# The twin deficits hypothesis in the SAARC countries: an empirical investigation

Navaratnam Ravinthirakumaran[a*], Saroja Selvanathan[b] and Eliyathamby A. Selvanathan[b]

[a]*University of Colombo, Colombo, Sri Lanka;* [b]*Economics and Business Statistics Discipline, Griffith University, Brisbane, Australia*

Twin deficits hypothesis postulates that there is a strong positive linear relationship between a country's budget deficit and its current account deficit. This paper empirically investigates the existence of this relationship in five South Asian Association for Regional Cooperation (SAARC) countries using time-series data for the period 1980–2012. The paper uses cointegration analysis, error correction modeling and Granger causality test under a vector autoregression framework. The results show that the direction of causality for the SAARC countries is mixed. The findings confirm that budget deficit causes current account deficit for Pakistan and Sri Lanka, whereas the reverse is true for India and Nepal. The direction of causality is found to be unidirectional from current account deficit to budget deficit in the short run for Bangladesh.

**Keywords:** budget deficit; current account deficit; SAARC; error correction; granger causality; vector autoregression

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## 1. Introduction

The twin deficits hypothesis theorizes the causal relationship between budget deficit (BD) and current account deficit (CAD). It is generally accepted in the economics literature that the direction of causality is from BD to CAD (Khalid and Guan 1999; Saleh, Nair, and Agalewattee 2005; Ratha 2012; Sahooa and Dasb 2012). The twin deficits problem suggests that when a government increases its budget deficit by cutting taxes or increasing government expenditure results in increase in consumers' income, and part of that increase will be spent on foreign goods and services. Thus, BD is accompanied by CAD.

Most developing countries have experienced problem with their current account balance (CAB) in the early 1980s. Several studies have attempted to empirically analyze the twin deficits relationship in developing countries and have confirmed that the unsustainable BD during this period has increased the CADs (Lau and Tank 2009). For instance, Laney (1984) argued that the relationship between BD and CAD is much stronger in developing countries than the developed countries.

In an attempt to study the twin deficits problem, numerous researchers have theoretically and empirically investigated the possible linkages between BD and CAD. Further, the issue has long attracted interest among economists and policy-makers. The two major strands of the twin deficits analysis are the *conventional* or *Keynesian approach* and the *neoclassical* or *Ricardian approach*. While the Keynesian approach states that BD causes

*Corresponding author. Email: navaravi@econ.cmb.ac.lk