The Journal of Economic Asymmetries 12 (2015) 124–132

Contents lists available at ScienceDirect

The Journal of Economic Asymmetries

journal homepage: www.elsevier.com/locate/jeca

The impact of FDI on economic growth in Eurozone countries

Panagiotis Pegkas *

Department of Home Economics and Ecology, School of Environment, Geography and Applied Economics, Harokopio University of Athens, El. Venizelou 70, Kallithea 17671, Athens, Greece

ARTICLE INFO

Article history:
Received 22 February 2015
Received in revised form
15 April 2015
Accepted 18 May 2015

JEL classification:
C33
F21
O11
O40

Keywords:
Economic growth
FDI
Eurozone
Panel data

ABSTRACT

The purpose of the study is twofold: Firstly, to analyze the relationship between the foreign direct investments and economic growth and secondly, to estimate the effect of foreign direct investments on economic growth in the Eurozone countries over the period of 2002–2012. The paper employs panel data estimations to test the relationship between the variables. The empirical analysis reveals that there is a positive long-run cointegrating relationship between FDI stock and economic growth. By using the Fully Modified OLS (FMOLS) and Dynamic OLS (DOLS) methods the elasticity of GDP with respect to FDI is 0.054% and 0.147%, respectively. The results also indicate that the stock of foreign direct investment is a significant factor that positively affects economic growth in the Eurozone countries.

1. Introduction

Economic growth and its determinants have been a main focus in the past few decades especially in developing countries. Investment is the engine of economic growth and it may be either domestic or foreign direct investment (thereafter FDI). Either way it acts as the force of economic growth. More specifically, FDI inflows contribute to economic growth through an increase in productivity by providing new investment, better technologies and managerial skills to the host countries. FDI tends to be directed at those manufacturing sectors and key infrastructures that enjoy actual and potential comparative advantage. Findlay (1978) postulates that FDI increases the rate of technical progress in the host country through a knowledge diffusion effect often referred as externalities or efficiency spillovers, from the more advanced technology and management practices used by foreign firms. This effect of FDI on economic growth is dependent on the level of technological advance of a host economy, the economic stability, the state investment policy, the degree of openness and the amount of human capital.

Furthermore, among the variables of FDI and others determinants of economic growth like domestic investments, exports, human capital, research and development expenditures there are interactions and strong relationships. More specifically, FDI inflows can play a vital role in host countries due to the fact that it increases the supply of funds for domestic investments. FDI can have two potential effects on domestic investment by competing in product and financial markets.

* Fax: +30 210 9577 050.
E-mail address: ppegas@hua.gr

http://dx.doi.org/10.1016/j.jeca.2015.05.001
1703-4949/

Thus FDI can increase growth in two ways: (1) it increases total investment by attracting higher levels of domestic investment, (2) through interaction of the more advanced technology with the host's human capital, FDI is more productive than domestic investment (Ewe-Ghee, 2001). FDI not only boosts capital formation but also enhances the quality of capital stock (Ajayi, 2006). Furthermore, FDI inflows not only can increase the export capacity of the host country but also induces new job vacancies (Stamatiou & Dritsakis (2013)). FDI creates potential spillovers of knowledge to the local labor force while at the same time, the host country's level of human capital determines how much FDI it can attract and whether local firms are able to absorb the potential spillover benefits (Adefabi, 2011).

The motivation for this study came from the necessity to identify the relationship between economic growth and FDI in the Eurozone. Also, this study examines, if the Eurozone membership and the adoption of the euro of the countries which joined Eurozone after 2002 have any impact on economic growth of Eurozone. The results may have very interesting about the effect of the use of the euro as a common currency to FDI and economic growth in Eurozone. The overall results may improve the decisions of policymakers about FDI and its contribution to economic growth. These results have significant interest especially the last years, since the austerity was implemented in Europe. The restrictive economic policies in the Eurozone have as main aim the economic growth, by increasing the competitiveness, reducing the fiscal deficits and creating a secure economic environment in every country in the Eurozone. One of the purposes of these policies is to attract foreign direct investments.

The purpose of this study is to investigate the relationship between FDI and economic growth and to estimate the effect of FDI on growth of the Eurozone countries over the period 2002–2012.

The rest of the paper is organized as follows. Section 2 provides a brief description of the Eurozone economy over the examined period. Section 3 reviews the literature on the relationship between FDI and economic growth, including empirical studies. Section 4 presents the empirical analysis, discusses the methodology, explains sources and data and reports the empirical results based on econometric analysis. Section 5 presents the concluding remarks.

2. A brief reference to the Eurozone economy during the period 2002–2012

The roots of the Eurozone were first established in 1957 when the Treaty of Rome created the European Economic Community. Plans for a single currency were first agreed in the Maastricht Treaty in 1992. The first official Euro notes and coins were issued on January 1, 2002. Eurozone is a subset of those European Union member states that have fully incorporated the euro as their sole national currency. There are currently 18 such states: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain. Monetary policy for the Eurozone is under the authority of the European Central Bank.

According to Eurostat in Eurozone the average annual GDP growth rate over the period 2002–2012 was approximately 0.95% in real terms, but there were years of high growth and years of stagnation or recession. In particular, the growth rate of GDP was approximately 3.2% in 2006 and −4.5% in 2009. Furthermore, over this period, Slovakia (4.55%) and Latvia (4.16) have the highest GDP growth rate. Greece, Italy and Portugal have the lowest GDP growth rate with an average rate of −0.06%, 0.00% and 0.05% respectively.

The creation of the European Monetary Union, exchange rate stability, inflation stability, inflation stability, GDP growth are important factors behind FDI flows (Kilic, Bayar, & Arica (2014)). But, after the 2008 global financial crisis the inflows of FDI have significantly decreased. More specifically, in 2012 inflows of FDI to the Euro zone slumped −41% (after increasing +20% in 2011) but held above their 2008 low. This fall was caused by across-the-board investor wariness, in particular on the part of Europeans: FDI from Eurozone countries fell −77%. This can be explained by tensions linked to the risk of a Eurozone breakup, with the Greek exit risk (Boata, Islam, & Bouillet (2013)). The financial and industrial sectors will remain at the forefront among the major beneficiaries of FDI. Economists forecast that renewed FDI flows can be expected to aid the return to growth in some Eurozone countries.

3. Literature review

A large number of studies have been done in the field of FDI and economic growth. Some of the major studies are reviewed below.

De Gregorio (1992) found a positive effect of FDI on growth in his analysis of twelve Latin American countries for the period 1950–1985. Blomstrom, Lipsey and Zejan (1994) for a combination of 78 developing and 23 developed countries found that over the period 1960–1985 FDI has a significant positive influence on economic growth but the influence seems to be confined to higher – income developing countries. Borenzstein, De Gregorio and Lee (1998) for 69 developing countries over the period 1970–1989 found that while FDI is an important vehicle for the transfer of technology and positive contributor to economic growth, its impact is greater the higher the level of human capital in the host economy. Campos and Kinoshita (2002) examined the effects of FDI on growth for the period 1990–1998 for 25 Central and Eastern European and former Soviet Union transition economies. Their main results indicated that FDI had a significant positive effect on the economic growth of each selected country. Chowdhury and Mavrotas (2003) examined the casual relationship between FDI and economic growth for Chile, Malaysia and Thailand covering the period 1969–2000 and their empirical findings suggest