

Editor's report on:

"Should we trust the empirical evidence from present value models of the current account?"

First, I should mention that I think this type of evaluation papers are valuable and highly needed. When this is said there is a number of problems with the paper, most of them pointed out by the referees. I will summarize what should be done to the paper before it can become a serious input in the Current Account debate.

The literature has tested the present value model of the CA using Wald and F tests. These are based on well understood statistical theory, implying that the test procedures are valid given that the underlying assumptions are satisfied. Thus, the validity of these assumptions should be carefully checked before using the tests. Admittedly, this is often not done in the literature suggesting that reported significance levels may have no meaning. To point this out is a major purpose of this paper. One problem of this paper is that it also to some extent relies on assumptions rather than empirical testing. I suggest the following major points:

1. State *all* assumptions underlying the Wald test (stationarity, iid residuals, etc.) and check the data for these conditions based on the assumed VAR model. For example, the characteristic roots of the model are informative on the dynamic properties of the model and the data.
2. State the properties of the data if the CA present value model is correct (stationarity, equality of mean values, the current account contain all relevant information to form expectations of future ΔY , etc. (The latter assumption could easily be checked by adding other variables to the VAR.)
3. Discuss whether there seems to be a correspondence between 1. and 2. Since this is obviously not the case show what happens when one closes the eyes, assumes that the assumptions are valid and does the testing.
4. Wald tests may (or may not) have bad small sample properties. However, showing this should be based on models where the assumptions hold. For example, as referee 2 points out, if you analyze ΔY_t when it measure *absolute* income changes over a period of growing real income, then absolute income will grow exponentially, whereas relative (%) changes might very well be stationary. That this is the case can be seen from the graphs that almost without exception show that ΔY_t tend to increase in absolute value over time. In case previous studies have not acknowledged this simple fact, then the present paper has an important point to make: Wald or F tests of such CA models may have no meaning. However, whether this is the case or not has to be carefully checked. In case previous studies have avoided this problem by dividing ΔY_t and CA_t by Y_t to achieve relative changes

instead of absolute ones, then the simulations of the present version do not make sense and should be redone for the case of relative changes. Though I am not familiar with this literature, I find it hard to believe that this problem has not been recognized before. Let me add that I would expect pronounced persistence in the model even for the case of relative changes.

Additional points to be accounted for:

1. The notation has to be made clearer as pointed out by both referees: You cannot use CA for the current account at the same time as you call coefficient matrices for C and A ! It is completely confusing for the reader. Also the conventional notation is that T stands for the sample length, K often for lag length or the number of regressors. Reversing the notation gives an impression of lack of professionalism.
2. I found the treatment of the means very confusing at several places (also pointed out by referee 1). They are *assumed* (but not checked) to be the same for ΔY_t and CA_t , they are subtracted in some cases, but not when calculating R . I suggest again that you first check the assumptions, then discuss what the consequences would be if one proceed as if the assumptions are correct.
3. I suggest that the paper refers to the theoretical results by Elliot as mentioned by referee 1.
4. The simulation study should be explained in more detail as pointed out by referee 1.
5. Generally account for any outstanding issues pointed out by the referees.

As appears there are quite a number of issues that need to be adequately explained and clarified. Acceptance of the paper as a journal article is conditional on successfully accounting for these issues. I realize that this may take some time. However, I believe that some other papers of the special issue will also need more time to be revised and accepted. Would you be able to produce a revised version before October 15th.