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ABSTRACT

The network approach to internationalization of the firms has warranted the research focus of many international business scholars. Firms are increasingly involved in international business endeavors and arguably need to learn to adapt to idiosyncratic milieus they encounter in the foreign markets. This paper proposes a conceptual model suggesting that integration in networks strengthens corporate competitiveness in international markets. Network membership provides access to knowledge that facilitates adaptation to the various dimensions - economic, political, legal, cultural – of the international business environments. Membership in social and business networks are likely to ease internationalization by reducing firms' perceived psychic distance.

Keywords: Networks, internationalization theories, psychic distance.

INTRODUCTION

The increasing globalization of markets and production, most prominent in the last three decades has led to multiple challenges for firms and governments. Firms now have an increasing need to reconsider their strategies at a global level. That entails choices regarding not only which markets to access but also which are the best locations for each stage of the value chain (Aulack, Teegen and Kotabe, 2000) to improve their competitive capacity. With the gradual lightening of the traditional trade and investment barriers and the lowering of transportation costs, the national (or domestic) markets are becoming open to all sorts of foreign competitors (Buckley and Casson, 1998) that come to challenge local players even within the national borders. For governments, the challenge relies on how to promote the competitiveness of the economy, eventually by enhancing firms' competitiveness, which may include actions to improve the infrastructures, education and RandD, but also fostering a wide array of partnerships among firms.

An important source of competitive capacity in the contemporary world economy is the access to knowledge and innovation. Indeed one of the reasons for why firms internationalize is the access to novel knowledge that may be internally transferred. This rationale supports, for instance, the internationalization to locations of excellence, such as high-tech industry clusters (Porter, 1998; Giuliane, 2005), but there are many unanswered questions and doubts concerning the transferability of knowledge, namely doubts related to the capture of locally-specific knowledge and to the internal mechanisms required for an effective internal transfer. That is, questions regarding the mobility of knowledge. Another set of doubts emerge related to the actual sources of firms competitive advantages which, at least in some instances, may be embedded in firm-specific resources (Barney, 1991). In any case, the strategies of the multinational corporations (MNCs) may need to be adapted for international expansion.

The internationalization of firms is not always just a strategic option, rather it is often a competitive imposition and a requirement for firms' survival (Ghemawat, 2007). From an internationalization strategy perspective it is necessary to identify the best ways to develop a foreign presence. In this sense, the foreign entry modes are well known. For example, the international presence can be sustained by exports but increasingly requires at least forms of international partnership, which may take the form of network membership, joint ventures, strategic alliances or licensing local partners capable (Root, 1994). In many cases, the most viable form of internationalization is through greenfield investments or the acquisition of existing firms (Singh and Montgomery, 1987). Notwithstanding, the specific entry modes selected by different firms warrant additional research to clarify the motivations. The case in point is research to understand the impact of perceived psychic distance in the choice of the entry mode for specific markets, and in particular how network membership may lower the psychic distance involved in foreign expansion.

In this paper we contribute to the discussion of how integration within industrial networks decreases the effects of psychic distance thus making the company more competitive in foreign markets and improving its performance. Firms need to engage in continuous process and product innovation and to constantly restructure their operations to meet the requirements of international competition. Failure to act internationally may lead to a loss of market opportunities, but also to a more severe inability to survive in the long run (Ghemawat, 2001, 2007). Firms must find new ways to develop a competitive advantage (Porter, 1980) which entails searching for and acquiring new skills, resources and capabilities (Barney, 1991). Knowledge is an important strategic resource (Wernerfelt, 1984; Peteraf, 1993) due to its impact on the competitive capacity. In many instances, firms may access those resources, including the knowledge-based, through alternative governance forms, such as 'industry networks' (Nohria and Ghoshal, 1997). In fact, firms seem to gain international competitiveness by being integrated in 'industrial networks'. The integration in a network facilitates access to a flow of knowledge that a firm in isolation would not hold.

This paper is organized in five main parts. First, we present different theories of internationalization. Second, we specifically review the extant literature on the concept of industrial networks and psychic distance, which support our proposed conceptual model. We discuss the integration of industrial networks in order to diminish the effects of psychic distance when firms internationalize. We conclude with a broad discussion and pointing out implications and avenues for future inquiry.

INTERNATIONALIZATION THEORIES

The internationalization of firms has been being addressed by various theories and under different perspectives. It is largely beyond our immediate scope an extensive review but it is worth noting that some explanations for the internationalization of firms rely on foundations based on increased market power (Hymer, 1976), the internalization theory (Buckley and Casson, 1976), the international product life cycle (Vernon, 1966), the eclectic paradigm (Dunning, 1981b) and the transaction costs theory (Hennart, 1988). Other perspectives include internationalization as a process that depends on factors such as attitudes, perceptions and behavior of managers (Andersen and Buvik, 2002) and internationalization as a sequential and evolutionary process (Johanson and Wiedersheim-Paul, 1975, Johanson and Vahlne, 1977, 1990). Noteworthy are also the explanations based on network concepts and theory (Ford, 1980; Hakansson, 1982, Hakansson and Johanson, 1984, 1992).

Classic theories of internationalization

According to Hymer (1976) the theory of market power is based on market imperfections - that is, in markets with monopolistic or oligopolistic characteristics. According to this theory a firm seeking to enter foreign markets when the domestic market grows and gets bigger profits, thereby gaining greater market power. Firms seek external markets as a way to sustain and even strengthen their position in the market with its market power that is reinforced by failing to limit its operations to the domestic market (Hymer, 1976). According to the product life cycle theory (Vernon, 1966), firms must produce their innovative products in domestic markets mature and produce their products in developing countries for access to resources and / or materials at lower prices.

The internalization theory, developed by Buckley and Casson (1976), assumes that firms should internalize their activities, both in national and international markets, when the free market is less efficient and / or more expensive (Rugman, 1981). According to Buckley and Casson (1976) firms began their entry into foreign markets exporting, followed by licensing and finally undertaking foreign direct investment deals. When the market does not grow outside the expected firms cannot pass on exports. Firms that have competitive advantages prefer to internalize their operations in order to protect these same advantages of their competitors (Buckley and Casson, 1976).

According to the eclectic paradigm developed by Dunning (1981, 1988), firms enter foreign markets only when they have competitive advantages of ownership, location and internalization. Ownership advantages are specific to a company and are related to property developed by the company, technology or products (for example, exclusive access to a particular technology). The benefits of internalization are related to the ability of a firm to develop and coordinate all activities of its value chain - i.e not use the market. Finally, the location advantages are derived, for example, the intervention of governments to provide businesses with infrastructure or reduce the tax burden in a given geographical area, which would reduce costs for firms.

The profound changes in the world technological, political and economic links, the Soviet Union's demise and the consequent opening up of markets in Eastern Europe, China's opening to world trade and the emergence of new economies such as the Malay, Thai and Brazilian, leads Dunning to update his perspective and to highlight the particular importance and benefits of inter-firm cooperation, be it using strategic alliances, networks or other hybrid form (Dunning, 1995).

Other approaches to internationalization

The theory of internationalization in stages, or the Uppsala evolutionary model, was developed by Johanson and Wiedersheim-Paul (1975) and Johanson and Vahlne (1977). This evolutionary model proposes that internationalization is a gradual process that may be generally characterized in four stages: the lack of outdoor activity, including exports, export through intermediaries, to open a sales subsidiary and finally construction of a subsidiary for production. According to Johanson and Wiedersheim-Paul (1975) internationalization is a gradual process due to the psychic distance, or the differences between countries that cause uncertainty (Cavusgil and Zou, 1994). In sum, firms seek to minimize uncartainties by entering initially closer countries (proximity evaluated as to the economic and cultural profile and geographic distance) and as they gain experience move to farther countries. Similarly, when entering unchartered territories, firms prefer to do so using low involvement/low investment modes and as they gain knowledge of those markets evolve to more investment intensive entry modes. In sum, the implicit proposition in the extant research might be formulated as follows: *the largest the perceived psychic distance of home and host country the riskier the performance in the foreign market and the more firms prefer to mitigate the risks involved leading to the choice of low involvement entry modes*.

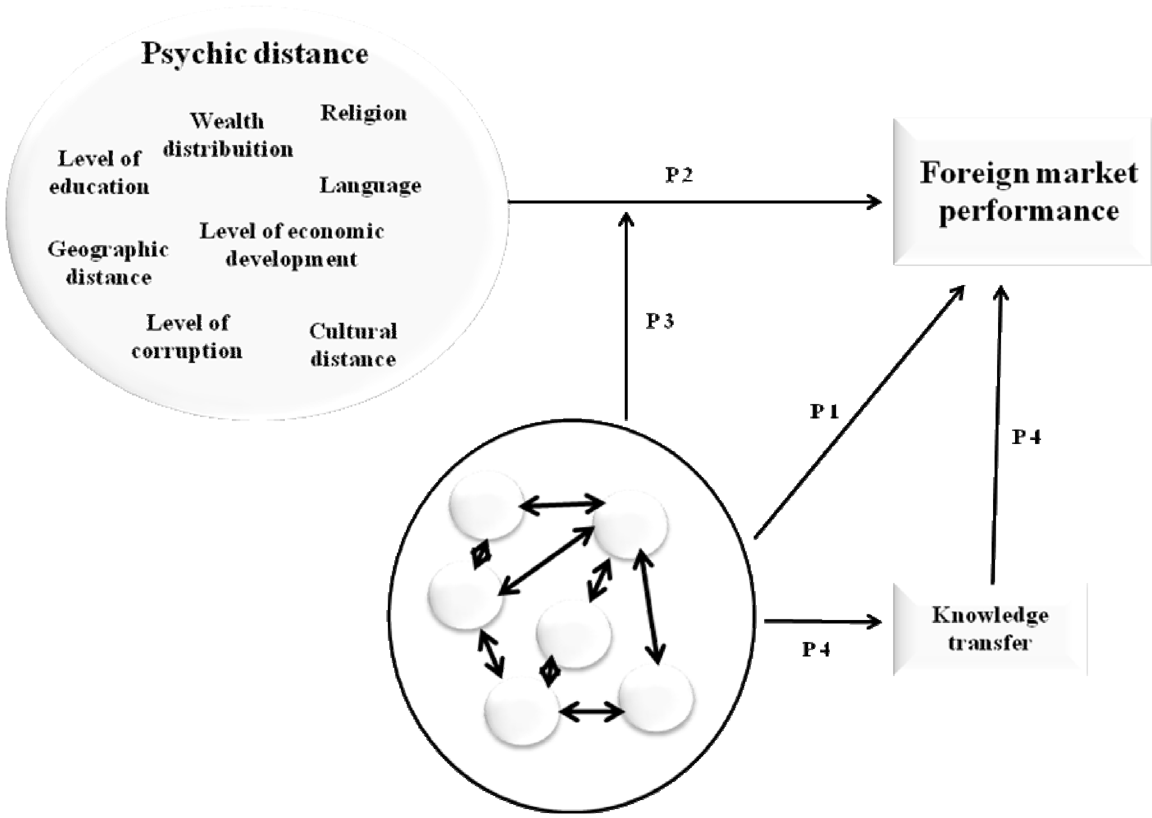
Firms internationalization based on network explanations are somewhat more recent and are founded on the core ideia that firms have much to gain from partnering with other firms for both access to scale and scope resources and also to gain knowledge on the markets (Weisfeld, 2001). For Johanson and Mattson (1988) the integration in networks turns out to be compulsory for businesses - as strategic resources are increasingly scarce and firms in isolation are unable to hold a pool of resources that may render them competitive, it may be necessary to establish relationships with other firms that hold them. Johanson and Vahlne (1990) and Welch and Welch (1996) also posited that firms should be seen as embedded within a network of relationships – and networks that may be unintentional or strategically planned - namely when entering foreign markets.

NETWORK SUPPORTED INTERNATIONALIZATION

Network integration is likely to strengthen the competitiveness of firms in international markets. The membership in a network of related and unrelated firms provides a variety of benefits that range from access to legitimacy, financial and technical resources and flows of technical and perhaps more important, of market knowledge, thus reducing possible hazardous effects of psychic distance.

We propose that we may scrutinize the network benefits on a specific impact – the impact on the perceived psychic distance – and advance a conceptual model depicted in Figure 1 below.

FIGURE 1. Conceptual model



Industry networks

Industrial network theory describes the market as a social system where industrial relations exist linking customers, suppliers, competitors, family and friends. The nature of the relationships between the various parties will influence the strategic decisions. One basic assumption in the model of industrial networks is that the individual firm is dependent on the resources controlled by other firms, be it for obtaining the needed inputs or for placing outputs. Only by establishing a position within the firm network may firms access these resources (Andersen and Buvik, 2002).

Network research in international business studies has witnessed many contributions. Hakansson and Johanson (1984), for instance, put forward a model of industrial networks known as *ARA* model (Actors - Resources - Activities) pointing that the main actors in the internationalization process are the institutions, firms and individuals that interact to facilitate the exchange (Hakansson and Johanson, 1992). These actors include importers and exporters, financiers, government institutions and consultants, to name but a few. The activities consist of the various forms of exchanges – direct and indirect - that occur between actors within the network. The direct activities affect the exchange process, as in the case of individual firms, while the latent and indirect links are derived from actions of governments and multilateral organizations. Another distinction of activities differentiate between the processing activities – where the resources, held by a particular actor, is altered in some way – and transfer activities – resources are shared by the actors (Hakansson and Johanson, 1992). A core assumption of network theory is that individual firms have to rely on other firms for the resources and to gain access to these resources must establish a position within the network (Johanson and Mattsson, 1988; Axelsson and Easton, 1992). The resources of the network include such items as products, raw materials, information, knowledge, capital and technology (Johanson and Wiedersheim-Paul, 1975).

The extant research has employed different terms to designate industrial networks, including networked organizations, organizational networks, inter-organizational networks, network businesses, networking among firms, network, networking, relationship network, networks of inter-organizational networks, inter enterprises and enterprise networks. Regardless of the actual usage, a network refers to a set of business relationships, both horizontal and vertical, with other organizations - be they suppliers, customers, competitors, or other entities. According to Hakansson and Ford (2002) a network is a structure in which multiple nodes are connected to each other by specific relationships. The relationships are inter-organizational ties of strategic importance for the firms involved and may include strategic alliances (Gulati et al., 2000). Following Elo (2005) we use industry network to reflect the "long-term relationships between legally independent companies that exploit mutual complementarities and exchange information / knowledge". In these networks, each party carries out different activities and exchange valuable resources, based on cooperative trust relationships and an alignment of long-term interests (Johanson and Mattsson, 1988; Easton and Hakansson, 1996; Ford et al., 2002). For the interactions to last, there must be benefits for all parties involved (Johanson and Wiedersheim-Paul, 1975).

In sum, the received literature seems to formulate a broad proposition taking the following form:

Proposition 1. *Firms' industry network membership are likely to perform better in their foreign operations.*

Psychic distance and firms' internationalization

The internationalization of firms has been explained as an incremental process, following a sequence of phases. As firms internationalize they accumulate experience, knowledge and proceed with higher commitment to investment in foreign markets (Johanson and Vahlne, 1977). According to Johanson and Wiedersheim-Paul (1975), firms begin internationalizing in nearby markets - markets in close geographic proximity, with a cultural, political and legal system that is similar to that of the home country of the MNC. The initial expansion to proximate locations seeks to reduce the risks by avoiding unfamiliar spaces and by selecting entry modes of low commitment. The most common foreign entry mode is, therefore, direct and indirect exports. As firms expand to farther countries, they assume greater risks.

The first researcher referring the concept of "psychic distance" (PD) was Beckerman, in 1956, to point out the perceived distance between countries and the consequences for international trade. According to Beckerman (1956) trade between countries was not only determined by the physical distance between countries, but also by other factors that create a sense of dissimilarity, such as language, culture and personal relationships between entrepreneurs. According to Johanson and Wiedersheim-Paul (1975, p. 307) the psychic distance is "the result of factors that prevent or impede the flow of information between firms and the market", or "the set of factors that impede the flow of information and the market" (Johanson and Vahlne, 1977, p. 24). The psychic distance can also be defined as the degree of ignorance of a firm on the characteristics of a foreign market (Kogut and Singh, 1988). For Evans, Treadgold and Mavondo (2000a, 2000b) it is the distance between the domestic and foreign market, resulting from the perception and understanding of the existence of cultural differences and negotiation between them. The construct of psychic distance is composed of a set of variables that make the environments of the home and host country differ, including such aspects as the language, religion, level of economic development, wealth distribution, level of education, degree of technological sophistication, geographic distance, pervasiveness of corruption and cultural differences (Johanson and Wiedersheim-Paul, 1975).

The internationalization of firms is done incrementally. Initially, firms select markets less psychologically distant, which allows to gain experience in carrying out international operations generally and operations in that specific market particularly. In order to minimize risks while gaining knowledge about customers, suppliers, bureaucratic procedures, exchange rates, taxation, customs barriers, and so forth, firms begin to enter foreign markets through exports (Johanson and Vahlne, 1977). As they accumulate knowledge on the market they may assume more involvement using alternative modes such as strategic alliances or joint ventures and may even evolve to deploy acquisitions or establish greenfield subsidiaries in those countries. According to Vahlne and Wiedersheim-Paul (1975) uncertainty about foreign markets is related to the psychic distance home-host countries. For instance, the psychic distance between Sweden and any given foreign market is determined by a number of factors such as level of development, level of education, business language, cultural differences, language and relationships of many kinds between the country of origin and the host. The greater the difference between the factors, the greater the psychic distance between countries which lead to greater uncertainty in operating in those countries (Carlson, 1975; Ford, 1984). A proposition may be specified as follows:

Proposition 2. *Psychic distance is likely to have a negative impact on firms' performance in foreign markets.*

When firms decide to internationalize they need to make a set of decisions, namely on the market/country in which to operate and with which mode. According to Ghemawat (2001) the decision to internationalize may be seen in two perspectives. One, considering the convergence of markets as a result of globalization (Levitt, 1983), internationalization is nothing more than entering a new market, already known, so the perceived risk is reduced. Other, realizing that markets differ, the decision to internationalize a firm involves high risk and the need to adapt to an entire set of norms and rules different from those of the home country. To succeed in this adaptation, firms may require new skills and resources. To reduce the potential risks and hazards, firms initially choose to enter proximate markets and only in a later stage in more distant markets (Johanson and Wiedersheim-Paul, 1975).

For Hallen and Wiederscheim-Paul (1993) internationalization, is a consequence of the growth process and is seen as an incremental process and its speed and sequence depends on the degree of knowledge on foreign markets (external environment), experience, etc. The degree of knowledge will reduce the "psychic distance" between the domestic and external environment (Johanson and Vahlne, 1977) and we have seen that network membership contributes positively to attenuate those effects.

The sharing and transfer of knowledge may be maximized for firms integrated in an industrial network. The sharing of knowledge and resources among network members is likely to reduce possible effects of psychic distance for firms entering a new country. The effect of the psychic distance is reduced when firms enter into foreign markets because firms belong to networks where information and knowledge of foreign markets is shared

(Nohria and Ghoshal, 1997) which means that firms obtain better performance. Thus we may advance in proposition form:

Proposition 3. *Firms' industry network membership positively moderates the negative impact that psychic distance has on the performance in a foreign market.*

Industrial networks' effects on knowledge transfer

Industrial networks are particularly important for international business and as a tool for understanding foreign cultures (Hakansson et al., 1992). For example, the international transfer of technology, even within the boundaries of a firm, is faced with many aspects of culture. The ability to transfer knowledge among firms in a network may be harder, albeit the potential individual and joint benefits. The ability to create a synergy within firms in a network is important in business relationships between firms in different countries namely because the network helps in providing and understanding about and an acceptance of the cultural variations that are reflected in practices.

A network is a set of exchange relations among firms that are linked by long-term relationships and joint interests or commonalities (Cook and Emerson, 1978). However these relationships are in constant change (Johanson and Mattsson, 1988). The firms develop and / or alter the relationships with partners, in accordance with its objectives. For example if a firm wants to enter a new market it has to establish new relationships and sometimes end up with others (Hakansson and Snehota, 1995). The more integrated the firm's network is the fewer changes firms need to do, because firms trust more in their partners. The networks promote an environment conducive to sharing knowledge and resources, which enables firms to achieve competitive advantages in both domestic and external markets.

Unlike centralized and hierarchical management, which may not allow the exchange of information, firms belonging to industrial networks, put particular emphasis on knowledge transfer between all partners/firms, including among subsidiaries (Nohria and Ghoshal, 1997). It may be that the knowledge absorbed from local, domestic, partners is market-related, while the ties binding other firms may rely on the transfer of technology-related knowledge, labor practices, process-related best practices, RandD efforts, new distribution channels, and so forth. The ultimate purpose is to apply this knowledge to improve performance. In sum, we propose an effect of network membership on knowledge transfer, noting that this is a crucial transfer – albeit knowledge may refer to many different issues – in network forms:

Proposition 4. *Firms' industry network membership is likely to impact performance positively by promoting knowledge transfer among network members.*

DISCUSSION AND FINAL REMARKS

Industrial networks assume an important role in the internationalization of firms worldwide, as confirmed by the increasing number of published articles on the topic (Ford et al., 2002). These networks provide firms with an array of resources and market and client information, improving the odds of survival and success. Moreover, the networks may be intentionally and strategically constructed so as to serve the goals of the firms in a specific moment. Due to their facilitating role, research on the influence of the networks in international business literature is warranted.

Firms construct industrial networks to reduce the barriers and hazards faced pre-, during and post-internationalization and it is the responsibility of managers to identify opportunities to integrate networks, which networks to enter and from which to exit. The success of each firm in the network is the result of the conduct of all firms in the network (Tornroos, 2002, 2004), thus deserving managers' attention to the evolution and performance of the network they belong to.

Understanding the importance of the network is relevant for practitioners of both internationally inexperienced as well as multinational corporations. Through the network ties firms may access resources they do not hold and that they could not access otherwise, namely through internal development. It is also interesting to consider network membership as a manner to reduce the exposure of the firm to unchartered countries. Using network ties firms may avoid employing other entry modes that involve greater risk. In fact, the network membership may be seen as an alternative entry mode to add to the pool of available strategies. Arguably, networks may be of even greater interest for small and medium enterprises that lack the human, technical and financial resources to undertake internationalization alone.

For theory the network research may present avenues that have been somewhat underexplored. It is now recurrently referred to that firms should focus on their core competences and core business. All activities outside the core that are not of strategic importance may be contracted out in the factor market. Indeed, firms may use this rationale when selecting and constructing their networks. The value of a network depends on the moment and on the medium and long term strategy for a specific market. Future research could explore how firms are reshaping their networks to face different needs and strategies in foreign markets.

Future research may evolve in a number of different paths. For instance, what is the composition of firms networks that better support the internationalization in different stages. That is, how should networks differ for firms that are looking for their first international experiences from those that have accumulated a wealthy track record of foreign deals? How stable or unstable are the networks? This is important in understanding if firms in a network tend to assume opportunistic behaviors and as soon as they capture a certain benefit whether they remain or exit the network. What is the ideal network configuration for supporting internationalization? A number of questions emerge from applying a network rationale to the study of internationalizing firms.

To conclude, network membership may prove to be a valuable distinctive factor and one with the potential to provide a competitive advantage. It seems reasonable to suggest that the degree of embeddedness in a network lowers the perceived psychic distance hazards of internationalizing firms. The consequence should be on better performance and improved odds of survival. For instance, foreign entry into countries of the former Soviet sphere of influence where the economic and cultural realities are quite different from those found in other Western European countries, warrants that we investigate not only how much perceived psychic distance is involved but also how this distance and the associated hazards may be overcome by partnering with either local or other foreign firms.

As we begin to question again how far should firms go in their diversification efforts – including geographic diversification – other theories may be brought to bear on examining the actual implications and modes to deal with the increased risks. The focusing on the core competences by some firms is coherent with the configurations that may emerge from networked firms.

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