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# Testing present value models of the current account: a cautionary note

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## Abstract

Following Campbell and Shiller [J. Pol. Eco. 95 (1987) 1062], many papers have evaluated the intertemporal approach to the current account by testing restrictions on a Vector Autoregression (VAR). The attractiveness of the Campbell–Shiller methodology is that it is thought to be immune to omitted information. This paper shows that this is not always true. In particular, it is shown that if fundamentals are driven by unobserved (to the econometrician) permanent and transitory components, then the restrictions of a standard Present Value model of the current account might not be testable with a VAR. This is because the theoretical moving average representation can turn out to be non-invertible. This implies that observed data, including the current account, do not reveal the underlying shocks to agents' information sets.

The paper shows how researchers employing the Campbell–Shiller methodology can be tricked into thinking the current account responds excessively to shocks when in fact the data are consistent with the theory.

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## 1. Introduction

The intertemporal approach to the current account has improved our understanding of a wide range of issues in open-economy macroeconomics, including the effects of monetary and fiscal policies, the effects of terms of trade shocks, the effects of

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trade policies, and the degree of international capital mobility.<sup>1</sup> The basic idea behind the intertemporal approach is that a (small) country operating in a global capital market is like an individual operating in a domestic capital market. This analogy is extremely useful since it makes available all of the machinery that has been developed to study the Permanent Income Hypothesis of consumption. From this perspective, the key prediction of the intertemporal approach is that current accounts should respond to transitory shocks, but not to permanent shocks.<sup>2</sup>

Operationally, the predictions of the intertemporal approach rest on a number of auxiliary assumptions about asset market structure, demographics, and the decomposition of observed time series into various components. Most studies are quite explicit about their asset market and demographic assumptions. In keeping with the Permanent Income Hypothesis, it is usually assumed that international financial markets are incomplete, in the sense that bonds are tradeable but state-contingent claims are not. At the same time, domestic capital markets are usually assumed to be effectively complete, in the sense that a representative agent exists for each country. In addition, most studies assume these representative agents have infinite planning horizons, presumably due to an operative bequest motive.

While the existing literature is usually clear about its asset market and demographic assumptions, it is noticeably less clear about the way decompositions are handled. In fact, one could argue that along this dimension there has been a bit of technological regress. Early empirical studies of the intertemporal approach focused on a single expenditure category, and examined whether the current account responds only to its transitory component. For example, [Ahmed \(1986\)](#) studied the response of Britain's trade balance to government expenditures. Ahmed decomposed government expenditures into permanent and transitory components using a simple univariate linear de-trending procedure. He argued (persuasively) that for this particular case alternative decompositions are likely to produce similar results, since most of the variation in government expenditures were driven by the 'natural experiments' of wartime expenditure, which are widely perceived to be temporary.

More recently, however, empirical testing of the intertemporal approach has shifted to a methodology pioneered by [Campbell \(1987\)](#) and [Campbell and Shiller \(1987\)](#). Campbell and Shiller evaluate the predictions of Present Value models by testing the implied cross-equation restrictions on a Vector Autoregression (VAR). The attractiveness of their methodology rests on its perceived robustness to omitted information. That is, under certain conditions their tests are valid even when the econometrician has access to less information than individual firms and households. Clearly, in most applications this kind of robustness is important. The key insight of Campbell and Shiller is to note that the observed decisions of agents can be

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<sup>1</sup> [Obstfeld and Rogoff \(1995\)](#) survey the intertemporal approach to the current account, and provide an extensive bibliography.

<sup>2</sup> [Glick and Rogoff \(1995\)](#) emphasize another important distinction, i.e., between global and country-specific shocks. They show that under certain conditions, the current account should only respond to country-specific (transitory) shocks. Global shocks manifest themselves as changes in the world real interest rate.

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