

Abstract

Two broad categories such as macroeconomic and financing the balances of payments are taken in to consideration by Countries in borrowings. Previous literature has shown mixed results in relation to impact of public debt to the economic growth. In this study, researcher examined several objectives such as “Debt Overhang” effect “Debt Crowding out” effect in the economy, significant long run association between public debt and economic growth in Sri Lanka, and effect from major election on public debt. Thus, this study attempts to provide more specific accurate understanding of impact of public debt to the economic growth in Sri Lanka. Government debt and other related variables have been used to carry out the study taking time series quarterly data of 69 year period commencing from 1950 to 2018. Objectives are addressed by employing Gross Domestic Production, Debt service ratio, Exports, Population, Domestic debt, External debt and Educational expenditure. Unit root analysis, Lag length criteria, Cointegration test, Vector Error Correction Model (VECM), Linear Regression models, Diagnostic tests and CHOW break point test have been applied in the study. ADF test says that all the variables are I (1) and there are two periods’ lags with two cointegration equations. Error Correction Term (ECT) is -0.35 and it is representing that debt is having the long run effect on economic growth. Probability of External Debt (DED) is highly significant with negative beta value and Sri Lanka is having Debt Overhang Effect. Probability of Debt Service (DDS) is 0.07 with negative beta value and Sri Lanka is experiencing the Crowding Out effect as well. Main elections have influenced significantly on domestic debt and external debt. As the debt is having long run association with economic growth, government should stimulate the economy through fiscal and monetary policies.

Keywords: Long Run Association, Cointegration, debt overhang effect, crowding out effect, Structural shift of debt,