

The effect of currency crises on foreign direct investment

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Despite the ample literature on currency crises, the effect of currency crises on FDI activity has been largely unexamined. Nevertheless, most researchers assume that since currency crises have a negative effect on the host economy, they should reduce FDI activity. This paper takes a closer look at FDI activity during currency crises. The sensitivity of four measures of U.S. outbound FDI activity to currency crises is tested using two empirical models. The findings of this analysis suggest that currency crises have no significant effect on FDI activity, regardless of whether the affected country is developed or developing. These results underline the distinctive nature of FDI as opposed to other types of international capital flows. However, when currency crises are accompanied by banking crises, the effect of twin crises is negative in industrial countries, but remains insignificant in developing countries. This reflects the importance of banks and financial institutions to FDI activity in industrial countries, where the twin crises may undermine the ability of foreign investors to finance their activity locally.
