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# Financial factors in foreign direct investments: A dynamic analysis of international data

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## Abstract

In contrast to existing empirical foreign direct investment (FDI) studies that examine the static effects of strategic or real economic variables, this paper focuses on the impacts of financial variables on FDI outflows for four largest industrial countries using dynamic time series methods. The results show that FDI outflows are non-stationary but have a long-run cointegrating relationship with real exchange rates. In addition, there are causal effects of exchange rates on direct investments in the short run. Multivariate cointegration analysis shows the significance of financial channels such as cost of capital and real wealth through which the real exchange rate effects operate. The effects of financial channels are comparable to those of the real wage rate channel. Overall, the present paper provides significant and methodologically consistent international evidence for dynamic interactions between FDI and financial variables.

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*Keywords:* Foreign direct investment; Real exchange rates; Cost of capital; Cointegration; Unit root

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The mainstream international business literature in the tradition of [Kindleberger \(1969\)](#), [Caves \(1971\)](#) and [Hymer \(1976\)](#) focuses on strategic operational variables to explain foreign direct investment (FDI). In this view, FDI take place as a result of a multinational corpora-

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tion's (MNC) attempts to exploit its oligopolistic advantages, relative to indigenous firms, by internalizing transactions within the firm. Internalization offers an advantage over external market transactions because of savings in transaction costs or because it can achieve better value appropriation by avoiding uncertainty in the external pricing of information-intensive products. However, it is not so plausible that firms undertake international investments without considering financial factors as well as operational strategies.

It is possible to include financial variables within a paradigm of the traditional oligopoly or internalization theory, if a source of a MNC's advantage is defined to include its superior access to finance in imperfectly integrated international capital markets. Stein and Jeremy (1997) and others show that internal capital markets can provide the firm with an advantage similar to the case of internal product markets. Aliber (1970) argues that MNCs have a lower cost of capital than indigenous firms because of their ability to obtain financing in strong-currency terms. Froot and Stein (1991) suggest that, in an environment where investors have imperfect information and thus charge a premium for monitoring costs, a firm that has assets in an appreciating currency experiences a wealth gain. The firm is then in a position to finance more assets internally and avoid costly external financing, which stimulates international investments.

Fundamentally, exchange rate changes affect international investments directly because of changes in relative asset prices and cost of capital at a given point in time, and also indirectly through changes in wealth over time. Provided that there is a real component in exchange rates due to deviations from purchasing power parity, some longer-term real strategic decisions such as FDI are necessary as a way of managing the firm's exposure to real operating exchange risk (Miller and Reuer, 1998). Therefore, it is expected that real exchange rates will have an impact on firm value and international investments, and that this impact may vary dynamically over time.

Existing empirical FDI studies show a mixed influence of exchange rates for FDI *outflows* in the US Froot and Stein (1991) document the effects of exchange rates on international investment of US industries for the period of 1973–1988. However, a study of foreign acquisitions of US firms by Dewenter (1995) indicates an insignificant relationship between the level of exchange rates and foreign investments.<sup>2</sup> The effects of exchange rates on FDI *inflows* in various countries are also inconclusive (e.g., Klein and Rosengren, 1994; Bayoumi and Lipworth, 1998; Kiyota and Urata, 2004). In addition, these studies use the standard static regressions, without considering the dimensional stability of FDI stock versus flow variables.

The mainstream international business literature on FDI has generally focused on strategic operational variables, leaving out financial variables such as exchange rates or cost of capital. These studies also use both stock and flow FDI data in ordinary static regressions

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<sup>2</sup> Additional work in economic literature (e.g., Goldberg, 1993; Blonigen, 1997; Guo and Trivedi, 2002) has examined the foreign production decisions of US industries in a broader macroeconomic context. In earlier finance literature, the absence of exchange rates in asset pricing was often motivated by an argument that the exchange risk can be hedged or diversified away. Given imperfect or incomplete capital markets, however, complete elimination of exchange risk by hedging or diversification is not realistic, especially against operational exchange exposures that do not have a deterministic set of foreign exchange cash flows. See e.g., Dumas and Solnik (1995), Choi and Rajan (1997), and Choi et al. (1998) for the existence of non-diversifiable exchange risk in international equity markets. Ajayi and Mougoue (1996) examine the dynamic relation between stock prices and exchange rates.

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