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At the Crossroad: Twin Deficits in the Asian Crisis-affected Countries

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Abstract

Casual observation suggests that the twin deficit hypothesis accurately captures the US experience in the 1980s and the first few years of the new century, the twin deficits are back (Frankel, 2006). With this development, this paper analyzes the two deficits in the Asian crisis-affected countries (Asian-5: Indonesia, Korea, Malaysia, the Philippines and Thailand). Empirical results suggest that the Keynesian view fits well for Malaysia, the Philippines (pre-crisis) and Thailand. For Indonesia and Korea the causality runs in an opposite direction while the empirical results indicate that a bi-directional pattern of causality exists for the Philippines in the post-crisis era. From these results, we have demonstrates that the twin deficit phenomenon is not universally accepted and appears to be country specific. As these countries are on the crossroad in the aftermath of the 1997 crisis, managing these deficits are indeed important policy option in promoting the macroeconomic stability and sustainability in the region.

Keywords: Twin deficits, cointegration, variance decomposition, Asian-5.
JEL classification: F30, H60, H62

INTRODUCTION

The consensus of the 'twin deficits' across an array of countries has been the concern of policymakers and economists. This is due to the fact that in order to maintain the macroeconomic stability and sustained economic growth, the current account deficit (CAD) and budget deficit (BD) must be kept under control. Despite its increased recognition, however, this important prerequisite is often difficult to achieve by both developing and developed countries[1]. Recently, there has been a revival of interest in the twin-deficit hypothesis to the forefront of the policy debate especially for the US economy (see for example, Frankel, 2004; Obstfeld and Rogoff, 2005; Bartolini and Lahiri, 2006; Coughlin *et al*., 2006)[2]. Their linkage has been the subject of analysis largely due to its important implications on a nation's long-term economic progress.

A look into the literature of the 'twin deficits' arrived with two schools of thought: Keynesian and Ricardian Propositions. However, as pointed out by Darrat (1988) and Abell (1990) these are not the

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[1] The interest arise from three important developments in the global economy: (1) the appreciation of the dollar and an unusual shift in current account as well as fiscal deficits, not in favor of the US in the 1980s; (2) countries in Europe (e.g. Germany and Sweden) faced problems in the early part of the 1990s where the rise in budget deficits was accompanied by a real appreciation of their national currencies that adversely affected the current accounts (see Ibrahim and Kumah, 1996). The fiscal expansion following the unification of Germany moved the DM and interest rate upwards has also raised a lively debate on the twin deficit issue and; (3) in East Asia, most of the regional currencies lost value on the eve of the 1997 financial crisis. Most of these countries (ASEAN in particular) experienced large and persistent current account deficit. In fact, Milesi-Ferretti and Razin (1996) pointed out that the fiscal expansion (budget deficit) contributed to the deterioration of the external balance in most of the ASEAN countries.

[2] A series of papers in the special issue of Journal of Policy Modeling (Vol. 28 No.6, pp. 603-712, 2006) are dedicated to the debate on "Twin deficits, growth and stability of the US economy". The interest arose due to the recent declines in the US current account and fiscal balances and the impact to the world economic instability.