TWIN DEFICITS HYPOTHESIS IN SEACEN COUNTRIES: A PANEL DATA ANALYSIS OF RELATIONSHIPS BETWEEN PUBLIC BUDGET AND CURRENT ACCOUNT DEFICITS

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Abstract
In this paper, the twin deficits hypothesis was examined using the panel data of nine SEACEN countries. Empirical results provide evidence to support the view that Asian budget deficit causes current account deficit directly as well as indirectly. From policy perspectives, the statistical analysis suggests that managing budget deficit offers scope for improvement in the current account deficit. However, this finding does not support the policy of manipulating the intermediate variables to reduce the twin deficits to a sustainable level since these variables appear to be endogenous in the system.

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1. Introduction

Most observers consider large and persistent current account deficits to be the cause of macroeconomic imbalances that have important implications on long-term economic progress. Numerous researchers have explored the possible long-run (positive) link between budget and current account deficits. The so-called 'twin deficits hypothesis' that emerged in the 1980s marked a period of strong appreciation of the dollar and an unusual shift in current account as well as fiscal deficits, not in favor of the US. This close connection between current and budget deficits is not unique to the US. Countries in Europe (e.g. Germany and Sweden) faced similar 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). Developing economies have also experienced the simultaneous upsurge of budget and current account deficits (Laney, 1984; Anoruo and Ramchander, 1998 and Khalid and Teo, 1999). In fact, writers like Laney (1984) noted that the unsustainable budget (debts) in the early 1980s had widened the current account deficits and went on to say that the relationship between these two variables is much stronger in the developing countries.[1]

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[1] For instance, Latin America countries (Mexico, Brazil, Venezuela and Argentina) went through an international debt crisis. The high debts obligation was due to the oil price shocks of the 1970s leading to inflationary import prices, which in turn led to serious balance of payments problems.

The emergence of the current account and budget deficits phenomenon in many of the countries has drawn increasing attention to the problem of twin deficits.

A review of the literature in the last two decades suggests the following: first, it highlights the importance of financial variables such as interest rate and exchange rate in the budget-current account deficit nexus. Most of the earlier studies have ignored the role of these two financial variables in bridging the link between the two deficits. Second, unlike the debt crises of the 1980s that was driven by a budget deficit, the 1994 Mexican and the 1997-98 East Asian crises were due to imbalances in the current account. Third, the body of evidence has not yielded a consensus on the causal relationship between the two deficits. In our view this is important, as it will determine the source of the problem and provide the right policy mix to address the issue of external imbalances in the developing countries. Motivated by the work of McCoskey and Kao (1999) and the emergence of the twin deficits phenomenon in many countries in the last decade, this paper first attempts to provide an in-depth analysis of the twin deficits for a panel of South East Asian Central Banks countries (SEACEN: Malaysia, Singapore, Thailand, Indonesia, South Korea, Myanmar, Nepal, Sri Lanka and the Philippines). The second objective of this paper is to trace the causality pattern through which fiscal budget affects current account deficit.

The plan of the paper is as follows. Section 2 describes the theoretical paradigms and the relevant literature in the research area. Section 3 briefly discussed the panel-based testing procedure and the data utilized. The empirical results are reported in Section 4. Finally, Section 5 contains concluding remarks and policy stance.

2. Theory and Previous Empirical Debate

The theoretical explanation for the twin deficits hypothesis is based on the well-known Mundell-Fleming framework. According to this model, an increase in budget deficit induces upward pressure on interest rates that in turn trigger capital inflows and appreciation of the exchange rate. Ultimately, the appreciation of the domestic currency will lead to an increase in current account deficit. Private saving remains the same as the public perceived the government bond issue to finance deficit as increasing their wealth. The response of domestic investment and current account deficit to a large extent depends on capital mobility. In the case when capital is highly mobile, domestic interest rate is unresponsive (inelastic) to fiscal shock. Hence, there no crowding-out effect on domestic investment as foreign capital will quickly offset the fall in domestic investment. Capital inflow in turn puts upward pressure on exchange rate through either a rising nominal exchange rate in the case of a fixed exchange rate regime or rising prices under a flexible exchange rate system. Therefore, the conventional Mundell-Fleming model predicts a positive relationship between the two deficits.

Beside the Mundell-Fleming framework, there is the Keynesian absorption theory that links the two deficits. According to the absorption theory, an increase in budget deficit would increase domestic absorption and hence imports, and the expansion of imports leads to the worsening of the current account deficit. Hence, like the Mundell-Fleming model, the Keynesian suggests that the causal relationship between the two variable runs from budget deficit to current account deficit and not the other way round.