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Psychic and geographic distance in the process of firm internationalization. Example of companies from Poland and Lodz region

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Internationalisation of firms has been described in many theoretical concepts, among which the Uppsala model is the most widely used. It focuses on the sequence of the process in terms of both forms and directions of internationalisation. The need to gradually advance in internationalisation and the choice of foreign markets are explained by the concept of “psychic distance”, which results, among the others, from cultural differences or business practices of the home and host country. Our paper makes an attempt to answer the question whether Polish firms which enter the path of internationalisation start to invest in one or a few neighbouring countries rather than investing in distant markets and/or several markets simultaneously. The idea is analyzed using the example of firms based in Poland and in the Lodz Region involved in foreign direct investment.

The paper has been divided into 3 parts. The first one reviews the literature on internationalization models, with particular stress on the Uppsala model; the second part validates the main assumptions of the model using data concerning firms from Poland and the third part focuses on foreign operations of companies from the Lodz Region.

JEL Classifications: F21

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Introduction

Internationalization of firms has been closely followed by researchers for decades. Numerous theoretical concepts have emerged so far to describe models of international expansion of firms. The Uppsala model is one of the most commonly used to study the phenomenon. It focuses on the sequential aspect of the process in the context of both forms and directions of internationalization. In terms of application, the model seems to work particularly well for the initial stages of internationalization of the economy when single firms decide to practice more advanced forms of international operations (foreign direct investment - FDI). Since they cannot count on the support of more experienced companies from more distant markets, they first expand to closer markets. Following the concept of the Uppsala model, ‘closer’ markets are those that are perceived to be close, i.e. those, which represent similar culture and advancement of knowledge. These are the markets located at a shorter psychic distance, which may sometimes diverge from straight geographical distance (Johanson and Vahlne, 1990).

The paper attempts to answer the question whether Polish firms, which enter the path of internationalization, start and continue to invest in one or a few neighbouring countries

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rather than investing in distant markets and/or several markets simultaneously. We shall analyze the concept using firms based in Poland and in the region of Lodz involved in foreign direct investment as an example.

The paper includes three parts. The first one reviews the literature concerning internationalization models, stressing in particular the Uppsala model; the second part validates the main theses of the model using data from firms from Poland and the third one is devoted to international operations of companies from the Lodz Region. Statistical analyses are based on data from Central Statistical Office of Poland. Main findings are presented in the concluding remarks.

Literature review

Internationalization of firms is a complex subject hence it is hard to find its coherent definition in literature. The notion of internationalization depends, among others, on the motivation or on the propensity of economic operators to expand to foreign markets and results from the engagement of firms' own resources or from their involvement in various forms of cooperation with foreign partners. E.g. Wind et al. (1973) stress that internationalization is a process where specific attitudes are associated with successive stages in the evolution of international operations. Turnbull (1987) argues that it is linked with a physical establishment abroad, outside of the borders of a firm's home country. Johanson and Vahlne (1977), Johanson and Mattsson (1993), Calof and Beamish (1995) conceive internationalisation as a process of increased international involvement and adapting firms' operations (strategy, structure, resources etc.) to international environments. Welch and Luostarinen (1988), in turn, understand it as a firm's involvement in economic operations, which encompass both internal (e.g. imports, purchase of licenses, franchising) and external (e.g. exports, foreign direct investment) forms of firm's internationalization. The idea of Dunning eclectic paradigm (1981) is also worth quoting, which treats internationalization as a model of investing abroad, where a firm uses its own advantages of: ownership, internalisation and localisation.

Increasing interest in internationalization of firms has led to the emergence of many different approaches and models, which attempted to explain its usual course. Within last 40 years many concepts were conceived and some authors have openly declared that at present internationalization should be interpreted as a part of an ongoing strategic process of most business firms (Melin, 1992).

Among models which describe expansion to foreign markets the following are listed the most frequently: the Uppsala model of internationalization (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977), innovative internationalisation models (Bilkey and Tesar 1977; Cavusgil, 1980; Reid, 1981; Czinkota, 1982), network business models (Möller and Rajala, 2007; Johanson and Mattsson, 1993; Ng and Zain, 2006), and models of firms born global (Rennie, 1993; Knight and Cavusgil 1996, 2009; Freeman, Edwards and Schroder 2006; Zhou, Wu and Luo, 2007). None of the above concepts is universally applicable and usually their applicability is limited by many conditions. The latest studies in the field of internationalization of firms make an eclectic use of the achievements of various theories and try to adapt them to the specificity of a firm, to its objectives and to the environment (Gorynia and Jankowska, 2007).

Definitely the most popular and the most often validated is the Uppsala model, which assumes that internationalisation activities increase incrementally. The authors claimed that internationalisation is a slow and long-lasting process. Besides, it is a consequence of earlier growth and successes on the domestic market followed by expansion to markets in countries the closest in terms of geography, which are similar when it comes to culture and knowledge base. The need to internationalize gradually and the choice of foreign markets are explained with the idea of "psychic distance", which results from cultural differences, or different business practices in the home and host countries. Wishing to

minimise the risk of operating abroad, the firms first expand to markets, which are closer to them with respect to “psychic” and by that reduce the likelihood of failure. Acquired experience is then used to enter markets, for which “psychic distance” is bigger.

The authors argue that a firm gradually increases its control over sales and manufacturing going through four stages: from incidental exports followed by sales through independent agents, setting up a branch or a trade division up to transferring production abroad. As the company is receiving more knowledge and is learning more from international activities it overcomes barriers to its growth and operates more efficiently on other markets. That often translates into propensity to penetrate more geographically distant markets and the use of more advanced forms of internationalization.

As we have already mentioned, the Uppsala model assumes that internationalization of a firm starts from the markets with the shortest psychic distance. The idea of psychic distance was introduced for the first time in the work by Backerman (1956) relating to trade-flows between European countries. At the beginning, however, no studies were conducted at a large scale to analyze the impact of psychic distance upon the choice of a foreign market to which a firm wants to expand. Only in the 1970s the concept was further developed by Johanson and Wiedersheim-Paul (1975, p.308), who defined it as “factors preventing or disturbing the flow of information between firm and market”. The most common disturbing factors are differences in language, culture, political system, level of education, level of industrial development etc. Firms, which wish to bypass the barriers will favour countries that share similar business environment with their home country (Sousa and Bradley 2006). According to O’Grady and Lane (1996, p. 310) we can notice that “an implicit assumption that psychically close countries are more similar, and that similarity is easier for firms to manage than dissimilarity, thereby making it more likely that they will succeed in similar markets.”

The concept of psychic distance in internationalization of firms has been discussed in literature on numerous occasions. Many authors identify psychic distance as an essential factor explaining organizational performance (Evans & Mavondo, 2002; Dikova, 2009), which impacts, e.g., the internationalization process of knowledge-intensive SMEs (Hashai and Almor, 2004). Kogut and Singh (1988) have predicted that large psychic distances between countries will increase a firm’s preference for greenfield investment. In contrast, the studies by Brouthers and Brouthers (2000) demonstrate that large psychic distances increase the likelihood of acquiring an existing firm in a foreign market.

An issue close to the notion of psychic distance is the idea of cultural distance (Barkema, Bell, and Pennings, 1996; Kogut and Singh, 1988; Pothukuchi et al., 2002), which identifies the existing cultural differences. The most comprehensive research on the subject were conducted by Hofstede (1980; 2001). Kogut and Singh (1988) based on Hofstede’s (1980) work aggregate measure of cultural distance among countries. Many subsequent works made references to the above studies to explain the sequence of foreign investment (Benito and Gripsrud, 1992) or the entry mode (Agarwal, 1994). Despite rather rich literature, one might have an impression that the division into psychic distance and cultural distance has not been followed in studies of international environment. Both terms are treated as equivalent by, e.g., Eriksson, Majkgard and Sharma (2000) or Lee (1998).

The Uppsala model provided inspiration to many economists who in their concepts referred to the idea of sequential internationalization process. Theories that followed proposed different stages of internationalization¹ and other view on the determinants of the process. On the other hand, the model was often criticised. Its concept of stages of internationalization and psychic distance were questioned the most frequently. Johansson and Mattson (1988) state that it is of little use when both the market and the firm are highly internationalized. Reid (1983) claims it is too deterministic and general. Sullivan and

¹ For example Bilkey and Tesar (1977) and Czinkota (1982) distinguish 6 stages of internationalization, Reid (1981) and Cavusgil (1984) five, while Rao and Naidu (1992) only four.

Bauerschmidt (1990) criticise the influence of geographical distance of markets upon internationalization. Similar observations can be traced in the works by Vahlne and Nordstrom (1990) and Dunning (1995), who claim that the distance between markets is not so important because of globalisation. The latter is characterised with trade liberalisation, access to the Internet and common use of English as a universal business language, which taken together blur borders and give trouble-free access to many markets.

Also the idea of psychic distance is not appreciated by many contemporary researchers of internationalization. The Uppsala model built around such a conviction has become questionable as it cannot properly explain the course of internationalization under the conditions of modern economy. At present, psychic distance plays an ever smaller role as technical progress, quicker communication, flow of information, and efficient transport make the markets more homogenous and similar to one another (Przybylska, 2009). O'Grady and Lane (1996) point to the specific paradox of the idea. They are of the opinion that economic operations in a geographically closer region with "shorter psychic distance" not necessarily bring better economic results. Besides, the choice of foreign markets, which a manager considers similar to the domestic market, i.e. easier to operate on, not always allows assessing real threats and may lead to failure. It turns out that what seems closer in terms of psychic may be very different from our expectations in reality. As a result, an apparent similarity may hide unexpected barriers.

The idea of the Uppsala model, in particular its part indicating the existence of psychic distance for firms entering foreign markets, seems to us especially interesting. Hence we will take a closer look at directions selected as investment locations by companies from Poland and from the Lodz Region. Thus we would like to demonstrate whether they most often select countries close culturally and geographically as the destination of their expansion and whether exports are the most preferred initial form of internationalization.

Scale and directions of foreign direct investment by Polish firms

Economic growth and intensive integration processes connected with the EU accession have made Polish economy an active participant of international market. That is reflected, among others, in intensified flows of long-term capital in the form of foreign direct investment. Although still inflows of capital into the Polish economy exceed the outflows (meaning Poland remains net importer of foreign capital), recent years have witnessed more active investments by Polish companies on foreign markets.

In the period 2009-2011 (in spite of economic crisis) we could note the increase in FDI by Polish enterprises. The number of companies with branches and subsidiaries (together called entities or units) abroad increased from 1313 to 1501 in the period in question, while the number of foreign entities themselves increased from 2747 to 3178. The biggest group is that of industrial processing companies (they accounted for ca. 30%-32% of all foreign entities of Polish firms). What is more, their advantage over trading companies (representing ca. 22%-26%) was continuously growing. The trend is positive as it confirms increasing competitiveness of Polish industry, which is capable of fighting for its position on foreign markets effectively. To be able to start manufacturing on international scale one needs specific advantages, which in the idea of J.H. Dunning are referred to as ownership advantages (1988). Growing outward investments shows that Polish companies have already gained these competitive advantages.

Taking account of relatively short period of international activity of Polish firms one should expect, in accordance with the Uppsala model of internationalization, that investment destinations are dominated by the neighbouring countries. Their distance, both geographical and "psychic" is small. Neighbouring countries from the East and South can be considered parts of Slavonic culture, while the German market, despite cultural differences, is close due to historical experiences and intensive economic and social links.

Empirical data in principle confirm presumptions resulting from the Uppsala concept. In the period covered by the study, four dominant outward FDI directions for Polish firms were: Germany, Ukraine, Czech Republic and Russia - see Table 1.

TABLE 1. STRUCTURE OF FOREIGN BRANCHES AND SUBSIDIARIES OF POLISH FIRMS
BROKEN BY COUNTRY IN THE YEARS 2009-2011

| | No of foreign entities | | |
|-----------------|------------------------|------|------|
| | 2009 | 2010 | 2011 |
| TOTAL | 2747 | 2988 | 3178 |
| of which: | | | |
| Germany | 372 | 400 | 427 |
| Ukraine | 348 | 356 | 355 |
| Czech Republic | 228 | 346 | 270 |
| Russia | 210 | 231 | 242 |
| Romania | 131 | 150 | 159 |
| Slovakia | 122 | 125 | 150 |
| Hungary | 111 | 114 | 118 |
| Lithuania | no data | 105 | 116 |
| Belarus | 84 | 88 | 78 |
| Cyprus | 83 | 102 | 131 |
| Great Britain | 62 | 64 | 67 |
| USA | 59 | 71 | 68 |
| The Netherlands | 55 | 67 | 73 |
| France | 45 | 67 | 68 |

Source: own calculations based on data from the Central Statistical Office of Poland (GUS) (*Operations of firms with foreign entities abroad*, for the years 2009-2011, GUS, 2011, 2012, 2013).

Foreign investments were launched mostly to win the markets. The total value of sales by foreign entities increased in the studied period by over 17%, from ca. EUR 26 bn in 2009 to EUR 30,5 bn in 2011. The biggest sales were generated by industrial companies (EUR 15,6 bn in 2009 and EUR 22,6 bn in 2011). Their share in total revenues of foreign units increased from less than 60% to almost 73%.

Revenues were achieved mostly on the markets where investment projects were located. In 2009 as little as ca. 23% of the production of foreign branches and subsidiaries was exported (in industry the proportion was the highest and reached a little more than 30%), and only ¼ out of it was directed, within vertical links, to other entities within capital group. Foreign entities in the service sector were even more oriented at local markets. The share of exports in revenue from sales in these units was ca. 10-15%.

In 2011 the share of exports in the total revenue of foreign entities increased to almost 30% and in industrial companies even to 35%. On average ca. 30% of that was sent to related entities in a capital group. The changes should also be evaluated positively. They show further gradual increase international involvement of firms and more conscious and effectiveness seeking management of geographically dispersed resources. The inclusion of foreign production into corporate chain of value creation is characteristic for experienced international companies, which intentionally manage their global efficiency.

However, it is worth noting that in terms of geography there are significant divergences in market orientation. Units based in Germany, Russia, Slovakia, Ukraine, Hungary and also in the U.S. were oriented mostly exclusively at local markets - they exported not more than 8% of their production. In the Czech Republic the percentage was a bit higher, ca. 17%-22%, but still the result was below the average. The most pro-export were foreign

units in Belarus¹ and in France (the share of exports in their sales increased from ca. 30% to 40%) and Norway (exports worth even up to 90% of revenues).

Expansion of companies from the Lodz region

Out of the total number of foreign branches and subsidiaries of Polish companies, ca. 4.5% were established by enterprises registered in the Lodz Region. Their number increased in the period 2009-2011 from 119 to 146 (see Table 2). The main directions of foreign expansion for firms from the Lodz Region are in principle identical with destinations selected by other Polish companies. These include first of all the neighbouring countries: Germany, Ukraine, Czech Republic, Slovakia, Russia, and Lithuania, although their popularity differs a bit. Companies from around the Lodz most willingly established their foreign units in Lithuania², Russia, and Ukraine.

TABLE 2. STRUCTURE OF FOREIGN BRANCHES AND SUBSIDIARIES OF FIRMS FROM THE LODZ REGION BROKEN BY COUNTRY IN THE YEARS 2009-2011

| | No of foreign entities | | |
|--|------------------------|---------------|---------------|
| | 2009 | 2010 | 2011 |
| TOTAL (share in values for Poland) | 119 (4.3%) | 137 (4.6%) | 146 (4.6%) |
| of which: | | | |
| Lithuania | 18 | 17 | 20 |
| Russia | 14 | 18 | 18 |
| Ukraine | 16 | 17 | 17 |
| Czech Republic | 9 | 10 | 11 |
| Germany | 7 | 10 | 11 |
| Romania | 5 | 10 | 10 |
| Slovakia | 8 | 9 | 10 |
| Belarus | 6 | 6 | 7 |
| Hungary | 5 | 4 | 4 |
| U.S. | 4 | 3 | 4 |

Source: own calculations based on the data of Central Statistical Office of Poland.

The analysis of directions selected for foreign expansion by companies from the Lodz Region also confirms presumptions resulting from the Uppsala model. The closest destinations with short “psychic” distance are usually the first choice. Polish companies operating on the markets of the former Eastern bloc countries have an additional advantage - an experience acquired on similar market conditions and the ability to “cope” in various stages of the development of market economy.

Sectoral structure of foreign entities established by companies from the Lodz Region significantly diverges from the average profile for Poland, though still the operations of these companies remain within the assumptions of the Uppsala model remaining on average, however, in the earlier stage of internationalization. In accordance with the model, the firms start with developing exports, also based on trade branches and agents and at a later point, gradually transfer production operations abroad. Contrary to the trend observed for Poland, in the period 2009-2011 almost 80% of foreign entities from the

¹ We must stress, however, that in Belarus, despite relatively high number of foreign entities established by Polish firms, total revenue from sales increased from EUR 100 mln in 2009 to ca. EUR 226,7 mln in 2011 representing the lowest value per a single foreign entity.

² For example, almost 20% of all Polish foreign entities operating in Lithuania were established by the companies from the Lodz Region.

Lodz Region were dealing with services, mainly wholesale trade. Trade operations were established not only by companies, which in Poland also deal with trade, but also almost a half of foreign trade entities were established by manufacturing companies. That reveals market seeking orientation of companies involved in FDI.

Interestingly, wholesale or retail branches dominated mostly in the neighbouring countries. In the Czech Republic, in Russia but also in Slovakia, Lithuania and in Germany their share reached almost ca. 70%-80%. In less popular, more distant countries¹, the share of trading entities was much smaller, only ca. 35%-43%. Thus we may expect that seeking better conditions for production, cheaper production factors and higher efficiency (rather than market seeking) was an important motivation for the location decision (it is also confirmed by a much higher share of exports in the revenue of these entities than in the neighbouring countries).

Despite the domination of trade, the period covered by the study revealed slight upward tendency in the number of entities dealing with industrial processing. For industry the most attractive were the markets of Romania and Ukraine. Ca. 35%-40% of units established in these markets operated in industrial processing which exceeds more than twofold the average for the entire studied countries. While in Romania we can observe strong concentration of industrial entities in the chemical sector, in Ukraine the profiles of foreign units vary a lot: from textile and apparel industry through chemical products, caoutchouc, gum and man-made plastics, machinery and equipment up to vehicles. It is worth noting that on markets with higher share of Polish industrial entities the share of exports in their revenues is also higher. On average, for all operators included in the survey, the share of exports was ca. 4.5%-8.5% and in Ukraine it reached 30%. It is worth stressing that the share of exports, including exports to related entities within a capital group, was systematically increasing. That demonstrate again an increasing experience in international involvement of firms, reflected in the intensification of their “*efficiency seeking*” behaviour. Exemptions are observed only for Lithuania and Russia, where foreign entities practically did not export.

Concluding remarks

Data presented in the paper provide the evidence that Polish firms prefer a conservative model of internationalization, well subscribed to the framework of the Uppsala model. Clear majority of firms started their internationalization with the best known and geographically close markets with little psychic distance and decided to invest in trade-related activities. The primary motivation for an FDI was to win the market of the country of destination, however, many entrepreneurs expanded to find better conditions for their production operations, cheaper production factors or higher efficiency. We should also mention the increasing share of exports in the total revenue of foreign entities. These positive changes provide evidence of further international expansion of companies and more intentional management of geographically dispersed resources.

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¹ Which were reached in total by ca. 30% of entities established by companies from the Lodz Region.

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