

Fiscal Deficit and Interest Rate in India: A Cointegration Analysis

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Economists differ in their theoretical conclusions over the relation between fiscal deficit and interest rate. The empirical studies in different countries have also produced varied results. As high fiscal deficit is a characteristic feature of the Indian economy, different econometric studies have been done to search for causal relation between India's fiscal deficit and interest rate but the conclusions derived are divergent. Our paper also enquires into the statistical relation between these two variables. It follows the methodology of unit root and cointegration tests using quarterly data up to recent period (2003). The paper finds that the fiscal deficit and interest rate do not appear to be connected in the context of Indian economy during the period of study. Moreover, the non-existence of the relation cannot be attributed to expansion in either money supply or savings, considered separately. However, macro variables like interest rate, GDP, money supply are found to be linked in an integrated framework combining real and monetary sectors of the economy. Another important finding of the study is non-stationarity of fiscal deficit. This result brings to the fore the issue of sustainability of country's fiscal deficit in the long-run.

Introduction

The theory of determination of interest rate has a long historical background. The classical focus their attention to long-run interest and conclude that interest is determined by real factors. The subsequently developed loanable fund theory admits the role of real, as well as, monetary determinants in interest rate theory. The liquidity preference theory of Keynes (1936) claims that interest is a monetary phenomenon and formulates the model in terms of stock of demand and supply of

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