Product Differentiation and the Location of International Production*

by

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Abstract:

This paper analyses the role of product differentiation in firms' choice between exporting and foreign direct investment as ways to supply overseas markets. When the degree of product differentiation is exogenously fixed, we show that the overseas firm favors exporting at low and high degrees of product differentiation while foreign direct investment is favored at intermediate values: there is a "double switch" in location choice. Moreover, if firms have the same domestic locations, we show that they can be trapped in a prisoners' dilemma in which each firm chooses overseas production although exporting would be more profitable. We then consider a three-stage location/product specification/price game in which the firms choose their product specification. Irrespective of the mode of market serving, there is no symmetric solution to the product specification subgame. One firm chooses a "fighting brand", while the other selects a more passive product specification. The cost disadvantage incurred by an exporting firm translates into a disadvantage in the product specification subgame, with the implication that overseas production is favored if this gives the investing firm the ability to adopt a more aggressive product specification.

Key-words: product differentiation; location; foreign direct investment.

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