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**Emerging East-West Collaborative Networks:
An Appraisal**

by
Klaus-Dieter Schmidt

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Abstract

Although an extensive amount of literature reviews emerging patterns of east-west co-operation, it is not easy to grasp the state of the art. Too many of the books, articles and papers tend to mark the trees rather than to map the forest.

The paper analyses recent trends from the point of view of modern economics which emphasizes the growing use of a wide variety of new types of co-operative mechanisms between firms in organizing international business. It takes an appraising look at the outcome of a recent research project of a group of scholars from east and west.

The paper comes to the conclusion that east-west integration is proceeding at a considerable rate. But it is dominated by shallow modes — by arm's length transactions and contract work. To a certain extent, this might reflect new patterns of inter-firm co-operation. But this might also be an indication that co-operation with partners in CECTs is still in a flat state. Eastern firms find it hard to obtain an adequate position in international networks. Their lack of competence, reliability and reputation is often an insurmountable barrier. Accordingly, they must improve upon their technological and organizational standards to be considered by western firms as competent, reliable and trustworthy and, hence, equal partners in collaborational networks (D2, 8; F02, 1, 2, 14, 15, 23).

Introduction[1]

There is a rich and valuable body of literature on the Central European countries' in transition (CECTs) re-integration into the world economy. It emphasizes

- the massive geographic trade re-orientation towards western, especially EU-markets,
- the moderate commodity specialization, in particular the increase in intra-industry trade and the decrease in the strong comparative bias against skill-intensive industries, and
- the incipient integration of eastern firms into international production networks.

The message seems to be clear: east-west co-operation is progressing — but along distinctly multispeed routes.

Looking down from the mountains of books, articles and papers, though, nobody can be satisfied. Too many publications suffer from a serious shortcoming: they tend to mark the trees rather than to map the forest — in other words, they fail to scrutinize facts and figures in depth within the context of modern economics. As it is all too often the case that researchers still find themselves in a position of playing theoretical catch-up. Frequently, they still tend to examine available evidence on the issue

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[1] Research for this paper was undertaken with support from the European Commission's Phare ACE Programme 1996, project no. 96-2003-R. An earlier version was presented on a workshop held in Prague from 17–19 April 1998. I am grateful to the participants of the workshop for their helpful comments and to Wolfgang Winkler for linguistic improvements.

from the analytical perspective of traditional trade theory which generates a story about unrelated firms, competing in international markets by exploiting local advantages in terms of different factor endowments. This approach, however, underscores the growing use of a wide variety of new types of co-operative mechanisms between firms in organizing international business.

There is a general lesson to be learnt: the advance of the global business has generated the intensification of inter-firm co-operation. In order to cope with global competition, firms find it increasingly hard to pursue a stand-alone strategy. They try to integrate themselves into a complex international corporate system in the form of vertically and horizontally organized networks.

There is a substantial amount of evidence that firms in CECTs have difficulties getting access to networks of western multinationals. At best, they can obtain a subordinate position because organizers of networks tend to favour firms with provable competence, reliability and reputation. Even a low cost advantage will not necessarily open the door to them. Businessmen and policy makers in CECTs tend to complain about this. However, they often have only vague ideas of what really matters in order to create synergies and to realize economies of scope. It is the objective of this paper to sketch a framework for a better understanding of the network approach.

The paper is organized as follows: it

- first, sketches the basic theoretical assumptions of the network approach,
- second, reviews the state of the art of east-west co-operation,

- third, reveals the incentives for co-operating firms,
- fourth, lists the main obstacles to finding access to collaborative networks, and
- fifth, discusses some policy conclusions.

The paper is the outcome of many years of intensive co-operation of a group of researchers from several European countries within the framework of the European Commission's ACE-Phare Programme. Starting in the summer of 1992, the group has extensively examined the process of the integration of firms in CECTs into European trade flows and co-operation schemes and has accordingly accumulated a substantial stock of information. Thus, the paper has many contributors, namely all members of the group.[2]

Nevertheless, the paper does not necessarily reflect consensus of opinion on all aspects of the research issue. It rather presents the highly personalized account of the group's research.

I New Trends in Network Operations

It is advisable to start the paper with a look at recent trends in business organization which has undergone massive transformation. In response to the rapidly changing environment, firms have been, in particular,

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[2] The group comprised the following members: Prof. Benjamin Bastida and Prof. Tereza Virgili, Universidad de Barcelona; Prof. Bruno Dallago, Universitá degli Studi di Trento; Katja Gerling, Kiel Institute of World Economics; Dr. Maciej Grabowski, The Gdansk Institute of Market Economics; Prof. Judit Hamar, Kopint-Datorg, Budapest; Dr. Gábor Papánek, GKI Economic Research Institute, Budapest; Dr. Romulus Palade, National Bank of Romania; Dr. Julie Pellegrin, University of Birmingham; Dr. Jana Sereghyová, Economics Institute, Prague (co-ordinator).

- moving from Fordist, mass production patterns to flexible, small lot sizes and short run production;
- buying rather than making parts of their inputs and reducing the number of suppliers dealt with directly;
- switching from short-term contracting to long-term interacting enhancing the partners' ability to commit themselves credibly; and
- overcoming uniform organizational modes by shaping specific, tailor-made strategies.[3]

Changes in business organization are not a novelty. Firms have always reorganized themselves as well as their relationships to others. Over time, new organizational modes have emerged, though gradually rather than eruptively. In recent years, however, firms have started to reorganize their organizational structures in a fundamental way — optimizing all parts of their value chain with respect to production, sourcing, trading, research and development, investment and financing, information flows, logistics and administration. In particular, they have been breaking down the value chain into discrete functions and shifting parts of it to locations where they can be carried out most profitably. And they have been building up a sophisticated business infrastructure across the value chain for safeguarding good product quality, reliable delivery times, post-sales activities, and unhindered information flows.

[3] For a discussion of the recent literature about business organization see Siebert [1995].

Changes in Business Organization
– Mass Production versus Lean Manufacturing –

Dimensions	Mass production: *Transfer lines, specialization, and economies of scale*	Lean manufacturing: *Flexibility, rapid responses, and economies of scope*
Capital equipment	Specialized	Flexible (low set-up costs)
Production runs	Long runs, large lot sizes	Short runs, small lot sizes
Product changes	Infrequent	Frequent
Markets	Mass markets	Targeted markets
Worker skills	Low or specialized	High, with cross-training
Decision making	Central expertise and hierarchic planning	Local information and self-regulation
Communications	Primarily vertical	Primarily horizontal
Product development	Sequential	Cross-functional teams
Operational focus	Static optimization	Continuous improvement
Day-to-day emphasis	Accent on volume	Accent on quality
Inventories	High	Low
Managing uncertainty	Supply management	Demand management
Customer relations	Make-to-stock, limited communications	Make-to-order, extensive communications
Supplier relations	Short-term, price-based	Long-term, competency-based
Vertical integration	High	Low
Employee relations: Factory workers	Low commitment, confrontational	High commitment, co-operative

Source: Milgrom and Roberts [1995].

The new features observed have important implications for inter-firm co-ordination [Casson 1985; Blaine 1994]:

- First, with more supply purchased outside (which was formerly produced inside) the trend is towards greater use of market transactions. In terms of traditional theory, co-ordination via internal hierarchy is tentatively being replaced by market transactions.

- Second, with integrated production networks (which are substituting arm's-length deals made by separate firms) the trend is towards close inter-firm transactions. Whereas in markets, co-ordination is

effected by prices and in hierarchies by control, in networks it is effected by a wide range of contractual and co-operative mechanisms.

Although a comprehensive theory of new forms of business organization, in particular with regard to inter-firm co-operation, has not been developed, this is no disadvantage. Like a tree with many branches, there are many schools which made important contributions to explaining the wide-spread use of the new co-operative mechanisms. In a short introduction, focusing on the transaction cost theory, the interorganizational theory and the strategic management theory [Gerling 1997], we provide some cornerstones of the new network approach [Schmidt 1997c].

1 Networks and Transaction Costs

Perhaps the most important contribution to modern business organization theory has come from the New Institutional Economics (NIE). While standard microeconomic theory focuses on a "frictionless world" (with zero transaction costs, hence perfect markets), a more realistic view requires consideration of such issues as asymmetric information, uncertainty and opportunism. The question to be answered is: why do economic actors organize their business neither in external markets nor in internal hierarchies but in intermediated form such as collaborative networks?

The focal point of NIE is the study of a "contract" which is the core of a network. For that, NIE provides a set of "tools" not available in the orthodox production and market theory [Furubotn and Richter 1991; Richter 1996]. The most important ones are:

- *Transaction costs* which can be described as the costs of concluding, monitoring and enforcing the performance of a contract. The central idea here is that specific institutional arrangements such as co-operating in a network can reduce transaction costs and can thus be efficient in terms of resource allocation.
- *Property rights* which authorize the recipient to proper enforcement of the contract. The point is that organizations cannot only be considered as rational entities formed by deliberate actions but must

also be seen as the outcome of a certain distribution of power among economic actors co-operating within an accepted set of rules.

- *Principal-agent relations* which clarify the responsibilities in co-operations under conditions of asymmetric information (bounded rationality) among contracting parties. They also deal with the possibility of opportunistic behaviour of one party.
- *Incomplete or relational contracts* which make allowance for the fact that it is ex ante not possible to contract for all unforeseeable eventualities which may arise in the future.
- *Self-enforcement* which directs attention to the fact that not all business relations (e.g. binding customers to trademarks) can be safeguarded by contractual obligations. In this case, both partners have to do their best with respect to their reputation.

From the standpoint of NIE, network co-operation can be efficient if, by taking account of the above, transaction costs can be reduced, competence can be increased, uncertainty can be limited, and hence allocation of resources can be optimized.

Once again: co-operation within a network should be understood in terms of NIE as a special form of co-ordination — located between the market place and a hierarchical organization of a single firm. Instead of opportunism (dominating market transactions) and control (dominating hierarchical organizations), networks are governed to a great extent by contractual and collaborative arrangements based on reputation. This means that parties in a network refrain from cheating and fully honour their obligations.

2 Networks and Resource Dependencies

While NIE views networks as a response to general market imperfections which need specific contractual arrangements, interorganizational theories (IT) consider them somewhat differently: as response to a specific problem, namely the changing and hence unstable environmental conditions. IT suggest a causal link between firms' performance, their organizational structure and the environment in which they operate. A central issue is the importance of external dependencies on resources which might be essential for firms' survival [Håkansson 1987; Johanson and Mattson 1991].

One basic argument of this approach is that co-ordination takes place through interaction of firms in a network in which prices or costs are but one of several influencing conditions. This view is consistent with the critique of transaction cost economics which focuses on the marginal cost principle in explaining the firms' strategic behaviour between markets and hierarchies.

Inter-organizational theories are seen as a combination of three integral parts:

- *Resources* which include e.g. raw materials, technology, human and financial capital and information. In order to get access to resources, firms engage in relations with other firms managing their mutual dependencies in a way that guarantees their survival.
- *Actors* who are a sample of firms which are able and willing to form stable and interdependent relations.
- *Activities* which are performed by the actors not in an isolated way but via activity chains.

Interaction within networks takes the form of exchange relations which co-ordinate resources and activities among actors in an efficient way. By that, it is hoped to achieve an economic advantage over competitors that is higher than in markets and hierarchies.

Like NIE relationships (which use the term reputation), IT relationships are based on a degree of trust. Trust is important as it enables to cope with uncertainty. In conceptualizing trust, one can distinguish four dimensions, namely

- *competence* which refers to the actors' technical capability,
- *openness* which refers to the actors' willingness to provide and share information,
- *caring* which refers to the actors' expectation that one actor will not exploit the others, and
- *reliability* which refers to the actors' predictability [Mishra 1993, cited from Kumar 1996].

Trust implies a cognitive and an affective dimension so that it is useful to differentiate between familiarity and liking. The concept can become crucial in many cases, in particular if partners do not like each other. Consequently, cultural factors can and do influence the partners' deci-

sion to form a network as an alternative to using external markets or internal structures.

As trust is a sort of capital which has to be accumulated over time, a network can take long to develop. Usually, it evolves in a slow process, starting with minor transactions in which little trust is required because little risk is involved. Sometimes, it remains restricted to a "flat state" — due to the absence of mutual trust. Consequently, there is a multiplicity of collaborative ventures between firms.

3 Balancing Co-operation and Competition within Networks

The crucial issue in networks is to find the balance between co-operation and competition. Independent firms, which are competitors in special markets, might co-operate in special fields, e.g. in research activities in order to pool their resources and to reduce costs and risks.

The conditions to which competing and co-operating firms underlie are the subject of the Strategic Management Theory (SMT). SMT explains how competing firms can shape a strategic partnership — and how to manage the difficulties it involves. According to Ajami [1989], a strategic partnership requires the following elements in order to succeed:

- *Shared goals and objectives* which implies that firms must agree on a clearly defined and workable business strategy.
- *Coupling of chances and risks* which implies a fair distribution of gains and losses.
- *Flexibility* which implies the creation of new routines with respect to research, production and distribution.
- *Clearly defined boundaries* which implies accepting and respecting the independency and the responsibility of the partners when competing in markets excluded from partnership.
- *Shared understanding and agreement* concerning mechanisms which implies, besides some contractual arrangements, a strong element of trust.

It is important to mention that strategic alliances are an arrangement suitable for horizontal integration rather than for vertical integration. They are not intended for "eternity", but frequently have a short lifespan.

To claim that inter-firm relationships are "networked" does not imply that they are uniform in shape. It would also be misleading to say that all firms follow the same "paradigm path". In reality, we find a broad variety of network relations, e.g. offshore processing, licensing, franchising, strategic alliances, which can be explained in different ways depending on firms' economic and technological environment. As a rough guideline, Nunnenkamp, Gundlach and Agarwal [1994] suggested distinguishing three categories of industries with different co-ordination mechanisms:

- For highly complex production processes where network relations involve information, intangible assets or R&D-intensive goods and services, a hierarchical control on the basis of an equity arrangement and hence a high share of intra-firm transactions are likely to occur.
- For less complex production processes the mechanisms of co-operation are principally open and hence a high share of both intra-firm and arm's-length transactions is possible.
- For production processes involving standardized goods a non-equity, contractual form of co-operation can be expected. The resulting transactions are more likely of an inter-firm than an intra-firm type.

From this, one can derive that deep or complex integration strategies are mainly adopted in knowledge-intensive industries like chemicals, mechanical engineering, electrical engineering, electronics and transport equipment, whereas shallow or simple integration strategies are preferred in capital- and labour-intensive industries like wood, pulp and paper, glass and pottery, and textile and clothing.

The implications are hard: they suggest that it is difficult, in particular for knowledge-intensive firms, to find access to networks. For many firms in CECTs, it is presently still out of the scope. They have neither the competence nor the reputation to overcome the impediments to close co-operation. They are not able, e.g., to guarantee required product qualities and just-in-time delivery, to undertake specific investments in machinery and skills, or to conclude a long-term fixed price contract (which pushes all the risk of an unforeseeable cost increase on to them). Accordingly, they are not regarded as reliable partners by western firms.

Frequently, firms in CECTs fail to understand that the network approach implies completely new, radical ways of organizing sourcing and storekeeping, production and quality control, research and development, transport and deliveries, marketing and post-sales activities — and that these changes also imply important alterations in the nature and forms of relationships between firms.

II Extent and Forms of East-West Network Operations

New organizational theories suggest that changes in the environment are crucial components in understanding recent trends in inter-firm co-operation. The basic message is that in establishing collaborative networks, firms follow different routes and progress at different speed — in accordance with political, institutional, economic and technological circumstances.

1 Economic and Political Integration

In models of international trade theory, economic factors clearly determine the route and speed of integration: markets are considered fully

integrated when goods and factor flows across borders are not restricted by political boundaries and, hence, firms on both sides of the border can completely exploit their competitive advantages.

International economic integration, however, is seldom purely "market driven". It often follows routes designed by economic policy. Not surprisingly, the CECTs' integration process appears to be somewhat westward biased — in anticipation of full membership of the EU. For most businessmen, economists and policy makers in CECTs, international economic integration has become synonymous with EU-integration. Therefore, the ongoing east-west integration widely differs from integration in other parts of the world which followed economic rather than political routes [Agarwal et al. 1995]. It is debatable at least whether firms in CECTs are well advised to concentrate all their efforts on co-operation with partners in the east — and neglect co-operation with traditional partners in the west. Despite political rhetorics, there is only a slow train towards the EU full membership, and only a few countries are already sitting in it [Schmidt 1997a].

One might argue that the pronounced westward orientation is a "must" for firms in CECTs: given the enormous technological gap, it is the only route towards restoring their competitiveness. The crucial point is, however, that the EU's admission strategy of "hub and spoke bilateralism", which links each candidate for full membership as a separate "spoke" to the west European "hub", tends to marginalize the majority of transformation countries politically and economically by favouring western investment in some "spoke countries" [Baldwin 1994]. Actually, western foreign direct investment (FDI) is extremely unevenly distributed: the lion's share is concentrated in only four countries, in the Czech Republic, in Hungary, in Poland and in Slovenia, which are the most successful

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candidates [Hunya 1996]. So far, the EU's admission strategy has become a springboard for these countries, while for others it has become a barrier.

2 Deep and Shallow Co-operation

CECTs' achievements in westward-integration are impressive by any standards, but they should not be overrated: until now, they have mainly taken the form of trade re-orientation, interlinked with mainly shallow forms of foreign engagements, such as offshore processing, franchising and licensing — the process of becoming deeply involved in internationally integrated production networks has proceeded more slowly. So far, CECTs still have a long way to go until they reach full international integration.

The implementation of east-west co-operative networks — their extent and forms, success and failures, gains and losses — was studied intensively. The picture appears to be very multi-coloured, reflecting different firm strategies depending on the type of production, company size, corporate structure and, last but not least, competence. Pellegrin [1997a] suggests distinguishing four criteria for characterizing networks: the forms of organizing the value chain (horizontal or vertical), the extent of recourse to local suppliers (strong or weak), the relations with partners (merchant or captive) and the regional scope of transactions (bilateral or regional). As a rule, western firms have mainly

- built up vertical relationships: local firms have been mostly suppliers of materials and components, assemblers or refiners.

- delegated subordinated tasks: local firms have been commissioned with labour-intensive, low value added operations, while headquarter functions and high value added activities have remained at home.
- established minority equity joint ventures or subcontractual relationships with a low degree of commitment: by that, local firms have become economically dependent on their foreign partners rather than legally dependent.
- concentrated their activities on supplying certain markets, in particular on supplying host country markets: local partners have nevertheless been used as bridgeheads for serving other markets.

In most cases, east-west collaborative networks have started with shallow forms of mutual integration, since the capacity of firms in CECTs to become competent, reliable and reputable partners has been very limited: product quality and delivery punctuality have been low, specialization has been poor and co-ordination of activities has been difficult. Consequently, many western multinationals have considered the establishment of strong linkages with a foreign subsidiary as too risky. Therefore, they have performed a strategy of "testing the water" first but they have not been "in a hurry to jump".

It is understandable that economists, businessmen and policy makers in CECTs are not happy with this state of affairs. They bridle at western firms what they call "downgrading" of local producers to "third-tier" subcontractors — representing the "most simple" and "underdemanding" type of commission work [Sereghyová 1997b,c]. However, they often fail to notice that network production is decisively governed by the partners'

competence, reliability and reputation. Sometimes, a network remains restricted to a flat state — due to the absence of these factors. In this case simple commission work might protect firms at least from bankruptcy. For unviable firms it might be also a vehicle to a well-ordered exit [Balcerowicz et al. 1996].

In a dynamic perspective, the prospect looks somewhat brighter: empirical evidence suggests that successful subcontracting relations will be sooner or later gradually upgraded — to more balanced forms of partnership [Pellegrin 1997b, c]. Frequently, for instance, outsourced stages of the production process may become more sophisticated over time. There is an impressive example: the progressing move of the manufacturing of men's jackets, one of the most complex clothing operations, from western countries to CECTs. It illustrates that subcontractors are seen as pivotal in the supply also of complex and high quality products [Graziani 1996].

There are good reasons to judge the role of western firms for the restructuring process in CECTs positively. Generally, foreign-owned or foreign-managed firms outperform domestic firms clearly — e.g., by larger investments, easier access to foreign commodity and financial markets, better logistics and organization and, as a result, higher profits [Halpern and Körösi 1997; Zemplinerova 1997]. In particular, foreign-owned or -managed firms are more export-oriented [Grabowski 1997; Hamar 1997a,b]. Needless to say that not all the hopes of eastern firms have been fulfilled so far [Papánek 1997; Sereghyová 1997c]. However, often these hopes have been too over-ambitious.

3 *Equity-Based and Contractual Relationships*

Firms have a degree of choice of how to organize their relationships with partners — ranging from simple arm's-length transactions among legally independent firms to fully integrated production lines under the strict governance of a parent company. Deep co-operation is usually associated with equity links. Accordingly, many researchers have focused on this type [Naujoks and Schmidt 1995; Hunya 1996; Nesvera 1997]. They have traced a clear pattern: foreign ownership is relatively high

- in technology-intensive industries, not in those producing standardized labour-intensive goods,
- in industries with a great market potential and not in those facing shrinking markets, and
- in industries dominated by large "healthy" firms and not in those dominated by ailing firms.

Main industries with above-average shares of foreign capital participation are motor vehicles and transport equipment, machinery and electrical equipment, food, beverages and tobacco, paper, publishing and printing. Co-operation in these industries might require an equity control over partners in order to overcome, e.g., deficient property rights, quality and delivery uncertainties and imperfect information flows.

However, many operations in networks are facilitated by weaker and simpler forms of integration, in particular by contract work outside internal hierarchies. By contract work, the subcontractor is integrated into a value adding chain by functional linkages rather than by equity. Relatively low shares of foreign ownership have been observed in mining, in

iron and steel, in chemicals and in metal industries as well as in furniture, in textiles, in apparel and in leather which are usually highly integrated in international networks by offshore processing trade (OPT).

All in all, there is ample evidence that east-west network operations frequently take intermediate forms representing a relatively flat state of co-operation. Dominating are OPT and other types of contract work [Hamar 1997a,b; Sereghyová 1997b,c; Pellegrin 1997c; Papánek 1997], which do not require equity links between partners. In the typical case, the western contractor provides input mainly in the form of materials and technological assistance, i.e. machinery and know-how, to the eastern sub-contractor. This makes sense. Often, an equity involvement might be considered by him as too risky. It might also absorb too much of his management capacity, usually the shortest factor in western firms. A full or a majority ownership is only necessary if the contractor has a strong interest in keeping the subcontractor on a short lead.

For several reasons, firms in CECTs are extremely suitable candidates for OPT [Naujoks and Schmidt 1994]:

- They can offer low wage rates for unqualified as well as for skilled labour, combined with relatively high labour productivity. This constitutes an important source of comparative advantages for sub-contractors in so-called Heckscher-Ohlin industries.

- They operate geographically close to manufacturing centres in western Europe. The modern production concepts of western firms (such as just-in-time delivery or consumer-response delivery) favour geographic proximity between producers and their foreign offshore plants as they require fast and reliable transport.

- They have competitive advantages in the production of so-called "sensible goods" which are subject to trade barriers upheld by the EU: exports and imports of OPT are, as a matter of principle, duty-free since only the added value has to be declared.

4 *Producer-Led and Retailer-Led Networks*

Traditionally, networks among firms are producer-led, that is large-scale manufacturers organize sourcing production, storage, transport, distribution and after-sales service. However, their influence has been weakening all over the world. Large-scale retailers operating chains of department stores and supermarkets have been drastically re-organizing their sales routes. As a result, they have been gaining the leadership in networks — controlling prices, quality, assortment lot, and delivery times. In dealing with producers, they have come into a strong, frequently even into a superior position. Basically, they can rigorously select with whom they do business.

In recent years, more and more western retailers have started to expand their business including their sophisticated sourcing system eastwards, too. For local producers in CECTs, this is a chance as well as a threat. It is a chance if they are able to meet the demand of their counterpart, but it is a threat if they fail. Experience has shown that it is difficult, but not impossible even for small-sized producers in CECTs to form close and stable ties with them. A striking example for a successful network between foreign retailers and domestic producers is the engagement of the international furniture chain IKEA in Poland: IKEA holds roughly 150 Polish firms under contract which generate 15 percent of IKEA's worldwide added value [Grabowski 1997].

5 Networks between Neighbouring and Distant Regions

As far as cross-border co-operation is based on different factor endowment and factor prices, economic theory suggests that it should start in neighbouring regions where not only transport costs but also transaction costs are lower than in distant regions. For example, short distances make frequent face-to-face contacts possible, thus helping to generate an atmosphere of trust and control which is essential in a network. There is empirical evidence all over the world that border regions can become an economic power-house by economic integration [Sander 1997; Schmidt 1997b]. However, this is not a self-propelling process. There is also evidence that great development differences can be a constraint to rather than an impetus to integration.

Statistical information on cross-border activities along the former Iron Curtain is rare. The indicator most frequently used is regional distribution of FDI in CECTs. This indicator suggests that western firms tend to invest mainly in agglomeration areas (in particular in the capital of the country and its surroundings). In recent years, however, they have increasingly invested also in the border belt, in particular in Poland in the Szczecin and Zielona Góra regions, in the Czech Republic in the Tachov region, in Slovakia in the Bratislava region and in Hungary in the Györ-Moson-Sopron region. Nesvera [1997] observed a pronounced westward move of economic activities in the Czech Republic. Nevertheless, FDI figures should be interpreted with some caution. Geographic distribution of FDI can be heavily influenced by engagement of a few large multinationals. The figures are not necessarily a proof for a fast integration in the border belt, in particular for close transboundary co-operations of small- and medium-sized firms [Gerling and Schmidt 1998].

III Incentive Issues of East-West Network Operations

Much has been written about firms' objectives of investing abroad. Generally, the following reasons appear to be the most relevant [Lall 1978]:

- *Marketing requirements*: the need of getting access to markets; the need of controlling distribution facilities; the need of a great deal of specialized after-sales services, of maintaining and updating; the need of transferring information to and from consumers; and the need of keeping direct representation to governments in order to influence politics or to win large orders.
- *Exploiting cheap labour*: the need of relocating parts of the production to low-wage countries in order to cut costs.
- *Specificity of the product*: the need of safeguarding uniqueness, high quality standards and suitability to given requirements.
- *Risk and uncertainty*: the need of avoiding disruptions in production, quality changes and other events which may influence sources of supply as prices change.
- *Unexploited capacity and scale economies*: the need of exhausting own facilities by supplying related affiliates rather than going to open markets.
- *Transfer pricing*: the desire to evade high tax rates or to remit profits.
- *Government policy in home and in host countries*: the need of overcoming trade barriers such as tariffs, quotas or local content regulations.

However, this taxonomy accounts mainly for circumstances under which firms prefer a hierarchical control over the foreign partner by an equity involvement. It cannot sufficiently explain the proliferation of a network without or with only little FDI. To call into mind: co-operation in networks allows firms to manage a wide range of international activities through contractual rather than equity means.

In the following the focus is directed on four main strategic objectives for networking firms: increasing competence, reducing transaction costs, balancing common and diverging interests, and pooling and delegating risks. Their importance may vary from one case to the other. An eastern firm, e.g., might put significantly more emphasis on increasing its technological competence, while a western firm might be more interested in reducing transaction costs or pooling risks.

1 Increasing Competence

Firms forming a network aim to obtain competitive advantages by exploiting synergies through partnership. In a network, each partner principally benefits from other partners' strengths. This does not mean that benefits are always equally distributed. In networks partners are necessarily ranked in different positions according to their professional competence and economic power.

Basically, researchers who examined the state of the art of east-west co-operation tend to classify it as a valuable tool for upgrading competence. They find that the majority of firms under investigation has increased engineering capacity and productivity, product design and quality, delivery reliability and flexibility, brand image and firm reputation, financial capability, and, as a result, profitability. However, some re-

searchers counter that many firms have been degraded to "sub-ordinates" —

- carrying out the most simple tasks as "second-tier" or "third-tier" sub-contractor far below their technological capabilities,
- bearing higher risks than usually inherent in co-operating,
- obtaining prices and making profits much lower than normal.

They quibble that these firms have become an object for destroying rather than for building up competence [Sereghyová 1997a,b].

Critics raise a crucial problem. The unequal distribution of competence and power might lead to opportunistic behaviour of one partner on the costs of the others. Opportunistic behaviour cannot be completely excluded by a contract. In the end, co-operation within a network must rely on trust and fairness rather than on legal enforcement. Not surprisingly, many east-west business ventures are instable and fail. There is, however, no evidence that these relationships are more instable than those between firms located in western industrialized countries and partners in developing countries where failure rates of 30–65 percent have been reported [Beamish 1987].

2 Reducing Transaction Costs

Another motive for establishing a network type of organization is to cope with high transaction costs in complex production lines and markets. Traditionally, it had been hoped to solve this problem by centralized decision making within hierarchically structured organizations. However, centralization of control and co-ordination had often proved to be an inflexible and, hence, inefficient mode. The dramatic decline in information

and communication costs made contractual and collaborative agreements between firms an attractive alternative to equity control.

For many western firms, the CECTs are still a terra incognita — the search for a competent and reliable partner looks like a gamble. In such a situation, they must have a strong preference for stable collaborative relationships. A hire and fire strategy would be dangerous because it generates high search and exit costs. There is some empirical evidence that western firms prefer long-term relationships with partners in CECTs. They usually start with a flat venture in order to test the opportunities and the risks. But later on, they deepen it step by step. Permanent not volatile subcontracting is the predominant form of co-operation between foreign and local firms in CECTs [Grabowski 1997; Pellegrin 1997]. Stable and long-term relationships have an important advantage. They can limit or reduce transaction costs. Important factors in this context are frequent and intensive communication between all partners, significant investments by and management transfers from the western partners, and specific practices that build up mutual trust. Recent case studies by Dallago [1997], Papánek [1997] and Pellegrin [1997] provide ample empirical evidence that joint ventures between western and eastern firms performed along these lines have been very successful.

In this respect, the transaction costs approach seems to be a robust tool for explaining network operations — even when partners prefer contractual arrangements rather than equity control. For firms in CECTs, low transaction costs may become an asset when their advantage of low labour costs disappears in the years to come.

3 Balancing Common and Diverging Interests

In principle, firms co-operating in networks have common interests. However, they are often factual or potential competitors, too. Co-operation does not exclude competition, but at least gradually restricts it. Frequently, firms co-operate only in certain fields while in others they compete. Inevitably, they might run into conflicts when marking out demarcation lines. Collusions between producers linked in a network are a problem around the world.

As a rule, eastern firms are integrated as sub-contractors in vertically structured networks conducted by western firms. The share of contract work in total added values differs by type of industry and firm size; it is the largest in textiles and clothing for small- and medium-sized firms [Papánek 1997]. Basically, firms linked upstream in a network do not compete. However, they might hope to climb up the ladder at the expense of other partners. In essence, they are potential competitors, too.

In contrast to a hierarchical organization, where ownership matters and where usually only one partner makes decisions, the use of contractual arrangements provides some degree of freedom for all partners, including the exit option. This makes sub-contracting attractive for those firms which attach importance to their independency but do not want to follow a stand-alone strategy.

4 Pooling and Delegating Risks

Finally, firms organize their business in networks in order to delegate risks. In retailer-producer networks, e.g., retailers tend to use producers as buffers against unexpected fluctuations in consumer demand. In essence, they hold only small inventories — trusting that an ordered article

can be immediately delivered. Because of short distances to western markets, firms in CECTs might gain from competitive advantage against their main competitors in South-East Asia — provided they are able to adequately accommodate the orders of retailers.

In recent years, however, producers have started to re-organize their outsourcing chain by drastically reducing the number of suppliers. In this way, they hope not only to bring down transaction costs but also to pool risks: they tend to delegate most of the sourcing activities to a few so-called system-suppliers which operate at their own risk. In building up supply networks in CECTs, large western multinationals have often pulled their traditional main suppliers behind them. As a result, many local firms in CECTs have considered themselves as "downgraded" to the position of sub-ordinates. However, western firms have no choice. In order to promote comprehensive restructuring throughout the entire value chain, the know-how and experience of a proven system supplier are indispensable [Sander 1994]. In addition, there is nothing much to worry about: local suppliers are offered a "free-ride" on the learning curve. In this context, mention should be made that many western firms have now started to contract out sophisticated activities, including research and development, and to place them within their supplier park. This has increased opportunities for local firms to catch up, too. Once again: for most firms in CECTs the possibility of climbing up the ladder lies within the networks of western multinationals and not outside of them [Bellak 1997].

IV Obstacles to East-West Network Operations

Firms in CECTs are undoubtedly latecomers in the process of internationalization. In many ways, our appraisal provides evidence that there

are still many obstacles to closer east-west economic co-operation. These obstacles can be divided into three main categories: first, market and policy failures, second, management failures and third, different corporate cultures.

1 Deficiencies in Shaping Workable Market Conditions

In a well-working market economy, firms are expected to become optimally linked into the international division of labour by developing an adequate degree and adequate modes of cross-border operations in accordance with their competitive advantages. However, as a matter of fact, the markets in CECTs are still in a rudimentary state. In such circumstances it is questionable whether firms can respond quickly and efficiently in order to facilitate their restructuring and reorganization.

Most deficiencies identified in east-west network operations have to do with deficiencies in shaping workable market conditions. This is the case if governments impose or fail to remove

- restrictions on trade and investments,
- regulations in commodity and financial markets,
- exchange rate controls,
- excessive tax rates and double taxation,
- public or publicly tolerated private monopolies.

Evidently, institutional reforms, corporate privatization and restructuring, and macroeconomic stabilization in CECTs are far from being completed. If, e.g., firms lament that local banks refuse to fund risky though potentially big-return projects, then governments should straight away

liberalize capital markets. In essence, government failures bias the balance of costs and benefits of cross-border operations — and in most cases the bias is negative as to CECTs.

In order to promote east-west corporate networks, governments can do their best by shaping a sound regulatory framework supporting market efficiency [Sadowska-Cieslack 1995]. Experience has shown that those countries whose governments have striven for a liberal open-market policy are often those that perform well in the global economy.

2 *Insufficient Efforts in Developing Competitive Advantages*

Liberal western economists consider decisions with regard to internationalization as a commercial matter for firms themselves. In principle, markets provide enough incentives for making an optimal allocation of resources and capabilities. However, eastern firms find it hard to undertake the necessary steps to adjust their product range, technical capacities, sourcing and distribution facilities and organizational structures. As Aghion, Blanchard and Burgess [1994] have shown, there is an intertemporal problem in restructuring: it involves high costs in the first period while gains can be expected, if at all, only in the period that follows. This dilemma has considerably delayed deep corporate restructuring in all CECTs [Carlin and Landesmann 1997]. Many firms in CECTs, formerly large combines or parts of them, still suffer from excess capacity, overstaffing and inflexible organizational structures [Pellegrin 1997c]. They are anything but an ideal candidate for western firms in search of a network partner.

There is some evidence that eastern managers tend to overstate their resources and capabilities. In negotiations with potential western part-

ners, they often start with unrealistic expectations. Frequently, they can offer no more than idle plants. They hope to quickly become "upgraded" by a joint venture — but find themselves later "narrowed down" [Sereghyová 1995]. Sometimes, it happens that western firms underestimate the potential of eastern counterparts which still suffer from the negative image of the socialist past. However, their hesitant behaviour is understandable: reputation is a vital pre-requisite to successful co-operation in partnerships.

3 Existing Difficulties in Dealing with Different Corporate Cultures

Operating in a foreign country demands some country-specific knowledge. This can be expected to be high if the cultural environment — in this context the corporate culture, the organizational structure and the management practice in the home and in the host country — is similar. Although the geographic distance between western and central eastern European countries is short — Germany and Austria on the one side and Poland, the Czech Republic, Slovakia and Hungary on the other side are neighbours — and although these countries are closely connected by historical and cultural ties, after half a century of political division, differences between them appear to be greater than between western countries separated by a long distance. Kumar and Nti [1996] argued that businessmen coming from an individualistic and a collectivistic culture think very differently. In particular, they prefer different ways of dealing with a conflict: while individualists emphasize competition and tend to exacerbate the conflict, collectivists emphasize an accommodative strategy which tends to avoid or to smooth it.

Cultural discrepancies as a source of conflict are common. From the large body of case studies, there is evidence that western managers tend to promote a "strategic-active-deep restructuring" while their local partners like to opt for a "defensive-reactive-shallow restructuring" [Carlin and Landesmann 1997]. For promoting a joint venture, therefore, western firms frequently find it necessary to delegate their own staff to the partner's firms in order to reorganize activities there. Later though, if things run as planned, they withdraw their managers and gradually replace them by local ones.

The impact of cultural discrepancies on firms' strategies is a crucial issue which has been addressed in the literature in many ways. How managers transmit information, set targets, make decisions and deal with conflicts — all that is shaped by their cultural background. But congruence in objectives and strategies is an important pre-requisite to successful co-operation. Therefore, potential partners should find out in advance whether their objectives and strategies are likely to be congruent or different. If they are different, co-operation will sooner or later fail.

V Turning Obstacles into Opportunities in East-West Network Operations

The aim of our paper was to take stock of what has happened in the field of east-west economic co-operation — and to see how this fits into the new theoretical paradigms of inter-firm co-operation which frequently stresses flexible contractual relationships between market transaction and equity control. The books, articles and papers under consideration show that these new forms are a powerful channel for linking eastern firms into western corporate networks. The empirical evidence offers

support to the hypothesis that the balance of costs and gains of network co-operation is positive for them.

However, many an obstacle has yet to be removed before economies of scope from economic integration can be fully exploited. Only a limited number of eastern firms have already reached a technological and organizational standard that would make western firms regard them as competent, reliable and trustworthy partners. As Bellak and Cantwell [1997] point out, there is a "vicious development cycle": for eastern firms, it is often difficult to enter a network and to climb up within it since they would have to provide beforehand what they actually want to gain from such a network.

Nevertheless, it makes no sense to lament about this. What is necessary is to convert obstacles into opportunities. It is up to eastern firms and governments to go ahead with this.

The crucial question is what can and what should governments do to promote east-west network co-operation? Our appraisal has led us to making the following recommendations:

- *Correcting policy failure*: market liberalization is the most important factor to boost international business and trade. It opens market opportunities in domestic as well as in foreign markets. Liberalization focuses on removing or reducing
    - legal and procedural barriers,
    - tariff- and non-tariff barriers to goods and capital flows,
    - double taxation of profits,

- exchange rate controls.

Governments which are reluctant to introduce general liberalization can start with a limited and controlled experiment. They can establish special areas where enterprises are allowed to do their business as they like. Results from border regions [Sander 1997; Schmidt 1997; Hamar 1997b] suggest that Free Economic Zones provide enterprises with an ideal environment for cross-border operations. Beyond liberalization, private industrial parks can offer services which allow to overcome market imperfections.

- *Supporting public infrastructure*: great value should be attached to investing in public, and especially traffic, infrastructure. A modern transport and communication network can effectively reduce transportation costs which are natural barriers to trade. Moreover, eastern and western countries should develop efficient border crossing facilities after these had been closed for several decades.

- *Overcoming information asymmetries*: sophisticated sourcing of information and efficient communication are of vital importance for eastern firms. High-tech communication by Internet, E-mail and leased lines is still relatively poorly spread among them.

Thus, eastern firms frequently incur excessive costs for obtaining information which is indispensable in international business, such as information on actual market trends, potential customers, legal provisions or regulations with respect to trade, taxes, foreign exchange and foreign ownership. In principle, this kind of information is provided by commercial information services, thus available only on charge. Governments can help to make it cheaper by promoting in-

ternational competition among private information services. The business of private industrial parks, for instance, is largely based on collecting and, respectively, selecting the information relevant to foreign firms.

- *Building up firms' competence*: A concern of government policy should be increasing firms' international competence. These are often not familiar with the business environment abroad. They cannot easily cope with the attitudes of their foreign customers and intermediaries, and they have difficulties in understanding the foreign legal and regulatory framework. Finally, they find it hard to overcome the language barrier. In many instances, international competence can also be provided by private agents which have comparative advantages in this respect and find it profitable to specialize accordingly.

  Governments cannot directly eliminate the lack of competence. However, as long as private agents do not enter the stage, they can help firms to overcome their problems, e.g. by

  - supporting business advisory services as provided by chambers of commerce or so-called one-stop shops (collecting and providing business information in one single place),
  - initiating communication and collaboration activities among firms for sharing marketing facilities or delivery services,
  - promoting training initiatives to raise the level of sophistication in using modern tools for international business,

- enhancing capabilities for developing successful cross-cultural relationships, e.g., foreign language initiatives and trainee scholarship schemes.

- *Eliminating market failures in the banking sector*: with respect to finance, governments should give a good deal of consideration to design a regulatory framework which first is suitable to eliminate market failures in the banking sector, and which second is conducive to allowing private agents to remove market imperfections impeding firms' internationalization. It is true that eastern firms suffer from a lack of financial resources. But next to market failure and market imperfections, ill-designed rules — that is: government failure — may account for the largest part of their financial restrictions.

  In general, governments in transformation economies should consider

  - privatizing and liberalizing the financial sector in a comprehensive way, especially with respect to foreign banks,
  - setting up a legal framework conducive to developing a private venture capital market,
  - taking a subsidiary role only if private solutions do not work out within an acceptable time horizon or if market imperfections produce too high an obstacle for firms to surmount.

  In particular, governments should focus on

  - promoting private risk sharing by offering tax incentives to banks which participate in a private guarantee fund. Such tax incentives can be differentiated by enterprise size.

- promoting public-private risk sharing if a private guarantee fund cannot be set up. A public body could take over the risk premium private banks charge from firms, such that these only have to pay the "riskless" market rate,

- promoting activities of small foreign banks in their country. Small foreign banks can be the ideal partner to small service or manufacturing enterprises. An efficient instrument to promote them may be setting up a guarantee fund which compensates for the loss the small foreign bank may incur if firms fail. To ensure efficiency, however, it is crucial to charge a fee from banks which want to get the guarantee. The fee makes the bank weigh up if the credit risk is large enough to justify this expense or if the risk is relatively small and the bank would be better off bearing the risk on its own.

- offering public credits as long as either private or public-private guarantee schemes do not yet work properly. It is important, however, to offer public funds not as a gift but as an outright credit for which a fee, even if below market-rates, should be charged.

Beyond these specific measures, governments should take into account the close interconnections between real estate markets and financial markets. In particular, they should remove all restrictions to real estate ownership in order to encourage, on the one hand, the establishment of both banks and enterprises and to allow, on the other hand, real estate assets available to serve as one of the most valuable guarantees enterprises can offer to banks. Notwithstanding the role governments play in the face of large and long-lasting mar-

ket imperfections, they have to be aware that each market acting of public institutions is likely to crowd out private initiative. This may narrow the scope for efficiency-enhancing inventions made by private agents.

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