

The euro introduction was an important step towards closer political and economic integration. The euro exerts influence on many economic activities and the debate on the contribution of a common currency to economic development is vital. The formation of the European Monetary Union (EMU) has sparked academic interest in the analysis of the role of common currency and its impact on investment flows. Nevertheless, the results are ambiguous and the discussion about the magnitude of the impact is far from settled.

In our paper, we contribute to the mosaic of the impacts of a common currency on the economy by investigating one specific aspect of a common currency - the link between the introduction of the euro and the inflow of foreign direct investment (FDI). We ask two main research questions regarding the euro and FDI: first, has the common currency enhanced FDI flows for countries that adopted the euro as compared with the rest of OECD countries and, second, has the euro fostered capital reallocation for euro countries as compared with the rest of the EU? In addition, the impact of introducing the euro is compared with the impact of the EU membership. The main contribution of the paper is the adoption of rigorous methodology and the use of larger datasets from the latest wave of the euro area enlargement.

The identification strategy is based on propensity score matching technique. We argue that we can match otherwise similar districts, the only difference being the euro currency (we compare country-pairs sharing the euro with the ones which do not). Filtering out variation in FDI flows caused by variables such unit labor costs ratio, distance, common border, etc., the remaining difference in FDI flows presents the estimated impact of the euro.

We find that the common currency positively affects FDI flows within a group of relatively integrated markets. The euro increases FDI flows among the EU countries by 14.3 to 42.5 percent. When estimating the impact of the common currency on global FDI flows, we find only limited impact of the euro. For countries outside the EU, being the EU member shows to be a far more crucial factor in FDI boost as the effect on FDI flows lies in interval from 54.5 to 166.2 percent. This result is slightly contradictory to the existing literature on the FDI effect of the euro as most of the existing literature finds a positive and significant effect. One possible explanation of this discrepancy is a time-dimensional nature as previous studies suffer from a short time span. When we explore the time dimension of the euro impact on FDI finding that the euro impact is more pronounced in the first years after the launch of the euro currency (ranging from 23.7 to 54.1 percent), becoming negligible only in the longer run.

The quantification of the impact of the euro on FDI flows should become one of the factors under consideration of the EU countries that have not adopted the euro so far. Furthermore, it also indicates the advantage of a common currency for different regions or groups of countries, too.