ELSEVIER

International capital mobility in the long run and the short run: can we still learn from saving–investment data?

Mathias Hoffmann [*]

Department of Economics, University of Dortmund, D-44221 Dortmund, Germany

Abstract

The idea to learn about international capital mobility from saving and investment data remains appealing. Our approach is based on VAR methods and overcomes some of the problems associated with saving–investment regressions when the data are non-stationary. We propose a new measure of long-run capital mobility that can be easily calculated as a by-product of the estimation procedure of a cointegrated VAR. In an application to historical US and British data, we find long-run capital mobility to have been remarkably stable over the century whereas variations in the mobility of capital primarily seem to have affected short-run capital flows.
© 2003 Elsevier Ltd. All rights reserved.

1. Introduction

In a world with perfect capital mobility, a country can always run current account deficits if its desire to consume and invest cannot be funded domestically. This basic insight provided the motivation for the seminal paper by Feldstein and Horioka (1980) in which the authors found very high saving–investment correlations for a large cross-section of OECD countries. Their result has long been perceived as a puzzle and constitutes a challenge to the view that world capital

---
[*] Tel.: +49-231-755-3102; fax: +49-231-755-3069.
E-mail address: m.hoffmann@wiso.uni-dortmund.de (M. Hoffmann).

markets are well integrated. In the presence of perfect capital mobility, investment should go where it yields the highest real returns, whilst consumption should depend only on the permanent value of income, not on contemporaneous investment decisions.

Even though it has recently been questioned on theoretical and econometric grounds, the basic intuition behind the Feldstein–Horioka approach—that it is possible to make inference about international capital mobility (ICM) from saving and investment data alone—remains appealing.

In this paper, we propose a new approach to measuring capital mobility based on saving and investment data. Our approach overcomes some of the most important problems of simple saving–investment correlations. Not only does it take account of the fact that, under the assumptions of standard open-economy models, the two variables are likely to be cointegrated, but it also allows us to distinguish clearly between short-run and long-run capital mobility. The measure of short-run capital mobility is a suitably adjusted correlation, similar to the one suggested by Feldstein and Horioka, whereas the measure of long-run ICM is based on Johansen's (1988) procedure for estimating the cointegrating space. In an application of our method to historical US and British data, we find long-run capital mobility to have been remarkably stable over the century whereas variations in the mobility of capital seem primarily to have affected short-run capital flows.

Obstfeld and Taylor (2002) have argued that if capital mobility could be summarized in one single number, the time path of this measure would have described a U-shape over the course of the 20th century: a period of increasing capital mobility up to the beginning of world war I, then a period of low capital mobility in the interwar period, followed by a gradual recovery of capital mobility in the second half of the 20th century. Our formal results confirm this narrative evidence but they also show that countries' ability to smooth consumption over long time periods (i.e. long-run capital mobility) has varied less than their ability to implement short-run changes in domestic investment independently from changes in savings (i.e. short-run capital mobility).

It is not within the scope of this paper to attempt to survey the huge literature on the Feldstein–Horioka finding (for a recent survey see Coakley et al., 1998 or Obstfeld and Rogoff, 1995). But we will briefly sketch the theoretical and econometric developments that have led to an emerging consensus in the profession that simple saving–investment correlations are not very informative with respect to ICM. We will also survey how the empirical literature has responded to this challenge.

It is interesting to note that formal theoretical rationalizations and most empirical explorations of the saving–investment correlation aim at explaining the time series behaviour of the two variables, whereas the original study by Feldstein and Horioka (1980) emphasized the cross-sectional result. The present paper is in line with the bulk of the literature and confines analysis to the time series properties of saving and investment.

There are three challenges to the Feldstein–Horioka approach of measuring capital mobility that have proven to be particularly powerful, presumably because