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# *Managing Global Transitions*

## *International Research Journal*

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### *Table of Contents*

- 211 The Editor's Corner
- 213 Interdependence Between Social Values  
and National Performance Indicators:  
The Case of the Enlarged  
European Union  
*Cene Bavec*
- 229 Personality and Attitudes of Indian Young Female Workforce:  
Entrepreneurial Orientation by Education and Regions  
*Subhash C. Kundu*  
*Sunita Rani*
- 253 Determinants of Consumer Willingness to Purchase  
Non-Deceptive Counterfeit Products  
*Irena Vida*
- 271 Measuring the Impacts of Organizational Responses:  
Case of Northern Cyprus Hotels  
*Erdogan Haktan Ekiz*  
*Huseyin Arasli*
- 289 Emerging Economies Crises:  
Lessons from the 1990's  
*Sebastjan Strašek*  
*Timotej Jagrič*  
*Nataša Špes*



## *The Editor's Corner*

The journal continues to focus on the transition research and emphasizes the openness to different research areas, topics, and methods, as well as international and interdisciplinary research nature of scholarly articles published in the journal. The current issue focuses on social values, personality characteristics, consumer preferences, organizational responses, and economic crises.

In the first paper of this issue, Cene Bavec examines the interdependence between social values and national performance indicators. The second paper, by Subhash C. Kundu and Sunita Rani, investigates personality characteristics and attitudes of young female workforce in India. The focus of the third paper written by Irena Vida is on determinants of consumer willingness to purchase non-deceptive counterfeit products. In the fourth paper, Erdogan Haktan Ekiz and Huseyin Arasli measure the impacts of organizational responses by using the data from hotels in Northern Cyprus. The last – fifth paper, by Sebastjan Strašek, Timotej Jagrič and Nataša Špes, examines the financial crises of the 1990s.

Boštjan Antončič  
*Editor*



# *Interdependence Between Social Values and National Performance Indicators: The Case of the Enlarged European Union*

Cene Bavec

Based on the desk research, the paper provides an empirical insight into correlations between some social values and five selected economic performance indicators for 20 European Union countries. We concentrated on Composite Trust. This is a one-dimensional representation of citizens' trust on national level and is calculated from three different types of trust that van Oorschot and Arts (2005) derived from the European Values Study (2001). We confirmed correlations between trust and economic performance, but we have also noticed a very different pattern for the old and the new EU member states. The old EU member states show a positive correlation, on the other hand there is no such correlation for the new member states. A plausible hypothesis is that the same level of Composite Trust causes different effects in different societies and economies. We could also assume that social structures in the new EU member states are still distorted and are not in the equilibrium which characterizes EU countries with long democratic and market economy traditions. Economic performance in the new EU member states is based mainly on economic and not on social incentives. On the other hand, correlation between trust and innovativeness is strong in all studied countries. It confirms many studies which see trust as a fundamental social enabler and stimulator for innovativeness.

*Key Words:* trust, composite trust, social capital, social values, economic performance, innovativeness, European Union, new EU member states

*JEL Classification:* O50

## **Introduction**

Interactions and interdependences between economy and social structures and values attract many researchers from social and economic sciences. It is a promising research area revealing social variables that influence economic development and vice versa. Transition to the Infor-

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*Managing Global Transitions* 5 (3): 213–228

mation Society and the New Economy has already disclosed many limitations of the traditional view on economic performance, which is still based mainly on macroeconomical and technological indicators. Our first steps into the information society follow significant changes in social structures and values (Castells 2000) which consequently complicate interplay between social structures and economy. We can also notice uncertainty among researchers and practitioners about the relevance of some macroeconomic and particularly technological indicators in new economic environments. There is an evident lack of ‘softer’ indicators, which would reveal development forces based on social structures, system of values, and other societal characteristics.

Researchers agree that social structures influence economic development (Sabatini 2006), for example creating a healthier atmosphere for innovativeness, readiness to take business risks, and a better educational system. On the other hand, we can very rarely find these indicators in official national statistics or even in government development policies. This issue is still an academic affair with a minimal influence on a wider public perception of national performance and economic development. Nevertheless, the European Commission has stimulated some interesting researches on the EU level (European Trend Chart on Innovation and Special Eurobarometers), which give an insight into national and regional characteristics.

In this paper, we present a research that focused on correlation between Composite Trust and five macroeconomic indicators in the enlarged European Union. We also experimented with the Composite Social Values Index, as an approximation for social capital. We gathered data on national levels from different EU and international information sources and current researches (Van Oorschot and Arts 2005) and analyzed behavior of these indicators. Putting the ‘new’ EU25 economies into the same context with the ‘old’ EU15 member states, we have revealed some social and economic features that could be interesting for other regions, too.

### **Some Current Researches**

#### **SOCIAL CAPITAL**

Social capital simplifies our perception and even substitutes a complex concept of social structures and values. Many current researches are focusing on social capital and its interaction with the economy (Florida and Tinagli 2004). The World Bank has even proclaimed social capital as

a missing link in theories of economic development (Torsvik 2000). Recently, Adam and Roncevic (2005) summarized debates and researches, and concluded that social capital is important because *it is a catalyst for disseminating human and intellectual capital, it is a basis for greater levels of synergy and coordination, it is a 'lubricant' of network organizations, and it is a facilitator of intermediary institutions*. This view is very common among social researchers.

Despite theoretical (Putnam 1993) and empirical (Hjerppe 2003; Francois and Zabojnjk 2005; Sabatini 2006) evidences of its social and economic relevance, we still lack an unambiguous definition of social capital. Torsvik (2000) argues that: *First, the explanatory variables must be clearly defined. Second, it must be specified how these variables interact in the production process; the mechanisms that these variables work through must be specified. The social capital idea falls short of both standards*. As a result, we measure social capital with indirect indicators. Sabatini (2006) argues that *indirect indicators may be misleading because they do not represent social capital's key components and their use causes a considerable confusion about what social capital is, as distinct from its outcomes, and what the relationship between social capital and its outcomes may be*.

Ambiguity and too descriptive definitions of social capital lead researchers to empirically less convincing conclusions. Often, we are more guessing at results than getting them objectively from empirical data. For that reason, many researchers focus on simpler but less ambiguous social indicators, such as trust or tolerance. These indicators cannot reveal all the complexity of social capital, structures and relations, but they are at least measurable and easier to interpret. In this paper, we follow this path concentrating mainly on trust.

#### TRUST

As we already said, trust is not a replacement for social capital. It is just one of social variables. Many authors see trust as an ingredient of the social capital (van Schaik 2002). Sometimes, trust is even a synonym for the social capital itself (Francois and Zabojnjk 2005). On the other hand, for Torsvik (2000) trust is a consequence of social capital. Trust has not attracted such attention among researchers as social capital, but there are many reasons that make trust an interesting social and even economic issue.

What makes trust particularly relevant is its double role. It can be a component of social capital, tolerance, or other social variables. How-

ever, it can play a role on its own, as an independent social and economic variable. Trust plays a crucial role in the contemporary management and organizational theories and practice, particularly in virtual and networked organizations that are becoming an organizational paradigm of the 21st century (Mowshowitz 1997). Trust is an indispensable enabler of virtual organizations and virtual management (Bavec 2005). Many studies are dealing with the importance of trust in virtual teams (Keyzerman 2003; Coppola 2004) and in interorganizational networks forming virtual organizations (Holland 1998). They confirm a rising relevance of trust in the global and digitalized economy. Even common sense would tell us that acceptable trust is cheaper than distrust in any business environment.

Van Shaik (2002) assumed that interpersonal trust is unrelated to economic growth at regional levels in Europe. Rimac and Stulhofer (2005) discussed economic development as correlates of trust in the EU. For them, trust is a motivator for cooperation and it lowers operational costs. Their discussion was limited to qualitative arguments without empirical evidence. Raiser (1999) argued that trust relates to economic growth only in developed market economies, but not the case of the Central European countries.

Many other studies deal with trust in an indirect way, as a part of more general social indicators. Florida and Tinagli (2004) introduced the 3Ts (Technology, Talent and Tolerance) indicator and a single Euro-Creativity Index. For them, tolerance stimulates openness to new people and new ideas. An important part of the tolerance indicator is trust, because *distrust can paralyze society* and makes it uncompetitive. However, we could argue that the concepts of social capital and tolerance are partially overlapping and would have similar effects on economic performance.

Mihaylova (2004) published an extensive work on the Social Capital in the Central and Eastern Europe and discussed the trust and economic growth. The main concern of her research was the question: *what is the relationship between society and the economy?* Her paper stayed on the descriptive level, concentrating on sociological and political perspectives with few empirical data. However, her work is important because she tried to find a rationale behind different social structures and economic performance in the CEE and other European countries.

Authors with sociological and not economic background conduct the majority of current researches on social capital. This could be a reason

that we see very little empirical evidence for otherwise plausible and conceivable models of interaction between trust and other social values with economic performance. This fact has even intensified our search for additional empirical evidence to confirm these hypotheses.

In our research, we set up working hypotheses that follow common understanding and perception of the relationship between social values and national development performances. We started with the following hypotheses:

1. Composite Trust will be positively correlated with economic performance indicators for all EU member states.
2. The Composite Social Values Index will be also positively correlated with economic performance indicators for all EU member states but it would be less distinctive than Composite Trust, because of its too simplified structure.
3. Correlations will be equal for both groups of countries – the old EU15 member states and for new EU25 members.
4. Differences between old and new EU member states will be a result of differences in economic development, only.

### **Research Methods**

The primary goal of our research was to assess correlations or interdependences of some social variables with economic performance in the European Union. This is a wide geographical area with significant regional and national differences in economic development and social values, which offers an opportunity to test different hypotheses. We were particularly interested in any differences in behavior between old and new EU member states.

Gathering any primary data on the national levels was far beyond our research resources. For that reason, we conducted desk research looking for in-depth relations between selected indicators, using secondary data from public domain information sources and published researches:

1. The *IMD World Competitiveness Yearbook 2005*;
2. The *European Innovation Scoreboard 2005*;
3. W. van Oorschot and W. Arts, *The Social Capital of European Welfare States: The Crowding out Hypothesis Revisited* (2005);
4. L. C. J. M. Halman, *The European Values Study: A Third Wave* (2001).

Van Oorschot and Arts (2005) used primary data from the European Values Study and introduced eight variables as multidimensional representation of social capital. Three of them were dealing with trust (*trustworthiness, trust in institutions, and interpersonal trust*) and five with other social values (*passive participation, active participation, friends, family, and political engagement*). We used their individual data on the country level to describe social values.

We simplified van Oorschot and Arts' multidimensional view on social capital, and introduced two one-dimensional variables:

- Composite Trust
- Composite Social Value Index

Composite Trust is a one-dimensional representation of citizens' trust on national level and was calculated from three different types of trust that van Oorschot and Arts (2005) derived from the European Values Study. The idea was to represent trust as a single indicator that can be used for assessing correlations with economic performance indicators. Introduction of the Composite Social Value Index was purely experimental. Following the proposition of van Oorschot and Arts that all eight selected indicators can be an approximation for social capital, we were interested in whether it was positively correlated with economic performance indicators, as predicted by other studies.

#### ECONOMIC PERFORMANCE INDICATORS

The IMD *World Competitiveness Yearbook 2005* was a source of individual data on national level for competitiveness, business efficiency, economic efficiency, and government efficiency (columns 4–7 in table 1). From the *European Innovation Scoreboard 2005* we obtained the Summary Innovation Index for selected countries (column 8 in table 1). This index gives an overview of an aggregate national innovation performance. We should mention that not all individual indicators are referring to the same year; they are spread over a period of four years. We could justify this methodological inconsistency with the fact that social values and economic performance indicators are changing relatively slowly overtime, and they did not change significantly over the period of four years.

#### CALCULATIONS OF COMPOSITE TRUST AND THE COMPOSITE SOCIAL VALUE INDEX

We obtained individual data on the national level from van Oorschot and Arts (2005). We calculated Composite Trust as simply as possible.

Trustworthiness, trust in institutions, and interpersonal trust were normalized on the average 1, and summed up with equal weighting applied to all three indicators. The result is normalized again; so on average Composite Trust in the selected countries is equal to 1 (column 2 in table 1). We also experimented with other social variables, calculating a Composite Social Value Index (column 3 in table 1) in a similar way as Composite Trust, using the following eight indicators (Van Oorschot and Arts 2005): trustworthiness, trust in institutions, interpersonal trust, passive participation, active participation, friends, family, and political engagement. The average Composite Social Value Index for selected countries equals 1.

#### SELECTED 20 EU MEMBER STATES

We were able to gather a full set of selected data only for 20 EU countries (column 1 in table 1), 14 old member states from the EU15 and 6 new member states from Central Europe and including Estonia. In the research, we calculated correlations separately for old and new member states, and for all 20 EU countries together.

### **Discussion of Results**

In table 1, we collected individual data used in our research. We calculated Composite Trust (column 2) and the Composite Social Values Index (column 3); other data are from primary sources, as described.

Table 2 shows correlation coefficients between Composite Trust, the Composite Social Value Index, and national performance indicators for old and new member states, and for all 20 countries under discussion.

#### COMPOSITE SOCIAL VALUE INDEX

From table 2 we can conclude that the Composite Social Value Index does not correlate significantly with all five performance indicators. We could argue that correlation coefficient 0.61 (business efficiency) and correlation coefficient 0.59 (competitiveness) indicate some correlation of composite social values for old member states, but we did not explore these relations further because correlations with trust were significantly higher. However, it is interesting to point out that for new member states the correlation coefficient is much lower. As we will see later in discussion of the results, these significantly lower correlations indicate differences in behavior patterns in old and new member states. The results also rejected our second hypothesis, i.e. that the Composite Social Values Index

TABLE 1 Individual data at the country level EU

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
<i>Old member states</i>							
Austria	1.03	1.02	74.3	68.9	50.8	58.9	0.51
Belgium	0.98	1.09	67.5	51.3	54.1	41.9	0.50
Denmark	1.17	1.11	82.5	77.1	47.0	74.3	0.60
Finland	1.11	1.06	82.6	75.7	46.1	75.9	0.68
France	0.95	0.92	64.2	37.5	58.9	38.6	0.46
Germany	1.02	0.97	67.8	44.7	52.5	45.9	0.58
Greece	0.86	1.08	50.3	31.1	40.2	31.1	0.21
Ireland	1.03	1.02	77.8	73.4	61.8	68.9	0.42
Italy	0.99	0.93	45.8	21.6	44.2	18.1	0.36
Netherlands	1.09	1.39	77.4	67.9	58.4	56.2	0.48
Portugal	0.94	0.82	52.4	25.1	42.4	42.2	0.28
Spain	1.02	0.89	59.4	34.3	50.8	47.8	0.30
Sweden	1.12	1.36	76.3	67.6	49.2	57.9	0.72
United Kingdom	1.00	0.98	68.5	51.0	56.5	51.0	0.48
<i>New member states</i>							
Czech Republic	0.94	0.93	60.1	47.7	45.2	40.3	0.26
Estonia	0.93	0.84	66.7	49.3	54.4	65.3	0.32
Hungary	0.95	0.81	59.9	47.4	39.8	44.8	0.31
Poland	0.98	0.82	39.0	11.5	35.5	21.2	0.23
Slovakia	0.93	1.03	58.6	44.1	33.8	61.4	0.21
Slovenia	0.96	0.95	49.3	21.8	43.3	33.3	0.32

NOTES Column headings are as follows: (1) EU country, (2) Composite Trust, (3) Composite Social Values, (4) competitiveness, (5) business efficiency, (6) economic efficiency, (7) government performance, (8) Summary Innovation Index.

SOURCES *European Values Study 2005*; *IMD World Competitiveness Yearbook 2005*; *European Innovation Scoreboard 2005*; Van Oorschot and Arts 2005.

would be positively correlated with economic performances indicators for all EU member states. Our guess is that the Composite Social Values Index, as we calculated it, cannot be a realistic approximation for social capital. The main reason that we experimented with this indicator in the first place was just our curiosity to discover whether a simple composition of publicly available social values has any meaning as an indicator on its own.

TABLE 2 Correlation coefficients for old and new EU25 member states, and for total of all states under discussion

(1)	(2)	(3)	(4)	(5)	(6)
<i>Composite Trust</i>					
Old	0.81*	0.79*	0.18	0.77*	0.79*
New	-0.93*	-0.90*	-0.41	-0.94*	0.07
All	0.72*	0.69*	0.33	0.58*	0.82*
<i>Composite Social Values</i>					
Old	0.55*	0.61*	0.18	0.36	0.51*
New	0.11	-0.12	-0.28	0.29	-0.41
All	0.59*	0.61*	0.30	0.38	0.59*

NOTES Column headings are as follows: (1) EU member states, (2) competitiveness, (3) business efficiency, (4) economic efficiency, (5) government efficiency, (6) Summary Innovation Index. \*Correlation is significant at the 0.05 level.

#### COMPOSITE TRUST

On the other hand, we can notice a significant correlation between Composite Trust and performance indicators, with the exception of economic efficiency. To gain a better insight into these correlations we graphically visualized the results. Graphical presentations have revealed some very distinguishing features.

The first three graphs (figures 1, 2, and 3) show the interdependence between Composite Trust and competitiveness, business efficiency, and government efficiency. We can see that Composite Trust in all new EU member states is below the EU average and is nearly equal, regardless of their economic performance. Ten years ago, Kolankiewicz (1996) argued that in the Central European countries lower trust remains as a legacy of socialism, in which generalized trust tended to be low. We could also suspect that the lower level of trust in the new EU member states reflects their 'historical experience' with triple and often traumatic transition in the last 10 to 15 years, which caused radical changes in their societies. We have in mind political transition from the socialistic system, economic transition to the market economy, and finally accession to the EU. All together, the new EU member states are more distrustful than the old member states, but this fact has no direct influence on their economic performance.

All three graphs (figures 1, 2, and 3) reveal different patterns in behavior of the old and the new EU member states. Trend lines for both groups

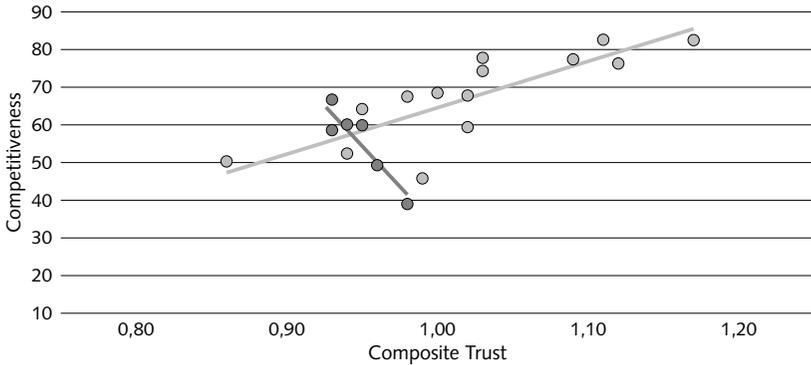


FIGURE 1 Correlation between Composite Trust and competitiveness  
 ○ old member states (— linear), ● new member states (— linear)

are nearly perpendicular to each other. We have some difficulties in interpreting negative correlations for the new member states because we cannot assess errors in primary data and consequently in the correlation coefficients. Trend lines are slightly inclined to the left side. We interpreted this anomaly as a statistical error in data and we assumed that these lines are vertical to the x-axis and do not characterize any negative correlations. They just show that in these countries the performance indicators do not depend on Composite Trust, or vice versa. On the other hand, a positive correlation between Composite Trust and performance indicators is evident for all old EU member states.

The trend-line for the old member states, in figure 1, shows that higher trust means higher competitiveness. The correlation coefficient 0.81 is high. On the other hand, the trend-lines for the new EU member states are nearly vertical, which means that competitiveness, business, and government efficiency do not depend on Composite Trust. Correlations for the old member states are high enough to be statistically significant.

This Result leads to the conclusion that the effect of trust is not equal in the old and new member states. A plausible hypothesis is that the same level of Composite Trust has different effects in different societies and economies. We will see the same behavior in figures 2 and 3. Obviously, other development forces compensate for the lack of trust in the case of new EU member states. These results also to some extent confirm Raiser's (1999) observation that trust relates to the economy in developed market economies, but not in the Central European countries.

A positive correlation between trust and business efficiency (figure 2)

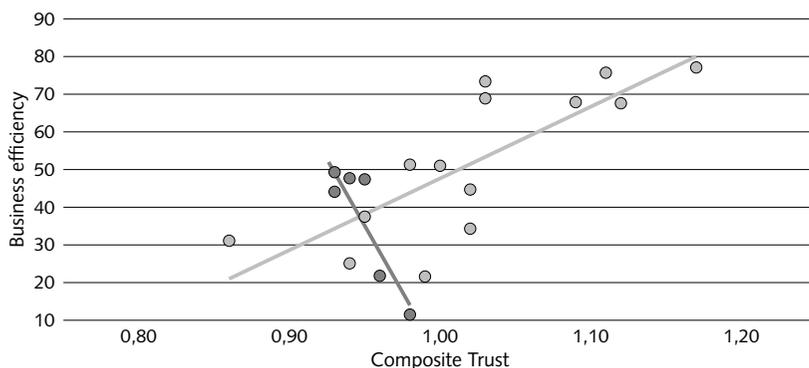


FIGURE 2 Correlation between Composite Trust and business efficiency  
 ○ old member states (— linear), ● new member states (— linear)

looks straightforward. By the definition of business efficiency (IMD *World Competitiveness Yearbook 2005*) it is *an extent to which enterprises are performing in an innovative, profitable and responsible manner including productivity and efficiency, labor market, finance, management practices and attitudes and values*. Estonia is on the top and Poland is on the bottom of business efficiency in the Central European and Baltic region, regardless of their nearly equal level of trust. Looking for the forces that compensate for a lack of trust, we can assume that Estonia introduced more efficient development incentives than Poland.

A similar situation is seen in figure 3. Government performance (IMD *World Competitiveness Yearbook 2005*) is *an extent to which government policies are conducive to competitiveness: public finance, fiscal policy, institutional framework, business legislation and societal framework*. Again, Estonia and Slovakia are on the top and Poland on the bottom. Portugal, for example, is falling behind all EU member states. We can also notice large differences in government efficiency in new member states, which are independent from the level of trust. Government efficiency depends on a wide spectrum of issues, from economic to historic (Bavec 2006), but it seems that social issues are lower on the influence list than others are.

In figure 4, we can see a very different pattern. We notice a significant correlation between Composite Trust and the Summary Innovation Index (correlation coefficient 0.82). In the contrast to figures 1, 2, and 3, the old and the new EU member states follow a similar trend line. This result confirms researches that placed the trust at the center of social values

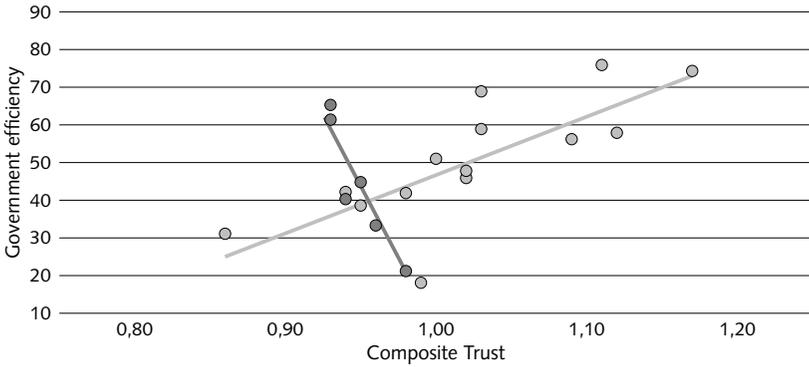


FIGURE 3 Correlation between Composite Trust and Government Efficiency  
 ○ old member states (— linear), ● new member states (— linear)

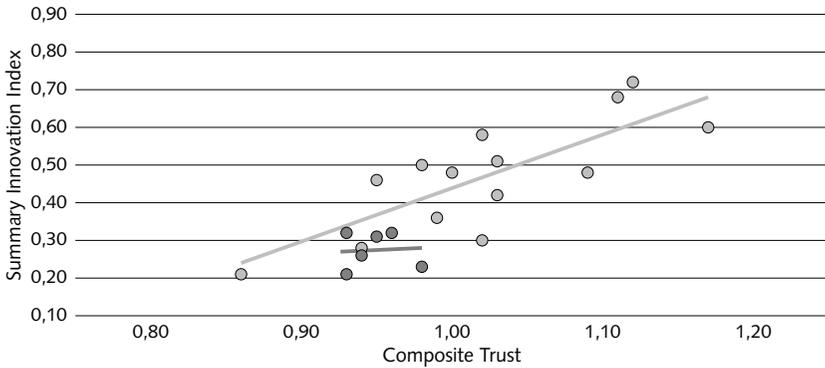


FIGURE 4 Correlation between Summary Composite Trust and the Summary Innovation Index  
 ○ old member states (— linear), ● new member states (— linear)

relevant for human innovativeness (Florida and Tinagli 2004). Scandinavian countries have the highest Composite Trust (table 1). In general, high social capital and consequently high levels of trust are trademarks of innovative societies. Researches in other regions, for example Singapore (Keong 2006), have empirically confirmed similar conclusions.

What is particularly worrying for the new EU member states is their significantly lower level of innovativeness. We will not argue about the reasons. What our research shows is just the fact that the low level of trust is associated with low innovativeness, and vice versa. This means that we cannot stimulate innovativeness just with economic incentives. We are supposed to introduce social changes, too. On the other hand, we know that social values and structures are changing very slowly, which

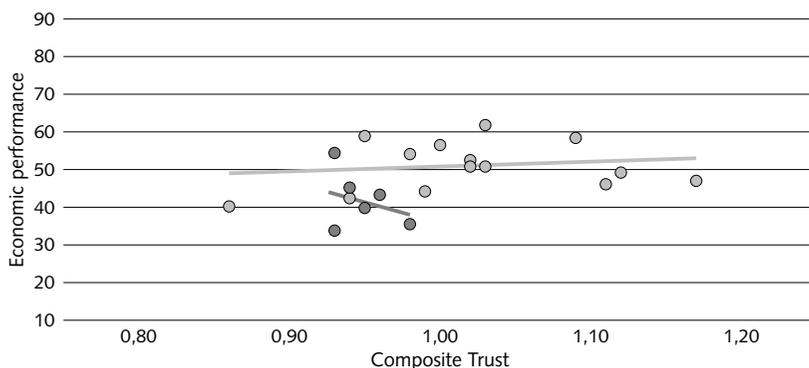


FIGURE 5 Correlation between Composite Trust and National Economic Performance  
 ○ old member states (— linear), ● new member states (— linear)

leads to the plausible conclusion that positive changes in innovativeness are slower than economic changes. This could explain the decade long struggle of new EU member states to raise their innovativeness, with very slow improvements. New EU member states still compensate for the impact of lower innovativeness to their economies with a higher level of direct foreign investments and import of new technologies.

The figure 5 shows an unexpected result. Composite Trust is not correlated with economic performance for all 20 selected EU countries (correlation coefficient 0.33). Correlation with the Composite Social Value Index is even lower (correlation coefficient 0.30). This result is interesting because it has triggered some methodological warnings related to our desktop research. We are not in position to assess correctness of the primary data and we have to take them as accurate. In the case of the Economic Performance indicator published in the *IMD World Competitiveness Yearbook 2005*, we have some reservations about its correctness. Looking at other economic indicators it is hard to justify the economic performance indicators for Slovenia 21.8 and Italy 21.6 on the one hand, and Slovakia 44.1 and Estonia 49.3 on the other.

Our opinion is that correlation between Composite Trust and economic performance should be more significant in the case of data that are more realistic. This would also back up Raiser's (1999) view about the character of trust in national economies.

## Conclusions

The ambition of this paper is to present some empirical evidence and not to provide a detailed explanation of the present situation. For that

reason, we can just briefly comment on our working hypothesis. Surprisingly, the hypothesis that Composite Trust will be positively correlated with national performances indicators was confirmed only for the old EU member states and not for the new ones. The hypothesis that correlations will be alike for the old and the new EU member states was confirmed only for correlation of Composite Trust and the Summary Innovation Index (SII).

We do not have enough empirical evidence to make decisive conclusions, but our research leads to some plausible suggestions. One of them is that trust and other social variables do not have the same effects in all countries. The old EU member states represent relatively stable social structures and values in comparison with the new member states. The most developed North European countries like Denmark, Sweden, Finland, and the Netherlands have significantly higher Composite Trust than others. Greece and Portugal are on the other side, with the lowest Composite Trust. However, they do show a positive correlation between trust and their performance. There is no such interdependence in the new EU member states. At first, they all represent a distinguishable cluster, with Composite Trust lower than the EU average. We could presume that social structures in the new EU member states are still distorted and are not in the equilibrium which characterizes developed countries with long democratic and market economy traditions (Mihaylova 2004; Kolankiewicz 1996). Nevertheless, the new EU member states are economically and socially successful, despite some deficiency in their social capital. This indicates another stimulus for economic development and opens up a dilemma if higher social capital is primarily a result of economic development, or vice versa.

The Summary Innovation Index (SII) is the only one of five performance indicators that shows a different pattern. It is strongly correlated with Composite Trust for all countries studied. This confirms many studies, which see trust as a fundamental social enabler and stimulator for innovativeness (Rimac and Stulhofer 2005; Florida and Tinagli 2004). This fact could have significant consequences for the new EU member states, because they all face low national innovativeness. If innovativeness follows the same time-resistance as social structures, then it will be difficult for them to make 'big leaps' in innovativeness that are often seen in their economic performance. It is not a surprise that their national innovation policies reflect frustration with slow progress in this field. On the other hand, it is very indicative that there are nearly no references to social

values in their innovation policies. Understanding of social incentives in national innovation policies is obviously very low.

The results support the view (Van Oorschot and Arts 2005) that we have to adopt a 'multi-dimensional' interpretation of trust and other social variables as social capital. They used an eight-dimensional indicator for social value, which proved to be difficult to manipulate and interpret. On the other hand, our oversimplified approach – when we transformed their 8-folded indicator into a single number – proved to be inappropriate. Behavior of this one-dimensional social indicator was not even close to the behavior that we would expect from the social capital. A multidimensional view would complicate our models and interpretation of results, but it is the only way to gain a deeper insight into the complicated interplay between social values and economy in general. The multidimensional model of social capital and its interactions with economy deserves further researchers' attention.

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# *Personality and Attitudes of Indian Young Female Workforce: Entrepreneurial Orientation by Education and Regions*

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This investigation analyzes the impact of region and educational background on entrepreneurial orientation of Indian young female trainees by using four personality descriptors i. e. need for achievement, innovation, personal control, and self-esteem around three attitude components i. e. affect, behavior, and cognition. The findings reflect the highest score of the respondents on the achievement motivation as compared to the other three personality descriptors (innovation, personal control, and self-esteem) and lowest score on the self-esteem dimension. Among attitude components, cognition has emerged as highest. Entrepreneurial orientation score of the sample as a whole is moderately high and female trainees from South India are having an edge over their counterparts from North India. Significant differences are not found between females of different educational backgrounds.

*Key Words:* Entrepreneurial Orientation, Achievement, Attitude, Female, Self-esteem

*JEL Classification:* L26, M12

## **Introduction**

Entrepreneurship is gaining increasing respect from the scholars as a field of research as well as practical application worldwide as a means to achieve wealth creation and personal fulfillment (Ma and Tan 2006). History has proven that with each economic downturn, it is the entrepreneurial drive and persistence that brings us back (Kuratko 2006). Entrepreneurship is the capacity in an individual to innovate, to bear

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risks, to foresee the prospects of the project, confidence and competence to meet unforeseen and adverse conditions. The activities of entrepreneurs are crucial to the economic growth and prosperity of modern societies. Entrepreneurship is a mindset that assigns different values to resources and opportunities than does the general population and a mindset that encourages creativity and innovation, changing the game, and being unique (Shane and Venkataraman 2000).

That's why the efforts to know more about entrepreneurs, factors influencing their decision to become entrepreneurs and their ultimate success are becoming important. So, a growing number of researches concentrate on entrepreneurship, entrepreneurship in organisations (Kundu and Rani 2004; Kuratko 2006; Garcia-Morales, Ruiz Moreno and Llorens-Montes 2006), and the impact of Globalisation on entrepreneurship (Kumar and Liu 2005). Rather, it is an issue of growing interest globally among policy makers (Diochon, Menzies, and Gasse 2005).

Entrepreneurs are examined from various perspectives, such as attitudes, backgrounds, personality traits, economic factors, contextual circumstances, and aspect of social marginality, gender, and geographical location (Beaver and Jennings 2005). But there is no unified, generally accepted definition and model of entrepreneurial activity and development.

Like men entrepreneurs, women entrepreneurs have an equal role to play in the nation's development. Women entrepreneurs seem to influence positively the economic growth and employment creation in a country and also it is a vehicle to empower women economically, socially, and politically. Women make up only 6% of India's workforce and the numbers get more skewed if we look up the corporate ladder. Though there are comparatively more working women in South India, only 5% of the senior management posts is held by them. Against this, North India has the lowest ratio of women managers (*The Times of India* 2006). Now women are earning greater numbers of business and professional degrees and entering the labor force, however these women are not reaching the top corporate management tiers (Burke and Vinnicombe 2005) and they experience differential treatment such as being offered less challenging work (Budhwar, Saini, and Bhatnagar 2005). As women receive higher relative returns for their skills in self-employment than in the wage and salary sector especially in professional and managerial areas (Moore and Buttner 1997) and report higher satisfaction from entrepreneurial

careers, it seems inevitable that some senior women managers will choose to exit corporate organisations and start their own companies (Terjesen 2005).

### **Personality Descriptors, Attitudes, and Entrepreneurial Orientation**

For this study, the following constructs have been selected which are studied by Robinson, Stimpson, Huefner and Hunt (1991) and commonly used in dealing with business motivation (Robinson et al. 1991): need for achievement, locus of control, self-esteem, and innovation. These personality descriptors were studied around attitude components e. g. affect, behavior, and cognition (Robinson et al. 1991) to determine the EO of young female trainees. The need for achievement is based on expectation of doing something better or faster than others and better than the person's earlier accomplishments (McClelland 1961). Innovation is creating new products, methods, markets or a new organization. It relates to perceiving and acting upon business activities in new and unique ways (Drucker 1985). Perceived person control (locus of control) of business outcomes is concerned with the individual's perception of control and influence over his or her business. Internal person control leads to a positive entrepreneurial attitude (Robinson et al. 1991). Self-esteem is associated with feelings about oneself. It is an important construct of personality for researches in the workplace because perceptions of others' about self esteem may influence individuals' outcomes (Strauss 2005).

Other than personality traits, cognitive and social processes also have impact on entrepreneurial behavior. Cognitive models of attitude have been used in entrepreneurial research where attitude instruments tend to account for more of the variance in a particular set of behaviors (Ajzen and Madden 1986) than do personality dispositions or trait-based instruments. Further, a lot of studies have shifted attention to the cognitive processes and mechanisms, according to which entrepreneurs select and process information, to make sense of the external environment (Shane and Venkataraman 2000; Nicholls-Nixon, Cooper, and Woo 2000). Even though environmental resources play a role, human resources are generally found to be better predictors of outcome of the business start-up process (Rotefoss and Kolvereid 2005). Key human resources like the owner, the entrepreneur or a few other managers play the most relevant roles and their knowledge and personal characteristics relate to individ-

ual and business performance to a great extent (Herath, Herath, and Azeez 2006).

Robinson et al. (1991) argued that attitude is a better approach to predict the entrepreneurial orientation. Attitudes are developed from cognitive, affective, and behavioral information and these show moderate relationships with each another (Breckler 1984). Beliefs (the cognitive component) in combination with evaluations (the affective component) lead to attitudes. There is empirical evidence that attitudes can be predicted from beliefs and evaluations (Fishbein and Ajzen 1975). The above mentioned four personality traits are studied around attitude components (affect, behavior and cognition) to determine EO. Salient beliefs concerning self-employment determine attitudes towards self-employment, that attitude and subjective norm determine intentions to become self-employed, and that intentions to become self-employed determine actual entry into self-employment (Kolveried and Isaksen 2006). While studying EO, researchers have pursued studies on identification of factors that predict EO, identification of EO's effect on various dimensions of firm performance and the identification of variables that moderate the EO-firm performance relationship. Entrepreneurial orientation includes the processes, practices, decision-making activities that lead to new entry (Lumpkin and Dess 1996), set of personal psychological traits, values, attributes, and attitudes strongly associated with a motivation to engage in entrepreneurial activities (Hornaday and Aboud 1971). Lumpkin and Dess (1996) emphasized individuals who determine a firm's activities. Empirical research (Begley and Boyd 1987; Utsch, Rauch, Rothfuss, and Frese 1999) as well as meta-analytic results (Stewart and Roth 2001) found evidence that some components of EO (autonomy, innovativeness, competitive aggressiveness, achievement orientation, and risk-taking) were higher in samples of business founders than in samples of managers (human resources). The businesses that adopt a more entrepreneurial strategic orientation perform better (Covin, Green, and Slevin 2006). Identifying the relationship between personality characteristics and entrepreneurial orientation is important for theoretical and practical reasons.

### **Objectives and Importance of the Study**

The main objective of the study is to assess the entrepreneurial orientation of young female trainees at Air Force Academy in India. To achieve the main objective, the study attempts to seek answers to the following questions:

1. How do young female trainees from North India and South India differ on achievement motivation, innovation, personal control, and self-esteem?
2. How do young female trainees from different educational background differ on achievement motivation, innovation, personal control, and self-esteem?
3. How do young female trainees differ on attitudinal components i. e. affect, behavior, and cognition?
4. How do education background and regions interact on four personality descriptors and attitude components?
5. How do young female trainees differ according to region and educational background on entrepreneurial orientation?

The study on Indian female entrepreneurs is not only important because of their numbers, but also because of their increasing contribution in entrepreneurial activity. The percentage of entrepreneurial activity in India is 17.9% (Male = 21.4% and Female = 14.1%), as compared to United States (Total = 10.5%, Male = 12.9%, Female = 8.1%), UK (Total = 5.4%, Male = 7.4%, Female = 3.3%), and Japan (Total = 1.8%, Male = 3.0%, Female = 0.6%). The Indian women's share in the total percentage of entrepreneurial activity is 39.4% among 29 countries participating in the 2002 Global Entrepreneurship Monitor (GEM) (Verheul, Van Stel, and Thurik 2006). Further, South Indian women are more educated and employed than North Indian women. So these two regions of India (North and South) are important for such type of studies. Other reasons of importance were:

- Human resource management, psychological aspects, corporate entrepreneurship, and the need for entrepreneurial cultures have gained greater research attention during the past few years (Kuratko 2006).
- This survey was a national level survey because the candidates were selected by pooling candidates nation-wide, covering the majority of the States of India.
- As young female trainees joined this organization (Air Force), they were ready to accept the challenges of the masculine nature of jobs, which were not routine jobs for the Indian females.
- This study was also useful for trainees as individuals because, by knowing their EAO, they can take their future career decisions.

- Trainees were studied with the aim of creating a more holistic EAO theory.

### **Literature Review**

The existing literature concentrates on women who have already made the decision to pursue business ownership or who are already successful entrepreneurs in their field, rather than those who have the potential or intention to start a new venture (Delmar and Davidsson 2000; Fielden and Dawe 2004). Women entrepreneurs face a variety of challenges in developing and running a business and many of them remain, even after establishing and growing businesses. A number of obstacles faced by female entrepreneurs, affecting the development and growth of the firm include lack of knowledge of skills required to develop their business, acquiring appropriate training (Walker and Joyner 1999), obtaining capital (Moore and Buttner 1997), and financial planning. Women use only personal assets at start-up and employ no or minimal external funding (McClelland, Swail, Bell, and Ibbotson 2005).

Other than the above financial constraints, resistance from family (Babaeva and Chirikova 1997), cultural conditioning (Simmons 1996), gender stereotypes (McClelland et al. 2005), gender discrimination (Simmons 1996), social constraints, and discrimination put women at a disadvantage in pursuing entrepreneurial endeavors. Women acquire certain inhibitions right from their childhood which are further reinforced by parents and society (Kulkarni 2002). Women have been socialized to possess feminine traits such as warmth, kindness, selflessness, sympathy (Schein 1973) whereas men are considered to possess traits such as being aggressive, forceful, rational, competitive, decisive, strong, self-confident, and independent (Schein 1973), which are required for the managerial roles. There are also gender-role stereotypes that the workplace is the men's area as they are the bread winners, while the women's sphere is domestic responsibilities (Kang and Rowley 2005). Females appear less forceful only if you take the males' behavior as the norm (Tannen 1998).

The literature highlights various 'push' and 'pull' factors as motivators for business start-up (Alstete 2003) that push or pull women towards entrepreneurship and factors which affect the success of entrepreneurs. A study reveals that the pull of an entrepreneurial idea is the more prevalent motivation for starting a business among women and men (Mattis 2004). Women entrepreneurs rate the desire to face challenges, and self-

determination as the influencing factors, which indicates that women's entrepreneurial motivation stems from 'pull' factors rather than 'push' factors (Moore and Buttner 1997).

A number of studies have attempted to develop typologies and profiles of the women entrepreneurs (Hisrich and Brush 1986), by studying their background, education and previous experience. Some demographic characteristics of women business owners are similar to those of men, like marital status (married), age (30–45), and birth order (first born) (Watkins and Watkins 1984). In reference to education it has been observed that women have pursued undergraduate degrees in liberal arts as compared to business, engineering or technical subjects. Formal education positively affects opportunity recognition but cannot significantly discriminate between successful and unsuccessful entrepreneurial process (Davidsson and Honig 2003; Ravasi and Turati 2005). Regarding previous work experience, the literature highlights the predominance of women in the traditional sectors such as service and retail (Cooke 2005), teaching, office administration or secretarial areas rather than executive, managerial, scientific or technical positions (Watkins and Watkins 1984).

Due to socialization processes, women have different ways of thinking and different values (Cliff 1998). Women are viewed as having the skills like co-operating, nurturing, adapting, and persuading (Winn 2004) as women are mostly operating in the service industry. Generally, women are considered as less assertive, less competitive, and less aggressive in meeting the demands of business situations (Budhwar et al. 2005). They are more likely to delegate authority, more successful in dealing with clients, better customer service providers, and score more on integrity, honesty and human relations, and are more adoptive of interactive leadership styles (Budhwar et al. 2005). Neider (1987) measured locus of control in women entrepreneurs and found them to be more internally oriented. Motivation (achievement motives, independence motives, and economic necessity motives) had a significant effect on the business performance of women entrepreneurs (Lerner, Brush, and Hisrich 1995). Fagenson (1993) found that men and women who become entrepreneurs are more similar to each other in terms of values than they are to others of the same gender in other professions. Women owned businesses are said to be more innovative than men owned businesses because men tend to inherit or buy the venture while women start one more often (Gumpert 1983).

Segal, Borgia and Schoenfeld (2005) found a positive relationship be-

tween an individual's entrepreneurial self-efficiency and his or her intention to become an entrepreneur. High self-esteem individuals utilized more adaptive self-regulatory strategies than low self-esteem individuals (Baumeister, Campbell, Krueger, and Vohs 2003) and these strategies might be a factor in their higher levels of reported happiness and satisfaction (Di Paula and Campbell 2002). The esteem as a personality variable exerted a significant influence on job performance of managers (Strauss 2005). People with positive self regard performed better, tended to be more satisfied with their work and life and tended to choose the goals that have the best chance to make them happy with their work and lives (Judge, Bono, Erez, and Locke 2005).

Thus, on the basis of literature review, we propose following hypotheses:

- H1 *Female trainees have achievement motivation (orientation).*
- H1A *Female trainees of North and South India do differ on achievement motivation (orientation).*
- H1B *Female trainees of different educational backgrounds (humanities and science background) do differ on achievement motivation (orientation).*
- H2 *Female trainees have innovation orientation.*
- H2A *Female trainees of North and South India do differ on innovation orientation.*
- H2B *Female trainees of different educational backgrounds (humanities and science background) do differ on innovation orientation.*
- H3 *Female trainees have internal locus of control (personal control).*
- H3A *Female trainees of North and South India do differ on locus of control (personal control).*
- H3B *Female trainees of different educational backgrounds (humanities and science background) do differ on locus of control (personal control).*
- H4 *Female trainees have positive self-esteem.*
- H4A *Female trainees of North and South India do differ on self-esteem.*
- H4B *Female trainees of different educational backgrounds (humanities and science background) do differ on self-esteem.*
- H5 *Female trainees have positive affect.*
- H5A *Female trainees of North and South India do differ on affect.*

- H5B *Female trainees of different educational backgrounds (humanities and science background) do differ on affect.*
- H6 *Female trainees have positive behavior.*
- H6A *Female trainees of North and South India do differ on behavior.*
- H6B *Female trainees of different educational backgrounds (humanities and science background) do differ on behavior.*
- H7 *Female trainees have positive cognition.*
- H7A *Female trainees of North and South India do differ on cognition.*
- H7B *Female trainees of different educational backgrounds (humanities and science background) do differ on cognition.*
- H8 *Female trainees have overall entrepreneurial orientation (EO).*
- H8A *Overall entrepreneurial orientation (EO) differs according to regions (North and South India) of trainees.*
- H8B *Overall entrepreneurial orientation (EO) differs according to educational backgrounds (humanities and science background) of trainees.*

### **Research Methodology**

This study is based on primary data collected from India through a questionnaire containing variables on the issue of entrepreneurial attitude and skills. The modified variables incorporated in this questionnaire were mainly picked up from the scale on entrepreneurial attitude orientation (EAO) developed by Robinson et al. (1991). In addition to 75 variables on entrepreneurial attitude orientation (EAO), seven background variables (see table 2) were also incorporated in the questionnaire. Regions (North and South India) and educational backgrounds (Humanities and Science) variables were taken as independent variables in this study. Dependent variables related to entrepreneurial attitude orientation (EAO) were divided into four main scales on the pattern of earlier study (Robinson et al. 1991) i. e. achievement motivation, innovation, personal control, and self-esteem. Each of these four main scales contained the attitude variables regarding affect, behavior, and cognition components of trainees. The dependent variables in the questionnaire were framed on a five-point scale ranging from strongly disagree (one) to strongly agree (five). Actual responses of the respondents on the variables (one to five) were considered as weights.

The sample items of all personality measures around attitude components are:

TABLE 1 Distribution of sample

Educational background	North India	South India	Total
Humanities	37	20	57
Science	21	18	39
Total	58	38	96

1. I do every job as thoroughly as possible (achievement-behaviour);
2. I spend a lot of time planning my activities (personal control-behaviour);
3. I get excited when I think of new ideas to stimulate activities (innovation-affect);
4. I believe successful people handle themselves well in gatherings (self-esteem-cognition).

Out of 550 trainees, selected through national level test and interview, of the batches of 2003–2004 at the Indian Air Force Academy, all 105 female trainees at the academy were given the survey questionnaires personally with a request to fill in the same at a single sitting. Finally, we could collect 101 questionnaires from the respondents in the time span of 15 days. Out of the collected questionnaires, five were found incomplete and the same were deleted from further processing. Finally, 96 completed questionnaires were used for analysis. This number exceeds the 91.4 per cent of the target respondents. Table 1 shows the region and educational background-wise break up of the sample.

Statistical tools such as correlations, analysis of variance (ANOVA), means, grand means, standard deviations and percentages were used for the analysis of the data gathered. The higher the mean scores of four main scales (i. e. achievement motivation, innovation, personal control, and self-esteem), the higher will be the entrepreneurial orientation (EO). A lower mean score will be indicative of lower entrepreneurial orientation (EO) i. e. more towards managerial tendency.

## Results

Primary data collected from young female trainee respondents were used to assess the score on four main factors around three attitudinal components i. e. affect, behavior, and cognition. While table 1 explains the distribution of the sample, table 2 explains the characteristics of the sample around educational qualifications, education subjects, family background, work experience, aim of life, region of study (North and South),

TABLE 2 Characteristics of sample

Variables	Categories	Number	Percentage
1. Educational qualifications	Graduate	58	60.4%
	Post graduate	38	39.6%
2. Subjects	Humanities	57	59.4%
	Science	39	40.6%
3. Family backgrounds	Service	80	83.3%
	Business	16	16.7%
4. Work experience	No experience	62	64.6%
	Experience	34	35.4%
5. Aim	Executive/officer	81	84.4%
	Business person/ entrepreneur	15	15.6%
6. Region	North India	58	60.4%
	South India	38	39.6%
7. Average age	North India	58	22.66 yrs
	South India	38	22.74 yrs
	Humanities	57	22.98 yrs
	Sciences	39	22.26 yrs

and age of the respondents. Table 3 shows very interesting correlations and means and table 4 shows alpha values of the scales. Achievement is significantly correlated with personality descriptors except self-esteem. Again, achievement is having the highest correlation with cognition component ( $r = 0.806$ ), whereas self-esteem is not significantly correlated with cognition. Innovation ( $r = 0.759$ ) and personal control ( $0.710$ ) show highest correlations with behavior component. Further innovation ( $r = 0.738$ ) and personal control ( $r = 0.604$ ) also show high correlations with cognition. Self-esteem is highly correlated with affect component ( $r = 0.691$ ) and least correlated but significant with innovation and personal control. The extent of achievement level ( $\bar{x} = 4.34$ ) is highest, and least in the case of self esteem ( $\bar{x} = 3.08$ ) of the sample. The Alpha value of full scale was 0.80.

Table 5 showed the ANOVA results of four personality descriptors, three attitude components, and overall attitude. Achievement differed significantly according to region effect ( $p \leq 0.006$ ), innovation differed significantly according to region effect ( $p \leq 0.000$ ) and interaction effect ( $p \leq$

TABLE 3 Inter-factor correlations, means, and sds

Factors	F1	F2	F3	F4	C1	C2	C3
F1 Achievement	—						
F2 Innovation	.584*	—					
F3 Personal control	.588*	.529*	—				
F4 Self-esteem	.114	.268*	.205*	—			
C1 Affect	.497*	.589*	.501*	.691*	—		
C2 Behavior	.656*	.759*	.710*	.449*	.536*	—	
C3 Cognition	.806*	.738*	.604*	.167	.393*	.596*	—
Mean	4.34	3.86	3.83	3.08	3.78	3.56	4.27
SD	0.308	0.300	0.355	0.433	0.310	0.297	0.301
Scale items	23	26	12	14	24	27	24

NOTE \* Correlation is significant at the 0.01 level (2-tailed).

TABLE 4 Alpha values

Four factors – 75 items arranged in four personality trait groups	0.68
Three attitude components – 75 items arranged in attitude groups	0.76
Full scale – 75 items	0.80

TABLE 5 Analysis of variance of personality descriptors and attitude components

Factors	(1)	(2)	(3)
F1 Achievement	7.923 (0.006)	0.315 (0.576)	0.570 (0.452)
F2 Innovation	18.204 (0.000)	3.740 (0.056)	3.797 (0.054)
F3 Personal control	7.795 (0.006)	0.901 (0.345)	0.100 (0.753)
F4 Self-esteem	0.656 (0.420)	0.001 (0.972)	0.959 (0.330)
C1 Affect	3.019 (0.086)	0.026 (0.872)	0.220 (0.640)
C2 Behavior	20.230 (0.000)	4.223 (0.043)	3.129 (0.080)
C3 Cognition	8.666 (0.004)	1.251 (0.266)	1.101 (0.297)
EA Attitude	14.349 (0.000)	1.545 (0.217)	1.841 (0.178)

NOTES Column headings are as follows: (1) region effect (main),  $F$  value; (2) educational background effect (main),  $F$  value; (3) 2-way interaction,  $F$  value. Significance levels are indicated in parentheses.

0.054), personal control differed according to region effect ( $p \leq 0.006$ ), and self-esteem did not differ on any of the effects. Further, achievement of female trainees from South India was higher ( $\bar{x} = 4.44$ ) than from

TABLE 6 Summary of means and grand means for four descriptors and three components

Factors		North India	South India	Grand mean
F1 Achievement	Hum	4.31	4.44	4.35
	Sc	4.22	4.45	4.44
	GM	4.28	4.44	4.34
F2 Innovation	Hum	3.85	3.99	3.90
	Sc	3.63	3.99	3.80
	GM	3.77	3.99	3.86
F3 Personal Control	Hum	3.77	4.00	3.85
	Sc	3.73	3.91	3.81
	GM	3.76	3.96	3.84
F4 Self-esteem	Hum	3.09	3.08	3.09
	Sc	3.00	3.16	3.07
	GM	3.06	3.12	3.08
C1 Affect	Hum	3.74	3.82	3.77
	Sc	3.72	3.86	3.79
	GM	3.73	3.84	3.78
C2 Behaviour	Hum	3.55	3.71	3.60
	Sc	3.33	3.69	3.50
	GM	3.47	3.70	3.56
C3 Cognition	Hum	4.26	4.38	4.30
	Sc	4.12	4.37	4.24
	GM	4.21	4.37	4.27
Attitude (EO)	Hum	3.84	3.96	3.88
	Sc	3.71	3.96	3.83
	GM	3.79	3.96	3.86

North India ( $\bar{x} = 4.28$ ). Trainees from South India again scored higher on innovation ( $\bar{x} = 3.99$ ) and personal control ( $\bar{x} = 3.96$ ) than trainees from North India ( $\bar{x} = 3.77$ ) and ( $\bar{x} = 3.76$ ), respectively. These results confirmed the H1A, H2A, and H3A. However, H1B, H2B, and H3B were not supported. On innovation dimension, female trainees from North India with science background scored least ( $\bar{x} = 3.63$ ). On self-esteem dimension, all mean scores were least as compared to other dimensions. However, self-esteem was highest in the case of females of science back-

ground from South India ( $\bar{x} = 3.16$ ) but significant differences were not there. So, self-esteem results did not support H4A and H4B.

Affect did not differ significantly on any of the effects. It resulted rejection of H5A and H5B. Behavior differed significantly according to region effect ( $p \leq 0.000$ ) and educational background effect ( $p \leq 0.043$ ), and cognition differed significantly according to region effect ( $p \leq 0.004$ ) only. A further perusal of table 6 showed that female trainees from South India scored higher on behavior and cognition. These results supported the H6A, H6B, and H7A, but did not confirm the H7B.

In case of the overall attitude variable, region effect showed the significant difference. On overall attitude, females from South India scored higher ( $\bar{x} = 3.96$ ) than North India ( $\bar{x} = 3.79$ ). Overall attitude/orientation results confirmed the H8A, but did not confirm H8B.

Overall entrepreneurial orientation (EO) can be seen through table 3 and table 6. The results were derived by considering the sample as a whole ( $N = 96$ ). The respondents scored highest orientation on achievement motivation ( $\bar{x} = 4.34$ ) and least orientation on self-esteem ( $\bar{x} = 3.08$ ) but positive. Further, they scored moderately high orientation on innovation factor ( $\bar{x} = 3.86$ ) and personal control ( $\bar{x} = 3.83$ ). On attitudinal components, the respondents scored highest orientation on cognition ( $\bar{x} = 4.27$ ) and moderately high orientation on affect ( $\bar{x} = 3.86$ ) and behavior ( $\bar{x} = 3.56$ ). For bringing out the entrepreneurial orientation (EO), the overall mean score of these four main personality factors and three attitudinal components was considered. The brought out overall score ( $\bar{x} = 3.86$ ) i. e. entrepreneurial orientation (EO) was considered moderately high/high. Hence, H1, H2, H3, H4, H5, H6, H7 and H8 were approved.

### **Discussion and Managerial Implications**

The Entrepreneurial Orientation (EO) has been used to differentiate entrepreneurs and managers on achievement, innovation, personal control, and self-esteem (Robinson, Ahmed, Dana, Latfullin, and Smirnova 2001), and significant differences have been found on achievement, personal control, and self esteem but not on innovation. In the present study, female trainees have scored highest on the achievement motivation as compared to the other three personality descriptors (innovation, personal control, and self-esteem) and among attitude components, cognition has emerged as highest. Specifically, female trainees from South India showed relatively higher achievement orientation. Entrepreneurs

have a higher need to achieve than non-entrepreneurs. According to McClelland (1961), high need for achievement drives people to become entrepreneurs. Innovation orientation is moderately high throughout the sample and South Indian female trainees from Humanities background have scored higher. The innovative spirit is the quintessence of entrepreneurship and the most basic quality requirement of the modern enterprise system for entrepreneurs as well (Drucker 1985; Robinson et al. 1991), entrepreneurs being more creative and innovative than non-entrepreneurs are able to see things differently (Hodgetts, Luthans, and Doh 2006). Innovative culture as well as knowledge and capabilities play a critical role in the success of the entrepreneurial firm (Knight and Cavusgil 2004). Entrepreneurial behavior can add significant value and innovation is an essential aspect of this process. On the dimension of locus of control (personal control), female trainees from South India have shown higher internal personal control as compared to trainees from North India. Individuals who perceive their outcomes in life as determined by forces beyond their control such as the result of luck, fate or powerful others are considered to be externally oriented. Internals assume responsibility for their actions and accept responsibility for outcomes. Individuals with a high internal control demonstrate higher levels of achievement (Auer 1992) and are more likely to accept the responsibilities of starting and running their own businesses. Internal locus of control in that way is associated with the desire to become an entrepreneur (Bonnett and Furnham 1991) and women entrepreneurs have been found as internally oriented (Neider 1987).

Self-esteem of the female trainees is found lowest. Women have been socialized to possess feminine traits such as warmth, kindness, selflessness, sympathy (Schein 1973). They acquire certain inhibitions right from their childhood (Kulkarni 2002) and internalization of negative stereotypes may be one of the reasons for women not looking beyond basic employment and settling for less than they are capable of. Women are affected by demoralization due to their family responsibilities (Kang and Rowley 2005). Further, gender conditioning and internalized oppression causes feelings of inadequacy and self-criticism and finally low self-esteem (Simmons 1996). Gender stereotypes (Still and Timms 2000; McClelland et al. 2005) and social constraints and discrimination put women at a disadvantage in pursuing entrepreneurial endeavors (Starr and Yudkin 1996).

In this study, no difference is noticed between females of different ed-

educational background. However, female trainees are highly qualified as they are selected as officers in the Air Force. Attaining a high level of education positively influences the probability of becoming involved in the business start-up process (Delmar and Davidsson 2000). But the entrepreneur's level of education and academic studies (economics, business, and engineering) is not found to be significantly correlated with the performance of the business (Lerner, Brush, and Hisrich 1995). Further, educational background of women business owners (social sciences and/or arts) can restrict or discourage them from turning to start-up ventures in manufacturing, finance or technology and also partly explains the high concentration of women-owned businesses in the service sectors (Brush 1990). However, female aspirants (MBA students) from Marketing and International Business streams scored very high entrepreneurial orientation on the dimensions 'self-starter and leader', 'hard-worker', 'organizer' and 'social and trustworthy' than male aspirants (Kundu and Rani 2004).

Out of the four personality descriptors, achievement motivation, innovation, and personal control are moderately highly correlated with each other. Self-esteem is not significantly correlated with achievement but correlated with innovation and personal control. Other studies have drawn a strong relationship between self-esteem and locus of control (Klein and Keller 1990). Further entrepreneurs have shown a personality pattern characterized by a high need for achievement, high locus of control, and medium risk taking propensity (Korunka, Frank, Lueger, and Mugler 2003) and another study has shown that respondents with a higher degree of internal locus of control show higher levels of achievement (Auer 1992). The three components of attitude (affect, behavior, and cognition) are moderately co-related with each other. This is in tune with the results found regarding these attitude components by another study (Breckler 1984). Entrepreneurial orientation score of the sample as a whole is moderately high. Attitude (EO) differs significantly according to regions of India. A broad overview of the results shows that females from South India are having a higher entrepreneurial orientation/ attitude. It has been observed that regions with a high proportion of small firms have significantly higher new firm formation rates (Spilling 1996). This may be because of availability of entrepreneurial role models who encourage other individuals to consider business ownership.

This study does have practical implications for the younger generation of female students, professionals, organisations, and government. After

a few years, the participants of this study may face career challenge as they belong either to permanent or to short service commissions. This study may be useful for them to take their career decisions after this job i. e. bridge employment – including entrepreneurial activities (Singh and DeNoble 2003). For female students, this study is helpful in identifying their orientation towards entrepreneurship/salaried job. This may help them to decide whether they should concentrate on higher studies or should take some entrepreneurial training.

Larger organizations need to appreciate the depth of potential that exists and the revenue that can be created if it is tapped. Corporate sector and Air Force organization may use this study while making decisions regarding HRM i. e. planning, recruitment and selection, placement, training, performance appraisal, career guidance, and separation of its human resources. Further organisation can cultivate corporate entrepreneurship and make inclusive organisation by empowering women. In practice, intrapreneurship can have beneficial effects on the firm's growth and profitability, both in absolute and relative terms (Antonicic 2007). The reasons for the pursuit of corporate entrepreneurship are: (i) required changes, innovations, and improvements in the market place to avoid stagnation and decline; (ii) perceived weaknesses in the traditional methods of corporate management; (iii) turnover of innovative minded employees who are disenchanted with the bureaucratic organisations (Pinchot 1985).

For policy makers, it shows a relationship between entrepreneurial orientation and the intention to start a business. Government may identify such type of aspirants and motivate them to start new activity (self-employment) by creating favorable environment and facilities. Training and Management institutes in India provide trained manpower which makes significant contributions to establishing the pace of industrialization and accelerating socio-economic development of the country. The vast reservoir of human resources represented by the training and management institutes contains a fairly large population of potential entrepreneurs whose talents and energy must be tapped for optimum results in entrepreneurship development (Kundu and Rani 2004). Despite manifold efforts being made from different parts of the country, it appears that the entrepreneurial culture is yet to find its roots in the Indian youth community. By taking cues from this study, educators can build curriculum and development programs to encourage and empower future female entrepreneurs. Developing countries like India may use such

studies in reducing the problem of unemployment by developing and diverting the potential candidates towards self-employment.

A potential limitation of this study was that personality traits and attitudes of the female workforce were measured with the same survey at the same point in time. Thus, relationships among these constructs could be influenced by common method variance. Podsakoff and Organ (1986) recommend that researchers should at least report results from a test of single-factor hypothesis as an explanation of inter-correlation of the variables. Harman's one-factor test showed that the first factor accounted for only 13.850% of the covariance among measures (Podsakoff, MacKenzie, Lee, and Podsakoff 2003; Podsakoff and Organ 1986), suggesting that common method variance is not a severe issue.

While this research was limited to a small sample, the findings are nevertheless important because of the nation-wide distribution of the sample. This research may provide a useful insight into the changing perception of young females despite the effects of different stereotypes and gender discrimination in the working environment. Special counseling and training programs may be useful for developing females to come out from the age old stereotypes, social barriers, and to enhance their self-esteem. Further, only four personality traits were included in this study, whereas more traits could have been included to give a comprehensive view about the objective. Despite this, these four traits i. e. achievement motivation, personal control, innovation, and self esteem around three attitude components, could give very interesting and applicable results.

In order to obtain better results, the study may be extended by including more personality traits, more background criteria including intentions, variety of female respondents, and larger survey. Extended researches may also be conducted on comparative analysis of potential and existing women entrepreneurs on different personality and attitude dimensions across cultures.

### **Conclusion**

In addition to the measurement of overall entrepreneurial orientation of young females, the study has analyzed the impact of region and educational background on entrepreneurial orientation. The findings reflect the highest score of the respondents on the achievement motivation as compared to the other three personality descriptors (innovation, personal control, and self-esteem) and lowest score on the self-

esteem dimension. Among attitude components, cognition has emerged as highest. Entrepreneurial orientation score of the sample as a whole is moderately high, and young female trainees from South India have the edge over their counterparts from North India. Significant differences are not found between females from different educational backgrounds.

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# *Determinants of Consumer Willingness to Purchase Non-Deceptive Counterfeit Products*

Irena Vida

This study offers insights into non-deceptive counterfeiting by focusing on consumers in a new EU member country. More specifically, consumers' inclination to purchase counterfeits at various price levels relative to retail prices of genuine branded products is examined, and the effects of various socio-economic and socio-psychological characteristics are explored. In reviewing the consumer behavior literature and recent empirical work, a conceptual model of consumer general willingness to purchase counterfeit products was developed. Using path analyses to test the system of structural relationships among the variables, inconsistent patterns of results were found across three classes of counterfeit products. Implications for management and further research are provided.

*Key Words:* counterfeit products, consumer unethical behavior, willingness to buy, Slovenia

*JEL Classification:* M31, M39

## **Introduction**

Despite the efforts on the part of international trade organizations to deter counterfeiting practices, product counterfeiting represents a growing problem for legitimate producers of global branded products ranging from pharmaceuticals to computer software and fashion merchandise. Even in light of technological advancements facilitating recognition of genuine products and legal pressures on illegitimate buyers and sellers, corporations continue to incur billions of US dollars in lost sales annually due to this problem (2005 Commercial Piracy Report 2006; Harvey and Ronkainen 1985; Shultz and Saporito 1995; Stoettinger and Penz 2003).

According to some estimates, international trade in counterfeit products accounts for three to six percent of overall world trade, with trends indicating that the counterfeit product market is booming (2005 Commercial Piracy Report 2006; Delener 2000). Clearly, the consequences of

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counterfeiting practices are not only economically devastating to manufacturers of genuine products and brands, but also affect hundreds of thousand of jobs, increase the cost of marketing legitimate products, and diminish brand equity and trademark owner reputation. Moreover, counterfeit trade may threaten consumer health and safety such as in the case of fake amphetamines and tranquilizers, and bogus birth control pills (Chakraborty, Allred, and Bristol 1996).

With counterfeit merchandise cutting across various industries in business-to-consumer and business-to-business markets in industrialized and emerging economies alike, trademark infringement cannot be ignored. Such illegal practices can be reduced by cutting into either of the two sides in the exchange: the supply side of counterfeits or the demand side for counterfeits. While the supply side of counterfeiting has received considerable attention in the literature, investigations focusing on the demand side are still scarce (Ang, Cheng, Lim, and Tambyah 2001; Bloch, Bush and Campbell 1993; Dubinsky, Nataraajan, and Huang 2005; Stoettinger and Penz 2003).

Generally, academic studies differentiate between two types of transactions involving fake products, i. e., deceptive and non-deceptive counterfeiting (Grossman and Shapiro 1988; Chakraborty et al. 1996). The former represents situations in which consumers believe they have purchased a genuine product when in fact it is a fake. On the other hand, the non-deceptive counterfeits refer to situations when consumers are fully aware (based on price, quality and the type of outlet from which the product is purchased) that they are buying a knock-off at the time of purchase.

This study focuses on the demand side of counterfeiting, examining consumer perceptions of non-deceptive counterfeiting in Slovenia, one of the most successful transitional economies among the new EU countries. There have been reports indicating that the production of fake labels, decals and packaging has become a virtual cottage industry in some Central, Southern and Eastern European (CSEE) markets, with imported fake products from the Far East adding to the problem (Al-Khatib, Robertson, and Lascu 2004). For instance, Mattel has lost millions from fake Barbie dolls made in Russia, and the Italian alcoholic beverages producer Martini & Rossi has sought to combat counterfeits through the court system in various CSEE countries (Crisp 1993; Delener 2000). While a wide range of products can be counterfeited, consumers knowingly engage in purchasing fakes particularly in some

product categories such as luxury fashion items and computer software. As a result, this research addresses various determinants of consumers' attraction to lower priced counterfeits in three product-categories, two fashion-oriented products (a branded T-shirt and a watch), and an item of software. More specifically, consumers' inclination to purchase these non-deceptive product counterfeits at various price levels relative to retail prices of genuine branded products are examined in this exploratory study.

### **Literature Review and Conceptual Framework for the Study**

Various researchers have studied counterfeit practices, production and trade of illicit goods, i. e., illegal goods freely chosen by the consumer, and the demand side of counterfeiting. This includes criminologists, legal scholars, criminal psychiatrist and sociologists studying deviant behavior, as well as business and marketing scholars (Albers-Miller 1999; Dubinsky et al. 2005; Harvey and Ronkainen 1985). While the latter have in the last decade focused primarily on the supply side of counterfeiting, a renewed interest in empirical investigations of the demand side of counterfeiting practices seems apparent since the mid-1990's, after the renowned marketing scholar, Elisabeth Hirschman, had expressed the need for deeper explorations of the 'dark-side' of consumer behavior. In response, a special issue of *Psychology and Marketing* was published by Budden and Griffith (1996) to study aberrant and dysfunctional consumer behavior, including addictive and compulsive behavior, consumer fraud and shoplifting.

While various theories and models attempt to explain ethical behavior in a marketing context, studies specifically addressing determinants of illegal and inappropriate consumer behavior are scarce and scattered. For instance, Ferrell and Gresham's (1985) model suggests that the decision process individuals encounter when faced with an ethical issue (such as in the case of a non-deceptive counterfeit product purchasing dilemma) is affected by individual factors (e. g., knowledge, values, attitudes, and intentions), significant others (differential association and role set configuration) and opportunity (e. g., professional codes, rewards and punishments). Yet other researchers believe context specific frameworks are needed when examining determinants of individual illicit product purchases, such as in the case of software piracy (Simpson, Banerjee, and Simpson 1994).

Despite the paucity of theoretical guidance, literature in the field and

recent empirical studies seem to suggest that various individual characteristics and situational factors motivate people to willingly engage in misbehavior such as the purchasing of fake branded products (Dubinsky et al. 2005; Al-Khatib et al. 2004). Price advantages of counterfeits relative to genuine products play a major factor in consumer continuing demand for counterfeit products (Bloch et al. 1993; Schlegelmilch et al. 1998; Stoettinger and Penz 2003). Other factors underlying consumer counterfeiting behavior suggested in the literature include a) the penalty and sanctions associated with criminal behavior, b) direct or indirect social pressure (e. g., whether the person is conducting illegal behavior in the presence or absence of others), c) personality traits and characteristics of individuals, and d) the ability of participants to rationalize the behavior (Albers-Miller 1999; Ang et al. 2001; Simpson et al. 1994; Stratton et al. 1997).

Hence, against this background, we propose a conceptual model presented in figure 1, and explore consumer willingness to purchase fake products. This focal concept is similar to the concept of *willingness to pay*, which practitioners (market researchers, psychologists and economists) use in estimating demand for private and public goods and in designing optimal price schedules (Werterbroch and Skiera 2001, 3). In the economic literature, willingness to pay denotes the maximum price a buyer is willing to pay for a given quantity of a good (i. e., a ration-scaled measure of the subjective value the buyer assigns to the good). A consumer chooses an item from a set of alternatives for which a person's willingness to pay exceeds price the most. Similar dependent variables in examining consumer ethical issues were used in recent studies (e. g., De Pelsmacker, Driesen, and Rayp 2005; Stoettinger and Penz 2003). As is common in attitude models (Fishbein and Ajzen 1975), this construct measured the intention to purchase counterfeits and served as a proxy to predict behavior.

As several consumer behavior researchers suggest, consumers always balance monetary cost on the one hand and other types of costs on the other against perceived benefits, and there is no reason to believe that the case of consumers contemplating the purchase of a fake product over a genuine product would be different (Ang et al. 2001; Bloch et al. 1993). Hence, the willingness to purchase construct in our model refers to an individual's inclination to purchase counterfeits at various price levels relative to retail prices of genuine branded products.

Our conceptual model suggests that consumer willingness to purchase

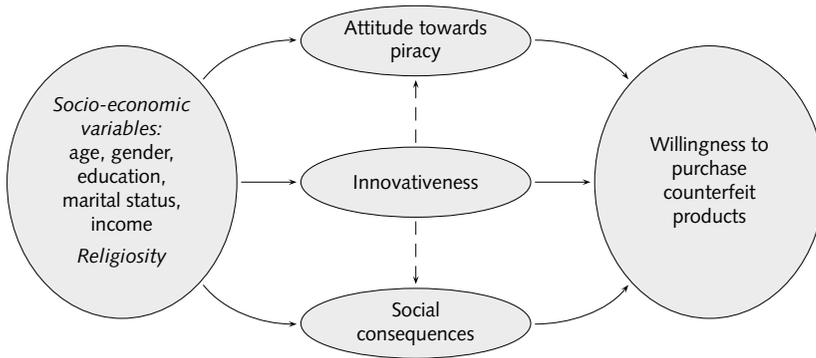


FIGURE 1 Conceptual model for the study

a fake product will be a function of three underlying factors previously identified in the literature, and believed to be category- (counterfeit products) rather than product- specific: a) a person's attitude towards piracy and counterfeiting, b) consumer innovativeness as a personality trait factor, and c) consumer perception of social consequences of purchasing and using fake products. In turn, these three factors are influenced by consumer demographics and religious beliefs, which only indirectly affect an individual's willingness to purchase counterfeits.

A *person's attitudes towards piracy* and counterfeiting in figure 1 refers to the degree people are able to rationalize counterfeiting practices with respect to the costs, pricing and quality of genuine vs. fake products. As Gellerman (1986) suggested, one way people tend to rationalize their behavior is by deciding that it is not really illegal or immoral. For example, people viewing counterfeiting simply as a result of original trade mark holders ripping off consumers by overpricing their products, would be more likely to purchase fakes (Schlegelmilch et al. 1998). Hence, positive attitudes towards counterfeiting are expected to be positively related to consumer willingness to purchase fakes.

An individual's *perception of social consequences* in our model is defined as consumer perception of the social risks involved in purchasing and using fake products. More specifically, the concept reflects an individual's attitude towards the social effects of knowingly purchasing fakes, i. e., the risk of being discovered to have purchased or used a fake product. As suggested by various authors, social pressure can lead people to either follow or break the rules, meaning that peer support of the (mis)behavior may either encourage participation or serve as its deter-

rent (Ang et al. 2001; Albers-Miller 1999). Therefore, consumers more concerned with the embarrassment potential of using fakes will be less willing to purchase them. This is consistent with Ferrell and Grisham's (1985) model of ethical behavior, which addresses the importance of reference groups, specifically peers in affecting a person's ethical behavior in their 'significant others' variable.

Consumer *innovativeness*, typically thought of as a personality trait underlying adoption of new products, was defined as an individual's predisposition to use novel, unconventional products and brands or engage in novel experiences rather than remain with previous choices and consumption patterns. The literature suggests that innovativeness is 'correlated positively with optimum stimulation level, independence, extraversion, impulsivity, risk taking, tolerance for ambiguity, inner-directed (vs. other-directed) social character, capacity for status, and is correlated negatively with dogmatism, need for structure, and need for clarity' (Steenkamp, Hofstede, and Wedel 1999, 56). Hence, more innovative consumers, who are willing to take risks by trying unfamiliar products, brands, restaurants and willing to engage in new experiences, are expected to be more willing to purchase fakes. Considering the research setting in this study (i. e., Slovenia), and the assumption that status and luxury goods (typically subject to counterfeiting) are novel to the majority of consumer segments in CSEE transitional economies (e. g., Reardon et al. 2005; Rojšek 2001), the construct of innovativeness may be particularly relevant to investigations of counterfeiting behaviour in a given research context. In previous work, Stoettinger and Penz (2003) used two related constructs to model the demand for counterfeiting in two countries, i. e., Fashion involvement index and Readiness to take risks. They found that the impact of these determinants varies, based on the prices differential between original and counterfeit product, and on the product as well as the country investigated.

Therefore, we hypothesize that consumer willingness to purchase counterfeit products is influenced by their attitudes towards counterfeit products, perceptions of social consequences, and by their innovativeness with regard to new products in general. In turn, these three factors are influenced by consumer demographics and religious beliefs. As most ethical behavior models and empirical studies suggest, factors endemic to the individual such as age, gender, educational, marital status and income, as well religious beliefs will impact a person's ethical dilemmas (i. e., willingness to purchase a counterfeit product) directly or indirectly

(Al-Khatib et al. 2004; Dubinsky et al. 2005; Ferrell and Grisham 1985; Simpson et al. 1994; Stoettinger and Penz 2003).

Not only do we hypothesize in our conceptual model that the three socio-psychological constructs directly affect an individual's willingness to purchase fakes, but we also postulate that innovativeness influences the other two factors, i. e., attitudes towards piracy and perceptions of social consequences. Consistent with the literature reviewed earlier, more innovative people are believed to have a greater ability to rationalize particular behavior (i. e., positive attitude towards piracy) and they are less prone to conform to what is considered socially desirable in a given cultural environment (i. e., perceptions of social consequences).

### **Research Methodology**

The proposed conceptual model in figure 1 was investigated on a convenience sample of 223 consumers in the advanced transitional CSEE economy of Slovenia. The selected country offers an interesting site for this kind of research for the following reasons: a) a lack of research investigating consumer ethical issues in transitional economies (Al-Khatib et al. 2004); b) purchasing of pirated goods continues to represent a problem, particularly in the category of pirated software (e. g., Lu 2006; Milinković 2004); c) considering the size of the country, the results tender a reasonable external validity of the study. As part of their study program, senior undergraduate and part-time MBA students at two major universities were asked to administer the survey in their local communities and at work. A self-administered survey was utilized as a data collection methodology.

The questionnaire was divided into four parts and was based on the existing knowledge of counterfeiting, established measures in the literature (e. g., Bloch et al. 1993; Kecskes and Wolf 1993; Raju 1980; Stoettinger and Penz 2003) and self-constructed measures. Five point Likert-type scales were used to measure socio-psychological constructs and respondents' willingness to purchase a fake at various prices levels. The scales were anchored by '1 = strongly disagree' and '5 = strongly agree'. Demographic questions consisted of open and close-ended questions. On the average, it took respondents approximately 12 minutes to complete the survey.

As for demographic characteristics of our respondents, our sample consisted of 61.8% female respondents with an average age of 28.33 years (SD of 13.37). Less than a quarter of the sample (23.3%) had attained col-

TABLE 1 Sample characteristics by gender

Characteristic	Men	Women
<i>Number</i>	85 (38.5%)	136 (61.6%)
<i>Average age (standard deviation)</i>	26.1 (13.0)	29.5 (13.7)
<i>Education</i>		
College graduate	20.7%	25.9%
Not a college graduate	79.3%	74.1%
<i>Status</i>		
Partnered	29.9%	43.6%
Single	70.1%	65.4%
<i>Net monthly income</i>		
Below national average	63.2%	62.6%
Above national average	36.8%	37.4%

lege education, and 36.75% of the respondents were married or shared a household with a partner. Table 1 shows sample characteristics by gender. For two-thirds of the respondents, their net monthly income was lower than the average net monthly income in Slovenia.

### Data Analyses

Analyses of data were performed in two steps. First, all Likert-scale type statements were factor analyzed and alpha estimates computed to obtain reliable measures of the constructs in the model. Second, path analysis was run to test the system of structural relationships among the variables, and examine the determinants of consumer willingness to purchase counterfeit products.

Consistent with the model in figure 1, the variables consisted of four constructs, five socio-economic variables, and three measures of consumer willingness to purchase fake goods. The four constructs included attitudes towards purchasing counterfeit goods, perceived social consequences of purchasing fake goods, innovativeness and religiosity. The three measures of consumer willingness to purchase fake goods were: a) consumer willingness to purchase a fake Lacoste shirt ( $wTP_s$ ), b) willingness to purchase counterfeit software ( $wTP_c$ ), and c) willingness to purchase a fake Rolex watch ( $wTP_w$ ). Each  $wTP$  item consisted of three 5-point scales measuring consumer willingness to purchase a counterfeit merchandise if it were priced below the price of the genuine brand

TABLE 2 Construct measures

Construct (source)	Description	(1)	(2)
WTP <i>shirt</i> ( $WTP_s$ ) (Stoettinger et al. 2003)	Willingness to purchase a counterfeit Lacoste shirt at various price levels relative to prices of genuine branded products.	3	0.91
WTP <i>software</i> ( $WTP_c$ ) (Stoettinger et al. 2003)	Willingness to purchase counterfeit PC software at various price levels relative to prices of genuine branded products.	3	0.92
WTP <i>watch</i> ( $WTP_w$ ) (Stoettinger et al. 2003)	Willingness to purchase a counterfeit Rolex watch at various price levels relative to prices of genuine branded products.	3	0.93
Attitudes towards piracy	Attitudes towards counterfeiting – ability to rationalize counterfeiting with respect to costs, pricing and quality of genuine vs. fake products.	6	0.70
Social consequences	Consumer perception of social risks involved in purchasing and using fakes.	4	0.73
Innovativeness (Raju 1980)	Consumer predisposition to novel and different products, brands and experiences	5	0.80
Religiousness (Kecskes and Wolf 1993)	Deep rooted religious beliefs.	5	0.93

NOTES Column headings are as follows: (1) number of items, (2) Cronbach's Alpha.

at a 20, 40 and 60 percent lower price. Table 2 lists the constructs, the sources of measures, conceptual definitions, the number of items pertaining to each construct and the associated reliability measure. For all four constructs, the Cronbach's alphas are within the prescribed range of Nunnally's (1978) alpha requirement for psychometric scales (0.70 or greater).

In the second stage of analyses, path analysis was run to test the system of structural relationships. We ran three separate models, one for each product specific measure of consumer willingness to purchase fake goods. Each model was specified as a recursive system with six exogenous variables  $x_i$  and four jointly dependent endogenous variables  $Y_i$ . The exogenous variables included the religiosity construct and the five socio-economic variables, and the endogenous variables included consumer attitudes towards piracy, perceived social consequences, the innovativeness construct and a willingness to purchase construct. The five socio-economic variables tested in the model were age, sex, education, partnered status, and income. Due to the broad range of respondents'

age and the consequently large variance, a logarithm of age was used. Since the observations of other socio-economic categories were found unevenly distributed in the sample, they were converted to binary variables (Bollen 1989).

The three models were identical in their set up, replacing  $WTP_s$  (a counterfeit branded T-shirt) in the first model with  $WTP_c$  (counterfeit software) in the second model, and with  $WTP_w$  (a counterfeit branded watch) in the third model. Basic identification rules followed guidelines provided by Kaplan (2000) and Bollen (1989). As several of the variables were dichotomous, a polychoric correlation matrix was computed using the PRELIS software (Joreskog and Sorbom 1996), and all estimations were performed using Weighted Least Squares option in the LISREL 8 software.

### Findings and Discussion

Consistent with traditional reporting of results when using covariance analysis, we first report on the fit measures of the three models ( $WTP_s$ ,  $WTP_c$  and  $WTP_w$ ), and then discuss the findings of the path analyses. The measures of fit across the three models are adequate (see table 6). As a standard measure of fit, the chi-squares (ranging between 113 and 327) are provided. They were significant (at  $p < 0.001$ ), which is consistent with the fact that correlation rather than covariance matrices were used in the estimation. Bollen (1989) suggests using additional measures of fit, which are also provided in table 6. These measures (i. e., GFI, AGFI, RMSEA, RMR) are within an acceptable range for all three models of  $WTP$ . We then examined the variance in  $WTP$  explained in each model. The amount of variance in  $WTP$  was calculated using a measure of squared multiple correlations for the structural equations, indicating that model 1 (counterfeit shirt) performed best since significant variables in the model explained 38 percent of the variance, followed by model 3 (counterfeit watch) with 24 percent of variance and model 2 (counterfeit software) with 14 percent of variance explained.

Next, results of the path analyses are discussed in three sections, following the conceptual model in figure 1 from left to right. For each section, the findings for each of the three models ( $WTP_s$ ,  $WTP_c$  and  $WTP_w$ ) are presented. Table 3 reports on the results of the first section, specifying standardized total effects of socio-economic variables and the religiosity construct on consumer attitudes towards piracy, perceived social consequences and consumer innovativeness. The results indicate that religios-

TABLE 3 Standardized total effects of socio-economic variables and the construct of religiosity on consumer attitudes, social consequences and innovativeness

	(1)	(2)	(3)	(4)	(5)	(6)
<i>Model 1: WTP T-shirt</i>						
Attitudes towards piracy	-0.25*	-0.19	-0.21†	-0.06	0.31	-0.17
Social consequences	0.09	-0.12	0.06	0.10	0.13	-0.10
Innovativeness	-0.20*	0.15	-0.05	-0.05	-0.02	0.16
<i>Model 2: WTP software</i>						
Attitudes towards piracy	-0.17*	-0.06	-0.23*	0.32	0.25	0.10
Social consequences	0.18*	-0.31	0.05	-0.37	0.18	-0.33
Innovativeness	-0.05*	0.19	-0.06	-0.07	-0.24	0.29
<i>Model 3: WTP watch</i>						
Attitudes towards piracy	-0.15†	-0.11	-0.19	0.17	0.30	0.02
Social consequences	0.09	-0.40	0.07	-0.32	0.28†	-0.33
Innovativeness	-0.07	0.09	-0.11	-0.09	-0.20	0.31

NOTES Column headings are as follows: (1) religiosity, (2) age, (3) sex, (4) partner, (5) education, (6) income. \* $p < 0.001$ . † $p < 0.01$ .

ity was a significant predictor of respondents’ attitudes toward piracy in all three models, with the two variables being negatively related. As expected, more religious people were less able to rationalize the existence of costs involved, pricing and quality of fakes than their less religious counterparts. Religiosity seemed to have impacted the perception of social consequences in the case of pirated software (with more religious people more concerned by the embarrassment potential of being discovered), but not in the case of branded fashion products (a T-shirt and a watch). The effect of religiosity on innovativeness was significant in two models, i. e., for the T-shirt and for computer software, but not in the model of willingness to purchase a fake Rolex.

Contrary to our expectations, other socio-economic variables had little effect on the three socio-psychological variables in our conceptual model, with the exception of *gender* influencing respondents’ attitudes towards piracy when modeling data for T- shirt and computer software, and the level of *respondents’ education* on perceived social consequences when modeling consumer willingness to purchase a fake Rolex watch. In both models 1 and 2, men had significantly more positive attitudes towards counterfeiting practices and were better able to justify their existence than the females in the sample. This finding is consistent with the

TABLE 4 Standardized total effects of innovativeness on consumer attitudes and social consequences

<i>Model 1: WTP T-shirt</i>	Attitudes towards piracy	0.19*
	Social consequences	-0.29*
<i>Model 2: WTP software</i>	Attitudes towards piracy	0.00
	Social consequences	-0.19*
<i>Model 3: WTP watch</i>	Attitudes towards piracy	0.00
	Social consequences	-0.19*

NOTE \* $p < 0.001$ 

evidence obtained in a recent study of buyers vs. non-buyers of a pirated music CD in Asia (Ang et al. 2001). Furthermore, in model 3 (WTP watch) only, education had a positive and significant effect on the respondents' attitudes towards social consequences of buying and using a knock-off product, with more educated respondents being more concerned with the social consequences of being discovered should they engage in an illicit behavior.

Focusing on the central part of our conceptual model in figure 1, we not only hypothesized that the three socio-psychological constructs directly affect consumer willingness to purchase fakes, but also postulated that innovativeness influences the other two factors, i. e., attitudes towards piracy and perceptions of social consequences. Table 4 shows the results of this part of the analysis for all three measures of consumer willingness to purchase counterfeit merchandise. The results indicate a negative and strong relationship between innovativeness and respondents' perception of social risks involved in purchasing and using fake products in all three models, i. e., counterfeit T-shirt, computer software and a fake Rolex watch. This is consistent with the existing knowledge of the associations between personality traits and actual adoption behavior (for a review, see Rogers 1983). Early adopters of novel products have been frequently (though not always) found to have higher ability to deal with abstractions and cope with uncertainty and risk, and they are less fatalistic and dogmatic (Steenkamp et al. 1999). The discussion of adoption behavior in a given research context is particularly relevant as status brands, commonly subject to counterfeiting, represent novelty to the majority of consumers in (even advanced) transitional economies (Reardon et al. 2005; Rojšek 2001; Steenkamp and Burgess 2002).

Moreover, findings of the first model indicate that more innovative

TABLE 5 Standardized total effects of consumer attitudes, innovativeness and social consequences on willingness to purchase fakes

	Attitudes towards piracy	Social consequences	Innovativeness
<i>Model 1: WTP T-shirt</i>	0.27*	-0.54*	0.04
<i>Model 2: WTP software</i>	-0.02	-0.03	0.36*
<i>Model 3: WTP watch</i>	0.14*	-0.38*	0.24*

NOTE \* $p < 0.001$ .

people not only care less about the social consequences, but also have a stronger ability to justify counterfeiting practices. On the other hand, results presented in table 4 indicate that consumer innovativeness has no bearing on respondents' attitudes towards piracy in models 2 in 3.

Finally, in the last section, we focus on direct effects of consumer attitudes towards piracy, innovativeness, and perceptions of social consequences on respondents' willingness to purchase fakes regardless of the product class involved (figure 1). Standardized effects of consumer attitudes, innovativeness and social consequences on willingness to purchase fakes are presented in table 5 for all three models. The hypothesized effects of consumer attitudes towards piracy and perceptions of social consequences on willingness to purchase fakes are confirmed when modeling data for respondents' willingness to purchase a counterfeit T-shirt and a watch (models 1 and 3), but not their willingness to purchase counterfeit computer software (model 2). This means that respondents with greater ability to rationalize illicit behavior and weaker perceptions of social risks involved in purchasing and using fakes are more willing to purchase pirated branded fashion products, but no more willing to buy pirated software. Results in table 5 also indicate that consumer innovativeness is significantly and positively related to consumer willingness to purchase counterfeit software and a branded counterfeit watch but not his/her willingness to purchase a fake branded T-shirt.

### Conclusions and future research

This study sought to generate some insights into non-deceptive counterfeiting by focusing on consumers in an advanced CSEE economy and a new EU member country. In reviewing the consumer behavior literature and recent empirical studies, we identified several socio-economic variables and religiosity that influence consumer attitudes towards counterfeiting, their innovativeness and perceptions of social risks of the illicit

behavior, i. e., socio-psychological constructs which, in turn, affect consumer willingness to purchase fakes. Our conceptual model was thought of as generalizable across product categories for which consumer willingness to purchase was measured, i. e., a fake branded T-shirt, a fake branded watch and pirated computer software. Our results, however, do not support this conjecture, as models 1, 2 and 3 do not show consistent results across the three product classes.

The findings of modeling a fake T-shirt data indicate that consumer willingness to purchase this product is a function of religiosity and gender (indirect effects through attitudes for both variables and through innovativeness for religiosity), and a function of respondents' attitudes towards piracy and their perceptions of social consequences. In model 1, consumer innovativeness had only an indirect effect through the other two socio-psychological variables. Despite the somewhat similar product class in the third model (a pirated branded fashion product, i. e., Rolex watch), the indirect effects of religiosity and socio-economic variables on the  $WTP$  watch were different (i. e., impact of religiosity through the attitudes only and education through social consequences variable) as were the indirect effects of innovativeness (influenced the social consequences only – rather than both central constructs as in model 1). Furthermore, the differences pertained to the direct effects on  $WTP$  as-unlike in the  $WTP$  shirt model – all three socio-psychological constructs had a significant impact on the endogenous  $WTP$  watch variable.

Yet another pattern of results can be seen when modeling  $WTP$  pirated computer software. In model 2, the indirect effects of exogenous variables were somewhat similar to those in model 1 ( $WTP$  shirt) with religiosity influencing  $WTP$  through all three socio-psychological variables and gender through the attitudes only. The indirect effect of innovativeness (through social consequences) represents a pattern of influences which is closer to that of model 3. Unlike in models 1 and 3, consumer innovativeness was the only socio-psychological variable with a direct effect on consumer  $WTP$  pirated computer software.

Overall, we can conclude that the patterns of findings, while inconsistent across the three product classes, seem more coherent for  $WTP$  pirated fashion products (models 1 and 3) than in the case of a counterfeit computer software. These findings suggest, consistent with previous research (Chakratborty et al. 1996; Stoettinger and Penz 2003) that consumer illicit behavior tends to be product specific.

Since this study represents a preliminary attempt at studying factors

TABLE 6 Measures of fit

	Model 1	Model 2	Model 3
Chi-square ( <i>df</i> )	326.9	166.7	113.1
Goodness of fit index (GFI)	0.98	0.99	0.99
Adjusted goodness of fit index (AGFI)	0.96	0.98	0.99
Root mean square error of approximation (RMSEA)	0.23	0.16	0.12
Root mean square residual (RMR)	0.12	0.09	0.07
Standardized RMR	0.088	0.08	0.06

underlying consumer counterfeiting behavior in a novel cultural environment relative to existing empirical research (which was conducted mainly in the US, Europe and Asia), our findings should be interpreted with caution. Future studies should further examine the role of product specificity in consumer illicit behavior, and possibly examine other psycho-sociological constructs to increase the explained variance of the models. Our findings indicate that studying direct and indirect effects of consumer innovativeness, in particular, should yield fruitful results.

The effect of religiosity and demographic variables on the socio-psychological variables used in this study (which were believed to indirectly effect consumer WTP fakes) were often (though not unequivocally) found to be related to consumer illicit behavior in previous research (Ang et al. 2001; Dubinsky et al. 2005; Simpson et al. 1994; Schlegelmilch et al. 1998). Considering the inconsistent pattern of our results in modeling consumer willingness to purchase fakes across the three product classes, future studies should examine the direct and indirect impact of these variables in consumer counterfeit buying behavior.

As the countries of Central, Southern and Eastern Europe (CSEE) continue to make progress in their evolving market economies, international marketers and investors will have an increasing need for understanding behavioral patterns and attitudes of CSEE consumers, particularly in view of the reportedly increasing volume of counterfeiting practices in the region (Al-Khatib et al. 2004; Delener 2000). As a result of dynamic changes in the external environment, consumers in CSEE transitional economies have been experiencing not only a growing economic stratification of their societies, but also altered hierarchies of consumer values, standards and purchasing patterns (Nasierowski 1996; Vida and Fairhurst 1998). Some of these changes include erratic switches between higher-status foreign and often lower-priced domestic products (e. g.,

Reardon et al. 2005; Vida and Dmitrović 2001). It is our contention that any strategy aimed at managing the counterfeit problem should include ways to reduce the demand for counterfeits. In order to accomplish this, managers need to have a strong cognizance of the most effective means of communication to be directed at the right target audience. Studies such as this one can facilitate this understanding.

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# *Measuring the Impacts of Organizational Responses: Case of Northern Cyprus Hotels*

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Today, businesses are operating in a global economy, markets are characterized by hypercompetition and businesses must adapt themselves to the empowered consumer. Companies need to focus on customer needs and wants, quality and customer retention through correcting mistakes. This study aims to measure the effects of apology, redress, explanation, attentiveness and promptness on complainant satisfaction, repurchase intentions and word of mouth communication through the use of a sample of Turkish customers, accommodated in three, four, and five star hotels in Northern Cyprus. Implications for managers, limitations, and implications for future research are presented in the following sections of the study.

*Key Words:* customer complaints, organizational responses, satisfaction, repurchase intention, word of mouth communication, Northern Cyprus hotel industry

*JEL Classification:* L83, M31

## **Introduction**

In era of intense competition, service organizations attempt to differentiate themselves from their competitors. By providing exceptional services that will benefit its target market, service organizations are likely to achieve differentiation (Kotler, Bowen, and Makens 1999). However, mistakes and failures are frequent occurrences in service businesses (Babakus et al. 2003). Therefore, service firms seek effective solutions in order to minimize the number of mistakes and failures in the service encounter. When the failures occur customers are likely to complain. Possible remedies to service failures and customer complaints are based on effective service recoveries (Boshoff 1999).

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Service recovery is a specific activity in which a company engages to address a customer complaint regarding a perceived service failure (Spreng, Harrell, and Mackoy 1995). A review of the services marketing literature indicates that the attributes or dimensions of service recovery have been associated with justice principles, customer satisfaction, and post-purchase customer behaviors (Smith, Bolton, and Wagner 1999; Yavas et al. 2003; Mattila 2001; Tax, Brown, and Chandrashekar 1998). By providing equitable and quick responses to customer complaints, service organizations aim to achieve a pool of satisfied customers and increase the level of repeat patronage.

Although there may be other indicators of service recovery such as facilitation and work efforts (Davidow 2000; Tax, Brown, and Chandrashekar 1998), a synthesis of the literature reveals that organizational responses to complaints or dimensions of effective service recovery are based on apology, redress, explanation, attentiveness, and promptness (Smith, Bolton, and Wagner 1999; Boshoff 1999; Yavas et al. 2003). Research demonstrates that the aforementioned dimensions are related to: complainant satisfaction, repurchase intentions and word of mouth (WOM) communication (e.g. Karatepe and Ekiz 2004; Davidow 2000; Yavas et al. 2003; Boshoff 1999; Mattila 2001).

In light of the existing discussion, this study aims to measure organizational responses to complaints in Northern Cyprus hotels serving Turkish customers. Specifically, the current study investigates the effects of apology, explanation, redress, attentiveness, and promptness on complainant satisfaction, repurchase intentions, WOM communication and the effect of satisfaction on repurchase intentions in three, four, and five star hotels in Northern Cyprus.

This study, investigating these issues, is useful for at least two reasons. First, a growing body of research shows that the issue of service recovery is at the development stage in tourism and hospitality literature (Becker 2000), little is known about the effects of organizational responses to customer complaints on satisfaction and repurchase intentions (Davidow 2000; Yavas et al. 2003; Ekiz 2003), and there is a paucity of empirical research in this area. Second, as well as contributing to the existing body of knowledge, this study has important implications at both micro and macro levels. The tourism and hospitality industry is the lifeblood of Northern Cyprus economy, having a significant portion in the overall Gross National Product (State Planning Organization 2003). However, there are specific customer complaints such as late check-in and check-

out transactions, physical environment, and attitudes of hotel staff in the hotel industry (Karatepe and Avci 2002; Ekiz 2003; Yavas et al. 2003). These issues are of great interest to both public officials and hotel managers in tourism and hospitality industry.

The present study provides a review of the literature concerning service failure, customer complaints, and service recovery. By examining a number of research findings, a brief explanation is provided of service failure, customer complaint and service recovery as well as organizational responses to these service failures. Then, the conceptual model and study hypotheses are proposed based on a number of research findings. This is followed by the presentation of the methodology, discussion of the results, and implications of the study.

### **Literature Review**

A number of problems take place in service encounters due to the inherent variability feature of services. Although service organizations attempt to take precautions in order to minimize specific problems in service encounters, they are unlikely to prevent incidents such as the occasional late flight, burned steak, or missed delivery (Hart, Heskett, and Sasser 1990). In the related literature, these problems are named as 'service failures'. Service failure is defined as a service performance that falls below a customer's expectations (Hoffman and Bateson 1997).

When service failures take place, customers are likely to complain about these incidents. Complaining can be defined as a formal expression of dissatisfaction with many aspect of a service experience (Lovelock and Wright 1999). Garrett, Meyers, and Camey (1991, 66) have provided a very extensive definition of consumer complaints as 'an action taken by an individual which involves communicating something negative regarding a product or service, either to the firm manufacturing or marketing that product or service, or to some third-party organizational entity'.

Service recovery is a well-accepted term for what service companies attempt to offset the customers' negative reaction to the service failures. It includes all the actions that should be taken by companies in order to move a customer from a state of disappointment to a state of satisfaction (Bell and Ridge 1992). Service recovery, or putting right what has gone wrong, is crucially important (Bailey 1994). One reason for this is that it costs several times as much to create a new customer as it does to keep and satisfy an existing one (Lovelock 2000; Kotler 2003). The other reason is that customer satisfaction and loyalty is much greater after a

problem has occurred and been put right than it was before the problem occurred (Bailey 1994). What can be understood from these points is that customers are aware of the fact that up to a certain level mistakes can happen, but they demand timely, fair, courteous, clear, efficient, and interactive solutions.

The organizational responses analyzed in this study can briefly be explained as follows. *Apology* is a psychological exchange, what is offered in exchange for the inconvenience or problem which the customers face. Boshoff and Leong (1998) report that apologizing for the inconvenience, as a first step towards re-establishing the equilibrium, plays an important role in customer satisfaction with a firm's service recovery effort. *Explanation* basically refers to information given by the service provider about why the problem occurred. Appropriate provision of explanation reduces the recipient's perceptions of injustice and, in turn, affects recipient satisfaction and loyalty (Dunning and Pecotich 2000). *Redress* refers to the 'fair settlement or fix' of the problems that arise between the company and the customer (Diener and Greyser 1978). Blodgett, Wakefield, and Barnes (1995) stated that customers who receive a fair settlement, are satisfied and more likely to show re-patronage. *Attentiveness* is the interaction and communication between the company staff and the complainant. Davidow (2000) argues that this interaction is the key construct and can enhance or detract from complainant satisfaction, repurchase intention and negative WOM. *Promptness* represents the fairness of the organization in responding to the customer complaints in a timely manner. Kincade, Redwine, and Hancock (1992) reported that the speed of the response is very important in affecting consumers' satisfaction and repurchase behaviors.

In his critical review, Yi (1990) proposes that there are three types of definitions of satisfaction as an outcome or as a process. These definitions include: 'the buyer's cognitive state of being adequately or inadequately rewarded for the sacrifices he has undergone'; 'an emotional response to the experiences associated with particular products or services purchased, provided by retail outlets, or even molar patterns of behavior such as shopping and buyer behavior, as well as the overall marketplace'; and 'the summary psychological state resulting when the emotion surrounding disconfirmed expectations is coupled with the consumer's prior feelings about the consumptions change' (Yi 1990, 69).

Post-purchase behavior is defined as 'a series of steps in which consumers compare their expectations to perceived reality, experience con-

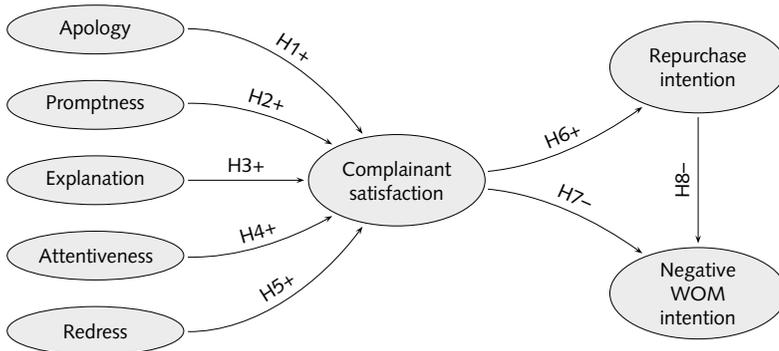


FIGURE 1 Conceptual model

sequent satisfaction/dissatisfaction, and then act in a way influenced by that satisfaction and dissatisfaction' (Gilly and Gelb 1982, 323). When customers praise the firm and express preference for the company over others, it means that they are likely to increase the volume of their purchases and disseminate a positive word of mouth communication, or the opposite (Zeithaml, Berry, and Parasuraman 1985; Konečnik and Ruzzier 2006). Based on the preceding discussion, the following model and hypothesis are proposed:

- H1 *A sincere apology will have a significant positive effect on customer satisfaction.*
- H2 *Promptness will have a significant positive effect on complainant satisfaction.*
- H3 *Explanation will have a significant positive influence on complainant satisfaction.*
- H4 *Attentiveness will have a significant positive influence on complainant satisfaction.*
- H5 *Redress will have a significant positive effect on complainant satisfaction.*
- H6 *Complainant satisfaction will exert a significant positive influence on repurchase intention.*
- H7 *Complainant satisfaction will exert a significant negative influence on negative WOM intention.*
- H8 *Repurchase intentions will exert a significant negative influence on negative WOM intention.*

## **Methodology**

The current section consists of the methods used in collecting data and related statistical analyses. The results of reliability coefficients and Pearson product-moment correlations as well as the results of descriptive statistics are presented for study. Psychometric properties of the scale are assessed through corrected item-total correlations and Pearson product-moment correlations. In addition to these analyses, confirmatory factor analysis is used to evaluate the psychometric properties of the scales for main study. Path analysis using LISREL 8.54 (Joreskog and Sorbom 1996) is used so as to test the hypothesized relationships.

### MEASURES

The current study employs the scales developed by Davidow (2000) and used by Yavas et al. (2003) Ekiz (2003) and Karatepe and Ekiz (2004) in order to operationalize the model depicted in figure 1. Furthermore, this study uses five items from Davidow (2000) to measure the repurchase intentions and negative WOM intentions. The questionnaire items were originally prepared in English and then translated into Turkish by using back-translation method (McGorry 2000). Results of the pilot study suggest that there is no compelling reason to modify or delete any items in the questionnaire.

### SAMPLE

The sample for this study included customers who were accommodated in three, four, and five star hotels in January and March, 2005. A judgmental sampling approach was undertaken for data collection. Research team collected data from customers who had complaints and reported them to the organization during their stay in three, four, and five star hotels. In addition, questionnaires were personally distributed to hotel customers, and they were given assurance for confidentiality. Hotel customers were requested to fill out the questionnaires in a self-administered manner. Of the 500 questionnaires distributed, 394 usable questionnaires were retrieved with a response rate of 78.8%.

The majority of the respondents (62.7%) were male. More than sixty-seven percent of the respondents were between the ages of 38 and 57. More than seventy-three percent of the respondents had college education and fifteen percent of the respondents had secondary and high school education. Additionally, more than fifty-four percent of the respondents reported the purpose of visit as vacation. Twenty-eight per-

cent of the respondents reported that their motive for visiting Northern Cyprus is gambling.

#### PSYCHOMETRIC PROPERTIES

In assessing the psychometric properties of the instrument, issues of reliability, dimensionality, convergent and discriminant validity are considered. In order to provide support for the issue of convergent validity, corrected item-total correlations were computed. The inter-item correlations being equal to or exceeding 0.32 provided support for the convergent validity of the scale (Tabachnick and Fidell 1996). Reliability coefficients were also computed for each study variable. Overall Alpha coefficient score was found to be 0.92 at the aggregate level, see table 1. These findings show that each coefficient exceeds the cut-off value of 0.70 as recommended by Nunnally (1978), as were the cases with those of Davidow (2000), Yavas et al. (2003) and Karatepe and Ekiz (2004).

A series of stringent tests were undertaken for the issues of convergent and discriminant validity, and dimensionality. Specifically, confirmatory factor analysis was employed to provide support for the issues of dimensionality, convergent and discriminant validity of the instrument. Table 1 indicates a reasonable fit of the eight-factor model to the data on the basis of a number of fit statistics. As also demonstrated in table 1, the majority of the factor loadings are above 0.75, and all *t*-values are significant. Overall, these results provide support for the dimensionality, convergent and discriminant validity of the scale (Anderson and Gerbing 1988). The results of fit statistics of this study are almost the same, when compared with those of Davidow (2000), Ekiz (2003) and Karatepe and Ekiz (2004). Additional assessment was undertaken using composite scores. Specifically, composite scores for each study variable were calculated by averaging scores across items representing that dimension. All correlations among the study variables were significant at the 0.01 level. The correlations among the study variables range from 0.42 (attentiveness and negative WOM) to 0.71 (complainant satisfaction and repurchase intention). Means and standard deviations of dimensions composite scores are also calculated. Overall, these results provide additional support for the discriminant validity of the scale.

#### TESTS OF RESEARCH HYPOTHESES

The hypothesized relationships were tested using path analysis (Joreskog and Sorbom 1996). The first group hypotheses refer the effects of organi-

TABLE 1 Scale items, reliabilities and confirmatory factor analysis results

Scale items	(1)	(2)	$\alpha$
<i>Apology</i> (APO)			0.84
I received a sincere 'I am sorry' from the hotel	0.76	34.61	
The hotel gave me a genuine apology	0.84	32.26	
I did not receive any form of apology from the hotel (R)	0.72	27.11	
<i>Promptness</i> (PROMPT)			0.79
It took longer than necessary to react to my complaint (R)	0.81	23.16	
They were very slow in responding to the problem (R)	0.74	17.55	
The complaint was not taken care of as quickly as it could have been (R)	0.86	28.40	
<i>Explanation</i> (EXP)			0.81
The hotel did not give me any explanation at all (R)	0.71	24.37	
I did not believe the hotel explanation of why the problem occurred (R)	0.83	21.89	
The hotel explanation of the problem was not very convincing (R)	0.84	16.58	
<i>Attentiveness</i> (ATT)			0.76
The representative of the hotel treated me with respect	0.76	14.18	
The representative of the hotel paid attention to my concerns	0.78	20.73	
The representative of the hotel was quite pleasant to deal with	0.88	22.46	
<i>Redress</i> (RED)			0.78
After receiving the hotel response, I am in the same shape or better than I was before the complaint	0.82	33.41	
The hotel response left me in a similar or improved position to where I was before the problem	0.74	30.92	
The outcome that I received from the hotel returned me to a situation equal to or greater than before the complaint	0.81	26.10	

*Continued on the next page*

zational responses (apology, promptness, explanation, attentiveness and redress) on complainant satisfaction. The second group hypothesis relates the effect of complainant satisfaction to repurchase intention. The last group hypotheses show the effect of complainant satisfaction and repurchase intention on negative WOM intention.

The empirical results demonstrate that all hypothesized relationships were supported. Consistent with the prior studies (Davidow 2000; Ekiz 2003; Yavas et al. 2003; Karatepe and Ekiz 2004) apology, promptness, explanation, attentiveness and redress have been found to be positively related to the complainants' satisfaction. Thus, the hypotheses 1, 2, 3, 4,

Continued from the previous page

Scale items	(1)	(2)	$\alpha$
<i>Complainant satisfaction (CSAT)</i>			
My satisfaction with the hotel has increased	0.89	19.87	
My impression of this hotel has improved	0.91	27.01	
I now have a more positive attitude toward this hotel	0.87	31.62	
<i>Repurchase intentions (RI)</i>			
Consider this hotel your first choice to reaccommodate	0.92	34.98	
Accommodate more in this hotel in the future	0.90	29.24	
<i>Negative WOM intention (NWOM)</i>			
I do not say positive things about this hotel	0.93	16.81	
I do not recommend this hotel to those who are interested in my advice	0.87	18.74	
I do not encourage my friends/relatives to stay in this hotel	0.89	24.19	
<i>Fit indices</i>			
Chi-square/df	3.12	NNFI (non-normed fit index)	0.90
GFI (goodness of fit index)	0.91	CFI (comparative fit index)	0.94
AGFI (adjusted goodness of fit index)	0.89	RMR (root mean square residual)	0.042

NOTES Column headings are as follows: (1) standardized loadings; (2) *t*-values. Each item is measured on a five-point Likert scale. All loadings are significant at 0.001 level or better. (R) indicates a reverse coded item.

and 5 are accepted. A careful examination of table 2 reveals that complainant satisfaction has a significant positive effect on repurchase intention. Thus, hypothesis 6 is accepted. Table 2 also shows that negative WOM is negatively affected by the complainant satisfaction and repurchase intention. Hence, hypotheses 7 and 8 are accepted.

Reexamination of table 2 shows that service recovery attributes jointly explain 61% of the variance in complainant satisfaction. Complainant satisfaction alone explains 40% of the variance in repurchase intention. Finally, complainant satisfaction and repurchase intention explain 47% of the variance in negative WOM.

### Discussion

The current study has aimed to investigate the affecting relationships among the organizational responses, complainant satisfaction, repurchase and negative WOM intentions. Specifically, the study aimed to investigate the effects of apology, promptness, explanation, attentive-

TABLE 2 Path analysis results

Type of impact	(1)	(2)	(3)
<i>Impact on complainant satisfaction</i>			
H1: APO → CSAT	0.14	8.41	0.0001
H2: PROMPT → CSAT	0.12	6.72	0.0001
H3: EXP → CSAT	0.11	7.61	0.0001
H4: ATT → CSAT	0.28	10.54	0.0001
H5: RED → CSAT	0.42	14.73	0.0001
Explained variance ( $R^2$ ) = 0.61			
<i>Impact on repurchase intention</i>			
H6: CSAT → RI	0.42	9.19	0.0001
Explained variance ( $R^2$ ) = 0.40			
<i>Impact on negative WOM intention</i>			
H7: CSAT → NWOM	0.36	10.88	0.0001
H8: RI → NWOM	0.21	9.06	0.0001
Explained variance ( $R^2$ ) = 0.47			

NOTES Column headings are as follows: (1) standard parameter estimates (ML); (2)  $t$ -values; (3) significance.

ness, and redress on complainant satisfaction. Moreover, effects of complainant satisfaction on both repurchase and negative WOM intentions are measured by using Turkish customers in the Northern Cyprus hotel industry.

Empirical findings reveal that the established scales provided sound psychometric properties. Broadly speaking, the instrument has been found to have convergent and discriminant validity as well as acceptable reliability coefficients.

As for the hypothesized relationships, all hypotheses are confirmed by the empirical data. More specifically, path analysis results demonstrate that apology depicts a significant positive relationship with complainant satisfaction. Although apology is not significantly related to satisfaction in other empirical studies (e.g. Davidow 2000; Ekiz 2003; Yavas et al. 2003; Goodwin and Ross 1989), the results report a significant positive relationship between these two constructs.

Path analysis results also reveal that promptness exerts a significant positive effect on satisfaction. This means that speedy response is a key to a successful complaint management and the prompt service recovery

leads to an increase in complainant satisfaction (Boshoff 1999). While this finding is not supported by Yavas et al. (2003), it is consistent with that of Davidow (2000) and Ekiz (2003).

Empirical evidence indicates that explanation portrays significant positive relationships with complainant satisfaction. When hotel representatives provide complainants with reasonable information about why the problem has occurred and what will be done to resolve that problem, complainants will at least understand that the hotel is aware of the problem and doing its best to solve it. This finding is consistent with those of Davidow (2000), Ekiz (2003) and Karatepe and Ekiz (2004).

In addition, path analysis results provide support for the significant positive relationship between attentiveness and complainant satisfaction. This finding implies that complainants expect hotel representatives to provide sincere care and treat guests with respect. This finding is also consistent with those of Goodwin and Ross (1989), Ekiz (2003), Yavas et al. (2003), and Karatepe and Ekiz (2004).

Path analysis results demonstrate that redress has a significant positive influence on complainant satisfaction. This outcome is consistent with those of Boshoff (1999) and Mattila (2001). When a comparison of the effects of organizational responses to complaints on satisfaction is made, redress is found to have the highest significant positive effect on satisfaction ( $\beta = 0.42, t = 14.73$ ). Attentiveness is reported to be the most influential response on satisfaction in other empirical inquiries like Davidow (2000) and Yavas et al. (2003). In another study Karatepe and Ekiz (2004) found the most influential response on satisfaction as effort. This study found redress as the most influential response on complainant satisfaction.

When the other hypothesized relationships are examined, evidence reveals that complainant satisfaction exerts a significant positive effect on repurchase intentions and negative effect on negative WOM, as predicted. Consistent with other studies (Cronin and Taylor 1992; Davidow 2000; Ekiz 2003), the higher the level of complainant or customer satisfaction, the higher will be the intention to revisit the same hotel and the lower will be the intention to spread negative WOM.

Finally, path analysis results revealed that there is a negative relationship between repurchase and negative word of mouth intentions. Consistent with other studies (Ekiz et al. 2005; Cronin and Taylor 1992), the higher the level of intention to revisit the same hotel – repurchase intention –, the lower is the intention to spread negative WOM.

It should here be noted that the effect of apology on satisfaction is not as high as the effects of redress, attentiveness, and explanation. Although apology is said to be the first step for acknowledging the complaint, it should be accompanied by other actions such as redress, attentiveness, or explanation. Providing an apology for complaint resolution is not always a remedy, in most cases it should be accompanied by compensation (Mattila 2001).

In addition, the individual effects of explanation and attentiveness on satisfaction are higher than the individual effects of apology and promptness on satisfaction. Providing apology and being prompt in responding to the complaint or problem is of course important, but dealing with the problem in a courteous way and providing reasonable explanations about why the problem has occurred is more important (Yavas et al. 2003). By doing so, it might be possible for hotels to increase the satisfaction levels and repurchase intentions of complainants. As an important note, findings provide support for the generalizations of the previous study results (Davidow 2000; Ekiz 2003; Mattila 2001; Karatepe and Ekiz 2004).

#### MANAGERIAL IMPLICATIONS

The findings have important implications for managers and public officials in the Northern Cyprus hotel industry. It should be noted that Northern Cyprus hotels suffer from a number of complaints (Karatepe and Avci 2002; Ekiz 2003; Karatepe and Ekiz 2004). At the micro level, hotel managers should firstly be committed to delivery of superior service quality and effective complaint management. The lack of top management commitment to effective complaint management leads front-line employees to unsuccessful service recovery efforts. Hotel managers should also satisfy their employees, since job satisfaction leads to customer satisfaction and loyalty (Rust et al. 1996).

In addition, hotel managers need to establish proper complaint procedures so that their customers know how and where to complain. Since most of the Turkish customers are reluctant to report complaints (Ekiz 2003; Yavas, Bilgin, and Shemwell 1997), hotel managers should encourage their customers to voice their complaints or problems.

Establishing appropriate complaint mechanisms is not adequate to manage the service recovery process. As cogently discussed by Yavas et al. (2003) and Ekiz (2003), hotel managers should hire suitable frontline employees who have interpersonal skills. Filling out vacant posts with in-

appropriate individuals can contribute to hotels' short-term profitability levels.

Babakus et al. (2003) suggest that the simultaneous application of training, empowerment, and rewards leads to an increase in frontline employee commitment and service recovery performance. Therefore, hotels need to organize training sessions based on the critical importance of complaint management and the crucial role of frontline employees in the service encounter. This is also supported by Arasli (2002), stating that hotels aiming to bring total quality management philosophy to their organizations should provide scientifically based training programs. When frontline employees are empowered, they will be capable of providing their apologies with a tangible token of atonement. Successful service organizations such as the Ritz-Carlton Hotel Company empower its employees to respond to complaints and/or service failures immediately and to keep the existing customers for a long time (George and Weimerskirch 1994).

As mentioned above, study results provide a number of implications for public policy makers in the Northern Cyprus hotel industry. As suggested by Omerzel (2006), public policy makers should provide long-run solutions for the co-operation between involved stakeholders, in this case hoteliers. Specifically, at the macro level, public officials can encourage hotel organizations to deliver exceptional quality to their customers. For this purpose, state-funded training and education programs can be triggered in the industry. Since the tourism and hospitality industry plays a critical role in the overall economic situation of the country, public officials should introduce strict standards for the delivery of superior quality to customers. Creating an industry-wide service quality culture and creating a pool of loyal customers depends heavily on the continuous cooperation between state organizations and hotel organizations in the industry.

Moreover, state organizations may encourage western management talent in the Northern Cyprus hotel industry. Western management talent may equip the industry with modern management and marketing approaches for the delivery of superior service quality and achievement of high profitability levels.

#### LIMITATIONS AND AVENUES FOR FUTURE RESEARCH

It should be underscored that there are several limitations to the current study. First, this study employed a judgmental sampling approach.

Future studies should use a probability sampling approach in order to support the current study findings. Second, the selection of a single industry may lead to questions regarding generalizations of the study findings. However, research indicates that the selection of a single industry eliminates problems that may emerge from industry differences (Hartline and Ferrell 1996). Third, this study used apology, promptness, explanation, attentiveness, and redress as the organizational responses to customer complaints. The inclusion of other constructs in the model such as empowerment (Boshoff 1999), facilitation (Davidow 2000), and process control (Tax, Brown, and Chandrashekar 1998) would provide further insights to understand their effects on complainant satisfaction and repurchase intentions. Fourth, this study has not examined the magnitude and type of failure. Future studies should also investigate the effects of organizational responses to complaints on satisfaction in low failure and high failure situations and/or in outcome and process failure situations (Smith, Bolton, and Wagner 1999). Until further studies are conducted, the present study findings and the strategies based on them should remain tentative. As a closing note, replication studies with larger sample size elsewhere would be fruitful for further generalizations of the study findings.

### **Conclusion**

It is widely accepted that service organizations should consider the critical roles of complaint management and effective service recovery efforts in strict competitive environments. Since their effective efforts result in increases in complainant satisfaction, loyalty, and profitability levels, service organizations consider these efforts as crucial determinants for their survival.

With this realization, the current study set out to investigate the effects of apology, promptness, explanation, attentiveness, and redress on complainant satisfaction and repurchase intentions, and the effect of satisfaction on repurchase intentions. Findings reveal that all hypothesized relationships were supported by the empirical data. Broadly speaking, apology, promptness, explanation, attentiveness, and redress have significant positive effects on complainant satisfaction. Additionally, redress appears to be the most influential organizational response on satisfaction. However, explanation is the only organizational response that has been found to be a significant predictor of repurchase intentions. Study results also indicate that complainant satisfaction exerts a significant positive effect

on repurchase intentions. Finally, this study has provided useful implications for both hotel managers and public officials in the Northern Cyprus hotel industry.

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# *Emerging Economies Crises: Lessons from the 1990's*

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The paper examines the financial crises of the 1990s. They represent a new kind of crises, as they do not seem to conform to the so-called first generation and second generation literature on currency crises. The outburst of the Asian crises brought a new challenge for economic policy. The attention has been placed on the self-fulfilling character of the speculative attacks and microeconomic weaknesses. The first part of the paper reviews the recent theoretical literature on financial crises, the second part addresses some lessons for emerging economies. The authors consider the policies to manage financial crises and reduce the risks associated with them.

*Key Words:* financial crises, emerging markets, contagion

*JEL Classification:* G15, G18

## **Introduction**

Over the past decades, the total capital flows to emerging economies have increased tremendously and most of the increase was in equities and portfolio investments. However, as international capital movements have been the main catalyst for the accelerating global economic integration, market failures associated with them have also become more visible. Since 1982 emerging markets have been rocked by three major financial crises: the American debt crisis of the 1980s, the Mexican crisis of 1994–1995 and the Asian crisis 1997. The Asian crisis spread to Russia and Latin America and impacted the economies of many industrialized nations as well.

Financial crises in emerging economies are very different today than they were in the past. Between 1940 and the 1970s, financial crises in-

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volved large fiscal deficits, repressed domestic financial systems, and balance of payments situations that were associated with a sharp worsening of terms of trade. In the late 1990s, however, a ‘new variety’ of crisis has evolved in Asia. Many of the emerging economies that have experienced financial trauma have been considered very successful until the crises explode.

This paper aims to analyze the determinants of currency and financial crises in the aftermath of the Asian 1997 experience. In the literature the commonly identified factors that increase vulnerability to the currency and financial crises have been imprudent fiscal policies, fragilities of the financial sector, inadequacy of prudential supervision and regulation, appreciated real exchange rate, a heavy lending to private sector and low levels of foreign reserves in proportion to government’s liabilities as measured by broad money. There is a general consensus that all crises of the 1990s involved two kinds of market failures, namely, first, international financial institutions over-lent to emerging market economies and, second, governments’ financial institutions or corporations over-borrowed.

The paper is organized as follows. The next section summarizes financial crises and recent theoretical developments. Section three addresses some lessons from the recent crises for emerging economies. The final sections discuss the findings and conclude.

### **Financial Crises and Recent Theoretical Developments**

Serious financial crises are not a new phenomenon; the Asian crisis follows on the tracks of Mexico 1994, the European Monetary System 1992–1993, and previous crises in Latin America. These currency crises have been the subject of extensive economic literature, both theoretical and empirical. The theoretical literature on balance-of-payment crises has flourished following Krugman’s (1979) seminal paper. Krugman argued that crises occur when a continuous deterioration in the economic fundamentals becomes inconsistent with an attempt to fix the exchange rate. Krugman’s canonical model therefore explains crises as the result of fundamental inconsistency between domestic policies – typically the persistence of money-financed budget deficit – and the attempt to maintain a fixed exchange rate. The inconsistency can be temporarily papered over if the central bank has sufficiently large reserves, but when these reserves become inadequate speculators force the issue with a wane of selling. The timing of the attack in Krugman’s model is therefore determined by

a critical level in the amount of reserves. Once the reserves have been lost in the attack, the central bank has no choice but to abandon the peg. Crises thus result in a transition to floating. More recently, however, some papers have argued that the authorities may decide to abandon the parity for other reasons: they may be concerned about the adverse consequences of policy needed to maintain the parity (such as higher interest rate) or other key economic variables (such as the level of employment).

The Krugman model and its extensions represent what has become known as first-generation models of balance-of-payment crises. Since crisis arises as a result of an inconsistency between an excessive public sector deficit that becomes monetized and the exchange rate system, a crisis is both unavoidable and predictable in an economy with a constant deterioration of its fundamentals.

Recent models have shown that a crisis may develop without a significant change in the fundamentals. Models built along this line are known as second-generation models of balance-of-payment crises. There are at least two types of these models, where crises are not affected by the position of the fundamentals, but instead, they may simply occur as a consequence of pure speculation against the currency. Calvo and Mendoza (1997) developed the model of herding behaviour; the model stresses that information costs may lead foreign investors to take decisions based on limited information and therefore to be more sensitive to rumours.

A second type of models stresses the possibility of contagion effects. There are again two types; the first type (Gerlach and Smets 1995) focuses on trade and on the loss of competitiveness associated with devaluation by a main trading partner, which in turn leaves the domestic currency more vulnerable to attack. The model presents a situation in which the devaluation by one country leads its trading partners to devalue in order to avoid a loss of competitiveness. The same effect could be derived in a model with multiple equilibria, in which the devaluation by a trade partner serves to coordinate a worsening of expectations about the domestic economy and generate a self-fulfilling attack. If contagion effects are present, a crisis in a neighbouring country may be an indicator of a future domestic crisis. Masson (1998) developed a second type, which is related to multiple equilibria, suggesting that a crisis in one country may raise the odds of a crisis elsewhere by signalling that a devaluation is more likely as a result of the initial crisis. The signal may then lead to a self-fulfilling speculative attack.

One may conclude that many of the second-generation models im-

plicitly or explicitly accept the possibility of self-fulfilling crisis. Esquivel and Larrain (1998) define this type of crises as crises that occur when the sheer pessimism of a significant group of investors provokes a capital outflow that leads to the eventual collapse of the exchange rate system, thus validating the negative expectations. These recent theoretical developments accord a smaller role to fundamentals in generating balance-of-payment crises, but they also have highlighted the importance that other variables may have in helping to predict those crises.

The difficulties in accounting for some key aspects of more recent crises have led some economists (Krugman 1998) to emphasize the need for a 'third generation' crises model, centring around banking system problems associated with moral hazard.

### **Lessons from the International Financial Crises of the 1990's**

Two major approaches dominated in the post-1997 theoretical literature. The first one, represented by McKinnon and Pill (1998) as well as Krugman (1998; 1999) modelled the 'over-borrowing syndrome', and emphasized the role of moral-hazard-driven lending by unregulated banks and financial institutions (Corsetti, Pesenti, and Roubini 1998). According to this view, a rational agent can expect the government rescue operation of any large bank or corporation with good political connections in case it had solvency problem.

Radelet and Sachs (1998) blamed a combination of a set of factors such as panic in the international investment community, policy mistakes in crisis management, and poorly designed international rescue programs, for triggering a fully fledged financial panic resulting in currency crises, bank runs, massive bankruptcies, and political disorder. Chang and Velasco (1998) have proposed similar approach, i. e. explaining the Asian currency crisis as a product of a bank run. The first theory of herding (Chari and Kehoe 1997) underlines that a bandwagon effect is driven by an assumption that some investors have private information.

Building on this discussion, Krugman (1999) elaborated a third-generation model concentrating on microeconomic weaknesses (such as moral hazard and resulting over-borrowing), which may trigger, in the world of high capital mobility, speculative attacks against the existing exchange rate regimes. This model attempts to consider both fundamental factors and multiply equilibria in the market behaviour.

Financial crises of the kind experienced in East Asia have highlighted the fact that in a globalizing environment policy mistakes can have more

abrupt and profound consequences for the country involved than has been the case in the past. The Asian crisis and the wave of currency crises in Latin America had significant spillover effects outside the regions, and especially transition economies have been negatively affected by developments in Asia and Russia. What can the Asian and Russian experiences tell us about how a small emerging economy might avoid such crisis in its own economy?

The issue that arises in connection with crisis is to determine what policy implication the currency crisis holds. The problems experienced by the emerging countries differ from each other, but there are certain weaknesses that should be addressed for the small open emerging economy to reduce the chance of a recurrence. Let us single out some lessons on key areas, many of which are interrelated:

*LESSON 1: Financial Market Liberalization is the Best Predictor of Currency Crises*

This fact has been realised in Latin America in the 1980s, in Europe in the early 1990s and again in Asia in 1997. Kaminsky and Reinhart (1999) found that banking crises were rare during the 1970s, with only 3 taking place (in contrast to a total of 26 balance-of-payment crises). The absence of banking crisis may reflect the highly regulated nature of financial markets during this period. While the number of balance-of-payment crises per year does not increase much during the 1980s and 1990s (from 2.9 to 3.1), the number of banking crises per year more than quadruples in the post-liberalization period. Empirical studies suggest that domestic financial market deregulation leads to boom-and-bust cycles. The wave of liberalization that started in the mid-1980s had two major effects (Wyplosz 1998): making self-fulfilling attacks possible and installing weaknesses in domestic financial markets.

Two problems are exacerbated when the domestic financial market becomes international. The asymmetry of information widens when the lender and the borrower belong to two very different economies. The result is that risk and volatility associated with financial operations are higher in global markets than in domestic financial markets.

The second channel through which volatility in financial markets is widened when they become international is through the increased use of derivatives (options and futures). Although the main target of such a market was to reduce risk (mainly exchange rate risk) in financial or trade operations, the use of these kinds of products quickly became spec-

ulative, leading to higher volatility through a wider asymmetry of information.

The third mechanism through which risk increases volatility in global financial markets is through the role played by institutional investors (hedge funds, pension funds, mutual fund, insurance companies ...). Some big institutional investors display highly leveraged operations (Das 1998; Reisen 1999). Leveraged operations are highly risky, adding higher volatility to the financial system.

The message is clear: financial market liberalization must be preceded by a number of measures (effective prudential regulation and supervision of banks, implementation of market-based instruments such as reserve requirements on foreign currency deposits and short term borrowing, etc.). Deregulation must follow, not precede the strengthening of the banking and financial sectors. This factor has been admitted also by the International Monetary Fund (IMF 1998). The events in East Asia have demonstrated that the partial financial reforms could lead to increasingly fragile financial systems characterized by growing short-term foreign debt, rapidly expanding bank credit, and inadequate regulation and supervision of financial institutions. Such weaknesses leave the economy vulnerable to rapid reversal of capital flows.

#### LESSON 2: *Increased Globalisation Raises the Contagion Effects*

The last two decades have been characterized by significant and fundamental changes, which have challenged the capacities of economies to adapt. Widespread lowering of national and regional barriers to trade and foreign direct investment has led to closer links between economies. Increased integration of markets across countries has acted as a major stimulus to trade between developed and transition countries on the one hand, but also as a potential channel of contagion on the other hand (Strašek and Jagrič 2002).

The contagion effects are the contribution of the second-generation models. Masson (1998) argues that contagion reflects a situation where a crisis in one country may trigger a crisis elsewhere for reasons unexplained by macroeconomic fundamentals. Contagion is therefore an additional effect above and beyond those of domestic fundamentals. The rising importance of contagion is striking: some studies (Schmukler and Frankel 1996) suggest that investors differentiated among countries to a greater extent after the 1994 Mexican crisis than after its 1982 predecessor.

Mason (1998) also points out that the notion of contagion is not really

well defined, since assigning explanatory power to 'contagion' could be regarded as a measure of our ignorance. A possible way of avoiding confusion is to distinguish between various reasons. The factors that help to explain why currency crises tend to be clustered fall into several categories:

- *Monsoonal effects*, defined as major economic shifts in industrial countries that trigger crises in emerging markets. In this case, crises may be due to common shocks, for instance policies undertaken by industrial countries (a steep rise in world interest rates, a sharp slowdown in world aggregate demand, a decline in commodity prices, large changes in exchange rates between major currencies) which have similar effects on emerging markets.
- *Spill-over effects*, defined as a case where a crisis in one emerging market may affect the macroeconomic fundamentals in other emerging markets. Spillovers result from interdependence among developing countries themselves. Typical examples: a devaluation in one emerging country reduces the price competitiveness of the emerging countries, or because lack of liquidity in one market leads financial intermediaries to liquidate another emerging market (Valdes 1996).
- *Pure contagion effects*, defined as indirect spillover effects, i. e. the simultaneous occurrence of crises which are not directly linked to the common deterioration of macroeconomic fundamentals. This kind of pure contagion may be explained in two manners (Blejer 1998): either there are psychological factors that result in similar behaviour (unrelated to fundamentals) or a crisis in one country has a trigger-effect in a second country, by creating panic. The first type of effects include the so called 'wake-up call' hypothesis (Goldstein 1998). It is said that Thailand acted as wake-up call for international investors to reassess the creditworthiness of Asian borrowers and when they did that reassessment, they found that a quite a few of these economies had weaknesses similar to those in Thailand.

The evaluation of the East Asia crisis suggests that contagion effects played a role, even greater than in previous crises. Trade and financial ties and associated emerging market economies (EME) vulnerabilities appear to help explain some of the spread of the crisis in Thailand to other Asian EMES in 1997/1998. In the more recent crisis in Argentina, a lower incidence of EMES with both strong links to Argentina and high

associated vulnerabilities to shocks may go some way towards explaining why the crisis has had a less marked impact elsewhere (Hall and Taylor 2002). If shifts in investor behaviour explain the limited spillovers from Argentina, contagious crises may be less likely in the future.

LESSON 3: *Increased Entwinedness Between Banking and Balance-of-Payment Crises (BOP Crises)*

There was no apparent link between balance-of-payment crises and banking crises during the 1970s, when financial markets were highly regulated. Liberalization of financial markets in the 1980s brought very close entwinedness between banking and currency crises. The crises in Asia in 1997 highlighted this important link. Kaminsky and Reinhart (1999) found some interesting lessons:

- Most often, the beginning of banking sector problems predates the BOP crisis. A banking crisis increases the probability that a country will fall prey to a currency crisis.
- Empirical results also suggest that the twin crises may have common origins in the deregulation of the financial system and that the credit booms and asset bubbles appears to accompany these. Inadequate regulation and lack of supervision at the time of the liberalization may play a key role in explaining why deregulation and banking crises are so closely entwined.
- Empirical tests found also evidence of a vicious cycle, in which the currency collapse further undermines an already ailing banking sector. There may be also an adverse relation: financial sector problems undermine the currency. Devaluation, in turn, aggravates the existing banking sector problems and creates new ones. When currency and banking crises occur jointly, they are far more severe than when they occur in isolation. In both types of crises, a financial shock, possibly financial liberalization or increased access to international capital markets, appears to activate a boom-bust cycle by providing easy access to financing.

Twin crises have been characterised by the following stylised facts: sharp reversal of capital flows, financial liberalisation, financial fragility, market overreaction. The mechanism relies on two features that characterised emerging markets which experienced twin crises:

- First, governments held fixed exchange rate regimes or narrow exchange rate bands, which were vulnerable to speculative attacks.

- Second, domestic banks had a mismatch between foreign liabilities and domestic assets and were thus exposed to exchange rate risks.

Goldstein's (2005) study shows, that an increase in the probability of one type of crisis generates an increase in probability of the other type. Both crises occur as a result of the complementarities between the banking sector and the currency market. Twin crises are expected to be more frequent in financially liberalised emerging markets and are expected also to be more costly than regular banking and currency crises. Important implication: policy measures that do not affect the reserves of government, such as an international lender of last resort or suspension of convertibility may be preferable for attacking twin crises.

#### LESSON 4: *Crises are Becoming Unanticipated*

Financial crises in Mexico in 1994–1995, Argentina in 1995 and the five East Asian economies 1997 display elements of self-fulfilling crises. The evidence so far is that self-fulfilling attacks have become more likely in a world of increased capital openness and mobility. Until the mid-1980s, most countries enforced capital controls, therefore the self-fulfilling attacks have played a minor role.

Many observers have noted the increasing intrinsic instability in international lending: Radelet and Sachs (1998) concluded that emerging markets are especially prone to self-fulfilling crises, since many emerging markets lack the lender of last resort capacity to handle sudden shifts in depositor confidence. Premature financial liberalization in such markets creates self-fulfilling attacks. Emerging markets are handicapped twice:

- First, they aren't sufficiently equipped with a bulwark against panic, since they usually don't pass a well-defined and relatively transparent system for managing bankruptcies, liquidations and other forms of debt workouts.
- Second, international financial markets feel the lack of bulwarks against self-fulfilling panics, that are available in the domestic markets (deposit insurance, lender of last resort function, etc). With globalization and premature financial liberalization the emerging economies are increasingly exposed to the instabilities of the international financial markets.

The handicap of partial and incomplete liberalization has been manifested in opening loopholes in other areas, which firms were quick to exploit (Cole and Slade 1996). Asian events suggest an important lecture

for emerging economies: if an economy suffers from distortions deriving from implicit and explicit public guarantees that everybody would be bailed-out if things went wrong, the liberalization of the capital market will surely exacerbate these distortions. Government bail-out guarantees will lead to serious moral hazard problems in the behaviour at banks: they will be tempted to overland in the more risky investment projects. The bail out promise derives from political distortions that lead governments to want to increase short-term growth and investment above their socially optimal values (Corsetti, Pesenti, and Roubini 1998).

The difficulties in predicting crises lead to the suggestion that specialists should be focused instead on the more modest goal of developing early-warning indicators in order to prevent (and not predict) the recurrence of crises. In order to create a new set of early-warning indicators, economists should focus on non-conventional deficiencies, such as those related to financial fragility associated with financial deregulation and with capital inflows, to a declining efficiency of investment and to high short-term external debt.

#### LESSON 5: *Keep Current Account Deficit Sustainable*

A number of authors indicate that balance of payment crises are typically related to persistent current account deficits. The East Asia crisis and some studies (Frankel 1998) confirm that close attention should be paid to any current-account deficit in excess of 4% of GDP, particularly if it is financed in a way that could lead to rapid reversals. A current account imbalance may be less sustainable if it is derived from a large trade deficit than from a large negative net factor income from abroad component. In the case of Mexico (1994), a large and growing current account deficit is often singled out as a key determinant of the crisis. The Asian crises also confirm a clear connection between real appreciation, current account deficit and possible currency crashes.

Large deficits lead to high external debt, to the point where the country either becomes insolvent (the present value of conceivable trade balance surpluses does not suffice to cover external obligations) or hits borrowing constraint (lenders understand that the country will have no incentives to repay any additional debt). In the case of the Thailand crisis, macroeconomic policy should have reigned in aggregate demand, avoided excessive credit expansion and curtailed the excessive external reliance on foreign savings. This would have reduced the extent of real effective overvaluation and the current account deficit, and slowed the build up of short-term external debt relative to foreign exchange reserves.

The common factor observed in many crises is that economies had serious macroeconomic imbalances, besides large and growing current account deficit also fiscal deficit, which led to excessive accumulation of public debt or external debt that eventually become unsustainable. The lesson is clear: avoid large current account deficits financed through short-term, unhedged private capital inflows.

National measures, the aims of which are to improve the mechanism for crisis prevention, management and resolution at the national level should include these instruments:

- secure adequate foreign exchange reserves,
- maintain sound fiscal and monetary policy,
- adopt a viable exchange rate regime,
- establish orderly capital account liberalization,
- aggressively regulate and supervise financial systems to ensure that financial institutions manage risks prudently.

Although strong macroeconomic fundamentals are necessary, they are not sufficient for averting all crises; a resilient financial sector is required for coping with abrupt changes in asset prices and capital flows. Having a resilient and robust financial sector is therefore the key to avoiding crises. It deals as a preventive measure against contagion and allows flexibility to cope with external shocks. Empirical studies (Stiglitz and Bhattacharya 1999), suggest policies that can achieve this financial structure: prudential regulation of asset liability mismatches, and portfolio and loan standards that adhere to internationally accepted norms; capital adequacy regulations that, at a minimum, match those which are required under the Basle standards; clear governance rules to prevent insider and group lending not subject to loan evaluation and creditworthiness and standards; transparency for investors and depositors through mandatory public disclosure of audited financial statements; and, finally, deposit insurance limited to a minimal share of private liabilities to bound government contingent liabilities in event of crisis, and share risk with investors and depositors. These policies should be supplemented on a global level with policies that tighten regulations over financial institutions that lend to highly leveraged institutions.

### **Policy Implication**

The generation approach towards financial crises clearly shows evolution of economic policy considerations: the differences between first and second generation approach suggest that crises are no longer the result

of obviously irresponsible economic policy and that crises may occur suddenly in situations where no crises seemed inevitable. With the third generation, crises are no longer mainly about monetary policy, so crises become damaging for the economy.

Considering recent changes in the proliferation of third generation models, we accept Krugman's suggestion (2001) that a fourth generation crisis model may not be a currency crisis model at all; it may be a more general financial crisis model in which other asset prices play the starring role.

In order to improve the policy response to financial crises, three issues must be considered: first, the complexities involved in designing an appropriate policy framework; second, the considerable trade-offs that policy makers face in formulating policy options; third, in the long run, a country can remain exposed to significant post-crisis vulnerabilities. Economic policy response is especially complicated by the need to assess a variety of trade-offs; fiscal consolidation vis a vis medium-term growth prospects; administrative measures for quelling a banking crisis vis-a-vis risks of eroding confidence in the banking system and triggering capital flight.

The appropriate policy framework is attributed to the government to undertake the appropriate restrictive measures at the right time: the low interest rate policies in Malaysia after the runs on the Thai baht are a fitting example of the unwillingness. The maintenance of restrictive measures beyond an 'emergence scenario' can have destabilizing consequences. Excessively tight fiscal discipline made the crisis-induced recession worse.

The Asian experience suggests that the economic policies with their effective rescue strategy must be bound to address the issues at the very core of the crisis: strategies and measures have to differentiate between structural problems and traditional macroeconomic imbalances. The lessons we elaborate in our paper could significantly reduce the frequency and damage from capital flow reversals and contagion.

It appears that policy makers have to focus on three distinct elements: preventing crises, managing crises, and resolving the systemic consequences of crises. In order to improve mechanisms for crises prevention, management and resolution, Kawai et al. (2003) suggest measures at the national, global and regional level. Financial globalization and surge of capital flows to emerging economies has made these economies more vulnerable to shocks coming from the capital market itself. Calvo

(2005) referred to these capital market shocks as 'globalization hazard' and found that traditional fiscal and monetary stabilization policies do not seem very effective and need to be complemented with structural policies that help to lower domestic financial vulnerability, especially in economies suffering from a high incidence of foreign-exchange denominated domestic bank loans.

### **Conclusions**

The evidence reviewed in this paper confirms that the growing vulnerability in emerging market economies can be attributed to the surge in capital inflows and private investment. Financial crises of the 1990s have undoubtedly involved several interlinked phenomena, most of which seem to be very important for the future development of the emerging economies. Several aspects of the lessons are worth highlighting:

- The factors that underlie the emergence of imbalances of the financial sector could be seen as the combined consequence of domestic financial liberalization, external capital account liberalization, massive capital inflows and lack of prudential supervision and regulation of the financial system.
- If an economy initiates, but does not complete, the process of financial sector liberalization and reform, this fact would lead to an increasingly fragile financial system. Such a system is potentially very vulnerable to rapid reversal of capital inflows. Emerging economies need properly functioning and well-regulated financial sectors. Banks and other financial institutions need to be well-structured and properly supervised.
- Current account imbalances have become larger since 1980 and have led to building up a serious source of instability to the global macroeconomy. National economy could be seriously damaged, if the current account deficit is financed with the accumulation of foreign debt in the form of short-term foreign-currency denominated and unhedged liabilities. Asian events clearly suggest that current account deficit should be financed largely by direct investment; in this way, first, a deficit is more sustainable than a deficit financed by short-term hot money (especially if it is coming from official creditors), and second, financial flows are less volatile and less reversible.
- Lessons from Asia, Russia and Argentina suggest that the power of the early warning system is still weak. The problem with recent

crises lies in the fact that an early warning system should indicate vulnerability to crises well in advance and that a number of the indicators tend not to signal vulnerability until a crisis is about to occur.

- Emerging economies must be warned against the cases where external borrowing is heavily reliant on short-term, foreign currency-denominated and unhedged foreign debt. The possible depreciation (exchange rate crisis) would increase the real burden of the debt and provoke a further financial crisis.
- Emerging economies are by definition poorly institutionally developed. Therefore, what may start out as one type of crisis may develop into others as well – foreign debt crisis, banking crisis, currency crises or even systemic financial crises.
- A key feature of recent crises arises from financial linkages between countries. Globalization in the 1990s has turned out not to be the cure but a cause of financial crises. Changes in asset returns that are due to shocks will contribute to changes in portfolio allocation to all other emerging markets. Recent contagion episodes show that the financial crises in small economies have devastating effects on economies of very different sizes and structures, with very few direct trade or financial links and in very severe and unexpected ways. Recent events suggest that contagion is the likely reason for huge and sudden withdrawal of capital.
- The financial channel is, besides the trade channel, and similarity channel another strong conduit spreading the contagion. With the larger rise of mutual fund industry it is on a good way to becoming the dominant channel.

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VOLUME 5 · NUMBER 3 · FALL 2007 · ISSN 1581-6311

- 213 Interdependence Between Social Values  
and National Performance Indicators:  
The Case of the Enlarged  
European Union  
*Cene Bavec*
- 229 Personality and Attitudes of Indian Young Female Workforce:  
Entrepreneurial Orientation by Education and Regions  
*Subhash C. Kundu*  
*Sunita Rani*
- 253 Determinants of Consumer Willingness to Purchase  
Non-Deceptive Counterfeit Products  
*Irena Vida*
- 271 Measuring the Impacts of Organizational Responses:  
Case of Northern Cyprus Hotels  
*Erdogan Haktan Ekiz*  
*Huseyin Arasli*
- 289 Emerging Economies Crises:  
Lessons from the 1990's  
*Sebastjan Strašek*  
*Timotej Jagrič*  
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