The flexible tiger

Taiwan has largely escaped the mauling many Asian economies have suffered. One reason may be that its companies are allowed to fail

ECONOMICS FOCUS

ASIA'S string of financial crises has exposed the fact that the fast growth of many companies has depended critically on easy money. The ready availability of bank loans, often extended at government behest and at attractive interest rates, allowed Indonesia's nascent conglomerates and South Korea's *chaebol* to pursue market share and expand into new fields without worrying about rates of return. In Thailand and the Philippines, fixed exchange rates made foreign-currency loans look cheap. But when crisis came and the easy money dried up, debt-laden companies were quickly mired in financial trouble. Their restructuring will entail redundancies and plant closures, which will make the economic situation all the more serious.

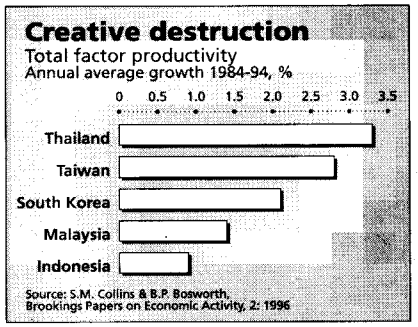
One of Asia's so-called Tigers, however, has fared far better than the rest. While Korea and South-East Asia are struggling, Taiwan has so far escaped with a small currency devaluation and a relatively modest decline in share prices. Economic growth remains strong. Working out why Taiwan has outperformed its neighbours will keep economists busy for years to come. A light foreign-debt burden is one likely explanation. Better banking regulation is another. A third probable cause of Taiwan's success is more controversial: by having a more flexible economy than some other Asian countries, Taiwan may have been better positioned to withstand the storms.

Exactly what does "flexibility" mean? A new paper*, by Bee Yan Aw and Mark J. Roberts of Pennsylvania State University and Xiaomin Chen of the World Bank, offers a partial answer. One secret of success, they suggest, is that Taiwan makes it easy for new companies to get a start—and for old ones to fail.

Start-up companies, they find, have a key role in the most unlikely industries. Chemical manufacturing, for example, is widely regarded as a business where the need for huge capital spending gives an advantage to big, well-established companies. And yet in 1991, 40% of Taiwan's chemical output came from firms that did not exist in 1986. One-third of the value of Taiwan's plastics production and half its output of fabricated metal products were also attributable to firms less than five years old.

The newcomers, it seems, establish their place in the market by forcing old-timers out of business. Firms that had accounted for 58% of Taiwan's chemical production in 1981 had left the business by 1991. In other sectors—including ones which were expanding rapidly overall—the carnage was even worse. Four out of five firms that manufactured clothing, metal products, textiles and plastics in 1981 either closed or changed lines of business over the next decade.

This creative destruction spurs incumbents to stay trim and helps spread new skills quickly. As the successful entrants tend to be more efficient than the firms that die, they boost productivity across the economy. Between 1986 and 1991, total factor productivity—the increase in output due to more efficient use of inputs such as labour and capital—in Taiwan's electrical-machinery industry rose 23.6%. Over a third of that, the researchers estimate, came from new firms pushing out less efficient ones. In the chemicals industry, where productivity growth was slower, a whopping three-fifths of the gain was due to the entry of highly efficient firms and the exit of stodgier ones.



These impressive figures probably understate the impact of Taiwan's sink-or-swim attitude toward business. Improvements in existing firms' efficiency, which account for most of the rest of Taiwanese productivity growth, are in large part spurred by potential competition from new entrants and the fear of bankruptcy. The ease with which companies are born and fail is clearly one reason why Taiwan's total factor productivity has improved faster than that of all other Asian countries since 1960. From 1984-94 only Thailand had a better record (see chart).

How has Taiwan succeeded in stimulating so much new business formation? In earlier decades, the Taiwanese government used directed lending and import protection in order to foster domestic manufacturing. But as these policies have receded in recent years, lowered trade barriers have forced manufacturers to face vigorous competition domestically and to seek markets overseas. This is directly related to productivity growth: the authors find that firms that export tend to have higher productivity than those that do not.

The benefits of bankruptcy

Taiwan's policies differ from those of some other Asian countries in another important way. The Taiwanese legal system puts relatively few obstacles in the way of bankruptcy. This encourages investors, lenders, workers and managers to act prudently, because they know that the consequences of bad decisions may be fatal for the firm. It has also made entrepreneurs accustomed to starting again after their ventures collapse. Failure is no sin.

Manufacturers appear to shape their strategies in response to these pressures. In particular, many Taiwanese companies deliberately seek to minimise irretrievable expenses or, as economists call them, "sunk costs". Firms tend to cluster in less capital-intensive industries and to subcontract the production of many of their components. That means they do not need to spend much on fixed assets such as machinery, which, in any case, can easily be sold off to rivals if a firm goes out of business. Many Taiwanese companies have also chosen to be suppliers for other firms, often in America or Japan, rather than developing brands of their own. This reduces the need for expensive advertising and research.

Taiwan is by no means immune from the broader forces that have afflicted all of Asia. Its stockmarket has fallen 7% since October, and its currency, the New Taiwan dollar, is off 12.5% against the American dollar. The even larger exchange-rate devaluations in countries such as South Korea and Malaysia will undoubtedly put many Taiwanese firms under pressure. But its history of allowing troubled businesses to die and new ones to spring up should make it easier for Taiwan to adjust to turbulent times.

*"Firm-level evidence on productivity differentials, turnover and exports in Taiwanese manufacturing". NBER Working Paper 6235. October 1997.