

ARE SMALL-SCALE SVARS USEFUL FOR BUSINESS CYCLE ANALYSIS? REVISITING NON-FUNDAMENTALNESS

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Abstract

Non-fundamentalness arises when current and past values of the observables do not contain enough information to recover SVAR disturbances. Using Granger causality tests, the literature suggested that several small scale SVAR models are non-fundamental and thus not necessarily useful for business cycle analysis. We show that causality tests are problematic when SVAR variables cross sectionally aggregate the variables of the underlying economy or proxy for non-observables. We provide an alternative testing procedure, illustrate its properties with Monte Carlo simulations, and re-examine a prototypical small scale SVAR model. (JEL: C5, C32, E5)

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