Fund Managers Ltd.

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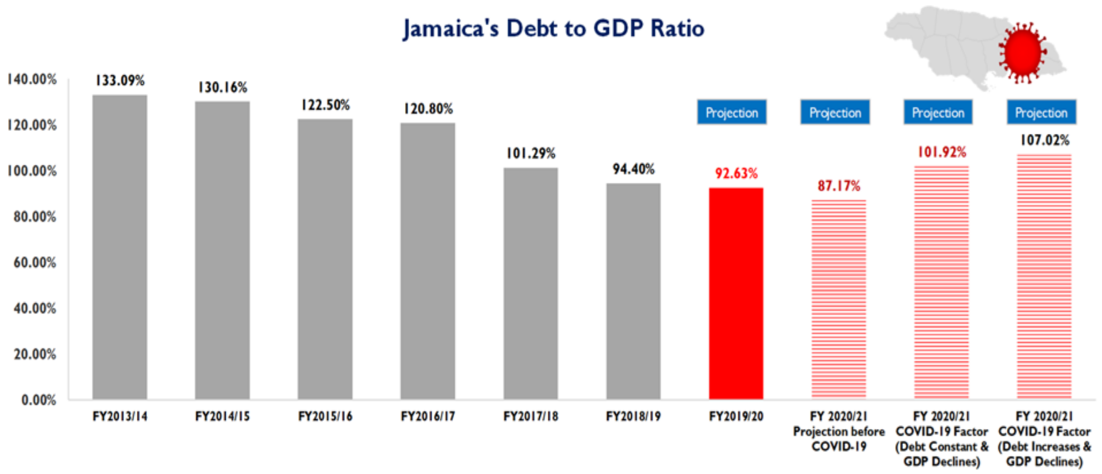
Understanding the Debt-to-GDP Ratio

A country's debt to Gross Domestic Product (GDP) ratio is a very useful tool for its stakeholders including investors, its leaders and economists. However, this ratio is often very confusing at first for persons unfamiliar with the metric. Expressed as a percentage, the debt-to-GDP is the ratio of a country's debt to its GDP or simply, the country's public debt to its annual economic output. This ratio allows economists and other stakeholders to make a quick assessment of a country's financial position and its capacity to repay its debt. Intuitively, a high debt-to-GDP is undesirable as a high ratio indicates that a country may not generate enough to pay off its debt, while a low ratio means that payment demands are easily met with high economic activity.

Typically, the movements in either debt, GDP or both lead to an improvement (reduction) or worsening (increase) of a country's debt to GDP ratio. Assuming GDP remains constant, when a country increases its borrowing, the numerator (debt) increases and as a result the ratio increases. Take Jamaica, for example, its debt to GDP at the end of the fiscal year (FY) 2018/19 was 94.4% calculated with a debt of J$1.94 trillion divided by J$2.05 trillion in GDP. Holding the GDP constant at J$2.05 trillion and assuming debt moves to J$2.12 trillion in the 2019/20 period, the country's debt to GDP ratio at the end of the period would have been 103.4%. However, what happens if GDP declines? If we make a similar assumption that debt is held constant at J$1.94 trillion while GDP decreases to J$1.88 trillion, debt to GDP ratio at the end of the period increases to 103.2%. Noteworthy as well, if both debt and GDP increase, in a given year, the size of the debt increase must be higher than that of the GDP for the ratio to increase. Similarly, if both debt and GDP were to fall, the extent of the GDP fall would have to be greater than the decline in debt for the ratio to increase.

An important point to keep in mind is that there is a connection between a country's debt accumulation and its economic growth. Countries may increase their debt burden to generate economic activity and increase GDP. However, once the debt capacity limits are exceeded and economic activity slows, so will the GDP growth of the country as debt creates a drag on growth. As a high level of debt puts economic capital at a disadvantage, many countries are transitioning to what they term as a sustainable debt path to minimize debt that has now become unsustainable or mitigate against such a situation.



Special Insights...

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Jamaica had taken a course of debt reduction and economic reform, driven by fiscal rules and supported by the two consecutive reform programmes by the International Monetary Fund. Consequently, debt to GDP, which stood at over 133% in FY 2013/14 fell to 94.4% at the end of FY 2019/20 and in the government's fiscal policy paper published in February of this year, the debt to GDP was still on a sustainable path towards the goal of 60% by the end of for FY 2025/26. However, with the onset of the COVID-19 pandemic and with the number of cases worsening for Jamaica's main trading partners, Jamaica's GDP is projected to see a contraction of up to 10% according to the Bank of Jamaica (BOJ). With the reduction in economic activity and loss of revenues, from taxes for example, debt is likely to increase. As a result, Jamaica's debt-to-GDP target of 60.0% was postponed by the government from FY 2025/26 to FY 2027/28 on this basis.

Jamaica's debt to GDP ratio, which stood at 133.09% in FY 2013/14 declined to reach 94.4% at the end of FY 2018/19. Additionally, in February 2020 the government had projected Jamaica's debt to stand at J$1.97 trillion at the end of FY 2019/20. From this, debt to GDP ratio of 92.63% was estimated based on the GDP outturn of J$2.13 trillion by the Statistical Institute of Jamaica. At the same time, and prior to the global pandemic, the government had also projected that the ratio would have decreased to 87.17% in FY 2020/21 which was in line with the sustainable debt path. However, if we assume that Jamaica's GDP contracts by 8.5% (mid-point of BOJ's last estimate) in FY 2020/21, even when holding debt constant, Jamaica's debt-to-GDP is projected to be 101.92%.

If Jamaica is unable to "reopen its economy" to generate adequate business activity the government will likely need to borrow to provide social support to the thousands currently out of employment as well as undertake further spending to boost its health care capacity. Considering this, we hypothetically applied a 5% increase in the debt level projected for FY 2020/21 in the fiscal paper, by the government in February 2020. When this adjustment is made along with an 8.5% contraction in GDP, the debt-to-GDP ratio is projected to climb to 107.02% at the end of FY 2020/21.

Jamaica entered 2020 in a relatively strong position on the back of a well-crafted economic reform program, with fiscal buffers and organically grown Net International Reserves of over US$3.0 billion. These have been used to good effect to cushion the effects of the pandemic including implementing health care measures, which helped to slow the spread of the virus in the early stages. Notwithstanding, Jamaica's economy has deteriorated significantly and to prevent a further fallout from the pandemic, continued support will be needed to boost its health care capacity as well as provide for the vulnerable amid the expected high unemployment.

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