



10th Departmental Seminar (2009-2010)

**“FDI or Outsourcing: Do we have free trade?”**

- Speaker:** Dr. Xiaopeng YIN  
School of International Trade and Economics  
University of International Business and Economics
- Language:** English
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- Time:** 4:30 – 5:30 p.m.
- Venue:** Room WLB 601  
Wing Lung Bank Building  
for Business Studies  
Shaw Campus  
Hong Kong Baptist University

**Abstract**

This paper attempts to develop the theory of strategic outsourcing. It examines the strategic choices within the broader-defined outsourcing: FDI or intra-industry trade, and the effects of strategic tariff agreement and potential trade liberalization on such choices by modifying Chen, Ishikawa and Yu's two-firm-two-country model (2003), which both domestic and foreign firms produce the homogenous intermediate good and compete in the domestic market for heterogeneous final goods, with our boarder definition of outsourcing including FDI and intra-industry trade. We find that for the intermediate good, the choice made by the multinational firm between FDI and intra-industry trade depends on the bargaining power on tariffs between both developing and developed countries. Since the developing country seems possess more bargaining power with its lower marginal cost of production, we find FDI, the other form of outsourcing, is more possible to be chosen by the multinational firm, while it increases multinational firm's profit and welfare with reduction of its rival's profit. It could cause the tariff war between both countries. Moreover, when it is demonstrated as a two-stage game, the proper export tariff levied on the intermediate good by the developing country can result in the Nash equilibrium. However, when the developed country levies the import tariff as the reply, lowering it will be the Nash Equilibrium to have FDI for both countries, while the ratio of tariffs for such equilibrium is set up as given. Therefore, the tariff agreement between two countries is necessary to build trade equilibria and the expected trade liberalization is limited. That is, free trade will not be achieved. Furthermore, our model can be extended to the scenario that there exists different substitutability of produced final goods.

All are Welcome