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Local content requirement on foreign direct investment under exchange rate volatility

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Abstract

This paper analyzes the effects of exchange rate volatility of both the host country and the parent country on host-government policy related to local content requirement (LCR) on export-oriented foreign direct investment (FDI) in the context of an oligopolistic market in a third country. We, inter alia, find that an increase in the volatility foreign exchange rate decreases optimal LCR both under free entry and exit of foreign firms and when the number of foreign firms is fixed. We also find that the government uses a less strict LCR policy when the number of foreign firms is endogenous than when it is exogenous.
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1. Introduction

Over the last two decades, the world economy has witnessed a dramatic increase in direct investments by transnational corporations (TNCs), and also a radical change in the conception about the benefits of foreign direct investment (FDI). In fact, FDI has grown significantly faster than trade flows, particularly

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among the world's most developed economies, and according to UNCTAD (2000) the combined inward and outward FDI stocks made 31.7% of global GDP, and FDI's export accounted for 46% of global exports of goods and non-factor services in 1999.

The new generalized view about FDI has moved governments to dismantle many barriers in order to attract foreign investment. However, some recurrent practices of intervention and a number of important qualifications proposed by trade researchers have led over recent years to an abundance of theoretical and empirical research which examines this issue, using a diverse range of analytical approaches.

Different economic models have been constructed to analyze the effects of a wide range of policies on TNC behavior and on host country welfare. These models point out the interrelationships between different economic variables and issues such as labor demand, income distribution, market-share rivalry, technology spillover effects, environment degradation, etc. However, the study of FDI behavior under conditions of uncertainty has not had the same degree of attention. This paper attempts to contribute to the theoretical literature in this direction.

The main objective of this paper is to examine the behavior of TNCs and a host government when the latter applies local content (or sourcing) requirements (LCR) on foreign firms under conditions of uncertainty about exchange rates.

LCR becomes an issue when a firm establishes operations abroad but buys most of inputs from the firm's 'home' base, thus failing to build interdependent or complementary linkages in the host country. Under such situations, LCR may have desirable domestic welfare effects, since this policy could help to raise employment level and economic growth in the host country.[1] Two points need to be noted here. First, a stricter LCR policy may drive some TNCs out of the country and thus reduce employment and growth. Second, in the presence of competing domestic firms, a host government may use LCR as a strategic instrument as these requirements are limited to foreign owned firms producing in the host country and thereby give local firms a competitive advantage.

Our model which is based on an imperfectly competitive market for a final good, analyzes the impact of LCR on employment level. A number of foreign firms compete with domestic firms for the oligopolistic market of a homogeneous good in a third consuming country. Thus, FDI in this paper is purely export-oriented. Furthermore, in making its policy decision, the host government takes into consideration the effect of uncertainty of exchange rate variations on the variables of the model.

The relevant literature can be divided into two categories. The first category considers the relationship between FDI and LCR. An early analytical contribution is Grossman (1981) who, under a partial equilibrium framework with a competitive firm, finds that LCR raises the price of the domestic input, thus benefiting input suppliers but harming the final-good producer.[2] Later, Richarson (1993) showed that, under a general equilibrium framework, LCR may induce foreign firms to invest in the input-producing sector, and therefore the price-raising effect of LCR could be mitigated to some extent.

The second group of studies is about the relationship between FDI and exchange rate uncertainty. The effects of exchange rate uncertainty on FDI have been examined, among others, by Cushman (1985), Goldberg and Kolstad (1995) and Hongmo and Lapan (2000). The scope of the papers is restricted to the analysis of the effects of uncertainty on TNC decisions such as where to buy inputs, where to produce

[1] Structural unemployment has become a major concern in many countries, specially in less developed economies, and if we are to understand government policy related to FDI, it ought to be included in any analysis of FDI. According to Davidson et al. (1985), although LCR reduces world and home outputs, legislators consider it as a policy target because of its effect on local employment.

[2] Other papers that followed Grossman (1981) are Davidson, Matusz, and Kreinin (1985), Krishna and Itoh (1988), Hollander (1987), Vousden (1987), Belderbos and Sleuwaegen (1997), and Qiu and Tao (1998), among others.

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