Public Debt Thresholds: An Analysis for Cyprus

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Abstract

We examine whether a threshold exists in the debt-to-GDP and output growth relationship. Such a threshold exists, however, we find that prior to the threshold level, i.e. when debt is lower, government spending has a negative impact on the economy, while after it the impact turns positive. When the unemployment rate is used as the threshold variable, we find that government spending has no impact until unemployment reaches 10%, after which a strong positive impact on GDP growth is registered. Overall, the results suggest that while additional government spending can crowd out the private sector when the economy is booming, it can still have a strong positive impact on GDP when unemployment is high. As such, the results highlight the fact that what matters is the timing and not the debt-to-GDP level per se.

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