Reverse Imports, Foreign Direct Investment and The Exchange Rate

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Abstract

This paper investigates systematic linkages among "reverse imports", foreign direct investment, and exchange rates. We have in mind the competition in the Japanese market of a Japanese multinational firm and a Chinese domestic firm. Products are differentiated based on Japanese consumers' brand name recognition and retail barriers in Japan. The model shows that the appreciation of the Yen leads to an increase in Japanese FDI in China and "reverse imports", and a decrease in Japanese domestic production. Due to the barriers in brand name and the distribution system, the exports of the Chinese firm may fall, because the increase of reverse imports may erode the market share of Chinese firm, even though total exports from China increase. The predictions of the model fit well with the actual data. In addition, we find that Yen appreciation may improve the profits of the Japanese firm and welfare in Japan under reverse imports, against conventional wisdom.

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