

IDENTIFYING THE RELATIONSHIPS BETWEEN BUDGET DEFICIT AND THE SELECTED MACROECONOMIC VARIABLES: A STUDY OF SRI LANKA DURING THE POST-LIBERALIZATION ERA

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From 1980 to 2014, the Sri Lankan government budget deficit averaged 8.75% of GDP, and recorded the highest ratio of 19.2% of GDP in 1980. This study examines the association between budget deficit and the selected macroeconomic variables in Sri Lanka, using annual time series data for post-liberalization period; 1980-2014. The selected explanatory macroeconomic variables are inflation, interest rate, exchange rate, debt, and real GDP growth rate. Specifically, the study seeks to ascertain the relation between selected macroeconomic variables and the budget deficit with a view to making appropriate recommendations to curb its negative effect to economy. The secondary data used in the time series analysis study for budget deficit and selected macroeconomic variables will be obtained from Central Bank annual reports in Sri Lanka from 1980 to 2014. The literature implied that the above selected macroeconomic variables have closer cause to budget deficit, when compared to other macroeconomic variables. The short-run dynamic was examined using the ARDL Granger-Causality test. Further, the Granger Causality test was carried out to determine the causality between selected variables and budget deficit, whether the impact was uni or bi-directional. In this study uni-directional relationship was confirmed between budget deficit and debts. The budget deficit causes debt. Additionally, a uni-directional relationship was also identified between budget deficit and inflation. The budget deficit causes inflation. Moreover, this study confirmed that there were no uni or bi direction causality between Budget Deficit, and other selected variables; Interest rate, Exchange, Real GDP growth rate. Furthermore, the findings show that budget deficit has a significant effect on inflation, and Debts. The paper recommends that the Sri Lankan government should take actions to reduce its sustained sizable budget deficit which has been maintaining since 1957. The reason was this sustained sizable budget deficit has repercussion on controlling inflation and minimizing debts. This research contributes the idea that there are dimensional and dynamic factors involved between budget deficit and macroeconomic variables, which require comprehensive knowledge to increase productivity, improve living standards, and to ensure stability of the economic system in Sri Lanka.

Keywords: Budget deficit, Macroeconomic variables, Granger causality test