

# PUBLIC FINANCES, BANK CREDIT, AND FOREIGN DIRECT INVESTMENT: EVIDENCE FROM EUROPEAN UNION COUNTRIES

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## Abstract

This study explores the macroeconomic and financial determinants of Foreign Direct Investment (FDI) inflows in the 27 European Union member states over the period 2005–2023. Using a dynamic panel specification, we assess the influence of domestic demand, fiscal stance, political stability, and credit conditions on FDI dynamics. The results indicate that lagged FDI, GDP growth, household consumption, and political stability significantly enhance FDI inflows, while inflation is not a significant driver. Public debt and fiscal deficits are associated with reduced FDI, pointing to the importance of macro-financial stability. Of particular interest is the role of bank credit, which shows a positive and marginally statistically significant effect on FDI. This finding suggests that improved access to domestic credit may lower entry costs, increase investor confidence, and facilitate integration into local value chains. The analysis underscores the complementary relationship between financial intermediation and foreign investment, providing empirical support for policies aimed at strengthening banking sector depth as part of FDI attraction strategies.

**Keywords:** foreign investment inflows, credit to private sector, fiscal policy, panel data econometrics, GMM estimation

**JEL Classification:** G21, H62, H63, C23, F21

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## 1. Introduction

Foreign direct investment (FDI) continues to be a key driver of economic growth, providing not only capital but also knowledge transfer, access to global markets, and productivity gains. For many countries, particularly within the European Union, attracting stable and long-term FDI is an essential part of development strategy. While

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classic factors such as tax rates, labor costs, and infrastructure still matter, there is a growing understanding that deeper institutional and financial variables shape investor decisions in more complex ways.

Among these, the strength and accessibility of the domestic banking sector is gaining attention. When local firms and foreign investors have access to credit, it becomes easier to finance operations, build partnerships, and expand activity. A stable and supportive financial system also sends important signals about the country's economic health and resilience. In this sense, credit conditions do more than just support the local economy; they may influence whether or not foreign capital decides to enter in the first place.

At the same time, public finance indicators remain crucial in shaping investor confidence. High fiscal deficits and growing public debt can raise concerns about macroeconomic risks, future tax burdens, and exchange rate stability. Even when other fundamentals are strong, weak fiscal positions can undermine credibility in the eyes of investors. The relationship between fiscal policy and FDI is therefore not simply a matter of numbers, but a reflection of how broader economic governance is perceived internationally.

Based on the existing literature and the theoretical foundations outlined earlier, this paper puts forward several working hypotheses. It is expected that greater availability of credit to the private sector contributes positively to foreign direct investment inflows across European Union countries. Conversely, higher fiscal deficits and elevated levels of public debt are anticipated to have a discouraging effect on FDI, as they may signal macroeconomic instability and reduced fiscal discipline. Political stability is assumed to enhance investor confidence, thereby exerting a positive influence on FDI dynamics. Furthermore, it is hypothesized that the effect of domestic credit on FDI may not be uniform across countries, but rather more pronounced in economies that already attract moderate to high levels of foreign investment, suggesting a heterogeneous relationship along the FDI distribution.

Based on an empirical analysis covering all 27 EU countries from 2005 to 2023, we find that larger fiscal deficits and higher levels of public debt are associated with lower FDI inflows. In contrast, the availability of bank credit to the private sector is positively related to FDI and reaches statistical significance at the ten percent level. These results suggest that even in the presence of fiscal challenges, strong

domestic credit markets may help mitigate risk perceptions and sustain investor interest. By improving access to finance, countries may enhance their attractiveness and capacity to absorb foreign capital more effectively.

This study contributes to the literature by exploring how financial sector development, particularly through bank credit, interacts with macro-fiscal conditions to shape FDI flows within the European Union. Unlike previous research that focused mainly on tax incentives or labor market reforms, this paper highlights the complementary role of financial intermediation in building a credible and investment-friendly environment. It offers new evidence on the importance of credit markets in supporting foreign investment and suggests a more integrated policy approach that considers both fiscal responsibility and financial sector depth as part of a broader strategy for attracting sustainable FDI.

What sets this paper apart from previous studies is its integrated approach to analysing both fiscal sustainability and financial sector development as joint determinants of FDI inflows within the European Union. While prior research has largely focused on the effects of tax incentives, labour costs, or institutional quality in isolation, this study explicitly examines how the availability of domestic credit interacts with macro-fiscal imbalances—such as public debt and deficits—to shape investor behaviour. In doing so, it contributes to the growing body of literature that emphasises financial intermediation as a key enabler of investment and provides new empirical evidence based on dynamic panel techniques and quantile regression analysis. By identifying the conditions under which bank credit may offset negative fiscal signals, this paper offers a more nuanced understanding of FDI drivers in post-crisis and post-pandemic Europe, with clear implications for integrated policy design.

## **2. Literature review**

Foreign Direct Investment (FDI) is widely recognized for its potential to enhance economic growth by contributing to capital formation, technology diffusion, and productivity gains (Borensztein et al., 1998; De Mello, 1997; Alfaro et al., 2010). However, empirical findings on the causality between FDI and growth remain inconclusive. A comprehensive meta-analysis by Iamsiraroj and Ulubaşoğlu (2015) found that only 43% of studies report a statistically significant positive

relationship. More recent panel analyses (Nupehewa et al., 2022) show regionally divergent results: bi-directional causality in Asia, uni-directional causality from growth to FDI in the Americas, and no clear direction in Europe and Africa.

The sustainability of public debt plays a critical role in shaping investor sentiment. Large and persistent budget deficits are often interpreted as signals of macroeconomic vulnerability, potentially deterring FDI. Onafowora and Owoye (2019) found that in Caribbean economies, high public debt had a significant negative impact on growth, while FDI had a generally positive impact. Their findings suggest that fiscal imbalances may crowd out private investment or undermine the credibility of macroeconomic policy, especially in small or open economies.

While fiscal deficits may discourage FDI through higher risk premiums, certain deficit-financed expenditures—such as infrastructure, education or tax incentives—can actually improve a country’s investment climate (Egert, 2015; Banday & Murugan, 2021). Governments may strategically run deficits to attract FDI, particularly in sectors with strong externalities. Nonetheless, the success of such strategies hinges on institutional quality and policy coherence. Studies confirm that the FDI-growth link is stronger in countries with sound institutions and transparent governance (Fabro & Aixalá, 2012; Li & Liu, 2005).

Recent studies highlight the relevance of sovereign solvency and financial cycles for FDI and bank credit interactions. Korzeb et al. (2023) show that host-country creditworthiness enhances foreign bank presence, while Rancan et al. (2023) reveals that elevated public debt constrains banks’ domestic funding. Zhou et al. (2024) underscore that credit booms significantly shape debt cycles, suggesting complex feedback effects. Palmén (2020) further finds that sovereign risk dampens private lending, a mechanism highly relevant for FDI financing in EU member states.

The COVID-19 pandemic, the war in Ukraine, and the rise of nationalist policies have reshaped global capital flows. UNCTAD (2021) reports that while global FDI rebounded after COVID, flows became more concentrated and risk-sensitive. According to Nupehewa et al. (2022), FDI volatility increased notably in regions affected by political instability or external shocks. This suggests that fiscal stability and predictable governance are now more critical than ever in retaining

and attracting investment. Countries with high debt and weak institutions face compounded risks of FDI flight.

Together, these studies underscore the importance of integrating fiscal policy dynamics into the analysis of FDI inflows. There is a growing need for research that explores threshold effects—identifying the point beyond which fiscal deficits cease to be simulative and begin to deter FDI. Moreover, the role of FDI in supporting fiscal consolidation (via increased tax revenues or GDP growth) remains under-explored. Future studies should build on the methodologies of Onafowora & Owoye (2019) and Nupehewa et al. (2022) to examine how different compositions of public expenditure and external shocks alter the FDI-deficit-growth triangle across various country groups.

Building on this body of research, the present study proposes that the relationship between fiscal conditions and FDI inflows is strongly influenced by the depth and functioning of the domestic financial system. More precisely, we argue that high levels of public debt and persistent budget deficits tend to discourage foreign investors by increasing perceptions of macroeconomic risk and reducing confidence in the long-term stability of the host economy. At the same time, a well-developed banking sector, reflected in the availability of credit to the private sector, can improve the overall investment climate by facilitating access to finance, supporting business expansion, and signalling institutional maturity. This paper investigates whether the presence of robust credit markets can mitigate the negative effects of fiscal imbalances on FDI inflows, and whether there are thresholds beyond which fiscal deterioration becomes a dominant deterrent to foreign investment, particularly in the European Union.

### **3. Data description**

This study is based on a balanced panel dataset comprising all 27 European Union member states over the period 2005 to 2023. The dependent variable is the level of foreign direct investment (FDI), measured as a percentage of GDP. This indicator captures the relative intensity of foreign capital inflows into each country and is widely used to assess international investment dynamics.

The model follows a dynamic specification by including the lagged value of FDI, which reflects persistence in investor behaviour and the cumulative nature of investment decisions. A range of macroeconomic and institutional control variables is included to

account for country-specific conditions that may influence FDI inflows. These include real GDP growth, which reflects overall economic performance; household consumption, as a proxy for domestic demand; inflation, capturing macroeconomic stability; the public debt, representing fiscal discipline and sustainability; and political stability, used to approximate institutional quality and predictability.

A central variable of interest is bank credit to the private sector, which serves as a proxy for the depth of financial intermediation in each country. This indicator is used to assess whether greater access to domestic credit facilitates the attraction and absorption of foreign investment. All variables are collected from TheGlobalEconomy.com, which provides harmonized and comparable economic indicators across countries and time. The dataset is balanced and spans nineteen years, ensuring consistency and robustness in the panel estimations.

Before proceeding with the estimation, it is essential to examine the stationarity properties of the panel data series used in the analysis. Non-stationary variables can lead to spurious regression results, compromising the validity of statistical inferences and potentially overstating relationships between variables. To ensure robustness, we apply the Levin, Lin, and Chu (LLC) panel unit root test, which assumes a common unit root process across cross-sections and is appropriate for balanced panel data such as ours. The results of the stationarity tests for all variables included in the model are summarised in Table 1.

**Table 1**

**Unit Root Tests**

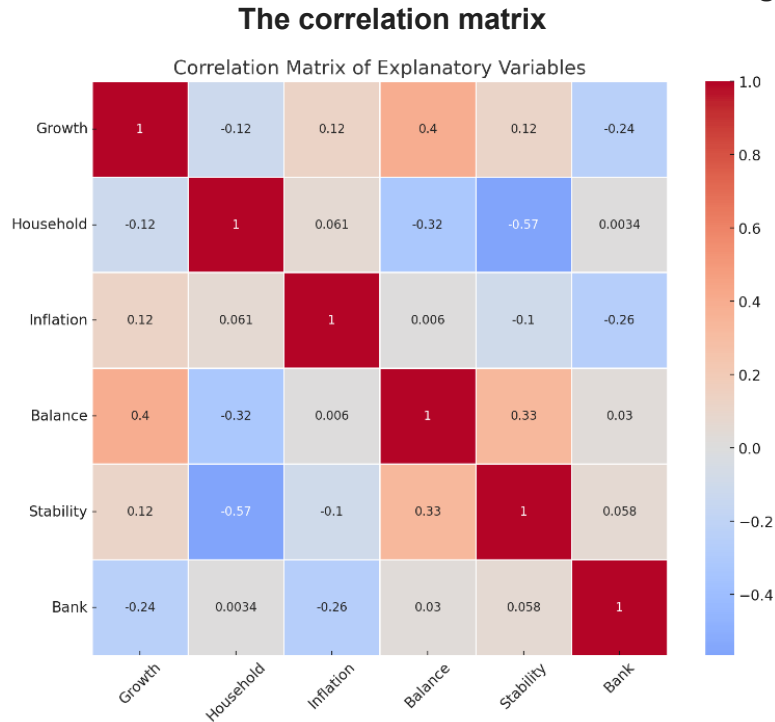
<b>Variable</b>	<b>Statistic</b>	<b>p-value</b>
FDI	-6.4305	0.0000
Growth	-11.9085	0.0000
Household	-2.3679	0.0000
Inflation	-3.0761	0.0010
Balance	-5.0148	0.0000
Stability	-2.9118	0.0018
Bank	-1.8442	0.0326

*Source: Author's*

The results of the Levin, Lin, and Chu panel unit root tests indicate that all variables are stationary at conventional significance

levels, thereby mitigating concerns about spurious regression and supporting the validity of the econometric estimates.

Figure 1



Source: Author's

Examining the correlation matrix among explanatory variables is a key diagnostic step to ensure the robustness of the regression model and to detect potential multicollinearity. As shown in Figure 1, the correlations between variables are generally low to moderate, indicating that the explanatory variables capture distinct economic dimensions and are not excessively overlapping. The relationship between household consumption and political stability appears to be inversely associated, suggesting potential structural differences in consumption patterns across countries with varying institutional environments. Economic growth tends to be positively related to fiscal balance, which is consistent with the notion that stronger economies often exhibit healthier public finances. Bank credit shows weak associations with most macroeconomic variables, reflecting its

independent contribution as a measure of financial depth. Overall, the correlation structure supports the inclusion of all selected variables in the model and reduces concerns about multicollinearity affecting the accuracy of the estimated coefficients.

#### **4. Results**

To investigate the determinants of foreign direct investment (FDI), we applied the System GMM estimator, which is particularly suitable for panel datasets with a moderate time dimension and a relatively small number of cross-sectional units. This approach addresses key econometric challenges such as unobserved heterogeneity, potential endogeneity of explanatory variables, and autocorrelation within country panels. Including the lagged value of FDI as a regressor captures the persistence of investment behaviour over time, which is in line with the literature on path-dependence in capital flows. Moreover, the use of internal instruments ensures more consistent estimates in the presence of potentially endogenous regressors like domestic credit, institutional stability, and macroeconomic indicators. Compared to traditional fixed-effects or pooled OLS approaches, System GMM offers a more robust framework for identifying causal patterns in dynamic investment processes. The estimation results are presented in Table 2.

A particularly novel contribution of this study lies in emphasizing the role of the domestic banking sector—measured through the availability of credit to the private sector—as a significant and robust driver of FDI inflows. While existing studies have largely focused on growth, trade openness, or fiscal variables as FDI determinants, relatively few have explicitly examined how financial intermediation conditions shape investor confidence. Our results show that credit to the private sector is strongly and positively associated with FDI inflows (coefficient = 0.6051;  $p < 0.01$ ), suggesting that domestic financial systems are not merely supporting players but central pillars of the investment climate. This finding introduces a new dimension to the FDI-growth-deficit framework and positions financial depth as a potential buffer against macroeconomic risk perceptions.

Beyond facilitating access to capital, a well-functioning credit market may also act as a proxy for broader institutional maturity. In economies where banks operate transparently and allocate credit efficiently, foreign investors are more likely to perceive reduced

operational risks and stronger enforcement of contracts. This interpretation is especially relevant in emerging markets or transitional economies where fiscal imbalances and political uncertainty can deter long-term investments. Our results support the view that a sound financial system can offset some of the negative signals sent by fiscal deficits or inflationary pressures. This mechanism helps explain why credit availability remains a statistically significant predictor of FDI, even when other macro-fiscal variables such as inflation or the current account balance are not.

**Table 2**

**System GMM results**

Variable	Coefficient	Std. Error	z	p-value
Lagged FDI	0.1352	0.0360	3.76	0.000
Growth	1.3901	0.5668	2.45	0.014
Household	1.9997	0.6031	3.32	0.001
Inflation	-0.2768	0.6624	-0.42	0.676
Balance	-0.3348	0.8749	-0.38	0.702
Stability	0.7031	0.1563	4.50	0.000
Bank	0.6051	0.0966	6.27	0.000

*Source: Author's*

Aside from banking credit, several other variables exhibit important effects. Both economic growth and household consumption have strong and significant positive impacts on FDI, consistent with the market-seeking motive of many investors. These results align with classical studies (e.g., Borensztein et al., 1998; Alfaro et al., 2004) that emphasise the role of host market size and demand potential in attracting foreign capital. Interestingly, inflation and fiscal balance were not found to be statistically significant, suggesting that short-term macroeconomic instability may carry less weight for investors than structural conditions or institutional quality. The significance of the “Stability” variable reinforces this interpretation—predictable legal and political environments remain critical for long-term investment decisions. Finally, the positive and significant coefficient on the lagged FDI variable confirms the presence of inertia and continuity in

investment flows, supporting the idea that once a country becomes an investment destination, it tends to remain attractive over time.

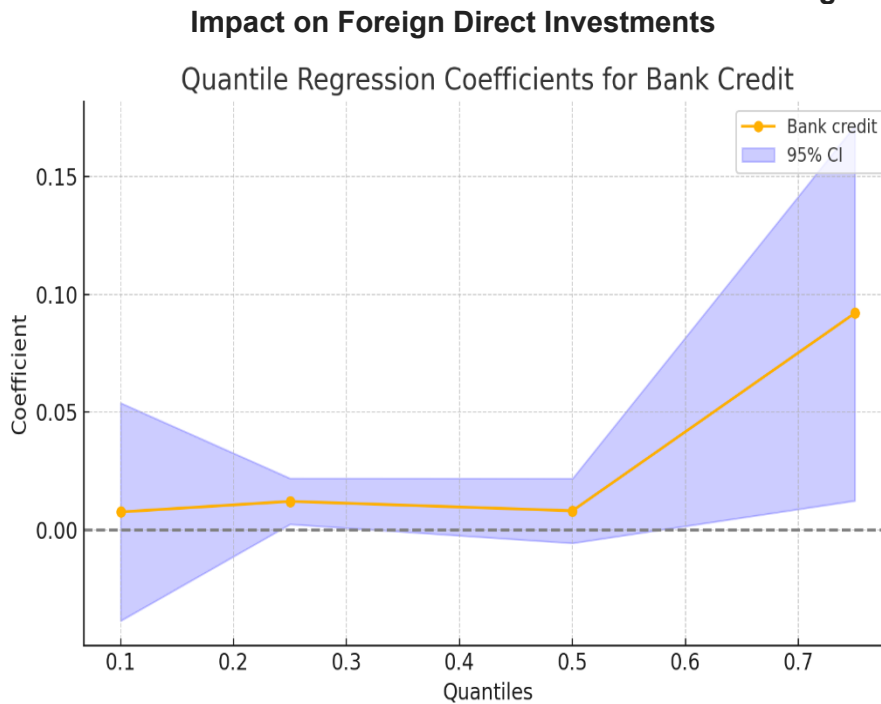
While average effects derived from linear or GMM estimations offer valuable insights, they may obscure significant heterogeneity across the distribution of FDI. Quantile regression allows us to examine whether the determinants of FDI—particularly access to domestic credit—vary between countries that attract low, median, or high levels of investment. This is especially relevant in the context of European economies, where structural and institutional differences produce widely dispersed FDI levels. By modelling conditional quantiles, we can uncover whether banking credit plays a more prominent role at higher levels of FDI, or whether its effect is only observable in low or moderate FDI environments.

The results presented in Figure 1, confirm the previous finding reported by the SYS GMM. The results from the quantile regression analysis provide important insights into the heterogeneous effect of bank credit across the FDI distribution. While traditional mean-based estimators assume a uniform relationship, our findings indicate that the influence of domestic credit availability varies depending on a country's position within the FDI distribution. Specifically, bank credit does not appear to significantly affect FDI in countries with very low investment levels, where structural weaknesses or institutional instability may override financial considerations. However, the effect becomes positive and statistically significant in the middle and upper parts of the distribution, implying that in economies with moderate to high FDI inflows, the depth and accessibility of credit markets play a more substantial role. This pattern suggests that banking sector development serves as a key enabler in converting macroeconomic potential into actual investment, particularly in settings where other investment fundamentals are already in place. The growing importance of bank credit at higher quantiles may also reflect investor confidence in the long-term financing environment, reinforcing the notion that financial infrastructure complements broader investment strategies.

These findings are broadly consistent with the existing literature, particularly the work of Alfaro et al. (2010), who emphasize that well-developed financial systems amplify the positive effects of foreign direct investment by improving resource allocation and enhancing investor confidence. Similarly, Borensztein et al. (1998) argue that the absorptive capacity of the host country—especially through financial market development—is a critical determinant of the

effectiveness of FDI. The positive and statistically significant impact of credit on the private sector in our model aligns with this perspective. In contrast, our finding that inflation and fiscal balance are not statistically significant stands in partial contradiction with Onafowora and Owoye (2019), who report a negative impact of inflation on FDI in the Caribbean region. This divergence may reflect structural differences between European and developing economies, particularly in terms of monetary credibility and investor expectations. Moreover, the importance of political stability in our model confirms the role of institutional quality highlighted by Fabro and Aixalá (2012), reinforcing the notion that FDI flows are sensitive to governance and legal predictability. Overall, our results support the view that financial intermediation and institutional conditions jointly shape the FDI environment, extending previous research by integrating both fiscal and credit-based determinants in a unified empirical framework.

Figure 1



Source: Author's

## **5. Conclusions**

The results of this study suggest that improving access to credit is not only a financial reform objective but also a strategic tool for attracting foreign direct investment (FDI) and supporting inclusive economic development. Given that the impact of bank credit on FDI becomes more pronounced in economies with moderate and high levels of investment, central banks could consider revisiting certain regulatory constraints that limit credit expansion—particularly those affecting sectors with strong externalities or investment spillovers. Targeted relaxation of credit-related policies, such as easing collateral requirements for productive investments or creating countercyclical lending schemes, could enhance the depth of the financial system and improve investor perceptions of long-term financial stability. In contexts where macroeconomic fundamentals are sound, such measures may amplify FDI inflows and reinforce a virtuous cycle of capital accumulation, productivity, and growth.

At the same time, governments have a key role to play in broadening the credit base by supporting small, and medium-sized enterprises (SMEs), particularly in structurally disadvantaged or underbanked regions. Many of these firms are excluded from traditional finance due to size, risk profile, or lack of formal records, yet they represent a critical foundation for local economic resilience and supply chain integration. Public credit guarantees, subsidized loan programs, or hybrid financing mechanisms—especially when tied to performance or formalization efforts—can reduce perceived risks and catalyze private lending. By embedding such strategies within a broader policy framework that emphasizes territorial cohesion, institutional trust, and sustainable development, governments can not only enhance the country’s attractiveness to FDI, but also ensure that its benefits are more evenly distributed across regions and social groups.

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