Foreign Direct Investment and Exchange Rates:  
A Case Study of US FDI in Emerging Market Countries

by

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This paper investigates the impact of exchange rates on US foreign direct investment inflows to a sample of 16 emerging markets, using panel data for the period 1990-2002. Three variables are used to capture separate exchange rate effects. The bilateral exchange rate to the $US captures the value of the local currency (a higher value implies a cheaper currency and attracts FDI). Changes in the real effective exchange rate index (REER) proxy for expected changes in the exchange rate: an increasing (decreasing) REER is interpreted as devaluation (appreciation) being expected, so that FDI is postponed (encouraged). The temporary component of the (bilateral) exchange rates is a proxy for volatility of local currency, which discourages FDI. The results support the hypothesis that, ceteris paribus, there is a negative relationship between the expectation of local currency depreciation and FDI inflows. Cheaper local currency (devaluation) attracts FDI while volatile exchange rates discourage FDI.