

Foreign Direct Investment, Exchange Rate Variability and Demand Uncertainty

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Abstract

Variable real exchange rates influence the country choice for location of production facilities by a multinational enterprise. With risk averse investors and fixed productive factors, a parent company should not be indifferent to the choice of production capacity location, even when the expected costs of production are identical across countries. If a non-negative correlation exists between real export demand shocks and real exchange rate shocks, the multinational will optimally locate some of its productive capacity abroad. The share of production capacity optimally located abroad increases as exchange rate volatility rises and as export demand shocks become more correlated. These theoretical results are confirmed by empirical analysis of quarterly United States bilateral foreign-direct-investment flows with Canada, Japan, and the United Kingdom.

Keywords: Foreign Direct Investment, Exchange Rates, Uncertainty, Investment

JEL Classification Codes: D81, F21, F23, F31

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