

Present value tests of the current account with durables consumption

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Abstract

The present value tests of the intertemporal model of the current account usually assume that all goods are traded and that aggregate consumption decisions can be closely approximated by a random walk process. This paper extends these models by explicitly introducing durables and nontraded goods into an intertemporal model of the current account, and tests the model using Canadian data. Since aggregate consumption expenditures on durables do not exhibit random walk behavior even when the aggregate consumer has a quadratic utility function, the model that includes durables makes predictions that differ from those of the basic approach. When nontraded goods are also incorporated into the model, the most appropriate income variable becomes output net of nontraded production. These implications are examined using present value tests. The results suggest that, in the annual data, introduction of both durables and nontraded goods improves upon the model with (traded) nondurables only. This seems to be due to the combination of durables and nontraded goods, as durables alone do not sufficiently refine the basic model. © 2002 Elsevier Science Ltd. All rights reserved.

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1. Introduction

From an intertemporal viewpoint, the current account is simply a manifestation of the saving–consumption decisions at a national scale. It is therefore possible to think of a number of analogies between the current account behavior of individual

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countries and the consumption–saving behavior of individuals. For instance, according to a version of the permanent income hypothesis, saving is merely a response to the expected changes in the labor income earnings: an individual who anticipates a declining labor income adjusts current and future consumption by increasing current savings (Campbell, 1987). This understanding of saving for the “rainy day” is also instructive once the current account is interpreted as the saving of a country vis-à-vis the rest of the world. By analogy, therefore, movements in the current account should reflect the expected changes in domestic income, net of investment and government spending. This view of the current account also makes the prediction that there would be no change in current income when shocks to net output are expected to be permanent. In contrast, when shocks are temporary, the current account would respond by the amount equal to the expected change in net output appropriately discounted; i.e. only transitory disturbances would have an impact on the current account.

All these implications of the basic intertemporal approach seem to concur well with the conventional understanding of adjustment to disturbances in open economies, and they have formed the basis of many studies on the current account; see, for example, Sheffrin and Woo (1990), Otto (1992), Ghosh (1995), and Agénor et al. (1999). However, the empirical success of this intertemporal approach has been somewhat mixed. While there are a number of industrialized countries for which the intertemporal model appears to be doing a “reasonable” job at fitting the data, for many countries the results are discouraging.

Fig. 1 compares the actual Canadian current account series with those obtained from a model inspired by Campbell (1987), developed in a different context. From this standpoint, the basic intertemporal model of the Canadian current account either fails to closely track the actual series (annual data) or is biased (upward or downward in quarterly data depending on the real interest rate)—a conclusion also reached by Sheffrin and Woo (1990), Otto (1992), and Ghosh (1995) (see also Johnson, 1986).¹ Since most economists would view Canada as a quintessential small open economy, and since the current account tests of this variety are best suited for those small open economies which are relatively free of capital controls and have access to international capital markets, such evidence may call into question the relevance of an intertemporal approach to the current account.

However, one important aspect of the present value tests of this intertemporal current account model is their reliance on a rather special description of optimal consumption decisions. More specifically, existing present value tests of the current account adopt the view that the instantaneous utility function can be closely approximated by a quadratic function over traded nondurables, so that *aggregate* consumption follows a random walk process. For this reason, these tests are interpreted as joint tests of the degree of approximation for aggregate consumption behavior and the rational expectations hypothesis. Such an approximation may, however, be ques-

¹ Conclusions based on more formal tests, which are discussed later in the text, are consistent with the overall inadequacy of the model in matching certain properties of the model and data.

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