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# International relocation, the real exchange rate and effective demand

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## Abstract

By introducing an international relocation mechanism into a two-country model, we analyze the effects of an increase in the corporation tax in the richer country on employment and effective demand in both countries. This taxation policy proves to produce not only enterprise relocation, but also depreciation in the real exchange rate. The latter is also shown to dominate the former, such that rich-country employment and effective demand are stimulated. However, the two countries respond in opposing ways regarding enterprise relocation and real exchange rate adjustment. Consequently, employment and effective demand in the poor country will fall.

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## 1. Introduction

The main purpose of this paper is to investigate whether enterprise relocation from a home to a foreign country under synchronized stagnation worsens conditions in the former and improves conditions in the latter. Recently, the possible existence of stagnated equilibrium was investigated by Ono (2001). Ono (2001) shows that stagnation may occur in a closed economy when two assumptions not found in the neoclassical literature are fulfilled: namely insatiable liquidity preference and sluggish price adjustment. In such a model, Ono (2001) considers the effect of fiscal and monetary policy on effective demand. Furthermore, Ono (1999, 2006) extends the closed economy model to an open economy setting and examines the effect on the two

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countries' effective demand of one country's fiscal and monetary policy. However, Ono's model does not embody any form of international location behavior between the two countries.

Alternatively, in the multinational firm literature, Fukao (1997) uses a dynamic model to derive an equilibrium where enterprise relocation does not work completely, and examines the impact of relocation by comparing it with free-entry equilibrium. However, since the regulation of enterprise relocations among developed countries has been substantially liberalized, we believe it is appropriate to examine the impact of the relocation of unrestricted firms at the initial point. In addition, because Fukao (1997) assumes a small open economy, he cannot consider the impact of enterprise relocation on another country that faces an inflow of firms. We consider it is then appropriate that a two-country model should be adopted to examine the impact of enterprise relocation among economic powers, including the U.S. and Japan.<sup>1</sup>

As a point of further comparison, Johdo and Hashimoto (2005) investigate the effects on welfare of a corporation tax in a world in which production is globalized so that firms can relocate easily using a two-country monopolistic trade model. However, this model lacks the adjustment mechanism between relocation and effective demand under stagnation, because the model assumes that demand is always met with supply in the labor market. Our contribution to the literature is to present a two-country monopolistic trade model incorporating the international relocation of firms, and show how it can be used to shed light on the relationship between the corporation tax rate and effective demand under stagnation. The main result is as follows. If the home country increases the corporation tax rate that led to international relocation under stagnation, this could improve employment and effective demand in the home country and worsen employment and effective demand in the foreign country if the home country is rich (or the foreign country is poor). The remainder of the paper is structured as follows. Section 2 outlines the features of the model. Section 3 describes the steady-state equilibrium. Section 4 presents the comparative steady-state results and explains the underlying intuition. The final section summarizes the findings and concludes the paper.

## 2. The model

### 2.1. Definitions of various prices

We assume a two-country (home and foreign) world economy in which monopolistically competitive producers exist continuously in the range of  $[0, 1]$ , each of which produces a single differentiated product. An individual producer must choose either the home or the foreign country as its production location, and productive activity cannot be carried out in both locations simultaneously. We assume that the home location consists of those producers in the interval  $[0, n]$ , and the remaining  $[n, 1]$  producers are in the foreign location, where  $n$  is endogenous. This paper adopts a consumption index of the Dixit and Stiglitz (1977) type (shown below), in which case the consumption-based price indexes are

$$P = \left[ \int_0^1 P_j^{1-\sigma} dj \right]^{1/(1-\sigma)} = \left[ \int_0^n P_j^{1-\sigma} dj + \int_n^1 (\varepsilon P_j^*)^{1-\sigma} dj \right]^{1/(1-\sigma)}, \quad (1)$$

<sup>1</sup> Ethier and Markusen (1996) show that 80 percent of total foreign direct investment is between developed countries. In addition, Stevens and Lipsey (1992) and Fukao (1996) are examples of empirical research in which enterprise relocation is represented by foreign direct investment.

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