Twin deficit relationship in a developing open economy

5. 1 Summary.

This study investigates the twin deficit relationship in a developing open economy like India. The study strives to demonstrate that Keynesian proposition of a long run equilibrium relationship exists between the twin deficits, but the reversed direction of causality was found. That is the causality flows from current account deficit to budget deficit as against from budget deficit to the current account deficit. This study reveals that the twin deficit have a positive long run relationship between the budget deficit and current account deficit using the Johansen multivariate co-integration approach. The result confirms the existence of a long run relationship between the two deficits, thus supporting the Mundell-Fleming theory and refuting the Ricardian Equivalence Hypothesis (REH).

The term " twin deficit" was initially invented to describe the co-movement between the budget deficit and the current account deficit in the United States (Chang and Hsu, 2009). Afterwards, researchers began applying it to other countries. Ever since, it has become an important area for researchers to examine the causal link between the two deficits and the direction of causality. The coincident of budget deficit and the current account deficits for most countries most especially in the United States (US) during the mid-1980s led to the characterization of this phenomenon as the " twin deficits" issue as both economic theory and empirical observation suggested a link between the two deficits.

The main thrust of the twin deficit hypothesis is that current account deficits of most countries is caused by government's budget deficits phenomenon

and the most suitable way to solve this problem and stabilize internal and external deficits is reducing the government’s budget deficit. In other words, the direction of causality flows from the budget deficit to current account deficit.

Two major theories used to explain the causal link between budget deficit and current account deficits are the Mundell-Fleming Model and the Ricardian Equivalence Hypothesis (REH). The traditional Keynesians use the Mundell-Fleming model to explain the twin deficit relationship by arguing that when budget deficit increases, the current account balance will deteriorate as the increases in the budget deficits will lead to increase real exchange rate, domestic interest rates and leads capital inflows and will deteriorate budget deficit.

Some group of researchers used the Ricardian Equivalence Hypothesis (REH) to argue that no relationship exists between the two deficits as budget deficits results mainly from tax cuts which tend to reduce public revenue and public savings. They suggest that individuals will recognize these tax cuts as incurring future tax liabilities and thus will increase savings rather than consumption and will not have any effect on the current account balance.

In examining the causal link between the two deficits for India, the study carry out the Augmented Dickey Fuller unit root test (ADF) and all the variables were found to be stationary after first differencing at 1 percent level of significance. Then applying the Johansen co-integration method, the study followed the max statistics and maximum Eigen value which stated that there exists at most one co-integrating equation in the model, signifying

the existence of a long run relationship between the twin deficits as argued by the conventional twin deficit hypothesis. To identify the direction of causality between the two deficits multivariate Granger causality test was employed. To estimate the short run causality among the variables Vector Error Correction Model (VECM) was employed between the twin deficits and their interacting variables (such as inflation, interest rate and exchange rate) for the period (1990 to 2013). To predict the movements and behavior of two deficit impulse response function was used to traces the impact of one standard deviation shock to one innovation on its current and future value of endogenous variables.

The Granger causality test showed a uni-directional causality flowing from the current account deficits to the budget deficits in India between 1990 and 2013. The result of the Wald Test showed that the causality between budget deficit and current account does not exist, on the other hand it has been proved it is the current account deficit which leads the budget account deficit for the India economy.

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5. 2 Recommendations.

From the findings of the study, the following recommendations are given:

1) If government intends to reduce its “ twin deficit” dilemma, it must begin by reducing its current account deficits and this can be achieved by reducing imports, increasing exports or a combination of both measures.

2) Also, since the findings of this study showed evidence of reverse causation from current account deficits to budget deficits, adjustments in fiscal balance can only be achieved through the implementation of strong external policies.

3) It is important for government to equally diversify the sources of national income since the economic transformation will result to minimal fluctuations in the fiscal balance of the Indian economy, thus resolving the " twin deficits" dilemma.

4) The study found that of all the interacting variables, in which interest rate and exchange rate Granger causes current account deficits. This implies that changes in the interest rate of the Indian economy will impact significantly in the current account balance. So the Central Bank of India must endeavour to consciously monitor the inflation and interest rate in the economy.

5) In reducing the current account deficit, increase in domestic savings is required which in turn requires the development of a strong financial sector.

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5. 3 Conclusions.

The study using modern econometric methods for estimation which showed that the twin deficits hypothesis was valid for the Indian economy as the result from the co-integration test showed the existence of long run equilibrium relationship between the budget deficit and the current account deficit. Also, the study found strong support for reverse causation also known as " current account targeting" for India. This implies that even the Mundell-

Fleming model was valid for India the direction of causality was not from budget deficit to current account deficit but rather from current account deficit to budget deficit. It is evident from the results of the study that the direction of causation is from trade deficit to budget deficit therefore if there is trade deficit then it can certainly cause serious problem for the fiscal policy as well. That is why to avoid such problematic situation prudent steps should be taken to reduce trade deficit by coordination of fiscal and monetary policies with trade policy. Higher interest rate and higher inflation reduce competitiveness of our export and consequently deteriorate our trade balances and creates new problem for economy.

The economic implication of this phenomenon is very important for the Indian economy. The reverse causality that was found to exist for India implies that if the Indian government intends to reduce the “ twin deficit” phenomenon in India, it must begin by reducing the current account deficits. In other words, policies showed should be geared towards controlling the deficit in the current account most especially by diversifying the export base of the economy by promoting.