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The present-value model of the current account has been rejected: Round up the usual suspects

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Abstract

Tests of the present-value model (PVM) of the current account are frequently rejected by data. Standard explanations rely on the “usual suspects” of non-separable preferences, fiscal policy and world real interest rate shocks, external imperfect international capital mobility, and an internalized risk premium. We confirm these rejections on post-war Canadian data, then investigate their source by calibrating and simulating alternative versions of a small open economy, real business cycle model (RBC). Bayesian Monte Carlo experiments reveal that a “canonical” RBC model is close to the data, but far from the PVM predictions. Although each suspect matters in some way, none improve the fit to the data. However, the PVM restrictions are reproduced when the internalized risk premium is introduced into the canonical model. By adding the exogenous world real interest rate shock to this version of the model, it matches the data better and is moved closer to the PVM predictions. This suggests that there is an important common world component to current account fluctuations, which points to additional underlying macroeconomic factors that drive the current account.

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1. Introduction

Current account fluctuations resist easy explanations. Large current account deficits have persisted in the U.S. through periods of large government budget deficits and surpluses, large and persistent real appreciations and depreciations of the dollar, and all phases of the business cycle. In Canada, the expansion of the 1980s coincided with large current account deficits, but an expansion in the 1990s witnessed current account surpluses.

Economists increasingly employ the intertemporal approach to study the current account. The intertemporal approach views the current account as a tool domestic residents use to smooth consumption by borrowing from or lending to the rest of the world. For example, if future income is expected to rise, say due to a technology shock, domestic agents try to smooth consumption by borrowing abroad prior to the high-income years, thereby running a current account deficit. As such, the intertemporal approach relies on permanent income fluctuations (driven by technology shocks) to explain current account movements. Compared to traditional Keynesian views, the intertemporal approach reduces emphasis on the economy's intratemporal competitiveness measured by the real exchange rate.

The intertemporal approach to the current account is encompassed by several classes of small open economy models. The most basic is the present-value model (PVM) of the current account. Sheffrin and Woo (1990), Otto (1992), Ghosh (1995), and Bergin and Sheffrin (2000) test the PVM and find it routinely rejected by the data.¹

Despite rejections of the PVM cross-equation restrictions, it is argued that abandoning the underlying scheme is unwarranted. Adherents point out that the (in-sample) current account forecast of the most unadorned PVM often closely tracks the actual current account (e.g., Obstfeld and Rogoff, 1996, pp. 92–94). Thus, the PVM, which is rejected, is seen in the literature as “useful” overall. Although appropriate, this conclusion is unsatisfactory because it fails to say which parts of the intertemporal model are most responsible for the poor empirical performance of the PVM.

This paper studies a set of “usual suspects”—factors other than technology shocks that theory teaches can matter for the current account—as potential sources of empirical rejections of the PVM. These factors are non-separable preferences, country-specific fiscal and world real interest rate shocks, imperfect international capital mobility, and an internalized risk premium. We place the suspects in a “canonical” small open economy-real business cycle (RBC) model that nests the PVM and serves as our benchmark intertemporal model of the current account.

Our “testing” strategy compares moments of synthetic data produced by the RBC model to those of actual data. Rather than focus on the usual variances and covariances, the “moments” we study are the cross-equation restrictions of the PVM. The actual data we use is from post-war Canada, a proto-type small open economy for which rejections of the

¹ Other authors, such as Ahmed (1986) and more recently Glick and Rogoff (1995), İşcan (2000), and Nason and Rogers (2002), test a variety of implications of the intertemporal approach and present evidence that favors some aspects of it.

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