Title: The Simultaneous Response of Local-Currency Pricing and Foreign Direct Investment to Exchange Rate Volatility

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Abstract: Exchange rate volatility affects multinational firms on deciding level of their foreign direct investment. To capture the role of firm to expect exchange rates change before deciding their local-currency pricing, exchange rate movement can be either temporary change or permanent change due to demand-supply of currency as well as the policy implementation toward exchange rate regime. We extend the previous studies of dynamic international duopoly model of Froot and Klemperer (1989) and Tivig(1996). In the real world, multinational corporations can simultaneously invest in local market and perform the local-currency pricing strategy by observing the exchange rates volatility. The results show that multinational firms will less likely to change their international price-setting as well as degree of foreign direct investment outflows if exchange rates are expected to change in the future. Moreover, as found by Tivig(1996), a temporary depreciation of domestic currency induces the foreign to "perverse" the pass through effect by increase in the price in the first period instead of lowering the price. The uncertainty effects are not included in this model to follow the perfect-foresight condition.

JEL classification: F23, F31, L11
Key Words: Local-Currency Pricing, Exchange Rate Pass-Through, Foreign Direct Investment, Exchange Rate Vitality
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