

TWIN DEFICITS OR TWIN DIVERGENT: AN INQUIRY OF KEYNESIAN AND RICARDIAN VIEW IN THE CASE OF SRI LANKA

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Abstract

This study analyses the causal relationship between budget deficit and current account deficit, and the validity of Keynesian and Ricardian views in the Sri Lankan context. The study employed annual time series data for budget deficits, current account deficits, interest rates, real GDP growth rate, and real exchange rates of Sri Lanka over the period of 1977 to 2022. The Auto Regressive Distributed Lag (ARDL) model was employed to identify long-run and short-run dynamic relationships between the variables. The findings revealed that a higher fiscal deficit widens the current account deficit in Sri Lanka in both the short-run and long-run during the post-liberalisation period. The Granger causality test also detected a unidirectional causation running from budget deficit to current account deficit in Sri Lanka. Thus, the empirical results in this paper support the Keynesian view regarding the linkage between the current account deficit and the budget deficit and the potential absence of a strong Ricardian equivalence effect in the case of Sri Lanka. The study found that the short-run relationship between budget deficit and current account deficit is smaller than the long-run effect. Real exchange rate appreciation increases the current account deficit significantly in the long run by reducing exports and increasing imports. Although the interest rate does not have any significant impact on the current account deficit in the long run, it has a significant negative impact in the short run, as expected. The current account deficit widens significantly with the lower economic growth rate in both the short-run and long-run.

JEL: E21, E44, E62, E63, F31, F32, F4, H61, H63, O53

Keywords: Budget deficit, current account deficit, Granger causality, Keynesian view, Twin deficit hypothesis



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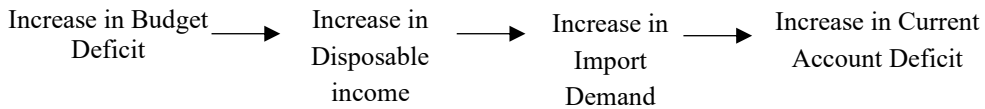
INTRODUCTION

The current account balance is a measure of a country's trade and financial transactions with the rest of the world, which includes the export and import trade balance of both goods and services, net earnings on cross-border investment, and net current transfers. A positive current account balance indicates that a country is a net exporter, and a negative current account balance indicates that a country is a net importer. The negative current account balance is known as a current account deficit, which implies the amount by which a country's imports exceed the value of its exports. Large current account deficits are considered to be one of the main macroeconomic challenges, endangering both macroeconomic stability and overall external stability of a country (Perera and Liyanage, 2012).

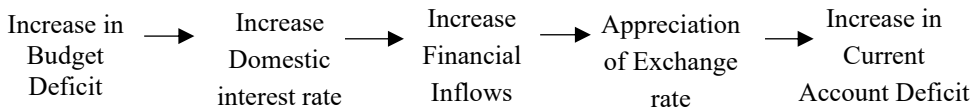
A budget deficit occurs when government expenditure exceeds its revenue. It has been argued that maintaining sustainable budget deficits is one of the major preconditions for achieving higher economic growth and development targets. A budget deficit is not always bad for an economy, as it acts as a stimulus for economic growth during an economic crisis by injecting money into the economy and boosting aggregate demand. However, a large and persistent budget deficit can have negative consequences on the macroeconomic stability of a country. The increasing budget deficit leads to a current account deficit, and this phenomenon is termed the twin deficits hypothesis (Salvatore, 2006; Perera and Liyanage, 2012; Saleh, Nair, and Agalewatte, 2005; Jayasundara and Fernando, 2022).

A twin deficit problem occurs when there is a simultaneous rise in both fiscal and current account deficits. According to the twin deficit hypothesis, there is a strong positive relationship between a nation's current account balance and government budget balance (Perera and Liyanage, 2012; Saleh, Nair, and Agalewatte, 2005; Jayasundara and Fernando, 2022). The theoretical explanation of the Twin Deficit hypothesis is based on the Mundell-Fleming model and Keynesian absorption theory (Fleming, 1962; Mundell, 1963).

According to the Keynesian absorption theory, the rising budget deficit due to increased government spending or reduced taxes leads to expansionary fiscal policy. This expansionary fiscal policy raises households' and firms' disposable income, which in turn increases aggregate demand for goods and services in the economy. Then, the rise in disposable income increases aggregate demand. Again, the extended overall demand encourages consumers to increase the demand for imports, eventually leading to a current account deficit (Devi and Sarma, 2022; Jayasundara and Fernando, 2022). Thus, as per the Keynesian absorption channel, expansion in the fiscal deficit tends to worsen the external balance of a country via influencing its domestic absorption (Devi and Sarma, 2022).



The Mundell-Fleming model stated that the increase in the budget deficit creates a demand for government borrowing, creating upward pressure on the market interest rate. The increase in interest rate will create capital inflows to the country, given that the country adopts free capital movement policies and ultimately appreciates the domestic currency. Then, the appreciation of domestic currency will make exports less attractive and imports more attractive, subsequently worsening the trade balance and thereby the current account balance. This entire mechanism assumes that the excess government expenses are financed by government borrowings (Mundell, 1963).



In contrast, the Ricardian Equivalence Hypothesis claims that there is no direct relationship between the current account deficit and the budget deficit. It demonstrates that the real interest rate and the current account deficit are not influenced by the budget deficit (Barro, 1974; Miller and Ruseek, 1989). In a nutshell, there is a strong theoretical dilemma behind the relationship between the current account deficit and the budget deficit.

Economists began discussing and theorising about twin deficits more in the latter half of the 20th century, likely in the 1970s and 1980s. This is around the time when countries started focusing more on international trade and its impact on their economies. In the late 1970s, many of the developing countries experienced large budget deficits to finance infrastructure and development projects (Jayasundara and Fernando, 2022). This could have contributed to a need for external borrowing, foreign capital, potentially leading to a current account deficit. In the last twenty years, there has been a noticeable increase in interest in twin deficits. The United States has been running both a budget deficit and a trade deficit for a significant amount of time, particularly since the early 2000s. While the U.S. is a prime example, twin deficits can occur in any country. The increased focus on globalisation and international trade has made understanding these imbalances more important.

Accordingly, the past four decades have seen a surge in research on twin deficits. Researchers analyse how twin deficits play out in different developing countries and the short-term and long-term consequences related to the budget deficit and the current account deficit. Like many other developing countries, Sri Lanka has also been experiencing a budget deficit and external current account deficit for decades. The

structural reforms adopted since 1977 under a broad liberalisation package targeting export-led growth have not been effective in reducing the current account deficits of the balance of payments, mainly due to the weak macroeconomic fundamentals. Large and persistent budget deficits have been widely identified as a major cause of chaos in macroeconomic fundamentals (Colombage, 2015). Both deficits expanded during the post-liberalisation period. The annual average budget deficit rose from 4.8 per cent of GDP in the pre-liberalisation period of 1950-1977 to 8.7 per cent in the post-liberalisation period of 1978 to 2022, while the current account deficit rose from 1.5 per cent of GDP to 4.7 per cent between the two periods. These imbalances are a major constraint on sustaining macroeconomic stability and economic growth of the country.

Increased government expenditure, mainly on account of interest payments on public debt and large funds transfers to loss-making state-owned enterprises, coupled with inadequate revenue generation, led to persistent budgetary imbalances. On the external front, lack of dynamism and expansion in the export sector in the face of escalating import demand resulted in a widening of current account deficits. When a country imports more goods and services than it exports (expansion in current account deficit), this creates a demand for foreign currency to pay for those imports, which can put downward pressure on the value of the domestic currency (rupee). Then, the depreciation in the rupee value against the dollar has led to the deterioration of the foreign exchange reserve position and the imposition of strict trade restrictions on imports, which prevents pure liberalisation and continuous reliance on foreign debt borrowing (International Monetary Fund, 2015).

Therefore, it is important to identify the existence of the twin deficit hypothesis in the context of Sri Lanka. Only a few studies have examined the continuous twin deficits on a few occasions using the twin deficit hypothesis in Sri Lanka (Colombage, 1991; Saleh, Nair, and Agalewatte, 2005; Chowdhury and Saleh, 2007; Sivarajasingam and Balamurali, 2011; Perera and Liyanage, 2012; Premaratne, Ravinthirakumaran, and Kesaverajah, 2013; Jayasundara and Fernando, 2022). This study differs from other studies on the twin deficits hypothesis about Sri Lanka in several ways. First, this study tries to examine the twin deficit hypothesis for Sri Lanka, including the most important financial variables such as interest rates and real exchange rate, which are known to influence the twin deficit process.

Secondly, the casualty between the two deficits is examined in a multivariate regression model consisting of real exchange rates, interest rates, and GDP growth rate, in addition to the budget and current account deficits. The previous studies (Saleh, Nair, and Agalewatte, 2005; Sivarajasingam and Balamurali, 2011; Premaratne, Ravinthirakumaran, and Kesaverajah, 2013; Jayasundara and Fernando, 2022) used only the budget deficit and current account deficit to measure a one-to-one relationship for analysing the twin deficit hypothesis. Thus, this study considers important macroeconomic variables, namely exchange rates, interest rates, and real GDP growth rate, in addition to the twin deficit. It is expected that these variables will capture both

demand and supply shocks adequately and generate robust estimates. Finally, this study uses the data pertaining to the post-liberalisation period of 1978-2022. In comparison, the previous studies on Sri Lanka (Saleh et al., 2005; Chowdhury and Saleh, 2007; Perera and Liyanage, 2011) use data that overlap the pre-liberalisation period as well. Statistical distortions arising from the substantial structural breaks between the two periods could be avoided by excluding the data for the pre-liberalisation period and focusing on the post-liberalisation period.

Hence, the objective of this study is to explore the Twin Deficit Hypothesis in Sri Lanka to test the validity of Keynesian and Ricardian views. Accordingly, this study attempts to understand the relationship between the budget deficit and the current account deficit by revisiting the twin deficit hypothesis. Further, this study attempts to address three research questions, namely, (i) is there a short-run and/or long-run relationship between the budget deficit and the current account deficit? (ii) If a relationship exists, is it bidirectional or unidirectional? and (iii) Does Sri Lanka support the Keynesian twin deficit hypothesis or the Ricardian Equivalence theory?

TWIN DEFICITS AND MACROECONOMIC TRENDS IN SRI LANKA

Sri Lanka is a developing nation with a per capita GDP of 3,474 US dollars in 2022 (CBSL, 2022). The country was ahead of many Asian nations and had economic and social indicators comparable to Japan when it gained independence from the British in 1948. Sri Lanka had a higher level of education and healthcare facilities even at the time of independence, and it was the third richest country (US\$142) in Asia after Japan (US\$ 569) and Malaysia (US\$ 225) in 1961. With its strategic location in the Indian Ocean, Sri Lanka was expected to have a better chance than most other Asian neighbours to register a rapid economic take-off (Agalewatte, 2004).

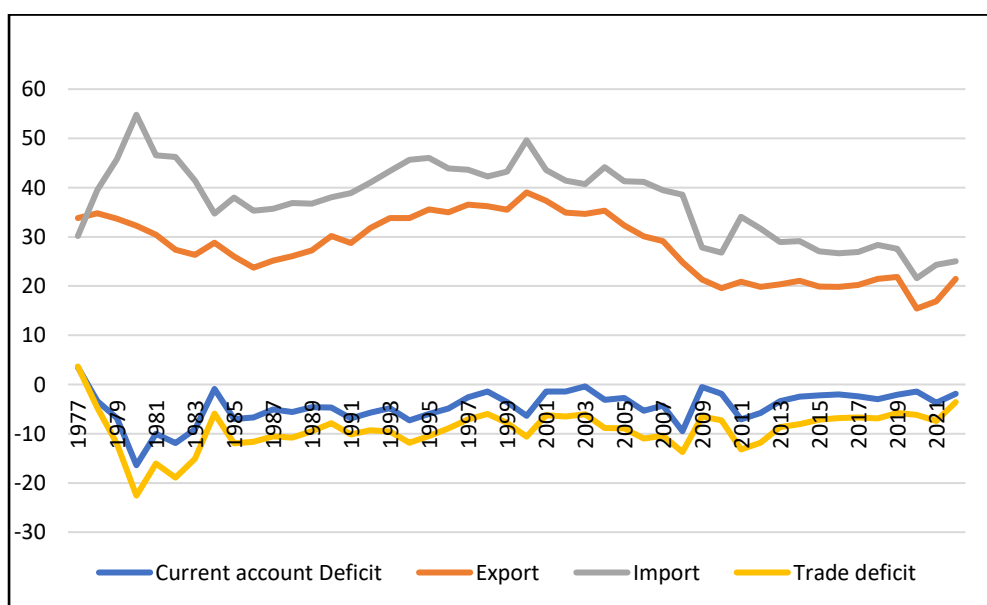
However, the early optimism of 1948 had faded by the 1960s as a result of the wrong economic policies and mismanagement of the previous ruling governments, and East Asia and other neighbouring countries were gradually overtaking Sri Lanka. Though Sri Lanka had a higher level of socio-economic status at the time of independence, it is still in a middle-income trap. According to the World Bank Report, Sri Lanka took 20 years to graduate to lower middle-income country (in 1997) from lower-income country status after the economic liberalisation in 1977. Though in 2019, Sri Lanka was promoted to the upper middle-income category after attaining a GDP per capita of USD 3852, the country again downgraded to the lower middle-income category as per the latest classification of the World Bank (World Bank, 2023).

The economic liberalisation failed to lower the balance of payment problem and achieve higher growth targets. Sri Lanka has experienced continuous budget and current account deficits throughout the post-liberalisation period. Only one year after economic liberalisation in 1977, Sri Lanka managed to achieve a positive current account balance

of 3.5% of GDP. After that, the nation's current account balance was continuously negative until 2022. If we examine the external sector performance during the post-liberalisation period, it was not satisfactory, leading to a widening current account deficit. The sharp decline in the export of goods and services as a ratio of GDP from 35 per cent in 1978 to 15.4 per cent in 2020 reflects the dismal performance of the export sector in spite of a series of export promotion policy strategies implemented during the last four decades. Various factors, including weak macroeconomic fundamentals, policy inconsistencies, and real exchange rate appreciation, have adversely affected the export sector. Such factors were determinant to foreign direct investment (FDI), which is essential for export diversification and growth. Industrial exports still largely consist of basic manufactured products, mainly garments. As such, the country's export sector did not graduate to produce technology-based high-value-added industries, as in the case of newly industrialised economies in Southeast Asia.

Meanwhile, the country's import payments rose at a faster pace (Figure 1), reaching nearly 34 per cent of GDP in 2011, as against the export ratio of 20.8 per cent in 2011. Although, the trade deficit and current account deficit widen throughout the post liberalization period, the external current account deficit moderated notably in 2022, mainly led by significant contraction in the trade deficit with import expenditure reducing sharply due to restrictive trade policies, sharp depreciation of the exchange rate and tight monetary and fiscal conditions that were necessary to manage pressures in the external sector (CBSL, 2022).

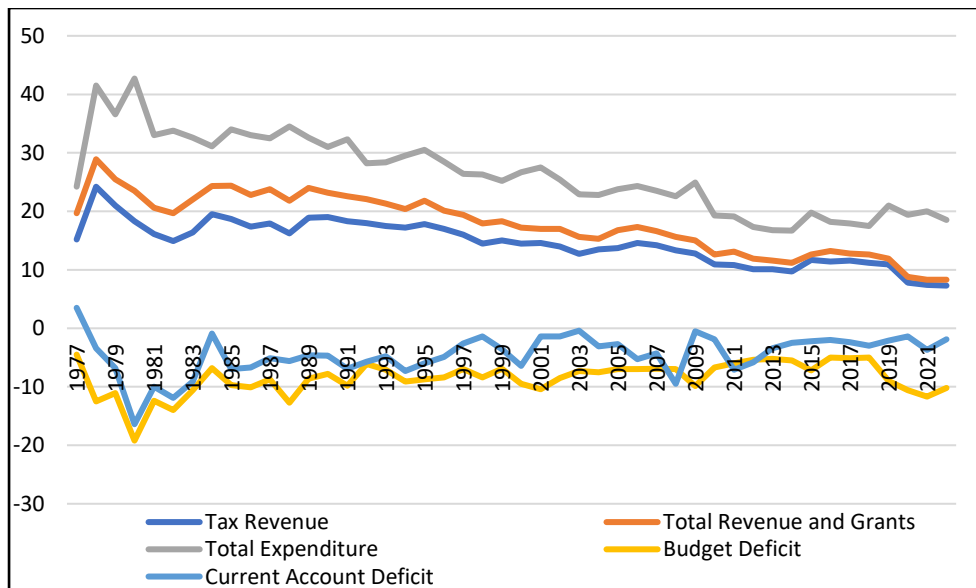
Figure 1: External Balance (% of GDP)



Source: Central Bank of Sri Lanka, 2024

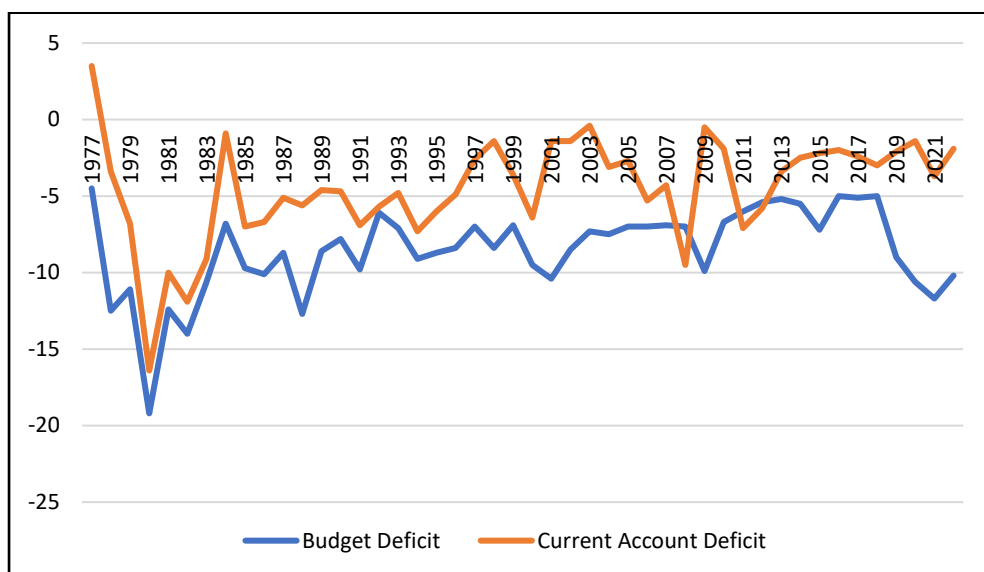
On the fiscal front, the government budget was continuously in deficit throughout the post-liberalisation period. As indicated by Figure 2, although the total government expenditure ratio was brought down from the high levels that prevailed in the early 1980s to around 18.5 per cent by 2022, the budget deficit remained high mainly due to the revenue shortfalls. The total government revenue as a ratio of GDP continuously fell from 28.9 per cent in 1978 to 8.3 per cent in 2022. Weakness in the tax administration, coupled with a wide range of tax incentives, has been mainly responsible for the downward trend in revenue mobilisation in relation to GDP. This resulted in persistent deficits in the current account of the government budget each year since 1988, where government revenue from tax and non-tax revenue sources was not sufficient to meet the recurrent expenditure of Sri Lanka, which led to an excessive budget deficit and a higher debt profile. During the post-war period, the budget deficit as a ratio of GDP was maintained within one digit. However, after 2020, the budget deficit increased to two digits and recorded 11.7 per cent in 2021.

Figure 2: Fiscal Balances (% of GDP)



Source: Central Bank of Sri Lanka, 2024

Figure 3 shows the current account deficit and the budget deficit (as a percentage of GDP) in Sri Lanka from 1977 to 2022. During these four decades, the Sri Lankan government could not achieve a budget surplus, and the deficit was -8.6% of the GDP on average from 1977 to 2022. After liberalising the economy in 1977, only the same year, Sri Lanka could attain a positive current account balance of 3.5% of the GDP. After that, the country experienced only negative current account balances until 2022. For example, when there were excessive budget deficits in the first half of the 1980s, the trade deficit was also high.

Figure 3: Budget and Current Account deficits/ surpluses (% of GDP) in Sri Lanka

Source: Central Bank of Sri Lanka, 2024

Figure 3 demonstrates that the budget deficit and current account balance have had the same pattern until 1987, which clearly illustrates the twin deficit hypothesis. However, after 1987, the two variables have shown inconclusive patterns until 2022.

LITERATURE REVIEW

Theoretical background of the Twin Deficit Hypothesis

The relationship between the fiscal balance and the external balance can be explained by different perspectives. The first perspective, which is based on the Keynesian or Mundell-Fleming model, suggests that an increase in the budget deficit leads to an increase in consumer spending. As per the Keynesian proposition, higher spending on domestic and foreign goods resulting from the budget deficits increases the demand for imports and thereby import expenses, leading to the distortion of the current account balance. The Mundell-Fleming model postulates that budget deficits have a statistically significant impact on current account deficits, mainly through channels related to interest rates and exchange rates (Kearney and Monadjemi, 1990). According to this model, an increase in budget deficit induces upward pressure on interest rates that, in turn, trigger capital inflows and appreciation of the exchange rate. Then the appreciation in the exchange rate pulls down exports and pushes up imports, eventually leading to a current account deficit. As per the theoretical arguments, both Keynesian propositions and the Mundell and Fleming model identify that a positive relationship exists between current account and budget deficits. Secondly, it found the existence of a unidirectional Granger causality that runs from budget deficit to current account deficit (Baharumshah, Ismail, and Lau, 2009;

Jayasundara and Fernando, 2022). Accordingly, the twin deficit hypothesis states that a budget deficit will lead to a current account deficit, while a budget surplus will improve the current account deficit.

Alternatively, the second perspective suggests that there is no positive relationship between the budget deficit and current account deficit. This is known as the Ricardian Equivalence Hypothesis. This implies that consumers are indifferent or equivalent regarding the way the government finances the expenditure by taxing or issuing bonds. Since rational agents anticipate that the current tax cut would eventually become a tax burden, neither the current tax cut nor the increase in government expenditure will have an impact on the balance of current consumption and investment. As a result, they will save more money to cover any future tax rises. Therefore, as Ricardian discloses, the tax cut is viewed as a temporary procedure. The national savings will not be impacted since the decline in public savings will be offset by an equivalent rise in private savings. Put another way, the Ricardian Equivalence Hypothesis supports the absence of any causal relationship between the two deficits (Perera and Liyanage, 2012).

The connection and importance of the current account and budget deficits have been closely studied by academics and policymakers alike. The Keynesian theory of the twin deficit suggests that a government's fiscal deficit and a country's current account deficit are closely linked and tend to move together. According to this view, when the government increases its spending or reduces taxes, it creates a fiscal deficit by spending more than it earns. This expansionary fiscal policy raises households' and firms' disposable income, which in turn increases aggregate demand for goods and services in the economy. As domestic demand rises, consumers and businesses not only buy more locally produced goods but also import more foreign goods and services. Consequently, the increase in imports causes the current account balance to deteriorate, resulting in a current account deficit. In other words, the Keynesian theory explains that a higher fiscal deficit leads to greater domestic absorption and higher imports, which ultimately worsens the external balance (Imimole, 2017). On the other hand, testing within Ricardian Equivalence Hypothesis rejects any causal relationship between the two deficits. It explains that the actual interest rates, the amount of expenditure, and the current account balance are all unaffected by changes in taxation and budget deficits due to the fact that people would save more and consume less, contemplating a tax increase in the future to finance fiscal deficits.

Empirical Literature Review

Many empirical studies have examined the relationship between current account deficits and budget deficits in great detail. The majority of the aforementioned empirical research looked at the connection between twin deficits in developed countries. Only a few empirical studies examined the existence of the twin-deficit hypothesis in developing countries. Even though the twin deficit hypothesis has been studied extensively in a

variety of settings, the results have produced debatable arguments. A range of studies have explored the dynamics of the twin deficit, with mixed results. The Keynesian theory is supported by studies like Darrat (1988), Abell (1990), Deniz and Celik (2009), Saleh et al. 2005; Chowdhury and Saleh, 2007; Perera and Liyanage; 2011; Colombage, 2015; Sivarajasingam and Balamurali, 2011; Jayasundara, and Fernando, 2022 which show that the increasing fiscal deficit leads to the expansion in current account deficit. Conversely, research by Miller and Russek (1989), Evans (1988), and Munir and Mumtaz (2021) supports the idea that there is no connection between the budget deficit and the current account deficit.

The dynamics of the twin deficit in the US have been extensively studied, with a focus on the relationship between the budget deficit and the current account deficit. Kundu (2020) examined the twin deficit hypothesis in the USA economy from 1972 to 2018. The study was based on an analysis of the co-integration model of error correction (ECM), the VAR, the function of impulse response, and the decomposition of variances. The findings showed a long-term correlation between the trade deficit and the fiscal deficit, supporting the Keynesian theory with causality from budget deficit to current account deficit, and indicating a unidirectional correlation between the twin deficits.

Acaravci and Ozturk (2008) also examined the general validity of the twin deficits hypothesis for Turkey during the period 1987 to 2005, using the autoregressive distributed lag (ARDL) model and the bounds test for cointegration. This study rejects the Ricardian Equivalence Hypothesis and supports the Keynesian view of a long-run relationship between budget deficit and current account imbalances. The empirical results also indicate that the direction of causality runs from the budget deficit to the current account deficit in Turkey. This specific unidirectional relation that emanates from the budget deficit to current account deficit has also been observed by Vamvoukas (1999) for Greece, Banday and Aneja (2019) for China, Vishnyak (2000) for Ukrain, Banday and Aneja (2015) for India, Khalid and Guan (1999) for the developing countries, Boileau and Normandin (2012) for industrialised countries, Forte and Magazzino (2013) for 33 European countries, Perera and Liyanage (2012) for Sri Lanka and many more. Trying to evaluate the twin deficits incident for Pakistan based on annual data for the period 1973 to 1998, Aqeel et al. (2000) have observed the twin deficits to be valid for the country only in the long run, but in the short run, the authors have found the two to move in the opposite directions, indicating the presence of reverse causality. Thus, there exists a large number of studies that have confirmed the validity of the twin deficits hypothesis in different countries that are experiencing deficits in both their budget and current accounts simultaneously.

The dynamics of the twin deficit hypothesis in Sri Lanka have been explored in several studies since the 1950s. According to research published between 1957 and 1960, a series of budget deficits, including subsequent current account deficits, resulted in a substantial loss of foreign currency reserves, which caused a serious foreign exchange problem for

the country that persisted until the economic reforestation in 1977 (Premaratne, 1983). Saleh et al. (2005) explored the phenomenon of the twin deficit hypothesis in the case of Sri Lanka during the period 1970 to 2003, using an autoregressive distributed lag (ARDL) model and the bounds test for cointegration. They found the long-run relationship between current account imbalances and budget deficits in Sri Lanka, supporting the Keynesian view and suggesting that reducing the budget deficit could help in reducing current account imbalances. The empirical results also found that the direction of causality runs from the budget deficit to the current account deficit during the above-mentioned period.

Furthermore, Salvatore (2006), Perera and Liyanage (2012), Saleh, Nair, and Agalewatte (2005), Sivarajasingam and Balamurali (2011), Premaratne, Ravinthirakumaran, and Kesaverajah (2013), Jayasundara and Fernando (2022) also found a long-run positive relationship between the budget deficit and the current account deficit, supporting the Keynesian view and showing a unidirectional causality from the budget deficit to the current account deficit in Sri Lanka. However, Mumtaz (2016) and Munir (2021) did not find evidence of the twin deficit hypothesis in the Sri Lankan context, which rejected the Keynesian view and supported the Ricardian Equivalence Hypothesis. These conflicting findings indicate the need for further research to fully understand the dynamics of the twin deficit hypothesis in Sri Lanka.

METHODOLOGY

This study aims to examine the Twin Deficit Hypothesis in the context of Sri Lanka, with the objective of testing the validity of both the Keynesian and Ricardian views. Accordingly, this paper seeks to investigate whether a relationship exists between the budget deficit (BD) and the current account deficit (CAD) in Sri Lanka.

Following key studies such as Colombage (2015), Perera and Liyanage (2012), and Devi and Sarma (2022), this study examines the relationship between the two deficits within a multivariate framework that includes the real exchange rate, interest rate, and GDP growth rate, in addition to the budget deficit (BD) and current account deficit (CAD). To identify both the short-run and long-run relationships among the variables, the current account deficit (CAD) is employed as the dependent variable, while the budget deficit (BD), interest rate (INT), GDP growth rate (GDP), and real exchange rate (RER) serve as independent variables. Moreover, the two key variables, BD and CAD, are expressed as ratios of GDP to normalise the data and avoid distortions arising from extreme absolute value differences.

This study uses annual time series data from various annual reports of the Central Bank of Sri Lanka and World Development Indicators for the period of 1977 to 2022, since the country liberalised its economy in 1977. To identify the validity of either Keynesian or Ricardian 'twin deficit' view in the case of Sri Lanka, the following multivariate regression model is used.

$$CAD_t = \beta_0 + \beta_1 BD_t + \beta_2 INT_t + \beta_3 GDP_t + \beta_4 RER_t + \varepsilon_t \text{ ----- (1)}$$

Where,

CAD = Current account deficit, defined as net exports of goods and services plus net factor income, which is shown as a ratio of GDP.

BD = Budget deficit, defined as the difference between government revenue and government expenditure, which is expressed as a ratio of GDP.

INT = Interest rate represented by the 91-day Treasury bill rate.

GDP = Real Gross Domestic Product Growth rate (as a proxy for economic growth)

RER = Real Exchange rate

ε is the random error term, and t is the time period (1977 to 2022).

β_0 is the intercept and $\beta_1, \beta_2, \beta_3$ and β_4 are the coefficients of each independent variable.

Since most time series variables could give rise to spurious regression problems, it is necessary to check the stationarity of the time series by performing a unit root test. Therefore, the estimation of equation (1) begins with the identification of the order of integration of each variable using the Augmented Dickey Fuller (ADF) and Phillips-Perron (PP) unit root test for this analysis. Therefore, we can compare the results of the ADF test with the PP test to see whether we have obtained the same conclusion or not.

In the second step of the estimation procedure, we have to identify the optimal lag length that can be used in the model. Because the underlying theory and any hypothesised structure indicate to the economist which variable to be included in the model and how many lags would be appropriate. Therefore, the method of determining the appropriate lag length is still an important issue in the time series literature since longer lag lengths increase the number of estimated parameters, reduce degrees of freedom, and increase data requirements. There are several criteria, such as sequentially modified Likelihood Ratio (LR) statistics, Akaike Information Criterion (AIC), Swartz Information Criterion (SC), Hannan-Quinn Information Criterion (HQIC), and Final Prediction Error (FPE), to select the optimal lag length that can be included in a time series model (Vinayagathan, 2020). However, we will adopt either one or more of these criteria in our analysis according to the results and the requirements.

In the third step, we employ the ARDL co-integration procedure developed by Pesaran et al (2001) to empirically analyse the dynamic relationship between the variables described in equation (3.1). An ARDL representation of equation (3.1) is formulated as follows:

$$\Delta CAD_t = \delta_0 + \delta_1 CAD_{t-1} + \delta_2 BD_{t-1} + \delta_3 INT_{t-1} + \delta_4 GDP_{t-1} + \delta_5 RER_{t-1} + \sum_{i=1}^{q_1} \beta_{1i} \Delta CAD_{t-i} + \sum_{i=0}^{q_2} \beta_{2i} \Delta BD_{t-i} + \sum_{i=0}^{q_3} \beta_{3i} \Delta INT_{t-i} + \sum_{i=0}^{q_4} \beta_{4i} \Delta GDP_{t-i} + \sum_{i=0}^{q_5} \beta_{5i} \Delta RER_{t-i} + e_t \text{ ----- (2)}$$

Where Δ denotes the first difference operator, δ_0 is the drift component, e_t is the white noise error term, $\delta_1 \rightarrow \delta_5$: denotes the long-run coefficients, the remaining expressions with the summation sign ($\beta_{1i} \rightarrow \beta_{5i}$) represent the short-run dynamics of the model and $q_1 \rightarrow q_5$ denotes optimum lag lengths of the variables CAD, BD, INT, GDP, and RER, respectively.

To investigate the existence of long-run cointegrating relationships between the variables, the bound testing procedure is used, which is based on the F-test. A F-test is actually a test of the hypothesis of no cointegration among the variables ($H_0: \delta_1 = \delta_2 = \delta_3 = \delta_4 = \delta_5 = 0$) against the existence of cointegration among the variables ($H_1: \delta_1 \neq \delta_2 \neq \delta_3 \neq \delta_4 \neq \delta_5 \neq 0$). Two critical values are given by Pesaran et al. (2001) to check the above hypothesis. The lower critical bound assumes that all the variables are $I(0)$, implying that there is no cointegrating relationship between the examined variables. The upper critical bound assumes that all the variables are $I(1)$, which means that there is a cointegrating relationship between the variables. Then, the calculated F-bound statistic is compared against the Lower Critical Bound (LCB) and the Upper Critical Bound (UCB).

If calculated $F_{Bound} > UCB \Rightarrow CAD_t$ is cointegrated with BD_t , GDP_t , INT_t , RER_t

If calculated $F_{Bound} < LCB \Rightarrow CAD_t$ is not cointegrated with BD_t , GDP_t , INT_t , RER_t

If $LCB \leq \text{calculated } F_{Bound} \leq UCB \Rightarrow \text{Result is inconclusive}$

From the bound test, if the variables are cointegrated, both short-run and long-run ARDL models will be specified. Once we confirmed the cointegrating relationship among the variables using the above F test, in the next step of the estimation procedure, we obtain the short-run dynamics of parameters and long-run adjustment coefficient of the model by estimating the error correction version of the ARDL model about the variables in equation (3.2) is as follows:

$$\Delta CAD_t = \pi_0 + \sum_{i=1}^{q_1} \pi_{1i} \Delta CAD_{t-i} + \sum_{i=0}^{q_2} \pi_{2i} \Delta BD_{t-i} + \sum_{i=0}^{q_3} \pi_{3i} \Delta INT_{t-i} + \sum_{i=0}^{q_4} \pi_{4i} \Delta GDP_{t-i} + \sum_{i=0}^{q_5} \pi_{5i} \Delta RER_{t-i} + \gamma ECT_{t-1} + \mu_t \text{-----} (3)$$

where, γ : speed of adjustment coefficient, which should have a statistically significant and negative sign to support the long-run adjustment towards the steady state line, μ_t : pure random error term. Then, besides the ARDL long-run and short-run analysis, the post-estimation diagnostics are generated to establish how the above model fits the data.

Finally, the Granger causality test is applied to determine the direction of causality between the selected variables. This test is specifically employed to determine whether the budget deficit (BD) causes the current account deficit (CAD), whether the CAD causes the BD, or whether a bidirectional causality exists between the two. If the current account deficit (CAD) Granger causes the Budget Deficit (BD), i.e., $CAD \rightarrow BD$, then the VAR model could be expressed by the equations (4).

$$CAD_t = \sum_{i=1}^{q_1} \beta_{1i} \Delta CAD_{t-i} + \sum_{i=0}^{q_2} \beta_{2i} \Delta BD_{t-i} + e_t \text{-----} (4)$$

On the other hand, if $BD \rightarrow CAD$, then the VAR model would be:

$$BD_t = \sum_{i=1}^{q_1} \beta_{1i} \Delta BD_{t-i} + \sum_{i=0}^{q_2} \beta_{2i} \Delta CAD_{t-i} + e_t \text{-----} (5)$$

RESULTS AND DISCUSSION

The unitroot test results using both ADF and PP unitroot tests are shown in Table 1.

Table 1: Results of ADF and PP Unit Root Test

Form	Variables	ADF test statistic		PP test statistic	
		Intercept	Trend & Intercept	Intercept	Trend & Intercept
At Level	CAD	-4.527***	-5.945***	-4.690***	-5.953***
	BD	-3.908***	-4.916***	-4.226***	-5.145***
	INT	-3.129**	-2.968*	-2.222	-1.925
	GDP	-1.312	-1.571	-3.331**	-3.766**
	RER	8.128	1.907	17.347	8.1366
At First Difference	CAD	-7.005***	-6.819***	-10.746***	-10.455***
	BD	-10.925***	-10.829***	-11.379***	-13.739***
	INT	-3.650**	-3.556**	-2.558*	-2.546*
	GDP	-10.661***	-10.665***	-11.518***	-12.428***
	RER	0.046*	-5.754***	-2.957**	-5.679***

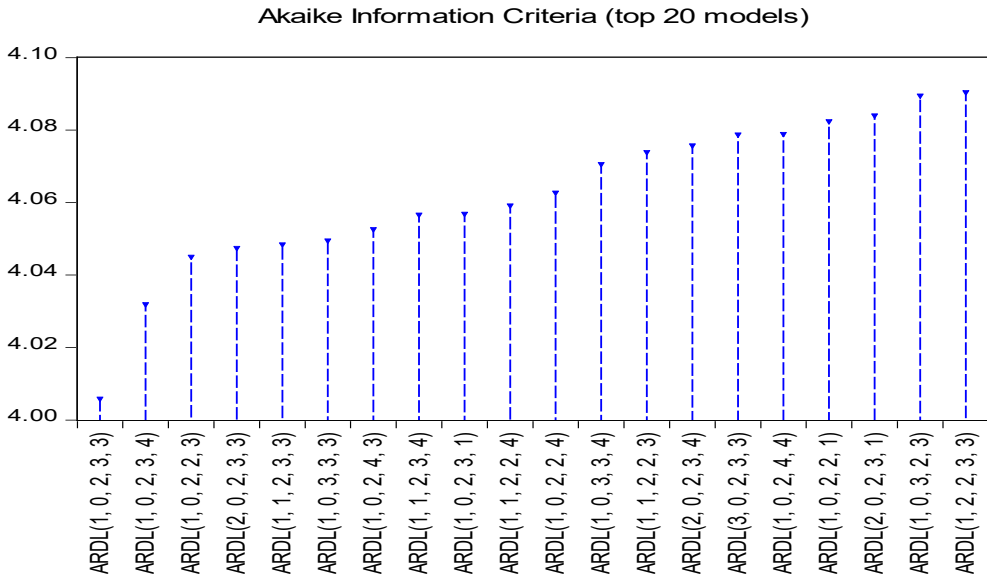
Note: ***, **, * represents variables are stationary at 1%, 5% and 10% level of significance, respectively.

Source: Author's calculations, 2024

According to the results of the ADF unit root test, all variables are stationary in their level form except for GDP and RER, which become stationary only after first differencing, under both the intercept-only and the trend-and-intercept specifications. In contrast, the PP unit root test results indicate that all variables are stationary at their level form except for INT and RER, which became stationarity only in their first-differenced form. Thus, the ADF and PP unit root test results with intercept only and with both trend & intercept models in Table 1 confirm the mixture of both $I(0)$ and $I(1)$ order of integration of the variables used in this study. It is also noteworthy that none of the variables are in $I(2)$ or higher order. Therefore, the ARDL approach is more suitable than other approaches for examining relationships between the variables.

Furthermore, the optimal lag length selection, based on the Akaike Information Criterion (AIC), suggested the use of the ARDL (1, 0, 2, 3, 3) model among the top 20 models, which was subsequently adopted in this study (Figure 4).

Figure 4: Results of optimum lag length of each variable (AIC)



Source: Author's calculations, 2024

Next, we examine whether there exists a cointegrating relationship between variables by adopting the ARDL Bound testing procedure. The result of the ARDL Bounds test confirms that there exists a stable cointegrating relationship between the variables under consideration in this study since we reject the null hypothesis of no cointegration among the variables due to the computed F-statistic of 21.376, which is obviously greater than the upper bound critical value of 4.37 at the 1% level of significance (Table 2).

Table 2: The Results of the ARDL Bounds Test

F- Bounds Test		Null Hypothesis: No level relationship		
Test Statistics	Value	Level of Significance of Critical Values	Lower Bound I(0)	Upper Bound I(1)
F- statistic	21.376***	10%	2.2	3.09
K	04	5%	2.56	3.49
		2.5%	2.88	3.87
		1%	3.29	4.37

Note: *** denotes rejection of the hypothesis at 1% level of significance.

Source: Author's calculations, 2024

Once the existence of a cointegrating relationship among the variables is confirmed, the long-run coefficients of the selected ARDL (1, 0, 2, 3, 3) model were estimated, which are given in Table 3.

Table 3: The results of the ARDL long-run form

Dependent Variable: CAD (Current Account Deficit)					
Variables	BD	INT	GDP	RER	Constant
Coefficients	0.983*** (0.0000)	-0.131 (0.1930)	-0.845*** (0.000)	-0.047*** (0.0097)	9.196 (0.0006)

Note: The values inside parentheses are the probability values corresponding to those test statistics. ***, **, * represents the variables are statistically significant at 1%, 5% and 10% level of significance respectively.

Source: Author's calculations, 2024

The above results reveal that the budget deficit has a positive and significant impact on the current account deficit in the long run at a 1% significance level. This implies that if the budget deficit (as a ratio to GDP) increases by one percentage point, the current account deficit (as a ratio to GDP) will increase by 0.983 percentage points. This finding clearly indicates that rising budget deficits put more strain on the current account deficits in the case of Sri Lanka. Several existing studies (e.g., Jayasundara and Fernando, 2022; Perera and Liyanage, 2012; Premaratna et al., 2013; Sivarajasingam and Balamurali, 2011; Epaphra, 2017; Manisha and Sarma, 2022; Chowdhury and Saleh, 2007;) and Sri Lankan experiences also support this finding. In Sri Lanka's case, the growing budget deficit has worsened the country's current account deficit primarily in two ways. The Sri Lankan government often borrows money, either by issuing domestic bonds or taking on external debt, in order to finance its severe budget deficit. The Increased domestic borrowing competes with private businesses for loanable funds, driving up interest rates. This deters economic activity and private investment, which eventually lowers exports and causes a current account deficit. In the same way, financing the budget deficit through foreign borrowing increases the country's external debt burden. Foreign currency is needed to repay the principal and interest, which could put pressure on Sri Lanka's foreign exchange reserves and cause significant currency depreciation. A depreciating rupee increases the cost of imports of raw materials and inputs and deters exports by lowering their competitiveness in the world market. Finally, this widens the current account deficit. Thus, a positive relationship between Sri Lanka's budget deficit and current account deficit aligns with the Keynesian twin deficit hypothesis in the long run and a potential absence of a strong Ricardian equivalence effect in the case of Sri Lanka.

According to the long-run estimation, although the interest rate has no significant effect on Sri Lanka's current account balance, it does have a negative impact, as predicted. Moreover, both real GDP growth rate and real exchange rate have a significant negative impact on the current account deficit in Sri Lanka in the long run at a 1% significance level. The negative coefficient of the real GDP growth rate indicates that a 1 percent decrease (increase) in real GDP growth leads to an increase (decrease) in the current account deficit (as a ratio to GDP) by 0.845 percentage points. This implies that a lower

GDP growth rate may lead to a wider current account deficit in Sri Lanka. This happens due to decreased production and export of goods and services, which would slow down export growth, limit the amount of the inflow of foreign currency from exports, and perhaps widen the trade deficit in Sri Lanka (Colombage, 2015). Further, the negative coefficient of the real exchange rate (RER) indicates that a 1 percentage point increase in the RER results in a 0.047 percentage point reduction in the current account deficit (as a ratio to GDP). This suggests that the current account deficit in Sri Lanka widens when the real exchange rate declines, reflecting an appreciation of the domestic currency. Currency appreciation renders imports relatively cheaper and exports less competitive, thereby increasing import volumes, reducing export volumes, and ultimately exacerbating the current account deficit. Conversely, a depreciation of the real exchange rate enhances external competitiveness, contributing to a reduction in the current account deficit. These findings are consistent with the empirical evidence documented by Devi and Sarma (2022), Colombage (2015), Perera and Liyanage (2012), and Banday and Aneja (2019). Moreover, the long-run estimation results indicate that the budget deficit exerts a more substantial and dominant effect on the current account balance in Sri Lanka.

According to the short-run estimation results, the budget deficit (current period value) has a positive and significant impact on the current account deficit, which implies that the increasing fiscal deficit in Sri Lanka will expand the current account deficit in the short run as well. Compared to the short-run impact of the budget deficit (BD) on the current account deficit (CAD), the magnitude of the long-run impact of the budget deficit (BD) on the current account deficit (CAD) is higher in Sri Lanka. In contrast, the interest rate (one-period lagged value) has a significant negative impact on the nation's current account deficit in the short run. This implies that a one-percentage-point increase in the interest rate would lead to a 0.2945 percentage point decrease in the current account deficit (as a ratio to GDP). The observed inverse relationship between the current account deficit and the interest rate suggests that higher interest rates could help reduce the current account deficit. When a country raises its interest rates relative to other countries, its financial assets become more attractive to foreign investors, as they could earn higher returns on their investments. The resulting inflow of foreign capital thereby contributes towards narrowing down the current account deficit in Sri Lanka.

Similarly, the real GDP growth rate (current and two-year lagged values) has a significant negative impact on the current account deficit. The same conclusion was also reached in the long run. Thus, the reasons for these relationships might be those explained earlier. Yet, the real exchange rate does not influence the current account deficit significantly in the short run; but in the long run, it has a significant negative impact on the current account deficit, as expected. Further, the coefficient of the Error Correction Term (ECT) carries an expected negative sign, which is highly significant, indicating that the dependent variable (current account deficit) can get back towards the long-run equilibrium at the speed of 68.9 percent in each period, one period after the exogenous

shocks, yielding further evidence for co-integration relationships among variables in the model (Table 4).

Table 4: Results of Error Correction Representation of the ARDL Model

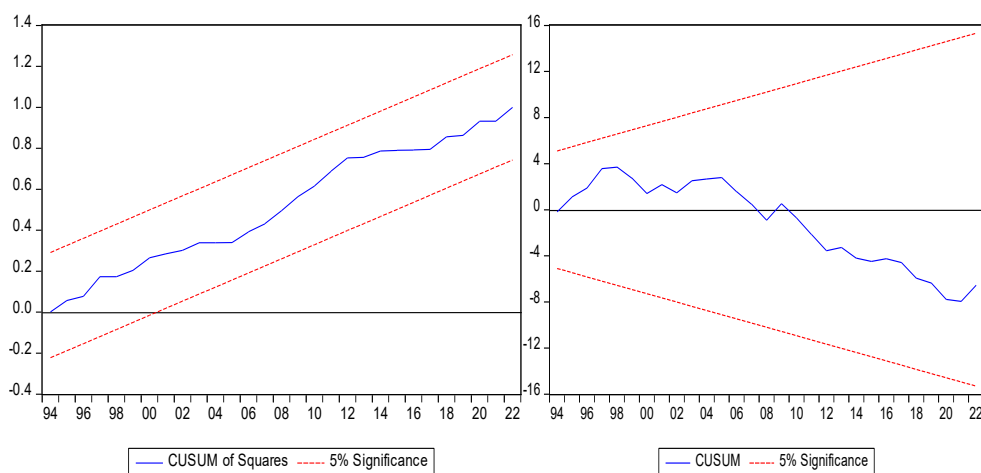
Variables	Dependent Variable: Δ CAD			
	Lag order			
	0	1	2	3
Δ CAD		-0.0932 (0.4604)		
Δ BD	0.7628*** (0.0001)			
Δ INT	-0.0605 (0.4102)	-0.2945** (0.0167)	0.1426 (0.2215)	
Δ GDP	-0.5439*** (0.0009)	-0.0829 (0.6554)	-0.3177* (0.0629)	-0.0048 (0.9755)
Δ RER	0.1101 (0.2007)	-0.0858 (0.3195)	0.0319 (0.6696)	-0.0836 (0.3414)
ECT (-1)	-0.689*** (0.0066)			
Adjusted R ²	0.6334			
F-statistic	6.0605 (0.00003)			

Note: The values inside parentheses are the probability values corresponding to those test statistics. ***, **, * represents the variables are statistically significant at 1%, 5% and 10% level of significance respectively.

Source: Author's calculations, 2024

Moreover, the stability of the long-run relationship between CAD, BD, INT, GDP, and RER of the ARDL (1, 0, 2, 3, 3) model is tested using CUSUM (Cumulative Sum test) and CUSUM of squares tests. As illustrated in Figure 5, the CUSUM and CUSUM squares statistics lie within the critical bounds at a 5% significance level, which confirms the stability of the selected model.

Figure 5: CUSUM test and CUSUM of squares test



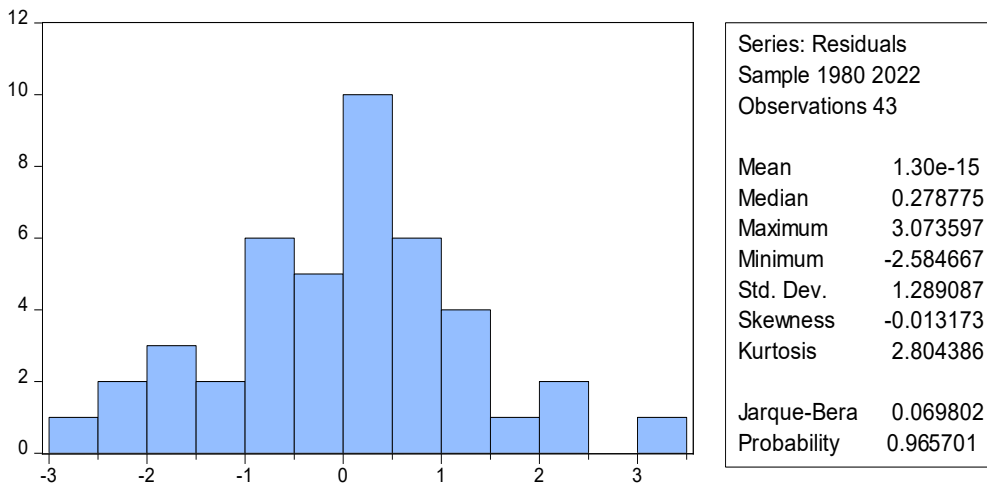
Source: Author's calculations, 2024

Table 5: The Results of diagnostics test of ARDL (1, 0, 2, 3, 3)

Test	Probability value (F or Chi-square test statistic)
Serial Correlation [LM Test: $\chi^2(df)$]	0.4226
Normality Test (Jarque-Bera)	0.9657
Heteroscedasticity: Breusch-Pagan-Godfrey (BPG Test)	0.2759
Heteroscedasticity: ARCH Test	0.8374
Omitted Variable (Ramsey's RESET)	0.6538

Source: Author's calculations, 2024

Figure 6: Normality of residuals



Source: Author's calculations, 2024

Further, the ARDL (1, 0, 2, 3, 3) model passes all the diagnostic tests. That is, firstly, the Lagrange Multiplier (LM) test of serial correlation (Table 5 above) advocates that the residuals are not serially correlated since we failed to reject the null hypothesis of no serial correlation in the residual, as the probability value is greater than the 5% level of significance. Secondly, according to the Jarque-Bera (JB) test output shown in Figure 6 above, the null hypothesis of normally distributed residuals cannot be rejected as the probability value is higher than 5% significance level, which indicates that errors are normally distributed in the ARDL model. Thirdly, the Breusch-Pagan-Godfrey (BPG) test and ARCH test of heteroscedasticity in Table 5 suggest that the disturbance term in the equation is homoscedastic, as we failed to reject the null hypothesis since the probability value exceeded the 5% significance level. Finally, the Ramsey RESET test result confirms that there is no specification error in the estimated model since we cannot reject the null hypothesis of no omitted variable in the model, as the probability value is greater than the 5% level of significance.

Table 6 discusses the direction of causality between the variables. This study aimed at analysing mainly the direction of causality between the variables CAD (current account deficit) and BD (budget deficit). Granger causality results show a causal effect runs from BD to CAD at a 5% significance level. At the same time, no causation is observed from CAD to BD. Therefore, the causal effect appears unidirectional, and the effect created by the budget deficit would be on the current account deficit. Hence, the findings suggest the existence of the twin deficit hypothesis in Sri Lanka.

Table 6: Granger causality test results

Null Hypothesis (H ₀)	Probability Value	Decision
DBD does not Granger-cause DCAD	0.0465**	Reject H ₀
DCAD does not Granger-cause DBD	0.7806	Do not reject H ₀
DGDP does not Granger-cause DCA	0.5695	Do not reject H ₀
DCA does not Granger-cause DGDP	0.8888	Do not reject H ₀
DRER does not Granger-cause DCA	0.5264	Do not reject H ₀
DCA does not Granger-cause DRER	0.6441	Do not reject H ₀
DINT does not Granger-cause DCA	0.1679	Do not reject H ₀
DCA does not Granger-cause DINT	0.5613	Do not reject H ₀
DGDP does not Granger-cause DBD	0.8384	Do not reject H ₀
DBD does not Granger-cause DGDP	0.2351	Do not reject H ₀
DRER does not Granger-cause DBD	0.5450	Do not reject H ₀
DBD does not Granger-cause DRER	0.9354	Do not reject H ₀
DINT does not Granger-cause DBD	0.9990	Do not reject H ₀
DBD does not Granger-cause DINT	0.4155	Do not reject H ₀
DRER does not Granger-cause DGDP	0.0084***	Reject H ₀
DGDP does not Granger-cause DRER	0.3209	Do not reject H ₀
DINT does not Granger-cause DGDP	0.6954	Do not reject H ₀
DGDP does not Granger-cause DINT	0.0814*	Do not reject H ₀
DINT does not Granger-cause DRER	0.0098***	Reject H ₀
DRER does not Granger-cause DINT	0.1530	Do not reject H ₀

Note: ***, **, * represent the variables that are statistically significant at 1%, 5% and 10% level of significance, respectively.

Source: Author's calculations, 2024

The results support the Keynesian view, showing causation from budget deficit to current account deficit and a potential absence of a strong Ricardian equivalence effect in the case of Sri Lanka. Further, this study identified that a unidirectional causality runs from RER to GDP, GDP to INT, and INT to RER. The unidirectional causality runs from INT to RER, which also supports the twin deficit hypothesis in Sri Lanka, where higher interest rates compared to the neighbouring country attract more capital inflows to the country, causing an appreciation of its real exchange rate that will intensify the deterioration in its trade balance and thereby in the current account balance.

CONCLUSION AND POLICY RECOMMENDATION

Higher budget imbalances are considered one of the prime reasons for the economic disruptions (Perera and Liyanage, 2012) in developing countries. Therefore, a greater focus on lowering persistent fiscal deficits is crucial for a country to maintain a stable internal and external macroeconomic environment. Thus, the main objective of this study is to identify the causal relationship between budget deficits and current account deficits to test the validity of Keynesian and Ricardian views in the Sri Lankan context. Moreover, the study also focuses on investigating the direction of causality between the budget deficits and the current account deficits. In order to achieve these research objectives, the study employed annual time series data for budget deficits, current account deficits, interest rates, real GDP growth rate, and real exchange rates of Sri Lanka over the period of 1977 to 2022. Furthermore, the Auto Regressive Distributed Lag (ARDL) model is employed to identify the long-run and short-run dynamic relationship between the variables. The Granger Causality test was also used to detect the direction of causality between the variables. ARDL Bound testing approach identified the cointegrating relationship between the variables, which confirms the existence of a long-run relationship among the variables considered in this study.

The results of both the ARDL long-run and the short-run version of the ECM of ARDL detected that there is a positive and significant relationship between budget deficit and current account deficit in Sri Lanka during the period of 1977 to 2022, implying higher fiscal deficit widens the current account deficit in Sri Lanka in both the short-run and long-run. The positive relationship between Sri Lanka's budget deficit and current account deficit aligns with the Keynesian twin deficit hypothesis in the case of Sri Lanka. The findings revealed that Sri Lanka's ongoing budget deficit compelled governments to borrow excessively from external markets, which harmed the country's debt level, interest payments, foreign exchange reserve position, exchange rate, and ultimately led to current account imbalances. This study is consistent with the findings of several other studies, such as Deniz and Celik (2009), Saleh et al. (2005); Chowdhury and Saleh (2007); Acaravci and Ozturk (2008); Sivarajasingam and Balamurali (2011); Perera and Liyanage (2012); Premaratne, Ravinthirakumaran, and Kesaverajah (2013); Kundu (2020), Jayasundara and Fernando (2022).

Though the interest rate does not have any significant impact on the current account deficit in the long run, it has a significant negative impact in the short run, as expected, on Sri Lanka's current account deficit. Moreover, the real GDP growth rate has a significant and negative impact on the current account deficit in both the short run and long run. This implies that a lower GDP growth rate may lead to a wider current account deficit in Sri Lanka. However, the real exchange rate does not affect the current account deficit significantly in the short run, but in the long run, it has a significant negative impact on the current account deficit, as expected. The significant inverse relationship between the real exchange rate and current account deficit in the long run depicts that the

current account deficit of Sri Lanka increases with a decline in the real exchange rate. According to the findings, the appreciation of the real exchange rate leads to an increase in the volume of imports and a decrease in the volume of exports, and finally worsens the current account deficit in Sri Lanka. Moreover, the coefficient of Error Correction Term (ECT) carries an expected negative sign, which is highly significant, indicating that the dependent variable, current account deficit, can get back to the long-run equilibrium path at a speed of 68.9 percent in each period, one period after the exogenous shocks which is further evidence of co-integration relationships among the variables in the model.

Based on the long-run and short-run estimation results, the budget deficit has a more dominant effect on the current account balance in Sri Lanka than other variables used in this study. Moreover, the results reveal that the positive association between the budget deficit and the current account deficit is less pronounced in the short run than in the long run, indicating a stronger long-term linkage between the two deficits. The Granger causality test also detected a unidirectional causation running from budget deficit to current account deficit in Sri Lanka. This empirical result partially supports the Keynesian view regarding the linkage between the trade deficit and the budget deficit, while the Ricardian equivalence hypothesis is not valid for the Sri Lankan economy during the study period.

The findings indicate that lowering the fiscal deficit is important to control the current account imbalances at a manageable level in Sri Lanka. On the policy front, these results draw immediate attention to the perfect policy implications for addressing these budgetary problems and reducing current account imbalances. Structural weaknesses in the expenditure structure lead to excessive fiscal deficit in Sri Lanka. Increased government expenditure, mainly on account of interest payments on public debt, salaries and wages, and large funds transfers to loss-making state-owned enterprises, coupled with inadequate revenue generation, led to persistent budgetary imbalances (Colombage, 2015). Extended welfarism-oriented government policies and mismanagement of public funds are other important reasons for not achieving a stable internal account (Jayasundara and Fernando, 2022). Therefore, improving the efficiency of the government institutions and minimising the existing bureaucracies to deliver an efficient and productive civil service are very important.

To reduce the excessive fiscal deficit in Sri Lanka, several strategic policy measures are essential. First, enhancing revenue generation through comprehensive tax reforms is crucial. This includes broadening the tax base, minimising exemptions, improving tax compliance, and shifting towards more progressive taxation to ensure both equity and increased revenues. Simultaneously, rationalising public expenditure by eliminating non-essential and inefficient spending, while prioritising investments in infrastructure, health, and education, will improve long-term fiscal sustainability. Reforming state-owned enterprises (SOEs) is also necessary, either through privatisation or by introducing clear performance benchmarks and greater accountability to reduce their fiscal burden.

Strengthening fiscal transparency and governance—by ensuring transparent budgeting, regular public disclosure, and independent fiscal oversight—will help build public trust and fiscal credibility. Additionally, adopting a medium-term fiscal framework (MTFF) with binding targets and fiscal rules can anchor expectations and guide responsible policymaking. Prudent public debt management, including restructuring high-cost debt and avoiding unsustainable external borrowing, is essential to reduce interest burdens. Promoting economic growth by investing in key productive sectors, such as hospitality, logistics, renewable energy, technology, agriculture, and apparel & textiles—along with improving the overall business environment and reducing corruption, can significantly contribute to fiscal deficit reduction through enhancing the government's revenue generation. Finally, reducing dependence on imports and enhancing domestic production and export diversification will improve the trade balance and reduce external fiscal pressures.

In conclusion, by effectively reducing its fiscal deficit, Sri Lanka can strengthen its macroeconomic stability by lowering reliance on foreign borrowing and attracting both domestic and foreign investment. This would enhance export competitiveness, helping to narrow the current account deficit. A strong fiscal position also boosts investor confidence, enabling Sri Lanka to secure international financing at lower interest rates. This will lead to redirecting the resources for productive investment ventures and induce economic growth.

This study provides valuable insights into fiscal policy dynamics in Sri Lanka. However, it should be acknowledged that the study is subject to a few limitations. Although both Keynesian and Ricardian perspectives are introduced, the analysis is mainly framed within the Keynesian paradigm. Further, the econometric model applied does not incorporate structural breaks or account for major external shocks. Therefore, global factors such as fluctuations in oil prices, the global financial crisis, and the COVID-19 pandemic were excluded from the model. Also, it is important to acknowledge that the political constraints, supply chain disruptions, informality in trade, dependency on exports, sectoral disputes, and public resistance to reforms were not considered. Therefore, these limitations can be considered in future studies.

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