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An International Duopoly Model of Multinational Enterprise and Exchange Rate Pass-Through Strategy: Business Implications and Policy Debates

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This paper provides theoretical justification of Foreign Direct Investment (FDI) effect on the extent of exchange rate pass-through by deriving the standard Cournot fashion of international duopoly. Preliminary results of theoretical framework indicate that FDI will affect on lowering degree of exchange rate pass-through and generates higher degree of Pricing-to-Market behavior. This results are intuitively explained by analyzing the business implications under performance orientation, sourcing and location, distribution systerm, and brand loyalty that determine the multinational's strategic pricing. Finally, this paper generates some policy debates relating to monetary policy, international trade, and competition policy.

Field of Research: Economics, Multinational Enterprise

1. Introduction

The relationship between exchange rates and international price-setting is one of the most striking topics of international business studies. Called exchange rate pass-through, it refers to the response of import prices to exchange rates. Another terminology, Pricing-to-Market is referred to price discrimination across export markets induced by the exchange rate volatility. Initially, the model of balance of payments assumed a one-for-one response of import/export prices to exchange rate as "full" or "complete" exchange rate pass-through. However, several studies suggest that exchange rate pass-through is less than complete where the prices of foreign products sold in the domestic market change by a lower percent than do exchange rates.[1] During the end of 1990's to present, exchange rate pass-through has been extended to explain optimal monetary policy with consideration of exchange rate flexibility. Devereux and Engel (2000) explain that, when prices are not very responsive to exchange rates or less degree of exchange rate pass-through, monetary policymakers cannot rely on the exchange rates to provide the necessary adjustment to real shock. As the result, customers in that country do not interpret exchange rates change as relative price changes.[2] Another importance of studying exchange rate pass-through is to explain market competition status of traded goods. The rise of imperfect competition and strategic trade theory led researchers to estimate exchange rate pass-through at the industry level. Incomplete pass-through also explains when markups of price over marginal cost change with exchange rate changes and perform as nonzero markups. Because the nonzero markup is a deviation against the perfect competition condition, incomplete exchange rate pass-through validates the shift toward models of imperfect competition. Therefore, exchange rate

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