



# Reverse imports, foreign direct investment and exchange rates

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## Abstract

This paper investigates linkages among “reverse imports”, foreign direct investment and exchange rates. As an example, 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. The model shows that yen appreciation leads to an increase in Japanese production in China and “reverse imports” and a decrease in Japanese domestic production. Due to the barriers in brand name, the exports of the Chinese firm could fall, because the increase of reverse imports may erode the market share of the Chinese firm, even though total exports from China increase. Further, we find that yen appreciation may improve the profits of the Japanese firm and welfare in Japan under reverse imports, against conventional wisdom. The predictions of the model fit well with the actual numbers and shed light on the current debate on the Chinese currency.

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## 1. Introduction

China’s exports have experienced two-digit growth rates in the past decade. “Made in China” is available in almost every corner of the global market. Many point to the relatively low labor cost as the ‘secret of success’. While we do not wish to down play the importance of labor costs, we note that labor in China was even cheaper 10 years ago compared with that of today. Why was “Made in China” not popular then?

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A quick reality check reveals that the devaluation of the Chinese yuan since the late 1980s played an important role in fostering China's export growth in the last two decades, especially through the indirect effect—the influx of export oriented foreign direct investment (FDI). In fact, this indirect effect has been far more important in increasing exports than the direct effect, which is on the exports of Chinese domestic firms. For instance, from 1992 to 2005, China's exports more than tripled from US\$ 84.94 billion to US\$ 762.00 billion (China Statistics Yearbook, various years). But such dramatic increase is mainly the contribution of foreign multinationals, i.e., the subsidiaries of global multinational enterprises (MNEs) in China, because the exports of foreign invested firms surged from US\$ 1.74 billion to US\$ 444.20 billion over the same period. China has become the largest destination country for FDI in the developing world. Multinationals flock to China for its cheap labor, land and other inputs (which Krugman, 1998, calls “firesale FDI”), to conduct export-processing operations. These have caused cries of “deindustrialization” and “hollowing out” in the home countries of the MNEs.<sup>2</sup>

The present paper sets out to investigate the linkages among “reverse imports”, FDI and exchange rates. We especially have in mind Japanese subsidiaries producing in China and then importing back to Japan for consumption, i.e., the so-called “reverse imports”.<sup>3</sup> One Chinese and one Japanese firm compete in the Japanese market. The Japanese firm can also produce in China. Products are differentiated due to brand name recognition. We find that exchange rate changes, wage differentials and barriers in brand name recognition contribute to increases in Japanese outward FDI and reverse imports.

Specifically, 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, the exports of the Chinese firm could fall, because the increase of reverse imports may erode the market share of the Chinese firm, even though total exports from China increase. In addition, yen appreciation may improve the profits of the Japanese firm and welfare in Japan under reverse imports, which is contrary to conventional wisdom. This implies that outsourcing has made the Chinese economy and those of the MNEs' home countries interdependent, as is recently recognized by not only business groups but also the Japanese government and the media that a major contribution for the Japanese GDP growth in 2003 and 2004 was “the China factor”.

It is counter intuitive that the yuan's depreciation may erode the Chinese firm's market share. This arises under the possibility of reverse imports: yen appreciation helps the Japanese firm to gain an edge on the Chinese firm in acquiring cheaper Chinese inputs, leading to more Japanese FDI and reverse imports. The relatively low cost of reverse imports together with high consumer recognition enhances the competitiveness of the Japanese MNE in the Japanese domestic market. If the substitutability between the products of the Chinese firm and the Japanese affiliates in China are high, then these increased reverse imports will replace goods made by the Chinese firm.

The model sheds light on the current China debate, because the predictions of the model fit well with the actual figures of China. The sudden popularity of “Made in China” can be ascribed to China's devaluation in the early 1990s, in addition to other factors. The devaluation reduced the input cost and improved the relative wealth of foreign investors, leading to more FDI inflows

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<sup>2</sup> For example, some US lobby groups allege that the Chinese currency had made lots of American workers jobless. The US Senate even voted on April 6, 2005, to increase tariffs on Chinese imports to 27.5% if China does not revalue the yuan within 6 months. Former Japanese Finance Minister M. Shiokawa repeatedly accused China of “exporting deflation” to Japan.

<sup>3</sup> While we use China and Japan as examples, the model and its predictions also apply to other countries in similar situations of close economic ties, such as the US and Mexico, Japan and Korea, the US and China, etc.

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