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Contents

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Dear Readers,

This issue of EBS Review is mainly based on carefully selected papers from the EIASM Workshop on Organisational Change & Development in Transitional Countries, which took place 9–10 November 2006 in Tallinn, Estonia.

The conference was hosted by the Estonian Business School (EBS) and attracted over 30 participants from as far as Australia. Participants presented on a range of topics and used a variety of methodological approaches and research designs. The conference theme was explored in countries ranging from Central and Eastern Europe, Russia, the Middle East and Asia Pacific. The conference was jointly chaired by Prof Ruth Alas (EBS), Dr Chris J. Rees (Manchester University) and Prof Vincent Edwards (Buckinghamshire Chilterns University College).

The general tenor of the papers in this issue is both conceptual and empirical. The authors demonstrate the use of a range of methodologies, often adopting a multi-method approach.

The first article by **Mikael Collan, Tomas Eklund** and **Barbro Back** from Turku, Finland provides an illuminating presentation of self-organising maps. The paper utilizes the self-organizing map (SOM), a two layer unsupervised neural network, to observe, compare, and visualize development in 25 transition economies. Using longitudinal (1998-2002), multidimensional (14 indicators) socio-economic data, the authors present how the SOM can be used to plot the position of transition economies and track their development. The data was taken from the World Development Indicators (WDI) online database within the World Bank Group. The authors discuss the advantages achieved by using the SOM over simply comparing yearly indicator values when observing and visualizing socio-economic development.

The purpose of the article is to show how the SOM can be used to observe, compare and visualize development in transition economies; it does not seek to propose a new "correct" model for measuring socio-economic development, but to show, with examples, that the SOM could be a helpful tool in intuitively visualizing and comparing multidimensional socio-economic development.

The authors of the second article, **Piia Heliste, Päivi Karhunen and Riitta Kosonen**, from the Helsinki School of Economics, take an institutional approach to examine the role that foreign investors play in organizational transformation in transition economies. The central argument in the article is that institutional transformation in Estonia was fostered by the influx of foreign firms that introduced organizational and management practices to their Estonian subsidiaries. The authors state however that, particularly at the early stages of transition, these practices could often not be transferred as such. Focusing on human resource management (HRM) policies in Estonian subsidiaries of Finnish firms between 1991 and 2004, the authors empirically illustrate this hand-in-hand transformation in formal institutional frameworks and organizational practices. First, they demonstrate how the challenges associated with HRM in Estonia changed as transition proceeded and second, how Finnish investors responded to these challenges. In doing so, they show how HRM practices among Finnish business units in Estonia evolved as the interplay of institutional and organizational change.

In the next article, **Wei Sun** and **Ruth Alas** from Estonian Business School, discuss the implementation of organisational changes in Chinese organisations. The article draws on prior research on organizational change, including theories about change, models of the change process and resistance to change and overcoming resistance. The authors carried out a survey covering 160 Chinese companies in northern China, selected from various industries, ranging from manufacturing and technology, banking and insurance organizations to those in energy and education. Interviews about changes in their organizations were conducted with top, senior or middle managers. The research provides an understanding of the current state of organizational change in China and examines the relevance of existing literature concerning the implementation of changes in countries in transition. According to the study, almost all changes in Chinese organizations are initiated by the top managers or even government agencies and lower-level employees are rarely involved. Much attention has been paid to planning the change; however, evaluating the process of change and making modifications are ignored. Moreover, although employees sometimes appear indifferent and show no strong response to changes, some resistance to change has been identified. However, few efforts have been made to overcome this resistance and consolidate the improvements. Finally, based on the survey results, the authors propose suggestions to managers in Chinese companies on how to implement changes more efficiently.

Mohammed Shanikat from Jordan considers the pathways of organizational change within Jordan Telecom (JT). The author suggests that JT will not survive in its current form as a public sector organisation, and the privatization remains a very controversial issue. The author's intention is to show that the approach developed in the article for analyzing organizational change in JT should be appropriate for studying other privatization programs and other forms of organizational change in both the public and private sectors. According to the author, JT's privatization process is distinct from many other western public sector reforms and has two distinguishing features. The first is that the stimulus for change has come from the government, and the second is that JT is dependent on French Telecom (FT) for its technological progress. The study uses Laughlin's (1991) organizational change model (LOCM) as this model offers layers of analysis useful for locating the various levels of change –– interpretive schemes, design archetypes and sub-systems –– enabling adaptations that build on the original LOCM, by exploring another aspect of "external stimulus" using Resource Dependency Theory (RDT). RDT better explains the unique official relationship between JT and FT as they are both supervised by government and this can also be described as an important alliance. Therefore, the impetus for change, the process of change and the consequence of change are specific features of JT. The study discussed in the article demonstrates that without a basic change in the interpretive scheme from a 'technical culture' to 'business culture', privatization cannot achieve its aims.

Christopher Rees and **Derek Eldridge** offer a unique perspective on HR practices in radical change settings by exploring the issue of employee selection. In their conceptual paper, they use psychometric criteria to demonstrate the predictive limitations of conventional selection methods. They argue that traditional approaches to selection have tended to neglect the fact that people as well as societies and organisations change over time. They present a model of selection that emphasises the changing nature of both job roles and individual characteristics and attitudes in radical change settings. In later sections of their article, they highlight the idea that HR activities such as management development and performance management have to be integrated in order to identify changes in roles and people and to enable employees to develop essential learning-related attitudes and skills.

The last article by **Gundar King, David McNabb** and **Bruce Finnie** from the Pacific Lutheran University takes a broader look at changes in emerging economies. The objective of their article is to generate further discussion on a set of recommendations proposed for bringing inflation under control in Estonia, Latvia, and Lithuania, with special emphasis on Latvia. Inflation and disinflation observed in Latvia over the last decade suggest a fluid situation that calls for more decisive, smaller adjustments rather than sweeping changes in economic programs. This dynamic argues for a phased inflation-management program that can be accelerated, slowed down or simply monitored and readjusted. The authors suggest a broadly balanced program to serve the interests of most groups concerned. The program is organized in three or four phases, starting with most immediate, rather light actions, and, if necessary, eventually stepping up to the draconic measures that were practiced by the Latvian government in the 1920s. The recommendations proposed in this paper are based on the accumulated knowledge of inflation management experience in several countries, and economic development in the Baltic States as a whole.

Dear readers, we hope that this brief introduction to the topics of the current volume of EBS Review was able to generate your interest in the topics and articles gathered here. As in most quality scientific journals, it has become our requirement that all the articles go through a time consuming process of review and evaluation, and the authors often have to rewrite and submit their papers several times before our distinguished editors are satisfied with the results. We consider the topics covered to be important and hope, dear readers, that you can find something interesting to discover. We would also like to show our gratitude to the authors, editors and partners, indeed to everybody who has helped us prepare this issue for our readers. Wishing you all a pleasant and stimulating read.

On behalf of the editorial board

Ruth Alas and Mari Kooskora

Using the Self-Organizing Map to Visualize and Explore Socio-Economic Development

Mikael Collan,Tomas Eklund[1] and Barbro Back

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Abstract

The socio-economic situation of a country can be measured in a number of ways, often by looking at indicator values describing different aspects of the social and economic reality in the country in question. Socio-economic development can be measured and observed by comparing yearly indicator values. As a large number of indicators are often required to accurately assess the socio-economic development of a country, the dimensions of the analysis quickly become difficult. Composite variables, such as the Gini-coefficient and the Human Development Index, are often used, but drill-down analysis and visualization of the results reached with these is demanding and may be very laborious. The realm of data mining offers a number of tools for dealing with these problems.

This paper utilizes the self-organizing map (SOM), a two layer unsupervised neural network, to observe, compare, and visualize development in 25 transition economies. Using longitudinal (1998-2002), multidimensional (14 indicators) socio-economic data, the paper presents how transition economies can be positioned, and their development tracked, with the SOM. The data is from the World Bank Group's World Development Indicators (WDI) on-line database. The paper discusses the advantages achieved by using the SOM over simply comparing yearly indicator values, in observing and visualizing socio-economic development.

The purpose of this paper is to show how the SOM can be used to observe, compare, and visualize development in transition economies. The paper does not seek to propose a new "correct" model for measuring socio-economic development, but to show, with examples, that the SOM could be a helpful tool in intuitively visualizing and comparing multidimensional socio-economic development.

Keywords: Multidimensional comparison; Socio-economic development; Self-organizing map; Transition economies

Introduction

In the years following the break-up of the former Soviet Union, much interest has been focused on the development of the newly independent countries. Recent history has seen precious few similar opportunities for scholars to study the simultaneous development of a large number of newly independent countries, all emerging from a similar economic and political system. Therefore, this has received

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great attention in the form of numerous research papers (including Fischer, Sahay et al., 1996; Lavigne, 2000; Murrell, 1996; Raiser, Schaffer et al., 2004). Initially, very little data was available to researchers, but the situation has now reversed and currently data concerning the former east block countries is abundant (Filer and Hanousek, 2002; Grosh and Glewwe, 1998). However, there is much ongoing discussion concerning the reliability and accuracy of the data.

Measuring the state of the socio-economic status of a country is interesting from the point of view of predicting social and health related outcomes for that country, such as fertility, health, mortality, and obesity (Higgs, 2002). Tracking the development of the socio-economic status can further enhance our predictive capabilities about the future of a nation. Higgs discusses the measurement taxonomy of socio-economic status, and reviews the measures and variables used for the determination of socio-economic status. For measuring aggregate data between countries, the variables suggested are GDP per capita, the Gini coefficient (a measure of inequality), and Human Development Index (HDI), which incorporate life expectancy, health, income, and education measures. In general, the reviewed variables integrate an aspect of the overall socio-economic situation into one value. Unfortunately, these indicators are sometimes alone used as a measure of the whole socio-economic situation. Our opinion is that using single, even composite, variables does not always illustrate the situation of a country in an unbiased way. Indeed, if possible, the most objective status estimation for countries, when measuring them comparatively against other countries, can probably be constructed by using a (rather large) number of indicator variables simultaneously.

Because of the increasing access to large amounts of data in electronic form, for example, concerning transition economies (Filer and Hanousek, 2002), it is possible to do this, however the importance of good visualization tools suitable for data exploration becomes apparent. Visualization is an important addition to understanding statistical data. Usually two-dimensional graphs are used and, at most, the data visualization is three-dimensional. When visualizing country-to-country comparisons based on a number of variables, 3D visualization does not allow more than three variables to be visualized without using composites of the variables. The problem with using composite variables is that putting variables together means having implicitly, or explicitly, to assign them weights. Such weight assignments are always subjective, at least to some degree. This issue may become even more complicated if we wish to include the status of a given country for a number of different years, and at the same time compare it to the status of another country for each same year. Such analysis is more complex, however it has some considerable advantages:

> 'If the set describes the state of the same system at different times like in the case of time series analysis, then relations of the states will be illustrated. If, on the other hand, the set describes the states of different systems, the systems will become comparable'
> (Kaski and Kohonen, 1996: 499).

In this study, a combination of both of the aforementioned is considered. The data set includes longitudinal (multi period) data on different systems (countries), which means that the differences between countries and the development in their own socio-economic situation can be compared.

This study utilizes computer-based methodologies for analysis. IT tools are increasingly being used for the visualization and analysis of multidimensional data. In this paper, we propose the use of the self-organizing map (SOM) for visualization and exploration of socio-economic data. The SOM is an unsupervised neural network that can be used for visual clustering of data. The SOM allows both analysis of the relation of states within a country, and comparison of these with other countries at the same time and according to a number of variables simultaneously. We present the SOM method, and discuss how the SOM has previously been applied in some cases with a macroeconomic focus. Finally, we illustrate using a case study concerning the socio-economic development of transition economies during the period 1998-2002.

The paper does not aim to propose a new "correct" combination of socio-economic variables for the measurement of socio-economic status for a given nation. The number, or the type, of the selected variables has not been exhaustively analyzed to give an optimal picture of the socio-economic country status. The selected variables rather act as a placeholder for such an optimal bouquet of variables, and illustrate how a rather large number of variables can be used simultaneously with the SOM in an easy to understand and tractable way

Methodology

The SOM is a two-layer unsupervised neural network that maps multidimensional data onto a two dimensional topological grid or map (Kohonen, 2001). The data is grouped according to similarities and patterns found in the dataset, using some form of distance measure, usually the Euclidean distance. The result is displayed as a series of nodes or points on the map which can be divided into a number of clusters based upon the distances between the nodes. As the SOM is unsupervised, no target outcomes are provided, and the SOM is allowed to freely organize itself based on the patterns identified, making the SOM an ideal tool for exploratory data analysis. "Exploratory data analysis methods, like SOM, are like general-purpose instruments that illustrate the essential features of a data set, like its clustering structure and the relations between its data items" (Kaski and Kohonen, 1996). Thus, the SOM can be said to perform visual clustering of data.

A simple illustration of a SOM is provided in Figure 1.

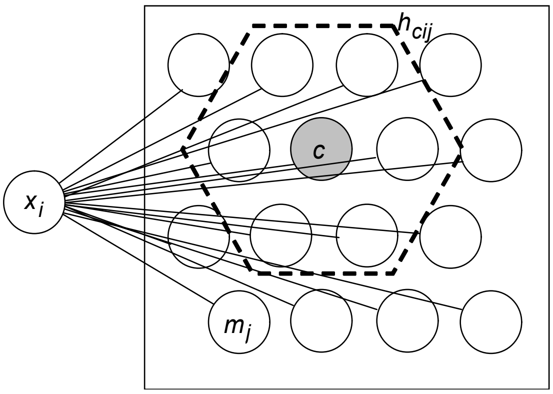

Figure 1 The SOM grid (adapted from Haykin, 1999: 445)

The SOM training process can be described as follows (Haykin, 1999; Kaski and Kohonen, 1996; Kohonen, 2001; Vesanto, 2002). Essentially, the SOM consists of a grid of neurons, *j*, each containing a parametric reference vector, *mj*. The reference vector is of the same length as the data vectors, i.e. it contains as many attributes as the data being compared. After the network size is defined, the network is initialized, i.e., the reference vectors are assigned to the neurons. This is done either randomly, or by using some kind of data feature extraction, such as linear initialization, which extracts the two principal components based upon their variances. After initialization, the algorithm proceeds by repeating two steps.

The algorithm works as follows. In the first step, a random data vector *xi* (i.e., a row of data) is compared to the reference vectors *mj* and the best matching neuron c according to a specified distance measure, in the case the *Euclidean distance* $\|x_i - m_j\|$, is identified using the formula in Eq. 1:

$$\|x_i - m_c\| = \min_i \left\{ \|x_i - m_j\| \right\}$$

(Eq.1)

The neuron *c* is termed the winning neuron. The SOM algorithm is often called competitive learning, as each neuron competes to attract as much data as possible (Haykin, 1999).

In the second step, the winning neuron *c* and the neurons within a certain geometric distance of it, *hcji*, "learn" from the attracted row of data x_i according to a specified learning rate α(*t*).

$$m_j(t+1) = m_j(t) + \alpha(t) h_{c_i j}(t) \left[x_i(t) - m_j(t) \right]$$

(Eq. 2)

where *t* is the training step, α(*t*) is the learning rate, and *hcji*(*t*) is the neighbourhood centred around the winning neuron *c*. The learning rate α(*t*) decreases from the centre of *hcji*(*t*), for example, using a Gaussian function.

These two steps are repeated a specified amount of times, or until a cut-off threshold is reached, in terms of the accuracy of the mapping. In simple terms, the algorithm first finds the neuron most similar to the input data, and then the winning neuron and its surrounding neurons learn from the data becoming more similar and further attracting similar data. This will result in clusters of data most similar to each other on the map.

The SOM differs from statistical clustering methods in a number of ways however it is similar to k-means clustering. Firstly, when using the SOM the targeted number of clusters does not have to be defined. Secondly, the SOM is more tolerant towards data that does not follow a normal distribution. Thirdly, the SOM is quite efficient and is faster than most top-down hierarchical clustering methods (Vesanto and Alhoniemi, 2000). Finally, the SOM is a very visual method, as opposed to many statistical methods.

The primary application area of the SOM has been in engineering (Oja, Kaski et al., 2003), in applications such as process monitoring (e.g., Alhoniemi, Hollmén et al., 1999; Simula, Vasara et al., 1999), but it has also been applied in various other fields, including medicine (e.g. breast cancer diagnosis, Chen, Chang et al., 2000) and text retrieval (Kohonen, Kaski et al., 2000; Visa, Toivonen et al., 2000). The SOM has also been used for a variety of tasks relating to financial analysis, for example, credit analysis (Back, Oosterom et al., 1995; Kiviluoto, 1998; Martín-del-Brío and Serrano-Cinca, 1993; Serrano-Cinca, 1996; Tan, van den Berg et al., 2002), financial benchmarking (Back, Irjala et al., 1998; Eklund, Back et al., 2003), macroeconomic analysis (Costea, Kloptchenko et al., 2001; Kasabov, Erzegovezi et al., 2000), and macro environment analysis (Länsiluoto, Eklund et al., 2004).

A related study was presented in Kaski and Kohonen (1996). In the study, the authors grouped a number of countries according to 39 welfare indicators, such as life expectancy at birth, adult illiteracy, and infant mortality rate. The result of the study was a map on which welfare decreased from the left side of the map (OECD countries) to the right (the poorest African countries). Eastern Europe and South America formed their own clusters somewhere between these. Kasabov, Erzegovezi et al. (2000) used the SOM to analyze the annual development of 15 countries according to five economic indicators (DBT/GDP, DEF/GDP, inflation rates, interest rates, and unemployment). Costea, Kloptchenko et al. (2001) used the SOM to cluster the performance of a number of eastern European countries, also according to primarily economic indicators.

The map in Kaski and Kohonen (1996) constituted a general model of international welfare. Although it is similar to this study, there are a number of important differences. We are interested in the economic development of a selection of transition economies, and have placed an emphasis on the development over a number of years. The focus on the development of specified countries and the temporal dimension are different from the Kaski and Kohonen study. Kasabov, Erzegovezi et al. (2000) and Costea, Kloptchenko et al. (2001) are more similar to the application in this study. However, we focus on a mixture of social and economic indicators, and specifically on the socio-economic development of transition economies.

Socio-Economic Development in Transition Economies

In this section we demonstrate, with an illustrative case study, how the development of countries can be compared and visualized with the SOM. A "development map" is built by using a set of statistical indicators. The map presents some of the differences between the state of development between and within countries at different times, according to the selected indicators. The relations between different states (yearly state) of each country are visible as geometrical relationships on the map. The longer the distance between two states, the more different the states generally are. Because longitudinal data is used on each country, the development of countries can be measured and visualized for the period of analysis. Development can be seen as changes in the state of a country on the map.

The socio-economic development of a country, especially in rapidly changing transition economies, can be of interest to many different parties, all of whom have different purposes for their analyses. For example, potential investors are primarily interested in economic risk/return scenarios, but may also be interested in social factors, such as income distribution and availability of schooled labour. International institutions, such as the World Bank, are interested in the socio-economic development of countries, both for identifying necessary support initiatives, as well as for following up current ones. Political leaders are interested in the development of their own country relative to others in a similar position, a form of country benchmarking. The intent of the analysis, of course, determines the variables used. In this case, a general model of socio-economic development will be used to illustrate the use of the SOM in this area. The variables selected do not constitute an ideal or optimal set for studying the socio-economic status of a nation, rather they have been selected on basis of data completeness and so that different types of indicators relevant to socio-economic development are present.

The Data Set

The data set was retrieved from the World Bank Group's World Development Indicators (WDI) on-line database. Data was selected for 27 countries, including 25 transition economies and two European benchmark economies (Germany and Finland). In addition, two classification indicators (European Monetary Union average (EMU) and Heavily Indebted Poor Countries (HIPC)), were included. The countries included are summarized in Table IV. Fourteen (14) variables covering social, technological, financial, and general economic situation were selected to model the state of the socio-economic system in each of the selected countries for the period of five years (1998-2002). The selection of the variables was not based on a thorough analysis on which variable combination would yield the best possible descriptive power on the state of the country, but rather on an ad hoc selection of social, technological, financial, and economic indicators. Higgs (2002) points out that very often the choice of variables is limited by what is available in a dataset. The indicators for which the data were most incomplete were discarded, a choice that narrowed down the number of usable indicators, but enhanced the consistency of the results obtained with the selected indicators. The emphasis in the selection of variables is slightly on financial and economic data. The selected indicators are listed in Table I.

Social and Technological Indicators	*Economic and Financial Indicators*
Life expectancy (years)	GDP growth (% / year)
Population growth (% / year)	Inflation (% / year)
Fixed phones & mobile subscribers (/ 1000 ppl)	Overall budget balance (% / GDP)
Personal computers (/ 1000 ppl)	Gross capital formation (% / GDP)
Aid per capita (/ 1000 ppl)	Total debt service (% / goods & services)
High technology exports (% of manuf. exports)	Import of goods & services (% / GDP)
	Exports of goods & services (% / GDP)
	Trade in goods (% / GDP)

Table I Variables used in the creation of the SOM

In total, the set of data used consisted of 145 rows, with 14 variables for each. Some variables in the original WDI database, such as infant mortality rates and poverty headcount, had to be discarded due to the substantial amount of missing data. The SOM is capable of handling small amounts of missing data, however, if too much data is missing the variables may become unnecessarily strong classifiers, which may result in the formation of separate clusters containing only cases for which these particular data are available. In some cases (such as with binary attributes) such an effect is preferable, but in our case it was not desired. Comparability of variables demands the data to be in the form of ratios, hence absolute values such as total population or GDP cannot be used without pre-processing.

The data does not follow a normal distribution, as is typical for financial indicators (Salmi and Martikainen, 1994). In addition, the variance between countries can be high, thus scaling of the data was important. In this case the data has been normalized according to the variance. In addition, sigmoid transformation has been used to handle outliers, which are common in financial indicators. Sigmoid transformation creates a more balanced distribution by stretching the centre of the histogram and squeezing the ends (Deboeck, 1998a). Transformation should, however, be used with caution since it may change the relationships of the data.

The software used for creating the SOM was Viscovery SOMine (Ver. 4.0 build 532). There are several different SOM software packages available for academic use, and some examples are shown in Table II. Readers are referred to Deboeck (1998b) for a detailed discussion concerning some of the different available SOM software packages.

Software package	*Available from*
SOM_PAK 3.1	http://www.cis.hut.fi/
Nenet v1.1	http://koti.mbnet.fi/~phodju/nenet/Nenet/General.html
Viscovery SOMine 4.0	http://www.eudaptics.au
eSom	http://www.ellipse.fi
SOM Toolbox for Matlab	http://www.cis.hut.fi/projects/somtoolbox/

Table II Some of the available SOM software packages

The map was created using a network size of 2000 nodes and a tensil value of 0.5 (neighbourhood range indicator, low values produce more locally detailed maps, whereas higher values produce more general, coarser maps). The size of the map is influenced by the purpose of the study. If clustering is desired, a small map is created (Deboeck, 1998a). If visualization and detail are desired, a larger map is created. We, therefore, chose a large map, with a large number of nodes available to be fine-tuned to specific countries, allowing for greater detail and accuracy. Once the map is trained, the software package includes a function for determining a "natural" amount of clusters for the map. This approach, two-level clustering, was proposed by Vesanto and Alhoniemi (2000), and essentially consists of objectively determining the number of clusters on the map using a hierarchical clustering algorithm. In this case, six clusters were determined to provide sufficient detail for our purposes.

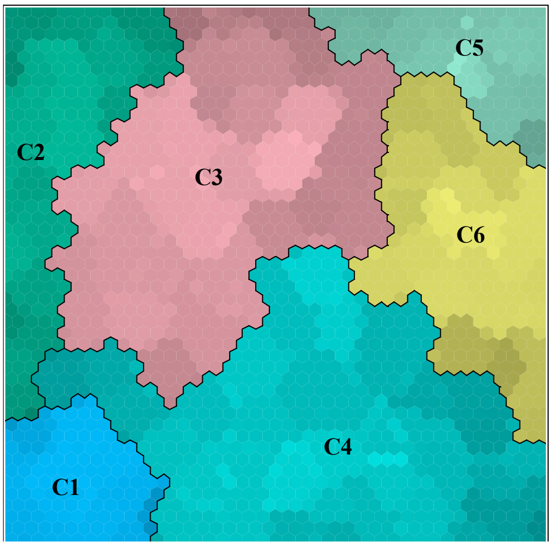

Figure 2 The clustered map.

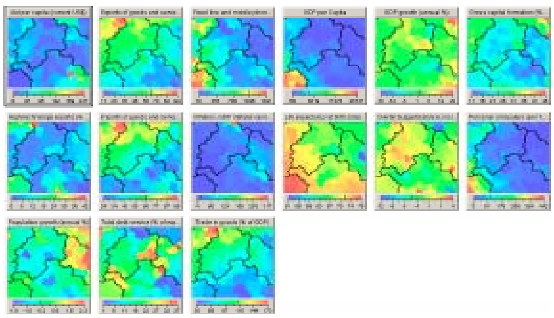

Figure 3 The component planes of the map.

Results

In Figure 2, the final map and the identified clusters are displayed. The characteristics of the different clusters are identified using the component planes in Figure 3, which show the values of the different variables as they are distributed across the map. Warm colours on the component planes illustrate high values, whereas cool colours illustrate low values, in black and white warm colours are mostly lighter.
Figure 2 shows that the 145 sets of data, one for each year and each country, have formed clusters according to similarity. Different clusters represent different types of socio-economic states. Table III summarizes the characteristics of each cluster based upon the component planes in Figure 3. The table, therefore, illustrates the different types of socio-economic states that are predominant in each cluster, as well as examples of countries that can be found in a particular cluster.

For example, looking at the component planes in Figure 3, we can see that the countries in Cluster 1 display characteristics such as low inflation, very high GDP per capita, average GDP growth, very high life expectancy, and a high number of phones and computers per capita. The countries in this cluster are western European countries. Cluster 6, on the other hand contains countries that display very high population growth, low GDP per capital, low life expectancy, and a low amount of phones and computers per capita.

Cluster	Type of socio-economic state *(examples of countries)*
Cluster 1 (C1)	hi-tech, slow growth, long life (EU countries, Finland, Germany)
Cluster 2 (C2)	hi-tech, rapid growth, long life, high-export (Estonia, Czech Republic, Hungary)
Cluster 3 (C3)	medium-tech, medium growth, medium-life (Bulgaria, Lithuania, Ukraine)
Cluster 4 (C4)	low-tech, low trade, long life, miscellaneous (Georgia, Armenia, Poland)
Cluster 5 (C5)	low-tech, high growth, short life, very poor (Mongolia, Turkmenistan)
Cluster 6 (C6)	low-tech, medium growth, short life, poor (Kyrgyz Republic, Uzbekistan)

Table III Cluster characteristics

It is important to note that clusters are not equally uniform internally. Specialized clusters tend to form on the fringes of the map, such as the highly developed countries in Cluster 1 and the low development-level countries in Cluster 6, whereas the countries in the two general clusters (3 and 4) tend to display more variation.

In the following section, we will present two different types of countries; stable and rapidly changing. We will compare these to the benchmarks selected for the study.

Analysis of the Map

In this section, the use of the SOM for comparing the socio-economic development of countries will be illustrated using a few examples. The map containing all of the included data can be found in the Appendix. Studying the map reveals that countries not only show different development, but also that the pace of development in different countries displays substantial differences. Generally speaking, based upon the map countries can be divided into stable and mobile economies. In this study, we will provide examples of both types of development by looking at the development of Estonia (EST), Finland (FIN), Germany (DEU), Lithuania (LTU), Poland (POL), Romania (ROU), the Russian Federation (RUS), Turkmenistan (TKM), and the Ukraine (UKR). These are illustrated in Figure 4.

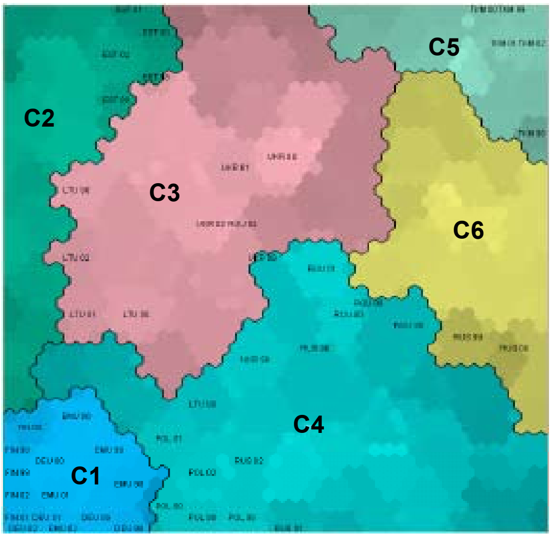

Figure 4 Stable countries on the map, with cluster indicators (C1 - C6).

Estonia (EST), Finland (FIN), Germany (DEU), Poland (POL), and Turkmenistan (TKM) are good examples of stable economies, although their socio-economic statuses differ considerably. Estonia (Cluster C2) is an example of a rapidly developing country that has already reached a considerable level of development compared to the other former Soviet countries. As we can see from the feature planes (Figure 2), exports, especially in high technology, are very high, and life expectancy and infrastructure are quite near the level of EMU countries (Cluster C1). GDP per capita, however, is still considerably lower. Trade in goods is still predominant in 2002, although the service sector was growing considerably.

Finland and Germany (Cluster C1) are examples of highly developed countries in which growth has slowed down considerably. In this case, this cluster is used as a benchmark to measure the development of transition economies against.

Poland (Cluster C4) displays fair social development according to measures such as life expectancy and technological infrastructure, but the economic development is lagging far behind the economies in Cluster C2. Exports and trade in goods is lower, and indebtedness is higher.

Turkmenistan is located in one of the poorest clusters (Cluster C5). Population growth is high, but life expectancy is fairly low. However, GDP growth and investments are very high. Cluster C5 contains several very rapidly growing economies.

Lithuania (LTU), Romania (ROU), the Russian Federation (RUS), and the Ukraine (UKR) are examples of countries displaying more or less rapid changes. Lithuania (Cluster C3) is developing towards Cluster C2, although in 2002 technological infrastructure and trade development is still behind that of the countries in Cluster C2.

Of the illustrated countries, the Russian Federation displays the largest changes in socio-economic status for the period. During 1999 – 2000, the primary drivers for the change from a poor part of Cluster C4 to the fringes of Cluster C6 are slight increases in GDP growth, overall budget balance, and exports. In 2001-2002, development is very positive. High technology exports, increased investments, and increased life expectancy are important drivers for the change.

Romania and the Ukraine display similar development ending up in virtually the same position in 2002. However, during 1998-2001 socio-economic development was much more rapid in the Ukraine than in Romania, especially in economic terms. In particular the budget balance, GDP growth, and exports are better in Ukraine.

Benchmarks	Transition economies	
Countries	Albania (ALB)	Moldova (MDA)
Finland (FIN)	Armenia (ARM)	Mongolia
Germany (DEU)	Azerbaijan (AZE)	Poland (POL)
Indexes	Belarus (BLR)	Romania (ROU)
European Monetary Union (EMU)	Bulgaria (BGR)	Russian Federation (RUS)
Heavily indebted poor countries (HIPC)	Croatia (HRV)	Serbia and Montenegro (SCG)
	Czech Republic (CZE)	Slovak Republic (SVK)
	Estonia EST)	Slovenia (SVN)
	Georgia (GEO)	Tajikistan (TJK)
	Hungary (HUN)	Turkmenistan (TKM)
	Kazakhstan (KAZ)	Ukraine (UKR)
	Kyrgyz Republic (KGZ)	Uzbekistan (UZB)
	Lithuania (LTU)	

List of countries included in creating the map

Summary

The socio-economic state of a country is an interesting issue to research, due to the business and policy decision-making implications that the results may have. Comparing the status across several years and observing the changes gives us an indicator of the development of the country. Comparing development between countries reveals information about the differences between nations.

We suggest that the analysis or measurement of the socio-economic state of a country should be done with a number of indicators simultaneously to avoid assigning subjective weights to different indicators, and thus having a more objective result. Naturally the selection of indicators itself may be subject to a subjective selection. Visualization of the results should make it easier to understand the socio-economic state and development of a country in relation to other countries. Unfortunately the commonly used 2D and 3D graphs have limitations. The SOM offers a solution that solves many of the problems apparent in the use of 2D and 3D graphs, as well as some of the limitations of using composite variables.

Conclusions

In this study, the self-organizing map has been proposed as a tool for visualizing and exploring socio-economic data available in electronic form. Using a case example we have illustrated the capabilities of the SOM for visualization and exploration of socio-economic data.

The SOM is a tool capable of visualizing multidimensional data and provides a good way to analyze and present the socio-economic development of transition economies on a macro-economic level. We feel that the study shows that the SOM can provide an interesting alternative to the traditional and more frequently used methods, and in particular that visualization capabilities of the SOM are intuitive and easy to understand, making them superior to commonly used graphical representations of multidimensional data. The SOM is particularly suitable tool for visualizing and analyzing countries in phases or rapid development, such as transition economies, because the changes their direction are clearly visible, comparable, and easy to intuitively understand.

The purpose of this paper has not been to propose a new model for the measurement of socio-economic development, but to illustrate how the SOM can be used to extend other models and support new analyses that were, previously difficult to perform. As always, the choice of measures is a delicate problem, due to reliability issues with the measures available. Another problem is free or inexpensive access to data. However, using data sources such as the World Bank overcomes some of these issues.

This research should now be further developed by utilizing different validated models for measuring socio-economic development.

As the SOM seems to be a useful method in visualizing development, it might be a good idea if the World Bank Group would publish an independent SOM map with standard indicators for the world to enhance the intuitive understanding of development and direction of development in different countries.

Acknowledgements

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Appendix. The final map with all countries labelled.

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Foreign Investors as Agents of Organizational Change in Transition Economies: Human Resource Management Practices of Finnish Firms in Estonia[1]

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Abstract

This paper adopts an institutional approach to examine the role that foreign investors play in organizational transformation within transition economies. Our central argument is that institutional transformation in Estonia was fostered by the inflow of foreign firms that introduced their respective organizational and management practices to their Estonian subsidiaries. However, particularly at early stage of transition, these practices could often not be transferred unaltered. . Focusing on human resource management (HRM) policies in Estonian subsidiaries of Finnish firms between 1991 and 2004, we empirically illustrate this hand-in-hand transformation in the formal institutional framework and organizational practices. First, we demonstrate how the challenges associated with HRM in Estonia changed as transition proceeded and second, how Finnish investors responded to these challenges. In so doing, we show how HRM practices of Finnish business units in Estonia evolved as part of the interplay between institutional and organizational change.

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Keywords: Estonia, Finland, foreign investor, human resource management, institutions, organizational change, transition

Introduction

Estonia has undergone a rapid institutional transition from a command to a market economy during the past decade and a half. The change was in part fostered by foreign investment, which flew into the country at a rapid pace. However, notwithstanding the quick establishment of formal market economy institutions such as legislation, informal institutions, i.e. the managerial and work culture continued to pose challenges to foreign investors. In the early years of reforms the legacy of the socialist past was evident in the thinking and behavior of Estonian managers and employees, which created a need for foreign firms to adapt their human resource management (HRM) practices. As transition advanced, characteristics specific to the new Estonian market economy started to emerge, which, however, did not always decrease the need for adaptation of foreign firms' HRM practices.
The importance of institutional forces affecting the HRM policy of foreign firms in transition economies has been widely recognized in

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international business and management studies. Firstly, it has been pointed out that the very concept of HRM as an independent organizational function was unknown in centrally planned businesses. Tasks and responsibilities associated with HRM were distributed among various departments of the socialist enterprise and of the central planning bureaucracy (Garavan et al., 1998; Koubek and Brewster, 1995; Rees et al., 2005; Karhunen, 2007). This was reflected in a relative underdevelopment in the HRM practices of local enterprises (Garavan et al., 1998; Kiriazov et al., 2000; Taylor and Walley, 2002). Moreover, socialist enterprises were very particular organizations (Pearce et al., 2000; Luthans et al., 2000), where the recruitment, evaluation and reward of employees was based on subjective criteria such as personal relations rather than on impersonal judgment (Pearce at al., 2000; Cyr and Schneider, 1996; Tung and Havlovic, 1996). Finally, the very role of employer in the socialist economies was much wider than in market economies, as socialist enterprises were responsible for providing extensive fringe benefits to their employees (see e.g. Kosonen, 2002; Shekshnia and Puffer, 1996; Karhunen et al. 2004).

Secondly, existing research has identified a number of features in the thinking and behavior of workers and managers in transition economies, which challenge the applicability of Western HRM models and techniques. Features such as workers' and managers' reluctance to make decisions, avoidance of responsibility, reluctance to share information, and the need for an authoritarian leadership and clear hierarchy have been cited as the legacy of the socialist system (Fey and Björkman, 2001; Child and Markóczy, 1993; Michailova, 2000; Makhija and Stewart, 2002; Nurmi and Üksvärav, 1996; Karhunen et al. 2004; Heliste et al. 2005). Moreover, the uncertainty caused by economic transition is reflected in the importance of financial rewards as motivational factors (Elenkov, 1998; Upchurch et al., 2000) and resistance to organizational change, particularly among the older generation (Alas and Vadi, 2004).

Consequently, it has been proposed that Western HRM techniques concerning, for example, empowerment, employee motivation and reward would not necessarily work in transition economies (Michailova, 2002; D'Annunzio-Green, 2002; Welsh et al., 1993). Also, it has been shown that in the early years of transition, the local institutional context even challenged the right of Western entrants to pursue a clear strategic approach to their HRM (Shekshnia, 1994; 1998). It has also been pointed out that foreign firms do not always systematically standardize or localize all the HRM functions in transition economies but take an integrative approach with regard to HRM strategy (Ervasti and Suutari, 2004).

In summary, existing research has examined the challenges associated with HRM management in foreign affiliates and within transition economies from many viewpoints. However, there are some issues that call for more attention. Firstly, the majority of research has taken the institutional constraints in transition economies as a given, without discussing how they evolve as transition proceeds. Those studies that have taken a dynamic perspective have shown that considerable change has occurred on both environmental and individual levels (Shekshnia, 1998; Alas et al., 2006). The most rapidly developed countries, such as Estonia, have already moved from the transition to the post-transition stage in their socio-economic development. Consequently, the challenges faced by foreign enterprises and the ways in which they respond to them are very likely to be different now than in the early years of transition.

This paper aims to contribute to filling some gaps in existing knowledge by examining, how the institutional constraints on the HRM policies of foreign investors change as transition proceeds, and how foreign investors respond to these changes. This will be accomplished by empirically focusing on Finnish firms' HRM practices in their Estonian affiliates from 1991 to 2004. We will analyze how the institutional framework in Estonia developed in this period, and how new HRM practices characteristic of the Estonian market economy were formulated by Finnish entrants.

The paper is structured as follows. We will start by presenting the theoretical background of the article and then describe the data and methodology of the empirical analysis. The subsequent empirical description is structured around the Harvard model of HRM (Beer et al., 1984) analyzing three elements of Finnish firms' HRM practices in Estonia: human resource flow, rewards and employee influence. We will describe how these practices and the institutional context surrounding them changed during the 1990s and the first half of the next decade. Finally, we will present the conclusions of the study.

Theoretical Background

This paper adopts an institutional perspective to examine HRM policies in the Estonian business units of Finnish enterprises. In so doing, we support the view that HRM in enterprises is a part of the local business system, which for its part is embedded in the national institutional framework (Whitley, 1992; Holden, 2001).

To analyze the elements of the institutional framework in Estonia we build on the work of economic historian Douglass North (1990, 1994), who defines institutions as "the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction" (North 1990: 3). These "rules of the game" comprise an institutional framework, which sets formal and informal constraints on strategic choices that firms make (North, 1990; Oliver, 1997). The formal constraints include political rules, judicial decisions, and economic contracts. Informal constraints include socially sanctioned codes of conduct and norms of behavior, which are embedded in culture and ideology (North, 1990).

The complexity of post-socialist institutional transition stems from the different speeds at which formal and informal institutions change. Formal institutional constraints can be changed overnight, while informal practices that are rooted in the previous institutional framework change only gradually. Organizations, such as enterprises, have a key role in the process as agents of institutional change. Organizations induce change by pursuing their own objectives. In so doing, they interpret and modify the existing institutional constraints, thereby gradually shaping them.

This paper applies the conceptual approach of North to describe how the formal and informal elements in the institutional framework of Estonia changed between 1991 and 2004 as transition progressed. These elements are viewed as providing the constraints that influenced how Finnish investors organized the HRM functions in their Estonian business units. At the same time, we propose that Finnish firms contributed to institutional change by introducing HRM practices firmly rooted in the principles of the market economy. However, it is important to recognize that business practices often cannot be transferred from one national culture to another. Notwithstanding the trend for globalization of business, national environments differ in their institutional frameworks. For example, HRM practices that increase productivity in one culture may prove counterproductive in another. Therefore, adaptation is needed.

This paper is interested in how institutions and organizational practices co-evolve in the context of transitional economies. It is proposed that this occurs as an interplay of two factors. Firstly, practices rooted in the socialist system are likely to be applied by local actors even after the systemic change. As transition proceeds, they would usually, however, gradually lose their relevance as the actors adapt to the new formal rules and modify their behavior accordingly. Secondly, to cope with the transitional context, foreign investors import their own practices and adapt them to the local context. As the investors in our case come from a developed market economy, it is likely that the need for adaptation would be greater in the early years of transition and gradually diminish as the market economy gains a firmer foothold.

The human resource management system of an enterprise includes a variety of levels and dimensions, ranging from the general HRM strategy as a part of overall business strategy to specific HRM techniques and practices (Beardwell, 2001; Garavan et al., 1998). Existing studies focusing on the HRM practices of foreign enterprises in transition economies have examined these dimensions in varying combinations. Some studies have analyzed both the HRM strategy and selected practices (Shekshnia, 1998; Ervasti and Suutari, 2004; D'Annunzio-Green, 2002), whereas others have focused on certain aspects such as worker motivation (Upchurch et al., 2000) or participation and empowerment (Michailova, 2002). In addition, the impact of Western human resource management practice on worker performance in transition economies has been examined (Welsh et al., 1993; Fey and Björkman, 2001).

In this study, we build on the Harvard model of HRM (Beer et al., 1984) to define the HRM policy It is worth noting that although the Harvard model distinguishes employee influence and work systems as different HRM policy choices, we address choices to be empirically examined. The model represents a "soft"2 approach to HRM, where the outcomes and consequences of HRM are defined more widely than merely in terms of organizational effectiveness (Beer et al., 1984; Gooderham et al., 2004). In contrast to "hard" HRM (Fombrun et al., 1984), which emphasizes the resource dimension and sees HRM as a dependent variable of business strategy, the Harvard model recognizes the interests and characteristics of employees thereby emphasizing the human dimension of HRM (Gooderham et al., 2004). Hence, it can be labeled as a stakeholder model of HRM. Moreover, the Harvard model presents a comprehensive map of the determinants and consequences of HRM policy choices, from stakeholder interests and situational factors to HRM policy choices, outcomes and long-term consequences (Beer et al., 1984; Gooderham et al., 2004). This study applies the Harvard model's classification of HRM policy choices (see Table 1) to investigate HRM in Estonian business units of Finnish enterprises.

Table 1: HRM policy choices in Estonian business units of Finnish enterprises

Policy choice	*Elements analyzed*
Human resource flow	Inflow, internal flow and outflow
Reward systems	Extrinsic and intrinsic rewards
Employee influence Work systems	Empowerment and participation

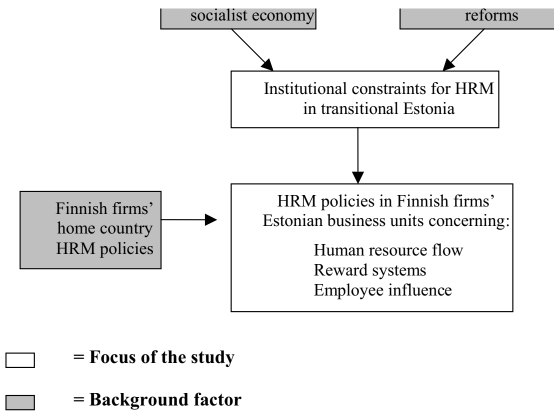
Source: Adapted from Beer et al. (1984)

It is worth noting that although the Harvard model distinguishes employee influence and work systems as different HRM policy choices, we address them jointly in this paper. Both policies emphasize the importance of participative arrangements and therefore some aspects of employee influence and work systems seem interchangeable (Poole, 1990). Hence, we view employee participation as both employee influence on managerial decisions via labor unions, and participation in work arrangements via for example, employee initiatives or self-supervision.

Examination of the policy choices above provides a good illustration of the changes that the systemic change from a central planning to a market economy brought to the HRM of enterprises in Estonia. In the Soviet Socialist Republic of Estonia, policy was determined by socialist ideology and the administrative bureaucracy of the Soviet's central planning organization. As Estonia re-gained3 independence in 1991, the guiding principles came to be defined according to the ideology and institutions of a free market economy.

Based on the theoretical foundations of the paper, we apply the conceptual model illustrated in Figure 1 in our empirical analysis. The figure illustrates how HRM in Finnish enterprises' Estonian business units evolve as a result of the interplay of old Soviet-era practices, the establishment of formal market economy institutions in Estonia, and practices imported by the Finnish management. In the empirical analysis we focus on two elements of the figure more in detail. We describe the change in the formal and informal institutional constraints for HRM in Estonia during the transition period of 1991 to 2005. Here, institutions rooted in the preceding socialist system and post-1991 market reforms are treated as background factors. In parallel, we illustrate how HRM practices applied by Finnish investors in their Estonian business units developed during this period. In addition to pressures from the local institutional environment, HRM practices characteristic to Finnish enterprises in the home country are viewed as a background factor.

Figure 1: Conceptual model of the paper



Research Design

The study draws on a qualitative analysis of interviews, conducted to highlight the aspects that Finnish companies have found most challenging when operating their HRM policies in Estonia. The primary data consists of interviews with 30 Finnish managers responsible for Finnish firms' business operations in Estonia. They occupied positions in the companies including CEO of the Estonian subsidiary, country/area manager or manager of international operations. Out of the 30 interviewees, 12 had become engaged in business operations with Estonia at the beginning of the 1990s (some of them as early as the 1980s), 11 during the period 1995-2000 and 7 since 2000. Their ages ranged roughly from 30 to 65 years old. In addition, they had all been involved in designing and implementing the HRM policies in the Estonian business units despite not being specialists in HRM.

While the original interviews dealt extensively with the challenges that companies faced in their relations with the state, employees and other companies in Estonia4, the present study discusses empirical data regarding exclusively HRM issues. The data collection was performed by interviewing respondents between 2004 and 2005 with semi-structured open-ended questions.5 The time period addressed in the interviews retrospectively covered the years 1991-2004, however, that was dependent on the duration of the interviewee's involvement in Estonian operations. The open in-depth interview was chosen as the data collection method to allow the respondents themselves to identify the key issues and challenges in implementing their HRM policies. The data was handled anonymously. In addition, secondary data such as companies' annual reports, and articles in newspapers and magazines was used as supplementary information.

As in qualitative analysis in general, the data reduction process involved the coding of the interview material. In this study, data that referred to various elements of HRM policies were picked out from the empirical database. The relevant data was coded, i.e. broken down into discrete chunks (Malhotra and Birks 2005), and analytical categories were produced from the respondents' statements. A comparison was made between the early transition period versus the EU integration period in each category to pinpoint changes that had taken place both in the institutional context and in the Finnish firms' HRM policies. In the following sections, the empirical findings of the study are discussed.

Changing HRM Practices in Finnish Business Units in Estonia

The starting point for HRM issues was quite challenging for Finnish firms starting operations in Estonia at the beginning of the 1990s. The most common means of entry into the Estonian market was the acquisition of an existing company or production unit. The organizational structure of the acquired unit was often hierarchical and its production processes ineffective both in terms of the use of technology and labor. At the managerial level, the skills of the local managers were often inadequate for the needs of the new market system. However, as transition proceeded, these HRM challenges were gradually replaced with others rising from features characteristic of the Estonian market economy. The next subsections discuss three aspects of HRM in the context of Finnish firms' subsidiaries in Estonia: human resource flow, reward systems, and employee influence.

Human Resource Flow

Soviet enterprises had abundant human resources and they did not usually strive for the most efficient use of these resources or for their development. As a result, in the beginning of the 1990s, Finnish firms acquiring Estonian companies usually had to start by restructuring the organization, which usually also included downsizing the headcount. Labor legislation was still in the making and did not much restrict the companies in this regard. Thus, the human resource flow was largely outward due to employee layoffs. The acquisitions also often involved the dismissal of the old management. The Soviet style management was portrayed as formal, slow, averse to change, and in the worst case, unethical. Consequently, in almost every acquisition the whole management team was replaced by a younger, more flexible team or by Finnish expatriate managers and experts. The primary tasks of the Finnish managers were to act as catalysts of change and introduce Finnish corporate culture and business concepts. The local personnel were often skeptical of the "Finnish teachers", especially in the establishment phase of operations. Direct opposition was even encountered. Nevertheless, foreign firms were considered to be very attractive employers in the beginning of the 1990s.

> *"In the beginning we were lucky to find a high-quality, educated workforce. At that time foreign companies were considered very attractive employers. They paid better wages and could even offer a company car. In addition, other work equipment was of a high quality. I must say that when we had a job opening, we received several kilograms of applications, from which we had to choose."*

The situation, however, changed dramatically during the following 15 years. Currently, Finnish firms are battling against a shortage of labor at all levels of the organization. This is caused by the increasing demand for labor, due in turn to the rapid economic growth in Estonia. The most acute shortages are of technical professionals and sales people. One of the main reasons for the shortage is the inadequate vocational training system in Estonia, which according to Finnish interviewees, does not correspond to companies' needs. The situation is worsened by the younger generation's preference for higher management positions over industrial work. This has resulted in a dramatic increase in the number of private business schools while the previously high-quality state-owned technical education providers lack both resources and students. In addition, since the EU enlargement, many Estonian workers have moved abroad for work purposes. Finland, for example, has attracted a high number of construction workers. In order to solve the problem of the shortage of qualified labor, Finnish companies have introduced large-scale in-house training programs. This applies to both traditional fields (e.g. furniture and foodstuff industries) as well as new fields that started to develop in Estonia only in the 1990s (such as information technology and the retail trade).

The formal institutional framework governing HR flows in post-transition Estonia is flexible, enabling, for example, the temporary dismissal of employees provided that they are paid at least the minimum wage during the period of dismissal. In addition, the employee may usually take other employment during the temporary dismissal and still get paid the minimum wage from the original employer. This practice has been applied by some Finnish firms, in particular in manufacturing, to adjust the number of personnel to the market situation. From the employees' viewpoint the coin has two sides. On the one hand, employment contracts cover a longer time period, which brings more stability, while on the other hand, the level of income of the employee may drop unexpectedly despite him/her not being officially laid off. This is a problem faced mainly in the labor-intensive fields and it tends to increase the labor turnover. These fields have also experienced a change in terms of age distribution and ethnic background of the employees. They are increasingly more often occupied by the older generation and the Russian speaking population, which have limited employment opportunities elsewhere, e.g. in trade or services.

Finding qualified middle and senior managers continues to be a challenge in Estonia. At the beginning of the 1990s, Finnish firms favored hiring young people straight from school into senior management positions. Their advantage was that they did not carry the heavy weight of the old system, were interested to learn new things, had better language skills and were internationally oriented. On the other hand, they lacked the management and leadership skills, which can be learned only through experience. It was nevertheless considered easier to train them into the more Finnish style of running the business than to train the Soviet style managers out of the old habits. Nowadays, companies are looking for more "ready-made" managers but still find the level of education, amongst other things, inadequate. There is a great variety in the quality of education provided by different institutions and universities, which is a great concern for the Finns. Due to these challenges, the use of Finnish expatriate managers is, though declining, still common.

> *"...our initial thought was to look for such a person [a plant manager] who could do the job, but we did not find one. We have had to continue the process so that we are looking for a person, with a sufficient educational background, but we have not been able to find one yet, either..."*

Clearly, the labor turnover in general is currently higher than it was in Soviet Estonia, where employees often stayed with the same employer for their whole working lives. The high labor turnover is both demand and supply driven. In addition, the pool of competent managers is still relatively small in Estonia, which has led to the aggressive use of

head hunting in recruitment. This has resulted in an increasing need to build commitment among the employees so that they stay in the company.
The development of the means of motivating the employees is discussed in more detail below.

Reward System

In the 1990s, salary was clearly the most important means of motivating Estonian employees. Finnish firms usually paid slightly higher salaries than local companies did. It was also a factual motivation that the salary was paid regularly, which was not always the case in the local companies. In addition, the local companies often paid a part or even all of the salary unofficially, "in an envelope", which was not a practice applied in Finnish firms. More recently, by setting a relatively low flat income tax rate, the Estonian government has tried to encourage employees to demand that their salaries are paid officially.

Even today, the importance of salary in motivating people should not be underestimated. As the social security system is virtually non-existent, most employees are hardworking and the younger generation in particular, aims at improving its standard of living. The incentive systems applied in Estonia differ somewhat from the Finnish ones. The main difference is in the shorter time perspective and higher bonus percentages in Estonia. Given the rapid economic development in Estonia, people are more worried about the present day than they are about the future. A performance-based salary system is common, especially in trade and services where the salary is often composed of a small base salary plus bonuses paid as incentives.

> *"Professional skills are very high and motivation is very high, because people need the money they make. So they work hard to get more money so that they are doing ok and can buy cars and stuff, they need every kroon they can make. It is much more motivated by money than in Finland."*

Money motivates performance improvements, but it also makes the employees relatively itinerant at all levels of the organization. Finnish firms have found it challenging to retain employees who are prone to change employment upon the offer of a higher salary. In the Soviet Union, employee commitment was largely based on the social infrastructure (e.g. daycare, school and housing) offered by the employer. Such additional services were rapidly cut by the Finnish firms and responsibility for their provision transferred out to the community. The nature of fringe benefits offered in Estonia has changed in the sense that they currently include for example sports activities or provision of health care insurance, which is also common practice in Finland. However, the Estonian government does not encourage the offering of fringe benefits as they are taxed at a heavy 79% rate. Nevertheless, Finnish firms still acknowledge the poor social security system in Estonia and have assumed a wider social responsibility in the case of unexpected events encountered by their employees.

> *"We have largely cut them (social responsibilities) down but we do still provide some support occasionally, for example, if a member of the family dies we support them with some kind of an amount so that they can arrange the funeral."*

> *"We had this incident that the house of one of our employees burned down. The company guaranteed his bank loan and we also gave him some kind of financial support, because he lost everything... There isn't such security and insurances like we have (in Finland), so of course we help in this kind of case."*

In-house training programs have been one additional means applied by Finnish companies to increase employee commitment. In the 1990s the training often took place in Finland, which was also an attraction for the employees. The training was deemed necessary due to the need for new skills, e.g. in marketing, finance and international operations as well as for learning new more efficient production methods. In-house training is offered and also still required today but now it usually takes place in Estonia. The long-term results of training in building commitment are nevertheless questionable. As the knowledge and skills of the employees increase, they appear to be getting more tempting offers.

> *"When we start the training of a manager, it takes some 5-10 years and then there is the fear that somebody headhunts him during the process."*

Many Finnish interviewees note that it is becoming increasingly challenging to motivate managers.

A large proportion of today's Estonian managers reached senior positions in the 1990s when they were still in their twenties. Currently they are in their thirties and forties and have basically gained everything they can gain in Estonia. Still, their managerial, and especially leadership skills, may in many cases be considered underdeveloped by the Finns. Whereas the Finns consider the huge development in the Estonian economy to be a consequence of the opportunities in the environment and market, the Estonians typically make a case for their personal characteristics and know-how as being the major drivers. This has resulted in differences of opinion between the Finnish owners and the Estonian managers for example when the organization structure is changed and the responsibilities of the managers change.

There also seems to be a "motivation gap" among university graduates entering the labor market. They have heard of the examples of the "stars" of the 1990s and expect a similar fast tracked career development, without realizing that there are not so many managers needed as there are recent graduates in Estonia.

Developing the softer means of motivation can be one option in building employee commitment. One such issue is the ability to influence the work conditions and the involvement of the employee in the development of the company in general. This is, however, still a challenge in Estonian organizations. The reasons behind this are discussed in the next section.

Employee Influence

In the Soviet Union, employee involvement and influence was formally encouraged in the form of various kinds of work councils and because labor union membership was in practice compulsory. In reality, employees were rather discouraged from assuming responsibility and expected to follow orders from above. Legacies of this tradition are still to be found in present day Estonia. The role of labor unions and collective bargaining is marginal and it is not expected to develop rapidly. Finnish interviewees largely interpret it as an indication of employees being satisfied with their situation. Finns have, however, encouraged an organization culture that engages the employees in developing the work community without labor union involvement. They also point out that the employees are certainly not discouraged from unionizing in Finnish owned firms, while they may be in local firms.

> *"As far as I have been asking around..., well in my opinion it is a pretty good answer, which I have heard a few times, that why should we unionize, when [the company] is acting according to all laws and is fair. We have not considered it meaningful to unionize."*

According to the majority of the Finnish interviewees, the local non-management employees still shy away from responsibility, which one of the interviewees characterizes as "a central problem among the employees, excluding only a very limited group of highly professional people". This applies in particular to employees who entered the labor market during socialist times and were thus subject to the hierarchical, initiative-discouraging management style. As a result, especially in the fields where customer service is essential, there is a clear tendency to favor hiring people under forty who have no experience of the old system.

> *"...if you reflect back on the Soviet era, everything back then was controlled and structured, you were not allowed to think for yourself or make any decisions. Back then people were accustomed to it and the culture dates from that heritage. People still expect someone else to make the decisions and assume the responsibility. One has to learn to take responsibility"*

It is surprising to many Finnish managers that there is a persistent need for strong leadership in Estonian operations. Finnish expatriates in Estonia, who have been educated in Finland and have also gained international experience, have had to adopt a new, more authoritarian management style, especially in production plants. The willingness to assume responsibility among younger employees and lower-level management is increasing, however the Western, liberal management style can be introduced only in small steps. Finnish firms usually attempt to introduce a more open discussion and team working culture but have found that such an approach does not necessarily add to the motivation of Estonian managers. They are used to making decisions on their own and perceive the new management style to be diminishing their power and status. Teams and projects still need to be observed and kept on a tight leash. At the workers' level, the flatter organizational structure often increases work satisfaction, as long as it is not implemented in haste and is communicated clearly.

> *"Despite the fact that we have together now for over a half a year built this organization model with this group, and agreed on how to proceed, we have problems. The problems are, however, much smaller than before. The management style is still authoritarian by nature and people are not motivated or persuaded, but strictly ordered to do things and get them done, and employees actually expect to get orders."*

Estonian employees still seem to expect clearly defined responsibilities and prefer not to take the initiative so as to avoid making mistakes. This behavior is also encouraged by legislation, which includes the "duty of explanation" of an employee. Finnish interviewees complain that this results in a situation that in the case of making a mistake the employee's first reaction is to start finding excuses instead of finding solutions. Neither is job re-designation easy, as labor contracts include detailed descriptions of duties, and anything omitted from the contract is considered extra work. In short, Finnish firms aim to increase employee influence, but it turns out to be challenging, due to both the slow-changing nature of informal institutions, and the formal institutions not supporting change in this respect.

Discussion and Conclusions

This paper examined the development of Finnish firms' human resource management practices in their Estonian subsidiaries during 1991-2004. We applied the Harvard model of HRM by analyzing the flow of human resources, reward systems and employee influence in the Finnish firms' Estonian subsidiaries. The empirical evidence was based on 30 interviews with Finnish managers in charge of Finnish companies' Estonian operations.

Consistent with existing research, in the transition period of the 1990s the HRM challenges identified in our study were highly influenced by the country's socialist heritage. Formal institutions to govern companies' labor relations were still in the making. Employees were relatively weakly protected by the law and the restructuring of the previously state owned enterprises brought about unemployment due to lay offs. With the introduction of the more liberal formal institutions, the labor unions also lost their role. They were associated with the Communist ideology, and thus, when membership in the labor unions became voluntary, they experienced a radical decline in the number of members. Nevertheless, the informal institutions of the Soviet system still largely prevailed. Organizational structures remained hierarchical and the management style authoritarian. Finnish companies brought in Finnish expatriates to act as catalysts for change and to introduce the Finnish business culture. However, adaptation was required to the Finnish management style in order to build respect among the employees. The level of initiative and self-direction of the employees could not be changed overnight, which forced the Finnish managers to apply a more authoritarian management style than they were accustomed to. A salary paid on time was the main source of motivation for employees who had largely lost the social infrastructure provided earlier by the Soviet enterprises. Foreign companies were therefore considered attractive employers as they were perceived as financially more stable and as paying slightly higher salaries than the local companies. In-house training and development of personnel was of utmost importance as there was a need for new types of skills, for example, in marketing.

However, the situation changed drastically towards the end of the 1990s as the market economy gained a firmer foothold in Estonia. Currently, Finnish firms are competing head-to-head for qualified labor with other foreign and local companies. Many fields are experiencing a shortage of labor. Salary still continues to be the main source of motivation for workers due to the deficient social security system in Estonia. Also in managerial positions, salary and titles count. This has resulted in uncommitted employees who frequently change employment seeking a higher salary. Motivation through career development is challenging as employees with a higher education expect fast-tracked career development, which is not realistic in present day Estonia. It was a phenomenon of the 1990s that cannot be repeated in the current situation. Finnish firms have introduced flatter organizational structures and more democratic management approaches, for example, teamwork and a more open discussion culture. However, increasing employee influence is still considered challenging outside of the managerial level. Employees still tend to revert with detailed descriptions of their duties in their labor contracts when faced with any suggested job redesign.

To conclude, our research demonstrated major changes both in the institutional framework for HRM and the practices of Finnish firms as Estonia moved from being a transition to becoming a post-transition economy (see summary of the main research results in Table 2). The institutional context stabilized, as legislative reforms were completed. However, the reforms resulted in a more liberal institutional framework than in Finland, and so challenged Finnish companies to adapt their HRM practices. In addition, characteristics of the transition period, such as the brilliant career development opportunities that the economic restructuring provided for young managers, resulted in new types of challenges in the post-transition period. Finnish companies have had to invent new ways of motivating, on the one hand, middle-aged managers who have already reached top-level positions, and, on the other hand, university graduates who cannot follow such a career path, because demand for managers is close to saturation point. In summary, our study shows that HRM in post-transition Estonia is very different from in transitional Estonia, but also still varies from mature market economies such as Finland. For companies, this implies additional challenges related to HRM when operating in countries in transition. In short, this means that policies that worked well in the early stages of transition are not likely to provide similar results at later stages. Thus, HRM practices need to be adapted accordingly as the transition proceeds.

Notes

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2 The division of theoretical approaches to HRM into “soft” and “hard” models was introduced by Storey (1989).
3 Estonia was under Swedish and Russian rule until 1918, and its independence was acknowledged with the signing of the Tartu Peace Treaty in 1920. It was occupied by the Soviet troops in 1940 and formally annexed to the Soviet Union in 1945.
4 For a complete report of the interviews see CEMAT (2005).
5 The authors thank Ms Laura Erkkilä and Mr Alpo Tani for their assistance in conducting and transcribing the interviews.

	Transition		Post-transition	
	Institutional framework	HR policy	Institutional framework	HR policy
HR flow	**Formal:** Labor law in the making, employees weakly protected **Informal:** Resistance to change in organizations	-lay-offs of excess labor -filling managerial positions: -laying off old management -wide use of expatriates -hiring students with language skills to be trained in-house	**Formal:** -Labor legislation protecting employees,temporary dismissal of employees allowed -Inadequate educational system -Emigration **Informal:** Young generations' preference for managerial positions over industrial work	-battling lack of labor and footloose employees: -active headhunting, use of expatriates -in-house training
Rewards	**Formal:** Abolition of centralized wage setting, introduction of free-market wages **Informal:** Increased uncertainty among employees as social infrastructure no longer provided by the employer	-salary as the main motivation -foreign firms paying slightly higher salaries on time -local firms paying grey salaries -training programs in Finland	**Formal:** Low, flat income tax rate, high tax on fringe benefits, weak social security system **Informal:** Desire to improve own standard of living, unrealistic career development expectations among students	-results based incentives, salary still motivates -training & career development -introduction of softer values & developing other means of motivation to build commitment
Employee influence	**Formal:** Decline of labor unions associated with the Communist Party **Informal:** No desire to take responsibility	-restructuring of the traditionally hierarchical organizations -foreign managers applying more authoritarian mgmt style to compensate for the lack of initiative taking	**Formal:** Labor legislation requiring detailed work contracts **Informal:** Initiative taking remains low at other than managerial levels	-step-by-step introduction of new models to encourage employee initiative -teamwork, open discussion culture

Table 2 Main changes in the institutional framework and HRM policies in transition and post-transition Estonia

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Implementation of Organizational Changes in Chinese Companies

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Abstract

This paper draws on prior research on organizational change, including theories about change, models of the change process and resistance to change and overcoming resistance. The authors carried out a survey covering 160 Chinese companies in northern China selected from various industries ranging from manufacturing and technology, banking and insurance, to those in energy and education. Interviews about changes in their organizations were conducted with top managers and senior or middle managers. The research provides an understanding of the current situation of the implementation of organizational changes in China and examines the relevance of the existing literature concerning the implementation of changes in countries in transition. According to the study, almost all changes in Chinese organizations are initiated by top managers or even government agencies, and lower-level employees are rarely involved. Much attention has been paid to planning the change; however, evaluating the process of change and making modifications are ignored. Moreover, although employees sometimes appear indifferent and show no strong response to changes, some resistance to change has been identified. However, few efforts have been made to overcome the resistance and consolidate the improvements. Finally, based on the survey results, the authors propose suggestions to managers in Chinese companies on how to implement changes more efficiently.

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Keywords: Chinese company, implement change, organizational change, process of change, resistance to change, type of change

Abbreviations
CPC - Communist Party of China
SOEs - State-owned Enterprises

Introduction

The authors have studied organizational changes in an emerging economy, China. Organizational change in emerging economies, although difficult, is inevitable (Zhou et al., 2006). The Chinese economy, previously a relatively closed system is on a reform path toward an open, market-driven system. Faced with fierce competition in the world economy, especially after China's entry into the World Trade Organization in 2001, Chinese companies are undergoing fast-paced, fundamental change processes. The Communist Party of China (CPC) has led the People's Republic of China (PRC) under a one-party system since the country's establishment in 1949. Despite this, nearly half of the PRC's economy has been privatized in the past three decades under "Socialism with Chinese characteristics" (People's Republic of China, 2006). During the 1980s, Chinese economic reforms helped lift millions of people out of poverty. However, due to the mixing of market and planned economies, China as a country itself and all Chinese organizations underwent great difficulties in the process of reform.

The controlled process of change in China has attracted growing attention from around the world due to its significance for theory and practice. What has been missing in the literature is the temporal dimension; that is, the change performance implications, since Chinese reform officially began in 1978. Taking a dynamic systems perspective and drawing literature from organizational studies, the authors study the implementation of change in China, especially the steps involved in the change process and resistance to change based on a survey conducted in 160 Chinese organizations.

The main aim of the study is to examine the relevance of the existing literature concerning the implementation of change in countries in transition, and to put forward suggestions on how to implement change more effectively and efficiently in Chinese organizations.

Here, the authors would also emphasize that the target of the study involves companies from the northern part of China. Southern China, where Chinese Economic Reform first started, is a region with a more developed economy and more open ideology. In contrast, northern China has a long tradition of heavy industry and is the location of many large-scale and significant state-owned enterprises. Therefore, it is more difficult to implement changes in northern China. The authors have studied this area in particular and put forward recommendations hoping to contribute to the development of change management in the organizations located in northern China.

Literature Review

Change, one type of event, is an empirical observation of a difference in form, quality, or state over time in an organizational entity. The entity may be an individual's job, a work group, an organizational strategy, a program, a product, or the overall organization (Ven-Poole et al., 1995). The following section presents an overview of relevant work from existing literature on organizational change.

Types of Organizational Changes

Ackerman (1986) has described three types of organisational change: (1) developmental change, (2) transitional change, and (3) transformational change. Developmental change improves what already exists through the improvement of skills, methods or conditions. Transitional change replaces current ways of doing things with something new over a controlled period of time. Transformational change means the emergence of a new state, unknown until it takes shape, out of the remains of the chaotic death of the old state.

Burke and Litwin (1992) have developed a model for making a distinction between transactional and transformational change. They argue that transformational change occurs as a response to the external environment and directly affects the organisational mission and strategy and the leadership and culture (Burke and Litwin, 1992). Transactional change could be compared with transitional in Ackerman's terminology.

Moreover, organizational changes are connected with institutional development (Alas and Vadi, 2006). There are connections between the institutionalisation stages of change at the societal level and types of change in organizations (Alas, 2004a). In Estonia, an economy in transition, transformational change took place in 90% of organizations (Alas and Sharifi, 2002).

Resistance to Change and Strategies for Overcoming Resistance to Change

Woodward's' (1954) empirical study of British manufacturing firms indicated that no matter how carefully and slowly the idea of change was introduced, the immediate reaction from lower supervisors and operators was to resist it. According to Senge (1997), people do not resist change; they resist being changed. Most studies of organizational change have shown that employees resist social change more than technical change, (though they are not separate in practice) and the change programs which ignore psychological resistance to change are likely to fail, irrespective of the way the new desired attitudes are presented (Schein, 1986). Alas and Sharifi (2002) has pointed out that resistance in Estonian organizations was mainly attributed to inertia in the thinking of employees.

As Greenwood and Hinings (1996) note, "Radical change cannot occur without the organization's having sufficient understanding of the new conceptual destination, its having the skills and competencies required to function in that new destination, and its having the ability to manage how to get to that destination" (1996: 1039-1040). Senge (1997) suggests not pushing harder to overcome resistance, but discerning the source of the resistance. Kotter and Schlesinger (1979) present six strategies for facilitating change and overcoming resistance: employee participation and involvement, education and communication, facilitation and support, negotiation and agreement, manipulation and co-optation and finally explicit and implicit coercion.

Process of Change

Lewin's (1989) basic model consists of three steps: unfreezing, moving, and refreezing. Tichy and Devanna (1986) have also used three steps: Recognizing the need for change, Creating vision and Institutionalizing the change.

One of most popular process models is Kotter's (1998) 8-step model, which includes eight phases in the change process:

1. Establishing a sense of urgency by relating external environmental realities to real and potential crises and opportunities facing an organization.
2. Forming a powerful coalition of individuals who can rally others to support the effort. Encouraging the group to work together as a team.
3. Creating a vision to help direct the change effort and developing strategies for achieving that vision.
4. Communicating the vision through numerous communication channels.
5. Empowering others to act on the vision by changing structures, systems, and procedures that seriously undermine the vision in ways that will facilitate implementation.
6. Planning and creating short-term wins and building momentum for continued change.
7. Consolidating improvements and producing still more change. Changing such structures, systems, procedures and policies that aren't consistent with the vision.
8. Institutionalizing the new approaches by articulating connections between the change effort and organizational success. Developing the means to ensure leadership development and succession.

One process model has been developed based on a survey, conducted in 137 Estonian companies, especially for change implementation in Estonia (Alas, 2004b). This model consists of four steps. Lewin's (1989) first step has been divided into two parts and emphasis has been added to the need for unlearning past practices and changing attitudes. The new steps in the change model for Estonian companies are: (1) Determining the need for change and unlearning followed by creating a vision; and (2) Determining the obstacles to change and unlearning, followed by gaining the participation of organisational members. These steps are followed by (3) the implementation of unlearning and the implementation of change; and (4) consolidating improvements and institutionalising the change. In this paper the authors will find out whether this process model, worked out for an economy in transition in Eastern Europe, is also suitable for studying changes in another economy in transition – China.

Institutional Changes and Organizational Changes

Socio-economic transformation, at both macro and micro levels, could be understood as institutional change, from both the structural and social perspective, embracing both new structures and social values. In such an environment the elements of an institution may lose credibility and need redefining – the processes of *deinstitutionalisation* and *reinstitutionalisation* take place (Clark and Soulsby, 1999:40). During deinstitutionalisation the contingent nature of cultural accounts and rules are revealed, interrogated, contested, opposed, effectively challenged and ultimately overturned. The process may be gradual or sudden and may affect formal institutions and institutional practices at different rates. Deinstitutionalisation takes away the certainty associated with institutionalised rules, attacks the meaningfulness of the social world and thereby reduces the level of social support and motivation.

From this institutional view, social transition may be interpreted as the period between the effective demise of one institutional system and the point at which another institutional system has been established and accepted on new cognitive and normative grounds. Such circumstances create acute social and psychological problems for social actors and as a period it has been called *social transience* (Clark and Soulsby, 1999:40).

Changes in the environment necessitate that organisations modify themselves as well.

During the stable stage of institutionalisation, mostly developmental changes take place (Alas, 2004a). In order to evoke transitional changes, additional institutional forms could be added to established institutions. Deinstitutionalisation in society, which initiates a period of social transience, calls for transformational changes in organisations, and at the same time reinstitutionalisation starts. If reinstitutionalisation is completed then transitional changes start to dominate over transformational (Alas, 2004a).

Chinese History from an Institutional Perspective

In order to provide socio-economic explanations rooted in the historical and contemporary circumstances of societal and organizational transformation, a short description of important stages in Chinese history starting from the founding of the Communist Party of China (CPC) will be given.
In Table 1 Chinese history viewed from an institutional perspective

By the time of the First Republic in 1911, imperial China was in ruins – the social system was in collapse, central authority had evaporated, the most lucrative sectors of the economy were in the hands of foreigners, and significant areas of territory had been lost (Foy and Maddison, 1999). When the Communist Party of China (CPC) was founded in 1921, a new additional institution was created since the CPC had totally different institutions from those of the Nationalist Party (Kuomingtang), which was the ruling party at that time. From 1921 to 1949 the situation in China became more and more chaotic, culminating in the country's military collapse under the weight of the Japanese invasion, the Second World War and the Civil War that followed (ibid).

When the Chinese Communist Party came to power in 1949, it restored central control under the People's Republic. National unity with economic independence was its priority.

Between 1949 and the eve of economic reform in 1978, China, after long years of war and revolution, experienced thirty years of peaceful reconstruction unprecedented in its modern history (Qin, 2005). It was a recovery period and substantial progress toward a return to normalcy was achieved in spite of the Sino-Soviet split and disastrous economic experiments, such as the Great Leap Forward, which were designed as short cuts to industrialization, and political errors, the most destructive of which was the Cultural Revolution (Johnson, 1998). Against this background, the old system and its "planned economy", typified by the high accumulation mechanism, did play a major role in the primary accumulation of China's industrialization (Qin, 2005). From 1952 to 1978, GDP measured by value in purchasing power parities was multiplied by three, while per capita income increased by 80 per cent and the economy's structure was transformed and industry's share of GDP rose from 10 to 35 per cent (Foy and Maddison, 1999).

Appendices Table 1 Institutionalization in Chinese History from 1921

Period	Event	Institutionalization
1921	Foundation of the Communist Party of China	Creation of new additional institution
1937-1945	Anti-Japanese War	Deinstitutionalization
1945-1949	Chinese Civil War	Deinstitutionalization
1949	Founding of the People's Republic of China	Creation of new institutions
1949-1977	Mao Zedong Era: command economy	Period of stable institutions
1978	Start of Chinese economic reforms	Deinstitutionalization
Late1970s-early-1980s	Opening trade with the outside world, instituting the household responsibility system in agriculture	Creation of new additional institutions
1980s	Creating market institutions, converting an administratively driven command economy to a price driven market economy	Social transience
1990s	Creating a viable banking system	Creation of new additional institutions
Late-1990s-early-2000s	Industrial reform, involving the closing of unprofitable state-owned factories	Reinstitutionalization
2001	Entry to WTO	Continuation of Reinstitutionalization

Source: The authors

In 1978, an ambitious reform program was launched in China. Rural economy was de-collectivized, private and semi-private enterprises mushroomed, and the state sector steadily shrank (Zhang, 2004). Reform has been accompanied by decentralization of economic control and local governments have gained some or all of the decision-making power relinquished by the central government (Jia, 1998). The rigid monopoly of the government over foreign trade and the policy of autarky were both abandoned after 1978 (Foy and Maddison, 1999).

The reform in the late 1970s and early 1980s consisted of opening trade with the outside world, instituting the household responsibility system in agriculture (by which farmers could sell their surplus crops on the open market) and the establishment of township village enterprises (Chinese Economic Reform, 2006). In addition, foreign trade decisions were also decentralized.

The second phase of economic reform occurred in the 1980s and was aimed at creating market institutions and converting the economy from an administratively driven command economy to a price driven market economy. The difficult task of price reform was achieved using the dual-track pricing system, in which some goods and services were allocated at state controlled prices, while others were allocated at market prices (Chinese Economic Reform, 2006). The late 1980s and early 1990s focused on creating the pricing system and decreasing the role of the state in resource allocations. In response to the greater yielding to market forces, competition emerged, resource allocation was improved and consumer satisfaction was increased.

In the 1990s, the focus of the reform was to create a viable banking system, which could control the economy via monetary policy and issue loans on the basis of profit and loss, rather than political orders (ibid).

The persistence of state-owned enterprises and the lack of competition in trade and industry have hampered economic reform in China. The inefficiency of state enterprises has led to a vast network of subsidies, and the deficits of state enterprises have been financed to an increasing extent by bank credits (Dorn, 1989). Considering these situations, the reforms of the late 1990s focused on closing unprofitable enterprises and dealing with insolvency in the banking system.

As of 2001 China became a member of WTO. This was 'a historic step in the process of reform and opening up to the world' as President Jiang Zemin said (President Jiang, 2002). It presents a new stage of reform and opening up to the outside world – from a self-designed process of reform and opening up, to real integration with the international system. China's entry into the WTO will make China's door even more open (Chow, 2000). While it is pursuing institutional reforms in state-owned enterprises and the banking and financial sectors, it is aware that the reforms and the accompanying globalization of the Chinese economy have to proceed at an appropriate speed. Meanwhile, there has been an enormous impact on the approach to and processes of policy making, as well as to society and culture.

To summarize, since the 1970s, a fundamental transition has transformed the economic landscape of the People's Republic of China. One of the central aims of the reform in China is to improve the performance of the economy, which ultimately boils down to performance of the firm, especially the previously inefficient state-owned enterprises (SOEs) (Tan and Tan, 2003). During the transition, as the state gradually relinquishes its role in policing economic changes, state firms are being granted
more and more autonomy and the government increasingly tolerates more private ownership of private and collective firms that are outside the state sector (Peng and Heath, 1996). In other words, over the past several decades China has experienced significant changes in transforming its bureaucratic system of state planning into a more market-oriented economic regime.

Methodology

A survey was carried out in 160 companies based in a number of large cities in northern China: Beijing, Tianjin, Jinan and Zibo. Structured interviews were conducted with top managers or middle managers from different companies to enquire about change in their organizations. The questions in the interview were adapted from the survey conducted in Estonian organizations (Alas and Sharifi, 2002). The companies involved represented various industries and sectors. Characteristics of the sample according to the industry and size of the companies are shown in Table 2 and Table 3 respectively.

Table 2 Size of Chinese Organizations in the Survey

Number of employees	*Percentage*
less than 100	23.1%
100-500	31.9%
501-1000	11.3%
1001-3000	13.8%
3001-5000	4.4%
more than 5000	15.6%

Source: The authors

Table 3 Categories of Industry in the Sample

Industry	**Percentage**
Production	28.1%
Trade	4.4%
Consultation and training	6.3%
Banking	1.3%
Telecommunication	13.8%
Entertaining	2.5%
Education	17.5%
Service: hospital, transport, sale, insurance	21.9%
Governmental agencies	4.4%

Source: The authors

Looking at the entire sample, the top manager or CEO responded in 39.4 per cent of companies, deputy directors or vice general managers in 40 per cent and middle managers from different functional departments, of which 5 per cent and 3.8 per cent specialized in HR and marketing respectively, in the remaining cases. Others were responsible for departments, such as finance (3.1 per cent), sales (2.5 per cent), project management (2.5 per cent), assistance (2.5 per cent) and customer service (1.3 per cent). All interviewees had experienced recent organizational change in their organizations, and have been directly involved in strategy formulation and implementation. Apart from their knowledge and views on the questions asked, the interviewees were encouraged to elaborate on the process and complexities of the organizational changes experienced inside the companies.
Most questions were open-ended, however, in some cases closed-ended questions were used, for example, in order to identify the factors that had changed in the process of change. The interviews were first analyzed individually to identify issues relating to organizational change and then compared and summarized.

Analysis of the Results

Types of Changes and Duration

According to the survey, only 5 per cent of the changes were developmental changes that normally took place in one department – for example, the introduction of new software in IT or adjusting new systems within a single department. Meanwhile, 41.3 per cent of the changes were transitional and 53.7 per cent were transformational. As the Chinese economy is still on its way to a market economy from a planned economy, half of the organizations in the survey experienced dramatic changes in ownership or size. For example, some state-owned enterprises had become private limited companies; some small state-owned enterprises had been merged to form larger entities and some enterprises were acquired by private owners. Some government agencies operating under the planned economy were even transformed to become independently-run companies or affiliates of local authorities.

With regards to duration, the survey results reveal that the duration planned for changes ranged from 1 month to 4 years. The most common planned timeframe was from 4 to 12 months. As Chinese organizations normally have quite a large number of employees, it changes are not likely to be finished within a short period. Some enterprises with several thousand employees have to spend several years in a state of dramatic transformation. Among the 160 respondents, about half of them mentioned that changes in their organizations were finished on time, 28.1 per cent did not manage to complete the changes within the planned timeframe, while 15.6 per cent completed the changes ahead of schedule. This is largely due to the existence of a polychronic culture in China – Chinese people normally prefer to plan more time than they think will actually be needed.

Initiators of Change and Factors that Changed

The respondents were also asked about the initiators of change. Top leaders in the organization initiated 72.5 per cent of the changes, local government or authorities initiated 20 per cent, for example, the government decided to privatize state-owned enterprises or sell shares in one plant to foreign investors. This is a special feature of changes in transition economies, especially China. Under the Chinese administrative system only a very small proportion of changes are proposed at a hierarchically low level of the organization. Only 2.5 per cent and 5 per cent of changes were initiated by middle managers and lower-level employees respectively. However the changes proposed by them are normally developmental changes, taking place in a certain department or in a specific aspect of the management. Revolutionary or strategic changes were initiated and had to be initiated on the basis of decisions from the government or top management group.

In the process of the changes, some specific factors also changed. Almost 84 per cent of organizations (83.8) experienced changes in strategy, 77.5 per cent changed their leadership, 74.4 per cent their management practices, 72 per cent structure and 71 per cent their systems. Then 70 per cent changed their mission and 65 per cent changed their culture. For example, the corporate culture turned from being relationship-oriented to task-oriented in some organizations. Compared to these factors, the least changed factor was individual skills, which was mentioned by only 42 per cent of respondents. This shows that changes in most organizations tended to be oriented towards the organization level, while individual skills were ignored. This can be partly attributed to the fact that managers in Chinese organizations lack the competency for handling change and employees lack knowledge and skills to accept and adjust to changes.

The respondents were also asked about whether there was a specially formed task force to manage the process. A task force or specialized body to handle the changes was established in 36.3 per cent of organizations, and these were normally composed of top managers or members of the board. Others explained that instead of creating a special team, the general manager or the departmental manager were normally in charge of implementing the changes. Furthermore, a quarter of the companies experienced changes in management style as the result of the change. For example, in those organizations being privatized, the decision-making group became more independent of local authorities. And in some companies the process of decision-making to some extent became simpler and more transparent.

Steps in the Change Process

The steps in the process of change in Chinese organizations were analyzed on the basis of the most popular model of the change process – Kotter's (1998) model presented in Table 4.

Table 4 Steps in Implementation the Change Process in Chinese Companies (% of companies)

Steps in change process	Percentage
Unfreezing Establishing sense of urgency	58.1%
Forming a coalition or team	30.6%
Creating a vision	78.1%
Communicating the vision	51.3%
Moving Creating a suitable climate	38.1%
Employee involvement	31.3%
Creating short-term gains	19.4%
Re-freezing Institutionalizing the new approaches	11.3%

Source: The authors

Table 4 Indicates that most of the attention was paid to the unfreezing stage while re-freezing was given the least emphasis.

Among the steps in the unfreezing stage in Kotter's model, creating a vision (the third step) is the most widely adopted step, followed by establishing a sense of urgency (the first step). However, although 78.1 per cent of the respondents created a vision, only half of them communicated it to the employees in the organization. In addition, only one third of the respondents mentioned Kotter's second step – forming a coalition. These results show that in the initial stage, Chinese companies created an awareness of the need for change and also created an aim for the change. However, they were not good at communicating with and educating employees, which possibly led to misunderstandings, confusion and even resistance among the employees in the later stages of the change. Besides, teamwork was not well-developed in the implementation of changes. The management relied heavily on administrative order. As I have mentioned in the previous part, most of the changes in Chinese companies were initiated by top managers or even the government. Thus, Chinese companies lack the awareness and skills to inform the employees about the need and vision of the change. Some companies simply pass the decision to change as an administrative order to the lower-level workers of the organizations without adequate explanation and information sharing.

Regarding the steps in the moving stage (the second stage in Kotter's model), only 38.1 per cent and 31.3 per cent of the respondents mentioned creating a suitable climate and involving employees respectively. Even a smaller percentage of the respondents created short-term gains (Kotter's seventh step). This reveals that the implementation of change in Chinese organizations remains, to a large extent, part of the conventional administration. The top-to-down hierarchical management system was still used to administer change as in the daily running of the business. It is clear that the empowerment of employees was not a popular activity and the leaders of the organizations were not motivated to empower employees. Therefore, the situation in many organizations was that employees had no choice but to accept the change passively because they lacked adequate knowledge and motivation to be involved in the change.

The table also indicates that the last step in Kotter's model: institutionalizing the new approaches was the least emphasized step compared with other steps. As a result, the consolidation of changes and ensuring their success was the least popular activity among the three main stages in the change process.

To sum up, most of the organizations neglected the refreezing stage in the whole process while their main focus was placed on the unfreezing stage.

Reactions to Change

According to the survey, employees held positive attitudes to change in 26.3 per cent of organizations. An almost equal percentage of companies (27.5 per cent) experienced negative reactions to change, and 15 per cent of respondents explained that there was a mixture of acceptance and opposition in their organizations. Fourteen per cent of respondents mentioned that the employees were indifferent to the change. If their interests were not largely involved in the change, they were inclined to accept the decision from the top management without showing any strong response. Without specifying a positive or negative attitude, 3.1 per cent of the respondents said that the employees showed an attempt to adapt to the change. The authors take this as positive attitude. Finally, 14.4 per cent of the respondents saw a gradual change in the reactions of employees from being initially unaccustomed to eventually being adaptive.

Resistance to Change and Overcoming Resistance

The common resistance to the process of change and strategies used to overcome resistance are shown in Table 5.

Table 5 Resistance to Change and Strategies for Overcoming Resistance in Chinese Organizations

Resistance to change	% of answers	Strategies for overcoming resistance	%of answers
Inertia in the thinking	26.9%	Education and communication	33.8%
Fear of the unknown	14.4%	Employee participation and involvement	5.0%
Unwillingness to do additional work	3.8%	Facilitation and support	9.4%
Planned redundancies	6.9%	Negotiation	3.8%
Reaction to overly quick and unclear changes	5.6%	Manipulation and cooptation	8.1%
Information Blockades	5.0%	Explicit and implicit coercion	10.6%

Source: The authors

According to the survey, 26.3 per cent of respondents claimed that there was no resistance to change. The others stated they encountered difficulties. Among six causes of resistance, inertia in people's thinking was most frequently mentioned (by 26.9 per cent of respondents) as the main root of resistance. Institutional inertia came from a lack of information, lack of knowledge, social and political pressure affecting economic decisions and the simply persistence of customs and habits. Inertia explained those difficulties encountered in reforming state enterprises. Another element of inertia was the tendency to retain the old ways of doing things. In many state-enterprises that have become share-holding companies, the shareholders still elected the same governing people to the new board of directors and so there was no change in the management. Meanwhile, 14 per cent of respondents demonstrated that the resistance came from fear and worry about the future after the change. In some organizations confronting bankruptcy, while the employees were positive about changes that may help the company survive, some middle managers were against it as they were afraid of losing their current positions. Furthermore, 7 per cent of respondents found that the employees were worried about being laid-off and becoming jobless, and therefore had very strong negative attitudes to change. There was an almost equal percentage of respondents (about 5 per cent) who regarded the resistance as a reaction to overly quick and unclear changes and a lack of information about the change. It frequently happened that changes were implemented as a command from the top management with manipulation and insufficient information sharing. This is one unique feature of a socialist system – people are just informed what to do without being told why. In addition, about 4 per cent of the respondents mentioned an unwillingness to do additional work. Before vital social transformations took place in China, a job was regarded as an "iron ice bowl" in many people's minds, and no effective incentive system existed in many organizations. When confronted with more challenging and efficient systems, people, being used to routine tasks, were not willing to devote more time and energy to work.

The survey indicates that the most frequently used and the most effective strategy for overcoming resistance was communication and education. However, to interpret it more specifically, communication in China may not mean involving the employees in planning the change or collecting the employees' opinions. It may simply mean informing the employees about the change before starting to unfreeze. Another noticeable feature in change implementation in China is that coercion or manipulation was frequently used and was acceptable. This may result in strong negative feelings towards the implementer in the initial stages; however, people eventually accepted it since there was a long tradition of following commands in this socialist country. Even though the economy is gradually being converted to a free-market economy, the management style and the old thinking style still prevail or dominate under the socialist regime, especially in northern China. The result also reveals that the employee involvement was rarely used due to the incompetence of managers to empower the employees.

Discussion and Conclusions

Based on the survey, the authors identified the main issues associated with changes in Chinese organizations – the types of changes, stages of change, the resistance to change and strategies for overcoming resistance.

Organizational change taking place in this transitional economy is a result of government commitment to replace a planned regime with market mechanisms. After a decade of economic disruption and chaos in the period of the Cultural Revolution (1966-1976), Chinese people longed for the return of economic order. Therefore, when Deng Xiaoping launched the economic reform, the people expected that this could bring about economic prosperity. Although they were eager to change, they had to work hard to get rid of the old thinking prevailing from the Cultural Revolution. As of the early years of 21st century, a considerable percentage of Chinese organizations are still experiencing transformational changes. Since entry to the WTO, a significant percentage of Chinese organizations have struggled to improve performance and implement transitional changes.

The findings of our survey revealed that change in Chinese organizations did not seem to be a smooth process because of the institutional and cultural complexities in China. The government still played a vital role in initiating and regulating changes. Moreover, most of changes were initiated from the top management and lower-level employees were rarely involved.

Regarding the process of change, much attention has been paid to planning the change. However, assessing the process of the change and making improvements have been ignored. Moreover, although employees sometimes appeared indifferent and showed no strong response to changes, some resistance to change has been identified.

The most significant resistance to implementing change was the inertia in the thinking of employees. It was hard for them to change their habits and thinking, which had been formed under a command economy. This finding corresponds with the results of a study conducted in a huge and progressive enterprise – Haier Group by Yeung and DeWoskin (2001), which showed that the major barriers to change in China are related to the ownership structure of Chinese enterprises, the traditional mindset of Chinese people and the lack of good visionary leaders. The second biggest source of resistance was the fear of the unknown. Even though some employees didn't hold a completely negative attitude to the changes, they had some doubts about the new regime where economic decisions were still affected by political and social pressure. Some other resistance was associated with redundancies, which was a noticeable feature during the reform. A large proportion of Chinese enterprises were tough when downsizing since they had suffered from an oversized and inefficient workforce in the previous command economy.

One point the authors would like to emphasize is that managers in Chinese organizations underestimate the resistance and the significance of employee attitudes. They were actually aware of the persistence among employees in the previous regime. Nevertheless, they didn't provide strong incentives to help them change their attitudes. The mostly commonly used strategy was to educate and communicate the plans and importance of the change to the employees. However, there was rarely any involvement of the employees in planning the change at the initial stages. Some managers were even of the opinion that coercion was the easiest approach to control the reform. The findings indicated that in the transition period, the management approaches were still to some extent bureaucratic and entrenched due to the profound influence of the period before the reforms.

Comparing this study with previous research about organizational change conducted in Estonia by Ruth Alas, certain similarities and differences between Estonia and China can be noted in regard to the pace of changes. Regarding the types of changes, one significant similarity is that a large proportion of companies in both countries experienced transformational changes – the deepest by scope. In social transience, companies underwent dramatic changes in strategy, culture, leadership and values. However, in more stable institutions in Estonia and China, they experienced more transitional instead of transformational changes. In terms of people's attitudes to change, Chinese organizations encountered mixed reactions to change. By contrast, Estonian companies encountered two extreme responses – support and opposition. With regard to the resistance to change, in both countries inertia in people's thinking is the largest obstacle. Regarding strategies for overcoming resistance, Chinese organizations use more coercion due to the deep influence of totalitarianism. Finally, from the perspective of the process of change implementation, both Chinese and Estonian managers paid more attention to initiating changes and much less to consolidating changes; although Estonian managers attached more importance to motivating and involving employees.

Based on the survey results and the steps that were adopted in the change process, the authors would like to make the following suggestions on how to implement changes more effectively and efficiently in Chinese organizations.

Managers in Chinese companies are recommended to pay special attention to the following activities:

Firstly, managers in Chinese organizations should establish the need for change on the basis of the current situation in the company. The need for change may come from fierce market competition or serious problems in the internal structure. Benchmarking may be recommended by some researchers, however, the authors are of the opinion that it doesn't always apply in practice since the companies in China differ greatly in size, development history and cultural context. Strategies in leading companies may not be performed properly and effectively in other companies. A new vision must be developed. The managers should carefully diagnose and analyse the current situation in order to identify the gap between the existing situation and the favourable future state.

Secondly, managers should predict potential obstacles and points of resistance. According to the survey results, managers in Chinese companies just relied on administrative order and tended to ignore the employees' attitudes to the change when starting the change. Actually, in order to obtain a more accurate understanding of the employees' reactions to change, some consultations or meetings with employee representatives are crucial and beneficial. A plan should then be created concerning how to minimize the resistance and remove obstacles. Currently, most managers lacked the awareness and skills to involve employees in change. The authors propose that representatives of employees should be involved in the planning. This would help gain the trust and understanding of the employees. In the meantime, managers should develop a more open and democratic management style.

Thirdly, a vision for change should be communicated to the employees. The authors particularly emphasize the importance of this activity. Adequate communication will greatly help avoid the negative consequences caused by the low level of transparency in information, which still prevails in many companies in northern China. Relevant information about the change and the significance of the change should be explained in great detail to the employees. Chinese companies are normally rather large, which makes informing every employee overly time-consuming and impractical. The appropriate way is to educate and share information via meetings involving large groups of personnel. However, the meetings and other educational forms should be planned, prepared and organized very well in advance. This will contribute to creating a suitable climate before implementing changes.

Fourthly, in the process of implementing change according to plan, negotiation and support are preferable to manipulation and coercion. At present the combination of education and coercion was the main strategy adopted by many Chinese organizations. However, manipulation and coercion discouraged the employees to participate actively in the change and even led to psychological resistance to the change. So always leave coercion as the last resort. This also requires managers in charge of the implementation to equip themselves with skills to empower and develop the employees. When necessary, HR staff should organize training courses to improve the skills of employees to help them adjust to changes.

Lastly, the authors suggest that managers in Chinese organizations assess the change results and institutionalize new approaches. Although this step is of great significance, managers in Chinese organizations were not conscious of its importance in consolidating and reinforcing the change. Therefore, in order to make change implementation more successful, it is necessary for managers in Chinese organizations to analyze and reinforce the results of the change. This involves the following aspects. Those goals that were not achieved should be identified and the reasons should be identified. Remedy measures should be taken to improve factors inconsistent with the vision. After adjustment, the successful processes should be made into new rules and be institutionalized. Meanwhile, successful experiences should be recorded and shared among managers to help improve their competence in handling change.
In summary the authors highly recommend that managers in Chinese organizations pay special attention to the following activities: (1) establishing the need for change and developing a vision; (2) predicting the obstacles to change and involving employees in planning; (3) communicating the change to employees in a well-organized manner; (4) avoiding coercing employees in the process of implementing change and (5) reinforcing and institutionalising the change.

To conclude, managers in Chinese organizations should be aware of the importance of changing the traditional management style when implementing changes. Managers should place more emphasis on fostering support and participation among employees rather than simply relying on the mixed approach of communication and coercion. Unlearning old habits should be a priority task in the process of change in Chinese organizations, especially those located in northern China.

As mentioned in the introduction, the target of this paper was organizations in northern China. In the future, the authors will carry out a similar survey in southern China and compare the characteristics in these two main regions.

Further Research Proposal

This study was based on interviews conducted with top or senior managers in Chinese companies. In the future, a study could be conducted among first-level employees. The same questions in this study could be asked of the employees and the answers could be compared with those from this study and then analyzed. In this way a complete picture of organizational change in Chinese companies can be constructed and presented to researchers and managers. Another option for future research is that the same study be conducted after some years in order to see what Chinese managers have learnt and what they are doing differently when implementing changes.

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Understanding organisational change in the privatised enterprise: Case study of Jordan Telecom

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Abstract

This paper considers the pathways of organisational change within Jordan Telecom (JT). JT will not survive in its public sector form, and the privatisation of Jordan Telecom remains very controversial. It is intended that the approach developed here to analyse organisational change in JT should be appropriate to the study of other privatisation programmes and to other forms of organisational change in both the public and private sectors.

The JT privatisation process is distinct from many western public sector reforms. JT has two distinguishing features, firstly that the stimulus for change comes from the government, and secondly that JT is dependent on France Telecom (FT) for its technological progress. This study uses Laughlin's (1991) organisational change model (LOCM) as this model offers layers of analysis that are useful for locating the various levels of change, e.g. interpretive schemes, design archetypes, and sub-systems. It also adapts and builds on LOCM, by exploring another aspect of "external stimulus" using Resource Dependency Theory (RDT). RDT better explains the unique official relationship between JT and FT as they are both imposed by government and can also be described as an important alliance. Therefore, the impetus for change, the process of change and the consequence of change are specific features of JT. The study demonstrates that without a basic change in the interpretive scheme from a 'technical culture' to a 'business culture', privatisation cannot achieve its aims.

Keywords: Institutional theory, Jordan, Laughlin's organisational change model (LOCM), Organisational change, Organisational culture, Privatisation, Private Sector, Public sector, Resource Dependency Theory (RDT).

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Introduction

Jordan is a small country with very few natural resources and a population of about 5.5 million. Jordan is quoted as having a GDP per capita of US$ 4900 in 2006. The Jordanian economy is a service economy, not an oil-based one. Its economy faces several obstacles, including the lack of natural resources and the Israeli wars and subsequent occupations of Palestine in 1948 and 1967, which drove thousands of Palestinians into Jordan as refugees.

During the 1970s and early 1980s, Jordan's economy greatly depended using external sources of finance, which included assistance and loans from more developed countries, such as Arab countries and international institutions, in addition to the remittances from Jordanians working abroad (Al-Quaryoty, 1989; Abu Shair, 1997). "…This makes the country's foreign exchange pool very vulnerable to external shocks, particularly the tourism sector, remittance inflows, and official development assistance and aid from the Arabian oil-rich countries" (El-Sakka, 2005: 2). From 1982, Jordan experienced an economic recession (Al-Quaryoty, 1989); many problems built up, leading to the country's economic collapse in 1988-89 (El-Sakka, 2005). Al-Quaryoty (1989) identifies the external problems that confronted the Jordanian economy as the increase of foreign debt and its servicing, deficits in the balance of payments, the decrease in remittances from Jordanians working abroad, the decrease of foreign aid, and the existence of various managerial problems. Surpluses which became available through foreign aid and remittances in the late 70s and early 80s resulted in an economic boom with great public sector investment in heavy capital–intensive industries, representing 40 percent of the total government expenditure in the five year plan of 1976-1980 (Al-Quaryoty, 1989). Most of these industries, however, were not developed in a timely or effective manner. Al-Quaryoty (1989) observes that delays in implementation were costly, and that many of the public agencies in charge of the preparation and implementation of development plans were enormously overstaffed. The negative effect of the losses incurred by these major industries was substantial. Instead of making profits, or at least breaking even, these ventures became a drain on Jordan's scarce resources.

Privatisation was seen as a way of addressing these inefficiencies. It was one of the economic policies that was identified with Jordan in the beginning of the 1990s. Since the decision to privatise has mainly been driven by political and economic considerations, the economic and financial impact of privatisation has been widely reported in a number of studies (Al-Quaryoty, 1989; Abu Shair, 1997; El-Said, 2001; Awamleh, 2002). However, the literature on Jordan asserts that there are also economic, social and political objectives that link social support packages to the privatisation of State Owned Enterprises (SOEs). Privatisation in Jordan has received a lot of attention from economists and political scientists, but little from management academics. The economic case for privatisation is predicated on the assumption that resources would be more efficiently deployed in the private sector than in the public sector (Ogden, 1995; Parker, 1995; Martin and Parker, 1997). Literature dealing with the specifications of the organisational changes brought about by privatisation in Jordan seems to be quite scarce. Examination of the impact of the external environment on organisational change exposes the consequences of the political and economic reforms underpinning the privatisation process in Jordan and the significance of these factors for the forces behind the drive for organisational change in the public sector.

This paper considers the privatisation of Jordan's telecommunication industry from the point of view of organisational change. The study is organised as follows: The next section provides a review of the literature. The third section outlines the theoretical framework, drawing especially upon previous studies on organisational change by Laughlin (1991). The fourth outlines the research method and techniques. The fifth section highlights JT's historical background. The sixth section presents the external organisational environment stimuli. The seventh section presents the internal organisational elements. The eighth section discusses the organisational change and presents the main conclusions.

The purpose of the study is to understand organisational change and provide an appropriate framework for the study of privatisation and other forms of organisational change in both the public and private sectors. To achieve this goal, the study tries to answer these research questions:

- What is the role of the state in stimulating the public enterprise environment in order to influence an organisational form? How did the state of Jordan exert this coercive role?
- Is the organisational form affected by the privatisation process, and if so, how?
- What are the external pressures on Jordan Telecom, and how did the organisation respond to these pressures?
- What was the major outcome of the unique relationship between Jordan Telecom and France Telecom?

Review of the Literature

The review of the literature encompasses three themes; firstly the nature of the public sector, secondly the nature of the private sector, and thirdly the relationship between privatisation and organisational change.

The nature of the public sector: The public sector is simply the part of a nation's economic activity that is traditionally owned and controlled by the government. Broadbent and Guthrie (1992) point out that the public sector is composed of several public organisations providing basic utilities and services to the community. The public sector domain covers quite a broad range of organisations and activities. Broadbent and Guthrie (1992: 7) provide a framework for the public sector domain, observing that "the public sector could be seen as comprising two areas of activity: one is funded through grants raised by government from taxation, and the other is those monopolies which supply services and utilities seen as part of the infrastructure of society".

This raises the issue of the public sector's areas of responsibility. Economics gives two rationales for the public sector's responsibilities towards society and for the necessity of government intervention.

The World Bank (2004) asserts that this responsibility has grown out of the need to address market failures and provide social justice. It states that market failures arise from society's belief that the services produced and consumed will be less than optimal without public sector intervention. Moreover, individuals have few incentives to build and maintain the infrastructures that are crucial to promoting access to services (World Bank, 2004). Consequently, government intervention is required to produce public goods. The second reason for public responsibility is equity. The World Bank (2004) gives the public sector responsibility for providing public goods and reducing the gaps between the poor and those who are better off. In most attempts to clarify the nature and role of the public sector, it is quite obvious that the definitions and explanations stress the main responsibility of the public sector to take collective decisions and actions for the provision of public services and to address issues of social equity and justice (Stewart and Ranson, 1988).

The nature of the private sector: If the argument of a free market is accepted, it can be argued that the significant structures in the private sector emphasise the superiority of free market operations, with the forces of supply and demand efficiently allocating available resources. Perhaps the most significant component of the private sector paradigm is the concept that competition will, without doubt, ensure that customers receive high quality services at a reasonable price. Harden (1992) argues that customer sovereignty is dominant in the private sector when free market operations exist.

However, Conrad and Sherer (2001) analysed these two ideal types, public and private paradigms, as suggested by Stewart and Ranson (1988: 15), and found that these concepts and roles failed fully to describe the transitional periods in which companies undergoing privatisation transform or adapt. British Gas is a case in point. To address this weakness, they proposed an additional model, saying that "in attempting to chart the processes of change from a nationalised to a privatised industry it was found necessary to extend this framework by including an intermediate stage identified as the commercial model and it exhibits characteristics that distinguish it from the other two models" (Conrad and Sherer, 2001: 514).

Privatisation and Organisational change: Privatisation is a change from government to private ownership and it is the end-point of a continuum of changes in ownership structure and management style. Forrer et al. (2004) assert that transferring ownership from the public to the private sector will lead to changes within the organisation. They assert that some of these changes are structural, such as changes in the membership of the Board of Directors; changes in management style; strategic changes such as those of mission, goals and values; changes in capital investment; and changes in investment in employees. They also explore changes in organisational culture, such as changes in decision-making, changes in human resource management, and changes in employee perceptions (Forrer et al., 2004). Organisational change is also discussed by Macias (2002) with an exploration of the impact of ownership structure on management accounting systems. Macias finds that transforming an enterprise from a public to a private sector organisation entailed fundamental changes in the overall strategic outlook of the management and in the accounting system. The privatisation process leads to changes in the management enterprise apparatus and this has implications for the accounting system. The accounting system is an organisational apparatus that can be used to monitor and evaluate the decision-making behaviour of agents. Coram and Burnes (2001) studied the privatisation of the Property Services Agency (PSA) in the UK, and concluded that "it is necessary to adopt an approach to change which integrates both the structural and cultural aspects of change, and which recognises the need to appreciate and respond to staff fears and concerns" (p. 94).

It has also been observed that cultural changes are associated with a change in attitudes towards an ethic advocating efficiency and quality. Considering this evidence from the literature, it is clear that companies undergoing privatisation have adapted to changes in their external environment with major changes in their internal organisation (Goodstein and Boeker, 1991). This change is reflected in the development of new strategies and increased responsiveness to environmental changes, and also in restructuring (Goodstein and Boeker, 1991). These changes, all of which are likely to lead to changes in the internal organisational environment, must be explored.

Theoretical framework

The earlier studies identified that the phenomenon of privatisation is simply a process of transferring public organisations from the public sector form to the private sector form. The transformation process cannot occur without a crucial stimulation from several agents in the external organisational environment. In addition, how the internal organisational elements respond to these stimuli is evidence of the impacts of privatisation. A theoretical framework is described that can give help in understanding these themes. Table 1 provides a general framework for the external and internal organisational environment.

Table 1 The External and Internal Organisational Environment Frameworks

1. <u>The External Organisational Environment Elements: Stimuli</u>
• Agent: The role of state
• Legislation: Laws and regulations
• Resources: Technology and Knowledge
2. <u>The Internal Organisational Environment Elements: Organisational Form</u>
• Design archetype: Organisational structure
• Sub-System: Human resources.
• Interpretive Scheme: Organisational culture.

The main aim of this study is to provide a framework for analysing privatisation and other forms of organisational change in both the public and private sectors. Therefore, this study adopts three theoretical frameworks, Institutional Theory, Resource Dependency Theory and Laughlin's Organisational Change Model (LOCM) in order to explore the example of the role of Jordan's state in intervening economically to initiate the relationship between France Telecom (FT), as a strategic partner, and Jordan Telecom (JT), and to give a better understanding of the organisational change that was affected by the privatisation process.

Privatisation and Institutional theory: Privatisation can be seen as a shift from one institutional template to another and can be seen as a coercive institutional change (Johnson et al., 2000). To understand the privatisation process, Johnson et al. (2000) argue that using institutional theory can help to perceive the process of privatisation. Moreover, they state that aspects of institutional theory allow the researcher to establish that privatisation includes institutional change and offers mechanisms which create an optimal pattern of organisation, not only through a coercive mechanism, but also through normative and mimetic mechanisms (DiMaggio and Powell, 1983). Underlying privatisation there seems to be an organisation that is subject to new private sector forces. Thus the potential pressures from the market will naturally create the desired changes in the nature of the working processes of the organisation. Kondra and Hinings (1998) predict that the change is likely to occur in institutional environments where there are more impacts from other organisational fields. They also say that the organisational field exerts a regulative and normative effect on the institutional perspective. Greenwood and Hinings (1996: 1025) point out the importance of using institutional theory to articulate organisational responsiveness to external institutional pressures and state:

> Institutional theory shows how organisational behaviours respond not solely to market pressures, but also to institutional pressures (e.g. pressures from regulatory agencies, such as the state and the professions, and pressures from general social expectations and the actions of leading organisations).

Consequently, institutional pressures lead organisations to adopt the same organisational form. Greenwood and Hinings (1996) define convergent and radical change. Convergent change occurs within an existing typical pattern, while radical change involves moving away from the existing orientation through a transformation of the organisation. This occurs when an organisation moves from one pattern of use to another. In this sense, the institutional changes that occur in the privatisation process seem to be radical changes because they constitute changes in those institutional templates that are challenging and problematic (Greenwood and Hinings, 1993).

The institutional perspective within organisation theory focuses on how organisations conform to the norms and values integrated in their environments through the process of adaptation (Meyer and Rowan, 1977; Rowan, 1982; DiMaggio and Powell, 1983). Institutional theory assumes that organisations are embedded in institutional environments that provide organisations with support and legitimacy affecting their structure, practice and processes (Scott and Meyer, 1991).

According to institutional theory, structural changes in organisations arise from institutional agencies: government, industry, legislation, professional associations, and societal expectations. Organisations adopt certain structures and processes because they are forced to do so by legislation or regulation, or persuaded to by other organisations upon which they depend (DiMaggio and Powell, 1983), or because they are driven to do so by general expectations and prevailing institutionalised norms (Meyer and Rowan, 1977), or because they intentionally choose to follow or imitate some patterns that organisational decision-makers believe are suitable and efficient (Fligstein, 1991; Scott, 1991).

Despite the contribution of institutional theory in explaining to the role of some external stimuli such as the role of the state and legislation, it does not sufficiently explain JT's organisational change, particularly the acquisition of resources. This paper argues that Resource Dependency Theory (RDT) can better explain some important aspects of this change. The following section will throw some light on the Resource Dependency Theory and its relevance to this case study.

Resource dependency theory (RDT): RDT provides a conceptual framework for elaborating privatisation as a process and as a means of resolving organisational dependence on resources over time, particularly in transferring new technology. Pfeffer and Salancik (1978) point out that there are two factors that determine the dependency of an organisation on other organisations. The first is the importance of the resources for organisational survival or the extent to which certain resources are critical for an organisation's functioning (Pfeffer and Salancik, 1978). The second is the availability of the resources in the environment or the degree to which another organisation controls the resources (Pfeffer and Salancik, 1978). Organisations acquire resources in the marketplace through competition with other organisations or through regulatory agencies, parent organisations, and partner organisations (Pfeffer, 1981). Organisations which need the resources are urged to manage their dependent situation if they are to survive. In this way, Suen (2002) builds a framework to assess the firm's importance to its alliance as a whole, and to its individual partners. The framework identifies which firm needs the other's resources more, the immediacy and magnitude of the impact of a partner's actions, and whether the firm is able to respond. Suen used cases from different industries in which the type and uniqueness of the resources contributed to the firm's financial position, and to the extent to which partners are technologically or operationally integrated. Suen (2002) also found that the capacity for action depends on how much a firm needs its partners' resources, how tightly integrated they are into the alliance, and what external options are available.

In cases of high environmental uncertainty, when resources are both critical and scarce, organisations are generally more dependent on each other, vertically and horizontally, in solving their specific problems. Thus, in order to increase their survival chances, organisations enter into various formal relationships with other organisations. Those organisations that have control over resources are able "to organise and structure the activities of other social actors for their own interests" (Pfeffer and Salancik, 1978: 49), and develop a greater concentration of power within their network of organisations (Aldrich, 1979).

This study, in addition to using Institutional Theory and Resource Dependency Theory, also resorts to the Laughlin (1991) Model of Organisational Change to explain fully all the relevant aspects of the case.

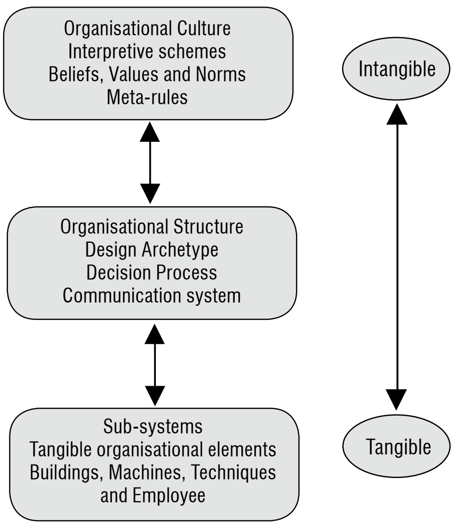
Organisational Change Model: Laughlin (1991) provides a framework for the analysis of organisational change. The framework classifies the organisation into a combination of Interpretive Schemes, Design Archetypes and Sub-systems (see Figure 1). He conceptualises organisations as being an amalgam of the three layers of the organisation form; "interpretive schemes", "design archetypes" and "sub systems", and (1991: 213) asserts that the three elements must be in a dynamic balance with one another to "bind the organisation together and make it a coherent whole", and therefore "the sub-systems [in] an ideal-type situation are, guided by the design archetype in ways which are commensurate with the values represented in the interpretive schemes" (Broadbent, 1992: 345).

This model assumes that the environmental disturbances initially lead to change in the design archetype, and then to both the sub-systems components and the multiple layers of interpretive scheme.

Laughlin built his perspective based on the assumption that the organisational change process and the dynamics of change can be better understood by tracing the pathway, which an environmental stimulus takes through an organisation. In essence, this is a major motivation behind adapting Laughlin's organisational change model (LOCM) as a theoretical framework for understanding the organisational change in Jordan Telecom (JT).

The four models of organisational change which Laughlin (1991) develops ("rebuttal", "reorientation", "colonisation" and "evolution") describe the different pathways an environmental disturbance can take through an organisation. These pathways are related to the idea of first and second order change. First order changes involve changes initially at the level of the design archetype. This may lead to changes in the subsystem elements and the design archetype, but will not affect the interpretive schemes. In contrast, second order changes involve changes not only in those elements changed by first order changes, but also in the interpretive schemes.

Figure (1) A model of Organisation, Adapted from (Laughlin 1991, p.211)



Change of a rebuttal nature entails some changes but these will mainly be in the design archetype. Rebuttal is a change of a first order nature since it fails to shift the balance and coherence between the original interpretive schemes and the old and adapted design archetypes (Laughlin, 1991). It has little impact on the life of the organisation.

Reorientation changes are assumed to affect not only the design archetype but also the subsystems (Laughlin, 1991). The organisations cannot ignore the environmental disturbances; therefore, they should be understood and accepted into their lives. The change therefore is of a first order nature and is a transition rather than transformation.
Colonisation, on the other hand, involves a second order change which is apparently forced on the organisation. The environmental disturbance results in changes to the design archetype, the subsystems and the interpretive schemes of the organisation, consistently through the activities and actions of organisational participants (Laughlin, 1991). Such a change in the interpretive schemes results in a totally new underlying ethos for the organisation as a whole. This type of change therefore represents a transformation.

Evolution is also a second order change which involves major shifts in the interpretive schemes (Laughlin, 1991). However, change of an evolutionary nature is assumed to be chosen and accepted by all the organisational participants freely and without coercion.

Regarding the accounting system, Broadbent (1992) suggests that accounting, which is a part of the design archetype, can be viewed as providing visibility to the less tangible elements of the interpretive schemes. She suggests that the design archetype "is a tangible manifestation of the values of the interpretive schemes, there to guide the subsystems in a way commensurate with those values" (Broadbent, 1992: 347).

Theoretical integration: the theoretical combination of institutional theory, the resource dependence perspective and LOCM allows for a better understanding of the determinants of organisational change in conditions of environmental disturbance, and the organisational responses to these conditions. Using the institutional and the resource dependency theories provides a complementary view of the interaction of the external environment pressures on organisations and the variety of organisational alternatives in responding to the external constraints and demands (Oliver, 1991). Furthermore, using Laughlin's (1991) organisational change model provides an interpretation of an organisation's responses to these factors and identifies the organisation's alternatives in responding. Figure 2 provides the theoretical integration.

This framework suggests that the organisation will tend to remain in balance between the three organisational elements of organisation form; design archetype; interpretive schemes and subsystems, unless the external environment changes against the organisation

Research methods

The case study under review concerns JT. This paper investigates the influence of organisational changes within JT from the late 1980s onwards on its operation, until its completed privatisation and the liberalisation of the communication industry between 2000 and 2005.

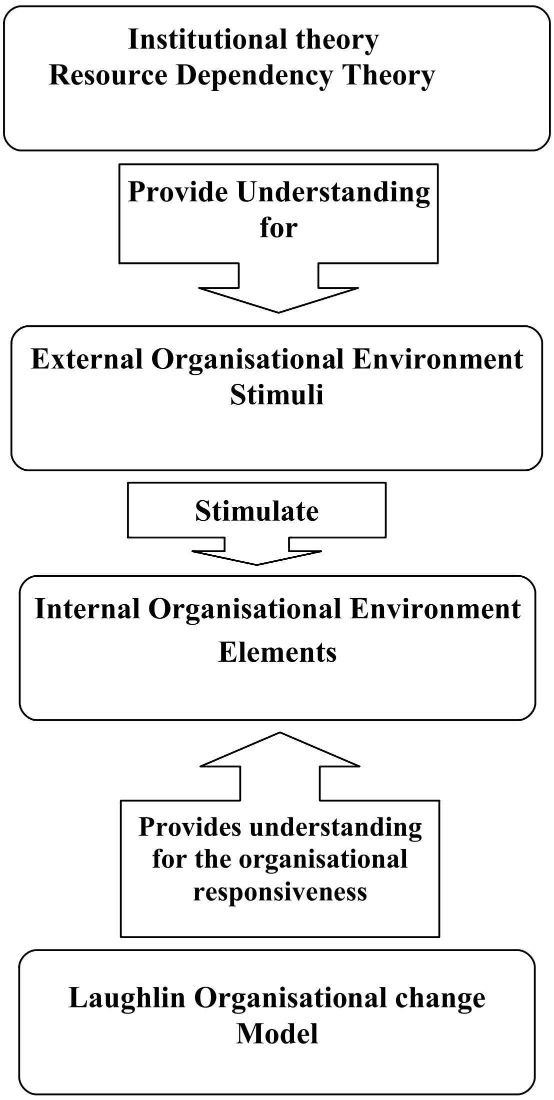


Figure 2 The theoretical integration

Case study method Berry et al. (1985), Dent (1991) and Pallot (1998) used organisations as a case study. They studied organisational changes and how the changes may or may not be effected. Berry et al studied one area of the National Coal Board in Britain and investigated how the technical perspective for production planning is more important while finance is effectively ignored. Pallot's study of New Zealand Telecom looked at how the change in the telecom company's organisational environment and culture had impinged on the organisation's structure and culture. In the organisation structure, there was a change from a highly bureaucratic structure with a large head office in the capital city Wellington to more regional autonomy. Organisational structuring in New Zealand Telecom was mostly geared towards greater decentralisation. In the organisational culture, there was a shift from an engineering culture with an emphasis on physical production to a commercial culture, which emphasised markets and finance. In the same way, Cooper (2004) looks at the factors affecting a UK Metropolitan Borough (local Government) Council Housing division as it attempts to move towards adopting a private sector capital structure and management style.

Yin (2002: 13) provides a definition for the case study as a research strategy. "A case study is an empirical inquiry that investigates contemporary phenomena within their real-life context, especially when the boundaries between phenomena and context are not clearly evident; and in which multiple sources of evidence are used". As a research strategy, Yin (2002) also discusses the possibility of using the case study in many situations, among them organisational and management studies, community, political and social science, and the writing of dissertations and theses in social sciences.

Research method. The research method adopted in this case study involves two data collection methods – documentary evidence, and semi-structured interviews. The documents analysed include official records (corporate annual reports, documents, annual budgets, presentation analysis and parliament minutes), newspapers, periodicals and books written on the history of JT.

Interviews were conducted with 19 managers. 10 of the interviews were conducted in Arabic and later translated into English. The majority of the participants were in the financial sector of JT, while some senior managers were from other sectors of JT – marketing, technical, strategic, information technology and human resources. Interviewees also included external parties such as a non-executive board member of JT. Each interviewee was provided with a summary of the research objectives prior to the actual interview. The interviews conducted can be classified as exploratory, in-depth and follow-up interviews. Permission was sought and granted for all three categories to be recorded on tape and later transcribed. In addition, notes were taken of significant points to facilitate follow-up probing questions. The exploratory interviews began with eight general (semi structured but focused) questions on JT and its accounting and financial management systems. Interviews in this category lasted 30 minutes and sometimes more than one hour, depending on the issues raised by the respondent. In depth interviews were conducted within the financial sector and among its staff in the main JT offices in Amman.

The in-depth interviews had three objectives, which were to obtain a description of organisational change in terms of, firstly, the structure and culture and secondly, the accounting systems; and the third task was to understand what the systems were and what they are today. During the fieldwork, the tape recordings made during the day were played back in the evening in order to reflect on the day's work. This invariably resulted in the need to seek clarification on certain issues which were either unclear or required substantive support. Follow-up interviews therefore became necessary for such issues. During follow-up interviews, some interviewees produced documents including memos to support their statements. This allowed a form of triangulation of research evidence. Interviews were conducted over a three-month period.

JT's management and its people demonstrated interest and were helpful in this study. Consequently, at the beginning of the fieldwork stage, JT's financial officer appointed the financial manager to arrange the interviews with those other JT managers who were initially interested. All the interviewees showed their interest by allocating a significant amount of time for the interview itself, as an important part of their job. Furthermore, they gave their business cards to the researcher in order to give him the opportunity to contact them, whether for further information or for future questions that might be raised concerning the study.

Historical Background

Telecommunications, along with other public utilities, is considered an important service for the standard of living of a people and for the development of an economy. Therefore, the telecommunications industry took on a significant role and was subject to public control. The history of telecommunications in Jordan can be traced back to early 1921. After the foundation of the Kingdom of Jordan, the Ministry of Post, Telegraph and Telephony was established, which further developed the country's telecommunications services. In 1971, a new government-controlled body, the Telecommunications Corporation (TCC) (*Muassast El Etessalat*) was established to take over the provision of communications services such as telephone, telegraph and telex. The Telecommunications Law of 1971 retained TCC as the dominant player in the sector. The law allowed TCC not only to deliver services, but also to act as regulator.

The outcome of these efforts did not satisfy the subscribers (customers), who complained that none of the benefits of the huge expansion in the telecommunications networks were being passed on to them. The majority of the call switching was manual. What is more, the government effort focused on satisfying the city centre populations, and neglected the countryside.
From 1973 to 1985, Jordan Telecom's network underwent significant expansion as part of a government investment programme. In 1993 the government was able to initiate a development programme known as the National Telecommunications Program (NTP).

In 1994, the government launched a programme to improve the telecommunications sector and participate in the international development in the telecommunications industry. Before 1995, the Telecommunications Corporation (TCC) was the regulatory body and the main operator of the telecoms sector. It used to handle all of the telecommunication services in the kingdom under the supervision of the Post and Telecommunications Ministry. In 1995, a new Telecom Law was issued that introduced the Telecommunications Regulatory Commission (TRC). It stated that the TRC should be financially and managerially independent to regulate the sector and to implement general government policy.

TCC became a registered company and was renamed Jordan Telecommunications Co. (JTC) on January 1, 1997. This date marked a turning point for the company in all its fields of operations, owing to its new administrative and financial independence. The company introduced changes and advances to the local, national and international switching systems and started the development of ground stations for satellite communications, and local area and wide area communication networks, in addition to the introduction of fibre optic technology as the network backbone. In order to achieve its future vision of maintaining its leading position in telecommunications services, the company embarked on the largest development project in the country, with a philosophy of "customer comes first" (Jordan Telecom, 2000). Full automation and computerisation of all activities and operations, especially with regard to customer care and service centres, was one of the developments that was planned.

Jordan Telecom is considered to be the largest operator and provider of telecom services, as it owns the nationwide network that constitutes the base for the various communication services in Jordan. An agreement was signed on January 23rd 2000, allowing the Jordan Telecommunications Corporation Investment Group, led by France Telecom, to buy into the company with 40% shareholding equity, while the Jordanian government retained a 60% stake. JTC is owned partly by France Telecom, with 88%, and partly by the Arab Bank Ltd. with 12%.

JTC started to draw up its plans and strategies for developing and upgrading the telecommunications network owned by Jordan Telecom, and it has the main network and the fundamental base for telecom services. However, the company's priority is to fulfil the requirements of the market and of its customers.

It seems from this brief history that JT's life contains three clear historical periods. The first period is from 1971 to 1995 (pre-privatisation era), between the first Telecommunications Law and the new Liberalisation Law in 1995. The second period is from 1995 to 1999 (transformation era), when it became necessary to develop the telecommunications sector by considering the international transformation in this vital industry. The third period is from 2000 to 2005 (post-privatisation era), which "saw the beginning of" a unique relationship between Jordan Telecom and France Telecom until the final liberalisation of the whole industry by the end of 2005.

External Organisational Environment Stimuli

This section of the study comprises two parts highlighting the significant role of the state of Jordan's on organisational changes during the three eras of JT's life. Moreover, it offers a deep understanding of organisational changes during these eras.

The Role of the State of Jordan

In many developing countries, the government's intervention in the country's economy is influenced by their experience as colonies of external powers (Tanzi, 1997). In such countries, the nationalisation of enterprises became a crucial decision at the time of independence (Tanzi, 1997). In the 1950s and the 1960s, especially in developing countries, the economic literature often assumed that the government was the best judge in deciding which public goods were essential or necessary and which were not (Tanzi, 1997). The assumption was that the government had more knowledge than the private sector on how the market and the economy operated, and what the citizens' needs were.

According to Abu Shair (1997), in Jordan's case the government intervenes through its public enterprises for three reasons. It intervenes, firstly, if there are no private parties willing to carry the risk of substantial capital requirements for capital-intensive projects which the private sector cannot afford. Secondly, it is the desire of the government to exercise control over industries to achieve some development objectives. Thirdly, there was a belief that the government had more capacity than the private sector to attract and negotiate with international associates about providing the capital and the technology.

There was a formal policy of ministerial intervention to control or determine pricing and wages. In the meantime, the employment policy was influenced by the government's decisions in terms of economic expansion or employment creation in areas of unemployment. There is also evidence regarding the government intervention from participant no 6 who commented on employment policy:

> I can remember instances when unemployment was at its peek, when the government would employ people regardless of whether JT needed them or not. Moreover, there was a lot of pressure from the government secretly to appoint some people in spite of their lack of sufficient qualification (Participant no 6).

Coercive pressures are relevant to understanding changes. They are basically imposed by the authority of the state through its legitimate power to formulate and enforce laws, regulations and rules in order to create a framework to organise relationships between organisations in the same industry (Scott, 1994). The role of the state of Jordan was noticeable from its actions at the macroeconomic level in the liberalisation of the legal environment in order to stimulate the microeconomic elements. The state of Jordan had adopted the successful restructuring of the economy and the privatisation of public enterprises as methods for the state to achieve sustainable social and economic development. Awadallah, who was the economic advisor to the Prime Minister (1999: 4), points out the role of the state action at the macroeconomic level:

> The restructuring effort has been largely successful in addressing itself to the productivity and efficiency of the various sectors. New laws have been enacted including a new Investment Law, Tax Law, Companies' Law, Customs Law, Securities Law, Competition and Anti Trust Law, Electricity Law, and Telecommunication Law. Regulatory Bodies and Commissions have been established for Securities and Telecommunication… in the meantime, all the restrictions on foreign exchange have been totally removed (Awadallah 1999: 4).

In this regard, privatisation in Jordan has been adopted in order to achieve political, economic and social objectives. Alnaboulsi (1999: 14-15) points out that privatisation in Jordan has six major objectives:

1. To raise the efficiency, productivity and competitiveness of economic enterprises.
2. To facilitate the transference of the advanced technology and modern management techniques required to reinforce Jordan's economic competitiveness.
3. To develop the local capital market while steering private savings towards long term investments.
4. To stimulate local private savings and attract local, regional and foreign private investments.
5. To stop public funds being drained in the form of subsidies and loans granted to loss making and unprofitable public enterprises.

Internal Organisational Environment Elements

Design Archetype. During the post privatisation era, the management structure and style was governmental management, and its decision making dovetailed with government policy in terms of the pricing of the services and subscription fees. To integrate government policies, a decentralisation management was adapted. Therefore, JT's organisational structure was organised into four main sectors or departments, the technical, financial, human resources, and subscription departments. The huge technical sector got significant attention from the management. The financial sector had limited responsibility and authority. The responsibility of the human resources department was also restricted to particular tasks such as preparing the payroll sheets and the schedule of employees' absence and attendance. Moreover, it did not have any power or authority over appointing employees. The authority of the subscription department was limited to distributing the bills and collecting the money. Moreover, the company had no marketing department at all, and in addition, the technical department was not involved in the decision making process. Participant no 11 pointed out the significant change in interpretive scheme from a technical ethos to being market oriented, led by the marketing sector and supported by the financial sector:

> Before the privatisation we had an abundance of highly qualified engineers and technicians. Now, it is almost the opposite. We (JT) have probably got several qualified accountants and financial analysts. They are highly professional in their jobs and they now have a power base in a way they have never had before. But, right now I think there is no dominant sector, so all the sectors are working in parallel to achieve JT's new vision (Participant no 11).

Since the government observed international changes that were taking place, particularly in the telecommunications industry, several actions were taken. For example, Price Waterhouse Coopers and Merrill Lynch were appointed to restructure JT and improve its financial sector. Therefore, JT altered the accounting system from a manual to a computerised one by adapting a ROSS system in 1996, purchased for US$ 850,000 (participant no 7). As a result, a marketing sector was created in order to realise a new vision of a "customer oriented" JT. The new organisational structure contains six main sectors, Financial, Marketing, Information Technology, Strategic, Technical and Human Resources.

Alongside the hiring of financial analysts, the introduction of sales and marketing people brought entirely different values to the former government departments. The customer focus, product development and entrepreneurial behaviour that the new members introduced to these organisations had a significant impact on how they operated. Such extensive changes in professional demography and power relations were encouraged by new organisational policies where investment decisions had to be based on commercial and financial measures, not on engineering superiority.

Sub-system. The powerful professional groups of finance, marketing and information technology were particularly affected by the tremendous change through commercialisation post privatisation as JT transferred responsibilities from technical groups to other professional groups such as marketing and financial. The dominance of technical professions pre-privatisation can be explained by the importance of technical skills for the early development of various industries. Through transition and the privatisation process, the technical sector's influence had been reduced. Finance, marketing and information technology became vital resources for organisational survival. Concerning the role of the accounting system during the pre-privatisation era, Participant no 7 said:

> In the end of 1980s, Arthur Anderson, the auditor, was appointed by the Board of Directors because they were appointed by the Ministerial cabinet, and reported to them rather than to the Auditing bureau. Furthermore, a commercial accounting section was created, but unfortunately, the management did not consider the reports produced by either of them. I can say that the board created them nominally (Participant no 7).

This evidence shows that the accounting system was incidental, ignored and neglected. It is obvious that during the pre-privatisation era the technical sector was dominant, and therefore, the engineers played the major role. Moreover, all the regional department managers were engineers.

At the level of the subsystems, the effect of this change on the design archetypes was to generate more information to consider. For every decision, JT's managers in different sectors and levels now had to consider accounting information concerning business profit as well operating the information based on adherence to the timetable which they had previously used. The quantity of accounting information having to be manipulated increased the coherence of the structure.

This change in the subsystem could not have occurred without qualified employees. Therefore, during the transformation era, the management extensively recruited some professional staff from other organisations particularly in the financial, marketing and information technology sectors. During the "meta-colonisation" period, JT's management had become more aware of the role of the qualified employee in carrying things out and leading JT to the future. In addition, without accurate and adequate information, JT's new strategic decision making was not possible. As a result, the majority of JT's managers are qualified, with, for instance, the financial sector managers having a specific professional certification such as CPA, CMA, CIA or CFA. In this regard, participant no 13 pointed out the new management philosophy regarding training programmes and JT's policy in choosing new staff.

> Right now, the first degree, the Bachelor's, is not enough to get a job in JT. So, candidates holding a professional certificate have more chance. Moreover, they created a specialised department to run training programmes, not only technical, but also financial marketing and social programmes. It is worth noting that, we have a specific training programme to enhance the employees' morality and loyalty (Participant no 13).

Interpretive scheme. Cultural transformation was parallel to changes in the organisational structures of JT. Prior to 1997, JT was a technically oriented organisation organised for engineering dominance in building infrastructure (networks) rather than providing customer services. Corporatisation, deregulation of the market telecommunications industry and privatisation, however, brought a completely new cultural approach based on market values and creating value for the shareholder. One of JT's managers elaborated on the new values:

> One of the key drivers for putting in the bonus scheme, besides improving the company's performance, was to try and align the interests of the employees to those of the shareholders and to start to get people thinking about shareholder value as opposed to just doing a good job. A good job is not good enough (participant no 18).

Within JT, strategies were developed to create a new corporate culture by changing management, decision-making processes, staff attitudes and performance measurement. The development of the new systems and processes in different areas of operations attracted more attention.

Privatisation brought new ways of achieving individual and organisational goals into these organisations. The organisational structure in JT was further developed to create an optimal system at different levels of management. The new cultural 'paradigm' was for people to take responsibility and depend on their own vision and the vision of their leaders, rather than on the boundaries created by existing technologies or institutionalised rules and policies. This is how one of the human resource managers (participant no 12) describes attempts to change JT's organisational culture:

> We are trying hard to drive into JT a strong sense of individual accountability for results. It is the employee's accountability and it is he/she who makes the decision and wears it, good or bad. We think accountability for outcomes or the result is very empowering creating an environment for innovation and for people to take some risks to make some choices about where their own jobs are heading (Participant no12).

The new managerial, professional and financial structures suggested by PriceWaterhouseCoopers were in place by the beginning of transitional period in 1995, and were made possible by JT's radical transformations. With significant pressure from the government, a new professional board member and qualified managers who were attracted from other organisations were able to formulate and realise market-oriented strategies. In terms of the public service approach of its former technically dominated government departments, JT went through significant changes in the number and structure of employees and radical transformation of management systems towards a customer-oriented approach.

Moreover, new technologies, market conditions, and, finally, managerial and professional structures required innovative strategies. The threats and opportunities of a competitive environment were recognised and built into diversification strategies immediately after corporatisation. Therefore, JT decided to enter the competitive business. In 2000, the Jordanian government signed an agreement with the Joint Investment Telecommunication Company (JITCO) for the sale of 40% (250 Million shares) of the Telecommunication Corporation JITCO at US$508 million (El-Khatib, 2002). At the same time, El-Khatib (2002) highlights the "shareholding agreement" which specified the rights and responsibilities of all partners. Referring to the management responsibility, El-Khatib also revealed that a new Board of Directors was created which signed a management agreement whereby FT would manage JT for five years. Privatisation of the telecommunications industry was believed to be an essential and inevitable strategic step. As a result of this new strategic orientation, JT joined an alliance with FT that established Jordan's first alternative telecommunications company (participant no 19).

Another new initiative involved the internationalisation of businesses. Although the domestic market provided a natural basis for their operations, the importance of international markets increased during the transitional period. This trend was reflected by internationalising with suppliers of technology through ownership arrangements (joint-venture and long term contracts) as well as by the sale of knowledge and expertise in international markets (El-Khatib, 2002).

Radical changes in strategy and organisational form were encouraged and supported by the strategic intent of the owners (both government and private acquirers). It is important to point out that in the privatised JT, the new owner, FT, came from within the same industry as its acquisition. In addition, JT's privatisation took place within a deregulated environment but without any active competition.

Following the modernisation and liberalisation of legislation, the signing of many commercial treaties, and the signing of a Free Trade Area Agreement (FTAA) with the USA in 2000, The Jordanian Euro-Mediterranean Association Agreement (JEMAA) of 2002 replaced the Association agreement signed in 1997. Jordan joined the World Trade Organisation (WTO) in 2000 (Hikmat, 2005), and JT become an attractive target for overseas investors for several reasons. First, the telecommunications industry in Jordan was under-developed with potential for a range of innovations. Second, Jordan, in the late 1990s, was a rapidly developing economy with good potential for competitive development, particularly in the telecommunications sector. Third, the country had a solid institutional foundation for such rapid development, a technically well-educated workforce and an innovative culture. Finally, Jordan's geographical position enabled overseas investors to use it as a stepping stone to larger markets in the Middle East region. One of the JT managers (participant 19) commented on the acquirers' motives in the following way:

> Due to these facts, the Jordanian government insisted on attracting a technical and managerial expert as a strategic partner; France Telecom was that expert. Actually, France Telecom represented an investment (participant 19).

Moreover, one of the managers (participant 13) identified the significance of Jordan's geographical situation for FT.

> There were many reasons for France Telecom to enter Jordan's Telecommunication market. The first is the existence of qualified employees. The second, fundamentally significant, is that FT has strategic plans to enter the larger market in the Middle East, so I can see JT will be a stepping stone for FT to access the Middle East market (participant 13).

With this aim, the new owners preferred to retain market dominance for as long as possible and to draw out the profits needed for the realisation of a long-term strategy. It seems that the JT's culture under the government era can be described as a passive culture.

Discussion and Conclusion

This study uses LOCM to help understand JT in an organisational context. This is done by dividing JT's life into three eras defined by the major motivation within them (see figure 2). The first era is a Pre-Privatisation Era. This period represents JT's existence from 1971 to 1994 (see figure 3). The major role is played during this time by the government, exercising its role in stimulating the organisational form to enable JT to provide public services. In the JT of this period, the government was one of the major stimuli, appointing board members who were members of the government, selecting the executive manager, exercising more pressure in filling the vacancies and exerting ministerial accountability for the organisation management through the Minster in charge.

The second era is called the Transformation Era, which is divided into two periods. The first is 1995-1996, which is compatible with the reorientation model suggested by Laughlin (1991). The second is 1997-1999, which fits with the colonisation model (see Figure 3). During the Transformation Era there were many governmental efforts to restructure the telecommunications industry in order to establish the new vision. As a step towards privatisation of the telecommunications sector, Jordan's government corporatised Telecommunications Corporation (TC), a government-owned entity, and created Jordan Telecommunications Company (JTC), a public shareholding company that opened most of its activities to private operators. The corporatisation of state enterprises in Jordan is regulated by the Companies Law, which allows the transformation of these enterprises into public shareholding companies fully owned by the government. During this era, the government issued and renewed several laws such as privatisation law, securities law and investment law.

The third phase is the Post-Privatisation Era, which ran from 2000 up to the liberalisation of the telecommunications sector at the end of 2005 (see Figure 3). The main distinguishing feature of this period was an alliance with France Telecom (FT) in order to acquire newly developed technology in the telecoms sector in which JT itself was unable to create technological development. The Jordanian government (1998) highlights the importance of protecting its interests and putting some aspects of industry into the privatisation process, particularly the telecommunications sector. Therefore, the government determined certain conditions that should be available after the strategic partner had been chosen. The Jordanian government refers to the desperate need of the organisation for certain inputs not available in the local market such as new technology, precise technical and managerial experience, and development techniques. The second requirement is the existence of these resources in the international market and the availability of a qualified international organisation to transfer these needs. The Jordanian government (1998) asserts that JT desperately needed to transfer developed technology, which can be achieved by conducting an official relationship with a strategic partner in an alliance. Thus, the two factors of RDT are obtained. To build a theoretical complementary relationship between LOCM and RDT, the study considers the official alliance between JT and FT, which is a basic motivation for organisational change post-privatisation. Therefore, the existence of the unique relationship between JT and FT led to significant organisational changes in order to set up JT for potential regional competition. To allow integration between LOCM and RDT, this study named this period 'meta colonisation'. Figure (3) shows the organisational changes in JT through the three eras.

In this paper, the integration of different theoretical frameworks helped the researcher to analyse and understand the process of the change in JT. Institutional theory facilitated a researcher focus on the role of the Jordanian state in the form of intervention in the economy. It has been argued that the role of the Jordanian state was basically to stimulate the organisational environment through political and economic decisions, and by developing the legislative environment and creating the regulatory framework. It has been argued that the changes in the role of the government provide a significant and unique opportunity to examine the organisational transformation from public to private sector.

Furthermore, the combination of three theoretical frameworks has assisted the researcher in understanding the pathway of organisational change through JT's life. The researcher used the institutional theory to articulate the coercive role exerted by the Jordanian government; Resource Dependency Theory gave a deep understanding of the alliance between JT and FT and considered an important factor in radical organisation change; and the Laughlin Organisational Change Model gave a deep understanding of the inter-relationships between changes in design archetypes, subsystems and interpretive schemes.

The study presented evidence for integrated changes both between the elements of interpretive schemes and other components of organisational form, design archetypes and subsystems.

Studying the pathways of radical change in JT seemed to be an acceptable model for studying other cases where the nature of interpretive schemes is critical to organisational survival. The challenge for future research is to identify and

Figure 3 The organisational changes in JT through three eras

Era	Pre-Privatisation	Transformation		Post-Privatisation
Periods	1971 -1994	1995-1996	1997-1999	2000-2005
Coercive pressures	The state	The state	The state	The state / strategic partner
Organisational form	Governmental	Restructuring	Corportisation	Business
LOCM	Rebuttal	Reorientation	Colonisation	Meta Colonisation
Interpretive Schemes	Public service, political constraints, justice and fraud prevention, engineering culture	No change	Market orientation	Business culture, customer orientation.
Sub-system/ Accounting System	Incidental and neglected, manual system, less qualified employees	Adapting some developed computerised accounting system	Attracting some qualified employees	Hiring qualified employees, multiple training programmes, reduction in unqualified staff

analyse the new organisational environment for JT, particularly after liberalisation of the whole telecom industry at the end of 2005, and to develop a theoretical framework for the extensive understanding of organisational changes in such privatised companies. Further research into the privatisation of public sector enterprises in Jordan's context needs to be viewed from a different perspective that will address the role of the unique relationship between JT and FT.

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Changing Jobs, Changing People: Developing Employee Selection Processes in Radical Change Settings

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Abstract

In recent years, there has been growing recognition that organisations are required to acquire change management capabilities in order to survive and flourish in radical change settings. We posit that the examination of change at the individual level is a neglected area of study within the organisational change discourse. The underlying basis of this conceptual paper is that the effective management of organisational change should incorporate recognition of the fact that people, as well as organisations and their operating contexts change over time. In this paper, we seek to apply this thinking to the specific issue of employee selection.

The main aim of this paper is to examine critically, with reference to change at the individual level, the efficacy of using selection methods to predict behaviour. It is argued that the procedures that have improved the efficiency of selection in recent years should not be abandoned. We argue that there is a need to adopt a genuinely integrated approach to traditional HR activities such as selection, performance management, training and development and job design, which recognises the fact that individual employees change over time. It is proposed that data relating to the skills and aspirations of employees should be gathered from an ongoing developmental process, linked to activities such as performance appraisal and job design, as well as entry-level selection. In addition to informing key HR decision-making processes linked to change management initiatives, recognition of this developmental process would serve to dispel any prevailing view that the identification of skills and abilities is an activity that can be conducted solely during traditional selection procedures.

Keywords: Employee Selection, Organisational Change, Development, Learning

Introduction

It is increasingly apparent that the effective management of change and development at the organizational level is a vital yet problematic activity (Mozenter, 2002; Newman, 1998). Mainstream Human Resource Management (HRM), Human Resource Development (HRD), and Organisational Development (OD) activities are now inextricably associated with change management issues to such a degree that the disciplines of HRM, HRD and OD appear to be converging around organisational change themes (Ruona and Gibson, 2004). This convergence is an international phenomenon and it raises concerns about whether HR-related change management ideas and techniques are cross-culturally transferable (Fey et al., 2004; James, 2004; Michailova, 2000; Perlaki, 1994). Nevertheless, it is apparent that change management issues are now dominating HR-related activities in the global setting (Mendenhall et al., 2003).

HR theorists have identified key levers, such as performance management and reward systems (Storey, 1992) which they argue, have a vital role to play in creating flexible organisations that are capable of surviving and flourishing in radical change settings. One of the HR levers that has attracted a particularly high level of attention in

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recent years is employee selection (see Iles and Salaman, 1995). The role of selection is seen as integral to strategic HR practice, as the performance of employees is considered in the light of its contribution towards the realisation of strategic objectives (Smid, van Hout and Burger, 2006). Yet the issue of employee selection is particularly problematic in radical change settings as the tasks associated with a particular role are likely to change over relatively short periods of time, thus raising questions about the criteria upon which selection should be based. The main aim of the paper is to examine critically the efficacy of using selection methods to predict behaviour. However, rather than emphasising solely the selection issues associated with changing environments, changing organisations and changing job roles, this paper also explores selection implications surrounding the fact that people, as well as organisations and their operating contexts, change over time.

At the outset of this discussion, it should be noted that relevance and applicability of models of HR and their associated selection techniques, are heavily dependent upon cultural and social variables (see Budhwar and Debrah, 2001; Iles and Yolles, 2003). For example, the choice of specific selection methodologies may be highly dependent upon prevailing legal frameworks (Wolf and Jenkins, 2006). There is little evidence to suggest that models of selection are common to, or indeed are transferable in, the international arena. Hence, it is not surprising to note the stark contrasts that have been drawn between selection practices, for example, in countries such as the UK and India. Budhwar and Khatri (2001: 805) cite Kanungo and Mendonca (1994) and Sharma (1984) in drawing their conclusion that there is: *'a strong influence of social, cultural, economic and political factors on HRM policies and practices in Indian organisations. At times, selection, promotions and transfers in Indian organisations are based on ascribed status and social and political connections... Motivational tools in Indian organisations are more likely to be social, interpersonal and even spiritual... In contrast, such a situation does not exist overtly in British organisations'*. Further, differences in selection and assessment practices should not necessarily be seen to exist solely between western-based organisations and the rest of the world. For example, Strauss (2001: 886) has drawn attention to fundamental differences that exist between British and US perspectives and approaches to HRM, as reflected by the more legalistic and technical US HR texts that cover such topics as selection test validation.

While recognising these differences in selection practices, it can be argued that these differences in themselves provide an opportunity for managers and organisations to engage in vicarious learning based on the success and failure of HR initiatives in diverse settings. For example, the formalisation of selection that has occurred within the UK has produced a number of interesting and valuable insights into the process of the selection and assessment of managers. The wide-scale adoption of psychometric tests and procedures by organisations in the UK has led to the production of a wealth of knowledge relating to the strengths and limitations of a number of methods of selection. Thus, at very least, knowledge of the weaknesses of a selection method that have emerged in one setting, can be used in varying ways to inform practice in other settings. This paper considers the changing nature of employee selection. The extent to which data derived from selection methods does actually predict job-related behaviour is discussed with reference to psychometric criteria which, in many cases, are used to justify the use of these methods. In the light of this analysis, the paper proceeds to call for an increased appreciation of the changing nature of both workplace activities and of people in all HR related activities.

The Changing Nature of Employee Selection

Traditional management selection within countries such as the USA and UK has been based upon task-orientated methodologies. Selection has been based on predictions surrounding the capacity of candidates to undertake specific job-related tasks. Traditionally, this selection process has involved the production of detailed job descriptions based upon job analysis. Techniques such as critical incident methods, repertory grids and diaries are used in order to clarify the precise duties and responsibilities of post-holders (see Blum and Naylor, 1968). Barrett (1996: 88) summarises this traditional approach to assessment by highlighting that: '*the objective of job analysis is to translate an organisation's policies into what is expected on the job*'; hence: '*job analysis data is closely tied with many personnel functions, includ-*

ing selection, compensation, training and performance appraisal…'. The production of personal specifications based on detailed job descriptions provides formal clarification of the person-related factors such as educational background, appearance, motivation and mental ability that selectors deemed necessary in order to perform the job at the standard required. The demands of the day-to day duties of posts are assessed in relation to these factors and candidates are then assessed against the factors.

This task-based selection has faced criticism for a number of reasons. For example, conventional job analysis is dependent upon the stability of the post in question. Selection that is based solely upon a candidate's ability to perform particular tasks is considered suspect because the tasks may well undergo fundamental changes on a frequent basis. This observation is particularly pertinent to radical change settings where the very societies in which organisations are located are undergoing transition (Alas and Rees, 2005; Alas and Rees, 2006). As a result of such criticism, there has been a general shift away from task-based selection towards a more person-centred approach (see Smith and Robertson, 1993). Lawler (1994: 9) states that there is now a need for selection processes: 'to focus on identifying people who can learn and follow the various career tracks that are available in the organization ... In a more traditional job-based approach, in which organizations simply worry about filling jobs, the skills competencies of employees receive less focus'. On a similar theme, Iles and Salaman (1995) point to the "increasing emphasis" given to managerial competencies, and the need to identify the key managerial skills that underlie effective management performance. Organisations have sought to measure these managerial competencies through the use of two complementary strategies (Rees and Doran, 2001). First, traditional selection methods have been re-designed to focus upon the assessment of competencies. This is particularly true of the selection interview (see Barclay 1999; Barclay, 2000). Second, there has been a move towards using a range of selection methods as opposed to relying on a single method such as the interview (CIPD, 2006). This multi-method approach to selection is reflected in the widespread use of assessment centres that incorporate a range of assessment methods designed to measure the competencies required for the post.

The move towards person-centred assessment has led to the use of person-centred assessment methodologies, together with complementary evaluation processes. The primary purpose of such assessment is comparative, that is, to discriminate between candidates. This objective has led many selectors into normative, as opposed to idiographic person-centred methodologies. In particular, the psychometric approach to assessment has, over the last three or four decades, tended to dominate selection theory and practice within the UK. Words and phrases such as selection ratios, quadrant analysis, utility analysis, reliability, validity, and meta-analysis have emerged to occupy a central stage in selection practice, as well as in selection literature. This observation is made not to challenge the psychometric perspective on selection and assessment but rather to consider a number of issues that are emerging from data that has been generated from the application of psychometric procedures in selection settings. Specifically, the data that has emerged about the generalised *validities* of various selection methods raises a number of issues that are of particular relevance to integrated HR practice.

Validity of Selection Methods

The widespread adoption of psychometric methods of assessment has inevitably led researchers to consider the efficacy of various selection methods using psychometric terminology. Indeed, Lavigna and Hayes (2004: 244) identify the emergence of validation studies for entry-level selection tests and examinations as a key trend in occupational selection practice. Further, they argue that it is: '*...essential that any test protocol be validated for job-relevancy and discriminatory impact'*. Certainly, HR and occupational psychology literature is replete with quantitative studies and discursive accounts relating to the relative worth of a number of popular selection methods, particularly interviews, personality questionnaires, ability/aptitude tests, bio-data and assessment centres (for example, see Harris and Lee, 2004: Higgins and Judge, 2004; Jones and Fletcher, 2004). Validity has emerged as the key indicator of the predictive value of a selection method. It has been described as the extent to which a test measures what it purports to measure (Rees, 1996). Validity is usually expressed in the form of coefficients; these coefficients are often calculated by correlating scores obtained on selection tests with scores obtained on measures of job performance.

Interestingly, attempts have been made to rank the quality of selection methods according to generalised validity coefficients (see Taylor, 1998). The general consensus that has emerged is that multi-faceted selection methods, particularly in the form of assessment centres, tend to produce higher validity coefficients than uni-faceted methods of selection such as interviews. Hence, Taylor states that assessment centres for promotion are likely to yield validity coefficients in the region of +0.6, whereas personality questionnaires used for selection may yield validity coefficients in the region of +0.4. Validity coefficients have also been used to make comparisons between different approaches to the design of a single selection method. For example, Cooper and Robertson (1995: 81) point to the "*poor predictive power"* of the traditional selection interview: *'typically their mean validity coefficient is less than +0.2, whereas the mean validity coefficient for structured interviews is in the region of +0.44'.*

In recognising that validity coefficients for selection methods are cited and compared, the question that arises is how a specific validity coefficient should be interpreted. In order to address this issue of interpretation, general guides can be found in the literature as to what constitutes an 'acceptable' validity coefficient for selection purposes. For example, Smith and Robertson (1993: 129) state that: '*the following benchmarks may be used as a rule of thumb guide: over 0.5 – excellent; 0.40 to 0.49 – good; 0.30 to 0.39 – acceptable; less than 0.3 – poor'*. Arguably, the production of these rule of thumb guides is indicative of the fact that the statistical interpretation of the validity coefficient is not altogether straightforward. Problems attached to the interpretation of correlation-based validity coefficients have long been recognised (see Cronbach, 1970). Thus, at face value, a validity coefficient of +0.4 is 'better' than a validity coefficient of +0.2, as the coefficient of +0.4 is likely to indicate a closer relationship between scores on the selection test and scores on the measure of job performance. Yet, it should be noted that correlation coefficients are not linear expressions; a validity coefficient of +0.4 should in no way be seen to be 'twice as good' as a validity coefficient of +0.2. Similarly, the difference between the predictive values of two selection methods with validity coefficients of +0.6 and +0.4 is not the same as the difference between the predictive values of two selection methods with validity coefficients of +0.4 and +0.2.

Arguably, the interpretation of validity coefficients is one of the most neglected issues in selection literature. The reasons for this are unclear. Perhaps, for reasons explained below, some of those who are sympathetic to psychometric methodology are uneasy about entering into a debate in this area. On the other hand, many of those who remain unsympathetic to psychometric methodology may hold no real desire to explore the statistical interpretation of a concept that they view as positivist and generally unhelpful. Yet, it is proposed that the interpretation of validity coefficients merits scrutiny, if the strengths of the psychometric approach to assessment are to be built upon and the limitations of the psychometric approach recognised.

Interpretation of Validity Coefficients

References to texts on psychological statistics reveal that the Pearson product-moment correlation coefficient (r) used to calculate validity coefficients may be interpreted in a number of ways. Two ways of interpreting r are summarised in Table 1 below. Thus, the second column of Table 1 reports a variance interpretation of r, and hence of validity coefficients. It can be seen that a validity coefficient of +0.2 can be interpreted as meaning that only 4% of the variance in job performance is accounted for by performance on the selection test, that is, 96% of the variance in job performance is not associated with scores on the selection test. Similarly, only 16% of the variance in job performance is accounted for by scores on a selection method with a validity coefficient of +0.4 (a magnitude described by Smith and Robertson as "*good*").

The third column of Table 1 portrays a second method of interpreting validity coefficients, namely using coefficients of alienation. Thus, for a selection method with a validity coefficient of 0.00, the error of an estimate based on the coefficient of alienation is, predictably, 1.00 or 100%. For a selection method with a validity coefficient of +0.6 (a magnitude that falls within Smith and Robertson's "excellent" category) the error of an estimate has been reduced by only 20% when compared to the use of a selection method with zero validity. Only when the validity of a selection method approaches a rather imaginary figure of +0.90 does the error of an estimate reduce by 50% when compared to the use of methods with zero validity.

Table 1 Interpreting Validity Coefficients

Validity Coefficient (r)	% Variance Explained (r^2 x 100)	Values of Coefficient of Alienation: $\sqrt{1-r^2}$
0.00	00	1.00
0.10	1	1.00
0.20	4	0.98
0.30	9	0.95
0.40	16	0.92
0.50	25	0.87
0.60	36	0.80
0.70	49	0.71
0.80	64	0.60
0.90	81	0.44

Implications of Variance and Error of Estimate Interpretations of Validity

The preceding discussion helps to explain the emphasis that psychometricians place upon the development and refinement of 'valid' selection methods. It becomes apparent that selection methods that produce validity coefficients of less than +0.3 have questionably practical value when attempting to use the scores they generate to predict job performance at the individual level. This statement is based upon the very principles that are espoused by those who are sympathetic to the psychometric model. It is the authors' opinion that psychometric literature has performed a valuable role in highlighting the limitations associated with popular standardised selection methods. Consideration of the 'hallowed' principle of validity reveals that even the best predictors of job performance explain the variance on measures of job performance in a rather limited way. Using variance interpretations of the validity coefficient, Table 1 confirms that it is highly unlikely that scores on a selection method will share 50% of the variance associated with scores on the measure of job performance. The challenge for the constructors of selection methods is to account for the unaccounted variance. This may involve designing new selection methods. It may involve the continual refinement of existing methods in order to identify and remove sources of error variance. It may involve placing a greater emphasis on the development and refinement of appropriate measures of job performance. It may involve emphasising the need for selectors to establish a *priori* links between test scores and scores on these refined measures of job performance. It may involve devising strategies to ensure that sources of error associated directly with test-takers are reduced as far as is possible. It may involve trials of new cocktails of established selection methods in order to produce elevated validity coefficients. As was alluded to earlier, the improvements in validity coefficients surrounding the use of structured as opposed to unstructured interviews suggest that it is possible to improve, over time, the validity coefficients of even the most traditional of selection methods.

Nevertheless, in considering the implications of the relative limitations of selection methods, it does seem reasonable to at least question whether the limited advances in selection and assessment practice that have occurred over the last two or three decades have reached a plateau. Certainly, it is difficult to argue that there have been major steps forward over the least two decades in areas such as interviewing, personality testing, ability testing and assessment centre methodology. This statement is in no way intended to minimise the benefits that have accrued to selectors as a result of incremental refinements that have occurred in relation to, for example, interview practice. The statement is based on the absence of studies to indicate major breakthroughs in selection practice, as demonstrated by reference to validity coefficients obtained in selection settings. In view of this observation, it does seem appropriate to hypothesise that the next major breakthrough in selection practice will occur only when the very concept of employee selection has been re-thought.

Changing Jobs: Changing People

Despite the move towards competency-based selection procedures noted above, it is proposed here that selection is still treated as the focal point of employee assessment by many organisations. The view is prevalent that entry-point assessment mechanisms have the capacity to identify future potential. For example, it has been argued that even the organisations that adopt internally orientated HR policies, and hence have a commitment to the internal development of the workforce, still need:

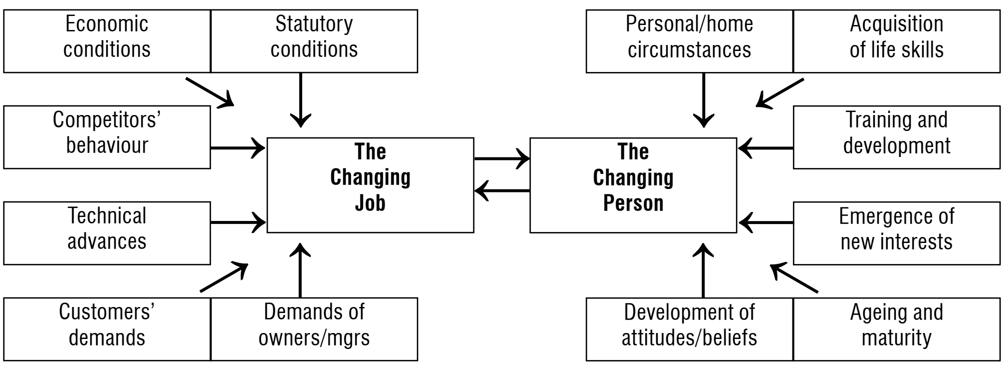
> *'...careful selection procedures that take into account not only the candidates' technical qualifications for the positions to which they will initially be assigned, but also their personal characteristics (such as loyalty, ability to fit in with the organizational culture, and willingness to accept permeable and expandable job-roles) and their future potential... Even in the selection of employees who will be initially assigned to entry-level positions at the bottom of the career levels, the selection procedures will emphasize the candidates' potential for future advancement. This allows organizations to have more confidence that they will be able to recover the costs of broad and in-depth training for new recruits and that they will be able to draw upon the steadily increasing capabilities of employees who had initially started out in lower positions.' (Barnard and Rogers, 2000: 1019).*

It is apparent that assessment conducted during entry-level selection is seen by some as an activity that can be used not only to identify personal characteristics such as loyalty, but also to identify candidates with the long-term potential for future advancement within the organisation. Two specific issues are raised here about this view of selection. First, the preceding sections of the paper have identified the limitations of selection methodologies when they are used to predict the job-related behaviour of candidates who have applied for specific existing jobs. In view of this, there is very little evidence to suggest that current selection methodology can provide accurate long-term predictions of candidates' future behaviour in relation to unclear future roles within an organisation.

Second, such a view of selection contains a number of major assumptions about learning and development, and arguably about human nature itself. It is understandable that heavy emphasis should be placed upon selection when one considers that selection provides an entry port to the organisation; even the existence of employment legislation provides an incentive for employers to take the process of selection seriously. What is challenged here is the determinism that underpins the view that accurate long-term predictions of a person's future behaviour can be achieved in a meaningful way. Such predictions cannot take account of potentially defining unanticipated events in life such as marriage, parenthood, bereavement, religious experiences, and illness, let alone overlapping variables and concepts such as ageing, maturity, learning and development. Further, when practised, this type of determinism (that, incidentally, complements the biological determinism found in the writings of leading psychometricians) can be seen to undermine general attempts within organisations to foster and encourage learning and development processes. For example, the characterisation of socialization as a potentially beneficial change and development process (see Fisher, 1986) has been used to explore the career success of Asian managers (Chow, 2002). Yet if one adopts the deterministic perspective of employee behaviour highlighted above, effective socialisation programmes will be beneficial only to those employees who already possess, at their point of entry to the organisation, a propensity to engage successfully in socialisation tactics.

In summarising this discussion, Figure 1 highlights a number of broad and overlapping factors that help

Figure 1 Changing Jobs: Changing People



to explain why, for example, the person that an organisation recruited say two years ago cannot be assumed to be the same person today.
Figure 1 is intended to be indicative as opposed to definitive. It emphasises that the person-job match, so frequently discussed in selection literature, has to take account of both the changing nature of jobs and the changing nature of people. One research hypothesis that has received scant attention in psychometric literature is that much of the unexplained variance surrounding selection procedures may be explained with reference to the changing skills, knowledge, needs and aspirations of employees. That is, the limitations that surround attempts to link selection and performance data may, in part, be due to the fact that people change over time. Model building and testing surrounding this hypothesis may provide fresh thinking and insights into not just selection procedures, but also the discussions about the integration of key HR activities and functions.

Moving Forward: Integrating HR Activities

The paper has drawn attention to two specific problems that are central to predicting the job-based behaviour of candidates. First, attention has been drawn to the changing nature of the workplace; the tasks included in today's job descriptions may be very different from the tasks included in the job descriptions of tomorrow. Second, whilst the changing nature of tasks and jobs is recognised in selection texts, many such texts fail to recognise the truism that people, as well as jobs, change over time.

The importance of selection has already been highlighted in this paper; precisely because of the importance of selection, it is vital that the predictive limitations of current selection methodologies are recognised by all organisational stakeholders. Recognition of these limitations should be reflected by the extent to which key HR activities are clearly integrated in order to utilise the developing aspirations and strengths of employees. There is some evidence to suggest that the integration of HR activities has been taking place in recent years. For example, one recent survey of a group of Australian HR professionals found that the: '*integration and strategic focus of HR policies*' was the most significant change to HR that had occurred over the previous five years (see, Fisher, Dowling and Garnham, 1999: 512). In terms of future HR activity, Fisher et al. conclude: *'there is strong agreement within this group that HR policies need to be integrated and strategically focused'*, and this call for the strategic integration of HRM activities has been echoed in other places (Sheehan, 2005). The exploration of managerial selection within this paper draws further attention to this need for integration; a number of specific integration-related issues are summarised below.

Selection as an Ongoing Activity

First, entry-point selection should be seen as the first stage of an ongoing employee assessment programme. Interestingly, selection is sometimes referred to as a snapshot of a candidate's knowledge, skills and ability. With Figure 1 in mind, perhaps it is more appropriate to consider selection as equating to the filming of the first scenes of a motion picture; selection is the beginning of filming rather than the making of the film in its entirety. It is noteworthy that phrases such as lifelong learning, self-directed learning, continuous development and the learning organisation have become entrenched in the management vocabulary, if not practice, of the 21st century. If organisations wish to promote learning and development as activities and processes that take place on a daily basis, it is indefensible to argue that entry-point selection data are the key to long term career planning. It is relevant to note that, whilst in the past, performance appraisal may have been seen as an annual or biannual event, more recent thinking recognises that the appraisal of performance is an ongoing activity. What is being proposed here is that a similar change of mind-set is required in relation to managerial selection and assessment. Just as performance appraisal can take place informally on a daily basis, so can an assessment of the development of employees' knowledge, skills, understanding and needs.

Performance Management and Selection

Second, if it accepted that managers do change and develop over time, questions arise as to *how* organisations can tap into the positive aspects of such developmental processes. The use of development centres may provide an opportunity for organisations to continue the so-called filming process mentioned above. However, formalised development centres are often linked to career and promotion opportunities and as such there is a tendency for development centres to revert to selection-based assessment centres. In order to overcome this problem, it is suggested that performance management systems should be more closely integrated with employee assessment systems. For example, the performance appraisal element of performance management could be used as an opportunity to discover the new skills, new aspirations, new interests and needs that are emerging in the lives of employees. It is proposed that many employees may welcome the opportunity to talk about such matters, provided appropriate safeguards were put into place to ensure that such assessments of development were seen positively by employees and not as an unwelcome intrusion into their 'private' lives. Thus, rather than attempting to attain ever-greater degrees of precision in defining job-roles and their associated role-incumbent requirements, it may be more beneficial to engage in dialogue, designed to create a shared sense of meaning between employees about the contribution they can make to the organisation. The information obtained from this dialogue could then be fed into HR activities such as career planning and training and development.

However, where such dialogues are constituted as part of performance management systems, Deming (1986) refers to an inherent problem which is the failure of such systems to increase organisational effectiveness to its full potential. This arises because of the tendency in assessment to focus predominantly on a manager's individual targets, possibly with performance related pay in mind at the expense of group dialogues more collaboratively geared towards achieving results. The individual orientation, with its incumbent "psychological locking" for the manager, can lead to non-stretching standards being set which cumulatively results in the sub-optimisation of possible outcomes for the organisation (Kohn, 1993).

Job Design Activities

Third, Figure 1 highlights the fact that the genuine integration of HR activities is likely to involve mechanisms that allow employees to contribute to job design activities. The theme of the paper suggests that employees' development over time should be recognised in job design activities. (There may be a lack of fit between a job and a job-incumbent, not because the selection process was error-ridden, but because the employee's skills, aspirations and needs have changed since selection took place). It is accepted that the goal of involving employees in job design may prove more problematic is some contexts than others; issues relating to national cultures and the nature of the work arise. For example, in their exploration of employee turnover, Khatri, Budhwar and Fern (2001: 69) suggest that: '*companies in Singapore rely mostly on control-based management philosophy. The control-based management emphasises compliance/obedience over commitment, written rules over informal norms, and authority over participation'*. In terms of the nature of the work, Hunt (2002) points out that employee behaviour that contributes to organizational performance, but is not formally specified as an aspect of the job, may be neither desired nor encouraged in situations where Taylorist principles are applied to job design. Nevertheless, the initial step forward is to recognise and emphasise the fact that people change over time; the application of this fact to HR activities may, ironically, be facilitated in certain contexts by demonstrating how inefficient it is to assume that people remain the same over time.

Learning to Learn

Fundamentally, this perspective on selection requires an insight into the 'learning to learn' willingness on the part of the manager. This is an area fraught with difficulties because of: its wide range of possible interpretations; the challenge of describing it in everyday language; and its under exposure for meaningful examination as a key development process in performance management. Arguably, managers' concepts and language for this phenomenon, if developed at all, remain at very personalised, although valuable, level and are not extended through dialogue to support the development of the learning skills of others. For managers, this represents a culmination of the lack of exposure to a conceptual understanding on how learning skills develop, primarily as a result of having experienced a lack of stimulation in this respect in the education and training system. Managerial recruits usually arrive in the organisation unaware of how to present their capabilities in "learning to learn" and proceed through training programmes where often little recognition is given to the process of learning (Knowles, 1990). Further, the developmental constraints relating to the employees' lack of understanding on what constitutes a "learning to learn" willingness are often compounded by the increasing ability of organisations to be highly articulate on what is termed the "learning organisation". The implication for newcomers to the organisations concerned is that they can expect to face a cultural emphasis on learning, strategies to enhance development beyond conventional training and an expectation that they will take responsibility for their own learning.

Conclusion

The paper has draw attention to recent advances in, and the predictive limitations of, current selection methodologies. It has been argued that these limitations have to be faced if future selection processes are to be refined and improved. This conclusion is particularly relevant to radical change settings where organisations and job roles are subject to constant change stemming from wider societal and global upheaval. A major theme of this paper is the need for organisations to recognise, as part of an integrated HR strategy, the fact that people, as well as societies, organisations and job roles, change and develop over time. As a result, change and development associated directly with individual's characteristics and motivation, should feature in ongoing selection and assessment activities.

One of the major implications that arises from this position is how to offer the opportunities to individuals to sustain questions and activities that explore the assessment of learning capability and generate understanding of how to cope with varying learning situations in a constantly changing environment. Perhaps, ultimately, selection in this respect then rests on concepts such as philomathia and mathophobia, terms that have been used to describe positive and negative attitudes towards learning (Antonacopoulou, 1999). Generally speaking, a philomathic attitude is associated with the need to learn and engage in a conscious and active learning process to improve themselves beyond the boundaries of the context in which they operate. By contrast, a methaphobic attitude is associated with a reluctance to learn and engage in self-development and also a tendency towards risk-aversion in learning situations. Sensitivity of approach is required here, however, as attitudes towards learning are not permanent and are subject to change depending on the interaction of personal and organisational factors.

The clear implication for organisations is that, in selecting and nurturing the best available individuals, it is the capacity and willingness for learning geared towards organisational results that ultimately counts. However, the capacity to be self organised in the pursuit of learning can fail to develop in the face of the lack of self directedness and individual autonomy discernible in various cultures, particularly in the developing world (Brookfield, 1986). This demonstrates the imperative that organisations face in creating their own cultural sensitivities and support for the role of the individual learner (Abbot and Dahmus, 1992). The development of 'learning to learn' attitudes and skills has practical implications across a wide range of human resource activities including performance management and management development. For example, performance management systems have to be designed to ensure that willingness to learn, and the skills surrounding this attitude, feature prominently in performance measures. Similarly, management development activities should be seen as enabling mechanisms that equip employees not just to cope with changing environments, but also to chart and develop their own learning capabilities (Blackman and Lee-Kelley, 2006).

Given these emphases, which hopefully go beyond rhetoric, the selection of new managerial recruits perhaps does not have to stress full capabilities in "learning to learn", but a willingness to enter a "learning journey" and to be responsible for the development of one's own learning skills. This latter point is premised on the assumption that only an individual can be responsible for his or her own learning and the development of it as a skill over time (Harri-Augstein and Thomas, 1977; 1992; 1991). If it is recognised that the new recruit will change and develop over time, then it is in an organisation's interests to equip the new recruit with insights into this process of development. Further, equipping employees with a 'development vocabulary' may enable them to engage fully in the dialogues and conversations that form essential elements of an ongoing process of assessing their own skills and aspirations.

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Growth and Inflation in the Baltic States: Recommendations for a Phased Inflation-Management Program

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Abstract

This review of inflation in the Baltics, and particularly in Latvia, addresses some of the principal complexities of economic growth, inflation and economic policy. The manufacturing-dominated economies of Latvia, Estonia and Lithuania, formed during the Soviet era, collapsed with the USSR. However, they are now well into the process of evolving to market economies. Among other aspects, this evolutionary process includes adapting to new social institutions and economic relationships, reacting to the impact of new technologies, and meeting the increasing social needs of an aging population. In recent years, the Baltic states have experienced relatively high annual growth rates well above 7 percent. This growth has also exacerbated growth in inflation that threatens to derail plans to enter the eurozone. The authors introduce a phased inflation-management program that can be accelerated, slowed, or simply monitored and re-adjusted as needed. A broadly balanced program is presented designed to serve the interests of all stakeholder groups and organized in four phases, starting with the most immediate, rather light actions that promise important quick successes.

Keywords: Inflation, economic growth and development, economic policy, Latvia, Estonia, Lithuania.

Introduction

Inflation may be one of the most problematic of all economic phenomena. On the one hand, low rates of inflation—two percent or less per year—are often considered desirable. They occur as a result of steady growth in a nation's economic base that often results in low levels of unemployment, moderate wage gains and price increases, and the availability of funds for investment in productive infrastructure. On the other hand, high rates of inflation typically result in distrust of government, a wasting away of the value of savings, high unemployment, distress for citizens on fixed incomes, and the eventual threat of catastrophic deflation.

Very-high rates of inflation—*hyperinflation*—are destructive to all economic and social relationships, whereas lower rates are widely perceived as a stimulant for maintaining employment and economic growth as a safeguard against deflation.
To avoid extreme measures, it is prudent to bring economically, politically and socially disturbing inflation rates down to the norms of a the given

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economic system (EU). Thus inflation control tends to be a disinflation process, attending to the several causes of inflation. In practice, the process of control with the least pain to society is achieved by striking a balance between economic development, levels of unemployment, interest rates, and keeping the decline of money value to politically acceptable limits.

Inflation may be brought on by a number of different sources, and each has an uneven impact on various elements of a country's population and social structures. Moreover, governments have tried a variety of different, often ineffective ways to deal with inflation. These have included raising taxes and/or interest rates, placing strict controls on government expenditures, and/or exercising rigid private sector price controls. In Soviet systems, decision makers often became skilled in avoiding such controls.

Prudent fiscal policies and finely-tuned controls on the money supply as exercised in many market economies and democratic civil societies have been shown to be effective ways to control inflation. However, these remedies are neither formed nor administered in isolation; even the simplest, apparently minor policy adjustments often affect other segments of an economy. These adjustments often have unexpected and contradictory consequences.

Major policy goals and possible conflicts were well stated by Ben Bernanke, the current chairman of the US Federal Reserve System who took office on February 6, 2006. According to Bernanke (2006), the tasks of the Federal Reserve banks are consistent with the views expressed by Keynes (1920). These are to control inflation, foster economic growth, and help maintain a favorable climate for high employment. Thus, in practice this approach allows for a moderate rate of inflation, easily available credit, and a monetary policy of a stable dollar in an increasingly international economy.

When identifying and implementing adjustments, economic policies and decisions are shaped (or at least influenced) by extant social and moral values. These values naturally vary from one country to another and from region to region. Thus, these considerations serve as a bar to the application of uniform policies and their consistent worldwide application. Inflation controls are, therefore, often situation and country specific.

The moral and ethical norms that shape Latvia's economic policies have been influenced by such forces as the individualistic ethic of a nation in which agricultural, forestry, and fishing were once primary economic activities (BBC, 2007), to the more collectivist sentiments inherited from the Soviet system when the command-economy became heavily industrialized and the EU-led drive to rapidly evolve into a market economy. This evolution has been characterized by periods of rapid economic growth, high inflation, and the social costs that these two phenomena produce.

Among other necessary compromises, this evolutionary process involves 1) changing personal values and attitudes, 2) adapting to new social institutions and economic relationships, 3) adjusting to the impact of new technologies, and 4) finding the resources necessary to provide for increasing social burdens of an aging population while investing in long-neglected infrastructure. Administrative and leadership relationships are often complicated by internal power struggles and uneasy governing coalitions where responsibilities are sharply delineated and coordination is often difficult.

Social Costs of Inflation

An optimally complete analysis of economic problems should include private costs (internally accountable operational and administrative costs of individuals, enterprises and organizations) and social costs––the costs borne by society, including damage to the environment. Social costs are often difficult to determine with any high degree of accuracy, but making the effort makes the economy seem even less efficient. Moreover, ignoring social costs may inadvertently lead to increasing external costs. The analysis of price changes in Latvia today is still limited to direct, internal costs extant in both the private and government sectors, where in the past, externalities were often ignored.

The four chief social concerns about inflation and disinflation are: 1) effects on retail prices, 2) availability of credit, 3) maintenance of employment, and 4) a possible decline of monetary stability. Realistically speaking, these are public fears of both the inflation and the remedies proposed by government economists.

After Latvia's accession to the EU in 2004, annual retail price increases alarmed the population and the government. This trend was driven by both domestic and international forces. Internal forces include high consumer spending, a low savings rate, and deficit spending by the government. External forces are led by pressures to comply with EU policies and requirements. The ongoing equalization of prices within the EU economy directly affects the Baltic states. The perceived problem is how to incorporate this integration of prices with European trends while maintaining local consumer purchasing power.

Rapid price increases have lead pensioners and wage earners to call for price controls and upward adjustments of pensions, minimum wages and salaries. Other groups call for more easy credit, primarily for purchasing automobiles and housing. While inflation eats away the modest savings of some citizens, it also increases retail sales, provides benefits to the construction industry, including the producers of building materials, and increases vehicle imports.

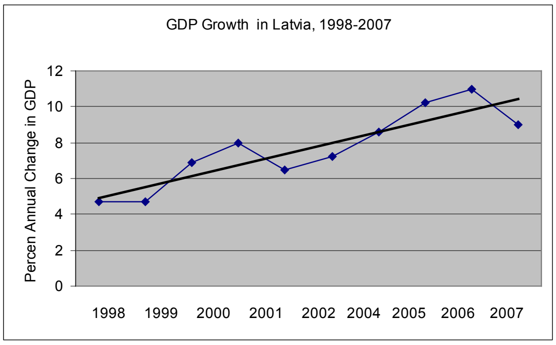
Objective of the Paper

The objective of this paper is to generate further discussion on a set of recommendations proposed for bringing inflation under control in the emerging economies of Estonia, Latvia, and Lithuania, with special emphasis on Latvia. Inflation and disinflation observed in Latvia over the last decade suggest a fluid situation that calls for more decisive, smaller adjustments rather than sweeping changes in economic programs. This dynamic argues for a phased inflation-management program that can be accelerated, slowed down or simply monitored and re-adjusted. We suggest a broadly balanced program to serve the interests of most groups concerned. The program is organized in three or four phases, starting with most immediate, rather light actions, and, if necessary, eventually stepping up to the draconic measures that were practiced by the Latvian government in the 1920s. The recommendations proposed in this paper are based on our accumulated knowledge of inflation management experience in several countries, and economic development in the Baltic States as a whole.

Growth and Inflation in the Baltic States

After two years of growth at 4.7 percent per year, annual percent increases in Latvia's GDP began to accelerate in 2000, when growth reached 6.9 percent (Figure 1). Growth in GDP reached 8.0 percent in 2001. After a dip to 6.5 percent in 2002, growth in the Latvian economy has increased every year since, eventually reaching 11.0 percent in 2006 (IMF, 2006).

Figure 1 Rates of Growth in Latvia, 1998-2007 (Trend line added)



Source IMF 2006, World Economic Outlook

As can be seen in Table 1, rates of growth were only slightly more manageable in Latvia's two neighboring states, Lithuania and Estonia, although growth in Lithuania did reach 10.5 percent in 2003. Growth in Estonia increased to nearly 10 percent per year in both 2005 and 2006. In all three states, growth has been fueled by increases in consumer spending.

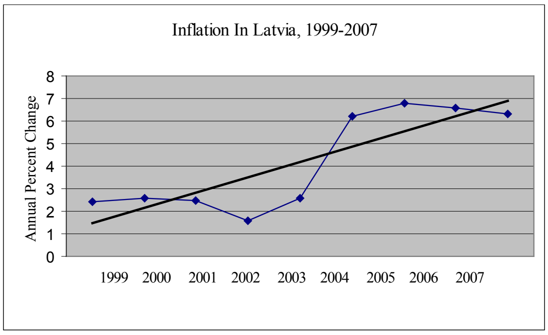
During more or less the same period, the rate of inflation in Latvia (as measured by increases in

Table 1 Annual GDP Growth in the Baltic States, 1998-2007 (Annual Percent)

	1998	1999	2000	2001	2002	2003	2004	2005	2006[a]	2007[a]
Latvia	4.7	4.7	6.9	8.0	6.5	7.2	8.6	10.2	11.0	9.0
Lithuania	7.3	-1.7	4.7	6.4	6.8	10.5	7.0	7.5	6.8	6.5
Estonia	4.4	0.3	7.9	6.5	7.2	6.7	7.8	9.8	9.8	8.0

Source: IMF World Economic Outlook. September 2006 consumer prices) also steadily increased, eventually reaching 6.8 percent per year in 2005. The inflation rate was projected to drop slightly to 6.6 in 2006 and drop again to 6.3 percent in 2007 (IMF, 2006). Figure 2 displays the annual growth in inflation in Latvia. A trend line has been added to the IMF data.

Figure 2 Annual Inflation Rates in Latvia, 1999 to 2007 (Trend line added)



Source IMF 2006, World Economic Outlook

In Estonia, Latvia's neighbor to the north, inflation grew by an annual rate of 3.0 in 2004, 4.1 percent in 2005, and 4.6 percent in 2006. Following a decline of -1.1 percent in 2003, inflation in Latvia's other Baltic neighbor, Lithuania, grew by 1.2 percent in 2004, 2.7 percent in 2005, and 3.6 percent in 2006; it was projected to drop back to 3.3 percent in 2007. Rates of inflation for the three Baltic nations are displayed in Table 2.

Failure to Meet Eurozone Requirements

The most immediate effect of the inflationary trends in Latvia and the other two Baltic states has been their failure to meet European Union (EU) requirements for joining the eurozone. The EU requires that nations joining the zone have 12-month average inflation rates no higher than the average of the three lowest EU inflation rates plus 1.5 percentage points (EUbusiness, 2006). Estonia, which had hoped to adopt the euro in 2006, has moved its application date forward to 2008. Meanwhile, Lithuania's 2006 application was rejected by the EU—the first rejection of an application since the formation of the eurozone in 1999 (Bloomberg News, 2006). Latvia is not expected to be able to meet the inflation requirements until after 2010.

The threat of continued high unemployment among unskilled and young workers has also been a continuing concern in Latvia. High unemployment in industries no longer viable in the Baltic States has been offset in part by worker's remittances from labor performed elsewhere in the EU. As a result, even with premium level domestic salaries, skilled labor is scarce in the Latvian capital city of Riga. Unskilled workers in the countryside tend to avoid work for low-level wages that predominate away from the few urban areas. The shortage of skilled workers in some areas has been further aggravated by Latvians seeking seasonal work in England and Ireland. On the other hand, these guest workers show that their employment abroad should really be treated not only as exports, but also as possible sources of new knowledge and new skills for growth industries.

Despite the shortages of skilled workers, a 2005 survey in the national newspaper, *Diena*, reported that 35 percent of Latvian citizens considered unemployment—which was running at nearly 10 percent in 2005—to be the second most important domestic economic problem (*Diena* 28 July 2005). In addition, 55 percent of the respondents believed that inflation, its causes and remedies, were the most important issue facing the nation.

Inflation can seriously erode public confidence and a major concern of pensioners and others with fixed low incomes. The statistical calculations of consumer expenditures is priced at 106 *lati* (or about 200 USD)––well below the typical monthly

Table 2 Annual Percent Inflation Rates in the Baltic States, 1999-2007

	1999	2000	2001	2002	2003	2004	2005	2006[a]	2007[a]
Latvia	2.4	2.6	2.5	1.6	2.6	6.2	6.8	6.6	6.3
Lithuania	1.5	1.1	1.6	0.3	-1.1	1.2	2.7	3.6	3.3
Estonia	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.6	3.8

Source: IMF World Economic Outlook. September 2006 pension or minimum wage (*Latvijas Avīze* 25 July 2005). Price increases over seven percent for a pensioner's market basket of goods indicate that low income segments of the population are especially vulnerable to inflationary price changes. Inflation in Latvia is mostly found in price increases for consumer products, including food, and services. Pensioners spend 25 percent of their income on food and 20 percent of their incomes on health maintenance services (*Diena 9 August 2005; Neatkarīgā Rīta Avīze* 9 August 2005).

Measurement Imprecision

Reported measures of inflation statistics are seldom precise. For better or worse, changes in economic development are still registered in the statistics for Gross Domestic Product (GDP). Changes in GDP do not generally distinguish the important differences between investment and consumption; these measures are in some ways faulty and inadequate, especially when the impact of investments in education and/or technology on productivity is considered. Imprecision in measurement methods can also influence policy decisions. For example, prices calculations based on the *Laspeyres* index overstate the cost of living, while the *Paasche* index overstates inflation rates (Pindyck and Rubinfeld, 1998). Inadequacies in the collection of information also undermine the reliability of reports on consumer prices. Finally, changes in wholesale prices are considered to be better for forecasting future developments than for measuring past rates of inflation.

Despite these limitations, conflicting purposes and means that are related to inflation are widely tolerated. Policies of control are often compromises calling for implicit and explicit changes. Two influential economists (Abel and Bernanke, 1995) reason that even perfectly anticipated inflation presents unexpected policy issues on the incidence and management of related private and public economic costs. These range from "shoe-leather" costs of adjustments to improvements in productivity. As long as inflation is costly to individuals and to society at large, there will be professional as well as popular analytical and value-based arguments about which policies to pursue.

Monetary policy has, of course, been a sovereign right; in the eurozone, however, it is federation-wide, affecting all 25 EU member states and the closely aligned economies of countries for which the EU represents a major trading partner. The central banks of the Baltic states are thus committed to maintaining a stable relationship between their currencies and the *euro*. As a result, the monetary policy options available to Latvia, Lithuania and Estonia are limited by the European Central Bank (ECB) to raising or lowering reserve requirements and influencing credit policies among local banks––important functions reserved for them. The EU ECB policies also allow the free flow of funds from one country to another in the larger economic system of the EU.

Monetary policies do not seek to eliminate regional differences that are obvious when the economy of the Silicon Valley in California is compared to the declining agricultural economies of the western plains of Dakotas and Nebraska. In the EU, there are disparities such as those that range from rich Germany and poor Poland or the Baltic states. In practice, support for depressed areas is more a function of fiscal management and the redistribution of government income. Regulation appears to be of more dubious value.

While catching up with other countries in the EU, in addition to keeping inflation rates to the limits allowed by the ECB, the Baltic states must increase productivity, competitiveness, and exports. Together, these actions are necessary to maintain a rising GDP while also protecting savings and encouraging investments. Because the EU is the larger domestic market for the Baltics, policies among the Baltic states must reflect the policies of the EU.

In practice, a variety of inflation control instruments are available in the EU. On the fiscal side, they permit limited deficit spending to maintain economic growth and employment. In this sense, deficits are a hedge against deflation and the related economic recession. Other instruments are used by the ECB to maintain relative monetary stability.

Changes drive the formulation of new policies; however, new policies also produce new, unexpected changes (Hosmer, 1996). This realization informs us that the management of inflation necessarily includes more than an impersonal economic analysis; it also involves a search for politically, legally and socially acceptable compromises. Such compromises are difficult to manage in a period of economic, political and social transition.

Controlling Inflation

Inflation control is both an art and a science. Different rates of inflation and variations in economic foundations call for a variety of selected policies. At a very low level of inflation, inflation control can be left largely to market forces. A healthy market economy thrives on increased productivity that keeps costs more or less stable and permits the expansion of international markets. At higher rates, inflation is the same as a cruel tax on those least able to afford the tax. On the other hand, some see value in higher inflation: it serves as a force to bring about changes to institutional and other relationships. This 'value' of higher inflation may be overstated, however (Gillis et al., 1996).

In Latvia, the high a rate of inflation is a potential force in the destabilization of the country's emerging, but still fragile economy. Most Latvian inflation-control proposals are oriented to maintaining economic development. The advocates of these proposals stress the need to strengthen the supply side and increase the nation's competitive abilities (Andris Strazds of the Stockholm School of Economics in Riga, Diena 23 July 2005; Aigars Rotkovskis of the "Turība" Business School (*Dienas bizness* 1 August 2005)).

Inflation impacts private individuals and their families as well as business enterprises and public agencies. Thus, the management of inflation becomes an important issue in almost all private and government endeavors. Public management goals set in terms of targets for allowable inflation guide policy; in practice however, the results of these policies vary. This is especially true in the Baltic states where economic transition is substantial and rapid.

In the Baltic states during the post-Soviet era, the disruption to the economy in the early 1990s was caused primarily by the expansion of money supply in a situation where the public was hoarding large amounts of cash as they expected a sudden influx of cheap consumer goods. The effects of this disruption were the reduction of profits and tax receipts—while also a requirement to fund increases in subsidies and pensions. The "shock therapy" used to bring inflation under control included both monetary and fiscal measures (McConnell and Brue, 2005). Experience shows that inflation is difficult to control in emerging economies where economic growth is, just as it is in Latvia, given a high priority for economic, political and social reasons.

Managing Growth and Inflation

The management of inflation is risky in the Baltic states. Considered by some to be the "poor cousins" within the EU, these states have few accumulated economic strengths. Policy makers and policy changes are not trusted very much (King et al., 2004; *LETA* 29 July 2005). The public suspects elected and appointed administrators to be excessively devoted to their own interests. Even worse, they are widely believed to be corrupt. These suspicions are aggravated by a general lack of open political discussion. In Latvia, much public concern is expressed about the secrecy of government plans to limit inflation (*LETA* 28 July 2005). This distrust limits the effectiveness of economic policies in Latvia (King et al. 2004). Redundant staffing and perceived inefficiencies further reduces operational productivity in government (*Delfi* 9 August 2005). Together, these conditions function as constraints to what actions the government might take to bring inflation under greater control.

In recent years however, the Baltic states have experienced relatively high growth rates of about seven percent and currently as high as 11 percent per year. On the basis of current progress in economic development, the World Bank (WB) is making optimistic predictions for the region (*Diena*, 22 July 2005). The WB estimates that average incomes in the Baltic States will be on a par with current average incomes in the EU as early as after 16 years in Latvia, 17 years in Estonia, and 18 years in Lithuania.

Over the same period, however, prices were increasing unevenly. In 2003, for example, prices of all consumer goods increased by 3.2 percent; food products by 2.9 percent; other goods by 4.0 percent; and services by 2.1 percent. Overall, price increases in the first quarter of 2005 compared to the first quarter of 2004 were above inflation rate for most food products (including double digit increases for meat and fish products, and seasonal variations for fruit and vegetables). Price increases in hospitality services at 10.2 percent grew faster than inflationary rates, as did higher education (including public and private institutions) at 8.3 percent. These prices were essentially negotiated with suppliers also seeking "normal" profits. This distribution of price increases was in general consistent with predictions made by the Bank of Latvia's director of monetary policy, Helmūts Ancāns (2005). Wholesale prices for natural gas, imported from Russia, were expected to increase 10 to 17 percent in the next few years (*LETA* 1 August 2005).

The largest increases were observed for domestic services, especially health care, insurance, and personal transportation. There were substantial discounts and rebates for the indigent to reduce the impact of inflationary price increases on medicines. On the other hand, tariffs for telecommunications, a field much affected by technology changes and unexpected competition, declined substantially.

The growing cost of housing and other real estate was reflected in mid-2005 by an increase of 86 percent over the preceding year (*LETA* 31 July 2005). This represented an increase of about $US 1 billion dollars into the small Latvian economy. Together with real estate purchase prices, rental rates have also increased rapidly, particularly apartments in desirable, central locations in Riga rising faster than inflation. In the country, investors have purchased many lakeshore and seaside properties, as well as farmlands suitable for large-scale farming.

In the construction industry, wages and prices for materials increased by 11 per cent in the second quarter of 2005 (*Dienas bizness*, 19 July 2005). Increased costs of government development projects were also attributed to the bureaucratic procedures of the Latvian Investment and Development Agency (*Diena* 11 August 2005).

Influence of the Banking System

One of the most serious concerns in the Baltic states remains how to maintain monetary stability. Looking back at the previous century, savers were first wiped out when the Czarist system was replaced by the republican government, then several times during Soviet devaluations, and eventually with the collapse of the Soviet economy. The bankruptcy of the large *Banka Baltija* and some other banks shook the confidence of savers in Latvia and led to effective demands for closer bank supervision.

Increasing availability of credit through banks in Latvia was a factor in increasing bank profits by 80 percent (*LETA* 29 July 2005), bank assets by 16 percent, and bank capital and reserves by 12 percent in the first half of 2005. Gradually, inflation in Latvia ran from 2.4 percent in 1999 to 2.9 percent in 2003. The rate in June of 2005 was reported to be 6.6 percent (*LETA* 18 July 2005).

Provided that the inflation rate is reduced below the current six or seven percent to the EU standard of about three percent, it anticipated that the Baltic currencies will be absorbed in the *euro system* not earlier than 2010. Lithuania and Estonia may convert earlier. For Latvia, meeting the target date is still in doubt, as planners appear to prefer a more gradual process of disinflation than preferred by modern economists (Abel and Bernanke, 1995).

Despite the strong popular opposition to any government action to control inflation (*Delfi* 29 July 2005), there is little the government can do independently. Domestic overall monetary policy is, for all practical purposes, guided by the European Central Bank (ECB), which aims to keep the inflation rate in the EU at about two percent.

Disinflation and Deflation

Disinflation, a gradual reduction of the inflation rate, is the result of many economic and other actions taken by individuals, organizations and government agencies concerned. It is a reflection of the sum of these sentiments, interactions, and actions. Therefore, the overall rate of disinflation is difficult to forecast. In some sectors of an economy, where the demand is very strong for limited goods or properties, the probability of hyperinflation and buyer panic in some quarters does exist. Prices are then driven up by imprudent domestic and international buyers. Often, the result is implementation of a formal policy of disinflation.

High productivity in terms of market values helps encourage Latvia and the other Baltic states to raise compensation and the standards of living. In other industries, there is a minor risk of excessive disinflation that could lead to deflation and related shrinking of employment and other economic activities (Farrell, 2004). A European deflation could be devastating in some sectors of the small Baltic economies. International trade accounts for eighty percent of Latvian economic activities. Latvian producers of raw materials would face substantial, worldwide price reductions.

The significantly large low-income elements of the Latvian population that have no accumulated cash resources are most at risk. Moreover, they have the potential to upset existing social and economic relationships. Unfortunately, the country's traditionally stable industries are already plagued with low productivity. These weak industries are cash poor, low cost competitors in the EU and world markets. Almost any major economic change endangers these industries. This recognition does not lead to deflation, but the fear of a recession in a particular industry is likely to cause full compliance with ECB inflation controls. To gain credibility in the government and in the market economy, it is important that potential losses in the weak industries be offset by gains in others. Such a balance is a strong step toward economic development, higher per capita GDP, and real economic well-being.

Demand-pull vs. Cost-push Considerations

For the study of inflation, it is useful to distinguish between *demand-pull* and *cost-push* inflation. In identifying possible remedies, it may be even more important to consider what is and what is not controllable for policy makers in Latvia. Characteristic of the demand-pull phenomena is a general price increase due to excess demand and very high employment rates. "Too much money chasing too few goods," is one expression that describes this situation. This seems not to be the case in Latvia. Excessive domestic demand is visible primarily in the real estate and housing sector. This situation also points to fiscal and monetary policy as concepts that are essential to even partial inflation abatement, as employment is not high enough to generate inflation. It can be argued that Latvian remittance workers abroad actually reduce unemployment and add to the purchasing power of the nation as any exports would. This argument is moot when it is realized that total Latvian demand is but a part of the total demand picture in the EU.

Latvian statistics suggest a continuing growth of the middle class. Members of this group are upgrading their food consumption from a traditional bread-and-potatoes diet. They drive their own automobiles and buy real estate, including new and remodeled housing. Today, high priced real estate attracts domestic buyers and property developers as well as foreign investors. Indeed, the strongest opposition to inflation control comes from the real estate lobby (*Delfi* 29 July 2005). This suggests that the heated-up demands for credit should be controlled with selective credit restrictions, improved relationships with suppliers, and primarily with tighter fiscal policies. However, restrictions placed upon expansion of the housing market have the potential to reduce employment in the building trades. Large numbers of unemployed in this category would have to be supported somehow by Latvian society.

More than demand-pull inflation, the slow growth of factor costs in industry and in the nation as a whole is more obvious. This is *cost-push* inflation, the most important factor in Latvian inflation in 2005. Driving this inflation are rapidly increasing wage rates. Higher overall wage levels are attributable in part to the expected rise of minimum wages not offset by growth in productivity. Market related countervailing forces should also be considered by the economic policymakers. The other major component is the "supply-shock". This reflects the rising cost of locally produced or imported materials. Higher incomes among government workers are also a factor as government services are often sold on the market. In Latvia, fuel and other energy costs, mostly imported from Russia, depend on external pricing.

A new source of inflationary pressure is the recent rapid growth of the tourist industry in Latvia, where services are expanding to meet this rising demand. However, with prices for tourist services up by 10 to 20 percent, moderately affluent European tourists visiting Riga tend to resist buying higher-priced services (*Diena* 4 August 2005). This resistance by visitors and the shortage of discretionary funds among local consumers may help keep Latvian inflation in check.

Fiscal Discipline and Monetary Management of Inflation

An important factor in the formulation of Latvian inflation control policy is the European Central Bank (ECB). The ECB currently seeks to limit inflationary increases to around two percent. Because of this, the bank is accused by some of fomenting further inflation by promoting economic growth, while others contend that the ECB is controlling inflation excessively with its policy of keeping inflation below 2 percent (*The Economist*, 16-22 July 2005).

A more important factor may be Latvia's own fiscal policy. Although the Maastricht agreement limits budget deficits in member countries to three percent, there are tolerated exceptions. Actual results vary in different countries, but Latvia is expected to manage the state budget very conservatively, at least before the conversion of lats to the euro on 1 January 2008. In the mean time, large development grants by the EU, which must be spent in a short period, contribute to inflationary pressures.

Recommendations

Because management of inflation must reconcile a variety of interests, the policy analysis process should be thorough and include the benefits and disadvantages for each major group of stakeholders. Recommendations can then be prepared that consider the costs and benefits for all sectors of the economy. Only then will the resulting recommendations be what Green (1994) termed *omnipartial.*

An important aspect of the recommended analysis is that of externalities such as private and social (public) benefits and costs. As reallocation of resources is one of the consequences of changes in policy, and in practice, inflation and the management of inflation bring about resource and income reallocation, a competitive company, pressed to keep its prices and private costs low, may choose not to invest in pollution abatement to subsidize customers.

Accurate accounting for actions considered or taken and precise predictions are not likely in the Baltics, where social costs of externalities were largely ignored under the former command economy system. However, the reduction of pollution and other threats to the environment should have a high priority in any fiscal strategy. A similar recognition would take into account the phenomenon that unemployment that is related to disinflation not only eliminates production, but also transfers costs of supporting the unemployed to other private or social means.

Because of the complexity of inflationary changes and the many remedial choices available, inflation management should use a broad approach and avoid detailed price and credit controls. Fiscal and monetary macroeconomic approaches are more effective when combined with other programs. Care should be taken that stability, growth, productivity and fairness are not unnecessarily impaired by austerity. It is also important to increase the credibility of government programs. To these ends, an objective, neutral approach (Green, 1994) should consider and balance the economic goals of major interested parties. These include all stakeholder groups, private citizens, nonprofit organizations, business and industry managers, employees, suppliers and the public in general. This balancing best includes both the rights and obligations of the individuals, groups, and organizations involved (Donaldson, 1989). Green's approach suggests a structured, analytical procedure, which includes the following steps:

- Description of the conduct (action) to be evaluated
- Identification of the parties affected
- Assessments made from the affected party's perspective
- Weighing and balancing the likely effect of alternatives considered
- Taking appropriate steps to correct or improve the given situation

A Recommended Action Plan

We recommend that Latvian economic policy analysts and decision makers follow the broad and flexible approach described by Green and Donaldson. While we do not have any iron-clad, firmly fixed and inflexible programs in mind as panaceas, we do propose in the pages that follow a multiphase program that may serve as a guide for policy makers to refer to when developing inflation-fighting policy. To begin with, we strongly suggest that more than one alternative strategy be identified and considered before beginning to frame policies and programs. For all practical purposes, only Latvians can formulate policies consistent with Latvian values, and other realities. However, even this suggestion calls for caution. Many Latvians intuitively call for comprehensive price controls and detailed credit restrictions. Selective credit policies and procedures are exceedingly difficult to enforce.

Experience elsewhere suggests that they do not work reliably or well.
The Bank of Latvia (BoL) is an important factor in inflation control deliberations. The BoL completed several analytical studies in the fall of 2005, and published a special collection of papers on economic development and inflation (*Averss un Reverss*, 19 September 2006). The bank also organized a special conference on inflation. The major conclusions emphasized competitiveness and entrepreneurship in a low inflation situation; this combination would secure balanced economic development (*Averss un Reverss*, No. 4, 2005):

- Maintenance of economic growth should be of high priority
- Gradual disinflation is favored as it is compatible with economic growth
- It is important to view inflation as a process that optimally takes several years

The disinflation program suggested below is to reduce inflation to less than the three percent in line with the expectations of the ECB. If achieved, this rate would permit Latvian access to the *euro* system earlier than 2010 now forecast. Price competition in the markets brings about real price reductions. If domestic standards of living are to be improved and Latvian competitiveness increased, a rollback of prices and active competition must become an important part of economic policy in Latvia.

Linking actions taken to goals and targets is also important. In the fall of 2005, a phased program was presented to the Latvian prime minister's economic adviser (King, 2005). The suggested program offered Latvian policy makers a choice of control tools for further assessment, selection, adoption, and implementation. The several choices of action and the suggested phases for implementation emphasized the need for a broad program that must be coordinated and checked against progress measurements extending over a period of several years.

The timing of the proposed action is, in many ways, problematic. Usually, decisive actions of control are taken late in a transformation plan, perhaps too late to help an economy that is already in the process in making sufficient adjustments. On the other hand, premature actions may unnecessarily cripple a very desirable economic development. The potential problems that can emerge from too great a dependence upon government deficits must be reviewed early on which ever plan is adopted, although it has been pointed out that actual deficits may not actually be as high as are often reported (Heilbronner and Bernstein, 1989). However, deficit spending may be justifiable in Latvia if it is used for productivity-oriented investments.

A Recommended Four-Phase Program

This section discusses each of the recommended phases in greater detail. We strongly recommend that substantial public discussion of the actions that policy makers consider take place before any programs are implemented. Transparency in governance is a model that will greatly improve the public's trust in government and, in turn, improve the government's ability to muster support for unpopular actions that will undoubtedly be needed later (Wiekeraad, 2005). However, we also recognize that discussions that relate to direct and indirect credit controls will need to remain largely confidential until the time chosen for their implementation.

First Phase

For the first phase, we recommend several immediate actions by the government to first increase its credibility, and then to maintain economic growth and stability. The three activities included in this phase are:

1. Increase public trust in government in both the short- and the long-term
2. Direct more resources to increased productivity
3. Reduce government borrowing and spending
   This first phase may be considered a limited "shock" treatment. If all goes well, some emergency measures can be reduced or postponed.

Second Phase

It is expected that the first phase will be followed by a larger number of selective initiatives that will be implemented gradually. In this phase, individuals, business enterprises, and government must begin planning for selective credit restrictions to curb inflation. Recommended second phase activities include:

1. Cut the planned increases in the government budget. As anyone familiar with the economics of agencies and enterprises recognizes, it is often feasible to cut expenditures by five to ten percent without seriously curtailing the effectiveness of programs. These are not only typically feasible, but they also assure the electorate that government is taking the planned transformation seriously.
2. Direct the spending of government and EU grant funds to projects that increase productivity in the nation. It is not simply government spending that builds lasting economic development; it is the private investments to increase productivity and purposeful government programs that help build knowledge of new technologies, skills and related institutions that assure real growth in export-dependent countries.
3. Tie cost reduction programs to corruption abatement—regretfully malfeasance and corruption are still extant in many government agencies and programs. Realistic corruption control usually requires a broad, comprehensive approach to be effective (King et al., 2004; Kārkliņš, 2005). Moreover, to be successful, it needs the broad-based support of government, business, and the electorate.
4. Freeze purchases or leases of passenger automobiles by the government. The recent rush of some Latvian government administrators to procure expensive automobiles is clearly irresponsible and popularly offensive. This very important, highly visible policy change is needed to repair the credibility and reputation of the Latvian government both domestically and abroad.
5. Enlist government supply-chain partners in efforts to plan cost and expenditure reductions. Experience in countries such as the US suggests that this approach is far more effective than internal cost cutting reviews. Internal authorities should devote their time and energies to the evaluation of supplier proposals.
6. Increase bank surveillance with special attention to risky real estate loans. Impose high, *ad valorem* user fees for recording real estate purchases in the government land registry.
7. Delay new construction and remodeling of buildings but do not defer necessary maintenance, which typically results in higher than necessary costs in following years.
8. Strengthen the base of higher productivity by investing in more research laboratories, libraries, and information technology centers.
9. Discourage administrative and business travel, especially travel abroad. The current extent of such tourism is publicly scorned and reduces the already low trust in the government.
10. Place a freeze on hiring more government workers and compensation, with the only exceptions being to reward outstanding performance in cutting costs and expenditures. Replace only critically essential employment vacancies for administrators and civil servants. This suggestion is intended to both save money and to publicly indicate the government's seriousness in the economic reforms.
11. Stimulate price competition. Strive to maintain stable prices in government purchases. Seek reductions in prices on current contracts and favor longer contracts. Support price reductions and stabilization anywhere, by everyone. Publish prices companies charge the government.
12. Encourage all buyers, individual, private and public, to clearly identify purchasing priorities, cut costs and reduce prices paid.

Third Phase

With the credibility of government and trust in economic policies raised, and helped by increased exports and foreign investments, substantial EDP growth can be expected with successful implementation of the Phase Two initiatives. With these accomplishments in hand, policy makers can turn to initiating the following third phase activities:

1. Selectively retain and enhance actions taken in the first two phases.
2. Conduct public opinion surveys to monitor public response to actions taken.
3. Aggressively promote exports and foreign direct investments in the country.

4. Consider reducing taxes on basic food and medicines. This is an effective and universally popular measure to help low- and fixed-income consumers and large families. This action can be tailored to the most important purchases by the poor.

Fourth Phase

Only after having achieved a solid measure of success should government consider planning to implement a severe, emergency step: draconic budget cuts reminiscent of the 1920s. However, we suspect that, given the actions suggested above, it will not be necessary. Rather, that with the EU's help, the Latvian economy will have evolved to the fourth phase on its own. This involves a continued commitment to a disciplined and productive society—even if some of the restrictive features discussed above must be retained.

The early successes will make it possible for the government to restore vital but postponed social programs. With a high rate of economic growth combined with controlled inflation, tax reductions or some other type of social dividend may be enacted to help the plight of the poorest segments of society. In other words, the fourth phase promises, among other hopes and expectations, to confirm the fairness and effectiveness of the Latvian government's actions to improve the quality of life.

Summary and Conclusions

The authors began this study in 2006 with the goal of measuring and assessing the Latvian public's responses to a rate of inflation that was approaching double digits. In January of 2006 alone, inflation had increased another full percentage rate; the year would end with annual inflation continuing to grow at rates above 6 percent. Compared to about 7.0 per cent a year earlier, inflation appeared to be rising at an annual rate of about 7.6 percent (*Neatkarīgā Rīta Avīze*, 8 February 2006). Further, significant price increases were occurring for natural gas and other fuels. Clearly, the inflationary situation in Latvia was becoming serious. There was rising discontent among the public; inflation was considered to be the most important economic problem by 55 percent of the population already in the summer (*LETA* 28 July 2006). There were widespread calls for wage and pension increases. There were especially noisy campaigns for improvements in the wages of teachers and public health workers, to the point where confidence in the government was in danger.

Although a 7.0 percent inflation rate would be found intolerable by the ECB, major changes in Latvian monetary policy did go beyond informal tightening of credit. The principal means of inflation control, still part of the government's confidential plans, would be the fiscal tightening of budgets and other expenditures. A step in this direction, perhaps more intended to improve the image of Latvian policies to outside investors, was the stabilization of Latvia's external debt. Otherwise, there was no significant progress in inflation control. As a practical matter, the Latvian government was cautious, perhaps even complacent about implementing any changes. It had taken a few steps in the fall of 2005, primarily to improve public confidence. Those actions included a freeze on cabinet ministers' salaries that was strongly opposed by many members of the cabinet. Not surprisingly, the general announcement of a thrift discipline in government spending met with what appeared to many as a weak and uncoordinated response.

The Latvian government placed economic development at a high priority, and allowed several wage increases and similar adjustments for the needy, a very large segment of the population. In both the public and private sectors, wage and salary increases were beginning to move out of control, with predicted increases of 14 to 16 percent for 2006 (*Neatkarīgā Rīta Avīze*, 8 March 2006).

Expectations of disinflation or a gradual inflation control was implied in the prime minister's economic development plan for 2007-2023. This plan was to be coordinated with the EU (*LETA* 11 January 2006), and would incorporate a selection of the suggestions and recommendations described in this paper. Strategic in content, the plan was criticized by those who wanted at least a partial return to detailed command-type planning (*LETA*, 6 March 2006). In the spring of 2006, the government was not ready to do much more than to maintain *the status quo with* the hope that some disinflation could take place automatically (*Dienas Bizness* 6 February 2006).

That restrained approach to inflation management was not altogether imprudent, was uncertain, indecisive, and even contradictory to the previously espoused policy. Although the recommended actions could possibly reduce Latvian inflation to three or four percent in a few years, they could also make further economic growth possible. They would, however, allow the government to meet other critical priorities. A stronger and more effective program of growth and inflation control was likely to be tied to the longer-term benefits of rising foreign capital investment, the formation and accumulation of necessary skills, and improved competitiveness. Moreover, such strengthening of the Latvian economy would provide a more solid base for the maintenance of a modest, stable inflation rate. The importance of the longer term programs was indeed stressed by the Latvian prime minister, an experienced economist, who stated repeatedly that there was a need for more substantial entrepreneurship in a competitive, market economy (*Diena* 9 February 2006).

It is important to recognize that Latvia has not yet been irretrievably hurt by high inflation. In many ways, the Latvian economy has been getting stronger; one of these ways is the most-important sphere of international trade, where increased exports are perhaps the best measure of productivity. Exports rose by 33.6 percent in 2005, with imports increasing by 27.1 percent––as much as 76 percent of the country's exports are to the EU (*LETA* 17 February 2006). Largely driven by this increase, Latvian GDP increased to a full ten percent in 2006 (*LETA* 20 February 2006), and reached more than 11 percent in 2006.

Still, the consequences of poor inflation control are socially and politically serious enough to prompt the Latvian government to begin a more active program of disinflation; although, the planning for the program was ordered earlier (*Dienas Bizness* 4 July 2005). Critics of the plan claimed it would bring on serious difficulties in coordinating future economic policy formulation and implementation. The failure of all three Baltic States to gain acceptance into the eurozone represents a clear warning to the countries' leaders: growth is good, but controlling inflation is critical.

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