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THE INTERNATIONALIZATION OF SMES IN EMERGING ECONOMIES: INSTITUTIONAL EMBEDDEDNESS AND ABSORPTIVE CAPACITIES

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ABSTRACT

We examine the importance of institutional embeddedness and dynamic capabilities in the internationalization strategies of small and medium-sized enterprises (SMEs) in emerging economies. We focus on two types of SMEs – incumbent SMEs and entrepreneurial start-ups. We argue that incumbent SMEs can increase their internationalization capabilities by using their embedded networks with local governments and business groups. Entrepreneurial start-ups in emerging economies may develop new capabilities by learning from foreign firms and business groups. Therefore, entrepreneurial start-ups identify, create, and exploit new opportunities continuously in foreign markets. This work contributes to our knowledge of how incumbent SMEs and entrepreneurial ventures in emerging markets build knowledge and capabilities to enter and compete successfully in international markets.

INTRODUCTION

Firms from emerging economies are accelerating their efforts to integrate into the global economy (Hoskisson, Eden, Lau, & Wright, 2000; Khanna & Palepu, 1997). The conventional foreign direct investment (FDI) pattern has changed in the last two decades. Although developed economy firms remain the dominant source of FDI, emerging economy firms have started to invest aboard in increasing numbers in recent years. In recent years, the increase in outward flow of FDI from emerging economies (from $16.3 billion to $469 billion from 1980 to 2002) has tripled the increase from developed countries (from $507 billion to $4.3 trillion) (Henisz, 2003). A recent study further showed that small and medium-sized enterprises (SMEs) in emerging markets are increasingly internationalizing to capitalize on opportunities in foreign markets (Organization for Economic Co-operation and Development [OECD], 1997). For example, SMEs accounted for roughly 40 percent of manufacturing exports in Korea in 1999 (OECD, 2002). Emerging economies are moving away from inward-oriented import substitution policies toward outward-oriented export-led growth (Aulakh, Kotabe, & Teegen, 2000).

Traditional internationalization theories focus on how multinational enterprises

(MNEs) in developed economies capitalize their competitive advantages and gain rents in foreign markets (Dunning, 1988; Hymer, 1976; Johanson & Vahlne, 1977; Vernon, 1966). Yet, these internationalization theories are less pertinent when applied to explain SMEs' internationalization behavior from emerging markets because these firms are generally less resource endowed and less competitive compared to firms from developed economies (Aulakh et al., 2000).

Further, traditional internationalization theories have paid less attention to the institutions that have been commonly accepted as support for firms to compete fairly in the developed markets, yet rarely exist in emerging economies (Khanna & Palepu, 1997). Institutional transition - fundamental and comprehensive changes introduced to the formal and informal "rules of the game" in emerging economies - is a critical characteristic of emerging markets (Peng, 2003; Tan, 2002). Emerging economies also exhibit a greater institutional variance relative to the institutions of developed economies often featured in the literature (Peng & Heath, 1996).

Recent research on emerging economies has adopted institutional theory suggesting how institutional environments in these economies facilitate or constrain emerging market firm strategies (Peng, 2003; Peng, & Heath, 1996; Hitt, Ahlstrom, Dacin, Levitas & Svobodina, 2004). Institutional theory suggests that "economic action is embedded in structures of social relations" (Granovetter, 1985, p. 481; Oliver, 1996). As a result, the strategies employed by firms, such as internationalization, are affected by the institutional framework in their home country and in the country entered (Scott, 1995; Peng & Heath, 1996).

The massive infusion of capital, technology, and managerial expertise from developed economies into major emerging markets has intensified competition for local firms in emerging markets. Thus, SMEs in emerging markets are no longer able to operate independently in relatively protected environments. SMEs in emerging economies need to compete with larger and more established rivals (e.g., domestic firms and MNEs) on the basis of resourcefulness - that is, doing more with less (Peng, 2001; Peng, Lee, & Wang, 2005; Hitt, Li, & Worthington, 2005). Because of the intense competition in their home market, internationalization provides emerging country SMEs an important opportunity for growth and wealth creation. However, to succeed in international markets, they need to build competitive capabilities. Global competition by established MNEs makes it difficult for them to compete solely on the basis of comparative cost advantages in labor and natural resources (Shrader, Oviatt, & McDougall, 2000).

Emerging market SMEs are often constrained by scarce resources including financial, managerial, and technological resources, established brands and innovative products (Aulakh et al., 2000; Filatotchev, Hoskisson, Buck, & Wright, 1996). Additionally, they face high barriers to access these resources because of "institutional voids" such as the lack of financial intermediaries in emerging markets.

Emerging economies provide a natural setting to study the role of institutional embeddedness and dynamic capabilities (Granovetter, 1985; Oliver, 1996; Kale, Singh, & Perlmutter, 2000; Uzzi, 1997; Zahra & George, 2002b) in the internationalization process of local SMEs. We argue that SMEs in emerging economies are embedded in structures of institutional relations (Granovetter, 1985) that confer resources to and increase the legitimacy of the SMEs (Granovetter, 1985; Oliver, 1997; Powell & DiMaggio, 1991). SMEs identify, create, and exploit opportunities in foreign markets by leveraging resources and by learning from connected institutions to develop their competitive capabilities (Peng et al, 2005). Thus, we contribute to internationalization theory by exploring how SMEs in emerging markets internationalize, given their constraints in resources and capabilities. We also contribute to institutional theory by arguing that institutional embeddedness not only confers resources but also helps to develop dynamic capabilities that can sustain firms' global competitiveness in the long term.

TIME HORIZON

As Zaheer, Albert, and Zaheer (1999) emphasized, a necessary and critical first step in the development of a theory is to define the time horizon over which the theory holds. It is also important to note that "the rules of the game" are changing as emerging countries liberalize their economies and adopt a free-market system (Hoskisson et al., 2000; North, 1990; Nee, 1992). A central and consequential feature of institutional development in emerging economies is the change from heavily regulated economies to market-supporting institutions (Khanna & Palepu, 1997). Although researchers studying emerging economies have noted this turning period, researchers predominantly emphasize one aspect of institutional environments in emerging economies (e.g., institutional voids; the construction of market-supporting institutions), and debate which strategy is more appropriate to gain a competitive advantage in these economies (White, 2000; Peng & Health, 1996; Spicer, McDermott, & Kogut, 2000). For example, Peng (2003) proposed a two-phase model of institutional transition, and argued that strategic choices to gain competitive advantages differ in the early and late stages of transition. Specifically, firms compete using the network-based strategy, emphasizing intangible assets embodied in managers' interpersonal ties and firms' inter-organizational relationships with various players in the earlier stages of transition; and they compete using their own resources and capabilities in the later stages of transition.

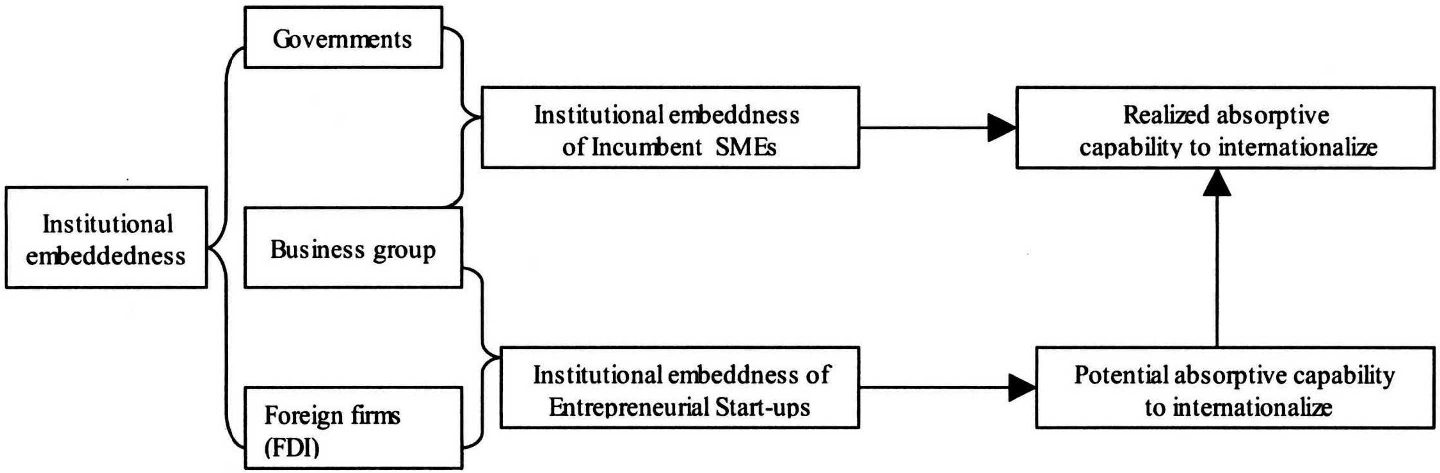
However, as market transition is rarely linear and often displays a mixture of progress and regress, focusing on one aspect of transition may provide limited help in explaining the behaviors of different firms in emerging economies (Peng, 2003; Nee, 1992). Market transition is also likely to occur over a protracted period as institutional barriers are dismantled and market supporting institutions are developed (Nee, 1992; Williamson, 2000). According to Williamson's (2000) classification, it may take from one to one hundred years to establish a complete market-supporting institutional infrastructure.

Further, although many researchers suggest that economic growth typically occurs in developed economies, the rapid pace of economic development of emerging economies and their underdeveloped institutional structures is contrary to conventional wisdom (e.g., North, 1990). The rapid growth, especially in some emerging markets (e.g., China), also places in doubt the ability of organization theories suggesting the necessity of transparent market-supporting institutions to account for the emerging market firms' behavior and economic growth (Boisot & Child, 1996; North, 1990). Hence, theoretical development to explain how institutional environments affect firms' behavior in emerging markets is needed and important. We limit our predictions to the transition period when institutional environments are characterized by dismantling institutional barriers in heavily regulated economies and constructing the market-supporting institutions. The theoretical model is depicted in Figure 1.

INSTITUTIONAL EMBEDDEDNESS

Emerging economies are "low income, rapid-growth countries using economic liberalization as their primary engine of growth" (Hoskisson et al., 2000). Although the phenomena of "fast follower, emerging economies" puzzled economists, sociologists

Figure 1
Theoretical Model of the Internationalization of SMEs in Emerging Economies: Institutional Embeddedness and Absorptive Capacities



have provided part of the answer in that institutions may affect economic outcomes through their impact on firms' strategic responses (Granovetter, 1985; Oliver, 1991, 1997).

Research on emerging economies has emphasized the importance of networks and connections (Peng, 2003; Peng & Heath, 1996; Peng et al., 2005). Researchers have used transaction cost economics to argue that relational contracting decreases transaction costs such as monitoring costs, costs of opportunism, and information costs when rule-based institutions are limited in emerging economies (North, 1990; Peng, 2003). Further, although firms are constrained by resources available from markets because of institutional voids in financial, labor, and product markets, researchers have argued that firms can gain legitimacy and resources by becoming embedded in the dominant institutions that control resources in emerging market (Peng, 2003; Peng & Heath, 1996; Peng et al., 2005).

A large number of SMEs has been established as a result of institutional transition involving privatization and market liberalization in emerging economies (Brezinski & Fritsch, 1995). In the early stage of transitions, SMEs face high barriers to gain legitimacy because large firms are dominant and have been recognized as legitimate. SMEs also face the hazards of liability of smallness. Barriers to the access of financial and human resources and to the ability to allocate products further constrain SMEs growth. The institutional intermediaries tend to not exist or, if they exist, they are controlled by governments, state-owned enterprises (SOEs), or business groups in emerging economies (Khanna & Palepu, 2000a). Thus, SMEs need to develop connections with resource controllers (e.g., governments, business groups) to access needed resources. Further, competition may increase as more foreign firms invest in emerging markets. The entry of MNEs from developed countries may motivate SMEs to build their capabilities and, thus, to seek connections with firms that possess advanced knowledge (e.g., business groups, foreign firms) (Hitt, Dacin, Levitas, Arregle, & Borza, 2000; Zahra, Ireland, & Hitt, 2000). As a result, they tend to be embedded in networks (e.g., government, business groups, foreign firms), and their strategic actions are likely influenced by these relations (Granovetter, 1985).

Government

Governments in emerging economies often have considerable power in the resource allocation process. As a result of the legacy of bureaucracy in planned economies, officials are likely to arbitrarily intervene in the markets to make specific resource allocations, thus, creating unfair competition for firms (Nee, 1992; Peng, 1996). Although these governments often try to emulate developed economies to establish market-supporting institutions, such institutions require time to develop.

Governments in emerging economies use more than purely economic criteria to design their policies. The implications of government policies for social issues such as employment rates and social stability matter greatly in emerging economies, especially in those with former central planning. Thus, during the transition periods, governments design, experiment, revise, and implement new policies as they gain feedback on the various economic and social institutions. Therefore, the interaction between the firms and governments can have substantial influence on the policies. The policies and the institutions are in the process of development and remain somewhat flexible. The new policies are often biased toward specific interested groups. Meanwhile, from the government's point of view, these new policies are intended to benefit economic growth as well. As a result, it is not surprising that the newly established SMEs are likely to establish and maintain their contacts with government officials, given that governments are influential in resource allocation and in determining the rules of the game.

Business Groups

Resources

Business groups refer to "a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action" (Khanna & Rivkin: 2001, pp. 47-48). Research on emerging economies suggests that business groups are a response to market imperfections and replace weak institutions in capital, labor, and product markets (Leff, 1978; Khanna & Palepu, 1997; Khanna & Rivkin, 2001). Membership in business groups allows firms to appropriate quasi-rents by accessing scarce and imperfectly marketed inputs such as capital and information (Chang & Hong, 2000; Leff, 1978). For example, SMEs in emerging markets need reliable information about the inputs they purchase and the investments they make. Without reliable information, SMEs are unlikely to invest in unfamiliar ventures. Therefore, SMEs can overcome their resource liability and reduce their investment uncertainty by building relationships with business groups.

Further, consumers in emerging economies lack information about the quality of the products made by SMEs. SMEs may need the group brand to signal the quality of their products to the consumers. Thus, connection to a well-known business group provides legitimacy in the marketplace for SMEs (Khanna & Palepu, 1997).

Additionally, because governments in emerging economies have significant discretion, business groups maintain extensive relationships with the government to reduce the uncertainty of the regulatory system and to obtain tangible benefits such as priority access to inward FDI (Hoskisson et al., 2000; Khanna & Palepu, 1997). SMEs operating as members of business groups can reduce their costs of maintaining a relationship with government officials, increase their legitimacy in the eyes of government officials and facilitate their access to government resources. Studies on emerging economies have demonstrated that firms affiliated with business groups tend to exhibit higher profitability than independent firms do (Chang & Hong, 2000; Khanna & Palepu, 2000a, 2000b). The research by Khanna and Palepu (1997) has shown that the business group is an efficient governance structure in the early stage of transition in emerging economies.

Capabilities

Competition has become increasingly fierce in emerging economies where more resource-rich foreign firms enter to exploit the new market opportunities. As Peng (2003) noted, firms compete on the basis of their resources and capabilities in the late stage of transition when market-supporting institutions are established and stabilized. Yet, SMEs in emerging economies are resource poor and thus unable to compete with rivals by solely relying on their internal resources (Hitt et al., 2005; Uhlenbruck, Meyer, & Hitt, 2003). However, they can add to their capabilities by building a strong relationship with a large diversified business group.

Further, the rapid globalization of markets and increasing competition are dramatically reducing the time horizon required to build capabilities needed for survival, much less to develop competitive advantages. In this circumstance, SMEs have a short time horizon to acquire the necessary capabilities (Etemad, Wright, & Dana, 2001). Symbiotic collaboration between two or more firms is intended to improve the value of the output by leveraging their network capabilities to shorten the time span to market. Business groups in emerging economies possess various resources and capabilities, and they can create synergy across member firms within the business group (Chang & Hong, 2000). Therefore, SMEs in emerging markets are enticed to become a member of a business group or to build important relationships with them. In so doing, they can often utilize the resources and capabilities of the group to enrich their own competitiveness in a shorter time period. Alternatively, through the sharing of knowledge, SMEs may be able to develop their own capabilities that they in turn share with other businesses within the group. These capabilities also enhance their independent competitiveness in their markets served.

Foreign Firms

Attracted by prospective market opportunities and reinforced by the potential profits first-movers can earn in emerging economies, the number of foreign firms investing in emerging economies has increased exponentially in recent years (Henisz, 2003). However, foreign firms often bring value to emerging markets as well. Meyer (2004) emphasized that foreign firms introduce new technologies and new management techniques to emerging economies. Emerging market firms can learn from foreign firms, especially when they partner with them in strategic alliances (Hitt et al., 2005).

As we argued previously, SMEs facing substantial competition have to develop competitive capabilities and/or differentiate themselves in order to compete against their rivals as more firms enter emerging economies. Establishing relationships with foreign firms provides opportunities to enhance their technological and innovative capabilities and, hence, to increase their competitiveness (Meyer, 2004; Hitt et al., 2005).

Further, a result of competition in the developing global competitive landscape, firms more regularly introduce new products and processes to the markets to build and maintain competitive advantages, thereby continuously reducing product life cycles (Bettis & Hitt, 1995; Hitt, Hoskisson, & Kim, 1997). Hence, SMEs in emerging economies need to develop a series of temporary competitive advantages to sustain their competitiveness (Sirmon, Hitt, & Ireland, in press). Thus, SMEs need to scan their environments to identify and obtain timely information about new products and technologies in the markets; in so doing, they are able to constantly learn and innovate to sustain their competitive advantage (Hitt, Tyler, Hardee, & Park, 1995). Because foreign firms provide a store of global information and knowledge including market standards, marketing opportunities, and innovative technologies, SMEs need to develop relationships with foreign firms to access this information and knowledge (Meyer, 2004; Hitt et al., 2005).

Therefore, as emerging economies are changing to the rule-based market transactions, firms compete on the basis of resources and capabilities (Peng, 2003; Peng & Luo, 2000). SMEs in emerging economies are likely to build their connections with foreign firms to access timely information and knowledge about markets, products, and services.

Institutional Embeddedness of Incumbent SMEs

In the early stage of the transition in many emerging economies, a large number of SMEs are established as a part of government policies to liberalize their economies, to promote economic development, and to support social progress (Zahra, Ireland, Gutierrez, & Hitt, 2000). We define these SMEs as incumbent SMEs because the focus is on the middle of the transition period. However, SMEs entering the markets in the middle of the transition are considered as entrepreneurial start-ups.

In the early stage of the transition, these newly established SMEs often experience several barriers to growth. Financial barriers have been the most important because the banking system focuses on financing large state-owned firms and business groups (Peng, 2003; Walder, 1991). Banks rarely offer loans to SMEs, because these firms do not have legitimacy in the early stage of the transition and, thus, are perceived as high risks (Peng, 2003).

Another equally critical barrier is the underdeveloped institutions (Bartlett, 2001). Because property rights often are not well defined and governments still have substantial discretion in resource allocation in the early stage of transition, governments impose unreasonably high taxes and enforce regulations in a manner that discriminate against SMEs. Governments also restrict SMEs' access to resources (Bartlett, 2001; Nee & Yong, 1990). Government officials often engage in individual rent-seeking and corruption (e.g., collection of bribes) that creates uncertainty for SMEs and increase their transaction costs. Therefore, SMEs are encouraged to cultivate networks with government officials to acquire the goodwill of the government agencies and reduce the arbitrary intervention, thus, decreasing the transaction costs (Boddewyn & Brewer, 1994; Rodriguez, Uhlenbruck, & Eden, 2005). Further, according to the resource dependence perspective, SMEs can gain legitimacy and mobilize resources by maintaining relations with government agencies and the members thereof that control resource allocation in the early stage of transaction (Pfeffer & Salancik, 1978; Boddewyn & Brewer, 1994). Therefore, SMEs can overcome the financial and institutional barriers by gaining support from the government.

SMEs also can overcome these barriers by gaining external legitimacy. Rodriguez et al. (2005) suggested that social networks can be important sources of external legitimacy. Business groups in emerging economies indeed provide such social networks linking independent firms under the tight control of headquarters (Chang & Hong, 2000), because business groups have been recognized as a legitimate organizational form (Khanna & Rivkin, 2001). Therefore, SMEs could attain external legitimacy by joining to a business group (Khanna & Rivkin, 1997). Additionally, SMEs can access scarce resources and obtain lower costs because members in business groups share their resources and capabilities (Chang & Hong, 2000; Khanna & Rivkin, 2001).

In the early stage of transition, a limited number of large MNEs invest in emerging economies to exploit their special capabilities that provide them competitive advantages in developed markets. However, in the early stages, these MNEs are often unfamiliar with the local markets such as the preferences of local consumers, thus, they experience high risks with their investment decisions. Linkages with local governments and business groups can confer legitimacy and decrease uncertainty resulting from arbitrary interventions from local governments. Furthermore, foreign firms may also obtain advantages such as tax deferrals from relations with government (Hoskisson et al., 2000). Relations with governments may provide foreign firms with potential competitive advantages in emerging markets because acts of governments can create individual winners and losers in marketplace (Boddewyn & Brewer, 1994; Leone, 1986). Yet, such relationships do not guarantee positive outcomes for the foreign firms (Hitt et al., in press).

According to density dependence theory, legitimacy dominates competition when SMEs are born in the early stage of transition (Hannan & Freeman, 1989). Thus, SMEs are less likely to build linkages with foreign firms because foreign firms have not been identified as legitimate organizational forms when they first enter emerging economies (Hannan & Freeman, 1989). Furthermore, because of legitimacy needs, foreign firms desire to build relationships with firms having legitimacy in local markets and, thus, are unlikely to seek alliances with new SMEs.

Organizational ecology theory assumes that inertia is a prevailing property of organizational evolution and, consequently, SMEs retain their basic attributes (e.g., type of relations) of their early forms (Freeman, Carroll, & Hannan, 1983). Incumbent SMEs establish organizational routines and accumulate experiential knowledge in product manufacturing and marketing over time as the transition progresses. Their profits in early stage of transition reinforce existing organizational routines. Organizational knowledge is also reinforced in all firm activities and, over time, becomes increasingly calcified in organizational practices (Cohen & Levinthal, 1990). As such, these firms are likely to exploit the established routines along with the experiential knowledge and capabilities developed (Grant, 1996; Gersick, & Hackman, 1990). Thus, incumbent SMEs are likely to maintain their relations with governments and business groups as the transition progresses over time.

However, incumbent SMEs have problems in changing the capabilities they have developed earlier due to path dependence (Levitt & March, 1988). The development of new capabilities often involves not merely the learning of new knowledge but also the unlearning of existing knowledge held. Eliminating established organizational practices becomes more difficult as firms institutionalize these practices (Autio, Sapienza, & Almeida, 2000). Therefore, they are less likely to contact foreign firms to learn new technologies and managerial techniques in later stages of the transition.

Proposition 1: Incumbent SMEs are likely to have relations with governments and business groups and are less likely to have relations with foreign firms in the mid-range of the transition.

INSTITUTIONAL EMBEDDEDNESS OF ENTREPRENEURIAL START-UPS

Incumbent SMEs play important roles in the early stage of transition by helping to develop economies through job creation, innovation, improvement of the living standards, etc. (Bartlett, 2001; Brezinski & Fritsch, 1996). Reinforced by the wealth creation of the incumbent SMEs in the early stage of transition, entrepreneurs during the mid-range of the transition are enticed to start new businesses to exploit the opportunities in more liberalized markets (Bartlett, 2001). According to density dependence theory, at this stage in the transition, SMEs have been recognized as a legitimate organizational form; a large proportion of firms in emerging economy transitions are SMEs (Hannan & Freeman, 1989).

By the middle of the transition, the institutional environments have changed, often significantly. As SMEs steadily become a major source of economic development in emerging economies, governments change their policies to promote the development of SMEs (e.g., decreasing the costs of start-up). Formerly centralized state-run banks that were controlled by the government primarily to offer loans to SOEs in which the state (central, provisional, or local government) retains a dominant ownership stake begin to offer loans to the SMEs to stimulate economic development (Boisot & Child, 1996). Research has shown that the state often provides SOEs access to rare and valuable domestic and foreign economic resources in the pre-transition and the early transition stages (Keister, 1998). Yet, in later stages of the transition, the government reduces its ownership and, thereby, places pressure on the former SOE to become competitive and earn profits (Zahra et al, 2000). Further, as governments gradually open financial markets, state-run banks transform to commercial banks, competing on the basis of their capabilities and financial performance. So, SMEs that have demonstrated good financial performance are likely to access financial resources from the banks. Foreign banks also enter emerging economies, providing more channels to obtain financial resources. The developing financial institutions such as IPO markets also provide SMEs with alternatives to obtain financial resources. Thus, it is less important to establish relations with government officials as the transition progresses (Peng, 2003; Peng & Luo, 1996). Firms compete more on the basis of resources and capabilities rather than relations that have provided competitive advantages in the early stage of transition (Peng, 2003).

Further, as the transition progresses, the number of foreign firms entering emerging markets grows at an exponential rate (Peng, 2000, 1999). The rents that first-movers receive in the emerging economies signal that substantial latent values exist in the emerging market. Because of this, foreign firms are motivated to invest in emerging economies (Haveman, 1993). As we argued previously, inflow FDI leads to competition on capabilities in emerging markets. Thus, SMEs in emerging markets need to build their capabilities in order to grow.

Strategy scholars have proposed the notion of syncretic rent-seeking behavior that has been defined as "a firm's strategic orientation to achieve a dynamic balance between competitive and cooperative strategies" (Lado, Boyd, & Hanlon, 1997: 122). Although entrepreneurial start-ups and foreign firms compete with each other, syncretic rent-seeking behavior leads to a collaborate advantage (Lado et al., 1997). Access to financial, technological, and managerial capabilities is valuable to entrepreneurial start-ups in emerging economies to pursue promising market opportunities (Hitt et al., 2004; Zahra et al., 2000). In turn, local market knowledge, strategic and operational flexibility, innovation, entrepreneurial spirit, and the advantage of "newness to learn" are valuable to foreign firms operating in highly dynamic environments (Autio et al., 2000; Park & Luo, 2001). As Sirmon et al. (in press) suggested, "merely possessing resources does not guarantee the development of competitive advantages" Management of resources (i.e., structuring the resource portfolio, bundling resources into capabilities, leveraging the capabilities to create value for customers) contributes to the development and maintenance of competitive advantage. Meanwhile, competition often stimulates innovation necessary to compete in the global competitive landscape (Bettis & Hitt, 1995; Hitt et al., 1997). Many western firms, including powerful MNEs, have penetrated emerging markets. Luo and Peng (1999) indicated that MNEs prefer to have alliances with a diverse set of local partners in order to effectively learn how to compete in the unfamiliar environment.

In the same logic of "syncretic rent-seeking behavior" and resource management, entrepreneurial start-ups and business groups can also benefit from "the positive-sum efficiency-enhancing effects of competition and cooperation" (Lado et al., 1997; Sirmon et al., in press). Business groups hold intangible resources such as the group brand and the know-how to set up a plant and absorb foreign technology. These intangible resources are highly valuable to entrepreneurial start-ups to build their own capabilities (Barney, 1991; Hoskisson & Hitt, 1990). Flexibility, innovation, and advantage of newness to learn provided by the entrepreneurial start-up are valuable for business groups to overcome their rigidities and lack of access to new ideas (Mahmood & Mitchell, 2004).

Proposition 2: Entrepreneurial start-ups are more likely to have relations with business groups and foreign firms than government officials in the mid-range of the transition.

INSTITUTIONAL EMBEDDEDNESS AND INTERNATIONALIZATION OF INCUMUBENT SMEs

Exposed to competitive pressures within their emerging economies in the mid-range of the transition, incumbent SMEs are disadvantaged in competing with resourceful rivals in the local market because the network-based strategy they formed in the early stage of the transition can potentially require too much of their attention and resources. This dilutes their investment in activities (e.g., developing new competitive capabilities) that are beneficial for their long-term performance (Keister, 1998). Thus, they need to find new ways to utilize their current capabilities and to create value.

Internationalization offers emerging market incumbent SMEs a way to create value by exploiting opportunities that exist outside their domestic markets (Zahra & George, 2002b). The aggressive and export-oriented development policies often followed by emerging market governments further induce SMEs to expand into foreign markets (Aulakh et al., 2000; Chang & Hong, 2000). These incumbent emerging market SMEs can also test the knowledge they have learned from partners when they enter international markets. They build experiential and, thus, tacit knowledge in doing so (Hitt et al., 2005). Scholars highlight the importance of entrepreneurial opportunities (i.e., existence, discovery, and exploitation) for firms to create value in new markets (Shane & Venkataraman, 2000; Zahra & George, 2002b). Firms can exploit the information asymmetry that occurs due to differential time and geography to earn entrepreneurial profits.

Yet, SMEs alone may find it difficult to identify foreign opportunities that they can exploit. Strategic management researchers emphasize the importance of environmental scanning to facilitate internationalization (Autio, Yli-Renko, & Salonen, 1997; Zahra & George, 2002b). Evidence indicates that events in the environment generate informational clues that can help firms to expand to foreign markets (Miner & Haunschild, 1995). Firms discover the entrepreneurial opportunities in foreign markets from their environmental scanning. Further, social network theory suggests that networks, such as alliances and interlocking boards, can facilitate environmental scanning through the diffusion of information (e.g., entrepreneurial opportunities in foreign markets) (Galaskiewicz, & Burt, 1991; Haunschild, 1993; Haunschild & Beckman, 1998; Palmer, Jennings, & Zhou, 1993).

SMEs in emerging economies have inherent disadvantages, such as financial resource constraints and the difficulty in obtaining adequate capital. Limited financial resources may hinder SMEs' ability to identify opportunities in foreign markets, and inadequate financial resources also restrict the exploitation of identified opportunities. Further, internationalizing firms are subject to the so-called "liability of foreignness" (Hymer, 1976; Zaheer, 1995; Eden & Miller, 2004). Yet, a substantial number of studies have demonstrated that firms can mobilize resources from their networks to scan the environments for internationalization opportunities (Coleman, 1990). Thus, emerging market firms can overcome the liability of foreignness using their networks to learn from their partners' experiences (Guillen, 2002; Hitt et al., 2005). As a result, SMEs increase their capability to exploit the opportunities that have been identified using their linkages to other firms. Accordingly, SMEs transform their domestic operational routines by incorporating new routines to exploit foreign market opportunities. Zahra and George (2002a) referred to "realized absorptive capacity" (RACAP) as the function of transformation and exploitation. Thus, as SMEs transform their routines to exploit foreign opportunities, they increase their RACAP.

Related to internationalization of incumbent

SMEs in emerging economies, relations with governments and business groups play important roles in opportunity discovery and exploitation to facilitate the expansion to foreign markets. International entrepreneurship researchers have indeed found that extensive networks significantly influence the speed and degree of internationalization (Oviatt & McDougall, 1995; Zahra & George, 2002b).

REALIZED ABSORPTIVE CAPACITY –THE EXISTENCE, DISCOVERY AND EXPLOITATION OF OPPORTUNITY

Governments

Opportunity identification

Government may act as a means of institutionally bridging across markets. Incumbent SMEs and foreign firms not linked by the market, may develop relationships with government entities. In the early stage of transition, governments control foreign trade and investment, and they accumulate information and knowledge about foreign markets through their interaction with foreign firms. Thus, SMEs may obtain relevant information about foreign market opportunities through their relations with governments. Relying on governments to identify foreign market opportunities is also more cost-effective than using a random search model.

Opportunity exploitation

Although SMEs may have financial constraints that hinder their ability to exploit opportunities in foreign markets, they can overcome this liability by obtaining resources from the government. Government officials in emerging economies have discretion in resource allocation through procurement programs, tax incentives, business development assistance, and export assistance (Spencer & Gomez, 2004) and may exercise preferences in the absence of clear property rights. SMEs having effective relations with government officials are more likely to increase their legitimacy and visibility (Oliver, 1996), thus, allowing them to mobilize resources through government-sponsored programs and enjoy privileges stemming from government policies.

As SMEs exploit the identified opportunities in foreign markets, they need to refine their routines to seize new market opportunities. In the process of exploiting opportunities in foreign markets, SMEs accumulate knowledge, partly about new capabilities developed from knowledge learned from various sources (Hitt et al., 2005). Applying the acquired knowledge in new markets yields further tacit knowledge. Venturing into new markets also yields new insights about foreign markets and facilitates identification of additional foreign opportunities. The new knowledge alters the firm and the way it approaches the global competitive landscape (Zahra et al., 2000). Zahra and George (2002a) defined the ability to generate new competencies based on the refined routines as transformation and exploitation, two dimensions of RACAP.

Proposition 3: Allying with governments in emerging markets increases incumbent SMEs' realized absorptive capacity facilitating their expansion into foreign markets.

Business Groups

Opportunity identification

Business groups in emerging economies act as hubs of resources for foreign firms in the early stage of transition when emerging market governments permit only certain business groups to access foreign resources and markets through their trade and investment policies (Guillen, 2002). Having little reliable information about emerging economies in the early stage of transition, foreign investors prefer to invest only in the large and established business groups (Khanna & Palepu, 1997). As the market transition progresses, business groups accumulate knowledge and information about foreign firms and markets. Therefore, SMEs are likely to learn about foreign market opportunities through their linkages with business groups (Guillen, 2002). SMEs may also expand into foreign markets indirectly, by providing factors, interim products, or services to their business group affiliates that establish operations in foreign markets (Khanna & Palepu, 2000b; Shrader, Oviatt, & McDougall, 2000). For example, Samsung Corporation, a general trading company within the Samsung business group, serves as the export window to overseas markets for manufacturing affiliates in the group (Chang & Hong, 2000).

Opportunity exploitation

Incumbent SMEs can also overcome the barriers to access necessary financial, technological, and managerial resources to internationalize by allying with business groups. Incumbent SMEs benefit from cost reductions in acquiring these resources from business groups' internal capital, labor, managerial, and technological markets. While SMEs may not have the capabilities to exploit foreign opportunities, business groups often have experience in foreign market expansion and can share their knowledge of how to exploit those opportunities with affiliated SMEs. Sharing information indicates relational embeddedness (Uzzi, 1997).

Business groups also offer their unique group reputation to affiliated SMEs (Khanna & Palepu, 2000b). Reputation has been viewed as an intangible asset that contributes to a firm's competitive advantage (Barney, 1991; Hall, 1992). First, this reputation facilitates SMEs entry into foreign markets by providing legitimacy and, perhaps, brand recognition. For example, many South Korean firms attempted to access foreign markets using their own resources and brand names. Discovering that they lacked the brand recognition and other internal resources required for rapid internationalization, they formed alliances with large and well-established firms and marketed their products globally under the brand names of the larger firms.

Second, reputation provides cost-efficiencies in internationalization. According to a status-based model of market competition (Podolny, 1993), SMEs linked with business groups can reduce their advertising costs and transaction costs necessary to convince consumers in foreign markets of the quality of their products and services.

Thus, SMEs allied with business groups are more likely to exploit their foreign expansion opportunities successfully. In the process of foreign expansion, such SMEs may be able to transform their domestic operation routines, thereby, adapting to their new businesses in foreign markets. SMEs also learn by doing, accumulating knowledge, and developing their capabilities to implement an international strategy. Reinforced by successful foreign expansion, SMEs are more likely to utilize their refined routines, accumulated knowledge, and capabilities to further exploit opportunities in foreign markets (e.g., other emerging economies or under-developed economies) (Hitt et al., 2005; Yli-Renko, Autio, & Tontti, 2002). Zahra and George (2002a) defined this ability as realized absorptive capability, a capability to leverage the knowledge that has been absorbed.

Proposition 4: Alliances with business groups in emerging markets increase incumbent SMEs' realized absorptive capacity facilitating their expansion into foreign markets.

POTENTIAL ABSORPTIVE CAPACITY AND INTERNATIONALIZATION OF ENTREPRENEURIAL START-UPS

As emerging economies achieve higher levels of economic development, firms tend to compete on the basis of resources and capabilities (Luo, 2003). Yet, although many emerging economies are transitioning to a market system, incumbent SMEs may be less able to operate under free market conditions as they are embedded in their existing business networks (Uzzi, 1996). Reinforced by their success in domestic and foreign markets, incumbent SMEs become committed to these existing operations, persist in using the same routines, and, thus, become inertial and fail to acquire new knowledge. In other words, as their learning becomes more path dependent, especially because of their success, the path dependency jeopardizes their competitive advantage (Lei, Hitt, & Bettis, 1996; Guillen, 2002). Furthermore, incumbent SMEs may find it difficult and costly to discontinue their institutionalized routines and to change their strategy or behavior. Knowledge acquisition and assimilation are two dimensions of potential absorptive capacity that "play an important role in renewing the firm's knowledge base and the skills necessary to compete in changing markets" (Zahra & George, 2002a: p. 196). Potential absorptive capacity is defined as firm's capability to value, acquire, and assimilate external knowledge (Cohen & Levinthal, 1990; Lane & Lubatkin, 1998; Zahra & George, 2002a). Thus, incumbent SMEs are likely to continue utilizing established routines to exploit foreign market opportunities.

However, new entrepreneurial start-ups do not have "structural inertia" because of their newness. Instead, they have strategic and operational flexibility and enjoy the advantages of newly acquired knowledge (Autio et al., 2000). As latecomers in emerging economies, entrepreneurial start-ups need to prove that they are legitimate players with high-quality products and services and also need to differentiate themselves to gain a competitive advantage (Peng, 2003). Thus, they are more intent on learning and have an entrepreneurial mindset unlike incumbent SMEs (Ireland, Hitt, & Sirmon, 2003) and concentrate on developing their distinctive competences (Peng, 2001).

As discussed earlier, embedded relationships can provide firms with opportunities to internationalize and gain rents in foreign markets. More importantly, embedded relationships provide entrepreneurial start-ups the opportunity to acquire and assimilate new knowledge (i.e. potential absorptive capacity) and, thus, to transform and exploit the knowledge (i.e., realized absorptive capacity) to develop a competitive advantage in domestic and foreign markets. While learning may facilitate the development of core competencies (Lei et al., 1996), Sirmon et al. (in press) argued that continuous learning is necessary for firms to establish a series of temporary competitive advantages in order to sustain a competitive advantage over time.

In sum, entrepreneurial firms not only exploit foreign market opportunities offered by their allied business groups and foreign firms but, also, create opportunities to expand into foreign markets through their entrepreneurial efforts of offering new products and services.

Potential Absorptive Capacity

Relations with foreign firms - knowledge acquisition and assimilation capability (Potential absorptive capacity)

As entrepreneurial start-ups need to develop advanced technology and managerial capabilities to gain a competitive advantage, they are more likely to establish relations with prestigious foreign firms that offer cutting-edge technologies. Accumulating advanced technology in the early stage broadens the entrepreneurial start-ups' knowledge base and increases their capability to assimilate new knowledge. According to Zahra and George (2002a), knowledge accumulation and assimilation are two dimensions of potential absorptive capacity.

As emerging markets become more open, their investment potential attracts many competitive foreign firms. Foreign firms are not only competing against the increasingly strong local firms (e.g., SOEs, business groups) but also against other foreign firms (Hitt et al., 2005). As a result, foreign firms need to continuously offer innovative solutions to local customers in order to gain a competitive advantage in emerging markets and the global market. Thus, they are likely to engage in exploratory learning in addition to exploitive learning in emerging markets to provide new products or services that cater to the idiosyncratic preferences and needs of local consumers (Hitt et al., 2005). Indeed, many foreign firms have started to develop R&D centers in emerging economies (Li, Holmes, & Hitt, 2005). Additionally, foreign firms have begun to explore the business opportunities that had not been tapped at the base of the economic pyramid in emerging markets (London & Hart, 2004; Hitt et al., 2005). Accordingly, foreign firms tend to focus more of their attention on an innovative orientation and/or capabilities, in addition to market knowledge and social capital, when seeking appropriate local partners (Hitt et al., 2000; Li & Atuahene-Gima, 2001).

Compared to business groups and incumbent SMEs, entrepreneurial start-ups are more flexible and innovative because of their entrepreneurial mindsets (Ireland et al., 2003). They are better able to recognize entrepreneurial opportunities in local markets in which new goods and services can be introduced to create or satisfy customer demand. Large firms and incumbent SMEs are strongly influenced by institutionalized routines, accumulated resources, and capabilities that contribute to core rigidities. "Core rigidities are inflexible capabilities that in part disallow acquiring new resources that can be bundled into value-creating capabilities" (Ireland et al., 2003: 978). As such, core rigidities stifle innovation and lead to organizational inertia (Leonard-Barton, 1995). Therefore, it is expected that foreign firms will tend to establish linkages with entrepreneurial start-ups to seek collaborative rents because resources (e.g., technologies, managerial skills, financial capital) from one party cannot generate rents in emerging economies without utilizing the resources from the other party (Lado et al., 1997).

Because foreign firms are generally concerned that their knowledge will be expropriated by local partners, they are generally unwilling to share their core competences with local firms in the early stages of cooperation. However, as firms gain more knowledge about each other and establish trust and reciprocity over time, foreign firms and entrepreneurial start-ups are more willing to share valuable resources and cooperate closely to achieve collective benefits. These efforts facilitate effective knowledge transfer between them.

Although entrepreneurial start-ups may not have significant absorptive capacity, foreign firms accumulate considerable experience in transferring their knowledge and capacities to their partners and may devise a formal means for transferring that knowledge (Hitt et al., 2005). Close working relationships (i.e., relational capital) further facilitate the knowledge transfer between them (Hitt et al., 2005; Lane & Lubatkin, 1998). As a result, entrepreneurial start-ups expand their knowledge bases (i.e., potential absorptive capacity) that increase their capability to comprehend new information, knowledge, and capabilities (Cohen & Levinthal, 1990). Their entrepreneurial mindsets help them to identify new opportunities that will contribute to value creation (Ireland et al., 2003). Additionally, entrepreneurial start-ups also accumulate knowledge acquisition and assimilation experiences and, thus, formalize a developed and refined routine or process to acquire and assimilate external knowledge, which increases potential absorptive capacity continuously (Zahra and George, 2002a).

Hitt et al. (in press) found that relational capital with prestigious clients did not help a firm enter foreign markets unless the firm had strong resources (e.g., human capital). Thus, we expect that as entrepreneurial start-ups develop their absorptive capability by acquiring and assimilating knowledge from foreign firms (knowledge held by their human capital), they are able to exploit or explore opportunities in foreign markets.

Further, Perrow (1961) indicates that if a firm is well regarded, it more easily attracts other firms to invest in it. Entrepreneurial start-ups establishing a close relationship with prestigious foreign firms are likely to enter a diverse knowledge network because prestigious foreign firms tend to occupy the hub of the networked firms and knowledge diffuses throughout the network (Peng & Heath, 1996). Zahra & George (2002a) suggested that diverse and complementary knowledge is the antecedent of potential absorptive capacity. Because of the diverse knowledge possessed by prestigious foreign firms, entrepreneurial start-ups are likely to increase their potential absorptive capacity as well.

Proposition 5: Alliances with foreign firms increase entrepreneurial start-ups' potential absorptive capacity.

RELATIONS WITH BUSINESS GROUP–KNOWLEDGE ACQUISITION AND ASSIMILATION CAPABILITY (POTENTIAL ABSORPTIVE CAPACITY).

In the early stage of transition, foreign firms invest in emerging markets to gain rents but are fearful that their advanced technology will be expropriated (Khanna & Palepu, 1997). As a result, foreign firms are more likely to invest in business groups because the groups are less likely to put their reputation at risk to expropriate advanced technologies. Therefore, business groups in emerging markets play a major role in acquiring and assimilating advanced technology from foreign firms. Thus, business groups form their technological bases (Amsden & Hikino, 1994). Accordingly, business groups tend to use these technologies and their rich internal resources (e.g., internal capital markets, distribution channels) to develop innovative products and services to cater to local consumer tastes. Over time, they may build the routines and skills necessary to produce innovations and to gain rents. However, these routines engender organizational inertia that is detrimental to business groups' competitiveness in the increasingly competitive emerging markets.

Studies have shown that new firms contribute to the generation of new ideas and radical breakthroughs (Shan, Walker, & Kogut, 1994). As a result, these new firms are likely to enjoy transient monopoly advantages and gain abnormal profits, thus, challenging business groups' market power through exploiting new ideas and radical breakthroughs (Ireland et al., 2003).

Perceiving the potential business opportunities in the entrepreneurial start-ups, business groups are likely to develop ties with them. Furthermore, although entrepreneurial start-ups can produce innovative ideas, they often do not have the resources to commercialize their ideas (Teece, 1996). To access needed capital, entrepreneurial start-ups may be willing to transfer partial ownership to or even be acquired by business groups. By doing so, entrepreneurial start-ups and business groups can share the rents of innovations.

Because business groups frequently include a range of firms operating in a variety of industries (Guillen, 2000), entrepreneurial start-ups, as members of business groups, can mobilize resources from the business groups' networks. Thus, entrepreneurial start-ups can enhance their capability to acquire and assimilate new knowledge from the broad knowledge base available in the business group network (Cohen & Levinthal, 1990; Ireland et al., 2003; Zahra & George, 2002a). According to social identity theory, business group members tend to cooperate with each other, providing support for and commitment to the business group. Loyal, committed, and trustworthy group members facilitate the knowledge transfer, which increases entrepreneurial start-ups' absorptive capacity (Kane, Argote, & Levine, 2005).

Proposition 6: Alliances with business groups increase entrepreneurial start-ups' potential absorptive capacity.

POTENTIAL ABSORPTIVE CAPACITY AND REALIZED ABSORPTIVE CAPABILITY TO INTERNATIONALIZE.

Zahra and George (2002a: 190) defined knowledge transformation as "the ability to recognize two apparently incongruous sets of information and then combine them to arrive at a new schema". Acquired and assimilated knowledge expands the entrepreneurial start-ups' knowledge base, enhancing their capability to combine previously unconnected elements to create new knowledge (Nahapiet & Ghoshal, 1998). Although entrepreneurial start-ups may not need resources and capabilities to exploit new knowledge, their allied firms (e.g., foreign firms and business groups) have the capabilities to do so. Moreover, their allied firms have international networks and, thus, may have the ability to exploit entrepreneurial opportunities in other markets, thereby, gaining transient monopoly rents (Ireland et al., 2003).

Additionally, entrepreneurial start-ups are likely to identify opportunities in foreign markets of which allied firms are unaware because of their size and lack of entrepreneurial thinking (Cohen, & Levinthal, 1990; Ireland et al., 2003). Because entrepreneurial start-ups tend to excel at opportunity-seeking, allied firms may pay attention to entrepreneurship start-ups' actions.

Moreover, some entrepreneurial start-ups with limited resources can exploit foreign market opportunities independently. For example, they may exploit the opportunities in other emerging or under-developed economies where fewer resources are needed. Their home market experiences are transferable to these institutional similar environments (Wright et al., 2005).

Alternatively, entrepreneurial start-ups can increase their visibility and reliability to consumers in foreign markets, particularly in developed markets when the start-ups are allied with prestigious foreign firms and business groups. The prestige of foreign firms and business groups spills over into the inter-organizational networks (Podolny & Phillips, 1996). Sociologists have argued that firm performance in markets is affected by the status levels of their close associates (Podolny, 1994; Baum & Oliver, 1991). As a result, the possibility to export their products to or establish an international alliance in foreign markets increases when entrepreneurship startpups are allied with prestigious foreign firms and business groups (Podolny, 1993). Entrepreneurial start-ups' networks with foreign firms and business groups can provide them with the knowledge necessary to pursue foreign market opportunities and, thus, reduce uncertainty surrounding foreign expansion (Guillen, 2002). Entrepreneurial start-ups can obtain timely, useful, and reliable information and know-how to solve the problems in the process of foreign expansion (Beckman & Haunschild, 2002). Therefore, entrepreneurial start-ups allied with foreign firms and business groups increase their own capabilities to exploit identified opportunities in foreign markets.

Additionally, given that potential absorptive capacities are captured in entrepreneurial start-ups' unique network capabilities, these flexible entrepreneurial start-ups are likely to transfer this domestic network capability to foreign markets (i.e. emerging markets, under-developed markets). In so doing, they develop international networks to acquire resources and capabilities in these foreign markets over time, thereby, increasing their realized absorptive capacity (i.e., transformation and exploitation) in foreign markets (Barkema, Shenkar, Vermeulen, & Bell, 1997).

Proposition 7: Entrepreneurial start-ups' potential absorptive capacity is positively related to their realized absorptive capacity to expand to foreign markets.

DISCUSSION

Contribution and Implications

Traditional internationalization theories have provided useful frameworks to explain why and how resourceful and competitive MNEs, based in developed economies, exploit their capabilities in foreign markets (Dunning, 1988; Hymer, 1976; Johanson & Vahlne, 1977; Vernon, 1966). Traditional theories, however, assume that firms moving into international markets are resource-endowed and technologically advanced. Under these theories, MNEs can overcome their liability of foreignness by exploiting their capabilities to establish a competitive advantage and gaining rents in foreign markets (Eden & Miller, 2004; Hymer, 1976). Counter to the assumptions in traditional internationalization theories, firms in emerging economies generally are less resource-endowed and technologically advanced. Therefore, the traditional theories do not effectively explain how firms based in emerging economies internationalize successfully. The theoretical arguments presented herein complement the traditional internationalization theories that dominate in the field of advanced economies by exploring how SMEs in emerging economies expand into foreign markets.

We make several contributions in this work. First, we have argued that institutional environments are critical to understanding how SMEs in emerging economies can expand to foreign markets. We adopted an institutional embeddedness perspective to explain how SMEs in emerging economies internationalize to grow and to gain rents in global markets. The institutional perspective is especially important in understanding these firms given their liability of smallness and difficulty in accessing resources in emerging economies (Granovetter, 1985; Oliver, 1996; Uzzi, 1996).

We discussed the differences between the internationalization of incumbent SMEs and entrepreneurial start-ups. According to organizational ecologists, organizations' survival chances are sensitive to the population density levels at the time of their founding (Baum, 1996). We propose that incumbent SMEs are likely to imprint their established institutional relations in the early stage of transition that, in turn, affects their strategic behavior (e.g., internationalization) in the middle stage of transition. Yet, entrepreneurial start-ups tend to be embedded in different institutional relations that focus on developing competitiveness; competition in the middle stage of transition is based on resources and capabilities rather than on networks, as in the early stage (Peng, 2003).

Additionally, Uzzi (1996) argued that firms increase their survival capability by tapping the opportunities in their embedded exchange networks, but that the benefits decrease beyond a threshold where embedded networks are inertial and create path dependencies that disallow acquisition of new knowledge and support a strong commitment among embedded firms to the status quo. We employ ecological thinking to extend the embeddedness perspective and propose that whether firms become trapped by their embedded networks depends on their founding environments. Although incumbent SMEs are likely to be constrained by the opportunities available in their embedded relationships, entrepreneurial start-ups develop their potential absorptive capability. Because of this, start-ups have the ability to continually revamp their knowledge base to create and exploit new opportunities in global markets.

Second, our model complements internationalization theory. The approach presented herein suggests that competitive capabilities are necessary for firms to create value in international markets. However, firms' strategic actions in emerging economies are influenced by an institutional reality that is uncertain and biased in favor of special interest groups (Hoskisson et al., 2000). Institutional relations determine whether firms are able to access rare and valuable resources and advanced knowledge to develop their competitive capabilities. Therefore, our model emphasizes the important role of institutional embeddedness in firms' internationalization.

Third, we extend our understanding of absorptive capacity by emphasizing its importance for internationalization. In particular, we adopted the potential and realized absorptive capacity constructs (Zahra & George, 2002a) to explore how different types of institutional embeddedness can lead to potential or realized absorptive capacity. In our model, institutional embeddedness of incumbent SMEs helps to build realized absorptive capacity; institutional embeddedness of entrepreneurial start-ups helps to build potential absorptive capacity. Potential absorptive capacity is critical for firms to gain and sustain competitive advantages in international markets because it allows firms to enrich their capabilities (Zahra & George, 2002b).

Fourth, our research contributes to the entrepreneurship and SME research streams. Entrepreneurial researchers have suggested that an international network is critically important for new SMEs to internationalize (Oviatt & McDougall, 1995). However, our framework suggests that domestic institutional networks in emerging economies also play an important role for SMEs to internationalize. SMEs in emerging economies are likely to identify opportunities to internationalize from their embedded institutional networks (Cohen & Levinthal, 1990). Although researchers argue that embedded institutional networks may constrain firms' strategic actions, we suggest that SME's embedded institutional networks facilitate their internationalization by providing resources and opportunities.

Future Research Directions

As Sirmon et al. (in press) emphasize, value creation depends not merely on holding valuable resources but also on the effective management of those resources. Although incumbent SMEs and entrepreneurial start-ups have relations with business groups, our model shows that they develop realized and potential absorptive capacities, respectively. Future research is needed to understand how incumbent SMEs and entrepreneurial start-ups manage their institutionally embedded relations, thereby, allowing them to develop different types of absorptive capacity.

It is also worthwhile to investigate whether incumbent SMEs are likely to be constrained by familiarity traps based on their current competencies and how they restructure their resources to overcome inertia to sustain their competitive advantage in the long run. As Sirmon et al. (in press) proposed, firms need to create a series of temporary competitive advantages to sustain an advantage over the long term. This requires firms to continuously create new value for their customers and, in turn, create value for the firm's owners.

Finally, it is important to empirically test the propositions presented herein. We suggest that researchers conduct empirical research in diverse emerging economy countries because institutional environments in emerging economies are not homogenous as exemplified by countries undergoing massive privatization and countries experiencing gradual transition (Hitt et al., 2004). Such studies can provide a richer understanding of how various institutional environments in emerging economies influence the internationalization of SMEs.

In conclusion, we have presented an integrated model to show how SMEs in emerging economies internationalize. We suggest that embedded institutional relations are critical resources for SMEs in emerging economies. SMEs can utilize this resource to overcome their liabilities in the process of internationalization and to identify, create, and exploit opportunities to internationalize. Our work provides a value-added contribution to research on internationalization of SMEs in emerging economies.

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