

The New Catch-up Phase: How do Small International Subcontractors from the Baltic States Get out of the Trap of Low Cost Production and High Dependency?

Abstract

The end of a first phase of the catch-up period seems to be over in the Baltic States. Estonia is down to negative growth in mid 2008, Latvia is approaching the same situation, while Lithuania's growth has been considerably reduced. Competitiveness founded on low production costs needs to become more knowledge-based and specialized. Small international subcontractors are some of the most vulnerable exporters in this situation, especially since many are highly dependent on a few foreign customers. How do they get out of the trap of low-cost production and low technology content to avoid to get out-competed by other international producers of even lower-cost products, on one hand, or higher-tech products, on the other?

This issue is analysed from a background of how such firms have internationalized compared to exporters from mature European markets. The theoretical framework is based on three types of networks found in the internationalization process of the small firm, viz. the exposure network, the formation network, and the sustenance network. The paper reports on research conducted between 2004 and 2007 on SMEs in the Baltic Sea region with researchers participating from eight countries in this region.

Key words: international business networks; internationalization processes; subcontractors; emerging markets; Baltic Sea region

The empirical material in this paper has been gathered by several people other than the authors. We would like to thank Joachim Timlon, Baltic Business School at University of Kalmar; Raigo Ernits, Faculty of Economics and Business Administration at University of Tartu; Indre Piktumiene, International Business School at Vilnius University; Jesper Manniche, Centre for Regional and Tourism Research on Bornholm.

Introduction

This research focuses on internationalization processes of small and medium-sized enterprises (SMEs) in a region affected by major changes of their societies, from plan to market, from dependence to independence, and a wave of democratisation, namely Central and Eastern Europe. Over the last decades, the Baltic Sea has changed from moat to open sea. Trade barriers have disappeared and a common market come into force, reducing institutional distance considerably. This has favoured international trade among neighbouring countries, in particular SMEs that could expand internationally to new markets nearby. However, the transition is not over by far. The end of a first phase of the catch-up period seems to be over, at least in the Baltic States. Estonia is down to negative growth in mid 2008, Latvia is almost in the same situation, while Lithuania's growth has been considerably reduced. E.g. this new situation was noticed by the Economist through articles with the following headlines: "Baltic blues: Europe's fastest growing economies hit choppy waters" (18-10-2007) and "Swan songs: The crises to watch in 2008" (19-12-2007).

In the new catch-up phase, production is moving away from the Baltic States due to rising costs, competitiveness needs to change from low cost advantages to more knowledge-based and specialized competitive advantages. Small international subcontractors are some of the most vulnerable exporters in this situation. How do they restructure in the new situation? How do they get out of the trap of low-cost production and low technology content of their products to avoid to get out-competed by new producers of low-cost products?

This is a new situation compared to the previously mostly studied issue on how increased subcontracting of products and services has led to loss of jobs in mature markets. This is mostly researched from the point of view of the firms of these markets, e.g. how companies need to re-structure at home or internationally and even close

down. So this subcontracting or off-shoring problem is rarely studied from the perspective of the firms from emerging markets, viz. the suppliers. In this paper we shed light on the subcontractors based in emerging country markets as we pay attention to their dilemma of maintaining competitiveness with a decreasing low cost advantage.

To put this problem into perspective, exporters from emerging markets to mature markets are compared with exporters from mature markets to emerging markets. Most SMEs studied are in the internationalizing phase and therefore not fully internationalized, mainly being involved in trade rather than foreign direct investment. This is especially relevant for SMEs from the new market economies in East Europe, whereas this research also contributes new knowledge about the beginning of this process as called for by Johanson & Vahlne (2003).

This article takes up the internationalization of SMEs from a business marketing approach, which is an underrepresented area in the international marketing literature. First, most research is about MNCs. Second, there is little knowledge about such internationalization related to emerging markets, in particular about SMEs from these markets. The present research is based on the institutional network approach to internationalization, the main reason being that emerging markets are characterized as network societies and differing a lot from mature markets through another institutional environment (Jansson, 2007a,b). The focus is on networks: how SMEs establish and maintain relationships in networks during the different stages of the internationalization process.

This paper is structured as follows; first we account for the methodology of the research project, then we present our theoretical framework. Thereafter, we analyze the internationalization of SMEs from immature markets in three steps. First, one representative case of an exporter from this group of firms is presented followed by a comparative analysis of the four cases of the group. Then a comparative analysis is

done of the four cases from mature European markets. Finally, the two groups are compared with each other and general conclusions are drawn.

Methodology

The paper reports on research being done within the EU financed project Baltic Business Development Network (BBDN). The purpose of this project was to study how internationalizing firms from 'old' EU countries expand their business to new EU members' country markets and vice versa. The research has been conducted between 2004 and 2007 with participating researchers from eight countries on the shore of the Baltic Sea. The study encompasses eight exporting firms and eight importing distributors/agents/ subsidiaries. 8 case studies have been done about the expansion of internationalizing firms from the newer member states Estonia and Lithuania to the more traditional EU country markets Germany and Finland, and from Sweden and Denmark to other new member states, viz. Latvia, Poland and Estonia. The cases studied are introduced in Table 1.

The research strategy is abductive, being a mix of deduction and induction (Alvesson & Sköldberg, 2008; Dubois & Gadde, 2002; Jansson & Sandberg, 2008; Timlon & Hilmersson, 2008). The purpose is theoretical development, where the empirical support of a theory is continuously assessed, or, inversely, a reality's theoretical support investigated, through the matching of theories with realities (e.g. Merriam, 1998; Yin, 2003). A theoretical framework on internationalization in networks was developed, which was used to analyze the empirical results of the study.

At the selected companies, about twenty tape recorded on-site interviews have been conducted. A major benefit of the research project was that the interviews could be done in the local language. The informants within the firms have been export managers, market managers, CEOs and/or business development managers for the exporting firms

and sales personnel and/or CEOs representing the intermediary. The interviews followed a semi structured-questionnaire (Merriam 1998) that was restructured from case to case in order to fit the character of the firm and their particular organization of business activities. The research group, consisting of all participating nations, met on a regular basis to discuss, clarify and update the cases as well as to secure that there was a balanced compilation and description of each and every case. In total, six meetings were held.

The four cases from immature markets represent a major industry of the area, viz. manufacture of basic metals and fabricated metal products. In 2005, 743 firms were operating in this industry in Estonia and 1262 in Lithuania. The turnover was 613 million Euros and 12091 employees in Estonia and 485 million and 17191 employees in Lithuania. The industry grew 3 times in Estonia and 5 times in Lithuania between 2000 and 2005. Treatment and coating of metals together with general mechanical engineering are dominating in Estonia. In Lithuania it is forging, pressing, stamping and roll forming together with powder metallurgy and treatment plus coating of metals. Since 1989, the industry has undergone a rapid transition from being tightly integrated into the centrally-planned manufacturing industry of the Soviet Union to being more and more integrated into the market economy of the European Union. Since 1995, SMEs from Sweden, Denmark and Germany have increasingly developed sub-contractors in these countries for low cost production of metal, wood, electronics, plastic and textile products. (Pavlovs & Friedman, 2008).

	Nexö Vodbinderi	Norfo	Norba	Naxoflex	Viljandi Metall	Terg	Auridos	Splitas
Origin:	Denmark	Denmark	Sweden	Sweden	Estonia	Estonia	Lithuania	Lithuania
Entry in:	Poland	Poland	Latvia	Estonia	Finland	Finland	Germany	Sweden
Turnover (mEUR) 2006:	1.6	10.6	30	10	22	n/a	2	5.2
Employees 2006:	9	70	130	70	270	70	45	150
Export % 2006:	40	90	75	85	65	90	88	95
Foreign main market prior to entry in X:	Sweden	Germany	U.K except for Scandinavia	U.S except for Scandinavia	None	None	none	None
Degree of Internationaliza- tion prior to entry in X:	Experimental involvement	Committed involvement	Active involvement	Committed involvement	Pre- export	Domestic focus	Domestic focus	Pre-export
Product:	Trawls and nets for fishery	Portioning machines for meat/fish	Waste collectors	Grinding material	Semi construct- ions	Construct- ion details	Compone- nts	Compone- nts

Table 1. The eight cases studied

Internationalization through Networks

SMEs are assumed to gain international experience by establishing and developing relationships to business partners. The more network relationships that have been established in a foreign country and the more countries this has been done in, the more internationally experienced the firm becomes. This is derived from research on internationalization processes, which has found that how firms respond to changes in international markets largely depends on where in the internationalization process they are found, i.e. their degree of internationalization. The relationship process and the internationalization process are combined into a five plus five stages process for the

internationalizing firm. It is influenced by the institutional distance between countries, and organizational learning is the key internal process behind these processes.

These internationalization processes involving emerging country markets are assumed to follow the typical patterns found for firms in general, i.e. taking place in a stepwise manner. Companies commit themselves through an incremental learning by doing process. Companies tend first to establish themselves in geographically and culturally proximate markets and increase their commitment more and more, starting with agents, and passing through sales companies to manufacturing companies (Johanson & Wiedersheim-Paul, 1975; Johanson & Vahlne, 1977). This has mainly been studied for MNCs but also for SMEs (Hohenthal, 2001). However, 'Born globals' or 'International new ventures' (that are international from inception) tend to follow another pattern (Oviatt & McDougall, 1994; Madsen & Servais, 1997; Zahra, 2005).

Entry Nodes

Internationalization to emerging country markets are found to take place by establishing and maintaining business relationships in the foreign market networks. Firms enter by establishing two-party or three-party relationships or entry nodes (Jansson, 2007b; Timlon & Hilmersson, 2008). Various entry modes such as subsidiaries, agents, and distributors are viewed as hubs for building and maintaining relationships. The local network organization is therefore defined as a hub organization, which main task is to control dyads and/or triads.

Five/Five Stages of Internationalization

The relationship process is seen as an entry process, taking up how relationships are developed with actors of importance to the firm. Jansson & Sandberg (2008) develops a five/fives stages model of the internationalization process. It is based on an experiential

knowledge process, where internationalization processes are divided into different degrees of internationalization or stages. A classical grouping of firms is made by Cavusgil (1980), which has been found to be valid also for exporting SMEs (Gankema, Snuif & Zwart, 2000). The internationalization of firms takes place in five stages. These five stages are integrated with the five stages of the relationship process, originally developed by Ford (1980) and by Ford et al (1998/2002). While the former concerns how the internationalization knowledge of the firm is developed, the latter is a good approximation of how network experiential knowledge is gained in a country (Blomstermo et al, 2004). The more developed the customer relationships, the more experience the firm has of the particular foreign country market. By establishing more and more relationships abroad the firm moves further and further along the internationalization process, starting in the experimental export stage. The larger the number of relationships established, the larger the part of the firm's resources and capabilities are dedicated to international business, inter alia meaning locating them increasingly abroad. The development of the relationships in the foreign country market starts in the early stage, when commitments and experience increase somewhat. The establishment of relationships is a mutual learning process, where the parties learn to know more and more about each other. The first adaptations are made, but are still few. High uncertainty is experienced and high distances prevail between the parties. The early stage is followed by the development stage, during which business between the customer and the supplier starts to grow and resources are increasingly shared. The relationship settles in a stable stage of the long term stage, where it is a matter of maintaining relationships for continuous business between the parties. The exporter and the importer have now learnt to know and trust each other, which gives high experience and that the uncertainty is perceived as being low. Distances are small and commitment high. The main aim with building relationships is to reach the long term stage, to get on-

going long-term relationships.

Thus, relationships being at the core of the entry process follow a similar pattern as the internationalization process as a whole. In accordance with Forsgren (2002), Eriksson et al (1997), three types of experiential knowledge are behind the step character of the Five/Five Stages model. The gradual build-up of internationalization knowledge takes place through increased network experiential knowledge. The passing through the stages of the entry process is intimately connected to institutional knowledge. The more such knowledge acquired, the easier it is to develop the customer relationships. As a consequence, the more relationships in a foreign country that have reached later stages, the more established and internationally experienced the firm becomes and the higher its degree of internationalization. Also, the more countries the firm has established relationships with, the more internationally experienced the firm is said to be.

Main Characteristics of Networks in Internationalization

The relationship stages above focus on the development of individual relationships but not how they relate to each other, i.e. the totality of relationships or the network aspect. Based on Harryson et al (2007), a multilevel perspective is taken to networks, where a distinction is made between two levels of networks: interpersonal or social networks, and interorganizational networks. These networks interact so that activities at one level result in consequences, which become antecedents for another level. For example, the structure of the informal social network becomes an antecedent to the interorganizational network, since it influences the pattern of cross-unit connections. Social network relationships take place between individuals and how they form networks influences the formation of organizational networks. These network ties are therefore socially embedded. The main network theories concern such social networks, e.g. 'social

exchange theory' (Blau, 1964), 'weak/strong ties theory' (Granovetter, 1973) 'social embeddedness theory' Granovetter (1985), 'structural holes theory' (Burt, 1992) and 'social capital theory' (Coleman, 1988). Research findings by Uzzi (1996), Rowley et al. (2000) and Van Wijk et al. (2004) confirm that strong ties are positively related to firm performance when the environment demands a relatively high degree of exploitation and weak ties are beneficial for exploration purposes.

Open and Closed Networks

Along the connectivity dimension of the social network, a distinction is made between open and closed social networks. Based on the idea that organizations are embedded in social ties (Granovetter, 1985), the characteristics of these networks are assumed to be valid at the organizational level of the network. The open network is mainly about resource exchange of information, while the closed network focuses on social exchange, trust and shared norms. An example of an open network is one in which firms have direct social contacts with all their partners, but these partners do not have any direct contacts with each other. A high number of such non-connected parties, or structural holes, means that the network consists of few redundant contacts and is information rich, since people on either side of the hole have access to different flows of information (Burt, 1992). Burt (1993) argues that to enhance network efficiency an actor should focus on maintaining only primary contacts and delegate the task of maintaining all complementary contacts to the primary contacts. The major selection criterion for such partners then concerns how many contacts they have. This implies that the structure of an open network is suitable when gathering, processing and screening of information is the primary purpose as well as identifying information sources. This kind of information network then stresses the indirect linkage, has mainly weak relationships and is loosely coupled. The opposite is the tightly coupled closed network, where all partners have

direct and strong ties with each other. This network is centered on social capital, which is built through trust and shared norms and behavior (Coleman, 1988). The contradiction between open and closed networks is also stressed by Ahuja (2000). There seems to be a trade-off between a large network that maximizes information benefits and a smaller network promoting trust building and more reliable information

Trustworthiness

Trustworthiness is related to the differentiation made above between the social network and inter-organizational relationships. A distinction is made between organizational trust and individual trust (Jansson, 2007a). Organizational trust is a relation between an individual and an organization, i.e., combining the social and organizational aspects of the network. However, it does not mean that it is less emotional than other person-to-person relationships, since an individual may be highly involved in an organization, and identifying with it through its brand in a very personal way. Reputation is an expression of this trust. Individual trust regards persons and the friendship among them, i.e., the social network. One type of individual trust is related to coalitions and concerns the individual as a representative of his or her company. This type of trust is defined as professional trust, since it has to do with how tasks are completed together with other individuals, and is more instrumental than emotional. An employee can, for example, be expected to complete his tasks in a certain way, not being biased from undue influences. This relationship is personal and formal. The connection between the social and organizational networks becomes another than for organizational trust. Professional trust originates from the organizational network, is established through the social network, and strengthens the organizational network.

Establishing trustful relationships is a critical part of the internationalization process, whereas trustworthiness becomes a key ingredient of every capability profile of a firm.

The term trustworthiness signifies that trust is defined as a capability of the firm. Trustworthiness is a major norm of the social capital that constitutes a social organizational capability established from the resource base of the firm in the form of relationships.

Three Types of Networks

The network aspect of the entry node and the entry process is deepened in this section based on Jansson & Hilmerston (2008) by mainly extending the relationships part of the 5/5 stages model. A potential exporter creates contacts of various kinds to expose itself to various parties of relevance to the business it wants to have in a new market. This first type of network that the SME becomes part of is defined as the exposure network. It consists of many general and weak ties. It is information dominated, open and loosely coupled. The focus of the potential exporter is to find hubs in order to expose the firm to as many networks as possible. The aim is to find hubs to specific business networks in a certain country or countries encompassing various customers and intermediaries.

If successful or lucky, new partners are found by or find the company, to which relationships are established through the next type of network defined as the formation network. Exporters develop businesses through this network and certain weak ties are gradually transforming into stronger ones. The customer development process can therefore be seen as an act of transformation from relatively open to closed networks. Strong social ties are developed with persons found through the exposure network, which are developed further with those selected as promising prospects. The social network is therefore gradually closing. The formation of this social network leads to the formation of the inter-organizational network, thereby being a precedent to it.

The exposure and formation networks are thereby driven by social networks, which close into the next type of network. It is defined as the sustenance network, since

relationships are becoming more permanent or integrated more permanently into the firm's regular business. It is an organization-based network superior to the social network.

The nature of internationalization of relationships at the interpersonal level is described by the social network, while its nature at the organizational level is described by the organizational network. Social trust and professional trust is developed through the social network, which later is turned into organizational trust. Interaction in social networks leads to the inter-unit relationship between firms. This inter-organizational network seems to be mainly based on professional trust.

In the exposure network, it is mainly a question of limiting the network size by linking up to certain hubs of interest. In the formation network, it is more the other way around, to use these few hubs to expand the network. Leverage effects play a critical role to get this network large enough. Agents are good examples of such hubs, from where to expand the customer network. In the sustenance network, the purpose is still another, namely to go on with partners in the formation network, with which sustainable business can be developed, or develop new partners, with which this is possible.

Analysis of the Cases

The four exporters from emerging markets are analysed, viz. Terg Oü and Viljandi Metall from Estonia, plus Auridos and Splitas from Lithuania. But before these cases are compared, the experience of Viljandi Metal is described, since it is an especially interesting case on how to develop competencies by moving forward in the vertical customer network.

Viljandi Metall AS (VM)

Prior to the entry in Finland VM had no international experience. In the early days of independence in Estonia there was a remarkable decrease of activity in the construction

industry causing a major market slow down for VM. The company actively searched for new projects in the domestic market and tried to stick to its core competences of metal treatment. Nevertheless, VM was unsuccessful in finding more than marginal projects.

Thanks to personal relationships and the individual network of VMs management, contacts in Finland were made. A Finnish firm had approached a professor at the Tallinn Technical University asking for information concerning potential suppliers in Estonia. The professor mediated contacts to VM.

The establishment of the business relationship is described as more strategically planned and proactive by the Finnish counterpart:

“It was about in year 1993 or 1994, something like that, we really tried to find some companies from Estonia that could serve as subcontractors to us. At that time I knew an Estonian gentleman, Mr. Kalju Loorits who was professor at Tallinn Technical University, I asked Mr. Kalju Loorits if he could help us to find some suitable companies. We visited several companies in Estonia and finally we found Viljandi Metall. Of course it was very important that the price level at that time it was lower in Estonia compared to the price level in Finland. Previously, we ordered the same things from Finland.”-Klaus Saarikallio (KS), Managing Director, Normek

Thus, the entry of VM in Finland was initiated by its customers, Normek OY. They searched for decreased costs of production and found VM, who were in desperate need of new market opportunities. Trust and the personal relationships with the professor are described as the major reason to why Normek chose VM as their partner.

As VM had no prior international experience the relationship between N and VM was characterized by quite an intensive transfer of knowledge from N to VM. VM had to learn about Western standards, requirements and culture. In order to stay in business

they had to develop its products and production processes to ensure a certain level of quality and to stay as a preferred supplier to Normek.

Eight years after their first contacts with the Finnish market, VM decided to establish an own sales office in Finland. This strategic move was in line with the development of VMs business. Primarily by supplying Normek, VM had grown from 55 to 270 employees. A decision had been taken to become more independent in the market by spreading its risks to more customers than Normek. At the same time the strategic direction was to move further along the value chain from being a detail producer to also involve in the assembly of details. The decision to set up an own office in Finland can be seen as a manifestation of the success of the latter.

Setting up a local sales office in Finland was seen as a prerequisite for VM to develop its position along the value chain. Primarily it gave access to information and knowledge about local customers. However, it wasn't VM that identified this growth opportunity that was enacted on. Rather, it was the customers of Normek that encouraged VM to also involve in the assembling activities. This encouragement was the result of the customers of Normek tracing the products (for quality inspections) down the value chain. Normek was unwilling to reveal their subcontractors. But when their customers wanted to inspect the quality of their products Normek was unable to hide this information. As a result, the Finnish customers became aware of the competences of VM and encouraged them to move forward along the value chain. The manager of VM stresses that this move purely was driven by the customers, and not by VM:

"We didn't offer ourselves to order the assembling from us instead Normek, it would be against fair business traditions in our business culture." – Jaak Sulg, CEO, Viljandi Metall

However, once the sales office was set up in Finland VM has been successful in establishing its own contacts in the Finnish market. They have had orders to produce details and to assemble on site. The consequence thereof is that VM has started to compete with Normek. The relationship that previously was described as a personal relationship from VMs side, at the same time as Normek said that we are almost friends is now ended.

The main focus of VM is to strengthen the position in the Finnish market. However, as a result of their success there, a few orders have come from Sweden. But, the manager describes that Swedish companies generally mistrust East Europeans, which causes a lot of trouble for VM to compete outside Finland and Estonia. Therefore, VM is focusing on strengthening their position in Finland at the moment. In a few years, they expect the Swedish market to be ready for Estonian suppliers in the construction industry.

Comparative Analysis of Four Cases

The comparative analysis of the four exporters from emerging markets is summarized in Table 2. Prior to their entries, none of Viljandi (in Finland), Terg (in Finland) Auridos (in Germany) Splitas (in Sweden) had any experience from supplying foreign customers; all production was addressed to the domestic market. Thus, the restructured companies from the former Soviet Union had no knowledge of quality standards, business logic or requirements of the mature markets in the EU.

None of the firms were actively searching for foreign customers. Instead they were all found by the customers looking for opportunities to lower costs by finding cheaper sources of supply and by outsourcing of production. The two Lithuanian firms, Splitas and Auridas, exposed their services on a subsupplier forum on the Internet in order to be

found by potential customers. This forum was hosted by the Lithuanian Enterprise Development Agency (LEDA), a state founded development agency which mediated contacts between foreign and local firms. Viljandi, in turn, leaned on their managerial personal network when internationalizing its business activities. The board of managers had developed a personal relationship with a professor at the Tallinn technical university, through whom the company was found by a Finnish customer. Terg was also identified by its customer in Finland.

	Viljandi	Terg	Splitas	Auridos
Pre Entry	-Domestic market focus	-Domestic market focus	-Exploratory	-Domestic market focus
Trigger to entry	-Unsolicited order	-Unsolicited order	-Unsolicited order	-Unsolicited order
Find/Found	-Was found by customer on recommendations	-Was found by customer	-Was found by customer in a web forum	-Was found by customer
Initiator	-Customer searching for decreased costs	-Customer searching for decreased costs	-Customer searching for new suppliers	-Customer searching for decreased costs
Establishment of relationships	-Having provided the first pilots, Viljandi was approved as subsupplier, the customers visited Estonia to teach about quality, leadtimes and general business standards of the Finnish business network	-Provided by blueprints Terg started to produce for its Finnish customer who in turn visited (controlled) production to ensure quality	-After the first pilots Splitas agreed to produce on the terms set by the Swedish partner.	-After the first test order, Auridos became a sub supplier for its German customer and soon orders were repetitive.
Sustainment of relationships	-Ended relationships with the original partner -Moved further up in the vertical production structure -Started to compete with its former	-Slimmed organization, -Invested in equipment for automatization -Focus on keeping low cost advantage	-Applied for ISO certification -Invested in equipment -Started to develop own products	-Focus on more efficient production -Mediate contact with complementing Lithuanian suppliers

	customer			
Social Network	-Of great importance as it mediated first foreign contacts	-pure business relationships	-pure business relationships	-pure business relationships
Organizational network	n/a	n/a	-Of great importance for the first entry as contacts were mediated by LEDA	-Of great importance for the first entry as contacts were mediated by LEDA
Trust	-Individual and organizational	-Organizational	-Organizational	-Organizational
Continued Internationalization	-Further commitment to the Finnish market	-Keeping their Finnish customers	-Keeping present customers and looking for opportunities with own product in Russia	-Searching for customers in Austria, by exposing their services on the Internet

Table 2. The exporters from emerging markets studied

As none of the firms had any prior international experience they all learned a lot from their customers in the mature markets such as quality, business culture, lead time and logistics. Relating this learning to the subcontractor's dilemma, one notices that Auridos and Terg have primarily learned to become efficient sub-suppliers, i.e. to efficiently fit into the sub supplier network of its customers. At the same time they have strived to spread the risks by starting to supply more than one customer. Splitas and Viljandi, on the other hand, initially had a similar development. But, having learned a lot from their customers from EU mature markets, they started to develop their own products/projects to become more independent. This development started off in parallel to becoming more efficient sub suppliers.

Viljandi set up office in Finland of their own, thereby moving forward in the value chain by starting to compete with their former customer. Splitas, on the other hand,

developed products of their own to be launched in the Russian market. They are therefore actively searching for new customers.

Concerning the future internationalization, Splitas and Viljandi are actively searching for new foreign customers. Viljandi is primarily committing themselves further to the Finnish market by dedicating resources to its foreign sales office, whereas Splitas is planning to enter the Russian market with its own products. In parallel Splitas applies for ISO certification in order to safeguard its position as supplier to a couple of large customers in mature markets. Terg and Auridos are primarily focusing on strengthening their positions as preferred suppliers to their existing customers. Terg is primarily focusing on keeping their Finnish customers, while Auridos has started to pay interest to the Austrian market. The latter will be manifested by Auridos listing its services in Forum of sub-suppliers available to Austrian firms.

Conclusions

General conclusions are drawn based on the analysis above of exporters from emerging markets, which are compared to exporters from mature markets reported in Jansson & Hilmersson (2008) and Timlon & Hilmersson (2008). Key differences and similarities are identified concerning the building of international business networks in the BSR. The conclusions are summarized in Table 3 below. These conclusions establish a ground to conclude on the major issue raised in the beginning of the article. It is therefore ended with recommendations regarding how the exporting subcontractors should get out of the trap of low cost production and high dependency.

Prior to the entries accounted for in this paper none of the SMEs from immature markets had any international experience. None of them was actively searching for international growth opportunities, rather they were found by companies from mature markets searching for decreased costs of supply. Consequently, the immature exporters

are described as passive in their early internationalization. The degree of international experience of firms from mature markets, on the other hand, seems to make them initiate international business networks around the Baltic Sea. The establishment of international business networks in the BSR generally is initiated by firms from mature markets, either exporters searching for international growth opportunities or importers looking for decreased costs of supply.

	SMEs from mature markets	SMEs from immature markets
International experiences	-Extensive -Primarily generated from Western Europe and the U.S	-none
Initiator	-Supplier/ customer	-Customer
Establishment of business relationships	-First relationships are established with local partner/intermediary -Thereafter joint attempts to establish relationships with customers	-Initiated and dominated by customers
Sustainment of business relationships	-Investment of time, energy and resources in business network entry node	-Investments in production efficiency
Social Network	-Of great importance for establishment of business relationships	-Of marginal importance
Organizational network	-Of marginal importance	-Of great importance for establishment of business relationships
Trust	-Individual between exporter and local intermediary/ partner/ employees	-Organizational between exporter and customer. Relationships are described as pure business oriented
Continued internationalization	-Heading Eastwards towards Russia and/or China	-Heading west. Deepening their commitment in present markets or searching opportunities within E.U.

Table3. Major conclusions from the comparative analysis of the cases

The entry node into foreign business networks seems to be closely influenced by the initiators' motive of internationalization. The SMEs from mature markets are all actively searching for new potential customers, while the entry of SMEs from immature markets was initiated by its customers searching for new sources of supply. To develop their positions in the local market, the SMEs from mature markets soon realized that local knowledge and a local network was of utmost importance. In contrast, the SMEs from immature markets are not searching for new customers, they do not have to identify the needs of their customer and they are not identifying or solving any problems. They are rather learning from the customers how to produce the products as efficiently as possible. Thus, they are in no need of any intermediary translating preferences of the local business network. Instead they are directly connected to local business network in dyads, the problem being exposure to few networks and a high level of dependency on a limited number of customers. Thus, the entry nodes connecting international business networks around the BSR generally are adapted to the needs of the customers in the network.

To sustain business in the foreign market networks, SMEs from immature markets are investing in their production units, while SMEs from mature markets seem to invest in their entry nodes/hubs. The latter firms have primarily invested time and energy in educating their local partners/employees related to the products to be sold, while the SMEs from immature markets have invested in their production facilities to become more efficient and cost competitive. Thus, there seems to be different drivers of the two groups, the latter one aiming to decrease production costs to stay preferred as suppliers, while the former is aiming to increase sales by attracting new customers. The social network seems to play a less important role to the SMEs from immature markets entering mature market compared to vice versa. The former SMEs describe their networks with customers as purely business oriented and organizational, while SMEs

from mature markets have all taken advantage of social network in order to develop relationships both with intermediaries, partners and customers. The main factor behind this seems to be that exporters from emerging markets adapt to the specific circumstances of mature markets, where networks are more organizational in kind. The same behaviour is found for the exporters from mature markets, who adapt to the high prevalence of social networks in immature markets. Therefore, the importance of social networks for SMEs from mature markets manifests itself in the greater level of trust in individuals rather than in organizations. This characterizes both the relationships with intermediaries and partners.

The business networks of SMEs from immature markets will be extended westwards, while the ones of SMEs from mature markets are extending eastwards in the future internationalization processes. The SMEs from immature markets are searching for more sub supply partners or projects in the E.U. One exception, though, is Splitas heading for Russia with its own newly developed products. The SMEs from mature markets are all looking east towards Russia and China. Strengthened by their experiences from the BSR they are about to enter more distant emerging markets, some of them in a joint parade with their BSR partners.

Exporters from emerging markets play a more passive role in the exposure network, and get involved in dyads in the form of direct contacts with the customers in the mature markets instead of in triads. For the exporters from immature markets, the inter-organizational network is the main vehicle of internationalization from exposure to establishment, being the main antecedent to the structure of the social networks of the sustenance network. However, the opposite situation prevails for the exporters from mature markets. The formation network of the exporters from emerging countries is therefore smaller and less complex, since it only involves developing relationships with a few large customers. The social network is less important and usually preceded by the

organizational network. The exporter from emerging markets establishes itself more firmly in the country through the sustenance network by deepening the relationship to a few customers by more efficient production and logistics or moving forward in the vertical market by replacing the customer by the customer's customer as illustrated for Viljandi. The exporter from mature markets, on the other hand, does this through forming a joint venture or establishing a subsidiary.

The entry mode is subordinated to the entry node, and that the mode varies between the networks. Agents and distributors play a critical role in the formation network for exporters from mature markets, thus being a triad. In the sustenance network they are turned into dyads by the agents being replaced by subsidiaries or joint ventures. If agents are still used in the latter network, their role changes to becoming more independent: from parallel to sequential triads. The exporters from emerging markets, on the other hand, develop dyads directly with their mature market customers.

How to escape the low cost trap

The overall internationalization process of the exporters from mature markets follows the normal pattern of such a process, while this process for the exporters from emerging markets is different. One reason is the difference in the type of product exported. The former type of exporter sells a product of its own that is used as an input in production, used up, or used for production. The latter type of exporter, on the other hand, is more directly engaged in the production of the customer, either participating directly in this production, or supplying semi-finished products for the customers' production. But the main reason seems to be the difference in degree of internationalization, where the exporters from emerging markets are only in the beginning of their internationalization process. For their continued internationalization they can learn from the more experienced exporters from mature markets. The main lessons concern how to develop

network experiential knowledge on customers and new products for existing and new markets. The challenges they face are mainly in business marketing, since most of them are manufacturing units. They need to learn how to be more active in the markets, e.g. getting know-how about how to expose themselves in various international customer networks. The strive for the emerging market subcontractors should therefore aim for a shift in the power balance in their relationship with their contractors. By generation of more business marketing knowledge the subcontractors can become more than low cost production units of western firms. In that sense they would become less dependent and vulnerable to rising costs in the home market. However, the ability to succeed in such a transformation process seems to rely on the dynamic capabilities found at the firm level. In this case, the ability to transform low-cost advantages into differentiation advantages based on business marketing knowledge.

The results of this research project then imply that to escape the low cost trap, exporters from emerging markets primarily need to develop their network capabilities, primarily network experiential knowledge but also institutional knowledge. In order not to be out-competed as a result of increasing costs in the home country, SMEs with low cost advantages need to develop complementary competences. As some of the case companies have started to do, they need to identify niches in which to compete or develop capabilities in marketing. In the latter situation, own products need to be developed, which should be actively marketed internationally. The findings on the mature market exporters revealed that the key to success when entering institutionally distant markets heavily rely on the firms' ability to match market specific knowledge with experiential marketing knowledge. That occurred as marketing knowledge was exploited whereas new market knowledge was explored. International marketing of own products is a strategic innovation enabling a greater degree of internationalization of the firm, either by developing business in established markets or developing new customer

relationships in new foreign markets, e.g. Russia and China as exemplified above. By developing more customer relationships, the degree of dependency is reduced. This can also be accomplished by moving forward in the vertical network through developing relationships with the customer's customer. SMEs unable to develop any of those competences will most likely be trapped in the low cost cage, involving a big risk to be outcompeted in the on-going third wave of internationalization of firms.

References

- Ahuja, G. 2000. Collaboration Networks, Structural Holes, and Innovation: A Longitudinal Study. **Administrative Science Quarterly**, 45(3): 425-455.
- Alvesson & Sköldberg
- Blau, P. 1964. **Exchange and Power in Social Life**. New York: Wiley.
- Blomstermo, A., Eriksson, K., Lindstrand, A., Sharma, D.D., 2004. The Perceived Usefulness of Network Experiential Knowledge in the Internationalizing Firm. **Journal of International Management**, 10, 355-73.
- Burt, R.S. 1992. The Social Structure of Competition. **In Networks II**. 2004. 65-103.
- Burt, R., S. 1993. The Social Structure of Competition. In R. Swedberg (Ed.), **Explorations in Economic Sociology**: 65-103. , New York: Russell Sage Foundation.
- Cavusgil, S.T. 1980. On the Internationalization Process of Firms, **European Research**, 86.: 273-281.
- Coleman, J.S. 1988. Social Capital in the Creation of Human Capital. **American Journal of Sociology**, 94: 95-120.
- Dubois, A. & Gadde, L.E. 2002. Systematic Combining: An Abductive Approach to Case Research. **Journal of Business Research**, 55: 553-560.
- Ford, D., 1980. The Development of Buyer-seller Relationships in Industrial Markets. **European Journal of Marketing**, 14 (5/6), 339-353.
- Ford, D. et al. 1998. **Managing Business Relationships**. John Wiley, Chichester.
- Forsgren, M. 2002. The Concept of Learning in the Uppsala Internationalization Process Model: A Critical Review. **International Business Review**, 11, 257-277.

- Gankema, H.G. Snuif, H.R. & Zwart, P.S. 2000. The Internationalization Process of Small and Medium-sized Enterprises: An Evaluation of Stage Theory. **Journal of Small Business Management**, 384.: 15-27.
- Granovetter, M. 1985. Economic Action and Social Structure: The Problem of Embeddness. **American Journal of Sociology**, 91: 481-510.
- Granovetter, M. S. 1973. The Strength of Weak Ties. **American Journal of Sociology**, 78: 1360-1380.
- Harryson, S. & Jansson, H. & Kliknaité, S. & Dudkowski, R. (2007). Building Relationships across Multiple Levels for Born Global Innovation, Paper Presented at the IMP Conference in Manchester, September.
- Hilmersson, M. & Sandberg, S. (2007) "EU-Enlargement Effects on International Trade in the Baltic Sea Region – The case of Exporting/Importing SMEs from Southern Sweden", **Paper Presented at the International Business Conference in Vasa, Finland, 19-21 August.**
- Hohenthal, J., 2001. **The Creation of International Business Relationships. Experience and Performance in the Internationalization Process of SMEs.** Department of Business Studies, Uppsala University.
- Eriksson, K., Johanson, J., Majkgård, A., Sharma, D.D., 1997. Experiential Knowledge and Cost in the Internationalization Process. **Journal of International Business Studies**, 28 (2), 337-360.
- Jansson, H. (2007a). **International Business Strategy in Emerging Country Markets. The Institutional Network Approach**, Cheltenham, U.K.: Edward Elgar .
- Jansson, H. (2007b). **International Business Marketing in Emerging Country Markets. The Third Wave of Internationalization of Firms.** Cheltenham, U.K.: Edward Elgar.

- Jansson, H & Hilmersson, M. (2008), Building and Sustaining International Business Networks in the Baltic Sea Region -A Comparison of Small and Medium-sized Exporters from Emerging and Mature European Markets. **Paper presented at the IMP conference, Uppsala 2008.**
- Jansson, H., Sandberg, S. (2008), Internationalization of Small and Medium-Sized Enterprises in the Baltic Sea Region. **Journal of International Management** .14 (1), pp 65-77.
- Jansson, H., Johanson, M., Ramström, J., (2007), Institutions and Networks. Business Networks in the Chinese, Russian, and West European institutional contexts, **Journal of Industrial Marketing Management**, 36, pp. 955-67.
- 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(1): 23-32.
- Johanson, J. & Vahlne, J.E. (2003). Business Relationship Learning and Commitment in the Internationalization Process. **Journal of International Entrepreneurship** 1: 83-101.
- Johanson, J. & Wiedersheim, Paul, F. (1975). The Internationalization of the Firm – Four Swedish Cases. **Journal of Management Studies**, 12(3): 305-22.
- Madsen, T. & Servais, P. 1997. The Internationalization of Born Globals – An Evolutionary Process. **International Business Review**, 6(6), 1-14.
- Merriam, S.B. (1998). **Qualitative Research and Case Study Applications in Education**. Jossey-Bass, San Francisco.
- Oviatt, B.M. & McDougal, P.P. (1994). Toward a Theory of International New Ventures. **Journal of International Business Studies**, 25(1): 45-64.
- Pavlovs, M. & Friedman, E. (2008). The Baltic States Market Study: Case Study for the

- Entrance of a Swedish High-Tech Company. **Master Thesis**, Baltic Business School, University of Kalmar.
- Rowley, T., Berens, D. & Krackhardt, D. 2000. Redundant Governance Structures: An Analysis of Structural and Relational Embeddedness in the steel and Semiconductor Industries. **Strategic Management Journal**, 21: 369-386.
- Sharma, D.D., Blomstermo, A., 2003. The Internationalization Process of Born Globals: A Network View. **International Business Review**, 12, 739-753.
- Yin, R.K., 2003. Case Study Research – Designs and Methods, 3rd Edition, SAGE Publications Inc.
- Timlon, J. & Hilmersson, M. 2008. Balancing Intermediated Business Relationships in Emerging Country Markets. **Competitive Paper presented at the AIB Conference 2008 in Milan.**
- Uzzi, B. 1996. The sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect. **American Sociological Review**, 61(4), 674-698.
- Van Wijk, R., Van Den Bosch F.A.J., & Volberda H.W. 2004. Knowledge and Networks. In M. Earsthy-Smith, M.A Lyles, (Eds.), **Handbook of Organizational Learning and Knowledge Management**: 428-453. UK: Blackwell Publishing.
- Zahra, S.A., 2005. A Theory of International New Ventures: A Decade of Research. **Journal of International Business Studies**, 36 (1), 20-28.