cash in receivables from its customers in order to benefit from the high inflation rate.

Because payments were still notoriously slow especially between various distant parts of the country, there is also a discrepancy in the statistics amounting to the sum of payments being transferred at any time. The amount of this "float" was also important for the banks, who have been accused of intentionally slowing down transfers while taking advantage of this non-interest bearing financial resource provided by the transfers.

As shown in table 6 the liquidity position of Russian firms deteriorated rapidly at the same time as the discrepancy between payables and receivables has become larger. At the end of 1995 less than one fifth of the overdue debts were covered by liquid money resources of the enterprises in comparison to about 50 percent in the beginning of 1994.

The weak liquidity of Russian enterprises also reflects low profitability. According to Goskomstat statistics the share of loss-making enterprises in the Russian economy reached 30 percent in November 1995. In industry the share was 25 percent on average but it was above average in the fuel industry (36 percent), non-ferrous metallurgy, forest, pulp and paper industries as well as light industries (37 percent in all).

Table 6. Liquidity and overdue indebtedness of Russian industrial enterprises in 1994-95

	1994				1995			
	Jan.	April	July	Oct.	I	II	III	Nov.
Money balances of enterprises as %-share of overdue debts to suppliers	51	32	23	21	26	23	20	16

Source: 1994 Statistical Yearbook of Goskomstat (Sotsialno ekonomitsheskoe polozhenie Rossii 1994 g).

The reduced liquidity of the enterprises, in turn, increased the interest towards barter transactions, which offered the buyers a way to finance their purchases and the sellers a way to avoid production cuts. According to a survey carried out in 1994 the share of barter transactions of the total sales of industrial companies increased considerably in 1993 and reached 16 percent in the beginning of 1994. In addition, the use of barter transactions was clearly related to the accumulation of payment arrears. The most indebted industries were among the most frequent users of barter transactions[14].

In comparison to the other Eastern European transition economies the problem of payment arrears has persisted for a longer period of time in Russia. Whereas in other countries the arrears stabilized in a couple of years after the price reform, the stabilization that took place in Russia during 1992-93 can be considered only a technical and temporary solution. The fact that the problem reappeared in 1994 is typical of the Russian enterprise behavior characterized by special priviledges given to the energy sector as well as growing wage and tax arrears.

[14] Russian Economic Barometer, Vol III, No 3, 1994, pp. 3-13; Krupnov J.S. (1995) p. 8, estimated the share of barter transactions as high as 90 percent of the industrial production in the middle of 1994; The statistics covering barter transactions can generally be considered relatively unreliable, because there is no uniform definition of barter transactions; official recording of them, for example for tax reasons, can also be easily avoided.

4.3.2 Wage arrears

In addition to interenterprise debts and debts to the state and local budgets, a significant arrears problem in the Russian economy consists of the amount of unpaid wages to employees. In December 1995 such arrears amounted to 13.4 trillion rubles, about 6 percent of all payment arrears recorded in the economy and one percent relative to GDP.

Within industry the energy sector and machine-building sectors in particular were highly indebted towards their employees. At the end of 1995 the wage arrears of the gas and coal industries amounted to 168 and 123 percent as a share of the average wages, respectively, while the industrial average was 78 percent. The military industry and coal industry had high wage arrears due to the fact that there were significant delays in budgetary payments to these companies[15]. Within the wood, pulp and paper industries the wage arrears in relation to the average wages were somewhat above (86 percent) and in the metallurgical industries somewhat below (63 percent on the average) the industrial average of 78 percent. The wage arrears were growing at a more rapid rate during 1994 and 1995 than interenterprise debts but not as rapidly as the tax arrears.

The problem of wage arrears was also influenced by other phenomena, which did not depend only on the low liquidity of the companies. It was benefitial for the companies to keep personnel on their payrolls under minimum salary contracts and to send them on unpaid vacations without laying them off. In such a way the enterprises were able to pay others higher salaries without having to pay fines for those wages, which exceeded the legal maximum of wages, determined as 8 times the minimum wage level[16].

The accumulated wage arrears caused loud protests among the employees only within the coal industry. The miners threatened to strike many times during 1994 unless the arrears were paid. However, in the beginning of 1995 such threats were silenced by the much more serious threat of closing down many of the unprofitable mines. In other industries the wage arrears caused very little public protests, which can be explained by the same fear of unemployment as within the coal industry (Morvant, 1994). In practice the employees did not have any legal means to enforce salary payments.

If the wage arrears are taken into account, the real wages of the Russian employees decreased even more than is indicated by the wage statistics. This fact draws attention to the specific feature of Russian transition according to which the employees were much more willing to accept a decrease in real wages than open unemployment (Layard and Richter, 1995).

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[15] Kommersant, 21 April, 1995

[16] Segodnija, 21 April, 1995: the restrictions on highest salaries were lifted in the beginning of 1996.

4.3.3 Russian banks and payment arrears

Simultaneously with the accumulation of interenterprise arrears the role of the Russian banks diminished as a source of financing. The enterprises resorted increasingly to trade credits received from each other instead of using bank credits. During the first half of 1992 the Russian payment arrears grew rapidly and amounted to twice as much as the amount of bank credits before the Central Bank intervened with new credits to settle the problem. Table 7 shows the development of credits given by banks to the nonfinancial sector in relation to the payables and overdue payables in the Russian economy since July 1993. Between July 1993 and December 1994 the overdue debts of the enterprises to each other outgrew again the credits given and by September 1995 they amounted to more than twice the credits extended by the banking sector.

Table 7. Bank credits and interenterprise debts in Russia during 1993-95 (billion rubles)

	Credits	Overdue Payables	Overdue payables as percentage of credits
1993			
July	15925	3400*	21
October	23578	6000*	27
December	30902	9200*	30
1994			
January	30019	16400	55
April	38888	30500	78
July	52940	48100	91
October	69865	71800	103
1995			
January	64000	84900	133
April	78800	124300	158
July	83600	165600	198
September	91400	212200	232

* Payables and overdue payables of industrial enterprises only

Sources: Tekushie tendentsii b denezhno-kreditnoi sfere 3/94, 12/94 and 11/95, Central Bank of Russia, Russian Economic Trends 1-3/1994,
1994 Statistical Yearbook of Goskomstat (Sotsialno ekonomitsheskoe polozhenie Rossii 1994 g.) and monthly Goskomstat statistics of 1995

There can be a number of reasons behind the growth shown in the table. The two most obvious explanations are the interest rate developments, on the one hand, and the credit-worthiness of the enterprises, on the other hand. First, the credits given by the banks became more expensive not only in nominal terms but also in real terms whereas the trade credits extended between the enterprises did not necessarily carry any interest at all. Secondly, as the economic situation of the Russian enterprises deteriorated, the banks became more reluctant to extend credits to them. As the amount of bank credits as a percentage of the annual GDP was 19 percent at the end of 1993, that share fell to about 12 percent by the end of 1994 and to about 6 percent by September 1995.

Additional reasons for low interest in bank credits can be found in the interest of the enterprises circumventing the banking system in general. By avoiding the use of banks enterprises had better possibilities to bypass taxation, the 50 percent currency repatriation requirements or sometimes even the alleged connections of the banks to the various mafias operating in the country (Grossman, 1995, p.2). It can also be assumed that it has been easier for the enterprises to negotiate credits from each other than from the banks. An indication of the initial softness of interenterprise debts in comparison to bank credits is also provided by the Central Bank statistics. The overdue bank credits reported by Central Bank amounted to approximately 21 percent of the credit portfolio of the banks in January 1994. On the other hand, the share of the overdue interenterprise debt in comparison to their total debt stabilized at the level of approximately 50 percent. It can also be assumed that the banks recorded their credits more strictly due to the banking supervision, which was not extended to enterprises. However, by July 1995 the share of overdue bank credits had risen to 47 percent of the credit portfolio of the banks[17], which is a further indication of the tightening liquidity situation of Russian enterprises and, as a result, also an indication of increasing difficulties in the banking sector.

4.3.4 Reasons behind the indebtedness problem and implications for foreign companies

Analytical reports covering the early development of the Russian interenterprise problem during 1992-93 point out technical problems within the Russian banking sector as reasons behind the phenomenon. Such problems included technical delays in transferring payments within Russia and especially between the CIS states, shortage of cash rubles and of credit emission to cover the liquidity needs caused by rapidly rising prices. The last point, brought up especially by Russian economists, can also be interpreted as a criticism towards the tight monetary policy of the Central Bank[18]. It has also been shown that privatization and commercialization of state-owned enterprises could increase interenterprise arrears by increasing the sheer number of enterprises for whom trade credit was necessary (Se-Jik Kim and Goohoon Kwon, 1995). Finally, it can be claimed that the magnitude of the arrears problem for the years of 1992-93 has been overestimated, as it was mainly an adaptation to payment terms prevailing in market economies (Gros, 1995, pp. 25-28).

Another line of reasoning concentrates on the behavioral aspects behind the persistent arrears problem. Some point out the collapse of financial discipline among the Russian enterprises (Bigman and Pereira Leite), while others refer to the hardening budget constraints (Ickes and Ryterman, 1992, p. 348, Suslov and Buzulutskov, p. 100), to creditor passivity (Begg and Portes, p. 7) or collusive behavior of the enterprises (Perotti, Lahiri and Citrin) while still

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[17] Bulleten bankovskoi statistiki No 12, 1994, p. 33 and No 12, 1995, p. 54

[18] Bigman and Leite, Odess, Delovoi Mir, 3 November, 1994, Delovoi Mir, 31 March, 1995

others argue that low credibility of the monetary policy is the main reason behind the discerned behavior (Rostowski, Fan and Schaffer). It is relatively easy to agree with these writers that the problem is not just a technical problem that can be solved by making the payment transfer systems more effective in the economy. However, it is most likely also not a question of a collapse in the financial discipline but rather a continuation of the atmosphere of lobbying and negotiation which the Russian managers were already accustomed to during the centrally planned administration. Their main motivation was to continue production and not to lay off employees.

In 1994 a committee commissioned by the Russian government found additional reasons behind the growing interenterprise arrears. The committee reported among others things that they had detected many indebted enterprises, which had not surrendered their foreign currency earnings to the Central Bank but kept their currencies in foreign banks and at the same time accumulated ruble debts to their suppliers and even employees[19]. This had apparently happened in the expectation that sooner or later the authorities would bail out the indebted companies. As a result they would not have to use the accumulated foreign currencies to pay the domestic debts at all. In some cases the indebted companies "found" additional financing only when they were threatened by bankruptcy proceedings.

Through such a mechanism there is also an obvious link between the development of the interenterprise debt problem and capital flight, which was estimated at 10 - 15 billion USD in 1994[20]. Also many other ways of not reporting earnings to the tax and other authorities were found. Such practices are most probably one result of low respect for authorities and law in general in the transitionary Russia. They can also be a sign of the inefficient control of the managers by the owners of the companies. The managers could use their companies freely to pursue purely personal economic goals without having to face any controls at all. This was made possible by the fact that the state as a major, if no longer a majority owner, was a passive owner and did not intervene in the management of the companies. The other owners possessed insufficient information and had no organized control mechanisms.

It was argued, in addition, that the most significant reason behind the arrears problem was the government itself, which also accumulated significant arrears and by doing so, set a bad example for the other actors within the economy. It was estimated that the governmental arrears had a cumulative domino effect of 3-6 times the original amount of arrears due to the fact that it mostly buys finished products and, if they are not paid, financial difficulties are created to all the companies which have delivered raw materials or components to the enterprises producing these products. In this situation the Russian government was under crossfire. On the one hand, it was committed to tight monetary policy and, on the other hand, the tight monetary policy backfired, in the short run, by creating tax arrears, which in turn

[19] Kommersant 34/13 September, 1994, Rossijskaja Gazeta, 7, 24 September, 1994, Izvestija 28 December, 1994, Segodnija 4 February, 1995

[20] Ekonomika i Zhizhn 42/94, IFR EBRD Report 1994

made it impossible for the government to honor its commitments without softening its monetary policy[21].

Multilateral clearing used as the first solution to the arrears problem created additional moral hazard problems as no differentiation was made between the debts of enterprises according to their viability. It is likely that these contributed to the various kinds of immoral behaviors, tax evasion, capital flight and the whole shadow economy, which developed at the same time as the arrears problem.

The attempts at cracking the arrears problem included various restrictions, controls, and sanctions, as well as a few market-based solutions, notably the use of promissory notes in payments. So far the administrative measures have not proved very successful in Russia. Most likely, the real change of conduct among the Russian enterprises will depend on the lobbying powers of banks, on the one hand, and the industrial enterprises, on the other hand, as well as on the credibility of the economic policies of the Russian government.

The implications of the arrears problem and related phenomena described above for foreign companies are mostly the same as for the local Russian enterprises. However, the difficulties of acquiring accurate and relevant information are much greater for foreigners than they are for local enterprises. These include difficulties in assessing the financial viability of their Russian business partners as well as uncertainty about the credibility of the financial policies and stability of the economic development.

For the Finnish metal and engineering companies, in particular, their target customers within the Russian wood, pulp and paper industry as well as ferrous and non-ferrous metallurgy had the highest net indebtedness among the Russian industries and a higher than average share of loss-making enterprises. Their potential partners in the Russian machine-building industry also had high net indebtedness and high wage arrears but a smaller-than-average number of loss-making enterprises.

As the arrears problem was worst in the energy sector of the economy, the forest and machine-building industries as heavy users of energy, were likely to suffer directly from the repercussions of the arrears problem in the energy sector. They were vulnerable to pressure from the energy suppliers to expedite payments and it is questionable to what extent they could exert the same kind of pressure on their customers. This in turn is likely to have worsened their financial standing and further limited their possibilities to finance needed investments. However, they in turn could also have resorted to lobbying in order to strengthen their negotiating position. For foreign business partners it is therefore increasingly important to identify the various power groups and networks within and among the industries.

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[21] Rossijskaja Gazeta, 19, January, 1995

4.4 Developments in the Russian foreign trade regime

The liberalization of the Russian foreign trade regime was initiated as part of perestroika, the economic reform introduced by Gorbatchev in 1987. First the sphere of organizations eligible for foreign trade transactions was enlarged during the years of 1988-90 (Bykov, pp. 37-44) and finally the state foreign trade monopoly was officially eliminated by law in November 1991 just before the disintegration of the former USSR. However, state intervention in foreign trade activities continued in various forms.

On the export side, "strategically important raw materials", such as crude oil, electric power and timber continued to be subjected to administrative regulation. Export of these raw materials, which represented an important share of Russia's total export earnings, was possible only for enterprises which were registered and had received an export license issued by the Ministry of Foreign Economic Relations. In 1993 the system was further recentralized under the program of centralized exports for raw materials mainly to curb illegal exports of raw materials from the country and increase the domestic availability of these goods[22].

In May 1994 President Yeltsin signed a decree which aimed at further liberalizing Russia's export regime. According to the decree, all export quotas and licences were to be removed starting July 1, 1994. However, as a victory for the powerful oil lobby, on the day this decree was to come into force, two new decrees appeared, which allowed the oil-producing and refining industries to keep oil exports under its control and to preserve all its tax benefits[23]. Export taxes were a significant source of government funding, but certain energy exporters had received exemptions from the tax authorities. It was not until March 25, 1995 after pressure from the International Monetary Fund when the system of special exporters was finally eliminated[24].

On the import side, the so-called "centralized critical imports" entailed high import subsidization, since they were distributed internally at subsidized prices. Such imports included either commodities or investment goods, which were imported and financed through certain governmental credit limits. At the beginning of 1994 all import subsidies were abolished and the system of centralized critical imports was eliminated[25].

In addition to these major changes Russian foreign trade regime was subject to frequent changes in both export and import tariffs and taxes during the years of 1992-95. In 1992

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[22] Russian Economic Trends 1/1993, p. 41

[23] Russian Economic Trands 2/1994, p. 65

[24] Russian Economic Trends, Vol 4(2), 1995, p. 71

[25] Russian Economic Trends, 2/1993, p. 43 and 4/1993 p.

import tariffs were introduced for the first time at the average rate of 5 percent. This was increased to an average rate of 15 percent in September, 1992. The coverage of both the value-added tax and various excise taxes was expanded to include imports in February 1993[26].

A major step in liberalizing the exchange rate regime was taken in July 1992, when the previous multiple ruble exchange rates where unified and the single rate was determined at the interbank currency auctions. Since then the nominal ruble exchange rate has experienced a drastic fall but the real exchange rate, deflated by the consumer price index, started an upward trend already at the end of 1993. Figure 5 illustrates the development of ruble/dollar nominal and real exchange rate since July 1992.

In real terms the ruble was undervalued when the liberalization of the rate of exchange was undertaken. As the real rate of the ruble appreciated against the dollar as a result of the high domestic inflation in Russia in comparison to the rate of inflation in the US, Russian goods started to lose their price competitivenes in dollar terms and consequently foreign goods started to gain.

Export earnings of Russian enterprises were subject to 40 percent repatriation, which was raised to 50 percent in 1994. From January 1 1994 onwards a stricter control over commodity and cash flows was also introduced. Two systems, one administered by the Ministry for Foreign Economic Relations, and another by the Central Bank and the Customs Committee aimed at supervising the activity of special exporters and uncovering any hidden revenues and capital flight[27]. Barter transactions were one concern of the authorities as in the Russian case the value of barter exports usually exceeded the value of imports. This was thought to happen as export goods in barter deals were priced below the world market price level either as a result of incompetence, or deliberately, using barter transaction as a concealed form of capital flight[28].

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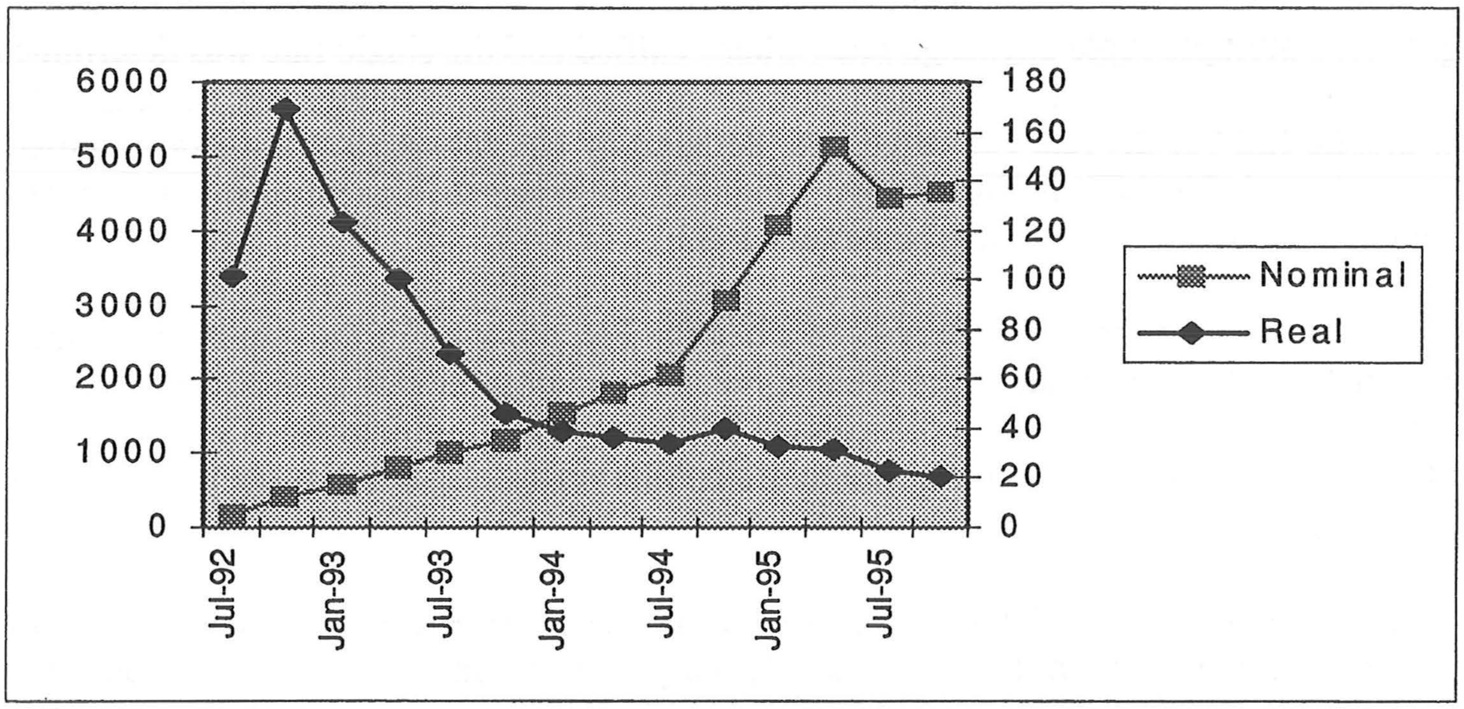
[26] Russian Economic Trends 3/1992, p. 30

[27] Russian Economic Trends 1/1994, pp. 61-62

[28] Russian Economic Trends, 3/1994, p. 79

Figure 5. Development of nominal and real* ruble/USD exchange rate during 1992-95



* the nominal rate deflated by the ratio of the US consumer price index/ Russian consumer price index
A rise indicates either a nominal or real depreciation of the ruble
Source: Russian Economic Trends Monthly update December 1996

At the end of 1991 Russia assumed responsibility for the foreign debt of the former USSR. At the end of 1995 the Russian gross foreign debt amounted to USD 130 billion (35 percent of 1995 GDP)[29]. Through the years of 1992-95 negotiations were carried out, first to reschedule current capital and interest payments that became due, and secondly to arrive at an agreement to reschedule the whole foreign debt both to official western creditors within the Paris Club and to commercial banks within the London Club. The second aim was only reached in April 1996, when the rescheduling agreement with the Paris Club was signed. This prolonged negotiation process signified in turn that as long as there was no agreement in place, only limited amounts of commercial financing were available to Russia.

Russian foreign trade statistics show a dramatic reorientation of trade from the former CMEA countries to western industrial countries after 1991. They also show a decreasing trend especially for Russian imports since 1990. In 1994 the imports amounted to roughly 40 percent of their level in 1990. The structure of trade also changed. In Russian exports particularly the share of metals increased since 1991 while the share of machinery decreased.

[29] Russian Economic Trends, Vol 4(4) 1996, p. 87

Also in Russian imports the share of machinery decreased while the share of various consumer goods increased sharply[30]. However, Russian trade statistics for the transition years are unreliable as comparisons with mirror statistics from the western trading partners indicate. It can be assumed that both exports and imports are underreported for tax evasion purposes, but the discrepancy is larger in imports. The share of imports, which were not officially registered, has been estimated at 24 percent for 1994.

The frequent changes of the Russian foreign trade regime caused difficulties for foreign companies, first, in keeping up with the most recent regulations, and secondly, in planning their operations ahead as changes were expected to happen also in the future. For foreign exporters the real appreciation of the ruble was favourable as their prices became more competitive in the Russian market. However, the value-added tax introduced in 1993 and the significant raise in import tariffs carried out in 1994 provided a negative surprise. The foreign companies wishing to export from Russia had no access to strategically important raw materials and the realized exports were subject to various export taxes, as well.

Russia signed an agreement on Partnership and Cooperation with the European Union in June 1994. The agreement regulates the economic relations between the counterparties by granting each other the most favoured nation treatment in trade. In addition to regulating trade the agreement also contains relatively detailed stipulations concerning foreign direct investment and capital flows. For foreign investors it guarantees, among other things, free repatriation of profits, although it gives Russians the possibility to restrict Russian direct investments abroad (Korhonen, 1995).

4.5 Development of Finnish exports to Russia and Estonia during 1991-95

Finland's trade with Russia was regulated by the bilateral trade and payment agreement, which was abolished at the end of 1990. A new trade agreement was signed at the beginning of 1992. Like the earlier agreement the new one was also a free trade agreement by nature. However, free trade was discontinued already in December 1992, when Russia introduced a customs tariff. Consequently, also Finland started to apply customs tariffs to trade with Russia (Rautava, 1995). When Finland joined the European Union in the beginning of 1995, the Agreement on Partnership and Cooperation between Russia and the European Union became the frame agreement also for Finnish trade and economic relations with Russia.

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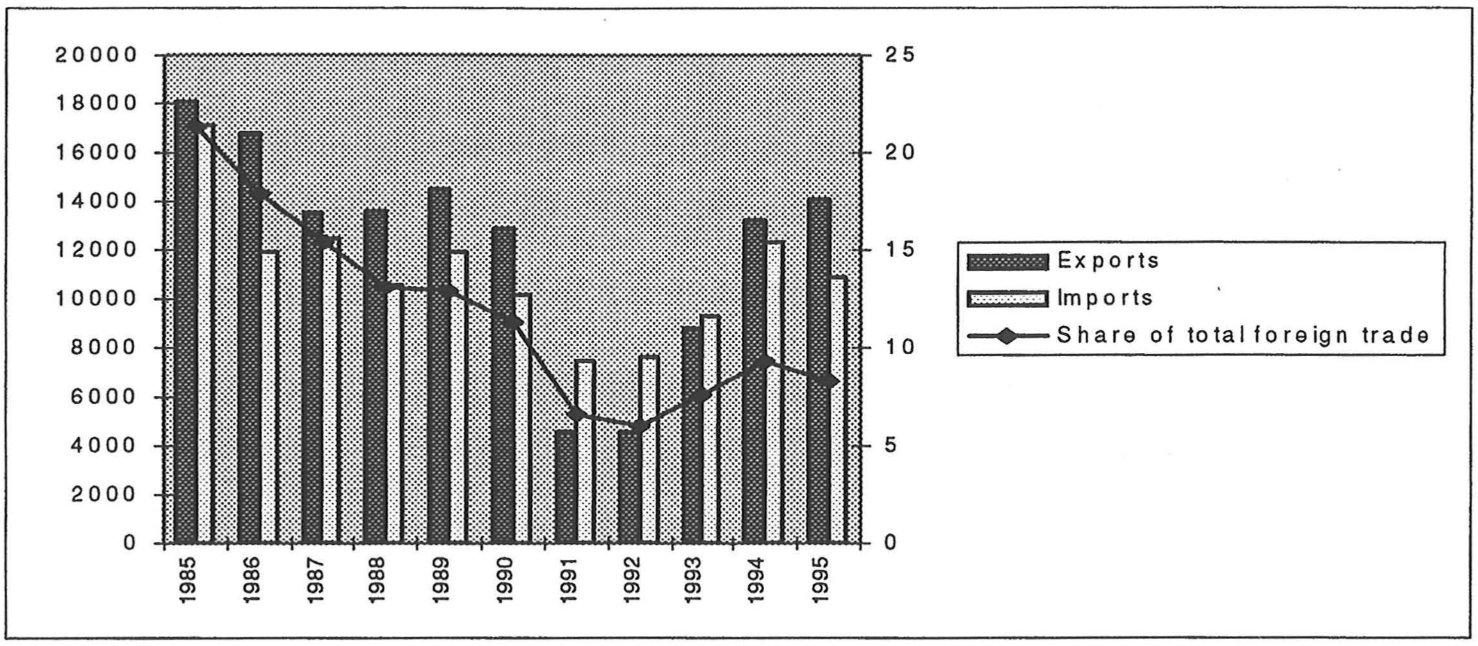
[30] Havlik, 1995, Tabata, 1994, p. 445 and Russian Economic Trends, Vol 4(3), 1995, p. 73

Finland's exports to the former USSR experienced a drastic fall in 1991 after the bilateral trade and payment agreement had been abolished. Exports stayed on the very low level of 1991 also in 1992 but started to pick up in 1993 and reached the level of 1990 again in 1994. However, the political disintegration of the Soviet Union at the end of 1991 changed drastically also the structure of Finnish exports to the region. Russia has remained the largest export market for Finnish goods within the region but her position has been challenged by the development of Finnish exports to the Baltic countries, particularly to Estonia, which has been remarkably rapid since 1992. In 1995 exports to the Baltic countries amounted to as much as 40 percent of the total exports to the former USSR countries.

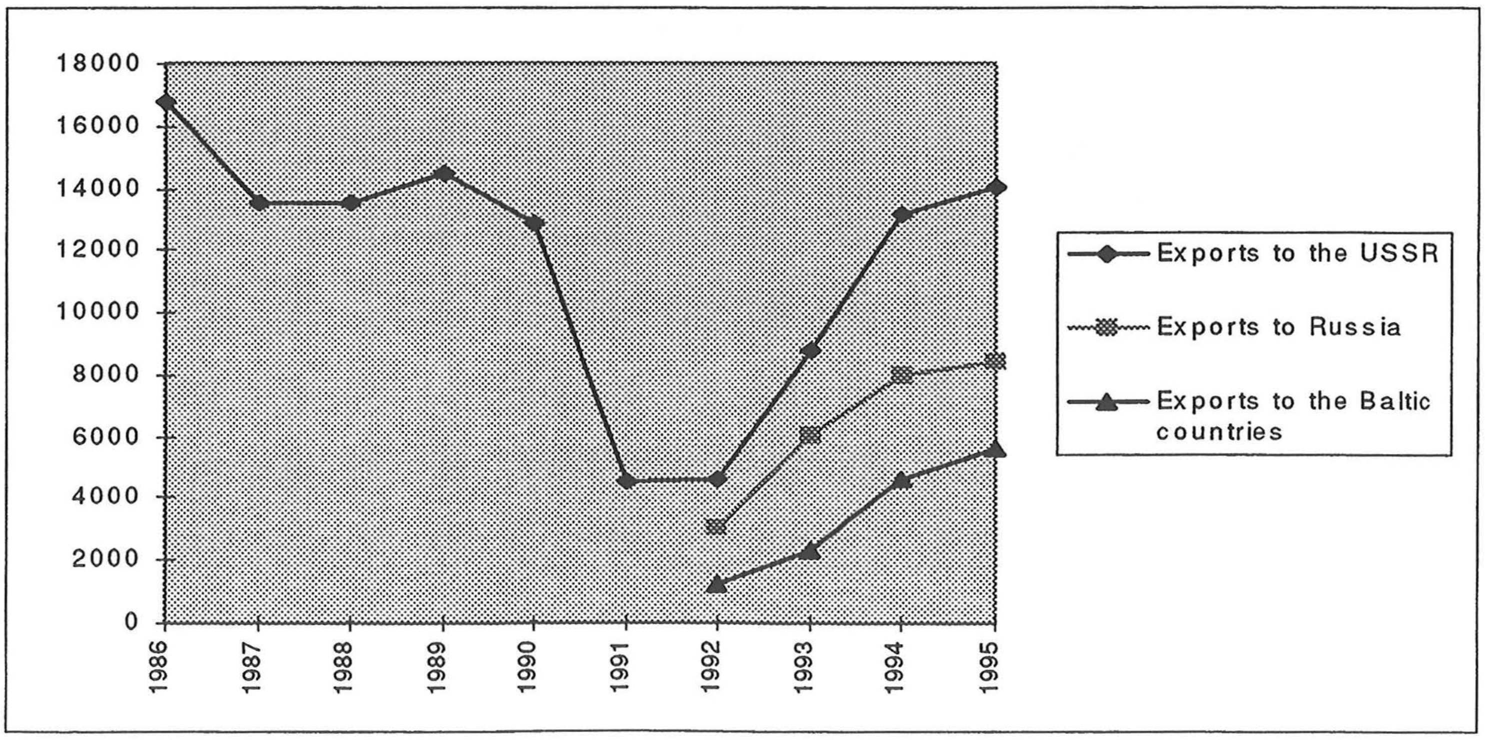
It is worth noting here that Finnish exports to the USSR had started diminishing already in 1985, when the export possibilities within the bilateral clearing arrangement were drastically reduced as a result of the decrease in the world market price of crude oil, the main import article of Finland. In 1985 the share of the USSR in Finland's exports was 21 percent. During 1991-92 the share came down to 4-5 percent but climbed again to 8 percent by 1995. The share of Russia in Finland's exports reached 5 percent and the share of Baltic countries 3 percent by 1995. During 1991-93 Finland had a deficit in trade with the region. After 1994 the deficit has turned into a surplus, which used to be the situation also during the clearing arrangement. Figures 6-7 illustrate the development of Finland's trade with the USSR, CIS and Baltic countries during 1986-95.

Figure 6. Finland's trade with countries of former USSR during 1985-95 (million FIM, left hand scale; percent, right hand scale)



Source: Official Statistics of Finland. National Board of Customs

Figure 7. Finland's exports to the USSR, CIS and Baltic countries during 1986-95 (million FIM)

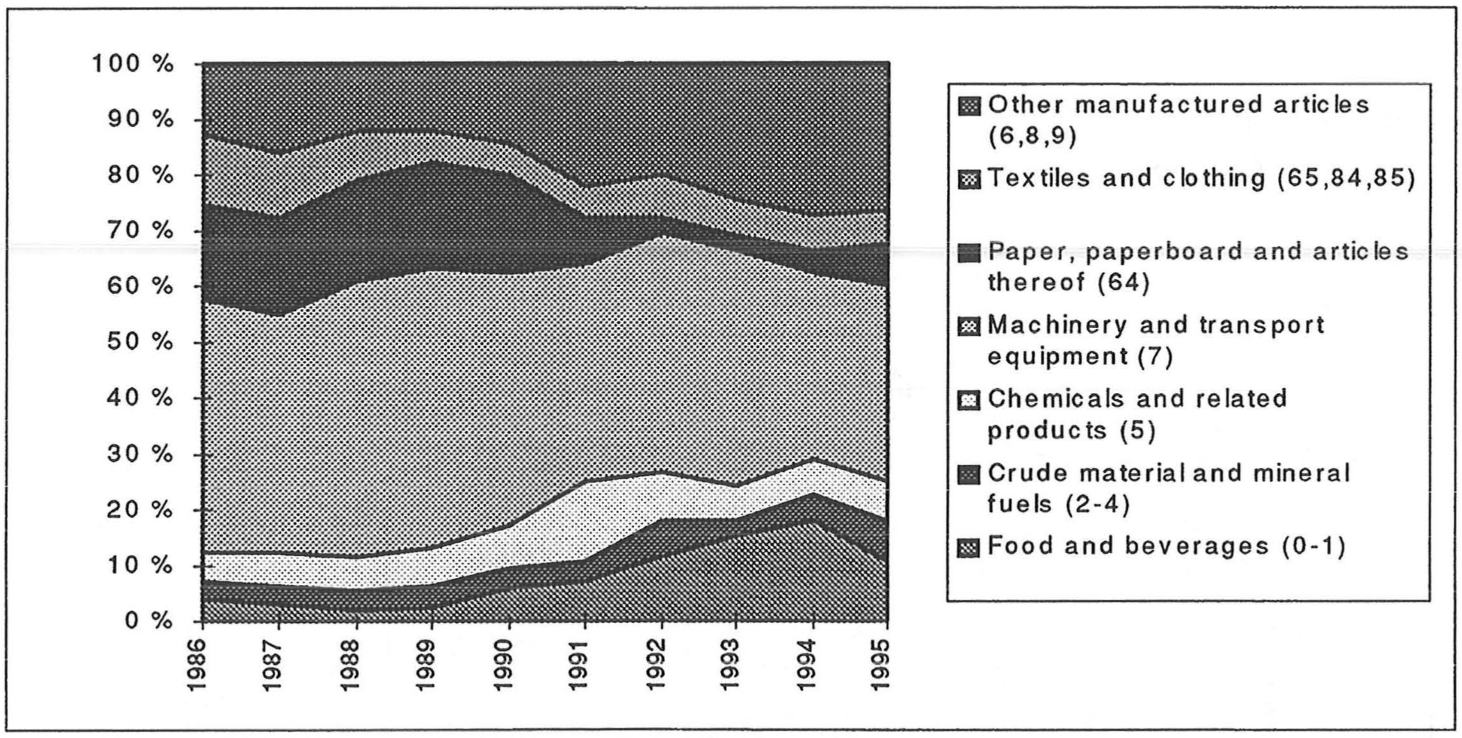


Source: Official Statistics of Finland. National Board of Customs

The structure of Finnish exports to Russia and the Baltic states was also changed since 1991. The share of food and beverages as well as manufactured goods increased while the share of traditional export articles, paper and paper products decreased significantly. The share of paper diminished from 17 percent in 1986 to 3 percent in 1993. It has been argued that the changes in the structure of Finnish exports cannot be of permanent nature as the new exports were not based on Finland's actual competitive advantages (Kivikari, 1995, p. 23). The first signs of changes towards the traditional export structure were seen in 1995, when the share of food and beverages fell and the share of paper and paper products grew.

Finnish exports of machinery and equipment also fell and their share diminished from 45 percent to 33 percent by 1993. However, machinery and equipment kept their place as the largest group of export articles in Finland's exports and also their share started to grow again in 1994. Figure 8 illustrates the structure of Finland's exports to the USSR, CIS and the Baltic countries during 1986-95.

Figure 8. Structure of Finland's exports to the USSR, CIS and Baltic countries during 1986-95



Source: Official Statistics of Finland, National Board of Customs

It has been estimated that the decline in Finnish exports of machinery and equipment to the former USSR during 1985-89 was of such magnitude that it corresponded to a 9.2 percent decline in the manufacturing of metal and engineering industries. During 1990-91 the corresponding decline of production in those industries for the same reason has been estimated at 2.2 and 6.5 percent, respectively (Kajaste, 1993). While during 1985-89 the food and textile industries were the worst hit, during 1990-91 the metal and engineering industries suffered most.

Although Russian foreign trade underwent radical reorientation from trade within the CMEA area to trade with the western industrialized countries, Finland's share of the Russian imports remained remarkably stable. While during the second half of the 1980's Finland's share of the total Soviet imports was about 3 percent, the share has remained approximately the same although the absolute exports have fallen. However, while in the 1980's Soviet imports from Finland amounted to 10-15 percent of all imports from western trading partners, after 1991 Finland's share within that group diminished greatly. After 1992 Germany emerged as by far the largest trading partner of Russia. Finland has, however, been able to keep her position among the 10 largest trading partners. In 1992 Finland was the seventh and in 1994 the fourth largest importer to Russia among the western industrial countries.

More specifically, Finnish exports of machinery and equipment accounted for 18 percent of Soviet imports of the category in 1990, while in 1995 Finland's share in the corresponding categories of imports had fallen to 6-10 percent[31]. On the other hand, in 1995 Finnish exports of machinery and equipment to Russia and the Baltic countries reached 88 percent of their level in 1990.

4.5.1 Financing of Finnish exports

Within the bilateral clearing payment system export credits could not, as a rule, be extended to individual Soviet organizations, because the system was based on balancing exports and imports on a cash basis and any imbalances were financed on the governmental level, by the Bank of Finland, on the one hand, or Vnesheconombank, on the other hand. Import credits were used in some cases to promote imports from the USSR. Export credits were only allowed within the clearing system during the last two years, 1989-90, of its existence. However, only a relatively small amount of credits was granted to Soviet buyers of Finnish goods before the system was abolished[32]. It was also possible, with the permission of the Bank of Finland, to extend credits to Soviet buyers outside the clearing arrangement in convertible currencies, but also these were used only to a limited extent by Finnish companies. Therefore Finnish exporters of capital goods did not gather experience from credit arrangements in their exports to the USSR.

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[31] The 1990 share is based on OECD statistics and the 1994-95 shares on Russian Customs Statistics for 1995.

[32] Kauppapolitiikka 1-2, 1989, pp. 17-18, Laurila, 1995, pp. 39-40

After the disintegration of the USSR Russia assumed responsibility for the debts of the Soviet organizations to Finnish creditors, including both the debts accumulated within the clearing system and those in convertible currencies. The total of these debts amounted to 7 billion Finnish marks (1.1 billion dollars), about 1.3 percent of the total foreign debt of Russia in 1991 (Laurila, 1993). However, if measured per capita, Finland had become the third largest creditor of Russia after Austria and Germany. As Russia was not able to service the foreign debt according to the original loan agreements, the State Guarantee Board of Finland stopped guaranteeing any Russian political or credit risks and Finnish commercial banks closed their Russian credits limits.

Finnish companies also changed their payment terms for Russian buyers from collections to prepayments. For all practical purposes collections which had been used within the clearing payment system had equalled payment on open account because goods were mostly delivered directly to buyers without authorization of Vnesheconombank, through which the payment documents were chanelled in the USSR. Letters of credit were rarely used in trade with the USSR and they did not become common even after the default of Vnesheconombank. The reason for this was that Russian banks also required advance payment from their Russian customers for opening a letter of credit in favor of a foreign bank or company. As the costs of letters of credit also were higher than the costs of simple advance payments directly to the accounts of foreign companies, the latter payment mode became the rule. Even after the State Guarantee Board of Finland and Finnish commercial banks started to cover short-term Russian risks, the payment terms did not change in exports and the prepayment remained the most widely used payment mode.

As this tightening of payment terms coincided with the "cash and credit crunch" in the Russian economy, financing of exports became a real bottleneck for foreign exporters. The cautiousness of Finnish commercial banks was no exeption; after the default of Vnesheconombank, at the end of 1991, no commercial credits were available to Russia. Only after Russia became a member of the International Monetary Fund (IMF) in 1992 was it possible for the Russian government to start negotiations for balance of payments financing from the IMF and some project financing from the World Bank and other international financial organizations. However, those negotiations progressed slowly due to the political and economic unstability in Russia. International commercial banks were also not willing to extend any financing to Russia as long as there was no agreement to reschedule the existing foreign debt of Russia, a situation which lasted until April 1996.

For Finnish companies exporting to Estonia the situation of export financing was similar to that of Russia during 1992-93. Advance payments became the most commonly used payment terms in exports. During 1992-93 the Estonian banking system also suffered from a severe crisis, which was partly caused by the freeze Vnesheconombank imposed on their currency accounts, including those of Estonian organizations (Hirvensalo, 1994). However, after the Estonian economy stabilized in 1993, foreign financing from the World Bank and other international financial organizations became available for Estonian companies and also Finnish exporters of capital goods could find financing sources for their exports to Estonia.

4.6 Direct investments from Finland to Russia and the Baltic countries during 1991-95

Foreign direct investments became possible in the USSR when, as part of the perestroika reform, a new law on joint ventures was passed by the Soviet Council of Ministers in 1987. The first joint venture with a partner from a capitalist country was a Finnish-Soviet enterprise, which started operations in Tallinn, Estonia in that same year. By the end of 1990, when the bilateral clearing payment system was abolished, the Bank of Finland had authorized capital exports for a total of 270 Finnish firms or individuals for participation in joint ventures with Soviet partners. At that time Finland occupied the third place among foreign countries which had founded joint ventures in the USSR, after Germany and the United States (Laurila, 1992).

Initially joint ventures, which had a higher than 30 percent foreign ownership enjoyed tax holidays. However, these were not continued in the legislation passed in 1992 and designed to govern various activities of foreign investors. For most foreign investors tax treatment equalled that of domestic companies even though some tax incentives for significant foreign investments were reintroduced in 1993. It was also possible to get preferential tax treatment by local authorities in some regions of Russia. Imports of enterprises with significant foreign ownership also enjoyed some priviledges for foreign currency holdings and exemptions from customs tariffs. There were frequent changes in all these regulations over the years but the general trend was to treat foreign-owned companies increasingly like Russian enterprises[33].

The cumulative investment flow received by Russia (or the USSR until the end of 1991) during 1990-94 amounted to 3.6 billion USD at the end of 1994. Finland's share of the total was about 2 percent. The largest foreign investor was the United States, whose investments during 1990-94 accounted for 29 percent of the total. Switzerland (15 percent) and Germany (10 percent) were the second and third largest foreign investors, while Finland ranked 10th-12th in terms of cumulative investment flows and 8th-10th in terms of numbers of the foreign-owned enterprises. However, in the republic of Karelia Finland was the largest and in the city of St. Petersburg the third largest foreign investor[34]. In Estonia the cumulative inflow of foreign direct investment reached USD 433 million by the end of 1994. Finland was the largest foreign investor with a share of close to 25 percent.

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[33] Laurila, 1992, EBRD Transition Report 1994, pp. 122-149, Transition, 12 May, 1995, Honkanen, 1994, pp. 23-24

[34] UN/ECE Econmic Bulletin 1995, p. 100

In international comparison direct investments have been modest particularly to Russia. The cumulative inflow of foreign direct investment in the Eastern European transition economies during 1990-95 amounted to USD 21.2 billion, which is only slightly more than the total stock of Finnish direct investments abroad[35]. The Russian share of that total was 19 percent and the share of Baltic countries amounted to 4 percent. The largest foreign direct investments have been directed to Hungary, whose share of the total was 35 percent.

Finnish investments to Eastern Europe are concentrated much more in Estonia than foreign direct investments to Eastern Europe in general, particularly, if the amount of investments is compared to the population of the host country. In 1994 they amounted to USD 34 per capita in Estonia compared to less than one USD per capita in Russia.

According to the balance of payments statistics of the Bank of Finland the flow of direct investment to Russia and the Baltic states amounted to approximately 600 million FIM in 1995 and the cumulative flow since 1988 to approximately 1.1 billion FIM at the end of 1995[36]. Figure 9 illustrates the development of direct investment flows from Finland to Eastern Europe since 1988.

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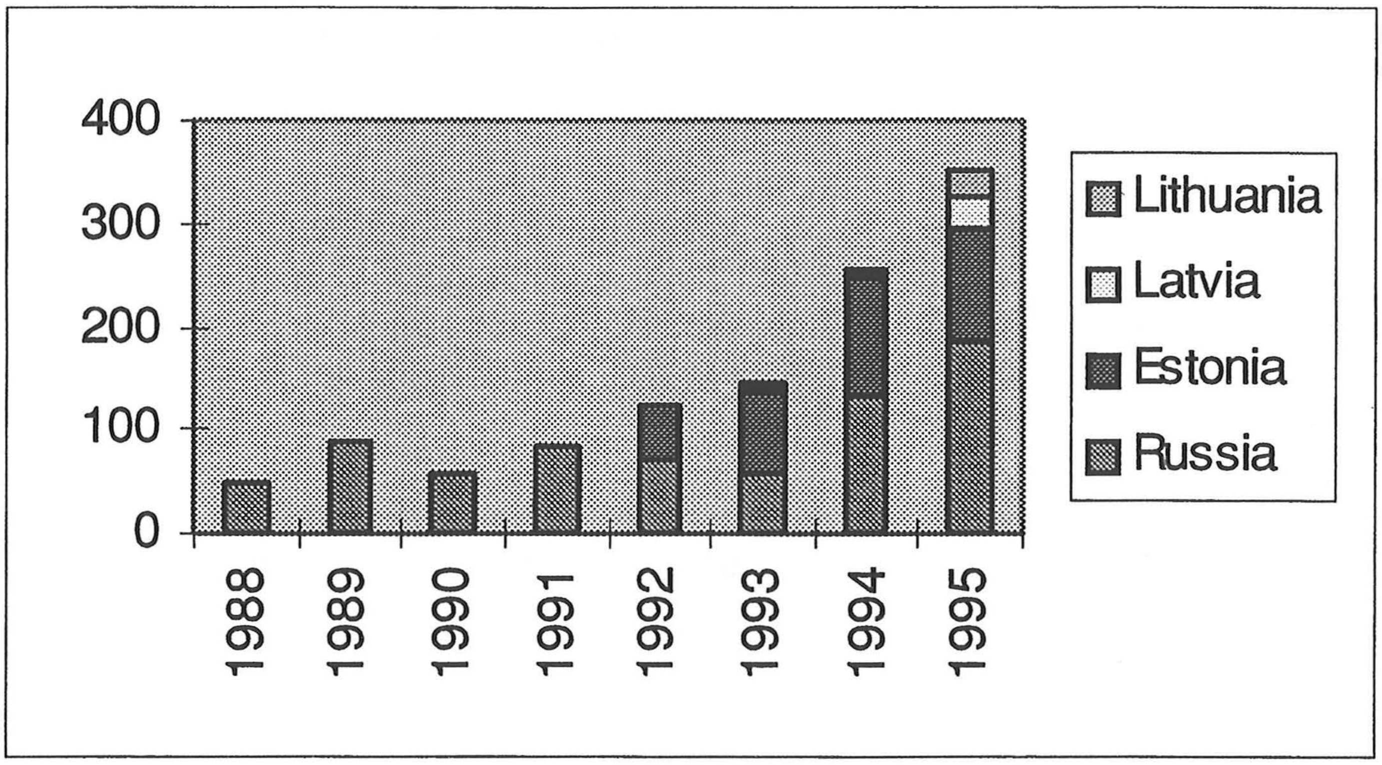
[35] UN/ECE Economic Bulletin 1995, p. 100 and Bank of Finland statistics

[36] In accordance with IMF guidelines, direct investment is defined as capital investments where the investor's holding or proportion of the voting rights is 10 percent or more.

Figure 9. Finnish direct investment to Russia and the Baltic countries during 1988-95 Net capital flow excluding reinvested earnings (or incurred losses), mill. FIM



Source: Bank of Finland

Compared both to the stock and flow of total foreign direct investment from Finland the level of investments to the USSR, Russia and the Baltic countries has been very modest. In 1995 their share of the total investment flow was 2.7 percent and of the foreign investment stock about 2 percent.

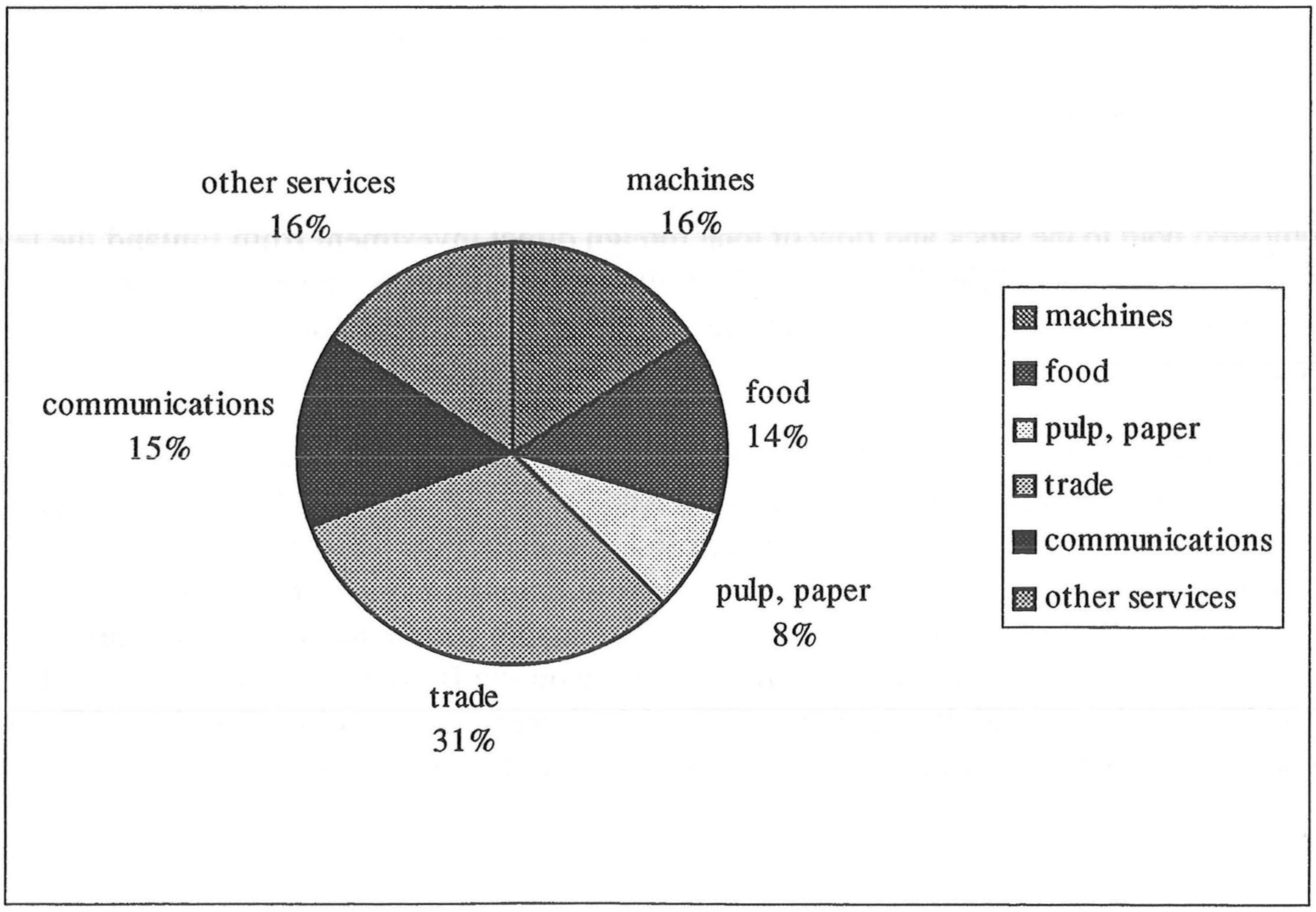
According to surveys carried out by the Bank of Finland in 1991, 1993 and 1995 the number of operative enterprises with Finnish ownership was 137 in 1991, 280 in 1993 and an estimated 1150 in 1995 in the countries of the former USSR. From 1991 until 1995 the number of operative enterprises grew most rapidly in Estonia, from 92 to about 600, while in Russia the number of operative enterprises with Finnish ownership increased from 112 to about 550[37]. The following account is based mainly on the Bank of Finland survey of 1995. In addition to the general development of Finnish direct investment into Russia and Estonia the account illustrates the financial conditions of the enterprises with Finnish ownership.

[37] Laurila, 1994, and Laurila-Hirvensalo, 1996; the number of operative enterprises with Finnish ownership differs greatly from the number of registered enterprises with Finnish ownership. Particularly in Estonia, where the registrations of subsidiaries with Finnish ownership exceeded 7000 in 1994, it was noted that most of them were founded by private individuals and were not operative.

According to the Bank of Finland survey direct investments into Russia and the Baltic countries accounted for more than 70 percent of all Finnish direct investments to Eastern Europe in 1994. Outside them investments were directed mainly to Hungary and Poland. In Russia about 60 percent of the enterprises with Finnish ownership operated in St. Petersburg or regions close to the Finnish border, about one quarter operated in Moscow and the rest in other parts of Russia. In Estonia most of them were located in Tallinn.

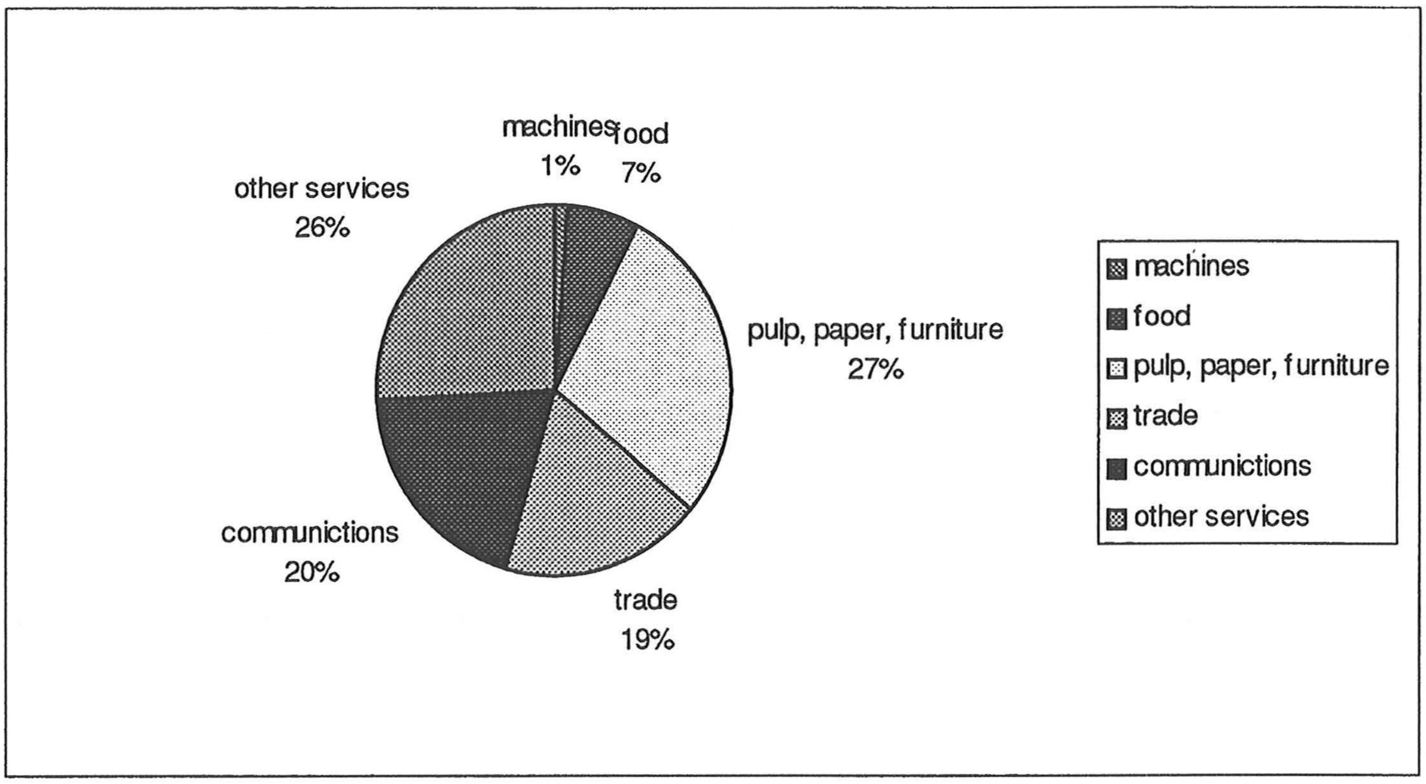
In 1994 about two thirds of the enterprises with Finnish ownership in Russia and Estonia operated in the service sector (trade, transportation, distribution, consulting, financial services, etc.) and one third in industry, mainly in the metallurgy, machine-building and engineering, pulp and paper as well as food and beverage industries. Figures 10-11 illustrate the distribution of enterprises with Finnish ownership among various economic sectors in Russia on the basis of the number of enterprises in each sector, on the one hand, and on the basis of the total investment, on the other hand.

Figure 10. Distribution of the number of enterprises with Finnish ownership by economic sector in Russia in 1994



Source: Bank of Finland survey 1995, Total number of enterprises 601

Figure 11. Flow of direct investments from Finland by economic sector in Russia in 1994



Source: Bank of Finland survey 1995

While the service sector's share in Russia is approximately the same by both accounts, the number of enterprises and total investment, there are some remarkable differences within both the service sector and industrial sectors. Within the service sector the share of trading companies was 32 percent but their investment only accounted for 19 percent of total investments. Among the industrial companies the share of enterprises in the pulp, paper and wood industry was small (2 percent) but their share of investment was 28 percent of the total. On the other hand, the share of metallurgy and machine building industry among the enterprises was 16 percent, while their share of the investment was only 1 percent. However, the subsidiaries of metal and engineering parent companies were often operative in a different sector than the parent company, mostly in the service sector.

In Estonia the service sector had a considerably smaller share if measured by total investment than if measured by the number of enterprises. Consequently, the industrial companies had made about half of the investments in Estonia, while the number of enterprises was only one third of the total. Among the industrial companies the share of food, beverage, chemical and glass industries amounted to almost half of all Finnish investments but their share of the number of enterprises was only 15 percent. Within the industrial sector the metal and engineering enterprises were somewhat more concentrated in Russia and particularly in Moscow, whereas other industrial enterprises were more concentrated in Estonia.

According to the Bank of Finland survey the internal trade between the Finnish parent companies and the subsidiaries was very small, on average only about 6 percent of the sales of the enterprises with Finnish ownership. The internal exports were about four times as large as the internal imports of the enterprises, which shows that the enterprises did not rely much on internal sourcing of materials but served as subcontractors to the parent companies in Finland.

In international comparison Finnish direct investments to Russia have been directed to different sectors than foreign direct investments to Russia in general. In 1994 between one half and three quarters of the direct investments to Russia were concentrated to the energy sector[38] while there were no investments of Finnish origin in this sector. The second largest recipient of foreign investments was trade and public catering and in this sector Finnish enterprises were also active. The Russian pulp and paper industry attracted a growing number of investors while the metallurgy and machine-building industries lagged behind these sectors[39]. As seen above there was interest among Finnish companies in both of these industries. Compared to the total of foreign investments in these sectors in Russia the investments of Finnish origin have been somewhat more significant than in the foreign investments in general.

According to the joint venture legislation introduced in the former USSR in 1987 it was only possible to establish joint ventures where the share of the foreign partner was less than 50 percent. By 1992 the new legislation allowed 100 percent foreign ownership as well as all existing juridical ownership forms for foreign investors[40]. As a result of this development the ownership structure of the firms with Finnish ownership has changed particularly in Russia. Table 8 illustrates the owhership structure of firms with Finnish ownership in Russia and Estonia.

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[38] Russian sources give differing information on this account, Goskomstat figures are lower than those given by Russian Economy - 1994, End of year report. According to Goskomstat the second largest recipient of foreign direct investments in 1994 was the construction sector and the share of the energy sector fell to 10 percent during the first 9 months of 1995.

[39] According to the monthly Goskomstat statistics the Russian pulp and paper industry attracted USD 150 million and the machine-building industry USD 100 million worth of foreign investments in 1994. Compared to these figures the Finnish ivestments into pulp, paper and furniture industry have been substantial whereas the investments in the machine-building industry have been modest.

[40] The decision of the Soviet Council of Ministries on 19 Sep, 1987 allowed foreign ownership up to 49 percent in Soviet organizations. The restriction on the maximum share of ownerhip was abolished by the decision of the Council of Ministries of 2 Dec 1988. At the end of 1991 (28 Nov 1991) a decree of the government obliged the existing joint ventures to reregister and both old and new foreign-owned companies to assume juridical forms similar to those already available for Russian firms.

Table 8. Finnish ownership share of subsidiaries in Eastern Europe by founding year (number of subsidiaries, %)

Finnish share	Founding year 1991 or earlier	Founding year 1992 or later	Total
0 - 50 %	63 (34 %)	124 (66 %)	187 (100 %)
50 - 99 %	26 (22 %)	93 (78 %)	119 (100 %)
100 %	16 (8 %)	175 (92 %)	191 (100 %)
Total	105 (21 %)	392 (79 %)	497 (100 %)

Source: Bank of Finland survey 1995

Within Russia the share of wholly owned subsidiaries was higher in St. Petersburg (52 percent) than in Moscow (32 percent) due to the fact that after 1992 a relatively large number of wholly owned subsidiaries have been founded in St. Petersburg. The share of joint ventures with less than 50 percent ownership is in turn relatively high (40 percent) in Moscow. In Estonia the enterprises with Finnish ownership included somewhat more joint ventures with less than 50 percent owhership than in Russia.

There were more joint ventures among industrial companies than among service companies. However, also among the industrial companies the Finnish ownership share had increased and most Finnish investor companies owned more than 50 percent of the shares of their industrial joint ventures in Eastern Europe.

About two thirds of the investments made from Finland had been made in the form of equity capital and the rest in the form of loans. Out of the equity capital, in turn, about 25 percent had been paid in kind and the rest in foreign currency. The equity payments in kind were more significant in small industrial companies and those situated in Russia close to the Finnish border than they were in service companies or large industrial companies which operated in other parts of the region. The survey results do not allow evaluation of the current market value of the equity paid in kind. However, the relative significance of payments in kind has diminished after 1992 in comparison to the preceding years.

About a quarter of the enterprises with Finnish ownership in Eastern Europe had financed their operations partly through loans received from Finland. These loans amounted to approximately 500 million FIM in 1994, an increase of only 23 percent from 1992 (Laurila, 1994, p. 14). However, from all sources of financing borrowing from Finland represented approximately 57 percent and borrowing from host countries 43 percent, a slight increase in favor of the host countries from 1992, when the relationship was 60/40. The companies, which reported borrowing from Finland, were mostly large industrial enterprises, however usually not in the metal industry. More loans were taken from Finland after 1992 by companies operating in Estonia than by companies in Russia. Only 6 per cent of the subsidiaries had borrowed from banks in their host countries and this share had not changed from 1992.

The volume of loans taken from local banks in Eastern Europe was very modest and amounted to approximately the volume of deposits of the firms with Finnish ownership in the local banks. Also the volume of accumulated accounts receivable from the local clients of the firms with Finnish ownership equalled approximately the volume of the accounts payable to the customers and amounted to about 10 percent of the sales. However, the accounts receivable of the firms with Finnish ownership and were more significant in Estonia and other Eastern European countries than they were in Russia, which suggests a greater confidence among the subsidiaries in the creditworthiness of the companies in other countries of Eastern Europe than those of Russia.

In comparison to Finnish foreign direct investments in general the investments made to Eastern Europe were less profitable in 1994. While the operating income in general amounted to an average of 11 percent of sales, the operating income in Eastern Europe was barely positive. While the net income (including net interest charges and excluding direct taxes) in general reached 2 percent of sales, the net income of the Eastern European subsidiaries was slightly negative. This is no doubt a result of the young age of most of the subsidiaries in Eastern Europe, as the older subsidiaries were clearly more profitable than the younger subsidiaries. However, it is also likely a reflection of the high risks in the operative environment.[41] There were no conspicuous differences in the profitability among subsidiaries in different countries in Eastern Europe. However, among the industrial companies, those operating in the metal and engineering industries were somewhat less profitable than other industrial companies. This was also characteristic of the metal and engineering companies in general and not only in Eastern Europe. Within the service industries trading companies were also somewhat less profitable than other service companies.

As in the two preceding Bank of Finland surveys the respondents to the 1995 survey were asked to assess the quality of banking services in their host countries and to give an evaluation of their experiences and future expectations in Eastern Europe. The banking services to be evaluated included opening a bank account in a local commercial bank, transfer of payments in the host country or between the host country and foreign countries, as well as the availability of credit. All responses reflected marked improvements both in Estonia and in Russia in comparison to the preceding survey results. However, there still was a clear difference between the evaluations in favor of the Estonian banks. The least improvements were recorded in the availability of credit but even in this case the responses reflect clear improvement from the situation two years earlier. In 1992 the situation regarding the

[41] It is not possible to assess the significance of taxes in the financial performance of the FFOs. However, as was pointed out by some respondents, particularly in Russia the taxation of Finnish subsidiaries has been very high.

availability of credit was generally considered to be poor but in 1994 it was considered increasingly tolerable or neutral.

In addition to differences between Russia and Estonia the evaluations of the banking services differed also according to the size of the enterprises and the economic sector. Large companies had generally somewhat more positive evaluations than small companies. However, in the question of availability of credit, particularly large industrial companies considered the services of the Russian and Estonian banks very poor. The evaluations of by trading companies were generally more favorable and the evaluations of metal and engineering companies less favorable than the average.

In the assessments of the experiences there was also a clear distinction between Estonia and Russia. The experiences the subsidiaries had in conducting business in Russia was characterized most often "tolerable". In the comments which many respondents added to the questionnaire the following reasons were given for the still low grade for the Russian business environment. Problems in conducting day-to-day business were still great. The firms encountered recurrent difficulties with the unpredictability of customs regulations and taxation, which changed constantly and of which generally no information was available in advance. Moreover, the arbitrary and inconsistent interpretations of the regulations by local authorities were considered an additional difficulty. Domestic payment transfers were still slow, which aggravated the problem of credit risk evaluation and collecting receivables from Russian customers. There were also problems with the sourcing of needed raw materials as well as finding skilled employees, which signified higher training costs than the companies had expected.

The experiences of enterprises with Finnish ownership in Estonia were most often described as "satisfactory". Excessive bureaucracy and unpredictable interpretations of the legislation by the local authorities were also considered a problem for many subsidiaries in Estonia. However, the Estonian legislation was also considered liberal and improving rapidly. For some companies the small size of the Estonian market and limited access to energy and raw material sources constituted a problem. Competition had also increased rapidly. On the other hand, many subsidiaries were satisfied with the availability and quality of local employees.

Future expectations were fairly positive both among companies operating in Russia and Estonia. However, compared to the 1993 Bank of Finland survey the expectations among companies in Russia were somewhat less favorable in 1995 than they were were in 1993 whereas the expectations among enterprises in Estonia had not changed. In Russia the opportunities of the future were seen by some respondents in the growing consumption market. In Estonia some firms with Finnish ownership expected that the increase of the FDI into Estonia will further improve the business climate and conditions for conducting business there. The difference between the expectations of the firms with Finnish ownership in Estonia and Russia seemed to be merely in the time horizon; In Estonia improvements were expected to take place in the near future whereas in Russia they were expected to materialize in the course of a longer time period.

4.7 Implications of the environmental factors, export development and trends in foreign investments

The transitionary recession in Russia and the Baltic countries created a difficult economic environment particularly for foreign companies, first, because the demand for imports plummeted, and secondly, because accurate and relevant information about the economy in general and their business partners in particular became more difficult to acquire.

More specifically, the potential customers and business partners of Finnish metal and engineering companies in the Russian forest industry, metallurgy and machine building industries were not among the favored industries in the state investment programs of Russia, nor did they have any significant resources of their own to finance investments. Measured by the interenterprise payment arrears they belonged to the most indebted industries and particularly within the pulp and paper industries the share of loss-making enterprises was higher than the industrial average. These industries, most likely, did not have the same possibilities as the powerful energy sector to speculate and benefit from the high inflation or export earnings, nor did they attract significant foreign investments. Therefore they, most likely, belonged to those companies which lobbied for governmental help in their difficulties.

In the sphere of foreign trade frequent changes in the trade regime, tariffs and taxation caused additional difficulties for foreign companies. However, the real appreciation of the uble was favorable for them and increased their competitiveness on the Russian market after the initial price reform freed the import prices from regulation.

Finnish exporters of machinery and equipment lost part of their market share in Russia after the bilateral clearing payment system was abolished at the end of 1990 and Russian imports from other western market economies increased in relation to imports from Finland. However, in 1995 the exports of machinery and equipment to Russia and the Baltic countries reached 88 percent of the level exported to the USSR in 1990 even though no official credit support was available for exports to Russia and only in a small number of cases for exports to Estonia.

Finnish direct investments to Russian and Estonia grew rapidly after 1992, although compared to the total foreign direct investment flows from Finland, their share amounted only to about 2 percent. The majority of enterprises with Finnish ownership in these countries operated in the service sector and only about one third were industrial enterprises. Within industry the metal and engineering companies which operated in Russia were very small as their share of the total investments to Russia amounted only to 1 percent even though their share of the number of enterprises with Finnish ownership was 16 percent in 1994. In addition, the metal and engineering parent companies had often founded subsidiaries, which operated as service companies in Russia.

Subsidiaries of Finnish firms, which operated in the metal and engineering industries were also not among those which had financed part of their operations by loans from the Finnish parent company. As the sector also fared worst in profitability of foreign investments in general, this most likely reflected the difficult financial situation of industry in general, not only the attitude towards financing investments in Russia. However, the metal and engineering subsidiaries were also among the most critical towards the quality of services offered by the Russian banks, which suggests that also the Russian banks might have given them more reason to be critical than subsidiaries in other industries or sectors of the economy.

Finally, a comparison between the attitudes and expectations of enteprises with Finnish ownership in Russia and Estonia showed that the future expectations among enterprises in Russia were somewhat less favorable in 1995 than they had been in 1993 whereas the future expectations among enterprises in Estonia had improved since 1993.

5 Research design, methodology and case descriptions

This chapter contains descriptions of the research design, methodology and the empirical case studies of three Finnish metal and engineering companies, Valmet, Ahlstrom and Outokumpu.

5.1 Research design and methodology

The study employs different methods of analysis and sources of data. In addition to books, journal and newspaper articles as well as official statistics, the study relies on empirical survey data and case studies. The empirical data includes structured interviews with 42 companies in 1991 and 29 companies in 1992. In addition, a case analysis of three Finnish engineering companies was carried out in order to capture the adaptation processes within the companies. The three companies were among those initially interviewed in 1991 and 1992 and interviews of their personnel continued in 1993-95.

The overall research design of the study has two different parts and resembles that of a time series experiment[1]. The first part, covering the year 1991 and supported by Luostarinen's earlier FIBO surveys of 1976, 1983 and 1990, represents a pre-change measurement. My licentiate thesis covers essentially that part of the study. The survey of 1992 supported by the case-studies in 1993-95 represents the after-change measurement of the dependent variable, the operational strategies of Finnish companies. The change in this context refers to the disintegration of the former USSR at the end of 1991 and the introduction of economic reform at the beginning of 1992. The part of the chart 3 with bold text describes the present empirical study which covers the years 1991-95.

As the political and economic changes unfolded in Russia, the limitations of surveys based on structured questionnaires in such rapidly and continuously changing environments became obvious and another approach, that of case study design, was chosen to supplement the overall design. The three cases, in turn, follow general replication logic, according to which the findings of the first case study will be compared to two other cases, the first in the same industry and the second in a different industry. However, as the case companies themselves were operating in more than one industry, comparisons between units of the case companies are also possible and offer interesting insights into the differences in operative strategies

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[1] Campbell and Stanley, 1963, pp. 37-42

between different units of companies. The overall research design is illustrated in the following chart 3.

Chart 3. Overall research design
(years 1976-91 are covered in the licentiate thesis)

Occurrence of the independent variable	Measurements of the dependent variable Operative Strategies
	1976 Luostarinen's FIBO survey * 1983 Luostarinen's FIBO survey * 1990 Luostarinen's FIBO survey *
Abolition of the clearing payment system	
	1991 Hirvensalo's structured survey *
Disintegration of the former USSR and start of economic reform	
	1992 Hirvensalo's semistructured survey **
	1993 case company interviews by Hirvensalo **1994 case company interviews by Hirvensalo** **1995 case company interviews by Hirvensalo**

* analyzed in detail in Hirvensalo (1993a)
** described in Hirvensalo (1993b)

5.1.1 Structured and semistructured surveys in 1991-92

The companies originally chosen to be interviewed in 1991 were selected on the basis of industry and size of their exports to the USSR. The exports of the 42 companies (47 persons) interviewed in 1991 covered 70 percent of Finnish exports to the USSR in 1990 and represented well the commodity structure of those exports. The exports of 29 of the same companies (36 persons) interviewed in 1992 covered 60 percent of Finnish exports to the USSR in 1990. The companies were predominantly large companies by Finnish standards, because within the bilateral trading system Finnish exports to the USSR were traditionally concentrated in the hands of large exporters.

Table 9 lists the companies surveyed during 1991 and 1992 and industries that they represented.

Table 9. Companies included in the surveys in 1991-92 and industries they represented

	companies or units of larger concerns 1991	1992
Metal and engineering industry	22	13
Woodworking industry and their marketing agencies	6	3
Construction industry	6	4
Chemical industry	4	4
Clothing, textile and footwear industry	4	1
Trading houses	5	4
Total	47	29

Two thirds of the persons interviewed were directors responsible for the exports to the USSR, one third were general managers with wider responsibilities. In large companies it was normally the export manager responsible for the USSR market. In smaller companies it was usually the the general manager who was best informed about trade and strategy formation in the USSR market. In addition to the representatives of the exporting companies specialists from various industrial and trade associations involved in trade with USSR were also interviewed in both 1991 and 1992.

As the original research questions in 1991 targeted the operational changes of Finnish companies in the former USSR as a response to the abolition of the bilateral clearing payment system, it became clear during the research process that the political and economic changes underway in Russia would actually imply much bigger changes for the companies in the future. It also became evident that the changes were more varied and the process longer than inially thought, when the research was started. Consequently, the conclusion reached after the first round of interviews in 1991 was that structured questionnaires were not very good at capturing the adaptation process, which the companies were going through. Therefore, a different methodological approach was chosen for the follow-up research.

In the 1992 interviews the respondents were asked about changes in their operational modes and strategies since the previous year. However, 20 out of the 36 persons interviewed were different persons than those interviewed a year earlier and particularly in these cases the interviews covered also the development of the operations for a longer period of time, which provided a possibility to check with the information provided earlier. No big discrepancies in the information were discovered. There were practically no novices to the trade among the new respondents, which reflects the situation in trade with Russia among the experienced Finnish exporters after the drastic fall of exports in 1991.

When the companies were approached in 1992, the interviews were carried out in a less structured way, which allowed for more open-ended questions and more detailed description of the changes. As in 1991 all interviews had been carried out in Finland. In 1992 representatives of 11 companies in Moscow or St. Petersburg were interviewed. However, it became clear that it would be impossible to track down the changes in as many as 42 original companies because of the rapid restructuring processes within the companies due to many other causes than changes in the Russian markets only. A number of the companies had gone bankrupt or been merged with other companies. For these and some other reasons of a more practical nature, only 29 of the original companies were reached. As also the research questions had changed form from the first round of survey, it was decided to continue the research with the help of a few case studies instead of larger surveys.

5.1.2 Case studies in 1992-95

The structured survey, which was carried out in 1991 was designed to answer the questions[2]: had the operation modes of the companies changed; had these changes taken place in accordance with the stages theory of internationalization; and had the companies lost competitive advantages in the former USSR market? As the research was planned to continue in order to answer questions referring to the process of how and why these changes had come about, the case method was chosen because it is better suited to address these kinds of research questions than the survey method (Yin, 1994, pp. 3-8).

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[2] The questionnaire is provided in Hirvensalo, 1993

However, there were other still more compelling reasons for choosing the case method. In order to be able to carry out a meaningful statistical analysis of the changes caused by a large number of variables the needed number of data points exceeds by far the possibilities of a single researcher to collect such data. The case method offers a solution to cope with technically distinctive situations, in which there will be many more variables of interest than data points. It is therefore suited to investigating a contemporary phenomenon within its real-life context and when the boundaries between the phenomenon and context are not clearly evident (Yin, 1994, pp. 13). In case studies the role of theory can be characterized as analytic generalization as opposed to statistical generalization, which is mostly used in surveys.

Especially in this particular context, when changes in operative strategies are the topic of the study, case analysis permits the testing of multiple-variable, complex causal explanations within a single case by pattern matching (Daft 1983, Eisenhardt 1989, Parkhe 1993, Yin 1993, pp. 19-21). An analysis of emerging patterns of behavior in a longitudinal context is also advocated by Stacey (Stacey 1995, pp. 492-493) for the study of strategic change processes.

The three case companies were chosen among those that had participated in the study at earlier stages so that the case descriptions could be built on earlier data already collected from those companies. All three were engineering companies with more than ten years of operational experience in the former USSR and Russia. All of them were also producers of investment goods, which is why their interest in the Russian market was of a long-term nature and the strategic alignment needed to accommodate that position.

The three companies were not interviewed simultaneously. The study was started by interviewing representatives of two companies, Valmet and Ahlstrom, in the industry producing paper and pulp machinery in 1993-94. The motivation behind having two companies from the same industry as subjects in the study consisted of the possibility of replication of the findings in the first company within the same industry. The third company, Outokumpu, was chosen from a different industry (mining) and was studied later than the first two. The motivation in this case was the possibility of replicating the findings in a different industry, which would enhance the external validity of the findings. However, as it turned out, all of the companies were operating in more than one industry also on the Russian and Baltic markets, which allowed comparisons between operative strategies of different units of the companies as well.

The key respondents in the three case companies were the same persons who were interviewed originally in 1991. They were interviewed several times during 1992-95 and they also reviewed the draft case reports. In addition to them several other persons in the case companies were interviewed in Finland, Moscow, St. Petersburg and Tallinn. The vast majority of the repondents were Finns.

Construct validity concerns the establishment of correct operational measures for the concepts being studied. These were addressed by using several sources of information and having the respondents review the draft case study reports. The internal validity concern of explaining or establishing a causal relationship, whereby certain conditions are shown to lead to other conditions, was addressed by the method of pattern matching. The reliability concern was addressed by careful note-taking and detailed write-ups covering all interviews.

The interviews were all carried out by the author personally. Each interview lasted about an hour in 1991, between one and two hours in 1992 and between two and three hours in the case companies in 1993-95. Accordingly, the total time spent for interviews amounted to about 50 hours in 1991, about 60 hours in 1992 and about 45 hours in 1993-95. Of the total time spent for interviewing about one third was thus spent in the case companies. The interviews were not recorded because it was felt that it would have hindered the respondents from speaking freely. However, the notes taken during the interviews were typed up as soon as possible in order to formulate the findings as correctly as possible. The pursuit of objectivity was a natural aim but it is clear that any subjective biases of the author are imbedded in the research method. A summary and a timetable of the interview data collection is presented in table 10.

Table 10. Empirical data collected for the study in 1991-95

	Structured survey 1991	Semistructured survey 1992	Case interviews 1993-95
Number of companies	42	29	3
Number of SBU	47	29	9
Number of respondents	47	36	14
Number of interviews	47	36	20
out of which interviews in case companies	3	4	20
Number of case interviews in Finland	3	2	12
in St. Petersburg	-	1	5
in Moscow	-	1	3
in Tallinn	-	-	2
%-share of the exports of the Finnish companies included in the study of total Finnish exports to the USSR or Russia	70	60	6-7

5.2 Case VALMET

5.2.1 Brief history of the company

Valmet Corporation was founded after the second world war when the State Artillery Works were merged with the state-owned shipyards. The history and roots of Valmet go back, however, to 1750, when the first shipyard was founded in Suomenlinna, the fortress island just outside Helsinki. In 1918, one year after Finland had gained independence, and after almost 170 years in shipbuilding the company first diversified its operations and started repairing aircraft also in Turku. In 1938, just before the war the Finnish State founded the State Artillery Works (Valtion Asetehdas) in Rautpohja near Jyvaskyla. After the war, in 1944, another shipyard started ship repair work in Pansio, Turku. In 1946 the shipyards and Rautpohja factories were merged and formed the State Metal Works (Valtion Metallitehtaat), which became one of the biggest suppliers of war reparation deliveries to the USSR.

Valmet Corporation was formed in 1950 and introduced diversification into paper machinery, which became the main product line of Rautpohja factory. However, ships continued to be the major products of Valmet well into late 1980's, when the shipyards were sold. The first paper machine was delivered from Rautpohja factory in 1953. In addition to ships and paper machinery the company has produced aircraft, cars, elevators, automation equipment, tractors and other transportation equipment. These last two businesses were sold in 1994. In 1992 Valmet acquired Tampella Papertech and became a leading manufacturer of paper machinery in the world. The first public share offering of Valmet Corporation was carried out in 1988 and in 1996 more than 50 % of the shares were held by private shareholders, the majority of which were foreign institutional investors.

Internationalization of the company was boosted by the establishment of the first foreign subsidiary, the tractor factory of Valmet do Brazil, in 1960. The internationalization development accelerated considerably in the mid 1980's and led, among other things, to the founding of a paper machines producing subsidiary Valmet-Xian in China in 1989.

5.2.2 Characterization of the company and developments in 1990-1995

In 1994 Valmet Corporation was described as an engineering company specializing in paper and board machinery as well as related automation equipment. After the acquisition of Tampella Paper Tech in 1992 Valmet had become the only producer of paper machines in Finland and the leading producer in the whole world. In addition to the core businesses of paper and board machinery and related automation equipment, which accounted for 88 percent of the company's net sales in 1994, Valmet produced transportation and power transmission equipment, which accounted for the remaining 12 percent of net sales in 1994.

The Finnish Government held 79.8 percent of the shares of Valmet in 1990. By 1994 the share of government ownership was reduced to 58.6 percent as a result of two new share issues, the first in the nominal amount of 60 million FIM 1992 and a major new share offering in the nominal amount of 140 million FIM in the spring of 1994. The corporation's shares have been quoted on the Helsinki Stock Exchange since 1988. A decision made in the Finnish Parliament in December 1994 gave the state permission to sell all the shares in its ownership, but no definite timetable has been set for completing the privatization.

Between 1991 and 1995 the company underwent a restructuring process, which included both mergers and acquisitions as well as asset sales. In 1991 the corporation consisted of a holding company and the following 7 independent major business units: Valmet Paper Machinery, Valmet Automation, Valmet Transportation Equipment, Valmet Logging, Valmet Tractors, Valmet Aviation Industries and Saab Valmet. In 1994 the transportation equipment, logging and tractor units were sold to the state-owned truck manufacturer Sisu. However, Valmet retained a minority ownership of 24 percent in Sisu after the sale. On August 31, 1995 the core business units of paper and board machinery were merged with the holding company.

The development of Valmet's net sales between 1990 and 1994 reflects both the recessionary market conditions especially during the years of 1991 and 1992 as well as the acquisition of Tampella Paper Tech in 1992 and the sale of Transportation, Logging and Tractors to Sisu in 1994. As a result, the net sales of 8.3 million FIM in 1994 were 18 percent smaller than in 1990 and 22 percent smaller than in 1993. Valmet's profitability improved, however, consistently from 1991, when the company had a record loss of 692 million FIM before taxes. In 1994 Valmet recorded a net profit for the first time since 1988. Table 11 summarizes Valmet's financial performance during the years of 1990-94.

Table 11. **Financial performance of Valmet Corporation during the years of 1990-94 (million FIM)**

	1990	1991	1992	1993	1994
Total net sales	10110	7666	9645	10676	8328
Operating income of which:	-181	-471	171	479	371
Paper and board machinery	180	68	-59	182	235
Automation	-38	13	61	77	80
Saab-Valmet	-	-	307	74	92
Aviation Industries	-1	-32	-23	-1	-36
Power Transmission	14	-12	7	19	22
Others	-199	-120	-95	-140	-96
Subtotal	-45	-83	198	211	296
Operations sold	-216	-380	-30	176	53
Less inter-business eliminations	80	-8	3	92	22
Total income before taxes	-290	-692	-219	-54	178

Source: Annual reports of Valmet for the years of 1990-94

Valmet Corportion operated increasingly on a global scale. In 1990 net sales in Finland accounted for about 25 percent, Nordic and other Western European countries for 38 percent, North America for 22 percent and Asian countries for 2 perceent of the total net sales. In 1994 the share of Finland had fallen to 19 percent and European countries to 31 percent of the total while the share of North America had risen to 28 percent and that of Asian countries to 10 percent of the total.

In 1994 Valmet had altogether 105 subsidiaries, 22 of which were in Finland. The remaining 83 subsidiaries were located abroad including A/O Valmet STP in St.Petersburg, Russia. In addition to subsidiaries Valmet had 29 associated companies, where Valmet's ownership was 50 % or less, including Contur S.P. in Moscow, Russia.

In terms of personnel the company had also diminished in size from 1990 when it employed 17 000 people until 1994 when the personnel amounted to only 12 000 people. The 29 percent fall in the number of persons employed from 1990 to 1994 was larger than the fall in net sales, 18 percent, during the same period. In 1994 68 percent of the personnel was based in Finland, 15 percent in North America and 14 percent in other European countries. The largest sector measured by the number of people employed (67 percent of the total work force) was the paper and board machinery unit while automation equipment was the second largest (13 percent of the total). Since 1992 Valmet had operated under the leadership of CEO Matti Sundberg.

In 1990 the company's goal was defined as building a balanced and growing portfolio of profitable and adaptable businesses based on
- high quality human resources
- high quality operations
- superior customer value through product design and engineering
- marketing that stresses value and service to customers
- and focused operations abroad and strategic alliances with suitable cooperating partners.

The stress on quality and giving customers superior value remained key ingredients of the company's goals through the five years of 1990-94. However, as a result of the restructuring measures the target of building a balanced portfolio of businesses had changed into a more focused view on products but a broader view on markets. In 1994 the goal was phrased as continuing to operate on a global scale and in all markets as the leading supplier in its field.

What was the significance of the former USSR market for Valmet and how did the company adapt to the changes in that market during the years of 1991-94?

The significance of the Russian market for Valmet was based on the simple fact that Russian forest resources are the largest in the world and a leading paper technology company simply cannot ignore such a market. Moreover, Russian forest industries are concentrated in the European parts of the country and are, in fact, geographically much closer to Finland than other target markets of Valmet. However, even such clear motivation backed by a long experience and commitment to the market, did not come very far in helping the company articulate an operational strategy in 1991 after the bilateral clearing arrangement between Finland and the USSR had been abolished and the USSR was on the verge of disintegration.

The following account summarizes first Valmet's export strategies and performance within the bilateral clearing arrangement and secondly during the years of 1991-94. It then describes the organizational features of Valmet's Russian operations, probes into financial questions and finally looks at the major customers of Valmet in that market.

5.2.3 Development of export strategies of Valmet in the former USSR market within the bilateral trade framework

Within the bilateral clearing payment system Valmet was one of the biggest Finnish exporters to the USSR. As for most of the Finnish companies exporting to the USSR the bilateral trade framework determined the exporting strategies also for Valmet. It was essential to secure a quota both in the five-year trade agreements as well as in the yearly trade protocols for Valmet's principal products, which included ships, paper machinery, and transportation equipment. This was accomplished in part by maintaining good relationships with both Finnish and Soviet foreign trade authorities responsible for concluding the trade protocols. In this framework Valmet's main competitors were other Finnish shipyards and engineering companies. Foreign companies were practically excluded from the Finnish-Soviet bilateral trade framework.

Actual contracts were signed with specialized Soviet foreign trade organizations, which were monopoly buyers in the products entrusted to their organization. A single contract could cover deliveries during the entire five-year planning period or at least during one calendar year. The intergovernmental clearing payment arrangement ruled out the use of trade credits in exports and consequently financing was not a significant problem for the exporting companies. On the contrary, Valmet as one of the companies delivering ships to the former USSR could benefit from generous downpayments from the Soviet buyers that exceeded their need for working capital in the beginning of a contract period.

The Russian end-users of ships or paper machinery were rarely involved in trade negotiations. However, contacts to the end-users became frequent as a result of another process, which developed within the bilateral trade framework from the beginning of the 1970's, namely that of scientific, technical and economic cooperation. Within the intergovernmental mixed commission several working groups were set up in the 1970's to study the possibilities of technical and industrial cooperation between Russian and Finnish companies. Valmet was one of the companies that participated actively in these working groups and developed a network of connections to various Russian companies and organizations as a result of this.

On the governmental level the major motivation to set up these working groups was to increase imports from the USSR to Finland as within the bilateral framework Finnish exports to the USSR showed a chronic tendency to grow larger than imports from the USSR. Finnish companies did not face direct countertrade requirements from the Soviet buyers because the bilateral arrangement was designed to reach an overall balance of payments between the two countries. However, Valmet like other Finnish engineering companies faced increasing demands from the Soviet organizations to buy technology from them and include Soviet components into their export products. As a result of this many ships sold by Valmet to the former USSR customers were furnished with Soviet equipment. However, this was a contradictory policy also in the USSR, because often the end-users were strongly opposed to buying Russian technology, which they claimed to be inferior, through Finland.

The exports of Valmet to the USSR fell dramatically after 1986, when the oil prices started to fall. Until that year ship exports had amounted to about 1.4 billion FIM each year. In 1985-86 these exports fell to 1 billion FIM per year, but after 1987 no ships were delivered to the USSR. Since 1987 the yearly exports of Valmet only reached 150-270 million FIM. Table 12 summarizes the development of Valmet's exports to the former USSR in 1986-90.

The dramatic fall in exports also led to a change in trading strategy, because most of Valmet's export products no longer belonged to those which had a quota of their own in the trade protocols. In the years of 1987-90 only ship gears and spare parts and a small number of trucks had a small quota of their own.

The conclusion Valmet made at that point was that the Soviet purchasing power within the bilateral payment agreement had disappeared in 1986 and the company had to start selling its products in the Soviet market in return for convertible currencies. That conclusion was reached four years before the clearing system was abolished, which took place at the end of 1990. In practice the new strategy was carried out by seeking new customers in addition to the old buyers, who had bought within the clearing arrangement. This was possible due to the foreign trade reform which diminished the role of the Soviet foreign trade organizations at the same time. The new strategy also meant that new intermediaries had to be found, because the Soviet foreign trade authorities did not allow direct payments in convertible currencies to be paid to Finnish companies as long as the clearing arrangement was valid. Therefore subsidiaries of Valmet in Great Britain and Sweden were used as intermediaries.

Table 12. **Net sales of Valmet to the USSR during 1986-89 compared to total sales and total of Finnish exports to the USSR (million FIM, %)**

	1986	1987	1988	1989	1990
Sales to the USSR	1277*	270	210	156	228
Total sales of Valmet	6620	7268	8518	10027	10110
of which exports to the USSR	19	4	2	2	2
Finnish exports to former USSR	16786	13522	13564	14498	12888
Valmet's share of Finnish exports to USSR (%)	8	2	2	1	2
Finnish exports of machinery and transportation equipment to USSR	7586	5736	6631	7262	5821
Valmet's share of machinery exports to former USSR	17	5	3	2	4

Sources: The annual reports of Valmet and statistics provided by the company; Finnish foreign trade statistics
* depicts exports to Eastern Europe of which less than 5 % went to other countries than the USSR

As explained above Valmet did not face other countertrade requirements within the clearing payments arrangement than those that were justified by increasing the imports of machinery from the USSR. However, when selling against convertible currencies the countertrade requirements were common and also Valmet faced them. The company concluded successfully a couple of such deals, one of which led to continued subcontracting from a factory in Volgograd. However, later countertrade became more and more cumbersome to conclude, as it became increasingly difficult to find any import products in the USSR.

When the clearing arrangement was finally abolished at the end of 1990, the unit responsible for the USSR market felt that they had already adapted their operative strategies to the changed situation and because of that no significant changes were needed in the immediate future.

However, in 1991 there was a discrepancy between the importance attached to the Russian market for Valmet in the long run and the short-term strategy, which was characterized by an attitude of "wait and see". This discrepancy led to the realization that rather than having a long-term strategy the company used short-term tactics to guide their operations in the market. The long-term view in turn is characterized by the following view of the top management at that time: "We shall retreat from the Russian market only if the Russians start shooting at us!"

5.2.4 Development of exports during 1991-94

Table 13 summarizes the development of Valmet's exports to the USSR and Russia during the years of 1991-94. The volume of recorded exports fluctuated greatly reflecting among other things the restructuring process of the company. Particularly the drastic fall in exports in 1994 as compared to the previous year was due to the sale of logging and transportation equipment to Sisu. These sectors had increased their exports to Russia especially in 1993. The share of net sales to the USSR of Valmet's total net sales had fallen to 2 percent in 1991 and fell further to 1 percent in 1992.

It is worth noting, however, that Valmet's exports still played a more significant role in the Finnish-Russian trade at times than they did for Valmet Corporation. They reached a high of 7 percent of Finnish exports to the former USSR area in 1993 but dropped to 1 percent in 1994. Compared to the total exports of machinery and transportation equipment from Finland to the former USSR area Valmet's exports reached a high of 9 percent in 1991, when the total exports of that product group fell by a record 70 percent from the previous year.

Out of the two remaining sectors of Valmet the Paper Machinery sector experienced a relatively large fall in exports to Russia after 1991. Although no new paper machines had actually been sold to the USSR after 1985, other equipment to the wood-working industries, renovations of machines that had been sold earlier as well as spare part deliveries kept the exports close to 100 million FIM per year. After 1991 they dropped to merely one quarter of that level and consisted mainly of spare parts. Valmet Automation, on the other hand, was able to maintain the level of exports reached at the end of 1980's in spite of the drastic fall of exports to the USSR in general.

Table 13. **Net sales of Valmet to and Russia (USSR in 1991) during 1991-94 compared to Valmet's total sales and total of Finnish exports to Russia (million FIM, %)**

	1991	1992	1993	1994
Sales to the Russia (USSR)	157	108	132	44
Total sales of Valmet	7666	9645	10676	8328
of which exports to Russia (%)	2	1	1	1
Finnish exports to Russia (USSR-91)	4522	3020	6037	7994
Valmet's share of exports to Russia/USSR (%)	3	4	2	1
Finnish exports of machinery and equipment to the former USSR region	1756	1967	3677	4361
Valmet's share of machinery exports to former USSR region	9	6	11	3

Sources: Annual reports of Valmet and statistics provided by the company; Finnish foreign trade statistics

5.2.5 Development of Valmet's organization dealing with the Russian market

This section will account for the organizational changes within the units in Valmet which were responsible for the Russian market during 1991-95. There were three kinds of units in charge of the market: the Russian trade unit in the head office, Valmet Automation Projects, which was an independent company within the organization, and the representative offices in Russia.

5.2.5.1 Changing role of the Russian trade unit in the head office

When trade with the USSR was conducted within the bilateral clearing arrangement Valmet had a specialized unit in the head office, whose role was that of a coordinator between the various sectors of Valmet, on the one hand, and the Russian counterparts, on the other hand, and the manager of the Moscow representative office in the USSR. When the trading strategy changed from clearing to selling against convertible currencies the role of the centralized unit also changed. It began to take a more active role in the business itself by engaging a countertrade specialist in Moscow in 1988-90 and a specialist of paper machines in starting from 1989. At the same time the overall structure of Valmet developed towards independent business units under the holding company structure.

By 1991 Valmet's Russian trade unit in Finland had diminished from 5 to 3 persons while the business sectors employed a total of 33 persons dealing with exports to the USSR. In practice the unit's role had developed into more than coordination for most of the sectors, while Valmet Automation operated independently in the USSR market. In addition to planning, budgeting as well as managing the representations in Russia the Russian trade unit became an initiator of new types of operations in Russia. Particularly, the 100 percent owned subsidiaries for the Russian markets were designed within the unit.

Both tasks of coordination and development had their problems. The task of coordination was difficult because the old Russian counterparts of Valmet did not appreciate the situation where sector representatives of Valmet approached them and were not aware of each other's efforts. They put the blame on the central unit, which, however, did not have the power to make decisions on behalf of the independent units. The development task in turn faced a lot of resistance to change within the organization. The unit acted both as a "firebrigade" and a back-up of last resort for sectors that faced difficulties in dealings with Russians and a "crying wall" for Russian engineers who had problems with their machines and equipment. The unit's long experience and what was described as "a potpourri of survival means" served them well in many akward situations.

Among Valmet's factories there were two different ways to organize the sales to Russia. The first was to assign the marketing responsibility to a couple of Russian speaking persons within the general marketing organization of the unit. This way was used in the tractor and transportation equipment sectors. The second way was to set up a small marketing unit specializing only in the Russian markets. This way was used within the forest machinery unit, which developed a group of 6 persons for the Russian market only. In addition to those Valmet Automation Projects, which was a separate subsidiary of Valmet, specialized totally in trade with Russia. The unit had altogether 40 persons, including marketing, planning and projecting personnel.

The coordination problems were biggest in Valmet Paper Machines, which had not concluded a major deal in Russia since 1985. Each of the units in Pansio, Järvenpää, Rautpohja and Karhula and after 1992 also Tampella had their own specialists for the Russian market. There was no coordination among the units, and they did not know of each other's contacts in Russia. As the problems became evident, plans were made within the Paper Machinery sector to form a group which would be specializing in the Russian market, and assign certain large Russian customers to persons within the group. The organization was modelled after the one in Valmet Automation. That model was, in fact, a duplication of the old centralized Russian trade unit on the business sector level.

It was realized, however, that the model would not remove the need of coordination among various business sectors, because in a number of cases they were trying to reach the same customers in Russia. Also in barter, compensation or countertrade deals the sectoral units could be negotiating with the same trading house in the western markets. However, the barter deals lost their earlier significance in 1994 and the specialist hired for that purpose in 1993 left the company. The need for coordination diminished also significantly after the sale of Transportation equipment, Logging and Tractor businesses to Sisu.

From a general strategy point of view the marketing strategies of Valmet in Russia were, however, not integrated into the general strategies of Valmet in Finland or in other markets. Only machinery and equipment made in Finland were exported to Russia. Units in other countries did not have any contacts with the Russian market until the acquisition of a Canadian factory in 1993, which had sold distant control systems for gas pipelines to Russia and started to market their equipment to Russia with the help of Valmet's organization in Finland.

In 1993 the Russian trade unit was transferred from the head office to the central administration of the Paper Machinery sector. In 1994 the Russian trade unit gained marketing responsibility for the Paper Machinery sector in Russia and continued in the coordinating role mainly by retaining control of the representative offices in Russia. The unit also grew in size and employed altogether 10 Finns by the middle of 1995, including 4 marketing specialists and 6 general administrators who were needed to manage the growing infrastructure of offices in Russia. The number of Russians was also on the increase. Valmet's experience of employing them was better than expected and they seemed to be able to carry out more demanding tasks than thought before. However, the marketing responsibility needed to be carried out mostly by Finns. After Paper Machinery was merged with the Valmet holding company in 1995 the unit found itself again in the head office. Chart 4 describes the organization of the Russian trade unit in 1995.

Chart 4 Organization of the Russian trade unit of Valmet Paper Machinery

5.2.5.2 Valmet Automation Projects

Valmet Automation Projects Ltd (VAP) was founded in 1985 as an independent company, which became the USSR marketing and project delivery unit serving the whole automation sector of Valmet. Its original goal was to enlarge the product basis of Valmet and to make it less dependent on cyclical fluctuations in paper and pulp machinery business.

From the very beginning the company adopted a different way of operating in the USSR than the other units of Valmet. VAP targeted the end users directly instead of trying to sell through the normal channels of bilateral trade, through the Soviet foreign trade organizations. It sold against convertible currencies not only because their products did not have a quota in the bilateral trade agreements but because the domestic content requirements of the clearing arrangement made it impossible to sell western technology through the clearing system.

As VAP did not lean on the official channels they developed a more customer-oriented approach to doing business in the Russian market. Based on their experience they claimed that the competitive advantages Finnish companies enjoyed in the Soviet market due to the clearing payment system backfired in the multilateral business environment, because the companies had a hard time adopting a new attitude to dealing with the Russian customers. Also within Valmet they claimed that the old "representative" approach to customers was no longer appropriate and a new sales-oriented approach was needed.

VAP developed a new marketing approach, which was based on finding a solution to the customer's financing problem. Mostly this involved accepting responsibility for finding buyers for some of the products available to the customer. In some cases there was such a need not because the potential customer did not have sufficient income to finance the required investment but because a major customer of the factory had not paid their bills in time. One way of finding a financing solution in such cases involved solving the financing problem of the customer's customer. And the chain could have been even longer.

In such a strategy the traditional role of a technical marketing expert was really secondary and even VAP had difficulties in adapting to that approach not to speak of the rest of Valmet's engineering-driven organization. Also on the Russian side the approach signified bypassing the technically oriented buyers of the potential customers. What was crucial for that strategy, though, was to find a marketing channel, normally a proficient trading house, which in turn could identify a potential buyer for the products available. Valmet's own possibilities to buy the offered products were very limited. Increasingly crucial for the success of the strategy became also the ability for Valmet to assume part of the risks of the deals, because competitors in the Russian market started doing that.

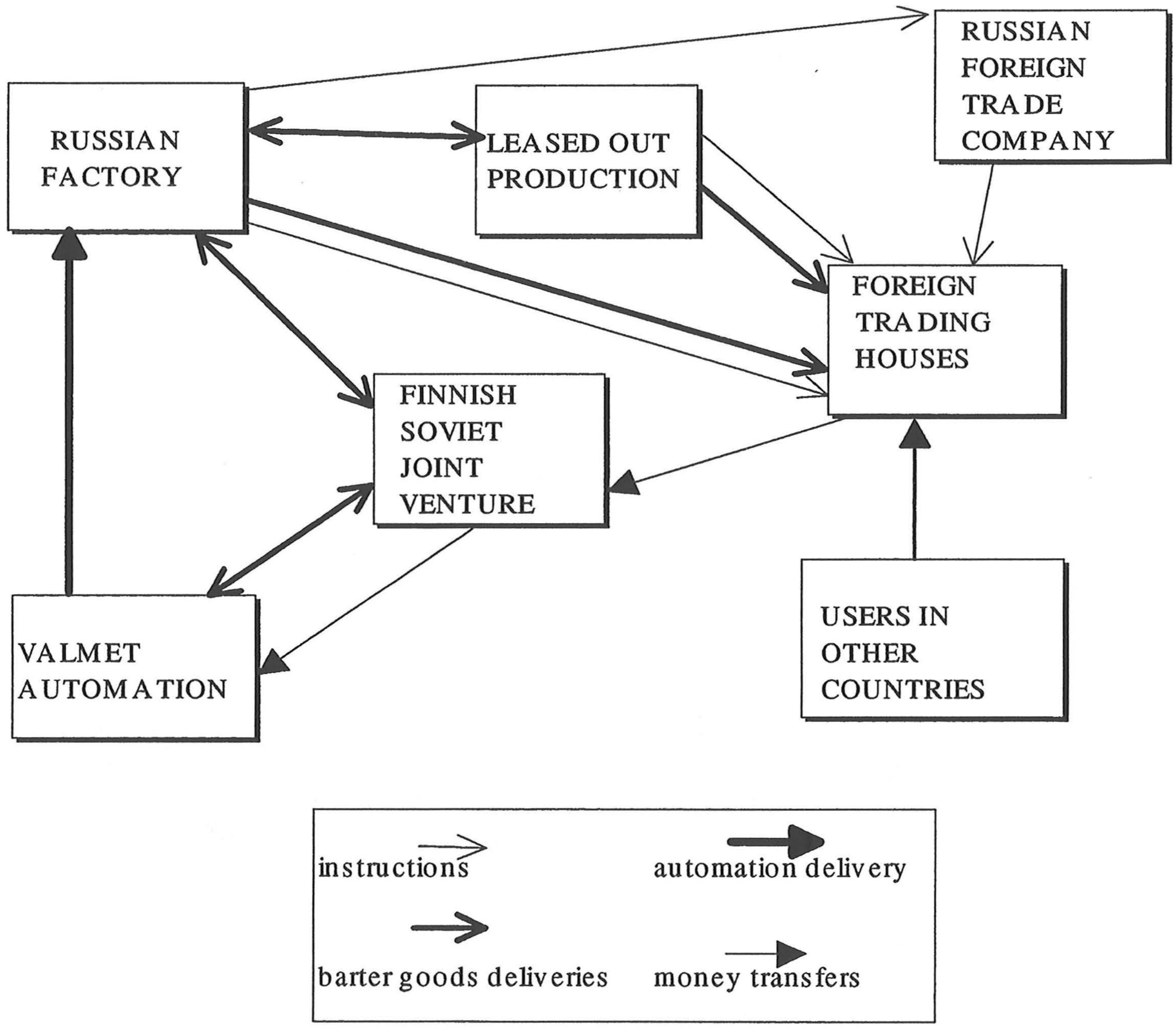
In 1993-94 most of the contracts signed by VAP's Russian partners were financed by barter, compensation and similar arrangements, in which the money came from another source than the buying customer. An example of a barter arrangement is given in chart 5. In developing their expertise in concluding such complicated and risky deals VAP did not receive any help from the financing department of Valmet, which considered such deals as abnormal and archaic ways of conducting business. In their words, "the less they knew about them the better".

However, using this strategy VAP was relatively more successful in the Russian market than the paper machine sector. They were helped by the fact, though, that most of their potential customers who had various needs for automation equipment were already old customers of Valmet. As such equipment is normally worth much less than paper machines are, it was also easier for VAP to find financing solutions for the deals. They realized that bigger units would also need different financing solutions.

Such more comprehensive financing solutions, which were required to finance bigger deals, involved normally an international financing organization because commercial banks were not ready to assume any Russian credit risks. In 1994 Valmet Automation succeeded in concluding a 10 million FIM contract in Estonia to furnish the Tallinn Iru Power station with automation equipment with the help of World Bank financing. The financial negotiations of that deal were also carried out by VAP without any technical help from the financing department of Valmet. The strategy of finding a solution to the potential customer's financing problem had expanded from barter solutions to targeting other international financing sources.

During 1994 and 1995 it also turned out that the possibilities of concluding barter, countertrade and similar arragements had considerably diminished as a result of increased activity of major international trading houses, who had developed direct contacts to the Russian factories and were prepared to assume part of the financing risks themselves by paying advance payments to the factories. In such circumstances VAP could no longer compete with the trading houses in finding solutions to the financing problems of their potential customers. Also the Russian factories had established trading units of their own and no longer required the help of outside intermediaries.

Chart 5. Example of a barter transaction concluded by Valmet Automation in 1991



5.2.5.3 Representative and sales offices in the former USSR and Russia

Valmet was one of the first foreign companies which opened a representative office in Moscow as early as 1975. The office was shared with three other Finnish state-owned companies, Enso, Rautaruukki and Neste until 1987 when Neste left the group and set up an office of their own. In 1993 the family-owned engineering company Ahlstrom joined the group and brought the number of companies back to four. At that time Ahlstrom was no longer a competitor of Valmet, because they had sold their automation equipment business to Honeywell. The major benefits of a joint office were in sharing the relatively high costs of maintaining it.

In 1991 Valmet's Moscow office employed two Finnish expatriates, the chief of the representation and a specialist of paper machinery, as well as three local Russian technicians. Two Finnish and two Russian secretaries, chauffeurs and other technical personnel were shared with the other Finnish partner companies. In 1994 the number of Russians serving partly one company only and partly the whole representation had gone up to 8 while the number of Finnish expatriates had diminished by one. It was also expected that the number of Russians would continue to increase and the number of Finns to decrease further in Moscow. The high costs of expatriate salaries, apartments, cars and related services made them very expensive for the company in comparison to Russians. It was also not difficult to find Russians with good basic training and sufficient English language skills to be trained by Valmet.

Moreover, the whole justification of the representation was being questioned in the changed circumstances. It had lost its earlier significance as the contact office between the company and the former Soviet foreign trade authorities. The office served more as a base for Valmet's sales engineers, who travelled increasingly in other parts of Russia. The status of representation within the Russian environment had also become more ambiguous due to the efforts of the tax authorities to tax the office for the sales of Valmet in Russia. Although so far unsuccessful these efforts caused some concern.

From the practical point of view Valmet also found that the cooperation with the other Finnish companies did not serve them well because more space was needed for the increased number of Russian employees and negotiations with the increasing number of Russian customers. Therefore Valmet decided to apply for an accreditation in their own name only in order to set up an office of their own. After a lengthy process of finding new premises and dividing the joint property of the joint office Valmet moved to an office of its own in February 1995.

Consideration was given to the alternative of changing the representation into a sales office but plans were made, instead, to change it into a joint subsidiary of Valmet STP and the Russian subsidiary of Sisu. However, it was unclear how the owner of the new premises, the State Ministry of Health, would react to the change of the tenant. They might not consider a subsidiary of two Russian companies a reliaible tenant. In that case the planned ownership structure would also have to be changed.

In addition to the Moscow representation Valmet Automation was also one of the first foreign companies which opened a representative office in Tallinn as early as 1989. It became possible after new legislation was passed at that time in the USSR enhancing the economic independence of the former Soviet republics. The representation was reregistered in 1991in the independent Estonia. In practice it operates as a representation of Valmet Automation and serves also as a base for marketing efforts in Latvia and Lithuania, to some extent also in Belorus, Ukraine and even Russia. In 1994 the unit employed two Estonians who were marketing automation systems in general and four others who were selling automation systems for gas stations alone.

In 1993 Valmet opened a representative office in St. Petersburg. The decision was motivated mainly by the fact that most of Valmet's big customers in the paper and pulp industries were situated within the Leningrad region. However, the representation was registered by the local authorities as a suboffice of the Moscow representative office. That strategy was chosen because it was considered a much quicker way to proceed than to set up a totally new representation in St. Petersburg.

Also a subsidiary, Valmet STP was registered October 18, 1993 in St. Petersburg and it started operating on the same premises as the representation formally as a sales office. According to the Russian legislation a subsidiary is a Russian juridical person whereas a representative office is not. The combination of the two different but complementary juridical forms of operation offered Valmet clear benefits.

The representative office, on the one hand, offered Valmet a tested way of operating in the country based on the long experience of running such an office in Moscow. It offered an official status for the Finnish employees to be employed by it and an established procedure for importing cars, office equipment and furniture free of duty into the country (with the understanding that they will eventually be returned to Finland). Consequently, the representative office was able to provide secretarial, telephone and other services to the sales office at no additional cost while the sales office was being set up. Moreover, the representative office did not face similar restrictions of holding cash or limitations on the salaries of the Russian employees that could be paid without penalties as a sales office did.

The sales office, on the other hand, offered more flexibility and, above all, the possibility to perform commercial operations, which were not possible for a representative office. The sales office also provided a legal way to employ Russian marketing engineers and a possibility to buy office premises, even production premises, if needed. From a more practical point of view it also provided a possibility to exchange currencies, which the representative office could not do.

Formally the representation was headed by the chief of the Moscow representation, who also served as the CEO of the St. Petersburg sales subsidiary. The representation originally employed two Russian engineers, one representing the Paper Machinery and the other representing the Tractor, Logging, Transportation Equipment and Automation sectors. The sales subsidiary in turn hired Russian salesmen, who started working for the sectors of Tractor, Logging and Transportation Equipment later acquired by Sisu. After the acquisition the Russian salesmen continued to be employed by Valmet even though they worked for Sisu due to an arrangement by which Valmet formally sold their services to Sisu. As a result of this Sisu became a major customer of Valmet in St. Petersburg. However, this arrangement ended June 30, 1995, when Sisu founded a subsidiary of its own in the city.

The representative office in St. Petersburg served its main purpose during the stage of establishing the subsidiary but was planned to continue formal existence at least for some time in the future. At the end of 1995 only the subsidiary was active in practice. It employed 16 persons, two Finnish expatriates, the CEO and a Finnish secretary, and 14 local Russians.

The experience Valmet gathered in managing offices both in Moscow and St. Petersburg testified first that Russia was much more bureaucratic than the old Soviet Union. After the central administration of the USSR disintegrated, the number of various local administrators increased considerably and they all had to have their say about operations to be conducted within their territory or supervision. As a result in St. Petersburg alone Valmet had to pay local taxes to at least six different organizations.

Secondly, there was also a big difference between the two major cities of St. Petersburg and Moscow, which even had a different interpretation of the Russian constitution concerning some issues of ownership. In addition the administration of St. Petersburg was particularly annoyed if they were told to follow some instructions given out of Moscow. For example, only the general licence for establishing a subrepresentation by the authorities in Moscow was respected by the local authorities. Everything else had to be negotiated with the local administration.

The planned division of work between St. Petersburg office and Moscow office of Valmet was such that St. Petersburg office was supposed to serve the area near to Finland, Karelia and the Leningrad region. Moscow office in turn was assumed to take responsibility for the rest of the European part of Russia, which ends at the Ural mountains. However, the division was not very clear-cut and more flexible in practice and depended on the available resources in each unit.

Additional representative offices were also planned in other parts of the former USSR by Valmet Automation Projects. In Dnepropetrovsk Ukrainian personnel was employed and everything was ready for opening a new office at the end of 1995 just waiting for a contract to be signed with a local cooperation partner. In other cities of Russia and the former USSR Valmet Automation Projects was on the lookout for suitable office premises and local persons who could represent Valmet's products in their cities.

The question of premises was much more difficult to solve everywhere in Russia and the former USSR than in other markets. In the former USSR practically all office space was occupied by state-owned companies and various state organizations. In the transitionary circumstances state-owned companies had not given up their properties and most vacant office space was to be found in governmental organizations, which were been reorganized and had lost a great part of their funding. It was difficult to find an organization which would not face the threat of disappearing altogether. A long lease is necessary, though, because the premises to be rented regularly need renovation at the cost of the occupant and due to the normally bad condition of the premises such costs can be very high.

5.2.6 Valmet's approach to joint ventures and production cooperation

The joint venture boom started in the former USSR in 1988. The enthusiasm for creating joint ventures with foreign partners was so great in the country when it first became possible, that the proposals overwhelmed foreign companies. In Valmet's representation in Moscow one person's time was fully taken up by receiving joint venture proposals and negotiation requests concerning the proposals. As a result in 1988 Valmet set up 2 joint ventures with Russian partners. The first one, Contur S.P., was founded to manufacture process automation equipment for the chemical industry. The second one, Russkij Diesel Valmet, was designed to produce gears for diesel engines but never saw daylight because the big project for which it was supposed to produce the gears was delayed and finally ran out of funding.

Contur S.P. in turn still operates in Moscow but did not become a manufacturing unit. Instead it operates mainly as a service and marketing unit and carries out some assembly and programming operations for Valmet Automation Projects. It employs about 20 persons, all of whom are Russians after the Finnish managing director returned to Finland in 1994.

The experience Valmet has gathered from the one functioning joint venture is mixed. On the one hand, their experience shows that Russians can operate very efficiently, in fact more efficiently than Finns, when sourcing raw materials, channelling basic technical information, projecting, planning even carrying out market research and financial planning in the Russian environment. On the other hand, they realized that there was a problem in entrusting marketing responsibility to the Russians, not because the Russian engineers were not competent enough, but because they were not credible enough in the eyes of the potential Russian customers. Therefore the marketing of investment goods and related negotiations had to be carried out by Finns.

In addition, it turned out that the image of joint ventures had actually become bad in Russia in spite of the initial enthusiasm of setting them up. There had apparently been too many examples of short-sighted profit-pocketing among the first successful joint ventures. The envy of the majority of Russians, who had not been able to benefit from similar possibilities, had made the joint ventures unpopular and suspicious in the eyes of Russians.

Consequently, Valmet planned to diminish its ownership in Contur from the original 50 percent level and continue cooperation with it on the same basis as with other cooperation partners in the country. The Russian ownership of the company changed somewhat already in 1993 when it received a new Russian shareholder, who in addition to the shares of Contur was buying up shares in Russian companies in many parts of Russia with funding that came from the United States.

In addition to joint ventures Valmet developed also other forms of cooperation with Russian partners. In St. Petersburg there were two such institutes, a mathematics institute (Leningradskij Matematisheskij Institut, Lemma), and an institute which dealt with the paper industry (Giprobum). Cooperation with the mathematics institute was motivated by the effort to develop contacts to the military industry in St. Petersburg and the Leningrad region and the institute provided such connections which for a foreign company would have otherwise been inaccessible. The institute also provided help and suitable premises in the early stage of planning for the St. Petersburg representation of Valmet.

Valmet's idea in the field of industrial cooperation was to identify potential subcontractors within the military industry, which was known for better quality facilities and machinery than the civil engineering industry. The military industry also had idle capacity after the strategic arms limitation talks had led to agreements with the U.S. In 1992 a few small contracts were signed with a couple of factories. The results were, however, not very promising and the cooperation with the institute was terminated already in 1993. The best results were reached in cooperation with a factory in Volgograd, which continues to deliver parts of paper machinery to Valmet. In other cases there were problems either with the quality of the products or with finding markets for those products whose quality was acceptable. Most of the products offered by the potential partners in the military industry could not be used by Valmet.

Cooperation with Giprobum, on the other hand, continued. During the centrally planned system the insitute was responsible, among other things, for evaluating all investment plans of the Soviet paper and pulp industry. Therefore it knew intimately all the factories and their machinery including those bought earlier from Finland. The institute continues operating as a consultancy and their contacts are still valuable for a company targeting the pulp and paper industry. Valmet's representative office and subsidiary in St. Petersburg are operating on premises rented from the institute.

With the help of the contacts of the institute and through their other contacts to the industry Valmet tried to evaluate the state of the Russian paper and pulp industries as a potential customer and the engineering industry as a potential cooperation partner.

Of the potential cooperation partners a machine building factory in Petroskoi, Karelia, showed interest in selling shares to Valmet as well as to many other foreign investors, because the managers did not believe that Russians could restructure the factory. According to the factory management Russians could not provide the needed know-how, nor had they the necessary funding to buy western technology. The factory did also not have any research and development or marketing channels and marketing know-how of its own. The management also believed that a western owner would not hesitate in showing the door to most of the unneeded employees. The Russian managers had difficulties in doing this because of personal relations at every level of the company.

Valmet was not interested in becoming a shareholder, because they had no reliable way of evaluating the investment. In addition the cost of raw materials had risen above the world market price level and the cost of labor was rising rapidly. The expectations of the local authorities in Karelia would have been enormous as the foreign investor was expected to solve all their transitional problems at one blow. There was also no apparent threat of Russia raising import duties considerably, which would have justified an investment into a factory there. Moreover, a group of Moscow investors had bought one third of the shares of the factory a couple of years earlier but resold them back to the factory.

Valmet also investigated the idea of establishing a small joint venture together with an engineering and/or maintenance division of a Russian paper factory. The machine building factory of Svetogorsk was considered as a possible partner, but the whole idea was dropped after Valmet realized that due to the envy of the other Russian factories, the unit could not have sold anything to the other factories.

Until 1994 also the general economic situation in Russia was such that Valmet considered it impossible to make any production investments in the country. The company had formulated a number of minimum criteria, which would have to be fulfilled before any direct investments could be made into the Russian industry. The criteria could be summarized as follows:
1) there is an irreversible and strengthening trend toward the market economy in Russia, and
2) the capital earned in the kiosks and casinos of the transition economy starts to be channelled into the industrial sectors of the country.

By 1995 the Russian transition seemed to have reached the point of no return. The Russians had accepted capitalism; everybody wanted to become rich because it had a practical meaning to them and gave motivation to work - there were good quality goods in the shops. Also the Russian workers had become interested in how well their companies were doing, because they saw the connection to their salary level. Instead of worrying about the day care center's services, housing problems or places in the vacation datshas, the workers had started to be interested in the production figures, the price level of their products, the market forecasts and how they could contribute to the development of the company. New private ownership will most likely also enjoy very high protection of property rights, probably even better than in many market economies, once the concept of private ownership has gained wide acceptance.

By 1995 also the economic situation in Russia seemed to have stabilized so much that Valmet started considering the possibility of setting up small production units in the country mainly to learn how to operate in those conditions. However, the option of cooperation with Russian factories had become much less interesting than a wholly owned controlled subsidiary. The production in such cases would consist of products that would be used in Valmet's factories in other countries, service bridges of a paper machine providing one example. It was realized, however, that there were still significant obstacles on this road. Particularly the vague and changing legislation and the ubiquitous powers of the local authorities were a major concern that was hindering Valmet from realizing such plans.

5.2.7 Russian paper and pulp industry during 1991-95

The situation of the Russian paper and pulp industry had been deteriorating since 1991 and by 1994 is was considered desperate by most observers, Valmet among others. As an example, only one of a total of 11 paper machines was operating in the Segezhda paper factory in Karelia. There were many reasons that had lead to this situation.

First, the price of raw material had gone up so much that the factories could not buy enough of it. Some factories were even selling raw wood abroad rather than producing pulp out of it. Secondly, the financing difficulties of the factories were enormous. All factories owed vast sums to their suppliers and no factory was able to pay their debts. The factories expected help from the government but prime minister Chernomyrdin was quoted as having said that "it is their own problem". Thirdly, there was no interest in making investments and consequently the industry continued to deteriorate. All spending in the country seemed to go to consumption and paying for imports of western food and other consumer products.

Russian production of paper and cardboard amounted to approximately 3.4 million tons 1994. Finland alone produces about 11 million tons per year while production in the former USSR amounted to about 10 million tons per year. Thus there was huge potential to be seen in the market once the economy would start growing again. For Valmet investing in the paper industry was not a strategic option because then it would become a competitor of the Finnish paper industry, which was a major customer of the company. However, the Russian paper and pulp industry was also a significant potential customer of Valmet.

In 1995 the production finally started to grow after the continuous fall during the four consecutive years. During the first quarter of 1995 paper production increased by 8-12 percent and production of pulp by 20-45 percent compared to the same period in 1994. Russian production had also become competitive on the world markets, where prices had generally increased. There were also more potential buyers in Russia as a result of the improved financial situation.

In addition, it had also become possible to separate the winners from losers within the paper industry. There were very small and old-fashined factories, for example the Stupino cardboard factory, which had a surprisingly effective and innovative management. Such factories had started making small investments to improve their production facilities, whereas there were large factories which were not able to accomplish that. The above-mentioned Segezhda was an example of the latter kind. Some factories even operated only to the personal benefit of their managers. As an example, one Russian paper factory sold their small production to Iran against textile imports, which in turn were marketed in Russia through the company owned by the management or their families.

According to the judgement of Valmet the companies that seemed to perform well were companies which had kept all the shares in the hands of the old management and employees. This was the case particularly in the Kontupohja and Syktyvkar factories. In Stupino, the small cardboard factory, all the shares were bought by the managers even before the privatization law was passed with the stipulation that the state had the right to hold 20 % of the shares.

Those companies, in turn, where the management did not hold all the shares and which were not performing equally well, seemed also to be surrounded by a group of jobbers or agents of dubious kind, who wanted to buy their shares in the expectation that one day they would be able to sell those shares to an outside investor and make a large profit as a result of the deal. However, such agents are not likely to be interested in the final round of privatization, because the investors are required to make a commitment of additional investments into the company, and the jobbers do not have such possibilities.

Among the top ten potential customers of Valmet there were only a few paper factories which had attracted foreign investors during the years of 1994-95. Among them were Svetogorsk, the cardboard factory of St. Petersburg and Balahna factory near Nizhnij Novgorod. The foreign investors in these cases were the Swedish paper company Tetrapak and German Knauf and Herlitz.

For Valmet that development was, at first, a promising sign, because the foreign owners were considered prone to buy new machinery and Valmet, who had originally delivered many of the paper machines operating in those factories, was apparently one of the choices to supply new equipment. In the 1960's Valmet had delivered to the Balahna factory three paper machines which badly needed repair investments. However, it turned out that the investment plans of the foreign investors were small and take long to carry out.

When negotiating with these factories Valmet's representatives always met the foreign owners and Russians in separate teams and never together. In Balahna there seemed to be a particularly large gap between the the foreign owners and the Russian managers. The Russians felt that they had become totally overrun by the new owners, who have replaced all Russians in the key 5 -6 management positions by managers who did not have any experience in managing in the Russian conditions. There was also one Frenchman as a representative of International Finance Corporation, but the financing of IFC was still open.

Also in Svetogorsk the new owners seemed to make all the strategic decisions, because they were the ones who have the money. The Russians were involved only as technical advisors, because the new owners did not know the machinery as well as they did. The foreign investors were in each case paper companies and not engineering companies. Therefore they were not as good experts in paper machinery as the Russians who also had to know their machinery very well, because they had to be able to do all the repair work themselves.

When the Balahna factory was turned over to German hands at the end of 1994, the new management paid all the wage arrears, raised wages and gave all the employees a Christmas gift. However, during the following spring there were again delays in paying wages and breaks in production. The management blamed the inefficient banking system and difficulties in getting enough raw materials due to the deficient transportation system for the problems. Even when the factory paid in advance for the raw materials these problems occurred. The factory was also selling a significant share of the production abroad, which in turn raised complaints that not enough was being left for the domestic market.

For Valmet all this showed that the problems in the paper and pulp industry were far from being overcome but that modest but serious reconstruction had started in the industry. As a result Valmet responded to the new market challenge with a strategy that concentrated on relatively small projects, worth a maximum of 5 million USD, which could be financed by the factories themselves. With that money the factories will already be able to finance all needed maintenance investments as well as some renovation works. Projects of that size had already accumulated 20 million FIM to the company during the first months of 1995 and were expected to amount to 30 million FIM by the end of year. In 1993 and 1994 such sales amounted only to 17 million FIM in each year.

In addition, the final stage of privatization, in which the shares held by the state are going to be sold to private investors, has high importance for Valmet as a provider of investment goods, because the state sells mainly to investors who commit themselves to significant new investments. Because of such commitments Svetogorsk is expected to invest another 120 million USD and Balahna 150 million USD within the next few years.

One new channel of information about the development within the Russian pulp and paper industry was provided by an association called Mekor formed by former bureaucrats of the Soviet Ministry of Forest Industry and led by former vice-minister Tshuiko of the same ministry and presently vice-minister of Roslesprom. The organization has both Russian and foreign members. Valmet inherited the membership from Tampella after the company was acquired by Valmet a couple of years earlier.

The purpose of Mekor is to promote investments in the forest and paper industries and it was particularly active in trying to attract American investments into the industry. It has also lobbied for reductions in customs duties for the forest industry products. However, cooperation within this organization seemed quite uncoordinated and unlikely to lead to large scale specialization and division of markets because the companies, which for the first time enjoyed independence, were not yet interested in cooperation. Furthermore the role of Roslesprom within the organization was very peculiar, because it was both a state-owned company and authority responsible for channelling subsidies directed to the Russian companies within the woodworking industry.

The attitude towards foreign investors seemed somewhat negative within the paper industry. Such feelings were born mainly out of the understanding that the first foreign acquisitions within that industry were made on conditions too favorable for the foreign investors. For example, about 57 percent of the shares in Svetogorsk were sold against only 20 million FIM. It seemed to be a question of national pride among the industry representatives.

The attempts to solve the problems of interenterprise arrears had also led to some organizational changes within the industry. For example, the Arkangelsk and Ust Ilimsk paper factories were corporatizing their factories under the umbrella of a holding company. The new units under the holding company would be freed from the old debts but it was not clear who would assume responsibility for them. Discussions were also carried out at Kontupohja and Pitkaranta factories about the need to unite smaller factories into larger and potentially more profitable units.

The role of Moscow as the administrative center of the country diminished after the disintegration of the USSR. In 1995 its role as a business center seemed to be on the increase again. One sign of that was the fact that Russian factories were establishing subsidiaries to become their representative offices in the capital. The managers of the paper companies had to visit Moscow more and more often in order to discuss financing matters with their bankers or taxation with the Ministry of Finance.

This made it easier for Valmet to keep in contact with their customers also in Moscow and many contracts could be signed there instead of the premises of the companies. At the same time the significance of St. Petersburg also continued to grow as a center for technical negotiations and point of service for the same customers of Valmet.

5.2.8 Role of financing

The role of financing changed dramatically in Russian trade first when the clearing payment system was abolished at the end of 1990 and secondly after the default of the Vnesheconombank, which handled all the foreign payments of the USSR until the end of 1991. As described earlier Valmet was well prepared for the first change as it did not have any receivables in clearing rubles that had to be settled in the international rescheduling negotiations. However, the developments influenced greatly both the availability and use of trade credits and the daily banking operations in Russia.

The financing of representative offices and other operations in Russia was provided by the head office of Valmet. The transfers were made mostly in FIM and were exchanged into rubles to cover the costs of running the operations. The small income earned by the subsidiaries was also mostly in FIM as the customers were Finnish companies. Valmet did not plan to sell against rubles until 1994 when it was considered possible to start selling the local customers spare parts against rubles.

The experiences Valmet had acquired of the local banks both in St. Petersburg and Tallinn were very bad in 1992, when opening an account was cumbersome and payments could take weeks within those cities only. The situation had rapidly improved in both cities by 1994, when most payment transfers were carried out within a couple of days. However, particularly in St. Petersburg the day-to-day banking matters still took an enormous amount of office time and energy.

Particularly the requirements of the local authorities were sometimes such that it was impossible to fulfill them even through an efficiently operating banking system. For example, Valmet had to pay penalties for not having paid in time pension fund transfers, which had the same due date as wage payments, even though it was theoretically impossible to transfer the funds in time. Matters were additionally complicated by the fact that there were many similar funds, which used different banks and had different documentation requirements and different interpretations of the concepts needed to calculate the sum of the transfers.

In St. Petersburg Valmet also experienced difficulties in transferring the authorized capital of the subsidiary and faced restrictions in the use of it. It turned out that also the Russian bank, which handled the payment, had received conflicting advice from the central bank, whose approval was needed for the transfer. The exchange of currencies by the offices had also proved to be problematic due to the rapidly changing regulations of the central bank. Moreover, the daily financial management of the operations was complicated by the nearly hyperinflationary conditions of 1992 and 1993. All rent payments, for example, had to be made as early and quickly as possible in order to avoid losses from holding money.

The local Russian banks were not considered a source of financing for Valmet's operations because the interest rates were exorbitantly high and financing would have been available only for a very short period, a month or two. Even though the real interest rates were negative for long periods of time, the uncertainty of the economic development made it impossible to assume such risks in the hope of benefiting from the situation.

After 1991 most export contracts were made on advance payment terms. In only a few exceptional cases did Valmet accept a 50 percent advance payment with the remaining 50 percent to be paid on delivery. After 1991 the Finnish banks had not assumed any Russian credit risks, nor had any other western commercial banks done so. It was expected, though that the Russian central bank might impose limitations on the use of advance payments at some point, which is why companies had to start preparing for ways to cover the financing needs and risks involved.

More importantly, by 1994 the role of financing had become increasingly important in winning any bigger contracts and the role of national export guarantee boards and international financial organizations had become crucial in that context. Financing had become so crucial that technology or even price had become secondary sales arguments.

Valmet had discussed financing possibilities with EBRD and the Russian Project Finance Bank, which offered their services in providing financing packages for large deals. They would, however, only offer 30 percent of the financing needed and other banks had to be found to finance the rest.

Valmet's Moscow office had also been in contact with a few Russian commercial banks in order to find out their possibilities to offer financing. Valmet had also been asked to evaluate a couple of paper machines for use as collateral for their Russian factories in order to secure financing. As the Russian companies were still limited to having only one ruble account for current transactions, they were also limited to having one house bank. Therefore it was realized that they would also need to track down the banking relations of their major customers in order to complete the search for Russian funding possibilities.

In these discussions the role of Valmet's financing department had increased considerably. However, there was an increasing need for the marketing managers and administrative personnel alike to become well versed in the financial questions of Russian operations.

However, it was also realized that the most promising sources of financing would be the western national and international financial organizations. Particularly the American and Canadian institutions were seen to play a crucial role in opening the international doors of financial institutions for Russian borrowers.

5.3 Case AHLSTROM

5.3.1 Brief history of the company

The company was founded in 1851 by the farmer Antti Ahlstrom, who started the business as a lumber dealer but expanded in the 1870's by buying up a number of ironworks with vast forest tracts. By the end of the 19th century Ahlstrom had become one of Scandinavia's largest producers of sawn goods. Antti's son Walter expanded the company vigorously by purchasing papermaking operations, machine shops and glassworks during the international boom that followed World War I. After World War II the war reparations that Finland had to pay to the USSR spurred in turn the growth of Ahlstrom's engineering industry.

Ahlstrom's first international acquisition was carried out in 1963, when the company acquired a majority shareholding of an Italian paper producer in Bosso near Turin in northern Italy. In the 1980's Ahlstrom acquired two important American companies, Ahlstrom Filtration, whose roots go back to one of America's oldest papermakers, and Kamyr, Inc., an engineering company. In addition to intensified internationalization a major restructuring process was also started in the 1980's by selling the Varkaus paper factory in 1986.

Throughout the years, however, Ahlstrom had remained faithful to iron and wood, although the refinement process has made them less easy to recognize. The Ahlstrom family has also remained faithful to its company. Antti Ahlstrom's descendants still owned about 80 % of the company. The incumbent CEO Christer Ahlstrom, the grandson of the founder's son, has steered the company since 1982.

5.3.2 Characterization of the company and developments in 1990-95

In 1995 Ahlstrom was one of Finland's largest family-owned companies. It specialized in two main businesses, specialty papers on the one hand, and processes and equipment for the pulp and paper industry on the other hand. In addition to those two it had a general products sector, which included among other things packaging materials and electrical accessories.

The groups financial performance during the years 1990-94 is summarized in Table 14. Net sales stagnated in 1991 but recovered in 1992 boosted by a particularly favourable development in the U.S. market and exchange rate development between the Finnish markka and the US dollar. However, the profitability of the group suffered from the recession in most markets through the years of 1991-93 when the company showed a net loss before extraordinary items and taxes. The losses were compensated by significant asset sales particularly in 1992 and 1993.

Table 14. Financial performance of Ahlstrom during 1990-94 (million FIM)

	1990	1991	1992	1993	1994
Total net sales	8735	8282	10149	10840	10842
Operating income	854	605	1022	937	940
Income before taxes	240	-191	-36	-23	216
Extraordinary items	268	-18	412	511	157
Net profit	339	-321	289	460	271

Source: Annual reports of Ahlstrom for the years of 1990-94

The restructuring process initiated in 1986 led to further asset sales as well as acquisitions in the 1990's. The most significant ones were the acquisition of a 47 percent ownership in a French specialty paper company Sibille-Dalle in 1992, the acquisition of the Swedish packaging company Akerlund & Rausing AB in 1994 as well as the purchase of a majority holding in the Norwegian company Elektrokontakt A/S in 1994. Ahlstrom sold its pyropower and container businesses in 1995.

At the end of 1995 Ahlstrom had a total of 87 subsidiaries. Of those 14 were in Finland and the remaining 73 were abroad, including one in Estonia, one in Latvia and one in Poland. In addition to subsidiaries Ahlstrom had 23 associated companies, where Ahlstrom's ownership was 50 percent or less. The degree of international commitment is illustrated by the fact that very few of the international units, created or acquired had been sold off or discontinued even though the initial phase had often involved financial difficulties.

In 1990 the Ahlstrom Group was divided into four major sectors: Machinery, Pyropower, Paper and General Products. Ahlstrom Machinery was the biggest of these and accounted for 44 percent of the net sales. It was followed by General Products and Paper sectors, which both accounted for about 20 percent of net sales. In 1994 the main sectors were still the same but the relative share of their net sales had shifted somewhat in favor of General Products and Paper. Pyropower was sold in 1995.

Table 15 depicts the relative shares of net sales of each sector in those years.

Table 15. Net sales of Ahlstrom group by main sectors during 1990-94 (million FIM, %)

	1990(FIM)	(%)	1992(%)	1993(%)	1994(%)	(FIM)
Machinery	3840	44	43	44	38	4200
Pyropower	1018	12	11	13	10	1200
Paper	1763	20	24	23	24	2600
General Products	1866	21	17	18	26	2800
Others	248	3	5	2	2	42
Total	8735	100	100	100	100	10842

Source: Ahlstrom's annual reports for the years of 1990-94

In terms of geographic distribution of sales Ahlstrom's internationalization had continued to develop rapidly in the early 1990's. In 1990 net sales in Finland accounted for about 30 percent, the Nordic and other Western European countries for another 30 percent, North America for 29 percent and Asian countries for 3 percent of the total net sales. In 1994 the share of Finland had fallen to 16 percent of the total while the share of European countries had risen to 43 percent, North America to 30 percent and that of Asian countries to 8 percent of the total.

The geographic distribution of Ahlstrom's personnel also reflected increasing internationalization. In 1994 only 43 percent of the personnel was based in Finland while that share had been 58 percent in 1990. Some 30 percent of the personnel was based in other European countries in 1994 as opposed to only 17 percent five years earlier. However, the total size of personnel employed by the group had remained essentially the same, approximately 13 000, throughout the five years.

Since the restructuring process was started in 1986 a careful portfolio analysis had been carried out in order to identify the potentially most viable businesses. In 1990 the company was characterized as a technology based company serving demanding industrial customers and operating on the edge of the engineering and paper industries as well as manufacturing a number of other products. The strategy defined in 1995 focussed on two major businesses, specialty paper and packaging as well as equipment and processes for the pulp and paper industries. In addition to the traditional geographic markets Asia was identified as the most promising new target market.

5.3.3 Exports to the former USSR and Russia during 1991-95

As most Finnish large engineering companies Ahlstrom had a long history of exporting machinery to the USSR within the bilateral clearing payment arrangement. During the last 5-year trade agreement, until the end of 1990, Ahlstrom's exports to the former USSR amounted to approximately 150-200 million FIM each year. In 1991 and 1992 exports slipped back to less than half of that level but the earlier level was regained during 1993-1994. All sales during those years were made on a cash or prepayment basis. In 1995 exports were expected to grow significantly from that level. Ahlstrom's sales to Eastern Europe, USSR and Russia during the years of 1990-94 are depicted in table 16.

Table 16. Ahlstrom's sales to the USSR and Russia during 1990-94 (million FIM, %)

	1990	1991	1992	1993	1994
Exports to USSR	200	-	-	-	-
Exports to Russia	-	50	100	150	200
Total net sales	8735	8282	10149	10840	10842
of which the share of exports to USSR/Russia (%)	5	1	1	1	2

Sources: Annual reports of Ahlstrom for the years of 1990-94 and other information provided by Ahlstrom

The significance of exports to Eastern Europe, Russia included, is illustrated by their share of the total sales. The share fluctuated between 1 and 4 percent during the first half of 1990's. While in 1990 the Machinery sector was the largest exporter, the Paper sector the second, and General Products the third, in 1994 all three sectors had approximately equally large exports. The exports of General Products had thus grown faster than the exports of the Machinery or Paper division.

5.3.4 Ahlstrom's approach to the Russian market in 1991

In 1991 the exports to Russia were described as an essential part of Ahlstrom's international operations. However, it was realized that their earlier high strategic significance would diminish as a result of both the changes in the trading system and changes in the Russian economy. As a result the Russian market would be considered a market among others and business more like business as usual.

In 1991 the unit responsible for exports to the former USSR in Ahlstrom employed 14 persons, including 7 marketing managers and 5 marketing assistants. Their role was described as that of an internal consultant and liason office between the Soviet organizations and Ahlstrom's business units. Their major task was to search for new cooperation partners. In 1991 Ahlstrom's approach to the Russian market was described as follows:

First, direct contacts to the end-users had become more important and therefore marketing and sales efforts had to be increased. This involved more travelling in Russia by a larger group of persons than before, even though it is was not easy to persuade people to do that due to the sometimes primitive conditions that they encountered in the distant factory sites of their customers. The best way to approach the customers was through participation in the problem solving and finding out the best and least costly solutions for the customers.

Secondly, barter trade was not considered a form of trade that could be offered to Russians as a solution to their financing problems, because the Russians would only end up undercutting their own prices in the western markets by accepting to sell their products through barter arrangements. Barter was also formally forbidden by the Russian foreign trade authorities even though their stance was subject to frequent policy changes also on that question.

Thirdly, Ahlstrom was interested in finding potential cooperation partners among Russian factories for sourcing subdeliveries to factories in Finland. However, the company was only prepared to take small risks and make small investments in Russia. They considered that the significance of joint ventures had been overestimated and that any investments they would possibly make would be majority equity investments in certain potentially profitable industries.

Fourthly, Ahlstrom did not consider that their company or even Finland could become the major gateway to Russia. Instead, they considered that Estonia had better possibilities in that respect, because many Estonians knew both Finnish and Russian and it was easier for them to travel in Russia than it was for Finns. Moreover, the foreign currency surrender requirements were smaller in Estonia than they were in Russia, which increased the attractiveness of Estonia as a gateway to Russia.

Finally, as operation strategies in the USSR market were considered a part of the global strategies of Ahlstrom, also operation units there should become locally managed production units in the long run. That would also involve the employment of more Russians in all functions on the USSR territory. It was realized, however, that this long-term view could not be operative in the very short term.

It was also realized that Finns had lost most of their previous advantages in trading with Russians. Moreover, the Finnish products had a reputation of being expensive in the eyes of Russian buyers and many of those believed that they had really paid too much for them within the clearing system.

Consequently, when the Russians in 1991 faced the choice of travelling to the neighboring Finland, where many of them had been before, or to the United States, where most of them had never been before, they had many reasons not to choose Finland. However, it was believed in Ahlstrom that the more intimate knowledge of the Russian market and access to more reliable sources of information that they had in comparison to some western competitors would over time sharpen their competitive edge again in Russia.

5.3.5 Operations in the former USSR, Russia and the Baltic countries during 1992-95

Ahlstrom established a representative office in Moscow in 1980. In 1993 the office moved to the same premises with the state-owned companies Enso, Rauratuukki and Valmet. After Valmet moved to an office of its own in the beginning of 1995 Ahsltrom shared one floor with Rautaruukki while Enso occupied the other floor of the office. During the negotiations concerning the division of common property among the partners, all companies realized that it would not be easy to leave the premises of the representative office because quite a lot had been invested into the renovations and installments, which could not be compensated for by the landlord.

On the other hand, the representative office as an operation form did not provide the best possible legal framework because it could not be used as a sales office. Even though, in Ahlstrom's case there were three Russian salesmen working in the office, the contracts with Russian customers had to be signed by the units in Finland or elsewhere to avoid double taxation. The treaty on elimination of double taxation signed between Finland and Russia was not respected by the Russian authorities.

It was also not possible for a company of limited liability to operate within a representative office, because the legal and taxation issues would have become much too complicated. For example, in the case of another Finnish company 10 percent of the costs of the Moscow representation were considered as income and taxed by the tax authorities because the representation had informed their local accounting firm that about 10 percent of their activities were commissioned by the headquarters in Finland and 90 percent by individual units.

The use of a representative office was beneficial, on the other hand, for the Russian employees because it could pay salaries in foreign currencies. A company of limited liability could not do that; they would have to pay all salaries in rubles and respect the limitations imposed on the average level of salaries.

In July 1995 the administration of the Moscow Representation was moved to the paper sector. Also the arrangement of cost division was going to be changed from one where the central administration paid 10 percent of the costs and the rest was divided between the sectoral units using its services according to a yearly budget. In the future the paper division would bear the whole cost and the user units would be charged according to the actual use of the representation.

In 1993 Ahlstrom founded a subsidiary in St. Petersburg. The subsidiary was planned to become a vehicle for eventual small scale assembly operations in Russia but operated in the beginning like a representative office. Originally it was also planned to serve the whole Ahlstrom concern but in practice it was acquired by the Machinery sector, which used it as their home base in the city. Since the beginning the subsidiary operated as a marketing unit like the office in Moscow. There were three Russian engineers, a Finnish secretary and a Finnish accountant in the subsidiary.

There were many legal complications in the early stages of the subsidiary. Legally it was treated as a joint venture, because the joint venture legislation offered the only framework within which foreign investors could be governed in Russia at the time. Only after the legislation was changed in 1993 could it be registered as a Russian joint stock company. There were also problems in effecting the share capital payment because the joint venture law and legislation concerning foreign investments had conflicting stipulations regarding this.

Another office founded in 1993 in St. Petersburg was acquired by the packaging materials division Eurapak Åkerlund Rausing in 1994 after the acquisition of the Swedish company by Ahlstrom.

In 1992 marketing subsidiaries were also established in the three Baltic countries to serve mainly the General Products sector of the company. As opposed to the marketing offices in Russia the offices in Estonia, Latvia and Lithuania could also sign contracts in their own name. In the Baltic countries the taxation authorities did not treat their sales as taxable in their countries as they were already taxed in their country of origin. In addition to marketing subsidiaries Ahlstrom founded two production subsidiaries in the Baltic countries. The first became a subsidiary of the Riihimaki Glass factory in Estonia in 1993 and was sold in 1995 together with the whole container business of Ahlstrom. The second was a subsidiary of the Electrical Accessories Division in Latvia founded also in 1993.

A more detailed account of the operations of the divisions in Russia and the Baltic states is presented in the following.

5.3.5.1 Ahlstrom Machinery

For the Machinery Division upgrading the role of the St. Petersburg subsidiary had proved problematic because of the continuously changing tax rules and stipulations had become an additional risk factor. In 1995 the St. Petersburg subsidiary was taxed for all payments that were channelled through its accounts, whatever their purpose. Even the profit had to be budgeted and taxes paid on it for each quarter of the year in advance. For this reason the subsidiary acted only as an intermediator between the various units of the mother company and the Russian organizations and all contracts were signed between the Finnish production units and Russian cooperation partners.

The nature of the work carried out in the subsidiary had therefore also not changed much from what it had been in the Moscow representative office before the big changes took place in the Russian economy. However, the efficiency had changed. The Finnish chief of the representation could only visit personally about 10 major client factories a year. There was no time to visit more of them. As personal contacts continued to be the best sources for useful information about the situation of the clients, the two Russian engineers working as marketing specialists in St. Petersburg helped the office to accomplish a lot more.

The Russians had responsibility for a certain group of client factories. In that work they had proved to be both cheaper and more efficient for certain types of tasks than Finnish representatives. They had easier access to the local factories, they could travel more easily to other locations within Russia and communicate much better with the factories than the Finns could. The Finnish units communicated with them mostly in English. The Russians were fluent in English and could even act as translators if needed. The communication with Russian factories, though, had to take place in Russian, because they had very few people who knew any foreign languages. However, all commercial matters continued to be discussed only by the Finns and only the technical details were trusted to the Russians.

Ahlstron Machinery had no representative office of its own in Moscow. The representative office of the corporation was considered sufficient for the Machinery Division, because it could offer the services needed.

The significance of Moscow as a business center for the Machinery Division was also limited to that of a common meeting ground with the Russian clients who needed to go to Moscow to contact their own bankers, various authorities or organizations like Roslesprom, which were lobbying for more influence. Some also met with their own trading subsidiaries operating in Moscow. However, St. Petersburg was a better base for operations because it was closer to Finland and Russian clients all over the vast Russian territory could be reached by telephone from the city. There was also no need to set up other subsidiaries for the Machinery Division in other parts of Russia. Also Ukraine, Belorus and Estonia could be covered out of St. Petersburg.

In 1995 Ahlstrom Machinery had three cooperation partners in St. Petersburg. Those three were used as subcontractors and had been found after screening dozens of possible partners throughout the Russian territory for their interest and suitability as a cooperation partner.

A typical project where Russian factories could be used as subcontractors was described as a modernization of a pulp producing process or a bleeching line for a pulp factory, which consists of planning, deliveries of materials, some manufacturing of various parts and the work on site. All of the various parts of the project could be bought from Russian organizations should a suitable partner be found for each case. Ahlstrom, in turn, would carry the responsibility for the whole project, including the subconstractors, which is why the Russian partners had to be screened very carefully.

Because all of the contracted projects had been different and had required different kinds of parts and know-how, the idea of starting production in Russia, with or without a Russian partner, had not been relevant so far. The possibilities of setting up long production lines for a certain type of product had therefore been very limited. However,that was often the idea that the Russian potential partners had in their mind.

Ahlstrom had also discussed the idea of leasing a big machine tool together with a group of workers from a Russian factory. The idea was interesting to Ahlstrom because in the previous military factories near St. Petersburg there were some very big machine tools, which could be used for certain kinds of repair work for Finnish customers or even potential customers in other western European countries. Some simple parts of machinery could also be subcontracted from such factories and be delivered to factories in other parts of Europe. The contracts would have to be negotiated each time just as they had to be negotiated with Russian clients, who were also particular about not accepting Russian quality for any purpose.

The Russians had, however, difficulties in understanding the idea. One of their main concerns had been the emerging wage differences among the various working groups within the factory. Even though it would have been totally up to the Russian factory management to decide the wages of the group to be leased, they apparently feared increasing pressures to raise wages throughout the factory.

The Machinery Division did not fear Russian factories as potential competitors in the near future. The quality/price relationship was too unfavorable for them. As a result of privatization Russian factories had improved their marketing and increased prices considerably but continued to have problems motivating their personnel to produce high quality products and therefore still lacked credibility. Those Russian factories that were performing better than others normally had both good products and cheap sources of energy, notably gas. Coal, which had to be transported by railway from distant coal mines had become expensive and also had to be paid in advance.

From the Machinery Division's point of view Ahlstrom Corporation did not have a common strategy for the Russian market. The production units operated independently and had to develop the business first before they could ask for help from the corporation. All big projects had to be carefully prepared and analyzed before presenting them to the headquarters. There seemed to be a common strategy to develop businesses in the Far Eastern markets but also that strategy was led by the production units, which first had to identify the opportunities.

5.3.5.2 Financing of machinery exports to Russia

In 1994 the exports of the Machinery Division to Russia amounted to about 30 million FIM. In 1995 they were expected to triple. In the cooperation factories of Ahlstrom development was very rapid in 1995 and activities were picking up. The most active and optimistic factories were likely to start investments in the near future. One of the potential clients had investment plans worth of 2 billion USD for the next four years and many other factories had applied for financing from American sources for an estimated 100 - 500 million USD.

It was out of question to find Finnish financing sources for such large financing needs. There were no realistic possibilities for that in Finland. Even the possibilities offered by the European Union did not seem to interest the Finnish authorities enough in order to start negotiations on creating a European source of financing for large export projects to Russia. Some of the Russian factories had set up subsidiaries of their own in the West in order to indentify financing sources for their planned investments. The Machinery Division also realized that it was essential to involve the financing unit, Ahlstrom Capital based in the US, in the negotiations when trying to compete for such projects.

The Finnish competitors of the Machinery Division in Russia were Tampella, which after the restructuring was held by the holding company owned by the Bank of Finland, and Sunds Defibrator of the Repola group. Valmet was not considered to be a competitor. Of foreign competitors Kvärner Pulp from Norway, Vost Alpine and Beloith from Austria as well as American and Canadian engineering companies were considered serious competitors in the Russian markets. All the lost deals had been lost on the basis of financing.

Although the Machinery Division expected a boom in investments in the paper and woodworking sector in Russia in the near future, they also saw many risks ahead. Particularly, the timing of investments was considered crucial. It was feared that the Russians, in their new optimism, might end up investing too much and consequently face difficulties in paying for the investments when the markets within a few years inevitably again were headed towards a recession, which the Russian factories most likely have not taken into account.

The Machinery Division had carried out discussions about project financing possibilities with the European Bank for Reconstruction and Development a couple of years earlier. It had turned out, however, that the Russian companies did not need and were not committed to any particular company even though the company had negotiated an attractive financing package only to finance the sale of their own products. Therefore the interest in such negotiations was lost. The Machinery Division still needed to find out, whether the privatized Russian companies had changed their behavior. The role of the St. Petersburg subsidiary in the financial negotiations was to arrange the initial contacts between the potential buyer and the financial experts.

In 1995 the Machinery Division sold to Russian buyers only against prepayment or a Letter of Credit opened by a Russian bank, which was accepted by the house bank of Ahlstrom. The company's board of management had recently reconfirmed their earlier decision that the company should not take any risks in Russia.

The Russian Ministry of Finance had in turn recently issued a new regulation stipulating that Russian companies needed to have a special permission from the ministry if their advance payment period is longer than six months for projects or three months for individual machines. Accordingly, the Machinery Division needed to make sure that the deliveries in their projects were scheduled so that no special permissions would be needed.

The Russian paper and pulp factories did not sell anything without having advance payment from their Russian customers. Although barter transactions seemed to be common between the Russian companies, the Russians were not willing to conclude them with foreign companies. They preferred to find buyers for their products themselves and wanted to control the currency flows themselves. Only goods which were not easily marketable were being offered as barter goods. Ahlstrom had had very little success in concluding barter deals with Russian customers. They had also found out that western bankers in pinstriped suits were not willing to travel to Siberia to clear the details of the deals. Nor were they able to explain Russian managers the need for very complicated documentation in such deals.

5.3.5.3 Electrical Accessories Division

In 1995 the situation in the Electrical Accessories Division had changed dramatically compared to that in 1991. Then the division had had 5 units: Strömfors, Ii-valo and Esmi in Finland, Eljo in Sweden and Norwesco in Norway. The market share of those units in Scandinavia was about 50 percent. After Ahlström acquired the Norwegian company ELKO, which was the main competitor in Scandinavia, that share rose to about 80-90 percent. The increase in market share was also due to the acquisitions and units established in Eastern Europe, including the former East Germany.

Eastern Europe was the only direction open for expansion by the division because Southern Europe, particularly France and Spain used a different standard in their electric appliances. The German speaking Europe used the same standard as Scandinavia but the German market was considered the most difficult to penetrate. The division had some exports to Germany, about 10 million FIM per year, but that business was unprofitable.

In 1991 Ahlström carried out a market study in the former USSR covering the structure of electrical accessories market, the producers and distribution networks in the country. At that time it was believed that factories within the old structure could be used as possible joint venture partners in order to penetrate the market. That strategy was greatly influenced by the then prevailing price level of the products in the USSR, which was about 5 percent of the level in Finland. However, that price level rose within a year to 50 percent of the level in Finland and has increased even after that. Consequently, the idea of utilizing the low cost benefits soon lost its sense. As at the same time Ahlstrom gathered experience in running a joint venture in Latvia it was soon realized that the idea of setting up joint ventures for production was not very viable.

Another idea was to use the Baltic countries as a gateway to the Russian market, but that also proved too idealistic. It became too difficult to export from Estonia to Russia and imposible to judge whether the Baltic gateway to Russia might be a viable solution at some point in the future. However, the Estonian office was used to studying the Ukrainian market and the Lithuanian office to studying the market in Belarus.

Ahlström had already started negotiations with a production unit in Latvia to establish a manufacturing joint venture before the August 1991 events reshaped the area. Those discussions continued and as a result a joint venture was set up in Riga in 1992. Ahlström had 60 percent of the shares of the Ahlstrom-REMLR Elektra, Sia, and the Latvian company 40 percent. The operation of the joint venture proved, however, to be very difficult.

The Latvians did not understand the Finnish way of operating. It took an enormous amount of management's time and energy to run the company. The company was still operating in 1995 but it was not even expected to become a first class unit within the concern. The level of production know-how was very low. The unit employed about 20 people and was used to assemble low cost products for the Finnish and German markets.

After that experience Ahlström was not likely to enter any other joint ventures in Eastern Europe. Some Russian factories had been interested in such ventures but their ideas proved totally unrealistic. Their production know-how was also very low and, what was worse, the Russians did not even understand how much would be needed to update it. Ahlström carried out negotiations concerning production and assembly with Russian companies both in St. Petersburg and Moscow in 1992 but concluded that there was no future in them.

In Russia the market for electrical accessories was also spoiled by the production which continued 1-2 years after the demand collapsed in the country. As a result the market was filled with low cost, low quality products, for which there was very little market demand.

The remote regions of Russia, which had high purchasing power due to oil and gas exports were, in fact, more interesting markets than some of the closer areas of Moscow or Ukraine and Belorus. However, in those markets also competition from Korea, Taiwan, India and China already manifested itself. Also the European competitors were already investigating that market.

However, it was also realized in 1992 that there is demand for Ahlström's products in the Baltic countries. As a result marketing subsidiaries were set up in each Baltic country. They employed a local marketing manager, a couple of sales engineers, a secretary and an accountant. No Finnish expatriates were employed because it would have cost far too much. All the Baltic units had storage facilities and an inventory of their own, which enabled them to deliver quickly to the local retailers. The Baltic units also sold products from factories in Sweden and Poland. No additional subsidiaries were planned in these countries but potential new cooperation partners were sought.

All the Baltic subsidiaries had a Finnish chairman of the board and a local managing director. The Finnish chairman met with the managers and some key customers once a month. In addition each factory sent their own representatives to meet with key customers in the markets. Three times a year a so-called Baltic operational planning meeting was organized.

In Russia the division had followed a similar strategy and used the marketing offices both in St. Petersburg and Moscow in 1993 after the ideas concerning manufacturing joint ventures had been dropped. The structure differed, however, from that in the Baltic states because the Russian subsidiary did not sell in its own name and did not have inventories of its own. The subsidiary only received a commission on the sales channelled through them. Most of the goods sold on the Russian market were delivered by factories in Germany and Sweden. It was easier for these factories to price their products lower for the Russian market than it was for the Finnish units. The Finnish units were still under the impression that the Finnish price level could be exported to Russia. In Russia the sales were also effected on credit terms, according to the established creditworthiness of the customer. New customers were required to pay in advance. Payment terms had also there become crucial sales arguments.

In 1992 Ahlstrom acquired a production unit in the former eastern pert of Germany. The factory ELSO was technically of high quality but it had no marketing or management skills. The German price level was also high but it was easier for the German factory to keep the Russian market segment separate from others than it is was for Finnish factories, which were "too close" to Russia. However, the marketing concept was quite complicated in Russia because it was not easy to create brand awareness among the Russian very technically oriented wholesale organizations.

In 1994 Ahlström bought a Polish company Elda and paid USD 20 million for that acquisition. The acquisition required long negotiations within Ahlstrom because an earlier acquisition by the Pyro-Power Division in Poland had proved to be a disappointment. The competing offer came from the Danish NKT-concern, with which the Electrial Accessories Division was going to be merged in the near future. The new Finnish-Danish company would be among the five largest electrical accessories companies in Europe, which include the French Legrand, the German Busch-Jaeger/ABB and Siemens and the British MK Electric.

In Poland Ahlstrom owed 65 percent of the shares and the operational responsibility was implemented through strategic meetings with the local managers about three times a year. There were 1200 employees in Poland and they enjoyed a 40-month employment commitment given by Ahlstrom. The factory was profitable and was financed out of current earnings.

The Russian market was defined as one of the strategically important markets for the division but it was very difficult to evaluate the market potential. Therefore the division had planned to set up a small "pedagogical" subsidiary in St. Petersburg. It would be 100 percent subsidiary and operate a rented warehouse and small production facilities. The project would advance step by step depending on the success of the unit in getting their products certified in Russia. The investments would not be bigger than 1 million USD.

No bigger investments were planned in Russia. The experience of a French competitor of Ahlstrom in Russia was frightening in this respect. The company had bought a Russian factory but did not succeed in starting production. In their words "the project just disintegrated". After that experience the company established a new and wholly owned unit in Russia.

In 1994 the sales of the Electric Accessories Division amounted to approximately 800 million FIM and it was the most profitable of Ahlstrom's divisions. Approximately 300 million FIM worth of products was sold to Eastern Europe. The Russian market accounted for 20 million, the Baltic countries for another 20 million, Poland for 100 million, and the remaining 160 million FIM was sold in the eastern part of Germany.

In the beginning payment terms had been advance payments exclusively but now more recently most of the sales had taken place on credit terms. The local retailer paid after having received payment from his customer in the Baltic countries. The average payment period was 45 days. So far no losses had accrued due to non-payment in the Baltic states. The credit losses were bigger in Germany than in the Baltic countries. However, some payment difficulties were expected to incur particularly in Estonia, where the 40 percent inflation rate was considered too high for the established fixed rate of exchange.

The money invested in the Baltic units had mostly been invested in working capital to finance inventories. Only very small investments into office furniture and equipment (about 100 000 FIM for each office) had been made and the whole investment had not exceeded 500 000 FIM in each country. These investments had been financed through the internal financing company Ahlcorp, which had required a guarantee of a Finnish unit (Strömfors) for the loans granted. Part of the financing had also been arranged by not requiring immediate payment for goods delivered to the units.

Ahlström had not arranged any formal training for their employees in Eastern Europe. Also the employees had not been willing for this because they did not want to miss the sales commissions for the time "lost". Learning by doing had been the training strategy. The packaging unit of the company had organized training by a British consultant, but that had not turned out to be very successful. Particularly the Russian managers complained that the western economic concepts would not be valid in the Russian conditions. In Poland there had been more formal training of the employees.

In the experience of the electric accessories division of Ahlstrom the old experience of trading with the former USSR was probably useful in selling large units of machinery but in selling electrical appliances it was sometimes even harmful. Situations changed very rapidly and sometimes even 6-moths-old information was already too old. The Russian employees could also not be trusted with evaluating possible business partners, because with little understanding of the market, they could make 100 percent wrong evaluations.

Within the Ahlstrom concern there were no synergies between the various units when operating in the Russian and Baltic markets. There were practically no discussions going on between the Machinery Division and General Products Division. In St. Petersburg the Electrical Accessories Division had common premises with the packaging unit but even that tie was going to be broken in the near future. There was also no common strategy in the Eastern European markets. Each division had followed their own strategy.

5.3.6 Paper Division's approach to the Russian market in 1995

By 1995 the Russian trade unit had been been disbanded on the level of headquarters and the sectoral units had gained full responsibily for the Russian markets as well. Only the administration of the Moscow representative office remained in the headquarters but plans were already adopted to place that responsibility within the paper division of the company.

Based on Ahlstrom's experience there was a certain logic in starting and developing operations in Russia. It was easiest to start with representative offices, which could be developed into marketing offices. Through them in turn it was possible to find potential partners for production cooperation. It had also proved relatively easy to carry out market studies once the company has established a presence in the market in the form of a representative office. The 50 or so customers of the Russian factories were used to the Soviet Russian quality and therefore not a difficult market to sell products at somewhat higher prices but clearly better quality.

The fastest way to get into business would be to buy shares in a production unit and start production and sales cooperation with that unit. As a legacy from the planned economy the production units still had access to the only working distribution systems in the country. As an example, the production and distribution of filter paper in Russia was still very centralized. There were only a small number of customers within the country and those were captive customers of the Russian factories, because any foreign or even domestic competitor would have to break into the tight distribution system. Acquiring such a factory would enable the foreign investor to penetrate the system. A similar situation prevailed in all special papers (wallpaper, etc.), produced by Ahlstrom. It would not be impossible that within 3-5 years some sectors of Ahlstrom Paper Group had a partner factory in Russia.

Ahlstrom had acquired shares in one Russian paper factory so far. The first acquisition was made during the first round of privatization and through another Russian-owned company. Ahlstrom bought 30 percent of the paper factory but found out later that the particular company was not favorably situated nor otherwise suited for further development. However, the cost of that acquisition was not more than what a thorough market study would have cost.

The fact that Ahlstrom was seriously considering investments in Russia was a result of the increased understanding and knowledge of the market, not so much of increased confidence in the economic reform of Russia. The confidence had also grown as a result of other foreign investors' increasing confidence in the market. Foreign companies were investing among others in the Russian food and tobacco industries, which in turn were big consumers of packaging materials.

There was increasing understanding also of the nature of power groups, which were active in the economy. The role of president of Russia seemed weak and the real power seemed to rest with the at least 8 different power groups of large consortiums of companies in key sectors of the economy.

St. Petersburg still seemed to be center of that industry with two technical universities and a research center, Giprobum, which had designed all Soviet paper factories. However, within Russia St. Petersburg had not developed into the kind of financial and industrial center expected still a few years earlier. Moscow had become relatively more important again because the significance of legislators, various authorities, and banks had grown for the industry. In addition, there were important customers also in Siberia, which could not be forgotten.

In summary, even though the CEO of Ahlstrom had still recently been against investing the family's money into Russia, the company was searching for profitable investment opportunities in the country in the longer term. However, the Russian economy was not considered stable enough for major production investments. Only high import barriers would make such moves justified in the prevailing circumstances. On the other hand, the Russian market continued to be a natural export market for the company. A concrete indication of the market opportunities was the paper consumption of Russia which amounted only to 17 kg per capita, whereas in Europe and in the United States it amounted to 200-300 kg per capita.

5.4 Case OUTOKUMPU

5.4.1 Brief history and strategic development of the company

Outokumpu had its origins in a general partnership founded in 1910 to exploit a rich copper ore deposit at Outokumpu in eastern Finland. Following the incorporation of the company as a wholly state-owned company in 1932, Outokumpu set out to establish itself over the next two decades as a strong integrated copper producer. Operations were expanded to cover a full range of activities from exploration and mining to smelting and refining and the fabrication of copper products. A notable achievement was the development in the late 1940's of the Outokumpu Flash-smelting process, which became a standard in the industry world wide.

With new ore discoveries and the development of innovative technologies, Outokumpu moved into a new expansion and diversification stage in the mid 1950's. The company built up new mining and metals processing operations in Finland to include nickel, zinc, chromium, ferrochrome and ultimately, in the mid 1970's, stainless steel. The proprietary technology which Outokumpu had begun to market in the 1950's established the reputation of the company as a technology leader in its field.

The 1980's marked a period of rapid international expansion for Outokumpu. This was prompted by the need to replace the company's depleting domestic raw material base and to strengthen its competitive position in its main markets. To achieve these objectives, Outokumpu ventured into new mine projects in Europe, North and South America and Australia and made a number of substantial acquisitions, notably within copper products. As a result, Outokumpu has developed into a diversified metals group with operating subsidiaries in some 30 countries around the world.

5.4.2 Characterization of the company and developments in 1990-95

In 1994 Outokumpu was described as a versatile metals group operating world wide and focussing on base metals production, stainless steel, copper products and technology. The group aimed at ensuring their position as experts at the forefront of their industry.

Since the beginning of 1991 the major business segments of Base Metals, Stainless Steel, Copper Products, and Technology had operated as independent units. Copper Products was the largest segment accounting for 39 percent of the group's total sales in 1994. The segment of Base Metals, which in 1990 had accounted for 30 percent of the group's total sales, was replaced by Stainless Steel as the second largest segment in 1994. The share of Technology was 10 percent of the total sales at the end of 1994. Among other business operations the sales of Finenco, the group's trading subsidiary had become the most significant.

The Finnish government held 57.5 percent of the shares of Outokumpu at the end of 1990. By the end of 1994 the share of government ownership was reduced to 40 percent as a result of three new share issues carried out in 1993 and 1994. Foreign ownership of the shares increased to almost one third by the end of 1994. Based by an authorization granted by the Finnish Parliament, the government can further reduce the shareholding in the company to a level which must exceed one third of all issued shares and voting rights. Outokumpu's shares has been listed on the Helsinki Stock Exchange since 1988 and traded in the London Stock Exchange's SEAQ International quotation system since 1993.

The financial performance of Outokumpu during the years of 1990-94 is summarized in table 17. In the years of 1991-93 Outokumpu accrued losses which were due, above all, to the recessionary market conditions in all major markets of Outokumpu during those years. However, they also reflected the fact that several of the company's mines were old, inefficient, and nearly depleted whereas newer investments had not yet been completed. The market conditions improved significantly in 1993 and the positive development continued in 1994. While the segment of Stainless Steel continued to contribute most to the company's profits, also the segment of Copper Products produced sizable profits in 1994.

Table 17. Financial performance of Outokumpu Group during the years of 1990-94 (million FIM)

	1990	1991	1992	1993*	1994
Net sales	11286	12617	15125	16566	16683
Operating profit out of which:	146	3	604	852	1051
Base metals	341	-60	183	191	49
Stainless steel	197	384	607	844	909
Copper products	-199	-116	11	-240	354
Technology	-63	-123	151	50	-139
Profit before taxes	-79	-543	-191	509	1022

Source: Annual reports of Outokumpu for the years of 1990-94
* The figures for 1993 are restated to comply with the changed accounting principles, which Outokumpu adopted January 1st, 1994

During the years of 1990-94 an average of 92 percent of Outokumpu's sales consisted of either exports from Finland or sales of foreign units. In 1990 71 percent of Outokumpu's products were sold in the European markets, including 12 percent in Finland. In 1994 sales to Europe had diminished in relative importance and their share amounted to 61 percent of the total sales, while the share of Finland had dropped to 9 percent of the total sales. The largest single market for Outokumpu in 1990 was the United States, with a share of 15 percent of the total sales. The American market continued to increase in importance until 1994, when its share of the total sales amouned to 23 percent. In Europe the share of Germany had grown from 10 to 12 percent during the same period.

In 1994 Outokumpu had 187 subsidiaries and was a significant owner in 18 associated companies. Only 46 of the subsidiaries and 5 of the associated companies were in Finland while the rest were placed throughout the world. In addition to operating in Europe and North America Outokumpu had a large number of companies operating also in Australia and South America, particularly Chile. In Russia there were 4 subsidiaries and 2 associated companies in 1994. Close to one third of the subsidiaries, or 53, operated as production units, one quarter, or 49, were management or holding companies, 39 operated as marketing susidiaries, 35 as service companies, and 11 as exploration or research units.

Among Outokumpu's business segments the Technology segment had the largest number of subsidiaries, 63 altogether. One of those was the service company of A/O Mineral Processing Engineers in Russia. The Base Metals segment had 44 subsidiaries, including the exploration company AOZT Kola-Mining in Russia, the Copper Products segment had 41 subsidiaries, also including the marketing subsidiary of A/O Outokumpu Copper St. Petersburg in Russia, and the Stainless Steel segment had 20 subsidiaries, however none in Russia. Among the other business operations of Outokumpu the trading company Finenco had a subsidiary, A/O Finenco, in Russia, and among the associated companies there were two Russian companies, where Outokumpu's share was less than 50 percent, the exploration company A/O Kivijarvi and the consulting company A/O "JV Energy Ecology Engineering".

In terms of personnel Outokumpu had diminished in size from 1990, when it employed close to 19 000 people until 1994, when the personnel amounted to 15 000 people. If the 20 percent fall in personnel is compared to the close to 50 percent increase in the sales over the same period, the difference testifies of greatly improved efficiency even if inflation is taken into account. Roughly half of the personnel was based in Finland both in 1990 and in 1994. The largest business segment measured by the number of people employed in 1994 was the Copper Products segment, which employed 35 percent of the personnel, followed by Base Metals, which employed 27 percent, and Technology, which employed 17 percent of Outokumpu's personnel. Since 1992 Outokumpu had operated under the leadership of CEO Jyrki Juusela.

Within the major business segments a restructuring process of asset sales and new acquisitions was going on throughout the period of 1991-94. The aim of that process was to focus more on the core competence areas of the company in mining, metallurgy and metal working as well as to tap integration benefits and synergies inherent in the overall business portfolio of the company. At the end of 1994 the Technology business segment was dissolved and parts of it formed a new Technology Sales segment. Most of the equipment manufacturing, comprising the Rammer and Roxon companies, was sold at the beginning of 1995. The new Technology Sales segment also aimed at focussing more on Outokumpu's core competence areas.

5.4.3 Trade with the former USSR in the years of 1982-90

Outokumpu's export sales to the former USSR were initiated in the 1970's and already in 1982, two large smelters were delivered to the Norilsk nickel factory in Siberia. At that time it was the biggest single export contract (USD 350 million) ever signed between the former USSR and Finland within the clearing payment agreement. It was an unusual contract also from the point of view of how Outokumpu won the contract, because the company never tried to sell smelters to the former USSR. The Soviet factory had learned about Outokumpu's technology from other sources, had become interested in it, and wanted to buy it. In addition to Outokumpu, the Finnish mechanical engineering companies Rauma-Repola and Ahlstrom also benefitted greatly from the deal as suppliers of the equipment.

In 1986 Outokumpu won a smaller contract (FIM 150 million) to deliver equipment for a mineral processing factory in the Kola Peninsula. In 1987 a somewhat larger contract (FIM 350 million) was signed to renovate a nickel ore dressing plant also in the Kola Peninsula. All three contracts benefitted from the framework of the bilateral trade and payment agreement. However, each project had been harder to sell than the previous one due to the diminishing financing possibilities within the bilateral framework. No big contracts were signed within the clearing agreement after those three. In metal exports rather significant deliveries also took place within the clearing arrangement but practically none after the system was abolished at the end of 1990.

On the other hand, the clearing system had also some clear disadvantages for Outokumpu, particularly in the field of metals trading, because the Soviet foreign trade organizations did not want to sell metals to Finland against payment in clearing rubles. Moreover, the Finnish authorities did not give Outokumpu permission to pay convertible currencies to the USSR.

As a result, Outokumpu took an effort to circumvent the clearing system and channel purchases through subsidiaries in Sweden and a company established for that purpose in London. Therefore Outokumpu was well prepared for the abolition of the clearing system. The Finnish clearing apparatus proved helpful, though, in solving the payment problems when the USSR was driven to insolvency before its dissolution. Outokumpu had practically all of its receivables paid before the line was drawn.

Within Outokumpu's organization relations with the former USSR were the responsibility of a small 4 person unit in the headquarters of the company. In addition to this the Technology business segment had a few persons concentrating on Soviet sales only. A representative office was established in

Moscow in 1981. After the abolition of the clearing arrangement the unit saw its role as an initiator of new kinds of operations in the changing Russian market.

5.4.4 Outokumpu's operations in Russia in the years of 1991-95

The last big project which was negotiated between Outokumpu and the former USSR organizations, the Petsamo Nickel smelter project, never saw daylight, because it fell victim to the disintegration of the USSR. It had been negotiated with members of the Council of Ministries, some of whom happened to be on the wrong side when the coup of August 1991 took place. What was accomplished, though, was an increase in the general awareness of environmental problems within the Russian metallurgical industry.

The share of exports to Russia out of total sales of Outokumpu had traditionally been 1-2 percent. In 1994 trade with Russia reached an alltime high of 500 million FIM, 3 percent of total sales. Most of that consisted of raw material imports from Russia, which very well fits the general strategy of a multinational company having three modern metallurgical plants located in Finland.

5.4.4.1 Cooperation in mining

However, as early as in the fall of 1986 Outokumpu had started to look for new operative strategies and right after the decree on joint ventures was passed in the USSR in the beginning of 1987 Outokumpu made a suggestion to the Soviet ministry of non-ferrous metallurgy about establishing a joint venture. The ministry answered after one and a half years and stated their willingness to study the matter in greater detail. When the first concrete proposal was finally received from the ministry it concerned a mine, which would have needed investments in the amount of 1 billion USD - much too much for Outokumpu to consider at that time.

However, the seeds of cooperation had already been planted and in 1989 cooperation started with development of a smaller mine in the Tsheljabinsk region in the Urals. The cooperation lasted for three years before the local authorities realized that they wanted to set up a competition for the utilization of the ore deposit. The consortium, in which Outokumpu participated lost the deal to a locally led ultra-nationalistic consortium, which promised to build new production facilities in two years. The needed investments amounted to 50 million USD. In 1995 the winning consortium had not even formed a company to start the work and the Russians considered restarting cooperation with Outokumpu but the company was no longer interested.

Based on their experience of cooperation with the Russian mines Outokumpu had formulated a new strategy according to which the company aimed at building and owning new mines in Russia. The company had also realized the importance of finding the right local cooperation partners. In the Urals the experienced local partners deliberately stayed out of the deal, while Outokumpu formed a consortium with new commercial structures. That strategy did not succeed for Outokumpu and it has been suspected that the competing consortium had "oiled" all the relevant local authorities and won the competition due to those contacts.

To carry out the new strategy Outokumpu formed a small service group for mining in the beginning of the 1990's. The group consisted of a Finnish director, two experienced mining specialists and an experienced interpreter. By 1995 the group had established three mining companies with Russian partners in the North-Western Russia not far from the Finnish border. In AOZT Kola-Mining in Murmansk Outokumpu owns the majority, 83 percent, of the shares and in A/O Kivijarvi in Petroskoi Outokumpu has a 49 percent minority stake. The former local vice-governor of Murmansk had been nominated local director of AOZT Kola-Mining and a Finnish senior geologist had been nominated the managing director of the mining company A/O Kivijarvi in Petroskoi.

The company in Murmansk had received a license for mining at the end of 1994. If a similar site would have been found in Finland, a mine would have been opened there almost immediately. However, Outokumpu was a conservative investor in the turbulent Russian conditions and wanted to proceed more carefully and investigate the site further. Should the site prove more promising, it would make investment decision easier. In the mining industry the smallest greenfield investments amount to 50-100 million dollars and the lead time is usually more than two years.

The unit responsible for the Russian market in Outokumpu was working in close cooperation with the mine development unit. About 20 percent of the unit's time had been spent for projects in the mining sector during the previous few years. One of the reasons why the Russian mining market was very interesting to Outokumpu was the fact that there were already many known undeveloped deposits in the country. Therefore in Russia the investor would not have to start from searching first for the deposits. However, in Russia the time required to fight the administrative jungles was much longer that in other parts of the world. The process of opening new mines is slow in all countries but not necessarily slower in Russia than in other parts of the world, where one has to start from the search of suitable deposits.

5.4.4.2 Technology exports

In the domain of Outokumpu's technology exports the roots of a changed marketing strategy also extended as far back in time as the year of 1987, when a new law of the socialist enterprise was passed in the USSR. The law was carefully studied at Outokumpu and interpreted so that it gave the enterprises independence from the supervision of the powerful industrial ministries. After that direct contacts were made with the factories and a new approach of selling directly to them instead of the foreign trade organizations in Moscow was formulated.

However, in some cases the process of making new contacts was very slow, e.g. in the case of the Petsamo nickel factory it took 1.5 years for the representative of Outokumpu to get the first visa to visit Petsamo. The visa was finally arranged through the local authorities and not through the ministry of non-ferrous metallurgy.

One of the first new marketing operations was a symposium organized at the "Severonikel" metallurgical plant in Montsegorsk, on the Kola peninsula in October 1989. At that time the Norilsk Nickel-consortium had just got their independence from the ministry of non-ferrous metallurgy and was very keen on attending a symposium where Outokumpu know-how and technology was demonstrated. The second similar symposium was organized the following year in Sverdlovsk in the Urals. The attendance was also very good, because the same process of liberalization from the supervision of the ministry was also taking place there. Coinciding with the symposium there was a local meeting of industry specialists, which discussed reorganization of the ministry into associations or consortiums of different type and all the relevant persons attended also the symposium. A third similar symposium was organized in Ust-Kemenogorsk near the Altai mountains the following year (1991). After the contacts to factories were made Outokumpu's business units started selling directly to them.

In 1989 a joint venture, A/O Mineral Processing Engineers, was founded in St. Petersburg together with the former centralized planning institute of the Soviet mining industry, which had detailed information of all the mines on the Soviet territory and held a monopoly in advising mines on technological questions throughout the country. The contacts of the institute were important when developing the channels of direct selling. The joint venture has since been transferred into a joint stock company and had plans for factory renovations and deliveries of equipment to those factories. In 1994 the joint venture employed 25 people, among them 2 Finns. In their consulting work they outperformed any Finnish organizations in Finland due to the much lower wage level in Russia.

The direct selling efforts of metallurgical technology and mineral processing equipment from Finland were carried out mainly by the daughter company Wenmec and by a unit within Mintec, respectively. They are being supported by the trading company Finenco, which, in addition to buying raw materials, also has started selling equipment. The combination of all these various units of Outokumpu forms a contact network which covers all potential buyers within the Russian metallurgical industry.

By 1995 there had been no concrete negotiations concerning joint equipment production in Russia. The markets were too limited for that. One reason for that was the size of the heavy metal industry in the former USSR. It had a huge overcapacity, because it was built to satisfy the needs of the whole CMEA area. After the political disintegration of the region there was no other possibility than to run down parts of the industries also in the metal production. Therefore the market was not as large as it seemed at the time of the former USSR.

The Technology business segment of Outokumpu was also reluctant to make investments due to the disappointing financial performance of the segment during the early 1990's. This meant that, in practice, cooperation in the field of technology could only mean subdeliveries from some Russian factories. However, within the Outokumpu Technology business segment there was no demand for such subdeliveries. Moreover, the company was short of both financing resources and personnel resources to develop such contacts in Russia.

On the other hand, the exporting strategy had been quite successful, even though it had turned out that financing was not always available for all the contracts signed by Russian enterprises. Prepayments were a precondition of Outokumpu for delivering any equipment. It was estimated that for Outokumpu Technology the CIS market as a whole had a potential of 30 million USD worth of sales per year, which amounted to approximately 10 percent of the potential total sales of that sector within the next few years.

It was further expected that the size of individual equipment contracts in Russian factories could go up from the level of 1-2 million USD to the range of 5-10 million USD within the following few years. However, reaching that level would mean that outside financing sources would have to be found, which did not seem easy. Only the first category of investments, in the range of 1-2 million USD, which aimed at solving bottleneck problems in the production processes, could be financed using the prepayments. All investments aiming at creating new capacities would be considerably larger. The repayment time for mining investments is generally long and in the highly inflationary conditions of Russia such investments were not yet possible. The economy had to stabilize first. Therefore no big investments were expected in Russia for many years. The Norwegian company which won the contract worth USD 250 million to equip a factory in the Kola Peninsula in 1992 was also known to have great difficulties in finding the financing for the deal.

5.4.4.3 Exports of copper and stainless steel products

Outokumpu's exports of copper and stainless steel products to Russia had been very limited during 1991-94. However, the products had already become competitive on the Russian market by 1995, because the Russian domestic price level had almost reached the world market level but the quality was still inferior. More importantly, a market of about 3 billion USD per year for copper and steel products was likely to develop in Russia in the course of the following 20-30 years. A society of consumption like in the western countries could develop in that time if nothing exceptionally disturbing happened to keep that development from taking place.

Outokumpu had started sales efforts to capture that potentially growing market. The company had hired the first specialist to carry out market research for copper and steel products in Russia already in 1991. In 1995 Outokumpu Copper founded a sales (and purchase) subsidiary in St. Petersburg. In case customs barriers were raised to limit imports into Russia, the company would also be prepared to consider establishing production units in the country.

The particular problem in selling copper products in 1995 was caused by the fact that the production capacity was fully utilized for production sold to other markets. The situation was the same also for competitors. However, it was realized that the long-term perspective in the Russian market required flexibility in the early stages of developing that market and the production units of Outokumpu were advised to leave some of their capacity for the emerging Russian and CIS market.

5.4.4.4 Imports of raw materials from Russia

Outokumpu's trading company Finenco was founded in 1989 and had become a success story after only 5 years of operation. It had developed raw material imports from Russia to major factories in Finland and aimed at continuing the imports so that Russia could become an important permanent source of raw materials for the company. The most important material bought from Russia was nickel needed for the production of stainless steel. Nickel was also produced in Finland but partly sold to other markets. Potential nickel imports from Russia could amount to 20-30 percent of the total nickel purchases of Outokumpu.

Outokumpu has copper products factories in five different countries and the CIS countries were considered as important sources for copper as well. However, Russia was not a natural exporter of copper even though it was temporarily exporting it due to the exceptionally low domestic level of consumption. After the domestic demand for copper started to increase, there would not be enough copper for the export markets.

The raw material purchases from Russia in 1994-95 amounted to approximately 100-200 million USD per year, which exceeded by far the amount of exports to Russia. There were three modern factories which needed imported raw materials not available in Finland. Therefore the major significance of the Russian market for Outokumpu was that of a source of needed raw materials in 1995.

When developing the raw material imports from Russia Outokumpu had also tried to develop counter-trade and barter transactions. However, the idea of barter had not worked well in Russia. On the one hand, the newly privatized Russian factories wanted to use their earnings for social investments, cars, hotels, houses, etc, and not for production investments. The owners were only interested in the cash flow and how best to benefit from it in the short run. The long-term view was neglected. Some factories which had been bought by the local worker collective and had a wise enough management to prefer production investments were rare exceptions from the general rule. Even though such cases were likely to increase in the future as the concept of ownership would become better understood in Russia, barter trade also had disadvantages for Outokumpu.

Within the company the exporting units were not willing to yield the benefits of their work to other units within the group. As in most cases the commodities offered in barter deals could not be used by the exporting units directly, there was little initiative to put an effort into developing such deals in the first place even though a potential buyer could be found within the Outokumpu group. The raw material imports of Outokumpu, in turn, did not consist of commodities that were offered as barter or countertrade commodities because for there was a market for them already. However, in general the potential for very large countertrade deals in Russia was considered still high or even increasing.

5.4.5 Organization in Russia

In 1995 Outokumpu' organization in Russia consisted of the following units:

The Russian subsidiary of trading company Finenco had a subsidiary Finenco AO in Moscow and an office in St. Petersburg and Alma Ata. There was one Finnish expatriate working in the Moscow office. There were also plans to open new offices in the Urals and in Kiev, Ukraine.

The subsidiary of Outokumpu Copper in St. Petersburg had 5 persons, including 2 Finnish expatriates and the joint stock company, A/O Mineral Processing Engineers, had 2 Finns out of 25 employees.

The representative office in Moscow, which was a joint office with another state-owned company, Kemira, had been closed down two years earlier because of expected tax problems. However, the Finnish Finenco was considering the establishment of a new representative office in Moscow, because it was likely to offer some new benefits for the personnel. Among other things a representative office might be able to pay higher wages and offer tax exemptions for the imported cars. How long such benefits would be there was an open question, though. It was also expected that the wage tax would be abolished in 1996. Many foreign companies operating in Russia seemed to have the combination of both a representative office and a subsidiary.

6 Adaptation by Finnish companies: surveys and case study findings

This chapter describes and discusses the findings from surveys and case studies of Finnish companies during the years of 1991-95. The analysis of the various elements of the strategy formulation process of Finnish companies will be divided into two time periods, the first covering the years 1991-92 and the second covering the years 1993-95. The motivation for separating the two periods lies in the different nature of changes that took place in the environment during 1991-92 in comparison to 1993-95. During 1991-92 the changes that the Finnish companies faced, first in 1991 after the bilateral clearing payment system had been abolished and secondly in 1992 after the USSR disintegrated, represented abrupt and unexpected changes of a more political nature. During 1993-95 the economic reform process produced additional major changes in the Russian and Baltic economies, but they could all be considered parts of the same reform process, although the political battle over their fate continued in Russia. Chart 6 illustrates major events in the region during the years of 1990-95 and the nature of the empirical data used to describe the strategy formation process of the Finnish companies in each period.

The transitional adaptation model will be used as a framework for analyzing the various elements of the strategy formulation process of Finnish companies in the former USSR, Russia and the Baltic states during those years. Therefore, for each period the discussion covers the main groups of factors identified earlier as parts of the model. The financial performance of the companies will be considered as part of the budget constraints and performance of the companies is analyzed in terms of the realized strategies, which are the focus of interest of this study.

Chart 6. Milestones of environmental development and empirical data of the study

End of the bilateral clearing payment system	**1990**	
Various reform programs discussed in the USSR Attempted coup d'etat in August Baltic countries gained independence USSR disintegrated Default of the Vnesheconombank	**1991**	Surveys of 42 companies in the spring and summer including the three case companies
Economic reform started in Russia Foreign trade liberalized Prices increased 4-fold in January Baltic national currencies introduced Limited convertibility for floating ruble Exchange rates unified but started falling Interenterprise debts started to grow Debt crisis solved by new credits to firms Russia joined the IMF Privatization vouchers issued	**1992**	Surveys of 29 companies in the spring and summer including the case companies' offices in Moscow, St. Petersburg and Tallinn
The political battle over the economic reform between president Yeltsin and the parliament continued and culminated in violent confrontation in October. The reformists won the December parliamentary elections by a small margin Licensing of foreign banks stopped	**1993**	Case company interviews
Ruble fall continued and culminated in "Black Tuesday" in October, when its sudden crash created a crisis Investment Fund "MMM" went bankrupt Voucher privatization ended Privatization with money started Inflation down to 200 % p.a. Chechen war started in December	**1994**	Case company interviews
Russia signed a 6.4 billion dollar stand-by credit agreement with IMF Privatization of state-owned enterprises strongly criticized First signs of banking crisis in August	**1995**	Case company interviews

The various parts of the model will be operationalized as follows. The characteristics and perceptions of the environment as well as the dominant logic of the companies operating in Russia and the Baltic states is described as revealed by the interviews. Secondly, the nature of informal contacts is described by the number and characteristics of persons employed in the units responsible for those target markets and by the nature of their customers and other target organizations. Also the informal contacts within the Finnish companies are included in the description. Thirdly, the description covers the nature of skills and the learning experiences of the key personnel involved in Russia and the Baltic countries as well as the nature of the budget constraints they faced. The budget constraints in turn and particularly those of the three case companies are represented by the financial results of the companies, the development of their exports to the target area, as well as the financial constraints of their target customers, which influence the development of exports directly and also enhance the role of financing in all operations in the target market.

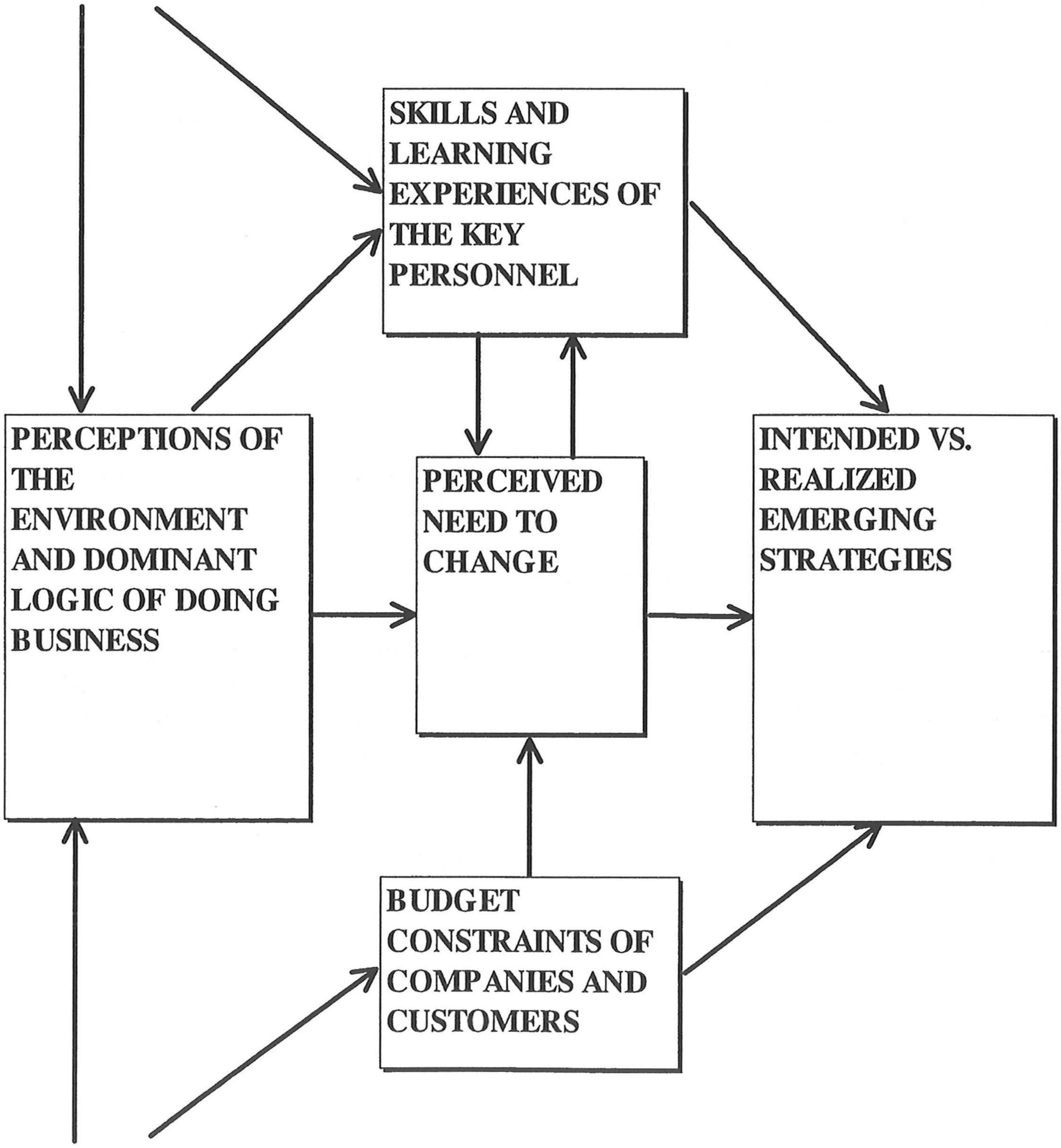
The fourth factor described for each period is the perceived need to change, which according to the model is influenced by all the three preceding groups of factors: the perceptions of the environment and dominant logic; the nature of informal contacts; and the skills, experiences and budget constraints. The three groups of factors will be analyzed particularly in order to identify any pressures to change which would lead to the perceived need to change.

Following the description and analysis of the four factor groups influencing the decision making process in the companies the operative strategies of the Finnish companies in each time period will be described on the basis of the interviews. The emphasis is on emerging strategies as most companies did not have formally approved long-term plans for the Russian and Baltic markets. A distinction is made between the intended and realized strategies, when possible, to illustrate the process of adaptation that took place when the companies faced abrupt changes in the environment.

The following Chart 7 illustrates the model and its various parts as adapted to the case of the Finnish companies' operations in the former USSR, Russia and the Baltic countries in 1991-95. The arrows illustrate the main lines of causality as hypothesized in the model. However, in real life there are more complicated feed-back loops and interactions of the various factors, which cannot be captured by the arrows or other simple formalization of the nature of the relationships. The empirical material also does not lend itself to simple quantification of the variables, which is why the strength of the causal impacts also cannot be quantified. It is hoped, however, that the model will help to illustrate the process of adaptation within the Finnish companies.

Chart 7. The model of transitional adaptation as applied to the empirical case data

INFORMAL CONTACTS: number and nationality of persons employed in the units responsible for Russia and Baltic markets; number and nature of target customers as well as cooperation organizations; contacts within the Finnish companies.



ENVIRONMENTAL DATA: Economic developments as well as trade and direct investments in the target region

6.1 Strategies of Finnish companies in the former USSR and Russia during 1991-92

In this section the transitional adaptation model will be used as a framework for analyzing the various elements of strategy formulation process of Finnish companies in the former USSR and Russian markets based on the round of interviews of the Finnish companies carried out during 1991-92, including those of the three case companies. A more detailed description and analysis of the 1991 survey results is available in Hirvensalo (1993a) and of the 1992 survey results in Hirvensalo (1993b). In 1992 the interviews concentrated on the perceived changes in the economic circumstances of Russia and other parts of the former USSR as well as in the realized changes in the operative strategies of the companies in comparison to the previous year. The case studies continued to probe the same questions in more detail for the years of 1993-95.

6.1.1 Perceptions of the environment and dominant logic of operating in the USSR, Russia and Baltic countries during 1991-92

The Russian and Estonian economic environment during 1991-95 has been described broadly in chapter 3. For the Finnish companies the bilateral clearing payment system had been terminated at the end of 1990, which meant that payments had to be effected in convertible currencies instead of clearing rubles.

In the spring and summer of 1991, when the first round of surveys was conducted, various radical alternatives for economic reform were discussed in the USSR and Estonians were already carrying out theirs. Foreign trade had been liberalized and there were the first signs of potential liquidity problems facing the USSR.

The Finnish companies perceived the market in 1991 as presenting big opportunities in the long-run but entailing unacceptably large risks in the short-run. The Finnish economy in turn was in a recession, the depth of which was still not quite visible for the companies in 1991[1]. Many large manufacturing companies, including the three case companies had started a restructuring process aimed at concentrating more on the core competencies of the companies and selling or closing down marginal and/or unprofitable businesses. At the same time the various core businesses became more independent and more international.

Within these broad perceptions of the economic environment the dominant logic of doing business in the former Soviet Union among the large Finnish manufacturing companies,

[1] In their annual reports for the year 1991 all three case companies were much more optimistic about their financial performance in 1992 than what actually turned out to be the case.

the three case companies in particular, presented itself as follows in 1991 (see also Hirvensalo, 1993, pp. 97-113):

Even though most large manufacturing companies had extensive experience in exporting to the USSR, they were not dependent on the Soviet market. The share of exports to the former USSR from the total sales of the three case companies was only 1-2 percent in 1991. The companies did not need to be concerned about their competitiveness on that market, because their exports had increased on other more competitive markets and they also had started to sell to the USSR against convertible currencies.

In addition, even though the USSR market was perceived to provide long-term opportunities the companies saw little need to change marketing activities in those markets in 1991, because they had already adapted to the new way of trading with the Soviet organizations outside the clearing arrangement in convertible currencies. The large manufacturing companies were also pursuing what could be called a "global niche" product strategy, which meant that the same products were sold in the USSR markets as in other markets. Therefore they also saw little need to adapt their products to local needs nor were price or supplier credits used as marketing means by most of them.

However, there were other groups of companies, whose view departed from this view. Particularly trading companies used price as the key marketing means after the bilateral clearing system was abolished and they were free to trade any goods, not just those of Finnish origin, which were generally regarded by Russian buyers as high quality products but also expensive. Trade credits were used as the main marketing argument by construction companies, which sought to become subdeliverers to foreign companies that in turn had access to credit provided by other western countries. The state of Finland did not offer any credit support for Finnish companies in 1991 due to the fact that the final settlement of the clearing account was still pending.

There was widespread interest in joint ventures established with Soviet partners. About two thirds of the companies interviewed in 1991 had become partners to at least one Finnish-Soviet joint venture since 1988. Most of these were small trading or service operations, including those two which had been set up by two of the case companies[2], but a few large manufacturing joint ventures had also been founded by Finnish companies[3].

Particularly the large companies no longer viewed the Russian market as a potential market for big business as it had been for Finland during the bilateral clearing trade arrangement. Then large contracts had been signed by the CEO's of the companies and top level Russian bureaucrats for the period of a year or at least several months at a time. As exports had shown a diminishing trend since 1986, the small deals made during 1990-

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[2] SP Contur by Valmet Automation and JV Energy, Ecoloy and Engineering by Outokumpu

[3] The largest among them Lenraumamebel manufacturing furniture in St. Petersburg

91 were considered indicative of a trend for some time to come. Due to the diminishing exports the significance of the Soviet trading units within the companies had also diminished and the attention of the top management was turned to other markets.

In the spring and summer of 1992 the market was characterized by major political, structural and economic changes. The former USSR had disintegrated at the end of 1991. The Commonwealth of Independent States had been founded on the ruins of the former USSR but could not replace the former USSR as a political power. Russia assumed leadership of the group but remained both politically and economically much weaker than the former USSR. The three Baltic countries had gained independence from the former USSR in the aftermath of the August 1991 attempted coup d'etat.

Vnesheconombank, which held a monopoly on transferring foreign payments and was responsible for servicing the foreign debt of the former USSR defaulted at the end of 1991 and subsequently froze all foreign assets placed on its accounts.

Economic reforms had been introduced in the beginning of 1992 both in Russia and the Baltic countries. Most commodity prices were set free in Russia in January 1992 and the ensuing rate of inflation exceeded all expectations and reached approximately 1500 percent for the first half of the year.

In Estonia practically all prices were freed in the beginning of 1992 and the new national currency, the kroon, was introduced in June. Latvia and Lithuania introduced currencies of their own later in 1992.

In Finland the recession continued and the situation seemed almost equally gloomy in the major western markets of the Finnish companies and as a result most companies continued to record large losses in 1992. However, the Finnish currency had been devalued in November 1991 and January 1992, which had helped boost the competitiveness of the Finnish companies abroad.

In those circumstances the dominant logic of the Finnish companies of doing business with Russia as revealed in the interviews in 1992 presented itself as follows:

The Russian market was still considered significant and offering great opportunities in the long run but riskier than the year before in the short run. Large companies, in particular, did not attempt to utilize short-run opportunities, which attracted large numbers of small companies into Estonia and St. Petersburg area in Russia.

The most significant changes in the way business was conceptualized from the previous year had taken place in the geographic orientation of the companies as a result of the political disintegration of the former USSR. When in 1991 the majority of companies (31 or 66 percent out of 42 companies) still considered the former USSR as a whole as their target market and the Moscow-based state organizations as their target customers, in 1992 the vast majority (87 percent or 34 out of 39) of respondents considered the St. Petersburg area and/or the Baltic States as their target markets. St. Petersburg was named as a target market by 18 (62 percent) and the Baltic states by 16 (55 percent) of the companies. In addition to these two main target areas Ukraine, Karelia and Kazakstan were mentioned by a few companies.

However, in 1992 the "wait and see" attitude of large Finnish companies particularly in Russia seemed even more widespread than among the companies interviewed in 1991. 19 out of 30 companies (or 66 percent) did not plan any changes in their marketing operations in 1992 as opposed to 17 out of 42 (or 36 percent) a year earlier. They were mostly the same companies who had expressed this kind of views already a year earlier. However, the "business as usual" approach of these companies also did not mean any significant retreats from the export market, either.

On the other hand, interest in direct investments also remained strong among the companies. One third of the companies interviewed had become partners to new small joint ventures or subsidiaries in service or retail business either in St. Petersburg or Estonia. It had also become possible to establish wholly foreign-owned subsidiaries both in Russia and Estonia and such a possibility attracted the interest of many companies. Three of the companies interviewed had already made a decision to establish wholly owned subsidiaries in either country. No new manufacturing joint ventures were established by the interviewed companies. However, among the rest of the companies there were also seven companies, whose interest particularly in joint ventures had decreased from the previous year due to negative experiences from the existing joint ventures, especially in manufacturing.

Moreover, reflecting the worsened liquidity situation of both Russia and Estonia in 1992 the payment terms of exports to Russia had changed dramatically. Documentary payments were replaced by cash payments or payments in advance often from the Russian or Estonian customer's account in a western bank. The act of freezing foreign currency accounts of Vnesheconombank had created distrust towards all Russian banks also among Russian and Estonian companies and led to significant capital flight especially from Russia. Cash payments became common both in Russia and Estonia also, because the banks in both countries were slow in effecting money transfers. However, they also created additional security problems for the Finnish companies. The devaluation of the Finnish markka had helped pricing pressures but supplier credits for Russian customers were even more difficult to obtain than the year before.

6.1.2 Organization and the nature of informal contacts

The adaptation model rests on the characteristics of complex systems, which stress the significance of informal connections both to actors outside the organization and between members of the organization. The 1991 survey showed, first, that the number of persons employed by the Russian trading units in Finland was decreasing due to the disappointing development of exports to that market. This decrease was in many cases offset by an increasing number of Russians employed at the Moscow representative offices of the same companies and increased traveling of Finns, who were not specialists on the Russian markets but product specialists of the company.

The connections Finnish companies had to Russian organizations fell in two main categories: 1) old connections to ministries, foreign trade organizations, various institutes, and in some cases to end users of their products in Russian factories, 2) new connections to an increasing number of both old and potential new customers. The old connections were maintained even though in some cases the Russian persons in question had moved to new organizations. For new connections especially such customers who had access to earnings in convertible currencies were targeted. Whereas the major motivation of Finnish companies in maintaining and creating new contacts was to keep up their sales and identify potential new customers and cooperation partners, the motivation of Soviet organizations to create new contacts was influenced to a great extent in finding western joint venture partners. Finnish companies were contacted by numerous Soviet organizations for this purpose.

Within the Finnish companies, especially the large manufacturing companies, the units responsible for the Soviet market operated directly under the headquarters and were relatively independent from the rest of the organization. Not much communication took place across the lines between various other units of the organizations and the Soviet trade units. Many large companies, including all the three case companies, shared representative offices in Moscow with other Finnish companies mainly to reduce the high costs of maintaining such offices. However, cooperation between companies was limited to administrative matters.

In summary, contacts were increasing between potential new Russian customers and non-Russian specialists of the Finnish companies at the same time as the old contacts continued to be important. The increased quantity of information concerning developments in the Soviet markets was channeled through and processed in smaller Soviet trading units in the headquarters.

In 1992 the number of the informal contacts to potential new customers was generally increasing among the Finnish companies due to the fact that most companies continued their marketing operations as usual in Russia. The marketing organizations in Finland continued to diminish in size whereas Russians and Estonians employed in either representative offices or joint ventures in Russia and Estonia increased in numbers.

However, the political developments and geographic reorientation of trade had a more significant effect on the marketing organizations of the companies. After the disintegration of the former USSR it was no longer possible to cover the whole region out of

Moscow. As a rule, the marketing responsibility for the Baltic states was given to persons working out of Finland and often in units which were responsible for the domestic markets. Those companies, who had established a presence in Tallinn, used their office also as a bridgehead to other Baltic countries, some to Belarus and Ukraine and a few even to the Russian market. On the other hand, companies operating in the other CIS countries, Kazakstan for example, noted that potential customers in those countries would not favor a company operating from Moscow.

6.1.3 Skills and learning experiences

Until 1991 the large manufacturing companies had gained their experience on the Soviet market mainly from exporting activities, which were conducted by the special Soviet trading units of the companies in Finland, the representative offices established in Moscow and most recently from small service joint ventures set up together with Russian partners. Experience had also been gathered by the companies through efforts to increase imports from the USSR to Finland within the bilateral trading system. The companies had tried, in particular, to find suitable Soviet products which could be used as components in export products to be delivered to their Soviet customers.

The personnel in charge of the marketing efforts on the Soviet market were generally very seasoned experts of Soviet trade. Most had longer than 10 years experience in Soviet trade and were fluent in the Russian language. Many had also lived in Moscow as company representatives for several years. They considered that their competitive advantages on the Soviet market consisted of the particular skills of understanding the Russian business culture and perseverance in dealing with Russians. However, they had very little experience of trading in other markets as the relatively rare Russian language skill tended to keep them in the Soviet business. As an example they had little experience in dealing with trade financing questions because it had not been needed on the Soviet markets within the bilateral system.

By 1992 the companies had already gained experience from working in the rapidly changing environment in Russia. They had learned, among other things, that Russian nationals were not only much less expensive but many times also more efficient in operating in the difficult local conditions of Russia. Often they were also very highly motivated to work for a foreign company, which could pay higher wages and/or offer better benefits than the local companies.

However, they had also gathered negative experiences, especially from joint ventures, which had been established earlier in the former Soviet Union and were operating both in Russia and Estonia in 1992. In particular, they had experienced managerial problems due to differences in business culture and the work ethic between Finnish and Russian companies. As a result of the experiences the Finnish companies had learned more about both the positive and negative features of Russian nationals as business partners.

6.1.4 Budget constraints

The budget constraints of Finnish companies were generally tightening in 1991 due to the recessionary conditions on both domestic and foreign markets. The financial results of all the case companies for 1991 showed losses. As the exports to the former USSR had been falling for most companies since 1986, hiring new personnel into the marketing units responsible for the former USSR had become very difficult. On the other hand, large manufacturers had sufficient idle resources which enabled them to keep most of the personnel responsible for Soviet market even though trade had diminished. In 1991 Finnish exports to the USSR fell by more than 60 percent and the exports of the three case companies also experienced a drastic fall.

The financial constraints of the Soviet enterprises and foreign trade organizations were also tightening and as a result Finnish companies faced counter trade requirements, which was a new phenomenon in the Finnish-Russian trade relations, because the bilateral clearing payment system excluded such arrangements between the companies. There were also payment delays from the Russian customers, which within the clearing payment system were unheard of.

In 1992 financial problems due to the default of the Vhesheconombank and the inefficiency of the local banking systems manifested itself especially for joint ventures in difficulties in opening bank accounts, slow transfer of payments, and very high banking fees. Credits were not available, or if they were, only for the very short term and at exorbitant nominal interest rates (50-120 %, p.a.). Therefore the parent companies in Finland had to arrange all financing needed and often transfer the money in cash both to Russia and Estonia.

Financial risks due to counter trade requirements were also faced by almost half (45 %, or 13 out of 29) of the interviewed companies in 1992 because barter transactions had become a common way to solve the financing problems faced by the Russian customers of the Finnish companies. For the Finnish companies barter transactions signified increased traveling in search for available raw materials or other suitable barter goods.

The budget constraints were hardening first, due to the worsening financial situation of their customers in Russia and the increased burden placed on them by the advance payment requirement and secondly due to the additional efforts that needed to be taken to conclude barter transactions. Exports to Russia in most companies remained on the level of the previous year but sales in general continued to decrease, which further tightened the budget constraints faced by the Russian trading units of the companies.

However, even though most companies still recorded losses in 1992, the overall financial results of the companies improved from 1991.

6.1.5 Perceived need to change

Based on information gathered through formal and informal contacts, the prevailing business logic, budget constraints and the skill profile of the large Finnish manufacturing companies operating in the Soviet markets it can be concluded that in 1991 the large Finnish companies did not perceive any great outside or inside pressures to change their operations on the Soviet market. Particularly the case companies felt that they had already adapted to trading in convertible currencies with the USSR clients. Consequently a "wait and see" attitude seemed to be prevailing in most large manufacturing companies.

From the various sources in the model which could initiate change pressures the informal connections to various Soviet organizations on the top management level of the companies had decreased even though they had increased on lower levels. There were no big opportunities in sight in the short run although the market was considered significant in the long run. The tightening budget constraints did not allow the companies to hire new Finnish personnel into the Soviet trading units but there was enough slack to allow most of the old personnel to continue in their old positions. The new personnel which was hired for the Moscow representative offices was mostly Russian, which was not influential and experienced enough to call for major strategic changes. The most pressure to change was felt by the marketing managers responsible for the Soviet trading units because they were actually at the crossroads of all the information, formal and informal, concerning the market development. They were also concerned, if not particularly threatened, by the trend of replacing Finnish employees by Russian nationals in the representation and sales offices of their companies in the former USSR.

Any upgrading of operations, direct production investments in particular, were considered risky in the Soviet political and economic turbulence of 1991, although many companies were actively searching for new cooperation partners or subcontractors among the Russian enterprises. There was also very little pressure from competitors in the market. The few western competitors of the Finnish companies which were active investors in the former USSR were almost all in the service industries, in trading, restaurant, hotel or banking businesses, and not in manufacturing. On the other hand, the companies felt that they could not be seen to retreat from the market, either, because that would harm the established contacts to the Russian customers who were considered potentially important in the long run.

In 1992 the pressures from the informal networks, dominant logic, experiences, skills, and hardening budget constraints could be considered stronger than they were in the previous year. The informal networks especially in Estonia had enlarged significantly, because new persons had become responsible for the Estonian market within the companies. In Russia more Russians were employed by the companies and joint ventures created by them in Russia even though less Finns worked for the marketing organizations.

The dominant logic of doing business in the region reflected the political developments and saw the need to establish a presence in various parts of the Baltic countries and the CIS countries. At the same time it took note of the increased financial risks of doing business in the region. The skills of the companies had increased in operating in the changing environment but the budget constraints had tightened due to the financial difficulties of the Russian companies as well as the Finnish companies themselves. All these can be seen to have contributed to a somewhat increased perceived need to change operative strategies in the region but the perceived risks and tightening budget constraints acted simultaneously more as brakes than stimulants. There were also no great pressures from the competitors of the large manufacturing companies, who were not perceived to increase their activities to a great extent in the market.

6.1.6 Emerging strategies during 1991-92

As the large Finnish manufacturing companies perceived no great environmental or internal pressures to change operative strategies in the former USSR, the adaptation model would imply continuation of operations as usual in those markets. Accordingly, most of the export managers of large manufacturers interviewed in 1991 stated that their strategy on the Soviet market was to continue operating in that market as they had been doing until then and any changes under consideration were small. Most wanted to wait to see the economic situation of the former USSR stabilize before they would introduce any major strategic changes.

In fact, in quite a few companies, including all three case companies, the first reaction to the question concerning operation strategies in the former USSR was that there was no formal strategy in the company to guide the development of operations in the Soviet market. However, when the question was discussed in more detail it turned out that all of the marketing managers had specific goals and ideas in their minds regarding how to develop operations in that market. They had only not been formulated as formal strategies and undergone formal planning procedures by their companies. However, the managers had relatively free hands in carrying carry out their plans as long as they did not incur large financial costs or risks.

These plans included increasing use of Russian locals in order to cope with the tightening budget constraints and increasing need to travel in the various parts of the USSR in order to identify potential new customers. They also included new representative and/or sales offices in other parts of the former USSR than Moscow. The suggestion made above that the strongest pressures to change were felt within the Soviet trading units themselves and not, for example, at the level of top management or in various product units of the companies, supports the finding that the new ideas were emerging from within the Soviet trading units themselves. The Soviet trading units of the three case companies themselves also defined their roles as agents of change and initiators of new ideas.

However, in 1991 manufacturing joint ventures were not considered as viable new alternatives in the prevailing conditions on the Soviet markets. Instead, many companies, including all three case companies were actively looking for subcontractors or cooperation partners among the Russian and Estonian enterprises.

The geographical orientation of the companies had shifted somewhat from the Moscow centered view to consider the opportunities within the geographically close regions to Finland, particularly the St. Petersburg region and Estonia. Most large companies, including the case companies continued to consider, however, the whole USSR as their target market. There was much general interest in the idea of Finland becoming a gateway to the emerging Soviet markets, but none of the companies were pursuing the idea in their operative strategies. In a few companies the gateway idea was pursued internally so that foreign units used Finnish expertise when operating in Russia. However, in many others not even an internal Finnish gateway was considered feasible. A few others considered the Baltic countries as a better gateway to Russia than Finland.

Based on the interviews carried out in 1992 the realized strategies of the Finnish companies included the following elements. Perceiving the new political map of the former USSR region the companies planned to spread their marketing organizations further to match the requirements of the individual markets. However, no major investments were planned. Instead it was planned to hire more local representatives to work for the companies in the region.

Many companies recognized a need to change the role of their Moscow representative offices, which had become increasingly costly in relation to the export volumes of their companies. However, many did not have a clear idea of what their role could be in the future. To simply change them into sales offices was not considered a viable option by many due to complicated tax issues.

Some of those companies that had established a presence in Estonia, most often in the form of a subsidiary, wanted to use the market as a testing ground for operations before entering the vast Russian market. Such companies also had a long-term view when developing their operations and did not expect their investments to become profitable in the short-run.

Those companies, which considered making direct investments in Russia, became increasingly interested in the option of establishing wholly owned subsidiaries instead of joint ventures, from which the experiences of themselves and others had increasingly turned out to be negative. However, also these investments would be very small and would not include any great financial risks for the companies, because there were no possibilities in sight to obtain credits from outside sources for such investments. Companies that had tried to identify credit sources for investments in Russia had been discouraged by the lack of support by the international financing organizations as well as by the lack of official credit support from the Finnish government. Finland had become one of the largest creditors of the former USSR among the western countries, as pointed out in chapter 3.

More specifically the three case companies described their strategies in 1991 and 1992 as follows:

Valmet

Within Valmet there were two different approaches to the former USSR market in 1991[4]. On the one hand, the approach of the Paper Machinery Division to the Soviet market was to maintain old and create new contacts with the potential end-users of Valmet's machinery within the Soviet pulp and paper industry. The production units in Finland sent their specialists to the Russian factories in order to get first-hand knowledge of their needs and problems, which possibly could be solved with the help of Valmet's technology.

Barter transactions were excluded, because the Paper Machinery Division did not consider the trading functions included in the barter transactions proper for the engineering company. Moreover, the company had already tried, with practically no success, to pursue the countertrade and barter opportunities in late 1980's when it faced countertrade requirements for the first time. However, within the division there was interest in finding potential low cost subcontractors among the Russian engineering enterprises, particularly in the former military industry, which was being converted into civilian use.

On the other hand, Valmet Automation Projects (VAP), which specialized in the former USSR markets, pursued a more proactive policy of finding solutions to the financing problems of their Soviet customers. This policy caused them to be more favorable towards, among others, barter transactions and search for ways of carrying them out. VAP was the unit within Valmet which held the shares in SP Contur, the joint venture founded in 1988. VAP also founded a representative office in Tallinn before Estonia declared independence from the USSR in 1991. VAP wanted to establish a presence in the Estonian market and to monitor the other Baltic markets, Belarus and Ukraine out of

[4] A somewhat different approach was also within the division of transportation equipment, logging and tractors, which were sold in 1994. These divisions also approached the Soviet end-users but emphasized somewhat more the reliable and quick service function for the machines they delivered.

Tallinn. The Paper Machinery Division in turn did not consider the Baltic countries as significant markets for them as there were no large paper or pulp factories in those countries.

The Russian trading unit, which operated in the headquarters of Valmet continued coordinating the marketing efforts of the Paper Machinery and Transportation Equipment, Logging and Tractors Divisions. At the same time the unit was involved in tracking down potential subcontractors in Russia and in planning for a wider geographical presence in the country.

In 1992 Valmet continued to pursue the two different lines of strategies, for which the foundations had been laid already in the previous years. Moreover, the plans had developed into definite actions in 1992 even though the plans one year earlier had been quite tentative.

The Russian trading unit had taken action to set up both a representative office and a subsidiary in St. Petersburg. At the same time the unit was pursuing the strategy of searching for suitable subcontractors or cooperation partners among the Russian enterprises through and with the help of two former Soviet planning institutes in St. Petersburg.

Valmet Automation Projects in turn continued with the policy of finding financial solutions for their Russian and Baltic customers and concluded several barter transactions in 1992.

Ahlstrom

Within Ahlstrom two somewhat different market approaches emerged in 1991. Within Machinery Division, which had traditionally been the largest exporter to the USSR among Ahlstrom's divisions, the emphasis was also on creating more direct contacts with Soviet end-users and potential cooperation partners, which involved more travelling by a larger number of persons from the division than before. They also saw participation in the problem-solving of their customers as a good way of approaching both old and new customers. Barter transactions were also excluded due to the risks they would create not only for Ahlstrom but also for the Soviet enterprises by spoiling their markets in the west.

Within the General Products division new opportunities were seen especially for electrical accessories and market research was initiated to estimate the potential size of the market for those products. The Baltic markets were considered particularly interesting as they provided a potential gateway also to the vast Russian markets.

The Soviet trade unit of the company continued in the role of coordinating the marketing efforts of the various divisions and tracking down potential cooperation partners in the USSR.

In 1992 Ahlstrom Machinery set out to found a subsidiary in St. Petersburg. The Electrical Accesories division in turn had concluded the market research both in the Baltic countries and Russia and proceeded to set up a joint venture with a Latvian partner in 1992. The division also continued the search for a suitable Russian joint venture partner.

Outokumpu

Within the divisions of Outokumpu there were different approaches to the USSR market depending on the particular characteristics of the businesses involved.

In 1991 the Outokumpu Technology Division was negotiating the renovation of Petsamo Nickel-smelter project with Soviet authorities. It was a huge project, which would have filled the order books of the division for a long time. At the same time the company continued the series of symposiums designed to target the potential users of Outokumpu technology within the Soviet metallurgical industry. There was, however, no interest nor resources to pursue the policy of finding subcontractors among the Soviet enterprises.

On the other hand, cooperation was pursued with the former centralized planning institute of the Soviet mining industry within the joint venture of A/O Mineral Processing Engineers mainly to identify direct selling channels to the mining industry.

Within the mining unit of Outokumpu cooperation had also been started and continued in 1991 to develop a mine in the Tsheljabinsk region in the Urals.

Within the unit for copper and stainless steel products a market research study was initiated in 1991 in order to evaluate the Soviet market potential for those products.

In addition to the other units aimed at developing exports markets for their products in the former USSR, Outokumpu had also created a trading company in 1989 to develop imports of raw materials from the USSR. The abolition of the clearing payment system had made direct imports from the USSR to Finland possible in 1991. Before that the Soviet organizations had not been willing to sell nickel to Finland against clearing rubles. However, it was not possible to arrange barter transactions, because generally the materials offered for such deals were not of the type and quality the units of Outokumpu were interested in. They would also have required cooperation between the units, which was difficult due to the increased independence of the various units.

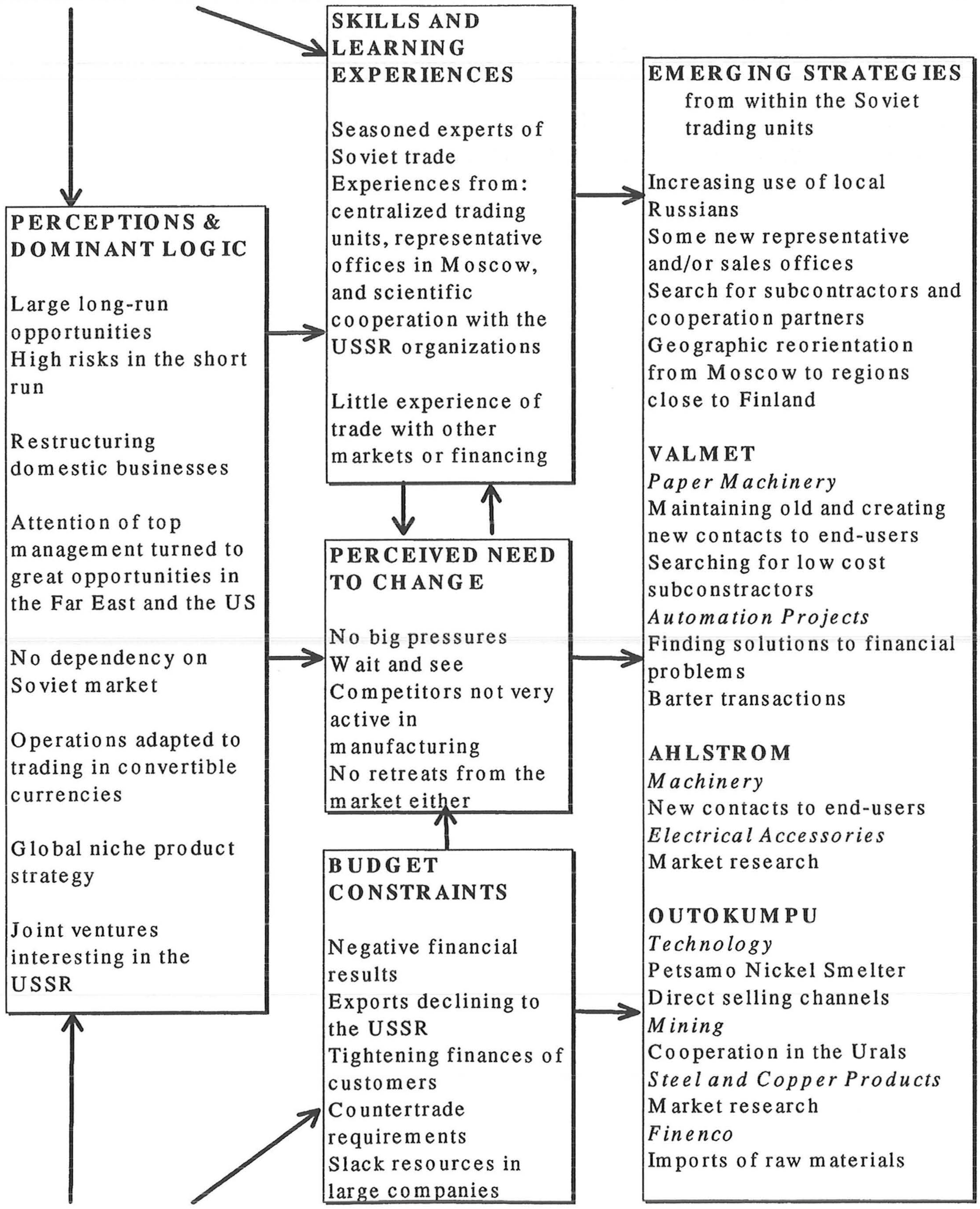
The Soviet trade unit within Outokumpu was involved in coordinating the efforts of the various units in the Soviet market and particularly in developing contacts with potential new cooperation partners.

In 1992 Outokumpu continued with the strategies designed already a few years earlier although the company had lost the contract negotiated for the renovation of the Petsamo Nickel smelter project to another group. In 1992 particularly the strategy to develop imports of needed raw materials from Russia was emphasized within the company.

Charts 8 and 9 illustrate the model of transitional adaptation as applied to the situation of Finnish manufacturing companies' operations in the USSR and the Baltic countries in 1991 and 1992.

Chart 8. Adaptation of operative strategies in 1991

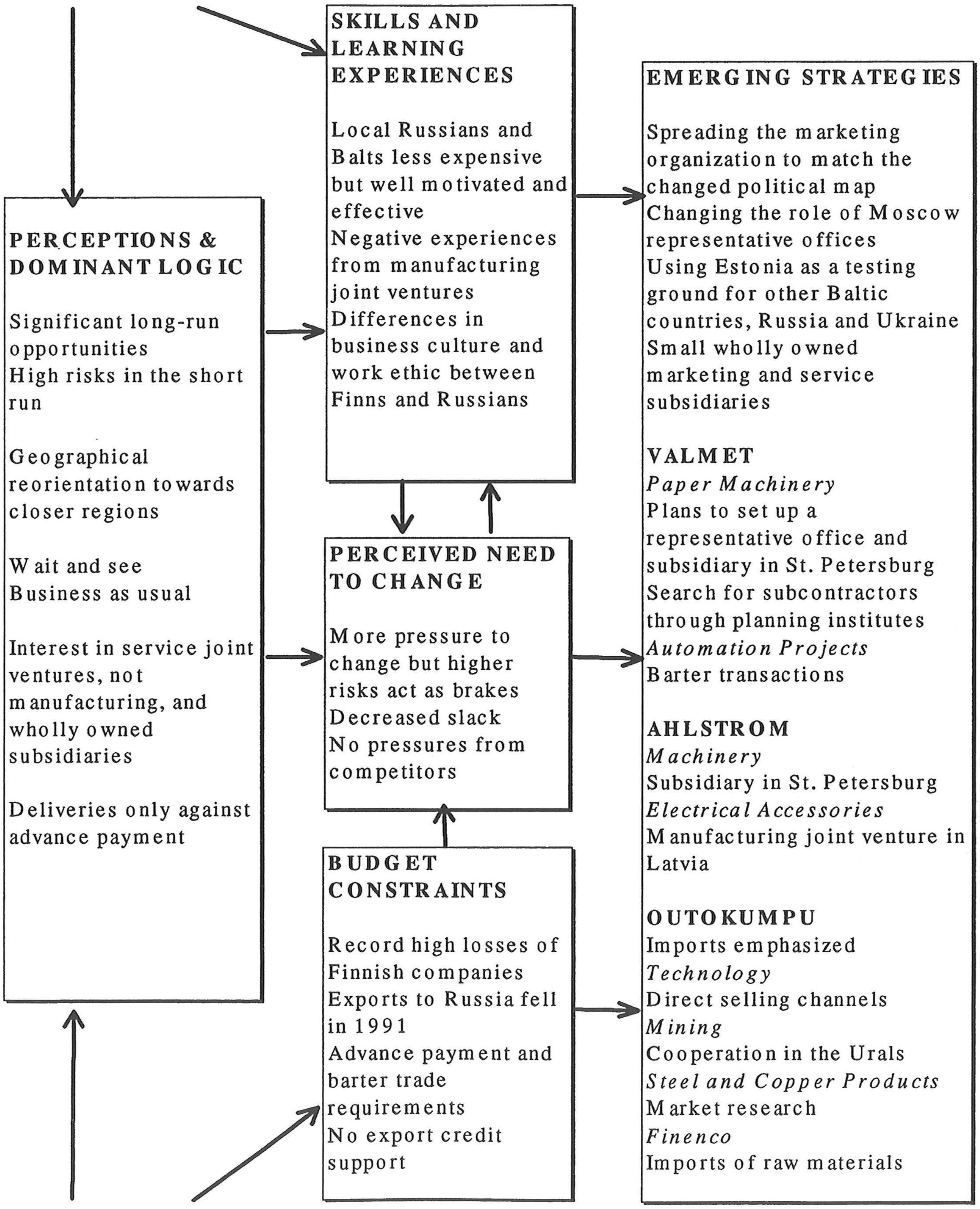
Informal contacts: old connections to ministries and foreign trade organizations; new connections to end users and/or those who have access to earnings in convertible currencies; less Finns employed in Soviet trading units; increasing number of local nationals in units in Russia and the Baltics.



Environment: Soviet-Finnish clearing system abolished at the end of 1990; various economic reform programs discussed in the USSR; recession in the domestic markets

Chart 9. Adaptation of operative strategies in 1992

Informal contacts: contacts increasing to end-users, potential new customers; marketing organizations decreasing in size in Finland; more locals employed in Russia and Estonia; marketing organizations for Russia and the Baltic countries separated.



Environment: major political, structural and economic changes; disintegration of the USSR; independence of the Baltic countries; creation of the CIS; default and freeze on the accounts of Vnesheconombank; economic reform started in the USSR; Baltic countries introduced national currencies; recession continued in Finland

6.1.7 Emerging strategies in 1991 vs. dominant logic and realized strategies in 1992

If the intended and emerging strategies of the Finnish companies as reflected in the interviews carried out in 1991 and described in 5.1.5 above are compared to the description of the dominant logic of doing business with the Russians and the realized strategies in 1992 a significant difference is detected between the two. This is most likely due to the unexpected political events which led to the disintegration of the former USSR at the end of 1991. For example, the companies had not planned to separate their marketing organizations for Russia and Estonia, at least not as quickly as they did at the end of 1991 or the first half of 1992. Of the case companies the plans of Valmet and Ahlstrom to found subsidiaries in St. Petersburg also matured rapidly. The companies were also taken by surprise when Vnesheconombank defaulted and they had to change their payment terms to Russian clients on very short notice. Only a few companies had plans to develop their skills in concluding barter deals, but many were faced with those requests by their Russian customers.

It is most likely due to the nature of the big changes that companies adapted quickly. It also did not require major new resources from them, which made quick adaptation possible. In most cases the marketing responsibility for the Baltic states was added to the responsibilities of existing personnel within the companies. One could also argue that the nonexistence of formal strategic plans may have played a role in the speediness of the adaptation.

6.2 Case companies and the adaptation model in 1993-95

The following account summarizes the findings in the case companies during 1993-95 in terms of the transitional adaptation model. The perceptions of the enviroment for all the case companies in Russia and the Baltic countries during the years of 1993-95 is briefly described as follows:

6.2.1 Perceptions of the environment and the dominant logic of doing business in Russia and the Baltic countries

In Russia the economic reform process continued. The voucher privatization program was launched at the end of 1992. By the end of 1994 over 50 percent of the Russian enterprises were in private hands. However, the state had retained 20 percent, on average, of the shares. The central bank continued to finance the large enterprises with cheap credits, which exerbated the problem of interenterprise arrears in the longer run.

The official unemployment rate remained low but unpaid leaves and wage arrears became common. The inflation rate came slowly down from about 2000 percent p.a. in 1992 to about 1000 percent p.a. in 1993 and to about 300 percent in 1994. The ruble depreciated steadily in nominal terms but was stabilized in real terms after the black Tueday in October 1994. The crimes, supposedly committed by various mafia became more and more visible particularly in the banking sector. Foreign investors started to become interested in the country.

The political battle over the Russian economic reform sharpened in 1993 and led in October to a violent confrontation between the supporters of Yeltsin and those of Hasbulatov, the speaker of the parliament and supporter of more conservative economic policies. In December 1993 parliamentary elections the reformists lead by Yeltsin won by a very small margin.

The reforms and economic stabilization continued in Estonia and the other Baltic countries, but problems surfaced especially in the banking sector. In Estonia a crisis in the banking sector broke out in 1992-93, in Latvia and Lithuania a couple of years later, in 1994-95.

The Finnish economy started growing in 1993 boosted by the open sector developments following a world wide boom and helped by the devaluation and the ensuing floating rate policy of the Bank of Finland. All case companies increased their sales especially in North America and the Far East and the financial results of the companies continued to improve.

Valmet

The situation in the Russian paper and pulp industry had deteriorated since 1991 and was considered desperate by Valmet in 1994. The price of raw materials had increased so much that many factories could not afford it and were selling wood abroad instead. The financing difficulties of the factories were enormous. They owed vast sums to their suppliers and no factory was able to pay its debts. There was also no interest in making investments, as all spending seemed to go to consumption.

In 1995 the production finally started to grow and Russian products became competitive in the world markets due to a general increase in world market prices. The Russian paper and pulp industry had also attracted the first foreign investors and there were more potential buyers in Russia due to the somewhat improved financial situation. In addition, it had become possible to separate winners from loosers within the paper industry. Some small factories under effective management were making small investments into their production facilities while some large factories seemed to operate only for the personal benefit of their managers. Among the top ten potential customers there were also a few, which had attracted foreign investors during 1994-95.

In Valmet the two different approaches of doing business in Russia continued. In paper machinery the aim was to sell spare parts and renovation projects of old machinery for the little money that the customers could come up with in advance. The market continued to be seen important in the long run, because the investment needs in the Russian paper and pulp industry were considered enormous.

In Valmet Automation Projects the concept of finding solutions to the financing problems of the customers by arranging barter trades prevailed. Neither of these approaches was, however, integrated into a general strategy of Valmet for the Russian market.

The Russian market became the major target market for paper machinery sector whereas Valmet Automation also targeted the Baltic states and other CIS countries.

In the field of direct investments the approach was to use the old contacts and with their help to indentify potential Russian partners who could perform subcontracting tasks in the conversion industries or elsewhere. However, no large investments were planned. For that the environment continued to be far too risky until 1995, when Valmet started to consider the possibility of setting up small production units mainly in order to learn how to run a production operation in the Russian conditions. The marketing subsidiary in St.Petersburg had been the first step in that process but operated with limited financial and personnel resources.

Ahlstrom

As the Finnish market was recovering from recesssion very slowly the pull of especially American and Far Eastern markets was felt increasingly strong in Ahlstrom. The Russian market continued to be plagued by great uncertainties and risks of unacceptable magnitude for direct investment types of operations. The Baltic markets were considered more stable and offered potential opportunities especially for the Electrical Appliances Division of the company.

The general strategic approach of the management was reflected in the restructuring process, which aimed at focussing more on the core businesses of the company, particularly those of specialty papers and packaging materials and those of producing equipment and processes for the pulp and paper indusries. It also implied a strategy of divesting other businesses, which fell outside of these two main businesses. However, the Electrical Accessories Division of the company, which did not belong to either of the defined core businesses, developed very rapidly and profitably and expanded its operations especially in Scandinavia and the Baltic countries.

The management culture gave the divisions great leeway in designing their own operative strategies and the responsibility of "finding the business" was clearly with the divisions. There was no special strategy designated for the Russian or Baltic markets. The units had to come up with the strategy themselves and get support for any investment requirements from the board by providing proof for profitability. Foreign subsidiaries and other foreign units were run by local managers in each country of operation. Very few expatriate Finns were employed abroad.

The geographic orientation of the divisions also varied among the divisions. While the Machinery and Paper Divisions concentrated more on Russia, the Eletrical Appliances Division was more interested in the Baltic and other Eastern European markets.

Outokumpu

Within Outokumpu the perceptions of the Russian market during the years of 1993-95 varied depending on the particular business segment of the company. The technology segment saw the market as providing opportunities for relatively small sales contracts, which could be financed by the mining companies in the difficult economic situation.

The mining segment was interested in the known ore deposits of Russia and wanted to participate directly in their development as the company was doing in many other parts of the world.

The segment of stainless steel in turn was monitoring the Russian market because of the huge future potential it would offer for stainless steel and copper products in the course of the following 20-30 years. A western type consumption society could develop in Russia during that time and boost the demand of innumerable steel and copper products. By 1995 the domestic price level for stainless steel products had almost reached the world market price level but the quality was still inferior.

Finally the trading company Finenco developed raw material imports mainly for Outokumpu's factories in Finland.

All the segments had a long-term view towards the market and did not expect any quick returns from their marketing and cooperation efforts. However, raw material imports could be developed much faster than technology exports or mining companies particularly in the Russian conditions, where the domestic demand for many materials had fallen drastically since 1991.

6.2.2 Organization and the nature of informal contacts

Valmet

The contact network of Valmet in Russia developed rapidly due to the efforts to find solutions both for the pressing technical and financing problems of their Russian customers and to identify potential cooperation partners. New contacts were created also to banks and trading houses, who could provide help in concluding barter transactions and particularly in finding financing sources for larger contracts among the international financial organizations.

As within Valmet there were differences in the approach to barter transactions, which were considered archaic ways of doing business especially within the paper machinery sector, the know-how that was developed in VAP did not spill over into the paper machinery sector nor was the financing unit of Valmet involved in them.

Very little new personnel was hired; in fact the number of employees was diminishing in the company through those years. However, new Russian employees were engaged in the units operating in Russia.

Ahlstrom

The contacts between the Finnish units of the company were quite limited as each pursued its own strategy on the Russian and Baltic markets. The subsidiary, which was set up in St. Petersburg was originally planned to serve the need of all units of Ahlsrom. It was, however, "adopted" by Machinery, which started to use it as a representation for their division only.

The various divisions had a different clientele in the Russian markets. The Machinery Division was targeting mostly their old customers in the paper and pulp industries, (the same as Valmet) the Specialty Paper and Packaging Division was looking for potential customers within a wide sector of potential industrial consumers and the Electrical Appliances Division targeted both the wholesale and retail markets for their products.

However, both in Russia and other markets the strategy of using local nationals rather than Finnish expatriates prevailed. With the help of the local personnel the marketing efforts of the company could be made much more effective. However, at the CEO level the management of the Baltic and other subsidiaries was kept in Finnish hands. The Finnish CEO did not live in the contries concerned but visited the units in question several times per year for board meetings and meetings with significant local customers.

Outokumpu

Outokumpu's contact network in Russia expanded due to the continuing marketing efforts carried out by the Wenmec and Mintec units within the technology segment as well as by the trading company Finenco. A new unit was also set up in 1990-91 in Finland to develop cooperation with the Russian exploration organizations and by 1995 three new exploration and mining companies had been founded. The Russian contact persons of the mining companies were often local authorities of the communities of the targeted ore deposits.

Within Outokumpu the various segments operated relatively independently but there were two particular units in the organization where coordination and exchange of information took place. The first one was the Russian trading unit, which continued to coordinate Outokumpu's operations in the Russian market and the second one was the trading firm Finenco, which in addition to importing raw materials had also started selling metal products and technology.

6.2.3 Skills and learning experiences

Valmet

The experiences learned during those years were mostly of a very practical kind, of how to carry out every day operations in the highly inflationary and rapidly changing environment. The old experiences of running representative offices were useful when planning and setting up new ones. However, the local authorities had more and more to say about their operations and Valmet found that what was possible in Moscow was not necesarily that in St. Petersburg and vice versa.

By keeping in contact with the customer factories they also learned what kind of enterprises were likely to be successful restructurers and which were not. It seemed that those whose shares were held by the former managers and employees were the most successful ones.

The skills in dealing with various financial questions developed particularly within Valmet Automation Projects. However, they also found out that the Russian enterprises also developed those same skills and no longer needed so much outside help.

In addition, Valmet gained experience in working together with the Russians in a joint venture and learned about both the high skill level of the Russians and the low credibility of them in the eyes of other Russians. They also came to realize how bad the image of joint ventures had become among Russians due to the extraordinary good benefits that a few of them were believed to have offered to their Russian shareholders.

Ahlstrom

Ahlstrom's experiences in Russia and the Baltics in 1991-92 were based on keeping contact with the old customers of the Machinery Unit in the pulp and paper industry, looking for potential subcontractors for the Machinery Division in Finland as well as extensive market research for the Electrical Appliances Division both in Russia and the Baltic countries.

The experiences of setting up what became a de facto marketing subsidiary in St. Petersburg in 1992 were considered at first negative due to the fact of having to comply with conflicting Russian legislation for foreign investors, on the one hand, and domestic enterprises, on the other hand. However, the experience taught the company to comply with the turbulent environment of Russia.

The first investment in Latvia, a Finnish-Latvian joint venture, made in 1992, was also considered disappointing from the day it starting operating due to the differences in the Latvian and Finnish ways of managing the company.

The Finnish personnel engaged by the unit for Russian trade at the headquarters of Ahlstrom and the Machinery Division included mostly persons with long experience of trade with the former USSR and Russia whereas the Electrical Appliances Division engaged persons with little or no earlier experience with the market.

Outokumpu

The persons employed in the new units in Finland were in part old veterans of Soviet trade and in part mining specialists with no or very little previous experience from trade or operations with Russia.

Within the technology segment the learning experiences were related to understanding how the Russian metallurgical and mining industries were performing and developing.

In the mining segment of Outokumpu the learning experiences were particularly related to the way the local authorities operated and influenced significant investment decisions. The Petsamo Nickel-smelter project was lost to a competing consortium, as part of the local partners did not survive the August 1991 attempted coup. In Tsheljabinsk the cooperation with a local mining company ended when their group lost the contract to a local Russian consortium, which was suspected of oiling the local decision makers. By December 1995 neither of these projects had really started.

6.2.4 Budget constraints

Valmet

The budget constraints of Valmet continued to be tight. The company was running losses until 1994, which was the first profitable year in a long time. The exports to Russia fluctuated from year to year but remained on average on the level of 1991. In 1994 the exports fell significantly due to the sale of the Transportation Equipment, Logging and Tractor Unit, which was a significant exporter to Russia. There was slight improvement in the financial conditions of the Russian customers in 1994 but no major change in the continued difficulties of getting official export credit support from Finland or international financial organizations.

Ahlstrom

The budget constraints of Ahlstrom as a whole eased somewhat after 1992 as reflected by the net profits of the company. However, as the positive financial results were reached only by using slack resources of the company in the form of extraordinary asset sales, it can be assumed that the budget constraints remained in fact tighter than in the case where the profit had reflected the development of the operating income directly. The exports to Russia troughed at 50 million FIM in 1991 but grew each year since that and reached the 1990 level (200 million FIM) in 1994. The financial constraints of the Russian customers continued to be extremely tight. Advance payment was required from them and no export credit support was available. The situation had softened somewhat for the Baltic customers, who were extended short-term trade credits for small purchases.

Outokumpu

The internal budget constraints of Outokumpu were softening somewhat after 1993 when the company showed positive financial results. However, the performance of the Technology Unit continued to be disappointing. Also the exports to Russia increased somewhat in 1994-95 and particularly the raw material imports from Russia developed rapidly, which by itself did not influence the budget constraints directly but increased the significance of the market for Outokumpu.

However, the budget constraints of the Russian customers in the metallurgical and mining industries continued to be tight and their preferences for spending were for consumption rather than for investments. Barter transactions were not attempted to a significant degree by Outokumpu, not even by the trading company Finenco, due to the distorted structure of prices and distribution channels of Russian metal exports.

6.2.5 Perceived need to change

The perceived need to change summarizes, as before, the various pressures to change arising through perceptions of the environment, organizational development and the nature of informal contacts as well as budget constraints.

Valmet

Even though Valmet had considerably more information and experience of the changes in the Russian economy, the market was still perceived as too risky for major new investments. The new information concerning the economic development was also contradictory. On the one hand, the reform was going on and markets were developing, but on the other hand, authorities, especially on the local level introduced new controls, new taxes and limitations on operations almost daily. It was very difficult to make sense of it. The pressure on the Russian trading unit and offices in Russia was more to make sense of the reform developments than anything else.

There was little pressure from within Valmet because other foreign markets provided better opportunities for the company. The budget constraints continued to be tight, which kept the pressure on, especially in the specialized units responsible for the Russian markets, but did not allow engagement of any major new resources. Information flow was also blocked somewhat between various units of Valmet due to different views on barter transactions, as an example. Competitors in the engineering industries were also not seen to upgrade their operations in the Russian market.

Ahlstrom

In Ahlstrom the pressures to change the approach to Russian market were initiated within the marketing and coordinating unit for Russia at the headquarters and the Machinery

Division as the company philosophy expected the units to craft their strategies and find the business by themselves before asking for resources from the top management level. The share of sales to the Russian market remained at 1-2 percent of total sales and other foreign markets were considered more promising. The risks of the Russian transitionary market continued to be considered very high.

The pressure to change, as it was channelled through the contact network within the company, was relatively weak due to communication barriers between units. New personnel included local Russians in St. Petersburg, who provided a network of new Russian contacts and a lot of information concerning the risks involved in the development of the Russian economy, and a few Finns, who had earlier experience from trade with the former USSR. The information sources, particularly the Russians, were not credible enough to be influential and the outside information as well as experiences in St. Petersburg highlighted the considerable risks involved, which is why also pressures to change were low.

Budget constraints softened somewhat after 1991 due to positive financial results and increasing exports to Russia. Taken together all these factors contributed to a relatively low perceived pressure to change operation strategies in Russia.

The pressures to change operation strategies were somewhat different within the Electrical Accessories Division which saw opportunities to develop operations particularly in the Baltic states based on extensive market research carried out in those countries as well as in Russia.

The persons involved in these markets within the company were new to the area and did not have recourse to old connections. They approached the market with methods they had used in market economies, which signified a clear change from the old ways of doing business in the area. They also questioned the significance of old connections due to the rapidly changing environment and the reliability of information received particularly from Russians due to unrealistic expectations.

Outokumpu

For Outokumpu all factors identified in the model as influencing the need to change can be seen as producing pressures to change. First, the market was perceived as providing increasing opportunities not only in the long run but also in the relatively short run particularly for the raw material sourcing of Outokumpu. Secondly, a new unit was founded to develop investments into the Russian mining industry which brought new persons and contacts to the organizations involved with the Russian market. Likewise the marketing responsibilities for technology exports were widened and included among others the trading company. Thirdly, the budget constraints of Outokumpu were softening enabling somewhat upgraded activities.

6.2.6 Realized strategies in 1993-95

Valmet

Valmet's operative strategies in Russia during the years of 1993-95 were guided by three major goals: broadening the geographic scope of the operations, developing the subsidiary as an operation and testing tool in the learning process, and cooperation with chosen Russian organizations. The difference between the strategic approaches of the paper machinery division and Valmet Automation projects became smaller as the significance of barter transactions diminished in Russian foreign trade. All units became aware of the crucial importance of financing in concluding anything but very small deals with the Russian enterprises.

The strategy of finding financial solutions to the problems of their customers through barter proved successful in the years of 1991-94, after which the Russians had become wary of the problems linked with barter and had learned to approach the trading houses themselves. Financing questions for larger projects became more and more significant and the company started to contact international financial institutions and Russian banks to have a better grip of that situation. In 1994 VAP succeeded in concluding a contract to furnish the Tallinn Iru Power station with automation equipment with the help of World Bank financing.

In 1993 Valmet first opened a representative office in St. Petersburg and later in the same year the subsidiary Valmet STP was registered. The decisions were motivated by the fact that most of Valmet's large customers in the Russian paper and pulp industries were situated within the region close to St. Petersburg.

The strategy of setting up both a representative office and a subsidiary was chosen because each offered different kinds of benefits for practical operations. The representative office, which was set up as a subrepresentation of the Moscow office, was particularly helpful in the initial stages of starting the subsidiary. It offered an official status for the Finnish employees and an established procedure for importing cars, office equipment and furniture. Moreover, the representative office did not face similar restrictions for holding cash or limitations on salaries it could pay to Russian employees. The subsidiary or sales office, in turn, was able to perform commercial operations, which were not possible for a representation. By 1995 most operations were carried out by the subsidiary.

There was a division of labor between the Moscow and St.Petersburg offices in principle. The St. Petersburg office served the area near to Finland, which included Karelia and the Leningrad region. Moscow in turn had the responsibility for the rest of the European part of Russia. However, in practice both offices operated in a flexible cooperation and according to the available resources in each unit.

In early 1995 Valmet's Moscow representation broke the cooperation with other Finnish companies and moved to its own premises. In the shared representation there was no longer enough room for the increased number of local Russians employed by all the companies. It was also planned to change the representation into a sales office or a subsidiary of Valmet STP at some future point.

The joint venture Contur S.P. was originally planned to become a manufacturing unit but operated instead as a service and marketing unit for Valmet Automation Projects. Due to the bad image early joint ventures had created, Valmet also planned to diminish its ownership in Contur from the original 50 % but continue cooperation with it on the same basis as with other cooperation partners.

The strategy of looking for subcontractors was carried out through the contacts of two institutes situated in St. Petersburg, Lemma and Gibrobum. The initial idea in 1992-93 was to try and identify potential subcontractors within the large military industry in the Leningrad region, which was being converted into civilian use. However, the efforts were not very successful due to the fact that there was limited demand within Valmet for products that could have been produced in the Russian factories. On the other hand, finding markets for the Russian products also proved very difficult. The scale of the Russian factories was far too large for them to become interested in adapting their production to the needs of some small buyers in the western markets. However, one single contact in Ukraine from those efforts led to continued cooperation.

In 1994 the Russian trading unit became the marketing arm for the paper machinery division in the Russian markets. However, it also continued in the role of administering the offices within Russia.

Ahlstrom

During 1993-94 Ahlstrom was pursuing two quite different operative strategies in Russia and the Baltic states. There was no common strategy within the corporation for the Russian and Baltic markets. Each production unit designed their own strategies.

In Russia the Machinery Division, which had been the most significant exporter, operated mainly through its subsidiary in St.Petersburg. The subsidiary operated mainly as a representation and an intermediator between Alhstrom's various units and Russian organizations, because the subsidiary the Russian authorities started to tax all payments that were chanelled through its accounts, whatever their purpose. The subsidiary employed two Russian engineers who facilitated the networking with the Russian client factories particularly in all technical matters. The commercial negotiations continued to be the responsibility of the Finns only.

The strategy of finding suitable subcontractors among the Russian factories had produced three cooperation partners for the Machinery Division by 1995 after careful screening of dozens of potential partners. A typical project where subcontractors would be used was described as a modernization of a pulp producing process of a pulp plant, which consists of planning, deliveries of materials, some manufacturing of various parts and the work on site. So far the question of starting production in Russia had not been relevant. The potential Russian partners always had the idea of long production lines in their minds but all the contracted projects had been different and had not required any mass production.

The role of the Moscow representation was ambiguous for several reasons. First, Moscow as a trading center seemed to have lost some of its importance after the disintegration of the former USSR but retained its significance as a common meeting ground with the Russian clients. Second, the legal form of the representation did not allow it to be used as a sales office and the Russian tax authorities started also taxing representative offices on the basis of the costs incurred. Third, it proved difficult to cancel the leases signed by several Finnish companies without getting any compensation from the Russian landlord for the renovations and installments made over the years.

The financial arrangements had become crucial in winning any contracts in Russia. Ahlstrom had had very little success in concluding barter deals with the Russian companies, who also were reluctant to conclude them with foreign companies. All contracts were concluded either on prepayment terms or using Letters of Credit opened by a Russian bank, which was accepted by the house bank of Ahlstrom in Finland. There were only a couple of such Russian banks.

As no official credit support was available from Finland the Machinery division realized that it was essential to involve the financing unit of the corporation based in the US, Ahlstrom Capital, in the negotiations for future projects. The company had found out erlier that any financing negotiated with the European Bank for Reconstruction and Development would not be tied to the contracts of Ahlstrom only and consequently lost interest in pursuing the timeconsuming negotiation process with that particular bank.

The Machinery Division had no representative of their own in the Moscow representative office, which in turn served the corporation as a whole until July 1995 when it was transferred to the Paper Division. The Packaging Materials Division of Eurapak Akerlund Rausing also acquired an office in St. Petersburg in 1994.

The Central and East European market was considered particularly important for the Electrical Accessories Division because other markets in Europe were either using a different electrical standard or were considered already saturated by competitors. In 1994 about 30 % of the division's sales took place in Central and Eastern Europe, mainly the eastern part of Germany, Poland and the Baltic countries.

In the Baltic states the Electrical Accessories Division pursued a policy of setting up marketing subsidiaries in each Baltic country. They employed a local marketing manager, a couple of sales engineers. a secretary and an accountant. No Finnish expatriates were employed, because the cost would have been far too high in comparison to using the local employees. All Baltic offices had storage facilities and an inventory of their own, which enabled quick delivery to local retailers. The Baltic units also sold products which were produced in factories in Sweden and Poland.

This kind of sales policy was made possible due to the fact that local authorities in the Baltic states did not pursue a similar tax policy as Russian authorities in St. Petersburg and Mocow, who imposed sales taxes irrespective of taxation treatment in Finland and irrespective of the treaty on preventing double taxing signed between Finland and Russia.

Investments in the Baltic offices were small, only about 500 000 FIM in each case, mainly in office equipment and inventories. The financing came from the internal financing company Ahlcorp backed by the guarantee of a Finnish production unit. Part of the financing was arranged in the form of trade credits for the goods delivered. Payment terms extended to the local customers in the Baltic countries were originally advance payments only. However, when the relationships with the local retailers developed, small trade credits on average for 45 days were extended to them, which allowed them to pay after receiving payment from their customers. By the middle of 1995 no credit losses had been accrued in the Baltic states.

In Russia the Electrical Accessories Division used the similar strategy as the Machinery Division using both the St.Petersburg subsidiary and the Moscow representation to contact the potential customers. After the idea of a production joint venture with a local producer was dropped due to the unrealistic expectations of the potential Russian partners, the idea of a "small pedagogical subsidiary" in St. Petersburg surfaced and was being developed.

By 1995 the Russian trade unit had been disbanded on the level of headquarters and the sectoral units had gained full responsibility for the Russian markets as well. It was also planned to move the administration of the Moscow representative office under the Paper Division of the company.

The Paper Division in turn had developed an interest in the Russian market and experimented with the strategy of acquiring shares in one Russian paper factory. The division considered production and cooperation with such factories as the fastest way of getting into business in Russia. The major reason for this was that the production units still had access to the only working distribution systems in the country. However, the emphasis was still on arms-length operations, mainly increasing sales to Russia. Any direct investments of significance would require more stability in the Russian economy and/or strong import restrictions.

Outokumpu

Whereas the technology sales segment and the trading company Finenco continued their marketing efforts and import operations as they had done until 1993, the mining segment developed a new strategy in Russia as a result of their experience with the cooperation with a mining company in Tsheljabinsk during the years of 1989-92. The new strategy aimed at founding new mining subsidiaries or joint ventures with Russian mining companies in order to develop some promising ore deposits in the country. As cooperation with the existing local mining companies had proved problematic, it was thought that setting up new greenfield investments would avoid at least some of the problems encountered when cooperating with the old companies.

Even though cooperation with local partners was considered crucial in the mining industry, joint production of equipment with Russian engineering companies was not considered a viable possibility within the technology segment of Outokumpu, because the markets were too limited for that. Also the diappointing financial results of the technology segment had limited the unit's possibilities in engaging new ventures.

Within the stainless steel and copper segment Outokumpu Copper founded a sales (and purchase) subsidiary in St. Petersburg in 1995 and was prepared to consider establishing production units in Russia should the Russian customs barriers be raised for those particular products in order to curb imports.

In Moscow Outokumpu had closed down their representation in 1993 because its maintenence was costly. The representation was immediately replaced by opening another office in Moscow, this time a subsidiary of the trading company Finenco, because the significance of Moscow as a trading and economic center for Russia was increasing again.

6.2.7 Realized strategies vs. intended strategies

Valmet

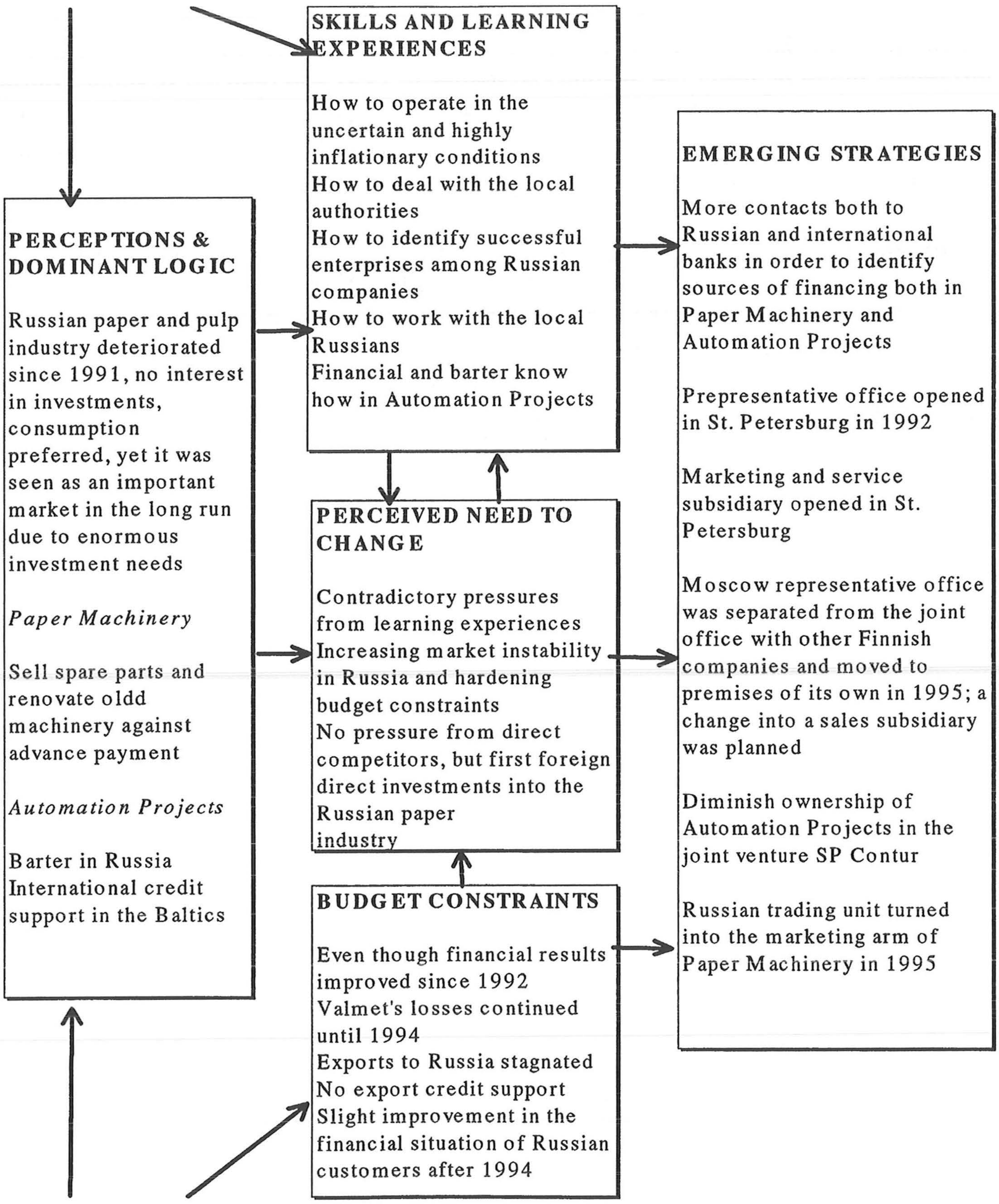
As opposed to the years of 1991 and 1992, during 1992-95 there was not a great difference found between the intended strategies in 1992 and realized strategies during 1993-95. Even though the Russian economic development continued to be turbulent, there were no longer such enormous political changes as that of the disintegration of Russia at the end of 1991 and its immediate consequences throughout the region.

Therefore the strategies of geographic reorientation were pursued in broad terms as planned by Valmet and many other companies in 1992. However, the strategy of setting up new offices and the St.Petersburg subsidiary emerged without a great master plan but rather by adapting to the evolving local conditions.

Chart 10 describes Valmets adaptation process during 1992-95.

Chart 10. Adaptation of the strategies of Valmet during the years of 1993-95

Informal contacts: broader contact network in the Russian paper and pulp factories; new contacts among the conversion industries; within the Automation Projects new contacts to trading houses and banks; new Russian employees in St.Petersburg



Environment: The political battle continued over the Russian economic reform, which lost some of its momentum; Baltic economies were stabilized but crisis broke out in the banking sectors; In Finland the recession gave way to an upturn particularly in exports

Ahlstrom

In 1992 Ahlstrom planned to set up a subsidiary in St. Petersburg. However, the founding procedures took much longer than expected and the subsidiary operated as a representative office of the Machinery Division still in 1995. Originally the subsidiary was also planned to serve the entire Ahlstrom Corporation in the St. Petersburg area but was "adopted" by the Machinery Division in practice. The other divisions developed their own strategies separately from Machinery.

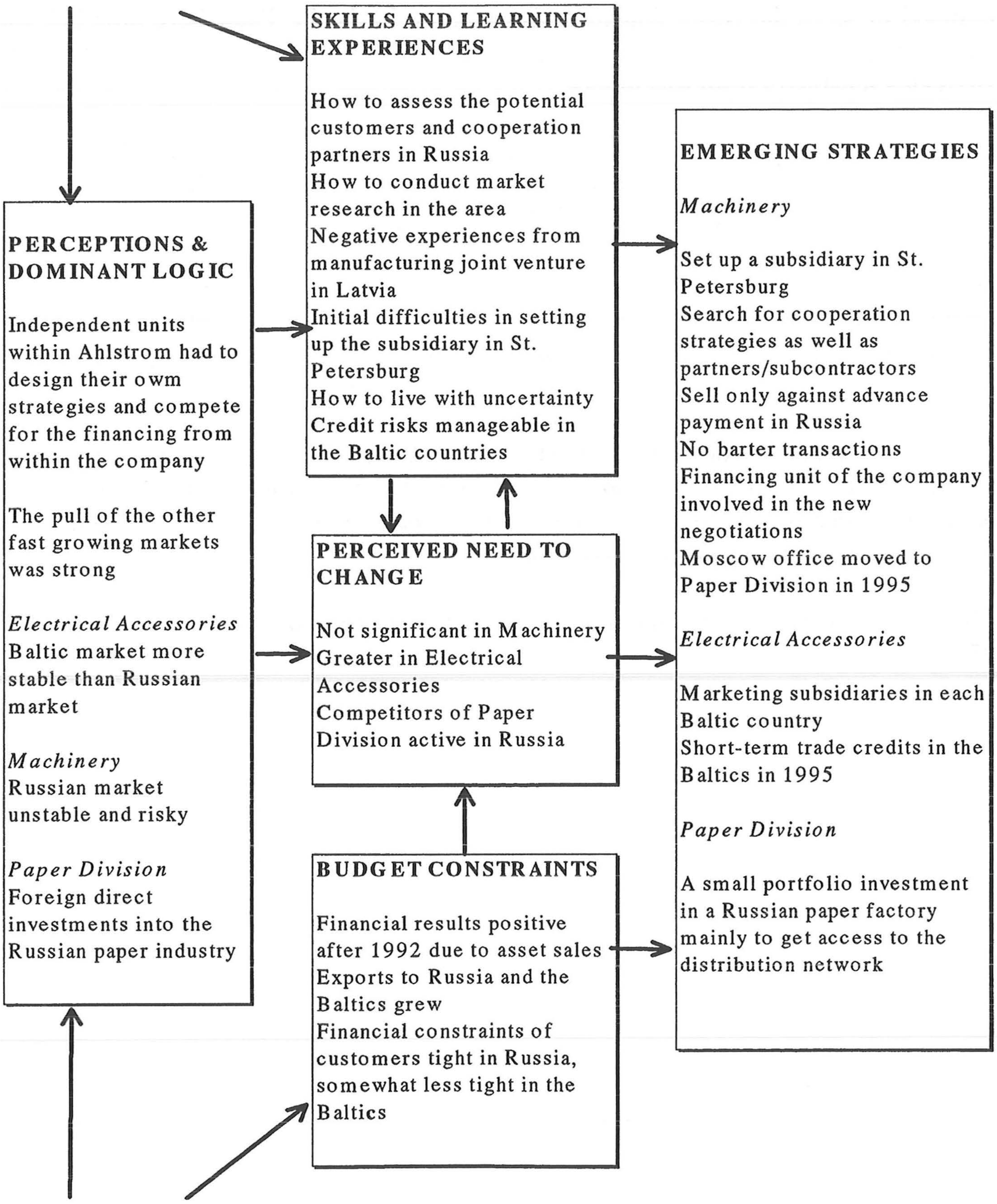
The intended strategies of the Electrical Accessories Division included production joint ventures in both Russia and the Baltic states, based on the idea of utilizing the low cost of those products in the former USSR. However, the negative experiences that the company gathered from operating a joint venture in Latvia, soon caused the company to change that strategy into one of setting up wholly owned subsidiaries instead. Also the rapidly rising price level particularly in Russia soon made any such plans unrealistic in Russia. The idea of using Estonia as a gateway to Russian markets did not prove realistic either due to the political controversies between the two countries.

The Paper Division had developed an active interest in the Russian market later than the Machinery or Electrical Accesories Divisions. Demand for specialty papers and packaging materials was, however, increasing in Russia after 1993 reflecting the interest in western types of consumer goods in the country.

Chart 11 describes the adaptation process of Ahlstrom's operations in Russia during 1993-95.

Chart 11. Adaptation of the strategies of Ahlstrom during 1993-95

Informal contacts: Limited contacts between the various units of the company operating in Russian and Baltic markets; Different clientele of the various units; more local personnel employed both in Russia and the Baltics; new Finnish personnel employed in the Electrical Accessories Division; experienced exporters to Russia employed in the Machinery Division



Environment: The political battle continued over the Russian economic reform, which lost some of its momentum; Baltic economies were stabilized but crisis broke out in the banking sectors; In Finland the recession gave way to an upturn particularly in exports

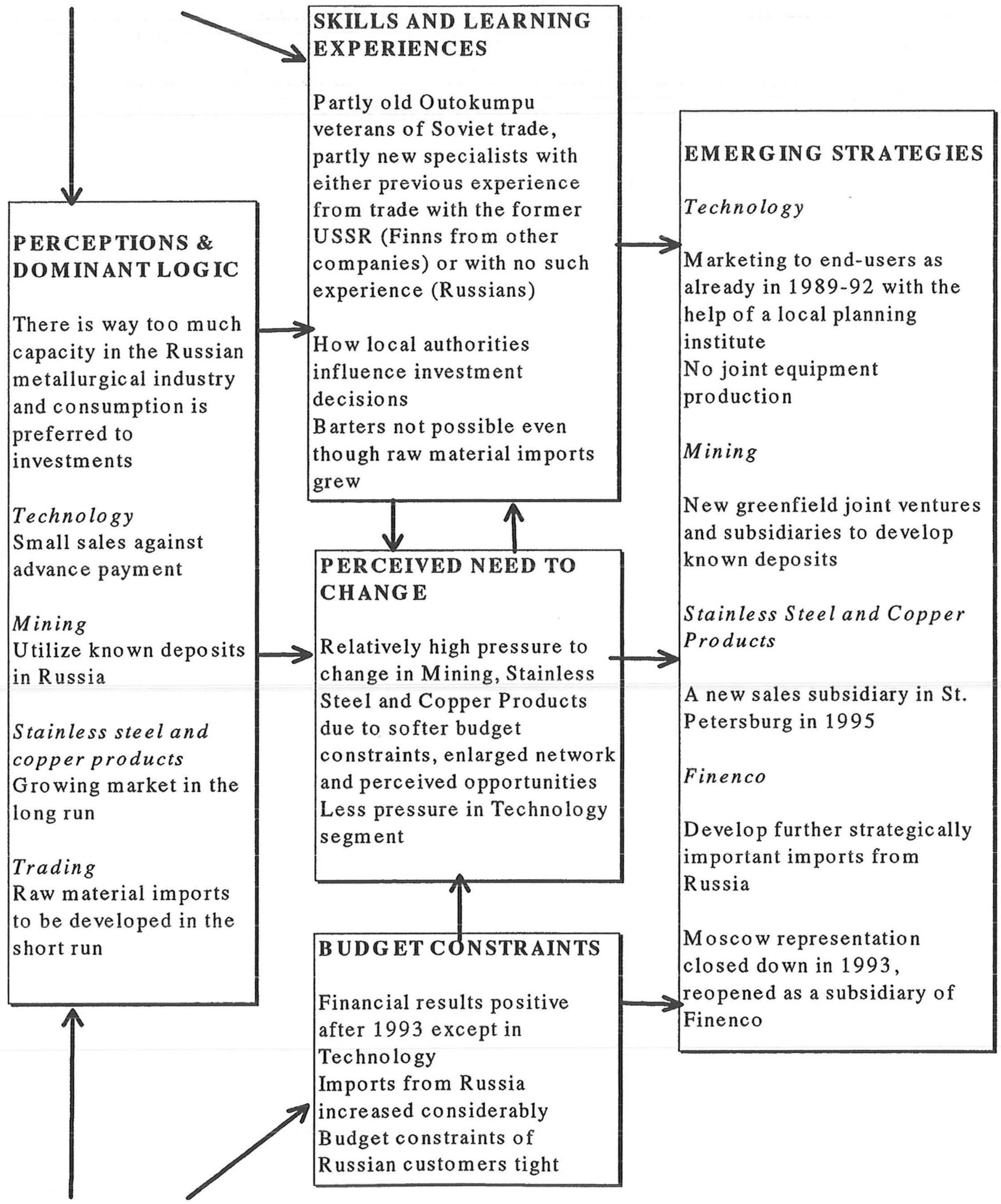
Outokumpu

When the emerging strategies of Outokumpu during 1991-92 are compared to those of 1993-95 mostly the strategies initiated in the beginning of the 1990's were continued until 1995. However, in the case of the Mining segment a clear change took place after the cooperation with the mining company in the Urals was discontinued and the new mining development unit started a new strategy of targeting known but undepleted deposit sites. The change was motivated by the realization of how difficult it was to work together with the Russian authorities who had vested interests in the old mining structures.

Chart 12 illustrates the adaptation process of Outokumpu during 1993-95.

Chart 12. Adaptation of operative strategies of Outokumpu during 1993-95

Informal contacts: Sales efforts of Technology by Wenmec and Mintec as well as Finenco targeted at metallurgical industry; Mining development unit targeted the known ore deposits through local authorities and mining companies; increased number of both Finns and Russians employed in the organizations



Environment: The political battle continued over the Russian economic reform, which lost some of its momentum; Baltic economies were stabilized but crisis broke out in the banking sectors; In Finland the recession gave way to an upturn particularly in exports

6.3 Comparison of the case companies' perceived need to change and adopted strategies

In this section a comparison is made between the strategies of case companies as described above and their perceived need to change those strategies. It needs to be acknowledged first that there were different strategies within the various units of the case companies, which is why it is not possible to speak about a general strategy applied to the former USSR market for any of the companies in question except in relatively general terms.

However, general similarities in the adopted strategies include following features:

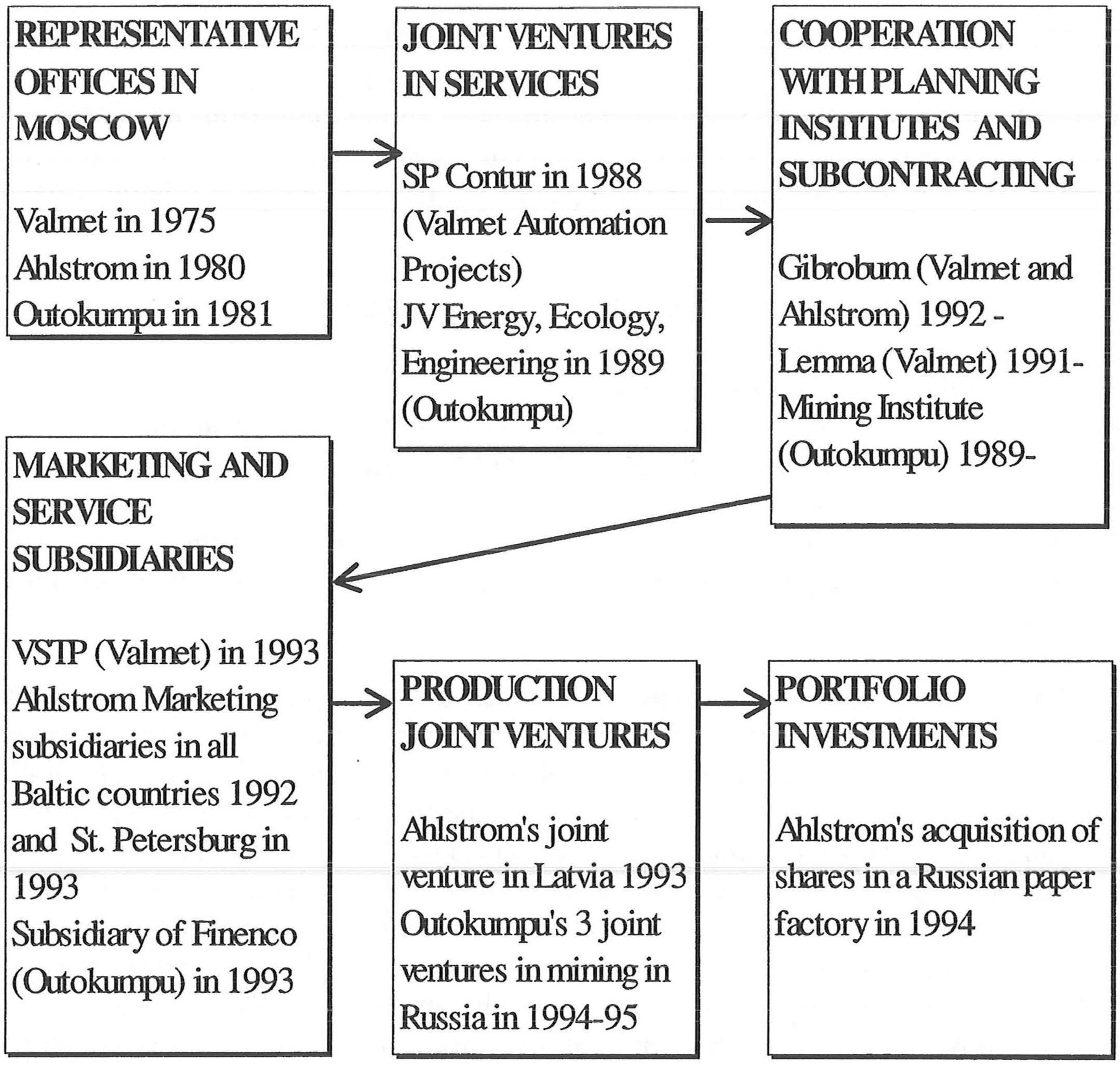
- Small investments
- Careful step-wise learning approach
- Search for potential cooperation partners through planning institutes
- Increasing use of local nationals instead of Finnish expatriates

All these strategies emphasize the avoidance of significant risks but, at the same time, aim at developing networks, which are needed to analyze and utilize the market potential in the longer run.

In chart 13 the strategies the case companies used are placed in a chronological sequence. The chart illustrates the path of operation form development of the case companies mainly in Russia but in one case also in the Baltic countries. The chronological path of operation mode adoption was the same for all three companies, but not all companies used all operation forms. If the strategies used only in Russia were taken into account, the sequence would be even clearer. Of the case companies Valmet followed all the first four stages but did not enter the last two. Ahlstrom skipped both service and production joint ventures in Russia but entered into a production joint venture in Latvia and was the only company to make a small portfolio investment in Russia. Ahlstrom also introduced marketing subsidiaries in all three Baltic countries simultaneously with the cooperation strategies in Russia. Outokumpu in turn used all operation forms except the last one. None of the case companies started wholly owned production subsidiaries.

The sequence indicates that the stages of setting up wholly owned service or marketing subsidiaries were preceded by such networking strategies as joint ventures and subcontracting from Russia and Baltic enterprises. The findings suggest that those strategies are an important vehicle in the learning process on the internationalization path, which leads to operation forms of increasing degree of commitment. In addition it needs to be recognized that subcontracting or contract manufacturing in this case belongs to inward-directed foreign operations whereas the others are outward-directed foreign operations, which suggests that there is also a connection between inward and outward-directed operations.

Chart 13. Path of operation form development of case companies



For a more detailed analysis of the adopted strtegies an assessment is made for the strength of the perceived need to change in each unit of the case companies on the basis of the three components of the adaptation model. In table 18, first, perceptions of the environment, secondly skills and learning experiences, and thirdly, budgetary constraints are evaluated on a three point scale which ranges from no impact to strong impact on the perceived need to change. A consolidated assessment divides then the various units into two groups, which have faced either a relaltively strong or weak need need to change.

Table 18. Assessment of the perceived need to change in the various units of the case companies during 1993-95

	Environmental perceptions & dominant logic	Skills and learning experiences	Budget const-raints	Consoli-dated impact
Valmet Paper Machinery	**	**	*	**
Valmet Automation Projects	***	***	**	***
Ahlstrom Machinery	**	**	*	**
Ahlstrom Electrical Accessories Division	***	***	**	***
Ahlstrom Specialty Paper Division	***	**	*	**
Outokumpu Technology	**	**	*	**
Outokumpu Mining	***	***	**	***
Outokumpu Stainless Steel and Copper	**	***	***	***
Finenco (trading)	***	***	***	***

* no impact on the perceived need to change
** weak impact on the perceived need to change
*** strong impact on the perceived need to change

Perceptions of the environment influence the need to change strategies mainly by the perceived opportunities in the short or long term, the risks perceived and competing opportunities perceived in other markets. Along those dimensions particularly the view of having significant market opportunities, not only in the long term but also in the medium term, differentiates the units. The dominant logic of doing business among the units can also be seen to differentiate the units. Particularly the scope of alternative operations and the length of the gestation or development time of operations differentiate the units so that the broader the scope of operations and the longer the gestation period, the stronger the impact on the perceived need to change.

Skills and learning experiences differentiate the units mainly from the point of view of employing or not employing new Finnish personnel with little previous experience from the former USSR market but experience from other markets. Budget constraints have in turn mainly a restricting effect on the perceived possibilities to change strategies due to the fact that all of the companies also perceived greater short-term growth possibilities in other markets.

The most distinguishing divisive factor among the various strategic approaches between the companies is their approach to direct production investments into the target markets. If the units are grouped according to their approach to direct investment production operations in the Russian and Baltic markets, two different groups can be distinguished; first, a group of three units which had actually made such investments by 1995 and, secondly, the rest of the units that had not made direct production investments in the region. The first group consists of the Ahlstrom Electrical Accessories Division, Ahlstrom Paper Division and Outokumpu Mining segment. In the second group there are Valmet Paper Machinery and Automation Projects, Ahlstrom Machinery as well as Outokumpu Technology, Stainless Steel and Copper Products. Finenco, the trading subsidiary of Outokumpu was mainly involved in developing imports.

In the first group the three units had a similar proactive approach to the crucial question of direct production investments even though they operated in different industries and mostly in different markets, Outokumpu Mining in Russia, Ahlstrom's Electrical Accessories Division mainly in the Baltic countries and Ahlstrom paper mainly in Russia. None of the units had any previous experience from operations in Russian or Baltic markets. The characteristics of their approach included among others:

- Direct production investments; the Electrical Accessories Division of Ahlstrom set up a joint venture in Latvia, Outokumpu Mining started mining cooperation and set up mining joint ventures in Russia, and Ahlstrom Paper Division made a small portfolio investment in a Russian paper factory.

- As new units they employed persons, who had no or little experience from the markets before; In Ahlstrom Electrical Accessories the persons had had no earlier experience in exporting to the region, in Outokumpu and Ahlstrom Paper both "old hands" as well as experts new to the market were included in the units.

- A change from the original direction of the strategy as a result of early negative experiences; in Ahlstrom joint ventures were no longer considered a viable option after 1993 and the company continued its operations through wholly owned sales subsidiaries which had inventories of their own; in Outokumpu the strategy of setting up new production units was developed after negative experiences from cooperation with an existing mine in the Urals; in Ahlstrom paper division the investment was a part of a strategy to get access to the distribution network of the Russian paper industry and was sold after it turned out that the location of the plant was not favorable.

- A change in the credit policy; Ahlstrom Electrical Accessories started extending small short-term trade credits to clients in the Baltic countries after positive experiences from punctual payments.

The second and larger group of units consists mainly of experienced technology exporters. All of the four units were old exporters to the former USSR, employed mostly experienced experts of the Soviet trade, and their exports to the region fell sharply after 1990. The strategies used by this group include the following characteristics:

- Early adaptation (before 1990) to trading in convertible currencies with the former USSR.

- From 1991 onwards the main targets of marketing operations were the end-users of their products among the Russian enterprises mainly within the pulp and paper and mining and metallurgical industries.

- Cooperation with previous centralized planning institutes when targeting both the old end-users and potential new customers among the Russian enterprises.

- Search for potential cooperation partners and subcontractors among the Russian engineering companies (with the exception of Outokumpu Technology).

- Creation of a marketing and service subsidiary in Russia; Valmet and Ahlstrom both established a subsidiary in St.Petersburg, Outokumpu used the trading company Finenco for this purpose.

- Selling against advance payment only since the end of 1991 and targeting the international financial institutions for export credit support particularly after 1994.

- Abstaining from direct production investments; the early joint ventures created by Valmet and Outokumpu operated as consulting and/or marketing units.

Valmet Automation Projects pursued a strategy which was in many ways similar to the one described above but differed particularly in their approach to the financing questions. VAP set out to find solutions to the burning financial problems of their customers, which led them to pursue a policy of barter transactions until the customers became knowledgeable enough to carry out the financng themselves or found other sources of financing. With the help of this policy they were successful in maintaining the level of their exports after the general fall in exports after 1991 and winning a contract in Estonia with the help of World Bank financing.

Outokumpu Copper and Stainless Steel cannot be considered an exporter of technology and also had no previous experience of selling to Russia or the Baltic countries. However, the unit was selling goods for which the markets developing in the region were perceived to offer huge new opportunities in the long run when a western type of consumer-oriented economy has developed there. Their approach to the market was to carry out thorough market research and following that set up a sales subsidiary.

There were also differences in the organization of the Russian and Baltic operations among the units of the case companies. Whereas Valmet and Ahlstrom kept their Moscow representative offices, Outokumpu closed its and continued operations through subsidiaries. In Valmet and Ahlstrom the domestic units which were in charge of coordinating the operations in the former Soviet markets were transformed into Russian marketing units for a major division of their companies while other divisions set up Russian marketing units of their own. In Outokumpu the corresponding unit remained in the coordinating role but that role itself changed into a role of new business development for and in cooperation with various units of the company. However, all three companies reported limited cooperation between the various independent units operating in the Russian and Baltic markets.

In chart 14 the various units of the case companies are placed in four different categories according to the division between marketing and production investments, on the one hand, and the perceived need to change as assessed above for each unit, on the other hand. The chart shows that in the units where there was a greater pressure to change there was a proactive approach towards production investments or an approach characterized by an emphasis on trading and financing solutions, whereas a lower pressure to change was detected in units which refrained from any production investments in the region. The chart also gives characterizations of the particular strategies used by the companies in each group.

Chart 14. Units of case companies according to their perceived need to change and their engagement in direct investments in Russia and/or Baltic countries and characterization of the particular strategies used

	Weak need to change	Strong need to change
Direct production investments	**Portfolio investments** Ahlstrom Specialty Paper	**Direct investments in production joint ventures** Ahlstrom Electrical Accessories Division (Latvia) Outokumpu Mining (Russia)
Direct marketing investments	**Direct Marketing investments in wholly owned subsidiaries** Valmet Paper Machinery Ahlstrom Machinery Outokumpu Technology	**Direct marketing investments with emphasis on trading and financing solutions** Valmet Automation Projects Outokumpu Stainless Steel and Copper Products (Finenco)

The chart can also be used to make assumptions about the dynamics of the various strategies in the Russian and/or Baltic markets as the pressure to change grows. As all the case companies are operating in many international markets, they ultimately are also interested in creating manufacturing operations in the target market. Therefore they most likely want to move from the lower left corner to the upper right corner of the chart. This could take place directly or via the upper left or lower right corner. In the first case the companies facing weaker pressures to change would use portfolio investments as a learning vehicle to enter the category of direct investments with hands-on control of the operations. In the second case the companies facing stronger pressures to change would first engage in activities which would secure and strengthen the financial basis of the marketing operations before engaging in direct production joint ventures or ultimately wholly owned production subsidiaries.

6.4 Finnish adaptation strategies vs. Russian adaptation strategies

Even though Russian and Finnish adaptation strategies cannot be directly compared to each other due to different circumstances, some observations are warranted. If the various strategies indentified in chart 14 are compared to the transition strategies of Russian enterprises depicted in chart 2 in chapter 2, a difference is first noted in the pressures leading to a perceived need to change. Whereas the Russian enterprises were described in the literature as resorting to lobbying rather than introducing real changes in their companies in the expectation that the state will eventually bail them out anyway, the Finnish companies have been monitoring the market for cues that would signify increasing growth opportunities at least in the medium term. In the absence of such evidence they have made small investments, which would enable them to rapidly upgrade their operations when the situation changes.

In both cases the dominant logic of doing business can be considered a strong motivator for the chosen strategies. In Russia the dominant logic can be seen to have challenged the credibility of monetary policies and led to slow adaptation. In Finnish companies the dominant logic emphasized high risks in Russia and bigger opportunities on other markets and led to small test-like investments. Just as in Russia there were very few restructurers; none of the Finnish companies invested in wholly owned production subsidiaries in Russia.

However, where the Russian and Finnish adaptation strategies met in practice according to the case interviews, and are also likely to meet in the future, is between the few restructurers of Russian companies and particularly those, who are looking for outside investors to help them in the restructuring process, and those Finnish companies, who are interested in production joint ventures. In addition to the market conditions and financial possibilities the outcomes of such encounters depend, to a great extent, on the understanding of the dominant logic of both the strategic decision making process and the business culture of the negotiating partners.

7 Summary and conclusions

This final chapter discusses the theoretical implications of the thesis and provides suggestions for future research, summarizes the findings in relation to the research questions, lists managerial implications and concludes by discussing the limitations of the thesis.

7.1 Theoretical implications and suggestions for future research

An affirmative answer to the first research question, can western economic concepts be used for analyzing enterprise behavior in transition economies, lays the foundation for building the model of transitional adaptation, which is used as a framework in the analysis. Its use is based, first, on the observation that enterprises in the transition economies have started to respond to market signals, even though the development has been slow. Secondly, the model is based on concepts of the strategy literature, the dominant logic in particular, supplemented by the notion of a perceived need to change, which are well suited to the analysis of behavior in transition. The environmental changes that enterprises face in market economies can also be as radical as those faced by enterprises in the transition economies. Thirdly, the model is built using the ideas of complex systems, which are connected both with formal and informal networks.

Using concepts developed within market economies for the analysis does not, however, overlook the fact that there are significant cultural differences between western-type market economies, where these concepts have been developed, and former planned economies of Eastern Europe. In fact, it is realized that concepts of the western-type market economy are widely misunderstood in Russia, for example. This does not, however, present justification for not using them to analyze enterprise behavior within Russia. Cultural differences, on the other hand, need attention in any comparative economic analysis and were also analyzed between Finnish and Russian businesses. The conclusions will be dealt with below in connection with the research questions of a more empirical nature.

The model of transitional adaptation proved useful in analyzing the dynamics of strategic adaptation of both Russian and Finnish enterprises in transitionary conditions. By using the perceived need to change and the level of activity determined by the skills, dominant logic and financial constraints, as two major dimensions influencing the adaptation strategy Russian enterprises were grouped into 5 different hypothetical strategic groups. These were labeled 1) strategic restructurer and restructurers looking for outside help, 2) traders, 3) lobbyists, 4) asset strippers and downsizers, and 5) footdraggers.

As the evidence so far indicates that the majority of Russian enterprises are not very active and do not engage in restructuring operations, it implies according to the characteristics of the model, among others, that the informal connections to other restructurers are scarce, that the learning process conditioned by dominant logic is very slow, that there are no slack resources to increase environmental scanning or that recourse to soft budget constraints slows it down. There is most likely also a connection to the credibility of the economic policies in the country so that if the authorities are consistent in pursuing tight monetary policies, an increasing number of enterprises will recognize a greater pressure to change.

When applied to the Finnish companies' operations in Russia the model of transitional adaptation facilitated identification of strategic groups among the different units of the Finnish case companies. The following four groups were identified: 1) those who had made direct marketing investments in wholly owned subsidiaries, 2) those who had made direct marketing investments and emphasized trading and financing solutions, 3) those who had made small portfolio investments, and 4) those who had made direct investments in production joint ventures.

Due to different circumstances and different choices faced by Russian and Finnish enterprises no direct comparisons between the Russian and Finnish strategic groups can be made. The Russian business partners of the Finnish case companies in the Russian forest industry, metallurgy and machine building industries were not among the favored industries in the state investment programs, nor did they have any significant resources of their own to finance investments. They also belonged to the most indebted and loss-making industries. On the other hand, the Finnish metal and engineering companies faced more lucrative markets in Asia and North America. Their subsidiaries in Russia were very small and operated often as service companies instead of manufacturing units. However, the Russian and Finnish adaptation strategies are most likely to meet when those Russian restructures who are looking for outside investors meet with Finnish companies that in turn are looking for potential cooperation partners. In such encounters the outcome will depend to a great extent on the understanding of the dominant logic and business culture of the negotiating partner.

The model of transitional adaptation proved useful as a general framework for the analysis, particularly from the adaptation process point of view. However, more research would be needed to build a more detailed model and hypotheses for the direction and strength of causal relationships between the variables. The hypotheses presented in the analysis relied on the case company interviews and other relevant environmental information. However, the nature of available information and the complex framework did not allow testing of them in a systematic way.

A comparison of the model of transitional adaptation and the internationalization model developed by Luostarinen concluded that the latter can be regarded similar to the transitional adaptation model under relatively stable conditions. This realization makes it possible to draw conclusions from the observed patterns of behavior under rapidly changing transitionary conditions concerning the internationalization behavior under similar conditions.

Particularly the concept of dominant logic offers an additional explanation for the internationalization path which companies choose to follow. It can be argued that the internationalization path is greatly influenced by the dominant logic of the management. A related suggestion, according to which attitudes of executives and not necessarily objective environmental factors drive internationalization, has recently been proposed by Calof and Beamish (Calof and Beamish, 1995). However, more research would also be called for concerning the process by which the dominant logic changes, particularly how the environment and business culture influences it and who are the most influential actors, whose views are likely to influence it.

The transitional adaptation as exemplified by the case companies of the study supports the view of strategies which emerge in the adaptation process rather than strategies that are deliberately planned. It also supports the view of self-organizing systems used within the science of complexity as opposed to systems organized from above.

In comparison to the model describing the internationalization behavior of a firm the adaptation model highlighted particularly the role of budget constraints and networking strategies in the development of international operations. Soft budget constraints inherited from the centrally planned system have significantly influenced the behavior of enterprises in transitionary Russia. They were found to slow down the adaptation of Russian enterprises in the same way as slack resources were found to do in Finnish companies. On the other hand, evidence was also found in Russian enterprises about changes which were introduced with the help of considerable slack resources but which stalled, even reversed, in conditions of hardening budget constraints.

Budget constraints offer also explanations for companies not proceeding with their internationalization process or even reversing it. In the present study they offer one reason for the high barrier between direct investment marketing and production operations and also for the small size of investments.

Networking strategies, such as subcontracting, strategic alliances or joint ventures, which are neither growth strategies within the hierarchy of enterprises nor use factor markets like mergers and acquisitions, offer a useful concept to differentiate, among others, between joint ventures and wholly owned subsidiaries, both of which are relevant operational strategies in transitionary Russia. Joint ventures represent a networking strategy while wholly owned subsidiaries are established within the hierarchy of the enterprise. It is argued that networking strategies offer in a turbulent environment a vehicle for learning without making any large and risky investments. The differentiation of growth strategies into hierarchic, market-based and networking strategies opens also a viewpoint into the internationalization path, which could offer additional insights in cases where companies are skipping certain stages on the generally established path.

Especially in Russian non-transparent and turbulent markets the inward-directed networking strategies, such as subcontracting seem to offer a useful way to test the potential cooperation partners. In such a way the inward-directed operations are supporting outward-directed operations later on. Also imports were used as a tool to promote exports in barter transactions, which one of the case companies used as their main strategy in Russia. An interesting topic for further research is to analyze whether such interconnections between inward-oriented and outward-oriented foreign operations are common in other kinds of markets and where they occur along the path of internationalization.

Finally, the theoretical frameworks of internationalization and transitional adaptation offer theoretical grounds for studying the internalization process of enterprises in the transition economies and not only that of foreign enterprises in those economies.

7.2 Findings in relation to the research questions

The first empirical research question asked what kinds of operations the Finnish metal and engineering companies developed in Russia (and the Baltic states) during 1991-95 and how the turbulent environment influenced the strategies of the companies. The first part of the question is related to the particular path of internationalization that the companies have followed in the transitionary market of the Russian and the Baltic countries.

The findings reconfirm, first, one of the hypotheses of the licentiate thesis, which stated that the operation forms will include more direct investment type of operations than earlier. However, the direct investments made after the first joint ventures included mainly wholly owned service or marketing subsidiaries whereas direct investments into production joint ventures or subsidiaries were still rare.

As already found at the end of 1980's the Finnish companies were developing both direct investment marketing operations through representative offices in Moscow and non-direct investment production operations, mainly partial and turnkey project exports and subcontracting within the framework of scientific and technical cooperation with the Soviet organizations, at approximately the same pace. During 1991-95 the representative offices were replaced or supplemented by sales subsidiaries and the subcontracting motivation, which consisted of interest in increasing imports from the USSR within the bilateral trade framework, was replaced by a genuine interest in finding low cost subcontractors and cooperation partners among the Russian factories. As earlier, also during 1991-95, both kinds of operations were developed by the metal and engineering companies more or less simultaneously.

In general the findings conform with the internationalization path of Finnish companies as discovered by Luostarinen. The preference of setting up marketing operations before production operations is very clear both in direct investment type and non-direct investment type of operations in the Russian transitionary markets. However, the preference is not so clear between the non-investment type of production operations and direct investment marketing operations, which continued to develop more or less hand in hand in the Russian market whereas the Finnish companies in general were found to prefer direct investment marketing operations to non-direct investment production operations.

One obvious explanation for such a pattern stems from the development of the relevant legislation in Russia. All direct investment forms were actually forbidden in the former USSR until 1988, when the law on joint ventures was adopted. Other administrative forms, including wholly owned subsidiaries, became possible after 1990. However, due to the very short period since the introduction of the first law, there was not a lot of experience available that the companies could draw upon. Therefore all direct investment forms were considered riskier in Russian than they were in other markets. This would suggest in turn that also direct marketing investments into Russia were still held back from the level they could have reached under more normal market conditions.

This view is also supported by the case company interviews, which illustrated various kinds of practical problems particularly in taxation matters connected with establishing marketing subsidiaries in Russia. In addition the interviews highlighted the impact of the negative experiences gathered from the early joint ventures established in the former Soviet Union. Also the comparison between the number of subsidiaries founded in Russia, on the one hand, and Estonia, on the other hand, supports this view, because the conditions for subsidiaries were more favorable in Estonia. However, when comparing direct investments into Estonia and Russia, the cultural factors are also likely to play a significant role.

Another explanation for the relatively high level of non-investment production operations, which are typically networking strategies and preceded wholly owned marketing operations in Russia, can also be found in the particular nature of the Russian market conditions. For foreign companies the Russian market offers huge long-term opportunities, clearly stated also by all the case companies. However, compared to other relatively close markets of similar size the short-term purchasing power of Russian customers was considered very low. On the other hand, the cost level was also low. Whereas the direct production investments were discouraged by the high short term risks involved, the low cost level, even though it was expected to rise in the longer run, acted as a pulling factor for the non-investment production operations, such as subcontracting. The low cost level of such networking strategies also gave a possibility for a strategy of experimenting and learning by doing.

The above analysis does not contradict the internationalization model of Luostarinen, which takes into account the joint effects of the physical, cultural and economic distances on the determination of the various combined modes of international business operations (Luostarinen, 1989, p. 164). However, it illustrates the ambiguous state of the transitionary market and particularly the difference between short-term and long-term expectations as well as the role of networking strategies in such circumstances. In particular, if a distinction is made between direct investments into joint ventures, which represent networking strategies, and direct investments into wholly owned subsidiaries, which represent hierarchic expansion strategies, a pattern emerges in transitionary Russia and Baltic countries, where the wholly owned marketing subsidiaries are preceded by the networking strategies, such as inward-directed subcontracting and joint ventures. As pointed out earlier, further research is called for to investigate the role of such networking strategies along the path of internationalization.

The second part of the first research question asked how the turbulent conditions on the target markets have influenced the operative strategies of the companies. The findings in the case studies suggest two different ways to comply with the turbulent environment.

First, it is clear that the unstable environment slowed down the development of operations, particularly the direct investments into the transitionary market. On several occasions the various units of the case companies stated that similar opportunities that were offered to them in the Russian markets would have resulted in direct investments in more stable markets.

Secondly, the turbulent market conditions have induced the companies to experiment with small investments and/or non-investment types of networking operations which do not require large financial or managerial commitment but enable the companies to have a presence in the market, monitor the market development from within and learn by operating in the changing conditions.

The second research question targeted the role of extensive previous experience of operations in adapting to the changed circumstances. Two hypotheses were suggested. On the one hand, the long previous experience could slow down the adaptation process by causing the companies to stick to old operation forms. On the other hand, it could help the companies in identifying and assessing the risks involved using the old contact networks and understanding of the business culture. Both of these hypotheses, which are not mutually exclusive, were supported by the findings.

First, as already suggested by the findings in the licentiate theses, it was found that also among the various units of the case companies, those that did not have previous experience in the markets were somewhat quicker to found new and riskier operations than those with earlier experience in the market. Secondly, it was found that those new operations by inexperienced units changed their course of strategies very soon after starting the operations. This implies that the more experienced units, which were less proactive, had good reasons for a more cautionary approach to the markets.

However, this does not imply that the more proactive approach would have been less appropriate in those circumstances. It can also be considered a strategy of learning by doing, which compensates for the lack of experience in the companies. When supplemented by a quick adaptation of operations to the environment as learned by the unit, such a strategy can be considered viable in rapidly changing circumstances.

In the case of the case companies, which all had internationalized their operations to a great extent, there could not be a question of "leapfrogging", which indicates jumping over certain logical stages in the process of internationalization because all of them were experienced in other markets in the operation modes that were introduced in Russia or the Baltic countries.

A related research question concerning closeness of the Russian and Finnish business cultures was discussed in chapter 3. Based on international comparisons Finnish business culture does not seem to be particularly close to the Russian business culture. Even though this finding is not directly related to the quality of communication and interaction between the two cultures, it is likely that the Finns are overconfident in their competitive advantage based on cultural understanding. The experiences of the case companies also testified that they had great difficulties in understanding particularly the political aspects of the business and political ties of their target customers in Russia. This finding suggests in turn that the chosen strategies of the companies could be made more successful by a more in-depth understanding, particularly of the political features of Russian business culture.

The third research question asked what is the role of financing in developing new operational forms and how have the hardening budget constraints of Russian and Baltic customers influenced operations in those markets. The findings indicate that for some units the role of financing was decisive in developing new operation forms in the Russian and Baltic markets. Particularly the strategy of concluding barter transactions of one unit of the case companies was based on finding a financial solution to the marketing problem.

However, most units in the study did not pursue such a policy, which would have required new expertise in concluding complicated barter transactions, nor did they use price or credit terms as marketing means in that market. They considered selling against advance payment the only feasible payment option in those circumstances. On the other hand, as most units were producers of expensive investment goods, barter transactions could not offer a feasible long term financial solution. Export credit support is clearly needed in such cases and it was not available from Finland. The companies had to turn to international and also Russian financial sources in search for finance and had not come very far on this path yet. The default of the former USSR influenced greatly this impasse. However, also the poor financial results of the case companies in the beginning of the 1990's played a role in the slow development, just as did the inexperience of the Russian trade specialists in international finance.

The hardening budget constraints of the Russian and Baltic customers influenced the development of the operations in a few additional ways. First, individual export contracts became much smaller than they had been at the end of 1980's. Secondly, counter trade/barter requirements increased as described above, which complicated matters for the exporters. Thirdly, the credit risks increased and became increasingly difficult to assess as the interenterprise debts mounted among Russian and Baltic enterprises. Payment for a delivery would sometimes come from a debtor or a debtor of a debtor of the customer organization. Advance payment was the only way to control the risk. Small contract size became a way of controlling the credit risk when one of the units believed that small trade credits could be extended to Baltic customers. New deliveries were made only after payment was received for previous deliveries.

7.3 Managerial implications

The following managerial implications seem warranted based on the findings of this study.

- First, Finnish companies need to become aware of the various transition strategies used by Russian enterprises in order to assess their potential as customers or cooperation partners.

- Secondly, the increasing use of Russian and Baltic nationals in various operations highlights the need to sharpen the intercultural managerial skills of those Finns who occupy managerial positions in such operations, as well as the need to educate also the locals to understand how the Finnish managers behave.

- Thirdly, increasing contacts to both Russian and Baltic as well as international financial institutions are needed in order to find financing sources for the export of investment goods.

- And fourthly, increased networking also between various units within large organizations would secure a faster flow of information concerning strategies and ways of operation which have been found successful.

7.4 Limitations of the study

As this study is based mainly on qualitative data, no conclusions can be made on the basis of statistical analysis of the data. The generalizability of the findings will have to be judged by the persuasiveness of the arguments and the similarities or differences found in the processes behind those findings.

The price of targeting increasing richness of details and deeper insight into the adaptation processes, is lower measurability and comparability of the various constructs used by the case companies when describing their strategic behavior. The adaptation model developed for the theoretical framework of the study aims to overcome some of these problems by limiting the processes being analyzed to those few described by the model.

The surveys carried out during 1991-92 and the subsequent case company interviews during 1993-95 targeted Finnish companies, which had a relatively long experience of operations in the former USSR market. Thus the adaptation of operation strategies covers the changes in the previous operative strategies of those companies and not the creation of new strategies of companies with no previous experience on the market. To some extent the creation of new operative strategies is illustrated by those units of the case companies, which did not have any previous experience in the USSR market but developed operations in Russia after 1991. However, those units had access, if not exposure, to previous experience of operations in that target market within their companies.

The common industry of the three case companies, the engineering industry producing investment goods, limits further the generalizability of many of the findings to that industry alone or at least to the industries producing investment goods in general. It is likely that within industries producing consumer goods and services the findings of a similar study would have been quite different.

Finally, the interview method may encompass biases of the researcher, who has conducted, recorded and interpreted the interviews alone. However, the nature of a longitudinal study stretching over several years like this one helped the researcher to identify at least some of the early biases. Some others were revealed by the key respondents from the case companies who reviewed the case reports in part II. It will be the task of the future research to reveal the remaining ones.

Probably the strongest researcher bias in the beginning of the study was to expect more radical strategic changes than were actually recorded by the interviews. Another bias was built in the research method. In the beginning the interviewees were less open but they grew more confident over the years that the information they will provided would not be misused. The researcher, on the other hand, learned to interpret better the accounts of the respondents and the various concepts used by them as the process was repeated over the years. However, as pointed out above the lessening of such biases would tend to increase the validity and reliability of the findings over the years of the research process.

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Appendix 1

Guiding Questionnaire for the Case Company Interviews Carried Out during 1993-1995

1. What was the value of your company's exports to Russia/Baltic countries during the last three years?

2. How large were the sales of your company (unit) during the last few years? (The annual reports usually provided this information)

3. Do you expect your sales to Russia/the Baltic countries to grow or diminish in the next year? Do you expect growth in exports of your traditional exports goods to this market or in new products?

4. What is the size of personnel in your company in charge of operations in Russia/Baltics?

5. How experienced are these persons in dealing with the Russian/Baltic market and/or other markets?

6. Does your company employ native Russians/Balts in Russian/Baltic units or units in Finland?

7. How long has(ve) your office(s) operated in Russia/Baltics? In which cities are they operative?

8. How many persons are working in your offices in Finland and/or Russia/Baltics?

9. What is the role of the board of management in operations in the Russian/Baltic market? Has it changed during the last few years?

10. How would you describe the significance of the Russian/Baltic market for the overall strategy of your company?

11. Is the significance of Russian market for your company growing or diminishing in the future?

12. What kind of competitive advantages do we as Finns have in Russia/Baltics?

13. How have your key contacts in Russia/Baltic countries changed during the last few years?

14. How can your describe the financial situation of your customers in Russia/Baltics?

15. Describe the payment terms in your trade with Russia/Baltics.

16. Are you planning to increase your marketing efforts in Russia/Baltics in the near future or diminish them?

17. Are you concentrating your marketing efforts in any particular geographic part of the former USSR?

18. Are you interested in manufacturing joint ventures with Russian/Baltic organizations?

19. Are you interested in establishing wholly owned subsidiaries in Russia and/or the Baltics?

20. Have you used imports/barter transactions to boost your exports?

21. Have you used/discussed licensing exports to Russia/Baltics?

22. Have you used/discussed subcontracting possibilities with Russian/Baltic factories?

23. Have you used/discussed coproduction possibilities with Russian/Baltic factories?

24. To what extent have other new markets compensated for the diminution of exports to Russia?

25. What kind of cooperation is there between the various units of your company when operating in Russian/Baltic markets?

26. How do you see the significance of the Russian market in the long run vs. short run?

27. How do you assess the risks in the Russian markets?

28. How are your competitors operating in Russia?

Appendix 2

Persons Interviewed from the Case Companies during 1991-1996

Valmet

Aaro Ikonen, Director	1991, 1992, 1993, 1994, 1995, 1996
Leo Krogerus, Managing Director, Valmet St. Petersburg	1991, 1993, 1994, 1995
Aleksei Kyber, Representative in St. Petersburg	1992
Jüri Ülesoo, Marketing Manager in Tallinn office	1992
Ulla Lankinen, Marketing Manager, Valmet Automation Projects	1994
Teuvo Laaksonen, Managing Director, Valmet Automation Projects	1994
Matti Pirhonen, Representative in Moscow	1994

Ahlstrom

Ville Ounaskari, Director	1991, 1993, 1995, 1996
Jarmo Huotari, Managing Director, St. Petersburg office	1992, 1993
Alpo Pursiainen, Managing Director, St. Petersburg office	1995
Jan Rostedt, Director, Electrical Accessories Division	1995
Tarja Lähteinen, Secretary in St. Petersburg office	1993
Markku Merenheimo, Consultant to Ahlström in Tallinn	1993

Outokumpu

Olavi Urvas, Director	1991, 1994, 1995, 1996
Antti Nissinen, Representative in Moscow	1992