Social Structure and Intermediation: Market-making Strategies in International Exchange*

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ABSTRACT    Information gaps between markets create opportunities for international trade intermediaries to negotiate cross-border exchanges. Faced with the prospect of eventually being eliminated from these exchanges, intermediaries must continually search for new opportunities to mediate international exchange. In this paper an original explanation is derived from the core principles of structural hole theory to explain how these market-making firms operate in the tension found between the inevitable decay of existing exchange relationships and the uncertainty of finding replacement sources of income.

INTRODUCTION

International trade intermediaries have played an unparalleled role in international business ever since Europe’s maritime powers created the first chartered trading companies in the early seventeenth century. In their quest for profitable trade routes these forerunners to the modern multinational enterprise promoted colonialism, engaged in state-sponsored piracy, trafficked drugs, annexed entire nations, and carved much of the world into the geopolitical shape it is today. Although corporate strategies have since become more civil, international trade intermediaries (ITIs) remain a potent force in many of the world’s major markets. In Asia alone the 131 ITIs listed among the region’s top 1000 firms have a combined annual turnover of more than US$1.6 trillion (Anwar and Alex, 1999).

ITIs are distinguished from multinational enterprises primarily by their emphasis on the organization of trade. ITIs are also unique in their unrivalled ability to reinvent themselves ‘generation after generation’ (Jones, 1998a). It is somewhat surprising therefore, that mainstream organizational research has generally dis-
missed the ITI as a relic of a bygone age. This is unfortunate for two reasons. First, for better or worse, over the past four centuries ITIs have demonstrated their ability to integrate the poor two-thirds of the world into the global economy (Ellis, 2003). Indeed, their very existence depends on their knack for making markets where none previously existed and then moving on when those markets mature. Second, as one of the most enduring species within the genus *intermediary* – truly the dominant corporate form of the information age – ITIs ‘encapsulate very neatly the vision of a firm as an information processing system’ (Casson, 1997, p. 245). For these reasons chiefly, the study of ITIs has much to offer both management theorists and society at large.

The aim of this paper is to develop a generic explanation for those organizational routines which ensure the survival of ITIs in mediated cross-border exchanges. The paper is divided into four parts. In the opening section the eclectic literature on the topic is briefly surveyed and this is followed by a more in-depth review of the dominant theoretical frameworks which have been used to account for ITI behaviour. In the third part of the paper the entrepreneurial role of the trade intermediary is assessed in light of recent insights drawn from structural hole theory and this leads to the derivation of four propositions.

**BACKGROUND**

International trade intermediaries have been studied in their many guises and natural habitats and an extensive mosaic of literature on the topic has emerged. To date considerable research has been done on North American ITIs (Bello and Williamson, 1985; Howard and Maskulka, 1988; Kelly and Lecraw, 1985; Perry, 1990), Asian ITIs (Cho, 1984; Ellis, 1998; MacBean, 1996; Sarathy, 1985), and the many European variations on the theme (Carlos and Nicholas, 1988; Mattsson, 1990; Sugiyama, 1987). While research into ITIs is largely nationalistic in scope (Ellis, 2001), with few truly cross-national studies in existence (cf. Armine, 1987), within this chauvinistic body of literature common research themes have emerged relating to, for example, patterns of diversification (Balabanis and Baker, 1993a, 1993b; Cho, 1987) and organizational evolution (Ellis, 2001; Kim, 1986; Perry, 1990). Two especially fertile topics for study have been (i) the unique and highly diversified Japanese version of ITI known as the *sogo shosha* (Kojima and Ozawa, 1984; Shao and Herbig, 1993; Shin, 1989; Yoshihara, 1982) and (ii) the ‘US Export Trading Companies Act’ of 1982 (Armine et al., 1986; Howard and Maskulka, 1988; Kaikati, 1984; Williams and Baliga, 1983). (These otherwise dissimilar topics are intrinsically connected as the rationale for the latter was inspired in part by the success of the former (Kaikati, 1984).)

Even a cursory glance at the studies just listed reveals that ITI research has waxed and waned in correspondence with the economic performance of Japan. After Japan entered a sustained period of recession in the early 1990s, the number...
of papers extolling the might of the Japanese general trading companies declined markedly. At around the same time, scholars and policy-makers were beginning to acknowledge the failure of the ETC Act (1982) to live up to expectations (Czinkota and Onto, 1990). The result? A once active area of international business research entered a period of hiatus.

Now research investigating ITI behaviour is enjoying a renaissance of sorts. Two recent papers published in a leading international business journal have promoted the study of ITIs as the missing link in export development research (Peng and Ilinitch, 1998) and endeavored to more fully classify the nature of the ITI service-offering (Balabanis, 2000). A recently edited volume (Jones, 1998b) has made a substantial contribution towards understanding the many varieties of multinational trading company. Qualitative research conducive to theory building has emerged in place of the simple descriptive surveys of the earlier era (Buchan, 1994; Ellis, 1998; Jones, 1996; Munro, 1998). Indeed, case studies of high performing ITIs are even finding their way on to the syllabi of prestigious business schools (e.g., Long and Seet, 1995; O’Connell, 1995).

Perhaps most significantly, from an epistemological perspective, ITI research which was once largely descriptive and classificatory in nature (e.g., Brasch, 1978; Cho, 1984; Howard and Maskulka, 1988), has now progressed towards goals of explanation (e.g., Balabanis, 1998; Peng, 1998) signalling the maturation of the field. New theories emphasizing the role of the ITI as an information hub (e.g., Casson, 1997, chapter 9) seem especially promising in this regard. However, to date theoretical advancement has been slow and piecemeal due in part to a lack of a consensus on matters of definition (Armine, 1987; Bello and Williamson, 1985; Brasch, 1978; Cho, 1987). By way of illustration, trade intermediaries are referred to as export management companies or export trading companies in the USA, foreign trading companies in China, senmon shosha in Japan, and Chonghap-mooyeok-sangsa in Korea (Cho, 1987; MacBean, 1996). They may also be categorized according to the type and range of services offered, hence the terms general trading company, specialized trading company, commodity trading company, and federated export management group (Armine, 1987). For these reasons, very few universally applicable definitions are available (cf. Balabanis and Baker, 1993b) and the more common approach is to define the ITI in terms of the service it provides. In this regard, Casson’s (1998) recent definition is arguably the most useful yet least restrictive: a trading company is any firm that specializes in market-making intermediation, an activity which may involve brokerage (selling on behalf of another) or reselling (taking title to the goods traded). Building on this definition, an international trade intermediary may be defined as any market-making intermediary involved in the indirect export of a product between a supplier and a buyer located in separate countries. The high number of permutations on this fundamental intermediary role reflects either differences in the scale and scope of operations (Cho, 1987), the stage of organizational development (Balabanis and
ALTERNATIVE EXPLANATIONS FOR INTERNATIONAL TRADE INTERMEDIARIES

Uncertainty in economic activity is correlated with the geographic, cultural, and temporal distance separating buyers from sellers. Trading companies exploit this uncertainty and its inherent risks by developing and mediating international trade flows (Kojima and Ozawa, 1984). The resulting connections between ITIs and their trading partners have been analysed from the perspective of agency theory, which is concerned with the optimal contract governing relations between parties pursuing potentially incompatible goals (Eisenhardt, 1989; Jensen and Meckling, 1976), and transaction cost analysis, which considers the efficiency tradeoffs inherent in different exchange structures (Coase, 1937; Rindfleisch and Heide, 1997; Williamson, 1975, 1985, 1996).

Agency Theory

In a brokerage-type trading relationship, a manufacturer will contract with an external ITI who will assume the export marketing responsibilities for the manufacturer’s product in return for a commission fee. Contractual problems will arise when the intermediary (or agent) acts opportunistically in the event that their interests conflict with those of the manufacturer (or principal) (Sharma, 1997). This arrangement is particularly troublesome for the principal because each party possesses different information about the task to be performed and this imbalance or asymmetry favours the agent. For example, to win the contract in the first place the intermediary may be tempted to conceal or misrepresent information regarding their abilities and resources. If the principal cannot fully verify these claims in advance, they may inadvertently suffer from a problem of adverse selection. A second potential problem, moral hazard, may arise after the contract has been signed when the principal is unable to ensure that the agent delivers the agreed-upon level of effort (Eisenhardt, 1989). The central issue of agency theory therefore, concerns the structuring of exchange relationships with the appropriate mix of incentives and penalties to ensure intermediaries are motivated to perform the delegated task in accordance with the expectations of the principal (Lassar and Kerr, 1996).

The chartered trading companies of seventeenth century England provide a classic example of contracting to reduce agency costs. These early multinationals had to devise methods for controlling agents in far-flung parts of the world in an age when market information was highly imperfect. Information asymmetries meant that agents based in India or Hudson Bay could easily pursue their own self-enrichment at the expense of their principals back in distant London (Carlos and
Nicholas, 1988). To counteract this temptation, the trading companies provided generous compensation packages, required managers to take oaths of allegiance and periodically opened and read the private mail of employees. As a case in point, the Royal African Company dealt with the problem of moral hazard by requiring employees to post a bond ranging from six to ten times their annual salary. This bond, combined with thorough searches for contraband items every time a ship reached an English port, evidently induced the required level of effort while attenuating opportunism (Carlos, 1992). Such measures, however, did little to protect the Royal African Company against the problem of adverse selection. In this regard the Hudson Bay Company of the same era was unique in its development of an apprenticeship programme to train managers. By promoting managers though the ranks, the company was able to effectively screen out unsuitable agents while developing a class of managers closely allied to the goals of the organization. This system, which replaced an earlier bonding arrangement, may partly explain why the Hudson Bay Company survives today (Carlos, 1992; Carlos and Nicholas, 1988).

Transaction Cost Analysis

The hazards associated with relying on intermediaries may render the agency relationship inefficient in a given situation and compel the would-be exporter to pursue other modes of exchange, such as direct exporting. The matching of appropriate exchange characteristics (or governance problems) with exchange modes (or governance structures) describes the domain of transaction cost analysis (Heide and John, 1988, 1992). Transaction cost analysis, or TCA, is based on the axiom that firms will choose exchange modes which minimize the costs of transacting. To overcome the barriers to trade created by uncertainty, potential exporters will incur at least four discrete types of transaction costs:

1. **Search costs** associated with gathering information to identify and evaluate potential trading partners.
2. **Contracting costs** associated with negotiating and writing agreements.
3. **Monitoring costs** associated with ensuring that each party honors the pre-determined set of obligations.
4. **Enforcement costs** associated with *ex post* bargaining and the sanctioning of trading parties that fail to perform according to the agreement (Dyer, 1997, p. 536).

All things being equal, TCA suggests that instead of performing export-related tasks in-house, a potential exporter will be better off using a specialist trade intermediary in order to tap into the benefits that the middleman is able to obtain in the form of scale economies in distribution (Anderson and Coughlan, 1987). By carrying product lines for several manufacturers, even small ITIs are able to export
more cheaply than a single manufacturer going it alone (Perry, 1990), and competitive pressures will compel intermediaries to pass along these lower costs to manufacturers (Williamson, 1979). Thus, from a TCA perspective, ITIs exist because they are able to lower transaction costs for their clients (Jones, 1998a; Peng and Ilinitch, 1998; Roehl, 1983).

However, the value of employing an intermediary will vary with the nature of a given exchange. For example, in situations where the manufacturer fears that the intermediary may act opportunistically, the costs of transacting will increase in tandem with the specificity of the assets being traded (Erramilli and Rao, 1993; Pilling et al., 1994). This happens because of the additional costs incurred in safeguarding assets that have little value outside of particular exchange relationships (John and Weitz, 1988). In such situations the cost-minimizing properties of various governance structures (organizations, markets, and hybrid arrangements), will be brought to bear to determine the most efficient means for structuring the exchange (Heide and John, 1992). For example, in a study of channel preferences by US manufacturers, it was shown that for export settings involving complex products with a high service component, respondents tended to prefer integrated channels to relying on external intermediaries (Anderson and Coughlan, 1987). In such cases, investments in distributor training represent a sunk cost that can not be easily recovered in the event that the distributor shirks his or her responsibilities and needs to be replaced. Consequently, the additional bureaucratic and coordination costs of conducting the exchange within the firm’s boundaries may be less than the combined ex ante costs of negotiating stringent contracts to demarcate the expected level of service and the ex post costs associated with monitoring and enforcing contractual obligations.

Provided the opportunistic tendencies of middlemen are kept in check by competitive product markets (Dwyer and Oh, 1988; Klein et al., 1990), the value-added contribution of the intermediary will be correlated with the uncertainty or risk inherent in the particular exchange setting. Generally export intermediaries will be preferred in the early stages of opening new markets (Shin, 1989), for exchange involving more distant markets (Klein and Roth, 1990), or when the manufacturer has limited international experience (Anderson and Gatignon, 1986).

If TCA constitutes a valid explanation for the existence of ITIs, it follows that the performance of trade intermediaries will be directly related to their ability to minimize transaction costs for others. However, this question has rarely been asked in TCA research (Aulakh and Kotabe, 1997). Existing studies have generally sought to verify whether governance choices conform to the core TCA predictions relating to various exchange conditions with superior outcomes assumed to result from more efficient matches (Shelanski and Klein, 1995). Peng’s (1998) survey of 195 US ITIs is a recent exception to this practice. In this study the author hypothesized that trade intermediaries’ performance would reflect the presence of skills directly relating to the four transaction costs identified above. The results showed
that intermediaries who were more knowledgeable about foreign markets (lowering their search costs), had superior negotiating abilities (lowering their negotiation costs), and were able to take title to the goods they traded (lowering their clients’ monitoring and enforcement costs), generally recorded higher per capita sales and trading margins.

Summary

Agency theory and TCA offer powerful insights into ITI behaviour. Yet, both are inherently partial in their explanation for the existence of trade intermediaries. With its emphasis on the potential conflict residing within principal-agent relations, agency theory makes no attempt to accommodate those trading activities which involve reselling. In merchant trading situations where the middleman takes title to the traded goods, there is no delegation of decision-making responsibilities to the intermediary. In such cases the ITI is effectively no different from a domestic customer and no agency relationship exists. TCA is less restrictive in scope but has nevertheless been criticized for emphasizing efficiency considerations over various strategic objectives, such as those relating to competitive positioning, which may also affect governance decisions (Aulakh and Kotabe, 1997). Strategic variables, along with transaction-specific characteristics, will influence the choice of exchange mode (Hill et al., 1990), and in noncompetitive industries firms with slack resources may choose to retain control even if such choices create transactional inefficiencies (Anderson and Gatignon, 1986).

Intermediaries exist because they promote and add value to mediated exchange relationships. At the level of the individual exchange intermediaries create value by reducing the transaction and agency costs within a channel (Casson, 1997). Improvements in transactional efficiencies can have a significant wealth-creating effect. Historical studies have shown that cumulative efficiency gains in distribution can lead to an overall improvement in the allocative efficiency of the economy with a corresponding rise in per capita living standards (Porter and Livesay, 1971). In addition to improving the productivity of the channel however, intermediaries may engage in innovation leading to a second source of value creation being realized. For ITIs innovation may be defined in terms of opening up new markets and discovering new sources of supply (Casson, 1997). Whenever a trade intermediary develops a new value chain the result is a reorganization of available resources within two or more local economies. This has implications for the future deployment of resources in each economy affected (Ellis, 2003). Insofar as economic value is derived from the use or combination of resources (Penrose, 1959; Schumpeter, 1934), then value creating possibilities will be redefined every time exchange alters the set of resources available for successive rounds of combination (Moran, 1996; Moran and Ghoshal, 1999). Consequently, the immediate effect of creating new value chains will be a more efficient reorganization of the local production...
matrix. This in turn will stimulate new forms of exchange as traders become motivated to find markets for the additional outputs now being produced. In short, ‘every change in the use of resources – every reorganization of productive activities – creates the opportunity for a further change which would not have existed otherwise’ (Kaldor, 1972, p. 1245). This never-ending process of reorganization is particularly evident in those sectors of the economy characterized by competition, elastic demand, and increasing returns to scale. When these three conditions are present, economic growth, triggered by the pursuit of new markets for industrial output, may become a self-reinforcing phenomenon (Young, 1928).

In summary, the value added contribution of ITIs can be defined two ways: (i) in terms of the finite efficiency gains brought to the channel; and (ii) in terms of the open-ended Schumpetarian innovation that results from creating something (trade) out of nothing (missing markets). TCA and agency theory are helpful in understanding the first kind of value creation but are irrelevant to the study of the second kind. From time to time trade intermediaries may play a catalytic role in creating exchange relations where none previously existed, but neither agency theory nor TCA make any attempt to account for this type of market-making behaviour. Rather, these existing theories seem more concerned with explaining why middlemen are inclined to act opportunistically some of the time than with explaining how they manage to be entrepreneurial most of the time. Indeed, a widely shared view in channel research is that trade intermediaries passively wait to be approached by manufacturers looking to reduce their exporting costs (e.g., Anderson and Coughlan, 1987; Klein and Roth, 1990; Peng and Ilinitch, 1998). Yet there is extensive evidence to show that ITIs usually take the initiative in approaching potential clients (e.g., Brasch, 1978; Haigh, 1994; Mattsson, 1990). Proactive searching is consistent with the definition adopted here that ITIs are specialist market-making firms. Finally, TCA defines the criteria for survival, namely the minimization of transaction costs for others, but offers no insight into how this can be achieved beyond making loosely-specified references to capturing scale economies in distribution. Despite the validated claims of TCA, much remains unknown about the actual ways and means by which ITIs manage to minimize search, negotiation and policing costs.

TOWARDS A NEW EXPLANATION

It is readily evident that differences in the quality of information among potentially transacting parties create opportunities for intermediaries. These information asymmetries may provide the basis for both negative behaviours (e.g., opportunism) and positive behaviours (e.g., coordination of new exchange). An alternative approach to the study of ITIs therefore, is one which de-emphasizes the costs associated with controlling the former, and highlights the value-added contribution of the latter (Ghoshal and Moran, 1996; Madhok, 1997; Nayyar,
From this perspective the ITI is viewed as an information broker whose main role is the coordination of information relating to the organization of trade (Casson, 1998; Etgar and Zusman, 1982).

The information handled by the intermediary may be of a routine nature, such as that relating to the processing of clients’ orders, or it may be strategic in nature and relate to the identification of new opportunities to mediate exchange (Casson, 1998). The handling of routine information is subject to economies of scale and thus provides the intermediary with an opportunity to improve the efficiency of the exchange. Organizational survival, however, ultimately depends on the management of strategic information and this is where the intermediary must be most entrepreneurial. Consequently, the remainder of this discussion will be concerned with the issue of how ITIs collect and manage information which is germane to their continued existence.

The Facts of Intermediary Life

Traders operate at the boundaries between groups. Initially their chief source of competitive advantage stems from the knowledge gap separating potential buyers from sellers (Nayyar, 1990). Traders exploit these gaps by mediating exchange flows between locations distinguished chiefly by their price differentials. As this is an inherently risky undertaking, traders will endeavour to develop market-related expertise as a means of risk-minimization. This superior information gives them their ‘edge’ in the market and is the basis for their survival. However, the information asymmetries that exist between a particular buyer and seller and which the ITI is able to exploit, generally diminish over time compelling the trader to continually seek out new opportunities to broker relationships. Consequently, survival of the intermediary will be a function of (a) prolonging the inevitable decline of existing exchange relationships and (b) replacing lost business with new relationships. When the addition of income from new business no longer matches the loss of income from exiting clients, the intermediary will have started down the path to organizational extinction.

Any theory purporting to explain the endurance of the ITI must account for the operational realities just identified. This implies an accommodation of the following questions:

1. How do ITIs identify and evaluate new exchange partners?
2. How do ITIs negotiate the terms of trade?
3. How do ITIs preserve exchange relationships in the face of decline?

If intermediaries can be considered to be entrepreneurial responses to market imperfections separating buyers from sellers, then useful insights into these ques-
tions may be provided by social network theory which recognizes that knowledge of entrepreneurial opportunities diffuses unevenly through society and that unique information benefits accrue to those individuals connected by non-redundant bridge ties to distant social clusters (Aldrich and Zimmer, 1986; Rogers and Kincaid, 1981; Weiman, 1989). The relationship between social structure and entrepreneurial outcomes is neatly captured in Burt’s (1992, 1997, 2000) structural hole theory which describes how social capital is a function of the brokerage opportunities inherent within social networks. The gist of Burt’s argument may be paraphrased as follows: Trading behaviour is explained in terms of access to ‘holes’ in the social structure of the trading arena. This idea is distilled below.

**Structural Hole Theory**

In any market, imperfections separating buyers from sellers will lead to the emergence of entrepreneurial middlemen who match supply with demand. Where potential exchange parties are located in different countries, the most significant obstacles impeding direct exchange are initially those barriers which inhibit the free flow of information across national boundaries. Although information will eventually spread to all people in a market, it will circulate within groups before it circulates between groups. Consequently, not everyone can be simultaneously aware of the opportunities in all groups and some individuals will be quicker to perceive market opportunities than others resulting in a short-term competitive advantage (Burt, 2000).

In pre-equilibrium markets opportunities may present themselves in the form of gaps or ‘holes’ between individuals possessing complementary resources or information (such as a rubber plantation in a developing country and a sneaker factory in another). These holes represent unrealized market opportunities which may be exploited by a third individual who recognizes that the needs of one party may be served by the skills or resources of another. The entrepreneur who perceives the opportunity to be the *tertius gaudens*, or the ‘third who profits from the disunion of others’, is able to do so by virtue of his or her central position within a network of nonredundant contacts (Burt, 1992). It is the network – itself a dynamic social construction existing between the player and the environment – which induces both the motive and the entrepreneurial opportunity to secure the benefits of productive relationships in imperfect markets (Burt, 1992; Nahapiet and Ghoshal, 1998).

Although Burt’s (1992) structural hole thesis has been advanced as a general theory ‘about the competition for the benefits of relationships’, the framework would appear to have special relevance for understanding the behaviour of those firms whose sole *raison d’être* is the mediation of exchange relationships across national boundaries. Two reasons support this. First, international trade interme-
diaries, by definition, operate on a social frontier between two or more countries and as Burt (1992, p. 163) explains:

Hole effects are most evident for managers operating on a social frontier. A social frontier is any place where two worlds meet, where people of one kind meet people of another kind. Individuals who live on a social frontier are more likely to live by their entrepreneurial wits than are individuals in a socially homogenous environment.

Second, Burt’s (1992, p. 9) claim that ‘social capital is the final arbiter of competitive success’ seems especially pertinent in a business characterized by very low entry barriers and where performance is less a function of individual ability than in creating value through contacts with other people. In other words, success for trade intermediaries is less a question of financial and human capital than social capital which, in turn, is defined by the brokerage opportunities afforded by each trader’s network. Viewed from a structural hole perspective, ITIs exist, not by virtue of their privy market knowledge *per se*, but by exploiting their unique *tertius* position at the intersection of player relations.

Trade intermediaries innovate by matching buyers and suppliers who otherwise might have no contact with each other. The execution of this marketing function is, however, structurally constrained by the information and control benefits inherent within each trader’s idiosyncratic network. Information benefits describe who gets to learn of new trading opportunities whereas control benefits determine who gets to mediate new relationships and for how long. From these underlying premises, four propositional statements can be derived. These relate to the identification and evaluation of new exchange partners, the negotiation of the terms of trade, and the maintenance or preservation of relationships already in existence.

**PROPOSITIONS**

**Identifying Exchange Partners**

As markets mature, channels shorten (Sharma and Dominguez, 1992). Rising competition and improved information flows may lead to the middleman being squeezed out of the mediated exchange. Consequently, traders must continually identify new opportunities to broker exchange relationships. Without the replenishment of lost income traders run the risk of being eliminated altogether.

Opportunities to broker international exchange may be identified via a number of ways including advertisements in trade-related publications, attendance at trade fairs, market research, client referrals, and so on. In the search for new trading
partners it can be assumed that ITIs will tend to rely on those search behaviours which minimize the costs of information acquisition. Moreover, these costs will be unique to each trader reflecting the personal stock of social capital. If there are significant latent opportunities inherent in an individual’s social network then search patterns will tend to be based on personal sources of information. In such circumstances social interaction will be the main basis for the diffusion of information. Conversely, if the individual does not possess substantial social capital, that is, network opportunities are comparatively small, then individual search behaviour will tend to be based on more impersonal sources of information.

**Network constraint.** The ability of an individual to participate in the diffusion of information across national boundaries will be contingent on the value of the social capital inherent within that person’s network. Interpersonal networks serve as conduits for market information. Several studies have shown how personal ties with extended family (Kotkin, 1992; Rauch, 1996), distribution channels (Hsing, 1999), local government (Barrett, 1997), and even the military (Peng, 1998; case study #3) can provide traders with a valuable source of information regarding market opportunities. In their survey of Malagasy agricultural traders, Fafchamps and Minten (1999) found that respondents rated their relationships with other traders, suppliers and clients as their most important sources of information on market conditions. More than 90 per cent of their information needs were met via their trading networks suggesting that relationships ‘reduce search costs’ (p. 18). Social relations with others in the network may provide the intermediary with timely access to resources. However, the extent to which the trader is able to participate in and control this process will be constrained by his or her network characteristics. In short, in the ongoing search for new trading opportunities sparse, diverse networks will be more efficient and less constraining than small dense networks (Burt, 2000). Network size or reach determines the quantity of information one is exposed to, whereas network diversity affects the quality of information (Aldrich and Zimmer, 1986; Birley et al., 1991).

**Experience.** While there are advantages to being connected to large, diverse networks, such networks take time to develop suggesting a correlation with personal experience in the market. Social capital accumulates over a career (Burt, 2000). Although this link has not yet been tested empirically, the available evidence tends to support the claim (Nijsen et al., 1999; Warms, 1990). For example, in Björkman and Köck’s (1995) study of Western companies with investments in the Peoples’ Republic of China, interviewees with ‘long China experience’ rated good personal relations most highly.

**Exchange uncertainty.** Hole effects will be most noticeable where there are obstacles to the flow of information between two groups. Such conditions arise when the
cultural distance separating buyer and seller is high and when market imperfections are many. Cultural distance impedes information flow by adding semiotic complexity to the encoding and decoding of messages relayed across market boundaries. Market imperfections, such as a lack of contract-enforcing institutions, further obscure signals by rendering price an unreliable indicator of value. When international exchange is couched in uncertainty, the potential for opportunism – at any point in the channel – is magnified. In such an environment contract writing becomes impractical and actors will tend to rely on those potential partners about whom they have the greatest knowledge (Ganesan, 1994; Larson, 1992; Podolny, 1994). Fluctuations in price will compound these variables by introducing a dynamic element of risk and creating opportunities for speculation (Casson, 1998).

In combination, cultural distance, market imperfections and volatility interact to create substantial barriers to trade. Significant costs will be incurred in overcoming these barriers and therefore any intermediary with the social resources to reduce these costs will have the means to profitably broker exchange relationships. A classic example of this is provided by the Maghribi traders of North Africa. The Maghribi traders were Jewish middlemen who operated in the Muslim Mediterranean during the eleventh century (Greif, 1989, 1992). The Maghribi traders coped with the uncertainty and complexity of long-distance trade by relying on business associates within a nonanonymous institution referred to as the coalition. Coalition members were simultaneously merchants with their own trading interests and agents acting on behalf of other members. Relations within the coalition were governed by the understanding that no merchant would ever employ an agent who had cheated another coalition member. Thus, membership in the coalition lowered the costs of trade by reducing the premium needed to keep an agent honest. Agency relations were preserved, not by the inadequate legal system of the day, but by the premium entailed in membership within the coalition (Greif, 1989). Evidence of the value of social capital within the coalition is found in the observation that links between Maghribi and non-Maghribi traders, whether Jewish or Muslim, were rare and that the volume of trade was primarily limited by the coalition’s size (Greif, 1992).

Summary. The identification of new opportunities to mediate international exchange is affected by two variables: (1) the uncertainty separating would-be exchange parties; and (2) the social capital of the broker who would bring the two parties together. Exchange uncertainty is a cumbersome label for what is really an information gap. The gap is an obstacle to the current identification of suitable partners (who do I know in foreign markets?) with a shadow extending into the future (who can I trust in volatile markets?). The information gap or hole provides the setting for a tertius-broker to mediate new exchange relationships. The ability to do this, however, is defined not in terms of the broker’s personal attributes which
are merely correlates of entrepreneurial behaviour, but in terms of the information benefits inherent in the broker’s relationships with others (Burt, 1992).

This social capital explanation may be contrasted with the normative view adopted in the export marketing literature which advocates a more formal approach to partner identification based on the collection of objective information gathered systematically via market research (Douglas and Craig, 1983; Root, 1994). Although this textbook model has been implicitly accepted as the received view in mainstream marketing for many years, several recent studies have revealed that international exchange partners are frequently identified on the basis of prior social ties (Axelsson and Johanson, 1992; Bonaccorsi, 1992; Ellis, 2000; Wong and Ellis, 2002). This emerging body of evidence complements the intuitive appeal of the structural hole theory and suggests the following proposition:

**Proposition 1:** The use of social ties as a means for identifying new opportunities to mediate international exchange will be positively related to:

(a) the diversity and reach of the trader’s network;
(b) the experience of the trader in the market;
(c) the degree of uncertainty surrounding the exchange, which in turn will reflect (i) the cultural distance and (ii) the extent of market imperfections separating the buyer and seller.

**Evaluating Potential Exchange Partners**

In identifying and evaluating market opportunities, traders may acquire information via ties embedded in networks of social relationships or via arm’s-length ties with strangers. There are clear advantages to identifying exchange partners on the basis of network ties (Egan and Mody, 1992; Larson, 1992). For example, if a new client is introduced on the basis of a referral from an existing supplier, it does not serve the purposes of the existing supplier to pass along the name of someone known to be a risky proposition. No such qualitative screening is possible for potential partners identified solely through impersonal means (e.g., in response to an advertisement).

*Trust.* Embedded ties not only facilitate the screening of potential exchange partners, but they also promote the development of trust in new relationships. They can do this in several ways. First, for the reasons just discussed, social ties are more likely than arms-length ties to lead to the *a priori* identification of trustworthy partners (Gulati, 1995; Lyon, 2000). Moreover, exchange partners referred by known others will be more inclined to share information without being asked to do so (Rauch, 1996). That is, they are more likely to engage in trust-creating behaviours. Further, new exchanges which are embedded within existing social relationships will come ‘primed’ with social resources such as uncertainty-reducing norms
regarding behavioural expectations and ‘an initial stock of trust appropriated from a preexisting social relationship’ (Uzzi, 1996, p. 680). In short, exchanges embedded in existing personal relationships are more likely to be characterized by trust (a relationship variable) between partners who are themselves more likely to be trustworthy (an individual trait).

Commitment. Exchange partners identified on the basis of third party referrals and previous personal relations are more likely to be credited as initially trustworthy than partners identified via anonymous sources (Uzzi, 1996). Trust has been described in terms of confidence in, and a willingness to rely on, the exchange partner (Moorman et al., 1993). Consequently, trust promotes commitment to a relationship (Morgan and Hunt, 1994; Moorman et al., 1992; Nielson, 1998). It follows then that traders will display greater commitment to new partners identified on the basis of social ties than those identified under more fortuitous (e.g., a chance meeting at a trade fair) or impersonal encounters.

Start-up speed. The contracting costs associated with arms-length transactions may be reduced for exchanges based on embedded ties reflecting the added value of tacit information gleaned from known contacts. One implication is that embedded exchanges promote economies of time resulting in faster start-ups and rapid access to new opportunities emerging within the network. As Uzzi (1997) has observed, where partners are either known or vouched for by known others, transactional details can be negotiated ‘on the fly’ or even after the deal is completed when time is of the essence.

Summary. In markets characterized by risk or rapidly closing windows of opportunity, social ties provide unique advantages for evaluating potential exchange partners. Exchange partners identified on the basis of the recommendations of others are likely to be more trustworthy than strangers and the resulting ventures will more likely be characterized by higher levels of trust and commitment. In addition, embedded ties may enable potential exchange parties to move quickly to capitalize on market opportunities without being waylaid by the need to install all the requisite safeguards. In contrast, arms-length exchanges will require additional time to develop trust and prepare contracts which protect against opportunism. The preceding arguments can be expressed in proposition-form as follows:

**Proposition 2**: In contrast with arms-length exchanges, the use of social ties as a means for identifying new opportunities to mediate international exchange will be positively related to:

(a) the identification of exchange partners who are perceived to be more trustworthy;
(b) the trader’s resulting degree of commitment to the new venture;
(c) quicker start-up times.
Information is one thing, control is another. While the identification of potential exchange partners will be influenced by the information benefits of the trader’s network, the terms of trade agreed upon will reflect the control benefits or the degree of autonomy enjoyed by the intermediary. Autonomy is concerned with the replaceability of the intermediary; a trader who can be easily replaced has low autonomy in the mediated exchange. A trader’s degree of autonomy will first be evident at the negotiation stage of the exchange process.

Structural autonomy. The greatest value in brokering connections across a structural hole goes to the first few people to do it, when uncertainty is highest (Burt, 2000). This is the point when the two parties linked by the middleman are the least familiar with one another. In the absence of a common reference point, the mutually-linked intermediary has the freedom to exploit the ‘swirling mix of preferences’ and to play the demands of one party against the other. The intermediary may even contribute to this uncertainty by strategically moving accurate, ambiguous, or distorted information between the two parties (Burt, 2000). When the uncertainty of exchange is at its highest, the tertius enjoys the greatest freedom to negotiate for favourable terms of trade. However, this opportunity diminishes in direct proportion to the number of rivals or peers who could replace the intermediary. In the current context the term ‘peers’ would include other ITIs (industry rivalry), the exchange partners themselves (the threat of integration), as well as those banks, government agencies, and freight forwarders offering substitute intermediation services. Peers undermine the trader’s autonomy in a given exchange by providing a competitive frame of reference against which claims for compensation may be judged (Burt, 1997). In short, peers erode the value of the intermediary’s social capital by inhibiting the freedom of the trader to settle for anything other than the market rate.

Summary. In a perfectly competitive market players lack the freedom to negotiate the terms of trade. But in an imperfect market multiple rates of return are possible because disconnections between players leave some people unaware of the benefits they could offer others (Burt, 1999). The value of a trader’s social capital in an imperfect market will be correlated with the degree of uncertainty separating potential exchange partners. However, the trader’s latitude in exploiting this uncertainty will be constrained by the presence of others against whom the trader’s terms can be assessed. This can be expressed as follows:

**Proposition 3:** The negotiated rate of return (or trading margin) will be positively related to the trader’s degree of structural autonomy in the mediated exchange which, in turn, will be inversely related to the number of peers (reflecting the
replaceability of the trader) and positively related to the exchange uncertainty separating buyers from sellers.

**Maintaining Exchange**

Ultimately mediated exchanges decay. As markets mature and competition intensifies information and resources will begin to flow more freely between producers and consumers undermining the role of the intermediary. For example, economic development led to a decline in the number of ITIs based in the San Francisco area from 1400 in the late 1940s to less than 100 by 1988 (Perry, 1992). At the domestic and international levels, pressures to eliminate the middleman will invariably rise as market imperfections diminish.

Within specific exchange relationships intermediaries may find themselves caught on the horns of a dilemma. If they perform their marketing function well, generating substantial sales or orders for their clients, they may inadvertently prompt either the buyer or seller to internalize those activities performed by the trader. For example, an ITI that is successful in developing a new export market runs the risk of being eliminated from the channel by a manufacturer keen to reap the benefits of more direct entry modes. Once the ‘liability of newness’ has been overcome, the manufacturer may stand to gain more by eliminating the middleman. On the other hand, if intermediaries perform poorly they run the risk of being replaced, either by another trader or by one of the exchange parties.

Given time, competitive threats to the existence of trade intermediaries will eventually emerge irrespective of, and possibly because of, their level of performance in the indirect export channel. These threats originate from two sources: other middlemen (or organizations offering substitute services, e.g., banks) and the exchange parties themselves. For these reasons the traders interviewed by Perry (1992) estimated that few in their business survive as long as ten years.

While scholars (e.g., Hennart and Kryda, 1998; Peng, 1998) have long recognized the ‘built-in mortality’ of mediated exchange relationships, no satisfactory explanation of the process of decline has yet been developed. Rather, within the international business literature the main emphasis has been on those relational variables, such as commitment, which are presumed to forestall the inevitable (see, for example, Barovick and Anderson, 1992; Castaldi et al., 1992). However, commitment to one’s clients, while commendable, will not of itself sustain the ITIs role in the mediated exchange. Rather, the duration of any given trading relationship will be dependent upon the control benefits inherent in the particular tertius strategy.

*Switching incentives.* Middlemen are eliminated when they are replaced either by other middlemen or by exchange parties assuming responsibility for the middleman function. It follows then that an intermediary’s position in a cross-border
exchange will persist for just as long as the incentives for preserving or maintaining the arrangement counteract the pressures for elimination. Pressures for elimination, or ‘switching incentives’ if viewed from the perspective of the manufacturer-supplier, have been described in terms of (i) dissatisfaction with the intermediary’s current level of performance, (ii) the accumulation of market knowledge, (iii) export market growth, and (iv) growth of the company (Benito et al., 1999). The first switching incentive will result in the ITI being replaced by another intermediary, while the other incentives will stimulate integration of channel functions by the supplier.

Switching costs. Fully aware of the pressures for elimination posed by both rivals and other channel members, intermediaries can be expected to engage in dependence-balancing actions designed to preserve their role in the mediated exchange. One strategy is to make relationship-specific investments and thus create exit barriers for clients. Investments may be supplier-specific or customer-specific. Supplier-specific investments would include the effort expended by the intermediary to gain a unique understanding of how the supplier operates in order to be able to promote the supplier’s products more effectively (Weiss and Kurland, 1997). Such investments make the intermediary more valuable to the supplier as any decision to terminate the agency relationship must now be offset against the additional costs incurred in replacing this enhanced level of service (Anderson and Schmittlein, 1984). Conversely, customer-specific investments may take the form of building close personal relationships with buyers (Ganesan, 1994; Weiss and Kurland, 1997). Suppliers will hesitate to terminate agency agreements if there is a prospect of losing key customers with whom the intermediary has formed a close bond (Heide and John, 1988). The anticipation of high switching costs associated with such barriers may result in clients’ desire to maintain the relationship (Lewin and Johnston, 1997).

Estimating duration. Mediated exchange relationships terminate altogether when the benefits of integration outweigh the costs of doing so. Assuming the use of ITIs in international exchange as the default hypothesis (a lá TCA), implies that any change in the cost/benefit ratio of the current channel arrangement must be assessed in light of the conditions present at the initiation of the mediated exchange. This can be done by imagining an X–Y graph where movements away from the Y-axis reflect changes in the underlying costs of the exchange and movements away from the X-axis reflect changes in the underlying benefits. Again, adopting the perspective of the supplier, the exchange conditions at time \( t = 0 \) are described by the point \((0,0)\) on the graph. The costs of altering the existing arrangement can be expected to fall (move to the left of the Y-axis) as the supplier acquires either direct knowledge of the foreign market or slack resources with which it may purchase such information. Counteracting this are transaction-
specific investments made by the intermediary which increase the costs of altering the existing exchange structure (reflected in movements to the right of the Y-axis). On the benefit side of the equation, growth in the export market will create an incentive for the supplier to integrate the intermediary functions (as reflected in a movement upwards from the X-axis). Conversely, the emergence of additional uncertainty in the market (captured in a movement downwards from the X-axis) will reinforce the intermediary’s position in the exchange.

Taking these factors together and assuming that, all things being equal, the status quo will prevail, the duration of any mediated exchange can be expressed in the following equation:

\[
\text{If } \frac{C}{C^{alt}} \leq \frac{B}{B^{alt}} \text{ then maintain independent channels, otherwise integrate.}^{[1]}
\]

This simple ‘duration equation’ is useful for discriminating between those variables which are salient in determining relationship duration and those which have indirect effects. For example, it could be tempting to infer a negative correlation between relationship duration and the competitive intensity generated by the presence of industry rivalry and substitute intermediary services. However, the number of peers who are able to replace the intermediary in a given exchange is merely correlated (inversely) with the degree of ambiguity regarding the ITI’s level of performance. Peers provide a competitive frame of reference against which the delivered effort may be gauged (Burt, 1992). If the ITI is executing its marketing tasks at a competitive price, the existing arrangement will remain unchanged.

What if the ITI is performing well above the supplier’s expectations? A high level of intermediary performance, resulting perhaps from growth in the export market, may indeed stimulate the supplier to investigate the possible benefits of integration. However, again the status quo will not be challenged unless the subsequent accumulation of market knowledge or slack resources causes \( C^{alt} \) to fall below the \( t = 0 \) baseline.

Finally, the duration equation can be used to reconcile contradictory hypotheses logically derived from the axioms of TCA. For example, high uncertainty in a market can and has been correlated with both market-based (Jones et al., 1997) and hierarchical modes of governance (Klein et al., 1990). Both arguments are persuasive. On the one hand, in situations of high demand uncertainty, decoupling of activities via subcontracting or outsourcing increases organizational flexibility improving the firm’s ability to respond to a wide range of unforeseen contingencies (Jones et al., 1997). On the other hand, uncertainty in foreign markets impedes forecasting making it difficult to write comprehensive contracts. Therefore, high external uncertainty will lead to high transaction costs encouraging high levels of integration to reduce such costs and to improve adaptive sequential decision-making in the market (John and Weitz, 1988; Klein et al., 1990).
Reconciling these divergent claims is not difficult when one realizes that uncertainty, by itself, can say little about the suitability of particular exchange modes. Uncertainty simply refers to the cost of acquiring information which must be offset against the value assigned to that information by the purchaser. In the case of international exchange a supplier may assign a high value to information relating to a fast-growing market and opt for a direct entry mode for all the reasons identified by Klein et al. (1990). Conversely, a less desirable (but equally uncertain) market may only warrant indirect exports, as per Jones et al. (1997).

Summary. Whether traders perform the marketing function poorly or well, they run the risk of being eliminated from the indirect export channel. The duration of any particular mediated exchange will be circumscribed by this Catch-22 situation. The specific point of relationship termination however, will be found in the complex interplay of a variety of switching incentives and costs as perceived by the exchange parties. In essence, ITIs will not be replaced until the pressures for elimination outweigh the pressures for preservation. This can be expressed in propositional form as follows:

**Proposition 4:** Mediated exchange relationships will end when the pressures for eliminating the intermediary outweigh the pressures for preserving the relationship:

(a) Pressures for elimination will be positively related to (i) the number of peers who could replace the trader when clients perceive the trader to be performing poorly and (ii) the perceived gains from integration when clients perceive the trader to be performing well.

(b) Pressures for preserving the relationship will be positively related to (i) the presence of relationship-specific investments made by the trader and (ii) the perceived degree of exchange uncertainty.

**CONCLUSIONS**

Despite their historical and contemporary significance in cross-border trade, ITIs remain outside the scope of mainstream organizational research. Even within the interdisciplinary domain of international business these highly adaptable service firms have been largely overlooked in deference to the multinational enterprise. One possible explanation for this state of affairs is that although ITIs are conceptually fascinating at many levels, very few generic models of ITI behaviour exist. Much of the available research is highly particularistic in focus with little relevance beyond the country in which the study was conducted. Recently this situation has begun to change. TCA scholars are now beginning to realize that because ITIs operate largely by minimizing transaction costs for others, they constitute an ideal setting for investigating the hitherto ignored link between governance
structures and performance (Peng, 1998). In addition, respected economists and business historians are turning their powerful analytical lenses towards ITIs (see for example, Casson (1998) and Jones (1996) respectively). While such trends augur well for the future of ITI research, fundamental questions regarding the entrepreneurial role of traders persist: How do traders create new value chains? How do they make markets? What measures do they enact to sustain their place in mediated exchanges?

Market-making intermediaries such as ITIs are primarily vehicles for exchange. The limitations of agency theory and TCA in explaining these organizational forms stem from the fact that exchange is a source of at least two kinds of value creation. First, value is created whenever exchange improves the allocative efficiency of the economy. This exchange process benefits from the writing of contracts that ensure goal congruency between principals and agents and from the appropriate matching of exchange modes with exchange characteristics. Thus, both agency theory and TCA are concerned with this first type of value creation. But ITIs also engage in a second, more innovative type of value creation in the form of stimulating new trade flows. In contrast with the finite gains from trade achievable by improving the efficiency of trade (doing the same thing better), this type of value creation, which is captured in the persistent search for new markets, is potentially limitless in scope (Young, 1928). It is in the organization and management of this second type of trade that ITIs must be most entrepreneurial.

ITIs as entrepreneurs are a diverse breed and trading entities from one part of the world may have little in common with those elsewhere. Structural hole theory offers a neat way of sidestepping this issue by explaining entrepreneurship, not in terms of individual or organizational traits, but in terms of the competition for the benefits of productive relationships (Burt, 1992). Every trade intermediary has social capital, but the landscape of opportunity – in effect, the size of the structural hole being spanned – determines the value of that social capital. The intermediary as entrepreneur creates value by participating in, and controlling, the diffusion of market information across national boundaries. The ability to do this will be influenced by the information and control benefits inherent within his or her social network. Information benefits come into play at the initial stages of exchange creation whereas control benefits will influence the rate of return and the duration of the mediated exchange.

NOTES

*Earlier versions of this paper were read by Gabriel Benito, Ron Burt, and Mark Casson. The author is grateful for the constructive feedback provided. However, the usual caveat applies. This project was supported by the Research Grants Council of the HKSAR (Project no. PolyU 5234/99H).

[1] C and B denote the costs and benefits of using an intermediary, whereas C_{int} and B_{int} denote the costs and benefits of performing intermediary functions in-house.
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