The Influence of Domestic Interfirm Networks on the Internationalization Process of Taiwanese SMEs

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The Influence of Domestic Interfirm Networks on the Internationalization Process of Taiwanese SMEs

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Abstract
This study investigated how domestic interfirm networks contribute to a better understanding of the internationalization process of Taiwanese small and medium enterprises (SMEs) in the automobile and textiles sectors. The rapid growth of business networks in Taiwan’s newly internationalizing firms provides an appropriate context in which to study the emergence and evolution of such networks. Findings from the in-depth case studies indicate that domestic interfirm networks are a major factor in the decision to internationalize. Furthermore, the benefits of assured orders in an unknown international market coupled with the availability of market information from other network partners can be a potential source of competitive advantage for the internationalized SME.

Key Words: Foreign direct investment (FDI), internationalization, networks, SME, Taiwan

Introduction
SMEs have been traditionally considered as weak contributors to internationalization due to financial and managerial constraints (Martinez & Jarillo, 1989; Oviatt & McDougall, 1999). However, while internationalization has become a major trend in the business world, the international market is no longer the preserve of only large international firms or a few high technology companies. Many SMEs have been involved in the trend to internationalize because more open and integrated international markets create opportunities for profitable growth. The Taiwanese SMEs, which have constituted the majority of firms in Taiwan over past decades, also show a high and growing propensity to internationalize. This has been spurred on by the country’s outward-oriented trade policy (Levy, 1990). Clark et al. (1999: 164) suggest that ‘developing countries will industrialise faster by adopting outward-oriented strategies’. Glick & Moreno (1997) provide data to confirm that Taiwan, as part of East Asia, has benefited in terms of growth due to the country’s outward-oriented trade strategy. In the 1970s Taiwanese SMEs were assisted by the efforts of a large number of small export traders intent on gaining export orders for these smaller companies (Levy, 1988). This export-led
expansion has continued with one-quarter of Taiwanese SMEs being involved in international trade and 10 per cent of them establishing overseas productions or business units (MOEA, 2002).

In discussing Taiwanese SMEs, it is essential to note that subcontracting relationships are ‘deep-rooted’ in Taiwan (Levy, 1988; Levy, 1991) with interfirm networks playing an important role in the business systems (Redding, 1995; Chen, 2003). Such a characteristic also appears in their internationalization process with many Taiwanese SMEs internationalizing with their domestic partners and duplicating their domestic interfirm networks in the host markets. This approach has been described as ‘convoy migration’ (Brookfield & Liu, 2005: 358), ‘herd internationalization’ (Tseng, 1995: 1), or ‘follow-the-herd’ (Forsgren, 2001: 24). Its main attraction is in transferring to the international environment the advantages gained from being part of the network, such as low transaction costs, assured orders, access of external resources and knowledge and high production process integration within the network partners (Chen, 1995; Yiu, 1997; Huang, 1999).

Literature Review

SMEs

Traditionally, SMEs were regarded as less competitive in the international market than large firms, especially multinational companies (MNCs). However, SMEs do possess certain advantages in their internationalization activities as they tend to be highly specialized with only one or two product lines and due to their relatively small organizational size, they usually have more flexibility in operations and human resources (Fiegenbaum & Karnani, 1991; Karagozoglu & Lindell, 1998). SMEs employ skilled workers to exploit sophisticated, general-purpose machinery to produce a wide range of goods. This ‘flexible specialization’ strategy is usually regarded as a competitive advantage for the SME (Tayeb, 2000). However, despite their advantages, SMEs are confronted with greater difficulties in accessing international markets than larger scale firms (Tesar & Moini, 1998; Smallbone & Wyer, 2000).

Limited resources can be the most notable limitation in an SME’s internationalization, including the constraints in finance, time, management and market knowledge (Gilmore & Carson, 1999). In terms of lack of financial resources, this may 1) limit the firm’s ability to identify opportunities arising from the opening-up of markets; and 2) restrict the exploitation of opportunities that have already been identified (Smallbone & Wyer, 2000). In terms of constraints in non-financial resources, lack of management skills may also limit SMEs’ internationalization. Unlike large firms, SMEs are usually administered by sole owners or by a limited number of managers, who are also usually technicians of the firms. Such a management structure leads to less time spent on management and planning, and control systems are consequently inefficient (Karagozoglu & Lindell, 1998; Gilmore & Carson, 1999).

After entering the overseas markets, SMEs still face several limitations in their foreign operations. Jones (1999) pointed out they are more vulnerable in terms of
price control in foreign markets due to limited production capacity and a high dependency upon a relatively smaller customer base. Karagozoglu & Lindell (1998) viewed the limitations of SMEs in terms of networking with local firms. Firstly, they pointed out that cultural distance is a significant barrier for SMEs to international partnerships. Furthermore, due to limited resources and a low level of trust, SMEs usually face difficulties in forming partnerships with local firms in the international market. This in turn restricts their ability to gather information about the local market and promotes problems in obtaining distribution channels in foreign markets.

Taiwanese SMEs and FDI

During the post-war reconstruction from 1945 to 1952, there were very few SMEs in Taiwan and they were concentrated in only a few labour-intensive and low-tech sectors. During this time, the Taiwanese government instigated import substitution strategies with inward-oriented policies, for example, increased tariffs and import control. However, this strategy was not successful as the local market still showed signs of saturation and surplus labour was still a major issue (MOEA, 1998). Economic reform was undertaken in the late 1950s with the government encouraging inflow of FDI from developed countries, especially into export processing zones (Schive, 1995).

The internationalization of Taiwanese business started from inward investment of foreign capital in the 1960s and 1970s. The inward FDI to Taiwan also played an important role in diffusing the technologies needed by local firms with regard to production, marketing and product design (San & Tsai, 1990). After learning from foreign investors and noting the rapid economic growth in the Asia-Pacific region, Taiwanese firms themselves commenced investment abroad. Several Asia-Pacific countries such as Malaysia, the Philippines and Vietnam adopted open policies towards international trade and investment to improve their domestic economic growth. These countries were suitable FDI targets as they possessed sufficient labour and low production costs while their governments also provided incentives such as low or no tariffs on the initial investment.

By the 1990s, Taiwanese FDI flows were around US$2 billion annually, ten times the investment capital in the 1970s and 1980s (MOEA, 1999). The main reasons why Taiwanese companies have engaged in FDI are to expand the market and to take advantage of low-cost labour in the host market (Sim & Pandian, 2003). Thus, the venture of Taiwanese SMEs into overseas markets was spurred on by both the pulling forces of the overseas markets and also the domestic economic conditions. Dunning (1998) refers to these as market-seeking and efficiency-seeking investments.

Throughout the 1980s, Taiwan’s currency appreciated rapidly against the world’s major currencies. Simultaneously, the Taiwanese government introduced new Labour Standards Law (LSL) in 1984 to regulate the conditions of employment, especially minimum wage levels. However, some of these standards were higher than in some developed countries during the same period, for example, in Japan, Germany, the USA and the UK (San & Tsai, 1990). The impact on companies was increased wages and labour shortages (Chen, 1992).
To counteract these problems SMEs, particularly those in the low-technology and labour intensive industries, took advantage of the government dismantling its foreign exchange controls in 1987 and transferred their production bases to other developing countries in South East Asia (50 per cent), the USA (16 per cent), Latin America (15 per cent), China (10 per cent) and Hong Kong (10 per cent) (MOEA, 1999).

Dunning (1998) identified international political and economic events as main determinants on the changing geography of FDI. This is evident in the case of Taiwan as it increased its investment in China to over 42 per cent by 2001 making it the largest host market for Taiwanese companies (MOEA, 2002). Although psychic distance may be a strong factor in this interest in China, the political situation has been an important influencer (Dunning, 1998). In terms of the domestic economy, the Chinese government used foreign investment as a tool for stimulating its economic development (Strange et al., 1998). In 1992 when restrictions on FDI in China were lifted by the Taiwanese government, firms could then take advantage of this ‘open door’ policy. In the decade following the restriction removal there were over 20,000 Taiwanese investment projects in China, three times the total number of projects in other South East Asian countries (MOEA, 2002).

**Theory**

As previously noted subcontracting is a common network strategy adopted by Taiwanese SMEs. Manufacturing SMEs usually subcontract to other SMEs when demand exceeds their capacities (capacity subcontracting), or the firm is not specialized in some parts of the products (specialization subcontracting), (Chou & Lin, 1999). In certain industries in Taiwan such as the semiconductor industry, vertical disintegration has become prevalent (Hung et al., 2004). In this production system, individual companies specialize and focus on one specific procedure of the total production process. For companies seeking economies of scale, the increasing production investment costs can be spread throughout the individual companies rather than one company producing the entire product with its resultant heavy investment costs (Hung et al., 2004; Chen, 2005).

In analysing the network structure of Taiwanese SMEs, Perrow (1992) identified the centre-satellite system (C-S system) as the major form of Taiwanese interfirm network. The C-S system is a hierarchical association centred on one or several large firms (usually assemblers) and containing multiple smaller satellite companies in the same industry (usually component suppliers). The centre firm provides assistance in the form of technical know-how and the small subcontracting firms have a guaranteed market for their products (McQueen et al., 1997). In 1991 the Taiwanese government in their quest to develop internationally competitive enterprises within the country drew up a statute stressing their support in the establishment and promotion of the centre-satellite system (MOEA, 2003: Article 7). As a result, this form of strategic alliance is now prevalent in Taiwanese SMEs with the number of registered factories approximately 2,700 covering 24 industrial sectors with industrial production
An important advantage of interfirm networks is acquiring valuable information (Barney, 1991; Nahapiet & Ghoshal, 1998; Gulati, 1999). The informational benefits from the network are important for SMEs, because such benefits can help the firms overcome market information hurdles and develop new capabilities in an efficient manner. Gulati & Gargiulo (1999) pointed out that an interfirm network is an important intelligence web for SMEs allowing the participants to share and analyse information through network exchange.

An interfirm network may offer an efficient means for the firms to overcome deficiencies of the firm’s organizational capabilities. Jarillo (1993) pointed out that firms in a network can specialize in activities of the value chain that are essential to their competitive advantage. By specializing in a specific part of the value chain that serves a number of customers, SMEs can still achieve a certain degree of scale economies. Finally, long-term relationships with network partners have been recognized as being of a strategic benefit because they provide direct and indirect access to key resources, skills and knowledge controlled by other members within the network (Roy et al., 2004). Such resource advantages are sustainable because they are difficult for the firms outside the networks to appropriate or copy.

There has been a growing interest in the use of networks or collaborative strategies in international business and how relationships such as the C-S system can impact on the international activities of the firms. Network relationships may affect the pattern of international market growth of SMEs (Axelsson & Johansson, 1992; Bell, 1995; Johansson & Mattson, 1988). More importantly, networks contribute to accelerating the internationalization of SMEs (Coviello & Martin, 1999; Prashantham & Berry, 2004). As discussed previously, resource deficiencies have been a main constraint for many SMEs and hence can restrict their level of internationalization (Chen, 1995; Buckley, 1998; Crick & Spence, 2005). Interfirm networks provide a potential mechanism for the firms to access the resources held within the networks when they expand internationally into other markets (Yip et al., 2000). By embedding in a network, SMEs can enhance the capabilities to identify and acquire external resources needed to successfully expand overseas (Coviello & Munro, 1997). Interfirm networks also play a significant role in accessing new information and know-how to the SMEs. Overall, the embeddedness in a network provides SMEs with more opportunities for internationalization through the assistance of other players in the network (Majkgård & Sharma, 1998; Jones, 1999).

Chen & Chen (1998) argued that network linkages are the impetus for FDI for Taiwanese companies. They suggest that relational networks are important for the smaller Taiwanese company and that ‘small firms are also more inclined to use the strength of their counterparts in national networks to overcome entry barriers to foreign markets’ (Chen & Chen, 1998: 453). In a study of Taiwanese firms it was noted that the elaborate subcontracting networks were very important to the internationalization of companies with members being persuaded to relocate their production overseas (Sim & Pandian, 2003). The role of the domestic interfirm network in the development of internationalization strategies is thus important but...
Research Questions

Two research propositions are considered:

1. that a firm’s decisions related to internationalization are generally made on the basis of collective experience and knowledge through their business networks (see Bonaccorsi, 1992; Hadley & Wilson, 2003; Sharma & Blomstermo, 2003);

2. by learning through interfirn networks, firms can reduce perceived uncertainties of foreign markets without having to wait until their own market knowledge has reached the required level (see Forsgren, 2001).

Methodology

As this is an exploratory study, a case-study approach was utilized to gain in-depth insight into the ‘how’ and ‘why’ of internationalization strategies (Eisenhardt, 1989; Yin, 1989). A multiple case comparison methodology was employed, conducting a series of in-depth group and personal interviews with several SMEs who had internationalized through their domestic interfirn networks. The sample selected was restricted to SMEs for two reasons. Firstly, network relationships may deeply influence the internationalization strategies of SMEs, but usually do not apply to large and internationalized firms (Bell & Young, 1998). Secondly, SMEs are usually characterized as being deficient in resources and knowledge and are thus more likely to face difficulties when expanding into foreign markets. The effects of domestic interfirn networks should be more significant for SMEs than for large firms.

The textile and automobile sectors were chosen as these are important manufacturing sectors in terms of international business in Taiwan (MOEA, 2004). The potential sample frame was provided by managers at the Federation of Textile Industries (FTI) and the Corporate Synergy Development Centre (CSDC). An invitation letter with a brief introduction to the research was sent to 40 potential owners or managers of Taiwanese SMEs which had internationalized through their domestic interfirn network. Telephone calls were made to the recipients of the letter to confirm whether they would be willing to participate in face-to-face interviews. Those not able to be interviewed cited heavy schedules at the time designated for the interviews. Interviews lasting approximately two hours were held in Taiwan during January 2003 for those 11 firms that agreed to participate. The language used was Chinese Mandarin.

The purpose of conducting group interviews was to have primary contacts with the firms and to increase the possibility for individual interviews at a later stage. Furthermore, the interactions among the group members can lead to a productive discussion with interviewees responding to the questions with different views which would then set off further discussion (Saunders et al., 2003), and would generate a rich flow of data. However, the drawback is that some members may
feel intimidated in this group environment and this can prevent the voicing of diverse opinion. To ensure this had not been the case follow-up personal telephone calls and face-to-face interviews were undertaken to confirm the responses made in the group environment.

The characteristics of the 11 participating firms are listed in Table 1. The most internationalized firm had five foreign investments in three countries and the most recently internationalized had only one foreign investment experience. According to Table 1, the initial entry mode among the firms was exporting (3), joint venture (1), and wholly-owned (7). The network size (number of network partners) amounted to 83 firms in Case One, 16 in Case Two and 7 in Case Three.

Data Analysis

Group One: Automotive Network

This case report includes three auto-component subcontractors to China Motors, the largest auto-manufacturer in Taiwan. China Motors (centre firm) had 83 component suppliers in Taiwan and these firms formed a centre-satellite system (the C-S system). This network system is an interfirm-level cooperation rather than an intra-organizational network, as the members of the C-S systems are not subsidiaries or cross-share holdings of the central firms.

The auto-manufacturer initially considered internationalization in the late 1980s. Due to uncertainty in respect to local sourcing in the new market, the manufacturer planned to move its existing cooperative relationships to the new market. All the suppliers in the C-S system were invited to participate in the venture. The internationalization project of China Motors started in 1993. The manufacturer and its 30 suppliers, including A1, A2 and A3 firms, started to

<table>
<thead>
<tr>
<th>Firm</th>
<th>Industry</th>
<th>Year Established</th>
<th>Entry Mode</th>
<th>Number of Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>Automotive</td>
<td>1973</td>
<td>Wholly-owned</td>
<td>200–250</td>
</tr>
<tr>
<td>A2</td>
<td>Automotive</td>
<td>1977</td>
<td>Wholly-owned</td>
<td>125</td>
</tr>
<tr>
<td>A3</td>
<td>Automotive</td>
<td>1984</td>
<td>Wholly-owned</td>
<td>50</td>
</tr>
<tr>
<td>T1</td>
<td>Textile</td>
<td>Late 1970s</td>
<td>Exporting</td>
<td>120</td>
</tr>
<tr>
<td>T2</td>
<td>Textile</td>
<td>1963</td>
<td>Wholly-owned</td>
<td>20</td>
</tr>
<tr>
<td>T3</td>
<td>Textile</td>
<td>Late 1960s</td>
<td>Wholly-owned</td>
<td>12</td>
</tr>
<tr>
<td>T4</td>
<td>Textile</td>
<td>1976</td>
<td>Joint venture</td>
<td>75</td>
</tr>
<tr>
<td>T5</td>
<td>Textile</td>
<td>1963</td>
<td>Wholly-owned</td>
<td>270</td>
</tr>
<tr>
<td>C1</td>
<td>Textile</td>
<td>1978</td>
<td>Exporting</td>
<td>250–300</td>
</tr>
<tr>
<td>C2</td>
<td>Textile</td>
<td>1982</td>
<td>Exporting</td>
<td>170</td>
</tr>
<tr>
<td>C3</td>
<td>Textile</td>
<td>Late 1980s</td>
<td>Wholly-owned</td>
<td>650</td>
</tr>
</tbody>
</table>

Note: all company names are in codes to provide anonymity.
establish production facilities together in China. The same interfirm network was duplicated in China and the firms’ cooperative model was also maintained. China Motors and its affiliates established ‘southeast motor-city’ in the Fujian province. The car manufacturer helped the affiliates to establish factories and import equipment, and it assisted with human resource management (recruitment and training) during the initial stage. The costs were shared by China Motors and the affiliate firms. In 1995, the manufacturer started to produce commercial cars, the same model (Derrica) that they produced in Taiwan.

The C-S system formed by the firms operated successfully in the Chinese market. In 2000, the manufacturer achieved 60,000 unit production capacity and was the third largest commercial car manufacturer in Southern China. In 2004 the manufacturer achieved 160,000 units and is projected to expand up to 300,000 units in the next stage (China Motors, 2004). Due to the increased demands in the Chinese market, more component suppliers in Taiwan joined the expansion plan.

In 2003, China Motors posted a net profit of RMB 0.72 billion (£80 million). Driven by this success, both the manufacturer and the suppliers began seeking new customers in other regions in China. In November 2004 the company started exporting commercial cars to North Korea (China Motors, 2004). Many component suppliers, including A1, A2 and A3 firms, also started to seek new customers. A1 and A2 started to supply other production networks formed by a Chinese car manufacturer. Due to reasons of cost and efficiency, A2 also closed down its factory in Taiwan and moved to China. A3 also increased its production capacity to cope with the growing demands of the central firm. These component suppliers generated a ‘cluster effect’ to other Taiwanese and local firms. By 2004, over 60 component manufacturers had set up factories in the motor city and nearby areas. The total sales of these related sectors achieved RMB 3 billion (£330 million) in 2004. The internationalization process of the firms is illustrated in Figure 1.

**Group Two: Textile Network**

Case study two discusses the internationalization process of the interfirm network constructed by 16 textile firms. Five firms from the network were interviewed in the second session. The network structure of case one is customer (that is, manufacturer)-centred and case study two is supplier-centred. The production network is formed by a cotton cloth supplier (centre firm, T1) and finished clothes manufacturers (including T2–T5). The products manufactured include children’s clothing, hats, socks and medical textiles.

The main reason for the firms’ internationalization is increasing production costs in Taiwan, as well as strong competition from manufacturers in both local and other south-east developing countries. In the late 1980s, a large number of Taiwanese textile firms started to seek overseas markets and overseas production bases due to a serious downturn in the economic environment due to surging land cost, labour shortage and labour wage increases and currency appreciation. These factors forced the SMEs to restructure their operational modes in order to stay competitive.
In 1989, T1, a children’s clothing manufacturer, started to export products through an agent in Hong Kong. Their products were mainly exported to the United States but also partly to Hong Kong and China. However, the company considered it was not competitive due to production costs and decided to move its production facilities to the Guangdong province in China in 1992. The firm received overseas orders in Taiwan, imported raw materials from Taiwan, processed the raw materials according to the clients’ demands or samples, and then exported the finished products to overseas markets. Such a strategy helped the firm to reduce production costs. However, due to quota limitations in the Chinese domestic market on those firms who took ‘processing trade’ productions, T1 formed a joint venture with a local firm in Guangdong province from 1995.

T2 and T3, another children’s clothing manufacturer and an accessories (hat and socks) manufacturer, launched factories in China in 1995. The two firms undertook wholly-owned as their entry mode for several reasons. Firstly, many Taiwanese manufacturers, including their business partners and competitors, had entered the Chinese market. As a late mover, T2 and T3 decided to take a direct mode to enter the market. Secondly, other Taiwanese firms’ successful experience also encouraged them to take a high control entry mode. Thirdly, as they brought their original equipment to the host market, the initial costs of establishing production facilities were affordable to the firms.

T4 is a medium-sized medical textile goods manufacturer in Taiwan. Due to higher entry barriers and the manager’s perceived risks concerning the Chinese market (the required investment capital was higher), the company chose to form a joint venture with a local manufacturer (T4 hold 45 per cent shares) in Guangdong.
province in 1996. The aim of T4 in forming a joint venture with a local partner was to access a local market channel, as well as to learn local knowledge from the partner. However, this joint venture failed in 2001. T4 closed down the factory in Guangdong but still maintained its company in Taiwan.

Due to the movement of the majority of downstream firms, the central firm (T5), a textile producer, started to consider following its customers. The firm finally decided to move its production to China for three reasons. Firstly, a production cluster of Taiwanese textile firms had been formed in China and the company could be involved in this cluster quickly and serve its original firms more efficiently. Secondly, the huge potential market attracted the firm’s entry. Thirdly, the production costs in Taiwan were too high for the textile industry and the company had to seek a new production base. Based on these reasons, T5 closed down its production in Taiwan and internationalized with several business partners in 1995.

The trend of textile firm networks transplanting to China has been increasing since the early 1990s (Chiu, 2000). The production network constructed by T1 and its affiliates has existed in China since the early 1990s. The internationalization process of the firms is shown in Figure 2.

**Group Three: Textile Network**

The interviewee firms (C1, C2 and C3) in the third case study are located in the same regional cluster in mid-Taiwan. The firms, one textile producer and two finished clothes manufacturers, are OEM (original equipment manufacturing)
subcontractors for several US brands. Due to serious competition in the US market, the three firms decided to establish factories in Mexico to be near the US market. To locate the production lines close to the main market brought the firms several advantages, namely more effective response to customers’ needs and the changes of demand; reduction in transaction costs; and ability to gain more customers in the new market. Furthermore, the firms realized the benefits in moving their production facilities to Mexico when this country joined the North American Free Trade Agreement (NAFTA).

The three manufacturers established overseas factories concurrently in 1997, locating in the same area. Internationalizing together benefited the firms in several ways. First, the firms could share a part of the initial costs, such as equipment and technician cost. Second, the firms could reduce the difficulties of technical integration. Third, the firms could share market information and local knowledge. The benefits above were important for the firms because they were investing in a host market with large language and cultural differences.

Although the firms have moved their production to Mexico, they maintain a close relationship with their original business network in Taiwan. The firms keep parts of their production and headquarters in Taiwan. The manufacturers can still subcontract to their processors and subcontractors in Taiwan when needed. The internationalization process of the firms is shown in Figure 3.

![Figure 3. The internationalization process of Case Three firms * Cn: the interviewee firms in interview 3](image-url)
Discussion

Determinants of Internationalization

In general, the firms made their internationalization decision under different considerations with the firms being motivated by several factors. Most of the firms decided their internationalization strategy by considering a combination of factors (including environmental conditions in both home and host markets, production costs and business relationships). However, the predominant and most important motivation was the market-seeking strategy encapsulated in ‘to capture the local market’. By enlarging its customer base through attracting new customers in the host markets, the firms were able to maximize their production capacity and enhance their performance.

A second important consideration in the firms’ internationalization relates to efficiency-seeking, that is, the reduction of production and transaction costs. This can usually be achieved by relocating the production bases to areas where production costs are low (for example, case study one and two), as well as to locations close to the main market (for example, case study three). By taking advantage of the low cost production factors in these markets, the firms managed to cut production costs which translated directly into a higher profit margin. This concurs with previous findings from the footwear and computer peripheral industries, suggesting decisions to relocate are often based on efficiency-seeking measures such as a reduction in labour costs (Chen & Chen, 1998; Chen, 2003).

‘To follow the customer/supplier to the host market’ was another important reason for several firms. During the interviews, most of the firms emphasized the need to match the scope of their network partners (customers/buyers), as well as to take advantage of undertaking group internationalization through their interfirm networks. The firms agreed that their competitive advantage was attributed to their network, as all the network partners competed as a whole rather than as individual firms in a unified quest for achieving and maintaining quality. One manager stated that:

We competed as a group (network) not as individuals. Our first task was to establish a good reputation for CH motor (the central firm) and its cars (products). When people recognize the car’s high quality, they will also identify our component supplier’s ability. Customers in China may not know our product quality in the beginning. But if they know we are a part of this network, they will come to us because they have confidence in our products. I think it is a niche for SMEs [like us] for exploiting new customers in China [A2 manager, Interview 1, 2002].

The interviewees agreed that internationalizing with network partners reduced not only investment risk, but also investment costs and time for production process integration. Furthermore, SMEs usually face greater competition in the host market than larger firms due to a lack of local knowledge and resources and relocating with network partners with guaranteed orders can cushion the impact of competition at the initial internationalization stages. The same manager stated that

We have to make sure we have assured demand before we invest in the market. We went to China with CH motor [the central firm] because
they had the ability to explore the local market, which was unachievable if we went alone. No firm will buy products from a small firm of whom they have never heard. This kind of cooperative relationship benefits both sides. For CH motor, they can save time in technique integration with new suppliers in China. They don’t have to spend time finding appropriate component suppliers in China. …For the suppliers, we don’t have to worry about the competition from local firms because we have secure demand from the beginning (A2 manager, Interview 1, 2002).

‘Internalization of techniques’ also explains the network migration. Investment with original partners can avoid transference of the firm’s specific techniques and know-how to the firms outside the network and keep the firms’ competitive advantages within the group. Gereffi & Pan (1994) pointed out that Taiwanese firms’ concurrent internationalization strategy was to avoid firms’ specific techniques being acquired or learned by local firms. Lee (2002) suggested that firms within the network could enjoy several competitive advantages, including production costs, production efficiency and flexibility. These advantages will disappear if the firms sever from the network.

Acquisition of Local Market Knowledge

Previous literature has suggested various approaches that can be used for overcoming local knowledge deficiencies by the firms. These include drawing on assistance from government departments, industry associations, personal contacts, banks and magazines (Walters, 1983; Leonidou & Katsikeas, 1997). The data agrees with Walters (1983) finding that personal sources are preferred to those that are documented. The firms’ local knowledge was derived from a small number of sources, with interfirm network partners having the most important role. Other Taiwanese firms in the local market were also an important information resource. For some interviewees, native local firms in the international market provided knowledge while others held the belief it was difficult to obtain accurate information and knowledge from local firms as they usually regarded Taiwanese firms as potential competitors. A low level of mutual trust between the interviewees and local companies may also result in the unwillingness of some of the firms to cooperate with local firms.

From the interviews it is evident that governmental foreign investment departments and professional research institutes did not play an important role in providing local market knowledge. Only two companies had asked for investment information from a government department (for example, the investment committee and Small and Medium Enterprise Administration in Ministry of Economic Affairs (MOEA)) and most of the firms did not know that the Taiwanese government provided investment information on overseas markets.

Due to the limited availability of the information sources (or firms not knowing where to obtain the information), many of the firms did not obtain enough knowledge of the local market before they decided to internationalize. The
existing network partners thus have become their main source of market
knowledge. However, such an approach limits the depth and breadth of the local
knowledge and can lead to an ‘information lock-in effect’ (Grabher, 1993). The
information lock-in effect, as well as a lack of trust in local firms, could be a
reason for the firms tending to take a combined entry strategy with other network
partners into the host market.

While deficiencies in local knowledge occur in firms of all sizes, deficiencies in
resources are more prevalent among smaller firms. For these SMEs, it could be
problematic to find appropriate local partners and to learn to work with them.
SMEs usually have a narrow information web which may not be wide enough
when seeking an appropriate local partner. Furthermore, even if they could find a
potential partner, the SMEs were new to the host market and did not have a
reputation to lend credibility to their investment projects or abundant resources to
impress the potential partners. Finally, the firms did not have a high level of trust
in local firms. T4 explained that its joint venture with a local partner in China
disintegrated when the partner launched a new factory and turned into their
competitor.

SMEs usually suffer from a double handicap, lacking in both local knowledge
and resources. In addition, they tend to have limited international experience and
it is very difficult to attract local or foreign partners. Even if they could locate local
or international partners, the cooperation is usually very difficult to maintain due
to a lack of mutual trust. Therefore, internationalizing through existing interfirm
networks tends to be an alternative choice for many Taiwanese SMEs. The
manager quoted above stated that:

We are too small to internationalize on our own. This is not about
capital or technology; actually it is not a problem at all. We need
someone to guide us to invest, to solve the problems at the initial stages
in the host market, to reduce our investment risks. Our interfirm
network partners can do this for us. Partly it is because we have
common interests [we competed as a group], but the most important
reason is that we have cooperated together for more than 20 years and
we trust each other (A2 manager, Interview 1, 2002).

**Entry Mode Selections**

The internationalization process of SMEs is usually characterized as an
incremental process from a domestic base to high international market
involvement due to limited resources and local knowledge (Johansson & Vahlne,
1977). It has been suggested that SMEs are also more likely to take lower
control entry modes due to investment risks at the initial stage of
internationalization (Palenzuela & Bobillo, 1999). However, this study found
that many of the firms did not start their internationalization from lower entry
modes. According to the interviews, seven of the eleven firms took full control
entry mode (that is, wholly-owned); three firms chose exporting; and only one
case formed a joint venture with local partners (see Table 1).
As discussed previously, a low level of trust in local firms and difficulties of finding local or international partners could be a reason for the firms’ FDI decision. Furthermore, from the view of cost–benefit analysis, the initial costs of a high control entry mode were not largely different from other modes, but the benefits were higher than other approaches. As the manager quoted above stated:

Exporting or other lower control entry modes may not be an economic way for us. We only consider exporting when we cannot do business in that market. If we chose to export goods to China, we may save 30% of our initial costs, but we also have to lose 30% of the profits to the agents (A1 manager, Interview 1, 2002).

The firms tended to take a similar international entry mode to their other network partners and this might be explained in terms of ‘imitation’ (Tseng, 1995). The firms imitated other firms’ successful experience when they did not have enough local knowledge or faced high uncertainty in the market and environment in the host country. Therefore, it is suggested that the firms’ dependence on the interfirm networks in information sourcing and production activities could be also an important factor in the firms tending to follow other partners’ entry modes. For example, one of the managers stated that:

Before we went to Mexico, many Taiwanese firms had already established factories in the US or Mexico. We learned from their successful experience in the US and followed their step (C1 marketing manager, Interview 3, 2002).

Brookfield and Liu (2005: 375) noted that due to assembler bargaining power ‘convoy migration would seem most likely in the automobile industry and least likely in the textile industry’, however, the data does not support this perspective. All three cases, two in the textile industry and one in the automobile industry, had undertaken FDI with their network partners. The only difference between the cases is that the automobile firms undertook FDI as their first internationalization mode whereas the textile firms had export experience before committing to FDI. This exporting experience provides a level of expertise at the outset of their FDI (Chen, 1992).

**Network Impact Post-internationalization**

The networks of the firms started to expand after the initial stage of acquiring new customers within two to three years of entering the market. It was noted that network partners also played an important role in attracting new customers. Apart from finding new customers themselves, five of the firms admitted that they found their new customers via the introduction of other network partners.

The network also influenced the performance of the firms in the host market. At the initial stage, the firms enjoyed a secure market provided by the network partners. It provided a comfort zone for the firms to avoid competition from local and other foreign firms. The firms could establish production facilities at the initial
stage and then develop their marketing units in the later stages. This strategy has been widely used by Taiwanese SMEs (Chang & Lee, 1999).

As illustrated in this section, the networks had a function in attracting new business opportunities. Partners usually play a role as introducers between new customers and the firms. Furthermore, the reputation established by the network members also helped the firms to attract more customers at later stages. Compared to firms that internationalize independently, the firms in the network had more opportunities to attract new customers in the host market.

**Implications**

The interfirm networks of Taiwanese SMEs are usually based on a high level of flexibility in production, as well as mutual trust and long-term cooperation. According to this qualitative research, market knowledge and technology know-how are generated through the interactions and cooperative behaviour of the entire network. These network advantages are the main source of competitiveness for Taiwanese SMEs and are transferred from the domestic market to their international markets. For those firms hesitant to internationalize alone, participating in FDI concurrently with partners will enable them to make effective use of their flexible production and technologies as well as utilize information resources held within the network.

Network migration minimizes perceived investment risks and helps overcome uncertainties and problems inherent when investing in unfamiliar environments. This form of internationalization should be encouraged by policy makers, however, it appears that the Small and Medium Enterprise Administration (SMEA is a division of the Ministry of Economic Affairs in Taiwan) has not been instrumental in the international activities of firms in this study. The finding that only two firms had used the resources of SMEA suggests there is scope to target specifically domestic interfirm networks to achieve SMEA’s stated objective ‘to encourage SMEs to participate in international trade so that they can develop new market opportunities’.

**Conclusion**

The firms participating in this study, although vertically disintegrated, realize the competitive advantage of acting cooperatively with their network partners. Therefore, they migrated to other countries in convoy with localization of production facilities, providing support not only in the early stages of internationalization but also at later stages when seeking market information in their quest for new customers. However, from the case studies there is little to suggest that Taiwanese SMEs are using their close to home internationalization with network partners as a stepping stone to more distant locations. In only one case had firms invested initially in a nearby location (China) where network support is facilitated and used this experience to move further afield (Mexico). As the data for the study was collected in 2003 when China was a major recipient of Taiwan’s FDI, it may have been too soon for the participating firms to have
expanded beyond their close neighbours. A follow-up study may reveal the firms are now involved in ‘gradualism in internationalization’ (Chen, 2003:1116).

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