

Budget Deficit and Macroeconomics Fundamentals: The case of Azerbaijan

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Abstract

In recent years, the emergence of rising budget deficit is the main reason forcing economists to investigate the reasons for changes in fiscal balances. The purpose of the paper is to investigate the relationship between budget deficit and macroeconomic fundamentals using data from Azerbaijan. The empirical analysis applies ARDL Cointegration methodology in conjunction with Granger causality tests to provide evidence for both the long and short run dynamics between the variables involved in the analysis. Using the Error Correction specification, there was found evidence of long-run causality running from current account, real interest rate, GDP, inflation and exchange rate to budget deficit. There was also found evidence of short-run Granger causal effects running from current account and real interest rate towards budget deficit and a rather weak causal effect from inflation to budget deficit. However, there is no short – run causality running from interest rate to budget deficit.

Key words: Budget deficit, Fiscal policy, Cointegration methodology, Error correction model

JEL classification: E62, H62, C22

1. Introduction

Azerbaijan became an independent state in October 1991, following the dissolution of the USSR. The Azeri economy, geared to the demands of the Soviet GOSPLAN (*the state planning commission of the former Soviet Union or any of its constituent republics: it was responsible for coordination and development of the economy, social services, etc*) and part of CMEA (*Council for Mutual Economic Assistance*), faced external shocks with the demise of these structures, and by the onset of regional conflict over Nagorno – Karabakh. The break-up of trading links and payment mechanisms within the CMEA bloc, and more particularly within the Soviet Union was exacerbated by the deterioration in terms of trade for Azerbaijan as the formerly planned economies began to move towards transition at different speeds and with different rates of price adjustment. The start of the stabilization process was possible following the cessation of conflict Garabag in 1994. During this year

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