Household and Government Consumption and Gross Domestic Product in Sri Lanka: A Cointegration Analysis

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The Gross Domestic Product (GDP) is an important indicator which represents the economic health of a country. Household and government consumption are the important elements that influence the formation of the GDP. Therefore, the study examines the relationships among household final consumption expenditure, government final consumption expenditure and Gross Domestic Product in Sri Lanka. For the study, data were extracted from the World Bank database for the period of 1962-2016. The study applied Augmented Dickey Fuller and Phillips-Perron unit root test to test the stationarity of the data series and Johansen cointegration, Engle and Granger test and pairwise Granger Causality test to identify the short run and long run relations among the variables. Results of unit root test revealed that all the series were stationary at first difference. Since the variables are co-integrated it was extended the study by performing a Vector Error Correction Model (VECM) which elaborated that about 53% of disequilibrium corrected each year by changes in GDP. Pairwise Granger Causality revealed that bidirectional causal relation between government expenditure to Gross Domestic product and household expenditure to government expenditure. Further, there is a one directional causality from GDP to household expenditure but not vice versa in Sri Lanka.

Keywords: consumption expenditure; gross domestic product; co-integration