Foreign Investment Decision-Making in Transition Economies

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FOREIGN INVESTMENT DECISION-MAKING in Transition Economies

Abstract

The purpose of this project is to describe and explain the foreign investment decision process in the uncertain and turbulent environment of transition economy. By getting an in-depth understanding of how decision-making works in the environment of transition economy, the study intends to contribute to the development of business administration theory in the area of foreign investment decision-making, particularly its application in the turbulent and uncertain world.

Theoretical ‘blocks’, elaborated on the basis of literature study, include the following concepts: the framework of transition economy; initial motivation (or reasons) of companies to make foreign direct investments (FDI); investigation of the investment climate and information collection methods; project evaluation and investment decision criteria; risk assessment factors and risk reduction measures.

Transition economy is defined in the study as ‘a non-planned, non-market economy’ where the new emerging market institutions coexist with the bureaucracy and hierarchy inherited from the old administrative system. Investment projects, therefore, should probably be seen as being under institutional influence from both the local (i.e. transition economy) and the Western investor’s home country environments. The empirical data presented in the paper also shows that it is necessary to establish the relevant economic, legal, political and social institutions in order to attract FDI. The study further includes the analysis of the main components and features of transition economies and their influence on FDI decision-making.

One of the results of the study is that FDI decision-making in transition economies is largely consistent with different theoretical approaches suggested in the literature. On the other hand, the empirical support obtained for different theoretical approaches is often questionable and opened to alternative interpretations. The presented project suggests that theoretical perspectives do not preclude each other, but rather have a complimentary character.

The study attempts to contribute to the mainstream FDI theories through a firm-level approach based on the case studies. Two in-depth case studies are presented in the paper: Ericsson’s direct investments in Russia and Vattenfall’s investments in the Baltic countries. A formal questionnaire based on the parameters of theoretical ‘blocks’ was created and 25 top executives from Ericsson and Vattenfall who participated in FDI decision-making were surveyed. The empirical investigation took place during the period 1997 - 1998 with partial updating of the cases during the year 2000.

The study shows that where companies confront stable environments, investment decision routines and procedures will be less necessary and important than where market uncertainty is high. The strong appreciation of the local business partners for properly done investment calculations increases the importance of capital budgeting in transition economies more than in developed market economies.
Besides, traditional investment appraisal methods provide managers with an ‘objective’ or ‘materialistic’ feedback for the decision-making in the rapidly changing uncertain environment. On the other hand, the study emphasises the importance of strategy over financial techniques and argues that FDI decisions in transition economies should be based on methods consistent with the company’s long-term objectives. In case of permanent changes, new approaches as well as better co-ordination of traditional techniques with strategic, political, historical, geographical and cultural issues are required.

Ericsson’s direct investments in Russia are presented in the paper in connection with other factors: the company’s historical involvement in Russia, marketing strategy, human resource development, privatisation and restructuring of the telecommunication sector in Russia, etc. Nordic Electric Power Co-operation (Nordel), the EU’s decision in 1996 to create an internal electricity market in Europe, Baltic ring study, future plans to privatise the energy companies in the Baltic countries, etc., are the framework to present the second case.

An application of project evaluation and risk assessment techniques for broader and more complicated environments shows that investment decision-making is probably as much, if not more, a social, political and cultural technology as an economic one. The study argues then that the rational choice decision-making model often co-exists with alternative models elaborated in social science - limited rationality, political and garbage can.

According to the empirical data, the investment decisions are largely based on intuition, business experience and judgement, personal contacts with representatives from the local country, and these investment criteria are inevitable and acceptable in a situation of total chaos and permanent change. The right chosen partner, for example, is one of the major criteria for the success of the investment project in a transition economy. One of the outcomes of this study is that the revitalised form of investment decision-making will differ rather markedly from much of what has gone before: less emphasis on the quantitative aspects of capital budgeting, more on the qualitative aspects of companies and investment environment.

The project also argues that determinants, approaches and criteria of investment activity in transition economies are largely consistent with patterns observed in other parts of the world. A few specific environmental conditions of transition economies, however, are shown in the study to affect the pattern of FDI decision-making. The level of turbulence is still different compared to the developed market economies due to uncertainties and unpredictibilities associated with environment of transition economies. Other major differences are the large power distance with authoritarian leadership, strong hierarchy and bureaucracy as well as the vital role of personal contacts in transition economies. It is not clear, however, if these features of transition economies should be seen as inherited from the past communist system or as an alternative way to organise the economic actors through networks, a way that is natural and appropriate for the majority of Asian societies.

Key words: FDI, transition economy, initial motivation (or reasons) for FDI, capital budgeting methods and investment decision criteria, investigation of investment climate and information collection methods, risk assessment and risk reduction measures, decision-making models, case studies, survey method.
ACKNOWLEDGMENTS & PREFACE

This research paper is a result of hard and enjoyable work at School of business, Stockholm University (SoB, SU) which provided me with an opportunity to conduct my postgraduate studies.

First of all, my sincere gratitude goes to my supervisors, Dr. Jan-Erik Gröjer and Dr. Jens Lindberg for guidance and support throughout the study. I have been privileged to benefit from their experience in science, business and life.

Research is mysterious phenomena. There is no substitute for actually writing - all the preparation in the world does not save a researcher from having to put words on paper. There is nothing more frustrating than sitting down nearby a table and looking into a computer screen without being able to write… “When the writing is not going well, we probably have nothing (yet) to say”, - explained Wolcott (1990, p. 21). Unfortunately, I have not found a formula to make writing an easy task. The real learning can only take place in doing.

My deep gratitude goes to opponents of the intermediate versions of the paper: Dr. Olle Högberg, Dr. Li Malmström, Doctoral candidate Nils Bagelius (all SoB, SU), Dr. Mats Edenius (Stockholm School of Economics), Dr. Erik Bergström (SoB, SU and Institute for Economy at the Uddevalla University), Dr. Carl Fey (Institute of International Business, Stockholm School of Economics), Dr. Bestrat Tesfaye (University in Södertörn), who substantially contributed to the research through their valuable insights and comments.

Another challenge of being a researcher is probably the necessity to communicate with the audience: colleagues, students, business people and other interested parties. As Dey (1993, p. 237) points out, ”what you cannot explain to others, you do not understand yourself”. Of course, producing an account of our analysis is not just something we do for an audience. It is also something we do for ourselves.

Thanks to colleagues inside and outside the School of business with whom I have had stimulating discussions on my topic as well as on the problems of research in general: Prof. Pierre Guillet de Monthoux, Prof. Kaj Sköldberg, Dr. Addri De Ridder, Dr. Bo Green, Dr. Cecilia Bergström, Dr. Tom Hemming, Dr. Ali Yakhlef (all from SoB, SU), Prof. Victor Pestoff (University in Södertörn), Prof. Anders Persson (Växjö University), Dr. Jonas Engberg (Center for Eastern and Central European Cooperation, SU), Phil. Lic. Björn Isberg (“Optimal Portföljstrategi”), Doctoral candidate Martin Johanson (Uppsala University) and many others. I want to thank Dr. Apostolis Papakostas (SCORE - Stockholm Center for Organizational Research) and Oscar Almén (Center for Pasific Asia Studies, SU) for valuable comments from multi-disciplinary perspective on the draft of the chapter about conceptual framework of transition economies.

I am also indebted to the executives of two companies: Ericsson and Vattenfall. Without their cooperation this work would have been impossible.
Financing is a common concern of all Ph.D. students. Scholarship during 1999 - 2001 provided by Anna Ahlström and Ellen Terserus Foundation is extremely appreciated.

I would add that planning is another important part of being a researcher. Decision-making process appears discontinuous with numerous stops and re-starts. I believe that there is no Biblical view of FDI decision-making, but the Darwin one. Research is, therefore, also an ongoing process that can extend indefinitely. There is always a new book that could be reviewed and another person who could be interviewed. Deciding when to stop and quit is then an important moment for the researcher, and I feel that I have reached this step. I have learned a considerable amount about foreign direct investments in transition economies and a little bit about myself.

Many thanks to my family and friends for support and understanding, especially to Freddie Henriksson.

I am indebted to Dr. Paul Terry for help in revising the language. I am, however, solely responsible for the paper’s views, errors and omissions.

April 2001

Stockholm

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LIST OF INTERVIEWED DECISION MAKERS FROM ERICSSON AND VATTENFALL (ANONIMOUS)

Manager, Export & Project Finance, Business Area Infocom Systems
Ericsson Telecom AB

Manager, Project Finance
Representative Office LM Ericsson International AB

General Director
Ericsson Training Center

Director & General Manager, Global Marketing - Europe, Public Networks
Ericsson Telecom AB

Vice-President
Ericsson Corporatia AO

Senior Vice President, Corporate Business Development
Telefonaktiebolaget LMEricsson

Corporate Financial Control, Mergers and Acquisitions
Telefonaktiebolaget LMEricsson

Senior Vice President, Corporate Technology
LMEricsson

Vice-President
Ericsson Corporatia AO

President
Ericsson Corporatia AO

Vice President, Infocom Systems Business Control
Ericsson Telecom AB

Vice-President, Finance and Business Control
Ericsson Corporatia AO

Controller, Fixed Networks
Ericsson Corporatia AO

Senior Manager, Export & Project Finance, Business Area Infocom Systems
Ericsson Telecom AB

Vice-President
Ericsson Corporatia AO
Regional Director, Eastern Europe, Corporate Markets
Telefonaktiebolaget LMEricsson

Corporate Financial Control
Telefonaktiebolaget LMEricsson

Manager project evaluation
Vattenfall International AB

Project Director
Vattenfall AB International / Division Europe

Senior Executive Vice President
Vattenfall AB

Senior Adviser Corporate Strategy
Vattenfall AB

Project Director
Vattenfall AB, International/Division Europe

Managing Director
Vattenfall Latvia SIA

Senior Executive Vice President
Vattenfall AB

Managing Director, Vattenfall Estonia

General Manager, Vattenfall Lithuania UAB
1. INTRODUCTION

1.1. World ‘in transition’

"The essence of formulating competitive strategy is relating a company to its environment." This opening sentence of Porter’s (1980, p. 3) well-known book "Competitive Strategy" is a useful statement of the importance of environment for a company’s success.

During the last decades some features began to emerge that have changed the face of the international investment environment and the conditions of doing business. One of the most important events was probably the renaissance of the market system as the dominant form of economic organisation.

First, this was demonstrated by the opening up of Mainland China and the demise of the communist economic system in Central and Eastern Europe in the late 1980s. With the collapse of the former Eastern Bloc and parts of the developing world embracing deep-going reforms towards market economy, important regions have become new players on the international stage. An increasingly important role in 1980s was played, therefore, by Third World countries. According to OECD calculations, the major developing countries have already obtained a 22.5 per cent share of the global GDP in 1990 (calculated on the basis of purchasing power parities) and will generate a third of the world output by the year 2010 (Aiginger, Havlik, Wolfmayer-Schnitzer, 1998, p. 16).

Another triumph of the market economy is the opening up for competition of whole sectors that have been unreachable for companies other than monopolies or other protected firms. Such markets as the UK financial services industry, telecommunications markets, electricity markets, and transport markets relying on railways have been emerging around Western economies.

The increasingly significant role of foreign direct investments (FDI) is probably the third trend of the modern economy. For the first time, in 1989, the sales of the foreign affiliates of multinational enterprises (MNEs) exceeded the value of world trade; the growth of FDI flows outpaced that of world trade throughout all the 1980s with a rapidly increasing share of the developing countries (UNCTAD, 1994). Between 1989 and 1994, for example, developing countries attracted 26.7 percent of the FDI flows compared with 20 per cent for most of the previous decade (UNCTAD, 1995).

Other changing patterns of the modern economy include:

- a gradual decline in mass consumer markets (standard products with predictable demand and long production runs) and a rise in more fragmented, differentiated markets and short production runs;
- the increasing significance of services compared to manufacturing ones;
- the accelerated globalisation of production and marketing;
- and the increasing extent and intensification of internationalised competition.

A new generation of generic innovations in communications further extends the international boundaries of firms and facilitates a variety of cross-border inter-firm alliances and network arrangements.
Though the channels may differ, all firms are increasingly exposed to the shocks and disturbances of a global marketplace with what Genus (1998, pp. 4-5) called "the new and continuing uncertainties" and "transition to the new paradigm" while Ansoff and McDonnell (1990, p. 4) labeled this as the "current escalation of turbulence."


Taken collectively, these events demand a major restructuring of economic theory in both developed and developing countries. They also force economists to give much greater attention to the process of economic change and emphasise the exploitation of dynamic rather than static methods of decision-making.

### 1.2. FDI in transition economies

A term ‘transition economy’ appeared both in the scientific literature and in common language to describe the state and development of emerging markets in Central and Eastern Europe.

Since 1990, the Central and Eastern European countries in transition have received large capital flows in the form of foreign direct and portfolio investments. While the centrally planned economies were getting less than 1 percent of the world FDI before 1989, the share of the European (including Russia) countries in transition in 1995 already amounted to 5 percent of the world total (Lavigne, 1999, p. 254). Table 1 shows that there has been a rapid growth of net FDI inflows for the period 1991 - 1997 in transition economies.

**Table 1. FDI in Countries in Transition, 1991 - 1997 (million US $)**

<table>
<thead>
<tr>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Europe</td>
<td>2330</td>
<td>3120</td>
<td>4106</td>
<td>3479</td>
<td>9159</td>
<td>7573</td>
<td>9076</td>
<td>38403</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>56</td>
<td>42</td>
<td>40</td>
<td>106</td>
<td>90</td>
<td>106</td>
<td>498</td>
<td>1000</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>513</td>
<td>1004</td>
<td>654</td>
<td>869</td>
<td>2562</td>
<td>1428</td>
<td>1300</td>
<td>7473</td>
</tr>
<tr>
<td>Hungary</td>
<td>1460</td>
<td>1471</td>
<td>2339</td>
<td>1146</td>
<td>4453</td>
<td>1983</td>
<td>2085</td>
<td>15403</td>
</tr>
<tr>
<td>Poland</td>
<td>117</td>
<td>284</td>
<td>580</td>
<td>542</td>
<td>1134</td>
<td>2768</td>
<td>3077</td>
<td>8442</td>
</tr>
<tr>
<td>Romania</td>
<td>37</td>
<td>73</td>
<td>94</td>
<td>341</td>
<td>419</td>
<td>263</td>
<td>1222</td>
<td>2389</td>
</tr>
<tr>
<td>Slovakia</td>
<td>82</td>
<td>100</td>
<td>134</td>
<td>170</td>
<td>157</td>
<td>206</td>
<td>161</td>
<td>912</td>
</tr>
<tr>
<td>Slovenia</td>
<td>65</td>
<td>111</td>
<td>113</td>
<td>128</td>
<td>176</td>
<td>185</td>
<td>321</td>
<td>1074</td>
</tr>
<tr>
<td>Baltic countries</td>
<td>100</td>
<td>236</td>
<td>471</td>
<td>457</td>
<td>684</td>
<td>1034</td>
<td>2708</td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>58</td>
<td>160</td>
<td>226</td>
<td>205</td>
<td>150</td>
<td>262</td>
<td>809</td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>42</td>
<td>46</td>
<td>214</td>
<td>180</td>
<td>382</td>
<td>418</td>
<td>1287</td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>30</td>
<td>31</td>
<td>73</td>
<td>152</td>
<td>355</td>
<td>612</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>CIS, total</strong></td>
<td>-100</td>
<td>830</td>
<td>1495</td>
<td>1603</td>
<td>3656</td>
<td>4567</td>
<td>10593</td>
<td>19990</td>
</tr>
<tr>
<td>Russia</td>
<td>-100</td>
<td>700</td>
<td>900</td>
<td>640</td>
<td>2016</td>
<td>2479</td>
<td>6241</td>
<td>9743</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>2230</td>
<td>4050</td>
<td>5837</td>
<td>5553</td>
<td>13272</td>
<td>13894</td>
<td>20703</td>
<td>61100</td>
</tr>
</tbody>
</table>

* CIS = Commonwealth of Independent States

As we can see from the table, however, FDI has been concentrated on very few countries. In 1997, Hungary, the Czech Republic and Poland had cumulatively attracted 84 percent of overall FDI in Eastern Europe, and Russia - 85 percent of FDI in the CIS area.

Central and Eastern European countries in transition are lagging behind the main host countries for FDI in emerging markets. An estimation for the accumulated FDI up to 1996 shows that all the countries in transition taken together have received 50.6 billion US dollars, which is half that of Brazil and less than one third that of China ("Newly Independent States and Baltics Update, Spotlight on Foreign Direct Investment", 1997, p. 3).

The present situation with foreign direct investment in Central and Eastern Europe allows some researchers to conclude that inflows of FDI into transition economies have lagged far behind original projections and foreign capital had but little effect on the lively corporate investment climate in the countries in transition ("Overcoming the Transformation Crisis : Lessons for the Successor States of the Soviet Union", 1993; Stankovsky, 1998).

1.3. A new or an old research field?

This paper appears at a time when the reforms in Central and Eastern Europe have been continuing since the fall of the Berlin Wall in 1989. Is it still relevant to talk about the economies in transition when the transformation process is already ten years old? When shall we stop talking about ‘countries in transition’ and when shall we know that the transition is over - if ever?

It is hard to deny that the reforms have proceeded sufficiently far ahead and are successful on the whole. But after some of the objectives have been met and the basis of a market economy has been set up, albeit over a rather short period, other problems have appeared. Some researchers share the view that the progress of Central and East European economies towards a market economy has not been as smooth and rapid as initially expected (Buckley and Ghauri, 1994). Why did transition lead from central planning to a chaotic market, and not to a markets similar to the Western economies? Is transition an identifiable stage, or state, or process?

Shall we treat ‘transition economy’ as a new research field? Is it possible that we might have a transformation process already experienced by a number of societies and studied but in another context? Can we apply decision-making methods elaborated for other emerging markets, say, Latin American or Asian, to the investment environment of transition economies?

We can not exclude the possibility that with all the changes that have occurred in the global economy during the last decades, there is no principle difference between decision-making in transition economies and the rest of the world: all companies operate nowadays under conditions of environmental uncertainty and high turbulence…

1.4. Structure of the thesis

In order to answer (or rather to make an attempt to answer) the questions raised in the previous paragraph, I will turn in the second chapter to existing literature and search for the conceptual framework for analysis of transition economies.
The problem, purpose of the research, limitations and theoretical sources are described in the third chapter which is followed by the chapter presenting the methodology of the project. The fifth chapter introduces concepts included in the suggested model for the analysis of FDI decision-making.

Chapters six and seven present two cases chosen for the project. They are followed by five chapters (eight to twelve) dedicated to analysis of the empirical data. The logic of presentation of analysis is shaped by the theoretical framework suggested in the fifth chapter. The final (thirteenth) chapter concludes the thesis.

The following structure of the paper is suggested:
Figure 1: Structure of the thesis

Source: Olga Golubeva (own)
2. TRANSITION ECONOMY : CONCEPTUAL FRAMEWORK

"There is a certain relief in change, even though it be from bad to worse : as I have found in travelling in a stage-coach, that it is often a comfort to shift one’s position and be bruised in a new place."

Washington Irving (1783-1859)


2.1. Introduction

The purpose of this chapter is to provide a theoretical framework for analysis of transition economies and to relate this category to other concepts.

The relevant studies on environmental uncertainty as a ‘multidimensional’ phenomena and its perception by managers are summarised in the second paragraph.

In the third paragraph I will turn to the concept of transition economy which represents one of the cases of the uncertain and turbulent environment of the modern world. The aim is to summarise the research discussions as well as to present my own suggestions about the content, components, timing of transformation period and main characteristics of transition economy.

In the fourth paragraph transition economies are related to the broader global framework. The purpose is to analyse different assumptions about similarities of transition economies with the investment environments of the Third World countries, Western societies, other emerging markets, industries and regions.

Some conclusions are drawn in the last paragraph. The main suggestions and assumptions discussed in the chapter will be classified in four blocks of Figure 2: ‘Transition economy: conceptual framework’.

2.2. Environmental uncertainty and its perception by managers: state of the art, problems, and challenges

2.2.1. The concept of uncertain environment

The environment is defined by Duncan (1972) as the relevant physical and social factors outside the boundary of an organisation that are taken into consideration during the decision-making process. The variation in environments has received considerable attention in theory and research conducted over the last twenty years or so. There appears to be an emerging consensus that the environment exists in two layers that have a distinct influence on decision-making and, therefore, are supposed to be studied separately. (Hambrick, 1981; Brown and Utterback, 1985).
The first layer - task environment - involves environmental elements with which the organisation has direct contacts. These elements are commonly defined to include competitors, suppliers, customers, regulatory bodies, etc. The second, or outer layer is the general environment. It refers to sectors that affect organisations indirectly. The general environment often includes economic, political and social sectors.

It is taken for granted that the environment is a major source of uncertainty and turbulence for managers, involved in the decision-making process. Even the most sophisticated authors presume that organisations succeed when they operate in states of stability and emphasise the necessity to avoid surprises (Mintzberg, 1979; Mintzberg, 1983; Nadler and Tushman, 1992; Stacey, 1993). Uncertainty has traditionally been seen as a problem by the majority of researchers, and theories emphasise the importance of a reduction of the external turbulence for successful operations. Classics as Thompson (1967) postulated that uncertainty appears as the fundamental problem for complex organisations.

The figure below shows two main types of the environment distinguished by Burrell and Morgan (1982): stable and certain vs. turbulent and uncertain.

**Figure 2. Main types of the environment - stable and certain vs. turbulent and uncertain**

*Source: Burrell and Morgan (1982, p. 171) (re-arranged by Olga Golubeva)*

Uncertainty (in some texts replaced by the term unpredictability) should not be mistaken for mere complexity and it is not just a result of bounded rationality. According to Williamson (1975), uncertainty as a property of the environment means that it is impossible to foresee what is going to happen, even if we were perfectly rational. There are things we simply cannot know and which no amount of information can reveal the probability of their happening.

Authors who studied the process of decision-making and organisational change have shown that changes in the turbulent and uncertain environment are bottom-up driven, emergent, and incremental, rather than formulated and implemented as assumed in the older strategic adaptation frameworks (See the recent discussion between Mintzberg and Ansoff, 1994).

Fredrickson and Mitchell (1984), Fredrickson (1984), and Fredrickson and Iaquinto (1989) advocate adoption of rationality, represented by the comprehensiveness of the planning process, in stable environments and their abandonment in uncertain environments.
According to them, in an uncertain turbulent environment, comprehensiveness is doomed to failure since the data are not available, relationships are not obvious, and the future is unpredictable. Comprehensive processes are time-consuming and in an uncertain turbulent environment a slow decision-making process would clearly be inappropriate.

Similarly, Eisenhardt (1989) found that successful decision-makers in uncertain environments use more information, consider more alternatives, and seek a greater amount of advice. Instead of departing from the analytical requirements of comprehensive decision-making, they accelerate the cognitive processes. Further empirical support for this position is provided by Judge and Miller (1991), as well as by Priem, Rasheed, and Kotulic (1995).

These authors believe that the primary task of an organisation in an uncertain and turbulent environment may be to facilitate adaptation to change, while in a more stable environment the primary task is the achievement of more static goals. Miller and Friesen (1983) also argue that a turbulent environment must be studied more carefully and diligently to afford executives with an adequate degree of mastery.

Another well-known approach to dealing primarily with internal complexity and only secondarily taking into account the external uncertain environment is that of Quinn (1980, 1994), who emphasise incremental adaptation to external changes and primary focusing on rational (bounded) decision processes.

Some researchers point out that most present studies have focused on one aspect of the environment, namely, uncertainty. However, there are other critical aspects of a firm’s operating environment, for example, complexity, munificence and dynamism which until now have received little attention and require more theoretical and empirical studies (Rajagopalan, Rasheed and Datta, 1993; Goll and Rasheed, 1997). As Rajagopalan et al. (1993) point out, uncertain environments that are also munificent (e.g., high growth industries in initial stages of industry evolution) are very different from uncertain environments that are far less munificent (e.g., mature industries with declining demand or increasing competition). Those features of the environment, however, are still on the agenda for future research.

2.2.2. Uncertainty: different sources and dimensions and their interpretation by managers

Even if the concept of uncertainty has been a central component in a number of theories of organisation, strategy and marketing, findings from studies that are based on different theories examining the effects of uncertainty on decision-making appear to contradict one another.

For example, empirical work grounded in strategic management theory (e.g., Porter, 1980; Harrigan, 1985) suggests that firms facing uncertainty require greater flexibility and has shown that uncertainty results in a lowered rather than an increased degree of vertical integration. In contrast, studies grounded in transaction cost theory by John and Weitz (1988), and more recently by Heide and Stump (1995), provide empirical support for the proposition that vertical integration of companies is an efficient response to environmental uncertainty.
One plausible explanation to account for the contradictory findings noted above may hinge on the source or the type of uncertainty being examined. More specifically, given that uncertainty may arise from a number of sources or may be characterized along a number of dimensions, it is possible that different sources or dimensions of uncertainty have different implications for decision-making.

I refer to a classical work of Williamson (1985) to develop a typology of three forms of uncertainty that arising from three different sources: primary, competitive, and supplier uncertainty.

Williamson himself builds on Koopmans (1957) who distinguished between primary and secondary uncertainty as follows: primary uncertainty reflects a lack of knowledge about states of nature, such as the uncertainty regarding natural events, whereas secondary uncertainty reflects a lack of knowledge about the actions of other economic actors. Koopmans argues that both forms of uncertainty affect a firm’s investment decisions. Williamson describes both primary and secondary uncertainty as ‘innocent’ and ‘non-strategic’ forms of uncertainty and distinguishes them from behavioral uncertainty. Behavioral uncertainty arises from the difficulty in predicting the actions of other relevant actors, particularly in view of the potential for opportunistic behavior.

Following Koopmans (1957) and Williamson (1985), Sutcliffe and Zaheer (1998) suggest that uncertainty is multidimensional and in future research we need to develop further a typology of uncertainty dimensions and their simultaneous effects on decision-making.

Decision-making is dependent not only on different sources and dimensions of uncertainty, but upon the perceptions and interpretations of the environment by managers (See Schneider and De Meyer, 1991). Moreover, Bourgeois (1985) has provided evidence indicating that the greater the match between managers’ perceived environmental uncertainty and true environmental volatility, the higher the economic performance of a firm.

Perceived environmental uncertainty is the difference between the amount of information required to perform the task and the amount of information which has already been obtained. (See Galbraith, 1977).

Milliken (1987) states that managers generally will come up against several types of uncertainty in the course of trying to interpret and respond to the environments of the companies. Uncertainty about the state of the environment (state uncertainty) means that we do not understand the way in which elements in the environment may be changing and that we are not able to assign probabilities to states of nature. Effect uncertainty is a lack of knowledge about cause-effect relationships, in particular about how states of nature will affect the organisation; and response uncertainty is the ability to predict the outcomes of decisions. The last type of uncertainty comes closest to the definitions of decision theorists.

In practice, perceived environmental uncertainty exists when decision-makers do not feel confident that they understand what the major events or trends in an environment are, or when they feel unable to accurately assign probabilities to the likelihood that particular events and/or changes will occur (See Milliken, 1987). "In the face of market turbulence, it is difficult, if not impossible, to judge what the future development will be", - stressed Hadjikhani and Johanson (1996, p. 55).
Some researchers stress the importance of measuring uncertainty in terms of the general manager’s total perceived uncertainty (See Pehrsson, 1985). The uncertainty in making unequivocal interpretations of gathered and selected information about business climate generally dominates the general manager’s total uncertainty. A major reason for this is, according to Pehrsson (1999), that the environment becomes less controllable and foreseeable all over the world. Therefore, more studies examining managers’ perceptions and interpretations of different types of uncertainty are required.

2.2.3. Challenges to existing theory and some conclusions

Decision-makers in the modern world are challenged by environments that become increasingly more complex and qualitatively more demanding, contradictory and dynamic. Given that uncertainty may arise from a number of sources or may be characterised along a number of dimensions, it is necessary to develop further a typology of uncertainty dimensions and their simultaneous effects on decision-making. More studies examining managers’ perceptions and interpretations of different types of uncertainty in different countries are also required due to the fact that environments become less controllable and foreseeable all over the world. Besides uncertainty, such critical aspects of a firm’s operating environment as complexity, munificence and dynamism, as well as their influence on a particular firm’s decision-making routines, are still on the agenda for future research.

In the modern world business environments are often changing unpredictably, so prepared solutions might become useless, or they may remain so unstable that no specific decision model can be useful. In his classical article "Uncertainty, Evolution, and Economic Theory”, Alchian (1950) argued that economics do not need the dubious assumption that firms are engaged in profit-maximization, which is impossible in a world of pervasive uncertainty and incomplete information. Instead, firms adapt, imitate and use trial and error in order to survive. And those firms who succeed in replacing rationality by selection are the survivors. Some recent studies continue to explore alternative decision-making solutions for managers dealing with extreme complexity on a day-to-day basis, and try out alternative options and invent new ones. (See Lowendahl and Revang, 1998).

Institutional theory is a continuation and extension of the intellectual revolution which begun during the mid-1960s and introduced open systems conceptions into the study of organisations in general, and companies in particular. Open systems theory transformed existing approaches by insisting on the importance of the wider context or environment as it constrains, shapes, and penetrates decision-making routines. To the earlier emphasis on the importance of the technical environment - resources and technical know-how - institutional theory has called attention to the importance of the social and cultural environment, in particular to social knowledge and cultural rule systems. (See Scott, 1995).

Furthermore, perceptions of political, government policy, and macroeconomic uncertainties differ significantly across nations (Miller, 1993). More specifically, national culture influences perceptions of crisis and danger, as well as proactive responses, both internally and externally oriented (Schneider and De Meyer, 1991; Elenkov, 1997).
Researchers also start to doubt the existence of universal models that suit all types of environment. If we accept the statement - "in today’s world, different types of organisations have different environments" (Mintzberg and Ansoff, 1994, p. 80) - future research shall rather concentrate on particular cases of decision-making than search for general models explaining the universal connections suitable for all types of environment.

The applicability of current decision-making models to the turbulent and uncertain world is often questioned with regards to post-socialist countries that are characterised by higher investment uncertainties than the Western economies (See, for example, Elenkov, 1997; Johnson, McMillan and Woodruff, 1999; Nasierowski, 1996; Raagmaa, 1997).

The new emerging markets of Central and Eastern Europe are experiencing a radical change from the old regime, dominated by central-bureaucratic planning, to a more decentralised coordination, based on market relationship. The environment of transition economies represents a pattern of uncertain and turbulent environment of the modern world which, due to the short duration of transformation period, has not been carefully investigated.

2.3. Transition economy as one of the cases of uncertain and turbulent environment

2.3.1. What does ‘transition economy’ mean?

I have found that a concept of transition economy in emerging capital markets of Central and Eastern Europe seems to be used in literature to mean - ‘a non-planned, non-market economy’. The economic reforms envisioned under perestroika have as a major objective the establishment of a market-based demand economy to replace a socialist command economy (Åslund and Layard, 1993; McCarthy, Puffer and Shekshnia, 1996; "Entrepreneurship and SMEs in Transition Economies", 1997).

Kornai (1992) calls transition period ‘a dual system’, in which many elements of socialist and capitalist societies exist side by side. Nuti (1993, 1996) labelled transition period as a necessary stage of forced market socialism, during which the state sector cannot just disappear but must be commercialised, reorganised, undergo financial restructuring, and be treated equally with the private sector in its fiscal burden and access to credit. Clarke (1996) observes that even if the traditional system of central planning has disintegrated and dented, traditional economic relationships are still maintained and have an enormous inertia. According to Sharma and Wallström-Pan (1997), transition period in China presumes introduction of new modern Western management methods while the old Chinese management style still remains.

Some researchers, for example Brezinski and Fritsch (1997), suggest that transition economy is a transformation from ‘hierarchies’ to a market economy. They define hierarchy as "a system in which everything happens according to the order of a central agency that has the power to dictate"; relationships in such economic system, therefore, are characterised by a certain asymmetry (p. 11). A market is commonly defined as "a set of social institutions that brings together buyers and sellers by announcing time, location, price as well as type and quality of a product to be voluntarily exchanged between different actors" (Stiglitz, 1993, p. 13). During the transition period, the hierarchic system should be transformed into the market one.
This suggestion fits quite well the new institutional economics’ school, focusing primarily on the micro-analytic questions of which alternative generic forms of governance - markets or hierarchies - economise on transaction costs “rather than on the broader questions of origins and changes in the institutional rules of the game: customs, laws, politics” (Williamson, 1991, p. 269).

It can be argued, however, that the economic systems in the former socialist countries did not rely on pure hierarchical coordination while, on the other hand, there have never been societies in the West where everything was decided only by the market mechanism. According to Kornai (1995), the classical socialist system was predominantly based on a bureaucratic (hierarchical) coordination and, to a lesser degree, on market coordination.

Davis (1997) suggests that transition economy is a transformation process from what may be termed ‘informal’ to ‘formal’ markets. An ‘informal’ market may be defined as one in which the conventional western institutional framework as regards property rights, legal background, taxation, norms of business behavior and monopoly policy are ill-defined, subverted or non-existent. Economic agents within ‘informal’ markets or, using the development economists’ terminology, the ‘informal sector’ evade taxation and regulation from the government and also exploit the legislative loopholes existing within the economy. Davis (1997) labeled an informal market prevalent nowadays in Bulgaria as ‘a curious hybrid’, characterized by the continuation of pre-reform links and behavior within a distorted, monopsonistic and poorly regulated market structure. He also concludes that transition economies are neither centrally planned markets, nor free/mixed economy ones.

Some authors see reforms as a transformation from dictatorship to democracy, which means that countries in transition should leave the socialist legal tradition where everything not specified by the law was forbidden, and create a system where everything not explicitly forbidden is permitted (See Haavisto and Elgar, 1997).

Another group of researchers argues that transition economy is not just transformation from a centrally planned to a free market economy. They claim that China and some Central Asian countries are in transition from a command economy to a market economy, from stagnation to growth, but not, for the time being, from communism to democracy. Therefore, Chinese experience cannot be relevant to Central or Eastern Europe because the initial political aims of transition were different (See, for example, Lavigne, 1999; Pomfret, 1997). Accepting this argument means that transition can lead from stagnation to growth, from underdevelopment to development, but not necessarily from communism to democracy.

Yergin and Gustafson (1994) suggested a term ‘triple transition’ in order to describe reforms in Russia followed the disintegration of the former Soviet block and point the multiple nature of the transformation process.

The ‘triple transition’ is:
- from dictatorship to democracy
- from centralised economy to free market
- from four-century-old empire to nation state.
In my opinion, there might be different types of transformation depending on the specific characteristics of the former and the target systems (or transition economy might have different sides). That is why researchers describe transition economy as a transformation from plan socialist to free economy, from ‘hierarchies’ to markets, from ‘informal’ to ‘formal’ markets, from stagnation to growth, from dictatorship to democracy, etc. We can, therefore, observe the societies which experience ‘a double’ or ‘a triple’ transition by combining several types of transformations in the program of their reforms.

Another group of authors prefers to look upon transition economies in terms of deepness of undergoing changes. Liuhto (1997) in her analysis of the Estonian reforms contrasts the real transition with transformation that may produce results of a cosmetic nature. Auroi (1998) noticed that in some cases, such as the Bolivian one, economic actors do not really change their habits during the transition period and continue to act as if they are still living in the old import substitution system under the mighty protection of the state.

In other cases, such as Chile, the transition led to real changes. According to Auroi (1998), it is not clear yet which path the East European countries will finally follow. Shen (1994) is more negative in his analysis of the Baltic transition economies and claims that it is merely market language and symbols, not their essence, that have been imposed until now, while the system is still Soviet in its effects.

There are also suggestions to see transition economy as a broad social process. According to some researchers, everything has been in transition: how people earn a living, buy things, address each other, choose their homes, plan vacations, educate themselves, seek medical assistance, and socialise (See, for example, Holden, Cooper and Carr, 1998; Mikheyev, 1996). Schopflin (1997) calls those values, attitudes, behavioural dispositions from the past - ‘the intangibles’ of transition.

My definition of transition economy is similar to a classical one: it is ‘a non-planned, non-market economy’. One can hardly question the fact that for the time being these economies are ‘mixed’ or ‘mutant’ in the sense that they carry both a specific inertia of the ruined but still operating former system and emerging basic institutions of financial markets. These economies are not coherent either with the logic of the former system or with the target system. It might be suggested, therefore, that transition economy is characterised by the uncertainties associated with coexistence of an emerging market and an old administrative system.

2.3.2. Main components of transition economy

Main components of the transformation period have been identified by several authors (see, for example, Auroi, 1998; Buck, Filatotchev and Wright, 1996; Corbo, Corricelli and Bossak, 1991; Mertlik, 1996; Mygind, 1997) and include:

(1) **Stabilisation**, under which the objective is to control macroeconomic indicators such as the rate of inflation, or the exchange rate, by using basically monetary and financial means. Another important and correlated objective of this phase is to remove basic deficits in government expenditures, the financial sector and the trade sector.
(2) **Liberalisation**, a more complex process which means that former controls over different economic parameters are set free to move according to supply and demand, that is, the prices on various markets (commodity, labour, financial market). Liberalisation presumes also transformation of decision, information and motivation to independent market units. Some authors call this sub-process deregulation.

(3) **Privatisation**, which may be considered as a transfer of wealth (stocks, assets) from the public to the private sector in order to diminish the intervention power of the state and enable the private sector to fully utilise available resources.

According to common theoretical foundation, the processes of stabilisation, liberalisation and privatisation should lead to the transition to an efficient and dynamic capitalist economy. The most important issues in this context are the order of implementation of different components, or as it has been phrased by Fanelli and McMahon (1996) - ‘the problem of sequencing’. One of the most important lessons from Latin America, for example, is that full liberalisation of the capital account is fraught with dangers, and consequently should be delayed for as long as possible.

Some researchers stress that not enough attention is paid to the fourth component of transition economies - **reformation of government** from the communist police state to an institution supporting a market economy, from direct ownership of assets towards indirect control (Hoos, 1996; Johnson, Kaufmann and Zoido-Lobaton, 1998; Kaufmann, 1997; Shleifer and Vishny, 1998).

In transition economies, as in developing countries generally, governments have often been accused to be the central barrier to economic development and attraction of FDI. The theory of "market-preserving federalism", for example, stresses the importance of the government officials’ fiscal and political incentives during the developing and transition states. Contributors to this literature (Qian and Weingast, 1997; Jin, Qian, and Weingast, 1999) argue that the Chinese fiscal reform of the early 1980s until 1994 gave governments incentives to pursue local economic growth and possibly created a basis for China’s remarkable economic performance and attraction of foreign investments.

Shleifer (1997) and Frye and Shleifer (1997) provided evidence that the Russian government (in comparison with the Polish government) acts like a "grabbing hand" and retards private business development and investments. According to Zhuravskaya (1999), Russia, in contrast to China, represents a model that deserves to be called "market-hampering federalism" since local revenues are more dependent on the distribution of bargaining power than on the economic prosperity. As a result of this bargaining, 90 kopecks out of each additional ruble in revenues is taxed away which gives local government no incentives to encourage the growth of private business.

Interestingly, Russia has done more than China in terms of privatisation of state-owned enterprises and liberalisation of markets. But, apparently, liberalisation and privatisation without altering government incentives are insufficient to produce meaningful economic reform and attract foreign investments. Comparing Chinese and Russian federalism, we may conclude that discussions on transition should go beyond the usual focus on stabilisation, liberalisation and privatisation to pay more attention to the reforming of the government.
Intriligator (1997) argues that the suggested three components are not necessarily present in all transition economies and there is an alternative, for example, to privatisation as the route to a market economy. The alternative in case of China is to focus the program on the ‘new’ economy rather than the ‘old’ economy, and to establish new enterprises, particularly those oriented to exports, rather than to concentrate on privatising the existing old enterprises (See also Sachs and Woo, 1994). The combination of a gradual reforming of the former state-owned enterprises with rapid growth of the economy through newly established firms was also observed in Poland (Gomulka, 1994).

We must be also aware that transition process by nature presumes evolutionary dynamic multi-sequential development where the basic components are generally not undertaken simultaneously. The beginning of one phase may be started without necessarily waiting for the end of the precedent.

Reform of the educational system does not yet have a prominent place in the textbooks on transition towards a market economy which mostly deal with price liberalisation, privatisation or budget consolidation. However, according to Beer (1999), the restructuring of general and vocational education is an inseparable component of transition.

If transition economies are to succeed in their moves toward market-type economies, they will need, among many other requirements, managers who can function in that environment (See also McCarthy and Puffer, 1996).

To sum up, the main components of transformation process, identified according to the ‘neo-classical’ model, are: stabilisation, liberalisation and privatisation. The reformation of government has also been suggested as a main component by some researchers. The consensus, however, has not been reached as to whether those components are necessarily present in all transition economies or if additional items, for example, educational reform, should also be included. More empirical studies and theoretical discussions are needed to answer these questions.

2.3.3. Speed of transition: instability and unpredictability of the process

According to Fanelli and McMahon (1996), the most important issue during transition is the question of the speed of the process (shock therapy versus gradualism or incrementalism).

Most of the authors prescribe that transition in post-socialist countries shall be implemented ‘as quickly as possible’ because an incremental approach does not seem capable of obtaining sufficient momentum to make the process self-motivating. The transition can proceed rapidly towards a market economy, but it also might slow down and perhaps even revert back to the old society’s economic relationships. General political instability is, therefore, probably the most common characteristic of transition economies (See Fanelli and McMahon, 1996; Lavigne, 1999; Liuhto, 1997; Meyer, 1996). The difference between Central and East European countries could be described on a scale of certainty and stability vs. uncertainty and turbulence.
Due to political instability, transition is not a phenomenon that continues automatically once begun. Some authors go further and warn policy-makers that they will probably never get a second chance ‘to make a first impression’ (Peitsch, 1997). In any case, most of the researchers agree that one has to get out of the transitional state as quickly as possible.

The European Bank for Reconstruction and Development (EBRD) suggests that a formal criterion of the end of the transition period and the requirements of membership in the EU is similar: as soon as a country is accepted in EU, the transition period is over (“Transition Report 1997, Enterprise Performance and Growth”, 1997). Experts have tried to assess in how many years the various countries in transition in Central and Eastern Europe might reach the Western European level. The estimates range from at least twenty years to several decades.

The Bretton Woods institutions usually link the duration of catching-up with two sets of variables. The first set of variables is related to the transformation process and assumes that the faster-growing countries are those that were quickest to complete stabilisation and liberalisation (Fisher, Sahay and Vegh, 1996). The second set of variables is derived from standard neoclassical and endogenous growth models (investment ratio, government consumption in GDP, and human capital indicators) (Lavigne, 1999).

Using several such models, Fisher, Sahay and Vegh (1998) come to the conclusion that Central Eastern European countries would need on average 30 years to converge to the per capita income level of the three lowest income countries in the European Union, with annual rates of growth in the range of four and a half to six percent (assuming EU low-income countries would grow by an annual rate of three percent).

We must remember, however, that the slightest change in the assumptions would result in different quantitative calculations. According to Lavigne (1999), the duration of the transformation process is not yet clear.

Izak (1996) and Hoos (1996) believe that the transformation in Central and Eastern Europe will take many years, a decade at least, especially as the creation of different market institutions and rules is a time-consuming task. King (1997), who studied Latvian transition economy, came to the conclusion that transition also presumes radical changes to values and attitudes. Even with the help of business schools, values compatible with the market are likely to emerge gradually and slowly. Transition to the market is, therefore, a long lasting process that cannot be implemented in a spontaneous manner and might extend to a whole generation. Different scenarios, options and threats are possible during the long lasting transformation period. In this sense, transition may well never be over…

Due to the political instability that might remain during the long transition period, unpredictability of development with completely different possible outcomes for different undertaken scenarios seems to be an important feature of transition economies. According to OECD Advisory Group on Investments, for example, Western investors often describe political stability rather in terms of predictability of future development than in terms of democracy vs. authoritarianism (Assessing Investment Opportunities in Economies in Transition, 1993).
Thunell (1977) pointed out that “a country can have a bad investment climate for two reasons: either because of the policy itself, or because there is great uncertainty about the stability of that policy regardless of whether it is good or bad” (p. 5).

According to Baltic beverages holding company, a joint-venture between Hartwall (Finland) and Pripps (Sweden), which was created to manage and monitor operations in Eastern Europe, major problems include, among others, political instability (Rutihinda, 1996).

It is hard for me to conclude which strategy - shock therapy versus gradualism or incrementalism - should be recommended for implementation. On the one hand, history shows that transformation is an unstable state, which may last longer than expected or even revert back towards the former system, if rapid measures are not undertaken. On the other hand, transition period implies various components, phases, steps, directions that focus on different economic aspects and requesting differentiated instruments of economic policy. Besides, creation of institutions and rules, as well as the introduction of new values and attitudes, are time-consuming tasks.

General political instability and unpredictability of the development might be derived from the research discussions as the important characteristics of the transition period.

2.3.4. Other characteristics of transition economy

The literature on post-socialist reforms might give an impression that transformation is mainly influenced by economic liberalisation and stabilisation policy. In the short run, however, behavior has been much more influenced by the collapse of the institutional structures in which individuals and organisations used to operate (See Dewatripont and Roland, 1996; Swaan, 1997; Widmaier and Potratz, 1999).

In their book from 1973, North and Thomas (1973) concluded that by the early 19th century most of the institutions required to support the functions of a viable market economy were in place in Western Europe, notably the legal functions supporting the property rights system.

‘Institutions’ can be defined as ”symbolic and behavioral systems containing representational, constitutive, and normative rules together with regulatory mechanisms that define a common meaning system and give rise to distinctive actors and action routines” (Scott, 1994, p. 68). Institutions are founded on norms. By defining rules of behavior, institutions regulate the relationships among individuals, i.e. their rights and duties, and hence the costs and benefits of social action (Goglio, 1997; Mygind, 1997). Every treatment of institutions emphasises their contribution to stability in the society, continuity and predictability of social action (see Zucker 1988) while there is still disagreement among theorists about the mechanisms producing this stability.

Jepperson (1991) insists, for example, that the hallmark of an institution is its capacity for automatic maintenance, for self-restoration. Institutional mechanisms are those requiring no conscious mobilisation of will or effort. But others (DiMaggio, 1988) argue that the maintenance of institutions requires active effort.
By transition period Dallago (1997) means a situation where economic agents are no longer coordinated by old institutions and structures (e.g. central planning), while new coordination and some fundamental institutions (e.g. market ones) are not yet in place. According to Meyer (1996), the institutional constraints reduce the number of foreign investors in transition economies.

Shleifer (1997) argues that the economic difficulties of Russia’s last decade are explained in part by the failure to provide institutions that promote business growth and foreign investments. Due to the fact that market economy will emerge much more slowly in some countries than in the others, researchers that studied transition economy in Kyrgyzstan, for example, suggest that the Kyrgyz leadership should not move too quickly to dismantle the institutional structures of the command economy (See Garland, 1997).

To sum up, lack of institutional development (public infrastructure, banking system, etc.) can be pointed to as a representative feature of transition period.

The importance of well-elaborated legal rules, a common good allowing coordination of individual actions in the society, was stressed by many researchers involved in the analysis of transformation process (See Benini, 1997; Hoos, 1996).

Hart and Moore (1990) advanced a property rights theory assuming that ownership means control, and control is the ability to exclude others from use of an asset. The firm is seen as a set of property rights where ownership of non-human assets leads indirectly to control over human assets. Svensson (1998) constructed the country-level indices of property rights based on evaluations obtained from consultants to foreign investors. He found that this property-rights index significantly affects investment and growth.

Besley (1995) found a significant link between legal assurance of property rights and investment in Ghana. Lasserre and Probert (1998) who surveyed 294 West European and American managers employed by MNE in Asia Pacific region concluded that executives frequently complained about the apparently unreliable legal environment in Asia.

Murrell (1996) suggests that some serious obstacles in legal structures and law enforcement also remain in Central and Eastern Europe. A lack of legal rules, procedures and property rights guarantees might be suggested, therefore, as an important characteristic of transition economies.

According to some authors (see Dallago, 1997; Nuti, 1993, 1996), a situation of institutional vacuum can also explain the development of other pathological features of transition economy, particularly the existence of so called Mafia and corruption of the government agencies.

Corruption has been blamed for the failures of certain emerging markets to develop, and recent empirical research confirms a link between higher perceived corruption with lower level of investments and growth (Mauro, 1995) and, particularly, with ability to attract foreign investments (Wei, 1998). Mauro (1995) finds that a one standard-deviation improvement in corruption index elaborated by the author is associated with a 3% increase in a country’s investment/GDP ratio.
Lasserre and Probert (1998) who surveyed 294 West European and American managers employed by MNE in Asia Pacific region concluded that only in three of twelve investigated countries - Japan, Hong Kong and Singapore - is corruption not seen to be an important factor for foreign investors. Indonesia was pointed as the country with the most corruption, followed by India, Vietnam and Thailand.

Corruption in the government agencies as a pathological feature of the countries in transition was discussed by several researchers (Johnson, Kaufmann, McMillan and Woodruff, 1999; Meyer, 1996; Triesman, 1999).

The extortion by criminal gangs (or existence of the so called Mafia) is also viewed as one of the obstacles that post-communist transition economies face in attempting to build up the market economy and attracting the FDI (See Gustafson, 1999; Johnson, McMillan and Woodruff, 1999; Meyer, 1996; Zhuravskaya and Frye, 1998).

As research indicates, lack of institutional development with well developed public infrastructure, reliable banking system, etc., as well as lack of legislation regulating market, are the important characteristics of transition economy that destroy the credibility of the transformation process. Besides, corruption in the government agencies and existence of the Mafia in the local country might be suggested as other pathological features of transition economy.

2.3.5. Conclusions

This paragraph summarises the state of the art of present discussions and my own suggestions about meaning, timing, main components and features of transition economy which represent a pattern of uncertain and turbulent world.

Researchers believe that transition period is a ‘dual’, ‘mixed’ or ‘mutant’ system, in which many elements of the socialist and capitalist societies exist side by side. A concept of transition economy, however, seems to be more complicated than one can expect: different types (levels, sides) of transformation might exist depending on the specific characteristics of the former and the target systems. For the time being these economies are in the sense ‘non-planned, non-market’ economies because they carry both a specific inertia of the ruined but still operating former system and emerging basic institutions of financial markets. It might be suggested, therefore, that transition economy is characterised by uncertainties associated with the coexistence of an emerging market institutions with an old administrative system.

The following main components of transition period have been identified by several authors and include stabilisation, liberalisation and privatisation. Some researchers stress that not enough attention is paid to the fourth component of transition economies - reformation of government from the communist police state to an institution supporting a market economy. The consensus, however, has not been reached as to whether those components are necessarily present in all transition economies or if additional items, for example, educational reform, should be also included. More empirical studies and theoretical discussions are needed to answer these questions.
One of the most important uncertainties during transition is the speed of the process (shock therapy versus gradualism or incrementalism). Most of the authors prescribe that transition in post-socialist countries shall be implemented ‘as quickly as possible’ because an incremental approach does not seem capable of obtaining sufficient momentum to make the process self-motivating. The transition can proceed rapidly towards a market economy, but it also might slow down and perhaps even revert back to the old society’s economic relationships. General political instability, therefore, might be suggested as one of the characteristics of transition economies. The difference between Central and East European countries could be described on a scale of certainty and stability vs. uncertainty and turbulence.

It has been shown by some researchers that transition to the market is a long lasting process which cannot be implemented in a spontaneous manner and might extend to a whole generation. Different scenarios, options and threats are possible during the long transformation period.

Therefore, unpredictability of development with completely different possible outcomes for different scenarios seems to be an important feature of transition economies.

As research indicates, lack of institutional development with well developed public infrastructure, reliable banking system, etc., as well as lack of legislation regulating market are the important characteristics of transition economy that destroy the credibility of the transformation process. Besides, corruption in the government agencies and existence of the Mafia in the local country might be suggested as other pathological features of transition economy.

In summary, it can be hypothesised that one of the necessary preconditions for overcoming uncertainty of the transition period is the creation and establishment of an institutional framework which contributes to the structuring and organisation of the transformation process on both the micro- and the macro-level.

2.4. Transition economies in the global framework

2.4.1. Transition economies and the Third World countries

According to some researchers, the economic and political transformation of the former planned economies is unique in the sense that they have no identical cases in history (See Haavisto, 1997). Sometimes post-communist Central and Eastern European nations have been grouped together with other developing countries only to reach more general conclusions regarding differences of the environment in these countries from that of Western industrialized nations. Otherwise, authors stress the fundamental differences between developing countries and post-communist Eastern European nations.

Central and Eastern Europe has some major problems to deal with that either did not exist or were much less important in other developing countries. Fanelli and McMahon (1996) and Elenkov (1997) include to the list of such problems the general lack of institutions, the absence of an adequate legal framework, the massive scale of privatisation, the problem of commercial banks, and the enormous bad-loan problem.
Many developing countries are already accustomed to the functioning of a market economy, despite the numerous distortions they suffer. On the contrary, in the Central and Eastern Europe the market economy has to be built from the grassroots.

Klochkovsky and Semenov (1998) who analysed Latin American transition in comparison with Russian transition, came to the conclusion that Latin America changes within capitalism, whereas Russia changes totally its mode of production. The magnitude of the problem is much larger in Eastern Europe than in Latin America. According to some estimates, we need to privatised firms worth about 50 per cent of GDP in three to four years in Russia versus firms worth 10 per cent of GDP in eight to ten years in Latin America (Fanelli and McMahon, 1996, p. 5). Most Central and Eastern European countries are, therefore, on the same road as Latin America, just a few steps (or kilometers) behind.

Another group of authors who also recognize the fundamental differences between developing countries and transition economies gives more credit to the post-communist Eastern European nations. In particular, the former Eastern Block nations have a well-educated work force, qualified engineers with significant industrial experience, and developed industries that set them apart from most Third World countries (See Elenkov, 1997).

In the global world framework, transition might be also seen as a process similar to the transformation occurring in different geographical regions, countries, and industries. Analysts define emerging markets according to such characteristics as size, growth rate, or how recently they have opened up to the global economy. Although the scale of the reforms in transition economies of Central and Eastern Europe is unique, some researchers found substantial similarities, at least of a qualitative kind, to the systemic transformation being undertaken in other emerging markets (See Auroi, 1998; Buch and Heinrich, 1998).

The study of Sharma and Wallström-Pan (1997) based on the interviews conducted in the Swedish joint ventures (JVs) in China portrays the transition period as a dual system combining the logic of the Maoist era industrial governance systems with elements of market economy.

Therefore, the authors’ definition of transition economy does not differ from the statements of researchers who studied the transformation processes in other geographical regions.

Bogo (1998) claimed that most of the features of Chilean pre- and post-crisis period and privatisation process were represented in the Hungarian case. In spite of the differences in the initial conditions, Izak (1996) found the packages of reform measures have been very similar in Latin America and Eastern Europe, and almost identical in some areas. Both regions quickly move from state-directed, closed economies of varying degrees to market-based, open economies. The comparison and the possibilities of transferring experiences among the emerging markets seem, therefore, quite promising.

In summary, two alternatives can be drawn from the research discussions: the environment of transition economy might be seen as a unique phenomenon that requires special methods and knowledge; or it might be seen as a process similar to the systemic transformation being undertaken in other emerging markets (like China, Latin America, etc.) with, at least partly, comparable and transferable experiences and decision-making routines.
2.4.2. Transition economies and the Western countries

According to some authors, experiences gained these days in the post-socialist countries are also relevant for Western market economies. To start with, the historical experience of European markets that had emerged in 17-19 centuries can be used as a background to analyse the emerging markets of transition economies (See Goglio, 1997; Neal, 1997).

If we see transition as a transformation from protectionism to a more private liberal development model, the reforms occurred in the Central and Eastern Europe are relevant even to modern Western society. One of the most common references is telecommunications, which for decades has been a sector of national monopolies, massive state intervention and international cartelisation of national carriers. During the past ten to fifteen years, radical changes have occurred: deregulation and dissolution of national monopolies, internalization of competition on the basis of new mobile networks and the opening up of existing networks. According to Schenk (1997), this type of transition is a challenge to monopolized industries.

Besides telecommunications markets, there are several other markets that are being opened up: electricity markets and transport markets relying on railways are emerging in many countries. Such markets previously have been unreachable for companies other than monopolies or other protected firms. Nowadays they become reachable by deregulation initiatives or by political developments in general. (Pehrsson, 1999).

Lindbeck (1998) goes even further and expands the idea of market liberalisation to a particular country. He claims that Sweden may be viewed as a ‘mini-transition economy’. The period of transition started in Sweden in the late 1980s and early 1990s, one that includes deregulation of markets for capital and foreign exchange, intensified importance of private saving and private supply of capital, comprehensive tax reforms (with lower rates, a broader base and fewer asymmetries), a stricter budget process in the public sector, as well as some (modest) attempts to reform and rewind various welfare-state arrangements.

Indeed, there are essential differences between Swedish reforms and transformation process experienced by Central and Eastern European countries: while socialist countries have nationalised production firms, in Sweden the income and service production of households have been nationalised, or more accurately ‘communalised’.

Buckley (1996) analyses single markets like the European Union that emerge across identifiable regions. According to Buckley, the concept ‘Europe in transition’ probably has several levels: first, the emergence of a single EU market, and second, the transformation experienced by the Central and Eastern Europe. Yamin (1996) agrees that both East and West Europe are in a process of transition and face, in different ways, a fundamental and difficult set of transformations. Western Europe is grappling with the problems of fully integrating already functioning market economies, the problems arising from economic, political and institutional differences between member countries and from a deep-seated resistance to trading-off national for multi-national sovereignty. Eastern Europe’s problems are a mirror image of those encountered in Western Europe, namely, how to break up a regional ‘union’ or at least a political and economic block. What if the limited (in time and space) transition in Eastern Europe is but the prelude to a world-wide transition, or to the ‘big’ one, ‘the earthquake that rocks the system’, as Thurow (1996) puts it.
To conclude, if we see transition as a transformation from protectionism to a more private liberal development model, the reforms that occurred in Central and Eastern Europe can be compared with changes that occurred in Western societies. Therefore, it might be assumed that the acquired experience and elaborated decision-making methods gained these days for the environment of transition economies are relevant to those of the Western market economies.

2.4.3. Conclusions

In the fourth paragraph transition economy was placed in the global framework and was related to the environments of the Third World countries and the Western societies.

Some researchers believe that the economic and political transformation of the former planned economies is unique in the sense that they have no identical cases in history, especially due to the major problems that either do not exist or are much less important in other countries. Although the scale of the reforms in transition economies of Central and Eastern Europe might be unique, another group of authors found substantial similarities, at least of a qualitative kind, with the systemic transformation being undertaken in other emerging markets.

In summary, two alternatives can be drawn from the research discussions: the environment of transition economy might be seen as a unique phenomenon that requires special method and knowledge; or it might be seen as a process similar to the systemic transformation being undertaken in other emerging markets (like China, Latin America, etc.)

If we see transition as a transformation from a protectionism to a more private liberal development model, the reforms that occurred in Central and Eastern Europe are relevant even to modern Western society. One of the most common references is a challenge to monopolised industries (telecommunications, electricity markets, transport markets relying on railways, etc.).

The idea of market liberalisation can be expand further to a particular country (like Sweden); or transformation experience can be applied, for example, to the emergence of a single EU market.

Therefore, it might be assumed that the acquired experience and elaborated decision-making methods gained these days for the environment of transition economies are relevant (similar, comparable, etc.) to those of the Western market economies.

More comparative studies are needed in order to get an answer as to which of those assumptions about comparability of transition economy’s environment with Western economies is correct.
2.5. Conclusions for the chapter

The purpose of this chapter was to provide a theoretical framework for analysis of transition economies and to relate this category to other existing concepts.

It has been shown in the second paragraph that more studies examining managers’ perceptions and interpretations of different sources and dimensions of uncertainty in different countries are required due to the fact that environments become less controllable and foreseeable all over the world. Researchers also start to doubt the existence of universal models that suit all types of environment; therefore, future studies shall concentrate on particular cases of decision-making with specific uncertainties associated with different regions, countries, branches, companies, etc. The environment of transition economies represents a pattern of uncertain and turbulent environment of the modern world which, due to the short duration of transformation period, has not been carefully investigated.

‘Transition economy’ was defined in the third paragraph as ‘a mixed economy’, ‘a non-planned, non-market economy’, a ‘dual’ and ‘mutant’ system. The following main components of transition period have been identified by several authors and include stabilisation, liberalisation, privatisation and, possibly, reformation of government. Consensus has not yet been reached, however, as to whether these components are necessarily present in all transition economies, or if additional items, for example, educational reform, should be also included.

Due to the short duration of the transformation period, uncertainties associated with transition economies are not carefully investigated. The following characteristics of the environment of transition economy might however be suggested: uncertainties associated with coexistence of an emerging market and an old administrative system, and general political instability and unpredictability of development. Besides, lack of institutional development with well developed public infrastructure, reliable banking system, etc., lack of legal rules, procedures and property rights’ guarantee, corruption in the government agencies and existence of the Mafia in the local country can be pointed as other pathological features of transition economy. More theoretical and empirical studies examining transition economies’ characteristics, their influence on the decision-making as well as their perception by different economic actors are required.

In the fourth paragraph transition economy was placed in the global framework and related to the environments of Third World countries and Western societies. According to some researchers, the economic and political transformation of the former planned economies is unique in the sense that there are no identical cases in history.

In the global world framework, however, transition is often seen as transformation from state-protectionism to a more private liberal development model. This transformation occurs in different geographical regions, countries, and industries. Although the scale of the reforms in transition economies of Central and Eastern Europe is unique, some researchers found substantial similarities, at least of a qualitative kind, to the systemic transformation being undertaken in other emerging markets and Western societies.
Several alternatives can be drawn from the research discussions: the environment of transition economy might be seen as a unique phenomenon that requires special methods and knowledge; or it might be seen as a process similar to the systemic transformation being undertaken in other emerging markets (like China, Latin America, etc.) with, at least partly, comparable and transferable experiences and decision-making routines.

It might be also assumed that the acquired experience and elaborated decision-making methods gained these days for the environment of transition economies are relevant (similar, comparable, etc.) to those of the Western market economies. More comparative studies are needed in order to get an answer as to which of those assumptions about comparability of transition economy’s environment with Western economies is correct.

Even if we agree that transition leads to the market economy and define some specific uncertainties associated with transformation period, theoretical support for the reforms is less solid than it is often assumed to be. There have been attempts to include different levels and aspects of transition into the concept of transition economy which is, according to Davis (1997), neither clearly defined nor complete. More comparative studies are needed in order to understand the comparability of transition economy’s environment with other types of uncertain and turbulent environment. We probably have to admit that we simply do not have a consensus about the concept of transition economy, and that we do not know ”where we are coming from, where we are going to, or how we are getting there” (Clarke, 1996, p. 8).

In summary, assumptions and suggestions presented in this Chapter may be classified in the following 4 blocks that can serve as an analytical framework for analysing the concept of transition economy (see the schema below):

1. TRANSITION ECONOMY AS ‘NON-PLANNED, NON-MARKET ECONOMY’

2. MAIN COMPONENTS OF TRANSITION ECONOMY

- Stabilisation
- Liberalisation
- Privatisation
- Reformation of government
- Educational reform

Assumptions of neo-classical economic theory
Suggestions of some researchers
Figure 3. Transition economy: conceptual framework for analysis

*Source: Olga Golubeva (own)*
3. PROBLEM AND PURPOSE OF THE RESEARCH. RESEARCH QUESTIONS AND LIMITATIONS

"There is nothing so disastrous as a rational investment policy in an irrational world."
John Maynard Keynes

Cited from "The Executive’s Quotation Book", edited by James Charlton, Svenska Dagbladet, 1986

3.1. Introduction

In this chapter the research problem is going to be described and the purpose of the study will be formulated. The chapter starts with a presentation of the main types of decision-making models that are commonly identified in social science - the rational model, the bounded-rational model, the political model and the garbage can model - and discusses the possibilities of their application to the uncertain and turbulent environments.

The third paragraph is devoted to the investment environment of transition economies and describes the research problem. The existing theory and models of investment decision-making applied in the case of transition economies might be influenced and modified by the uncertain and turbulent environment of transition economy.

In the fourth paragraph the research purpose is formulated. The research questions are posed in the fifth paragraph. Research limitations concerning the choice of origin of an investor and a host country, type of investments, time longitude of empirical data collection, etc., are specified in the sixth paragraph. The last paragraph summarises the main ideas of the chapter.

3.2. Traditional FDI decision-making theory and models

3.2.1. Foreign investment decision-making theory

Decision-making is at the heart of management. Surprisingly, I have found that some authors believe that investment decisions as a general rule are easier to analyse than other decisions. Davis (1985), for example, writes:

“The goals are generally clearly defined (maximizing profits, minimizing costs); reliable information is often available (the size of potential markets, the effect of advertising on sales); and the causal relationship between what you do and what ultimately happens, is clearer” (p. vii).

The traditional theory commonly assumes that decisions are based on preferences (e.g., wants, needs, values, goals, interests, subjective utilities) and expectations about outcomes associated with different alternative actions where the best possible alternative (in terms of its consequences for a decision-maker’s preferences) is chosen.

One of the most fruitful developments in decision sciences has been the adoption of subjective probability judgements, where for any mutually exclusive set of outcomes the total of these subjective probabilities must add to 1.
To decide, in these terms, is to choose the alternative in terms of their possible outcomes, conditional on a particular choice by using available analytical tools and calculations.

However, the traditional definition seems to contain some problems:

1) Neither all alternatives nor all the consequences of any one of them can be known, especially if we are taking into consideration non-quantified factors;

2) The relationships between different factors (or concepts) that are commonly included in the traditional models can be more complicated than the process of linear consequential steps.

Foreign investment decision-making seems to be an even more sophisticated process. Foreign investments are usually motivated by a wider and more complicated set of strategic, behavioural, and economic considerations. The investigation process is often longer, more costly, and yields less information with which to evaluate opportunities. Financial evaluations of foreign investments using traditional discounted cash flow techniques are not relied on as heavily as they are in domestic investments because of greater perceived business, economical, political and social risks. Besides, the experience of decision-making in some foreign country or region of the world might not be helpful in the another investment environment. Foreign investment decision theory is, therefore, permanently challenged by appearance of new factors, circumstances, local conditions, historical periods, etc.

3.2.2. The main models of decision-making in social science

Many researchers have studied decision-making; different models describing the process have been suggested and, sometimes, tested. Four models of decision-making are commonly identified (see, for example, Buckley, 1998) in the modern social science theory:

- the rational model,
- the bounded-rational model,
- the political model,
- the garbage can model.

The rational model (i.e. the standard model of the natural sciences) assumes that decision-makers tend to search for all possible courses of action, to compare and to evaluate them and to choose the optimal solution.

This model represents the traditional view of how decisions are made (or rather supposed to be made). Common themes associated with this approach have been summarised by Mintzberg, Raisinghani and Theoret (1976) as involving a number of distinct routines or stages in the decision-making process. The classical model assumes that decision-makers have knowledge of all alternatives, the consequences of all alternatives, and a consistent preference-ordering and rule that allows one to choose among them.
The picture presented by the rational model is of active, alert decision-makers, aware of their objectives, accumulating relevant information and searching for knowledge about possible solutions, who then choose the best course of action which is then authorised and implemented. Decision-making becomes a sequential process which should lead to the best solution - namely action which optimises utilities. Undoubtedly some investment decisions conform to this rational model.

There are scholars who suggest that with increasing uncertainty the process moves away from the purely rational model (Buckley, 1998). An argument of the opponents is that the rational model saves time by selecting action alternatives that are most likely to produce success, which is of great importance in organisations that find themselves in rapidly changing and uncertain environments (Mintzberg and Ansoff, 1994). Brunsson and Olsen (1997) claim however that when people are requested to estimate consequences or probabilities, and to weigh consequences, they use a number of rules of thumb which are incomplete and, in fact, faulty. They conclude that "the rational model has far greater competitive power in the world of ideas than in the world of action" (p. 85).

A group of writers, for example Simon (1960), March and Simon (1956), Cyert and March (1963) and later Hrebinjak and Joyce (1994), pointed out divergences between the rational model and the way in which actual decisions are made in the real world. They have argued that the classical economic theory of rational decision-making does not adequately attend to the limited information-handling capacity of decision-makers. This led to the proposal of an alternative model, namely the bounded-rational approach or a theory of limited rationality.

‘Muddling through’ is Lindblom’s (1959) term which describes the opposite of the rational process of choosing the means that best satisfied goals that were previously clarified and ranked - rational-comprehensive decision-making, or ‘the root method’. A decision-maker following an alternative ‘branch method’ (successive limited comparisons) would expect to repeat endlessly the sequence of the rational process from the current situation, step-by-step and by small degrees, as conditions and aspirations changed and as accuracy of prediction improved.

This model emphasises the need for managers to make decisions with incomplete information, under time pressures and/or with possible disagreement over goals. Within these constraints, the optimal solution may not always be achieved and in this sense, rationality is bounded. The rational model seems to be more appropriate for the routine decision and the bounded-rational model for the non-routine. However, in the modern environment where change occurs on a daily basis, it seems that managers rather face unpredictable decision situations than routine ones.

The third model of decision-making is a political model that is based upon the idea that in any organisation there are many interested parties potentially competing for resources and attention. In the extreme case, it may mean that interests are opportunistically pursued - one person may deliberately set out to ensure that a decision is made in that person’s favour (See Butler, Hickson, Wilson and Axelsson, 1977). Hickson, Butler, Cray, Mallory and Wilson (1986) also describe decisions driven by personal interests, with biasing and suppression of various data designed to win power struggles.
People can find ideas and proposals valuable because they serve their own interests or hold some advantage for them in one or more respect (See also Boddewyn and Brewer, 1994; Brunsson and Olsen, 1997).

According to several scholars, the political process perspective model is the one that fits best the uncertain and turbulent environment. Björkman (1997), for example, hypothesises that "actors will be more likely to engage in political action in situations where the outcome of the political process is uncertain" (p. 346).

A challenging description of the way some decisions are made is given by the garbage can model associated with Cohen, March and Olsen (1972) and Cohen and March (1974). In this approach, events and decisions are not at all systematic. Organised anarchy and ambiguity is a far better description. An important feature of the garbage can model is that the decision process is not a sequence of steps beginning with a problem and ending with a solution. Problems, solutions, participants and choices flow through the organisation, which acts as a garbage can in which these streams are jumbled and stirred with the possibility of reconnecting.

The organisation then consists of "a collection of choices looking for problems, issues and feelings looking for decision situations in which they might be aired, solutions looking for issues to which they might be the answer, and decision-makers looking for work" (Cohen, March and Olsen, 1972, p. 2).

Despite criticisms of the rational model, it is the one that supplies managers with practical instruments and solutions for the decision-making on a daily basis. Therefore, in most of the situations the environment is seen as a pool of information and resources. Companies and decision-makers are, respectively, portrayed as unitary rational actors. There is an obvious danger to exaggerate the importance of the rational approach, or to use it in the wrong context.

Besides, these models are not mutually exclusive and the boarders between these approaches are not well defined. Some views of decision-making may be more amenable to modeling than others. Some views of decision-making may be beyond the bounds of a traditional consistent model - for example, an utterly anarchic approach. Of course, anarchy is not the key characteristic of most business decisions - but is rationality?

We must be also careful not to become so enamored of theories of limited rationality that we propose ‘theories of non-rationality’ for all decision-making situations (See Hrebiniak and Joyce, 1994). ”Companies relying on random decisions clearly will find themselves in danger”, warns Pehrsson. (1999, p. 35).

Another problem is that economists possess a variety of well-elaborated analytical tools to deal with markets from a static and rational perspective (See Brezinski and Fritsch, 1997). However, our knowledge concerning market dynamics and rapidly changing environments is still rather deficient. We still do not know very much about how markets emerge, how they mature and in what way their evolution influences a particular company’s decision-making. Which model describes most accurately the decision-making in the rapidly changing uncertain environment is a question still open for future debates.
3.3. Decision-making in transition economies

The future is basically unpredictable. Who, for example, predicted the collapse of communism in the Eastern Europe and the turmoil in the Soviet Union in 1990? Hollis (1997) writes, for example:

"The 1980s ended with the collapse of communist regimes throughout Eastern Europe. It has become hard to remember how impossible that had seemed. One great certainty of the world since 1945 was that communist and capitalist systems were both here to stay, with the Soviet Union and America as the two poles of a permanently bi-polar international order." (p. 1)

The change in the environment of a western economy is usually slow and can be reasonably forecasted by extrapolating existing patterns and by assessing the probabilities of the possible outcomes. Traditional evaluation methods and investment criteria can be applied to the case of the developed market economies. (The correctness of such forecasts can be also questioned, but at the moment I am leaving this problem outside the framework of this discussion.)

When standard economic policy is pursued in non-standard situations, problems usually arise. Researchers stress that the environment of transition economies of former socialist states represent a special type of capitalism with higher investment uncertainties than the Western societies, owing to political as well as socio-economic problems (See Elenkov, 1997; Johnson, McMillan and Woodruff, 1999; Nasierowski, 1996; Nieminen and Törnroos, 1997; Raagmaa, 1997). Identifying, analysing and explaining the changing conditions for the application of economic theories in the course of the transformation process can be an interesting field of investigation.

The transition economies are characterised by a rapidly changing environment often in an unexpected way. Clarke (1996) stresses that economists are unable to understand, or even to identify, changes occurring in transition economies because they are not changes that they had anticipated. The future in transition economies will be radically different from the past. The only thing that is certain is uncertainty itself. Two different scenarios of the economic development will probably lead to mutually exclusive outcomes. Even if the decision-maker has some possible outcomes of the development and their associated probabilities, he can not use them in the long run.

It is also suggested that a totally different approaches to developing business in Central and Eastern Europe is needed, especially when compared with market economies. "The optimal way to run a business in the West is not necessarily optimal in Russia", - writes Fey (1995, p. 50).

Research problems often emanate from currently emerging new economic, social and political issues and trends (See Merriam, 1998). Some authors question the applicability of theories in business administration to the uncertain and turbulent environment, particularly in the case of transition economies. Current ideas and knowledge about decision-making, as well as managers’ perception of the environment, are challenged by markets that emerge as a result of deregulations and the opening for competition in general (Pehrsson, 1999), and by transition economies in particular (Nasierowski, 1996).
The existing theory of foreign investment decision-making applied in the case of transition economies would probably be influenced and modified substantially by the main characteristics of the environment of transition economy suggested in the previous chapter. Transition economies then offer the opportunity to apply existing paradigms to uncertain and rapidly changing environments and to study the interaction of the specific transition environment with traditional theory of FDI decision-making.

Due to the short duration of political and economic reforms in Central and Eastern Europe, there is, however, a lack of both theoretical investigations and empirical studies. The question - if the usual techniques for investment decision and risk assessment do meet the requirements of the investor in transition economies - has not been answered yet in theory.

It seems that companies are not ready with the final answer to this question either.

AssiDomaen AB, a Swedish forestry company, conducted an investment into a controlling 57 per cent stake in a Russian company Segezhabumprom, also known as Segezha Pulp & Paper. At the beginning of 1998 AssiDomaen’s executives informed the market that they took a charge for pulling out its investment to Russia. A charge of 549 million Swedish kronor was directly booked by AssiDomaen to cover losses (Bloomberg news database, January 5 and February 12, 1998).

AssiDomaen’s withdrawal at Segezha is considered to be one of the biggest investment failures conducted by Swedish companies in transition economies. Why did it happen?

It was highly unlikely then to expect that another big Western corporation would soon invest directly into the Russian paper sector. Surprisingly, in just half of a year, a Swedish group, SCA, announced the purchase of 85 per cent of Russian printing paper maker Svetogorsk from Tetra-Laval, the Swedish-Swiss concern, for 200 million Swedish kronor. SCA has acquired the assets at only US$ 260 per tone of capacity while most of the Western paper companies are traded at US$ 1,200 per tone of capacity (Fleming UCB Research, July 1, 1998). Why did SCA conduct FDI in Russia and how did management explain the decision? No comments from financial analysts were available at the time of acquisition concerning evaluation of the investment project.

"Investment decision in transition economy is as simple as a list of paper where the resolution of the Board of Directors to proceed is presented... The question is what factors and variables had predetermined this decision", a top decision-maker from Sweden once told me. (1)

New methods of doing business and new concepts of flexibility are probably required from companies in the rapidly changing environment of emerging markets.

(1) Interviews conducted in Swedish and Russian were translated to English by the author. Every effort was made to translate words and ideas so as to fully preserve their intended meaning. The author takes full responsibility for any misinterpretation or misunderstanding stemming from these translations.
It might be exciting to investigate why and how companies make investment decisions in transition economies as well as to challenge traditional foreign investment decision-making theory with the new empirical phenomena.

3.4. Research purpose

This paper is about foreign investment decision-making in transition - a transition that has been going on for more than ten years. The approach to transition economies, therefore, starts to change: we know increasingly more about them than at the beginning of reforms. One of the objectives of my paper then is to use the research experience and practical lessons drawn from the first ten years of transition towards a market economy.

On the other side, the transformation period is recent and still underway. Today we can speak about the first (and definitely not sufficient) experience of investment decision-making in transition economies rather than well established forms and elaborated strategies of Western companies in Central and Eastern Europe. It takes time to build theories, elaborate models, and conduct empirical studies. Inevitable, some of the phenomena under scrutiny have as yet been subject to a limited amount of analysis.

Many studies, especially those based on neo-classical economic theory, focused on macro-economic framework conditions of transition economies such as stabilisation, liberalisation and privatisation of enterprises. Emphasis was put on the right sequence and pace of the process, since a more or less linear ‘transition’ from a socialist planned economy to a market economy was assumed. As it was shown by some researchers, stabilisation did not simultaneously mean transformation (Widmaier and Potratz, 1999).

It is most probable that a macro-economic program will not be realised if companies are unable to implement them.

Therefore, in the present state of transformation there seems to be a general tendency which is driving research to shift the focus of attention from macroeconomic issues to a greater concern with the transformation processes on industry and enterprise level. Attention has shifted away from broad assessments of the macro-economic situation towards micro-economic investigation based upon detailed case studies of companies and entrepreneurs, sectors and countries (See Meyer, 1996).

While early scholars started with description of different phenomena in transition economies, present research has started to move to the analysis of more specific issues. Until recent times, the substantial part of papers dedicated to the ‘real life’ of enterprises in Central and Eastern European economy, or ”matching of theory against data” (Strauss and Corbin, 1994, p. 273), was often based on the consultancy principles rather than research objectives.

At the same time, even if the number of researchers dedicated to transition economies grows, we still can not predict the consequences of the transformation process. During all transition periods our ability to explain the present situation and foresee the future trends did not improve at the same speed that changes occurred.
In order to understand transition economy, we might need to search for alternative or supplementary explanations and see the phenomena in a broader socio-cultural context (See also Lavigne, 1999; Liuhto, 1997; Schopflin, 1997).

*The purpose of this project is to describe and explain the foreign investment decision process in the uncertain and turbulent environment of transition economy.*

By getting an in-depth understanding of how decision-making works for companies in the environment of transition economy, the study intends to contribute to the development of the theory of business administration in the area of foreign investment decision-making, particularly its application to the turbulent and uncertain world.

There is also a practical purpose that I bear in mind: the usefulness of the model sometimes is more important than its theoretical coherence (See Elfring, Jensen and Money, 1996). Czarniawska-Joerges (1995) pointed out that “practitioners are educated enough to understand what we write; they rarely read us because they do not find our texts interesting” (p. 22).

The ambitions of the project are far from providing advice for policy-makers or formulating guidelines for companies. If practitioners would find valuable some parts of my analysis for their particular cases, or if they would get some new ideas in the field of decision-making, the ‘pragmatic’ purpose of my paper will be fulfilled.

Besides, if the aim of a researcher is to describe and analyse a new phenomenon, then Central and Eastern Europe presents an ideal opportunity. It is precisely this unexpected nature of transition that makes its study so challenging.

3.5. Research questions

Any investment project is heavily dependent on the environment, including not just customers and competitors but also the legal structure and its implementation, various government authorities, availability of reliable subcontractors, etc.

*Do the uncertainty and unpredictability of transition period described in the second chapter influence FDI decision-making? Do other features of transition economies modify the investment decision process? And how unique is, then, the environment of transition economies in comparison with other emerging markets and even Western societies?*

Another question is *why companies invest in Central and Eastern Europe?* What motivates them to take extraordinary risks of operations in the uncertain and turbulent environment? While Karl Marx (1845/1976) viewed the interpretation of history and the changing of history as opposites, it is possible that the two processes are closely related. The research paper might help not only to understand why certain firms choose to invest in the region, but also why many others did not invest, and, hence, provide some guidance for policy makers of how to change the situation.
What investment decision criteria are used by managers? Do they rely upon the properly done capital budgeting calculations, collected information and carefully chosen risk reduction measures? Or have they discovered an alternative investment decision criterion, which is more appropriate for the environment of transition economy than traditional analytical instruments?

The success of an investment project in a turbulent economy probably is based on entirely different concepts than in a stable economy. How does the decision-making process look in the case of dramatic permanent change? Can a decision to build a factory in transition economy be explained by a rational or a political model?

Probably, the decision-making process will look rather like total chaos than a normative process, some sort of ‘garbage can’ guided by intuition of decision-makers.

It is necessary to mention that the aim of the project is rather to generate than to test hypotheses. Therefore, the sort of normative conclusions that can be drawn from the study are not ‘how shall we proceed’ but rather ‘what shall we consider’.

3.6. Research limitations

Previous studies show that companies based in continental Europe develop their investment strategies in transition economies on an individual country basis (‘country specific’ approach) while US multinationals and UK investors develop a regional strategy, in some cases viewing transition economies as part of a ‘greater’ Europe (“Assessing Investment Opportunities in Economies in Transition”, 1994). I chose to study investments conducted in Russia and the Baltic countries. Actually, it can be interesting to analyse different Central and Eastern European countries that appeared to be in the various steps of the transformation process. However, in order to challenge such a project, a team of researchers from different countries and sufficient finance are required.

My choice of Russia and the Baltic countries can be explained by my personal interest in and knowledge of the north-western part of the former Soviet Union as well as by the importance of this region in the neighborhood of Sweden. Besides, even if most of the outlined disturbances are common to all countries in transition, they acquire a special relevance in the case of Russia. Russia had experienced a much higher degree of the burden of the Soviet legacy, which was not present in other Eastern European economies due to historical reasons (see, for example, Benini, 1997). Therefore, the ‘extreme case’ is present in the study.

One of the directions to investigate FDI decision-making in transition economies is to analyse and compare the investment behaviour of foreign investors from different countries. According to Hausner, Jessop, Nielsen:

“various Western ‘models’ seem to offer different solutions to the problems of a post-socialist future. Germany’s ‘social market economy’, Britain’s neo-liberal ‘Thatcherism’, ‘the Third Italy’, and the Scandinavian model (‘the negotiated economy’) are among those most frequently referred to in current reform discourses in Eastern Europe”. (1993, p. 4).
When Western investors look for investment opportunities in Central and Eastern Europe, different investment strategies and investment criteria may develop that are similar to those they have already exploited back home. A study of 229 German and British firms (with response rate of 39.3 per cent) performed by Meyer (1996) shows, for example, that not only are German are more active in transition economies than British firms, but that that the region is also more important for them (p. 163). The comparative study of different foreign investors is outside the framework of the research project.

I limit my research to investments made by the Swedish companies that due to the historical contacts and geographical closeness have always been active in the north-western part of the former Soviet Union. Sweden belongs to the ten leading countries with highest volumes of cumulative investments into the Russian economy (See Supplement 1).

Sweden is also the second biggest investor after Finland in Estonia, accounting for 23.9 per cent of the total investments, as well as one of the major players both in Lithuania and Latvia ("Estonia. Latvia. Lithuania. 4th quarter 1996"); "Estonia. Latvia. Lithuania. Country profile. 1996-1997").

It is also possible that decision-making is guided by different factors for foreign and local companies as well, as they might have different risk perception. The empirical study searching for the most important factors influencing local firms’ investment decisions in Estonia done by Vensel (1996) shows the very small importance of regulatory environment variables and scale variables for financial and investment decisions of local firms. The most significant factor influencing investment decision of local firms was the lack of finance (limited availability of loans, necessity of collateral in obtaining credits, etc.).

In my project, the investment decision process is described from the point of view of foreign companies exploring the transition economies and the question of the local firms’ perceptions is touched only when it is relevant to the main purpose of the research.

Individuals and public and private organisations might differ sufficiently when it comes to decision-making routines. There are probably differences between evaluation of projects done from the perspective of a company or society in general. Jansson (1992) points out that a company’s decision to move a factory to a developing country will be evaluated by the regional authorities with respect to employment possibilities for the local population rather than profitability criteria.

Small companies might also have unique investment decision criteria that are not used by bigger companies. For the moment I am leaving these cases outside my study and I will concentrate on the big stockholding companies where the decision-making is governed (or at least supposed to be governed) by organisational routines and principles.

It is also possible that financial and direct investments are determined by different factors and variables. My study will be limited to the main types of direct investments, i.e.:

- establishing of a joint venture;
- building a new plant;
- establishing of a representative company owned by investing company;
- an acquisition of a foreign company.
Financial investments as well as other issues will be dealt with only in connection with direct investments.

As most investments in Central and Eastern Europe have been made recently, it is hard to evaluate them. Different researchers proved that post-investment calculations done after the project had been launched only sometimes confirmed the results of pre-project calculations (See, for example, Segelod, 1986; Jansson, 1992).

A study of 189 large investment projects in Sweden done by Segelod (1986) shows that these projects in general resulted in 60 per cent higher costs than was calculated from the beginning due to the changes in the project’s design or in future prices, and because some sort of costs were not included in the calculations.

Due to the short historical horizons of the reforms and lack of the empirical data I do not intend to study the formal implementations of investment decision and conduct post evaluations.

It should be remembered that transition is a dynamic ongoing process. Neither of the processes of change, either in Eastern Europe or in other emerging markets, has really come to an end. Much of the argument is open to further development. All that I can do is to present a few snapshots of the situation at selected points of time during that process.

With the research issues being longitudinal in nature, where the transition economies’ environment have been changing rapidly and can be expected to continue to change in future, it might be a good idea to follow the development of companies over a period of some years. This could provide us with a chance to observe the impact of the environmental changes on the foreign investment decision-making in a particular company on the different steps of the transition period.

The time for the empirical investigation in my study is, however, limited to the period 1997 – 1998, with partial updating of cases during the year 2000.

3.7. Summary of the chapter

Four main types of decision-making models are commonly identified in social science - the rational model, the bounded-rational model, the political model and the garbage can model. Which model describes most accurately the decision-making in the rapidly changing uncertain environment is a question open for future debates.

Current ideas and knowledge about decision-making as well as managers’ perception of the environment are challenged by markets that emerge as a result of deregulations and opening for competition in general, and by transition economies in particular. Researchers stress that the investment environment of transition economies of former socialist states represent a special type of capitalism which is much more unstable than Western societies owing to political as well as socio-economic instability. The problem is that economists are unable to understand, or even to identify, changes that occurred in transition economies because those changes had not been anticipated.
In the present state of transformation there seems to be a general tendency which is driving research to shift the focus of attention from macroeconomic issues towards microeconomic investigation based upon detailed case studies of companies and entrepreneurs, sectors and countries.

The purpose of this project is to describe and explain the foreign investment decision process in the uncertain and turbulent environment of transition economy.

By getting an in-depth understanding of how decision-making works for the environment of transition economy in practice, the study intends to contribute to the development of the theory of foreign investment decision-making, particularly its application to the turbulent and uncertain world.

Several questions are posed in the study. Do the uncertainty and unpredictability of transition period described in the second chapter influence FDI decision-making? Why do companies invest in Central and Eastern Europe? What investment decision criteria are used by managers? How does the decision-making process look in transition economies and which of the social science models is more suitable to describe it?

The aim of the project is rather to generate than to test hypotheses. Therefore, the sort of normative conclusions that can be drawn from the study are not ‘how shall we proceed’ but rather ‘what shall we consider’.

The research is limited to direct investments done by the big stockholding Swedish companies to Russia and the Baltic countries. Due to the short historical horizons of the reforms and lack of the empirical data, I have no intention to study the formal implementations of investment decision and conduct post evaluations. The time for the empirical investigation in the study is limited to the period 1997 - 1998 with partial updating of the cases during the year 2000.
4. METHOD

"The great tragedy of Science - the slaying of a beautiful hypothesis by an ugly fact."

Thomas Henry Huxley (1825-1895), ‘Biogenesis and Abiogenesis’, 1870


4.1. Introduction

Many researchers stress that the problem of developing methods appropriate to the nature of the phenomena to be studied remains one of the most pressing issues within the whole realm of social science (Burrell and Morgan, 1982). The aim of this chapter is to present a method elaborated for the study.

The chapter starts with a general description of the paper’s research design, which includes both deductive and inductive steps. The third paragraph is devoted to the data collection methods: case study as a research strategy, formal survey conducted for the study, and other data collection methods. In the forth paragraph the question of access, both to chosen companies and the individuals involved in the foreign investment decision-making, is raised. How pre-understanding, which combines both theoretical knowledge and empirical specific considerations with attitude and life experience, might influence the study is discussed in the fifth paragraph.

The sixth paragraph presents methods of analysis and interpretation. First, the paragraph presents theoretical sources that might be relevant for the study. Different schools and approaches to analyse transition economies are suggested, and the question of the relevance of studies from other emerging markets to the investment environment of transition economy is raised. Methodological assumptions that help to position the study among the main philosophical schools of social science are presented afterwards. The possibility of generalisation from the results of a limited number of cases, reliability and validity of the research as criteria of science, and qualitative vs. quantitative methods applied in the study are also discussed.

The question of ambiguity of method is raised in the seventh paragraph. The last paragraph summarises the main statements of the chapter.

4.2. Research design

The approach adopted in this thesis seeks to describe what actually happens - its findings shall be derived from ‘real life’ data; in other words, it is inductively based. Glaser and Strauss suggest that theories and models should be grounded in actual empirical observations rather than be governed by the established, traditional approaches (See Glaser and Strauss, 1967; Strauss and Glaser, 1970; Glaser, 1978). An inductive method based on research findings derived from empirical evidence and data seems to be appropriate for the project due to the lack of existing theory that can adequately explain the environment of transition economy.
In contrast to deductive researchers who "hope to find data to match a theory, inductive researchers hope to find a theory that explains their data" (Goetz and LeCompte, 1984, p. 4).

As Schwandt (1993) states, however, "atheoretical research is impossible" (p. 7). Becker (1993) also points out that "if we didn’t have at least an implicit theory of knowledge; we wouldn’t know what to do first" (p. 221).

Therefore, this thesis is designed to start with a deductive search for the main factors relevant to the purpose of the research, i.e., to describe and explain how the companies make foreign investment decisions in transition economy. Initially, the model is based on literature study, including consideration of general foreign decision-making theory and the particular investment environment of transition economy. The concepts constitute a model that later on shall provide a framework for the empirical investigation as well as make perception of descriptive empirical data theory-laden. The empirical results and findings shall be analyzed and related to theoretical arguments. Theory, therefore, "allows seeing what we would otherwise miss; it helps us anticipate and make sense of events" (Thornton, 1993, p. 68).

The research design includes, therefore, both deductive and inductive steps. The first step is to identify the main factors (concepts, variables) of the model which capture the most important features of investment decision process in transition economy. The second step is to conduct an empirical study (based on the logic of the factors of the model) of how companies make foreign investment decisions in transition economies.

By doing empirical investigations, we can get an in-depth understanding of how investment decision-making applied to the particular case of transition economy is working. We might confirm, disprove or adjust the concepts of the suggested model according to the demands of reality. New factors might be discovered and will appear in the decision model.

In this study, there are two stages of analysis - the within case-analysis and the cross-case analysis. For the within-case analysis, each case is first presented as a comprehensive case in and of itself. On the second step, an attempt is made to see processes and outcomes that occur across cases, "to understand how they are qualified by local conditions, and thus develop more sophisticated descriptions and more powerful explanations" (Miles and Huberman, 1994, p. 172). Simply summarising the two cases superficially across main concepts or variables by itself will tell us little. The intention is to look carefully at the complex configuration of processes within each case and understand the local dynamics before we can begin to see patterns of variables that transcends both cases. New research problems and questions will probably emerge during the investigation.

Formally, the study’s design with two consequential steps can be structured in the following way:
4.3. Data collection methods

As it is uncertain whether theories predicated upon data collected in stable markets are valid for turbulent Eastern European markets, this research is exploratory in nature. Therefore, theory-building, rather than theory-testing, research methods are more appropriate.

4.3.1. Case study as a research strategy

The word ‘case’ comes from the Latin *casus*, meaning ‘occurrence’. Social scientists use the term ‘case study’ to point to the unit of study - the case as an integrated system, the case as a specific, complex, functioning thing (Miles and Huberman, 1994; Stake, 1995). Researchers also see case study as ”an end-product of field-oriented research”, a holistic description rather than a strategy or method (Wolcott, 1992, p. 36).

Figure 4. Research design with two consequential steps: deductive and inductive

*Source: Olga Golubeva (own)*
Each of the suggestions reveals something about case studies and contributes to a general understanding of the nature of case studies. In summary, the qualitative case study can be defined in terms of the process of actually carrying out the investigation, the unit of analysis (the bounded system, the case), or the end product. As the product of an investigation, a case study is “an intensive, holistic description and analysis of a single entity, phenomenon, or social unit” (Merriam, 1998, p. 34).

This method is often used while a researcher is seeking categorical rather than numerical responses. As Yin (1988) pointed out “case studies are the preferred strategy when ‘how’ or ‘why’ questions are being posed, when the investigator has little control over events, and when the focus is on a contemporary phenomenon within some real-life context” (p. 13).

Some authors even tie the essence of a case study with decision-making problems, pointing out that the central tendency among all types of case study is to illuminate a decision or set of decisions: why they were taken, how they were implemented, and with what result (See, for example, Schramm, 1971).

Besides, the Advisory Group on Investments, established in September 1992 under the umbrella of OECD, decided to pursue in particular a case study approach in order to develop concrete advice on policy-making and policy implementation in transition economies (“Assessing Investment Opportunities in Economies in Transition”, 1994).

In this context a case study method seems to be appropriate strategy for my research - to investigate ‘how’ and ‘why’ Swedish companies make foreign direct investment decisions in transition economies. A case study design is going to be employed to gain an in-depth understanding of the situation with decision-making in transition economies. The research interest is in “process” rather than outcomes, in context rather than the specific variables, in discovery rather than confirmation.

The research topic is complex and probably inter-disciplinary in nature. There is a strong possibility that decisions about direct investments are inseparably interconnected with a company’s other strategic considerations: future customers, suppliers, competitors, and shareholders. There are arguments in favour of studying investment decisions in their context (Aharoni, 1966; Pettigrew, 1985).

Therefore, case studies in the paper shall be presented inside the broader aspects of the development of social, political and economic systems. According to some researchers, to present a company’s decision-making experience in transition economies in isolation from those wide macro-economic trends is “to depict it as the victim of changes unfolding outside its control” (Clarke, 1996, p. 5).

4.3.2. A formal survey as a part of research strategy

As a part of case studies, a formal survey was conducted where qualitative (informal) interviews with decision-makers were followed by a structured interview questionnaire.

According to Patton (1990), the purpose of interviewing is “to allow us to enter into the other person’s perspective” (p. 196).
Interviewing was used in the study in order to get insights into the past events where only few selective decision-makers were participating. Interviewing was, therefore, the only way to get data. In this type of research the crucial factor is not the number of respondents but the potential of each decision-maker to contribute to the development of understanding the phenomenon.

**Twenty six top decision-makers participated in qualitative (informal) interviews.** Informal interviews and open-ended type of questions seem to be more appropriate to study the influence of transition economy on the investment decision-making than a set of already defined alternatives and suggestions. In general, an interview was conducted for about an hour and had a focused character due to time limitations.

After qualitative (informal) interviews, managers were asked to fill in a structured interview questionnaire for the following purposes:

- it seemed an appropriate technique for collecting detailed case study information from a small number of cases;
- the structured interview method enabled comparative data to be obtained (at least, to some extent) through the use of standard questions.

**Twenty five managers filled in the questionnaire**, choosing either to do it direct after the qualitative (informal) interview, or to find a more suitable time and return it to me by post. One top executive from Ericsson informed me via secretary that he was unable to complete the questionnaire due to a lack of time.

The questionnaire for the key decision-makers from the Swedish companies, consisting of twenty two mainly open-ended questions, was elaborated and discussed with both researchers and decision-makers (See Supplement 2). The questionnaire went through several stages of development before reaching the final form and was reviewed by a number of researchers, as well as a few managers and consultants.

The questionnaire is based on the concepts that will be discussed in the fifth, theoretical part of the study, and is designed to search for different factors influencing investment decision process in transition economies. The theoretical framework of the study then also determines what we did not see and did not ask.

The combination of elements of structured and unstructured questions allowed me both to obtain some standardised information and to get fresh insights and receive unexpected information.

The purpose of the interviews and questionnaire was to define variables and the relationships between them rather than to seek numerical responses. Participants were instructed that there were no right or wrong answers, but that their opinions mattered. However, quantitative measurement of some variables was required (like the degree of influence of each variable on their decision-making, etc.).

By conducting personal interviews it was possible to overcome any suspicions managers might have had about the motives for obtaining information about investment decision-making.
Additional inquiries, responses to question number two of the questionnaire and verification of some unclear data, were made via telephone.

4.3.3. Other data collection methods

While someone is conducting interviews with top decision-makers, it seems logical to start collecting as much information as possible via other available sources: documents, archival records, video tapes, etc., to save the managers valuable time.

My search of the database of Stockholm University, Bloomberg and Reuters financial and economic data system, Internet, company’s reports, other published materials, photographs and even video films provided the background for case studies. Quantity of information is no guarantee of comprehensiveness, but it is a good start. That search also allowed me to concentrate during interviews on data that were not possible to acquire in any other way than personal communication as well as to verify the previously collected multiple data.

While using previous studies and banks of information, we rely on someone else’s description and interpretation of data rather than use the raw data as a basis for analysis. These ‘meta-analyses’, as they are sometimes called, are common in quantitative research, although there has been some recent thinking as to how this strategy might apply to qualitative studies (West and Oldfather, 1995).

Observation offers a firsthand account of the situation under study and, when combined with interviewing and document analysis, allows for a holistic interpretation of the phenomenon being investigated. Direct observations of a few meetings and working environment in the selected companies were done to the extent permitted by management and with full respect of the confidential nature of the issues.

The method I chose for data collection - combination of case study, personal interviews and telephone conversations with study of documents, newspaper articles and observations - is quite common for studying the environment of transition economies (See, for example, Lehtinen, 1993).

4.4. Access to companies and decision-makers

Besides access to money in order to finance the project, the concept of access often distinguishes between access to the system (e.g. information about the company) and access to individuals in the system (see, for example, Brown, Guillet de Monthoux and McCullough, 1976).

4.4.1. Selection of cases

Two cases have been selected for the research project: Ericsson’s direct investments in Russia and Vattenfall’s direct investments in the Baltic countries.

According to Merriam (1998), sample selection in qualitative research is usually non-random and small, as opposed to the larger, more random sampling of quantitative research.
The most appropriate sampling strategy for qualitative research is non-probabilistic, which Patton (1990) terms “purposeful.” The logic of purposeful sampling lies in selecting information-rich cases from which one can learn a great deal about issues of central importance to the purpose of the research. LeCompte, Preissle and Tesch (1993) prefer the term criterion-based selection to the term purposeful sampling. In criterion-based selection one creates a list of the attributes essential to one’s study and then proceeds to find or locate a unit matching the list.

Meyer (1996) noticed that many authors who conducted empirical studies of Western companies in transition economies are vague about the method of selection of their sample firms which may, but need not, have major implications for the validity of results.

The selection of cases was done according to the following criteria:

To start with, cases have been selected in view of the research objectives - to describe and explain foreign investment decision process in transition economies. Studies in financial economists and policy advisors’ papers would preferably be based on a broad sample to explain the aggregate trends of FDI flows in transition economies. In my project, however, the aim is to generate rather than to test hypotheses.

Second, cases were selected in accordance with the limitations formulated in the third chapter. Therefore, the choice was reduced to the big stockholding Swedish companies that conducted direct investments in Russia and the Baltic countries.

Third, both Ericsson (telecommunication branch) and Vattenfall (energy branch) belong to so called ‘emerging’ industries that have been recently exposed to a deregulation process and, hence, face the ‘double’ transition dilemma.

As it was stressed by Barius (1987), the process of investment decision-making often have a confidential character. When I started to phone different companies in order to choose the cases for the paper, I found that the subject of foreign investment decision-making, and particularly the experience of the new emerging markets in Eastern Europe, is an important strategic issue that companies are not eager to discuss with outsiders.

One of the major reasons for choosing Ericsson and Vattenfall for my final cases was the willingness of management to provide me with necessary information.

It is interesting to notice that some quantitative researchers who performed regression analysis for transition economies were forced to use selection criteria based on the availability of respondents instead of random sampling.

The choice of respondents in the sample in the study conducted by Zhuravskaya (1999) depended, for example, on the personal ties of the deputy director of the LRC (League of Russian Cities), a former mayor of Kaliningrad, with the mayors of other cities. "Without these personal ties, it would have been impossible to schedule interviews and convince the city-administrations to fill in the questionnaires. However, I do not have reasons to believe the choice of the cities would systematically affect the findings”, writes Zhuravskaya (p. 17).
It seems that qualitative and quantitative methods of selection of cases for research about transition economy have more in common than we might believe.

4.4.2. Access to companies

Two Conferences that I attended helped me to gain access to the companies. The first one - “Development and Financing Commercial Opportunities in the CIS Energy Sector” in Vienna on 24-27 of June 1997 where Gunnar Wickström, Project Director of “Vattenfall AB International” presented Vattenfall’s activities in the Baltic Sea Region. Later in Stockholm we met for the formal interview and he also recommended me to the other people involved in investment projects in Baltic countries.

During ”The Information Technology Seminar on Nordic and Russian Equities” in Stockholm in September 1997, Yngve Redling, former President of Ericsson in Russia, presented the company’s activities and direct investments in Russia. He also advised me whom should I meet among the decision-makers for the interviews.

A letter of recommendation from School of Business of Stockholm University that I submitted to Ericsson and Vattenfall (which explained the purpose of my research as well as guaranteed that the results of empirical studies would be used only for research and educational purposes) contributed a lot to the development of mutual trust and understanding from the management side. Therefore, one must be aware that some information acquired during my research is confidential. In both cases, however, I intend to use the data not to answer questions like ‘how much’ and ‘how often’ but to discover what occurs, the implications of what occurs, and the relationships linking occurrences.

4.4.3. Access to the decision-makers

The situation is even more complicated when it comes to access to individuals. Some authors distinguish between an overt access (i.e., physical access to the individuals) and covert access (actual access to the data) (See Taylor and Bogdan, 1984).

In a sense organisations don’t have problems: people do. People perceive problems, are motivated to seek solutions and then are needed to implement them. Gummersson described a multinational company’s decision to invest in Latin America, where the decision to invest was made by four top executives over informal dinner in New York (1988, pp. 25-26). A professor studied this particular case by questioning the executives on the reasons behind their decision. They submitted about 50 different factors. The professor, however, did not succeed in getting the company to describe how it arrived at its decision. This case illustrates the difficulties of gaining access to the key decision-makers.

Investment decision to start production in the Eastern Europe is a complicated process involving both top management and field specialists. Close cooperation proved to be particularly difficult in large companies (like Ericsson and Vattenfall) where different units, business areas, and project teams are involved in the decision-making. So, even if only a very limited number of people in both companies have the real authority to participate in investment decision-making, it was extremely hard to identify them.
FOREIGN INVESTMENT DECISION-MAKING IN TRANSITION ECONOMIES by OLGA GOLUBEVA

The decision-makers interviewed during the research project include members of the Board, top managers from different business areas, and chief specialists responsible for project evaluation and risk assessment.

The second problem is that the key decision-makers have very busy schedules and are frequently away on business trips abroad (or even permanently live in Eastern Europe) and, therefore, sometimes tried to send me to the lower position line or business area managers that did not possess the required information or had limited knowledge about key aspects.

According to my experience, the key decision-makers are often critical to the success of a case study and can not be replaced by lower position managers without lowering the quality of information. Top position managers not only provide the case study with insights into a subject, but they also can help with access to different sources of information-internal papers and documents.

Therefore, my strategy was to try to meet with the identified top decision-makers from both companies despite all the troubles on the way. Sometimes, I had to wait some months in order to get the time with an important person and sometimes interviews were interrupted by telephone calls, postponed or canceled the last minute. However, it is an achievable task in case of a strong commitment.

Nine key decision-makers from Vattenfall have been identified and interviewed during the period August 1997 - June 1998. Seventeen decision-makers from Ericsson have been interviewed during September 1997 - March 1998.

I noticed that the empirical data that I found via publicly available sources helped me to get access to the decision-makers. Aware of the fact that I already had acquired some information via other sources, decision-makers were more relaxed about confidentiality and talked more freely and openly. One of them joked “you seem to know more than I do about the subject”. I took it as a compliment.

An important task during interviews was to establish an atmosphere of personal trust and mutual interest. Surprisingly for myself, I found that top managers often have nobody with whom to discuss their decision-making routines. Some of top managers spent much more time with me than was agreed upon because they found it interesting to describe and analyse their own investment decision-making. Establishment of professional and personal contacts helped me later on when I needed to verify some parameters and variables via telephone. At that point I almost always received the required additional information.

4.5. Preunderstanding

What makes the case study work ‘scientific’ is, according to Kemmis (1983), ”the observer’s critical presence in the context of occurrence of phenomena”, participants’ perceptions, interpretations and so on (p. 103). Preunderstanding presumes that a researcher’s knowledge of theories, models, market and industry specific considerations are combined with certain attitude and life experience.
Ödman (1979) defines preunderstanding in the following terms:

"In response to frequent or everyday occurrences, individuals have developed a preunderstanding in order to avoid having to bother themselves with the interpretation of these events. Sense impressions, interpretation, understanding and language merge instantaneously, making it impossible to identify separate phases." (p. 45).

My knowledge of Central and Eastern Europe is based on my personal experience. I was born in St. Petersburg and Russian is my mother tongue. I received my Bachelor of Economics from the Faculty of Economics of St. Petersburg University. My MBA paper, devoted to the problems of valuation of companies, was written under the umbrella of a UCEMET project (University Council for Economics and Management Education Transfer), where I got the chance to work with researchers from the School of Business of Stockholm University and ten other European Universities. From 1993 until January 1996 I worked as a project manager at the Division of International Affairs and later on at School of business of Stockholm University for CPAS (Center for Public Administration Studies), aimed at the development of management training programmes for top officials from the Russian government.

The experience of living and studying in different societies and social environments was a good starting point for my current research. I also have some working experience in business, both in different republics of the Soviet Union and with the former Soviet Union countries. I started to be involved in business in Russia on a part-time basis in the beginning of the perestroika period. So, I had a unique chance to observe and be an active participant in this process.

My work at private co-operatives (the first non-government sector firms in Russia), the experience with some foreign companies entering Russia (AT&T joint venture project in St. Petersburg), the job with financial analysis and portfolio management of the East European equities at “Vostok. Nafta. Investment. Ltd.” - have all provided me with an opportunity to experience ‘the real world’ of decision-making where risks, leadership, and personal responsibility are demanded.

4.6. Methods of analysis and interpretation

4.6.1. Different schools and approaches to analyse transition economies

Some fields of science are dominated by a mainstream of thought that can be recognised by a high measure of consensus among researchers with regard to basic premises and fundamental theories. A research field of transition economies, however, has no significant body of shared views but is fragmented into different schools of thought.

Various analytical frameworks have been suggested to analyse the market economy that is emerging in the countries in transition.

Because transformation is obviously very much affected by political factors, one group of analysts used the framework of public choice theory, which applies the tools of Economics to non-market decision-making (See Murrell, 1991). The importance of the political process approach was emphasised, among others, by Boddewyn and Brewer (1994).
A company is often viewed as the core element of the transformation process. The contemporary developments of the theory of the firm are called, therefore, to understand the phenomena of transition economies: the concepts of property rights, industrial organisation theory, incentives theory, strategic behaviour, and asymmetric access to information, etc. (See Frydman and Rapaczynski, 1994; Yavlinsky and Braguinsky, 1994; Charap and Webster, 1993).

The most common assumption in management studies is probably that companies tend to adopt practices that are efficient from an economic point of view. Transaction cost theory (Williamson, 1985) is a typical example of theories which are based on this assumption. FDI conducted in transition economies and evaluated as an entry fee to the new markets can provide MNE with transaction cost advantages in different areas: sales, service, research, etc.

The institutionalisation perspective (DiMaggio, 1988; Scott, 1994, 1995) takes as its point of departure that organisations are under pressure to adapt and to be consistent with their institutional environment. They are assumed to search for legitimacy and recognition, and they do so by adopting structures and practices defined as appropriate in their environment. Dallago (1997) introduced an institutional framework to understand transition economies. Dewatripont and Roland (1996) also see transition as a general process of large-scale institutional change. Within the institutional approach, the evolutionary theory as applied to transition economy is well presented by the numerous articles of Murrell (1992, 1995) as well as Murrell and Wang (1993).

Hood, Kilis and Vahlne (1997) suggest that neither of these approaches taken separately provide clear insights into what did happen or what will occur in the future or explain why our expectations are seldom proved by reality. No single academic approach alone could possibly accommodate the complexity of intertwining causal chains in a unified model - so there is a visible need for an inter-disciplinary approach.

Rutihinda (1996), for example, used the resource-based model for analysis of internalisation process in transition economies which combines behavioural theory of a firm, theory of industrial organisation, organisational economics and strategic management theory (See the figure below).

![Resource-based Internalisation Model Diagram](image-url)

**Figure 5. The Resource-based View as a Theoretical Base for Analysing Transition Economies**

*Source: Rutihinda (1996), p. 16 (Re-arranged by Olga Golubeva)*
We might require then *different theories and approaches (or combination of them)* in order to explain *undergoing transformation process*. In the absence of a dominant mainstream, the research paper, therefore, should seek to present a wider variety of theoretical perspectives.

**4.6.2. Relevance of studies from other emerging markets**

Another important issue is whether ‘transition economy’ shall be viewed as a new unique phenomenon or as a transformation process that has already been experienced by a number of societies and studied but in another context. One of the possible approaches to analysing the process of transformation of an administrative economy into a market one is to presume that the emerging system must be of the same type as in existing Western or at least developing countries.

According to the conclusions from Chapter 2 of the present paper (that provided some theoretical framework for analysis of transition economies) as well as personal interviews with managers involved in business with Central and Eastern Europe, current transformation does not differ considerably from transitional problems already faced by many societies.

Some managers and researchers believe that companies that have been involved in the foreign investment decision-making in other emerging markets have more chances to succeed in transition economies.

I will therefore assume that even transition economies in Central and Eastern Europe might have specific features not existing elsewhere, they will share some common characteristics with other uncertain environments: emerging markets, industries, regions. In that case theoretical sources of the research can include both the traditional foreign investment decision-making theory and studies of foreign companies invested directly somewhere in Latin America or China. Research about specific features of transition economy and their possible influence on investment decision process will be also included.

Therefore, by assuming that transition economies have some specific features not existing elsewhere and probably share some common characteristics with projects in uncertain environments, I will consider research done in both directions as theoretical sources relevant for my study.

![Theoretical Sources of Literature Assumed to Be Relevant for the Study](image)

**Figure 6. Theoretical sources of literature assumed to be relevant for the study**

*Source: Olga Golubeva (own)*
4.6.3. Methodological assumptions

Analysis and interpretation are the processes of understanding the data according to the concepts and theories that structured the study in the first place. Research analysis of any paper determines substantially by which school (tradition, paradigm) of philosophy the author is guided.

Three sets of assumptions from the philosophy of social science have direct implications for the thesis’s methodological nature (See, for example, Burrell and Morgan, 1982). First, there are two alternative assumptions of an ontological nature: we can assume that the social world is made up of nothing more than names, concepts and labels which are used to structure reality (nominalism) or that the social world is a real world made up of hard, tangible and relatively immutable structures (realism). The second set of assumptions is of an epistemological nature - about the grounds of knowledge, whether knowledge is something which can be acquired (positivist epistemology), or is something which has to be personally experienced (the epistemology of anti-positivism). A third set of assumptions concerns human nature and, in particular, the relationship between human beings and their environment. Determinism views human beings as products of the environment while voluntarism sees man as creator of his environment.

The three sets of assumptions outlined above determine main approaches in the methodology of the research: ideographic approach based on the analysis of the subjective accounts which one generates by getting inside situations and nomothetic approach which lays emphasis on the importance of basing research upon systematic protocol and technique.

The extreme positions of each of the four directions are reflected in the two major intellectual traditions that have dominated social science. The first of these is usually described as positivism. Positivistic research tradition applies scientific method to human affairs as belonging to a natural order open to objective inquiry. The task of positive economics, according to Friedman (1953), "is to provide a system of generalisations that can be used to make correct predictions about the consequences of any change in circumstances”. (p. 4). Therefore, “only knowledge obtained by means of measurement and objective identification can be considered to possess truth”. (Rubenowitz, 1980, p. 26). This research tradition is backed up by a ‘positivist’ epistemology, relatively ‘deterministic’ views of human nature and the use of ‘nomothetic’ methodologies.

The second intellectual tradition, grounded on the traditions of German idealism, is interpretative, humanistic school, which is often referred to as hermeneutics. It is ‘anti-positivist’ in epistemology, ‘voluntarist’ with regard to human nature and it favors ideographic methods as a foundation for social analysis. Researchers from the hermeneutic school do not disagree with the traditional statistical techniques employed nor with the research design but rather with the philosophical preconceptions that the authors bring to their work. They accept influence from both science and personal experience. This framework provides a way of seeing decision-making practices within firms in terms of habits, routines and rule-based behaviour - as an alternative to using the rational maximising approach of neo-classical economics. These alternative methodologies are beginning to generate a small but important literature, especially in the accounting area.
According to Humphrey and Scapens (1996),

“accepting that empirical data and philosophical argument cannot provide objective answers (only answers which are based on particular assumptions, beliefs, value judgements, etc.) means that we have to be conscious of and prepared to debate and defend the assumptions, beliefs and value judgements we use in addressing research questions and in making knowledge claims”. (p. 93).

However, in finance it is still almost impossible to publish research in the mainstream journals, which departs from the positivist methodological orthodoxy. In most of the cases financial phenomena is considered only in terms of their statistical properties or in terms of their compliance with abstract models of market behaviour. The research has been narrowly construed “to encompass only large sample sizes of the latest sophisticated numerical analytical techniques, rather than openness to use other methodologies that are likely to produce significant insights into the phenomenon” (Gartner, Bird and Starr, 1992, p. 21).

It is hard for me to draw the distinguished boarder between these two schools in my research (and consequently in my head). I believe that there is an objective reality: unpredictable, multidimensional and ever-changing. It is hardly a single and fixed phenomenon waiting to be discovered, observed, and measured. I also believe that environment has the ability to surprise human beings and predetermine their actions, while human beings still have the power to create reality. Reality seems to bring companies closer to a compromise position between determinism and free choice. Environments seldom preempt all choice, just as they seldom offer unlimited choice.

Being raised in the traditions of positivism, my intention is to explain how I arrived at conclusions through my presentation of evidence and careful consideration of alternative interpretations. Besides, anti-positivists who reject the notion that science can generate objective knowledge of any kind, make their own research papers worthless.

As LeCompte, Preissle, and Tesch (1993) observe, qualitative research “is distinguished partly by its admission of the subjective perception and biases of both participants and researcher into research frame” (p. 92). The purpose of the research - to describe and explain the investment decision process in transition economies - presumes that a researcher needs to use his or her own personality as one of the primary instruments for data collection, analysis, understanding and interpretation of chosen cases.

We should also remember that twenty six interviewed decision-makers representing six nationalities have different backgrounds, life experience, personalities, philosophical views, etc. Executives, supervisors, project managers, board members and other participants make decisions based on past experience, current context and future expectations. Since there often are multiple parties involved in investment decisions, there might be multiple perspectives on how those decisions were made. Therefore, different parties may tell different stories. In interviews, the decision-makers just presented their own view of the situation.

Johnson, McMillan and Woodruff (1999) warn that managers’ perceptions likely differ even more in the case of transition economy undergoing deep reforms, where institutions and circumstances change quickly. The responses of the decision-makers may be affected by those rapid changes.
The method applied in my research, therefore, is hermeneutic to some extent, since it is about interpretations.

There is an ongoing debate in the literature about the extent to which the methods of analysis characteristic of one paradigm can be utilized in the other (Reichardt and Rallis, 1994). Over the last seventy years or so there has been an increasing interaction between these two traditions, particularly at a socio-philosophical level. As a result, intermediate points of view have emerged, each with its own distinctive configuration of assumptions about the nature of social science. Some researchers view the concepts of positivism and hermeneutics “rather as complements in the spirit of yin and yang. Consequently there is nothing to stop a researcher from adopting a positivistic paradigm in a certain research situation and a hermeneutic paradigm in another, even in the same project” (Gummesson, 1988, p. 146).

These two views of society can be seen as two sides of the same coin; they are not mutually exclusive and, therefore, do not need to be reconciled. However close one’s position might be to the middle ground, it would seem that one must always be committed to one side more than another. Hopefully, the results of case studies will provide us with more arguments supporting this or that philosophical school, or both of them.

4.6.4. Generalisation

Due to the fact that case study is a time and finance-consuming job I decided to concentrate only on two in-depth case studies: Ericsson’s direct investments in Russia and Vattenfall’s direct investments in the Baltic countries. Science, however, should have wider aims than ”just providing one particular company with decision material for one particular situation. In other words, it deals with the generation of knowledge that is generalizable to some extent at least” (Wärneryd, 1985, p. 11).

Big differences between chosen companies and countries of investments contribute to doubts about whether it is possible to generalise from the limited number of cases. Therefore, we can fall into the trap of discussing whether Ericsson’s case in Russia and Vattenfall’s activities in the Baltic countries belong to ‘representative’ or ‘generalisable’ case or set of cases. (Yet no set of cases, no matter how large, is likely to deal satisfactorily with the complaint.)

According to some researchers, however, ”it no longer seems so ‘obvious’ that a limited number of observations cannot be used as a basis for generalisation. Nor does it appear to be ‘obvious’ any longer that properly devised statistical studies based on large number of observations will lead to meaningful generalisations” (Gummesson, 1988, p. 78).

Erickson (1986) compares two possible strategies of generalisation: a search for abstract universals arrived at by statistical generalisations from a sample to a population and a search for concrete universals arrived at by studying a specific case in great detail and then comparing it with other cases studied in equally great detail.
In contrast to enumerating frequencies of the phenomena (statistical generalisation), the purpose of my paper is to expand and generalise theoretical concepts (analytic generalisation). I see my task as analyst in generalising the findings of empirical research to the theory of foreign investment decision in general and the specific environment of transition economy in particular. Theoretical framework becomes, therefore, not only an immense aid in defining the appropriate research design and data collection, but also the main vehicle for generalising the results of chosen and presented case studies.

The possibilities to generalise from two single cases can be founded in the possibility "to reach a fundamental understanding of the structure, process and driving forces rather than a superficial establishment of correlation or cause-effect relationship" (Normann, 1970, p. 53).

Besides, Triesman (1999) who performed a cross-national study of corruption (transition economies among them) claims that the only alternative to trying to analyse subjective data in some research areas as systematically as possible is to continue to generalise on the basis of individual case studies or hunches.

Patton (1980) states: "To generalise is to be an idiot"; he actually goes on to discuss the opposite of generalisation, particularisation (i.e. social phenomena are part of specific social situation and are far too liable to change to allow meaningful generalisation) (pp. 279-283).

Both theoretical analyses and policy prescriptions concerning transition economy might have to be even more cautious about the correctness of broad generalisations. Authors of the study based on a panel of over 200 privatised and state firms in the Czech Republic, Hungary and Poland observe that privatisation, for example, when it is effective, affects differently the firm’s revenue and cost performance (Frydman, Gray, Hesse and Rapaczynski, 1999).

De Man (1996) separates the universal and the pluralist approaches in the science of business administration, where the first one deals with explaining regularities and looks for parallels with general theories as opposed to the second one which concentrates on specific peculiarities occurring in the firms and their local circumstances.

I chose analytic generalisation and particularisation of cases as the leading directions in research design. The research should provide perspective rather than truth, empirical assessment of local decision-makers’ theories rather than generation and verification of universal theories. My feeling is also that the traditional demand for generalisation is probably not relevant to the study of the process of such a unique and changing phenomenon as transition economy.

4.6.5. Reliability and validity

Reliability as one of the criteria of science means that two or more researchers studying the same phenomenon with similar purposes should reach approximately the same results. The concept of validity may be defined in terms of whether it is an accurate representation of the situation it purports to describe (Taylor and Bogdan, 1984).
Both definitions imply that there is an objective reality that may, more or less, be accurately measured and described. It also implies that the only problems deal with the researcher’s ability to make the necessary measurements. An alternative approach argues that there is no such thing as objective reality. All our words are socially constructed; we each choose to place our own interpretations on the data to which we are exposed.

Therefore, a case study is simply a particular researcher’s view of the world. Accepting this vision does not, in my opinion, invalidate the use of case studies, but it does change one’s approach to them. By accepting this vision, “there is no reason why they should not learn the skills of model building and evaluation using case studies. But they will be less concerned about the validity of the case writer’s view of the world and more interested in developing their own interpretation of it and how they might act within it” (Easton, 1992, p. 65).

My initial intention is to “portray” the objective reality (assuming that it exists) and try to increase the reliability and validity of data collected in the chosen cases. A study report combining the results of an informal interview and formal questionnaire was done for the each interviewed decision-maker. Some of the reports of the decision-makers were reviewed by their colleagues who have also been participating in the survey.

The general conclusion of the decision-makers was that the facts mentioned in the reports fit the reality of events that occurred (one might even argue about the importance and role of different variables in the decision-making process).

Confirmation of facts acquired during interviews with information from other sources hopefully contributed to increasing the reliability and validity of the research as well as provide the reader with opportunity to reach his or her own conclusions. Earlier drafts of the paper were given to some managers involved in FDI decision-making in transition economies for reviews and approval.

According to some authors, reliability is a problematic concept in the social sciences simply because human behavior is never static (Merriam, 1998). Lincoln and Guba (1985, p. 288) and Dey (1993, p. 251) suggest thinking about the ‘dependability’ or ‘consistency’ of the results obtained from the data. That is, rather than demanding that outsiders get the same results, a researcher wishes outsiders to concur that, given the data collected, the results make sense - they are consistent and dependable. The question then is not whether findings will be replicated but whether the results are consistent with the data collected. If I cannot expect others to replicate the study’s results, the best I can do is to explain how I arrived at my results and conclusions.

A possible limitation of this research relates to external validity. However, I took some precautions to decrease threats to external validity.

First, our sample was composed of executives and managers who are presumed to be similar to the executives and other professionals to whom the results may be generalised. Second, my findings seem to be consistent with more recent theoretical and empirical treatments, which lends credence to their validity.
Consensus within the research community regarding the appropriate criteria for assessing validity and reliability has not yet been reached. Recent writing from postmodern, post-structural, constructivist, and critical perspectives calls for the careful consideration of totally different conceptualisations of validity and reliability (See Donmoyer, 1996; Lenzo, 1995; Lincoln, 1995).

It is possible that research studies of transition economy might contribute to our understanding of reliability and validity as scientific criteria. Johnson, Kaufmann, McMillan and Woodruff (1999) studied bribes and unofficial activity (unreported sales and wages) in transition economy. Because of the sensitive nature of the subject, questions were phrased in terms of actions of ”typical firms in your industry”. Authors presume in their research that managers most often respond based on their own experiences. It is possible that we might have a problem with internal validity by interpreting responses as indications of the firms’ own payments. However, it seems to be the only way of getting data about the phenomenon.

Besides, as with most questionnaire surveys, the information provided is based on memory of the decision-makers that may not be objective. Questions requested not only factual, but also some evaluative and perception variables which might cause some biases in the study.

4.6.6. Qualitative and quantitative methods

Qualitative relationships that seem to dominate the foreign investment decision process in transition economies are more difficult to establish than relationships among quantitative variables. The fact that variables are not always quantitative obviously makes the testing of relationships difficult. I am aware that the data acquired in the cases are not capable of supporting the multi-variable analysis that is often required in positive science. Even if we can measure the impact of some quantified variables on the investment decision, other, unmeasured, variables will often get in the way and distort the relationship. There is no point, therefore, in calculating formal statistical measures of correlation such as correlation coefficients.

Even if my intention is to present the acquired data in the most accurate way, the study has a mainly qualitative nature. Qualitative research is an effort to understand situations in their uniqueness as part of a particular context and, therefore, ”implies a direct concern with experience as it is ‘lived’ or ‘felt’ or ‘undergone’” (Sherman and Webb, 1988, p. 7). Guba and Lincoln (1981) make the point that qualitative researchers do not measure. Rather, ”they do what anthropologists, social scientists, connoisseurs, critics, oral historians, novelists, essayists, and poets throughout the years have done. They emphasise, describe, judge, compare, portray, evoke images, and create, for the reader or listener, the sense of having been there” (p. 149).

Therefore, instead of taking apart the components and variables and examining their influence on foreign investment decision-making, the intention of this project is to reveal how all the concepts work together to form a whole picture of the phenomenon.

The chosen approach - supplementing the main qualitative framework with available quantitative data - seems to be popular among scholars in the analysis of investment decisions (See, for example, a model suggested by Barius (1987) and presented below where profitability had been inserted as an example of quantitative variable).
4.7. Ambiguity of method

Recently, a number of publications were devoted to describing and explaining the process of qualitative analysis - or how researchers should make sense out of their data. (See, for example, Coffey and Atkinson, 1996). Nevertheless, there is little doubt that the process is highly intuitive; a researcher can not always explain where an insight (that may later be a finding) came from or how relationships among data were detected. Some authors warn that the qualitative researcher must have an enormous tolerance for ambiguity because the best way to proceed will not always be obvious. Qualitative method "places the investigator in a largely uncharted ocean. For some it becomes an adventure full of promise for discovery; for others, it can be a disorienting and unproductive experience" (Merriam, 1998, p. 21).

Throughout the research process - from designing the study to data collection and further to data analysis - there are no procedures that can be followed step by step (as it is presented on Figure 4: "Research design with two consequential steps: deductive and inductive"). In practice, designing a study is not a linear process of reading the literature, identifying the theoretical framework, and then writing the problem statement. Rather, the process is highly interactive.
A qualitative design is emergent, and the right way to analyse data in a qualitative study is probably to do it simultaneously with data collection. The analysis started with the first interview, the first observation, the first document read. Emerging insights and theoretical hypotheses directed the next phase of data collection, which in turn leaded to the reformulation of questions, and so on. Writing the paper appeared to be a complex process that involved moving backward and forward between concrete facts and concepts of the model, between inductive and deductive reasoning, between description and interpretation.

We must also be aware that foreign investment decisions are often ambiguous, for instance when they are the result of compromises. What goes on in practice may also be ambiguous; it may be difficult to know what is really happening and how to describe it (Sahlin-Andersson 1989). It is not surprising, therefore, that some authors claim that the research method used in social science in general is going through some sort of ‘transition period’ which is ”characterized by random research, aimless verification, and accidental discoveries” (Nachmias and Nachmias, 1981, p.21)

### 4.8. Summary of the chapter

The aim of this chapter was to present a method elaborated for the study. The project is designed to start with deductive search for the main factors relevant to the purpose of the research, i.e., to describe and explain how the companies make foreign investment decisions in transition economy. The second step, of an inductive nature, is to conduct an empirical study based on the logic of theoretical study.

Case study method is chosen as a main research strategy. A formal survey was conducted where qualitative (informal) interviews with decision-makers were followed by a structured interview questionnaire. Other available sources of data collection were also used: databases, company’s reports, archival records, photographs and video films, etc.

Selection of sample was nonrandom, purposeful or criterion-based. Ericsson and Vattenfall provided access to the required information and allowed me to conduct personal interviews with top management. Despite the difficulties with access to top executives, for example their busy schedules, and other problems along the way, the strategy was to meet with all executives identified in both companies.

An author’s preunderstanding of the problem is substantially influenced by personal experience, such as leaving, studying and working in different social environments, particularly in transition economies.

Various analytical frameworks have been suggested to analyse the market economy which is emerging in the countries in transition: public choice theory, the theory of the firm, institutional framework, etc. However, none of these approaches taken separately provide clear insights into what did happen or will occur in the future or explain why our expectations are seldom proved by reality. No single academic approach alone could possibly accommodate the complexity of intertwining causal chains in a unified model - so there is a visible need for an inter-disciplinary approach.
We might require different theories and approaches (or combination of them) in order to explain the undergoing transformation process. In the absence of a dominant mainstream, the research paper, therefore, should seek to present a wider variety of theoretical perspectives.

Conclusions from Chapter 2 of the present paper and personal interviews with managers involved in business with Central and Eastern Europe might suggest that current transformation does not differ considerably from transitional stages already faced by many societies.

Therefore, it is assumed that even transition economies in Central and Eastern Europe might have specific features not existing elsewhere, and they will also share some common characteristics with other uncertain environments: emerging markets, industries, regions. In that case theoretical sources of the research can include both the traditional foreign investment decision-making theory and studies of foreign companies that invested direct somewhere in Latin America or China.

The analysis and interpretation of the research paper are influenced by different schools of philosophy. There are strong traditions of positivism in the paper; therefore, the intention is to motivate the logic of conclusions via sufficient presentation of evidence and careful consideration of alternative interpretations. The purpose of the paper, however, presumes that a researcher uses his or her own personality as one of the primary instruments for data collection, analysis, and the understanding and interpretation of chosen cases.

Besides, since there are multiple parties involved in investment decision-making, there may be multiple perspectives on how those decisions were made. The method applied in the research, therefore, is hermeneutic to some extent, since it is about understanding and interpretations.

Two in-depth case studies were chose for the project: Ericsson’s direct investments in Russia and Vattenfall’s direct investment in the Baltic countries. In contrast to enumerating frequencies of the phenomena (statistical generalisation), the purpose of the paper is to expand and generalise theoretical concepts (analytic generalisation). Analytic generalisation and particularisation of cases have been chosen as the leading directions in research design. The research should provide perspective rather than truth, empirical assessment of local decision-makers’ theories rather than generation and verification of universal theories.

The initial intention is to ‘portrait’ the objective reality (assuming that it exists) and try to increase the reliability and validity of data collected in the chosen cases. Even if my intention is to present the acquired data in the most accurate way, the study has mainly qualitative nature. There is little doubt that the research process making is highly intuitive and ambiguous; a researcher can not always explain where an insight (that may later be a finding) came from or how relationships among data were detected. Designing a study, besides, is not a linear process of reading the literature, identifying the theoretical framework, and then writing the problem statement. A qualitative design is emergent and the right way to analyse data in a qualitative study is probably to do it simultaneously with data collection. Writing this paper was a complex process that involved moving back and forward between concrete facts and concepts of the model, between inductive and deductive reasoning, between description and interpretation.
5. FDI DECISION-MAKING: THEORETICAL FRAMEWORK AND MODEL BUILDING

"... Advances in the sphere of the social sciences are substantively tied up with the shift in practical problems and take the guide of a critique of concept construction”.

Max Weber, "The Methodology of Social Sciences"


5.1. Introduction

The purpose of this chapter is to introduce the theoretical framework for analysis of FDI decision-making. Based on the theoretical studies of traditional models, my own suggestion about the main concepts in the model describing FDI decision-making is presented in the second paragraph. In the third paragraph the initial motivation of companies to invest abroad (or reasons for FDI in transition economies) - the first block of the suggested model - are discussed. The role of information about investment climate and information collecting methods for FDI in transition economies is analysed in the fourth paragraph. Suggestions about the next block - project evaluation methods and investment decision criteria - are presented in the fifth paragraph. The sixth paragraph is devoted to risk analysis and risk reduction measures for companies conducting FDI in transition economies. Each of the blocks presented in the fifth Chapter will provide the guiding theoretical framework for empirical analysis. Some conclusions are derived in the last paragraph.

5.2. Suggestions about the main concepts (theoretical blocks) in a model describing FDI decision-making

5.2.1. Main concepts traditionally included in a model describing FDI decision-making

To ‘explain’ a phenomenon is to stipulate a set of causal links between the variables. When a number of such relationships have been identified, or have even assumed or hypothesised, and have then been further related to one another, a holistic picture or model of the situation begins to emerge.

Concepts are the most critical element in theories and models. According to Ghauri, Gronhaug and Kristianslund (1995), “a concept is an abstraction representing an object, a property of an object or a certain phenomenon” (p. 17). Concepts help us to understand what is captured by previous research and define what we are interested in. Several concepts (‘blocks’ or ‘boxes’) are often included in existing models that describe and explain FDI decision-making.

Aharoni (1966) probably is the most cited author who described the foreign investment decision process. The model suggested by Aharoni is presented below.
The Foreign Investment Decision Process

The Decision Process

<table>
<thead>
<tr>
<th>Initiating force</th>
<th>General investigation</th>
<th>Field investigation</th>
<th>Formal decision</th>
<th>Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

Time

Risk Strategy

Avoidance Transfer Adoption

Figure 8. A model describing the FDI decision process

Source: Aharoni, 1966, p. 49 - 76

A summary of two models by Cooper and Chapman (1987) is another example illustrating the traditional FDI decision-making modeling:

Information Calculation Decision

Distribution of single value forecasts

Rate of return Net Present Value

Sensitivity analysis

Decision

Non-quantified factors

Attitude to risk

Figure 9. A model describing the FDI decision process

Source: Cooper and Chapman, 1987, p. 208 - 209 (re-arranged by Olga Golubeva)

Despite some differences, there are obvious similarities between the two models in the way they describe investment decision process. Both models include almost similar concepts (variables) as well as describe investment decision-making as a normative process with linear development of consequential steps.

The traditional models that have been suggested, and sometimes tested, by other researchers might be a good starting point for my own assumptions.
5.2.2. My own suggestions about the main concepts in a model describing FDI decision-making

What main concepts should be included in the model explaining FDI decision-making and what are the relationships between them? Fararo (1989) pointed that "realism is an operative ideal in the production of models, not just in the interpretation of them after they exist" (p. 56-57). As usual, a researcher tries to include all the variables that effect the outcome of the dependent variable, but no specification can perfectly determine the movements and attributes of the variable in question. While "model building is more art than science" (Lee, 1993, p. 688), the best a researcher can do is to search for concepts that seem consistent with both theory and practice.

The following four blocks might be suggested in a model describing FDI decision-making according to underlying theory, existing models and common sense:

- **Initial motivation (or reasons of companies to invest directly)** (Why do companies conduct FDI?);

- **Information about investment climate and information collecting methods** (What type of information do companies collect about investment climate and what techniques do they use);

- **Project evaluation methods and investment decision criteria** (Traditional set of project evaluation methods; applicability of capital budgeting techniques to particular projects; other investment decision criteria);

- **Risk analysis** (The influence of political risks, macro- and micro risks on FDI decision-making; risk reduction measures; determination of premium adjusted to the undertaken risks).

Relating is the process by which relationships between variables or concepts are uncovered. The research process is described mainly in the textbooks as a series of logical, rational, step-by-step activities, following objective rules, and leading from the identification of a problem up to an endpoint of results. It is the same logical sequence that traditionally is supposed to guide FDI decision-making. If we place the identified concepts according to the logic of a linear, step-by-step relationship, the suggested model might look as follows:

![FDI DECISION-MAKING](image)

**Figure 10. Own suggestion about main blocks in the FDI decision-making model**

*Source: Olga Golubeva (own)*
Scott (1994) identified two different approaches - variance theory and process theory - that might be applied to model construction. Variance theories attempt to determine what factors influence the outcomes observed: they address the question, why did this happen? By contrast, process approaches deal with a series of events and address the question: how did this happen? Although these types of approaches are sometimes combined in the same study, the distinction is useful for broadly differentiating among styles of research.

Some companies might start with a formal decision to conduct direct investments and later provide the set of traditional calculations to justify the decision that has been already made.

It might happen that the relationship between the main concepts will have a more complicated character than a linear development of consequential steps. Entrepreneurship in general begins with a discontinuous, non-linear and usually unique event that cannot be studied successfully with methods developed for examining smooth, continuous, linear (and often repeatable) processes.

The whole set of concepts can be repeated more than one time. Increasing risks can require a new investigation about the rapidly changing environment, or the new initial motivation will be incorporated in the decision process.

Buckley (1998) warns that many of the models in the social sciences with the sequential steps is "anything but an immutable picture of a complex process. Nonetheless it should not be given short shrift; it deserves healthy respect - and also a certain amount of suspicion" (p. 116).

We also have to be aware that it is probably not possible to find one unique model for all countries. Researchers in that case shall concentrate on the search of concepts as well as their specification within chosen cases, rather than engage in a cross-sectional analysis. To sum up, more empirical studies are necessary in order to verify variables influencing the FDI decision-making and to understand the interaction between the basic concepts of the model.

5.3. Initial motivation of companies to invest abroad (or reasons for FDI)

5.3.1. The mainstream theories of reasons for FDI

An immense body of literature emerged in the last 35 years to explain the reasons of FDI. The mainstream theories are unanimous in the conclusion that market imperfections created by the existence of an oligopolistic advantage should prevail to motivate companies to make FDI. The pioneering work of Hymer (1960) explains the application of market imperfections to FDI. He suggested that the decision of a multinational to invest in an overseas market can only be explained if the company has, and can utilise, certain advantages not possessed by its local competitors. These advantages may derive from skills in management, marketing, production, finance or technology.

Since 1960, numerous studies have developed the internalisation theory. This theory claims that foreign investments should occur when a firm is able to increase its value by internalising markets for its intangible assets or growth opportunities (referred to by Hymer as monopolistic advantages). Such assets are commonly thought to include technological know-how, expertise in research, marketing ability, goodwill, effective management, etc.

The study of 61 investments of US corporations in Eastern European countries during the period 1988-1991 done by Lang and Ofek (1995) is consistent with the internalisation theory. The empirical evidence shows that US firms increase their values by internalising the East European region markets for their higher intangible assets or growth opportunities, and vice versa.

The internalisation theory is also relevant to the *multinational network hypothesis* by Doukas and Travlos (1988). They argue that the value created by US multinationals is higher when firms expand into new industry and geographic markets - especially those less developed than the U.S. economy, particularly Eastern Europe.

Inotai’s (1995) research in Hungary suggests that the countries most successful in attracting FDI are those that have been included into multinational companies’ global networks. Such theory implies, according to the author, that FDI should decreasingly be linked with the privatisation process that has initiated FDI in transition economies.

In addition to the above mentioned internationalisation theory, other hypotheses explaining the reasons of FDI, such as low cost labour, opportunities for tax avoidance or reduction, benefits of natural resources, large domestic markets, etc., have been also discussed among the researchers.

The *low labour cost hypothesis* argues that international expansion may increase a firm’s value because it enhances its access to low cost labour inputs (Hood and Young, 1979). There have been many case studies (for an overview of the main surveys since 1991, see Lankes and Venables, 1996) that listed low labour costs, especially inexpensive for a level of skills comparable to what is found in industrialised countries, as a usual motivation for FDI in transition economies.

Franko (1996) investigated the reasons behind investments in Eastern Europe and the former Soviet Union made by North American, European and Japanese firms. He showed that cheap labour, or even cheap, educated labour was not a sufficient or even a necessary condition to attract FDI into the region. He writes:

"Even in apparel, the sector where cheap labor is supposedly the greatest single attraction a country can offer, other factors, such as transport and communications infrastructure, experience in related and ancillary industries, facilities or lack thereof for expatriate managers and technicians and their families, access to markets (e.g., to the EU), and institutional, currency and political stability can overwhelm "labor costs" as a determinant of a DFI decision". (p. 50).

Economic theory of location suggests the substantial FDI would enter Eastern Europe in search of lower labour costs (Ozawa 1992a, Borsos 1995). Meyer (1996), however, concludes that no supporting evidence exists that the search for low labour costs has been a major motive for firms investing in Central and Eastern Europe.
The original assumption that large flows of capital would be directed to Eastern Europe based on the expectation that cheap labour would motivate investors to relocate large portions of their production capacity was not confirmed by Widmaier and Potratz (1999).

Stankovsky (1998) found that, for domestic market oriented FDI, cheap labour certainly is a major consideration. Multinationally operating corporations, on the other hand, appear to think that low labour costs in transition economies are not yet a sufficient reason to relocate facilities that produce for the world market.

The tax avoidance (reduction) hypothesis argues that international expansion may increase a firm’s value because it provides the firm with more opportunities for tax avoidance (reduction) (See, for example, Harris, Morck, Slemrod and Yeung, 1991; Hood and Young, 1979).

A study conducted by Arthur Andersen of roughly 300 companies from some of the OECD countries that have been active in Central and Eastern Europe showed that investment incentives, in particular tax holidays, were not a decisive factor or the prime motivation. Investors rather perceived this often quoted ‘traditional’ advantage of the region as a potential short-term benefit that, though attractive, should not form the main basis for long term strategic investment decisions (“Assessing Investment Opportunities in Economies in Transition”, 1994).

Benefits of national resources and local production costs are often mentioned as important reason for FDI in transition economies. Resource oriented motives - access to low cost production and sources of raw materials - was named as a motive by 15.1 per cent of foreign investors in a study conducted by Burger and Jungnickel (1996, p. 18).

According to another survey, however, only 9 per cent of foreign investors were motivated by the prospect of cutting production costs (“Assessing Investment Opportunities in Economies in Transition, 1994). The study rather classified cheap resources as a short-term benefit than a key motive factor. Meyer (1996) also found that only 2.3 per cent of companies were invested in the region solely to utilise the lower factor costs advantages (p. 174)

The absolute size of domestic markets is often proposed as one of the leading location factors employed to explain FDI inflows (Clegg, 1996; Hood and Young, 1979; Pehrsson, 1999).

Several researchers stressed that this factor might play a decisive role in explaining FDI in transition economies (See Lavigne, 1999; Peitsch, 1997, Stankovsky, 1998; Widmaier and Potratz, 1999). According to a survey commissioned by the OECD, 44 percent of foreign investors wished to gain access to the markets of countries-recipients of FDI (“Assessing Investment Opportunities in Economies in Transition, 1994). The domestic market was ranked as the key attraction by 43.8 per cent of foreign investors in a study conducted by Burger and Jungnickel (1996, p. 18). Meyer (1996), by analysing evidence from 269 German and British companies conducting investments in five countries in Central and Eastern Europe, found that 97.2 percent of investors were attracted by new markets. According to Nieminen and Törnross (1997), one of the main reasons for the attraction of Finnish firms to Estonia is the new emerging domestic market.
Oligopoly theory may also explain the phenomenon of *defensive investment*, which may occur in concentrated industries to prevent competitors from gaining or enlarging advantages that could then be exploited globally (McClain, 1983). Hood and Young (1979) also suggested that FDI decisions may be affected by the presence of local competition in the host country.

‘Defensive’ investment in order to be early in the opening emerging markets relative to other competitors might then be of a special importance for transition economies (See Meyer, 1996; Pehrsson, 1999).

Nieminen and Törnross (1997) pointed out that the liberalisation process resulting from Finland’s EU-membership increased competition in the domestic market, created the vital need for companies for active internalisation and, therefore, pushed Finnish firms to invest in Estonia.

In summary, the following mainstream theories can be suggested to explain the reasons for FDI in transition economies:

- internalisation theory, (i.e. a company’s search for international expansion of its advantages - technological know-how, expertise in research, marketing ability, goodwill, effective management, etc.);
- the low cost labour hypothesis;
- tax avoidance or reduction hypothesis;
- benefits of national resources and local production costs;
- access to domestic markets;
- ‘defensive’ investment in order to be early in the opening markets of transition economies relative to other competitors.

5.3.2. Other suggested hypothesis that might explain FDI in transition economies

The *behavioral approach* to analysing the foreign investment decision has been developed by economists from Uppsala University in Sweden. Human rationality is bounded by one’s ability to gather and process all the information that would be needed to make a perfectly rational decision based on all facts.

This observation lies behind two related theories of FDI. The first one, *internalisation process theory* was introduced by two Swedish scholars, Johansen and Weidersheim-Paul (1975) and further developed by Johansen and Vahlne (1977). The second one, *internalisation network theory*, is an application of network theory to multinational firms, written by one of its Swedish pioneers, and can be found in Forsgren (1989).
In the Uppsala model, the internalisation of a firm is seen as a process in which the firm gradually increases its international involvement. According to the model, the process "evolves in an interplay between the development of knowledge about foreign markets and operations on one hand and an increasing commitment of resources to foreign markets on the other... A critical assumption (of the model) is that the market knowledge, including perceptions of the market opportunities and problems, is acquired primarily through experience from current business activities in the market. Experiential market knowledge generates business opportunities and is consequently a driving force in the internalisation process" (Johanson and Vahlne, 1990, pp. 11-12).

As the Swedish firms learned from their initial investments, they became willing to take greater risks both with respect to the psychic distance of the countries and the size of the investments. "Rarely should a company establish manufacturing facilities as its first international business operation", - writes Pehrsson (1999, p. 58).

Buckley (1998) stresses that internalisation normally moves through exporting to the setting up of a foreign sale subsidiary, to licensing agreements and similar contracts before actual direct investment in foreign production facilities takes place (See Figure 11 below).

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**Figure 11. Typical foreign expansion sequence**

*Source: Buckley, 1998, p. 113*

Several studies of business in transition economy, such as the post-socialist countries in Eastern Europe and China, have revealed that investments are often conducted in an incremental way characterised by learning-by-doing. Hence, research might still benefit from the basic ideas behind the original Uppsala model. Hence, *a step-by-step process* (behavioural approach) may be suggested as a relevant determinant to explain FDI in transition economies.

There have been numerous discussions about the applicability and correctness of Uppsala model. Forsgren (1989), for example, illustrated the growing number of investments conducted by Swedish multinationals abroad without going through a ‘step-by-step’ process. Lindqvist (1991) showed that some small Swedish firms had started to set up directly production subsidiaries abroad without following the stages described by the model. Sullivan and Bauerschmidt (1990) did not find any support for the incremental process hypothesis of the Uppsala model, and neither did Millington and Bayliss (1990) in their empirical studies.
The importance of a geographical determinant, i.e. the proximity of potential investor from transition economies, was stressed in several reports (Lavigne, 1999; Nieminen and Törnross, 1997).

Some researchers believe that there is a correlation between geographic proximity and the relative importance of uncertainties in transition economies for the foreign investors. The closer an investor is to any given country experiencing transformation process, the more likely there is to be "a considered response rather than a 'knee jerk' reaction" ("Assessing Investment Opportunities in Economies in Transition", 1994, p. 10).

Evidence in favour of the geographical proximity hypothesis and its variation across the five Central and East European was found by Meyer (1996). Mayer showed that German firms, in particular those located near Germany’s eastern border, were more active in transition economies than British firms due to their proximity to the region. The author also suggests that while Austria and Switzerland are important in Central Europe, the Nordic countries are prominent in the Baltic states.

According to the Uppsala model, firms are expected to enter new markets with successively greater psychic distance. The psychic distance between the home country and the foreign one is defined in terms of factors like differences in language, culture, and historical traditions between the two countries, that is factors that disturb the flow of information between the firm and the market (See also Langhoff, 1997).

Cultural affinity and historical contacts might then be seen as reasons (or rather motives) for FDI in transition economies ("Assessing Investment Opportunities in Economies in Transition", 1994; Nieminen and Törnross, 1997).

During the 1990s, two surveys were conducted - one on the determinants of Japanese FDI in UK manufacturing and the other on the location of international offices (See Dunning, 1991). In both surveys, variables associated with relations, language and culture, existing trading relationships, learning about the quality of communications and adapting to local business practices were ranked considerably higher as investment determinants than traditional motives.

"It is customary in books about management systems in other countries to stress the value of gaining insights into their cultural dimensions. In the case of Russia - to make a crucial distinction - it is essential to understand the historical dimension, and there is a lot of history to digest… In order to understand Russia today, you need to understand where Russia has come from ", - write Holden, Cooper and Carr (1998, p. x). According to Neal (1997), the culture factor poses the greatest threat to companies operating in unstable and uncertain markets. The decision to invest in such markets, therefore, must take this influence of culture into account in the early phase of FDI decision-making.

Successful transformation process from socialist to market economy is also suggested by several researchers as a factor initiating and stimulating the inflow of FDI in transition economies ("Assessing Investment Opportunities in Economies in Transition", 1994; Inotai, 1995; Lavigne, 1999; Peitsch, 1997; "The Competitiveness of Transition Economies", 1998).
Due to the fact that ‘in risky markets, the latecomers’ advantages are likely to be larger than the benefits to be earned by pioneer status, the principal cause of the slow inflow of FDI into the Central and Eastern Europe is to be found in the disappointing speed of transition to market economy (Burger and Jungnickel, 1996, p. 15).

The effects of progress in transition and political risk on FDI, however, could not be found in the analysis of 269 German and British companies covering business relationships with five countries in transition economies performed by Meyer (1996).

To sum up, the following hypothesis might be helpful in explaining the reasons for FDI in transition economies:

- a step-by-step process (behavioural approach);
- geographical determinant, i.e., the proximity of potential investors to transition economies;
- cultural affinity and historical contacts;
- successful transformation process from a socialist to a market economy.

5.3.3. Other approaches that might be relevant for explaining why FDI occurs in transition economies

Aharoni (1966) studied the FDI decision process within thirty-eight firms and observed that most international investment decisions are undertaken in an environment full of uncertainty. Coupled with a relatively low level of information and knowledge, the decision process appeared to be a haphazard one. The final decision to invest seemed to depend not so much on a full appraisal but rather on the personalities of the managers involved. He found that managers may have a fixation on a certain investment project and that they tended to push it through irrespective of economic feasibility.

Buckley (1998), discussing the reasons for FDI, suggests that that ”group chief executives may also bask in the glory of this bigger empire whilst also taking home bigger salaries and having bigger and better business trips overseas” (p. 150).

Therefore, some other reasons might exist for FDI in transition economies. These reasons might include an outside proposal from the foreign governments or the distributors of the company’s products, or a push from the powerful member of the firm’s board of directors, or personal qualities of managers involved in the decision-making.

Dunning’s eclectic paradigm, summarising the firm-specific advantages, location-specific advantages and internalisation, was introduced in the 1970s (Dunning, 1981; Dunning, 1988a; Dunning, 1988b).
An eclectic paradigm "avers that the propensity of firms to engage in FDI will depend on the interaction between their unique competitive and/or monopolistic (or ownership-specific (O)) advantages and the locational (L) attractions of alternative sites for the creation or use of those advantages; and also on the extent to which firms find it in their interests to govern internally (I) these resources and capabilities in preference to other organisational routes, for example, the external market or co-operative arrangements” (Dunning, 1997, p. 4).

Dunning (1997) also claims that although the greater part of FDI - and particularly that directed to developing countries - continued to be of the traditional market- and resource-seeking, an increasing proportion of cross-border FDI was being undertaken to acquire new competitive, or ownership-specific, advantages, rather than to exploit existing ones.

An advantage of the eclectic paradigm is that it offers an attempt to analyse and explain different types and aspects of FDI and international business activities.

However, we have to acknowledge that the operational robustness of the eclectic paradigm is limited due to the large number of possible variables that may influence FDI, and partly because their value is dependent on contextual variables, such as those which are specific to countries, types of investments, firms’ specific considerations, etc. Dunning’s eclectic paradigm does not address the importance of strategic or dynamic factors. Besides, the paradigm is very comprehensive and covers multiple level of analysis.

To sum up, the search for new concepts explaining the initial motivation for FDI in transition economies continues. First, some explanations that do not yet fit the mainstream theories and hypothesis can be relevant for explaining FDI in transition economies. They might include an outside proposal from a foreign government or the distributors of the company’s products, a push from the powerful member of the firm’s board of directors, or the personal qualities of managers involved in the decision-making. Second, the large number of possible variables, depending on the specific considerations, might exist and be ‘eclectically’ connected with each other, or the new ones might appear due to the changes in the investment environment.

5.3.4. Summary of the paragraph

The following schema may be suggested as a starting point in a search for initial motivation (or the reasons) of FDI in transition economies (see the figure below):
5.4. Information about investment climate and information collecting methods

Research has shown that information is likely to have an instrumental effect on actual decisions (Bourgeois, 1985; Sutcliffe, 1994). "The collection of information relevant to the decision and reliance upon analysis of this information in making the choice is central to effective decision process", - suggested Dean and Sharfman. (1993, p. 608). Presumably, better investment decisions are a consequence of more extensive information collection that leads to more accurate perception of environmental conditions.

Johanson (1994) claimed that the lack of knowledge due to differences between countries is a major obstacle to decision-making connected with the development of international operations. Buckley (1998) suggested that we see internalisation as a learning process or an attempt to overcome the problems of information.

Since an investor has neither the time nor the ability to collect all the information, most of the decisions have to be made on the basis of imperfect information, probabilities rather than certainties. However, most of the authors agreed that the principal obstacles in FDI decision-making can be surmounted by learning about the foreign markets via collecting the information about investment climate (De Mortanges, Pahud and Allers, 1996; Ginter and Duncan, 1994; Johanson, 1994).
The concept of an investment climate (or regime for foreign investments) should not be mixed with the political uncertainty of a particular country (or political risk) (Thunell, 1977). One of the broadest definitions of investment climate suggests that a country’s investment climate relates to its economic situation and tendencies, institutional infrastructure, and its social and political climate (Litvak and Maule, 1970). Collecting information about the suggested variables included in the concept of investment climate might be vital for FDI decision-making in transition economies.

It was also argued that the need for information increases when organisations are large, have diverse product lines, require large investments or face complex and turbulent markets. “If the decision relates to something with which we have less experience, our need for information increases”, suggested Ginter and Duncan (1994, p. 158). It might be hypothesised, therefore, that the process of collecting information is more important in providing feedback for the decision-makers in transition economies than in developed market economies.

Executives involved in the FDI decision-making in the Central and Eastern Europe stressed that ”a shortage of good, accurate and reliable market data and information” negatively influenced the future of investment projects in transition economies (“Assessing Investment Opportunities in Economies in Transition”, 1994, p. 12).

On the other hand, it is possible to collect huge amounts of information and to not use it when decisions are made (See Feldman and March, 1981). Besides, collecting information might be less important for transition economies due to permanent changes in the investment environment and absence of good quality, sufficient and reliable data (The same problem for the Asian region was discussed by Lasserre and Probert, 1998).

The reliability of accounting information providing the data for evaluation techniques, was questioned by many researchers. Underreported sales for the registered firms in the Ukraine averaged 41 percent of total sales, in Russia - 29 percent, while in Slovakia, Romania and Poland underreported sales were much lower, averaging between five and seven per cent (Johnson, Kaufmann, McMillan and Woodruff, 1999, p. 3). Can we treat such data as an ‘objective’ instrument?

In order to get the information about the investment climate in the country of potential investment, different methods of data collection can be used (See, De Ginter and Duncan, 1994; Mortanges, Pahud and Allers, 1996). These methods include:

- **Qualitative unstructured methods** (knowledge of managers and expert opinions);
- **Qualitative structured methods** (Delphi technique, standardised checklists and different scenarios methods);
- **Quantitative methods**.

Schoemaker (1994) believes that companies confronted with major uncertainties or sudden discontinuities may find the scenario method to be the most useful. The method is well suited for addressing such external changes in information as deregulation, foreign competition, new technology, and increased environmental concerns.
Ginter and Duncan (1994) claim that the Delphi technique, expert opinion and scenario development are the most effective to study emerging trends in the social, economic, political, and technological uncertain environments.

Some researchers, however, have found that most of the companies do not use all the available methods and are often satisfied with the information obtained via mass media (Zink, 1973). Other methods might be appropriate for the rapidly changing environment of transition economies.

Personal contacts have been identified as important sources of technological information in the uncertain innovative process (Malmberg, Sölvell and Zander, 1996; de Meyer, 1991).

Besides, managers are often forced to wade into a sea of ambiguous, conflicting, and contradictory information and decide what to pay attention to and what to ignore. Sutcliffe and Zaheer (1998) suggest, therefore, that an extensive search for information shall be incorporated into a broader context and seen in connection with a firm’s background, decision-making routines, current decision situation, history, etc. The extent to which managers take relevant contextual information into account may moderate the relationship between the level of uncertainty and decision-making.

To sum up, the following schema may be suggested as a starting point for the analysis of the information about the investment climate and information collecting methods used by companies conducting FDI in transition economies:

**Figure 13. Information about the investment climate and information collecting methods for FDI in transition economies: a schema for analysis deduced from theoretical and empirical studies**

*Source: Olga Golubeva (own)*
5.5. Project evaluation methods and investment decision criteria

5.5.1. Traditional capital budgeting methods

What investment criteria might help companies to decide about investing in countries of Central and Eastern Europe? Some authors suggested reducing the universe of competing opportunities (Frydman and Rapaczynski, 1994). This means that if the decision about investment to a transition economy’s country has already been made, the assessment problem is reduced to the internal investment options with approximately the same level of risks involved. But what are the initial investment decision criteria?

Although the original decision to undertake an investment in a particular foreign country may be determined by a mix of strategic, behavioural, and economic decisions, the specific project, as well as all reinvestment decisions, should be justified by traditional financial analysis. The traditional investment appraisal methods are covered by such well-known authors as Brealey and Myers (1996), van Horne (1995) and Ross, Westerfield and Jaffe (1996).

Theory of business administration uses the Net Present Value (NPV) of the investment as the basic concept for capital budgeting. Capital budgeting for a foreign project is based on the same theoretical framework as a domestic one. Project cash flows are discounted at the firm’s weighted-average cost of capital, or the project’s required rate of return, to determine net present value. Alternatively, the Internal Rate of Return (IRR) that equates project cash flows to the cost of the project is sought.

The traditional Pay-back Method (in spite of its critics) is still one of the favorites among decision-makers. Tell (1978) studied investment budgeting calculations performed at thirty big Swedish companies from different branches. The investigation has showed that Pay-back Method is the most often used, and the second most popular method is IRR (approximately 50 per cent of companies used it) (p. 249). Other studies also show that at least one of the capital budgeting methods and quantified criteria are used by companies for FDI decision-making (Björkman, 1989; Persson, 1990; Yard, 1987). Barius (1987) came to the conclusion that projects with yearly profits of 25-40 percent, or Pay-back equal to 2,5-3 years, were classified by investors as attractive investment possibilities (p. 160).

Theoretical literature attempts to separate sophisticated and basic calculation methods. According to Jansson (1992), in order to be ranked as sophisticated, a method should treat the time dimension with the help of discounting. In order to cover different factors, the calculation methods also started to introduce concepts of uncertainty and multiple decision-making criteria, the influence of taxation, inflation, exchange rates, etc. Once the most likely outcomes are determined, a sensitivity analysis and different scenarios method are normally undertaken. (Kim (1982) and Haka, Gordon and Pinches (1985), on the other hand, provided empirical evidence that there is no correlation between using the sophisticated evaluation methods and the profitability of the projects.)

Some scholars have demonstrated that ‘magic numbers’, such as NPV or Pay-back figures, guide companies’ investment decisions in transition economies.
High profits to new entrants are believed to be common in the early stages of reform in the formerly planned economies. An average rate of profit on capital in China was reported to be 40 per cent in 1978, the first year of reform; in subsequent years this profit rate fell as China’s reformation proceeded (Naughton, 1995, p. 150). On the basis of a survey conducted by Lasserre and Probert (1998), it can be argued that financial and business risks, as well as return on investment (ROI), are generally perceived to be higher in Asia than in Europe.

Initial entrants in transition economies often earn large profits, which fall over time as new firms enter. The results of the survey show that the reported after-tax profits in 1996 were 21 percent in Russia and 18 percent in Ukraine. In comparison, companies operated in Poland where the transition process had progressed much further than in Russia and Ukraine, reported the after-tax profit amounted to 10 percent in 1996 (Johnson, McMillan and Woodruff, 1999, p.5).

Therefore, one might suggest a set of the traditional capital budgeting techniques as investment criteria to conduct FDI in transition economies, i.e.: The Net Present Value of the investment, The Pay-back Method, The Accounting Rate of Return Method, The Internal Rate of Return, The Sensitivity Analysis, Different Scenarios Method.

However, the perspective traditionally taken in capital budgeting analysis is a static one. It is static in the sense that FDI decisions are assumed to be fixed in advance and it is this scenario that underpins the base case set of incremental cash flows. In reality, managers frequently attempt to maintain flexibility on as many operating fronts as possible, enabling them to alter direction in response to attractive changes in the business environment or to avoid potential pitfalls.

Therefore, some authors suggested option theory as a complementary criterion to traditional capital budgeting techniques (See Aggarwal and Soenen, 1989; Dixit and Pindyck, 1994 and 1995; Myers and Majd, 1990). Sercu and Uppal (1994) and Bell (1995) focus on the production flexibility of the international firm to switch sourcing following shocks in economies in which the multinational operates.

Consideration of the options aspect of investment in asset markets (as opposed to financial markets) has not been widely explored in the literature in terms of its application to international capital budgeting. In respect to investment decision-making, this means keeping open the opportunity to make decisions contingent upon information becoming available in the future. For example, depending on a particular situation, the existing production facility of a project may be preserved, accelerated, closed temporarily or even abandoned.

Buckley (1998) believes that this kind of contingent methodology "would clearly lend itself to toe-in-the-water type investments that a lot of Western companies are undertaking in Eastern Europe or China where upside potential may be evident and, if found to be forthcoming, would involve an up-grading of relatively minor initial investment” (p. 70)

The biggest problem is that Black and Scholes’ model for pricing stock market traded options was based on several assumptions that are probably not directly applicable to international investment decisions (See Supplement 3 for short descriptions of assumptions).
The Black and Scholes approach is only fully appropriate where potential out-turns exhibit a random walk with a constant variance over the lifetime of the option - which can only be exercised at maturity. One can hardly assume that the potential results of building a new plant in transition economies will likely display random walk characteristics and the variance of returns shall be constant over the life of the option. Therefore, the exercise of valuation of real operating options in transition economies probably looks too complex for practical implementation in the real world.

5.5.2. Do capital budgeting methods work?

The conventional wisdom of capital budgeting starts from the economically-rational net present value maximising behaviour of individual managers. It is grounded in the assumptions of the neo-classical theory of the firm, in particular, the assumptions of economic rationality and market equilibrium. The neo-classical theory of the firm, however, was developed for market and industry analyses, not as a description of what managers actually do and how they arrive at this or that investment decision. Instead of describing why and how investment calculations should be done, it might be useful to ask why and how the investment calculations are really used. Or can we predict better, for example, the future of a project by changing investment techniques and by using one method instead of another?

Many researchers are starting to doubt whether a capital budgeting perspective is the most fruitful way of approaching the decision-making process. It is perfectly possible to draw up a budget according to numerous and complex routines in the investment calculations and not to follow it, suggested Högheim, Monsen, Olsen and Olson (1989).

Jansson (1992) refers to the study of English companies where a research fellow, by making a check of answers received via questionnaire, found that only four of 45 companies that replied positively about using NPV - method as decision-making criteria really did use the method (p. 13). Jansson suggested that companies do not want to admit that they only use simple evaluation techniques (if any at all). Another explanation is that the persons participated in the survey were poorly informed about the situation in their own company.

Jansson (1992) also distinguishes between cognitive and communicational purposes of making investment calculations. In the first case, the purpose of making calculations is to provide the internal decision-makers with project background while in the second case the purpose is to explain to others why this particular project has been accepted or rejected. In the first case, project management works with the investment itself, in the second case, project management works with the investment’s image among the others.

Barius (1987) suggests that it is easy for project managers to manipulate the input figures in investment calculations in order to receive desirable result for presentation to the top decision-makers or Board members. Foreign project returns will be particularly sensitive in the case of transition economies when changes in assumptions about political scenario, exchange rate developments and repatriation of funds can lead to different conclusions.
To adjust the investment project to be economically acceptable, the following strategies were suggested by Brunsson (1989): adjust revenues, adjust project expenditures, or both.

Buckley (1998) pointed out that "the decision to invest seemed to be propelled by a process of negotiation and compromise as opposed to economic evaluation. Personal influence and negotiating skills often dictate the outcome of an FDI decision" (p. 151).

"The decisive factor… is personal competence and the interest of those who perform the market appraisals, as well as the expectations and aspirations which the relevant decision-makers have with respect to the basis provided for the decision", according to Barius (1987, p. 208).

Therefore, one might hypothesise that none of the capital budgeting methods suggested in the previous paragraph can help to evaluate the FDI project in transition economies and be used as investment decision criteria.

Some other approaches can be derived from the existing literature. Albaum et al. (1994), for example, argue that FDI decision-making, initially and on a continuing basis, should use methods that are consistent with the company’s strategic objectives and that, ideally, all elements of the marketing mix (including decisions on products, prices, distribution, and promotion) should be determined simultaneously.

Budgeting, according to Czarniawska-Joerges and Jacobsson (1989) is seen

“as a symbolic performance rather than a decision-making process; a means of conversation rather than a means of control; and an expression of values rather than an instrument for action. It is reasonable to start with goals, to consider alternatives, to discuss the costs and the revenues of different alternatives. Budget reports then become instruments for reflecting these dominant, rationalistic ideas”. (p. 32).

Hill (1985) and McDonald (1985) state that a sound investment should be viewed as one which contributes to agreed corporate strategy rather than satisfying criteria laid down by a set of accounting rules and evaluations, and should emphasise the importance of strategy over financial techniques. The impact of some ‘intangible’ benefits are often excluded from financial analysis due to unsuitability for precise quantification (See Finnie, 1988; Swann and O’Keefe, 1990).

In the 1990s, two surveys were conducted - one on the determinants of Japanese FDI in UK manufacturing and the other on the location of international offices (See Dunning, 1991). In both surveys, variables related to costs associated with interpersonal relations, information asymmetries, language and culture, searching for and dealing with subcontractors, learning about the quality of communications and adapting to local business practices and customer needs, and bureaucratic controls were ranked considerably higher as investment determinants than were traditional variables included in calculations.

According to Watkins-Mathys and Hill (1995) the previous business experience of joint ventures in transition economies in the former socialist countries was a major factor influencing their success.
Some research results stress that besides expected return on the investment, companies who are considering investments in transition economies must adapt the investment criteria to the type of investment vehicle, appraisal techniques, assumption of existing liabilities, duration of negotiations, etc (“Assessing Investment Opportunities in Economies in Transition”, 1994). Fey (1995) who studied Russian-foreign joint ventures suggested that strategic issues are even more important in transition economies than in most countries because the environment is changing so radically.

It might be hypothesised that opportunities available to the foreign investor - like strategic competitive advantages, market position, access to the natural resources, etc. - could explain starting the project even if orthodox NPV is negative, especially when the project consists of several steps and the information about the total cost of investment will be revealed only as the first few steps of the project are undertaken.

We might also question the role of traditional calculations in FDI decision-making in transition economies.

Three alternatives can be suggested:

- The decision can primarily be based on the capital budgeting calculations;
- Or after the decision had already been made, a decision-maker provided the full package of calculations according to the capital budgeting techniques;
- We can not exclude the possibility that a decision-maker ‘balances’ all the time between the formal calculation requirements and other strategic positions.

5.5.3. Alternative suggestions about investment decision criteria

Some researchers suggest that intuition and the judgement of management often play as big part in complex decisions as do budgeting techniques. According to the results of an investigation conducted in Russia, 50 percent of Russian bankers make their investment and financial decisions on the basis of intuition, personal contacts and private recommendations (See “Kommersant”, 1993).

For many decisions, the answer does not just fall out of the figures; numerical calculations may be made to inform the outsiders. A decision can instead rely upon judgements about the feel for the direction of movement in the market place or the extent of retaliation by competitors (See Eisenberg, 1984; Issack, 1978; Simon, 1987). We can hypothesise, therefore, that the judgement and intuition of managers might be as important investment decision criteria in transition economies as properly done calculations.

The importance of personal contacts in the business sector of the local country was stressed by several researchers (See Wilson and Donaldson, 1996). McCarthy and Puffer (1996) write, for example, that ”western managers need reliable and effective business partners to navigate through the confusing and political environment” (p. 162).

According to Fey (1995), the most common cause of joint ventures failure was a basic misunderstanding about the roles or goals of the partners. Foreign managers often do not realise that there are differences between the optimal way to run a Russian-foreign joint venture and the traditional method by which most Western firms are operated.
Choosing the ‘right’ partner, spending extra time in the negotiation phase to understand the other partner, reliable communication between partners, as well as knowledge regarding business practices in Russia in general are among the most vital criteria for surviving in rapidly changing and unfamiliar environment.

Personal contacts have been identified as important sources of improvements in the uncertain innovative process (Malmberg, Sölvell and Zander, 1996; de Meyer, 1991). Elenkov (1997) has shown that the creation and maintenance of close exchange-of-favor relations with the dominant political and economic power networks is the most important source of competitive advantage in Bulgaria. When environmental uncertainty is high, personal sources may provide the adequate understanding needed by decision-makers to interpret unclear issues. Furthermore, the use of personal connections and informal influence to get the job done are considered by the author to be typical for the business culture in the Central and Eastern Europe.

Lasserre and Probert (1998), who surveyed 294 West European and American managers employed by MNE in the Asia Pacific region, confirmed that the issues of relationships and personal contacts were more crucial in Asia than in other parts of the world. ‘Old school ties’ or regimental networks are of course not unknown in Europe or the United States, but in many Asian countries their activities can be much more pervasive and not simply confined as they often are in the Western societies. Decisions in Asia tend be built on ‘softer’ criteria than one finds in western business circles, and personal relationships in the working environment - with employees, suppliers, partners - take priority over rationally based business arguments.

To conclude, the existence of personal contacts with individuals in the business sector of the local country help to navigate the investment project through the uncertainties associated with environment of transition economies. This factor might be suggested as an investment decision criterion.

Making contacts with the representatives of local government is also suggested as a decisive factor when the destiny of an investment project in a transition economy is determined (See “Assessing Investment Opportunities in Economies in Transition”, 1994; Lasserre and Probert, 1998; Neal, 1997).

Due to the specific characteristics of the environment of transition economies, new investment decision criteria might appear.

5.5.4. Summary of the paragraph

The following schema may be suggested as a starting point in a search for project evaluation methods and investment decision criteria for FDI in transition economies (see the figure below):
5.6. Risk analysis in transition economies

5.6.1. Political risk, macro and micro risks in FDI decision-making

Risk, especially political risk, is considered to be one of the most important factors when a company is deciding whether or not to invest direct in a foreign country. On the basis of survey, Lasserre and Probert (1998) argued that financial and business risks are generally perceived to be higher in the emerging markets of Asia than in Europe.
Thunell (1977) studied instability and analysed the relationship between risk and the outcome of the investment decision process. He confirmed the hypothesis that the investments in a country decrease when a country is unstable and increase when it is stable. However, Thunell also noted the opposite trend in some Latin American countries.

Paradoxically, studies show that systematic analysis and evaluations of investments in countries with high political risks are rarely done. Studies of US firms conducted in the 1980s indicate that there are still a large number of firms that do not rely on systematic means of assessing political risk (See, for example, Kobrin, Basek, Blank and Lapolombaro, 1980).

Ehrengren (1986) constructed the so-called BERA model (Business Environment Risk Assessment) and applied it to two examples of production investments made by Swedish companies in the Philippines and in Colombia. The study supports the assumption that a systematised risk assessment gives better investment decisions based on the fact that a well-structured action program in each step of the process will increase the efficiency of the risk assessment. The study postulates that risk assessment could readily lead to incorrect investment decisions.

The study conducted by Sandin (1980) aimed to construct a model for a risk statement, a risk accounting instrument. Interviews have been conducted in 15 large business groups and 11 small companies representing different activities. “A decision alternative is found ad hoc from case to case”; the decision rule “don’t risk too much for too little” seems to be often used (p.207).

De Mortanges and Allers (1996) examine the political risk assessment strategies of 23 Dutch firms. Results show that the institutionalisation of political risk assessment practices is not very high in the Netherlands, and that for the chosen sample of firms risk analysis is carried out mostly in an ad hoc fashion.

On the other hand, the strategy to rely upon up-to-date ad hoc assumptions might be the right one due to the fact that political risk appears to be “very unsystematic in nature and thus very unpredictable” (Khoury and Zhou, 1999, p. 8). Why shall companies invest sufficient resources in producing long-term forecasts when the political situation is changing so rapidly?

The effect of political risk on FDI was not found in an analysis of 269 German and British companies investing in five countries in transition economy performed by Meyer (1996).

Several hypotheses about the role of political risks for FDI decision-making in transition economies may be suggested. It may be also hypothesised that political risks essentially influence, have some impact, or are irrelevant for FDI decision-making in transition economies.

Kobrin (1982) has classified contemporary risks along two dimensions: country-specific, or macro, risks that affect all foreign firms in a country without regard to what they do, and firm-specific, or micro, risks that are specific to an industry, a firm, or a project.
Macro risk occurs when all foreign enterprises are affected in much the same way by discontinuities in the business environment. Examples of macro risks are revolutions, civil wars, nation-wide strikes, protests, riots, and mass expropriations. At the macro level, firms attempt to assess a host country’s stability and attitude toward foreign investors in general.

Different scenarios describing the role of macro risks for FDI decision-making in transition economies are possible. It may be assumed that macro risks essentially influence, have some impact or are irrelevant for FDI decision-making in transition economies.

Micro risks occur when changes affect only selected industries, firms or even projects (so-called industry, company and project risks). Examples of micro risks are selective expropriations, discriminatory taxes and import restrictions for specific industries or even firms. At the micro level, firms analyse whether their firm-specific activities are likely to conflict with a host country’s goals as evidenced by existing regulations.

Kobrin (1982) argues that most contemporary risk for multinational firms involves firm-specific risks and operations rather than ownership. Most often changes involve constraints, such as restrictions on the free setting of prices, limitations on the use of expatriate executives or workers, or local content regulations for manufactured goods, etc.

Therefore, it might be suggested that micro risks (industry; company and project risks) might be very important and might have some impact, or are irrelevant for FDI decision-making in transition economies.

5.6.2. Risk reduction measures for FDI in transition economies

Even with the best possible country, and industry and firm-specific analysis, companies cannot be assured that the political or economic situation will not change. Some proactive steps (or measures) in advance might help to minimise the risk of damage from such changes.

The study performed by Johanson (1994) describes and analyses the internalisation of four Swedish firms - Sandvik, Atlas Copco, Facit and Volvo. This research shows that Swedish firms often develop their international operations in small steps, rather than by making foreign production investments on single occasions (See also Forsgren, 1989; Johansen and Vahlne, 1977; Johansen and Weidersheim-Paul, 1975). Buckley (1998) claims that this evolutionary approach may act “as a risk-minimizing process given the relative uncertainty associated with operating in a foreign environment” (p. 113).

"In risky markets, the latecomers’ advantages are likely to be larger than the benefits to be earned by pioneer status”, - concluded Burger and Jungnickel (1996, p. 15).

A ‘step by step’ strategy, or gradual transfer of investment money, might then be suggested as a risk minimising approach for FDI in transition economies.

A significant effect of the government policy on the investment climate and attraction of FDI into the country was shown by several researchers (Hood and Young, 1979).
Negotiating with government about investment incentives (especially profit repatriation guarantee and tax holidays) prior to investment might substantially reduce the risk in transition economies (“Assessing Investment Opportunities in Economies in Transition”, 1994).

The research of Rodriguez and Carter (1984), however, resulted in conclusions different from the mainstream research trends. They claim that, to the extent that the corporation views itself as a true multinational, the effect of restrictions on repatriation may not be severe. If the firm anticipates continued investment in a country that is in a growing market, the restriction is not even an issue to be addressed in a good-citizen or bad-citizen framework. Rather, the commitment is made for long-term continuing investments in the country and the restriction on repatriation is generally irrelevant. Meyer (1996) also found that general policy framework plays a more important role in attracting FDI than fiscal incentives and allowances specially designed to attract investments.

Preparing a crisis plan in case the situation deteriorates is another example of a risk reduction measure. Crisis planning for US firms in the Philippines was described in detail by Gonzalez and Villanueva (1992).

Investments insurance, or getting assistance within private or government organisation, is suggested as a risk reduction measure by several researchers, although only one third of companies (of 300 companies interviewed) had benefited from this measure (“Assessing Investment Opportunities in Economies in Transition”, 1994).

Companies that chose not to take advantage of insurance and official aid programs did so for a variety of reasons including: the small size of the investment did not meet the parameters of assistance programs, non-favourable insurance terms and burdensome application requirements.

Khoury and Zhou (1999) warn that ”the concern in country risk is largely in the liquidity (broadly defined) of the investment” (p. 6) Therefore, it might be hypothesised that high liquidity of assets is a powerful risk reduction instrument.

Elenkov (1997), by analysing a sample of 141 medium-size Bulgarian companies, all of them operating in a highly constrained external environment and business culture, has shown that the creation and maintenance of close exchange-of-favor relations with the dominant political and economic power networks is the most important source of risk reduction in Bulgaria. When environmental uncertainty is high, personal sources may provide the adequate understanding needed by decision-makers to interpret unclear issues”, claims Elenkov (p. 294). He also suggests that these personal connections and informal influence have been used to solve important problems in situations characterised by uncertainty in Eastern European cultures for centuries.

Lasserre and Probert (1998) confirmed the continued importance of relationships for risk reduction for the Asia Pacific region.

One might suggest, therefore, that the creation of strong alliances with important power centers that will safeguard the interest of the project under changing conditions might reduce the risk of a potential investment.
Due to the short duration of transformation periods and, therefore, the lack of empirical evidence, new risk reduction measures applicable for FDI decision-making in transition economies might be discovered. Bridgewater and Wenslew (1996), for example, suggested that a company’s high level of international involvement, as well as the experience of presence in emerging markets, may help to reduce the investment risks in transition economies.

5.6.3. Risk adjustments in project evaluations

The central proposition of trade-off between risk and return in modern financial theory is based on the proposition that risk-averse investors must be promised a higher nominal return to bear a higher risk. The additional risk that stems from its ‘foreign’ location can be handled in at least three ways (See, for example, Shapiro, 1990).

The first method is to treat all foreign risk as a single problem by increasing the discount rate applicable to foreign projects relative to the rate used for domestic projects to reflect the greater foreign exchange risk, political risk, and other uncertainties perceived in foreign operations.

In the second method all foreign risks are incorporated in adjustments to forecasted cash flows of the project. The discount rate for the foreign project is risk-adjusted only for overall business and financial risk, in the same manner as that for domestic projects. Buckley (1998) believes that the most explicit way of dealing with a country’s risk is to make adjustments to the numerator of the present value calculation, that is, in the cash flow forecast for the project itself.

The third method suggested by theory for incorporating the additional risks into foreign investment analysis is shortening the minimum Pay-back period.

None of the aforementioned approaches, however, lends itself to a careful evaluation of the actual impact of a particular risk on investment returns.

Using a uniformly higher discount rate might just distort the meaning of the present value of a project by penalising future cash flows more heavily than current ones, without obviating the need for a careful risk evaluation. Furthermore, the choice of a risk premium is an arbitrary one, whether it is two percent or 10 percent (See, for example, Eiteman, Stonehill and Moffett, 1995).

Johnson, McMillan and Woodruff (1999) asked managers whether they would invest 100 USD today if they expected to receive 200 USD in two years. The response of 1,471 managers from five countries with transition economies’ gives an indication of the opportunity cost of money. A striking 98.9 percent of Russian, and 99.3 percent of Ukrainian, managers would not make such investment (in comparison with 22.1 percent of managers from Poland) (p. 41).

If we adjust the calculations to additional risks confronted in transition economies according to such high discounts, there would be no direct investments at all!
The CAPM is a theory based on very strict assumptions and is applied only under perfect market conditions. If the true relationship between the risk of a particular company and that of the market portfolios was not established, there is no reason to believe the basic CAPM formula is correct.

According to the study of Franko (1996), companies in different industries clearly rank and assess risk in countries with transition economies in different orders. Sometimes companies in the same industry, even direct competitors, rank the same country at opposite ends of the ‘investment-attractiveness’ spectrum.

It can happen that a one company’s risk is another’s opportunity. Instead of the usual description of risks in general terms, they should probably be related to the specific project in the particular investment environment.

Therefore, one might suggest that risk adjustments for project evaluations be elaborated for a particular project. At the same time, it can be hypothesised that risk adjustments might be the same for all projects for a particular country with a transition economy, or the same for all transition economies, or emerging markets.

5.6.4. Summary of the paragraph

The following schema may be suggested as a starting point in risk analysis in transition economies:

**Figure 15. Suggestions about risk analysis for FDI in transition economies deduced from theoretical and empirical studies**

*Source: Olga Golubeva (own)*
5.7. Conclusions for the chapter

The purpose of this chapter is to provide a theoretical framework for FDI decision-making model in transition economies. Based on the theoretical studies of traditional models, the following building blocks are suggested: initial motivation (or reasons for FDI), information about investment climate and information collecting methods, project evaluation methods and investment decision criteria, and risk analysis.

Relating, in other words the process by which relationships between variables or concepts are uncovered, is unclear. FDI might be conducted as a series of logical, rational, step-by-step activities. On the other hand, the relationship between the suggested blocks might have a more complicated character than a linear development of consequential steps.

The four main blocks suggested for investigation will be used as a theoretical framework for empirical investigations. Each of the blocks of the schema deduced from the literature will be filled then with empirical data. Besides traditional theories broadly approved in the research community, some alternative hypotheses are suggested for different blocks of the model. All blocks of the model contain some open questions and, therefore, provide the possibility of searching for the new variables that might be relevant for explaining FDI decision-making in transition economies.
6. CASE 1: ERICSSON’S DIRECT INVESTMENTS IN RUSSIA

“It’s about communication between people...
The rest is technology”.

Ericsson’s slogan

6.1. Introduction

The purpose of this chapter is to present the first case - Ericsson’s FDI in Russia. During 1997 - 1998 sixteen top managers from Ericsson who participated in the decision-making about direct investments to Russia were surveyed. The qualitative (informal) interviews with decision-makers were followed by a structured interview questionnaire based on the theoretical framework elaborated in Chapter 5. Partial updating of the case was done in 2000.

The case is based on the information obtained during the interviews and survey, a review of the literature, the company’s archives, documents and press releases, newspaper articles and direct observation of some meetings. (1)

Interviewed managers were unanimous in their opinions that the process of FDI decision-making shall be co-ordinated with strategic, political, historical, social and cultural issues. Therefore, Ericsson’s direct investments in Russia are presented in connection with other relevant factors: the company’s historical involvement in Russia, marketing strategy, human resource development, the privatisation and restructuring of telecommunication sector in Russia, etc.

6.2. Ericsson’s organisation and its decision-making implications

6.2.1. Ericsson as one of the world’s leading telecommunication companies

Ericsson is one of the world’s leading telecommunications companies. The company offers systems, products and services for the transmission of speech, images, data and text over private and public networks. It was built up around production of the AXE switches to serve the state-owned telecommunication clients. In 1999 more than 70 percent of Ericsson’s sales were generated from mobile systems and terminals.

The rapid changes in markets and technologies make it necessary for Ericsson to become more efficient in all areas of business: strategy, research and development, design, production, marketing, administration, risk assessment and investment decision-making.

As a result, the company’s employees have become accustomed to very rapid changes in all spheres. According to the management, due to market and technological changes, every third year Ericsson becomes a new company.

Ericsson’s operations are global and around 90 percent of its sales are outside Sweden. Ericsson’s more than 100,000 employees are active in 140 countries. Global presence means economies of scale as Ericsson can focus resources on the technologies and geographical areas that show the best potential for growth and profitability.

6.2.2. Investment decision-making at Ericsson Corporation

Foreign investment decision-making at Ericsson is conducted on two levels. The direct investment decisions are often initiated by three main business areas. A unit of a business area is quite independent at Ericsson and is authorised to make decisions of a smaller scale on their own (like investments of approximately one million US dollars). When it comes to bigger volumes or more strategic issues - like decision to enter a new country - a Board of Directors makes the decision. However, the informational background and suggestions regarding the decision are mostly prepared by the business areas.

Ericsson has established local companies in about 50 countries that are concentrating on the ‘local added value’ questions (services, sales, legislative information, etc.). Their task is to estimate the potential of the market and elaborate possible strategies, including the valuation of investment projects. In order to support this other dimension of decision-making - on the level of companies - each of the countries has a separate Board of Directors.

At present the main business areas are much stronger than decision-making at the local corporate level. Some managers pointed out, however, that it can be logical to delegate more decision-making power directly to the country’s office that possesses the information about the local investment environment.

According to management, the investment routines - project evaluation and risk assessment - are changing all the time. The world becomes more complicated and new considerations become necessary in the decision-making process. These considerations include investments into design, marketing and education. Direct investment projects, according to the management, shall be viewed in the whole spectrum of organisational and institutional changes in Ericsson corporation as well as the whole fabric of the society.

Some managers also believe that the investment decision-making process developed by Ericsson for Eastern Europe influenced decision-making in the whole Ericsson concern. Now, if Ericsson wants to enter some turbulent market, similar research about the country (to that conducted for Eastern Europe) is required.

"Foreign companies operating in transition economies learn from experience. My personal impression is that Ericsson’s experience in Eastern Europe has been incorporated into the decision-making process of the whole company", said one of the top managers.

At the same time, according to management, the process of decision-making becomes more formal. More routines are often required in order to decide about particular project financing.
The Credit Committee has been settled in Ericsson in order to decide about credit and financial risks. Managers responsible for a project present the materials to the Credit Committee, and if we have a complicated case (like the majority of projects in Eastern Europe), the approval of the Board of Directors is required.

The foreign investment decision process at Ericsson is presented in the schema below:

![Diagram](image)

**Figure 16. Foreign investment decision process at Ericsson**

*Source: Ericsson, company archives and interviews*

### 6.3. Ericsson in Russia: history, presence, future

The story of Ericsson in Russia began in 1893, and has continued through the whole century and includes ambitious plans to expand in Russia in the next century. According to the management, the decision to start to invest directly in Russia is inseparably connected with the history of the company.

#### 6.3.1. Ericsson in Russia before the October revolution of 1917

Over a hundred years ago, Russia was the most important foreign market for Ericsson. Its first telephone exchange in Russia, a limited company under the name of Aktiebolaget LM Ericsson & Co. (LME), had installed as early as 1893 in Kiev.
It was followed by installations in Kharkov (1896), Riga, Kazan and Tiflis (1900). Therefore, when in 1897 Ericsson opened a workshop in St.Petersburg where telephone equipment was assembled from the components manufactured in Stockholm, it was a perfectly logical development.

By 1900, severe competition in Sweden raised the question about transferring the main business from Stockholm to Russia. Among the questions Lars Magnus Ericsson, the founder of the company, asked while interviewing his prospective employees at that time was the question about their willingness to be posted in St. Petersburg.

Ericsson believed that, given a fairly modest share of Swedish orders in the company sales, there was no reason why his business could not be conducted from the Russian metropolis as successfully as from Stockholm. However, these plans were never carried out (fortunately for Sweden, which might have lost what has since become her national pride).

The Russian Post and Telegraph Administration, which purchased its equipment mainly from Ericsson, had been for some time pressing the company to start production in St. Petersburg. That insistence was perfectly in tune with the overall industrialisation strategy pursued at the time (in the 1890s) by Russia’s famous Finance Minister Sergei Witte. As for Ericsson, who had lost most of his Swedish market by 1896, he naturally considered the offer worth his while. December 31, 1897, is the foundation date of Ericsson’s factory in St. Petersburg.

Over the four years that the factory was operating on the Island of St Basil, it assembled 12,000 telephone sets and about a hundred exchanges for 100-200 subscribers. As the business grew, the new factory, built at the total cost of about a million kronor, was opened in December of 1901. Lars Magnus Ericsson celebrated his satisfaction with the new factory building by rewarding each of his workers with 25 kopecks of ‘vodka money’.

However, the successful story of Ericsson’s establishment in Russia was interrupted by the October revolution of 1917. Things became more and more difficult: the output was on the decline, and in the spring of 1918 the work had to be stopped altogether due to the shortage of materials, fuel and a labour force. Finally, in the early summer of 1919, the management had to hand the factory over to the government without any compensation. The parent company in Stockholm made several attempts to negotiate with the Soviet authorities about indemnity for its Russian subsidiaries lost through the nationalisation, but without any success whatsoever. Ericsson’s factory in Petrograd entered the Soviet period of its existence under the new name of Krasnaya Zaria (Red Dawn).

In 1921 the Russian losses had to be written off completely, with the losses of the Moscow subsidiary alone estimated at about 50 million Swedish kronor. The all-inclusive value of Ericsson’s factory in St.Petersburg, also lost to the parent company without any compensation, was assessed at 14 million kronor. To cover these formidable losses, Ericsson’s share capital had to be reduced by half with the face value of its shares dropping from 100 kronor to 50!
6.3.2. Never broke links with Russia

It is quite surprising that after losing all its assets in Russia, Ericsson established the first tentative link with new regime as early as 1918. In 1925 Ericsson signed an agreement with the State Trust for Low-Current Industry in the USSR. Since then, occasional deliveries of equipment to the Soviet Union have continued.

Between 1957 and the end of the 1980s Ericsson products were known to the USSR, mainly thanks to the trade efforts of a Croatian company, Nikola Tesla from Zagreb, which had a license to produce Ericsson products. In 1995 Ericsson finally purchased 49 percent of Nikola Tesla’s shares and the Croatian company joined the big Ericsson family under a new name, Ericsson Nikola Tesla. In the course of almost 40 years of its co-operation with the Russian telecommunication industry, Nikola Tesla provided and installed over 250 big telecommunication objects of various types in all of Russia. In the late 1980s, when there was a boom of joint ventures in the Soviet Union, Ericsson was not in a hurry to join the trend. Having lost its property in Russia in 1918, Ericsson certainly had better reasons than any other Western company for circumspection and caution.

It was only in 1991 that the first joint venture with Ericsson’s participation - the joint-stock company Incom that specialised in supplying office communication networks - was formed in Russia. Apart from the Swedish partner, it incorporated the Moscow international operator MMT, the Russian national operator of long-distance communication Rostelecom, and two Croatian companies collaborating with Ericsson on the Russian market - Nikola Tesla and Machino Impex.

6.3.3. In Russia again

On 16 November 1994 the Russian subsidiary of Ericsson was opened in Moscow. It was registered in accordance with Russian law as the joint-stock company, Ericsson Corporatia. The structure of Ericsson Corporatia is presented on the schema below:

![Figure 17. Structure of Ericsson Corporatia, a local Russian subsidiary of Ericsson](image-url)
At the inauguration ceremony of the Ericsson Corporation, the former Minister of Communications in Russia remarked that Ericsson had been two years late compared to its main competitors. At the same time, the rapid expansion of Ericsson’s operations on the Russian market shows that the company’s arrival was carefully and thoroughly prepared.

6.3.4. Well prepared to enter Russia in a ‘Swedish’ way

According to the management, Ericsson entered Russia in the traditional ‘Swedish’ way.

"We did not get the ‘signals’ from the senior decision-makers from Ericsson to enter Russia. In the case with ABB and Tetra Laval, for example, top leaders took personal responsibility and convinced other members of the Board to proceed. At Ericsson, nobody from the top management took the initiative ‘to push’ the development,” explained one of the managers.

The fundamental research about Russia was done in the framework of the project ‘Eastern Europe’ headed by former Vice CEO of Ericsson Lennart Grabe. The information sheets prepared in cooperation with the East European Institute of the Stockholm School of Economics contain the general information about the demographic, macro-economic, legal, political and economic situation of twenty-seven countries. The second part – a description of the situation in the telecommunication industry - was prepared by members of an Ericsson team. It contains the short description of the legal framework in the industry, market potential of the different regions, the main actors in the branch, a description of local networks, long-distance communication systems, mobile systems. Comparisons and analysis of the acquired facts have been carried by the Ericsson’s managers (such as GDP per capita in comparison with the telephone lines per 100 inhabitants, etc.).

According to the report, Hungary, Poland, and the Czech Republic were considered to be of special interest for Ericsson. The potential long-term interest has been identified in Slovak Republic, Baltic countries, Croatian Republic, and Bulgaria. Rumania was identified as a country of a permanent limited local presence. The rest of the countries were classified as ‘opportunities markets’. Russia was called the ‘country of an outstanding market potential’.

Risk issues were central to the research report ‘Project Eastern Europe’. From the graphic presented in the Supplement 4 we can see that ‘an outstanding market potential’ of Russia will depend on the political situation.

6.3.5. Ericsson’s strategy in Russia

The general strategy of Ericsson in Russia includes different variables:
- Marketing and sales, including market adaptation and certification of products
- Financing
- Local establishment in different regions
- Real estate business
- Transfer of technology & competence development
- Production
The well-elaborated strategy is often mentioned by both Russian government and management of the company as one of the reasons of the successful establishment of Ericsson in Russia.

6.3.6. Plans for expansion in Russia

At the end of 1997 Ericsson employed about 350 persons in Russia, and had eight representative offices and five joint ventures. In 1998 Ericsson planned to double the scale of activities in Russia. The number of employees was to increase from 350 persons to 600, the number of offices, from eight to 15, and the number of joint ventures from five to eight.

In 1999 the major market for Ericsson was USA where sales reached almost 24 billion Swedish kronor. The China and Hong Kong markets, which were Ericsson’s largest markets in 1998, declined sharply in 1999 due to weakening after Asian economic crisis. In 1997 Russia had a modest two percent share of sales of Ericsson’s products. Management expectations were then that Russia would appear on the list of Ericsson’s ten biggest markets in the year 2000.

According to Yngve Redling, the former President of Ericsson in Russia, the company had 50 percent of the market of mobile phones and 20 percent of the market of fast telephones in 1997. In some regions, for example East of the Urals, Ericsson had almost 70 percent of the market. Redling estimated sales around 350 million USD in 1997, and orders for about 500 million USD. “According to our prognoses, the revenues will reach the number of 850 millions USD (or 6.4 billion SEK) by the year 2000, and I would not be surprised if we will reach the figure of 1 billion USD”, said Yngve Redling.

Figure 18. Ericsson’s forecasts of sales in Russia in million US dollars for 1997 - 2000

Source: The article ”Ericsson bygger ut och fördubblar verksamheten”, published in ”Dagens Industri”, October 8 1997, p. 1,6
Despite the financial crisis in August in 1998 in Russia, Ericsson planned to double its sales in Russia in 1997 to 600 million USD dollars. According to management, none of the Russian cellular phone companies which have short-term contracts with Ericsson had yet announced changes in their investment programs due to the political and economic crisis in Russia.

The plans were not implemented in reality. Instead of Russia, Turkey became one of Ericsson’s ten largest markets in 1999. In Central and Eastern Europe, the trend for 1999 in general was positive, while a huge downturn amounted to 55 percent was noted in Russia.

The Russian crisis (when Russian rouble was devalued 75 percent and the banking system collapsed) hurt Ericsson’s expansion plans. The situation has started to change only during the year 2000. On the 22nd of September, 2000, Ericsson informed the market about getting the largest order contract valued at one billion Swedish kronor from Sonic Duo, one of the three GSM-operators in Moscow. This order confirmed for Ericsson that the Russian market started to be re-born after the huge down-turn in 1998.

To sum up, Russia provides Ericsson with enormous marketing possibilities while the uncertainty is very high.

6.4. Investment environment in the telecommunication sector in Russia

6.4.1. Considerably underdeveloped, but offers room for growth

In the former USSR, telecommunications for non-military applications were not given a high priority. The consequence of this was that Russia inherited a largely underdeveloped telecommunications infrastructure. Russia considerably lags behind the OECD average on all measures of a country’s telecommunications situation: penetration, digitalisation, revenues per line and revenues as a percentage of GDP (See Supplement 5).

The number of access lines in Russia offers room for growth; Russia has only 18 lines per 100 inhabitants, compared to the OECD average of 45. The number of people waiting to have lines installed exceeds the number of existing lines.

According to estimations made by the management of Ericsson, approximately 20-25 million fast network lines are older than 40-50 years and need to be replaced soon. Additionally, every year Russia needs the installation of new lines. During the next 5-7 years, Russia will need about 50 million lines. Russia’s primary public network is the world’s largest with roughly 200,000 kilometres of cable lines and 120,000 kilometres of radio-relay lines, but its quality is far behind not only those of industrialised countries, but also of many developing countries.

The number of international channels serving Russia has increased from 2,000 in 1992 to the present 51,000. However, international capacity is still low by global standards. (The UK, for example, has 51,000 international channels serving a population of roughly 50 million.)
The Russian cellular market has grown spectacularly in recent years, from a total of 6,000 subscribers in 1992 to more than 200,000 in 1996, and has reached 358,000 by October 1997. However, the current penetration rate is still only 0.1 percent compared to a rate of 5-6 percent in the rest of Eastern Europe.

The need for substantial investments into the Russian telecommunication sector provides foreign investors with big potential for growth.

6.4.2. The privatisation process and investment possibilities in the telecommunication sector in Russia

The Soviet telecommunications company was broken up in 1992 and the industry was privatised in a process similar to the AT&T divestiture. At present the Russian telecommunication sector includes 87 regional telephone operators and the long-distance and international provider Rostelecom (See Supplement 6).

These companies were privatised in 1993, where the management received 5 percent, the employees 35 percent, the Russian state 38 percent and the remaining 22 percent was sold through auctions. The state’s holdings were put into Svyazinvest, a quarter of which was sold in 1997 via auction to a group led by Uneximbank, Deutsche Morgan Grenfell and George Soros. The next 25 percent of Svyazinvest is planned by the government for sale through auction. However, according to management, Ericsson does not plan to bid for the stake.

"The whole telecommunication sector in Russia has been created from scratch. And this process is not finished yet”, - pointed out one of the managers from Ericsson. Besides, following the market collapse in 1997-1998, many telecommunication stocks currently trade at depressed multiples, presenting a buy opportunity for investors with a good potential value given the sector’s generally solid fundamentals.

Some factors, however, reduce substantially the investment attractiveness of acquisitions. The biggest problem, according to managers from Ericsson, is political uncertainty. The second biggest problem is the poor technical level of the majority of assets in the whole of Eastern Europe, including Russia.

A manager responsible for Ericsson’s acquisitions in Eastern Europe commented: “In the West we have already sent assets of such age to the Technical Museum 20 years ago. It is almost impossible to find the proper acquisition object in Eastern Europe. If you will see the list of Ericsson’s acquisitions in Eastern Europe, it looks quite poor. We bought the distributor of Ericsson’s products in Estonia and a company in Croatia that produces equipment according to the Ericsson’s license. If Ericsson wants to acquire something, we’d rather look for plants in the USA than in Eastern Europe. In Russia we have to build plants from scratch”.

The low attraction of the physical capital stock is also the cause of a new phenomenon in transition economies labeled by Meyer as ‘brownfield’ (1996) (contrary to the greenfield strategy). Foreign investors acquire a local firm, or form a JV, but establish completely new production facilities instead of the old factory.
According to management, Ericsson’s JVs serve rather as a reservoir of skilled employees and facilitate relationships with government and local business contacts than as a physical capital stock.

To sum up, Russia which considerably lags behind the OECD average on all measures of a country’s telecommunications situation, provides foreign investors with enormous growth possibilities. Foreign investors, however, are careful with acquisitions due to the political uncertainty and poor technical condition of the assets. Ericsson, for example, prefers to conduct direct investments in the form of constructing a new plant with modern technical equipment.

6.5. Ericsson’s investments in Russia

6.5.1. Schema of main investments

The schema of Ericsson’s main investments in Russia is presented below. It consists of two major parts: direct investments and other types of investments.

![Figure 19. Schema of Ericsson’s investments to Russia, including direct investments](source)

*Source: Ericsson*
6.5.2. Direct investments

The first direct investment of Ericsson in Russia is a joint venture with a powerful financial holding group owned by the government of Moscow, “Sistema”. A joint venture where Ericsson owned a 55 percent majority stake is located nearby Moscow at the city of Zelenograd. The plant that started to operate in the beginning of 1998 produces AXE-switching equipment for mobile and fixed phone networks.

From the beginning, the factory occupies just one floor and employs about 100 persons. It assembles and tests equipment produced in Sweden. The intention is also to use the production facility as a distribution channel for Ericsson’s products.

In 1998 Ericsson started production on the smaller scale of radio access products (DRA 1900) for linking mobile phone calls into the fixed network. The factory with about 100 employees in Nizhnij Novgorod, 450 kilometers to the east of Moscow, is a joint venture between Ericsson (51 percent) and Sviazinform Nizhnij Novgorod, a Russian public telecom operator, and Nitel, a Russian telecom vendor (49 percent). The pilot study was presented in Nihznij Novgorod in August 1997. The capacity of the plant will gradually increase to about 500,000 lines a year.

These two projects are the main direct investments of Ericsson in Russia.

6.5.3. "Entry fee to Russia"

The most interesting remark made during the interviews with the top managers from Ericsson was:

"Even if we started the production in Russia, Ericsson was not interested to produce in Russia from the economic point of view. However, the company decided to make direct investments in order to establish the image of Ericsson in Russia as a loyal citizen with 'permanent residence' in the country. Our direct investments can be seen as a method of establishment of goodwill of Ericsson in Russia."

Another major reason for starting production was the adoption of a Decree in February 1996 by the Russian government that elaborated various restrictions on import quotas for the foreign telecommunication companies that had no local production. Actually, the story has not been invented by the Russian government. Countries like China and India, for example, also adopted some export restrictions for the companies that had no local production.

The other Presidential Decree in Russia (from 31 of March 1997) also forces foreign companies to produce locally in order to be able to sell on the market. According to the Degree number eight from the Russian Duma about four million telephone lines should be installed in 1998. Sixty percent of lines were reserved for foreign telecommunication companies that had local production in Russia, 25 percent - for the local suppliers and only 15 percent for the rest of the market participants.
It was necessary for Ericsson to start production in Russia in order to keep and increase the market share (even if the intention to make direct investments had been declared before). The possibilities of marketing internalisation would be very limited if Ericsson would not start to produce in Russia. The pressure from the Russian government was a serious argument for conducting FDI.

"Direct investments is our entry fee to Russia", - joked one of the managers.

6.5.4. Other types of investments

Investments made by Ericsson in Russia are not limited just to two producing joint ventures. While studying the foreign direct investment decision-making, we must consider that the role of production has been changed during the last years, especially in high technological industries.

For companies like Ericsson, it is not any more important to build many plants around the world. It takes just six minutes to produce a mobile phone nowadays. According to the management, the switch produced 10 years ago by Ericsson consisted of 20 percent software and 80 percent hardware. Now the proportions are about 50%-50%. Brains have become more important than machines and buildings.

The substantial part of investment at companies like Ericsson shall be reserved for the promotion of direct investments rather than building new factories. The customer service network, the design of new products, and the training and education of both the labour force and customers are becoming the essential part of the investment decision-making.

Investments of Ericsson in Russia also include
- A training center to educate the labour force and customers
- A customer service network
- HW/SW Design in Russia
- Consulting services

6.5.5. Ericsson Training Center

Surprisingly, the Training Center in Moscow is one of Ericsson’s biggest investments in Russia. According to management, the total investment in Russia amounted 100 MUSD in 1998 (including direct investments, marketing, regional establishment, etc.) while the cost to build the Center was about 15 MUSD.

The Training Center is a Joint Venture (50% - 50%) between Ericsson and Moscow Technical University of Communications and Informatics (MTUC), which was founded in 1921 and which is the leading educational and scientific establishment of Moscow and the whole of Russia in the field of telecommunications.

Reidar Braathen, the Director of the Center, said: "Technology is marvelous - but only as marvelous as the people who know how to make the most of it. Investing in your work force makes economic sense, for it is their skills and motivation that determine how effectively your network is handled. And that is what builds your competitive edge in the market place. In Ericsson, we recognise the importance of your most valuable asset - your people".
The Centre was opened in December 1995. It was followed by the Ericsson Institute - the company’s own Centre for the postgraduate and in-service training of Russian telecommunication specialists.

6.5.6. Design Centre in St.Petersburg

Another sphere of the company’s expanding activities in Russia is research and development. In this sphere Russian computer experts collaborate with their Swedish colleagues in devising software for the Ericsson automatic exchanges.

The next investment planned by Ericsson was in a soft design Centre in St.Petersburg (HW/SW Design). Ericsson believes that by building this Centre the company is getting access to a highly educated labour force in Russia.

6.6. Other activities in Russia

In 1996, Ericsson became a sponsor of the first exhibition of the Viking heritage in Russia. The unique gold and silver treasures from the 7th to the 14th centuries have been brought on loan from the Stockholm Museum of National Antiquities and displayed in the Moscow Kremlin.

In the official statement Ericsson explained its involvement in the exhibition project: “Nothing brings people closer together than an understanding of their mutual history and common spiritual values. Russia and Sweden are neighbours. In the past they were rivals, and now they are partners. Through trade and wars, through making alliances and breaking them again in the course of more than a thousand years, the two countries influenced each other’s cultures as well as their mutual business relations. The opportunity to become a sponsor of the exhibition, The Viking Heritage - A Dialogue of Cultures, is regarded by Ericsson as a great honour and an important step in raising the company’s prestige”.

As a sign of recognition of Ericsson’s role in Russia, the company received an invitation to join the Telecom Forum, an international club of telecommunication companies and specialists operating in Russia. The club, which was conceived and initiated by Vladimir Bulgak, a top Russian decision-maker in the telecommunication sector, has become a venue for informal meetings of the representatives of the world telecommunication giants and the executive personnel of the Russian Ministry of Communications.

Ericsson’s management takes an active part in all activities that can promote the image of Ericsson in Russia. They believe that production in Russia must be seen as a part of this strategy – the establishment of Ericsson as a local company with long-term interests in this particular market.

6.7. Summary of the case

Ericsson’s decision to invest directly in Russia is inseparably connected with the history of the company. The story of Ericsson in Russia began in 1893, was interrupted by the October revolution of 1917, has been continued through the whole century to nowadays, and includes ambitious plans to expand in Russia in the next century.
Ericsson had been two years late compared to its main competitors and entered Russia in the traditional ‘Swedish’ way. The fundamental research about Russia was done in the framework of a project ‘Eastern Europe’ where Russia is considered to be a ‘country of an outstanding market potential’.

Some managers believe that the investment decision-making process developed by Ericsson for Eastern Europe influenced the decision-making of the whole Ericsson group. Nowadays, if Ericsson wants to enter some turbulent market, similar research about the country to that conducted for Eastern Europe is required. The process of decision-making for projects in transition economies becomes even more formal than for developed market economies: required traditional investment routines perform some sort of ‘objectivity’ function in the rapidly changing environment.

Russia, which considerably lags behind the OECD average on all measures of a country’s telecommunications situation, provides Ericsson with enormous growth possibilities. Poor technical condition of the assets in the branch pushes foreign investors to conduct direct investments in the form of a construction of a new plant from scratch rather than to search for acquisition possibilities.

Two main direct investments of Ericsson in Russia are presented in the study: a joint venture with a powerful financial holding group owned by the government of Moscow ‘Sistema’ and production on the smaller scale of radio access products in Nizhnij Novgorod. The reasons for investing directly in Russia have a little to do with the economic profitability of production (even if we can not totally exclude this factor). Direct investments are mainly made in order to establish the image of Ericsson in Russia as a loyal citizen with ‘permanent residence’ in the country and to demonstrate the long-term commitment to the market. Another crucial reason for starting production was the adoption of some decrees by the Russian government that presumed various restrictions on import quotas for the foreign telecommunication companies that have no local production. Therefore, direct investments can be seen as some sort of an ‘entry fee’ for getting the market share in Russia for Ericsson’s products.

The substantial part of investment at companies like Ericsson shall be reserved for the promotion of direct investments rather than building new factories. The customer service network, design of new products, training and education of both the labour force and customers are becoming the essential part of investment decision-making. The Training Center with educational courses for both employees and customers is one of Ericsson’s biggest investments in Russia.

Ericsson’s management takes an active part in all activities that can promote the image of Ericsson in Russia. They believe that production in Russia must be seen as a part of this strategy - establishment of Ericsson as a local company with a long-term interest in this particular market. This strategy does not exclude the importance of economic profitability of direct investments, but stresses the importance of co-ordination of traditional capital budgeting techniques with other issues – the company’s strategy, marketing, investments into research and human resource development, and the historical and cultural traditions of both investor and recipient.
7. CASE 2: VATTENFALL’S INVESTMENTS IN THE BALTIC COUNTRIES

“The Baltic Sea is no longer a sea that divides but a sea that unites…”

Göran Persson, Prime Minister of Sweden


7.1. Introduction

The purpose of this chapter is to present the second case - Vattenfall’s FDI in the Baltic countries. During 1997-1998 nine top managers from Vattenfall who participated in the decision-making about direct investments to the Baltic countries were surveyed. The qualitative (informal) interviews with decision-makers were followed by a structured interview questionnaire based on the theoretical framework elaborated in Chapter 5. Partial updating of the case was done in 2000.

The case is based on the information obtained during the interviews and survey, study of the literature, the company’s archives, documents and press releases, newspaper articles and the direct observation of some meetings.

Following the logic of the previous case, Vattenfall’s investments in the Baltic countries are presented in co-ordination with strategic, political, historical, geographical and cultural issues that can provide us with a better understanding of the decision-making routines. According to management, Nordic Electric Power Co-operation (Nordel), the EU’s decision in 1996 to create an internal electricity market in Europe, the Baltic ring study, future plans to privatise the energy companies in the Baltic countries, etc., all must be taken into consideration when Vattenfall’s investment decisions in the Baltic region are described.

7.2. The Vattenfall’s organisation and its decision-making implications

7.2.1. Vattenfall as one of the leading European energy companies

Vattenfall is one of the largest energy companies in the Nordic market, accounting for 20 percent of the total electricity production. Vattenfall produces and delivers about half of Sweden’s total electricity requirements and is Europe’s sixth largest power supplier. The group generates its electricity primarily through hydro and nuclear power plants, with supplementary production using other energy sources. Vattenfall also conducts operations in the areas of heating, natural gas, accessory services and energy techniques.

During the 1990s, Vattenfall had undergone the transition from a public utility into a customer- and business-oriented limited company. At present, the Vattenfall Group consists of the parent company, Vattenfall AB, and more than 80 wholly or partly owned operating companies.

Vattenfall’s formal organisation is presented in the following schema:

![Figure 20. Structure of Vattenfall’s organisation](source: Annual report, 1999)
With the growing competition on the electricity market, as of July, 1999, the Group was restructured into a matrix organisation, where each business area is responsible for its own separate value chain activity - electricity generation, distribution, energy market operations and services - in all of the countries where it does business.

The Swedish market forms the basis of the Group’s operations, but Vattenfall’s domestic market is being expanded steadily in the Nordic region countries: Finland, Norway and Denmark. Outside the Nordic region, Vattenfall is active in Germany, the Baltic countries, Poland, the Czech Republic, Southeast Asia and South America. Vattenfall’s ambition is to be among the leading players in the Nordic and European energy markets by seeking partnerships, making acquisitions and through direct investments.

7.2.2. Decision-making in Vattenfall’s organisation

Vattenfall is a shareholding company that belongs to the Swedish State. Until 1990, all business activities had been concentrated only in Sweden.

Managers from Vattenfall pointed out that:

- "Vattenfall is a very Swedish company…”
- "We use to follow the traditional set of decision-making routines…”
- "It takes time for us to make decisions and we are very careful with risk evaluation…”
- "We use to earn our money in Sweden…”
- "Vattenfall prefers step-by-step approach as investment strategy…”

However, Vattenfall’s organisation, as well as its decision-making routines, have changed during the last years. The company has been restructured in order to adjust to changes in the energy market and face greater international competition.

In order to handle foreign acquisitions and value the investment possibilities, a special department - Vattenfall International - was built. The new division - Europe- has been formed in 1998 to cover activities outside the Nordic countries (like Germany, Poland and the Czech Republic).

"We must learn to understand other cultures and apply our business methods to the different investment environments. We must learn to make decisions while some parameters and variables are unknown”, mentioned one of the top executives.

Vattenfall International develops the project until the acquisition is made. Then one of the business areas takes over and operates the facilities. Project evaluations are done mostly by internal specialists from the Group functions departments.

The Board of Vattenfall is making strategic decisions (like to enter a new market or to make direct investments). Different business areas, as well as the special department, Vattenfall International, initiate the investment projects.
7.3. From Nordel (The Nordic Electric Power Co-operation) to the Baltic Sea Ring

7.3.1. Introduction

The political and economic opening of Central and Eastern Europe, the reunification of Germany and collapse of the Soviet Union all provided the necessary environment for the compatibility of the European energy sectors.

At the same time the power sector has evolved from being national to international. Creation of Nordic Electric Power Co-operation (Nordel), the EU’s decision in 1996 to create an internal electricity market in Europe, and the Baltic ring co-operation all changed ‘the face’ of the investment environment of the European energy sector.

The purpose of this paragraph is to describe an investment environment in the energy sector in the Baltic Sea Region. Nordel (The Nordic Electric Power Co-operation) brought forward the idea to expand this co-operation to all the countries situated around the Baltic Sea.

7.3.2. Nordic electricity market and Nordel

During 1996, new legislation for the electricity market was introduced in both Sweden and Finland. The national regulatory systems in Sweden, Norway and Finland now emphasise competition and the customer’s right to freely choose electricity suppliers. This creates an electricity market that is, to a large extent, common, deregulated and open to competition.

Sweden and Norway have established a joint pool trading system for electricity called NordPool, and Finland has opened its own exchange, EL-EX. The Nordic region was thus transformed into the world’s largest combined electricity market with free competition. While electricity trading between Nordic countries functions well, there are still some obstacles regarding structural acquisitions in the energy sector. In Norway, for example, the ownership and control over production resources is still protected by law.

The Nordic Electric Power Co-operation (Nordel) was created in 1963. Its role was mainly to optimise the production costs of power in the region. Nordel played a very important role in co-ordinating the construction of new production units and transmission lines. A system was created to make the best use of the cheapest production units with the profit shared between producer and buyer.

Mutual co-operation and increasing competition characterise the latest development of the sector. For Vattenfall, for example, the market share declined slightly in 1996 in Sweden but increased in Norway and Finland.

7.3.3. European electricity market

The trend toward deregulated electricity markets is a European phenomenon. Signing the European Energy Charter in 1991 was aimed to help to liberalise the European electricity market.
Another decisive step was taken within the EU in June, 1996, when Europe’s energy ministers unanimously agreed on a directive to open up the EU’s electricity markets. An electricity market directive was approved by the EU Parliament and Council and took effect on January 1, 1997. The electricity markets in the various EU countries will now be gradually opened to competition.

The national era started with local systems in the early 1900’s, expanding to regional systems in the 1920s-30s, followed by the development of national systems after World War I. Today we have reached the international era in European markets which are characterised by:

- electricity exchange between countries
- introduction of market mechanism
- a good knowledge of the environmental situation and the advantage that can be reached through cross-border exchange
- growing acceptance of ‘commercial’ ways of handling environmental matters in trade
- deregulation of electricity markets

Tough competition between the major players - Vattenfall, Hafslund, RWE, Preussen Electra, HEW, VEAG, etc. - is going to continue in the European energy market. Being a global energy partner, Vattenfall plans to continue to operate within the entire Nordic region and Western Europe as well as to seek investment opportunities in the attractive growth markets of Eastern Europe.

7.3.4. ‘Acquisitions boost growth’

For several years, Vattenfall has pursued a strategy of generating growth on markets outside Sweden. The share of sales outside Sweden increased from 19 percent in 1998 to 25 percent in 1999. According to Vattenfall’s estimations, within a year, operations abroad will be as large as in Sweden.

1999 was a year of major developments in terms of strategic acquisitions and partnerships. In Finland, Vattenfall acquired two electricity companies, Revon Sähkö and Heinola Energia, with a combined customer base of 67,000. Early in 2000, Keski-Suomen Valo was acquired, with 75,000 customers. In Norway, a 49 percent stake in Oslo Energi, which has 385,000 customers, and a 40 percent stake in Fredrikstad Energi, with 35,000 customers were acquired. In November 1999, Vattenfall acquired a 25.1 percent stake in HEW (Hamburgische Electricitäts-Werke) and signed a co-operation agreement with the City of Hamburg that provides Vattenfall with a platform for further expansion in the German market.

At the end of 1999, 10 percent of Vattenfall’s personnel were based outside of Sweden. ”Acquisitions boost growth”, stressed Carl-Erik Nyquist, President and Chief Executive Officer of Vattenfall.

7.3.5. The Baltic Ring study

Baltic ring is not a single but rather several projects that plan to connect neighboring countries in the Baltic Sea Region, to balance fuel resources between countries as well as to concentrate on environmental problems.
Baltic Ring is a vision of a future integrated electric power system in the Northern Europe. (The data describing the situation the energy sector in the Baltic region is presented in Supplement 7.)

Vattenfall, together with Finnish Imatran Voima, German Preussen Electra and Danish SK Power, as well as power companies from the countries around the Baltic Sea, were invited to take part in the study. Thus, the Baltic Ring Study Group included 18 power companies from 11 countries. (1)

The purpose of the study was to investigate the ways of gradual development towards an open and integrated electricity market among the countries surrounding the Baltic Sea as well as to create a mutual understanding among the companies involved in the study.

Modernising the system of generation and distribution of electricity, including the respective institutional settings in the Eastern Baltic Ring countries, is an essential prerequisite for the economic recovery and the environmental rehabilitation of the region. The Baltic Ring projects can contribute to these aims already in the planning stage by providing a forum for discussion, by stimulating a common understanding of problems and by eventually implementing actual projects of mutual interest.

For that reason, the project acted as a catalyst for socio-economic changes. It is important to point out that electricity is one of the most important factors for economic and social stability. A common market for electricity will attract foreign investors in all sectors and thereby benefit the macro-economy of the countries involved.

The Baltic Ring report presented in Riga on January 22, 1998 identifies many advantages of a common electricity market. Higher stability and possibilities of reducing emissions through common environmental standards create extensive benefits for the region as a whole. In economic terms, a common market can lead to lower running costs and reduced investment needs.

It was recommended to initiate the rehabilitation of Riga CHP 2 to a total capacity of 630 megawatt (MW) and to construct new CHP capacity in Kaliningrad. These projects could be the first cases of activities implemented jointly in the Baltic Sea Ring.

Before these possibilities can be fully realized, however, a number of changes are needed. To avoid ‘environmental dumping’ and give all players equal conditions on the market, environmental and trading rules need to be harmonised. The integration should be driven by market forces and socio-economic aspects and not solely by an increased electricity demand.

(1) Participants of the Baltic Ring Study Group : DC Baltija (Baltic States), Eesti Energia (Estonia), Elkraft (Denmark), EnFO (Norway), Fingrid (Finland), IVO Group (Finland), Jantarenergo (Russia), Latvenergo (Latvia), Lenenergo (Russia), Lietuvos Energija (Lithuania), MFE Belarus (White Russia), Preussen Electra (Germany), PSE (Poland), RAO EES Rossii (Russia), SK Power (Denmark), Svenska Kraftnät (Sweden), Vattenfall (Sweden), VEAG (Germany)
The Baltic Ring Study has proved to be an unprecedented exercise in co-operation among utilities in the Baltic Sea Region. One of the major accomplishments of the study has been on-going discussions among the 18 participating power companies and utility co-operation, with substantial input from the scientific environment, the international financial institutions, the EU and other relevant actors from around the Baltic Sea.

In order to continue the co-operation and discussions in the Baltic Sea Region and to promote the further development of a common market, it is recommended that the co-operation between the partners in the Baltic Ring Study is organised in a Baltic Ring Electricity Co-operation (BALTREL). The next step, and the big challenge, is to encourage all countries around the Baltic Sea to form a Baltic Sea electricity market.

The largest energy companies that dominate the market around the Baltic Sea face a new era of co-operation and co-ordination of the activities. At the same time, harder competition is expected in the region. The installed capacity in the Baltic Sea area is 260 gigawatt (GW) while the demand for electricity reaches a maximum of 165 GW.

7.4. Investment environment in the energy sector in the Baltic countries

7.4.1. Introduction

Before 1991 the economy of the Baltic countries was inseparably integrated with the rest of the former Soviet Union. Large industrial enterprises were created, many of them in heavy industry and defense, with production almost completely dependent on imports of raw materials and exports to the rest of the Soviet Union, Russia in particular.

Independence achieved by the Baltic countries in 1991 was followed by a massive economic decline. The main causes were energy shortages due to payments arrears, liberalisation of gas prices by Russia and the loss of export markets in the former Soviet Union. Since 1994 key indicators have been showing a gradual improvement and a recovery of the economy (See Supplement 8).

The purpose of the next paragraph is to briefly describe the investment environment in the energy sector in the Baltic countries.

7.4.2. The privatisation process and investment possibilities in the energy sector

The main instrument of economic restructuring since independence has been privatisation.

Voucher privatisation in Estonia was initially confined to land and housing purchases; in June, 1994, the law was changed to allow citizens to exchange their certificates for shares, with the first public offering for vouchers taking place in November, 1994. By mid-1996 Estonia had sold 433 companies for a total of 227 million USD; by this time the private sector was estimated to be generating 70 percent of GDP. The large enterprises due to be privatised in the coming years include Estonian Telecom, Estonian Gas, Estonian Energy, Estonian Railways and the Port of Tallinn.

Eesti Energia (Estonian Energy), which produces and distributes 95% all electricity in Estonia shall be privatised in the future, when the suitable model for restructuring will be elaborated.
Privatisation of small companies in Latvia has been more or less completed, with 83 percent sold by the end of 1994. Voucher privatisation started in January 1995 when the government adopted the privatisation program with the goal to sell 75 percent of all state-owned companies during 1996. During the first step a 33 percent stake in Latvian Gas was sold to a consortium of Russia’s Gazprom and Germany’s Ruhrgas and Preussen. However, due to the banking crises that occurred at the end of 1995 the privatisation process was almost stopped.

The next major firms to be privatised are Ventspils Nafta and Latvenergo. Latvenergo is the state-owned electricity company that produces, transmits, distributes and trades the energy. The Latvian Privatisation Agency (LPA) expects strategic investors to take up stakes of around 25-30 percent in Latvenergo and has invited 15 international companies, including Vattenfall, to submit bids. At present, the privatisation of Latvenergo is proceeding quite slowly.

Privatisation in Lithuania has been fairly successful. By mid-1996 about 70 percent of all state assets were in private hands. Privatisation in Lithuania started in 1991 with a voucher program, although there were also some cash auctions. The voucher program, which earned the government 850 million USD, officially ended in mid-1995, by which time 90 percent of farms and 97 percent of houses were privately owned.

Discussions about the privatisation of Lietuvos Energija (Lithuanian Power Company - LPC), which has a monopoly on the transmission and distribution of electricity, have been on-going since 1996 among different national and international investors. On January 1, 1997, the Lithuanian State still owned 91 percent of Lietuvos Energija (according to legislation, the share of the state can not be less than 70 percent). In April, 1997, the Parliament adopted a new Law about the restructuring of Lietuvos Energija, under which the non-core activities like heating were transformed to new business entities and would be privatised later on. Vattenfall’s share acquired during privatisation of the vertically-integrated LPC reached 9.7 percent in 2000.

To sum up, after the successful privatisation of small assets in the Baltic countries the focus shifted to cash sales of large state enterprises, particularly in the energy sector. Privatisation of Eesti Energia in Estonia, Latvenergo in Latvia and the continuing privatisation of Lietuvos Energija JSC in Lithuania have been started or will start in the near future. It seems to be the right time for the international energy companies that are looking for strategic acquisitions to enter the Baltic countries and participate in the coming privatisation of the local companies.

7.4.3. First steps in the restructuring of the energy sector in the Baltic countries

The energy industry collapsed after the disintegration of the Soviet Union, losing its main market and its former access to cheap fuel. As non-members of CIS, the Baltic states were charged world prices by Russia payable in hard currency.

After the independence from the former USSR, electricity production and consumption had been substantially reduced in the beginning of 1990, but have started to stabilise over the last few years. The industry sector stands mostly for reduction in the consumption of energy due to the structural reforms of the economy (See Supplement 9).
The total installed capacity in the Baltic countries in 1995 was 11,651 MW, of which 26 percent is the nuclear power plants and almost 20 percent the hydro power plants. Today the total capacity of electricity production in the Baltic countries is higher than the electricity demand, with the exception of Latvia, which imported almost half of its electricity in 1996 (See Supplement 10).

The share of electricity production of countries in the Baltic Sea region is rather low. Estonia accounts for one percent of electricity production inside the Baltic sea region, Latvia for 0,4 percent, and Lithuania for one percent (Sweden, for example, for 13 percent). However, with economic recovery, the Baltic countries started to restructure and reorganise its energy sector according to market economy rules.

In August, 1995, an EU-financed project, the Estonian Power Legislation Project, was launched in Estonia. The purpose of the project was to elaborate the suggestions for establishing an open market in the energy sector. The new legislation regulating the energy sector was adopted in June, 1997, by the Parliament and became effective on January 1, 1998.

In Latvia, the Ministry of Economy, with a special energy department, is responsible for the strategic development of the energy sector. The special body – the Latvian Energy Agency - advises the Ministry of Economy on the issues related to the strategic development of the energy sector. In December, 1994, Latvia signed the European Energy Charter which became the basis for the development of legislation in the energy sector. At present, the work of creating the general laws regulating the whole sector is in process.

Lithuania also has an ambitious national energy strategy with new legislation adopted in 1995. After the election in Lithuania in 1996, the Ministry of Economy with two special departments - energy development and energy resources - took responsibility for the energy questions. The Lithuanian Energy Agency is connected directly with the Ministry of Economy and conducts the planning activities. The creation of the State Commission of Energy Pricing and Energy Activities Control, as well as Vatesi, a nuclear power controlling agency in charge of inspection, has been successful.

We can conclude that even if the Baltic States experienced a sufficient decline in energy production and consumption after achieving independence from the former USSR, the governments of these countries started to restructure and reorganise their energy sectors.

In 1995, Baltic countries also signed an Association Agreement with the EU. The ambition of countries to be members in the EU can lead to a more rational energy sector structure and environmental situation.

7.4.4. The main obstacles on the way to reforms

The main problem in the energy sector of all Baltic countries is that the assets and transmission nets are very old. In Estonia, for example, the life-time of Baltic, Kohtla-Järve and Ahtme’s assets is estimated to be a maximum of 10 years. Water power stations in Latvia, that stand for ¾ of the domestic production of electricity, were built between 1936 and 1979 and need modernisation. The majority of the production assets in Lithuania are more than 20 years old. Even after renovation, the expected life-time of Vilnius-2, for example, is not more than 10 years.
The transmission cables in the Baltic countries are in bad shape and require renovation. About 50 percent of high voltage cables in Lithuania, for example, are more than 30 years old and have reached the end of their life-time. The transmission losses are very high in the Baltic countries and reach, in Estonia for example, 20 percent of the total electricity production. Besides the age of the equipment, theft of electricity also contributes to transmission losses.

Renovation and modernisation in the energy sector demand substantial long-term investments. Due to the economic problems, local investors will have a shortage of finance in the near future. Searching for strategic foreign partnership, therefore, is a desirable strategy in the energy sector in the Baltic countries.

The second problem of the energy sector is pricing. The planning socialistic economy had always subsidised energy prices. In comparison with a market economy, industry customers had higher electricity prices than household customers. "Energy was not treated as a commodity before. In the former Soviet Union it was something that you could get for free from two holes in the wall", joked one of the managers from Vattenfall. "But the situation is changing now. People are starting to understand that electricity is a commodity”.

New systems have been introduced in all Baltic countries. The prices for household customers have been raised (See Supplement 10). Household customers who previously were always subsidised by the government, now pay at least as much as customers in industry.

Tariffs are now differentiated depending on voltage, time of use, etc. High electricity prices have led to a situation where many consumers are unable to pay their bills.

Prices for electricity in Estonia, for example, were raised 382 percent in 1996 relative to 1992 prices. However, during the same period, inflation and exchange rates increased more than electricity prices, which means that the electricity prices went down in terms of real value. For the energy companies it means that revenues do not cover the production costs.

In order to maintain and increase investments, companies must continue to raise electricity prices while they experience some difficulties to collect payments even with this level. Bad payments led to customers’ huge debts to energy companies.

"It is almost impossible to generate cash flows sufficient for financing investments. The old equipment in Latvia, for example, has already depreciated in price. So, everybody is happy to produce cheap energy when the industry has no future,” pointed out a top decision-maker from the Baltic countries.

However, in the long run the electricity prices in the Baltic countries match prices in Northern Europe. One of the major arguments is that energy companies need huge investments.
The third problem of the energy sector (as well as of the whole economy) is the dependence on Russia. The transmission network in the Baltic region had been developed as a part of the former Soviet Union’s electricity network in the north-western region (Estonia, Latvia, Lithuania, White Russia, Karelia, Kola, St.Petersburg and Kaliningrad) and, therefore, was not designed for smaller Baltic countries.

Latvia has insufficient domestic sources of energy, and is therefore almost entirely dependent on imports from Russia. This dependence is a serious constraint on the Latvian economy. As of June 1996, Latvian debt to Gazprom, the Russian gas giant, amounted to 12.6 million USD. Lithuania is also up to 90 percent dependent on energy sources imported from Russia. Lithuania regularly has problems paying its bills, and periodically faces cut-off threats from the Russian gas monopoly, Gazprom. Unlike Latvia and Lithuania, Estonia has substantial reserves of oil shale, about 70 percent of which is used to generate electricity and heat. However, even Estonia still depends on Russia for much of its fuel supplies.

The last problem that was mentioned by managers is that Baltic countries have a big share of nuclear production. More than half of the energy in the Baltic countries in 1995 was produced by the nuclear power plant Ignalina. In 1996, the nuclear power plant at Ignalina produced about 83 percent of Lithuania’s electricity and it now gives the country the world’s highest dependency on nuclear-generated energy. Despite the assistance in upgrading its safety features, the USA recently described the plant as one of the least safe in the world. In mid-1995, the government announced that the plant’s two reactors would be shut down in 2005 and 2010 respectively, and a new plant will be built to replace the generating capacity. Since then Lithuania has postponed the closure plans.

A high share of nuclear production reduces the investment attractiveness of assets for Western investors. One of the managers stated: “Vattenfall will never invest in nuclear power plant production, even if the project can have high profitability. Vattenfall is an environmentally ‘clean’ company. Our image is more important than short-term profits”.

7.5. Vattenfall’s direct investments in the Baltic countries

7.5.1. Vattenfall’s expansion in Eastern Europe

The expansion of Vattenfall in Eastern Europe is a logical step in the formation of an integrated electricity market with competition among producers across international borders. The existing network of international co-operation can be seen as a model for a future integration of the East European countries.

Vattenfall AB intends to invest in Poland’s energy industry and to participate in the government sale of 43 local electricity distributors for several billion dollars. In 1998, Vattenfall invested 10 million USD in a 40 percent stake in Kostrzyn Paper power station. In January, 2000, a 55 percent stake was acquired in Electrocieplownie Warszawskie (the Warsaw Electricity Company) which generates electricity and heat in Warsaw.
Vattenfall also formed a partnership with the Polish Power Grid Company encompassing electricity contracts and part ownership, together with Svenska Kraftnät (The Swedish National Grid) of SwePol Link, a planned direct current cable between Sweden and Poland. In November, 1999, an environmental license was granted to operate the 600 megawatt direct cable. Vattenfall owns 48 percent of SwePol Link AB.

In 1997, Vattenfall AB bought a 6.2 percent stake in the Czech Republic's Vychodoseska Energetcka AS (VCE). In 2000, additional shares were acquired in this electricity distribution company. Vattenfall’s stake in the company with 676,000 customers has reached 42 percent. The future of Vattenfall’s one billion Swedish kronor investment in VCE is quite uncertain. According to Vattenfall, the Czech government intends to change initial privatisation plans and sell a package of eight energy companies including VCE to another foreign investor. "We were little bit shocked when we have heard about the plans of the government", said Björn Sjögren, Managing Director of Vattenfall in the Czech Republic. A package of eight energy companies that cost around 25-30 billion Swedish kronor would not be affordable for Vattenfall. The uncertainty about privatisation rules might, therefore, hurt Vattenfall’s investment plans in the Czech Republic.

It took 30 years to integrate the electricity markets in Scandinavia. To integrate markets in Central Europe will take much longer due to enormous differences in political and economic systems as well as the energy situation. According to the Chairman of Baltic Ring, former Vice President of Vattenfall Lennart Lundberg, it will cost 1,8 billion Swedish kronor to connect the West European electricity system with Eastern European countries that are situated around Baltic sea.

7.5.2. Vattenfall’s entry to the Baltic countries

In 1990, Vattenfall’s top management started to discuss the possibility of conducting investments in Baltic countries. Vattenfall already had experience working in Nordic countries, so expanding to the Baltic region was a natural step.

Local representation offices were opened in each of the capitals of the Baltic countries. Their task is to observe the investment environment and evaluate direct investment opportunities as well as to participate in the future ‘big’ privatisation of the energy sector. Establishment of the image of Vattenfall in the Baltic region as a major actor in the energy sector is an important task of representative offices. The desired strategy is, therefore, to acquire the large monopoly energy companies that are state owned.

Vattenfall started to build the network of representative offices together with Finnish Imatran Voima Oy (IVO) in the form of joint venture in 1994. From the beginning it was practical to share the costs of establishment with another foreign partner. However, after some time, Vattenfall’s and IVO’s interests started to separate.

The beginning of privatisation of the energy industry in the Baltic states increased conflict of interests, the companies said in a joint statement. IVO bought Vattenfall’s share in Baltic Power Estonia Ltd., and changed its name to Imatran Voima Eesti AS. Vattenfall established its own operations in Estonia by starting the new company Vattenfall Estonia OU. Vattenfall acquired the shares of IVO in representatives’ offices in Latvia (Baltic Power Latvia SIA) and Lithuania (Baltic Power Lithuania Ltd.), and changed their names to Vattenfall Latvia SIA and Vattenfall Lithuania UAB, respectively.
Some million Swedish kronor have been invested since 1994 to run the network of representative offices in Baltic countries and to cover the costs for different projects of a smaller size.

Vattenfall’s entry strategy design then is a combination of new venture entry strategy and joint venture acquisition. New venture entry strategy here refers to the establishment of new holding companies with the role of directing and monitoring operations in the respective markets of the Baltic countries.

7.5.3. Expansion in the Baltic countries

Vattenfall is looking for the bigger direct investment projects and intends to play an active role during the privatisation process in the Baltic region. However, according to the management, it is very hard to make direct investments in an energy sector that is highly protected by the government in most of the countries. In that situation, it is important to market Vattenfall’s name during privatisation and establish the network of contacts with top decision-makers from the energy sectors of Baltic countries.

Some smaller direct investments were made in order to test the mechanism of investment decision-making as well as to provide some cash to cover the costs of operation in the Baltic region. The risk with these projects is quite low, however, and they can help to establish the position of Vattenfall on the market and help Vattenfall to be known among the key decision-makers in the branch.

In 1995, Vattenfall, IVO and LPC formed a joint venture to conduct direct investment in Lithuania: a purchase of an electric boiler. It was a project in Kaunas of a smaller size with 40 MW capacity, with potential up to 200 MW. This project, in operational leasing of heating equipment for a period of 15 years, appears to have good returns. At present the cash flow from the project covers up to 30 percent of the operational costs of running the representative office in Lithuania.

The situation with the project in Kaunas, however, should not be described solely in positive terms. The whole ‘package’ of a transition economy’s characteristics interact and predetermine the development. According to Swedish newspaper ‘Dagens Industri,’ from 18 of April 2000, Vattenfall almost ‘burnt’ themselves arguing with a newly elected mayor of Kaunas who attacked the foreign companies for their intention to raise electricity prices. Vattenfall argues that the electricity prices should cover the production costs and should allow to pursue a reasonable environmental policy. According to the newspaper, the company is prepared to abandon the project in Kaunas if the original conditions on the foreign investor would not be applied.

In 2000, Vattenfall already acquired a stake equal to 9.7 percent in the vertically-integrated LPC. The book value of the investment is 183 million Swedish kronor (or approximately 21,3 million USD according to the exchange rate used by Vattenfall in their 1999 Annual report). Vattenfall is actively participating in preparations for the restructuring of the entire power supply system in Lithuania.

Some investments in smaller projects were made in Latvia and Estonia.
Latvenergo, a hydropower based company, is a profitable, and therefore desirable, investment object. According to management, privatisation of Latvenergo has been delayed so far due to the numerous intrigues of different political actors. When Latvenergo is privatised, however, Vattenfall plans to bid for the stake alongside with other candidates.

It is worthwhile to mention that the representative office of Vattenfall in Riga is managed by the former CEO of Latvenergo, who also had been previously employed by the government of Latvia.

Even if the Estonian government proclaimed some years ago that Eesti Energia should be privatised, the process is going quite slow. A clear policy towards the participation of foreign investors in the privatisation of assets in the energy sector has not been established yet either.

Following the discussion conducted by the management with the government of Estonia, Vattenfall was offered a strategic partnership in an investment project. The suggested project did not match the environmental standards adopted at Vattenfall and, therefore, was rejected by management.

Due to slow development of the privatisation process and unclear government policy towards foreign investors, the question of closing the representative office in Estonia was raised. Vattenfall, however, decided to continue to run their investment activities in Estonia on a smaller scale.

In January 2001 Vattenfall has finally acquired 99.95 percent of the shares in Pärnu Soojus (Pärnu Heat). The remainder of the shares belongs to the City of Pärnu. The acquired company, which was founded in 1971, currently sells 75 percent of the district heat consumed in Pärnu. This agreement means that Vattenfall is now the largest generator and seller of heat in Estonia’s fifth largest city.

Direct investments in the energy sector are often long-term projects that allow the Baltic countries not only to earn money, but also to train people, learn Western management traditions and work with project development. Short-term courses, seminars and conferences were organised by Vattenfall in all three Baltic countries.

The schema of Vattenfall’s main investments in the Baltic countries is presented below:
Figure 21. Direct investments of Vattenfall in the Baltic countries

Source: Vattenfall

7.6. Summary of the case

In order to adjust to changes in the energy market and face higher international competition, Vattenfall’s organisation, as well as their decision-making routines, have been changing over the last few years. Being a global energy partner, Vattenfall plans to continue to operate within the entire Nordic region and Western Europe, as well as to seek investment opportunities in the attractive growth markets of Eastern Europe.

The European power sector has developed from being national to international. Creation of Nordic Electric Power Co-operation (Nordel), EU’s decision in 1996 to create an internal electricity market in Europe changed ‘the face’ of the investment environment of the European energy sector. The experience from the co-operation within Nordel brought forward an idea to expand this co-operation and include all countries situated around the Baltic Sea.
The Baltic Ring Project plans to connect neighboring countries in the Baltic Sea Region, to balance fuel resources between countries, and to concentrate on environmental problems. The Baltic Ring Project, which can be seen as a vision of a future integrated electric power system in Northern Europe, was a good platform for Vattenfall’s expansion into the Baltic countries.

Another important factor that influenced Vattenfall’s decision to start to invest in this area is that after successful privatisation of small assets in the Baltic countries, the focus shifted to cash sales of large state enterprises, particularly in the energy sector. It seems to be the right time for the international energy companies that are looking for strategic acquisitions to enter the Baltic countries and participate in the coming privatisation of the local companies.

The main problem of all Baltic countries is that the assets and transmission nets are very old and require renovation. Besides the age of the equipment, the theft of electricity, energy shortages due to the payments arrears, the liberalisation of gas prices by Russia, the loss of export markets in the former Soviet Union, and low energy prices all contribute to the description of the sector. The renovation and modernisation in the energy sector demand substantial long-term investments. Due to economic problems, local investors will have a shortage of finance in the near future. Searching for strategic partnership, therefore, is a desirable strategy for the governments of the Baltic countries that provide foreign investors with unique acquisition possibilities.

To support Vattenfall’s activities, local subsidiaries were set up and smaller-scale projects were carried out in Estonia, Latvia and Lithuania. A stake in LPC is the first purchase of a restructured privatised local company in Lithuania. The task of the representative offices is to observe the investment environment and to evaluate direct investment opportunities, as well as to participate in the future ‘big’ privatisation of the energy sector. The establishment of the image of Vattenfall in the Baltic region as a major actor in the energy sector is also an important task of the representative offices. Direct investments of a smaller size were made in order to test the mechanism of investment decision-making as well as to provide some cash to cover the costs of operation in the Baltic region. The risks with those projects are quite low, however, and they can help to establish the position of Vattenfall in the market and help Vattenfall to be known among the key decision-makers in the branch. Besides, the projects can help to train local employees and teach them Western management traditions.
8. THE CONCEPT OF TRANSITION ECONOMY: EMPIRICAL DATA ANALYSIS

"There can be no society which does not feel the need of upholding and reaffirming at regular intervals, the collective sentiments and the collective ideas which make its unity and its personality."


8.1. Introduction

The purpose of the chapter is to present the acquired data about transition economy and its influence on FDI decision-making.

Figure 3 (Chapter 2) presents a conceptual framework for the analysis of transition economy. The schema is divided into four blocks: the nature of transition economy as a ‘non-planned, non-market economy’; the main components of transition economy; the main characteristics of the environment of transition economy, and transition economies in the global context.

The suggestions about the nature, main components and features of transition economy, as well as alternative assumptions about the comparability of the investment environment of transition economies in a global context are derived from Chapter 2, which presented the theoretical framework for the concept of transition economy.

The analysis in this chapter is based on qualitative (informal) parts of interviews with decision-makers and answers to questions from number one to four in the questionnaire. Due to the exploratory nature of the questions, managers were asked to submit additional comments when they felt to do it. The empirical results are related to conclusions from other studies.

A figure describing the FDI decision-making process as it is perceived in the environment of transition economy is presented at the end of the chapter. The figure has been updated according to the empirical data.

8.2. Transition economy as ‘a non-planned, non-market’ economy and its influence on FDI decision-making

8.2.1. Empirical data presentation

‘Transition economy’ was defined in Chapter 2 as ‘a non-planned, non-market’ economy. Therefore, transition economy might be characterised by uncertainties associated with the coexistence of emerging market with ruined but still operating old administrative systems.

Decision-makers were asked to define the importance of those uncertainties for foreign investment decision-making in transition economies according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant.
Due to the explorative nature of the subject, managers were also asked to submit additional comments on the issue. The answers of the decision-makers are summarised in the table below:

**Table 2. The importance of uncertainties associated with transition economy being ‘a non-planned, non-market’ economy for FDI decision-making**

<table>
<thead>
<tr>
<th></th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Very</td>
</tr>
<tr>
<td></td>
<td>of answers</td>
<td>important</td>
</tr>
<tr>
<td>‘Transition economy’ as ‘a non-planned, non-market’ economy where emerging markets coexists with old systems</td>
<td>16</td>
<td>9</td>
</tr>
</tbody>
</table>

The coexistence of emerging market institutions with ruined but still operating old communist institutions of administrative system influences substantially the decision of foreign companies to invest directly in transition economies. Fifty two percent of decision-makers ranked this factor as very important, forty percent said that it has some impact, and only eight percent said that this factor is not relevant.

- “Things do not change in one day. I think that in Russia the old administrative forms often dominate the content of the new market mechanisms. The communistic economy is dead, but an administrative system still remains... It is like a combination of different historical periods where a decision-maker should consider both the old and the modern rules of the game,” said one of the managers from Ericsson.

Managers from Vattenfall used the terms ‘mixed’ and ‘unbalanced’ to describe the economy of the Baltic countries.

- "The pricing of electricity is centralised and controlled by the government such that does not permit the financing of new investments. Besides, electricity prices are not balanced with the pricing of the energy sources”, explained a manager from Vattenfall.

According to the managers from Vattenfall, the ‘unbalanced’ economy, that combines both market mechanisms and administrative system’s methods, influences the investment decision-making in the Baltic countries.

*The bureaucracy and hierarchy inherited from the communist system were mentioned by almost all interviewed managers as features that influence foreign investment decision-making in transition economies.*
It seems that managers from Western economies should be aware of the existence of procedures that have no special economic meaning or function, but still must be followed.

- "Many foreigners become very angry about bureaucracy that starts to follow them immediately after the Russian boarder. But I am not stressed about these small things, I understand the system. If you do not understand the system - how to invest in Russia ?” commented a decision-maker.

According to executives, the investment decision process in transition economies is often built on old traditions and routines left over from the communist economy.

- "Managers participating in the investment decision-making in Sweden are authorized to make decisions within the framework of adopted company’s strategy. Decision-making is delegated to the people that work as closely with customers as possible. In Baltic countries decision-making is influenced by the old system when the person still can not decide even about simple things” said one of the managers from Vattenfall.

- "It is quite easy to understand the formal process of decision-making in the Baltic countries. But it is very hard to understand ‘who is really deciding what’. People are afraid to make decisions… People sometimes want to be involved in decision-making for getting power rather than for taking on responsibilities. In the former Soviet Union, the Ministry of Energy distributed finance among the different enterprises. People often remain in the old mentality and think about how to get a loan rather than how to make a project profitable and pay back the loan”,- commented a manager who works with the Baltic countries.

According to managers, the majority of people from Eastern Europe have not been experienced enough either to make their own decisions or to take responsibility for their implementation.

A top executive from Ericsson said:

- "During negotiations with a local joint venture partner you must identify ‘The Boss’. You will hardly make a mistake because it is so obvious from the behavior of Russians who is in charge. It is quite opposite to Swedish traditions where decision-making is decentralised and people are authorised to make decisions themselves on particular issues within the framework of their responsibilities”.

Representatives of the foreign companies also must be recognised by local partners as the key persons. Then, according to one of the interviewed managers, “the doors are going to be opened”. He told me that Russians were very upset at the beginning of the local establishment of Ericsson because they could not find ‘The Boss’.

- “Then I said to them: I am The Boss. And everything became easier. They started to treat me as a key decision-maker and turned to me with all important issues. Sometimes, an hierarchical structure of decision-making has its positive features as well. When you are already recognised as a key decision-maker, everything is possible. I would never dream in the West to meet such high executive officials as I do in Russia due to the fact that ‘I am The Boss’."
The same feature was mentioned by some managers from Vattenfall:

- "In the Baltic countries hierarchy, status and symbols play an important role. It is important, for example, to have a secretary and a driver if you want to be recognised as a businessman and a top decision-maker”.
- "Hierarchy and bureaucracy are enormous in the Baltic counties. Nothing happens without a decision from The Boss. There is a very big difference in comparison with Sweden, where the decision-making is often based on collective principles. Besides, everything takes a longer time”.

8.2.2. Some conclusions and comparisons with other studies

The fact that the newly emerging market institutions in transition economies remain the features of an administrative system should be taken into consideration by decision-makers when they assess the investment projects. Ninety two percent of executives ranked this factor as very important or having some impact on decision-making.

Bureaucracy and hierarchy inherited from the old system could influence the future of an investment project in a transition economy. This conclusion is supported by several researchers who claim that bureaucracy and hierarchy are the main obstacles that deter potential foreign investors. Time-consuming establishment procedures, with the lag for documentation collection varying from one to three months, complex approval of investment projects, and protracted negotiations are named by several authors as existing barriers to investments in transition economies (See “Assessing Investment Opportunities in Economies in Transition”, 1994; Benini, 1997; Peitsch, 1997).

Hood, Kilis and Vahlne (1997), who studied transition economies in the Baltic countries, came to the conclusion that the prevailing environment is characterised by ‘rigid hierarchies’. The communist legacy left Russia, according to Åslund and Layard (1993), with the wreckage of the ‘old hierarchical and gerontological system’.

Empirical findings conducted by Rutihinda (1996) show that bureaucracy structures explain of why Swedish firms did not locate value adding activities in emerging markets of Central and Eastern Europe.

The administrative control inherited from the past can both damage the balance between different sectors of the economy and destroy the reproduction cycle of a particular industry.

Dallago (1997), for example, claims that the asymmetries in the distribution of old systemic capital and investment in systemic change might explain general disproportions in the economy and multiple conflicts between different economic actors (for example, between a foreign investor and a local joint venture partner).

Western managers are expected to understand the rules of the previous administrative system that are inseparably incorporated into the present one. As Clarke (1996) suggested, transition economy is not simply an imperfect realisation of the capitalist society, but ‘a distinctive social organism’ with its own rationality (p. 13). Decision-makers should be aware of the existence of procedures that have no special economic meaning or function, but still must be followed.
"Russian enterprise management is rarely a team; there is a boss, inclined to take all big decisions and delegate authority and to take it back at will", observed Holden, Cooper and Carr (1998, p. 38).

This also resonates with the findings of a major survey of management change in Eastern and Central Europe conducted by researchers from the Harvard Business School (Aguilar, Loveman and Vlachoutsicos, 1994). A technical director of a manufacturing plant is thought of as a person who should know everything.

A Finnish researcher also mentioned that local bosses expect the top management of a Western company to be involved in the negotiations. The presence of the actual boss is a sign of goodwill and commitment although the actual expertise needed is often found at lower hierarchical levels (Salmi, 1996).

The necessity to co-operate with the East European bureaucracy, hierarchy and other residuals from the past might, however, reduce the positive impact of the FDI during the transformation period. What types of ‘sacrifices’ Western managers should be prepared to take in order to succeed with investment projects in a transition economy is a question still open for debate. More studies of how bureaucracy and hierarchy inherited from the past modify the socio-economic environment in general, and influence the behaviour of the foreign investors in particular, are necessary.

In summary, the first block ‘The nature of transition economy as ‘non-planned, non-market economy’ of Figure 2 “Transition economy: conceptual framework for analysis” may be updated according to the empirical data in the following way:

<table>
<thead>
<tr>
<th>1. THE NATURE OF TRANSITION ECONOMY AS ‘NON-PLANNED, NON-MARKET ECONOMY’</th>
</tr>
</thead>
<tbody>
<tr>
<td>The new emerging market institutions coexisting with bureaucracy and hierarchy inherited from the old administrative system influence FDI decision making</td>
</tr>
</tbody>
</table>

Figure 22 (1). Updating of the first block ‘The nature of transition economy as ‘non-planned, non-market economy’ according to the empirical data

Source : Olga Golubeva (own)

8.3. Main components of transition period and their importance for FDI decision-making

8.3.1. Empirical data presentation

It was suggested that the following main components of transition economy be evaluated in terms of their importance for foreign investment decision-making: stabilisation, liberalisation, privatisation, reformation of government and reform of the educational system.
Due to the explorative nature of the subject, managers were also asked to submit additional comments on the issue.

Decision-makers were asked to define the importance of those components for foreign investment decision-making in transition economies according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant. The answers to this particular question were obtained via telephone and are summarised in the table below:

**Table 3. The importance of the main components of transition economy for FDI decision-making**

<table>
<thead>
<tr>
<th>Main components of transition economy</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of answers</td>
<td>Very important</td>
</tr>
<tr>
<td>Stabilisation</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Liberalisation</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Privatisation</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>Reformation of government</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Reform of educational system</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

Many studies, especially those based on neo-classical economic theory, focus on macro-economic framework conditions of transition economies such as stabilisation, liberalisation privatisation of enterprises, assuming a more or less linear ‘transition’ from a socialist planned economy to a market economy.

All interviewed managers think that those components are essential for foreign investors and ranked them as very important or having some impact on foreign investment decision-making.

There is a slight difference between the answers of the decision-makers of two companies: one hundred percent of managers from Ericsson ranked stabilisation factor as very important while in the case of Vattenfall it is the privatisation component that received one hundred percent of votes. Even if the data is non-sufficient to make broad generalisations, the difference might be explained by local conditions: while Russia succeeds more in the privatisation of industrial assets, the Baltic countries have more stable investment environments.

About ninety three percent of managers ranked reformation of the government as a very important component of transition.

- "A free market needs strong government”, commented one of the decision-makers.
Reform of the educational system was unanimously classified as a very important factor. Several managers however suggested the use of a broader term: formation of market economy mentality and traditions among the local population, which includes educational reform.

- "It is not so hard to supply modern equipment or to renovate offices for an investment project. However, it will take more time to change people’s way of thinking. We must be aware that future customers and business partners often miss the proper understanding of market economy rules. People in Russia have a very good technical education, in many aspects they are better than Swedish engineers. But the economic mentality is often missed. Sometimes they are familiar with modern financial terms like ‘performance bond’, ‘cash flow’, and LIBOR, but often they do not understand the meaning of these terms. In several cases I had to spend a couple of hours with our business partners explaining the meaning of the economic terms. The understanding of market economy by the majority of people is still ‘on the surface’, concluded a top financial manager.

According to another manager, the local population often misses the quality in their work:

- “They often want to do things immediately and run around the office under big pressure without proper planning. People often do things on an ‘ad hoc’- basis. And we are supposed to work with them, co-ordinate their activities and educate them”.

Several managers also stressed that a poor knowledge of English by the inhabitants of Eastern Europe should be taken into account.

- “Can you imagine an engineer in Sweden who works in the high telecommunication industry but is not able to send an e-mail because of poor knowledge of English? How do we communicate with the local staff involved in the investment projects if they do not speak proper English?” - one of the Ericsson’s managers asked me.

8.3.2. Some conclusions and comparison with other studies

The study suggests that the main components of transition identified by researchers and policy-makers (see Auroi, 1998; Buck, Filatotchev and Wright, 1996; Corbo, Corricelli and Bossak 1991; Fisher, Sahay and Vegh, 1996; Mertlik, 1996) - stabilisation, liberalisation and privatisation - are important for foreign investment decision-making.

As it was suggested by some researchers (Hoos, 1996; McCarthy and Puffer, 1996; Nuti, 1993, 1996; Shleifer, 1997; Shleifer and Vishny, 1998), reformation of the government from direct ownership towards indirect control is as important for foreign investors as three previously mentioned components of transition. While in the early 1990s the emphasis was placed on reducing the role of government as a direct controller and allocator of resources, in the later 1990s it is becoming increasingly recognised that in order to provide the ‘right’ economic environment for FDI, governments need to be strong (See Dunning, 1997).
The study supports the theory of ‘market-preserving federalism’ (see Jin, Qian and Weingast, 1999; Qian, Weingast, 1997), which stresses that the Chinese reform, that took place between the early 1980s and 1994, provided governments with incentives and possibly created a basis for China’s remarkable economic performance and attraction of foreign direct investments.

According to Zhuravskaya (1999), the Russian ‘market-hampering federalism’ presumes that the regional-local and federal-regional revenue sharing arrangements in Russia are frequently dependent on the distribution of bargaining power. As a result, the system gives local governments no incentive to maximise a city’s own revenue because 90 kopecks out of each additional ruble in revenues is taxed away. The conclusion of the paper is that economic reform needs to be supported by reforms of the government.

Lavigne (1999) also found that the involvement of foreign capital in Russia is very low because investors are dissuaded by conflicts with the government authorities, particularly on the regional level (which explains the high share - over 70 percent in 1996 - of overall FDI located in Moscow and Moscow region) (p. 256).

It might be suggested that the importance of the main components for FDI decision-making in transition economies can depend on a particular local environment.

We should probably not exclude the possibility that companies might evaluate differently the importance of the main components for foreign investment decision-making, even in the same country. Frydman, Gray, Hesse and Rapaczynski (1999), for example, came to the conclusion that the effects of privatisation, while often quite powerful, are not uniform across different types of firms or different performance measures.

Several managers suggested that the formation of a market economy mentality and traditions among the local population, which includes educational reform, is an important component of transition period.

According to Goglio (1997), the precondition for the historical emergence of markets in Europe was a change in mental and social human values, which are perceived not only by a small minority - who would have ended in prison - but by at least a considerable part of the population involved.

It is well known that in a typical socialist enterprise, workers were not accustomed to see a relationship between productivity and income; managers were concerned almost exclusively with production and supply. Employees were less than competent in issues related to marketing, the quality of goods produced, and the satisfaction of customers than they were in engineering (see also Hood, Kilis and Vahlne, 1997).

Puffer (1996) observes that Russia has a core of talented and motivated managers, and the old system of the centrally-planned economy stifled their ability to manage effectively. "They were caretakers rather than decision-makers. In the current transition period they have been sent many contradictory signals and have become terribly confused" (p. 141).
Research has also suggested, for example, that Estonian managers operate more like their Western colleagues than their Russian counterparts. At the same time, however, “the influence of the old Soviet rule, with its emphasis on centrally-planned, centrally-managed economies, and the powerful role of the state, suggests a lingering collectivistic influence” (Vadi and Buono, 1997, p. 66).

Rutihinda (1996) found that the greatest problem experienced by Electrolux in Eastern Europe has been the lack of qualified local managerial staff in the areas of finance and accounting. The scholar also claims that most of all the success of Pripps strategy in the Baltic countries lies in the intensive training programs which enabled the parent companies to transfer their unique experiences and capabilities in the industry to their new employees.

Holden (1996), who studies management learning in Russia and Poland, concludes that Westerners do not share a common language of business and management - literally and metaphorically - because the Slavic languages have not yet developed the concepts and terminology adequate to describe market economies. The language, therefore, might also be ‘in transition’.

To sum up, one of the major barriers to get FDI in transition economies is a lack of experience in private entrepreneurship, the lack of acquaintance with the market system, or ‘experience gap’ (”Entrepreneurship and SMEs in Transition Economies”, 1997, p. 11).

The second block ‘Main components of transition economy’ of Figure 3 "Transition economy: conceptual framework for analysis” may be updated according to the empirical data in the following way (see the figure below):
8.4. The main characteristics of the environment of transition economies and their importance for FDI decision-making

8.4.1. Empirical data summary

The interviewed managers were asked to rank the importance of the following characteristics of transition economies identified in the second chapter that might influence a project’s investment decision-making: the general political instability and unpredictability of development; the lack of institutional development (public infrastructure, banking system, etc.); the lack of legal rules and procedures regulating market and property rights’ guarantee; corruption in the government agencies and the existence of the Mafia in the local country.

Decision-makers were asked to define the importance of those characteristics for foreign investment decision-making in transition economies according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant.

Due to the explorative nature of the subject, managers were also asked to submit additional comments on the issue. The answers of decision-makers are summarised in the table below.

![Figure 22 (2). Updating of the second block ‘Main components of transition economy’ according to the empirical data](image)

*Source: Olga Golubeva (own)*
Table 4. The importance of suggested characteristics of the environment of transition economies for FDI decision-making

<table>
<thead>
<tr>
<th>Characteristics of transition economy</th>
<th>ERICSSON</th>
<th></th>
<th></th>
<th>VATTENFALL</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of answers</td>
<td>Very important</td>
<td>Has some impact</td>
<td>Not relevant</td>
<td>Number of answers</td>
<td>Very important</td>
</tr>
<tr>
<td>General political instability</td>
<td>16</td>
<td>9</td>
<td>7</td>
<td>0</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>Unpredictability of development</td>
<td>16</td>
<td>11</td>
<td>5</td>
<td>0</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Lack of institutional development</td>
<td>16</td>
<td>14</td>
<td>2</td>
<td>0</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Lack of legal rules, procedures regulating market and property rights’ guarantee</td>
<td>16</td>
<td>16</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Corruption in the government agencies</td>
<td>16</td>
<td>1</td>
<td>4</td>
<td>11</td>
<td>9</td>
<td>0</td>
</tr>
<tr>
<td>The existence of Mafia in the local country</td>
<td>16</td>
<td>0</td>
<td>3</td>
<td>13</td>
<td>9</td>
<td>0</td>
</tr>
</tbody>
</table>

8.4.2. General political instability: empirical data analysis and comparison with other studies

Forty eight percent of decision-makers ranked political instability as a very important factor and fifty two percent as a factor that has some impact on decision-making. The majority believe that political stability is an important condition for the successful development of market reforms and attraction of FDI to transition economies.

- “Russia is still a country of a wild west’. All the descriptions of wild west economies can be applied to Russia. It is not so important in Sweden (in comparison with Russia) which party will win the election. In Russia we speak about different political systems and life styles, not just about some changes in the political course of development. And investments do not like unsafe environments,” remarked a senior manager.

Besides, according to the managers, all business decisions are extremely influenced by the interests of the powerful financial-industrial groups. If Russia will develop into a liberal country based on the democratic market economy traditions or into a society ruled by the giant financial-industrial groups is still an open question.
The concept of political instability in the Baltic countries differs substantially from the situation in Russia. None of the interviewed managers believed in the restoration of an old system in the Baltic countries. However, a sharp border between politics and economy is still missing.

- "The political system of the Baltic countries has not been formalised yet. If I remember correctly, during the last six years ten Ministers for Foreign Affairs have been replaced in Estonia. It creates political instability”, explained one of the managers from Vattenfall.

In summary, the study supports the thesis suggested by some researchers (see “Assessing Investment Opportunities in Economies in Transition”, 1994; Lavigne, 1999; McCarthy and Puffer, 1996; Peitsch, 1997; Stankovsky, 1998) that the principle cause of the slow inflow of FDI into transition economies will be found in general political instability.

In 1996, the year in which McKinsey brought out its management guides, the National Training Foundation published results of surveys of more than 400 respondents who were asked to rank in importance environmental obstacles most seriously impeding management in transition economies. General political instability was ranked by 66.2 percent of managers as being a very important obstacle (National Training Foundation, 1996).

Political instability as a major issue in most transition economies’ countries was confirmed by Meyer (1996) and Rutihinda (1996). Meyer (1996) found that the variation of FDI projects among the Visegrad countries (Hungary, Poland and the Czech Republic) is surprisingly minor given the variation of aggregate inflows of FDI capital. In the main sector of manufacturing, MNEs follow very similar strategies towards the three countries. The differences between the Visegrad countries and Russia and Romania suggest that FDI inflow depends on the degree of the political instability in the host country.

It has been shown by some researchers that general political instability has also hindered local investments in transition economies.

The survey conducted by Holmström (1996) showed that in transition economies the capital available from unreinvested profits exceeds the capital provided by the banking sector. The firms could, if they chose, use their considerable unreinvested profits to finance further investment. The local investors do not make investments because of general political instability rather than a shortage of capital.

8.4.3. Unpredictability of development: empirical data analysis and comparison with other studies

Managers ranked unpredictability of development as a key issue influencing investment decision-making in transition economies. Sixty percent of interviewed persons believe that this factor is ‘very important’ and forty percent believe that it ‘has some impact’.

Besides the term ‘unpredictability’, the following expressions were used by managers to describe the investment environment of transition economies: ‘ambiguity of environment’, ‘nearly impossibility to plan for the longer term’, and ‘total chaos’. During the course of the reforms, both Russia and the Baltic countries had experienced several moments when totally different scenarios of development were possible.
Chaos in its scientific sense, as it was defined by Stacey (1994), is an irregular pattern of behaviour generated by nonlinear feedback rules where the specific links between cause and effect are lost, and the specific path of its long-term future development is completely unpredictable. It is this property of being bounded by recognisable qualitative patterns that seems to be missing in transition economies.

- “Russia is so chaotic in comparison with the well-structured institutional environment in Sweden. The market is supposed to be a little bit unpredictable and go up and down. But in Russia it is too much up and too much down. It is hard to make plans when things are changing so rapidly,” commented one of the managers.

Another manager who lived and worked in Russia added:

- “The concept of planning is totally different here. In Sweden we use to plan things in advance several months ahead. In Russia I have plans for the next two days. And I am not sure that I will manage to do what I have planned. Probably, tomorrow I will come to my office in Moscow and see some important Russian partners in the corridor who suddenly decided to ‘pass by’ and discuss investment projects. There is always a disturbance and a lack of planning. Western managers must forget about predictability when they are passing the Russian border.”

The same comments have been made by managers from Vattenfall.

- ”The rules of the game are not just different from Sweden. They are unclear and change permanently. If the Swedish State wants to privatise a company, clear privatisation rules would be settled from the beginning. In the Baltic countries we have both ‘official’ and ‘informal’ rules. You never know which of them would be applied in a particular project. Everything is so unpredictable…”

- ”Investments into the energy sector is a long-term engagement with a break even period of ten or more years for medium size investments. Therefore, I do not believe that it would be possible to attract foreign direct investments of a bigger scale to the energy projects if the situation remained unclear”, commented one of the managers from Vattenfall.

An executive who had been doing business with the former Soviet Union admitted that it was easier to conduct business before “perestroika.”

- ”Do not misinterpret me. I am for democracy and market economy. But for business it is extremely important to clarify the rules of the game”.

Unpredictability was pointed out by several researchers as being a major characteristic of transition economies (See McCarthy and Puffer, 1996). Unpredictability and impossibility of long-term planning were ranked by 56 percent of respondents as very important environmental obstacles most seriously impeding the successful economic development and attraction of FDI in transition economies in the survey conducted for Russia (National Training Foundation, 1996).
8.4.4. Lack of institutional development: empirical data analysis and comparison with other studies

Lack of institutional development (public infrastructure, banking system, etc.) is an important factor influencing the investment decisions in transition economies. Eighty percent of interviewed managers ranked the factor as a very important one and twenty percent of executives believed that it had some impact on investment decision-making.

- “The biggest problems in transition economies lie not in a project, but in a framework”, said one of the decision-makers.

The whole specter of market economy mechanisms like reliable banking system, stable currency exchange rates, developed social infrastructure, availability of information, etc., play an important role in foreign investment decision-making.

According to the managers, all these essential features of the developed markets are still under formation in transition economies. Managers from Ericsson pointed out:

- "The Russian accounting standards differ from the Western standards. Therefore, Western investors can not rely on the information provided by the financial statements of the companies when they are evaluating projects and business partners…”;

- "The lack of infrastructure raises substantially the expenditures of a project. Everything is very expensive. A business trip for a foreigner, for example, is approximately 40 percent more expensive in Russia than in Sweden due to the lack of public infrastructure and pricing discrimination for foreigners. Real estate costs are higher in Moscow than in Stockholm with rent amounting to one thousand US dollars per square meter per year. An office needs security services on a level that is not common in the Western economies”.

The decision-makers from Vattenfall unanimously admitted that the Baltic countries have been very successful in developing an institutional framework during the course of the market reforms. However, managers think that this fact should not be ignored in the decision-making.

- "The Baltic countries are still transition economies: the privatisation process is not completed, the banking system is under permanent reconstruction, etc. It simply takes time to introduce market mechanisms”, explained one of the decision-makers.

In line with the EBRD’s Transition Report (1997) and Johnson, Kaufmann and Shleifer (1997), the evidence provided here suggests that the building of market-supporting institutions is an important requirement for a successful transition and attraction of FDI.

After analysing the evidence from 269 German and British companies investing in transition economies, Meyer (1996) concludes that institutional constraints reduce the number of investors, and those investing must adapt to the regulatory environment.
If western economies are based on institutions and infrastructural support systems developed over centuries, including public and social infrastructure, reliable banking systems, availability of information, predictable administrative policies, etc., then in transition economies they are yet to be firmly established (The same view is expressed by Lavigne, 1999; Nuti, 1993, 1996; Schopflin, 1997).

### 8.4.5. Lack of legal rules, procedures regulating market and property rights’ guarantee: empirical data analysis and comparison with other studies

One hundred percent of managers from Ericsson believe that the lack of legislation is an extremely important factor prohibiting FDI in Russia. Forty four percent of managers from Vattenfall ranked this factor as a very important one and fifty six said that it has some impact on direct investment decision-making.

According to management, legislation in Russia changes all the time and often laws and decrees are not co-ordinated with each other. Due to ambiguity of legislation, there is a room for different interpretation of laws in practice.

- “Different lawyers give different advice. If you invite five different lawyers, you are lucky if you will get two similar answers. There are many contradictions between Tax Code, Custom regulations and, say, Civil Code. It is does not matter what are you doing - you will make mistakes anyhow. It is not possible to do things in a proper and correct way. The system is designed in this way. However, Ericsson being a world-wide company can not afford to do something illegal. It is really hard for us to cope with the situation in Russia,” said one of the managers.

A complicated legal procedure was described by one of the executives in the following way:

- ”In order to register a company in Russia you must prepare a lot of papers and then visit one of the local bureaucrats who is available just for a few hours, two days a week. And he (or she) will definitely find some mistakes in your papers. So, after making the necessary changes you have to return. You have to be prepared to continue with this cycle without being upset; the legal system works in this way.”

A manager from Vattenfall described the legal framework in the Baltic countries in brighter terms:

- “Baltic countries have been gradually introducing legislation that will stimulate FDI. However, it takes time to develop a well-functioning legislative system. The legislation about environment protection that the Baltic countries have nowadays, for example, can be comparable with fifty year old legislation in Sweden”.

The importance of the legal framework for attraction of FDI was stressed by several researchers (See Benini, 1997; Cook and Kirkpatrick, 1966; ”Entrepreneurship and SMEs in Transition Economies”, 1997; Hoos, 1996; Lavigne, 1999; Puffer, 1996; Stankovsky, 1998).
The low amount of FDI flowing to transitional economies can be attributed in part to inadequacies of the legal and contractual framework for investors, unclear and fluctuating legislation, and the difficulties in establishing legal property rights. Investors are dissuaded by the fact that the rule of law is not assured.

Rutihinda (1996) found that major problems encountered by AGA in Eastern Europe included coping with the constant changes in laws and regulations due to policy changes in the transition to a market economy.

Murrell (1996, p. 34) summarises the legal situation in transition economies: "In the large majority of countries, especially in the former USSR, it will take a generation, or more, for the legal system to buttress capitalism in the manner imagined by the drafters of the new laws. Although these laws are beginning to affect behaviour, they are presently of no more than marginal significance" (p. 34).

According to a study conducted among 400 respondents in Russia, unsuitable legislative foundation was ranked by 38 percent of managers as very important environmental obstacles most seriously impeding the successful economic development and the attraction of FDI in transition economies (National Training Foundation, 1996).

Johnson, McMillan and Woodruff (1999a) surveyed managers of privately-owned manufacturing firms in Russia (269), Ukraine (270), Poland (303), Slovakia (308), and Romania (321) in 1997. The authors found that the courts had been used only by 39 percent of the surveyed firms involved in a recent dispute with a business partner. The situation however could be worse. When Vietnamese firms were asked the same question in 1995-96, a mere nine percent answered in the affirmative (See McMillan, Woodruff and Woodruff, 1998).

Another conclusion of the same authors is that property rights are fundamental: those firms in the sample with the least secure property rights invest nearly 40 percent less than those with the most secure property rights (Johnson, McMillan and Woodruff, 1999b, p. 1). Therefore, researchers conclude that reforms to secure property rights are more urgent than reforms in the banking system.

The same complaint from Western executives about the apparently unreliable legal environment in Asia was found by Lasserre and Probert (1998), who surveyed 294 managers employed by MNE in Asia Pacific region.

8.4.6. Corruption in the government agencies: empirical data analysis and comparison with other studies

Corruption in government agencies was not ranked by managers as an important factor influencing foreign investment decision-making in transition economies. Only four percent of interviewed executives believe that this factor is a very important one, twenty four percent believe that it has some impact, and seventy two believe that it has no significance at all.

One of the explanations that I have received from management is that both Ericsson and Vattenfall are big companies with well-established reputations in Eastern Europe which probably protected them from the interest of the corrupt civil servants.
However, some of the managers guessed that this factor can influence foreign investment projects, especially for smaller-size companies.

- "Bribes exist in transition economies, even if our company has not yet been faced with this problem. It is not surprising that corruption exists in the society because, for example, a public servant in Estonia has a salary of about 2-3000 SEK per month,” commented a manager from Vattenfall.

The perceived corruption scores (adjusted so that 0 is least corrupt, 10 is most corrupt) presented in a cross-national study conducted in 1998 by Triesman (1999) were 7.6 for Russia, 7.3 for Latvia and 4.3 for Estonia, in comparison with 0.5 for Sweden and 5.4 for Poland (pp. 64-65). A survey conducted by Johnson, Kaufmann, McMillan and Woodruff (1999b) of approximately 300 firms in Poland, Romania, Russia, Slovakia and Ukraine shows that a striking 91.2 percent of the Russian and Ukrainian managers say it is normal for bribes to be paid to government officials, while in Slovakia 40 percent say bribes are paid, and in Poland and Romania 20 percent say bribes are paid (p. 41).

Therefore, even if corruption in the government agencies has not been influencing the decision-making in these particular cases, this factor can not be ignored in the foreign investment project assessment in transition economies.

Besides, it has been shown that countries with long exposure to democracy and openness to trade and imports are less vulnerable to corruption. (Lasserre and Probert, 1998; Triesman, 1999).

It is interesting to mention, however, that some researchers prefer to search the routes of corruption in the broader historical, religious, social and economic context rather than to reduce the analysis of corruption to a feature inherited from the administrative system of the former communist countries.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997), for example, found evidence that hierarchical religions, such as Catholicism, Islam, and Eastern Orthodoxy, are associated more with perceived corruption than cultures shaped by egalitarian or individualistic religions, such as Protestantism. If we accept this thesis, the roots of corruption in transition economies might be found much earlier in history than we usually assume.

8.4.7. The existence of the Mafia in the local country: empirical data analysis and comparison with other studies

Nobody from the interviewed managers ranked the existence of the Mafia as an important factor. Only twenty four percent believe that the presence of the Mafia can have some impact on the decision-making and seventy six percent believe that this factor has no influence at all.

Managers admit that this phenomenon exists in transition economies and should be accounted for in the decision-making. However, no-one from the management side of these two companies has ever been experienced a threat from the Mafia either in Russia or in the Baltic countries.
“If you are sitting in Sweden and getting the information from the mass media, you can probably get the impression that a businessman from the west can not leave a hotel room without being approached by the Mafia. I guess that the Mafia is like ‘a shadow’ in Russia, you can see a phenomenon only under special circumstances. Ericsson has never been approached by the Mafia in Russia”, said one of the decision-makers.

One of the explanations is that Ericsson, being a world-established company, performs foreign investment projects under the supervision of the Russian government and, therefore, feels protected from such ‘disturbances’ as the local Mafia.

Managers from Vattenfall have not experienced this problem yet either.

”However, due to the energy branch specifications, Vattenfall has never been involved with cash activities. I think that the Mafia is well informed about cash earnings. The situation can be different for consumer product industries who are selling goods for cash”, said one of the managers from Vattenfall.

The survey does not confirm the results obtained by other researchers. Mygind (1997), who studied the Baltic Countries, came to the conclusion: “The payment of protection ‘tax’ to different Mafia gangs is widespread in all sectors”.

According to a survey of 300 firms in Poland, Romania, Russia, Slovakia and Ukraine, approximately 90 percent of the managers in Russia and Ukraine said firms in their industry pay for ‘protection’ of their activities. In Central Europe the Mafia was found to be a smaller problem: 15 percent of Slovakian managers, and still fewer Polish (8 percent) and Romanian (1 percent) managers, said protection payments are normally made (Johnson, Kaufmann, McMillan and Woodruff, 1999, p. 3).

An explanation for the difference in conclusions between this study and other research papers may be found in Johnson, McMillan and Woodruff (1999). The authors claimed that different firms may face different realities in transition economies. Managers’ perceptions may also vary and might depend on a foreign company’s status in the business community.

8.4.8. Other characteristics of transition economies that influenced the FDI decision-making in transition economies

Interviewed managers were asked to suggest other factors in addition to those mentioned in the questionnaire that influenced the foreign investment decision-making process.

Managers suggested that personal contacts are vital in transition economies.

In market economies, companies acquire projects primarily via public tenders where the best offer is going to be accepted. However, the interviewed managers were unanimous that countries of transition economies are different. A great deal of business is happening because you know someone, not because you have the best project. The decision-making is often based on the personal interests of individuals with power rather than principles of market efficiency.
One of the managers used the term ‘personalisation of projects’ to describe the situation when projects are accepted not due to the commercial interests of the parties but because of the close relationship between the partners.

- "If you have found the ‘right’ partner, you have more chances to succeed in the Baltic countries and to implement the project”, commented a manager from Vattenfall.

- "Due to the fact that the key decision-makers are changing all the time in the Baltic countries, we need to reestablish our contacts all the time. You must keep an eye on the events and have close contact with local persons. I fly to one of the Baltic countries almost every second week”, added another executive from Vattenfall.

- “Everything is different in Russia. Personal contacts are of crucial importance. That is why Ericsson spent a great deal of time establishing contacts with politicians, Ministry of Telecommunication, private companies. My experience in Russia is that a network of personal connections, contacts and references is the key to success for the investment projects and is often more important than traditional calculations “, commented a manager from Ericsson.

One of the suggestions that came up during the interviews is that that a network of personal contacts replaces the missing institutional framework that ‘backs up’ business in the Western countries.

According to Schopflin (1997), the widespread distrust of institutions results in a "personalisation of policies, which thereby continues to undermine respect for institutions, reproducing the cycle of weakness” (p. 277)

Another explanation is that the present generation of decision-makers from the West have been born and raised during the period of the cold war with the Eastern block and often lack proper knowledge of the region. Personal contacts with representatives of the host country, therefore, can mitigate, at least partly, the lack of knowledge and understanding of the investment environment on the part of the Western managers.

- "We (Swedes) often misunderstand people from Eastern Europe because we think in a different way. You can adjust to the system, but you will never understand it”, commented one of the decision-makers.

- "When I was a child the countries to the east of the Berlin wall did not exist in my reality. Representatives of my generation inherited this traditional perception of Eastern Europe as countries ‘from the other planet’. With the exception of some specialists, we did not study these countries. It is not strange, therefore, that it is hard for us to understand if Eastern Europe is ‘a dark horse’ or a golden investment opportunity when we decide about particular investment projects. It will take time to understand that Eastern Europe is a part of Europe. Probably, the next generation of the decision-makers will have another risk perception…”, said one of the Board members.

Richardson (1995) has also observed that every project investment negotiation between the Western and local partners is an occasion for Machiavellian intrigues, manoeuvring and posturing. Dunayeva and Vipperman (1995) compared some business negotiations between Americans and Russians with a dialogue of the deaf.
It may be suggested then that personal contacts with representatives of the host country can mitigate, at least partly, the lack of knowledge and understanding of the investment environment on the part of the Western managers.

The importance of private relationship and personal contacts in Central Europe has been suggested by some researchers. Brezinski and Fritsch (1997) showed that the old administrative system had been based on "long-established social and economic relations between actors that might well be described as ‘networks’" (p. 16).

Johnson, McMillan and Woodruff (1999a) found that contracting in transition economies is based at least as much on relationships as on the courts. A firm that says the courts are effective gives 6 percent more trade credit on average (trade credit is used by the authors as a measure of a firm’s trust in a customer). By comparison, dealing with the customer for three years accounts for a 13 percent increase in trade credit compared to a new customer; having obtained information about the customer from other manufactures accounts for a 10 percent increase; and the customer’s being managed by a family member or friend accounts for a 10 percent increase. (p. 3). The authors also found some evidence that relational contracting works as a substitute for the courts and hypothesised that the introduction of laws will reduce such inefficiencies.

McCarthy and Puffer (1996) share the view that utilising networks of personal contacts rather than formal, legal mechanisms is a feature of transition economies that should be taken into consideration by foreign investors.

Lasserre and Probert (1998) confirmed the crucial importance of relationships and personal contacts for the Asia Pacific region. The rules of society require Western project managers to take a paternalistic interest in employees, for example by arranging suitable marriages for staff members, providing loans to employees to pay for festival celebrations, and helping relatives of workers to find jobs. This trend was supported by empirical data for Vietnam, Indonesia, Korea, Thailand, Taiwan, China, Japan and Philippines, with the exception of Westernised business communities of Singapore and Hong Kong.

To sum up, Western enterprises which look for investment opportunities in Eastern Europe should realise that they can only successfully set up promising projects in transition economies if their plants can be embedded into a framework of relations in the respective country.

One might question whether the situation will change in future. Some authors believe that institutional rules in the West have accorded greater individual autonomy and independence to social actors - both persons and firms - that have related rules in Eastern societies. Thus, whereas "the United States has institutionalized competitive individualism in its market structure, Asian economies are organized through networks of economic actors that are believed to be natural and appropriate to economic development" (Biggart and Hamilton, 1992, p. 472).

The idea of the individual, that has been an important concept in Western philosophy since the time of classical Greece, expresses that human beings are unique units clearly distinguished from their environment, stable over time and in different situations.
Responsibility is one important consequence of the institution of the individual. In Western culture, the definition of responsibility is linked to the perception of influence: the person who is seen as affecting actions or events is also responsible for them (See, for example, Aristotle (384-322 BC), 1985, Book Three, Chapter 1).

The concept of the individual often stands in contrast with ideas from non-Western cultures, where "human beings are not seen as such clearly separate units, where human action is considered more a product of the situation than of ‘personal characteristics’, and where the human being is basically considered to be equivalent to his or her role in various context” (Brunsson and Olsen, 1997, p. 60).

We need to combine the efforts of social scientists from different disciplines in order to answer the question whether the importance of personal contacts in transition economies might be seen as a feature inherited from the past communist system or as an alternative way to organise the economic actors through networks, a way that is natural and appropriate for the majority of Asian societies.

8.4.9. Connections between the main characteristics of transition economy

Some researchers suggested that several features of transition economies are interconnected. An EBRD report (1997) asks why transition countries exhibit such high levels of corruption and organised crime in comparison with other countries and whether this is rooted in the transition process itself, or in the legacies from the past. The answer was that those disturbances are the means of hedging against the uncertainties associated with political instability and unpredictability of government policy.

Friedman, Johnson, Kaufmann and Zoido-Lobarton (1999) found in a study across 69 countries that high levels of corruption are positively correlated with the existence of ‘shadow’ economy. Besides corruption, entrepreneurs go ‘underground’ because of the burdens of bureaucracy and a weak legal system.

Johnson, Kaufmann, McMillan and Woodruff (1999) came to the conclusion that managers in Russia and Ukraine who faced worse bureaucracy were more likely to attempt to hide the activities and turn to the ‘shadow’ economy than in Poland, Romania and Slovakia where the bureaucracy was less burdensome.

Corruption is viewed sometimes as one of the obstacles that post-communist transition economies face in attempting to consolidate democratic institutions and open market economies (Triesman, 1999). At the same time, embryonic institutions of ‘non-market nor planned economy’ and general political instability might explain the existence of the Mafia and corruption during the transformation period (Raagmaa, 1997).

In a survey conducted by Zhuravskaya and Frye (1998), 33 percent of respondents reported that one of the roles of ‘protection organisations’ was to enforce agreements, i.e., to perform the function of a legal system (though more commonly their reported role was to ‘protect’ business from other criminals). Anecdotal evidence also indicates that criminals in former communist countries obtain their information through government employees and from tax returns and statistical reporting (Gustafson, 1999, Chapter 6).
Some authors, therefore, suggest that an inadequate legal system and onerous official regulations promote the development of an unofficial economy and corruption (Johnson, Kaufmann and Shleifer, 1997; Schneider and Enste 1998; de Soto 1987). It also appears to be legitimate to ask whether certain networks, e.g. nomenclatura or Mafia-type organisations, may be an obstacle to the process of erecting real markets.

Many of the variables are likely to be interrelated; sometimes it is hard to find the direction of causation between them. The main components of transition economy derived from theoretical studies and tested empirically provide a starting framework for the analysis. We can not be sure, however, in which way they might influence and predetermine each other.

8.4.10. Summary of the paragraph

In summary, the third block ‘Main characteristics of the environment of transition economy’ of Figure 3 ”Transition economy: conceptual framework for analysis” may be updated according to the empirical data in the following way:

3. MAIN CHARACTERISTICS OF THE ENVIRONMENT OF TRANSITION ECONOMY

- The following characteristics of the environment of transition economy were ranked by managers as very important or having some impact on the FDI decision-making: political instability; unpredictability of development; lack of institutional development; lack of legislation regulating market
- Corruption in the government agencies and existence of so called Mafia were ranked in analysed cases as unimportant characteristics for FDI decision-making. These two factors might be important for other industries, companies, and projects because different firms might face different
- A new characteristic that is important for FDI decision-making was suggested: personal contacts are vital in transition economies
- Characteristics of transition economy are often connected with each other. The direction of causation is sometimes unclear

Figure 22 (3). Updating of the third block ‘Main characteristics of the environment of transition economy’ according to the empirical data

Source: Olga Golubeva (own)
8.5. FDI decision-making in transition economies: empirical analysis in the global context

8.5.1. Empirical data analysis

Top managers were asked to choose an alternative or some alternatives among the suggested assumptions that describe in the best way the nature of foreign investment decision-making in transition economies.

Due to the exploratory nature of the subject, managers were also asked to submit additional comments on the issue. We must be aware of the fact that the responses of the managers depend on their international experience and involvement in the foreign investment decision-making in other regions of the world. The purpose, however, is to look for insights that might help to understand the process of foreign investment decision-making in transition economies rather than to search for universal conclusions. The table below summarises the answers of managers.

Table 5: Evaluation of alternative assumptions suggested for managers about the nature of FDI decision-making - ‘To decide about direct investments in transition economies is …’

<table>
<thead>
<tr>
<th>Alternative assumptions</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of answers</td>
<td>The assumption is right</td>
</tr>
<tr>
<td>Is similar to investment decision-making in the projects in the Western economies</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Is a unique process that require special methods and knowledge to deal with</td>
<td>16</td>
<td>11</td>
</tr>
<tr>
<td>Is similar to decision-making in the emerging markets (like China, Latin America, etc.)</td>
<td>16</td>
<td>4</td>
</tr>
</tbody>
</table>

From Table 5 we can see that almost 70 percent of managers found similarity between deciding to invest in transition economies and in projects in Western economies.

The most common comment in this respect was that main principle of investment decision-making is the same for the whole world: to invest the shareholders money in order to increase profits. To get the risk-adjusted return on the capital invested is the main rule of the decision-making.

The decision-making process both at Ericsson and Vattenfall is performed with consideration of the interests of the whole concern and must follow the same routines for all business units and potential countries of investments.
According to managers, it should not matter (at least to some extend) if a company looks for investment possibilities in Germany, Baltic countries or Russia. Projects from all over the world should compete for required finance.

- "The foreign investment decisions are based on international decision-making routines as well as on a particular corporate culture and traditions. Vattenfall is a shareholding company owned by the Swedish State. So, the decision-making is ‘very Swedish’ and the same procedure is applied for all countries”, commented one of the managers from Vattenfall.

Executives also pointed out that an investment decision process for transition economies becomes even more formal and structured.

- "Routines and traditional techniques are probably more important for the case of total change than for developed market economies because they perform some sort of ‘objectivity’ function and provide management with the situation of desirable certainty”, explained his position one of the decision-makers.

A rapidly changing environment, however, influences the investment decision process. Almost 70 percent of managers believe that the decision-making in Russia and the Baltic countries requires special knowledge and methods. One of the explanations is that the decision-making in Russia and Baltic countries is a more complicated process that is influenced by many uncertainties.

One of the top managers told me:

- "We need more time to get the information and very experienced personnel to make evaluations. Among one hundred projects probably ten are good and only one is very good. We need to make calculations. Business needs calculations. But in the unstable environment feelings and intuition can add to decision-making as much as the proper budgeting calculation. You need to have ‘a good nose’ in order to survive in transition economies”.

Many parameters are unclear and need to be specified. Some factors and variables can be verified with the help of consultants and local business partners while some factors will remain unknown.

- “I work very much with capital budgeting. How can you be sure about, for example, sales in your calculations when everything is so unstable?” asked one of the decision-makers.

- Another managers pointed out: “In transition economies it is almost impossible to make decisions within one year. The situation is changing too rapidly to cover all the changes. We are talking about long-term establishment in Eastern Europe rather than getting ‘quick’ profits. It takes time to establish in transition economies where changes in the economy and politics are taking place all the time. So, we have to consider different scenarios.”
Big differences exist between geographical regions, clients and business partners in transition economies. One of the managers from Ericsson suggested that:

- "Eastern Europe has invented the phenomenon of extremely segregated projects, where some partners and business contractors on the market can be granted as high ratings as Western partners while others are not reliable at all".

In general, managers agreed that transition economies, Russia and the Baltic countries in particular, require management to search for new methods to work and do business. Management can not be sure that the investment decisions they made yesterday can be helpful in the future. Even if a solution works today, the decision-makers must be prepared to search for a new one tomorrow. Even if the variables influencing the project are identified, we can not expect that new crucial factors would not emerge in the future.

In the rapidly changing environment full of uncertainties, decision-making becomes an ongoing process where further steps are determined by the results of previous ones.

Only twenty percent of managers believe that deciding about direct investments in transition economies is similar to decision-making in the emerging markets. According to managers, emerging markets are more incomparable with each other than the Western economies. One of the similarities among different emerging markets is that they are ‘non-compatible’. New variables influencing foreign investment decision-making should be identified for each particular region, country, industry, company and project.

- ‘You can not classify Russia as a country similar to other emerging markets. It is something extra. Russia is Russia. All countries in the world are unique, but the emerging markets are even more unique and incomparable. However, my experience of working in China and Latin America helped me to adjust to life in Russia simply because I had to adjust before. People have the ability to learn, so do companies”, pointed out one of the top managers from Ericsson.

It seems like FDI decision-making becomes a unique process for each country in emerging markets. However, those companies that have been working in the uncertain environment of different emerging markets might use the acquired experience in transition economies.

The experience of being in transition economies might also influence the companies’ traditional FDI decision-making routines.

- ”When we started to expand internationally, especially into countries of transition economies, we (Vattenfall) realised that there are other ways of doing business than we used to have in Sweden. If we want to be successful with international projects, we must adjust our decision-making to the investment environment of the countries of potential investments”, said one of the decision-makers.

It is interesting to mention that some of the managers believe that the whole process of foreign investment decision-making is in a ‘transition phase’. Emerging markets - Asia, Eastern Europe, Latin America - as well as emerging industries, become an inseparable part of the world economy. Therefore, FDI decision-making in the West will be more and more influenced by new emerging uncertainties that should be taken into consideration.
8.5.2. Some conclusions and comparison with other studies

We can conclude that the investment decision-making process in the environments of transition economies has similarities with the investment decision-making in the Western economies. Almost 70 percent of managers found similarity between deciding to invest in transition economies and deciding to invest in projects in Western countries.

Therefore, one might assume that the most successful Eastern European countries in attracting FDI will be those that will successfully compete with other geographical regions for investments and be the most integrated into the globalisation process. (See also Lavigne, 1999). According to managers, foreign investment decision-making in transition economies becomes even more formal and structured because the traditional routines and procedures perform a certain function of ‘objectivity’ in the rapidly changing environment.

On the other side, almost 70 percent of managers believe that decision-making in transition economies requires special knowledge and methods. In the rapidly changing environment full of uncertainties, decision-making becomes an ongoing process where each successive step is determined by the results of the previous one.

Only twenty percent of managers believe that deciding about direct investments in transition economies is similar to decision-making in other emerging markets. Emerging markets are more incomparable with each other than Western economies. New variables influencing foreign investment decision-making should be identified for each particular region, country, industry, company and project. On the other hand, those companies that have experienced the unstable environment of emerging markets can use the knowledge it in other countries.

Companies’ experience in transition economies might also influence the traditional decision-making routines. If Western companies want to be successful with international projects, they must adjust their decision-making routines to the new emerging environmental uncertainties of the countries of potential investments.

According to managers, the entire process of FDI decision-making might be in a ‘transition phase’. The features of transition economy, at least some of them, analysed in this survey can also be identified in other emerging markets or even in Western economies.

The study based on the interviews conducted in the Swedish joint ventures in China shows that the logic of the Maoist era industrial governance systems might be also described in ‘non-planned, non-market’ terms. (Sharma and Wallström-Pan, 1997).

Auroi (1998) described, on the other hand, a role of predictability of the investment environment in attracting FDI to Peru and Chile. "Peru changed governments five times during the period under consideration (1970-95), compared to four changes in government in Chile. … The real difference, however, is in the length of the different mandates, with the Pinochet regime remaining 16 years in power. This allowed more time than other governments to implement changes and stabilise new models and policies.” (p. 160)

Political instability, unpredictability and inadequacies of the legal framework as factors exerting a major influence in attracting FDI to emerging markets in general was pointed out by Cook and Kirkpatrick (1996) and Hadjikhani and Johanson (1996).
According to Khanna and Palepu (1997), in advanced economies, companies can rely on a variety of outside institutions that minimise these sources of market failure. In such a context, companies create value primarily by focusing on a narrow set of activities. In emerging markets institutional voids are still common enough to cause market failures. As a result, companies in emerging markets often have to perform these basic functions themselves. Authors concluded that this difference is the crucial distinction between doing business in an emerging market and operating in an advanced economy. Transition economy seems to share this feature - the lack of institutional development - with other emerging markets.

The crucial issue of relationships and personal contacts - a feature described by managers for transition economies - was also confirmed for Asia by Lasserre and Probert (1998).

Lindbeck (1998) claims that unpredictability of the rules of the game is a remaining problem even in Sweden! "For instance, tax rules tend to be changed all the time - also after the 1990-91 tax reform. Social insurance rules have turned out to be even more unstable. There have been more than 200 changes in these systems since 1990." (p. 34). The problem of unpredictability is, of course, much more serious in the post-socialist transition economies.

It can be suggested that the investment environment of transition economies have more similarities with both emerging markets and Western economies than we often assume.

8.5.3. Summary of the paragraph

In summary, the fourth block ‘Transition economies in the global context’ of Figure 3 "Transition economy: conceptual framework for analysis” may be updated according to the empirical data in the following way:
Figure 22 (4). Updating of the fourth block ‘Transition economies in the global context’ according to the empirical data

*Source: Olga Golubeva (own)*

### 8.6. Conclusions for the chapter

Transition economy, with uncertainties associated with ‘still imperfectly functioning markets’ and ‘embryonic institutions,’ as well as bureaucracy and hierarchy inherited from the old administrative system, influences substantially the FDI decision-making of Western investors. (Economic Survey of Europe in 1994-1995, 1995, p. 14).

The study supports the thesis of the neo-classical economic theory that the main components of transition period - stabilisation, liberalisation and privatisation - are very important for FDI decision-making. The reformation of government from the communist police state to an institution supporting a market economy is as important for foreign investors as three previously mentioned components. The formation of a market economy mentality among the local population (which includes educational reform) was suggested by Western managers as an important component of transition. Although institutions represent continuity and persistence, they exist only to the extent that they are carried forward by individuals. (See Scott, 1995). We must be aware that the importance of the main components for FDI decision-making might range among different countries.
The following characteristics of the environment of transition economies were ranked by interviewed managers as very important or having some impact on FDI decision-making: political instability, unpredictability of development, lack of institutional development and lack of a legislation regulating market. Corruption of the government agencies and existence of the so-called Mafia were ranked as unimportant characteristics for FDI decision-making. The survey did not confirm the results obtained by other researchers. However, these two factors might be important for other industries, companies, and projects because different firms might face different realities in transition economies.

In summary, the study confirms that uncertainties associated with the environment of transition economies do influence the FDI decision-making. The results of the study are in line with another investigation, which concludes that in 40 percent of cases, the existence of transition economies’ uncertainties has resulted in a significant change in investment strategy. Most commonly, companies have chosen to limit either the number of projects undertaken or the size of their investments. However, 18 percent chose not to invest or at least delay their investments. (“Assessing Investment Opportunities in Economies in Transition”, 1994, p. 11).

A new characteristic that is important for FDI decision-making was suggested: personal contacts are vital in transition economies and play more important roles than in Western economies. We need to combine the efforts of social scientists from different disciplines in order to determine whether the importance of personal contacts in transition economies might be seen as a feature inherited from the past communist system or as an alternative way to organise the economic actors through networks. This alternative way is natural and appropriate for the majority of Asian societies.

Another challenging question is whether we should frame some of the analysed features in the broader historical, religious, social and economic context and search for their roots rather than just blame the administrative system of the former communist countries for their existence. We might, for example, find the roots of Russian hierarchy and corruption, at least to some extent, in the socio-historical traditions of Eastern Orthodoxy.

A broader social and philosophical framework of analysis will raise additional questions about the nature of transition economies. Can the new emerging market institutions of transition economies be of a Western type? Can we combine the Western philosophy of individual autonomy of both firms and persons with non-Western cultures that traditionally organise economies through networks of social actors?

The main components and characteristics of transition economy derived from theoretical studies and tested empirically provide a good starting framework for analysis. We can not be sure, however, in which way those components and characteristics might influence and predetermine each other. Many of characteristics of transition economy are also likely to be endogenous: whether or not a variable causes a factor, it can also be vice-verse. It is sometimes hard to find the direction of causation. More empirical studies and theoretical discussions are needed to answer those questions.
The study shows that FDI decision-making in transition economies has the same foundations as in the rest of the world. To get the risk-adjusted return on the capital invested is the main rule of decision-making. Executives pointed out that the FDI decision process becomes even more formal and structured because the traditional routines and procedures perform some sort of function of ‘objectivity’ in the rapidly changing environment.

On the other side, managers believe that FDI decision-making in transition economies requires special knowledge and methods: it becomes an on-going process with many unspecified variables. Transition economies and emerging markets in general are not comparable. FDI decision-making becomes a unique process for each country, industry, company, and project.

The experience of FDI decision-making in transition economies might also influence the traditional routines and procedures of Western companies.

The features of transition economy analysed in the survey, at least some of them, can be found in other emerging markets and even Western economies. Some managers believe that the process of FDI decision-making in the whole world is in ‘transition phase’. More comparative studies of FDI decision-making in different countries are needed in order to prove or disprove this hypothesis.

In summary, Figure 3 "Transition economy: conceptual framework for analysis” can be updated according to the empirical data in the following way:

1. THE NATURE OF TRANSITION ECONOMY AS ‘NON-PLANNED, NON-MARKET ECONOMY’

The new emerging market institutions coexisting with bureaucracy and hierarchy inherited from the old administrative system influence FDI decision-making

2. MAIN COMPONENTS OF TRANSITION ECONOMY

The main components identified by neo-classical economic theory - stabilisation, liberalisation, privatisation - are very important for FDI decision-making

Reformation of government is as much important for FDI decision-making as the three previously mentioned components

Formation of market economy mentality and traditions among the local population (which includes educational reform) was suggested as a component influencing FDI decision-making

The importance of the main components for FDI decision-making can depend on the urgency of implementation of those factors and might range among different countries
3. MAIN CHARACTERISTICS OF THE ENVIRONMENT OF TRANSITION ECONOMY

The following characteristics of the environment of transition economy were ranked by managers as very important or having some impact on the FDI decision-making: political instability; unpredictability of development; lack of institutional development; lack of legislation regulating market.

Corruption in the government agencies and existence of so called Mafia were ranked in analysed cases as unimportant characteristics for FDI decision-making. These two factors might be important for other industries, companies, and projects because different firms might face different.

A new characteristic that is important for FDI decision-making was suggested: personal contacts are vital in transition economies.

Characteristics of transition economy are often connected with each other. The direction of causation is sometimes unclear.

4. FDI DECISION-MAKING IN TRANSITION ECONOMIES: COMPARISON ANALYSIS IN THE GLOBAL CONTEXT

FDI decision-making in transition economies has the same foundations as in the rest of the world and becomes even more formal and structured process.

FDI decision-making in transition economies requires special knowledge and methods: it becomes an on-going process with a lot of unspecified variables.

Transition economies and emerging markets in general are extremely incomparable with each other. FDI decision-making becomes a unique process for each country, industry, company, and project.

The experience of FDI decision-making in transition economies might influence the traditional routines and procedures of the Western companies.

The features of transition economy analysed in the survey, at least some of them, can be found in other emerging markets and even Western economies. According to some managers, the process of FDI decision-making in the whole world is in ‘transition phase’.

Figure 22. FDI decision-making applied for and perceived in the environment of transition economy according to the empirical data analysis

*Source: Olga Golubeva (own)*
9. ANALYSIS OF INITIAL MOTIVATION TO INVEST IN TRANSITION ECONOMIES (OR REASONS FOR FDI)

"In the why and wherefore is neither rhyme nor reason?"

William Shakespeare, "The Comedy of Errors"

Cited from "A Dictionary of Quotations from Shakespeare", selected by Margaret Miner and Hugh Rawson, 1992, published by Penguin Group, p. 228

9.1. Introduction

The purpose of this chapter is to analyse the initial motivation to invest in transition economies (or reasons for FDI). The empirical data is guided by, and is structured according to, the logic of Figure 12 (Chapter 5). The decision-makers were encouraged to evaluate the applicability of different theories and hypotheses that might be relevant for explaining the reasons for FDI in transition economies.

The analysis presented in the chapter is based on the answers of managers on the fifth and sixth questions from the questionnaire. Due to the explorative nature of the subject, managers were also asked to suggest the new variables that might explain a company’s motives for investing in transition economies.

The results of the empirical investigation are compared to the conclusions from other studies. At the end of the chapter the suggested theoretical framework for analysis of reasons of FDI in transition economies will be updated according to the empirical data.

9.2. Mainstream theories of reasons for FDI: application to transition economies

9.2.1. Summary of the empirical data

Managers were asked to rank the importance of mainstream theories explaining FDI to transition economies according to the following grades: very important, has some impact, not relevant. The summary of answers about the reasons for FDI in transition economies is presented in the table below:
Table 6. Reasons for FDI in transition economies - testing application of the mainstream theories

<table>
<thead>
<tr>
<th>Main theories</th>
<th>ERICSSON</th>
<th></th>
<th>VATTENFALL</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Very important</td>
<td>Has some</td>
<td>Not relevant</td>
</tr>
<tr>
<td></td>
<td>number</td>
<td></td>
<td>impact</td>
<td></td>
</tr>
<tr>
<td>Internalisation strategy in order to use company’s advantages: markets for</td>
<td>16</td>
<td>16</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>technological know-how, expertise in research, marketing ability, goodwill,</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>effective management, etc.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI enhances the firm’s access to low cost labour inputs</td>
<td>16</td>
<td>0</td>
<td>4</td>
<td>12</td>
</tr>
<tr>
<td>FDI provides the firm with more opportunities for tax avoidance or reduction</td>
<td>16</td>
<td>0</td>
<td>0</td>
<td>16</td>
</tr>
<tr>
<td>Benefits of national resources and low local production costs</td>
<td>16</td>
<td>0</td>
<td>2</td>
<td>14</td>
</tr>
<tr>
<td>The size of a domestic market</td>
<td>16</td>
<td>16</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>‘Defensive’ investment in order to be early in the market in comparison with</td>
<td>16</td>
<td>2</td>
<td>14</td>
<td>0</td>
</tr>
<tr>
<td>the competitors</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9.2.2. Internalisation strategy: empirical data analysis and comparison with other studies

Empirical studies support the thesis that an internalisation strategy expanding a company’s advantages - markets for its technological know-how, expertise in research, marketing ability, goodwill, effective management, etc., influences substantially the decision to conduct FDI in transition economies. All managers from both Ericsson and Vattenfall believe that this factor should be classified as a very important one.

The following arguments were used by the decision-makers in order to explain their positions:

- “FDI can be seen as a step in a long-term international strategy of establishing a company’s image as a loyal citizen with ‘permanent residence’ in the Baltic countries”.

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• "An expansion of technological know-how or research, for example, is limited for Ericsson without direct investments due to the poor technical shape of assets in Russia”.

• "Marketing possibilities in Russia are limited without FDI commitments”.

• "The existence of effective management in transition economies is achievable only after sufficient investments in training of the local staff”.

Besides, after the liberalisation of the energy sector in Europe and the creation of the Baltic Ring, the expansion into the Baltic countries seems to be a natural step for Vattenfall’s international strategy.

The study supports the internalisation theory that claims that foreign investments should occur when a firm is able to increase its value by internalising markets for its intangible assets or growth opportunities (See Buckley and Casson, 1976; Dunning, 1973; Grubaugh, 1987; Morck and Yeung, 1991, 1992; Rugman, 1979; Williamson, 1975).

Internalisation strategy expanding a company’s advantages: markets for its technological know-how, expertise in research, marketing ability, goodwill, effective management, etc., can be ranked as an important motive for FDI in transition economies. The same conclusions were reached by Doukas and Travlos (1988), Inotai (1995) and Lang and Ofek (1995).

9.2.3. Low cost labour hypothesis: empirical data analysis and comparison with other studies

Managers from both companies did not give a high priority to this factor in explaining FDI in transition economies. Only twenty eight percent of managers believe that this factor has some impact on the decision to make FDI in transition economies while seventy two percent think that the factor is not relevant.

• "The labour costs are relatively low in Eastern Europe compared with labour costs in Sweden. An engineer with a high school education in Sweden earns approximately 16-18,000 SEK per month. A salary of an engineer who works for a Western company in Russia or Baltic countries reaches a maximum of 8,000 SEK per month. There is still a difference in labour costs even if it is not as huge as one might think”, pointed out one of the managers.

Decision-makers from both companies stressed that Western companies need people with a good education, a knowledge of industry and the English language, management and communication skills, business contacts, etc.

• "Such people are hardly classified as ‘low labour costs’ and their salaries often reach the Swedish level. The administrative people are lower paid in Eastern Europe than in Sweden. At the same time it is very hard to find a well-organised professional secretary. So, instead of one person you often have to employ three. Besides, savings on salaries of low qualified labour are offset by high costs of accommodation of Swedish professionals in Eastern Europe,” - explained one of the executives.
Access to cheaper labour costs in Russia and the Baltic countries then can be classified as a factor having some impact or not being relevant.

The low labour cost hypothesis argues that international expansion may increase a firm’s value because it enhances its access to low cost labour inputs (Hood and Young, 1979).

Ozawa (1979) describes Japanese investment in Asia as being a result of industrial upgrading in Japan itself; as the economy has advanced towards skill intensive sectors, labour intensive production processes have moved to South-East Asia. The shortage of unskilled labour in Japan led to investment in labour intensive production in the economies of South-East Asia, where labour costs were low. Recent research on FDI from the newly emerging markets of Korea, Taiwan and Hong Kong found similar features (See, for example, Wells, 1993).

Lankes and Venables (1996) listed low labour costs, especially costs that are low for a level of skills comparable to what is found in industrialised countries, as a usual motivation for FDI in transition economies.

The study does not support the original assumption that large flows of capital would be directed to Eastern Europe based on the expectation that cheap labour would motivate investors to relocate large portions of their production capacity. It confirms the conclusions reached by Franko (1996) and Widmaier and Potratz (1999) that cheap labour, or even cheap, educated labour, is not a sufficient condition to attract FDI into the region. The study by Meyer (1996), based on the evidence from 269 German and British companies operating in five countries in Central and Eastern Europe, also shows that labour costs appear, at best, as a complementary motive for the foreign investors, which contrasts with patterns frequently reported for investments within Eastern Asia.

The hypothesis suggested by Rutihinda (1996), that the advantages of low cost labour do not apply in today’s modern technology where most machines are automatic and thus require less human inputs, might be especially relevant for highly technological companies such as Ericsson and Vattenfall.

9.2.4. Tax avoidance or reduction hypothesis: empirical data analysis and comparison with other studies

The managers from Ericsson are unanimous that the opportunities for tax avoidance are not relevant to FDI in Russia.

“I can summarise the situation with taxation in Russia by just one expression: It is the most ridiculous system that I have ever seen in my life. The Russian economy is driven by the collection of taxes. Custom duties for most of Ericsson’s products are up to 30 percent in Russia, and VAT (Value Added Tax) is 20 percent. Ericsson has raised the prices of products in order to balance the tax pressure. The companies also must pay higher taxes for losses than for profits (38 percent taxes for profit and 58 percent for losses). A lot of costs are not deductible: hotels, training of personal, taxi, mobile phones, etc. So, the majority of the participants in the market in Russia try to cheat the government. A lot of payments are going via different non-official channels. However, companies like Ericsson can not participate in the ‘black’ economy transactions and
must use legal methods to cope with the situation”, a manager from Ericsson commented on the situation in Russia.

One may conclude that the tax pressure is very high and prohibits rather than supports investments in Russia.

In the case of Vattenfall, six persons (of nine) believe that opportunities for tax avoidance or reduction have some impact, while three managers think that this factor has no relevance to foreign investments in the Baltic countries. Nobody ranked the factor as a very important one.

The difference between the position of managers from Ericsson and Vattenfall can be explained by the better taxation climate that has gradually evolved in the Baltic countries compared to that in Russia.

• “Taxation in Lithuania is created with the purpose to attract foreign investments. I think that the taxation climate there is better than in Sweden”, pointed out one of the managers from Vattenfall.

To sum up, opportunities with tax avoidance or reduction a play smaller role in attracting FDI to Russia and the Baltic countries and can not be qualified as a decisive factor. The study, therefore, does not confirm the statement that tax avoidance (reduction) (see Harris, Morck, Slemrod and Yeung, 1991; Hood and Young, 1979) might explain the reasons for FDI.

The study supports the conclusions of an empirical investigation conducted by Arthur Andersen that showed that investment incentives, in particular tax reduction benefits, were not a decisive factor or the prime motivation of FDI in the region (“Assessing Investment Opportunities in Economies in Transition”, 1994).

9.2.5. Benefits of national resources and low local production costs: empirical data analysis and comparison with other studies

Thirty six percent of managers think that benefits of natural resources have some impact on FDI decision-making while sixty four believe that this factor is irrelevant. Nobody ranked this factor as a very important one.

• ”Russia has more natural wealth than any other country in the world. However, Ericsson has quite a low share of resources in the final product. I think that this factor stimulates investments rather to raw material industries than high technological ones”, explained one of the managers from Ericsson.

Higher dependence of the energy sector on the availability of mineral resources is probably an explanation of why this factor received higher ratings from managers from Vattenfall.

In general, hypotheses explaining FDI as searching for benefits from the natural resources or low local production costs did not get a priority status. The study supports conclusions of empirical investigation that cheap resources and the prospect of cutting production costs should be rather classified as a short term benefit than a key motivating factor (“Assessing Investment Opportunities in Economies in Transition, 1994).
On the contrary, the benefits of national resources and low local production costs are mentioned as important reason for FDI in transition economies in other research papers (See Burger and Jungnickel, 1996).

Meyer (1996), for example, suggests that factor-cost advantages in transition economies may arise from the low costs of some still-subsidised raw materials, especially in Russia.

9.2.6. The size of a domestic market: empirical data analysis and comparison with other studies

The size of a domestic market was classified as a very important factor by ninety six percent of the decision-makers while only one person (four percent) thought that it has some impact on attracting FDI to transition economies.

- "Ericsson’s strategy is to concentrate on big markets rather than on particular group of products. Russia is the biggest country in the world with 150 million potential customers."
- "The size of Russia suits Ericsson’s ambition to be one of the best in the world in the area of telecommunications”.
- "We can look upon direct investments in Russia as our “entry fee” for acquiring the substantial market share”, pointed out the decision-makers.

The same opinion about the importance of the market size to FDI decision-making was expressed by the managers from Vattenfall:

- "At present Vattenfall controls about half of the Swedish energy market and around 20% of the Nordic market. Our possibilities to grow in Sweden and Scandinavia are limited. We must admit that electricity systems have already been established in Western Europe. Redistribution possibilities of market shares between the biggest companies are limited due to the high competition. In the Baltic countries we are in the beginning of privatisation of the energy sector. There are some risks involved, but the possibilities are also enormous. If we look upon Latvia, for example, we can see a unique market opportunity. The country produces just half of the required energy”.

Another important comment is that the Baltic countries are of a smaller size where Vattenfall has very good chances to become a big player in the energy sector.

- “These tiny economies suit our ambitions. We feel more like at home in Sweden”, joked one of the decision-makers.
- "I think our chances to expand and be successful are smaller in Russia than in the Baltic countries due to the higher competition and larger capital requirements”, explained another manager.

The size of a domestic market appropriate for the company’s ambition to expand internationally seems to play an important role in FDI decision-making. The market growth constraints in the home market and limited possibilities for expansion in Sweden may have increased the search for new possibilities presented by transition economies.
Market size could influence decision-making in different ways: either the firm started operations in a country with larger markets (like Ericsson in Russia) or it preferred smaller markets (like Vattenfall in the Baltic countries). In the latter case an argument could be that smaller markets are more similar to the domestic Swedish market and require a smaller initial resource commitment or have less competitive domestic and foreign industries.

The study shows that marketing possibilities are limited without FDI commitments. Direct investments might be, therefore, viewed as a step of a marketing promotion strategy and some sort of “entry fee” for getting a market share.

The study supports a thesis that domestic market belongs to the key attractions for foreign investors.

The size of domestic markets was proposed by some researchers as one of the leading location factors employed to explain FDI inflows in transition economies (See ”Assessing Investment Opportunities in Economies in Transition, 1994; Burger and Jungnickel, 1996; Lavigne, 1999; Nieminen and Törnross, 1997; Peitsch, 1997, Stankovsky, 1998; Widmaier and Potratz, 1999). The ”market seeking” motive for FDI is well covered by Dunning’s (1981) discussion of home-based firm-specific competitive advantage.

Hadjikhani and Johanson (1996), by examining the responses of three Swedish MNEs to the dramatic changes in the Iranian market, found that the major reason for staying during the turbulent period of 1975-1992 in Iran was the companies’ future needs of the market.

9.2.7. “Defensive” investment in order to be early in the market in comparison with the competitors: empirical data analysis and comparison with other studies

Twenty four percent of managers think that defensive character of investment is a very important factor, and seventy six percent said that it has some impact on FDI decision-making.

- ”Ericsson has several global competitors including Motorola, Nokia, Lucent, Siemens, Alcatel, Nortel, NEC and Qualcomm. I think that the role of competition is very high in motivating companies to invest in Russia. However, direct investments are only one sphere of competition. When Ericsson came to Russia in 1994, the main competitors had already been there. If we would start to use the “defensive” investment strategy, the company would always be two steps behind the competitors. It is not enough to invest in production facilities in Russia to cover the “gap” with competitors. Ericsson’s strategy in Russia includes networks, regional establishment, goodwill promotion, human resource development, etc. “, pointed out a top executive from Ericsson.

“The investment possibilities are enormous in the Baltic region. But it is important to be early in the market. In order to invest directly, you must be established in the country. When Latvenergo is privatised, Vattenfall is among eleven other candidates for the strategic partnership. You can not search for investment projects and observe the situation from Sweden”, explained one of the Vattenfall’s managers.
Managers from both companies stress the importance of the defensive character of FDI in transition economies. The study supports a thesis that the phenomenon of defensive investment in order to be early in the opening markets in comparison with the competitors is relevant for explaining FDI in transition economies (See also Hood and Young, 1979; McClain, 1983; Meyer, 1996; Pehrsson, 1999). Oligopoly theory, which explains the phenomenon of foreign investment, which may occur in concentrated industries to prevent competitors from gaining or enlarging advantages that could then be exploited globally, received support in the study.

An investment decision then has to be made quickly to exploit an opportunity which, if not taken, may be grabbed by a competitor, or as Barius (1987) formulates it: ”If we believe that a market emerges and do not take it, someone else will do it” (p. 65; translated from Swedish by Olga Golubeva). The study confirms that FDI decisions are affected by the presence of competition in the host-country, and, therefore, have a defensive character.

Besides, as an effect of the ongoing liberalisation, deregulation and integration of market economies, both Vattenfall and Ericsson experience increasing global competition. Nieminen and Törnross (1997) also found that one of the reasons for attracting Finnish firms to Estonia is the liberalisation process that occurred as a result of Finland’s EU-membership. The integration of Finland into EU increased competition in the domestic market and, therefore, created the vital need for companies for active internalisation in the Baltic countries.

Managers from both companies pointed out that the escalation of global competition induces, among other things, a strategic involvement of firms in transition economies. The question of FDI decision, therefore, becomes a ‘how’ and ‘when’ rather than ‘whether’ and ‘why’ and may be compared with ‘jumping on the running train’.

### 9.2.8. Summary

To sum up, *internalisation strategy; the size of a domestic market* and the *"defensive" character of investment* are ranked by the executives as theories that are *very important or having some impact* on explaining the motives behind FDI in transition economies.

*Access to low cost labour inputs, opportunities for tax avoidance or reduction, benefits of national resources and low local production costs* were ranked as having *only some impact or not relevant* for the explanation of the reasons for FDI in transition economies.

The often quoted ‘traditional’ advantages of the region, such as low labour and production costs, cheap resources and investment incentives, though considered in the investment process, do not appear in our study as prime motivations and are perceived instead as potential short term benefits which, though attractive, should not form the main basis for long term strategic FDI decisions.
9.3. Other hypotheses suggested for evaluation that might explain the reasons for FDI in transition economies

9.3.1. Summary of the empirical data

Besides the mainstream traditional hypotheses explaining reasons for FDI, the decision-makers were asked to express their own opinions about hypotheses identified by other researchers. Managers used the following grades to rank the importance of a suggested variable for the explanation of motives behind FDI in transition economies: very important, has some impact, not relevant. The summary of answers is presented in the table below:

<table>
<thead>
<tr>
<th>Suggested hypothesis</th>
<th>Total number of answers</th>
<th>Very important</th>
<th>Has some impact</th>
<th>Not relevant</th>
<th>Total number of answers</th>
<th>Very important</th>
<th>Has some impact</th>
<th>Not relevant</th>
</tr>
</thead>
<tbody>
<tr>
<td>A ‘step-by-step’ process where future expansion depends on the success of the previous investments</td>
<td>16</td>
<td>16</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>8</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Geographical position and closeness to Sweden</td>
<td>16</td>
<td>6</td>
<td>8</td>
<td>2</td>
<td>9</td>
<td>9</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Historical and cultural contacts with the Northern region</td>
<td>16</td>
<td>9</td>
<td>6</td>
<td>1</td>
<td>9</td>
<td>7</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Successful transformation process from socialist economy to market economy</td>
<td>16</td>
<td>16</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>8</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

9.3.2. A ‘step - by - step’ process: empirical analysis and comparison with other studies

Ninety six percent of managers think that a ‘step-by-step’ process, where future expansion on the market depends on the success of the previous investments, is an important factor explaining FDI in transition economies. Four percent of managers believed that this factor had some impact on the decision to invest in transition economies; none of the managers ranked the factor as irrelevant.

The following explanations were submitted by managers:

- "The initial direct investments conducted by Ericsson were modest in size in order to minimise the risk of the uncertain and unfamiliar environment of the Russian market.”
The idea of taking cautious steps in an unknown terrain suits Vattenfall’s corporate strategy. By learning from the initial investments in the Baltic countries, we prepare the platform for future investments.”

The same ‘step-by-step’ strategy was described by several scholars. Buckley (1998), for example, stressed that internalisation normally moves through exporting to the setting up of a foreign sale subsidiary, to licensing agreements and similar contracts before actual direct investment in foreign production facilities takes place. "Rarely should a company establish manufacturing facilities as its first international business operation”, writes Pehrsson (1999, p. 58).

The study, therefore, has provided considerable, although not indisputable, empirical support for the Uppsala model (see Johansen and Weidersheim-Paul, 1975; Johansen and Vahlne, 1977), which postulates a linear relationship between market knowledge and market commitments. As it was shown in the case studies, due to the unpredictability and political instability of the environment of transition economy, foreign investors might consider different strategic options - from a intensive and rapid investment strategy to a low involvement and ‘sleeping’ position (in Vattenfall’s case even the withdrawal of investments was evaluated.)

There have been other researchers who raised questions about the universal character of the Uppsala model. Forsgren (1989), for example, illustrated the growing number of investments conducted by Swedish multinationals abroad without going through a ‘step-by-step’ process. Lindqvist (1991) showed that some small Swedish firms had started to set up production subsidiaries abroad without following the stages described by the model.

9.3.3. Geographical position and proximity to Sweden: empirical analysis and comparison with other studies

The role of geographical position and proximity to Sweden seems to be an important factor when FDIs are considered. Sixy percent of managers from Ericsson and Vattenfall believe that this factor is very important, while thirty two percent believe that it has some impact on decision-making, and only eight percent believe that it has no relevance.

The unanimous position of managers from Vattenfall can probably be explained by the fact that the energy sector development is often based on the geographical proximity among countries.

- "Electricity networks unite the neighboring countries… Our ambitions are to expand the Nordic and European co-operation between energy companies to the countries of the Eastern block”, said one of the senior executives from Vattenfall.

- "We (Ericsson) took a lot of our clients from different parts of the world and introduced them to Russia. Scandinavia is a bridge between Russia and the rest of the world due to geographical closeness”, commented a managers from Ericsson.
The study, therefore, confirms the suggestion of some researchers that a geographical determinant, i.e. the proximity of a potential investor to transition economies, is an important motive for FDI (The importance of geographical closeness was stressed in “Assessing Investment Opportunities in Economies in Transition”, 1994; Lavigne, 1999; Nieminen and Törnross, 1997).

The evidence in favour of the geographical proximity hypothesis and its variation across the five Central and East European countries (i.e. German firms, in particular those located near Germany’s Eastern border were predicted to be more active in transition economies than British firms due to their proximity to the region) was found by Meyer (1996). Meyer also suggested that while Austria and Switzerland are important in Central Europe, the Nordic countries are prominent in the Baltic States.

9.3.4. Historical and cultural contacts with the Northern region: empirical analysis and comparison with other studies

Sixty four percent of managers believe that historical and cultural contacts with the Northern region is a very important factor influencing FDI decision-making, thirty two percent believe that it has some impact, and only four percent believe that it is not relevant. Therefore, the majority of interviewed persons from both companies gave relatively high ratings to this factor.

The comments of the decision-makers are presented below:

- ”It is actually an advantage to be a Swedish company in Russia. I personally use the image of Scandinavia and Sweden during business negotiations. I think Russians like neutral countries. Russians do not see any threat from such a small country as Sweden. There are more political pressures involved when, for example, German companies like Siemens invested directly in Russia. But we, Swedes, are used to adjusting ourselves to different cultures. We know that our culture is not the only one in the world and we are not pressuring other nations.”

- ”The fight between Karl XII and Peter the Great is not connected directly to our decision to invest in Russia. But there is something about these historical facts that make business with Russia more interesting, more personnel for Swedes. Historical events can have different impacts on decision-making. Ericsson’s property in Russia was confiscated after the October revolution in 1917. I think that the decision to start production in Russia was probably harder to make for us than for other companies that have no history of presence in Russia.”

- ”We have a lot of things in common - from wars and fights over the centuries to a mutual enjoyment of playing hockey and drinking vodka. My experience is that Russians do like Swedes and vice-versa, and we have some sort of understanding between nations.”

- ”Baltic countries are culturally and mentally closer to Scandinavia than Russia. For me it is often harder to understand Russians than people from the Baltic countries. We can not explain foreign direct investments due to the cultural closeness of Sweden to the Baltic countries. But we have to bear this factor in mind…”
FOREIGN INVESTMENT DECISION-MAKING IN TRANSITION ECONOMIES by OLGA GOLUBEVA

- "The history of relationship between Estonia and Sweden goes back to the Viking times. For over 150 years Estonia belonged to Sweden... Tartu University was founded by the Swedish king... The names of some places come from the Swedish language... There are many people in Estonia who have relatives in Sweden. In modern Estonia people often study the Swedish experience of management and decision-making. They want often to do things in the same way that Swedish people do them... Do all these historical facts influence the investment decision of Swedish companies? I do believe so, even if it is something that is hard to quantify and measure."

The study confirms the hypothesis that historical contacts and the cultural affinity between countries should not be ignored when we search for motives explaining FDI (see Dunning, 1991).

According to Neal (1997), the culture factor poses the greatest threat to companies operating in unstable and uncertain markets. The decision to invest in such markets, therefore, must take the influence of culture into account in the early phase of FDI decision-making.

The study confirms that variables associated with relations, culture and history, as well as adapting to local business practices, are important investment determinants in transition economies (See also “Assessing Investment Opportunities in Economies in Transition”, 1994; Holden, Cooper and Carr, 1998; Nieminen and Törnross, 1997).

9.3.5. A successful transformation process from a socialist economy to a market economy: empirical analysis and comparison with other studies

Ninety six percent of managers ranked the successful transformation process from a socialist economy to a market economy as an important factor that influences FDI in transition economies while only four percent of the decision-makers believed that this factor had some impact. Nobody ranked the factor as insignificant.

Industry privatisation, the creation of financial institutions, and the introduction of market economy legislation were stressed to be vital for attracting FDI in transition economies. One of the managers commented on the transformation process in Russia in the following way:

- "The transition of Russia to the market economy was quicker than we expected, say, five-six years ago. Russia is still very unpredictable... I think things are moving in the right direction even if there are ups and downs on the way. We have not yet realized the impact of revolutionary Russian reforms on the world economy. We will probably never experience such big changes in such a short period of time in history anymore. A new market emerged with enormous possibilities for the foreign capital. We have learned a lot about changes due to this transformation period. The world has changed because of the collapse of the former Soviet Union. Decision-making must also change in order to meet the challenge of the century and requirements of the current reality”.

Managers from Vattenfall stressed that the success of the transformation process is crucial for attracting FDI into the energy sector.
One of them said:

- "When the economy of the Baltic countries stabilises, energy consumption will increase in the region. Only then we can expect more investments into capital consuming branches such as the energy sector. The ambition of Baltic countries to be in the European Union can also influence the development of the reforms”.

The study supports a thesis that a successful transformation process from a socialist to a market economy is a factor initiating and stimulating the inflow of FDI in transition economies (See also “Assessing Investment Opportunities in Economies in Transition”, 1994; Burger and Jungnickel, 1996; Inotai, 1995; Lavigne, 1999; Peitsch, 1997; “The Competitiveness of Transition Economies”, 1998). The principal cause of the slow inflow of FDI into Central and Eastern Europe, therefore, is to be found in the disappointing speed of transition to market economy.

In contrast, the effect of progress in transition on FDI was not found in the analysis of 269 German and British companies invested in transition economies performed by Meyer (1996).

9.3.6. Other reasons for FDI in transition economies suggested by managers

Besides ranking the mainstream theories and existing hypotheses, the interviewed managers were also asked to suggest other motives that might explain the reasons for FDI in transition economies.

The importance of management skills for the success of FDI in transition economies was stressed by several researchers (see Peitsch, 1997; Radosevic, 1997).

In the study, several executives confirmed that the availability of human resources is an important factor motivating FDI in transition economies. A high levels of education in the local population has also been identified as a factor attracting foreign investments.

- "Any attractive investment project is dead if the wrong management is employed”, concluded a senior manager.

Managers commented:

- "An investment project presumes not only technical equipment but the availability of human resources. Eastern Europe has old traditions in education and research, particularly in technical spheres. Our (Ericsson’s) plans for the future, for example, include transformation of a part of the research and development activities to Russia…”
- "People learn and adjust fast to the new market conditions in the Baltic countries. It gives hope for future investment projects…”
- "A labour market is very flexible in Russia. It took one week for us to move some employees from St.Petersburg to Moscow. The American type of labour market is under formation in Russia which makes it easier to find the right people for investment projects.”
There also seems to be a growing interest in describing the international firm as a social community, that specialises in the creation and internal transfer of knowledge (See Kogut and Zander, 1993). In the case of transition economies, the East Europeans can learn how to use Western technology and management business practices.

Another motive for FDI in transition economies is a government’s restrictions on imports for those companies that do not produce locally.

• "The restriction on imports imposed by the Russian government for the foreign companies that do not produce locally was a decisive motive for Ericsson’s FDI in Russia”, stated a top manager.

Such impositions are used by many host countries trying to attract FDI (see Hood and Young, 1979; Pehrsson, 1999). Ozawa (1992) described barriers that were placed on Japanese exports as the major factor explaining why Japanese firms set up (or acquired) production facilities in Europe.

Hadjikhani and Johanson (1996) described how in 1964, after the Iranian government had imposed restrictions on the import of fabricated products, a joint venture contract for assembly production of trucks, tractors, and other agricultural machines was signed between Volvo and the former agent Nasir, a wealthy Iranian businessman with political contacts and influence.

As managers pointed out, decision-making traditions in the company, as well as personalities of executives and their ability to push the project through discussions and formal approval, might be relevant factors in the initial motivation to conduct FDI in a transition economy.

Some executives suggested:

• "Absence of signals of ‘moral support’ from Ericsson’s executives might explain careful investigation and ‘step-by-step’ development of FDI projects in Central and Eastern Europe (in comparison with ABB and Tetra Laval, where the companies’ leaders took personal responsibility for the investment decision and convinced other executives to proceed)”.

• "Vattenfall’s strict decision-making routines of a company owned by the Swedish State might also explain a slow and careful initial involvement in investment projects in the Baltic countries”.

The study, therefore, supports the thesis initiated by Aharoni (1966) and later developed by other researchers (Buckley, 1998) about the decisive role of personalities of executives in the investment decision-making.

9.3.7. Summary

Decision-makers confirmed that hypotheses suggested for evaluation in this paragraph were as important as the mainstream traditional theories for explaining the reasons for FDI in transition economies.
The study confirms the thesis that geographical determinants, i.e. the proximity of potential investors from transition economies, is an important motive for FDI.

**Historical and cultural contacts between the Northern region and transition economies** were ranked by executives as an important force initiating FDI.

The study supports the thesis that a successful transformation process from a socialist to a market economy is a factor initiating and stimulating the inflow of FDI in transition economies. The principal cause of the slow inflow of FDI into Central and Eastern Europe, therefore, is to be found in the disappointing speed of transition to market economy.

Other factors explaining motives for FDI in transition economies have been suggested by managers. The availability of human resources and the government’s restrictions on imports for those companies that do not produce locally were evaluated as factors motivating FDI in transition economies.

Besides, decision-making traditions in the company, as well as the personalities of executives and their ability to push the project through discussions and formal approval, might be relevant factors in explaining the initial motivation to conduct FDI in a transition economy.

**9.4. Conclusions for the chapter**

An internalisation strategy, the size of a domestic market and a ‘defensive’ character of investment are ranked by the executives among the mainstream theories as very important or having some impact for explaining the motives of FDI in transition economies.

The study supports the internalisation theory that claims that foreign investments should occur when a firm is able to increase its value by internalising markets for its intangible assets or growth opportunities.

The size of a domestic market appropriate for the company’s ambition to expand internationally seems to play an important role in FDI decision-making. **Marketing strategy** could influence decision-making in different ways: either the firm started operations in a country with larger markets (like Ericsson in Russia) or it preferred smaller markets (like Vattenfall in the Baltic countries). The market growth constraints and limited possibilities for expansion in Sweden may have increased the search for new markets.

The study supports the thesis that the phenomenon of defensive investment in order to be early in the opening markets in comparison with the competitors is relevant for explaining FDI in transition economies. **Oligopoly theory** explaining the phenomenon of foreign investment, which may occur in concentrated industries to prevent competitors from gaining or enlarging advantages that could then be exploited globally, therefore, received support in the study.

On the contrary, access to low cost labour inputs, opportunities for tax avoidance or reduction, benefits of national resources and low local production costs were ranked as having only some impact or not relevant for the explanation of the reasons for FDI in transition economies.
The often quoted ‘traditional’ advantages of the region, such as low labour and production costs, cheap resources and investment incentives, though considered in the investment process, do not appear in the study as prime motivations and are perceived instead as potential short term benefits which, though attractive, should not form the main basis for long term strategic FDI decisions.

The study supports the thesis of the growing importance of created, relative to natural, assets as the main generators of future income for companies in transition economies. Ericsson’s investments into a training center in Moscow and plans to invest into a design and research center in St. Petersburg provide evidence that highly technological foreign companies search to exploit the intangible assets rather than search for natural resources.

Decision-makers confirmed that the following hypotheses are at least as important as the mainstream traditional theories for explaining the reasons for FDI in transition economies:

- a ‘step-by-step’ strategy;
- a geographical determinant, i.e. the proximity of potential investor to transition economies;
- and historical and cultural contacts between the Northern region and transition economies.

The study has provided considerable, although not indisputable, empirical support for the Uppsala model, which postulates a linear relationship between market knowledge and resource commitments. FDIs of Ericsson in Russia and Vattenfall in the Baltic countries were conducted in an incremental, slow and gradual way characterised by learning-by-doing.

Geography, history, culture matter and should be considered in the search for the initial motives of companies to conduct FDI in transition economies.

The study also supports the thesis that a successful transformation process from a socialist to a market economy is a factor initiating and stimulating the inflow of FDI in transition economies.

Other factors explaining the motives for FDI in transition economies have been suggested by managers. The availability of human resources and a government’s restrictions on imports for those companies that do not produce locally were evaluated as factors motivating FDI in transition economies. Besides, decision-making traditions in the company as well as the personalities of executives and their ability to push the project through discussions and formal approval might be relevant factors in explaining the initial motivation to conduct FDI in a transition economy.

The main result is that the determinants of multinational business activities in transition economies are largely consistent with those suggested by the literature and by observed patterns in other parts of the world. Only a few specific environmental conditions of transition economies are shown to affect the pattern of inward FDI.
To sum up, Figure 12 suggested in Chapter 5 as a schema for explaining the initial motivation (or reasons) for FDI in transition economies can be updated according to the empirical data in the following way:

**Figure 23. A schema of initial motivation (or reasons) for FDI in transition economies updated according to the empirical data**

**THEORIES AND HYPOTHESIS THAT ARE VERY IMPORTANT OR HAVING SOME IMPACT FOR EXPLANATION OF MOTIVES OF FDI IN TRANSITION ECONOMIES**

- internalisation strategy;
- the size of a domestic market;
- “defensive character of investment;
- geographical determinant;
- cultural affinity and historical contacts;
- successful transformation process from socialist to market economy.

**THEORIES AND HYPOTHESIS THAT HAVE ONLY SOME IMPACT OR NOT RELEVANT FOR EXPLANATION OF MOTIVES OF FDI IN TRANSITION ECONOMIES**

- access to low cost labour inputs;
- opportunities for tax avoidance or reduction;
- benefits of national resources and low local production costs.

**OTHER SUGGESTIONS OF MANAGERS ABOUT MOTIVES OF FDI IN TRANSITION ECONOMIES:**

- availability of human resources;
- a government’s restrictions on imports for those companies that do not produce locally;
- a company’s decision-making traditions as well as personalities of executives.

*Source: Olga Golubeva (own)*
10. THE ANALYSIS OF INFORMATION / INVESTIGATION PROCESS FOR FDI decision making in transition economies

"Only reason can convince us of those three fundamental truths without a recognition of which there can be no effective liberty: that what we believe is not necessarily true; that what we like is not necessarily good; and that all questions are open."

Clive Bell, 1881-1964, "Civilization", 1928, Chapter 5


10.1. Introduction

The purpose of this chapter is to analyse how companies investigate the investment climate in transition economies and what role the information/investigation process has in FDI decision-making. The empirical data is guided by, and is structured according to, the logic of Figure 13 (Chapter 5).

The analysis is based on the answers of managers to questions 7-10 of the questionnaire as well as on their comments during the informal part of the interviews. Due to the exploratory nature of questions, managers were asked to submit additional comments or suggest new variables (for example, about the information collection techniques that have been used in the investigation of the investment climate). The empirical results are compared to the conclusions of other researchers. At the end of the chapter the suggested theoretical schema for analysis of the information/investigation process in transition economies will be updated according to the empirical data.

10.2. Information collected about different parameters of investment climate: empirical data and comparison with other studies

Decision-makers from both companies gave a unanimously affirmative answer to the seventh question of the questionnaire, if their companies collected the information about a transition economy’s investment climate prior to make FDI decisions.

- "A manager who will participate in the FDI decision-making for Central and Eastern Europe must be well equipped with sufficient and reliable data about the investment climate", stressed a top executive.

The study, therefore, confirms the hypothesis suggested by Lasserre and Probert (1998) that comprehension of an unfamiliar business milieu requires good quality data and sufficiently reliable information for the decision-making.

Interviewed managers were also asked to rank the completeness of information acquired about different parameters of the investment climate according to the following grades: we collected complete information, we collected some information, we did not collect any information about this parameter.
The table below summarises the answers of the decision-makers:

**Table 8. The completeness of information collected about parameters of investment climate for FDI decision-making in transition economy**

<table>
<thead>
<tr>
<th>Different parameters of a country’s investment climate</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of answers</td>
<td>We collected complete information</td>
</tr>
<tr>
<td>--------------------------------------------------------</td>
<td>-------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>Macro-economic situation and tendencies</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Institutional infrastructure</td>
<td>16</td>
<td>2</td>
</tr>
<tr>
<td>Social climate (for example, working conditions)</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>Political climate (risk for nationalisation or expropriation, change of regime)</td>
<td>16</td>
<td>8</td>
</tr>
</tbody>
</table>

According to the Table 8, the information collected about macro-economic trends is considered by sixty eight percent of managers to be exhaustive while thirty two percent believe that they acquired some information about this parameter.

- "Macro-economic conditions and trends in their development are more important for the investment decision-making in Central and Eastern Europe in comparison to, say, investment projects considered by our company for Germany or Finland. Ericsson paid attention to the fact that at the beginning of the reforms we did not know so much about the investment environment of transition economies. Sufficient macro-economic data was a good precondition for decision-making, even if it could not guarantee the perfection of future results”, said a manager.

Institutional infrastructure and social climate conditions received less attention during the investigation step. Only twelve percent of the decision-makers believe that they collected exhaustive and complete information about the institutional infrastructure, seventy six percent believe that they got some information, and twelve percent believe that they did not acquire any information about this parameter (for the variable of social climate the respective figures are: four percent, seventy two percent and twenty four percent).
"We were not aware of the importance of institutional infrastructure and social relations for decision-making in transition economies. Those factors deserve more attention from foreign investors when they investigate the investment climate. Western managers are used to working in the framework of functioning institutional infrastructures and stable social relations. That is why we probably underestimated the importance of those factors for transition economies. One of the lessons that we learned was that collecting complete information about institutions and social conditions is vital for FDI in transition economies", pointed out one of the managers.

Political climate also attracted the attention of the decision-makers. Thirty six percent of managers believe that they acquired exhaustive and complete information about political climate and sixty four percent believed that they collected some information about this parameter. The following arguments were used:

- "The political situation in Russia might influence substantially the development of a particular investment project… The description of the political climate as well as some prognoses for future development have sufficient impact on understanding what is really happening…"
- "Despite some stabilisation of the political system in the Baltic countries, it is still rather unstable. Updating the information is then essential for the decision-makers”.

It may be concluded that both Ericsson and Vattenfall collected relative complete information about economic and political climate and less complete information about institutional infrastructure and social climate (variables of investment climate, identified by Litvak and Maule, 1970; Thunell, 1977; etc.).

One of the explanations of why managers underestimated the importance of the latter parameters was that Western decision-makers are used to operating in the framework of functioning institutional infrastructure and stable social relations. Executives participating in FDI decision-making suggested that the lack of institutions in transition economies increased the need for information compared to Western countries, where such information is often provided by different government and non-government institutions.

The majority of managers added that they believed that collecting information about different parameters of investment climate leads to a better investment decision. The study, therefore, confirms the central role of collecting extensive information as a means of attaining a more accurate perception of environmental conditions and making better decisions. (See also Bourgeois, 1985; Buckley, 1998; Dean and Sharfman, 1993; Johanson, 1994; Sutcliffe, 1994).

10.3. Data collection methods for FDI decision-making in transition economy: empirical analysis and comparison with other studies

Managers were asked to assess the importance of selected data collecting methods derived from the previous studies (see, for example, De Ginter and Duncan, 1994; Mortanges, Pahud and Allers, 1996) for the decision-making in transition economies. The following grades were available: a method was often used, a method was applied sometimes, a method had never been applied.
The answers of managers are summarised in the table below:

### Table 9. The importance of suggested data collecting methods for FDI decision-making in transition economies

<table>
<thead>
<tr>
<th>Suggested data collecting methods</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of answers</td>
<td>A method was often used</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>--------------------------</td>
<td>-------------------------</td>
</tr>
<tr>
<td>Judgement and knowledge of managers</td>
<td>16</td>
<td>7</td>
</tr>
<tr>
<td>Expert opinions</td>
<td>16</td>
<td>2</td>
</tr>
<tr>
<td>Qualitative structured methods (like Delphi techniques, standardised checklists and different scenarios method)</td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>Quantitative methods (regression analysis, correlation coefficients)</td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>Mass media information</td>
<td>16</td>
<td>10</td>
</tr>
</tbody>
</table>

According to executives, qualitative unstructured methods play an important role in collecting information for FDI decision-making in transition economies and, therefore, were quite popular among the decision-makers.

Forty eight percent often applied the judgement and knowledge of managers, forty four percent used this method sometimes and only eight percent had never applied the method. Twenty percent of managers used expert opinion as an important method, sixty eight percent applied it sometimes and only twelve percent believed that it had never been used for obtaining information about transition economies.

Other methods of collecting information - Delphi techniques, standardised checklists, different scenarios method and quantitative methods - were seldom used by the decision-makers.

The empirical data did not confirm conclusions reached by some researchers. Schoemaker (1994), for example, believed that companies confronted with major uncertainties or sudden discontinuities can find the scenario method to be the most useful.
Ginter and Duncan (1994) claimed that the Delphi technique, expert opinion and scenario development were the most effective to study emerging trends in the macro-social, -economic, -political, and -technological uncertain environments.

The study also shows that it is very popular to collect information through mass media sources. Sixty percent of managers ranked this method as ‘often used,’ and forty percent of decision-makers ranked this method as ‘used sometimes.’ These data support, at least partly, the conclusion of Zink (1973), who found that most companies do not use all methods available to them and are often satisfied with the information obtained through the mass media.

Managers were also asked to suggest their own methods for collecting information about the investment climate in transition economies.

One of the suggestions made by the interviewed managers was using personal sources of information acquired through private contacts in the local countries.

• "In Eastern Europe, some information you can obtain only through top business executives, because only senior managers possess the knowledge of what is really going on”, commented one of the executives.

The importance of using personal connections for scanning the environmental uncertainty in Bulgaria was also stressed by Elenkov (1997). Lasserre and Probert (1998) also found for the Asia Pacific region that Western managers have difficulty finding reliable sources of information if they do not have personal contacts within the local informal networks.

Another method mentioned by managers was to obtain information about the investment climate through the Internet.

• "We do not have to pay for expensive experts and consultants for the information that can be obtained free through the Internet. Besides, the investment climate in transition economies changes so rapidly. We need modern techniques to follow quick changes”, pointed out a decision-maker from Vattenfall.

The last method suggested by executives for collecting information for FDI decision-making is sharing the data about transition economies among Western companies. Due to the fact that companies sometimes enter the foreign markets together, they might help each other obtain information about decision-making and share the available data.

The following arguments were submitted:

• "Vattenfall, in the beginning of establishment in the Baltic countries, co-operated with the Finnish company IVO and we shared both the financial resources and the available information”.

• "Ericsson management visited ABB’s main office in Switzerland in order to study their strategy in Eastern Europe. We received some advice from ABB’s executives which we deemed valuable for decision-making in Russia".
Managers stressed the importance of sharing information about transition economies among Western firms. This suggestion supports the trend described by Contractor and Lorange (1994). The authors claim that cooperative aspects of an international strategy between potentially competitive Western firms have been given priority in the past few years, especially when the investment shall be made in a former socialist or developing country.

To sum up, qualitative unstructured methods - judgement and knowledge of managers and expert opinions - play an important role in collecting information for FDI decision-making in transition economies.

Other methods of collecting information - qualitative structured methods and quantitative methods - were seldom applied by the decision-makers. Mass media sources were very popular among the managers.

Three other methods for collecting information about the investment climate in transition economies were proposed by the decision-makers: to use the personal sources of information acquired through private contacts in the local countries; to obtain information about the investment climate through the Internet, and to share the acquired data about transition economies between Western companies.

10.4. Information for decision-making in transition economies and in developed market economies: empirical data and comparison with other studies

Executives were asked about the importance of collecting information for FDI decision-making in transition economies in comparison to collecting the information in developed market economies.

All interviewed managers were unanimous in their opinion that collecting information about the investment climate in transition economies is more important than in developed market economies.

- ”Information is an important factor for investment decision-making in all countries. I believe, however, that this factor is even more important for transition economies simply because it is very hard to get reliable information for decision-making. It took for us (Ericsson) eight months, for example, to collect the information about a real estate acquisition project in Moscow …”, explained one of the managers.

- ”The research conducted by Ericsson about Eastern Europe in general and Russia in particular gave us a good background for decision-making. The data acquired during the investigation step is a Bible for investment decision-making in the uncertain and rapidly changing environment,” commented a top executive from Ericsson.

The study, therefore, supports the idea that organisations that face complex or turbulent markets require more information for decision-making (see Ginter and Duncan, 1994). Decision-makers believe that the process of collecting information is more important in providing feedback for the decision-makers in transition economies than in developed market economies.
Empirical data support the conclusions reached by other researchers that a shortage of accurate and reliable information negatively influence the future of investment projects in transition economies. Empirical data also support the conclusion that the principal obstacles in FDI decision-making can be reduced by learning about foreign markets by collecting information about investment climate. (“Assessing Investment Opportunities in Economies in Transition”, 1994; De Mortanges, Pahud and Allers, 1996; Johanson, 1994; Lasserre and Probert, 1998).

Due to the rapid changes in the investment environment of transition economies the collected information, however, must be revealed and upgraded permanently.

- "The biggest problem with transition economies is that changes happen all the time. Therefore, it is important to update the acquired information on a daily basis including information on political and economic issues, as well as information on the situation in the energy sector and privatisation plans”, pointed out a manager from Vattenfall.

Executives suggested that a learning effect that inevitably following the process of collecting information is extremely important in the uncertain and rapidly changing environment of transition economy. The process of collecting information on different parameters of the investment climate leads to more accurate perception of environmental conditions full of uncertainties.

- "Due to rapid changes in the environment the collected information becomes worthless before long. I think, however, that the learning effect from collecting the data is important. As a result, we, managers, understand the investment environment better”.

Managers from both Ericsson and Vattenfall stressed that research about a particular industry, region and project played a very important role during the investigation step.

- "An investment climate can differ substantially between industries, regions and projects in transition economies. The foreign investors should investigate a particular industry and region’ investment climate rather than collect general information about the country. What is good for one project can be bad for another one”, explained one of the managers.

The suggestion of executives was to give a high priority to information about the investment environment of a particular project, as well as to evaluate carefully what data to pay attention to and what data to ignore. Sutcliffe and Zaheer (1998) also concluded that the extent to which managers take relevant contextual information into account may moderate the relationship between the level of uncertainty and the decision-making.

10.5. Conclusions for the chapter

Research has shown that information is likely to have an instrumental effect on investment decisions in transition economies. Presumably, extensive information collection about different parameters of an investment climate leads to more accurate perceptions of environmental conditions full of uncertainties, and, therefore, to better investment decisions.
A learning effect that inevitably follows the process of collecting information is extremely important in the uncertain and rapidly changing environment of transition economy.

Both Vattenfall and Ericsson collected complete information about economic and political climate and less complete information about institutional infrastructure and social climate. It might be suggested that the lack of institutions and social stability in transition economies puts these variables a more central position and demands more attention from managers than in the developed market economies.

Qualitative unstructured methods (the judgement and knowledge of managers and expert opinions) play an important role in collecting information for FDI decision-making in transition economies. Other methods suggested for evaluation - Delphi techniques, standardised checklists and different scenarios method, as well as quantitative methods, were seldom applied by the decision-makers. Mass media sources were very popular among the managers.

Three other methods for collecting the information about the investment climate in transition economies were proposed by the decision-makers: to use personal sources of information acquired through private contacts in the local countries; to obtain information about the investment climate through the Internet, and to share the data with other Western companies.

All interviewed managers were unanimous that collecting information about the investment climate is more important in transition economies than in developed market economies. Due to rapid changes in the investment environment of transition economies, the information must be upgraded perpetually.

A decisive factor is also how we can apply the information about different parameters of an investment climate to a particular project. It is the extent to which managers take relevant contextual information into account that may moderate the relationship between the level of uncertainty and decision-making in transition economies.

To sum up, Figure 13 (Chapter 5) suggested as a starting point for the analysis of information about investment climate and information collecting methods for companies conducting FDI in transition economies may be updated according to the empirical data in the following way:
Figure 24. Information about the investment climate and information collecting methods for FDI in transition economies: the schema, updated according to the empirical data

Source: Olga Golubeva (own)
11. ANALYSIS OF PROJECT EVALUATION METHODS AND INVESTMENT DECISION CRITERIA

"The best investments are often those that looked dead wrong when they were made".

Anonymous stock market maxim.


11.1. Introduction

The purpose of this chapter is to analyse project evaluation methods and investment decision criteria in transition economies. The chapter starts with an analysis of the application of traditional capital budgeting techniques for FDI in transition economies. The role of calculations as a decision-making criterion in transition economy is discussed. An attempt to search for investment decision criteria alternatives to the traditional capital budgeting techniques is made.

The empirical data is guided by, and is structured according to, the logic of Figure 14 (Chapter 5) which was deduced from previous studies. The analysis is based on the answers of interviewed managers to the questions 11-15, as well as on the comments of managers during the informal part of interviews.

We should be aware of the fact that questions 12-14 provide us with information about what managers think about specific issues, not what they have done in particular situations (even if it is logical to assume that their opinions are based on their personal experience of participating in FDI decision-making).

The empirical findings of the study will then be compared with the results of prior research. At the end of the chapter a schema with suggestions about project evaluation methods and investment decision criteria for FDI in transition economies (Figure 14) will be updated according to the empirical data.

11.2. Application of traditional capital budgeting methods for transition economies: empirical data and comparison with other studies

Decision-makers were asked to identify those methods that, according to their experience, were used in the evaluation of FDI in transition economies. A set of the most commonly used capital budgeting techniques was suggested for evaluation: The Net Present Value (NPV) of the investment, The Pay-back Method, The Accounting Rate of Return Method, The Internal Rate of Return Method, and The Sensitivity Analysis and Different Scenarios Method.

A summary of answers about the applicability of capital budgeting methods for the evaluation of FDI in transition economies is presented in the table below:
Table 10. Application of traditional capital budgeting methods for the evaluation of FDI in transition economies

<table>
<thead>
<tr>
<th>Method</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of answers</td>
<td>A method was used for evaluation of projects</td>
<td>Number of answers</td>
</tr>
<tr>
<td>The Net Present Value (NPV) of the investment</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td>The Pay-back Method</td>
<td>16</td>
<td>11</td>
</tr>
<tr>
<td>The Accounting Rate of Return Method</td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>The Internal Rate of Return Method</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>The Sensitivity Analysis</td>
<td>16</td>
<td>3</td>
</tr>
<tr>
<td>Different Scenarios Method</td>
<td>16</td>
<td>6</td>
</tr>
</tbody>
</table>

Eighty four percent of decision-makers used the NPV method for the evaluation of projects. The traditional Pay-back method reword the second place with sixty eight percent of ‘votes’. The internal rate of return method was chosen only by eight percent of interviewed managers while accounting rate of return had never been used by any of them. Forty percent of managers used sensitivity analysis as the instrument for FDI decision-making in transition economies. The same forty percent chose different scenario method.

Executives stressed that Pay-back and NPV provided them with a good background for the evaluation of projects.

- “A NPV-calculation gives us something ‘materialistic’ and stable’… I believe that the application of capital budgeting techniques in decision-making is more important for transition economies than in the market economies because they provide the decision-makers with an ‘objective’ feedback in the chaotic environment”, explained one senior manager.

Another decision-maker commented:

- “The background for project evaluation is the same for all potential countries of investments. I think that it is possible to apply the capital budgeting techniques for FDI decision-making in the Baltic countries. The world has not been able to introduce better methods than capital budgeting as a background for decision-making. We can also substitute different figures for particular variables (such as future prices for electricity) and perform sensitivity and different scenario analysis”.

The study, therefore, supports the importance of traditional investment appraisal methods for project evaluations (see Björkman, 1989; Brealey and Myers, 1996; Jansson, 1992; Lasserre and Probert, 1998; Persson, 1990; Ross, Westerfield and Jaffe, 1996; Tell, 1978; van Horne, 1995; Yard, 1987).

Traditional investment appraisal methods provide managers with ‘a materialistic’ feedback for decision-making and, therefore, perform some sort of function of ‘objectivity’ in the rapidly changing environment of transition economies. The empirical data fits the conclusions of other researchers that the ‘magic numbers’, such as NPV or Pay-back figures, guide, at least to some extent, the investment decisions in transition economies (see Johnson, McMillan and Woodruff, 1999; Naughton, 1995).

It should be pointed out that twenty five surveyed decision-makers work for two big publicly quoted companies that use (or rather are supposed to use) the same evaluation techniques to motivate investment decisions and to evaluate the projects. The fact that different methods were applied for the decision-making might be explained, at least to some extent, by the personalities of managers, their knowledge of available financial techniques and their previous experience. (See Buckley, 1998).

11.3. Do capital budgeting methods work in transition economies?

Decision-makers were asked to express their opinions about the correctness of the statement that none of the capital budgeting methods could help managers to make the right decision in transition economies. Sixty eight percent of managers (11 persons of 16 surveyed from Ericsson and 6 managers of 9 from Vattenfall) gave an affirmative answer.

- "Political, macro economical, social and cultural considerations are often ignored in traditional capital budgeting techniques. My personal impression is that a cash flow forecast of sales in transition economy describes more our hopes than plans,” said one of the top executives.

The interviewed managers were also asked if the availability of certain opportunities - like strategic competitive advantages, market position, access to the natural resources, etc. - could explain starting a project, even if orthodox NPV is negative. This strategy might be relevant when the project consists of several steps and the information about the total cost of investment will be revealed only as the first few steps of the project are undertaken.

The results were quite surprising. Fifty six percent of managers (13 persons of 16 participants from Ericsson and 1 manager of 9 interviewed from Vattenfall) gave affirmative answers to the question.

Forty four percent of decision-makers answered that NPV must be positive in order to accept the project.

- “We need to convert our strategic project plans to the language of figures. Capital budgeting is just a monetary way of presenting our ideas. The Board would never accept the project with negative NPV calculation”, explained one of the decision-makers.
Calculations, therefore, help managers to present the investment projects and, afterwards, to legitimise them in the eyes of the Board members, financiers and bankers, business partners, government organisations, etc. It might be suggested that traditional investment appraisal methods used as a language for communication between different partners are important in transition economies.

Another strong argument for using traditional capital budgeting methods in transition economies comes from the side of the East European management. Decision-makers from both Ericsson and Vattenfall stressed the importance of properly done technical evaluations of investment projects for the East European business partners.

- "Our partners in joint ventures often give high priorities to pay-back and NPV methods. It might be explained by the fact that the majority of the decision-makers in Eastern Europe are engineers. The properly done technical evaluation is often a key decision-making factor for our local partners. They do not understand that a quantitative package of decision-making tools does not include all variables that might influence the future of a project in the rapidly changing and unstable environment,” mentioned one of the managers.

More than half of interviewed managers, however, expressed their doubts about the decisive role of NPV method as an investment decision criterion and were skeptical about the possibilities to forecast some variables (for example, future sales) in the turbulent environment.

Those decision-makers believe that it is not the profitability of a particular investment that counts, especially when projects of a minor size are evaluated. The key factor is the future potential profitability of the whole market. According to some decision-makers, if a consolidated budget for all business activities in a country looks well, the NPV of a particular investment project can be negative.

- "We must compare the size of a particular project with the importance of relative issues that can be solved with the help of this direct investment. I think that we should value particular projects in context with other factors - business strategy, marketing opportunities, research and development issues, the existence of network of personal contacts with government people and local businessmen and so on”, said one of the top executives.

11.4. The role of calculation in FDI decision-making in transition economies

The decision-makers were also asked to choose one alternative among the selected ones that describes in the most accurate way the role of traditional calculation in FDI decision-making in transition economies.

A table below summarises the answers of managers:
Table 11. The role of capital budgeting calculations in FDI decision-making in transition economies

<table>
<thead>
<tr>
<th></th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of answers</td>
<td>The statement is correct</td>
</tr>
<tr>
<td>The decision is primarily based on calculations</td>
<td>16</td>
<td>2</td>
</tr>
<tr>
<td>After the decision had been already made, managers provided the full package of calculations according to the capital budgeting techniques</td>
<td>16</td>
<td>5</td>
</tr>
<tr>
<td>The decision-maker must ‘balance’ all the time between the calculations and other strategic positions</td>
<td>16</td>
<td>9</td>
</tr>
</tbody>
</table>

Only sixteen percent of managers answered that FDI decision was primarily based on calculations. Twenty eight percent of executives believed that the full package of calculations was provided after the decision had already been made.

The majority (fifty six percent) chose an alternative where a decision-maker must ‘balance’ all the time between the calculations and other strategic positions.

- “The aim of business is to earn money, not to produce calculations. To invest in Russia is a strategic and political decision rather than technical one. You can prepare a perfect calculation, but if you do not know the ‘right’ people in Russia, than a project will probably fail anyway. Calculations play some role, but they are not as important as one might think. According to my experience, the calculation can stand for about 25 percent of the decision-making. The rest is something else - less technical, more personal. And this 'something else’ might differ for different projects”, said one of the decision-makers.

- "A decision to invest directly should be connected to other activities in the market - sales, research, education of local staff. Therefore, the whole market budget calculation might be suggested as a decision-making criterion”, said a manager.

Another decision-maker stressed the importance of the personalities of managers involved in the project development.

- "I am a person who believes in an ‘ad hoc’ approach rather than in ‘cold facts’. People stand behind investment decisions. A strong knowledgeable person might influence the destiny of an investment project by convincing the Board of Directors to proceed with investments. Calculations should be seen as a means of presenting ideas rather than a decisive factor".
The changing role of calculation in FDI decision-making was related by Ericsson’s managers to recent developments in the telecommunication industry.

- “When the telecommunication industry was technically oriented, calculations always played an important role in FDI decision-making. During the last years the situation has changed. Market strategy, research and development, software products, etc. became the driving forces of the competition. Sixty percent of Ericsson’s turnover is represented by the products that were not on the market three years ago. Things change, new issues emerge, while the calculations are still the same”, pointed out one of the managers who works with calculations.

An executive from Vattenfall said:

- “Calculation is an important background for investment decision-making. However, traditional calculations do not include a variety of factors that influence FDI decision-making in transition economies. We need to modify and improve our traditional capital budgeting techniques by enclosing more qualitative factors and variables into evaluation. I think that it is time to learn to combine both qualitative factors and quantitative evaluations. That will help us, by the way, to compare investments projects from different countries”.

Managers pointed out that extensive information collection for capital budgeting calculations leads to more accurate perceptions of environmental conditions full of uncertainties and, therefore, to better investment decisions. A learning effect that inevitably following the process of making capital budgeting calculations is extremely important in the uncertain and rapidly changing environment of transition economy.

11.5. Comparison of acquired empirical data about the role of capital budgeting in transition economies with conclusions from other studies

The hypothesis that none of capital budgeting methods (suggested in the previous paragraph) can help to evaluate the FDI project in transition economy and be used as investment decision criteria was confirmed by sixty eight percent of managers.

Fifty six percent of executives (more than half!) said that opportunities presented to the foreign investor - like strategic competitive advantages, market position, access to the natural resources, - could justify starting the project even if orthodox NPV is negative. When the project consists of several steps, the information about the total cost of investment will be revealed only as the first few steps of the project are undertaken.

Only sixteen percent of managers believed that investment decisions were primarily based on calculations while twenty eight percent thought that the full package of calculations was provided after the decision had been already made. The majority - fifty six percent of executives - chose an alternative where a decision-maker had to ‘balance’ all the time between the calculations and other strategic positions.

The acquired empirical data supports the doubts of those scholars who wonder whether a capital budgeting perspective is the most fruitful way of approaching the decision-making process. (See, for example, Brunsson, 1989; Czarniawska-Joerges and Jacobsson, 1989; Haka, Gordon and Pinches, 1985; Högheim, Monsen, Olsen and Olson, 1989; Kim, 1982).
The study also supports arguments of researchers who emphasise the importance of strategy over financial techniques and argue that FDI decision-making should be made using methods that are consistent with the company’s long-term objectives (see Albaum et al., 1994; Hill, 1985; McDonald, 1985). Managers believe that strategic issues are even more important in transition economies and that besides expected return on the investment, companies who are considering investments in transition economies must adapt the investment criteria with respect to ‘intangible’ benefits. (See also “Assessing Investment Opportunities in Economies in Transition”, 1994; Fey, 1995).

The role of calculation in FDI decision-making should be evaluated in connection with changes occurring in the business environment. In the modern high tech industry, attention has been shifted from pure industrial assets to the intangibles, human capital, etc. Managers warn us, therefore, that the impacts of some benefits - marketing possibilities, research and development issues, personal contacts with government and local business community, etc. - should always be excluded from financial analysis due to their unsuitability for precise quantification. (See Finnie, 1988; Swann and O’Keefe, 1990).

Executives supported a thesis suggested by Jansson (1992) that it is necessary to distinguish between cognitive and communicational purposes of making investment calculations. There is a difference between calculation’s role as a feedback for the internal decision-making or as a mean of explaining to others why this particular project has been accepted or rejected. Managers also stressed that personal preferences, as well as the competence and the negotiating capacities of the decision-makers or investors, might dictate the outcome of an FDI decision. (See Buckley, 1998).

11.6. Evaluation of suggestions about alternative investment decision criteria: empirical data and comparison with other studies

11.6.1. Summary of the empirical results

Besides traditional capital budgeting techniques, managers were asked to express the usefulness of selected variables as criteria for FDI decision-making in transition economies. Due to the exploratory nature of the subject, managers were also asked to suggest the new variables that might serve as investment decision criteria.

The answers of the interviewed decision-makers are summarised in the table below:
Table 12. The usefulness of selected variables as a criteria for FDI decision-making in transition economies

<table>
<thead>
<tr>
<th>Alternative decision-mak...</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of answers</td>
<td>A criteria was often used</td>
<td>A criteria was used some times</td>
</tr>
<tr>
<td>Judgement and intuition of managers</td>
<td>16</td>
<td>11</td>
</tr>
<tr>
<td>The existence of contacts with business sector</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>The existence of contacts with the local government</td>
<td>16</td>
<td>15</td>
</tr>
</tbody>
</table>

11.6.2. Judgement and intuition of management as a decision-making criteria

Seventy two percent of managers said that they often used judgement and intuition as investment decision criteria while twenty eight percent said that they applied them sometimes.

- "In transition economies you must have a nose that feels where the wind blows", commented an executive from Ericsson.

The majority of interviewed managers share the view that investment decision-making in transition economies is as much based on personal judgement capability and intuition as on capital budgeting techniques.

The study, therefore, supports the hypothesis that an investment decision can rely as much upon the judgement and intuition of managers about the direction of market movement as on properly done calculations (see Eisenberg, 1984; Issack, 1978; Simon, 1987).

11.6.3. The existence of personal contacts within the business sector and government as a decision-making criterion

Ninety six percent of the interviewed managers believe that personal contacts within the business sector of the local country is a key factor of the successful decision-making, and four percent believe that this factor has some importance. Having contacts with the representatives of the government in the local country was also highly ranked by interviewed managers. Eighty eight percent of decision-makers use contacts with local government often while twelve percent of executives believe that the factor has some impact.
In general, managers from both Ericsson and Vattenfall expressed their doubts about implementing projects in transition economies without the ‘right’ contacts.

- "Cash flow earnings from potential direct investments depend on access to the future customers...There is no reason for Ericsson to advertise switches on TV. Instead we elaborate contacts with top business people from the telecommunication industry and the Russian government. These personal networks help us to create distribution channels in the rapidly changing environment. In 1994 Ericsson participated in some smaller-scale joint ventures in Russia. Some of them failed because of the wrong partner, not because of the wrong valuation methods. Good contacts with the governments of Moscow and Nizhnij Novgorod were more important for choosing the location for two of Ericsson’s production facilities in Russia than were properly done calculations. One of our partners in the joint ventures - holding "Sistema" - was recommended to us by top leaders of the telecommunication industry as well as by the City of Moscow. We show commitment to our Russian partners, not calculations. Everything depends...", explained one of the executives.

By establishing the network of contacts with local business people and government, Western companies get better access to information, financial solutions, and safeguard future sales in the rapidly changing environment.

- "To loose a ‘right’ contact sometimes means to loose a project”, concluded one of the decision-makers.

The study supports prior researchers who claimed that the existence of personal contacts within the business sector and with representatives of local government is an important decision-making criterion in transition economies. ("Assessing Investment Opportunities in Economies in Transition”, 1994; Elenkov, 1997; Fey, 1995; McNarthy and Puffer, 1996; Neal, 1997; Wilson and Donaldson, 1996).

Lasserre and Probert (1998) and Sharma and Wallström-Pan (1997) show that the issue of relationships and personal contacts is more crucial for projects in Asia than in other parts of the world. The emphasis on relations in China, for example, has created a special concept regarding the interaction of individuals - Guanxi - relationship and connection. Guanxi is an informal, unofficial power relationship established to facilitate business as well as to increase one’s control over a valuable goods or access to them. (See Sharma and Wallström-Pan, 1997, p.369).

The network perspective, which draws attention to the long-lasting business relationships that exist between firms in industrial markets and has also been utilised to analyse the internalisation of firms, might be a relevant framework for analysis (Johanson and Vahlne, 1990, 1992; Forsgren and Johanson, 1992). Johanson and Vahlne (1992) have shown a way in which the development of a company’s operations in foreign markets has been influenced by the relationships gradually developed in that particular market. Therefore, the network perspective emphasises the social and cognitive ties that are formed between actors engaged in business relationships. The latter perspective points to the great difficulties in making an FDI decision and then implementing it, and underscores the way in which on-going interactions between actors shape the network structure. In other words, the network perspective stresses on-going interactions in decision-making (Johanson and Vahlne, 1992).
The network paradigm was chosen by Nieminen and Törnross (1997) to analyse FDI conducted by Finnish companies - Hartwall, Paulig, Raisio Margariini and Valio - in Estonia.

The study supports the thesis that Central and East European markets form a specific case for the network approach and stresses the special importance of business networks in the shifting stage of transition economies.

Instead of presenting decision-making in ‘planning - implementing’ terms, it might be fruitful to analyse it in terms of important actors and their relative positions.

11.6.4. Investment decision criteria suggested by managers

Managers suggested that criteria related to costs associated with human resources, language and culture, as well as adapting to local business specific considerations, are considerably underestimated as investment determinants in comparison with traditional variables included in calculations.

The awareness that there are eleven time zones in Russia was suggested by several managers as an important criterion for the evaluation of FDI.

- ”A time difference between geographical regions creates problems with communication, control and development of the project, transportation, etc. Western management must learn to work within another time and scale dimension… Local specific considerations should be taken into account when the FDI opportunities are evaluated”, suggested a top executive from Ericsson.

The study supports the conclusion of those researchers who insist on addressing and assessing the costs and benefits of culture-specific consideration in the design of investment. (“Assessing Investment Opportunities in Economies in Transition”, 1994; Lavigne, 1999).

Human resource issues represent a common problem encountered by foreign investors. Executives stressed the importance of the availability of management and English speaking locals as a decisive factor in determining the performance of FDI in transition economies. Location and training of local staff as well as obtaining quality expatriate management (especially in fields very much under-developed in centrally planned economies such as marketing or financial management) should be considered.

Shekshnia (1996) suggested that costs associated with interactions between Western managers and local populations, i.e. the extensive training of employees, developing customised programs, etc., might even exceed investments in machinery. According to Neal (1998), for example, 16 to 40 percent of Western managers posted abroad fail and return home prematurely. The rate of management turnover in less developed countries may be up to about 70 percent. (p. 24). Watkins-Mathys and Hill (1995) suggested, therefore, that managers’ previous business experience in the former socialist countries was a major factor influencing success of joint ventures in transition economies.
According to Baltic Beverages Holding Company, a joint-venture between Hartwall (Finland) and Pripps (Sweden), which was created to manage and monitor operations in Eastern Europe, major problems include the cultural gap and the conflict with business partners. (See Rutihinda, 1996).

The study, based on the interviews of the Swedish managers operating in China, also shows that installing technical equipment for projects appear to be less problematic than introducing changes in the values, norms, and work ethics in the uncertain and turbulent environment of emerging markets. (Sharma and Wallström-Pan, 1997).

The option characteristics of investment should be taken into consideration as a general FDI decision-making criterion in transition economies. The executives suggestion to evaluate FDI as the ‘entry fee’ to the market. Possibility to keep open an opportunity to conduct further direct investments is contingent upon the success of the transformation period. All these features definitely have some connection to the option theory (even if the exercise of valuation of real operating options in transition economies probably looks too complex for practical implementation).

Direct investments might be evaluated as some sort of option to get a market share.

Consideration of the options aspect of investment in asset markets (as opposed to financial markets) has not been widely explored in the literature in terms of its application to international capital budgeting. In the case of investment decision-making, this means keeping open the opportunity to make decisions contingent upon information to become available in the future. Both Vattenfall and Ericsson are shown in the study to be prepared, depending on the particular situation, to preserve, accelerate, close temporarily or even abandon the existing production facility of a project in transition economy. Option characteristics of investments, therefore, may be taken into consideration as a general approach to evaluate FDI.

11.7. Conclusions for the chapter

The study supports the importance of traditional investment appraisal techniques for project evaluations in transition economies. Capital budgeting methods provide managers with an ‘objective’ or ‘materialistic’ feedback for decision-making in the rapidly changing environment of transition economies.

A learning effect that inevitably follow the process of preparing the capital budgeting appraisal, and a strong appreciation for the proper done investment calculations from the side of the East European managers, increase the importance of calculations in transition economy.

On the other hand, the study questioned whether a capital budgeting perspective is the most fruitful way of approaching the decision-making process in transition economies. Calculations are often used as a language for communication between different partners than an objective criterion.
Managers also emphasise *the importance of strategy over financial techniques* and argue that FDI decisions in transition economies should be based on methods consistent with the company’s long-term objectives. The ‘*whole market budgeting calculation*’ might be suggested as a decision-making criterion where the financial performance of different strategic directions in a particular country is taken into consideration.

Due to the changes in the modern business environment, *benefits - like marketing possibilities, research and development issues, human capital, etc. - must be included in a financial analysis*. It is also necessary to distinguish between cognitive and communicational purposes of making investment calculations, as well as to pay more attention to the personalities of managers involved in FDI decision-making.

*The judgement and intuition of management, and personal contacts within the business sector and local government, were ranked higher than traditional capital budgeting methods* by executives when considering investment decision criteria in transition economies. Besides, managers suggested that *criteria related to costs associated with human resources, language and culture, as well as adapting to local business specific considerations* are considerably underestimated as investment determinants. The *option characteristics of investment* shall be taken into consideration as a general FDI decision-making criterion in transition economies.

To sum up, Figure 14 (Chapter 5) with suggestions about project evaluation methods and investment decision criteria for FDI in transition economy might be updated according to the empirical data in the following way:
**PROJECT EVALUATION METHODS AND INVESTMENT DECISION CRITERIA**

<table>
<thead>
<tr>
<th>TRADITIONAL CAPITAL BUDGETING METHODS (used by following percent of managers)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The Net Present Value of the investment - 84%;</td>
</tr>
<tr>
<td>• Pay-back Method - 68%;</td>
</tr>
<tr>
<td>• The Accounting Rate of Return Method - 0%;</td>
</tr>
<tr>
<td>• The Internal Rate of Return - 8%;</td>
</tr>
<tr>
<td>• Sensitivity Analysis - 40%;</td>
</tr>
<tr>
<td>• Different Scenarios Method - 40%;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DO CAPITAL BUDGETING METHODS WORK?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Capital budgeting is important in transition economies because it provides managers with ‘an objective’ feedback, is required by the local partners and is inevitably followed by the learning effect;</td>
</tr>
<tr>
<td>• 68% of managers believe that non of capital budgeting methods can help to evaluate projects because ‘intangible’ benefits are often missed in the financial analysis;</td>
</tr>
<tr>
<td>• 56% of executives believe that a decision-maker ‘balances’ all the time between calculations and other strategic positions.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OTHER IMPORTANT INVESTMENT DECISION CRITERIA SUGGESTED BY MANAGERS:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The ‘whole market budget calculation’</td>
</tr>
<tr>
<td>• Judgement and intuition of managers;</td>
</tr>
<tr>
<td>• The existence of personal contacts with business sector from the local country;</td>
</tr>
<tr>
<td>• The existence of contacts with the representatives of local government;</td>
</tr>
<tr>
<td>• Criteria related to human resources, culture, adapting to local business specific considerations;</td>
</tr>
<tr>
<td>• Option characteristics of investment</td>
</tr>
</tbody>
</table>

Figure 25. Project evaluation methods and investment decision criteria for FDI in transition economies: the schema, updated according to the empirical data

*Source: Olga Golubeva (own)*
12. RISK ANALYSIS IN TRANSITION ECONOMIES

"Without risk there is no faith."

Sören Aabye Kierkegaard, 1813 - 1855, Danish philosopher and thinker
"Concluding Unscientific Postscript", 1846

Cited from "Chambers Dictionary of Quotations". Editor Alison Jones, 1996, p. 556

12.1. Introduction

The purpose of this chapter is to analyse risks in FDI decision-making in transition economies. The chapter starts with an investigation of how political, macro and micro risks influence the decision to conduct direct investments in transition economies. The chapter also deals with issues of how companies reflect higher risks in project assessments and what risk reduction measures they usually apply.

The empirical data is guided by and structured according to the logic of Figure 15 (Chapter 5) which was deduced from previous studies. The analysis is based on the answers of interviewed managers to the questions 16-22, as well as on the informal part of interviews.

The empirical findings of the study will then be compared with the results of prior research. At the end of the chapter a schema with suggestions about risk analysis in transition economies (Figure 15) will be updated according to the empirical data.

12.2. The influence of political risk, macro and micro risks on FDI decision-making: empirical data and comparison with other studies

12.2.1. The influence of political risk on FDI decision-making in transition economies

Managers were asked to express their opinions about the influence of political risks on FDI decision-making in transition economies. The following suggestions were available: a concept of political risk is too general and did not influence particular FDI decisions; political risks had some influence on a particular project; political risks essentially influenced a decision to invest in a particular project.

The opinions of decision-makers about the influence of political risks on a particular investment project are summarised in the table below:
Table 13. The influence of political risks on the FDI decision-making in transition economies

<table>
<thead>
<tr>
<th>Political risk</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of answers</td>
<td>The assumption is right</td>
<td>Number of answers</td>
</tr>
<tr>
<td>Political risk did not influence a decision to invest into particular project</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>Political risks had some influence on a particular project</td>
<td>16</td>
<td>6</td>
</tr>
<tr>
<td>Political risks essentially influenced a decision to invest into particular project</td>
<td>16</td>
<td>9</td>
</tr>
</tbody>
</table>

Fifty two percent of managers believe that political risks essentially influenced the FDI decision; forty percent think that political risks had some influence on a particular project and only eight percent ranked those risks as too general to be accounted for when a decision about the particular investment is made.

Managers from both Ericsson and Vattenfall stressed the importance of political risks analysis for FDI decision-making in transition economies.

- "The political scene of Russia is characterised by permanent nervousness and even chaos. The president’s health problems, fights inside the government as well as between different financial groups for power, etc., prove that political uncertainty still exists in Russia. I do not believe that communism can return to power. It is not a question of ‘communism - capitalism’ anymore. However, the relationships between old administrative and the new market mechanisms, between the powerful financial-industrial groups and minor shareholders, are still uncertain. These types of political risks influence our customers, business partners and the future of our investment projects in general. However, the role of political risks in Russia is greater for strategic investment decisions (such as whether to enter the market or to conduct a substantial direct investment) than for a particular direct investment project on a smaller scale. Ericsson’s purpose is to establish on the market, and we can not afford to close our operations every time the next political turmoil occurs in Russia”, commented one of the senior managers from Ericsson.

The decision-makers from Vattenfall also believe that political risks influence investment decision-making in the Baltic countries.
• "The political risks are important in decision-making, especially in the energy sector that demands substantial investments. However, the concept of political risks has been changing during the years of the reforms. I do not believe in the possibility of changing the course of the reforms in the Baltic countries even if they might go with different speeds and in different ways. But perpetual changes in the governments give us political uncertainty. One government can promise to increase the prices of energy, for example, while another one might abolish previous decisions. The question of the Baltic countries joining the European Union is not clear yet as well. Therefore, political risks still remain", explained a manager from Vattenfall.

We can conclude that even if the concept of political risks has been changing during the transformation period and differs for Russia and the Baltic countries, in general those risks play an important role in FDI decision-making in transition economies. Ninety two percent of decision-makers believed that political risks essentially influenced, or had some impact on, a decision to invest into particular project. It was also suggested by managers that political risks influence the strategic investment decision-making - like entering a market or making FDI of a substantial level - rather than investment projects on a smaller size.

12.2.2. The influence of macro risks on FDI decision-making in transition economies

Managers were asked to choose one among the suggested alternatives that, according to their experience, described in the most accurate way the role of macro risks (i.e. risks that influence all investors in the same way) in the investment decision-making process in transition economies. The opinions of managers are summarised in the table below:

<table>
<thead>
<tr>
<th>Table 14. The influence of macro risks on the FDI decision-making in transition economies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ERICSSON</strong></td>
</tr>
<tr>
<td>Number of answers</td>
</tr>
<tr>
<td>Macro risks are too general to be taken into consideration and influence the particular project</td>
</tr>
<tr>
<td>Macro risks had some influence on a particular project</td>
</tr>
<tr>
<td>Macro risks essentially influenced a decision to invest into particular project</td>
</tr>
</tbody>
</table>

Seventy six percent of managers believe that macro risks had some influence on a particular investment’s decision; sixteen percent think that macro risks essentially influenced a decision to invest in a particular project and only eight percent believe that macro risks are too general to be taken into consideration.
• "What prices for electricity we will have in 2010? How will currencies of different countries perform? I think that macro risks should be carefully evaluated when an investment decisions about the particular project is made”, explained a manager from Vattenfall.

Therefore, the majority of decision-makers (ninety two percent) believed that macro risks essentially influenced, or had some impact on, a decision to invest into particular project.

12.2.3. The influence of micro risks on FDI decision-making in transition economies

The decision-makers were asked to rank the importance of micro risks (i.e. those risks that affect selected industries, companies or projects) as well as to suggest other type of risks that influenced FDI decision-making in transition economies. The table below summarises the answers of managers about the role of micro risks in foreign investment decision-making:

Table 15. The influence of micro risks on the FDI decision-making in transition economies

<table>
<thead>
<tr>
<th></th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of answers</td>
<td>Risks were very important</td>
</tr>
<tr>
<td>Industry risks (i.e. risks that affect only selected industries, for example selective expropriations, discriminatory taxes and import restrictions for specific industries)</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td>Company and project risks (i.e. selective expropriations, discriminatory taxes and import restrictions for specific firms and projects)</td>
<td>16</td>
<td>11</td>
</tr>
</tbody>
</table>

Industry risks play an important role in the investment decision-making in transition economies: eighty four percent of managers ranked industry risks as very important and sixteen percent believed that industry risks had some influence on the FDI decision-making in transition economies. None ranked industry risks as being an irrelevant factor.
For the managers from Ericsson, micro risks are mostly associated with the discrimination of those telecommunication companies that have no local production. The importance of micro risks for investment decision-making at Vattenfall was explained by the strategic position of the energy industry and, therefore, by strict control over foreign investments in the energy sector from the side of the local governments.

Company and project risks seem to play also an important role while FDI are considered in transition economies. Fifty six percent of managers ranked these types of risks as very important while forty four percent believed that they had some impact on decision-making.

According to the managers from both Ericsson and Vattenfall, the success of a project in transition economies depends on the risks undertaken in a particular project rather than risks associated with the general investment environment in the country.

• "A project can result in a big success or a total failure even if an investment decision is based on the same calculations. It depends on the micro investment environment and particular risks associated with investments”, - commented one of the decision-makers.

The importance of regional risks for projects in Russia was stressed by the majority of managers from Ericsson.

• "Russia is a big country where the foreign investor has to operate within eleven time zones! The Moscow region and Siberia are like two different countries… Geographical position, time zones, climate, the political and micro-economic situation, and the cultural and historical traditions of the different regions influence investment decision-making”, - pointed out a manager from Ericsson.

Managers from Vattenfall stressed the importance of environmental risks in FDI decision-making.

• "Our colleagues from the Baltic countries often ignore environmental risks associated, for example, with investments in the nuclear power plants. Those projects can be profitable from an economic point of view, but they are not acceptable due to the environmental risks. The image of Vattenfall as an environmentally ‘clean’ company is more important than short-term profits”, - explained a top executive from Vattenfall.

Managers from both companies also pointed out that the search for new type of risks should be continued.

• "I found that the role of risks associated with human resources - like questions of project management’s personal safety and general hardships - are very high in transition economies. When Ericsson prepared a research report, ‘Project Eastern Europe’, general hardships and risks associated with personal safety issues were five percent of the total investment risks in Russia during 1993-1997”, said one of the executives.
12.2.4. Summary and comparison with other studies

The study supports the proposition that political risks play an important role in FDI decision-making in transition economies, especially when the strategic decisions - like entering a foreign market or making FDI of a substantial level - are considered. (The importance of political risk assessment for investment decision-making was stressed by Thunell, 1977; Ehrengren, 1986).

Ninety two percent of interviewed managers pointed out that political risks essentially influenced, or had some impact on, a decision to invest in a particular project. The study does not confirm hypothesis that the concept of political risks is too general to influence the destiny of a particular project and that companies, therefore, rarely become involved in systematic analysis and evaluations of those risks. (The same conclusions were achieved by De Mortanges and Allers, 1996; Kobrin, Basek, Blank and Lapolombaro, 1980; Sandin, 1980).

On the contrary, the effect of political risk on FDI was not found in an analysis of 269 German and British companies invested in five countries in Central and Eastern Europe (Meyer, 1996).

A study used Kobrin’s (1982) classification of risks along macro and micro levels to investigate how they affect FDI decision-making in transition economies. In the present study ninety two percent of executives believed that macro risks essentially influenced, or had some impact on, a decision to invest in particular project. One hundred percent of managers ranked industry risks as very important or having some influence on the FDI decision-making in transition economies. In presented cases they were associated with the discrimination of those telecommunication companies that have no local production in Russia and strict control of the energy industry from the side of the local governments in the Baltic countries. Company and project risks seem to play also an important role while FDI are considered in transition economies. All executives ranked these types of risks as very important or having some impact on decision-making. The study, therefore, supports the idea that most contemporary risks for multinational firms involve industry and firm-specific risks and operations with constraints, restrictions and regulations applied for particular micro investment environments.

Managers suggested that regional risks and environmental risks should be taken into consideration when FDIs in transition economies are evaluated. The role of risks associated with human resources - like questions of project management’s personal safety and general hardships - is very important in transition economies. Therefore, the search for the new types of risks associated with FDI in transition economies should be continued.

12.3. Risk reduction measures for FDI in transition economies

12.3.1. Summary of the empirical data

Executives were asked to rank the importance of the selected risk reduction measures for FDI in transition economies according to the following grades: a method was often used, a method was used sometimes or a method has never been used. Besides, decision-makers were also asked to suggest other risk reduction measures used for transition economies that are not mentioned in the questionnaire.
Managers’ opinions are summarised in the table below:

**Table 16. Risk reduction measures applicable for FDI in transition economies**

<table>
<thead>
<tr>
<th>Risk reduction measures</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of answers</td>
<td>A method was often used</td>
</tr>
<tr>
<td>A ‘step by step’ strategy, or gradual transfer of investment money</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Negotiating with the government about investment incentives prior to investment (profit repatriation guarantee, tax holidays, etc.)</td>
<td>16</td>
<td>15</td>
</tr>
<tr>
<td>Preparing a crisis plan in case the situation deteriorates</td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>Investment’s insurance, or getting assistance help within private or government organisation</td>
<td>16</td>
<td>7</td>
</tr>
<tr>
<td>High liquidity of assets</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>Creation of strong alliances with important power centres that will safeguard the interest of the project under changing conditions</td>
<td>16</td>
<td>16</td>
</tr>
</tbody>
</table>

12.3.2. A ‘step by step’ strategy, or gradual transfer of investment money: empirical data and comparison with other studies

Ninety six percent of managers used often a ‘step by step’ strategy, or a gradual transfer of investment money, as a risk reduction measure while four percent used this factor sometimes. None of the managers ignored this risk reduction measure.

Development ‘step by step’ was named by almost all managers as an important measure to reduce investment risks in transition economies. Substantial direct investment projects should be based on the successful results of sales, licensing agreements, establishment of local representative offices, projects on a smaller scale, study visits, etc.
The study confirms the hypothesis that this evolutionary approach might be used as an important risk reduction measure for FDI given the high level of uncertainty associated with operating in transition economies. (See Buckley, 1998; Burger and Jungnickel, 1996; Forsgren 1989; Johanson, 1994).

As it was described in the theory chapter, the Uppsala Model sees the internalisation of a firm as a process in which the firm gradually increases its international involvement. The gradual increase of a firm’s international involvement is explained by an interplay between the knowledge of foreign locations and operations and increasing resource commitment. Such knowledge is essential for resource commitment because it enables the recognition of business opportunities and reduces market uncertainty.

The presented project, therefore, has provided considerable, although not indisputable, empirical support for the Uppsala model. Even if Johanson and Vahlne (1990) assumed that large, diversified firms with surplus resources will be less risk-averse to foreign market commitments than small and medium-sized firms, the FDIs of Ericsson in Russia and Vattenfall in the Baltic countries were conducted in an incremental, slow and gradual way characterised by learning-by-doing. Hence, even research involving the big stock holding companies can still benefit from the basic idea of taking cautious steps in the unknown terrain lying behind the original Uppsala model.

Several studies of business in ‘economies in transition’, such as the post-socialist countries in Europe and China, have also revealed that market entry is often conducted in an incremental way characterised by learning-by-doing. On the contrary, Sullivan and Bauerschmidt (1990) did not find any support for the incremental process hypothesis of the Uppsala model, and neither did Millington and Bayliss (1990) in their empirical studies.

12.3.3. Negotiating with the government about investment incentives prior to investments: empirical data and comparison with other studies

Eighty four percent of managers used often negotiation with the government prior to foreign investment (about profit repatriation guarantee, tax holidays, etc.) as a risk reduction measure while twelve percent used this factor sometimes. One manager had never applied it.

- "I think that negotiating with government is more important in transition economies than in the Western societies. According to my experience, investors are often treated on an individual basis by the local governments. On the other side, investment incentives or negotiated tax holidays are not as important for the success of an investment project as, for example, a ‘step-by-step’ strategy", - commented a top executive.

Relative high ranking of this factor for FDI decision-making by the managers can be explained by the regulating and controlling role of the East European governments in the privatisation process. Negotiating with the government about benefits and promotion measures is especially important in the rapidly changing environment, where the future of an investment project depends on the particular conditions under which the project is going to be implemented.
The study, therefore, confirms the importance of the effect of the government policy and investment incentive programs on the attraction of FDI (See Hood and Young, 1979). The need to maintain contacts with government as an important risk reduction factor was found throughout the entire Asia Pacific region by Lasserre and Probert (1998).

The study does not confirm the hypothesis of Rodriguez and Carter (1984) who claim that the effects of restrictions on repatriation of profits, for example, might be generally irrelevant when a company plans to continue to invest in a market in the long run. The availability of investment incentives was also found to have no significant impact by seventy two percent of corporations operating in transition economies. (“Assessing Investment Opportunities in Economies in Transition”, 1994, p.12).

One of the explanations for the different results of the empirical findings lies in the statement of a top executive who was cited before. It might be hypothesised that negotiations about specific government policies, such as incentives or tax holidays, though considered to be important by foreign investors, can not solely form the basis for investment decisions. They are used as the measures to reduce project investments risks rather than as a decisive investment criterion.

12.3.4. Preparing a crisis plan: empirical data and comparison with other studies

Ninety six percent of the interviewed managers had never prepared a crisis plan in case the situation deteriorated. Only four percent made them in some cases.

- ”Something is always happening. In Russia I have to elaborate a crisis plan every day instead of working”,- joked one of the managers.

It may be concluded that elaborating a crisis plan is a rather irrelevant method for minimising FDI risks in transition economies. The study does not confirm conclusions reached by Gonzales and Villanueva (1992) for US firms in Philippines.

12.3.5. Investment’s insurance, or getting assistance help within private or government organisations

Forty percent of decision-makers did not often use the insuring of the investment or getting assistance within private or government organisations as risk reduction measures. Fifty six percent used them sometimes and only four percent had never applied them.

One of the financial managers gave an example:

- ”If a total investment is 10 million USD and 50 percent is financed by our local partner, then we can try to insure, say, 25 percent through EKN, an insurance company or a bank. Than the risky part of the project that we shall manage on our own is reduced to 25 percent. We usually compare the amount of the non-insured part of the investment with future returns by calculating a ‘risk-return ratio’ which is not supposed to be higher than 1:1”.
To sum up, the insurance of projects in transition economies and getting assistance help provide companies with opportunities to minimise risk exposure through sharing risks with banks, government and private organisations, financial institutions, etc. Unfortunately, according to the survey of 300 companies, only one third of companies had benefited from them. (“Assessing Investment Opportunities in Economies in Transition”, 1994).

12.3.6. High liquidity of assets

Only eight percent of managers used high liquidity of assets as a risk reduction measure in transition economies; thirty six percent applied it sometimes while the majority of the decision-makers - fifty six percent - did not use this method.

One of the explanations is that both Ericsson and Vattenfall conducted direct investments of a smaller size.

- ”The possibilities of expansion on the market can be more important than probable losses of some one million Swedish kronor. However, the liquidity of assets can play a much greater role in those cases where substantial investments have been made”, - commented a top executive.

The study does not confirm the importance of high liquidity of assets as a risk reduction measure for FDI in transition economies. (See, on contrary, Khoury and Zhou, 1999). On the other hand, one should not exclude the possibility of an increasingly important role of this factor if the substantial sum of money would be invested.

12.3.7. Alliances with powerful centers: empirical data and comparison with other studies

Eighty percent of managers often used an alliance with important local power centres as an important factor that could minimise investment risks in transition economies and twenty percent applied this measure sometimes. None of the managers underestimated this factor.

Following arguments were used:

- ”The role of establishing contacts with powerful industrial and financial groups is very important for Russia where up to 80 percent of the success depends on the level and quality of your contacts. You must know someone who knows someone from the Duma or Ministry of Telecommunication, etc. The most important way to reduce risks is to establish the network of contacts with top leaders from the government (including local regions) and top managers from the telecommunication industry. Mutual respect and trust are also important.”

- ”To employ the local people who have good contacts in the sector reduce risks for investment projects more than all adjustment measures done with the help of capital budgeting techniques... One of our local employees, for example, is the former Deputy Minister of Energy and the former General Director of the biggest energy companies in Latvia. I think that the ‘right’ business contacts can help to minimize risks and safeguard the future of investments.”
One of the decision-makers used the term ‘moral insurance’ to describe what a Western company can acquire by choosing the right partner and employees who can safeguard the interests of the project in a rapidly changing and unfamiliar business environment.

The study confirms the results of prior studies regarding the importance of personal contacts in transition economies, a feature discussed previously in the paper. (See Brezinizki and Fritsch, 1997; Elenkov, 1997; McCarthy and Puffer, 1996; Meyer, 1996; Richardson, 1995; Rutihinda, 1996; Schopflin, 1997). The study also suggests that we see the alliance with important local power centres as an important factor that can help to minimise risks of FDI undertaken in transition economies.

The same trend was confirmed by Lasserre and Probert (1998) for the Asian Pacific region. Hadjikhani and Johanson (1996), on the contrary, warn that personal contacts might increase the risk of an investment project during a time of political turbulence. The Western company may then indirectly become involved in a political action through interaction with its local partner. During the cleansing process in Iran in 1980, when the revision group had the authority to nationalise a firm on the basis of minor suspicions, Atlas Copco could resist the pressure because it had no local partner. Scholars also pointed out that the problems of Swedish firms in Iran during the turbulent period 1975-1992 were worsened by the fact that the local networks of the firms had changed completely.

12.3.8. Other measures to decrease risks in transition economies

Other measures to decrease risks undertaken in transition economies were suggested by the decision-makers.

First, managers tried to substitute the lack of reliable institutional infrastructures in transition economies with available market economy mechanisms from the West.

In order to avoid currency and banking system risks in Russia, for example, off-shore transactions in American dollars are often used. According to one financial manager, up to 85 percent of financial transactions of Western companies with Russia proceed this way.

Co-operation with other companies in order to reduce risks exposure is often practiced in the earlier steps of project development. The role of co-operative ventures that allow Western companies to share the risk of a large project over more than one firm was suggested hypothetically in the literature by Contractor and Lorange (1994). Co-operation of Swedish Vattenfall with Finnish IVO is a good example of sharing risks when these companies entered the Baltic countries.

Rutihinda (1996) suggested that when the foreign environment is very uncertain, a sole venture could lead to greater loss in case of failure compared to a joint venture with other Western companies.

Executives also stressed that investments into human resource development - the education of local employees and future customers - is an important risk reduction measure.
"We want to understand the local people. Future customers and local employees are important for the success of an investment project. We have to learn to speak the same business language and, therefore, educate the people in the former Soviet Union”, commented one of the managers.

This measure was also supported by empirical data for Vietnam, Indonesia, Korea, Thailand, Taiwan, China, Japan and the Philippines (Lasserre and Probert, 1998).

Several managers as a key risk reduction measure for FDI in transition economies mentioned the importance of ‘being at the place’ and establishing representative offices.

Direct investments are evaluated by managers not only as a strategic goal, but also as steps of long-term establishment on the local market and a measure of decreasing the risks of operations in the rapidly changing environment.

"It is impossible to get insights into the Baltic countries from the Stockholm office. Regional local establishment in the Baltic countries allows Vattenfall to understand the ‘rules of the game’ in these countries. Collection of adequate and comprehensive information helps to reduce investment risks in transition economies”, commented a manager.

Conducting direct investments as a risk reduction measure was suggested in the literature by Buckley (1998). The author claims that setting up a production facility overseas enables a firm to decrease risks by keeping up to date with local market developments. Executives participated in the survey confirmed the validity of this hypothesis.

According to Rutihinda (1996), firms with manufacturing facilities in the host market are in a better bargaining position for political resources with the host government officials. Those companies can also overcome government restrictions such as trade barriers and currency inconvertibility.

To show the long-term commitments to the local market is an important measure that might help to decrease the investment risks of an investment project.

The survey conducted by Lasserre and Probert (1998) of 294 West European and American managers employed by MNE in the Asia Pacific region confirmed the need to make long term commitments both to investments and to relationships. A Western company which, for example, decides to withdraw from the Japanese market may lose its reputation entirely and find it very difficult to return at a later stage.

Hadjikhani and Johanson (1996), who examined the responses of three Swedish MNEs to the dramatic changes in the Iranian market during the turbulent period 1975-1992, found that if the decline is only temporary, the reward for those who stay in the market may be considerable, since it may be costly for those who withdraw completely to return after a market turnaround. By the end of the 1960s, Atlas Copco’s market share in Iran was 10 percent for mining equipment and 20 percent for compressors. In 1991, after stabilisation had been achieved, Atlas Copco had a 70 percent market share for their main products. (p. 59, 61). The Iranians appreciated the fact that Asea (later ABB) had not left the country in spite of the difficulties due to the crises and the war.
12.3.9. Summary

The following risk reduction measures for FDI in transition economies were often or sometimes used by executives: a ‘step by step’ strategy, or a gradual transfer of investment money, negotiations with the government prior to foreign investment (profit repatriation guarantee, tax holidays, etc.), an alliance with important local power centres, and insuring the investment or getting assistance within private or government organisations.

Preparing a crisis plan in case the situation deteriorates and high liquidity of assets were not used by executives as measures to minimise the risk of FDI in transition economies.

The following risk reduction measures for FDI in transition economies were added by managers:

- to substitute the lack of reliable institutional infrastructure in transition economies with available market economy mechanisms from the West;
- to co-operate with other companies in order to reduce risks exposure is often practiced in the earlier steps of project development;
- to combine FDI with sufficient investments in human resource development;
- to be ‘at the place’ and establish representative offices;
- to show long-term commitments to the local market.

12.4. Methods of reflecting higher risks in transition economies

12.4.1. Summary of empirical data

Managers were asked if they assessed additional risks associated with FDI in transition economies in project evaluations.

Sixty four percent of executives made adjustments for additional risks associated with projects in transition economies. Those who answered positively were also asked to specify which methods among the selection of traditional capital budgeting techniques were used to assess those risks.

The answers are summarised in the table below:
### Table 17. Methods used for adjustments for additional risks for FDI in transition economies

<table>
<thead>
<tr>
<th>Method Description</th>
<th>ERICSSON</th>
<th></th>
<th>VATTENFALL</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>To increase the discount rate applicable to foreign projects relative to the rate used for domestic projects</td>
<td>9</td>
<td>7</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>To adjust the forecasted cash flow of the project</td>
<td>9</td>
<td>2</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Shortening the minimum pay-back period</td>
<td>9</td>
<td>0</td>
<td>7</td>
<td>0</td>
</tr>
</tbody>
</table>

12.4.2. To increase the discount rate

Half of the managers (among those who assessed additional risks in transition economies compared to market economies) gave higher priority to the method of increasing discount rates.

"I think that the discount rate for Russia should be increased by 5-6 percent relative to the domestic projects. I often use IRR method for the evaluation of investment projects. A project for Russia with 18 percent returns seems to be attractive, which implies a 6 percent increase of discount because of higher risks perceived in Russia relative to WACC (Weighted Average Cost of Capital) at Ericsson", - explained a top executive. Another group of managers expressed their concern that an extra five-six percent can accurately reflect the additional investment risks undertaken in Russia. A decision-maker from Ericsson commented:

- "We probably should use higher discount rates to reflect all investment risks in Russia. I doubt, however, if we can afford it: high competition in the telecommunication branch does not permit us to do so: we can miss many interesting investment opportunities”.

- "I do not think that it is a good idea to increase the discount rates. If we will apply the discount rates that are fully adjusted to all uncertainties in the Baltic countries, we would not be able to find any projects”, - commented one manager.

Managers from both companies mentioned that if the discount rates would adequately reflect risks undertaken in a particular project, industry and region, they might become powerful instruments in decision-making. A time-consuming information collecting process, as well as rapid changes in the investment environment, were mentioned by managers as factors prohibiting the possibility to elaborate such discounts.
12.4.3. To adjust the forecasted cash flow of a project

Fifty percent of managers (those who assessed additional risks in transition economies compared to market economies) gave higher priority to the method of adjusting the forecasted cash flow of a project.

- "I think that additional risks in investment projects in transition economies should be assessed through adjustments of the forecasted cash flows. If the discount rates could not be adjusted to project investment risks due to the shortage of information, we should take the most careful and accurate scenario of forecasted sales", - pointed out a top executive from Vattenfall.

Some managers mentioned the possibility of increasing the price of for the goods sold (up to 20 percent!) in order to cover the higher risks of the local production.

12.4.4. Shortening the minimum pay-back period

None of the managers shortened the Pay-back period as a method of mitigating the higher risks in transition economies.

- "How can the Pay-back be shorter in Russia where everything take such a long time? If we use the traditional risk adjusted measures for investment decision-making, we should forget about this market"," - commented one of the decision-makers from Ericsson.

According to the managers from Vattenfall, possibilities to shorten the Pay-back are limited due to the long-term character of investments in the energy sector.

12.4.5. Risk adjustments shall not be made

Thirty six percent of managers did not make adjustments for the higher risks associated with projects in transition economies (7 of 16 decision-makers from Ericsson and 2 of 9 – decision-makers from Vattenfall).

The most common explanation of decision-makers was that the present models of risks adjustments can not take into consideration all the factors that influence investment decision-making in transition economies.

- "The traditional concepts of risk adjustments do not help to make investment decisions in transition economies, they just confuse managers. A search for new techniques is vital for the development of project decision-making", - said an interviewed manager.

- One of the top executives commented: "One of our direct investment projects has a Pay-back of three years. However, no interest rate adjustments had been made for extra risks in transition economies. Future cash flow evaluation has less impact on direct investment decision-making than strategic issues. There is some philosophy behind this statement: it is more important to get the market share than to earn a return on a particular investment project".
• "I do not think that we have ready solutions or elaborated approaches for transition economies. Is it better to increase discount rates or to downgrade forecasts? If we look upon the direct investments as our ‘price’ (which mean costs) for a market share in Russia, what difference does it make if we use a 15 or 35 percent discount rate in our calculations? Strategic goals and opportunities are more important for direct investment decision-making than shortening pay-back and using higher discount rates", - said another decision-maker.

Due to the fact that FDI are often seen in connection with other strategic goals, some executives believe that the decision to invest directly in transition economies is as much political as economic. The properly done capital budgeting evaluation methods and risk adjustment techniques should be viewed in a broader context of different economic, political, historical, social and cultural variables.

12.4.6. Summary and comparison with other studies

Sixty four percent of decision-makers made adjustments for additional risks associated with projects in transition economies. The majority of managers, therefore, confirmed the results of the survey conducted by Lasserre and Probert (1998) for the Asia Pacific region that return on investment (ROI) should be adjusted for generally higher financial and business risks.

Three main techniques to handle the ‘foreign’ location of the projects were suggested for evaluation. (see Shapiro, 1990). Half of the managers used increasing discount rates as an applicable method to reflect higher risks perceived in the transition economies. The decision-makers, however, expressed their concern about the arbitrary character of the risk premium. (The same doubts were described in Eiteman, Stonehill and Moffett, 1995).

Fifty percent of managers gave higher priority to the method of adjusting the forecasted cash flow of a project. They supported the hypothesis suggested by Buckley (1998) that the most explicit way of dealing with risk is to make adjustments to the numerator of the calculation. The idea of increasing the price of the goods sold in order to cover the higher risks of local production was suggested.

None of the managers used shortening of the minimum Pay-back period to mitigate higher risks in transition economies.

Thirty six percent of managers did not make adjustments for higher risks in projects in transition economies because the available models of risk adjustment could not take into consideration all the factors that influence FDI decision-making.

Due to the fact that FDI are often seen in connection with other strategic goals, some executives believe that the decision to invest directly in transition economies is as much political as economic.

The properly done capital budgeting evaluation methods and risk adjustment techniques, therefore, should be viewed in a broader context of different economic, political, historical, social and cultural variables.
12.5. *Is it possible to design a unique risk adjustment approach?*

The decision-makers were asked to choose one alternative that describes in the best way their risk adjustment approach for evaluation of projects in transition economies. A summary of their answers is presented in the table below:

**Table 18. Risk adjustments for project evaluations in transition economies were …**

<table>
<thead>
<tr>
<th>Assumptions suggested for evaluation</th>
<th>ERICSSON</th>
<th>VATTENFALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of answers</td>
<td>The assumption is right</td>
</tr>
<tr>
<td>Elaborated for a particular project</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td>Elaborated for a particular country (for example, Russia or the Baltic countries)</td>
<td>16</td>
<td>2</td>
</tr>
<tr>
<td>Elaborated for the countries of transition economies</td>
<td>16</td>
<td>0</td>
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<tr>
<td>Elaborated for all emerging markets</td>
<td>16</td>
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</tbody>
</table>

Sixty percent of decision-makers made risk adjustments for project evaluations in transition economies for each particular project. Forty percent of managers elaborated the same risk adjustment mechanisms for all projects in Russia or Baltic countries. None of the managers made the same risk adjustments for projects in all transition economies or emerging markets.

- “Each project should be treated on an individual basis where risk management is applied to a particular investment environment. A universal approach for investment decision-making does not exist…” - commented one of the Ericsson’s managers.
- Another senior executive joked: “The search for new factors and variables is a perpetual process in transition economies. To design a unique approach suitable for all investment environments is a task similar to the invention of the perpetual engine”.

In general, the study confirms the hypothesis that companies in transition economies, even in the same industry, might assess differently risks involved in FDI. (See Franko, 1996). Instead of a description of risks in general terms, risk adjustments should be elaborated for particular projects. One company’s risk may appear to be another’s opportunity.

There is a difference between the opinions expressed by managers from Vattenfall and those expressed by managers from Ericsson. Decision-makers from Vattenfall use the possibility to elaborate a risk adjustment mechanism, applicable to projects in all Baltic countries in general, rather than search for a unique approach for each case.
• "Due to the commitment to the market reforms of the Baltic countries, the successful transformation process, geographical closeness and mutual historical traditions, we can find many similarities in the investment environments of these states. Therefore, we can elaborate a risk adjustment approach that is possible to apply to all three countries”, - explained one of the managers.

Even if the data are not sufficient to make broader conclusions, it might be suggested that the ‘unsystematic nature of risk’ in transition economies would slowly be eliminated during the successful transformation process.

12.6. Conclusions for the chapter

Risk seems to be a vital concept when companies decide to conduct FDI in transition economies.

Ninety two percent of managers believe that political and macro risks essentially influenced, or had some influence on, a particular project. Industry, company and project risks were thought of as being essential or having some influence on decision-making by all of the interviewed executives.

Executives also suggested that regional risks, environmental risks and risks associated with human resources should be considered in the investment decision-making in transition economies.

The following measures for FDI in transition economies were used by executives as risk reduction factors:

• ‘step by step’ strategy, or a gradual transfer of investment money,
• negotiation with the government prior to foreign investment (profit repatriation guarantee, tax holidays, etc.),
• an alliance with important local power centres, and
• insuring the investment or getting assistance within private or government organisations.

Preparing a crisis plan in case the situation deteriorates, and a high liquidity of assets, were not applied by executives as measures to minimise the risk of FDI in transition economies.

New risk reduction measures for FDI in transition economies were suggested by managers:

• to substitute the lack of reliable institutional infrastructure in transition economies with available market economy mechanisms from the West,
• to co-operate with other companies in order to reduce risks exposure are often practiced on the earlier steps of project development,
• to combine FDI with sufficient investments into human resource development,
• to be ‘at the place’ and establish the representative offices, and
• to make long-term commitments to the market.
Sixty four percent of decision-makers made adjustments for additional risks associated with projects in transition economies. Half of the managers increased discount rates to reflect higher risks perceived in transition economies. Fifty percent of managers gave higher priority to adjusting the forecasted cash flow of a project.

The possibility to increase the price for the goods sold in order to cover higher risks of the local production was suggested. Nobody used shortening of Pay-back period as an appropriate method for mitigating additional risks in transition economies in comparison with market economies.

Thirty six percent of managers did not make adjustments for higher risks undertaken in projects in transition economies because the available models of risk adjustment could not take into consideration all factors influencing FDI decision-making. Due to the fact that FDI are often seen in connection with other strategic goals, some executives believe that the decision to invest directly in transition economies is as much political as economic.

The study, therefore, confirms the hypothesis that companies in transition economies, even in the same industry, might assess differently the risks involved in FDI. Sixty percent of managers made risk adjustments for each particular project in transition economies. Forty percent of managers applied the same risk adjustment mechanisms for all projects in Russia or in the Baltic countries. However, none of the managers made the same risk adjustments for all projects in transition economies or for the emerging markets. There is a difference between the opinions expressed by managers from Vattenfall and the opinions expressed by managers from Ericsson. Decision-makers from Vattenfall elaborate a risk adjustment mechanism, applicable to projects in all Baltic countries in general, rather than search for a unique approach for each case. Even if the data are not sufficient to make broader conclusions, it might be suggested that the ‘unsystematic nature of risk’ in transition economies would slowly be eliminated during the successful transformation process.

The schema suggested as a starting point (Figure 15) for risk analysis in transition economies might be updated according to the empirical data in the following way:
### RISK ANALYSIS IN TRANSITION ECONOMIES

#### Risks Ranked by Managers as Essential or Having Some Impact on FDI Decision-Making:
- Political risks - by 92%;
- Macro risks - by 92%;
- Industry risks - by 100%;
- Company and project risks - by 100%.

#### Other Risks Suggested by Managers:
- Regional risks;
- Environmental risks;
- Risks associated with human resources.

### Risk Reduction Measures Used by Managers:
- A ‘step by step’ strategy, or gradual transfer of investment money;
- Negotiating with government about investment incentives prior to investment;
- Investment’s insurance, or getting assistance help within private or government organisation;
- Creation of strong alliances with important power centres that will safeguard the interest of the project under changing conditions.

### Risk Reduction Measures That Were Not Used by Managers:
- Preparing a crisis plan;
- High liquidity of assets.

### Additional Risk Reduction Measures Suggested by Managers:
- To substitute the lack of institutional infrastructure with Western market economy mechanisms;
- To co-operate with other companies;
- To invest in human resource development;
- To be ‘at the place’ and establish the representative offices;
- To show the long-term commitments.

### Risk Adjustments in Project Evaluations Used by 64% of Managers, Among Them:
- 50% - adjusting the discount rate;
- 50% - adjusting the cash flow;
- None - shortening the Payback period.

### Risk Adjustments in Project Evaluations Were Not Done by 36% of Managers
- None of the risk adjustment methods could help. Decision to invest is as much political as economic one.

### Risk Adjustments for Project Evaluations Were … (Approved by % of Managers):
- elaborated for a particular project - 60%;
- the same for all projects for a particular country of transition economy - 40%.

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Figure 26. Risk analysis for FDI in transition economies: the schema, updated according to the empirical data

*Source: Olga Golubeva (own)*
13. CONCLUSIONS

‘Would you tell me, please, which way I ought to go from here?’
‘That depends a good deal on where you want to get to,’ said the Cat.
‘I don’t much care where,’ said Alice.
‘Then it doesn’t matter which way you go,’ said the Cat.
‘So long as I get somewhere,’ Alice added as an explanation.
‘Oh, you’re sure to do that,’ said the Cat, ‘if you only walk long enough.’

Carroll, Lewis (1865) "Alice’s Adventures in Wonderland"
Cited from the edition of Penguin Books, Great Britain, 1994, pp. 75-76

13.1. Introduction

The purpose of the last chapter is to summarise the results of the study, to draw conclusions and to suggest several directions for future research.

The second paragraph defines the concept and the main components of transition economy from the point of view of foreign investors. The definitions used in the study are related to the propositions of the institutional perspective and the public choice theory.

The third paragraph concludes with a discussion of the reasons behind FDI in transition economies. The results of the study are compared with the relevant theoretical approaches: transaction costs theory, Uppsala school’s model, the network perspective, internalisation theory, marketing approach, option theory, oligopoly theory as well as the ‘traditional’ determinants’ hypothesis.

In the fourth paragraph the study’s conclusions about the main decision-making models and investment decision criteria are presented. The applicability of different social science models described in the third chapter (the rational model, the bounded-rational model, the political model and the garbage can model) in the environment of transition economy was analysed with the help of acquired empirical data. At the end of the paragraph I will turn to the model with four main ‘blocks’ or ‘concepts’ describing FDI decision-making in transition economies which were suggested in the fifth chapter and empirically tested in chapters nine to twelve. The study then concludes with a discussion of the relevance of different social science decision-making models to the ‘blocks’ or ‘concepts’ of the model explaining FDI in transition economies.

In the fifth paragraph the conclusions about FDI decisions in the global context are formulated. The study emphasises both the similarity and differences of FDI decision-making in transition economies to the patterns observed in the other regions of the world. The question of the influence of FDI decision-making experience on Western companies is raised at the end of the paragraph.

The last paragraph suggests several directions for future research.
13.2. Transition economy and FDI

13.2.1. What is ‘transition economy’: the institutional perspective

The transformation of the administrative economy towards a free market system (unclear) offers the foreign capital access to a whole new range of investment opportunities. The crucial question then is: does the dismantling of the Soviet enterprise model, the controlled price system, and the state monopolistic ownership of the means of production, create effective incentives for foreign investments and lead to a wholesale change in the culture? If the answer is yes, is the free play of market forces enough to channel the values change in the required direction and to attract foreign capital?

Transition economy is defined in the second chapter as ‘a non-planned, non-market economy’ where the new emerging market institutions coexist with bureaucracy and hierarchy inherited from the old administrative system. The empirical data presented in the eighth chapter suggest that decision-makers do not perceive the transition as a dualistic condition in which the new exists with and confronts the old, each retaining its purity through their opposition. Transition is then shown in the study as a process, which expresses the development of a contradictory unity, characterised by the features inherited from the Soviet system of production and management culture and embryonic market economy institutions.

The starting point of the institutionalisation perspective is that companies are under pressure to adapt and to be consistent with their institutional environment. Contemporary institutional thinking assumes that the visible structures and routines that make up companies are direct reflections and effects of rules and structures built into (or institutionalised within) wider environments. Besides, the environmental patterns go beyond simple direct control: they are not only narrowly legal and economic, but also broadly social and cultural in character and effect.

Turning to the question of FDI in transition economies, it should probably be seen as being under institutional influence from the parent companies and from the local environment. Both the local (transition economy) country and the Western investor’s home country environments will exert coercive pressure on the investment project. Investment projects, therefore, need adaptive mechanisms and change processes for the mutual benefit of the involved business partners.

Although the institutionalisation theory did receive support in the study, some limitations of this perspective need to be mentioned: we indeed have a society of organisations, but the organisations involved are by no means autonomous actors. Companies are creatures of their institutional environments, but most modern firms are constituted as active players, not passive pawns. Foreign investors are able to influence the local institutions through purposeful political activities (like Ericsson’s participation in the Telecom Forum in Russia, or Vattenfall’s activities in the Baltic Ring project). Foreign companies can also influence the local institutions through the education of the employees and customers (conducted by Ericsson through a Training Center in Moscow, and by Vattenfall through short term courses and seminars in the Baltic countries).
The local transition economy’s pressures are likely to change over time as a result of general societal transformation changes but also because of the actions taken by, among others, foreign investors.

While the institutional theory sees the environment as imposing structures on individual companies, it is important to emphasise differences among them and stress the varied nature of organisational responses to institutional demands. Whether and how Ericsson and Vattenfall responded to transition economies depended on their individual characteristics, even if we can hardly deny the existence of some general ‘rules of the game’ and pressure from the institutionalised environment.

13.2.2. The main components of transition economies

The history of the transformation processes has proved that foreign companies need more than just a ‘market to work’: a minimum level of economic development is certainly a precondition to attracting major FDI inflows. The empirical data presented in the eighth chapter suggest that it is necessary to establish the relevant economic, legal, political and social institutions in order to attract foreign investments. The study then might help us to understand why the countries which had started out with very rigid macro-economic transition programs soon had to slow down and switch to strategies for more gradual change, while considering more of the institutional, political and social factors in the transformation process. Simply changing the labels on existing entities will not change much, particularly if the same managers are running the same institutions, using the same workers and the same (largely obsolete) capital and technology.

The importance of the main components of transition economies identified by neo-classical economic theory - stabilisation, liberalisation and privatisation - was confirmed by the interviewed decision-makers. Besides, in the transition from one economic model to another, where property rights, organisation of labour and political instability are involved, only a strong ‘hard’ government has a reasonable chance of successful reform.

This does not mean that the regime must be very repressive, along fascist or Stalin-type lines, but it necessarily means that social upheaval must be kept under control one way or another. There is need for a new vocabulary to promote the image of government in transition economies as a public good rather than as a necessary evil. A ‘perestroika’ of government should eschew such negative or emotive sounding words such as ‘command’, ‘intervention’, ‘regulation’, and replace them with words such as ‘empower’, ‘steer’, ‘co-operative’, ‘co-ordination’ and ’systemic’.

The institutional environment needs to be conceptualised not only as a supply house of resources and a target of outputs for organisations in general, and foreign companies in particular, but also as a source of meaning and stability. The stability of regulations, laws, taxes, and institutions in general is very important for attracting foreign investments. Hence, the frequent statements by the decision-makers of a desire for ‘stability’. ’Stability’ need not imply social or governmental perfection, but it does imply some predictability.
Sufficient amount of capital investments are unlikely to be expected by companies into Central and Eastern Europe unless the operating costs and revenues of an investment can be estimated with some degree of confidence. A foreign company’s involvement in a transition economy country can, for example, begin with export sales and licensing accords, management contracts and direct investments of a smaller size. Major capital investments may follow only with a considerable time lag when new commitments are based on the previously achieved results. Successful investments attract future investments.

*Formation of market economy mentality and traditions among the local population* was suggested by the decision-makers as an important component of the transition period. Weber’s argument that the strong ontological status of the individual is one source of Western rationalisation tells only part of the story. In terms including the more institutional version of Weber’s theory, the individual is an institutional myth evolving out of the rationalised theories of economic, political, and cultural action.

Executives have experienced that the installation of technical equipment for projects appear to be less problematic than introducing changes in the values, norms, and the work ethics in the uncertain and turbulent environment of transition economy. The most important contribution of foreign investments, therefore, will not necessarily be the transfer of advanced technology or funds for financing the operations, but the transplanting of cultural attitudes and behaviours appropriate to a market economy.

### 13.2.3. Transition economy and Public choice theory

Taking into account the nature of the former centrally planned economies as complex political systems, one might argue that the structure of the transition economies might be explained by the interaction of political and economic forces, the essence of the public choice approach. Public choice theory can be defined as the field of study that applies the methodological tools of the Economics to non-market decision-making, particularly within political systems. Due to the fact that economic outcomes of the transformation process are obviously effected by political processes, public choice theory was suggested by several researchers as a framework for analysis of transition economies. (See Murrell, 1991).

The research design of the paper neither includes the elaboration of public theory issues nor their application to the environment of transition economy. *The main thesis of the public choice theory*, however, that economic agents should not be solely viewed as narrowly economic, but also as political actors, *found some support in the study*. The existence of powerful financial-industrial groups in Russia and the perpetual change of Ministers representing different political coalitions in the Baltic countries were examples provided by the interviewed managers in order to show that a sharp border between ‘politics’ and ‘economy’ in transition economies simply does not exist.

On the contrary, the corruption of the government agencies and the existence of the so-called Mafia in the local country were ranked in the study as unimportant characteristics for FDI decision-making. Some managers pointed out, however, that these factors might be important for retail industries, small and medium size companies, or those foreign investors that miss the linkages with powerful local actors.
During interviews with the decision-makers, much emphasis was placed on the negative role of bureaucracy in the implementation of investment projects in transition economies. This also constitutes the beginnings of a public choice analysis of the determinants of system structure.

Public choice analysis has found a niche in analysing endogenous government policy in market economies. Such analysis might be even more vital for transition economies with primacy of different political processes over economic development.

On the other side, the argument of a Russian researcher, Popov, concerning the usefulness of public choice in studying transition economies should not be forgotten. (Described in Murrell, 1991). His skepticism is based on the belief that a rational economic actor model might not be appropriate when it is applied to a system with a very underdeveloped political culture.

In any case, even if these questions are elaborated in Economics, the field of Business Administration can also benefit from the main ideas of public choice theory.

13.3. Why do firms invest in transition economies?

13.3.1. Transaction cost theory and transition economies

Transaction cost theory (see, for example, Williamson, 1985) suggests that there are two sources of transaction costs related to foreign market involvement. First, there is the loss of economic value due to the tacit nature of the know-how being transferred. Second, transaction costs occur because of the costs related to drafting, negotiating, monitoring, and enforcing contracts with a possibly opportunistic counterpart. The first kind of transaction cost occurs irrespective of the existence of opportunism, whereas the second kind attempts to measure the effect of opportunism. (See Kim and Hwang, 1992).

FDI conducted in transition economies can provide MNE with transaction cost advantages in different areas: management, sales, service, research, human resources, etc.

Differences between the Western investor’s home country and the host country transition economy environment can be analysed from the perspectives of the transaction costs theory. The lack of institutional development and legislation regulating market in transition economies, as well as the absence of market economy traditions and knowledge of foreign languages on the part of the local employees, would probably sufficiently increase the transaction costs.

The fact that the marketplaces in transition economies operate with the tremendous costs of hierarchies and bureaucracy might also explain why companies prefer FDI in transition economies instead of other types of foreign involvement.

The fact that Russia is the biggest country in terms of area in the world, with eleven time zones, may accelerate the need to invest locally instead of running operations from Sweden, pointed out the managers from Ericsson.
Besides explaining why companies have conducted FDI in transition economies, the logic of transaction cost analysis may also be helpful in understanding why other companies did not invest. Sufficient amounts of FDI in transition economies can hardly be expected until the extensive part of costs associated with environmental disturbances in transition economy countries are eliminated.

The empirical data in the study support further the logic of transaction costs theory for FDI decision-making in transition economies. The biggest problem is that transaction costs are hard to measure. In order to obtain extensive empirical evidence for transaction cost theory in transition economies, dummy variables should be introduced and tested. This latter method was not included in the research design of this project.

13.3.2. Does the Uppsala Model work for transition economies?

As it was described in the fifth chapter, the Uppsala Model views the internalisation of a firm as a process in which the firm gradually increases its international involvement. The gradual increase of a firm’s international involvement is explained by an interplay between the knowledge of foreign locations and operations and increasing resource commitment. Such knowledge is essential for resource commitment because it enables the recognition of business opportunities and reduces market uncertainty.

This understanding of the internationalisation process has three implications. First, firms will typically follow an ‘establishment chain’ moving from lower to higher modes of involvement. The second implication is that firms enter markets in a sequence starting in countries in close ‘psychic distance’. This distance includes not only geographical but also cultural, political and linguistic similarities between the home and the host economy. Third, initial investments in a country can serve as a platform for learning about a market or to allow customers to develop brand loyalty. A platform creates an option for further FDI and taking advantage of emerging opportunities.

The presented project has provided considerable, although not indisputable, empirical support for the Uppsala Model. Even if Johanson and Vahlne (1990) assumed that large, diversified firms with surplus resources will be less risk averse to foreign market commitments than small and medium-sized firms, FDI of Ericsson in Russia and Vattenfall in the Baltic countries were conducted in an incremental, slow and gradual way characterised by learning-by-doing. Hence, even the research involving the big stock holding companies can still benefit from the original Uppsala Model.

The choice of the Baltic countries by Vattenfall especially fits the Uppsala Model, which emphasises the role of psychic distance in the choice of foreign markets. Apart from being geographically closer to Sweden, these countries have cultures and traditions that are closer to those in Sweden than to other countries. Vattenfall’s limited international experience (in comparison to Ericsson’s) might also explain the search for markets that were geographically and culturally closer to Sweden.

The interviewed decision-makers unanimously stressed the importance of a strategic factor in FDI decision-making in transition economies. The Uppsala Model, however, is primarily concerned with factors associated with the past, such as firm-specific experience and established growth patterns. By missing strategic factor we are not able to consider variables associated with the future prospects of the companies.
In that sense, I agree with Andersen, who argues that the Uppsala Model "seems to learn on assumptions about the firm’s behaviour that dominated the literature in the 1960s" while later theories should to a higher degree "incorporate the influence of the market side and regard the decision-maker as strategically more conscious". (1993, p. 219). As it was pointed out by Dunning, the "full incorporation of strategic-related variables into a general theory or paradigm of MNE has yet to be accomplished." (1993, p. 93).

An additional problem with the Uppsala Model is that it postulates a linear relation between market knowledge and market commitment. As it was shown in the study, due to the unpredictability and political instability of the environment of transition economies, foreign investors might consider different strategic options - from an intensive and rapid investment strategy to a low involvement and 'sleeping' position (in Vattenfall’s case even the withdrawal of investments was evaluated).

Besides, Johanson and Vahlne (1977) emphasised the explanatory limitations of the model: "We, for the time being, disregard the decision style of the decision-maker himself, and, to a certain extent, the specific properties of the various decision situations" (p. 32-33). The importance of those variables for transition economies limits the predictive value of the model.

13.3.3. The network perspective for the analysis of transition economies

Besides the Uppsala Model, Scandinavian researchers have occupied a central role in the development of a network perspective which has also been utilised to analyse the internalisation of firms (e.g. Johanson and Vahlne, 1990, 1992; Forsgren and Johanson, 1992). The network perspective draws attention to the long lasting business relationships that exist between firms in the markets. Johanson and Vahlne (1992) have shown the way in which the development of a company’s operations in foreign markets has been influenced by the relationships gradually developed in that particular market.

While the Uppsala Model is based on the behavioural theory of the firm (Cyert and March, 1963), the network perspective attaches considerable importance to the social and cognitive ties that are formed between actors engaged in business relationships. The latter perspective points to the great difficulties in making an FDI decision and then in implementing it, and underscores the way in which on-going interactions between actors shape the network structure. The network paradigm was chosen, for example, by Nieminen and Törnross (1997) to analyse FDI conducted by Finnish companies - Hartwall, Paulig, Raisio Margariini and Valio - in Estonia.

The study supports the thesis that Central and East European markets form a specific case for the network approach and stresses the special importance of business networks in the shifting stage of transition economies.

The network approach especially fits the case of Vattenfall’s direct investments, which can be seen as an extension of the existing networks of energy companies around the Baltic Sea to the new emerging markets of the Baltic countries. The interviewed decision-makers from both Ericsson and Vattenfall also stressed the vital role of establishing local networks of personal contacts for the success of an investment project.
It might be suggested that the resources are committed to the market in two ways. First, commitment decisions are made in response to perceived opportunities. Second, resources are committed incrementally in order to safeguard those already committed to the market. In both cases, current interaction with the market actors is crucial. In the first case, the perceptions of opportunities mainly arise through current market interactions. In the second case, current market interaction is critical to forging links with other market actors. Thus, current interaction with other actors in the market is shown in the study to be critical to both market learning and resource commitment.

It is necessary to point out, however, that the approach has its limitations. Combining heterogeneous resources with activities provides the possibility to stress the dynamic ongoing interaction between the actors rather than stress strategic issues. In other words, the network perspective can not explain, for example, why Ericsson conducted the initial FDI in Russia.

13.3.4. Internalisation theory and transition economies

The empirical results of the study support the internalisation theory which claims that foreign investments should occur when a firm is able to increase its value by internalising markets for its intangible assets or growth opportunities (referred to by Hymer (1960) as monopolistic advantages).

All managers approved the thesis that an internalisation strategy expanding a company’s advantages - markets for its technological know-how, expertise in research, marketing ability, goodwill, effective management, etc., influences substantially the decision to conduct FDI in transition economies.

The decision-makers from Vattenfall and Ericsson suggested that we evaluate FDI as a step in a long-term international strategy of establishing companies’ images as loyal citizens with ‘permanent residence’ in Russia and the Baltic countries. An expansion of technological know-how or research is limited for the foreign companies without direct investments due to the poor technical shape of the local assets. The existence of effective management in transition economies is achievable only after sufficient investments in training the local staff. Besides, after the liberalisation of the energy sector in Europe and creation of the Baltic ring, the expansion to the Baltic countries seems to be a natural step for Vattenfall’s international strategy.

13.3.5. Marketing approach and option theory for the analysis of transition economies

Marketing possibilities influence FDI decision-making; either the firm started operations in a country with large markets or it preferred smaller markets. For Vattenfall the argument may be that the small markets of the Baltic countries are more similar to the domestic Swedish market and require a smaller initial resource commitment or have less competitive domestic industries.

In the case of Ericsson in Russia we have the opposite case. The ‘market seeking’ motive for FDI is well covered by Dunning’s (1981) discussion of home-based firm-specific competitive advantage.
The study shows that marketing possibilities are limited without FDI commitments. *Direct investments might be, therefore, viewed as a step of a marketing promotion strategy and evaluated as some sort of ‘entry fee’ or ‘an option’ for getting a market share.*

Consideration of the options aspect of investment in asset markets (as opposed to financial markets) has not been widely explored in the literature in terms of its application to international capital budgeting. For the case of investment decision-making, this means keeping open the opportunity to make decisions contingent upon information becoming available in the future.

FDI decision-making is shown in the study as a dynamic process, sometimes a lengthy one, with neither a real beginning nor an end. No company - no matter how brilliant, rational, or imaginative - could possibly foresee the timing, severity, or even the nature of all precipitating events in transition economies. Recognising this, top executives usually consciously tried to deal with precipitating events in an incremental fashion. Early commitments with FDI were kept broadly formative, tentative, and subject to later review. In both cases neither Ericsson or Vattenfall, nor the external players (like the local partner, or the foreign government) understood at the beginning the full implications of alternative actions. All parties wanted to test assumptions and have an opportunity to learn from and adapt to each other’s responses.

Both Vattenfall and Ericsson are shown in the study to be prepared, dependent upon particular situations, to preserve, accelerate, close temporarily or even abandon the existing production facility of a project in transition economies.

The biggest problem is that the Black and Scholes approach is fully appropriate where potential out-turns exhibit a random walk with a constant variance over the lifetime of the option - which can only be exercised at maturity. One can hardly assume that potential results of building a new plant in transition economies will likely display random walk characteristics and the variance of returns shall be constant over the life of the option. Therefore, the exercise of valuation of real operating options in transition economies probably looks too complex for practical implementation in the real world. Option characteristics of investments, however, may be taken into consideration as a general approach to evaluate FDI.

13.3.6. Oligopoly theory and transition economies

Oligopoly theory explains the phenomenon of foreign investment, which may occur in concentrated industries to prevent competitors from gaining or enlarging advantages that could then be exploited globally. ‘Defensive’ investment in order to be early in the opening markets in comparison with the competitors might be of a special importance for transition economies. An investment decision may have to be made quickly to exploit an opportunity which, if not taken, may be grabbed by a competitor.

The decision-makers confirmed that *FDI decisions were affected by the presence of competition in the host-country, and, therefore, had a defensive character.*

As an effect of the ongoing liberalisation, deregulation and integration of market economies, both Vattenfall and Ericsson experience increasing global competition.
Hout, Porter and Rudden (1982) suggest that an MNE pursuing global synergy is motivated by factors beyond the narrow calculus of country-by-country efficiency. These arguments are prevalent within two research streams: the international market power (industrial organisation) perspective and the resource-based perspective on strategic management. The first research stream focuses on the efficiency reducing aspects, whereas the second research stream focuses on the efficiency enhancing aspects of global integration. A strategic motive of enhanced global strategy can be positioning for future expansion, creating strategic options, maintaining international oligopolistic competition, and utilising international scale or scope advantages.

Interviewed managers from both companies pointed out that the escalation of global competition induces, among other things, a strategic involvement of firms in transition economies. FDI decision-making, therefore, becomes a 'how' and 'when' question rather than a 'whether' and 'why' question, and may be compared with 'jumping on the running train'. This suggestion might be even more important for the small, open market economies like Sweden, where foreign operations have long played a vital role in a firm’s development.

13.3.7. ‘Traditional’ determinants of transition economies as motives for FDI

The often quoted ‘traditional’ advantages of transition economies, such as low labour and production costs, though considered in the investment process by foreign investors, do not appear in my study as prime motivations and, though attractive, do not form the main basis for long term strategic FDI decisions. The evidence from the cases also suggests that specific government policies, like incentives or tax holidays, are used as measures to reduce project investments risks rather than as a decisive investment criteria.

The study supports the thesis of the growing importance of created, relative to natural, assets as the main generators of future income for the companies. Ericsson’s investments into a training center in Moscow, and plans to invest into a designing and research center in St. Petersburg, provide evidence that high technological foreign companies search to exploit intangible assets rather than seek for natural resources.

Dunning (1997) suggests that although the greater part of FDI - and particularly that directed to developing countries - continues to be of the traditional labour and resource-seeking character, an increasing proportion of future FDI will be undertaken to acquire new competitive, or strategic-ownership specific, advantages, rather than to exploit existing ones. The empirical data of the study are not sufficient to specify the type of new resources and capabilities available for foreign investors in transition economies (with the exception of new markets emerging from scratch). We shall, however, consider that the whole logic of making FDI in order to seek complementary competitive advantages, rather than merely utilising such an advantage, is contrary to the traditional explanations based on the industrial organisation or internalisation perspectives.

13.3.8. The combination of theoretical perspectives: supplementary rather than alternative

One of the results of the study is that FDI decision-making in transition economy is largely consistent with different theoretical approaches suggested in the literature. At the same time, the empirical support obtained for different theoretical approaches is often disputable and open to alternative interpretations.
The following theories and approaches were found to be relevant to the subjects highlighted in the study:

The data suggest that it is necessary to establish the relevant economic, legal, political and social institutions in order to attract FDI. Although the institutionalisation theory did obtain support in the study, some limitations of this perspective need to be mentioned. While the institutional theory sees the environment as imposing structures on individual companies, it is important to emphasise differences among them and to stress the varied nature of organisational responses and their ability to influence and change the institutions.

The main thesis of the public choice theory, that economic agents should not be solely viewed as narrowly economic, but also as political actors, was supported empirically. One might, therefore, benefit from the logic of public choice theory in the analysis of FDI in transition economies, even if the acquired facts were controversial in some cases.

FDI conducted in transition economies can provide MNE with transaction cost advantages in different areas: management, sales, service, research, human resources, etc. Besides explaining why some companies have conducted FDI in transition economies, the logic of transaction cost analysis may also be helpful in understanding why other companies did not invest. The biggest problem is that transaction costs are hard to measure and estimate.

The presented project has provided considerable, although not indisputable, empirical support for the Uppsala Model. The FDI of Ericsson in Russia and Vattenfall in the Baltic countries were conducted in an incremental, slow and gradual way characterised by learning-by-doing. The Uppsala Model, however, is primarily concerned with factors associated with the past and misses strategic factors and variables associated with the future prospects of the companies. An additional problem with the Uppsala Model is that it postulates a linear relation between market knowledge and market commitment that is not always true in transition economies. Besides, the Uppsala Model disregards the decision style of the decision-maker himself, and, to a certain extent, the specific properties of the various decision situations that limit the explanatory power of the model.

The study supports the thesis that Central and East European markets form a specific case for the network approach and stresses the special importance of business networks in the shifting stage of transition economies. It is necessary to point out, however, that the approach has its limitations. Combining heterogeneous resources with activities provides the possibility to stress the dynamic on-going interaction between the actors rather than strategic issues.

The empirical results of the study support the thesis that an internalisation strategy expanding a company’s advantages - markets for its technological know-how, expertise in research, marketing ability, goodwill, effective management, etc., influences substantially the decision to conduct FDI in transition economies.

Marketing influences FDI decision-making; either the firm started operations in a country with large markets or it preferred smaller markets. The study shows that marketing possibilities are limited without FDI commitments. Direct investments might be, therefore, viewed as a step of a marketing promotion strategy and evaluated as some sort of ‘entry fee’ or ‘an option’ for getting a market share.
The exercise of valuation of real operating options in transition economies probably looks too complex for practical implementation in the real world. *Option characteristics of investments*, however, may be taken into consideration as a general approach to evaluate FDI.

The decision-makers confirmed that FDI decisions were affected by the presence of competition in the host-country, and, therefore, had a *defensive character*. Interviewed managers from both companies pointed out that the escalation of global competition induces, among other things, a strategic involvement of firms in transition economies. FDI decision-making, therefore, becomes a ‘how’ and ‘when’ question rather than ‘whether’ and ‘why’ question, and may be compared with ‘jumping on the running train’.

The often quoted ‘traditional’ advantages of transition economies, such as low labour and production costs, though considered in the investment process by foreign investors, do not appear in my study as prime motivations and, though attractive, do not form the main basis for the long term strategic FDI decisions. The evidence from the cases also suggests that specific government policies, like incentives or tax holidays, are used as measures to reduce project investments risks rather than as a decisive factor.

*The presented project suggests that theoretical perspectives do not exclude each other; they rather have a supplementary character.*

I can suggest at least three good reasons why one single theory cannot capture all aspects of the phenomenon of FDI in transition economies.

First, different theories address different aspects of FDI decision-making in transition economies. It is hard to imagine that a single theory might cover different concepts included into an analysis.

Second, each of those concepts initially included in the theoretical framework might also need different approaches. FDI, for example, might be carried out for a number of reasons and motives. One theory might highlight certain processes, but might be useless in relation to other processes.

Third, FDI in transition economies can be analysed at three different levels: the macro-economic level (addressing broad national and international trends), the meso-economic level (considering the interaction between the firm- and the industry-level), and the micro-economic level (individual firms). The present study focuses on the company level and takes the industry-level and macro-level into consideration to the extent permitted by the chosen framework. The analysis of FDI decision-making conducted at three different levels (the macro, the meso and the micro-economic levels) might require different theoretical frameworks. The importance of theories appropriate for analysis at these three levels might be different.

To sum up, no single academic approach alone could possibly accommodate the complexity of intertwining causal chains in FDI decision-making in transition economies - so there is a clear need for a multi-theoretical approach.

*The study attempts to supplement the mainstream FDI theories with a firm-level approach based on the case studies.*
A theoretical framework is regarded as an essential starting point for any paper, but it might be argued that it should be capable of being challenged, developed and refined as a result of the research process. Case studies in this respect can do more than ‘illustrate’ particular theories in business administration.

Rather than making a particular theory the focus of the research, with a somewhat ‘linear’ relationship between theory and case-based observations, the presented project used different theories and approaches more flexibly in order to address questions concerning FDI decision-making in transition economies. The case study method was used as issue-driven, problem-solving approach, which allowed to analyse a new research phenomenon of transition economies.

13.4. Which of the decision-making models and investment criteria works in transition economies?

13.4.1. A rational model and investment decision criteria applied to transition economies

The most common assumption in management theory is probably that companies tend to adopt practices which are efficient from an economic point of view. In Whitley’s terms: “While economic rationalists may accept that firms are complex social organisations whose constitution and activities reflect the conceptions and values of owners and/or their agents as well as employees, they consider competitive pressures to be so strong that efficient forms of business organisation and ‘rational’ strategic choices quickly dominate all market economies whatever cultural and institutional variations may exist between them”. (1992, p. 121).

The rational model, discussed together with other models in the third chapter, assumes that decision-makers tend to search for all possible courses of action, to compare and to evaluate them and to choose the optimal solution.

According to interviewed managers, FDI decision-making becomes an even more conservative process in transition economies than in developed market economies. Decision-making routines and procedures provide managers with ‘a materialistic’ feedback and, therefore, perform some sort of function of ‘objectivity’ in the rapidly changing uncertain environment of transition economies.

Calculations also help managers to present the investment projects and, afterwards, to legitimate them in the eyes of the Board members, financiers and bankers, business partners, government organisations, etc. It was suggested by executives that traditional investment appraisal methods used as a language for communication between different partners are especially important in transition economies.

The conclusions of the thirteenth chapter about the information/investigation process confirm that information is likely to have an instrumental effect on investment decisions in transition economies. Consequently, an extensive information collection for capital budgeting calculations leads to more accurate perceptions of environmental conditions full of uncertainties and, therefore, to better investment decisions.
Managers believe that the learning effect that inevitably follow the process of collecting the information for capital budgeting calculations is extremely important in the uncertain and rapidly changing environment of transition economy.

The interviewed executives also suggested that the strong appreciation of the properly done investment calculations from the side of the local business partners increases the importance of the application of capital budgeting techniques to transition economies.

To sum up, decision-makers stated that where companies confront stable and predictable environments then investment decision routines will be less necessary and less important than where market uncertainty is high.

It might be argued, therefore, that capital budgeting should be regarded as an aspect of organisational stability rather than of organisational change. Investment projects are routines rather than interruptions in a company’s life. Researchers often claim that a company should adapt to important changes in its environment by changing its routines. I will add that the fairly mundane, common and stable aspects of decision-making help a company to do so.

In short, it is not enough to worry about the effects of new routines and procedures because it is not the effects that make traditional decision-making important. Rather, it is important in itself; it is not the means to an end, but has a value of its own. It is less a matter of sudden big changes in the decision-making routines in transition economies or invention of a new project assessment criterion, and more a matter of gradual transitions resulting from changes in the environment.

While it is true that everything depends on everything else in decision-making, it is also true that a dominant direction, deriving from the principle of intended rationality, is the one that provides management with assistance on the daily basis.

13.4.2. The bounded rational model in transition economies, or other investment decision criteria

A bounded rational model (or a theory of limited rationality) questions whether decisions are to be regarded as guided by rational considerations or a broader conception of practical action. As Barius suggested, “the decisive factors in investment decisions are qualitative variables such as stimulation, potential, relationships, environmental factors, uncertainty, conformity with traditions, willpower, values, preferences, ambition, strategy and goals etc. (on condition that quantitative decision variables have attained satisfying levels).” (1987, p.210).

Although the role of the rational model should not be underestimated in the environment of transition economies, executives identified other factors that have at least as much importance for decision-making as properly done capital budgeting calculations.

Managers emphasise the importance of strategy over financial techniques and argue that FDI decisions in transition economies should be based on methods consistent with the company’s long-term objectives. Fifty six percent of the executives answered positively on the ‘provoking’ question whether some strategic opportunities could explain starting the project even if orthodox NPV is negative.
Ericsson’s involvement in Russia through the entire 20th century, starting in 1893, and Vattenfall’s expansion around the Baltic Sea area demonstrate that history and geography matter. The study suggests, therefore, that each company’s history and geographical location, and its own time- and place-dependent line of development, affect the decision-making process. According to interviewed managers, geographical closeness, traditional historical contacts, previous record of relationships, etc., might be as important for FDI decision-making in transition economies as the logic of the rational model.

The study also shows that cultural characteristics influence the success of FDI in transition economies. The decision to invest in such markets must take the influence of culture into account, and make moves to counter it through effective human relations strategies. According to executives, this type of research must be carried out in the early phase of FDI decision-making.

We must be aware that the fate of a project is not merely a matter of profit and loss, it is the fate of people and their futures. The presented cases show that success would be based on far more than modern machinery and techniques or available finance. Although the focus of investment decision theory is on symbols and meanings and rules, the presented study shows that it is essential not to lose sight of the human agents that are applying these symbols, interpreting these meanings, and formulating, conforming to, disobeying, and modifying these rules.

According to the empirical data, investment decisions are also largely based on intuition, business experience, personal judgements, acquaintance and co-operation; and these investment criteria are inevitable and acceptable in a situation of total chaos and permanent change.

Another dimension of alternative investment decision criteria is linking up with a local partner. Such a partner may have sufficient political and business clout to steer an investment project clear of local government action or interference from the Mafia. The correctly chosen partner is shown in the study as a major criterion providing the success for investment projects in transition economies. “It takes two to tango.”

A fundamental transformation from an industrial to a service-based economy with an increasing emphasis on human capital (the knowledge, skills and experience of people), rather than on physical capital, is probably changing the nature of direct investments. Since the 1960s a growing body of research, experiment, and theory has attempted to develop methods of accounting for an organisation’s human assets. This field has come to be known as human resource accounting (HRA). Why have we not been even considering investments in human resources as a part of FDI decision-making?

To sum up, in comparison with the rational decision-making thinking, it may be argued that it is necessary to appraise FDI in transition economies on a much wider range of costs and benefits.

The biggest problem of the application of the model of limited rationality for analysis is that several potential benefits often can not be quantified in monetary terms but are often critical in assessing the investment projects.
13.4.3. Political process perspective and transition economies

The basic assumption of the political process perspective (or the political model of decision-making) is that in any organisation there are many interested parties potentially competing for resources and attention. In the extreme case, it means that interests are opportunistically pursued - the decision-makers have conflicting interests and the political actions undertaken by the actors may influence the outcome.

Based on the political perspective, decisions would be driven by personal interest, with biasing and suppression of various data designed to win power struggles. People can find ideas and proposals valuable because they serve their own interests or hold some advantage for them in one or more respects. Björkman (1997) even hypothesised that "actors will be more likely to engage in political action in situations where the outcome of the political process is uncertain" (p.346), as it is in transition economies.

The present study confirms the importance of power processes and political context for FDI decision-making in transition economies.

Several decision-makers stressed that the decision to invest in transition economies is as much economic as political. Scenarios are not neutral; they are designed by people who have their own interests.

Managers pointed out that the personalities of executives and their abilities to push projects through discussions and formal approvals are extremely important for FDI in transition economies.

The absence of signs of ‘moral support’ from companies’ executives might explain careful investigation and ‘step-by-step’ development of investment projects in Ericsson and Vattenfall in Central and Eastern Europe (in comparison with ABB and Tetra Laval where the companies’ leaders took personal responsibility for the investment decisions and convinced other executives to proceed).

The political importance of the Baltic region to Sweden contributed, among other factors, to Vattenfall’s decision to invest directly in the Baltic countries.

The study also stresses that investment projects are increasingly subject to individual negotiations between a foreign investor and the host country agencies, and, therefore, fit the basic assumption of the political process perspective. What types of individuals are involved in negotiation, evaluation and implementation of an investment project might determine its destiny.

Moreover, a psychic distance is hardly an objective factor that exists between a firm and a transition economy country. This means that the distance cannot be seen as an independent variable that influences all firms in the same way. It is rather a distance that exists in the minds of individuals and the perceived distance depends on the way these individuals see the world - the individual perception of reality.

As such, the term ‘psychic’ refers to something in the mind of each individual. Individual decision-makers thus seem to be relevant units of analysis in investigating FDI decision-making.
It is difficult to conclude whether FDI decisions could be explained better in terms of political processes than in terms of analytical procedures. We do not know whether cognitive maps better explain managers’ perceptions of the environment than analysed position statements and evaluative techniques. It might be fruitful, however, to add a new dimension to FDI decision-making and analyse it in terms of important political actors and their positions in the company instead of presenting the process in strictly ‘planning - implementing’ terms.

13.4.4. Garbage can decision-making model and transition economies

A garbage can model assumes that organised anarchy and ambiguity are far better descriptions of decision-making than cognitive systematic-structured analysis. The environment itself is the biggest source of ambiguity: the long-term future of a MNE is absolutely unknowable, and no one can predict its direction over the long term or control it. The decision-making area then revealed social structures from two different worlds: the world of ideas and the practical world that are seldom met.

The study confirms that transition economies are characterised by an even higher degree of unpredictability than Western countries and that the long-term plans and visions of future sales in transition economies are illusions and hopes rather than scientific forecasts.

Cognitive limits exist in the search process. This is another way of saying that the human mind is limited in its comprehension of problems. Decisions rarely involve the full process of mapping out all possible paths on a complete decision tree. Often, it is merely felt that there is a problem and something must be done. The long-term future of an FDI project in transition economies is absolutely unknowable, and no one can predict its direction over the long term or control it. In such a system long-term plans and visions of future cash flows can be only illusions.

Ericsson’s expectations in 1997 were that Russia would appear on the list of Ericsson’s ten biggest markets after year 2000. Instead of Russia, Turkey became one of Ericsson’s ten largest markets in 1999 while a huge downturn of 55 percent of sales was noted in Russia. Vattenfall claimed that they would conduct FDI in the smaller size markets of the Baltic countries that suit their ambitions. One of the independent consultants drew my attention to the fact that Vattenfall had been much more active in the bigger markets of Central Europe than in the Baltic countries. What companies planned to do in transition economies and what they actually did are not always the same thing.

Presented cases demonstrate that in many of decision-making situations, multiple and sometimes conflicting rules exist and the data are open to a number of alternative interpretations.

Companies vary in how they organise and locate rationality and, hence, in the ways in which they make decisions. Systematic differences in the decision-making routines between firms may then be a natural law in modern society.

It can happen that a one company’s risk is another company’s opportunity. If a company would like to conduct FDI in transition economies, the decision-makers will face another ‘problem - solution’ garbage can situation than Vattenfall and Ericsson had experienced.
Instead of one unique answer we might have to face the necessity for a perpetual search for new methods and approaches for each particular case. We must be aware of the fact that no firm can attain competitive advantage in the same way as another firm. The study suggests that *FDI decision-making is an area where there is no universal algorithm for all the companies from all over the world and, hence, some elements of the ‘garbage can’ are always present in the process.*

13.4.5. *Back to the model*

While chaos means disorder and randomness in the behaviour of a system, it also means that there is a qualitative pattern at a general, overall level. As a result of analysis of the empirical data, several logical patterns of behaviour associated with uncertain and unpredictable environments of transition economies have been identified.

All interviewed decision-makers believed that the questions based on theoretical ‘blocks’ of the model (i.e. initial forces to invest abroad, information/investigation process, project evaluation methods and criteria, risk analysis) adequately cover the issues of FDI decision-making in transition economies.

*Managers confirmed that the suggested ‘blocks’ of the model with a linear ‘step-by-step’ relationship between the included concepts were a good starting point for the description and analysis of FDI decision-making in transition economies.*

FDI will be done only when the motives to invest directly are consistent with the long-term objectives of a company, the information about the investment climate is collected, capital budgeting calculations are adopted by the Board of Directors, managers have found the prospective future business partner and the risk of investment is insured. In this instance, what is being highlighted is the significance of the simultaneous presence of ‘blocks’, their interaction, and the dependence of those interactions on the synchronised timing.

According to the empirical results, many of the variables included in theoretical ‘blocks’ are endogenous: whether or not they cause a factor in the decision-making process, this factor may cause them. To sum up, *even if the major concepts and variables of the FDI decision-making process in transition economies have been identified and confirmed to be important, we can not be sure in which way they might influence and predetermine each other. The direction of causation is often unclear, if the holistic picture of the decision-making is required.*

At present, much of significance for FDI decision-making in the wider economic, social and political settings of companies has been ignored. Relatively little consideration has yet been given to the ways in which ‘pure’ rationality becomes implicated in, and, in turn, shaped by, the emergence of political factors, socio-cultural criteria or ‘ad hoc’ events.

The study shows that *the rational choice model often co-exists with alternative decision-making models - limited rationality, political and garbage can.*
Therefore, the 'synthesising' approach, integrating rational model with other models, might be suggested as a powerful instrument for analysing FDI decision-making in transition economies. And we do not know yet how this 'synthesising' view will change the idea of what the FDI decision process looks like. **Investment decision-making is probably as much, if not more, a social, political, cultural, etc. technology as an economic one.**

One likely outcome of this study is that the revitalised form of FDI decision-making will differ rather markedly from much of what has gone before: less emphasis on the quantitative aspects of ‘pure’ rational models, more emphasis on the qualitative characteristics of companies and investment environment. In other words, some sort of ‘managerial’ forms of foreign investment decision-making have been highlighted in the study.

If we challenge the rational model, we are also challenging some of the most influential norms and conceptions prevailing in social science. Consequently, I have no expectations that the presented study will unsettle the hegemony of the rational-instrumental philosophy. Theory should never be used as norms for a standard, but should merely be used as aids to judgment. Without neglecting the prime importance of the rational model, the latter is presented in the study among other determinants that influence FDI decision-making in transition economies. Besides, it is important to bear in mind that the rational model has long been the subject of criticism, and that some of its assumptions are particularly unrealistic in the contemporary world with its uncertainty and unpredictability.

The concepts specified in the ‘blocks’ of the suggested rational choice model will be ‘filled’ with the real data in each particular case. While ideas recognise no borders, many approaches are more appropriate in some countries than in others. Different assumptions about national, industry, and corporate cultures affect the FDI decision-making process. The diversity between the ‘real’ models will be so substantial that it will be impossible to lay out probabilistic decision diagrams that would have much meaning. Decision-making after all has different meanings and boundaries in every different context.

The basic model has no right answer. It is not the truth, the whole truth and nothing but the truth. **Not all elements of the traditional FDI decision-making model will be relevant in all situations; we need ways of choosing the factors that are relevant in a given situation.**

Decision-making models, then, should be unique: the best ones are supposed to result from a process of creative design. The choice of objectives and the formulation of policy to guide action in the attainment of objectives depend on many variables unique to a given company and environment. It is not possible to make useful generalisations about the nature of these variables or to classify their possible combinations in all situations.

**In some situations it is neither possible nor relevant to identify causal relationships between different variables. What might be helpful, then, is to understand the concepts, the data, the behaviour of actors, and the value system in the investment context.**
There is also another profound philosophical point. All descriptions of human situations are necessarily partial and incomplete. For reasons mentioned above a model may be partly a work of fiction and to some extent artificial. I just constructed my own versions of reality even when I tried to be as ‘objective’ as possible. Nevertheless, we can probably sum up by saying: ‘It all depends… Yet, so what’.

13.5. Transition economies in the global context

13.5.1. Consistency of FDI in transition economies with patterns observed in other parts of the world

Events at the beginning of the twenty first century seem to be challenging long-cherished ideologies and values, and, in some cases, the very institutional fabric of modern society. Many of the events now occurring are paradoxical, if not antithetical, in both their characteristics and implications. A new generation of telecommunication advances has been shrinking the boundaries of economic activity. The opportunities and challenges of globalisation cut across the traditional East/West or North/South divide between countries.

As we approached the new millennium, both inter-firm and international relationships took on more complex, pluralistic and contradictory forms. It seems that contemporary companies are operating in permanently turbulent environments, in which a familiar world of marketing and production changes to an unfamiliar world of new technologies, new competitors, new consumer attitudes, and new dimensions of political risk and social control. How unique is the environment of transition economies in the post-industrial society? And how important is the FDI decision-making in transition economies in the global context?

One of the results of the study is that the determinants, approaches and criteria of investment activity in transition economies are largely consistent with those suggested by the literature and the observed patterns in other parts of the world. To get the risk-adjusted return on the capital invested is the main rule of decision-making.

The decision-making process both in Ericsson and Vattenfall is performed with consideration of the interests of the whole concern and has to follow the same routines for all business units and the potential countries of investments. According to the interviewed managers, at least to some extent, it should not matter if a company looks for investment possibilities in Germany, Baltic countries or Russia. Projects from all over the world should compete for required finance.

The unique character of the decision-making process in each particular case is also an argument supporting the similarity of the nature of the decision-making in transition economies with the rest of the world.

In my opinion, it might be impossible to describe how to make investment decisions in practice either for transition economies or for other countries. An investment project conducted in Japan or Germany is as unique as the projects in Russia or China. Investment decision-making falls into the same category as creativity - by its very essence it cannot be programmed for any geographical region. Is Adhocracy, then, still an incorrect method? To some extent, it is an art that can not be taught, though it can be learned.
There also seems to be a growing interest in describing the international firm as a social community that specialises in the creation and transfer of knowledge. (See Kogut and Zander, 1993). The intelligence of organisational action is seen as lying not in the capability to know everything in advance but in the ability to make marginal improvements by monitoring problems and searching for solutions.

Nieminen and Törnross (1997) defined learning as "a cognitive change based on the actor’s ability to perceive the world in a new way". (p. 192). The perceived uncertainty will be reduced due to learning from the experience. In case of transition economies, the East Europeans can learn how to use Western technology and Western business practices. The Western company, on the other hand, learns how to deal with their East European business partners and how to conduct investment projects in these markets.

The main lesson that ‘we need lessons’ is, therefore, relevant for all countries and geographical regions. We do not need to copy the Chilean solutions for solving the problems of the Baltic countries, but we have much to learn from their decision-makers’ ways of thinking, namely how they have constantly sought new solutions, how they have dared to replace obsolete economic institutions and relations with new and effective ones and, last but not least, how they have been able to learn from their own mistakes. The general lies in the particular; that is, what we learn in a particular situation we can transfer or generalise to similar situations subsequently encountered.

To conclude, researchers working with any particular aspect of the theory of business administration might benefit from analysing these features as they emerge while conducting business in transition economies. This implies then that the results of this study are relevant beyond the region of Central and Eastern Europe.

13.5.2. Specific environmental conditions affecting FDI in transition economies

Even if the nature of decision-making is the same for all countries, a few specific environmental conditions of transition economies are shown in the study to affect the pattern of FDI decision-making.

Almost 70 percent of managers believe that deciding whether to engage in FDI in transition economies requires special knowledge and methods. The statement can be explained by uncertainties and unpredictibilities associated with the environment of transition economies. The level of turbulence is still different between transition economies and developed market economies.

Besides, two sociological dimensions might be suggested to explain the differences between Western market societies and transition economies: the distribution of power between individuals and collectivism vs. individualism management approaches.

It is stressed in the study that transition economies inherited from the past a large power distance with an authoritarian leadership and a strong hierarchy and bureaucracy. Companies in such countries centralise the power to a few hands and those who do have power enjoy many privileges. There are many levels of seniority and differences in financial rewards are large.
This explains the need for titles, business cards, cellular telephones, expense accounts, cars and other symbols of status and authority as important boosters of decision-making managerial power in Russia and the Baltic countries. On the contrary, the interviewed managers described Sweden as a country with small power differences and democratic decision-making traditions, where the subordinates’ dependence on their superiors is limited and consultation between manager and subordinate is preferred.

Management in an individualist culture can be also compared to management in a collectivist society. (See Weber, 1951). Management in individualist culture presumes that the financial rewards are distributed according to an individual’s performance. A statement of the unique individual requires a high degree of freedom and responsibility when it comes to making and executing decisions. Management in a collectivist society is management of groups and networks of individuals. These societies are less achievement oriented than Western economies because it is more important to arrange proper personal connections than to work.

The interviewed decision-makers suggested that personal contacts are vital in transition economies. Managers were unanimous that a great deal of business occurs because one knows someone, not because one has the best project. One of the managers used the term ‘personalisation of projects’ to describe the situation when the projects are accepted not due to the commercial interests of the parties but because of the close relationship between the partners.

Hence, transition economies, at least to some extent, belong to the collectivist societies and have different ‘rules of the game’ in comparison to the Western market economies.

The study emphasises that the ability of managers to understand business practices in transition economies which are determined by different rules of distribution of power between individuals as well as collectivism vs. individualism management practices might determine the destiny of an investment project.

This feature of transition economy can hardly be regarded as a new social phenomenon. The emphasis on relations, for example, in China has even created a special concept regarding the interaction of individuals - Guanxi - based on a fundamental Confucian assumption that man exists in relationship to others. Guanxi is an informal, unofficial power relationship utilised to get things done as well as to secure one’s control over a valuable good or access to it. (See Sharma and Wallström-Pan, 1997).

Commitment, according to the executives, becomes a core concept in understanding and explaining FDI decision-making in transition economies. Nieminen and Törnroos (1997) came to the same conclusion for the Asian region and stressed that an investment project is unlikely to be successful there unless a long-term commitment is made. The definition of commitment in this context is related to the state of being dedicated to the project as well as being devoted to commit the financial and technical resources for a certain period of time for the project’s purposes. Lasserre and Probert (1998) also pointed out that in societies of several Asian countries, including Vietnam, China, Indonesia and Thailand, an investment contract with foreign company signifies to the local partner the beginning of a commitment rather than the conclusion of a business deal.
Another challenging question is whether we should blame the administrative system of the former communist countries for the existence of transition economies’ problems. It might be fruitful to analyse features of transition economies in connection with different historical, religious, social and demographic parameters. We might then, for example, find the roots of Russian hierarchy and corruption in the socio-historical traditions of Eastern Orthodoxy.

*It is not clear whether the importance of personal contacts in transition economies should be seen as a feature inherited from the past communist system or as an alternative way to organise the economic actors through networks, a way that is natural and appropriate for the majority of Asian societies.* The combined efforts of scientists from different disciplines is required to study further this issue.

13.5.3. Transition economies and Western companies

The study shows that even if companies are affected by changing environments, they are also capable of responding to these influences creatively and strategically. By acting in concert with other organisations facing similar pressures, companies can sometimes counter, curb, circumvent, or redefine these demands.

The two-presented cases differ from each other. What can probably make them comparable (besides theoretical framework) is *the role of experience of decision-making in transition economies and its influence on the strategic development of both organisations.* The decision to invest in transition economies was a significant step in both companies. The investment decision methods elaborated by Ericsson for Russia and by Vattenfall for the Baltic countries, including investigation of the investment climate, risk reduction methods, project evaluation techniques, etc., play an important role in the wider processes of organisational perception, governance and strategic development. The knowledge acquired during particular investment projects had been integrated into the company’s routines, traditions, and culture. The experience of working in transition economies might then become a powerful tool for organisational change during the uncertain and rapidly changing conditions world-wide.

It is not always recognised how dramatically the whole structure of decision-making has changed when companies entered turbulent markets - how many more rights and capacities are generally established for particular managers, and how many more complex educational, occupational, and psychological properties they possess! What environments demand, environments often supply. Particularly successful managers are able either to buffer their organisations from the environmental disturbances of transition economies or to arrange smooth adjustments that require minimal disruption of organisational structure.

The special focus on the transition economies of Central and Eastern Europe provides managers with insights that may influence their future competitive positions in the global arena. Managers involved in the decision-making in transition economies can use previous cases to reflect on the need to adapt their own perspective to other situations and to explore their areas of applicability and the limits to their relevance.

*Companies that entered the new emerging markets come equipped with approaches, techniques, knowledge and experience of how to deal with uncertain, complex and turbulent environments.*
Malmberg, Sölvell and Zander suggested a concept, a ‘Greta-Garbo effect,’ after the Swedish actress who was attracted by the creativity of the Hollywood milieu. “By moving there, she was able to develop her acting skills and become a movie star. At the same time she added to the artistic development of the milieu and created returns which could be reinvested in new projects.” (1996, p. 16). This approach was used by Meyer (1996) to explain such seemingly paradoxes as Korean FDI in the Californian semiconductor industry. By becoming an insider they obtained access to the knowledge pool in the Silicon Valley, which enriched their own innovation and development strategy. If we follow the logic of the concept, entering the new emerging markets of Central and Eastern Europe might challenge, enrich and even change the traditional decision-making routines of Western companies.

13.6. Suggestions for future research

The rapid growth of FDI inflows conducted by MNE increases the need for a theoretically sound model of cross-border investment appraisal. With only two cases in the presented study, the relating of differences in industry and country of origin to underlying variables has been difficult. Thus, a wider range of home countries should be analysed, considering for instance the United States of America, which is a major investor in transition economies, but also in Western European countries.

Another important issue is the diversity of changes, which are taking place in Central and Eastern Europe. Rather than assuming that all countries in transition are alike, future researchers should search for the reasons why different economic forms arise in varying social and cultural contexts. Comparing transition economies with Asian and Latin American emerging markets would also be a worthwhile goal of future research. Such ambitious tasks as international comparative studies require building international networks of researchers from different countries.

As no single academic approach alone could possibly accommodate the complexity of intertwining causal chains in a unified model, there is a visible need for an interdisciplinary research design. Foreign investment decision-making is not a self-determined issue. The further development of main concepts, as well as the accumulation of empirical data, are, in my view, only achievable through the integration of capital budgeting techniques and other research areas that influence investment decision-making. Within management studies, the contribution of organisation theory, financial management, a company’s strategy, international management, marketing, and even human resource costs and accounting should be considered. The incorporation of achievements from other academic disciplines - economics, political science, sociology, history, geography, anthropology, psychology, law etc. - might also contribute to the creation of a ’synthesising’ approach to decision-making issues.

For the traditional theories, we need to re-focus attention on the underlying assumptions, in order to explore their areas of applicability and the limits to their relevance. In addition, we need to discover and invent new approaches, concepts and terms relevant to this specific context. Since we do not know at this point in time what the post-industrial company may be, we must not limit our creativity as researchers, nor as managers, by prematurely investing in assumptions and frameworks which may turn out to be less than ideal for the new opportunities (and threats) to be discovered.
We need to explore alternative solutions with managers dealing with extreme complexity on a day-to-day basis, try out alternative options and invent new ones, and more than ever be critical about the relevance of the existing body of knowledge as well as sensitive to the possibilities created in this new and exciting context. It can be argued then that researchers increasingly should examine very specific and localised circumstances in order to explain foreign investment decision-making, as opposed to the generalising approach.

I believe that scholars can start to take advantage of the ‘natural experiments’ that are available in transition economies due to the high rate of changes occurring in a short period. The access to such ‘experiments’ might be achieved, for examples, through Western advisors or consultants who work in Central and Eastern Europe helping to build the market economy’s system that has emerged from scratch.

It may be also necessary to employ longitudinal designs of some strategically selected cases. Placing a decision-making process in time - systematically situating particular moments in a temporal sequence of events and processes stretching from the past into the future - from the fall of the Berlin wall - first joint venture experiences - Russian crisis - etc. - can greatly enrich our understanding of complex social dynamics.

I believe that timing dimension will be more and more the focus of researchers’ attention. When a particular event in a sequence occurs will make a big difference for FDI decision-making. Order in a sequence might be crucial to explaining outcomes. It is not just a matter of what happens, but of when it happens. The significance of sequencing and simultaneity in decision-making means that we wish to know not just what the ‘value’ of some variable is, but the order in which these variables should appear. The ‘small’ events at earlier stages of development might have a big impact on a company’s establishment on the foreign market, while ‘large’ events at later stages may be less consequential.

Another possibility is to explore concepts such as tempo and duration. In such instances, we may gain some understanding of the events that interrupt on-going sequences by paying closer to attention to the speed and length of particular processes. Where disruptive events are relevant, we may need to think of processes not only as ‘too early’ or ‘too late’, but perhaps as ‘too short’.

The interruption of some process by an event, where the specific timing of the event relative to the on-going process has very significant consequences, might also be an interesting field for investigation. How has the decision-making process changed after, say, the Russian crises? Was it the ‘objective’ background of the decision-making, like capital budgeting calculations, that changed, that changed, or was it manager’s perceptions that changed? In such an analysis, events matter because they cut into on-going sequences in ways that alter trajectories.

Companies may also develop double standards, one ideology for internal decision-making and another one for external use. It is then necessary to distinguish between the cognitive and communicational purposes of making decisions. Hence, researchers should not simply register facades; they should also make an attempt to look behind them.
It is suggested that research should pay attention to two level of analysis: organisational fields, or company level, and the individual level, or particular managers authorised to make decisions. The question of whether decisions are constructed primarily from the bottom up through the actions of participating managers or whether they are strongly shaped by external, top-down environmental forces is also on the agenda.

To conclude, presenting the state of the art of current thought, challenging traditional models and offering alternative ways of describing and analysing FDI decision making are the main directions available to the researchers. Discussions about FDI decision-making in transition economies then may alter the issues of the strategic values of companies, the purpose and meaning of the decision-making process, the rationale and legitimacy of organisational boundaries, the conditions under which different interests can be pursued and the way in which uncertainty and turbulence are handled by the companies. One can claim that the East European experience is an excellent starting point for reassessing the stability and completeness of theories and research methods we often take for granted.
## TEN LEADING COUNTRIES WITH THE LARGEST AMOUNT OF CUMULATIVE INVESTMENT IN THE RUSSIAN ECONOMY AS OF JULY 1, 1999

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Amount of foreign investment, million USD</th>
<th>% of the total amount of cumulative foreign investment</th>
<th>Amount of FDI, million USD</th>
<th>% of the total amount of cumulative FDI, million USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Germany</td>
<td>6480,0</td>
<td>23,3</td>
<td>950,3</td>
<td>8,1</td>
</tr>
<tr>
<td>2</td>
<td>USA</td>
<td>5852,9</td>
<td>21,0</td>
<td>4099,3</td>
<td>35,1</td>
</tr>
<tr>
<td>3</td>
<td>United Kingdom</td>
<td>3677,4</td>
<td>13,2</td>
<td>705,1</td>
<td>6,0</td>
</tr>
<tr>
<td>4</td>
<td>France</td>
<td>3344,7</td>
<td>12,0</td>
<td>164,8</td>
<td>1,4</td>
</tr>
<tr>
<td>5</td>
<td>Cyprus</td>
<td>3241,3</td>
<td>11,7</td>
<td>2644,9</td>
<td>22,6</td>
</tr>
<tr>
<td>6</td>
<td>Italy</td>
<td>622,6</td>
<td>2,2</td>
<td>148,8</td>
<td>1,3</td>
</tr>
<tr>
<td>7</td>
<td>Netherlands</td>
<td>567,3</td>
<td>2,0</td>
<td>445,1</td>
<td>3,8</td>
</tr>
<tr>
<td>8</td>
<td>Sweden</td>
<td>370,3</td>
<td>1,3</td>
<td>222,7</td>
<td>1,9</td>
</tr>
<tr>
<td>9</td>
<td>Japan</td>
<td>343,6</td>
<td>1,2</td>
<td>149,3</td>
<td>1,3</td>
</tr>
<tr>
<td>10</td>
<td>Finland</td>
<td>324,7</td>
<td>1,2</td>
<td>252,1</td>
<td>2,2</td>
</tr>
</tbody>
</table>

Source: Foreign Investment Promotion Center (FIPC) under the Ministry of Economy of the Russian Federation, archives
1. ‘Transition economy’ is sometimes defined as ‘a non-planned, non-market’ economy. Therefore, transition economy might be characterised by uncertainties associated with coexistence of emerging market with ruined but still operating old administrative system. Define the importance of suggested uncertainties for FDI decision-making in transition economies according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant

☐

Other suggestions and comments

2. The following main components of transition economy are often suggested by the researchers and policy-makers. Please, define the importance of those components for FDI decision-making in transition economies according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant

☐ Stabilisation
☐ Liberalisation
☐ Privatisation
☐ Reformation of government
☐ Reform of educational system

Other suggestions and comments

3. What are the main characteristics of transition economy that influence the FDI decision-making? (Define the importance of the suggested parameters according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant)

☐ General political instability
☐ Unpredictability of development
Lack of institutional development (public infrastructure, banking system, etc.)

Lack of legal rules and procedures regulating market and property rights’ guarantee

Corruption in the government agencies

The existence of Mafia in the local country

Other suggestions

a)

b)

c)

4. Please, choose an alternative (or some alternatives) among the suggested assumptions that describe in the best way the nature of FDI decision-making in transition economies. (Please, define the correctness of the following assumptions according to the following grades: 1 - the assumption is right, 0 - the assumption is wrong)

- Is similar to investment decision-making in the projects in the Western economies

- Is a unique process that require special methods and knowledge to deal with

- Is similar to decision-making in the emerging markets (like China, Latin America, etc.)

Other comments and suggestions

5. Why do companies make FDI in transition economy? (Define the importance of the following reasons according to the following grades: 2 -very important, 1 - have some impact, 0 - not relevant)

- Internalisation strategy in order to expand company’s advantages abroad : markets for its technological know-how, marketing ability, goodwill, effective management, etc.

- FDI enhances the firm’s access to low cost labour inputs
Benefits of national resources and low local production costs

The size of a domestic market

‘Defensive’ investment in order to be early in the market in comparison with competitors

Comments

6. What other motives can explain FDI to transition economies? (Define the importance of the following reasons according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant)

- A step-by-step process where future expansion depends on the success of the previous investments
- Geographical position and closeness to Scandinavian region
- Historical contacts and cultural affinity with the Scandinavian region
- Successful transformation process from socialist economy to market economy

Suggestions about other factors (please, specify)

7. Did you collect the information about a transition economy’s investment climate prior to making FDI decisions?

- Yes
- No

8. If Yes, how complete was the information that you collected about the following parameters (2 - we collected an exhaustive complete information, 1 - we collected some information, 0 - we did not collect the information about this parameter)

- Macro-economic situation and tendencies
- Institutional infrastructure
- Social climate (for example, working conditions)
Political climate (risk for nationalisation’s or expropriations, change of regime)

Additional comments

9. Define the importance of the following information data collecting methods for FDI decision-making in transition economies according to the following grades: 2 - a method is very important, 1 - a method is used sometimes, 0 - a method has never been applied.

☐ Knowledge of managers
☐ Expert opinions
☐ Qualitative structured methods (Delphi techniques, standardised checklists and different scenario methods)
☐ Quantitative analysis (regression analysis, correlation coefficients, etc.)
☐ Mass media information

Suggestions about other methods (please, specify)

10. Do you think that collecting the information about investment climate in transition economies is more important for transition economies than for the developed economies?

☐ Yes
☐ No

Additional comments

11. What traditional capital budgeting methods were used to evaluate the FDI projects in transition economies? (Please, put a cross nearby those methods that, according to your experience, were used for evaluation of projects.)

☐ The Net Present Value (NPV) of the investment
☐ The Pay-back Method
☐ The Accounting Rate of Return Method
☐ The Internal Rate of Return Method
12. Please, specify the correctness of the following statement "Non of these methods can help to make the right decision in transition economies" according to the following grades: 1 - the suggestion is right; 0 - the suggestion is wrong:

☐

Comments

13. Do you think that some opportunities opened before a company - like strategic competitive advantages, market position, access to the natural resources, etc. - could explain starting the project even if orthodox NPV is negative, especially when the project consists of several steps and the information about the total cost of investment will be revealed only as the first few steps of the project are undertaken? (Please, choose one alternative.)

☐ Yes, it is possible

☐ No, it is not possible

Additional comments

14. Which alternative describes in the best way the role of traditional calculation in FDI decision-making in transition economy? (Please, choose one alternative.)

☐ The decision is primarily based on calculations

☐ After the decision had been already made, the decision-maker provided the full packet of calculations according to the capital budgeting techniques

☐ The decision-maker ‘balance’ all the time between the calculations and other strategic positions

Additional comments
15. How useful were the following investment decision criteria for evaluation of FDI in transition economies? (Define their usefulness according to your experience with the following grades: 2 - a criteria was often used, 1 - a criteria was used sometimes, 0 - a criteria had never been applied)

☐ Judgement and intuition of managers
☐ Personal contacts with business sector from the local country
☐ Contacts with the representatives of the government from the local country

Suggestions about other factors (please, specify)

16. Do the political risks influence the FDI decision-making in transition economies? (Please, choose one alternative)

☐ Political risk is too general concept and did not influence a particular project
☐ Political risks had some influence on a particular project
☐ Political risks essentially influenced decision to invest into particular project

Other comments (please, specify)

17. How do macro risks (= risks that influences all investors in the same way, like expropriation or ethnic strife) influence the FDI decision-making in transition economies? (Please, choose one alternative)

☐ Macro risks are too general to be taken into consideration and influence the particular project
☐ Macro risks had some influence on the particular project
☐ Macro risks essentially influenced decision to invest into particular project

Others comments (please, specify)

18. What type of micro risks do influence the FDI decision-making in transition economies? (Define the importance of risks according to the following grades: 2 - very important, 1 - have some impact, 0 - not relevant)

☐ Industry risks (Risks that affect only selected industries, for example selective expropriations, discriminatory taxes and import restrictions for specific industries)
Company and project risks (Selective expropriations, discriminatory taxes and import restrictions for specific firms and projects)

Suggestions about other risks (please, specify)

19. What type of measures were used to reduce FDI’ risks in transition economies? (Please, define according to the following grades: 2 - a method was often used, 1 - a method was used sometimes, 0 - a method has never been used. You can choose several methods).

- A ‘step by step’ strategy, or gradual transfer of investment money
- Negotiating with the government about investment incentives prior to investment (profit repatriation guarantee and tax holidays)
- Preparing a crisis plan in case the situation deteriorates
- Insuring the investment or getting assistance help within private or government organisations
- High liquidity of assets
- Creation of strong alliances with important power centres that will safeguard the interest of the project under changing conditions

Other suggested measures (please, specify)

20. Did you reflect additional risks associated with FDI in transition economies in project evaluations? (Please, choose one alternative.)

- No, we did not make such adjustments for transition economies
- Yes, we made adjustments in calculations for higher risks associated with projects in transition economies

Comments

21. If YES, please, specify which method (or methods) among the selected were used to reflect risks in transition economies?

- To increase the discount rate applicable to foreign projects relative to the rate used for domestic projects
To adjust the forecasted cash flow of the project

Shortening the minimum pay-back period

Others suggestions (please, specify)

22. Risk adjustments for project evaluations were ... (Please, choose an alternative)

☐ elaborated for a particular project

☐ elaborated for a particular country

☐ the same for all transition economies

☐ the same for all emerging markets

Additional comments
SUPPLEMENT 3

**Black and Scholes (1973) formula developed for pricing stock market traded options**

The following assumptions are considered:

- The option can be exercised at maturity only
- There are no transaction costs and no taxes
- The risk-free rate of interest is constant for the life of the option
- The shares on which the underlying option is granted no cash dividends
- Share prices follow a random walk and the variance of the return on the share is constant over the life of the option. The historic variance may be estimated using past data.

\[
C = S N (\text{dist 1}) - \frac{E N (\text{dist 2})}{e^{r t}}
\]

where

- \(C\) price of the call option
- \(S\) current price of the shares
- \(E\) exercise price (in some texts this is referred to as \(X\))
- \(t\) time remaining before expiration of the option, usually expressed as a proportion of a year
- \(r\) the continuously compounded risk-free rate of interest
- \(e\) the base of the natural logarithm, or 2.71828

\(N (\text{dist 1})\) and \(N (\text{dist 2})\) the value of the cumulative normal density function. This is a statistical term and is easily found from tables showing the area of the normal distribution that is a specified number of standard deviations to the left or right of the mean.

\(\sigma^2\) the variance of the continuously compounded rate of return on the share. So \(\sigma\) is the standard deviation of the continuously compounded return

\[
dist 1 = \frac{\ln (S / E) + (r + 1/2 \sigma^2) t}{\sigma \sqrt{t}}
\]

\[
dist 2 = dist 1 - \sigma \sqrt{t}
\]

*Source: Black, Fischer and Myron Scholes (1973) "The Pricing of Options and Corporate Liabilities”. In: "Journal of Political Economy", 81, May-June, pp. 637 - 654*
RISK ASSESSMENT AND PROGNOSES OF SALES FOR DIFFERENT COUNTRIES OF THE EASTERN EUROPE

Sales

Risk ranking

1. Check Republic, Poland, Hungary
2. Slovak Republic, Baltic countries, Croatian Republic, Bulgaria
3. Kazakhstan
4. Ukraine, Uzbekistan, Turkmenistan
5. Russia (with reduced political risk)

Source: Ericsson
KEY CHARACTERISTICS OF RUSSIAN TELECOMMUNICATION INDUSTRY IN COMPARISON WITH OTHER COUNTRIES

Penetration, fixed lines

Digitalisation of access lines
Penetration, cellular

Russia
France
Hungary
UK
Sweden

Source: "Russian telecommunications sector", June 1997, Hagstromer & Qviberg equities, pp. 1-2, 7
STRUCTURE OF SVYAZINVEST, HOLDING OF THE RUSSIAN TELECOMMUNICATION INDUSTRY

SVYAZINVEST

80 Local Telecom Companies
- Uralsvyazinform
- Adygeyaelectrosvyaz
- Khakassiyaelectrosvyaz

Petersburg Telephone Network

Research Institute Giprovyaz

Rostelecom

Svyaz, Komi Republic

Moscow City Telephone

Voting control

88 Telecom Companies

Non-voting Control

Source: Svyazinvest’s archives
Production of electricity (TWh), installed capacity (MW) and the largest energy companies in the Baltic region

<table>
<thead>
<tr>
<th>Country</th>
<th>Annual production of electricity, TWh</th>
<th>Installed capacity, MW</th>
<th>The largest energy companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>50,4</td>
<td>10900</td>
<td>ELSAM and Elkraft produce 100% of electricity</td>
</tr>
<tr>
<td>Estonia</td>
<td>7,2</td>
<td>3300</td>
<td>Eesti Energia is the largest producer</td>
</tr>
<tr>
<td>Finland</td>
<td>66,4</td>
<td>15000</td>
<td>Imatran Voima Oy is the largest producer with 35% share</td>
</tr>
<tr>
<td>Germany</td>
<td>507,6</td>
<td>114000</td>
<td>Three largest producers - RWE Energie, Preussen Electra and Bayernwerk</td>
</tr>
<tr>
<td>Latvia</td>
<td>3,5</td>
<td>2100</td>
<td>Latvenergo is the largest producer</td>
</tr>
<tr>
<td>Lithuania</td>
<td>14,4</td>
<td>5800</td>
<td>Ignalina is the largest producer</td>
</tr>
<tr>
<td>Norway</td>
<td>104,9</td>
<td>27600</td>
<td>Statkraft SF is the largest producer with 30% share</td>
</tr>
<tr>
<td>Poland</td>
<td>137,1</td>
<td>33100</td>
<td>About 30 producing companies, Polish Power Grid Company manages transmission nets and sales</td>
</tr>
<tr>
<td>Russia (north-west part)</td>
<td>58,7 (totally for Russia 860)</td>
<td>14000</td>
<td>RAO EES Rossii and 6 regional energy companies produce the major part of electricity</td>
</tr>
<tr>
<td>Sweden</td>
<td>136,0</td>
<td>34200</td>
<td>Vattenfall AB is the largest producer with 50% share</td>
</tr>
</tbody>
</table>

Source: "Elmarknaderna runt Östersjön 1997", NUTEK, Swedish National Board for Industrial and Technical Development, p. 8
## ESTONIA’S MAIN COUNTRY DATA AND KEY MACROECONOMIC INDICATORS

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Population (million, mid-year)</td>
<td>1.50</td>
<td>1.48</td>
<td>1.46</td>
<td>1.46</td>
<td>1.43</td>
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<tr>
<td>GDP (billion USD at official exchange rate)</td>
<td>2.33</td>
<td>3.60</td>
<td>4.32</td>
<td>4.63</td>
<td>5.21</td>
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<tr>
<td>GDP per capita (USD)</td>
<td>1,553</td>
<td>2,433</td>
<td>2,960</td>
<td>3,168</td>
<td>3,643</td>
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<td>Real GDP growth (%)</td>
<td>-1.8</td>
<td>4.3</td>
<td>3.5</td>
<td>10.62</td>
<td>4.04</td>
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<td>Inflation (%)</td>
<td>41.7</td>
<td>28.9</td>
<td>14.8</td>
<td>11.17</td>
<td>10.58</td>
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<tr>
<td>Unemployment (%)</td>
<td>5.1</td>
<td>5.0</td>
<td>5.5</td>
<td>9.65</td>
<td>9.88</td>
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<tr>
<td>Export fob (billion USD)</td>
<td>1.327</td>
<td>1.848</td>
<td>2.079</td>
<td>2.30</td>
<td>2.68</td>
</tr>
<tr>
<td>Import fob (billion USD)</td>
<td>1.688</td>
<td>2.540</td>
<td>3.205</td>
<td>3.42</td>
<td>3.80</td>
</tr>
<tr>
<td>Trade balance (billion USD)</td>
<td>-0.361</td>
<td>-0.692</td>
<td>-1.126</td>
<td>-1.13</td>
<td>-1.12</td>
</tr>
<tr>
<td>Current account balance (billion USD)</td>
<td>-0.171</td>
<td>-0.185</td>
<td>-0.445</td>
<td>-0.56</td>
<td>-0.48</td>
</tr>
<tr>
<td>FDI inflows (gross, billion USD)</td>
<td>0.214</td>
<td>0.203</td>
<td>0.138</td>
<td>0.266</td>
<td>0.574</td>
</tr>
</tbody>
</table>

## LATVIAN’S MAIN COUNTRY DATA AND KEY MACROECONOMIC INDICATORS

<table>
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<tbody>
<tr>
<td>Population (million, mid-year)</td>
<td>2.55</td>
<td>2.51</td>
<td>2.49</td>
<td>2.47</td>
<td>2.45</td>
</tr>
<tr>
<td>GDP (billion USD at official exchange rate)</td>
<td>3.66</td>
<td>4.48</td>
<td>5.09</td>
<td>5.52</td>
<td>6.40</td>
</tr>
<tr>
<td>GDP per capita (USD)</td>
<td>1,432</td>
<td>1,778</td>
<td>2,045</td>
<td>2,236</td>
<td>2,613</td>
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<tr>
<td>Real GDP growth (%)</td>
<td>0.6</td>
<td>-1.6</td>
<td>2.8</td>
<td>8.61</td>
<td>3.56</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>26.3</td>
<td>23.1</td>
<td>13.1</td>
<td>8.40</td>
<td>4.67</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>7.0</td>
<td>7.0</td>
<td>7.8</td>
<td>7.50</td>
<td>7.58</td>
</tr>
<tr>
<td>Export fob (billion USD)</td>
<td>0.997</td>
<td>1.304</td>
<td>1.443</td>
<td>1.66</td>
<td>1.80</td>
</tr>
<tr>
<td>Import fob (billion USD)</td>
<td>1.375</td>
<td>1.817</td>
<td>2.320</td>
<td>2.72</td>
<td>3.19</td>
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<tr>
<td>Trade balance (billion USD)</td>
<td>-0.378</td>
<td>-0.513</td>
<td>-0.877</td>
<td>-1.05</td>
<td>-1.39</td>
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<tr>
<td>Current account balance (billion USD)</td>
<td>0.201</td>
<td>-0.021</td>
<td>n. a.</td>
<td>-0.35</td>
<td>-0.71</td>
</tr>
<tr>
<td>FDI inflows (gross, billion USD)</td>
<td>0.214</td>
<td>0.180</td>
<td>n. a.</td>
<td>0.52</td>
<td>0.10</td>
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LITHUANIAN’S MAIN COUNTRY DATA AND KEY MACROECONOMIC INDICATORS

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, mid-year)</td>
<td>3.73</td>
<td>3.72</td>
<td>3.71</td>
<td>3.71</td>
<td>3.71</td>
</tr>
<tr>
<td>GDP (billion USD at official exchange rate)</td>
<td>4.27</td>
<td>5.96</td>
<td>7.78</td>
<td>9.59</td>
<td>10.69</td>
</tr>
<tr>
<td>GDP per capita (USD)</td>
<td>1,147</td>
<td>1,602</td>
<td>2,095</td>
<td>2,581</td>
<td>2,881</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>1.0</td>
<td>3.0</td>
<td>3.6</td>
<td>7.28</td>
<td>5.15</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>45.1</td>
<td>35.7</td>
<td>13.1</td>
<td>8.91</td>
<td>5.10</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>4.5</td>
<td>7.3</td>
<td>6.2</td>
<td>5.90</td>
<td>6.40</td>
</tr>
<tr>
<td>Export fob (billion USD)</td>
<td>2.029</td>
<td>2.707</td>
<td>3.280</td>
<td>4.19</td>
<td>3.96</td>
</tr>
<tr>
<td>Import fob (billion USD)</td>
<td>2.353</td>
<td>3.083</td>
<td>4.405</td>
<td>5.34</td>
<td>5.48</td>
</tr>
<tr>
<td>Trade balance (billion USD)</td>
<td>-0.325</td>
<td>-0.376</td>
<td>-1.125</td>
<td>-1.15</td>
<td>-1.52</td>
</tr>
<tr>
<td>Current account balance (billion USD)</td>
<td>-0.090</td>
<td>-0.056</td>
<td>n. a.</td>
<td>-0.98</td>
<td>-1.30</td>
</tr>
<tr>
<td>FDI inflows (gross, billion USD)</td>
<td>0.031</td>
<td>0.146</td>
<td>n. a.</td>
<td>0.355</td>
<td>0.926</td>
</tr>
</tbody>
</table>

* billion LTL

RUSSIA’S MAIN COUNTRY DATA AND KEY MACROECONOMIC INDICATORS

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<tbody>
<tr>
<td>Population (million, mid-year)</td>
<td>148.0</td>
<td>147.9</td>
<td>147.7</td>
<td>147.10</td>
<td>147.11</td>
</tr>
<tr>
<td>GDP (billion USD at official exchange rate)</td>
<td>277.2</td>
<td>357.7</td>
<td>440</td>
<td>435.41</td>
<td>308.25</td>
</tr>
<tr>
<td>GDP per capita (USD)</td>
<td>1,873</td>
<td>2,419</td>
<td>2,980</td>
<td>2,960</td>
<td>2,095</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>-12.7</td>
<td>-4.2</td>
<td>-6</td>
<td>0.90</td>
<td>-4.60</td>
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<tr>
<td>Inflation (%)</td>
<td>215</td>
<td>131.4</td>
<td>21.8</td>
<td>14.74</td>
<td>27.66</td>
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<tr>
<td>Unemployment (%)</td>
<td>7.5</td>
<td>8.8</td>
<td>9.3</td>
<td>10.81</td>
<td>11.88</td>
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<tr>
<td>Export fob (billion USD)</td>
<td>67.7</td>
<td>81.6</td>
<td>n. a.</td>
<td>88.4</td>
<td>74.1</td>
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<tr>
<td>Import fob (billion USD)</td>
<td>48.0</td>
<td>58.9</td>
<td>n. a.</td>
<td>73.6</td>
<td>58.9</td>
</tr>
<tr>
<td>Trade balance (billion USD)</td>
<td>19.7</td>
<td>22.7</td>
<td>n. a.</td>
<td>14.8</td>
<td>15.2</td>
</tr>
<tr>
<td>Current account balance (billion USD)</td>
<td>11.4</td>
<td>12.3</td>
<td>n. a.</td>
<td>3.6</td>
<td>2.4</td>
</tr>
<tr>
<td>FDI inflows (gross, billion USD)</td>
<td>0.638</td>
<td>2.017</td>
<td>n. a.</td>
<td>6.24</td>
<td>2.18</td>
</tr>
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</table>

Sources: "Key Economic Indicators. Macroeconomic Indicators for Fourteen Transition Economies of Central and Eastern Europe", Stockholm Institute of Transition Economics and East European Economies, Stockholm School of Economics; 1997 - 1999
### Electricity consumption by different sectors in the Baltic countries during the period 1990 - 1996, TWh

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Industry</td>
<td>3.0</td>
<td>2.9</td>
<td>1.9</td>
<td>1.9</td>
<td>2.0</td>
<td>2.1</td>
<td>n. a.</td>
</tr>
<tr>
<td>Transport</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>n. a.</td>
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<tr>
<td>Housing and service</td>
<td>3.7</td>
<td>3.7</td>
<td>3.2</td>
<td>2.8</td>
<td>3.0</td>
<td>2.6</td>
<td>n. a.</td>
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<tr>
<td>Total consumption</td>
<td>6.8</td>
<td>6.7</td>
<td>5.2</td>
<td>4.8</td>
<td>5.2</td>
<td>4.9</td>
<td>5.5</td>
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<td>Industry</td>
<td>3.2</td>
<td>3.4</td>
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<td>1.4</td>
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<td>Transport</td>
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<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>n. a.</td>
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<td>Housing and service</td>
<td>5.2</td>
<td>4.7</td>
<td>3.8</td>
<td>3.0</td>
<td>2.8</td>
<td>2.9</td>
<td>n. a.</td>
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<tr>
<td>Total consumption</td>
<td>8.8</td>
<td>8.4</td>
<td>6.4</td>
<td>4.7</td>
<td>4.5</td>
<td>4.5</td>
<td>n. a.</td>
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<td>Industry</td>
<td>5.2</td>
<td>4.8</td>
<td>4.5</td>
<td>3.1</td>
<td>2.8</td>
<td>2.8</td>
<td>3.2</td>
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<tr>
<td>Transport</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
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<tr>
<td>Housing and service</td>
<td>6.5</td>
<td>6.8</td>
<td>5.1</td>
<td>3.8</td>
<td>3.7</td>
<td>3.5</td>
<td>3.3</td>
</tr>
<tr>
<td>Total consumption</td>
<td>12.0</td>
<td>11.9</td>
<td>9.7</td>
<td>7.0</td>
<td>6.6</td>
<td>6.4</td>
<td>6.6</td>
</tr>
</tbody>
</table>


### The consumption of electricity per person in the Baltic countries during the period 1990 - 1996

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>4334</td>
<td>4277</td>
<td>3394</td>
<td>2741</td>
<td>3467</td>
<td>3311</td>
<td>3767</td>
</tr>
<tr>
<td>Latvia</td>
<td>3282</td>
<td>3166</td>
<td>2417</td>
<td>1815</td>
<td>1765</td>
<td>1793</td>
<td>n. a.</td>
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<tr>
<td>Lithuania</td>
<td>3215</td>
<td>3165</td>
<td>2442</td>
<td>1787</td>
<td>1771</td>
<td>1710</td>
<td>1782</td>
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Electricity prices on the 1 of January 1997, öre per kWh, including taxes and VAT

<table>
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<tr>
<th></th>
<th>Householders 600-3500 kWh per year</th>
<th>Industry 1,25 GWh per year</th>
<th>Industry 500 GWh per year</th>
<th>Inflation rate, %</th>
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<tr>
<td><strong>Estonia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1995</td>
<td>22</td>
<td>22</td>
<td>n. a.</td>
<td>28.9</td>
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<tr>
<td>1996</td>
<td>22</td>
<td>35</td>
<td>21</td>
<td>14.8</td>
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<tr>
<td>1997</td>
<td>25</td>
<td>41</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td><strong>Latvia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>21</td>
<td>n. a.</td>
<td>34</td>
<td>23.1</td>
</tr>
<tr>
<td>1996</td>
<td>23</td>
<td>n. a.</td>
<td>29</td>
<td>13.1</td>
</tr>
<tr>
<td>1997</td>
<td>40.5</td>
<td>40.2</td>
<td>23.4</td>
<td>n. a.</td>
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Import and export of electricity in the Baltic countries during 1990 - 1996, TWh

<table>
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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Estonia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Import</td>
<td>1.5</td>
<td>2.2</td>
<td>0.3</td>
<td>0.0</td>
<td>0.3</td>
<td>0.2</td>
<td>n. a.</td>
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<tr>
<td>Export</td>
<td>8.5</td>
<td>7.0</td>
<td>3.5</td>
<td>1.6</td>
<td>1.5</td>
<td>1.0</td>
<td>n. a.</td>
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<tr>
<td>Net export</td>
<td>7.0</td>
<td>4.8</td>
<td>3.2</td>
<td>1.6</td>
<td>1.2</td>
<td>0.8</td>
<td>n. a.</td>
</tr>
<tr>
<td><strong>Latvia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Import</td>
<td>4.0</td>
<td>7.0</td>
<td>7.5</td>
<td>2.7</td>
<td>2.6</td>
<td>2.6</td>
<td>3.2</td>
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<tr>
<td>Export</td>
<td>0.4</td>
<td>2.8</td>
<td>3.4</td>
<td>0.2</td>
<td>0.8</td>
<td>0.4</td>
<td>n. a.</td>
</tr>
<tr>
<td>Net export</td>
<td>-3.6</td>
<td>-4.2</td>
<td>-4.1</td>
<td>-2.5</td>
<td>-1.8</td>
<td>-2.3</td>
<td>n. a.</td>
</tr>
<tr>
<td><strong>Lithuania</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Import</td>
<td>4.5</td>
<td>3.7</td>
<td>5.3</td>
<td>5.7</td>
<td>7.2</td>
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<td>4.2</td>
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<tr>
<td>Export</td>
<td>16.5</td>
<td>16.5</td>
<td>10.6</td>
<td>8.5</td>
<td>8.5</td>
<td>7.9</td>
<td>9.3</td>
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<tr>
<td>Net export</td>
<td>12.0</td>
<td>12.8</td>
<td>5.3</td>
<td>2.7</td>
<td>-1.1</td>
<td>2.7</td>
<td>5.2</td>
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