

Paper prepared for presentation at

28th EIBA Conference in Athens,
December 8-10, 2002

Conference Theme:
Research and Development and knowledge creation in Multinationals

Organizational Learning in Foreign Markets: Feeling Its Way in an Unfamiliar Environment

Torben Pedersen and Bent Petersen

Department of International Economics and Management
Copenhagen Business School,
Howitzvej 60, 2nd floor, 2000 F, Denmark
tp.int@cbs.dk • bp.int@cbs.dk

Competitive paper

Organizational Learning in Foreign Markets: Feeling Its Way in an Unfamiliar Environment

ABSTRACT

This empirical study addresses the question of how foreign market unfamiliarity of entrant firms develops post-entry. Three different predictions of post-entry change of foreign market unfamiliarity are derived from the literature on firms' internationalization process. The predictions are made subject to empirical examination using a set of primary data of current (i.e. at the point in time of mail interviews) foreign operation business operations reported by managers of Danish international firms. The empirical study gives insight to the incidence and character of the so-called 'shock effect' in relation to foreign market entry: the phenomenon of entrant firms' inclination to underestimate differences between the home and host country in terms of the business environment. The data support the supposition that entrant firms in general are exposed to a 'shock effect'. On average, the foreign market unfamiliarity as perceived by the entrant firms peaks seven years after entry. The company data indicate that entrant firms in general experience the shock effect in relation to entry of adjacent, rather than distant, countries. Hence, the 'psychic distance paradox' hypothesis is supported. Also, the data suggest that the shock effect befalls producers of customized products, but not producers of standardized products, and furthermore, entrant firms in general experience the shock effect in relation to acquisition of tacit rather than explicit knowledge.

Key words: Internationalization process of firms, liability of foreignness, learning, shock effect.

1. Introduction

When firms enter a foreign market they will usually be disadvantaged vis-à-vis the indigenous firms in terms of familiarity with the local business environment. This unfamiliarity - often denoted 'liability of foreignness' (Zaheer 1995) - induces high levels of uncertainty that impede effective decision-making, difficulties in dealing with local governments and local partners. Diverse local preferences, cultures, and business systems increase the odds that foreign firms will make costly errors, encounter substantial delays, or otherwise struggle with their attempts to establish operations abroad. At the root of many of these difficulties is a foreign firm's lack of local market knowledge (Johanson and Vahlne 1977). Local market knowledge is knowledge that is specific to a host country regarding its language, culture, politics, society, and economy. Acquisition of local market knowledge is critical for the successful planning and implementation of almost all aspects of entry into a new host country (Lord and Ranft 2000).

How entrant firms perceives their 'liability of foreignness' has implications both for their commitment of resources to the foreign market in question and for the performance of their business activities. The more uncertain the management of an entrant firm is about how it should conduct business in a foreign market the less inclined – all else equal - will that management be to involve in high-commitment operation modes (Johanson and Vahlne, 1977). Furthermore, if the management misjudge the 'liability of foreignness' in relation to a foreign market this will diminish the chances that the entrant firm performs well in the foreign market. Needless to say, the management's underestimation of business environment differences between home and host market will be more critical to the performance than an overestimation. Hence, an understanding of how managers of entrant firms ascertain their lack of knowledge about a foreign market is therefore essential for the development of positive as well as normative theory of firms' internationalization processes.

A number of authors have described internationalization, including the acquisition of local market knowledge, as a rich and complex process of organizational learning (Barkema et al. 1996, Erramilli 1991, Johanson and Vahlne 1977). The process of entering a new foreign market has some resemblance with the process by which the blind is feeling her way in the darkness. The blind will only move forward very slowly as she is becoming more familiar with what is immediately in front

of her. She will change the direction as she gains information about obstacles and opportunities on the way. In the same vein, firms handle the unfamiliarity problem through an incremental decision-making process, where information acquired through foreign activities in one phase is used in the next phase to take further steps.

The literature displays some controversy regarding the evolvement of firms' foreign market unfamiliarity after entry. In particular if one takes on the perspective of the entrant firm itself, i.e. the market unfamiliarity as perceived by the entrant firm. The controversy found in the literature on the internationalization process on how firms can increase their local market knowledge is to a large extent a resemblance of the different learning models identified in the literature on organizational learning.

The model of learning applied when firms go international remains largely empirically unexplored, thus, a number of questions can be identified in regard to perceived unfamiliarity and the way by which firms learn in foreign markets. First of all, does the mainstream internationalization theory assumption of entrant firms' post-entry unfamiliarity hold? Is it really true that unfamiliarity with local business environments only can be remedied *after* market entry, or are (some) firms capable of engage in extensive *pre*-entry learning that remedies their shortcomings in regard to familiarity with local business conditions? If yes, we would be able to observe firms that perceive permanently low, or even negligible knowledge lacks after foreign market entry. Furthermore, are entrant firms realistic about their inadequacies in terms of doing business in targeted foreign markets, or do they tend to underestimate these inadequacies prior to entry? In the latter case entrant firms will experience a 'shock effect' in the immediate period after entry. Also, little is known about time spans of foreign market unfamiliarity: when entrant firms perceive lack of local market knowledge how longwinded is then the learning process? Are we talking about months, years or decades of years? In particular, how long time does an eventually 'shock effect' lasts? Addressing these questions this paper reports an empirical study of how firms' unfamiliarity with foreign markets evolves after entry. The empirical study is based on primary data of current (at the time of study) foreign operations reported by managers of Danish international firms.

The paper is organized as follows: In section 2 we overview previous studies on foreign market unfamiliarity as perceived by entrant firms and derive our hypotheses for testing. Section 3 accounts

for the data compilation and sample characteristics. In section 4 we specify the statistical model and construct operationalization. The results are reported and discussed in section 5. Section 6 concludes.

2. Previous Studies and Development of Hypotheses

Post-entry learning

The internationalization process theory (Johanson and Wiedersheim-Paul 1975, Johanson and Vahlne 1977, Cavusgil 1984, Forsgren and Johanson 1992) argues that entrant firms will defer high resource commitment, such as subsidiaries, until their perceived unfamiliarity with the local business environment has declined to a tolerable level.

Thus, the internationalization process theory predicts that to a non-negligible degree do firms lack knowledge when they enter foreign markets, and the lacking how-to-do-business knowledge can only be acquired in the course of time following the initial entry. It is primarily those individuals working in the specific market who will discover the problems and opportunities intrinsic to that market.

The experiential and context-specific character of the local market knowledge implies that most of the learning will have to take place post-entry, while the opportunities for pre-entry learning are accordingly low.

From this we derive the following hypothesis about the post-entry learning pattern of entrants firms:

H₁ *Entrant firms' perceived unfamiliarity declines with elapsed time of operations in the particular foreign market.*

Pre-entry learning

The internationalization process theory indicates *indirectly* that to some extent does pre-entry learning takes place. The theory predicts that firms enter foreign markets of successively greater psychic distance from the home market. This implies that foreign markets in which a firm already

operates will function as ‘steppingstones’ to new markets. The stepwise geographical expansion reduces the foreign market unfamiliarity *prior* to entry of the individual foreign market because the entrant firm has learned from its preceding conduct of businesses in similar foreign markets. We note that these spillover effects across foreign markets in terms of learning is not quite concordant with the important role Johanson and Vahlne (1977) ascribed market-*specific* knowledge in the internationalization process of firms. Though, in a later work Johanson and Vahlne (1990) themselves suggest a relaxation of their original emphasis on market-specific knowledge. Johanson and Vahlne (1990) reiterate the general rule that resource commitment to foreign markets will be made in small steps due to a longwinded accumulation of experiential knowledge. However, some exceptions to the incremental expansion are conceivable. One exception is when entrant firms have considerable experience from markets with similar conditions. It may be possible to generalize this experience to the foreign market entered most recently (Johanson and Vahlne 1990, p. 12). In other words, pre-entry learning might be possible. It has also been pointed out in more recent work by some of the Uppsala-scholars that, through their business network, organizations can gain access to the knowledge of other firms, without having to go through exactly the same experiences as these firms (Eriksson et al. 1997). The possibility for pre-entry learning has been indicated by other IB-scholars as well. Casson (1996) has pointed out that it is difficult to conceive psychic distance patterns of firms without assuming some sort of scope economies with respect to learning about foreign market environments. In a similar vein Barkema et al (1996) conclude from an empirical study that centrifugal expansion patterns are more successful than random, diversified expansion routes. They identify a ‘locational path of learning’ in relation to firms’ engagement in foreign operations. The firms that followed this path of learning benefited substantially from their previous experience in the same country, but also – although to a lesser extent – from *previous expansion in culturally adjacent countries*. The firms benefited the least from previous operations in culturally distant countries.

Based on the above discussion, we conjecture a second, competing hypothesis, proposing that substantial pre-entry learning has taken place in adjacent foreign markets:

H₂ *Entrant firms’ perceived unfamiliarity does not decline with elapsed time of operations in the particular foreign market.*

The hypothesis envisages the rather extreme case where entrant firms have benefited from pre-entry learning to the extent of which the lack of local market knowledge has been remedied fully. Therefore, the degree of market unfamiliarity is permanently low throughout the post-entry period: the additional learning that takes place in relation to the on-going activities post entry is negligible.

Shock effect

An assumption made in the internationalization process theory was that the entrant firm's acquisition of knowledge about the foreign market would reduce the perceived uncertainty and, in turn, encourage more resource commitment in that market. However, the research done by Welch and Wiedersheim-Paul (1980) indicated that some firms perceive higher levels of risk and uncertainty as internationalization proceeds, in response to increased information and knowledge. Also, research by Erramilli (1991), on U.S. service firms, has shown that the desire for control of foreign operation (and thus the resource commitment to the foreign market) are not necessarily increasing when firms are acquiring more knowledge about the foreign market. Instead of a monotonically increasing proportionality between knowledge accumulation and resource commitment, as postulated by the international process theorists, Erramilli suggested a U-shaped relationship between learning and the inclination of an entrant firm to engage in resource-demanding foreign operation modes. On this background we submit a third competing hypothesis:

H₃ *Entrant firms' perceived unfamiliarity declines with elapsed time of operations in the particular foreign market, but only after a temporary increase ('shock effect').*

The studies on firms' unfamiliarity with foreign markets that underpin hypotheses 1-3 are summarized in Table 1.

--- Insert Table 1 about here ---

With a strong emphasis on experiential learning the organizational learning model implied by the internationalization process theory is in many ways very narrow in its scope operation. However, a closer look at the literature reveals that organizational learning is understood in two different ways in connection with an organization's effectiveness (Forsgren 2002). One understanding of organizational learning focuses on competences: learning is seen as improving the effectiveness in

conducting certain activities, by doing “more of the same”. Another understanding of organizational learning stresses the information aspect of learning, where learning is meant to increase the organization’s knowledge about possible alternatives. The more the range of alternatives is enhanced, the more the organization has learnt, and the larger the number of potential useful alternatives in the future. While the latter emphasizes the learning as an instrument to gain more information on alternatives the former focuses more on reducing uncertainty and improving performance of existing activities. The former learning model is more in line with hypothesis 1 that focuses on the accumulation of experiential knowledge, while the latter learning model that focuses on the improving information on local market conditions is more in line with hypothesis 3

Market characteristics - The psychic distance paradox

An assumption made in the internationalization process theory was that a firm would perceive its lack of market knowledge to be relatively little in similar, neighboring countries and great in distant and cultural dissimilar countries. In other words, a firm would expect to perform better in foreign countries associated with little ‘psychic distance’. But, as O’Grady and Lane (1996) point out, firms may overestimate the similarities between neighboring countries. Even countries that share language, historical, and legal traditions, often have very different institutions that do not allow the simple transfer of business practices and attitudes across borders. O’Grady and Lane (1996) provide many examples of Canadian retailers that performed poorly in the United States due to the large differences in the operating environment between countries. In fact, many of the examples that they present show that the differences in the business environment between Canada and the U.S. were more profound than the managers had expected. Moreover, the growing literature on survival of firms in foreign nations suggests that foreign investment into close countries often fails (e.g. Mitchell, Shaver and Yeung, 1994). The reason might be that firms take more precaution when entering distant markets and spend more time on planning, since they are fully aware of the significant ‘psychic distance’. From this we can derive the following hypothesis on the ‘shock effect’ (i.e. an initial *increase* and then a *decrease* of perceived market unfamiliarity):

H₄ *Entrant firms experience a ‘shock effect’ in relation to adjacent markets – not in relation to distant markets.*

Knowledge characteristics

As mentioned earlier many of the difficulties faced by entrant firms arise from not knowing how business is done in the foreign country. Some of the rules, customs, and practices are explicit and relatively easy to comprehend and adopt. At a deeper level, how the game is played is influenced by the foreign country's values and by its basic cultural assumptions. These differences tend to be implicit, and hence harder to uncover. They also are much more socially imprinted upon the individual, and hence foreigners find differences in values and cultural assumptions much harder to accept than differences in practices (Schein 1985). Reflecting these different knowledge characteristics the internationalization process theorists (Johanson and Vahlne 1977, Forsgren and Johanson 1992) made a distinction between two broad categories of knowledge that entrant firms are in need of: knowledge that can be acquired quickly and with relative ease because it is explicit (markets statistics, competition laws, product approval requirements, technical standards, import regulations, etc.), and knowledge that is characterized by its tacitness and therefore can be acquired only through learning-by-doing. Since the acquisition of latter type of knowledge is indispensable in the internationalization process, the decline of unfamiliarity is contingent upon the extent to which the firms accumulate knowledge through ongoing activities:

“International expansion is inhibited by the lack of knowledge about markets and such knowledge can mainly be acquired through experience from practical operations abroad” (Forsgren and Johanson 1992, p.10).

The vital, requisite knowledge about the local business environment is inherently experiential and specific to the individual foreign market. The opportunities for pre-entry learning are accordingly low for this experiential or tacit knowledge. Conversely, we would expect entrant firms to acquire the needed objective/explicit market knowledge (in contrast to tacit knowledge) before entry takes place.

Furthermore, for the ‘shock effect’ this would only be in relation to tacit knowledge, not in relation to perceived lack of explicit knowledge. Accordingly, we submit the following ‘shock effect’ hypothesis in relation to knowledge characteristics:

H₅ *Entrant firms experience a ‘shock effect’ only in relation to lack of tacit knowledge
- not in relation to explicit knowledge.*

Product characteristics

A firm's internationalization pattern is usually described by two dimensions: the geographical spread of the firm's international activities, and the commitment of resources to the individual foreign market. Welch and Luostarinen (1988) have argued that product characteristics constitute a third dimension. All else being equal, export of commodity goods is associated with a low degree of internationalization. Complex products, such as turnkey projects, requires a great deal of customization. Hence, some firms may operate in industries in which international product standards are widespread and little, or none, product modification is needed in relation to foreign market operations. Conversely, other industries are characterized by products that require extensive product modification in order to comply with the needs and preferences of the individual customer in the foreign market. Services will typically, but not exclusively, belong to the latter category of complex and customized products, whereas it is difficult to generalize anything about goods.

From what has been said, we would expect the knowledge requirements of entrant firms to differ significantly with product characteristics, i.e. customized versus standardized. More specifically, we would expect that producers/vendors of customized products are involved in much more sophisticated learning processes than are producers/vendors of standardized products. Conversely, we would expect little or no foreign market knowledge to be required in relation to internationally standardized products. And if some knowledge is needed this may be acquired even before entry.

Furthermore, for the 'shock effect' this will only be experienced by producers/vendors of customized products, not by standard product manufacturers/sellers. Accordingly, we submit the following 'shock effect' hypothesis in relation to knowledge characteristics:

H₆ *Only producers/vendors of customized products experience a 'shock effect' – not producers/vendors of standardized products.*

3. Data compilation and sample characteristics

The data of the study have been gathered through a mail survey as part of a large, international research project, "Learning in the Internationalization Process" (including researchers from

Denmark, Finland, New Zealand, Korea, and Sweden). A pilot study was conducted in 1997 in which ten Swedish managers were asked to answer the questionnaire in an interview situation. The final standardized questionnaire was sent out in August 1998 to all Danish firms applying to two criteria: (1) 20-200 employees, (2) involved in international operations, e.g. having export or operation subsidiaries abroad. The database *CD-Direct* was used to identify all the Danish companies that were applying to the two criteria. The population comprised 723 firms in various industries (both manufacturing and service firms were included), and with different geographical location of their international operations. The reason for choosing this population was the active involvement of these firms in foreign operations and the associated transfer of internationalization knowledge.

The questionnaires were mailed personally to the CEO. Most questionnaires were completed by CEOs or other top executives. A reminder was mailed one month after the initial mailing. Upon this follow-up procedure the number of replies reached 246, corresponding to a response rate of 34 per cent. For various reasons (e.g. no foreign activities anymore) a number of returned questionnaires were inadequate. After exclusion of incomplete questionnaires a total of 198 replies - making up a net response rate of 27.4 per cent - were usable for data processing. A test was conducted to check the sample for possible non-response bias. Regarding size and number of foreign subsidiaries no statistically significant differences between respondent and non-respondent were found.

An average profile of the firms in the sample is shown in Table 2. Reflecting a considerable variation the average size of the sample is 192 employees (in Denmark and abroad) providing turnover of DKK 238,000,000 (US \$ 28,000,000). One seventh of the personnel is employed outside Denmark and almost half of the average turnover originates from foreign activities.

--- Insert Table 2 about here ---

The average firm is indeed highly internationalized and possesses considerable experience in conducting foreign operations. However, the sample includes also a number of what one may call novice exporters.

4. Operationalization of Variables

In the questionnaire respondents were asked to select one recent business venture or operation (e.g. entering a new market, or undertaking a considerable expansion of an existing business). The operation should be important to the firm and its international expansion. Furthermore, the operation should preferably be well underway in the foreign location.

The **unfamiliarity in foreign markets** was measured as the perceived lack of knowledge in relation to the particular foreign business operation. More specifically, the firms should indicate to what extent lack of certain kinds of local market knowledge constituted an obstacle to the accomplishment of the particular foreign business operation. Following Eriksson et al. (1997) the required foreign market knowledge is of two different kinds: ‘Institutional knowledge’ and ‘Business knowledge’. ‘Institutional knowledge’ consists of knowledge of the institutional framework, rules, norms and values in the particular market. ‘Business knowledge’ includes knowledge on counterparts (customers, suppliers, distributors, and competitors) in the host country, including knowledge about local business cultures.

In the questionnaire the firms were asked to indicate on a 7-point Likert scale to what extent the lack of the following types of knowledge was an obstacle to the completion of the foreign business operation (1 = no obstacle, and 7 = serious obstacle):

- Knowledge of business law and rules of the foreign market
- Knowledge of financial practice of the foreign market
- Knowledge of the local business culture
- Knowledge of the products of customers in the foreign market
- Knowledge of the products of suppliers in the foreign market
- Knowledge of the products of competitors in the foreign market

The average score of the six items varied from 3.8 (knowledge of competitors) to 4.9 (knowledge of suppliers). The Cronbach alpha value for all six items was 0.78. Therefore, we have created a composite index of liability of foreignness where all six items are included.

The **elapsed time** of operation in the particular foreign market was measured in a straightforward way as the number of months and years since the particular international business operation was commenced. In principle, the value of the variable may vary from 1 month to infinite.

The characteristics of the knowledge in terms of being mainly **experiential or objective knowledge** was measured by asking the respondents to indicate on a 7-point Likert scale the extent to which the abovementioned six knowledge items (knowledge of: (1) business law and rules, (2) financial practice, (3) business culture, (4) products of customers, (5) products of suppliers, and (6) products of competitors in the foreign market) were acquired through own experiential activities or purchased from external sources of expertise. On the scale 1 was indicated that the knowledge was acquired mainly through purchase from external expertise sources (“objective knowledge”), while 7 indicated that the knowledge was acquired mainly through a learning-by-doing process (“experiential knowledge”). The Cronbach alpha value for all six items was 0.70. Therefore, we have created a composite index of the characteristics of knowledge in which all six items are included. The mean value of the composite index is 3.1. The sample was then divided into two categories: those that mainly purchased the local market knowledge from external expertise sources ($1 \leq \text{values} < 3$) and those that mainly acquired the knowledge by own experiential activities ($3 \leq \text{values} \leq 7$).

The **psychic distance** to the particular market was also measured as a perceptual measure. The respondents were asked to indicate on a 7-point Likert scale to what extent the particular market of the foreign operation would differ from existing, well known markets (1 = ‘well known market’, and 7 = ‘market very different’). The sample was then divided into two categories: business operations of markets with little psychic distance (original values of 1-3) and business operations carried out in markets with great psychic distance (original values of 4-7).

The level of **customization** of the product was measured perceptually on a 7-point Likert scale. The respondents indicated to what extent the main products/services associated with the foreign

operation were customized vs. standardized (the mean value on the scale is 3.6). The sample was then divided into two categories: those with customized products/services (values of 1 - 3) and those with standardized products (values of 4 - 7).

Control variables. The *international experience* is capturing the extent to which the firms have accumulated general knowledge about how to conduct business in an international environment, including handling of uncertainty attached to foreign markets. It is a measure of the firms' exposure to international activities and their ability to manage in unknown territory in the foreign markets. International experience is measured as the number of years in which the company has conducted international activities.

The *local adaptation* is a perceptual variable that was measured by asking the respondents to what extent the firms were making adaptations to the local market. In the questionnaire they were asked to indicate on a 7-point Likert to what degree they have made adaptation to the local market, as regards: the product, the production process and the business routines scale (1= no adaptations and 7 = substantial adaptation). The Cronbach alpha value for the three items was 0.89. The high value allows us to create a composite index of local adaptation where all three items are added together.

In the same vein, the *newness of the foreign customers* associated with the foreign operation was measured on a 5-point Likert scale comparing the customers on the particular foreign market with the existing customer relationships (1=wellknown customers and 5=completely new customers).

Finally, the number of years the particular respondent had been dealing with international business tasks was included in order to control for the *personal experience* of the individual. By inferring this we control for the personal experience and get a more accurate measure of the organizational perception of the unfamiliarity which is the focus in this study.

5. Results and discussion

In order to test hypotheses 1 - 3 on the interrelationship between elapsed time of business operations in the foreign market and perceived lack of experience a regression analysis was conducted. We apply the following regression model:

$$\text{Lack of experience} = f(\text{elapsed time}, (\text{elapsed time})^2, \text{control variables})$$

In order to test the proposed non-linearity of the relationship between lack of local market knowledge and elapsed time we have included both the first and second order of the independent variable: elapsed time. Following Hypothesis 1 we expect the first order parameter of elapsed time to be significantly negative and the second order parameter to be insignificant. Hypothesis 2 propose that both the first and second order parameter of elapsed time should be insignificant, while a significantly positive first order parameter and negative second order parameter would be in line with hypothesis 3. These predictions are summarized in the three left-hand columns of Table 3.

--- Insert Table 3 about here ---

Furthermore, the expected signs of the parameters in relation to hypotheses 4, 5, and 6 are indicated in the right hand columns of Table 3.

In table 4 are shown the results of the regression models with the inclusion of the four control variables.

--- Insert Table 4 about here ---

Hypotheses 1-3 are tested in Model 1 in Table 4 (left-hand column). In this model lack of knowledge is expressed as a function of elapsed time and the four control variables. As can be seen, neither hypothesis 1 nor hypothesis 2 are confirmed since the signs of the first order parameter in Model 1 are significantly positive. However, hypothesis 3 is supported by the significant positive sign of the first order parameter and the significant negative sign of the second order parameter of elapsed time. The result indicates that prior to foreign market entry companies tend to overestimate their knowledge about the foreign market. Upon entry the firms realize their inadequacy in terms of local market knowledge and consequently they spend a number of years familiarizing themselves

with the local market conditions. The typically pattern is shown in Figure 1. The curve is derived from the parameters estimated in Model 1, Table 4.

--- Insert Figure 1 about here ---

Figure 1 depicts how the ‘shock effect’ of foreign markets entry on average lasts for more than a dozen years. The local market uncertainty, as perceived by the sample firms, peaks in year seven. In other words, the ‘shock effect’ is at its highest in year seven. Thereafter the firms manage to familiarize themselves with the local market environment. However, not until year thirteen do the firms retrench to the level of uncertainty at the point in time of entry.

Hypothesis 4 on ‘psychic distance’ is tested in Model 2 in Table 4. As regards adjacent markets (of little psychic distance) the first order parameter has a significant positive sign and a significant negative sign of the second order parameter of elapsed time. This indicates a reversed U-curve in terms of development of familiarity with adjacent markets, i.e. a ‘shock effect’ as expected. As regards distant markets (of great psychic distance) neither first or second order parameters are significant.

Hypothesis 5 on ‘knowledge characteristics’ is tested in Model 3 in Table 4. As expected, lack of tacit/experiential internationalization knowledge is associated with a significant positive sign of the first order parameter and a significant negative sign of the second order parameter of elapsed time. In relation to lack of explicit/objective knowledge neither first or second order parameters are significant. Hence, the data suggest that a ‘shock effect’ appears in relation to internationalization knowledge that tends to be tacit, but not to explicit internationalization knowledge.

Figure 2 depicts the ‘shock effect’ in relation to entrant firms acquisition of experiential/tacit internationalization knowledge.

--- Insert Figure 2 about here ---

The last hypothesis, H 6 on ‘product characteristics’ is tested in Model 4 in Table 4. Also this hypothesis is supported, although on a 10 % level of significance. For producers/vendors of customized products the first order parameter of elapsed time of operations has a significant positive sign of the first order parameter and a significant negative sign of the second order (indicating a ‘shock effect’). Both first and second order parameters are insignificant as regards producers/vendors of standardized products.

The control variable, ‘Local adaptation’ is significant in all four models (with negative sign), whereas the control variable ‘Newness of customers’ is significant in model 1, in relation to distant markets (model 2), experiential knowledge acquisition (model 3), and producers/vendors of standardized products (model 4). The control variable ‘Personal experience’ is not significant in any of the models.

6. Conclusions

In this paper we identified three different – and competing - predictions of how perceived foreign market unfamiliarity. We developed hypotheses to each of the three predictions and tested these hypotheses on a unique set of primary data of current (at the time of data compilation) foreign operations reported by managers of Danish international firms. The observed behavior of the sample firms did fit with the ‘shock effect prediction: the phenomenon of entrant firms’ inclination to underestimate differences between the home and host country in terms of the business environment. The data indicate that the foreign market unfamiliarity as perceived by the entrant firms peaks seven years after entry. The company data indicate that entrant firms in general experience the shock effect in relation to entry of adjacent, rather than distant, countries. Hence, the ‘psychic distance paradox’ hypothesis is supported. Also, the data suggest that the shock effect befalls producers of customized products, but not producers of standardized products, and furthermore, entrant firms in general experience the shock effect in relation to acquisition of tacit rather than explicit knowledge.

References

- Barkema, H.G., Bell, J.H.J., Pennings, J.M., 1996. Foreign Entry, Cultural Barriers, and Learning. *Strategic Management Journal*, 17, 151-166.
- Barkema, H.G. and F. Vermeulen, 2001. Sloughing the Old: The Learning Process of Internationalizing Firms. Research Paper, Department of Business Administration, Tilburg University.
- Casson, M., 1996. Internationalisation as a Learning Process: A Model of Corporate Growth and Geographical Diversification. In V.N. Balasubramanyam and D. Sapsford (eds.), *The Economics of International Investment*. Cheltenham: Edward Elgar.
- Cavusgil, S., 1984. Differences among exporting firms based on their degree of internationalization. *Journal of Business Research*, 12, 195-208.
- Eriksson, K., Johanson, J., Majkgard, A., and Sharma D.D., 1997. Experiential knowledge and cost in the internationalization process. *Journal of International Business Studies*, 28(2) 337-360.
- Erramilli, M.K., 1991. The Experience Factor in Foreign Market Entry Behavior of Service Firms. *Journal of International Business Studies*, 22, 479-501.
- Evans, W., Lane, H., O'Grady, S., 1992. *Border crossings: Doing business in the United States*. Prentice Hall Canada: Scarborough, Ont.
- Forsgren, M., 2002. The concept of learning in the Uppsala internationalization process model: a critical review. *International Business Review*, 11, 257-277.
- Forsgren, M. Johanson, J. Managing Internationalisation in Business Networks. In: M. Forsgren, J. Johanson, 1992. *Managing Networks in International Business*. Gordon and Breach: Philadelphia.
- Johanson, J., Vahlne, J.-E., 1977. The internationalization process of the firm: A model of knowledge development and increasing foreign market commitments. *Journal of International Business Studies*, 8, 23-32.
- Johanson, J., Vahlne, J.-E., 1990. The mechanism of internationalization. *International Marketing Review*, 7, 11-24.
- Johanson, J., Wiedersheim-Paul, F., 1975. The internationalization process of the firm: Four Swedish cases. *Journal of Management Studies*, 12, 305-322.
- Lord, M. D., Ranft, A. L., 2000. Organizational Learning About New International Markets: Exploring the Internal Transfer of Local Market Knowledge. *Journal of International Business Studies*, 31 (4) 573-589.
- O'Grady, S., Lane, H.W., 1996. The Psychic Distance Paradox. *Journal of International Business Studies*, 27 (2) 309-333.

Schein, E. H. 1985. *Organizational Culture and Leadership: A Dynamic View*. Jossey-Bass: San Francisco.

Welch, L.S., Luostarinen, R. 1988 Internationalization: evolution of a concept. *Journal of General Management*, 14 (2) 36-64.

Welch, L.S., Wiedersheim-Paul, F., 1980. Initial Exports – A Marketing Failure? *Journal of Management Studies*, 17, 333-344.

Zaheer, S., 1995. Overcoming the liability of foreignness. *Academy of Management Journal*, 38(2) 341-363.

Zaheer, S., Mosakowski, E., 1997. The Dynamics of the Liability of Foreignness: A Global Study of Survival in Financial Services. *Strategic Management Journal*, 18, 439-464.

Table 1 *Different propositions of perceived local market unfamiliarity of entrant firms as a function of elapsed time*

Unfamiliarity at different points in time ▶ ▼ Study of Firms' Foreign Market Unfamiliarity ▼	Unfamiliarity at Pre-/Post-Entry t_1	Unfamiliarity at Post-Entry t_2	Unfamiliarity at Post-Entry t_3
Johanson and Vahlne (1977)	High	Low	[Greyed out]
Johanson and Vahlne (1990) Casson (1996), Barkema et al (1996)	Low	Low	[Greyed out]
Welch and Wiedersheim-Paul (1980), Erramilli (1991)	Low	High ('Shock effect')	Low

Table 2. *Characteristics of the sample (N=198)*

Company characteristics	Mean (1998)	Standard deviation
Total turnover (million DKK)	238 (US \$ 28 million)	488
- proportion of sales abroad	42.9 %	31.2 %
Total number of employees	192	419
- proportion of employees abroad	14 %	23 %
Number of foreign countries in which the company operates	18	17
Years of export experience	21	18

Table 3. *Summary of the predictions that follows hypothesis 1-3.*

	Hypothesis 1	Hypothesis 2	Hypothesis 3	Hypothesis 4		Hypothesis 5		Hypothesis 6	
				Short psychic distance	Long psychic distance	Experiential knowledge	Objective knowledge	Customized	Standardized
Elapsed time	-	insig.	+	+	insig.	+	insig.	+	insig.
Elapsed time ²	insig.	insig.	-	-	insig.	-	insig.	-	insig.

Legend: + = expect a positive coefficient

- = expect a negative coefficient

insig. = expect no significant coefficient

Table 4 *Regression analysis of the hypothesized models*

	Model 1	Model 3		Model 2		Model 4	
	Lack of knowledge	Knowledge characteristics		Psychic distance		Product characteristics	
		Experiential knowledge	Objective knowledge	Short psychic distance	Long psychic distance	Customized products	Standardized Products
Intercept	5.55 (0.35)***	5.03 (0.53)***	5.92 (0.50)***	5.17 (0.46)***	6.02 (0.59)***	5.21 (0.43)***	5.91 (0.61)***
Elapsed time	0.21 (0.09)**	0.33 (0.11)***	0.01 (0.20)	0.24 (0.11)**	0.09 (0.25)	0.19 (0.10)*	0.09 (0.25)
Elapsed time ²	-0.015 (0.008)**	-0.022 (0.009)**	-0.001 (0.020)	-0.02 (0.009)**	-0.002 (0.033)	-0.016 (0.008)**	0.008 (0.030)
International experience	-0.008 (0.005)	-0.004 (0.007)	-0.011 (0.008)	-0.01 (0.007)*	-0.002 (0.009)	-0.009 (0.006)	-0.003 (0.011)
Local adaptation	-0.452 (0.05)***	-0.425 (0.067)***	-0.482 (0.077)***	-0.45 (0.06)***	-0.48 (0.08)***	-0.45 (0.06)***	-0.43 (0.10)***
Newness of customer	0.111 (0.04)***	0.120 (0.057)**	0.090 (0.063)	0.06 (0.05)	0.16 (0.08)**	0.07 (0.05)	0.15 (0.08)*
Personal experience	-0.004 (0.01)	-0.004 (0.014)	0.004 (0.015)	-0.004 (0.013)	-0.01 (0.02)	0.009 (0.011)	-0.024 (0.019)
F-value	17.72***	9.67***	7.72	11.47***	6.11***	13.07***	5.95***
N	153	79	73	84	68	89	62
R-square	42.0%	44.3%	40.9%	46.9%	37.2%	48.6%	38.9%

***, ** and * indicate 1%, 5% and 10% level of significance, respectively.

Figure 1. *How the perception of unfamiliarity (lack of market knowledge) changes with elapsed time of operation. The calculations are based on the parameters in Table 4, column 1.*

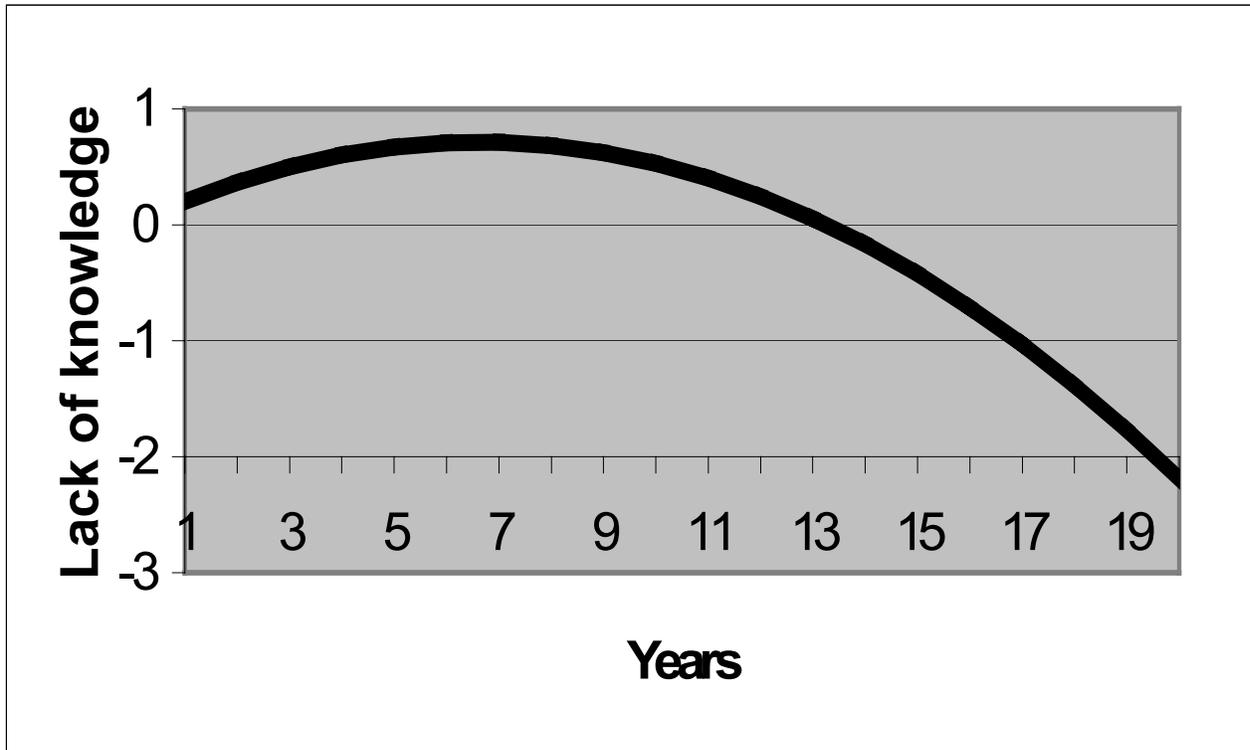


Figure 2. *How the perception of unfamiliarity (lack of market knowledge) changes with elapsed time of operation knowledge (broken line) and experiential knowledge (full-drawn curve line) .The calculations are based on the parameters in Table 4, column 2 and 3.*

