Meyer, Klaus E., 1998, *Direct Investment in Economies in Transition*,
Cheltenham: Elgar.

PART ONE

Overview and Research Issues

1.Introduction

After the fall of the Iron Curtain in 1989, most countries of the former Soviet bloc moved successfully from centrally planned economies and one-party governments towards market economies with multiparty parliamentary democracy. This systemic change now appears irreversible as many institutions in both the economic and political spheres have been established that will tend to resist any reversal of this change. However, the progress of transition varies within the region. The Visegrad countries (the Czech and Slovak Republics, Hungary and Poland) have to a great extent transformed their political systems, while progress has been slower in South-Eastern Europe. In Russia and other states of the former Soviet Union, the political changes have been more erratic and are still subject to a high degree of political uncertainty. These differences in political reform are reflected in the progress of economic reform and systemic transformation.

In the transition process, Central and Eastern Europe (CEE) opened to Western business in 1989. For fifty years, the region followed a policy of economic autarky. International business occurred mainly in the form of barter trade. Direct foreign investment (DFI) was impossible or tightly regulated, except for Yugoslavia. Within a short time, the policy environment changed radically, creating new conditions for international investment. Many multinational enterprises (MNEs) moved into the CEE region, but at different rates and with different types of local operations and business activity.

Of the various forms of international business, DFI creates the greatest expectations of policy makers in the region. DFI is the transfer of multiple resources to a host economy and requires a high degree of commitment to operating in the country. From the perspective of politicians and economists in CEE,[i] DFI is often seen as a potential source of knowledge transfer. It is expected to introduce new management and marketing know-how and the latest production technology. Western DFI is hoped to provide urgently needed capital for countries with limited access to international capital markets; to generate cash revenues via privatization for empty government budgets; and to contribute to the restructuring of industries and upgrading of the ageing capital stock in the region.[ii] The entry of Western firms is also expected to foster change in the economic system, create competition and promote the development of the private sector. Furthermore, investors facilitate exports to Western markets through knowledge of the relevant markets, as well as access to brand names and distribution networks.

For the business community in Western Europe, the fall of the Iron Curtain brought threats to established business operations, but also potential opportunities for expansion or reorganization. The region offered major business opportunities for West-East business because of its untapped 'virgin' markets and low labour costs. Consumers in the region were eager to assume the Western lifestyle and purchase consumer goods that they knew of from years of watching Western television, while being denied access by the rule of the Iron Curtain. Businesses concerned with their competitiveness in the high-wage countries of Western Europe saw new opportunities to compete with East-Asian manufacturers. The opening of CEE provided unique opportunities for expansion at a time of slow growth of West European economies. On the other hand, Western labour unions became concerned about the relocation of production and the loss of jobs of relatively less skilled blue collar workers.

The outcomes of these diverse expectations are explored, using the evidence in this first major analytical firm-level study on determinants of DFI in CEE. It investigates DFI in the first years of systemic transformation from 1989 to 1994. This was the period of most radical economic and political change in the region, when new political systems were emerging, radical policies for economic stabilization were implemented and the economies took many big steps towards systemic transformation.

ISSUES IN ECONOMICS OF TRANSITION

The focus of this research is on the microeconomic determinants of investment during the early, volatile years of transition. Its starting points are research questions arising from the analysis of the economic transition in Eastern Europe. Direct Foreign Investment (DFI) interacts with many aspects of the transition process. The transition affects incoming DFI and *vice versa*. Direct investment influences the transition in several ways: through its direct impact on macro-economic variables such as the balance of payments and employment, through the transfer of knowledge and through the role of investors as new owners of formerly state-owned enterprises. The latter brings a contribution of DFI to the host economy that is specific to the transition economies. Foreign investors are in a superior position to induce corporate restructuring because they can provide managerial and financial resources, they can create immediately effective corporate governance, and they contribute crucially needed managerial know-how [Meyer 1997].

To understand this interaction between foreign investors and the local economy, it is first of all necessary to understand the foreign investors as such. What are they doing in the region, why are they doing it and which factors influence what they are doing? These questions have motivated this study because transition economists need to understand the motives, strategies and determinants of DFI before engaging in impact analysis. Without understanding investors, impact analysis is build on sand. Some studies modeling impact have made very simplified, in my view inappropriate, assumptions about DFI and as a result reached peculiar conclusions.[iii] However, better models can only build on a better understanding of international business.

When this study was conceptualized in 1993/94, little systematic analysis of DFI in transition economies was available. Several authors expressed expectations of how DFI may contribute to the transition economies. Others discussed the often confusing statistical evidence, for example for the Soviet Union [Gutman 1992, World Bank 1992] and Hungary [Marton 1993, Csáki 1993]. The evidence from different countries has been brought together in comparative surveys in Meyer [1995] and EBRD [1995]. The motives of DFI in the region have been analysed by survey studies, for example Pfohl et al. [1992], Gatling [1993] and Genco, Taurelli and Viezzoli [1993]. This work has been advanced in the contemporary research reviewed in Chapter 2. Recently, the discussion on the impact of DFI has been advanced in conceptual papers, in particular with Bruce Kogut's [1996] contribution.

This study directly addresses three issues of concern to transition economists. Firstly, the actual flows of DFI have been disappointing in the first years of transition, but increased remarkably by 1995. Although Hungary already received substantial DFI, South-Eastern Europe and the former Soviet Union received only minimal amounts. The research attempts not only to understand why certain firms choose to invest in the region, but also why many others did not invest. Therefore, the empirical part of the study covers firms with and without direct investment in the region.

The second issue is the interaction of the specific transition environment with the strategies of Western enterprises. This analysis compares activity in CEE (Chapter 2) with the patterns posited by the international business literature (Chapters 3 and 4). In addition, the variation of MNE activity within the region is explored. The third theme is the comparison of enterprises from two countries that have shown quite different patterns of activity in the region. Firms from neighbouring countries, especially Germany, have been quickest to react to the new opportunities. Conversely, British firms have been surprisingly inactive.

The survey confirms that German firms are more active in the region not only in terms of DFI volume, but also by various criteria describing the extent of their business (Chapter 5). Patterns of business are generally similar to British firms active in CEE, except that they show more interest in utilizing the East-West factor cost differential. A surprising result is that by the number of projects, DFI varies far less among the Visegrad countries than official statistics on DFI capital would suggest. The main differences are between Central Europe on the one hand, and Russia and Romania on the other. This can be explained by the slower progress of economic reform and greater distance to the countries of origin. Furthermore, the data show that most investors follow market-seeking motives. At best, labour costs appear as a complementary motive.

The empirical analysis finds most propositions on determinants of international business to be confirmed (Part three). By and large, business with CEE thus follows the same motivations as business among other countries. However, the study finds some exceptions that are discussed below.

ISSUES IN INTERNATIONAL BUSINESS

The reseach uses concepts, theories and methods developed in the international business literature to analyse DFI as one aspect of economic transition (Figure 1.1). The results are hoped to advance knowledge in both fields of study. The theoretical foundation of this study is the Ownership-Location-Internalization paradigm (OLI) developed by John Dunning [1977, 1993]. Within this broad paradigm, two lines of inquiry are refined and applied: internalization theory and the developmental model of DFI.

Ultimately, the internalization literature draws on the work by Ronald Coase [1937]. Richard Caves [1971], Peter Buckley and Mark Casson [1976] and others have advanced its application to multinational enterprises in the 1970s. Recent work has broadened the concepts of internalization incentives, considering for instance the transfer of tacit knowledge [Kogut and Zander 1993], information economics and trust [Casson 1995]. In this study, a comprehensive model of transaction cost economics is presented for the international context by means of a synthesis of recent contributions in the field. It focuses on the trade-off between internal and external transaction costs. Postulated determinants of transaction costs relate to characteristics of the products, asset specificity and information content, as well as environmental characteristics of contract uncertainty and the likelihood of opportunism.

The empirical part of this study tests aspects of the internalization theory. It builds on the literature on choices between investment and licensing [for instance Davidson and McFetridge 1985] and between joint ventures (JVs) and full ownership [for instance Gatignon and Anderson 1988, Hennart 1991a]. Moreover, the analysis considers entry mode decisions regarding the choice between greenfield and acquisition entry. This follows lines of inquiry by Kogut and Singh [1988] and Hennart and Park [1993].

The results emphasize the nature of firms' capabilities as determinants of international business, their impact on internalization of business and on entry modes. Economists have modelled the functioning of markets as a determinant

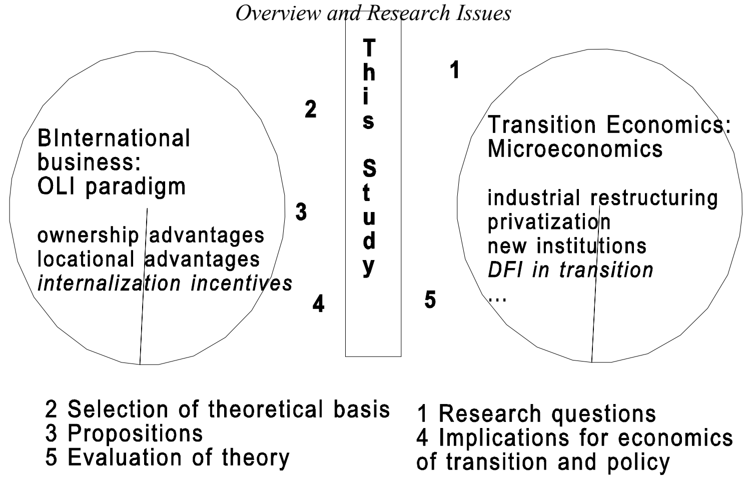

Figure 1.1 Analytical approach

of the expansion of multinational business and foreign investment. The theoretical work of this study suggests that characteristics of the firm should be an equally important component of the model. The empirical analysis confirms this view.

Complementing this work is a developmental model based on research on DFI in East Asia, for example Ozawa [1992] and Markusen [1991]. The model also incorporates aspects of the development cycle [Dunning 1986, Narula 1995]. It explains DFI as a function of environmental characteristics in the home and host economy, subject to barriers to relocation. If push-factors of structural change in an advanced economy combine with pull-factors from attractive locations in less advanced economies, then the model posits factor-cost oriented DFI. The model describes a special case within the OLI paradigm.

The empirical evidence for the application of this approach to CEE is however weak. The study detects slow growth as an incentive for DFI in CEE as predicted by this model, but in contrast to the growth theory of the firm. Yet market orientation dominates over investment-seeking factor costs which contrasts with patterns frequently reported for DFI within East Asia.

STRUCTURE AND METHODS OF ANALYSIS

The structure of this study is as follows: Part one gives an overview of the issues and outlines the research questions. Part two develops the theoretical basis for the empirical analysis in Part three. Part four concludes. The methods of inquiry change for each stage of the analysis.

Since this research covers a new and under-researched area, the basic facts on the local environment and on recent trends in DFI are summarized first. Chapter 2 provides a synopsis of the CEE business environment, DFI trends and contemporary research. The region offers unique business opportunities for West European business due to untapped markets and lower costs of production. The evidence has initially been clouded by the poor quality of available statistical data. Yet it is possible to outline the main trends of DFI since 1989 for host and home countries as well as investment characteristics. Recent studies have shed light on a variety of aspects of DFI, from the perspective of both the investors and the hosts. However, this research has only recently moved towards comprehensive studies and a systematic analysis of the phenomenon.

The second part of the study develops the theoretical foundations for the empirical analysis. The multitude of analytical and empirical approaches by economists on determinants of DFI are reviewed in Chapter 3, with a special appendix for the developmental model. The transaction costs (TC) approach has been selected as the analytical framework. In Chapter 4, an eclectic model is presented which focuses on the trade-off between internal and external TC. This is a middle-range theory which guides the empirical inquiry on the research questions of this study. The application in the empirical investigation provides insights that are hoped to advance the underlying theory.

Part three contains an empirical analysis of the determinants of international business in CEE (Figure 1.2). Prior and contemporary research on DFI in CEE has concentrated on actual investment projects and neglected firms which are not involved. However, decisions concerning involvement or non-involvement in a country are part of the decision process. Therefore, a broad base population has been selected for this analysis. The database for this study was developed with a questionnaire survey of a stratified random sample of German and British manufacturing enterprises. It contains information on the nature of the business relationships of 269 participating firms with CEE as well as company-specific data. Chapter 5 outlines the methodology of the survey and provides some summary results.

The empirical analysis consists of three tests related by one decision tree model. Firstly, a firm decides whether to engage in business with the region, then whether to invest directly, and finally the details of their investment project. In Dunning's OLI terminology, ownership and locational advantages are decisive during the first stage, while internalization incentives apply at the second stage and aspects of the third stage.

In Chapter 6, the differences between active and inactive firms are analysed. Hypotheses are tested on the determinants of the propensity of firms to be active in one or several countries of the region, using Probit and ordered Probit

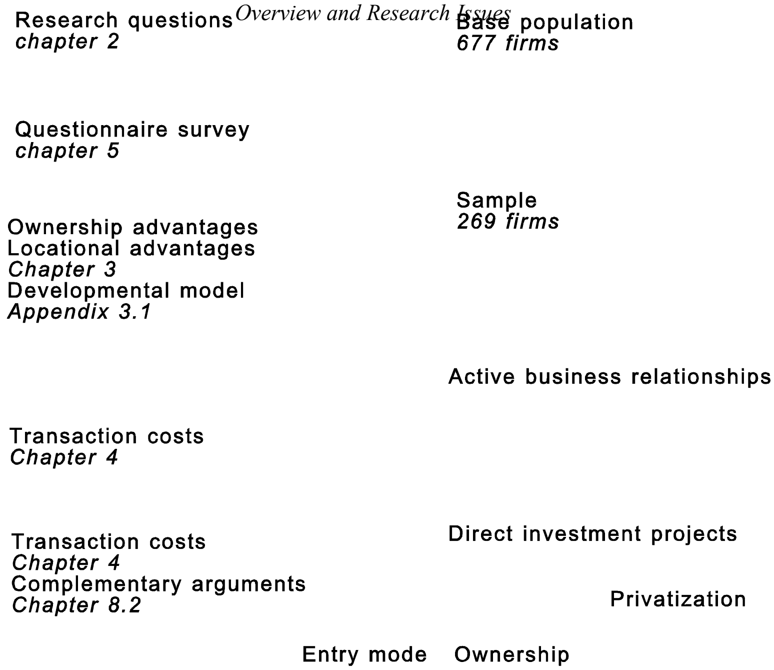

Figure 1.2 Structure of the empirical analysis

regression analysis. The incidence of business activity and the number of countries with whom business relationships exist, are explored. Firms with ownership advantages that can profitably be combined with the locational advantages in CEE are predicted to be more active. Evidence is found in favour of all four groups of proposed variables: intangible assets, common governance, barriers to growth and proximity. Common governance variables receive the strongest support: large, internationally experienced and undiversified firms are most active. Interestingly, slow-growing firms and German companies are more active, particularly in the Visegrad countries.

In Chapter 7, the active firms are investigated further to distinguish investors from firms with trade or contractual relationships. Ordered and multinomial Logit models are regressed and compared as alternatives in order to assess the notion that contracts are an intermediate form between trade and DFI. Internalization incentives are predicted to increase the preference for DFI relative to trade and contractual arrangements. Hypotheses are derived from the transaction cost model. The empirical results show that economies of common governance are the prime determinants of a firm's propensity to invest. This effect dominates over variables derived from traditional transaction cost proxies. Furthermore, the ordered model is rejected in favour of the multinomial, suggesting that contracts are a distinct mode of business. They are used even by high technology firms which are presumably most sensitive to market failure.

In Chapter 8, DFI projects are analysed with respect to equity ownership and mode of entry. Logit models are applied to analyse the preference for full versus joint ownership, and the choice of entry mode between greenfield, acquisition and JV, and JV-acquisition. As in Chapters 6 and 7, most hypotheses derived from general theories of DFI receive empirical support. Firms sensitive to market failure prefer full ownership while institutional constraints lead to a higher proportion of JVs in Russia and Romania. The nature of core capabilities explains preferences for greenfield entry by technology-intensive and non-food consumer good manufacturers. Surprisingly, acquisitions and JVs are not preferred in industries where the strategic motive of speedy entry is presumed to be important. Here, the weakness of local firms and the privatization process lead to unusual patterns. The effects of international experience and proximity are shown to be theoretically ambiguous. The empirical evidence suggests that the dominant effect is that inexperienced and distant investors prefer JVs as a mode of learning and risk-sharing.

An additional test finds that, by and large, the same firms participate in the privatization process and enter by acquisition or JV-acquisition. Two differences in the pattern emerge: German firms with international experience are more likely to acquire privatized firms while technology-intensive firms abstain.

The fourth and final part of this thesis is the concluding chapter. It presents an interpretation of the research findings and their limitations. Policy implications and suggestions for further research are discussed for both Transition Economics and the International Business literature.

NOTES

i. CEE refers to all countries of the former socialist bloc, including Albania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and the former Yugoslavia, Estonia, Latvia and Lithuania, Russia, Ukraine, Belarus, Moldova, as well as the Central Asian and Caucasian states of the former Soviet Union. The 'Visegrad countries' refers to Poland, Hungary, the Czech Republic and Slovakia.

ii. Such expectations were expressed by the joint study of the international financial institutions [IMF et al. 1991] as well as a number of research papers, for example Dunning [1991], Scott [1992], Csáki [1993], McMillan [1993].

iii. See for instance Sinn and Weichenrieder [1997], or Devreux and Roberts [1997].