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The Integration of the Supply Chain: Rationalization vs. Synergy

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Abstract

Management can improve results of enterprises, above all, by an innovative re-allocation of available resources and a synergetic integration of their working. A significant factor of the quality of management in enterprises such as business systems (BSs) is their restructuring by an innovative integration aimed at achieving better business results through synergetic effects. BSs can improve cooperation between their parts or their cooperation in broader integrations. Our research is focused on the supply chain (SC) as an instance of a possible integration of logistics in or between BSs and on the economic reasonableness of their participation in an SC, aiming to take advantages of value chains. In practice, each BS can create its own SC or can participate in broader SCs. For that reason, the economics of the participation of a BS's parts in an SC, and BSs as parts in broader SCs, are considered. Additionally, the business processes of an SC are examined as the cybernetic entities of the basic, management, and information partial systems of the participating BSs. To create an integration process, the concept of Business Re-Engineering, which enables the simultaneous realization of both rationalization and synergetic effects and their direct support to the creation and exploitation of a competitive advantage of value chains in an SC, is applied.

Keywords

Management; quality of management; innovative restructuring; integration; synergetic effect; rationalization effect; business re-engineering; value chain.

Introduction

The restricted availability of resources and severe conditions of operation determine the opportunities of enterprises as business systems (BSs) to achieve their competitive business results (Harman & Porter, 1997; Fly & Stoner, 2000; Jennings, 2005; Daft, 2009). Numerous management solutions have emerged in recent years as a response to competitive pressures calling for an improvement of operations which BSs can provide the required business success through (Wren, 2004; Mullins, 2007). Despite the relevance of the improvement of operations, there are limited research pieces of evidence about innovative management solutions aimed at holistically considering BSs' management (Wren, 2004; Jennings, 2005; Quick & Nelson, 2009) and corresponding management concepts behind them (Daft, 2009; Certo & Certo, 2011).

A significant improvement of a BS's results is possible to make when the business operations of such a BS are holistically defined – i.e. defined from essential aspects, their relations and synergies (Galbraith, 2002; Mulej, 2007; Quick & Nelson, 2009). Management's innovative measures of the re-allocation of available resources of BSs are especially important – as a creative destruction of the current business factors and structures, and their replacement by more innovative ones, and a synergetic integration of BSs' working – as possible solutions for the optimization of the existing capacities (Potocan & Kuralt, 2007; Potocan & Nedelko, 2014). When linking the re-allocation of available resources of BSs to a synergetic integration of BSs, we are focusing our research on the restructuring of the existing operating of BSs by an innovative management of integration aimed to lead to better business results through synergetic effects.

BSs can improve cooperation in the frame of the internal or the external environment (Drucker, 1990; Fly & Stoner, 2000; Galbraith, 2002; Jennings, 2005). Consequently, there are close links and synergetic inter-dependences between BSs and their environment that lead to the creation of various kinds and types of integrations between BSs. In the current business environment, a very promising solution for the improvement of a BS's economic results is derived from the supply chain (SC) as a system (i.e. a complex network) of organizations, people, activities, information and resources involved in moving products or services from suppliers to customers (Bowersox et al., 2012; Gibson et al., 2005). In practice, on the base of its interest and possibilities, on the one hand, and demands of the environment, on the other, each BS can choose appropriate ways and forms of its participation in an SC from the creation of its own SC to participation in broader supply chains (SCs).

Previously conducted management studies of SCs have led to the growing interest of a BS in referring to various methodological, content- and circumstances-based solutions concerning economic results of SCs (Mentzel et al., 2001; Lambert et al., 1997; Chopra & Meindl, 2015). Empirical studies, though, reported contradictory results regarding: (a) the possible goals, approaches and characteristics of the several forms of SCs; (b) the possibility of the integration of an SC in or between BSs and (c) the economic reasonableness of BSs' participation in SCs, aiming to take advantages of value chains (Stevens, 1989; Lambert et al., 1998; Goold & Campbell, 1998; Stevenson & Spring, 2007).

This article addresses controversies in considering the innovative management of SCs' integration, which characterizes the systemic approach and process thinking, which both enable goal-oriented operating and an adequate consideration of the majority of factors important for the simultaneous realization of both the rationalization and synergetic effects of SC and their direct impact on the creation and exploitation of the competitive advantage of value chains in SC (Stevens, 1989; Lambert et al., 1997; Chopra & Meindl, 2015).

Modern concepts of the systems theory, including but not limiting themselves to the consideration of the General Systems Theory, the Soft Systems Methodology and the Fuzzy concept, enable a holistic approach to the understanding, definition and implementation of business operations (Francois, 2004; Mullins, 2007; Daft, 2009;

Certo & Certo, 2011). However, within the traditional-structural concept – rather than the process one – of the business operation mode, not all possibilities aimed at by modern BSs can be utilized (Galbraith, 2002; Hammer, 2004; Daft et al., 2012). The advantages of the systems approach within the framework of the process concept of a BS's operations can much better be applied (Potocan, Mulej, & Kajzer., 2005; Mulej, 2007; Potocan & Nedelko, 2014). There are two areas in which the process approach is primarily important for the quality of management: (a) the cognition of the primary dependence of a BS's processes and their structures and (b) the holistic monitoring of events in the time and space dynamics.

The systems approach also enables an examination of business processes as a cybernetic entity of the basic, management, and information (partial) systems of the considered BSs and the corresponding SC, and provides the basis for the establishment and judgment of integrability (Potocan et al., 2005; Potocan & Mulej, 2009; Potocan and Nedelko, 2014). For the purpose of the rationalization of a BS's SC, such a BS can initially use each of above mentioned (partial) processes as the starting points. On the other hand, the realization of synergetic effects is only possible if one bases integration in the basic process, which produces the final business effects, i.e. products and/or services in its integration with the management and information processes. Further on, it is necessary that the corresponding managerial and information processes should be built for the basic process to be optimal.

The management of BSs and their corresponding SCs in which such BSs cooperate is increasingly oriented towards the achievement of such an optimum in which the economic goals remain the fundamental, but not necessarily sufficient, precondition of the desired quality of the BS's operations (Jennings, 2005; Mullins, 2007; Potocan & Mulej, 2009). Additionally, either directly or indirectly, ecological, ethical and many other BS's goal-related factors also determine economic results and typically create preconditions for a potential direct attainment of the BS's basic economic goals (Drucker, 1990; Wren, 2004; Buchanan & Huczynski, 2010).

At the same time, BSs can use various concepts for the determination of the adequacy of their economic results; such concepts vary from those traditionally oriented towards the maximization of a profit to those with a present orientation towards optimization within the framework of the

entire value chain (Drucker, 1990; Harman & Porter, 1997; Certo & Certo, 2011). In the current business environment, Porter's idea (Porter, 1985) about the use of the value chain concept for the recognition and determination of contributions for all parts of the considered entity and the optimization of the results of the whole of the considered SCs' entities can be seen in the forefront. This research or ours considers the economics of participation with respect to a BS's parts in an SC, when the BS creates its own SC, and BSs as parts of broader SCs.

To make the integration process work well, various methods and techniques enabling the realization of rationalization, a synergy, or a simultaneous realization of both rationalization and a synergy; a competitive advantage of a value chain in an SC is thus created and exploited (Porter, 1987; Goold & Campbell, 1998; Drucker, 1990; Palmer, et. al., 2009).

From the theoretical viewpoint, this study contributes to the existing literature, by presenting a more holistic consideration of: (a) the innovative re-allocation of available resources in or between BSs, (b) the innovative integration of the SC, (c) the economic reasonableness for BSs' participation in SCs, (d) possibilities of achieving advantages of value chains in the SC, (e) an achievement of better business results in SCs through rationalization and synergetic effects, and (f) the implementation of Business Re-Engineering for the purpose of the integration of the SC, which enables the realization of both rationalization and synergetic effects and the exploitation of the competitive advantage of value chains in the SC.

1. Literature Review

Numerous management ideas have emerged in recent years in response to the competitive pressures calling for enterprises' improved work and behavior (Daft, 2009; Buchanan & Huczynski, 2010; Certo & Certo, 2011). The cornerstone of our research is the management theory, (Wren, 2004; Mullins, 2007; Daft, 2009) according to which, above all, the operations of BSs and possible results of BSs' operating depends on an innovative re-allocation of available resources and the synergetic integration of their work (Potocan et al., 2005; Potocan & Mulej, 2009). This framework has been applied by several authors in order to predict BSs' intentions and behavior both within and outside BSs (Drucker, 1990; Hammer, 2004; Quick & Nelson, 2009). In our study, we have referred to the cognitions obtained from the management, organi-

zation and systems theories as a theoretical bridge between the results of the operating of each BS and the inclusion of individual BSs in broader integrations (Potocan et al., 2005; Potocan & Nedelko, 2014).

Following Whetten et al. (2009) recommendations on how to properly apply theories from different disciplines, we have modified the selected theories so as to make them fit the specific objectives of the present studies. First, under the objective norms' components, we have assessed BSs' perceptions of their economics expectations, which is a significant driver for the achievement of better business results through the implementation of synergetic effects (Ansoff, 1965; Porter, 1996; Goold & Campbell, 1998; Potocan & Mulej, 2009). We have also acknowledged that the global business environment enables us to exceed the barriers to and constrains of business integrations between BSs (Jennings, 2005; Certo & Certo, 2011). Second, we have extended the framework for the consideration of business integrations to incorporate systems and cybernetics construct in relations to the implementation of synergetic integrations. It is our intention to explore the manner in which each BS can participate in different integrations, and how our using different types of integrations can influence the operating and results of new integrations (Beer, 1985; Porter, 1987; Wren, 2004). Third, we have applied the systems theory and business cybernetics (see e. g. Ashby, 1956; Bertalanffy, 1968; Foerster, 1974; Rose, 1974; Mulej, 2007), which enabled us to use a more objective measurement of the contributions for each part of a new integration and the results of the whole of such a new integration (Wiener, 1956; Bertalanffy, 1968; Beer, 1985; Potocan et al., 2005; Mulej, 2007; Daft, 2009).

Management reported on several approaches for the restructuring of BSs by conducting an innovative integration aimed at achieving better business results (Porter, 1996; Galbraith, 2002; Wren, 2004). In an attempt to capture the interdisciplinary character of integration, we have adopted a holistic approach that views integration as the sum of a broader array of initiatives tied to planning, operating and functioning at the organizational level (Potocan et al., 2005; Mulej, 2007). We have extended the previous research into the advantages of linking operations in integration to the concept of the values chain so as to argue that different parts of integration, although distinct, are mutually supportive (Grant, 1991; Blanchard, 2004; Certo & Certo, 2011). Furthermore, when some parts of a functional integration are supplemented by new parts,

these new, different parts are likely to reinforce each other. We have, therefore, drawn on the complementarity theory (Milgrom, & Robersts, 1995) to argue that integration initiatives targeting different business areas produce synergistic effects and complete each other when put together. In addition, we have extended the previous research into the systems understanding a synergy as a possible way to implement a positive synergy in business integrations (Foerster, 1974; Beer, 1985; Goold & Campbell, 1998; Mentzer et al., 2001).

Previous studies of synergy in the management and business literature have been focused on the consideration of the forms of the appearance synergy and the reasons for their arising (Panrose, 1959; Ansoff, 1965; Porter, 1985). For example, Panrose (1959) considered two forms of synergy, Ansoff (1965, p. 80) defined the operating, investment and managerial synergies, whereas Porter (1985, p.328) provides us with broader explanations for the possible origins of the business synergy: “sharing has the potential to reduce cost if the cost of value activities is driven by economics of scale, learning or the pattern of capacity utilization”.

The latest management studies focus on the achievement of synergy in the integration of the individual areas or viewpoints of BSs – e.g. marketing, costs, finance, taxes, management etc. (Mullins, 2007; Daft, 2009; Daft, Murphy, & Willmott, 2012). Within that framework, several authors argue that synergy presents the preconditions necessary for the achievement of efficiency and effectiveness in business integrations (Goold & Campbell, 1998; Grant, 1991; Potocan & Mulej, 2009).

Management studies teach us that the holistic and innovative operating of purchasing operations and physical distribution also plays an important role in business (Nigel, 1996; Simchi-Levi, Kaminsky, & Simchi-Levi, E, 2007; Hugos, 2011; Chopra & Meindl, 2015). A possible level of suitability when assuring the needs and demands of end-users is the subject-matter of discussion in several studies (Lambert, 2004; Lambert, Cooper, & Pagh, 1998; Stevenson & Spring, 2007). The use of logistic and material management in BSs enables us to partly improve work rather than “optimize” the whole of the process of the production of products and/or services. To deal with the whole of the supply process, many different integrated concepts of managing across the traditional-functional areas of purchasing operations and physical distribution have been developed,

such as materials management, merchandising, logistic, and the supply chain (Hugos, 2011; Bow-ersox, Closs, & Cooper, 2012).

While the significance of integrated concepts in management across the logistic functional areas has been noted (Lambert, 2004; Lambert, Cooper, & Pagh, 1997; Mentzer et al., 2001), the framework for an innovative integration of the SC is still not clearly understood (Lambert et al., 1998; Gibson, Mentzer, & Cook, 2005; Stevenson & Spring, 2007). To a large extent, the literature suggests an innovative restructuring of the SC’s participants’ business operations, emphasizing the importance of the optimization of their work (Harman & Porter, 1997; Galbraith, 2002; Wren, 2004; Daft, 2009). For instance, Gibson et al. (2005) suggest that the SC’s aims should be set in such a way as to enable the rationalization of logistic activities; Mentzer et al. (2001) report on the results of the different types and forms of SCs, while Stevens (1989) discusses the influences of the SCM on the optimization of SCs.

On the other hand, the current interdisciplinary studies of the SC suggest that functional integration is what enables the simultaneous realization of rationalization and synergetic effects and their direct support to the creation and exploitation of the competitive advantage of value chains in the SC (Stevenson & Spring, 2007; Chopra & Meindl, 2015). Specifically, the value chain theory views the work of the SC as a result of the operations conducted by its parts, tied together through a causal chain (Porter, 1985; Goold & Campbell, 1998). The cornerstones of a values chain are contributions of participants in the creation of the new values of the final results of whole entity. We expect that individual participants in the SC will differently affect the SC. Additionally, the results of the participation of individual parts in the SC depend on the characteristics of the considered SC.

The above-mentioned theoretical and research findings with respect to the use of an innovative restructuring of BSs (e.g. Galbraith, 2002; Wren, 2004; Mulins, 2007), the integration of the SC (e.g. Lambert, 2004; Chopra & Meindl, 2015) and the basis for the integration of the SC (Lambert et al., 1998; Stevenson & Spring, 2007) suggest the following research questions:

H 1: How to select potential partners for the integration of a desired SC?

H 2: How to realize rationalization and synergetic effects in an SC?

H 2: What is the main criterion for the integrity of the parts of an SC?

2. Management of Logistics

2.1. The Supply Chain

In the modern environment, BSs can ensure their existence and long-term development by holistically satisfying the needs and demands of their end-customers (Lambert et al., 1998; Metzger et al., 2001; Gibson et al., 2005). Producers can be competitive on the market if they offer a suitable: price, quality, range, uniqueness, and contribution to sustainable development/social responsibility as judged by customers.

Therefore, producers are confronted with a constant dilemma of how to re-form their work in order to reach the desired target results (Fly, & Stoner, 2000; Potocan & Mulej, 2009). The role of the holistic and innovative forming and performing of their purchasing operations and physical distribution are in the forefront of modern business (Nigel, 1996; Lambert et al., 1997; Hugos, 2011). Several authors define a possible level of suitability when meeting the needs and demands of their end-users. The use of organizational logistic and material management enables just a partial improvement of work rather than the “needed optimization” of the whole of the process of the production of products and/or services. To deal with the whole supply process, four main integrated concepts of managing across the traditional functional areas of purchasing operations and physical distribution have been developed – i.e. material management, merchandising, logistics, and the supply chain (Blanchard, 2006; Bowersox et al., 2012). Each concept uses different ways to link and integrate participants involved in the flow of materials and services (Pohlman, Gardiner, & Heffes, 2000; Slack, Chambers, Johnson, & Betts, 2006; Hugos, 2011; Chopra & Meindl, 2015).

The materials management originated from the purchasing functions implying the importance of integrating the material flow in its supporting functions both inside and outside a BS in order to include the immediate customer. It includes the functions of purchasing, expediting, inventory management, stores management, production planning and control and physical distribution management. At the time of its inception in the 1970s, material management was seen as the reducing of “total costs associated with the acquisition and management of materials”. Merchandising presumes that in retail operations the purchasing task is frequently combined with the sales and physical distribution tasks into the role termed

merchandising. Merchandising is typically responsible for organizing sales intended for retail customers, the layout of the shop floor, inventory management and purchasing. The logistics concept supported the activities related to the management of the total flow of finished goods downstream from the plant to the customer. Here, the term logistic is used as the analogous term to what was previously referred to as “physical distribution management”. However, logistic has more recently been extended so as to include more of the total flow of materials and information. The supply chain includes the entire SC from the supply of a raw material, via manufacturing, assembly and distribution to the end-customer. When the content of the SC is concerned, it includes the strategic and long-term consideration of the whole of the logistic viewpoint of business operations as well as the shorter-term control of the flow through the SC.

Since the early to mid-1990s, there has been a growing body of the literature focusing on the SC and supply chain management (SCM); as a result, the literature has provided us with several definitions of both concepts (Pohlman et al., 2000; Handfield & Nichols, 2002; Blanchard, 2006; Slack et al., 2006).

Theory reported on different definitions of the SC, which was supposed to mean that the SC “encompasses all activities associated with the flow and transformation of goods from the raw material stage (extraction), through the entire process to the end user, including the associated information flow” (Blanchard, 2006, p. 26). In reality, there are several types of SCs whose several key points should be noted. . SCM presents “the systematic, strategic coordination of the traditional business functions and the tactics across these business functions within a particular company and across businesses in the SC, for the purpose of improving the long-term performance of the individual companies and the SC as a whole” (Lambert et al., 1998; see also Slack et al., 2006). Thus, the present management concept covers the planning, leading, organizing and controlling of the SC.

Successful SCM requires that companies should accept a BS-to-BS viewpoint, which can cause a BS to accept the practice and adopt the behavior rather not traditionally associated with buyer-seller interactions. Moreover, successful SCM requires that companies should apply the systems approach across all BSs in the SC. When applied to SCs, the systems approach suggests that BSs must recognize the interdependence of

the major functional areas within, across and between BSs. In turn, the goals and objectives of individual SC's participants should be compatible with the goals and objectives of other participants in the SC.

SCM also importantly changes relations between BSs. Conventional wisdom suggests that, in the twenty-first century, BS-versus-BS competition will be superseded by Supply-Versus-Supply-Chain Competition. While this may occur in a few situations, such competition may not be practical in many instances because of common or overlapping suppliers or the lack of a central control point, among other reasons. There is rather a more realistic perspective that individual members of an SC will compete based on the relevant capabilities of their supply network, with a particular emphasis on immediately adjacent suppliers or customers.

Modern logistic and management researches reported on the existence of several kinds, types and forms of SCs and the corresponding relationships between the parts of SCs and between the parts and the whole of SCs (Lambert et al., 1998; Stevenson & Spring, 2007; Hugos, 2011). In our research, we have examined the relationships in terms of the flows between the operations of SCs (Mentzer et al., 2001, Gibson et al., 2005; Slack et al., 2006; Bowersox et al., 2012). These flows may include transformed resources, such as materials, or transforming resources, such as people or equipment. The exact nature of the relationship between the different linkages within the SC can be viewed on a continuum, which goes from highly-integrated commitment, at one extreme, all through to temporary and short-term trading commitment, at the other.

Management can importantly improve BSs' results by conducting an innovative re-allocation of available resources and a synergetic integration of their working. In both cases, BSs must re-think the adequacy of their roles and importance in SCs and possibilities of improving their working inside SCs.

2.2. Supply Chain Integration

SC management is oriented towards all crucial integrating operations across all the facets of business flows within and across BSs in order to obtain competitive advantages (Lambert, 2004; Bowersox et al., 2012). Researches have been focused on the integrated SC-related competences and skills needed to enhance the customer value

(Handfield & Nichols, 2002; Slack et al., 2006; Stevenson & Spring, 2007).

Less developed are relationships among the parts of the SC and among the parts of the SC and the whole of the SC and the possible optimization of the whole of the SC working (Stevens, 1989; Simchi-Levi et al., 2007; Potocan & Mulej, 2009). Previous researches reported on the conceptualization of relations in operational processes (Slack et al., 2006; Bowersox et al., 2012), business interrelationships among the strategy, the structure, the process and performance (Harman & Porter, 1997; Galbraith, 2002; Daft, 2009), relationships among the logistic strategy, the design, and performance (Rushton, Oxley, & Croucher, 2001; Lambert, 2004), and the relational flow in the considered integrations (Bowersox et al., 2012).

Some researchers empirically tested the elements of business integrations including the SC and focused on (see Simchi-Levi et al., 2007; Hugos, 2011) the influence of the integration factors on a BS's performance (Slack et al., 2006); the relationship between the strategy, the organizational design and outputs (Gibson et al., 2005); and the influence of the integration factors on the selected viewpoint of performance as financial performance (Lambert, 2004; Lambert et al., 1997).

Other researchers reported on the consideration of the selected business viewpoint or areas of business integration and SCs and created the corresponding classifications of synergies (Hugos, 2011; Bowersox et al., 2012). Economics, management and technical viewpoints are often in the forefront in the researches into business integration (Porter, 1987; Goold & Campbell, 1998). Researchers also reported on the integration of marketing, costs, financial, taxes and general management (Wren, 2004; Jennings, 2005; Daft et al., 2012). Integrations originating from the use of the individually selected viewpoint or area can help a SC's participants to achieve a certain level of the optimization of operations and results. Contently, their approaches enable a partial rationalization of the SC operating and a partial improvement of the SC results, primarily in the parts of SC.

More promising is the idea about functional integrations as the main reason and cause for business integrations (Stevens, 1989; Gold & Campbell, 1998; Lambert et al., 1998). The functional integration of the SC provides the conditions necessary for a possible achievement of desired synergetic effects. Some recent studies have

also made a link between functional integration and the concept of the value chain, which enables very objective evaluations in judging the contributions of each part of the SC and the results of the whole of the SC; consequently, it presents possible solutions to a simultaneous improvement of the operation and results of the parts of the SC and the whole of the SC through synergetic effects.

The realization of actual synergetic effects is additionally influenced by the factors determined at a political or a strategic level in the presenting the preconditions or frameworks for the SC integration (Slack et al. 2006; Chopra & Meindl, 2015). In the literature, authors often mentioned the expected purpose, goals, extent, level, centralization, management etc. of the SC and the expected way of the inclusion and planning the role of individual participants of the SC. A further investigation into these factors exceeds the framework of our research.

Researchers into the functional synergy devote less attention to the integrability of the SC's part and the appropriate selections of potential partners for integration in a desired SC. Therefore, this research of ours develops itself taking into consideration the synergy and its use in the creation and evaluation of the operation and results of the SC.

3. Synergy as the Base for Business Integration

3.1. How to understand synergy?

The term synergy comes from the ancient Greek word *synergia*, derived from the word *synergos*, which means "working together" (Ayto, 1994). The more recent understanding of *synergy* originated from physiology as early as in the mid-19th century (e.g. see Mazel, 1896; Ward, 1909; etc.); it implied the creation of a whole greater than the simple sum of its parts (Corning, 1983; Corning, 2003; Blanchard, 2004). In management and the business literature, authors used the term *synergy* mainly for the purpose of a discussion about the effect arising between two or more different parts, agents, factors producing some results or additional benefits greater than the sum of their individual effects – for different definitions of synergy, see Ansoff (1965), Porter (1985), Campbell, Gould, & Alexander (1994), Gold & Campbell (1998), Mullins (2007), and Buchanan & Huczynski (2010).

In the recent literature on management, the consideration of synergy is importantly related to the composition of new entities for BSs' working (Mullins, 2007; Daft, 2009; Certo & Certo, 2011). There are two approaches possible us refer to: the compositions of the existing parts – in the systems of the first order, or making a new entity as the systems of the second order. The composition of the first-order systems are used in the second-order system on the basis of the relations existing between the initial systems and their (shared) environment. The composition of the first-order system can also be used in the second-order system also derived from the existing relations, but rather focusing on the creation of new relations, hence, of an entity with new attributes not only derived from the attributes of the composing parts.

The qualitative jump attained by composition, i.e. the difference between old qualities and new ones, is called a synergy. Regarding the possible results of business integration between BSs, there are three types of synergies possible to define, namely: the positive, the negative or the neutral synergy – for more details about each type of *synergy*, see Ansoff (1965), Porter (1985), and Gold & Campbell (1998). These insights allow us to suppose that the composition process only makes sense only if it provides for positive synergetic effects such as an improved efficiency in operations, a greater exploitation of opportunities and an improved utilization of resources. Integrations causing negative synergetic effects are problematic, such as a reduced efficiency of operations, the underutilization of resources and disequilibrium with the external environment. Integrations are also unsuitable if they provide for no synergetic effects, such as neutral synergies. In such conditions, efforts to achieve a composition only produce additional costs, thus diminishing the effectiveness and efficiency of potential partners.

Another important viewpoint of dealing with synergy tackles the direction of the synergy effort that can be directed either vertically or horizontally (Drucker, 1990; Harman & Porter, 1997; Wren, 2004; Potocan et al., 2005). Starting from the interdependency of the BS's parts of different BSs and the corresponding SC/SCs, there are three directions in the formation of synergies possible to define. The vertical synergies are generated between the processes and the systems (i.e. complex round-off units) whose basic processes provide for various/different phases of the business process and generate a sensemaking value chain. In this case, the synergy generating efforts

are focused on increasing the parts of the entire generated value and on optimizing partner links. The horizontal synergies are generated in the composition of the processes and systems whose basic processes compose the same phase of the business process and generate a sensemaking entity. The synergy generating efforts are focused on improving the shared position of the participating BSs by exchanging or uniting resources important for competitiveness. Synergies can also result from composing the business processes and systems whose basic processes are simultaneously interdependent and parallel and generate a sense-making entity; therefore, one tries to realize both the 'vertical' and the 'horizontal' effects.

When defining synergies, authors also refer to various additional criteria (Ansoff, 1965; Porter, 1985; Gold & Campbell, 1998). Thus, from the viewpoint of time, synergies can be either permanent or temporary. The permanent ones include the results of permanent integrations. The temporary ones include the results tackling a limited time period with the aim to cover the shared execution of single tasks or jobs. The *area* aspect of synergetic working also matters: the point is at the level of the openness of such integration to the internal or external environment. Synergies can be goal-oriented to the basic, information and managerial partial process; they also have different synergy potentials. The possibility to attain synergies also essentially depends on the phase of the lifecycle in which single integration partners are or the nature of the integration system (i.e. complex entity). One's being familiar with the levels of synergy also matters they can have an impact inside a single part of an integration, between its parts or between the integration and its environment, or the environment.

In addition to the foregoing, a possibility of attaining synergetic effects in a new integration – from the viewpoints of its single parts or the entire integration – is impacted by the several factors linked to the purpose and objectives determining the form of a future integration, the level of its centralization, its foreseen governance and ways of being managed, relations between its participants and the manner of the foreseen participation of single participants in the integration. These topics, though, reach beyond our contribution here (Potocan et al., 2005; Potocan & Mulej, 2009).

The fact that to conceptualize or assess the synergy on the basis of one single out of the given criteria makes no sense must especially be stressed at this point; the quality, the quantity, the

time and room make an integral entity, hence sharing their impact on the attainment of synergies.

3.2. The Synergetic Concept and Integration Processes

Our attention focuses on the functional, i.e. production relations between the parts and the entire entity at two different levels, namely at the level of the integration of the individual parts of a BS into an entire BS in the corresponding SC or the integration of the individual BS into the broader integrations of BSs in the corresponding SCs – for more details about the starting points and the methods for research, see Potocan et al. (2005), Potocan & Kuralt (2007), and Potocan & Mulej (2009). Within the issue of the integration of SCs, there is a problem of the linking of: (a) the given part to the other parts of the considered entity, enabling the given part to achieve the results that otherwise cannot be achieved by an individual part alone. The difference is made by a synergy, of course.

According to our experience and investigations, the synergetic results of each of the BSs' or SCs' operations can be best achieved by applying the systems approach. The latter, namely, enables the integration of the selected units into a new entity on the basis of the suitable restructuring of the integration partners.

Linking is supposed to form from parts an entity qualitatively different from its components: such a new entity must, therefore, possess characteristics which can (only) be derived from the relations of its components. This entity can best be achieved by a composition based on such new relations. The impact of the composition can also be reverse: the formation of a new entity changes the quality of its parts, too; they gain new characteristics arising from their new interdependences. This, of course, means that the precondition for achieving a successful composition is also its opposite, i.e. decomposition. Because of this, the process of the composition as well as the one of the decomposition of an entity is a two-way process as well.

The integration process of the BS/SC is a specific example of a composition the purpose of which is also to make a quality "jump", i.e. the synergetic effect.

Suppose that there are the "m" considered systems of the first order $S_i^{(1)}$ that achieve the effects of $e_i^{(1)}$. Their set $S^{(1)}$, which is a set of potential integration partners, can be expressed as:

$$S^{(1)} = \{(S_i^{(1)}, e_i^{(1)}); i = 1, 2, \dots, m\} \quad (1)$$

By various integration processes, one can compose the “n” various systems of the second order $S_j^{(2)}$ with the corresponding effects $e_j^{(2)}$, i.e. a set of possible integrated systems $S^{(2)}$:

$$S^{(2)} = \{(S_j^{(2)}, e_j^{(2)}); j = 1, 2, \dots, n\} \quad (2)$$

It appears that all the integrations $S_j^{(2)}$, which show an increased effect, are acceptable. Therefore, the necessary precondition for integrability is as follows:

$$e_j^{(2)} - \sum_{i=1}^m e_i^{(1)} > 0 \quad (3)$$

The question is whether the precondition (3) is also a sufficient precondition for integrability. Namely, the analysis shows that the above-mentioned quantity “jump” (3) consists of two parts different in their contents, i.e. of:

the rationalization effect $r_i^{(1)}$, which makes the difference between the optimal effect ${}_o e_i^{(1)}$, which is the local optimum of the initial system of the first order $S_i^{(1)}$, and its actual affect $e_i^{(1)}$

$$r_i^{(1)} = {}_o e_i^{(1)} - e_i^{(1)} \quad (4)$$

and

the synergetic effect $s_j^{(1 \rightarrow 2)}$, which is the difference between the effect $e_j^{(2)}$ of the integrated system of the second order $S_j^{(2)}$ and the sum of the optimal effects ${}_o e_i^{(1)}$ of the initial systems of the first order $S_i^{(1)}$, i.e. the sum of the local optimums of prospective integration partners:

$$s_j^{(1 \rightarrow 2)} = e_j^{(2)} - \sum_{i=1}^m {}_o e_i^{(1)} \quad (5)$$

It is obvious that the rationalization effects (4) cannot be attributed to the integrations, as they can be attained at the initial systemic level, without integration. Due to this fact, they must be excluded from the criteria for the judgement of integrability, which can only be judged on the grounds of the synergetic effects (5), i.e. on the quality “jump”, resulting from the new relationships between the partners and their environment. The synergetic effect is, therefore, a sufficient precondition for integrability.

Only the possible integrations of the set $S^{(2)}$, which show positive synergetic effects, will be acceptable. They can be expressed as the set of $S_*^{(2)}$:

$$S_*^{(2)} = \{(S_k^{(2)}, s_k^{(1 \rightarrow 2)}); S_k^{(2)} \in S^{(2)} \wedge s_k^{(1 \rightarrow 2)} > 0\} \quad (6)$$

The criterion to select the optimal integration $S_o^{(2)}$ in the set $S_*^{(2)}$ is the optimal synergetic effect:

$$s_o^{(1 \rightarrow 2)} = \left[{}_o e_k^{(2)} - \sum_{i=1}^m {}_o e_i^{(1)} \right] \quad (7)$$

which is the maximum difference between the global optimum ${}_o e_k^{(2)}$ of the integrated system $S_k^{(2)}$ and the sum of the optimums of ${}_o e_i^{(1)}$ of the initial systems $S_i^{(1)}$.

Not only can the synergetic effect be used for an evaluation of integrability and a selection of the optimal integration of the given integration partners, but it can also be used for a selection of potential integration partners. In this case, of course, the integration problem is an open one. Moreover, the judgement of integrability is not limited to a search for the optimal institutional form of integrations, but also includes every involvement of the parts in their value chains.

In the context of a synergy, the synergetic effect and integrability, the basic problem is the content concerning the measure of the quality of the systems, which is here expressed by the effect “e”. As in modern post-industrial conditions each BS must be relatively open at any integrational level, this measure must include, apart from internal, external knowledge as well, and apart from direct, indirect effects as well.

A synergy is aimed at by organizational structuring. Both the literature and empirical evidence, however, have demonstrated that structuring is insufficient if not process-based (Galbraith, 2002; Mullins, 2007; Buchanan & Huczynski, 2010).

3.3. The Process Consideration of Business Systems’ Working

The process concept is an alternative to the structure concept (Wren, 2004; Mullins, 2007; Daft, 2009; Certo & Certo, 2011). “What is going on for our results to be achieved?” is the central question rather than “Who reports to whom?” because the contemporary market requires so much flexibility, innovation, adaptation etc. that the structure essentially depends on processes rather than vice versa.

From the process viewpoint, a BS is an entity of the basic, managerial and information processes, and creates the basis for the establishment and judgement of integrability – for more details about the starting points and the methodologies of consideration, see Potocan et al. (2005), Potocan & Kuralt (2007), and Potocan & Mulej (2009). In this respect, as we shall reveal below, the starting point is the basic process producing the final business effects, i.e. products and/or services. Further on, one must build a corresponding managerial and information process for the basic process to be optimal.

The conscious impact on the relevant events and processes includes the following three interacting processes:

1. the basic process (BP) is the one supposed to be influenced and to make the core of the feature dealt with (production, teaching, research, etc.),
2. the information process (IP) is the one producing findings, data, messages and information on and for the basic process, about the natural, social and business environments and an impact on them,
3. the management process (MP) is the one built on decision making and decision execution by a concrete selected action program.

The business processes take place as follows:

(1) Through the basic transformation (BT), the basic process BP transforms the input XB (e.g. materials) into the output YB (e.g. products) and signals S, which all take place under the impact of the managerial actions A. Thus, the BP covers all the basic functions of the business system, and the signals reflecting the inputs XM, the managerial actions A, the basic transformation BT and the outputs YM:

$$BT: (XB \times A) \rightarrow \begin{bmatrix} YB \\ S \end{bmatrix}. \tag{8}$$

(2) All the said processes, events and features are conveyed by the S to the data retrieval process (the signal transformation) i.e. the ST in order to be reflected in the data D. The ST interlinks the basic BP process and information process IP as their intersection, requesting that they both be taken into consideration:

$$ST: S \rightarrow D. \tag{9}$$

(3) Inside the IP, the internal data retrieved D and the external data retrieved XD are transformed

by the data processing (data transformation) DT into the internal messages M and the external ones YM:

$$DT: (XD \times D) \rightarrow \begin{bmatrix} YM \\ M \end{bmatrix}. \tag{10}$$

(4) When the pragmatic dimension is added to the message M, it can become the information I in the message transformation process MT. This is not only an informatics problem, but a management problem, first of all for the reason that: a message can become information only in a given decision-making situation. Hence, the MT can only happen at the intersection of the information process IP and the management process MP:

$$MT: M \rightarrow I. \tag{11}$$

(5) The management process MP, or in its narrower sense the decision-making process (information transformation) IT transforms the internal information I and the external one XI into the internal measures program P and the external one YP. A part of them can be given an algorithm (and eventually be automated later on) because it is a routine; another part is creative and stands for a real decision-making process which can be supported by heuristics and/or systematic heuristics (Beer, 1985; Foerster, 1974; Umpleby, 1990; Mulej, 2007) or other creativity-supporting methods (Umpleby, 1990; Francois, 2004):

$$IT: (XI \times I) \rightarrow \begin{bmatrix} YP \\ P \end{bmatrix}. \tag{12}$$

(6) The IT is followed by the measures programme transformation PT converting the programme decided P into the concrete actions A. Of course, this process is still a part of the management process MP, whereas, at the same time, it is an intervention in the basic process BP (which is the reason for all of the said processes to be existing and consuming all the effort):

$$PT: P \rightarrow A. \tag{13}$$

The cybernetic circle is closed as a dialectical, soft, open and fuzzy system. Every partial process is relatively independent and has its own core activity, but at its start and its end, it is anchored in the other two processes. This confirms that they are merely the three viewpoints of the same feature, not the three isolated systems/entities. If this fact is disregarded, it is very hard to attain the efficiency and

effectiveness of the BS as a whole, not to mention partial sub-optimizations. The three processes cannot be separated. Every element of the BS belongs at the same time to each one of the three processes, however with a different degree of membership and influence.

Taking management into consideration from such a view point implies that there are three partial systems, rather than subsystems, that have to be dealt with; each of them contains all the components of the enterprise as a business process and the corresponding types of their relations, both mutual ones and those with their environment.

A fact has been established that all the three processes are open to the environment and, at the same time, mutually linked to each other: the reproducing (basic) interdependency produces the managerial one, which in its turn produces the information one, and vice versa. Because of the stated interdependencies, the establishment and judgement of integrability should take place as follows:

1. an analysis of the basic processes of potential integration partners, with the focus on the research into their actual and developmental interdependences, and further on, a synthesis of their new reproduction interdependences in a newly-integrated system (the creation of new reproduction relations),
2. the construction of the managerial process, which will be suitable to the new reproduction interdependency, and its decomposition at the managerial level into an integrated system (the creation of new managerial relations),
3. finding out the information needs and the construction of the information system supporting the management of the various single levels and areas in the integrated system (the creation of new information interdependencies),
4. finding out the vice-versa relations of the three sub-processes as partial processes.

Once a transition has been made from stressing the organizational structure only to the systemic consideration of the processes in a BS/SC, restructuring is then deemed to be based on processes. The literature reported on several solutions to creating the integration process, which enables the realization of the different levels of the rationalization and/or synergy of the BS/SC (Ansoff, 1965; Porter, 1987; Grant, 1991; Blanchard, 2006).

The chapter to follow gives an account of how the implementation of the concept of Business Re-

Engineering enables a simultaneous realization of both the rationalization and synergetic effects of the BS/SC through their direct impact on the creation and exploitation of the competitive advantage of the BS/SC.

3.4. The Use of Re-Engineering for the Purpose of Integration

The findings displayed in the previous chapters of the paper yet have not provided an answer to the question of how to tackle the implementation of the attained integrated BS/SC. The traditional methods and programs intended for increasing efficiency in the BS/SC require that the existing structure and processes of an enterprise should be mechanized, automated, rationalized and substantially upgraded by investments. Of course, the potential for improving is pre-restricted to rationalization effects. Out of the several solutions available, and for the purpose of presentation, we have opted for the concept of Business Re-Engineering, which provides a lot of opportunities for achieving not only rationalization, but synergetic effects as well.

Generally speaking, Business Re-Engineering endeavors to achieve a qualitatively new formation of business processes in terms of the so-called "Core Competences" and "Core Processes" (Hammer & Champy, 1993; Hammer, 2004; Daft, 2009; Buchanan & Huczynski, 2010). This formation is the most significant achievement of the synergetic effects aimed at making a major improvement of both the efficiency and effectiveness of both the initial and integrated business systems. The philosophy of Re-Engineering wants to cut down the traditional rationalization of the business operations based on the improvement of the existing structures and processes of an enterprise (see e.g. Hammer & Champy, 1993; Quick & Nelson, 2009; Daft et al., 2012). It studies the previous processes in the enterprise and considers them anew. Moreover, the processes should be re-conceived with the objective of drastically improving both efficiency and effectiveness.

Business Re-Engineering can only be successful if the business process is treated as an entity in a systemic way (see e.g. Potocan et al., 2005; Potocan & Mulej, 2009). This means that in this case the reconstruction comprises the basic process BP, the managerial process MP and the information process IP as partial processes, i.e. includes their relations.

The conceived business process takes place as follows:

$$\rightarrow BP \rightarrow IP \rightarrow MP \rightarrow BP^* \rightarrow \dots \quad (14)$$

or in accordance with the expressions (8) to (13), as the sequence of the transformation

$$\rightarrow BT \rightarrow ST \rightarrow DT \rightarrow MT \rightarrow IT \rightarrow PT \rightarrow BT^* \rightarrow. (15)$$

As it is known, the conceptualization of a process must take place in the opposite direction, i.e. from its end towards its beginning. Taking into consideration the expressions (14) and (15), the conceptualization of the process can be expressed in the following way:

$$BP \rightarrow MP \rightarrow IP \quad (16)$$

or in more detail as:

$$BT \rightarrow PT \rightarrow IT \rightarrow MT \rightarrow DT \rightarrow ST. \quad (17)$$

Only now can the construction of the procedures and the related structure in which our conceived process should operate start. How to tackle the concrete restructuring in the examined case depends on: (a) the important characteristics of the intended integration; (b) them who are the integration partners; (c) what the purpose of the integration is, (d) which its goals are; (e) what kind of linking is at stake (vertical, horizontal, mixed, interdependency); (f) what the institutionalized form of the integration should be etc..

The phases of Re-Engineering are as follows (Mullins, 2007; Daft, 2009; Certo & Certo, 2011):

1. setting the organizational framework (the identification of the key processes, the authorization of the promoters with empowerment, the appointment of the Process Owners, the nomination of the processing teams, etc.),
2. gaining an insight into the existing process (the understanding of the basic tasks of the process, the determination of the requirements from the customers' aspect, etc.),
3. creating a new process concept (a much simpler process, new technologies, a much shorter flow time, many fewer needs for coordination/interventions, in case of more complex processes there are more variants of implementation, etc.),
4. introducing a new process (taking decisive measures in order to introduce a novelty and eliminate resistance, old habits, former centers of power, etc.).

In the case of the application of Re-Engineering in the process of the formation of the integrated BS/SC, the above-described process is simultane-

ously employed at all levels: at the level of the initial BS/SC part and at the level of the integration partners. Namely, the key processes can generate synergetic effects only if they significantly liaise components into one single entity.

Some Conclusions

In the modern-market economy, BSs must permanently strive for the enhancement of the excellence of their operations, which ought to be efficient and effective in order to be successful. A significant improvement of business results can be achieved if BSs and integrations related to BSs, such as the SC, are researched into from all the essential aspects and their relations.

By achieving the optimization of the essential system of the viewpoints of dealing with: (a) links between parts – like departments, plants, etc. in the BS and its corresponding integrations such as the SC; (b) links between BSs as parts of broader business integrations such as SCs; and (c) links between the parts of the BS or BSs in broader integrations with the business and social environments such as vertical or horizontal value changes, for example corresponding SCs, we can make a considerable impact on the quality of the business operations through the innovative restructuring of the business processes and the structures for their implementation. Innovative integration links enable the optimal application of the available sources of the simultaneous implementation of both rationalization and the synergetic effect as well as a direct impact of the creating and use of competitive advantages of the integrations of a BS's or BSs'.

The linking of considered part an integration process enables the formation of new entities qualitatively different from their components. Due to the synergetic effects, a new entity can have characteristics which can only result from the relations of their components. At the same time, by the creation of a new entity, the quality of its components can be influenced. The components gain new properties generated from their new interdependencies.

Integration is conducted on the basis of the systemic reconstruction of the given entities and on the basis of an adequate integration of partners – e.g. the integration of a part of a BS into the corresponding SC or BSs as parts of a broader SC participating in the value chain. Their restructuring is based on the comprehension of the considered business process as a cybernetic entity of the basic, managerial and information partial systems.

The starting point presents the basic process as the process of the formation of effects/results. For the basic process to be optimal, it is necessary that adequate managerial and information processes should be built. All the three processes are inter-dependent and relatively open to the environment.

The creation of new entities – such as SCs – can be supported by an application of the Business Re-Engineering concept enabling the simultaneous attainment of both rationalization and synergetic effects. The objective of the concept is to achieve a significant improvement of the performance and efficiency of both the initial and the integrated entities together with a qualitatively new creation of the strategically important core key business processes. The competitive advantage of the SC and the participating BSs can directly be supported by these processes. **SM**

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The Success of Economic Transformation in the New EU Member States in the Global Context

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Abstract

The age of globalization poses imminent challenges to all economies, including the ones on the periphery of the global economy. The varieties of capitalism research programs investigate the different models of capitalism developed by the various macro-regions of the world in order to respond to these challenges. They include the Anglo-Saxon model, the Nordic model, the Far-East development model and various other models. Central and Eastern Europe have developed their own model, now generally referred to as the FDI-based competition model. This variety of capitalism relies on foreign direct investments so as to respond to all the challenges, be them employment, research and development, value added, regional development or any other. Rather than any policy efforts, the state competes with the wage moderation, low taxes and weak trade unions. In this way, they have integrated themselves into the low value added, the low wage periphery of global production chains. In spite of optimism about the enlargement of the Eastern EU emanating from the European Commission, this model of transition and capitalism has not proved itself to be successful. This is proved by the divergence rather than convergence of wages vis-a-vis Western Europe, low employment, and divergence in productivity. The populations of the region are aware of this, as demonstrated by their negative natural birth rates and their increasing migration away from the region.

Keywords

Globalization, FDI-based competition model.

Introduction

In this paper, the fact that the socio-economic transformation of the Central and Eastern European “new” European Union member states has resulted in a model that has led to a convergence in the GDP per capita vis-à-vis the crisis region of Southern Europe as well as the European Union average, which also includes the crisis region of Southern Europe, is argued. It has not led to a convergence, however, in terms of the key socio-economic indicators such as employment and income vis-à-vis Western Europe, which has traditionally been the benchmark region for the East of Europe. A quarter of a century has passed since the political and economic transition in 1989. In such a time period, countries such as South Korea

or Singapore have developed from impoverished Third World countries into the affluent ones. Twenty-five years after the total annihilation at the end of World War II, Germany had already gone through its Economic Miracle and once again was one of the richest countries in Western Europe. A single decade into its Celtic Tiger miracle, the wages in Ireland overtook British wages. Compared to these real economic convergences, the catch-up of Central and Eastern Europe is – to use a euphemism – doubtful. Even more reasons for concern lie in the fact that the key underlying factor for the overall economic convergence, productivity, has rather been diverging than converging.

The fact that the productivity levels of these countries are not converging but are rather diverging vis-à-vis Western Europe is the cause for serious concern. Since productivity is what enables the convergence of the standards of living, there are deep underlying structural reasons why the economic model of the CEE region has not achieved the same fast convergence like the other catch-up regions of the global economy already mentioned.

The varieties of capitalism (Hall & Soskice, 2001; Schonfield, 1965; Schmidt, 2002; Amable, 2003, etc) research programs in economics have identified the various models of capitalism in our global economy such as the Anglo-Saxon model, the Scandinavian model, the Continental model and the Mediterranean model. These models are all to be found in various regions of the European Union. In addition to this, there is the Far-East State Development Model in Asia. The post-communist economies of Central and Eastern Europe¹, however, fit into none of these categories. In the literature, they have come to be known as the FDI (Foreign Direct Investment)-Dependent Competition States (Cerny, 1997; Nölke & Vliegthart, 2009). These economies rely on the attraction of foreign investments for the development policy. In order to compete for these external resources, they engage in extreme wage moderation, a race to the bottom in terms of taxation and deliberately weaken the trade unions' rights. The state itself carries out almost no public policies, as it is customary in Western Europe. The social policy, the wage policy, the employment policy, regional development, research and development are all expected to result from an inward investment.

It is clear from comparative data that these expectations are unrealistic. The countries of the CEE region have positioned themselves at the low productivity and low wage end of the global production chains (Gereffi, Cattaneo, & Staritz, 2010; Gereffi & Korzeniewicz, 1994). In the absence of a public policy, the unrealistic expectations of the FDI-based convergence have proved to be a dead end. Not only have economic prospects declined, but the region has never developed a middle class strong enough to have preserved a vibrant democracy and transparency in public finances. As a consequence, the region is characterized as one of

declining democratic standards and rampant corruption by those contemplating leaving as well as those who have already left.

The low employment rates, the low living standards and the negative prospects for a convergence have all contributed not only to decreasing natural demographics and hardly any inward migration, but also to an increasing push-factor for an outward migration from the region. As a consequence, resentment has considerably grown in the recipient countries, as evidenced by the political forces calling for limiting or even rolling back the free movement of labor in Europe. It is hard to deny that this resentment is based on realistic assessments. Economists might attempt to convince the Western European citizens that the overall impact of the Eastern European labor migrants might be positive for their economy as a whole, but this will not change the situation on the ground. Individual citizens will be correct to assume that labor migrants are taking their jobs, lowering their wages and using benefits at a local level. This becomes especially acute in the case of an economic downturn. We must face the fact that the current labor market challenge of Eastern European labor migrants to the Western European labor markets is the consequence of the fact that Eastern European EU enlargement was carried through without the dimension of the setting of the social minimum standards. This enabled the Eastern periphery to deteriorate the Western European welfare states by constructing its own economic model based on social dumping.

The sustainable answer, however, is not to be found in rolling back the free labor movement. It is rather to be found in guaranteeing reasonable prospects for those contemplating leaving the CEE region. If these EU citizens had optimistic midterm prospects for the improvement of their living standards, not even the considerable pull-factors of the Western affluence would have a strong effect. Like everyone else, the majority of Eastern Europeans would prefer to find their livelihood where they were born and where they grew up, where their friends and families live, where they have established their social networks and cultural roots.

Unfortunately, as it stands today, the European Union is incapable of asserting these prospects in Eastern Europe (Pogátsa, 2015). Its external conditionality in terms of political and social rights was very strong while the CEE region was in the process of accession. Since they have become member states, however, their citizens have found

¹ Except for the former Yugoslav republics of Slovenia (Pogátsa, Slovenia: The Only Successful Case of Economic Transition, 2012) and Croatia. The former is closer to the continental model, whereas the latter is closer to the Mediterranean one.

that for all the talk of Social Europe, sustainability, transparency, competitiveness and political democracy, the European Union only has hard competencies in the areas of the trade policy, the competition policy as well as the monetary policy amounting to institutionalized austerity. Its external conditionality in the key areas is significantly weaker than what would be needed to influence the Eastern European political elites and the best practices within the framework of the open method of coordination raise no interest in the East, where the FDI-dependent economic model remains dominant.

Gross Domestic Product Per Capita

The twenty-fifth anniversary of transition and the tenth anniversary of the European Union membership provide a reason for reflections on the extent of convergence between the former state socialist economies and the developed capitalist economies of North-Western Europe. Frequently, these assessments of convergence (Darvas, 2014; Cueresma, Oberhofer, Smits, & Vincelle, 2012) have been based on a single indicator, primarily the per-capita Gross Domestic Product. They usually arrive at the conclusion that Central-Eastern European (CEE) enlargement has been successful since convergence can be demonstrated for the majority of the economies of the region. This leads to triumphalism on the part of the regional governments and the EU institutions² alike. Their optimism is in a sharp contrast with the actual political-economic developments on the ground. Most states in the region are faced with rampant corruption, political crises, social unrest, low fertility rates and an increasing outward migration. What is it that explains this apparent contradiction between the supposed economic success and the weak socioeconomic performance experienced by the citizens?

In this chapter, the fact argued is that if we take a more holistic approach and base our analysis on more than just a single economic output indicator we can understand why the superficial phenomenon of convergence is in fact a mirage. While the GDP/capita is obviously a valid and important figure, it only demonstrates one single element of a very complex picture: how much of a new value is produced in an economy in the given

year. We learn nothing about how *the* new value is distributed in the society among profits, wages and taxes, which is not a trivial question in a region where owners of capital are often foreign investors, and where ‘dependent competition states’ (Nölke & Vliegthart, 2009) race each other to the bottom with low taxes and low wages. The GDP figure also tells us nothing about how many wage earners there actually are (the employment rate) or the distribution of income amongst the households earning wages. How fast have prices caught up? How are these indicators converging with the developed states of North-Western Europe? (The ‘EU average’ served well as a convergence anchor initially, but since the economic collapse of the Southern European periphery, this average is too low a benchmark for the CEE region.) To gain a complete picture of it, we must examine all these dimensions of convergence and more.

Employment

After the GDP/capita indicator, the first and the most important question for the CEE countries is: How many citizens actually hold a job in these economies? What percentage of the adult population are taxpayers thereby contributing to the sustainability of the national budget and the social redistributive systems? (We take the view that the state-employed taxpayers are in no way less inferior to the private sector’s ones. While it is true that their salaries are paid from tax revenues, the private sector would in turn be unable to produce any wealth without the state’s and local governments’ services. A hypothetical separation ignores the intimate real life symbiosis between them, and how one would collapse without the other.) How does their level of employment compare to ‘Western Europe’?³

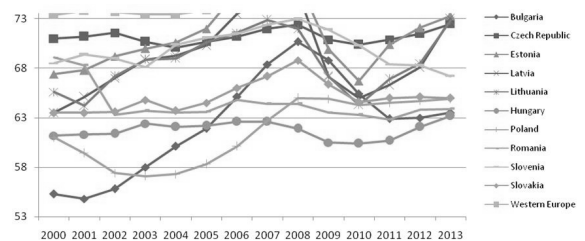


Figure 1 Employment rates in the CEE and the North-Western European average

Source: Authors' based on Eurostat, 2015a

² See, for instance, a speech by Lorenzo Bini Smaghi, a member of the Executive Board of the ECB, available at http://www.ecb.europa.eu/press/key/date/2007/html/sp071001_2_en.html

³ Defined as Austria, Belgium, Denmark, France, Germany, Ireland, Netherlands, Norway, UK, Sweden, and Switzerland.

The figure shows that, in 2012, no CEE country reached the Western European average. Their employment levels were in the 62-72% range, with North-Western Europe continuously averaging around 75% (with roughly a 67-82% spread). Employment in certain countries stagnated by and large (Hungary, Romania, the Czech Republic). The only two countries whose levels of employment were comparable to Western Europe were the Czech Republic and Slovenia. The latter is the only former socialist country to have transformed itself not into a dependent FDI-based economy, but rather into a coordinated, corporative Rhine-land model (Hall & Soskice, 2001; Pogátsa, 2012) economy.

As is visible from the chart, the three Baltic economies and Bulgaria played roller coaster with the jobs of their citizens: they show a significant increase, only to be followed by a decline. This is likely to be related to their significant levels of the outward migration of their guest workers to Western Europe before the Great Recession. The small size of the individual Baltic labor markets might also serve to explain the phenomenon, as the collapse of even one single industrial sector can have a dramatically greater effect on the entirety of a small economy. Western European economies have significantly higher employment stability compared to these unstable labor markets.

As for Slovakia, before the 2008 crisis, it basically caught up with its pre-restructuring levels of employment that characterized the country prior to the Dzurinda reforms (1998 = 67.4%) before the 2008 crisis. Employment in Slovakia decreased, reaching the end of the period at an only slightly higher level than it had been the case at the turn of the millennia. These empirical data contrast with the buoyant narrative that had surrounded the Slovak economy before Poland took over as the star student of the region during the crisis years. In spite of its alleged economic miracle during the Great Recession years, Poland itself never again managed to reach its 1998 employment rate of 65.4%.

All in all, the new member states as a group remain significantly decidedly below the Western European levels of employment. It is difficult to observe the convergence process in this group.

Income

For those holding a job in the CEE region, their actual income is the next most important issue. In addition, national and local budgets are to no small extent financed from the tax base of those

with income. It is therefore important to ask how much wage earners in the CEE region actually earn. How does this compare with the North-Western European levels of income over time?

While Eurostat publishes up-to-date, either quarterly or monthly, statistics about business indicators, it is far less helpful as a source of social indicators such as income. The best proxy we can work with is the total actual individual household consumption.

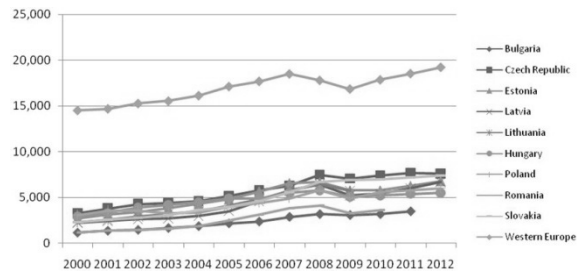


Figure 2 The total household consumption expenditure at current prices, the CEE and North-Western Europe
Source: Authors' based on: Eurostat, 2015b

At current prices, the only country to have achieved a slight positive convergence (of about €367) with North-Western Europe by 2013 was Slovakia. Hungary and Poland suffered considerable divergence (€2133 and €1833 respectively), whereas all the other countries went through a slight divergence.

Naturally, the consumption levels cannot be accounted for at current prices, but rather need to be brought to the purchasing power parity. Price levels play a decisive role in how much these earnings are worth in a given economy. Here, however, we run into difficulties because the officially published price level indices of Eurostat are contestable.

Even the official 'actual individual consumption' price level statistics of Eurostat indicate a very rapid price convergence, much faster than that of consumption itself.

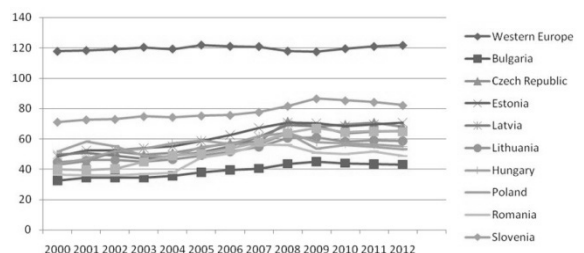


Figure 3 The actual individual consumption price level indices of the CEE and North-western European EU member states (the latter is an own calculation), EU27=100%.
Source: Eurostat, 2015c

Thus, if our assessment is based on these official figures, it is possible to conclude that while there was a mild divergence in nominal consumption, on the one hand, there was simultaneously a very rapid convergence in prices from about one-third of the Western European prices to about one-half, on the other. However, it is questionable whether this indicator is really a correct approximation of the actual consumption price levels. It is very likely that it undershoots it, if its components are looked at. The simple weighted average of the dominant elements of a household consumption basket yields a price level closer to two-thirds of Western European levels rather than one-half of those levels.

Table 1 The component price level indices, EU27=100% 2012

	CZ	HU	PL	SK	EE	LV	LT
A. Actual individual consumption	67.7	54.9	53	64.8	70.5	65.4	58.4
B. Food and non-alcoholic beverages	83.7	80.8	61.6	86.7	86.6	87.1	77.4
C. Electricity gas and other fuels	90.8	81.3	71.1	96.4	74.3	76.1	81.4
D. Transport services	66.4	65	57.3	55.1	73	68.1	58.7
E. Communication	112.6	111.9	70.1	125.4	72.4	81.2	58.3
F. Hotels and restaurants	58.2	50.1	74.9	70.9	76.3	80.7	63.6
Average B-E	88.375	84.75	65.025	90.9	76.575	78.125	68.95
Average B-F	82.34	77.82	67	86.9	76.52	78.64	67.88
Residential buildings	65.1	49.6	56.7	64.2	70.5		

Source: Eurostat, 2015c

It is hard to see what component of what supposed consumption basket yields the official overall ‘actual individual consumption’ price level index when its most important components are higher in value. One possible candidate could be *rent*. However, Eurostat does not publish a component index for *rent* alone, which is in itself problematic.

The Eurostat handbook (OECD – European Commission, 2012) provides explanations about these discrepancies. One problem is that the methodology does not use simple weighted averages, which means that services such as ‘hotels and restaurants’ are over-weighted in the price indices. (CEE citizens usually hardly spend any nights in hotels in their own countries, and a major proportion of them cannot afford to regularly dine in restaurants.) Even more significantly, the official price indices contain the price levels for government services that are not directly purchased by households from the market, such as education or healthcare. In the CEE economies, prices in these sectors are very low, mostly due to low wages. The underlying assumption of this methodology is that cross-country comparability

is only ensured with the countries where these services have to be purchased on a market basis if the cost of services is taken into account, even in the countries where they are provided free of charge by the state. However, this assumption is flawed. First of all, there are almost no such extreme market-based economies within the European Union, as health and educational services are available free of charge in most EU member states, or at least operate in a parallel manner, in that one can buy supposedly higher quality services privately, alongside a free public service. Even more importantly, it is mistaken to assume, as the ‘no-free-lunch’ argument often does, that public services are at the end of day financed by households through taxation. There are plenty of other sources of state revenue that can finance ‘free’ government services. They include taxes on profits, wealth, excise, environmental degradation and others. Considerably lowering the price indices by including these governmental services therefore introduces an unjustifiable downward bias. The actual consumption price indices are more likely to be in the range of 80-85%, as represented by the direct market-based household expenditure components published by Eurostat.

Distribution of Income

Given that Visegrad and Baltic citizens nominally earn on average around a third of what Westerners earn, yet their prices are half to two-thirds of the Western ones, there is a situation where a typical Eastern household is forced to spend almost all of its income on the basic consumption. The average Eastern household is about the seventh tenth of the society. This means that only the top deciles really have savings in the CEE region.

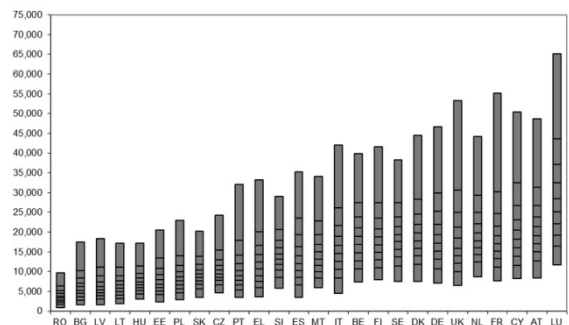


Figure 4 Income distributions across Europe, in €, at the official Eurostat PPS, 2010

Source: Eurostat, 2010

The Eastern European average corresponds to the lowest two deciles of the Western European income distribution. These are the only two deciles of Western society that do not have significant savings after the basic consumption on food, energy, housing and transport. The lowest tenths of the CEE societies continue to live in extreme physical poverty, which is almost non-existent in North-Western Europe.

As far as minimum wages are concerned, they provide no more than a façade of a welfare arrangement in the region. As can be seen from the graph below, the statutory CEE minimum wages are around 1/4-1/5 of the Western European minimum wages. Many Western European countries, such as Scandinavia, do not have general minimum wage levels. Instead, they agree on industry-specific wage floors, which serves the same purpose, but only in a more differentiated way. These industrial wage floors are mostly higher than even the statutory Western European minimum wage levels. Therefore, taking these countries into account, the minimum wage levels in Eastern member states approximate a 1:5 rather than a 1:4 ratios. Given the fact that the price levels can be approximated at around 2:3 of the Western price levels, it becomes clear that the CEE minimum wage levels are so extremely low that they become meaningless in terms of social protection. In fact, in almost all cases, they fall below the official subsistence minimum published by the National Statistical Offices. An additional issue related to income levels is that the statutory minimum wage level in the CEE countries is so low that in a social sense it is meaningless. Thus, not only is there an enormous pull factor for an outward migration, but the fact that the low end of the wage scale in Eastern Europe constitutes an unsustainable standard of living, characterizable as the constant depreciation of physical and mental health, as well as an absence of security must also be taken into account. The low minimum wages, as well as the low wages in general, are a consequence of extremely weak trade union power in the regions. In twelve countries of Northern, Western and Southern Europe, collective agreements cover more than 80% of all the employees. In these countries, the average wage share of the GDP is 67%. In the Visegrad OECD states (Estonia, Poland, the Czech Republic, Slovakia and Hungary), collective agreements only cover around one-third of all the employees. In these countries, the average wage share is only 57%...

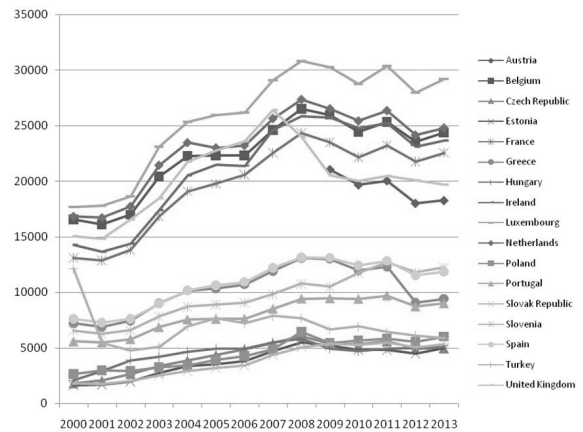


Figure 5 Official statutory minimum wages in European countries

Source: Eurostat, 2015d

Productivity Divergence as a Basis for Wage Divergence

What defines the dynamics of wage growth is also important. The central prospect of both economic transition and the EU accession was the gradual convergence of income with Western Europe in the medium term (i.e. within one single generation or so). There was no expectation of full convergence, which would have been insensible from an economic point of view. What was expected was a noticeable gradual process, much like what has actually been taking place in terms of the GDP. (It tells how, in spite of the Eastern GDP levels actually approximating and in some cases overtaking the Southern member states' levels, the actual household income levels remain far lower.) Since the populations of the region are not experiencing this convergence, it is important to examine the underlying factors. Apart from negotiations between employers and employees, it is productivity that determines wages. Extreme and continued wage increases beyond productivity increases price out an economy in international competition.

Naturally, productivity in a given economy is distributed across a range. This is significant in itself. Why do Eastern European societies have such flat income distributions, when their productivity distributions are quite likely to be wider? That is a question that begs for an answer. Productivity distributions, however, are not available, only national averages are. An economy's wide average productivity is estimated by dividing the aggregate GDP by the number of the employed, or by the number of the hours worked in the given economy.

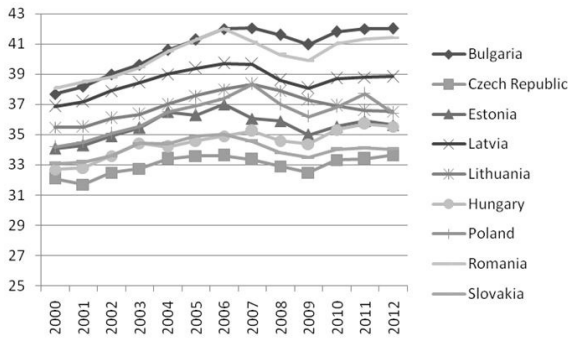


Figure 6 The productivity gap between the CEE economies and the Western European economies, euro per hour worked

Source: Authors' based on Eurostat, 2015e

What can be observed from the graph is that the productivity gap between the CEE and Western Europe actually increased before the crisis, only to be followed by a slight drop between 2007 and 2009. After that, divergence was resumed. Throughout the period, the region diverged by some €1-3. The worst performer, Bulgaria, an outlier, diverged by €4.3 in this period.

Productivity is a crucial underlying factor because it determines wages. Therefore, it is extremely important that what is being measured and its dynamics should be understood. The first key precondition is that because it is calculated by using the aggregate GDP figure, the GDP figure should be accurate. However, it can with certainty be asserted not to be the case. Since the region is dependent on transnational foreign investments, the massive effects of transfer pricing by these transnationals must be calculated with. According to a well-respected report (James, 2012) by an NGO dealing with offshore leakages, The Tax Justice Network, several of the economies of the region are amongst the greatest losers of the global offshore network. Thus, the actual GDP of these countries, and by inference their actual productivity levels, must in fact be higher than the official statistics suggest. If wages are to conform to real productivity levels, the existing wages are too low then. (Dicken, 2003)

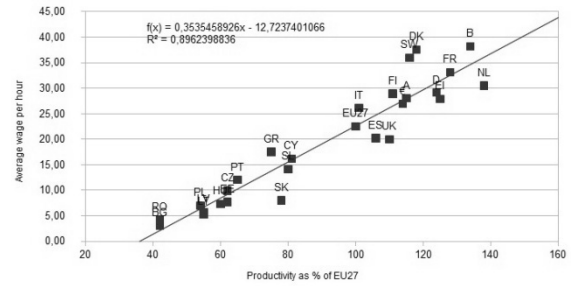


Figure 7 The linear regression trend line between productivity as a percentage of EU27 average and the average wage per hour in €, in 2010

Source: Authors' calculation based on Eurostat

What this regression line enables us to see is that there seems to be a very close correlation between productivity and wages. As we have already mentioned, if an economy moves too far above the trend line, it is going to price itself out. Seemingly, the economies of the region lie close to the regression line, which suggests that all is well with income. (Slovakia is a noticeable outlier.) This regression line, however, is not an explanation for the diverging of the productivity levels of the CEE economies, but rather a graphical representation of it. There is still a need to explain what it is that accounts for productivity divergence.

Productivity is related to both labor and capital (Sraffa, 1960). The human capital of the region is often assumed to be what explains the level of productivity. This claim can now be empirically tested with the help of the OECD's Programme for the International Assessment of Adult Competencies (PIACC). Like its better-known sister program, PISA, it measures the same numerical, computational and problem-solving capacities. It does so, however, amongst those already employed, rather than students. This means that the PIACC is an optimal tool for assessing the human capital of the region, as it measures exactly what we are seeking to find. If the productivity of the region was lower because of the weaker labor market skills of the locally employed, we would expect to find these characteristics reflected in the PIACC study. The OECD report (2013), however, does not confirm these expectations. The high-productivity North-Western European, North American and CEE economies are mixed in terms of all the three competencies. These results seem to indicate that it is not the human skills of labor in this region that serves as an explanation for the lower levels of overall average productivity.

Value Added Chains

The primary reason why the FDI dependent is that, in contrast to essentially every other variety of capitalism, decisions about the industrial structure are not made within the home economy, at the headquarters of domestic enterprises, or in domestic ministries. Most such decisions are made at the external global headquarters of multinational enterprises. Since there is pressure on these enterprises to keep the high value added production phases of their global production chains in the home economy (Gereffi, Cattaneo, & Staritz, 2010; Gereffi & Korzeniewicz, 1994) and since the FDI dependent competition stated competes by extreme wage moderation, low taxation, and weak trade unions and labor rights, the outcome is that this model attracts the low-end, low-wage production phases of the global productions chains. It is exactly this process that leads to the absence of productivity convergence.

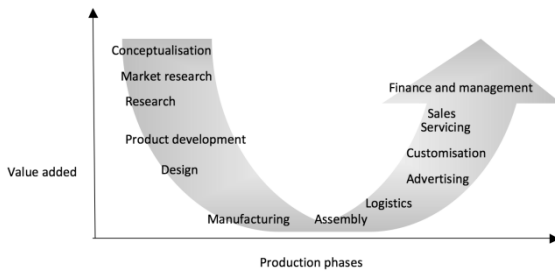


Figure 8 The value added curve of an international production chain

Source: Gereffi, Cattaneo, & Staritz, 2010; Gereffi & Korzeniewicz, 1994

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Russian Investment Funds and Globalization

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Abstract

The paper provides the characteristics of the types and categories of the Russian investment funds. It describes the constraints applied to the activities of management companies. The paper also observes the directions in which globalization affects the activities of the Russian investment funds in non-standard economic conditions.

Keywords

Investment funds, management companies.

Introduction

The first investment funds appeared in Russia in 1992. They were called specialized (voucher) privatization investment funds and were established for the purpose of their participating in privatization processes. A considerable part of such special privatization securities – privatization vouchers – were accumulated in these funds (Milovidov, 1996). The management companies of such investment funds gained some experience of collective investment management. By the end of the privatization in 1994, most of the specialized (voucher) privatization investment funds ceased to exist (Gorlovskaya & Miller, 2010). The first mutual investment funds appeared in the Russian Federation in 1996. Their operating rules were significantly changed in 2001 due to the adoption of the Federal Law № 156-FZ “On Investment Funds” (The Federal Law, 2001). Currently, there are 6 joint-stock investment funds (similar to corporate funds in foreign practice) and 1381 mutual investment funds (similar to mutual funds in foreign practice) in the Russian Federation. These funds are run by 396 management companies (Central Bank, 2015a).

Commercial banks compete with investment funds. They offer investors traditional deposits and non-state pension funds.

In the studies of the Russian investment funds, the following areas should be highlighted:

- the consideration of the regulatory issues of investment funds by the state regulator and the self-regulatory organizations of management companies (Milovidov, 1996; Kapitan & Baranowski, 2007; Alexandrov, Motrunich, & Shakhurin, 2014; Semenova, 2014),
- the study of the behavior of the investors who invest in mutual investment funds (Ivanitskii & Melnikov, 2000; Aizin, 2007; Belova, Kapitan, & Lekarev, 1999; Khmyz, 2010),
- the development of techniques for managing investment funds on the basis of an analysis of the features of the various types and categories of investment funds in Russia as well as methodological developments (Bark, 2004; Bogdanov, 2007; Volkova, 2005; Lukyanova & Nechaev, 2007),
- the study of the effectiveness of mutual investment funds companies in the different stages of the Russian securities market development by the types of such investment funds (Abramov & Akshentseva, 2014; Seltzer, 2006; Lukashin, 2011a, 2011b; Osipova, 2010a, 2010b; Sadkova, 2005; Hromushin, 2001),

- the study of the risks associated with collective investments (Boldireva, 2005, 2006, 2010; Galanov, 2007, 2008),
- the impact of globalization on the collective investments market is studied in the works of Mirkin (2002, 2011) and Nagornykh (2014).

In this work, the effect of globalization on the activities of the Russian investment funds in unusual economic conditions is determined. For this purpose, the Russian investment funds managed by the largest management companies have been analyzed.

1. Types of investment funds in the Russian Federation

Joint-stock investment funds are not common in the Russian Federation. This is facilitated by the following factors:

- the complicated procedure of the establishment of a joint-stock company,
- the fact that it is necessary that not only management companies, but also investment funds should obtain a license from the mega-regulator, i.e. the Bank of Russia,
- a lack of the guaranteed payment of dividends to shareholders, because a fund has the right to only issue ordinary shares, the dividend of which is not guaranteed, and
- a lack of tax incentives. As a legal entity, a joint-stock investment fund pays tax on its profits, and investors pay tax on their personal income upon receipt of their dividends.

Therefore, joint-stock investment funds are usually a “closed club” which does not disclose information publicly. In addition to including traditional financial instruments, the portfolios of such investment funds usually also include a real estate. The joint-stock companies’ investors’ actual income accounts for the difference between the liquidation value of the ordinary shares and the purchase prices at the establishment of the fund (Boldireva, 2010).

Mutual investment funds the most popular funds in the Russian Federation.

A mutual investment fund is a property complex without creating a legal entity, which is controlled by a management company. Mutual investment funds are created to increase the invested funds of investors (the owners of investment

shares). In the Russian Federation, mutual investment funds are divided into open-end, interval, closed-end and exchange mutual investment funds.

A mutual investment fund is referred to as an open-end fund if a management company undertakes an obligation to repurchase its issued investment shares at the request of the investor within a period not exceeding 15 days from the date of the submission of a redemption application. A mutual investment fund is called an interval fund if the management company undertakes an obligation to carry out the redemption of its issued investment shares within a period not shorter than once in a year. A closed-end mutual fund is created for a specified period, after which its investment shares are canceled. During the time of the operation of such a fund, a management company does not redeem its investment shares. When Russia is concerned, there is a new type of an investment fund known as an exchange investment fund (similar to an exchange traded fund). Such funds’ shares are listed on the Moscow Stock Exchange. The conditions mandatory for the inclusion of the investment shares of a mutual investment exchange fund in the quotation list of the first level of the Moscow Stock Exchange are as follows:

- a market-maker, working with investment shares, should be present on the spot,
- a management company should ensure the purchase points for the investment shares of a mutual exchange fund in not fewer than 7 federal districts of the Russian Federation. (There are only 9 federal districts in the Russian Federation) (Moscow Exchange, 2015).

The initiator of the establishment of a mutual investment fund is the management company the holder of a special license issued by the Bank of Russia. It registers the rules of a mutual investment fund with the Bank of Russia and issues investment shares. In order to register investors’ rights to investment shares, such a management company signs a contract with the registrar of the safety of the fund’s assets. It is a contract with a specialized depository.

2. Investment funds’ assets

Each investment fund has its own investment declaration, i.e. the document describing the purposes of the fund and the investment policy of the man-

agement company. The declaration of the investment of the mutual investment fund should include the following information:

- a description of the objectives of the investment policy of the mutual-fund management company,
- a list of investment objects;
- a description of the risks connected with investing in these investment objects,
- requirements for the mutual investment fund's asset structure.

It should be noted that investment funds' assets can be divided into specific and total ones. Total assets are assets constituting any investment fund's portfolio. Such assets include:

- a) cash funds, including a foreign currency,
- b) the state securities of the Russian Federation and the state securities of the subjects of the Russian Federation; municipal securities, if such securities were listed on a stock exchange or had a credit rating not below the "BBB-", rated by such rating agencies as "Fitch Ratings" or "Standard & Poor's", or not below the "Baa3" rating, according to the classification of the "Moody's Investors Service" rating agency,
- c) the shares and bonds of Russian economic societies,
- d) the securities of foreign governments and international financial institutions, provided that the information on applications for the purchase and/or sale of such securities are/is placed by such news agencies as Bloomberg or Thomson Reuters; or on condition that such securities are traded on the stock exchange as well as in case the issuer of such securities is rated with a long-term credit rating not lower than the "BBB-", rated by such rating agencies as "Fitch Ratings" or "Standard & Poor's", or not lower than the "Baa3" rating, according to the classification of the "Moody's Investors Service" rating agency,
- e) the shares of foreign corporations and the bonds of foreign commercial organizations, foreign depository receipts, if such securities were listed on one of the following stock exchanges: American Stock Exchange; Hong Kong Stock Exchange; Euronext Amsterdam, Euronext Brussels, Euronext Lisbon, Euronext Paris; Moscow

stock exchange; Irish Stock Exchange; BME Spanish Exchanges; Borsa Italiana; Korea Exchange; London Stock Exchange; Luxembourg Stock Exchange; Nasdaq; Deutsche Borse; New York Stock Exchange; Tokyo Stock Exchange Group; Toronto Stock Exchange, TSX Group; Swiss Exchange; Shanghai Stock Exchange,

- f) the investment shares of mutual investment funds,
- g) the mortgage securities issued in accordance with the legislation of the Russian Federation on mortgage securities,
- h) Russian depository receipts (RDR),
- i) the property rights of option agreements (contracts) and futures agreements (contracts) (excluding index funds) (Order of the Federal Financial Markets Service of the Russian Federation from 28.12.2010 № 10-79, 2010). Specific assets allow funds to be divided into fifteen categories.

3. Mutual investment funds categories

Depending on the content of the investment declaration and the characteristics of the composition and structure of portfolios, the following categories of funds can be established in the Russian Federation:

- 1) a money market fund (a substantial share in the fund's portfolio belongs to the cash funds and debt securities maturing up to 1 year),
- 2) a bond fund,
- 3) a share fund,
- 4) a mixed investment fund,
- 5) a direct investments fund (the fund's portfolio may include shares in the authorized capital of Russian companies with a limited liability),
- 6) a high-risk (venture capital) investment fund (the portfolio of which fund may include low liquidity, but potentially high-yield securities),
- 7) a fund of funds (whose portfolio may include the shares of joint stock investment funds and the investment units of mutual investment funds; foreign investment funds' shares, with the exception of foreign investment funds' shares which stand for a fund of funds in accordance with the personal law of the foreign issuer; Russian and foreign depository receipts for foreign investment funds' shares, with the exception

- of such shares of foreign investment funds that represent a fund of funds in accordance with the personal law of the foreign issuer),
- 8) a rental fund (the portfolio of such a fund includes a real estate and the right of its rent),
 - 9) a real-estate fund (whose portfolio includes a real estate and the right of its rent. It also includes property rights under contracts, on the basis of which the construction (creation) of such real estate objects is implemented; the rights of the land rent; the stocks or shares of Russian business entities dealing with the designing and construction of buildings and structures, engineering surveys for the construction of buildings and structures, and (or) the restoration of cultural heritage (historical and cultural monuments)),
 - 10) a mortgage fund (the portfolio of such a fund may include mortgage bonds certifying the rights of the mortgagee on mortgage-secured credit or loan agreements and mortgage contracts; the mortgage securities issued in accordance with the legislation of the Russian Federation on mortgage-backed securities),
 - 11) an index fund (with an indication of the index). The portfolio of this fund only includes:
 - a) cash funds, including a foreign currency in the accounts and in deposits at credit institutions,
 - b) such securities on the basis of which a corresponding index is calculated.
 - 12) a credit fund (whose assets may represent cash requirements on credit or loan agreements, the performance of the obligation regarding the same being secured by collateral, a guarantor or a bank guarantee; they may also be a property in a form of a pledge subject in accordance with the civil legislation of the Russian Federation),
 - 13) a commodity market fund (the assets of this fund are precious metals),
 - 14) a hedge fund (It is a fund of high-risk investments. Its portfolio includes precious metals, including requirements for the credit institution to pay their cash equivalent at the current rate; the property rights from option agreements (contracts) and futures agreements (contracts), the basic assets of which agreements are commodities; illiquid securities).
 - 15) an artistic values fund. This fund's assets may include:
 - hand-made paintings and drawings made on any basis and from any materials,
 - original sculptural works from any materials, including relieves,
 - original artistic compositions and montages made from any materials,
 - artistically designed objects of a cultural purpose, in particular icons,
 - postage stamps, other philatelic materials, either singly or in collections,
 - engravings, prints, lithographs and original printed forms,
 - works of decorative and applied arts, including pieces of art made from glass, ceramics, wood, metal, bone, cloth and other materials,
 - photographic, sound, film, video archives,
 - old books, publications of special interest (historical, artistic, scientific and literary), including rare manuscripts and documentary monuments,
 - unique musical instruments,
 - ancient coins (Order of the Federal Financial Markets Service of the Russian Federation from 28.12.2010 № 10-79, 2010).

Investment funds' assets (belonging to the category of index funds, whose stocks and investment shares are intended for qualified investors) may include foreign financial instruments which help calculate the following indices: S&P Global 1200 Index; S&P Global 100 Index; MSCI EAFE Index; MSCI EAFE Growth Index; MSCI EAFE Value Index; Dow Jones Global Titans 50; FTSE High Dividend Yield Index; S&P Global Industrials; MSCI EMU Index; MSCI Europe Index; MSCI Pan-Euro Index; Dow Jones Euro STOXX 50; S&P Europe 350 Index;

The quantitative composition of the Russian mutual investment funds is shown in Table 1 below.

Table 1 The quantity of the mutual funds on 26th January 2015

Category of fund	Open-end	Interval	Closed-end	Total number
Share funds	146	16	25	187
Bond funds	78	0	1	79
Mixed investment funds	83	15	34	132
Money market funds	10	0	0	10
Index funds	24	0	0	24
Funds of funds	44	1	0	45
Commodity market funds	Not provided	6	0	6
Hedge funds	Not provided	8	13	21
Mortgage funds	Not provided	Not provided	4	4
Artistic values funds	Not provided	Not provided	1	1
Venture capital funds	Not provided	Not provided	54	54
Real estate funds	Not provided	Not provided	571	571
Direct investment funds	Not provided	Not provided	102	102
Rental funds	Not provided	Not provided	79	79
Credit funds	Not provided	Not provided	66	66
Totally:	385	46	950	1381

Source: National League of Management Companies, 2015a

4. Restrictions on the activities of mutual investment funds management companies

The restrictions concern:

- the distribution of assets in the investment portfolio of a fund between the classes of financial instruments (stocks, bonds, derivatives, real estate),
- the industrial affiliation of financial instruments in the fund portfolio (there are restrictions on the purchase of the securities of the companies in the financial sector),:
- the determination of potential investors (there are categories of portfolios solely intended for qualified investors). The quantitative composition of the funds intended for qualified investors is accounted for in Table 2.

Table 2 Funds for qualified investors on 2nd June 2015

Category of fund	Open-end	Closed-end	Total number
Share funds	0	7	7
Bond funds	0	1	1
Mixed investment funds	0	5	5
Hedge funds	11	15	26
Mortgage funds	not provided	2	2
Venture capital funds	not provided	54	54
Real estate funds	not provided	373	373
Direct investment funds	not provided	121	121
Rental funds	not provided	12	12
Credit funds	not provided	73	73
Totally:	11	663	674

Source: National League of Management Companies, 2015a

The presence of specific assets in the portfolio of a mutual investment fund is regulated by the laws of the Russian Federation: a real estate and property rights to a real estate may only be part of joint-stock investment funds' assets and closed-end mutual investment funds' assets.

The investment funds classified as direct investment funds, mortgage funds, high-risk (venture) investments, rental funds, real-estate funds, funds of artistic values and credit funds can only be joint-stock investment funds and closed-end mutual investment funds.

The investment funds classified as hedge funds and commodity market funds can only be joint-stock investment funds, closed-end and interval mutual investment funds.

The shares (investment shares) of the investment funds belonging to the categories of direct investment funds, funds of high-risk (venture) investments, loan funds and hedge funds are only intended for qualified investors.

In accordance with the Federal law as of 29th November 2001, N 156-FZ "On Investment Funds", a management company is not allowed to perform the following actions, namely to:

- 1) acquire objects not provided by the investment declaration of the investment fund,
- 2) alienate gratuitously the property constituting the mutual investment fund,
- 3) enter into loan agreements or credit agreements, as well as repurchase agreements, except for the redemption of investment funds,

- 4) acquire (alienate) the property from its affiliates,
- 5) acquire the property from a specialized depository, the appraiser and audit organizations with whom/which the management company has concluded contracts,
- 6) dispose of the property constituting the mutual investment fund, without obtaining a prior consent of the specialized depository, except for transactions made on the organized trades conducted either by a Russian or foreign stock exchange or another trade organizer,
- 7) use the property constituting the mutual investment fund for ensuring the performance of their own obligations not connected with the trust management of mutual investment funds (the Federal Law "On Investment Funds" as of the day of 29th November 2001, N 156-FZ (ed. 3rd December 2014)).

As the mega-regulator of the financial markets, the Bank of Russia monitors how these rules and restrictions are observed.

5. Activities of mutual investment funds management companies in modern conditions

Russian management companies' primary task is to identify a potential client-investor. The fact is that, for objective reasons, there are no mass retail investors in Russia. According to the Federal State Statistics Service of the Russian Federation, the average per capita income was 20 80 rubles in 2011, 23,221 rubles in 2012, 25,928 in 2013 and 27,887.4 in 2014 (the data obtained for the III quarter). 47-48% of the income generated from the total amount of the population's income accounts for the group with the highest income that numbers only 20% of the entire population. The share of expenditure on the purchase of goods and services is about 74%. In the structure of the monetary income usage, people's savings had a share of 10.4% in 2011, 9.9% in 2012 and 9.8% in 2013 (The Official Statistics, 2014).

According to the Federal State Statistics Service of the Russian Federation, the population invested 1,964.5 mill. rubles in securities in 2013 (which equaled to 10.2% of the savings). In 2014, this increased to 2,521.4 mill. rubles (or 12.2% of the savings) (The Official Statistics, 2014). According to the National Association of Stock Mar-

ket Participants, the number of investors (who are individuals) actively conducting transactions on the organized securities market in 2012 was 824.1 thousand people. In the first half of 2013, this number was 818.1 thousand people and in the first half of the year 2014, it reached the figure of 900.9 thousand people. This is respectively 1.05% of the active population. There is no official data on the number of the investors-shareholders of mutual investment funds. But the data on the number of personal accounts in the register of investment shareholders can indicate their quantity indirectly. Thus, in 2011 their number was 1,951,877, in 2012 there were 2,034,593 and in 2013, there were 2,033,841 personal accounts (Russian Stock Market, 2013, 2014).

The strategy of a mutual investment fund management company is formed on the analysis of the factors of the external and internal environment. It is based on the collective investment principles: risk averaging; the investment diversification, the division of labor between the elements of the service infrastructure; the government regulation. This strategy is restricted by the rules of the national law on investment funds.

Globalization affects the making of the strategy of investment funds management companies. This is manifested in the extension of the range of the underlying financial instruments used by Russian management companies for the formation of investment funds' assets; the prospects for the use of derivative financial instruments whose underlying assets are foreign issuers' securities, including the securities of transnational corporations; the use of standardized approaches in the construction of new types of mutual investment funds.

Y. Mirkin (2011) indicates that the relationship dynamics of the stock markets of industrialized countries and Russia from 1992 to 2010 show that all financial markets in Russia acted as global. The national features are manifested during the change of the fundamental factors (political and economic) only (Mirkin, 2011). This demonstrates the collective investments market.

After the global financial crisis of 2007-2008, the net asset value of mutual investment funds sharply increased and reached 1.2% of the GDP by the end of 2010. In 2014, there was deterioration in the position of mutual funds (Figure 1).

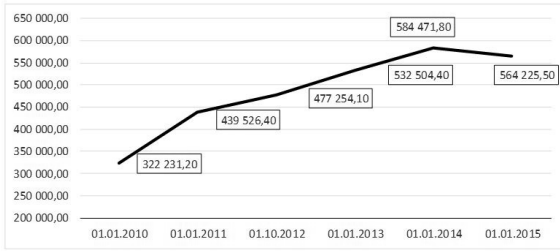


Figure 1 Change in the net asset value of mutual funds in 2010-2014, mill. rubles.
Source: National League of Management Companies, 2015b

Allow us now to consider the results of the activities of management companies and investment funds carried out in the last 5 years. The Russian Central Bank’s data show that, according to the number of the accounts, the leading role is played by interval funds. According to the net asset value, the leading role belongs to closed-end mutual investment funds (see table. 4).

Table 4 The activity indicators of mutual investment funds

Year	Number of personal accounts in the owners’ register of investment share, in thousands of units. / (Share by types of funds, in %)				Net asset value, bn. rubles / (share by type of funds, in %)			
	Totally	Open-end	Interval	Closed-end	Totally	Open-end	Interval	Closed-end
2011	1,951.88 (100%)	795.04 (40.7%)	1,148.22 (58.8%)	8.62 (0.5%)	1,294.2 (100%)	81.4 (6.3%)	20.9 (1.6%)	1,191.9 (92.1%)
2012	2,034.59 (100%)	871.98 (42.8%)	1,153.64 (56.7%)	8.97 (0.5%)	1,598.0 (100%)	88.8 (5.6%)	18.3 (1.1%)	1,491.0 (93.3%)
2013	2,033.84 (100%)	888.37 (43.8%)	1,135.74 (55.8%)	9.73 (0.4%)	1,865.9 (100%)	113.2 (6.1%)	19.5 (1.1%)	1,733.2 (93.3%)
2014 III quarter	2,277.87 (100%)	1,109.35 (48.7%)	1,158.95 (50.9%)	9.57 (0.4%)	2,048.5 (100%)	94.9 (4.6%)	19.8 (1.0%)	1,933.7 (94.4%)

Source: Central Bank, 2015b

Despite the fact that a greater number of accounts were opened in the open-end and interval mutual investment funds, closed-end mutual funds take the leading role on the net asset value. More than 60% of them are real estate funds and rental funds. Their shareholders are primarily legal entities. Open-end and interval mutual funds are intended for retail investors. Their attractiveness lies in the high degree of the liquidity of investment shares and the availability of tax benefits upon investment share redemption. Information on open-end and interval mutual funds is disclosed on management companies’ websites and the National League of Management Companies. Closed-end mutual funds and funds intended for qualified investors do not reveal such information. The studies by Abramov A., Akshentseva K. have shown that, during the recession period, the growth of assets was mainly ensured by the revaluation of the portfolio value and asset transactions (Abramov & Akshentseva, 2014, pp. 35-36). The

weighted average yield of mutual funds in the Russian Federation is presented in Table 5.

Table 5 The weighted average yield of open-end and interval mutual investment funds in the Russian Federation

Category of fund	Weighted average yield of mutual funds		
	For 5 years (from 31 st Dec. 2009 to 31 st Dec. 2014)	For 3 years (from 30 th Dec. 2011 to 31 st Dec. 2014)	For 1 year (from 31 st Dec. 2013 to 31 st Dec. 2014)
Share funds	20.64 %	17.35 %	-1.17 %
Bond funds	41.65 %	18.07 %	11.25 %
Mixed investment funds	22.52 %	20.84 %	10.35 %
Money market funds	46.53 %	24.69 %	7.52 %
Index funds	4.53 %	2.48 %	-6.01 %
Funds of funds	214.29 %	96.84 %	68.70 %

Source: National League of Management Companies, 2015b

As you can see, the funds of funds have shown the highest yields over the last five years. The ten best funds (in terms of their profitability) are presented in Table 6.

Table 6 The ranking of open-end mutual investment funds’ yield for 5 years from 31st Dec. .2009 to 31st Dec. 2014

Rank	Mutual investment funds	Management company	Minimum amount of share purchase, rub.	Category of fund	Growth of share value
1	Raiffeisen-USA	Raiffeisen Capital	3 000 000	Fund of funds	264.68%
2	OLMA - USA	OLMA-Finance	10 000	Fund of funds	178.06%
3	Alfa Capital High technology	Alfa Capital	1 000	Fund of funds	151.07%
4	Sberbank-telecommunications and technology	Sberbank Asset Management	15 000	Share fund	115.79%
5	TKB BNP Paribas – Foreign currency bonds’ fund	TKB BNP Paribas investment partners	50 000	Bond fund	105.66%
6	BCS - Foreign Funds	BrokerCreditService	50 000	Fund of funds	93.14%
7	Peter Bagration	Parma-Management	100 000	Mixed investment fund	90.00%
8	Alfa Capital Strategic Investments	Alfa Capital	50 000 000	Mixed investment fund	89.99%
9	VTB - Fund Global dividend	VTB Capital Asset Management	1 000 000	Share fund	89.48%
10	Sberbank - America	Sberbank Asset Management	15 000	Fund of funds	89.04%

Source: National League of Management Companies, 2015b

Funds of funds are focused on shares of foreign investment funds that have passed the listing procedure on the major stock exchanges of the world. Assets of share funds, bond funds and mixed investment funds are not only the underlying securities of Russian and foreign issuers, but also of futures and option contracts.

In terms of management companies, companies managing several funds are distinguished. These management companies implement a reasonable pricing policy when assigning a price for the sale or redemption of an investment share and are focused on different categories of investors. A special feature is that these management companies are “bank” management companies (Mirkin,

2011, pp. 147-148). The diversification of investments in such management companies (with the aim of minimizing risks) is primarily revealed in the allocation of resources by types of funds which are under their control (Table 7).

Table 7 The ranking of the management companies according to the number of the mutual investment funds under their control as at 2015.

Rank	Management company	Number of mutual funds under control				Share in the total number of mutual funds	Net asset value (without closed-end mutual funds) in bn. rubles	Share in total volume of net asset value
		Open-end	Interval	Closed-end	Totally			
1	VTB Capital Asset Management	17	2	15	34	2.46%	4,599	4.51 %
2	AKBARS CAPITAL	6		18	24	1.73%	0,055	0.05 %
3	Sberbank Asset Management	19	2	3	24	1.73%	22,244	21.80 %
4	Alfa Capital	14	3	4	21	1.52%	9,442	9.26 %
5	Promsvyaz	4		17	21	1.52%	0,094	0.09 %
6	University of Management	11	2	6	19	1.38%	0,205	0.20 %
7	URALSIB management company	18	1		19	1.38%	9,883	9.69 %
8	Raiffeisen Capital	17	1		18	1.30%	18,896	18.52 %
9	Gazprombank-asset Management	11		6	17	1.23%	3,394	3.33 %
10	Management of Savings	10	1	6	17	1.23%	1,338.96	1.31 %

Source: The Author's calculations based on the data taken from the National League of Management Companies, 2015c

The data in the table show that 2.5% of the considered management companies cover 15.5% of the total number of the mutual investment funds, including 10.1% of the open-end and interval mutual funds. The net asset value of the managed mutual funds (excluding the closed-end mutual funds) is 68.76% of the net asset value of all the open-end and interval mutual funds. This confirms the conclusion made by Y. Mirkin (2011) about a high degree of the monopolization of the collective investment market (Mirkin, 2011).

The further diversification is made according to the categories of the funds. The analysis of the open data of the five management companies (The National League of Management Companies. Mutual investment funds, 2014) with the most significant share of the total net asset value shows that 48.2% of the open-end mutual investment funds constitute share funds; 20.0% constitute the funds of funds; 15.3% are the bond funds; 10.6% belong to the mixed investment funds. The index funds and money market funds make up 3.5% and 2.4%, respectively. Among the interval mutual funds, 33.3% of them belong to the share funds and 22.2% constitute the commodity market funds, mixed investment funds and hedge funds. If the profitability of the funds is compared between the funds, it can be seen that, in 2014, the highest yield was shown by the following management companies:

- the open-end investment funds such as Sberbank Asset Management (99.80% – a fund of funds “Sberbank-America”, investing in ETF SPDR S&P500); VTB Capital Asset Management (85.79% - a share fund “VTB-Fund Metallurgy”),
- the interval mutual investment funds – Raiffeisen Capital (106.35% – a commodity market fund “Precious metals”, investing in unallocated metal accounts); VTB Capital Asset Management (100.51% – a commodity market fund “VTB-Precious Metals Fund”, investing in gold, silver and platinum).

In the course of the conducting of the analysis of the investment funds managed by the five most important management companies, a fact was established that during the recession period from 2011 to 2014, the strategy of the management companies of the Russian mutual investment funds was formed in line with the increasing share of the underlying securities of foreign issuers and derivative financial instruments, the underlying assets of which are securities of foreign issuers. The share of the financial instruments of foreign issuers in the net assets value (in 2015) remains significant, especially for such management companies as Raiffeisen Capital and Alfa Capital (Figure 2).

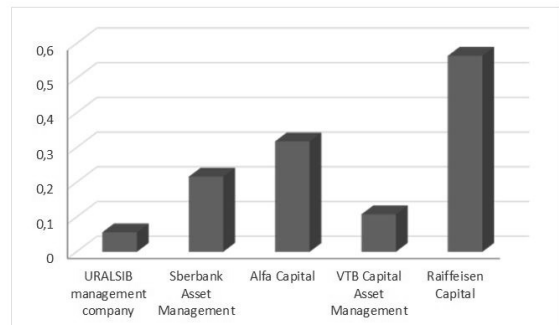


Figure 2 The share of the financial instruments of foreign issuers in the NAV of the open-end investment companies under the control of the management companies NAV5 on 01.30.2015.

Source: The calculations based on management companies' data.

The main areas of investment are: the investment units of foreign ETF, the securities of the issuers coming from BRIC countries, the securities of high-tech companies, and Eurobonds. The analysis of the investment returns and primary documents of management companies revealed that the volume of raising funds into funds for open-end mutual investment funds (i.e. the funds

primarily focused on retail investors) showed negative dynamics in 2014 compared to 2013: the cash outflows were equal to minus 16.7 billion rubles on the results generated in the first six months of 2014. That happened primarily due to the outflows from the bond funds. The outflows from the share funds amounted to minus 3.3 billion rubles (Russian stock market, 2014). The data analysis of the National League of Management Companies shows that the greatest decrease in the net assets value over the last four years has been demonstrated by the open-end mutual investment funds of the “share funds” category.

The calculations based on the Bank of Russia's data (Central Bank, 2015b) show that the overall volume of the redemption of investment shares is growing. If the available data for the first three quarters of 2014 are compared with the annual volume of the year 2012, it is possible to see an increase of 26.5%, while in comparison with the three quarters of 2013, it was 120.1%. The largest volume of the redemption of investment shares for the first three quarters of 2014 accounted for the open-end mutual investment funds (55.4 billion rubles) and the closed-end mutual funds (38.7 billion rubles). This sharp decline can firstly be explained by a fall in the market value of the underlying financial instruments (at the end of 2014, the MICEX index decreased by 7.2%, whereas the RTS index decreased by 45.1% (Ministry of Economic Development of the RF., 2015, p. 125)), and secondly, by the withdrawal of the investors' monitory funds from the high-risk market connected with new risks in the financial markets of the Russian Federation. Купцов (throughout 2014, the price of one barrel of crude oil “Urals” decreased by 44.4%; the real weakening of the ruble against the US dollar (including both external and internal inflations) was 34.5%, and against the Euro – 26.6% (Ministry of Economic Development of the RF., 2015, pp. 8-9, 118)).

The change in the volume of the borrowed funds in the funds of funds of the largest management companies is accounted for in Figure 3.

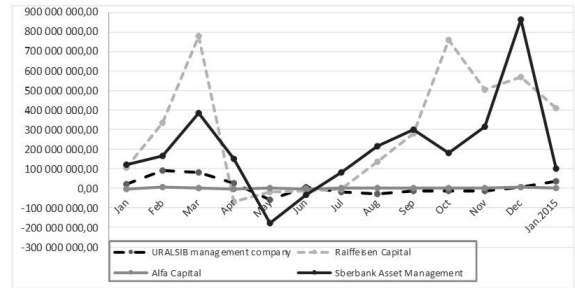


Figure 3 Change in the volume of the borrowed funds in the funds of funds of the largest management companies in 2014 and in January 2015 (thous. rubles).

Source: The calculations based on the management companies' data.

The change in the volume of the inflows into (outflows from) the funds of funds in 2014 is not associated with the change in the euro rate (the correlation coefficient being -0.394713871) and is weakly associated with the changes in the average yield and the net asset value. The correlation coefficients were 0.69 and 0.507009321, respectively. Similarly, there was a weak dependence of these indicators in 2014 when the share funds are concerned, the correlation being 0.464978487 and 0.490651114, respectively. The bond funds seem to be an exception. The relationship between the inflows (outflows) and the change in the average yield is more significant for them (the correlation coefficient being 0.705312593 in 2014), while the relationship between the inflows (outflows) and the change in the net asset value is rather a strong one (0.985633134). This is the violation of the “smart money effect” (Gruber, 1996, p. 807; Zheng, 1999, pp. 902-903; Sapp & Tiwari, 2004, pp. 2005-2006; Abramov & Akshentseva, 2014, pp. 44-45) in relation to Russia: in terms of the non-economic methods of the influence on the Russian economy, this effect begins to act for the bond funds and ceases its operation for the other types of investment funds.

6. Risks in the activities of mutual investment funds management companies

While designing a mutual investment fund strategy, the management company takes into account some risks. They are common risks (for all funds) and specific risks related to the category of a fund.

Common risks traditionally include:

- political and economic risks associated with the ability of having the political situation changed: expropriation; nationalization, a policy aimed at limiting investment in the sectors of economy which stand for

the areas of a special interest of the state; an energy prices fall and other circumstances,

- a systemic risk associated with the inability of a large number of financial institutions to fulfill their obligations; amongst such risks, the risks of the banking system, the risk of systemically important financial institutions (in Russia, they include a non-bank credit organization – CJSC “National Settlement Depository”, the central depository, the settlement depository, the repository) and the CJSC joint-stock commercial bank “National Clearing Centre” (the central counter-agent) can be distinguished,
- a market risk associated with fluctuations in exchange rates and interest rates,
- a price risk revealed in the securities price change that could lead to a drop in the value of the fund assets,
- a risk of unauthorized actions in respect of securities by third parties,
- a credit risk particularly associated with a possibility of the non-fulfillment of the undertaken obligations on the part of the issuers of such securities and the counterparties to transactions,
- a market liquidity risk associated with a potential inability to realize assets at favorable prices,
- an operational risk associated with a possibility of the malfunctioning of the equipment and the software used in the processing of transactions, as well as the wrongful acts or inactions of the organization’s staff involved in making calculations, the implementation of depository activities and other circumstances,
- a risk associated with changes in applicable laws,
- a risk of force-majeure circumstances, such as natural disasters and military actions (Galanov, 2007, 2008).

However, globalization brings new risks, which can be seen on the example of the modern securities market of the Russian Federation. Firstly, the reasons for new risks are non-economic. They are sectoral sanctions against Russian banks and companies from the US, EU and other countries due to increased tensions in Ukraine as well as sanctions against some Russian citizens. Secondly, in view of financial markets linkages, sanctions against some segments cause risks in other

segments, particularly in the mutual investment market. “The indirect effect of the sanctions is connected with the fact that, in order to avoid their wider interpretation by the US and the EU governments and having some fear of a possible spread of restrictions on a wider range of Russian companies, foreign contractors prefer to minimize their risks. In particular, they:

- limit the refinancing of the external debt – not only for the companies that have come under the sanctions, but in some cases for other Russian borrowers as well,
- reduce the limits on Russian banks even for transactions that are not subjected to the restrictions (swaps and short-term loans),
- increase the cycle of payments in a foreign currency (as the result of the delays in payments due to the verification procedures, such delays lasting from several hours to several days).

In addition, foreign rating agencies have stopped assigning ratings to the new instruments of the companies that have come under the sanctions. This restricts issuers from the placement of bonds among institutional investors obliged to make investments in bonds with a rating not below a certain level (Financial Stability Review, 2014, p.18).

Thus, new specific risks in the context of globalization and in terms of external influences on the national economy in order to change national political decisions are as follows:

- the risk of restrictions of the refinancing of the external debt, which can lead to the default by the issuers whose debt securities are the assets of such bond funds,
- risks of limiting cross-border transactions; it is especially important for mutual investment funds in whose assets there are underlying securities and derivative financial instruments of foreign issuers,
- the risk of the disconnection of payment systems; if this happens, it will make trade and exchange operations impossible,
- the risk of reductions in the credit ratings of the issuers whose securities are the assets of investment funds,
- the risks of accelerating capital export from Russia.

Under these conditions, risks such as the market liquidity risk, the market risk associated with

fluctuations in exchange rates and interest rates; the price risk, revealing in the price changes on securities which could lead to a drop in the value of the fund's assets appear to be particularly acute.

According to VTB Capital Investment Management, the geopolitical discount on shares in Russian assets was 0.92 in mid-September 2014 (A Look at the Capital Markets, 2014). The change in the coefficient α funds of funds shows a decrease in the effectiveness of the mutual investment funds and their management companies in 2014 (Figure 4). A sharp decline in the efficiency and an increase in risks occur on the background of the strengthening of the sanctions against Russia starting in March 2014. It can be assumed that some easing of the sanctions in late 2014 early 2015 will contribute to the growth of α .

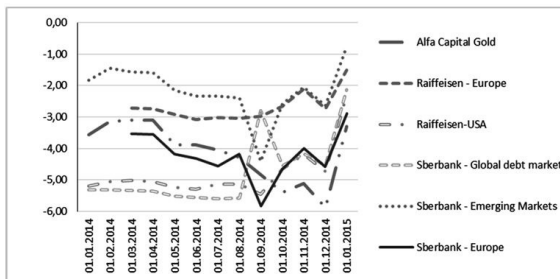


Figure 4 Change in the α coefficient of the funds of funds managed by Alfa Capital, Sberbank Asset Management, Raiffeisen Capital.

Source: Investfund Cbonds Group, 2015

Conclusion

On the one hand, the benefits of globalization turn out to be problems connected with the weakness of the national economy; on the other hand, one should speak about the specific forms of de-globalization. The political and economic sanctions and restrictions currently applied to financial institutions and industrial companies artificially force the acceleration of the domestic economic processes in Russia. Amongst these processes, the modernization of the strategically important national industries, the provision of food and industrial safety and the search of new economic partners in the countries not participating in the sanctions against Russia are possible to distinguish. (Dudin & Lyasnikov, 2014, p. 115). When the investment funds are concerned, it implies the adjustment of the investment strategy and tactics. Firstly, it is the orientation towards qualified and institutional investors as well as retail investors from a number of the top and middle management

of Russian companies. Secondly, it is the merging of the funds aimed at the reduction of management costs. Thirdly, refocusing on national securities and securities of issuers of emerging markets is inevitable. Fourthly, legislative changes concerning the rules of the formation of an investment fund's assets, an expansion of assets and tax incentives stimulating long-term investment are needed. **SM**

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Capital Raising for Financing Serbian Economy

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Abstract

The paper points out the importance and necessity of application of new models for providing funding that would enable Serbia to finance the development of the economy as well as projects of national importance. In addition to the permanent loans, Serbia should take advantage of issuing bonds in the national and international financial market. The capital required for funding infrastructure, industry and the development of entrepreneurship, agriculture and tourism may be obtained from domestic and foreign investors. Project finance, asset securitization, diaspora bonds and the GDP-indexed bonds are sources of capital applied to a greater or lesser extent by other countries in transition. The possibility of establishing special trusts for the securitization of commercial mortgage loans such as Real Estate Mortgage Investment Conduit (REMIC) and Real estate investment trusts (REITs) would bring additional capital for financing the economy in Serbia. Future-Flow Securitizations can use Diversified Payment Right (export earnings, foreign direct investment inflows, workers' remittances) as an asset for the issuance of bonds, credit card merchant voucher receivables, hotel revenues, vacation ownership receivables, future revenues from agriculture, repurchase agreements and warehouse receipts.

Keywords

Asset securitization, future-flow securitizations, diaspora bonds, GDP linked bonds, project finance.

Introduction

Development of economy requires capital for financing industry and infrastructure projects (roads, ports, airports, bridges, railroads, telecommunications, etc.), development of energy sector (hydroelectric plants, oil and gas pipelines), development of infrastructure, tourism, entrepreneurship, small and medium-sized enterprises, and construction of public facilities (hospitals, schools, prisons), etc. Like other transition countries, in addition to loans, Serbia should make use of other forms of capital raising. Capital can be raised by issuing bonds on the national and international financial markets. Bonds can be issued based on securitization of various assets, diaspora bonds, GDP-indexed bonds and project finance bonds.

Transition countries have been applying asset securitization for over 20 years, including loan

securitization (mortgage, student, agricultural loans, etc), equipment leasing, receivables from credit cards, receivables from telephone services, workers' remittances, foreign direct investments and export receivables. The collateral for securitization in transition countries may include future income from agriculture, repurchase agreements, warehouse receipts, and future income generated by hotels can be used as well. Diaspora bonds are used by Israel, India, Sri Lanka, Ghana, etc., and the raised capital is used for infrastructure projects. GDP indexed bonds are used by Bulgaria, Bosnia and Herzegovina, Argentina, and Greece. Project financing is used by Russia, China, Brazil, Poland, the Czech Republic, Mexico and Turkey.

1. Loans as collateral for issuing bonds

Mortgage loans and loans for small and medium sized enterprises are a particularly significant factor for the development of the Serbian economy. Also, development of Serbian agriculture requires issuing pool bonds based on agricultural loans.

A commercial mortgage loan is a loan approved for the purchase of assets generating revenue (CRE, commercial real estate). Loans are, in most cases, used for the purchase or construction of plants, business premises, warehouses and flats for leasing, hotels, restaurants, shopping malls, hospitals, etc. These loans are used for issuing commercial mortgage-backed securities (CBMS), debt instruments using commercial real estate as collateral. CBMS can be issued in a pool with one or more loans. Payments to investors depend on cash flows raised from the commercial assets. CBMS consist of several tranches, with different risks and returns. If banks in Serbia could sell commercial mortgage-backed loans (to private or public special purpose vehicle (SPV)), they could also approve new commercial loans to the Serbian economy.

The possibility of establishing special securitization trusts such as Real Estate Mortgage Investment Conduit (REMIC) and Real estate investment trusts (REITs) would provide additional capital for financing the Serbian economy. Real Estate Mortgage Investment Conduit (REMIC) is a trust established with a sole objective – to securitize commercial mortgage-based loans. REMICs buy commercial mortgage-based loans from banks and issue commercial mortgage-backed securities (CBMS) against these. REMICs invest in agencies, housing and commercial mortgages and securities. REMICs play a significant role in the development of tourism in the USA. These trusts buy mortgage loans for hotel construction and issue collateralized mortgage obligations (SMOs). 110 billion dollars of mortgage loans for the development of tourist accommodation has been approved and securitized through REMICs (Sullivan, 2011).

Real estate investment trusts (REITs) are companies investing in real estate yielding revenue. REITs buy and rent accommodation and commercial real estate. REITs invest in hotels, shopping malls, rental flats, business premises, mortgage-based securities, etc. REITs raise capital by issuing shares and bonds (CBMS). In the USA, they are exempt from federal income tax at the corporate level. To achieve tax exemptions, they have

to pay minimum 90% of the taxed income to shareholder, and invest more than 75% of capital in real estate (Fabozzi, 2002, p. 297). In addition to investing in real estate and land, they also purchase mortgage-backed securities. REITs are, therefore, investors financing the issuers of mortgage-secured securities. Depending on the portfolio, there are several types of REITs: REITs investing in industrial facilities, warehouses, business premises, development land etc. (industrial REITs), then REITs purchasing real estate of all types and earn income by renting them (equity REITs). Mortgage REITs invest in mortgage-based securities, approve mortgage loans, securitize mortgage loans and mortgage-backed securities. Residential REITs invest in residential facilities such as houses and flats. There are also REITs investing in hospitality facilities such as hotels, resorts, etc. (lodging REITs).

In order to reduce unemployment, the state should enable and stimulate individuals to start their own business. State support stimulates entrepreneurship and establishment of small and medium-sized enterprises. Entrepreneurs and SMEs use banking loans. They are, in most cases, commercial mortgage loans. Poland, the Czech Republic and Bulgaria securitized loans for SMEs in 2006. Raiffeisen bank performed a synthetic securitization of loans for small and medium sized enterprises based on the loan pool worth 450 million euros approved by Raiffeisen in Poland and the Czech Republic. The hedger is KfW Bankengruppe, which issued bond tranches and transferred the credit risk from the asset pool to investors. The bonds were purchased by KfW Bankengruppe, the European Investment Fund and Raiffeisen International. The hedge buyers (and loan originators) are banks from the Czech Republic (Raiffeisen Bank as. Czech Republic) and Poland (Raiffeisen Bank Polska S.A.). The first loans for SMEs in Bulgaria were securitized by ProCredit Bank Bulgaria in May 2006. ProCredit Bank AD Bulgaria sold loans to the Amsterdam-based ProCredit Company B.V. trust. The trust issued BBB rated bonds, as assessed by the FitchRatings agency. The guarantee was provided by the European Investment Fund (EIF) and KfW Bankengruppe. ProCredit Bulgaria used the revenues from securitization for approving new loans to small and medium-sized enterprises (First Synthetic Securitization, 2008, p. 12).

Securitization of agricultural loans enables raising capital for financing agriculture. In Brazil, Agrosec Securitizadora Company buys agricul-

tural loans from banks and issues securities (certificado de recebíveis do agronegócio, Certificates of Agribusiness, CRA). The first issue by Brazil Agrosec Securitizadora Company was worth 50 million dollars, and the collateral was livestock. In Brazil, 2001 saw the establishment of Credit rights investment funds (FIDCs), closed- and open-type fund specialising in investing in securities financing agriculture (Herscovici, Herszkowicz, & Stacchini, 2008, p. 35). As Serbia grants subsidies for agricultural loans, the collateral for the first securitization could be subsidies loans. Loans for financing agriculture in Serbia are short-term and long-term. Loans can be approved for the purchase of seeds, fertilisers, land, livestock, long-term plantations, construction of facilities, purchase of machinery etc. Short-term subsidised loans have the repayment periods of three, six, nine and twelve months, and can be securitized based on revolving structure.

2. Future flow securitization

Future-flow securitization enables financing based on revenue generated in the future. It is very popular in transition and developing countries, as it enables eliminating the country risk, by applying offshore SPV. More than 400 securitizations have been performed so far in transition and developing countries (ranked by agencies) based on assets to be generated in the future, and at least 80 billion dollars has been raised (Ketkar & Ratha, 2009, p. 34). It is applied by the countries of Latin America, Africa and Asia.¹ Securitization is performed based on Diversified Payment Right (DPR) flows, receivables against credit cards (VISA, MC), warehouse receipts and repurchase agreements, aeroplane tickets, international telephone bills, etc. In addition to these assets, Serbia can use fees for gas transport and contracts between Srbijagas and final consumers.

DPR flows

Diversified Payment Right (DPR) flows include money transfers from foreign banks to domestic banks. The transfer of funds is performed based on payment orders given by a private or corporate person to a foreign bank. Payments are done based on trade, service rendered, orders from expatriates sending money to families in the home

country, etc. In effect, DPR flows include export receivables, foreign direct investments and workers' remittances. These cash flows enable banks in transition countries to raise capital based on the estimated expected inflow of foreign currencies from various sources. Securitization enables the banks to issue bonds based on expected transfers from foreign banks. The bank of the transition country sells future receivables that it will have from foreign banks. DPR securitization has been performed by banks in Brazil, Guatemala, Peru, Jamaica, Russia, Kazakhstan and Turkey.

A bank wishing to raise capital sells the right to entire future rights based on foreign transfers to the offshore trust (special purpose vehicle, SPV). SPV issues bonds and forwards the capital from the sale to the bank in the transition country. Collateral includes money flows arriving from correspondent banks from highly developed countries of Europe and the USA. The correspondent bank forwards the funds to the SPV. Bonds based on DPR securitization have a higher rating than the rating of the transition country.

Banco do Brasil performed DPR securitization in 2002 and raised 450 million dollars. The transaction had Baa1 and BBB rating (Moody's and Standard & Poor's). Other Brazilian banks (Banespa, Bradesco, Itau, Unibanco) also used DPR securitization and raised over 5 billion dollars. The Turkish Garanti Bank performed securitization, but arranged its own DPR securitization. In 2013 they raised 1 billion dollars, and 550 million dollars during 2014 by means of DPR securitization (Asian Development Bank, 2007, p. 30).

Collateral for securitization can comprise entire DPR flows, but it can also be only a segment of these flows, such as export receivables and workers' remittances.

Export receivables from the sale of goods (oil, gas, coffee, produce, raw materials, minerals etc.) can be collateral for issuing bonds. If the securitization is done based on export of commodities, the foreign buyers of commodities will transfer the funds to the SPV, as it is the new owner of the receivable. SPV issues securities denominated in hard currency. The currency of the transition country is unstable and this is the way of avoiding currency rate change risk. Future receivables based on contracts (for the sale of commodities etc.) are guarantee to investors in bonds that liabilities will be met. Mexico is among the first countries that performed securitization based on the sale of oil. The Pemex company sells oil, and Pemex Finance Ltd is an offshore trust issuing

¹ Mexico, Brasil, Argentina, Venezuela, Chile, Columbia, Costa Rica, El Salvador, Guatemala, Honduras, Jamaica, Panama, Peru, India, China (Hong Kong), Malaysia, Indonesia, Kazakhstan, Egypt, Nigeria

bonds. The collateral for bonds is contracts with oil buyers, which effect the payment to the offshore account. Serbia can also use the benefits of securitization of export-based receivables.²

Workers' remittances are funds sent by the diaspora to the home country. Remittances are of national significance for transition and developing countries. Remittances enable development and reduce poverty, featuring as a constant inflow of funds. Workers' remittances are a stable source of foreign currency inflow, and thus investment capital. Countries with a large diaspora receive dozens of billions of dollar every year. According to the data from 2013, countries with the largest inflow of capital via remittances are India (71 billion dollars), China (60 billion dollars), the Philippines (26 billion), Mexico (22 billion), Nigeria (21 billion), Nigeria (21 billion dollars) and Egypt (20 billion dollars) (World Bank, 2013, p. 4).

Securitization of remittances provides a relatively stable inflow of capital for a bank in a transition country. The bank sells its future receivables against workers' remittances to a trust located in a tax haven, which issues bonds. Remittance securitization means that all receivables from future remittances from expatriates are transferred to a separate trust, established in order to issue bonds to investors. Foreign banks through which expatriates sell money transfer the money to the trust. The offshore trust enables a reduction in the credit risk related to the bank in the transition country. Remittance securitization yields benefits to banks: in addition to capital inflow that can be invested as loans, banks extend loan maturity and decrease debt costs, as bonds have investment ranking. Improvement in the rating of bonds can be achieved by guarantees of multilateral agencies and the IFC.

In 2002, Banco do Brasil sold future income from the remittances of Brazilian workers employed in Japan. The receivables were transferred to the trust Nikkei Remittance Rights Finance Company, on the Cayman Islands. Another trust, based in New York, issues bonds to investors and raises 250 million dollars. Banco do Brasil transfers workers' remittance to a separate account run by a New York-based trust. The principal and interest are paid to investors from the account. Apart from Banco do Brasil, securitization of workers' remittance was also performed by other banks in Latin America. Banco Cuscatlan's (El

Salvador) in 1998, Banco Salvadoreno's in 2004, Banco de Credito del Peru's (Peru) in 2005, and Banco Bradesco's (Brazil) in 2007 with the largest amount of 400 million dollars (Ratha, n.d., p.5).

African Export-Import Bank (Afreximbank) played the key role in financing against remittances in Africa. In 1996, African Export-Import Bank (Afreximbank) approved a loan to a bank in Ghana, and the collateral was workers' remittances transferred through Western Union. In 2001, African Export-Import Bank (Afreximbank) arranged the securitization when the value of issued bonds was 50 million dollars, based on remittances transferred through Moneygram (Shimeles, 2010, p. 5). In 2004, African Export-Import Bank (Afreximbank) approved a loan of 40 million to an Egyptian bank, based on remittances transferred through Western Union (Mohapatra & Ratha, 2011, p.14). Between 1994 and 2000, Mexico, Turkey and El Salvador raised 2.3 billion dollars based on the securitization of workers' remittances (Ratha, n.d., p. 4). This form of financing is also used by banks in Kazakhstan, Brazil, Peru, and Panama.

International institutions also saw the importance of the securitization of workers' remittances. In 2010, IFC approved a loan of 30 million dollars to the Fedecredito cooperative from El Salvador. Remittances of workers from El Salvador working abroad were the collateral. The raised funds are used for loans to entrepreneurs and population in low income brackets. Fedecredito is a cooperative owned by 55 credit unions and banks from El Salvador mobilising savings deposits of 600.000 low-income members accounting for one-quarter of workers in this country. IFC approved the loan, and later Fedecredito was able to finance itself with the help of investors on the financial market (International Finance Corporation, 2010).

Serbia is a country with a significant inflow of foreign currency from workers' remittances, and banks can raise capital to use it for approving loans to retail and corporate clients. According to the data from the National Bank of Serbia, between 2007 and 2013 Serbia saw the transfer of remittances at the amount of 19.55 billion euros, with a peak in 2009, when 3.24 billion euros was transferred to Serbia from abroad.

² For instance, export of ores, non-metals and minerals (e.g. zeolite) that Serbia abounds in

Credit and debit cards

Payments for products and services by credit cards can also be used as collateral for issued bonds (credit card merchant voucher receivables). Based on payments effected by credit cards, banks can issue bonds and raise capital. Popular tourist destinations or growth in the number of tourists in a particular country offers the opportunity to banks to use this financing method. Credit and debit cards are used for paying the services of tourist agencies, hotels, restaurants, air, rail or road transport, car rental, collecting cash from ATMs, etc. Cards are used for shopping, amusement parks, health care services, petrol stations, etc.

Banco de Credito del Peru sold its future receivables from Visa credit cards to BCLO Master trust. Based on these receivables, the trust issues bonds and sells them to investors. Income from the sale of securities is forwarded by the trust to Banco de Credito del Peru. Visa undertakes an obligation to transfer the credit card payments to the trust, instead of transferring them to Banco de Credito del Peru. This is a way of eliminating the country risk. BCLO Master trust, which receives funds from Visa, is outside Peru's jurisdiction. After paying the interest and the principal to investors, the remaining funds are forwarded by the trust to Banco de Credito del Peru. The trust issued securities in November 1998, with maturity date in November 2005. The credit rating of the securities was AAA, determined by Standard & Poor's. The securities were insured by Multilateral Investment Guarantee Agency (MIGA), meaning unconditioned guarantee of timely payment of interest and principal to investors. For the investors, the guarantee eliminates political risk and risk associated to the asset itself. Therefore, the rating of securities depends on the rating of Multilateral Investment Guarantee Agency (MIGA) (Ketkar & Ratha, 2004-2005, p. 11).

In 2000, FirstRand Bank of South Africa issued bonds at the value of 250 million dollars based on receivables from Visa, MasterCard and Cirrus. Trust FirstRand 2000-A, B Receivables Trust issued bonds rated BBB+ by Standard & Poor's. In 2001, Jamaican Credit Card Merchant Voucher Receivables Master Trust issued bonds worth 125 million dollars, maturing in 2006. The collateral comprised all current and future receivables of Commercial Bank Jamaica Ltd. (NCB) denominated in dollars by Visa International and MasterCard International Inc. The trust that is the owner of receivables and the issuer is on Cayman

Islands and MasterCard and VISA transfer all future payments to SPV (Kochubka, Flores, & Olivares, 2001, p. 8).

In addition to receivables from credit cards, another instrument that can be used for raising capital is securitization of hotels' future receivables.

Hotel revenues

Hotel revenues are also used as collateral for issued bonds. Hotel construction is based on the securitization of future revenues that the hotel will earn when it starts working. The US legal framework enables the bonds issued for financing hotel construction to be tax exempt if the hotel is the property of the state or local government. Although the owner of the hotel is a state authority, they cannot build a hotel, nor can they manage it. The state or the city enters partnerships with private companies – well-known hotel chains (Sheraton Operating Corporation, Hilton Hotels Corporation Hilton Hotels Corporation, Hyatt Corporation, etc.). Once the hotel has been built, a state authority becomes the owner, and the hotel chain undertakes to manage the hotel, under its own name. As they are not owners of the hotel, they earn profit based on management commission. In order to build a hotel, the city establishes a trust with the task to finance and build a hotel, but also to be the owner. Assets owned by the SPV are total future revenues of the hotel to be built (room rental, restaurants, coffee bars, auxiliary services (parking, hair stylists, massage, spa centre, laundry washing and ironing, etc. The trust's liabilities are bonds issued by the trust. The city's assets are protected this way, as investors in securitized bonds can claim their receivables only from the SPV, rather than the city budget. Thus, investors in bonds can reimburse themselves only from the hotel's revenues, not from other revenues from the city's budget. The bonds are issued in several tranches and subordination is used. Lower tranches often also have additional insurance, as they are riskier. The last (ownership) tranche is mostly purchased by the hotel chain that will be managing the hotel after construction. Cities in the USA that developed conference tourism attract large numbers of visitors, which makes a positive impact on the local economy. The tourists use accommodation facilities, but spend money in shops and restaurants, rent cars, etc.

In 1999, the city of Sacramento in the USA issued bonds through a trust: senior (92.8 million dollars) and subordinated bonds (4.1 million dol-

lars) to finance the construction of a 500-room hotel for conference tourism. After the construction, the hotel will be managed by Sheraton Operating Corporation. The hotel owner is the Sacramento Hotel Corporation, established by the city of Sacramento. The bonds are secured by the hotel's revenues and net profit of the parking facility owned by the city of Sacramento. In 2001, the city of Austin, Texas, established the Austin Convention Enterprises Inc. trust with the aim of financing and building a hotel and a parking facility. The Austin Convention Enterprises Inc. trust issued bonds worth 265 million dollars, used for the construction of an 800-room hotel and underground parking facility under the hotel, with 600 parking spaces. The owner of the hotel is the city of Austin, actually, its SPV, and the hotel will be managed by Hilton Hotels Corporation. The bonds were issued in three tranches, and the third tranche was purchased by Hilton and the contractor (Magan, Davis, Israel, & Liever, 2001-2002, p.47).

Revenues from tolls

The state can raise capital based on the securitization of revenues from tolls. The raised capital can be used for road construction and maintenance, but for other purposes as well. The Standard & Poor's has estimated that 92 billion dollars will be necessary in the USA by 2020 for the maintenance of the existing roads and bridges (Mitchell, 2006). One of the solutions for capital raising can be the securitization of toll revenues. Chicago and Indiana performed securitization based on future toll revenues. Chicago was the first in the USA to privatize toll revenues. The transaction included the right to charge toll on the Chicago Skyway bridge. In 2005, Skyway Concession Company, LLC (SCC) gained the right to charge toll for the period of 99 years, and the city of Chicago gained 1.83 billion dollars. The concessionaire bears the operating costs and bridge maintenance costs. Securitization of future toll revenues is used in Mexico, Japan, China, Hong Kong and Dubai. The Dubai government raised 800 million dollars based on the securitization of the motorway toll revenues. Dubai remains the owner of the motorway and manages it. The trust issued bonds worth 800 million dollars. Citibank, Commercial Bank of Dubai, Dubai Islamic Bank and Emirates NBD arranged the transaction, whereas the bond issue was signed by the syndicate of regional and international banks (Sharif, 2011).

Revenues from agriculture

Future flow securitization enables farmers to sell to the SPV the future receivables (that is, revenues) from the sale of their produce. By selling future revenues, the farmer gets funds and can use them for financing production. The SPV issues bonds based on receivables that will emerge in the future. As the rights to sell the merchandise are transferred to the trust, buyers of the produce pay the merchandise to the SPV, which then pays the liabilities to investors.

The Peruvian Drokasa company (2005) uses future flow securitization for financing. Through its subsidiary, Agrokasa, they produce and export asparagus and grapes. The collateral for bond issue comprises contracts made by Drokasa with produce buyers. Drokasa gains funds, and the SPV issues the bonds. The buyers pay the funds under contracts to the SPV. In practice, SPV can factor the receivables from the sale of wheat, soybean, maize, fruit, vegetables, livestock, etc. SPV sells bonds to investors during the sowing season or at the initial stage of cattle growing. For instance, a cattle farmer growing cattle for meat industry can sell his future revenue to the SPB and obtain funds immediately. When the buyer buys the cattle, the money will be forwarded to the SPV. Payment to investors is done when the SPV receives the income from the sale of cattle. The essence is that the sale of future revenues has enabled the farmer to get funds for financing the production. A fruit farmer can also sell the future income to SPV before the harvest and sale of fruit. The buyers of fruit will be paying to SPV, which will pay the investors. The fruit farmer receives the funds before the harvest, enabling him to finance production (purchase of machinery, new seedlings, chemicals, workforce wages etc.).

The collateral for securitization in agriculture may be repurchase agreement and warehouse receipts. In the case of repurchase agreement, the seller sells commodities and undertakes the obligation to repurchase it. Securities can be issued based on repurchase agreement. The bank or SPV that bought the repurchase agreement can use them as collateral and issue securitized securities. This is the way sugar mills were financed in Mexico in 1996. The mills sold sugar to the bank with the obligation to repurchase, and the bank issued securitized bonds at the value of 400 million dollars (ACE Global Depository, n.d., p.2). Therefore, the sugar repurchase agreement is collateral for issued securities. Securitization of repurchase agreements is also done in Columbia, when fi-

nancing livestock (livestock securitization). Cattle farmers sell cattle to the SPV, and undertake to purchase it in the future. Based on livestock repurchase agreement, the SPV issues securitized securities. Although they have sold the cattle to the SPV, the farmers have the obligation to raise and tend the cattle. SPV controls whether are raising the cattle well, i.e. growing it appropriately. The farmers grow the cattle for 11 months, repurchase it from the SPV and sell on the market. National Agriculture and Livestock Exchange (BNA) plays the leading role in securitization and selects farmers by certain criteria (Rutten, 2001, p.6).

Financing can also be done through securitization where the collateral is warehoused merchandise, i.e. warehouse receipt. Inventory is the collateral based on which the SPV issues securities. The warehoused merchandise is the guarantee to investors that liabilities to them will be met. If the SPV does not pay the interest and the principal, the buyers of securities have the right to reimburse themselves from the collateral – the stored goods. Securitization based on maize inventories is done in Venezuela. By selling the warehouse receipt to the SPV, the farmer gets funds immediately and has no credit liabilities.

Financing the gas pipeline through Serbia

Serbia can securitize future flows that will be achieved after the construction of the gas pipeline. The collateral can be transport fees and contracts that Srbijagas has with final consumers. Funds from the sale of bonds can be used for constructing the gas pipeline. The income that Serbia will be gaining in the future, after the completion of the pipeline, will be used for paying the investors. The collateral for bonds can be funds that Serbia will be charging for transport of gas through the pipeline. In the second case, the collateral comprises Srbijagas' contracts with gas consumers on the territory of Serbia. The contracts are collateral, because they are evidence that gas will be distributed and paid for. Future flow securitization would enable raising capital based on issue of bonds that have a higher credit rating than Serbia. The essence is that rating is determined based on the collateral.

3. Diaspora bonds

Countries that have a numerous diaspora in highly developed countries can use them to raise capital by issuing diaspora bonds. Issue of these bonds is based on the desire of expatriates to help their

home county. Diaspora bonds provide a stable and inexpensive source of external financing. The revenue from bonds is used by the issuing countries for the development of infrastructure, energy sector and other projects of national significance. Issue of bonds enables raising hard currency, as the expatriates live in highly developed countries (the USA, the EU, Japan, etc.). In practice, there are cases then the diaspora gives the so-called patriotic discount, meaning that some of the investors do not submit coupons for collection at maturity. The first diaspora bonds were issued by Japan and China in the 1930s. Today, by far the greatest issuer of these bonds is Israel, and they are also used as a capital raising method by Egypt, India, Ethiopia, Sri Lanka and Ghana.

Over the period of 30 years, Israel has raised 25 billion dollars from expatriates. Between 1983 and 2003, diaspora bonds accounted for 20-35% of Israel's external debt (Kayode-Anglade & Spio-Garbrah, 2012, p.2). In 1951, Israel established the Development Corporation for Israel (DCI) with the aim of raising capital from the Jewish diaspora. Bonds of various characteristics were issued over decades. Up to the early 1970s, Development Corporation for Israel (DCI) issued bonds with fixed interest rates and maturity periods of 10 to 15 years. In mid-1970s, bonds were issued with maturity periods of 5,7 and 10 years, denominated to 150,000, 250,000 and 1,000,000 dollar. In that period, the target investor group comprised banks and finance companies in the USA. From 1980 till 1999 the focus is once again on individuals. Israel issues bonds with floating rate and nominal value of 25,000 dollars, and later also with reduced amount of 5,000 dollars. The maturity periods of these bonds were 10 and 12 years. Israel's experience shows that it is desirable for nominal value of bonds to be adapted to both individual and institutional investors comprising the diaspora. 200 million dollars worth of bonds were never submitted for collection.

Table 1 Bond issues of Israel and India

Israel	India
25 billion dollars total issue	11 billion dollars total issue
annual issues since 1951	individual issues in 1991, 1998 and 2000
loans for development	support to balance of payments
high but declining patriotic discount	small patriotic discount
bonds with fixed and floating rate	fixed-rate bonds

maturity periods 1 to 20 years with payment on maturity date	maturity periods 5 years with payment on maturity date
sold by Development Corporation for Israel (DCI)	sold by State Bank of India (SBI) and international banks
target group: diaspora, but other investors as well	diaspora only
non-transferable	non-transferable

Source: Ketkar & Ratha, 2007, p.10

India issued diaspora bonds three times. The first time in 1991, it issued India Development Bonds (IDBs) worth 1.6 billion dollars. The second time, in 1998, India issued Resurgent India Bonds (RIBs) worth 4.2 billion dollars. The third issue was made in 2000, with India Millennium Deposits (IMDs), worth 5.5 billion dollars. The issuer of diaspora bonds is State Bank of India (SBI). Bonds are mid-term, with maturity up to 5 years. They are issued in hard currencies: dollar, pound sterling, euro, and yen. So far India has raised over 11 billion dollars selling bonds to the diaspora. All three types of bonds that India issued brought the investors a higher yield than corporate bonds of the countries they are living in. For instance, when RIBs were issued in 1998, with the return rate of 7.75% to a bond denominated in dollars, the return on BB ranked American corporate bond was 7.2%.

Ethiopia issued bonds (Millennium Corporate Bond) in 2008, with the aim of financing the public Ethiopian Electric Power Corporation (EPPCO). Also, it issued bonds (Grand Renaissance Dam Bond) in 2011 for the construction of dam on the river Nile.

Table 2 Issues of Ethiopian bonds

	Millennium Corporate Bond	Grand Renaissance Dam Bond
Purpose	Ethiopian Electric Power Corporation	financing the dam on the Nile
Currency	dollar, euro, pound sterling, other hard currencies, and BIR	dollar, euro, pound sterling, or BIR
Minimum denomination	100 dollars, minimum purchase 500 dollars	50 dollars, euros or pounds
Maturity period	5,7 and 10 years	5 or 5-10 years
Interest	4%, 4.5%, and 5%	5 years LIBOR + 1.25% 6-7 years LIBOR + 1.5% 8-10 years LIBOR + 2%

Payment of bonds	At maturity, the holder may: charge for the bond in foreign currency, buy another bond of the same nominal value, deposit in foreign currency or BIR, and pay import liabilities	at maturity
Interest	annual	semi-annual
Interest payment	BIR, deposit in foreign value or BIR, transfer across the border	in the currency of the bond
transferability	transferable	transferable – two to three owners
tax	interest on funds is exempt from income tax	income exempt from all taxes

Source: Kayode-Anglade & Spio-Garbrah, 2012, p. 5

Egypt sold bonds to the diaspora in the 1970s. In 2007, Ghana issued bonds worth 50 million dollars (the Golden Jubilee), which it offered not only to retail clients in Ghana, but to diaspora as well. In 2001 Sri Lanka issued Sri Lanka Development Bonds and raised 580 million dollars. South Africa issued Reconciliation and Development (R&D) bonds offered to domestic investors and the diaspora. Diaspora bonds were also issued by Nepal, Kenya and South Africa.

Diaspora is very loyal, especially in situations when the state cannot borrow capital from other sources. Israel, India and Ethiopia used diaspora bonds when they difficulties borrowing from other external sources.³

4. GDP growth indexed bonds

Transition countries can use financing based on indexing debt to the GDP of the issuing country. A GDP-linked bond⁴ is a debt instrument issued by the state. Payment of bonds depends on the trend of the issuing country's gross domestic product. GDP-linked bonds are floating bonds where the coupon depends on the growth rate of a country. So, the coupon paid to the investors depends on the state in the country's economy, i.e.

³ Israel sold diaspora bands in 1973 during the Yom Kippur War and in 2001 after the terrorist attack in the USA. In 2001 the diaspora purchased bonds worth 1.14 billion dollars, whereas 2000 saw the sale of 785 million worth of bonds.

⁴ Also referred to as GDP.indexed bonds, GDP-linked security, GDP-indexed security, GDP-linked warrants (GLWs).

growth or fall in the GDP. Thus, GDP-linked bonds reduce the issuing country's liabilities to investors when the GDP declines. At the time of slow or negative growth, GDP-linked bonds reduce the likelihood of default and debt crisis (Griffith-Jones & Sharma, 2006, p. 2).

Transition countries started issuing bonds in accordance with the Brady Value Recovery Rights (VRRs) during the 1990s. These are bonds with special warranties, enabling increased payments to investors if the issuing country's GDP grows to a particular level. Costa Rica, Bulgaria, and Bosnia and Herzegovina issued GDP growth indexed bonds (GDP-linked warrants, GLWs or GDP VRRs). According to the Bulgarian model, if the GDP growth exceeds a particular level, investors get additional 0.5% interest for every 1% growth in GDP. In June 2005, Argentina issued GDP-linked bonds with maturity period of 30 years. The bonds were issued with the purpose of reprogramming due liabilities. The bonds bring the investors additional profit if the GDP grows more than the Argentinean government has foreseen. In February 2012 Greece issued GDP-linked bonds.

Warrants provide investors with another benefit – they can be traded separately from the financial instrument with which they were issued. Therefore, by separating from the bond, the warrant becomes an independent financial instrument. Oil exporters such as Mexico, Nigeria and Venezuela issue warrants linked to the price of oil (oil warrants). The issuers will pay the investors additional funds if the price of a particular commodity grows to a defined level. Warrants enable additional payments to investors if the issuing country earns additional income from exports.

5. Project finance

Project finance enables financing large infrastructural projects (road network, bridges, tunnels, railroads, ports, etc), development of energy sector (oil and gas exploitation, construction of refineries, gas and oil pipelines, electrical plants, etc.), telecommunications, transport, agriculture etc. Project finance is used by highly developed countries, but also India, China, Malaysia, Taiwan, Viet Nam, Brazil, Mexico, Chile, Peru, Poland, the Czech Republic, Turkey and Morocco.

Project capital is based on equity and debt capital. Equity capital is provided by sponsors, but also by investors who buy shares, but do not manage the construction of the project. Equity capital accounts for about 30% of the total required capi-

tal for project financing. As equity capital is not sufficient for project finance, debt finance is used as well. Debt financing implies using loans and bonds. The creditors are commercial and investment banks, multilateral and bilateral institutions, export agencies, insurance companies, investment, pension and hedge funds, and other investors. Commercial banks' loans are the most important source of project finance. As these high-value projects, credits are approved by syndicated banks. Multilateral and development financial institutions and development agencies in most cases provide loans, guaranties, provide counseling services and insurance. Commercial banks and multilateral agencies together credit high-value project by applying the so-called A/B credit structure.

Capital raising is done through a project company, a specially established trust (Special Purpose Vehicle, SPV). So, this is an off-balance-sheet transaction, because financing is done through the SPV. The sponsor does not take loans directly, but through the project company. If the project sponsor goes bankrupt, the investor's receivables are protected, as they will be reimbursed from the asset which is in the SPV's balance sheet. The sponsor's other creditors do not have the right to reimburse themselves from the trust's assets. The SPV issues shares and bonds and takes loans from banks. The SPV is the owner of the entire project's assets and liabilities. Assets are comprised of all receivables that will be incurred in the future when the project is finished (e.g. contracts for transport of oil or gas, contracts with final consumers, etc). The SPV's liabilities are bonds (project CDO) that it has issued, as well as taken loans. In practice, an SPV is formed with the aim of buying the taken loan from the banks. The aim is to refinance at lower interest rate (Forrester, n.d.). Payment of liabilities based on taken loans, issued securities, dividends and costs will be effected based on the project's future flows. Collateral for loans and bonds includes real estate, right to oil and gas wells, leasing, licences, concessions, contracts with final consumers, etc. Based on the collateral, the SPV issues bonds (project collateralized debt obligation (CDO) or project finance CDO).

The assets which are the collateral for securitised securities may be a single project loan, or loans financing several different projects, i.e. different project finance loans. In 1996, the Argentinean company Transportadora de Gas del Norte S.A. (TGN) performed securitization based on a

single loan. International Finance Corporation (IFC) approved the loan to TGN, which was then sold to the SPV that issued the bonds. In 1998, Credit Suisse First Boston issued the first package of bonds with loans from project finance (Project Funding Corp. I). the collateral was a pool with 41 loans (Credit Suisse First Boston, 1998, p.13).

Conclusion

The aim of this article is to point out the significance of issuing various types of bonds, whereby Serbia would raise the necessary capital for the development of agriculture and projects of national significance. Starting from the experience of transition countries and financial instruments that they apply, it is obvious that there are sources of capital that Serbia can use. Capital for financing infrastructure, industry, entrepreneurship, agriculture and tourism is available from domestic and international investors. Serbia should finance infrastructure projects, improve its energy sector, finance the development of small and medium-sized enterprises, agriculture, tourism and public facilities. Securitization of the current and future assets, sale of bonds to the diaspora, GDP-linked securities and project finance are sources that other transition countries use for raising capital to a greater or lesser extent.

Commercial mortgage loans and loans for SMEs are especially important for the development of the Serbian economy. commercial mortgage loans are intended for the purchase or construction of plants, business premises, warehouses, rental flats, hotels, restaurants, shopping malls, hospitals etc. Commercial mortgage-backed securities (CMBS), debt instruments with commercial real estate as collateral, are issued based on these loans. The possibility of establishing special securitization trusts such as Real Estate Mortgage Investment Conduit (REMIC) and Real estate investment trusts (REITs) would bring additional capital for financing agriculture in Serbia.

Future flow securitization can use assets for issuing bonds in the form of DPR flows (revenues from import, foreign direct investments, future receivables from the use of credit cards, revenues from hotels, revenues from agriculture, repurchase agreements and warehouse receipts, revenues from tolls etc. It is very popular in transition and developing countries, as it enables eliminating the country risk by using offshore SPVs. Also, the advantage of future flow securitization is that issued bonds have a higher rating than the rating of

the issuing country. It is used by the countries of Latin America, Asia and Africa. Development and transition countries have so far completed over 400 securitizations based on assets to emerge in the future, and over 80 billion dollars have been raised. Serbia can use the securitization of future revenues from agriculture, as it enables farmers to obtain funds immediately and use them for financing production. Numerous successful examples of securitization in agriculture are found in the countries of Latin America. Also, securitization of toll revenues may bring capital to Serbia, due to a large number of foreign citizens using Serbian motorways.

Diaspora bonds are used by Israel, India, Sri Lanka, Ghana, etc., and the raised capital is used for infrastructure projects. The diaspora is highly loyal, especially in situations when the state cannot borrow capital from other sources. New ideas for raising capital from the diaspora are emerging in practice. A very interesting idea is establishing funds to be financed by the diaspora, with the aim of investing in the country of origin. Given that the Serbian diaspora is numerous (about 4 million Serbs are estimated to be living outside Serbia), it can be a significant source of capital.

Serbia can also issue GDP-indexed bonds, as these have been used successfully by other countries. These bonds are issued by Bulgaria, Bosnia, Argentina and Greece. Project finance is used by highly developed countries, but also Russia, China, Brazil, Poland, the Czech Republic, Mexico, Turkey, etc. It enables financing projects in the energy sector, but also road infrastructure and agriculture. **SM**

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Strategic Orientation of European Management in the Conditions of Globalisation

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Abstract

This paper emphasises the strategic orientation of European management according to modern global trends. Specific competitive advantages of European companies in an environment of globalisation are analysed from the point of view of strategic management. The research focuses on the relation between the European integration process and the development of European management and the influence of different cultural frameworks on managerial decisions. Macroeconomic business indicators become a point of departure for further analysis of integration processes with the objective of analysing their impact on microeconomic level of doing business. Improving efficiency and sustainability of European business is a precondition for developing multinational corporations in a global framework. Implications of management strategies on flexible adjustments of companies in the global market are analysed. Original contribution of European management approaches and methods is important in conditions of discontinuity of a global environment. Perspectives of cooperation strategies between different organisational structures and their significance for consistency of European economic systems are researched. Using the advantages of the economy of knowledge and a high level of expertise will create a possibility of complex business networking in the long term. A contemporary strategic approach of collaboration between business ecosystems and management relating to new business models in a dynamic environment are highlighted. Inter-organisational company connections and delegation of authority by lateral communication are also important. Thus the traditional approach and the challenge of creating a new management paradigm are examined. The paper evaluates current business models of European companies and the possibilities of cooperation based upon a strategy of global development.

Keywords

European management, development strategy, European company, business systems, competitiveness, global environment.

Introduction

A contemporary European business environment precludes a development model based on the idea of a common market leading to conceptual changes involving a strategic way of thinking and focuses on innovations. Complexity of European business systems will influence the diversity of managerial methods, aimed at their long-term co-integration. Respect for multiculturalism, intensification of forming world-class clusters, as well as

a high level of individualism in European management practices is significant.

Intensive market competition results in an increased level of connections between European companies with aspirations towards establishing a sustainable economic development focusing on a move towards economies of scale and economies of scope, as well as accomplishment of long-term economic cooperation in a broader sense. Incremental changes directed towards a more open

market are conditioned by current trends on a global level. Success of European multinational corporations creates a necessary competence through inter-departmental networking and cooperative strategies. Increase in company efficiency is often a result of extensive transfer of knowledge, which affected their global competitiveness. On the other hand, high level of responsiveness from local markets and use of advantages of resource specialisation are reflected through numerous regional comparative advantages. Global framework of business and original management concepts in many cases contributed to business success of European companies on the global market, where competition from “new players” is more evident.

1. Contemporary European Business and Management

From the point of view of European business and management, free circulation of goods, services, human resources and capital inside the European Union is relevant, as well as an economic policy centered on providing free competition between companies and protection of consumer interests. In this context, we analyse EU goals concerning a harmonious and balanced development of economic activities; solidarity between member states; sustainable and non-inflationary growth; protection and improvement of environment quality; high level of employment and social protection; increase in standard of living and quality of life; economic and social cohesion. Achieving a high level of competitiveness in global terms is related to the goal of converging economic performances which results in emulating business activities of successful companies. For managers this becomes a challenge in their efforts to implement external benchmarking methods.

Europeanization of business gained a strong momentum during mid 1980s. Currently there is a shift “from national to European companies” (Pelkmans, 2006). This represents “a corporate integration” in terms of vertical and horizontal integration of formerly separate economic activities located in different EU member states in order to have transactional benefits from putting these activities under mutual ownership (Dunning & Robson, 1987). European Company (Latin *Societas Europaea –SE*) is a result of aspirations towards creating a transnational enterprise, like a joint stock company, assuming that this company’s regulations must therefore be supranational. The advantage is the creation of an easier

way of managing business activities in more than one EU member state, as well as greater mobility on EU integrated market (European Union, 2015).

One has to keep in mind the importance of the ten-year EU development strategy, aka Europe 2020 from the perspective of European management. Its essence is creating conditions for smart, sustainable and inclusive development. The five main goals are creating new jobs; research and development; climate changes and energy sustainability; education; reduction of poverty and social inclusion. Priorities regarding digital economy, industrial policy, innovations and efficiency of resources are especially important for managers (Communication From the Commission, 2010).

Typically, the industrial policy in the EU is directed towards increasing competitiveness of European companies in conditions of pressures of globalisation, intensive economic, technological and social changes, demands regarding environmental protection, as well as orientation towards encouraging development of clusters. In addition, modern industries that have “a strong European presence” are being expanded and European “flagship” companies are being created. Teams of managers follow competitive trends, creating and implementing new competitive strategies. On the other hand, managers of companies from countries that are not EU member states are making efforts to understand possibilities of creating strategies for entering markets of EU member states more effectively.

What is typical for companies that belong to network industries is that they often had the initial monopoly position. These specific industries include: production and distribution of electricity and gas, railways, airlines, telecommunications and postal service, multimedia, Internet, radio and television production. In mid 1990s they participated with about 6% of gross domestic product in the EU (Pelkmans, 2006). The fast development that followed was evident, especially when it comes to mobile communications and Internet services. The importance of network industries is even greater from the aspect of business management, since virtually all business activities use outputs of these industries as their inputs. In this domain the European Union promoted internal market principles and competition, and paid special attention to liberalisation of air traffic and telecommunications. Managers must consider external effects of networks regarding companies from these industries.

Creating a business environment for European companies that supports innovations and changes is implied. On the other hand, it highlights the importance of an effective change management on company level. The European Union pays special attention to encouraging foundations and development of small and medium companies (*European Small Business Portal*, <http://europa.eu>).

Undertaking certain measures on EU level should contribute to creating stable competitive advantages. These measures are directed towards cooperation in areas of education, research and development and other areas of technological development. Such practice is also based on a concept of knowledge-based development in economy. From the standpoint of centering on new knowledge and encouragement for creating new jobs for young people, program *Erasmus+* is a very good example.

There is another important aspect regarding the growing competition around the world in terms of attracting investments in research and innovative activities. With attractive locations in developed market economies, new competitors like China, India and Brazil have emerged. Mutual research and innovation programmes are especially important in such situations. Innovation represent the essence of EU strategy for creating economic growth and new jobs (European Union, 2015). EU member states are encouraged to invest 3% of their gross domestic product in research and development by 2020. In this context there is an important initiative called *Innovation union* that also emphasises cooperation with states that are not members of the EU in the area of great challenges of the modern age such as energy, food safety and climate change. This entails intervention of the public sector in order to encourage the private sector. Unique European research space has been created in terms of possibilities for researchers to work anywhere in the EU while encouraging cooperation between states. The seven-year research programme *Horizon 2020* has been especially important since January 2014. Its goal is to strengthen the position of the EU in the field of science, as well as that of industrial innovations. This implies investments in key technologies, greater access to capital and encouraging small businesses. Goals of general social importance regarding climate change, sustainable transport, renewable sources of energy and food safety are also included. The importance of efficient and innovative digital economy, which has the potential to transform the business sphere and entire

societies, is also highlighted. Essentially, being able to provide better products through new and more effective processes has become very important. Information and communication technologies (ICT) sector represents 4,8% of EU economy and it accounts for 25% of total business expenditures on research and development. Investments in this sector generate 50% of total productive growth in the EU (European Union, 2015). *Digital agenda for Europe* has strengthened EU industry through support for strategic research and development of digital skills and businesses.

Increase in competitiveness nowadays largely comes from a combination of implementing new managerial methods and techniques, information and communication technologies and quality of human resources. It is evident that many EU companies are strategically oriented towards transferring resources and using opportunities on the market regarding new technologies such as biotechnology, nanotechnology, technology of pure energy but also a wide range of areas of development and implementation of new materials.

From the management point of view main problems are encountered in network connections and business network management (Milićević & Milić, 2011). Networking can occur through various activities, but some industries are more prone to forming business networks than others. According to current practices, European companies in the area of telecommunications, software, car industry, pharmaceutical and oil industry are more open to networking. The purpose of business networking at the beginning of 21st century is to establish mutually useful relations with other companies from Europe and the rest of the world, as well as find potential clients, i.e. buyers. What seems to be essential for real business networking is the establishment of a mutually useful relationship, while the networked groups function best as centres of exchange of business information, ideas and support. Economies of scale could emerge over a longer period of time. There is greater possibility of accessing new knowledge. In a world of rapid technological changes certain abilities and resources, especially financial ones, are merged in view of achieving innovation in case no company is able to achieve it on its own. Profit is often generated though a simple combination of resources. Connecting partners and unifying their selected resources demands greater efforts on the part of the management. *The Enterprise Europe Network* functions as “The Entrepreneurship Europe Network” and it helps small and medium

companies to market their products and services more successfully (Enterprise Europe Network, 2015).

2. Strategic Approach to Development of European Companies in Conditions of Globalisation

It is vital to point out that the importance and particularities of management in Europe and the rest of the world were noticed around the middle of 20th century. This especially refers to organisations that are influenced by the European cultural model, business practices and ways of thinking (Burnham, 1941). As the process of globalisation advanced, these general opinions and conclusions became ever more concrete through the consideration of possibilities for specific strategic approaches of European companies and management, fostered by the development of information and communication and transport technologies. By the beginning of 1990s, there was a well established opinion regarding the existence of a specific general management approach in Europe and that companies coming to European markets needed to make a strategic choice regarding the harmonisation of management with the European way of doing business and management in this specific environment (Thyrley & Wirdenius, 1991). Also, parallel to such reflections on a comprehensive European model of management and specific characteristics that distinguish European management, there are also differences and divergences regarding these general characteristics of European management, as well as differences caused by specific national cultural traditions, such as German and French for example (Lubatin & Floyd, 1997). Bearing in mind the historic development of European economies and consequently European management approaches, such tendencies are not surprising. However, when we take into consideration the trends of growing economic entities on the European continent, it is expected that the trend of convergence of European management will prevail in the future.

In order for an analysis of strategic orientation of European management to be as relevant as possible, it is necessary to note some general tendencies of development in the area of strategic management which are important for business operations of European companies in EU member states, but also in those countries that are not part of the EU. Bearing in mind the understanding of development of general management as “a proc-

ess of improving managerial effectiveness through the learning process” (Mumford, 1997) and specific features of the European business space which was created as a consequence of historic development of wider social structures in this region, as well as organisational particularities, including those in the area of management, one can conclude that determining development of strategic management as an activity with a purpose to improve strategic abilities and corporate performance (Brown, 2003) is applicable and relevant for analysing strategic orientations of European management. Figure 1 displays elements of the development of strategic management. In the context of studying strategic preference and orientation of European management, the later concept of holistic management and functional management development, including personal needs of managers and implementation of a personal development plan, are singled out as very important.



Figure 1 Elements of strategic management development,
 Source: Adapted according to Brown, 2003, p. 300

A specific managerial approach to solving strategic business challenges was noticed in a group of companies whose operations became global in the early stages of intensification of the process of globalisation. Their headquarters are located in Europe (Oomens & van den Bosch, 1999). The following key elements of strategic business challenges could be singled out: effect of challenges on organisation, differences in performance assessment of the existing organisation between the management and other stakeholders, as well as controversies – conflicts of interest that stem from these differences. It was noticed that the European organisations adopt one out of three approaches in order to respond to strategic challenges that doing business in an increasingly globalised environment places before them: process oriented organisation, organisation on corporate level and organisation on functional level. A

specific feature of European management approach to solving strategic business challenges is assigning of personal responsibility for specific challenges. Apart from traditional steps like environment analysis, identification of challenges, determining priorities, specific challenge analysis, making strategic decisions and action programmes together with their implementation and evaluation, what distinguishes the approach adopted by European companies (Oomens & van den Bosch, 1999, p. 51) is the assignation of personal responsibility to managers for solving individual strategic challenges.

The process of harmonising the European approach to management is supported by different social and political processes that take place within the European Union, as well as by numerous associations, alliances and acquisitions that take place between companies from various European countries. Within these processes, management of companies from some countries becomes a part of the same management team and, over time, there will be convergence of approaches to management on the whole continent (Mayrhofer, 2002). The complexity of tasks standing before European managers in such a complex environment with its rich historic heritage, notable differences between cultural elements typical for a particular region, as well as the desire and need for these differences to be overcome, are best illustrated by the notion that successful European managers need “international experience, the ability to speak at least three languages, geographic mobility and a global way of thinking” (Calori & de Woot, 1994). In such a complex environment, it is no wonder that there is a need to determine general directions for company development through strategic orientation. By looking for focal points in a diverse cultural and social environment, these companies use strategic orientation to find opportunities for developing competitive advantages and to define a specific company identity as an important strategic milestone in a globalised world. Cooperative strategies expected to ensure that European companies reached their planned targets are extremely important.

Human capital is perceived as a strategic value that will determine the possibilities of long-term successful business and company development. In this context, active participation of employees in various business processes presents a basis for strategic assessment of competitor's advantage in terms of knowledge economy development. Recent research shows

that European companies vary in their approach and that strategic orientation of European management in this area contains several different options, depending on specific operating conditions and organisational circumstances (Ferreira, Neira & Vieira, 2012). Currently the most frequent approaches are: bonuses based on the sharing of profits, strategic importance of communication, bonuses based on acquiring a share in ownership, employee representation, strategic importance of training and teamwork. Each of these approaches involves a whole series of activities based on fundamental engines of employee motivation. In European management practice they are implemented selectively, depending on specific conditions of a particular micro environment. In this context, enhancing lateral communication becomes very important.

The importance of cultural framework in which a company operates and its impact on management is most evident in Europe where many languages are spoken where there is a distinct divergence from the prevailing cultural model. With this in mind, an approach developed within the framework of cross-cultural management is very important for European management when considering possible strategic directions for development. This approach aims to better understand the impact of culture on management, define methods to increase overall management efficiency and identify differences and similarities of management activities in practice which appeared as a result of differences in cultural elements of the environment (Calori & Dufour, 1995). Explicit differences in European management practice are then picked up by institutions that provide training and education for managers. German and French approaches in manager training already exist, but owing to influences from USA, as well as increasing globalisation, they are beginning to converge towards a European management model, both in practice and in training (Kaplan, 2014). It is important to emphasize that in the European context there is a growing balance between demands for economic efficiency and corporate social responsibility (Pudelko & Harzing, 2007). In case of knowledge transfer in the field of special topics related to strategic management in European companies, it has been noticed that some countries have a certain advantage, namely the Netherlands and the United Kingdom (Ma, Rodríguez, & Ma, 2003). We must therefore conclude that, in spite of certain discrepancies

between elements of management approach within a wider European space in the sphere of manager training, which includes lifelong learning and education, there is a tendency for unification of key approaches to business, especially those concerned with strategic orientation in doing business.

In addition to its primary role in ensuring the security of business systems and processes, identity management has become increasingly important from the point of view of companies' marketing systems. This is especially true with the development of Web 2.0 technologies and the growing importance of user participation in business processes. The conflicting demands to preserve the integrity of vital business information and wide availability of business processes, and therefore business systems, mainly in the digital domain, impose a need for sophisticated solutions in this area. It has been proven that only a strategic company orientation that includes implementation of principles of strategic management in the field of identity management and compliance with business strategies can lead to positive business results, especially within the framework defined by business practices in European markets and within European companies (Kruger & Mama, 2012). Compatibility of all elements of doing business within the framework of general business strategies that have been adopted and strategic commitments in important segments of doing business, allows a large number of European companies to achieve significant long-term competitive advantages.

The importance of information and communication technologies in analysing business operations of European companies reflects the growing importance of machines in performing certain intellectual tasks – a tendency which has led many authors to describe the present day and age as the second era of machines (Brynjolfsson & McAfee, 2014). Bearing in mind this tendency as one of the most important strategic directions of development of modern technologies that have altered many elements of business environment, from labour market all the way to the need for a wider range of new services, primarily in creative industries, we can single out a desire to adjust business competencies to new circumstances where a successful team of humans and machines in performing intellectual tasks represents an important element that will determine a level of success in business (Sofronijević, Milićević & Ilić, 2012). Business

activities of European companies or those who sell their goods and services on European markets will necessarily have to accept the new reality that we live in and the need for new knowledge and skills of all employees. This will have to be based on a strategic framework of all those elements of doing business where specific features of a diversified European business space are especially evident. Another thing that stands out is the contemporary strategic approach to strengthening business eco-systems. Over the last few years, European businesses are increasingly adopting digital business eco-systems which dynamically include services from the area of information and communication technologies.

A great deal of attention has been paid to the study of matters relating to areas involving strategic orientations of European companies, changes in perception of their significance by top management, as well as wide distribution of certain topics in different industries. Attempts to find the answer are a result of a desire for further clarification of possibilities for effective strategic change management. Until 2004, the topic of climate change was not in the centre of attention of European management. In just three years, this topic became a strategic matter of greatest importance to most European companies. This, in turn, had an impact on creating new business models. In addition, problems related to economic crisis, the challenges it poses and possible solutions became very significant for European management. This was pointed out as a central issue in strategic approach of European companies (Blomgren, Sattari, Peighambari & Levihn, 2015).

A wider scope of topics that are of interest for the strategic framework of doing business in Europe include the European integration process where the question of the Euro becomes extremely important; corporate governance and reporting – especially in view of the Internet and growing user influence; finances; risk management; human resources management and intercultural management with all the cultural differences that are so typical for Europe (Scholz & Zentes, 2013). Bearing in mind that these topics are just some of the most important ones, it is easier to understand the need and value of strategic orientation of European management where with the right amount of focus and extended time frame for activities in a particular area we can create a number of business elements which, in their turn, will contribute toward creating long term business advantages in a given area.

Strategic orientation of European management also brings concrete advantages regarding the economic sphere in the form of measurable emergence of new value. Empirical research on a sample of 77 European companies discovered that the potential for creating new value could really be used in practice; that best results through the application of strategic approach can be achieved in better analysis of the environment, i.e. reducing business uncertainty but also that successful companies do indeed create new value based on a better understanding of the business environment and by reducing business uncertainty (Rohrbeck & Schwarz, 2013). Figure 2 represents results of this research relating to identified ways of creating value through by implementing strategic management in European companies. As we can see, successful companies create new value based on strategic orientation in all four identified areas. Strategic approach helped the largest number of successful companies create new value through further encouragement of company strategy review (42%). Both successful and less successful companies achieved approximately the same results by implementing the strategic approach in the areas of adjusting business operations in cases of uncertainty and creating a possibility to adopt alternative approaches (17-25%). Mostly successful (25%) and medium successful (17%) companies were able to improve coordination of business goals. We also noticed that a small number of companies, irrespective of the overall success of their business operations, failed to create new value using the strategic approach, thus confirming once again, and this time using empirical research, strong strategic orientation of European companies.

technological progress and financially more intensive production for the global market has created a need for extreme strategic thinking. When it comes to using nitrates in agriculture, European farmers have three options to choose from. The first is optimising the use of nitrates to achieve best possible yield; second is to attain bigger net income, and third is to reduce the effect nitrates have on the environment (Dumont, Basso, Bodson, Destain & Destain, 2015). Each of these three approaches has its advantages and disadvantages. Nevertheless, if implemented consistently, each of these three approaches will help improve the business side of farming compared to the situation where strategic orientation is not considered important.

Solid waste disposal is an ecological, economic and social problem in a modern business environment where the quantity of waste continues to grow while at the same time there is need for land that is either permanently or temporarily contaminated by this same waste. This problem exists in all European countries and public services dealing with it are being pressured for solutions that are not only financially efficient, but also permanently sustainable. Advantages of the strategic approach, which was proposed as a solution in case of Italian public service dealing with solid waste, will create a better business environment in this area. The economic crisis in Italy has brought to public's attention problems in this area and structural shortcomings of the economy as well as a widening gap between the resources that can be made available to public services and the demands that are set before them. Strategic orientations which are important for this area concern the general reduction in solid waste production and proper handling of newly created waste. The decisions are made by taking into account the recycling costs of certain types of waste, percentage of waste that will be recycled, area of land that will be used as landfill for non-recycled waste, possibilities of waste disposal that would not cause permanent or long term contamination of the land as well as economic efficiency of waste recycling facilities. The question of strategic decision making is rather important when it comes to investments into waste recycling facilities which require precise scale definitions in order to achieve economy of scale which would be cost-effective. Geographical distribution plays an important role in making this possible and cost-effective to deliver planned quantities of solid waste to waste recycling facilities.

			yes	partly	no	don't know
SM 1	Encourages analysis of overall company strategy	Top	42%		50%	8%
		Medium	23%	62%		11%
		Low	8%	84%		8%
SM 2	Supports adjustment of business operations in case of uncertainty	Top	25%	75%		
		Medium	17%	68%		13%
		Low	17%	58%		17%
SM 3	Improving the coordination of business objectives	Top	25%	67%		8%
		Medium	17%	72%		9%
		Low		68%		20%
SM 4	Creating the possibility to adopt alternative approaches	Top	25%	75%		
		Medium	20%	70%		8%
		Low	17%	67%		8%

Figure 2 Results of empirical research of the effect of strategic management on creating value in European companies

Source: Adapted according to Rohrbeck & Schwapz, 2013, p. 1601

We will also be taking a look at two examples that support strategic management decision-making related to development in case of business entities in Europe in the field of agriculture and ecology. In European agriculture, accelerated

ties (Cucchiella, F., D'Adamo, I., & Gastaldi, 2014).

Importance of constant monitoring, analysis and predicting the necessary business environment in order to be successful in global terms is best illustrated by good practices of European companies that adopted such a business orientation. Lufthansa group is one of the best examples where central business activities and competencies are successfully preserved while adjusting business models to macroeconomic trends in the region. At the same time, they created a specific competitive advantage based on strategic orientation of managers. Influenced by macroeconomic changes, Lufthansa group introduced incremental changes of business models and smaller adjustments over the past decade while waiting for the right moment to introduce heavier restructuring in accordance with their strategic evaluation (Dombrowski, 2014). They introduced a hybrid business model where short distance flights follow a low-cost airline model, while medium and long distance flights follow a modified version of the traditional airline model. This way, Lufthansa group has managed to preserve some of the existing competitive advantages while creating new ones.

Conclusion

Strategic orientation of European management provides an important base for achieving a competitive advantage in a global framework, achievement of long-term business success and development of European companies. In times of business globalisation and a growing need for European companies to offer their products and services globally, often against hyper competition, specific features of the market and industries created in the environment of diversified cultural elements and under specific historical circumstances result in prioritisation of strategic orientation aimed at ensuring long-term successful business operations, which also entails development of new business models. In doing so, we are talking about a particularly European contribution to the development of management theory and practice, stemming from practical achievements of European companies. In this respect, the interest of researchers for this area is constantly growing, and the same goes for those who want to implement examples of best practices in order to improve their business operations. At the same time, European businesses and management are facing new opportunities, but

also limitations and challenges created by the global environment. All this only confirms the absolute need for a proactive approach where managers will have to work on both macroeconomic and microeconomic level. **SM**

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Determinants of Choice of Global and National Food Products' Brands

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Abstract

Within the behavioural theories used for understanding and predicting dietary behaviour, consumer attitudes are a significant variable. In the context of the choice between national and global brands, consumer ethnocentrism can be a significant determinant. Consumer ethnocentrism is often being analyzed in the context of socio-demographic and behavioural characteristics of consumers, as well as in the context of the negative impact of different cosmopolitan identity concepts on it.

This paper presents the results of the research concerning consumer ethnocentrism and cultural openness of the respondents, the relation of these two variables, their dependence on certain socio-demographic and behavioural characteristics of consumers, as well as in regard to the impact of consumer ethnocentrism on the frequency of consumption of certain national and global food brands, and the impact of cultural openness on the frequency of consumption of certain global food brands. The survey was conducted in December 2014, in Subotica (n = 300) in relation to the three categories of food products.

By applying multiple regression used within general linear model, it was concluded that consumer ethnocentrism was significantly and positively influenced by consumers' age, while cultural openness is not significantly dependent on any of the investigated characteristics of consumers. In addition, with respondents' age and self-assessed household income being on average, the most ethnocentric are unemployed men with secondary education, travelling abroad once a year at most, while most culturally open are employed women with a university degree and travelling abroad once a year at least.

By using structural equation modelling, it was found that cultural openness significantly and negatively affects consumer ethnocentrism, that consumer ethnocentrism significantly and positively affects the frequency of consumption of national brands and significantly and negatively affects the frequency of consumption of global brands. The impact of cultural openness on the frequency of consumption of global brands is significant both directly and through mediator (consumer ethnocentrism), and there is also significant indirect impact of cultural openness on national brands' consumption.

Keywords

Global brands, national brands, consumer ethnocentrism, cultural openness.

Introduction

Factors influencing consumers' choice of food products can be classified into three categories: characteristics of the individuals, characteristics of the food itself, and characteristics of the environment (Randall & Sanjur, 1981), that is, it is possible to identify multiple influences on the choice of a certain food: ideals, personal factors, resources, social factors and contexts (Sobal, Bisogni, Devine & Jastran, 2006). Behavioural theories used in understanding and predicting behav-

our in food consumption, for instance, theory of planned behaviour (Ajzen, 1991), which is, in fact, a modified version of the theory of reasoned action (Ajzen & Fishbein, 1980), points that attitudes to behaviour (emerging in the relation of beliefs and their evaluation), subjective norms (as social pressure on individuals to behave or not to behave in a certain manner) and perceived behavioural control (perceived ability to display a certain behaviour) determine the intention to exhibit particular behaviour. The consumer behaviour

itself is determined, therefore, by the intention to perform this behaviour and the perceived behavioural control.

Consumer attitudes have been identified, therefore, as the relevant variable of their behaviour in relation to food products. Numerous pieces of research are devoted to researching the attitudes of food product consumers (for instance, Al-Khayri & Hassan, 2012; Ares & Gámbaro, 2007; Arvanitoyannis & Krystallis, 2005; Bhaskaran & Hardley, 2002; Childs & Poryzees, 1998; Fotopoulos & Krystallis, 2002; Gracia & de Magistris, 2007; Grubor, Djokic, Djokic & Kovac-Znidarsic, 2015; Hill & Lynchehaun, 2002; Koivisto Hursti & Magnusson, 2002; McEachern & McClean, 2002; O'Connor & Cowan, 2005; Padel & Foster, 2005; Storstad & Bjorkhaug, 2003; Tuorila & Cardelo, 2002; Urala & Lähteenmäki, 2004; Verbeke, 2005), and some articles develop scales of measurement of consumer behaviour and their relation to food (for instance, Bell & Marshall, 2003; Herman & Mack, 1975; Lähteenmäki & Tuorila, 1994; Lakshman, 2007; Martins & Pliner, 1998; Pliner & Hobden, 1992; Stunkard & Messick, 1985; Van Trijp, 1995).

Consumer attitudes can also be relevant in relation to the choice of global and national food brands, primarily in viewing them through this aspect. In relation to this, this article set several objectives. First of all, it is necessary to identify the existence of certain scales to be used for measuring consumer attitudes in the above mentioned context. Secondly, it is necessary to research the potential determinants of these attitudes. Finally, the objective is to view the significance of consumer attitudes as a determinant of choosing global and national brands of food products.

1. Literature overview, model generation and hypothesis construction

The most frequently used scale for measuring consumer ethnocentrism was generated by Shimp and Sharma, in 1987, and it has so far been used in research in several countries, both in the context of its own determinant, and the determinant of the choice of national and international brands. The authors, who developed this scale in the USA, state that buying imported products is wrong from the perspective of ethnocentric consumers because, in their opinion, it harms the domestic economy, leads to job losses, and is simply

unpatriotic, so that to such consumers imported products are an object of scorn, whereas for non-ethnocentric consumers imported products are subject to one's own assessment, regardless of where they are produced.

Applying the consumer ethnocentrism scale in Russia and Poland, Good and Huddleston (1995) conclude that consumer ethnocentrism is more manifest in Poland, but it is not manifested in different purchase intentions of the researched national and global brands. Balabanis, Diamantopoulos, Dentiste Mueller and Melewar (2001) conclude that consumer ethnocentrism in Turkey is under the influence of patriotism, and depends on the respondents' nationalism in the Czech Republic, whereas the state has no influence on consumer ethnocentrism in any of the observed countries. Research into consumer ethnocentrism was also performed in the Czech Republic in the conditions of the global economic crisis (Kreckova, Odehnalova & Reardon, 2012), where it was concluded that national identification affects consumer ethnocentrism, which is not the case with cosmopolitanism, where consumer ethnocentrism itself makes a significant and positive impact on the purchase of domestic products, and only marginally negative influence on the purchase of foreign products.

Consumer ethnocentrism in Serbia, Montenegro, Bosnia and Herzegovina, and Croatia (Dmitrović, Vida & Reardon, 2009) affects consumer behaviour related to purchasing domestic products both directly and indirectly through the evaluation of domestic products, openness to the world negatively influences consumer ethnocentrism, whereas there is no unanimously identified impact of national identification on consumer ethnocentrism. As regards Serbia, consumer ethnocentrism was reduced in the globalization process (Veljković, 2009), and younger, more educated, employed consumers in higher income brackets with a greater experience in contact with foreign environment tend to be less ethnocentric, although the presence of ethnocentrism is the most manifest when it comes to food, among others. In Croatia, consumer ethnocentrism is positively related with purchase intention of national brands, and negatively with the intention of purchasing brands from other countries of former Yugoslavia and the European Union (Renko, Crnjak Karanović & Matic, 2012).

In a number of studies, one of the determinants of consumer ethnocentrism considered includes variables called internationalism (Balabanis, Dia-

mantopoulos, Dentiste, Mueller, & Melewar, 2001), openness to the world (Dmitrovic, Vida, & Reardon, 2009), cosmopolitanism (Kreckova, Odehnalova, & Reardon, 2012) etc. Different approaches to the measurement of the concepts of cosmopolitan identity are given by Türken & Rudmin (2013), who also develop a scale for measurement of global identity, comprising two factors – cultural openness and non-nationalism. Also, socio-demographic factors, implicitly present in the theories used in comprehending and predicting consumer behaviour (Aertsens, Verbeke, Mondelaers, & Van Huylenbroeck, 2009), are also used in some research into consumer ethnocentrism (Good & Huddleston, 1995; Balabanis et al., 2001; Veljković, 2009; Kreckova, Odehnalova, & Reardon, 2012).

Bearing the latter in mind, we first set two hypotheses within the research to be conducted within this article:

H₁: It is possible to identify a statistically significant influence of at least some of socio-demographic or behaviourist variables (gender, age, education level, employment status, household income, frequency of travel abroad) on consumer ethnocentrism.

H₂: It is possible to identify a statistically significant influence of at least some of socio-demographic or behaviourist variables (gender, age, education level, employment status, household income, frequency of travel abroad) on cultural openness.

A model was identified based on the above mentioned sources, which will be tested in the research within this article:

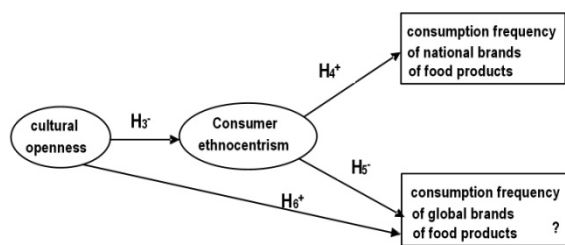


Figure 1 The set research model
Source: The authors

Relevant hypotheses follow from the demonstrated model:

H₃: Cultural openness statistically significantly and negatively affects consumer ethnocentrism.

H₄: Consumer ethnocentrism statistically significantly and positively affects consumption frequency of national brands of food products.

H₅: Consumer ethnocentrism statistically significantly and negatively affects consumption frequency of global brands of food products.

H₆: Cultural openness statistically significantly and positively affects consumption frequency of global brands of food products.

H₇: Consumer ethnocentrism positively and partially mediates in the impact of cultural openness on consumption frequency of global brands of food products.

H₈: Cultural openness statistically significantly indirectly affects consumption frequency of national and consumption frequency of global brands of food products.

The following section of the article presents assumptions, research results, and comments regarding the tested hypotheses.

2. Methodology

2.1. Questionnaire

The questionnaire comprised three parts. The first part gathers certain socio-demographic and behaviourist characteristics of respondents (gender, age, education level, employment status, self-assessed household income from 1 to 5 (1 = the lowest, 5 = the highest score), frequency of travel abroad – once a year at most, once a year at least).

The second part of the questionnaire pertained to the frequency of consumption of national and global brands within three categories of food products. Self-reported consumption frequency was used, as it was regarded as a good predictor of real consumption (Drewnowski & Hann, 1999). In two respective questions, the respondents circled one of the offered numbers on a scale of 1 to 7, with the following meaning of numbers: 1 never; 2 once in several months; 3 once in several weeks; 4 once a week; 5 several times a week; 6 daily; and 7 several times a day. The following product categories were chosen based on consultation with marketing experts: snacks, ketchup, and bear, their global brands Pringles, Heinz, Heineken, and domestic brands Chipсы, Dijamant, Jelen. The chosen brands are represented on the domestic market.

The third section of the questionnaire included measurement of consumer ethnocentrism and cultural openness by Likert scale from 1 to 7. Based on consultation with marketing experts, and previous research that used the consumer ethnocen-

trism scale (Shimp & Sharma, 1987), five of the original 17 item scale were chosen to be used in the research, whereas cultural openness was measured using items from the questionnaire developed by Türken & Rudmin (2013). The used items are presented in the section referring to testing the reliability and validity of the used scales. Double translation procedure was used in translation, i.e. scales were first translated into Serbian, and then back into English, and compared with the original. The above two phases were conducted by different experts for business English. Pre-testing was conducted on students, and did not indicate the need to reformulate the questionnaire.

2.2. The researched sample

Marketing research was conducted in the city of Subotica. Intentional convenience sample was used. Marketing research was conducted in December 2014. The sample comprised 300 respondents, equally distributed in terms of responding to questionnaires related to individual food categories, where filling the sample by respondents lasted between 10 and 20 minutes. The sample comprised 47.3% women and 52.7% men. Out of the total number of respondents, 48.3% finished secondary school, and 51.7% finished college. In addition, 39% respondents are unemployed, and 61% are employed. As for frequency of foreign travel, 52.3% travel once a year at most, whereas 47.7% travel more often than that. The average age of respondents is 35.78 years (standard deviation 12.597), whereas the average self-estimated household income is 2.87 (standard deviation 0.818).

2.3. Data processing

When using the undertaken scales, their reliability was tested first, by using Cronbach's alpha, Cronbach's alpha if item deleted, and Corrected item-total correlation. Exploratory factor analysis by maximum likelihood factor analysis method and rotation method (Varimax) was used for testing scale validity, where all items of both scales were tested together. Prior to this, adequacy of conducting exploratory factor analysis was tested by Kaiser-Meyer-Olkin (KMO) test and Bartlett's Test of Sphericity.

The influence of gender, age, education level, employment status and self-assessed household income on consumer ethnocentrism and cultural openness (both scales represented by arithmetic

mean) was tested by multiple regression with General Linear Model. Furthermore, results are observed at the level of average age and average self-assessed household income, and coding was performed so that the value of 0 was assigned to the following levels of respondent characteristics: female, finished secondary school, unemployed, travels abroad once a year at most, and value of 1 to the following levels of these characteristics: male, finished college, employed, travels abroad once a year at least. Structural Equation Modelling was used when testing within the model set in the articles (where both scales were transformed into composite variables). Highest Probability Method (Olsson, Foss, Troye & Howell, 2000) was used due to ordinary dependent variables related to consumption frequency. The data was processed in SPSS and AMOS statistical packages.

3. Research results

3.1. Reliability and validity of the used scales

Table 1 shows testing of the reliability of used scales.

Table 1 Reliability of the used scales

Items in the scale of consumer ethnocentrism	Cronbach's alpha if item deleted	Corrected item-total correlation	Items on the scale of cultural openness	Cronbach's alpha if item deleted	Corrected item-total correlation
Citizens of Serbia should always buy Serbian products rather than imported ones.	0.848	0.690	I regard myself as a citizen of the world more than of a particular nation.	0.729	0.268
We should buy Serbian products, rather than letting other countries get rich on us.	0.829	0.774	I could live in other cultures/countries	0.603	0.541
Citizens of Serbia should not buy foreign products because it harms the Serbian economy and generates unemployment.	0.839	0.727	I identify myself with people from the whole world.	0.569	0.612
It may cost me more in the long run, but I prefer to buy domestic products.	0.836	0.739	I enjoy learning something new about other cultures (countries)	0.642	0.459
Foreign products should be purchased only if unavailable in our country.	0.875	0.680	I enjoy listening to music from different countries	0.661	0.408

Source: The authors

Cronbach alpha amounted to 0,873 for five items of the consumer ethnocentrism scale, and 0.694 for the same number of items of the cultural openness scale. The height of corrected correlation of the first item of the cultural openness scale with total sum of assessed values of all items of the scale which declines significantly in relation to other (in accordance with Churchill, 1979), with the possibility of expressed growth in Cronbach alpha if the question is deleted and its growth to minimum recommended value (Nun-

naly, 1978), determined the omission of the mentioned item from further analysis. The results of Kaiser-Meyer-Olkin test of 0.785 higher than 0.6 (Kaiser, 1970, 1974) and the level of significance of Barthlett's sphericity test of 0.000 (Barthlett, 1954) pointed to the adequacy of conducting exploratory factor analysis. Conducted factor analysis identified two factors with Eigenvalues higher than 1 (Kaiser, 1960), and which explained 51.261% of the total variance. Table 2 shows the rotated factor matrix of unified items of both scales.

Table 2 Validity of used scales

Unified items in both scales	Factor 1	Factor 2
Citizens of Serbia should always buy Serbian products rather than imported ones.	0.792	-0.076
We should buy Serbian products, rather than letting other countries get rich on us.	0.858	-0.056
Citizens of Serbia should not buy foreign products because it harms the Serbian economy and generates unemployment.	0.771	-0.070
It may cost me more in the long run, but I prefer to buy domestic products.	0.778	-0.008
Foreign product should be purchased only if unavailable in our country.	0.604	-0.065
I could live in other cultures/countries	-0.228	0.620
I identify myself with people from the whole world.	-0.009	0.670
I enjoy learning something new about other cultures (countries)	-0.017	0.619
I enjoy listening to music from different countries	0.014	0.631

Source: The authors

High charges of the first 5 items (higher than minimum recommended than 0.35 for a sample of 250 respondents, and then 0.3 for a sample of 350 respondents – Hair, Tatham, Anderson и Black, 1998), belonging to the scale of consumer ethnocentrism, in the first factor, and other four items, belonging to the scale of cultural openness, in the second factor, point to the validity of the used scales.

3.2. Determinants of consumer ethnocentrism

Using multiple regression with the general linear model procedure, at average age of respondents and average self-estimated household income produced a table of values of parameters for the dependent variable of consumer ethnocentrism (Table 3).

Table 3 Values of parameters for the dependent variable of consumer ethnocentrism

Parameter	B	Standard error	t	Significance level	95% confidence interval	
					lower limit	upper limit
intercept	4.970	0.175	28.413	0.000	4.625	5.314
gender	0.151	0.151	1.004	0.316	-0.145	0.448
age	0.014	0.007	2.202	0.028	0.002	0.027
education	-0.012	0.154	-0.075	0.940	-0.314	0.291
employment status	-0.288	0.164	-1.753	0.081	-0.611	0.035
income	0.020	0.101	0.199	0.842	-0.179	0.219
travel abroad	-0.130	0.163	-0.795	0.427	-0.451	0.192

Source: The authors

The obtained results for the dependent variable of consumer ethnocentrism (CE) could be expressed by a regression equation as follows:

$$CE=4.970+0.151*gender+0.014*age-0.012*education-0.288*employment status+0.020*income-0.130*travel$$

It is reasonable to interpret the above equation only in the context of coding stated in the section on data processing. The only characteristic of respondents statistically significantly influencing their consumer ethnocentrism is age, in such a way that increase in age by one year in relation to average age (at other initial conditions), consumer ethnocentrism grows on the average by 0.014 on a seven-degree Likert scale. The influence of other variables is not statistically significant, but it can be established that, at the level of average age and self-estimated household income, and other initial conditions, in the units of seven-degree Likert scale, men are more ethnocentric in relation to women by 0.151, and respondents with finished college are less ethnocentric than those with secondary by 0.012, the employed in relation to the unemployed by 0.288, and those who travel abroad at least once a year in relation to those who travel abroad at most once a year by 0.130. As regards self-estimated household income, it can be found that, by its growth by 1 on a five-degree Likert scale in comparison with average graded, at other initial conditions, consumer ethnocentrism grows on the average by 0.020 on a seven-degree Likert scale.

The level of consumer ethnocentrism can be viewed by a combination of the level of respondents' characteristics, at average age and average self-estimated household income (Table 4).

Table 4 Consumer ethnocentrism (declining values) and characteristics of respondents

Consumer ethnocentrism	gender	education	employment status	travel abroad
5.121	male	finished secondary school	unemployed	once a year at most
5.109	male	finished college	unemployed	once a year at most
4.991	male	finished secondary school	unemployed	once a year at least
4.979	male	finished college	unemployed	once a year at least
4.970	female	finished secondary school	unemployed	once a year at most
4.958	female	finished college	unemployed	once a year at most
4.840	female	finished secondary school	unemployed	once a year at least
4.833	male	finished secondary school	employed	once a year at most
4.828	female	finished college	unemployed	once a year at least
4.822	male	finished college	employed	once a year at most
4.703	male	finished secondary school	employed	once a year at least
4.703	male	finished college	employed	once a year at least
4.682	female	finished secondary school	employed	once a year at most
4.670	female	finished college	employed	once a year at most
4.552	female	finished secondary school	employed	once a year at least
4.540	female	finished college	employed	once a year at least

Source: The authors

At average age and average self-estimated household income, consumer ethnocentrism is the most manifest in unemployed men with finished secondary school travelling abroad once a year at most (5.121)

3.3. Determinants of cultural openness

Using multiple regression with the general linear model procedure, at average age of respondents and average self-estimated household income produced a table of values of parameters for the dependent variable of cultural openness (Table 5).

Table 5 Values of parameters for the dependent variable of cultural openness

Parameter	B	Standard error	t	Significance level	95% confidence interval	
					lower limit	upper limit
intercept	4.808	0.158	30.405	0.000	4.497	5.119
gender	-0.186	0.136	-1.363	0.174	-0.454	0.082
age	0.001	0.006	0.152	0.879	-0.011	0.012
education	0.071	0.139	0.514	0.607	-0.202	0.345
employment status	0.112	0.148	0.754	0.452	-0.180	0.404
income	-0.017	0.091	-0.188	0.851	-0.197	0.163
travel abroad	0.261	0.148	1.769	0.078	-0.029	0.552

Source: The authors

The obtained results for the dependent variable of cultural openness (CO) could be expressed by a regression equation as follows:

$$CO = 4.808 - 0.186 * gender + 0.001 * age + 0.071 * education + 0.112 * employment status - 0.017 * income + 0.261 * travel$$

It is also reasonable to interpret the above equation only in the context of coding the stated in the section on data processing. In addition, none of the respondents' characteristics influence statistically significantly their cultural openness.

At the level of average age and self-estimated house income, and at other initial conditions, in the units of seven-degree Likert scale, men are less culturally open in relation to women by 0.186, respondents with finished college are more open on the average compared to those with secondary school by 0.071, the employed compared to the unemployed by 0.112, and those who travel abroad once a year at least compared to those who travel abroad once a year at most by 0.261. As regards the respondents' age, with increase in age by one year in relation to average age (at other initial conditions), cultural openness grows on the average by 0.001 unit of value on a seven-degree Likert scale, and when it comes to self-estimated household income, its growth by 1 on a five-degree Likert scale in relation to the average value, at other initial condition, cultural openness on the average declines by 0,017 on a seven-degree Likert scale.

The level of cultural openness can be viewed by a combination of the level of respondents' characteristics, at average age and average self-estimated household income (Table 6).

Table 6 Cultural openness (declining values) and characteristics of respondents

Consumer ethnocentrism	gender	education	employment status	travel abroad
5.252	female	finished college	employed	once a year at least
5.181	female	finished secondary school	employed	once a year at least
5.140	female	finished college	unemployed	once a year at least
5.069	female	finished secondary school	unemployed	once a year at least
5.066	male	finished college	employed	once a year at least
4.995	male	finished secondary school	employed	once a year at least
4.991	female	finished college	employed	once a year at most
4.954	male	finished college	unemployed	once a year at least
4.920	female	finished secondary school	employed	once a year at most
4.883	male	finished secondary school	unemployed	once a year at least
4.879	female	finished college	unemployed	once a year at most
4.808	female	finished secondary school	unemployed	once a year at most
4.805	male	finished college	employed	once a year at most
4.734	male	finished secondary school	employed	once a year at most
4.693	male	finished college	unemployed	once a year at most
4.622	male	finished secondary school	unemployed	once a year at most

Source: The authors

At average age and average self-estimated household income, cultural openness is the most manifest in employed women with finished college travelling abroad once a year at least (5.252).

3.4. Determinants of consumption of global and national food brands

Given that the model encompasses the relation between four variables, Table 7 gives descriptive statistics regarding these (data for scales were obtained for composite variables).

Table 7 Descriptive statistics of variables encompassed by the model

Variable	Number of respondents	Arithmetic mean	Standard deviation	Median
Cultural openness	300	4.52	1.27	4.69
Consumer ethnocentrism	300	3.64	0.91	3.69
Frequency of consumption of national food products	300			5
Frequency of consumption of global food products	300			3

Source: The authors

After correlating the residuals of the two dependent variables related to frequency of consumption of food product brands, conducted in accordance with the recommendations of modification, model adequacy indicators were obtained

and compared with recommended values (Hu & Bentler, 1999): Chi-square/df=1,885 (less than 3 good), p model value = 0.170 (should be greater than 0.05), DFI = 0.933 (higher than 0.95 – excellent), GFI = 0.997 (should be more than 0.95), AGFI = 0.969 (should be more than 0.80), SRMS = 0.0243 (should be less than 0.09), RMSEA = 0.054 (good if less than 0.05; if between 0.05 and 0.10 it is acceptable), PCLOSE = 0.318 (should be greater than 0.05) show that the obtained model is adequate.

Table 8 presents the results of structural equation models.

Table 8 Results of structural equation models

Independent variables	Dependent variables		
	consumer ethnocentrism	frequency of consumption of national food brands	frequency of consumption of global food brands
cultural openness	-0.197 (0.004)	-	0.302 (0.002)
consumer ethnocentrism	-	0.347 (0.002)	-0.305 (0.002)

Source: The authors

All direct effects shown in the previous table are statistically significant (corresponding values are given in parentheses). Results show that, when cultural openness grows by the value of a standard deviation, consumer ethnocentrism declines by 0.197 standard deviations. Growth in consumer ethnocentrism by one standard deviation increases frequency of consumption of national food brands by 0.347 standard deviations. In addition, growth in cultural openness by one standard deviation results in growth in frequency of consumption of global food brands by 0.302 standard deviations.

Table 9 contains the results of mediation analysis.

Table 9 Results of mediation analysis (standardised effects)

Relation	Effects		
	Total	Direct	Indirect
cultural openness → frequency of consumption of national food brands	-0.068 (0.004)	-	-0.068 (0.004)
cultural openness → frequency of consumption of global food brands	0.362 (0.002)	0.302 (0.002)	0.060 (0.004)

Source: The authors

Viewing the results from the previous table, it can be concluded that the total effects of cultural openness on the frequency of consumption of national food brands (indirect at the same time, given that the direct ones are not foreseen by the

model) are statistically significant and point out that growth in cultural openness by one standard deviation reduces the frequency of consumption of national food brands by 0.068 standard deviations. As regards standardized total, direct and indirect effect of cultural openness on the frequency of consumption of global food brands, they are all statistically significant, where the standardized total (direct and indirect) effect of cultural openness on the frequency of consumption of global food brands is 0.362, which is a consequence of both direct and indirect effects, so that the growth in cultural openness by one standard deviation increases the by frequency of consumption of global food brands by 0.362 standard deviations.

4. Discussion on research results and conclusions

All the objectives set by the authors in writing this paper are fully achieved. First, appropriate scales have been identified enabling the measurement of consumer attitudes potentially relevant for the choice of national and global food product brands; aspects of their application existing thus far are explained, and the entire topic of significance of consumer attitudes in shopping has been presented in a broader context.

Furthermore, the second research objective, to which the first two hypotheses referred, is achieved, that is, determinants of attitudes of consumer attitudes relevant for the choice of global and national food product brands were identified. In relation to this, the first hypothesis was confirmed and the second was rejected, as the application of multiple regression with the aid of general linear model led to a conclusion that consumer ethnocentrism is statistically significantly and positively affected by consumer's age (whose growth results in increase in consumer ethnocentrism), whereas cultural openness is not statistically significantly dependent on any of the researched characteristics of consumers. Moreover, at average age and average estimated household income, the most ethnocentric group is men with finished secondary school travelling abroad once at most, whereas the most culturally open are college educated women travelling abroad at least once. The stated results mostly match earlier research into consumer ethnocentrism in Serbia (Veljković, 2009), while the least expected is the positive impact of income on consumer ethnocentrism. However, one must bear in mind that this impact on the one hand is not statistically signifi-

cant, but on the other hand the measure of income was self-estimated household income.

Finally, the third research objective was achieved, pertaining to all other hypotheses, which were all confirmed. By the application of structural equation models it was established that cultural openness significantly and negatively affects consumer ethnocentrism, that consumer ethnocentrism significantly and positively affect consumption frequency of national brands, and significantly and positively influences the consumption frequency of global brands. The impact of cultural openness on the frequency of consumption of global brands is significant both directly and through the mediator (consumer ethnocentrism), and the indirect impact of cultural openness on consumption of national brands is significant as well. The above results are also dominantly convergent with the result of earlier research in domestic conditions (Dmitrović, Vida, & Reardon, 2009; Veljković, 2009).

Future research could encompass a wider territory and larger sample, so as to meaningfully define relevant management implications. Also, the level of observation could have individual brands as the starting point, while the analysis could also include other determinants of consumer ethnocentrism and cultural openness. **SM**

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An Analysis of the Proposed Strategic Decision-Making Model in the Local Governments of Pakistan

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Abstract

Strategic decision making was first introduced to the government in the form of strategic planning, which had already developed a considerable track record in the private sector. Strategic decision making (SDM) is a tool usually much preferred in the private sector. This study aims to find a relationship between political interference, decisional rationality, autonomy and the environment, and to propose a strategic decision-making model to local governments in order to have efficiency improved. The data have been obtained from the local government structure of Pakistan through a questionnaire survey and interviews. For this purpose, as many as 132 questionnaires have been collected from respondents working in the local government and 50 local government administrators have been interviewed so as to confine the use of the SDM. The results obtained point out the fact that there is a significant and positive relationship between decisional rationality, political influences and environmental stability, on the one hand, and strategic decision making in the local government, on the other. This study, however, finds no significant relation between autonomy and strategic decision making.

Keywords

Strategic Decision Making, Decisional Rationality, Nazim, Naib Nazims, Tehsils, Local Government, Pakistan.

Introduction

Local government is widely known as local self-government in most South Asian countries (Siddique, 1994). The United Nations (1962) definition of local self-government is considered as the most acceptable definition that defines it as an elected or locally selected political subdivision of a nation or state. It is constituted by law and has substantial control over local affairs. Boex, Gudgeon, and Shotton (2002) argue in favor of effective local government bodies for several reasons. First, the implementation of any poverty reduction strategy requires improved access to and the delivery of the basic local public

goods and services (primary education, health, water, sanitation, road access, flood protection and drainage, etc). Second, local government is in an advantageous position with regard to the financing, planning, management and oversight of these local public goods and services (if not necessary in their actual delivery). Third, local democratic governance mechanisms can be created for local government. They may ensure a positive interaction by effective decision making. Decision making is the core subject matter of administrative science. It has been observed that relatively less time is spent on decision making no matter whether it is important or not (Mintzberg, Raisinghani, & Theoret, 1976). Decision making

has been defined by researchers as the act of choosing one alternative amongst a set of alternatives. The core focus of this study is on strategic decision making in the public sector, especially in local government. The basic assumption in the public management theory is that decisions and processes of a public and a private organization differ; however, little research has identified the differences and similarities between a decision made in the public and the private sectors. The same situation is with decision making and strategic decision making. A number of researchers from different fields of management, mathematics, statistics etc. have discussed the types of decisions, processes, decision trees and other perspectives of decision making. The strategic aspect of management was basically triggered by the work of Miles and Snow (1978) and later Porter (1980), who introduced this concept in government in the shape of strategic planning. Recently, researchers have begun to examine strategic processes and models between strategic processes in the public and the private sectors (Mintzberg, Raisinghani, & Theoret, 1976). The central process among strategic processes is the decision-making process (Eisenhardt & Zbaracki, 1992; Astley & van de Ven, 1983). The literature search for data in different databases (EBSCO, JSTOR, Taylor and Francis, Scopus, Google Scholar etc.) indicate rare research articles and works in the field of strategic decision making in local government, particularly in South Asian countries (e.g. Pakistan). Hence, this study is an effort to make a proposal for and focus on the strategic decision-making aspect of the local government in Pakistan.

The pertinent questions are as follows: 1) What strategic decision-making model has been used in the local government of Pakistan? and 2) What is the strategic decision-making model in local government in Pakistan? The main problem statement of this study is based on the observation and the literature identifying the SDM as being mainly considered to be an important tool in the private sector and rarely do we find any SDM model to be followed and utilized by local governments. Thus, the problem statement of this study is "to develop and integrate the SDM as a technique of decision making in local government". The next section of this paper discusses the proposed SDM model for local government; the other sections are focused on the discussion and the conclusions.

1. The Proposed Model of Strategic Decision Making and Hypotheses Formulation

It will be useful to begin with the definition of strategic decisions. For the purposes of this research, a strategic decision is described as the one involving a commitment of large amounts of organizational resources in order to achieve organizational goals and purposes by applying appropriate means (Chandler, 1962). Dean and Sharfman (1996) describe strategic decisions as committing substantial resources, setting precedents and creating waves of lesser decisions (Mintzberg, Raisinghani, & Theoret, 1976); as ill-structured, non-routine and complex (Schwenk, 1988); and as substantial, unusual and all-pervading (Hickson, Butler, Cray, Mallory, & Wilson, 1986). In his research study, Streib (1992) presented the crux of a different study related to the strategic decision making theme by identifying the mission statement, the environmental and organizational scan, the strategic objectives and the implementation and reviews as the major components in all approaches. Strategic decisions have an impact on many aspects and functions of an organization and influence its direction, administration and structure in fundamental ways (Christensen, Andrews, Bower, Hamermesh, & Porter, 1982). Strategic decision making has been described as a series of analytical processes whereby a set of objective criteria are used to evaluate strategic alternatives (Hilt & Tyler, 1991).

Earlier strategic decision making has been used as a tool in private organizations. The SDM in the shape of strategic planning was introduced into the public sector 20 years ago, with much of the early literature focusing on local government applications (Dodge & Eadie, 1982; Eadie, 1983; Sorkin, Ferris, & Hudak, 1984; Denhardt, 1985). Streib (1992) supports the fact that many authors (McConkey, 1981; Eadie, 1983; Denhardt, 1985) promoted the use of the SDM as a technique to help the government to cope with the unstable environment. Research into strategic decision-making has often been divided into two categories: 'content research' and 'process research'. Content research deals with the issues of the strategy content, such as portfolio management, diversification, mergers and the alignment of firm strategies with environmental characteristics. Process research, however, deals with the process by which a strategic decision is made and implemented and the factors it is affected by. Janis's (1982)

case studies suggested that public policy decisions that used rational methods were more successful than those that did not use that method. Strategic decisions create the waves of sub-decisions and tasks (Mintzberg, Raisinghani, & Theoret, 1976) that must be implemented successfully. A successful implementation may need some sort of change in the organizational structure and culture (Bourgeois & Browdin, 1984; Skivington & Daft, 1991). Glen Whyte raised an important question in his research study, namely: Why do talented, ethical and experienced administrators occasionally make decisions on important matters they knew were likely to end in failure? Why do groups composed of such administrators occasionally display a lack of vigilance and excessive risk taking in dealing with matters of utmost importance? He explained such a type of behavior by applying Janis's (1982) groupthink model. In order to analyze which model is appropriate or in use with local government, this study highlights the literature on the decision making model. The rational perspective sometimes referred to as the synoptic or comprehensive model of decision making (Anderson, 1983; Nutt, & Backoff, 1987) assumes that during the decision making process, the majority of managers and administrators think they are the most rational of all. According to this model, actors approach decision-making situations with known objectives. These objectives determine the value of the possible consequences of an action (Eisenhardt & Zbaracki, 1992). Researchers presented the classical model of decision making that pre-assumes that managers/administrators are logical and rational if they identify and define the situation and the alternatives, evaluate the alternatives, select the best ones, implement them and follow them up. Several empirical studies reveal cognitive limitations (Cyert & March, 1963; Anderson, 1989). The original work is by Cyert, March, and colleagues (Cyert & March, 1963). These authors presented the theory and the case studies demonstrating that goals can be inconsistent from one person to another and across time, search behavior is often local, and standard operating procedures are those that guide much of the organizational behavior. This leads us to the behavioral perspective of decision making pre-assuming that decision makers have incomplete information and are constrained by bounded rationality and tend to satisfice when making the best alternatives.

The proposed model of strategic decision making is depicted in Fig. 1 below. It is our inten-

tion to examine administrators' cognitive and management criteria in decision making rather than the overall performance and outcome of strategic decisions.

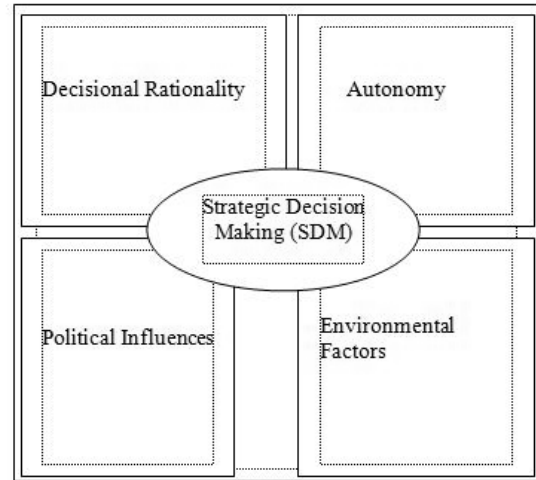


Figure 1 Proposed Conceptual Framework of Strategic decision making in Local Government

For this purpose, the following four hypotheses have been formulated based on the following literature review.

Decisional Rationality: The two concepts of bounded rationality and political interference play the central role in strategic decision making as identified by research studies (Cyert & March, 1963; Eisenhardt & Zbaracki, 1992; Pettigrew, 1973; Pfeffer, 1981). In a research study they had conducted, Eisenhardt and Zbaracki (1992) identified the fact that the rational model of decision making assumed that human behavior had some objectives. In their studies, Bourgeois and Eisenhardt (1988) concluded that a successful firm's decisions were mostly based on rationality. In their study, Dean and Sharfman (1996) conclude that an administrator's strategic decisions have an impact on the fortune of the organization. Janis's (1982) case study identifies that the public-policy decisions based on rationality are more successful. While researchers (Cyert & March, 1963; Anderson, 1989) presented the theory and various case studies which demonstrate that goals can be inconsistent from one person to another and across time, search behavior is often local and standard operating procedures guide much of the organizational behavior. In a review of the six top-level planning decisions, Cyert and March (1963) formulated a view of the search processes by segmenting them into two types. A personnel-

induced search occurs when strong executives with definite objectives in mind stimulate a search, while an opportunity-induced search occurs when firms engage in search upon the emergence of unexpected opportunities (Cyert and March, 1963). Dean and Sharfman (1996) examined rationality in their study. They studied 57 strategic decisions in 24 firms. They concluded that threatening environments, a high uncertainty and external control decreased rationality. It is often the case that research (Janis, 1982; Nutt & Backoff, 1987) indicates how decision makers can move along the rationality vs. bounded rationality continuum, typically by increasing a conflict. Eisenhardt & Zbaracki (1992) state that new threads of research actually break from this dominant view that rationality and bounded rationality anchors are the ends of a continuum. This work argues that rationality is multidimensional, so strategic decision makers are rational in some ways, but rather not in other ways. It also argues that such behaviors are effective, particularly in fast-paced environments. In another study of strategic choice in 8 microcomputer firms, Eisenhardt (1989) showed that effective decision makers developed many alternatives, but only thinly analyzed them. They also sought information from many sources, but rather focused on a few. In other words, these executives were rational in some ways, but rather not in other ways. Thus, decision makers are rather seen adjusting their rationality in complex ways than being blindly and uniformly more or less rational.

H₁: There is a significant positive relationship between decisional procedure and strategic decision making.

Politics and strategic decision making: The second concept presented in this model is politics. Research studies (Pettigrew, 1973; Quinn, 1980; Eisenhardt & Bourgeois, 1988) identify the fact that an organization is basically a political system in which people have conflicting goals. Conclusively, these studies significantly favor the fact that politics are common in strategic decision making. Dean and Sharfman (1996) identify the key idea underlying the political dimension of decision making that 1) people in organizations have different respective interests, such differences resulting from the functional, hierarchical, professional and personal factors (Hickson et al., 1986) and that 2) people in an organization try to influence the decision making process through a variety of techniques (Bacharach & Lawler, 1980;

Pfeffer, 1981). In addition, Quinn's (1980) study of executive choice indicated that effective managers used such politics, which he termed 'logical incrementalism'. Senior executives developed a broad strategy of what they wished to accomplish, but rather had the strategy implemented in a series of piecemeal, opportunistic decisions along the 'corridors of indifference'. From the traditional point of view, politics are essential to organizations (Quinn, 1980; Pfeffer, 1981). Initially, politics in any organization emerge in the form of a conflict or a difference of opinion that converts into a conflict at a later stage. Research studies identify the fact that people with conflicting preferences engage in politics in order to gain a favorable decision. They switch over their alliances or parties more frequently depending on their own benefits. Politics are triggered by power imbalances (Dean & Sharfman, 1992). He further stated that frustrated executives turn to politics as the last resort in autocratic and power-vacuum situations. For example, autocratic CEOs created an atmosphere of frustration and mistrust in which subordinates came to regard politics as their last resort to getting their views considered (Eisenhardt & Bourgeois, 1988). Empirical evidence suggests that decision makers rely on the same allies and the same politics time after time (Pettigrew, 1973).

In their study, Eisenhardt & Zbaracki (1992) mention that an emerging debate within the paradigm is whether politics are a positive, conflict-driven phenomenon or a power-driven process signaling dysfunctional decision making.

H₂: There is a significant positive relationship between political influences and strategic decision making.

Autonomy: The third concept of this model is autonomy in strategic decision making. A completely autonomous decision is a decision brought independently of other authorities, to a substantial extent of a policy freedom and on the board's own initiative. The prime responsibility of most government functions and services has been designated to the central government, or if local government does not have a constitutionally granted autonomy and a possibility of appealing to a court in the case of a central intrusion into its autonomy, the administrative system is centralized and the autonomy of local government is small (Fleurke & Willemsse, 2004). Decentralization and local autonomy are two inter-related concepts in intergovernmental studies. Many studies

in intergovernmental relations follow the deductive approach of autonomy. In this approach, decentralization and local autonomy are either implicitly or explicitly treated as interrelated concepts: the larger the extent of decentralization is, the larger the local autonomy is, and vice versa (Fesler, 1965; Rolla, 1998; Fleurke & Willemse, 2004).

In her study, Foster (1997) examined the role of several different measures of municipal autonomy in stimulating the creation of these governments. She found that the states imposing debt limits had greater reliance on special-district governments. In his study, Lewis (2000) identified the fact that local government officials, property owners and other interested parties have sufficient tools at their disposal to adapt to restrictions in local government autonomy without resorting to special-district governments to circumvent these laws.

H₃: There is a significant positive relationship between autonomy and strategic decision making.

Environmental Factors: Many environmental factors also influence strategic decision making. Among many factors, researchers' (Goll and Rasheed, 1997) focus is on the environmental uncertainty. In her study, Eisenhardt (1989) finds an association between fast decision making and a better performance. Fredrickson (1983) argues that in a stable environment, synoptic processes should be used (rationality), whereas in an unstable environment, incremental processes should be adopted. Goll and Rasheed (1997) find that a rational decision process is strongly associated with organizational performance in highly munificent environments. While other studies (Dean and Sharfman, 1996; Elbanna & Child, 2007) find that environmental instability does not moderate the link between procedural rationality and organizational outcomes. Elbanna and Child (2007) also concluded that decision-specific characteristics played the central role in relation to strategic decisions, with environmental factors playing a less significant role.

H₄: There is a significant positive relationship between environmental factors and strategic decision making.

2. The Methodology

This study is both qualitative and quantitative. In the quantitative research study, the survey has been conducted within the local government

structure of Pakistan. For the triangulation purposes, the qualitative research study has been carried out. The qualitative research aims at interpreting the precise meanings of people's interactions in normal social contexts. It is focused on the complexity, authenticity and shared subjectivity of the researcher and the subject-matter of his/her research (Fryer, 1991). Given the foregoing, the theory of the qualitative approach is generated from and "grounded" in data (Glaser & Strauss, 1967). In generating the "grounded" theory, researchers do not seek to prove their theories, but rather merely demonstrate a plausible support for these theories (Taylor, 2000). Using semi-structured interviews and the focused group interview, the study aims to identify the relationship between political interference, autonomy, environment and decisional rationality, respectively on the one hand, and strategic decision making, on the other.

2.1. Data collection

The data were collected in two stages. In the first stage, the semi-structured interviews were conducted in order to provide an in-depth examination of decisions in local government and to understand the SDM models followed. The relationship between decisional rationality, political interference and autonomy and strategic decision making was subjected to examination. In the second stage, the survey was conducted so as to find out the relationship between dependent and independent variables. The sampling criteria applied in this study comprised of the key officials of local government and the members of the districts and the local union councils of Pakistan (province-wise). For the purposes of the survey, the questionnaires were sent to 200 respondents, amongst whom approximately 150 of them returned their respective questionnaires, out of which questionnaires 132 were completely filled out, whereas 10 were not filled out at all and eight were partially completed. So, the sample size was 132 respondents. The members selected for the research agreed to participate in it. Later, informed consent was obtained from each member. The profile history depicted that, amongst respondents, 30% of them were Nazims, 20% were Naib Nazims and 50% were district officers and union councilors. While sampling the population, the focus of this study was put on the capital cities' offices. For the purpose of doing interviews, the local government offices at Quetta, Lahore, Karachi and Peshawar were in focus.

2.2. Results and Discussion

Table 1 below describes the mean, the standard deviation and the correlation matrix. The Pearson correlation of the studied variables is also significant, with the reliability of 0.78, where none of the values exceeds 0.80, which is the criterion of multicollinearity as recommended by Cooper and Schindler (2006).

Table 1 The Pearson correlations between the SDM and decisional rationality, political interference, autonomy and environmental stability

	Mean	S.D.	1	2	3	4	5
1. SDM	4.08	1.345	1				
2. Decisional Rationality	3.57	1.160	.013*	1			
3. Political Interference	4.11	1.292	.628**	.179*	1		
4. Autonomy	4.14	1.156	.222	.279**	.122	1	
5. Environmental Stability	3.51	1.156	.222*	.279**	.122	1.000**	1

* Significant at the 0.05 level (2-Tailed)
 ** Significant at the 0.01 level (2-Tailed)

Source: Authors

The correlation accounted for in Table 1 above suggests that there are significant relationships between decisional rationality and the environment, on the one hand, and the SDM, on the other, at $p \leq 0.05$, and between political interference and strategic decision making at $p \leq 0.01$. Autonomy and environmental stability have decisional rationality at the 0.01 level of significance, while autonomy is significant at the 0.05 level. Recruitment and organizational effectiveness are significant at $p \leq 0.05$. Similarly, there are significant relationships between autonomy and environmental stability at the 0.01 level of significance. The mean and the standard deviation value of all these variables range from 3.51 to 4.14 and from 1.292 to 1.345, respectively. Thus, the results imply that decisional rationality, political interference and environmental stability are significantly related to strategic decision making.

Table 2 Regression between strategic decision making and political interference, decisional rationality, autonomy and environmental stability

Model		Coefficients ^a			t	Sig.
		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta		
1	(Constant)	1.146	.422		2.715	.008
	Decisional Rationality	-.185	.081	-.159	-2.274	.025
	Political Interference	.487	.140	.465	3.470	.001
	Autonomy	.209	.144	.195	1.447	.150
	Environmental Stability	.209	.081	.179	2.579	.010
R		.667				
R Square		.445				
Adjusted R ²		.428				
F		25.504**				

a. Dependent Variable: SDM
 * Significant at the 0.05 level (2-Tailed)
 ** Significant at the 0.01 level (2-Tailed)

Source: Authors

The regression results (Table 2 above) suggest that there is a significant relationship between strategic decision making, political interference and environmental stability. The table depicts the R at .667, the R-square at 0.445 and the adjusted R-square at 0.428. Thus, on the whole, the proposed model can explain about 44.5 per cent of the variation in strategic decision making. The results support Hypotheses 1, 2 and 4, except for the fourth hypothesis implying a significant relationship between the SDM and autonomy. The results also show that Hypotheses 1 and 2 are found to be significant at $p \leq 0.05$ and Hypothesis 3 is significant at $p \leq 0.01$. The regression results suggest a negative and significant relationship between a dysfunctional conflict and the SDM.

In order to put our theoretical model to the test, we also did interviews. The first question related to rationality was found to be in line with the result of the questionnaire survey. Responding to the question related to the rationality of the manner in which they usually make decisions on local government, about 80% of the respondents responded by saying that they base their decisions on procedural and decisional rationality. Responding to the question related to eliciting their understanding of rationality, the respondents stated that “rationality means our bringing right decisions on a particular matter”. Responding to the second unstructured question whether political influences have an impact on strategic decision making, approximately all of the respondents agreed that political influences and interferences played an important role in strategic decision making. Responding to the question asking what kind of political interference is involved, about 75 % of the respondents identified in their concluding remarks the fact that influences mostly came

from influential parties and individuals, sometimes from a government official, contractors etc. when decisions on projects, the budget allocation and public facilities such as sanitations, parks etc. are concerned. Not one of them identified any influence coming from the general public in strategic decision making; on the other hand, this study has not confirmed the perception of local governments as ones established for people and by people. The general public's say is rarely heard in strategic decision making. Hence, this result is in line with the survey questionnaire of this study.

Responding to the question of the autonomy of decisions in local government, 55% of the respondents were somewhat doubtful about autonomous decision making. They perceived that the local government structure in Pakistan was mostly such that the powers of delegation were not defined, or in other words, Nazisms, nab Nazisms and district officers needed an approval from their provincial government and the federal government. 40% of them stated that decisions at the low level were autonomous, whereas decisions concerning two- and five-year plans and the budget were not autonomous at all. This is supported by Paracha's (2003) studies, in which he stated that the local governments had never been autonomously functional in the presence of democratic governments.

Goll and Rasheed (1997) find that a rational decision process is strongly associated with organizational environments that are highly munificent. This finding is in line with our finding in this study that a stable environment leads to making a successful strategic decision. About 95% of the respondents agreed that the environment is the major factor in strategic decision making. A hostile environment is a kind of a hurdle in strategic decision making, whereas, on the other hand, stability levers up the strategic decision making process.


To sum up, all the three hypotheses of this study have been supported, except autonomy. The LG structure of Pakistan does not support the autonomy of decision making, either, as LG is the third level of the government structure. The federal and provincial levels are the first and the second levels of the structure.

Conclusion

Strategic decisions are very important in the local government structure. Local government in Pakistan is the third level of the government, and the main aim is to provide services to the public and

look after public affairs. Hence, local government is made for people's welfare and their major strategic decisions have a direct influence on the public welfare. Considering the importance of strategic decision making, this study has formulated the conceptual model of the strategic decision model. The perceptual analysis of the SDM model in local government in the context of Pakistan is supportive of bounded rationality, political influence and environmental factors as the major contributors to strategic decision making, whereas autonomy has not been supported in the context of the LG structure of Pakistan. However, autonomy may be supported if such a kind of study is conducted in a mature local government structure and in another context.

Limitation

This study has tested a strategic decision model in Pakistan's local government structure, which is not at a mature level. The results may vary and the model can be tested in a mature local government structure. Hence, this study may be retested and the model may be reformulated in that context in the future; as a result, this model may be added to local government theories. In addition to this, more components may be added or removed, paying considerate attention to the local government structure in the context of that particular country. 

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- Ljubojević, T.K. (1998).
- Ljubojević, T.K. (2000a).
- Ljubojević, T.K. (2000b).
- Ljubojević, T.K., & Dimitrijević, N.N. (1994).

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Authors must be listed by their last names, followed by initials. Publication year must be written in parentheses, followed by a full stop. Title of the article must be in sentences case: only the first word and proper nouns in the title are capitalized. The periodical title must be in title case, followed by the volume number, which is also italicized:

Author, A. A., Author, B. B., & Author, C. C. (Year). Title of article. *Title of Periodical, volume number*(issue number), pages.

➔ Journal article, one author, paginated by issue

Journals paginated by issue begin with page 1 in every issue, so that the issue number is indicated in parentheses after the volume. The parentheses and issue numbers are not italicized, e.g.

Tanasijević, V. (2007). A PHP project test-driven end to end. *Management Information Systems*, 5 (1), 26-35.

➔ Journal article, one author, paginated by volume

Journals paginated by volume begin with page 1 in issue 1, and continue page numbering in issue 2 where issue 1 ended, e.g.

Perić, O. (2006). Bridging the gap: Complex adaptive knowledge management. *Strategic Management*, 14, 654-668.

➔ **Journal article, two authors, paginated by issue**

Strakić, F., & Mirković, D. (2006). The role of the user in the software development life cycle. *Management Information Systems*, 4 (2), 60-72.

➔ **Journal article, two authors, paginated by volume**

Ljubojević, K., & Dimitrijević, M. (2007). Choosing your CRM strategy. *Strategic Management*, 15, 333-349.

➔ **Journal article, three to six authors, paginated by issue**

Jovanov, N., Boškov, T., & Strakić, F. (2007). Data warehouse architecture. *Management Information Systems*, 5 (2), 41-49.

➔ **Journal article, three to six authors, paginated by volume**

Boškov, T., Ljubojević, K., & Tanasijević, V. (2005). A new approach to CRM. *Strategic Management*, 13, 300-310.

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Ljubojević, K., Dimitrijević, M., Mirković, D., Tanasijević, V., Perić, O., Jovanov, N., et al. (2005). Putting the user at the center of software testing activity. *Management Information Systems*, 3 (1), 99-106.

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Strakić, F., Mirković, D., Boškov, T., Ljubojević, K., Tanasijević, V., Dimitrijević, M., et al. (2003). Metadata in data warehouse. *Strategic Management*, 11, 122-132.

➔ **Magazine article**

Strakić, F. (2005, October 15). Remembering users with cookies. *IT Review*, 130, 20-21.

➔ **Newsletter article with author**

Dimitrijević, M. (2009, September). MySQL server, writing library files. *Computing News*, 57, 10-12.

➔ **Newsletter article without author**

VBScript with active server pages. (2009, September). *Computing News*, 57, 21-22.

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Basic format for books

Author, A. A. (Year of publication). *Title of work: Capital letter also for subtitle*. Location: Publisher.

Note: "Location" always refers to the town/city, but you should also include the state/country if the town/city could be mistaken for one in another country.

➔ **Book, one author**

Ljubojević, K. (2005). *Prototyping the interface design*. Subotica: Faculty of Economics.

➔ **Book, one author, new edition**

Dimitrijević, M. (2007). *Customer relationship management* (6th ed.). Subotica: Faculty of Economics.

➔ **Book, two authors**

Ljubojević, K., Dimitrijević, M. (2007). *The enterprise knowledge portal and its architecture*. Subotica: Faculty of Economics.

➔ **Book, three to six authors**

Ljubojević, K., Dimitrijević, M., Mirković, D., Tanasijević, V., & Perić, O. (2006). *Importance of software testing*. Subotica: Faculty of Economics.

➔ **Book, more than six authors**

Mirković, D., Tanasijević, V., Perić, O., Jovanov, N., Boškov, T., Strakić, F., et al. (2007). *Supply chain management*. Subotica: Faculty of Economics.

➔ **Book, no author or editor**

Web user interface (10th ed.). (2003). Subotica: Faculty of Economics.

➔ **Group, corporate, or government author**

Statistical office of the Republic of Serbia. (1978). *Statistical abstract of the Republic of Serbia*. Belgrade: Ministry of community and social services.

➔ **Edited book**

Dimitrijević, M., & Tanasijević, V. (Eds.). (2004). *Data warehouse architecture*. Subotica: Faculty of Economics.

➔ **Chapter in an edited book**

Boškov, T., & Strakić, F. (2008). Bridging the gap: Complex adaptive knowledge management. In T. Boškov & V. Tanasijević (Eds.), *The enterprise knowledge portal and its architecture* (pp. 55-89). Subotica: Faculty of Economics.

➔ **Encyclopedia entry**

Mirković, D. (2006). History and the world of mathematicians. In *The new mathematics encyclopedia* (Vol. 56, pp. 23-45). Subotica: Faculty of Economics.

C. UNPUBLISHED WORKS

➔ **Paper presented at a meeting or a conference**

Ljubojević, K., Tanasijević, V., Dimitrijević, M. (2003). *Designing a web form without tables*. Paper presented at the annual meeting of the Serbian computer alliance, Beograd.

➔ **Paper or manuscript**

Boškov, T., Strakić, F., Ljubojević, K., Dimitrijević, M., & Perić, O. (2007. May). *First steps in visual basic for applications*. Unpublished paper, Faculty of Economics Subotica, Subotica.

➔ **Doctoral dissertation**

Strakić, F. (2000). *Managing network services: Managing DNS servers*. Unpublished doctoral dissertation, Faculty of Economics Subotica, Subotica.

➔ **Master's thesis**

Dimitrijević, M. (2003). *Structural modeling: Class and object diagrams*. Unpublished master's thesis, Faculty of Economics Subotica, Subotica.

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Tanasijević, V. (2003, March). Putting the user at the center of software testing activity. *Strategic Management, 8* (4). Retrieved October 7, 2004, from www.ef.uns.ac.rs/sm2003

➔ **Document from an organization**

Faculty of Economics. (2008, March 5). *A new approach to CRM*. Retrieved July 25, 2008, from <http://www.ef.uns.ac.rs/papers/acrm.html>

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Jovanov, N., & Boškov, T. A PHP project test-driven end to end. *Management Information Systems, 2* (2), 45-54. doi: 10.1108/06070565717821898.

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Jovanov, N., & Boškov, T. A PHP project test-driven end to end. *Management Information Systems, 2* (2), 45-54. Retrieved from <http://www.ef.uns.ac.rs/mis/TestDriven.html>.

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➔ **Quotations**

If a work is directly quoted from, then the author, year of publication and the page reference (preceded by “p.”) must be included. The quotation is introduced with an introductory phrase including the author's last name followed by publication date in parentheses.

According to Mirković (2001), “The use of data warehouses may be limited, especially if they contain confidential data” (p. 201).

Mirković (2001), found that “the use of data warehouses may be limited” (p. 201). What unexpected impact does this have on the range of availability?

If the author is not named in the introductory phrase, the author's last name, publication year, and the page number in parentheses must be placed at the end of the quotation, e.g.

He stated, “The use of data warehouses may be limited,” but he did not fully explain the possible impact (Mirković, 2001, p. 201).

➔ Summary or paraphrase

According to Mirković (1991), limitations on the use of databases can be external and software-based, or temporary and even discretion-based. (p.201)

Limitations on the use of databases can be external and software-based, or temporary and even discretion-based (Mirković, 1991, p. 201).

➔ One author

Boškov (2005) compared the access range...

In an early study of access range (Boškov, 2005), it was found...

➔ When there are **two authors**, both names are always cited:

Another study (Mirković & Boškov, 2006) concluded that...

➔ If there are **three to five authors**, all authors must be cited the first time. For subsequent references, the first author's name will be cited, followed by “et al.”.

(Jovanov, Boškov, Perić, Boškov, & Strakić, 2004).

In subsequent citations, only the first author's name is used, followed by “et al.” in the introductory phrase or in parentheses:

According to Jovanov et al. (2004), further occurrences of the phenomenon tend to receive a much wider media coverage.

Further occurrences of the phenomenon tend to receive a much wider media coverage (Jovanov et al., 2004).

In “et al.”, “et” is not followed by a full stop.

➔ Six or more authors

The first author's last name followed by "et al." is used in the introductory phrase or in parentheses:

Yossarian et al. (2004) argued that...

... not relevant (Yossarian et al., 2001).

➔ **Unknown author**

If the work does not have an author, the source is cited by its title in the introductory phrase, or the first 1-2 words are placed in the parentheses. Book and report titles must be italicized or underlined, while titles of articles and chapters are placed in quotation marks:

A similar survey was conducted on a number of organizations employing database managers ("Limiting database access", 2005).

If work (such as a newspaper editorial) has no author, the first few words of the title are cited, followed by the year:

("The Objectives of Access Delegation," 2007)

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Also, the full name of corporate authors must be listed in the first reference, with an abbreviation in brackets. The abbreviated name will then be used for subsequent references:

The overview is limited to towns with 10,000 inhabitants and up (Statistical Office of the Republic of Serbia [SORS], 1978).

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(Bezjak, 1999, 2002)

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(Griffith, 2002a, 2002b, 2004)

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(Bezjak, 1999; Griffith, 2004)

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If two or more sources used in the submission were published by the same author in the same year, the entries in the reference list must be ordered using lower-case letters (a, b, c...) with the year. Lower-case letters will also be used with the year in the in-text citation as well:

Survey results published in Theissen (2004a) show that...

➔ To **credit an author for discovering a work**, when you have not read the original:

Bergson's research (as cited in Mirković & Boškov, 2006)...

Here, Mirković & Boškov (2006) will appear in the reference list, while Bergson will not.

➔ When **citing more than one author**, the authors must be listed alphabetically:

(Britten, 2001; Sturlasson, 2002; Wasserwandt, 1997)

➔ When there is **no publication date**:

(Hessenberg, n.d.)

➔ **Page numbers must always be given for quotations:**

(Mirković & Boškov, 2006, p.12)

Mirković & Boškov (2006, p. 12) propose the approach by which “the initial viewpoint...

➔ **Referring to a specific part of a work:**

(Theissen, 2004a, chap. 3)

(Keaton, 1997, pp. 85-94)

➔ **Personal communications, including interviews, letters, memos, e-mails, and telephone conversations**, are cited as below. (These are *not* included in the reference list.)

(K. Ljubojević, personal communication, May 5, 2008).

FOOTNOTES AND ENDNOTES

A few footnotes may be necessary when elaborating on an issue raised in the text, adding something that is in indirect connection, or providing supplementary technical information. Footnotes and endnotes are numbered with superscript Arabic numerals at the end of the sentence, like this.¹ Endnotes begin on a separate page, after the end of the text. However, Strategic Management journal **does not recommend the use of footnotes or endnotes**.

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