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Transaction services and SME internationalization: The effect of home and host country bank relationships on international investment and growth

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ABSTRACT

Building on the argument put forward by North and Wallis (1994) that the transaction sector enables economic growth by lowering the costs of transacting, we investigate how internationalizing firms' host and home country bank relationships affect their international specific investments and growth. Banks provide payment, liquidity, and risk management services, which are essential to international business relationships, yet little is known about how banks affect international business relationships. In a sample of 255 small and medium-sized enterprises (SMEs), we find that host and home country bank relationships affect the dependent variables differently. We contribute to the literature by explicating the role and effects of banks in international business relationships. Our findings have implications for understanding transaction services in international business as well as the choices made by their customers.

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1. Introduction

Understanding how the institutional environment affects firms' internationalization is central to international business (e.g. Hernádes & Nieto, 2014). The extant literature covers two main streams of research in this area: International business researchers drawing on economic institutional theory (North, 1991) use the aggregate properties of the institutional environment (Meyer, 2001) to explain the internationalizing firm's investments, choice of governance, and entry mode (Luo, 2005; Williams & Martinez, 2012). Researchers adopting the institutional perspective in organization theory have shown the importance of congruence with evolving norms and practices for firm performance (Davis, 2000; Kostova, Roth, & Dacin, 2008; Meyer & Peng, 2005; Powell, 1990). We do not question the important contributions made by this research. Rather, we wish to draw attention to a missing element in the discourse: the global transaction services organizations, which embody important aspects of the institutional environment and are important contributors to the growth of international business (North & Wallis, 1994). Despite their likely importance, their role and effect on their customers have been mostly ignored in the international business literature.

The transaction service sectors include public and private *transaction organizations* (North, 1991)—that is, organizations that provide services that reduce transaction costs (cf. Hall and Biersteker, 2002; North, 1991; North & Wallis, 1982). Banks represent an important category of such organizations. They specialize in screening and monitoring economic agents (North, 1991; North & Wallis, 1982) and supply firms with credit and other financial services (Hirsch & Lounsbury, 1996; Hoskisson, Eden, Lau, & Wright, 2000). Banks are particularly important to small and medium-sized enterprises (SMEs), which typically lack direct access to capital markets and, therefore, depend more on banks for financing than larger firms do (De Maeseneire & Clays, 2012).

In this paper, we examine how internationalizing SMEs' host and home country bank relationships affect the development and growth of international business relationships. Our study responds to calls for research linking macro-level factors to

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relationship-level international activities (Cantwell, Dunning, & Lundan, 2010; Johanson & Vahlne, 2009; North & Wallis, 1982).[2]

Transaction services are important to the growth and organization of the modern economy (North & Wallis, 1994). Primarily, we contribute, theoretically and empirically, by explicating the role and testing the effect of banks, an important class of transaction service organizations, on international business relationships. Secondarily, we contribute to the well-established stream of research examining how firms overcome the liability of foreignness (Meyer, Mudambi, & Narula, 2011; Peng & Ilinitch, 1998; Zaheer, 1995). Our findings have implications for understanding how transaction services affect international business as well as the choices that customers make.

The remainder of our paper is organized as follows: first, we develop the theoretical link between transaction organizations and international business relationship development. Second, we develop theory and hypotheses regarding how transaction organizations generally, and banks specifically, influence relationship-specific investments and growth, directly and indirectly. The independent variables are SMEs' relationships with host and home country banks and other host country organizations that provide institutional services. Relationship-specific investments and growth are the dependent variables. Third, we present data and methods, followed by our results. We conclude with a discussion of the findings and their implications for research and practice.

2. Institutions, transaction services, and economic growth

Institutions are humanly devised constraints that structure political, economic, and social interactions by providing dependable frameworks for economic exchange. They are manifest in a well-specified legal system, an impartial judicial party of government designed to enforce property rights, and a set of norms and attitudes that, taken together, reduce the cost of transacting (North, 1986, 1990, 1991, 2005). When institutions are effective, firms grow by realizing gains from both domestic and cross-border trade (Cantwell et al., 2010; North, 1990; North & Wallis, 1994).

2.1. Transaction services and economic growth

Economic growth results from specialization, division of labor, and innovation (cf. Romer, 1994; Solow, 1956). There are transaction costs that are associated with the implied exchanges. Typically, these costs are assessed only indirectly by their effect on choice of institutions governing the transactions (Williamson, 1975, 1985). In mainstream transaction cost theory, institutions are seen as responding to – rather than creating – firm opportunities (North & Wallis, 1994; Wallis & North, 1986). North and Wallis (1994) suggest extending Coase's (1937) transaction cost argument to allow for institutional change to drive firm changes. Specifically, they propose that changes in the productivity of transaction services affect economic growth. Taking a firm-level perspective, they argue that lowered costs of transacting enable firms to make changes to their value creation,[3] which improves productivity and leads to economic growth. To exemplify their argument, they refer to Chandler's (1977), Chandler's (1987) seminal work, which documented how major innovations in the transportation and communication sectors had their most important impact on directly reducing transaction costs. They propose a theoretical framework in which firms not only choose institutions to minimize transaction costs but also simultaneously choose institutions and technology to minimize total costs. In their proposal, North and Wallis (1994) specifically highlight the importance of transaction services, such as banking. These services embody important institutions, the effects of which are transmitted to other industries. As an example, they describe how the development of new financial services in investment banking dramatically altered the internal structure of firms in other industries.

From a transaction cost perspective, institutions are predominately viewed as efficient solutions to problems of organization (Williamson, 1975, 1985) and are chosen to minimize transaction costs (Coase, 1937). In accordance with this perspective, international business researchers have studied the formation and governance of interfirm relationships in response to properties of the institutional environment (e.g. Santangelo & Meyer, 2012). By contrast, firms strive to decrease *all* costs—both the cost of transforming input to output and the cost of exchange (North & Wallis, 1994). Taking both types of costs into consideration, firms choose technologies and institutions simultaneously so as to enhance the rate of growth. Thus, the institutional environment, in particular transaction services organizations, must be viewed as an independent source of growth (North, 1991; North & Wallis, 1994). Transaction service organizations represent an important, yet understudied, element of the institutional environment, with a potential direct impact on the growth of individual firms in their local and international relationships.

2.2. Transaction services reduce the cost of transacting

Transaction costs are a substantial component of costs faced by firms, but only those paid for in the market are directly observable. Wallis and North (1986) suggest that lowered costs of transacting resulting from the development of effective transaction services may have been as important to economic growth as the increased efficiency of production typically considered by economists. They reverse the classical analysis of economic growth by proposing that

Until economic organization developed to lower the costs of exchange we could not reap the advantage of ever greater specialization. The development of specialized banking, finance, trade, and other transaction functions are the necessary requirements for enhancing productivity (p. 121)

Transaction services represent transaction costs that result in a market exchange. They are an important part of the institutional matrix – described by North (1991) as "an interdependent web of institutions and consequent political and economic organizations that are characterized by massive increasing returns" (p. 109) – and encompass services such as finance, insurance, real-estate brokerage, wholesale trade, and retail trade (Wallis & North, 1986). Transaction services constitute a large and growing portion of the gross national product in developed economies (North, 1990, 1991; Wallis & North, 1986). Taken together, institutions and

[2] In their discussion on transaction costs that are visible through activities performed by transaction organizations such as banks, North and Wallis (1982) state the following:

> Economic historians and economists should address themselves to analyzing the basic costs of organization that accompany specialization; they should examine the links between these increasing transaction costs and the growth of transfers; and finally explain what determines whether these activities to reduce transaction costs are undertaken by firms, in the market, or by government (p. 340)

[3] North and Wallis use the terms technique and production functions to describe how firms organize their activities and "[. . .] raise the productivity of transformation inputs]" North and Wallis (1994, p. 617). Since Porter (1985) uses the similar terms to describe value creation, we have chosen to use the latter, more current term where we deem that appropriate

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