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Financial Development and FDI in Greece and Neighbouring Countries: A Panel Data Analysis

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Abstract

This paper aims to examine the association between financial development and foreign direct investment (FDI) in Greece and neighbouring countries (Bulgaria, Macedonia and Turkey) for the period 1996-2012. Bootstrap causality analyses are used to examine this causal linkage for these countries which are either European Union (EU) members or candidates for EU accession. The empirical results indicate that FDI has a predictive power to forecast financial development in all of the countries except for Macedonia. In addition, findings indicate that there is bidirectional causality in Turkey.

Keywords: Financial Development; FDI; Bootstrap Panel Causality Approach; European Union.

1. Introduction

The common view for the relation between financial development and FDI is that inward FDI contribute to the financial development in host countries. The rationale behind this view is that FDI cause an increase in funds available to the financial system. Hence, these funds contribute to the development in financial markets (Levine, 1997). In addition, it is also argued that a well-functioning financial system is an incentive especially for multinational firms to invest in host countries (King and Levine, 1993; Alfaro et al., 2008). However, there are also some studies arguing that FDI has no effect on financial development or even give harm to the financial system in

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host countries (Desbordes and Wei, 2014). This point of view depends on the idea that FDI is an alternative way financing through capital markets. This alternative financing method may weaken the capital formation in capital markets since funds are delivered via direct investment rather than capital markets (Hausmann and Fernandez-Arias, 2001). There are also some studies help to develop arguments against the static relation between FDI and financial development (Dutta and Roy, 2011). According to this view, the relation between FDI and financial development is dynamic rather than static.

The above arguments imply that the relation between FDI and financial development is rather ambiguous. The amount of inward FDI as percentage of GDP may give ideas about the current condition of countries and help to understand the relation between FDI and financial development in the countries analyzed in this study.

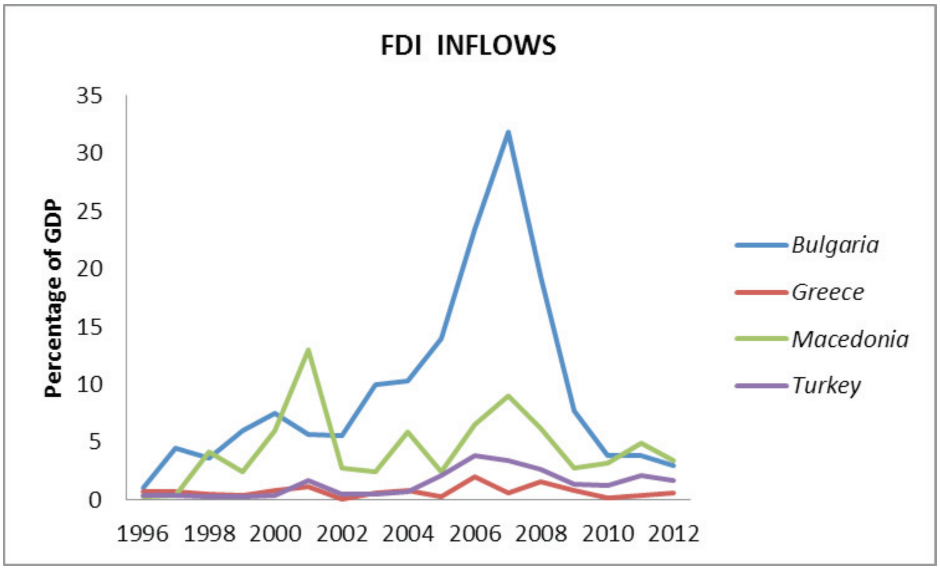

Fig. 1. FDI Flows to Bulgaria, Greece, Macedonia and Turkey.

It is seen that FDI as percentage of GDP is quite low in Greece and Turkey for all of the years starting from 1996 to 2012. FDI inflow in Bulgaria seems to increase starting from the year 1996. The percentage of FDI reached to %30 with a peak in 2007 when Bulgaria joined EU. After 2007, inward FDI decreased sharply in this country to the level %5. Though the percentage of FDI in Macedonia fluctuated for this time period, its average is again about %5. This figure also shows that though there are cycles of the inward FDI flows for the period 1996-2012, the current FDI as percentage of GDP is almost same for all of the countries in essence. The question here is that how these changes in inward FDI flows affect Greece, and its neighboring EU member and candidate countries. This paper addresses this issue by investigating this association using a relatively new method of panel causality approach. The rest of the paper is organized as follows. Section 2 briefly reviews the literature about the relation between financial development and FDI. Section 3 gives information about data and methodology. Section 4 presents the empirical results. Finally, Section 5 concludes the study.

2. A Brief Literature Review

Though there is strong intuition that FDI contribute to the development of financial system, empirical results are mixed. The following table is helpful to understand these mixed results in one shot.