

Exchange Rate Volatility and the Timing of Foreign Direct Investment: Market-seeking versus Export-substituting

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Abstract

This paper examines the impact of exchange rate uncertainty on the timing of foreign direct investment (FDI) with heterogeneous investing motives. We first extend Dixit-Pindyck's real options model to show that while an increase in exchange rate volatility tends to delay the FDI activity of a market-seeking firm, it might accelerate the FDI activity of an export-substituting firm if the firm's degree of risk aversion is high enough. The rationale behind this finding is that a market-seeking FDI might increase the exposure of the firm's profits to exchange rate risk, while an export-substituting FDI might reduce it. Firm-level data on the entry by Taiwanese firms into China over the period between 1987 and 2002 are used to test the theory's validity. Empirical evidence from a survival analysis based on the data is consistent with the theory. These results reveal that the relationship between exchange rate uncertainty and FDI is crucially dependent on the motives of the investing firms. Hence, it is essential to consider this factor in an empirical model so that the testing results are free from aggregation bias.

Keywords: FDI, exchange rate, real options, survival analysis

JEL Classification: F21, F31, G13

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