Department of Economics

Issn 1441-5429

Discussion paper 11/09

Twin deficits in Cambodia: Are there Reasons for Concern? An Empirical Study

Evan Lau* and Tuck Cheong Tang†

Abstract:
This study examines the inter-linkages between Government budget balance, and external balance for a transition economy in South East Asia – Cambodia. The empirical results of the quarterly data between 1996 and 2006, support twin deficits hypothesis that is the budget deficits do cause external deficits, in the short run. These two macroeconomics variables are moving together in the long run. For implication, these findings provide an insight for the Cambodia's policy design and formulation.

Key words: Budget Deficits; Cambodia; Current Account Deficit; Unit Root Tests

JEL classifications: F32; H62

* Universiti Malaysia Sarawak (UNIMAS)

† Corresponding author. *Monash University Sunway campus* Email: tang.tuck.cheong@buseco.monash.edu.my

1. Introduction

In attempt to study the current account imbalances numerous researchers had theoretically and empirically explored the possible linkages between government budget deficit (BD) and current account deficit (CAD). Generally speaking, the ‘twin deficits hypothesis’ arose during the “Reagan fiscal experiment” in the 1980s, marked a period of strong appreciation of the dollar with unusual shift hike in current account deficits. In Europe, Germany and Sweden faced similar problems emerged in the early part of the 1990s where the rise in the country’s Government budget deficit was accompanied by real appreciation of their national currencies which adversely affect the current accounts position (see Ibrahim and Kumah, 1996). By and large, it is not an exception for developing countries as most have also experienced problem with their current account balances in early 1980s[‡]. Several observations have confirmed that the unsustainable budget deficit during these periods has widens the external account deficits (i.e. trade account balances and current account balances).

Despite been an age-old issue, there has been a revival of interest in the twin-deficit phenomenon into the forefront of the policy debate especially for the US economy in the new millennium (see Bartolini and Lahiri, 2006; Coughlin *et al*., 2006). Also, 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. Definitely, the twin deficits issue presented here is found to be relevant for other countries, especially a transition economy.

Insert Table 1 about here

Thus, the objective of this study is to provide an empirical literature on the application of twin deficits hypotheses for a transition economy in South- East Asia, namely Cambodia.

[‡] The widening of CAD in a number of the Association of Southeast Asian Nations (ASEAN) countries (Indonesia, Malaysia, the Philippines and Thailand) over the past decades has generated policy concerns (Baharumshah *et al*., 2006; Baharumshah and Lau, 2007). Authors like Edwards (2001) and Obstefeld and Rogoff (2004) address the twin deficits issue from the point of view of macroeconomic stability of the country. They underlined that the negative implications of a combination of adverse factors (e.g. twin deficits, high interest rates and exchange rate depreciation) would increase the vulnerability of a country and that the fiscal instruments are crucial for sound macroeconomic policy for transition and developing countries. Therefore, twin deficits should be avoided.