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Role of Foreign Direct Investment Stock in Business cycle synchronization

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Abstract

The business cycle synchronization was widely discussed before the last economic crisis and now the interest in this topic revives. The majority of business cycle synchronization literature stresses the role of mutual trade and similarities among the economies, while the investment links are very often quite ignored or marginalized. The paper aims to estimate the role of continually increasing stock of foreign direct investment in synchronization of business cycles of Central European economies with business cycles of their most important trade partners. The extent of trade flows, industrial structure similarity and selected trade environment variables are used to extend the regression formula.
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Keywords: Business cycle synchronisation; foreign direct investment stock; foreign trade; product structure; transition countries; trade distance; panel data.

1. Introduction

Jeopardies and risks of a low nominal and real convergence and thus synchronization of economies has been discussed since 1960s. The writings of McKinnon (1963), Kenen (1969), Mundel (1961) pioneered the research of economic shocks impacts to countries under the partial loss of economic policy autonomy. The follow-up discussions resulted in criteria guaranteeing the absence of dangerous asymmetric shocks or minimization of their impact to involved economies. The following 1970s concentrated to analysis of positive and negative aspects of currency areas and to listing the requirement for optimal currency areas (Ishyama, 1975).

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After the faint progress in 1980s the synchronization effort and mainly convergence criteria obtain a quite new role. From a simple measures of current state the convergence they became the political indicators of willingness to deepen the unification of economies, restraint in economic policy and fix decision to keep the common rules in previously independent monetary policy (Bayiomi & Eichengreen, 1996, De Grauwe, 2014).

The detailed and representative evaluation of business cycle synchronization of 1990s could be found in Boone & Maurel (1998) or European Commission (2001). The famous discussion of that time between the European Commission and Krugman (1994) was about the impact of deepening integration. The European Commission supported the view of higher business cycle synchronization as a consequence of stronger integration (endogeneity hypothesis), while Krugman argued for drop in business cycles synchronization due to deeper specialization of individual economies after their integration. It then should result in more dissimilar structure of economies and thus to more asymmetric reaction to potential external shock (Krugman, 1994).

The external shocks spread through the so called channels that transmit the impulses from one economy to another. Thus we can speak about the international business cycle that is shared by the most interconnected economies. But this international business cycle is not perfect, the individual business cycles are not worldwide perfectly correlated. This is not only due to time lags, but mainly to differences in economies. No matter the differences, the economies with stronger economic tights and thus significant channel are more synchronized then others.

The most important channel for synchronization is foreign trade. Its positive influence on synchronization was described already by Frankel and & Rose (1998) and great number of other studies. For overview see e. g Baxter & Kouparitsas (2005). On the other hand some studies did not resulted in significant impact of mutual foreign trade. (Crosby, 2003, Inklaar & Jong & de Haan, 2008).

The second most important channel is the economic similarity. This channel follows the arguments of Krugman (1994) that the economic dissimilarity results in the higher asymmetry shock impacts and so in the lower level of business cycle synchronization (Imbs, 2004).

Next the financial integration of partner economies proved to be coincided with the business cycle synchronisation. The financial integration in the form of business financial linkages, mainly foreign direct investments or other joint ventures, increases the synchronisation (Imbs, 2004, Hsu & Wu & Yau, 2011). Other authors did not find enough evidence for this idea (Inklaar, 2008). Last the impacts of common economic policy were analysed. The role of unified or synchronised monetary, fiscal or exchange rate policies could be an additional strong channels for spreading the economic impulses (Schiavo, 2008, Jansen & Stokman, 2011).

The discussion and econometric tests of the role of foreign direct investment in business cycle synchronisation rank to the aims of this paper. The paper endeavours to profit from the combination of panel data approach and three stage method to test significance of foreign direct investment in business cycle synchronisation of selected former Central European transition economies to developed European economies.

1.1. Role of foreign direct investment

In previous decades the international trade was held for the most influential factor but its role is nowadays significantly changing. In last three decades there was substantial rise in mutual foreign direct investment mainly among the developed countries, while the rise in foreign trade flows is multiple times slower. Thus the share of foreign direct investment in international economic relations is rising step-by-step and substituting the classical foreign trade. The similar change could be supposed in reflections to business cycle synchronisation At least the role of foreign direct investment has to be added in explanatory models, it can be no more marginalised.

This is not only the result of administrative steps removing the barriers to free movement of capital among the economies, but chiefly of economic pressure to more and more competitive international business environment. The need to be closer to consumers, to serve them more accurately and flexibly is combined with the effort to minimise the cost of production. The decline in returns to scale from mass production with permanently rising share of transportation costs in total costs leads to lower variable cost of supplying through the foreign direct investment in comparison with the foreign trade.

The stock of foreign trade investment could influence the business cycle synchronisation of economic partners via several channels:

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