EXCHANGE RATE MOVEMENTS AND FOREIGN DIRECT INVESTMENT (FDI): EVIDENCE FROM JAPANESE INVESTMENT IN ASIA, 1987-2008

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The paper has explored the question of how exchange rate movements affect foreign direct investment (FDI) flows from a developed to developing and emerging market economies, a topic that has so far received relatively little attention. We have accounted for three possible channels of influence: (i) the level of exchange rates; (ii) exchange rate volatility; and (iii) expectations of future exchange rates. Based on existing theoretical and empirical studies, and corresponding to these channels, we have tested: (i) whether a depreciation of the host country currency encourages FDI inflows into the country; (ii) whether a more volatile exchange rate of the host country currency discourages FDI inflows into the country; and (iii) whether an expected appreciation of the host country currency encourages international investors to increase their investment.

The focus of the paper was on the impact of exchange rate expectations on FDI, an area of critical gap in the literature. To capture future expected depreciation or appreciation, we followed Chakarabari and Scholnick (2002) to use the third moment (skewness) of monthly exchange rate changes except that we have improved on their measure by utilizing the information contained in the current year as well as in the previous year. Assuming that exchange rate expectations are inelastic, we defined positive skewness as a depreciation shock for the Japanese yen, and negative skewness as an appreciation shock. The empirical results are consistent with the theoretical regularity suggested in the literature on exchange rate expectations that a larger depreciation shock is associated with mean-reverting expectations, namely, the yen exchange rate will revert (appreciate back) to its equilibrium level in the future.

We have filled a critical gap in the literature by highlighting the importance of exchange rate expectations on FDI decisions, especially those involving investment flows from a developed to emerging market economies. Our results clearly indicate that source country investors, in making a decision to purchase host country asses, are interested in the future stream of revenues and returns denominated in their own currency. This obvious fact also presents implications for policymakers in emerging and developing countries who want to maintain a stable flow of inward FDI. To the extent that actual FDI inflows respond to current and expected exchange rate changes, sharp exchange rate fluctuations may well create volatile FDI inflows. Avoiding erratic exchange rate behavior with respect to the currencies of major source countries is a way to prevent similarly erratic movements in FDI inflows.