Japanese Multinationals in European Transition Economies: Motivation, Location and Structural Patterns

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List of Abbreviations

ASEAN	Association for Southeast Asian Nations
BAT	Best Available Techniques
BTC	Bulgaria Telecom
BTMUFJ	Bank of Tokyo-Mitsubishi-UFJ
CE	Conformité Européene (European Conformity)
CEE	Central and Eastern Europe
CEECs	Central and Eastern European Countries
CIS	Commonwealth of Independent States
ČKD	Českomoravská Kolben-Daněk
COMECON	Council for Mutual Economic Assistance
DDR	Deutsche Demokratische Republik
DPFs	Diesel Particulate Filters
EA	European Agreements
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECU	European Currency Unit
EMU	Economic and Monetary Union
EU	European Union
FDI	Foreign Direct Investment
FGLS	Feasible Generalised Least Square
FSO	Fabryka Samochodów Osobowych
GDP	Gross Domestic Product
GE	General Electric
GLS	Generalised Least Square
GM	General Motors
GTCs	General Trading Companies
GUS	Glowny Urzad Statystyczny
HQs	Headquarters
HUF	Hungarian Forint
IMF	International Monetary Fund
IO	Industrial Organisation
IPA	Investment Promotion Agency
ISO	International Organisation for Standardisation
JBIC	Japan Bank for International Cooperation
JETRO	Japan External Trade Organisation
JIT	Just-in-Time
JVs	Joint Ventures

KSČM	Communist Party of Bohemia and Moravia (Komunistická strana Čech a Moravy)
KSS	Communist Party of Slovakia (Komunistická strana Slovenska)
LCD	Liquid Crystal Display
LDC	Less Developed Countries
M&As	Mergers and Acquisitions
MNE	Multinational Enterprises
MTs	Manual Transmissions
N/A	Not Available
NS	Not Significant
NAFTA	North American Free Trade Agreement
NGOs	Non Profit Organisations
NIFs	National Investment Funds
NUTS-1	Nomenclature of International Units for Statistics
ODA	Official Development Assistance
OEM	Original Equipment Manufacturing
OHSAS	Occupational Health and Safety Management System
OLI	Ownership-Location-Internalisation
OLS	Ordinary Least Square
OMV	Österreichische Mineralölverwaltung
OPT	Outward Processing Transactions
OJT	On-the-Job-Training
PAIiIZ	Polska Agencja Informacji i Inwestycji Zagranicznych
PCSE	Panel Corrected Standard Errors
PLN	Polish Zlotych
PR	Public Relations
PSA	Peugeot Société Anonyme
R&D	Research and Development
SARIO	Slovenská Agentúra pre Rozvoj Investícií a Obchodu in Slovak
SARS	Severe Acute Respiratory Syndrome
SEM	Single European Market
SEZ	Special Economic Zones
SKF	Svenska Kullagerfabriken
SMBC	Sumitomo Mitsui Banking Corporation
SME	Small and Medium Sized Enterprises
SMP	Single Market Programme
SOEs	State Owned Enterprises
SSD	Schools for Sustainable Development
SEWS	Sumitomo Electric Wiring System
TMIP	Toyota Motor Industries Poland

TMMP	Toyota Motor Manufacturing Poland
TNCs	Transnational Corporations
TPCA	Toyota Peugeot Citroën
TPS	Toyota Production System
TS	Technical Standard
TSCS	Time Series Cross Section
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States
VCT	Variable Camshaft Timing
VIF	Variance Inflation Factor
VW	Volkswagen
VW-BAZ	Volkswagen-Bratislavské Automobilové Závody
WDI	World Development Indicator
WIIW	Wiener Institut für Internationale Wirtschaftsvergleiche
WOS	Wholly Owned Subsidiaries
WSEZ	Wałbrzych Special Economic Zone
YKK	Yoshida Kōgyō Kabushiki-kaisha

1 INTRODUCTION

This dissertation aims to examine Japanese MNEs' activities and their FDI strategies in European transition economies, where the economic and institutional conditions have rapidly been changing through transition from state socialism to a market economy and integration into the regional and global markets through trade and capital flows. While a number of Western companies rushed into the transitional markets to gain first-mover advantages subjecting them to numerous threats and uncertainties in the CEE region from the fall of state socialism onwards, Japanese MNEs had a minimal presence or were totally absent for a long period of time. However, the number of Japanese MNEs has increased at a gradual pace in recent years. According to JETRO (2007), the number of Japanese manufacturing MNEs in the European transition economies reached 206 as the end of 2006, while in the year 1990 there was only one. This equals to the number of Japanese manufacturing MNEs in the UK (210). Faced with rapid changes in locational advantages in Europe, Japanese manufacturing MNEs have been under pressure to reorganise their value-creating networks of sales, distribution and production in response to emerging demands spurred by the completion of the Single European Market (SEM) in an enlarged Europe.

To date, rich empirical evidence exists on the characteristics and market entry strategies (*i.e.*, entry mode and management policies) of transnational activities of Western multinationals in the east of Europe through qualitative and quantitative methods (Brouthers, 2002; Brouthers and Nakos, 2004; Brouthers *et al*., 1999; Meyer, 1998, 2001). Most of the prior studies on this subject, however, have shown greater reliance on economic theories of international production (*e.g.*, Hymer's monopolistic advantages, Williamson's transaction cost theory, Casson's internalisation approach, and Dunning's eclectic paradigm). It should be kept in mind that Western-centric theoretical interpretations cannot sufficiently explain the investment behaviours of Japanese MNEs in European transition economies. It is because differences between Japanese and Western companies are substantial in cultural values, social organization of individual networks, corporate governance and business mindsets[1].

The main purpose of this thesis is to provide systematic and rigorous research into the patterns, processes and corporate strategies of Japanese MNEs in the CEE region. Understanding why Japanese MNEs decided to initiate production in or to relocate existing factories from Western Europe to CEE at a particular time constitutes our first

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[1] For example, against Japan's structural character of permanent employment practices, job promotion proportional to age, and *keiretsu* networks, Japanese firms have traditionally emphasized long-term stability over short-term profitability. In addition, 'consensus' and 'continuity' in the decision-making processes have been prioritized among Japanese firms, as compared to Western firms with emphasis on 'initiative' and 'change'.

significant concern. The subject of the examination to follow is to scrutinise local market environments in the CEE region. The quality of both economic and institutional forces embedded in national business environments is clearly paramount importance. In order to determine the appropriate FDI strategy in terms of competitiveness, efficiency, control over vital resources and legitimacy, firms should keep their eyes on the host country's transition environment. This thesis will also aim to investigate what determines investment decisions by Japanese multinationals at the subnational level and what variables are most important to operating successfully in the CEE region based on a combination of theories.[2] The results will help make crucial practice-oriented implications both for prospective investors and for host-based policy developers.

Sections 1.1 and 1.2 discuss research questions and the methodology issues addressed in the thesis. The organisation of this thesis is presented in Section 1.3.

1.1 Research Questions

CEECs in the post-socialist era remain in transformation. For foreign MNEs, economic and non-economic circumstances in the CEE region are more complex and difficult to manage. Thus the CEE region is a vital ground for an empirical investigation of foreign MNEs and their investment strategy since, in particular, the institutional infrastructure is different from and incomparable to those in less developed countries, for instance. I attempt to pay particular attention to systematically analysing the investment strategy of Japanese manufacturing MNEs in the European transition economies from the time of the collapse of state socialism to the present. A multi-method approach toward this goal is applied through the presentation of both descriptive studies and empirical analyses that enable us to test the explanatory power of a broad set of theoretical contributions. The central objective of this dissertation is to answer the following general questions:

- What is the state of FDI inflows in CEECs?
- What are the basic characteristics of Japanese FDI in CEECs in terms of the actual volume, destination, industrial distribution, motives, entry mode, ownership and operational experience?
- How do institution-based location advantages or disadvantages condition the overall trends and geographical scope of MNE activity in CEECs?
- What determines Japanese manufacturing MNEs' location choices at the sub-national regional level?
- What are the effects of changing environmental and institutional conditions of the host economy and firm-based advantages on the performance consequence of Japanese manufacturing MNEs? How do social networks, human resource management and the

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[2] Transaction cost theory, resource-based theory of the firm, industrial location theories and network theory are extended and advanced to probe the characteristics of Japanese FDI.

delegation of autonomy to the subsidiaries contribute to improving performance?

● How do the location strategy and performance outcome of Japanese manufacturing MNEs in CEE differ at the company level?

In particular, I concentrate on testing the postulation that not only economic factors (*e.g.* production cost advantages) but also non-economic factors in the CEE region are of significant importance in affecting the FDI strategy of foreign multinational organisations.

1.2 Methodology

The main question of this dissertation – whether corporate strategies of Japanese manufacturing MNEs have been determined not only by economic factors (*e.g.*, low production cost advantages: cheap but skillful human capital, transportation costs, inexpensive land costs, agglomeration economies and the like) but also by non-economic factors (*e.g.*, economic institutions, social networks and the like) – is explored by applying quantitative and quantitative methods: (1) the statistical analysis of existing data; (2) the statistical analysis of a questionnaire survey; and (3) case studies/in-depth interviews with open-ended questions.

(1) To identify the characteristics of host-based locational advantages and the historical development of inward FDI into the CEECs, this thesis used the UNCTAD '*World Investment Report*'; '*Economic Statistics and Forecasts*' from the EBRD; 'World Development Indicators' published by the World Bank. Data on the pattern of inward Japanese FDI and the locational and industrial distribution of Japanese manufacturing MNEs in the CEECs were collected from the JETRO '*Zai Ōshū Toruko Nikkei Seizōgyō no Keiei Jittai*' (in Japanese); '*Gyōshubetsu Taigai Chokusetsu Tōshi Jisseki*' (in Japanese) from Japan's Ministry of Finance; '*Kaigai Shinshutsu Kigyō Sōran: Kunibetsu*' published by Tōyō Keizai (in Japanese); the Chubu Industrial Advancement Centre '*Chūtōōshokoku e no Kigyō Shinshutsu no Genjyō to Kongo no Tenbō*' (in Japanese).

(2) To assess the Central and Eastern European strategy of Japanese manufacturing MNEs quantitatively, STATA 9, a statistical computer software package, was employed to determine which explanatory variables account for different aspects of corporate strategies (*e.g.*, industrial location and business performance). Giroud (2003: 149) argues the strength of quantitative methodology as follows: "a clear advantage of the quantitative design is that of credibility of results through a large number of responses organised in a structured way". The quantitative approach also empowers researchers to statistically test causal relationships between variables and thus verify the validity of existing theories.

(3) A case study approach helps to understand the significance of non-quantifiable determinants of the actions and behaviour of Japanese MNEs at a corporate-level by supplementing evidence found in quantitative methods. The case studies are based on a series of interviews with management from Japanese manufacturing MNEs operating in CEE and local government officials. The in-depth interviews were carried out on the basis of open-ended questions so that the interviewees can feel free to discuss company history, European strategy and operational experience. The case study method based on the interviews is helpful to advance our understanding of the decision-making and manufacturing activities of Japanese MNEs in CEE because of the following reasons: (1) detailed information about hidden, complicated and non-quantifiable factors; (2) the explication of cause-effect relationships; and (3) reliability. I also contacted the interviewees by email to obtain follow-up information. To support the information obtained from the interviews, secondary data from newspapers, a series of annual reports, company brochures, and magazines are utilised. The combination of primary and secondary data enriches the quality of the analysis.

1.3   Organisation of the Dissertation

This thesis contains 9 chapters, organised as explained below. The introductory part covers the background and purpose of the study, research questions, methodology and the organisation of this dissertation. **Chapter 2** sketches out various FDI-related theoretical contributions for comparison. I introduce an extensive range of theoretical contributions to the FDI strategies of foreign multinational organisations (*e.g.*, the characteristics and motivations of foreign investors, the dynamics of MNEs' location patterns and the consequence of MNE activity). First, I present theoretical insights into the underlying rationale behind MNCs' preference for foreign production over domestic production with special attention to Hymer's monopolistic advantage argument, Rugman's internalisation theory and Dunning's OLI configuration. Secondly, given the ownership advantages and internalisation advantages, this thesis also attaches importance to location advantages such as market- and non-market related causes that determine FDI. Along with L-type advantages, particular emphasis is placed on the general role of agglomeration economies. Thirdly, the chapter delineates the potential effect of non-market factors such as network relations and institutional changes on the attraction of FDI and its consequence. I investigate how sufficient an answer these theoretical contributions can offer to the question of FDI and MNE activity, and what limitations are inherent in them.

Chapter 3 describes the variations of market characteristics of the European transition economies and the general state of cross-border capital movement into the transition countries of CEE. It is intended to present the sequential development of inbound FDI

in the CEE region not only in absolute values, but also in population-adjusted terms. This chapter provides a comprehensive description of the pattern and trends of FDI transactions based on the countries of origin and industrial heterogeneity.

Chapter 4 summarises the characteristics, patterns and prima facie evidence of the motivations of Japanese FDI in CEE. The use of both FDI statistics and firm-level data help not only to characterise the recent trend of Japanese FDI but also to interpret corporate strategy and the motives of Japanese firms. This chapter shows that the whole history of Japanese investment in the CEE region is relatively short and that the geographical scope of Japanese firms is shifting gradually from the old western periphery of the EU (Spain and Portugal) to the eastern periphery. The chapter also discusses that both investment motivations and relocation determinants vary substantially by country. The descriptive part of the study ends with this chapter.

Chapter 5 concentrates on the extent and method of institutional development in order to attract foreign investors' attention to the European transition economies by relying on the combination of a variety of internationally recognised statistical sources and the prior relevant scholarship. This chapter views and scrutinises the cross-country variation on microeconomic restructuring and the institutionalisation of FDI practices. I empirically test how these institutional variables affect FDI inflows by virtue of comparison with market-related factors. The aim is to verify how the dynamic behaviour of profit-maximising multinational organisations is framed into a context of institutional transformation by utilising a dynamic panel data approach.

Chapter 6 is dedicated to examining how influential market and non-market factors are in determining Japanese multinational organisations' location choices in CEE at the sub-national regional level, utilising McFadden's conditional logit model. The data set contains 205 Japanese manufacturing firms operating in 20 NUTS-1 regions during the years 1991-2006. With particular attention on agglomeration economies in conventional economic and institutional considerations, I discuss exactly how spatial concentration contributes to shaping Japanese manufacturing firms' location strategy in the CEE region. I also aim to identify the industrial location contributions from institutional development, an ownership-type advantage of local operational experience and business groupings. Finally, the chapter discusses sequential shifts in the effect of industrial agglomeration on location choice. The limitations of this chapter and future suggestions are discussed.

Chapter 7 sheds special light on the question of how economic and non-economic factors, as well as firm-specific competitive advantage, determine performance heterogeneity. Additionally, in this chapter I also take a closer look at the nexus of

network relations (*e.g.*, parent-subsidiary relations, ties with home-based business groups and ties with local political and social actors). The data set covers the primary data of 55 Japanese manufacturing affiliates in CEECs. This primary data was collected by the author in January 2008. This survey analysis shows the extent of managers' perception of firm performance as well as shifts in environmental and institutional conditions. I perform multiple regressions on the basis of multidimensional performance measures (1. overall operational satisfaction; 2. profitability; 3. sales growth; and 4. cost reduction) as dependent variables. The very uniqueness of this study with the use of the econometric tool is to empirically identify the determinants of the performance outcomes of Japanese manufacturing firms in the European transition economies that have been disregarded by scholars of international economics and business. The limitations of this chapter and future suggestions are discussed.

Chapter 8 analyses the actual variation in investment strategies of four Japanese manufacturing MNEs by using the case study method. This chapter focuses on complementing evidence presented in the previous chapters. An in-depth case approach on the basis of a series of semi-structured interviews is adopted to scrutinize the variation of four case firms' (NSK-ISKRA, Denso Hungary, Sanyo Hungary and TMMP/TPCA) FDI strategies in terms of primary motivations for investing in CEE, economic and institutional factors affecting FDI strategy, current operational experience, and corporate performance. One of the greatest advantages of the case study approach is the ability to explicate complicated, non-quantifiable and hidden factors that influence the strategies and actions of MNEs. Hence, the case study approach is suitable for describing and interpreting the *process* as well as the *consequences* of FDI strategy of the four case study firms more appropriately relative to the survey approach and the econometric approach. The case study approach draws on semi-structured interviews with management of a number of Japanese manufacturing firms operating in countries in CEE and Western Europe. With the purpose of supporting the validation of the information gathered during the interviews, I adopt secondary data from media reports, companies' corporate websites, and newspapers.

Chapter 9 presents a summary of the empirical findings and provides concluding remarks. This chapter also presents policy and managerial implications for host governments in CEECs to win in the international competition for inbound foreign capital and to become an attractive destination not only for labour-intensive FDI but also for capital-intensive FDI.

For purposes of this thesis, CEE includes 16 countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia.

Figure 1-1: Map of Central and Eastern Europe

Source: United Nations
http://www.un.org/Depts/Cartographic/map/profile/easteuro.pdf (accessed on 9 October, 2008).

2　THEORETICAL DISCUSSION OF MNE ACTIVITY

2.1　Introduction

This chapter lays out a theoretical framework within which FDI strategies of Japanese manufacturing firms in the European emerging economies are analysed and interpreted. The market penetration of Japanese manufacturing FDI in the European emerging economies has intensified in recent years. Which theoretical assumptions can be utilised to understand this salient trend in line with the geographical, political and economic expansion of the EU? To what extent do existing FDI theoretical perspectives have explanatory power in examining the internationalisation of Japanese manufacturing firms in an enlarged Europe? This field of study has been underdeveloped with the exception of a few Asian scholars (*e.g.*, Hwang, 2007, 2008; Hwang *et al.*, 2008; Lim, 2003).

To date, significant weight has been placed on firm-specific characteristics and internalisation attributes affecting cross-border MNE operations in economic and business perspectives of international production. Hymer's (1960) industrial economics hypothesis embraces the importance of firm-specific advantages to outperform local firms when venturing into foreign markets, while internalisation theory (Buckley and Casson, 1976; Casson, 1987) considers the MNE as the formation of an internal market to avoid transaction costs in arm's length markets.

However, few previous studies have integrated aspects of location, institutional change and network development into the investment strategy of Asian MNEs in the European transitional economies. To build a dynamic and sequential model to explore and explain the establishment of multinational organisations beyond national boundaries in economies in transition, I review various FDI-related theories with special emphasis on these overlooked theoretical perspectives. The FDI theories I analyse in this chapter stem from five streams of theorising: (1) MNE-based; (2) economic geography; (3) strategic management; (4) network; and (5) institution-specific. Along with the key notion of each theory, the strengths and weaknesses of each theoretical work will also be explained. Theories I present in this chapter include:

1. MNE-based theories (*e.g.*, Vernon's product life cycle argument, Hymer's monopolistic advantage hypothesis, internalisation theory and OLI configuration in hierarchical capitalism);
2. Spatial analysis of MNE activity (*e.g.*, Marshall's localisation hypothesis, Krugman's economic geography approach, Porter's industrial cluster model);
3. Strategic perspective (*e.g.*, resource-based view);
4. Network-based theories (*e.g.*, network-based OLI configuration in alliance capitalism and *keiretsu* organisation hypothesis); and

5. Institution-specific theories (*e.g.*, institution-based OLI configuration).

First, I begin with Vernon's product life cycle theory, Hymer's industrial organisation economics, Rugman's internalisation theory and Dunning's OLI configuration of international production. Second, within the economic geography context, the spatial dynamics of MNEs is theoretically scrutinised. Third, the strategic management perspective (*i.e.*, the resource-based view of the firm) is introduced to supplement the theoretical notion of ownership advantages from the industrial organisation hypothesis. Fourth, the logic of network-based approaches to FDI (*e.g.*, business groups, assembler-supplier relations, customer-seller relations, intra-firm networks, external networks) is examined, followed by institution-specific theories. The analysis of these various existing theories helps us to build an integrative conceptual model for the examination of MNEs' investment strategies in the European transition economies. Moreover, the rationale for these diverse theoretical explanations is supported by the fact that the concept of FDI *per se* has become more complicated and intertwined with theoretical perspectives based on the disciplines of international business, strategic management, economic geography, networks and institutions. These theories share common economic and institutional perspectives.

I pay special attention to the following questions in order to construct a theoretical framework for the investment strategies of Japanese manufacturing MNEs in the European transition economies:

- What kind of theoretical frameworks can be persuasive in explaining the motives, conditions and types of MNE activity in general?
- To what extent can the conventional FDI theories and other relevant theoretical approaches provide sufficient and reliable accounts of the investment strategy of Japanese manufacturing firms in an enlarged EU?
- Can conventional economic factors (*i.e.*, cheap labour costs, supplies of non-skilled and experienced workers, transport infrastructure) satisfactorily explain the nature and determinants of Japanese manufacturing FDI?
- To what extent do nonmarket factors (*i.e.*, social organisation of Japanese *keiretsu* systems, institutional changes of European transition economies) play a critical role in influencing the pattern and location choice of Japanese manufacturing firms in CEE?

2.2   Approaches Related to MNE-Based Theories

2.2.1   Product Life Cycle Theory

With special emphasis on international diversification, Vernon (1966, 1979) theorised the transfer of production sites by US firms from the domestic market to less-developed

countries (LDCs) in response to the maturing and standardisation of products. The prism of the product life cycle hypothesis builds on the postulation that a firm innovates in its home-country market, especially in an advanced economy such as the United States. Emerging demand for new products in foreign countries validates the reasoning for venturing in foreign markets, especially to discourage foreign rivals. According to Vernon, the major incentive for firms to explore international diversification is to extend a product's life cycle and respond to shifts in comparative advantage. Vernon termed this sequential and dynamic model as product life cycle theory.

First, production activity is implemented inside the US market in the initial phase because of the specificity of new products (*e.g.*, low price elasticity) and the presence of external economies (*e.g.*, flexibility and swiftness in communication). In the second phase, firms start exporting their products in pursuit of scale economies through expanding markets in other advanced economies. However, other advanced economies may begin with imposing import restrictions to regulate the volume of exports from the US over time. In order to circumvent such restrictive trade policies, US firms set up their production factories in other advanced economies in order to secure or sustain their market share. More importantly, since production cost differentials between the domestic and foreign markets turn out to be disappearing over time, US firms are forced to seek other countries with greater comparative advantages. In the third phase, intensified competition for production costs turn out to be very threatening because production processes are more standardised and the need for communication and external economies declines more quickly. As a result, US firms are forced to start closing down their existing production factories in other advanced economies and then produce their products in LDCs where even economic uncertainty and FDI regulations do not cancel out cheap labour costs yet. These sequential production relocation processes turn out to cause the hollowing-out problems in the US market. Special attention is paid to changes in the intensity of competition between rivals, FDI motives, and dynamics of environmental changes in host economies (*e.g.*, labour costs) in Vernon's product cycle theory.

However, the explanatory power of Vernon's product life cycle theory is sufficient only in the manufacturing sector. Gordon and Lees (1986: 49-50) highlight several critical drawbacks underlying the product life cycle hypothesis. First, Vernon's theory postulates that only US MNEs play a leading role in the international expansion of production activities. Thus, his theory lacks the reliability of explaining the relevance of international businesses of Japanese and European MNEs. Second, MNEs have the ability to engage in manufacturing various types of products ranging from standardised to mature at the same time and to rapidly differentiate their products at present. Third, some variations in FDI objectives are neglected in Vernon's product life cycle theory. Horaguchi (1992: 119) also criticises Vernon's hypothesis for its weak theoretical clarity in the conception of product life cycles. As regards the actual product life cycles, the

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theory does not specify the length of a product's maturity phase and the speed of its product's obsolescence (Horaguchi, 1992: 119). These issues have weakened the explanatory power of the product life cycle theory as a theory to explain the actual behavior of MNEs in the contemporary global economy. Nevertheless, Michalski (1995: 30) claims that the explanatory power of the product life cycle hypothesis remains valid for the explanation of the foreign market operations of small-and-medium-sized enterprises that have difficulty creating their own global value chain systems because of limited sources of capital, weak ownership advantages and limited international experience relative to large MNEs.

2.2.2 Industrial Organisation Economics

Monopolistic behaviour of multinational organisations, developed in Stephen Hymer's MIT doctoral dissertation, has thus far been the intellectual principle of international business studies. Hymer's initial puzzle was *why* firms go multinational to engage in business operations in foreign markets (Yeung, 1997). According to Hymer (1960), firm-specific assets are the central determinant of FDI. An attempt is made by Hymer to detect how foreign firms transfer their own activities to and exploit them in foreign markets to overcome unfavorable conditions relative to indigenous firms. In other words, indigenous firms are strategically in an advantageous position for accessing superior information on institutional changes, language, regulatory structures and politics of their home country. On the other hand, foreign firms may have a high possibility of facing a host government's intervention and its discriminatory treatment differently from indigenous firms who have rich localised networks of production, sales and distribution. The issues of expropriation and exchange rate risks also inhibit MNE activity and behavior (Hymer, 1960: 35). These barriers to entry are referred to as 'liability of foreignness' (Zaheer and Mosakowski, 1997). Given these disadvantageous grounds, Hymer (1960: 41) argues that foreign firms aiming at entering foreign markets have to possess monopolistic power to outperform indigenous firms when going multinational. This concept of industrial organisation economics developed by Hymer (1960) has its roots in Bain (1956) who stressed that the strength of a firm's ownership advantages determines returns on investment. Bain (1956: 15-16) suggests that a newly established firm in a foreign market should have the ability to leverage cost effectiveness, price discrimination, advertisement intensity and product differentiation over indigenous firms.

Besides monopolistic advantages, Hymer (1960) highlights the motive for engaging in international operations. Various transaction costs inherent in imperfect markets induce a firm to go multinational in the form of direct investment. For example, "a conflict of evaluations" (Hymer, 1960: 50) prevents investors from licensing their advantages. Licensing ends up causing diverging interests between licensors and licensees in achievement of objectives and performance. Additionally, a licensor has

limited control over its advantage and is subject to the danger that his advantage may be imitated, reproduced and transferred to its competitors. To avoid such transaction costs arising from imperfect markets, an investing firm needs to choose FDI. Therefore, some theoretical elements overlap between Hymer's industrial organisation economics and transaction cost theory.

Hymer's industrial organisation hypothesis does not perfectly explain the extent and direction of FDI. One of the major weaknesses is that his attention is skewed towards the competitive advantages that the firm possesses relative to its rival firms in another country, while scarce attention is paid to location-specific factors. Michalski (1995: 49) also claims that the theory somewhat overlooks the industry structure of host countries. For example, the initiation of discriminatory trade policies by the European Community (EC) against Japanese products during the 1980s and 1990s motivated Japanese MNEs to invest in the region. Thus, the theoretical application of Hymer's monopolistic advantages to this tariff-jumping FDI seems irrelevant. Hymer also makes no mention about the determinants of the spatial organisation of MNE activity in his theoretical work.

2.2.3 Transaction Cost Economics

Before starting the discussion on internalisation theory, it is necessary to look back on the transaction cost theory (Coase, 1937; Williamson, 1975) that is known to be the major root of internalisation theory. Williamson (1975) made contributions to enriching the understanding of governance structures of a firm by emphasising the distinction between hierarchies and markets. Transaction costs refer to the costs of conducting economic exchange in a market exceeding the costs of organizing the exchange in a firm (Kretzberg, 2007: 60) .

According to the transaction cost theory (Williamson, 1985), firms need to overcome three transaction costs: (1) bounded rationality; (2) uncertainty in exchange; and (3) opportunistic behaviour in the external market. Williamson (1985: 20-22) emphasises that there are two types of transaction costs. One is ex-ante transaction costs that occur when actors prepare, negotiate and sign a contract. Ex-ante transaction costs include: (1) costs for searching information on the availability of potential partners; (2) costs for legal consultation prior to the agreement of a contract; (3) costs for hedging against a risk of investment failure. Ex-post transaction costs refers to: (1) costs for ensuring the quality of goods or services; (2) costs to shape a contract partner's behavior in a desirable direction; and (3) costs for revising contractual agreements to adapt to changes in market conditions.

Williamson (1975) details the three major attributes of a transaction: (1) *specificity*, (2) *uncertainty*, and (3) *frequency*. Consideration of these thee attributes provides us with the opportunity to understand how transaction costs affect actual organisations and rules. Investment *specificity* of transactions concerns investment in

the exclusive use of resources required by a transaction for a particular exchange relationship. For example, firm-specific knowledge about technology and management indicates asset specificity. It is assumed that the more opportunistically economic actors tend to behave the more specific the state of transactions would be. As a result, transactions with relevance to specific investments require an agreement or a means to safeguard an investor from the opportunistic behavior of its transaction partner. Otherwise, one party may threaten another to obtain more desired conditions relative to the initial condition with the cancellation of the transaction (Williamson, 1975).

Uncertainty makes a transaction complex. *Uncertainty* is determined by the degree of predictability and the number of shifts in the arrangement of a transaction in goods and services. *Uncertainty* of a transaction concerns changes in product quality, date of delivery, quantity and price. The more frequently transaction contracts need to change the more difficulty parties have in conducting control over and in reaching the optimal consensus of the exchange of goods and services.

Frequency of transaction refers to the number of times goods and services are exchanged between parties during a given period (Teece, 1986; Williamson, 1975). Specificity and firm strategy condition the *frequency*. For example, there are a number of potential suppliers and customers in the case of standardised intermediate parts. When transactions repeat themselves over a long-time period, certain rules and standards seem likely to form in order to mitigate transaction costs. The organisation of long-term transactional relationships reflects the control over the opportunistic behavior of partners.

There are two types of governance forms to circumvent or minimise potential transaction cost problems. One is *vertical integration,* while another is *horizontal integration*. *Vertical integration* refers to the integrated form to lower the risk of price fluctuations within the organisation. Transaction cost economics assumes that the common governance of complex MNE activities in dispersed locations should be internal to the firm. That is to say, the firms internalise transactions of intermediate products to ensure the quality of the final product. Intra-firm trade is thus favored by the firm.

Horizontal integration refers to the integrated form of MNE activities between the headquarters and its subsidiaries across national borders. Managerial resources such as product technologies, marketing, financial assets and management of human resources are shared between the headquarters and its subsidiaries as horizontal integration advances. Scope economies arising from information sharing within an intra-firm trade gives rise to principal incentives necessary to the growth of the firm.

2.2.4 Internalisation Theory

Rugman's (1975, 1980) internalisation approach builds on a synthesis of Hymer's industrial organisation theory and Williamson's transaction cost economics (1985).

Internalisation theory views that foreign firms tend to opt for direct investment, which contributes to overcome market imperfections and reduce high transaction costs. The internalisation hypothesis stipulates that a firm engages in FDI to internalise market or contractual transactions within its influence as a result of governmental regulations and market imperfections (*i.e.*, asymmetrical information and scarce knowledge of local market conditions vis-à-vis indigenous firms). Buckley *et al*. (1993: 276) also assume "internalisation of markets across international frontiers allows the reduction of the firm's overall tax bill relative to firms that trade at the arm's length". Rugman (1975, 1980) argues that returns from FDI correspond to the amount of the difference between the total sales from production costs involved in location-specific factors and special costs involved in firm-specific factors. Internalisation of technology is a strategic option for a firm to prevent other firms from entering the industry, enabling the firm to attain price discrimination. Casson (1987) considers that contractual resource transfers are the optimal option for MNEs when effective patent protection systems are well established in a market.

The preference of FDI over exporting and licensing is explained by the possession of monopolistic advantages that MNEs can exploit internally when expanding across national boundaries due to market failure and uncertainties (Buckley and Casson, 1976). MNEs may establish their subsidiaries (*i.e.*, wholly owned subsidiaries) in the form of complete ownership to ensure the quality of intermediate products, finished products and after-service and to avoid arm's-length price settings (Buckley and Casson, 1976). In management studies, transaction cost economics has often been applied to the choice of entry modes in manufacturing and non-manufacturing. Scholars (*e.g.*, Andersson, and Svensson, 1994; Brouthers, 2002; Gatignon and Anderson, 1988; Meyer, 1998; Meyer and Nguyen, 2005; Yiu, and Makino, 2002) consider that organisational forms for market penetration depend on the calculation of both benefits and costs of transactions either within or beyond the boundary of the firm. Knowledge leakage and free-riding problems involve high opportunistic costs in the formation of new joint ventures, while new ventures with complete ownership fend off the potential dissemination and exploitation of cutting-edge technological knowledge by others (Rhee, 2008). Hence, scholars of internalisation deem efficient control as a key determinant for the behaviour of MNEs and as a means of managing global strategies between the parent company and its foreign subsidiaries.

However, several remarks need to be given. First, the internalisation model is not aimed for describing *processes* (Johanson and Mattsson, 1993: 316), while it is suitable only for explaining why MNE exists. Second, it should be noted that the process of the internalisation of operations may give rise to efficiency, but entails more costs when a firm expands in foreign markets that are characterised as different from its home market in culture, social norms, market-supporting institutions and distance. Third,

the internalisation theory overlooks strategic competitive motives and neglects location-specific considerations (Michalski, 1995: 64).

2.2.5 Classic OLI Configuration in Hierarchical Capitalism

Dunning's (1977, 1988, 1993) eclectic paradigm of international production has been a conceptual foundation for analysing the processes and consequences of MNE activity and FDI in the disciplines of international business and strategic management. This eclectic paradigm stipulates that the configuration of three conditions: (1) ownership-specific factors; (2) location-specific factors; and (3) internalisation incentive factors affects the propensity of a firm to enter foreign markets by means of foreign direct investment over exporting or licensing (see Figure 2-1). The initial motive to establish this comprehensive and integrative model arises out of the argument that the behaviour of MNEs is more complex as time goes by.

The first pillar of Dunning's ownership-location-internalisation (OLI) paradigm is ownership-specific advantages (O). This dimension refers to a firm's possession of superior managerial skills, production techniques and privileged access to raw materials and components that enable it to outperform indigenous firms.

The second pillar of the eclectic paradigm, the location-specific attributes (L) of countries, includes: (1) market size for goods or services; (2) infrastructure; (3) the availability of labour at affordable costs; (4) government intervention in the form of setting performance requirements and ownership control; (5) scale economies; (6) trade barriers; and (7) transport costs. The L-specific advantages lead firms to generate and develop the value of O-specific advantages.

Internalisation (I) is the third pillar of the OLI configuration. The more superior ownership advantages a firm possesses, the higher the probability the firm will internalise them rather than externalise and control its own market by hierarchical governance. The holy trinity of Dunning's OLI configuration can determine not only whether FDI is preferred over exporting or licensing but also the structure and level of foreign MNEs in foreign markets (Dunning, 1977, 1988, 1993). The OLI paradigm of international production has been extended to an analysis of the characteristics and consequences of international operations related to entry mode choice (Brouthers *et al.*, 1999; Hill *et al.*, 1990; Luo, 2001; Nakos and Brouthers, 2002) and the location of FDI (Meyer and Nguyen, 2005).

It is noteworthy to mention several theoretical weaknesses in the OLI paradigm. First, the paradigm provides little or no analytical insight to explain a firm's acquisition of its rivals to enhance firm competitiveness (Michalski, 1995). Moreover, FDI is not necessarily conditional on the possession and exploitation of ownership advantages in the case of M&A-based FDI transactions because aggressive FDI undertaken by firms with weak competitive resources may occur with the aim of acquiring firms with strong competitive resources. Second, Dunning's OLI framework

is not a 'theory' but an 'eclectic paradigm' as it simply combines various theories together.

Figure 2-1: OLI Configuration in Hierarchical Capitalism
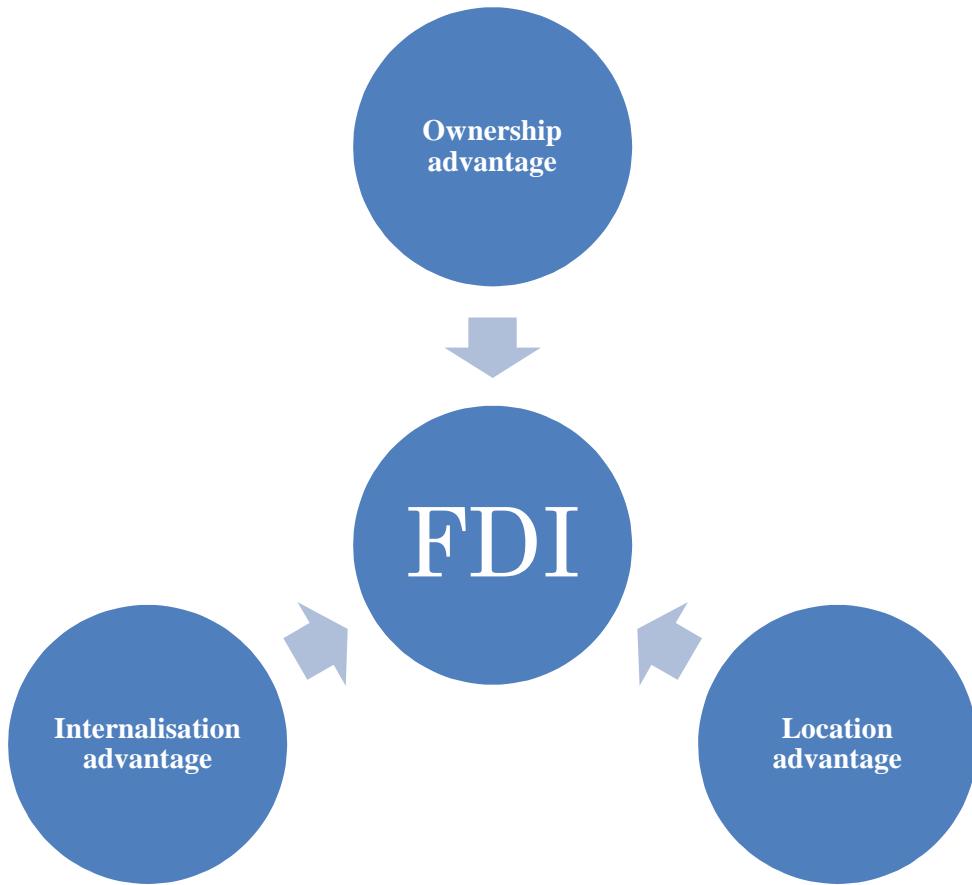
2.3   Strategic Approach

2.3.1   The Resource-Based View of the Firm

The resource-based perspective attaches importance to the logic that a firm's competitive advantage lies in its internal organisation (Barney, 1986; Leonard-Barton, 1992; Wernerfelt, 1984). The well-established resource-based view, with its roots from Penrose's (1959) "*Theory of the Growth of the Firm*", offers crucial insights into corporate strategy. The evident assumption of this view is that different internal resources in different firms shape their own capabilities that become competitive advantages. The resource-based view stipulates that core capabilities that constitute a set of distinguished R&D skills, managerial systems, values and norms are shaped by resources (Leonard-Barton, 1992). Wernerfelt (1984) seeks to analyse the essence of resources for the growth of the firm instead of highlighting that of products. Wernerfelt (1984: 172) suggests that key issues of the growth of the firm are:

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- On which of the firm's current resources should diversification be based?
- Which resources should be developed through diversification?
- In what sequence and into what markets should diversification take place?
- What types of firms will it be desirable for diversified firm to acquire?

In order to deal with these key issues, firms must formulate strategy to develop their resources. Resources include brand name, technical knowledge accumulated internally, talented labour, customer-supplier relations, machinery, financial channels and administrative efficiency. Making good use of these resources may make it difficult for other rivals to keep up with the firm. Wernerfelt (1984: 173) asserts that "what a firm wants is to create a situation where its own resource position directly or indirectly makes it more difficult for others to catch up". Barney (1986: 1231) terms this as the creation of "strategic factor market". Collis and Montgomery's (1998) approach is that balancing the interplay between business, resources and organisations results in creating competitive advantages. Collis and Montgomery (1995: 119) define firms as "different collections of physical and intangible assets and capabilities". This indicates that there exist no two identical firms that possess the same resources, experience, skills and organisational capabilities. Thus, firms compete in markets by business strategy based on the practical application of their unique resources. To distinguish whether resources give rise to competitive advantages, Collis and Montgomery (1995: 120-124) develop five analytical indicators as follows:

- Inimitability: Is the resource hard to copy?
- Durability: How quickly does the resource depreciate?
- Appropriability: Who captures the value that the resource creates?
- Substitutability: Can a unique resource be trumped by a different resource?
- Competitive superiority: Whose resources are really better?

With these indicators, firms can evaluate their business strategy and reinforce competitive advantages to overcome emerging competition.

When comparing the resource-based view of the firm with transaction cost economics and industrial organisation economics, we find various aspects in common. As stipulated by transaction cost theory, the resource-based view of the firm also considers that a firm continues to regularly control its transactional efficiency and adapt its business structure to changing environmental factors in order to reduce transaction costs. The major difference between these two theoretical perspectives is that the resource-based view is suitable not only for analysing any transactional relationships in cost-economising considerations but also for creating the resources necessary for the growth of the firm even at high costs involved. As Porter (1990) argues, the

resource-based view also stipulates that business strategy should be shaped by competition; firms thus seek to acquire new resources in their efforts to develop competitive advantages. One major difference is that scholars of the resource-based view highlight internal environments (*i.e.*, firm heterogeneity) at the individual company level, while scholars of corporate strategy (Porter, 1990) place more weight on external environments such as industry structure and market position (Dyer and Singh, 1998). Dyer and Singh (1998: 675) argue that a one-sided theoretical focus on the firm unit of analysis may be insufficient to explain the growth and survival of the firm in domestic and international business environments.

2.4   Spatial Analysis of MNE Activity

2.4.1 Marshall's (1920) Localisation

Marshall (1920) was among the first to attempt to conceptualise the relevance of positive agglomeration economies originating in the spatial concentration of specialised industries in particular localities. Marshall (1920: 225-27) argues as follows:

> "*When an industry has chosen a locality for itself, it is likely to stay there long: so great are the advantages which people following the same skilled trade get from near neighborhood to one another. If one man starts a new idea, it is taken up by others and combined with suggestions of their own; and thus it becomes the source of further new ideas. Every cheapening of the means of communication, every new facility for the free interchange of ideas between distance places alters the action of forces which tend to localise industries*".

Accordingly, these aforementioned statements suggest that the effect of clusters of firms competing in a particular place may contribute to lowering (in)tangible production costs and obtaining higher productivity and return on investment. Agglomeration plays a role in boosting business transactions and coordination, while in gathering information on the dynamics and structure of indigenous markets. The information that firms have acquired and shared with other competitors in clusters serves the objective of developing a way of doing business in new markets and improving product quality and production processes within their internal settings.

2.4.2 Krugman's (1991) Industrial Agglomeration Theory

The purpose of Krugman's (1991) *Geography and Trade* was to explicate geographic concentration of industries from an economic perspective. Krugman stipulates that the most critical essence of economic activities resides in spatial concentration. This principle of the spatial concentration of economic activities is modeled by Krugman

with focus on specialisation using the manufacturing belt in the United States as an example. The spatial cluster model rests on the interplay between scale economies, demand functions and reduction in transportation costs. Drawing on Marshall (1920), Krugman (1991: 43-54) integrates the concept of agglomeration economies into the patterns of firms' location choices as follows:

- *Additional thoughts on labour pooling*: The concentration of industrial activities in a specific location leads to an optimal balance between supply and demand in the labour market;
- *Intermediate inputs*: The abundance of suppliers of specialised input and services enhance specialisation. As a result, firms positioning themselves in industrial clusters can produce intermediate products at inexpensive costs; and
- *Technological spillovers*: Agglomeration of firms with similar products creates the development of technological knowledge.

These factors give rise to the incentive to promote the geographic concentration of economic activities. Krugman's theoretical weakness lies in the fact that spatial dispersion of economic activities is overlooked. Additionally, although it is true that the manufacturing belt has continuously sustained competitive advantages as an industrial agglomeration district, the share of the US manufacturing industry that the manufacturing belt possesses has dropped over time.

2.4.3 Porter's (1990) Competitive Advantage of Nations

Michael Porter's diamond model (1990) has provided useful analytical guidance for understanding the impact of a nation's location advantages on the competitiveness of a firm. In other words, the main unit of analysis is not firms but countries (see Figure 2-2). In his paradigm, productivity, which is determined by product quality and production efficiency, plays a central role in promoting the competitive advantage of the nation. Porter's model is based on four elements.

The first pillar in Porter's diamond model is *the factors of production*. This first dimension consists of various inputs required for competition: labour force, natural resources, capital, knowledge and infrastructure. Moreover, the factors of production are categorised into two distinct types: (1) basic factors of production (natural resources, climate, inexperienced human capital etc.); (2) specialised factors of production (advanced communication systems, human capital with highly specialised skills). In order to upgrade competitive advantages, the latter factors are considered of particular importance to serve the objective of engaging in product diversification and innovation.

The second pillar in Porter's diamond model is *demand conditions* that are made up of the nature and size of buyers' needs in the home market for the industry's goods or

services. Firms are forced to continue to upgrade their existing products and innovate new products in response to high demands of buyers when these buyers' ability to distinguish the quality of products and services is highly sophisticated by global standards (Porter, 1990:86-100).

The third pillar is *related and supporting industries*. Taking Italy as an example, Porter attributes the leading role of the Italian shoe industry to related and supporting industries that consist of a number of entrenched leather-processing and design services firms. Porter points out that sustainable development of related and supporting industries are based on the creation of industrial clusters (Porter's industrial clusters will be explained in more detail later.).

Lastly, *firm strategy*, *structure* and *rivalry constitute* the final pillar and are considered to create the evolution of specific industries. The types of strategy, structure, and rivalry among firms differ from nation to nation. The four key pillars of Porter's diamond model stress the environmental characteristics of a national economy that contribute to upgrading competitive advantages of the nation. There are some variations in terms of the role of the organisation in enhancing employees' motivations to work as social norms and work ethic greatly vary by nation. It indicates that the internal structure of the organisation is likely to be developed by the strategic goal of a firm. Porter postulates that innovation is created and promoted by a series of competitions within the domestic market.

Thus, the creation of competitive advantages can be achieved only when a firm enforces an adequate strategy in line with these four pillars of the model. In other words, consideration must be given to the supportive interplay between these marked country-specific attributes when making a strategic decision about timing, location and measures to develop price discrimination and product differentiation in an international business environment.

Furthermore, Porter states two additional elements that complement these four basic dimensions: (1) *chance* and (2) *the role of government*. Chance (Porter, 1990: 124) refers to:

- Acts of pure invention
- Major technological discontinuities
- Discontinuities in input costs such as the oil shocks
- Significant shifts in world financial markets or exchange rates
- Surges of world or regional demand
- Political decisions by foreign governments
- Wars

Government policy also makes significant contributions to the growth of many firms and industries. At the same time, government policy also acts as a detrimental effect on

the four determinants. Porter (1990: 127) explains how government policy affects each condition of the diamond model:

- Subsidies, policies toward the capital markets, policies toward education and the like all shape factor conditions.
- Demand conditions are affected by regulations and rules imposed by government authorities on buyers.
- The characteristics and consequences of related and supporting industries are determined by regulations of advertising media or supporting services.
- Antitrust laws and alternation in tax regulations exert an impact on firm strategy, structure and rivalry.

Both chance and the role of government serve to influence the four pillars of the model in positive and negative directions.

Figure 2-2: Determinants of National Competitive Advantage
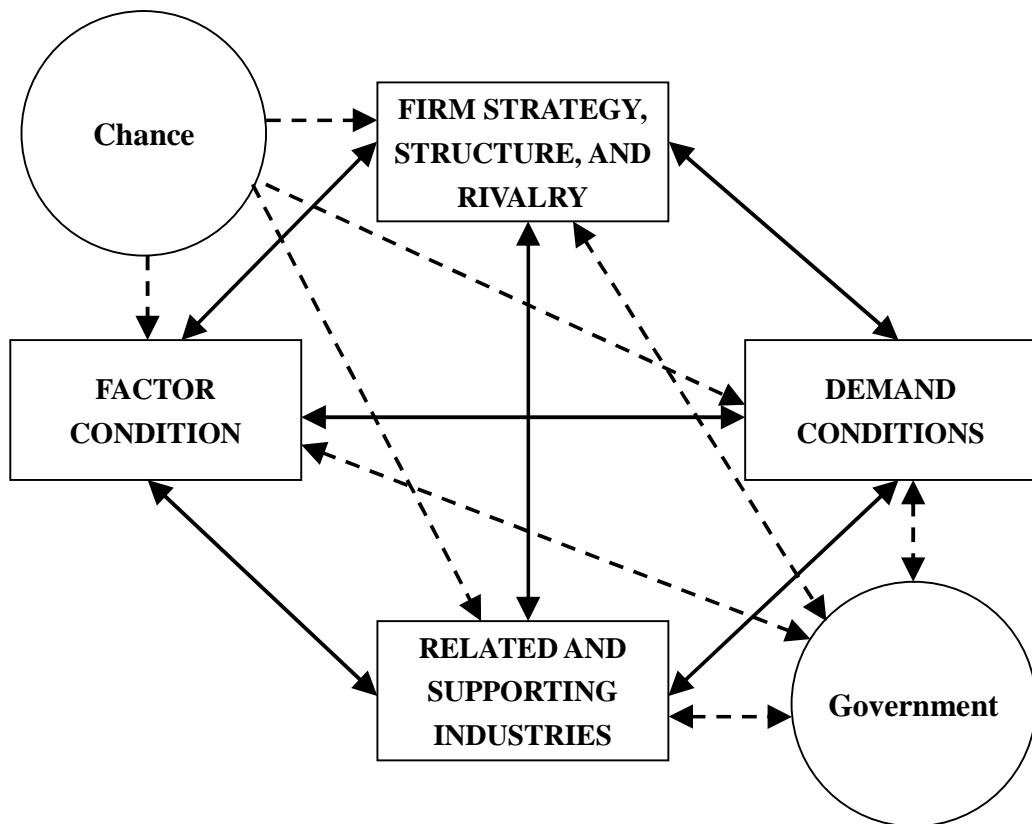
Source: Portner (1990: 127).

Porter attaches importance to country borders since there are great variations in factors of production, government policy *(e.g.*, environmental policies, tax systems and

property rights protection), and market conditions. Moreover, social norms of and political values of a nation's population are greatly influenced by the nation and its history. Thus, competitive advantages of nations are created and strengthened by combining conditions at the national level with those at the sub-national level. Government policy based on close cooperation between national and sub-national governments turns out to be effective in enhancing the competitive advantages of nations (Porter, 1990).

2.4.4 Porter's (1990) Industrial Cluster

Porter's central assumption is that the strength of external economies is developed by geographical proximity. Porter elaborates on the role and tasks of interaction within clusters in *The Competitive Advantage of Nations*. According to Porter (1990: 152-153), clusters meet two major tasks:

(1) Facilitators of information flow:
- Personal relationships due to schooling, military service
- Ties through the scientific community or professional associations
- Community ties due to geographic proximity
- Trade associations encompassing clusters
- Norms of behaviour such as a belief in continuity and long-term relationships

(2) Sources of goal congruence or compatibility within clusters:
- Family or quasi-family ties between firms
- Common ownership within an industrial group
- Ownership of partial equity stakes
- Interlocking directors
- National patriotism

Accordingly, Porter (1990) sheds light on the relevance of industrial agglomeration by the regional scale. Industrial clusters are sources of bringing various externalities into firms operating within the territories of the industrial clusters: low transaction and coordination costs of markets, constraints on breach of contracts and a rise in price of inputs by suppliers, stock reduction, low transportation costs, and creation of pressures on trust-building with localities due to high degrees of transparency and continuity (1990: 157). The incentives for suppliers to upgrade their products and develop relational assets are stimulated by potential market opportunities because of a number of clients within the industrial cluster. Moreover, the formation of industrial clusters urges firms to cooperate with one another for revamping their products and production processes. Industrial clusters also offer opportunities for taking advantage of quasi-public goods including physical infrastructure systems and educational programs

and for accessing resources that are not deployable in the outside of the cluster (Porter, 1990: 156-157). The presence of successful firms within the same clusters appears to be a psychological stimulus for other firms to continue to upgrade product quality and to implement an accurate measurement of business achievements.

2.4.5 Storper's (1997) Relational Assets

Storper's (1997) view of agglomeration shares some commonalities with Scott (1998) who highlights the role of Williamson's (1985) transaction cost economics of markets with a focus on inter-firm relations. Storper (1997: 28) characterises the importance of agglomeration "not simply as input-output relations or linkages, but as untraded interdependencies subject to a high degree of reflexivity". Storper's view about agglomeration builds on relational transactions structured by qualitative factors such as individual ties, reputation, and norms. Storper terms these "relational assets" (1997: 28), which are the central source for forming and developing agglomeration. Moreover, firms and localities (*e.g*., regions, countries, cities and communities) can take advantage of geographical proximity by developing relational assets because "these relations and conventions - much more so that stocks of physical capital, codified knowledge, or infrastructure - are difficult, slow and costly to reproduce, and sometimes they are impossible to imitate" (Storper, 1997: 44). In short, Storper takes organisations as a level of analysis and how network ties with localities contribute to the formation and development of agglomeration economies in the institutional context.

To sum up, I reviewed various existing agglomeration-based theories through a comparative lens and explored how these theories developed in sequence. Marshall took up various advantages of external economies arising from the spatial concentration of the same industry. Marshall's approach to agglomeration is more skewed toward economic benefits such as scale economies and cost reduction. In contrast, Porter's industrial cluster theory (1998) places particular importance to improvement in productivity, innovation, and creation of potential entrepreneurial spirits as key sources of enhancing agglomeration economies. Porter's industrial cluster theory may be applicable in detecting the impact of geographical proximity at the national level. However, his major weakness is that he does not offer a clear definition of the geographical extent of industrial clusters at the sub-national level. Apart from economic arguments, Storper (1997) sheds light on inter-firm relations. While Porter argues that agglomeration enables firms to economise on spatial transaction costs, attention has been paid by Storper to the role of agglomeration in the institutional context. Storper's main idea is that relational assets govern productive efficiency in the regional economy. These location-based theories may explain why a firm would want to utilise locational attributes of host countries, where the firm tends to position itself and why the firm specialises in some goods in specific locations. However, they do not explain how the relationship between trade and FDI may evolve over time.

2.5 Institution-Based Theoretical Approach to MNE Activity

2.5.1 Institutional Theory

The institutional aspects of the host economy have been neglected in international business and strategic management literatures (Meyer, 2001; Meyer and Nguyen, 2005; Yiu and Makino, 2002). Institutions serve to reduce transactional uncertainties and minimise transaction costs (Meyer, 1998, 2001; North, 1990, 1991). Organisations constituting groups of individuals who have common objectives and interests are shaped, developed and recreated by institutions (North, 1990, 1991). The conventional wisdom is that institutions facilitate social, political and economic interactions with multiple actors participating in a search for their own interests and benefits.

According to North (1990), there are two types of institutions. One category contains formal institutions, such as regime type, judicial independence, labour laws, property rights protection and trade restriction, for instance. Another includes informal institutions such as tradition, social organisation of individual networks, cultural values, political preferences and religious beliefs. Informal institutional constraints are "much less transparent and, therefore, a source of uncertainty" (Meyer and Nguyen, 2005: 67).

It has conceptually been argued that the logic of path dependency is also an integral dimension of institutional economics. Current formal and informal institutions determine the direction, structure and development of future economic processes (Meyer and Jensen, 2005; North, 1990, 1991). Bandelj (2008: 78) noted that "previous institutions structure the trajectory of future change". Likewise, not only are the current social behaviour and norms of multiple actors, such as the state, professional organisations, and individuals structured by legacies of institutional development, but so too are political interests. Path-dependence characterises the development of formal and informal institutions in Eastern European economies (Stark, 1992).

A circle of scholars of neo-institutionalism (DiMaggio and Powell, 1991) and economic sociologists (Granovetter, 1985; Scott, 1995) discuss the details of institutional influences that shape social behaviour of organisations and individuals. Institutions build on three pillars: (1) mimetic isomorphism, (2) normative isomorphism, and (3) coercive isomorphism (DiMaggio and Powell, 1983; Scott, 1995).

First, social behaviour is determined by isomorphic processes in the cognitive context (DiMaggio and Powell, 1983). Imitating other individuals and organisations is the way of avoiding uncertainties. Social actors take for granted shared identities or similar cultural patterns (Scott, 1995). Second, institutional behaviour is shaped by values, norms and morality prevailing in a society in the normative context. Third, the structure of social interactions in which actors are involved is also established by "regulative processes-rule-setting, monitoring, and sanctioning activities" (Scott, 1995: 35). This aspect of institutions entails coercion. In recent years, economic sociologists (*e.g.*, Bandelj, 2002, 2004, 2008; Granovetter, 1985; Uzzi, 1996, 1997) have extended

these dimensions of institutional isomorphism to the impact of social networks of relations on economic exchanges. The underlying nature of state action and human behaviour is deemed, by economic sociologists and institutional economists, to be governed by a desire to enhance "not efficiency but legitimacy" (Bandelj, 2004: 460). In an extension of institutional theory, Yiu and Makino (2002: 667) also point to the importance of legitimacy in MNE activity as follows: "the institutional theory posits that firms choose organizational practices and structures such as entry mode primarily to gain legitimacy from both internal and external claimants".

Compared with economic sociologists (DiMaggio and Powell, 1983; Granovetter, 1985), international business scholars were relatively late to apply institutional theory to the study of MNE activity. According to Slangen and Hennart (2008), Rosenzweig and Singh (1991) were the pioneers in advancing the nexus between institutions and MNE activity. International scholars (Rosenzweig and Singh, 1991; Slangen and Hennart, 2008) have argued that MNEs must deal not only with external conformity pressures from their circumstances but also with internal conformity pressures from their headquarters. These arguments based on institutional theory seem likely to share a number of commonalities with Bartlett and Ghoshal (1991, 1998) who conceptualise the strategic balance between global integration and local responsiveness.

In sum, institutions are a vital locational advantage. Foreign multinationals have to adopt their strategies to different institutional forces embedded in the host country since firm-specific resources and capabilities can be strengthened through the interaction with progress in institutions.

2.5.2 Institution-Based OLI Configuration in Stakeholder Capitalism

Dunning and Lundan (2008) argue that the determinants of investment strategy cannot be examined appropriately without an in-depth analysis of the interplay between formal and informal institutions and organisations. Institutions represent the rules of the game according to which organisations evolve (North, 1990). The institution-based theory serves as an inevitable conceptual instrument in exploring how rapidly changing environmental and institutional factors condition the determinants of cross-border MNE activity, especially in transition economies such as China, CEE and Russia. At the same time, organisations (*e.g.*, MNEs) determine the characteristics of institutions. Since institutions are of a very path-dependent nature, the direction of institutional development is not progressive but unpredictable in individual countries. Particularly, the transition experience of CEECs represents this special feature. Dunning and Lundan (2008) have extended institutional theory with its roots in North (1990) to Dunning's (1981, 1988) eclectic paradigm and reconceptualised each advantage of the OLI configuration (see Table 2-1).

As opposed to the ownership advantages *(e.g*., technological know-how, patents and marketing skills) defined in the hierarchical form of the OLI paradigm, the

institution-based ownership advantages considers "firm-specific norms, values and enforcement mechanisms sometimes labelled "corporate culture" (Dunning and Lundan, 2008: 580). From the institutional perspective, the ownership advantages include, for example, the ability to meet the standards of product quality and environmental management control (ISO 9000 and ISO 14000) and the adoption of the Toyota Production System (TPS) that rests on (1) *kaizen*, (2) *zero-defect*, (3) *jidōka* and (4) *just-in-time delivery*. Additionally, one of the critical institution-based ownership advantages concerns how firms respond strategically to stakeholder interests rather than to shareholder interests in the contemporary global world. It is because the actions and strategies of MNEs are constrained by meeting manifold political and societal goals that stakeholders such as NGOs and governments seek to attain (Dunning and Lundan, 2008: 589).

As regards institution-based location advantages, little has been discussed about the role of institutions of host and home countries as L-advantages over a long period of time, while scholars have investigated FDI strategies from a classic economic perspective with a focus on market size, economic growth, labour availability and wage differentials. In recent years, scholars *(e.g*., Dunning, 2005; Dunning and Lundan, 2008; Meyer, 1998, 2001; Meyer and Jensen, 2005; Meyer and Nguyen, 2005; Meyer and Peng, 2005) have begun highlighting the effects of institutional changes and continuity on foreign firms' investment strategies. Hoskisson *et al*. (2000) also argue that institutional economics should be integrated into the spirit of FDI and MNE activity, particularly, in transitional economies. The institution-based location advantages explain that institutions developed in home and host economies shape the geographical scope and organisational effectiveness of MNEs (Dunning and Lundan, 2008). Dunning and Lundan (2008: 588) note that "in a dynamic, complex and volatile global economy, the role of both firm and location specific institutions in reducing transaction costs of cross-border value added and exchange activities is becoming more important".

The institution-based disadvantages at the national level include corruption, political risks, weak systems of intellectual property rights, and arbitrary FDI regulations *(e.g*., export performance requirements, local content rules and technological transfer agreements, SEZ laws, financial and fiscal incentives). For instance, Meyer and Nguyen (2005) find that the supportive interplay between institutional changes and FDI investment strategies provide some bearings on both the location choice and entry mode of foreign MNEs in Vietnam. In the case of European emerging economies, scholars of transition economies draw on the role of EU membership that is thought to revamp the functioning of institutional infrastructure. A country characterised as lagging behind other countries in the creation of economic-supporting institutions may be subject to the danger of discouraging inbound FDI.

Table 2-1: Institution-Based OLI Configuration in Stakeholder Capitalism

	Ownership *Organizational/governance*	*Location* *Social capital*	*Internalization* *Relational*
Institutions			
Formal	Laws, regulations, conventions Discipline of economic markets	Laws, regulations, conventions Discipline of political markets	Contracts (both inter-and intra-firm)
Informal	Codes, norms	Religion, social mores, traditions	Covenants, codes, trust-based relations (both inter-and intra-firm)
	Country/corporate culture Moral ecology of individuals	Civil society	Institution-building through networks/ clusters of firms
Enforcement mechanism			
Formal	Sanctions, penalties	Sanctions, penalties	Penalties for breaking contracts
	Taxes, incentives	Quality of public organizations	Strikes, lock-outs, high labour turnover
	Stakeholder action (consumers, investors, labour unions)	Education (in shaping and implementing institutions)	Education, training
Informal	Moral suasion	Guilt, shame	Guilt, shame
	Loss or gain of status/recognition	Demonstrations, active participation in policy-making organizations (bottom-up influence)	No repeat transactions
	Retaliation	Moral suasion (top-down influence on institutions, organizations and individuals)	External economies/diseconomies arising from networks/alliances, e.g. learning benefits
	Build-up/decline of trust Blackballing		Blackballing

2.6   Network-Based Theoretical Approach to MNE Activity

2.6.1   Network Theory

Throughout the 1990s, network theory received limited attention relative to industrial organisation economics, internalisation theory, location theory and Dunning's OLI paradigm when analysing the dynamics of MNE investment strategy including location choice, entry timing, entry mode and firm performance. However, scholars of management have placed a growing weight on the causes and outcomes of taking advantage of networks to advance the internationalisation strategy of firms (Chen, 2003; Johanson and Mattsson, 1993; Johanson and Vahlne, 1990; Meyer, 2000; Meyer and Skak, 2002). The dynamism of FDI resides in "specific inter-firm dependence relations" (Johanson and Mattsson, 1993: 306), in "an effort by investors to forge linkages with foreign networks by establishing a presence in the foreign country" (Chen, 2003: 1107), and in "the co-evolution of the firm and its network" (Meyer and Skak, 2000: 179). From the management perspective, corporate networks are rather competitive assets created within and across the boundary of the firm as opposed to natural assets. Dyer and Singh (1998: 661) note that "idiosyncratic inter-firm linkages may be a source of relational rents and competitive advantage". Networks provide actors with special access to information which is not obtainable outside the boundary of the networks.

Drawing evidence from an analysis of 194 Austrian and Danish firms in Russia, Meyer and Skak (2000) find that corporate and personal networks have significant effects on MNEs' investment strategies in country-specific institutional settings. Meyer and Skak suggest that a key determinant for the firms to make their international business operations profitable is the ability to accumulate not only formal knowledge (*e.g*., market size, economic growth, tariff rates etc.) but also experiential knowledge (*e.g*., institutional and cultural idiosyncrasies) to adapt to new business environments both internally and in its network relations. Of particular importance is that the accumulation of the experiential knowledge allows firms to minimise the costs of designing, monitoring and executing exchange transactions in imperfect markets. However, the accumulation of such knowledge is not easy to realise within the organisation because of its tacit nature (Meyer and Skak, 2000). It can thus be managed, exchanged and upgraded between the firm and its business networks.

Dunning (1992: 92) asserts that "the activities are coordinated neither by the market nor by a central hierarchical plan, but by the establishment of a set of relationship between the members of the network". The network model is not completely distinct from Dunning's (1981) theory of ownership advantages. The network perspective embraces the continued upgrading of trust and shared knowledge based on the active interaction between the firm and its business partners, while recognition is given to internal assets such as managerial expertise and organisational technological

innovations as important determinants in investing abroad. Dyer and Singh (1998: 662-671) identify four factors of network advantages: (1) relation-specific assets; (2) knowledge-sharing routines; (3) complementary resources and capabilities; and (4) effective governance. Wu (2007: 125) places a great emphasis on the importance of a firm's network advantage and argues that "in today's increasingly dynamic business world, more and more firms are starting to find themselves trapped in the uninviting situation that their existing firm-specific resources and competencies are no longer sufficient to maintain their competitive advantages".

As opposed to industrial organisation economics and internalisation theory, network theory attaches importance to the role of mutual trust, bonds, interdependency, reciprocity and cross-cultural cooperation in determining the location selection and organisational modes of network MNEs. Particularly, investors must count on social networks when environmental and institutional uncertainties are high in foreign markets (Rhee, 2008). Moreover, the network perspective highlights that a firm's ability to mobilise, deploy and exploit proprietary and complementary assets in a foreign market is conditioned by how the firm can make maximum use of the value of network ties with other firms in the foreign market and by which strategic position the firm is within the network (Dyer and Singh, 1998; Meyer, 2000; Meyer and Skak, 2002). Chen (2003: 1127-1128) presents five main features of the network model of understanding the internationalisation process of firms:

- First, an investor is inclined to choose a country close to its home country. As a consequence, geographical proximity enables the MNE to mitigate the liabilities of foreignness and limited information channels vis-à-vis indigenous firms through receiving organisational and administrative support from the headquarters and other subsidiaries.

- Second, FDI location choice is determined not by low labour costs or easy access to raw materials but by the wealth of network resources. The active interplay between the investor and its business partners contributes to maximising agglomeration effects.

- Third, international expansion and diversification is a dynamic process of MNE activity. The firm internalises its own proprietary assets within its organization, while also attaching weight on the creation of localised channels to extract relational and innovative assets.

- Fourth, the primary motive of FDI is not to exploit privileged market access; rather, the investor aims to strengthen its relative bargaining power vis-à-vis other rivals through serving the customers in proximity.

- Fifth, the more formal and informal safeguards against business partners' opportunistic behaviour that are created within the network, the more hazardous business opportunities the firm seeks to exploit.

In short, network relationships between firms serve as a conduit for forming agglomeration economies, because network relations aid the firm in accessing information on local capital and labour markets, the position of buyers, suppliers and rivals and financial resources (Chen, 2003: 1111). The firm seeks to strategically develop its relational assets in order to minimise high transaction costs, particularly in deficient institutional settings. Overall average marketing and production costs can also be reduced by the appropriate choice of network partners. Accordingly, network resources creating competitive advantages are essential to the survival and growth of the firm since these network-based assets are hardly imitable, re-deployable and substitutable by rivals. Thus, firms are motivated to engage in FDI for the purpose of cultivating existing network ties and pursuing the acquisition of new linkage assets. In this light, the cheap factor endowment hypothesis *(e.g.*, cheap labour costs) is just a secondary motive for FDI. The unit of analysis of the network perspective has been "pairs or a network of firms" (Dyer and Singh, 1998: 674).

2.6.2 Network-Based OLI Configuration in Alliance Capitalism

With intensified competition between 'placeless' MNEs, speedier product life cycles and an emerging need for balance between global adaptation and local responsiveness, MNEs are likely to develop their competitive advantages rather through taking advantage of cooperation than through competition in recent years. In response to the dynamic complexity of environmental and technological changes, Dunning (1997) recognises the need to redefine his classic OLI configuration of international production. Dunning (1997: 69) writes that "although the autonomous firm will continue to be the unit of analysis for understanding the extent and pattern of foreign-owned production, the OLI configuration determining cross-border activities is being increasingly affected by the collaborative production and transactional agreements between firms, and that these need to be more systematically incorporated into the eclectic paradigm". This statement is a manifestation of the departure from the classic OLI perspective that market imperfections encourage firms to internalise intermediate product markets and replace markets within their hierarchical control. Dunning (1997, 1998) incorporates a network perspective (Gerlach, 1992) into the old OLI paradigm and theorises a new framework. The definition of the three pillars that the new OLI configuration builds on is as follows (Dunning, 1997: 80-84):

(1) Ownership (O) specific advantages that a firm possesses vis-à-vis other rivals in serving a particular market comprise: (1) backward access to R&D, design engineering and training facilities of suppliers in vertical alliances; (2) access to complementary technologies and innovatory capacity in horizontal alliances; and (3) access to embedded knowledge of networks members.
(2) A firm can gain advantages from participating in external alliances because of

access to resources that are not available to the firm, while internalising certain firm-specific assets within the hierarchy. Inter-firm alliances are complementary to rather than a substitution for a hierarchy.

(3) Locational (L) advantages of host countries arise from: (1) the presence of a portfolio of immobile local complementary assets, which produce a stimulating and productive industrial atmosphere; and (2) the presence of localised networks that help reduce the information asymmetries and the possibility of partners acting opportunistically in spatially linked markets.

Taking Japan as an example, recognition is given to the fact that Japan is the country where "there is less incentive by firms to internalise markets in order to avoid costs of broken contracts, or to ensure the quality of subcontracted products. […] The *keiretsu* network of inter-firm competition - sometimes between firms in the same sector and sometimes across sectors - is perhaps one of the most frequently quoted alternatives to hierarchical internalisation" (Dunning, 1997: 85). I will explain the *keiretsu* network with greater detail in the following section. Dunning (1997: 85-87) points out that there are two types of strategies to tackle market failure: (1) 'exit' strategy where the market is replaced by internal administrative fiat; and (2) 'voice' strategy where two or more firms cooperate together in the market to minimise the risk of market failure.

2.6.3 Theory of Japanese Business Groups

Dunning (1997) asserts the importance of alliance capitalism as follows:

"*What is clear is that, as networks of alliances become more important, the composition and behaviour of the group of firms becomes a more important determinant of the foreign production of the individual firms comprising the network. Nowhere is this more clearly seen than in the role played by the keiretsu in influencing both the competitive advantages of its member firms, and in the way in which these advantages are created, upgraded, and used*" (Dunning 1997: 80).

Keiretsu networks stand at the heart of the social organisation of Japanese capitalism (Gerlach, 1992; Lincoln and Gerlach, 2004). The social organisation of Japanese inter-corporate relationships has been characterised as informal relationships stemming from trust and mutual respect (Orrù *et al*., 1991), something in-between internal organisation and external market (Fruin, 1992; Lincoln *et al*., 1992), or a sort of hybrid governance (Dyer, 1996).

The broad concept of *keiretsu* consists of two distinctive forms, 'horizontal' *keiretsu* groups ('financial' *keiretsu* groups) and 'vertical' *keiretsu* groups ('non-financial' *keiretsu* groups) (see Figure 2-3). The former - represented by the so-called 'Big Six' financial *keiretsu* groups (Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa, and Ikkan) - have one enterprise in each business sector to maximise profits

accruing from economies of scale, scope, and learning, and cooperative specialisation (Dyer, 1996). Mitsui, Mitsubishi and Sumitomo come from the early *zaibatsu* that can be regarded as the major entrepreneurial conglomerates of the pre-war period.

Figure 2-3: Structure and Organisation of Horizontal and Vertical Keiretsu System
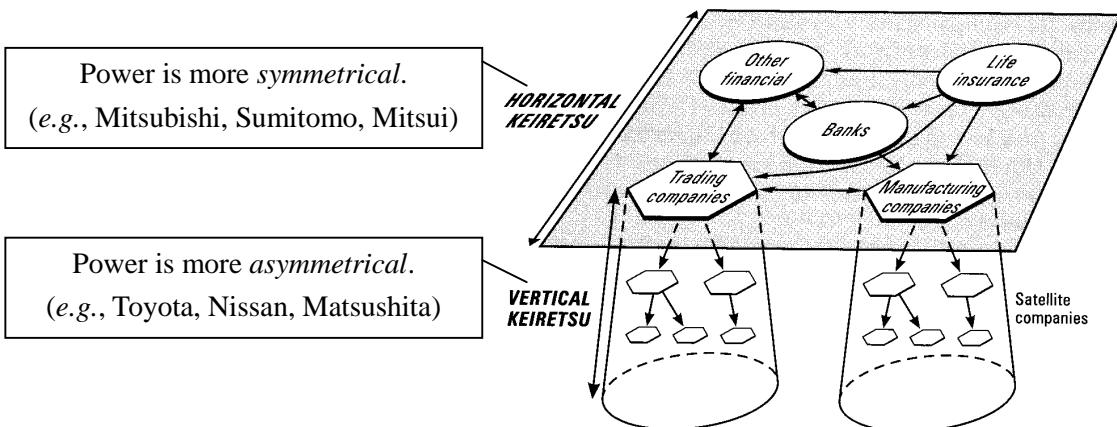
Source: Author's modification on Dicken (1998: 224).

The 'horizontal' *keiretsu* groups consist of members from a wide range of sectors such as food and beverages, textiles, chemicals, steel and real estate, linked, at the same time, by power and obligations to the large banks, insurance companies and general trading companies. Mitsui *keiretsu* thus consists of 25 firms, Mitsubishi 28, Sumitomo 20, Fuyo 28, Sanwa 44 and Dai-Ichi 48 respectively (Kigyō Keiretsu Sōran, 2000). Each enterprise group has its own Presidents' Club (Nimokukai for Mitsui, Kinyō-kai for Mitsubishi, Hakusui-kai for Sumitomo, Fuyo-kai for Fuyo, Sansui-kai for Sanwa, and Sankin-kai for Dai-ichi.). Although a Presidents' Council (*shachōkai*) is an informal opportunity to exchange information, it is also instrumental in promoting the significance of membership identity and solidarity and in having discussions on strategic interests and management concern group firms confront (Gerlach, 1992: 104-108).

Although the style and intensity of interdependence varies between them, the 'vertical' *keiretsu* and 'horizontal' *keiretsu* are not mutually exclusive industrial entities but are compatible. Many members of 'horizontal' *keiretsu* groups act as leaders of 'vertical' *keiretsu* groups. Some of the best examples of this phenomenon are Toyota Motor Corp. and Toshiba Corp. which are members of Mitsui *keiretsu*, while Nissan Motor Corp. and Hitachi Ltd. are members of Fuyo *keiretsu*.

The characteristics of Japanese-specific network institutions (*i.e.*, *keiretsu*) are: (1) relational ties; (2) long-term relationships; (3) extended networks; and (4) symbolic signification in the social context without legal commitments, while the form of American corporate governance revolves around arm's length relationships, and

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competitive linkages (Dresmus, 1998; McGuire and Dow, 2005). With reliance on these cooperative advantages, Japanese *keiretsu* member firms tend to internalise markets within their coherent alliances to avoid uncertainties inherent in arm's length market transactions (*e.g.*, Gerlach, 1992; Kensy, 2001; Lincoln and Gerlach, 2004; Lincoln *et al.*, 1992, 1996). As pointed out by Lincoln and Gerlach (2004), *keiretsu* groupings play critical roles in pooling financial burdens in times of crisis and in merging the goals of profit maximisation within the corporate community (Lincoln and Gerlach, 2004; Orrù *et al.*, 1991). In other words, this equalising function excludes the risks for uneven and unbalanced economic improvements of the member firms within the *keiretsu* infrastructure, with the benefits of an access to financial institutions (Dresmus *et al.*, 1998).

Drawing on the resource-based view of the firm, Japanese inter-firm coordination mechanisms under Japanese market capitalism represent a source of competitive relational advantages since *keiretsu* member firms can capitalise on material and financial resources embedded in a web of *keiretsu* networks below market rates (Buckley, 2004; Kim *et al.*, 2004). Kim *et al.* (2004: 617) argue that *keiretsu* member firms outperform independent firms because of "group-based resource allocation advantages". In return for access to financial, material and human resources, the *keiretsu* leader frequently obtains its suppliers' organisational transparency and technological development. Strong equity control of the car manufacturer over its suppliers in vertical production networks implies a guarantee of a stable demand for parts supplies for a long time.

Transaction cost economics also assumes that the form of *keiretsu* organisation is suitable for dealing with internal and external problems at the same time (Dyer, 1996; Williamson, 1985): (1) reducing costs; (2) expansion of control costs; and (3) information manipulation and exploitation of internal organisation. As a second set, it is suitable for dealing with (1) bounded rationality; (2) uncertainty; and (3) opportunistic behaviour in the external market. Hence, the creation of markets within the network leads to more frequent business transactions and more investments in far-reaching specialised assets relative to internal organisation and arm's length markets.

As regards vertical *keiretsu* arrangements in emphasis, the 'vertical' *keiretsu* is built upon a tight hierarchical relationship between the manufacturer and its suppliers, or its wholesale distributors, dealers and retailers. In particular, the automobile *keiretsu* network is asymmetric in power and legitimacy (Lincoln and Gerlach, 2004). As compared to horizontal *keiretsu* networks within which financial commitments determine the density, duration and intensity of organisational interdependence, Fruin (1992: 291) argues that financial ties not only promote group interactions in vertical *keiretsu* networks but also complement organisational learning processes among the affiliates.

Reciprocal assembler-supplier relationships prosper by means of: (1) an upgrade

of technical capabilities (Nishiguchi, 1994) and exchange of managerial know-how (Buckley 2004; Sako 1996); (2) a high degree of sales and demand stability (Tabeta, 1998); (3) effective communication and coordination in product development; (4) long-term contract (Tabeta, 1998); and (5) privileged access to financial sources (Gerlach, 1992). From an organisational learning perspective, Fruin (1992: 198) stresses that "brainstorming, clarification and verification of specifications, team-building, and product-development deadlines, are accomplished within corporate boundaries". Tabeta (1998: 2) also argues that the formation of closer ties based on sales and equity sharing facilitates the reduction of opportunistic hazards and enhances credible commitments from its suppliers for the manufacturer.

The existing literature regarding *keiretsu* organisation has reported that such organization exerts an influential impact on the pattern and consequence of the internationalisation of *keiretsu* group firms. Dyer (1996) presents empirical evidence that Japanese automotive value chains incur fewer transaction costs than US value chains. In addition, the endurance of the hierarchical form of *keiretsu* ties enables the *keiretsu* car assembler to lower transaction and coordination costs through capitalising on flexibility in its parts suppliers' production management process and through enhancing its corporate identity to which their suppliers should conform. K*eiretsu* membership may facilitate collective negotiations with the local government.

Comparing Toyota and GM with particular reference to the forging of supplier networks, Dyer and Singh (1998: 666) argue that Toyota has ensured efficient supply chain management systems through the transfer of new knowledge and personnel to the suppliers, while GM has failed due to the lack of knowledge sharing between the firm and its suppliers.

On the issue of the geographical development of *keiretsu* network alliance structure in foreign markets, Gilttelman and Graham (1994) find that independent *keiretsu* groups in the automobile industry form a collective economic group in North America and Western Europe as many subcontractors tend to be located close to or near their main assemblers.

The World Investment Report 2001 also revealed evidence of a strong presence of vertical integration of Toyota's group in Thailand. Out of the core component vendors producing engines and body parts, 73 of 134 consist of Japanese companies and Toyota group firms, with a product share value exceeding nearly 80 percent, although the total number of Toyota Motor Thailand's subcontractors reaches 575 (UNCTAD, 2001: 147). This outcome indicates explicitly that indigenous firms do not yet play a central role in creating added-value goods in Thailand. Rather, the Toyota group exercises a significant leverage over core components that serve as the main part of car production in Asia.

In sum, contractual relations under the *keiretsu* form of organisation and governance induces the *keiretsu* leader and its parts suppliers to have long-term

investment goals (McGuire and Dow, 2005), long-term and sustainable growth (Nishiguchi 1994), specific attention to quality development (Mori, 2006), and closer communication. By and large, *keiretsu* firms continue to rely on their inter-firm cooperation and reciprocal commitments within the network to achieve long-term economic prosperity. The existing literature also has confirmed the importance of *keiretsu* characteristics with relevance to production efficiency, geographical scope and supply management in international expansion.

2.7   Four Types of FDI

2.7.1   Resource-Seeking FDI

The central motive of resource-seeking FDI is to capture rich natural resources in foreign markets. Resource-seeking MNEs are induced to enter foreign markets to obtain specific resources that are either not available or available at an unaffordable cost in their home markets. The majority or all of the specific resources acquired by MNEs are likely to be exported back to their home markets (Dunning, 1992: 57). There are three groups of resource seekers. The first group includes those who seek to acquire raw materials and agricultural products. This type of resource-seeking investment requires capital expenditures to produce and process natural resources. MNEs are often subject to high institutional uncertainties and poor transport infrastructure in less developed or emerging countries with rich natural resources. The second group of resource seekers includes MNEs venturing abroad seeking to access a pool of inexpensive and inexperienced labour force. This group embraces firms who intend to produce labour-intensive products for export. To lure these type of resource seekers, host governments, especially in LCDs, have established special economies areas such as export processing zones (Dunning, 1992: 57). The third group of resource seekers is motivated to gain technology and managerial expertise, which are new sources of competitive advantage (Gil *et al.*, 2006).

2.7.2   Market-Seeking FDI

Market-seeking FDI refers to the FDI with the purpose of selling products or services in foreign markets. Market seekers are characterised as either defensive or offensive. The major motivation for defensive market-oriented FDI is to circumvent discriminatory trade barriers such as anti-dumping rules and countervailing duties imposed by host countries. Examples include the initiation of EU's anti-dumping cases against imported consumer electronics and automobile products from Japan. Moreover, the 'follow-my-leader' or 'band wagon' form of market entry is also more defensive oriented than offensive oriented (Dunning, 1992: 59). Evidence shows that a group of Japanese and Korean suppliers tend to follow their leaders in foreign markets (*e.g.*, Belderbos and Carree, 2002; Chang and Park, 2005; Head and Mayer, 2004; Head

et al, 1995). On the other hand, offensive market-oriented FDI is motivated to respond to emerging demands or changes in consumer tastes. Recent major environmental trends such as regionalisation are a key driver to increase offensive market-oriented FDI due to the growing size of regional markets. Examples include the completion of the Single European Market (SEM), North American Free Trade Agreement (NAFTA), and EU enlargement which affect the consequences of the international division of labour. Apart from sustaining or enhancing market shares, a MNE feels crucial for entering new markets dominated by competitors to acquire cutting-edge technological skills and organisational expertise. Most or all the market-seekers supply their products or services to the markets where their production units operate or in nearby markets.

2.7.3   Efficiency-Seeking FDI

For efficiency-seeking investments, cheap production costs (*e.g.*, labour, materials, machinery, etc.) and well-developed export channels for locally produced intermediate and final products to other lucrative markets are the crucial determinant of FDI. Moreover, the presence of agglomerative economies and investment incentives are decisive factors for this type of investment. In order to continue to have inbound FDI, a host government plays a crucial role in creating the appropriate economic, institutional and cultural environment for international business and in ensuring that essential manpower and infrastructure services are available (Dunning, 1992: 144). Efficiency-seeking FDI is undertaken when a firm attempts to streamline the function and organisation of geographically dispersed MNE value-added activities through making optimal use of factor endowments and deploying available intangible and tangible assets within its integrated business network. This type of FDI is also prompted by the need of firms to exploit and extract benefits arising from economies of scale, scope and learning. Recognition is given to the evidence that efficiency-seeking FDI is motivated not by demand conditions but by supply conditions.

2.7.4   Strategic Asset-Seeking FDI

Strategic asset seekers are prompted by the need to acquire proprietary resources that foreign rivals possess to rationalise the value and efficiency of geographically dispersed MNE activities. This type of FDI is undertaken in two basic forms. One is strategic alliance. A firm may build partnerships with its rival firms to share complementary assets to enhance its international competitiveness essential to survival in a more complex global market. The second type is cross-border M&A. A firm directly purchases its rival firms to diversify the range of product lines and the scale of value-added MNE activities. In this regard, objectives in both efficiency-seeking FDI and strategic asset-seeking FDI overlap (Dunning, 1992: 61). Strategic considerations

are turned to block competitors from buying a firm's proprietary resources. MNE activity is also revitalised by means of strengthening relational ties with local market-supporting institutions such as universities and technology and industrial parks.

2.8   Selection of International Entry Mode

Firms can advance their internationalisation process by undertaking the forms of exporting, licensing, cross-border merger and acquisition (M&A), joint ventures (JVs) and wholly owned subsidiaries (WOSs). Each means of entering international markets has its advantages and disadvantages. Therefore, the actions and strategies of MNEs (*e.g.*, timing, location choice, organisational restructuring and firm performance) vary depending on which mode a firm chooses and how the sequence of ownership modes develops over time.

2.8.1   Exporting

Exporting goods or services is undertaken to enhance the degree of multi-nationality at the initial stage of international expansion. By and large, firms engaging in exporting are not deterred by the high costs of initiating operations in the host countries. However, they are required to establish marketing and distributing channels to increase sales for their products. The advancement of Internet-based technology enables exporters to increase the capacities of critical knowledge acquisition of foreign markets and to quickly contact potential customers. Especially, small- and -medium-sized enterprises (SMEs) endowed with weak international experience and limited proprietary resources can make maximum advantages of exporting mode of international expansion.

2.8.2   Licensing

Licensing is characterised as a low-risk entry mode of international expansion. In addition to low risk, licensing also enjoys low cost and enables a firm in a host economy to engage in reverse engineering and in upgrading its own proprietary assets through being entitled to produce and market in the host country or neighboring countries. As one argues that licensing is a suitable form of adjusting to rapid shifts in consumer tastes and of producing products in foreign markets where human capital is inexpensive. However, licensing makes it difficult for firms to sustain control over their own production skills and product quality. The reason for low profitability involved in licensing should be that gain has to be divided into and distributed to both the licensor and the licensee. Last but not least, a licensor may experience the danger that a licensee becomes a rival after their contractual agreements have expired because the latter has taken advantage of learning economies during the contract period.

2.8.3 Joint Ventures (JVs)

Among the positive aspects of JVs is that they facilitate the creation of strong formal and informal connections with local regulators in order to get access to desired resources, hence enabling an enterprise to overcome the liability of foreignness (Gatignon and Anderson 1988). The positive impact of JVs on economic performance may also be derived from sharing risk and good will. Once trust-building efforts made by two or more actors lead to further cooperation and coordination, the form of JVs may create great synergy effects on firm performance. Some scholars advocate that shared ownership has a positive relationship on superior performance. Park and Kim (2005), in a panel analysis of performance determinants for 205 Korean firms in China, conclude that shared control structures help foreign investors enhance the ability to respond to market barriers, protectionism and unique business relationships.

In contrast, numerous coordination problems may increase over time because business interests of one partner in the joint venture may gradually diverge from those of another (Chang and Rosenzweig, 2001; Palenzuela and Bobillo, 1999). Such conflicting agendas become a potential cause for the dissolution of JVs because both actors may suffer from the agency problem at a high cost. When foreign firms enter local markets in the form of JVs, the transfer of asset specificity from the parent company to the affiliate may be interrupted by the opportunistic behaviour of partners such as the threat of a data leak of proprietary knowledge and broken contracts. Delios and Beamish's (2001) study confirms that JVs create difficulties achieving desired strategic goals between partners and requires to a great extent unwilling compromises. Moreover, of great importance is that there are costs involved in transferring production technology and marketing skills and streamlining organisational structures between companies. Shared ownership is also subject to the dynamic complexity of organisational, managerial and operational coordination since host-based governmental agencies often participate in joint ventures and constrain the effectiveness of shared ownership arrangements with opportunistic behaviour, resource duplications and asymmetrical information. MNEs have to ensure efficient organisational control relationships with various foreign partners as well as their parent companies (Woodcock and Beamish, 2001:86). According to Yiu and Makino (2002: 668-671), the cost of integrating contributed assets by local partners into a new venture may exceed the benefit from "a free ride on their reputational capital" when their assets are intangible. In short, JVs provide firms with the opportunity to achieve multiple gains, while creating inherent disadvantages such as knowledge leakage to and free-riding by partners, and conflicting goals.

2.8.4 Merger & Acquisition (M&A)

The popularity of cross-border M&A has been on the increase, as MNEs have been more 'placeless' and have been subject to intensified competition affecting their

corporate performance in the contemporary world. According to the World Investment Report (2007, 5), cross-border M&A increased by 23 percent to US$880 billion in 2006. Cross-border M&A can aid firms in capturing untapped business opportunities without time lags. Compared with other entry modes of international expansion, cross-border M&A can be considered the fastest and possibly the largest strategic investment mode. M&A is a useful strategic tool for alleviating location-specific costs (Anhand and Delios, 2001) and is a possible option for quickly obtaining general and specific knowledge about resource channels, supplier networks, and bureaucracy and culture in local markets (Belderbos, 2003; Meyer *et al.*, 2009). Given these advantages, cross-border M&A are used with frequency to enter emerging markets such as CEE, China, and Russia.

For firms aiming at becoming multinational, it is important to know the fact that the possibility to quickly capture new markets hinges on the duration and type of international negotiations for cross-border M&A. During the pre-acquisition period, a firm involved in the M&A process has to pay enormous costs. International negotiation for cross-border M&A in countries with both the lack of transparency and the persisting culture of excessive bureaucracy are deemed to be risky. Moreover, transition economies have lagged in the creation of market-supporting institutions. An acquiring firm may also be interrupted by incompatible legal and regulatory constraints involved in the negotiation process.

The ways of integrating the acquired firm into the acquiring firm often involve a great deal of difficulties during the post-acquisition period. First, firms are likely to incur substantial costs of restructuring the organisation of the acquired firm in terms of marketing, sourcing and financial competence (Woodcock and Beamish, 2001). This view is emphasised by Estrin and Meyer (1998: 224) stating that "the post-acquisition costs of organisational restructuring and technological upgrading may exceed the price originally paid for the acquisition". The acquiring firm may experience difficulties in aligning existing organisational culture, managerial behaviour, and social norms embedded in local employees of the acquired firm in the host country with the overall strategic objectives of the parent company. Discrepancies between the acquiring firm and the acquired firm in corporate cultures, corporate identity, social norms and trust are challenging and they cannot be resolved overnight. The greater the cultural differences the longer it takes to integrate the two firms in the post-acquisition process. When the post-acquisition process is unsuccessful, the two firms may not be able to effectively make maximum use of scale and learning economies. Accordingly, their corporate performance during the post-acquisition period may be affected by coordination costs of integrating the acquired firm into the acquiring firm not only in organisational terms but also in social terms.

Second, acquiring firms run counter to multiple political interferences. Aligning divergent political and economic interests multiple stakeholders seek to achieve with

strategic goals of the acquiring firm is a key factor in the success of the firm in the post-acquisition process (Meyer and Jensen, 2005: 132). The acquiring firm should be aware that host governments, political groups and labour unions involved in any privatisation projects may be concerned not about financial profits but about social consequences (Meyer and Jensen, 2005: 134). In addition, it should be important to note that the probability that the host government might complicate the restructuring process in transition economies, since host governmental agencies frequently participate in the formation of joint ventures in the privatisation process as one of major stockholders.

Given these institutional barriers that cause organisational and managerial conflicts, acquiring firms are exposed to the opportunistic behaviour of multiple actors and peculiar requirements of managing businesses, which limit the growth of corporate performance in the post-acquisition period. The transfer of effective organisational and management systems developed by the parent company to the subsidiary may not take place smoothly. Moreover, Woodcock and Beamish's (2001) study on the relationship between entry mode and performance finds that acquisition is the worst mode of entry in terms of corporate performance.

2.8.5 Wholly Owned Subsidiaries (WOSs)

The establishment of a wholly owned enterprise in foreign markets is referred to as a greenfield investment, which involves high costs of establishing, managing and improving operations in the host countries. A firm must establish some means of marketing and distributing their products, but the firm can completely take over the reins of the local subsidiary and achieve higher returns on investment relative to other entry modes. The advantages of undertaking greenfield investments are that a firm can leverage proprietary assets within its organisation. This potential holds especially true for firms with strong intangible capabilities that might be leveraged through setting up a greenfield venture. In this regard, greenfield investments are more suitable for high technology-intensive firms, while labour-intensive firms may better reap gains through a M&A form of international investment strategies.

A great disadvantage is that greenfield investments require the investor to invest a large amount of capital to set up a new factory from scratch. It is also costly to have access to local market-specific knowledge and learn everything from the beginning. Slangen and Hennart (2008) term this critical cost as the liability of newness. The acquisition of qualified labour at the management level is one of the most challenging tasks for the firm to overcome in LDCs and transition economies. Especially, feasibility studies need to be appropriately structured and carried out in the WOS case. Previous experience should play a crucial role in determining a firm's market entry by means of greenfield investments. It should also be noted that exit costs for greenfield investments may be the highest among all entry modes in international expansion.

2.9 Conclusions

Figure 2-4: Positioning of the Present Research

THEORY OF MNEs

NETWORK THEORY

LOCATION THEORY

This thesis focuses on *the motives, location patterns and corporate performance of Japanese MNEs in CEE*.

INSTITUTIONAL THEORY
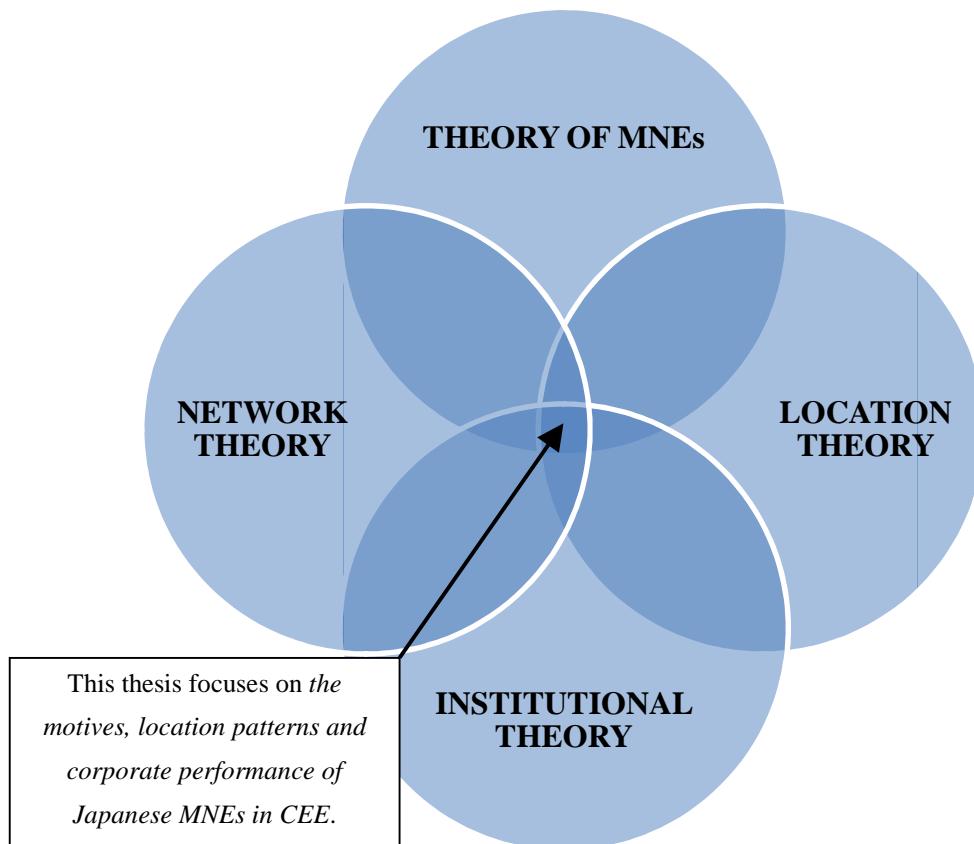
Source: Own illustration.

The focus of this chapter is to summarise a variety of existing FDI-related theoretical perspectives that characterise the relevant internal and external factors influencing the phenomenon of MNE activity. It is of great importance to provide a summary of the theoretical works highlighted in this chapter and to emphasise their core insight into the investment decision and corporate strategy of MNEs in different countries. The starting point for discussing these themes is Hymer's MIT dissertation work, which places importance on the assumption that the central motivation for FDI is positively related to the monopolistic advantages of the firm. It has been argued among scholars of internalisation that the firm enters into foreign markets in the form of FDI to internalise its ownership advantages and control them under hierarchy. The logic of internalisation with its roots in Williamson's transaction cost theory assumes that intermediate markets are imperfect and foreign firms are subject to potential risks and failures. Therefore, firms try to minimise the costs of coordinating, monitoring and executing exchange transactions through internalising their economic activities.

To fill the deficiencies of these two FDI theories, the OLI paradigm was

developed by Dunning. This eclectic paradigm is acknowledged as dynamically enhancing the in-depth understanding of MNE behavior and FDI strategy. From a spatial analysis perspective, scholars (*e.g.*, Disdier and Mayer, 2004; Head and Mayer, 2004; Head *et al*., 1995, 1996, 1999) integrate the role and function of agglomeration economies into the realisation of FDI. In the mid-1990s, Dunning claimed that the explanatory power of his OLI paradigm needs to be reappraised and should be modified in line with emerging shifts in country- and industry-specific circumstances. Dunning integrates the concept of alliance capitalism into his OLI configuration and stresses the importance of the evolution of the firm based on the accumulation of network assets. Dunning recognises the function of *keiretsu* systems as a hybrid form of transactional relationships between hierarchy and market as the optimal alternative to MNEs. It indicates that the creation of markets within the network leads to more active business transactions and more investments in far-reaching specialised assets relative to internal organisation and arm's length markets. The OLI configuration has also evolved to adopt the institutional economics that social, cultural and legal factors shape economic actors.

In sum, each theoretical perspective presented in this chapter provides us with the opportunity to explore the determinants of FDI (see Figure 2-4). The meaning of the OLI configuration has been in transition in recent years as the alliance capitalism and institution-based hypotheses have been at the heart of the OLI paradigm. Therefore, our conclusion emphasises the need to interpret the phenomenon of Japanese manufacturing FDI in the European transition economies by examining the market (macroeconomic conditions) and non-market (institutional change) characteristics of each individual post-socialist nation state of CEE. Moreover, it deserves elaboration of network-based and institution-based O-advantages of Japanese manufacturing firms in the enlarged EU. In the following chapters, I try to fit the investment strategies and actions of MNEs into the framework developed in this chapter with the use of primary data analysis at the macro- and micro-level.

3 FOREIGN DIRECT INVESTMENT IN EUROPEAN TRANSITION ECONOMIES

3.1 Introduction

According to the European Bank for Reconstruction and Development (EBRD), 16 former Soviet-type economies in Central and Eastern Europe (CEE) have successfully attracted inbound FDI totalling US$257 billion during the period from 2000 to 2007. Although the early phase of radical economic transition resulted in negative growth rates in some Central and Eastern European countries (CEECs), the increased inflow of foreign capital has been enabled by binding commitments made by central governments of CEECs to upgrade economic and institutional infrastructure. It has been perceived among host-based government officials of CEECs that foreign MNEs' economic activity yields manifold advantages[3]:

- Large cash revenues and financial assets for fixed investment (Meyer, 1995);
- Job creation (Domański, 2003; Parysek, 2004);
- Dissemination of superior technologies, organisational skills and marketing know-how (Cieślik and Ryan, 2002; Wisniewski, 2005; Neuhaus, 2006);
- Introduction of new corporate governance (Bellak, 2004);
- Integration of local suppliers into MNEs' global and regional value chains

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[3] In considering the effect of FDI on the transition economies, FDI also exerts a negative impact on the microeconomic environment. At the same time, it is important to note that FDI creates disadvantages such as (1) political resentment during the privatisation process (Sinn and Weichenrieder, 1996), (2) excessive local dependency on decisions undertaken by foreign investors (Domański, 2003; Pavlínek, 2004), (3) increased economic inequalities between regions and across countries (Domański, 2003) and (4) limited roles of local firms as labour intensive-oriented production units in part of the value-added activities of large MNEs (Domański, 2003). Empirically, numerous scholars present evidence that FDI creates disadvantages in European transition economies (*e.g.*, Bandelj, 2008; Djankov and Hoeckman, 2000; Domański, 2003; Hardy, 1998; Pavlínek, 2002, 2006; Zemplinerová and Jarolím, 2001). Employing firm-level data in the Czech Republic, Zemplinerová and Jarolím (2001) find that the intensity of foreign capital penetration exerts a positive and significant impact on the rate of productivity growth. FDI is characterised as the main reason for the widening of the performance gap in the region. Djankov and Hoeckman's study (2000) identifies that technology spillover from foreign-owned firms to local firms is limited in the Czech Republic. Ferencikova (1997: 18) confirms in the joint venture VW-BAZ (Bratislavske automobilove zavody) that integration of Slovak suppliers into VW's international production networks is limited. Hardy (1998) confirms that the extent and success of 'local embeddedness' of large MNEs has been negligible in the context of Poland, concluding that the critical phenomenon of 'cathedral in the desert' may deteriorate. Bandelj (2008) reports foreign capital penetration as detrimental to the host country since state authorities carry out policies designed to favour foreign investors over local firms and to reduce the bargaining power of labour. With an emphasis on the case of Daewoo Poland, the existing literature on economies in transition (Domański, 2003; Pavlínek, 2002, 2006) proves that foreign ownership may not necessarily contribute to the industrial upgrading and sustainable growth of Poland and may rather ruin its economic development with the radical downsizing of local employment. Accordingly, the interpretation of the effects of FDI on the local economy is not straightforward, but complex.

(Kaminski and Smarzynska, 2001; Pavlínek, 2004; Meyer, 2000);

- Improved competitiveness (Pavlínek, 2004);
- Growth of exports (Meyer, 1998; Pavlínek, 2006) and reduction in current account deficits (Domański, 2003); and
- Increased labour productivity owing to enterprise restructuring (Barrell and Holland, 2000).

Since the break-up of state socialism, a number of Western firms have started entering the European emerging markets to gain market share or sustain their position through various forms of market entry including exporting, licensing, and foreign investment. The potential transitional markets have been exploited not only by large-sized firms but also by small- and -medium-sized enterprises from Western Europe due to low cultural barriers, close geography and special support from government authorities (Estrin and Meyer, 1998: 217).

In order to determine the appropriate market entry strategy and to ensure high profitability after the initial entry, the locational advantages of the targeted FDI destination should be a crucial concern to many MNEs. In this chapter, I will attempt to answer the following questions in detail:

1. Are local market conditions homogeneous or heterogeneous among CEECs?
2. What are the major destinations of foreign investors?
3. Are there any specific patterns of FDI inflows in CEECs when the origin of country and industrial distribution are considered?

To respond to these questions, a brief picture of 16 European transition economies is drawn to highlight the inherent advantages and disadvantages of local market conditions. I use the data from the European Bank for Reconstruction and Development (EBRD)'s *Transition Indicators*, the Eurostat, World Bank's *World Development Indicator* (WDI) and Wienna Institut fuer Internationales Wirtschaftsvergleich (WIIW).

3.1   Varieties of Market Characteristics

Since the turn of the century in particular, scholars have observed that most of European transition economies have experienced remarkable industrial development together with steady economic growth. Yet, there are some variations on macroeconomic conditions, the pace of institutional reforms and the degree of integration into the world economy at the country and regional level in the European transition economies. As regards the difference among the sub-regional groups, Visegrád-4 and the Baltic countries have revived themselves by joining the old EU15 on the path of European integration. Most of south-eastern European and Balkan countries with the exception of Slovenia have been lagging behind the Visegrád-4 and Baltic countries in terms of economic and political stability, and improvement of institutional infrastructure.

Table 3-1: Macroeconomic Conditions of the European Transition Economies

Indicators	Year	ALB	BOS	BUL	CRO	CZ	EST	HUN	LAT	LIT	MAC	MON	POL	ROM	SER	SLK	SLV
Development Level																	
GDP per capita (US$ 1,000)	2006	3.0	3.0	4.1	9.6	13.7	12.2	11.1	8.3	8.8	3.0	3.4	9.0	5.6	3.8	8.8(c)	18.6
Industry (as % of GDP)	2005	7.1	22.5(a)	26.1	20.7	40.4	25.1	25.8	19.1	30.2	17.0	NA	28.1	24.1	34.3(b)	23.9	29.3(d)
Agriculture (as % of GDP)	2005	26.3	16(a)	8.0	6.3	3.4	3.3	3.7	6.3	5.2	9.7	NA	2.5	8.5	19.3(b)	3.5	2.7(d)
Private sector (%)	2008	43	34	81	67	96	88	90	68	68	58	28	83	70	78	92	50
International Trade																	
Foreign trade to GDP (%)	2006	42.3	86.6	121.3	74.2	131.7	138.6	134.1	87.8	112.3	99.1	97.4	69.8	68.6	61.3	159.1	127.0
Export (US$ billion)	2006	0.7	3.4	15.1	11.1	91.5	9.6	73.4	5.1	14.1	2.4	0.6	117.3	32.5	6.5	40.0	21.4
Imports (US$ billion)	2006	2.9	7.7	21.9	22.1	89.8	12.4	73.9	11.0	18.3	3.7	1.8	122.2	47.2	12.7	43.5	22.8
Labor Market Conditions																	
Average labour productivty per person (EU27=100)	2000–2008	NA	NA	33.7	61.5	67.8	57.7	71.5	47.0	53.1	NA	NA	60.8	36.2(e)	NA	67.4	80.2
Wage differentials (in Euro)	2007	277	480	220	961	781	725	736	566	525	395	497	711	422	484	597	1285
△ in wage differentials (%)	2000–2005	13.2	7.4	9.7	5.4	6.8	10.5	12.8	9.1	6.9	4.6	-1.9	5.8	31.1	57.6	8.3	8.2
Unemployment rates (%)	2006	13.8	41.0	8.9	11.7	6.7	6.4	7.5	4.4	5.6	35.9	19.7	12.2	5.2	33.2	15.3(c)	6.0
Market Size																	
Population (million)	2006	3.2	3.8	7.7	4.4	10.3	1.3	10.1	2.3	3.4	2	0.7	38.1	21.7	7.5	5.4	2
GDP (US$ billion)	2006	9.1	12.3	31.5	42.9	143.0	16.4	112.9	20.1	29.8	6.2	2.5	338.7	121.6	32.0	55.0	37.3
Risk and Uncertainty																	
Inflation (%)	2006	2.0	6.5	8.1	3.4	2.0	6.1	3.7	11.1	6.6	2.7	2.6	1.0	10.1	15.6	2.7	2.3
Credit ratings	2008	NA	NA	BBB+	BBB	A	A	BBB+	BBB+	A-	BB+	BB+	A-	BBB-	BB-	A	AA

Soucre: Own illustration based EBRD, WDI, Eurostat, WIIW and Credit Suisse.

Note : (a) indicates data for 1998, (b) for 2002, (c) for 2005, (d) for 2004, (e) for 2002-2008. NA indicates not available. ALB: Albania, BOS: Bosnia and Herzegovina, BUL: Bulgaria, CRO: Croatia, CZ: Czech Republic, EST: Estonia, HUN: Hungary, LAT: Latvia, LIT: Lithuania, MAC: Macedonoa, MON: Montenegro, POL: Poland, ROM: Romania, SER: Serbia, SLK: Slovakia, SLV: Slovenia. The value of credit ratings originates in standard & poor's.

Table 3-1 shows some selected macroeconomic features of the transition economies. When consideration is given to the level of economic development, the Czech Republic, Estonia, Hungary and Slovenia have achieved a relatively high level of economic development. Among them, Slovenia shows the highest GDP *per capita* of US$18,600, followed by the Czech Republic (US$13,700), Estonia (US$12,200) and Hungary (US$11,100). These countries have also cultivated trade ties with other countries in the global economy. In sharp contrast, most Balkan nations (*i.e.*, Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia) have been in trouble with a lower level of economic development with GDP *per capita* of below US$5,000. In most Balkan countries, a relatively high portion of the GDP is due to the agriculture sector (26.3 percent in Albania, 16 percent in Bosnia and Herzegovina and 19.3 percent in Serbia), indicating that they continue to lag in industrialising their economic structure. Moreover, the degree of integration into the world economy is seen as substantially low. Serbia, with the lowest trade ratio of 61.3 percent in the GDP, has been far from integrating itself into the era of globalisation.

The quality of the labour force has been a major factor for investors focused on high-technology in CEE, while the availability of a cheap labour force has been among the influential determinants for labour-intensive investors. Compared to other CEECs, Slovenia has been the most advanced country. The level of labour productivity in Hungary and the Czech Republic reached roughly 70 percent of the EU level although it fell short of that accomplished in Slovenia. It is commonly seen that in the Baltic, the Balkan and the Southeast European groups, their levels of labour productivity have been substantially far below the EU level.

The wage level that constitutes cost competitiveness has been justified by Western investors as a critical ingredient in the relative attractiveness of the European transition economies. An impressive gap between the highest wage level in Slovenia (1,285 Euro) and the lowest level in Bulgaria (220 Euro) was identified. Labour costs of Visegrád-4 countries are equivalent to those of Baltic countries. The former Yugoslav economies, with the exception of Croatia and Slovenia, were countries characterised by substantially cheap labour.

However, the concern that labour costs may in the near future cease to act as part of competitive factor endowments, because a growing number of foreign firms seek to expand their operations in CEE in the post EU enlargement era, has been discussed intensely. The risk of strong upward pressure on wages will be increased in order to prevent larger migration flows (Puga, 2002). In recent years, the growth rate of wage levels has turned out to be significant due to the gradual convergence of the level of economic development of European transition economies toward that of Western European counterparts. A high average rate of wage increase for the period from 2000 and 2005 was recorded in Romania (31.1 percent) and Serbia (57.6 percent) despite their comparative advantage of cheap labour costs. Should wage levels continue to grow

with such high speeds, Romania and Serbia may no longer lure would-be efficiency-inspired investors, even if labour costs remain cheaper than the Visegrad countries. On the contrary, changes in labour costs in the Czech Republic (6.8 percent) and Poland (5.8 percent) have not been as bad as in the aforementioned countries although some investors have pessimistic views on the issue of rising labour costs.

Turning to unemployment rates, a discrepancy between the countries of the former Yugoslavia and the rest has been remarkable. Bosnia and Herzegovina, Macedonia and Serbia have faced critical unemployment problems, with rates of 41.1 percent, 35.9 percent and 33.2 percent, respectively, in 2006. These high unemployment problems were mirrored by the persistence of a confounding mixture of political disorder and economic fragility derived from the impact of ruthless ethnic conflicts such as the Bosnia-Herzegovina War (1992-1995) and Kosovo War (1999). Thus, the speed of economic transition remains sluggish.

Taking a close look at market potential, the total population size of 16 European transition economies amounts is approximately 124 million, thus equivalent to that of Japan (about 127 million). It is observed that Poland and Romania can be attractive locations for market-seeking investors; Poland with a population of 38.1 million has the sixth-largest population among the EU countries, after Germany, France, UK, Italy and Spain. Romania, with a population of 21.7 million, ranks seventh in population as of 2008. As compared to Poland and Romania, the market potential of other CEECs is likely to be very small. As far as economic risks and financial uncertainty are concerned, some countries have become stable, while others have not yet gained financial stability. Notably, according to Credit Suisse, the Czech Republic, Estonia, Poland, Slovakia and Slovenia have achieved high levels of credibility from foreign capitalists, which is consequently reflected in the large volume of FDI inflows. Among them, Slovenia has been the most successful in this sense.

To sum up, there are significant variations regarding industrial development, economic openness, human resource endowment and financial risk among the transition economies. Poland and Romania appear to be favourable investment sites for market-seeking investors in the region because of their market size. Some attention also needs to be paid to labour conditions. It appears evident that cheap labour costs are highly attractive in the European transition economies, but high growth rates of wage levels as well as low labour productivity may pose some challenges to the reorganisation of value-generating economic activity of multinational corporations in the enlarged Europe, cancelling out the benefits from cheap labour costs in the foreseeable future. In terms of economic and financial risks, the Czech Republic, Estonia, Slovakia and Slovenia are judged as countries endowed with high certainty and stability.

3.2   The Regional Orientation of CEECs' Foreign Trade

The collapse of Soviet communism triggered a major change in the trading structure of CEECs, representing a great shift of their trade dependency away from the former Soviet Union to the EU (Hardy, 2007). In particular, from the start of the Cold War until the disintegration of the former Soviet Union, CEECs continued to rely heavily on foreign trade with the former Soviet Union and other Council of Mutual Economic Assistance (COMECON) countries, which accounted for most of their foreign trade.

As regards the regional orientation of CEECs' foreign trade, we can identify some clear features (Tables 3-2 and 3-3). First, most of the host European transition economies tend to have built strong commercial ties with Germany. It appears obvious that Italy and Russia are also important trade partners, of some of CEECs although falling behind Germany.

Second, both geographical proximity and historical connections between CEECs and their trading partners are likely to play a crucial role in structuring the trading patterns. For instance, Nordic countries such as Sweden and Finland are the major trading partners for Estonia. For the Czech Republic, Slovakia is ranked as one of three main trading partners both on the export side and on the import side, even in the aftermath of the break-up of Czechoslovakia.

Thirdly, it is somewhat surprising that two leading economic giants, such as the United States and Japan, are not considered as major trading partners of the above-listed CEECs. On the contrary, Western European countries account for a high concentration of realised trade transactions with CEECs, suggesting that the degree of trade interdependency between CEECs and Western Europe has been strong as a result of the wider European integration. According to Tanaka (2007: 100), Hungary's trade dependency on EU15 was the highest among CEECs in 2004, with the EU15 accounting for 70.8 percent of Hungary's total export share, followed by the Czech Republic (68.3 percent) and Poland (67.4 percent).

Fourthly, Tables 3-2 and 3-3 show that Italy is the main export and import partner for Albania and Romania. It reflects the fact that Western European MNEs operating in the textile industry are likely to make maximum use of outward processing transactions or trade (OPT) that is marked by 'foreign trade without foreign investment'. OPT indicates that the firms from the EU export raw materials for processing to CEE and re-import goods processed in CEE duty free. Many Italian textile and footwear firms strive to increase sales margins and to cut operational costs in the form of OPT.

Lastly, the eastward expansion of European integration has stimulated the advance of intra-company trade between the parent company and its affiliated companies or between their subcontractors within the EU in parallel with an increase in FDI. Take Audi in Hungary as an example: a large amount of automobile components is shipped from the parent company in Ingolstadt in Germany to its Hungarian factory in Györ.

New cars manufactured in Hungary are imported back to Western European markets. PSA in Slovakia and Fiat in Poland are also similar examples. Given these backgrounds, the reorganisation of the European car production hierarchy also tends to structure the trading patterns of CEECs.

Table 3-2: Export Partners as of the end of 2007 (Unit: percent)

Country	1	2	3
Albania	Italy (61.0)	Greece (9.1)	China (6.2)
B&H	Croatia (21.0)	Slovenia (16.5)	Italy (16.1)
Bulgaria	Turkey (11.5)	Germany (10.3)	Italy (10.2)
Croatia	Italy (19.3)	B&H (13.9)	Germany (10.2)
Czech Republic	Germany (30.9)	Slovakia (8.8)	Poland (6.0)
Estonia	Finland (17.9)	Sweden (13.2)	Latvia (11.4)
Hungary	Germany (28.1)	Italy (5.6)	France (4.7)
Latvia	Lithuania (15.1)	Estonia (13.7)	Russia (12.9)
Lithuania	Russia (15.0)	Latvia (12.8)	Germany (10.5)
Macedonia	S&M (19.4)	Germany (14.7)	Greece (10.5)
Montenegro	Switzerland (83.9)	Italy (6.1)	B&H (1.3)
Poland	Germany (25.9)	Italy (6.8)	France (6.0)
Romania	Italy (17.2)	Germany (16.9)	France (7.7)
Serbia	N/A	N/A	N/A
Slovakia	Germany (21.4)	Czech Republic (12.6)	France (6.7)
Slovenia	Germany (18.8)	Italy (12.5)	Croatia (8.0)

Source: CIA World Fact Book.
Note: B&H indicates Bosnia and Herzegovina.

Table 3-3: Import Partners as of the end of 2007 (Unit: percent)

Country	1	2	3
Albania	Italy (33.0)	Greece (18.3)	Turkey (8.7)
B&H	Croatia (24.7)	Slovenia (13.3)	Germany (13.1)
Bulgaria	Russia (12.3)	Germany (12.3)	Italy (8.7)
Croatia	Italy (16.1)	Germany (14.4)	Russia (10.1)
Czech Republic	Germany (32.0)	Netherlands (6.8)	Slovakia (6.4)
Estonia	Finland (15.9)	Germany (12.8)	Sweden (10.1)
Hungary	Germany (26.6)	China (7.8)	Russia (6.9)
Latvia	Germany (15.0)	Lithuania (13.9)	Russia (8.7)
Lithuania	Russia (18.1)	Germany (14.9)	Poland (10.6)
Macedonia	Germany (11.5)	Greece (11.3)	Russia (11.1)
Montenegro	Greece (10.2)	Italy (10.2)	Germany (9.6)
Poland	Germany (28.9)	Russia (8.8)	Italy (6.5)
Romania	Germany (17.2)	Italy (12.8)	Hungary (6.9)
Serbia	N/A	N/A	N/A
Slovakia	Germany (22.1)	Czech Republic (17.3)	Russia (9.2)
Slovenia	Germany (18.1)	Italy (17.1)	Austria (11.7)

Source: CIA World Fact Book
Note: B&H indicates Bosnia and Herzegovina.

In short, the European transition economies have steadily re-orientated foreign trade toward the EU, since the collapse of the COMECON countries in 1989. The main trading partners of the transition economies of the CEE region are mainly from Western European countries. North America and Asia play a negligible role in the trading structure of CEECs. The manifold causes such as geographical proximity, cultural and historical ties and the reorganisation of the European production system accompanied by EU enlargement tend to determine the trade partners of CEECs in the 21st century. Moreover, Western MNEs are motivated to exercise OPT with the desire to exploit the comparative advantages of a pool of cheap, but well-disciplined workers in CEECs. This close trade relationship between the two regions will be further strengthened since EU enlargement has added more fuel to the EU15's interdependence on the European transition economies *vice versa*. Nevertheless, our quantitative data remains insufficient in validating how far improved integration with the EU has helped the CEECs promote their competitiveness of knowledge-based assets in the trade consideration. Now let us turn to discussion of foreign direct investment.

3.3   Definition of FDI

What exactly is FDI? This is a starting point of understanding the functioning of cross-border activities in which MNEs are engaged. In economics and international management literatures, the definition of FDI is diverse and there is less clarity. To begin with, I present diverse types of definition of FDI. UNCTAD provides an example of a general definition of FDI as follows:

"FDI implies that the investor exerts a significant degree of influence on the management of enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among affiliates, both incorporated and unincorporated. FDI may be undertaken by individuals as well as entities" (UNCTAD, 2005: 297).

Hymer (1960: 1) points to the importance of control of assets such as factories and sales offices when distinguishing a direct investment from a portfolio investment. This type of definition of FDI is also shared by Dunning (1993: 5) as follows:

"The investment is made *outside* the home country of the investing company, but *inside* the investing company. Control over the use of the resources transferred remains with the *investor*. It consists of a 'package' of assets and intermediate products, such as capital, technology, management skills, access to markets and entrepreneurship" (Dunning, 1993: 5).

In the mainstream economic literature, FDI implies a product of an investor's avoidance

of risk and uncertainty in foreign activities. Minimising transaction costs and maximizing profits are at the heart of economic theories of FDI.

In contrast with scholars of international business, economic sociologists (Bandelj, 2008) and economic geographers (Yeung, 1998) view that the key motivating factors behind FDI are social networks and institutions. In an extension of the constructivist perspective, Bandelj (2008: 7) conceptualizes FDI as "*a socially constituted relational process, negotiated by practical economic actors*". This thesis therefore aims to explain the CEE operations of Japanese MNEs from both economic and non-economic theoretical perspectives.

3.3.1 The Evaluation of the Method of Data Collection

Before proceeding to the statistical evaluation of the FDI transactions in economies in transition, several points have to be taken into account. Meyer (1995: 302-303) draws attention to the fact that statistical information on the flow of foreign capital in the region and the data sources are subject to various drawbacks, as follows:

1. Small- and -medium-sized investors are unlikely to be covered in the balance of payment data. Those data are thus biased toward large investment projects.
2. FDI stock statistics face long time lags.
3. Potential biases emerge in registration data. There is the possibility that additional capital investments and the termination of projects are not included in the data on the stock of FDI inflows.
4. High data reliability is not expected in journalistic sources because there is the possibility that only well-known global corporations (in terms of size and multi-nationality) are included in the data.

As suggested by Meyer and Pind (1999: 202), the balance of payment data that the International Monetary Fund (IMF) publishes, although expected to be accurate, tends to be incomplete because only the capital transfer composes this data and the provision of machinery or technology is disregarded. Given these potential shortcomings of the sources of FDI data, one should keep in mind that there is the possibility that the actual FDI is not always correctly reported. In other words, the size of foreign capital in given countries tends to be overestimated. Hence, the quality of data has to be carefully judged and understood.

3.1   *Foreign Direct Investment in CEECs*

3.1.1 Cumulative FDI

This section reviews the evolution of foreign direct investment in CEE. I try to delineate

Table 3-4: The Evolution of Inbound FDI flows in the European Transitional Economies (Unit: US$ million)

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1989-2007
Central eastern Europe and the Baltic states													
Czech Republic	2,531	1,280	1,259	3,575	6,220	4,942	5,474	8,282	1,814	3,941	11,630	4,667	63,122
Estonia	199	111	130	574	222	324	343	153	763	703	2,252	569	7,741
Hungary	4,723	3,292	3,703	3,082	3,059	2,151	3,576	2,721	479	3,405	5,463	3,145	49,480
Latvia	245	379	515	303	331	400	114	250	254	528	584	1,493	7,860
Lithuania	72	152	328	921	478	375	439	715	142	510	689	1,551	7,766
Poland	3,617	4,445	4,863	6,049	7,239	9,327	5,804	3,901	4,284	12,259	7,013	10,037	97,734
Slovak Republic	194	199	84	374	701	1,897	1,520	4,130	1,913	3,052	2,279	3,797	23,357
Slovenia	161	167	303	221	59	71	226	1,508	-174	281	-67	-257	2,762
Total	11,741	10,024	11,183	15,099	18,309	19,486	17,495	21,659	9,475	24,679	29,843	25,001	259,822
South-eastern Europe													
SEE-3													
Bulgaria	98	138	507	537	802	998	803	876	2,070	2,879	4,003	7,333	29,444
Croatia	101	466	348	842	1,393	1,075	1,188	580	1,932	732	1,551	3,170	17,467
Romania	417	415	1,267	2,079	1,025	1,051	1,154	1,080	2,156	6,368	6,587	11,430	43,050
SEE-5													
Albania	89	97	42	45	51	143	207	135	178	341	263	325	2,669
Bosnia and Herzegovina	0	0	0	100	90	146	119	266	381	666	520	423	4,311
FYR Macedonia	10	11	30	128	32	175	441	78	118	322	94	424	2,207
Montenegro	NA	NA	NA	NA	NA	NA	10	84	44	63	482	650	2,333
Serbia	NA	0	740	113	112	50	165	475	1,365	966	1,550	4,264	11,995
Total	715	1,127	2,933	3,844	3,505	3,639	4,088	3,574	8,244	12,338	15,049	28,019	113,477

Source : EBRD

not only the size of FDI but also have a preliminary look at the rationale behind decisions on where to invest in a given country in the post-socialist region. Since 2000, FDI inflows have been recognised as a vital vehicle for achieving the rapid economic growth. The advance of IT industries enabled multinational corporations to benefit from lower communication costs and stimulated the proliferation of FDI inflows in the region. What is remarkable about the pattern of foreign capital penetration in CEE is the unprecedented growth of the inward FDI stock. According to UNCTAD's *World Investment Report* (2007), the actual stock of inward FDI in the 16 transition economies in 1990 represented only US$3.1 million yet and it however soared to US$440.1 billion in 2006, which exceed US$420.2 billion in Southeast Asia consisting of 11 countries (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Timor-Leste and Vietnam). This size, however, accounts for less than one-tenth of the EU's inward FDI stock, which amounts to over US$5 trillion. Now let us turn to briefly reviewing the intensity of foreign capital penetration of each country.

Czech Republic

At the end of 1990, the Czech Republic received inward FDI of only US$1.36 billion. The disintegration of Czechoslovakia turned out to exert a negative effect on the FDI inflow. Among the European transition economies, the Czech Republic attracted more than US$11 billion worth of investment in 2005. The FDI inward stock of US$77.5 billion in the Czech Republic at the end of 2006 was roughly the same as that in Austria (US$77.7 billion) and South Africa (US$77 billion) (UNCTAD, 2007: 255-258). UNCTAD (2006: 263) reported that the number of foreign affiliates recorded 71,385 in 1999, which indicates more than 30 percent of all foreign affiliates operating in the EU were operational in the Czech Republic.

Hungary

In 1988, Hungary was the first country in the region to permit foreign investors to form a JV, in the form of majority ownership, before the collapse of the former Soviet-type command economy (Meyer, 1995: 305). Hungary remained one of the frontrunners that attract a large amount of FDI inflows among the former Soviet type countries until the mid-1990s. The major reason why Hungary was attractive to foreign investors in the early phase of economic transformation lies in the presence of "a small private sector with business contacts and a reputation for entrepreneurship" (Meyer, 1995: 307). However, in the aftermath of the completion of the privatisation process in the mid-1990s, the relative growth of FDI inflows in Hungary appears to have slowed. In Hungary, the inward FDI stock was US$81.8 billion in 2006, about the same as the FDI stock in Turkey (US$79.1 billion) and Chile (US$80.7) and about twice as much as Nigeria (US$40.3 billion) (UNCTAD, 2007: 255-258). According to UNCTAD (2006),

the number of foreign affiliates totaled 26,793 in 2003. This means that more than 10 percent of all foreign affiliates operating in the EU were concentrated in Hungary.

Poland

Poland received a FDI inflow stock of US$103.6 billion at the end of 2006. Somewhat surprisingly, this value represents about the same as that in Japan (US$107.6 billion) and roughly one third of the inward FDI stock of US$292.6 billion in China. (UNCTAD, 2007: 255-258). In 2005, the number of greenfield FDI projects was 234, which exceeded 212 in Germany and was 10 times greater than in Portugal (UNCTAD, 2006: 263). Poland was ranked as the third most attractive destination for greenfield FDI projects after the UK and France. Given the emerging presence of Poland as part of the European division of labour with large stocks of FDI, Hardy (2007: 761) calls Poland as "a glowing example of market success".

Slovakia

Following the collapse of state socialism, it took many years for Slovakia to regain the confidence of foreign investors, because of political risks. The amount of cumulative FDI inflows into Slovakia skyrocketed from US$701 million in 1999 to US$1.897 billion in 2000. This rapid increase in FDI initiatives was driven by the overthrow of the Mečiar nationalist government and better economic performance vis-à-vis other CEECs (Brada *et al*., 2006). At the end of 2006, the inward FDI stock of US$30.3 billion in Slovakia was roughly the same as that in Vietnam (US$33.5 billion) and Morocco (US$29.8 billion) (UNCTAD, 2007: 255-258).

Slovenia

The former Yugoslavia had permitted foreign investment enterprises to enter its local market through the formation of JVs with local firms since 1967 (Stefancic, 2005: 46). At the end of 1993, 3,300 enterprises were recorded with foreign investment of US$1.2 billion (Meyer, 1995: 308). Despite the fact that Slovenia seems to provide a positive investment environment with high GDP *per capita* and close distance to Western markets, Slovenia's economic performance in terms of FDI inflows has been very disappointing. As seen in Table, the FDI outflows exceeded the FDI inflows in 2003, 2005 and 2006. Stefancic (2005) argues that these unsatisfactory results might have been attributable to Slovenia's small-sized economy and two major civil wars. In 2002, US$1.508 billion was recorded as the peak of FDI inflows in Slovenia owing to the enforcement of large-scale privatisation projects. Renault's investment was considered a driving force for modernising the Slovene automobile industry. Even with its superior economic development and institutional stability among the European transition economies, the FDI inflow stock in Slovenia was limited to US$7.5 billion, which was roughly the same as the inward FDI stock of US$7.3 billion in Jamaica (UNCTAD,

2007: 255-258).

Table 3-5: The Evolution of FDI Stock in European Transition Economies
(Unit: US$ million)

Country	FDI inward stock			FDI outward stock		
	1990	2000	2006	1990	2000	2006
CEE	3,100	109,495	440,124	1,053	5,674	42,201
Visegrád-4	2,323	83,487	293,163	605	3,410	29,738
Albania	–	568	1,284	–	82	110
Bosnia and Herzegovina	–	756	4,748	–	40	43
Bulgaria	112	2,704	20,707	124	85	343
Croatia	–	3,518	26,812	–	825	2,407
Czech Republic	1,363	21,644	77,460	–	738	5,058
Estonia	–	2,645	12,664	–	259	3,613
Hungary	569	22,870	81,760	197	1,280	12,693
Latvia	–	2,084	7,532	–	24	447
Lithuania	–	2,334	10,939	–	29	1,183
Macedonia	–	540	2,437	–	16	62
Montenegro	–	–	1,291	–	–	35
Poland	109	34,227	103,616	408	1,018	10,705
Romania	–	6,951	41,001	66	136	278
Serbia	–	1,015	10,094	–	–	–
Slovakia	282	4,746	30,327	–	374	1,282
Slovenia	665	2,893	7,452	258	768	3,942
EU15	747,186	2,081,979	5,086,710	807,143	3,045,103	6,384,839
Southeast Asia	63,165	263,421	420,192	9,220	84,045	171,396
China(a)	20,691	193,348	292,559	4,455	27,768	73,330

Source : UNCTAD (2007)

Note : (a) excludes Hong Kong, China.

Romania

The FDI inflow stock jumped from US$6.95 billion in 2000 to US$41.0 billion in 2006. The latter figure was more than twice that in Indonesia (US$19.1 billion) and Chile (US$80.7) and about twice as large as that in Nigeria (US$40.3 billion) (UNCTAD, 2007: 255-258).

Bulgaria

In Bulgaria, the inward FDI stock was US$20.7 billion in 2006, about equivalent to the FDI inflow stock in Peru (US$19.4 billion) and one fourth of the FDI inflow stock in Portugal (US$85.5 billion) and Chile (US$80.7) (UNCTAD, 2007: 255-258).

Baltic countries

The sum of the FDI inflow stock of three Baltic countries amounted to US$31.1 billion

in 2006, which was roughly the same as the FDI inflow stock in Slovakia (UNCTAD, 2007: 255-258).

Balkan countries

The former Yugoslav republics had - due to their enactment of joint venture laws - traditionally benefited from FDI inflows due to Yugoslavia's lenient FDI policy even before the break-up of the nation. However, ethnic conflicts became the main reason discouraging FDI inflows until the second half of the 1990s. In Albania, the shortfall of the financial pyramid schemes over the course of the 1990s also inhibited FDI inflows (Brada *et al.*, 2006). Among the Balkan countries (excluding Slovenia), Croatia received the highest FDI inflow stock of US$26.8 billion in 2006, followed by Serbia (US$10.1 billion) (UNCTAD, 2007: 255-258). Brada *et al.* (2006) assess that the Dayton Peace Accords were a significant factor encouraging FDI initiatives in Croatia.

3.1.2 Size-Adjusted FDI Inflows

When controlling for the size of the local economy, the country variation in terms of the scale of FDI inflows is more remarkable than the absolute value. Two size-adjusted FDI indicators are presented as follows: FDI *per capita* in value and FDI relative to GDP in percent. These indicators take the average data to avoid the large fluctuation of FDI inflows in the four different time periods (1992-1994, 1995-1998, 1999-2002, 2003-2006) as pointed out by Meyer and Pind (1999: 205).

First, focus will be placed on the average FDI in percent of GDP. Bulgaria and Estonia show steady growth of FDI over GDP ratio over the four periods. Poland and Romania follow these two countries. Serbia's FDI performance skyrocketed from 0.9 in percent over the years 1999-2002 to 8.1 percent over the years 2003-2006 in terms of average FDI in percent of GDP. Conversely, the Czech Republic, Hungary and Slovakia slightly dropped during those last two periods (1999-2002 and 2003-2006), although their FDI performance remained relatively high compared to other transitional economies.

Table 3-6 also reveals population-adjusted FDI figures. Overall, all the listed countries except for the Czech Republic and Macedonia have shown a great leap forward in FDI *per capita* over time. Similar to the average FDI in percent of GDP, Estonia ranks as the highest with US$1,235.10 during the period 2003-2006. The country has successfully established its credible reputation in encouraging FDI inflows in recent years. The Czech Republic (US$602) and Slovakia (US$530.7) follow Estonia. The FDI performance of some of the former Yugoslav countries *(e.g.*, Albania and Macedonia) remains considerably disappointing, with FDI *per capita* of less than US$10. Particularly surprising is that the average FDI *per capita* of Poland and Romania is relatively poor (US$309.5 and US$302.4, respectively), notwithstanding their large local markets. Similar to the actual value of FDI inflows, the average FDI *per*

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capita of Slovenia has been continuously one of the smallest over the four time periods. Estonia has been much ahead of other Baltic countries, having established itself to attract FDI inflows in *per capita* terms. The country has reached one of the highest levels among the CEECs. Even in the early phase of transition (1992-1994), the country was second to Hungary. On the other hand, despite the similar historical backgrounds, population and GDP, Lithuania and Latvia received moderate levels of FDI inflows. Moreover, it is noteworthy to point out that Estonia and Slovenia experience contrasting levels of FDI inflows despite their similarities in terms of market size and ethnic diversity (Bandelj, 2008).

Table 3-6: Size-Adjusted FDI Inflows to European Transition Economies

Country	Average FDI in percent of GDP				Average FDI per capita in US$			
	92–94	95–98	99–02	03–06	92–94	95–98	99–02	03–06
Albania	3.4	2.4	3.3	3.6	13.6	20.4	42.4	87.7
Bosnia and Herzegovina	N/A	0.4	3.1	4.9	N/A	4.6	46.5	127.9
Bulgaria	0.6	2.7	6.5	13.3	7.4	37.3	110.3	458.5
Croatia	N/A	2.5	6.2	5.6	N/A	115.2	280.0	471.5
Czech Republic	N/A	3.8	9.9	5.1	N/A	218.2	620.8	602.0
Estonia	3.9	5.9	6.3	12.4	101.8	213.9	271.3	1235.1
Hungary	4.3	8.6	6.1	4.8	159.7	378.4	319.5	503.3
Latvia	1.9	6.0	3.6	5.0	38.0	147.7	120.5	362.6
Lithuania	0.3	3.7	4.1	3.6	6.4	104.6	144.5	278.7
Macedonia, FYR	0.2	1.1	5.2	3.1	4.0	20.5	91.0	88.0
Montenegro	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Poland	1.6	3.1	3.7	4.1	37.0	125.7	172.0	309.5
Romania	0.6	2.5	2.8	6.9	7.5	43.5	49.3	302.4
Serbia	N/A	N/A	0.9	8.1	12.4	29.5	14.6	300.8
Slovak Republic	1.3	1.5	8.9	6.4	35.8	61.3	369.7	530.7
Slovenia	0.9	1.1	2.8	1.7	56.8	109.1	300.8	290.3

Source : Own calculation based on World Bank's *World Development Indicator*.

Moreover, taking Croatia as well as Bosnia and Herzegovina as an example, there is a marked discrepancy between these countries (US$471.5 and US$127.9) in FDI *per capita* although economic stabilisation of both countries were discouraged by two ethnic conflicts. Of notable interest is that Serbia's FDI performance in *per capita* terms increased to US$300.8 over the years 2003-2006, while it used to be substantially lower than other Balkan countries. According to the Serbia Investment and Export Promotion Agency (http://www.siepa.sr.gov), Serbia received the investment inflow of 1.51 billion Euros in 2006 as a result of the privatisation of formerly state-owned enterprises. One of these examples is the purchase of the Serbian mobile phone operator by a Norwegian conglomerate, Telenor.

In short, I found no evidence that there are simple, linear and definitive relationships of FDI inflows to CEECs and the level of economic development, geographical proximity to Western European markets or the degree of progress in institution-building when the size of the local economy is adjusted.

3.1.3 Countries of Origin

This section reviews the pattern and trends of FDI transactions based on the countries of origin. I also investigate whether there is a special linear association between FDI transactions and the origin of FDI (Tables 3-7 and 3-8). Hunya (2000a) suggests that the characteristics of foreign multinationals can be better understood through a comparison between countries of origin. The previous literature also sheds light on the importance of both national ideology (Dresmus *et al*., 1998) and social networks (Bandelj, 2002, 2004) which tend to shape the actions of foreign multinationals irrespective of the dynamic complexity of globalisation. Additionally, cultural ties (Bandelj, 2008) and geographic proximity to neighbouring countries (Hunya, 2000a) have a defining effect on the patterns of foreign capital inflows. The time-series data is more appropriate, but the limitation of data availability deters detailed analysis of the interaction of the country of origin with recipient countries. Tables 3-7 and 3-8 describe the variation between home countries with respect to the intensity of foreign direct investment stocks in European transition economies. Data for 10 countries (the Czech Republic, Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia), except for the Balkan countries were presented. The data were collected by the author from the central bank or statistical office of each host country.

Investments from Germany, Austria and the Netherlands have been of great relevance for most CEECs. Foreign investors from North America, Asia and old EU periphery countries such as Spain and Portugal have had a minor presence in the local markets of the region. Accordingly, it seems that geographical proximity is a critical predictor in the explanation of the intensity of FDI.

Austria

Austria has traditionally been considered to be the critical intersection between Western Europe and CEE in geographical terms. Austrian investors are active in Hungary and the Czech Republic, notably in the manufacturing sector, while their economic involvement is relatively weak in Poland (Hunya, 2000c: 100-101). Austrian investors made maximum use of the first mover advantage in the early phase of economic transition (Hunya, 2000c: 93) because of the country's geographical centrality, cultural ties and human networks in the region. As already confirmed by Hunya (2000c) in a study of the FDI characteristics of countries of origin in CEE during the second half of the 1990s, our data also reveals that the intensity of the stock of Austrian FDI has been extensively high in the neighboring transition countries such as the Czech Republic

(10.2 percent), Hungary (11.1 percent), Slovakia (32.3 percent), Slovenia (14.8 percent), Bulgaria (21.3 percent), Romania (23 percent) and Slovenia (32.3 percent). The underlying motive of Austrian FDI has been to aim at serving emerging local demand (Hunya, 2000c).

Table 3-7: FDI Inflows by Country of Origin in CEECs (Unit: million Euro)

Region	Origin	CZ	EST	HUN (a)	LAT	LIT (b)	POL (a)	SLK (a)	SLV	BUL	ROM (a)
EU	Austria	6,377	41	5,184	170	97	3,462	1,693	2,188	5,268	7,942
	Belgium	2,347	-30	886	40	36	3,002	–	249	559	–
	Denmark	594	256	181	641	949	2,365	–	95	193	–
	Finland	–	1,889	966	447	495	940	–	0	6	–
	France	4,500	62	2,175	30	126	10,822	–	588	341	2,766
	Germany	15,470	169	12,959	624	642	15,508	2,082	537	1,058	3,473
	Italy	418	-57	746	22	8	4,122	1,413	374	347	2,322
	Netherlands	9,623	30	6,950	420	279	18,836	2,221	619	4,088	5,887
	Portugal	–	22	32	0	0	467	–	–	28	–
	Spain	–	13	826	3	24	2,560	–	7	644	–
	Sweden	932	4,225	680	1,008	1,137	3,636	–	29	60	–
	UK	2,234	221	3,181	224	129	3,792	602	127	1,962	–
Europe	Switzerland	2,943	69	834	–	244	2,450	–	933	673	2,372
CIS	Russia	–	165	-5	340	998	502	–	2	448	–
North	USA	3,318	-63	1,824	347	164	6,889	380	147	897	628
America	Canada	–	53	118	3	34	184	–	0	34	–
Asia	Japan	951	6	723	0	0	808	–	20	79	–
	Korea	–	–	257	6	10	940	409	–	16	–
	China	–	-3	19	–	3	69	–	0	3	–
	Total	62,242	8,199	46,670	7,226	5,393	94,472	11,406	6,775	24,743	34,512

Source : Own calculation based on national statistics.
Note : (a) indicates data for 2006. (b) inicates data for 2008.

Germany

Germany has been the leading source of foreign investment in many CEE countries. Particularly notable is that German FDI has been dispersed across the region. German investors established themselves in various former command-type economies in the Czech Republic (24.9 percent), Hungary (27.8 percent), Poland (16.4 percent) and Slovakia (18.2 percent). The strong presence of German investors in these Visegrád-4 countries was attributed not only to their geographical proximity but also to their historical involvement. As a matter of fact, the economic system and institutional infrastructure of many of European transition economies have been influenced by Germany. CEECs usually follow the German legal framework in terms of corporate and competition laws. According to Hunya (2000c: 103), CEEC's economic growth is dependent on the state of the German economy; a decline of the German economy in 1998 exerted a more detrimental effect on CEECs trade performance than did the Russian financial crisis. It should be noted that German car producers have strengthened their economic involvement in CEE. VW's acquisition of Skoda in the Czech Republic has been considered as an encouraging role in revitalising the Czech automobile industry (Meyer, 2000). Besides large multinational firms such as VW, Siemens and

Bosch, German medium-sized firms have also been active in order to capitalise on cheap factor endowments such as labour and real estate (Cieślik and Ryan, 2002). German investors have been extensively involved in various industries such as manufacturing sectors, retailing, and financial intermediation in Poland (Wada, 2005). With the use of the ordered probit model to explore the association between proximity and involvement in West-East business, Meyer (1998) presents evidence that German multinationals are relatively active in the neighbouring countries such as the Czech Republic and Hungary compared to British counterparts. The strong presence of German capitalists appears to be an indication of the emergence of Germany's new imperialism in the eastern periphery of the EU territory.

Table 3-8: FDI Inflows by Country of Origin in CEECs (Unit: percent)

Region	Origin	CZ	EST	HUN(a)	LAT	LIT(b)	POL(a)	SLK(a)	SLV	BUL	ROM(a)
EU	Austria	10.2	0.5	11.1	2.3	1.8	3.7	14.8	32.3	21.3	23.0
	Belgium	3.8	–	1.9	0.6	0.7	3.2	–	3.7	2.3	–
	Denmark	1.0	3.1	0.4	8.9	17.6	2.5	–	1.4	0.8	–
	Finland	–	23.0	2.1	6.2	9.2	1.0	–	0.0	0.0	–
	France	7.2	0.8	4.7	0.4	2.3	11.5	–	8.7	1.4	8.0
	Germany	24.9	2.1	27.8	8.6	11.9	16.4	18.2	7.9	4.3	10.1
	Italy	0.7	–	1.6	0.3	0.1	4.4	12.4	5.5	1.4	6.7
	Netherlands	15.5	0.4	14.9	5.8	5.2	19.9	19.5	9.1	16.5	17.1
	Portugal	–	0.3	0.1	0.0	0.0	0.5	–	–	0.1	–
	Spain	–	0.2	1.8	0.0	0.4	2.7	–	0.1	2.6	–
	Sweden	1.5	51.5	1.5	13.9	21.1	3.8	–	0.4	0.2	–
	UK	3.6	2.7	6.8	3.1	2.4	4.0	5.3	1.9	7.9	–
Europe	Switzerland	4.7	0.8	1.8	–	4.5	2.6	–	13.8	2.7	6.9
CIS	Russia	–	2.0	0.0	4.7	18.5	0.5	–	0.0	1.8	–
North America	USA	5.3	–	3.9	4.8	3.0	7.3	3.3	2.2	3.6	1.8
	Canada	–	0.6	0.3	0.0	0.6	0.2	–	0.0	0.1	–
Asia	Japan	1.5	0.1	1.5	0.0	0.0	0.9	–	0.3	0.3	–
	Korea	–	–	0.6	0.1	0.2	1.0	3.6	–	0.1	–
	China	–	0.0	0.0	–	0.1	0.1	–	0.0	0.0	–
	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Own calculation based on national statistics.
Note : (a) indicates data for 2006. (b) inicates data for 2008.

France

France has also been one of the leading sources of FDI inflows in some CEE countries although its involvement is not as strong as that of its German and Austrian counterparts. French investors comprised only the third-largest group of investors in Poland, Romania and Slovenia at the end of 2006. French FDI accounted for 11 percent of the total foreign capital in Poland. One of the reasons for the significant involvement of French investors lies in the fact that French Telecom invested US$450 million to buy a local telecommunication company in Poland in 2004. This investment value was the second largest recorded, after the US$800 million invested by an American real estate company, Apollo Rida (Karpińska-Mizielińska and Smuga, 2005: 68).

Netherlands

Dutch firms have also established themselves in almost all local markets, other than those in the Baltic countries. Among the European transition economies, the proportion of Dutch FDI relative to the total FDI in Poland and Slovakia accounted for roughly 20 percent. In particular, the value of 18,836 million Euros in Poland was remarkable.

Nordic countries

The Baltic countries are generally targeted by neighbouring Western European countries such as Sweden and Finland. The FDI stock of Sweden in Estonia and Lithuania accounts for 51.5 percent and 21.1 percent, respectively. Likewise, Finland has strengthened its presence in Estonia (23 percent).

Russia

The value and share presented in Table 3-7 and 3-8 do not demonstrate the importance of the potential performance by Russian-based enterprises in the CEE region. The market presence and strategic investing patterns of Russian multinational firms are substantially prominent in the natural resource sector including natural gas and crude oil. Three major Russian-based multinationals - such as Gazprom, Rosneft, Yukos and Lukoil – have made resource-seeking and strategic asset-seeking FDI frequently in the form of cross-border M&A deals. The central intention of entering the market is explained by the desire to build a foothold to access US and EU markets and for diversifying the range of production (Weiner, 2006: 7). Interestingly, it appears evident that the geographical distribution of Russian capital has been concentrated in certain CEE countries, rather than dispersed. The Baltic nations have succeeded in luring Russian-based multinationals, while the presence of those same multinationals has been marginal in Visegrád-4 countries. The reason for this geographical asymmetry may lie in historical and cultural ties, and memories of these two sub-groups. According to CIA World Factbook (http://www.cia.gov), there is the large population of Russian speaking citizens (Estonia: 29.7 percent; Latvia: 37.5 percent; Lithuania: 8 percent) and of Russian ethnicity (Estonia: 25.6 percent; Latvia: 29.6 percent; Lithuania: 6.3 percent) in the three Baltic nations. According to Weiner's study (2006: 21-23), the absence of favouring Russian capital by Visegrád-4 countries and other CEE economies can be attributed to seven underlying factors: (1) memories of Soviet politics; (2) fear of losing control over strategic industries; (3) lack of transparency; (4) radical and strong pressures on host governments of CEE countries in the cross-border M&A negotiation procedure; (5) high uncertainties and risks involved (*e.g.*, potential violation of property rights); (6) bribery and corruption; and (7) potential decline in productivity and efficiency in the post-M&A period. Despite these discouraging grounds, the roles and tasks played by Russian-based multinationals are estimated to become more crucial in the future (Weiner, 2006: 25).

North America

North American investors have been an insignificant source of foreign investment in the region. US FDI was relatively dispersed and its presence was not as crucial as inbound FDI from other European countries. The reason for the high intensity of American FDI in Poland is related to the presence of large Polish communities in the United States (Bandelj, 2008). Food processing, financial intermediation and chemical-related investments accounted for the majority of the US investment in Poland (Wada, 2005: 47). Major US firms such as GE, GM, McDonalds, and Coca-Cola have promoted their market presence in the region to target the local and EU markets. Shama (1995) presents evidence that US investors have a strong tendency to form joint ventures with local firms when entering emerging markets in the former Soviet bloc. This suggests that entry strategies of US MNEs are characterised as more risk-averse than risk-preferring. The proportion of Canadian FDI in each host economy accounted for less than 1 percent. Their underrepresentation can be explained by geographical distance.

Asian countries

Asian investors did not account for a large proportion of the FDI inflow to each country in the former Soviet-type economic bloc as of 2006, compared with Western European investors (Cieślik and Ryan, 2002; Meyer, 1995, 1998).

In the above listed CEECs, the stock of inward Japanese FDI did not exceed even two percent. This minor presence of Japanese multinationals is somewhat surprising despite their established global and European business networks. Although the tables capture weak economic involvement of Japanese multinationals in the form of foreign investment, Japanese FDI has been perceived among host governments of CEEs as important investors in recent years. One major reason is that various forms of Japanese lean and flexible production strategies and their cutting-edge technologies are expected to contribute to boosting industrial modernisation of the local economy. Another is that Japanese FDI is thought to stimulate a reduced dependency on capital imports from certain countries (Bakos, 1992).

Korean firms were considered as "outliers to the gravity rule" (Hunya, 2000c: 92) during the 1990s due to their first-mover advantages (Linden, 1998; Ruigrok *et al.*, 2004). Korean investors were surprisingly active in the region despite the lack of historical ties, large geographic distance and linguistic obstacles. Since the mid-1990s Daewoo Motors, a pioneer of Asian FDI in CEE, has invested heavily in the automotive sector and has developed its own overarching sourcing linkages with local suppliers in CEE (Pavlínek, 2006). Daewoo also acquired 51.0 percent of a Romania car producer, RODAE, in November 1994 and 50.2 percent of a Czech truck maker, AVIA, in August 1995 (Hyun, 2003) aiming to produce relatively cheap products for the local and the European markets" (Hunya, 2000c: 103).

As of December 1994, the stock of Korean FDI in Romania became higher than Western European FDI because of a large-scale investment by a Korean *chaebol*, Daewoo, to set up an automobile joint venture firm with Craiova (Nishimura *et al.*, 1998). Of significant relevance is that the value of Korean FDI in CEE was rather large, while the number of projects was quite limited. For instance, only 33 investment projects were carried out by Korean investors, while the value was 573 million Zloty. The investment size per project of 17.4 million Zloty for Korean firms was much greater than that of 0.5 million Zloty for German firms as of 1996 (Nishimura *et al.*, 1998: 348). Contrasting the stock of German FDI in Romania with that of Korean FDI in Romania as of February 1998, the former amounted to US$353.4 million in value and a total of 7,045 projects, while the latter US$234 million in value and a total of 45 projects (Nishimura *et al.*, 1998: 356).

As of the mid-1990s, Chinese investors were seen in Hungary and Romania but it in rather small numbers and their investing motives may have been driven by "political reasons escaping the home environment" (Meyer, 1995: 312). Chinese multinationals are more active in Russia and Central Asia due to geographic proximity and historical and cultural ties. Asian firms are generally in favour of establishing wholly owned enterprises over joint ventures with local partners.

According to the CzechInvest, Japanese manufacturing FDI amounted to US$3.219 billion and created 23,420 job opportunities at the end of March 2007. In Slovakia, four Japanese manufacturing firms (*e.g.*, Yazaki, Sumitomo, Matsushita and Sony) and three Korean manufacturing firms (*e.g.*, Samsung, Kia Motors and Hyundai Mobis) were ranked within the top 20 foreign investors in terms of job creation (SARIO, 2007: 16). Encouraging signs and binding commitments by some CEE investment promotion agencies such as CzechInvest and PAIiIZ to attract more Asian investors are reflected in the availability of their websites in Japanese and Korean versions. Moreover, a Japanese investment advisor has been hired in each IPA (the CzechInvest, PAIiIZ, and Hungarian Investment Promotion Agency). In order to contribute to attracting more investment projects from Korea, the Korea Exchange Bank promised to dispatch a Korean advisor to the Czech Republic in 2006 in line with a partnership with CzechInvest (CzechInvest, November 2, 2006).

To sum up, our descriptive statistics confirm a high concentration of investment by Western European investors in the former Soviet-type economies. Geographical and cultural proximity between an invested country and an investing country seems likely to determine the size and destination of foreign capital. Neither U.S. nor Asian investors have established themselves yet at least from the perspective of FDI distribution by the nationality of origin. Nevertheless, it is important to note that scholars of economics in transition are inclined to reappraise the dynamic trend of Asian FDI and its role in modernising the local economy.

3.2 The Industrial Distribution of Foreign Direct Investments

This section looks at the industrial composition of foreign capital in selected CEECs. The data for the industrial distribution of FDI transactions was collected by the author from the national statistical office or the central bank of each recipient country. Less than 1 percent of the stock of FDI was concentrated in the agricultural industry as well as the mining industry, suggesting that multinationals' investments are not motivated by the desire to exploit resource-based assets in CEE in contrast to those in CIS (Meyer and Pind, 1999).

Table 3-9 reveals that the manufacturing sector has predominantly attracted the large share of foreign investment projects in most selected countries with the exception of Estonia, Latvia and Bulgaria. Notably, Hungary and Poland have been the leading recipients of investments by foreign-owned manufacturers, with the share of over 40 percent of all FDI inflows. Foreign multinational firms appear to play a crucial role in the financial intermediation sector in the Baltic countries.

Particularly notable is the great transformation from the non-service sector to the service sector that took place between the mid-1990s and the early 2000s. Taking Poland as an example, the share of the manufacturing sector used to be more than two-thirds of all FDI projects in value (Meyer, 1995: 313) as of the mid-1990s, but it dropped sharply to 41.3 percent as of the end of 2006. In contrast, the share of the financial intermediation sector jumped dramatically from 0.3 percent (Meyer, 1995: 313) to 21.4 percent. To some extent, these changes also hold true for other countries in the region.

Within the manufacturing industry, the transportation and electrical and electronics sub-sectors received the large share of FDI in the Czech Republic (11.6 percent), Hungary (21.5 percent) and Poland (10.6 percent). This is because of the realisation of a large number of greenfield and brownfield projects undertaken in these sub-sectors. For instance, the Toyota-PSA consortium in Kolín, and VW's acquisition of Škoda in Mladá Boeslav have made significant contributions to revitalising the Czech automobile industry (Pavlínek, 2005). Hungary attracted Magyar Suzuki in Esztergom, Ford in Székesfehévár, and Audi in Györ. These investors have helped to transplant new technical know-how and organisational expertise to the local economies (Meyer, 1995; Sadler and Swain, 1994; Swain, 1998).

The Polish passenger car industry has prospered due to the presence of Opel in Gliwice, Fiat in Tychy, Toyota in Wałbrzych, VW in Poznań and Daewoo-FSO in Warsaw (Pavlínek, 2006). A probable cause of stimulating these foreign car assemblers to relocate their production lines to the region could be the "strong comparative advantages within intermediate-level technical skills" (Meyer, 1998: 25). In contrast, the food, beverage and tobacco industry in the table, in which foreign entrants require access to local distributors to gain profits, accounts for less than 10 percent.

Table 3-9: Cross-Country Sectoral Distribution (Unit: percent of total FDI)

ISIC code	Sector	CZ	EST	HUN	LAT	LIT
1	Agriculture	0.3	0.5	0.4	1.0	0.8
14	Mining and quarrying	1.2	0.4	0.1	0.5	0.5
15-37	Manufacturing of which:	30.0	14.8	41.4	6.8	30.6
15, 16	food, beverage, tobacco	3.5	–	4.2	–	5.6
23-25	chemicals, petroleum	4.9	–	3.0	–	13.6
29-35	Machinery, vehicles	11.6	–	21.5	–	1.7
40, 41	Electricity, gas supply	4.5	2.8	4.2	3.3	8.4
45	Construction	2.0	1.9	0.9	2.6	1.6
50-52	Wholesale and retail trade	12.1	12.6	11.7	12.0	12.8
65-67	Financial intermediation	19.9	32.5	8.0	37.2	23.5
70-74	Real estate, renting	13.2	28.0	17.9	10.4	10.7
60-64	Transport, communication	15.3	4.7	10.1	4.9	8.9
	Others	1.5	1.8	5.4	21.3	2.2
Total		100	100	100	100	100

ISIC code	Sector	POL	SLK	SLV	BUL	ROM
1	Agriculture	0.3	0.4	0.1	0.4	–
14	Mining and quarrying	0.1	0.6	0.1	0.5	6.1
15-37	Manufacturing of which:	41.3	39.1	37.1	17.9	34.2
15, 16	food, beverage, tobacco	5.5	–	0.5	–	–
23-25	chemicals, petroleum	4.8	–	18.2	–	–
29-35	Machinery, vehicles	10.6	–	5.5	–	–
40, 41	Electricity, gas supply	2.7	13.9	3.9	–	3.7
45	Construction	1.7	–	0.1	6.5	– (a)
50-52	Wholesale and retail trade	14.1	11.5	16.5	–	12.2
65-67	Financial intermediation	21.4	19.2	20.7	18.4	22.2
70-74	Real estate, renting	11.7	5.0	15.7	19.4	– (a)
60-64	Transport, communication	6.0	8.4	4.5	17.7	8.2
	Others	0.7	1.9	1.3	19.2	13.4
Total		100	100	100	100	100

Note : Bulgaria (BUL): - 2007, Czech Republic (CZ): 1993-2007, Estonia (EST): -2008, Hungary (HUN): -2006, Latvia (LAT): 2000-2007, Lithuania (LIT): 1997-2008. Poland: - 2006, Romania (ROM): -2006, Slovakia (SLK): - 2006, Slovenia (SLV): - 2006. (a) indicates that only the sum of construction and real estate is available, accounting for 6.4 percent.

3.3 Conclusions

This chapter revealed the scale, scope and characteristics of foreign direct investment in CEE. Similarities and dissimilarities on these issues among the transition economies are confirmed. CEECs used to be far less appealing before the disintegration of the former Soviet Union. In the aftermath of the fall of the Communist regime in the late 1980s, improved economic conditions in labour and capital markets were observed in most

countries but there are great variations in the speed and extent of the transition from a command economy to a free market economy among the CEECs. By and large, Visegrád-4, Estonia and Slovenia are the forerunners in achieving steady economic development, moving toward the standards of Western European countries, while most former Yugoslav countries have lagged behind. Many CEECs experienced a dramatic change in their regional orientation of trade and foreign capital transactions from former COMECON partners during the era of the Cold War towards Western Europe during the post-socialist era. As for the trade relationship, Germany has been the primary trading partner for most CEECs. CEE has been considered not simply the backyard of Western Europe, but also as the crucial source of opportunities for European multinationals to produce products at affordable costs and capture local markets.

In reflecting on the scale of the FDI inflow stock, the Czech Republic, Hungary and Poland have been the three largest recipient countries, while most of the Balkan countries have failed to accumulate foreign capital due to the outbreak of two ethnic conflicts. When consideration is given to the adjusted volume of FDI in percent of GDP and in population, a systemic relation between FDI and economic and political factors is hard to capture. Surprisingly, Estonia ranks as the highest when the scale of FDI penetration in a given country was calculated in percentage of GDP. Bulgaria and Slovakia are also outstanding during the period 1999-2002 and the period 2003-2006 next to Estonia. Estonia also achieved the highest FDI *per capita*, followed by the Czech Republic, Slovakia and Hungary. The distribution of FDI in CEE varies by country of origin. The size of FDI transactions tends to be determined by geographical distance and historical ties. Similar to foreign trade, the German FDI position has been remarkable in most of CEECs, followed by Austrian FDI and Dutch FDI. Somewhat surprising is that Austria plays a marginal role in foreign trade, while at the same time its presence is remarkable with regard to the intensity of FDI. Russian investors have not been active in CEECs with the exception of Lithuania, while Russia has still had traditional trade connections with most of CEECs on the import side in particular. North American and Asian counterparts with the exception of Korean firms have shown their limited presence in the region. However, the growing number of Japanese manufacturing firms is expected by local policy makers to play a positive role in encouraging the economic development of the region. Descriptive statistical evidence also suggests that the high FDI intensity in the machinery and vehicle sector in the Czech Republic, Hungary and Poland reflect their relatively strong engineering tradition, but it requires further analysis in quantitative and qualitative terms.

This chapter has clarified the evolution of FDI in European transition economies with a focus on individual recipient and source countries. In the next chapter, I aim to drill down further recent trends in Japanese FDI in different European transition countries and the key dimension of transnational operations of Japanese MNEs, namely investment motives, entry modes, and operational experience.

4 JAPANESE FOREIGN DIRECT INVESTMENT IN EUROPEAN TRANSITION ECONOMIES

4.1 Introduction

Central and Eastern Europe (CEE) is one of the regions that Japanese investors neglected for a long time. The degree of Japanese business involvement in CEE in the form of foreign trade and foreign direct investment has been marginal relative to Western European firms and US firms. According to JETRO (http://www.jetro.go.jp), the post-socialist economies have attracted the Japanese FDI of US$2.5 billion at the end of 2007. This actual value of Japanese capital is considerably marginal as compared to that of Western European FDI. However, certain policy makers in host governments of CEECs have begun re-evaluating the importance of Japanese capital penetration in CEE, especially in the manufacturing sector. From the perspective of the host governments, the increasing importance of Japanese MNEs is expected to serve as a conduit for modernising the local economies of CEE. From the point of view of Japanese MNEs, the strengthening of Japanese involvement is undoubtedly associated with the expansion of EU boundaries, which stimulates more supply and demand effects as a result of the completion of the Single European Market. One would argue that this regional integration forces Japanese investors to reconfigure the spatial organisation of their industrial activities in the enlarged Europe.

In general, Japanese firms have shown a particular preference for the Czech Republic, Hungary and Poland, in the CEE region. These three countries have received the lion's share of Japanese FDI, while other countries such as Slovakia and Romania have been minor FDI destinations. There have been few or no investment projects undertaken by Japanese firms in Baltic and Balkan countries. Japanese MNEs in the CEE market tend to concentrate in the manufacturing sector and notably, in the electronics and automobile sectors.

A lack of relevant publications limits our exploration of the strategic nature of Japanese FDI sectors in CEE, requiring scrutiny of the motives for making investment decisions. Dynamic configurations of the value-added supply chain by Japanese firms are now starting to become apparent in the region although Japanese capital penetration is too new for us to generalise.

The organisation of this chapter is arranged as follows. I analyse the degree of Japanese economic involvement in CEE in terms of trade, FDI and the geographical and sectoral distribution of Japanese FDI. I present an examination of the motives of Japanese FDI. This article gives concluding remarks in the end. The data used is based on interviews, secondary literature and statistical data sources including JETRO, Japans Ministry of Finance, Japans Ministry of Foreign Affairs, and Toyo Keizai (2007).

4.2   Japan's Trade Relations with CEECs

This section reviews the factors that characterise commercial ties between Japan and CEE and how the trade relations have developed over time. This thesis also directs attention to the question of whether trade relations have been reciprocal.

The Japan-CEE trade relationship has a history of over forty years. Trade agreements between Japan and CEE countries were made in succession, after the open conflicts between Japan and the USSR in connection with the immediate consequences of the Second World War were relaxed in 1956 by a Japan-Soviet common declaration on the ending of the war (Stankovsky, 1974: 61-63). Until the 1970s, the trading scale between Japan and CEE was limited to less than US$10 million (Bakos, 1992: 150). The 1970s witnessed CEECs begin to make efforts to achieve modernisation in their pursuit of foreign capital, but their development plan was hit by the second oil shock and, thus, interrupted, falling into a prolonged economic recession. From that time, the trading volume did not grow for more than two decades (Bakos, 1992: 150). The fall of state socialism in 1989 turned out to be a great incentive for consolidating mutual trade.

In 1990, Japan's exports to five COMECON (Council for Mutual Economic Assistance) nations totalled US$888 million, with imports of US$654 million (Bakos, 1992: 150; Berény, 1996: 232). Trade between Japan and CEECs was of only limited relevance for the both sides. Trade between Japan and CEE was characterised by a strong complementary nature before and after the end of the Cold War. Natural resources such as steel, iron, coal, and petroleum products were imported by Japan, while Japanese machinery exports to CEE took a significantly large share in the 1960s and 1970s. Eighty percent of Japan's exports to the eastern periphery were general machinery, electrical and electronics products and cars, while imports are dominated by chemicals, agricultural products and ferrous and non-ferrous metal products (Bakos, 1992: 150; Berény, 1996: 232). Japan specialises in exporting car components and electrical parts to the European transition economies. This background may imply that the role played by exports seems to be complementary to FDI since local Japanese-affiliated companies still rely in part on imported goods from Japan to satisfy demand for procurement.

As indicated by Table 4-1, the CEE shares of Japan's world exports and imports account for only 1.1 percent and 0.4 percent, respectively, at the end of 2007, while Asia and North America were of greater importance to Japan. It confirms that the trade aspect of the economic partnership between Japan, on the one side, and the eastern European periphery, on the other side, seems to be underdeveloped. The Japanese trading intensity has been primarily dominated by Asia and North America. Although most European transition countries have implemented institutional restructuring and economic adjustment policies ranging from price and trade liberalisation to bank reforms since the end of command type economies, Japan's trading ties with them have not yet grown.

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Table 4-1: Japan's Foreign Trade with CEE in 2007

Country	Value (US$ million)			Share (%)	
	Export	Import	Balance	Export	Import
World	712,735	621,084	91,651	100.0	100.0
Asia	343,113	267,926	75,187	48.1	43.1
ASEAN	86,990	86,898	92	12.2	14.0
Asian NIES	159,581	55,541	104,040	22.4	8.9
North America	153,903	80,857	73,046	21.6	13.0
South America	35,063	24,117	10,946	4.9	3.9
Europe	112,492	72,510	39,982	15.8	11.7
EU27	105,270	65,009	40,261	14.8	10.5
EU15	96,355	62,745	33,610	13.5	10.1
CEE	8,043	2,248	5,795	1.1	0.4
Poland	1,637	379	1,258	0.2	0.1
Czech Republic	2,618	479	2,139	0.4	0.1
Slovakia	437	204	233	0.1	0.0
Hungary	2,380	620	1,760	0.3	0.1
Estonia	133	77	56	0.0	0.0
Latvia	93	44	49	0.0	0.0
Lithuania	109	22	87	0.0	0.0
Slovenia	198	50	148	0.0	0.0
Bulgaria	134	53	81	0.0	0.0
Romania	256	223	33	0.0	0.0
Croatia	46	97	-51	0.0	0.0
Russia and CIS	12,482	11,514	968	1.8	1.9
Middle East	26,184	113,824	-87,640	3.7	18.3
Africa	11,602	14,770	-3,168	1.6	2.4

Source : JETRO

4.3 Nature of Japanese Foreign Direct Investment in CEECs

4.3.1 The Location of Japanese Investment

The nature of Japanese FDI in European transitional economies has been disregarded for a long time. However, the influx of Japanese FDI to the new markets has been rising at a very gradual pace. One major explanation is that Japanese investors try to adapt to emerging competition as a result of increasing regionalism in the EU and hence reorganise their market strategy with plant diversification and product specialisation. The expansion of the EU's boundaries, which stimulates more supply and demand effects in the Single European Market (SEM), requires Japanese investors to reshape the spatial organisation of their profit-driven industrial activities.

Table 4-2 indicates that the FDI inflow stock of Japanese firms in the world reached US$812.1 billion in 2004, twice as much as US$379.1 billion in 1995. It is worth noting that the size and share of the stock of the Japanese FDI differ from region to region. When looking at Japanese FDI in Asia, the share of Japanese FDI continued

to drop significantly from 1998 to 2001. A probable cause of this phenomenon relates to the Asian monetary crisis in 1997 as well as slow-down in the world economy and the SARS problem in the early 2000s. When analysing Japanese FDI in North America, it appears evident that the amount of FDI inflow stock of Japanese firms at the end of 2004 doubled compared to that in 1992 but the share in North America continued to drop over the period from 1989-2004.

On the contrary, Europe's share of Japanese FDI stock has shown a phenomenal expansion. At the end of 2004, its share represents about 27.8 percent of all Japanese worldwide FDI. There has been a steady increase in Europe's share of the Japanese FDI inflow stock, especially, since the beginning of the new century. The cumulative Japanese FDI of US$225.5 billion in Europe at the end of 2004 tripled compared with that of US$80.4 billion at the end of 1995.

Table 4-2: The Evolution of the Cumulative FDI Inflow of Japanese Firms in the World over the Period from 1989-2004

Value (US$ million)	1989	1992	1995	1998	2001	2004
Asia	10,201	35,018	62,534	96,462	117,918	140,387
North America	42,172	120,697	174,946	236,434	282,567	308,128
South America	6,482	18,869	31,042	50,636	72,986	91,345
Western Europe	18,291	58,143	80,405	117,649	181,901	225,487
CEE	0.1	283.1	506.2	884.7	1,555.5	2,632.6
Middle East	79	1,061	1,712	2,669	2,829	2,893
Africa	826	2,798	4,062	5,429	6,278	6,723
Others	5,708	18,513	24,447	30,372	32,696	37,121
World	83,759	255,099	379,148	539,651	697,175	812,084
Share (%)	1989	1992	1995	1998	2001	2004
Asia	12.2	13.7	16.5	17.9	16.9	17.3
North America	50.3	47.3	46.1	43.8	40.5	37.9
South America	7.7	7.4	8.2	9.4	10.5	11.2
Western Europe	21.8	22.8	21.2	21.8	26.1	27.8
CEE	0.0	0.1	0.1	0.2	0.2	0.3
Middle East	0.1	0.4	0.5	0.5	0.4	0.4
Africa	1.0	1.1	1.1	1.0	0.9	0.8
Others	6.8	7.3	6.4	5.6	4.7	4.6
World	100.0	100.0	100.0	100.0	100.0	100.0

Source **:** Own calculation based on Japan's Ministry of Finance. (US$1=107.85 on 24 July, 2008)

Table 4-2 demonstrates that the total amount of Japanese FDI inflows over the period 1989-2004 by region and sector (manufacturing or non-manufacturing) in value and share. As regards the scale of Japanese FDI in value, the size invested by Japanese firms in North America is the highest among the regions in both the manufacturing and non-manufacturing industries. The former amounts to US$115,793 million, while the

latter US$191,424 million. The Asian manufacturing sector (US$79,829 million) is relatively larger than that invested in EU15 (US$66,482 million.) The scale invested in CEE is exceedingly small, especially, in the non-manufacturing sector (US$254 million).

Table 4-3: Japanese FDI in CEE and EU15 by Sector, 1989-2004 (Unit: US$ million)

Specification	North America		Asia		EU-15		CEE	
	Value	%	Value	%	Value	%	Value	%
Manufacturing	115,793	37.7	79,829	58.7	66,482	32.6	2,379	90.3
Non-manufacturing	191,424	62.3	56,218	41.3	137,232	67.4	254	9.7
Total	307,217	100	136,047	100	203,713	100	2,633	100

Source : Own calculation based on Japan's Ministry of Finance

Japanese FDI in North America and the EU15 is lower in the manufacturing sector but greater in the non-manufacturing sector when compared to Japanese FDI in Asia and CEE (see Table 4-3). The non-manufacturing sector accounts for more than two-thirds of the overall scale of Japanese FDI in North America and EU15. The sum invested by Japanese investors in the EU15 non-manufacturing sector is slightly greater than that in the North American non-manufacturing sector. From this statistical data, it is possible to conjecture that the general trend of Japanese FDI in North America resembles that in EU15. It is hard to conclude that the pattern of Japanese FDI in CEE replicates the Asian model. It is interesting to note that the CEE manufacturing sector has the highest concentration of Japanese FDI with over 90 percent among the four selected regions.

4.4   Japanese Manufacturing Investment by Region and Industry

Table 4-4 shows the general pattern of Japanese FDI in the manufacturing industry across the four regional blocs. It is quite obvious that Japanese FDI is concentrated in two major industrial sectors: (1) transportation equipment (63.2 percent) and (2) electronics components (12.8 percent). These industries are, to a large extent, also important for Japanese FDI in North America, Asia and EU15. When consideration is given to the scale of Japanese FDI in North America, the chemical industry (14.9 percent) follows the electric/electronics sector (39.2 percent). The degree of concentration of Japanese FDI in the North American electric and electronics sector is the highest among the four regional blocs. As for Japanese manufacturing FDI in Asia, the chemical sector accounts for 14.5 percent, second to electric and electronics (25.3 percent) and transportation (15.2 percent). As for Japanese manufacturing FDI in EU15, both the electric/electronics and transportation sectors account for 23.3 percent and 22.5 percent, respectively.

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Table 4-4: Japanese Manufacturing Investment in North America, Asia, EU15 and CEE by Sector (Unit: percentage in inward FDI stock from 1989 to 2004)

Specification	North America	Asia	EU-15	CEE
Food	6.3	5.3	18.2	0.8
Textile	1.5	5.9	2.8	1.5
Timber and pulp	2.5	1.9	0.7	0.2
Chemical	14.9	14.5	15.2	1.3
Metals and non-metals	6.5	10.3	1.7	2.6
Machinery	7.4	8.4	10.1	8.5
Electric/electronics	39.2	25.3	23.3	12.8
Transportation equipment	10.8	15.2	22.5	63.2
Others	11.0	13.3	5.5	9.0
Total in manufacturing	100.0	100.0	100.0	100.0

Source : Own calculation based on Japan's Ministry of Finance.

Interestingly, a relatively high share of 18.2 percent in the food sector is remarkable as opposed to the low degree of concentration in North America (6.3 percent), Asia (5.3 percent) and CEE (0.8 percent). The textile sector is the least favoured sector for investment by Japanese firms in North America. As a whole, the industrial patterns of Japanese manufacturing FDI do not greatly differ from one regional bloc to another, with the exception of CEE. It is worth commenting that the degree of industrial diversification by Japanese firms in North America, Asia and EU15 is very high, while the CEE induces Japanese investors to invest in the transportation equipment sector.

In short, the data confirms the high degree of concentration of Japanese capital in the transportation equipment sector and the electronics component sector in the four regional blocs, it is reasonable to assume that Japanese manufacturing firms possess strong competitive ownership advantages such as product innovation, production methods, quality control systems, procurement systems, financial resources and managerial expertise in these aforementioned sectors. Japanese firms could achieve above-average returns on investment through exploiting firm-specific competitiveness with various types of location-based advantages. Given these backgrounds of Japanese manufacturing FDI by regional distribution, one has to address the following questions:

1. Are there any similarities and differences in Japanese FDI strategies and sectoral composition among CEECs?
2. Are Japanese firms more concentrated in sub-regional groups within CEE (*e.g.*, the Visegrád-4 group, the South-eastern European group and the Baltic group)?
3. Why have Japanese investors been concentrated in the transportation equipment sector and the electronics components sector in CEE?
4. What are the motives of Japanese manufacturing FDI in CEE?

Table 4-5: Japanese FDI in the Eastern Periphery and the Southern Periphery in the EU (Unit: US$ million)

Specification	Czech Republic		Hungary		Poland		Slovakia		Romania		Spain		Portugal	
	Value	%	Value	%	Value	%	Value	%	Value	%	Value	%	Value	%
Food	0.0	0.0	11.2	1.0	8.7	1.5	0.0	0.0	0.0	0.0	0.9	0.02	3.0	0.8
Textile	35.5	4.7	0.0	0.0	0.6	0.1	0.0	0.0	0.0	0.0	43.7	1.1	74.2	20.1
Timber and pulp	5.7	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.8	0.2	0.0	0.0
Chemical	2.6	0.3	28.0	2.4	0.0	0.0	0.0	0.0	0.0	0.0	297.3	7.3	3.8	1.0
Metals and non-metals	27.4	3.6	11.8	1.0	12.0	2.0	10.5	56.5	0.0	0.0	333.7	8.2	63.8	17.3
Machinery	79.2	10.4	1.0	0.1	84.5	14.2	0.0	0.0	36.2	59.8	238.4	5.8	0.0	0.0
Electric/electronics	134.9	17.7	139.2	11.8	26.7	4.5	0.0	0.0	2.8	4.6	413.8	10.1	8.6	2.3
Transportation equipmen	389.7	51.2	882.8	75.0	230.1	38.6	1.2	6.5	0.0	0.0	684.5	16.7	29.4	8.0
Others	29.3	3.8	13.2	1.1	171.4	28.8	0.0	0.0	0.0	0.0	204.2	5.0	40.4	10.9
Total in manufacturing sector (A)	704.3	92.5	1,087.2	92.4	534.0	89.7	11.8	63.4	39.0	64.4	2,226.5	54.4	223.2	60.4
Agriculture	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	6.2	0.2	0.0	0.0
Fishing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.7	0.5
Mining	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.0	0.0	0.0
Construction	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.7	4.4	5.3	0.1	0.5	0.1
Trade	57.4	7.5	30.7	2.6	37.1	6.2	5.2	28.0	2.6	4.3	848.1	20.7	36.9	10.0
Financial intermediation	0.0	0.0	24.0	2.0	0.0	0.0	1.6	8.6	0.0	0.0	66.6	1.6	5.3	1.4
Service	0.0	0.0	28.8	2.4	9.1	1.5	0.0	0.0	0.0	0.0	447.9	10.9	21.5	5.8
Transport	0.0	0.0	0.3	0.0	15.2	2.6	0.0	0.0	16.2	26.8	13.4	0.3	0.0	0.0
Real estate	0.0	0.0	5.6	0.5	0.0	0.0	0.0	0.0	0.0	0.0	194.4	4.8	51.3	13.9
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total in non-manufacturing sector (B)	57.4	7.5	89.4	7.6	61.5	10.3	6.9	37.1	21.5	35.6	1,582.8	38.7	117.2	31.7
Branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	281.5	6.9	29.0	7.9
Total (A+B)	761.8	100	1,176.6	100	595.5	100	18.6	100	60.5	100	4,090.8	100	369.4	100

Source : Own calculation based on the Ministry of Finance, Japan. (US$1=107.85 on the 24th of July in 2008)

4.5 Japanese Foreign Direct Investment in the Eastern EU Periphery and the Southern EU Periphery

The objective of this section is to enrich our understanding of the general patterns of Japanese capital invested in CEE with greater details. I contrast FDI in CEE with that in the southern EU periphery (*e.g.*, Spain and Portugal). Table 4-5 shows the scale of Japanese FDI in the eastern EU periphery and the southern EU periphery in value and share. The descriptive statistics articulates that the market penetration of Japanese FDI differs widely between the eastern EU periphery group and the southern EU periphery group. The Japanese FDI stock in the Czech Republic was the second largest among the European transition economies, as the Ministry of Finance of Japanese reported that it amounted to US$761.8 million as compared to US$1,176.6 million invested in Hungary (see Table 4-5). Overall, roughly 90 percent of the total amount of Japanese FDI inflow into the Czech Republic, Hungary and Poland has been directed at manufacturing sectors, while non-manufacturing sectors have received little more than 5 percent. As for Slovakia and Romania, the manufacturing share of Japanese FDI is substantially larger than that in the southern EU periphery.

Among the manufacturing sectors, the transportation equipment sector accounted for the large share of Japanese FDI (51.2 percent in the Czech Republic, 75 percent in Hungary and 38.6 percent in Poland) yet accounted for less than 20 percent in Spain and Portugal. As for the industrial composition of Japanese manufacturing FDI in Portugal, focus was placed on the textile industry (20.1 percent) and the metals and non-metals industry (17.3 percent).

In contrast, the share of Japanese non-manufacturing FDI entering the southern EU periphery countries is much higher than that in the European transition economies. The trade-related industry represents over 20 percent of the total value of Japanese FDI in Spain, while the real estate sector accounts for roughly 14 percent in Portugal. Among the non-manufacturing sectors in CEE, Japanese firms have engaged actively in wholesale and retail trade activities. This is indicative of the important role of Japanese general trading companies (GTCs). Many GTCs set up their representative offices or subsidiaries in the eastern periphery. GTCs tend to enter the CEE market ahead of Japanese firms with manufacturing operations to serve local demand and search actively for business opportunities. They are also likely to possess equity shares of some Japanese manufacturing firms entering the region. According to the Toyo Keizai's *Kaigai Shinshutsu Kigyō Sōran* (2007), there are a number of JVs with GTCs in the region (see Table 4-5). For example, Itochu participates in the equity of Magyar Suzuki; Sojitz involves the equity participation of NSK Iskra S.A. in Poland (5 percent); Toyota Tsusho possesses 20 percent of the total equity share of Toyoda Gosei Safety Systems Czech; Mitsubishi Corporation controls 20 percent of the equity share of KYB in the Czech Republic.

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Although the high degree of concentration of Japanese FDI in the CEE manufacturing sector obscures the presence of Japanese FDI in the financial sector, some important cases should not be overlooked. Since 2001, the Bank of Tokyo-Mitsubishi-UFJ (BTMUFJ) in Warsaw has been serving Polish affiliates of Japanese companies. BTMUFJ also opened a branch office in Prague in April 2006 in response to the presence of a growing number of Japanese manufacturing multinationals. Mitsui-Sumitomo Bank followed BTMUFJ and opened the first Central European representative office in Prague in 2008. The Sumitomo-Mitsui Banking Corporation (SMBC) also entered into a cooperation agreement with the CzechInvest in October 2007 and the Polish Information and Foreign Investment Agency (PAIiIZ) in November 2007. It is hoped that this agreement can facilitate an exchange of information on the foreign investment of Japanese firms in Poland. Although Mizuho Corporate Bank has signed a cooperation agreement with PAIiIZ at the end of 2006 ahead of SMBC, no service offices have been opened in the eastern periphery yet. However, Mizuho Corporate Banking had a partnership contract with a leading Austrian bank, Raiffeisen Zentralbank Oesterreich AG, which has established itself in the CEE financial markets. Suzuki Financial Services in Hungary was jointly set up in 2003 by Merkantil Bank (a member of the OTP Group), Magyar Suzuki and a Japanese general trading company, Itochu Corporation, to provide loans and other financial services for Suzuki dealers.

The internationalisation of many Japanese financial firms has not expanded noticeably in the European transition economies yet, despite the presence of a growing number of Japanese manufacturing firms. There are two main reasons for the weak presence of Japanese financial institutions in the region. The first is a direct consequence of the bursting of the bubble economy. Japanese banks had to deal with huge non-performing loans during the 1990s. Another lies in the fact that many Central European affiliates of Japanese firms are inclined to rely on either German branches of Japanese banks or financial resources of their own parent companies for financing because the governments in the eastern periphery have not imposed any strict legal restrictions on the source of financing and loans.[4]

As regards the future trend of Japanese non-manufacturing firms in CEE, the number of Japanese firms in the service sector will continue to rise to serve emerging local demand. This is a result of an expectation of continually increasing income levels in the European emerging economies, in particular, the CEEC-10, due to EU membership and the gradual convergence of their institutional infrastructure and economic development towards the Western European standards.

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[4] Interview by the author with a Japanese senior manager in a German branch of a Japanese bank in April 2005 in Düsseldorf, Germany.

4.6 The Impact of the Eastward European Integration Process on Japanese Foreign Direct Investment

This section scrutinises how the enlargement process has changed the industrial and geographical configurations of Japanese FDI in CEE over time. I will compare the share of Japanese capital over the first time period (1989-1997) with that over the second one (1998-2004). There are three reasons for this cut-off point. First, the EU entry negotiation talks between EU and EU member candidate countries became a part of the official enlargement plan after 1998. The negotiation talks for accession started with a first wave of CEE aspirants (the Czech Republic, Hungary, Poland and Slovenia) in 1998 and a second wave of CEE aspirants (Bulgaria, Latvia, Lithuania, Romania and Slovakia) in 2000. Second, the year 1998 proved to be a watershed with the EU starting to provide the former Soviet satellite countries with structural assistance, after initiatives for institutional reforms in those nations shifted from the IMF to the EU. Third, FDI inflows in many transforming economies of the CEECs have been increasing since 1998 due to progress in institutional reforms, financial liberalisation, and mass privatisation. CEECs will be compared with the southern EU periphery countries such as Spain and Portugal.

Table 4-6 shows that the general pattern of Japanese FDI also diverges over time. One can observe that the share of the manufacturing sector declined in the southern EU periphery over these two periods. The Spanish share of Japanese capital invested in the transportation equipment sector has dropped by 8 percentage points from 18.9 percent to 10.9 percent. In Portugal, two manufacturing sectors such as metals/non-metals and transportation equipment have increased their share by 17.5 percent and 13.7 percent, respectively, across the two periods, while the overall share of manufacturing sector has declined by about 10 percentage points from 62.6 percent to 51.7 percent. The increase in the share of the transportation equipment sector and the decrease in the share of the textile sector suggest that Japanese FDI in Portugal has been moving away from labour-intensive oriented towards middle technology-intensive oriented.

On the other hand, the percentage of investment in non-manufacturing has increased dramatically both in Spain and in Portugal. In particular, the share of the trade sector has risen from 9.3 percent to 52.3 percent in Spain. The real estate sector in Portugal has experienced a phenomenal achievement with a 40 percentage point increase across the two time periods. One intriguing phenomenon to emerge is that the industrial focus of Japanese FDI in Portugal has shifted towards the non-manufacturing sector.

Overall, the degree of industrial concentration was reinforced in CEECs except for in Slovakia. Slovakia is somewhat an outlier since the rate of the non-manufacturing sector increased from 0 percent to 79.2 percent. The share of Japanese FDI in the transportation equipment sector increased sharply from 0 percent to 57.4 percent in the

Czech Republic and from 0 percent to 47 percent in Poland over the two periods. On the contrary, a 6.5 percentage point decrease was recorded in the transportation equipment industry across these two periods in Hungary, but the share remains over 70 percent. Romania has experienced a dramatic increase in foreign capital investment by Japanese firms in the general machinery industry across the two periods. A high concentration of Japanese FDI in the machinery sector occurred in Poland during the period from 1991 to 1997. Nevertheless, a great transformation of Japanese FDI in Poland from the machinery to the transportation equipment sector occurred over the two periods. This major shift could be explained by the localisation of production in southern Poland by Western automobile producers such as Fiat and GM-Opel and by Toyota and its vertical *keiretsu* members. The occurrence of a similar phenomenon in the Czech Republic can also be confirmed.

In sum, there are some unique variations among the geographical and sectoral composition of Japanese FDI between the southern and eastern EU periphery groups and within each group. The share of Japanese manufacturing FDI over the period 1998-2004 was reinforced in the eastern EU periphery relative to that during the period from 1989 to 1997, while the reverse structural change in Japanese FDI distribution is observed in Spain and Portugal. Japanese FDI in transport-related equipment comprised roughly 50 percent, or more than 50 percent, of the total amount of Japanese FDI in the Czech Republic, Hungary and Poland over the period 1998-2004.

Table 4-6: Japanese Investments in CEE by Sector: Before 1997 and After 1998 (Unit: percent)

Specification	Czech Republic		Hungary		Poland		Slovakia		Romania		Spain		Portugal	
	89–97	98–04	89–97	98–04	89–97	98–04	89–97	98–04	89–97	98–04	89–97	98–04	89–97	98–04
Food	0.0	0.0	0.0	1.7	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.1	1.0	0.0
Textile	21.7	2.6	0.0	0.0	0.5	0.0	0.0	0.0	0.0	0.0	1.5	0.0	24.8	1.5
Timber and pulp	0.0	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0
Chemical	3.1	0.0	5.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	8.1	5.0	1.3	0.0
Metals and non-metals	0.0	4.0	0.9	1.1	4.4	1.5	87.8	20.8	0.0	0.0	3.0	22.3	13.7	31.2
Machinery	2.9	11.3	0.0	0.2	62.2	3.8	0.0	0.0	0.0	77.0	7.9	0.1	0.0	0.0
Electric/electronics	60.7	12.5	2.7	19.4	5.9	4.2	0.0	0.0	20.6	0.0	13.0	2.1	2.9	0.0
Transportation equipment	0.0	57.4	78.6	72.1	0.0	47.0	12.2	0.0	0.0	0.0	18.9	10.9	5.2	18.9
Others	4.1	3.8	1.0	1.2	0.0	35.0	0.0	0.0	0.0	0.0	6.5	0.7	13.7	0.0
Total in manufacturing sector (A)	92.5	92.5	88.2	95.9	73.0	93.3	100	20.8	20.6	77.0	59.2	41.2	62.6	51.7
Agriculture	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Fishing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.2
Mining	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Construction	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.7	0.2	0.0	0.2	0.0
Trade	7.5	7.5	1.2	3.8	11.2	5.2	0.0	60.5	19.2	0.0	9.3	52.3	12.5	0.0
Financial intermediation	0.0	0.0	4.5	0.0	0.0	0.0	0.0	18.7	0.0	0.0	2.0	0.5	1.8	0.0
Service	0.0	0.0	5.4	0.0	1.4	1.6	0.0	0.0	0.0	0.0	13.0	5.2	7.3	0.0
Transport	0.0	0.0	0.1	0.0	14.3	0.0	0.0	0.0	60.0	17.2	0.3	0.5	0.0	0.0
Real estate	0.0	0.0	0.6	0.3	0.0	0.0	0.0	0.0	0.0	0.0	6.4	0.3	5.7	46.1
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total in non-manufacturing sector (B)	7.5	7.5	11.8	4.1	27.0	6.7	0.0	79.2	79.2	23.0	31.4	58.8	27.5	48.3
Branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.4	0.0	9.8	0.0
Total (A+B)	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Source : Own calculation based on the Ministry of Finance, Japan.

Table 4-7: The Evolution of Japanese Manufacturing Investments in the Enlarged Europe as of 2006

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Austria	6	6	7	7	7	7	7	7	7	7	8	8	8	8	8	10	10
Belgium	25	27	30	31	32	33	34	35	35	38	38	38	38	38	39	40	40
Denmark	2	2	2	2	2	3	3	3	3	3	3	5	5	7	8	10	10
Finland	0	0	1	1	2	2	3	4	4	4	4	5	6	7	7	7	8
France	57	63	65	69	72	79	89	91	97	99	106	117	122	124	128	132	136
Germany	53	63	70	74	76	79	81	82	86	91	92	96	103	107	111	114	129
Greece	2	2	2	2	2	2	2	2	2	2	2	2	3	3	3	3	3
Ireland	4	4	5	6	6	9	9	10	11	11	11	11	13	13	13	15	15
Italy	27	30	30	31	32	35	39	43	44	46	47	50	51	52	56	58	59
Luxembourg	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Netherlands	25	30	32	34	36	38	42	45	48	50	51	51	51	51	51	53	53
Portugal	7	7	9	10	10	12	13	13	15	15	15	17	17	17	17	17	17
Spain	32	36	37	38	39	41	42	43	44	46	46	49	51	52	54	55	59
Sweden	5	6	7	10	10	10	10	10	10	11	12	13	14	15	16	17	18
UK	92	104	113	120	127	132	143	155	166	177	191	193	195	200	203	209	210
Total in EU15	337	381	411	436	454	483	518	544	573	601	627	656	678	695	715	741	768
Czech Republic	1	2	6	7	7	8	11	14	14	16	20	32	44	51	61	64	68
Hungary	0	2	2	4	6	8	9	13	16	21	29	32	36	39	43	45	48
Poland	0	0	0	2	2	5	6	9	11	14	14	18	24	32	38	44	58
Slovakia	0	0	0	0	1	1	3	4	4	4	6	8	8	8	9	11	12
Lithuania	0	0	0	0	0	0	0	0	0	0	0	1	1	1	2	2	2
Slovenia	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1
Bulgaria	0	0	0	0	0	0	0	1	1	1	1	1	1	1	1	1	2
Romania	0	0	0	0	0	0	0	0	1	1	3	5	7	9	9	11	13
Serbia	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1
Montenegro	0	0	0	0	0	0	0	0	0	0	0	0	1	1	1	1	1
Total in CEE	1	4	8	13	16	22	29	41	47	57	73	97	122	142	164	179	206
Total	338	385	419	449	470	505	547	585	620	658	700	753	800	837	879	920	974

Source **:** JETRO (2007)

4.7 Cross-Country Difference in Sectors of Investment

Table 4-8: The Sectoral Distribution of Japanese Manufacturing Firms in CEECs

Specification	A	B	C	D	E	F	G	H	I	J	K	L
Automobile components	123	86	35	19	22	3	1	0	0	5	0	1
Electric components	62	36	11	8	7	7	0	1	0	2	0	0
General machinery	88	10	3	1	6	0	0	0	0	0	0	0
Chemical and petroleum	84	5	0	3	2	0	0	0	0	0	0	0
Others	61	12	4	2	3	0	1	0	1	1	0	0
Electronics products	49	15	5	3	4	2	0	0	0	1	0	0
Food processing	47	5	0	2	1	0	0	0	0	1	1	0
Plastic	45	4	2	1	0	0	0	0	0	1	0	0
Precise machinery	39	3	1	1	1	0	0	0	0	0	0	0
Metal	35	7	2	2	1	0	0	0	0	2	0	0
Pharmaceutical	30	0	0	0	0	0	0	0	0	0	0	0
Rubber	14	7	0	2	5	0	0	0	0	0	0	0
Automobiles	20	2	1	1	0	0	0	0	0	0	0	0
Ceramics	19	4	1	1	2	0	0	0	0	0	0	0
Footwear	13	2	1	0	0	0	0	0	1	0	0	0
Non-metal	7	3	0	2	1	0	0	0	0	0	0	0
Textile	8	0	0	0	0	0	0	0	0	0	0	0
Pulp	7	0	0	0	0	0	0	0	0	0	0	0
Medical appratus	7	0	0	0	0	0	0	0	0	0	0	0
Timber	5	0	0	0	0	0	0	0	0	0	0	0
Steel	4	1	1	0	0	0	0	0	0	0	0	0
Printing and publishing	3	2	1	0	1	0	0	0	0	0	0	0
Furniture	3	2	0	0	2	0	0	0	0	0	0	0
Total	773	206	68	48	58	12	2	1	2	13	1	1

Source **:** JETRO (2007)

Note **:** A: EU15, B: Central and Eastern Europe, C: Czech Republic, D: Hungary, E: Poland, F: Slovakia, G: Lithuania, H: Slovenia, I: Bulgaria, J: Romania, K: Serbia, L: Montenegro.

Czech Republic

Since the start of the 21st century, Japanese multinationals have been relatively active in the Czech Republic compared to other foreign multinationals. The Czech Republic received over one-fourth of all Japanese direct investment in CEE, about 10 times as much as Slovakia and Romania combined. Moreover, as seen in Table 4-7, the number of Japanese manufacturing MNEs totaled to 68 at the end of 2006, of which 35 firms are engaged in the automobile components sector. The first Japanese FDI in the Czech Republic can be traced back to Asahi Glass, which invested to produce sheet glasses in 1991. A Kyocera's US-subsidiary, AVX, also entered the Czech market in 1992 to supply capacitors to Tesla Lanskroun (Linden, 1998: 23). In 1993, Japan Metals & Chemicals Co., Ltd. also invested and set up Nikom a.s. with equity participation by a Japanese *sogo shosha*, Nissho Iwai, to engage in the production of ferro-vanadium and

corundum stones. In the late 1990s, a series of investment projects undertaken by Matsushita was remarkable. Despite the presence of this major Japanese consumer electronics company, the stock of Japanese FDI in the country at the end of 2002 accounted for only 0.8 percent (Wada, 2005: 53). However, the launch by Toyota and PSA (TPCA) of a new just-in-time production facility at Kolín (60 kilometers east of Prague) in November 2001 became a major turnaround for the evolution of Japanese FDI in the Czech Republic. Since that official announcement, many automobile-related companies entered and set up their production factories near the Japanese-French consortium. In 2006, a series of large LCD-related investments by Japanese firms took place in response to the emerging demand for high quality flat-panel TVs in the EU market. Hitachi invested in the Triangle Strategic Industrial Zone at the Usti region with an estimated employee size of about 1,500 persons.

Table 4-9: Major Japanese Manufacturing Investors in CEECs

Company name	Location	Employment	Est. Year
Automobile industry			
Suzuki	Esztergom, Hungary	4,500	1990
Isuzu	Tychy, Poland	1,030	1997
Bridgestone	Poznań, Poland	300	1998
Toyota/Peugeot	Kolín, Czech Republic	3,000	2001
Toyota	Wałbrzych, Poland	1,500	2002
Toyota	Jekz-Laskowice, Poland	670	2002
Bridgestone	Tatabánya, Hungary	N/A	2005
Calsonic Kansei	Ploiesti, Romania	1,000	2006
Consumer electronics industry			
Sony	Árpád Fejedelem Utja, Hungary	700	1994
Matsushita Battery	Gniezno, Poland	500	1995
Sony	Bratislava, Slovakia	3,000	1996
Panasonic AVC Networks	Plzen, Czech Republic	1,440	1996
Matsushita	Trstená, Slovakia	1,007	1997
Matsushita Electric Works	Prumyslova, Czech Republic	900	1998
Sanyo Electronics	Dorog, Hungary	1,800	1999
Panasonic Mobile	Pardubice, Czech Republic	1,182	2001
Panasonic	Krompachy, Slovakia	1,300	2002
Hitachi	Usti Region, Czech Republic	1,500	2006
Toshiba	Kobierzyce, Poland	1,000	2006
Sharp	Lysomice, Poland	800	2006
Funai Electric	Nova Sól, Poland	1,000	2006

Source : Own illustration based on Pavlinek (2002a, 2005), Deroitte (2006), Linden (1998) and company reports in various years.

Three major consumer electronics firms, Hitachi, Matsushita and Toshiba, also teamed up and together set up IPS Alpha Technology Europe to pool the supply of LCD modules near the Hitachi factory. Investment strategies by most Japanese manufacturers operating in the Czech Republic are aimed at reorganising their global and regional production networks.

Hungary

In a review of the behaviour of Japanese investors in Hungary, Kyowa Hakko already invested before the fall of state socialism in 1987. Large Japanese greenfield investment projects were not realised in Hungary until Suzuki Motors set up a car-manufacturing facility in Esztergom in 1991. The underlying motive of Suzuki's sizable entry in Hungary is explained by various aspects such as the country's good geographical location, more advanced financial arrangements, the lifting of Communist rule (Hutchings, 1999: 144) and peaceful labour relations (Toyama, 2005: 155). Only US$10 million worth of investment had been outside Hungary by 1992, whereas US$342 million were directed at the Magyar Suzuki project (Bakos, 1996: 244). In Hungary Japanese FDI reached a peak in both 1991 and 2000, accounting for US$218 million (23.5 billion yen) and US$239.8 million (25.8 billion yen), respectively. Manufacturing investment by Suzuki Motors has generated a band wagon effect, with its Japanese car-parts subcontractors such as EXEDY, Sumitomo Electric Industries and Diamond Electric following suit, after Suzuki's success in Hungary. Berényi (1996: 240) argues that Suzuki's production activity in Hungary represents "something of a test case for the future of Japanese manufacturing investment in Central Europe". The advancement of economic and structural reforms in Hungary encouraged Japanese manufacturing firms to choose the country as a favourable production site compared to other European transition economies.

The number of Japanese manufacturing projects in Hungary totaled to 48 at the end of 2006, next to the Czech Republic (68) and Poland (58), although Hungary was seen as the most attractive FDI destination among CEECs until 2000 (see Table 4-7). The probable cause is the intensification of FDI tournaments for large-scale FDI projects among CEE nation states. It has been said that the Czech Republic and Poland have become more successful in promoting the relative attractiveness of their business and institutional conditions through the provision of financial and fiscal incentives as well as the hospitable attitude of local population towards foreign investors in recent years (*e.g.*, Bandelj, 2008; Mallya *et al.*, 2004; Werner, 2004). As regards a unique feature of Japanese manufacturing FDI in Hungary, many Japanese multinationals invested not through their parent companies but through their European subsidiaries, suggesting that the production units seem to be transferred from Western Europe to Central and Eastern Europe (Wada, 2005: 57). Alpine and Clarion invested in Hungary with the purpose of circumventing the EU's antidumping initiative with regard to audio

visual equipment before 2000 (Wada, 2005: 58). The automobile components sector is a major sector that attracts Japanese FDI in Hungary, followed by the electrical components sector.

In sharp contrast to Japanese multinationals with manufacturing operations, only two companies engage in R&D-specific investment activity. Furukawa Electric Institute of Technology has been at work to research composite (silicon) insulators since 1991. Tateyama Laboratory Hungary has engaged in the development of software products since 1997.

Poland

Poland has been a successful destination for Western European FDI transactions since the early 1990s, but has failed to attract Japanese investors. At the end of 2000, the amount of cumulative Japanese FDI in Poland was one-seventeenth of German FDI, one-eleventh of French FDI, and one-nineth of Dutch FDI (Marinov *et al*., 2003: 160). When considering the sequence and development of Japanese multinationals' entry in Poland chronologically, the first major FDI project was Panasonic Battery Poland, which was established in cooperation with Philips in 1993 in Gniezno. The second major investor was Sumitomo Electric of Japan, which has engaged in the production of wiring harness since 1995. Besides these two major investments, Poland continued to fail - when compared to the Czech Republic and Hungary - in attracting Japanese investors until the mid-1990s. Marinov *et al*. (2003: 167) note two unsuccessful cases of Japanese FDI during the 1990s: (1) Daihatsu's failure in investing in FSO and (2) Asahi Glass's failure in acquiring Sandomierz factory.

Isuzu's investment in Tychy in the southern Poland in 1997 became the start of Japanese FDI inflows in the Polish automobile industry. Since then, major Japanese multinational corporations such as Toyota, Bridgestone, NSK and Calsonic Kansei followed Isuzu. In recent years, the new wave of Japanese investments specialising in the production of LCD TVs has been remarkable. Sharp has been in operation since 2007, creating a bandwagon effect. Sumitomo Chemical, Orion Electric, Sohbi Craft and Tensho Electric followed Sharp and set up their production plants in proximity to the Kujawsko-Pomorskie voivodship. Another major LCD-related investor to enter Poland was Toshiba. Toshiba's investment in the Dolnoslaskie voivodship over the next five years is estimated to be 6 billion yen (Toshiba Press Release, September 13, 2006). Toshiba also made a capital participation in LG Philips LCD in the same voivodship by investing 5.5 billion yen for a nearly 20 percent stake (Japan Times Online, October 11, 2006). Toshiba's participation in this strategic alliance with LG and Philips is aimed at ensuring a stable pool of LCD panels at competitive prices. Funai Electric also set up an assembly line in the form of OEM in the Lubuskie voivodship. Their central motivation for entering Poland was not to target the wealth of the Polish market but to facilitate access to the core EU market. On the contrary, Ajinomoto and YKK were attracted to

the market of 38 million people.

As of March 2008, the inbound Japanese FDI stock in Poland amounts to US$1.29 billion. The presence of large-scale investment projects notwithstanding, the size of Japanese FDI seems relatively limited compared to that of Western counterparts. According to the Polish Information and Foreign Investment Agency (PAIiIZ), no Japanese multinationals are ranked within the top 20 companies on the list of accumulated value of FDI in Poland at the end of 2003. Toyota is ranked 78th, followed by Bridgestone Corporation (93rd), NSK Europe Ltd. (149th) and Matsushita Electric Europe Ltd. (185th). With a large pool of cheap but skilled labour and the availability of land in contrast to the Czech Republic and Hungary in particular, Poland may have the potential to become one of the leading FDI destinations among the emerging European economies in the foreseeable future.

Slovakia

As of 2006, only 12 manufacturing operations took place in Slovakia. The Slovak automobile and consumer electronics sectors encouraged Japanese multinationals to establish their production plants there. In Slovakia, the speed of investments by Japanese multinationals has lagged behind investments by Western multinationals who have actively participated in the privatisation process. Exploring the evolution of Japanese FDI in Slovakia chronologically, the initial investment by Japanese firms can be traced back to 1994 when Yazaki Corporation formed a joint venture with a local TV manufacturing company, Debnar, to produce wiring harnesses for Ford. Yazaki Corporation has strengthened its market position through plant expansion and customer diversification in the enlarged Europe. Sumitomo Electric also followed Yazaki Corporation to produce wiring harnesses by means of entering the local market in the form of shared ownership with a British firm, Lukas. Two leading consumer electronics firms have also been active despite the fact that institutional uncertainties were high due to the Mečiar nationalist government, which was characterised as ultra-nationalistic. The first major consumer electronics maker to arrive in Slovakia was Sony in 1996. Sony transferred some of its Western production lines from Spain to Slovakia. The factory in Spain specialises in the manufacturing of color TVs, while the factory in Slovakia specialises in the manufacture of LCD TVs. Panasonic also established two plants in Slovakia.

Romania

As of 2004, foreign capital from Japan to Romania was US$60.5 million (6.53 billion yen) according to the Ministry of Finance of Japan. Compared to the three major Visegrád-4 countries, the stock of Japanese FDI in Romania is marginal. The total number of Japanese manufacturing operations was only 13, indicating that Romania has lagged behind Visegrád-4 countries in terms of the upgrading of its competitive

advantages. The first Japanese investor to arrive in Romania was JTEKT in 1998. The company was influenced in its decision by the intensification of competition in the worldwide bearing industry. To remain competitive in cost dimensions, JTEKT had to seek a location where the company would be able to exploit a pool of cheap labour within the enlarged Europe. As was the case with JTEKT, Sumitomo Electric, Yazaki Corporation and YKK were also characterised by efficiency-seeking FDI, indicating that labour-intensive products such as wiring harness and fasteners require the abundance of inexpensive human capital with less education. In 2006, a new factory to produce air conditioners and heat exchange products was set up by a Nissan's tier 1 supplier, Calsonic Kansei. To remain cost competitive, Calsonic Kansei liquidated its factory in Poland in 2008 and transferred its production unit to the Romanian subsidiary in Ploiesti.

Baltic countries

The MOF data does not report any FDI transactions involving Japanese firms. According to JETRO (2007), two Japanese firms have been in operation in Lithuania. One is Yazaki Corporation that established a production facility for wiring harnesses in 2001. Another case is Koei that has engaged in not only the manufacture of entertainment software but also in R&D operations since 2004. Especially, the absence of Japanese manufacturing investors in Estonia seems to cast some doubts on the causal mechanism between Japanese FDI and economic development and stability.

Balkan countries

The former Yugoslav republics have been rather undesired destinations for Japanese production investors. Three manufacturing investments took place following the turn of the century. One common feature is that these investment projects were undertaken in the form of merger and acquisition. The earliest investment undertaken in the Balkan region is Daido Metal Kotor established in 2002. Its strategic intent was to have access to the cheap labour force. In 2006 Sumida Corporation entered the Slovene electrical industry by purchasing a German firm, Vogt electronic GmbH. At the same year, JT also entered the Serbian market through participating in the privatisation process. According to Serbia Investment and Export Promotion Agency (http://www.siepa.sr.gov), the size of investment undertaken by JT amounted to 100 million Euros and ranks as the 23rd largest in Serbia. However, due to persisting institutional uncertainties and pessimistic impression of the region created by two ethnic conflicts the confidence of Japanese investors must still be gained.

4.8   Obstacles to Japanese Foreign Direct Investment in CEE during the 1990s

In this section, I try to review the factors of the passive Japanese attitudes toward CEE

in the post-socialist period during the 1990s. Contrasting with Western counterparts, Japanese multinationals were minor investors in the early phase of the transition. There are a few relevant factors. First, in the past Japan put much more weight on political and security considerations than on economic considerations in the region, in line with US foreign policy abroad. Even in the aftermath of the end of political hostility between the two superpowers in the Cold War, Japanese multinationals had shown their reluctance to invest in the European transition economies because the negative historical image of the region persisted in the minds of Japanese people. Moreover, the outbreak of two cruel ethnic wars in Bosnia-Herzegovina (1992-1995) and Kosovo (1999), within the CEE territory, discouraged Japanese firms from investing in the region. Rather, Japan has provided official development aid (ODA) to help promote stable democratic governance, upgrade a wide range of human resources and induce technological catch-ups and institution-building. According to the Ministry of Foreign Affairs (MOFA) database, the Japanese government provided financial assistance of US$809.9 million, US$587.8 million, US$0.9 million and US$666.9 million to the Visegrád-4 countries, the SEE countries, the Baltic countries and the Balkan countries, respectively, as of 2005 (see Table 4-10). Among the new EU-CEE countries, Poland received the largest amount of ODAs, while the Czech Republic was a minor recipient country. Of great relevance is that the Czech Republic, Hungary and Poland received less ODA due to their high level of economic development after 2000, while it was the opposite around for the rest.

Second, one would argue that the presence of cultural and geographic distance might have prevented Japanese investors from actively seeking potential business opportunities in the region (Bakos, 1992: 165; Bearmish and Delios, 1997: 11).

Third, the meagre presence of Japanese investors in macroeconomic dimensions could be attributable to the weak purchasing power and volatile economic and institutional conditions of the European transition economies. Beamish and Delios (1997: 7) posited that "prices are much less stable in the high inflation environment found in CEE countries in the early and mid-1990s".

Fourth, the wait-and-see attitude of Japanese investors in the European emerging economies seems to be related to the economic situation at home (Cieślik and Ryan, 2002). The Japanese economy plummeted sharply after the burst of the bubble economy in the very early 1990s, accompanied by an unanticipated drop of both land and stock prices. The prolonged economic stagnation caused Japanese firms to face credit crunch problems and led to the adoption of massive restructuring by cutting down the inefficient size of workforces.

Fifth, Japanese firms' slow and long decision-making procedures may have kept Japanese investors from active involvement or caused them to miss business opportunities in CEE because, at the same time, Western European firms and US firms were exploiting opportunities for the privatisation of state-owned enterprises, owing to their quick decisions and rich managerial experience of the region (Bakos, 1992). In

addition to the slow decision-making process, Berényi (1996) argues that Japanese investors also showed their pessimistic and unfavourable view of participation in the process of privatisation of state-owned firms. This may lie in the fact that Japanese firms are likely to prefer greenfield investments and training local employees without experience.

Table 4-10: Japanese Official Development Aid to CEECs (Unit: US$ million)

Year	CZ	HUN	POL	SLK	ROM	BUL	BALT (a)	BALK (b)
1990	–	2.0	149.9	–	0.3	0.6	–	0.1
1991	–	2.8	3.2	–	0.8	1.3	–	0.2
1992	–	6.2	83.5	–	1.8	3.5	–	0.4
1993	1.5	10.7	94.9	1.2	4.1	6.2	–	0.4
1994	3.3	7.8	92.9	1.9	6.6	7.7	–	8.9
1995	2.6	11.4	103.2	1.2	8.3	10.1	–	11.3
1996	1.9	17.5	89.2	1.2	6.2	13.0	–	35.2
1997	2.2	24.2	4.8	1.7	5.9	14.3	–	55.1
1998	1.9	20.1	2.5	2.1	9.3	11.3	–	72.2
1999	1.7	-33.6	-2.6	2.5	18.3	30.6	–	74.2
2000	1.8	6.6	-3.4	3.0	19.5	20.7	–	46.5
2001	1.2	7.4	-3.9	2.4	9.7	48.4	–	40.3
2002	1.6	6.9	-3.8	3.6	29.6	36.7	–	23.7
2003	1.8	6.6	-3.6	11.1	70.9	25.2	–	82.7
2004	1.7	4.7	-4.0	22.8	34.2	28.7	–	48.4
2005	0.8	3.7	-5.0	28.7	61.4	42.8	0.9	167.9
Total	23.9	104.8	597.6	83.5	286.8	301.0	0.9	666.9
Total in 90–99	15.0	68.9	621.3	11.8	61.5	98.5	–	258.0
Total in 00–05	7.1	35.9	-23.8	71.7	225.3	202.5	0.9	409.5

Source: Author's illustration based on the Ministry of Foreign Affairs of Japan.
Note: (a) includes data for Estonia, Latvia and Lithuania. (b) includes data for Albania, Bosnia and Herzegovina, Croatia, Serbia, Montenegro, Macedonia and Slovenia.

Lastly, Europe as a whole is essentially deemed - among Japanese businessmen contemplating plant diversification abroad - as the least profitable region of the globe, especially compared to the United States and Asia. This biased mindset is built on the fact that Europe is a heterogeneous, fragmented and idiosyncratic market (Munday, 1990; Belderbos, 1997) and its domestic industries are protected by the supranational EU institutions. In the context of cultural dimensions, language and mentality broadly differ from country to country.

These specific economic circumstances precluded Japanese MNEs from implementing the plant diversification strategy in the European transition economies. Instead, Japanese multinationals sought to enhance their influence in the blooming Chinese markets through taking advantage of low transportation costs, cheap human capital, a degree of cultural affinity and geographic proximity. In sum, Japan's active economic engagement in the European emerging economies could be constrained by the

lack of a stable business climate, immature institutional infrastructure and the persisting domestic economic slump as well as by its focus on the Chinese markets.

4.9   Market Entry Strategies
Table 4-11: Modes of Entry in Manufacturing

Entry Mode	WOSs	JVs	M&As	Ownership in 2007
Country				
Czech Republic (68)	79.4% (54)	17.6% (12)	2.9% (2)	96.1%
Hungary (48)	77.1% (37)	10.4% (5)	12.5% (6)	95.6%
Poland (58)	65.5% (38)	24.1% (14)	10.3% (6)	91.9%*
Slovakia (12)	66.7% (8)	33.3% (4)	0.0% (0)	95.8%
Others (20)	60.0% (12)	5.0% (1)	35.0% (7)	99.6%
Total (206)	72.3% (149)	17.5% (36)	10.2% (21)	93.5%
Timing				
1990-1994 (15)	53.3% (8)	33.3% (5)	13.3% (2)	98.7%
1995-1999 (41)	68.3% (28)	19.5% (8)	12.2% (5)	96.4%*
2000-2006 (150)	75.3% (113)	15.3% (23)	9.3% (14)	95.0%

Source : Own calculation based on Toyo Keizai (2007) and individual company websites.
Note : WOSs indicate wholly owned subsidiaries, JVs inidcate joint ventures and M&As indicate merger and acquisitions. * indicates that the ownership level of one company is not identifiable. The parentheses indicate the number of affiliates.

Table 4-11 shows that roughly 149 (72.3 percent) of 206 Japanese manufacturing MNEs penetrated the CEE markets in the form of wholly owned subsidiaries (WOSs). The underlying rationale for choosing WOS in CEE may be derived from the clear strategic intention of Japanese manufacturing MNEs to maintain financial independence and hierarchical control over production processes, product quality and technological assets. Another is that the establishment of greenfield plants in the form of complete ownership leads Japanese firms to implement effective training programs to develop corporate identity. Hence, Japanese firms can facilitate the smooth transfer of their own production systems to the local production. The recent trend of investment from Japan is dominated by WOSs, while JVs and M&A are losing their significance over time. This overwhelming preference for WOSs may be in part explained by the accumulation of local experience by Japanese manufacturing MNEs.

Shared ownership mode has been the second most popular among entry modes in Japanese manufacturing investment. JVs account for 17.5 percent. Among 36 cases, Japanese firms undertaking partial equity ownership can be divided into three groups. One is to form JVs with Japanese firms, such as *keiretsu* group companies and *sogo shosha*. The second form of shared ownership is to team up with locally-owned firms in CEE, although this form has been rare. For example, Bridgestone set up a joint venture with a Polish company in 1998 in Poznán and bought up the remaining equity shares to

take full control by degrees. Lastly, it is to create new ventures with Western firms which are familiar with local market conditions and have already developed the extensive supply chain across CEECs. As mentioned above, the Toyota-PSA alliance is one of the remarkable examples. During the period 1991-1994, Japanese manufacturers preferred forming joint ventures with Western European firms due to the lack of local market experience. The major cases during this early transition period were SWES Polska (with Lukas), Panasonic Battery Poland (with Philips), Yazaki Czech (with Siemens) and Yazaki Slovakia (with Siemens).

M&A is the third popular form of entry mode, accounting for 10.2 percent of the total. Ajinomoto, Ushio Denki and NSK in Poland, and Meiji Rubber Industrial Products, Hoya Lens and Tsubaki Hoover in Hungary are exemplary firms that undertook brownfield investments. It is said in general that M&A render acquiring firms capable of starting production relatively quicker than WOSs, which require the establishment of production factories from scratch. Particularly notable is that 35 percent of the Japanese manufacturing MNEs undertook M&A in other CEECs other than Visegrád-4.

4.10 Preliminary Findings of Japanese FDI Motivations

This section sheds more light on the motivations of Japanese FDI in the European transition economies. For Japanese firms, CEE provides not only chances to capitalise on cheap factor endowments and geographical proximity to Western Europe but also challenges to compete with Western rivals who have already established themselves to capture a business potential in the CEE market. In reality, the region has functioned as part of the European production hierarchy of leading Western producers in the automobile industry (van Tulder and Ruigrok, 1998) and in the electronics industry (Linden, 1998). It is because Western firms reap profits by enjoying inherent advantages, such as historical ties and regional collective identity developed by the dynamism of European integration, which neutralise institutional uncertainties and economic volatility. Accordingly, Japanese multinationals that possess relatively weaker network ties with the local market and poor managerial experience of economies in transition are bound to incur more expensive entry and exit costs compared to Western rivals. To capture the factors behind the motivations of Japanese investors, we will draw on the results of two surveys conducted by Toyo Keizai (2007) and Kawai (2006).

Table 4-12 demonstrates the determinants of Japanese FDI in CEE compared to Japanese FDI in Europe as a whole. Most of the Japanese stressed their interest in the rationalisation of international production and distribution networks as the most important motive for investing in CEE with the exception that most of Japanese FDI in Poland is undertaken to acquire local market share. It implies that Japanese firms are aiming at integrating CEE production units with their global value chain systems. This spearhead FDI by Japanese firms may be driven forward by the dynamism of European

integration. It also reflects that Japanese firms have demonstrated their concern about the unintended situation that excessive reliance on Western Europe may make them vulnerable in cost competitiveness.

Table 4-12: Determinants of Japanese MNEs' Entry Motives in CEECs (Part 1)

Reason	CZ N (%)	HU N (%)	PL N (%)	SK N (%)	MON N (%)	Europe N (%)
1 Exploitation of local resources and materials	–	–	–	–	–	8 (1.0)
2 Labor force	–	1 (12.5)	2 (12.5)	–	–	21 (2.7)
3 Financial and fiscal incentives granted by the host	–	–	1 (6.3)	–	–	10 (1.3)
4 International production and distribution networks	9 (37.5)	4 (50.0)	4 (25.0)	4 (66.7)	1 (100.0)	196 (25.4)
5 Acquiring local markets	8 (33.3)	3 (37.5)	7 (43.8)	2 (33.3)	–	296 (38.3)
6 Export to third countries	1 (4.2)	–	1 (6.3)	–	–	39 (5.1)
7 Re-import to Japan	–	–	–	–	–	10 (1.3)
8 Following expansion of competitors	3 (12.5)	–	–	–	–	12 (1.6)
9 Countermeasure to exchange rate risks	–	–	–	–	–	10 (1.3)
10 Information collection	1 (4.2)	–	1 (6.3)	–	–	87 (11.3)
11 R&D	1 (4.2)	–	–	–	–	34 (4.4)
12 Expanding into new activities	1 (4.2)	–	–	–	–	7 (0.9)
13 Integrating regional activity	–	–	–	–	–	29 (3.8)
14 Circumventing trade conflicts	–	–	–	–	–	–

Source : Toyo Keizai (2007) Kaigai Shinshutsu Kigyō Sōran Kaishabetsu hen.

As a consequence, Japanese firms have devoted themselves to diversifying the geographical scope of their operational units within the enlarged Europe. The extinction of national borders within an enlarged EU has pushed European affiliates to redefine the role of the spatial organisation of Japanese MNEs in the enlarged Europe. Moreover, the eroding comparative advantages of the Western European economy slashed the cost competitiveness of European affiliates of Japanese firms, spurring them to relocate their production from Western Europe to the European emerging economies. Accordingly, Japanese investors can sustain the price of their products at a competitive level or improve prices. Based on the rationalisation of extensive production networks

throughout Europe, Japanese investors can economise on location-based assets in different European economies

Serving customer demand in local markets also seems to be a critical factor behind the decisions whether to invest in the region. This is the most significant incentive for Japanese investors in Poland due to its large market size relative to other CEECs. It appears evident that Japanese FDI is not intended to acquire knowledge-specific assets as only 4.2 percent of the Japanese MNEs in the Czech Republic cited R&D to be a driving factor. The speed with which more Japanese manufacturers set up production facilities in CEE may accelerate further, while establishing regional headquarters and R&D facilities in the core markets such as Germany, the UK and France.

Table 4-13: Determinants of Japanese MNEs' Entry Motives in CEECs (Part 2)

Original motives	Total	A	B	C	D	E
1 Cultivation of network relations with Western clients	24 (53.3)	10 (52.6)	7 (58.3)	3 (42.9)	1 (33.3)	3 (75.0)
2 Cultivation of network relations with Japanese clients	20 (44.4)	11 (57.9)	5 (41.7)	3 (42.9)	0 (0.0)	1 (25.0)
3 Strong requests from Japanese clients	16 (35.6)	9 (47.4)	5 (41.7)	1 (14.3)	0 (0.0)	1 (25.0)
4 Cost advantages (e.g. cheap labour costs, transportation	16 (35.6)	6 (31.6)	7 (58.3)	2 (28.6)	1 (33.3)	0 (0.0)
5 Access to new markets	12 (26.7)	6 (31.6)	2 (16.7)	3 (42.9)	0 (0.0)	1 (25.0)
6 EU's economic potential	6 (13.3)	2 (10.5)	2 (16.7)	1 (14.3)	0 (0.0)	1 (25.0)
7 Strong requests from *keiretsu* firms	6 (13.3)	2 (10.5)	3 (25.0)	1 (14.3)	0 (0.0)	0 (0.0)
8 Circumventing trade barriers	5 (11.1)	2 (10.5)	2 (16.7)	1 (14.3)	0 (0.0)	0 (0.0)
9 Euro	4 (8.9)	1 (5.3)	0 (0.0)	1 (14.3)	1 (33.3)	1 (25.0)
10 Strong requests from host governments in CEE	2 (4.4)	1 (5.3)	0 (0.0)	1 (14.3)	0 (0.0)	0 (0.0)
11 Establishment of a foothold for entering Russia	1 (2.2)	0 (0.0)	0 (0.0)	0 (0.0)	0 (0.0)	1 (25.0)
12 Technological transfer from EU firms	1 (2.2)	1 (5.3)	0 (0.0)	0 (0.0)	0 (0.0)	0 (0.0)
Total	45	19	12	7 (100)	3 (100)	4 (100)

Source **:** Kawai (2006); N=45; multiple responses allowed.
Note **:** Parentheses indicate shares in percentage. A: Czech Republic, B: Hungary, C: Poland, D: Slovakia, E: Others.

Contrary to our expectation, neither the cheap labour force nor natural resources were rated as primary factors. This observation indicates that the primary investment

motive of Japanese firms is not explained by the desire to take advantage of a pool of cheap labour and abundant natural resources. Although, the survey presented above provided analytical insights into motives for investing in CEE, there is a critical drawback involved in this survey procedure that Japanese multinationals were not clearly distinguished between the manufacturing and non-manufacturing industries in the survey evidence.

Drawing on a firm-level examination of stylised information from a survey undertaken by me in 2006 (see Table 4-13), it is noteworthy that cheap factor endowments were not dominating determinants for MNE entry as our inference, representing that only 16 out of 45 sample firms (35.6 percent) cited cost advantages as a primary motive for entering the CEE markets. The forging of network relations with Western clients as well as with Japanese clients in Europe was of great importance for market entry in CEE. It may mirror the intention of Japanese manufacturing MNEs to reorganise their value-chain supporting activities and strengthen extra-firm relations, thus leading to an increase in sales and market share in Europe. It is also no wonder that Japanese multinational firms are aiming to respond to changes in customer demand for design and quality control as quickly as possible. At the aggregate level, strong requests and pressures from Japanese customers also seem to be influential in entering the CEE market (N=16, 35.6 percent). This result presents evidence that the replication of the hierarchical assembler-supplier relationship of Japanese firms is pronounced in the enlarged Europe. 26.7 percent of the respondents cited that access to new markets, which has yet to be completely mature was attractive. In sharp contrast, it is significant that EU's trade discrimination (11.1 percent), the introduction of Euro (8.9 percent), technological transfer from EU firms (2.2 percent), and the establishment of footholds for tapping into Russian markets (2.2 percent) have not received significant relevance. Namely, the nature of Japanese manufacturing FDI in European transition economies seems to be characterised by network-seeking FDI and efficiency-seeking FDI.

In terms of the variations in entry motives by country, the majority of sample firms in the Czech Republic reported that the cultivation of network relations with Japanese customers (57.9 percent) and western customers (52.6 percent) in CEE is important, followed by strong requests and pressures from Japanese customers (47.4 percent). The most important determinants for entering CEE markets for the sample firm in Hungary were said to be the cultivation of network relations with Western customers (58.3 percent) and reduction in input costs (58.3 percent). It is notable that over 40 percent of the sample firms in Poland reported that they were attracted to the potential access to new markets that have not yet been fully exploited. A major implication for this may be derived from the size of the Polish market in relation to other CEE counterparts. Poland has more than 40 million inhabitants; its size is almost equivalent to that of Spain. The strengthening of network relations with western customers provides a strong impetus for investment decisions of three out of four

sample firms in others (including Romania, Lithuania and Serbia and Montenegro). In sum, these survey results are consistent with Meyer (1995) and Hwang (2007) who argue that factor costs advocated by conventional economists are insufficient to explain the investment decisions of foreign MNEs in the post-Soviet type economies.

4.11 Location Decisions

Table 4-14 demonstrates the factors behind the Japanese manufacturing firms' location choices. Cheap labour costs (51.1 percent) dominate substantially, followed by geographical proximity to Japanese clients (44.4 percent) and geographical proximity to Western clients (44.4 percent) at the aggregate level. Excellent road networks (40.0 percent) and the active governmental support (including FDI incentives) (37.8 percent) also play a supporting role in Japanese subsidiaries' location choices. It is plausible that the geographical proximity to customers is mirrored by the crucial importance of shortened lead time to customers in line with the implementation of flexible production systems in response to demand fluctuations in the expansion of the single common market with free movement of capital, service, labour and goods. It is worth noting that 33.3 percent of all sample firms cited a low crime rate as a key site selection factor in the region. This outcome implies that sound living environments matter to Japanese expatriates who live with their family in CEE. On the other hand, purchasing power of local people (2.2 percent) was not a major incentive for locating at the aggregate level. The insignificance of relations between site selection for Japanese manufacturing firms and local market power lends support to the conjecture that the objective of Japanese manufacturing firms may be aimed at targeting more Western European markets than local markets.

The major determinants of location selection by Japanese MNEs vary among host countries. The major cited reason for site selection in the Czech Republic was said to be geographical proximity to major Japanese customers (57.9 percent) and active governmental support at the state level (47.4 percent), followed by excellent infrastructure systems (42.1 percent), low crime rate (42.1 percent) and cheap labour costs (36.8 percent). Moreover, six out of 19 firms (31.6 percent) which invested in the Czech Republic reported that enthusiastic working attitudes were the sixth crucial reason for location selection. This result indicates that labour quality is also one of the key determinants of FDI. It could also be related to a high proportion of Japanese FDI in the automobile sector, which is characterised by middle-technology-oriented and which requires skilled workers. The major determinants of locating in Hungary were said to be excellent transport networks (75 percent) and geographical proximity to major Western customers (75 percent), followed by access to cheap labour capital (50 percent), active governmental support at the state level (41.7 percent) and geographical proximity to major Japanese customers (41.7 percent). Both low crime rate (33.3 percent) and high unemployment rates (33.3 percent) also proved moderately important for site selection.

Table 4-14: Determinants of Japanese MNEs' Site Selection in CEECs

Location selectin factors	Total	A	B	C	D	E
1 Cheap labor costs	23	7	6	4	2	4
	(51.1)	(36.8)	(50.0)	(57.1)	(66.7)	(100.0)
2 Geographical proximity to Japanese clients	20	11	5	3	0	1
	(44.4)	(57.9)	(41.7)	(42.9)	(0.0)	(25.0)
3 Geographical proximity to Western clients	20	6	9	2	1	2
	(44.4)	(31.6)	(75.0)	(28.6)	(33.3)	(50.0)
4 Well-developed infrastructure systems	18	8	9	0	1	0
	(40.0)	(42.1)	(75.0)	(0.0)	(33.3)	(0.0)
5 Active support from the central government*	17	9	5	1	1	1
	(37.8)	(47.4)	(41.7)	(14.3)	(33.3)	(25.0)
6 Saftey climate (low crime rates)	15	8	4	2	1	0
	(33.3)	(42.1)	(33.3)	(28.6)	(33.3)	(0.0)
7 Enthusiastic working attitude	8	6	0	2	0	0
	(17.8)	(31.6)	(0.0)	(28.6)	(0.0)	(0.0)
8 No competitors within 30 km	6	1	1	0	1	3
	(13.3)	(5.3)	(6.7)	(0.0)	(33.3)	(75.0)
9 Active support from the local government*	5	2	1	1	0	1
	(11.1)	(10.5)	(8.3)	(14.3)	(0.0)	(25.0)
10 High unemployment rates	5	0	4	0	1	0
	(11.1)	(0.0)	(33.3)	(0.0)	(33.3)	(0.0)
11 Availability of engineers	4	1	2	1	0	0
	(8.9)	(5.3)	(16.7)	(14.3)	(0.0)	(0.0)
12 Pool of well-experienced workforce	4	4	0	0	0	0
	(8.9)	(21.1)	(0.0)	(0.0)	(0.0)	(0.0)
13 Low rate of increased wages	3	1	1	1	0	0
	(6.7)	(5.3)	(8.3)	(14.3)	(0.0)	(0.0)
14 Workforce who can speak English	3	2	0	1	0	0
	(6.7)	(10.5)	(0.0)	(14.3)	(0.0)	(0.0)
15 Low corruption rate	3	1	1	1	0	0
	(6.7)	(5.3)	(6.7)	(14.3)	(0.0)	(0.0)
16 Possibility to procure parts and materials locally	3	2	1	0	0	0
	(6.7)	(10.5)	(6.7)	(0.0)	(0.0)	(0.0)
17 Purchasing power of local consumers	1	0	0	1	0	0
	(2.2)	(0.0)	(0.0)	(14.3)	(0.0)	(0.0)
Total	45	19	12	7	3	4
	(100)	(100)	(100)	(100)	(100)	(100)

Source **:** Kawai (2006); N=45; Based on multiple choice question.
Note: Parentheses indicate shares in percentage. * includes FDI incentives. A: Czech Republic, B: Hungary, C: Poland, D: Slovakia, E: Others.

On the contrary, it is clearly observed that locational selection patterns of Japanese manufacturing firms in Poland, Slovakia and others differ from those in the Czech Republic and Hungary. Cheap labour force was considered the most dominant

location factor by most respondents of these three subpopulation groups (Poland, Slovakia and others), accounting for 57.1 percent, 66.7 percent and 100 percent, respectively. Apart from the importance of cheap labour costs, geographical proximity to major Japanese customers (42.9 percent) had a robust influence on the dynamic location behaviour of Japanese subsidiaries in Poland. This result may reflect the emergence of a cluster of foreign-owned automobile makers and suppliers in southern Poland. Of great interest is that three of four sample firms (75 percent) said that the absence of competitors within a 30 km radius was ranked as the second most important reason for location selection next to cheap labour force.

4.12 Information Networks of Japanese Investors in CEECs

Tables 4-15 and 4-16 show which professional organisations were contacted by Japanese manufacturing firms in order to acquire information on local market conditions and to discuss their investment opportunities in the pre- and post-entry periods, a total of 36 Japanese manufacturing firms provided answers.

Table 4-15: Information Sources in the Pre-Entry Period in CEECs

Information networks	Total	A	B	C	D	E
1 Local IPAs	24	13	4	4	1	2
	(66.7)	(81.3)	(36.4)	(57.1)	(50.0)	(50.0)
2 *Sogo shosha*	19	7	9	2	0	1
	(52.8)	(43.8)	(81.8)	(28.6)	(0.0)	(25.0)
3 Japanese firms	18	9	6	2	0	1
operating in CEE	(50.0)	(56.3)	(54.5)	(28.6)	(0.0)	(25.0)
4 JETRO	17	10	4	1	0	2
	(47.2)	(62.5)	(36.4)	(14.3)	(0.0)	(50.0)
5 Own European	9	4	1	1	1	2
subsidiaries	(25.0)	(25.0)	(9.1)	(14.3)	(50.0)	(50.0)
6 Western firms	7	2	1	1	1	2
operating in CEE	(19.4)	(12.5)	(9.1)	(14.3)	(50.0)	(50.0)
7 Indigenous firms	6	3	0	0	1	2
	(16.7)	(18.8)	(0.0)	(0.0)	(50.0)	(50.0)
8 *Keiretsu* firms	5	1	1	3	0	0
	(13.9)	(6.3)	(9.1)	(42.9)	(0.0)	(0.0)
9 Others	4	1	1	1	0	1
	(11.1)	(6.3)	(9.1)	(14.3)	(0.0)	(25.0)
Total	36	16	11	7	2	4
	(100)	(100)	(100)	(100)	(100)	(100)

Source : Kawai (2006); N=36; multiple responses allowed
Note : Parentheses indicate shares in percentage. A: Czech Republic, B: Hungary,
C: Poland, D: Slovakia, E: Others.

In considering only the pre-investment period, the most useful information source was

said to be local IPAs (66.7 percent), followed by *sogo shosha* (52.8 percent), Japanese firms operating in CEE (50 percent) and JETRO (47.2 percent) as a whole. It shows that the great variation on information sources exists depending on the host country. More than 80 percent of the firms in the Czech Republic answered that CzechInvest was a helpful information mediator, followed by JETRO (62.5 percent) and Japanese firms operating in the Czech Republic (56.3 percent). On the contrary, more than 80 percent of the sample firms in Hungary cited that *sogo shosha* was contacted to obtain the aforementioned information. Roughly 60 percent of the sample firms in Poland relied on the Polish Investment Promotion Agency (PAIiIZ).

Table 4-16: Information Sources in the Post-Entry Period in CEECs

Information networks	Total	A	B	C	D	E
1 Japanese firms operating in CEE	22 (61.1)	10 (62.5)	8 (72.7)	2 (28.6)	0 (0.0)	2 (50.0)
2 Own European subsidiaries	14 (38.9)	8 (50.9)	1 (9.1)	1 (14.3)	1 (50.0)	3 (75.0)
3 JETRO	11 (30.6)	5 (31.3)	4 (36.4)	1 (14.3)	0 (0.0)	1 (25.0)
4 *Sogo shosha*	11 (30.6)	3 (18.8)	5 (45.5)	2 (28.6)	0 (0.0)	1 (25.0)
5 *Keiretsu* firms	9 (25.0)	1 (6.3)	4 (36.4)	3 (42.9)	0 (0.0)	1 (25.0)
6 Indigenous firms	7 (19.4)	3 (18.8)	0 (0.0)	1 (14.3)	2 (100.0)	1 (25.0)
7 Western firms operating in CEE	6 (16.7)	2 (12.5)	1 (9.1)	0 (0.0)	1 (50.0)	2 (50.0)
8 Others	6 (16.7)	2 (12.5)	2 (18.2)	0 (0.0)	0 (0.0)	2 (50.0)
9 Local IPAs	5 (13.9)	4 (25.0)	1 (9.1)	0 (0.0)	0 (0.0)	0 (0.0)
Total	36 (100)	16 (100)	11 (100)	7 (100)	2 (100)	4 (100)

Source : Kawai (2006); N=36; multiple responses allowed
Note : Parentheses indicate shares in percentage. A: Czech Republic, B: Hungary, C: Poland, D: Slovakia, E: Others.

With regard to information sources in the post-investment period, the role of IPAs lost their significance compared to the pre-entry period; rather, the role of network relations with Japanese firms operating in CEE gained more importance. Likewise, it proved that 62.5 percent and 72.7 percent of the companies cited that a circle of Japanese firms operating in the Czech Republic and Hungary, respectively, were crucial information provider in supplying information on local markets. This phenomenon may also allow us to infer that Japanese chambers of commerce in both countries function as

an information facilitator. Of interest is that *sogo shosha* and JETRO served as a less crucial information source, notably in the Czech Republic and Hungary. Few changes in the information source between the pre- and post-entry of the sample firms in Poland were identified. In the case of Slovakia, it is significant that interactions with local firms turned out to be more active in relation to the pre-entry period. This unique feature may be mirrored by the small population of Japanese manufacturing firms and the absence of a JETRO office and *sogo shosha* in Slovakia compared to the Czech Republic and Hungary.

4.13 Operational Problems Faced by Japanese Investors in CEECs

This section considers obstacles experienced by Japanese subsidiaries based on the survey conducted by JETRO (2007). A total of 61 sample firms participated in the JETRO survey. Table 4-17 presents the variations on impediments to local operations at the country level and at the regional level (*i.e.*, Western Europe vs. Central and Eastern Europe). First, 43 companies (70.5 percent) cited that labour availability was the most serious impediment to their local operations at the aggregate. This result implies that the local competition for labour has been intensified. In sharp contrast, labour availability accounts for only 40.8 percent in Western Europe. Second, roughly 60 percent of the respondents reported that work and visa permission was problematic because of excessive bureaucracy, while managers' perception of this issue is not a serious concern in Western Europe. Labour cost ranks as the third most critical impediment to the local operations in CEE (54.1 percent), while it ranks as the most serious problem in Western Europe (69.7 percent). Relating to the problem of labour shortage, rising labour costs were likely to be caused by the intensified competition in CEE. Of great importance is that rigid labour markets and institutional deficiencies dominate in the above 18 criterion in CEE, as opposed to those in Western Europe. As a result, Japanese firms must strategically counter these challenging obstacles to their local operations through a variety of institutional and political forces such as negotiation, political bargains and lobbying.

With respect to the country variations on the obstacles to local operations, similarities and differences were observed. The sample firms in Hungary (73.7 percent) and Lithuania (100 percent) are concerned about rising labour costs, while managers deem this issue less problematic in the Czech Republic (25 percent). The most serious problem facing the sample firms in the Czech Republic was labour availability (100 percent) and CE (Conformité Européene) marks (87.5 percent). Additionally, work and visa permission (75 percent) and frequent shifts in regulations (62.5 percent) were also considered to be critical problems. 72.2 percent (13 firms) in Poland cited that poor road infrastructure disturbed local operations. Managers in Slovakia perceived labour availability (85.7 percent) and exchange rate fluctuation (85.7 percent) as having the negative impact on their production activities.

Table 4-17: Obstacles to Sample Japanese MNEs' Local Operations by Country

Criterion	WE (238)		CEE (61)		CZ (8)		HUN (19)		POL (18)		SLK (7)		ROM (6)		LIT (2)		MON (1)	
	N	%	N	%	N	%	N	%	N	%	N	%	N	%	N	%	N	%
1 Labour availability	97	40.8	43	70.5	8	100	13	68.4	12	66.7	6	85.7	2	33.3	1	50.0	1	100
2 Work and visa permission	87	36.6	36	59.0	6	75.0	11	57.9	10	55.6	4	57.1	4	66.7	1	50.0	–	–
3 Labour cost	166	69.7	33	54.1	2	25.0	14	73.7	8	44.4	4	57.1	3	50.0	2	100	–	–
4 CE mark	87	36.6	30	49.2	7	87.5	8	42.1	9	50.0	3	42.9	3	50.0	–	–	–	–
5 Exchange rate fluctuation	108	45.4	29	47.5	5	62.5	7	36.8	9	50.0	6	85.7	2	33.3	–	–	–	–
6 Road infrastructure	15	6.3	29	47.5	4	50.0	3	15.8	13	72.2	3	42.9	6	100	–	–	–	–
7 Tax rates	74	31.1	28	45.9	2	25.0	13	68.4	7	38.9	2	28.6	3	50.0	1	50.0	–	–
8 Product quality	67	28.2	27	44.3	5	62.5	10	52.6	7	38.9	2	28.6	2	33.3	–	–	1	100
9 Delivery of products	92	38.7	26	42.6	3	37.5	10	52.6	8	44.4	3	42.9	2	33.3	–	–	–	–
10 Frequent changes in regulations	20	8.4	24	39.3	5	62.5	10	52.6	4	22.2	1	14.3	4	66.7	–	–	–	–
11 Procurement costs	131	55.0	24	39.3	3	37.5	9	47.4	7	38.9	3	42.9	2	33.3	–	–	–	–
12 Tariffs	68	28.6	19	31.1	2	25.0	6	31.6	4	22.2	4	57.1	2	33.3	–	–	1	100
13 Complicated administrative procedures (trade)	29	12.2	19	31.1	3	37.5	5	26.3	6	33.3	2	28.6	2	33.3	–	–	1	100
14 Supply of electricity	18	7.6	18	29.5	2	25.0	8	42.1	6	33.3	–	–	1	16.7	–	–	1	100
15 Social welfare systems	44	18.5	17	27.9	5	62.5	5	26.3	4	22.2	–	–	2	33.3	1	50.0	–	–
16 Labour quality	93	39.1	16	26.2	3	37.5	7	36.8	5	27.8	1	14.3	–	–	–	–	–	–
17 Complicated administrative procedures (investment)	9	3.8	14	23.0	2	25.0	3	15.8	4	22.2	2	28.6	3	50.0	–	–	–	–
18 Complicated administrative procedures (tax)	16	6.7	14	23.0	2	25.0	3	15.8	7	38.9	–	–	2	33.3	–	–	–	–

Source : JETRO (2007)

In Romania, managers showed their concern about institutional deficiencies such as frequent changes in regulations (66.7 percent) and visa and work permission (66.7 percent). As regards the variations on local hazards at the sectoral level (see Table 4-18), managers in the transportation equipment sector were concerned about labour availability (81 percent), followed by the CE mark (57.1 percent) and product quality (57.1 percent). Roughly 50 percent of managers in the transportation equipment sector showed their significant concern about poor road infrastructure. Managers' perception of work and visa permission (71.4 percent) and labour cost (71.4 percent) was relatively high in the electronics/electric sector.

Table 4-18: Obstacles to Sample Japanese MNEs' Local Operations by Sector

Criterion	TRANS (21)		ELEC (21)		MACHIN (3)	
	N	%	N	%	N	%
1 Labour availability	17	81.0	12	57.1	2	66.7
2 Work and visa permission	8	38.1	15	71.4	3	100
3 Labour cost	7	33.3	15	71.4	3	100
4 CE mark	12	57.1	11	52.4	–	–
5 Exchange rate fluctuation	11	52.4	12	57.1	–	–
6 Road infrastructure	10	47.6	8	38.1	2	66.7
7 Tax rates	8	38.1	11	52.4	1	33.3
8 Product quality	12	57.1	9	42.9	1	33.3
9 Delivery of products	9	42.9	11	52.4	1	33.3
10 Frequent changes in regulations	11	52.4	5	23.8	1	33.3
11 Procurement costs	9	42.9	9	42.9	1	33.3
12 Tariffs	7	33.3	9	42.9	–	–
13 Complicated administrative procedures (trade)	4	19.0	6	28.6	–	–
14 Supply of electricity	6	28.6	6	28.6	–	–
15 Social welfare systems	7	33.3	2	9.5	2	66.7
16 Labour quality	3	14.3	7	33.3	1	33.3
17 Complicated administrative procedures (investment)	11	52.4	2	9.5	1	33.3
18 Complicated administrative procedures (tax)	8	38.1	1	4.8	1	33.3

Source : JETRO (2007)

4.14 Conclusions

The objective of this chapter was to provide a review of the patterns, characteristics and motivations of investments from Japan and the geographical scope of Japanese multinational organisations with manufacturing operations. Moreover, the use of both FDI statistics and firm level data enables us not only to characterise the recent trend of Japanese FDI but also to interpret corporate strategy and the motives of Japanese firms.

The Japanese position in foreign trade and foreign capital in CEE has been considerably negligible in number and value as compared with EU counterparts. This underrepresentation is accounted for by geographical and cultural distance as well as inherent institutional disadvantages in the region. Additionally, Japanese investors' market entry was delayed by the prolonged Japanese economic recession throughout the 1990s. However, the evident importance is that the number of Japanese FDI flows heading for CEECs has been slowly on increase in recent years. Faced with emerging competition under the deepening and widening of European integration, Japanese firms have felt compelled to reassess and reformulate their FDI strategies in Europe. Accordingly, their attitudes toward profit opportunities in the European transition economies have gradually turned to be more positive with improved democratic and industrial structure.

As regards the geographical scope, Japanese firms are shifting their interest from the old western periphery of the EU (Spain and Portugal) to the eastern periphery. Particularly, Japanese manufacturing-oriented investments have been skewed toward three Visegrád countries (*e.g.*, the Czech Republic, Hungary and Poland). It should also be noted that the geographical distribution of Japanese FDI has been highly unbalanced across the European transition economies. According to statistical evidence on the sectoral composition of Japanese FDI suggests that the Japanese FDI intensity in the manufacturing sector has been increased as the European enlargement process advances. The automobile sector that requires human capital with intermediate-level technical skills and knowledge tend to induce Japanese investors.

The surveys about the motives of Japanese FDI conducted by Toyo Keizai (2007) and Kawai (2006) have supported the view that cost considerations remain in part crucial but insufficient to explicate the factor behind the market entry of Japanese MNEs. More importantly, focus has been on the creation of new network values at the arm's-length market and customer and product diversification. The globalisation forces have urged Japanese MNEs to secure market presence through the strengthening of network relations with existing domestic and foreign clients. Networks tend to have power over the FDI decision process of Japanese firms.

As regards location decisions made by Japanese MNEs, the survey conducted by Kawai (2006) has provided the evidence that cheap labour costs play a critical role in determining the geographic scope of FDI transactions at the aggregate. However, it is particularly notable that Japanese investors in the Czech Republic and Hungary, which have strong engineering tradition and institutional stability, are motivated by the desire to position themselves near their customers as their top priority. FDI policies and infrastructure development are also the critical factors behind the location strategy. The post-EU enlargement era has seen the dramatic shift of Japanese investment toward more advanced technology-specific production activity. The recent trend of sequential investments related to high value-added digital electronics items (*e.g.*, LCD and Plasma

TVs) by Sharp, Hitachi, Toshiba, Sony, Matsushita and Funai Electric in the European transition economies reflects the fact that Japanese firms look for the location of production where highly skilled workforces are available. The criteria for location selection have shifted from low production cost advantages to specialised technical knowledge in the local economy.

The prior survey by JETRO (2007) has shown that manager's perception of location-advantages in CEE is inclined to be considerably pessimistic about rigid local labour markets and institutional deficiencies. Potentially, these threats may inhibit the future development and proliferation of Japanese FDI which helps transfer cutting-edge production systems and technological skills to the recipient economies. It should not be reasonable to say that CEE economies must continue to offer a secure business environment to attract FDI. Predictably, it may still take Japanese firms with manufacturing operations some more years to develop their status as compared to European and US firms in the enlarged EU and to adapt to an idiosyncratic set of location-based requirements in the European transition economies.

Although I discussed the general background of Japanese FDI in CEE, some critical questions remain unanswered or could only be approached in a preliminary way. Thus, I will try to tackle the following questions in the following chapters:

1. How do dynamic effects of institutional continuity and transformation affect the pattern of foreign capital movement in the CEE region?
2. What are the location strategies and the operational experience of Japanese manufacturing MNEs in CEE?
3. What factors have a bearing on the location decisions of Japanese manufacturing MNEs in CEE at the sub-national level? Are factor-cost endowments available in CEECs that classic economic theory addresses sufficient to explain the location strategy than firm-specific factors as well as institutional factors?
4. Is the local production of Japanese manufacturing MNEs as successful as it was expected before entering the transition economies? To which extent can existing theories (*e.g.*, Dunning's OLI paradigm, Porter's industrial cluster theory, and institutional theory) be extended and applied to firm performance?

5 COMPARISON OF EUROPEAN TRANSITION ECONOMIES' INSTITUTIONAL CONDITIONS

Corporate strategies in transition economies and other emerging markets can be explained only by incorporating the specific institutional context in the analysis.

Meyer, 2002: 266

Building an efficient and socially acceptable institutional infrastructure is likely to be particularly challenging in the case of transition economies' unused as they are to market-based institutions; and the speed with which and to what extent this can be efficiently achieved with minimum social disruption is likely to be a critical factor in influencing the capacity of a country to adjust to the demands of global capitalism and to attract inbound FDI.

Dunning, 2005: 53

5.1 Introduction

The gradual convergence of legal, economic and political structures of CEECs toward the Western European standards in recent years notwithstanding, becoming involved in transnational business transactions in the European emerging market economies involves inherent uncertainties and risks that distract the interests and goals of MNEs. Besides the functioning of a market-led economy, it has been viewed broadly among profit-driven multinationals that the upgrading of economic and non-economic institutions serves as a hedge against reversible paths toward centrally planned economies and hence facilitates economic transactions (*e.g.*, Meyer, 1998, 2001, 2002; Meyer and Jensen, 2005; Meyer and Nguyen, 2005). Corporate success is dependent on the way of balancing the interplay between MNE activity and institutional forces (Meyer and Nguyen, 2005). Meyer (1998: 4) also strikes the crucial note that "FDI interacts with many aspects of the transition process and *vice versa*". With a decade of transition efforts made by governments of CEECs, variations in the consequence of institutional reforms have turned out to be threats that deter MNE activity. Some former communist countries have succeeded in instituting sound market-based systems, while others are still struggling with the past. Along with the advance of microeconomic restructuring (*e.g.*, smooth stabilisation, effective privatisation of state-controlled enterprises and the speedy liberalisation of prices), the reception of foreign capital has been important for raising the economic, political, and institutional standard of transition economies of CEE to that of Western European nations. The thrust of this chapter is to explicate systematically the following issues:

● Is institutional development homogeneous or heterogeneous among CEECs?

- To which extent do institutional reforms determine the proliferation of FDI as compared with economic factors and how governmental policies designed to advance institutions shape investors' corporate strategies in CEECs?
- How does the transformation and continuity of economic and political institutions in CEE affect the evolution of FDI?
- Does the market environment have a greater effect than the institutional setting on firms' willingness to invest in a given country in CEE?

To date, increasing scholarly attention has been directed to extensively investigate the pattern of business activity from various perspectives of institutional economics (Bevan *et al.*, 2004), economic sociology (*e.g.*, Bandelj, 2002, 2004, 2008; Granovetter, 1985; Scott, 1995; Uzzi, 1996, 1997, 1999) and neo-institutionalism (DiMaggio and Powell, 1991). However, North (1990: 3) claims that the perceived significance of institutional building has been overlooked until now because there is "no analytical framework to integrate institutional analysis into economics and economic history". According to Rudinelli (2005), this issue also derives from the complex definition of institutional quality and from the difficulty of quantifying the concept sufficiently.

To date, emphasis has been given to various economic factors (*e.g.*, market potentia land costs, labour wages, economic agglomeration, labour availability, economic growth potential, exchange rate fluctuation and trade barriers) in international business literatures when assessing the relative attraction of a country or a region. Among these influential factors, market potential is known to be one of the most crucial determinants of inducing FDI inflows in the economies in transition (Pournarakis and Varsakelis, 2004).

However, an examination of how market-supporting institutions emerge raises the understanding of the effectiveness of economic exchange systems that enhance a nation's ability to attract foreign capital in the institutional context. Polanyi (1957) who placed particular emphasis on embeddedness put forward the assumption that the market would be framed into the dynamics of institutional infrastructure. Dunning (2005) underscores that the quality of institutional infrastructure is likely to determine the quality of business environments. The issue of whether profit-seeking investors are capable of maintaining and upgrading their ownership advantage hinges upon the degree of institutional-building in a given country. Dunning (2005: 55) stresses the need to regard the role of institutions as pivotal "location-bound competitive advantages" in his own ownership-location-internalisation (OLI) paradigm. Bevan, Estrin and Meyer (2004) also point out that progress in institutional arrangements is important location-specific variables and they promote the relations between ownership-specific variables and location-specific variables.

Furthermore, North (1990) and Scott (1995) acknowledge that institutions also contribute to either promoting economic performance or turning it in an undesired

direction. Accordingly, I argue that our interpretation of the overall set of FDI determinants in the European transition economies will be unsatisfactory without considerations of how a transformation from a centralised planning system to a market-driven economy occurred and the extent to which this transformation is successful from country to country in the level of speed and efficiency.

This chapter makes the following contributions. First, I lay out the extent and speed of progress in institutional reforms for each ex-Soviet type economy based on historical context together with published data from the European Bank for Reconstruction and Development (EBRD). Second, I will review institutional arrangements structured by the EU, institutionalisation of FDI policies and informal institutional particularities (*i.e.*, inherited political ideology and enduring informal society). It is valuable to incorporate national and supranational institution-specific variables into this study since the post-communist countries of Central and Eastern Europe have been undergoing two types of transition, in parallel: (1) from a commanding economy toward a market-supporting economy and (2) from non-EU membership toward EU membership (En, 2006). Third, I will construct an econometric model to test the relationship between FDI and institutional change. Based on a panel data set covering 14 countries for the period 1991-2006 and the use of an appropriate panel data econometric technique, this chapter provides a set of new empirical insights into the interplay between organisations and institutions in the post-communist region.

The chapter proceeds as follows. Section 5.2 provides a conceptual framework by drawing on the institutional perspective. Section 5.3 reveals relationships between various types of institutions and FDI capital. Section 5.4 provides an overview of empirical evidence of the prior literature. After specifying a econometric model in Section 5.5, Section 5.6 presents the empirical results. Descriptive data the impact of institutions on Japanese manufacturing firms' investment strategies in CEE are illustrated. Section 5.7 presents concluding remarks.

5.2 Analytical Framework

5.2.1 Institutional Change and FDI in CEECs

First I look further into the association between institutions and cross-border transactions in economies in transition. Why is it so important for FDI strategies to pay attention to institutions in the post-communist region? It is because the rapid transformation of institutions is an exceptional and unique issue that foreign investors have to deal with when investing in transition economies (Kornai; 1992; Kornai, 2006; Meyer and Jensen, 2005). Meyer and Jensen (2005: 127) also argue that CEE has faced an unprecedented experimental process of institutional evolution since the fall of the Iron Curtain in 1989. It has been generally argued that foreign firms investing in transition economies have to suffer from high transaction costs due to the absence of

sound market-supporting institutions (Meyer, 2001).

What makes transition economies unique, as compared with advanced economies, is the presence of informal institutional constraints that endanger efficient enforcement of a variety of macroeconomic reforms, such as price liberalisation, open trade, privatisation, and abolition of soft budget constraints of firms in transition (Maruyama, 1993). Even if the post-communist countries are converging toward a functioning market economy, informal institutions are unlikely to disappear completely (Maruyama, 1993). Rather, "the development of informal institutions may co-evolve with the establishment of formal institutions" (Meyer and Jensen, 2005: 130) and they may continue to exist in different forms. Moreover, Armingeon and Careja (2008: 441) also vindicate this argument by emphasising that "the core of an institution is hardly amenable to reform, but actors may successively add new elements to this unchangeable core". Scholars of international business (Peng, 2000, 2003; Peng and Heath, 1996) also argue that access to social networks of relations leverages the scale and process of economic exchanges in transition economies. Peng (2003) conceptualises a two-phase model of institutional transition and considers that the propensity for firms to shift from a network-based strategy to a market-based strategy rises over time.

In transition economies, governments and profit-driven multinationals act as social forces to reshape institutional infrastructure. In particular, governments are deemed to play a central role in creating, monitoring and controlling institutions (Rondinelli, 2005). International organisations, such as the EU and NATO, also contribute to institutional development in the post-communist region (Bandelj, 2008; Armingeon and Careja, 2008). An example of this would be some Asian countries (Thailand and Korea) that faced financial disruption in 1997 were obliged to enforce IMF-stabilisation package (Peng, 2003). To date, CEECs are subject to institutional arrangements or pressures from the EU since they are embedded in a web of economic, political and social networks of relations at the inter-governmental, supranational and national level (Bandelj, 2002, 2008). Similarly, the behaviour of individuals and organisations is governed by "the region's struggle to shed legacies of central planning, and create prosperous market-supporting economies" (Meyer and Jensen, 2005: 121).

Scholars of ex-Soviet-type economies in the CEE region suggest that institutional forces, such as inherent network relations, would be competitive advantages in making market entry more efficient and in rationalising the internal structure of organisations with a long time horizon in the post-entry period (Meyer and Peng, 2005). Inconsistencies and uncertainties of institutional infrastructure prevailing in civil society in CEE often hamper not only foreign firms' location choices and timing, but also national policy designed to induce FDI inflows (Meyer and Jensen, 2005; Meyer and Peng, 2005). Scholars of post-communist economies (Bandelj, 2002, 2004, 2008) and a pionner of the OLI paradigm in the discipline of international business (Dunning, 1981, 1988, 1993, 2005; Dunning and Lundan, 2008) have shown doubts about the

conventional wisdom that economic factors are the main magnet for FDI transactions. Emphasis has been given to the assumption that FDI would proliferate as institutions grow in the post-communist region.

In this chapter, I attempt to contrast the impact of formal and informal institutions on FDI inflows with that of economic conditions in the empirical part. Two types of institutions are carefully tested. One is formal institutions including progress in institution-building, institutionalisation of FDI policies and institutional arrangements with and pressures from the EU, while another is informal institutions including inherited political ideology from past state socialism and corruption (See Figure 5-1). I utilize OLS with panel corrected standard errors (PCSE) to test the effect of institutional factors on FDI flows to the CEE region.

Figure 5-1: Proposed Model

Source: Own illustration.

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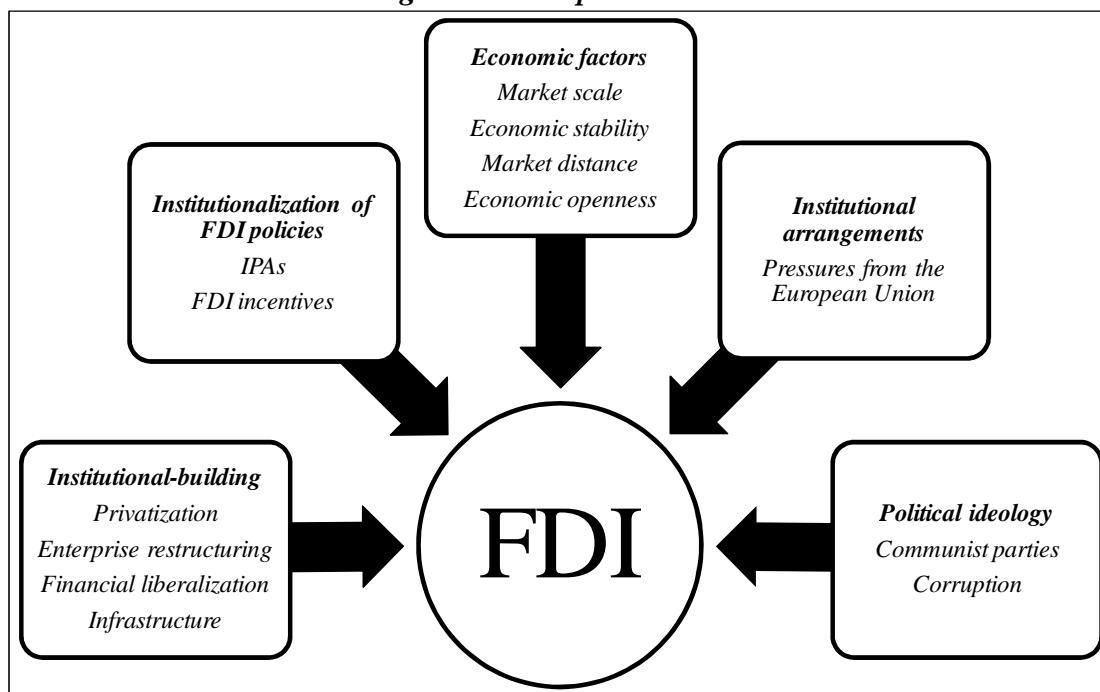
Table 5-1: Transition Indicator by Country and Field in 1989

Country	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Competition Policy	Banking reform	Securities markets	Overall infrastructure reform
Albania	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
B&H	1.00	3.00	1.00	2.67	1.00	1.00	1.00	1.00
Bulgaria	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Croatia	1.00	3.00	1.00	2.67	1.00	1.00	1.00	1.33
Czech republic	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Estonia	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Macedonia	1.00	3.00	1.00	2.67	1.00	1.00	1.00	1.00
Hungary	1.00	1.00	1.00	2.67	1.00	1.00	1.00	1.33
Lativia	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Lithuania	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Montenegro	1.00	3.00	1.00	2.67	1.00	1.00	1.00	1.00
Poland	1.00	2.00	1.00	2.33	1.00	1.00	1.00	1.00
Romania	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Serbia	1.00	3.00	1.00	2.67	1.00	1.00	1.00	1.00
Slovakia	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Slovenia	1.00	3.00	1.00	2.67	1.00	1.00	1.00	1.00

Source **:** EBRD

Note **:** B&H indicates Bosnia and Herzegovina.

Table 5-2: Transition Indicator by Country and Field in 2006

Country	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Competition Policy	Banking reform	Securities markets	Overall infrastructure reform
Albania	3.00	4.00	2.33	4.33	2.00	2.67	1.67	2.00
B&H	2.67	3.00	2.00	4.00	1.67	2.67	1.67	2.33
Bulgaria	4.00	4.00	2.67	4.33	2.67	3.67	2.67	3.00
Croatia	3.33	4.33	3.00	4.00	2.33	4.00	3.00	3.00
Czech republic	4.00	4.33	3.33	4.33	3.00	4.00	3.67	3.33
Estonia	4.00	4.33	3.67	4.33	3.67	4.00	3.67	3.33
Macedonia	3.33	4.00	2.67	4.33	2.00	2.67	2.33	2.33
Hungary	4.00	4.33	3.67	4.33	3.33	4.00	4.00	3.67
Lativia	3.67	4.33	3.00	4.33	3.00	3.67	3.00	3.00
Lithuania	4.00	4.33	3.00	4.33	3.33	3.67	3.00	3.00
Montenegro	3.33	3.00	2.00	4.00	1.00	2.67	1.67	2.00
Poland	3.33	4.33	3.67	4.33	3.00	3.67	3.67	3.33
Romania	3.67	3.67	2.67	4.33	2.67	3.00	2.00	3.33
Serbia	2.67	3.67	2.33	4.00	1.67	2.67	2.00	2.00
Slovakia	4.00	4.33	3.67	4.33	3.33	3.67	3.00	3.00
Slovenia	3.00	4.33	3.00	4.00	2.67	3.33	2.67	3.00

Source **:** EBRD

Note **:** B&H indicates Bosnia and Herzegovina.

In the following sections, the institutional change of each CEE state will be traced with a special focus on the privatisation process as an example since privatisation is a crucial source of connecting a local economy with foreign investors and encompasses overarching institutional constraints. Then, I will review other institutional forces influencing FDI inflows. They include (1) path dependence of political ideology and cultural struggle, (2) institutionalisation of FDI policies, and (3) institutional arrangements developed through the process of European integration (see Figure 5-1).

5.3 Progress in Transition

The EBRD offers a transition index of the extent of institutional-building of CEECs. The indicators have been viewed as one of the most appropriate data with which to evaluate reform progress of transition economies toward the standards of advanced economies (Meyer and Jensen, 2005). Progress in transition is assessed in a wide range of nine fields from privatisation to overall infrastructure. These fields are made up of four major categories essential for the transition toward a market-based economy: (1) enterprise reform; (2) market and economic transaction reform; (3) financial reform; (4) infrastructure reform. The scale for each indicator ranges from 1 to 4+ (4.33), with 1 indicating little or no change from a centrally planning regime, while 4+ refers to the stage that a nation has realised a functioning market-based economy.

Looking at eight selected fields, it is clear that CEECs have made great strides since 1989 (see Tables 5-1 and 5-2). According to EBRD transition indices that represent progress in transition over 18 years, the biggest difference in transition performance by country is between ten new EU-member countries and non EU-member countries. Especially, some countries of the former Yugoslavia, such as Bosnia and Herzegovina, Montenegro and Serbia, have made the least progress as compared to other CEECs. Price liberalisation in the European transition economies at the aggregate is rapidly converging toward the standards of industrialised countries, followed by small-scale privatisation.

On the other hand, convergence of competition policy has been laggard, followed by reform in securities markets and non-bank financial institutions, as the average values for these indicators are 2.6 and 2.7, respectively. In sum, the overall institutional infrastructure of the European transition economies has been developed, shifting steadily from the old system to a functioning market-based economy. However, it is observed that the speed and extent of institutional reforms vary largely by country. One explanation for this divergence is different governmental commitments to reform. Second, history may be a source of obstacles to the advance of the institution-building process in some countries. For instance, a typical case for this can be the enduring problem of soft budget constraints of firms in Romania and Bulgaria and ideological legacies.

5.3.1 Varieties of Institutional and Structural Development

In retrospect, economic, political and social institutions were divergent among CEECs since some ex-socialist economies (Czechoslovakia, Hungary, Poland and Yugoslavia) sought to experiment with their own economic systems based on labour participation in management and removal of collective farming in the 1950s and 1960s, while others remained good students of communism under the order of the Soviet Union. Moreover, the quality, complexity and speed of progress in institution-building have not been homogeneous but considerably heterogeneous, according to country, in the post-communist period (Bandelj, 2008; Kornai, 2006; Meyer, 2001; Meyer and Jensen, 2005; Peng, 2003). Concrete structural reforms and privatisation of former state-owned enterprises are regarded as a precondition for the establishment of a functioning market-based economy (Estrin, 2002). Hence, I will present a brief history of institutional reforms of CEE nation states at the disaggregate level.

5.3.2 Structural Constraints by Country

Table 5-3: Methods of Privatisation Used in Selected CEECs

Country	Primary Method			Secondary Methods		
	Direct Sales	*Management-Employment Buyouts*	*Vouchers*	*Direct Sales*	*Management-Employment Buyouts*	*Vouchers*
Albania		+				+
Bulgaria	+					+
Croatia		+				+
Czech			+	+		
Estonia	+					+
Hungary	+				+	
Latvia			+	+		
Lithuania			+	+		
Macedonia		+		+		
Poland	+				+	
Romania		+		+		
Slovakia	+					+
Slovenia		+				+

Source : Estrin (2002: 109)
Original source : EBRD (1998)

In the early start of transition, the ways of managing and implementing privatisation in CEE were dissimilar to those experienced in Western Europe (Meyer, 1998). Table 5-3 demonstrates the types of privatisation of state-owned assets across the ex-Soviet type economies of the region. It proved evident that different countries exercised different privatisation methods. It seems difficult to detect the defining patterns of privatisation even according to regional blocs (Visegrád, Baltic, and Balkan). Out of 13 transition economies, most transition economies listed used either direct sales

or management-employment buy-outs as the primary methods. Only three transition economies - the Czech Republic, Latvia and Lithuania - relied on a form of voucher privatisation as the primary method. The primary reason for this preference for privatisation without foreign participation lies in the two fears (Meyer, 1998: 18). One is that a direct sale of formerly state owned firms to foreign entities or individuals may inhibit the creation of local ownership and another is that the sales price of firms may be underestimated during the bidding procedure. Privatisation refers to a vital policy instrument in ensuring "a separation between the state and the enterprise sector" (Estrin, 2002: 107). Many observers of transition economies see privatisation as the heart of facilitating a transfer of state assets into private hands and institutionalising legal frameworks for competition and corporate governance (Bandelj, 2008; Estrin, 2002; Meyer, 2002). Despite this important element of privatisation for transformation, a shift from collective ownership to private ownership was slow with the exception of some countries. As a whole, private sector shares in most countries did not go beyond 50 percent of GDP by 2000 (Estrin, 2000: 110). As with the impact of formal institutional infrastructure on the direct investment of Western firms, Meyer (1995: 308) points out that "the privatisation policy adopted appears to be the major cause of the variation of quantity and pattern of FDI among the leaders" (Figure 5-2). Now let us turn to describe the privatisation story of each selected country in CEE.

Czech Republic

The Czech government relied on a combination of shock therapy and mass privatisation of state-owned enterprises. Its transformation process was not seriously hampered by the divorce of two countries constituting Czechoslovakia. However, deficient structural reforms and high current account deficits (Hunya, 2000a) decelerated the Czech economy. Privatisation of large-state banks and the bankruptcy of major former SOEs were blocked by the interplay of inward-looking cooperative social and political ties between major domestic banks, investment funds and ill-performing major former SOEs. These mismanaged reforms resulted in an increase in soft loans. The voucher scheme without sound fiscal discipline generated a number of newly local privatised enterprises who possessed poor managerial capacity. The lack of corporate governance drove indigenous private firms out of market competition. Consequently, this scenario ended up with a large amount of non-performing loans and the weakening of investors' confidence. Moreover, the Czech currency crisis in 1997 shattered the Czech economy.

The Czech Republic adopted voucher privatisation in 1990 (Pavlínek, 2002a). Eighty percent of the Czech assets were privatised by the end of 1994 (Klipper, 1998: 103). Investment funds owned by national enterprises played a central role in instituting voucher privatisation. They accumulated the large number of vouchers and leveraged strong control over the transfer of assets from state property into private hands, thus leading to poor progress in enterprise restructuring (Estrin and Meyer, 1998). It was

determined that voucher privatisation would educate people about investment choice in a market economy and contributes to the development of a capital market (Bornstein, 1997: 331). Mass privatisation through auctions, excluding foreign investors, was conceived of as a political instrument for the incumbent government in obtaining public support for the next election (Bornstein, 1997: 331). Bornstein (1997: 331) points out three major problems involved in voucher privatisation: (1) weak corporate governance; (2) high administrative and operational costs; and (3) no financial gains from the property sold by mass privatisation.

Figure 5-2: Foreign Direct Investment per capita and Share in Private Sector in CEECs in 2008

The Czech Republic continued to implement restrictive policies towards FDI in European transition economies until the late 1990s. All operations were subject to ubiquitous corruption. The privatisation process was politically manipulated and guided,

resulting in the exclusion of foreign investors. In the Czech form of privatisation, major Czech enterprises were controlled by state-controlled banks, indicating that opportunities to merge local firms were limited in real terms (Estrin and Meyer, 1998). "Czech Prime Minister Václav Klaus asked foreign investors to wait until privatisation was finished; his government has explicitly warned against selling the 'family silver'" (Sinn and Weichenrieder, 1997: 182). Václav Klaus was strongly against foreign capital and exercise the privatisation policy without foreign entrepreneurship, which was believed to have caused huge lay-offs. In fact, "the Klaus government interrupted Western multinationals such as Siemens, ABB, GEC Alstom, Framatom and others when they attempted to participate in the privatisation of such Czech engineering giants as ČKD and Škoda Plzeň" (Pavlínek 2002a: 364). This mismanaged privatisation policy retarded the Czech Republic's industrial restructuring and economic growth. The problem of soft budget constraints of firms in transition remained the impediment to the transition process as the governments continued to provide uncompetitive indigenous firms with generous subsidies in order to keep unemployment rates low (Estrin and Meyer, 1998; Tanaka, 2007). After Václav Klaus stepped down in 1998, a large amount of assets of domestic banks were sold to foreign investors.

Hungary

Hungary has been one of the most gradualist models of economic transition among CEE countries (Nuti and Portes, 1993). Hungary had already shown an explicit strong intention to enforce the swift liberalisation of prices and to restructure domestic manufacturing industry in line with the growth of FDI inflows in Hungary even before the post-socialist period. Despite "continuing subsidies, rent-seeking, and avoidance of serious restructuring" (Nuti and Portes, 1993: 12), there has been a consensus that economic development based on favourable FDI policy and structural reforms had also given rise to the large number of private capitalists with long-time horizons. In particular, foreign investors are concerned with the completion of price liberalisation since "prices determined by the interplay of supply and demand are the essence of a market economy" (Meyer, 1998: 13). The first quarter of 1993 witnessed the formation of 1069 international joint ventures or wholly foreign-owned firms in Hungary (Fahy *et al.*, 1998: 157). Hunya (2000a: 11), in an analysis of the sequence of structural reforms in industry for CEE during the period from 1994-1998, also reported that Hungary achieved over 10 percent annual growth in labour productivity.

In considering the transition of assets from state ownership to private ownership in more detail, Hungary enforced privatisation with a considerable reliance on direct sales of state-owned firms to foreign capitalists in the early 1990s but this privatisation scheme complicated negotiation procedures due to lack of property rights protection as well as institutional inconsistency (Estrin and Meyer, 1998). "The ruling political party from 1990 to 1994, the Hungarian Democratic Forum (MDF), was quite favourable to

FDI" (Brandelj, 2008, 76) although some opposition groups showed their political resentment to FDI (Sinn and Weichenrieder, 1997: 182). It is worth noting that Hungary had already started small-scale privatisation prior to the collapse of state socialism (Somogyi, 1993).

Besides trade liberalisation, mass privatisation was viewed as an inevitable condition to enhance productivity and make resource allocation more effective (Nuti, 1993). A sale of a stake in the Matav Telecommunication monopoly to a consortium of German and American investors in 1993 illustrates Hungary's keenness on shifting toward a functioning market-based economy (Brandelj, 2008). "Hungary has taken a gradual approach to privatisation and, with serious deficits in the budget and the balance of payments, has preferred to sell state assets including to foreign investors rather than distribute them free" (Bornstein, 1997: 335). On these grounds, foreign-owned enterprises showed their strong commitments to participate in the mass privatisation process in Hungary. Approximately 70 percent of privatised assets were held by foreign-owned enterprises in Hungary during the period from 1990-91 (Bornstein, 1997: 331). Mass privatisation with foreign ownership enabled the government to receive US$1.3 billion in proceeds (Bornstein, 1997: 334). It was perceived that "broad participation in the privatisation process would build public confidence in and support for privatisation" (Bornstein, 1997: 331). Privatisation also took place actively in the banking sector. The share of foreign banks in total banking assets increased from 65.3 percent in 1999 to 81.9 percent in 2003 (Barisitz, 2005: 60).

Poland

Poland adopted a *laissez-faire* approach to economic transition in the early phase of transition. The Polish government showed its commitment to enforcing structural reforms and strove to create favourable business climate privileged to the proliferation of small-and-medium-sized enterprises. Moreover, external financial support from the World Bank and Western countries permitted the Polish government to enforce a structural reform for partial recapitalisation of the banks and reduction of enterprise debts (Nuti and Portes, 1993: 17-18).

Privatisation was conducted on a large-scale. However, the start of transition witnessed neither a rise of FDI inflows nor high economic growth until 1998 due to the presence of non-transparent and inconsistent legal structure (Wisniewski, 2005). In parallel with the stagnant growth of FDI inflows, high unemployment problems and skyrocketing inflation spirals dominated the state of the Polish economy. The unemployment rate in Poland soared from 6.3 percent in 1990 to 16.4 percent in 1993 (Raiser, 1997: 544). More surprisingly, the average rate of unemployment reached 20 percent by 2004, reflecting that this structural constraint on the labour market has not been removed even as of today (Hardy, 2007: 765). According to Sachs (1994), one major explanation for this was that the focus was placed only on market liberalisation

and stabilisation of the Polish economy. In a similar vein to other European transition economies, such as Romania and Bulgaria, soft budget constraints also inhibited efficiency of the transition process in Poland. However, a circle of scholars and practitioners insisted that prospective EU membership should encourage Poland to undergo the significant transformation of its economic, political and legal structure.

The privatisation scheme enforced in Poland was called as "*nomenklatura privatisation*" (Shields, 2004). An effort was made by the Polish government to implement the privatisation of the economy in the early phase of transformation. However, this process was slow. The privatisation of over 3,000 formerly state-owned enterprises and many major monopoly firms, which suffered from huge debt problems, was an unprecedented, challenging task in the start of transition (Sachs, 1994: 56). Political volatility deterred Poland from implementing large-scale privatisation projects (Bornstein, 1997; Estrin and Meyer, 1998). "Hundreds of larger SOEs should be corporatised and their shares allocated in three ways: 15 percent given free to employees; 60 percent transferred free to 15 investment trusts called National Investment Funds (NIFs); and 25 percent retained by the State Treasury" (Bornstein, 1997: 332). At the beginning of transition, mass privatisation with the participation of foreign investors was restricted due to political resentment of foreign capital. Various domestic actors (*e.g.*, Polish privatisation minister Gruszecki, former prime minister Pawlak and Polish trade unions) showed their strong resistance to a wave of profit-seeking multinationals coming into Poland who might treat the Polish as "slave labour" (Sinn and Weichenrieder, 1997: 182). Nevertheless, privatisation, notably in the banking sector took a great leap forward at the turn of the century. The share of total banking assets held by foreign banks increased from 49.3 percent in 1999 to 75 percent in 2004 (Barisitz, 2005: 62).

Slovakia

Slovakia shares some similarities with the Czech Republic in the features of its economic transition. After the break-up of Czechoslovakia in 1993, the Slovak economy was in a poor condition since the country had committed itself to instituting hard budget constraints that were in practice until the mid-1990s. Ferencikova (1997) attributes the low level of Slovak FDI performance in the early 1990s to four critical factors: (1) unstable investment sites; (2) slow economic reform; (3) strong governmental intervention in acquisition of indigenous firms by foreign capital; and (4) economic policy in favour of domestic investors and owners during the privatisation period of the 1990s. However, Djankov and Pohl (1998) document that sales of national assets by insiders (*e.g.*, management-employee buy-outs) in Slovakia did not exert a negative impact on enterprise restructuring. Rather, operating profitability as well as labour productivity grew steadily for the period 1991-1996. After the break-up of Czechoslovakia, Slovakia constantly faced high unemployment rates in 1993, 1994 and

1995, of 12.2 percent, 13.7 percent and 13.1 percent, respectively (Raiser, 1997: 546). Moreover, this unemployment problem has been worsening over time; Slovakia reached an unemployment rate of 15.3 percent in 2005 (EBRD, 2008).

The first phase indicates the period from the break-up of Czechoslovakia to 1995. The second phase from 1995 to 1998 marks that foreign investors started purchasing equity shares of privatised firms in Slovakia. Following suit, local investors in the Czech Republic were prioritised to participate in the privatisation scheme in Slovakia (Djankov and Pohl, 1998) since the Slovak government wanted to create "strong domestic entrepreneurs" (Ferencikova, 1997: 26). Disfavouring the appointment of new managers to privatised firms in Slovakia, most pre-1991 managers were reinstituted as general managers by 1996 (Djankov and Pohl, 1998: 74). The pace of the privatisation process was relatively slow in Slovakia as compared with its neighbours in the start of economic transition. In contrast to the Czech Republic where approximately 80 percent of the national assets were transferred to private hands, Slovakia privatised only 44.6 percent of its property by the end of 1994 (Autner, 2006: 17-21). The privatisation process can be summarised in two phases. The market penetration of foreign owners in the banking sector has been remarkable since the beginning of the new century. The share of total banking assets held by foreign banks increased from 37.8 percent in 1999 to 98 percent in 2004 (Barisitz, 2005: 65). Deutsche Telekom's purchase of 51 percent of the shares of Slovak Telekom in 2000 is evidence that privatisation in the telecommunication sector occurred very late due to the presence of the Mečiar nationalistic government (Brandelj, 2008).

Slovenia

Slovenia took a cautious approach to the performance of microeconomic reforms and striving to circumvent internal and external imbalances in focus (Hunya, 2000a: 11). According to the World Bank's World Development Indicator, GDP *per capita* in Slovenia was US$10,860 in 2004, followed by US$6,120 in the Czech Republic and US$5,410 in Hungary. The most serious problem Slovenia has been facing in recent years is its relatively higher external debt, as compared to other CEE states.

The adoption of a gradual approach to privatisation was advocated by the government (Bandelj, 2008: 48) as taken in Hungary and Romania. Slovenia took the same method as the Czech Republic to allow domestic owners to dominate the privatisation process (Meyer and Jensen, 2005). "Slovenian policy encouraged management and employees to invest their ownership certificates in the companies they worked for" (Bandelj, 2008: 49). The enforcement of this privatisation method without capitalists resulted in leaving the country in isolation. In contrast to other CEECs, Slovenia has been lagging in direct sales of privatised banks to foreign banks.

Romania

Romania attached importance to a gradual macroeconomic reform since the introduction of shock therapy was perceived as not acceptable. Price liberalisation began in November 1991 and was completed in 1995. It has been argued that inefficient bank reforms essentially turned out to be impediments to the transition process in Romania. The enduring inheritance of the tripartite relations between formerly state-owned enterprises, banks and government also kept soft budget constraints from being completely removed (Kornai, 1992). Romania experienced high inflation rates and low economic growth during the 1990s. Until today, black market trade remains highly problematic in Romania (De Melo *et al*., 2001).

Neither small-scale privatisation nor large-scale privatisation was efficiently carried out in Romania despite new laws relating to privatisation enacted during the early phase of transition. By 1997, most small-scale privatisation projects were completed. Only 5.5 percent of the total formerly state-owned enterprise assets inherited from the old system of state socialism was transferred to individuals through the mass privatisation process (Earle and Telegdy, 1998: 328). One of the most serious problems involved in the post-privatisation period was that many privatised companies suffered from weak corporate governance resulting from the reinstitution of pre-1991 managers as general managers. As seen during the 1990s in Slovakia, this institutional constraint led the country to achieve capitalism without capitalists. On these grounds, Romania received marginal interests from foreign investors as compared to other European transition countries. Despite Romania's slow transition, the dawn of the new century saw that the majority of equity shares of Romanian oil giant Petrom was acquired by Austria's oil and gas firm, OMV. The structure of the domestic banking industry changed coupled with FDI inflows. The share of foreign banks in total banking assets jumped from 47.8 percent in 1999 to 62.0 percent in 2004 (Barisitz, 2005: 69).

Bulgaria

Bulgaria adopted a shock therapy at the start of transition. This structural adjustment plan forced Bulgaria to conduct price liberalisation, strict monetary policy and trade liberalisation. Similar to Romania, soft budget constraints were not eliminated overnight. Moreover, the domestic banking sector was considerably fragile during the 1990s because of a substantial amount of non-performing loans. While mass privatisation was conducted, six state-owned banks accounting for 70.7 percent and 72.6 percent of the total bank capital and total bank assets respectively continued to exist in 1995 (Budina *et al*., 2000: 458). The size of real GDP in Bulgaria was only 63 percent in 1997 relative to the level of 1989 (Raiser, 1997: 530) and the inflation rate of 948.53 percent was of paramount concern (World Development Indicator, 2006).

The Bulgarian mass privatisation program was classified into two distinctive periods. The first wave of the program ended in 1997. The second period started a year and a half after the first wave. As of the completion of the first wave, only one-fourth of

Bulgaria's formerly state-enterprises were privatised (Miller and Petranov, 2000: 225). Although voucher privatisation in Bulgaria shares many similar features to those in the Czech Republic, differences dominate. Learning from the Czech case and the first wave of mass privatisation in Bulgaria, the government conditioned vouchers gained in the second wave of the mass privatisation programs to be sold through the capital market only. The central government of Bulgaria placed an institutional constraint on the privatisation funds so as not to make the same mistake as the Czech Republic. "Bulgaria created an extensive regulatory structure including a Securities and Stock Exchange Commission which granted licences and regulated the activity of the funds" (Miller and Petranov, 2000: 229). Major mass privatisation in the energy and telecommunication sector took place after 2000. Seventy-five percent and 65 percent of total equity shares of Varna Shipyard and Bulgaria Telecom (BTC), respectively, were sold, ending up in private hands (Tanaka, 2005: 33). The share of total banking assets held by foreign banks increased from 28.4 percent in 1999 to 82.5 percent in 2004 (Barisitz, 2005: 67).

Baltic countries
The method of industrial restructuring and privatisation differed among three Baltic countries. In the aftermath of the dismantling of the central planning system, Estonia took the most radical approach to industrial restructuring by introducing direct sales to foreign investors and management-employee buyouts. In addition, rapid decisions were also meant to shut down former state-owned factories once restructuring was likely to be impossible or hopeless (Von Hirschhausen and Hui, 1995: 22). On the other hand, foreign investors played a marginal role in the privatisation process in both Latvia and Lithuania. These two countries took gradual steps, making voucher strategies a first priority. In Latvia, poor institutions such as political uncertainties and the lack of government competence in managing an appropriate privatisation program impeded effective industrial restructuring (Von Hirschhausen and Hui, 1995). Lithuania was the first country in CEE to implement a mass privatisation program that distributed vouchers to the employees and the population in 1991. Notwithstanding these different approaches, according to Estrin (2002: 110), the private sector contribution to GDP had already accounted for more than 50 percent by the end of 1994. As a result of later structural reforms led by governments of the Baltic countries, they achieved approximately 7 percent average growth in labour productivity in the years from 1995 to 2003 (Kornai, 2006: 214).

Balkan countries
Balkan countries were lagging behind other CEECs in privatisation due to their political instability and continuing inter-ethnic conflicts. Moreover, Brada *et al*. (2006: 657) argue that disappointing privatisation processes in the Balkan countries were a result of many former Yugoslav republics continuing to adopt the Markovic Law on the transfer

of state-owned assets to private hands, which allowed insiders to control essential assets. Baltic transition countries took common approaches to privatisation. As seen Table 5-3, management-employment buyouts received priority. Croatia embarked on privatisation of national assets in 1991. The Croatian government relied on management-employment buyouts in the early phase of transition and introduced voucher systems afterward. Similarly, Albania also adopted the two privatisation programs. Small-scale privatisation for agriculture and housing took place at a relatively rapid pace, but large-scale privatisation was greatly disadvantaged by economic and political upheavals in Albania during the 1990s. However, the Albanian government restarted the large-scale privatisation for banking, transportation, energy and communication sectors in 1998. Moreover, the long history of Albania as a closed country also inhibited the pace of its transition process. One of common problems involved in the privatisation process in the region was that the state controlled the majority ownership of many privatised firms.

5.3.3 Institutionalisation of FDI Practices

In this section, I elaborate on the significance of the institutionalisation of FDI policies. FDI policies are "institutional measures" (Bandelj, 2004: 459) created to capture the positive benefits of FDI but also "mechanisms that institutionalise official national attitudes toward the presence of foreign actors in the national economy" (Bandelj, 2004: 459). Institutionalisation of FDI policies is driven by two ways. One is the establishment of IPAs and another is the provision of financial and fiscal incentives. The following sections will present various institutional factors, which would affect FDI allocation of profit-seeking multinationals in CEE.

5.3.3.1 The Establishment of IPAs

The establishment of investment promotion agencies (IPAs) is said to have been a relatively crucial phenomenon for firms already in operation, as well as for prospective investors in CEE. Among scholars of international business pointing to the relevance of IPAs in attracting FDI inflows, Meyer and Nguyen (2005) argue that regions and countries that have IPAs to support FDI projects can promote ties with prospective foreign multinationals. IPAs play a crucial role in representing and promoting the image of their countries as attractive investment sites. Loewendahl (2001: 1) argues that "image, brand awareness, and perceptions are major factors influencing the location of foreign direct investment (FDI)". However, there are few scholars who have explained the causal association between IPAs and FDI inflows to date (*e.g.*, Bandelj, 2004, 2008; Cass, 2007; Head *et al*., 1999; Lim, 2005, 2008; Loewendahl, 2001; Woodward, 1992).

IPAs are a product of "legitimisation of FDI practice", affecting firms' business strategies (Brandelj, 2008: 72). The presence of IPAs in CEECs reflects a sign of a country's commitment to promoting economic liberalisation in line with the Washington

Consensus and to integrate the home economy into the world economy (Bandelj, 2008). Moreover, some scholars of economic sociology (*e.g.*, Bandelj, 2002, 2008) attempt to extend the logic of normative institutional forces or mimetic isomorphism (DiMaggio and Powell, 1990; Scott, 1995) to explain the relationship of the establishment of IPAs to FDI inflows in CEE in recent years. Actors such as the state involved in policy design to create and develop market-supporting institutions are likely to imitate successful FDI practices other actors exercise in their quest for economic efficiency as far as learning is necessary to survive in imperfect markets (Bandelj, 2004, 2008).

It is of critical concern that foreign investors comprehend what processes, structure and strategies IPAs adopt for attracting FDI and what variations exists across Eastern European transition economies in the institutional context. Functions and tasks of investment promotional activities have been diverse. The role of investment promotional activities can be classified into four main pillars in a broader sense (Cass, 2007). They are (1) investor facilitation and investor services; (2) image building; (3) investment generation; and (4) policy advocacy. First, investor facilitation is crucial to mitigate uncertainties and risks by providing investors with comprehensive and consolidated information (*e.g.*, market conditions, the potential giving of state aid, trade policy). Considering information on state aid, IPAs often play a crucial role in initiating discussions with investors about available incentives. From the perspective of institutional economists, all desired information is not freely obtainable since markets are imperfect. Hence, a problem arises where one party has complete information, while the other has no information.

Lim (2998: 40-41) states the significance of IPAs as an information provider as follows: "the asymmetry of information tends to change the bargaining power between the supplier and the demander and the side which possesses less information will be at a disadvantage. Therefore, in order to overcome asymmetry of bargaining power, harmonisation of information possession should be achieved". Compared to Western firms, non-European firms such as Japanese and Korean firms have less information on local market conditions, local business practices and local bureaucracy when searching for a site for production in the CEE region. In this case, the firm can acquire desired information from IPAs at minimum costs.

Table 5-4: Institutionalisation of FDI Practices in CEECs

Country	Name of Investment Promotion Agency	Year of Establishment
Albania	Albania Investment Promotion Agency	1998
B&H	Foreign Investment Promotion Agency of Bosnia and Herzegovina	1999
Bulgaria	InvestBulgaria Agency	1995
Croatia	Croatian Investment Promotion Agency	1996
Czech Republic	CzechInvest	1992
Estonia	Estonian Investment Agency	1994
Hungary	Hungarian Investment and Trade Development Agency	1993
Latvia	Latvian Development Agency	1993
Lithuania	Lithuanian Development Agency	1995
Macedonia	Agency for Foreign Investments of the Republic of Macedonia	2005
Montenegro	Montenegro Investment Promotion Agency	2005
Poland	Polish Agency for Foreign Investment	1992
Romania	Romanian Agency for Foreign Investment	1997
Serbia	Serbia Investment and Export Promotion Agency	2001
Slovakia	Slovak Investment and Trade Development Agency	2000
Slovenia	Trade and Investment Promotion Agency	1995

Source : Own slight modification based on Bandelj (2008: 71) and each IPAs website.
Note : B&H indicates Bosnia and Herzegovina.

Second, image-building has been recognised as a key factor to success for facilitating smooth FDI transactions (Leowendahl, 2001; Lim, 2008). Marketing techniques include general PR campaign, printing of brochures, newsletters, CD-ROMs and fact-sheets, participating in investment exhibitions, IPA conferences, investment missions, trade mission, direct mail campaigns, and creating an IPA website (Leowendahl, 2001).

Third, investment generation is one of the basic tasks of IPAs. Clear identification of targeted firms and prioritised industries contributes to the operational effectiveness of IPAs. Moreover, understanding the strength and weakness of location sites enables IPAs to evaluate whether they are able to meet the interests of potential investors and to match them with competitive advantages of firms (Cass, 2007; Loewendahl, 2001). Lastly, policy advocacy is central to upgrading investment environments through surveys, policy proposals and lobbying (Cass, 2007: 84).

In the post-communist region, IPAs are already in operation in 16 CEE countries (Table 5-4). CzechInvest supports joint ventures between foreign investors and indigenous companies (Loewendahl, 2001). CzechInvest is regarded as a FDI agency "with a clear strategy sharply defined sectoral priorities and an active

involvement in the negotiation of incentives with individual investors" (Cass, 2007: 112) across Central and Eastern European countries. "[CzechInvest] annual reports looked similar to those of multinational corporations, and the agency willingly provided estimates of the worth of the FDI transactions that it facilitated" (Bandelj, 2008: 72). On its website, firms interested in investing or being active in that region can access profiles of more than 2,000 local suppliers. There are also special data bases focusing on potential indigenous suppliers in the automobile industry and the aerospace industry. These supplier development programs may facilitate access to potential local suppliers, thus leading to the improvement of local embeddedness. In sharp contrast, Slovakia and Macedonia were relatively slow starters in advancing institutionalisation of FDI policies as compared to their neighbors.

5.3.3.2 Financial and Fiscal Incentives

In CEE, FDI incentives (*e.g.*, tax holidays, tax exemption, grants and the like) have become a greater concern to foreign investors since different countries in the region seem to offer similar business conditions. Preferential financial and fiscal privileges were commonly used by incumbent governments of CEE during the 1990s to attract FDI inflows (see Table 5-5). Tax competition has markedly intensified between Visegrád -4 (*i.e.*, Czech Republic, Hungary, Poland and Slovakia) since the late 1990s (Cass, 2007: 105) because of their similar economic advantages. Werner (2004: 11) calls this FDI-related policy battle between CEE-4 a "jurisdictional competition". As seen in Table 5-6, these four countries are graded as relatively active in concentrating both FDI incentives and promotional activities in the region (Meyer and Jensen, 2005: 143). It has been argued that state authorities in transition economies are more likely than those in developed economies to resort to the provision of FDI incentive schemes as a policy tool (Bitzenis, 2003). This is because incumbent governments seek to attract more FDI transactions for an increase in the wealth of the nation, technology transfer, improvement of balance of payments and job creation.

On the contrary, one of the critical problems facing the transition economies is that budgetary constraints inhibit the institution of sufficient FDI incentives to develop the attractiveness of their investment climate in relation to Western counterparts (Bitzenis, 2003). That is to say, the provision of FDI incentives indicates a decline in national revenues. Moreover, European transitional economies to enter EMU are also subject to the stringent fiscal requirements necessary for realising the Maastricht Convergence Criteria.

FDI incentives are more important for MNEs seeking to undertake greenfield investment projects than for those participating in the privatisation process. The relation between greenfield investors and host-based governments are not conflicting but economically reciprocal (Meyer and Jensen, 2005). Large investors are deemed to obtain more benefits from "non-transparent incentives" by leveraging their strong

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bargaining power against local governments, as observed in the Magyar Suzuki case and the Fiat Polska case (Werner, 2004). Institutional inconsistencies and deficiencies are exploited by powerful investors. Local governments are almost subordinate to large MNEs in negotiations involving the scale of incentive deals because the latter can feel free to choose other locations if their demands were not adapted. When it comes to industry heterogeneity, tax exemption is a great concern to production firms since "they require larger investment in fixed assets and are more likely to value incentives related to depreciable assets than service industries" (Lim, 2005: 66).

It has also been argued that greenfield investors may lose their legitimacy and reputation in a given country if they fail to match their own interests with what the local government desires to achieve (Meyer and Jensen, 2005). I look further into FDI incentives provided by some ex-Soviet type economies of CEE.

Figure 5-3: Correlation between log of FDI per capita and Corporate Income Tax in CEECs (1991-2006)

Source: Own illustration based on Michigan Tax Data Base, EBRD and UNCTAD
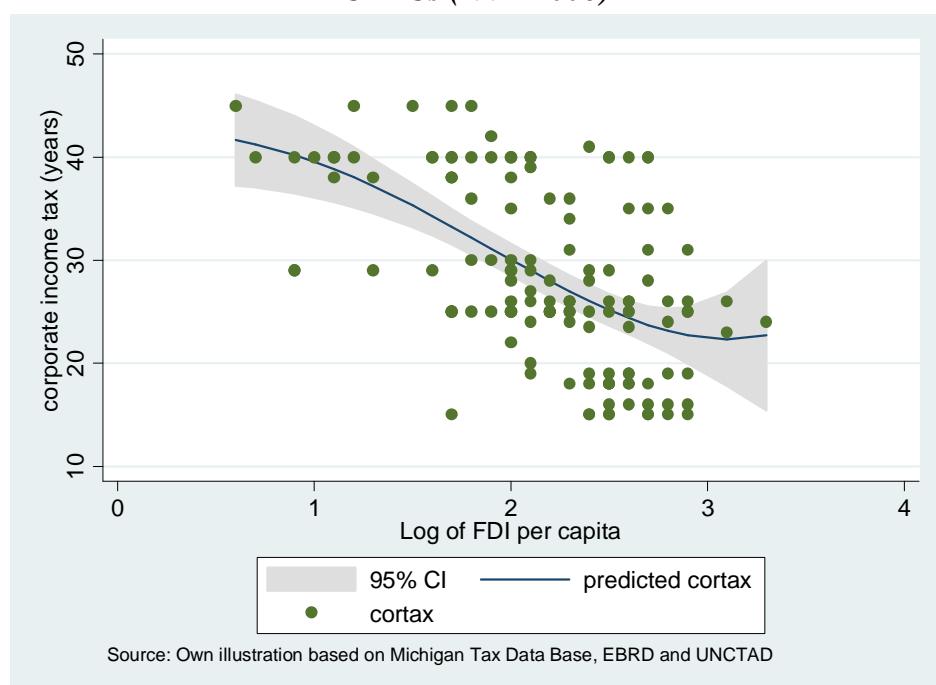
Note: The slope of coefficient of the OLS regression is significant at the 1% level (t-statistics=–8.38)

Czech Republic

The Czech government was passive in formulating favourable FDI policies toward inbound foreign capital during the 1990s. The provision of tax-based incentives was prohibited in 1993 in the Czech Republic (Werner, 2004), but from the late 1990s, these types of state aid have been reemployed. In 1999, the Czech government legislated investment incentive schemes that had not yet been seen among its neighbours (Mallya *et al.*, 2004). A new Act on Investment Incentives came into force in May 2000 that

Table 5-5: Summary of FDI Incentives in 2005

Country	Special economic areas	Tax concessions	Corporate tax (%)*	Tax holiday	Tax credits	Grants
Albania	N/A	N/A	20	×		
B&H	4 free zones	N/A	30	×	×	
Bulgaria	6 duty-free zones (since 1987)	Yes	15	×	×	×
Croatia	6 technology parks	Yes	20	×	×	×
Czech	Many industrial zones and technology parks	Yes	24	×		×
Estonia	Only free zones	Yes	22			×
Hungary	170 industrial parks and 13 logistic parks	Yes	16		×	×
Latvia	Free ports as well as special zones	Yes	15		×	×
Lithuania	Free trade zones and industrial parks	No	15		×	
Macedonia	4 technological development zones	N/A	10	×	×	
Montenegro	N/A	N/A	9		×	
Poland	14 special economic zones with sub-zones	Yes	19		×	×
Romania	30 industrial and technology parks	Yes	16		×	
Serbia	Free zones	N/A	10	×	×	×
Slovakia	Many industrial parks	Yes	19	×	×	×
Slovenia	Industrial zones (Bistrica, Celja, Lenart and Mursika Sobots)	Yes	23		×	×

Source : Own adaptation from Dresdner Bank (2005), Index of Economic Freedom (http://www.heritage.org), the homepage of each IPA and Cass (2007: 122).

Note : Data for corporate tax is 2007. B&H indicates Bosnia and Herzegovina.

streamlined application procedures for financial and fiscal incentives. As a result, since then the Czech Republic has been emerging as a major source of FDI in CEE. At present, FDI incentives are generally given to two particular sectors, to be exact the manufacturing sector and the business support services and technology services sector (Allen & Overy, 2006: 22). Unlike Poland, the Czech government has established no special economic zones where foreign investors can take advantage of a special legal status.

Hungary

Hungary has been deemed the forerunner in adopting a friendly-FDI policy prior to the fall of state socialism and has a well-structured legal framework for granting incentives in the post-socialist era (Allen & Overy, 2006). Act XXIV on Investments of Foreign Persons in Hungary was enacted in 1988. In 1995, the Act on Customs and Act CI on Custom Tariffs was instituted to facilitate the market entry of export-oriented foreign investors. In order to establish relations between foreign investors and indigenous small-and-medium-sized enterprises, Széchenyi Plan was worked out and has been enforced from 2001. Since January 2003 Smart Hungary Programme which offers preferential tax treatments and grants to major greenfield investment projects has been effective. Industrial parks were set up in regions situated close to Western European markets. This FDI-related policy was devised in harmonisation with the EU standard. Hungary has made the continued commitment of creating an attractive business climate by offering a corporate tax rate under 20 percent since the mid-1990s, while the corporate income tax of other CEE countries was not reduced until after 2000. There are two particular ordinances associated with investment incentives, namely the Investment Incentive Decree and the Investment Tax Incentives Decree. As of 2006, foreign investors benefit from the broad range of industrial parks, with a number reaching approximately 160 (Allen & Overy, 2006: 29).

Poland

During the 1990s, the Polish government adopted an active trade policy designed to affect the interest of major foreign car producers, such as Opel, Fiat and Daewoo, by imposing the tariff rate of 35 percent on cars imported from the Western European market (Werner, 2004: 12). This special governmental treatment aided them in selling cars produced in the oligopolistic domestic market. The Act on Financial Support for Investment has been enforced in Poland since 2002. It is important to note that under this FDI-related law the size of permissible grants differs from *voivodship* to *voivodship*[5]. Ahead of other CEE counterparts, 14 SEZs were officially set up by Poland to overcome growing regional economic inequality in October 1994 under the SEZ Act.

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[5] *Voivodship* indicates a Polish provincial unit. There are 16 *voivodships* (*i.e.*, provinces)

Technology parks are also situated in Gdansk, Krakow, Lodz, Poznan, Warsaw and Wroclaw. A total of 677 greenfield investment projects were launched within the SEZs by 2002 (Wisniewski, 2005: 13). Contrary to the Polish government's expectation, FDI experts state that the SEZs have been less successful to attract FDI inflows to Poland (Wisniewski, 2005).

Table 5-6: The Degree of Institutionalisation of FDI Practices by Country (Unit: average score 1994-2003)

Cluster	Country	Incentive score (A)	Promotion score (B)	Average (A+B)	Average in cluster
1	Czech Republic	3.00	3.37	3.19	
	Hungary	3.73	2.80	3.27	
	Poland	3.60	2.90	3.25	2.80
	Slovenia	2.77	2.13	2.45	
	Slovakia	2.84	2.04	2.44	
	Estonia	1.70	2.70	2.20	
2	Romania	3.10	1.80	2.45	
	Lithuania	3.00	1.70	2.35	
	Latvia	2.63	2.00	2.32	2.17
	Bulgaria	2.60	2.00	2.30	
	Croatia	1.90	1.00	1.45	
3	Serbia & Montenegro	1.54	1.30	1.42	
	Bosnia & Herzegovina	2.17	1.64	1.91	1.53
	Albania	1.67	1.20	1.44	
	Republic of Macedonia	1.70	1.00	1.35	

Source : Own modification on Cass (2007: 107).

Slovakia

In sharp contrast to the Czech Republic in the 2000s and Hungary in the 1990s, Slovakia undertook "the most unstructured approach to approving aid for investors" (Allen & Overy, 2006: 34). The major problem foreign investors seem to experience in Slovakia was the lack of transparent legal and institutional frameworks for FDI incentives. This did not change until the National Assembly of the Slovak Republic enacted the Investment Incentives Act in 2001. This Act includes tax allowances, cash contributions for the creation of new jobs, and cash contributions for the training of new employees.

Other CEECs

As the negotiation talks for EU accession advanced over time, the concerted effort to improve the legal structure related to FDI incentives was also seen in *Romania* and *Bulgaria*. In 2001, the Slovene government initiated the Programme of the Government of the Republic of Slovenia for the Promotion of Foreign Direct Investment in 2001-2004. This policy turned out to be a milestone in increasing FDI in Slovenia.

Croatia adopted a FDI-related policy similar to that in Slovenia during the same period.

As a whole, it has been seen that FDI practices were institutionalised by active state actions in Estonia, Hungary, and Latvia, while Croatia, Slovakia, and Slovenia are likely to have been disinclined toward the adoption of friendly FDI policies during the 1990s after the dismantling of the former Soviet Union (Brandelj, 2008). The extent and disposition of institutionalisation of FDI policies also diverge significantly at the state-policy level as seen in the previous sections.

5.3.4   Regional Institutional Arrangements

Now let us turn to the perceived importance of EU enlargement. The expansion of the EU to 25 Member States in 2004, and subsequently to 27 in 2007, is an indication of a challenging experiment for enhancing further the overall competitiveness and internal cohesion of the EU. One of the critical issues be aware of is that these two successive enlargement processes in the new century exacerbated internal economic disparities with reference to GDP *per capita*. The EU had already concluded European Agreements (EA) with ex-Soviet type countries in the start of transition with the EU's desire to promote mutual trade relations during the early 1990s. The EA indicated "basically free trade for non-food manufactured goods and the possibility to join the EU in the future" (Hunya, 2000a: 8). In June 1993, the Copenhagen European Council was held to consider eastward EU enlargement to integrate ex-communist countries if they met all necessary EU laws and rules. The late 1990s turned out to be a landmark for accelerating the eastward EU enlargement project. In 1998, the EU opened the official negotiation talks for accession with a first wave of CEECs (Luxembourg Group).[6] In 2000, the EU initiated the negotiation with a second wave of CEECs (Helsinki Group).[7] In October 2002, the EU declared that all the negotiation talks except those with Romania and Bulgaria had been completed. In May 2004, the EU celebrated the acceptance of 10 new EU-CEECs. Romania and Bulgaria also achieved EU membership in January 2007.

Economists place focus on the economic aspects of EU enlargement, while the political and social aspects of EU enlargement are likely to be overlooked. On the basis of the risk-return calculations of international economic activity, foreign investors can enjoy taking full advantage of access to the Single European Market, no tariff barriers within the territory of the EU, and cheap factor endowments in the East. It is a shared view among economists that prospective EU membership lessens the probability that economic risks (*e.g.*, large exchange rate fluctuation and rise in interest rates) occur in the CEECs (Baldwin *et al*., 1997; Bevan and Estrin, 2004). A study by Baldwin *et al*. (1997: 147) presents simulation results that indicate that EU membership reduces the trade costs between Western European countries and the CEECs by 15 percent and

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[6] The Luxembourg Group includes the Czech Republic, Estonia, Hungary, Poland and Slovenia.
[7] The Helsinki Group includes Bulgaria, Lativia, Lithuania, Romania and Slovakia.

CEECs can gain the real income of ECU30.4 billion.

Prospective membership in the EU is likely to serves as a guarantee of the quality of institutional development in CEE as Eastern European transition economies face institutional pressures from the EU to put structural adjustments and institutional reforms in practice (Clausing and Dorobantu, 2005). Membership also enables ten new EU-CEECs to benefit from various financial funding such as Cohesion Fund, Solidarity Fund, and Structural Fund designed to equalise the levels of regional economic development throughout the EU. Without facing budget constraints on their own, 10 new EU-CEECs can exploit rich financial sources from the EU. Moreover, "the CEE countries within the EU have access to new resources through the structural funds, which may be used also for financial incentives" (Meyer and Jensen, 2005: 136). For example, the European Commission reports that the EU provided the Czech Republic, Hungary and Poland with 936.1 million Euros, 1,112.7 million Euros and 4,178.6 million Euros as Cohesion Fund for years 2004-2006.[8]

On the other hand, scholars of transition economics (Kornai, 2006) and economic sociology (Bandelj, 2008) present a different view on the EU enlargement project than that which economists typically embrace. Kornai (2006: 208) points out that "the memberships may be seen as certificates, which are supposed to attest to the fact that [CEE] countries boast both democratic political systems and functioning market economies". The advantages of EU expansion for CEECs also reflectsinstitutionalisation of foreign ties with international economic and political organisations. Bandelj (2008: 113) states that "institutional connections could affect economic relations between countries by routinising transactions and therefore mitigating uncertainties and costs associated with international business". Institutional relations between West and East are expected to be further developed through active political dialogue (Bandelj, 2004).

Eastward EU expansion can be understood as a vital catalyst for instituting FDI-friendly practices into CEE and encourages mimetic behaviour of state action of each country (Brandelj, 2008). New EU member countries are likely to vigorously compete with one another to recruit foreign capital and imitate effective FDI practices exercised by others. Hence, reflecting on the concept of institutional isomorphism (DiMaggio and Powell, 1983), it can be said that Eastern European transition economies tend to embrace a take-it-for-granted mindset that FDI rules favourable to foreign multinational corporations are created, developed and legitimated through the course of European integration (Brandelj, 2008). Consequently, economic gains are of minor importance in this regard, rather, the adoption of favourable FDI practices is illustrative of the consequence of alignment toward Western European standards of neoliberal economic norms among political and societal groups in CEE.

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[8] See more detail in europa.eu.int/comm/regional_policy/intro/working1_en.htm

In the late 1990s, governments of CEECs had to promote the harmonisation of laws, anti-corruption campaigns, and efficient business transactions in order to become part of the EU. The exclusion of custom controls stimulated the frequency and intensity of trade transactions between the West and the East in the EU. As EU enlargement reduced a new members' average tariff rate of nine percent to an EU average tariff rate of four percent (Tanaka, 2005), foreign firms could undertake FDI policy complementary to trade activities, gaining benefits from cheap factor endowments (*i.e.*, labour, land, and transportation costs) and less strict trade impediments. Since the new member countries from CEE are locked into EU economic, political, and legal institutions in accordance with the *acquis communautaire*, foreign investors encounter a better investment climate. Foreign firms doing business in the single European market can benefit from reduced administration costs and political stability. Supranational pressures imposed on ex-Soviet type economies in CEE play a vital role in obliging the countries to undertake market liberalisation and implement stabilisation measures as a requirement of EU membership. The EU guarantees the introduction of 'good governance' including market openness, macroeconomic stability, excellent road infrastructure systems rules of law and property rights protection in CEE member countries.

The vision of EU membership may have kept European transition economies at an advantageous position in converging toward the institutional standards of the EU and in materialising the establishment of good governance at an early phase of transition in relation to other emerging economies such as the former Soviet Union, Central Asian and China (De Melo *et al*., 2001). The prospective integration of Eastern European transition economies into the EU is viewed as a cornerstone to make a turnaround to the communism unrealistic (Estrin and Meyer, 1998). The realisation of prospective membership of the EU is an indispensable precondition for promoting values of democracy, property rights and civil liberty.

In the future, the evolution of FDI in CEE may be interrupted by two major impediments. One is a massive drain of labour from CEE to rich EU member countries. In order to mitigate fears of large-scale labour migration from CEE, the European Commission has already enacted regulations restricting free movement within the EU of labour from the new EU member countries for seven years following enlargement. However, a few countries, such as Ireland and the UK, permitted workers from the new member countries to immigrate. For example, a number of Polish workers have immigrated to the UK, where the number of Polish migrant workers amounts to more than 168,000 (Barrell *et al*., 2007: 4). Government officials in Poland fear that human capital turns out to be scarcer due to massive emigration and this phenomenon thus intensifies competition among foreign investors for the indigenous labour force and

pushes up the wage level.[9] As a result, predictably existing and potential foreign investors may face difficulties finding human capital and economising on cheap labour costs in CEE (JETRO, 2005a). Accordingly, foreign MNEs whose motivation lies only in the exploitation of cheap labour capital would suffer from increasing marginal costs and decreasing productive efficiency.

Another impediment is the end or contraction of most special financial and fiscal incentives, such as tax breaks, grants and subsidies. Since 2004, the European Commission has screened FDI incentives devised by new EU members and regulated with caution whether state aid is given to particular businesses and distort EU competition policy (Allen & Overy, 2006). It has been debated that special economic areas may no longer be a policy instrument for leveraging and manipulating investors' preference and interests. One of best examples of recent restrictions on the provision of public incentives is that "the European Commission intervened to cut incentives for a new Skoda engine plant from US$120 million to US$22 million in 1999" (Werner, 2003: 15). Another example of the EU's interference with state aid to MNEs is the case of Ford in Romania. In the beginning of February 2008 the Romanian government was accused by the EU of giving illegal state aid to Ford in the privatisation process of formerly Daewoo-Craiova. Romania has now been asked to recover 27 million Euro (http://balkaninsight.com). These restrictions on FDI transactions should undermine incumbent state authorities' interests in reform and investors' interests in embarking on offshore production in CEE. According to Cass (2007: 105), "recent stabilisation of incentive levels – and, in some cases, reduction – appears linked to EU rules and may also reflect a shifting of competition from incentives to tax rates".

In sum, the European transitional economies have applied a diverse range of investment regimes and institutional development strategies, which render the region an ideal object of analysis of the location characteristics influencing entry strategies of foreign multinationals.

5.3.5 Institutional Continuity: Ideological Inheritance of State Socialism

Almost 20 years ago, citizens in CEE believed that the fall of state socialism would warrant the transformation toward free-market capitalism and democracy, which would allow for managing a successful integration into the global society. However, this promising picture has been incomplete and misleading today. Rather, it turned out that the mindsets of political elites structured by omnipresent communist ideology have not yet been easily displaced by the spread of capitalism overnight. It is surprising that "no Central European country, with the exception of the Czech Republic in the 1990s, excluded communists from public office" (Tupy, 2006:12). This statement represents to a large extent the limited progress in democracy during the course of joining the world

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[9] Interview with a local government in Katowice, Poland on 19 March, 2007.

economy in the era of globalisation. 'The end of history', to borrow an expression from Francis Fukuyama (1992) who addressed that the fall of the Iron Curtain would guarantee democratisation in European emerging market economies, seems to be illusory and out of touch with reality. From an institutional perspective of the world economy, history has been enduring and the past characterises the present.

Table 5-7: Freedom from Corruption

Country	1998	1999	2000	2001	2002	2003	2004	2005	2006	98–06
Albania	10	10	10	23	10	10	25	25	25	↑
Bosnia & Herzegovina	10	10	10	10	10	10	10	33	31	↑
Bulgaria	30	30	29	33	35	39	40	39	41	↑
Croatia	50	50	50	27	37	39	38	37	35	↓
Czech Republic	53.7	52	48	46	43	39	37	39	42	↓
Estonia	70	70	57	57	57	56	56	55	60	↓
Hungry	48.6	51.8	50	52	52	53	49	48	48	↓
Latvia	30	30	27	34	34	34	37	38	40	↑
Lithuania	30	30	30	38	41	48	48	47	46	↑
Macedonia	N/A	N/A	N/A	N/A	33	33	33	23	27	N/A
Montenegro	N/A	N/A	N/A	N/A	N/A	30	30	N/A	N/A	N/A
Poland	55.7	50.8	46	42	41	41	40	36	35	↓
Romania	50	34.4	30	33	29	28	26	28	29	↓
Serbia	N/A	N/A	N/A	N/A	10	10	N/A	N/A	N/A	N/A
Slovakia	50	50	39	37	35	37	37	37	40	↓
Slovenia	50	50	50	60	55	52	60	59	60	↑

Source: Own illustration based on Freedom House's Economic Freedom
Note: Scale from 0 (the highest corruption rate) to 100 (the lowest corruption rate)

To date, rising neoliberal forces, such as foreign multinational corporations and economic regionalisation, have been accused by populists of exploiting labour and national assets in the post-communist society of CEE. The core political culture of traditional communists who advocate improvement of workers' rights, equal redistribution of wealth, tax increases for private-owned enterprises, and promotion of labour unionism has once again received attention from those who suffer from poverty and unemployment problems.

The post-communist parties in CEE are not in power but its ideological remnants, inherited from the past, have been kept intact at the base of internal politics. For instance, in the Czech Republic, the recent rise of the Communist Party of Bohemia and Moravia (Komunistická strana Čech a Moravy: KSČM) revolves around a dramatic increase in regional economic inequality in the transition to capitalism, which creates a divide between winners and losers. In neighboring Slovakia, the Communist Party of Slovakia (Komunistická strana Slovenska: KSS) has steadily increased its parliamentary

presence. Its share jumped from 0.8 percent in 1992 to 6.3 percent in 2002.[10] Moreover, democracy was significantly threatened by a "return to communism" in the 2002 election campaign in the Czech Republic, as the political popularity of the Communist Party of Bohemia and Moravia (KSCM) in the Czech Republic increased its share of the parliamentary seats in 2002 to 18.5 percent.[11]

Connecting the ideological inheritance of communism to cross-border movement of capital into CEE, Bandelj (2008: 75) states that "governments committed to reform would be more likely to legitimise FDI by selling strategic monopolies to foreign investors, while successors of insignificantly reformed Communist parties or nationalist governments would have other political agendas". The conventional wisdom is that political parties advocating liberal democracy seek to adopt policies designed to evolve together with the participation of foreign owners. However, a society in which traditional communist and nationalist ideology is prevalent may show political resentment against foreign capitalists and thus inhibit the transfer of national assets to foreign hands.

Moreover, corruption remains critical in CEE's economic life. Freedom House's Index for Freedom from Corruption validates the proposition that corruption has remained a serious problem in the region despite the transition toward a market-based economy integrated into the family of European nations (see Table 5-7). More critical is that corruption has been growing over time. Freedom from Corruption is measured on a scale from 0 to 100. The larger the number, the lower a rate of corruption. Between 1998 and 2006, The Freedom from Corruption dropped in CEE-4, Estonia, Romania and Croatia. Poland and Romania have had difficulty overcoming the fundamental causes of corruption. Tupy (2006: 13) points out that the culture of corruption, bribery and red-tape politics is rooted in the prevailing informality of social networks in CEE, stating that "the strength of family and business ties, and the virtual nonexistence of local civil society groups in the region, allowed corruption to materialise at the local level, where enterprises, mayors and civil councilors have turned regional politics into a gold mine". Consequently, high corruption rates lower the reputation of the host economy and discourage a high degree of business involvement by foreign investors. Now let us turn to a review of the existing literature in order to highlight earlier findings on which institutional ingredients may exert a significant influence on FDI inflows.

5.4 *Available Empirical Evidence on the Role of Institutions for FDI in Transition Economies and Hypothesis Formation*

Research on the effect of formal and informal institutions on FDI in transition economies has been neglected than that in developed countries (Grosse and Trevino, 2005). Although the number of FDI studies, which place focus on institutions, has been

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[10] See more details in h<u>ttp://www.parties-and-elections.de</u>
[11] See more details in h<u>ttp://www.parties-and-elections.de</u>

limited in emerging economies, consensus develops and evolves on the link between FDI and the quality of institutions. Based on empirical evidence in prior work, hypotheses are developed. In considering methodologies used in the past literature, time-series and cross section analysis has been commonly employed as an econometric tool (Grosse and Trevino, 2005; Disdier and Mayer, 2004; Campos and Kinoshita, 2003; Resmini, 2000; Sugawara, 2006; Brada *et al.*, 2006; Bevan and Estrin, 2000; Clausing and Dorobantu, 2005). Bandelj (2008) checked the robustness of coefficients of parameters by employing Generalised Least Square (GLS) and Ordinary Least Square (OLS). Similarly, feasible GLS (FGLS) pooled-panel regressions were run by Brada *et al.* (2006).

Progress in Institution-Building

Disdier and Mayer (2004) incorporated the degree of freedom of a country in Europe into their location choice study and find that poor institutional infrastructure was responsible for reducing French firms' incentive to locate. Examining FDI inflows into 13 CEE countries during the period 1990-1999, Grosse and Trevino (2005) tested the variation of the impact of the quality of institutions on FDI inflows, as measured by various institutional criteria (corruption in government, political risk index, rule of law, repatriation controls, EBRD index of enterprise reform, and change in consumer price index). All of these studies on institutional factors find that immature institutions constrain FDI inflows.

Campos and Kinoshita (2003) verify that convergence toward a functioning market economy is a driving force toward inducing FDI inflows, thus concluding that countries with reform-minded politicians who intended to initiate a thorough shift toward market liberalisation may be at an advantage in the race of FDI. Bevan, Estrin and Meyer's (2004) study shows legal institutional infrastructure, foreign exchange and trade liberalisation are judged to be a success in attracting FDI inflows. Employing data consisting of 10 recipient countries over the period 1991-1995 at sectoral level, Resmini's (2000) study evidences that investors for scale-intensive sector as well as science-based sector are largely influenced by the degree of transition, while the degree of trade openness determines the volume of FDI inflows for traditional sectors.

It is important that the determinants of FDI vary by sectoral distribution. Drawing on empirical evidence from an analysis of FDI among 18 Eastern European transition economies including Russia, Sugawara (2006) notes that the increase in FDI inflows is due to privatisation. Furthermore, EU membership is found to be statistically significant at a 1 percent level and has a positive effect on the amount of FDI. Since progress in transition in the Balkan region is smaller than Central Europe, the Balkan region receives a limited amount of FDI for the period between 1990 and 1993 (Brada *et al.*, 2006). I postulate the following hypothesis:

Hypothesis 1: *Countries with more developed market-supporting institutions receive more FDI inflows.*

Pressures from the EU

Little attention has been directed toward the influence of pressures from the EU on FDI inflows. As for the transformative impact of the relational character of institutional configurations associated with EU integration, there has been little or no consensus in the literature. Using a panel of 28 host countries during the period 1992-2001, Clausing and Dorobantu (2005) find that EU membership and Copenhagen Criteria, measured by dummy variables, are statistically significant and positive. Furthermore, of interest is that the magnitude of the coefficients of the release of Agenda 2000 on the amount of FDI is larger for the second wave accession countries than that for the first wave accession countries. Bevan and Estrin (2000) report a significant positive effect of the 1993 Cologne announcement on the proliferation of FDI. In contrast, employing an OLS with Huber-White robust standard errors for the period 1990-2000, Bandelj (2008) also fails to identify a causal mechanism of institutional relations (*i.e.*, EU agreements) for FDI flows in Central and Eastern Europe. Evaluating US FDI inflows in EU12 over the period 1978-1995, Mold (2003) finds little evidence that American firms are sensitive to the effect of the Single Market Programme (SMP). I test the following hypothesis:

Hypothesis 2: *Countries with EU membership receive more FDI inflows.*

Institutionalisation of FDI Policies: Impact of IPAs and FDI Incentive Schemes

There is a strong consensus on the magnitude of institutionalisation of FDI policies (Bandelj, 2002, 2008; Lim, 2005; Head *et al.*, 1999; Woodward, 1992). Lim (2005: 74) suggests that "each government should adjust its FDI attraction policy to a particular firm from a strategic viewpoint and should also introduce the concept of strategic planning at the time investment policy is formulated". Lim's (2005: 74) study also advocates that the adoption of well-prepared investment promotional plans, which match investors' needs and interests, will be consequential for prompting the host economy to develop sustainably. Lim (2008: 49) evidences two significant results: (1) the operational effectiveness of IPAs is determined by "experience and a well-structured, well-staffed overseas network" and (2) IPAs play a central role in minimising the fear of information asymmetry that investors face. Bandelj (2002, 2008) highlights that the legitimisation and of FDI agencies matters to the decision-making of foreign investors in the eastern European economies. Employing a conditional logit model, Head *et al.* (1999) in an analysis of Japanese manufacturing firms' location choices in the US in the 1980s find that the presence of IPAs of states in Japan has no effect on the motivation and behaviour of Japanese investors. In sharp contrast, IPA branch offices opened in

Japan are the contributing factor to increasing Japanese FDI inflows (Woodward, 1992). A critical problem associated with Bandelj (2008), Head *et al*. (1999) and Woodward (1992) is that the details of promotional schemes are not scrutinised, while they merely take a close look at the presence of IPAs.

As regards the magnitude of financial and fiscal incentives in attracting FDI inflows, recent empirical evidence sheds light on the conflicting nature of FDI incentives. Mallaya *et al*. (2004), who examine whether the National Incentive Scheme influences the quality of FDI in the Czech Republic, suggest that the government should practice policy tools that stimulate domestic investment and technological transfer from foreign-owned enterprises to indigenous enterprises without strong reliance on quantitative incentives such as tax holidays. Devereux *et al*. (2007) identify that the influence of regional grants is powerful in recruiting FDI in Great Britain. Deichmann and Karidis (2005) find that regions which are endowed with SEZs and excellent transportation networks are successful in attracting foreign investors in Poland, using the data set of location selection for the period 1989-2002 that was compiled by the Polish Agency for Foreign Investment and the Polish Statistical Office, Glowny Urzad Statystyczny (GUS). Mallya, Kukulka and Jensen (2004) find that the announcement of financial incentives exerts a positive impact on FDI inflows in the case of the Czech Republic.

On the contrary, according to Bitzenis's (2003) study based on the primary data of 64 MNEs operating in Bulgaria, only 17.2 percent of the total sampled firms attribute their investment motivation to tax incentives. Cieślik (2005) find that the SEZ variable has no significant effect on the number of foreign firms in Poland. He infers this empirical result as follows: "most SEZs were established in relatively well-developed Central and Western part of the country and other factors were more important than fiscal incentives" (Cieślik, 2005: 873). Cieślik and Ryan (2005) in an analysis of Japanese FDI flows in Poland at the province-level over the period from 1991-2001 also identify that special economic zones do not raise the probability that a host region is selected, while controlling for other locational characteristics. Cieślik and Ryan find that inbound foreign capital in Poland is significantly sensitive to the size of both GDP and area. The following hypothesis is put forward:

Hypothesis 3: *Countries with more developed FDI policies receive more FDI inflows.*

Ideological Inheritance of Communism

Bandelj (2008) assesses whether left-wing governments, measured by a dummy variable of successors of communism and socialists, has some bearing on the pattern of FDI in CEE. Bandelj finds that FDI inflows are relatively small when a left-wing party is in power in a given country. Sugawara (2006) also identifies that the length of socialist periods are negatively related to FDI receipts. I test the following hypothesis:

Hypothesis 4: *Countries with a greater degree of ideological inheritance of communism receive less FDI inflows.*

5.5 Methodology

5.5.1 Sample and Data Sources

Now I empirically analyse the relationship between institutional factors and levels of FDI inflows in the CEE region by using panel data on aggregate FDI flows to host economies. I use the United Nations Conference for Trade and Development (UNCTAD) data base for the independent variable. EBRD publishes a Transition Index of 27 post-socialist countries at annual basis. This index is assessed on a scale of 1 to 4+ (4.33). A value of 1 means no change from a standard of the old planning economy and 4+ (4.33) represent a standard of advanced market economies. These indicators are the appropriate measurement with which to assess the degree of departure from the historical inheritance of ex-Soviet type economies. Other data sources are *Parties and Elections* (http://www.parties-and-elections.de), World Bank's *World Development Indicator*, Michigan University Global Tax Database, and Bandelj (2008) and Cass (2007) for IPAs.

The period of the sample is limited to the period from 1991-2006 due to the limitation of data availability. The recipient countries are 14 Eastern European transition economies (Albania, Bulgaria, Bosnia and Herzegovina, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovakia and Slovenia). Serbia and Montenegro were excluded from the sample because there was not sufficient and reliable FDI-related data to run an equation so that these limitations inhibit the time-series analysis. The focus is placed on the set of institution-specific variables expected to influence the pattern of FDI in accordance with the analytical framework presented in Section 2.

5.5.2 Description of Variables

I use annual net FDI *per capita* (UNCTAD) as a dependent variable. In terms of independent variables, three groups of independent variables are presented in this study (see Table 5-8). Group 1 consists of economic variables such as market size, market distance, economic stability and economic openness. Market size is measured by GDP (US$ millions). Following the study of Mold (2003), market distance is measured by a distance in kilometers from the capital city of each country to the central location of the European economy, Frankfurt. Following Clausing and Dorobantu (2005), a misery index is adopted to test economic stability. The misery index consists of a sum of each sampled country's inflation rate and unemployment rate. Economic openness is measured by trade relative to GDP in percentage. These data, except market distance,

were compiled from the World Bank's World Development Indicator.

Group 2 focuses on formal and informal institutions such as internal and external politics, ideological inheritance of state socialism and institutionalisation of FDI policies, and progress in institution-building. The variables of progress in institution-building are measured in 7 areas (1. large-scale privatisation, 2. small-scale privatisation, 3. enterprise restructuring, 4. price liberalisation, 5. bank reform, 6. securities market reform, 7. overall infrastructure) using EBRD transition indicators.

5.5.3 Model Procedure

I employ an Ordinary Least Square (OLS) with panel-corrected standard errors (PCSE) technique applied to dynamic panel data to explore how progress in institutional infrastructure leads to promoting the potential inflow of annual FDI capital over a long time horizon. The research is of interest since I use formal and informal institution-specific location variables in contrast to the existing literature, which presented relatively insufficient measures of institutions. Moreover, the use of updated data and other data sources, combined with modern econometric techniques, might provide more proper estimations of the interactions between institutional infrastructure and FDI.

This panel data analysis helps observe the impact of explanatory variables on the dependent variables across time and space simultaneously. Ordinary Least Square (OLS) with panel-corrected standard errors (PCSE) is employed for a time series and cross section (TSCS) analysis. There are two primary reasons for preferring OLS with PCSE. According to Beck and Katz (1995), OLS parameter estimates with PCSE are more accurate than Generalised Least Squares (GLS) of Parks.[12] Another is that OLS with PCSE enables us to deal with the problem of panel heteroskedasticity, autocorrelation and contemporaneous correlation more appropriately even in the presence of complicated panel error structures (Beck and Katz 1995: 634-641).

It is widely acknowledged that serial correlation and autocorrelation in the use of a pooled cross-sectional time series are also potential problems bearing statistical bias. To tackle this problem, which persists across unit and time, I use a first-order auto regression or AR(1) function in order to solve the problem of autocorrelation and serial correlation seen as a nuisance in the residuals. In the estimation, the econometric results present Prais-Winston coefficients with panel-corrected standard errors (Greene 2000). To overcome the simultaneity problem, all independent variables are lagged by one year. Zero or below zero valued net FDI inflows are a cause of a major problem for econometric estimation when the dependent variable is transformed into logs (Cieślik and Ryan, 2004). To overcome this problem, zero or below zero net FDI inflows are replaced with 0.0000001 consistent with Cieślik and Ryan (2004: 21). I employ a panel

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[12] Katz and Beck (1995) point out that significance levels are prone to be too optimistic when feasible generalised least square (FGLS) is considered and tested.

regression method since the data is available not only in cross-section but also in time-series. The generic TSCS model is as follows:

$$Y_{i,t} = X_{i,t}\beta_1 + \varepsilon_{i,t}, where\ i = 1, \dots, N; t = 1, \dots, T$$

As the generic model (1) demonstrates, Y is a dependent variable. β is a parameter of coefficients to be estimated and therefore explains the marginal effect of the explanatory variables. i and t indicate firm and year, respectively. ε indicates an error term representing immeasurable factors or idiosyncratic shocks and α is an interval term. To enhance the credibility and validity of the estimation, I checked problems of multicollinearity. I found numerous multicollinearity problems (see Table 5-9). First, CORRUPT and CORTAX are highly correlated with all the variables associated with progress in institutional infrastructure (LARGEPRI, SMALLPRI, RESTRUCT, PRICE, COMPETE, BANK, SECURI, and INFRA). Second, these eight institution-specific variables are also highly correlated with each another. Therefore, to avoid encountering biased empirical results, these aforementioned variables are alternately tested in the estimating equations. The following model is built on the aforementioned generic TSCS framework. To avoid the simultaneity problems, the explanatory variables are lagged by one year.

$$\begin{aligned} Y\ (FDICA)_{i,t} = {} & \beta_1(Economic\ conditions)_{i,t-1} + \beta_2(Political\ ideology)_{i,t-1} \\ & + \beta_3(Institutionalization\ of\ FDI\ policies)_{i,t-1} \\ & + \beta_4(Institutional\ arrangements)_{i,t-1} \\ & + \beta_5(Progress\ in\ market-based\ institutions)_{i,t-1} + \varepsilon_{i,t} \end{aligned}$$

The expected signs of the coefficients are as follows: $\beta_1 > 0$, $\beta_2 < 0$, $\beta_3 > 0$, $\beta_4 > 0$, $\beta_5 > 0$. I employed the OLS with PCSE to assess the parameters of the explanatory variables, which determine the evolution of FDI inflows for 10 EU-CEECs plus four Balkan countries utilising the panel data set over the years 1991-2006.

Interpretation: A host country's level of FDI inflows is expected to be positively correlated to its macroeconomic conditions and negatively correlated with the degree of its ideological inheritance of communism. It is expected that the level of FDI is positively correlated with the degree of institutionalization of FDI policies and EU membership. Immature and inconsistent institutional conditions embedded in a host country would have a negative influence over the level of FDI. The reason is that foreign multinationals would have to pay high bureaucratic costs and to encounter a limited degree of protection of intellectual property rights in countries with a weaker institutional framework.

Table 5-8: Description of the Variables Used in the Econometric Analysis

Variables	Description	Sign	Source
Dependent Variable			
FDICA	Log of foreign direct investment adjusted for population		UNCTAD & WDI
Independent Variables			
Economic Conditions			
GDP_{t-1}	Log of gross domestic product (US$ millions)	+	WDI
$MISERY_{t-1}$	Log of sum of inflation rates and unemployment rates (%)	–	WDI
$DISTANCE_t$	Log of distance of each capital to Frankfurt in Germany (km)	–	http://www.uk.map24.com
$OPENNESS_{t-1}$	Trade as percentage of GDP (%)	+	WDI
Political Ideology Formation			
$IDEOLOGY_{t-1}$	Share of post-communist parties of a national election (%)	–	Parties and Elections
$CORRUPT_{t-1}$	Ordinal variable (1=high corruption and 100= low corruption)	+	Economic Freedom
Institutional Arrangements			
EU_t	Dummy variable indicating whether a country is a EU member	+	EU
Institutonalisation of FDI practices			
IPA_{t-1}	Dummy variable representing whether a country has a IPA.	+	Bandelj (2008) and each IPA website
$CORTAX_{t-1}$	Corporate income tax rate (%)	–	Michigan University Global
Progress in Institution-Building			
$LARGEPRI_{t-1}$	Large scale privatisation (1=poorly improved and 5=highly improved)	+	EBRD
$SMALLPRI_{t-1}$	Small scale privatization (1=poorly improved and 5=highly improved)	+	EBRD
$RESTRUCT_{t-1}$	Enterprise restructuring (1=poorly improved and 5=highly improved)	+	EBRD
$PRICE_{t-1}$	Price liberalization (1=poorly improved	+	EBRD
$COMPETE_{t-1}$	Competition (1=poorly improved and 5=highly improved)	+	EBRD
$BANK_{t-1}$	Bank reform (1=poorly improved and 5=highly improved)	+	EBRD
$SECURI_{t-1}$	Securities markets (1=poorly improved and 5=highly improved)	+	EBRD
$INFRA_{t-1}$	Infrastructure (1=poorly improved and 5=highly improved)	+	EBRD

Table 5-9: Correlation Matrix of Multicollinearity

	Variable	Mean (SD)	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1	GDP_{t-1}	4.20 (0.51)	1																
2	$MISERY_{t-1}$	1.51 (0.43)	-0.32	1															
3	$DISTANCE_t$	2.87 (0.16)	-0.48	0.3	1														
4	$OPENNESS_{t-1}$	80.27 (27.41)	0.04	-0.3	-0.24	1													
5	$IDEOLOGY_{t-1}$	22.62 (15.05)	-0.32	0.2	0.27	-0.47	1												
6	$CORRUPT_{t-1}$	38.36 (14.25)	0.43	-0.4	-0.28	0.49	-0.64	1											
7	EU_{t-1}	0.07 (0.26)	0.26	-0.2	-0.08	0.32	-0.19	0.17	1										
8	IPA_{t-1}	0.63 (0.49)	0.40	-0.5	-0.10	0.22	-0.26	0.18	0.21	1									
9	$CORTAX_{t-1}$	29.23 (8.32)	0.10	0.6	-0.09	-0.49	0.23	-0.11	-0.37	-0.48	1								
10	$LARGEPRI_{t-1}$	2.75 (1.00)	0.43	-0.6	-0.17	0.54	-0.43	0.63	0.27	0.70	-0.66	1							
11	$SMALLPRI_{t-1}$	3.55 (1.00)	0.29	-0.5	-0.24	0.34	-0.30	0.60	0.22	0.62	-0.61	0.78	1						
12	$RESTRUCT_{t-1}$	2.33 (0.78)	0.51	-0.6	-0.26	0.48	-0.52	0.73	0.34	0.68	-0.54	0.87	0.79	1					
13	$PRICE_{t-1}$	3.87 (0.77)	0.30	-0.2	-0.06	0.30	-0.33	0.26	0.15	0.50	-0.45	0.66	0.68	0.62	1				
14	$COMPETE_{t-1}$	2.07 (0.75)	0.58	-0.6	-0.27	0.46	-0.45	0.70	0.37	0.66	-0.59	0.82	0.69	0.87	0.56	1			
15	$BANK_{t-1}$	2.63 (0.89)	0.45	-0.7	-0.20	0.50	-0.47	0.61	0.33	0.73	-0.70	0.88	0.81	0.91	0.67	0.81	1		
16	$SECURI_{t-1}$	2.15 (0.81)	0.62	-0.6	-0.27	0.40	-0.47	0.70	0.37	0.66	-0.59	0.80	0.71	0.86	0.52	0.84	0.83	1	
17	$INFRA_{t-1}$	2.15(0.81)	0.53	-0.6	-0.11	0.43	-0.41	0.53	0.35	0.77	-0.67	0.81	0.66	0.80	0.57	0.78	0.85	0.84	1

5.6   Empirical Findings

The panel data set constitutes observations of ten CEE-EU members plus four Balkan countries over the period 1991-2006. Tables 5-10 and 5-11 summarises the econometric findings for the variation in FDI inflows. OLS with PCSE method was used to estimate parameters of the 12 models. In general, the estimations demonstrate strong overall explanatory power that R squared values range from 0.22 to 0.53 except the low R-squared value of 0.104 for the model including only economic-specific variables. The regressions explain well over 50 percent of variation in the pattern of FDI inflows when including the corporate income tax rate variable and the corruption variable. The first and second rows correspond to the estimated coefficients and z-values, respectively.

As the dependent variable, the volume of FDI adjusted for population is used. The twelve model specifications are collapsed into three groups of specifications. The first group of a specification of the regression to run is one including only four macroeconomic variables (GDP, economic instability, distance, and trade openness). The second group is a synthesis of these four macroeconomic variables and political and ideological specific variables (*i.e.*, the ideological inheritance of communism, institutionalisation of FDI practices and EU membership). The third group includes these aforementioned variables plus variables for the degree of sophistication of institutional building.

Empirical evidence concerning the receipts of FDI by the European transition economies suggests that macroeconomic factors as well as non-macroeconomic factors affect the amount of FDI, as seen in Table 5-10. First, results for the market size variable are statistically significant and positive in almost all estimations ($p<0.01$). These results lend support to the notion that the behaviour of foreign firms in CEE are characterised by market-seeking and is of a horizontal nature. Since the market size variable and the dependent variable indicating FDI *per capita* are transformed into logs, this shows that a 1 percent increase in GDP in CEE countries indicates a 0.15-0.65 percent increase in FDI *per capita*. An association between the volume of FDI inflows and a misery index is consistently significant ($p<0.01$) except Model 3 and 9 and is as negatively signed as predicted. It suggests that foreign firms are interested in investing in a foreign market whose economic stability is high. This result is in agreement with the previous literature. All specifications except for Model 3 and 9 demonstrate that trade openness exerts a positive effect on the FDI transactions of foreign firms, indicating that the results are completely different from Wheeler and Mody's assumption that investment in closed markets would allow a foreign firm to gain its monopolistic position due to host government intervention against imported goods. The empirical evidence verifies that integration into the world economy determines the receipts of FDI.

On the other hand, all model specifications show that geographic distance to the

industrial center of the EU does not matter in attracting FDI. Evidence is incoherent with previous studies (Buch *et al.*, 2005). The IPA variable indicating the degree of institutionalisation of FDI practices is statistically significant ($p<0.01$) and exerts a positive effect on FDI *per capita*. The coefficients for this predictor range from 0.27 to 0.49. This result suggests that institutionalisation of FDI policies is likely to mitigate various information costs ranging from market conditions to institutional framework of a given country, hence facilitating internationalisation of business activity of foreign-based enterprises. Moreover, it suggests that transnational companies can benefit from a formal institutional framework to streamline administrative and legal procedures. A signaling effect on FDI inflows is considered. This result is in line with previous studies (Bandelj, 2008; Lim, 2008).

What makes this study unique and different as compared to past literature is the incorporation of the variable of negative political ideology into the model estimations. The communism variable indicating the degree of ideological inheritance of communism is statistically significant ($p<0.01$) and has a negative impact on the behaviour of FDI in the European transition economies. This evidence highlights that investors' attitude and economic transactions are shaped by and embedded in domestic politics. The ideological remnants of communism that hamper institution-building and the convergence of democracy to Western European standards are likely to discourage investment by foreign investors in any given country. This study is supportive of the evidence documented by Bandelj (2008). The level of corporate income tax rates has a negative impact on the pattern of FDI inflows ($p<0.1$).

What is worth noting is that EU membership is not statistically significant in this econometric study, although directional signs are as predicted. This result contradicts evidence documented by previous scholars of economies in transition (Bandelj, 2008; Bevan and Estrin, 2004; Clausing and Dorobantu, 2005). However, the reasons for no impact of EU membership on FDI in this econometric study should be interpreted cautiously. It would be more appropriate to infer that, with prospective EU membership for a given country, foreign multinational corporations operating in that region might have already embarked on the initiatives to reorganise their regional networks of production and service activities even prior to the official entry in 2004 of a particular country.

For instance, one possible interpretation of this result is that the data do not contain any sub-sectoral breakdown in non-manufacturing and manufacturing sectors. Another is that EU regulation on the provision of governmental incentives may have conveyed a negative signal to foreign investors in the aftermath of the eastward expansion of European integration. Hence, it may be too soon to verify the actual impact of EU membership on FDI inflows since the time span observed was only from 1991 to 2006. We would need to expand the data set for future research, but it would be necessary to wait additional time.

Table 5-10: OLS with Panel Corrected Standard Errors for 14 Eastern European Transition Economies, 1991-2006

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Economic Variables						
GDP$_{t-1}$	0.65***	0.37***	0.12*	0.42***	0.20***	0.32***
	(6.71)	(5.84)	(1.95)	(5.55)	(2.82)	(4.48)
MISERY$_{t-1}$	–0.61***	–0.47***	–0.12	–0.26***	–0.19*	–0.17*
	(–6.32)	(–4.32)	(–1.22)	(–2.81)	(–1.72)	(–1.77)
DISTANCE	0.22	0.03	–0.37*	0.34	–0.06	0.11
	(0.82)	(0.11)	(–1.75)	(1.26)	(–0.25)	(0.36)
OPENNESS$_{t-1}$	0.01***	0.006***	–0.0004	0.005***	0.003***	0.005***
	(9.35)	(6.74)	(–0.45)	(5.89)	(3.75)	(4.33)
Non-Economic Variables						
Political Ideology Formation						
IDEOLOGY$_{t-1}$		–0.01***	–0.008***	–0.009***	–0.007***	–0.009***
		(–5.67)	(–4.53)	(–4.47)	(–3.24)	(–4.05)
Institutionalization of FDI Practices						
IPA$_{t-1}$		0.55	0.33***	0.33***	0.43***	0.39***
		(7.00)	(4.68)	(3.44)	(5.04)	(4.00)
CORTAX$_{t-1}$						–0.009*
						(–2.00)
Institutional Arrangements						
EU$_{t-1}$		0.03	0.13	0.007	–0.007	0.09
		(0.30)	(1.14)	(0.06)	(–0.06)	(1.06)
Progress in Institution-Building						
LARGEPRI$_{t-1}$			0.53***			
			(10.26)			
SMALLPRI$_{t-1}$				0.39***		
				(7.13)		
RESTRUCT$_{t-1}$					0.46***	
					(5.98)	
Constant	–1.35	0.37	1.03	–2.32**	–0.10	0.35
	(–1.44)	(0.46)	(1.29)	(–2.20)	(–0.01)	(0.29)
Obs.	190	190	190	190	190	115
Group.	14	14	14	14	14	10
R-squared	0.104	0.227	0.330	0.251	0.252	0.530
Prob>chi2	***	***	***	***	***	***

Note **:** Z-values are reported in parentheses. *** Significant at the 1 percent level, ** Significant at the 5 percent level, * Significant at the 10 percent level. The empirical results presented in Model 6 are based on a sample of CEE-10 only during the period from 1995-2006.

Table 5-11: OLS with Panel Corrected Standard Errors for 14 Eastern European Transition Economies, 1991-2006 (Continued)

Variable	*Model 7*	*Model 8*	*Model 9*	*Model 10*	*Model 11*	*Model 12*
Economic Variables						
GDP$_{t-1}$	0.26***	0.24***	0.15**	0.23***	0.21**	0.27***
	(4.80)	(3.56)	(2.39)	(3.20)	(2.44)	(4.10)
MISERY$_{t-1}$	–0.53***	–0.37***	–0.06	–0.36***	–0.34***	–0.27***
	(–6.08)	(–3.37)	(–0.72)	(–3.04)	(–3.23)	(–2.73)
DISTANCE	–0.19	–0.05	–0.20	–0.09	–0.30	0.11
	(–0.83)	(–0.21)	(–0.87)	(–0.37)	(–1.12)	(0.36)
OPENNESS$_{t-1}$	0.004***	0.004***	0.001	0.004***	0.004***	0.006***
	(4.25)	(5.35)	(1.41)	(5.79)	(4.09)	(6.31)
Non-Economic Variables						
Political Ideology Formation						
IDEOLOGY$_{t-1}$	–0.008***	–0.01***	–0.007***	–0.01***	–0.01***	–0.003
	(–4.19)	(–4.83)	(–3.11)	(–4.73)	(–5.13)	(–1.38)
CORRUPT$_{t-1}$						0.001
						(0.27)
Institutionalization of FDI Practices						
IPA$_{t-1}$	0.38***	0.47***	0.27***	0.49***	0.38***	0.28***
	(5.13)	(5.63)	(3.06)	(5.56)	(4.12)	(3.15)
Institutional Arrangements						
EU$_{t-1}$	0.06	–0.008	–0.02	0.004	0.03	0.12
	(0.56)	(–0.07)	(–0.16)	(0.03)	(0.22)	(1.23)
Progress in Institution-Building						
PRICE$_{t-1}$	0.55***					
	(13.50)					
COMPETE$_{t-1}$		0.24***				
		(3.21)				
BANK$_{t-1}$			0.63***			
			(10.20)			
SECURI$_{t-1}$				0.20***		
				(3.18)		
INFRA$_{t-1}$					0.28***	
					(3.78)	
Constant	⁻0.43	0.63	0.023	0.78	1.45	0.43
	(⁻0.54)	(0.73)	(0.03)	(0.91)	(1.56)	(0.45)
Number of obs.	190	190	190	190	190	130
Number of grou	14	14	14	14	14	14
R-squared	0.317	0.221	0.350	0.219	0.221	0.534
Prob>chi2	***	***	***	***	***	***

Note **:** Z-values are reported in parentheses. *** Significant at the 1 percent level, ** Significant at the 5 percent level, * Significant at the 10 percent level. Empirical results presented in Model 12 are based on a sample of 14 countries for the period from 1997-2006.

Table 5-12: Summary of Empirical Results

Variables	1	2	3	4	5	6	7	8	9	10	11	12
Economic Variables												
GDP	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)**	(+)***	(+)**	(+)***
MISERY	(−)***	(−)***	NS	(−)***	(−)*	(−)*	(−)***	(−)***	NS	(−)***	(−)***	(−)***
DISTANCE	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS
OPENNESS	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	NS	(+)***	(+)***	(+)***
Non-Economic Variables												
Political Ideology Formation												
IDEOLOGY	–	(−)***	(−)***	(−)***	(−)***	(−)***	(−)***	(−)***	(−)***	(−)***	(−)***	–
CORRUPT	–	–	–	–	–	–	–	–	–	–	–	NS
Institutionalization of FDI Practices												
IPA	–	NS	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***
CORTAX	–	–	–	–	–	(−)*	–	–	–	–	–	–
Institutional Arrangements												
EU	–	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS
Progress in Institution-Building												
LARGEPRI	–	–	(+)***	–	–	–	–	–	–	–	–	–
SMALLPRI	–	–	–	(+)***	–	–	–	–	–	–	–	–
RESTRUCT	–	–	–	–	(+)***	–	–	–	–	–	–	–
PRICE	–	–	–	–	–	–	(+)***	–	–	–	–	–
COMPETE	–	–	–	–	–	–	–	(+)***	–	–	–	–
BANK	–	–	–	–	–	–	–	–	(+)***	–	–	–
SECURI	–	–	–	–	–	–	–	–	–	(+)***	–	–
INFRA	–	–	–	–	–	–	–	–	–	–	(+)***	–
Obs.	190	190	190	190	190	115	190	190	190	190	190	130
Group.	14	14	14	14	14	10	14	14	14	14	14	14
R-squared	0.10	0.23	0.33	0.25	0.25	0.53	0.32	0.22	0.35	0.22	0.22	0.53
Prob>chi2	***	***	***	***	***	***	***	***	***	***	***	***

Note : NS indicates not significance. (+/−): Sign of causal association.

Consistent with prior scholarship (Demekas *et al*., 2007; Grosse and Trevino, 2005), findings for institutional change show that all variables relating to the quality of institution-building are statistically significant ($p<0.01$) and positive. In particular, progress in banking reform, price liberalisation and large-scale privatisation is an inevitable element for attracting foreign capitalists. The positive relationship between large privatisation and FDI receipts to CEECs suggests that the spread of private ownership leads foreign firms to reduce transaction and coordination costs, facilitates the search for local partners with strategic business objectives similar to those desired by foreign firms and creates market-supporting economies (Bevan *et al*., 2004: 48). The result concerning the impact of competition policy on the magnitude of FDI suggests that competition policy eases foreign investors' market entry (Bevan *et al*., 2004). Foreign firms may not be in favour of positioning themselves in a country whose governmental authorities frequently intervene in market competition to protect monopolistic rents of particular domestic and foreign enterprises for political interests. Progress in bank reform suggests that foreign investors tend to rely on local banking channels to finance their service and manufacturing operations. The relevance of overall infrastructure to FDI receipts may be because well-established infrastructural service helps foreign investors minimise operational costs.

In sum, the conventional wisdom holds that the motives for internationalisation of economic activity of foreign multinationals are based on market-seeking (*e.g.*, market potential, as measured by GDP) and efficiency–seeking considerations (*e.g.*, labour productivity, as measured by misery index). In addition, I find that strategic decisions of foreign investors are embedded in the path-dependency of political ideology, institutionalisation of FDI policies and systemic evolution of institutional infrastructure. In contrast to the prediction, it is found that foreign investors are not sensitive to individual acts of corruption in a given country examined in this econometric study. However, this result requires further consideration that there may be a great variation among the type and the field of FDI. For instance, in the privatisation process, foreign investors participate in competitive biddings that are not based on "*price and quality*" but on "*criteria*" in Central and Eastern Europe (Tupy, 2006: 9). In the European transition economies, economic transactions are framed not by the optimal point between demand and supply, but in a web of social forces and the game of politics. Accordingly, formal and informal negotiations with multiple local actors whose interests are divergent are likely to give rise to a space for corruption.

5.7 Conclusions

Contrasting the approach adopted in this study with previous studies that are biased toward an analysis of determinants of FDI in a conventional economic context, this chapter sheds light on the institutional perspective. The concept of institutions has been extended to studies of entry mode, but inadequate attention has been directed toward

whether sophistication of institutional infrastructure acts as a catalyst for making the FDI recipient country more attractive.

Although the ex-Soviet type economies have been converging towards the standards of pure market-supporting economies since the early 1990s, the speed and sequence of transitional reforms vary broadly by country and field. Some ex-socialist economies (*e.g.*, Hungary, Poland and ex-Yugoslavia) sought to set forth their own mass privatisation process in conjunction with MNEs and their own citizens in the 1990s, while others (*e.g.*, Czech Republic, Bulgaria) failed due to various formal and informal institutional constraints persisting from the past. Kornai (2006: 210) noted that "the characteristic institutions of capitalism - private property, hired labour, market-type buying and selling, a credit system, and a legal system protecting the sanctity of private property and contracts - evolved in various countries at various speeds".

Employing the OLS with PCSE technique on a sample covering around ten CEECs plus four Balkan countries for the period 1991-2006, it was examined how the quality and specificity of institutional change and continuity (*e.g.*, progress in institutional building, political ideological orientation and institutional arrangements) affected FDI transactions in transition economies. I have demonstrated that FDI inflows are sensitive to institutional infrastructure in a given European transition economy in the context of state-level policies. Empirical findings show that European transitional economies with poor institutional quality experience limited FDI inflows, while controlling for other economic-specific variables. This econometric study identifies key economic and institutional factors that motivate FDI inflows in CEE as follows (see Table 5-12):

- Market size;
- Economic stability;
- Economic openness;
- Ideological legacies of state socialism;
- Institutionalisation of FDI policies; and
- Improvement of institutional quality.

It was shown that unreformed and insular countries in transition tend to have lower FDI inflows. The findings also suggest that the political ideology affects the geographical distribution of FDI in transition economies. What also deserves attention is that the establishment of IPAs gave an impetus for attracting FDI receipts to a given country, indicating that the significance of active state action in showing a welcoming-attitude to foreign capitalists. This study presented evidence that integration into the global economy by means of trade also stimulated further FDI inflows. In other words, a country's trade openness hints at the extent to which foreign multinational corporations can export freely. On the other hand, somewhat surprisingly, EU

membership did not necessarily confer rapid foreign capital inflows to European transition economies. The stage achieved in the transformation process is a crucial determinant of FDI in CEE. Reflecting on the empirical results presented here, host-based policy makers have to be aware of the fact that new investments or additional investments will not occur unless dependency on the informal and hidden economy is overcome. In other words, investors keep an eye on progress in institutional arrangements favourable to them. At the same time, it is natural to think that foreign investors themselves should continue to improve the ability to adapt to changing institutional conditions over time. It implies that organisations and institutions co-evolve in the European transition region.

There are a number of open issues to be addressed in future research. First, it would be fruitful to examine how the magnitude of coefficients of EU membership on FDI inflows differs by sectoral distribution and entry timing at a firm-level. Second, institutionalisation of FDI practices should be operationalised in a more appropriate fashion. It hence requires a context-specific approach. Third, future research should pay attention to industry heterogeneity, since each industry may force MNEs to meet an idiosyncratic set of conditions.

In sum, this chapter identifies that a higher degree of political and economic stability, improvement of institutional infrastructure, trade liberalisation, institutionalisation of FDI policies, and ideological inheritance of state socialism were robust forces in generating higher FDI inflows. Last but not least, one of the major implications for host-based policy makers in the European transition economies is that the continued upgrading of institutional quality must ensure that history will not repeat itself in the future.

6   WHAT DETERMINES THE LOCATION CHOICE BY JAPANESE MNEs IN EUROPEAN TRANSITION ECONOMIES AT THE SUB-NATIONAL REGIONAL LEVEL?

When studying the location decisions of FDI, the international business literature has almost exclusively focused on countries as the unit of analysis, while largely ignoring location within countries.

Meyer and Nguyen, 2005: 71

6.1 Introduction

Which determinants affect FDI location decision in the post-communist economies in Central and Eastern Europe (CEE)? Are foreign firms' investment strategies mostly influenced by emerging market demand in CEECs and their wage differentials with Western Europe? Do positive agglomeration externalities that arise from the spatial concentration of firms simply account for the rise in the number of foreign firms in CEE? Does spatial separation occur at a certain point in time? How do a firm's intangible and tangible resources yield influence over its geographic orientation? Not only a change in a variety of pull-push factors but also the extent of global integration of a firm's cross-functional units as well as the level of host-based government interventions complicate a firm's location selection process (Buckly and Casson, 1995). It has been perceived among scholars of economic geography (Krugman, 1991) and international strategic management (Chang and Park, 2005; Chung and Song, 2004; Porter, 1994; Shaver, and Flyer, 2000; Yamawaki, 2006) that the choice of FDI location is as important as entry mode and entry timing since it places constraints on the extent to which a firm can reduce operational costs and facilitates the reorganisation of existing value-creating units beyond boundaries.

At the same time, an in-depth analysis of systemic patterns of foreign entrants for plant location selection at a sub-national regional level is also critical for host-based government officials seeking to attract FDI inflows as a driver for economic development of disadvantaged regions in CEE. A firm may be able to successfully minimise transaction costs and the liabilities of newness and foreignness if the firm finds an optimal location based on sufficiently reliable information (Meyer, 2001; Meyer and Nguyen, 2005). The acquisition of formal and experiential knowledge about the site search process of foreign multinationals in CEE should allow the host government to propose policies designed to rationalise the smooth transfer of advanced product technology and superior managerial know-how to incumbent firms in regions that require effective allocation of limited resources. Moreover, it has also been argued that a dynamic inflow of foreign capital would help the ex-Soviet type economies to

gain tax revenues accruing from foreign firms' local operations.

Needless to say, it has been widely acknowledged that Hymer's monopolistic advantages (1960) and Cave's internalisation hypothesis (1971) contribute to answering the questions of *why* firms become multinational and *why* they internalise and exploit their competitive advantages by means of direct investments over non-equity entry modes. However, these theories are insufficient to detect *why* a firm chooses to locate at a specific site at a specific time. By integrating various theoretical works: (1) Marshall's agglomeration logic (1920); (2) old and new Dunning's OLI configurations (1981, 1993, 1998, 2005, 2008); (3) Porter's Diamond Model (1990); (4) the resource-based view of the firm; and (5) network theory, I develop a holistic model of the location choice of MNEs.

To date, many scholars of international economics, strategic management and economic geography have been devoted to constructing various models and elaborating on foreign firms' location strategies in the US, China and Europe. As far as Europe is concerned, most scholarly attention has been directed towards old EU member countries (Cieślik and Ryan, 2004). Most of the previous literature about the choice of FDI location in CEE have drawn on aggregate data sets and used survey and case study methods (*e.g.*, Bandelj, 2002, 2008; Bevan and Estrin, 2004; Grosse and Trevino, 2005). Some studies (Boudier-Bensebaa, 2005; Cieślik, 2005a; Cieślik and Ryan, 2005; Deichman, 2004; Deichmann and Karidis, 2005) used disaggregate data sets and attempted to examine MNE location choice at a single-country level. Spatial analysis of MNE activity at a sub-national, regional level should contribute to economic development within the single-country context.

In an analysis of plant location decisions at the disaggregate level in Vietnam, Meyer and Nguyen (2005: 68-70) note that "local governments put polices devised by the central government in practice locally and provide foreign investors with assistance for applying for land permits and various grants at the central level". Moreover, foreign investors have to negotiate with local authorities over business licenses, real estate, access to public utilities, and in some countries, tax incentives and subsidies. Chang and Park (2005: 68) also claim that scholars should direct more attention towards the choice of FDI location decisions on the basis of the sub-national regional unit since the level of macroeconomic, social and institutional development varies greatly by region. This particular focus could strengthen empirical grounds for location decisions by foreign multinationals who seek to choose an appropriate place to gain high risk-adjusted returns on investment, achieve scale economies and minimise production costs at the same time.

This research is unique because of the following: First, none of the previous studies, with one notable exception (Cieślik and Ryan, 2005), has focused on Japanese investors' location choices in CEE, although many have explored those in the United States (Florida and Smith, 1994; Head *et al*., 1995; Ó Huallacháin and Reid, 1997),

Western Europe (Head and Mayer, 2004; Yamawaki, 2006) and China (Belderbos and Carree, 2002; Cheng and Stough, 2006; Wakasugi, 2005). Moreover, to date, no research on location patterns for other Asian investors (*e.g.*, Korean and Taiwanese investors) in CEE has been done.

Second, the sample periods covered in the previous studies concerning the spatial distribution of FDI in CEE were only focused on the 1990s. The inclusion of post-EU enlargement years should provide deep insights into changes in location strategies of foreign investors, notably in the explanation of the choice of Japanese manufacturing FDI.

Third, to date, only a few scholars (*e.g.*, Cieślik and Ryan, 2005; Schlunze, 2006) try to unravel the question of which determinants are responsible for explaining the locational determinants of Japanese MNEs in CEE at the sub-national regional scale. Accordingly, research on this issue remains sparse. Limited data availability and small Japanese FDI inflows relative to EU counterparts in CEE tend to deter researchers from investigating the causal nexus between the spatial behaviour of Japanese subsidiaries and locational advantages inherent in CEE in greater detail and have hence resulted in this marginal interest. Moreover, this sparse attention also seems to echo the early stage of the internationalisation of Japanese firms in the European transforming economies.

The goal of this chapter is hence to provide evidence that identifies determinants that affect Japanese manufacturing firms' location strategies in the former Soviet satellite economies by shedding light on sub-national regions as the unit of analysis. In this current study, Bulgaria, Czech Republic, Hungary, Lithuania, Montenegro, Poland, Serbia, Slovakia, Slovenia, Romania are included. In assessing the spatial dynamics of Japanese FDI in CEE, I will employ McFadden's conditional logit model (1974). This discrete choice model at the disaggregate level provides concrete insights into each individual firm's site selection compared to ordinary least square (OLS) method that is instead based on the aggregate approach along with FDI stock (Cheng and Stough, 2006). In other words, McFadden's discrete choice model enables us to analyse Japanese FDI in CEE at a firm level. In this chapter, I will particularly seek to clarify the following questions:

- Where in particular did Japanese manufacturing firms invest in CEE at a sub-national regional level?
- What economic and non-economic factors can explain the location choice of Japanese manufacturing firms in CEE?
- To which extent does a web of *keiretsu* enterprises, which represents the social organisation of Japanese economy, play a pivotal role in shaping the geographical allocation of Japanese manufacturing FDI in CEE?
- How did the magnitude of agglomeration forces in the proliferation of Japanese manufacturing FDI evolve over time?

The data set used for this study consists of 205 Japanese manufacturing subsidiaries and 21 Nomenclature of Territorial Units for Statistics (NUTS-1) regions comprising 10 aforementioned countries in CEE in the period 1991 to 2006. The intention of this chapter is to detect how economic and non-economic factors influence Japanese MNEs' location choices in the CEE region (see Figure 6-1). The remainder of this chapter is organised as follows. In Section 6.2, I highlight the role of agglomeration economies in both economic and institutional considerations. In Section 6.3, testable hypotheses are developed in line with a brief summary of literature reviewing the relevant location attributes that could determine the choice of FDI location by Japanese manufacturing firms. Then, Section 6.4 and Section 6.5 demonstrate methodology, the description of sample selection, econometric models the operationalisation of explanatory variables and data sources. Empirical findings in the conditional logit model will be presented in Section 6.6, and Section 6.7 presents concluding remarks with propositions for future research.

Figure 6-1: Conceptual Model
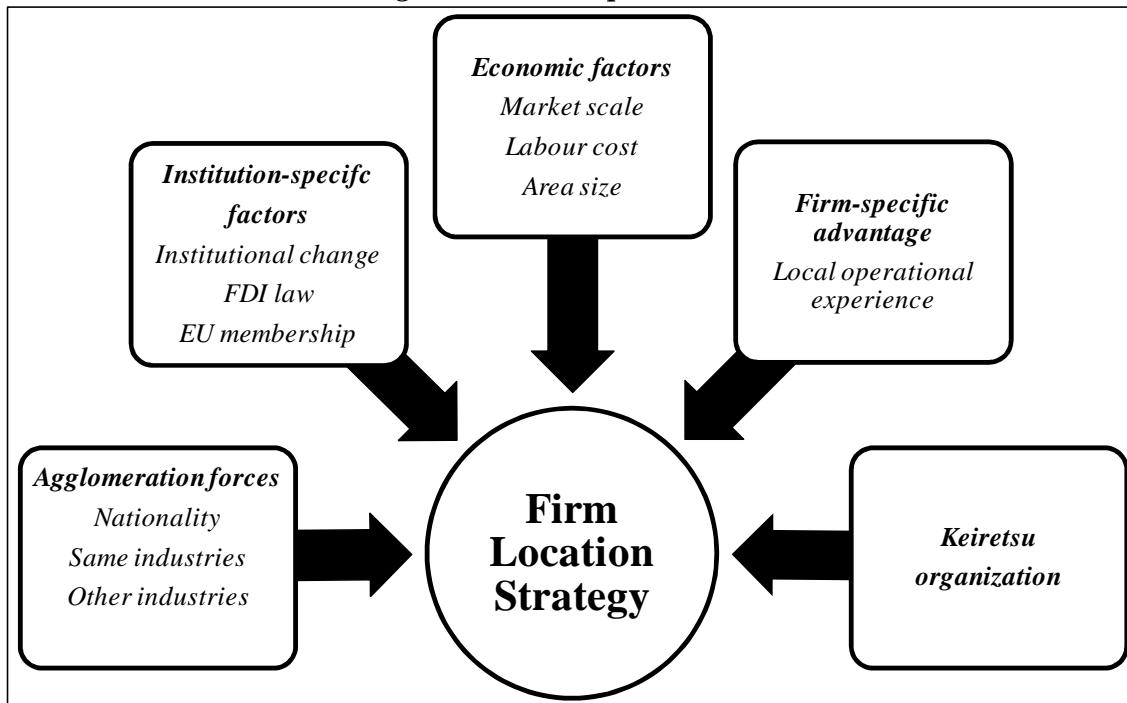
6.2 Agglomeration Economies in Economic and Institutional Considerations

There are two types of theoretical approaches toward an explication of a causal link between multinational corporations' location choices and agglomeration externalities when investing abroad. One relies on the economic perspective of agglomeration that a firm is likely to prefer industrial concentration to industrial dispersion because the

former would maximise risk-adjusted returns on investment and productive efficiency resulting from access to potential suppliers (Marshall, 1920), labour pooling (Krugman, 1991), information advantage and innovation-creating synergies (Porter, 1998). Another is based on the institutional perspective of agglomeration that the firm is likely to follow other firms in its quest for legitimacy in uncertain and unfamiliar environments. Namely, political, economic and institutional hazards would compel the corporate strategy to be more homogeneous (DiMaggio and Powell, 1983). DiMaggio and Powell (1983) integrate the term of isomorphism (Hawley, 1968) into organisational modelling and conceptualise the behaviour of organisations to be mimetic. Now let us turn to explain these two types of motives behind the causal association between location and agglomeration with greater detail.

6.2.1 Economic Considerations

As already discussed in the previous chapter, a fine-grained analysis of the concept of agglomeration economies serves as a critical step for tracing the localisation process of offshore business activity of foreign firms. It has been recognised among scholars in the fields of economic geography (Krugman, 1991; Marshall, 1920) and strategic corporate management (Porter, 1990) that firms face critical tradeoffs between costs and benefits in terms of agglomerative externalities. Discussing the positive aspect of agglomeration economies, Marshall (1920), a father of 'localisation' logic, stresses that the geographic concentration of specialised industries in particular localities would enhance the attractiveness of a particular host country or region to a foreign investor because of a pool of skilful labour capital and easy access to specialised inputs in proximity (Marshall, 1920). MNEs might prefer to interact with other foreign firms if the quality of the locally manufactured intermediate goods by domestic firms is lower than what MNEs expect. For consumers, agglomerative forces may also facilitate making visual inspection easy and reduce the frequency of their visits. Saving information gathering costs pertaining to new customers and potential suppliers is also part of the underlying concept of Marshall's agglomeration externalities.

Porter (1990) also argues that proximity stimulates the speed and scope of information flows over the attitudes, actions and strategies of competitors and on the dynamic complexity of local market conditions. As pointed out by Porter (1998), agglomeration economies encourage an organisation to collaborate with other organisations in the form of strategic alliances, increasing the probability of creating new technologies. Following Porter (1998), Tamayo (2000) also claims that industrial concentration would enable multiple organisations to learn marketing strategies from each other and would promote a pool of labour capital with specialised knowledge and expertise. Formal and informal knowledge that firms have acquired from and shared with other competitors in space reformulates the way of doing business more successfully in foreign markets, thus improving product quality and production

processes within their internal settings.

Scholars of economic geography (Arthur, 1990; Krugman, 1991) stress that the increased intensity and density of spatial clustering encourage firms to co-locate owing to increasing returns. Chung and Song (2004: 543) point out that "sequential entrants may take advantage of specific infrastructure already established by earlier foreign entrants, such as specialised suppliers and local institutions that sensitised to new entrants' requirements". Silicon Valley is one of best examples for this phenomenon, and Chang and Park (2005) suggest that positive agglomeration externalities neutralise rising costs that arise from intensified competition.

Conversely, the negative element of agglomeration externalities has also received attention from scholars (Chang and Park, 2005; Chung and Song, 2004; Head *et al.*, 1995; Oerlemans and Meeus, 2005; Shaver and Flyer, 2000). Oerlemans and Meeus (2005) argue that spatial proximity may yield more risks and uncertainties than benefits. Spatial clustering of firms may reduce potential investors' incentives to co-locate due to intensification of competition over time (Chung and Song, 2004; Head *et al.*, 1995). In the context of spatial proximity, the emergence of a large number of rivals tends to minimise lucrative local monopolies and rents that a firm seeks to exploit. It is critical to note that rising demand may result in pushing the price of inputs upwards (Head *et al.*, 1995; Chung and Song, 2004). Chung and Song's (2004) study appears to vindicate the argument that the propensity for this geographical isolation may notably increase when transportation costs are not expensive.

In a similar vein, as time elapses, competition for labour appears to be of more serious concern to firms operating in clusters since the supply of pooled talented labour is not always abundant. As indicated by Shaver and Flyer (2000), spatial concentration of economic activities enables firms to hire and attract competitors' employees with an offer of higher wages, indicating that the turnover rate of indigenous employees would trend higher over time. It is pointed out by the authors that whether a firm agglomerates or not depends on firm-specific traits such as the possession of technological competencies. Belderbos and Carree (2002) also document that, *ceteris paribus*, the more innovative firms are, the greater contribution they are likely to make to promoting spillovers within industry clusters. Puga (2002) argues that there may be a strong upward pressure on wages in order to prevent larger migration flows. Given these accounts, it can be said that the positive effects of spatial externalities may die out due to the upward trend of wage levels accruing from the growing intensity of competition for attracting talented labour. A limited supply of human capital may also inhibit potential foreign capital inflows and may hence reduce the probability of new R&D development projects by foreign investors who aim at promoting higher value-added activities. Chang and Park (2005) demonstrate in an analysis of Korean manufacturing FDI in China that marginal benefits should be surpassed by marginal costs at a certain point in time, while firms gain more profits from agglomeration economies at the initial

stage. Chang and Park find that the causal relationship between location selection by firms and agglomeration is an inverse U-curve.

6.2.2 Institutional Considerations

Apart from a heated debate on the role of mimetic behavior in stimulating a firm's plant locations and in enhancing economic welfare, scholars (DiMaggio and Powell, 1983; Guillén, 2002; Henisz and Delios, 2002) view the causal interplay between multinationals' plant location decisions and agglomeration externalities through a different lens, as compared to economists and business elites. The prior research (Belderbos and Sleuwaegen, 1996; Chang and Park, 2005; Guillén, 2002; Martin *et al*., 1998) underscores that the behaviour of organisations tends to be structured, developed and recreated by the desire to raise legitimacy and acceptance, suggesting that mimetic isomorphism would reduce economic and political uncertainty and risks (DiMaggio and Powell, 1983; DiMaggio and Powell, 1991; Scott; 1995) when investing abroad. Henisz and Delios (2001: 447) who study plant location patterns of 2,705 Japanese firms across 155 countries argue that "the number of firms adopting the same strategy or the similarity and/or strength of the information flow between a focal firm and the firms that it chooses to imitate may also influence rational bandwagons".

Barry *et al*. (2003) stress the importance of demonstration and reputation effects that indicate that existing firms send signals about the reliability and attractiveness of the host country to potential investors. Imitating investors' being already in operation in countries with favourable locational advantages appears to send a positive signal to banks that provide financial assistance to investors (Barry *et al*., 2003). Now let us turn to develop hypotheses based on a review of past scholarship.

6.3   Review of the Literature and Hypotheses Formation

6.3.1 Classic Economic-Forces

Market demand conditions

Market size is a classic economic variable in explaining the choice of FDI location for market-seeking investors, while the abundance of natural resources induces resource-seeking investors. To date, numerous scholars have directed their attention toward market potential. Driffield and Munday (2000) report that industry size and growth, as a proxy for the level of scale economies, encourages the sequential entry of foreign companies in the UK economy. Employing 117 Korean manufacturing firms in the EU during the period 1986-1997 in a conditional logit model, Hong and Kim (2003) find that the market size of the host country exerts a significant and positive impact on the spatial distribution of Korean manufacturing firms. The larger and the more stable the domestic market demand, the higher the possibility that a foreign firm can benefit from taking advantage of economies of scale. Head and Mayer (2004) find that market

potential, as measured by two primary indicators such as Harris market potential and Krugman market potential, has a significant and positive impact on the spatial concentration of Japanese firms in the EU. However, Yamawaki (2006) argues that the impact of economic potential may depend on characteristics of FDI, suggesting that the demand factor variable could be insignificant if MNEs target neighbouring markets through exporting. Hence, I test the following hypothesis:

Hypothesis 1: *Japanese manufacturing firms are more likely to locate in regions where market potential is large.*

Labour costs

It has been recognised that labour cost corresponds to the structure of employment. Similar to the unemployment rate variable, labour cost factor might also have two conflicting outcomes. Hansen (1987) postulates a positive association between location choice and wage, indicating that (1) labour is more efficient, (2) labour has more years of job experience and (3) the seasonality of labour may be induced by higher wage rates. Following the view of Hansen (1987), Majocchi and Strange (2007) argue that labour cost provides an indication of the level of host regions' labour productivity and average purchasing power since there generally is a positive correlation between salary and labour quality. Woodward (1992: 699) argues that "high wage level is considerably detrimental to site selection for manufacturing", while Head (1999: 206) suggests that "high skill intensity of Japanese manufacturing plants would result in the apparent preferences for high-wage regions". Belderbos and Carree (2000) provide evidence that Japanese electronics firms prefer to locate in a region where labour costs are inexpensive in the case of China since most electronics assembly operations are characterised by their labour-intensiveness.

In addition to previous studies, Cheng and Stough (2006) note that two more inferences behind the positive relationship between labour costs and location choice should be taken into account, with caution. One is that high wages can be an indicator of high quality of life, enabling the population to enjoy a variety of shopping opportunities and better social services (hospitals, libraries and the like). Another is that high wage levels may result from high inflation levels. Campos and Kinoshita (2003) point out that labour costs will be an important location factor for investors aiming at exporting finished products from CEE to Western Europe. The authors also stress that labour costs play a vital role in the choice of FDI location as far as low labour productivity cancels out low labour costs. High wage levels as a proxy for labour quality is of critical importance since labour quality is conditional on the introduction of Japanese management systems. Consequently, two hypotheses are put forward.

Hypothesis 2a: *Japanese manufacturing firms are more likely to locate in regions where labour costs are low.*

Hypothesis 2b: *Japanese manufacturing firms are more likely to locate in regions where labour costs are high.*

Area size

Conventional wisdom prevails that small regions or countries are less attractive than large regions or countries due to the availability of potential sites. Previous studies (Head and Mayer, 2004; Woodward, 1992) identify that the size of land is an important scholarly explanation of location choice for Japanese manufacturing firms in the United States and Europe, mirroring that, *ceteris paribus*, the larger the land size the higher probability of the region being chosen by Japanese investors.

In contrast, Friedman *et al.* (1992) confirm that Japanese and European firms were more motivated to invest in regions with less land available, while the land size variable had no significance when testing all the sampled firms. Cieślik (2005a, 2005b) find that the relevance of area size of *voivodship* in Poland in recruiting FDI is less important compared to other locational variables. In Woodward and Rolfe's (1993) study, since the estimated coefficients for the area size of each country in the Caribbean Basin region are positive but insignificant they draw a conclusion that there is no association between area size and location choice. Therefore, the directional sign of the land size variable remains inconclusive. I test the following hypothesis:

Hypothesis 3: *Japanese manufacturing firms are more likely to locate in regions where land size is large.*

6.3.2 Institutional Change

Progress in Institutional Infrastructure

The effect of institutions on FDI in transition economies has drawn less attention than that in developed countries (Grosse and Trevino, 2005). There has been consensus of the link between FDI and the quality of institutions. Disdier and Mayer (2004) incorporate the degree of economic freedom of a country in Europe into their location choice study and find that institutional deficiencies are responsible for reducing French firms' incentive to locate. Grosse and Trevino (2005), in a longitudinal analysis of FDI inflows into 13 CEE countries during the period 1990-1999, advance and test the study of the impact of the quality of institutions on FDI inflows, measured by various institutional variables (corruption in government, political risk index, rule of law, repatriation controls, EBRD index of enterprise reform, and change in consumer price index). The authors also find that bad institutions constrain FDI inflows. Drawing on evidence from previous studies, I expect the role of institutions to be of great significance. The premise to test is as follows:

Hypothesis 4: *Japanese multinationals are more inclined to invest in a region where political and economic institutions are stable.*

Institutionalisation of FDI policies

It has been argued among researchers and host-based policy makers that policy incentives are a crucial strategic instrument in influencing foreign firms' location choices in foreign markets. Host governments tend to attract foreign investors to deprived areas through financial and fiscal incentives, such as vocational training grants, new employment grants, and tax-holidays. It indicates that these policy incentives are likely to help to reduce the trend for a polarisation on the capital regions. From a corporate strategy point of view, it is expected that policy incentives enables foreign firms to curtail operational costs. Cheng and Stough (2006) find that the impact of policy incentives at the national level is more robust than those at the provincial level in China, suggesting that policy efforts made by provincial governments are neither sufficient nor effective.

In the Czech Republic, an investor obtains incentives ranging from 20 percent to 50 percent of the investment amount in a given region in accordance with state aid rules established by the EU (CzechInvest, 2004). Provided that a firm invests in a region with high unemployment rates, the government subsidises the firm with 200,000 CZK (almost 6,300 Euro) *per capita* for new employment and 35 percent of vocational training costs at a maximum in the Czech Republic.[13] On the other hand, these FDI incentives will be abolished or revised due to the application of EU competition policy, while EU membership enables CEE countries to receive a great deal of benefits, such as simplification of customs clearance, lowering of tariffs and access to Structural and Cohesion Funds.

From a scholarly point of view, it is worth pointing out that policy incentives have a confounding effect on foreign firms' location choices. Taking a closer look at the positive contribution that policy incentives make to plant location choices, Meyer and Nguyen (2005) find that a region with institutions such as industrial parks that facilitate access to scarce resources may attract more FDI at the provincial level in Vietnam by employing a negative binomial count model. Meyer and Jensen (2005) argue that special economic areas to attract greenfield investments may play a more important role in shaping investors' location choices in countries that completed privatisation.

With a negative binomial count model, Makabenta (2002) provides a detailed account for the impact of special economic zones on the spatial distribution of FDI in the Philippines. According to the author, the impact of special economic zones (SEZs) varies by region and time. SEZs in poor regions tend to weaken economic links with

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[13] See JETRO home page for more detailed information.

foreign investors. The impact of SEZs in the period 1993-1998 is more powerful than that in the period 1987-1992. Wakasugi (2005) identifies that the impact of SEZs on Japanese firms' location patterns vary by industry in China. In his analysis, it is also clarified that the average probability elasticity for Japanese FDI in the food processing industry is the highest, followed by chemicals and transportation equipment. Hence, numerous scholars confirm that benefits from policy incentives to attract FDI are promising since input costs, such as labour training costs and environmental standards costs, are diminished.

On the other hand, there are empirical findings that FDI is not necessarily responsive to policy incentives. For instance, Basil *et al*. (2003) employ the nested logit model and find that EU regional policy attracts EU MNEs to Cohesion Funds countries and Objective 1 regions, while only Objective 1 regions lure US MNEs. In contrast, as far as the spatial behaviour of Japanese firms in the EU concerned, Head and Mayer (2004) find that the countries that were qualified to receive EU Structural Funds failed to attract Japanese investment during the period 1984-1995.

Cieślik and Ryan (2005) analyse the Japanese FDI flows in Poland using a province-level data covering years 1991-2001. The authors also identify that SEZs do not raise the probability that a host region is selected, while controlling for other locational characteristics. Cieślik and Ryan also discuss that it may be too early to judge that fiscal incentives are not efficient FDI policy tools since the role of SEZs is measured by a binary dummy variable instead of the use of detailed data such as the amount of grants and tax exemptions. In accordance with the above empirical findings, I postulate the following hypothesis:

Hypothesis 5: *Japanese manufacturing firms are more likely to locate in regions where FDI practices are more institutionalised.*

EU membership
I propose that EU membership stimulates a CEE country's efforts to develop institutional infrastructure and thus increases the likelihood that a firm would choose the country. Empirical research, as noted by Bevan and Estrin (2004), confirms that the effect of Agenda 2000 on FDI is statistically significant and positive at the 1 percent level. Of great importance in Bevan and Estrin's study is that the first entry candidate countries including the Czech Republic, Estonia, Hungary, Poland, and Slovenia, as measured by a binary dummy variable, are positively related to FDI inflows. Suganuma (2006), in an analysis of 18 CIS and CEE countries over the period 1993-2003, also finds that EU membership positively influences FDI inflows. Iwasaki and Suganuma (2007) also document that FDI intensity significantly changes depending on whether or not countries completed the entry negotiations. In these studies in a macroeconomic perspective, panel data is commonly used. However, there has been little or no evidence

about the impact of EU membership on foreign MNEs' location choices at the firm-level.

Hypothesis 6: *Japanese manufacturing firms are more likely to locate in countries that are officially part of the European Union.*

6.3.3 Firm-Specific Advantages

Prior experience

Previous studies address that foreign multinationals learn from their prior experiences in a host location and familiarity increases their propensity to reinvest (Johanson and Vahlne, 1977). A consensus on the positive impact of experience on the internationalisation of a firm has been built on previous relevant studies. International experience is considered one of the vital factors in penetrating foreign markets by way of direct investment instead of exporting or licensing. Davidson (1980) advocates the argument that cumulative experience gives rise to learning, which leads to the development of the firm. It is more difficult to duplicate and transfer experience due to its intangible nature. Some behavioural theorists lend credence to the relevance of experience in determining the variations in perception of performance of MNEs. The accumulation of experience is believed to be a contributor to formulating more efficient corporate strategies.

Johanson and Vahlne (1977) argue that experience constitutes an intangible asset that rests on two types of knowledge: (1) general knowledge and (2) experiential market-specific knowledge. Yu (1990: 561) argues that "general international operations experience, which is composed of country-specific experience and experience gained from managing a network of operations in different countries, tends to lead a firm to conduct more international operations". Yu (1990) examines the determinants of international expansion of 100 US firms in developed and developing countries.

Consistent with Davidson (1980), Yu (1990) finds that the more experienced a firm is in international activities the higher probability it is able to invest in new overseas operations. In Yu's study, the coefficient on the experience effect is statistically more robust in developed economies compared to that in less developed economies. Experience is found to be a significant determinant for affecting the decision to invest in the United States (Hennart and Park, 1994). Henisz and Delios (2001) highlight that a firm is more inclined to count on its previous entry decision when political hazards are higher in a given location. By testing 540 Korean firms' location choices for the period 1988-2002 in China, Chang and Park (2005: 607) provide evidence supporting proposition that a 100 percent increase in the count of a firm's prior entry in a region raises the propensity to choose that region by 46.6 percent. Experience is an indication of scope economies including market knowledge, which facilitates subsequent investments (Hennart and Park, 1994: 431). With a longitudinal analysis of 506 South

Korean firms in China from the beginning of January 1987 to the end of December 1995, Guillén (2002) who applied a Cox proportional hazard model finds that local experience increases the rate of foreign expansion.

Shaver *et al*. (1997) find that the survival rate for firms with prior experience in the target industry in the United States is 87 percent, suggesting that knowledge of the host market makes reinvestments more successful. The survival of firms is in part dependent on the question of whether they can compensate for the liability of foreignness (Zaheer and Mosakowski, 1997). Zaheer and Mosakowski (1997: 439-40) argue that experience resulting from learning-by-doing can moderate the liability of foreignness defined as "high coordination costs, the foreign firm's unfamiliarity with the local culture and other aspects of the local market, a lack of information networks or political influence in the host country, or the foreign firm's inability to appeal to nationalistic buyers". A well-experienced firm's location selection process is inclined to be influenced by more technical considerations than social considerations (Henisz and Delios, 2001). The accumulation of operational experience is in large part a tool for alleviating environmental threats in the host country. "A host country experience generates general knowledge and capabilities applicable to the local environment, multinational firms that have accumulated host country experience reduce the scope of their competitive disadvantage and face fewer operational difficulties in the local market" (Delios and Beamish, 2001: 1029). An evolutionary perspective suggests that the process of adjustment with global markets requires time. Accordingly, the following hypothesis is tested:

Hypothesis 7: *The number of a firm's prior entry is likely to exert a positive influence on the probability of a region being chosen.*

6.3.4 Network-Specific Factors

Keiretsu organisation

Apart from the role of nationality and industry agglomeration in host nations in promoting FDI, little scientific attention has been paid to the role of Japanese industrial organisation (*i.e.*, *keiretsu*) agglomeration in European emerging economies. It is important for host governments to be aware of a sequential entry pattern of Japanese firms where one single *keiretsu* member firm's entry into a market leads to a series of FDI inflows by member firms of the same *keiretsu* as already stressed in the previous study (Belderbos and Carree, 2000; Blonigen *et al*., 2005; Head *et al*., 1995).

The *keiretsu* alliance of inter-firm arrangements as a source of competitive advantage minimises transaction costs such as co-ordination costs, risks of broken contracts, searching costs, switching costs and product quality tests in endemic and structural market impurities (Dunning 1997). Accordingly, geographic proximity between *keiretsu* members in foreign markets would also lead to the sustainable

development of the intensive inter-firm linkages designed to merge the goals of profit maximisation and risk sharing, and strengthen social relations. The duplication of the vertical and horizontal form of domestic *keiretsu* ties abroad may facilitate the *keiretsu* members' capitalising on various mobile and immobile resources, such as competent human resources, facilities, equipment, and experience, and financial assets within the hybrid market compared with the arm's-length market that involves a higher rate of market failure. *Keiretsu* affiliation may also help reduce additional costs for information acquisition, enabling member firms to stabilise the flow of parts supplies in the procurement system and leverage strong negotiation power in foreign markets.

Moreover, in the case of vertical inter-firm networks, the duplication of the *keiretsu* structure abroad permits group firms to cope with quality control and product innovation as well as planning, while benefiting from territorial proximity. It also promotes inter-firm business transactions at negotiated prices when capable indigenous supplier channels are lacking. In this context, a Japanese *keiretsu* affiliate's propensity to imitate the location strategies of other *keiretsu* affiliates is expected to be high and *keiretsu* member firms are at a more advantageous position relative to independent firms because of group-based resource allocation in foreign markets.

As pointed out by the prior literature (Belderbos and Carree, 2002; Belderbos and Sleuwaegen, 1996; Blonigen *et al*., 2005; Head *et al*., 1995; Head and Mayer, 2004), *keiretsu* affiliation impacts the probability of the choice of Japanese FDI in foreign markets. Chang and Park (2005) suggest that the marginal cost increase associated with the same group agglomeration will be limited since a firm or a business group should be more able to coordinate its location decisions to avoid any competition among its own foreign operations. Chang and Park (2005: 599) also stress that the geographical proximity of firms within the same corporate group or conglomerate is less subject to the marginal costs of industrial clusters since they make deliberate efforts to seek the overall competitiveness of the group.

Chang (1995) shows that Japanese electronics firms that belong to horizontal and vertical *keiretsu* groups have higher probabilities of tapping into the US market in a sequential form, as compared to independent firms. Firms in corporate networks reinforce their international expansion of operations by learning other member firms' entry experience. Chang also found that horizontal *keiretsu* firms have higher propensities to take the sequential investment pattern compared to vertical *keiretsu* firms.

Blonigen *et al*. (2005) argue that *keiretsu* affiliation empowers member firms to cooperate and coordinate product design and development as well as JIT delivery systems more flexibly with each other. Belderbos and Carree (2000: 198) also note that the core *keiretsu* firm is likely to provide its member firms with active assistance in the site selection process. The absence of local competing suppliers who can offer the same quality of components as Japanese suppliers can be a major deterrent to Japanese

manufacturing firms to achieve scale economies. In particular, the automobile sector requires tight cooperation and control between a car assembler and suppliers for specialised supplies, while products can be assembled in less complex production processes with standardisation of technology and the use of relatively small parts in the electric/electronics sector.

Gittelman and Graham (1994) find that the tendency that *keiretsu* member firms co-locate with their parents seems stronger in the US than in the EU in the late 1980s (Gittelman and Graham 1994). Their empirical findings are that independent *keiretsu* groups in the automobile industry form a collective economic group in North America and Western Europe as many subcontractors tend to be located close to or near their main assemblers. Belderbos and Sleuwaegen (1996) also detect that the presence of extensive vertical network systems developed by the parent company in the West increases the probability that a firm invests in the West.

Head *et al*. (1995) who examine Japanese firms' location pattern in the 1980s identify that *keiretsu*-specific spatial concentration is a crucial incentive for encouraging new establishments of Japanese manufacturing plants. They find that *keiretsu* agglomeration is more consequential for FDI inflows than industry agglomeration and Japan-specific agglomeration. Head *et al*. (1995: 242) identify that a 10 percent increase in *keiretsu* agglomeration economies in a state corresponds to a 5-7 percent increase in the likelihood of its location selection in the future. This suggests that geographic considerations of Japanese MNEs are highly linked to the importance of intra and inter-firm information transactions among Japanese MNEs, even when operating abroad. Hence, it appears that internalisation plays a crucial role in the locational selection of Japanese firms abroad.

Focusing on the location pattern of 229 Japanese electronics manufacturing firms in China over the period 1990-95, Belderbos and Carree's (2002) empirical results are consistent with those presented in the study of Head *et al*. (1995). The authors find that *keiretsu* agglomeration has a significant impact on plant selection in the electronics industry in China. More specifically, the location pattern differs between *keiretsu* group member firms and core *keiretsu* firms. *Keiretsu* group member firms prefer regions where the manufacturing units by other *keiretsu* group firms are already in operation because of information gathering costs, whereas this is not the case for core *keiretsu* firms. That is to say, *keiretsu* agglomeration does serve as a magnet not for *keiretsu* leaders but for *keiretsu* suppliers. More precisely, export-oriented *keiretsu* firms are more inclined to amass in clusters where a number of same *keiretsu* member firms are co-located.

It is importance that Japanese *keiretsu* suppliers tend to follow their customers in timing and place. This is because *keiretsu* leaders play a crucial role in looking for optimal candidate sites that yield high profits and low risks. In addition, core firms leverage their bargaining capabilities to negotiate with host-based governmental

agencies so as to exploit their strategic goals in a manner that is profitable for the overall competitiveness of the group (Belderbos and Caree, 2002). Hence, *keiretsu* member firms tend to chase after their leaders. Following these sequential investment processes, *keiretsu* firms can exploit economies of scale and leverage strong negotiation power over host-based governments.

Previous international business studies (Chang and Park, 2005; Guillen, 2002) also confirm that group network externalities are also important in the explanation of Korean firms' location choices. Chang and Park (2005) find that, when contemplating a location strategy in China, the degree of network externalities of Korean firms in the same group is much more important than that of other Korean firms in the same industry or different industries.

Surprisingly, there are a few studies that contradict the conventional wisdom that advocates the significant impact of the *keiretsu* count variable on location choice (Blonigen *et al.*, 2005; Henisz and Delios, 2001; Hennart and Park, 1994). These authors find that the vertical *keiretsu* agglomeration has no significant bearing on the locational behaviour of Japanese firms. Blonigen *et al.* (2005: 85) infer the major rationale behind this outcome as follows: "Vertical *keiretsu* members are so coordinated in their investment decisions due to strong production linkages that new investments into a region tend to generally occur all at roughly the same point in time". Following the above empirical results in the literature, I postulate:

Hypothesis 8: *Japanese manufacturing firms are more likely to locate in regions where the same keiretsu group firms are already operating.*

6.3.5 Agglomeration-Specific Forces

Japanese nationality agglomeration

Consensus on the impact of agglomeration economies on Japanese firms' location choices has developed and evolved in the previous literature (Belderbos and Carree, 2002; Blonigen *et al.*, 2005; Cheng and Stough, 2006; Head *et al.*, 1995; Head and Mayer, 2004; Smith and Florida, 1994; Togo and Arikawa, 2002; Woodward, 1992; Yamawaki, 2006). Considering Japanese FDI in the United States, various statistical methods such as Tobit, Poisson, negative binominal and conditional logit estimation models were employed in the past literature. It is commonly confirmed that the Japanese nationality agglomeration variable serves as a competitive advantage to lure the number of investment projects by Japanese automotive-oriented firms.

Head *et al*. (1996) and Belderbos and Carree (2002) explore Japanese FDI in China and also draw a similar conclusion that Japanese firms may imitate locational patterns of other Japanese firms and may choose a region with spatial clusters of Japanese-owned subsidiaries in China since they tend to rely on information on local labour markets and institutions, and other Japanese firms' experience. Cheng and

Stough (2006) calculate that the marginal effect of Japanese nationality agglomeration on regional location decisions in China is larger than that in the United States, suggesting that inferior infrastructure capacity may increase the intensity and density of spatial clusters of Japanese firms in China. These empirical results justify Chang and Park's (2005) postulation that the MNEs may show a preference for geographical proximity with firms with the same nationality since they can learn more easily from firms from the same nation than from firms that are from different nations.

It should be noted that spatial concentration of Japanese firms is strongly linked to the duplication of JIT that is considered as "part of the Japanese social organisation of production" (Sadler, 1994: 56). It is of great importance to duplicate good quality control and JIT delivery systems through spatial closeness in areas endowed with uncertainty (Belderbos and Carree, 2002). Although the quality of JIT relationships with Japanese suppliers is significantly heterogeneous in terms of regions and countries, as pointed out by Martin and Kenny (1988), the implementation of JIT deliveries is perceived among Japanese assemblers in the United States as the overall strategic competitiveness of Japanese automobile industry to outperform the Big Three firms (GM, Ford and Chrysler) in a substantial reliance on arm's length transactions. The adoption of JIT linkages with Japanese suppliers in the United States is hence perceived to be one of the key factors in success.

On the other hand, Sadler (1994) notes that the duplication of JIT linkages with Japanese suppliers in Europe is constrained since Japanese assemblers' greater reliance on the European automotive component industry was attributable to political pressure by the European Community and the presence of a number of component suppliers with competitive strength in Europe. Similarly, Florida and Kenny (1992) argue that strategic location behaviour of Japanese firms in the US steel industry is characterised by spatial concentration instead of spatial dispersion since they feel the need for supplying steel products to the Big Three on a JIT basis.

Chang (1995), who investigates the sequential entry process of Japanese electronics manufacturing firms in the period from 1976-1989 in the United States, identifies that Japanese firms take an evolutionary approach to entering the US markets ranging from core to non-core businesses. According to Chang's empirical analysis in the Cox proportional hazard model, Japanese firms tap into core businesses in which they can overcome the liability of foreignness by means of their strong intangible assets (R&D and advertising skills) and strong spatial concentration with other Japanese firms.

Previous studies (Barrios *et al.*, 2006; Belderbos and Carree, 2002; Shaver and Flyer, 2000; Wakasugi, 2005) highlight the extent to which firm heterogeneity and industry heterogeneity plays a role in promoting the impact of the geographical proximity with other firms on location selection. Shaver and Flyer (2000), with special focus on adverse selection, argue that firms that possess advanced technologies do not gain benefits from the existence of agglomeration economies, suggesting that spatial

separation thus enhances the probability of a firm's survival. Shaver and Flyer's study also confirms that larger firms are less motivated to cluster. Barrios *et al.* (2006) suggest the effect of agglomeration is heterogeneous depending on the level of technological competitive advantages that firms possess. Barrios *et al.* find that the impact of localisation, a measure to agglomeration economies, on low-tech firms' location choices is positive in the case of low-tech firms during the period 1983-1998 in Ireland, while it has no significant effect on high-tech firms' location choices during the same period when controlling for wages.

In addition, Wakasugi (2005), who explores market entry strategies of potential Japanese investors in China, finds the average probability elasticity varies by industry. According to the author, Japanese firms in the food processing sector are more sensitive to industrial agglomeration compared to other sectors such as electric and electronics as well as textiles. Japanese MNEs can also reduce lead times to improve delivery performance by means of situating their manufacturing plants close to local suppliers and customers. In other words, transaction costs and investment uncertainty, such as information sharing costs, transportation costs, supplier-searching costs, and coordination costs, will be minimised through the spatial concentration of business activities.

As far as soft factors are considered, it is important to note that Japanese nationality agglomeration tends to generate a large community of Japanese expatriates and their families and develop social infrastructure including Japanese schools and Japanese grocery stores. A series of my interviews with Japanese expatriates in CEE confirms that the presence of Japanese schools seems important to their location decisions. Following the above empirical results, we can assume that Japanese manufacturing companies may show a preference for sites situated close to Japanese nationality agglomeration in order to reduce information gathering costs relating to consumer preference, tax procedures, attitudes and behaviours of local workers and political culture in the ex-Soviet type economies. I hypothesise that being a part of an agglomeration confers upon Japanese firms more economic gains than competition costs. I expect the directional sign to be positive.

Hypothesis 9: *Japanese manufacturing firms are more likely to locate in regions where the intensity of Japanese nationality agglomeration is high.*

Japanese nationality agglomeration in the same industry and other industries
Strategic behaviour of rivals has played a critical role in affecting the location pattern of firms (Chang and Park, 2005). From the perspective of institutional economics and sociology (DiMaggio and Powell, 1983; Scott, 1995), mimetic isomorphism plays a crucial role in explicating the behaviour of foreign investors. Besides the issue of a cost-benefit calculation of economic returns, investors pay more attention to what rivals

are doing and where they exist. Investment strategies are structured by competitors and non-competitors, who notably are rooted in similar norms, cultural understanding and identity.

Drawing on the learning effect, Japanese MNEs may benefit from early Japanese entrants. In other words, we can assume that the intensity of Japanese agglomeration in the same industry and different industries may play a positive role in attracting would-be Japanese FDI since the success of early entrants in a region might create a positive image of the region. In addition, this demonstration effect may justify that formal and informal constraints external to firms are manageable even for Japanese firms. Employing both conditional logit and nested logit models, Head and Mayer (2004) find that Japanese nationality agglomeration in the same industry affects would-be Japanese investors' location choices in Europe.

On the other hand, the intensity of Japanese firms in the same industry may force a Japanese firm to rely on spatial dispersion due to decreasing marginal benefits resulting from competition. Chang and Park (2005), in a longitudinal analysis of Korean FDI in China during the period for 1980-1995, find that Korean firms in the same industry are inclined to agglomerate at an early entry period. However, they tend to rely on spatial separation at certain threshold in time. This phenomenon indicates a shift toward the introduction of a competition avoidance strategy. This leads to two competing hypotheses:

Hypothesis 10: *Japanese manufacturing firms are more likely to locate in regions where the intensity of Japanese nationality agglomeration in the same industry is high.*

Hypothesis 11: *Japanese manufacturing firms are more likely to locate in regions where the intensity of Japanese nationality agglomeration in different industries is low.*

I now turn to research methodology.

6.4   Methodology

This empirical study is dedicated to investigating explicit causal links between the spatial behaviour of Japanese investors and some key variables that influence their locational choices in CEE at the sub-national regional level. I focus on the location selection of Japanese manufacturing investments across regions in the ex-Communist economies. The original data set was compiled from *Kaigai Kigyō Shinshutsu Sōran 2007* by *Toyo Keizai Shimpōsha* and from *Zai Oushū Toruko Nikkei Seizōgyō no Keiei Jittai 2007* by *Japan External Trade Organisation (JETRO)*. The former database contains the information that includes location, entry mode, ownership characteristics, number of indigenous employees and Japanese expatriates, capital, name of contact person, telephone and fax numbers, and date of entry. The latter database contains the

information on location, industry classification, and date of entry. It should be noted that most of the sampled firms in this study are listed companies on the Tokyo Stock Exchange and are large transnational companies.

6.4.1 Sample Data

Table 6-1: The Number of Japanese Manufacturing Firms by the NUTS-1 Level

NUTS-1	91	92	93	94	95	96	97	98	99	0	1	2	3	4	5	6	Σ
Centralny	0	0	0	0	0	1	0	0	0	0	0	3	1	0	2	0	7
Poludniowy	0	0	0	0	2	0	1	0	1	0	2	1	1	0	2	1	11
Wschodni	0	0	0	0	0	0	0	1	1	0	0	0	1	0	0	2	5
Polnocno-Zachodni	0	0	1	0	1	0	1	1	0	0	0	0	1	1	1	2	9
Poludniwo-Zachdni	0	0	0	0	0	0	1	0	1	0	2	2	4	5	0	2	17
Polnocny	0	0	1	0	0	0	0	0	0	0	0	0	0	0	1	7	9
Czech Republic	1	4	1	0	1	3	3	0	2	4	12	12	7	10	3	4	67
Közép-Magyarország	0	0	0	1	0	0	1	0	1	2	0	2	0	2	2	1	12
Dunantul	1	0	1	0	0	1	2	2	3	4	0	2	2	1	1	3	23
Alfold es Eszak	1	0	0	1	1	0	1	1	1	2	3	0	1	1	0	0	13
Slovakia	0	0	0	1	0	2	1	0	0	2	2	0	0	1	2	1	12
Macroregiunea unu	0	0	0	0	0	0	0	0	0	0	2	0	0	0	0	0	2
Macroregiunea doi	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Macroregiunea trei	0	0	0	0	0	0	0	1	0	1	0	1	1	0	0	2	6
Macroregiunea patru	0	0	0	0	0	0	0	0	0	1	0	1	1	0	1	1	5
Lithuania	0	0	0	0	0	0	0	0	0	0	1	0	0	1	0	0	2
Severna i iztochna	0	0	0	0	0	0	1	0	0	0	0	0	0	0	0	0	1
Yugozapadna i	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Slovenia	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Serbia	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Montenegro	0	0	0	0	0	0	0	0	0	0	0	1	0	0	0	0	1
Σ	3	4	4	3	5	7	12	6	10	16	24	25	20	22	15	29	205

Source: Own illustration based on JETRO (2007)

Table 6-2: NACE Manufacturing Industry Sub-Classifications

NACE code	Description
DA15-16	Food Products, Beverages, and Tobacco
DB17-19	Textiles and Textile Products
DE21-22	Pulp, Paper and Paper Products Publishing and Printing
DG24	Chemicals, Chemical Products and Man-made Fibers
DH25	Rubber and Plastic Products
DI26	Other Non-metallic Mineral Products
DJ27-28	Basic Metals and Fabricated Metal Products
DK29	Machinery and Equipment Not Elsewhere Classified
DL30-33	Electrical and Optical Equipment
DM34	Transport Equipment
DN36	Manufacturing Not Elsewhere Classfied

I limit the analysis to the location decisions of 205 Japanese manufacturing firms for years 1991-2006. The reason for this is derived from data availability and mitigation of measurement errors. Moreover, of great importance is that economic, political and social distance between the EU member countries and EU candidate countries has decreased from the early phase of transition after the fall of state socialism. For instance, many of the sampled countries concluded the European Agreement with the EU in the early 1990s. Second, using this longitudinal data empowers us to capture the dynamic variation in the magnitude of location factors.

Table 6.1 demonstrates the relative proportion of Japanese manufacturing firms to the total. Roughly 75 percent of total establishment of Japanese manufacturing affiliates of the sample used took place after 2000. Table 6.3 shows the geographical distribution of Japanese-owned manufacturing firms across NUTS-1 regions. Macroregiunea doi in Romania had no new start-ups by Japanese firms during the years 1991-2006. The Czech Republic (67) is the most successful destination that accounts for the largest number of Japanese manufacturing firms at the NUTS-1, followed by the Dunántúl region (23) and Poludniwo-Zachdni region (17), in Hungary and Poland respectively. Based on the country breakdown, the Czech Republic has attracted 66 firms (I dropped one company that entered in 1990.), accounting for roughly 32.7 percent, followed by Poland (28.7 percent) and Hungary (23.4 percent).

Table 6-3 shows that the spatial distribution of Japanese firms is widely dispersed. Many favourable destinations are concentrated in southern Polish regions, northern Hungarian regions and central Czech regions. The 21 regions, as defined by NUTS-1 of the EU, consist of one region in the Czech Republic, three regions from Hungary, six regions from Poland, one region in Slovakia and four regions in Romania, two regions in Bulgaria, one region in Lithuania, one region in Montenegro, one region in Serbia, and one region in Slovenia. Previous relevant studies followed an estimation rule that all alternatives are required to be chosen at least once (*e.g.*, Belderbos and Carree, 2002; Cheng, 2005; Cheng, 2007; Cheng and Stough, 2006; Head *et al*., 1995). Following this rule of the estimation technique, Macroregiunea doi in Romania is excluded from this analysis, although this procedure may cause a sample selection bias. This study examines 205 locational decisions made by Japanese MNEs from 1991-2006 across 20 location alternatives for investment. The total number of observations is 4,100.

I also examine the location patterns for the years 1998-2006 as well because of the following reasons. Of great importance is that economic, political and social distance between the EU and EU member candidate countries became substantially closer after 1998. First, the EU started negotiation talks for accession with a first wave of CEECs (the Czech Republic, Hungary, Poland and Slovenia) in 1998 and a second wave of CEE aspirants (Bulgaria, Latvia, Lithuania, Romania and Slovakia) in 2000.

Figure 6-2: Nested Structure Tree of Regions in CEE
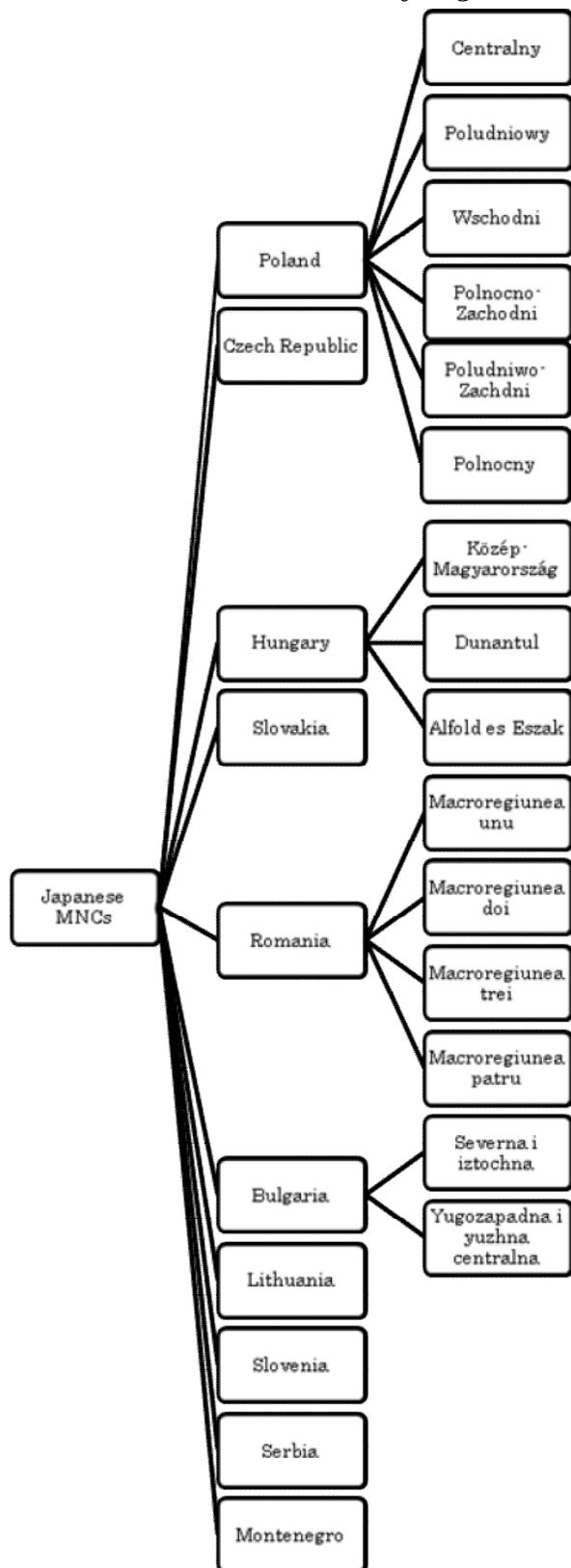
Second, the EU started providing the former Soviet satellite countries with structural assistance after initiatives for institutional reforms in those nations shifted from the IMF to the EU. Third, the late 1990s have witnessed a sharp increase in FDI inflows in many transforming economies of the CEE countries as an indication of success in institutional reforms, financial liberalisation, and mass privatisation.

Although the number of Japanese manufacturing firms has been increasing with slow pace since the dawn of the new century, their experience and knowledge about products, labour, capital and housing markets, work ethic and cultural divergence remain relatively limited compared to Western counterparts in CEE. Many firms in my interviews reported that communication gaps, amorphous social welfare systems, excessive bureaucratic complexity, and administrative procedures with much red tape shift transaction and coordination costs upward. Hence, a vital approach toward achieving better performance is to promote knowledge acquisition and exploitation in proximity with other firms with the same country of origin.

Table 6-3: Sub-National Regional Percentages of Japanese MNEs in New Manufacturing Plants in the Period 1991-2006 (205 plant start-ups)

Location	N	%	Location	N	%
Poland	58	28.7	Romania	13	6.3
Centralny	7	3.4	Macroregiunea unu	2	1.0
Poludniowy	11	5.4	Macroregiunea doi	0	0.0
Wschodni	5	2.4	Macroregiunea trei	6	2.9
Polnocno-Zachodni	9	4.4	Macroregiunea patru	5	2.4
Poludniwo-Zachdni	17	8.3	Bulgaria	2	1.0
Polnocny	9	4.4	Severna i iztochna	1	0.5
Czech Republic	67	32.7	Yugozapadna i yuzhna centralna	1	0.5
Slovakia	12	5.9	Lithuania	2	1.0
Hungary	48	23.4	Slovenia	1	0.5
Közép-Magyarország	12	5.9	Serbia	1	0.5
Dunantul	23	11.2	Montenegro	1	0.5
Alfold es Eszak	13	6.3	Total	205	100

Source : Own calculation based on JETRO (2007)

A number of companies in the sample invested across CEECs at least twice or more during the sample period. In the automobile-related sector, Toyota set up three factories (two in Poland and one in the Czech Republic). Nissan's leading tier one supplier, Calsonic, is also deeply involved in the development of the manufacturing units in Poland, Hungary and Romania. Bridgestone also invested five times. Of these, three factories are concentrated in the region of Polnocno-Zachodni in Poland. Sumitomo Electric invested more than ten times and has established an extensive network of production and sales across the region. Notably, Sumitomo Electric's

production activity is concentrated in Poland and Hungary. Yazaki also invested five times. What is common for Sumitomo Electric and Yazaki is that both of them focus on manufacturing labour-intensive products such as wire-harness. In the consumer electronics sector, Matsushita, which already invested seven times, has strengthened its market presence, while other firms such as Toshiba, Sharp and Hitachi were late comers who decided to invest in 2006.

6.4.2　Model Specification

Following neoclassical economic theory of utility-maximising behaviour, a decision maker would select one of the candidate countries or regions that would provide an investment environment that would maximise high earnings and returns on investment when setting up subsequent plants. In the plant location decision-making process, the issues of where to minimise high transportation costs, how to have efficient access to the labour pool and how to form well-functioning value chains in parallel with the exploitation of cheap but quality input attributes at a maximum. In this regard, discrete choice models have shown methodological reliability and appropriateness in disaggregate analyses. I present a conditional logit model and a nested logit model to assess crucial factors that determine the location patterns of new Japanese manufacturing start-ups in the CEE economies at the sub-national regional level.

6.4.2.1　Conditional Logit Model

Apart from topics in politics, labour economics, sociology and psychology, the conditional logit model established by McFadden (1974) has been commonly used as an econometric model to analyse the location behaviour of firms in the previous literature (*e.g.,* Chang and Park, 2005; Cheng and Stough, 2006, Chung and Song, 2004; Coughlin *et al*., 1991; Deichmann and Karidis, 2005; Friedman *et al*., 1992; Guimarães *et al*., 2000; Head *et al*., 1995; Head and Mayer, 2004; ; Wakasugi, 2005; Woodward, 1992; Yamawaki, 2006), since the model can incorporate various qualitative variables. McFadden's (1974) conditional logit model takes for granted that alternatives are not correlated with one another in the random utility maximisation specification (Guimarães, Figueiredo and Woodward, 2000).

　　　Assuming that firm i (i=1,…,n) selects one of J alternatives to locate and firm i is a rational decision maker in choosing area j which provides a higher profit than somewhere else, the profit function, $\pi_{i,j}$, that firm i chooses j is as follows:

$$\pi_{i,j} = Max\{ln\pi_{i,j}; j = 1, \cdots, J\}$$

The above equation can be transformed into:

$$\pi_{i,j} = \beta X_{i,j} + \varepsilon_{i,j}$$

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X denotes region j's observable attributes in the year t, while $\varepsilon_{i,j}$ corresponds to a function of unobservable or unmeasurable characteristics in the region y in the year t. β is the vector of parameters to be estimated. The primary aim is to explore β to be the maximum likelihood in the estimation model (McFadden, 1974). Considering the maximum likelihood $P_{i,j}$ that firm i chooses j in the year t, the likelihood to observe a particular pattern will be obtained in the linear function. McFadden (1974: 110) assumes that the disturbance terms are independently and identically distributed according to Weibull distribution. The probability of choosing j is mathematically expressed as follows:

$$P_{i,j} = Pr\big(\pi_{i,j} \geq \pi_{i,k}\big) = Pr\big(\varepsilon_{i,k} - \varepsilon_{i,j} \leq \beta X_{i,j} - \beta X_{i,k}\big), \forall k \neq j$$

Follwoing McFadden (1974), the likelihood that investor i chooses j in the year t is expressed as follows:

$$P_{i,j}^{CL} = exp\big(\beta X_{i,j}\big) \Big/ \sum_{j=1}^{J} exp\big(\beta X_{i,j}\big)$$

Accordingly, the likelihood that investor i chooses j in the year t in the explanation of a Japanese manufacturing firm's site selection in CEE is presented by:

$$P_{i,j}^{CL} = exp\big(\beta X_{i,j}\big) \Big/ \sum_{j=1}^{20} exp\big(\beta X_{i,j}\big)$$

The tested explanatory variables are structured into a five-component taxonomy of (1) classic economic factors, (2) institution-specific factors, (3) firm-specific advantage, (4) network-specific factor, and (5) agglomeration-specific factors, which originate in a combination of the logic of agglomeration externalities (Marshall, 1920; Porter, 1990), Dunning's O and L advantages (Dunning, 1981, 1993, 1997, 2008), theory of economic geography (Krugman, 1991) and network theory (Gerlach, 1992; Lincoln and Gerlach: 2004).

All variables used for this model appear in natural logarithm in order to make the range of the variable values narrower and to allow the coefficients to function as elasticity. In addition, it will contribute to scaling down the variation and minimising the probable impact of heteroskedasticity (Kumar 2002: 19). Since the effects of various locational variables on Japanese firms' location choice over time and space are examined, the structure of the model specification needs not only a spatial aspect but also a time dimension. I will explore the period from 1998 to 2006. Based on the significance of the coefficients, I will define whether selected variables play a role in

recruiting Japanese FDI.

All the variables are measured in *t-1*, because the investment decision is normally determined by an assessment of endowment effects in an earlier year, at least *t-1*. In other words, of importance is to avoid potential problems of simultaneity (Cieślik, 2005). The dependent variable takes the value of one, if a given MNE *i* established a plant in a given region y in a given year *t*, and zero otherwise.

Several critical aspects of the use of the conditional logit model should be kept in mind. First, it is of great importance that the conditional logit model is reliable only if the assumption of irrelevant alternatives (IIA) is not violated. In other words, random terms are required to be independent across locations in the conditional logit model (Head and Mayer, 2004).

Second, McFadden's conditional logit model does not give a complete picture of the structure of a hierarchical and sequential decision process from the national level to the sub-national regional level in managing the geographic configuration of foreign investors. To minimise the violation of the IIA assumption, regional dummy variables are included in previous studies (Bartik, 1985; Cheng and Stough, 2006; Head *et al.*, 1995; Woodward 1992). Coughlin and Segev (2000) find that the parameter estimates for explanatory variables do not change with and without regional dummy variables in their study. In contrast, according to Cheng (2007), the inclusion of regional dummy variables is just a temporal solution to counterbalancing the IIA problem. Hence, the author argues that the validity of empirical findings in the conditional logit model needs to be verified by different methods such as the nested logit model and the mixed logit model. Some researchers have confirmed their empirical findings with a greater reliance on more appropriate statistical methods including the nested logit model (Basile *et al.*, 2003; Cheng, 2007;; Disdier and Mayer, 2004; Guimarães *et al.*, 1998; Hansen, 1987; Head and Mayer, 2004 ; Yabe, 2005) and the mixed logit model (Cheng, 2005).

6.5   Operationalisation of Independent Variables

The appropriate operationalisation of explanatory variables is an important part of the econometric evaluation. The process of such selection tends to be contingent on interests for research as well as on data availability. The test is devoted to assessing what factors play a crucial role in shaping Japanese manufacturing firms' location choices at the disaggregate level. The hypotheses tested in this study are multidimensional. Japanese nationality agglomeration, *keiretsu* affiliation, market size, area size, highway network intensity are positively associated with Japanese manufacturing firms' location choices in CEE, while distance to Frankfurt is negatively related. As previous studies showed a mixed relationship, other explanatory variables such as unemployment rates and labour costs are inconclusive. The hypotheses will be rejected if the empirical results are not consistent with the expected signs. Three agglomeration-related variables will be tested separately to avoid problems of

multicollinearity (see Table 6-5).

6.5.1 Descriptive Statistics of Explanatory Variables

Table 6-4: Definition of Explanatory Variables

	Categorization	Variable	Definition	Signs
1	Economic forces	Market potential	ln(host GDP and neighboring GDP in millions)	+
2	Economic forces	Labour cost	ln(monthly labour costs) in 2006	?
3	Economic forces	Area size	ln(area size of NUTS 1 in square km)	+
4	Institution-specific	Progress in institutional infrastructure	Average index of 13 EBRD transition indicators*	+
5	Institution-specific	Institutionalization of FDI policies	1 if the country has a FDI promotion law in a given year	+
6	Institution-specific	European Union membership	1 if the country gained EU membership in a given year	+
7	Firm-specific advantage	Host-region experience	ln(1+count of a firm's own prior entry)	+
8	Network-specific forces	Keiretsu agglomeration	ln(1+number of *keiretsu* firms)	?
9	Agglomeration forces	Japanese agglomeration in all industries	ln(1+number of Japanese firms)	+
10	Agglomeration forces	Japanese agglomeration in the same industry	ln(1+number of Japanese firms in the same industry)	+
11	Agglomeration forces	Japanese agglomeration in different industries	ln(1+number of Japanese firms in other industries)	+

Note : * indicates the larger the indicator the more developed institutional infrastructure (1 indicates low convergence toward the standard of developed countries and 5 indicates high convergence.)

6.5.1.1 Dependent Variable

The dependent variable is dichotomous in this discrete choice model. If a Japanese manufacturing firm chooses one region out of 20 NUTS-1 regions for the period from 1991-2006, the value of one is taken, and zero otherwise.

6.5.1.2 Independent Variables

Now turn to consider the measurement of the independent variables. In the model part, I consider four groups of explanatory variables: (1) classic economic factors (market potential, labour cost and area size); (2) institution-specific factors (progress in institutional infrastructure and institutionalisation of FDI laws); (3) firm-specific advantage; (4) network-specific factors; and (5) agglomeration-specific factors.

Table 6-5: Correlation Matrix of Explanatory Variables

	1	2	3	4	5	6	7	8	9	10	11	Mean. (SD.)	Min. (Max.)
1	1											18.3 (6.0)	7.9 (32.2)
2	0.24	1										2.7 (0.2)	2.3 (3.1)
3	0.12	-0.32	1									4.6 (0.3)	3.8 (4.9)
4	0.38	0.47	-0.05	1								3.0 (0.7)	0.9 (4.0)
5	0.25	0.31	-0.19	0.42	1							0.7 (0.5)	0.0 (1.0)
6	0.08	0.15	-0.02	0.19	0.14	1						0.1 (0.2)	0.0 (1.0)
7	0.07	0.07	0.04	0.11	0.08	0.04	1					0.0 (0.1)	0.0 (0.7)
8	0.05	0.06	0.04	0.11	0.10	-0.04	0.30	1				0.0 (0.1)	0.0 (1.2)
9	0.51	0.39	-0.01	0.60	0.51	0.18	0.21	0.19	1			0.5 (0.4)	0.0 (1.8)
10	0.31	0.27	-0.03	0.38	0.31	0.08	0.23	0.26	0.70	1		0.2 (0.3)	0.0 (1.6)
11	0.48	0.38	0.01	0.57	0.48	0.20	0.17	0.14	0.96	0.52	1	0.4 (0.4)	0.0 (1.8)

Note : N=4100 (=205×20).

Market demand conditions

I measure market potential across regions by comparing Gross Domestic Product (GDP) in the European transition economies. As proposed in the previous literature (Belderbos and Carree, 2000), I include the market size variable such as GDP in the conditional logit specification of this study to avoid the problem that the coefficients of the agglomeration variables are biased. Cieślik (2005) stresses that the GDP variable can be characterised by two dimensions: (1) demand and (2) supply sides. The variable can be interpreted as an indicator of potential demand as well as the availability of domestic suppliers. Hong and Kim (2003) used the value of GDP as their indicator of economic potential. The sum of GDP of a host region and its neighbouring regions is used as a proxy for market potential in this study, consistent with Chung and Song (2004). Data was obtained from Eurostat. Positive directional signs are predicted.

Labour cost

The operationalisation of the labour cost variable is relatively straightforward. Hong and Kim (2003) use earnings per hour in manufacturing as their indicator of labour costs.

Head and Mayer (2004) use total wage bill divided by number of employees as their indicator of labour costs. The expected sign of labour cost is either positive or negative in the econometric estimation. Average monthly gross wage in the manufacturing sector is used for this analysis. Data for the level of wages at the NUTS-1 level in CEE is not available in the Eurostat database. I use WIIW's (Wiener Institut für Internationale Wirtschaftsvergleiche) database which provides the level of wages in the year 2006 for each country. Positive or negative directional signs are predicted.

Area size
Following previous studies (Woodward, 1992), I use land size in square kilometres to control for the size of the regions. The data source is from Eurostat. Positive directional signs are predicted.

Progress in institutional infrastructure
Consistent with Meyer (2001), the average value of EBRD's transition indicators in thirteen fields is used as a proxy for the development of institutional building of each country in a given establishment year.

Institutionalisation of FDI policies
Meyer and Nguyen (2005) use the sum of square metres of industrial zones within a province in Vietnam as the availability of special economic areas to capture the impact of policy incentives on the scale of FDI in the Poisson regression. Cieślik (2005) use a binary dummy variable for SEZs as his indicator of fiscal incentives. Yamawaki (2006) uses statutory corporate tax rates at the national level as an indicator for government intervention. Hong and Kim (2003) employ corporate tax revenue as a percentage of GDP to measure tax burdens. Hong and Kim argue that the level of tax burdens determines Korean firms' capacity to finance locally. Nevertheless, common statistical data on public incentives such as the amount of subsidies and tax exemption and the number of special economic areas at the NUTS-1 level are not available. I use a binary dummy variable for the enforcement of FDI promotion laws at the national level as a proxy for the institutionalisation of FDI policies. This variable accounts for the extent to which FDI practices are institutionalised to facilitate FDI inflows.

EU membership
Following the previous scholarship (Bevan and Estrin, 2004; Iwasaki and Suganuma, 2007; Suganuma, 2006), I use a binary dummy variable in a given region at a given establishment year..

Prior experience

In line with the previous scholarship (Chang and Park, 2005; Henisz and Delios, 2001), I use the count of a firm's prior entry in a given region as a proxy for experience or familiarity.

Keiretsu network externalities

Belderbos and Carree (2000) and Head and Mayer (2004) employ the number of affiliates owned by the same Japanese parent or members of the same vertical *keiretsu*. Similarly, the count of market entry by firms belonging to the same vertical *keiretsu* group is used as a proxy for *keiretsu* affiliation in this research in a given region at a given establishment year. Positive directional signs are predicted.

Japanese nationality agglomeration

Head and Ries (2002) and Blonigen *et al*. (2005) used the number of employees as a proxy for agglomeration and information effects, while Head *et al*. (1995, 1999) applied the number of Japanese-owned greenfield investments in a state prior to the decision of a particular investor as a proxy for agglomeration effects. In addition, the value of production of firms as well as the starting year of producing operations can be taken as alternatives. Here, this study employs the number of Japanese and foreign plant facilities already set up in each region.

Japanese nationality agglomeration is gauged by the cumulative number of previous investment projects at the time of each venture establishment in a given region. Following Belderbos and Carree (2002) and Head *et al*. (1995), to overcome a problem to take the log of zero for regions with no previous investment, the variable is hence measured by one plus the number of new plants the year prior to the investment *i* in a given region in a given establishment year. I use various directories of Japanese firms operating in the enlarged Europe in order to compile the appropriate data. The directories are JETRO (2006), Toyo Keizai's (2007) Kaigai Shinshutsu Kigyō Souran, the Japanese Chamber of Commerce in the Czech Republic (2006) and JETRO Hungary (2006). Since this list of Japanese firms with operations does not provide location at the sub-national regional level, the address of each individual company was checked on the Internet.

Japanese agglomeration in the same industry and different industries

Data were compiled from JETRO (2007). Agglomeration externalities arising from the geographic clustering of Japanese firms in the same industry and different industries were gauged by the cumulative number of previous investment projects at the time of each venture establishment in a given region. Following prior work, the variable is measured by one plus the number of new plants the year prior to the investment in a given region in a given establishment year. Positive directional signs are predicted.

6.6   Empirical Results

This section presents empirical findings. It is important to keep in mind that logit models do not allow us to directly interpret the coefficient estimates as marginal effects since logit models are not linear-oriented (Chang and Park, 2005; Head *et al.*, 1995; Wakasugi, 2005). The appropriate interpretation of empirical results requires us to calculate the average probability elasticity for each explanatory variable which represents the marginal effect, as pointed out by the prior scholarship (Chang and Park, 2005; Head *et al.*, 1995). The elasticity of the probability of investor *i* selecting region *j* with factor endowment X_k can be measured as follows:

$$E_{i,j} = \partial Prob(J)/\partial X_k \cdot X_k/Prob(J) = \beta_k\{1 - Prob(J)\}$$

The sum across all states of the individual probabilities of investor *i* selecting region *j* enables us to find the average probability elasticity of factor endowment X_k where *J* is the total number of alternative regions and β_k is the estimated coefficient of factor endowment X_k (Chung and Song, 2004). In this study, Japanese investors have 20 alternative regions in the period from 1991-2006. The average probability elasticity of explanatory parameter X_k is approximately 95.23 percent of β_k in the period.

$$E_{i,j} = \sum_{i=1}^{N}\sum_{j=1}^{20} E_{i,j} = \beta_k \cdot \{(Y - 1)/Y\} = \beta_k \cdot \{(20 - 1)/20\} \approx 0.95\beta_k$$

The coefficient magnitudes of explanatory variables can be measured by the elasticity of the probability of investor *j* selecting region *j* based on explanatory variables. Because the number of choices is equivalent to 20 in the estimations, elasticity can be found by multiplying the coefficient estimates by 0.95. The conditional logit model was employed to assess the impact of the explanatory parameters, which maximise the probability of choosing plant sites by 205 Japanese MNEs from 1991 to 2006 in CEE. Tables 6-6 and 6-7 summarise the empirical findings for the locational choice of Japanese MNEs. The statistical significance of agglomeration effects, cost variables, stimuli factor, demand and institutional conditions and supply factors are measured by maximum likelihood estimations. The first and second rows correspond to the estimated coefficients and z-values, respectively. More specifically, the empirical investigation includes various time-variant and time-invariant variables. While the former is the number of Japanese firms and the size of GDP, the latter is area size.

The chi-square statistic proves that all estimation models are highly significant, with $p<0.0001$. The pseudo R square ranges from 0.185-0.198 for the period from 1991-2006, indicating that all models presented in Table 6-6 have good model fit.

Market demand conditions

Market potential is found to exert no significant effect on location choice for both of the periods from 1991-2006 and 1998-2006, although the former period shows that the market potential variable is consistently as positive as predicted.

Labour cost

The labour cost variable is found to have a positive impact on location choice for the period 1991-2006. The coefficient estimates on this labour variable are statistically significant at the ten percent level for the period from 1991-2006. A ten percent rise in the labour cost would enhance the probability of choosing that area by 11.4 percent (*i.e.*, 0.95×1.204). However, when it comes to the coefficient estimate on the labour cost variable for the period from 1998-2006, its statistical significance disappears.

Area size

The area size variable is a significant positive determinant in affecting Japanese MNEs' location choices as seen in Models 2, 3 and 5. A ten percent increase in the area size results in a 6.76 (*i.e.*, 0.95×0.712) to 8.24 (*i.e.*, 0.95×0.867) percent increase in the odds of being chosen.

Progress in institutional infrastructure

Model 2 and Model 5 provide evidence that improvement of institutional infrastructure, as measured by the average value of EBRD's transition indicators for 13 fields, plays a vital role in increasing the probability of a NUTS-1 region being selected.

Institutionalisation of FDI laws

The FDI-institution variable, measured by a binary dummy variable for the enforcement of FDI promotion laws, is found to be significantly positive for both of the periods from 1991-2006 and 1998-2006, holding all other variables constant. Consistent with the previous chapter, the institutionalisation of FDI laws explains the spatial patterns and consequences of Japanese FDI.

EU membership

EU membership exerts no influential impact on Japanese manufacturing firms' location choice in CEE. The coefficients are as positive as expected, but they are statistically insignificant. Japanese manufacturing MNEs may not perceive EU membership as a direct effect on their location strategy.

Prior experience

Prior experience, measured by the count of a firm's own prior market entry, has a

statistically significant impact on a Japanese multinational corporation's location choice, holding all other variables constant. The coefficient estimates on this experience variable range from 3.524 to 3.871 for the period from 1991-2006. When calculating the average probability elasticity, it can be interpreted that a 10 percent rise in the count of a firm's own prior entry in a NUTS-1 area would enhance the probability of choosing that area by 33.5 (*i.e.*, 0.95×3.524) to 34.3 percent (*i.e.*, 0.95×3.871). The magnitude of the prior experience variable surpasses that of other explanatory variables, suggesting that Japanese firms are inclined to count on imitative market-entry strategies, as pointed out by Heinz and Delios (2001).

Keiretsu agglomeration

All things being equal, Table 6-5 shows that the *keiretsu* agglomeration variable shows high significant positive coefficient estimates. The presence of *keiretsu* networks serves as a magnet in the explanation of the spatial behaviour of Japanese MNEs in the formerly centrally-planned economies of the CEECs. Japanese *keiretsu* firms are inclined to follow member firms of the same *keiretsu* and be located in close proximity to each other. This phenomenon indicates that the social organisation of Japanese network relations is duplicated in the European transition economies, and a firm is highly inclined to benefit from information sharing and technical assistance by ways of entering the market at a close timing and proximity. The coefficient estimate on the *keiretsu* agglomeration variable ranges from 2.420 to 3.077 over the 1991-2006 period. When calculating the average probability elasticity, it can be interpreted that a 10 percent rise in the count of firms in the same group in a NUTS-1 area would enhance the probability of choosing that area by 22.99 (*i.e.*, 0.95×2.420) to 29.23 percent (*i.e.*, 0.95×3.077). The average probability elasticity for the period 1998-2006 ranges from 25.8 percent to 31.12 percent.

Japanese agglomeration in all industries

All things being equal, a rise in the number of existing Japanese firms in a given region should also have a positive effect on location strategy. The coefficients of the Japanese nationality agglomeration variable are consistent with the prediction and are statistically significant and positive at the one percent significance level. Largely supporting the existing literature (*e.g.*, Belderbos and Carree, 2002; Head *et al*., 1995, 1999; Woodward, 1992), the findings of this study provide evidence that location choice is shaped by other firms with the same national origin. When calculating the average probability elasticity for the period 1991-2006, a 10 percent increase in the count of Japanese firms in all industries in a NUTS-1 region leads to a 13.64 percent increase in the probability of that region being chosen. Interestingly, the average probability elasticity for the period 1998-2006 becomes slightly weaker relative to the former period.

Japanese agglomeration in the same industry

All things being equal, the count of Japanese firms in the same industry shows a positive sign as anticipated and is statistically significant at the 1 percent level, as seen in Model 2 and Model 5. This result is consistent with the previous study (Chang and Park, 2005; Henisz and Delios, 2001) When calculating the average probability elasticity, it can be interpreted that a 10 percent rise in the count of a firm's own prior entry in a NUTS-1 area would enhance the probability of choosing that area by 15.01 (*i.e.*, 0.95×1.580) for the period from 1991-2006 to 13.6 percent (*i.e.*, 0.95×1.436) for period 1998-2006.

Japanese agglomeration in different industries

The impact of the count of Japanese firms in different industries on location choice is positive and statistically significant at a 1 percent significance level in Model 3 and Model 6. When calculating the average probability elasticity, it can be interpreted that a 10 percent rise in the count of a firm's own prior entry in a NUTS-1 area would enhance the probability of choosing that area by 11.88 (*i.e.*, 0.95×1.251) for the period from 1991-2006 to 12.19 percent (*i.e.*, 0.95×1.283) for the period of 1998-2006.

In sum, the empirical results of this present study confirm that the wage variable exerts a significant positive impact on Japanese firms' location choices in CEE, all things being equal. One interpretation may be that Japanese MNEs pursue highly qualified labour with specialised skills required for the automobile and electronics/electric sector, which is intensively technology-oriented. At the same time, the role of the high wage cost in attracting current Japanese FDI implies that Japanese MNEs have to compete with foreign MNEs in search for better human capital, while the number of job-hoppers is constantly rising, thus it is not surprising that a very large and significant effect is estimated for the wage variable. Significant considerations are given to cheap labour costs in the European transition economies when compared to those in Western Europe. However, this study shows that cheap labour costs turned out to be of little importance for Japanese MNEs at the sub-national regional level.

It is clear that firms' location choices are inclined to be positively affected by the level of FDI-related policy certainty, which ensures the provision of employment creation grants, job training subsidies, tax breaks and environmental regulation grants. The enforcement of legal practices pertinent to FDI incentives under the established institutional structure helps ease financial and political burdens that Japanese MNEs have to incur when investing in CEE.

Table 6-6: Estimated Results for Japanese Location Patterns in CEE at the NUTS-1 Level for Years 1991-2006

Variable	Model 1	Model 2	Model 3	Model 4	Model 5
Market potential	0.001	0.008	0.002	0.005	0.007
	(0.05)	(0.53)	(0.14)	(0.32)	(0.47)
Labour cost	1.137	1.204*	1.127	1.127	1.078
	(1.60)	(1.78)	(1.62)	(1.60)	(1.55)
Area size	0.629	0.867***	0.712**	0.653**	0.647**
	(1.98)	(2.78)	(2.22)	(2.05)	(2.00)
Progress in institutional	0.113	0.447	0.271	0.198	0.258
infrastructure	(0.37)	(1.53)	(0.88)	(0.65)	(0.85)
Institutionalisation	0.773**	0.855***	0.815***	0.800***	0.837***
of FDI policies	(2.65)	(2.97)	(2.83)	(2.73)	(2.88)
EU membership	0.577	0.669	0.663	0.565	0.585
	(0.54)	(0.63)	(0.63)	(0.53)	(0.55)
Host-region experience	3.524***	3.590***	3.871***	3.426***	3.490***
	(4.16)	(4.26)	(4.55)	(4.06)	(4.13)
Keiretsu agglomeration	2.625***	2.420***	3.077***	2.328***	2.368***
	(3.14)	(2.92)	(3.68)	(2.79)	(2.85)
Japanese agglomeration	1.436***			0.805**	
in all manufacturing industrie	(6.35)			(2.47)	
Japanese agglomeration in		1.580***		0.943***	1.267***
the same industry		(6.46)		(2.68)	(4.45)
Japanese agglomeration in			1.251***		0.594**
different industries			(5.16)		(2.14)
Log-likelihood	–493.27	–492.65	–500.34	–489.60	–490.32
Chi-square	241.71***	242.95***	227.56***	249.05***	247.60***
Pseudo R-squared	0.1968	0.1978	0.1853	0.203	0.202
N	4100	4100	4100	4100	4100

Note **:** z-statistics in parentheses at the *** 1%, **5% and *10% level.

Macroregiunea doi (ROM) is excluded from this analysis.

Table 6-7: Estimated Results for Japanese Location Patterns in CEE at the NUTS-1 Level for Years 1998-2006

Variable	Model 6	Model 7	Model 8	Model 9	Model 10
Market potential	–0.015	–0.007	–0.012	–0.011	–0.009
	(–0.88)	(–0.44)	(–0.72)	(–0.68)	(–0.52)
Labour cost	0.397	0.408	0.385	0.346	0.283
	(0.48)	(0.53)	(0.48)	(0.43)	(0.36)
Area size	0.523	0.729**	0.567	0.531	0.495
	(1.51)	(2.14)	(1.62)	(1.53)	(1.41)
Progress in institutional	0.241	0.602*	0.365	0.325	0.355
infrastructure	(0.70)	(1.85)	(1.06)	(0.95)	(1.05)
Institutionalisation of	0.939**	1.093**	0.964**	0.996**	1.021**
FDI policies	(2.10)	(2.49)	(2.17)	(2.23)	(2.29)
EU membership	0.677	0.768	0.718	0.681	0.687
	(0.64)	(0.72)	(0.67)	(0.64)	(0.64)
Host-region experience	3.431***	3.508***	3.690***	3.353***	3.390***
	(3.81)	(3.92)	(4.08)	(3.74)	(3.78)
Keiretsu agglomeration	2.873***	2.718***	3.276***	2.613***	2.657***
	(3.27)	(3.12)	(3.73)	(2.99)	(3.04)
Japanese agglomeration	1.375***			0.794***	
in all manufacturing industrie	(5.66)			(2.25)	
Japanese agglomeration in		1.458***		0.843***	1.099***
the same industry		(5.69)		(2.27)	(3.64)
Japanese agglomeration in			1.283***		0.677**
different industries			(4.89)		(2.22)
Log-likelihood	–390.33	–390.23	–394.45	–387.70	–387.74
Chi-square	191.01***	191.21***	182.76***	196.26***	196.19***
Pseudo R-squared	0.197	0.197	0.188	0.202	0.202
N	3135	3135	3135	3135	3135

Note: z-statistics in parentheses at the *** 1%, **5% and *10% level.

Macroregiunea doi (ROM) and Severna i iztochna Bulgaria are excluded from this analysis.

6.6.1 Robustness Check

To check the validity and reliability of these empirical findings, I try other specifications to investigate the robustness of the above-reported findings. The primary reason for this is to show the extent to which the assumption of independence of irrelevant alternatives (IIA) holds for this study. It is necessary before turning to concluding remarks to justify whether the empirical findings of this study remain reliable through carrying out sensitivity tests. I eliminate (1) NUTS-1 regions where the number of entries by Japanese multinationals is less than two and (2) firms that entered the CEE market in the form of cross-border merger and acquisition. As seen in Table 6-8, the robustness check justifies that the results are almost similar to those found in Tables 6-6 and 6-7 with the exception of the variable for progress in institutional infrastructure. The detrimental effect of this institution-specific variable on location choice remains

questionable due to the issue of multicollinearity problems. The statistical significance of a firm's prior experience as a firm-specific intangible advantage as well as the significance of network externalities remains as high as predicted (see Tables 6-8 and 6-9).

Table 6-8: Robustness Check of the Independence from Irrelevant Alternatives (IIA)
(Excluding NUTS-1 regions with less than 2 market entries)

Variable	Model 11	Model 12	Model 13	Model 14	Model 15
Market potential	–0.025	–0.027	–0.027	–0.024	–0.023
	(–1.43)	(–1.58)	(–1.53)	(–1.39)	(–1.33)
Labour cost	3.039**	3.654***	3.286**	3.230**	3.256**
	(2.35)	(2.87)	(2.51)	(2.51)	(2.52)
Area size	0.416	0.576*	0.503	0.436	0.434
	(1.33)	(1.92)	(1.61)	(1.40)	(1.38)
Progress in institutional	–1.004*	–0.982*	–0.928*	–1.017**	–1.000**
Infrastructure	(–1.98)	(–1.92)	(–1.80)	(–2.01)	(–1.82)
Institutionalisation of	0.7446**	0.826**	0.777**	0.783**	0.814**
FDI policies	(2.33)	(2.57)	(2.45)	(2.44)	(2.54)
EU membership	–0.064	–0.172	–0.018	–0.150	–0.158
	(–0.06)	(–0.16)	(–0.02)	(–0.14)	(–0.15)
Host-region experience	3.568***	3.601***	3.868***	3.496***	3.547***
	(4.14)	(4.22)	(4.49)	(4.08)	(4.14)
Keiretsu agglomeration	2.310***	2.034**	2.741***	1.984**	2.011**
	(2.76)	(2.44)	(3.28)	(2.38)	(2.41)
Japanese agglomeration in all manufacturing industries	1.355*** (5.62)			0.626*** (1.80)	
Japanese agglomeration in the same industry		1.512*** (6.10)		1.034*** (2.87)	1.294*** (4.50)
Japanese agglomeration in different industries			1.134*** (4.44)		0.442 (1.51)
Log-likelihood	–429.227	–426.642	–435.807	–425.02	–425.48
Chi-square	147.01***	152.18***	133.85***	155.42***	154.50***
Pseudo R-squared	0.146	0.151	0.133	0.155	0.154
N	2548	2548	2548	2548	2548

Note **:** z-statistics in parentheses at the *** 1%, **5% and *10% level.

The positive relationship between labour costs and location choice may be attributed to the following reasons. One is that most of Japanese manufacturing firms operating in CEE are characterised as being middle-to-high technology-intensive rather than labour-intensive, since most of them are engaged in the consumer electronics and automobile sectors. In this regard, cheap wages are not as important as expected. During my field study, there was consensus on this point.[14] Second, complementing the first

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[14] Mr. Kambara in NSK Polska and Mr. Shimato in Ibiden Hungary pointed out that the quality of the labour force is more important than cheap labour costs.

point, Japanese manufacturing firms tend to be in favour of operation sites close to capital cities where educational, economic, and social infrastructures are more developed than in non-metropolitan areas. In other words, Japanese investors can have easy access to qualified labour force at the expense of high wage costs. The last is that the data used in this study may have created biased statistical results because the wage variable was based on the data in 2006 due to limited data availability.

Table 6-9: Robustness Check of the Independence from Irrelevant Alternatives (IIA) (Excluding market entries in the form of M&A)

Variable	Model 16	Model 17	Model 18	Model 19	Model 20
Market potential	0.002	0.009	0.002	0.006	0.009
	(0.13)	(0.56)	(0.14)	(0.38)	(0.55)
Labour cost	0.474	0.697	0.481	0.517	0.511
	(0.59)	(0.92)	(0.62)	(0.65)	(0.61)
Area size	0.477	0.805**	0.569*	0.512	0.511
	(1.40)	(2.43)	(1.66)	(1.50)	(1.48)
Progress in institutional	0.408	0.795**	0.589	0.481	0.558
Infrastructure	(1.14)	(2.32)	(1.63)	(1.35)	(1.58)
Institutionalisation of	0.654**	0.739**	0.717**	0.670**	0.722**
FDI policies	(2.07)	(2.38)	(2.30)	(2.11)	(2.29)
EU membership	13.060	12.859	13.160	13.070	13.0.65
	(0.02)	(0.03)	(0.02)	(0.02)	(0.02)
Host-region experience	3.443***	3.501***	3.814***	3.354***	3.427***
	(3.89)	(3.98)	(4.27)	(3.81)	(3.88)
Keiretsu agglomeration	2.688***	2.572***	3.181***	2.450***	2.502***
	(3.08)	(2.98)	(3.64)	(2.82)	(2.88)
Japanese agglomeration in all manufacturing industries	1.659*** (6.66)			1.050*** (2.87)	
Japanese agglomeration in the same industry		1.672*** (6.48)		0.852*** (2.24)	1.284*** (4.24)
Japanese agglomeration in different industries			1.469*** (5.50)		0.755** (2.46)
Log-likelihood	–419.87	–421.46	–427.522	–417.32	–418.36
Chi-square	250.70***	247.53***	235.40***	255.81***	253.72***
Pseudo R-squared	0.230	0.227	0.216	0.235	0.233
N	3640	3640	3640	3640	3640

Note : z-statistics in parentheses at the *** 1%, **5% and *10% level.

6.6.2 Learning Process

As Crozet *et al*. (2004), this study also confirms the downward trend of the coefficient estimate on agglomeration economies over time (see Table 6-10). First, a probable cause for this downward curve of the magnitude of agglomeration economies can be derived from the learning process of Japanese multinational firms in the European transition economies. This learning process involves the accumulation of both experience and

knowledge of an idiosyncratic set of local environmental and institutional conditions, as stressed in the internationalisation model of Johanson and Vahlne (1977). At the early stage, Japanese firms that lack experience and possess a poor understanding of local business traits are at a relative disadvantage in relation to indigenous firms or Western European firms sharing some cultural grounds. This unfamiliar environment may have a compelling effect on the geographic clustering of Japanese entrants. It is the cost of information about local market conditions that may appear to be compensated for by the spatial concentration of Japanese firms operating in CEE.

Figure 6-3: The Evolution of Coefficients of Agglomeration Effects over Time
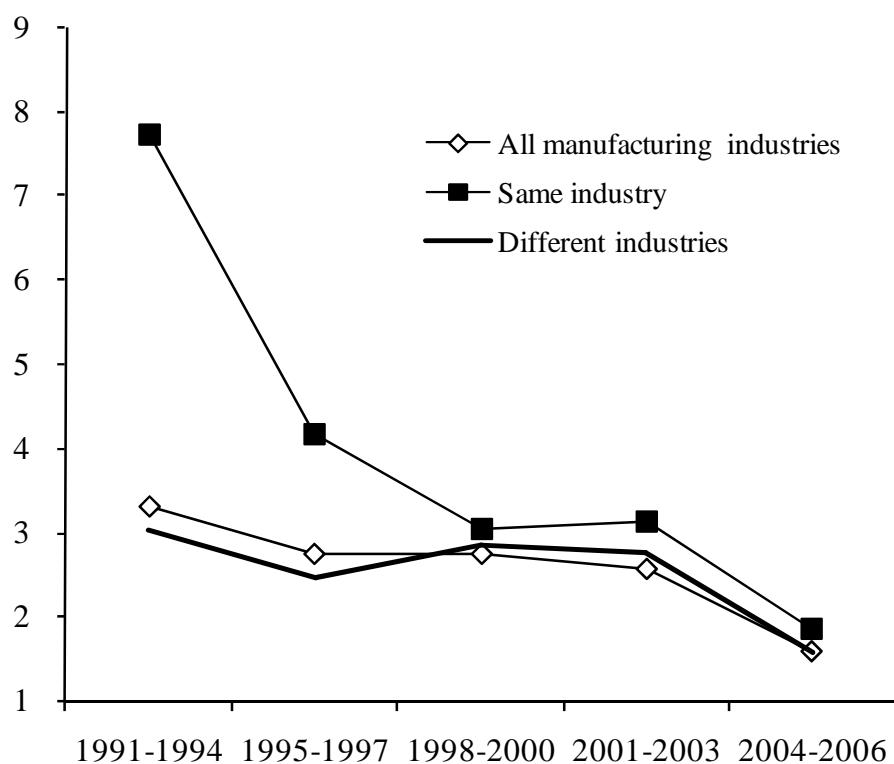
In contrast, the pervasiveness of information of local business traits as well as rising competition for input resources ought to reduce the necessity for agglomerating together at the later stage. Figure 6-3 plots the three coefficients over the period from 1991-2006 and proves the predicted fall. The positive outcomes of these agglomeration variables are dropping over time. The coefficients on Japanese agglomeration in all manufacturing industries begin with 3.309 over the 1991-1994 period and end at 1.590 for the 2004-2006 period. Likewise, the evolution of the coefficients on Japanese agglomeration in the same industry and different industries are also a downward curve, suggesting that the magnitude of the agglomeration effects loses significance over time.

Table 6-10: The Interaction Term of Agglomeration Externalities and Time

Variable	Model 21	Model 22	Model 23
Japanese agglomeration in all manufacturing industries*(91-94)	3.309*** (3.91)		
Japanese agglomeration in all manufacturing industries*(95-97)	2.749*** (5.01)		
Japanese agglomeration in all manufacturing industries*(98-00)	2.746*** (5.77)		
Japanese agglomeration in all manufacturing industries*(01-03)	2.569*** (8.90)		
Japanese agglomeration in all manufacturing industries*(04-06)	1.590*** (6.15)		
Japanese agglomeration in the same industry*(91-94)		7.708*** (3.48)	
Japanese agglomeration in the same industry*(95-97)		4.159*** (4.76)	
Japanese agglomeration in the same industry*(98-00)		3.019*** (4.66)	
Japanese agglomeration in the same industry*(01-03)		3.115*** (9.12)	
Japanese agglomeration in the same industry*(04-06)		1.858*** (6.03)	
Japanese agglomeration in different industries*(91-94)			3.020*** (2.96)
Japanese agglomeration in different industries*(95-97)			2.453*** (4.08)
Japanese agglomeration in different industries*(98-00)			2.846*** (5.56)
Japanese agglomeration in different industries*(01-03)			2.766*** (8.29)
Japanese agglomeration in different industries*(04-06)			1.561*** (5.64)
Log-likelihood	-515.80	-524.74	-533.07
Chi-square	196.65***	178.78***	162.11***
Pseudo R-squared	0.160	0.146	0.132
N	4100	4100	4100

Note : z-statistics in parentheses at the *** 1%, **5% and *10% level.

Table 6-11: Summary of Significant Predictors Influencing Japanese Firms' Location Choices (Part 1)

Variable	1991-2006					1998-2006				
	1	2	3	4	5	6	7	8	9	10
Market potential	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS
Labour cost	NS	(+)*	NS	NS	NS	NS	NS	NS	NS	NS
Area size	NS	(+)***	(+)**	(+)**	(+)**	NS	(+)**	NS	(+)**	(+)**
Progress in institutional infrastructure	NS	(+)*	NS	NS	NS	NS	(+)*	NS	NS	NS
Institutionalisation of FDI	(+)**	(+)***	(+)***	(+)***	(+)***	(+)**	(+)**	(+)**	(+)**	(+)**
EU membership	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS
Host-region experience	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***
Keiretsu agglomeration	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***
Japanese agglomeration in all manufacturing industries	(+)***	–	–	(+)**	–	(+)***	–	–	(+)***	–
Japanese agglomeration in the same industry	–	(+)***	–	(+)***	(+)***	–	(+)***		(+)***	(+)***
Japanese agglomeration in different industries	–	–	(+)***	–	(+)**	–	–	(+)***	–	(+)**
Pseudo R-squared	0.195	0.196	0.185	0.203	0.202	0.206	0.207	0.197	0.202	0.202
N	4100	4100	4100	4100	4100	3135	3135	3135	3135	3135

Note : NS indicates not significance. (+/–): Sign of causal association. Variables are significant at *** for $p < 0.01$, ** for $p < 0.05$ and * for $p < 0.1$.

Table 6-12: Summary of Significant Predictors Influencing Japanese Firms' Location Choices (Part 2)

Variable	Excluding NUTS-1 regions with less than 2					Excluding market entries in the form of M&A				
	11	12	13	14	15	16	17	18	19	20
Market potential	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS
Labour cost	(+)***	(+)***	(+)***	(+)**	(+)**	NS	NS	NS	NS	NS
Area size	NS	(+)*	NS	NS	NS	NS	(+)**	NS	NS	NS
Progress in institutional infrastructure	(–)*	(–)*	(–)*	(–)**	(–)**	NS	(+)**	(+)*	NS	NS
Institutionalisation of FDI	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**
EU membership	NS	NS	NS	NS	NS	NS	NS	NS	NS	NS
Host-region experience	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***	(+)***
Keiretsu agglomeration	(+)***	(+)**	(+)***	(+)**	(+)**	(+)***	(+)***	(+)***	(+)***	(+)***
Japanese agglomeration in all manufacturing industries	(+)***	–	–	(+)***	–	(+)***	–	–	(+)***	–
Japanese agglomeration in the same industry	–	(+)***	–	(+)***	(+)***	–	(+)***	–	(+)***	(+)***
Japanese agglomeration in different industries	–	–	(+)***	–	NS	–	–	(+)***	–	(+)**
Pseudo R-squared	0.195	0.196	0.185	0.155	0.154	0.195	0.196	0.185	0.235	0.233
N	2548	2548	2548	2548	2548	3640	3640	3640	3640	3640

Note : NS indicates not significance. (+/–): Sign of causal association. Variables are significant at *** for *p* <0.01, ** for *p* <0.05 and * for *p* <0.1.

What is worth noting is that the evolution of the Japanese agglomeration in the same industry indicates a sharp drop (from 7.708 for years 1991-1994 to 1.858 for years 2004-2006) relative to other two agglomeration variables. Accordingly, it can be interpreted that the emergence of rivals would compel a firm to rely on a competition-avoidance strategy and to choose spatial separation over spatial concentration.

6.7   Conclusions

The goal of this chapter was to examine Japanese multinationals' location choices and to evaluate the determinants of their choice processes in the formerly centrally-planned economies of the CEECs with firm-level data. Given the increasing scholarly and managerial attention to the comparative advantages of CEE, such as a pool of labour capital with intermediate technical skills (Estrin and Meyer, 1998) at affordable costs, which complements ownership advantages of MNEs, research on the determinants of FDI location in this region has not been completely popular. Since the late 1990s, the number of Japanese manufacturing firms has been growing gradually in CEE due to their increased search and need for lower production costs and higher efficiency in the emergence of the United States of Europe relative to Western Europe. In this context, location decision plays a critical role in the reorganisation of a firm's regional value chains that help accommodate accelerating European integration and thus influences its economic performance.

This chapter demonstrates the econometric findings of an empirical investigation of the determinants of Japanese firms' site choices in a multi-location setting by incorporating variables identified in studies on a regional sub-national level. McFadden's conditional logit model was employed. In this statistical analysis, I focused on a particular mechanism of agglomeration externalities together with the demand-pull mechanism (GDP, area size, labour costs), firm-specific traits (prior experience), the informal and formal institution effect (progress in institutional infrastructure, institutionalisation of FDI laws, *keiretsu* membership). The data set consists of 205 Japanese manufacturing entrants in 20 regions classified at the NUTS-1 level for years 1991-2006.

The present study relied on the theoretical perspectives ranging from institutional theory, agglomeration theory, the resource-based view of the firm, OLI paradigm and network theory. With particular emphasis on the importance of FDI-driven agglomeration economies, the empirical findings support evidence that various types of Japanese nationality agglomeration are inclined to increase the probability a region being chosen by would-be Japanese entrants (Tables 6-11 and 6-12). We can consider three possible reasons for the industrial agglomeration. First, Japanese manufacturing MNEs can compensate for potential economic and institutional hazards by geographical concentration. Second, the firms can take advantage of manifold benefits such as a pool

of formal and informal information, infrastructure development, and easy access to intermediate products. Lastly, the firms can enhance their legitimacy in local economic and political environments.

Furthermore, the empirical findings assign an overriding importance to a firm's prior experience and *keiretsu* membership. It appears convincing that plant location patterns by Japanese firms in the European transition economies are characterised by the consequence of "inter-organisational mimetic strategies" (Henisz and Delios, 2001: 448). Accordingly, host-based government officials should bear in mind that Japanese firms' location patterns are principally dependent on a firm's intangible assets and its network relations embedded in the social organisation of the Japanese economy. Accordingly, the speed and scale of the horizontal and vertical integration of Japanese multinationals across CEE are determined by network and institutional considerations.

As the market demand conditions have no significant impact on location choice, the empirical outcomes give little weight to market-seeking considerations. Consistent with evidence from existing studies *(e.g.*, Belderbos and Carree, 2002; Head and Mayer, 2004; Head and Ries, 2002; Head *et al*., 1995), this study confirm that the dominating role which the Japanese *keiretsu* system plays in the spatial formation of Japanese manufacturing activities prevails. The empirical tests presented in this study also confirm that spatial separation has not taken place yet in the case of Japanese-owned manufacturing affiliates in CEE, while a decline in the coefficient estimates of agglomeration externalities is observed. There are two possible explanations for the positive association between Japanese nationality agglomeration and location choice. First, the majority of Japanese FDI is highly related to consumer electronics/transportation equipment sectors which require the implementation of the JIT system. Second, the presence of poor transportation infrastructure and uneven roads in CEE countries may indeed increase transportation costs, thus increasing the probability of investing in regions that are characterised by a high degree of geographic intensity of Japanese manufacturing firms.

The statistical findings provide support for the assertion that the enforcement of FDI promotion laws as a proxy for institutionalisation of FDI policies at the national level plays an influential role in the increase in the number of Japanese manufacturing multinationals. The thesis draws a conclusion that the improvement of a legal infrastructure that ensures the protection of a foreign investor acts as an important catalyst for the industrial reconfiguration of foreign capital. The empirical test partially confirmed the positive association between the wage level and location selection, suggesting that low wage costs no longer translate into the attractiveness of candidate regions. Namely, it can be interpreted that wage differentials as a proxy for differences in the level of labour productivity and life quality matters to Japanese multinationals in this regard.

The estimated results have several practical implications for the incumbent

governments of CEE. First, the CEE central governments as well as local governments should be devoted to upgrading the quality of sustained location-specific traits, for example, quality communication and material infrastructure and educated labour capital, instead of relying heavily on the existing comparative advantages of CEE (*i.e.*, a pool of inexpensive labour force relative to Western counterparts).

Second, following the empirical results, it should be borne in mind that NUTS-1 regions with a small amount of FDI inflows could fall further behind in the future and remain uncompetitive in terms of location attractiveness. This pessimistic view implies that a region's success in attracting FDI in the future is locked into that in the past, pointing to the actual importance of history. Porter (1990, 1996, 1998) also extends this path-dependent character of FDI inflows to regional policies. Porter points out the caveat that an excessive effort to attract FDI inflows to distressed areas may result in yielding additional transaction costs and lead to diluting the degree of complementarities and already established interpersonal links in the development process of agglomeration economies in a given region. The introduction of regional policies without a special focus on efficient distribution of resources based on type of FDI inflows may also result in discarding potential opportunities to improve economic performance at the industry and firm level.

Third, Japanese investors assign substantial importance to the access to a qualified labour force that contributes to the sustainable growth of their local production. For policy makers of host central and regional governments, it is important to introduce various educational programs designed to constantly foster the quality of labour while creating a high quality of life.

Lastly, I should stress that institutionalisation of FDI policies should not serve as a simple conduit for winning in "international location tournaments" (Wheeler and Mody, 1992: 57). Rather it should be intended to overcome the widening gap between regions as well as countries and to ensure the transfer of advanced technology and managerial know-how to local firms. Moreover, it may be a feasible option for policy makers in CEE to shed light on the promotion of inter-regional cooperation rather than inter-regional competition across CEE in order to be more responsive to foreign investors' commitment to reinforcing global and regional networks of value-creating activities.

As with all empirical research, some shortcomings and caveats need to be addressed for further research. First, this empirical study did not identify differences in Japanese MNEs' location decisions based on different sectors, for example, in the electronics sector, the machinery sector, or the transportation equipment sector (labour-intensive vs. capital-intensive), since a small number of observations constrained further detailed empirical tests. Second, further research should confirm the extent to which the choice of FDI location varies between SMEs and large firms in CEE. Wakasugi (2005) argues that firm size plays a critical role in the choice of FDI location

because sources of capital, bargaining power, business networks and international experience are likely to bear upon location decisions. Third, the inclusion of political and institutional variables could be of great relevance, since the location choice may be to a greater extent influenced by FDI promotion policies conducted by the central governments in CEE. It is still conceivable that local politicians' commitments or enthusiasm may matter to Japanese MNEs' investing behaviour. Political interactions between Japanese investors and individuals in the central and regional governments should be scrutinised in the context-specific approach. Fourth, it would be of great interest to analyse the extent to which the presence of rival firms and rising competition encourage Japanese firms to reconfigure their location strategies in an extension of Knickerbocker's (1973) theory of oligopolistic competition. Moreover, it would be fruitful to assess the impact of the successes and failures of competitors in local operation on the spatial behaviour of new entrants. Last but not least, this study fails to distinguish whether the positive impact of agglomeration economies on Japanese multinationals' location choices in CEE is motivated by the desire to raise economic efficiency or legitimacy and acceptance. These questions are left for future research.

This chapter examined what factors determine the location pattern of Japanese MNEs in the CEE region. However, it deserves paying attention to the issue of how important changes in environmental and institutional advantages determine the success of Japanese investors in the CEE region. It is because locational advantages have been rapidly changing in recent years due to (1) the phenomenon of EU enlargement that forces CEECs to align their institutional quality with the standards of the EU-15 and (2) massive capital inflows.

7 WHAT DETERMINES THE PERFORMANCE OF JAPANESE MNEs IN EUROPEAN TRANSITION ECONOMIES

To determine the actual entry strategy, it is important to understand the most important performance determinants because the market entry strategy has to be designed in order to support the success factors in the best way. This is important for the entry itself but also for coping with the competitive situation in the new market beyond the short-term.

Kretzberg, 2007: 264

7.1 Introduction

The main focus of this chapter is on explaining the determinants of firm performance. Since the collapse of state socialism, multinational corporations have extracted profit opportunities in European emerging economies by capitaising on their comparative advantages of cheap factor endowments, and their geographical proximity to Western Europe in the European *maquiladora*[15] (Hardy, 2007: 775).

The former Communist countries in Europe have been traditionally attractive to major Western nations, such as Germany, France, the Netherlands, the United Kingdom and the United States (see Chapter 3). The conventional wisdom is that firms from Western European nations are in a more advantageous position than Asian firms in terms of historical ties, culture distance, and experiential market knowledge. Western capitalists have accumulated intangible assets, such as host-based managerial expertise and marketing knowledge, and have reinforced their reputation, brand awareness and legitimacy in CEE transition economies since the demise of the communist regime in 1989 (Meyer, 1998).

Moreover, Western European multinational corporations are not subject to the EU's institutional constraints related to trade and investment, such as local content rules and quotas, which have been used to protect interests of domestic industries from non-EU rivals such as Japanese and Korean MNEs. Consumers in CEE have also enjoyed vast inflows of Western products and pop culture into the region during the post-socialist period, implying that a number of Western MNEs are likely to have the benefit of a friendly reception in CEE. Given these grounds, non-European firms may be at a disadvantageous position when compared to Western entrepreneurs. From a MNE's point of view, a concrete understanding of key causes of corporate growth in an

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[15] A *maquiladora* means a manufacturing plant that imports duty-free materials and equipment for assembly or manufacturing and then reexports the assembled product to the originating country. Maquila production plants exist in the border region between the United States and Mexico. A number of MNEs capitalize on wage and price differentials.

environment of rapid changes in comparative advantages and in institutional circumstances in transition economies determines the decision-making and operation of the firm.

To date, there have been numerous Western firms that have exploited opportunities to enhance their business scale in unsaturated market environments relative in CEE. For instance, General Electric (GE) is an illustrative model not only of gaining high market share and profits but also of making great contributions to economic development of the host economy in CEE. GE, the largest US investor (US$1.1 billion) and the largest employer (15,000+) in Hungary, has established its strong market presence by advancing an integrated configuration of various functional units ranging from production to financial intermediation.[16] According to the Hungarian Investment and Trade Development Agency, GE has been remarkably successful as its destination sales to Hungary jumped from US$490 million to US$835 million and the company accounted for 23 percent of Hungarian exports in 2004.[17]

Another major case is the Volkswagen group. In CEE markets, Volkswagen, as a 'frontrunner' with strong access to the home government (Van Tulder and Ruigrok, 1998), has reinforced its strong market position since its acquisition of two former Czechoslovakian national car producers, Škoda and BAZ, in the early 1990s (Pavlínek, 2002). Having transformed Škoda's brand image and sales networks into the group strategy, Volkswagen has remarkably increased sophistication of value chains and price competitiveness despite the existence of a number of rivals in the enlarged Europe. As a result, the performance of Volkswagen is predominantly striking. In 2006, Škoda's share in the Czech Republic was 52.4 percent, followed by Slovakia (36 percent), Poland (12 percent) and Hungary (8.9 percent) at the country level (Škoda Annual Report, 2006). Thus, these two examples both share that the success of the host economy in CEE is strongly linked to that of major Western MNEs and *vice versa*.

The success of international business activities has long been perceived by a number of scholars, practitioners and business executives as an important theme of global management (Delios and Beamish, 2001). As of today, numerous studies of international business and strategic management have focused on the effects of firm-specific and internalisation-specific advantages on managerial satisfaction with foreign activities (Brouthers, 1999, 2002; Brouthers *et al*., 2000; Capar and Kotabe, 2003; Millington and Bayliss, 1997).

However, a cost-benefit approach to foreign subsidiary performance, with particular attention to the role of changing location-specific advantages, has been under-explored. Some scholars of international business (Brouthers *et al*., 2000; Keats and Hitt, 1988) point out that a comprehensive conceptual framework for how various

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[16] See more detail in GE's website (http://www.ge.com/hun/en).
[17] See more detail in Hungarian Investment and Trade Development Agency's website (http://www.itdh.com).

factors such as perceived environmental and institutional factors, entry mode choice, firm-specific characteristics influence firm performance has been lacking. It is important to direct more attention toward locational advantages since "characteristics of the environment are generally beyond the control of management" (Kotabe and Wheiler, 1998: 180). Especially, recent years have witnessed that rising labour costs, high turnover rates, a limited pool of labour capital and increased local competition have been detrimental to foreign firms' business activities in European transition economies. A few studies have provided evidence on this issue in transforming economies, such as Turkey (Demirbag *et al.*, 2007) and China (Abramson and Ai, 1999; Carlsson, Nordegren and Sjöholm, 2005; Li, 2004) as well as less developed economies (Appiah-Adu, 1999). Moreover, these studies have focused mainly on Western firms.

Hence, to narrow the gap between theory and reality for the case of Japanese manufacturing firms in CEE, this study attempts to conceptualise a dynamic model of the effects of environmental factors, a firm's ownership advantages and relational assets on firm performance. I try to answer the following questions with caution:

- Do locational advantages matter to the success of the subsidiary?
- If perceived environmental and institutional factors are not important, what factors are the most responsible for explaining firms' performance outcomes?
- Are there any particular predictors other than location-specific variables that merit attention?
- How do formal and informal institutions as location-specific assets structure economic performance?

It is important to note that the ability to generalise the empirical results presented in the past studies may not necessarily be applicable to Japanese MNEs within the CEE context. Due to linguistic and cultural barriers inherent in CEE markets, Japanese investors might feel the need for more incremental and careful market entry strategies in relation to Western counterparts. Importantly, what distinguishes Japanese MNEs from Western counterparts may be grounded in their consensus-oriented culture, networking organisation, and hierarchical control structure. Unlike Western MNEs that rely on transactional relationships in arm's-length markets, Japanese firms tend to take an evolutionary, sequential and incremental approach to tapping into foreign markets owing to their idiosyncratic cultural identity and philosophy, such as Confucian values, consensus, inter-personal relations, group-oriented thinking, respect to seniority and so forth (Chang, 1995; Kagono *et al.*, 1985).

Identification of influential predictors of market performance will contribute to enhancing resource efficiency and allocative productivity, achieving stable organisational development and streamlining site selection procedures for potential Japanese investors in the foreseeable future. Understanding the survival factors in

post-entry situations is important for penetrating the transition markets where societal, economic and political actors may still seek opportunistic rents and sunk costs remain relatively high due to institutions inherited from the past. This chapter will also present opportunities for a circle of policy makers, economists, and business experts in CEECs to reconsider policies, which enable not only Japanese investors but also local firms to survive and achieve better corporate performance in a complementary fashion.

Therefore, the goal of this chapter is to enhance our understanding of which factors are essential to determine the success of local affiliates of Japanese firms in CEE transition economies with a special emphasis on the link between environmental-institutional factors and performance in a more systematic way. The variables tested in this study are mainly categorised into six groups: (1) institutional-environment-specific factors; (2) firm-specific factors; (3) internalisation advantages; (4) parent-subsidiary relationships; (5) human integration; and (6) network-specific factors.

More importantly, most of prior studies tested the above correlation with the use of financial performance. This approach is unique since I examine the relative importance of the specific factors on Japanese firms' performance with subjective measures based on senior managers' judgment. Four subjective measures of performance are introduced in this analysis. Using an evaluative survey a variety of testable hypotheses will be detected by the use of a multiple regression analysis.

The structure of this paper is as follows. In Section 7.2 I begin with an overview of the performance outcomes of Japanese firms in CEE on the basis of past surveys conducted by JETRO and the Chubu Industrial Advancement Centre. A conceptual model is presented in Section 7.3. Testable hypotheses are developed in line with literature review in Section 7.4. Section 7.5 presents data and methodology. Section 7.6 demonstrates two primary data of a survey questionnaire: (1) performance assessment and (2) evaluative outcomes of environmental and institutional factors. Section 7.7 focuses on the operationalisation of explanatory variables and the development of the model specification. Section 7.8 evaluates the specific determinants affecting the growth of corporate performance of Japanese manufacturing firms in CEE transforming economies. Based on the empirical outcomes, Section 7.9 highlights some shortcomings and caveats for future research.

7.2 Background

First of all, a few cases of Japanese manufacturing firms operating successfully in CEE are presented. In Hungary, Magyar Suzuki has been acknowledged to be one of the most successful foreign investors (Hwang *et al.*, 2008). Since the initiation of the local production in Esztergom in 1992, Magyar Suzuki's production capacity and sales in Hungary have been steadily growing. Magyar Suzuki has won the acceptance of domestic consumers as a 'national car producer'. One of the most cited reasons for

Magyar Suzuki's success is grounded on free access to GM's global supplier network (globally optimised procurement system) as well as close communication with GM Europe in Rüsselsheim (Furukawa, 2005). Given these cooperative environments, Magyar Suzuki's new models were also introduced to stimulate market demand in cooperation with Opel and Fiat. These strategic co-operations have kept Magyar Suzuki competitive in quality and cost considerations in relation to other Western car manufacturers in CEE. Magyar Suzuki, located in the city of Esztergom near the Slovak-Hungarian border, responds to emerging demands for labour in Hungary by accessing available labour in Slovakia.

Another successful case is Panasonic that has established an integrated network of sales, marketing, product development and production operations in the enlarged Europe. Especially, Panasonic has concentrated LCD and plasma TV production lines in the Czech Republic. While Panasonic, as the biggest producer of television sets in the Czech Republic, produced more than 1.24 million televisions over the fiscal year 2005-2006, the company has been well-recognised as 'global citizen' actively cooperating with the University of Western Bohemia and sponsoring five to eight dissertations every year (CzechInvest, July 16, 2007). Balancing the strategic fit between global integration and local responsiveness keeps Matsushita Electric at a cost-competitive advantage despite rising competitive global circumstances. Moreover, the company has been successful in upgrading its brand name not only in Western Europe but also in CEE.

Denso Manufacturing Hungary, founded in 1997 in Hungary, has also been successful in achieving high sales growth and customer diversification. The company's sales turnover increased from 64.9 million Euro in 2002 to 428.4 million Euro in 2006 (Denso Europe, 2006) since the company won the large order of diesel common rail components from Ford in 2003.[18]

Drawing upon JETRO (2007), Table 7-1 reveals performance survey results from 2005-2007 by country and sector. It is apparent that roughly 60 percent of the total respondents reported 'gain' in each year, while only 20 percent reported 'loss'. In reviewing the performance at the country level, it turns out that Japanese manufacturing firms' performance in the Czech Republic and Hungary deteriorated substantially, while that in Slovakia and Romania ameliorated over time. A rationale behind this improved performance of the latter countries may perhaps be attributed to the fact that labour shortage and weakened labour cost advantages are not as critically problematic as in the Czech Republic and Hungary. When consideration is directed to the sectoral variation, it should be noted that the proportion of the respondents who reported a net loss in the transportation equipment sector dramatically increased from 20 percent in 2005 to 31.6 percent in 2007

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[18] See more detail in Denso's website (http://www.denso-europe.com).

Table 7-1: The Performance Outlook of Central and Eastern European Subsidiaries of Japanese Manufacturing Firms
(Unit: number and percent)

Country	2005			2006			2007		
	Gain	Even	Loss	Gain	Even	Loss	Gain	Even	Loss
Czech Republic	7 (87.5)	0 (0.0)	1 (12.5)	6 (75.0)	0 (0.0)	2 (25.0)	4 (57.1)	1 (14.3)	2 (28.6)
Hungary	12 (63.2)	4 (21.1)	3 (15.8)	9 (50.0)	4 (22.2)	5 (27.8)	7 (36.8)	5 (26.3)	7 (36.8)
Poland	11 (61.1)	3 (16.7)	4 (22.2)	15 (83.3)	2 (11.1)	1 (5.6)	11 (61.1)	6 (33.3)	1 (5.6)
Slovakia	3 (42.9)	1 (14.3)	3 (42.9)	3 (50.0)	2 (33.3)	1 (16.7)	6 (85.7)	0 (0.0)	1 (14.3)
Romania	2 (40.0)	1 (20.0)	2 (40.0)	3 (60.0)	1 (20.0)	1 (20.0)	4 (80.0)	1 (20.0)	0 (0.0)
Bulgaria	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Lithuania	2 (100)	0 (0.0)	1 (0.0)	1 (50.0)	0 (0.0)	1 (50.0)	1 (50.0)	0 (0.0)	1 (50.0)
Montenegro	0 (0.0)	1 (0.0)	1 (100)	1 (100)	0 (0.0)	0 (0.0)	1 (100)	0 (0.0)	0 (0.0)
Total	37 (61.7)	9 (15.0)	14 (23.3)	38 (65.5)	9 (15.5)	11 (19.0)	34 (57.6)	13 (22.0)	12 (20.3)

Sector	2005			2006			2007		
	Gain	Even	Loss	Gain	Even	Loss	Gain	Even	Loss
Food	0 (0.0)	0 (0.0)	1 (100)	1 (100)	0 (0.0)	0 (0.0)	1 (100)	0 (0.0)	0 (0.0)
Textile	1 (100)	0 (0.0)	0 (0.0)	1 (100)	0 (0.0)	0 (0.0)	0 (0.0)	1 (100)	0 (0.0)
Chemical	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Metals, steel and non-metals	2 (75.0)	1 (25.0)	0 (0.0)	2 (75.0)	1 (25.0)	0 (0.0)	2 (75.0)	1 (25.0)	0 (0.0)
General machinery	0 (0.0)	1 (33.3)	2 (66.7)	1 (33.3)	1 (33.3)	1 (33.3)	2 (66.7)	1 (33.3)	0 (0.0)
Electric and electronics	12 (57.1)	4 (19.0)	5 (23.8)	8 (40.0)	7 (35.0)	5 (25.0)	13 (61.9)	3 (14.3)	5 (23.8)
Transportation equipment	14 (70.0)	2 (10.0)	4 (20.0)	15 (75.0)	0 (0.0)	5 (25.0)	7 (36.8)	6 (31.6)	6 (31.6)
Total	37 (61.7)	9 (15.0)	14 (23.3)	38 (65.5)	9 (15.5)	11 (19.0)	34 (57.6)	13 (22.0)	12 (20.3)

Source : JETRO (2007)

Table 7-2: Performance Frequencies (Unit: number and percent)

Level of satisfaction	Overall satisfaction			Cost reduction		
	N	%	Cum.	N	%	Cum.
Completely satisfied	1	5.0	5.0	2	6.7	6.7
Likely satisfied	6	30.0	35.0	8	26.7	33.4
As expected	11	55.0	90.0	7	23.3	56.7
Likely unsatisfied	2	10.0	100.0	12	40.0	96.7
Completely unsatisfied	0	0.0	100.0	1	3.3	100.0
Total	20	100	100.0	30	100	100.0

Source : Chubu Industrial Advancement Centre (2004)

With regard to non-financial performance, somewhat surprisingly, the Chubu Industrial Advancement Centre (2004) reports that only 30 percent of the surveyed firms in CEE reported that their local operations were satisfactory (see Table 7-2). This negative finding may be representative of deteriorating environment-specific pressures, such as rising labour costs, intensified market competition, job-hopping problems, and macroeconomic uncertainty. The Chubu Industrial Advancement Centre survey (2004) concludes that local operations of Japanese manufacturing firms aiming only at exploitation of cheap production inputs may fail, indicating that the architecture of globally integrated production value chains and the adoption of sustainable training systems for local employees will be inevitable for raising the survival rate of local affiliates of Japanese multinationals for a long term. It is fair to say that CEE may gradually lose its comparative advantages, such as a cheap labour force and inexpensive land, over time as compared with Ukraine, Bulgaria, and Russia. To revamp managerial satisfaction, Japanese firms are likely to feel the necessity for upgrading their local responsiveness to adapt to changing market environments as well as idiosyncratic informal and formal institutions.

These two statistical surveys are subject to some limitations. One is that the number of sampled firms is considerably limited. Second, performance measures used in these surveys are not sufficient since they did not include major financial performance indicators, such as sales growth, profitability and market share. Last, these data are unable to offer clear and useful theoretical and practical implications for Japanese investors in CEE since they presented not the causal association between perceived location uncertainties and performance but a simple picture of performance based on descriptive statistics. Hence, the thrust of this chapter is to provide practical insights into performance determinants, since it reveals the success factors of doing business in CEE with a special emphasis on the strategic dynamics of the interplay between organisations and environmental-institutional forces in volatile transition economies.

7.3 Conceptual Framework

Numerous scholars have tested various theories in assessing firm performance, ranging from industrial organisation (IO) theory to transaction costs theory. The central theoretical foundation of this chapter is based on a synthesis of Dunning's eclectic paradigm, institutional economics and spatial approaches to FDI. Location-specific advantages have been discussed based on a neoclassical economic theory. Major neoclassical economists, such as Heckscher and Ohlin, point to the importance of comparative advantages in terms of input costs. I investigate the association between L advantages (host-based market conditions) and performance together with firm-specific attributes, internalisation advantages and other relevant forces. This integrative framework is appropriate since this allows us to grasp insightful information on causality. Perceived environmental-institutional factors originating in the transaction cost economics have been seen as a vital factor in having a bearing on the strategic decision process of firms. Li (2004: 153) sheds light on the relative importance of the location-performance relationship and claims that "natural or artificial impediments may vary across locations to create persistent unequal returns".

Dunning (1981, 1988, 1993) extends the concept of comparative advantage to his eclectic paradigm and insists that locational advantages would provide a firm with opportunities to reduce transaction costs and market uncertainty. Porter (1990) also conceptualises a competitive advantage framework integrating four factors which are referred to by (1) supply conditions; (2) demand conditions; (3) related and supporting industries; (4) firm strategy, structure and rivalry. There have been many studies in the past with respect to the effect of spatial conditions in the local economy on the nature and pattern of the allocation of foreign capital. However, limited efforts have been devoted to explore how changes in perceived locational advantages put constraints on the growth of corporate performance, although a number of economic geographers rely on secondary data and anecdotes, concluding that location influences corporate performance.

In addition to these firm-specific conditions as well as external conditions, it is also important to integrate "internal relational conditions" (Hewett *et al*., 2003: 569) such as the relationship between the subsidiary and headquarters. This view is emphasised by Hewett and his colleagues (2003: 569) saying that "within the MNE, foreign subsidiaries operate in a host country environment and, at the same time, they are part of a 'MNE environment".

As seen in previous chapters, local market conditions vary widely by country and region. For instance, MNEs run counter to rising labour costs and job-hopping problems, notably in the capital city of each ex-Communist country (Prague, Budapest, Warsaw, Bratislava and Bucharest) in recent years. The uneven development of infrastructure networks may be unfavourable to foreign investors. In particular, eastern

Poland has struggled with its stagnant economy. Poor highway networks have been a critical issue in the border regions between Hungary and Romania, whereas southern Poland and most areas of the Czech Republic benefit from specialised infrastructure systems, such as airports and highways, which are deemed to be key factors in attracting FDI inflows. Accordingly, the erosion of favourable market conditions is assumed to place formidable burdens on the business performance of foreign firms. Foreign investors should ensure a way to configure their profit-seeking goals with local business settings, since external resources and assets they rely on may become scarce due to unpredictable environmental uncertainties in economies in transition. The following section builds hypotheses by reviewing the vast literature on this issue. This study postulates that Japanese manufacturing firms' performance, as measured by overall operational satisfaction, profitability, sales growth and cost reduction, are contingent on six groups of variables (see Figure 7.1):

1. *Environmental-institutional factors* (economic and political uncertainty, unstable labour market, unfavourable government policy, special economic areas and agglomeration effects)
2. *Firms-specific factors* (cost leadership, managerial expertise, and bargaining power with the host government)
3. *Informal institutional relations* (social capital)
4. *Internalisation-specific factors* (entry mode)
5. *Parental control* (subsidiary autonomy)
6. *Human integration* (information sharing; sense of unity)
7. *Japanese-specific factors* (*keiretsu* organisation)

A more detailed theoretical and operational definition of the variables is presented below.

7.4 Literature Review and Hypothesis Development

7.4.1 Environmental and Institutional Factors

Economic and political certainty

Although numerous relevant studies have investigated the impact of economic and political uncertainties that are typically hostile to business, there is little agreement on this issue. Brouthers (2002), with the use of a convenience sample of 178 EU firms in CEE transforming economies, examines the impact of investment risks on performance using a set of four questions, such as (1) the risk of converting and repatriating profits; (2) nationalisation risks; (3) cultural similarity; and (4) the stability of the political, social and economic conditions. Brouthers finds that EU firms operating in countries with a higher degree of investment risk have better non-financial performance.

Figure 7-1: Proposed Model
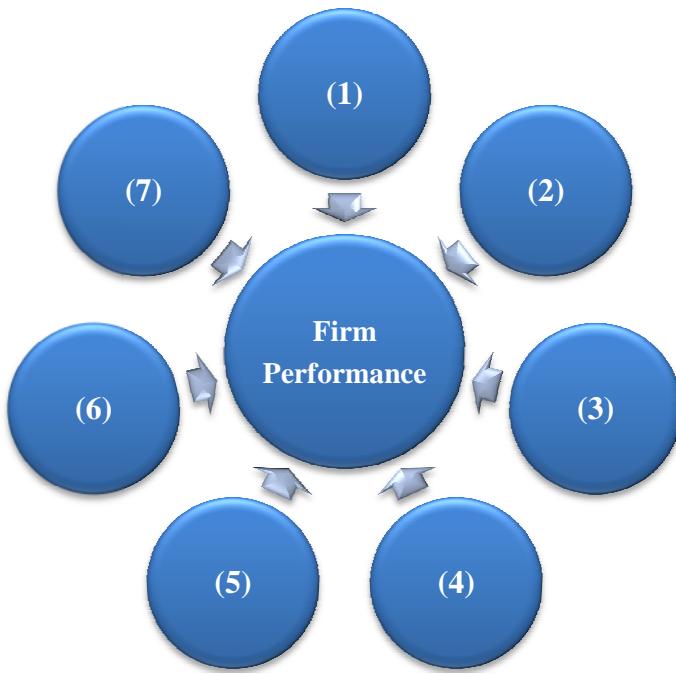
Note: (1) *Environmental-institutional factors* (economic and political certainty; stable labour market; favourable government policy; special economic areas; agglomeration effect), (2) *firm-specific advantages* (cost leadership; managerial expertise; bargaining power), (3) institutional environment relations (social capital), (4) *internalisation* (mode of entry), (5) Human integration (information sharing; sense of unity), (6) parent control (autonomy), (7) network relations (*keiretsu* organisation). (7) success of the firm (overall operational satisfaction; profitability; sales; cost reduction). Entry timing is a control variable.

Similarly, Brouthers *et al*. (1999) who investigate the relationship between investment risk and managerial satisfaction in an analysis of 369 German and Dutch firms in CEE also find that investment risk affects performance in a positive way. Rasheed (2005) who studies the performance outcomes of 123 publicly held manufacturing SMEs in the United States presents evidence that SMEs in markets with higher levels of foreign transactional risk perform better when their entry mode is equity-based. This result reinforces the validity of the contingency theory that underscores that foreign MNEs have to maximise a strategic fit between perceived environmental and situational volatility and entry mode to perform better in the international market.

Abramson and Ai (1999), in an analysis of 77 Canadian companies located in China, identify that high foreign transactional risks stimulate high overall performance and sales performance. In order to rationalise this conflicting effect, Abramson and Ai (1999) offer an explanation that changing Chinese market environments keep Canadian firms ready to undertake more flexible marketing approaches in response to risks, consequently leading to better performance.

In contrast, Demirbag *et al.* (2007) report that political risk, measured by two items, such as political stability and economic stability, on a five point Likert scale, is not an influential factor to stimulate or inhibit FDI performance in Turkey. Demirbag *et al.* clarify that the rationale behind this insignificant association between political uncertainty and FDI performance is rooted in the fact that Turkish governments have undertaken their active FDI policy toward foreign investors over time. It is plausible that convergence of CEE economies with the EU average has taken place with gradual pace due to contribution from EU regional policies to alleviating the regional economic inequality in an enlarged EU. It is argued by researchers that institutional uncertainty and structural immaturity in CEE are perceived by investors to be hazardous to additional investments. Hence, following the argument (Glaister and Buckley, 1998; Glaister and Buckley, 1999), I postulate that financial performance with a short-term horizon is likely to be more satisfactory in more stable markets.

Hypothesis 1: *Economic and political certainty will be positively associated with a Japanese firm's performance.*

Stable labour market

It is considered inevitable to the success of a foreign operation that local labour markets are stable and not volatile. Securing a pool of cheap but skillful labour is seen as an important element of offshore production management. Conventional wisdom is that the rationale behind rapid Japanese economic growth in the 1970s and 1980s is in part grounded in the stable employer-employee relationship. It is widely perceived that militant labour attitudes are a source of downgrading efficiency and productivity in Japanese production systems and of generating internal organisation costs. Moreover, foreign firms will encounter financial and non-financial damages from job-hopping problems. It is threatening when local employees leave after absorbing and accumulating a great deal of firm-specific knowledge within the organisation. Ceaseless job-hopping and absenteeism make it more difficult for firms to have local employees' long-term commitments based on mutual trust and reciprocity. Such disappointing labour markets may also become impediments to advances in localisation.

The previous chapters provide evidence that the primary aim of most Japanese firms investing in CEE is to enhance cost leadership by reconfiguring the expansion of their multidimensional business units with the exploitation of comparative locational advantages in CEE economies. A possible explanation for Japanese firms' relocation strategies is that they attempt to maximise economic benefits in the emergence of an enlarged EU by means of exporting their manufactured products in CEE to Western Europe. To capitalise on cheap input costs in CEE is part of their operational adaptation to losing locational merits in Western Europe. Following Demirbag *et al.* (2007), who find that firms motivated by capitalising on comparative cost advantages of the host

country perform better, I postulate as follows:

Hypothesis 2: *Stable labour markets will be positively associated with a Japanese firm's performance.*

Favourable government policy

To date, FDI-related policy variables, such as the creation of SEZs (Deichmann, 2005; Deichmann and Karidis, 2005; Devereux *et al*., 2007; Meyer and Nguyen, 2005), the presence of inter-state highways (Friedman *et al*., 1992; Head, *et al*., 1995; Head and Ries, 1996; Smith and Florida, 1994; Woodward, 1992), the implementation of stable and credible exchange rate policies (Loree and Guisinger, 1995; Sethi *et al*., 2002) and the development of formal and informal institutions (Meyer and Nguyen, 2005) have been broadly incorporated in the study of market entry strategies, notably strategic location selection and the intensity of FDI.

Scholars (Pangarkar and Lim, 2003; Sanyal and Guvenli, 2000) accentuate that host government policy serves as a key determinant in the successful operation of foreign firms. Supportive government attitudes toward cross-border movement of foreign capital, the exchange rate and tax policies are believed to directly influence the success of the firm (Demirbag *et al*., 2007; Luo, 2003; Luo and Peng, 1999). The host government hence plays a vital role in cushioning institutional risks, such as fragile judiciary systems, discriminatory tax regulations against foreign firms, weak property rights protection and a prevalent culture of corruption. Arbitrary changes in FDI policies may force foreign firms to shy away from profitable opportunities. A foreign firm's success in doing business may depend on the scale of government intervention in terms of ownership structure and the transfer of resources across borders (Cheng and Wu, 2001).

The impact of national policies on the internationalisation of firms has already been debated in numerous studies. Mallya *et al*. (2004), who compare foreign firms with incentives and those without incentives in terms of intention to reinvest in the Czech Republic, find that roughly 80 percent of foreign firms with incentives are motivated to reinvest in the foreseeable future. Pangarkar and Lim (2003) find that governments' friendly attitudes towards foreign companies are positively effective in increasing the perception of the overall success, stability and profitability. Demirbag *et al*. (2007) who analyse the performance of 145 Western MNEs in Turkey find that supportive governments' attitudes towards foreign capital also exert a positive impact on all three performance dimensions, such as (1) overall performance, (2) marketing-related performance and (3) productivity and cost efficiency. Moreover, Li (2004) reports that the effect of infrastructure on firm subsidiary performance is statistically significant and positive in China.

Conversely, some scholars (Cheng and Wu, 2001; Pan and Chi, 1999) identify that

MNEs operating in SEZs in China perform worse than those operating outside of SEZs. Cheng and Wu (2001) highlight that the rationale behind this contradicting result is that factor endowments in SEZs in China are more expensive than cities and the latter are more responsive to MNEs' demands. Sanyal and Guvenli (2000) find no specific relationships between government relations and the perception of the success of local affiliate of American firms in China. Park and Kim (2005) also show no relationships between Korean firms' profitability and SEZs or open cities in China, suggesting that incentives provided by the government may be offset by high wages and land costs in those areas.

What should be taken into consideration is that foreign firms have to deal with the infrastructure problems in emerging markets characterised by inadequate distribution channels, immature banking structure, and uneven road networks (Prahalad and Liebberthal, 1999). Li (2004: 153) underscores that "with the rapid advancement in transportation and communications, the role of location in determining firm performance may decrease with respect to factors that can be easily sourced across regions in free-market economies, such as capital, goods, and technology". As government policy influences the accumulation of FDI and location selection over the last decade, it could also contribute to affecting firm performance. Hence, I postulate the following hypotheses.

Hypothesis 3a: *Favourable government policy will be positively associated with a Japanese firm's performance.*

Hypothesis 3b: *Operating in a special economic area will be positively associated with a Japanese firm's performance.*

Agglomeration economies

In the economic geography literature, agglomeration forces have proved to be one of the most influential predictors to explain foreign firms' location patterns (Head *et al.*, 1995). Porter (1998) suggests that agglomerative forces lead to enhancing firm performance. According to Porter (1998), there are five factors in the explanation for the positive effect of clusters on the growth of corporate productivity, (1) better access to employees and suppliers; (2) access to specialised information; (3) complementarities; (4) access to institutions and public goods; (5) better motivation and measurement. Porter (1998: 80) stresses that "a cluster allows each member to benefit as if it had greater scale or as if it had joined with others formally without requiring it to sacrifice its flexibility". The cluster of firms that serves as a function of information exchanges helps reduce impediments to the growth of firm performance.

Porter (1998: 90) challenges a paradox that location matters less and less over time due to improved transportation systems, easy access to global markets and rising

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input costs such as labour and land by underpinning as follows: "The enduring competitive advantages in a global economy are often heavily local, arising from concentrations of highly specialised skills and knowledge, institutions, rivals, related businesses, and sophisticated customers". "The importance of interpersonal links of a common institutional culture amongst workers, entrepreneurs and politicians, and of a positive attitude towards collaboration, all facilitated by spatial proximity, stimulated interactions between actors in general and the flow of knowledge and information in geographical space in particular" (Oerlemans and Meeus, 2005: 95).

From an institution-based view of strategy, Meyer and Nguyen (2005: 66) attach importance to the impact of a cluster of firms on corporate strategies because "an area's population of firms creates pressures to establish institutions that best meet their needs". In this regard, firms in industrial clusters are likely to be able to accommodate institutional conditions more easily in comparison with firms in industrial separation.

In an analysis of the causal nexus between FDI inflows and industry development in the case of the UK economy, Driffield and Munday's (2000) study reports that agglomeration economies give rise to a strong revealed industry comparative advantage.

Shaver and Flyer (2000: 1191) also point out that agglomeration facilitates a competitor's hiring workers trained by other competitors and obtain access to the latter's technological expertise. Li (2004) confirms that the concentration of foreign firms in the same industry exerts a positive influence over firm performance, while the industrial concentration of domestic firms has an opposite impact. Eickelpasch *et al.* (2007) find that geographic proximity to rivalries does not improve firm innovativeness and performance in East Germany using 2,070 sampled firms and, in particular, firms that engage in knowledge intensive services are worse performers than high-tech manufacturers. Oerlemans and Meeus (2005), using a sample of 224 Dutch firms for the period 1989-1994 in the Netherlands, found that geographic proximity has a positive effect on firm performance. Oerlemans and Meeus document firms that take advantage of both intra- and interregional ties tend to have better performance. Chung and Kalnins (2001) demonstrate that independent and smaller hotels benefit from markets where large hotels are located. Shaver and Flyer (2000) find that centripetal forces decrease a firm's survival rate in the US. The following competing hypotheses are tested:

Hypothesis 4a: *Agglomeration economies will be positively associated with a Japanese firm's performance.*

Hypothesis 4b: *Agglomeration economies will be negatively associated with a Japanese firm's performance.*

7.4.2 Firm-Specific Advantages

When highlighting the importance of firm-specific strategic resources to invest abroad,

Hymer's monopolistic advantages (1960) and Dunning's eclectic paradigm (1981) have been dominant theories in the strategic management and international business literature. These theories have much in common with the resource-based view of the firm. Their central argument is that a firm's ownership advantages play a crucia role in compensating for the liability of foreignness and in outperforming indigenous firms that possess knowledge of and access to local labour, capital and product markets. At an initial stage of market penetration, foreign firms are at a disadvantageous position to compete against local rivals with well-accepted brand image as well as reputation and long-established value chains (Luo, 2003).

Firm-specific advantages, as referred to by technological intensity, marketing capability, reputational assets, managerial capabilities, and international experience, are expected to determine firm performance when investing abroad. Delios and Beamish (2001) suggest that the success of the transfer of intangible assets depends on the extent to which MNEs adapt to the complexity and dynamism of local markets. Foreign firms that have the ability to capitalise on ownership advantages, together with locational advantages, tend to be more active in CEE (Meyer, 1998). There is a strong tendency among scholars for employing R&D as a major proxy for intangible assets. Nevertheless, the following three advantages deserve additional attention in the era of a 'global chess' that forces MNEs to reorganise the strategic direction of foreign activities.

Cost leadership

Cost leadership is the term that refers to "cost control in the area of organisational management, engineering and accounting" (Reid, 1993: 128). More specifically, cost leadership can be interpreted as a firm's ability to reduce costs involved in the implementation of value chain systems ranging from sales to production. Strong cost leadership enables firms to outperform rivals and generate barriers that make it difficult for rivals to enter in an era of increasingly accelerating globalisation (Porter, 1980).

There are various measures that firms enhance cost leadership. Tight cost control in raw materials, efficient access to capital, flexible distribution channels, and high level of know-how in cutting-edge production methods are vital to firms in sustaining cost leadership. In addition, introducing in-house production enhances cost leadership since an increase in in-house production rates regarding core components requires original technological developments and hence results in product differentiation against rivals. The formation of strategic alliances is also effective for firms to acquire cost advantages. It is because the firm can sell its services and products below rivals' prices by forming strategic alliances with potential partners in fields, such as procurement, marketing, production and R&D. At the same time, the firm can improve product quality, streamline production processes and cut procurement costs. Dedicated cost leadership by means of strategic alliance formation points to the

importance of resource complementarity.

To date, the impact of cost leadership on firm performance has been poorly explored by scholars of strategy and international business. With a particular focus on the dismantling or reorganisation of the traditional *keiretsu* system in Japan in recent years, Nobeoka and Tanaka (2002) ask to what extent cost leadership has a positive influence on return on sales of 201 Japanese manufacturing firms in Japan. Nobeoka and Tanaka find that cost leadership is positively related to firm performance but the impact of the variable differs depending on the degree of perceived technology and business uncertainties. Similarly, Lee and Miller (1999) identify that dedicated cost leadership is at the heart of organizational success for the case of Korean firms. In sum, firms find it impossible to survive without upgrading cost leadership. Hence, I postulate the following hypothesis.

Hypothesis 5: *Cost leadership will be positively associated with a Japanese firm's performance.*

Managerial expertise

Managerial expertise within the firm is believed to be a source of competitive strength for MNEs. Managerial expertise refers to the ability for MNEs to organise strategies in terms of financing, product development, international marketing and the evaluation and training of human resources. This firm-specific ability generates good profit margins by streamlining the organisation. Hence, I postulate the following hypothesis.

Hypothesis 6: *Managerial expertise will be positively associated with a Japanese firm's performance.*

Bargaining power with the host government

Apart from the conventional ownership advantages, such as R&D intensity and advertising intensity, a firm's bargaining power with host government authorities are important predictors for foreign MNEs doing business successfully. A firm's bargaining power refers to the ability to realise its special objectives and aims over what counterparts aspire to achieve in the pre-and post-entry process. Moreover, the level of bargaining power that the firm possesses determines the success or failure of its competition for receiving government attention. MNEs with strong negotiation power are capable of bargaining for desired resources, such as training grants and tax exemptions in the ex ante and ex post investment periods. As a result, the policy formulation of state actors can be manipulated by the nonmarket power of firms. Moon and Lado (2000) assert that MNEs with strong R&D and advertising intensity are less vulnerable to host government intervention and are more capable of achieving desired strategic outcomes. This view supports the hypothesis that the success of the subsidiary

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is influenced by relative bargaining power. Moreover, the scale of a MNE's bargaining power varies depending on entry mode, notably in transition economies. Firms that build factories from scratch are more competitive in the FDI negotiation process with host governments than those who enter the market in the form of M&A because the former can feel free to choose one of many location candidates (Meyer and Jensen, 2005). Hence, I postulate the following hypothesis.

Hypothesis 7: *Bargaining power with a host government will be positively associated with a Japanese firm's performance.*

7.4.3 Informal Institution-Specific Factor

Institutional environment relations/social capital

Building personal ties and networking know-how has been treated as either social capital or social embeddedness (Grabher, 1993; Granovetter, 1985), which denotes that economic transactions and values are determined by social ties of networks in the fields of institutional economics, economic sociology, political science and organisational behaviour. For firms, the accumulation of social capital indicates the integration of "a sort of cultural software" (Grabher, 1993: 2) and "knowledge-sharing routines" (Yli-Renko *et al.*, 2001: 589) into an organisation. Zhou *et al.* (2007: 7) define social capital as "a collection of knowledge of foreign market opportunities, advice and experiential learning and referral trust and sense of unity by a third party". Social capital is cheap, rich and more detailed in the context of desired information, trustful in economic transactions apart from opportunism (Granovetter, 1985). Dunning and Lundan (2008: 585) define the notion of social capital as "a measure of the quality of the informal institutions in a society". Scholars of economic sociology (Uzzi, 1996, 1997) shed particular light on the intensity and breadth of knowledge sharing available in social relations relative to those available in arm's length markets. Social capital aids firms in gaining timely access to strategic resources and assets desired by economic actors seek (Grabher, 1993).

Granovetter (1985) and Yeung (1997) criticised Williamson (1985)'s transaction cost economics (1985) for disregarding the relation of economic transactions to social interactions and networking strength. In fact, Williamson (1985) treats MNEs as an economic entity economising on transaction costs and assumes that MNEs are motivated to enhance economic efficiency by establishing hierarchical governance systems.

Yeung (1997: 4)[19] underscores the importance of network arrangements with societal actors in considerations of economic geography and remarks that firms usually

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[19] Yeung (1997: 10) argue that there are three types of social relations in which MNEs are embedded: (1) intrafirm networks (coordination and control within the organization); (2) interfirm networks (personal and business contacts); and (3) extrafirm networks (political bargaining).

seek the following three goals at the extra-firm level: (1) to establish power relations more than monetary relations; (2) to search for proprietary rights; (3) to reinforce social and political legitimacy.

The institutional perspective considers that a firm's ability to survive is dependent on the extent to which the firm accommodates institutional controls and environmental constraints by minimising transaction costs (*e.g.*, asymmetric information problems and opportunistic behaviour) and maximising legitimacy, social support, stability, recognition, mutual acquaintance, and reciprocity (DiMaggio and Powell, 1991; Meyer and Rowan, 1991).

Scholars of strategic management (Peng, 2003; Peng and Heath, 1996) also attach importance to the forging of social ties. Transaction costs (*e.g.*, bureaucratic and coordination costs) are reduced when economic actors search for business-related information acquisition through the use of extrafirm networks because of no need for "substantial formal transfers of ownership rights" (Peng and Heath, 1996: 514). Peng and Heath (1996: 505-506) highlight that the impact of relational assets on the success of the firm is contingent on the accumulation of social contacts on the basis of personal trust, notably during the transition "because they offer some constancy and predictability in times of fundamental change in the formal institutional frameworks". In addition, Meyer (2000: 139) also emphasises that personal ties act as a vital mediator for binding firms with governmental institutions such as ministries, party officials in the commanding economic system. Moreover, Peng (2003) argues that firm performance is conditional on informal connections and social influences in the initial period of transition, whereas the importance of firm-specific competitive advantages exceeds that of such relation-specific advantages in the late stage of transformation in the Soviet-type economy.

The types of information available in the extrafirm networks range from tax reforms to political certainty and FDI-related incentives (Wu, 2008). According to Zhou *et al*. (2007), the growth of transaction values varies depending on the intensity and density of relationships and social ties. The development of such social capital enables MNEs to circumvent the liability of foreignness and to collect appropriate information on the local political system (Zhou *et al*. 2007). In other words, MNEs with stronger network relations with local institutional actors can more effectively exercise host-based business practices and hence mitigate cultural and language hurdles.

Cultivating institutional environment relations, notably with government agencies, facilitates the acquisition of desired resources such as "direct funding (*e.g.*, government subsidies), strategically useful information and contacts (*e.g.*, professional associations, government agencies), lucrative business contracts (*e.g.*, state contracts eligible only to firms that demonstrate compliance with regulations), and influential product endorsements (*e.g.*, 'healthy' food products)" (Oliber, 1997: 103).

It has also been perceived by MNEs to be imperative that they build social ties

with local communities. Increasing attention has also been given to corporate social responsibilities, for committing themselves to making their production facilities environment-friendly, sponsoring local sports and cultural events and participating actively in local dialogues and charities. Such efforts influence the development of cooperative relationships with the local society based on personal trust and reciprocity. Firms have the need to achieve shared goals and legitimacy, while seeking profits with long-term horizons.

In the existing international business and strategic management literature, social network has been used to enhance our understanding of the behaviour and nature of the firm (Oliver, 1997; Uzzi, 1996; Wu, 2008; Yli-Renko *et al.*, 2001). There has been strong theoretical and empirical agreement on the positive link between the magnitude of networks of social ties and firm performance (Rhee, 2008).

Zhou *et al*. (2007) find that social capital promotes the ability of MNEs to obtain credibility, legitimacy and efficiency in emerging markets. Demand for better understanding how to deal with the host-based government intervention and the local political system requires MNEs to more actively interact with local governmental officials. High degrees of social ties with host government agencies help firms enhance the degree of legitimacy in local markets. Special access to government authorities and excellent communication with them may also allow foreign enterprises to decrease the incurred coordinating and negotiating costs within the MNE-local government interaction.

Uzzi (1996), who studies how organisation outcomes of 23 apparel firms in New York are shaped by social capital, finds that the intensity of social capital reduces the possibility of operational failure. More interestingly, the author identifies the relationship between social capital and the likelihood of failure is U-shaped curve-linear oriented, indicating that hybrid social capital characterised by in-between arms-length ties and embedded ties generates the highest survival rate of the firm.

Yeung (1997) who investigates the role of personal ties and network competencies in promoting a Hong Kong firm's market position in ASEAN, identifies that personal contacts with government officials reduce the operational cost and augment the profitability of the firm. According to Yeung's survey conducted in the period from December 1993 to August 1994, roughly 20 percent of the sample Hong Kong firms operating in ASEAN report that relationships with host-based governmental agencies facilitate successful local operations by means of stimulation, guidance and assistance from local government institutions.[20]

Peng (2000), in an analysis of three Chinese-foreign automobile joint ventures (Beijing Jeep Corporation, Shanghai Volkswagen Automobile Company, and Guangzhou Peugeot Automobile Corporation) in China, examines how their

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[20] See more details in Yeung (1998).

relationships with local and state authorities improve organisational outcomes in the principal-agent context. Peng finds that the establishment of cooperative ties with local government enables foreign firms to achieve strategic interests. In a similar vein, Biziouras and Crawford (2001) point out that the primary reason for Shanghai VW's success in China should be attributed to its special access to the central government in Beijing. Special governmental support was provided to Shanghai VW in the 1989 economic crisis as well as in the process of market liberalisation in the early 1990s, while its counterpart, Guangzhou Peugeot suffered from the lack of strong connections with the central government in Beijing (Biziouras and Crawford, 2001: 180).

With the help of the informal local networks, TNC subsidiaries are able to extract information on unexpected changes in institutional conditions without time lags, while indigenous political and societal actors can also design policies and enforce rules, which bring optimal benefits not only to the whole society but also to their own political interests to coevolve with TNC subsidiaries. The premise is that poor social capital or network competences in the local market contributes to increasing chances for MNEs to confront asymmetric and insufficient information problems and poor legitimacy, and hence limit the success of the subsidiary. I propose the following premise:

Hypothesis 8: *The magnitude of social networks will be positively associated with a Japanese firm's performance.*

7.4.4 Internalisation-Specific Characters

Entry mode

The transaction cost theory has been commonly used as the central theoretical foundation for assessing the importance of the entry mode selection and performance link. Williamson (1985) claims that MNEs are likely to internalise technological knowledge, marketing skills and managerial know-how within their hierarchical organisations, because transactions in arm's length markets are characterised by cost and uncertainty. Especially, it is evident that the transfer of firm-specific advantages from the parent company to its affiliates involves coordination problems, transaction costs, market uncertainties and information asymmetry when investing abroad (Williamson, 1985). A debate on entry mode selection and performance has developed on the discussion of a trade-off between resource commitment and efficiency (Brouthers *et al.*, 1999). However, empirical research on this issue has been limited and its empirical results have been inconclusive (Brouthers *et al.*, 1999).

Regarding the build-up of own factories from scratch, it is a consensus that firms can better implement a smooth transfer of firm-specific assets from the parent to the affiliate without any intervention by local partners inherent in the JV mode. The advantages of a full ownership strategy face neither free-riding problems (Chang and Rosenzweig, 2001; Madhok, 2005), monitoring costs (Anderson and Gatignon, 1986),

nor the issue of shirking (Gomes-Casseres, 1989). To be more specific, complete ownership enables the parent to independently dictate value systems, technological innovation, resource networks, organisational patterns, financial leverage and managerial methods of its local affiliates at a lower cost (Anderson and Gatignon, 1986; Chang and Rosenzweig, 2001) and to achieve desired strategies and outcomes although the establishment of new ventures from scratch requires time and capital to operate and adapt to inflexible and ambiguous legal infrastructures in transition economies (Estrin and Meyer, 1998). Compared to JVs, wholly owned subsidiaries are in an advantageous position in implementing their own marketing, production and sales strategies and introducing new products developed in the HQs and other foreign units.

Greenfield investments are likely to be less influenced by host government regulations. This is because economic gains of local governments are linked to the gains of greenfield investors. Since the initial stage of the transition to a market-based economy, local governments have been under pressure to outcompete their rivals for inducing large greenfield projects that contribute to job creation, technology transfer, integration of local suppliers into global markets whereas greenfield investors desire to obtain financial and fiscal incentives (Meyer and Jensen, 2005).

To explain why the full ownership encourages the success of the firm requires reliance on the transaction cost theory, which underlines the importance of control. High degree of control may matter in achieving high returns on investment. Empirically, Brouthers (2002) and Brouthers *et al*. (1999) find that complete ownership commitments are an optimal entry form of investing abroad and increasing financial and non-financial performance. Brouthers and Nakos (2004), who examine the entry mode-performance relationship with a data set of 185 Dutch and Greek SMEs in 14 different CEE markets, find that firms that high degrees of entry mode fit in accordance with the transaction cost theory perform better. Conversely, Siripaisalpipat and Hoshino (1999) examine a causal association between entry mode and performance for 190 Japanese firms investing in Thailand. Siripaisalpipat and Hoshino draw the conclusion that Japanese firms with full ownership are the least profitable and ownership type does not matter in achieving successful operations. Thus, a premise to study is as follows:

Hypothesis 9: *Hierarchical control mode will be positively associated with a Japanese firm's performance.*

7.4.5 Human Integration

Information sharing and sense of unity

The growth of the firm hinges on the level of integration of local employees into the organisational structure of the firm. Drawing upon the resource-based view of the firm, efficient integration of key resources such as local personnel within the organisation makes the firm more valuable and efficient due to information, experience and

dedication contributed by local employees. Prior work notes that a firm's commitment to local employees serves to ensure high labour productivity, and to enhance a sense of involvement or unity (Eisenberger *et al.*, 1990; Lee and Miller, 1999; Organ and Konovsky, 1989; Whitney, 1994). The improvement of communications not only between foreign expatriates and local employees but also between workers and management and their contribution to the organisation of a firm, is likely to be seen essential to development of a shared vision and shared goals, thus engendering mutual trust between expatriates and local employees.

Active human integration can increase the likelihood of local employees behaving not opportunistically but complementarily. An effort to promote human integration through the upgrading of information sharing and sense of unity is considered fundamental to the success of a foreign operation. Majek (2005) who conducted interviews with managers from four Japanese subsidiaries (Toyota, Isuzu, Denso and Toyo Seal) in the Polish automobile industry, points out that improvement of group awareness would contribute to transferring the model of Japanese management systems to Poland. The study by Majek gave evidence that group consciousness, as measured by a five Likert scale in three items such as small group activities, information sharing practice and sense of unity, is not as high as the average. Luo (2003) also argues that the lack of efficient information sharing mechanisms within the firm will hamper technical or market opportunities that could boost business performance. Froese and Geritz (2007) who investigate two M&A cases (Renault and Nissan, Daimler and Mitsubishi) find that a high degree of organisational and human integration affects the success of M&A communication in Japan. En (2006) argues that insufficient communication that results from cultural gaps between Japan and CEE may hinder the development of stable labour relationships and the transfer of production technology in CEE. Using the case study approach of internationalisation of Western invested-enterprises in the Czech Republic and Slovakia, Pavlínek (1998) attributes the success of Whirlpool to efficient human resource management and communication initiatives such as face-to-face weekly meetings between management and workers. I postulate the following hypothesis.

Hypothesis 10: *Information sharing will be positively associated with a Japanese firm's performance.*

Hypothesis 11: *Sense of unity will be positively associated with a Japanese firm's performance.*

7.4.6 Parent-Company Control

Autonomy

The regionalisation of the manufacturing sector has been spurred by a heightened level of competition in an enlarged Europe, requiring subsidiaries to have the ability to react

flexibly to emerging customer demands so as to sustain access to local market knowledge and innovation. Considering these environmental dynamics and the complexity of the EU, firms have to attain a high level of autonomy. Subsidiary autonomy refers to "the degree to which the foreign subsidiary of the MNE has strategic and operational decision-making authority" (O'Donnell, 2000: 528) and "the level of freedom that a venture has to operate without parent company interference" (Newburry and Zeira, 1999: 264). Slangen and Hennart (2008) integrate internal conformity pressures based on institutional theory into performance of MNEs, assuming that *ceteris paribus* the lower internal conformity pressures from the HQs a subsidiary experiences, the higher degree of local responsiveness the subsidiary can enjoy. Slangen and Hennart's study verifies that foreign MNEs perform worse when the level of subsidiary integration is higher (*i.e.*, tighter HQs' control).

Yeung (1997) argues that the degree of autonomy depends on the extent to which the parent company trusts the local manager and how much that manager understands the corporate identity and vision. Greater autonomy for the subsidiary results in subsidiary managers having greater managerial discretion to be able to choose the way firm-specific resources, such as technology, knowledge, finance and human capital, are utilised. Bartlett and Ghoshal (1998: 105-107) underscore that "foreign operations dependent on a central unit may be unable to exploit local market opportunities or respond effectively to strong national competitors". Luo (2003: 292) supports this view, indicating that "through increased strategic adaptation in response to emerging market opportunities, local responsiveness and control flexibility embedded in a parent-subsidiary link support the deployment and exploitation of existing capabilities and bolster the building and upgrading of new capabilities vital in the host country". Bartlett and Ghoshal (1998) point out that too much reliance on practices and policies mandated by the parent retards a subsidiary's business activity due to too much bureaucracy in the consensus decision-making process, and asymmetric information between the parent and the subsidiary. The reinforcement of decentralisation helps lower operational costs and enhances the subsidiary's own responsiveness to rapid changes in its operating environments.

Scholarly attention has been given to the impact of the parent-subsidiary relationship on the success of the subsidiary. Additional costs arise from the misalignment of policy to local market conditions arising from dependence on the parent; strategies developed by the parent may not be adequate due to physical distance and less adequate knowledge than that possessed by the affiliate (Luo, 2003). The delegation of autonomy is of critical importance in making local operations efficient and workable. Empirically, it has been widely recognised that the delegation of authority and responsibility to subsidiaries increases their ability to adapting the changing host business climate in an efficient manner. Kotabe and Wheiler (1998) find that local autonomy has a positive impact on corporate performance since a higher degree of

transference of operational and managerial autonomy from the parent to the affiliate allows the subsidiary better to respond to changes in local demands and needs. Luo (2003: 292) argues that "MNE parents depend on subsidiaries to seize rent-generating opportunities or acquire host country-specific knowledge". The delegation of autonomy and responsibility to foreign subsidiaries could serve as an incentive for managers to increasing personal efficiency and commitments (Bartlett and Ghoshal, 1998). I postulate the following hypothesis:

Hypothesis 12: *The delegation of autonomy to a Japanese subsidiary will be positively associated with its firm performance.*

7.4.7 Network Relations

Social organisation of the Japanese economy (keiretsu)
Keiretsu membership, a network governance structure that augments learning and exchange efficiencies, can also be regarded as a relational asset. More precisely, *keiretsu* firms are embedded in social and economic relations at the inter-firm level when following Yeung's (1997) classification of social capital. Business group ties can also be interpreted as a contributor to synergising existing firm-specific competitive advantages, such as complementary marketing and managerial information, trust and shared goals with social capital that builds on groupthink, informal meetings and interpersonal relations. By virtue of frequent interaction with exchange partners a *keiretsu* firm can align with optimal strategic goals and enjoy economic reciprocity and minimise exchange partners' behavioural opportunism. The *keiretsu* tie enables group member firms to save costs involved in market transactions and economise on the costs of trading goods, labour, capital and service within the group boundary. Wang *et al*. (2005: 95) argue that "it is not uncommon for a *keiretsu* to have a long-term vision of collective welfare that some firms benefit, while others pay a price. Thus, a subsidiary whose parent firm belongs to a *keiretsu* would benefit more from the affiliation than one whose parent does not belong to a *keiretsu*".

To date, the impact of *keiretsu* affiliation on performance remains inconclusive, since some (Chen *et al*. 2006; Douthett *et al*. 2004; Hoshi *et al*. 1990; Lai and Limpaphayom 2003) agree that *keiretsu* is of great importance to the success of the firm in the home market, whereas others show conflicting results (Gerlach, 1992; Lincoln *et al* 1996; Jameson *et al*., 2000; Nakatani 1984). Gerlach (1992), in a cross-sectional analysis of the impact of ownership concentration on profitability of Japanese firms for the period 1976-85 in the home market, finds that group membership harms corporate performance. Lincoln *et al* (1996), who investigate the association between corporate profitability and the *keiretsu* presidents' council (*shachōkai*) using 197 Japanese industrial firms over the periods 1965-1988, 1967-1988 and 1967-1985 found that the *keiretsu* membership based on *shachōkai* has a significant and negative impact on return

on asset.

Wang *et al.* (2005) examine the *keiretsu* network in the Asian market as a significant predictor for the success of foreign affiliates of Japanese firms in the Asian monetary crisis of 1997 by using a sample of 1,128 firms. Wang *et al.* (2005) find that a local subsidiary whose parent company is a horizontal *keiretsu* member could enjoy better opportunities for making profits even in the crisis period, due to inter-group capital allocation and the impact of horizontal *keiretsu* membership providing additional advantages beyond a single subsidiary's experience.

Ma *et al.* (2006), who investigate the extent to which the intensity of business group affiliation is reflected in optimum levels of performance in China, fnd that the interaction of business group affiliation and state ownership exerts a positive impact on the success of firms. Wu (2008), in an analysis of 108 Hong Kong-based Chinese family-owned firms from the manufacturing sector also found that information-sharing in a business group network plays a mediating role in the positive relationship between network relations and firm competitiveness.

What is striking is that independent firms tend to better align their corporate strategy with economically turbulent environments in Japan, compared with *keiretsu firms*. Recent years witness that many independent suppliers compete against *keiretsu* firms in domestic and global contexts. Alps Electric, Bridgestone, Diamond Electric, Daikin Industry, NGK Ceramics, NSK, NTK Technical Ceramics, NYB, Sanden and Yazaki Corporation are all competitive independent firms in the 'arm's length market' and aggressively sell their products to foreign customers abroad. Given these above discussions, I postulate the following competing hypotheses.

Hypothesis 13a: *Keiretsu networks will be positively associated with a Japanese firm's performance.*

Hypothesis 13b: *Keiretsu networks will be negatively associated with a Japanese firm's performance.*

7.4.8 Control Variable

Entry timing

The impact of entry timing on firm performance has been an interest of research on international business and strategic management. First-mover effects are perceived to be of great significance among foreign investors who seek to take advantage of cheap input costs in less developed countries. Early entrants are able to stockpile intangible assets, such as experience and knowledge, and can thus establish a dominant market position. As a result of first-mover advantages, minor market players at home are likely to gain a strong market position in competitive industries in which the host government provides foreign investors with special support (Luo, 1995). For instance, the first-mover effect

holds for the case of Suzuki in Hungary (Van Tulder and Ruigrok, 1998). Employing 859 MNEs in China, Pan and Chi (1999) find that firms that began prior to 1988 perform better than those that began after 1990, suggesting that, at the early stage of transformation, first movers can enjoy various financial rewards and concessions that late comers cannot obtain. First-mover advantages lead firms to develop, strengthen and leverage ties with the host-based incumbent government and local customers with a long-term horizon. Lending support to this analytical view, Estrin and Meyer (1998: 217) also highlight that "firms may even be able to influence the local regulatory environment in their favour".

Despite various positive advantages accruing from the first-mover effect, early entrants bear additional costs related to institutional deficiencies in the host economy. Early investors' profits could be distorted by low quality of laws and peculiar requirements of operating, local politicians' erratic decisions, and corruption and bribery problems in the early stage of transformation, since a wide discrepancy exists between formal rules and social norms. In other words, host governments in emerging economies still need time to align rules and laws to those of industrialised countries and to develop the organisational and administrative capabilities to encourage foreign capital. Institutional convergence does not occur overnight. Estrin and Meyer (1998: 218) also contend that "brand names may be worth less where brand loyalty is low because consumers may want to experiment with new products", while the establishment of long term brand recognition can, in theory, be thought of as part of a superior competitive advantage for early entrants.

In contrast to early entrants, followers can learn from both successful and failing outcomes of strategic management associated with marketing and product development in transitional economies, while they may face a strong reaction from initial entrants to protect the market shares that they have gained (Fahy *et al.*, 1998). This behaviour can be interpreted as "free rider effects that refer to the ability of later entrants to avoid some of the costs that early entrant must pay, such as R&D and buyer education" (Schoenecker, 1994: 33). In the context of the economic transition, late investors capitalise on host government officials' increased acceptance of and pro-active stance towards foreign capital designed to open the path to a free market-based economy over time. The advancement of industrial restructuring driven by early investors helps to reduce institutional constraints. Estrin and Meyer (1998:218) state that late investors benefit from early investors' commitments to "building the market". Foreign MNEs that entered in CEE markets, especially, after 2000, have benefitted from improved legal and political infrastructure resulting from the implementation of the EU's *acquis communautaire*. Nevertheless, Woodcock and Beamish (2001: 90-91) point out that financial and non-financial performance may not be satisfactory in the start-up period because it takes time for late entrants to adapt to local markets, benefit from scale economies and acquire information about rivals, labour management and government

regulations. I postulate that the earlier a firm enters an emerging market, the greater the likelihood of superior performance by that firm.

Hypothesis 14: *Early entry timing will be positively associated with a Japanese firm's performance.*

7.5   Research Methods and Sample Characteristics

The analysis in this chapter relies on an evaluative survey including performance, changes in perception of location-specific advantages, firm-specific capabilities, internalisation advantages, institution-specific factors, human integration, parent-subsidiary relationships and *keiretsu* systems at the subsidiary level.

To identify sample firms, I used the latest *Tōyō Keizai Kaigai Shinshutsu Kigyō Sōran* 2007, a list of Japanese firms published by the Japanese Chamber of Commerce and Industry in the Czech Republic in 2006 as well as a list of Japanese investors in Hungary published by the JETRO Hungary Office in 2005. There were 206 Japanese manufacturing firms in CEE. 179 of those companies in the manufacturing sector were finally chosen, while 27 firms that were in operation since 2006 were excluded, because a new venture normally earns no or little profit in the first years of operations (Demirbag *et al.*, 2007). Then I confirmed whether the companies could participate in the survey aimed at evaluating a performance-changing locational advantages relationship. Those who were contacted were executive level company staffs who were asked to assess their affiliates' performance in a multi-dimensional way. Secondary data about each of the surveyed firms' investment projects in the ex-Soviet markets were compiled from their Internet websites.

In January 2008, I used three techniques of survey delivery to collect primary data from respondents from the Czech Republic, Hungary, Poland, Romania, Slovakia, Lithuania, Serbia and Montenegro: (1) survey delivery by email; (2) survey delivery by mail to senior managers of subsidiaries whose email addresses could not be identified; and (3) direct visits to some Japanese companies operating in CEE in January 2008. The survey questionnaires, accompanied by cover letters, were then personally delivered using the above techniques. The survey was prepared in Japanese. Two native speakers verified the accuracy of the Japanese-language questionnaire.

After sending out the two-page questionnaire by email and mail, reminders were delivered over the telephone for those who had not responded. In order to obtain a high response rate, I tried to keep the questionnaire simple and clear. Out of 179 Japanese subsidiaries in CEE, a total of 61 affiliates (33.4 percent) showed their willingness to participate in the evaluative survey. The responses of six affiliates' were unusable, due to a number of incomplete and invalid answers. There were two major underlying reasons for rejecting an offer of participation in the survey. First, some senior managers were prohibited from participating in this type of survey even for academic purposes,

Table 7-3: Representativeness of Sample Japanese Manufacturing MNCs

Representation	Population	Percent	Survey sample	Percent
Country				
Czech Republic	64	35.8	18	32.7
Hungary	45	25.1	15	27.3
Poland	44	24.6	16	29.1
Slovakia	11	6.1	4	7.3
Lithuania	2	1.1	0	0.0
Slovenia	0	0.0	0	0.0
Bulgaria	1	0.6	0	0.0
Romania	11	6.1	2	3.6
Serbia	0	0.0	0	0.0
Montenegro	1	0.6	0	0.0
Total	179	100	55	100
Industry				
Automobiles and automobile	83	46.4	16	29.1
Electornics products and electric components	35	19.6	17	30.9
General machinery	10	5.6	6	10.9
Chemical and petroleum	5	2.8	4	7.3
Others	29	16.2	9	16.4
Food processing	4	2.2	1	1.8
Plastic	4	2.2	0	0.0
Precise machinery	3	1.7	0	0.0
Metal	6	3.4	2	3.6
Total	179	100	55	100
Year of establishment				
Before 1990	0	0.0	0	0.0
1990-1994	16	8.9	2	3.6
1995-1999	41	22.9	19	34.5
2000-2004	107	59.8	29	52.7
2005	15	8.4	5	9.1
Total	179	100	55	100

due to the need to comply with strict company policy. Second, some senior managers reported that they were not inclined to participate in such a survey, given their busy schedules. This kind of attitude of senior managers towards the survey in general may indicate that they have little expectations of receiving a summary report after responding, and may find the empirical results of little importance to their local management. The final number of the valid cases was 55, which represents a response rate of 30.7 percent.

Table 7-4: Sample Industry Distribution, Ownership Structure and Entry Timing by Country of Destination

Country of Destination		CZ	HUN	POL	SLK	ROM	Total
Year of establishment							
Before 1990	Count	0	0	0	0	0	0
	Layer %	0.0	0.0	0.0	0.0	0.0	0.0
1990-1995	Count	0	1	0	1	0	2
	Layer %	0.0	6.7	0.0	25.0	0.0	3.6
1995-2000	Count	4	6	6	2	1	19
	Layer %	22.2	40.0	37.5	50.0	50.0	34.5
2000-2005	Count	11	8	9	1	0	29
	Layer %	61.1	53.3	56.3	25.0	0.0	52.7
After 2005	Count	3	0	1	0	1	5
	Layer %	16.7	0.0	6.3	0.0	50.0	9.1
Total	Count	18	15	16	4	2	55
	Layer %	32.7	27.3	29.1	7.3	3.3	100
Firm ownership							
Wholly-owned	Count	16	14	12	2	1	45
	Col %	88.9	93.3	75.0	50.0	50.0	81.8
Joint ventures	Count	2	0	3	2	0	7
	Col %	11.1	0.0	18.8	50.0	0.0	12.7
M&A	Count	0	1	1	0	1	3
	Col %	0.0	6.7	6.3	0.0	50.0	5.45
Total	Count	18	15	16	4	2	55
	Col %	32.7	27.3	29.1	7.3	3.3	100
Industry							
General machinery	Count	1	0	3	0	2	6
	Col %	5.6	0.0	18.8	0.0	100.0	10.9
Consumer electronics	Count	6	8	1	2	0	17
	Col %	33.3	53.3	6.3	60.0	0.0	30.9
Transportation	Count	7	4	4	1	0	16
	Col %	38.9	26.7	25.0	20.0	0.0	29.1
Chemical	Count	1	1	2	0	0	4
	Col %	5.6	6.7	12.5	0.0	0.0	7.3
Others	Count	3	2	6	1	0	12
	Col %	16.7	13.3	37.5	20.0	0.0	21.8
Total	Count	18	15	16	4	2	55
	Col %	32.7	27.3	29.1	7.3	3.3	100

The data collection process involved a great deal of time, complexity and difficulty in identifying proper contact persons and proper company addresses. The response rate is relatively reasonable in comparison with other relevant studies of emerging economies done by Brouthers (2002), Brouthers and Nakos (2004) and Carlsson *et al.* (2005) whose response rates are 21 percent, 29 percent, and 35 percent. It can be concluded that this relatively high response rate seems contributory to producing less biases in the data and hence leads to an increase in the degree of generalisation and reliability for the economic performance of Japanese manufacturing firms in CEE.

7.5.1 Sample Characteristics

Of the 55 valid responses, 3.6 percent of the sample firms entered the CEE markets between 1990 and 1994, 34.5 percent entered between 1995 and 1999, 52.7 percent entered between 2000 and 2004 and 9.1 percent entered in 2005. 32.8 percent of the surveyed firms operate in the Czech Republic, 26.2 percent operate in Hungary, 29.5 per cent operate in Poland, 8.2 percent operate in Slovakia and 3.3 percent operate in Romania.

Of the 55 valid responses, 81.8 percent of the sample firms undertook the wholly owned subsidiary (WOS) mode, 12.7 percent undertook the joint venture (JV) mode, and 5.45 percent undertook the merger and acquisition (M&A) mode. This result indicates that Japanese firms favour keeping control over their foreign subsidiaries. Of the 55 surveyed firms, 30.9 percent of the respondents are engaged in the electronic/electric industry, 29.1 percent are engaged in the transportation equipment industry, 10.9 percent are engaged in the general machinery industry, and 7.3 percent are engaged in the chemical industry (Table 7-3).

In terms of the nationality of senior managers in local operations, 86.9 percent of the respondents are Japanese. In terms of the number of Japanese expatriates, roughly 50 percent of the respondents employ between one and four Japanese expatriates, followed by 24.6 percent employing between five and nine Japanese expatriates, and 16.4 percent employing between 10-19 Japanese expatriates.

The above table shows that there are two main waves of Japanese manufacturing firms' market entry in CEE. The first entry wave occurred in the period between 1995 and 2000. This denotes that the strategic choices of Japanese manufacturing firms were based on risk-avoidance. The second entry wave took place in the period between 2000 and 2005, during which the majority of the surveyed firms entered CEE markets. In particular, 61.1 percent of the sample firms operating in the Czech Republic are concentrated in this specific period, indicating that numerous Japanese automotive suppliers followed their main customers such as Toyota in Kolín, Czech Republic. In this period, considerable effort by the host government in CEE was also given to the creation of various incentives and to the removal of key institutional constraints to promote foreign capital inflows.

The survey sample demonstrates that the industry specialisation of Japanese manufacturing companies differs depending on country of destination (see Table 7-4). The Czech Republic attracts Japanese FDI to the transportation equipment sector, accounting for 38.9 percent. More than half of the surveyed firms in Hungary (53.3 percent) and in Slovakia (60.0 percent) operate in the consumer electronics/electric industry. Romania seems to be an appropriate FDI destination for firms specialising in the general machinery industry.

7.6 Performance Assessment

The performance outcomes of Japanese manufacturing subsidiaries in CEE were assessed by their managers, who evaluate overall operational satisfaction, profitability, sales and cost reduction. Approximately 33 percent of the surveyed Japanese manufacturing subsidiaries reported that their overall satisfaction performance is lower than initially expected, while more than 40 percent stated that their performance exceeded their original expectations (see Table 7-5).

More than 40 percent of the surveyed Japanese manufacturing subsidiaries reported that their profitability performance is lower than their initial expectation, while less than 20 percent stated that their profitability performance exceeded their original expectations. In terms of sales performance, the majority of the surveyed firms answered that their sales performance is as expected. More than 50 percent of the surveyed Japanese manufacturing subsidiaries reported that their cost reduction performance is lower than their initial expectation, while only 4.92 percent stated that their performance exceeded their original expectations. Table 7-6 demonstrates the performance evaluation by Japanese manufacturing firms in the transforming economies in CEE on a five-point Likert scale. Higher scores on each performance variable signify relatively higher levels of performance achievement. As a whole, Japanese manufacturing firms were more satisfied with their overall operations (3.09), while their performance in profitability (2.67) and cost reduction (2.47) is lower than their original expectations. In examining results within the same country, the surveyed firms in Slovakia reported the highest score (2.88) in terms of the average, followed by Poland (2.86), the Czech Republic (2.85), Hungary (2.82) and Romania (2.75). With an average response of 2.81, one can conclude that Japanese manufacturing firms have assessed their local operations in a relatively pessimistic way.

As seen in Table 7-7 on a five-Likert scale, the findings of this study show that the performance of companies surveyed vary by industry and entry timing. Regarding the industry difference, the highest score for overall satisfaction is 3.38 in the transportation equipment sector, followed by the general machinery sector (3.00), the consumer electronics industry (2.82), and the chemical industry (2.50). It is evident that Japanese firms operating in the transportation equipment sector are more satisfied with their economic performance than those in the other sectors. Comparing the pre-2000 market entry firms with those that entered the market after 2000, Japanese firms who entered prior to 2000 perform better in terms of profitability (2.76) and cost reduction (2.71), while those who entered after 2000 do better in terms of overall operational satisfaction (3.12) and sales (3.06). In sum, it may be concluded that Japanese firms have not achieved outstanding organisational outcomes yet, while the economic performance of Japanese manufacturing firms operating in Slovakia and in the transportation equipment sector is slightly higher than average.

Table 7-5: Tabulation for Four Dimensions of Performance

	Overall operational satisfaction			Profitability			Sales growth			Cost reduction		
	Freq.	%	Cum. (%)	Freq.	%	Cum. (%)	Freq.	%	Cum. (%)	Freq.	%	Cum. (%)
1	3	5.5	5.5	5	9.1	9.1	1	1.8	1.8	4	7.3	7.3
2	15	27.3	32.7	19	34.6	43.6	12	21.8	23.6	24	**43.6**	50.9
3	14	25.5	58.2	21	**38.2**	81.8	28	**50.9**	74.6	24	**43.6**	94.6
4	20	**36.4**	94.6	9	16.4	98.2	14	25.5	100	3	5.5	100
5	3	5.5	100	1	1.8	100	0	0.0	100	0	0.0	100

Source: Own survey (2008)
*Note***:** Scale from 1 (the lowest performance) to 5 (the highest performance).

Table 7-6: Performance Assessment of Japanese Manufacturing Firms in the Ex-Soviet Economies by Country

Performance	Total (N=55)	CZ (N=18)	HUN (N=15)	POL (N=16)	SLK (N=4)	ROM (N=2)
Overall saisfaction	3.09	3.06	2.93	3.19	3.50	3.00
Profitability	2.67	2.72	2.73	2.63	2.50	2.50
Sales	3.00	3.11	3.20	3.20	2.75	2.50
Cost reduction	2.47	2.50	2.40	2.40	2.75	3.00
Average	2.81	2.85	2.82	2.86	2.88	2.75

Source: Own survey (2008)
*Note***:** Scale from 1 (the lowest performance) to 5 (the highest performance).

Table 7-7: Performance Assessment of Japanese Manufacturing Firms in the Ex-Soviet Economies by Sector and Entry Timing

Performance	Trans (N=16)	Electro (N=17)	Machine (N=6)	Chem (N=4)	Before 2000 (N=21)	After 2000 (N=34)
Overall saisfaction	3.38	2.82	3.00	2.50	3.05	3.12
Profitability	3.00	2.59	2.50	2.00	2.76	2.62
Sales	3.25	3.00	3.00	3.00	2.90	3.06
Cost reduction	2.56	2.59	2.33	2.00	2.71	2.32
Average	3.05	2.75	2.71	2.38	2.86	2.78

Source: Own survey (2008)
*Note***:** Scale from 1 (the lowest performance) to 5 (the highest performance).

Table 7-8 shows the mean score of different environmental and institutional factors assessed by all the surveyed Japanese firms operating in CEE in terms of country. The surveyed firms were asked to evaluate the nature of various environmental factors on a five-point Likert scale. Higher scores on perceived environmental factors indicate that firms face higher levels of uncertainty, difficulty and instability. Considering the overall assessment, the most distorting environmental factor was rising labour costs (4.55), followed by limited labour availability (3.98), exchange rate instability (3.82), competition with rivals (3.80), job-hopping problems (3.71) and economic instability

(3.22). Poor economic growth (2.51) and weak government support (2.80) were perceived among the surveyed firms to be the least troublesome environmental and institutional factors.

Table 7-8: Evaluative Outcomes of Environmental and Institutional Factors by Total and Country

Environmental factors	Total	CZ (N=18)	HUN (N=15)	POL (N=16)	SLK (N=4)	ROM (N=2)
Rising labour costs	4.55	4.56	4.53	4.63	4.50	4.00
Competition	3.80	4.11	3.80	3.56	3.75	3.00
Economic instability	3.22	3.17	3.53	3.13	2.25	4.00
Political uncertainty	3.00	3.00	3.47	2.81	2.00	3.00
Job hopping problems	3.71	3.67	3.60	3.94	3.50	3.50
Weak economic growth	2.51	2.44	3.07	2.31	2.00	1.50
Weak governmental support	2.80	2.39	2.73	3.38	2.50	3.00
Poor infrastructure systems	2.98	2.78	2.87	3.50	2.25	3.00
Exchange rate instability	3.82	3.89	3.53	4.00	4.00	3.50
Instable labor relations	2.93	2.78	2.60	3.38	3.00	3.00
Limited labor availability	3.98	4.11	3.93	3.94	4.00	3.50

Source: Own survey (2008)
Note: Scale from 1 (completely disagree) to 5 (completely agree): "Does the local environment in which your company operates experience …?"

Table 7-9: Evaluative Outcomes of Environmental and Institutional Factors by Industry and Entry Year

Environmental factors	Trans (N=16)	Electro (N=17)	Machine (N=6)	Chem (N=4)	Before 2000 (N=21)	After 2000 (N=34)
Rising labour costs	4.75	4.47	4.50	4.50	4.52	4.56
Competition	3.88	4.06	3.33	3.00	3.71	3.85
Economic instability	3.13	3.35	3.00	3.50	3.10	3.29
Political uncertainty	2.88	3.18	2.67	3.75	2.71	3.18
Job hopping problems	3.56	3.94	3.50	4.00	3.71	3.71
Weak economic growth	2.25	3.00	1.83	2.00	2.52	2.50
Weak governmental support	2.31	3.06	3.17	2.50	2.57	2.94
Poor infrastructure systems	2.38	3.24	3.50	2.75	2.67	3.18
Exchange rate instability	3.50	3.76	4.00	3.25	3.62	3.94
Instable labor relations	2.88	2.94	3.17	3.75	2.86	2.97
Limited labor availability	3.81	4.47	4.00	3.75	4.14	3.88

Source: Own survey (2008)
Note: Scale from 1 (completely disagree) to 5 (completely agree): "Does the local environment in which your company operates experience …?"

In terms of the country breakdown, the evaluative outcomes do not vary greatly. The issue of rising labour costs is considered the most severe problem that the Japanese firms have experienced in five countries. Although the mean value for rising labour

costs is similar, the surveyed firms in Poland show the worst mean score (4.63). The second and third most severe problems are limited labour availability and rising competition with rivals. These environmental pressures prove to be the most serious in the Czech Republic. The mean value for economic growth is more than 3.0, suggesting that the surveyed firms do not have pessimistic views about economic growth in each country. The firms surveyed in the Czech Republic, Poland and Slovakia, are relatively concerned about exchange rate volatility. It is interesting to note that the firms surveyed in Poland assess infrastructure systems as relatively poor. This reflects anecdotal evidence on the poor infrastructure in Poland, except for the south of Poland. With the mean value above the average, the firms surveyed in the Czech Republic and Slovakia agree that their host governments provide supportive attitudes towards foreign capital indicating that CzechInvest has succeeded in attracting FDI to the country and removing the complexity of its administrative procedure.

Similar to the ranking of environmental factors based on country, the evaluative outcome does not vary to any larger extent by industry and entry timing (see Table 7-9). The surveyed firms report that labour-related factors, such as rising labour costs, limited labour availability and job-hopping problems are the most challenging factors. Conversely, weak economic growth and weak government support are not perceived as problematic. In other words, their view on these two issues is relatively optimistic. The firms in the transportation equipment sector that were surveyed show great concern about rising labour costs (4.75), while limited labour availability is viewed as problematic among those in the electronics sector. What is surprising is that the respondents operating after 2000 are more concerned about exchange rate instability (3.94), political uncertainty (3.18), and economic instability (3.29) than those operating prior to 2000 despite the expectation that EU membership would oblige new member countries to enforce stable exchange rate policy and to make economic and political systems compatible with those practiced inside the EU.

In order to tackle labour-related problems, such as job-hopping problems and rising labour costs, Japanese firms have undertaken various measures. Upgrading labour productivity through the introduction of new machinery and the reduction of raw material procurement costs is considered a fundamental approach to dealing with rising labour costs. In terms of job-hopping problems and high absenteeism, a number of firms provide special rewards for those who show high commitments and eagerness to work. Some firms take wage settings based on constant job participation. Active communications as well as knowledge sharing within the organisation are likely to serve not only as a response to job-hopping problems but also as a mean of motivating local employees. The lack of communication within the organisation is subject to the risk of an increased rate of defects. The relative importance of morning assembly is largely considered (JETRO, 2003).

Some Japanese firms claim that the new construction of inter-country highways,

for instance, from the southern Poland to Prague, could lead to the further development of Japanese agglomeration in the automotive corridor and help forge the access to new customers as well as potential suppliers in the future (JETRO, 2003).

In contrast to Western firms, Japanese MNEs intend not to rely on arbitrarily setting higher wages. The provision of improved working environments and the development of working ethics and morale as well as loyalty to the firm are believed to achieve sustainable corporate growth with a long time horizon.

7.7   Operationalisation of Variables and Model Specification

In this section, I operationalise the variables that help capture the variation in the level of performance of a firm. The variables applied are defined as follows:

7.7.1   Dependent Variable

Defining corporate performance is a difficult and complicated task as no clear consensus on the measurement of adequate corporate performance exists in the international business literature (Glaister and Buckley, 1999; Keats and Hitt, 1988; Mao and Wang, 2007). Previous relevant studies have chosen various objective measurements, such as value-added per worker (Geng and Weiss, 2007; Li, 2002), imputed profit to total assets (Geng and Weiss, 2007), a ratio of total profit relative to total sales (Cheng and Wu, 2001), size adjusted sales (Abramson and Ai, 1999), productivity growth (Zemplinerová and Jarolím, 2001), return on assets (Luo, 2003; Miller and Eden, 2006; Riahi-Belkaoui, 1998), export performance and return on investment (Luo, 2003). Li (2004) employed output per employee as a proxy for firm productivity. Delios and Beamish (2001) used survival rates as one of their performance measures in the cox proportional hazard model. These balance sheet data have widely received acceptance from scholars.

However, it is substantially difficult to collect such objective financial figures of MNEs at the subsidiary level (Brouthers, 2002; Brouthers *et al*., 1999), whereas there are objective measures available at the aggregated corporate level (Rasheed, 2005). First, annual reports that the public can access are not published and obtainable at each subsidiary level. Second, it may be because foreign subsidiaries are excessively concerned about the risk that the data they supply would be misused or revealed in public. Shama (2000: 662) also reports according to his previous experience that "most executives are unable, unwilling, or forbidden to provide [exact profit figures]", recommending that subjective data are more obtainable. The unwillingness to supply objective financial data also became evident for the case of Japanese subsidiaries during my field research in CEE in 2006 and 2007. Moreover, Japanese firms are inclined to be more hesitant and less motivated to provide third parties detailed financial data compared with Western European counterparts. This explains the level of difficulty in conducting the survey regarding the perceived environment uncertainty and

performance link.

As far as objective measures are compared with subjective measures, various scholars argue that the latter are more appropriate. First, different national accounting systems tend to distort the quality of balance sheet data (Brouthers, 2002; Brouthers *et al*., 1999). Second, the transfer-pricing systems and financial reporting procedures of foreign MNEs vary "depending on features peculiar not only to the local subsidiary, but also to the multinational network as a whole" (Szanyi, 2000: 65). These divergences within the organisation complicate objective measures. Chen and Wu (2001: 35) also lend support to the use of subjective performance measures, pointing out that "the subjective indicators are considered better indicators than objective indicators in that the former may capture the long-term and non-financial aspects of the enterprises' performance". Subjective performance measures are appropriate in assessing a firm's strategic aims as well as market positioning (Anderson, 1990, Brouthers, 2002). Cheng and Wu (2001) point out that correlations between subjective and objective performance measures are of limited relevance and suggest that financial and non-financial indicators should be tested separately.

In my evaluative survey, subjective performance is measured in a multidimensional way. I follow previous relevant studies (Brouthers, 2002; Brouthers and Nakos, 2004; Brouthers and Xu, 2002; Brouthers *et al*., 1999; Delios and Beamish, 2004; Demirbag *et al*., 2007; Dimitratos, 2004; Glaister and Buckley, 1999; Pangarkar and Lim, 2003; Tatoglu and Glaister, 1998), which used multiple performance indicators in order to capture a comprehensive picture of the determinants of performance. It should be noted that part of the organisational efforts of firms are associated with a reduction of various costs pertaining to the local operation, such as labour costs, raw material costs, and transportation costs. To be precise, this variable focuses on the more qualitative side of organisational outcomes. Four subjective measures are introduced in this study: (1) overall operational satisfaction; (2) profitability; (3) sales; and (4) cost efficiency.

These four performance predictors are measured on a five point Likert scale ranging from "(1) completely dissatisfied" to "(5) completely satisfied" as well as from "(1) much less than expected" to "(5) much more than expected". It should be borne in mind that performance, as measured by overall satisfaction, sales, profitability and cost reduction, may be biased by the parent company's global strategy rather than determined by the successful improvement of the individual company *per se*. Table 7-11 demonstrates that there are two strong correlations between the subjective measures of performance. One is between overall operational satisfaction and profitability and another is between profitability and cost reduction.

Table 7-10: Variables and Operational Measures

H.	Variables	Operational measure
	Non-financial performance	Ordinal scale (overall operational satisfaction) from 1=completely not satisfied to 5=completely satisfied.
	Financial performance	Ordinal scale (profitability, sales growth and cost efficiency) from 1=much lower than expected to 5=much higher than
1	Economic and political certainty (reverse coded)	Composite of scores in three dimensions (Cronbach's α=0.72) Ordinal scale from 1: political certainty to 5: political uncertainty; 1: economic stability to 5: economic instability; 1: high economic growth to 5: low economic growth.
2	Stable labour markets (reverse coded)	Composite of scores in three dimensions (Cronbach's α=0.63) Ordinal scale from 1: no rising labour costs at all to 5: high rising labour costs; 1: abundant labour availability to 5: labour shortage; 1: no turnover to 5: high turnover.
3a	Favorable government policy (reverse coded)	Composite of scores in three dimensions (Cronbach's α=0.71) Ordinal scale from 1: low exchange rate policy fluctuation to 5: high exchange rate policy fluctuation; 1: rich infrastructure systems to 5: poor infrastructure systems; 1: strong government support to 5: weak government support.
3b	Special economic areas	A dummy variable (1 or 0) defined according to whether a firm is located in a special economic area.
4	Agglomeration	The log of FDI stock as of 2004 (each national statistical bureaus).
5–7	Firm-specific advantages	Ordinal scale from 1=much weaker than rivals to 5=much stronger than rivals (cost leadership, managerial skills and bargaining power).
8	Social capital	Composite of scores in three dimensions (Cronbach's α=0.82): central government, regional government, local communities). Ordinal scale from 1: weak ties to 5: strong ties.
9	Entry mode	A dummy variable (1 or 0) defined according to whether a firm is wholly-owned or not.
10–11	Human integration	Ordinal scale (information sharing and sense of unity) from 1=very low to 5=high.
12	Autonomy (reverse coded)	Composite of scores in three dimensions (Cronbach's α=0.83): (1) planning, (2) budget, (3) additional investment, (4) organizational restructuring, (5) diversification of business lines.
13	*Keiretsu* membership	A dummy variable (1 or 0) defined according to whether a firm belongs to any vertical *keiretsu* groups.
14	Entry timing	A dummy variable (1 or 0) defined according to whether a firm entered before 2000 or after 2000.

Table 7-11: Correlation Matrix of Four Dimensions of Performance

Variable	Overall operational satisfaction	Profitability performance	Sales growth performance	Cost reduction peformance
Overall operational satisfaction	1	Significant	Significant	Significant
Profitability performance	0.5897*	1	Significant	Significant
Sales growth performance	0.3102*	0.4571*	1	Significant
Cost reduction peformance	0.3882*	0.6297*	0.2775*	1

Note: The words significant or not significant in the top half of the table refer to the paired comparison tests for the two variables in the corresponding row and column. * means $p<0.05$

Table 7-12: Descriptive Statistics of Dependent and Independent Variables

	Independent and dependent variables	Companies reporting	Mean	S.D.	Min	Max
	Overall operational satisfaction	55	3.09	1.04	1	5
	Profitability	55	2.67	0.92	1	5
	Sales	55	3.00	0.75	1	4
	Cost reduction	55	2.47	0.72	1	4
H1	Economic and political certainty (reverse coded)	55	2.91	0.76	1.67	5
H2	Stable labour market (reverse coded)	55	4.08	0.69	2.67	5
H3a	Favourable government policy (reverse coded)	55	3.20	0.81	1.33	5
H3b	Special economic areas					
H4	Agglomeration	55	3.44	0.43	2.4	4.4
H5	Cost leadership	55	3.05	0.76	1	4
H6	Management expertise	55	3.20	0.78	1	5
H7	Bargaining power	55	2.69	1.00	1	4
H8	Social capital	55	2.66	0.86	1.33	4.33
H9	Entry mode (1: WOS)	55	0.82	0.39	0	1
H10	Information sharing	55	3.56	0.69	2	5
H11	Solidarity/sense of unity	55	4.18	0.64	2	5
H12	Autonomy (reverse coded)	55	2.95	0.81	1	5
H13	Vertical *keiretsu* membership	55	0.22	0.42	0	1
H14	Entry timing (1: before 2000)	55	0.38	0.49	0	1

Table 7-13: Correlation Matrix of Multicollinearity

Independent variables		1	2	3a	3b	4	5	6	7	8	9	10	11	13	14	15
1	Economic and political certainty	1														
2	Stable labor market	0.26	1													
3a	Favourable government policy	0.39	0.16	1												
3b	Special economic areas (1: SEZ)	0.18	0.36	0.25	1											
4	Agglomeration	0.11	0.00	-0.30	0.01	1										
5	Cost leadership	-0.19	-0.05	-0.04	-0.11	-0.21	1									
6	Management expertise	-0.14	-0.03	-0.04	0.17	-0.09	0.14	1								
7	Bargaining power	-0.21	-0.18	-0.11	-0.05	-0.19	0.05	0.13	1							
8	Social capital	-0.21	-0.06	-0.02	0.03	-0.09	-0.02	0.06	0.64	1						
9	Entry mode (1: WOS)	0.13	0.01	0.08	0.19	0.22	-0.22	-0.18	-0.10	0.02	1					
10	Information sharing	-0.22	-0.07	-0.08	0.03	-0.05	0.15	0.27	0.39	0.40	-0.16	1				
11	Solidarity/sense of unity	-0.03	-0.07	-0.06	0.06	-0.12	-0.06	0.30	0.21	0.27	-0.16	0.35	1			
12	Autonomy	-0.11	0.02	-0.17	-0.20	-0.23	0.20	-0.04	0.06	-0.09	-0.34	-0.08	0.01	1		
13	Vertical *keiretsu* membership	0.04	0.07	0.01	0.02	0.02	0.14	0.15	-0.01	-0.12	-0.09	0.08	0.26	-0.04	1	
14	Entry timing (1: before 2000)	-0.14	0.06	-0.24	-0.11	0.16	0.14	-0.06	0.25	0.30	-0.11	0.17	0.07	0.14	-0.14	1

7.7.2 Independent Variables

The operationalisation of explanatory variables is presented below. Some variables are created based on groups of multiple items to evaluate the extent to which divergent measures represent the same quality. I will check internal consistency reliability, measured by Cronbach's coefficient *alpha*, which is important in evaluating the level of the homogeneity or the complementarity of the different items of the same idea. Cronbach's coefficient *alpha* ranges from 0 and 1. The higher values are, the higher reliability among the indicators. A level of 0.6 or more is considered an acceptable cut-off point to denote sufficient internal consistency reliability (Nunnally, 1978).

Economic and political certainty (Reverse coded)

In this study, I use a three item additive measure. The scale of economic and political uncertainty was measured by three items: 'Does the local environment in which your company operates experience high macroeconomic volatility?', 'Does the local environment in which your company operates experience high political uncertainty?', and 'Does the local environment in which your company operates experience low economic growth?'. Responses were evaluated using five-point Likert scales *(i.e.*, 1="completely disagree" to 5="completely agree"). The reliability of this measure is relatively high as Cronbach's *alpha* is 0.72. I take the average score based on three items (see Table 7-14).

Table 7-14: Composite of Scores about Economic and Political Certainty

Variable (Number of obs=55)	Factor loadings	Cronbach's alpha score
Political uncertainty	0.851	
Economic instability	0.824	0.720
Poor economic growth	0.725	

Stable labour market (Reverse coded)

In this study, I use a three item additive measure. The scale of labour market instability was measured by three items: 'Does the local environment in which your company operates experience rising labour costs?', 'Does the local environment in which your company operates experience serious job-hopping problems?', and 'Does the local environment in which your company operates experience poor labour availability?'. I take the average score based on three items. Responses were evaluated using five-point Likert scales *(i.e.*, 1="completely disagree" to 5="completely agree"). The reliability of this measure is relatively high as Cronbach's *alpha* indicates 0.63 (see Table 7-15).

Table 7-15: Composite of Scores about Stable Labour Market

Variable (Number of obs=55)	Factor loadings	Cronbach's alpha score
Poor labour availability	0.780	
Rising labour costs	0.709	0.626
Serious job-hopping problems	0.794	

Favourable government policy (Reverse coded)

In Pangarkar and Lim's (2003) study, a five item additive measure (1. government restraints on cross-border ventures; 2. availability of investment protection scheme to foreign companies; 3. non-discriminatory policies towards foreign investors in terms of investment incentives; 4. state interference for the development of business; and 5. the extent of government influence on investment) was used. In this study, the scale of unfavourable government policy was measured by three items: 'Does the local environment in which your company operates experience high exchange rate fluctuation?', 'Does the local environment in which your company operates experience weak government support?', and 'Is the local environment in which your company operates endowed with poor infrastructural services'. Broz *et al.* (2008: 419-420) comment that: "The exchange rate is centrally important to economic activity, and government policy has a powerful impact on the currency. ... Volatile exchange rates create uncertainty about international transactions, adding a risk premium to the costs of goods and assets traded across borders". Accordingly, for international firms, it is a critical issue of whether a country confronts heavy exchange rate fluctuation, which makes their cross-border transactions more costly. Moreover, CEECs aiming for the EMU membership are required to keep their exchange rates stable for two years within the ERM II system prior to the official approval. Responses were evaluated using five-point Likert scales *(i.e.*, 1="completely disagree" to 5="completely agree"). I take the average score based on three items. The reliability of this measure is relatively high as Cronbach's *alpha* is 0.71 (see Table 7-16).

Table 7-16: Composite of Scores about Favourable Government Policy

Variable (Number of obs=55)	Factor loadings	Cronbach's alpha score
Strong exchange rate fluctuation	0.571	
Poor infrastructure	0.881	0.710
Favourable governmental support	0.904	

Agglomerative forces

I compile FDI stock data at the sub-national level from each national statistical bureau in CEE as of 2004 (see more detail in Chapter 6). The value was transformed into a logarithm.

Special economic areas

In this study, there are various ways of measuring the effect of special economic areas on firm performance. I employ a binary dummy variable to investigate this issue. A value of one is assigned where a firm positions itself in a special economic area, or zero otherwise.

Firm-specific advantages

I use three firm-specific advantages (cost leadership, managerial expertise, and negotiation power with host government). Responses were evaluated using a five-point Likert scale *(i.e.*, 1= "very weak relative to rivals" to 5= "very strong relative to rivals").

Institutional environment relations/social capital

Various measures of the magnitude of social capital of international ventures have been employed by the existing international business literature. Social capital is measured by the number of social networks a firm relied on to acquire information for international expansion (Rhee, 2008). In an analogy to the study of Zhou *et al*. (2007) who evaluate the role of *guanxi* networks in determining the success of global small-and-medium-sized firms located in China, the social capital variable is measured by a scale of three dimensions based on a five point Likert-type scale in this study: (1) connections and ties with the central government; (2) connections and ties with subnational governments; (3) connections and ties with local communities. The indicators range from (1) to "have very weak connections and ties" (5) to "have very strong connections and ties". All three measures loaded on a single factor with a Cronbach's alpha of 0.82. This high Cronbach's *alpha* score validates the use of these measures in this study (see Table 7-17).

Table 7-17: Composite of Scores about Social Capital

Variable (Number of obs=55)	Factor loadings	Cronbach's alpha score
Connections with the central government	0.826	
Connections with the regional government	0.929	0.820
Connections with the local community	0.835	

Internalisation advantages (entry mode)

I include a binary dummy variable so as to assess whether firms who engage in the build-up of their own operations from scratch perform better than those in the form of JVs and M&A. A value of one is assigned when firms are WOSs and zero otherwise.

Human integration

For firms, socialisation is a key task in coordinating and managing foreign operations abroad. In particular, installing the parent's corporate identity, as well as the subsidiary's management style and future goals into local employees may determine the sustained operational success. This process should also reinforce the quality of an employee-employer relationship, thereby building and developing trust, shared responsibility and loyalty.[21] Bartlett and Ghoshal (1998: 211) point out that "an enduring barrier to the development of a transnational organisation is the lack of individual understanding and acceptance that surrounds the international activities in most corporations". It is inevitable that the gap between expatriates and indigenous employees will be decreased, in order to increase operational efficiency and organisational competences. I measure socialisation with two proxies. One is a degree of information sharing among expatriates and local employees and another is a degree of sense of unity within the organisation.

The variable for human integration is measured by two predictors in this study. One is the extent of information sharing and the level of sense of unity within the affiliate. Apart from the importance of the transfer of high technology involved in FDI, full commitments of trust-building between Japanese expatriates and local employees are crucial predictors in affecting superior performance. Following Abo (2005) and En (2006), the human integration variable is measured by two separate indicators.

One is information sharing. In this item, the respondents were asked: "To which extent does information sharing take place within the organisation?" It was categorised as follows: (1) no information sharing within the organisation exists at all; (2) Communication gaps exist between expatriates and local employees, resulting in relatively passive information; (3) Although no particular measure is undertaken, our company is committed to efficient information sharing through meetings; (4) Our company undertakes various measures in order to improve information sharing; (5) No communication gaps exist at all, and active information sharing takes place within the organisation. An ordinal variable ranges from 1 to 5 for each category, respectively.

Another is solidarity/sense of unity. The respondents were asked: "To what extent does internal sense of unity exist?" It was categorised as follows: (1) There is no specific measure to improve an internal sense of unity; (2) There exist only social events; (3) Although no particular measure is undertaken, our company is aware of the importance of increasing internal sense of unity; (4) Our company undertakes a few measures in order to improve internal sense of unity; (5) Our company has a cafeteria that local employees can utilise, morning assembly, social events, work uniform. An ordinal variable ranges from 1 to 5 for each category, respectively.

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[21] Bartlett and Ghoshal (1998) attribute Matsushita's success to its efforts to instill corporate identity and goals in all company employees.

Managerial autonomy

O'Donnel (2000) used the percentage of the subsidiary's top management team that is from corporate headquarters as a proxy for subsidiary autonomy. The concept of managerial autonomy is defined as the extent to which a subsidiary can make its own strategic decisions independently from the parent company over key areas of its local management. The managerial autonomy variable is measured by a scale of five tasks based on a five point Likert-type scale: (1) mid-term planning; (2) budget organisation; (3) additional investment in equipments; (4) organisational restructuring; and (5) entry to new ventures. The indicators range from (1) "can fully decide independently from the parent company" to (5) "cannot decide independently from the parent company at all". These items were adapted from the measures that were used by Ito *et al*. (2002). The high Cronbach's *alpha* score (0.83) validates the use of these measures in this study (Table 7-18). This variable was reversely coded in data analysis.

Table 7-18: Composite of Scores about the Transfer of Autonomy

Variable (Number of obs=55)	Factor loadings	Cronbach's alpha score
Planning	0.833	
Budgetting	0.843	
Additional capital injection	0.822	0.828
Organisational restructuring	0.709	
Participation in new businesses	0.626	

Vertical keiretsu affiliation

As major aim of this study, I check the robustness of the impact of vertical *keiretsu* affiliation on the development of corporate performance. To define *keiretsu* affiliation, I use Dodwell Marketing Consultants Industrial Groupings in Japan (1988) and *Kigyō Keiretsu to Gyōkai Chizu* (2001). Since it is considerably difficult to compile concrete data on ownership concentration over time, I used a binary dummy variable. If a firm belongs to one of existing vertical *keiretsu* groups, the dummy independent variable assumes a value of one and zero otherwise. This method is consistent with previous scholars (Wang *et al*., 2005). A negative sign is predicted. The negative sign should indicate that a high degree of dependence, coordination and administration costs and the limited scope of customers within the hierarchy of the *keiretsu* organisation distort corporate performance.

Entry timing

Entry timing is another critical factor in affecting the performance of Japanese firms in the transforming economies in CEE. Firms that entered the emerging economies at the early phase of the transition period, in particular, in the 1990s, have accumulated

knowledge and experience over time in contrast to those who invested at the dawn of the 21st century. A huge difference in the cost of foreignness exists since the forerunner may be better embedded into the local community and more familiar with the complexity of local bureaucracy as well as local business practices than the latecomers. Moreover, the forerunner already found ways to achieve efficiency as well as legitimacy in the local environment. I use a binary dummy variable. If a firm entered after 2000, the firm takes the value of one and zero otherwise.

7.7.3 Model Specification

I test the multiple regression models as follows:

$$
\begin{aligned}
Degree\ of\ performance\ outcomes \\
= \alpha + \beta_1(Environmental\ and\ institutional\ factors) \\
+ \beta_2(firm\ specific\ factors) \\
+ \beta_3(Institutional\ environment\ relations) + \beta_4(Internalization) \\
+ \beta_5(Human\ integration) + \beta_6(Parent\ control) + \beta_7(Network) \\
+ \varepsilon
\end{aligned}
$$

Where the β terms are parameters to be estimated and ε terms refer to unobservable variables.

7.8 Empirical Results

A multiple regression procedure was run to identify which determinants account for the performance of Japanese manufacturing investors in the former socialist economies of the CEECs. Tables 7-19 and 7-20 summarise the empirical findings for four dimensional performance indicators. The columns presented in the table correspond to variable groups, explanatory variables, estimated coefficients, standard deviations and t-statistic, respectively. The statistical significance and magnitude of the explanatory and control variables based on firm-specific advantages theory, internalisation theory, institutional theory, resource-based theory and network theory were tested by the OLS. Since the empirical outcomes are based on self-evaluative surveys, we should interpret them with caution.

Pearson correlation tests were run and it was confirmed that none of the variable sets exceeds more than 0.50 except for the highest correlation coefficient (0.64) between the proxies of bargaining power and social capital (see Table 7-13). These two variables are used alternately so as to overcome the multicollinearity problem. There is also no multicollinearity problem through testing the variance inflation factor (VIF) values of all explanatory variables in the model estimations. The common agreement is that the multicollinearity does not exert any influence over the findings as far as the VIF is lower than five (Majocchi and Strange, 2007). In this study, the VIF values range from

1.22 to 1.54 and the mean value is 1.37.

With the use of the multiple regression analysis, a significant relationship between the independent variables and each performance measure is identified. The multiple regression analysis reports the most significant relationship ($p=0.001$) between the explanatory variables and overall operational satisfaction corresponding to the variance of 43-45 percent. Adjusted R-squared values were 38-39 percent for profitability performance, 22-24 percent for sales growth performance, and 37-39 percent for cost reduction performance. These high adjusted R-squared values indicate that the over-fitting bias arising from the small sample sizes is unlikely to be problematic in the regression models. In addition, they imply that the proposed predictors confirm a satisfactory level of explanatory power. Namely, to a larger extent, the conceptual model developed in this study recommends itself a proper avenue for bridging the gap between theory and practice consistent with previous studies (Brouthers, 2002; Brouthers *et al.*, 1999). The explanatory power of the model increases with the replacement of bargaining power with social capital.

Economic and political certainty

I found a positive relationship between performance and perceived economic and political uncertainty ($\beta=0.217$, $p<0.05$). This empirical result indicates that the company facing economic and political uncertainty had better cost reduction performance, consistent with previous relevant studies (Abramson and Ai, 1999; Brouthers, 2002; Brouthers *et al.*, 1999; Rasheed, 2005). Likewise, perceived economic and political uncertainty was also positively related to overall operational satisfaction and sales performance, but the relationship was not statistically significant. Hypothesis 1 was significant but opposite to the prediction.

Stable labour market

Labour market stability, measured by a composite of three items (rising labour costs, labour availability and job-hopping problems), is negatively related to overall operational satisfaction. Profitability performance is negatively associated with labour market instability but this relationship shows no statistical significance. As seen in Model 1 and 5, the erosion of comparative advantages, such as rising labour costs, limited labour availability and serious job-hopping problems, exerts a negative effect on overall operational satisfaction of Japanese MNEs in CEE ($\beta=-0.306$ and $\beta=-0.296$, $p<0.1$). Hypothesis 2 was partially supported.

Favourable government policy

Although the variable for unfavourable government policy, measured by a composite of three items (exchange rate fluctuation, weak governmental support for FDI and poor infrastructure) is negatively related to all the performance indicators, none of them are

statistically significant. Hypothesis 3a received no support.

Special economic areas

Hypothesis 3b predicting that special economic areas would exert a positive impact on firm performance was rejected. The variable is positively associated with overall operational satisfaction, profitability performance and sales performance but they show no statistical significance.

Agglomeration

Hypothesis 4 predicting that industrial clusterings of foreign firms would exert a positive impact on firm performance receives strong support. The agglomeration variable is positively related to profitability and the coefficients for the agglomeration variable are statistically significant at the one percent level. Hence, Hypothesis 4a is partially supported.

Cost leadership

Hypothesis 5, predicting that cost leadership would exert a positive impact on firm performance, was highly supported. The cost leadership variable helps shape the level of performance outcomes in a positive fashion and its effect is highly significant at the one percent level. New ventures with cost leadership are likely to reap superior performance in terms of overall operational satisfaction, profitability and cost reduction. An explanation for this is that cost leadership comes into play as the primary requirement in cultivating business transactions in arm's length markets in Europe where cost efficiency is crucial to winning the local market. Hypothesis 5 was highly supported.

Managerial expertise

Hypothesis 6, predicting that managerial expertise a firm possesses would exert a positive impact on firm performance, was highly supported. The managerial expertise variable is positively related to overall operational satisfaction (β=0.287, p<0.1; β=0.297, p<0.05), and sales growth (β=0.357, p<0.01) dimensions of performance. The managerial expertise variable is a key factor in doing business successfully in CEE since this type of ownership advantage is effective in streamlining the transfer of managerial expertise and in circumventing risks of huge demand shifts.

Bargaining power with host governments

Hypothesis 7 predicting that the ability to bargain for desired resources with host governments would exert a positive impact on firm performance was partially supported. The impact of the bargaining power variable was insignificant for three dimensions of organisational success but it is positively related to the cost reduction dimension of

performance at the five percent level (β=0.229). It highlights that firms with stronger bargaining power can attain better cost reduction consequences. It implies that leveraging firm-specific assets and capabilities, such as experience and advanced technologies, eases the acquisition and exploitation of financial and non-financial supports from the host governments. A typical case is that MNEs with strong resource capabilities are likely to demand the construction of new transport infrastructure, governmental support and information on potential indigenous suppliers in CEE. Hypothesis 7 was partially supported.

Institutional environment relations/social capital
Consistent with previous relevant studies *(e.g.*, Meyer and Nguyen, 2005; Uzzi, 1996; Wu, 2008; Yiu and Makino, 2002), the results offer strong evidence that social capital is a crucial determinant in positively affecting cost reduction performance. This result also explains that firms with strong ties with incumbent governments and local community may obtain up-to-date information on capital, product and labour markets and acquire business licenses more easily. They can also convey their desired interests to government authorities in a more informal and diplomatic fashion relative to firms with fewer social networks. In other words, reducing information costs may help to enhance cost reduction performance. In line with Oerlemans and Meeus's study (2005), I can reasonably infer that the success of the Japanese manufacturing firms in CEE may be determined by inter-organisational exchange relationships that legitimatise their behaviour and production activity in the local market. In this regard, the argument of institutional theorists (DiMaggio and Powell, 1991) about the positive association between social capital and performance is supported for the context of Japanese manufacturing firms in transition economies. Informal institutional arrangements improve a firm's ability to maintain its competitive position and rationalise allocative efficiency as well as productive capability. The result of the present study lends support to the fact that ensuring favourable business conditions requires foreign investors to develop close ties with the host government. Hypothesis 8 was supported in the explanation of cost reduction performance.

Entry mode
The coefficients for entry model were as positive as expected in the three performance dimensions expect for overall operational satisfaction. However, none of the coefficients showed any significant association between entry mode and firm performance. Thus, Hypothesis 9 was rejected.

Human integration (information sharing/sense of unity)
The relationship between human integration and performance has been widely discussed in the management literature. Hypothesis 10 predicting the relationship between

information sharing and performance heterogeneity was not supported. However, the variable for sense of unity is positively related to three dimensions of performance, such as overall operational satisfaction (β=0.422, p<0.05; β=0.380, p<0.1), profitability performance (β=0.491, p<0.01; β=0.460, p<0.05) and sales growth (β=0.292, p<0.1; β=0.323, p<0.1). Accordingly, sense of unity is likely to raise the probability of enhancing firm performance. The empirical results lend support to Hypothesis 11.

Autonomy

Hypothesis 12 predicting that a high degree of autonomy transfer to the affiliate leads to better firm performance due to high local responsiveness to the rapidly changing CEE business environment has not been supported. It is surprising that I found that centralisation exerts a positive impact on cost reduction performance and this association is significant at the ten percent level. The results contrast with those in the previous studies (Kotabe and Wheiler, 1998; Luo, 2003; Slangen and Hennart, 2008) that claim that *ceteris paribus* the higher degree of autonomy, the better performance outcomes. From an institutional theoretical perspective, MNEs' business actions and outcomes tend to be shaped by internal conformity pressures from their parents. A hierarchical decision-making structure from the parent to the subsidiary (*i.e.*, global integration) generates better firm performance. Slangen and Hennart (2008: 1305) reveal a variety of hints on the positive nexus between global integration and cost reduction performance, arguing that "the optimal exploitation of scale economies in manufacturing requires that managers of foreign subsidiaries implement the production methods of their MNE parents and make the smallest possible number of adaptations to the design of products, since such adaptations lower the size of production runs and hence scale economies. Intra-firm shipments of intermediate products should also be determined by headquarters, so as to avoid excessive inventories and production delays". It may also be possible to argue that this conflicting result may be derived from measurement errors. Moreover, the result may be different once I expand the data sample for future research. Hence, future research is warranted.

Vertical keiretsu membership

Hypothesis 13, predicting that vertical *keiretsu* membership would exert either positive or negative impact on firm performance, was not supported. The sign for the *keiretsu* dummy variable is negative, but not statistically significant. However, Table 7-21 exhibits results of t-tests on four dimensions of performance to investigate differences between *keiretsu* affiliated companies and independent companies. I found a significant difference in sales performance. This result conveys a message that *keiretsu* firms may benefit from cultivating transactional relationships with Japanese and Western firms through leveraging relational assets, such as extensive inter-firm sales and marketing channels, and personal contacts.

Table 7-19: Regression Estimates of Multidimensional Performance Outcomes

Explanatory variables	Overall operational satisfaction		Profitability	
	Model 1	Model 2	Model 3	Model 4
Environmental-institutional conditions				
H1 Economic and political certainty	0.086	0.116	0.218	0.237
(reverse coded)	(0.51)	(0.69)	(1.40)	(1.52)
H2 Stable labor market	–0.306*	–0.296*	–0.061	–0.078
(reverse coded)	(–1.72)	(–1.71)	(–0.37)	(–0.48)
H3a Favorable government policy	–0.177	–0.187	–0.025	–0.043
(reverse coded)	(–1.08)	(–1.16)	(–0.17)	(–0.28)
H3b Special economic areas (1: SEA)	0.008	–0.002	0.020	0.020
	(0.03)	(–0.01)	(0.09)	(0.09)
H4 Agglomeration	0.178	0.232	0.751***	0.734***
	(0.58)	(0.79)	(2.66)	(2.67)
Firm-specific advantages				
H5 Cost leadership	0.834***	0.852***	0.820***	0.819***
	(5.23)	(5.44)	(5.55)	(5.58)
H6 Managerial expertise	0.287*	0.297**	0.224	0.235
	(1.86)	(1.95)	(1.57	(1.65)
H7 Bargaining power	–0.025		0.082	
	(–0.20)		(0.70)	
Informal institution factor				
H8 Social capital		0.164		0.125
		(1.12)		(0.91)
Internalisation-specific factor				
H9 Entry mode (1: WOS)	–0.125	–0.160	0.145	0.127
	(–0.40)	(–0.52)	(0.50)	(0.44)
Local management				
H10 Information sharing	0.02	–0.053	–0.089	–0.097
	(0.11)	(–0.29)	(–0.51)	(–0.56)
H11 Solidarity/sense of unity	0.422**	0.380*	0.491***	0.460**
	(2.13)	(1.91)	(2.68)	(2.47)
Parent control				
H12 Autonomy	0.084	0.100	0.052	0.067
	(0.56)	(0.67)	(0.37)	(0.48)
Network relations				
H13 Vertical *keiretsu* membership	–0.407	–0.368	–0.284	–0.248
	(–1.45)	(–1.32)	(–1.09)	(–0.95)
Control variable				
H14 Entry timing (1: before 2000)	–0.392	–0.481*	–0.176	–0.195
	(–1.56)	(–1.92)	(–0.76)	(–0.83)
Intercept	–1.100	–1.525	–5.539***	–5.427***
	(–0.51)	(–0.73)	(–2.76)	(–2.78)
R squared (adj.)	0.43	0.45	0.38	0.39
Probability	0.0003	0.0002	0.0012	0.001
Cases	55	55	55	55

Note: t-values are reported in parentheses. ***=significant at 1% level, **=significant at 5% level, *=significant at 10% level.

Table 7-20: Regression Estimates of Multidimensional Performance Outcomes

Explanatory variables		Sales growth		Cost reduction	
		Model 5	Model 6	Model 7	Model 8
Environmental-institutional conditions					
H1	Economic and political certainty	0.147	0.125	0.217*	0.251**
	(reverse coded)	(1.05)	(0.89)	(1.81)	(2.05)
H2	Stable labor market	0.197	0.195	0.154	0.103
	(reverse coded)	(1.32)	(1.34)	(1.21)	(0.81)
H3a	Favorable government policy	–0.210	–0.200	–0.078	–0.117
	(reverse coded)	(–1.53)	(–1.48)	(–0.66)	(–0.99)
H3b	Special economic areas (1: SEA)	–0.189	–0.183	–0.140	–0.136
		(–0.89)	(–0.88)	(–0.78)	(–0.74)
H4	Agglomeration	0.408	0.382	0.385*	0.31
		(1.60)	(1.55)	(1.77)	(1.44)
Firm-specific advantages					
H5	Cost leadership	0.105	0.095	0.490***	0.479***
		(0.79)	(0.72)	(4.30)	(4.15)
H6	Managerial expertise	0.365***	0.357***	0.150	0.175
		(2.83)	(2.79)	(1.36)	(1.56)
H7	Bargaining power	–0.006		0.229**	
		(–0.05)		(2.55)	
Informal institution factor					
H8	Social capital		–0.124		0.243**
			(–1.00)		(2.25)
Internalisation-specific factor					
H9	Entry mode (1: WOS)	0.071	0.095	0.254	0.225
		(0.27)	(0.37)	(1.14)	(0.99)
Local management					
H10	Information sharing	–0.063	–0.020	0.151	0.168
		(–0.40)	(–0.13)	(1.12)	(1.24)
H11	Solidarity/sense of unity	0.292*	0.323*	0.081	0.021
		(1.76)	(1.94)	(0.57)	(0.14)
Parent control					
H12	Autonomy	0.046	0.033	0.182*	0.214*
		(0.36)	(0.26)	(1.69)	(1.94)
Network relations					
H13	Vertical *keiretsu* membership	0.227	0.196	–0.060	0.015
		(0.97)	(0.84)	(–0.30)	(0.07)
Control variable					
H14	Entry timing (1: before 2000)	–0.275	–0.220	0.044	0.043
		(–1.31)	(–1.05)	(0.25)	(0.23)
	Intercept	–1.491	–1.276	–4.019*	–3.502**
		(–0.82)	(–0.73)	(–2.60)	(–2.29)
R squared (adj.)		0.22	0.24	0.39	0.37
Probability		0.0324	0.02	0.001	0.002
Cases		55	55	55	55

Note: t-values are reported in parentheses. ***=significant at 1% level, **=significant at 5% level, *=significant at 10% level.

They can also take the best advantage of an information sharing mechanism within the group organisation. On these grounds, they may be able to expand sales volume in CEE. Other than sales performance, I found no clear statistical difference between *keiretsu* firms and independent firms. This consequence may allow us to consider a unique feature of *keiretsu* organisation, namely that k*eiretsu* firms are likely to pursue and sustain the overall competitiveness and profitability of the *keiretsu* group in a long-term perspective. In other words, the definition of performance for *keiretsu* organisation may be more dynamic and complex. This should be clarified in future research.

Table 7-21: Results of T-test (Keiretsu Affiliated Firms vs. Independent Companies)

Variables	Means for Keiretsu Sample (12)	Means for Independent Sample	t-statistic
Overall satisfaction	3.17	3.07	–0.28
Profitability	2.83	2.63	–0.68
Sales	3.42	2.88	–2.27 ***
Cost reduction	2.58	2.44	–0.60

Note: *** indicates p<0.01.

Entry timing

The large volume of existing literature justifies the consideration of entry timing as an important determinant of predicting firm performance. The empirical results presented in this study confirm that a first mover advantage does not hold for the context of Japanese manufacturing firms in CEE. A binary dummy variable for the period prior to 2000 exerts a detrimental impact on overall operational satisfaction (β=-0.481, p<0.1). In other words, the late entrants perform better, rejecting the postulation that the early entrants can benefit from the absence of competition and exploit affluent technical or market opportunities. Hypothesis 14 was significant but opposite to what was expected.

7.9   Conclusions

This chapter was devoted to advancing and testing factors of superior firm performance in an effort to synthesise the vast literature on this issue with a special emphasis on the location-performance link in a more systematic way. Firm location choice and entry mode *per se* are better viewed as a static process. However, it seems more difficult to evaluate firm survival in the rapidly changing foreign market and its complexity, notably in the post-socialist region. To shape the actual investment policy, it is important to be familiar with the performance aspect of foreign MNEs in transition economies since the real market entry strategy should be devised to achieve the firm's long-term growth as opposed to a quest for short-term profits. To date, existing findings are based more on anecdotal accounts or simple descriptive surveys without any conceptual framework for influencing performance of value-added activities of foreign MNEs in the former Soviet bloc.

Table 7-22: Summary of Empirical Findings by Multiple Dimensions of Performance

Explanatory variables	Operational satisfaction		Profitability		Sales growth		Cost reduction	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Environmental-institutional conditions								
H1 Economic and political certainty	NS	NS	NS	NS	NS	NS	(+)*	(+)**
H2 Stable labor market	(–)*	(–)*	NS	NS	NS	NS	NS	NS
H3a Favourable government policy	NS	NS	NS	NS	NS	NS	NS	NS
H3b Special economic areas (1: SEZ)	NS	NS	NS	NS	NS	NS	NS	NS
H4 Agglomeration	NS	NS	(+)***	(+)***	NS	NS	(+)*	NS
Firm-specific advantages								
H5 Cost leadership	(+)***	(+)***	(+)***	(+)***	NS	NS	(+)***	(+)***
H6 Managerial expertise	(+)*	(+)**	NS	NS	(+)***	(+)***	NS	NS
H7 Bargaining power	NS	–	NS	–	NS	–	(+)**	–
Informal institution factor								
H8 Institutional environment relation	–	NS	–	NS	–	NS	–	(+)**
Internalisation-specific factor								
H9 Entry mode (1: WOS)	NS	NS	NS	NS	NS	NS	NS	NS
Local management								
H10 Information sharing	NS	NS	NS	NS	NS	NS	NS	NS
H11 Solidarity/sense of unity	(+)**	(+)*	(+)***	(+)**	(+)*	(+)*	NS	NS
Parent control								
H12 Autonomy	NS	NS	NS	NS	NS	NS	(+)*	(+)*
Network relations								
H13 Vertical *keiretsu* membership	NS	NS	NS	NS	NS	NS	NS	NS
Control variable								
H14 Entry timing (1: before 2000)	NS	(–)**	NS	NS	NS	NS	NS	NS

Note: NS indicates no significance. ***=significant at 1% level, **=significant at 5% level, *=significant at 10% level.

Moreover, the potential impact of perceived institutional and environmental factors on the international expansion of MNEs has been neglected, whereas more emphasis has been placed on entry mode and site selection in this research.

This study is noteworthy for using primary data at the subsidiary level instead of secondary data and archival information at the aggregated corporate level, which are not sufficient to understand the underlying factors in doing business successfully in CEE in greater detail. I focused on Japanese manufacturing firms operating in CEE whose characteristics and dynamic behaviour have long been unexplored. A multiple regression analysis was conducted on a sample of 55 Japanese affiliates in CEE in January 2008. In order to investigate the determinants, I construct an integrative model that draws on various theoretical arguments, such as Dunning's OLI paradigm, Porter's Diamond Model, the resource-based view of the firm, organisational theory and institutional theory. In the absence of previous literature relevant to Japanese manufacturing FDI in the transforming economies of CEE, the empirical results should be interpreted as indicative. Moreover, empirical evidence found in this chapter verifies the utility of multidimensional performance determinants (see Table 7-21):

- The higher the level of labour market stability, the higher overall operational satisfaction.
- Greater economic and political volatility is likely to make a firm more aware of the need for commitments in coping with cost reduction.
- Agglomeration economies have a positive impact on financial and non-financial performance.
- The extent to which a firm's competitive advantage is based on cost leadership, managerial expertise and bargaining power against incumbent governments is positively associated with both non-financial and financial performance.
- The intensity of a firm's networking competencies (*e.g.*, institution environment relations/social capital) is positively related to firm performance (cost reduction).
- A sense of unity/solidarity has positive effects on firm performance.
- The extent to which the headquarters dominate strategic decisions by its subsidiary is positively related to cost reduction performance.

As seen in the descriptive statistics part, the performance evaluation of Japanese manufacturing firms in CEE is quite pessimistic in general. In particular, the mean scores for profitability and cost reduction are below the average. The major reason may be that their market experience in the former Soviet bloc is still insufficient. Moreover, the reorganisation of their global and regional networks has been far from completion and in transition due to various environmental changes within the enlarged Europe, such as eastward EU enlargement in 2004, the emergence of Russia, the dynamic complexity of the Single European Market (SEM), standardisation of FDI policy at the EU

supranational level and a wave of other Asian rivals into CEE. As time is perceived as crucial to the growth of firms (Pangarkar and Lim, 2003), Japanese firms may be able to win high profitability only with a long-term horizon in transition economies where cultural differences and governmental bureaucratic intervention remain critical and challenging to their local production activities. Hence, it should be borne in mind that it might be too early to judge the organisational outcomes of Japanese manufacturing firms in the CEE transition economies.

Regarding location-specific factors, namely perceived environmental factors, it seems reasonable to say that the overall operational satisfaction of Japanese manufacturing firms is positively affected by the degree of stability of local labour markets. What is somewhat surprising is that political and economic uncertainties, which are conventionally hostile to business, exert a positive effect on firm performance in cost reduction. There are two possible explanations. One is that the local environment featuring in highly volatile economies as well as unpredictable political conflicts may heighten Japanese companies' awareness of the rapidly changing CEE business circumstances and thus keep them well-prepared to be responsive to potential risks in their continuous efforts to enhance efficiency and flexibility in terms of human resource management, production processes, procurement channels and financing, consequently leading to better performance. Another is that we can infer that *ceteris paribus* the worse a country's economy is, the more enthusiastically indigenous workers would work not to let its economic situation fall behind other neighboring countries in CEE. The reliability of this assumption is reflected in one of my interviews conducted in Poland in 2007. According to a worker in a Japanese company operating in southern Poland: "*in comparison with our past structured by the central planning system of the Soviet regime, our present situation is satisfactory and happy because we have jobs and we are rewarded when we work harder. We are aware of the threatening scenario that our country may be left out of competition with neighbouring countries, such as the Czech Republic and Hungary, for foreign capital when we are not diligent. In addition, we fear that foreign firms may leave the country when the economy is stagnating so that we have to continue to work hard to secure our current jobs*" (Interviewed in a Japanese manufacturing firm in Poland on 24 March, 2007). The financial incentive variable, proxied by a binary dummy variable for special economic areas, does not impact on any of the performance dimensions although FDI location decision is determined by supportive FDI laws in the context of Japanese manufacturing firms.

The empirical contributions concur with the theoretical accounts of Marshallian agglomeration externalities (Marshall, 1920; Porter, 1990) that firms are likely to benefit from industrial concentration not only in the explanation of FDI location decision but also in the explanation of performance dimensions of profitability and cost reduction in the CEECs. An inference is that firms are more able to access desired resources, managerial talents and information on potential local suppliers as a result of

industrial clustering. Firms can also benefit from well-developed communication and transportation infrastructure, consistent with Li's (2004) study. While agglomeration stimulates the inflow of knowledge and information in territorial closeness in particular, firms can also ensure certain level of legitimacy to align their business objectives with those that local governments, local communities and other societal actors pursue in the context of the local market. Consequently agglomeration offers them incentives to reduce high transaction and coordination costs inherent in transition economies. In sum, I arrive at the conclusion that the level of firm performance could be largely predicted by the firms' perception of environmental changes. In short, location-specific advantages are deemed relatively vital in affecting the performance outcomes of Japanese manufacturing firms in the ex-Soviet type economies, although they have long been neglected in the international business and strategic management literature (Dunning, 1998). However, the inclusion of additional perceived environmental factors, such as socio-cultural dimensions in future research is likely to be highly warranted.

The empirical findings suggest that firm-specific competitive advantages exert a positive effect on the subsidiary performance, although those impacts vary depending on performance dimensions. For instance, cost leadership is the key variable of determining three dimensions of performance indicators, such as overall operational satisfaction, profitability and cost reduction. Managerial expertise also positively affects overall operational satisfaction, and sales performance, whereas negotiation power determines only cost reduction outcomes. This study confirmed that late entrants feel more satisfied with their overall operations in relation to early entrants. The theoretical implication for this result is perhaps that late entrants seem to benefit from both successful and failing outcomes of early entrants concerning marketing strategies and access to raw materials and governmental officials in transitional economies. Moreover, improved legal, social and economic infrastructure provides late entrants with opportunities to do business more successfully without being hampered by critical informal constraints, such as corruption and bribery. This allows us to draw a conclusion that firms that have not yet entered the CEE market can still consider offshore production.

What was different from expectation was that lack of autonomy, namely strong parent control, has proved to boost firm performance, notably in cost reduction. There are three main explanations for this result. One possible explanation for this consequence is that hierarchical management control by the parent company plays a crucial role in constraining moral hazards of the subsidiary. Another is that it may be perceived among senior managers of Japanese subsidiaries operating in CEE that high parent company involvement in business plans and policies would be one of risk avoidance strategies (Newburry and Zeira, 1999). Third, centralisation of decision-making procedures initiated by the parent company may render its subsidiary more capable of achieving high cost reduction strategy due to the former's financial and

non-financial resources to respond to an unpredicted change of global market trends.

As regards the salience of social network, the result verifies that interpersonal linkages with government officials in the transitional stage of European emerging economies are crucial relational assets in conducting the efficient cost reduction strategy. It suggests that Japanese MNEs operating in CEE should ensure that they can actively forge close social ties with host-based social networks so as to respond more rapidly to changing institutional environments. To mitigate transaction costs and market failure, Japanese firms with manufacturing operations leverage social ties with local stakeholders that serve as a strategic tool of making their local operations more lucrative and satisfactory. In other words, firms may leverage the social capital as a non-economic or lobbying tool for securing their legitimacy in policymaking considerations. Information on policy shifts, potential local suppliers and access to raw materials is expected to be obtainable by means of the development of social capital. The creation and strengthening of social ties with local actors in the postsocialist countries is an institutional precondition for better economic performance for Japanese companies. Moreover, evidence presented in this study stipulates that institution-building leads to an improvement of legitimacy and hence facilitates social integration into the local society. It is important to grasp how rules and trust developed by interpersonal ties as a governance mechanism determines the level of firm performance and the extent to which the magnitude of social networks changes as formal and informal institutions become more established.

Despite interesting factors found in this study, we should be aware of two caveats. One is that firm performance should be defined in a multidimensional fashion as the statistical significance of the empirical outcomes largely varies depending on which dependent variables are tested. Another is that it may be too early to judge whether local operations of Japanese manufacturing firms have been successful, since their history of the internationalisation of business in the CEE context is relatively short. It cannot be denied that it usually takes more years to attain high net profits through accumulated local market knowledge, building network ties and increased legitimacy over time.

This study has some drawbacks, as with all empirical research. The following steps should be taken to lead to more robust results with more comparative implications for future research:

First, the degree of generalisability of the outcomes of this study remains doubtful because the sample size is relatively limited, although the response rate and the representativeness are at least as high as in previous studies (Abramson and Ai, 1999; Appiah-Adu, 1999; Brouthers, 2002: Brouthers and Nakos, 2004; Carlsson *et al*., 2005). The data should be expanded so as to increase the reliability of empirical results in future research.

Second, the performance measures employed in this study were rather subjective than objective, indicating that the results might be biased since subjective data tends to

suffer from diplomatic responses, although a survey approach is good at integrating non-quantifiable factors. Subjective or perceptive success measurements may have the problem of biased empirical results due to retrospective elements. An effort should be made to test the hypotheses with the use of objective performance measures as well, such as the growth of total factor productivity, return on assets and return on sales. Moreover, longitudinal data should be collected from both headquarters and subsidiaries to capture deeper empirical evidence.

Third, it would be fruitful, for instance, to investigate whether the results are applicable to the case of other Asian affiliates such as Korean manufacturing firms in the transforming economies in CEE. Moreover, a cross-country comparative study (for instance, some transforming economies such as Russia, China, and Turkey) would enable us to check the robustness of the current theoretical model and to provide more practical and managerial implications for both top executives and policy makers, since institutional and cultural uniqueness in those countries may affect the validity of the location-performance relationship. Therefore, this type of comparative study should bring deeper insights into the variations in business practices and local market conditions on performance. This study remains inconclusive but suggestive for future research.

Last but not least, a firm's strategic orientation should be considered for future research. It would be of great relevance in exploring how the success of the subsidiary differs in relation to four types of a firm's strategic orientation, such as resource-seeking FDI, market-seeking FDI, efficiency-seeking FDI and strategic-seeking FDI.

Table 7-23: A List of the Surveyed Firms in CEECs

Nr.	Company name	Country	NUTS2 region	Entry year
1	Czech Republic ONAMBA	Czech Republic	Strední Morava	2001
2	Showa Alminium Czech s.r.o.	Czech Republic	Strední Cechy	1997
3	IBIDEN Hungary Manufacturing Kft.	Hungary	Közép-Magyarország	2004
4	Toyota Motor Industries Poland Sp.z.o.o.	Poland	Dolnoslaskie	1999
5	Taiho Corporation of Europe Kft.	Hungary	Közép-Magyarország	2000
6	Three Bond Czech s.r.o.	Czech Republic	Strední Cechy	2006
7	Takada Industries Czech Republic s.r.o.	Czech Republic	Severozápad	2002
8	TRCZ s.r.o.	Czech Republic	Severovýchod	2001
9	Mi-King s.r.o.	Czech Republic	Strední Cechy	2004
10	Toray Textile Central Europe s.r.o.	Czech Republic	Strední Morava	1997
11	Panasonic AVC Networks Czech, s.r.o.	Czech Republic	Jihozápad	1996
12	SEWS Components Europe Hungary Ltd.	Hungary	Közép-Dunántúl	2002
13	Ajinomoto Poland Sp.z.o.o.	Poland	Podlaskie	1999
14	Sanyo Hungary Kft.	Hungary	Közép-Dunántúl	1999
15	ASMO Czech s.r.o.	Czech Republic	Strední Cechy	2004
16	Clarion Hungary Electronics Kft.	Hungary	Közép-Magyarország	1997
17	Sunarrow Hungary Kft.	Hungary	Közép-Dunántúl	2002
18	NSK ISKRA	Poland	Swietokrzyskie	1998
19	Nachi Czech s.r.o.	Czech Republic	Severozápad	2003
20	Shin-Etsu Polymer Hungary Kft.	Hungary	Nyugat-Dunántúl	2003
21	Nissho Hungary Precision Kft.	Hungary	Közép-Magyarország	1999
22	TRIM LEADER a.s.	Slovakia	Stredné Slovensko	2000
23	Alpine Electronics Manufacturing of Europe Ltd.	Hungary	Közép-Dunántúl	1998
24	Summit D&V Kft	Hungary	Közép-Dunántúl	1999
25	ISUZU MOTORS POLSKA Sp.y.o.o.	Poland	Slaskie	1997
26	TBMECA Poland Sp.z.o.o.	Poland	Dolnoslaskie	2003
27	Makita Romania	Romania	Macroregiunea trei	2006
28	Koyo Romania	Romania	Macroregiunea trei	1998
29	SMK Hungary Kft.	Hungary	Del-Alföld	2000
30	ACCUROMM Central Europe Sp.z.o.o.	Poland	Dolnoslaskie	2004
31	Furukawa Electric Autoparts Central Europe s.r.o.	Czech Republic	Strední Cechy	2001
32	AKS Precision Ball Polska Sp.z.o.o.	Poland	Dolnoslaskie	2002
33	SATO Polska Sp.z.o.o.	Poland	Dolnoslaskie	2001
34	DAIDO METAL Czech	Czech Republic	Jihovýchod	2005
35	DENSO Manufacturing Hunagry Ltd.	Hungary	Közép-Dunántúl	1997
36	Yazaki Wiring Technologies	Czech Republic	Jihozápad	1993
37	INDET SAFETY SYSTEMS a.s.	Czech Republic	Strední Morava	1999
38	U-Shin Europe Kft.	Hungary	Közép-Dunántúl	2000
39	Yazaki Debnar Slovakia spol.s.r.o.	Slovakia	Východné Slovensko	1994
40	Ryowa Hungary	Hunagry	Közép-Dunántúl	2000–05
41	Sluzba SIIX Electronics s.r.o.	Slovakia	Západné Slovensko	2001
42	Sumitomo Electric Wiring Systems Slovakia	Slovakia	Stredné Slovensko	1996
43	NIFCO	Poland	Dolnoslaskie	2006
44	Daicel Safety Systems Europe Sp.z.o.o.	Poland	Dolnoslaskie	2004
45	AISIN EUROPE MANUFACTURING CZECH	Czech Republic	Jihozápad	2002
46	Meiji Rubber Europe Industrial Products Co.Ltd.	Hungary	Észak-Alföld	2003
47	Euro Comfort Sp.z.o.o.	Poland	Malopolskie	1995
48	NGK Ceramics Polska Sp.z.o.o.	Poland	Slaskie	2003
49	YAGI Factory Poland Sp.z.o.o.	Poland	Dolnoslaskie	2003
50	Elektroporcelan Louny	Czech Republic	Severozápad	2000–05
51	NTK Technical Ceramics Polska Sp.z.o.o.	Poland	Dolnoslaskie	2003
52	Muramoto Manufacturing	Czech Republic	Strední Cechy	2005
53	Sharp Poland	Poland	Kujawsko-Pomorskie	2006
54	Mitsubishi Electric Automotive Czech s.r.o.	Czech Republic	Severozápad	2000
55	Tokai Rubber	Poland	Malopolskie	1999

8 CASE HISTORIES: JAPANESE MANUFACTURING FIRMS IN EUROPEAN TRANSITION ECONOMIES

8.1 Methodological Issues

This section focuses on complementing some of the information presented in the previous chapters through the use of a survey approach, with four case studies. The in-depth case study method is adopted to highlight the primary motives of each firm in the study regarding their investments in CEE and its current operational experience. It is generally acknowledged that a case study approach on the basis of a series of semi-structured interviews empowers the researcher to acquire detailed information about the underlying motives behind corporate strategy (Meyer, 2000; Yeung, 1995). A case study approach has the ability to explain complicated factors that influence the strategies and actions of MNEs. More precisely, the strength of the case study method is rooted in the detail of cause-effect relationships, hidden insights and findings deviating from the expected and better inferences (Jensen and Rodgers, 2001). Yeung (1995: 314) also support this view by emphasising that "the beauty of [the case study approach] lies in its validity (*i.e.*, dealing directly with decision makers and the richness of information collected) and reliability (*i.e.*, ability to be repeated in practice)." The case study approach is useful in exploring the characteristics of FDI since different companies tend to utilise different investment strategies and invest in different location sites at different times. It is important to note that the management and strategy of MNEs cannot be accounted for by a 'one-size-fits-all' model. The case study approach is especially suitable for scrutinising the behaviour and nature of foreign investors in CEE since the transition into a market-supporting economy is still in progress (Lim, 2003: 350).

In sharp contrast, a survey approach encounters poor response rates and weak reliability of given information, although it can theoretically address a relatively large number of investments and incorporate non-quantifiable factors. Hence, one of the most critical issues facing those who adopt the survey approach is that a particular observation may not necessarily be applicable. Similarly, an econometric approach is largely unable to address non-quantifiable determinants of an investment decision or measures targeted at a specific investment although it has the advantage of a large sample size. On these grounds, the case study approach is more adequate and presents greater insight into the characteristics, actions and operational outcomes of Japanese subsidiaries in CEE. Hence, policy makers in the region can better understand the implementation of the strategies.

This chapter explores four case studies (NSK Poland, Denso Hungary, Sanyo Hungary and TMMP/TPCA). These firms are representative of the industrial competitiveness of the Japanese economy. There are some common characteristics behind the major reasons for the selection of these four cases in particular. First, these firms were at the forefront of entering in the European transition economies

(NSK-ISKRA in 1998, Denso Hungary in 1997, Sanyo Hungary in 1999 and TMMP/TPCA in 1999/2002). Second, the corporate strategy of all four of these firms is embedded in a strategic orientation toward actively advancing into foreign markets. Third, each case firm possesses competitive ownership advantages (*e.g.*, bearing products for NSK, automotive-related products for Denso, solar batteries and large-scale air conditioners for Sanyo, and hybrid technology as well as production methods for Toyota) at the global level. Fourth, the most common distinctive feature of these case firms is that network relations revolve around the central role in their internationalisation process. Lastly, these four case study firms are commonly characterised as well-experienced in foreign markets.

Of these four case studies, the NSK-ISKRA case is one of the most interesting ventures among Japanese subsidiaries because of its method of entry and organisational restructuring. Second, the Denso Hungary case provides an opportunity to test how the Toyota *keiretsu* system affects the motive and industrial location of Toyota *keiretsu* group firms when entering post-socialist economies. Third, emphasis should be given to the Sanyo Hungary case because of the company's internationalisation process. Lastly, the TMMP case reflects the significance of FDI incentives in attracting large scale FDI projects. The TPCA case also provides interesting insights into its location choice, network sources and corporate strategy, because of its 50-50 joint venture between Toyota and PSA.

During the period from autumn 2006 to spring 2007, we carried out semi-structured interviews with management from a number of Japanese manufacturing firms investing in CEECs in light of the eastward expansion of European integration. The interviewees were the same as those who participated in the preliminary survey presented above, except for the TMMP/TPCA case. All interviewees were either individuals who were involved in the FDI decision-making procedure or those who have been responsible for the local operations for a long period of time. The interviews were conducted in an open-ended manner. It was expected that the interviewee would be able to speak more freely due to an open-ended character of questions. Interviews were recorded so as to obtain as much insightful information as possible and they were subsequently triangulated. The average length of each interview was one hour. To check and back-up the information gathered during the interviews, secondary data from media reports and companies' corporate websites, and newspapers were also used.

The case study approach is suited to scrutinising the *process* as well as the *consequences* of the spatial organisation and corporate strategy of the four case study firms in the context of international business and economics in CEE. We emphasise the following questions in the examination: (1) what internal and external factors affected the FDI decision-making process of these case firms, (2) how institutional forces shape the spatial organisation of these MNEs, (3) whether the CEE region is a profitable location for them, (4) to what extent foreign investments are conducive to promoting

sustainable regional economic development in CEE. These questions will be deliberately expounded upon through the case study method. We will highlight a general profile of the historical development of the parent company in each case, followed by locational strategy, human resource management, external networks and performance.

Table 8-1: Comparison of Parent Company Data of Four Case Firms in 2007

	Parent-specific characteristics	NSK	Denso	Sanyo Electric	Toyota Motors
1	Sector	Machinery	Electrical machinery	Electrical machinery	Transport Equipment
2	Establishment year	1916	1949	1950	1937
3	No. of employees (ave. age)	23,413 (41.0)	112,262 (N/A)	94,906 (41.1)	299,394 (37.0)
4	Overseas sales ratio (%)	49	48	55	74
5	Sales (mil. yen)	717,225	3,609,700	2,308,628	23,948,091
6	Technology intensity (R&D/sales) (%)	1.3	8.1	6.2	7.6
7	First foreign market entry (Country name)	1970 (Brazil)	1973 (Canada)	1965 (Taiwan)	1959 (Brazil)
8	No. of overseas production subsidiaries	18	67	52	52

Source : Toyo Keizai (2007)

8.2   Case Study 1: NSK-ISKRA Poland

8.2.1   Company History

NSK was established in 1916 as the first bearing producer in Japan. NSK has been primarily involved in the manufacture of ball and roller bearings and successfully diversified its product range from automotive components to mechatronic products and precision machine parts. Steering technology and tribology technology are relatively high by global standards. The domestic share of NSK accounts for 30 percent while the world share is close to 17 percent (NSK Annual Report 2004). NSK is also the leading company producing the core components of Half Toroidal CVTs. The first foreign production facility of NSK was established in Brazil in 1970. Since then, NSK has expanded its value chains in Asia, Europe and North America. As of today, NSK has cross-border vertical and horizontal networks. NSK has approximately 30 sales subsidiaries and 20 production facilities abroad. The primary goal of placing production in Europe was to bypass anti-dumping barriers (Lange, 1993). As of 2007, NSK employed 23,413 people and for the year 2006-2007 had a sales volume of 360 billion yen (see Table 8-1).

NSK's globalisation strategy sought market presence in four specific regions:

North America, Asia, Europe and South America. The world bearing market is characterised by fierce competition, with a very limited number of rivals. The global bearing industry has seen organisational and geographical changes since 2000, coupled with a sequencing of competition and cooperation. NSK's foreign and domestic rivals, such as SKF (a Swedish corporation), INA (a German corporation), TIMKEN (an American corporation), NTN (a Japanese corporation) and Koyo Seiko (a Japanese corporation) have continued to exert significant pressures on the speed, extent and intensity of NSK's globalisation strategy (Figure 8-1). INA took over FAG (a German corporation) in 2002 and TIMKEN acquired Torrington (an American corporation) in 2003. In 2008, NTN is ranked as second next to NSK in terms of domestic market share. On the global scale, NTN has become the second largest bearing company, surpassing TIMKEN and NSK, due to its acquisition of the Renault subsidiary SNR in 2008. It can be said that NTN's purchase of SNR has enabled NTN to attain extensive market channels in the enlarged EU market. In 2006, the former Koyo Seiko, ranked third in the domestic market, merged with a Toyota *keiretsu* member, Toyota Machine Works, which produces machinery products and achieved the rationalisation of managerial and productive capabilities. A succession of mergers and acquisitions within the global bearing industry resulted in pushing NSK down to its position as the fourth largest bearing manufacturer in the world. Mr. Katsuyuki Kambara, the former president of NSK-ISKRA, was interviewed in Warsaw, Poland on 15 October 2006.

Figure 8-1: Market Shares in the Global Bearing Industry
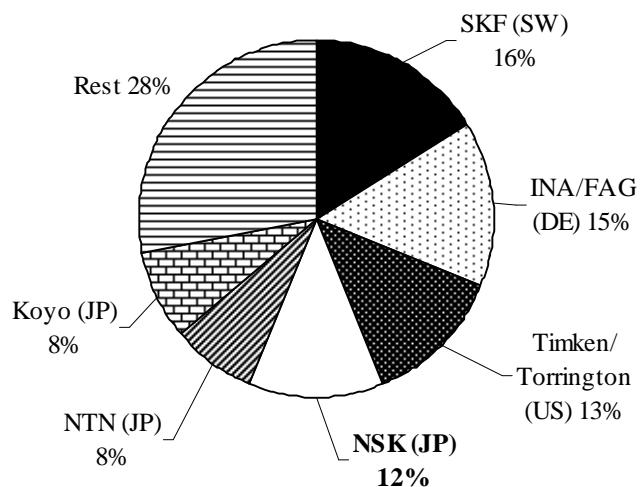
Source: NSK Poland

8.2.2 Location Strategy in CEE

NSK's location strategy in CEE can hardly be understood without considering its

production history in the UK. In order to penetrate the European markets, NSK decided to establish its production facility for standard ball bearing in the UK in 1974 (Figure 8-2). Great Britain finally became a member of the European Community in 1973 after France had blocked the country's joining the Community for a long time. Peterlee, Durham County, was chosen as NSK's strategic location serving the European markets. The NSK production facility was established in Peterlee, a town with an industrial structure heavily dependent upon the mining industry.

There were two decisive factors that determined NSK's location selection in Peterlee. One was that Nissan Motor Company had already invested in Peterlee prior to NSK's entry. Another was that NSK received financial grants from the British government.

NSK's acquisition of a local bearing maker, RHP Bearings Ltd., took place in 1990. Nevertheless, the company was subject to external shocks such as the bursting of the bubble economy in Japan, the rapid erosion of cost competitiveness of British car makers and rising transaction costs arising from the UK's refusal to enter the Economic and Monetary Union (EMU). The 1990s witnessed the UK placing more of its weight on the financial sector and not on the manufacturing sector. This industrial transformation was known as the "Wimbledon Phenomenon". Moreover, rising costs of labour force and raw materials and the increasing impact of fluctuations in the Pound-Euro exchange rate in the UK also prevented NSK from sustaining or achieving high labour productivity and sustaining cost leadership (NSK, 2003: 12). The exchange rate problem was of critical concern to the company, since 70 percent of finished goods produced by NSK in the UK were exported to the continent.

Intensified competition in the European ball bearing markets urged NSK to shift emphasis to cost-effective production management. For instance, a Swedish firm, SKF, and a German firm, INA/FAG, reinforced their market presence in the 1990s by decreasing operational costs and relocating to the European transition economies.

As a result of these changing macroeconomic circumstances in the UK and the behaviour of foreign rivals, NSK was pressured to reconsider the future of its UK operations and to discuss the possibility of relocation to other European nations that would offer NSK cheap input costs such as labour and materials. Losing its comparative advantage in the UK automobile industry (*e.g.,* with rising labour costs and stagnated labour productivity) was seen as a justification for NSK's relocation. In the mid-1990s, top executives at the headquarters in Japan concluded that relocation was necessary in order to rationalise production systems and regain cost competitiveness. However, there was a critical obstacle that deterred NSK's decision to immediately shut down its Peterlee factory. It was argued that the company could still benefit from financial incentives granted by the British government even though the UK was losing comparative cost advantages relative to CEE.

Figure 8-2: Spatial Distribution of European Subsidiaries of NSK (as of 2008)
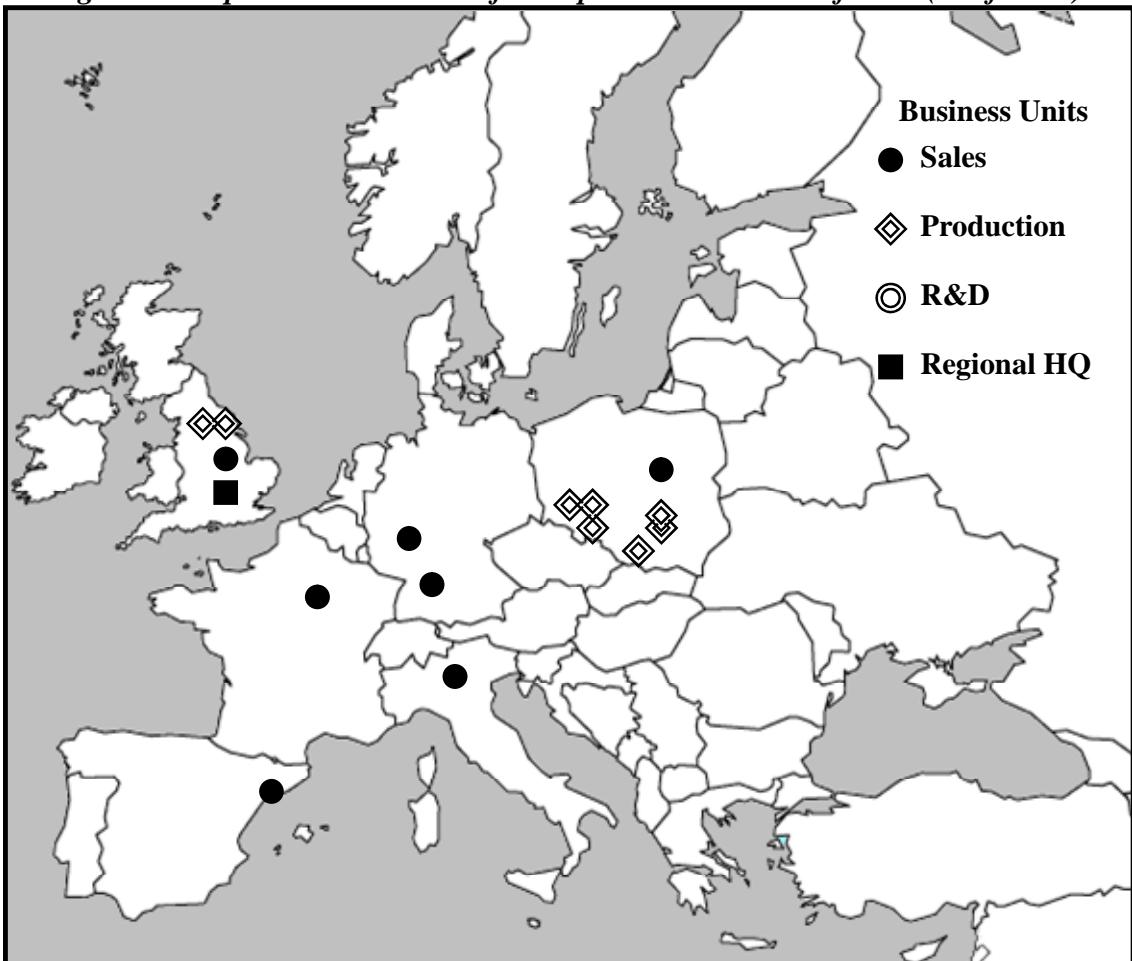
Source: Author's illustration based on Toyo Keizai (2007)

After the final decision on relocation was made in 1995, NSK launched a feasibility study about where to relocate its production facility. After investigating various locations, the company finally decided to target the Polish general machinery industry despite the economic turmoil in Poland in the 1990s, where the inflation rate was 600 percent. NSK has a history of business involvement in Poland stretching back to the mid-1990s. In the past, NSK had been asked by a Polish state-owned enterprise, FLT-ISKRA, to sell equipment and machinery for standard ball bearing production and to provide technical cooperation and to contribute capital. In those days, FLT-ISKRA desperately had to seek external support since the competitiveness of the Polish bearing industry was failing at a rapid pace during the 1990s. FLT-ISKRA had been used to producing 60 percent of the national bearing output as Poland's largest producer of bearings (Central Europe Automotive Report, 1998: 1). NSK exported equipment and machinery to a few bearing factories of this state-owned enterprise in Poland and offered Polish workers technical instruction and on-the-job training (OJT). An affiliated company of NSK, Amatsuji Bearing Company, also exported machinery to the Krasnik

factory of this state-owned enterprise, while NSK did so to the Kielce factory.

At the same time, the Polish government introduced large-scale privatisation schemes to restructure a weak economy hit by the deep recession of the late 1990s. Government officials felt that the country's reliance upon privatisation led by foreign entrepreneurship was inevitable, as the Polish government was not confident enough to administer the privatisation process on its own. The aim of the central government was the privatisation of the machinery and shipbuilding sectors in particular. In the cost-benefit calculations linked to brownfield investment opportunities, NSK paid particular attention to acquisitions of the Kielce and Krasnik factories of FLT-ISKRA. However, competition turned out to be intensive, as foreign rivals rushed to the opportunities arising out of the privatisation of state-owned firms in Poland. For instance, the FLT-Poznan factory had already been privatised by a Swedish firm, SKF, while the factory in Sosnowiec was acquired by an American bearing competitor, TIMKEN. FLT-Krasnik was privatised by one of the leading Japanese bearing firms, Tsubaki-Hoover. The only remaining chance was the Kielce factory of FLT-ISKRA. NSK succeeded in acquiring the Kielce factory of FLT-ISKRA after an intensive bidding competition. In the bidding process, price competition became severe, because NSK's major rival, SKF, also joined the bidding. NSK eventually won the bidding although the tender price was much higher. There was another reason why NSK wanted to take over the Kielce factory of FLT-ISKRA.

In January 1998, the Japanese companies, NSK Ltd. and Nichimen Corp., paid nearly US$44.8 million to the Polish Privatisation Ministry for 80 percent of the equity shares of the FLT ISKRA roller-bearing factory in Kielce (Central Europe Automotive Report, 1998: 1). Mr. Kambara, the former president of NSK-ISKRA, pointed out that "*our entry in Poland was not affected by the potential that Poland would receive EU membership in the future although Poland had announced its intention to obtain membership in the early 1990s. Rather, radical changes in the UK's market conditions, such as rising labour costs and falling industrial competitiveness urged us to relocate our UK operations to a location with cheap input costs within Europe. Other than Poland, Bulgaria was also studied because NSK had exported machineries and equipment to Bulgaria. We had no business activities in the Czech Republic and Hungary. In contrast with Poland, the Bulgarian government announced implementation of privatisation privileged to domestic investors. According to this type of privatisation, only Poland was selected as a relocation destination. Koyo Seiko also traced the same trajectory as ours to acquire an indigenous factory to which Koyo Seiko exported equipments for bearing production in Romania*".

Scholars of economies in transition have long argued that it is usual for brownfield investment to involve uncertainties about employee quality and organisational competences while mergers and acquisitions are instrumental in entering potential markets with high economic growth much faster than in the form of greenfield

investment and joint ventures (Meyer, 1998; Meyer, 2002). Furthermore, one could argue that brownfield investment in transforming economies would be more complex. First, acquiring firms inherit local employees whose work ethic may not have been aimed at economic efficiency during the era of state socialism. Second, outdated equipment may have lost value. On these negative grounds, investors are likely to be concerned about the scenario that costs may outweigh benefits. The former president of NSK ISKRA also stated that "*the question was raised of whether we can effectively transfer Japanese management systems and mentality to the local venture during the post-acquisition period. At the same time, we were afraid of the risk that the factory would be cheaply purchased and nationalised by the host government in transforming economies once local employees were trained and new machineries were well-equipped*".

In the NSK-ISKRA case, NSK was confident of gaining more benefits from brownfield investments in Poland as compared to greenfield investments. The rationale for NSK's acquisition of FLT ISKRA in Kielce was varied. First, NSK's historical relationship with the FLT ISKRA encouraged NSK to undertake the brownfield investment. Prior to the purchase, NSK had already assisted FLT ISKRA in recovering its business performance through exporting cutting-edge equipment for bearing production.

Second, NSK had already become acquainted with how to improve production systems, product quality, and engineers' competence due to its experience with FLT ISKRA. Moreover, many Polish employees were, to some extent, familiar with Japanese management systems since they had already been sent to Japan to undergo training during the two companies' technical cooperation period. This historical relationship relaxed the threats and uncertainties that were perceived by Japanese expatriates when working with the Polish employees, as these employees had already experienced how Japanese production systems function. At present, those who have undergone training in Japan work at the mid-management level. This background reinforces the explanatory power of the strategic network theory (Chen and Chen, 1998: 448) asserting that "network resources are particularly useful in entering a primitive market in which institutions that facilitate internationalisation are still lacking".

Third, emotional matters also played a critical role in urging NSK to prefer mergers and acquisitions over other entry modes. NSK was reluctant to give up its bearing production machinery to other competitors in the privatisation process. There was another case similar to the NSK experience. When a Japanese small-compact-car maker, Daihatsu, participated in the mass privatisation scheme in the automobile industry and tried to purchase an indigenous firm to which an Italian automobile assembler, Fiat, had traditionally exported machinery and equipment, Fiat blocked Daihatsu from purchasing the local firm. It was illustrative of the fact that Fiat did not want to abandon its machinery and its network relations with this local company.

Fourth, in general, the bearing industry requires a great amount of additional investment in facilities. Hence, greenfield investment constitutes more costs and time than M&A while a WOS firm can retain financial and managerial independence. Despite a Polish business climate with poor application of property rights and inconsistent legal practices during the 1990s, successful market entry was achieved by NSK through taking advantage of the path dependency of its established relational assets with ISKRA.

In the contemporary FDI policy environment in the CEE region, financial and tax incentives usually have a positive impact on MNEs' motives for investment. However, it does not hold true for the NSK-ISKRA case. As NSK received no financial assistance - such as cash grants and tax holidays - from the central government, financial and tax incentives had no direct impact on NSK's decision to relocate to Kielce in Poland. Rather, the Polish government laid down strict conditions on NSK for M&A. NSK was obliged to invest an additional US$46 million in the expansion of the acquiring factory for five years after the acquisition and to ensure a five-year employment guarantee and the same salary level as in the pre-privatisation period (Wada and Abo, 2005: 155). These constraining factors prevented NSK-ISKRA from restructuring organisational management, rationalising production, increasing productivity and profitability and downsizing the number of employees in a prompt fashion.

8.2.3 External Linkages

Originally, when the decision was made to enter Poland, the EU market was considered to be the target market for ball bearings. Currently, however, NSK exports finished goods produced in Kielce to Poland, Europe, North America, Southeast Asia and Japan. Of these destinations for export, Poland accounted for 20 percent and the remaining markets accounted for 80 percent. Among those other countries, the Western European market dominates. The firm has perceived it to be of great importance for them to sell quality products at cheap prices since a flow of cheap products from China into Europe became dominant during the 1990s and has exerted an enormous influence over the demand structure of global markets in recent years. NSK has been pressured to ensure cheap and steady sources of quality raw materials such as iron. Sources of raw materials for NSK-ISKRA are 20 percent from Poland, 40 percent from the Czech Republic and 40 percent from Western Europe. The company remains reluctant to purchase iron from Russia because the quality of Russian iron is unstable. The former senior manager of NSK-ISKRA reported that network relations with local suppliers remained immature.

A distinguishing feature of NSK's strategy of forging network relations is its encouragement of its affiliated companies to follow the parent, and its engagement in additional investments. This development of strategic networks has helped NSK-ISKRA to leverage its competitive advantage over Western competitors. At present, NSK has another factory in Wałbrzych. The entry strategy involved greenfield investment, which

profited from cash grants incentives from the local government. Amatsuji, an affiliated company of NSK, has been in operation in Poland since 2004. Investment decisions by NSK facilitated its small- and medium-sized affiliate companies to bypass some stages of internationalisation. For instance, Toho Industry, Toyo Seal, and Yagi Industry entered Poland after 2000, notwithstanding having only limited internal resources (international experience, technology and managerial expertise). Strategic linkages with NSK are likely to supplement their weak firm-specific advantages. Toho Industry and Yagi Industry had no foreign business experience before their entry into Poland[22]. Toyo Seal is also encouraged to supply seals for bearings produced by NSK Poland. In geographical terms, Amatsuji and Yagi are in operation in Wałbrzych, while Toho Industry and NSK run their production lines in Radom and in Kielce, respectively.

This sequential entry of the affiliated and related companies has enabled NSK to ensure quality control and delivery times and to respond quickly to market changes. The geographical advantage of the Polish operation serves as a strategic point for continued access to the global markets.

8.2.4 Human Resource Management

Figure 8-3: NSK-ISKRA's Employment Growth
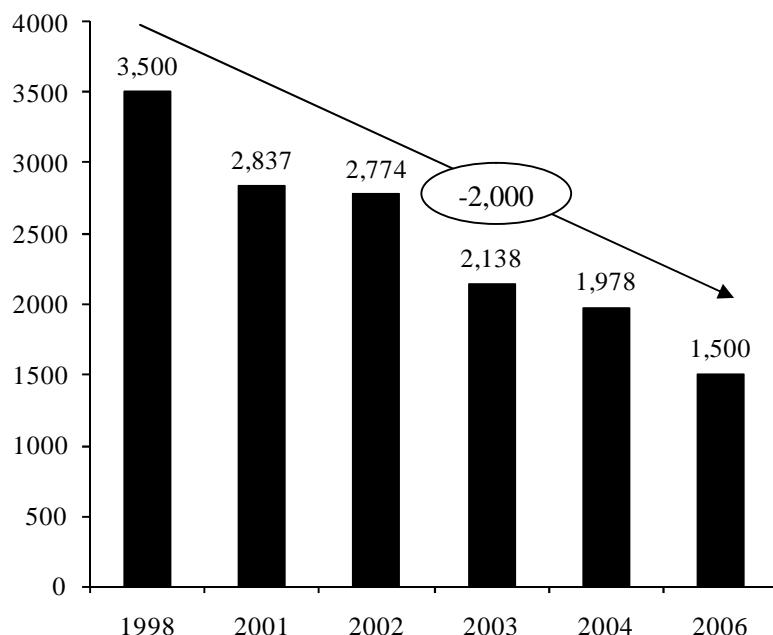
Source: Author's illustration based on data provided by NSK Poland and Toyo Keizai (1999, 2002, 2003, 2004, 2005, 2007)

During the post-privatisation period top executives of NSK perceived it to be important

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[22] NSK accounts for over 30 percent of the equity holdings in the parent companies of both Toho Industry and Yagi Industry in Japan.

not to make radical personnel cutbacks when initiating measures for enterprise restructuring. NSK showed a high degree of institutional engagement in and organisational commitments to its restructuring process. First, NSK deliberately explained to the governor of the Swietokrzyskie voivodship and the mayor of Kielce how the company intended to restructure the old system, creating functioning market competition with high productive efficiency in order to survive in the era of globalisation (Wada and Abo, 2005: 159). This close communication with key local actors was a precondition for enhancing legitimacy and trust. It is worth noting that 5,800 employees in a city with a population of 240,000 used to work for ISKRA in Kielce (Wada and Abo, 2005: 159) when it was restructured. Therefore, the company had to eschew antagonism and nationalist sentiments of the local population by practicing a gradual approach towards its enterprise restructuring process.

Second, NSK introduced an innovative measure for the restructuring of the formerly state-owned enterprise. NSK's privileged goal was to ensure better performance and to exploit cost economies without radical lay-offs. The measure was undertaken to encourage employees to retire early and voluntarily in return for a retirement allowance. The amount of this retirement benefit was 3,000 Polish Zlotych (PLN) a month for 12 months. Other than NSK, none of the foreign firms that merged with other firms or acquired additional companies introduced such early and voluntary retirement programmes. As a consequence of these efforts, 700 employees out of 3,500 retired. However, this measure for personnel cutback became gradually less effective over time because of the difficulty of finding new jobs for the retirees due to the weak Polish economy. Finally, the number of employees declined dramatically from 3,500 to 2,200. Although there was an incremental restructuring program, NSK-ISKRA was still NSK's largest factory in Europe, with 1,500 employees.

It should be noted that a former executive of NSK-ISKRA in Kielce used to be the senior director of the Polish subsidiary of Nichimen, a Japanese general trading company, in the 1980s. He was heavily involved in NSK's acquisition of ISKRA and was hired as the president of the newly acquired company because of his rich experience about the Polish business and relational ties with the local government.

The former senior executive of NSK-ISKRA commented on the eroding comparative advantages in Poland that "*the supply of cheap but skilled labour in Poland has been more constrained in specific regions such as Wroclaw and Katowice because not only Western firms but also Japanese firms are more heavily concentrated over time. This uneven distribution of foreign direct investment in Poland resulted in excessive demand for labour and indeed caused a dramatic rise in the level of wages among foreign investors, in particular, in Southern Poland. Coupled with competition for human capital arising from unbalanced and constrained labour markets, the job-hopping problem has also deterred Japanese firms from achieving stable and efficient production management to date. Moreover, the emergence of an enlarged EU*

has made the utilisation of cheap human capital more difficult since numerous Polish workers immigrated to Ireland or the UK after 2004 when Poland became a member of the EU. This changing nature of local labour conditions tends to keep Japanese firms from gaining continued access to high quality labour and puts them under pressure to pursue a specific policy designed to sustain the motivations of their employees for working longer. We are very concerned that the wage growth would offset the productivity growth in Poland".

As regards the risk of labour rigidity in Poland, the company is not subject to strong labour power. This runs counter to the traditional beliefs that strikes and lock-outs frequently occur as labour dominates capital due to the institutional inheritance of state socialism. The former senior executive of NSK-ISKRA pointed out that *"the main reason for the existence of peaceful labour relations is that it is commonly perceived among local employees that labour disputes would harm the domestic economic development as a whole and the Polish economy may hence be far behind other counterparts of CEE such as the Czech Republic and Hungary. Therefore, workers are reluctant to come out on strike. Enthusiasm for work has been much higher than expected since many people had suffered from being unemployed for a long period of time. In my opinion, they seem to be diligent and happy to work. The number of job applicants for a new recruitment of 35 employees reached more than 1,000 when the company set up its second production facility in Wałbrzych. NSK Poland in Wałbrzych pays 1,300 PLN (352.34 Euro) for starting pay"*[23].

The degree of delegation of authority to local employees is relatively high. Except for the president of NSK-ISKRA, leading positions in the HR, finance and marketing departments are occupied by local employees. An attempt has been made by the company to increase local employees' work morale and work ethic by introducing promotion systems. The existence of training systems for local employees in Japan also helps to facilitate the transfer of production and managerial expertise to the local production activity.

8.2.5 Corporate Performance

Together with the personnel cutback plan, NSK transferred part of the production lines used in the Peterlee factory in the UK to the Kielce factory in Poland in order to gradually rationalise production systems and expand manufacturing capacity (see Figure 8-4). NSK currently assumes one of the leading positions among foreign and Japanese bearing manufacturing firms. After the restructuring process, the company began generating profits in 2003. Total sales doubled from US$4.7 million in 2000 to US$9.8 million in 2003 (see Figure 8-5). NSK has pursued a strategy of subsequent expansion of equity shares to acquire managerial, production and financial control over other

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[23] Calculated based on 1 PLN=0.27 Euro on 26 November 2007.

shareholders (Table 8-2).

Figure 8-4: Shift of Production Base of Ball Bearing from the UK to Poland (Unit: thousands of units/month)
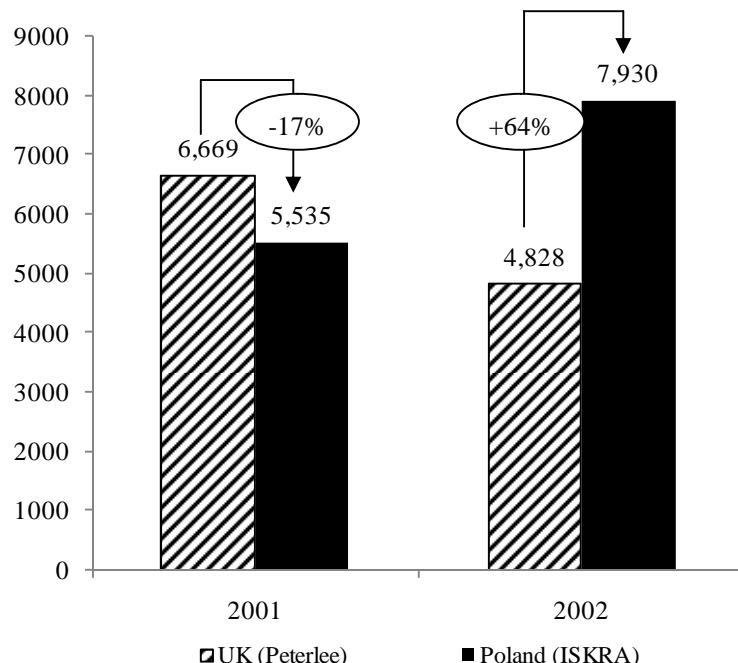
Figure 8-5: NSK-ISKRA's Corporate Performance (Unit: US$ million)
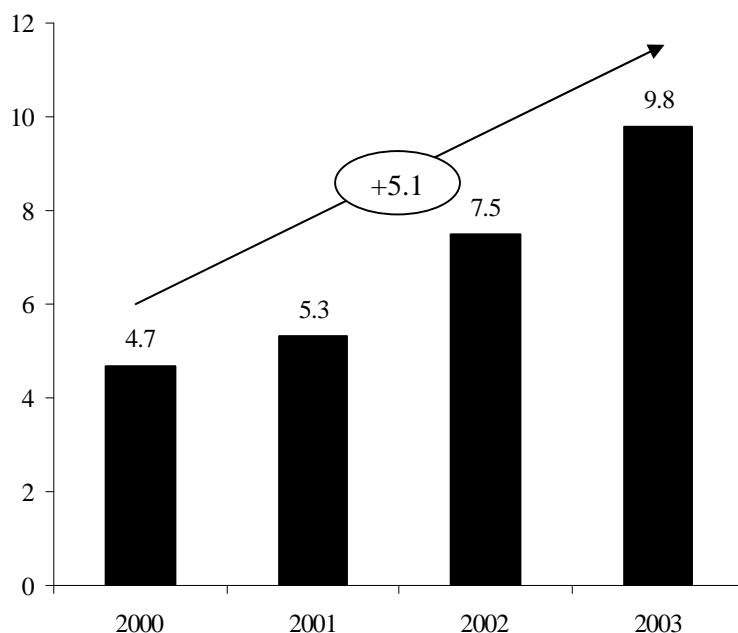
Table 8-2: Evolution of NSK's Equity Share of NSK-ISKRA

	1998	1999	2000	2001	2002	2003	2004	2005
NSK	70	70	70	88	88	93	93	93
Nichimen*	10	10	10	8	8	5	5	5
Polish government	20	20	20	4	4	2	2	2

Source **:** Toyo Keizai (1998, 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007)

Note **:** * Nichimen merged with Nissho Iwai in 2004. Since then, the new company has been Sojitz Corporation.

8.2.6 Summary

The relocation strategy of NSK into Poland has been depicted as successful seeking a response to the emerging competitive disadvantages of rising labour costs in the UK, deteriorating labour productivity and fluctuations in the Pound exchange rates. By relocating its factory lines from Peterlee in the UK to Kielce in Poland, NSK's global market position vis-à-vis Western and other Japanese rivals has been secured. Moreover, NSK's historical business connections with the formerly state-controlled firm, a gradual step in enterprise restructuring of the acquired firm in the post-privatisation period and the appointment of the former *sogo shosha* director of Nichimen Poland as president of NSK-ISKRA in Kielce eased the liability of foreignness. Poland's strong industrial tradition in the general machinery sector was also a vital factor in determining the entry of NSK. It is of significant interest that neither governmental incentives nor market size considerations influenced the FDI allocation of NSK in Poland. The NSK case is also illustrative of the expansion of the range of business units from sales and production to R&D in Poland. The NSK case lends support to the view that the accumulation of a firm's international experience permits its associated and affiliated firms to leapfrog some of the classic steps of internationalisation developed by Aharoni (1966).

8.3 Case Study 2: Denso Hungary

8.3.1 Company History

Denso is the largest auto-related supplier in Japan. As of the end of 2007, the company had more than 50 manufacturing factories in the global markets. Total employment amounts to 112,262 (Toyo Keizai, 2007). In the Fortune Global 500, Denso was ranked 214th in 2007 with a total net profit of US$1.754 billion. Denso has strong competitive advantages in technology, financial stability, managerial expertise and international experience. In particular, Denso's R&D ratio relative to sales over the 1998-2006 period reaches on average approximately 10 percent. In 2007, Denso invested 305 billion yen in its R&D activity. The main business lines of Denso have been diversified into two segments. One is the automotive-related segment that comprises 6 systems: (1) thermal systems; (2) power train systems; (3) information and safety systems; (4) electric systems; (5) electronic systems; and (6) small systems, while another is the new

business-related segment that includes bar-code readers, robots and non-contact IC card readers/writers.

The establishment of Denso can be traced back to 1949, following a spin-off from Toyota. Denso is currently the second largest automobile components supplier in the world behind a German competitor, Robert Bosch. Since Denso originally belonged to the Toyota Group, the company has established strong network ties with Toyota and other Toyota *keiretsu* firms. Toyota is the largest equity shareholder of Denso as it accounts for 22.7 percent (Toyo Keizai, 2007). However, Denso has been growing more independent from Toyota because of its very large customer ties (Ahmadjian and Lincoln, 2001). Denso extensively supplies its car components not only to Toyota but also to various domestic and foreign customers both at home and abroad. Denso's product quality in engines and electric as well as electronics components has been widely acknowledged.

To date, Denso has developed extensive production, sales and distribution networks around the world. The total number of overseas subsidiaries is 91, of which 22 are in North and South America and 23 in Europe (Toyo Keizai, 2007b). The most distinctive feature of Denso's corporate network in an enlarged Europe is that a large number of its subsidiaries are concentrated in CEE (see Figure 8-6). Mr. Nobuyuki Fujitani, the former president of Denso Hungary, was interviewed in Dunavarsány, Hungary on 12 October 2006.

8.3.2 Location Strategy in CEE

The main reason for Denso's market entry in Hungary was not related by Toyota. The presence of Isuzu Poland, which has produced diesel engines for Opel since 1997, was seen to justify Denso's local production (Toyama, 2005: 170). The rationale behind the establishment of Denso Hungary was based on Denso's core corporate philosophy emphasising the strategy of placing production facilities near its customers. An initial feasibility study for possible manufacturing sites was begun in the late 1990s. Denso's preference of CEE over Western Europe, notwithstanding the fact that Denso still has an extensive sales, marketing and distribution networks in that region, is based on two distinctive factors. First, Denso needed to select a location that was geographically distant from Robert Bosch which dominated Western European markets. By considering the importance of physical distance from this leading market competitor, Germany, France and the UK were automatically ruled out of Denso's location alternatives. The former senior executive of Denso Hungary stressed that "*it was already perceived even before the entry that Denso would not be able to compete equally with Robert Bosch in quality and price in case of producing products in Western Europe. To compete against Robert Bosch on equal terms, CEE is an ideal production site for Denso in cost and strategic considerations*". Second, Denso had to find a place with a pool of skilled labour because the production of engine parts in which Denso specialises requires not a

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labour-intensive process but a middle-tech oriented process. Hence, Denso had to select one of the Central European countries that had an engineering tradition. Feasibility studies of three Central European countries, namely Poland, the Czech Republic and Hungary, were carried out.

Figure 8-6: Spatial Distribution of European Subsidiaries of Denso (as of 2008)
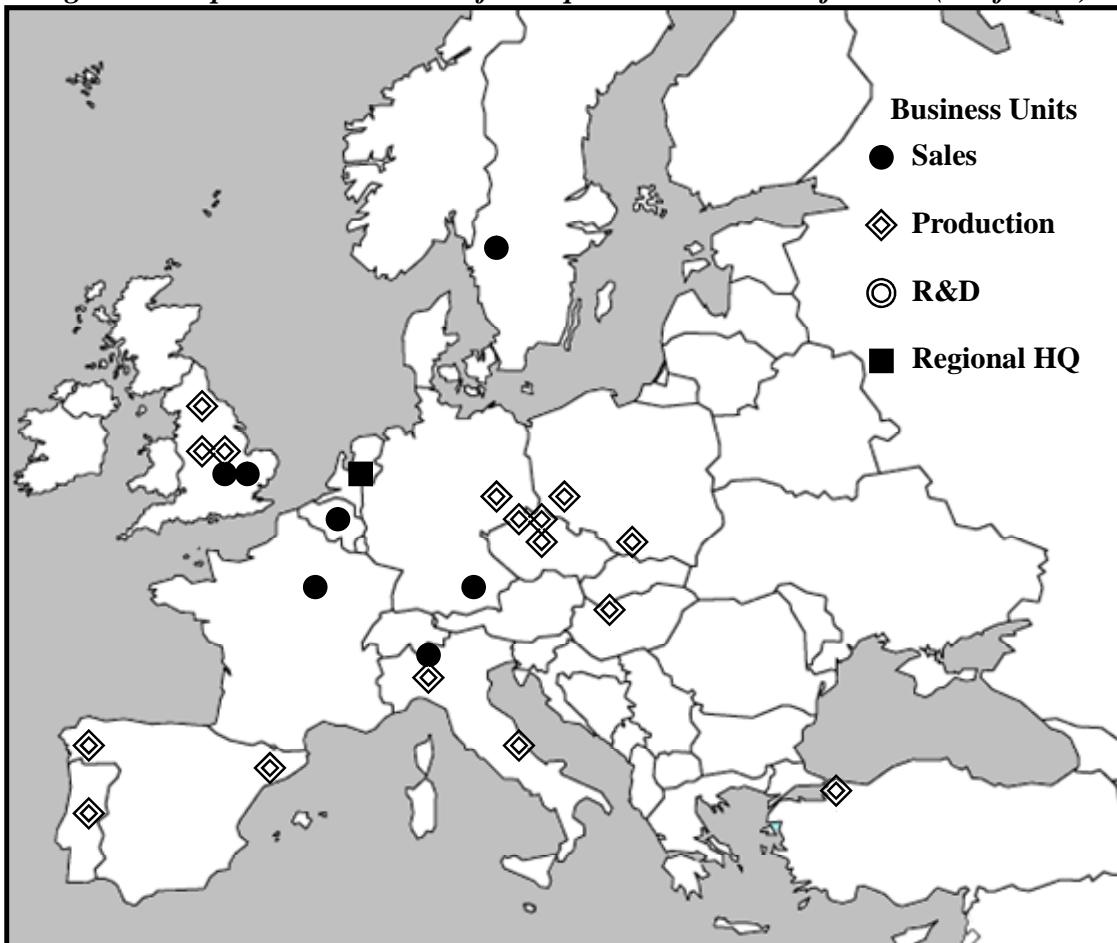
Source: Author's illustration based on Toyo Keizai (2007)

Poland was assessed to be insufficient in terms of the quality of its transportation and communication networks. Regarding the investment climate in both the Czech Republic and Hungary, the former senior executive of Denso Hungary stated that "*the Hungarian Investment Promotion Agency was keen on providing low cost information such as labour market conditions as well as high cost information such as institutional structure whereas the Czech Republic was not proactive in attracting inward FDI in the mid-1990s. Enthusiasm of Czech (sub) national authorities was lacking*". It was only Hungary that met investment conditions of Denso, which was seeking to capitalise on a combination of a pool of labour supply, cheap input costs and the existence of well-developed infrastructure systems.

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Moreover, the former senior executive of Denso Hungary mentioned that *"Hungary was attractive since the country has a higher level of technological potential than other counterparts. Denso's site selection was also affected by Audi's decision to shift its engine factory to Hungary in 1993. We also paid attention to non-economic factors such as cultural affinity, language and historical roots. Japanese feel kinship with Hungary as Japanese and Hungarians share the same root in Asia. As is well-known, Hungarian is the only language in Europe in which the family name comes first in the name order like Japanese. Hence, we believed that these non-economic factors will contribute to better communication between Japanese expatriates and local employees in Hungary"*.

Table 8-3: Grants of Larger Amounts in 1998 (Unit: HUF millions)

	Name of company	Subject of development	Grant	Loan
1	Caterpillar Hungary	Expansion of capacity	0	180
2	Curver	Expansion of capacity	50	300
3	Denso Hungary	Fuel-injector pump production	200	200
4	Ford Hungary	Modular fuel-pump production	9.7	266.6
5	GE Lighting Tungsram	Halogen car-lamp development	0	200
6	Luk Savaria	Clutch production plant	42.7	200
7	Philips Monitor	Computer monitor production	0	200
8	SCI Hungary	Electronic assembly plant	112.4	287.6
9	Sony Hungary	Video apparatus production	0	200

Source : Antalóczy (2000)

Table 8-4: Denso's Network in CEE

	Subsidiary	Year	N	Content of operations	Location
1	Denso Manufacturing Hungary	1997	4,039	Common rail systems, diesel injection pumps, and VCT	Székesfehérvár, HUN
2	Denso Thermal Systems	2001	244	Heaters and cockpit modules	Tychy, POL
3	TBMECA Poland	2003	105	Automotive components and engine components	Legnica, POL
4	Advanced Diesel Particulate Filters	2007	N/A	Diesel particulate filters	Wroclaw, POL
5	Denso Manufacturing Czech	2001	1,659	HVAC units, evaporators, condensers and radiators	Liberec, CZ
6	ASMO Czech	2004	186	HVAC units, evaporators, condensers and radiators	Zruc nad Sazavou, CZ
7	LIPLASTEC	2002	152	Plastic products forcar air conditioners and radiators	Liberec, CZ
8	Airs Manufacturing Czech	2002	314	Car air conditioner-related components	Liberec, CZ

Source : Author's illustration based on Denso's website. (http://www.globaldenso.com)
Note : N indicates the number of employees.

At the sub-national level, Denso chose to establish its factory in an industrial park in the city of Székesfehérvár, which is one of the oldest cities in Hungary and about 65 km away from the capital city of Budapest. Labour productivity, transportation costs, incentives and the level of support and friendliness toward inward foreign capital were decisive factors in Denso's location decision at the sub-national level in Hungary. In addition to these aforementioned factors, close geographical proximity and easy access to the capital city of Budapest were also felt to be inevitable factors for 20 Japanese expatriates who were scheduled to work for the Hungarian subsidiary. They could commute and their families live more comfortably due to the presence of abundant shopping opportunities and better transportation infrastructure.

8.3.3 External Linkages

As regards parts procurement, Denso Hungary imports most of components from Germany. Although Denso Hungary procured no parts from local suppliers when starting its operation in Hungary in 1999, the company has gradually cultivated a network of indigenous suppliers over time. At present, Denso Hungary closely cooperates with approximately 10 local suppliers (Toyama, 2005: 172). The former senior executive of Denso Hungary stressed that "*Denso Hungary directed its own attention to attaining a higher rate of local content in order to obtain favourable investment incentives*". In June 2004, Denso Hungary became one of four major foreign-owned enterprises [24] that received financial incentives for additional investments from the Hungarian central government (Tanaka, 2005).

The number of local suppliers increased to five indigenous firms in 2003 as compared to zero when investing in Hungary in 1997 (JETRO, 2003: 127). The existence of local content rules has also encouraged Denso Hungary to create and develop backward linkages. Despite its aim of seeking potential local suppliers, only a few local firms were successful in concluding business deals with Denso, since Denso's evaluation criteria in terms of constant product control, financial ability, and punctual delivery systems is thought to be considerably stringent (Szanyi, 2002: 19). In reality, Denso Hungary's business transactions were mostly established with local firms that have partial foreign ownership from the West, since purely Hungarian firms are far beneath them in quality control, technological strength and management systems (JETRO, 2003: 127). The president of Denso Hungary evaluates that network relations with local suppliers remain underdeveloped. Less than 10 percent of materials and components of Denso Hungary are from CEE, while the majority comes from Western Europe and Japan. Similarly, the region accounts for less than 10 percent of Denso Hungary's sales in value, while Western Europe dominates more than half.

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[24] Other than Denso, Robert Bosch, Exxon Mobile and Electrolux also received financial incentives in 2007.

8.3.4 Human Resource Management

Figure 8-7: Denso Hungary's Employment Growth
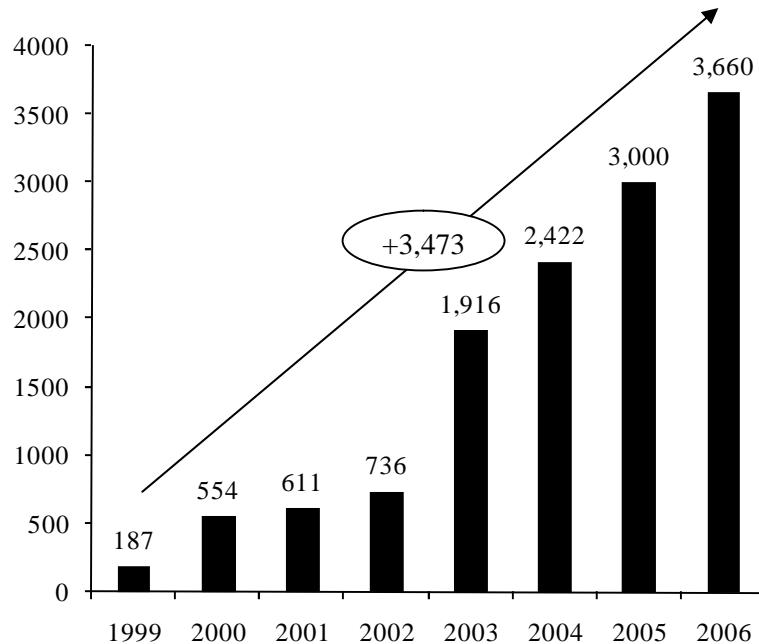
Due to its presence in a small city with a population of 100,000 people, Denso Hungary has faced difficulty in finding workers. To conquer this unfavourable labour market condition, Denso Hungary runs shuttle buses to reach the potential labour force within a radius of 30 km from Székesfehérvár (Toyama, 2005: 171-172). Denso Hungary maintains a turnover rate of 5 to 6 percent (Toyama, 2005: 172). The number of employees has been dramatically increasing, accounting for approximately 3,660 people as of 2006 while it used to be 600 people in the first-year operation in 1997 (see Figure 8-7). Forty Japanese expatriates are working for Denso Hungary. Considering management and employee-employer relations, the firm did not face any militant labour attitude and low labour productivity, while major job-hopping problems are currently problematic.

The degree of delegation of authority to local employees is relatively high. With the exception of the president of Denso Hungary, the individuals in leading positions of the finance and HR departments are local employees. The company has also introduced promotion systems in order to encourage local employees to work hard.

8.3.5 Corporate Performance

Denso Hungary has recently invested about 100 million Euros into enlarging its diesel engine fuel injection factory in Székesfehérvár, which is ultimately expected to employ

over 2,000 additional people. To ensure high quality standards, Denso Hungary has introduced various technologies such as calibration of machinery and assembly robots in addition to constant training of all local employees (Denso Hungary, 2007). Denso Hungary has been active in diversifying its products. The company has produced diesel injection pumps to supply Isuzu Polska since 1997. Since August 2002, the company has begun manufacturing variable camshaft timing (VCT) and other automotive-related components such as engine control valves to supply Toyota and Volkswagen (Denso News Release, March 19, 2002). Denso Hungary also expanded the overall volume of common rail diesel injection systems for supplying Ford Motor in 2005, against Robert Bosch's dominating role with 90 percent of the global share of advanced fuel systems for diesel engines and common rail systems.

Denso Hungary has devoted itself to strengthen social ties with the regional communities through supporting sports competitions, giving lectures and disseminating teaching materials. Denso's diversified client networks in an enlarged Europe are found to be very important for Denso's global expansion. Isuzu Poland, Toyota UK, Volkswagen, and Nissan are Denso's main customers (Toyama, 2005: 171). During our personal interview, a former senior executive of Denso Hungary commented that "*Denso knew it would experience intensive competition in a European market of engine parts because of the presence of Robert Bosch before entering Hungary. Especially, the demand for diesel common rail systems, diesel injection pumps, system control components and spark plugs is rapidly growing owing to the emergence of the rigid European environmental regulatory regime*". In response to this market trend with the pressure for environmental protection from European supranational institutions, Denso Hungary has been dedicated to an environmentally friendly production process, with the company introducing a strict EcoVision programme in 2001, becoming the first European subsidiary to achieve Zero Landfill Emissions in 2003 (Denso Hungary, 2007). Denso Hungary also received the 'European Union Environment Award' in 2004. The company has been certified with ISO 14001 and has actively engaged in environmental management in accordance with Denso Group Green Procurement Guidelines. Denso Hungary has ensured its product quality through the introduction of TS (Technical Standard) 19649 integrated certification. Denso Hungary's efforts to engage in activities that enhance corporate social responsibility have been acknowledged by various rewards. Denso Hungary received OHSAS 18001 certificate in 2001, Business for the environment award in 2003, NSCA accident reduction award in 2003, CE Environmental Reporting award in 2003, Clean and Healthy City award in 2003. Denso Hungary received the European Business Award for the Environment in 2004, as a result of the company's success in cutting packaging materials, CO_2 emissions and water consumption by 30 percent, 35 percent and 40 percent, respectively (Denso News Release, June 22, 2004).

After the initial production facility in Hungary, Denso has set up various

production facilities across the European transition economies by the time of Toyota's entry into Poland in the late 1990s and the Czech Republic in 2002. In 2007, Denso made an official plan to set up a joint venture with Robert Bosch in Wroław to produce Diesel Particulate Filters (DPFs). The equity ownership structure of this joint venture is equally divided, with 50 percent for each firm. The chief objective of this joint venture is to respond to the enforcement of "Euro 5" (EU's environmental regulation). Denso has expanded into various locations and succeeded in achieving a wide range of customer ties not only with Japanese car manufacturers but also with Western car manufacturers. The sales growth, which reflects a successful performance of Denso Hungary over time, is depicted in Figure 8-8. Contrasting its sales in 1999 with those in 2006, the sales level was roughly sixty times larger.

Figure 8-8: Denso Hungary's Sales Growth (Unit: million Euro)
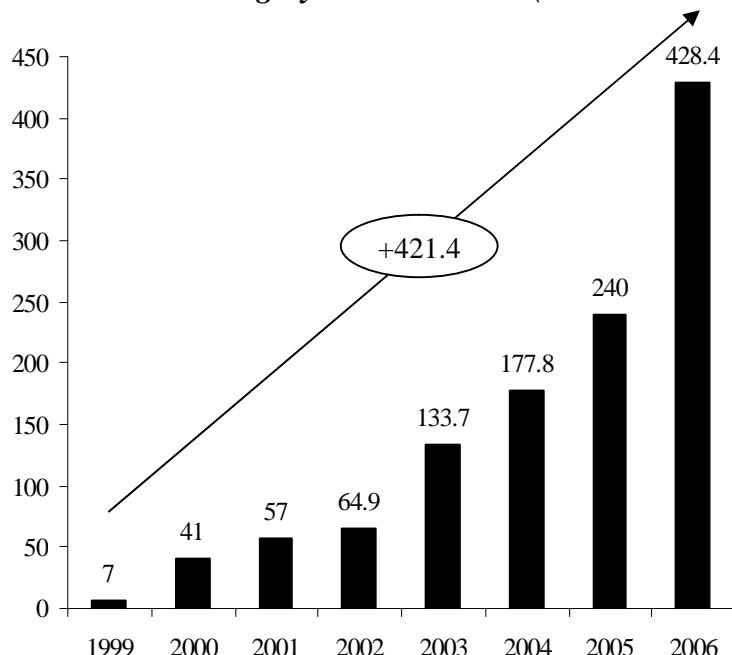
Source: Author's illustration based on company's website.

8.3.6 Summary

Denso Hungary's primary motives for investment and site selection were cultivation of network relations with their customers, as well as shortening production lead-times. Denso Hungary is an example of the recent trend of the first-tier Toyota *keiretsu* affiliates for expanding international subcontracting ties with other Japanese and Western firms from which it can learn managerial expertise and product development methods. No mention was made that cheap labour costs were the primary factor. Rather, labour quality, proactive attitudes of host-based FDI promotion organisation and geographical proximity to western and Japanese customers had positive effects on the investment strategy of Denso Hungary. Technological transfer seems likely to be limited,

while the local economy has benefitted from substantial job creation as well as sustainable and steady corporate growth by Denso Hungary since its inception in the late 1990s.

8.4 Case study 3: Sanyo Hungary

8.4.1 Company History

Sanyo has been one of the leading consumer electronics companies in the global markets. On the list of the Fortune Global 500 in 2007, the company was the 356th largest company with total revenues of US$19.737 billion and total employment of 94,906 people. In 2007, Sanyo Electric's overseas sales ratio was 55 percent, suggesting that the company has been fairly successfully integrated into the global economy. Sanyo Electric's business lines can be categorised into (1) consumer products, (2) commercial services, (3) components. Among these business lines, consumer products dominate in its consolidated sales, accounting for 43 percent, followed by components (38 percent) and commercial services (12 percent). In 2007, the company spent 123,000 million yen on R&D activity. This was equivalent to 6.2 percent of total sales.

Headquartered in the city of Moriguchi, Osaka, Sanyo Electric Co. Ltd was founded by Toshio Iue in 1947. Toshio Iue was the brother-in-law of Kōnosuke Matsushita who was the founder of Matsushita Electric Co. Ltd. Toshio Iue was employed by Matsushita from 1917 until he retired in 1946. The company's name, Sanyo, derives from the phrase *three oceans* in Japanese, referring to the founder's vision to expand its business scale to cover the Atlantic, Pacific and Indian oceans. Sanyo embarked on producing bicycle lamps as Sanyo's first product in 1947. Sanyo manufactured Japan's first plastic radio and Japan's first pulsator-type washing machine in 1952 and 1953, respectively. A combination of production technology and extensive delivery and sales channels has served as a driver for raising Sanyo's cost leadership in the global markets characterised by intensive price competition. At the end of 2007, the company had 52 manufacturing facilities across the world. Mr. Yoshio Oe, the president of Sanyo Hungary, was interviewed in Dorog, Hungary, on 14 October, 2006.

8.4.2 Location Strategy

The turn of the new century witnessed Sanyo having to dispose of its microwave oven manufacturing plant in County Durham in the UK due to a growing wave of Korean electronics firms in the EU, although the British Prime Minister, Tony Blair, tried to persuade the president of Sanyo Electric over the phone not to disinvest from the UK market. At present, Sanyo has only one TV factory in Lowestoft, UK. Moreover, Sanyo Electric also closed down its production factory in Spain. Changing market settings in the EU due to the introduction of the Euro, the presence of the Single European Market and eastward EU expansion put pressure on Sanyo to reshape and reconfigure its value

chain networks in Europe. In 1999, Sanyo Hungary was established to produce small rechargeable batteries for use in mobile phones. This business line is one of the most important segments for Sanyo Electric. Sanyo accounts for 45 percent of the total market share for rechargeable batteries in Europe (JETRO, 2001: 67). A capital of 36 million Euros was injected in this venture. Sanyo Hungary's equity is 100 percent owned by its parent company. This mode selection indicates Sanyo Electric's corporate philosophy to accumulate cutting-edge knowledge and ideas within the Sanyo group by controlling the whole production process from invention to manufacturing.

Figure 8-9: Spatial Distribution of European Subsidiaries of Sanyo (as of 2008)
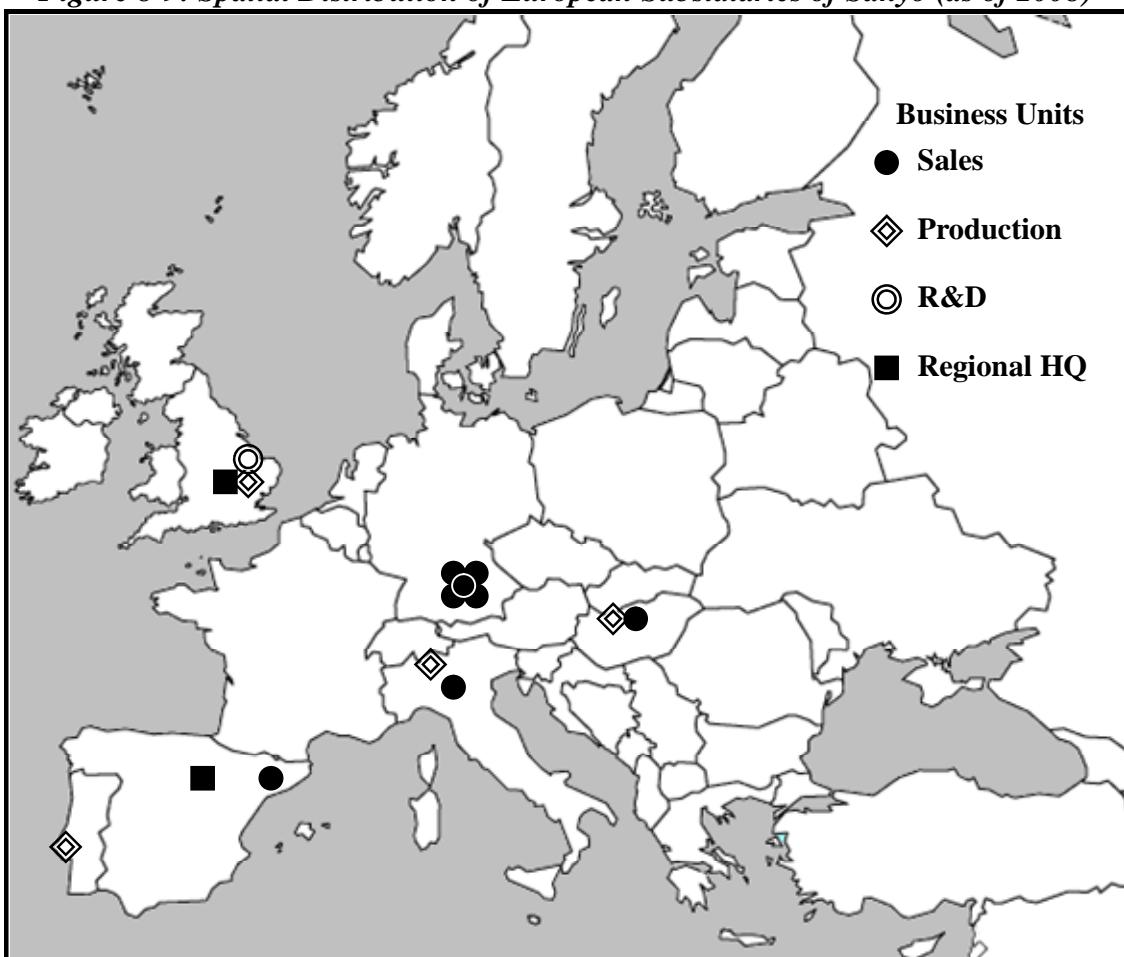
Source: Author's illustration based on Toyo Keizai (2007).

Demand considerations were of great concern to the FDI allocation decision of Sanyo Electric when investing in Europe. Demand for rechargeable batteries for use in mobile phones has been growing rapidly in the region. Importantly, Nokia's investment in Hungary was seen to justify Sanyo's local production. Since the beginning of the new century, Sanyo Hungary has been producing rechargeable batteries for Nokia, which invested in Komárom in Hungary and which has been in operation since 2000.

Sanyo's investment approach toward CEE can be treated as a step-wise and risk-hedge strategy. Before entering Hungary in 1999, Sanyo made limited market commitments such as exporting and licensing. First of all, Sanyo supplied rechargeable batteries to Nokia from Japan and China by exporting through its extensive sales and marketing channels in Germany. Currently, Sanyo Electric has five sales and marketing subsidiaries in Germany. The first establishment of Sanyo's sales network channel in Germany can be traced back to 1969. Sanyo Büro-Electronic Europe-Vertrieb GmbH was founded in München. However, a critical problem arose from their exporting strategy despite the fact that transportation costs remained low since cell materials were very small and light. Sanyo Electric was concerned that exporting may be inappropriate for responding effectively and flexibly to changes in future consumer demand and preference in Europe. Given this reason, Sanyo Electric had to consider a viable alternative to exporting. To enhance the ability to adapt to the Single European Market, the company relied on a dual supply strategy that was based on a mix of exporting and original equipment manufacturing (OEM) in the Czech Republic and Hungary. Moreover, a subcontracting agreement was conluded with Videoton MBKE Electronics, which employed 200-250 people and which would assemble rechargeable battery packs for Sanyo at a plant in Kaposvar (Radosevic and Yoruk, 2001: 13; JETRO, 2001: 67). While Sanyo injected some capital into this subcontracting firm, the company faced the need to produce on its own in response to a rapidly emerging demand for mobile phone batteries in Western Europe over time.

Feasibility studies focusing on the Czech Republic, Hungary Poland, Slovakia and Romania were conducted. Geographical considerations (*i.e.*, easy access to the Western European markets) were of great importance since Sanyo Electric sold various types of batteries for various equipment including electric tools and electric shavers. Hungary was thought of as the centre of CEE in geography and as the appropriate location to reap economies of scale, to bypass trade barriers and to capitalise on the presence of well-developed transportation infrastructure systems. Sanyo Electric was also attracted to Hungary because of the presence of relatively better financial, legal and economic infrastructure, a pool of skilled labour and political stability compared to other countries of CEE.

Looking at site location criteria at the sub-national level, geographical proximity to Nokia, which was located in Komárom, Hungary, had a significant influence on Sanyo Electric. The president of Sanyo Hungary pointed out that "*to develop more stable business networks with Nokia, Sanyo has paid attention to the importance of flexible response to Nokia's demand for design and quality since functions, shapes, and price in mobile phone production constantly change over time*". This primary business model of Sanyo originated from Toyota's *kanban* system and just-in-time delivery, which function as an efficient means of reducing excessive production, upgrading quality through the use of newest inventories, and controlling any delay in operations.

In addition to access to Nokia in order to shorten lead times and to respond to its demand for product quality and control, Sanyo sought potential location candidates to fulfil three primary conditions: price stability, labour availability and good distribution systems within Hungary. Particularly, the presence of excellent road networks was of great importance to Sanyo Electric to assure a stable supply of its products to Nokia and other western customers in Western Europe. Feasibility studies about potential production sites within a 50 km radius of the capital city of Budapest were conducted. Undergoing a consultation with a public FDI promotional agency, Sanyo Electric decided to choose an industrial park in the City of Dorog, although other alternatives could have been selected. The city is not only in the close vicinity of the capital city of Budapest, but also just 50 km away from Komárom, where Nokia runs its production facility.

The local authority of the City of Dorog proactively welcomed Sanyo Electric. In the past, the city had reaped economic benefits from the mining industry. However, the mining business within the city fell off dramatically, owing to the emergence of environmentally conscious European markets and increased market competition with emerging rivals from developing countries. As a result of a change in industrial structure caused by these external pressures, the unemployment level soared in the region. It was widely understood among municipal officials that the city *per se* would not be able to survive without introducing concrete industrial development plans, in particular, in parallel with some efforts to attract inward foreign capital. FDI was expected to have a great influence over future economic prosperity of the city. Officials of the City of Dorog lobbied the central government to promote FDI in order to combat high unemployment rates and requested that it should offer a policy designed to integrate the city into the world economy in the face of globalisation.

Although other cities close to the capital city and with a high intensity of Japanese firms' agglomeration were also short-listed as candidates for Sanyo's production location, the City of Dorog was chosen as the final destination since it felt welcoming. The president of Sanyo Hungary mentioned that "*abundant labour and strong enthusiasm of local government including the City of Dorog over FDI were attractive*". Moreover, government incentives were considered as one of the crucial preconditions for investment, because they would reduce operational costs. Sanyo Hungary gained benefits from various FDI incentives. First, a land price below market standard was offered for purchases of land in a Dorog industrial park. Second, Sanyo Hungary was promised a 15-year corporate income tax exemption. Third, 50 percent of costs on local job trainings and education were refunded upon request. As a result, government incentives were also felt to be crucial factors affecting the scale of FDI as well as promoting expansion plans and operational strategies in the Sanyo Hungary case.

8.4.3 Human Resource Management

Environmental and situational factors have been changing over time in Hungary. Increasing labour costs and high turnover rates have turned out to be critical problems for the local management of Sanyo Hungary. In particular, the absence of skilful labour, despite its low cost, proved to be a serious concern to Sanyo Hungary. Competition for access to labour intensifies as the number of foreign firms in Hungary increases. Notwithstanding these changes in environmental factors, the number of employees in Sanyo Hungary has grown steadily, proportional to the level of sales every year (see Figure 8-10, which demonstrates that the number of employees exceeds 2,000). Among its 2,000 employees, Sanyo Hungary has 1,500 regular employees. Temporary workers are also hired by manpower agencies in response to changes in market demand for products. The number of temporary workers varies seasonally from 500 to 1,000.

Sanyo Hungary does not intend to overcome the issues of job hopping and sick-leave through raising the level of wages. Rather, according to the president of Sanyo Hungary, "*particular attention was paid to creating stable and comfortable work environments through providing substantial welfare assistance and social amenities to local employees*".

Figure 8-10: Sanyo Hungary's Employment Growth
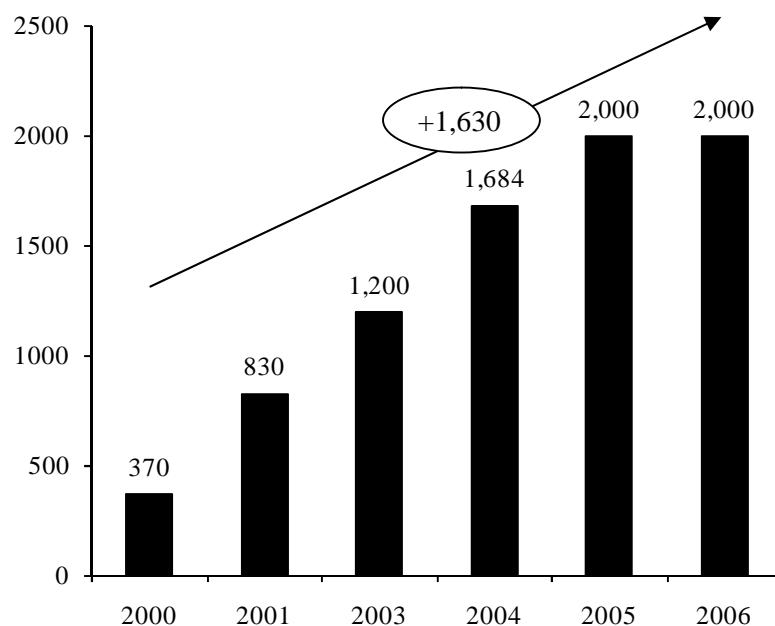
Source: Author's illustration based on information provided by Sanyo Hungary and various sources

Sanyo Hungary also points to the importance of delegating more authority to local staff at the management level, since localisation is deemed to be responsible for sustainable production management for the future of Sanyo Hungary. However, the

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degree of delegation of authority to local employees is not high. While the president of Sanyo Hungary and a head of the finance department are Japanese expatriates, responsibility for HR and marketing departments is in the hands of local employees. A possible cause of this preference for localisation concerning the HR and marketing units may be derived from the fact that local employees would be more familiar with both local labour conditions and local market opportunities as compared to Japanese expatriates. Promotion systems are introduced to strengthen local employees' morale and work ethic.

8.4.4   External Linkages

In 2006, half of Sanyo Hungary's batteries were supplied to Nokia, while more than 60 percent of its sales came from Nokia. The president of Sanyo Hungary pointed out that "*Sanyo Electric's efforts to forge a win-win relationship with Nokia indicates the formation of 'Schicksalsgemeinschaft' not as being one of Nokia's normal subcontractors but as being a true partner*".

As regards supply management, Sanyo Hungary procures parts and materials by leveraging its global and regional networks of production and distribution in Europe and imports from Japan and China. Sanyo Hungary imports 90 percent of components from Japan, while the rest is partially procured from Hungary and Germany. This high import figure is also affected by the fact that Sanyo Hungary takes advantage of a customs free zone in the City of Dorog. With respect to sales destinations, the Western European markets account for the majority. Batteries produced in the factory are supplied to Braun, Black & Decker, Robert Bosch, and Sagem Communication. In contrast to the automobile industry, Sanyo's battery business does not require tight local supplier networks, since battery cells are easily transportable. On these grounds, Sanyo's local content rate of parts and materials has not been as high as those in the automobile industry. Sanyo Hungary's local content rate was 25 percent in 2006. The degree of local embeddedness of Sanyo Hungary remains small, although Sanyo Hungary regularly visits local suppliers to provide them with technical instructions, assistance and product inspection. Imported components dominate in Sanyo Hungary's local procurements. This preference for in-house and imports is likely to reduce the possibility of local firms entering Sanyo's global and regional value-creating networks of production and distribution.

The president of Sanyo Hungary has played a central role in lobbying the Hungarian government directly to cancel the proposed increase in corporate tax rates, which the government had just announced at the time of our visit. At that time, the president of Sanyo Hungary was a representative of the Japanese Chamber of Commerce in Budapest, and he submitted a petition that underlines the need to maintain a good investment climate for Japanese investors, suggesting that Hungary may have difficulty in attracting further Japanese FDI in the future if the tax was increased.

8.4.5　Corporate Performance

The success of Sanyo Hungary is to a large extent attributable not only to the formation of extensive network relations with western firms but also to product and customer diversification with its strenuous efforts to align with the European regulatory institutions associated with environmental protection. According to the president of Sanyo Hungary, "*it is highly expected that the need for battery production for electric automobiles would be mounting in the near future. Thus, Sanyo has already made contracts with Volkswagen, Ford, and Honda which are leading and prospective assemblers for electric automobiles next to Toyota. Sanyo Electric has devoted itself to putting forward R&D projects with Volkswagen. Increasing efficiency, rationalising production and upgrading product quality are essential in winning 'survival' (Ikinokori) in an increasing competitive environment*".

Sanyo has been one of the leading photovoltaic cell producers, behind Sharp, Q-Cells, Kyocera and Suntech (see Figure 8-11). Since 2004, Sanyo Electric has been cooperating with Mercedes Benz to develop batteries for hybrid cars (JETRO 2005). In order to meet rapidly growing demands for solar photovoltaic equipments in Europe (see Figure 8-12), Sanyo invested approximately 3.5 billion yen to set up a new production facility on the grounds of the company in the Dorog industrial park and has begun to manufacture solar cells modules since 2005. In 2005, JBIC also decided to finance Sanyo Hungary's production of photovoltaic products with a loan of 5.2 million Euros for the purpose of promoting environment-related business ventures (JBIC, 2005). The level of sales in solar cells appeared to be equivalent to that of rechargeable batteries for use in mobile phones in 2006. Commercial air conditioners have also been produced since December 2006. The company aims to produce 100MW of solar cells and 120,000 units of commercial air conditioners. Most of the products manufactured in the Hungarian subsidiary are aimed at serving customers in Western Europe, notably Germany, where the number of photovoltaic applications are the highest in the world.

As regards the prospective investment in the internationalisation process of Sanyo, Russia was recently seen as attractive to Sanyo's global strategic considerations because of its market size. However, its high political risks, limited free market-based systems and a slow transition toward democratisation prevented Sanyo from making a final decision to produce in Russia. Given these critical factors, Sanyo's economic involvement is still confined to exporting to Russia from Finland.

Sanyo Hungary provides support for various social events. One of the most prominent examples is an environmental event for local students, the Environmental Children Day Event. By assisting such environmental activities, the company strives to promote the attention of the local population toward environmental protection and resource recycling. The company also provides technical college students with internship opportunities to understand the company's leading environmental protection

technologies and knowledge by the on-the-job training (http://www.sanyo.co.jp).

Figure 8-11: Major PV Cell Producers in 2006
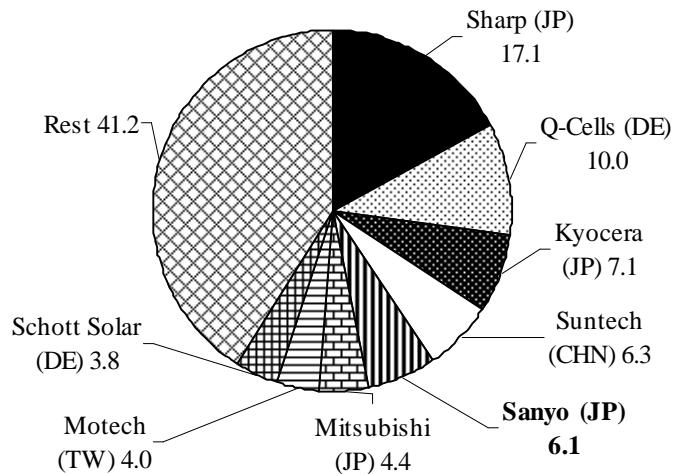
Figure 8-12: Trends in Photovoltaic Applications (Unit: MW)
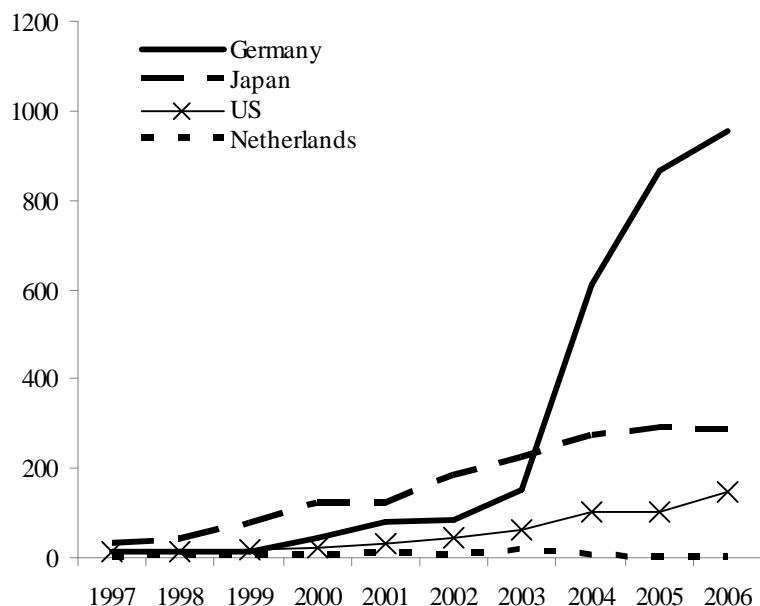
Table 8-5: Top 10 Consumer Electronics Producers in Hungary

Rank	Company name	2002 Net sales (EUR million)	2003 Net sales (EUR million)	2002-2003 Growth (%)
1	Nokia Kománom	1,643	2,234	36
2	Philips Magyarország	1,829	2,054	12.3
3	GE Hungary	1,230	1,543	25.4
4	Samsung Electronics Magyar	600	565	–5.8
5	Electroux Lehel	428	486	13.6
6	Sony Hungária	308	360	16.9
7	Siemens Nemzeti Vállalatcsoport	315	296	–6.0
8	Sanyo Hungary	184	281	52.7
9	Videoton Holding	279	235	–15.8
10	LG Electronics Magyar Kft	145	167	15.2

Source **:** PricewaterhouseCoopers (2004/2005: 49) Global Retail & Consumer Study from Beijing to Budapest.

Figure 8-13: Sanyo Hungary's Sales Growth (Unit: million Euro)
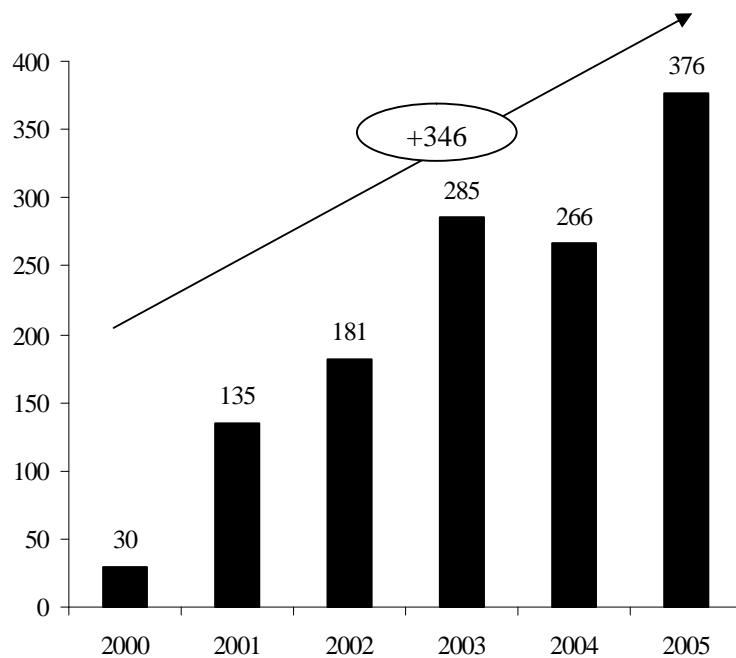
Source: Author's illustration based on information provided by Sanyo Hungary

8.4.6 Summary

The Sanyo case underlines the motivations for developing network relations and leveraging core technologies in the enlarged European markets. In sum, the major reason behind Sanyo's decision to set up its production factory in Hungary was indeed aimed at cultivating network relations with Nokia, as opposed to the phenomenon that Japanese FDI in Western Europe has been driven by the threat of (non-) tariff barriers such as quotas and antidumping proceedings during the 1980s and 1990s (Belderbos

and Sleuwaegen, 1996; Belderbos, 1998). Accordingly, Sanyo's FDI in CEE was characterised as network-and market-seeking FDI rather than tariff-jumping FDI. One of the most interesting points is that cheap labour costs were of little relevance to the Sanyo Hungary case. Besides cellular phone batteries, Sanyo Hungary is also an example of successful spearhead FDI for targeting the German market with the substantial growth of photovoltaic products. Its corporate performance has, to a large extent, followed an upward trend, suggesting that the company makes significant contributions to economic development and job creation.

8.5 Case Study 4: Toyota in CEE

8.5.1 Company History

Toyota, headquartered in the city of Toyota near Nagoya, is the largest vertical *keiretsu* parent company in the Japanese automobile industry. On the list of Fortune Global 500 in 2007, Toyota was ranked as the 6th largest corporation and the 2nd largest automobile maker with revenues of US$204,7 billion. Toyota has also received marked brand recognition and reputation, as it also ranked as 2nd in Fortune's 2007 list of the world's most admired companies.

The company was founded in 1937 by Kiichiro Toyoda. The original start of Toyota's corporate history can be traced back to the time when Kiichiro Toyoda became involved in automobile production as a part of Toyoda Automatic Loom Works in 1933 before the spin-off in 1937. Special financial support from the central government as well as high tariffs against the imported cars of foreign competitors such as GM and Ford ensured Toyota's sustainable corporate growth (Reich, 1990: 289). The company played a crucial role in producing trucks for the Japanese Army during the Second World War. In the late 1940s after the defeat, Toyota was on the verge of bankruptcy, but the government (the Bank of Japan, the Japanese Development Bank and the Industrial Development Bank of Japan) prevented the company from becoming insolvent (Reich, 1990: 289). Toyota's first overseas production facility was opened in Brazil in May 1959. Toyota also embarked on a joint venture with GM in the United States in 1982. It has been broadly acknowledged that Toyota has become the forerunner for technology in the automobile industry. The introduction of hybrid gas-electric vehicles and an advanced parking guidance system has reinforced the market presence of Toyota. Toyota has also invented efficient production methods such as JIT system, *kaizen* (constant improvement), Total Quality Management and Kanban with Western car makers following suit.

Toyota owns majority equity shares in Daihatsu (51.1 percent) and Hino (50.1 percent), and is a minority equity holder in Isuzu (5.8 percent), Yamaha Motor (4.3 percent), Fuji Heavy Industries (8.6 percent) (Toyo Keizai, 2007). Toyota has 52 manufacturing companies and 170 distributors in the world (Toyota in the World, 11).

A few distinctive features of Toyota stand out. First, Toyota has traditionally dominated the home market and has placed importance on a stepwise expansion of operations with an attitude toward avoiding risky investments abroad (Lim, 2003: 351). Second, concomitant with the first feature, Toyota has lagged behind other domestic competitors such as Nissan and Honda in the development of a localisation of automobile production in Europe (Wada, 2005: 144). To date, Toyota has established six factories in the enlarged Europe (1 for UK, 1 for France, 1 for Portugal, 1 for the Czech Republic and 2 for Poland). (see Figure 8-14). The company has diversified its product lines from compact cars, such as Yaris, to middle-to-high-class cars, such as Avensis, in the region. It is important to note that Toyota has set a new goal to achieve a 10 percent market share in Europe by 2010.

8.5.2 Locational Strategy

Toyota invested relatively late in the CEE region as compared to other Asian car producers such as Suzuki in Hungary (1990), Daewoo in the Czech Republic (1994), Poland (1995) and Romania (1994) and Isuzu in Poland (1997). The degree of business involvement of Toyota was very limited in the early stages of transition in CEE. Toyota set up sales and marketing subsidiaries in CEE in the early 1990s. In January 1991, Toyota started selling cars in Poland in cooperation with a Japanese general trading company, Nissho Iwai, followed by Toyota Motor Hungary Kft in December 1991 and Toyota Motor Czech Spol.s.r.o. in the Czech Republic in January 1994 (Toyo Keizai 1998; Toyota, 2005). The latter two companies were joint ventures of Toyota and its own trading firm, Toyota Tsūshō (Toyo Keizai, 1998). In the late 1990s, offshore production in CEE became an integral part of Toyota's corporate growth in response to the deteriorating investment climate in Western Europe and to the emerging demand for diesel engine vehicles that was derived from increased awareness of Europeans towards environmental protection. Specifically, the entry strategy of Toyota was ultimately determined by the imposition of institutional constraints such as Euro 5 in 2009 (Orihashi, 2006: 131). Toyota has three production facilities in CEE. Two factories in Poland are located in Wałbrzych and Jekz-Laskowice in Poland and one is in Kolín in the Czech Republic (see Figure 8-14).

Toyota Motor Manufacturing Poland (TMMP)
The establishment of Toyota's first factory in CEE can be traced back to the late 1990s. Toyota announced an investment in Wałbrzych, Poland, in 1999 and production of transmissions began in 2002. Isuzu had already been in operation in Tyhcy prior to TMMP in Wałbrzych. The size of Toyota's investment was US$600 million and it was the largest Japanese investment in Poland, followed by Isuzu in Tychy. The total equity share of TMMP consisted of the Toyota S.A./N.V. with 94 percent in 2007, indicating that Toyota prefers to take complete control over its subsidiaries.

Figure 8-14: Spatial Distribution of European Subsidiaries of Toyota (as of 2008)
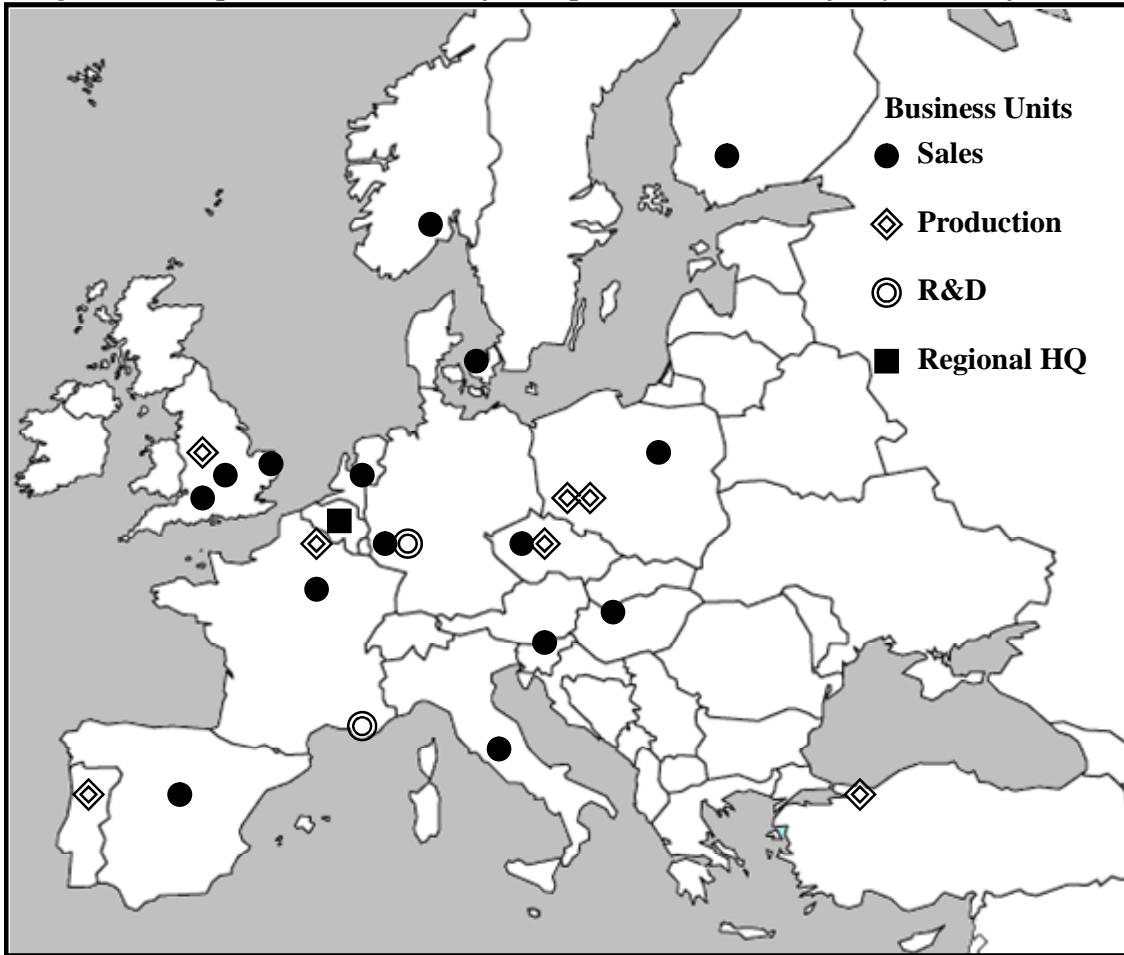
Source: Author's illustration based on Toyo Keizai (2007).

Toyota's decision to produce diesel engines in Wałbrzych in Poland is indicative of its initial efforts to develop an integrated European value chain system and to forge network relations with Western suppliers and to upgrade price leadership in Europe, characterised by the agglomeration of competitive car makers (IRC, 2005). The reasons behind the market entry of Toyota in Poland were diverse. First, the market size of Poland and easy access to the EU market due to its spatial centrality was attractive (IRC, 2005: 305; Wada, 2005: 150). Second, the provision of FDI incentives had a strong influence over the FDI decision-making procedure of Toyota (En, 2006: 131). Besides public incentives, the Polish government also showed its positive and supportive attitude toward Toyota. Third, together with the presence of already existing road networks[25], Poland's engineering tradition is notable and provides the advantage of a pool of quality labour capital. An executive manager from a Toyota-relational insurance company in Germany commented on the underlying factor behind Toyota's investment

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[25] Many foreign investors show their concern that poor road infrastructure is a critical problem in the whole area of Poland except southern Poland. TMMP is situated in southern Poland.

in CEE in our interview, *"Toyota's investment in CEE can be treated as an experimental offshore production project for entering Russia. Toyota will target both Eastern and Western markets, by strengthening its West-European networks"*.

As regards location choice, a primary explanation for choosing Wałbrzych to manufacture diesel engines and transmission was the provision of FDI incentives. Wałbrzych is also a convenient location from which to deliver diesel engines and transmission to Toyota factories in the UK, France and Turkey. Besides the favourable government treatment and the geographical proximity to Western Europe, Marinov *et al.* (2003: 171) point out that "high unemployment rate in the region of 25 percent, and the availability of abundant subterranean water needed for industrial production" also affected Toyota's location choice at the sub-national regional scale. Of importance is that the TPCA project in the Czech Republic did not act as a conduit for choosing Wałbrzych.

Toyota Peugeot Citroën Automobile

The Toyota-Peugeot/Citroën consortium is one of the largest FDI transactions (1.84 billion Euros) in the Czech Republic as of 2007 (Czech Business Weekly, October 29, 2007). The site selection of TPCA occurred between June and December 2001 (TPCA, 2005: 2). The joint venture was launched in 2002 and begun production in 2005. The plant is located in Kolín, which is located just 59.2 km east of Prague. A site in the 914-acre (365.6-hectare) Kolín-Ovčáry industrial zone was picked for the joint venture production. The Citroën C1, Peugeot 107 and Toyota Aygo have been manufactured at the plant, amounting to 300,000 units annually, of which 200,000 are for PSA and the rest is for Toyota. To alter the limited brand image and reputation of Toyota products relative to European competitors such as VW, PSA and Renault in the European markets, Toyota had to establish an assembly plant in the centre of the CEE region (*i.e.*, Czech Republic) in cooperation with PSA. This Japanese-French consortium specialises in customised car products, namely, inexpensive and small cars.

At the initial stages of the FDI decision-making procedure of the TPCA project, the Czech Republic, Hungary and Poland were short-listed. The negotiations took some years and were very tough. The biggest contender was Poland due to an already existing Toyota engine plant in Wałbrzych, a city in southern Poland. No French governmental authorities or unions took part in the location selection process of the TPCA project (Prague Tribune, July 11, 2002). Rather, a professional FDI organisation, CzechInvest, played a leading role in winning this project. CzechInvest worked hard to realise the project, creating a special team, which was led by Mr. Hruda (who much later became CEO of CzechInvest). CzechInvest also coordinated preparatory works on the Kolín-Ovčáry industrial zone, which became a strategic site. One interviewee from CzechInvest explained that *"winning the project would be impossible without cooperation with the central government including the CzechInvest, regional*

governments (notably, Kolín town hall) and other subjects".

The industrial zone at which the TPCA plant has been in operation today was originally prepared for BMW, which had searched for a 500-acre site in CEE. However, Leipzig, in the former East Germany, beat out the Czech Republic for the BMW's new project due to political pressures. This availability of large-scale land was consequential for attracting the TPCA project to the Czech Republic, since it was expected to enable the Japanese-French joint venture to make maximum use of scale economies.

Another vital reason for choosing the Czech Republic was to capitalise on its comparative advantages in the quality of labour (JAMA, 2005). Jean-Martin Folz, President of PSA, stressed that *"the Czech Republic attracted us mainly by its remarkable engineering tradition and high level of technical education. This is what we were looking for"* (CzechInvest, 2007). Lim (2003: 352) also states that the reason why Kolín was chosen - despite the fear that increasing wage levels would have a constraining effect on operational efficiency - was high labour productivity. This implies that consideration was given to labour quality which would facilitate the effective transfer of the Toyota Production System to the local operation of TPCA.

According to the company website (http://www.tpca.cz), there are five underlying motives behind the location choice of TPCA: (1) strategic location in the centrality of Europe; (2) short distance to key markets; (3) developed industry of production of car parts; (4) connection to main traffic routes; (5) industrial tradition; (6) government policies supporting investments. Complementing favourable government attitudes toward inbound foreign capital, it was said that financial incentives including corporate tax exemption for ten years and training grants (Lim, 2003: 352) and a promise of the extension of the D11 motorway to access the Polish border via Prague (Prague Tribune, July 4, 2004) had a significant impact on the final decision in favour of this location site. The presence of a Japanese school in Prague was also of great relevance to Toyota's decision (Orihashi, 2006: 128). Interestingly, low labour costs were of minor relevance.

8.5.3 Human Resource Management

Toyota Motor Manufacturing Poland

In the initial phase of operation TMMP sent 25 Polish workers to Japan, where they were trained for seven months at Toyota factories in Japan. Team leaders and group leaders were also sent to the Toyota factories in the UK and France. They acted as key drivers for transferring the Toyota Production System to the local operation in Wałbrzych. Most of the 25 Polish workers who received OJT (on-the-job training) in Japan are now group leaders. The group leaders are allocated to three chief tasks such as engine production, engineering and maintenance. While it takes 15 years to become a group leader in Japan, it takes only two years in Poland. There are three assistant managers and 15 group leaders. Under the direction of each group leader, there are a few chief leaders.

Figure 8-15: Employment Growth of TMMP and TPCA
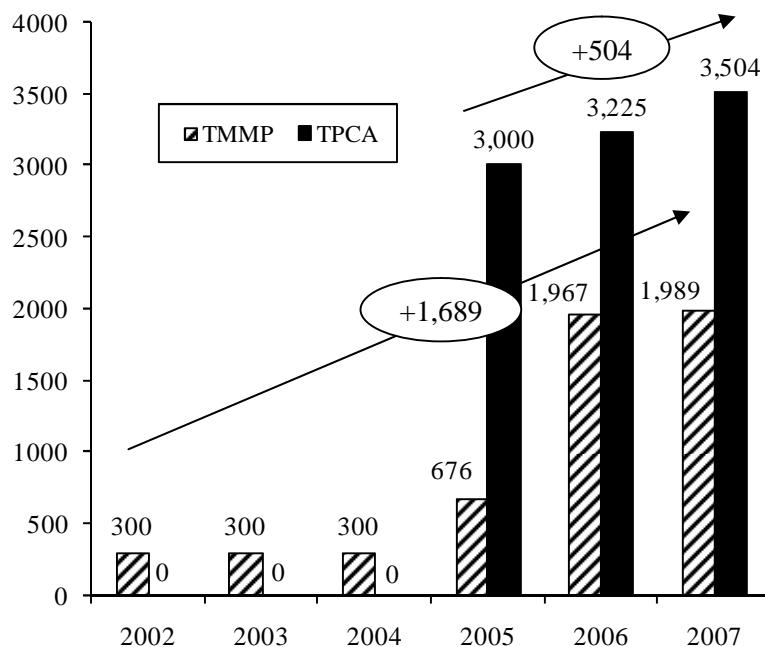
As regards the recruitment, Toyota Poland implemented three recruiting steps, including resume screening and interviews. Toyota Poland hired 7-8 interpreters from the University of Warsaw in order to aid local workers in understanding the Toyota Production System. The company made significant contributions to the creation of job opportunities in the local economy. The growing number of local employees is remarkable, reaching the number of 1,989 by 2007 (see Figure 8-15). The average age of local employees is under 30 years.

TMMP has no trouble hiring workers, because unemployment rates in Wałbrzych are higher than 30 percent, so that a large pool of labour is guaranteed. This large unemployment problem originates from the decay of the coal and mining industry. Turnover rates are much lower than for other companies, accounting for two percent. Some local employees who were working for a French automotive-related supplier, Faurecia, located within the same Wałbrzych Economic Sub-Zone as TMMP, left the company and started working for TMMP despite the fact that the French company offered better remuneration because of job stability and fair treatment by Toyota (Strzelczak, 2006: 75). With the purpose of rewarding hardworking local employees and keeping turnover rates at a minimum, in December 2006, TMMP introduced a reward system to provide local employees with a bonus for full attendance.

Communication within the internal organisation of the firm plays a central role in reducing technical defects. In the case of TMMP, production managers and group leaders meet every morning to discuss problems and solve them by brainstorming and

sharing ideas before the start of the production operations. A Japanese production manager stated that "*local employees are motivated to actively propose what needs to be improved. Moreover, local employees are very obedient and receptive to orders and instructions about the* Toyota *Production System. Hence, it is easier to teach the Toyota Production System to Polish workers than expected.* This implies that a combination of team work and labour quality have ensured high productivity and flexibility within the TMMP factory.

The degree of delegation of managerial autonomy to local employees has been relatively low. No major positions (president and head of HR, finance or marketing departments) are occupied by local employees. However, TMMP has the plan to increase the responsibilities of Poles, but this process may be gradual (Majek, 2005: 90).

Concerning the sense of unity, during my visit to Toyota Poland in March 2006, I noticed that management and workers used the same cafeteria. There was also a Japanese menu. It seems rare in the formal Polish culture that management and workers use the same canteen, since relationships between the former and the latter are hierarchical and allow for few personal interactions (Hardy, 2006). Furthermore, in order to narrow the gap between workers and management, TMMP initiated various social events such as EKIDEN competition and open offices. A Japanese production manager stressed that "*various social events within the organisation can generate a high degree of commitments to the company and hence encourage local employees to understand Toyota's visions, identity and values*".

Toyota Peugeot Citroën Automobile

There are 30 expatriates from Toyota and 10 expatriates from PSA (Orihashi, 2006: 129). TPCA hired roughly 3,000 local staff in 2005. Of these 3,000 workers, there were 100 foreign workers, half of whom were Poles and half of whom were Slovaks (Czech Business Weekly, October 29, 2007). The average age of local staff working for TPCA is 27. This age distribution may imply that the company considers young staff as important for a higher degree of adaptability and receptiveness to the Toyota Production System. The share of female workers is also relatively high, accounting for 18 percent.

Rates of absenteeism were also high among employees. This problem was caused by both the Czech social and health insurance systems and the demands of the company itself (European Industrial Relations Observatory Online, 2007). In response to this issue, which affected not only TPCA but also most Japanese firms, the Japanese Chamber of Commerce in the Czech Republic lobbied the Czech government to revise the domestic social welfare institutions by sending an official letter to Prime Minister Vladimír Špidla (Prague Tribune, July 4, 2004).

Table 8-6: Inter-firm Relationships of Toyota Keiretsu Group Companies in CEE

Country	Start of Operation	Company name	N	Main customers	Main products
CZ	2002	AISIN Europe Manufacturing Czech	61	TMUK, TMMF, TPCA, Renault	Water pump, oil pump
CZ	2000	AISAN Bitron Czech	190	TPCA, Fiat, Renault	Fuel pump
CZ	2002	AISAN Louny Czech	15	TPCA	Throttle body
CZ	2001	Denso Manufacturing Czech	672	TPCA, European car assemblers	Evaporator, HVAC
CZ	2001	TRCZ	400	TPCA, TMMF, Volvo, Ford	Switch, shift lever, seat belt
CZ	2003	Toyoda-Koki Automotive Czech	NA	TPCA, European car assemblers	Transmission parts
CZ	2001	Toyoda Gosei Czech	314	TMMF, TPCA, Ned Car, Magyar Suzuki	Wheel, air bag module
CZ	2003	KYB Manufacturing Czech	210	TPCA	Shock absorber
CZ	2001	Koito Czech	209	TPCA, TMMF, Renault, BMW, Audi	Head lamp
CZ	2002	Koyo Steering Systems Czech	260	TPCA, TMUK, TMMF	Power steering
CZ	2002	Futaba Czech	300	TMMF, TPCA, Ned Car, Magyar Suzuki	Body parts
CZ	2004	ASMO Czech	240	Denso	Motor for power wind
SLK	2000	Trim Leader	827	TMUK, TMMF, TPCA	Seat parts
HUN	1997	Denso Manufacturing Hungary	1916	TMUK, TMMF, Isuzu Motor Polska, Ford, Renault, VW	1800 bar supply pumps, rails and injectors
HUN	2000	Taiho Corporation of Europe Kft	163	TMMF, TMUK, Delphi, Visteon, Honda UK	Engine metal

Source : Author's illustration based on IRC (2005) Toyota Jidōsha no Sekai Senryaku Jittai Chōsa 2005 Nendo Ban and various company annual reports.
Note : TMMP-Toyota Motor Manufacturing Poland, TMIP-Toyota Motor Industries Poland, TPCA-Toyota Peugeot Citroen Automobile Czech, TMUK-Toyota Motor Manufacturing UK, TMMF-Toyota Motor Manufacturing France. N indicates the number of employees.

Table 8-7: TPCA's Network Relations with Major Western Parts Suppliers

Supplier name	Parts name	Nationality
Faurecia	Car exhaust systems	France
MGI Coutier S.A.	Washer systems	France
Hella KG Hueck & Co.	Horns	Germany
Dura Automotive Systems Inc.	Cable systems	USA
Allevard Rejna	Coil springs	France
Paulstra SNC	control arm	France
Magna Donnelly	Mirror	USA
Arvinmeritor Inc.	Window regulators	USA
A Raymond	Connectors	USA
Rehau AG	Moulding	Germany
TI Automotive Ltd.	Fuel tank	UK
Lydall, Inc.	Tape	USA
Automotive Lighting Equips	Lear lamps	Germany
CF Gomma S.p.A.	Weather stripping	Italy
Lear Corp.	Seating	USA
CML Innovative Technologies	Auto interior lighting	USA
Siemens VDO Automotive	Speedomeeters	Germany
Valeo S.A.	Air conditioning	France
Peguform Bohemia k.s.	Dashboards	Czech
Robert Bosch GmbH	Brake control systems	Germany
Ficosa International	Shift systems	Spain

Source : IRC (2006: 119) Toyota Jidousha no Sekai Senryaku Jittai Chousa 2005.

Consistent with US operations (Reid *et al*. 1995), Toyota follows the traditional recruitment policy to hire indigenous people who have had no experience working for the automobile industry. This recruitment process indicates the company's intention to train them more efficiently without any resistance and negative past working practices. Similarly to TMMP, Czech workers in the Toyota-Peugeot/Citroën consortium were also sent to Toyota factories in the UK, France, Turkey and Japan to learn Toyota's corporate identity and lean production system. In 2004, the first team of over 700 employees spent 21,150 days for trainings abroad (TPCA, 2005: 9).

The transfer of managerial authority to local hands seems high. The management structure of TPCA constitutes a Japanese president, three officers (one Czech, one Japanese and one French) and five general managers (three Czech, one Japanese and one French) (Žížalová, 2008: 10). Despite the advance of managerial localisation, the lack of a potential labour force qualified for the management level remains an issue in the Czech Republic. As regards this matter, Mr. Jiří Černý, vice president of production at TPCA, was quoted in a recent *Czech Business Weekly* article (June 16, 2008) on the difficulty of the automobile producers in finding quality human capital: "[The Czech Republic] has neglected education for the technical professions and this is starting to

come back on us".

8.5.4 External Linkages

Toyota Motor Manufacturing Poland

A large proportion of components are produced in-house (Majek, 2005: 77), while the company is dependent on imported parts supplied from Japan, Hungary, the Czech Republic, Germany, and South Africa. Particularly, imported parts from Japan account for 20 percent. There are a number of Japanese suppliers and relational companies that operate in Western Europe, mainly, in the UK, Germany, and France. In southern Poland, a number of Toyota *keiretsu* suppliers and relational companies (Toyota Boshoku, Toyota Tsūshō, Nifco, Fuji Seikō, Tokai Rubber Industries and Daicel Chemical Industries) are located adjacent to TMMP in Wałbrzych and TMIP in Jelcz-Laskowice (Sankei Shinbun, January 22, 2007).

To streamline the car parts procurement process, TMMP has introduced an electronic *kanban* system since its operation and has thus achieved more efficient inventory management (IRC, 2005: 114). The effective integration of Toyota's group suppliers into Toyota's global production network was enabled by the electronic *kanban* system, allowing Toyota to procure from various locations.

Toyota Europe Engineering & Maintenance SA has also invested over 2.6 million Euro in 2007 and has been in operation in the Wałbrzych Special Economic Zone (WSEZ). According to the Polish Information and Foreign Investment Agency (http://www.paiz.gov.pl), three Toyota *keiretsu* companies have already been situated in the Wałbrzych SEZ.

Toyota Peugeot Citroën Automobile

The organisational and managerial structure of the Japanese-French joint venture is governed by the use of a mix of ownership advantages both firms possess. Toyota takes charge of managing production methods and processes, while PSA plays a central role in purchasing and logistics. This distinction of operational responsibilities has implications for synergy effects and low transaction and coordination costs in the shared ownership activity. It is Toyota that can take advantage of PSA's good reputation; the French company has been ranked as the second-largest carmaker in Europe. In 2005, PSA group has dominated roughly 14 percent and 10 percent of the market share in Western Europe and CEE, respectively (EBS, 2007). Toyota aimed to upgrade both product image and reputation in Europe by virtue of the so-called "French effect". The rationale for Toyota's team-up with PSA in the Czech Republic also lies in gaining expertise in small car manufacturing from its French partner and to tap into the European market.

Some *keiretsu* firms (*e.g.*, Toyoda Gosei, Aisan and Aichi Steel in the Czech Republic and Denso in Hungary) actively entered the European transition economies

with the purpose to consolidate supplier-buyer relations with Western firms irrespective of Toyota's investments in Poland and the Czech Republic. For instance, the central motive for Toyoda Gosei in the Czech Republic was to supply automobile components to a joint venture, Nedcar, formed by Mitsubishi and Daimler Chrysler (JETRO, 2005). Aisan invested in Louny, the Czech Republic, because of the reinforcement of network relations with Renault (Tou, 2006). As seen above, Denso set up its factory in Hungary to supply Isuzu in Tychy, Poland. In 2007 Aichi Steel penetrated the Czech Republic to supply electromagnetic components (*i.e.*, magfine) to a German firm, Bosch, and has been in operation since January 2008. In contrast, other *keiretsu* firms such as Tokai Rika entered the market because of Toyota (Lim, 2003).

The phenomenon that some Toyota *keiretsu* firms are active in developing supplier-buyer linkages with Western firms in CEECs does not indicate that Toyota group companies desire to be independent of the *keiretsu* leader or to become a Toyota *keiretsu* breaker, but, rather, they intend to (1) maintain financial independence from the parent; (2) pursue scale economies; and (3) accumulate managerial skills and expertise from Western firms on their own. As pointed out by Toyota group top officials, it is believed that strong competition within and beyond *keiretsu* actually results in improving the overall competitiveness and unity of the Toyota *keiretsu* group (Nikkei Sangyo Shinbun, November 11, 2003). On these grounds, the core corporate strategy of Toyota *keiretsu* firms can be translated into the development of relational and strategic linkages with Western firms on the basis of arm's length transactions in the enlarged Europe, following the view of the strategic network theory (Chen and Chen, 1998; Chen, 2003).

When considering location strategy, Toyota *keiretsu* suppliers have, in particular, concentrated within a radius of 100 km from Kolín. The presence of an extensive network with PSA's suppliers as well as own *keiretsu* suppliers allows Toyota to procure automobile components at lower prime costs and to sustain its price competitiveness in the European automobile market. Hence, transaction costs to search for new suppliers are curtailed through the prolific Toyota-PSA cooperation.

To date, local embeddedness of TPCA remains rather limited. TPCA locally procures about 80 percent in volume and 50 percent in value of total components required for the assembly (Orihashi, 2006: 130). As regards the linkage between TPCA and local suppliers in the Czech Republic, the degree of local embeddedness remains limited, since Japanese and Western suppliers that followed Toyota and PSA have played a dominant role in boosting high local content rates. There is little doubt that local suppliers seem to play a minor role in the sourcing strategy of TPCA, although the TPCA joint project was supposed to promote technology transfer to the local economy. There are many underlying reasons why the degree of local embeddedness in the Toyota case is limited.

First, the company is in favour of inter-firm networks with Toyota-*keiretsu*

members and Western suppliers who possess independent technological capabilities. As a result, the effect of technology spillovers seems to be very limited (Žížalová, 2008: 13). Both Toyota and PSA have already cultivated global and regional networks of parts and materials in Western Europe (Lim, 2003). Moreover, a number of technologically competitive Western suppliers such as Bosch, Lear, and Siemens have operated across CEE (see Table 8-7).

Second, indigenous suppliers have experienced difficulties meeting Toyota's strict supplier selection criteria, such as quality control, product innovation, product engineering and inventory control. Lim (2003) also emphasises that the ability and competence of indigenous suppliers to absorb the Toyota Production System and its technological development remain weak.

Third, weak financial capabilities make it more difficult for indigenous suppliers to become a Toyota supplier. The horizontal spillover of technology and managerial expertise to local suppliers is unlikely to take place by way of collaborating with Toyota because of bank loans with high interest rates (Lim, 2003: 354). Hence, many of them do not have a desire to take risks by obtaining parts orders from Toyota.

Consistent with other foreign car manufacturers in CEE, TPCA has also procured low value-added products from indigenous suppliers, while existing Japanese and European suppliers in CEE are responsible for supplying high value-added and high tech-oriented products. A wide range of Toyota's sales, marketing and financial channels across CEE, combined with its effective sourcing policy, enables the company to increase its sales volume further in the enlarged Europe (see Table 8-8).

Table 8-8: Toyota's Sales and Marketing Channels in CEE (as of 2005)

Country	Company Name	Start of operations	Number of employees
Marketing companies			
Czech Republic	Toyota Motor Czech spol.s.r.o.	Jan. 1994	60
Hungary	Toyota Motor Hungary Kft.	Dec. 1991	53
Poland	Toyota Motor Poland Co., Ltd.	Jan. 1991	96
Slovenia	Toyota Adria d.o.o.	Nov. 1998	36
Other companies			
Czech Republic	Toyota Financial Services Czech s.r.o.	Jun. 2000	17
Hungary	Toyota Financial Services Hungary Rt.	Jul. 2002	10
Poland	Toyota Bank Polska S.S.	Mar. 2000	38
Slovakia	Toyota Financial Services Slovakia s.r.o	Jan. 2005	4

**Source :** Toyota in the World (2005, 2006, 2007)

8.5.5 Corporate Performance

Toyota Motor Manufacturing Poland

TMMP has produced 134,222 manual transmissions (MTs) for Yaris in TMMF and

Avensis in TMUK since the start of its operation. In 2004, Toyota Motors has committed significant financial resources to the expansion of the TMMP factory in order to supply MTs for Aigo manufactured in TPCA. The number of units of production was predicted to increase from 250,000 to 550,000. As of today, TMMP has been operating fairly successfully with a growth of its transmission production. The increased capacity of TMMP has also contributed to improving Poland's trade balance deficits. This is because TMMP has produced MTs and exported them to TMUK and TMMT since April 2002 and MTs and engines for the Aygo in TPCA since January 2005. The capitalisation of TMMP is 1.026 billion New Polish Zloty. The plant achieved certification in October 2003, which means that all plants in operation in Europe are now certified to meet the ISO 14001 quality certification (European Environmental & Social Report, 2005). TMMP strives for waste reduction. For instance, a large amount of lubricant oil used in the production process at TMMP is recycled and reduction in oil wastes consequently totals up to 400 litres per month (European Environmental & Social Report 2005). The expanded production size of TMMP is a signal of the locational attractiveness of the Dolnoslaskie voivodship to other potential investors. TMMP's success seems likely to trigger a sequence of other foreign investors such as LG, Toshiba and so forth.

Figure 8-16: TPCA's Turnover (Unit: million Euro)
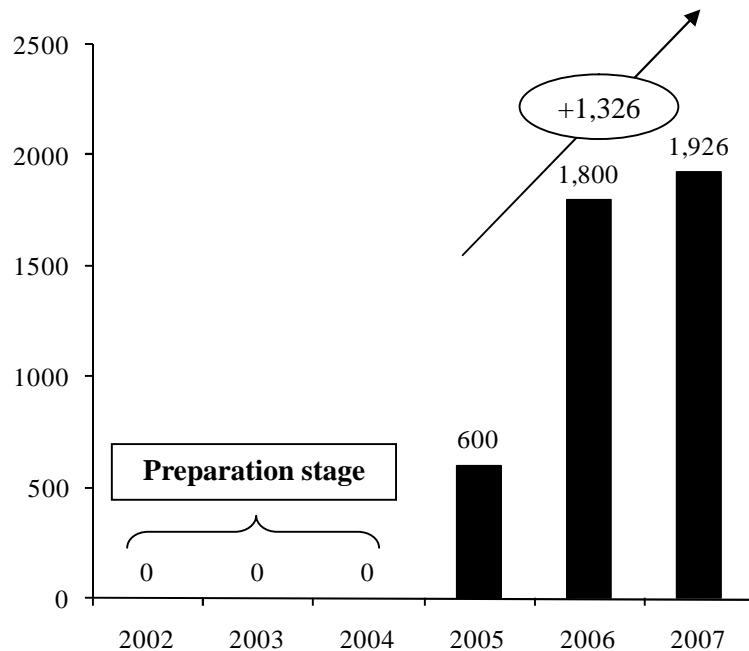
Source: Author's illustration based on the TPCA's website (http://www.tpca.cz)

Toyota Peugeot Citroën Automobile
The company produces 1,050 cars per day and 300,000 cars per annum (1/3 Toyota, 1/3 Peugeot 107 and 1/3 Citroën C1). The turnover of the TPCA project jumped from 600

million Euros in 2005 to 1,926 million Euros in 2007 (see Figure 8-16). This may reflect in the effective transfer of the three major principles of the Toyota Production System to the production process of TPCA: (1) *kaizen* or continuous improvement, (2) *just-in-time*, (3) *jidōka* or an automatic system to stop production processes if a problem occurs). Despite domestic production, Toyota's market share remains limited in the Czech Republic, because 99 percent of the cars produced are exported abroad. There are two major reasons, (1) the weak purchasing power of Czech consumers and (2) the dominating market status of VW- Škoda. However, it is predicted that the EU environmental institutional framework and the strong purchasing power of Western Europeans would encourage the sales performance of energy-efficient compact cars of TPCA to increase further (Czech Business Weekly, October 29, 2007).

Eighty percent of the volume of parts comes from the Czech Republic (CzechInvest 2007; TPCA, 2007). TPCA sells a lot of cars to Western European countries such as Germany, Italy, France and the UK (Czech Business Weekly, October 29, 2007). In particular, Italy is the largest sales destination to date, followed by France, where Peugeot and Citroën enjoy their established reputation (Czech Business Weekly, October 29, 2007). According to the CzechInvest, the TPCA project is predicted to contribute to raising GDP growth for the country by 1.5 to 2 percent points in 2005.

When considering TPCA's social engagement, the company received the ISO 14001 certificate: 2004 and the BAT (Best Available Techniques) certification was awarded for its environmentally-friendly production technology (http://www.tpca.cz). In order to raise the knowledge of environmental protection among the local community members, the Toyota Schools for Sustainable Development (SSD) programme was undertaken in the Czech Republic in 2003. Since the start of the operation, under a "Partnership for Kolín region", the Japanese-French consortium has distributed a large amount of grants to selected projects in which local societal actors such as municipalities and NGOs are involved. In order to raise the standard of local medical systems to the Western standard, TPCA also sponsors the hospital in Kolín (Czech Business Weekly, October 29, 2007).

Table 8-9: Case Study Firms Location Strategy and Organisational Characteristics

	Characteristics	NSK-ISKRA	Denso Hungary	Sanyo Hungary	TMMP/TPCA
1	Entry timing	1998	1997	1999	1999/2002
2	Location	Kielce, Poland	Székesfehérvár, Hungary	Dorog, Hungary	Wałbrzych, Poland /Kolín, Czech Republic
3	Special economic areas	No	Székesfehérvár industrial park	Dorog industrial park	Wałbrzych SEZ/Kolín-Ovčáry industrial zone
4	Subsidiary role	Exporting to Western Europe	Exporting to Western Europe	Exporting to Western Europe	Exporting to Western Europe
5	FDI motives for the initial FDI	Regional adaptation and reorganization	Network relations with Isuzu	Network relations with Nokia	Regional adaptation and reorganization/creation of relational assets
6	Economic factors influencing FDI strategies	(1) historical business relations	(1) labour quality; (2) transportation costs	(1) geographical proximity to Nokia	(1) strategic location/ (1)strategic location; (2) labour quality
7	Institutions influencing FDI strategies	Restrictive labour regulation that distorted the post-privatization restructuring	FDI incentives and proactivity	FDI incentives and proactivity	FDI incentives, Euro 5 and the role of CzechInvest, local content requirements
8	Corporate growth	Steady	Steady	Steady	Steady
9	Number of employees	Large	Large	Large	Large
10	Entry mode	M&A	WOS	WOS	WOS/JV
11	Ownership	Majority ownership	Complete ownership	Complete ownership	Complete ownership/ 50-50 shared ownership
12	Nationality of top management	Japanese	Japanese	Japanese	Japanese
13	Technology transfer	in-between	Limited	Limited	Limited

8.5.6 Summary

The Toyota case is illustrative of the fact that the impact of institutional settings such as the introduction of Euro 5 has had a significant effect on Toyota's internationalisation strategy, coupled with an increased emphasis on the EU market and an aim for raising corporate image and reputation in Europe. The strategy and characteristics of the market entry of Toyota in European transition economies can be defined not only by the replication of traditional hierarchical production arrangements but also by the creation of production networks with Western suppliers. In order to reinforce its market position, Toyota has specialised in the manufacture of diesel engines in Poland and of cheap and small-sized vehicles in collaboration with PSA in the Czech Republic. Its subsidiaries and associated companies have served the parent company and searched for new external business arrangements. It seems evident that strong social commitments were seen by both TMMP and TPCA to be of great significance to enhance the corporate image and to increase local legitimacy as a good corporate citizen.

8.6 Conclusions

With the help of the case study method, the nature of FDI strategies adopted by Japanese manufacturing firms and their operational consequence in CEE were investigated. Four Japanese manufacturing firms were selected for this qualitative study: (1) NSK-ISKRA; (2) Denso Hungary; (3) Sanyo Hungary; and (4) Toyota Motor Manufacturing Poland/Toyota Peugeot Citroën Automobile. These cases were assessed systematically on the basis of four strategic management aspects: (1) location strategy; (2) human resource management; (3) external linkages; and (4) corporate performance.

This chapter revealed that there were multiple investment motives of the case study firms. The case study firms cited that either the geographical reconfiguration of their European cross-border production activities or the forging of network relations with Western and Japanese customers were important determinants in their market entry. Regarding location choice, FDI incentives granted by host country governments, the welcoming of societal actors such as local communities, excellent transport infrastructure and easy access to the Western European markets were considered as key requirements in CEE. FDI incentives have played a dominant role in attracting the case firms. With the exception of NSK-ISKRA, the case firms engage to a large extent in the manufacture of environment-related products under the emergence of the European environmental regulatory institutions (*e.g.*, solar batteries for Sanyo Hungary, diesel engines/small compact cars for TMMP/TPCA, and diesel common rail components for Denso Hungary). As regards the impact of institutions on MNE activity in the CEE, the NSK case exhibits that problematic labour regulations distorted the post-privatisation restructuring. On the positive side of institutional forces, the reorganisation and new development of Toyota's supply chains was enabled by EU's local content rules. The

TPCA case illustrates the increased network linkages with Western suppliers in the Czech Republic.

All of these case study firms have shown a steady improvement of corporate performance over time. This suggests that the maintenance and development of labour quality through continued efforts to offer various training programs are crucial. As the case study firms target the Western European market, both increased production size and performance growth with a steady pace lead to enhanced exports and contribute to improved balance of payments. Somewhat surprisingly, EU membership did not directly affect the allocation decisions of FDI of the case firms. Even though positive effects of EU membership were not explicitly cited by the case firms in CEE, there is no doubt that they receive various direct and indirect benefits: (1) removal of trade barriers between the old EU members and new CEE-EU members; (2) the harmonisation of the EU legislation; (3) access to the mega-market of roughly 500 million inhabitants; and (4) development of transport infrastructure as a result of EU funds.

The impact of Japanese manufacturing FDI on regional economic development seems great in employment creation and in the transfer of efficient production methods to local employees (*e.g.*, TMMP and TPCA). In contrast to expectations among host-based policy makers, the development of local embeddeddness, though not easy to detect, remains relatively limited. It takes local entrepreneurs much longer to become 'multinationals' in their own right, even if the local economies grow and their institutional infrastructure is being developed. Hence, in order to keep the good economic performance coupled with FDI inflows, host-based governments in CEE should continuously strive to develop feasible policies aimed at connecting indigenous firms with international production networks of foreign-owned firms and to upgrade labour quality and entrepreneurial spirit as a whole. Otherwise, the phenomenon of 'the cathedral in the Central and Eastern European desert' will remain; moreover, this problem could even deteriorate in the future.

9 CONCLUSIONS

9.1 Summary

The main goal of this study was to empirically examine how both economic and non-economic forces affect the motivations and the corporate strategies of Japanese MNEs in post-socialist European economies. It is noteworthy that the primary data used for this dissertation was collected in the beginning of the year 2008 prior to the onset of the financial crisis arising from the subprime loan problems in the United States. It indicates that the empirical findings were not affected by the critical economic turmoil confronted by Japanese MNEs in post-socialist European economies.

We must be aware that numerous research has tended to point to the relevance of economic advantages such as market size and cheap factor endowments as the key FDI factor in the CEEC region, while the topic of the impact of both institutional changes and network relations (*i.e.*, intra-firm, inter-firm, extra-firm networks) on the MNE strategic behavior has substantially been neglected. In this thesis, emphasis is thus given to conduct an investigation of the phenomenon of FDI from Japan in the CEE context with mixed research methodology. Both quantitative and qualitative methods complemented each other to enhance the justification of the results with reference to Japanese MNEs' activities in the region. Particularly, as explained in the introduction, this dissertation endeavoured to answer the following research questions:

- How has the Japanese FDI position developed relative to European and US counterparts in CEE?
- What are the geographic scope, sectoral distribution, entry timing and entry mode of Japanese FDI in the European transition economies of CEE?
- What are the criteria governing the decision to invest in and to select a specific location within the CEE region?
- How far do the dynamics of institutional transformation explain the wave of foreign capital to the region? How do changes in institutional quality affect the actions of Japanese manufacturing MNEs?
- What determines Japanese manufacturing firms' location choices at a sub-national regional level?
- What are the underlying factors in determining the organizational performance of Japanese manufacturing MNEs?

To answer these questions, various types of qualitative and quantitative sources have been used in a multi-method approach. One crucial contribution of this thesis is the decomposition into their analytic components of the feature and strategic aspects of Japanese MNEs in post-socialist European economies. Based on a synthesis of the

results from each individual chapter, final conclusions can be drawn as follows:

Chapter 2 provided a basis for our understanding by outlining theoretical contributions to the internationalisation of firms. From the late 1990s, Dunning's OLI paradigm of the multinational organization tends to substantially shift its emphasis to the importance of both inter-firm alliances and institutions. For example, externalisation of transactions is reappraised by Dunning (1997) to replace internalisation of transactions. Dunning also highlighted the role of industrial clusters in generating synergetic effects for FDI performance. Moreover, the notion of North's institutions, which was neglected in international business studies, was also incorporated into Dunning's (2008) OLI framework. Dunning's latest eclectic paradigm has turned out to encompass a wide range of theoretical concepts in efficiency and legitimacy considerations.

In **Chapter 3**, I illuminated the evolution of FDI inflows into individual countries in absolute values and highlighted the cross-country variations in terms of (1) two size-adjusted FDI indicators (*e.g.*, GDP ratio and *per capita*), (2) the industrial distribution and (3) the country of origin. By and large, Visegrád-4 accounts for roughly 70 percent of the inward FDI stock into the CEE region at the end of 2006. At the country level, Poland has attracted the highest amount of FDI (US$103.6 billion), followed by Hungary (US$81.8 billion), the Czech Republic (US$77.5 billion) and Romania (US$41 billion). In sharp contrast, the nation states of the former Yugoslavia have lagged behind other CEE countries considerably, because of the persistent economic and political turmoil caused by two major ethnic wars. These descriptive statistical data revealed a positive relationship of FDI stock to market potential and the level of environmental and institutional stability. As regards the actual value of the size-adjusted FDI, Estonia and Bulgaria achieved the two highest FDI performances during the period 2003-2006, while Slovenia continued to encounter poor FDI performance in spite of its relatively high GDP *per capita*, labour productivity and institutional maturity. In this light, it is difficult to verify a linear association between FDI and the aforementioned economic and institutional criteria. As regards the origin of investors, the inbound FDI stock shows some positive association with cultural, geographical and historical proximity between investing and invested countries. For example, FDI from Nordic countries tends to concentrate in Baltic nation states. Asian FDI seems likely to be negligible. In considering the industrial distribution of FDI inflows in the region, Visegrád-4 succeeded in attracting FDI in the manufacturing industry due to their long engineering tradition, compared to other CEECs.

Chapter 4 concentrated on the characteristics of Japanese FDI. This chapter explained how, where, when and why Japanese investors penetrated the CEE market. The whole history of Japanese investment in the region is relatively short. With the exception of a

large-sized FDI project undertaken by Suzuki in Hungary investment in 1991, there was no major investment identified during the 1990s. However, as various agreements were concluded between the EU and some CEECs with reference to the eastern expansion of European integration, the number of new entrants increased gradually after the turn of the century. As regards the geographical scope, three of Visegrád-4 (Czech Republic, Hungary and Poland) have attracted the lion's share of Japanese manufacturing FDI. For many Japanese MNEs, a consolidation of network ties with Japanese and foreign customers have been a dominant factor of the phenomenon of relocation towards the CEECs, together with production cost advantages on the eastern European periphery. Japanese MNEs attach the biggest strategic value to rather production than sales in CEE and rationalize their global and regional sourcing strategy through reconfiguring operational units within the territory of the newly enlarged EU. We found that the criteria for location selection vary by country. The most persuasive argument in favour of the Czech Republic and Hungary as a production site was geographical proximity to customers as well as favourable government support, while labour costs were dominant location criteria in Poland and Slovakia, for instance. With respect to Japanese managers' perception of obstacles to their local operation, rigid labour markets and institutional inefficiency seem likely to be threatening, although there is a significant cross-country variation.

Chapter 5 explored the interaction between institutional changes and FDI inflows using a quantitative (cross-section and time-series) method. I directed considerable attention to variations in the advances of institutional development at a country level, because economics often tends to underestimate the institutional aspect of economic events as compared to market forces. It is found that MNEs have to pay relatively high transaction costs in managing sales, marketing, and production units in those countries with lower quality institutions. Particularly, it is significant that institutional changes seem likely to influence the success or failure of economic development of individual countries in Central and Eastern Europe. The empirical estimation demonstrated the pattern and spread of FDI inflows with the use of OLS with PSCE. My research aim was to seek to scrutinize the extent to which both economic and institutional forces play a crucial role in changes in the scale of FDI inflows in the European transition economies. Looking at the evidence drawn from this empirical investigation, economic forces (GDP, misery index and trade openness) seem to be very critical. Second, FDI is sensitive to the institutionalisation of FDI instruments, as measured by a binary dummy variable of the presence of a FDI promotion agency. Third, continued efforts by government to build market-supporting institutions tend to lead to an increase in FDI inflows. Fourth, the enduring nature of past political ideologies tends to shape FDI inflows. In sharp contrast to my prediction, EU membership shows not to provide any significant impact on the pattern and spread of FDI inflows in CEE. This analysis

allowed for clarifying more thorough analytical insights into the MNE activity in the region and generates an opportunity for host-based policymakers to design appropriate FDI policies.

Chapter 6 was a quantitative investigation of the location patterns of Japanese manufacturing firms. This quantitative empirical examination was based on the analysis of 205 Japanese manufacturing firms during the period from 1991 to 2006 in the European transition economies at a sub-national regional level. The data set of MNEs with a single source country (*i.e.*, Japan) has also enabled us to avoid the complexity deriving from the possible relations between the national identity of foreign MNEs and economic and non-economic forces. This study evidenced that firms make location choices based on considerations of economic and institutional advantages. Detailed results are as follows. First, I found that economic forces are less important than non-economic forces. Among the economic forces, area size exerts a significant effect on Japanese manufacturing MNEs' location choices. Second, institutionalisation of FDI practices matters in attracting Japanese investors. Judging from this empirical finding, the institutional hypothesis explains that institutional maturity that helps mitigate transaction costs and market uncertainties tends to determine the location strategy of Japanese manufacturing MNEs. Third, a firm-specific advantage, as measured by local experience, is a critical factor in determining the locational distribution of Japanese manufacturing MNEs. Fourth, the presence of Japanese nationality agglomeration not only in the same industry but also in different industries has a strong impact on firm location. Last but not least, the replication of Japanese *keiretsu* systems as a governance mechanism influences Japanese manufacturing firms' location choices within the CEE context. These empirical results have policy implications for the European transition economies: upgrading institutional infrastructure and agglomeration economies is one pivotal prerequisite for luring foreign direct investment by MNEs of Asian countries such as Japan and Korea.

Chapter 7 shows new analytical insights into the impact of economic and non-economic forces on firm performance variance in the European transitional economies. The data set was based on 55 Japanese manufacturing firms in the European transition economies, which participated in the survey conducted in January 2008. This survey analysis rested on managers' perception of firm performance. First, the findings support the hypothesis that stable labour market institutions are a necessary condition for operating successfully. Second, the more economically and politically risky a manager perceives a country to be, the better the performance a firm is expected to achieve in terms of cost reduction. Although this surprising result is the opposite of my prediction, evidence presented in this chapter supports the interpretation that changing market environments in the CEE region may keep Japanese manufacturing firms ready

to undertake more flexible marketing and production approaches in response to emerging risks and thus contribute to better performance. Third, as regards firm-specific advantages, both cost leadership and managerial expertise become highly relevant for firm performance in two or more dimensions. It was found that there is a significant positive relationship between the ability of the firms to bargain with the government for their particular interests and cost reduction performance. Fourth, there is a strong relationship between social capital and cost reduction performance. This result is the first indication that the mechanism of interpersonal relationships with various political and societal actors should not be ignored in the business studies of the European transition economies. For managers involved in business activities in the CEE region, it appears to be important to nurture a trusted tie with local stakeholders because they are a source of timely, reliable and adequate information about regulatory infrastructure.

Concerning the role of parent-subsidiary relations in improving firm performance, the less autonomy delegated to a subsidiary, the better cost reduction performance the subsidiary can achieve. This sharply contrasts with the claims by some studies (Luo, 2003; Kotabe and Wheiler, 1998) that autonomy is used as an effective tool in enhancing local responsiveness. This is to say, the centralised control by the headquarters with reference to resource allocation seems likely to improve firm performance. In other words, it is reasonable to argue that localisation is not necessarily an effective cost management tool in improving firm performance. It is important to note that sense of unity in the human integration aspect has a significantly positive relationship with three dimensions of performance measures: (1) overall operational performance, (2) profitability and (3) sales growth. Although I failed in verifying the direct impact of *keiretsu* systems on successful firm performance, the t-test showed the statistically significant difference between *keiretsu* and non-*keiretsu* firms in sales growth. Last but not least, late entrants are more satisfied with their overall operations as compared to first movers. Drawing on this evidence, first-mover advantages cannot necessarily be judged as a success factor in the context of Japanese manufacturing FDI in CEE. Rather, one could tell prospective Japanese investors that the region remains abundant opportunities.

Chapter 8 presented case histories of four major Japanese manufacturing companies that operate in the European transition economies. Interestingly, the case histories evidence that the underlying FDI motive is not explained by the EU's discriminatory trade policies against non-European producers that were major determinants in inducing Japanese manufacturing FDI in Western Europe in the late 1980s and the early 1990s. Rather, the case studies revealed that the underlying motive for a relocation of production capacities is critically driven by the reorganisation of international production and distribution networks and the forging of network relations with Western and Japanese customers. The NSK case explicitly demonstrates that the vanishing

locational attractiveness of the UK made the company feel compelled to strategically reorganise its production networks taking into account the enlarged EU landscape. Additionally, the NSK's acquisition of ISKRA in Kielce was enabled by their long historical business ties which lowered transaction and coordination costs inherent in normal cross-border acquisitions in transition economies. Drawing justification from the cases, it is important to note that institutional forces such as European environmental regulations (*e.g.*, Euro 5), financial and fiscal incentives, and receptiveness all tend to influence FDI strategies. A limitation of the case studies of this research project is undoubtedly the number of cases, so that it is not necessarily able to generalize the causes and consequences of these case firms to other Japanese MNEs in the CEEC region. However, a fair reliability and validity of the findings would be possible because of the particular attention directed to the major FDI features and operational experience of these four enterprises.

Figure 9-1: Concrete Measures of Future Operational Development (Unit: percent)
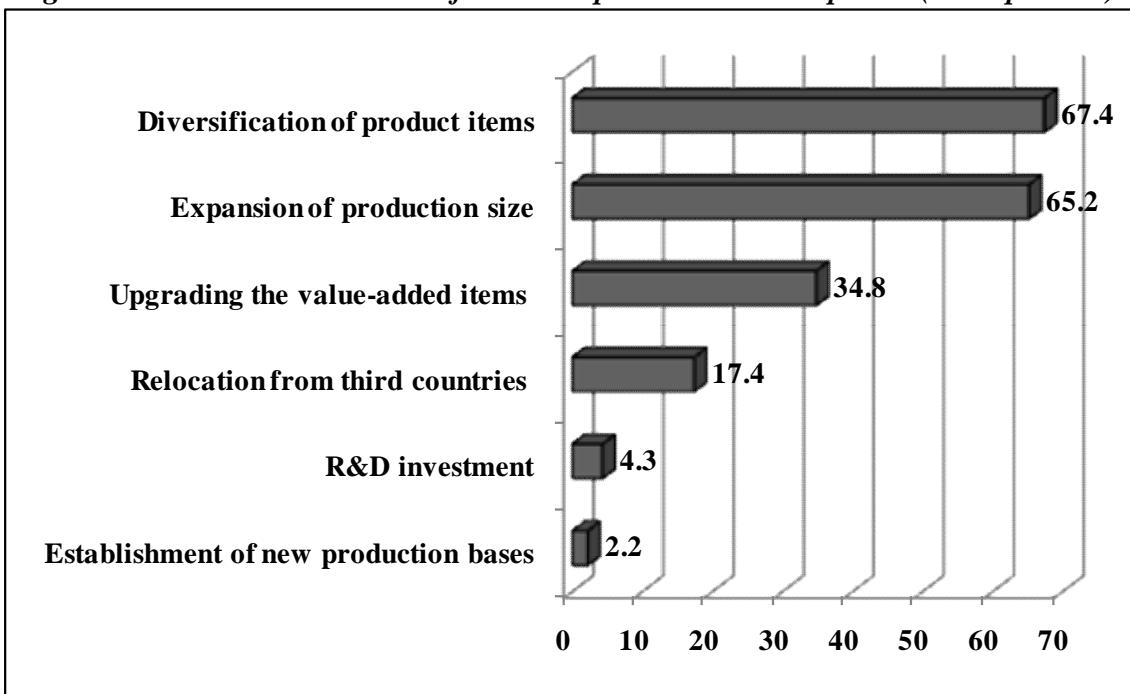
Source: JETRO (2007)
Note: N=46

9.2 Policy and Managerial Implications

Through the findings of the present study based on various types of quantitative and qualitative sources, policy and managerial implications can be made. First, each host government of CEE can increase FDI inflows by institutionalizing FDI policy incentives. It is essential that the provision of FDI policy incentives will provide an indicator of CEE's preparedness to welcome FDI inflows. Given a heightened level of competition for FDI at local, sub-regional and national levels, it could be more

important for each post-socialist European country to implement coherent FDI attraction policies designed to meet strategic goals of MNEs instead of merely giving investment incentives. This argument is in line with Lim (2005: 74), who points out that "host governments that intend to attain economic externalities from FDI will bolster their chances of success by devising and promoting incentives that will advance the strategic aims of potential investors". Moreover, each host government should introduce thorough FDI policy incentives fundamental to enable efficient transfer of cutting-edge technology, know-how, and managerial expertise from MNEs to local firms or to create strategic alliances between MNEs and institutions of higher education and local research centers. These efforts by each host government, in turn, would lead to strong backward linkages as a key to the long-term growth prospects of both MNEs and the host country. Emphasis should also be given to the importance of offering environments supportive to not only the low-end but also the high-end of the value-added chains of MNEs, which leads to a long-term economic development for the host country. So far, post-socialist European countries are unlikely to succeed in attracting high-tech intensive investment projects by Japanese MNEs. According to JETRO's survey (2007), despite a consolidation of manufacturing activities by Japanese MNEs in the consumer electronics, motor vehicle, and machine tool industries, the total number of R&D units set up by Japanese MNEs in CEE totals only 10, as of the end of 2006. In addition, only 4.3 percent of the surveyed firms (N=46) cited that setting up R&D units in post-socialist European economies is important in the future operation (see Figure 9-1).

Second, the present study shows that the pattern of FDI by Japanese manufacturing MNEs in CEE is not a mere sign of exploiting production cost advantages. Rather, it is more complex than expectation. This thesis notes that Japanese MNEs are increasingly aware of the importance of the rationalisation of international production and distribution networks in an enlarged Europe. As seen in the case-based research of this thesis (*e.g.*, the production network of Toyota-Peugeot Citroën), regional networking of different operational units of MNEs across European borders is aimed at gaining competitiveness, together with a consolidation of network relationships with rivals. Through network-based strategies, firms are compensated for greater uncertainties of investment and higher institutional hazards. A managerial lesson is drawn from current evidence of this thesis. The firms should simultaneously consider their firm-specific factors and country-specific factors (in particular, economic- and institution-specific location factors) in the internationalization process in post-socialist European countries. For the Japanese MNEs in the pre-entry phase, Japanese nationality agglomeration, previous experience and *keiretsu* networks are the decisive factors in influencing the location pattern of Japanese firms. Especially, current evidence from the context of Japanese MNEs in CEE stresses that spatial proximity seems to facilitate firms to acquire critical strategic information and enhance their political legitimacy as well as their economic efficiency. In the post-entry phase, firm-specific proprietary

resources such as cost leadership, managerial expertise and bargaining power are also at the heart of organizational success. In addition, formal and informal contacts with local stakeholders and the social climate inside a firm have to be developed in order to achieve organizational performance. This thesis denotes that the careful examination of internal resources inside the firm with inter-firm settings as well as with environmental and institutional conditions of the host country enables potential investors to overcome the liability of foreignness.

Third, policy makers of each government of CEECs should pay particular attention to the importance of developing human capital, together with structural reforms of labour markets. So far, a number of Japanese investors have already been concerned about the rising trajectories of wages in CEECs. Moreover, as increased competition makes prospective investors reluctant to enter, the existing investors are continuously in a struggle to accommodate both rapid changes in environmental conditions (*e.g.*, labour shortage, high turnover problems) and negative legacies from the past (*e.g.*, ill-functioning social welfare systems). The empirical findings show that the more stable labour market the better firm performance in the case of Japanese MNEs in CEE. Even though an upward curve of wage levels in new EU-CEECs cannot be avoided due to their improved standards of living and EU membership, CEECs should be devoted to investing constantly in the education of their population to keep the growth rate of labour productivity higher than that of labour cost. Thus, not only the central governments but also the regional governments of the CEECs should therefore continue to focus their attention on strengthening the value of created assets rather than relying heavily on the 'limited' advantage of natural assets.

Lastly, although a number of major Japanese MNEs have been attracted to CEE and Japanese MNEs' perceptions of this region as an FDI destination have substantially improved, the scale of Japanese FDI has still been limited, as compared to that of Western counterparts. It means that psychic distance resulting from Japanese MNEs' poor experiential knowledge of local markets and severe obstacles in the form of structural and institutional features in CEE, together with inherenet cultural and geographical distance, may continue to discourage Japanese investors to make the decision to produce locally. To minimize this psychic distance, mutual learning and understanding have to be nurtured through active dissemination of information among and regular visits by business associations and academic groups from Asian and Central and Eastern Europe. Prospective cultural activities and industrial cooperation between the two regions seem to be a crucial policy instrument of promoting Asian FDI. The organization of regular forums for sharing cultural and historical backgrounds of both regions could also help ease psychic distance between them. The knowledge of post-socialist European economies in Japan, and *vice versa*, should be improved by student exchange programs, for instance. Therefore, the dynamics of the internationalization process of Japanese MNEs would be revitalized not only by

economic factors of host countries and strategic aspects of the firm but also by social and cultural cooperation.

Although I have tried to present a comprehensive view of Japanese manufacturing MNEs' activities and their investment strategies through a multi-method perspective, the data set used in this dissertation is rather limited. Evidence presented in this thesis is thus not conclusive but suggestive. It also seems difficult to make firm judgments since I have presented the results of MNEs from one single country in the CEEC region without any comparative analysis and since the proliferation of Japanese FDI in the region has just begun at the turn of the new millennium. However, I hope that this dissertation will help scholars, business leaders and policy makers to gain a better understanding of factors influencing Japanese manufacturing MNEs' investment strategies in an idiosyncratic set of dynamically changing environmental and institutional situations, as they seek the strategic fit between local responsiveness and global integration in the CEE region.

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Appendix

<u>質問票</u>

在中東欧における日本企業の国際化・国際経営戦略
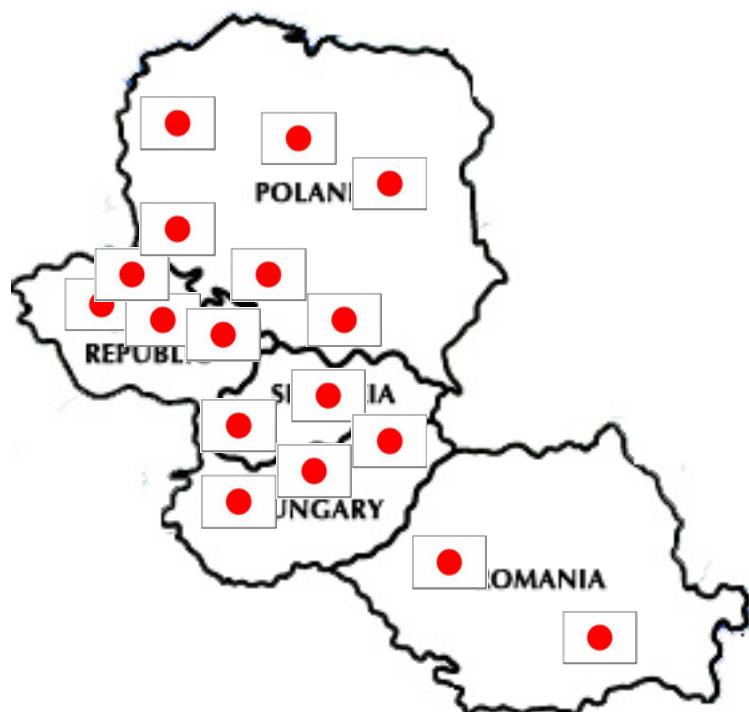
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もし、ご不明な点がございましたら、河合憲史
(norifumi.kawai@uni-duisburg-essen.de)の方までお問い合わせ下さい。

ご多忙のところ、誠に恐縮ではございますが、アンケートにご協力頂きますよう
お願い申し上げます。

現在、貴社が事業を展開しておられる中東欧の国をお答えください。
□ポーランド　　□チェコ　　□ハンガリー　　□スロバキア　　　　□ルーマニア

（一般情報）

1.　本社の主要業務に関し、お答えください。
□生産　　□販売　　□ロジスティックス　　□研究開発　　□サービス

2.　本社の海外拠点数はどれくらいございますか。
□1　　□2－4　　□5－9　　□10－19　　□20－49　　□50 以上

3.　中東欧の拠点はどれくらいございますか。
□1　　□2－4　　□5－9　　□10－14　　□15－19　　□20 以上

（子会社情報）

5.　貴社の中東欧子会社の属する業種をお答えください。

	建設業		製造業　金属加工
	製造業　機械		製造業　鉄鋼
	製造業　電気・電子機器		製造業　その他
	製造業　輸送用機器		卸売・小売業
	製造業　化学		倉庫・運輸業
	製造業　金属		金融・保険業
	製造業　食品		サービス業

6.　中東欧進出の投資形態についてお答えください。
□完全子会社　　□合弁　　□買収

7.　貴社の中東欧子会社の最高責任者の国籍をお答えください。
□日本人　　□現地人　　□その他

8.　貴社の中東欧子会社の最高責任者は、中東欧に勤務される以前、同地域に関する業務を本社/他の海外子会社にて行っていた経験がありましたか。
□はい　　□ない

9.　貴社の中東欧子会社の事業内容に関し、お答えください。
□生産　　□販売　　□ロジスティックス　　□研究開発　　□サービス

10.　最初の中東欧への進出は、いつ頃かお答えください。
□1990 年以前　　□1990－1994　　□1995－1999　　□2000－2004　　□2005 年以降

11.　貴社の中東欧子会社の現地日本人駐在員数をお答えください。
□0 人　　□1－4 人　　□5－9 人　　□10－19 人　　□20 人以上

12.　貴社の中東欧子会社の現地従業員数をお答えください。
□10 人未満　　□10－99 人　　□100－499 人　　□500－999 人　　□1000 人以上

13.　中東欧子会社の本社への資金依存度についてお答えください。
□0%　　□0% 超 － 25% 以 下　　□25 ％ 超 － 50% 以 下　　□50% 超 － 100% 未 満
□100%

14.　本社の役員による中東欧子会社への訪問はどれくらいかお答えください。
□月に一度　　□3 ヶ月に一度　　□6 ヶ月に一度　　□1 年に一度　　□全くない

15.　貴社の中東欧子会社の事業満足度についてお答えください。

満足度	非常に不満	やや不満	普通	やや満足	非常に満足
全体的な事業満足度	1	2	3	4	5

16.　貴社のオペレーション能力についてお答えください。

比較優位性	非常に弱い	やや弱い	普通	やや強い	非常に強い
コスト競争力	1	2	3	4	5
経営管理能力	1	2	3	4	5
人的資本の蓄積	1	2	3	4	5
現地政府との交渉能力	1	2	3	4	5

17.　現在の中東欧子会社の事業環境についてお答えください。

現地の事業環境の変化	非常に懸念している	少し懸念している	普通	あまり懸念していない	全く懸念していない
人件費の上昇	1	2	3	4	5
他社との競争激化	1	2	3	4	5
不安定なマクロ経済	1	2	3	4	5
不透明な政治	1	2	3	4	5
ジョブホッピング	1	2	3	4	5
低い経済成長率	1	2	3	4	5
インフラの不整備度	1	2	3	4	5
現地政府による支援が弱い	1	2	3	4	5
現地通貨の変動が激しい	1	2	3	4	5
労使関係の悪化	1	2	3	4	5
労働力の確保	1	2	3	4	5

18. 貴社の中東欧子会社の事業達成度についてお答えください。

事業達成度	予想を大きく下回る	予想をやや下回る	予想通りである	予想をやや上回る	予想を大きく上回る
コスト削減達成度	1	2	3	4	5
収益性達成度	1	2	3	4	5
売上高達成度	1	2	3	4	5
顧客拡大達成度	1	2	3	4	5

19. 貴社の中東欧子会社の現地事業決定権についてお答えください。

子会社の決定権	完全に決定できる	ほぼ決定できる	場合による	あまり決定できない	完全に決定できない
中長期計画	1	2	3	4	5
予算編成	1	2	3	4	5
設備投資の追加	1	2	3	4	5
組織変更	1	2	3	4	5
新規事業への参入	1	2	3	4	5

20. 貴社の中東欧子会社の現地化の度合いをお答えください。

ローカリゼーション	はい	いいえ
現地従業員を日本の本社でトレーニングするシステムがある		
現地社員に対し昇進制度がある		
マーケティング戦略部門の 責任者は現地人である		
財務会計部門の責任者は現地人である		
人事部門の責任者は現地人である		

21. 貴社の中東欧子会社の現地ネットワークについてお答えください。

現地ネットワーク	非常に 弱い	やや 弱い	普通	やや 強い	非常に 強い
現地中央政府との コンタクト	1	2	3	4	5
現地地方政府との コンタクト	1	2	3	4	5
現地コミュニティー とのコンタクト	1	2	3	4	5

22. 貴社の中東欧子会社の現地従業員との情報共有化並びに一体感についてお答えください。

情報共有化		一体感	
経営情報の交換、情報伝達を社内にて活発に行っている。言語的コミュニケーションギャップは全くない	5	一体感を醸成するため、全従業員が共有できる食堂、福利厚生施設、朝礼、親睦行事、ユニフォームがある	5
情報の共有化には各種の工夫をしている。	4	5 の中でいくつか欠けているが、いくつかの工夫はある	4
特別な施策はないが、ミーティングでは情報の共有化に努めている。	3	5 の中で 1 つはある。	3
言語的コミュニケーションギャップがあり、情報交換は消極的に行われている	2	親睦行事しかない	2
情報交換は全く行われていない	1	特別な施策は実施していない	1

この度は、大変ご多忙の中ご協力頂き、心より厚く御礼申し上げます。