



## The Relationship Between External Debt and Economic Growth

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**Abstract:** *The main objective of this study is to determine the effect of external debt on economic growth. This article analyzed the empirical literature on the relationship between economic growth and public external debt and the impact of public external debt on economic growth. Thus, through the analysis of the literature on the impact of external debt on economic growth, it was found that the impact of external debt on economic growth can have positive, negative and non-linear relationships. There are three groups of theoretical models describing this interaction.*

**Key words:** *economic growth, public external debt, neoclassical growth model, GDP.*

### Introduction

Currently, the main problem with external debt in developing countries like Uzbekistan is to determine whether external debt leads to economic growth in developing countries. Ensuring the economic development of the country is one of the most important national priority tasks, which is a condition for the stability and productive life of society, and for achieving success. According to mainstream economic theories, external debt should affect the economy through investment and labor productivity. Since the main reason for attracting foreign loans is the lack of own funds to finance investment projects, the increase in gross external debt should stimulate the growth of investment and capital formation, which will lead to an increase in the potential volume of GDP.

### Analysis and Results

According to Oleksandar (2003), the relationship between external debt and economic growth identified in the current literature can be divided into three

categories: positive relationship in which external debt leads to greater economic growth, negative relationship in which external debt harms economic growth, and a non-linear relationship that generalizes the previous two. Each of these arguments will be considered in turn below.

### **Positive impact on economic growth**

First, if the economy cannot produce enough capital per capita by itself, external debt can be used as a substitute for capital ( $k$ ), which represents the capital stock or investment according to the Solow growth model. In addition, if a country has a current account deficit, external debt is an opportunity for capital inflows to sustain economic activity and increase production capacity by improving the balance of payments. Therefore, foreign debt should have a positive effect on economic growth by providing the necessary capital and investments, as well as by providing the foreign currency necessary for the country (Pattillo et al., 2004).

Pattillo et al. (2004) argue that when external debt is kept at a manageable level and any excess taxes are removed, investors are more likely to invest repeatedly due to the expectation of higher returns when the debt is repaid on time.

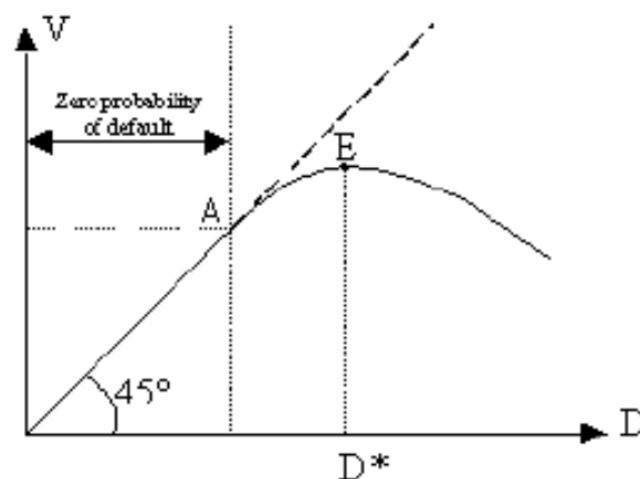
### **Negative impacts on economic growth**

On the other hand, for countries with accumulated debt, based on the theory of debt overhang, debt hinders economic growth. (Krugman, 1988; Sachs, 1989).

The “debt Laffer curve” was coined by Sachs to provide this argument; that is, higher debt reserves are associated with lower probability of debt servicing and debt repayment. This is shown in Figure 1 below. In the chart, expected debt service ( $V$ ) is measured on the vertical axis, and the country’s stock of debt ( $D$ ) is measured on the horizontal axis. The line from the starting point to A shows the range over which the increase in debt is related to the increase in expected debt payments. This means that the probability of default is zero. However, at points A to E, an increase in the debt stock is associated with an increase in expected debt repayment, but it increases at a decreasing rate. Thus, the probability of default increases, but at manageable rates, and debt management strategies can usually be used to successfully reduce external debt (Krugman, 1988).  $D^*$  represents the maximum value of the debt stock beyond which

any increase in debt would be unsustainable and would reduce expected debt repayments and therefore increase the likelihood of default.

Beyond point D\*, the country is said to be on the wrong side of the curve. Resources that could be used for economic development are diverted to debt servicing and debt repayment. Furthermore, a high probability of default may deter future investment (Patillo et al., 2004). In addition, fiscal adjustments (such as tax increases) required to meet debt repayments limit current consumption, while reducing the efficiency and productivity of investment. (Oleksandar, 2003). Thus, these actions contribute to lower economic growth. Therefore, it is clear that for countries with accumulated debt reserves, a further increase in debt will have a negative impact on growth.



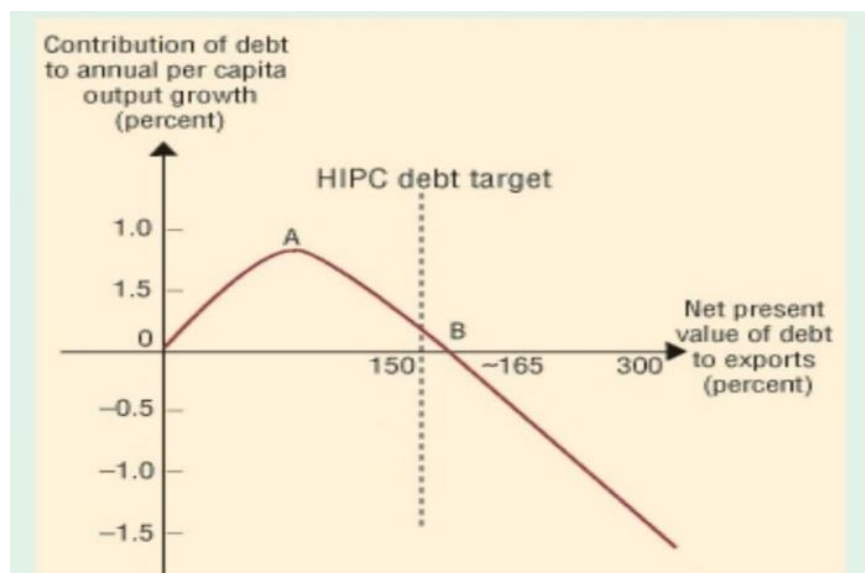
**Figure 1:** Debt Laffer curve

Source: Oleksandar (2003)

### **Bilateral relations of debt and growth**

Patillo et al. (2002) were the first scholars to propose a non-linear relationship between external debt and economic growth. A graphical representation of the relationship is shown in Figure 2. The vertical axis measures the contribution of debt to annual per capita output growth, and the horizontal axis measures the stock of external debt in the economy (measured as the ratio of the net present value of debt to exports). A positive relationship between the two is seen from the origin to point A, meaning that within this range of debt-to-export ratios, an increase in debt leads to an

increase in the contribution of debt to GDP per capita. At the same time, an increase in the net present value of the ratio of debt to exports is harmful to economic growth, as it reduces the contribution of debt to annual output growth per capita. Thus, this causes the straight line to change direction, creating an inverse curve. (Krugman, 1988). If the stock of debt continues to accumulate beyond point B, economies will continue to borrow beyond their means. Given this, as the net present value of debt to exports increases, this leads to a negative contribution of debt to annual growth in per capita output. Countries in this area are commonly known as highly indebted poor countries (HIPC) and continue to grow.



**Figure 2:** GDP per capita vs debt to exports

Source: Patillo et al. (2002)

The absence of a debt overhang allows for foreign currency to be used in productive investments which improves investor sentiment, and improves its economic growth performance as seen in the first part of the curve. Further to this, the evidence from the graph above shows that the “marginal effect of external indebtedness on efficiency becomes negative when its share of the total external debt exceeds an optimal threshold” (Adeve, 2015). Hence, similar to the argument put forward in above, debt overhang can cause harmful effects to economic growth as resources are directed towards debt servicing at the expense of development, the high

probability of default disincentivizes further investment, and high taxes that may be introduced curb consumption and lower productivity.

### **Conclusion**

Nevertheless, a sharp increase in the total amount of external debt or its inefficient use can cause negative consequences. This can not only derail our economy today, but also create systemic problems for the next generation. It is for this reason that the government is implementing a number of important measures to prevent adverse consequences related to the state's foreign debt. In particular, it was determined by law that the ratio of the state debt to the gross domestic product should not exceed 60 percent.

Economic theories suggest that moderate borrowing by a developing country can boost its economic growth. Countries in the early stages of development have small capital reserves and may have higher return investment opportunities than advanced economies. If developing countries use debt funds for productive investments, the rate of economic growth for these countries should increase and allow timely repayment of debts.

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