

CHAPTER 6

CONCLUSION

This paper has examined the Granger-causality relationship between budget deficits and interest rates in Malaysia. The results are obtained by adopting a causality-based analysis instead of a correlation-based one. This includes applying the cointegrating methodology, error correction (EC) modeling and Granger-causality analysis on relevant variables.

In both the investigations on medium-term and short-term interest rates, it is found that there are seven cointegrating relations for each system. Eight lags are also assigned to each of the variables in both analyses.

Based on the results gathered from this study, budget deficits in Malaysia do not seem to affect medium-term interest rates (one-year Treasury bill rates) and there is no evidence to support the Keynesian proposition of large deficits leading to higher interest rates. This is consistent with the results obtained by the likes of Evans and Darrat. Besides that, this finding also shares the same conclusion with Gupta's (1992) study of a different methodology on Malaysia that budget deficits do not have any effect on interest rates. Therefore, the scenario of deficits 'crowding out' private expenditure in Malaysia may prove to be unwarranted.

Instead, medium-term interest rates seem to have an effect on budget deficits. This is not totally unexpected as it is consistent with the finding of Darrat (2002) and it

has also been empirically proven that this possibility has occurred in developed nations. However, the application of the Granger-causality analysis does not allow for distinguishing whether medium-term rates raise or lower budget deficits.

As in the analysis between budget deficits and medium rates, there is no effect of deficits on short-term (three-month) Treasury bill rates. On top of that, three-month rates also do not have any effect on budget deficits. This implies that there is no causality whatsoever between budget deficits and short-term rates. This finding in particular is consistent with Hoelscher's (1986) study that deficits tend to influence long-term rates and not short-term rates. However, it is contradictory to the study by Cheng (1998) who has detected feedback causality between budget deficits and short-term rates in Japan. This could be due to the fact that Malaysia may not be as heavily dependent on short-term debt as Japan in financing budget deficits. Therefore, the finding on short-term rates supports the Ricardian Equivalence and rejects the possibility of deficits 'crowding out' private investment.

To further consolidate the findings above, several other tests, namely the normality and stability tests are also conducted. Based on these tests, it would appear that the findings obtained are valid.

The one shortcoming identified in this study is the unavailability of quarterly unemployment data in Malaysia since 1978. The use of this data might further add weight to the validity this study.

Nonetheless, results in this study do not represent the final verdict and may not apply in economies of other countries. It is also by no means definitive but the results do add weight to the notion that deficits do not raise interest rates just as in many other more recent studies.

Although the findings in this paper do not indicate that budget deficits affect interest rates in Malaysia and hamper growth by causing 'crowding out', this study do not by all means support excessive budgetary deficits. If deficits persist in the long-run, the economic stability of the country may be threatened. Hence, budget deficits should be gradually reduced and be kept low whenever possible.