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The effect of the euro on foreign direct investment

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Abstract

In this paper the recent effect of the European Monetary Union on inward FDI-flows is examined using a difference-in-differences approach. The estimated results show that the introduction of the euro raised inward FDI flows by approximately 16% within the euro area, by approximately 11% to non-members and weakly by around 8% from non-member countries into the euro area. Moreover, the geographical effects of the euro are explored. The results show partial agglomeration tendencies for the euro area. There are also some indications of increased importance of vertical specialization in the sample.
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1. Introduction

A large body of empirical literature on the effects of EMU on trade is now forming, following the seminal paper by Rose (2000). These include Bun and Klaasen (2002), Barr et al. (2003), Micco et al. (2003) and Flam and Nordström (2003). Their results show that EMU has increased trade volume by a magnitude ranging between 15% and 38%. Moreover, this increase in trade has not been confined to member states only, but has extended to non-member countries as well.

This paper will address an interrelated issue, namely whether EMU has had any effects on foreign direct investment (FDI) flows. FDI flows can be considered to be interrelated

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with trade since, at least at the theoretical level, such flows are often viewed either as a substitute for trade (*horizontal FDI*) or as a complement to trade (*vertical FDI*). In addition, it can give an indication of whether EMU creates better conditions for firms making long-term investment decisions. One argument against floating currencies is that higher exchange rate variability creates uncertainty that discourages international investment and trade. Fixing the exchange rate eliminates this risk, hence encouraging international investment and trade, as well as making firms cost calculations and pricing decisions easier. Adopting a single currency is a very credible commitment to exchange rate stability and has the advantage of reducing transaction costs that would otherwise occur, irrespective of the degree of volatility. Both effects should promote international investment, i.e. FDI flows.

In spite of the intuitive appeal of the argument that lower exchange rate volatility will increase FDI flows, empirical evidence regarding the effects of EMU on FDI flows, is currently absent.[1] The approach of this paper is novel since little or no research, to my knowledge, has been devoted to appraising the effects of EMU on *FDI flows*. From a broader perspective, the recent economic and policy debate, concerning the economic effects of EMU on its member states, has been based on an increasing body of empirical evidence and this paper is an attempt to investigate yet another of the aspects of EMU.

We use a new data set on FDI flows, a panel of unilateral FDI flows between 18 developed countries for the years 1992–2001. Since we are trying to uncover potential effects of an institutional reform, a difference-in-differences approach suitable for identifying such structural changes is used, to gauge the effects of EMU on inward FDI. The estimations are carried out within a partial equilibrium approach to FDI using a form of gravity regressions. The results of this study show that EMU increases inward FDI flows within the euro area by approximately 16%, inward FDI from member countries to non-members by approximately 11% and a weak increase in inward FDI from non-member countries to member countries of around 8%. These findings are robust to a number of measurement and specification issues.

The remainder of this paper is organized as follows. In Section 2 some stylized facts and basic concepts concerning FDI are presented. Section 3 discusses the data, and Section 4 considers the empirical methodology. Section 5 presents the main results, whereas Section 6 deals with the robustness of these results. Section 7 combines trade and FDI data in order to examine potential economic geography effects of the euro. Section 8 concludes the paper.

2. Basic concepts and stylized facts

An FDI is a cross-border investment made by an investor with the intent of obtaining a lasting interest in an enterprise resident in another country.[2] In principle, when a firm wishes to make sales abroad it has a variety of methods that can be employed, such as exporting, licensing, appointing agents or engaging in direct investment. FDIs are an equivalent to producing directly in the country one wishes to serve.

[1]A partial exception is Barr et al. (2003) that present some stylized facts concerning European FDI flows.

[2]According to Eurostat, who follow the OECD benchmark definition of FDI (third edition), an international investment is classed as FDI when an investor owns 10% or more of ordinary shares or voting rights in an incorporated or unincorporated enterprise abroad.

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