

## PUBLIC DEBT AND ECONOMIC GROWTH IN THE AFTERMATH OF THE COVID-19 ECONOMIC CRISIS

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### ABSTRACT

The Great Financial Crisis (GFC) of 2008 to 2010 increased the size of the public debt and decreased the fiscal space. The problem stems from the fact that fiscal resources are limited. Many OECD countries had used a substantial part of their limited fiscal space. Researchers suspected that higher levels of public debt in the future could slow down GDP growth. The first attempts to detect the tipping point at which GDP growth stalls or loses steam were made right after the GFC. However, the discussion was left open. The Covid-19 crisis required the further use of unprecedented amounts of fiscal stimulus resources to stabilise the economic situation. The objective of this paper is to establish whether new data of elevated public debt levels in relation to GDP confirms that higher levels of debt to GDP have an impact on future GDP growth and future financial stability. Debt and GDP data from OECD countries for the years 2000 to 2026 was used in order to carry out multilinear regression analysis, establishing the relationship between debt and future GDP growth. The results provide compelling evidence that the accumulation of higher debt levels slows down GDP growth, and require more fiscal resources in the future to stabilise the economic situation, compared with countries with lower accumulated public debt levels. Hence, higher inflation will require even more resources to service the debt.

KEY WORDS: *public debt, fiscal space, fiscal policy, GDP growth, debt threshold.*

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### Introduction

The size of the public debt has been a subject of discussion for more than a century. Depression, recession and greater or smaller crises have always required additional government support and fiscal stimulus in order to uphold demand and consumption, to strengthen additional public investment, and provide extra support to reduce unemployment and provide unemployment benefit. As long as the size of the budget deficit and the expansion of the public debt seem to be under control, there are only marginal general guidelines regarding the size and sustainability of the public debt.

The Great Financial Crisis (GFC) of 2008 to 2010 provided a wake-up call regarding the sustainability of multi-factor macro-equilibrium systems in the future. Financial sector bankruptcies, rising unemployment, the slow recovery from the crisis, increasing budget deficits, and the increasing ratio of public debt to GDP of many economies, were disturbing. Countries tried to recover to pre-crisis GDP and debt levels, and to build financial and fiscal buffers for future crises. In post-GFC times, few countries managed to build fiscal buffers and to renew the fiscal space for future challenges and hardship. Most countries did not manage to bring down the debt levels accumulated during the crisis, and even increased debt levels further. A substantial fiscal space was used to recover from the GFC. By not reducing the outstanding debt, the size of the fiscal space was reduced even further.

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The GFC of 2008 to 2010 sparked a new wave of discussions and research regarding whether a certain size of public debt has negative implications for future growth. Whether or not there are tipping points or magic threshold levels of debt to GDP beyond which GDP growth slows down, there is a need to return to more sustainable levels of debt. The Maastricht Criteria for Eurozone countries in 1999 stipulated that the debt levels of European Monetary Union (EMU) countries should not exceed 60%. At the end of the GFC, many Eurozone countries were already breaching that level, and several even received serious warnings for neglecting that criterion (ECB, 2010: 79–82). However, those notifications and Blue Papers were later dropped, and reminders were not renewed.

Thus, with the problem of limited fiscal resources and a diminishing fiscal space, the objective of this paper is to establish a close relationship between GDP growth and the size of the public debt, and to state that higher public debt levels have an impact on GDP growth. The paper will contribute to academic literature by providing multi-level linear regression analyses of how the new elevated debt levels of the Covid-19 economic crisis, exceeding 100% of GDP in OECD and G-7 countries, influence recovery and growth.

The results demonstrate that debt up to a certain limit stimulates GDP growth. The size of the debt is important. Once the ratio of the debt level to GDP reaches a certain level, and even exceeds that level, countries' GDP growth slows down and requires more financial resources to recover from crises and to service the debt.

## 1. Theoretical background

Research and studies have emerged about public sector debt levels up to which GDP growth is positively stimulated, but once the debt to GDP ratio level reaches 67% or 90%, or even higher, the growth rate of GDP is reduced. There is a vast amount of literature in academic research and studies from various angles about how to look at the debt to GDP ratio and GDP growth relationship explanations. The most prominent piece of research 'Growth in a Time of Debt' (Reinhart, Rogoff, 2010a: 1–25) claimed that there is a debt to GDP 90% ratio or threshold at which GDP growth slows down if the debt continues to grow further. It was followed up by Reinhart and Rogoff (2010b: 1–14) with an additional explanation of some of the data and assumptions.

Many analysts concurred with Reinhart and Rogoff's arguments, and provided additional evidence that there is a negative correlation between GDP growth and the debt level to GDP ratio once the debt level reaches a certain threshold. Cecchetti (2011: 14) stipulates that there is a certain level beyond which the debt increase will drag the future: 'Public debt has a consistently significant negative impact on future growth. And the impact is big: a 10 percentage point increase in the ratio of public debt to GDP is associated with a 17 or 18 basis point reduction in subsequent average annual growth.' Baum (2012: 2–3) established that in the short term, debt increase has a stimulating effect on growth, but once it reaches 67% the results become blurred, and when countries reach a 95% debt to GDP ratio threshold, they will experience a negative effect on future growth. Afonso and Julles (2014: 2; 22), Woo and Kumar (2015: 21) and Chudik (2017: 5) also established debt to GDP threshold levels beyond which future GDP growth will slow down. The research was complemented by an analysis of the permanent and transitory effects of the public debt on economic growth (Abubakar, Mamman, 2020: 1), acknowledging the negative effect of the debt on GDP growth, but emphasising that a short-term rise in the debt would not be harmful.

However, there were analysts who challenged Reinhart and Rogoff's 'Growth in a Time of Debt' conclusions, and carried out separate studies using the same datasets, admitting that there is some correlation between the size of the public debt and GDP growth, but only small probability of causality, if at all. Hurdon (2013: 1) claimed that Reinhart and Rogoff's research was inaccurate, and there was no consistency that the 90% threshold 'works' all the time and for all countries. However, Panizza and Presbitero (2012: 17) were less adamant, and careful with strict conclusions, stating only in their conclusion that: 'It seems that advanced economies in our sample are still below the country-specific threshold at which debt starts having a negative effect on growth.' Finally, Pescatori (2014: 4) did not find that there is any threshold which precludes countries growing in the medium term. The only important thing is the trajectory of the debt, and if it is declining, then growth will resemble its peers (Pescatori, 2014: 14). Ash (2017: 1) criticised the selection

of the data and the sample size, stating that outliers influence the results. An attempt to reconcile the work of several camps during the last decade and summarise the issue was made by Heimberger (2021:1–21), claiming that there is no universal threshold when debt is detrimental to future growth for all countries, and that 90% is not a ‘magic number’.

## 2. The impact of the Covid-19 crisis on public debt

The Covid-19 crisis has required a substantial amount of additional fiscal resources in order to tackle problems of a medical and economic nature, pushing the new borrowing and public debt increase even higher. Thus, public debt level or indebtedness (Fig. 1) in advanced economies or OECD countries rose from 71% of GDP in 2007 to 122% in 2020, and from 66% of GDP to 98% in the European area, and from 80% of GDP to 140% in the G-7 countries.

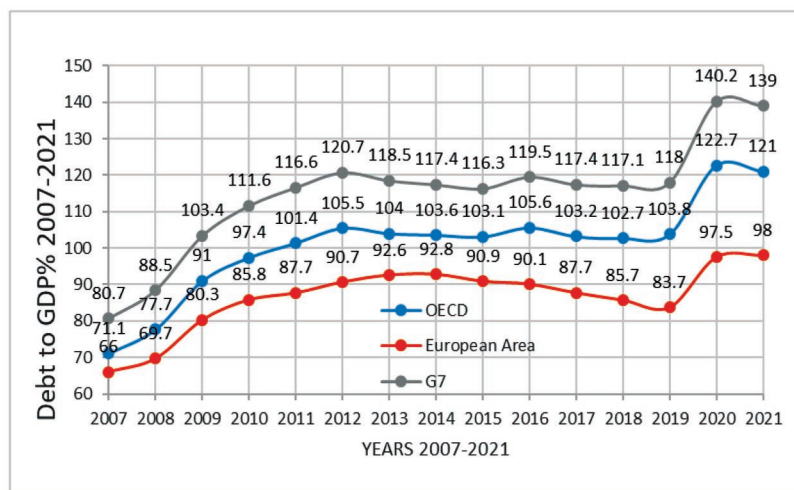


Figure 1. Debt to GDP%, 2007–2021

Source: IMF World Economic Outlook, October 2021.

The data for the year 2021 is provisional and based on IMF estimates, and was produced before the October 2021 wave of the pandemic, and therefore could be too optimistic.

Table 1 provides data and evidence that only a few countries (Denmark, Germany, Iceland, Israel, Malta, the Netherlands, Sweden, Switzerland and Taiwan) were able to return to pre-GFC debt levels by the end of 2019 (2019Q4). The Covid-19 crisis increased the debt for all other OECD countries, and it will require discipline to return to the pre-crisis levels.

The Covid-19 crisis began with huge uncertainty, and countries did ‘whatever it takes’ in order to stabilise the medical, epidemiological and economic situations. Cooperation between central banks and the respective governments was good by historical standards, and huge amounts of funds were made available and provided to stabilise and recover the situation. The question always remains: do larger fiscal resources warrant faster recovery? Figure 2 shows that countries provided large fiscal stimulus packages (2% to 12% of GDP) to support their economies. The fiscal response to the crisis was very important (Anderson *et al.*, 2020: 1–2), but can we claim that more money being available and provided in terms of share of GDP warrants a smaller GDP decrease in 2020?

So far, the results differ. The hypothesis that more money will do the trick and bring recovery sooner has not been confirmed. Larger fiscal stimulus support packages do not guarantee higher growth. Regression analysis was performed by using the IMF’s GDP data for the year 2020 in conjunction with the fiscal stimulus response of the respective countries. Several (especially rich) countries provided immense amounts of money and support measures in order to rescue firms and people from the hardship they are going through (Benmelech, Tzur-Ilan, 2020: 1–5), but so far with little response (Fig. 2).

Table 1. General government gross debt in advanced economies, % of GDP, 2007–2021

AEs	71.1	77.7	91	97.4	101.4	105.5	104	103.6	103.1	105.6	103.2	102.7	103.8	122.7	<b>121</b>
Australia	9.7	11.8	16.7	20.4	24.1	27.5	30.5	34	37.7	40.5	41.1	41.6	46.6	<b>57.3</b>	<b>62</b>
Austria	64.7	68.4	79.6	82.4	82.2	81.7	81	83.8	84.4	82.5	78.6	74	70.5	<b>83.2</b>	<b>84</b>
Belgium	87.3	93.2	100.2	100.3	103.5	104.8	105.5	107	105.2	105	102	99.8	98.1	114.1	<b>113</b>
Canada	66.9	67.9	79.3	81.2	81.8	85.4	86.1	85.6	91.2	91.7	88.8	88.8	86.8	117.5	<b>109</b>
Cyprus	53.2	44.1	52.8	55.5	65	79.4	102.9	109.1	107.2	103.1	93.5	99.2	94	119.1	<b>111</b>
Czech Republic	27.3	28.1	33.4	37.1	39.7	44.2	44.4	41.9	39.7	36.6	34.2	32.1	30	<b>37.8</b>	45
Denmark	27.3	33.3	40.2	42.6	46.1	44.9	44	44.3	39.8	37.2	35.9	34	33.6	42.1	<b>38</b>
EA	66	69.7	80.3	85.8	87.7	90.7	92.6	92.8	90.9	90.1	87.7	85.7	83.7	97.5	<b>98</b>
Estonia	3.8	4.5	7.2	6.7	6.2	9.8	10.2	10.6	10.1	10	9.1	8.2	8.6	18.5	<b>20</b>
EU	62.2	65.4	75.5	80.6	82.9	86.4	88.5	88.8	86.7	85.9	83.3	81.2	79	91.9	<b>93</b>
Finland	33.9	32.6	41.5	46.9	48.3	53.6	56.2	59.8	63.6	63.2	61.2	59.8	59.5	69.5	<b>72</b>
France	64.5	68.8	83	85.3	87.8	90.6	93.4	94.9	95.6	98	98.3	98	97.6	115.1	<b>115</b>
G7	80.7	88.5	103.4	111.6	116.6	120.7	118.5	117.4	116.3	119.5	117.4	117.1	118	140.2	<b>139</b>
Germany	64.2	65.7	73.2	82.5	79.9	81.2	78.8	75.7	72.3	69.3	65	61.6	59.2	69.1	<b>72</b>
Greece	104	110.3	127.8	147.5	183.9	162	179	181.5	179	183.4	182.4	189.9	184.9	211.2	<b>206</b>
Iceland	68.4	110.4	128.8	133.1	138.2	133.9	122	115.2	97.2	82.4	71.6	63.1	66.1	77.1	<b>75</b>
Ireland	23.9	42.5	61.8	86.2	110.5	119.7	120	104.3	76.7	74.3	67.8	63.2	57.3	58.5	<b>57</b>
Israel	72.9	71.6	74.4	70.4	68.6	68.1	66.8	65.6	63.8	62	60.2	60.4	59.5	<b>72</b>	<b>73</b>
Italy	103.9	106.2	116.6	119.2	119.7	126.5	132.5	135.4	135.3	134.8	134.1	134.4	134.6	155.8	<b>154</b>
Japan	172.8	180.7	198.7	205.7	219.1	226.1	229.6	233.5	228.4	232.5	231.4	232.5	235.4	254.1	<b>256</b>
Korea	27.4	26.9	30	29.5	33.1	35	37.7	39.7	40.8	41.2	40.1	40	42.1	<b>47.9</b>	<b>51</b>
Latvia	8.1	18	35.7	46.7	43.1	42.5	40	41.6	37.1	40.4	39	37.1	37	43.5	<b>47</b>
Lithuania	15.9	14.6	28	36.2	37.1	39.7	38.7	40.5	42.7	39.9	39.3	33.7	35.9	47.1	<b>47</b>
Luxembourg	8.2	15.4	16.1	20.2	19	22	23.7	22.7	22	20.1	22.3	21	22	24.8	<b>26</b>
Malta	61.9	61.8	66.3	65.3	69.3	65.9	65.8	61.6	55.9	54.3	47.5	43.4	40.6	53.3	<b>63</b>
The Netherlands	42	53.8	55.8	59.4	61.8	66.4	67.8	68	64.6	61.9	56.9	52.4	47.4	<b>52.5</b>	<b>58</b>
New Zealand	16.3	19	24.3	29.7	34.7	35.7	34.6	34.2	34.2	33.4	31.1	28	32	43.6	<b>52</b>
Norway	49.7	47.8	42.7	43.2	29.8	31.1	31.6	29.9	34.5	38.1	38.6	39.7	40.9	41.4	<b>42</b>
Portugal	72.7	75.6	87.8	100.2	114.4	129	131.4	132.9	131.2	131.5	126.1	121.5	116.6	135.2	<b>130</b>
Singapore	87.8	97.9	101.7	98.7	103.1	106.7	98.2	97.8	102.2	106.5	107.8	109.8	129	154.9	<b>137</b>
Slovakia	30.3	28.6	36.4	41	43.4	51.8	54.7	53.6	51.9	52.4	51.6	49.7	48.2	<b>60.3</b>	<b>61</b>
Slovenia	22.8	21.8	34.5	38.3	46.5	53.6	70	80.3	82.6	78.5	74.1	70.3	65.6	<b>79.8</b>	<b>77</b>
Spain	35.8	39.7	53.3	60.5	69.9	86.3	95.8	100.7	99.3	99.2	98.6	97.5	95.5	119.9	<b>120</b>
Sweden	39	37.5	40.7	38.1	37.1	37.5	40.2	44.9	43.7	42.3	40.7	38.9	34.9	37.3	<b>39</b>
Switzerland	44.5	44.6	42.8	41.1	41.5	42.2	41.6	41.6	41.7	40.5	41.2	39.2	39.8	<b>42.4</b>	<b>42</b>
Taiwan	32.2	33.4	36.7	36.9	38.3	39.2	38.9	37.5	35.9	35.4	34.5	33.9	32.7	32.7	<b>27</b>
UK	41.5	49.3	63.2	74.3	80	83.2	84.2	86.1	86.7	86.8	86.3	85.8	85.2	104.5	<b>108</b>
US	64.6	73.4	86.6	95.1	99.5	103	104.5	104.5	104.9	106.9	106	107.1	108.5	133.9	<b>133</b>

Source: IMF World Economic Outlook database, October 2021 (note: bold indicates an IMF estimate).

The correlation between the amounts provided and GDP growth in 2020 is small. Despite the large fiscal resources provided, GDP continued to shrink. One could always hypothesise about what could happen if support was not provided, or if it was smaller.

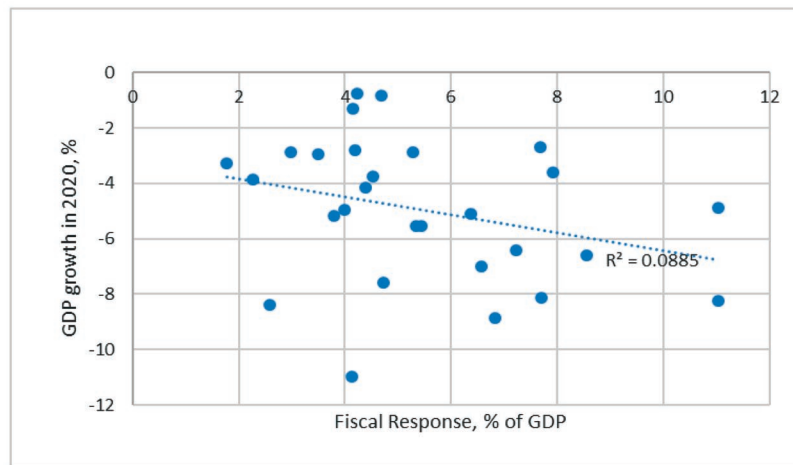


Figure 2. GDP% change and the respective fiscal response

Source: IMF Database 2021; author's calculations.

Since the Covid-19 pandemic in the world technically began at the same time (it was announced on 11 March 2020), it provided researchers with a unique opportunity to compare various countries and the respective measures applied to alleviate the hardships of the crisis and to cope with the economic hurdles. One indirect indication of how successful the applied policies were is the time span by which countries reached pre-crisis GDP levels. Why did some countries recover faster than others? And does it only depend on the amount of money provided during the crisis and the epidemiological measures imposed on the respective economies?

Table 2. The recovery of the 2019Q4 GDP level of several OECD countries

Country	Debt level	Year of Recovery to 2019Q4 level			
Australia	57%	2021			
Bulgaria	24%	2021			
Estonia	18%	2021			
Latvia	44%	2021			
Lithuania	47%	2021			
Luxemburg	25%	2021			
Korea	48%	2021			
Norway	41%	2021			
New Zealand	43%	2021			
Poland	57%	2021			
Romania	59%	2021			
Sweden	39%	2021			
Switzerland	42%	2021			
United States	133%	2021			

Source: Author's calculations.

Table 2 demonstrates that out of 35 selected OECD countries, only 14 had recovered to their pre-crisis level of GDP by 2021. What is obvious from Table 2 below is that these are countries with debt levels not exceeding 60% of GDP, and the majority of the countries do not even exceed the 50% debt level of GDP.

The USA is an exception and deserves a separate explanation, because the country was flooded with financial resources and instruments, and increased its debt to GDP ratio by more than 25% in order to preserve growth and safeguard the recovery, thus inflicting a heavy financial burden for the future.

The recovery of 2019Q4 GDP levels is an important yardstick and reference point. Table 2 provides additional evidence that the recovery could be more expeditious in countries with smaller debt levels, either because the fall was not so steep, or because the growth is faster and stimulates recovery. But the evidence that countries with smaller indebtedness recover sooner and GDP growth is larger than in countries with a higher debt level is indisputable this time.

### 3. Size of the ratio of debt to GDP and GDP growth

The dynamics of the public debt have been analysed broadly. The most prominent and controversial paper written in the aftermath of the GFC was the paper by Reinhart and Rogoff ‘Growth in a Time of Debt’, which provoked discussions between so-called Keynesians and Hooverites about the debt *per se*, and certain possible threshold levels of public debt to GDP beyond which potential growth will be impeded. The paper claimed that the 90% threshold level is a watershed, and beyond that potential economic growth will be lower due to the higher levels of debt.

At the same time, there is an opposing view that an increase in the public debt and spending, especially in the short term, stimulates the economy and GDP growth. Hence, GDP growth in the future will help to pay off and reduce the outstanding debt amount, and future growth will help to grow out of the debt and reduce the respective debt to GDP levels.

Once debt levels in the OECD European area and many countries have reached 100% of GDP, the analysis assumes a more zoomed-in approach, realising that a substantial fiscal space has been already used, and that a further increase in the debt will be costlier and less productive and sustainable, thus also opening discussions about sovereign default and insolvencies.

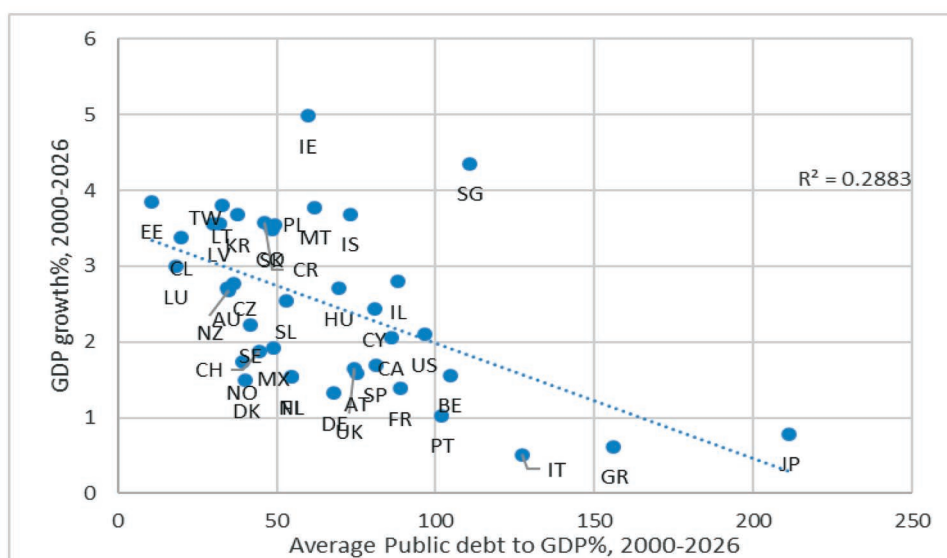


Figure 3. The impact of average public debt on GDP growth, 2000–2026

Source: IMF WEO, October 2021; author’s calculations.

Fig. 3 reflects the actual data for 23 years, and uses the IMF’s October 2021 World Economic Outlook forecast data for the years 2023 to 2026. Thus, the total period is from 2000 to 2026. Making a simple analysis of Fig. 3, it can be concluded that countries with higher debt levels over the studied period grow more slowly, and there is a close and undisputed correlation of  $R=0.54$  between the two variables.



#### 4. GDP growth change in 2000–2026

The Covid-19 crisis revived the discussion and new research about the impact of the substantially increased size of the public debt on economic growth, thus reigniting the discussion between two research camps on whether higher debt levels at a certain stage impede growth. Economists in one camp have come to the conclusion that there is a certain debt to GDP level at which the positive impact of debt increase on GDP is reduced, and after a certain point it is not even neutral any more, but has negative implications on growth (BAUM, 2012: 2). The other camp of researchers promotes the view that there is no evidence that a higher debt to GDP ratio impedes growth, but a slower growth in GDP especially increases the public debt. If GDP grows faster, it will reduce the outstanding debt to GDP ratio level.

Herndon (2013: 1) claims that economic growth in the future varies from country to country, and the 90% threshold is not applicable and could also depend on the period of development the country is in. Therefore, it is important to use fiscal stimulus and increase debt in order to support economic growth, which in turn will reduce the outstanding debt in the future. Fig. 4 does not prove this hypothesis, and clearly reflects that in the period 2000 to 2026, GDP growth has not been able to reduce the size of the outstanding debt. The debt has continued to grow. It could be stated that GDP growth has not been large enough to outpace the increase in the public debt.

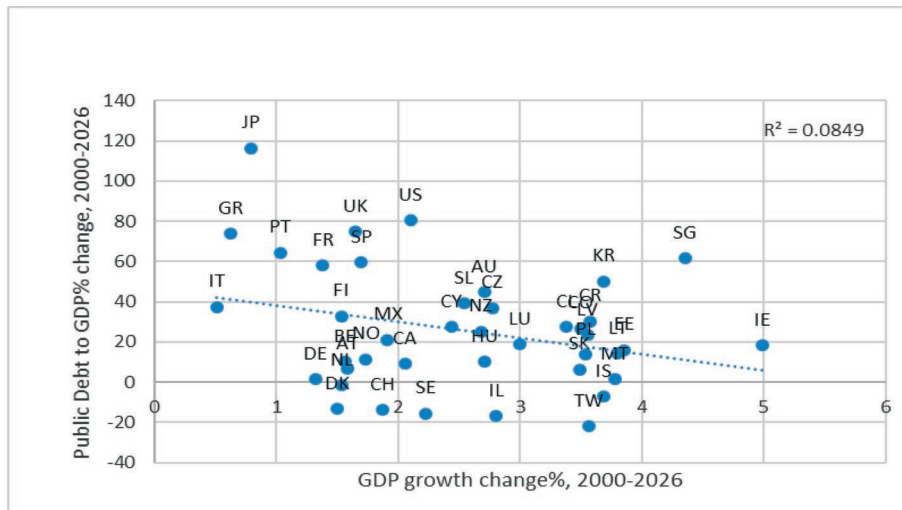


Figure 4. Will GDP growth reduce public debt in 2000–2026?

Source: IMF World Economic Outlook, October 2021, author's calculations.

Since the evidence is unclear and several studies have been sharply criticised by many other economists, and in the meantime economies have started to recover, the issue was put aside for the time being.

Now, two years since the pandemic was announced by the World Health Organization (WHO), debt levels have reached unprecedented levels. Two years of the Covid-19 crisis, when debt to GDP levels have surged even higher, respective IMF forecasts for the next four years provide additional information that higher levels of public debt will impede the GDP growth of several OECD countries, and there is a difference in GDP growth and speed of recovery between countries with higher and lower debt levels.

Therefore, the objective of this paper is to demonstrate that higher levels of economic growth over the given period of time from 2000 to 2026 do not reduce the level of outstanding public debt, and countries with a higher debt in the long term have been growing slower, thus questioning the justification for the further increase in the debt and the potential risk of insolvency of the respective countries, and urging the build-up of fiscal buffers and the creation of fiscal space for the next crises.

Should governments tighten fiscal policy after the crisis, and even carry out consolidation measures, or let automatic stabilisers and large discretionary spending stimulate further weak economies, hoping to pull themselves out of the crisis? That will be the challenge of the next few years.

## Conclusions

The GFC provided the first wake-up call regarding future problems associated with elevated debt to GDP ratio levels. The research by Reinhart and Rogoff received strong criticism and was slowly silenced and put aside. Arguments were put for both sides of the analysis, and researchers claimed the positive and negative effects of higher levels of the ratio of public debt to GDP. Ten years later, there are few who would deny that the current debt to GDP situation is slowly getting out of hand. If left unattended, it could severely break and slow down future GDP growth in the foreseeable future. In addition, new concerns are expressed regarding the solvency and sustainability of these elevated debt levels, especially in the light of increasing inflation and future debt servicing payments. Whether Growth and Stability Pact rules will be unfrozen in the Eurozone remains an open question. Therefore, this is the time to establish a clear agenda to tackle the mounting debt to GDP ratio problem. Governments should use the current economic recovery time to work out a plan to reduce accumulated debt levels, and to rebuild fiscal buffers for the next financial or economic crisis.

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## VALSTYBĒS SKOLA IR EKONOMIKOS AUGIMAS PO COVID-19 EKONOMINĒS KRIZĒS

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### Santrauka

Po 2008–2010 m. didžiosios finansų krizės laikotarpio, pasitelkta nemažai fiskalinių išteklių, siekiant atsigausti po krizės. Nurodyta atnaujinti fiskalinę erdvę ir išnaudoti palankų laiką, siekiant sumažinti neapmokėtą valstybės skolą ir sukurti fiskalinį rezervą, kai tik ištiks kita krizė. Namų darbus atliko ir valstybės skolą sumažino tik kelios šalys.

Netikėtai ištikusi COVID-19 krizė pareikalavo masinio ir neatidėliotino fiskalinio atsako. Ekonominei ir epidemiologinei situacijai stabilizuoti panaudoti didžiuliai finansiniai ir fiskaliniai ištekliai. Išnaudota ir papildoma fiskalinė erdvė.

Finansų srities analitinėse apžvalgose pateikiami prieštaringi tyrimų rezultatai, atskleidžiantys glaudų ryšį ir koreliaciją tarp valstybės skolos lygio bei atitinkamo ekonomikos augimo. Jei ši analizė būtų teisinga ir neginčijama, valstybės skolai ir BVP pasiekus tam tikrą iš anksto skelbtą BVP lygį bei sulėtėjus potencialiam BVP augimui, ateityje prireiktų būtinų taupymo priemonių.

Nauji COVID-19 krizės ekonominiai rezultatai tyrėjams suteikia papildomų duomenų, įrodančių stiprią koreliaciją tarp neapmokėtos skolos lygio ir BVP atsigavimo bei augimo. Dabar, po COVID-19 krizės, kai fiskalinė erdvė dar labiau apribota, o tolesni fiskaliniai stimulai didina skolą ir stabdo būsimą ekonomikos augimą, kas lemia lėtesnius atsigavimo rezultatus nei šalyse, turinčiose mažesnę skolų naštą, finansiniai rezultatai gali paskatinti ekonomistus grįžti prie diskusijos apie konsolidavimo priemones ir parengti veiksmų planą, kaip spręsti didėjančią skolų krizę, kol dar ne vėlu. Užuoat vėlavę ir laukę kitos krizės, sukurkite reikiamus fiskalinius buferius ir atlaisvinkite šiek tiek fiskalinės erdvės.

**PAGRINDINIAI ŽODŽIAI:** *valstybės skola, fiskalinė erdvė, fiskalinė politika, BVP augimas, skolos riba.*

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