The Euro Effect on FDI: A New Estimation and Interpretation

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Abstract

This paper examines the euro effect on bilateral FDI flows in the euro area from 2000 to 2007. By joining the euro, member countries gave up the ability to conduct an independent monetary policy. Yet, it was presumed that euro-induced risk sharing would at least partially compensate for the loss of this important policy instrument. The expectation was that the euro would boost bilateral FDI flows, and thus increase cross-border ownership of assets. This paper, however, argues that risk sharing in the euro area is still disappointingly low. It therefore carries out a new estimation of the euro effect on bilateral FDI flows, employing an improved method of estimation and more recent data. It finds that for control groups highly similar to early euro members, estimates of the euro effect on FDI from 2000 to 2007 cannot be statistically distinguished from zero. For a larger and more heterogeneous control group, the euro effect is estimated to be associated with an increase in FDI flows from 2000 to 2007 of around 60%. The paper also contributes to the literature by examining the winners and losers of the estimated euro effect. It finds that to the degree the euro increased FDI, the induced inflows and outflows primarily took place between countries in the euro area periphery. This is in line with economic theory. The reduction in exchange rate risk associated with the euro should have primarily benefited investors in the periphery. Similarly, the associated reduction in transaction costs should have primarily induced investment that was attracted by the periphery's lower labour costs. In addition, the paper argues that differences in regulation, culture, and historical heritage help explain the disappointing effect of the euro on investment flows. As this paper finds the presumed risk sharing benefits of euro membership are weaker than expected, it urges policy makers to more actively stimulate cross-border ownership of assets.