

Growth in a Time of Debt

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Nations typically see growth slow when their debt levels reach 90 percent of gross domestic product. The median growth rate falls by 1 percent and average growth falls even more, according to **Carmen Reinhart** and **Kenneth Rogoff** writing in **Growth in a Time of Debt** (NBER Working Paper No. 15639).

Using a newly developed historical data set, the authors examine 44 countries over a period of up to 200 years and find that the same slowdown occurs for advanced as well as emerging nations. However, the latter group is also vulnerable when their external debts reach 60 percent of GDP. In emerging nations, this debt level is associated with a decline in growth rates of about 2 percent. At higher ratios, growth is cut by about half. Inflation also rises sharply as emerging nations' debts increase, an inflationary link that does not appear to exist (at least simultaneously) for advanced nations as a group.

While there are some exceptions to the high-debt/slow-growth phenomenon -- Australia and New Zealand grew faster during their high-debt periods in the years after World War II than in other periods -- the median growth of the 20 advanced nations in this study fell by half as their debt levels moved from less than 30 percent of GDP to 90 percent or more.

The drop-off was particularly significant at the 90 percent threshold: between 60 and 90 percent of GDP, median growth was still 2.8 percent; above 90 percent it was 1.9 percent. The drop in average growth between countries with debt ratios of 60-90 percent of GDP, and those above 90 percent of GDP, was even greater: 3.4 percent to 1.7 percent.

The trend was also more pronounced among the 24 emerging markets in the study, including Argentina, Brazil, India, Mexico, Nigeria, South Africa, and Turkey, than in more developed nations. With debt between 60 percent and 90 percent of GDP, median growth in the emerging markets was 4.5 percent. Above 90 percent, it dropped to 2.9 percent. The change in average growth rate was far more severe: 4.2 percent to 1.0 percent.

A big difference between advanced and emerging nations is the correlation between debt levels and inflation. For advanced nations, median inflation actually fell as debt grew (5.2 percent when debts were less than 30 percent of GDP; 3.9 percent when debts were 90 percent and above). For emerging nations, by contrast, median inflation more than doubled, from 6 percent to 16.5 percent, as debt grew. "Fiscal dominance is a plausible interpretation of this pattern" for emerging economies, the authors write.

External debts represent another pitfall for emerging nations, although the impact of such debts on developed nations is less clear. Above external debts of 60 percent of GDP, growth rates for emerging nations dropped sharply between 1970 and 2009. Above 90 percent of GDP, median growth plummeted further, and average growth actually turned negative. The maturity of the debt also plays a factor, with nations heavily reliant on short-term borrowings most vulnerable to sudden crises.

The authors emphasize that theirs is a first pass at the new historical data set, that the 90 percent debt-to-GDP ratio is an initial estimate with considerable uncertainty around it, including tying down country-specific factors that may affect these limits. Nevertheless, the results do suggest that countries face thresholds for debt/GDP above which the growth impacts may increase non-linearly.

The authors point out that in addition to public debt, it is also important to track private debt. In contrast to public debt, private debt tends to fall sharply after financial crises. Such private-sector data are scarce for nations over time. But the historical record of the United States points out that growth slowed when the nation slashed its private debt.

During 1916-39, the median unemployment rate stood at 9.8 percent in years where debt-to-GDP rates were falling; in all other years, it was 6.7 percent. The period 1946-2009 saw a similar pattern. "Thus, private deleveraging may be another legacy of the financial crisis that may dampen growth in the medium term," the authors conclude.

"The sharp run-up in public sector debt will likely prove one of the most enduring legacies of the 2007-2009 financial crises in the United States and elsewhere," they conclude. "[A]cross both advanced countries and emerging markets, high debt/GDP levels (90 percent and above) are associated with notably lower growth outcomes.... Seldom do countries simply 'grow' their way out of deep debt burdens."

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