

Revival of the Twin Deficits in Asian Crisis-affected Countries

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ABSTRACT

This paper revisits the twin deficits argument in the Asian crisis-affected countries. We also include data from the 1997 crisis to examine the disparities in the empirical regularities governing the two deficits in these countries. Empirical results suggest that causality runs from budget deficit to current account deficit for Malaysia, the Philippines (pre-crisis) and Thailand, which fits well with the Keynesian view. For Indonesia and Korea the causality runs in the opposite direction while a bi-directional causality exists for the Philippines in the post-crisis era. As these countries are at a crossroad in the aftermath of the 1997 crisis, managing these deficits are indeed important policy options in promoting macroeconomic stability and sustainability in the region.

1. INTRODUCTION

OVER THE YEARS, researchers have explored the link between the budget deficit (BD) and current account deficit (CAD)². This is due to the fact that in order to maintain macroeconomic stability and sustained economic growth, CAD and BD must be kept under control. Developing countries are no exception, where several authors have documented that an unsustainable BD widens the CAD. Indeed, authors like Laney (1984) found that the relationship between these two variables is much stronger for developing countries.

Despite been an age-old issue, there has been a revival of interest in the 'twin deficits' phenomenon at the forefront of the policy debate, especially for the US economy in the new millennium (see for example, Obstfeld and Rogoff, 2005; Bartolini and Lahiri, 2006; Coughlin *et al.*, 2006; Frankel, 2006).³ Eichengreen (2006) for instance, indicates that the growth of the US current

account deficit was unsustainable and that the situation would interrupt capital inflows, leading to a sharp compression of the US current account and eventually worldwide imbalances. Makin and Narayan (2008) argued that the rise of the CAD in the US is strongly coincident with saving rates in East Asia, especially in the post 1997 period. Despite that, most analysts have suggested that the resolution to global imbalances is through the reduction of the CAD in the US. This would imply a decline in the rest of the world's collective current account surpluses. It further raises the issue of fragility in the global economy, especially in the emerging market economies of Asia (which consist of a vast accumulation of foreign reserves and high saving rates) which, worse still, a sudden halt in the presence of large CAD could collectively end up in a crash (Calvo and Talvi, 2006).

Obstfeld and Rogoff (2004), Blanchard *et al.*, (2005) and Mendoza *et al.*, (2007) raise the concern that unless major policy action is taken, the imbalances will generate global financial turbulence and possibly, a world economic crisis. As the worry about the risk of a disorderly unwinding of global imbalances arises in academic and policy circles, the current crisis can be viewed as the outcome of these episodes. With this motivation, we undertake an empirical study for five crisis-affected Asian countries (Indonesia, Korea, Malaysia, the Philippines and Thailand: Asian-5) to obtain further evidence on the twin deficits debate. Looking at the empirical work in the Asian context (see for example, Anoruo and Ramchander, 1998; Khalid and Teo, 1999; Kouassi *et al.*, 2004; Lau and Baharumshah, 2006; Baharumshah *et al.*, 2006; Baharumshah and Lau, 2007) they failed to establish consensus causality results. Therefore, it is of paramount importance for this study to reaffirm the causal relationship between BD and CAD. This paper also tentatively extends this line of research by examining a cluster of Asian-5 crisis-affected economies. Looking back at historical data, these countries recorded huge CAD and BD for most of 1990s. Interestingly, post 1997 crisis, the deficits amounted to about 4 percent and are recorded in BD. As we are in the midst of recession, the dynamic movement of the BD and CAD would be a concern for policymakers worldwide. Importantly, with the bailout incentives going on worldwide aimed at stimulating the economy (as has been adopted by most Asian countries since 1997), this would generate an additional impact on government budgets. In particular, the question of concern is: will the fiscal stimulus package introduced in these Asian countries lead to a further deterioration in the external balance? Therefore, the understanding of the interaction effects *between* BD and CAD is essential for establishing a proper macroeconomic policy implementation plan.

Besides answering this policy question, we are also interested in ascertaining the causal direction between CAD and BD. This may provide useful insights into how these economies are able to manage the deficits in the future. To accomplish the objective, rigorous systematic statistical tests of integration, cointegration and causality are offered in the present work. In this

manner, we are able to ascertain the robustness of our empirical findings in relation to the link between these deficits. This paper also splits the sample period into two non overlapping sub-samples of pre and post-crisis (a unique approach not taken in the aforementioned literature) to investigate any disparities among the empirical regularities obtained. Therefore, the choice of the countries in this study is not without considerable merit.

This paper proceeds as follows. Section 2 describes the simple theoretical framework of national accounting for analysing the causal relationship of the twin deficits. This is followed by the empirical approach and data description adopted in the paper. Section 4 reports the empirical findings, while concluding remarks and further implications for empirical research is presented in Section 5 of the paper.

2. THE TWIN DEFICITS IN NATIONAL ACCOUNTS

A wide range of models has emerged in the literature but, in most cases, the analytical results suggest the fiscal deficit is likely to lead to a worsening of the current account. The national account identity provides the basis of the relationship between the two deficits. The model starts with the national income identity for an open economy that can be represented as:

$$Y = C + I + G + X - M \quad (1)$$

where Y = gross domestic product (GDP), C = consumption, I = investment, G = government spending, X = exports and M = imports. Defining current account (CA) as the difference between export (X) and import (M), Equation (2) becomes:

$$CA = Y - (C + I + G) \quad (2)$$

where $(C + I + G)$ are the spending of domestic residents (domestic absorption). In a closed economy, saving equals investment: $S = I$. This relationship means the external account has to equal the difference between national savings and investment. It implies the current account is closely related to the decisions of savings and investments in an economy. In an open economy, total savings (S) equal domestic investment (I) plus the current account CA , that is

$$S = I + CA \quad (3)$$

Equation (3) states that unlike a closed economy, an open economy can seek domestically and internationally for the necessary funds for investments to enhance its income. In other words, external borrowing allows investment at levels beyond those that could be financed through domestic savings.