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Abstract

The Internet has the potential to improve the efficiency of market transactions. By use of the Internet companies can reduce their search costs significantly and increase their ability to respond flexible to new market opportunities as a result of reduced sunk costs. On the basis of internationalization theory and agency/transaction cost theory the paper examines the effects of the Internet on foreign market expansion by firms.

These theoretical issues and possible effects on internationalization are illustrated through the presentation of three general predictions regarding possible outcomes.

The predictions demonstrate that a range of foreign expansion effects of the Internet is likely: from limited impact to rapid, widespread global expansion in many cases.

The Internet may contain a challenge to mainstream internationalization theory in regard to the role of knowledge: instead of acting as an initial constraint it may be a factor that propels firms into foreign market expansion.

Introduction

An important aspect of recent information and communication technology advances is the Internet and the World Wide Web (hereafter we will only refer to the Internet, implicitly including the WWW). The Internet is expected to have a major impact on the business world (Business Week 1996; The Economist 1999). Unlike other existing media, it has truly global reach and is predicted to re-define the way business is conducted (Sivadas/Grewal/Kellaris 1998). This is not only because of the speed and ease with which the Internet conveys information across borders. In the early nineties, before the Internet took off, many multinational corporations introduced Electronic Data Interchange (EDI) systems as a means of achieving fast and smooth communication. This was not only among the dispersed units of the corporation, but also between the corporation and its worldwide network of core suppliers and main customers (The Economist 1999, 2000a; Mol/Kopius 1999). In contrast to the EDI, the Internet is a public and potentially all-embracing, global network. With full utilization of its network externalities, the Internet's searching properties are immense. As such, the Internet holds the potential of reducing the uncertainty associated with doing business in foreign markets. Since the uncertainty about foreign markets (as perceived by firms' decision-makers) has been considered a major barrier to foreign market expansion, in the hands of international managers the Internet may be an instrument that accelerates foreign market expansion.

Thus, marketing scholars have underscored the potential of the Internet to reduce substantially the search costs of companies and consumers, particularly in the case of goods and services with 'digital attributes' (Bakos 1997; Lal/Savary 1999). In addition, the Internet provides opportunities for almost costless distribution of

information goods. All in all, the Internet has the capacity to significantly increase the efficiency of market transactions. It may even enhance the learning process about international operations through faster and more extensive access to relevant information. In this respect, it could change the nature of the internationalization process and the underlying character of learning-by-doing stressed as a key component of internationalization theory.

Nevertheless, information asymmetry can be difficult to bridge in the international arena. Internationalization theory has a tradition of emphasizing the importance of tacit knowledge about how to do business in foreign markets, and it is still an open question as to the extent that the Internet will facilitate the creation, transfer and retention of such knowledge. Furthermore, uncertainty about the credibility of international information and sources via the Internet may exacerbate information asymmetry. There is doubt about how readily uncertainty-reducing measures – such as branding – can be extended across national borders. Thus, a company may mitigate buyers' aversions to doing transactions on the Internet by virtue of its well-established brand name, but there are very few firms that operate global brands (Boze/Patton 1995). In the business-to-business market, buyers request and expect references, and in a domestic setting, this appears to be an effective standard procedure capable of reducing uncertainty about a prospective supplier. In an international business-to-business context, the reference procedure does not always work because references to domestic companies may be of less use in relation to foreign transaction partners. In comparison with domestic business transactions, information asymmetry is more fundamental in international business transactions and the measures to reduce this asymmetry have to be accordingly stronger.

Hence, in spite of the forecasts of huge impact, the effect of the Internet on firms' foreign market expansion is disputable and far from obvious. In this paper we outline three different predictions of how the Internet may affect (or not affect) firms' foreign market expansion, including the speed of initial entry into foreign market operations Thus, our focus is on exporting firms in the early stages of internationalization rather than on well-established multinational corporations. Furthermore, we focus on the geographical pattern of foreign market expansion more than the pattern of resource commitment to individual foreign markets, including firms' choice of foreign operation mode.

The paper is organised in the following way: In the next three sections the different predictions are outlined and related to existing positive and normative theories of foreign market expansion. Thereafter we discuss whether the three predictions are competing or complementary. The final section, conclusion and managerial implications, includes an evaluation of the role that the three predictions assign to knowledge in the internationalization process of firms.

PREDICTION ONE: Modest Internet Effect on Foreign Market Expansion

The first prediction is that, apart from firms operating in some special product markets (commodities and certain Internet-transferable products - see later), the Internet effect on firms' foreign market expansion will be very modest. While the Internet offers indisputable advantages in terms of facilitating repeat buying

transactions across borders, company managers will find that it is an unsuitable medium when it comes to new task buying and selling transactions. The support for this postulate can be found in mainstream internationalization theory (the Internationalization Model) as well as in agency theory (the Hidden Information Model).

Underlying PREDICTION ONE is the argument that foreign market penetration through the Internet, as a general rule, is not feasible, simply because market penetration requires a local presence. Conducting export business exclusively through the Internet may, at best, allow for a skimming of foreign markets, but certainly not penetration. In other words, if companies rely on the Internet as their sole international transaction medium they will sacrifice most of the sales potential of foreign markets.

Very few products can be sold on a global scale without some modification to local customer needs and/or in response to government regulation, and the modification process is often difficult to carry out without a local presence. Modification does not restrict itself to the adaptation of the physical product, but encompasses physical distribution, marketing, sales and after-sales activities as well. A few product markets, however, are characterised by a minimum need for modification when sold internationally, either because they are very generic and commodity-like by nature (a raw material such as crude oil is an obvious example), because the product market consists of unique, but very universal products (English literature, CDs, etc.), or because the processing, marketing, transfer and final consumption of the product takes place electronically (e.g. computer software).

Internationalization theory arguments:

Mainstream theory on firms' internationalization considers information and knowledge to be critical resources for the international expansion of the firm. IB-scholars have underscored the importance of information obtained through business experience as decisive for the speed with which the firm's internationalization advances (Johanson/Vahlne 1977; Welch/Luostarinen 1988; Ursic/Czinkota 1984; Denis/Depelteau 1985; Reid 1984). Experiential knowledge is acquired through action and is not easily expressed formally and transmitted to others; it is to a large extent tacit and implicit. In contrast, objective knowledge is acquired through standardized methods of collection and transmission of information (von Hayek 1937; Penrose 1959; Polanyi 1966). Clearly, the Internet has a vast potential for facilitating firms' acquisition of objective knowledge, whereas its role as a provider of experiential knowledge is much more questionable. Of course, use of the Internet in international operations also can be assumed to demand the development of various forms of experiential knowledge (eg how to deal with customers in high context cultures) that may constrain the rate and pattern of market expansion. Thus, it is an open question as to whether the Internet qualifies as a medium for accumulation of experiential knowledge. If not, the Internet should be allotted a minor role as an agent of internationalization

Agency and information theory arguments:

Normally, the acquisition of market-specific knowledge is assumed to reduce perceived market uncertainty. Indisputably, the Internet expands the quantity of data and information accessible by, and manageable for, decision-makers, but does not

necessarily enhance the quality of the data or the amount of useful information that may qualify as knowledge (Dretske 1981; Nonaka/Takeuchi 1995.

Apart from aggravating the risk of information overload of managers subject to bounded rationality, the Internet also creates opportunities for creating a virtual reality that decision-makers misconceive to be how business life in the broad actually functions. As an example, company home pages constitute a new, easy-to-access source of information available to firms looking for foreign business partners. Seemingly, in this form, the Internet is an uncertainty-reducing information source (Sullivan 1999). However, the Internet will also be an electronic arena for those who are prepared to misinform potential, information seeking business partners about their qualifications. Hence, companies searching for business partners on the Internet face an adverse selection problem (Akerlof 1970) in as much as the opportunities for false signalling (Spence 1973) have been improved with the emergence of the Internet. Barua/Savindran/Whinston (1997) demonstrate how the costs of evaluating potential suppliers identified through the Internet may be substantial.

Thus, the Internet may appear to be a poor foreign market expansion instrument due to adverse selection problems (low perceived credibility) and because of its shortcomings in terms of mediating experiential knowledge. Accordingly, company managers are likely to be more inclined to follow a foreign market expansion strategy of concentration (Ayal/Zif 1979) or concentric expansion (Lee/Yang 1990), i.e. concentration of company resources in a few foreign markets with gradual expansion into countries of successively greater home country dissimilarity.

PREDICTION TWO: The Internet Induces Faster "Foreign" Market Expansion

The second prediction is that, over time, the Internet will evoke faster foreign market expansion of firms in contrast to PREDICTION ONE. In other words, PREDICTION TWO promotes a much more optimistic view of the Internet's capabilities and impact on foreign market expansion. The optimism is based on three main factors: (1) international transaction efficiency; (2) experiential learning; (3) reduced sunk costs.

(1) *Increased transaction efficiency*

An important component of transaction efficiency for internationalizing companies will be the reduced search costs associated with locating international customers and from the customers' perspective the increased exposure made possible through the Internet. It will also accelerate internationalization because of the increased speed of contact with potential foreign customers. It will also enhance this process because of the instant contact that the Internet enables with a wider range of customers and countries.

While in this second prediction the adverse selection problem of the Internet is recognized, it is assumed that the problem can be mitigated through various instruments and institutions. Thus, searching via the Internet should reduce the cost not only of identifying potential buyers and suppliers, but also of evaluating them (Business Week 1996; Mol/Koppius 1999). In this regard, it can be expected that

companies will develop Internet-related routines, as a result of their experiences, for assessing information obtained via the Internet, and evaluating potential clients.

(2) *Experiential learning*

Internationalization theory has a strong emphasis on experiential learning as an important factor in firms' internationalization. PREDICTION TWO acknowledges the importance of experiential learning and argues that the Internet facilitates the process and managers take account of this.

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Insert Figure 1 about here

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Internet-based activities in the international arena can be expected to generate experiential learning in a way that enhances those operations (see Figure 1). Even if international operations are totally internet-based, staff will be required to develop a range of techniques for handling foreign clients and cross-cultural exchanges through the Internet, for example in coping with language differences. Dealing with clients from high context cultures over the Internet may be particularly demanding, requiring the development of special skills. This learning process, though focused on Internet use, is likely to have spillover effects to more traditional forms of international operations, as also in the reverse direction (see Figure 1). Many cross cultural communication lessons (e.g. surrounding language differences) learned on the Internet may be readily applicable in face-to-face situations. The magnitude and form of the experiential learning and spillover effects in both directions between Internet-

based and conventional international business activities are somewhat unclear at this stage, but are likely to be an important new ingredient in the internationalization processes of companies. As Figure 1 illustrates, experiential learning provides critical feedback into the ongoing activities of internationalizing companies.

(3) *Reduced sunk costs*

As an extension of Levitt's (1983) argument about globally converging demands, PREDICTION TWO advances the idea that the Internet facilitates the development of global customer segments. Furthermore, the Internet holds the potential for catering to these customer segments to their full extent. Given the existence of an unexploited need for standardized, but price competitive and easy accessible products, companies *can* penetrate foreign markets via the Internet without involving themselves in substantial and irrevocable foreign direct investments. In this way, the sunk investment proportion of firms' international market expansion is reduced.

The opportunities for Internet-mediated foreign market penetration are substantial across industries and are not limited to a few, 'special case' product markets, as claimed in PREDICTION ONE. Recently, many business-to-business markets have appeared amenable to Internet exchange. By March 2000 more than 20 product markets, at a combined value of more than US $ 100 billion, were trading publicly on the Internet and this figure is expected to multiply in the years to come (The Economist 2000a). Moreover, the Internet exchange is not restricted to very standardised, commodity markets, but includes fairly sophisticated products, such as dental equipment, gas-valve supply chains, and car components (The Economist 2000a). Furthermore, the range of products that can be transferred via the Internet

(not involving any physical transportation) might increase to a substantial proportion of world trade. Many services, such as business consulting and higher education, hold great potential for international exchange.

A conclusion flowing from PREDICTION TWO is that the Internet will pull companies in the direction of *diversified* foreign market expansion (Ayal/Zif 1979), that is, rapid and simultaneous or closely spaced entry into a large number of foreign markets. Concentric patterns of market expansion precipitated by the decision-maker's psychic distance will be absent or difficult to find.

PREDICTION THREE: The Internet Causes Rash Foreign Market Expansion

PREDICTION THREE envisages a situation of a temporary overconfidence in the Internet's attributes as an international business transaction medium. The hype surrounding the Internet and e-business may hinder managers as a whole in reaching a balanced assessment of Internet opportunities. A bandwagon effect similar to what has been observed in relation to foreign direct investment behaviour (Knickerbocker 1973; Shaver/Flyer 2000) cannot be excluded. Di Maggio/Powell's (1983) description of mimicry in the strategic behaviour of firms may also apply to the use of the Internet and international market expansion. Furthermore, excessive investment in new technology has been reported in connection to the introduction of railways in Britain and other European countries in the 19th and 20th century (see for example Cipolla 1973). A more recent example is the over-investment in the 1980s and early 1990s in computer hardware and software (and correspondingly insufficient

investment in the development of employee computer skills) by US and European companies (The Economist 2000b/2000c).

PREDICTION THREE pursues this line of thinking: that firms might be enticed by the Internet to embark on rash foreign market expansion – 'rash' in the sense that the Internet generates rapid, diversified international expansion as a dominant, but chiefly unsuccessful strategy. Normative research on companies' choice of international expansion strategy does not give any answer as to whether a strategy of concentration or diversification is preferable. Empirical studies are fairly split in terms of their recommendations; some studies have recommended a market concentration strategy (BETRO Trust Committee 1976; ITI 1979; Jung 1984), but other studies suggest a market diversification strategy (Piercy 1981; Hirsch/Lev 1973; IMR 1978; Airakinsen 1982; Cooper/Kleinschmidt 1985). The study by Lee/Yang (1990) is inconclusive. Presumably, the divergence as to what is an appropriate strategy is to a large extent due to the very different research methodologies of the studies (including different categorizations of firms as to their international market expansion strategy), but the divergence does also stress the fact that the choice of the "right" expansion strategy is contingent upon situational factors (Ayal/Zif 1979; Piercy 1981). PREDICTION THREE argues that companies will misjudge situational factors associated with the use of the Internet, leading to an over-emphasis on diversification strategy.

Why this misjudgement? It has already been mentioned that the hype surrounding the Internet may mislead firms into imitating other companies (in other industries – eg the effect of Amazon's experience) that are reported as being successful role models for other firms. Thus, the notion of the 'border-less marketplace' of the Internet has been

featured strongly in the international media. The fear of getting a reputation as being 'technologically backward' probably haunts most company managers, and has even become a feature of some advertising (e.g. IBM's Internet advertisements in the Australian media).

In addition, as a company links up with the Internet through its web site – sometimes in connection to vertical Internet portals - its exposure to potential foreign business partners (suppliers, customers, intermediaries) increases drastically. Although companies have been identifiable to foreign companies through other means than the Internet (export directories, embassies, etc.) the searching efficiency of the Internet is far greater than previous electronic or non-electronic information sources. Unsolicited inquiries have been shown to be important in past export starts (Bilkey/Tesar 1977; Wiedersheim-Paul/Olson/Welch, 1978). Setting up a web site creates the basis for a company, whether deliberate or not, to be noticed and contacted regarding its goods and services. In this way a company may, in a relatively short time, find itself involved in exporting to a large number of foreign markets without having performed any other pro-active export activities.

These Internet-mediated international contacts and businesses starts may work out well for market skimming purposes, but do not necessarily lead to any deeper penetration. In order to further penetrate the foreign markets in question, companies often will have to establish some physical presence. Even e-commerce companies find it necessary to establish a presence in foreign markets (popularised as 'clicks and mortar'). For example, American online companies such as Amazon.com achieved a high degree of penetration initially in the Australian market: reaching 50 % in 1999.

However, this dropped significantly in only one year, to 34 % in mid-2000 (Hopkins 2000b). In a short time Australian retailers have been able to combine the advantages of an established local presence with an increasing range and sophistication of online services. Some US retailers had already built local operations (e.g. Dell/Gateway) and have been able to take advantage of an existing local base. Others, though, such as Amazon.com, face the difficult question of whether, and in what form, to build a local presence in response to the emerging local online competition. Australian information technology and Internet companies face a similar question in seeking to penetrate the US market. The Australian trade commissioner has advised Australian companies that they need to set up an office in Silicon Valley if they want to succeed: "don't expect anything unless you're willing to move here. Everything else can stay, including R&D, but they (Silicon Valley companies) want constant access to the management" (Hopkins 2000a).

Only at the stage of establishing local presence are the entrant companies confronted with the liability of foreignness to its full extent. Until then, companies may have experienced a false confidence conveyed by the unrestrained world of the Internet. In particular, companies from English-speaking countries tend to be exposed to a false confidence (Marschan-Piekkari/Welch/Welch 2000) in so far as much of the Internet-information and communication is in English. A study of Canadian retailers' inroads into the US market (O'Grady/Lane 1996) indicated that managers' false confidence about similarity between the two markets led to poor financial performance. Apparently, operations in psychically close countries are not necessarily easy to manage, because assumptions of similarity can prevent executives from responding to

critical differences – a phenomenon O'Grady/Lane (1996) described as 'the psychic distance paradox'.

Furthermore, national environments of firms often are resistant to change (Whitley 1992; Zucker 1987). The mere introduction of advanced communication technology, including the Internet, is not likely to lead to a reduction of environmental barriers, such as cultural differences and business regulation (Mol/Koppius 1999). In other words, instead of alleviating the liability of foreignness, the Internet may simply delay or shift the hurdle of doing business in a foreign country to a different and later part of the international activity. Establishment of a physical presence exposes the novice international firm to the disadvantages of foreignness with its concomitant high costs of learning by experience.

Before looking at the resulting effects of the Internet in PREDICTION THREE we can summarise the underlying assumptions of the three predictions, as shown in Table 1.

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Insert Table 1 about here

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Faced with the true costs of operating in foreign markets, companies will be forced to consider consolidation of their international business or even giving up attempts to penetrate certain foreign markets. Thus, a stage of geographical contraction could follow a strategy shift from diversification to concentration. Since the abandonment

or downsizing of business activities are likely to be most pronounced in those countries where psychic distance is greatest, reversion to a pattern of foreign market operations in fewer markets and based on psychic distance may emerge. The development from an initial diversified market expansion to concentration on fewer markets is depicted in Figure 2.

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Insert Figure 2 about here

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During the time period t_0 - t_1 (indicated on the horizontal axis in Figure 2) firms diversify rapidly, spurred by the seemingly promising Internet-based opportunities. As firms realize the problems and demands of operating in diverse foreign business environments they will give up high commitment to those foreign markets that turn out to be the most troublesome, thereby precipitating a pattern of gradual, or concentric, contraction (t_1 - t_2). After a period of consolidation (i.e. from t_2 onwards) they re-engage in foreign market expansion, but this time in a more cautious, gradual way. Figure 2 also indicates the other two predictions of dominant foreign market expansion patterns following worldwide proliferation of the Internet.

Table 2 summarises the patterns of foreign market expansion of firms as outlined in the three predictions.

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Insert Table 2 about here

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Competing or complementary predictions?

By and large, the three predictions have been presented as applying to *all* companies that engage in foreign market expansion in the future as the full effect of the Internet is played out. Being very general in their application, the three predictions have been presented as being competitive and mutually exclusive. However, one should not exclude the possibility that the three predictions are complementary in the sense that they comply with different and separable segments of firms. As indicated already, the circumstances in which the prediction should be used as an explanation may differ in terms of the product area. In some industries that are highly regulated - such as agriculture and health care, the Internet effect is likely to be very modest (PREDICTION ONE) whereas in others, e.g. software and information services, the Internet is likely to result in faster foreign market expansion (PREDICTION TWO).

Especially in relation to PREDICTION THREE one might speculate that the circumstances will differ even among firms operating in the same product area (industry). Let us assume that the foreign market penetration capabilities of the Internet in fact are very limited. Some managers, but not all, will realize this and revise their market expansion strategy accordingly (PREDICTION ONE). Other decision-makers, operating companies in the same industry will overestimate the suitability of the Internet as a foreign market penetration instrument. PREDICTION THREE would therefore apply only to this group of "mismanaged" companies. Hence,

it is difficult to argue that one prediction is likely to be applicable to the entire population of firms in the process of internationalization. A contingency approach would seem to be more appropriate.

Conclusion and Managerial Implications

It is by no means evident what effect the Internet will have on firms' foreign market expansion. Depending on various perspectives, for example internationalization process models and agency theory, and the interpretation of future Internet developments, a range of outcomes is feasible. Instead of promoting a single, unified prediction of how the Internet will affect foreign market expansion we have outlined three opposing forecasts. Individually, the three predictions are quite extreme, and as such, many, if not most, firms will fall short of these extremes. The three predictions taken together can be seen as 'fencing off' a wealth of in-between possibilities, among which the reality of future foreign market expansion patterns is likely to be found.

A comparison of the three predictions outlined in the paper suggests a need to re-think a key issue in internationalization theory; namely the role of knowledge, in this case as a determinant of the pace with which companies expand internationally. In PREDICTIONS TWO and THREE the conventional role of knowledge as a limiting, slowing factor in the international market expansion process is reversed to that of being a catalyst because of the impact of the Internet. In addition, the Internet may promote international experiential learning, directly through Internet-related

activities, but also as a result of generating spillover effects to international operations in general. Thus, the optimistic Internet predictions of the business press, seeing the borderless virtual marketplace just around the corner, if realised could pose a major challenge to internationalization theory as currently understood.

Clearly, there is much empirical and theoretical research to be done in order to get behind the hype and develop a clearer picture and understanding of how the Internet is changing the world of international business – including that of firms' foreign market expansion. Hopefully, the three predictions and associated theoretical issues analysed in this article will provide a useful framework for some of this research. So far, the empirical data that can underpin predictions are scarce and anecdotal. A particular need, in the light of the three predictions framework, would appear to be longitudinal studies of the effect of the Internet on internationalization behaviour, wherein it will be possible to analyse the impact in areas such as foreign operation mode development, which has not been focused on in this article, as a way of discerning short term and long term effects. As with foreign market expansion, after initial atypical expansion without a local presence, many companies may then have to build local operations in some form, embarking on a process of mode development that looks similar to past patterns, with psychic distance influences operating more forcefully.

As to managerial implications this paper deals with a number of issues relevant to managers. PREDICTION THREE may be seen as a warning to managers not to be 'seduced' by the Internet hype when they define their foreign market expansion strategy. So far, the warnings in business magazines and journals have tended to be

in one direction: against 'Internet backwardness'. This has been viewed as being potentially detrimental to the international competitiveness of the individual company. PREDICTION THREE, however, calls for a more critical and cautious approach to the Internet as a means of penetrating foreign markets. It is effectively a warning that there is still a need for careful planning of the rate and pattern of foreign market entry, so that the possibilities opened up by the Internet do not cause firms to over-reach their capabilities.

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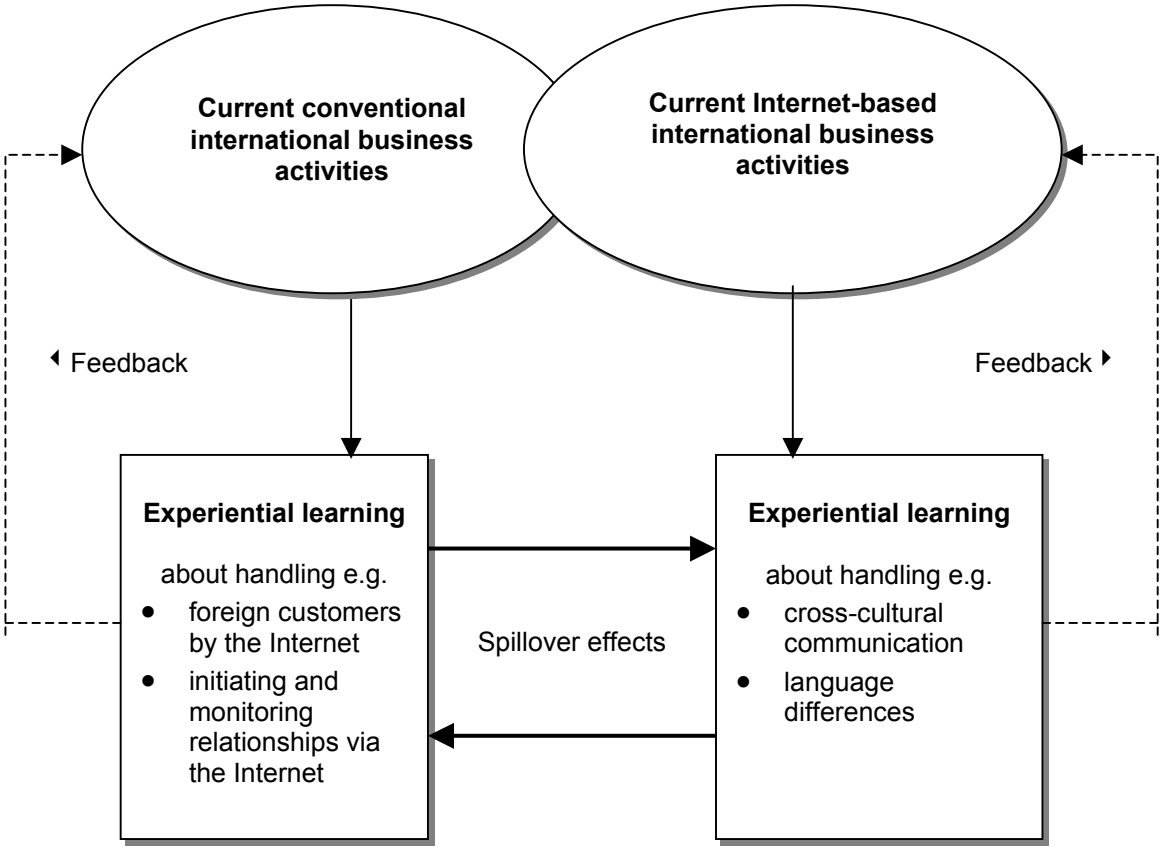

Figure 1: Experiential learning via the Internet

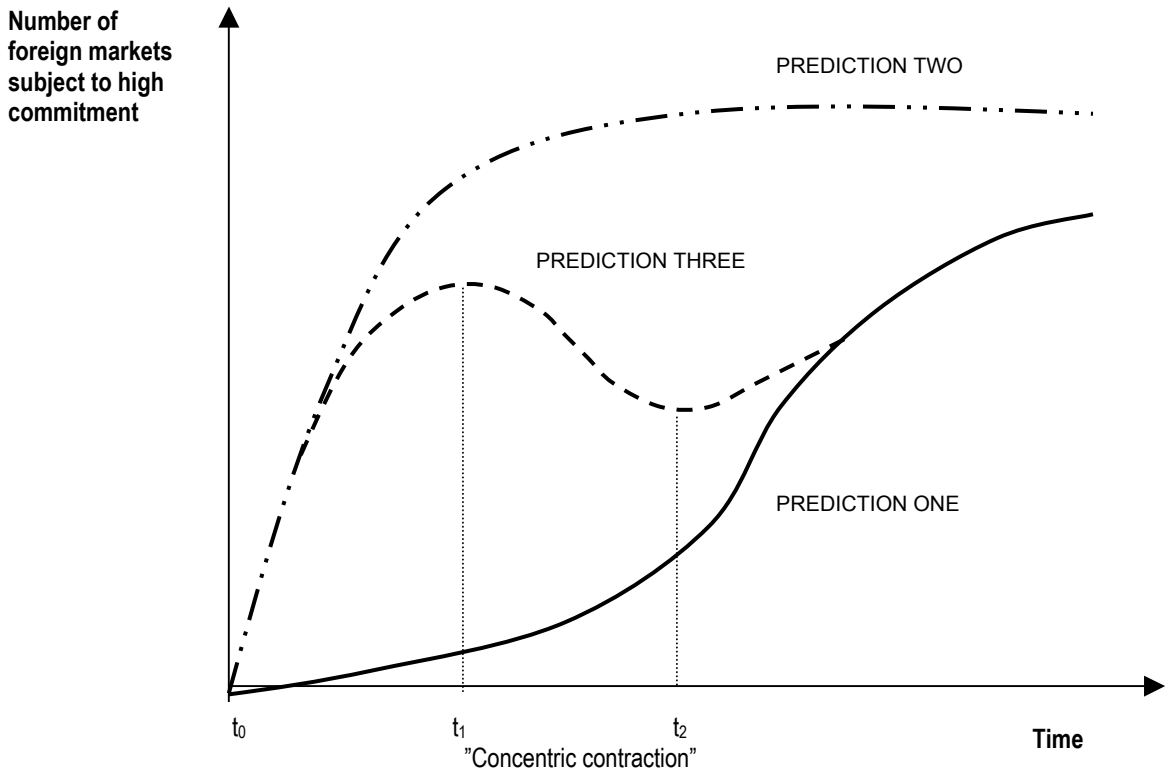

Figure 2: Three different predictions of dominant foreign market expansion patterns following worldwide proliferation of the Internet

Table 1: Underlying assumptions of the three predictions

PREDICTION	I	II	III	
			INITIAL PERCEPTION	REALITY
Foreign market risk/disadvantage	Substantial	Minor	Minor	Substantial
Accumulation and transfer of tacit knowledge via the Internet	Difficult	Possible	Possible	Difficult
Adverse selection problem of Internet	Serious	Negligible	Negligible	Serious
Need for local adaptation & presence	Substantial	Limited	Limited	Substantial

Table 2: Resulting Internet effects on international market expansion of firms

PREDICTION	I	II	III
Predicted pace of expansion	No/moderate change of pace	Faster expansion	Faster, but impetuous expansion
Pattern of geographical expansion	Concentric expansion	Indeterminate	Indeterminate → Concentric contraction
Allocation of int'l marketing resources	Concentration	Diversification	Diversification → Concentration
Role of knowledge in expansion process	Constraining	Catalytic	Catalytic → Constraining