International Business Research
on Transition Economies

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Introduction

Until 1989, the countries of the Soviet bloc traded primarily in autarky from the world economy. The small volumes of East-West business were conduced on the basis of counter-trade negotiated with state-trade monopolies (e.g. Neale and Shipley 1990). Only few Western businesses operated within the region, including Occidental Petroleum and Great Northern Telecom (Jacobsen 1997) who offered services considered vital by the socialist leadership.

The revolutions of 1989 brought dramatic changes for existing business relationships (e.g. Salmi and Møller 1994) and opened major business opportunities for the first time since respectively 1917 in Russia and 1945 in Central Europe. The region from Prague to Vladivostok embarked on reform from similar starting positions and with comparable objectives, yet with increasingly divers development since[1]. The transition economies in Central and Eastern Europe (CEE) become similar to other medium-income market economies, while most successor states of the Soviet Union are lagging especially in building market-oriented institutions.

The international policy framework evolved very favourably for international business, with rapid reduction of trade barriers and liberalization of foreign investment regulation. Membership in international organizations, such as WTO, facilitated this process. The westernmost countries signed ‘Europe Agreements’ with the European Union that further reduced trade barriers vis-a-vis the union, and became stepping stones towards eventual membership in the union (e.g. Lavigne 1998).

Western businesses were quick to position themselves in the new markets, as is illustrated by the acceleration of foreign direct investment (FDI) in the region,[2] see Figure 1, and the dramatic reorientation in the pattern of international trade (EBRD 1999). However, businesses operating in the region face a distinct institutional environment, which pre-determines the strategic opportunities for businesses (Peng 2000, Hoskisson *et al*. 2000). This creates challenges for managers of both local firms and Western business partners that differ not only from Western experience, but also among transition economies. On the other hand, outward international business from the region has been slow to evolve, and rarely been studied (but see Svetli...i... *et al*. 1999). However, the comparison with China or Latin America (Child 2001, Grosse 2001) suggests that it will be of increasing importance in the near future.

International business research has so far focused on Western multinational firms operating in the region. Research have approached the transition economies in different ways:

- by testing the validity of general theories in the specific context of transition, and
- by exploring and explaining the specific features of the business context and their implications for business operating in the region.

The former is prominent in leading management journals, and offers insights for those pursuing development and refinement of theory in their respective fields. The latter research is generally more exploratory and generates novel insights on the functioning of business in transition economies, and theoretical frameworks to analyse it. It contributes to our understanding of the interaction between firms and their environment, which in turn can stimulate research on the relationships between firm behaviour and institutions in mature market economies. This review focuses on challenges faced by businesses in the transition context drawing upon research beyond mainstream business journals.

This review is structured as follows: section two summarises the microeconomic aspects of economic transition, taking the development of new institutions as starting point as they set the stage for developments in the enterprise sphere. The third section discusses multinational firms entering the region, considering their motives, and their strategies to deal with the specific context. Section four addresses some managerial challenges that arise for multinational firms operating in the region. Section five concludes with perspectives for future research.

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Figure 1 approxiamtely here

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Note to Figure 1: net inflows recorded in the balance of payments, source: EBRD 1999, table 3.1.6.

2. Transition

2.1 New Institutions: What Kind of Capitalism?

The essence of economic transition "from plan to market" (World Bank 1996) is the replacement of one set of institutions governing economic activity by a different one. Institutions, albeit frequently neglected in economic theorising, have an essential role in setting the 'rules of the game' by which individuals interact in a market economy (North 1990). They ensure the competitiveness of markets, for instance by preventing or regulating monopolies, insider trading and negative externalities. Only with a solid framework set by institutions does the free interaction of agents lead to efficient allocation of goods and services.

The Western market economies have built their institutions over decades, if not centuries, and they vary as a result of both different historical evolution and underlying cultures (North 1981). The institutions are supported by strong and impartial states, e.g. as guarantors of law enforcement and an independent judiciary. The path dependency of institutional frameworks let to a variety of 'business systems' that differ not only between the US, Asia and Europe but even within Western Europe (Whitley, ed. 1992).

Eastern Europe is building its institutions under strong outside influence, especially from the Anglo-Saxon sphere. Yet, new institutions cannot be superimposed from above as they must meet not only an efficiency test, but also be socially acceptable (Offe 1995). The distinct cultural and systemic inheritance influences especially informal institutions such as norm and values. In addition, the political development during the early years of transition influenced the way new institutions have been set up, notably the methods of privatisation (Stark 1992, Hare *et al.* 1999). Policy choices made during the period of radical change around 1990 created institutions and established distribution of power. In many countries, the weak legal framework permitted a large extent of opportunistic behaviour, rent shifting, bribery and corruption (e.g. Nelson *et al.* 1998). In some countries, vested interests have been created that would not benefit from further reform (Stiglitz 1999, EBRD 1999). Due to path dependency of institutions, policies during that 'window of opportunity' and the inheritance from the previous regime shape the future institutional frameworks (North 1990, Stark 1992). Consequently, Eastern Europe may develop a distinctive form of capitalism.

In the 1990's, the institutional frameworks were unstable and rapidly changing. The fundamental change in the environment may prompt an expectation of equally radical change of behaviour, but this did not happen in many CEE organisations (Whitley and Csaban 1998a). Even where formal institutions were established quickly, e.g. by copying laws from elsewhere, informal institutions are slow to evolve. Consequently, the process of building institutions in transition economies takes more time than most reform scenarios envisaged in 1990 (Murrell 1992, Kogut 1996). During this process, agents face the additional challenge that they cannot base their decisions on present institutions, which are unstable, and possibly inconsistent. Flexibility and short-term objectives should thus be the norm.

The distinctiveness of the CEE business systems, be it temporary or permanent, limits the transferability of Western business strategies and organisational concepts. Hence, strategies observed in transition economies differ from those in developed economies (Peng and Heath 1996), and strategies applied successfully in one country may fail in another. Corporate strategies in the transition economies can thus be explained only by incorporating the specific institutional context in the analysis. This holds for China (Peng 2000, Child 2001) as well as for Hungary or Russia. Some generalizations across these countries may be helpful, yet one has to be cautious as the variation among transition economies may be just as large as that between transition and mature market economies. The following sections review the evolution of the enterprise sector in this context, starting with the central institution of the market economy - the market.

2.2. From Plan to Market: Change of Co-ordination Mechanisms

During socialism, the central plan was the core institution co-ordinating economic activity. The societies thus had strong vertical co-ordination, but failed, among other, because horizontal linkages between firms were weak (Vlachoutsicos 1998) leading to high transaction costs between enterprises within supply chains. In addition, the plan focussed on quantitative output targets with few incentives for quality and customer service.

The main purpose of transition was to introduce markets as more efficient co-ordination mechanisms. Yet, the old economic system disintegrated before the institutions supporting a market economy were in place. The absence of, among other, systems providing information, accounting and auditing as well legal enforcement of contracts allowed extensive information asymmetries and opportunities for opportunistic behaviour, thus increasing transaction costs (Swaan 1997). The politically motivated push towards creating markets before creating institutions (Hare *et al.* 1999) has been especially drastic in the areas of capital markets. Mass privatization quickly brought firms on the stock exchanges, notably in the Czech Republic. Yet as institutions were not in place, this led to multiple opportunities for abuse by insiders, and in fact very slow restructuring of enterprises (Spicer *et al.* 2000).

In particular, the lack of informal institutions such as routines, knowledge and procedures at the individual and organizational level provoked market failure. Essentially, administrators had to act as independent economic agents from the day the central plan was dissolved. They had to act on markets that did not yet exist; they lacked the (often tacit) knowledge on how to use the market mechanism, and who potential partners and competitors are. Without experience, they had to identify potential types of business and preferences of customers; and they had to assess the composition of demand and supply, and estimate demand elasticity. Thus, agents engaged in considerable search processes to set up transactions and to find the right prices (Swaan 1997).

The lack of institutions increases transaction costs, especially for new business relationships, and thus inhibits many potential transactions, in particular those of complex or long-term nature. The resulting co-ordination failure has been a major cause of the deep recession of the early 1990's (Blanchard and Kremer 1996, Swaan 1997). The most visible consequence of failing markets is the widespread use of barter in several successor states of the former Soviet Union (Gaddy and Ickes 1998, Commander and Momsen 1999, Seabright 2000). Yet it also affects international businesses with the transition economies. Western MNEs lack information on their partners; have to negotiate with persons inexperienced in business negotiations (Antal-Mokos 1998); and confront unclear regulatory frameworks, inexperienced bureaucracy (Thornton and Mikheeva 1996) and the weak enforcement of property rights.

The weaknesses of market institutions, and constraints on internalizing transactions, led to the widespread use of alternative, intermediate mechanisms of exchange through informal networks in CEE (Stark 1996, Clark and Soulsby 1995, Todeva 2000), and even more in Russia (Puffer *et al.* 1996, Holden *et al.* 1998, Salmi 1996, 1999). The post-socialist economies inherited systems of personal networks that served to overcome shortage under the central plan. These networks connected firms to authorities, especially the communist party and the plan ministries, and focussed on influencing plan targets and delivery of crucial inputs.

The central plan regime created large interdependent production units. They were split into separate enterprises, but retained a high degree of asset specificity and resource dependencies. Many firms reacted by recreating inter-firm relationship by informal means to establish industrial groups (Stark 1996, Hayri and McDermott 1998). In Hungary, Stark (1996) observed 'recombinant networks' of firms with interlocking ownership and other formal and informal arrangement between related companies. In Russia financial-industrial groups developed close ties with banks and political institutions and became significant power bases. Where conventional strategies of internal or external growth are inhibited because the markets for relevant resources are defunct, 'network-based growth strategies' offer an alternative (Peng and Heath 1996). Businesses react to imperfect markets by network-based co-ordination.

Informal networks have retained their importance as a co-ordination mechanism, due to structural and cultural characteristics. However, they do not necessarily reflect the needs of a market economy. Many focus on extraction of rents from the state through collusion between businesses, and between business and units (or individuals) of the government, in particular municipal authorities. In a market economy, networks also serve an important role in relating interdependent business and overcoming various market imperfections. Yet clear legal and ethical codes prevent transactions that cause harm to third parties. Restructuring the networks to serve the needs of a market economy is thus an essential component of transformation.

2.3. Privatisation and Corporate Governance

Enterprises in socialist countries had been set-up to achieve the objectives defined by socialist ideology and the central plan, notably the fulfilment of quantitative plan targets. The transition places enterprises at a different place in society, redefining the purpose of their existence. This change involved a formal, legal change and an informal, internal transformation. This section reviews the changes in formal structures through privatisation and systems of corporate governance, and the next section discusses the organisational transformation.

Privatisation in transition differs from Western experiences by the scope of the task, the absence of efficient capital markets, and the lack of private domestic savings that could be invested. These obstacles were overcome by novel routes of privatisation, most notably mass privatisation based on voucher schemes. More conventional modes included direct sales to outside investors, management-employee-buy-outs, and restitution to former owners (Brada 1996, World Bank 1996, Bornstein 1997).

Privatisation is, however, not a sufficient condition to trigger enterprise restructuring. Many privatisations other than by sales to outside investors failed to create powerful incentives that would guide managers in transforming firms. Therefore corporate governance has become the most debated issue in the transition economics literature (e.g. Frydman *et al.* 1997, La Porta, Lopez-de-Silanes and Shleifer 1999, Estrin and Wright 1999). The collapse of communism left state-owned firms without mechanisms for the state to enforce control, and weak internal structures to handle the new demands of the marketplace.

Frequently, managers and/or worker councils attained considerable influence, *de facto* or *de jure*, especially in Poland and many CIS countries. In many cases, insiders managed to convert their *de facto* control into formal ownership by opting for privatisation modes that gave them preferential access to shares. As a result, many firms, particularly in Poland and the former Soviet Union, have managers and employees as minority or even majority shareholders (e.g. Åslund 1995, Blasi et al. 1995). Therefore, theories considering stakeholders, rather than solely shareholders, have been revived to analyse corporate governance in transition economies (Buck *et al.* 1998, Berglöf and von Thadden 1999, Mygind 1999).

Corporate governance problems also arose as a result of voucher privatisation. Most transition countries (with the notable exception of Hungary), have implemented a voucher scheme as a main pillar of their mass privatisation (e.g. World Bank 1996, Estrin and Stone 1996). It permitted the creation of widespread popular ownership of industrial equity and the redistribution of the wealth to citizens in a 'fair' way, thus generating popular support for reform. The Czech scheme - the first and most publicised - privatised a major share of the country's assets in several waves of multiple-auction bidding processes. Investment funds attained considerable power through the accumulation of vouchers and bidding on behalf of individuals (Coffee 1996). They now control major Czech businesses, but themselves are often owned by (largely state owned) banks. This creates interdependent institutions without clear monitoring and control structures, but with multiple agents that have hold-up power (Hayri and McDermott 1998). The resultant lack of effective corporate governance has frequently been blamed for the slow progress of enterprise restructuring (e.g. Nellis 1999).

In Poland, the large privatisation was delayed due to political conflicts over its conditions. In 1996, shares of some 500 enterprises were allocated to government-sponsored investment funds, which in turn were privatised through vouchers that are now traded on the Warsaw stock exchange. Each enterprise was initially owned by a fund holding 33% of equity, plus minority shareholdings by the other funds, workers, and the government. While overcoming defaults of corporate governance in the Czech voucher privatisation, the Polish scheme still suffers from conflicts between different control institutions. In Russia, mass privatisation has been rapid and created a substantial private sector - but dominated by insider ownership (e.g. Boyko *et al.* 1995, Blasi *et al.* 1997, Earle and Estrin 1997, Wright *et al.* 1998). The resulting management and employee ownership may have positive effects on motivation and labour productivity (Ben-Ner and Jones 1995), but can be a major obstacle for restructuring in large firms, if lay-offs or access to outside finance are required.[3]

Following privatisation, the emergence of local equity markets is crucial. The need to raise fresh capital should induce insider-controlled firms to accept new outsider equity stakes and provide acquisition opportunities. However, progress has been slow (Earle and Estrin 1996, Filatochev *et al.* 1996) and ownership patterns are relatively stable (Jones and Mygind 1999*a*, Anderson *et al.* 1999). Especially in the former Soviet Union, it is difficult to obtain ownership and effective control of privatised firms, among other because stock market institutions such as protection of minority shareholders are not in place.

However, competition is at least as important as privatization for enterprises to improve their efficiency - a result consistent with empirical research on privatization in the West (e.g. Vickers and Yarrow 1988). Yet while many major Western privatisations are in industries with natural monopolies that require complex regulation to create competition, most firms privatized in Eastern Europe enjoy monopoly powers courtesy of past or present government policy. After privatization, the key difference is "not how competition affects firm performance, but in the degree to which market forces in transition are either softened or distorted" (Bevan *et al.* 1999:14). Firms in transition frequently face soft budget constraints and obtain protected market positions of various sorts. In Russia, a particular problem appears to be the lack of domestic entry, and thus contestable markets, in part due to protective intervention by regional authorities (Broadman 1999). In other countries, new entrants are a major source of competition (see Section 2.5).

Thus the transition economies are poised to retain corporate governance systems that differ from those in mature market economies, even taking into account the variation found for instance between the US and Continental Europe. Some of the largest firms in the region are subject to weak governance while enjoying close contacts to government and, in some ex-Soviet Union states, considerable barriers to entry. Yet other firms have gone very far in shedding these legacies of the 20th century. This diversity of governance mechanisms and of competition patterns is likely to be a continuing feature of the region for years to come.

2.4. Organisational Transformation

In the socialist regime, firms' overriding objective was plan-fulfilment.[4] The incentives created by central planning led however to severe distortions, such as the production of large volumes of standardised low quality products, lack of concern for consumer demand, disregard for externalities of any kind, notably for the environment. By establishing positions rather than creating jobs, firms employed far more people than necessary to achieve their output target as labour costs were not a constraining variable. Employment relationships were effectively based on life-time employment and enterprises provided many of the social needs of both current and retired employees. The enterprise sector was reasonably efficient in allocative efficiency, but failed dramatically in innovation (Berliner 1976, Murrel 1990, Kogut and Zander 2000). In this system, management had few incentives, or in fact opportunities, to act as business leader or entrepreneur in a Western sense.

As this brief characterisation makes clear, firms have a very different *role* in socialist and in capitalist societies (Heidenreich 1993). Consequently they have different resource configurations, skill and capability reservoirs, and ways of organising themselves. As transformation involves all these areas - and I do not content this would be a complete list - it is a complex task.

It typically started with *defensive adjustments* aimed at survival under hard budget constraints, e.g. laying off workers or shifting the product mix (see reviews by Brada 1996, Carlin 2000, Bevan *et al.* 1999 and EBRD 1999). Productivity improved, even before privatisation, as management reacted to external pressures. However, further *strategic and organisational restructuring* is necessary to attain sustainable competitiveness (Meyer 1998*b*). Few domestic-owned firms have been able to pursue corporate strategies that would lead to a viable position in the international competition (Brada 1996, Wright *et al.* 1998, Stiglitz 1999). Foreign-owned firms engaged in more strategic change such as development of new products, investment in new production facilities, entry into new markets and establishing marketing, new brand names and distribution channels (e.g. Carlin *et al.* 1995, Estrin *et al.* 1997, Newman and Nollen 1998, Djankov 1999*a*, Hooley *et al.* 1996).

At the onset of transition, many advisors focussed on productivity improvements, promoting redundant assets and downsizing to reduce over-employment. However, excessive reliance on cost cutting has been criticised for undermining firms' ability to develop new strategies. A certain degree of slack can be an important resource for innovation (Nohria and Gulati 1996), for managerial learning (Geppert 1996) and thus for transformation. Many firms undoubtedly had excess slack. However, some firms, notably in East Germany, seem to have cut the workforce to such extent that the moral was undermined, and no slack left that could become a source for new growth (Thomson and Millar 1999).

Beyond downsizing, the re-configuration of resources needs a pro-active approach to acquiring complementary resources, through both investment in complementary assets and organisational learning (Uhlenbruck and Meyer 2000). Especially in the area of marketing, firms have to improve their basic competences in terms of structure, systems and processes, organizational culture and human resources (Batra 1997). The learning begins with top managers, who are often not well prepared to lead the transformation process. Many essential management capabilities were not developed under socialism because other skills were asked for. Managerial learning (see Section 4.2) and employee training thus are crucial elements of the resource upgrading.

These organizational changes also include the methods of organising production. The labour process in the socialist period was designed on Taylorist principles, with high degrees of division of labour and technical job specialisation, and close supervision. Yet, the frequency of distortions in supplies, inadequate machinery and to some extent shortage of skilled labour made the full realisation of the cost advantages impossible. As Taylorism has been the norm of industrial production in the 1950s, but passed into history in most sectors in industrial countries, it was expected that transition would instigate the shift to post-Taylorist production (Sorge 1993, Meyer and Møller 1998). Yet evidence from Hungary shows that in some firms, notably locally owned ones, the opposite occurred. Firms refined their 'scientific management' and reduced costs by more precise division between skilled and unskilled workers and more rigorous supervisory control. In the short-term, these firms showed above average productivity and profitability (Whitley and Csaban 1998*b*, Taplin and Frege 1999). Yet it is doubtful if such a strategy will enhance competitiveness in the longer term.

Also other empirical evidence points to continuity rather than radical change. Observing 27 Hungarian case firms, Whitley and Csaban (1998*a*) conclude that by most criteria, they showed a remarkable degree of continuity, for instance in terms of product mix, production technology, and markets. Although top management had often been replaced, the new leaders were typically promoted internally. Interdependence led firms to continue existing relationships rather than to seek business opportunities with different partners (Stark 1996, Todeva 2000). The continuity of personnel, the persisting importance of the political environment and limited role of product market competition contributed to continuity in management strategies and behaviour (Martin 1999, Newman and Nollen 1998).

This continuity is natural, according to the evolutionary view of transformation. Resource re-configuration requires the acquisition of new capabilities, which have to be developed from existing ones, in combination with imported know-how. Organizations thus evolve, rather than reincarnate themselves overnight, when facing change - even radical change - in their environment. Consequently, Spicer, McDermott and Kogut (2000) are concerned that privatization was too radical and broke up existing industry networks and thus inhibited the effective use of co-specialised resources. Kogut (1996) learning through experimentation and internal development of new routines and capabilities adapted to the specific context, rather than the wholesale imposition of imported routines. Lieb-Dóczy and Meyer (2000) suggest that especially foreign acquirers risk losing valuable local capabilities if they concentrate on transfer of their established best practice and neglect development of variety by fostering indigenous capabilities.

In conclusion, ET and the ensuing managerial challenges are complex phenomena that cannot be analyzed satisfactorily with established theoretical frameworks only. Having reached the limits of conventional economic analysis, further analysis may extend the resource-based view of the firm to explore specific challenges of emerging and transition economies (Hoskisson et al. 2000). I see potential in complementing this perspective with organizational learning theory (Uhlenbruck and Meyer 2000), evolutionary theory (Lieb-Dóczy and Meyer 2000) or theory of coordination games (Meyer 2000*c*) to analyze the changing resource base during ET.

2.5. The Growth of Entrepreneurial Start-ups

Despite the major efforts in privatisation, much of the recent economic growth in the transition economies comes from newly established firms. Especially in Poland, the new private sector is flourishing while much of the former state sector is stagnating (e.g. Johnson and Loveman 1995, EBRD 1999). These new firms are often the most dynamic units in the region. Peng (2000) points to four groups of individuals that become entrepreneurs by setting up their own businesses in transition economies:

- Scientists and other professionals pursue entrepreneurial activity in reaction to the rapid decline in real income at their job in the public sector or a privatizing firm. Often this starts as part-time job, notably for academics seeking to better their income through consultancy (Webster and Charap 1993, Kirby et al. 1996).
- Former cadres frequently become entrepreneurs especially in Russia, capitalizing on their control over key resources, including physical and financial assets, and most importantly network connections to the bureaucracy (Rona-Tas 1994, Parish and Michelson 1996).
- Individuals who were left at the bottom of society after losing their previous position may survive as street trader, and gradually upgrade to bazaar trader, and to shop owner-managers. They thus mature from the grey economy to the official economy.
- Farmers may have enjoyed private ownership of their plots, as in Poland, which provided them with initial resources for entrepreneurial activity in related sectors.

The pressure of enterprise transformation created strong push factors for specialists to leave the uncertainty of a privatizing firm, and seek their own fortune. Many, however, retain close business relationships with their former employer, more than spin-offs in the West typically do (Kirby et al. 1996). Entrepreneurial firms thus grow as part of the new corporate networks in the region (Stark 1996). They are joined by managers who attained control, with or without formal ownership, over privatized enterprises.

The newly established businesses benefit, compared to privatized ones, from simple governance structures, low fixed costs, and flexibility to switch from unpromising markets to more attractive ones (Johnson and Loveman 1995, Puffer et al. 2000). Moreover, without the burden of inheritance from a predecessor organization, entrepreneurs have the freedom to hire selectively the most suitable employees. In the early years of liberalisation, many newly established firms were extremely profitable, in part because they offered products not previously available, or served niche markets, and second-movers were slow.

However, the opportunities for entrepreneurs are often constrained by their lack of resources and by the institutional context. Financial resources have been a major constraint for many given the underdeveloped capital markets (Holmström 1996, Johnson and Loveman 1995). Venture capital funds have only recently been established in the region and are gradually developing expertise in assessment and monitoring of entrepreneurial firms in the transition context (Karsai et al. 1997). Yet equally important are human capital as well as political and social capital, i.e. access to key decision-makers in politics and business (Batjargal 2000).

Institutional change permitting the establishment of new businesses and simplifying licensing procedures was the starting call for entrepreneurship. Yet obstacles in the institutional framework are still the main hindrance for further development of entrepreneurial firms, especially in the less advanced transition economies. This includes high informal barriers to entry, weak protection of property rights, excessive bureaucracy, and corruption. For instance, newly established firms pay on average over 5% in 'bribe tax' compared to around 4% for privatised and state-owned firms (EBRD 1999). Johnson, McMillan and Woodruff (1999) found that reinvestment of profits has been especially constrained by the weak protection of property rights. Moreover, entrepreneurs continue to be obstructed by a weak investment climate and indirect barriers to entry (EBRD 1999, Broadman 1999).

Entrepreneurship research on transition economies stands - unless major contributions have escaped my attention - very much at the beginning.[5] However, it ought to be as important as the transformation of existing SOE for the future of these economies, as well as for Western businesses looking for suitable partners in the region.

3. Strategies of Multinational Businesses

3.1. Motivations

Theoretical research has pointed to the importance of factor cost advantages (e.g. Ozawa 1992), as has a comparison of CEE with East Asia (Urban 1992, UN 1995, Meyer 2000*b*). FDI was expected to utilise factor differences and to build export oriented production. CEE still has low labour costs compared with Western Europe although higher than some locations in Southeast Asia. Factor cost advantages may also arise from low cost of locally extracted raw materials.

However, there is almost undisputed evidence that markets are the main attraction of the region, as reported in the large number of surveys conducted among Western firms with investments in CEE and among joint-ventures within the region (e.g. Meyer 1998*a*, Pye 1998, OECD 1995, Lankes and Venebles 1996). Many MNEs considering entry expect considerable long-term growth of demand, especially as the income of the middle class, their prime customers, grows faster than the average measured by GDP (Batra 1997). Several features make the markets in CEE particularly attractive (Estrin and Meyer 1998):

First, consumers in CEE had previously had little or no access to consumer goods and brands available in other countries at similar levels of per capita income. Trade liberalisation unleashed a catch-up demand, especially for consumer durables for which West European markets are saturated. The high status of Western goods was in part a result of Western media penetration, even before 1989. It was sustained through effective advertising and brand-building in the newly liberalised local media.

Second, entry in CEE may be a strategic move by MNEs to sustain or enhance their global strategic position. Global leaders may invest to prevent challenges from their rivals or the emergence of new competitors from within the region. Firms dominated by a larger competitor may see early entry in new markets as an opportunity to gain competitive advantages. MNEs established in both Western and Eastern Europe may have superior opportunities to exploit price discrimination, product differentiation or vertical integration. In industries with major network externalities, such as consultancy and financial services, presence in the region may be necessary to offer global coverage for their globally operating customers.

Third, several underdeveloped sectors of industry are being reestablished to accelerate productivity growth across the economy. Governments in CEE are therefore inviting foreign investors to upgrade telecommunications, power-generation and distribution, and transportation infrastructure. They encourage selective private entry, e.g. licensing of new service providers or concessions to operate existing public infrastructure (EBRD 1996). In addition, the privatization of utilities, especially in the telecommunications sector, attracts substantial FDI capital inflows. The infrastructure development creates furthermore opportunities for those providing inputs, such as construction firms, turnkey-plant engineers, and manufacturers of telecommunications equipment.

Factor cost oriented FDI has picked up since the early 1990s. While fewer in number, this includes some high profile FDI projects and substantial capital inflows. Many projects may initially have focussed on local markets, but as these were saturated and productivity in the new affiliate increased, they started exporting to other nodes in the investors' multinational network.

CEE has comparative advantages in intermediate technical skills as the level of technical education in the region was relatively high, although it has considerably deteriorated since 1990, at least in Russia (Clarke and Metalina 2000). At the same time, unit labour costs have risen substantially but are still significantly below West European, especially German, levels. Economic policy has strengthened this advantage in some countries through an effective undervaluation of exchange rates or incomes policy, such as constraints on wage increases.

Low factor costs attract especially SME and firms from the neighbouring countries who exploit the cost differential through outward-processing with or without equity investment. The relocation of production has been important is a small number of industries including textiles, clothing, furniture or musical instruments. It gained in relative importance in the mid 1990's as cost-seeking investors were under less time-pressure than market-seekers.

However, many cost-oriented investors were deterred by low productivity, lack of telecommunication and transportation infrastructure, and bureaucracy (OECD 1995, Meyer 1998a, Pye 1998). In addition, investors face obstacles in identifying suitable local partners and suppliers able to provide inputs and services at the required level of quality.

3.2. Entry Strategies

Since most Western businesses entered the region only in the 1990s, CEE provides an excellent laboratory to study international business entry. Entry strategies encompass a number of interrelated strategic variables, however, researchers have preferred to analyse the different components separately, and so will this review. Firstly, there are locational choices, which have been discussed in the previous section. Secondly, entrants select an entry mode, such as export, contractual co-operation or FDI. Direct investors furthermore have to decide the share of their equity ownership, and whether to invest in a greenfield project or by acquiring an existing firm. Third, the timing and speed of entry is crucial for instance for those pursuing first-mover advantages. Moreover, a successful entry requires an appropriate strategy for marketing, e.g. branding of products, and for human resource management.

3.2.1. Entry Mode Strategies

The choice of entry mode soon became a foremost research topic of IB scholars interested in Eastern Europe (e.g. Brouthers et al. 1998, Meyer 1997, 1998a, Pye 1998). Initially, entrants preferred modes with low exposure to country risk, especially exports and contracting. Ten years into the transition, this still applied in some countries of the former Soviet Union, but less in Central Europe. Most businesses started with exporting, but accelerated soon with contractual and investment modes. Many firms moved quickly along the internationalization process, some even establishing FDI in their firstly activity (Engelhard and Eckert 1993, Ali and Mirza 1996, Czinkota *et al.* 1997).

Contractual modes were particular important before legal constraints had been fully removed, and when investment risks were perceived to be high. Beyond the standard forms, this included for instance management-, technology- and turnkey-contracts. Franchising became popular as eager local entrepreneurs looked to franchisers to provide them with both resources and managerial training. At the same time, those managing global brands found franchising a fast way of expansion while limiting their investment risk. Subcontracting has been particularly popular with German and Italian SMEs relocating selected stages of their production process (e.g. Pellegrin 1998). New contractual arrangements have been developed to facilitate the region’s infrastructure investments. For instance, build-operate-transfer contracts permit private investment and ownership, yet with ultimate transfer to the public sector.

Ownership of FDI

In the early 1990s, a JV was the only legally permissible mode to establish a direct investment (OECD 1995, Hood and Young 1994, Hunya 1996). Yet, the ownership patterns have rapidly changed since then. Regulations have been relaxed in many small steps, and by 1992, FDI was fairly unregulated in most countries (EBRD 1994), though it took far longer in Russia.

This explains the initially high share of joint-ventures, and the massive shift towards fully-owned affiliates in the mid 1990's as both new investors and by old investors increasing their equity share (Sharma 1995). Many acquisitions in the privatization process occurred in a staggered pattern, and were thus registered as JV although from the beginning the investor attained management control and envisaged the acquisition of full ownership (Perotti and Gulati 1993, Lieb-Dóczy and Meyer 2000). These ‘transitory alliances’ (Hagedorn and Sadowski 1999) are means of implementing acquisitions in a particular institutional context, and share little of the characteristics typically observed in joint-ventures (cf. Beamish and Killing 1997). As temporary arrangement they offer advantages to both partners. Governments obtain some control over the firm’s restructuring, and thus externalities for the local economy, while capitalising on the probable appreciation of the share value as the transition economy becomes less uncertain (and avoid embarrassment over initial underpricing). Governments may also be reluctant to transfer control over firms deemed strategic, or trading with governmental institutions (Wright *et al.* 1993) for both political and economic reasons. The investor obtains access to local institutions and networks while sharing investment risk.

Investors normally aim for full control of acquired businesses, not only to reduce transaction costs but to be able to enforce faster turnaround of former state-owned enterprises (Aulakh and Kotabe 1997). However, many entrants, at least initially, accept lower degrees of involvement. A local partner may be useful in many ways, notably in accessing local business and government networks. Especially in Russia, such informal networks are vital for business, substituting many functions of the institutional framework in mature market economies (Thornton and Mikheeva 1996, Puffer *et al.* 1996, Holden *et al.* 1998). Consequently, entry modes with higher capital commitment are preferred in the advanced transition economies, while low risk modes are employed where institutional frameworks are still unstable or of low repute.

Formal tests of the determinants of entry modes mostly find support for the same factors as studies elsewhere, especially with respect to firm and industry specific variables, thus confirming the validity of the respective theoretical framework. For instance, Brouthers *et al.* (1998) showed the influence of cultural attributes of both home and host country, in addition to cultural distance. CEE-specific aspects emerge with the factor endowment of the local economy and the institutional framework, which influence the transaction costs in pertinent markets and thus investors’ internalization preferences (Meyer 1998*a*).

The performance of FDI has been analysed on the basis of survey data, e.g. in Hungary (Lyles and Baird 1994, Meschi 1997), Russia (Fey 1995, Thornton and Mikheeva 1996) and Kazakhstan (Charman 1998). The success of a JV depends mainly on issues such as the compatibility of the objectives of the parents, and establishment of mutual trust while avoiding of dominant control by either partner. International business experience of the local partner is important, as is the Western partner's management training. However, wholly owned operations are judged to perform better in investors' own assessment (e.g. Lyles and Baird 1994).

Acquisition or Greenfield

Foreign investors wishing to establish a wholly-owned operation could often do so only through an acquisition in the privatisation process. This, however, requires complex negotiations with multiple governmental authorities (Brouthers and Bamossy 1997, Antal-Mokos 1998, Marinova 2000) as well as with management and work councils (Bak and Kulawczuk 1997). Moreover, the investor has to take responsibility for enterprise transformation (cf. Section 3), and may face considerable post-acquisition investment in resource upgrading and organisational change while being constraint by stipulations of the privatization contract (see Section 4.1).

As this post-acquisition investment often exceeds the initial investment, the project takes on features normally associated with greenfield investment, and different from conventional acquisitions. Such 'brownfield' investment (Meyer and Estrin 1999) can substitute both greenfield strategies where crucial local assets are not available in unbundled form, and acquisition strategies where the resources of local firms are too weak to face international competition.

Investors prepared to commit to enterprise restructuring and technological upgrading, find acquisitions attractive to access valuable human capital in local firms, especially their technological skills, and to (informal) local networks and to government agencies. Local brand names and distribution networks are also valuable assets in some consumer goods industries. Acquirers furthermore report fewer bureaucratic obstacles to acquiring land and obtaining the permits required to start or expand production (Estrin *et al.* 1997).

Despite these advantages, investors increasingly bypass the restructuring of local firms and set up greenfield operations. This allows them to implement their corporate strategy without having to incorporate the heritage of an acquired firm. Small firms that lack the managerial and financial resources to lead enterprise restructuring, are even more avoiding acquisitions in the privatization process (Estrin and Meyer 1998). Consequently, the share of greenfield investment is increasing in CEE, in contrast to world-wide trends.

3.2.2. Strategies for Timing and Acceleration of Entry

Many MNEs in industries with world-wide oligopolistic structures were among the first entrants (Marton 1993, Kogut 1996). They pursued first-mover advantages that are *perceived* to be very important in consumer goods industries where brand names are crucial competitive assets (e.g. Arnold and Quelch 1998). Expected long-term benefits include brand recognition, control of distribution channels, and preferential access to local suppliers and governments. One way to attain such advantages is to acquire the dominant local firm in the industry. Moreover, early entrants may even be able to influence the local regulatory environment in their favour. The perceived importance of first-mover advantages is highlighted by Lankes and Venebles (1996) who report a bimodal distribution on the first-mover motive: very important for 39% of investors, especially for those targeting the local market, but unimportant for most others.

Is this euphoria about first-mover advantages justified? Liebermann and Montgomery (1998) cast doubt on the first-mover argument by showing that product innovators rarely became market leaders. An optimal product specification and a marketing strategy to penetrate a mass market are more important for lasting success. The entry in Eastern Europe poses different challenges as the products in question are mature, and their marketing methods have been tested elsewhere. Even so, first entrants have to overcome obstacles in the local environment, and strategic decisions on e.g. location and partner choice incur considerable sunk costs. Moreover, brand names may be worth less where brand loyalty is low as consumers still experiment with new products. Case evidence suggests that some first-movers failed to realize their expected benefits, and second-movers could build a larger market-share or a more profitable operation (Meyer and Estrin 1998, Bridgewater *et al.* 1995).

Later entrants benefit from local bureaucrats' improved understanding of the needs of business, and from first-movers' investment in training and introduction of new types of products to 'build the market'. 'Fast-seconds' can learn from successes and failures of the first-mover and adapt their strategies for marketing and government relations accordingly.

Aiming for the best of both strategies, many investors followed a foothold strategy that provides an entry to the market, but delays commitment of substantive capital investment. Such 'platform investment' (Kogut 1983), e.g. a representative office, permits the investor to learn about the local environment while investigating business opportunities. The local base permits a rapid response to emerging business opportunities. Foothold strategies were important for the first investors in Hungary (Marton 1993) and in the volatile environment of Russia (Fey 1995).

Some authors have developed more detailed typologies of strategies that they observed in Eastern Europe (Hooley *et al.* 1993, McCarthy and Puffer 1997, Bridgewater *et al.* 1995). By distinguishing entrants by their strategic investment motives and the speed of resource commitment, they observe some noteworthy strategies:

Many investors are client-followers in that they enter Eastern Europe to serve customers they have served before (Bridgewater *et al.* 1995). Their investment decisions are thus linked to the strategies of major customers. This applies in particular in the automotive industry (v.Tulder and Ruigrok 1998, Meyer 2000*b*) and in the financial sector, but also ordinary products such as soft-drinks can draw bottling companies and manufacturers of modern packaging to the East. The client provides a sufficiently large and secure demand to merit the commitment, and from that base the follower may expand on the local market. Last not least, many Western accountants and consultants supply projects funded by Western agencies such as the EU (Gilbert 1998).

Investors in the oil and gas industry face heavy up-front investment, especially for extraction and refining (McCarthy and Puffer 1997). The sector attracts a major share of FDI in Russia and her neighbours to the South, but investors have to be cautious not only because of high sunk costs, but because they need to cooperate closely with key local players in governments and among state-owned or privatized monopolies. Investment consortia between major multinational are thus common, both to share the risk, and to negotiate with the authorities.

3.2.3. Marketing Strategies

Beyond entry mode choice, marketing scholars have addressed issues of market penetration, consumer behaviour and marketing management (reviewed by Schuh and Springer 1997). A major concern is the trade-off between standardization and differentiation. Batra (1997), and Arnold and Quelch (1998) recommend a multi-tier product strategy to serve not only the high-end segments but also the middle and lower price segments of the markets. They suggest that foreign companies should adjust their product mix to the purchasing power given the low average household income in these countries. Adaptation of consumer electronics, for example, may strip-out of existing sophisticated products those features - with the corresponding costs - that are not highly valued yet, and provide products that are more reliable and need less servicing (Batra 1997).

However, empirical research suggests that foreign investors typically position their products at the upper end of the market, leaving the lower end to local brands, in anticipation of market growth with the emergence of the middle class (Schuh 2000). Many of the first entrants were global-oriented companies that create products pro-actively and adapt them passively, pursuing highly standardized marketing strategies in CEE with limited adaptation e.g. of labelling, package design and brands (e.g. Church 1992, Hooley *et al*. 1993). Classic country-related differentiation can only be found in the consumer goods industry and is often connected to the acquisition of local companies (Dahm, 1995). In fact, several incidences have reported that investors discontinued an acquired local brand, but later re-introduced it after realizing the loss of the mass market (Meyer and Estrin 1998, Lieb-Dóczy 2000).

Research into marketing mix and distribution channels points to major challenges for multinational entrants. Distribution channels are often fragmented, with small retailers accounting for a large share of consumer markets. Reliable marketing information is scarce. Channels of mass communication are less developed and less effective where consumers prefer to rely on personal experiences. This suggests a need for high distribution intensity and multiple marketing partners rather than exclusive distributors. Extensions of successful brands (“Umbrella branding") and multi-tier product strategies to cover high- and middle-price segments of the market have proven to be successful. However, consumers are very price sensitive such that markets tend to be price competitive. TV and event sponsorship are reported to be most effective to establish brand names if used considerate to local cultural, political and religious sensitivities (Shama 1992, Batra 1997, Arnold and Quelch 1998).

Consumer behaviour has been volatile and varying across the region, making it hard to give definitive answers on issues such as buying behaviour, attitudes to country of origin and impact of advertising. Most marketing researchers essentially benchmark CEE against the West thus failing to address issues of specific relevance to countries in transition (Schuh and Springer 1997). Future research may thus pay more attention to issues such as national marketing systems, specifics of marketing in CEE by country and industry, marketing at different stages of enterprise transformation, and establishment of effective marketing institutions and networks in CEE.

Reviewing the marketing literature, one notices a variety of innovative strategies proposed. Yet few authors provide convincing evidence of superior performance of these strategies. Counter-intuitive evidence, such as first-mover failures, suggest caution. Future research may focus more on the long-term performance implications.

4. Management Challenges

Western businesses operating within transition economies face a number of specific challenges that arise from the transition context. This section focusses on the implications of running a formerly state-owned firm, knowledge transfer, managerial training, and cultural diversity within the organization.

4.1. Privatisation Acquisition

Owning and managing a privatized business unit confronts businesses with national politics. From the investor's perspective, it is a case of 'mergers and acquisitions'; yet buying a firm from the government results in a number of peculiarities. Privatization aims to break the link between governments and firms. Yet, the political social and economic context of privatisation constrains post-privatisation strategies (Uhlenbruck and DeCastro 2000):

C Government sell firms not only to maximise their financial revenues, but to pursue broader social objectives (e.g. Estrin 1994). The corporate strategy pursued by the (formerly) state-owned firm is interdependent with other aspects of public policy. For instance, the divestment of social assets (kindergartens, health care facilities, etc) is interdependent with the ability of other providers, municipal or otherwise, to provide these services. Layoffs are constrained by the social consequences of unemployment.

C The negotiation process is complicated not only by the broader set of objectives of the seller but by the multiplicity of interest groups involved in the process and by the relative inexperience by the local negotiators (Antal-Mokos 1998). Brouthers and Bamossy (1997) and Arens and Brouthers (1999) analyse the role of the government using the concept of the 'key stakeholder'.

C After completing the sale, governments often continue to be indirectly involved with the privatised firm. They can create tools to control the actions of the acquirer as an agent by extending the contract beyond outright sales. This occurs in CEE through retained minority shareholding, conditions imposed on the acquirer (Stark 1992, Uhlenbruck and DeCastro 1998), and competition policy. At the same time, governments may support privatised firms by securing financing, guarantee procurement, tax breaks, restrictions on import competition etc. (EBRD 1994, 1999).

Especially ‘staggered divestment’ (Perotti and Guney 1993) allows privatization agencies a temporary influence on post-acquisition management. If the acquirer attains management control, the influence of the government on operational management is limited. The foreign investor may not like the possible government interference in strategic decisions, but would appreciate the risk sharing and the lower amount of capital to be raised at the outset. Furthermore, the interests of the government, especially regional or local authorities, are becoming more aligned with those of the business if they share the profits of the venture. This should reduce undue bureaucracy and regulatory interference, while providing access to important local networks.

One might expect weaker performance of firms in mixed ownership because the government may aim at obtaining social rather than financial returns. At the same time, the private partner faces weaker incentives arising from the lower share in profits, and may benefit from some form of transfer pricing. (The MNE has to share any profit of the JV, but keeps all if it is accounted for elsewhere). Compared to local firms, JVs do not show better performance than local firms, as would be expected given their more proactive restructuring (Section 2.3). Managers themselves assess performance of firms with residual government ownership more negatively (e.g. Lyles and Baird 1994). However, Uhlenbruck and DeCastro (2000) find that firms with residual state-ownership actually perform better in terms of sales growth.

With the acquisition, the investor takes responsibility for the enterprise transformation process. This requires substantial additional investment in upgrading of equipment, organizational restructuring and training. Foreign acquirers thus face an uphill struggle, although compared to local firms, they have a number of advantages:

- They have access to complementary resources, in particular finance and managerial knowledge.
- They can establish clear control structures, and thus avoids most of the corporate governance problems associated with other forms of privatisation in CEE.
- They can better initiate organisational change through the experience in leading competitive businesses and thus providing and vision and a strategy for the restructuring
- They can create market access by integrating the acquired business into their international production networks (Schwartz and Zysman 1998, Meyer 2000a).

The importance of investing in the acquired business is illuminated not only by the frequency of brownfield investment in the region (Meyer and Estrin 1999), but by the fact that investment is the only strategic variable that Uhlenbruck and DeCastro (2000) and others found clearly associated with better performance. Also research on joint-ventures suggests that support from the foreign partner is crucial (Lyles and Baird 1994, Lyles *et al*. 1996, Fey 1995). The investor has to create a comprehensive strategy for the post-acquisition restructuring and integration (Obloj and Thomas 1998, Meyer and Møller 1998, Thomson and McNamara 1998). A central part of this strategy is the learning process of the local organisation.

4.2. Managing the Learning and Education Process

Firms have to upgrade their managerial capabilities far more fundamentally than is catered for by conventional management training. Technological skills were on a high level due to good general education in natural sciences, especially mathematics and engineering. Yet managerial and social skills were deficient due to both the change of skills and capabilities required in the new institutional setting, and the separation from modern social sciences. Incumbent leaders were often insufficiently prepared as they had different tasks and developed other skills in the central plan system. In fact the required capabilities are often beyond the experience-horizon of individuals used to the central-plan system. What is worse, the new private sector in Russia makes very little provision for training of their employees, while locally available training is limited and relatively expensive (Clarke and Metalina 2000). The required new skills are often based on tacit know-how, which requires an interactive learning process (Swaan 1997). They can be described in three levels (Child 1993, Villinger 1996):

C At the *technical* level, new and specific techniques have to be acquired such as methods for quality measurement, scientific and engineering techniques or the construction of samples for market research.

C At the *systemic* level, new systems and procedures have to be adopted, which requires integrative learning emphasising co-ordination, relationships and links. Examples include co-ordination of integrated production systems, or production control and budgeting systems. Already at this level, the learner not only has to unlearn acquired routines and replace them by new ones, but to reassess attitudes and value systems underlying behaviour within the organisation under the old and the new regimes (Michailova 1997, Meyer and Møller 1998).

C At the *strategic* level, senior managers have to change their cognitive framework for doing business and conducting the tasks of management. They need to reassess their criteria of business success and factors contributing to that success. This requires understanding of technological and managerial processes in such depth that they can engage in innovation, select and adapt technology and take strategic decisions.

The acquisition and adaptation of this complex, and in many cases tacit, knowledge is inhibited by the cultural and institutional context of its transfer (Jankowicz 1994, Kostera and Wicha 1996, Geppert 1996). Managerial learning, and in particular the internalisation of new knowledge, is modified by the connection made by recipients between new ideas, information and experiences and their prior knowledge and experiences. The content of received knowledge is filtered through the mind set of the recipient in CEE and their experiences in the socialist society (Soulsby and Clark 1996).

Most academic observers therefore stress the need to contextualize the contents and methods of training in Eastern Europe (e.g. Jankowicz 1994, 1996, Child and Czekledy 1996). Yet, a fundamental discrepancy separates Western training methods, which are grounded in extensive research, and the expectations of Eastern course participants. The contextualisation of training programs thus faces the dilemma that formalisation of delivery methods, as preferred by many participants, cannot achieve the objectives of the training, i.e. inducing managers to think for themselves on a strategic level (Hollinshead and Michailova 1999).

Those transferring management knowledge to the East often took, especially in the early 1990's, an ethnocentric perspective, believing in the superiority of the Western way of doing things and being disrespectful, or unaware, of local traditions, cultures and accomplishments (Hollinshead and Michailova 1999). Western consultants in particular are resented, delivering reports of little practical use because they fail to understand the institutional context of the CEE firms (Soulsby and Clark 1996). This led to considerable ‘consultancy fatigue’ (Gilbert 1998) especially if the consultants obtain only superficial information on the ground and, as they are paid for by international institutions, are more concerned about Brussels or Washington than with Novgorod or Vladivostok.

This literature advises to employ individuals that relate modern management and post-communist reality. For instance, Soulsby and Clark (1996) report that local consultants with Western training and émigrés returning to their roots have been highly appreciated by local managers. In Central Europe, the intellectual and cultural gap between Western and local managers is narrowing, yet finding persons capable of communicating effectively in the former Soviet Union is still a considerable challenge.

Vlachoutsicos and Lawrence (1996) argue that positive change in managerial practice will come about only if continuities with the values and decision-making processes of the Russian traditional collective are preserved, and the natural behaviour of Russian managers are integrated into newly-introduced managerial systems and practices. From the perspective of evolutionary and institutional economics, new practices have to be build on existing attitudes and value systems, preserving selectively what is worthy, and using experimentation to discover new best practices suitable for transition economies (Kogut 1996, Spicer *et al*. 2000). JV research confirms the importance of incorporating local management as ‘shared management’ is generally associated with better performance (Lyles and Baird 1994, Fey 1995).

The gradual development of capabilities is however challenged by the radical nature of the organisational change faced by many firms. The turbulence, the dramatic shortfall of available resources, and the fundamental threats created for many people has inhibited, if not undermined, their willingness to learn (Hedberg 1991, Villinger 1996). In the face of high uncertainty, imitation of imposed practices may be preferred to an internalisation of new knowledge (Child and Czegledy 1996). Newman and Nollen (1998) thus observe an inverse-U shaped relationship between firms’ ability to learn and to restructure and the gap between existing and required capabilities. This suggests that training should be based on a step-wise learning process, with clearly delimitated intermediate targets.

4.3. Managing Cultural Diversity

Western investors managing acquired businesses or joint-ventures in transition economies experience considerable cultural diversity, and consequently conflicts between different groups within the organization (e.g. Child and Markoczy 1993, Puffer and McCarthy 1997). Managing such conflicts of organisational culture is a major challenge for joint-ventures, especially in Russia (Puffer *et al*. 1996, Michailova 2000, Fey and Beamish 1999). As Russian culture is often seen as not conducive to successful market-based management, managers, as well as researchers, face a major challenge in *how* to change organizational culture (Fey and Denison 1999). Yet what are the origins of such cross-cultural conflicts?

The cultural legacy of socialism

The business culture in transition economies is in flux, and therefore hard to define. Three distinct cultural forces are, metaphorically, battling for the hearts and minds of East European people. These are firstly the historical cultural roots that have been loosened, but not lost with the arrival of socialism. Secondly, the socialist experience bears upon those who grew up under the system. Thirdly, many people are willing to shed either legacy to adapt Western culture, or what is received of it through the media, business contacts and tourists. Thus, culture is unusually unstable and shows considerable discrepancies between the cultural norms and behaviours communicated in public and those people actually internalized (Todeva 1999). Feichtinger and Fink (1998) describe the volatility of culture in the 1990's, and the corresponding confusion at the individual level, as ‘collective culture shock’. This analogy suggests that after a period of disorientation, the societies will recover and prosper with the new cultural identity. In the Western parts of the region, culture is converging towards West European patterns, with regional specialties such egalitarian and religious values.

Socialism left behind a ‘bloc culture’ (Sztompka 1993). This is not the officially propagated philosophy of Marxism-Leninism, but the reality of values and attitudes of individuals within real existing socialism. Despite the communitarian ideology, socialist regimes were low-trust regimes. Distrust was institutionalised through networks of informers of KGB or its partner institutions, fostering suspicion even when it was without foundation. In consequence people drew a sharp separation between their private and public circles. As a double legacy of socialism, “individuals are likely to have a high degree of trust in their immediate social network, and a high degree of distrust in the formal institutions of the state” (Rose *et al.* 1997:10). Low levels of trust in institutions continue in the transition period, reinforced by insider privatization that benefited the old nomenklatura, the growth of the Mafia, and corrupt politicians. Transition thus has to build trust in institutions, beyond the personal level.

Russian business culture has however roots that go deeper than socialism. Several researchers aim at explaining this culture and the emerging cross-cultural discrepancies in Russian-Western organisations (Lawrence and Vlachoutsicos 1990, Puffer *et al.* 1996, Michailova 2000, Holden and Cooper 1994, Holden *et al.* 1998, Elenkov 1998). Vlachoutsicos (1998) presents a comprehensive analysis of ’the inner logic of Russian management’ based on its roots in both Russian history and the influences of 70 years of socialism. He outlines the ’matrioshka’ structure of Russian organisations with strong vertical ties, but weak horizontal co-ordination, and the traditional decision making process. This is typically top-down on strategic matters, but contains a major consultative element on issues of implementation, if only in a ritualised fashion.

These traditions influence Russian managers’ interactions with Western counterparts. For instance, Russians are reported to act short-term orientated, averse against planning, and they typically expect the leaders to take strategic decisions, but discuss methods of implementation (Michailova 2000).

Yet there is considerable variation of behaviour and belief systems between, say, a Soviet-area senior executive and a young entrepreneur (e.g. Puffer *et al.* 1997, 2000).

Networking

Bonding and other forms of network activities have a central role in Russian business. They arise from both cultural traditions and as substitute to legal institutions such as contract enforcement. East European managers are well versed in developing personal business networks, and in making informal arrangements to compensate for the breakdowns in formal resource allocation and distribution systems (Child and Czegledy 1996, Martin 1999). At least the former is, while commonly overlooked in economic models, an important part of business in any economic system, and fostered in modern management under the title of the 'network organization'.

In Russia, networking occurs more at a personal level activity rather than between institutions. Several studies emphasise the importance of personal relationships as Russians typically do not distinguish between personal friends and business relations (Salmi 1999, Meyer *et al.* 2000). Social activities thus are part of business dealings. This arises from co-operative value systems, distrust towards strangers, and traditions such as *blat* (Ledeneva 1999). To overcome initial mistrust, Russians are reported not to engage in business before they have shared social activities, and substantial amounts of vodka. Western partners are expected to participate in such bonding activity (Holden *et al.* 1998).

The reliance on informal relationships raises pertinent issues of business ethics for local and in particular foreign business persons operating in the region. The emphasis on connections may undermine the introduction of new and objective standards of performance by creating distrust and dissatisfaction (Cyr and Schneider 1996). Moreover, there is a thin line between networking and unethical or illegal activity. Russians consider for example violation of insensible laws as normal, yet can it be for a Western investor? It may be infeasible to do business if one was to obey all the rules at all times (Puffer and McCarthy 1995). Experienced investors claim that there are always to cope with the situation, e.g. building contacts at highest level in the authorities, knowing the law precisely, and exchanging experiences with other Western expatriates. Yet, Russia is not for beginners.

Human resource management

Human resource management has to accommodate the cultural diversity. An area where this appears particular difficult is the recruitment and remuneration of people for the local operation. Many investors assign expatriates to all top management positions, and aim at recruiting and training local personnel to take over these positions after a few years. This however proved difficult, especially for finance and marketing personnel. The small number of qualified people in these fields, often younger than their Western counterparts, found themselves head-hunted by Western investors. Yet, beyond this small elite, managerial labour markets hardly function at all because of the shortage of key personnel (Peiperl and Estrin 1997).

Local firms have generally low turnaround of managers. Three years into transition, 78% of top and second tier management positions in the Czech Republic were still held by former nomenklatura managers. Most changes occurred at the position of the CEO and the personnel managers, often the party representative, who were mostly replaced internally (Clark and Soulsby 1996, Newman and Nollen 1998). Management change is more frequent in firms facing competition and hard budget constraints (EBRD 1999:139) and, where outsiders were recruited, associated with better performance (Claessens and Djankov 1998), suggesting that active recruitment will eventually take hold in the region.

Western HRM approaches have been adopted in the region, for instance by creating a wider spread of salaries (Basu *et al.* 1997, Clark and Soulsby 1996). Incentive-based pay has been introduced, especially by Western investors, but with mixed success as it sometimes conflicts with the egalitarian local culture (Mueller and Clarke 1998, Cyr and Schneider 1996). As in other areas of management, HRM practice in Central Europe converges towards West European models, while Russians still have a high level of suspicion over the introduction of Western management ideas (Holden *et al.* 1998, Shekshina 1998). MNEs adopted their HRM policies to the local context to varying degrees. While performance appraisal and promotion were standardized, recruitment, training and financial reward systems were locally adapted, especially in Russia (Björkman and Ehrnrooth 1999). Only some of the HRM policies adapted in Russian firms were found to actually improve performance (Fey *et al.* 2000).

An often underestimated HRM challenge is the communication across cultural and linguistic divides (Villinger 1996, Cyr and Schneider 1996, Jankowicz 1994). Effective communication is important to convey to the entire workforce the strategic direction of the business, to obtain direct feedback, and to build personal relationships and trust. It requires that both partners are sensitive to each others cultural and historical context and share a common language (Villinger 1996, Michailova 2000). In particular, the communication has to overcome the culturally-conditioned differences in key concepts such as ’time’, ’plan’ and ’control’ (Michailova 2000), which is a particular serious problem in Slavonic languages where expressions for certain Western business terminology have not been developed prior to 1990.

5. Perspectives for future Research

The study of business in transition economies offers opportunities not only to understand ‘transition’ but to generate insights, concepts and theoretical frameworks for international business in general. The transition economies provide a laboratory for business; and insights gained here will contribute to the discourse on global economy in the 21st century. Research challenges include questions on how business evolve during radical organizational change, and how institutions shape corporate behaviour. Scholars may venture more inductive research, and develop new concepts and frameworks relevant beyond the region.

In the 1990s, research focussed on issues that were specific to the start of transition and the opening to international business. Research needs to move on, from privatization to new entrepreneurial businesses, from entry strategies to operations strategies, and from negotiating acquisitions to managing subsidiaries. Yet this research needs to consider the business context that, as proposed in Section 2.1, has developed specific institutional characteristics that are likely to persist for the next decades.

The analysis of institutions and their influence on corporate strategies and enterprise behaviour can be taken beyond Peng (2000) to explain not only the differences of strategies between capitalist and transition economies, but to explain variations within regions. China followed a different path of transition, with gradual reform since the late 1970s, but observers detected interesting similarities with transition in Europe at the level of enterprises (Child and Markoczy 1993, Batra 1997, Peng 2000). Yet researchers need to be cautios about generalizing across emerging economies - as evident from comparing this paper from its companion on China (Child 2001). Challenges faced by enterprises vary considerably due to different macroeconomic and institutional contexts even within the region. Hungary and Poland, for example, converge with Western Europe, while Russia will retain distinct features for many years.

For example, the legal-institutional framework cannot yet guarantee property rights, which creates interesting challenges for contracting under uncertainty and without external enforcement mechanisms. Corporate ownership and governance exhibits specific features such as a high share of employee-ownership, staggered privatization, and close relations between businesses and governments. This implies that managers have to pursue profits as well as non-monetary objectives set by the firm’s shareholders and stakeholders.

Firms design their corporate strategies and management procedures in response to these institutions, in particular by building business relationships that rely not only on markets as coordination mechanism. Consequently, we observe innovatory strategies such as conglomerate building in form of ‘recombinant property’ (Stark 1996) and ‘network-base growth strategies’ (Peng and Heath 1996). Further research may explore in more depth how different institutions influence the design of business organisations. This requires the development of more sophisticated analytical tools concerning the link between institutions and strategy.

Foreign investors too select and adjust their modes of business. They develop new forms of non-equity cooperation, engage in ‘transitory alliances’ (Hagedorn and Sadowski 1999) and ‘brownfield investment’ (Meyer and Estrin 1999). Businesses moreover face major challenges in understanding the local business cultures and in developing appropriate approaches to cross-cultural management and to change management - areas where applied research could be of great value. Last not least, technological advances may permit the region to leap-frog stages of technological development and innovate business, e.g. in e-commerce.

The analysis of business in an unusual context provides a laboratory to explore aspects that are less observable in mature market economies. Novel concepts and analytical frameworks may feed back into theories used in mainstream international business research. In addition to the institutional perspective, Hoskisson *et al.* (2000) point to the potential of adapting transaction cost theory and the resource-based view of the firm to the specific challenges of emerging markets. However to enrich these frameworks, researchers have to be venturous in their approaches, and apply exploratory research methods. Existing theories help analysts by concentrating attention on important variables and relationships - but they fail if important variables or relationships are missed. Few region specific insights are born out of hypothesis testing of standard theory. We need inductive research to understand new or unconventional business contexts. Longitudinal studies and linkages to related literature in, for example, transition economics and sociology may help to develop new, relevant and dynamic theoretical frameworks.

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Endnotes:

1. Readers interested in comprehensive reviews of economic transition are recommended to consult Lavigne (1999) as well as reviews comissioned by multilateral institutions (e.g. World Bank 1996, Havrylyshyn and Gettigan 1999, Fisher and Sahay 2000, EBRD annually). Independent studies are published e.g. in the *Journal of Comparative Economics*, *Economics of Transition*, and *Comparative Economic Studies*. This author maintains a website with information on recent research and links: **http://www.econ.cbs.dk/institutes/cees/**

2. Concise surveys of recent trends of FDI are provided by EBRD (annually), and UN (annually). For a critical evaluation of the data see Brewer (1994), Meyer (1995) and Meyer and Pind (1999).

3. The empirical evidence on performance implications is hotly debated as many Western advisors see it as a key obstacle to restructuring (e.g. Havrylyshyn and Gettigan 1999). Several studies suggest that manager-ownership outperforms employee ownership (e.g. Frydman *et al.* 1997). Yet other studies find positive effects of employee ownership compared to dispersed shareholding or state-ownership on production efficiency (Smith *et al.* 1997, Jones and Mygind 1999*b*), on labour productivity (Earle and Estrin 1997, Djankov 1999*b*), and on product, input and asset restructuring (Estrin and Rosevear 1999).

4. On the nature of firms in the real existing socialism see for instance Berliner (1952), Kornai (1980, 1992) and Lawrence and Vlachoutsicos (1990).

5. A starting point may be the series of short research notes on transition economies in the *Journal of Small Business Management* in 1995 to 1997.