THE APPLICATION OF THE TWIN DEFICIT HYPOTHESIS TO A SMALL ISLAND ECONOMY

The Case of Barbados

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Outline

- Definition
- Research Motivation
- Twin Deficits in Barbados
- Regression Results
- Policy Implications and Conclusions

Definition

- The twin deficit hypothesis states that a fiscal deficit can cause an external current account deficit, more specifically, that a deterioration in the fiscal balance leads to a deterioration in the external current account.

- The twin deficits suggest that the country is depending on the rest of the world for resources.

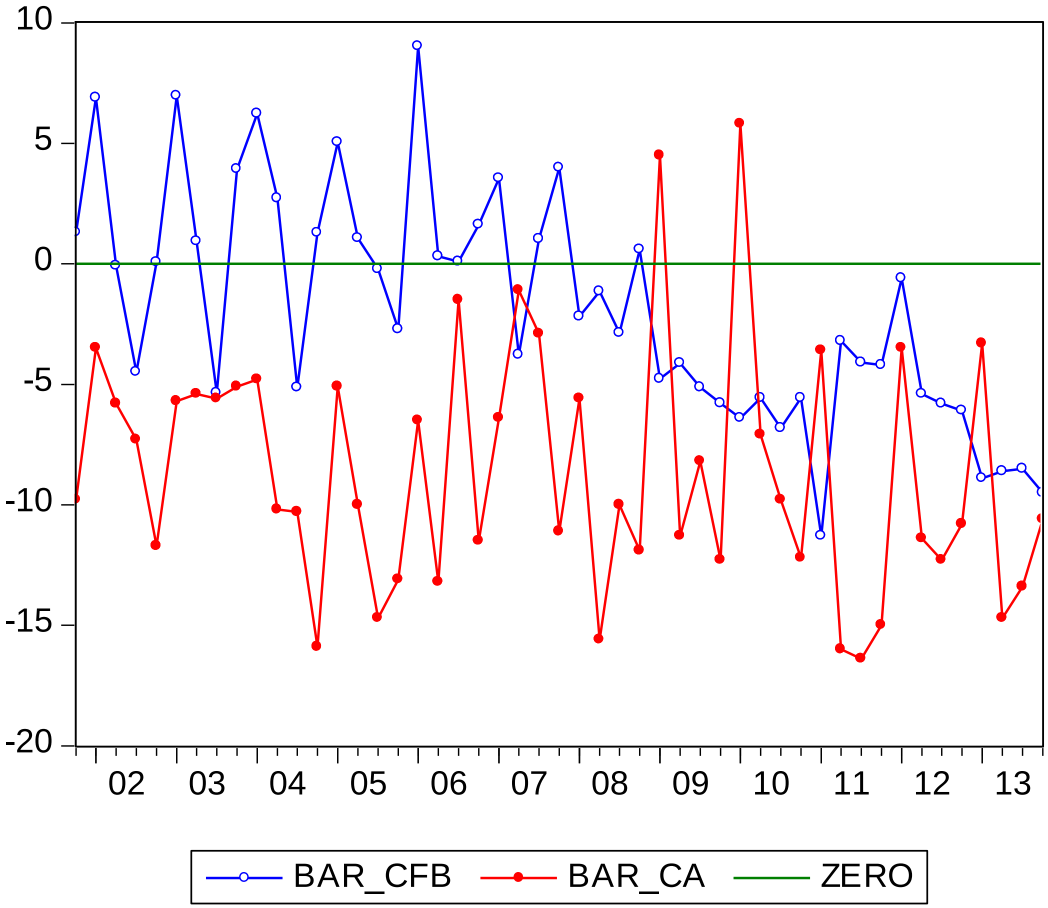
Research Motivation

- Rubin, Orsag and Sinai, (2004), indicate that "ongoing budget deficits decrease national saving which reduces domestic investment and increases borrowing from abroad ... The reduction in national saving, raises domestic interest rates, which dampens investment an attracts capital from abroad. The external borrowing that helps finance the budget deficit is reflected in larger current account deficit..."

Methodology

- Unit Root Testing
- Cointegration
- Vector Error Correction Model

Barbados Fiscal and Current Account Trajectory



VEC - Model Specification

$$z_t = \sum_{i=1}^{k-1} \tau_i \Delta z_{i-1} + \Pi z_{i-k} + \varepsilon_t$$

- Where, z_t is the column vector of observations

  $\Pi = \alpha\beta'$

- with α is the speed of cointegration and $\beta'$is the cointegrating vector.

Results
Vector Error Correction

- Sample (adjusted): 2000Q3 2013Q4

- Included observations: 54 after adjustments

Cointegrating Eq	BAR_CFB (-1)	BAR_CA(-1)	OILP(-1)	FOODP(-1)
CointEq1 (Vector of cointegration in L-R)	1.00000	0.19414 (0.11036)	-0.09646 (0.02165)	0.23789 (0.03308)
Error Correction	**D(BAR_CFB)**	**D(BAR_CA)**	**D(OILP)**	**D(FOODP)**
CointEq (the speed of adjustment)	-1.18637 (0.17457) [-6.79588]	-0.40024 (0.32316) [-1.23849]	0.55284 (1.24083) [0.44554]	-0.47266 (0.54047) [-0.87454]

Results

- The results indicated a long-run relationship between these two macroeconomic variables; this means that we can expect some positive correlation between the fiscal balance and the external current account balance, which is in line with the Twin Deficit Hypothesis.

- On the other hand, in the short-run the VECM indicates a result contrary to the Twin deficit hypothesis where the fiscal balance and the external current account move opposite to each other.

Policy Implications and Conclusions

- Internal Stabilization
- Incorporate Monetary Policies
- Diversification