THE IMPACT OF INFLATION ON PUBLIC DEBT IN SOUTHEAST EUROPEAN COUNTRIES

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Abstract: This paper investigates the impact of inflation on the level of public debt, expressed as a percentage of GDP, in Southeast European countries during the period from 2008 to 2023. The research was conducted on a sample of eight countries using panel data regression analysis. Special emphasis was placed on distinguishing between the current and delayed effects of inflation, with two control variables included: interest rates on public debt and real GDP growth. The random effects model (REM), selected as the most methodologically suitable based on the Breusch-Pagan LM test and Hausman test, shows that inflation from the previous period has a negative and statistically significant impact on public debt, while current inflation is not significant. The interest rate on public debt was found to be highly significant and positively correlated with debt levels, while real GDP growth did not have a statistically significant effect. The results suggest that inflation may play a role in the relative reduction of fiscal burden, but that responsible debt management and strengthening institutional frameworks remain key factors for maintaining fiscal stability and public debt sustainability in the region.

1. Introduction

In contemporary debates among professional economists, the issue of public debt and the factors determining its trajectory occupies a central position, particularly in the context of rising indebtedness and high inflation. Over the past fifteen years, the global economy has faced several external shocks – beginning with the Global Financial Crisis of 2008, followed by the COVID-19 pandemic and the energy crisis triggered by the Russian-Ukrainian military conflict. In an effort to mitigate the negative effects of the global economic downturn and geopolitical crises, many countries opted for expansive monetary and fiscal policies, effectively postponing the direct consequences to future periods. These measures have led to a dynamic increase in public debt across economies worldwide. As a result of attempts to alleviate fiscal pressures through debt monetisation, another challenge has emerged for macroeconomic policymakers in the form of controlling inflationary processes.

The Southeast European region, as a specific group of countries characterised by ongoing transitional processes, continues to face the risk of fiscal unsustainability due to institutional constraints, limited fiscal capacity, and restricted access to international capital markets. Those countries within this group that are also full members of the EU have made significant progress in addressing these shortcomings. Nevertheless, a clear distinction remains when compared to Central European countries (also full EU members), such as the Czech Republic, Slovakia, and Slovenia, which completed their transitional processes much earlier and possess considerably greater fiscal and administrative capacities. This makes them more resilient to external shocks.

The aim of this paper is to evaluate the impact of inflation on public debt as a percentage of GDP in a sample of eight Southeast European countries over the period from 2008 to 2023, using panel data regression analysis. Particular attention is given to distinguishing between the immediate and lagged effects of inflation, while the robustness of the model is assessed through the application of the Breusch-Pagan LM test and the Hausman test. The model also includes two control variables—interest rate on public debt and real GDP growth—in order to isolate the direct effect of inflation on public debt. This research seeks to contribute to the academic discourse on public debt sustainability in the region by providing empirically grounded findings and policy recommendations.

2. Literature Review

The beginning of the 21st century has brought numerous challenges to the global economy. The world economy was first confronted with the Global Financial Crisis (2008–2012), followed by a period of recovery that was disrupted by two major external shocks: the COVID-19 pandemic and the Russian-Ukrainian military conflict. During the recessionary phases of economic cycles, governments

attempted to mitigate declining economic activity through interventionist policies, particularly by increasing public spending and external borrowing to stimulate recovery. However, economic agents often failed to respond in alignment with macroeconomic policy initiatives, leading to a lack of synergistic effects and a marked escalation of public debt worldwide. Additionally, poor project selection significantly contributed to the gap between expected and actual outcomes, further complicating debt servicing. In this context, transition economies—especially those in Southeast Europe—were disproportionately affected due to inherited institutional weaknesses, limited fiscal space, and a high dependence on external financing. Consequently, in recent years, the issue of public debt sustainability has re-emerged as a central topic in expert economic discourse, with the identification of public debt determinants becoming a key research priority.

Economic theory does not offer a unified stance on the interaction or causal relationship between inflation and public debt. While proponents of the Keynesian school of economic thought maintain a positive view of inflation and increasing indebtedness when these are components of counter-cyclical policy (Blinder, 2008), neoclassical economists, on the other hand, advocate for low budget deficits and long-term fiscal sustainability, viewing inflation as a consequence of monetised fiscal irresponsibility (Barro, 1979). In line with this neoclassical perspective, various theories have emerged that interpret inflation as a mechanism for reducing fiscal pressure—a phenomenon referred to in the economic literature as the "inflation tax." Sargent and Wallace (1981) argue that inflation contributes to reducing the real value of public debt and is, in that sense, an unavoidable tool when debt servicing relies on primary money issuance. Reinhart and Sbrancia (2015) hold a similar view, having analysed public debt dynamics in the post-war period (1945–1980). They conclude that negative real interest rates, driven by inflation exceeding nominal interest rates, effectively eroded public debt by reducing its burden over time. However, it should also be noted that inflation may arise as a result of anticipated future budget deficits, even without direct debt monetisation (Cochrane, 2011).

The impact of inflation on public debt in a given country is largely determined by the institutional frameworks that govern fiscal policy. In their empirical study, Catão and Terrones (2005) examined the relationship between budget deficits and inflation across more than 100 countries from 1960 to 2001. The authors demonstrated that budget deficits contribute to inflation, particularly in developing countries and under conditions of high inflation, ultimately leading to a reduction in the real fiscal burden. Reinhart and Rogoff (2010) argue that high levels of public debt—especially when exceeding 90% of GDP—pose a long-term threat to economic growth, which in turn hampers debt servicing and opens the way for the use of alternative mechanisms of fiscal relief, including inflationary taxation. Ghosh et al. (2013) develop the concept of public debt sustainability from the perspective of the interest-growth differential (r–g), whereby inflation can help

reduce the real interest rate and thereby contribute to temporary relief from fiscal pressure, particularly in the context of fiscal fatigue.

The specific characteristics of Southeast European countries are reflected in the transitional nature of their economies, limited fiscal capacities, constrained access to foreign capital, and underdeveloped institutional frameworks for implementing fiscal policy. Although some countries within this group—namely Bulgaria, Croatia, and Romania—have become full members of the European Union and made significant strides in strengthening institutional frameworks and fiscal institutions, challenges to fiscal sustainability remain, particularly during periods of economic relaxation following crisis episodes, when there is a heightened need for public spending. The EBRD (2023) highlights that a significant number of countries in this group lack adequate long-term planning capacity, which undermines the implementation of structural reforms aimed at enhancing fiscal sustainability and public debt stability. These structural weaknesses, when combined with external shocks, render the region particularly vulnerable in terms of maintaining fiscal stability and ensuring the long-term sustainability of public debt.

Given the pronounced fiscal vulnerabilities, as well as the specific institutional and macroeconomic challenges faced by Southeast European countries, there is a clear need for a deeper examination of the factors that influence public debt sustainability in these economies. Particular importance lies in analysing the role of inflation, interest burden, and real GDP growth, as well as understanding the effects of fiscal policy on debt dynamics. This paper aims to contribute to a better understanding of the mechanisms that affect fiscal stability and public debt sustainability in a post-transition context, through quantitative analysis and cross-country comparison within Southeast Europe.

3. Methodological Approach and Hypothesis Formulation

The panel data regression analysis is based on a sample of eight Southeast European countries, as defined by the OECD classification[2]. The sample includes Serbia, Montenegro, North Macedonia, Bosnia and Herzegovina, Albania, Croatia, Bulgaria, and Romania. Croatia, Bulgaria, and Romania are full members of the European Union, while the remaining countries are candidates for EU membership. This distinction may, to some extent, result in differing economic contexts, particularly in terms of institutional frameworks and approaches to inflation and public debt management. Nevertheless, in order to provide a broader regional perspective on the determinants of public debt influenced by inflation and to enhance the generalisability of the findings, the authors opted to include all countries within this group in the analysis. It is important to note that all selected

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[2] OECD. (2024). South East Europe: *Regional Programme*. https://www.oecd.org/en/regions/south-east-europe.html

countries share a comparable transitional trajectory, along with institutional and fiscal challenges typical for the region, which makes them suitable for joint inclusion in the process of identifying the key determinants of public debt dynamics. The research covers the period from 2008 to 2023, using annual data.

The hypotheses to be tested in this research paper are as follows:

Main Hypothesis (H0):

H0: Inflation does not have a statistically significant impact on changes in public debt in Southeast European countries.

Alternative Hypotheses (H1, H2):

H1: Current-year inflation has a statistically significant impact on changes in public debt in Southeast European countries.

H2: Lagged inflation (Inflation_L1) has a negative and statistically significant impact on public debt in Southeast European countries.

The research model also includes two control variables: real GDP growth and interest payments on public debt, given their influence on the dynamics of public debt. Their inclusion aims to increase the precision and validity of the regression models by evaluating the isolated effect of inflation on public debt in the observed countries. GDP growth may contribute to a reduction in the debt-to-GDP ratio by increasing economic output and fiscal revenues. As noted by Checherita-Westphal and Rother (2012), there is a bidirectional relationship between public debt and economic growth, necessitating mutual control of these variables to avoid estimation bias. Including this variable allows for a more accurate isolation of the inflation effect on public debt. The academic literature also emphasises the importance of the impact of the interest rate on debt dynamics. According to Ghosh et al. (2013), interest payments on public debt tend to increase the debt-to-GDP ratio, particularly in situations where the interest rate exceeds the real growth rate and fiscal authorities are unable to compensate for the gap with a primary surplus. As the objective of this paper is to identify the pure effect of inflation on public debt in the selected countries, the authors decided to include this indicator in the model as a control variable.

The data used for this research and hypothesis testing include public debt as a percentage of GDP, inflation, the real growth rate, and interest payments on public debt as a percentage of GDP. All data were collected from the IMF website, except for interest payments on public debt for Serbia, Bosnia and Herzegovina, and Montenegro, which are not available on the IMF platform. These figures were calculated by the authors based on budget execution reports available on the official websites of the respective ministries of finance. It is important to note that the dataset is double-indexed (by country and year) and organised in a panel structure, which allows for the control of unobserved heterogeneity across

countries. The panel data analysis was conducted using SPSS software, while model testing (Breusch-Pagan LM test and Hausman test) was performed manually in Excel.

In the process of panel data analysis, the pooled regression model (pooled OLS) was first estimated, followed by the random effects model (REM) and the fixed effects model (FEM), in order to identify the most reliable approach. To determine whether pooled OLS or REM was more appropriate, the LM test (Breusch & Pagan, 1980) was employed, while the Hausman test (Hausman, 1978) was used to differentiate between FEM and REM. Based on the results of these tests, the random effects model (REM) was selected as the most statistically robust and best suited to the panel data structure.

4. Results of the Regression Analysis and Discussion

This chapter presents the results of the regression analysis of panel data for eight countries in the Southeast European region for the period from 2008 to 2023. The research aimed to determine whether inflation, either in the current period or with a one-year lag, has a statistically significant impact on the level of public debt expressed as a percentage of GDP. The analysis procedure initially involved the implementation of the pooled OLS regression model, followed by models with random and fixed effects. The final decision regarding the most reliable and methodologically acceptable model was made based on the LM test (selection between the pooled OLS and REM models) and the Hausman test (selection between REM and FEM models).

The coefficient of determination ($R^2 = 0.673$) for the pooled OLS model indicates that the model explains approximately 67.3% of the variation in public debt, which is a relatively high value for a pooled OLS model. However, failing to account for heterogeneity among the observed countries represents a limitation, as further confirmed by the Breusch-Pagan LM test and the Hausman test. The results of the pooled OLS model show that current inflation does not have a statistically significant impact on public debt as a percentage of GDP ($p = 0.295$), while inflation with a one-year time lag has a borderline statistically significant effect ($p = 0.024$), with a negative coefficient ($B = -0.789$). These results suggest rejecting hypothesis H1 and providing weak support for accepting hypothesis H2. The interest rate on public debt was found to be a highly significant control variable ($p < 0.01$) and has a positive correlation with the share of public debt in GDP, while real GDP growth did not show a statistically significant effect ($p = 0.496$). The results of the pooled OLS model are presented in **Table 1.**

Table 1 – Results of the Pooled OLS Model

Variable	Coefficient (B)	Std. Error	t-value	p-value
(Constant)	21.223	2.626	8.082	0.000
INFLATION	0.369	0.351	1.053	0.295
INFLATION_L1	-0.789	0.345	-2.289	0.024
INTEREST_RATE	18.560	1.219	15.227	0.000
GDP_GROWTH	-0.194	0.285	-0.683	0.496
R²	0.678			
Number of observations	127			
Variable	Coefficient (B)			

Source: Calculated by the author

The analysis of the fixed effects model (FEM) also showed a high level of explanatory power regarding the variation in public debt in Southeast European countries with respect to the observed regressors ($R^2 = 0.824$), meaning that the model explains 82.4% of the variation. Among the observed variables, inflation with a "time lag" shows a high degree of statistical significance ($p = 0.01$) and is negatively correlated with public debt (B = -0.899), confirming hypothesis H2. As in the previous model, current inflation did not have a statistically significant impact on public debt in the observed countries ($p = 0.214$), which disproves hypothesis H1. Among the control variables, the interest rate on public debt was again found to be highly statistically significant ($p = 0.000$) and has a positive correlation with the growth of public debt. The results of the fixed effects model (FEM) are presented in Table 2.

Table 2 - Results of the Fixed Effects Model (FEM)

Variable	Coefficient (B)	Std. Error	t-value	p-value
(Constant)	36.548	4.473	8.171	0.000
INFLATION	0.322	0.258	1.249	0.214
INFLATION_L1	-0.899	0.253	-3.559	0.001
INTEREST_RATE	11.102	1.72	6.455	0.000
GDP_GROWTH	-0.265	0.208	-1.272	0.206
R²	0.824			
Number of observations	127			

Source: Calculated by the authors

The random effects model (REM) showed an adequate fit to the data, given the high value of the coefficient of determination (R^2 = 0.824), indicating that the model explains 82.4% of the variation in public debt, including differences between countries. As with the previous models, inflation with a "time lag" was found to be statistically significant (p = 0.001) and negatively correlated (B = -0.899) with public debt in the observed countries, confirming hypothesis H2. Current inflation was not statistically significant, so hypothesis H1 must be rejected. The interest rate on public debt, as a control variable, was also found to be statistically highly significant (p = 0.000) and positively correlated with public debt, while real GDP growth had no statistically significant effect on the public debt dynamics in the observed countries. The results of the REM model are presented in **Table 3**.

Table 3 - Results of the Random Effects Model (REM)

Variable	Coefficient (B)	Std. Error	t-value	p-value
(Constant)	31.607	4.690	6.739	0.000
INFLATION	0.344	0.271	1.271	0.206
INFLATION_L1	-0.874	0.265	-3.296	0.001
INTEREST_RATE	12.305	1.698	7.247	0.000
GDP_GROWTH	-0.250	0.219	-1.142	0.256
R^2	0.805			
Number of observations	127			

Source: Calculated by the authors

The Breusch-Pagan LM test showed that the obtained test statistic was LM = 19.76, which is significantly higher than the critical value at a 5% significance level ($\chi^2(1)$ = 3.84). This result suggests rejecting the null hypothesis of no differences between entities and indicates the appropriateness of choosing the random effects model (REM) over the pooled OLS model. A simplified variance form of the Breusch-Pagan LM test, derived from the concept of testing random effects according to Greene (2012, p. 417), was used in the study.

$$LM = \left(\frac{NT}{2}\right) \times \left(\frac{\sigma_u^2}{\sigma_u^2 + \sigma_e^2}\right)^2 (1)$$

where:

- **LM** – the value of the LM test statistic
- **N** – the number of countries observed
- **T** – the number of years observed
- σ_u^2 – the variance of the random intercept
- σ_e^2 – the residual variance

The results of the Breusch-Pagan LM test are presented in **Table 4**.

Table 4 – Breusch-Pagan LM Test Result

N	T	σ_u^2	σ_e^2	$((\sigma_u^2)/(\sigma_u^2+\sigma_e^2))^2$	LM Test
8	16	92.905	74.276	0.308819	19.76439
			LM > 3.84	REM	

Source: Calculated by the authors

The Hausman test was conducted to make a decision between the random effects model (REM) and the fixed effects model (FEM). The obtained test statistic value is $\chi^2 = 0.2583$, which is much lower than the critical value of 9.49 at the 0.05 significance level (df = 4). Based on this result, the null hypothesis of no significant differences between the REM and FEM models is not rejected, and the REM model is considered more appropriate for the analysis conducted. The study used a simplified scalar form of the Hausman test (due to the lack of complete covariance matrices), which is equivalent to the standard form and is theoretically supported (Greene, 2012, p. 420):

$$H = \Sigma \frac{(\beta_{RE}-\beta_{FE})^2}{Var(\beta_{FE})+Var(\beta_{RE})} \quad (2)$$

Where:

- **H** – the value of the Hausman test statistic
- **β_RE, β_FE** – the estimated coefficients from the random effects and fixed effects models, respectively
- **Var(β_FE)** – the squared standard errors from the FEM model
- **Var(β_RE)** – the squared standard errors from the REM model

The results of the Hausman test are presented in **Table 5**.

Table 5 – Hausman Test Result

Variable	β_RE - β_FE	(β_RE - β_FE)²	Var(β_FE)	Var(β_RE)	Var(β_FE) + Var(β_RE)	Hausman
INFLATION	0.022045	0.00049	0.0666115	0.073437	0.140049	0.0035
INFLATION_L1	1.203038	1.44730	2.9579735	2.883153	5.841127	0.2478
INTEREST_RATE	0.015032	0.00023	0.0433189	0.04784	0.091159	0.0025
GDP_GROWTH	0.024774	0.00061	0.0638017	0.070365	0.134167	0.0046
					H < 9.488	0.2583
					REM	

Source: Calculated by the authors

The conducted analysis and confirmed tests indicate that the random effects model (REM) is the most suitable for identifying the impact of inflation and control variables on public debt in Southeast European countries, as it generates methodologically consistent and efficient estimates, while taking into account the specificities of individual country samples and the time dimension of the observations.

5. Policy Implications for Southeast European Countries and Recommendations for Future Research

The research conducted and the findings presented in this paper may be of practical use to economic policymakers in Southeast European countries in the process of developing development strategies and implementing monetary and fiscal measures. The confirmation of Hypothesis H2 – that lagged inflation (Inflation_L1) has a negative and statistically significant impact on public debt in Southeast European countries – suggests that inflation can play a role in the relative reduction of the fiscal burden and contribute, to some extent, to the sustainability of public debt. Moderate and controlled inflation, when adequately coordinated with the objectives of both monetary and fiscal policy, may serve as a tool for reducing the real value of public debt. It should be emphasised, however, that such a strategy must be carefully and properly balanced. Otherwise, there is a risk of negative externalities from excessive inflation, which could adversely affect other aspects of economic performance, such as real income, savings, investment, and market stability.

On the other hand, interest on public debt, as a statistically significant and positively correlated control variable (with respect to public debt), confirms the importance of prudent management of public debt policy and borrowing costs. This implies that governments in these countries must pay particular attention to the selection of projects financed through borrowing, ensuring that the economy can withstand the future burden of additional interest payments on public debt. Furthermore, it is crucial to anticipate future trends in capital markets—particularly the risks associated with interest rate fluctuations on new borrowing and exchange rate volatility—and to adjust public debt strategies in line with these projections.

The absence of a statistically significant impact of real GDP growth on the level of public debt suggests that, in the observed countries, the positive effects of economic growth are being offset by the influence of other factors. These may include expansionary fiscal policies that generate higher budget deficits, inefficient public spending by the government (due to poor project selection), or institutional shortcomings related to the strict enforcement of fiscal rules.

Future research in this area could extend this analysis and further enhance it by incorporating dynamic models (e.g. Arellano–Bond) with the aim of more precisely identifying the interaction between public debt dynamics and the influence of previous periods. In addition, the countries under observation could be segmented into EU member states and candidate countries for full membership, thereby further reflecting the institutional and political effects on public debt sustainability. Such an approach would provide deeper insights into the dynamics and magnitude of public debt in these countries and establish a solid foundation for developing practical recommendations for the macroeconomic policymakers in the region.

6. Conclusion

The analysis of the impact of inflation on the level of public debt in Southeast European countries has shown that coordination between monetary and fiscal policy objectives by macroeconomic policymakers in the region can serve as a significant instrument for promoting fiscal stability. Lagged inflation, as a statistically significant and negatively correlated variable with public debt, may be utilised as a component of broader economic policy to alleviate fiscal pressure. However, the potential negative externalities of high inflation—should it exceed acceptable thresholds—must be taken into account, and a responsible strategy should be developed to prevent such a scenario.

On the other hand, the statistical significance of interest on public debt as a control variable confirms that responsible debt management is of great importance for the countries in this region. Meanwhile, the lack of statistical significance of real GDP growth as a control variable suggests that economic growth alone is insufficient and must be accompanied by additional structural reforms and more efficient public spending in order to enhance fiscal balance.

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UTICAJ INFLACIJE NA JAVNI DUG ZEMALJA JUGOISTOČNE EVROPE

Sažetak: Ovaj rad istražuje uticaj inflacije na nivo javnog duga izražen kao procenat BDP-a u zemljama Jugoistočne Evrope u periodu od 2008. do 2023. godine. Istraživanje je sprovedeno na uzorku od osam zemalja, primenom regresione analize panel podataka. Poseban akcenat stavljen je na razlikovanje trenutnog i odloženog efekta inflacije, uz uključivanje dve kontrolne varijable: kamate na javni dug i realnog rasta BDP-a. Model sa slučajnim efektima (REM), koji je odabran kao metodološki najpogodniji na osnovu Breusch-Pagan LM testa i Hausman testa, pokazuje da inflacija iz prethodnog perioda ima negativan i statistički značajan uticaj na javni dug, dok tekuća inflacija nije značajna. Kamata na javni dug pokazala se kao visoko značajna i pozitivno korelisana varijabla, dok realni rast BDP-a nije imao statistički značajan efekat. Rezultati sugerišu da inflacija može igrati ulogu u relativnom smanjenju fiskalnog opterećenja, ali da odgovorno upravljanje zaduživanjem i jačanje institucionalnih okvira ostaju ključni faktori očuvanja fiskalne stabilnosti i održivosti javnog duga u regionu.

Ključne reči: javni dug, inflacija, Jugoistočna Evropa, kamata na javni dug, realni rast BDP-a.

Authors' biographies

Miloš Golubović is a research associate at the Innovation Center of the University of Niš. He is currently pursuing doctoral studies and working on a dissertation titled *"Empirical Observation of the Determinants of Public Debt in the Countries of Southeast Europe."* His research interests include public debt, fiscal policy, economic analysis, and macroeconomic studies in Southeast European countries. Additionally, Miloš is a member of the Innovation Center team for business plan development.