

Exchange Rates and Foreign Direct Investment: An Imperfect Capital Markets Approach

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Abstract

We examine the connection between exchange rates and foreign direct investment that arises when globally integrated capital markets are subject to informational imperfections. These imperfections cause external financing to be more expensive than internal financing, so that changes in wealth translate into changes in the demand for direct investment. By systematically lowering the relative wealth of domestic agents, a depreciation of the domestic currency can lead to foreign acquisitions of certain domestic assets. We develop a simple model of this phenomenon and test for its relevance in determining international capital flows.

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