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Revisiting the current account sustainability for the G-7countries: The role of structural break and nonlinearity

Shyh-Wei Chen[a]

a. Department of International Business, Tunghai University

Abstract: We reexamine the current account sustainability for seven developed countries by taking account of different types of non-linearities in this study. For this purpose, we adopt a battery of well-known nonlinear unit root tests in the literature. Our results show that the structural break nonlinearity and size nonlinearity are critical to the current account-GDP ratios of Canada, France, Italy, Japan, the UK and the US in testing the null hypothesis of a unit root. Nevertheless, the current account-GDP ratios of the G-7 countries do not exhibit the sign nonlinearity. That is, by taking the nonlinear trend into consideration, the threshold autoregressive and momentum threshold autoregressive models do not detect any asymmetry in the response of the external debt imbalance to deviations from its long run nonlinear trend. The current account-GDP ratio of Germany is the only one that does not have any type of nonlinearity.

Key words: Current account; sustainability; unit root; non-linearity; structural break

JEL: F32, C22

1. Introduction

Economists have shown considerable interest in the issue of current account sustainability, which argues that if it holds, then an economy is able to meet its intertemporal budget constraint in the long run without a drastic change in private-sector behavior or policy changes. Generally speaking, when a country runs large and persistent current account deficits for a number of years, and the deficits are financed with short-term