A COMPARISON OF FOREIGN DIRECT INVESTMENT IN BULGARIA, THE CZECH REPUBLIC AND SLOVENIA

Saul Estrin
London Business School

Xavier Richet
Universite Marne Le Vallee

June 1996

© London Business School, 1998
1. Introduction

In this paper, we summarise the findings from a series of twelve case studies of foreign direct investments by Western firms into state owned enterprises in transitional economies. The cases were undertaken according to a common methodology, reflected in a questionnaire and in a similar framework for all the case write ups. Four case studies were undertaken in Bulgaria, in the Czech Republic and in Slovenia respectively. The aim of the study was to throw light on the determinants of foreign direct investment into the region, and upon its impact on the recipient economies. The effects of such investments fall into two categories - upon the firm themselves and the broader economy, notably in this context on the process of transition from plan to market.

In the remainder of this chapter, we provide a comparative overview to the twelve cases. In the following section we briefly consider the country sample, and the differences in preconditions to reform and transition policies followed in Bulgaria, the Czech Republic and Slovenia. The third section analyses foreign direct investment into the transitional economies, indicating the scale of the flows as well as the rationale and possible impact. The lessons from the cases are summarised in the fourth section, which includes case summaries and an analysis by host country, donor country and sector. Policy conclusions are drawn in the fifth section. In the remainder of this section, we briefly review the methodology of the study.
1.1. **Project Methodology**

The project was centred around a common analytical framework, reflected in a questionnaire which was used in preparing all the case studies. Research objectives were to study the determinants of each investment, and the impact - both on the firms themselves and on the host economy more generally via spillover effects. The questionnaire therefore sought to distinguish between cost, market and strategic motives for investments, and to highlight the main "pull" and "deterrent" factors in each investment proposal, including the economic, political and institutional environment in each host country. The main impacts were hypothesised to come from technology transfer, management know-how and labour skills development. Key mechanisms were expected to be investment, training, reorganisation and the increased use of information technology. Relevant in the analysis were production processes and their technological levels, market structures in donor and host countries and the nature of supply relationships up and down stream.

Sectors were chosen for the study to ensure spread by size and industry, to reflect both the industrial status of each country and its technological skills. It was hoped that we would be able to keep two common sectors across the three countries - engineering, vehicles or pharmaceuticals and to allow for some country specific differences (e.g. food processing in Bulgaria, chemicals in the Czech Republic). Finally, of the four cases at least one in each country was to be small to allow some consideration of size effects. Lists of the major investments into each country were developed, and firms chosen approximately in size rank order according to the industry criteria. The refusal rate was quite high, no doubt reflecting exhaustion in many companies in the region with academic researchers. However, by intelligent replacement of refusals, the desired sectoral spread was still achieved.
The three countries were chosen to allow some comparison across the region in terms of pre-
conditions and progress in reform\(^1\). The Czech Republic is widely regarded as having made a
highly successful and rapid early transition from plan to market, as well as being able to exploit
its pivotal location at the heart of Europe. However, there remain serious macro imbalances
and difficulties in capital markets (see eg. Portes (1993), Mejstrik(1997)). Slovenia's high level
of development and sustained sound money policies have acted to offset many of the problems
associated with the disintegration of the Yugoslav federation, though the country is small as a
host for major Western investors (see Bohn (1992, 1993, 1994)). Finally among the ten
European Union Association Agreement countries of Central Europe (see Estrin and Holmes
(1998)), Bulgaria is regarded as one making slower progress towards a liberal market
economy (see Dimitrov (1997)). It was hoped that this spread of country characteristics would
highlight important variations in the nature and effects of foreign investments. We take up the
question of country differences in more detail in the following section.

2. Transition Shock and Macro-Stabilisation Programmes

The three countries in our project are small both in size and population and two of them share
a similar experience of being a new political entity formed by the disintegration of a larger
state. However there are many differences among them in terms of historical background,
comparative advantages of their industries, macro-stabilisation policy outcomes, privatisation

\(^1\) Progress in the transition process is surveyed annually by the European Bank for
Reconstruction and Development in their Transition Report, and was summarised over a six year period by the
World Bank in the 1996 Development Report, From Plan to Market. These reports provide a comparative
evaluation of macro economic, institutional and enterprise developments. This background information is
beyond the scope of, but of course relevant to this study. Hence interested readers are referred to these
publications as a starting point.
and transformation strategies, and these influence the speed of industrial restructuring, the
reorientation of their trade and their attractiveness regarding FDI inflows.

Two countries, Slovenia and the Czech Republic, were formerly regions (Republics) of
countries that were created at the end of the First World War. Previously, they had both been
part of the Western, industrialised and Austrian ruled part of the Habsburg Empire. In 1939
Czechoslovakia was ranked as the tenth most developed economy in the world (see Begg
(1991)) and the new Czech Republic (CZR) has became one of the more promising economies
in Central Europe. Slovenia used be to the most developed region of the former Yugoslav
Federal Republic; GDP per capita was by far the highest among transition countries, its
industries supplied the domestic Yugoslav market and exported towards
western economies a non-negligible part of its production. In quite different ways, both
countries have been affected by the disintegration of their former political and economic
entity, losing important commercial and industrial ties. Breaking their links with their former
counterparts, on the other hand, has helped them to stabilise, and to reorient their trade, if not
to restructure their industries. Bulgaria however, a late and surprisingly highly industrialised
economy under the former socialist system, was strongly integrated to the former
COMECON, particularly to the former Soviet Union (FSU); its economy has suffered much
more from the disintegration of its former trading partners.

The three countries had different experiences in reforming their economic system before the
final collapse of the former socialist system. Slovenia, as a developed republic former
Socialist Federal Republic of Yugoslavia, had an early experience of self management with
both negative and positive aspects regarding inside power of workers and managers (see
Estrin (1984)). Thus, from 1965 Slovenian self managed firms experienced market
mechanisms both in domestic and external markets; this has been a strong stimulant to enterprise adjustment, even if insiders have been able to maintain their stakes in terms of welfare provision and other collective consumption. Slovenia was also much more open than any other COMECON country. On the contrary, Bulgaria and the former Czechoslovakia had less experience in reforming their economy; they still remained strongly centralised and oriented towards the COMECON markets up to the end of the 80s, getting major contracts for imports to the FSU and receiving large subsidies. Their price structures were also heavily distorted and high barriers protected their industries from western competition.

Industries relied on different comparative advantages in the three countries (see Jeffries (1992)). Slovenian industry has developed a kind of international (western) comparative advantage, thanks both to its strategic situation and its level of development. Many Slovenian firms had developed industrial co-operation programmes from the sixties and the early seventies with Western partners, allowing them to have access to more sophisticated technologies, and paving the way to the creation of joint-ventures. Structural deficits in their exchanges with the West were balanced by trading surpluses with the other parts of the Yugoslav economy. This has allowed Slovenian industry to create niches in some sectors and to develop substantial exports of more sophisticated goods with advanced market economies. An important advantage of investing in the Slovenian market has been seen by many Western investors to be that it is a springboard to businesses in the surrounding markets.

Even if industrial co-operation with Western firms did take place in Czechoslovakia and Bulgaria, it was severely constrained by the bureaucratic organisation of the economy which left limited room for enterprises to experience autonomy in managing and in developing their own strategies. Under the socialist system, Czech industry lived on its traditions, favouring
routine procedures exploiting the craftsmanship, the quality of its labour force and tapping on its strong engineering tradition. As has been highlighted in a variety of studies (see eg. Gomulka (1986), Jeffries (1992)) the level of innovation remained low and concentrated on processes instead of on final products. However, the development strategy that Czech industry supported under planning (priority to heavy industry) did not destroy its industrial potential and in many sectors, Czech industry has been able to keep up and even up-grade to some extent, its technology or its products. For instance, Skoda has almost developed its models of cars virtually by itself while Polish or Russian carmakers have heavily relied on in technologies and design provided by their Western partner (Fiat).

Bulgaria started its socialist industrialisation from a far more backward situation. Its quasi integration to the FSU facilitated its industrial development on a large scale, with the setting up of big industrial complexes in basic and transformation industries, over-sized relative to its domestic market. In spite of heavy investments directed towards these industries, the level of qualification of the work force and the quality of the output remained behind the standards reached by in the socialist economies of Central Europe. The huge Soviet market, less sensitive to the quality of products, was able to absorb this supply from the Bulgarian market. For these three countries, the disintegration of their domestic market (for two of them) and of the former COMECON market have hit them more strongly than the more open and more Western oriented economies such as Hungary and Poland. In this respect, Bulgaria has been more affected by the collapse of the COMECON than Slovenia and the Czech Republic have been by the splitting up of their federal links. Macro-stabilisation policies and institutional reforms implemented after the systemic changes in the early 90s have produced different outcomes. The three countries have implemented macro policies in a context of brutal changes which have strongly affected the performances
of these economies. As can be seen in Table 1, the last seven years has seen a massive recession in which GDP and industrial production fell by at least 20%, and much more severely in Bulgaria. Slovenia and the Czech Republic are now growing once again but Bulgaria has returned to recession. At the same time, unemployment has increased enormously (though by less than in Czech Republic) and the rate of investment has declined.

The evidence suggests that firms have begun to adjust, passively in most cases due to the lack of financial resources and to the high degree of uncertainty; other have undertaken their restructuring, among them firms with a strong comparative advantage, by seeking to develop partnership links with western firms (see Estrin et al (1995), World Bank Development Report, (1996)). Restructuring, either passive or active, took place while industrial production was strongly declining. GDP and industrial production growth has resumed, indicating that macro-stabilisation measures have had strong effects on the adjustment of firms, and on the development of de novo enterprises, even if some strong imbalances still remain. The rate of inflation remains quite high, however, especially in Bulgaria and indebtedness of firms and the weakness of financial institutions slow the financial restructuring of firms (see World Bank Development Report, 1996).

Concerning macroeconomic issues, each country has achieved some important objectives after facing the transition shock; inflation has been curbed, growth has been restored the level of public debt brought under control, at least in the Czech Republic and Slovenia. These two countries indeed are probably closer to the convergence criteria of the EMU than many actual members of the European Union, though Bulgaria is still facing serious structural imbalances, eg. high rate of inflation, slow growth and structural deficits. Import elasticity, in the context of changing foreign trade patterns, is high and has had a negative effect on the current account
balance of the Czech Republic, and of Bulgaria while Slovenia has accumulated reserves which have contributed to a strong appreciation of the national currency. Slovenian exports are presently driven both by a mix of price and quality effects, which correlate the strong relative comparative advantage of this economy. Thus two of the three countries, are at last now on the growing side of the J curve, perhaps partly in response to the depreciation of their currencies. However, Bulgaria’s progress of 1994 and 1995 appears more recently to have been reversed.

In Table 2, we report a summary of progress in various macro-economic and business environment indicators. Institutional reforms have clarified the participation of foreign investors in the privatisation of State-owned enterprises and bankruptcy laws have been passed, though they are only partially or recently enforced. Privatisation strategies were not however specially oriented in order to favour inflows of foreign direct investment. In the Czech Republic, one aim of the privatisation programme was on a wide scale to transfer ownership to the population (indirectly via national-owned investment funds) in order to create a so-called popular ownership. It is important to realise that in the first instance, this approach excluded foreign ownership, for understandable reasons (cheap value of national assets, problem of the former German minority, nationalist attitudes on the eve of the splitting of the Federation). Some strategic businesses have been allowed to look for foreign participation but FDI was not initially used as a tool to boost restructuring (see Estrin (1994)).

Adjustment of firms relied mainly on the old management teams. The Czech Republic has now mostly achieved its privatisation programme but restructuring of firms started later. Corporate governance of the new privatised firms, perhaps with the exception of the few firms controlled

---

2 As has been suggested in the case of Hungary - see Estrin, Hughes and Todd (1997).
by foreign investors, is still relatively weak as most of the new Privatisation Investment Funds had no experience of controlling and monitoring complex organisations in a market environment. As reported in Estrin, Hughes and Todd (1997), macroeconomic achievements fuel the inflow of FDI in the country; Table 3 shows that after Hungary, the Czech Republic has attracted the largest share of FDI in Central Europe.

In Slovenia many firms have undertaken restructuring without government or foreign intervention, and the assets of some strategic businesses have also been sold to foreign investors. But the Slovenian government has repeatedly delayed its privatisation programme. It has been reluctant to proceed along the Hungarian path for nationalist reasons, reinforced by the small size of the country and by the importance of stakes of workers in state owned enterprises (SOEs), an inheritance from the Yugoslav self management system. The privatisation programme, by selling shares to workers at discounted prices, favours insider-controlled firms.

In Bulgaria, the privatisation programme has been postponed several time by the different governments reluctant to proceed on the sale of state assets because of the threat of the former communist apparatus regaining its power by bringing back perhaps in part liquid capital that had earlier evaporated from the country. The new post-socialist majority that came to power in 1995 has also been cautious to avoid a loss of control of so-called strategic assets. The extent of the economic crisis, however, with a sharp decrease in industrial production, the collapse of the former COMECON and a lack of financial resources have finally pushed the Bulgarian government to adopt a mass privatisation programme based on the Czech model. The scale of the transition shock and the delay in the implementation of deep institutional
reforms have severely limited the extent of restructuring.

In summary in the early phase of transition none of our three sample countries used forms of privatisation particularly conducive to foreign direct investment. However, the focus has shifted more to favour strategic foreign partners in both the Czech republic and Slovenia now, though rather less so in Bulgaria.

3. **FDI, Speed of Adjustment and Rationale for Investing**

3. 1 Flow of FDI

As can be seen in Table 3, the three countries have not received large sums in total during the past five years, with a strong asymmetry between countries. Per capita, the Czech Republic and Slovenia have a similar amount but Bulgaria has a stock which is five times smaller. The Czech Republic is second to Hungary, which, up to now, has received the lion's share. In spite of these differences in volumes, the three countries have had an irregular flow of investment year after year which has recently strongly increased. Often a few big investments realised in one shot are larger than the sum of other investments represented by small projects. This has been the case with FDI in automotive industry in the CZR, Hungary, Poland and Slovenia. The same comes from the progress in privatisation policies. For instance, in Hungary, the privatisation of public utilities in December 1995 has brought in more money in one month that during the past two years. According to projections, this trend in the increase should continue until the turn of the next century with three countries leading the others, Hungary, Poland and the CZR. The growth of FDI is projected to be being constrained in Bulgaria by the economic uncertainty about the future of reform.
3.2 Rationale for investing in CEE

Different factors push enterprises to move and to organise their production in other countries, and we attempt to summarise these in Table 4. "Pull" factors and deterrent factors are at work in CEEs but some are more important than others such as factors costs, skills, market and eventual vertical integration or integration in the world economy. With respect to market shares by entrant enterprises, three approaches can be witnessed:

- penetration of local markets; this strategy being repeated across the region (beverage, tobacco, consumer goods),
- penetration of one domestic market with the aim of conquering neighbouring markets (electronics, finance)
- market penetration and integration strategy into the global economy (car industry).

In the three cases, the strategic move of incoming firms threatens local firms, as well as at least some parts of the internal coalition of the firm (insiders), and other competitors (followers) which have not been left enough room to enter the market. The strategy followed by Volkswagen in the Czech Republic highlights this point. Volkswagen negotiated directly with the Czech government as well as the management and labour of Skoda and has committed itself to the purchase with a high price plus investment promises far in excess of offers proposed by others car makers. This closed off the possibility for competitors such as Renault to enter the market at a low price\(^3\). The other objective of Volkswagen was to

\(^3\) However, in the fall of 1995 Opel and Fiat started "a price war", i.e. selling their two models at a price lower than that of the Skoda Felicia. The interest of local customers has been very high. An agreement with the only other
integrate Skoda into the global economy, by restructuring the firm and its affiliates in order to meet world competition⁴.

Firms whose strategy is to penetrate domestic markets (consumer goods, beverages, electrical industry) seek to reach a monopolistic or oligopolistic position (Nestle, Schlumberger, in Hungary). Schlumberger, a French multinational which has acquired the majority stake in the Hungarian firm Ganz Meter, has also bought the company in charge of measuring the consumption of electricity in Hungarian cities. The control of domestic firms by Western investors has been argued to facilitate and speed up their restructuring and their return to profitability. Several case studies conducted in Hungary (Lakatos & Papanek, 1994) have shown the existence of a strong correlation between the mode of control, flows of exports and profitability. Generally, firms with foreign capital are more profitable than local firms without foreign participation or oriented towards the domestic market. 100% controlled enterprises or those with majority foreign participation are more profitable than enterprises with minority stakes or oriented towards domestic market. In the first case, global integration and flows of exports are higher; in the second case, and especially in the third one, profitability is linked to the level of internal demand which is presently stagnating. We will return to these issues for our sample countries in the fourth section.

FDI has a strong effect on the adjustment and the behaviour of firms even if, as several case

---

⁴ In this respect, Renault has followed a similar approach in Slovenia. Although the initial investment was intended to take market shares in the Former Yugoslavia, the joint-venture has been able to switch its sales to Southern European markets (Italy, south of France); the subsidiary, like Skoda has rapidly become one of the most efficient units in the group.
studies have concluded, Western investors are facing serious difficulties in implementing their programme (see Estrin, Hughes and Todd (1997)). Genco & et al, (1993) reviewed internal and external factors that hampered the adjustment of foreign owned or controlled firms FDI in different countries. Seven factors have been highlighted by this study, the importance of which might differ according to countries and sectors:

- Problems relating to the weakness of the infrastructure and production system,
- Manpower problems,
- Lack or weakness of commercial channels,
- Companies' organisational problems,
- Financial problems,
- Problems with local partners or due to "red tape",
- Problems relating to uncertainty in the legal-legislative framework or political instability.

Restructuring of firms starts with the reorganisation of production lines, often by reducing the product range in order to attain minimum efficient scale, the development of marketing, and accounting departments and the development of new links with suppliers and distributors. It has also a financial dimension with the settling up of bad debts. This point is generally resolved during the negotiation of the deal with the government agency in charge of selling off public property. Restructuring affects production upstream and downstream. In the automotive industry, local sub-constructors are put under pressure to adjust quickly in order to reduce production costs of the supply of parts (Volkswagen in Czech Republic, Renault in Slovenia, Ford in Hungary). In the case of strategies promoting the extension of market shares, the incoming firm may try to reinforce links with local suppliers to avoid their control by foreign partners. The control of local enterprises has allowed a reduction in the range of
products that could compete with products made by Western firms. This is the case of General Electric with the control of Tungsram, or Schlumberger in Hungary, where, in the first case, production with high added value has been abandoned, and, in the second, the Hungarian branch was not allowed to ship its production to markets where the mother company already had a dominant position. In the paper industry in Hungary, the Austrian investor rapidly closed down the operation of the firm in order to eliminate a potential competitor. In Slovenia, the new Italian owner of a paper works has quickly integrated the Slovenian asset by transforming it into a functional division.

For some multinationals, an investment in one country is the starting point for further investments in the region, by taking advantage of the former links developed by the local firm as in consumer goods (Electrolux) or electronics firms (Bull, Siemens).

4. **New ownership and restructuring of firms.**

4.1. **Lessons from the cases**

The cases were realised through interviews and questionnaires in twelve industrial enterprises in the three countries which allow us to make some interesting cross-sectoral and cross countries comparisons. It highlights important questions on how the acquisition and the co-operation have developed after the foreign acquisition or involvement, notably with regard to technology and know-how transfer, the speed of restructuring, the up-grading of such functions as marketing, accounting, strategy. It is clear, on the other hand, that the modest sample of firms does not allow us to draw general statements. Our discussion is centred around the summary of findings in Table 5.
The enterprises selected operate in eleven industries belonging to two broad sectors: seven enterprises in intermediate products and five in final goods. The break down by nationality of owners shows a majority of Western Europeans (2.5 Germans, 2.5 French, 1.5 NL, 1 UK, 1 Swiss, 1 Italian, 1 Danish), the rest, (2.5) being US owners. One international bank, the EBRD, is also involved in minority control of a firm\(^5\). The twelve firms have several features in common.

All the East European firms had achieved a certain minimum level of technological competence (one, a Slovenian firm had even overtaken its foreign partner in term of innovation!) which made them appealing to foreign investors; they had a relative comparative advantage, capacity to export and to co-operate with western firms. Nevertheless, they believed that they could survive by themselves in the new open, competitive, market environment and they needed to have access to the factors that they lacked, such as: technology, cash, managerial know-how and marketing. Most of the enterprises in our sample are in a monopolistic or oligopolistic position on their domestic markets. In Slovenia, one already had co-operation links with their partners. All enterprises were lacking financial resources and were unable to obtain funds from domestic capital markets. The search for a foreign partnership had been accepted in the early stage of the transformation policy, even if it did not fit with the national privatisation policy.

Workers in the sample firms were for the most part well paid, compared to the wage level in their industry and/or in the region where the business was located. With the exception of one or two enterprises, redundancy has not been an issue in these cases and the restructuring

\(^5\) The use of decimals reflects the fact that one firm can be purchased by several owners (generally two) of different nationalities.
which has followed the take-over has handled this question smoothly. The work forces have been retrained, and there have been particular efforts with middle and higher management.

Restructuring has taken place quickly in these cases through the speedy implementation of a variety of measures such as up-grading product quality, reducing the range of products, reorganising the different functions inside the enterprises, training the work force and developing sales departments. Productivity objectives have been attained without decreasing the level of wages. Generally, the control of firms by the foreign owners has been quite lax in terms of monitoring, the extent of centralised decision-making and the presence of expatriate managers, [with the exception of two enterprises, Skoda in the Czech Republic and Sarrio in Slovenia]. Strategic decisions have been taken at headquarters but routine operations have been left relatively autonomous. New forms of reporting (accounting, financial) have been set up however.

Once the rules under which enterprises could be acquired by foreign owners and the list of firms that could be sold were formulated, host governments in the former socialist countries have also not been intrusive. Where they have received stakes, they have behaved as minority share holders, avoiding shadowing the role of the majority owners. This is true for all three countries and occurred even when problems have arisen because a buyer, such as Volkswagen, did not entirely fulfil to what it had initially proposed in terms of investment. The threat of divesting into another country (Mexico) was sufficient to moderate the Czech partner. In almost all cases, the negotiation about the sell-off (price, level of assets to be sold) has been conducted at Ministry level or by the agencies directly in charge of promoting privatisation. This has had a positive effect on the work force and particularly managers.
From the information provided from the questionnaires some interesting correlations can be drawn from the cases. Germany has realised the highest level of investments, mostly capital intensive, [principally in the Czech Republic, and in Slovenia], followed by France. As can be seen in Table 5, the cost motive for investing has been quite significant, notably in the automotive and transformation industries; it is second to the motive of market penetration however. In some industries, a strategic move by the foreign investor can be considered as the primary motive (automotive, paper, tobacco). For final goods, the most recurrent motive for investing seems to be market access, which can be associated with strategic motives in some cases (automotive, tobacco).

The twelve enterprises can be distributed into medium and low technologies sectors. High technology industries fall under the denomination of "strategic industries" and with the exception of telecoms these appear so far to have been less likely to have been sold to foreign companies. The cases suggest that foreign partners did bring to their new partners what they had been principally looking for: technology (process, product and organisation), know-how and, to a lesser extent, cash and market access for their products.

After the change of ownership and the start of restructuring, however, firms have only performed moderately. Firms that displayed a good performance previously (Kolektor in Slovenia) seem to have been restructured more easily. The same appears to apply to smaller companies, where presumably the problems are less severe. Skoda is an exception; the organisation of the firm has been shaken up and reorganised in such a way that productivity has risen quickly. Otherwise, two conclusions can be drawn concerning this point:
- restructuring is time consuming; the more specific is the asset is the longer it takes to adjust and to solve problems arising in the process.
- rapid return on capital and short term profitability have not been the main concern for foreign investors in our cases. Nevertheless, the reorganisation and the development of new functions (such as marketing, quality control) have contributed drastically to improvements in the situation.

4.2  **Asset specificity and adjustment of firms**

The speed and range of an enterprise's adjustment depends on several factors such as the control of owners and creditors, the relative power of insiders, market structure, the nature of the product and the level of competition in the market. The enterprises from our sample adjust differently according to the relative importance of these factors.

4.2.1.  **Intermediate goods sector**

- **Biterm** is a small Slovenian enterprise specialised in the production of thermostats for the fridge industry. It is a low-medium technology product. It only employs 64 people including white collar workers. It is a quasi-integrated unit to its mother firm, Gorenje. The joint-venture was created in 1994 but the parent firms have co-operated since 1985. It is a single product firm operating on an oligopolistic market. 75% of its assets belong to Gorenje, a Slovenian industrial firm and a minority stake of 25% to a Danish company, Danfoss. The company has attained its minimum efficient scale of production. The Danish firms is supplier of its inputs and buyers of its output. The Danish company provides only in-kind contributions and a loan as guarantee capital. For Biterm, forming a joint venture was
necessary to get access to technology and know-how; for the foreign partner, the participation in the assets of this company helped it to reduce costs and offered a springboard to extend its market shares in Eastern Europe and in the EU. The primary motivation of the Danish firm was to export kits at specific transfer prices. The foreign company brought technology, new products, capacity utilisation, management and training. It has signed different kind of contracts; one for the kits that the foreign partner sells to the subsidiary, another for the subsidiary's product which is sold back to the Danish firm.

Production has increased since the joint venture was set up; marketing is not an issue as the output is directed towards the parent companies. Routine operations are run autonomously. There is no formal R&D at all and financing is internal. Danfoss can take full ownership when the former market in the former Yugoslavia opens up. In only a few months, the investment had positive effects on productivity and profits. Training of the work force has been successful and wages have increased. Nevertheless, if there are technology changes in the market, the firm could be in jeopardy since the company only produces one product and has no access to R&D. The specificity of the asset and of the product explain the successful short-term restructuring thus far.

- **Kolektor**, a Slovenian firm producing commutators (medium technology), is an atypical case. It developed a co-operative agreement with a German firm, K&B, from 1968. This was later taken over by an American company, Kirkwood, when the K&B went into financial difficulties. Kolektor, under this partnership, is enjoying a quite large degree of autonomy due to its management skill and its relatively high level of technology. Several of its products have reached international standards. In 1995, the company was nominated as the best supplier by the French firm Valeo and the American firm, United Technologies. Kolektor has
20% of the European market and exports 85% of its production. For Kirkwood, the interest in maintaining control over Kolektor is to have access to the European market and to the technology supplied by Kolektor. For Kolektor, it was (with the former foreign partner) the opportunity to have access to western technology and markets and to obtain finance. The success of this joint-venture, in addition to the high skills of the management can be explained by a variety factors: the initial comparative advantage of Kolektor on its market, the relatively strong competition that exists on the automotive spare parts markets, and the ability of Kolektor employees to appropriate and enrich the available technology.

- **Sarrio** is a Slovenian company producing carton-board. The company was heavily in debt and was not able to invest. The firm has been sold to an Italian investor, Saffa. Geographically, the site was near the Italian border and the capacity of the firm was such that the company could be transformed. The company was been sold through a bid and Saffa offered considerably more than their rival who competed in a tender. Saffa had four main objectives: to reduce significantly the number of employees, to unbundle activities that were not directly connected to the main business of the company, to improve the quality of management and production and to transfer its culture to Slovenian employees. For these purposes, Sarrio has been centrally managed and integrated into the corporate culture. Sarno is now a functional division of Saffa; the company has to produce monthly reports and annual plans for the head office.

The work force been reduced and some activities unbundled through externalisation of assets that have been taken over by workers. The quality of the processes and of products have increased. Relations with suppliers, due to the fact that the company was not a good payer, have been difficult to build up. Investment in new machinery has helped to rationalise production.
The company exports 60-70% of its production, the same level as before. Restructuring has been long and costly; the Italian company has brought equipment and cash, has reorganised production and control of operations. Performance is still only moderate even if profits are up; sales have not increased though margins have now improved.

This case is a more typical one: weak performance, financial difficulties, an oligopolisitic sector, and medium technology.

- **Linde** is a Czech company producing industrial gas with two plants. The company was first transformed from a State-Owned Enterprise to a joint-stock company owned by the National Property Fund and then 51% of shares were sold to the German owner. Linde has since brought out the remaining shares. The foreign partner has brought technology, know-how and training. For the Czech company, the search for a foreign partner was to obtain finance and know-how, mainly in marketing. For the German investor, the Czech firm was chosen because of the quality of the work force, its high market share and the distribution network that was already in place.

Linde was chosen because the Czech company had a similar corporate structure and because Linde brought substantial financial reserves. Linde created a sales centre; the distribution network has been enlarged and extended. The subsidiary is responsible for most other activities and decisions are made by mutual agreement.
Linde has expanded the companies’ activities in the Czech Republic away from gas to the food industry and water treatment. It has improved quality, monitoring, selection and testing. The process of adaptation to the new market is going on; the work force is more highly motivated and flexible; however the rate of return remains low due to the time necessary to bring to maturity the development of new activities.

- **Temace**, was one of the most modern companies in the Czech Republic producing sealing products. There were two alternative ways discussed by the managers to privatise the company. The first was to look for a foreign partner that would provide access to new technology which did not involve asbestos and markets. The R&D laboratory of the subsidiary has expanded, which is quite a unique phenomenon! The second was an internal and domestic alternative: relying on the personal resources of employees and domestic capital. The foreign company, from the Netherlands, was motivated by market shares and cost advantage and the quality of the workforce. An asbestos free production line has been transferred to the subsidiary and also some R&D activities. Some production has since been transferred from the partner to the subsidiary.

Since the acquisition, production capacity remains at the same level but quality has improved and new products have been introduced. The company should be ready to supply a growing market in Eastern Europe for asbestos related technology. The restructuring has been smooth, due to the quality of the enterprise (product, organisation, qualification of the work force, know-how) and the convergence between the enterprise’s aims and those of the foreign investor.

- **Vidima Ideal** and **Berg**, in Bulgaria, are two small enterprises that have created joint
ventures with Western firms. The first is with an American and the second is with a Swiss company, each mainly from the Western point of view for cost reasons but partly also for access to the domestic Bulgarian market. Vidima Ideal produces final and intermediate products, and Berg, intermediate products. The foreign investor brought financial resources, managerial know-how and, training. Performance levels are quite good but they can easily be explained by the small size of the investment and the relatively modest level of technology involved.

4.2.2 Final goods sector

- Tobacco Ljubljana was the first foreign direct privatisation in Slovenia. The Slovenian company wanted to develop a good product to survive; it had to develop new sales and marketing techniques. Reemstma, a German company faced international competition from Phillip Morris, BAT and Rothmans. It chose to co-operate with SEITA\(^6\) in order to compete more effectively. The investment was made to obtain market share; it was also a strategic move in order to block the entrance of other competitors. Several factors explain the rapid drive of major transnational tobacco corporations towards Eastern markets: the strong legal constraints on consumption of tobacco products in the West, as yet not so severe in the East; the low and medium quality of Eastern tobacco products; and the huge demand in the region for higher quality. Reemsta has an orientation toward CEE and is the largest independent cigarette manufacturer. Its intention, when acquiring the Slovene company, was to supply the whole Yugoslavian market. The Slovene firm has anticipated a change in tasks and has developed its own light cigarettes. The German partner has transferred technology and know-how plus working capital.
The development of this co-operation was successful overall, though not without a problem. First, the loss of the Yugoslav market had negative effects on the performance of the joint venture. The introduction of new brands (German and French) created a crowding out effect for the Slovenian products and hindered the development of an up-graded Slovenian brand. The Slovenian government has also put higher taxes on the price of cigarettes and is claiming for taxes not paid before the creation of the joint-venture.

- **Prazske Pivovary** in the Czech Republic is an old brewery located near Prague. The products have a good reputation but the company lacked the financial resources to modernise and to expand exports. The British brewing firm, Bass, has taken a participation (minority stake) in the company, both to get access to the domestic market, to take market share and to export Czech beer to the West (mainly the UK). The foreign partner brought markets, advertising skills, sales and marketing and transferred managerial know-how and technology. There have been no major technological changes however, only managerial and organisational ones. Up-grading quality, controlling costs and strategic planning for exports on the one hand, and the opening up of new markets, on the other (mainly in the UK), have contributed to increased profits.

- **Zagorka**, in Bulgaria, is also a brewery which was loss making. Losses increased with economic transformation for lack of financial and managerial resources. The company has been transformed into a joint-venture with Heineken and Coca-Cola which have a long experience in restructuring local firms that they acquire by bringing in capital, equipment, sales and delivery, and through aggressive advertising. The pace of restructuring was generally quick and profitable. The cost of penetrating the market and reorganising is low in

---

6 At the time of the acquisition, it was still a French state-owned enterprises. It was privatised in 1995.
this industry.

- **Skoda**, in the Czech Republic, is a well-known and well studied case. It is a big, one-shot, direct investment which has given to VW the majority of market share in the Czech Republic (and Slovenia). Using its monopoly power, VW has obtained from the Czech government higher tariffs in order to protect its market share (as did all other car-makers who have invested in the region (*Transition Report*, 1994)). But the VW strategy is not limited to the Czech market; its aim is to integrate Skoda as one part of its globalisation strategy, both on Western and Eastern markets. The restructuring of the company, which has been successful, has three priorities: quality, price and service. Co-operation with the suppliers, is important in this industry. One of its effects has been to externalise many of its activities, pushing former suppliers of Skoda to join an integrated scheme in order to reduce costs, stocks and to produce on a just-in-time basis. Upstream Czech companies working for Skoda have been obliged to join with Western suppliers of VW in order to reduce costs by attaining the minimum efficient scale required in their business. More than 33 joint-ventures have been created in the Czech Republic, including with German, French, Italian, American and British investors. Today Skoda is a springboard of VW for its development eastward: assembly lines are operating or are being built up in Poland, where fierce competition is going to take place for this big market, and in Belarus and Russia where labour costs are still very low and the demand for cars will grow dramatically in coming years. Quality and cost improvements have been demonstrated with the launching of a new model, the Felicia, which is produced to Western standards at similar or even lower cost level. Skoda is considered today the most

---

Apparently however the import content is very much higher for this new model.
efficient unit of VW. Even if wages are 25% higher than the average for the Czech industry, they are still ten times lower than in the Germany.

- **Danone Serdika JSCo**, the Bulgarian food processing firm, has been taken over by the French transnational corporation Danone. The firm produce dairy products, and yoghurts, for which Bulgaria has a long standing reputation. It is a challenge for the French company (which is already present in other transition economies) to show that it is possible to produce yoghurt of Western quality. Danone has 53% ownership and EBRD is a sleeping partner. The company, under the former socialist management, had no profit maximising strategy. The company was located near Sofia, supplied by State farms and selling at controlled prices. The French company is looking for increased market share and has brought new machinery and cash to the venture. Capacity in the plant has increased, as has employment from 100 to 200 people. Nevertheless, in spite of the profitability of the business, the company is facing many problems:
  - the Bulgarian government is threatening its expansion. It has to give its agreement for the expansion of a foreign company in this sector,
  - the government is putting ceiling prices on food products, reducing the margins,
  - the supply of fresh milk is difficult to organise as former state farms have disbanded, the cattle stock reduced by more than 50% and the supply chains have been severely disrupted. The company has to construct a supply network and to contract with farmers with more than 20 cows, supplying them with tankers. Downstream distribution is another problem.

The company has succeed in improving shelf life from three to ten days.

5. **Conclusion**
Although it is difficult to draw general conclusions from only twelve cases, this research has allowed us to highlight some interesting points concerning the motivation and expectations of foreign investors, the behaviour of enterprises under the new management, and the main difficulties in restructuring firms.

The most important conclusion is that the pace of restructuring relies on a variety of factors, notably the nature of the product, the relative power of insiders and the structure of the market. We find that there is a clear relationship between the sector and industry under consideration and the motive for foreign investment; cost factors are important in intermediate production while strategic and market share factors are crucial in final goods production. Unsurprisingly, strategic factors are of particular significance in sectors where the foreign firms are operating in oligopolistic markets. However, there is no particular relationship between the country of origin of the investment and the motivation to invest. Moreover, the bulk of the firms in the study have low or middle technology; here we consider no technological motivation behind FDI. From the perspective of the host companies, the Western investors typically brought technology, and know how. Market access and cash were sometimes also important factors, especially in the case of the final products. There seems little host country variation in this finding.

Turning to performance and impact of foreign direct investment, there is again a sharp distinction between intermediate and final goods. The former sectors take longer to restructure, with their assets being more specific and the return on capital being slow to increase to Western levels. In the final products, the cost of turnaround seemed to be lower and the attainment of profitability more rapid.
With regard to the three countries in our project, incentives to invest by Western firms were more closely strategic in the more developed and larger countries. In the less advanced countries, Western firms took fewer risks, sunk less costs and chose projects of a smaller size and less-asset specific in character.

The project isolated some important externalities from FDI. First, foreign firms do appear to bring some of the elements in short supply in transitional economies - technology, financial resources and managerial know-how, notably in areas like sales, marketing and accounting. Acquisitions were followed relatively rapidly by an upgrading of product quality and manufacturing methods in most cases. The acquiring firm also in some important examples exercised pressures up-and down-stream to raise product quality and production methods.

However, the foreign direct investment process does not bring only advantages to the recipient country. The overall effect on the balance of trade may in some cases be negative because foreign owners are sometimes motivated to increase domestic rather than global market share, yet tend to rely more on their traditional home based (imported) suppliers.

8 In the case of Kolector however, it was the Western firm that was interested in the Slovene technology.
From the perspective of the investing firms, investments in the region appear so far to have been only modestly rewarding. One reason is that earlier investments were often motivated to obtain market shares across the region, for example throughout the former Yugoslavia objectives that became infeasible for political reasons. The variance in performance however, does not appear to be well explained by sector or country of investment.
References


