

TRANSMISSION MECHANISM OF TWIN DEFICITS HYPOTHESIS: EVIDENCE FROM TWO NEIGHBOURING COUNTRIES

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ABSTRACT

In spite of the apparent importance of the effect of budget deficit on macroeconomic variables, not much empirical work has been carried on the ASEAN economies. Hence, the primary objective of this study is to establish the causal relationship between the twin deficit. An insight on the particular story of twin deficits nexus in Malaysia and Thailand is presented in this paper. The role of exchange rate and interest rate which acts as a source transmission mechanism are proven to be important in the innovation of twin deficits debate and a version of a 'vicious circle' is detected in Malaysia. First, we found causality run from budget deficit to current account deficit (Keynesian paradigm) for Thailand and bi-directional causality for Malaysia. Second, on the whole, budget deficit is the driving force for interest rate, exchange rate and current account where the transmission mechanism channel operates through exchange rate and interest rate between the two deficits, supporting a version of Abell's causal chain (or Keynesian view). Third the exchange rate was found to "Granger" cause current account deficit and not vice versa.

INTRODUCTION

The relationship between budget deficit and other economic variables is of great importance to policy makers. In the 1980s interest rate in the US rose and the dollar depreciated following a steady increase in the US budget

deficit that began in 1981. The fiscal expansion following the unification of Germany which moved the DM and interest rates upwards has also raised a lively debate on the twin-deficit issue. In East Asia, all the regional currencies, except for Hong Kong, lost value on the eve of the 1997 financial crisis. Most of East Asian 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 ASEAN countries.

In spite of the apparent importance of the effect of budget deficit on macroeconomic variables, not much empirical work has been carried on for the ASEAN economies. Hence, the primary objective of this study is to establish the causal relationship between the twin deficit. This study explores the issue for two neighboring ASEAN countries, namely Malaysia and Thailand. Both of these countries were severely affected by the recent Asian financial crisis. In this study, we adopt the Toda and Yamamoto (1995) approach to determine the causal connection between budget deficit, interest rate, exchange rate and current account. This paper serves as the basis for the experiences of developing countries in the twin deficits debate by extending previous studies to include two mediating variables to test for the twin deficits hypothesis. Indeed, the issue has become very important for developing nations.