

Aliber's Currency Premium Theory

The renewal of interest in FDI as a financial phenomenon in the post Hymer dissertation era is largely due to Aliber's currency premium theory. Various authors, in addition to Aliber, have since emphasised the link between exchange rates and FDI. While some have argued that exchange rates is one of the crucial factors that determine the location of a firm, others have also pointed out that exchange rate factors determine the extent to which firms finance their foreign activity by equity capital exports from their home country. The currency premium theory is not a general theory of FDI. It merely suggests that firms internalise imperfections in the capital and exchange rate markets, as they do with any other form of market failure.

Aliber (1970, 1971) observed that the key factor in explaining the location of FDI involves capital market relationships, exchange risk and the market's preferences for holding assets denominated in select currencies. The bias in the evaluation of exchange risk determines whether a country is likely to be a source country or a host country. Aliber pointed out that countries with strong currencies could borrow at lower cost thereby enabling them to engage in risky investments in weak-currency areas. In other words, countries whose currencies command a premium have an advantage in investing abroad. Studies by Agarwal (1980) with regard to FDI in the US, UK, Germany, France and Canada yielded results that were consistent with the currency premium theory. Graham and Krugman (1995) also recorded that substantial increases of foreign acquisitions in the US coincided with the depreciation of the US dollar.

Buckley and Casson (1976) provided a useful summary of the mechanics underlying Aliber's explanation regarding the role of exchange rates in the export of equity capital from the home country. "Investments in other currency areas are often overlooked. The investors take no account of the exchange risks involved in the repatriation of profits to the parent firm. Thus the assets of, say, a US firm operating in the UK, are valued by the market as though they were dollar assets instead of sterling assets. It follows that if the currency premium on dollars is lower than the currency premium on sterling (dollars are the preferred currency) then the market rate

of interest on the debt of the US based MNE will be lower than on the debt of an indigenous UK firm, after allowance for expected currency depreciation. Thus the US based MNE can borrow more cheaply than the UK firm to finance any form of capital expenditure in the UK. One implication of this is that a US firm can realise an immediate profit by financing the takeover of a UK firm.”

Drawing from Kindleberger, Aliber also argued that foreign investments resulted from the trade-off between tariff barriers and economies of scale. The underlying assumption is that domestic production reduces costs by achieving economies of scale, while foreign production reduces costs by avoiding tariff barriers. However Aliber missed factors such as skill levels, unionisation rates, and technological progress. Furthermore, he operated under the simplifying assumption of standardised products.

The currency premium theory did well to predict the direction of post war expansion of MNEs. However, it failed to explain anything about capital flows within currency areas. It was also not able to account for cross investments between currency areas. For instance, we do know that the Japanese yen depreciated from 90 to the dollar in 1995 to 130 to the dollar in 1997. The currency premium theory would then advocate inflows of FDI into Japan from the US during this period. Also, FDI outflows from Japan to the US must have diminished.

Inflow of FDI into Japan from USA

Units: Case,JPY100million,%

1994			1995			1996			1997		
Cases	Value	Share (USA)	Cases	Value	Share (USA)	Cases	Value	Share (USA)	Cases	Value	Share (USA)
347	1642	37.9	463	1772	47.9	411	2390	31	445	1518	22.4

Outflow of FDI from Japan to USA

Units:Case,JPY100million,%

1994			1995			1996			1997		
Cases	Value	Share (USA)	Cases	Value	Share (USA)	Cases	Value	Share (USA)	Cases	Value	Share (USA)
509	18016	42.1	510	21845	44.1	581	24789	43.8	582	25486	38.5

Source: Ministry of Finance, Japan.

The data above, however, indicates that during the years of the weakening Yen (relative to the US dollar), the US share in FDI inflows to Japan actually decreased. The outflow of Japanese direct investments to USA increased till 1996. But in 1997, the US share in FDI outflows from Japan US reduced. Yet, even in 1997, the decrease in inflows was much more pronounced than the decrease in the outflows. Quite clearly, empirical data does not support the currency premium theory. Further Aliber is also unable to provide an economic rationale for Greenfield Investments. After all, would it not have been simpler to firms to profit from investor myopia and simply take over going concerns?

Buckley and Casson endorsing Aliber's theory agreed that imperfections in national and international markets for products and factors of production are a precondition for FDI. However, they observed that the mere existence of imperfect markets and competitive advantages does not result in FDI. For FDI to occur, the competitive advantages must be firm specific and also transferable to foreign affiliates. Further they must be of such a nature that they cannot be easily duplicated. Most authors now acknowledge the determining role played by firm specific assets or advantages in the occurrence of FDI. We will analyse the relationship between these firm specific advantages and FDI in the next chapter. In particular, we will examine the role of exchange rates in this relationship.