

ABSTRACT

The primary objective of this research is to investigate the Granger-causality relationship between Federal budget deficits and interest rates in Malaysia since 1978. This is to ascertain whether budget deficits have an effect on short-term and medium-term interest rates. The effects of short-term and medium rates on budget deficits are also determined.

Quarterly data from 1978 to 2002 is used in this study. Apart from the budget deficits and interest rates series, other variables that theoretically influence the outcome of this relationship are also included as part of the analysis.

This study applies the causality-based approach instead of a correlation-based one. All the variables are tested for the presence of unit roots using the Augmented Dickey-Fuller test and the number of cointegrating relations between them is determined by applying the Johansen methodology. Subsequently, Error Correction models are constructed and the Granger-causality analysis is performed.

The findings of this study indicate that budget deficits do not Granger-cause both short-term and medium-term interest rates. Therefore, evidence from this study supports the Ricardian Equivalence and rules out the possibility of crowding out as a result of increased interest rates. Short-term interest rates also do not Granger-cause budget deficits but there appears to be evidence indicating that medium-term interest rates do Granger-cause budget deficits.