The Feldstein–Horioka Puzzle across EU Members: A Panel Approach

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Abstract: The degree of integration to the international capital markets is a crucial issue for the economic policy implementations in developing countries. A major determinant of the degree of international capital mobility is the saving-investment association. One of the biggest problems of developing countries is the insufficiency of savings for financing their investments that is crucial for economic growth. This gap is financed by foreign capital in today's global economies. It is generally believed that, the correlation between national savings and domestic investments becomes weak when there is high capital mobility between countries. The degree of capital mobility through the domestic saving-investment interaction is first analyzed by Feldstein and Horioka (1980).

Feldstein and Horioka (1980) used regression in the investment ratio against a constant and the saving ratio in a cross section of 16 industrialized countries, which are OECD members, over the period 1960-1974 and found that the coefficient on saving was in the range of 0.85-0.95. They interpreted this finding as indicating that 85-95 % of national savings was invested in the country of origin, which implied a rejection of perfect capital mobility. The basic conclusion of Feldstein and Horioka's analysis is that an increase in domestic saving has a substantial effect on the level of domestic investment. However, with perfect world capital mobility, there is little or no relation between the domestic investment in a country and the amount of savings generated in that country. This result was known in the literature as the Feldstein-Horioka Puzzle. Feldstein and Horioka (1980) argued that the relationship between domestic investment and domestic saving rates is related with the international capital mobility and thus caused the rise of a puzzle in the economic literature.

The purpose of this paper is to investigate the level of capital mobility in European Union members using the Feldstein–Horioka puzzle proposed by Feldstein and Horioka (1980) in order to investigate relations between saving and investment flows.

Keywords: Feldstein–Horioka puzzle, Saving-investment, Capital mobility, European Union, Panel