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The Role of Small and Medium Sized Export Trading Companies in Taiwan's Economic Transition 1950-1990

By

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The requirement of the degree of
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The work has not previously been submitted for a degree or diploma in any university. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.

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The Role of Small and Medium Sized Export Trading Companies

in Taiwan's Economic Transition 1950-1990

Abstract

In the period from 1950 to 1990, the Taiwanese economy, which has become famous for its rapid growth, underwent many dramatic changes. This thesis examines the role of the small and medium sized export trading companies (SMETCs) in the transition of Taiwan's economy under its export-oriented policies.

Taiwan's SMETCs not only acted as intermediaries between manufacturers and international buyers in the export channels but also provided strategic information relating to the global market and acted as an agent in changing the focus and direction of Taiwanese industries. They exercised significant power, leading Taiwanese industries into successive stages of globalization. Furthermore, SMETCs also pushed Taiwan into achieving both "scale economies" and "scope economies".

Taiwan's SMETCs provided the logistics for the famous Taiwanese subcontract domestic production networks. Under this manufacturing system, SMETCs helped to develop Taiwan's economy first from the stage of agricultural and processed products into labour-intensive light industry, then into the skilled labour-intensive industries of electronic and electrical assemblies, and finally into the capital-intensive high technology industries. The SMETCs have played a significant role in the staged development of the Taiwanese economy.

CHAPTER ONE

Introduction

The role of Taiwan's small and medium sized export trading companies (SMETCs) in Taiwan's economic growth is examined. This thesis deals with the period from 1950 to 1990. The central question addressed is that while their counterparts in other countries such as Japan and South Korea are large-scale organizations with abundant capital and other resources, what were the factors enabling Taiwanese SMETCs to survive in Taiwan's growing economy? In other words, how did they carry out their changing roles in the development of Taiwan's economy?

Taiwan's economy is well recognized for its rapid growth and its success in outward-looking industrial strategies since the 1960s. For example, Taiwan's GNP grew at 10 percent per annum between 1972 and 1981, and its per capita GNP grew from US$196 in 1951 to US$13 198 in 1990.[1] Its initial import substitution industrialization having run out of steam by the late 1950s, Taiwan adopted an export-oriented strategy. In this respect it was similar to two other Asian "dragon" economies, South Korea and Japan, but Taiwan differed radically from them in its industrial structure. Whereas the export sectors of both South Korea and Japan were dominated by very large companies and conglomerates with their own large trading companies, Taiwan's export sector in the 1960s and 1970s was dominated by tens of thousands of small and medium enterprises (SMEs), most of which were run by so-called "black hands" (*o-chiu-e*), persons with manual skills and often no more than a middle school level of education if that. Their products were aimed at the low-priced consumer market particularly, though not exclusively, in the United States,

[1] Quarterly Taiwan Bank Vol.48 No.1 1997 pp. 90-129

but their owners lacked the language skills and business acumen to negotiate with foreign buyers or even to know what to manufacture.

As this thesis demonstrates, this void was filled by the SMETCs who played a most significant role. These trading companies, all small, were often run by university graduates who possessed a knowledge of foreign languages, especially English, and a desire for the high income level that business could give them but other lines of work were unlikely to. These trading company proprietors, with their foreign language skills, their relative sophistication and, in many cases, their home town ties to operators of SMEs, formed an indivisible bridge between those operators and foreign buyers anxious to avail their companies of the benefits of Taiwan's relatively low cost but very efficient and hard working labour force. Without this bridge, it is improbable that the potential productivity of the SMEs and indeed Taiwan's economic miracle could have been realized.

This thesis explains the types of linkages that proprietors of SMETCs established with the SMEs on one hand and with foreign buyers on the other. It explores how these ties were developed, how they changed over time and why the system largely died in the late 1980s. In so doing, this thesis fills a gap in the literature on Taiwan's economic development. Much has been written about Taiwan's economic miracle per se and much has also been written on the roles of the SMEs. However nothing so far has systematically examined the role of the SMETCs.

Taiwan's export product mix changed at different stages in its economic development, affecting the interaction between manufacturers and SMETCs; moreover these

changes identified those different stages. The importance of SMETCs to manufacturers, which are generally SMEs, lessened as the degree of technology associated with their respective products increased.

While Taiwan's economy developed from a labour-intensive stage associated with agricultural goods production (including processed goods) and light industries in the period from the 1950s to 1970 to a skill-intensive stage (1971 to the 1980s), and then to a capital-intensive stage (1990 to the 2000s), correspondingly, the key role of the SMETCs, initially intermediaries and coordinators in a complementary and coexistent relationship with SMEs, also developed into a competitive role, and then into the role of an investor in an integrated relationship.

Certainly the SMETCs in their intermediary role were always needed by the smaller sized suppliers, but as the SMEs grew larger with greater industrialization of the economy, so the opportunities became fewer for the export trading companies. The thesis examines the various functions of the local trading companies in the different economic development stages. This thesis also discusses the interaction between SMETCs and manufacturers, and the performance of subcontract manufacturing systems to meet international buyers' enquiries and to assist in the promotion of the internationalization of Taiwan's industries in an environment of international labour division.

As mentioned previously, very large conglomerates such as *chaebol* and *keiretsu* and their export-import subsidiaries, the general trading companies (GTCs) and s*ogo shosha* dominated the South Korean and Japanese economies. Having noted the success of these two large export-import business organizations, Taiwan's

government tried to establish similar large-scale trading companies called “Large Trading Companies” (LTCs) in the 1970s to overcome the weakness of Taiwanese SMEs and SMETCs, such as the shortage of capital and limited international market information and international trading experts. However, the policy failed to achieve this goal and the thesis also examines the reasons for its failure.

Networks are very important in Chinese society and business. They are built upon the basis of personal relationships, and trust is an essential element in the networks. Schak says “it was necessary that a basis of trust exist within a relationship when doing business; a commercial system based on contracts between strangers could not work; but a system based on networks and personal ties could.”[2] This thesis uses many networks, such as export networks, and decentralized production networks, to examine the roles of SMETCs in Taiwan’s outward looking economy, industry progress, and the factors involved in Taiwan’s economic growth. Thus, the thesis explores the importance of trust in Chinese business networks. SMETCs, with the support of SMEs and their flexible decentralized production networks, also known as subcontracting networks, were able to link themselves with foreign buyers and sell the SMEs products on the international market, despite separation by distance, culture and languages. Without the products and the flexible production networks of the SMEs, SMETCs could not penetrate the global market successfully. SMEs and SMETCs were closely bound on a bilateral basis, and worked as logistics and frontiers in the battle of international trade. Therefore a study of the structure of SME networks is essential for understanding the role of Taiwan’s SMETCs. .

[2] Chan, Kwok Bun (edited), *Chinese Business Networks- state, economy and culture.* Singapore: Prentice Hall 2000 p. 115

1.1 Purpose of the study

As an owner of an SMETC, I have been involved personally in Taiwan's export-oriented economy for seventeen years and witnessed the "miracle" first hand. My experience has been applied in this thesis to demonstrate that the trading company is a *sine qua non* of the Taiwan economy. The thesis provides future researchers with information about the Taiwan experience including its transitional economic development, the functions of Taiwanese trading companies and its Large Trading Companies (LTCs). In addition, because of the common ethnic Chinese language and culture involved, international enterprises will be provided with appropriate and beneficial information to assist their entry into the Chinese market and subsequent performance there.

1.2 Period studied

The thesis focuses on the period from 1950 to 1990. During the post-war incorporation of Taiwan into the Republic of China[3] and the Kuomintang (KMT) government's subsequent withdrawal from mainland China (1945-1950)[4], Taiwan was in a state of political chaos and economic recession. Its economy completely stagnated.

However, in the period from 1951 to 1990, Taiwan was renowned for its astonishing economic growth (average of 8.9 percent per annum)[5] and its outward-looking industrial policies. As mentioned in the Introduction, Taiwan's per capita GNP soared

3 Taiwan was ceded to Japan by the Qing dynasty in 1895 as a peace condition of the first Sino-Japanese War. At the end of the Second World War (1945), Taiwan was incorporated into the ROC based on the Cairo Conference.
4 Following the defeat of the Nationalist party (KMT) led by Chiang Kai-Shek by the Chinese Communist Party (CCP) in the civil war, the KMT fled to Taiwan in 1949.
5 Trading Bureau of ROC, 1995

from US$196 in 1951 to US$13 198 in 1990. The number of trading companies also increased dramatically from 17 to 50 679 in the same period.[6] In addition, in the 1970s Taiwan achieved the economic "miracle" of full employment and was described as one of the four Newly Industrialized Countries (NICs) in Asia together with the three other dragon economies of Hong Kong, Singapore, and Korea.

Since the 1990s, Taiwan's economy has significantly changed under the impact of the opening up of China, which presented Taiwanese economic policy makers with an unprecedented challenge to restructure its enterprises. In addition to cheaper and abundant labour in China, Taiwan's economic boom was accompanied by increasing labour and land costs, which accelerated the evaporation of Taiwan's comparative advantage in the export arena. Taiwan's traditional SMEs such as footwear and textile producers relocated to China. High technology and capital-intensive enterprises have replaced SMEs to become the basis of Taiwan's manufacturing structure. As a result, SMETCs were forced to change their roles in this period of economic transition. For this reason, the thesis does not cover the period after the1990s.

1.3 Contents of the thesis

In accordance with the objectives of this study, the seven chapters of the thesis discuss the following topics. The first chapter of the thesis describes its rationale, background, period of study, contents of the thesis, and research methodology.
The second chapter illustrates the history of the Taiwanese economy, and locates the position of SMETCs in Taiwan's economic transition. Charts of trading companies'

[6] Trading Bureau of ROC, 2001. Trading companies include importers and exporters.

networks help to identify their roles. The effects of Taiwan's Export Processing Zones and their development are examined in this chapter.

Chapter Three studies the functions of Asian general companies, i.e., Japan's s*ogo shosha*, Korea's Great Trading Companies (KGTCs), and Taiwan's Large Trading Companies (LTCs). The chapter will examine the reasons for the success of Japan and Korea's GTCs and the failure of Taiwan's LTCs.

The fourth chapter provides an explanation of export channels and categories of export intermediary firms. It also gives an overview of the performance of Taiwan's SMETCs and SMEs. It covers the definition, characteristics, functions and performance of Taiwan's three export networks, i.e., initial export network, secondary export network, and integrated export network. The role of SMETCs in the development of Taiwan's light industry and electronics industry are also examined in this chapter.

Chapter Five examines the role of SMETCs in Taiwan's economies of scale and scope, and their role in Taiwan's famous Decentralized Production Networks. This chapter examines the decentralized production networks of light industry and their relationship with SMETCs in different periods. This is achieved by examining the growth patterns in three examples of the textile, footwear and electronic components industries during Taiwan's economic transition. The function of the traditional element of "trust" in the relationship between SMETCs and their networks is also studied in this chapter.

Chapter Six explores the management of SMETCs and their marketing strategies.

Chapter Seven is the conclusion of the thesis.

1.4 Methodology

The three supporting approaches to provide the material for this thesis are:

a. Primary: In the thesis, I adopt the results of two different surveys. In order to examine the role of "trust" in the management of SMETCs and SMEs, and the relationship between them and in their production networks, the content of a survey conducted in June and July 2000 (17/6/2000-15/7/2000) with 33 people in Taiwan, is quoted. The number of people employed by these interviewees ranged from 50 or less to 1000 or more. Their businesses could be divided into three major groups: traditional firms, high-skill labour intensive manufacturers, and services. Traditional firms included suppliers of shoe materials, packing materials, textiles, BBQ sets, construction materials, and furniture. The high-skill labour intensive group included manufacturers of computers, cables, weight systems, musical mixers, LEDs, and internet and telecommunication supplies. The services group included chain store corporations, e-commerce, vehicle engine distributors, and airline services.[7]

   My own networking enabled me to conduct ten in-depth interviews with management personnel of local private Taiwanese export-oriented organizations during my stay in Taipei in December 2001 and January 2002. The interviewees were either from Collins (one of Taiwan's Large Trading Companies), the purchasing office of an American importer, companies trading in gift items, plastic products, electronic parts and ribbons, or the retired owners of SMETCs that had exported products as diverse as garments and plywood. Thus, the interviewees ranged from the managers of large firms down to one-person

[7] I have been in the export business for 17 years, from 1983 to 1990. Then I immigrated to Australia in 1991. Although I haven't contacted my suppliers for more than 10 years, because of our previous relationship, I was still able to interview them. After arriving in Taiwan and contacting them in 2000, I realized that 10% of the suppliers of wooden furniture, tableware, toys, and gift items had closed down and 90% had relocated to China. One manufacturer of electronic products and parts, which require labour intensive but highly skilled labour, had moved their manufacturing plants to China, leaving a small department which is mainly the financial section, in Taiwan. The owners travel across the Strait frequently to look after their business. This caused me unexpected problems in catching up with them. Sometimes I had to interview them at a dinner party, but I could not record the interview. I even had to conduct an interview with the interviewee on his way to the office in his car.

SMETCs. The limited duration of my stay did not permit me to conduct further interviews. Furthermore, Taiwan's local elections at the time limited the availability of interviewees. Moreover, as happened in my first survey, many Taiwanese SMEs have now transferred to Mainland China and many acquaintances who are the owners of SMETCs have also moved to the mainland to monitor the manufacturers' production lines there. Nevertheless, they afforded invaluable assistance in facilitating new contacts and the resulting interviews with them were most productive.

However, if time and budget had allowed it, then the surveys should have been wider and more deeply analysed.

b. Secondary: Relevant published material including articles on websites and in journals, conference papers, theses and books were reviewed.
c. Practical experience: As the owner for seventeen years of an SMETC exporting garments, electronic parts, sporting goods, wooden furniture and other goods, my experience provided practical insight into aspects of the role of SMETCs in Taiwan's economic transition.

CHAPTER TWO
Taiwan's Export Trade and Its Economic Transition

Introduction

Although this thesis focuses on the period between 1950 and 1990 and the economic transition during those years, this chapter also examines the history of Taiwan's export trade which originated from ancient barter trade about four hundred years ago. This will highlight the importance of Taiwan's outward trade in its economic development and will also indicate that there were no large-scale trading companies under the KMT government except for fruit exporters in the 1950s, and Large Trading Companies in the 1970s. However, the former originated in the Japanese colonial period and continued to operate, while the latter failed.

Before 1905, Taiwan's export trade was in the hand of Westerners, i.e., Portuguese, Dutch and Spanish, as well as the Japanese and Mainland Chinese. This provided very limited opportunities for Taiwan's indigenous trading companies to develop and grow. From 1905 to 1945, export trading was mainly in the hand of Japanese zaibatus. Similar conditions also existed in the early stages following World War II, when American firms took an important role in the Taiwanese export trade at the expense of the Japanese. This situation also affected SMETC development and growth. Table 4 indicates the changes in Taiwan's export market.

Table 1 Top five markets for Taiwan's exports

Year \ Area	First	Second	Third	Fourth	Fifth
1952	Japan 52.6%	Singapore 9.6%	HK 7.7%	UK 4.2%	USA 3.5%
1956	Japan 37.2	Singapore 8.2	HK 6.9	USA 5.6	4.9
1961	Japan 29.0	USA 21.9	HK 13.3	Thailand 4.6	ROK U.K., W.G. 2.9
1966	Japan 24.0	USA 21.6	HK 6.1	W. Germany 5.5	Thailand 3.3
1971	USA 41.7	Japan 11.9	HK 7.8	Canada 5.6	W. Germany 4.2
1976	USA 37.2	Japan 13.4	HK 7.5	W. Germany 5.2	Canada 3.8
1981	USA 36.1	Japan 11.0	HK 8.4	W. Germany 4.0	Australia 3.0
1986	USA 47.7	Japan 11.4	HK 7.3	W.G. & Canada 3.2	UK 2.4
1990	USA 32.4	HK 12.7	Japan 12.4	W. Germany 4.7	Singapore 3.3

Source: Taiwan Statistical Data Book 1991, CEPD

To assist in understanding the industrial environment of SMETCs in Taiwan, this chapter compares the Asian General Trading Companies of Japan, Korea and Taiwan, and discusses the reasons for their success and failure.

Taiwan is an island with an area of only 36 000 sq km. Its population is 23 million. Other than a small natural gas deposit in Miaoli and coal in Keelong, the island is deficient in natural resources. It is located off the eastern coast of Asia and is

separated from the Chinese Mainland by the Taiwan Strait.[8] It occupies a key position in the Northeast Southeast Asian economic channel. Geographically, it is close to Mainland China. However, both the Ming Dynasty in the early sixteenth century and the Qing Dynasty in the late sixteenth century had implemented maritime bans on the coastal cities, e.g. Quanzhou and Zhangzhou, to prohibit their residents from migrating to Taiwan. However, these policies failed to restrain residents from trading with Taiwan, either through their migrants or foreign merchandisers, such as the Portuguese, Dutch, Spanish and Japanese.

In fact, the interaction between Mainland China and Taiwan has never been interrupted except during the period of implementation of martial law[9] from 1949 to 1978. Since 1978, the turnover of trade across the Taiwan Straits grew very rapidly. From 1978 to 1988, the trade amount increased from US$47 million to US$2.07 billion. It grew to 57 times its original size, and continued growing. This trade resulted in an excess of exports to Taiwan and its favourable trade balance was 27.66 percent in 1991 (January to August).[10] Consequently, Mainland China's market became increasingly important to Taiwan's export trade. In the past, merchandisers promoted Taiwan's products to the international market. Today, Taiwan's SMETCs are using their export experience and skill to assist Mainland China's manufacturers to improve the quality of their products, link them with international buyers and export them to international markets.

[8] The Strait is about 220 km at its widest and 130 km at its narrowest.
[9] In 1949, the KMT government started to implement "Martial Law". It strictly prohibited interaction between Mainland China and Taiwan. In 1979, the Beijing government opened its doors to the world, and trading started again through Hong Kong.
[10] Lin, Manhong , 1993 Taiwan's capital and the relationship between the Straits (1895 and 1945*)* in Song Guangyu (ed) *Taiwan's Experience p.* 69

Looking at Taiwan's economic history over the past four hundred years, outward looking trading was always an essential business activity for the inhabitants[11] to ensure their survival in an environment of limited resources and restricted domestic markets. As previously mentioned, the Taiwan Strait effectively constitutes a major path in the access route between European countries and Japan. But Taiwan was also on the outskirts of the Chinese empire and so the ruling dynasty had no strong motivation to protect this island as a part of its own territory. These factors ensured that any country attempting to expand its economic power in Asia would see Taiwan as a convenient midway base for accessing other Asia Pacific regions. As a result, the islanders have been subject to a number of different ruling eras: the Ming dynasty, the Western Imperialists, the Koxinga (Zheng Chenggong), the Qing dynasty, the Japanese and the Republic of China. Consequently, the Taiwanese have participated in various types of external trade ranging from basic bartering and semi-self sufficient trade to colonial type trading and full-scale international trade. In fact, the Ming dynasty did not set up any administrative office in the island. According to Tsao Yonghe's "A research of Taiwan's early history"[12], in the Jiaqing period (1522 to 1566) the Ming established a patrol station for a short period in Penghu which is one of Taiwan's offshore islands, under the county government of Quanzhou in Fujian. The interactions of trading and fishing between coastal cities, e.g. Quanzhou, in Mainland China and Taiwan's ports, such as Keelong, Tanshui, and Beigang, were very frequent.

[11] The inhabitants include aboriginal Malay-Polynesian people, Fujian (Hokkien) migrants who emigrated before 1945 mainly from Ch'uan Chou and Chang Chou, and new migrants who moved to Taiwan after 1945.
[12] Tsao, Yonghe 1979 *A Research of Taiwan's Early History*. Taipei: Lianjing, p. 125

During the era covered by the thesis, the export products have varied from primary agricultural products such as deerskins, camphor, tea, sugar, rice, fruit and their associated processed products to manufactured products including textiles, garments, footwear and highly technological products. Taiwan's export markets have shifted from China, Europe and Southeast Asia to Japan, and eventually to the USA and Europe. However, although the type of trading, the products and the market destinations have changed over time in Taiwan, the fact that foreign capital has dominated the Taiwanese export business has never changed. In other words, Taiwanese exporters' access to foreign markets has been under the control of foreign trading companies for centuries. To rid Taiwan of its dependency on those foreign companies and viewing the success of Japanese General Trading Companies (JGTCs-s*ogo shosha)*, and Korean Great Trading companies (KGTCs), the KMT government started to set up Large Trading Companies (LTCs - *damaoyishang*) in 1978. Originally there were seven companies, but by January 2001 only one remained. This chapter will compare the background, formation, structure and functions of these larger trading companies, and the reasons for their failure and success. The failure of Taiwan's LTCs provided the evidence that its SMETCs were an essential means for exporting Taiwan's manufactured products to international markets and a vital component in creating Taiwan's economic miracle.

Taiwan's economic miracle was based on exporting manufactured products to the world market. In order to establish Taiwan as a centre of the processing industry and to stimulate foreign direct investment, the KMT government also established Export Processing Zones (EPZs) in the 1960s. Although SMETCs were not directly involved in the EPZs, which played a significant role in Taiwan's export industries, numerous owners of SMETCs and SMEs obtained their export experience and upgraded their

skills in foreign firms in the EPZs. Thus, the analysis of their background, formation and function provides a clear picture of the development of Taiwan's manufacturing industries.

2.1 History of Taiwan's export trade

2.1.1 The Ming dynasty era (1368-1644)

In the Ming dynasty, the Xiamen area was the liveliest trading area of China, very active in the spice trade with Southeast Asia. In 1381, the Ming dynasty implemented a maritime ban to prevent coastal residents from supporting pirates and smuggling.[13] In 1567, the government even implemented a system of licensing trading ships to control trading along the coast. By 1600, a small Chinese colony was established to service the international trade along the Japan-Southeast Asia trade route. The export trade in this period was a form of barter trade: islanders exchanging their agricultural products, e.g. deer products for Chinese clothing or silk.

2.1.2. The Western Imperialist era (1557-1661)

Due to the increasing competition of maritime power and the extension of economic power in Europe, Western countries such as Portugal, the Netherlands and Spain wished to obtain bases for expanding their marine power and they saw the Philippines, Singapore and China to be ideal places for them to develop. But the maritime ban isolated Mainland China from international trading, and Taiwan was in a pivotal geographical position to control trading between these countries and Japan. In 1557,

[13] In the early stage of the Ming dynasty, the coastal chaos caused by pirates mirrored the problems of governance. In the Hongwu period (the reign of the first emperor of the Ming dynasty), in order to stabilize the new authority and enhance the trading system, the government had implemented a "Marine ban" many times , but it was also lifted many times because of the real needs of the residents on the coastline. According to the ban, the coastal residents were prohibited from conducting any activities in the sea.

the Portuguese sighted the island of Taiwan and named it *Ilha Formosa* or beautiful island. From that time they and other Western imperialists including the Dutch and Spanish all used the island as "a jumping off point for trade with China and Japan"[14] and as "a base to compete in commerce, war and missionary work"[15] with their rivals.

In 1624, the Dutch erected Fort Zeelandia in Tainan, and began to colonize the southern part of Formosa. The Dutch East India Company set up its Taiwanese operations at Anping[16] to export Taiwan's deerskins and sugar to China, Japan, Batavia (Jakarta) and Europe. The Dutch East India Company also re-exported from Taiwan China's raw silk, silk and china to their branch companies throughout the world. In 1626, Spain established an embassy in Tamsui (Tanshui) to expand its power, but they were expelled by the Dutch in 1642.

2.1.3 Koxinga era (Zheng Chenggong: 1662-1683)

The Ming dynasty was collapsing in the face of the peasant rebellion and Manchu expansion into China. By early 1662, troops led by Zheng Chenggong, a leading Ming loyalist, retreated to Amoy (Xiamen) in 1660 and expelled the Dutch from Anping, then established a base in Taiwan. This was the end of the Western Imperialist era. The main export products in the Koxinga era were deerskins, rice and sugar which were exported to China, Japan, and Southeast Asia.

To prevent the inhabitants of the mainland's southeast coast from supporting Zheng Chenggong's troops in their plan to upset the government and re-establish the Ming

[14] Gold, Thomas (1986), *State and society in the Taiwan Miracle,* M.E. Shape Inc. New York, p. 23
[15] *ibid*, p. 23
[16] It was named Fort Orange and later named Zeelandia.

dynasty, the Qing government applied a maritime ban and evacuated the regions covered by the ban. This act became "a boon to the development of Taiwan as a trading centre away from mainland control".[17]

2.1.4 Qing era (1644-1911)

Taiwan had for many years participated in external commodity trade with the Chinese Mainland and with the West and other Asian destinations. Mainland Chinese and foreign merchants dominated the export trade in primary produce. In this era, with the assistance of Mainland Chinese merchants who worked as compradors (*maiban*), Taiwan's export trade was directed mainly through the many branches of foreign firms of European countries such as the UK and Germany, e.g. Swire and Boyd & Co. In the nineteenth century, three items- deerskins, rice and sugar, were exported from Taiwan to mainland China in exchange for silk, textiles and opium. In 1875 the ban implemented by the Qing government in the sixteen century which made all overseas traders pirates was lifted.

2.1.5 Era of Japanese rule (1895-1945)

Taiwan was ceded to Japan by the Qing Dynasty under the Treaty of Shimonoseki (*maguan tiaoyue*) in April 1895 after the first Sino-Japanese War of 1894-1895. It became Japan's first colony, and the Japanese reshaped the Taiwanese economy to suit Japan's needs. They developed Taiwan's economy to become a producer mainly of rice, sugar and sweet potatoes which were exported to Japan in exchange for manufactured goods.

[17] *ibid*, p.25

From 1895 until 1902, foreign firms from countries such as Japan and Britain controlled the export of Taiwan's tea. After 1902, through tariff controls and subsidies to Japanese merchandisers, the Japanese government established Japan as Taiwan's main trading partner at the expense of Mainland China. For example, the government imposed an export tax on any of Taiwan's products exported to countries other than Japan. This transition ensured that Taiwan's international trade supplanted domestic trade in importance.[18] After Japan's victory in the Russian–Japanese War in 1905, foreign trading houses were expelled from Taiwan. The Japanese government policy stressed the supply of foodstuffs and raw materials as the backbone of the Taiwanese economy while industrializing the home of islands - Japan. Many financial-industrial-trading conglomerates were enticed to Taiwan to invest in its agricultural industries, mainly sugar production. Monopolies were established in tobacco, salt, liquor, and opium production. The Japanese *zaibatsu* almost monopolized the export trade and Taiwanese traders had very little involvement in international trading. Consequently, they could not obtain experience in international trade, a factor which would adversely affect their future development. However, the infrastructure establishment during this Japanese colonial period, which included railway and telephone system development, the dredging of Kaohsiung and Keelong harbours and the establishment of irrigation systems, unquestionably provided a very solid foundation for Taiwan's eventual economic take-off. In this era, Japanese companies brought with them their management systems consisting of a combination of Japanese traditional culture and Western concepts. This modern system has had a lasting effect on Taiwan's SMETC management.

[18] Song, Guang-yu eds. (1993), *Taiwan experience_1*, Dongda, Taipei, p. 69

The main export products in this period were camphor, sugar, tea and rice. From 1898 to 1906, 20 percent of Taiwan's rice and 90 percent of its sugar production was exported, nearly all to Japan.[19] Immediately following 1944, Japan lost its control over air and sea transportation, causing Taiwan's export trade to diminish substantially. Total exports declined to 55 percent[20] of the 1940 level.

2.1.6 The Republic of China (1946 onwards)

In 1945, following the end of World War II, Taiwan was retroceded to the Republic of China (KMT government) from Japanese rule according to the resolutions of the Cairo conference. Since then, under "government-guided" policies, Taiwan has developed its economy and boosted its exports. This era consisted of six stages[21]:

1. the chaotic stage of 1945-1949;
2. the reconstruction stage in the post-war period of 1950-1959;
3. the export expansion stage of 1960-1969;
4. the second import-substitution stage of 1970-1979;
5. the liberalization and internationalization stage of 1980-1989; and
6. the Asia-Pacific technology manufacturing centre-promoting stage of 1990-1999.

All stages except the sixth are illustrated in this thesis, the sixth being beyond the period studied.

Stage 1: The chaotic stage of 1945-1949

[19] Gold, Thomas (1986*), ibid p.37*
[20] Lin, Zhongxiong (1995), *One hundred year experience of Taiwan's economy, Santong*, Taipei, p.90
[21] In addition to Shieh Sh'eng Ts'ong's four stages (Song, 1993, pp. 142-145), I have included a pre-1950 stage and an additional stage from 1990 to 1999.

During the years from 1946 to 1949, Taiwan suffered the after-effects of wartime US Air Force bombing which wiped out most of its infrastructure, such as transportation networks, power stations, industrial complexes and factory installations on the island. This impeded the growth of Taiwan's economy. Taiwanese agricultural production, for example, sugar and rice, was nearly eliminated. Taiwan's major export market to Japan collapsed after the war and the KMT government was engaged in a civil war with Mao's Communists. A very high population growth rate (3.5 percent)[22], a food shortage and political instability (The 2-28 Incident in 1947)[23] caused social chaos in the early stages of the post-war era. All these factors contributed to Taiwan's economic stagnation and severely affected its exports. Taiwan suffered all-time high hyperinflation (3 000 percent alone in the first half of 1949).[24]

Following the withdrawal of the KMT from Mainland China, the influx of new migrants[25] introduced some talented officials (public servants) including Yin Zhongrong and Li Guoding. They realized their experience in Mainland China would not translate to the conditions in Taiwan, so they speedily implemented many practical policies to rescue the island's economy. They carried out monetary reform to quell inflation and stabilize Taiwan's economy.

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[22] Kang, *op cit.* p.121. This resulted from the influx of about 1.5 million Mainlanders who were defeated by the Chinese Communists and fled to Taiwan. This sudden influx caused shortages of resources, including food, education, and employment.

[23] "The 28 February 1947 arrest of a woman selling cigarettes without a license was the spark which led to large-scale public protests against repression and corruption. For some ten days, *Chiang* (*Chiang Kai-shek*) still on the Mainland and his governor Chen Yi kept the pretence of negotiations with leaders of the protest movement, but at the same time they sent troops from the Mainland.
As soon as the troops arrived, they started rounding up and executing people, in particular scholars, lawyers, doctors, students and local leaders of the protest movement. ……" *An overview of the events of 1947* _www.taiwandc.org/228-intr.htm p.1

[24] Kuo, 1983 *op cit*, p.2

[25] Distinction between the old migrants who came to Taiwan before 1949 and the new Chinese emigrants following the KMT government's withdrawal to Taiwan in 1949.

Stage 2: The reconstruction stage in the post-war period of 1950-1959

The top priority in this stage was the pursuit of economic stability and self-sufficiency. The principal export market was Japan, and rice and sugar were the major export products.

In 1950, Taiwan and Japan signed a "barter trading" agreement under which Taiwan exported agricultural products, e.g. rice and sugar, in exchange for daily necessities from Japan. Thus, Taiwan recommenced the export of sugar and rice to the Japanese market. Subsequently, other agricultural products, such as tea, bananas and pineapples, and processed food were also exported to Japan in steadily increasing quantities. Besides the Japanese market, by the end of 1958, the export of textiles and handcrafts to the USA had started and progressively increased.

In this stage, the KMT government also implemented very successful land reform policies as part of ongoing economic reconstruction. These policies, including "reducing land rent to 37.5 percent", "land-to-the tiller" redistribution and "sales of public land", were carried out to solve the food shortage on the island. According to Shirley Kuo, the results of these policies were the reduction in the size of landholdings, changes in the pattern of production, agriculture diversification and a scaling down of farming systems.[26] Furthermore, land reform and especially "land-to-the tiller" forced landowners to release land to tillers, giving the tillers ownership of the land; the landowners in turn obtained shares in national enterprises from the government in return for their land. This enabled the government to obtain the necessary capital from landowners to channel into other enterprises such as

[26] Kuo,1983, *op cit*. p.28

industries and banking. This paved the way for Taiwan's initial economic transition from agriculture to light industry.

In addition to the capital obtained from the old and rich migrant families[27], US aid from 1951 to 1965 also helped the island to import machinery and materials to develop low-skill, low capital, and labour-intensive industries, such as textiles and plywood, to reduce the need to import such goods. Consequently, this stage is also called "the import substitution stage".[28]

Certainly, in this stage, with the recommencement of the exportation of Taiwan's agricultural products to the Japanese market, Taiwan's economy overcame the dilemma of export deficiencies. The KMT government's land reform policies and US aid were the most significant indirect factors promoting Taiwan's export performance.

In 1954, the first plastics factory was established in Kaoshiung by Wang Yong Ching, the chairman of Formosa Plastics Corporation, under Yin Zhongrong's policy of "Planning Free Economy"[29] by means of US aid and its funding. This is a milestone in Taiwan's industrialization. Initially, the government intended to ask He Yi from the *Yong Fengyu* group, a paper manufacturer, to establish the company, but he withdrew due to the drastic price decrease of plastic material in the international market. Yin then discovered that Wang had savings of NT$8 million (NT$ is Taiwan's local

[27] There were five famous rich families in Taiwan in the 1950s - the Lins of Wufeng, Taichong, the Lins of Panchiao, Taipei, the Chens of Kaohsiung, the Gus of Lukang and Changhua and the Yans of Keelong. Sima Xiaoqing 1993 *Five Renown Families in Taiwan* (1)

[28] Song, *op cit.* p.144

[29] In the1950s, the US government required the KMT government to adopt a "free economy" and released the state enterprises to the public. Yin Zhongrong, a chairman of the committee of Taiwan Industry, insisted that the government should be involved with the plans of industrial development, but allowed private capital to hold shares on these industrial companies. Many landowners were offered stocks in these companies, which produced goods such as fertilizer, cement, and glass.

currency) in Taiwan Bank's *Jiayi* Branch. Because this was the largest saving amount at that time, Yin invited Wang to join the plan, but eventually the government sold its shares to Wang, making Formosa Plastics Corporation a completely private enterprise. Currently, the company is capitalized at NT$48,069 million, and engages in the production and sales of plastic raw materials, chemical fibres and other petrochemical products. The company mainly focuses on PVC (polyvinyl chloride) and synthetic fibres. These products speeded up Taiwan's industrialization and led to growth in the export trade. In particular, the production of synthetic fibres accelerated the boom in Taiwan's textile and apparel industries, because they compensated for the lack of natural materials, such as cotton and wool.

Stage 3: The export expansion stage of 1960-1969

With international competition and protection rising, a target task became the expansion of light industrial exports. By the 1960s, most industrialized countries, such as the USA, the UK and France, had recovered from the damage of World War II. Their growing economies and increased personal income boosted market demand. Japan was still a leading market for Taiwan's exports, but not a dominant one as in the 1950s. The USA and Hong Kong became significant markets for Taiwan's exports. In 1960, the Japanese market accounted for 37.4 percent of Taiwan's exports, the USA 12.5 percent and Hong Kong 11.5 percent.[30]

Because of the limited demand of the domestic market and the large demand from international markets, especially the USA market, an export-oriented policy was the

[30] Lin, Sheng-hsiung, *op cit* p. 90

strategy to initiate Taiwan's economic take-off. The annual growth rate of exports during this period exceeded 20 percent.[31]

Following the termination of US aid in 1965 and in order to obtain capital resources, Taiwan's government adopted a series of policies to attract foreign investment, especially direct investment in labour-intensive industry thus utilizing local Taiwanese labour while importing foreign skills. These policies had attracted firms including GE, RCA, Admiral and Motorola. Export Processing Zones were established for this purpose, the first zone being established in 1965 in Kaohsiung.

Apart from the government's policies, high productivity, and the effectiveness and low wages of Taiwanese labour were the key elements which resulted in success in achieving an export-oriented economy. Full employment was attained in Taiwan in 1971, which led to the equalization of family incomes.

In this period, labour-intensive products, mainly textiles, some electrical machinery and electronic products, which only required a low skill level, supplanted agricultural produce in Taiwan's exports. The proportion of manufactured goods in the GNP first exceeded that of agricultural products in 1963.

Stage 4: The second import-substitution stage of 1970-1979

Emphasis was placed in this stage on developing basic and heavy industries. However, the two petroleum crises of 1973-1975 and 1978 resulted in a downturn in international market demand and economic stagnation which harmed Taiwan's economy. The annual GNP growth rate dropped from 10 percent in the period from

[31] 22 percent in Kuo, *op cit* , p.137, 25 percent in Song, , *op cit.* p. 144

1961 to1965, to 8.2 percent in 1972, and the growth rate of exports also reduced to 19.2 percent per annum.[32] Despite the impact of these two crises, the USA's economy stabilized and continued to grow, and consequently became the main market for Taiwan's exports. The proportion of Taiwanese exports to the US market increased from 12.5 percent in 1960 to 38.1 percent in 1970.[33]

The development of capital-intensive industries was the major economic thrust in this period. To rid itself of the control of foreign manufacturers, Taiwan developed a widespread and stable system of supplying material and parts from domestic sources as substitutes for imported goods. This was the second import-substitution stage. The percentages of GNP from the agricultural, manufacturing, and services sectors changed to 13.1, 38.9, and 47.9 respectively in 1971[34], indicating that Taiwan's economy had been transformed from an agriculture base to a skills-intensive manufacturing and unskilled services economy.

However, the withdrawal of Taiwan from the United Nations in 1972 and the closure of the American Embassy in Taipei in 1979 awakened the Taiwanese to the need to diversify their exports into foreign markets other than the USA and further into the European and Japanese markets.

Stage 5: The liberalization and internationalization stage 1980-1989

Economic liberalization and internationalization were the new targets for Taiwan's economic development in this stage. The upgrading of domestic industry to

[32] Kuo, *op cit* , p.18
[33] *Statistics of Foreign Currency Evaluation Committee of Executive Yuan*, ROC, 1965
[34] Song, *op cit*, p.145

skills-intensive and high value-added industries was a new trend which brought the establishment in 1981 of the Hsinchu Science-Based Industrial Park (HSIP) to fruition. Its various industries had been transformed from labour-intensive to high technology-intensive production methods.

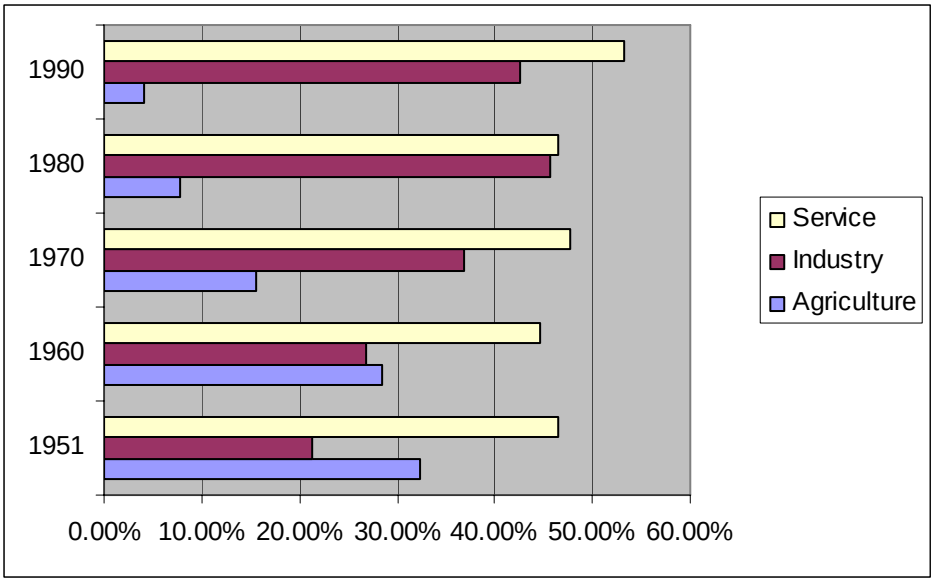
The NT dollar progressively appreciated from US$1.00 = NT$40.00 in 1960 to NT$26 in 1989. The increase in the cost of labour, a shortage of labour in manufacturing industries, more stringent environment protection, the high price and shortage of land, the Labour Standard Law, and Mainland China's open door policies weakened Taiwan's competitive position, increased the costs of Taiwan's products and shrank their export volume drastically. As a consequence, those factors drove many of Taiwan's traditional industries overseas to Malaysia, Thailand and Indonesia, but mainly to Mainland China. This was the preliminary stage of the internationalization of Taiwan's capital.

Because of its high foreign exchange reserves, Taiwan now became ranked as a rich and developed country, bringing with it international pressure to open its economy to international competition. Joining GATT (General Agreement on Tariffs and Trade) and the WTO (World Trade Organization) were some of the main policy measures at this stage resulting in customs tariffs being reduced. The percentages of GNP of the agriculture, industry and services components in 1980 were 7.7, 45.8 and 46.6 respectively.[35]

Figure 1 illustrates the changes in the percentage of GNP contributed by the agriculture, industry and services components in different years.

[35] Song, *op cit*, p.142

Figure 1: Percentage of GNP made up by service, industry and agriculture components



Source: Statistics Summary of Citizen Income in Taiwan's Area, R.O.C.-1951-1991 Executive Yuan. Dec. 1991

According to Schak's analysis, there are six factors involved in entrepreneurial investment abroad, especially in Mainland China[36] as follows:

The first factor is the appreciation of the NT dollar against the US dollar. The NT dollar had a stable official rate of NT$40=US$1 from 1960 to 1984. In 1984, the NT dollar began to rise, increasing to NT$38=US$1. By the end of 1986, the US dollar dropped to NT$35, and NT$29 in 1987. This made Taiwan's products more expensive. Table 5 indicates the variation in the foreign exchange rate and its influence on wages and labour costs.

Table 2 The foreign exchange rate and its influence on wages and labour costs

[36] Schak, David (edited) *Entrepreneurship, Economic Growth and Social Change: the Transformation of Southern China*, Faculty of Asian and International Studies, Centre for the Study of Australia-Asia Relations, Australia-Asia Paper No. 71, 1994 p.63

Year	Exchange rate NT$/US$	Increasing ratio of wages in manufacturing industries (%)	Increasing ratio of unit labour cost in manufacturing industries (%)
1981	**37.84**	**18.67**	**16.77**
1982	**39.91**	**9.74**	**9.01**
1983	**40.27**	**6.35**	**-1.55**
1984	**39.47**	**9.44**	**8.46**
1985	**39.85**	**4.25**	**5.21**
1986	**35.50**	**10.10**	**0.50**
1987	**28.85**	**9.92**	**1.29**
1988	**28.17**	**10.90**	**4.66**
1989	**26.17**	**14.59**	**5.70**
1990	**27.11**	**13.50**	**6.22**

Source: Huang Ren-De A research of the impact of the exchange rate and the changing of labour costs to employment and production in Taiwan, Taiwan Bank Quarterly, 1993 pp. 22-72

The second factor is that the increasing labour costs became a heavy burden which SMEs and SMETCs could not absorb. In ten years, from 1982-1992, Taiwan's labour costs almost doubled. In 1994, Taiwan's wages in the textile industry was 14.7 times higher than its counterpart in Mainland China.[37] This lower wage attracted Taiwan's textile manufacturers to move their production lines to Mainland China.

[37] *ibid*. p. 63. Schak says "In 1982-83, females working at essential unskilled positions in factories and those with vocational school qualifications working in offices in bookkeeping earned around NT$8000 per month as a basic starting wage. Female factory workers with several years' experience and promoted to positions such as quality control inspectors earned NT$9500-10 000, while female office workers with a few years' experience earned around NT$1000 more. Males working in factories as unskilled labourers began at approximately the same wage as females, but as their work usually entailed learning a skill, their wages increased more quickly. A vocational high school graduate with a skill could expect to begin at close to NT$10 000.
Ten years later, the basic wage for any factory worker was NT$15 000 and for skilled workers with a year or two of experience, NT$25 000. For office workers, it ranged from NT$13 000 for someone who had not finished high school to NT$18 200 for a worker with a junior college (*zhuanke*) degree and a high school graduate getting NT$15 600. Labour costs in the textile industry, are now ……..14.7 times

The third factor is the soaring cost of land. Rapid appreciation of the NT dollar and escalation of stock market index points attracted a large amount of foreign capital to infuse into the local capital liquidity. The saving rate was higher than the investment rate. These factors provided excess liquidity which was invested in real estate and stimulated the price of land to rise. Real estate began to boom in the late 1980s resulting in increased costs for those renting land.[38] The manufacturers transferred the increasing costs to the prices of their products to ease this pressure. The international markets could not accept the price increases and either switched their orders or subcontracted out their products from Taiwan. SMEs were forced to follow the international buyers and to relocate their production lines overseas.

The fourth factor is the introduction of environment protection regulation. Many polluting industries, such as plastics and electroplating companies, left Taiwan and moved abroad. Taiwan's SMEs could not afford to abide by the Environmental Protection Agency (EPA) standards, so they chose either to close down or relocate to countries where environmental consciousness is not as powerful as in Taiwan. The environmentalists have affected industry "in two ways: in the form of social movements to protest the siting of various plants and facilities, and through the work of the Environmental Protection Agency (EPA).[39]

The fifth factor is the shortage of labour. The prosperous life changed the values of the new generation. Higher education, as well as easy money earned from the stock market and land speculation of the 1986-89 periods all affected the younger

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higher than in mainland China"
[38] *ibid.* p.63
[39] *ibid*. p.63

generation's attitude towards work and productivity. The older generation, who entered the workplace in the 1960s, 1970s or the early 1980s, work for a living, but the younger ones work for leisure. As Schak says, factory labour "was no longer attractive or even an acceptable option to the majority of new entrants into labour force."[40] Schak continues, "… the younger generation was unwilling to labour. They wanted jobs in the service industry or in offices. …. 'They want to dress nicely and not get their hands dirty; they want air conditioning."[41] When rush orders need overtime work, the older worker will still do it, the younger worker won't. This unwillingness to work in the factories is the main reason for the shortage of labour, resulting in SMEs being unable to meet their orders.

The implementation of the Labour Standard Law in 1984 is the sixth factor. It requests a minimum wage level which is higher than the normal market level. Under the law, the owners of enterprises have to pay various extra expenditures which range from pension and severance payments, overtime premiums, annual paid vacations, and year-end bonuses. The law also supports the unions which encourage labour organizations to utilize strikes as a means of negotiation. SMETCs or SMEs are unable to absorb those additional expenditures and suffer losses due to strikes. As a result they transfer their production lines abroad.

2.2 The effects of Taiwan's Export Processing Zones (EPZs) on SMETCs

The development of Export Processing Zones (EPZs) was a significant outcome of Taiwan's export expansionist policies of the 1970s, causing a profound impact on the

[40] *ibid.* p.64
[41] *ibid.* p.65

development of Taiwanese industry, especially the electronic and instrument industries. This was because foreign companies were mainly involved in the electronic and instrument industries. Although the level of exports from EPZs did not achieve a high rate of sustained economic growth in the 1970s, and some economists have argued that the importance of Asian EPZs has been exaggerated[42], it is undeniable that EPZs attracted enormous foreign direct investments, including from Japanese and US firms, either in wholly-owned or joint ventures in the Kaohsuing EPZs. Foreign capital manufacturers, mainly in the machinery and electronics industries, were all equipped with their own export departments to re-export their products to their mother countries or their own markets. Basically they did not need local trading companies to export their products. However, the firms in the EPZs employed a significant number of local staff either in their production lines or export departments. These employees profited from their working experience and interpersonal relationships to form export networks based on their accumulated expertise in the zones. On the strength of a "*Laoban* (boss) syndrome" as mentioned previously, some of these employees set up their own businesses as SMEs or SMETCs producing electronics components or related products.

An EPZ is an efficient industrial region where the principles of free trade apply, and where legal restrictions are minimized and administration procedures for the registration of firms are simplified. Essential facilities to serve investors are provided conveniently with the aim of enhancing their competitiveness in international markets. All products imported by manufacturers located in EPZs for their own use are exempt

[42] Angus Hone indicates in his article "Multinational Corporations and Multinational Buying Groups: Their Impact on the Growth of Asia's Exports of Manufactures-Myths and Realities" that "exports from Kaohsiung in Taiwan in 1970 were $109 million out of more than $800 million in manufactured exports……although by 1973 Kaohsiung exports were $300 million out of a national total of $2.7 billion.". *World Development. Vol.2, No.2 February 1974, pp.140-149*

from customs duties. The products of the manufacturing industries in the zones are totally for export, and benefit from a preferential tax system. The zones benefit the investing manufacturers by reducing labour costs, and benefit the host society by providing employment and incomes.

Over the last decade, EPZs and similar zones have mushroomed in both developed and developing countries; examples are the "Trade Development Zone" in Australia, "Free Ports and Zones" in Europe, "Foreign Trade Zones" in the USA, the " Free Trade Zone" in Hong Kong, "Export Processing Zones" in Taiwan, South Korea, the Philippines and Thailand and "Special Economic Zones" in China. In 1975, there were 80 free trade zones operating in 25 developing countries; by 1986, there were 175 zones in 47 countries.[43]

There are three EPZs in Taiwan - Kaohsiung EPZ, Kaohsiung Nantsu EPZ and Taichung Tantsu EPZ. The first was set up in 1966 and the other two in 1974. The land areas of the three EPZs are 67, 90 and 23 hectares respectively.

Due to their success, EPZs became internationally well known, and many countries such as South Korea, Thailand, the Philippines, Vietnam, Indonesia and the Dominican Republic either used Taiwan's EPZs as a pattern for their own development or sent delegations to Taiwan to observe and learn how EPZs operated. Some were very successful and some not. Mainland China, after adopting open economic policies, copied Taiwan's EPZs and set up Special Economic Zones in five coastal cities to attract foreign capital. These zones have been most influential in aiding Mainland China's economic development.

[43] The Institute for Advanced Strategic and Political Studies Jerusalem, Washington. *The Free Export Processing Zone in Theory and Practice* www.Jasps.org/eldar8.htm 12/4/2004

2.2.1 The establishment and contribution of Taiwan's export zones

Taiwan's economy, led by its state enterprises, experienced a period of import substitution (ISI) from the 1950s to the early 1960s.During this period its export mix changed from agricultural to light industrial products. The island's government faced problems in further economic development, such as the resettlement of abundant surplus village labour released from agriculture and insufficient capital to upgrade local industries and expand exports.

To meet those needs, EPZs were established to attract foreign direct investment (FDI) and to finance industrialization, expand exports, effectively utilize surplus village labour, and import skills and technology to raise local industrial expertise. The Taiwanese government started to set up its first EPZ in Kaohsiung in 1966 to develop the Taiwanese economy via a combination of cheap domestic labour, foreign capital, advanced facilities and modern technology. It offered cheap land, bonded warehouses, tax incentives such as exemption from taxes on imported materials used by manufacturers themselves in the zones, and commodity and business taxes. In addition, a management centre was set up in the zone to approve applications through a fast and simplified procedure. Applicants were able to process all the steps of registration in this one-stop management centre. The centre also strove to improve the investment environment by such means as setting up a warehousing transportation service centre to shorten customs clearance procedures. With the addition of such facilities as a post office, banks, power supply and a branch of the taxation office, the zone quickly attracted much attention from international investors. Despite the

specified prerequisites and conditions,[44] all vacancies were quickly taken up by firms from the US, Japan, West Germany, the Netherlands and overseas Chinese communities. Multinational corporations and multinational buying groups: their impact on the growth of Asia's exports of manufactures - Myths and realities

This rapid saturation and continuing applications stimulated the establishment of a second EPZ in Kaohsiung and a third in Taichung in 1974. In these EPZs, there were 303 manufacturers[45] equipped with advanced plant and facilities, and up-to-date manufacturing skills and technology. The types of businesses permitted in EPZs were as follows:[46]

[44] For investment projects and businesses in EPZs, the following prerequisites and conditions apply: (http://investintaiwan.nat.gov.tw/moea-moea-web/InvestOpps/AppProcs/EconpressZones, 12/04/2004)
A. Minimum paid-in capital (NTD): $10 million for plant leasing/purchase and $20 million for plant construction on leased land for manufacturing businesses, $80 million for warehousing businesses, $50 million for transportation businesses, $5 million for trading businesses, and $1 million for transportation service business and other businesses. If minimum capitals specified in other laws and regulations are higher than the above standards, the higher amounts shall apply.
B. Minimum area of land leased for plant construction: 2000 square metres for manufacturing businesses, and 3000 square metres for warehousing and transportation businesses. No restrictions on other businesses.
C. Establishments within EPZs shall use land, water, and electricity efficiently and conscientiously.
D. Establishments within EPZs shall not endanger public safety and environmental hygiene.
[45] Song Meidong, *Taiwan Export Processing Zones—A transition from a decayed area to a miracle (Hua fuxiu wei shenqi de Taiwan jiagong chukou qu*), Economic Daily News (Taiwan Jingji Ribao), ROC, 26 Feb. 1970.
[46] http://investintaiwan.nat.gov.tw/moea-web/InvestOpps/Appproces/EconPrcssZones/

1. Precision machinery/instruments, optical/medical instruments and timepiece manufacturing;
2. Electric and electronic machinery/instrument manufacturing, repair and distribution;
3. Computer, communications and audio/video electronic product manufacturing;
4. Metallic product manufacturing;
5. Machinery equipment manufacturing, repair and distribution
6. Chemical and biochemical product manufacturing;
7. Food manufacturing;
8. Transportation tool manufacturing, repair and distribution;
9. Aviation equipment and related component manufacturing;
10. Utilities business;
11. Textile, garment and apparel/accessory manufacturing;
12. Miscellaneous industrial product manufacturing;
13. International trading;
14. Consultation services;
15. Data processing and information provision services;
16. Warehousing/trans-shipment; and
17. Other high tech., capital-intensive, high quality or high value- added business, and /or business which have been approved for establishment.

These businesses produced a wide variety of items including electronic products and parts, optical products and instruments, black and white and colour TV receivers, hi-fi stereo systems, watches, leather shoes and gloves, other leather products, cameras, printed circuit boards, apparel, knitting wares, plastic products, fishing equipment, and yachts. Products were exported to 120 countries. The major market was the USA accounting for 25 percent of the exports. Electronic products accounted for a third of total national exports and constituted the main export products from the zones.[47]

[47] Song *op cit*. p. 142

In 1970, Kaohsiung EPZ, with a land area of 69 hectares and state investment of US$3 250 000, attracted an inflow of US$39 792 000 capital investment including US$6 423 000 from overseas Chinese, foreign capital of US$25 406 000 from elsewhere and joint venture capital of US$7 963 000. Its exports amounted to US$100 million with a favourable trade balance of US$21 440 000. Employees numbered 45 000.[48] By 1973, total employees in the three EPZs had risen to 80 000, exports had increased in value to US$400 million, which was 9 percent of Taiwan's gross national product, and the three EPZs attracted investment of US$100 million of which 30 percent was from abroad.[49]

This inflow of foreign capital resulted in advanced facilities and technology, and scientific management ensured that local employees used up-to-date technology and paved the way for the modernization of Taiwan's industries. For example, Zeiss introduced advanced optical technology and Canon introduced the technology for optical instrument and camera manufacture.

2.2.2 The decline of the EPZs

According to a 1979 article in the Taiwan Economic Daily[50], 82 manufacturers in the EPZs or approximately one third of the total, had either ceased operations or withdrawn from the zones by 1979, eleven years and seven months after the zones were initiated. Since 1984, many factories in the EPZs have relocated to other

[48] *Five years' achievements of the establishment of Kaohsiung Export Process Zone, Taiwan (Kao jaogong chukou qu sheli wu nian you cheng)*, ShinSheng Bao, 28 Nov, 1971
[49] Deng Genshi, Export Process Zones in Five Years (Wu nian lai de Jiagong chukou qu), *Central Daily(Zhongyang Ribao) ROC*, 25 Nov, 1973 Taipei
[50] Zhang Zhenghua, The gradual decline of EPZs. *Economic Daily (Jingji Ribao*), ROC. Taipei 20 July, 1979

countries. The report also indicated three reasons for this decline, which are outlined below.

Firstly, the preferential term of five years of tax exemption for most users had expired, decreasing the competitive advantage for products made in EPZs. Moreover, EPZs in other developing countries offered more attractive conditions to induce the firms to move, and local bonded factories outside the EPZs were offering better conditions and fewer restrictions.

Secondly, problems in equipment replacement arose with the ageing of facilities, affecting product quality and cost, and production planning. Manufacturers of labour-intensive products, such as leather shoes and garments, attempted to replace production lines based on manual labour with those based on automated processes. However, the superseded equipment could not be sold and the manufacturers continued to use the machines until they became virtually unusable. The consequence was that these manufacturers moved out of the zones.

Thirdly, there was a problem with stocks of spare products retained for the replacement of products. They could be neither exported nor sold locally, and they became a financial burden. Rising labour costs and land prices in the 1980s also decreased Taiwan's competitive advantage. The opening of the Hsinchu Science-based Industrial Park in 1980 quickened the pace of the decline.

For these reasons, by the end of 2000, the number of manufacturers had declined to 209 in the three zones, and the number of workers employed in them declined to about 68 000.[51] However, the firms in the EPZs facilitated the export of inexpensive

[51] Free Taiwan, *Free Trade Zones/Warehouses*, http://www.kishtpc.com/free_taiwan.htm, 8 April 2004

labour. They also benefited the manufacturer by reducing labour costs, and they benefited the host society by providing employment and incomes. In conclusion, EPZs made a substantial contribution to Taiwan's earlier economic development, especially in the manufacturing sector.

2.3 Conclusion

Taiwan is an island, and its economic development inevitably relates to trade by sea. Its geographical location has necessitated very close ties with Mainland China, and Taiwan's merchants' trade behaviour also imitated Chinese sea-traders. According to Zhang Rongcun,[52] Chinese sea-traders were small-scale business owners. They did not have formal organizations, and performed their business individually. They brought along their goods with them and travelled in rented vessels, conducted trade overseas by themselves when the vessels arrived at the foreign harbours. This occupation was passed down to their descendants. In the twentieth century, Taiwan's SMETCs followed this model; instead of vessels, they travelled by aeroplane to every corner of the world to promote their products.

In the seventeenth century, the competition among European countries was extended to Asia. In Taiwan, Spain took over from Portugal, and the Netherlands replaced Spain in using Taiwan as a base for their trade in Asia, and in controlling Taiwan's export economy. These Western imperialists also introduced new knowledge to update their international trading skills by expanding their markets into areas other than China.

[52] Song,Guangyu, 1993 p.47

Under pressure from the military and to satisfy political needs, *Koxinga* took Taiwan from the hands of Dutch in 1662. He started to cultivate Taiwan as a base for re-establishing the Ming dynasty. Taiwan's small trading businesses started to develop again.

In the Qing dynasty, the trade interaction between China and Taiwan was very active; however, the major trading activity was in the hands of Western companies and their compradors.

Before 1895, Taiwan traded mainly with Mainland China. During the first seven years of Japanese rule, there were no obvious changes to this pattern. However, after 1902, the Japanese government deliberately switched Taiwan's market to Japan. The Taiwanese economy fell into the hands of the Japanese government and the *zaibatsu*. There was no room for Taiwan's small-scale trading companies.

In the KMT period, the government implemented a series of polices to fuel economic development, with very positive results. The establishment of EPZs for FDI manufacturers was one of the elements of Taiwan's economic miracle. The government's outward looking economy led to the growth of international business. Under its "equality of income" *(jun fu*) policy, the government depressed the growth of large-scale business organizations. This enabled SMEs and SMETCs to flourish.

CHAPTER THREE

Taiwan's Large Trading Companies and General Trading Companies in Asia

Introduction

While the General Trading Companies (GTCs) played a significant role in the Japanese national economy by performing their various functions, Taiwan's SMETCs were criticized for the enormous number of members, the small size of the businesses and their limited functions. The success of the Japanese GTCs stimulated policy decision makers in Taiwan's government to establish the same business firms in Taiwan. They believed larger scale firms were the panaceas for expanding Taiwan's export trade and extending its export arms directly to the international markets bypassing foreign control by countries such as Japan and the USA.

Under these circumstances, the estimated effectiveness of large-scale general trading companies was grossly exaggerated. However, as an old Chinese saying goes "An orange grown across the River Hui will be different" (*Ju guo Huihe hua wei zhi*) - meaning that things will turn out differently in different locations and surroundings. Both policy makers and economic researchers lacked a practical understanding of the differences in the economic environments of Japan, Korea, and Taiwan and the diversity in their cultures. The failure of Taiwan's Large Trading Companies (LTCs) was not surprising.

The failure of the Taiwan's LTCs did not change the general opinion about SMETCs. In their research, Nelson N.S Shen (1982), Gong Zhouming (1984) and Shen Limei (1986) still tended to sing the praises of large-scale trading companies and point out

the weaknesses of the SMETCs. However, Japan's bubble economy eventuated in 1990, followed by the Asian economic crisis in 1997; and although they do not fall into the period covered by this study, it is interesting to note that Taiwan's economy has remained stable, indicating that "big is not necessarily good."

In this chapter, the general functions of trading companies will be examined to reveal the effectiveness of the functions of Taiwan's SMETCs. Japanese and Korean general trading companies will be studied and comparisons of these large-scale trading companies will be undertaken to understand the reasons "why Japanese and Koreans can but Taiwanese cannot."

3.1 General functions of trading companies

In order to understand the role of the SMETCs and the reasons for establishing General Trading Companies, the functions of trading companies should be examined.

In general, trading companies perform two essential tasks. They act as bridges between users and suppliers, and develop trade flows by engaging in activities that increase supply of products and stimulate additional demand. Lin Junxiu (1976), Daniels and Radebaugh (1992) and Onkivist and Shaw (1993) state that export trading companies are supposed to provide such functions as:

1. handling correspondence
2. transporting and warehousing.
3. market planning and promotion
4. collecting various information covering market trends, the economy, culture, and politics
5. providing financial assistance to their suppliers and sharing risk with the suppliers

6. providing insurance, customs clearance, after-delivery services, and credit investigation of both buyer and producer
7. supplying material, technical support and technology transfer to their suppliers
8. offshore trading also called triangle trading - trading companies export products directly from overseas to third countries
9. FDI-foreign direct investment - trading companies play the role of investors in foreign countries
10. R&D – research and development

While the General Trading Companies in Japan perform these functions successfully, and play a significant role in Japan's national economy, Taiwan's SMETCs have been able to carry out only the basic functions, such as handling correspondence, quality inspection and collecting samples, because of restrictions on their size and capital.

For the purpose of enhancing Taiwan's competitive power in the international market, the Taiwanese government tried to establish their own system of GTCs.

3.2 General Trading Companies in Asia

People in business circles have used the term "General Trading Company" (GTC) for decades to describe Japanese trading companies called *sogo shosha*, which "belonged to a different league from the other trading companies in terms of size, scope of activities, and their strategic directions. These Japanese GTCs were so unique in nature that the word GTC became a generic term to identify only these companies."[53]

Japan, South Korea and Taiwan are countries with very limited natural resources and have had to rely on international trade to develop their economies. As a result, these

[53] Cho, Dong Sung, The Anatomy of the Korean General Trading Company. *Journal of Business Research* 12, 1984 pp. 241-255

countries all experienced the control exerted by the European trading houses which "were established around the beginning of the 17th century with the intention of exploiting the colonies of their mercantilist motherland. In particular, the companies of the United Kingdom and the Netherlands, such as the East India Company and Oost-Indische Company, expanded their business territories from India to Indochina and China, and to Japan when her door was opened with the Meiji Reform in 1868. Within years these European trading houses occupied up to 95 percent of the Japanese import market".[54] In order to remove this foreign control, to diversify their markets and to approach international markets directly, the governments of Japan, South Korea and Taiwan directed their efforts into transferring their export business from these foreign companies to their indigenous trading companies. The Japanese government urged the large business conglomerates or *zaibatsu* to export their various products through their trading companies to the international markets directly. The first GTC in Asia, Mitsui, was modelled after the European trading houses and was established in 1876 by the Japanese Meiji government.

In the 1970s, the consistent growth of Japanese GTCs in the midst of worldwide economic recession drew the attention of policy makers in many countries. Taiwan, Korea, and Thailand "recognized Japanese GTCs as a leading force in the Japanese export front and one of the major causes of her trade surplus. Thus these countries started to develop their own GTC systems in order to survive and prosper in the face of mounting pressure from the protectionist moves adopted by major importing countries."[55] Consequently Korea set up its first GTC, Samsung Trading Company, in 1975; followed by the establishment of another nine Korean GTCs. These companies

[54] *ibid*.
[55] Cho, Dong Sung, *op cit*. pp.241-255

have proved to be very successful, whereas Taiwan's Large Trading Companies have suffered the bitter results of failure. The Taiwanese government established seven GTCs, but only one was still surviving in 2002. This shows that Taiwan's GTCs are not as essential as their counterparts in Korea and Japan, and also proves that Taiwan's export trade relied heavily on SMETCs to create its economic miracle. The success and failure of Asian GTCs is dependent on factors including the size of the national business groups, government policies, and the relationship between manufacturers and trading companies. This chapter will examine these factors.

3.2.1 Japanese General Trading Companies

There are over 8,000 trading companies in Japan today, but only a few hundred are engaged in foreign trade. Most are specialized trading firms (*semmonshosha*); only a few are General Trading Companies.[56] As mentioned previously, General Trading Companies originated in Japan's *sogo shosha*, the export arms of large business conglomerates (*keiretsu*, known as z*aibatsu* before World War II). *Sogo* means "general", and *shosha* is a trading company. The term began to be used around 1954.[57] They are wholesaling companies which focus on trading and handling enormous numbers of products, whereas specialized trading companies only handle one or two particular categories of product. For example, Sumitomo Corp. handles some 20,000 products. *Sogo shosha* are Japanese traders, existing at the centre of Japan's global economic effort and serving as supply and sales intermediaries for half of Japan's total foreign trade and much of its domestic transactions. They are not manufacturers and financial institutions, but they are giant financial intermediaries.

[56] Herbig, Paul www.geocities.com/Athens/Delphi/9158/kwujmktg13,html 7/11/04
[57] Gong, Zhouming (1984) indicates that the term *sogo shosha* was used in 1947. *A study of Japanese Sogo shosha*, Chuangxian Cultural Enterprises Co. Ltd, Taipei, p.3

They search the world, collecting information and using their international offices to meet the needs of their customers. Mr. Motoyuki Oka, President and CEO of Sumitomo Corporation indicates that a *sogo shosha* should, based on its integrated corporate strength, strive to meet its clients' diverse demands and respond immediately to changes in world markets.

After the Meiji Restoration of 1868, which followed almost two hundred years[58] of self-imposed isolation by the government, Japan opened its doors to the world and was eager to link itself to the world economy. But Japanese manufacturers were unfamiliar with the export business, including procedures such as handling customs and marketing processes, so they needed export companies to promote their products in the international market. Initially, Western trading firms filled the gap in Japan's needs and dominated its international trade. They handled 97 percent of Japan's total exports in 1874.[59] Japanese tariff reform ensued in 1899. The new tariff system benefited the local *zaibatsu* and granted them a privileged position in the development of their foreign trade. Therefore, Japanese *zaibatsu* trading companies gradually replaced foreign firms and became prominent by the mid-1920s. In the early stages, *zaibatsu* mainly handled paper work for imports and exports and provided transportation and storage services. Later they began to branch out into other activities such as marketing, acting as market intermediaries for the domestic and international distribution of Japanese-manufactured goods.

The first of the *sogo shosha* was Mitsui Bussan, a subsidiary of Mitsui. Mitsui started its alcohol business in 1615, and then developed into a well-known apparel dealer in

[58] Cui Zairong (1991), *A comparative research of Chinese and Korean large trading companies*, Cultural University masters thesis, p.9. Cui indicates that the period of Japanese self-imposed isolation was more than three hundred years.
[59] Kunio Yoshihara (1982), *Sogo shosha*, Oxford University Press, Tokyo, p.187

the 1700s. It became a moneylender and was allowed to issue both currency and government bonds. The Mitsui Bank opened in 1876. In the same year, it was expanded again as a general wholesaling trader and founded a trading company, Mitsui Bussan which "wrested control of Japanese international trade from the hands of the West"[60] and by the 1930s had already grown to be the largest corporate group in Japan. The four biggest business conglomerates, Mitsui, Mitsubishi, Sumitomo and Yasuda, started to boom during the First World War. They supplied armaments and other goods to the Allies. They grew very rapidly and dominated a large segment of the market. Later, they supported the Japanese military by supplying them with munitions during the Second World War, and consequently after the War they were broken up into numerous small trading companies by the Supreme Commander for the Allied Power (SCAP) in 1947 to "insure that the former enemy would never again become a threat to world peace".[61] The owners of the groups and their relatives were forced to dispose of their shares in the companies and were prohibited from taking any managerial or higher positions. The SCAP also froze the owners' and the companies' assets.

The outbreak of the Korean War provided Mitsui with the opportunity in 1952 to reintegrate its former businesses and regain its leading position in international and domestic markets. Other former *zaibatsu* companies also grouped around the banks and manufacturers, and re-established their conglomerates, which were called *keiretsu*. Their export arms, General Trading Companies, also reverted to their previous lines of business. Their import and export business grew rapidly to the extent that they handled 49.5 percent of Japan's total export volume in 1981.

[60] Kenichi, Miyashita (1994), *Keiretsu – Inside the Hidden Japanese conglomerates,* McGraw-Hill, New York, p.25
[61] *ibid*. p 31

Sogo shosha are unique Japanese business organizations because of their size, scope, functional diversity and information gathering capability. *Sogo shosha* handle all types of trading, and the sale of a wide range of merchandise: 20 000 to 40 000 items ranging from instant noodles to satellite communications. They not only work as intermediaries in foreign trading but also carry out banking, manufacturing, warehousing, transportation, resource development, and offshore triangle trade where neither buyer nor seller is a Japanese company. Other than these ordinary commercial transactions, *sogo shosha* are also involved in local and domestic project investment and formation, financing, information, distribution and risk assumption. From fiscal 1965 to fiscal 1974,[62] the combined sales of the top nine *sogo shosha* amounted to about 17 percent of Japan's nominal GNP growth. The top ten *sogo shosha* enjoyed 54 percent[63] of Japan's foreign trade and 48.7 percent of its export volume in 1980.[64] Although exports are not the major business of *sogo shosha*, they acted as vital export arms of Japanese *keiretsu.* A *keiretsu* is a group of a thousand companies all working for a single large firm exerting a major influence on the Japanese economy. The manufacturing *keiretsu* integrates a pyramid of suppliers and component manufacturers in one structure. These suppliers and manufacturers have their own vertical relationships with, for example, SME subcontractors, to accomplish the flow of products, service, and so on. They have many close knit overseas networks collecting first hand market and economic information to transmit to their respective head offices in Japan for analysis so that the most efficient and effective strategies to cater for rapid changes in the economic environment can be adopted.

[62] Japan Foreign Trade *Council Inc.* (1998) *Portrait of Tomorrow's Trading Firms. p.14*
[63] *Marubeni corporation, the Unique world of the Sogo shosha in 1978*, http://marubeni.com/network
[64] Gong, Zhouming, *op cit* p.12

The success of the Japanese *sogo shosha* has been due mainly to government policies, particularly its personnel policy, the separation of production and marketing operations systems and close knit information networks. *Sogo shosha* won very strong support from the Japanese government due to their involvement in supplying military necessities during many wars. Shortly after the end of the Second World War, Japan officially announced a policy to place trade as the backbone of the national economy. The government established a series of export-supporting institutions, such as banks and other financial institutions,[65] and also encouraged those banks and institutions, which were the biggest shareholders in the *sogo shosha*, to maximize their loans at the lowest interest rates, enabling *sogo shosha* to operate their businesses with sufficient capital. In addition, Japan's government also installed provisions for tax deductions based on export income, preferential financing for exports, export insurance and other systematic support for exports.

With these financial advantages, *sogo shosha* were able to provide short-term low interest loans to their suppliers and had the facility to share risks with them. Through their vast access to trading opportunities, *sogo shosha* were able to provide raw material to manufacturers at low cost and provide Japan's SMEs with established channels to conduct international marketing operations. In so doing, a very stable relationship between *sogo shosha* and their suppliers resulted, helping to form an effective system wherein manufacturing and marketing operations were separated. Japanese manufacturers have preferred to leave the marketing function to trading companies. Consequently, Japanese exporters, including manufacturers and trading

[65] Japan set up the Export Bank of Japan in 1950, and the Bank of Tokyo and Japan External Trade organization in 1958. Financial institutions include trust companies and life and merchandise insurance companies.

companies, can concentrate on utilizing their particular expertise and compete internationally in unison.

Sogo shosha personnel systems emphasize the importance of training. Every new male employee has to undergo eleven years of training before being eligible for promotion. They need fifteen years' training to be a section chief. They are required to sit for company internal examinations annually thus ensuring that the staff's performance, knowledge and skills are updated. Recruitment is open to the public and new staff has to be guided by senior staff having at least five years' working experience.

In accordance with Professor Paul Herbig's "Evolution and cultural basis of the Sogo Shosha", the chances for employees to travel overseas and rotate jobs are other factors which draw in young Japanese graduates.

> The trading companies' role is to spot business trends and opportunities throughout the world. This role positions the companies to pick the top Japanese graduates. Another strength is that the groups encourage specialists rather than generalists and move employees into new jobs every five to seven years rather than every two or three years as in most Japanese companies.[66]

Life-long employment prospects and seniority mean higher wages which also attract young graduates into secure jobs and engender loyalty and devotion to the employer. The loyal and experienced employees have led the respective organizations to outstanding economic achievements. Japanese *sogo shosha* have had an aversion to

[66] *From a series of Japanese marketing lectures* p. 2
http://www.geocities.com/Athens/Delphi/9158/kwujmktg22.html

"job hoppers" because of the problem of loyalty and the diversity of organizational culture.

In Japanese *sogo shosha*, decisions are made by the most senior person of the organization in consultation with the top management team. For example, Marubeni has three committees - the Corporate Management Committee, the Committee of Chief Operating Officers, and the Committee of Executive Officers - who work as a team of consultants to assist the president to make a decision. The team comprises highly trained specialists with an average of at least 15 years of trading experience in different fields.

The other vital element in the success of the *sogo shosha* has been their gigantic worldwide information networks, which are scattered throughout the world. In 1983, nine *sogo shosha*[67] had 1 415 subsidiaries overseas and employed 23 920 people. For example, Mitsubishi's 232 offices sent in more than 30 000 pieces of information daily. They acted as eyes and ears for its *keiretsu*. They collected directly applicable information such as product prices, market demand and supply conditions, and foreign currency and shipping data. They also collected indirectly applicable information, relating to subjects such as the local economy, politics, society, culture and weather. Business organizations all paid very close attention to this information, since such indirect data could also affect the economic development of a nation or an area. Their internal financial organizations provide sufficient capital to *sogo shosha* overseas subsidiaries to ensure that they operate without difficulty.

[67] They are *Mitsui, Mitsubishi, Marubeni, Itochu, Sumitomo, Nissho Iwai, Tomen, Kanematsu and Nichimen*

Prompt and precise information enables *sogo shosha* to predict market and potential business trends before competitors from other countries do. *Sogo shosha* utilize this information to maximize their profits, minimize risks and provide market trend information to their own suppliers. Through offering updated information, *sogo shosha* maintain a close relationship with manufacturers, thus ensuring the supply of products for export. Both parties ensure that the system of separation of production and market operations is maintained. This is another important factor in the success of *sogo shosha*.

3.2.2 Korean General Trading Companies

Korea's GTCs are recognized as the export arms of its *chaebol*. A *chaebol* is a "business group of varied corporate enterprises operating in diversified areas, and typically owned and managed by one or two related family groups. They were intentionally created by the government to marshal the scale economies inherent in mature technologies, to compete in export markets, and to engage in technological learning".[68] In short, the Korean *chaebol* is a borrowed version of the Japanese *zaibatsu*. They perform entrepreneurial functions to fulfil the Korean government's development goals on one hand, but their survival and prosperity are controlled by the government on the other hand.

Korea had limited natural resources, small land area and plenty of high quality and low wage labour. Similar to Taiwan, South Korea faced the problems of capital accumulation in the agricultural economy, and its access to export trade was controlled by Japanese *sogo shosha* and Western companies. But the Korean

[68] Kwong, Kai-Sun 2001, p. 162

government had a more ignitable will than its counterpart government in Taiwan. With its executive power, the government acted to allow Korea's export-oriented economy to grow by controlling resources allocation, combining its labour force, and increasing its potential for development and foreign capital investment. The 1960s and 1970s marked Korea's great leap towards a semi-developed state, and the 1970s and the 1980s from semi-developed to economic maturity. Efficient resources allocation and effective cooperation between government and business are the major factors in its economic success. Korean General Trading Companies were successful results of these strategies and played a significant role in Korean economic growth.

The Korean government implemented a series of Five-Year Economic Plans and a policy of export expansion in the early 1960s. The government adopted strategies which provided Korean exporters with assistances in areas of finance, tax exemption, and manipulation of foreign exchange rates. Since then, Korea's export trade underwent rapid expansion. As a result, the number of inexperienced small and medium-sized trading companies dramatically increased. These small and medium-sized trading companies were unable to cope with competition in international markets in the wake of reduced international protection in the 1970s. The global economic recession in 1973, the year of the first oil crisis, caused Korean export stagnation. In relation to the expansion of export channels and adding new markets for its exports, the Korean government's new economic policies[69] aimed at setting up an agency system to maximize the size of domestic export manufacturers and firms, and to reduce their dependence on the government's export subsidies. In the meantime, the Korean export structure progressed from light industrial products to heavy

[69] The government attempted to use economic growth to cover its political failure in the 1970s.

industrial products. This transition demanded large-scale business organization. The success of the Japanese *sogo shosha* motivated South Korea's government to set up similar entities, and they established the first *chonghap sangsa* (the Korean pronunciation of *sogo shosha*) at Samsung Trading Company, in 1975. With strong government cooperation and support, twelve General Trading Companies[70] (GTCs) were established after 1975. In addition, the Koryo Trading Company was set up by the government to assist small and medium-sized Korean manufacturers to handle their export business. To channel all Korean exports through the GTCs, the government even prohibited non-Korean trading companies from engaging in foreign trade, both importing and exporting.

The Korean GTCs are in the centre of the c*haebol* and their activities cover the full business spectrum, including importing, exporting, futures trading, mining, steel making, vehicle manufacturing and government international purchasing. They do not manufacture, but purchase products from their subsidiaries' manufacturers or suppliers outside the *chaebol* organization. They are also involved in many overseas investment projects such as coal mining, e.g. Dayton and Eastham in Australia, and petroleum production in Indonesia, Canada and Alaska. In contrast to their counterparts in Japan, whose businesses were mainly in domestic markets[71], Korean GTCs have focused on exporting heavy industrial products. They act as the export arm of the *chaebol* to expand the international markets for their products. Korean GTCs accounted for 40.6 percent and 37.9 percent of Korea's total export volume in 1980 and 1989 respectively.[72] Korean GTCs are also equipped with a large number of

[70] Samsung, Hyundai, Lucky-Goldstar (LG), Daewoo, Sunkyong (SK), Ssungyong, Hyosung, Kumho, Koryo, Yulsan, Samhwa Korea Explosives and Hanjin,
[71] In 1983, Japan's *sogo shosha* shared 60% of national imports, 50% export and 40% domestic market. In 1984, Korean GTCs shared 52% of national export. Shen, Li-Mei p. 33
[72] Gong Zhouming *op cit*., p.10

overseas information networks. They had 321 offices and employed 3 809 people worldwide in 1990.[73] These international resources also provided their head offices with much valuable information enabling GTCs to formulate effective plans and strategies.

Korean *chaebol* and their GTCs are family businesses managed mainly by the families themselves. In his book, *The Chaebol*, Steers indicates that:

> ….one study found that of the top twenty *chaebols*, 31 percent of the executive office were family members, while 40 percent of the executives were recruited from outside corporation and 29 percent were promoted from within. . . . A second study . . .found 26 percent of the presidents of the major companies were founders, while 19 percent the sons of the founders, 21 percent were promoted from within, and 35 percent were recruited from outside.. . . the core managerial positions in nearly all the companies belonged to family members.[74]

Final decision-making is virtually the role of the single proprietor of the founding family. This is true of *chaebol* and their GTCs. This system indicates that the management of Korean GTCs is very centralized. In the absence of consultation with expert staff, the founders take full responsibility for the risks involved. This vulnerability has caused bankruptcy crises in GTCs when the decision-making was not based on pertinent information.

Similar to the situation in Japan, Korean banks provided full support by way of loans to the GTCs at discounted interest rates, and GTCs in turn provided low interest rate loans to their suppliers. But in order to inhibit the rapid growth of small and medium-sized manufacturers and to prevent their expansion to large-scale business

[73] Cui Zairong, *op cit.*, p.74
[74] Steers, Richard M. Yao Keun Shin, and Ungson, Gerardo R.,(1989) *The Chaebol - Korea's New Industrial Might*, Harper & Row, New York, p. 37

groups as competitors, GTCs adopted a strategy of integrating these SMEs into their operations by creating a bankruptcy dilemma through their loan controls.[75] The relationship between Korean GTCs and their suppliers is not as extensive and strong as that of their counterparts in Japan. However, they exercise very tight control over the manufacturers to ensure reliability in the supply of export products. They either produce the products themselves or acquire them from their respective associated companies.[76]

To enhance the GTCs' financial flexibility, the Korean government provided foreign exchange control relief for those companies that had total exports with an annual value of at least US$50 million. Since the criteria for government assistance, including financial aid, and tax and foreign exchange benefits were based on the annual export value, Korean GTCs increased the value of their exports by any means possible, irrespective of the profit consequences. Thus, the competition among GTCs increased, leading to the elimination of some GTCs. In 1975, Korea had thirteen GTCs, but by 1979 only nine had survived.[77] However, the competition between exporters induced a growth in total national exports. This growth led Korea to international markets and intensified their direct and indirect trading relationships with 187 countries in the world. Although the USA and Japan were still their major export markets, Korea also exported a significant amount to India, Norway and Panama.[78] GTCs improved their fiscal structure in the 1980s. They also changed their strategy from seeking merely to increase the volume of exports to increasing company profits. GTCs also filled a leading role in national exports. They accounted for a high

[75] GTCs are not allowed to have their own banks. But some *chaebol* can have "merchant's banks" which control the loans.
[76] Field, Karl .J (1989) *Asian Survey* V29 No.11. The former had 16 percent and 35 percent from the latter. pp.1073-1089
[77] *ibid*, p.57
[78] Cui Zairong, *op cit.*, p.69

proportion of the volume of Korean exports, e.g. 43.2 percent, 46.5 percent and 37.5 percent in 1982, 1985 and 1989 respectively, with an average of 41.5 percent from 1980 to 1989.[79]

To conclude, the Korean GTCs successfully realized their original objective to expand and diversify international markets for Korean exports. The key elements in the success of Korean GTCs were government sponsorship, large business group support and exclusive access to captive suppliers.

3.2.3 Taiwanese Large Trading Companies

After withdrawing from Mainland China, the KMT government and its economic policy makers implemented outward-looking strategies to develop the Taiwanese economy. Taiwan's exports expanded in the 1960s and its economy took off in 1970s: the well-known Taiwanese economic miracle. Though all the evidence indicates that the Taiwanese economic miracle resulted from the efforts of numerous SMEs and SMETCs, their weaknesses, such as small size, insufficient capital, shortage of experienced personnel, fragile marketing networks and backward management, were initially counted as obstacles to securing direct access to international markets and in building up their own direct selling channels. With reference to Charts 1 and 2 in the previous chapter, Taiwan's export products were not actually delivered into the hands of the end users and consumers but to foreign importers or large-scale foreign trading companies under the foreign traders' brands. By the late 1970s, these foreign traders handled 70 percent of Taiwan's exports, and in 1986, 65 percent was still in their

[79] Cui Zairong, *op cit.*, p.71

hands.[80] Most of the profits from exports went into the pockets of those foreign traders.

In the 1970s, Taiwan's booming outward looking economy resulted in proliferation of its SMETCs, resulting in fierce competition among exporters in domestic and overseas markets. This weakened the competitive advantage of Taiwanese products in overseas markets. Furthermore, together with the increase in international protectionism, local labour costs and oil prices in the 1970s, Taiwan's exporters saw an urgent need to penetrate international markets. Taiwan's government was aware of this situation, and having witnessed the success of the Korean GTCs and Japanese *sogo shosha* in promoting exports. It was led to consider restructuring Taiwan's trading regime by establishing designated Large Trading Companies (LTCs) to achieve their four specific objectives and offering them "duty-free import of raw materials to be used for export products, establishment of bonded warehouses, guarantees for loans to SMEs for import of raw materials and preferential treatment in financing based on letters of credit".[81]

The fist objective of government in setting up LTCs was to lead Taiwan's industries from Original Equipment Manufacturing (OEM) to Original Brand Manufacturing (OBM). In OEM, international buyers provide designs and the main components of the products and then use Taiwan's manufacturing facilities to produce goods under the buyers' brand. International clients take care of product designs, sales, and marketing. The functions of SMETCs are limited to domestic tasks, such as interpreting, translation, coordination and shipping. In OBM, Taiwan's SMEs and

[80] Field K.J., *op cit.* pp. 1073-1089
[81] *ibid.*, p. 1083

SMETCs are involved in R&D to develop their own designs, and market their own brand directly into the international market. Even though this was likely to cause cash flow pressures in SMETCs and SMEs, Taiwan's government guided the enterprises in this direction. The government attempted to break through the foreign traders' control of international sales channels, and to enhance the ability of Taiwanese companies to export directly to the international market using Taiwan's own brands and to approach the international market through its own selling networks. Moreover, because Taiwan's markets were concentrated in the US, Japan, and Hong Kong, the government also attempted to diversify the markets. Product similarity and market overlap was causing vicious competition that disturbed orderly trading, so the government hoped to rationalize export product categories. For example, in the early 1980s, the Rubik cube was a very popular product with good profits, then many similar products were produced filling the markets everywhere. This "swarm of bees" phenomenon causes cutthroat price wars and shortens the life cycle of the product.

The government's second objective was to assist SMEs to promote the export of their products as export agencies to replace foreign firms. Its third objective was to collect information: LTCs were supposed to establish overseas subsidiaries and trading networks to enhance their ability to collect information which would help Taiwan's exporters to compete successfully in international markets. The fourth objective was to source materials effectively, i.e. to import them through the sole channel of LTCs with tax exemption to ensure product quality, cost reduction and an increase in profits of LTCs and their partner manufacturers.

In 1977, the government consulted Japanese experts and initiated the establishment of LTCs. Taiwan's first LTC, Pan Overseas, was established in 1978.[82] By 1983, a total of seven Large Trading Companies were set up. They were:

1. Pan Overseas International, with fourteen overseas Chinese companies, twenty local manufacturers, six trading companies, and two state monetary institutions, Central Trust of China and United World Chinese Commercial Bank (November1978);
2. Collins, established by Collins Co., an exporter of building materials, and five other SMEs (January 1979);
3. Tainan Textile Enterprises, a famous textile manufacturer, with investment from the International Commercial Bank of China, joined 41 other SMEs to establish Nanlien International (February 1979);
4. Great International, established by the China Farmers' Bank, Wei Chen Food Enterprises, and 36 other firms (March, 1979);
5. E-Hsin International, set up by the Overseas Chinese Commercial Banking Corp., the United World Chinese Commercial Bank and 11 other business organizations (March, 1980);
6. Peacock (1984); and
7. Taipoly (1984).

Few of these LTCs had a long life. Great International was closed down in 1984 because of the financial crisis of its related enterprise, Wei Chen, Peacock, Taipoly and Nanlien withdrew because their exports failed to reach the criteria set for LTCs in 1985. Thus by 1989, only three LTCs, E-Hsin, Collins and Pan Overseas, survived, and by 2000 only one, Collins, remained.

[82] Taiwan's oldest Large Trading Company was established in the 1950s, consisting of Central Trust Bureau, and Taiwan provisional Bureau of Material. Both are state enterprises. The second one was Chinese Trading and Development Co., which was set up in 1965. It was a semi-state enterprise. Taiwan's government held 40 percent of its capital. Rigid laws and regulations caused them to fail. In 1972, under the support of Central Trust Bureau, a group of domestic entrepreneurs established the first completely private General Trading Company - World Trading Ltd. Co., (*Shijie Tongshang Gufen Youxian Gongsi*). Capital was NT$1 billion. However, because the staff at managerial level lacked knowledge of and experience in international trading, it failed two years later.

These LTCs were expected to be able to take care of the following functions:

1. Collecting commercial information
2. Marketing the product and visiting customers overseas
3. Developing markets
4. Obtaining support from banks - funding capital
5. Setting up distribution centres overseas
6. Risk-sharing with SMEs.

The contribution of Taiwan's LTCs to national exports was well below that of their counterparts in Korea and Japan. They provided 1.04 percent, 1.43 percent and 0.65 percent of Taiwan's exports in 1981, 1985 and 1989 respectively.[83] Their export markets were still predominantly the US and Japan. For example, in 1989, Pan Overseas exported 60 percent of its goods to the US market and Collins exported 83.4 percent to the US. Their main exports were manufactured light industrial products, such as food, garments, house wares and building materials. Regarding overseas subsidiaries, Pan Overseas in 1989 had four and Collins had eleven, five of them in the USA. They worked as sales units bypassing the international intermediaries contacting retailers and wholesalers directly. They had only a limited information collection function, in contrast to that of the overseas offices of Japanese *sogo shosha* and Korean GTCs.

In summary, Taiwan's LTCs failed to reach the government's expectations. Taiwanese and international economists attributed this failure to government policies, production and marketing systems, family business management and cultural factors. The first factor in the failure of LTCs was the inadequate support provided by local

[83] *Directory of Merit Importer and Exporter,* 1979 to 1989 edition, Ministry of Economic Affairs R.O.C

business groups and the government. Although basically similar to their counterparts in Korea, the Taiwanese LTCs were not formed to serve their own needs but rather originated from a government agenda. They failed to attract the strong support of big business groups as GTCs did in Korea. Their partners, who were their manufacturers, already had their own international market and export access. They were unwilling to support the new LTCs by giving out information on markets and access. For example, Nanlien's major partner, Tainan Textile Co., was a very famous textile manufacturer and exporter. It was very successful both internationally and domestically, and had numerous quotas[84] for various textile items for the USA market. But they were unwilling to give information about their customers and quotas to the new LTC. For this reason Nanlien quickly died. It was difficult to find a mutually advantageous basis for fostering cooperation between the partners, because the competition between them continued to threaten every individual business.

Taiwan's LTCs were not granted the same privileges by government as were their counterparts in Korea and Japan. The Taiwanese government did not allocate responsibility for the international purchase of commodities to its LTCs. State organizations, such as the Centre Trust of China and the Bureau of Materials dominated the international purchase of commodities for the government. State enterprises monopolized major large-scale business activities such as electrical power generation and supply, telecommunications, petroleum distribution and the supply of tobacco, alcohol, rice and sugar. As a result, the range of business was limited, and space for development was restricted.

[84] The United States has quotas on textiles and apparel from non-WTO countries. Non-WTO countries are subject to quotas imposed by the President under section 204 of the Agricultural ACT of 1956 (7 U.S.C. 1954), which provides the President with the basic statutory authority to enter into agreements with foreign governments to limit their exports of such items to the United States.

LTCs could only become involved in the sort of small-scale business that any individual SME was able to handle. However LTCs had to face severe competition from SMETCs that had lower prices because of lower administration costs, greater flexibility because of smaller organizational structures, and better support from suppliers because of long-term cooperation.

The Taiwanese government's strict policy of controlling foreign currency movement also impeded the operations of the LTCs and their overseas subsidiaries. This policy raised difficulties for Taiwan's LTCs in their attempts to perform as competently as those in Japan and Korea.

Moreover, Taiwan's government policies were not favourable to trading companies. The government favoured the development of manufacturing. For example, the process of tax-reimbursement of imported and exported material was not imposed on the manufacturers, but on trading companies, including LTCs. That meant trading companies had to pay tax on material used in the export trade in advance, and then they were able to obtain a refund after exporting the products. Bank interests accrued because of this and consequently costs increased.

Banks also ignored the financial needs of trading companies, and only offered secure loans to LTCs. They had to lodge their assets with the banks as a part of a pledge. Only then would the banks release the loans. However, because LTCs did not have sufficient assets, they always had problems with finance.

The second factor was the inability of the government to establish a manufacturing and marketing system. Taiwan's government adopted a system which integrated production and marketing systems. This encouraged Taiwan's manufacturers to import their materials and export their products themselves, without going through intermediaries, such as LTCs and SMETCs.

Manufacturers were reluctant to support trading companies, because the services offered by trading companies were inadequate. Taiwan's LTCs did not have complete worldwide information networks as did their counterparts in Japan, and could not provide up-to-date and precise information to their suppliers. They also complained that trading companies put higher margins on the products, and caused selling to stagnate. In Japan, manufacturers and *sogo shosha* relied on a system in which manufacturing and marketing were separated by custom. The implementation of this policy not only provided business opportunities for the *sogo shosha* but also decreased the cost of materials and made Japanese products more competitive in the international market.

The third factor was that Taiwan's LTCs had the same traditional style of management as family businesses. Therefore, they also had no complete and systematic accounting system. *"Guanxi"* (relationship) was the priority in personnel recruitment and promotion. There was no system of retirement benefits, so employees of LTCs felt insecure and uncertain, so that they would pursue every opportunity to cultivate their own relationship with customers and suppliers, paving the way for setting up their own trading companies (SMETCs). This resulted in a shortage of trading expertise, and high turnover of employees.

The fourth factor was that LTCs also had incomplete marketing systems which inhibited their efforts to modernize and innovate.

The fifth factor was that the rigid centralized decision-making system of the LTCs prevented a timely response to market needs. The core personnel of the LTCs paid greater attention to their own businesses than to the LTCs and failed to authorize the frontline managers to react properly and promptly to market needs. Such a response to the market is of course indispensable in conducting a successful business.

The five factors outlined above were instrumental in the failure of Taiwan's LTCs. However, while the other LTCs terminated their operations soon after their establishment, Collins did not. This case illustrates the fact that size was not the vital determinant for the success of trading companies in Taiwan. Collins did not have any financial institution investment, which probably caused a shortage of capital and limited the size of the firm. But the core partners in the firm's establishment were competent exporters. They had abundant experience in and knowledge of international trading which helped them to make quick and accurate decisions. Rejecting the preference for family linked staff found in other traditional enterprises, Collins' professional managerial staff contributed more business expertise to the company. The company's flat and lean organizational structure, with only four levels, enabled them to respond quickly to market needs.

Similar to other SMETCs, Collins' export products were mainly labour-intensive consumer household products which could be grouped into nine categories: hand tools, household hardware, giftware, electrical products, plastic products, sports goods,

office wares, indoor and outdoor furniture, and garments.[85] To cope with rising competition from China and Southeast Asia, (e.g. Thailand), Collins set up overseas trading offices in Thailand, Hong Kong and China to search for low-priced products to fill gaps in Taiwan's product range. With the appreciation of the New Taiwan dollar in the late 1980s, export profits declined, and Collins utilized its worldwide networks to look for similar products at lower prices to meet its customers' requirements and ensure its own profits.

Collins grasped the opportunity of this NT dollar appreciation, and started to import products for the Taiwanese domestic market and commenced the distribution of computer software, e.g. the Alpha Omega system and different brands of apparel, e.g. G2000, Mexx and Zegna. Besides import and export, Collins also diversified their business activities into investment and financial management. Motor vehicle loans are an example of its successful related enterprises.

Thus Collins is the only LTC which has transformed itself from an existing trading company. Their managerial level staff are all equipped with experience in managing a trading company. With their effective and sophisticated management, Collins keeps itself at the centre of a flexible and responsive network. Dr. Gossot Mylene ,"Their supplier chain management relies on a Chinese network, customer relationship management is based on harmony and trust."[86] He also points out:

> Collins is a global Chinese resource manager, they integrate and coordinate all the linkage of the network, mainly composed of Chinese overseas, whether in the backward or forward integration,…they will build up a relationship and

[85] *Collins Co. Ltd Annual Report* 1999, Taipei p. 9
[86] Gossot, Mylene (2001), *Trader's global age - East Asian market driven strategists*, Taoyuan: Yuan Ze University p.7

> partnership which will share the risks and costs of strategic alliances. It goes beyond the organization and structure of a firm; it is based on trust and on a global, fluctuant, shapeless network in turbulent and smart markets. Flexibility, share information, and trust, are the core values of the Chinese network.[87]

In 1999, Collins had 509 employees, eight overseas offices including those at Shanghai and Shenzhen in Mainland China, nineteen related enterprises (*guanxi qiye*), and exported goods to the value of US$141 200 000. Collins is the sole success story of Taiwan's Large Trading Companies.

3.3 Conclusion

The successes of the Japanese *sogo shosha* and the Korean GTCs stimulated the KMT government to follow this model and establish the same organizations, which were known as LTCs. The government expected LTCs to increase exports, and replace numerous SMETCs, but all the LTCs ultimately failed excepted Collins. Taiwan's export-oriented economy still depends on the efforts of SMETCs. Without SMETCs, Taiwan's economy would not have been able to take off.

By contrast, the success of the Japanese economy rested on *sogo shosha*, whereas the success of Korean exports was dependent on GTCs. The characteristics of these models are contrasted with the Taiwanese model below and in Table 6.

The Japanese *sogo shosha*

In spite of the magnificent achievement of the *sogo shosha* in supporting Japan's high economic growth, they were challenged by domestic manufacturers and smaller

[87] *ibid.* p.7

specialized Japanese trading companies. While Japan's manufacturers grew and learnt how to market their products abroad, they also found it increasingly unnecessary to rely on the trading companies. For instance, non-*keiretsu* companies such as Honda, Sony and Toyota evolved into successful multinationals, set up their own direct export sales networks and eventually bypassed the trading firms' export networks to control product distribution themselves. Small, specialized trading companies utilized the advantage of lower costs, personnel costs, in-depth product knowledge and after-sales capabilities to compete with *sogo shosha.* In addition, the rise of other national trading companies, e.g. Korean GTCs, also brought greater competition to international trade.

Throughout the period of challenge and competition, s*ogo shosha* experienced times of spectacular growth while suffering significant societal criticism and even decline. Nevertheless, they possessed the necessary qualities to enable them to remain active in the global business arena. These include: [88]

1. Familiarity with and expertise in the workings of most of the world's markets;
2. Access to a vast amount of information pertaining to industry and trade and the capability to process and disseminate this information quickly;
3. The ability to provide financial assistance in the form of trade credits to finance import/export activities, investments, loans and loan guarantees, and lease financing for capital equipment; and
4. The means to absorb some of the risks inherent in trade. This ability stems from the wide range of products handled by trading companies and their effectiveness in managing foreign exchange and other types of risk.

The Korean Great Trading Companies

[88] *The Role of Trading Companies in International Commerce*
202.167.121.158/ebook/jetro/executive html

The Korean government provided full support to large business groups, known as c*haebol,* and formed Korean GTCs for the purpose of economic modernization. As the export arm of those *chaebol*, Korean GTCs, through the sheer volume of their exports, made a tremendous contribution to Korea's economic growth. However, the bankruptcy of Daewoo in 1999 and the restructuring of Hyundai in 2000 mirrored the inefficiency of family-dominated business organizations. Korea's *chaebol* faced a new wave of modernization that pushed them to streamline their organizational structure and the Korean GTCs were also forced to adopt slimmer organizational structures.

Taiwan's Large Trading Companies

Taiwan's Large Trading Companies were established to overcome the inadequacies in the operations of SMETCs, and they were expected to perform in similar way to Japan's *sogo shosha* or at least to Korea's GTCs. But the diversity in the cultures and characteristics of these three countries and their people, and the conditions under which they were formed, were ignored. For example, the Chinese are good at working independently but do not excel at teamwork whereas the Japanese and the Koreans are prefer team work, and are willing to cooperate in a team.

In examining the success of Collins and the failure of the other Taiwanese LTCs, this study finds that neither capital requirements nor the scale of operations are determinants of business success; rather, SMETCs can grow to become successful large-scale businesses provided that they have professional management capable of utilizing trust effectively in their networks, watching market trends closely, then leading the companies towards appropriate directions of development and expanding

themselves in a timely manner to a large-scale firm. For example, Collins started to purchase garments for their US buyers in Southeast Asia when Taiwan's labour costs increased. They began to be involved in the import business when Taiwan's consumers accepted high quality products at high prices.

To successfully form large-scale companies, Taiwan's trading companies should have initially adopted a specialized smaller scale operating mode which would have enabled them to provide a timely response to market needs, and to satisfy their customers' special demands. Once they have accumulated capital, cultivated their own networks and built up their reputation based on trust in the international market, they are then able either to set up offices overseas or invest in large demand markets such as Mainland China, thus becoming large-scale trading companies. Many of Taiwan's SMETCs and SMEs have achieved this in Mainland China, providing good evidence that this strategy is successful.

Differences among Asian General Trading Companies

Other than the differences in their criteria, the major differences among these three Asian General Trading Companies are as follows:

1. Government policy and awards: The Japanese and Korean governments offered more grants to their GTCs than Taiwan's government.
2. Monetary institution loans: Taiwan's LTCs obtained less support from the banks than Japan and Korea's GTCs.
3. System of manufacturing and sales: Japan and Korea adopted separate manufacturing and marketing systems which provided GTCs with export opportunities. Taiwan's system of integrated manufacturing and marketing resulted in the reluctance of suppliers to use LTCs as export agents.
4. Human resources: Providing employees with job training and education enhances their effectiveness and competence. Japan's *sogo shosha* has a systematic program for its employees.

5. The circumstances of formation: Japan' *sogo shosha* developed naturally and the GTCs of Korea were formed with strong government support. Both of them enjoyed internal and external cooperation. However, while Taiwan's LTCs were formed under government policy, they were given no practical support, and they found it difficult to gain the support of suppliers.

Table 3 Comparisons of Asian General Trading Companies

Countries and Companies	Japanese *sogo shosha*	Korean General Trading Company	Taiwanese Large Trading Company
Year of first establishment	1876[89]	1975	1978
Number	9	13 reduced to 9	7 then 5 then 2
Purpose	To end control by foreign (Western) companies	To end control by foreign (Japanese) companies	To end control by foreign (Japanese) companies
Background of formation	Formed under the support of *keiretsu* and working as their trading arms. Formed naturally by willing firms.	Formed under the support of *chaebol* and working as their trading arms. Requested strongly by government.	No conglomerate support. Government policies
Capital	US$ Five Hundred million	US$ Two million (1980)	US$ Five million (1984)
Percentage of national export volume	48.7% (1980)	40.6% (1980)	0.24% (1980)
Overseas stations	969 (1994)	298 (1993)	3 (1984)
Trading items	All range of trading Real estate retail Transportation and air freight. International trading	All range of trading International and domestic trading Trade of futures Government international	Before 1984, only imported material and exported manufacturing products, no domestic trading or

[89] The term, *sogo shosha*, first appeared in 1954.

	and offshore triangle	purchases	government purchasing at all
Marketing	Worldwide	USA, Japan	Japan, USA
R & D	Positive	Positive	Negative

CHAPTER FOUR

The Performance of Taiwan's Small and Medium Sized Export Trading Companies and Small and Medium Sized Enterprises

Introduction

In 1984, Taiwan's export trading companies were large in number but small in size - the number of traders totalled 20 597, with an average of seven employees.[90] These were SMEs whose role was to act as intermediaries between international buyers and domestic manufacturers who were themselves SMEs. They also coordinated the distribution of orders from international buyers to SMEs. They had very high mortality and fertility rates. Their numbers increased by 223.5 percent from 1977 to 1980. The rate of withdrawal, excluding companies which did not report their status, was 7.18 percent between 1989 and 1990.

In addition to examining the performance of SMETCs in the export and decentralized production networks, this chapter also provides details of their definition, scale, organization, functions, strengths and weaknesses, as well as the interaction between SMETCs and SMEs, whose relationship with each other was critical. This relationship altered as Taiwan's economy developed. The key role of SMETCs emerged during the transition stage. This chapter illustrates the role of the SMETCs using four export network charts which include Taiwan's initial export networks, Taiwan's secondary export networks, backward integrated networks, and forward integrated networks (refer to p.84, 94 and 98). SMETCs filled an intermediary and a coordinating role in the initial export networks from the 1960s to the early 1970s. In

[90] Hsing, You-tien, Trading companies in Taiwan's fashion shoe networks, *Journal of International Economics* Vol. 48, issue 1, June 1999, pp. 101-120

the beginning of the 1960s, the manufacturing of products such as textiles, plywood and footwear replaced agricultural products and grew in scale. In this stage, both SMETCs and SMEs relied on each other in terms of entering the international market. SMETCs exported SMEs' products to satisfy international buyers' needs. SMEs used SMETCs to access international market information.

Secondary networks demonstrated their role as competitors in the subsequent competitive stage from the late 1970s to the 1980s. The major export products became garments, electronic parts and assemblies. At this point SMETCs and SMEs regarded each other as competitors. Owing to the growth of Taiwanese industry, SMEs attempted to get rid of the control of SMETCs, while SMETCs also acted as contractors arranging their own production and bypassing SMEs.

The third stage network demonstrates the role of the SMETCs as investors in the integrated phase from the late 1980s to the 1990s. During this stage, high technology electronic products gradually became the major export. Both the SMETCs and SMEs invested in each other, and two types of integration resulted, forward and backward integration. In forward integration, SMETCs merged with their international buyers or set up their own overseas sales outlets, and SMEs owned shares in trading companies or set up their own trading companies to handle their export business. In backward integration, SMETCs invested in their partner manufacturers' businesses. In that way they were not only intermediaries and coordinators but also financial supporters.

These three stages existed simultaneously and overlapped each other. The duration of the three stages mentioned previously is indicative of the predominant structure at a particular time. The networks associated with exporting agricultural products to the

Japanese market in the period from the 1950s to 1960 were not included in the initial export networks because the local small trading companies concerned had less involvement in and existed outside the networks. Agricultural products, e.g., sugar and rice, were exported through state firms such as the Taiwan Sugar Corporation, and fresh fruits, e.g., pineapples and bananas, were exported to Japan under a system called the "integration of production and marketing operations"[91] which originated from the time of Japanese rule but was interrupted when the KMT commenced governing Taiwan.[92] The Fruit Cooperative Organization (FCO) was formed with the support of the government and dominated the export of all fresh fruit. It comprised 50 percent of the Taiwanese economic elite from the period of Japanese rule (1895-1945) and Japanese overseas Taiwanese. This newcomer found it difficult to enter the market as it had no relationship with the Japanese market or the fruit growing districts of Taiwan. Furthermore, most of the fresh fruit exporters owned refrigerated vessels to ship their goods which ensured the delivery of the products in good condition. Small and medium-sized trading companies were unable to afford such shipping. Outside of the FCO's dominant position in the fruit trade, the Japanese *sogo shosha* had a part in controlling the trade in products such as frozen prawns, eels and dehydrated foods. The FCO and the *sogo shosha* contracted the supply of produce direct from the Taiwanese farmers in the growing districts and shipped the produce directly to the market without SMETCs. In this way there were no subcontractors involved. As a result, decentralized production networks did not exist in the agricultural product export structure.

[91] Liu Shujing (*20*01) *Trade Network of Taiwan's Export of Bananas to Japan, 1945-1971* p.27
[92] KMT=Kuomintang, Nationalist Party – a Chinese (Taiwan) political party.

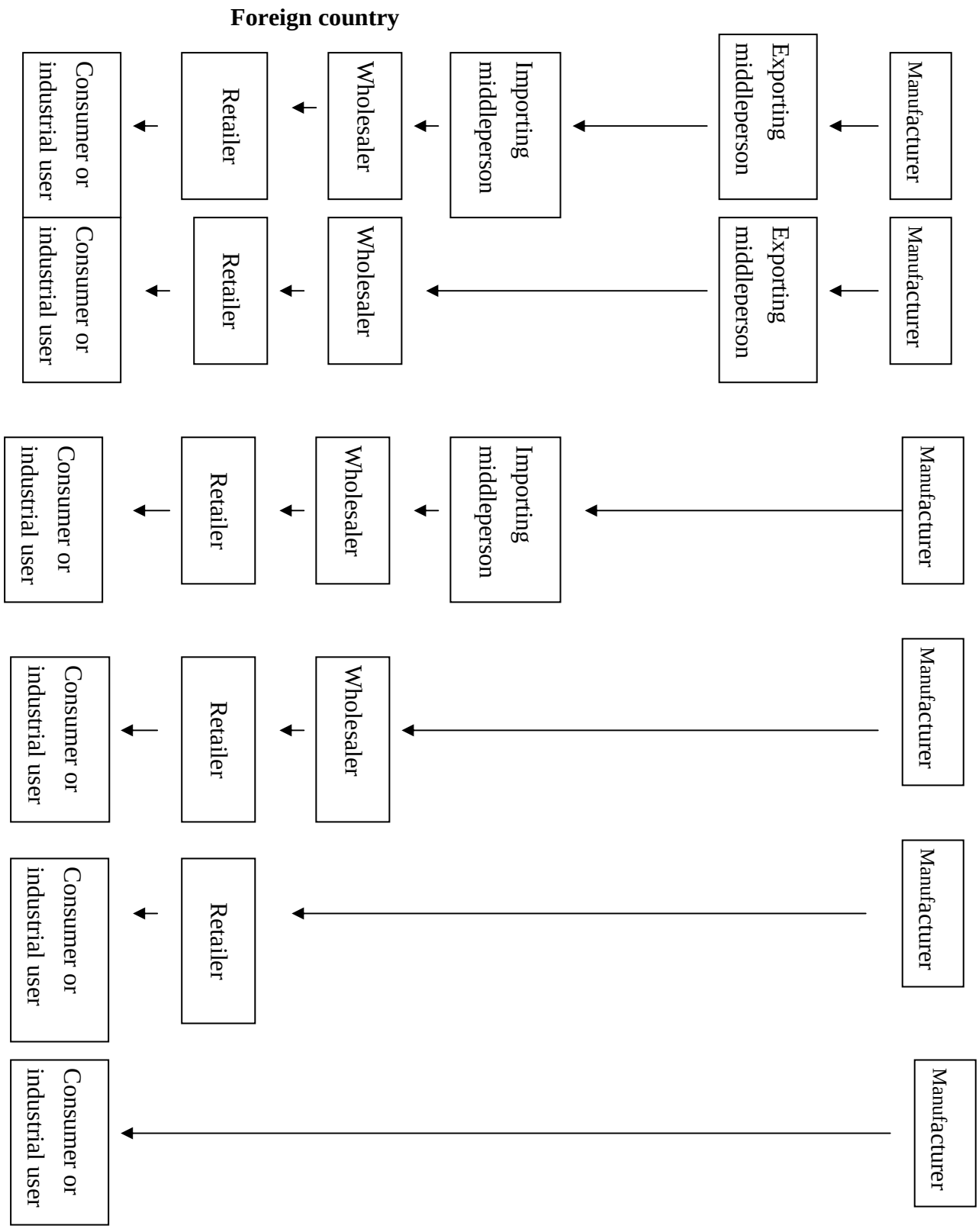
Although SMETCs are the principal theme of this study, they are a type of SME and so their formation and performance are interwoven with that of SMEs. The first part of this chapter examines the role of the SMETCs in the performance of the Taiwanese export networks. The second part of this chapter describes the formation of SMEs and demonstrates their importance in and contribution to Taiwan's economic development with the assistance of SMETCs. The production networks of SMEs will be emphasized.

4.1 Exporting channels and categories of export intermediary firms

In order to identify the role of SMETCs, export channels have to be classified. They include direct and indirect channels. Direct channels are the exporters who have a complete network covering purchase, export, import, wholesale and retail. They can complete the entire scope of international trading activities inside their own organization. Indirect channels are the exporters who have to export goods through intermediate channels. They include the following groups, which are also illustrated in Figure 2:

1. Export merchants and export agents acting as trading companies
2. Combination export managers (only in the USA)
3. Foreign travelling buyers
4. Foreign import merchants
5. Foreign import agents
6. Foreign importers

Figure 2: International trade channels



However, the Taiwanese government recognizes that, other than exporting through local export merchants and export agents, all export channels are direct export. In other words, if local manufacturers export their products directly to the foreign customers by themselves and receive payment in the form of a Letter of Credit, transferred (L/C), or foreign currency, it is then considered as a direct export. Taiwan's SMETCs belong to the category of domestic companies who purchase products from local suppliers and export them to foreign buyers under the trading company's name. SMETCs are responsible for all the activities and the risks related to the exporting business, such as contact with foreign markets, contract (order) signing, shipping, and L/C negotiation.

According to Onkvisit and Shaw's classification (1993), export intermediary firms fall into five categories: 1) domestic-based merchants; 2) domestic-based export agents or export brokers; 3) export management companies; 4) cooperative organizations; and 5) buying offices of foreign companies. Domestic-based export merchants and domestic agents/brokers are trading companies that have similar functions to those of export management companies. There were two types of companies such as this in Taiwan. The first were product-oriented trading companies which were established by personnel with manufacturing or export experience in the special line of a trading company. They had a very close relationship with production networks. They were also reasonably knowledgeable in their particular product. In general, they worked as export agents for the SMEs and concentrated on promoting only a single range of products.

The second were market demand-oriented companies whose owners originated from foreign offices in Taiwan or local trading companies. Their main function was to seek products to meet their buyers' markets and identify appropriate SMEs to supply their buyer's orders.

4.2 Definition of Taiwanese SMETCs

As mentioned in the introduction to this chapter, SMETCs are a form of SME which had a strong relationship with SMEs. Before 1983, SMETCs were considered to be a type of SME in terms of background, personnel resources, and so on, differing only in their functions. This is the reason why the definition of an SME is discussed in this chapter. SMEs form part of a business system that was identified with, although not unique to, Taiwan. SMEs in developed countries, such as the USA and Japan, also form a high proportion of national enterprises, but rank low in total national export amount. However, in 1996 SMEs constituted over 97 percent of all Taiwanese enterprises, and accounted for over 99 percent of enterprises in the USA, Japan and Korea in the years 1990, 1995 and 1992 respectively. However, Taiwan's SMEs had a dramatic impact on Taiwan's economy as indicated by national economic performance data. In 1983, Taiwan's SMEs produced 99.3 percent of all its manufactured goods and 49.8 percent of total exports. In addition, the percentage of employees linked to export-oriented SMEs was as high as 22 percent in 1987.[93] Although SMEs "form a crucial part of the overall national industrial infrastructure structure and economic development"[94] in developed countries, they mainly meet the needs of the local market. In contrast, SME exports were pivotal to Taiwan's export-oriented economy. For example, 99.3 percent of national manufacturing in 1983, 59.75 percent of total national amount through SMEs and 22 percent in 1976 of employed population linked with SMEs involved in export are outstanding figures in terms of national economic structure.[95]

[93] *Small and Medium Enterprises Statistics*, 1988
[94] Zegveld, Water 1982, p. 20
[95] *Small and Medium Enterprises Statistics*, 1988

Data relating to capital, assets, and the number of permanent fulltime staff are the primary criteria used in the classification of an enterprise as an SME, yet the definition of an SME has varied historically as well as geographically. In Taiwan, the definition for general regulatory purposes had been modified several times. In September 1967, an SME was defined as "a manufacturing enterprise having total assets of less than NT$5 million (US$125 000) with no more than 100 persons regularly employed, or a commercial firm having an annual turnover of no more than NT$5 million with less than 50 persons regularly employed".[96] This definition was modified three times between 1973 and 1978. In 1982, an SME was defined as "a manufacturing, process or handicraft enterprise having a paid up capital of less than NT$40 million and having total assets of no more than NT$120 million, an importer/exporter, a commercial firm, a transportation company or other service establishment having an annual turnover of no more than NT$40 million or a mining enterprise having a paid up capital of less than NT$40 million".[97]

4.3 Comparison of SMETCS and SMEs among Asian Newly Industrialized Countries

Compared with the other export-oriented Asian NICs (Newly Industrialized Countries), namely Singapore, Hong Kong and South Korea, Taiwan's SMEs made a more significant contribution to the economy.

Asian NICs are either small islands or peninsulas sharing the same comparative international trading advantages, i.e., productive and efficient labour and low wages. They also shared the same factors, such as small size of land area, lack of natural resources, limited domestic demands, etc., to push them to develop an export-oriented

[96] S*mall and Medium Enterprises Statistics*, 1988
[97] Chou, Tien-chen, *Industrial Organization in a Dichotomous Economy: Case of Taiwan* 1995 p.227

economy, and generating a strong tendency towards permanent foreign trade dependence.

South Korea, under the direct and active guidance of the government and with various supportive policies, established Korean *chaebol*, which dominated Korea's economy in the post-war period. The Korean government granted these *chaebol* many favourable policies, such as tax concessions, low interest loans,[98] guaranteed foreign loans, while tariffs and licensing protected their markets from foreign and domestic competition. The favouritism was not applied to Korea's SMEs, and their growth was restricted in the absence of government initiation and assistance. Similar to Japanese SMEs, Korea's SMEs only had vertical relationships with large sized enterprises, and had no horizontal connection with the other SMEs. They manufactured and supplied a very wide range of components to major corporations. The expansion of Korea's SMEs was restricted in both capital and size. Furthermore, as in Japanese *keiretsu* (previously known as *zaibatsu*) and their *sogo shosha*, Korea's *chaebol* had Great Trading Companies acting as their export arm. SMETCs had no space to expand their functions, and were unable to exert any influence on Korea's economy. In a nutshell, SMEs and SMETCs played very little role in the vicissitudes of the Korean economy. Even though Hong Kong and Singapore's economies are small-scale economies, and Small Scale Enterprises (SSEs) played "an almost indispensable part in the economic growth",[99] their economies were classified as urban economies, and are thus less comparable with the Taiwanese economy. Furthermore, these two city-states were historically exposed to Western culture and markets, and the owners of their enterprises were equipped with more knowledge of the English language and

[98] Kwong, Kai-Sun 2001, p.162
[99] Ho, Yin-ping 1992 p.107

international trading than in Taiwan's SMEs. In other words, SMEs in Hong Kong and Singapore did not rely on SMETCs for exporting as much as did Taiwan's SMEs. As a result, the role of SMETCs in their economies was not as important as it was in Taiwan.

Other factors are also responsible for the weaknesses of Singapore's SMEs. The Singaporean government made an effort to link itself with the global market through numerous foreign multinational firms (FMFs). The goal of many young university graduates was to be employed in an FMF, rather than the local SMEs. The FMFs had little linkage with the local SMEs, and the advanced technology of the FMFs was not transferred to the SMEs. As a result, the SMEs could not upgrade their technology. The Central Provident Fund centralized private savings, which had been a major source of starting capital in Chinese ethnic society, and thus private savings were not available "to fuel the growth of SMEs".[100] Consequently, Singapore's economy was dominated by FMFs, and Singapore's SMEs have not played an important role in its economy. SMETCs were also not considered important in Singapore's economy. Hong Kong was an important entrepot port,[101] and acted as a transhipment centre for goods between China and the rest of the world. Re-export in and out of China was Hong Kong's main trade, and entrepot was the main source of its national income. Entrepot in Hong Kong amounted to 88.70 percent and 74.7 percent in 1950 and 1990 respectively.[102] Hong Kong's domestic exports were low. This is because Hong Kong did not have material industries such as the petrochemical industries, and manufacturers had to import materials or semi-manufactured parts from China, and

[100] op cit. *p. 39*
[101] Ho, Yin-ping 1992 , p. 17. He identified the term of entrepot as a commercial centre such as a port city, a free-trade zone or a trans-shipment centre, and also as a "warehouse or wharf where merchandise is deposited temporarily for re-port."
[102] op cit. p. 79

other Asian countries, then process them or assemble the parts for export to international markets again. Hong Kong has about 40 000 trading companies, but their trade is a processing trade. To meet customers' urgent delivery requirements, Hong Kong's manufacturers also split their orders to some subcontractors, who recruit labourers by themselves, but use the contractors' facilities to work inside the factories. The relationship between contractors and subcontractors is not strong as it is in Taiwan, because a lack of trust exists between contractors and subcontractors. Trust is a vital element of subcontracting networks in Taiwan. The majority of Hong Kong inhabitants have been refugees and migrants from China. Their interpersonal relationships were not mature enough to form solid networks such as they had in their hometowns, and thus there was less of a basis for a trust network.

4.4 SMETCs in the performance of Taiwan's export networks

A "network" describes a form of interaction between people in any society. In business, H. B. Thorelli identifies a network as "two or more organizations involved in a long-term relationship".[103] In international business, the networks' interdependency enhances the cooperation between firms. There are four export networks which illustrate the role of SMETCs in different stages as explained in the introduction. The essential tasks of an SMETC in these networks were to act as an intermediary, an order coordinator, a risk absorber, a resource developer and an information provider.

Figure 3 (p.84) illustrates how the Taiwanese export network was initially structured. It consisted of upstream and downstream sections. The upstream section comprised

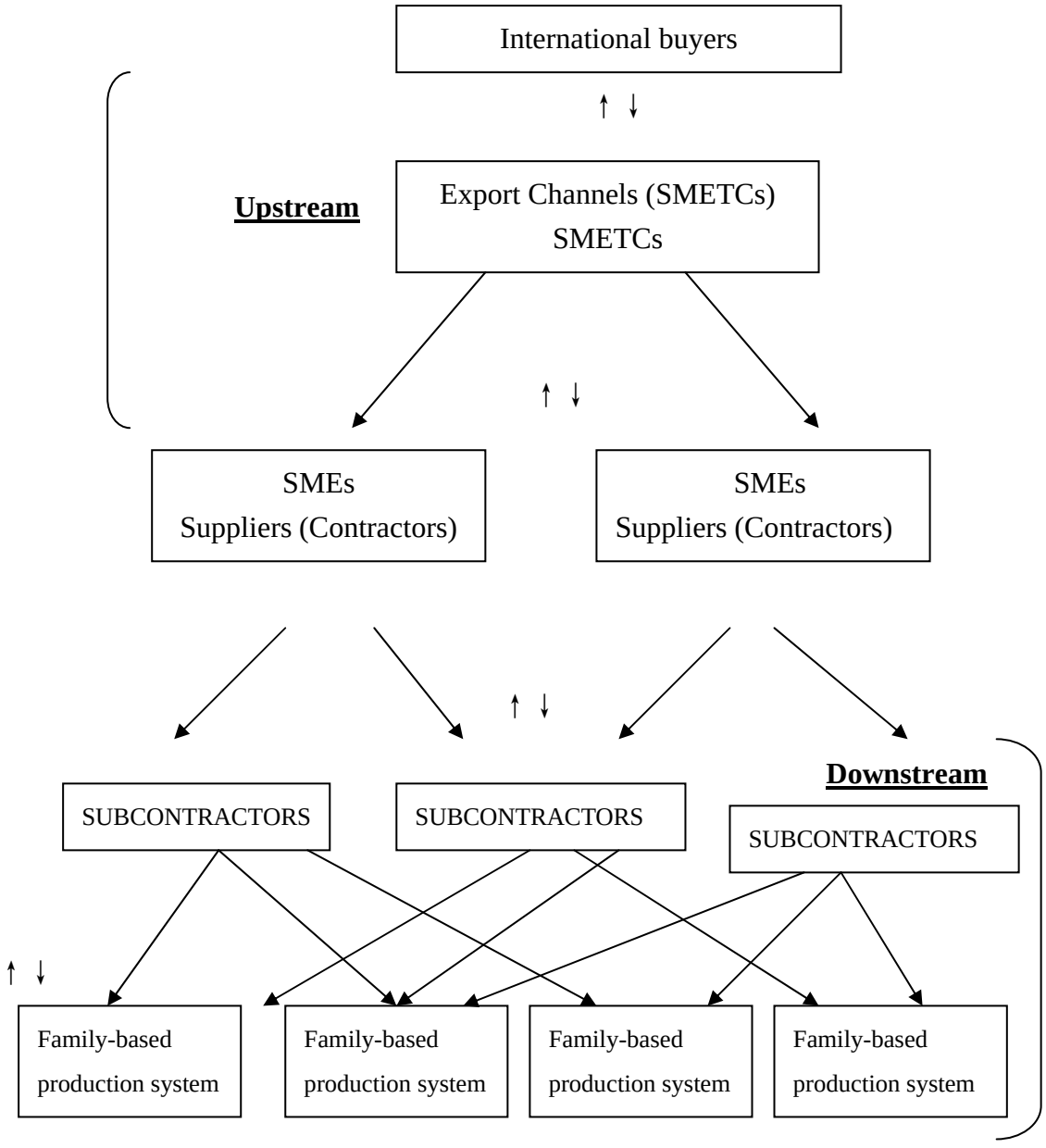
[103] Ford, David, (ed) 1990, p.443

international buyers and SMETCs while the downstream section comprised contractors and their subcontractors. It also recognized SMEs' decentralized production networks.

SMETCs were the principal elements in the upstream section and acted as a bridge between international buyers and SMEs. After receiving orders from international buyers, SMETCs acted as coordinators in allocating orders to reliable and adequate suppliers (SMEs). In general those suppliers were contractors. It is obvious that without SMETCs' leadership, SMEs could not bridge the communications gap between international buyers and themselves at least in the initial stage of Taiwan's economic development. Conversely, without the support of SMEs, the SMETCs could not satisfy the demand of the international market for the relevant goods.

In the downstream section, SMEs and their subcontractors achieved the supply of the appropriate products. This section comprised what are also called "decentralized production networks". The downstream section indicates that after receiving orders from an export channel, e.g., an export trading company, a contractor would distribute the jobs to various reliable subcontractors. The contractors collected the semi-finished products from the subcontractors and carried out the necessary additional steps such as quality control and packaging to complete production in their own "home" factories. The upstream performance is examined in the section on trading companies' functions, and downstream performance is discussed in the section on SMEs' decentralized production networks.

Figure 3: Taiwan's initial export networks



For a country such as Taiwan, which is so deficient in natural resources, exporting has always been the backbone of its outward-looking economic policies. Table 1 shows how dependent Taiwan's economy was on foreign trade in the three decades concerned.

Table 4 Contribution of exports to Taiwan's economic growth 1961-1990

Years	GDP annual growth	Exports as a percentage of GDP	Exports annual growth	GDP growth arising from exports
1961-1970	9.64%	18.74%	21.78%	3.76%
1971-1980	9.89%	44.69%	17.61%	6.87%
1981-1990	9.76%	31.03%	19.89%	5.24%

Source: A Collection of Theses on Outward Trading Development in Taiwan, Taipei: *Lianjing* 1994, p.305.

This outward-looking economic structure was strongly supported by the efficient division of labour in the networks involved in international trade. International buyers, SMETCs and SMEs comprised these networks. International buyers concentrated on developing product designs and the markets, SMEs focused on manufacturing and SMETCs were responsible for communications between the two groups.

4.4.1 SMETCs in the performance of Taiwan's initial export networks

As shown in Table 1, Taiwan's export trading companies concentrated their efforts in the upstream section of the export networks as an intermediary between international buyers and local suppliers. They also acted as export coordinators. In addition to offering communications and export documentation preparation services, the main functions of Taiwanese SMETCs were to allocate orders to reliable and adequate suppliers, handle product development, and ensure quality control and effect product delivery. Their knowledge of the SMEs' areas of specialization, production capacity and lines, financial situation, new production skills and new materials enabled them to carry out these functions.

Many international buyers were multi-product importers in their own countries and therefore needed one or more export-trading companies to work as an agent or agents for them to fill their orders. For example, an American or British buyer of garments or footwear commonly dealt with a wide range of products to suit varying sizes, ages and materials as well as catering for both genders. Fashion designs have to be brought out in time for their markets every season. Similarly, a German importer of electronic products had over two hundred items in its 1990 catalogue. The products ranged from resistors and capacitors to hi-fi stereo systems. Importers frequently had to search for new items to satisfy their vendors' market requirements.

Given their size, Taiwanese SMEs were unable to supply the whole range of products demanded by the market from their own factories. They might only specialize in one part of a product. This meant that international buyers had difficulty in handling orders from their home sites. The language barrier was another obstacle to be overcome. Even though some of the international buyers visited Taiwan twice a year or more, their orders were composed of a variety of products and the suppliers of these products were scattered throughout the island. They were also not familiar with Taiwan's domestic manufacturers. Because of the time required, they were unable to arrange all the orders themselves, thus they needed SMETC operators to prepare in advance and to follow up afterwards. In short, SMETC operators stepped in to make up for the deficiencies of the SMEs.

SMETC operators used their networks, language skills, and the accumulated knowledge of local suppliers to arrange appropriate suppliers to meet the buyers' differing requirements, thus saving the buyers time and money. The SMETCs' ability

to group particular cooperative manufacturers or contractors in their networks was an essential selection criterion for international buyers in appointing their agents.

Speaking about the garment (knitted wares) market, one interviewee said:

> I still remember that in 1975 a British buyer handed me 37 sketching drafts for men and women's sweaters, including jackets and pullovers. The drafts only indicated sizes but there were no gauges and no weight. He asked me to give him the samples within fifty days. I distributed them to eight manufacturers, and finished more than a hundred pieces of samples of different styles, sizes, and gauges.

There are two channels in international trade, direct and indirect. In the direct channel, the products are exported directly by a manufacturer to a consumer or industrial user. It is also called a "short channel". In an indirect channel, products are exported through intermediate channels consisting of an exporting middleman at home and an importing middleman, a wholesaler or a retailer abroad and finally to the consumer or industrial user. It is also termed a "long channel". It is obvious that trading through a "long channel" will take longer and cost more than through a "short channel". From the business viewpoint the latter is of course preferable. However the interviewee quoted above also explained the reasons why international buyers would pay commissions and place orders through trading companies rather than dealing with SMEs directly. He said:

> Why? First of all in the beginning of the 1970s, there was no one in Taiwan's small and medium sized factories who could speak English. They had problems in communicating with the buyers. Secondly, time was another critical factor. The fashion industry has time limits, which forces them to run their orders through the most expedient channel available at the time. Furthermore, the long channel saves time for the foreign buyer, in this case, placing orders through export trading companies' networks can help them save a lot of time. In business, time is money.

In the field of electronic components and products, the situation was slightly different. While the SMEs for garments and footwear still used SMETCs as their export channels, electronic manufacturers in the 1980s tried to export directly and bypass SMETCs. Electronic products are dissimilar to traditional products like agricultural produce. Electronic component manufacture in the 1970s needed little more than basic manufacturing processes such as the use of a pressing, welding, punching and electro-plating, and since most of the owners of these SMEs had served apprenticeships, they had the needed skills. But they were not highly educated, and as they knew no English they needed SMETC operators to assist them to deal with international buyers. In the early stages, electronic products, such as radios and calculators required basic assembly skills. The suppliers of these items probably had some basic electronics knowledge, but they relied on the SMETC operator's language skills to communicate with international buyers and market information to develop their products to meet the trends.

On the other hand, international buyers needed SMETC operators to inspect products, guarantee quality, and consolidate their shipments from different suppliers to ensure

quality and cost saving. In the early 1980s, the electronic product industry was well developed and demanded more advanced technology. More and more owners had worked for FDI[104] firms, such as GE, Philips or Sony, or had graduated from a relevant department of a university or trained in a vocational high school, and so were equipped with better language and technology skills. They could probably deal with international buyers on a technological basis, but they relied on SMETC operators as efficient international marketing and managerial resources, and took advantage of their experience to obtain more orders from international markets.

New products were of two types. One was developed by a supplier and the other was a buyer's own design. In order to obtain a supplier's new design, SMETC operators would often visit the supplier to cultivate a close relationship, thus obtaining samples of the newest product. For buyer's designs, a SMETC would either work with an SME as a partner to transform the prototype or design into a sample, or make a new sample in accordance with the buyer's specifications. Some of the suppliers might have understood the design drawing and the terminology of the specification, but they still needed trading companies to translate the detailed information from English into Chinese to avoid misunderstanding. As You-tien Hsing states,[105]

> When a foreign buyer placed an order on a trading company, the requirements of the order were often vague, with loose specifications such as 'make the waist tighter' or 'avoid an overly shiny surface'. Trading companies translated the requirements from English into Chinese, and from abstract to clear and technical language. They also made technical suggestions to the partner

[104] FDI = foreign direct investment
[105] Hsing, You-tien, Trading companies in Taiwan's fashion shoe networks. *Journal of International Economics* Volume 48, Issue 1, June 1999, pp. 101-120

manufacturer on the buyer's specification, such as 'adjust the front part of the last', or 'apply a certain type of finishing or moisturizer on the leather'.

Controlling quality was another of the SMETCs' essential roles. They inspected products on the assembly lines, particularly the first lot produced, before packaging and shipping. After buyers' acceptance of the quality of the sample and before large batch production began, the SMETCs had to send inspectors to the suppliers' factories to monitor production and ensure that all parts of the products met requirements. Then they randomly inspected the finished products. In some cases, inspectors had to stay in the locality where the factory was sited to ensure the supplier followed the buyer's requirements and to ensure timely corrective action for production problems.

Ensuring that shipments would meet contracted deadlines was a crucial mission of SMETCs, especially for fashion products. According to Hsing, "buyers would also deduct a penalty of 5-10 percent of the payment"[106] for delayed delivery. If delayed payment was "a severe penalty for small manufacturers with limited operating capital,"[107] then cancelling an order because of a delay in shipment could be a disaster for both SMEs and SMETCs.

Once a delayed shipment occurred, an SME would suffer the pressure of running out stock in a buyers' markets causing delayed payment, even a cancelled order. A SMETC might lose the commission entirely[108] or receive a late payment when the buyer released the payment. In addition, SMETCs had to help SMEs solve

[106] You-tien Hsing, *Journal of International Economics* Vol.48 Issue 1999 pp. 101-120 "Trading companies in Taiwan's fashion shoe networks"
[107] *ibid.*, pp. 101-120
[108] Hsing says the commission in the fashion shoe industry was usually 5-10%. However, from my own experience in garments or electronic components or products, trading companies charged 2-15% depending on the order quantity and total order value.

manufacturing and supply problems. For standard products, SMETC operators might have to negotiate continuously with the original buyers to accept the shipment via air instead of by sea or search for new buyers to take the shipment at lower prices. But for buyers' own exclusive designs, accelerating the delivery was the only method of meeting the deadline, because exclusive designs goods are not allowed to be sold to any other customer. In such a case, both the SME and the SMETC would face financial problems and lose their reputation for punctual delivery.

International buyers have the right to cancel any order when the shipment has been delayed and the supplier does not have the goods for the market. This disaster could result in bankruptcy for an SME. In general, trading companies had to share the losses and the extra charges. Therefore, for the sake of the three parties concerned (international buyers, trading companies and SMEs), SMETCs had to monitor the SMEs very closely to avoid any delay in delivery.

Frequent visits and socializing were the most effective method of monitoring production line progress. From frequent visits, SMETCs could build up good long-term cooperative relationships (*guanxi*) with suppliers and also collect information on the finances, material sources and production capacity of the SMEs. SMETC operators also had to entertain and socialize with their suppliers by going out to a pub or lounge, attending factory anniversary parties, or playing golf. These activities help build a good relationship with suppliers. A good relationship was very important for arranging the insertion of a rush order into an SME production line or preventing the insertion of another buyers' order in the production line and adversely affecting the delivery of the goods. Furthermore, a close relationship between SMETCs and SMEs facilitated the resolution of claims and disputes. Although there

were rational legal contracts which constrained buyers and sellers, they were not always able to be enforced, leading to problems which were not easily solved.[109]

Other information, such as information about the equipment in a supplier's factory, would assist an SMETC to assess the performance capability of an SME. For example, an SMETC operator could assess suppliers' capabilities from the arrangement of their production lines and factory floor management and categorize them as, for example, a contractor assembling factory, or a subcontractor. All these factors affected product price, quality, and delivery.

Representatives of SMETCs commonly travelled around the world to attend overseas international business exhibitions and visited international buyers abroad to collect information. They shared information on the latest international market trends such as garment colour and style with the SMEs. The SMEs would make product samples, which SMETC operators used at the exhibitions to obtain more orders for themselves. Based on information provided by the SMETCs on buyers' credit ratings and other financial data, they were aware of the buyer's financial condition, and could minimize the risk of non-payment. The SMETC gathered information on the buyer, for example, whether they were an importer, wholesaler, manufacturer, or chain store, and where they were located (the US, Japan, or Europe), allowing them to match the quality requirement in different markets with their suppliers' products. This would help them to price products appropriately.

[109] Cheng, Lu-lin, 1996, pp. 45-46. Cheng says that legal contracts had four problems which could not be solved: 1) Solving disputes through lawsuits was costly, especially in international trade; 2) Contracts that are highly complex damaged the efficiency and flexibility of transactions; .3) Transactions that involved mutual adjustments during commercialization required tacit knowledge that could not be replaced by formal written language and; 4) Transactions that relied too much on formal and complex contracts hindered the development of trust among the parties.

Thus a triangular structural relationship between international buyers, SMETCs and SMEs existed emphasizing their complementary nature.

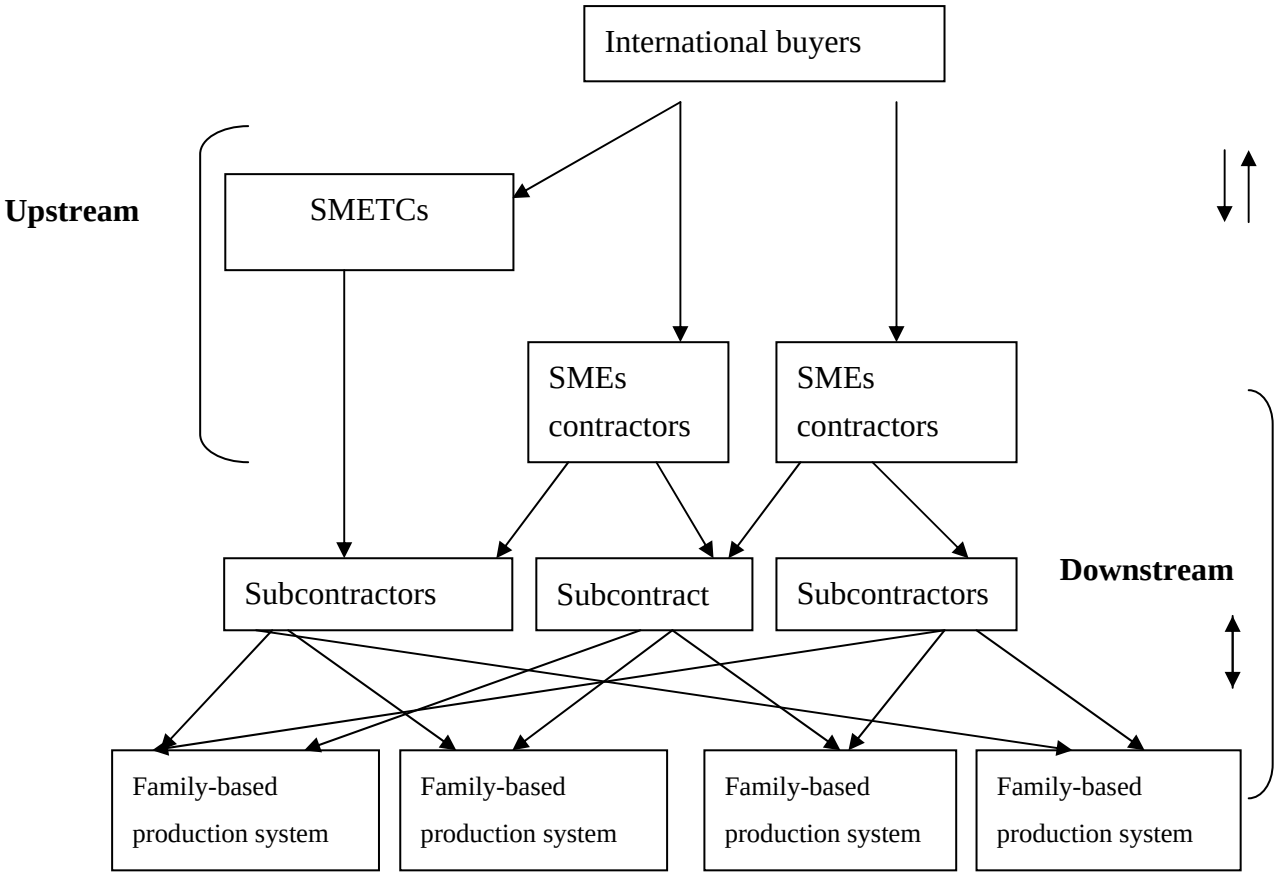
4.4.2 SMETCs and Taiwan's secondary export networks

As mentioned previously, international trade can be organized through channels of two types, described as direct or indirect channels. In the former type, the products are exported directly from the manufacturers to the consumers or industrial users. For indirect channels, the products are exported through intermediaries comprising exporting middlemen at home and importing middlemen, wholesalers, and retailers abroad, then on to the consumers or industrial users.

According to G.S. Shieh, the proportion of direct exports increased as SME size increased. He indicated that SMEs with fewer than five employees exported 80.4 percent of their products through SMETCs, while those with employee numbering between 40 and 49 exported 45 percent of their products through SMETCs. The proportion exported through SMETCs decreased to only 1.6 percent for SMEs with between 100 and 199 employees.[110] Figure 4 illustrates diverse export channels.

[110] Sheih G.S. "*Boss" Island* 1992 p.40

Figure 4: Taiwan's secondary export networks



The downstream section remains the same as in Chart 1 but the upstream side is split into direct and indirect routes in approaching the international buyers. Under this divergence of direct and indirect export, SMETCs in some cases also acted as competitors of the SMEs, as distinct from their intermediary and coordinating roles in the previous stage.

With accumulated financial strength and experience in exporting through SMETCs in the complementary and coexistent stage, more and more SMEs attempted to bypass the relationship with SMETCs and export directly setting up their own export departments to handle export business. Additionally, most second-generation SME leaders were better educated than their parents, with foreign language competency as

well as good international business networks and knowledge. Consequently, in this stage some SMEs chose to use direct export channels to international buyers to save paying commissions to the SMETCs, ranging from 2 percent to 20 percent, depending on the items and order amounts. Majaro Simon (1978), Boone and Kurtz (1992) and Daniels and Radebaugh (1995) analysed the factors involved in selecting export channels. They demonstrated that products characterized by small sized orders and low unit values were generally exported through intermediate firms. Moreover, where a market was geographically diversified or where production-oriented firms had only a simple basic organization, inadequate financial backing, limited product lines or inadequate international marketing managerial resources and experience, and where the intermediate firms were adequately promoting their new products or developing new market sectors, the firms opted to use indirect channels. In other words, SMETC operators had to be equipped with know-how in distribution techniques and distribution management, and had to have sufficient competent personnel to sell the products abroad because, otherwise, SMEs preferred to export directly.

To survive, SMETCs would lure core personnel of the SMEs with the required product expertise and familiarity with the supplier's decentralized production networks to their firms. The SMETCs were then able to contract directly to subcontractors, skipping over the contractors. SMETCs provided material to the subcontractors to ensure product quality. In the first stage, international buyers were not familiar with Taiwan's environment and telecommunications were underdeveloped, but, as time passed, they found they could easily contact suppliers themselves. They preferred to import directly without the middlepersons. Increasing international competition also pushed buyers to search for lower cost avenues – direct channels - to import products for their respective markets. Many foreign importers,

wholesalers and retailers such as KMART and Franklins set up their own buying offices in Taiwan to deal directly with local contractors.

Nevertheless, there were still 10 324 SMEs (manufacturers) in 1984 which did not have internal import/export departments.[111] They still relied on SMETCs to export their products. For example, 21.27 percent and 18.58 percent of SMEs' production was exported through SMETCs in 1989 and 1990 respectively.[112] From that time however, a labour division system separating "selling" from "manufacturing" commenced to develop which initiated the decline in the importance of the SMETCs.

An SME owner said:

> Trading companies were 'exploiters'. They used our samples to obtain orders and then shopped around with our samples among the other local manufacturers to get the lowest price for a higher profit margin. It was unfair that we put a lot of effort into developing new items, while trading companies sat in air-conditioned offices and got much more profit than we did.

A SMETC owner said:

> You know, every time buyers came to Taiwan, we always invite our suppliers to join our meetings or bring buyers to factories to discuss the order details or any technical problems. They would exchange business cards. Some manufacturers use these as a means of accessing my buyers, even quoting prices directly. Eventually, we lost our buyers. But the suppliers did not know the categories of buyers, for example, whether they were importers, wholesalers or retailers. They had no idea of market segments and how to quote appropriate prices to different buyers. In order to obtain more orders, they just made a 'throat-cutting' offer. To cut costs, they used second-class material. Poor product quality resulted. Eventually the product line involved died and the products disappeared from the market.

[111] *Report of Trading Section in the Association of Economic Reform*, Taiwan Trading Bureau, 1985
[112] Gao Cheng-shu, 1995, *The Social Institutional Foundation: Trade networks and monetary organizations in Taiwan*

Another SMETC owner stated:

> Once suppliers started to export directly, their direct orders were their production line priority. They ignored urgent orders from trading companies. We could not control our delivery schedules. This was the reason for organizing my own decentralized production network, to ensure my orders could be shipped on time.

These comments all indicate that the relationship between SMETCs and SMEs developed into one of conflict and competition.

Figure 5 and Figure 6 show the two types of vertical integration of Taiwan's export networks: backward integration and forward integration.

Figure 5: Backward integrated networks

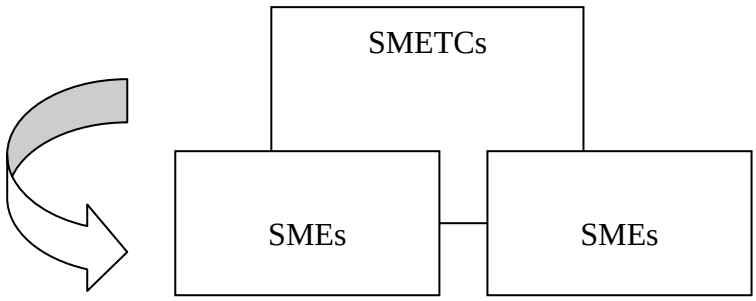
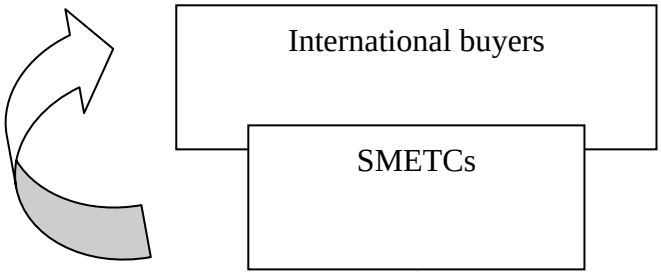


Figure 6: Forward integrated networks



In the1980s, as a result of Taiwan's economic growth, SMETCs and SMEs faced the problem of declining comparative advantage with the increasing cost of wages, land and plant, environmental problems, and exchange rate increases.[113] Taiwan's SMEs and SMETCs faced the tremendous impact of these problems and Taiwan's original export networks were unable to withstand the competition from underdeveloped countries.

[113] The exchange rate for the NT dollar relative to the US dollar changed through 1985 from 39.85:1 to 25.75:1, an increase of 55%.

To reduce export costs and thus to decrease the pressure from international competition, and also to eliminate the conflict and competition which arose in the previous stage, SMEs and SMETCs were compelled to restructure the “manufacturing and sales system”(MSS) and began integrating with their long-term partners by investing in each other’s firms or merging with their partners.

The SMETCs’ forward integration involved merging their international buyers into overseas marketing or resource offices responsible for formulating and implementing long-term plans to develop or promote their own brands. Designers were also recruited in the marketplace to introduce new product designs that catered for the local market, and the SMEs were then required within their new networks to manufacture items to the new designs for display to direct international buyers in order to secure orders. This integration changed the traditional export concept from “to be led by the international market” (*Gen zhe guoji shichang zou*) to “to lead the market” (*Lingdao shichang*) as many famous brands do in the international markets. The change compelled SMETCs to extend their functions to include marketing, rather than acting as a single export service. This change also compelled SMEs to work closely with SMETCs to solve their common problems and to share risks and also profits.

The SMETCs’ backward integration was the SMEs’ forward integration. By means of loans and joint ventures, SMETCs cooperated with SMEs, mainly small sized contractors or subcontractors, to form integrated export networks. Arising from this partnership, SMEs acquired the additional capital required and stable long-term orders. They also obtained first-hand information on international buying, market trends and

prices. The accruing benefits enabled them to improve their production plans and develop their products. SMETCs could ensure the quality, delivery and pricing of the products ordered since they participated in material sourcing, arranging production lines and cost estimates.

After this stage, it was intended that both SMETCs and SMEs would grow to become large-scale enterprises. The relationship between these two parties was no longer one of competition and conflict. Both worked side by side to increase their common profits.

It became more and more difficult for the SMETCs which were without the cooperative support of SMEs to continue to operate. It became obvious that the SMETCs' role was no longer as important as it was in the initial export networks. However, there were difficulties arising from the integration. According to Professor Chen Xizhao,[114] about 68 percent of the owners of both parties, as general managers, were reluctant to lose decision-making power. The "*Laoban* (boss) syndrome" would undo the cooperation. Trust played a key role in this integration.

[114] Ma Kai, *A study of cooperation in manufacturing and sales among Taiwan's small, medium and large enterprises* 1992 p.125

4.5 SMETCs in Taiwan's industrial progress

In the last five decades, Taiwan's economy has changed from being one almost entirely dependent on agriculture to one dependent on manufacturing and, in the process, progressing from manufacturing cheap, labour-intensive products to being a world leader in supplying information technology hardware. Taiwan's economy was well known for its outward-looking industrial strategies and its industries were known as export-oriented industries.

The upgrading of these "shallow dish" type industries was not spontaneous; it was stimulated by international demands which were passed down to the SMEs via the SMETCs' networks with international buyers. These caused the export content of Taiwan's production to alter markedly. Tables 2 and 3 indicate the rapid change in the content of Taiwan's exports. In 1952, agricultural and processed agricultural products constituted 91.9 percent of the value of total national exports with industrial products being only 8.1 percent. By 1970, the value of the former declined to 21.4 percent while the latter had grown to 78.6 percent.

SMETCs were the agency which brought the latest product information and technology into Taiwan to help SMEs to upgrade their products. Though different industries had certain similarities in this growth phase, there were also dissimilarities in this transition. SMETCs always played a significant role.

Table 5 Taiwan's export trade by sector (percentage)

Year	Agricultural products	Processed agricultural products	Industrial products[115]
1952	22.1	69.8	8.1
1955	28.1	61.5	10.4
1960	32.3	55.7	32.3
1965	23.6	30.4	46.0
1970	8.6	12.8	78.6
1976	5.0	7.4	87.6
1980	3.6	5.6	90.8
1985	1.6	4.5	93.9
1990	0.7	3.8	95.5

Source: Monthly Statistics of Exports and Imports, Taiwan Area, the ROC No.244, 20.2.1990

Table 6 Taiwan's industrial exports (percentage)

Year / Item	1956	1961	1966	1971	1976	1981
Food	40.5	11.1	10.1	0.5	0.1	0.2
Textiles	9.4	28.1	19.9	14.6	14.0	10.1
Garments	3.9	5.8	9.6	27.0	25.7	21.4
Machinery	0.3	0.9	4.0	4.1	4.7	5.1
Electrical & electronic	0.0	1.7	8.1	15.9	17.0	17.6

Source: Monthly Statistics of Exports and Imports, Taiwan Area, the ROC, No.136 20.2.1981

[115] Processed agricultural products include sugar and canned food. Industrial products include electrical machines and equipment, plastic products, electronic products and other manufactured items which include textiles, garments, footwear, plywood, umbrellas, furniture, travel products, sports goods, toys, etc.

4.5.1 SMETCs in the development of Taiwan's light industries

The major light industries in Taiwan between the 1950s and the 1980s were the manufacture of textiles, garments, and footwear. This section will examine the role of SMETCs in the different steps of Taiwan's light industries development. An upgraded pattern of the industries will illustrate the processes of their improvement.

Because of climatic factors, cotton growing did not meet the demand in Taiwan and textile industries were not well developed in the period of Japanese rule from 1895 to 1945. With the infusion of US aid from 1950 to 1965[116] and the expertise of new migrants[117] from Shandong and Shanghai (the Shandong and Shanghai "gangs") in China in 1949, the textile sector, including yarn spinning and cloth weaving, made significant progress between the 1960s and the 1970s. These new migrants benefited from their ability to access the centre of political authority and had an advantage in being able to obtain the essential raw material for their textile businesses. Their products were exported to Southeast Asia through state firms or their contacts established in China before migrating to Taiwan. Because of these factors, SMETCs had a lesser involvement in these export businesses.

The invention of synthetic fibres, such as nylon and polyester, which replaced natural materials to become the key component in cloth for garments, boosted the quantity required to meet the booming market demand. Cheap and hard working labour and good quality control attracted foreign buyers to place their orders in Taiwan through

[116] After the Korean War, the US government commenced in 1950 to provide Taiwan with aid averaging US$100 million per annum and daily necessities including US surplus agricultural products, such as soy beans, wheat, flour, milk powder, and cotton. Cotton amounted to 20% of those products.
[117] To differentiate those migrants who moved to Taiwan after 1945 form other migrants, they are termed "new" migrants.

SMETCs. Since then until 1984, textiles and garments were the major export products. Taiwan became one of the “Big Three” Asian producers – Hong Kong, Taiwan, and Korea, and was the major exporter of low cost apparel.

Owing to the change in their domestic manufacturing environment and based on their assessment of Taiwan’s products, international buyers either discontinued their domestic purchasing or closed their production lines and transferred the production of low added value items to Taiwan’s SMEs, and exported them to their markets thus securing higher profits. Under these circumstances, Taiwanese manufacturers commenced to set up production lines for low-end products.

Following the improvement in Taiwanese skills and cost increases, either the buyers or the Taiwanese SMEs relocated their lines for these product ranges to third world countries. Then middle range products were introduced into Taiwan replacing the low-end products. Consequently, the international buyers concentrated on marketing and Taiwan’s SMEs shared the production tasks. This is the so-called international labour division. The SMETCs’ position in the growth of the textile industry is indicated in Figure 7.

There were four stages in the development of the garment industry. In the first stage of low-end products (1960s -1970s), international buyers transferred their orders to Taiwan to take advantage of its cheap and ample labour. This constituted the period when Taiwan’s textile and garment exports were at their peak. SMETCs acted as an educator, teaching local SMEs the business of exporting, including such things as the importance of export packaging and shipping marks, and also acted as interpreters and translators. Meanwhile, SMETCs also worked as purchasing agents to perform basic

and traditional functions such as correspondence, document preparation and goods inspection.

One of my informants, a retired owner of an SMETC, said:

> A company that I owned in the 1960s placed an American importer's order with a manufacturer located in She-tz'u.[118] I visited them to discuss the details of the order. The factory was as simple as a small workshop. It was just equipped with two huge plywood boards which were erected on the clay floor. These were used as a cutting board. I had to ask them to be aware of the rough surface of the board which might damage the clothes and could initiate a quality claim. I also had to tell them the importance of the shipping mark and how to write it on the shipping carton.

In the second stage of middle range products, because of rising competition in their home and international markets, international producers or importers of middle range products transferred their production lines or orders into Taiwan. With the SMETC operators' assistance they passed on the latest technology and skills to Taiwanese producers. This led SMEs to upgrade the level of their products from low-end products to middle range products. The SMETCs' major task was to collect samples from the market or international exhibitions and then ask SMEs to make counter samples to search for more orders.

In the third stage of high-end products, the improvement in the quality and design of Taiwanese products attracted international producers of high-end products who closed their production lines at home and set up OEM production lines in Taiwan to manufacture products under their own brand names. SMETC operators acted as distributors of orders to the appropriate SMEs. Based on their accumulated knowledge

[118] She-tz'u is a suburb in northern Taipei City. It was on the outskirts of Taipei City at that time.

of the local SMEs' production lines, they placed orders with the most suitable manufacturers. They also transferred technical and other product information to SMEs and collected information on design, materials and market trends. These were key factors in driving Taiwan's industries to upgrade their products. Furthermore, "some Taiwanese trading companies had set up branch offices or affiliated firms in the USA or Europe in order to gather fashion information and explore new markets. Larger trading companies regularly hired freelance designers from Europe to work with Taiwanese master shoemakers to develop new styles…"[119] New product designs were a vital element in competing for orders in all industries but were even more important in the fashion industries, such as footwear and garments.

SMETCs also helped SMEs to set up sales plans and to price products appropriately for various customers from different countries. For instance, prices and items for Japan differed from those for the USA. Similarly, the quality requirements for products for Kmart certainly differed from those for Hallmark.

The fourth stage was the stage of international labour division. International buyers concentrated on marketing and relied on the Taiwanese producers. In this stage, SMETCs integrated with SMEs as illustrated previously and acted as exporters and manufacturers.

After 40 years of development and growth since the 1950s, Taiwanese light industry had excellent results in the research of new products and upgrading their production equipment. These industries have become the main suppliers in the global textile consuming market, and the footwear market. However, the quota on textiles and

[119] Hsing, You-tien, **"**Trading companies in Taiwan's fashion shoe networks." *Journal of International Economics* volume 48, Issue 1 June 1999 pp.101-120

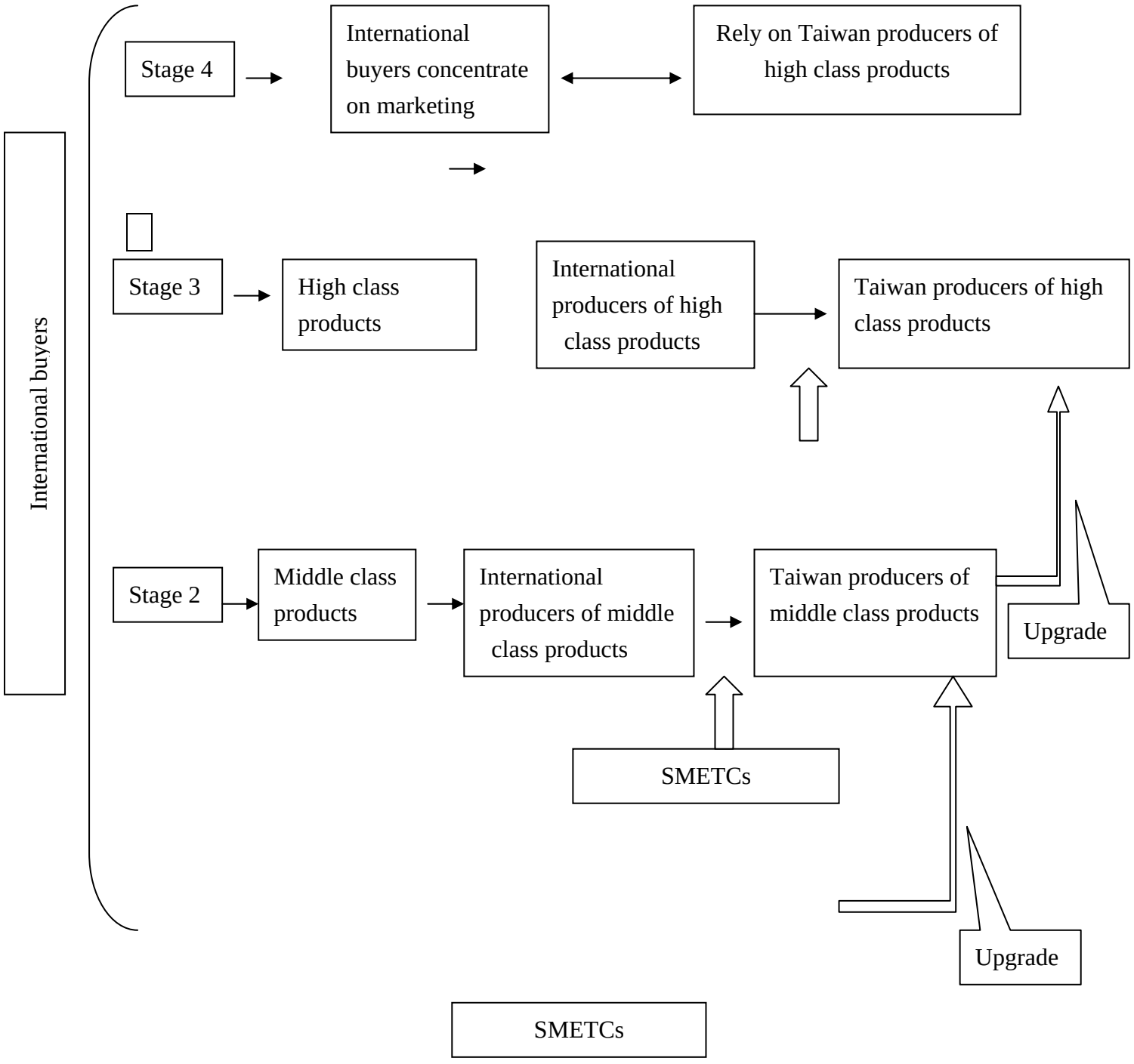
footwear[120] imposed by the US government since the 1970s led to increased customs duties, which increased the costs of Taiwan's EOI products and affected Taiwan's export SMEs and SMETCs. Quotas also limit the levels of imports from Taiwan and dampen the growth of Taiwan's textile and footwear industries. SMETCs, which had no quotas, and they had to buy a quota from other local firms which held quotas. Naturally, their costs were higher than the quota holder, and sometimes the price was higher than the unit price of the product itself. As a result, SMETCs faced an unfair competition.

These light industries belong to traditional labour-intensive industries; therefore when Mainland Chinese opened its doors, and the underdeveloped Southeast Asian countries, such as Vietnam, the Philippines, and Thailand joined the labour markets with their ample cheap labour, direct foreign investors were attracted to set up plants in these countries. This impacted Taiwan's light industries directly, and forced Taiwan's local suppliers of the industries to move to these places to process the products overseas. SMETCs again played an important role as a bridge between the international buyers and the Taiwanese merchants (*Taishang*).

[120] Quota is a quantitative restriction on import.

Figure 7: The upgrade pattern of Taiwanese light industry

(Adapted from Economic Structure and Special characteristics of Taiwan's SMEs", Doctoral Thesis, Chen Chieh-Hsuan's, 1991 p.98)



4.5.2 The development of Taiwan's electronic industry

For the same reasons as for textile and garment buyers, foreign electronic industry manufacturers such as General Electric, Philips, RCA and Sony transferred their assembly lines for low-end products to Taiwan, but initially used fully imported parts in their assembly lines. For example, in the beginning, the foreign direct investment (FDI) firms' assembly lines for transistor radios in Taiwan used 100 percent imported parts except for the plastic cases for the radios. Using these imported parts as samples, SMEs commenced producing these electronic components or the employees of these FDI firms resigned to set up their own SMEs to manufacture parts and supplied them to FDI companies. Eventually, the finished products used all Taiwanese manufactured components. Products assembled in Taiwan were exported to international markets. According to international trading regulations, 1 to 5 percent of product parts had to accompany every shipment so the users became aware of Taiwanese products and their quality. This practice in effect initiated the export of electronic components made in Taiwan.

Taiwan's export electronic industry developed from exporting parts and assembled products and then progressed to exporting products of Taiwanese design. So the industry grew from the manufacture of basic components such as capacitors, resistors, plugs and cables to labour-intensive items such as radios, calculators, speakers, hi-fi systems and TV receivers.

The industry experienced an upgrade process similar to that for the textile and garment industries described previously. But the expertise of the average high-tech firm's founder or owner was higher than that of the traditional "black hand" industry

boss. They were university graduates or overseas students who had worked in the USA's Silicon Valley. They possessed both language and international trade skills. They could carry out all the SMETCs' functions. As a result, the role of SMETCs in this industry progressively disappeared.

4.6 Conclusion

SMETCs were recognized as the drivers of Taiwan's export/economic growth engine. Their representatives travelled to every corner of the world with their suitcases to promote Taiwanese products in the international market. They also brought back vital market information and updated technologies. Without these "brief case" salespersons, Taiwan's economy would not have grown as it did. This research indicates that no matter how the relationship between SMETCs and SMEs changed, and the Taiwanese economic structure changed, the intermediary role played by the SMETCs, which led Taiwan's SMEs onto the international stage, did not change. Their major contribution to the export-oriented economy should not be ignored.

This study also finds that the smaller SMEs were more dependent on SMETCs than the larger ones. The latter preferred to export their products directly and bypass the SMETCs. As G S Shieh says, "Domestic trading companies are the key export channels for the small manufacturing establishment."[121]

SMETCs have received many critical comments in the past because of their limited functions. But they were able to vary their roles. With their key characteristics of flexibility, rapid response and diligence, SMETCs modified their strategies over time

[121] Shieh, G S., *"Boss" Island*, New York: Perter Lang, 1992 p. 40

and brought about a new “manufacturing and sales” cooperative system which enabled both SMETCs and SMEs to coexist for their mutual benefit.

CHAPTER FIVE

Economies of Scale and Scope

Introduction

As Hsing You-tien states:

> One of the most important roles of trading companies in Taiwan's industry has been coordinating inter-firm scale and scope economies…while scale economies were achieved by specialized manufacturers, scope economies were achieved by the coordination of trading companies that run the orders in the networks of firms. [122]

This emphasizes the important coordination role of SMETCs in leading Taiwan's export networks to achieve scale and scope economies in Taiwan's industries. This then is the reason for discussing the economics of scale and scope in this thesis.

No matter what the size of an enterprise, all firms focus on profit, which is a significant element in whether a firm makes a profit. Therefore, reducing costs to maximize profit can be seen as the common goal for all enterprises. Economies of scale and scope, the most effective ways to reduce the cost of products and increase the manufacturer's efficiency, are the major elements that increase a product's competitiveness. Therefore, economics of scale and scope are the ultimate goals for all business organizations which devote all their effort to achieve the economies. Theoretically, these economies should only occur in large enterprises such as the automobile and steel industries, or when a small enterprise grows to a large-scale. It would normally be thought impossible for the two economies to occur in Taiwan's enterprises, because most of them are small- and medium- sized business organizations. However, Hsing also indicates scale and scope economies have occurred in Taiwan. She

[122] Hsing, You-tien, Trading Companies in Taiwan's Fashion Shoe Networks *Journal of International Economics* Vol. 48, Issue 1 June 1999 pp. 101-120

states: “Both scale and scope economies were achieved through a hierarchy of specialization and networks of production among independent producers.”[123]

This hierarchy of specialization and the networks of production were introduced in the section on initial export networks where I showed that SMETCs are the vanguard of these networks and act as bridges between international buyers and Taiwan’s local suppliers. They deal with international buyers directly and get the initial orders from the buyers, then form an upstream section of the network. Other constituents in each tier of the network specialize in one process or job, and form a downstream section to support the SMETCs. This downstream section is a production chain which consists of SMEs, their subcontractors and their family-based production units.

Individual SMETCs handle a variety of products from their different suppliers to meet their international buyers’ various demands; for example, their international customers are retail chain stores which generally cover a wide range of consumer products, i.e., garden tools, cosmetics, clothes, sporting goods, and so on. These customers import Taiwan’s products through one or two SMETCs who act as their purchasing agents in Taiwan. Cost saving is achieved for the export oriented industry (EOI) goods by utilizing the common facilities of the same SMETC. In the case of SMEs, cost savings for more closely related products is achieved along the production chains, for example, a plastics injection factory uses the same machines and tools to produce plastic buckets and rubbish bins. This results in Taiwan’s OEI goods becoming more competitive. SMETCs then have a role in furthering economies of scope in Taiwan’s economy.

[123] *ibid*. pp. 101-120

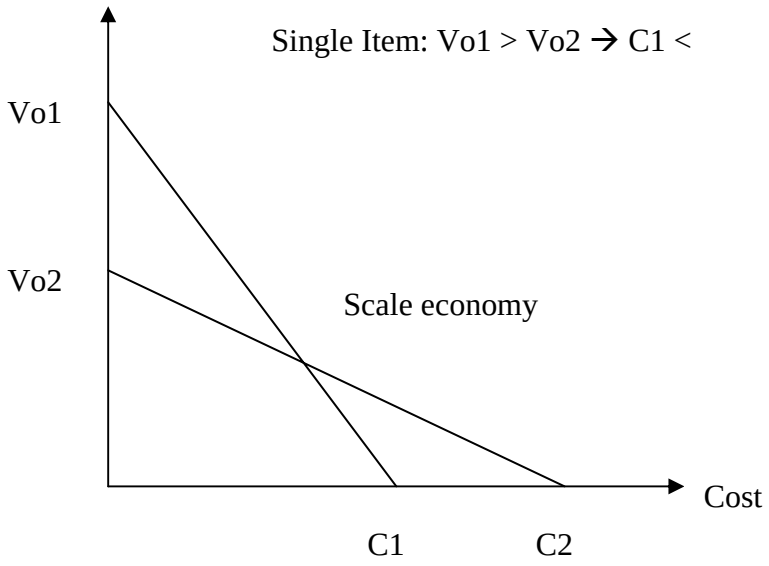
This chapter will explore the methods used by SMETCs to lead the hierarchy of specialization and networks used by Taiwan's SMEs to achieve economies of scale and scope. Before moving on to study the structure of the hierarchy of specialization and the production networks, the performance of SMETCs in social coordination (e.g. family networks) among SME networks will be examined. By employing decentralized production networks, SMETCs and SMEs promote economies of scale and scope. This chapter will also illustrate the operation of labour division in Taiwan's decentralized production networks. Quality and reliability are the vital elements for SMETCs and SMEs to win trust in their networks, assisting them to equip themselves with the flexibility and speedy responses needed to achieve scale and scope economies.

5.1 Definition of scale and scope economies

Scale economies are possible when the unit cost and price of a sole item drops when mass production reaches a certain level. Economies of scale can be accomplished because, as production increases, the cost of producing each additional unit falls. In other words, the firm's scale economies are formed due to the expanding scale of output. For instance, a SMETC operator concentrates on promoting a single product to the international markets, and wins orders for the item from various international buyers. Consequently the quantity of the item will accumulate, and then the operator places these orders to its suppliers and their production networks. As a result, these orders benefit from the advantages of large quantities of purchasing power, sales, also from the specializations of management and technical staff. These advantages and specializations lead various outputs to a lower average cost. In addition, mass production helps spread fixed or sunk costs. The bulk buying of material tends to further minimize costs; a number of cost components are fixed making it beneficial to

produce on a large-scale. To accomplish this, it is not necessary for SMEs to form a partnership or to merge with other manufacturers of the same products. It is sufficient for them to cooperate with similar businesses to utilize all their facilities to the maximum through vertical production chains with labour division networks. In other words, the SMETCs lead SMEs to achieve economics of scale through their finer detail decentralized networks. Figure 8 explains this statement.

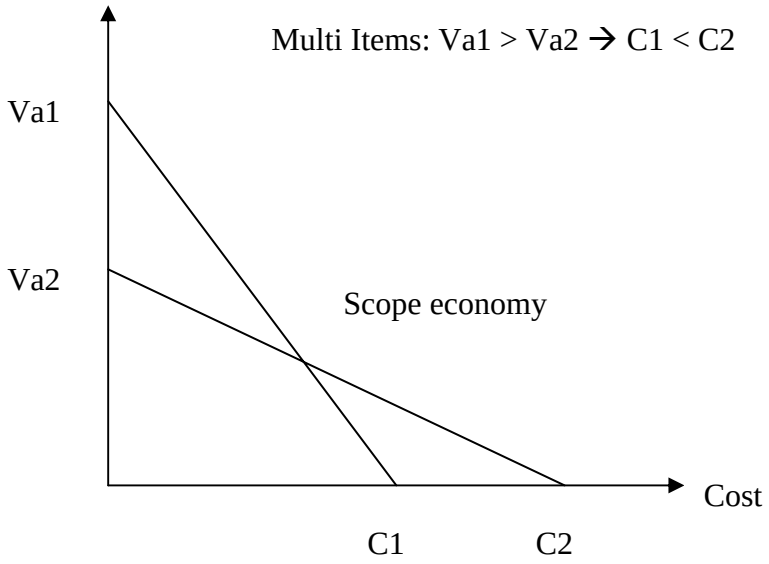
Figure 8: Economic scale



Scope economies are the result of varying the product mix such that, when the variety of products is increased, unit cost is consequently reduced. Scope economies arise when the cost of performing multiple business functions simultaneously proves more efficient than performing each business function independently. Scope economies also occur when there are cost savings arising from by-product processes. For example, a newspaper publisher utilizes its colour printer to publish a weekly magazine. The latter is a by-product of the newspaper production. These are quite related to each other. These economies can exist in

production, product development and distribution, but generally focus on the production processes. Manufacturers may reduce their costs by producing various products using the same facilities e.g., using knitting machines to produce gloves and hats. It also occurs in the case of SMETCs, which work as export agents for several SMEs to export their products. This results in a reduction in per-unit export cost and lowers the sale price of the goods supplied to bring about a competitive advantage for the SME products. Figure 9 illustrates the statement.

Figure 9: Economic scope



In short, large quantities and diversity of products can minimize production costs and increase profit, and they are significant elements of scale economies and scope economies respectively. However, when the quantity manufactured of a single item is large, the production cost and other expenses will decrease, which will induce manufacturers to engage in direct export, bypassing the trading company. By contrast, when the quantity is small and

the range of designs wide, the manufacturers' cost is increased making it advantageous to export indirectly, through a trading company.

In conclusion, Taiwan's domestic market is limited, and its outward looking economy relies on international markets to increase the volume and variety of its EOI products, two elements of scale and scope economies. SMEs and SMETCs utilize their decentralized production networks and export networks to reduce the cost of products and then achieve these two economies. Taiwan became a famous "international industries processing base" before the 1980s. Therefore, there is no export where there are no scale and scope economies in Taiwan. As export engines in Taiwan, the SMETCs play an essential role in achieving these two economies.

5.2 Decentralized production networks (DPNs)

In the process of achieving Taiwan's scale and scope economies, and with support from Taiwan's decentralized production networks (DPNs), also known as subcontracting networks, SMETCs carried out their roles as significant leaders of the export networks. Taiwan's DPNs, which are a detailed labour division and a fundamental element of the export-oriented economy to support the SMETCs at the top of Taiwan's export network, should be given attention. This is one of the reasons for examining DPNs in this chapter.

Small establishment contractors and their downstream layers of decentralized production networks have relied on SMETCs to handle their exports. They prefer to export indirectly through domestic trading companies while large-scale manufacturers tend to export directly through their own export departments. According to Shieh's survey, among Taiwan's enterprises, 78.3 percent of small contractors with fewer than nine employees preferred to

export EOI products via SMETCs, whereas only five percent of large-scale factories, those which employed more than 500 staff, exported through SMETCs. In other words, SME constituents from the networks are more dependent on SMETCs and these two parties have bilateral interests. Therefore, it is necessary to provide an explanation of the formation of DPNs, their characteristics, their problems and their performance, even though they are not the focus of this thesis.

5.2.1. Formation of DPNs

A decentralized production network is a form of labour organization which provides "a means of reducing production costs directly with output",[124] and "is used to avoid the wide range of overhead costs associated with direct employment and to exploit sources of low-paid labour".[125] Taiwan's decentralized production networks are an economic system of outwork networks and are a result of the division of labour.

5.2.2 Background of DPNs

Rapid expansion, lack of capital, sequential change in composition, and wide fluctuation of Taiwan's EOI products have shaped the Taiwanese production organization into decentralized production networks. These networks bring about the capacity, capability, and flexibility to cope with the fluctuations of international markets. The chart indicates the fluctuation.

Taiwan's DPNs were initiated by multinational buyers when they faced fierce international competition and growing worker demands in their home countries. In response, they shifted

[124] Wilkinson, Frank, *The dynamics of labour market segmentation* Sydney: Academic Press 1981 p.116
[125] *ibid*.p.*116.*

their low-cost and fragmented production of labour-intensive consumer products to Taiwan on an OEM basis. Since these consumer products were huge in quantity and short in delivery time, Taiwan's SMEs had to expand their production lines to meet such rushed delivery requirements. However, their limited capital meant they were unable to cope with the rapid expansion. Some SMEs farmed out their work to factories belonging to their friends or relatives. Some SMEs helped their employees by providing them with second hand machines to establish their own businesses, and used them as subcontractors. Consequently production networks were formed.

The international buyers switched their orders for labour-intensive items in and out of Taiwan frequently. The life cycle of these items was very short. The duration of introduction, growth, maturity, saturation, and decline varied enormously from item to item. These items lasted on average from a few months to two to three years. In other words, new items replaced them very rapidly. In Taiwan, it was very common that whole families closely related to an SME would be busy assembling polyester flowers one week, and the next week they would be busy sewing parts for dolls. Seasonal items would be back the following year, but most items disappeared forever. This rapidity of change has meant fluctuating international market demand for Taiwan's export products. Such fluctuations have required variations in the quantity of labour to meet the wide diversity of products, and this has favoured the use of networks.[126]

At the same time, the Taiwanese economy in the 1960s was at a turning point in its transition from agriculture to labour-intensive industry, and many agricultural workers were released from the agricultural community economy and entered into the labour market. The production lines in EPZs or FDI factories absorbed most of this workforce. But some people

[126] Wilkinson, Frank, 1981*The dynamics of labour market segmentation*, London: Academic Press pp. 118-122

realized that they might face obstacles in job promotion and achieving wage increases in large-scale manufacturing. They therefore started their own business which, although difficult, was the only way of increasing their household income, escaping poverty and also upgrading their social position. The traditional value of being a boss drove people to establish their own businesses, but a lack of capital ensured that their establishment would be small.

Additionally, according to Poon, the production process for these labour-intensive products was "highly divisible and demands only simple technologies and basic skills".[127] For example, wooden Christmas ornaments can be easily divided into three steps of shaping, polishing, and painting. Every step is so simple that it requires only a short period of training to operate simple machines and gain a basic knowledge of the handicraft process.

The agricultural population was generally deficient in capital, and hampered by very low education and basic skills levels.[128] Some had no knowledge of the skills required for particular jobs. Through introductions by family members, relatives and friends, they entered the business or were trained in the production process. They developed their own production networks from household production, based on social networks, and they developed relationships of personal ties, based on kinship and territory, as their sources of labour and information. This resulted in a very flexible system of recruiting work units. Thus, when market demands were growing, SMEs did not require increasing in-house production, but extended subcontracting networks by putting out work to more home-based work points and involving more housewives in the jobs to spread the risks arising from discontinuous and

[127] Poon, Teresa Shuk-Ching. (1996) Department development: the subcontracting networks in the tiger economies, *Human Resource Management Journal*, Vol.6 Iss.4; pp. 38-50

[128] According to Ka, Chih-Ming's survey, 29.4% of male owners of garment work points and 40.4% of female owners had six years of education, only 4.8% and 0.5% respectively over 13 years of education. *Market, social networks, and the production organization of small-scale industry in Taiwan - the garment industries in Wufenpu* Taipei: Institute of Ethnology Academic Sinica, 1993 p.33

insufficient work. In other words, SMEs did not expand their internal structures; they expanded the external networks by means of horizontal cooperation with other subcontractors in the same field and by vertical lengthening of the subcontracting chain to divide the jobs into more detailed processes.

However, the golden age of ample Taiwanese cheap labour was over by the late 1960s when the pool of unemployed potential workers was exhausted, and from 1969, wages rose as a result. The implementation of the Labour Standards Law in 1984 led to the situation further deteriorating because of the stronger labour unions and the higher demands of the manufacturers' in-house workers. Large-scale manufacturers tended to contract out their jobs to the DPNs to save labour costs, including health insurance, pensions, and other fringe benefits. This resulted in the growth of Taiwan's decentralized production networks. Furthermore, Taiwanese geographical factors also favoured the formation of the DPNs. On this small island, the distances between villages and towns, and even cities, are very small. The transportation infrastructure has been well developed. The network constituent is able to deliver materials, semi-products, and products as quickly and conveniently as in-house production lines. This is why most constituents of the networks in the same field usually gather in the same towns or villages. For example, shoe industries were grouped together in Taichung, ready-made apparel industries flourished in Wufenpu, and electronic components in the suburbs of Tainan and in a suburb of Taipei.

5.2.3 Characteristics of DPNs

DPNs are characterized by inter-firm specializations. Every individual firm is a single task workshop, carrying out only one step of production and is "embedded in a complex chain of

input-output relations with other firms".[129] Based on "trust", these networks build up stable business ties and maintain bilateral relationships between SMETCs and SMEs. In order to achieve the four competitive priorities of cost, quality, delivery, and flexibility, SMETCs help SMEs to use this labour division system to contract out uneconomic parts of production to their subcontractors or home-based production points. Production efficiency and flexibility[130] are not only the characteristics of SMETCs but also those of decentralized SME networks. They are made possible and sustained by the survival of highly structured subcontracting networks. They save costs and expedite delivery of consignments.

Both of these characteristics are based partly on traditional Chinese values of diligence[131] and social networking, and partly on a lack of capital. The firms in the networks cannot afford to have their production capacity idle. Their family-link members, i.e., family members or relatives, allow them to conduct a type of self-exploitation, and the flexible allocation of the workforce to keep the equipment running. They work workers overtime or in shifts. Some of them have 24 hour shifts. In this case, the firms or the constituents of the networks possess the ability to produce cheaply, to cope with cyclical and seasonal fluctuation in demand, and "to meet urgent deadlines and to accommodate changes in production design quickly and inexpensively".[132]

Taiwan's DPNs are small working units of output subcontracting in an OEM system. They produce on the basis of buyers' orders and according to their specifications and designs. In other words, they operate under order production rather than plan production. Moreover, Taiwan's decentralized production networks are different from

[129] Dyer, Jeffery H. *Strategic Management Journal* (1986-1998) Vol. 17, Apr. 1996 pp. 271-291
[130] Flexibility enhances the competitive advantage of networks in term of volume, product mix, changeover, modification, rerouting, material and sequencing.
[131] Tai, Hung-chao (1989) "Having a diligent attitude towards work, following a frugal life, and maintaining high savings" are important Chinese concepts of human life p. 22
[132] Poon, *op cit*. 1996

the satellite manufacturers of Japan's *sogo shosha* and large-scale manufacturers. These satellites manufacture products exclusively for their "central" manufacturers. For example, Japan's motor giant, Toyota, has eleven manufacturing subsidiaries and affiliates in Japan and two supplier organizations.[133] They are either wholly owned subsidiaries of Toyota Motor Corporation, contractors for Toyota plants, or affiliated company plants. They produce vehicle bodies, transmissions assemblies, drive train parts, aluminium wheels, auto parts and components, and supply their products solely to Toyota.

In contrast to Japan's centralized production networks, Taiwan's contractors or subcontractors maintain multiple relationships with several SMETCs or contractors at the same time to ensure continuous orders for their equipment and increase their bargaining power. Furthermore, working for several customers enables the contractors and subcontractors to accumulate quantity up to a scale that permits bulk purchasing, and the spreading of unit cost, reducing the average cost per unit. These cost savings are often out of reach of SMEs.

SME DPNs produce a single range of products to a common specification which is adapted for different items. For example, a screw manufacturer concentrates on producing certain sizes of screws and supplies them to several knockdown furniture factories. (Knockdown furniture is a type of buyer-assembled furniture, e.g., Ikea's products.) These knockdown furniture factories then ask their contracted factories to drill the screw holes in the counter sizes to fit the screws. Accordingly, Taiwan's SMETCs advise their multinational buyers to use the compatible screws as much as possible in their designs to save on tooling charges for

[133] www. Toyato.co.jp/en/about-toyato/manufacturing/index.html p.2

special sizes or types of screws, thus enabling them to strengthen their competitiveness. Consequently, scale economies occur.

5.2.4 Advantages and disadvantages of DPNs

Advantages

Since the individual production units in the networks are small organizations and their slim structures have few levels of management, their decision-making structures are relatively simple and centralized, thus shortening the process of decision-making and allowing quick responses to changes in the environment at the time. This results in flexibility which maximizes the network's marginal utility of facility. When the markets were flourishing, and the demand was high, the networks could quickly unite to cater for the changes. When the markets are slow, they can disband.

Furthermore, since firms of these networks were family-based, their organization structures were flat and simple with their owners filling multiple roles as administrators, marketing personnel, material purchasers, and even as production workers. They are personally involved in detailed production matters, so that they had a good knowledge of the production lines. Thus, they tended to be very responsive to changes in the environment and could solve problems autonomously and immediately. Cheng, Lu-Lin's thesis provides two examples from a SMETC manager to illustrate this statement:

> He [the manager] went to a Korean factory to check the samples being developed and realized that the vamps was (*sic)* overlaying the toecaps. When he pointed out the problem, the Korean manager pulled out the drawings provided by the trading company to prove that he was just following instructions. "That would never have happened to my Taiwanese suppliers.

In such circumstances, Taiwanese suppliers normally will contact their cooperative partner SMETC straight away and change the design immediately.

Another example is from a garment manufacturer:

> When the fabric specified in initial drawings was not available, Taiwanese suppliers would try to find substitutable materials and make some samples for evaluation. They don't just wait there and waste time. We may not be satisfied with their adjustments, but sometimes they came out even better.[134]

In so doing, the production line would not be interrupted and delivery could proceed as scheduled. Subsequently, punctual shipment would fill the multinational buyer's shelves with stock-in-trade and satisfy the market demand. This is a result of a kind of "trust" in the networks and between the SMETC operators and suppliers that would accelerate cooperation and maintain the business relationship with multinational customers, especially for seasonally sensitive and price sensitive products, such as fashion shoes and apparel.
In the networks, every unit brought its own expertise to the respective sector, increasing the ability of the networks to remedy the weaknesses of individual production units. Through the cooperation between contractors and subcontractors, SMEs created complete industrial networks to achieve efficiency in labour utilization.

Disadvantages

These networks operated on a basis of "order manufacturing" which is a passive production system. In other words, they ran their production lines only when they receive orders. This lessened the risk of surplus stock. But the members of the networks could not control production quantity, marketing and reasonable profit

[134] The manufacturer will do his level best to satisfy the buyer because he wants continued business from him.

margins. They instituted an active system of plan manufacturing to control these three elements under OBM (Own Brand Manufacturing).

As mentioned previously, due to a system of international labour division, Taiwan's export-oriented enterprises concentrated on production and suffered from being isolated from updates and trends in international markets because of their size and lack of information. These factors resulted in enterprises being unable to set up their own production plans to follow changing global trends. Although SMETCs would pass part of the information about trends on to them, they relied on multinational buyers' OEM orders to fuel their production lines. They devoted so much time to chasing orders rather than undertaking R&D so that they were unable to develop their own brands and designs. In the long run, even though their products filled the shelves of international retailers' stores, Taiwanese manufacturers' brands and names were invisible. The network constituents earned only low wages and lost the high additional profits accruing from marketing. Since the channels for contact with international consumers in the markets were controlled by the multinational firms, the network constituents were unable to obtain the whole marketing picture and they therefore easily fell into the trap of blind expansion, to be displaced rapidly by indigenous and international competitors once the environment changed.

5.3 SMETCs as coordinators and labour allocators in Taiwan's DPNs

As leaders in the export networks, SMETCs acted as coordinators in awarding orders to the appropriate manufacturing contractors. This section further discusses their activities in coordinating DPNs, and allocating labour.

SMETCs, at the front line in the networks, played a critical role as middlemen making the matches between the suppliers and the international buyers. In so doing, they acted as an engine for facilitating the tasks, such as ensuring societal coordination and labour allocation in the export networks, and at the same time exercising their own responsibility for supply coordination between suppliers (contractors) in their networks and multinational buyers. To develop contacts with multinational buyers, SMETC operators used different strategies, e.g., attending multinational business exhibitions to find potential buyers and visiting the buyers from time to time to cultivate good interpersonal relationships. When orders were received, SMETC operators analysed them, and then from their networks of cooperative suppliers, they selected the appropriate contractors based on the contractors' specialization and capacity to meet the requirement of the orders. In general, every SMETC had two or three long-term partner contractors for each item to ensure the delivery and quality of the products. These contractors owned a group of subcontractors and the subcontractors in turn had several home-based workshops. To enhance the expectation of future reciprocation, every tier of the networks had many basic long-term cooperative teams or "key employees," also known as *bandi*. They could "ensure priority in production, special attention to the orders and confidence in secrets."[135] This would affect product delivery and quality, and information about trends. These were very critical aspects in international trading, especially for short delivery items or seasonal products, where all orders are supposed to be shipped out at about the same time. Any constituent of the networks without *bandi* could fail as a result of delays in shipment, because their order might be set aside to provide production capacity for another company's order. As a rule, in long-term cooperation

[135] Cheng, Lu-lin (1996) *Embedded competitiveness: Taiwan's shifting role in international footwear sourcing networks.* The department of sociology in the graduate school of Duke University PhD thesis, p. 145

in the networks, when an SMETC received an order, it consulted with its *bandi* first to arrange a new constituent. The following example explains the procedure for this social coordination and labour division.

An SMETC received an appeal for an OEM order which comprised different styles of men's, ladies', and children's garments. The specified gauges and knitting patterns ranged from 3, 5 and 12 gauge to 24 gauge, the knitting patterns included single and double knitting, and also jacquard and plain knitting. Materials covered natural and synthetic fibres such as cotton, acrylic, and polyester. Sometimes buyers would provide samples; sometimes buyers just provided drawings. SMETC operators had to study the samples or drawings detailing the order's requirements carefully and then split the order between several subcontractors for different categories based on the suppliers' specializations, and discuss the details of the specifications and requirements with the appropriate suppliers. According to the suppliers' specializations, SMETC operators would ask those selected suppliers to make counter samples for buyers to approve the design and quality including gauges, patterns, colours, sizes and weight. The counter sample was normally made by the contractors themselves in-house, but put out for mass production by their subcontractors after sample approval. SMETC operators might visit the selected suppliers to check out the capacity of their production lines to ensure they could delivery the goods on time. During production, the SMETC would visit them from time to time for quality control purposes and to remedy any problems as early as possible.

The garment industry, as in other labour-intensive industries, is very fragmented and easily divided. It includes knitting, cutting, trimming, stitching, ironing and packing

components. Thus once the quality and design and the consequent order are confirmed, contractors allocated the jobs of knitting, cutting, trimming, and stitching to their subcontractors who specialize in a single task or multiple tasks. The subcontractors then allocated more detailed jobs, e.g., sewing, zipper fixing and button fixing, to the home-based workshops. This was the procedure for managing an order in a vertical production chain. It comprised a highly responsive and competitive system of labour division in the DPN. Apparently, every production unit of the DPN could accumulate a sufficient quantity of any single product to save on production costs and achieve the economies of scale needed for the performance of the networks. However, there is no doubt that SMETCs initiate the fulfilment by the DPNs of the desired production objectives.

When different portions of the products were finished, the upper level of every tier in the networks would collect the parts from their next tier, inspect them to ensure the quality, and process their own jobs to complete the semi-finished products, e.g., sewing the body, sleeves and collars together. They passed the products to the contractors for ironing and packing. In the process of production, SMETC operators had to inspect production samples from the production lines or send the samples out to the international buyers to ensure the products met the buyers' requirements and gain the buyers' final confirmation of the quality and design. The SMETC operators usually inspected the final goods at the contractors' plant sites and arranged the export procedures, such as consolidating the products from different suppliers into one shipment to save costs in customs clearance, the banking charges for negotiating the L/C, issuing export licences and shipping documents, and so on. This outward

process meant that the SMETCs could accumulate their quantities and verities of export items, and thus achieve the scope economies.

Figure 10, taken from *Boss Island,* explains the role of the SMETCs in the process of coordinating and labour division in Taiwan's DPNs in the garment industry.[136]

Figure 10: The process of coordinating and labour division in the garment industry

Unit of production	**Labour division**
International buyer	Placing order; providing designs or samples
Trading company (SMETC)	Looking for appropriate domestic suppliers, inspect product quality
Contractor	Making samples; looking for sub -contractors; Q.C., packing
Subcontractor	Looking for home workers, primary examination of subcontracted works. Knitting and ironing (Sometimes these works are subcontracted out to workshops)
Cutting workshop Sewing workshop Home workers Home workers	Knitting, cutting, sewing, trimming, ironing, buttonholing

[136] Shieh, G.S., *"Boss Island" the Subcontracting network and Micro-entrepreneurship in Taiwan's Development.* New York: Perter Lang 1992 p.53. I modified Figure 3-1 to match my illustration in the text.

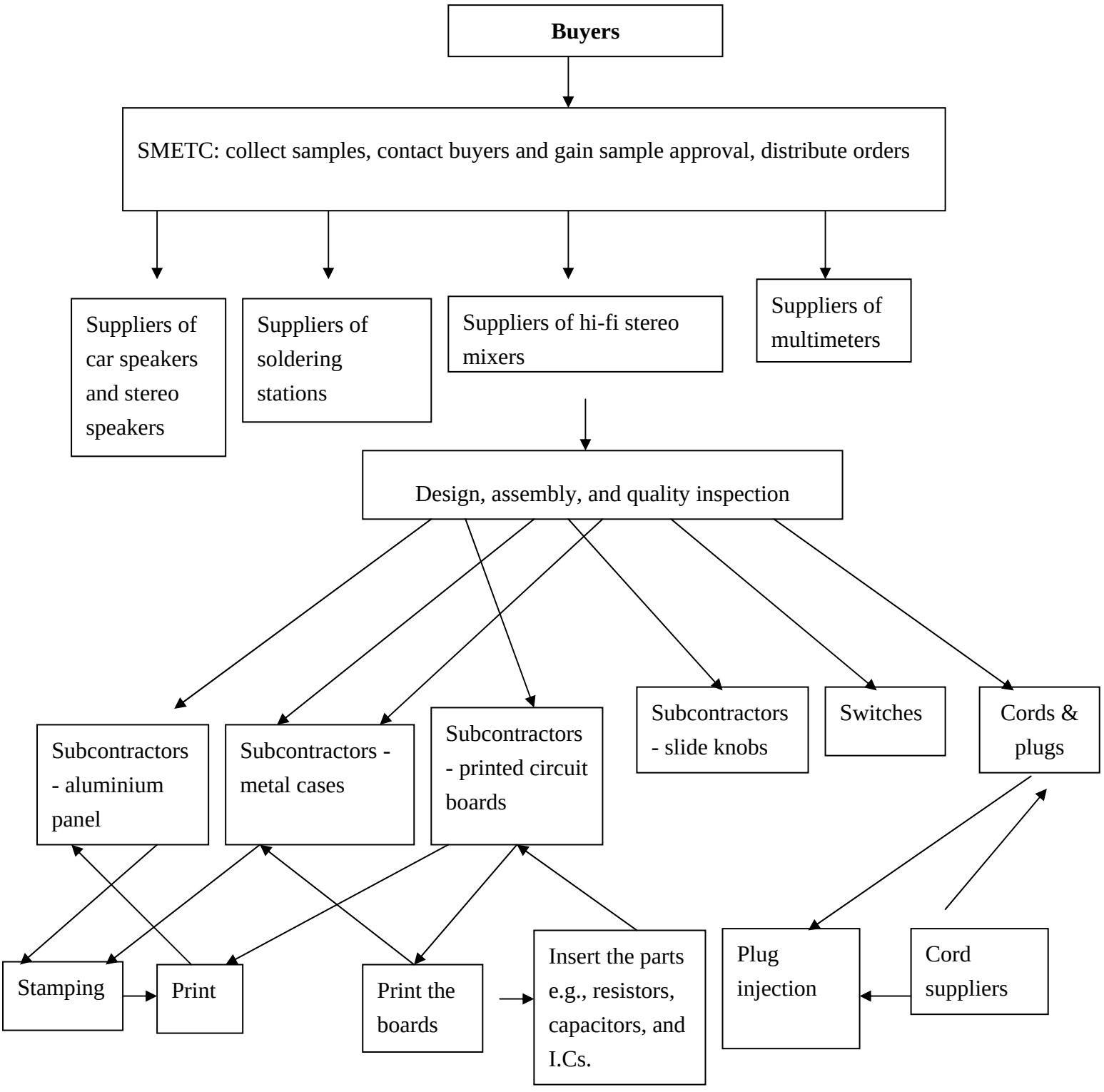
In the electronic industry, multinational buyers could purchase standard products off the suppliers' shelves. SMETCs sent local suppliers' samples out to buyers or kept them in their showrooms pending buyers' visits. Buyers selected the items and placed orders based on their standard specifications. In my own trading company, before our buyers' seasonal visits (normally twice a year, April and October), the staff had to visit or contact our suppliers or find new suppliers for new product samples ranging from mini switches to stereo mixers. Our relationship with the suppliers played a pivotal role in getting orders for new products. Some suppliers did not display their newly developed items in their showrooms, but locked them in the owners' offices and only showed these items to the SMETC operators whom they trusted. The reasons for hiding the samples from unfamiliar SMETCs are that some SMETC operators might hand the samples to their *bandi* suppliers to copy and offer the items at lower prices to their buyers.

For simple and basic items, for example switches and plugs, buyers placed orders when the prices were accepted; for more technological items such as stereo mixers, measuring equipment, car and home hi-fi stereo systems, then the orders would be conditional as "subject to approval of samples". Then samples were requested and sent out for approval. As in the garment industry, SMETC operators had to split the orders between the suppliers of the samples. The suppliers (also known as contractors) then purchased the parts from the parts suppliers and assembled them in their production lines. Sometimes the suppliers would contract out portions of the job to their subcontractors. For instance, a hi-fi stereo system supplier would contract out their panels and metal cases to stamping factories, then deliver the goods to them to print the marks, logos, item numbers and brand names. Normally the artwork would

be provided by the buyers or the SMETC. They also assigned the job of producing printed circuit boards (PCBs) to PCB manufacturers and then deliver the PCBs to parts assembly factories for the mounting of IC chips, capacitors and resistors. When all the contracted jobs were completed, the contractors would carry out the initial inbound PQC (parts quality control) and put them into their in-house assembly lines. The SMETC would come to inspect the quality of the first batch of products to ensure the specifications and printing complied with the requirements listed in the order. When all products were finished, SMETC operators would inspect the quality again and check the packing. Figure 11 illustrates this process for hi-fi stereo mixers.[137]

[137] The chart shows only the major steps of the process.

Figure 11: The processes chart in the network of hi-fi stereo mixers



In deciding the priority for distributing orders or tasks, as well as contractors' specialization, capacities and capabilities, "trust" has been widely considered as a crucial element in the decision-making process.

However, Shieh points out "the inter-unit relations with respect to task and order are also affected by the mobility path."[138] . He gives an example in the footwear industry to illustrate the situation:

> Some employees of trading companies invest in shoe factories and become their partners. So when the trading companies are putting out orders, these employees may give those factories in which they invest the orders with higher piece price or even put out all of the orders to these factories. The orders with lower price then would be put out to other factories. And this may anger other factories, which may then set their own trading departments to seek orders directly from foreign buyers.[139]

Obviously, the setting up of a bypass between buyer and manufacturers results in the failing of the SMEs' dependence on SMETCs and damages the "trust" among the constituents in the networks. When trust withers away, the export networks will diminish and even become corrupt.

5.4 Trust in the SMETC export networks

Trust is defined by Cheng, as "the expectation that another party will perform actions that will result in positive outcomes, a social actor voluntarily gives up preventive measures to give another party freedom to act alone and therefore allows the uncertain

[138] *ibid p. 55*
[139] *ibid p. 55*

possibility of being hurt".[140] In the long and uncertain process of international trade, both buyers and suppliers try to seek reliable partners to deal with to avoid unexpected risks, such as time lags between contracting and delivery or execution gaps between order specifications and final production.[141] Therefore, trust is apparently the most significant element in the transaction. For example, in order to meet rapid changes in market demand, both parties of buyers and suppliers at both ends of the international channels have to remove "preventive measures", such as legal contracts or documents of guaranteed payment, such as letters of credit (L/C) and run the production line straight away to meet an urgent market demand. In such circumstances, international buyers will "trust" the SMETC regarding the quality of the products. Conversely, the SMETC will accept orders from the buyers by fax or even by telephone. The relationships among the production networks operate in a similar manner.

Apart from making it difficult to meet rush orders, according to Cheng's analysis, there are at least four problems in having rational written legal contracts:

1) Solving disputes through lawsuits is costly, especially in international trade.
2) Contracts that are highly complex will damage the efficiency and flexibility of transactions.
3) Transactions that involve mutual adjustments during commercialization require tacit knowledge that cannot be substituted by formal written language.
4) Transactions that rely too much on formal and complex contracts hinder the accumulation of trust among parties.[142]

[140] Cheng, Lu-Lin 1996 p.46
[141] *ibid. p.45*
[142] *ibid. p. 46*

Moreover, as Schak says in his "Networks and their uses in Taiwanese society":

> In Chinese society, what we call networks were traditionally alliances embedded in a *guanxi* base, that is, sets of affective ties between people linked through kinship, native place, dialect group, school or workmate, or sworn brotherhood, etc. Embedded in these relationships is the basis of trust…[143]

In my research on Chinese traditional values in 2000, I also found that the Chinese prefer to put their trust in their family members, then in the five "same" groups (*wu tong)*. Firstly, *tongxing* - people with the same surname, although not related. Secondly, *tongxiang* - people from the same hometown or same village. Wufenpu's ready-made apparel industry is a good example. According to Ke Zhiming's study, the majority of performers in Wufenpu are from Fengyuan, a small town in Zhanghua. Thirdly, *tongnian* - people of the same age. Before the Republic, they were scholars of the emperor's examination in the same year. In Taiwan, men transfer this to the same year of military service. Fourthly, *tongxue* refers to schoolmates and fifthly, *tongshi* refers to workmates. A stranger earns the least trust. People not embedded in the five *tongs* need time to build up trust step by step. Schak indicates this progress clearly:

> The first several transactions with a customer were on a cash basis. His trustworthiness (*xinyong*) was established on the basis of the one introduced him, inquires about him through friends, his reputation as a trustworthy individual, and the subsequent demonstration of ability and willingness of the credit recipient to meet financial obligations. It was built up over a period of

[143] Chen Lu-lin *op cit.* p. 115

> time, and its level determined the amount of risk premium he paid for using credit - the more reliable he was deemed to be, the less he had to pay.[144]

Before trust is established, no credit can be extended. Trading in cash limits the company's turnover, and affects the development of the company.

The reason for this credibility gap is that the Chinese believe people who are from the five "same" groups will share the same values and ethnic norms; so that they can predict these people's reactions when unforeseen problems arise. This kind of problem may be hidden in any step in the long international trade process. Sometimes, as Cheng emphasizes, law, contract codes or administrative procedures cannot be avoided in solving all the problems.[145] But "trust" might bring a win-win result in negotiations on the grounds of the expectation of future business or opportunities for cooperation.

In the same research in 2000, I also found a new trend in values has developed in the networks of skill-intensive industries such as the electronic industry. A family member is no longer the priority for a business partner, and is replaced by a classmate or workmate, because skill-intensive industries require technological knowledge with which the family member may possibly not be equipped, while a classmate or workmate who has the same educational background and the same working environment is definitely equipped with the necessary knowledge and skills. Thus, the performers in the networks of skill-intensive, high tech industries prefer to select their

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[144] Schak, David, (2000) 'Networks and their uses in Taiwanese society' in Chan, Kwon Bun's *Chinese Business Networks: State, Economy and Culture*, Singapore: Prentice-Hall

[145] Cheng, Lu-Lin *op cit*. p. 46

business partners from their schoolmates or workmates when they attempt to organize a business or a decentralized production network.

In the organization of each constituent, the Chinese are more concerned with interpersonal relationships than with the tasks, and “trust” is an element of synergy inside the organization. Thus the management of Taiwanese enterprises is classified as “management of trust”. Additionally, in a Taiwanese organization, only a manager trusted by the owner can be authorized to conduct his managerial activities within reason. A member of staff trusted by his/her colleagues can gain assistance from others to complete his/her tasks, and from his/her superior. In other words, “management by trust” means in the Taiwanese managerial environment, obtaining others’ trust is a vital factor in completing a task. This managerial style, which is based on trust and acceptance, does not exist only in Chinese management. However, it is particularly salient to the Chinese family business system.

5.5 Conclusion

Although business organizations make every effort to pursue scale and scope economies, Taiwan’s SMETCs work as coordinators, concentrate on exporting products of smaller quantity but more varieties to achieve scope economies. However, because most big orders are exported by manufacturers directly, in order to survive and obtain higher profits, SMETCs can focus on developing their own designs and authorize SMEs to produce their exclusive items. They can then promote them under their own brands to the international market. In doing so, SMETCs are able to grow into large enterprises and achieve scale economies.

Taiwan's DPNs enabled its SMEs to accomplish their task of processing various EOI products under a system of international labour division, and made a name for Taiwan as an "international processing base". Moreover, the DPNs were the backbone of Taiwan's export networks and supported the SMEs and SMETCs in creating Taiwan's economic miracle.

However, their overdependence on international buyers caused SMEs to separate themselves from the international market. This caused blind expansion, so that when the SMEs lost their comparative advantage, the international orders disappeared immediately without any warning, resulting in declining profits. To avoid these problems, SMEs found that they needed to invest R&D, and to develop their global sales networks.

In Chinese society, trust has always played a very important role. In Chinese business culture, trust is superior to any other element. Sometimes, it could replace a contract, and could even solve problems which the law failed to work out. However, following the influence of the Western concept of law, Chinese business culture is becoming more rational, and traditional trust is tending to gradually fade out of Chinese society.

CHAPTER SIX

Management and Export Marketing Strategies of SMETCs

6.1 Management of SMETCs and SMEs

The management practices of SMETCs are influenced by Chinese traditional values and foreign strategies. This section examines the management practices of SMETCs based on Western theories, and explores the relationship between Chinese values and contemporary management. The latter is studied by means of analyzing the results of my interviews which were conducted in June and July 2000 in Taipei with 33 enterprises including traditional firms, high-skill and labour-intensive manufacturers, and service providers. The majority of interviewees came from SMEs, and from some SMETCs which were one-man companies or companies where the number of staff was fewer than seven. However, the results can still be applied to all SMETCs, as they are members of Taiwan's SMEs and are similar in many aspects, such as in their accounting systems and short-term planning. The illustration in this section will provide a clearer picture of the reasons for the success of the SMETCs, the restrained scale of their development, and their decline.

In Taiwan, the management systems of SMEs and SMETCs can be classified into four categories: grass roots, mainlander, specialist, and transitional types. The grass roots and mainlander categories are traditional Chinese categories. The founder acts as the owner and also the manager. They lack any long-term plan, and the annual budget is set on a "rule of thumb" basis. The authority structure is unitary and paternalistic, with insufficient power delegation, and is very centralized. Companies belonging to

both of these categories have ambiguous job and regulation prescriptions. They recruit people from inside the network and their recruitment criteria are based on the owners' personal judgments. The transitional type is mainly headed by the second generation of the founder, or by owners who have had working experience in the US or Japanese subsidiaries in Taiwan. The transitional type is characterized by a hybrid of traditional styles, Japanese styles, and Western rationalism. This type of organization places more emphasis on the importance of planning. The owner still retains a major share of the decision-making, and is reluctant to delegate power. In other words, the authority still belongs to a centralized system. Furthermore, individual proficiency is not a high priority in their recruitment criteria.

The specialist type is Westernized and rationalized. The head is not the founder, but a salaried manager. They have formal and systematic plans which are based on modern techniques of forecasting. Within the work hierarchy, power distribution is more dispersed and decentralized. They use a formal universal set of criteria for recruitment. Regulations and rules are bureaucratically prescribed. As far as I know, there is no such type of SMETC in Taiwan. However, salaried managers possibly exist in some large-scale SMEs and SMETCs.

In 1971, Anant Negandhti undertook research into the management practices of 60 enterprises in Taiwan,[146] covering US subsidiaries, Japanese subsidiaries, and local firms. In his research, which was based on four basic functions,[147] he aimed to

[146] Negandhti, Anant T. MSU *Business Topic*, 1971 pp. 47-55

[147] Peter Drucker (1974, p.17) divides the work of management into several functions: planning, organizing, integrating, measuring, and developing people, they are further reduced by Robbins & Mukerji (1990, p.7) to the basic four functions: planning, organizing, leading, and controlling. Then Robbins & Mukerji illustrate their basic four functions of management as follows:
Planning: defining goals, establishing strategy and developing plans to coordinate activities;

examine in depth the feasibility and utility of transferring advanced management practices to industrial enterprises in Taiwan. However, from his analysis, some of the effects of Chinese values on managerial behaviour in Taiwanese local firms have been revealed as outlined below.

Planning: Due to a somewhat insecure migrant society and a colonial economy, planning in the establishment of Japanese subsidiaries and local firms tended to be carried out in the short to medium-term range, either three or five years. This is because the new migrants felt insecure in the new society, due to their lack of experience in dealing with the business environment, and these factors caused them to be particular unsure of their future success. As a general rule, a colonizer is reluctant to establish a permanent economic system in its colony. Thus Japan simply exported raw materials such as sugar, camphor and deer hides to its homeland.

Organization: Organization is run along the same lines in the Japanese and US subsidiaries, except the Japanese subsidiaries and local firms lack a qualified and trained personnel manager. The owner is in charge of employee recruitment and evaluation of the employee's performance. Manpower policies are not formulated, and the job description is unclear and varied. In other words, one person is utilized in many areas. This may derive from Chinese frugality: the tendency toward saving in personnel expenditure.

Organizing: determining what tasks are to be done, who is to do them, how the tasks are to be grouped, who reports to whom, and where decisions are to be made;
Leading: motivating subordinates, directing others, selecting the most effective communication channels, and resolving conflicts;
Controlling: monitoring activities to ensure that they are being accomplished as planned and correcting any significant deviations. I use these four functions to analyse the management patterns of Taiwan's SMETCs and SMEs.

Leading: In US subsidiaries, the management places a great deal of trust and confidence in their subordinates. However, the management of local firms exhibit a low level of trust and confidence in their subordinates. This stems from the values instilled by the paternalistic Chinese social structure. Due to a concern for interpersonal relationships, local firms generally have very good cooperation among the staff. The most common compensation and motivational devices in the local firms are monetary rewards in place of sophisticated verbal praise. This could be recognized as Chinese pragmatism, which originated from the Chinese value of frugality. Low absenteeism and high productivity is indicative of Chinese diligence.

Controlling: There is a system of product quality control in all three types of firm. However, while the US and Japanese subsidiaries have a rational system to conduct frequent evaluations of costs, budgets and job performance, this is not so in the case of local firms. This is because local firms are centralized in the hands of the owners. In the area of personnel control, only a few local firms have selection criteria for promotion. These managerial behaviours could be another result of the value the Chinese place on social hierarchy.

These two studies by Anant and Durcker mainly examine the practice of management and values on the basis of Western theories. Thus the results of my interviews offer ample factual evidence both supporting and disputing the importance of Chinese traditional values. These are new trends in contemporary management practice in SMETCs and SMEs.

1. There is still gender inequity in Taiwan's enterprises, especially at the managerial level. However, the wife or mother of an enterprise owner usually plays an important role as an accountant controlling the company's finances.
2. Keeping the business in the family is no longer a top priority. The competence and willingness of the second generation will be the key consideration governing their inheritance of the business. Trust is no longer confined to family members but extended to hired staff from outside the family. Alumni and collegial ties, which attract a business reciprocal relationship, are more important than mere family ties.
3. The traditional hierarchy in an organization is gradually disappearing. In lieu of the traditional hierarchy, which took into account factors such as seniority, position and loyalty, it is now knowledge, skills, and job competence which are more sought after and respected.

   The distribution of authority within the company is now more dependent on its size. SMEs and SMETCs still have a centralized management which lies in the hands of the owner. If they have to distribute the authority, instead of allocating authority to managers at different levels as would be done in larger firms, they prefer to rely on staff from the traditional network, which is comprised of their relatives, friends and classmates, rather than relying on strangers who are recruited through advertisement, from companies in the same field, or from head hunters.

   In addition, Anant's survey showed that in local firms, there was less participation by low-level management in policy formulation. Only the top executive or the owner understood the task of management, and policies were utilized as guidelines and control mechanisms. In other words, authority in

the local firms was centralized. Low-level management and general staff were expected to follow the superior's centralization, and the subordinate's conformity was derived from the notion of patriarchy and filial piety in the Chinese values system. They were the key elements of Chinese social hierarchy, and reflected the value placed upon respect for authority.

4. Frugality was a vital value used as an effective means of accumulating capital, but is no longer an essential virtue. Due to Taiwan's developed economy, it has a more affluent society than the earlier migrant society. The share market and the public monetary organization provide entrepreneurs with a second source of capital.[148] There is no incentive for the new generation to be frugal. Although all my interviewees agreed that the most effective means of motivating staff is by monetary means, some of them also suggested that the staff of the new generation, who are younger than 30, have a new attitude towards work. They are still very diligent, but they work not only to improve the quality of their life style, but also choose their work on the basis of their interests. They strive for more balance between work and enjoyment. In order to cater for this change, the managerial levels of SMEs and SMETCs are following the trend to provide employees with a good working environment which can provide self-fulfilment, learning, and profit sharing for their staff. Overtime work is linked to personal responsibility and interest, and no longer to wages.

[148] This is in contrast to initial capital, which is the capital to start a business, and normally is from traditional channels.

5. As Gordon Redding says, "…the old tradition has largely disappeared except for the residual respect for education…"[149] Education still plays a significant role in Taiwanese society. It provides opportunities for increased economic worth and a higher social status, but has nothing to do with family glory as it did in the traditional value system. The owners and staff of Taiwanese SMEs and SMETCs are aware of the importance of the power of knowledge, which can keep them abreast of rapid social and economic changes, and education is recognized as an essential channel for achieving "expert power". It was found in the interviews that the owners of Taiwanese SMEs and SMETCs intend to send their second generations, or potential heirs, to study management. However, most of them are reluctant to provide training programs for their employees, although a few of them give on-the-job training in basic skills. This lack of a formal training program is due to the owners' fears that employees will learn enough to start their own businesses, not only wasting the time and resource investment the employers have made, but also creating more competition for the employers.

   The owners of the larger companies, which require huge resources such as capital investment and broad interpersonal networks, do provide training courses and seminars to fulfil the personal and professional learning requirements of their staff.
6. Other than the historical factors listed in the section on planning above, fluctuating export oriented industry (EOI) products and a system of international labour division are other reasons for the short-term and incomplete business planning implemented by Taiwan's SMEs and SMETCs.

[149] Redding, Gordon, 1993 p.17

This is because they are operating under a system that concentrates all their efforts on producing and coordinating international buyers' products, isolating themselves from the market trends and demands which are important elements of making a long-term plan.

One of my interviewees said:

> Our production line is based on the customers' orders. We cannot have production plans, as they will create unwanted stockpiles.

Another interviewee said:

> Our designs have to meet the customer's demands. We can't produce first and then ask the customer to meet our specification.

A third interviewee said:

> The Taiwanese economy is a shallow dish economy, and is affected by the global business environment. As a small to middle-sized business, we do not have sufficient finance and human resources to have long-term plans, e.g. 10 year plans.

7. In traditional firms, the relationship between the owner and employees is one of paternalism. The owner treats employees as members of the family. For example, one interviewee told me, "I represented one of my employees to solve her family problem, and protect her from other people's bullying." However, in firms on a larger scale, interactions only take place between the owner and managerial levels, or his/her immediate subordinates.

In general, the owners and senior managers sensed the changing style in management, and when asked what the relationship is between their employees

and themselves, they all declared, “We are friends.” However, they also confessed that the hierarchy is still there, but that the employees do not obey the owner as implicitly as before.

6.2 Marketing strategies of SMETCs

Export is the most effective method for entering international markets. Export firms operationalise the “management process responsible for identifying, anticipating and satisfying customers’ requirements profitably”[150] across a number of foreign country markets, and this enables them to satisfy their multinational customers’ needs and wants. To achieve this objective, export firms have to identify the method best suited to satisfying those needs and wants, and orient the company towards the process of providing that satisfaction.[151] Rather than developing and conducting management processes on a global scale, as large firms do, small and medium sized firms take responsibility for pricing, promotion, distribution and market development. Taiwan’s SMETCs are no exception, and their strategies are formulated based on these elements.

In the international marketplace, Taiwan’s SMETCs consistently face significant domestic and international competition including competitive forces from new entrants or potential competitors, the threat of substitute products, as well as the bargaining power of suppliers and of buyers.[152] In addition to these competitive forces, SMETCs must also overcome any number of internal and external operating obstacles. These range from problems which may arise in areas of finance, sales and

[150] Doole, Isobel & Lowe, Robin (1999)*International marketing strategy analysis, development and implementation* p. 8
[151] *ibid*. p. 8
[152] Porter, Michael E. (1979) *How competitive forces shape strategy*

manufacturing, human resources and R&D in the internal environment, to those created by social, legal, economic, political and technical (SLEPT) factors in the external environment.

Although most of Taiwan's SMETCs are capable of handling various products concurrently, and are also equipped with special skills and abilities in developing new markets, or new products, they are restrained by the system of division of international labour, and primarily utilize their marketing strategies in the export networks. In other words, they are probably unable to carry out all the marketing functions across as many export markets as Japan's *sogo shosha* or Korean GTCs are able to do. However, in order to ensure survival in this competitive and challenging environment, SMETCs rely on their existing marketing strategies to gain access to international market opportunities.

According to the processes which take place during the formulation of an international marketing strategy, the decision makers have to first understand the environmental factors which influence a firm's international markets, such as finance and culture. They must then segment international markets, identify and analyze opportunities, develop appropriate international marketing strategies, planning and control processes, and then decide upon suitable market entry strategies, before finally building added-value through an effective application of marketing mix strategies. The structures of SMETCs are similar in type to those of SMEs, and thus do not have a sufficient budget, or the required human resources to conduct marketing according to the steps mentioned. However, SMEs do not have the burden of the substantial fixed costs associated with SMETCs. These elements highlight the flexibility

characterizing SMETCs, enabling them to cope with the short life cycle of EOI products. As a result, their marketing strategies are more reactive to changing circumstances for which the organization has not planned.

This chapter examines the marketing strategies of Taiwan's SMETCs through the analysis of obstacles to their operation, and of the marketing strategies used to overcome these obstacles. The chapter will conclude by providing suggestions for marketing strategies for SMETCs.

6.2.1 Obstacles to the operation of SMETCs

Obstacles to the operation of SMETCs can be divided into two categories: external and internal. This section will use the SLEPT approach to look at the external obstacles initially, followed by the internal obstacles.

External obstacles to the operation of SMETCs

In examining the external obstacles experienced by Taiwan's SMETCs, five primary contributing factors can be identified - social,[153] legal, economic, political and technical.

During the initial stages of Taiwan's economy during the KMT government period, the development of SMETCs was restrained by the social chaos which was taking place in Taiwan as a result of conflicts between new migrants and old migrants. After the economy took off, escalation of land value and labour costs, and environmental

[153] Generally, social elements in international marketing environments cover both value and cultural elements. They are language, religion, aesthetics, value and attitude, social organization and material culture. In this chapter, I would like to discuss this element from the point of view of social changes which have affected the export environment for SMETCs in Taiwan.

protection regulations led to increasing business operating costs which made it more difficult for SMETCs to compete successfully with rival companies in other newly rising industrial countries. The threat of new entrants to the international markets was beginning to mount up.

According to Schak's 1994 paper[154], from 1982 to 1994 wages approximately doubled from NT$8000 to NT$15 000 for a worker with basic skills. However, wages had begun to rise by the late 1960s, and through the 1970s, wages rose more rapidly. Labour shortages began to become a serious problem in the 1980s. In the central Taiwan area, there was a 60 percent average shortage rate, and in the industries of transportation, machinery, and electric-electronics the rate even reached 70 percent. In 1990, the supply of manpower was 4 730 000 people, and the demand was 4 780 000 people. The situation became increasingly worse.[155]

Land prices rose drastically in the 1980s. From 1985 to 1989, land prices increased by 3.1 times. In the same time period, Japan's land prices increased by one third, Korea's land prices doubled, and land prices in the USA and Singapore increased only by one tenth. The implementation of environmental protection regulations also increased manufacturing costs and made it difficult for high polluting industries to operate in Taiwan.

Legal obstacles represent a second external factor affecting Taiwan's SMETCs. These obstacles have come about as a result of the variety and complexity of Taiwan's laws and regulations. In the early stages, foreign currency was strictly controlled, and

[154] Schak, David (ed) 1994 pp. 60-83
[155] Gao, Chengshu, *op cit*. 1995 p. 32

trading companies could not hold foreign currency after negotiation from the banks. These rigid laws and regulations reduced the flexibility of trading companies to cope with the rapid changes in international markets. In short, they did not encourage the growth of private and trading companies. Moreover, the laws and regulations regarding trading in the target markets change from time to time. The resulting uncertainty creates difficulties for SMETCs in developing plans to cope with such changes.

The third set of external factors affecting Taiwan's SMETCs are economic factors. The exchange rate system of foreign currency is a vital economic element which has had an effect on the development of SMETCs. In the period between the 1950s and the 1970s, Taiwan adopted a fixed exchange rate which supported SMETCs by enabling them to maintain stable growth. In 1985, the currency exchange rate was floated. Since then the currency has appreciated and has fluctuated widely between 39.85: 1 to 25.75:1 (NT dollar: US dollar).[156] The appreciation of the NT dollar reached 55 percent, making Taiwan's products more expensive, and weakening the ability of SMETCs to compete with the rising export-oriented nations. These factors together with an increase in price-cutting competition among the local trading companies trading in the same products forced SMETCs to face enormous decreases in profits.

A fourth form of obstacle is the political situation. The rise of protectionism in international markets has impacted the development of SMETCs directly. Many developed importing nations, such as the USA, Japan and European countries, have adopted many policies designed to restrict the variety of imports. For example, the

[156] Gao Chengshu *op cit*. 1995 p. 33

quota restriction on the import of textiles and related side products is a well-known example of protectionism policy. However, large-scale companies, such as *sogo shosha*, are able to request that the lobbying delegations sent by their government to target nations, make efforts to influence the policymakers of these nations to adopt more encouraging and supportive attitudes toward their companies. Taiwan, with its weak diplomatic links, cannot assist their SMETCs while settling international trading conflicts. Since there are only 28 nations in the world that have official relations with the Taiwanese government, there is a deficiency in the ability of the government to provide assistance to a company in settling a trading conflict through friendly diplomatic access. SMETCs are forced to suffer the consequences of international discrimination against the Taiwanese government.

The fifth and final external obstacles are related to technical factors. Information on market trends plays a very significant role in the development of a trading company. Due to their restricted size and level of capital, Taiwan's SMETCs cannot set up their own worldwide information networks to enable the collection of market research information as effectively as larger scale companies can. For example, Japan's *sogo shosha* assign their employees to be stationed in the target markets to collect information. However, as Doole and Lowe suggest, "the ability to gather data on markets, management control capabilities and the practicalities of carrying out the business function internationally over the past few years have been revolutionized with advancement of electronic communications."[157] They also point out "satellite communications, the internet, and the World Wide Web, client server technologies, ISDN, cable as well as e-mail, faxes and advanced telephone networks have all led to dramatic shrinkages in world wide communications." Taiwan's SMETCs can

[157] Doole and Lowe, *op cit*. p. 25

probably take advantage of their advanced and developed IT industries to accelerate their information collection, but they also have to face the added competitive pressure of companies who are developing e-commerce capabilities.

Internal obstacles to the development of SMETCs

The internal obstacles affecting SMETCs can be categorized into four parts: finance, manufacturing and selling, human resources, and research and development.

Financial obstacles - Lack of initial capital, as well as a lack of a flexible loan process.

Manufacturing and selling - It is difficult to build up separate domestic systems for manufacturing and selling. SMETCs find it difficult to gain the support of the manufacturers; especially the large-scale manufacturers who tend to export directly by themselves. Furthermore, SMETCs cannot afford to set up distribution points in the target markets. As a result, they are also unable to afford to have service points overseas to provide follow-up service to the users of their products. Moreover, SMETCs normally purchase their products from their suppliers. Even though they inspect the quality carefully and thoroughly, they cannot completely control the quality of their products, neither are they able to improve the quality, unless they purchase from their long-term cooperative partner suppliers.

*Human resource*s - The successful management of international trading requires knowledge and expertise in a wide range of areas, including law, finance and accounting, taxation, political issues, skills and technology of production. In Taiwan, other than in the educational institutions, such as vocational high schools, universities and the China External Trade Development Council (CETDC), there are few options

for students to undertake international trading courses or training. SMETCs are reluctant to provide on-the-job training to their employees, because of fears of job-hopping by employees. This creates a vicious cycle which results in a shortage of expertise in the industry. Furthermore, the tendency of family businesses to block access to promotion to employees who are not part of the extended family circle is one of the factors contributing to the high level of employee turnover.

Research and development - The absence of investment flowing into R&D impedes the development of new products. As a result SMETCs are unable to introduce competitive products to the markets, the life cycle of their products becomes very short, and their profit margin grows meagre.

These external and internal obstacles cause difficulties in developing international markets for the SMETCs' products, resulting in the decline of the SMETCs' competitive abilities in the international market.

6.2.2 Achieving SMETC marketing targets

Once the obstacles to development are understood, SMETCs are able to formulate strategies to overcome those obstacles and can therefore achieve their marketing targets by utilizing their resources. Normally, marketing strategies are organized according to the four Ps: product, price, place and promotion.

Product: In order to remove the difficulty of controlling quality of products, SMETCs generally place orders with their long-term suppliers in their export networks. Through their networks, they can identify and confirm the quality level of their partner suppliers. Apart from developing relationships in the networks, they also

conduct frequent visits to make sure the products on the production lines are following the instructions contain within the order.

Regarding their efforts to upgrade the quality of products and services, SMETCs obtain updated information about the quality requirements of international markets by means of visiting the target markets or attending international exhibitions and collecting advanced samples of products from the markets which they can then pass on to their partner suppliers.

Since most SMETCs do not have an R&D department, they are unable to bring new products into the markets. However, recently some SMETCs have removed these obstacles by developing their own designs. In order to enhance their competitive ability, Taiwan's SMETCs also strive to decrease their costs by increasing the variety of their products to achieve scope economies. A giftware SMETC product range covers all gift items such as porcelain, wood, metal and plastic products related to various foreign festivals to meet the needs of international markets. A plug SMETC also tries to source all the different types of plugs (i.e. audio, video, computer, etc) from different suppliers for international users.

Pricing: Pricing is a very important strategy in marketing which should mirror costs and competitive factors. International pricing is complicated by the fact that business markets conform to the different competitive environments of each product or country, which means that an exporter must assess its products carefully. There are six elements which make up the process of pricing products: pricing objectives, demand

analysis, competitive analysis, impact on firm's other products and legal considerations.[158]

In the case of family business SME in Taiwan, there is no rational system for pricing products. In contrast to the processes mentioned above, they cut down their profit margin in order to win orders and sell more. Consequently, the primary pricing strategies of SMEs can be summarized as "generation of meagre profits, but a quick turnover (low profit, more sales- *bo li duo xiao)*, flexibility of prices and elastic terms of payment". This strategy assists SMEs to reach scale economies by increasing trading volume by reducing prices. Their prices are very flexible because of their poor analysis of cost and self-exploitation. They accept any price that can give them a surplus. In addition, in the decentralized production networks, SMEs are allowed a payment credit of 90 days or 180 days depending on the items and the relationship between the SMETCs and their suppliers. This long-term payment enables the owners of SMETCs and SMEs to operate their businesses on a larger scale within their capital limits.

However, the profits of SMETCs are based on commissions which vary from item to item, but are generally 2 percent to 20 percent, and the prices they obtain from SMEs' quotations are fixed. It is clear that when the purchasing quantity of SMETCs is increased, the prices should be decreased. But with an increase in the quantity of orders, the negotiating power of the international buyers also increases, and they will ask for lower prices. Consequently, SMETCs do not obtain the advantage of the lower prices. On the other hand, the terms of international trading payments are normally by

[158] Hutt, Michael D and Speh W. Thomas *Business marketing management: A strategic view of industrial and organization markets.* TX: The Dryden press 1998 p. 445

L/C at sight, which is more rigid than local payment, but enables payments to be processed faster and with greater certainty.

Place: Overseas service points are very important for providing after-purchasing services, and collecting information about the market and products for sale in the market. Furthermore, the SMETCs can gain the buyer's credit information quickly and easily from the stationed local bank, and can thus avoid "bad accounts".

In order to accommodate their budgets, rather than assigning their employees to the target market, SMETCs instead cooperate with the overseas Chinese merchants to extend the arms of their services to the target markets.

Promotion : The most popular export promotion strategies of SMETCs are participating in the international commercial exhibitions, and advertising in local and overseas magazines. SMETCs can locate new or potential buyers by using either or both of these two strategies. There are many domestic and international business shows. In Taiwan, the China External Trade Development Council (CETDC) holds exhibitions for different industries, such as giftware, textiles and garment, machinery, furniture, computers, jewellery, electric and electronic products.

The shows attract international buyers from different countries. In this way SMETCs can promote themselves to many buyers at one time to save time and the cost of travelling. There are also many international shows featuring different items in different countries. For example, electronic component shows in Chicago and Las Vegas, giftware shows in Tokyo, and so on. By participating in the shows, SMETCs can find new buyers or potential buyers and can also obtain updated information on market trends in international markets.

Advertising in the local export magazines and import magazines in the target nations is also a very effective strategy for marketing promotion. The circulation of Taiwan's export magazines (for example, Trade Wind) is large, encompassing every location in which international buyers are to be found, for example, airports, international hotels and offices. The buyers are easily able to find and notice the names and products of SMETCs.

SMETCs can advertise in foreign import magazines or professional industry magazines by contacting them directly overseas or through their agents in Taiwan. By doing so, SMETCs can penetrate and promote themselves directly into selected markets.

However, these promotion strategies such as participating in international exhibitions or advertising in industry publications are very expensive. Some SMETCs do not have the budget to conduct these tactics, even though they are the most direct and effective ways to reach the international buyers.

6.2.3 Future development strategies for SMETCs

There are no two identical markets, and there are no fixed rules for doing business. Basically, marketing strategies are tools to assist SMETCs succeed in the international market. In order to form more effective strategies, SMETCs have to assess their own core competencies and distinct competencies, evaluate the tactics available to them, and then choose the most appropriate strategy likely to achieve a good output and lead the entire company in the direction of profitability.

During the era of the economic boom, Taiwan's export products were in a mature period of their life cycle. They did not have their own brand. SMEs were in a production-oriented stage, and the cost of the products was their main concern. During this stage, SMETCs did not need to develop new sales channels, but utilized international buyers' existing access to market the products. However, Taiwan's products faced severe competition because their comparative advantages disappeared, with the result that SMEs and SMETCs had to alter their strategies to enter a quality-oriented stage. During this stage, both SMEs and SMETCs highlighted the importance of product quality as the main element to lure the international buyers to subcontract their products out in Taiwan on an OEM basis. In other words, Taiwanese SMEs still worked as the foundation of the international processing industries, and Taiwan's products were still exported through foreign importers, or trading companies, but not via direct access. Their profits were meagre. In future, Taiwan's SMEs and SMETCs should lead Taiwan's products into a marketing-oriented stage which has a rational system of pricing. To achieve this goal, SMETCs should develop their own brands and penetrate the products into international markets by themselves. Taiwan's SMETCs should change their extension to the target markets through foreign purchasing representatives to develop their own access rather than using foreign importers and trading companies by means of a complete marketing process including six elements: product, product of good quality, good presentation, design, reasonable pricing and selling plan, and selecting the target market.[159]

Since SMETCs act as intermediaries in the international market and as agents in cross-cultural contexts, they offer their services to coordinate and build buyer demand

[159] Gao, Chengshu, *op cit*. p. 16

and ensure product availability. In order to accomplish their objectives, they have to consider another three marketing mix elements - people, process, and physical aspects[160] - when they are developing marketing tactics.

People: People play a very significant role in the service industry. SMETCs need to motivate and train their employees well to ensure that high standards of service, including speed of service and punctuality of delivery, are maintained. Furthermore, international trading across many countries requires consideration of the cultural diversity that exists within and between different countries. It is therefore imperative that SMETCs assign the right person to the right place to avoid unnecessary misunderstanding. In addition, good interpersonal relationships are critical for any successful business transaction.

Process: Because of the system of international labour division, the SMETCs normally take care of domestic export processes, such as sample collecting, order distributing, goods inspection, shipment consolidation, and so on. In the future, in order to extend their service to international markets directly, SMETCs should consider implementing a well-designed process of delivery. Such a process would rely on a transportation mechanism and the location of distribution warehouses in the selected markets to control the delivery of goods and services. This would enable the SMETCs to avoid delayed shipments, and to better cope with unexpected changes in the local environment or bad weather, and therefore to ensure the quality of service.

[160] Doole and Lowe *op..cit.* p. 369

Physical aspects: Doole and Lowe state "Many physical reminders including the appearance of the delivery location and the elements provided to make the service more tangible can enhance the experience (for clients)."[161] They also point out that customers need "constant reminders of the firm's corporate identity"[162] to help them build awareness of the suppliers' existence and loyalty to the suppliers. Taiwan's SMETC strategy can emphasize marketing of their intangible services through the development of their brand, by means of media advertising and other marketing communication techniques. They also can build brand recognition by participating in trade shows, developing their public relations and sponsoring industry events and exhibitions.

6.3 Conclusion

This study examines the management practices of SMETCs and SMEs from the viewpoints of Chinese traditional values and Western theories. Initially, they were profoundly affected by Chinese traditional values: for example, values such as traditional social hierarchy, paternalism and frugality. Their plans were incomplete and short. Generally they had a short-term plan, for example a one-year plan, which needed to be modified on a continuous basis. However, they have modified their strategies to cope with the rapid changes in the business environment. Consequently, the paternalistic system has gradually vanished in contemporary enterprises. In traditional firms, the owner treats employees as members of the family, because some of them have fewer than 50 employees. However, owners under the new trend of management have changed their attitude to respect their staff. Job proficiency has become the most important consideration when making a decision about promotion,

[161] *ibid*. p. 369
[162] *ibid*. p. 369

and age or seniority is not the major factor in promotion. However, interpersonal relationships (*guanxi*) and trust still play significant roles in SMETCs and SMEs. These two elements are examined in Chapter Five of this thesis.

From the analysis of the obstacles facing SMETCs and the strategies to overcome them, I contend that the weaknesses of their implantation marketing strategies derive from their weak finances and lack of required human resources. To address problems associated with the substantial early costs of financing international operations, "joint venture and franchising are rapidly growing entry methods".[163] Another valuable strategy is the formation of alliances or 'piggybacking' as existing clients move to new markets. Taiwan's SMETCs can also penetrate the international markets through worldwide overseas Taiwanese networks. This strategy can assist Taiwan's SMETCs to provide the end users in the target markets with a stable level of service, and furthermore can assist SMETCs to develop their own brands. As has been previously mentioned, developing their own brand is an effective strategy to directly link Taiwan's SMETCs with international end users and selected local markets.

[163] *ibid.* p. 371

CHAPTER SEVEN: CONCLUSION

The roles played by the SMETCs have been modified as the Taiwanese economic structure has changed. However, the intermediate roles of SMETCs, which led Taiwan's SMEs onto the international stage, remain unchanged. Their contribution to Taiwan's export-oriented economy is easy to discern.

This study provided a very clear picture of Taiwan's economic miracle, and Taiwan's well-known economic experience, and these two successful economic outcomes were derived from Taiwan's production and export networks. Networks played a very significant part in the SMETCs' intermediate roles in Taiwan's export trade. The networks originated from Chinese traditional social and family networks. Thus the elements of Chinese traditional values worked as lubricators in the relationships between SMETCs and their partner SMEs, and between SMETCs and their international buyers, which accelerated SMETCs backward and forward integration. Production networks provided logistical support to SMETCs, allowing them to satisfy international buyers' wants and needs. In the export networks, SMETCs, by means of their high levels of professional expertise and uniquely small but flexible organizational model, were able to modify their functions to cater for the Taiwanese economic transition. They therefore won the trust and dependence of SMEs and overcame the obstacles of limited capital and lack of human resources. Consequently they survived, and grew to lead the Taiwanese enterprises to achieve scope and scale economies.

However, following the decline in traditional labour-intensive industries and the rise of capital- and technology- intensive industries, these small-scale trading companies

rarely had the same opportunities as their counterpart SMETCs during the 1950s to the 1980s. Herewith I include some recommendations to the SMETCs. Firstly, the cooperation of constituents of the export networks under a labour division system of "manufacturing and marketing", and a system of domestic labour division, would allow SMEs to concentrate on manufacturing their own designs. Meanwhile, SMETCs could concentrate on the marketing and sales of SME products through their own channels. This system would result in a fair distribution of jobs and profits, remove conflict and ease the potentially destructive rivalry between SMETCs and their suppliers, thus creating a situation of mutual benefit.

Secondly, SMETCs need to transform their role from a simple sales role to that of marketing push hand. In other words, they have to change their operating strategy from a passive own equipment manufacturer (OEM) to an active own brand manufacturer (OBM). To accomplish this task, SMETCs should set up direct sales networks. Rather than taking a wide range of products as occurs in the *sogo shosha,* SMETCs, with their limited resources, should concentrate on fewer but more specific items to enhance their professional services, such as collecting market information on a single and unique item.

Thirdly, SMETCs must also highlight the importance of research and development which is an essential investment strategy for maintaining SMETC leadership in export networks, and which will assist all the constituents in the export networks in becoming free from multinational importers' control, and lead them to a stage of high added value and high profit.

Recalling the history of Taiwan's export industry, Taiwan's merchants (*taishangs*) were very active in export and import. Their major market was Mainland China. After 1902, the trade volume was drastically reduced, and Japan's *zaibatsu* monopolized Taiwan's export market. But according to Lin Manhong's statement in her article "*Taiwan's capital and the economic and trading relation between two shores"*, *taishang*s were also very active during the Japanese ruling period. They shifted the type of trade with Mainland China from domestic trading into international trading. In the first thirty years since the KMT government's withdrawal from Mainland China in 1949, trading between China and Taiwan was completely interrupted. In the 1980s, China adopted open policies, and their ample and cheap work force attracted many multinational buyers to transfer their purchasing to China. However, those buyers have encountered problems of lack of quality control and punctual delivery. They needed Taiwan's SMETCs, their long-term trading partners, to be pioneers and to act as the middleperson in communicating with the local suppliers in China, and to look after their consignments. On the other hand, more and more joint venture manufacturers had been set up in China. In order to compete with these suppliers, many of Taiwan's SME suppliers with the assistance of SMETCs, also moved their production lines to China to take advantage of cheaper labour. As a result, China became the major market of Taiwan's export industry. Now there are huge numbers of *taishang* in China. Some of them are manufacturers; some are exporters. There were no cultural obstacles for Taiwan's SMEs and SMETCs to enter the markets. Many *taishang* managed SMEs and SMETCs, but these became larger scale enterprises after moving to Mainland China. Forming joint ventures with Mainland state enterprises was a quick strategy to enter the market. The role of *taishang* exporters in this transaction could be a very interesting topic for future study.

Nowadays, it is not enough for SMETCs to maintain their traditional roles as simple middlemen. The innovation of various types of high technological communication equipment shortens the distance between buyers and suppliers, while e-commerce enables international buyers to easily bypass SMETCs and to do business directly with the suppliers. In addition, the high education level and language proficiency of suppliers encourage and enable them to contact the international buyers directly. As a result, the role of SMETCs has diminished in importance. This has forced SMETCs to adopt special strategies to enhance their competitive strength and to ensure survival. The flexibility which characterized SMETCs enabled them to cope with the rapidly-evolving Taiwanese EOI products, however, the short product life cycle of EOI products gave rise to SMETCs opportunism. They did not have long-term plans or clear strategies for marketing their products. “low profit, more sales” “Hit and Run” and “price cutting” were their basic marketing strategies.

Although these strategies helped Taiwan’s SMEs and SMETCs to step in the stage of international markets, in the long run, these strategies affected their ability to grow. However, as previously mentioned, if SMEs and SMETCs can cooperate with each other by embracing a systematic separation of “manufacturing and marketing” and the concepts of simplifying products and diversifying markets, then both SMEs and SMETCs cannot only achieve economies of scale and scope, but can also become larger scale business organizations.

Due to their weaknesses of size and finance, they were unable to effectively carry out their function as middleperson in the international trading arena. In the meantime, the

success of Japanese *sogo shosha* and Korean GTCs stimulated Taiwan's government to set up large-scale trading firms in order to compete with these countries in the international market. But the failure of Taiwan's LTCs proved that size was not an essential factor in achieving success. Management and SMETCs' networks were key factors which enabled Taiwan's SMEs and SMETCs to achieve scale and scope economies. Moreover, with its export-oriented policies, the government built EPZs to attract foreign investment. These made a very significant contribution to Taiwan's economy.

Due to their interactions with Mainland Chinese, Japanese, and Western capitalists, Taiwanese management comprises a mixture of traditional Chinese values, modern Japanese style and Western concepts. But Chinese values can be seen in every corner of the society. In other words, the management in Taiwan's SMETCs is conducted using a combination of traditional values and rational system management. Chinese social hierarchy, interpersonal relationships, and "trust" play very critical roles in the management of business.

Trust is a fundamental element of Chinese networks; it has same powerful function of restraining Chinese business behaviour as a legal contract does. Chinese social networks are used widely and effectively in business, SMETC export networks and SMEs, compensating for the weakness of shortage of capital and human resources. Economies of scale and scope were not only achieved through cooperation in export networks and decentralized production networks, and but were also one of their objectives. Changes to the external and internal environment led to a decline in the competitive advantage of Taiwan's SMEs and SMETCs, and initiated a transition from product orientation, to manufacturing orientation, and then finally to market

orientation. Their strategy also changed from price-cutting to quality upgrades and then to targeting high added value markets. Taiwan's SMETCs played a role as an order hunter, exporting service provider, and marketing service provider. However, people questioned their marketing role, because they did not sell the products to the end users directly, but relied on international customers to distribute Taiwan's products to end users in the selected markets.

The role of SMETCs in Taiwan's economy has been changing in the wake of their transition, and the changing nature of the international trading environment. Under the pressure of manufacturers moving out, and the decline of Taiwan's competitive advantage, SMETCs face many crises which are forcing them to develop different strategies to save their position in the worldwide trading networks.[164] They use their accumulated skills, experience and capital to upgrade manufacturing industries, and enhance their ability to penetrate markets. In doing so, SMETCs can move themselves from a negative to a more positive position in the international trading arena. They can also extend and develop their business into overseas markets through outbound investment. By adopting this method, SMETCs can control their access to material and markets. These two strategies will enable them to resist the rising competition from Mainland China and to secure their core role in the Asia Pacific regional trading networks.

[164] Trading networks consist of three parts: producing, exchanging and consuming. Trading companies undertake the part of exchange. They look after products transaction and job distribution.

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