



Dynamic Linkages between Government Budget Deficit and Trade Deficit: Evidence from Sri Lanka

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Abstract

The current account deficit and the government budget deficit have been important characteristics of Sri Lankan economy over the past decades. Positive significant relationship between budget deficit and current account deficit, which is termed as the Twin Deficit Hypothesis has been empirically tested for both developing and developed country contexts. Few researchers have examined this relationship for Sri Lanka using different approaches. However, there is a gap of a recent study on the co-movement of these two important macroeconomic variables. Therefore, this study aimed to test the validity of twin deficit hypothesis in Sri Lankan economy for the period of 1977 to 2016. Secondary data for current account deficit, government budget deficit and savings and investment balance are collected from annual reports of Central Bank of Sri Lanka. Unit root tests followed by the ARDL bounds test for Co-integration and Granger Causality test have been used for data analysis. Results of the ARDL co-integration test confirm the existence of a significant equilibrium relationship between government budget deficit and current account deficit in Sri Lanka, during the study period. It emphasizes the role of budget deficit in the determination of the current account deficit in Sri Lanka. Therefore, this research suggests policy makers to focus on fiscal consolidation and tightening as a powerful tool for correcting current account problems in Sri Lankan economy.

Key words: *ARDL bounds test, budget deficit, current account deficit, Twin Deficit, Sri Lanka*

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