

A Heterogeneous Dynamic Panel Approach to The Feldstein-Horioka Puzzle: Evidence From the European Union Countries

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Abstract

The literature has paid a good deal of attention to the correlation between domestic saving and investment since the seminal study, “Domestic Saving and International Capital Flows” conducted by Martin Feldstein and Charles Horioka, published in *The Economic Journal* in 1980. The high correlation which they found between domestic savings and investment even when capital is perfectly mobile has been called Feldstein-Horioka puzzle since then. This study investigates whether the Feldstein and Horioka puzzle concerning domestic saving-investment relationship is supported by the data of the European Union (EU) countries when economic freedom is taken into account. The study uses a heterogeneous dynamic panel approach and Cross-Sectional Augmented Distributed Lag (CS-DL) which is robust to cross-sectional dependence is employed in the analysis. The findings of the study provide evidence in support of the Feldstein-Horioka puzzle and they reveal that even though the EU countries differ in terms of economic freedom the puzzle still holds.

Keywords: Feldstein-Horioka puzzle, Heterogeneous panel, Cross-Sectional Augmented Distributed Lag estimator (CS-DL), EU

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