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Demand, Costs and Product Scope in the Export Market

Bee Yan Aw, Yi Lee

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Demand, Costs and Product Scope in the Export Market[☆]Bee Yan Aw^{a,*}, Yi Lee^b^a*Department of Economics, The Pennsylvania State University, University Park, PA 16802, U.S.A.*^b*Department of Economics, National Tsing Hua University, Hsinchu, Taiwan 30013.***Abstract**

In this paper, we distinguish between the contributions of two dimensions of firm heterogeneity, quality and productivity, to the export performance of Taiwanese multiproduct firms. We develop a theoretical model in which the relative importance of these two dimensions of firm heterogeneity depend on the degrees of product differentiation and cost elasticities of quality improvement. Our empirical results confirm the predictions of the theoretical model. Both quality and productivity play important roles in explaining firm export participation and export scope. Quality contributes more to export decisions for firms in more differentiated product markets and products with lower cost elasticities of quality improvements while productivity effects are stronger in markets with low degrees of product differentiation but high cost elasticities of quality improvements.

Keywords: Product Differentiation, Product Cost Elasticity, Productivity, Demand, Export Participation

JEL: Classification: F1, L1

1. Introduction

For many middle-income countries such as Taiwan, the heavy dependence on exports has meant that these economies are particularly susceptible to the swings in conditions in the global market. Over the last two decades, the foundation of Taiwan's export success, initially based on inexpensive domestic labor and low costs, was gradually transformed into one where product upgrading and market diversification played an increasingly important role in driving export success. In fact, since the mid-1990s, the production of low-skilled and labor-intensive goods has been outsourced to countries with low wages so that by the year 2000, almost half of Taiwan's total export orders were outsourced overseas, primarily to China. At the micro-level, this development meant that success in the export market no longer belongs only to firms that are able to compete on the basis of costs but also those that produce high value-added products demanded by consumers in multiple foreign markets. Indeed, there is increasing evidence that firm adjustments on the demand side of the market in the form of product and market diversifications consti-

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*Corresponding author

Email address: byr@psu.edu (Bee Yan Aw)

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