

PUBLIC DEBT AND ECONOMIC GROWTH: A CONTEMPORARY LITERATURE REVIEW.

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Abstract

This article reviews the most important contributions to the literature in the relationship “public debt - economic growth”. We classified the relevant studies into two categories (“empirical” and “structural”) according to the explicit theoretical, or not, foundation of the identified models they use, as well as, whether they seek to detect the relevant causal relationship. The main findings of the literature seem to be that both neoclassical and endogenous growth models support the thesis that an increase in public debt always reduces economic growth. This effect has been verified by the majority of studies we've surveyed but only in two of these cases it has been found unidirectional Granger causality. The opposite, that is, economic growth Granger causes public debt negatively was also proven in one of the empirical studies. The negative interaction to a non-linear relationship above a specific limit of debt, the so-called “threshold hypothesis”, has been characterized as a “stylized fact”. We contribute to the literature through identifying three important issues that have not yet been taken explicitly into account. First, there is no systematic analysis of the impact of the gross domestic product on the public debt, especially when the latter gets seriously worse because of economic or financial distress as in the global crisis of 2008. Second, despite that theoretically, higher public debt is related to analogous sovereign risk premia and long-term interest rates, this has not been empirically confirmed in advanced countries, which live in the era of the zero-lower bound. Third, we emphasize that the current macroeconomic illness of “secular stagnation” cannot be ignored in the relevant research. Our analysis suggests that policy makers and investors should reconsider the establishment of the 90% threshold as a “stylized fact” in the relationship of sovereign debt and economic growth.

Keywords: Public debt, economic growth, financial crises, interest rates, secular stagnation, methodology.

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