

Fiscal and current account deficits have been a common phenomenon on the Kenyan macroeconomic scene from the 1960s. This study examines the relationship between these two deficits using annual data covering the period 1965 to 2000. The relationship between fiscal and current account deficit "twin deficit hypothesis" was presented. These are the Ricardian, neoclassical and Keynesian schools of thought. The Ricardian equivalence argues the absence of any relationship between the deficits, while the Keynesian proposition affirms that fiscal deficits lead to a current account deficit.

To enable to undertake this study, data from International Financial Statistics is used. Granger causality tests are performed on the fiscal and current account balances series. The tests revealed that there was no causality between fiscal and current account deficits. Estimations are done using OLS estimation technique. Wald tests are performed to ascertain the overall significance of the coefficients. The estimations are repeated using growth values of fiscal and current account balances, to ascertain if short-run dynamics are the same as long run equilibrium relationships. The study confirmed that there is no relationship between the two deficits. In this study, the Ricardian equivalence is valid in the Kenyan case. The study also found out that the short-run dynamics are the same as long run equilibrium relationships.

Since, the results in the study show independence, one important implication for policy is that if the government would wish to reduce both deficits, it should deal with them separately.