

An Absorption Approach to Modeling the US Current Account

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Abstract

This paper derives and estimates a current account model based on the absorption approach (which views the current account balance as the difference between domestic saving and investment). This approach provides a framework which allows drivers of cross-border financial flows and other determinants of saving and investment to be included in a current account model, an advantage not offered by the elasticity approach (which views the current account balance as the sum of net exports, net investment income, and net unilateral transfer). We estimate and compare vector error-correction models of the absorption and elasticity approaches, with the absorption model nesting the elasticity model. We find that (1) the restrictions imposed by the elasticity model are rejected; and (2) the mean-squared prediction errors of the absorption model are significantly smaller than those of the elasticity model.

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