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PUBLIC DEBT AND ECONOMIC GROWTH: A TWO-SIDED STORY

Abstract:

The recent European sovereign debt crisis proved public debt issues should not be easily approached. While, prior to the crisis, public debt was of little concern in most of the developed European countries, as there had been no recent episodes of sovereign default, the crisis revived longtime forgotten memories. It once again proved that, although at different debt levels, just like the developing countries the developed ones should fear high public debts and that public debt is almost always a two-sided story: although public indebtedness can promote economic growth, especially when debt resources are used for financing public investment expenditure, when the debt is very high it can negatively affect economic growth.

Against this background, in this paper we aim to study the relationship between public debt and economic growth for a panel of 33 European countries (28 European Union Member States and 5 candidate countries to European accession) over the period 1990-2011. More specifically, we investigate if there is evidence of a non-linear (quadratic) relationship, both for the entire European countries group and for the developed and developing countries subgroups. The main sources of data are World Bank's World Development Indicators and International Monetary Fund's World Economic Outlook and Historical Public Debt datasets.

The results of our study confirm the existence of a „U inverted” relationship, with a maximum debt threshold of about 94% of GDP. After this threshold public debt is expected to negatively affect the economic growth rate, due to higher interest rates, fear of public debt unsustainability and severe budgetary consolidation measures. However, this threshold is found to be more than twice lower in developing European countries compared to the developed ones, as the former enjoy lower credibility, higher vulnerability to shocks and depend more on external capital transfers.

Keywords:

public debt, economic growth, public policy, developed European countries, developing European countries

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