



# Exchange rates and ownership structure of Japanese multinational firms

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## Abstract

This paper investigates the determinants of Japanese multinationals' ownership structures. Unlike most previous studies that neglect the impact of financial constraints on ownership, we add the exchange rate as a measure of wealth and test whether exchange rates affect the ownership share of foreign direct investment projects. After controlling for other variables that affect ownership, we find that exchange rates have a significant effect on the likelihood of wholly owned subsidiaries. We also discuss several other explanations for the link between exchange rates and foreign direct investment and provide evidence that the link stems from capital-market imperfections.

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## 1. Introduction

Ownership strategy is critical for foreign investors because it affects the foreign affiliate's performance (Lee and Beamish, 1995; Li, 1995). Foreign investors' ownership share is important also for host countries. Local subsidiaries will receive greater resources from their parent firms when they are wholly owned subsidiaries (WOSs) than when they are joint ventures (JVs) (Ramachandran, 1993). Sometimes, foreign firms are requested to purchase the stock or increase the equity share in order to help a troubled company in the host country.<sup>1</sup> On the other hand, host countries often impose ownership restrictions; governments worry that the presence of

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<sup>1</sup> For example, in the late 1990s, Japanese automaker Nissan needed to strengthen its financial position and decided to form an alliance with French automaker Renault. Renault bought a 44 percent stake in Nissan Motors.

foreign-owned firms will distort the domestic political process and/or that multinationals will shift profits out of the host country (Graham and Krugman, 1995). Thus, the ownership of foreign investors can raise international economic issues.

Several studies have been made on the ownership structure of foreign direct investment (FDI) projects (Gomes-Casseres, 1989; Hennart, 1991; Delios and Beamish, 1999; Asiedu and Esfahani, 2001). These studies suggest that ownership shares depend on the types of the parent and local firm's assets, the international experience of the parent firm, and the institutional environment of the host country. These studies focus on firm and host country characteristics because their main purpose is to assess the validity of internalization theory (which explains why foreign firms choose FDI instead of other entry modes such as licensing). Consequently, they neglect the impact of exchange rates and financial constraints on ownership.

Exchange rates and financial constraints do matter to foreign investors. Froot and Stein (1991) demonstrate that a depreciation of the dollar (which increases foreign investors' wealth) positively affects FDI flows into the United States; Klein and Rosengren (1994) also present evidence consistent with Froot and Stein's hypothesis that exchange rates affect FDI because of costly external finance. This hypothesis is a special case of a familiar idea that costly external finance affects investment (Fazzari et al., 1988; Hoshi et al., 1991; Lamont, 1997). Clearly, the problem of costly external finance applies to FDI. It affects not only the parent firm's location decision (whether firms invest in the host country) but also the ownership decision (whether they choose a WOS).

The model of Froot and Stein (1991) does not allow for JVs while foreign investors in the real world often choose JVs (probably because of financial constraints). Note that, without the distinction between WOSs and JVs, the location decision is not distinguishable from the ownership decision. Most of the studies on FDI flows focus on the location decision rather than on the ownership decision although they do not explicitly distinguish between these two decisions.

The volume of FDI flows into a country depends both on (1) the location decision of parent firms and on (2) the ownership share of the FDI project.<sup>2</sup> It is important to note that a single key determinant of FDI can affect these two steps differently. For example, exchange rates can possibly affect the first step through their effect on relative labor costs as suggested by Klein and Rosengren (1994) and the second step through their effect on relative wealth as in Froot and Stein (1991); secure property rights attract FDI (Globerman and Shapiro, 2002) but negatively affect ownership share because parent firms can protect their proprietary technology from their partners without establishing a WOS in a country with strong legal protection (Lee and Mansfield, 1996; Delios and Beamish, 1999; Asiedu and Esfahani, 2001). Thus, without distinguishing between WOSs and JVs, we cannot fully understand how exchange rates and other key determinants affect FDI. Actually, evidence in the literature on the link between exchange rates and FDI is not conclusive. Stevens (1998) shows that the significant effect of exchange rates on FDI flows in Froot and Stein (1991) disappears when the sample period is extended through 1991 (Froot and Stein use data from 1973 to 1988). Klein et al. (2002) show that the striking correlation between the value of the dollar and Japanese FDI into the United States (observed in the 1980s) disappears in the 1990s. When one focuses on aggregate FDI flows, which depend on the location decision and on the ownership decision, it is very difficult to control for their potential determinants and

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<sup>2</sup> When a foreign firm builds a new plant and owns only 10 percent of the voting stock, FDI flows become 1/10 of the WOS case.

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