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FACTORS AFFECTING FOREIGN DEBT IN OIC COUNTRIES

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Abstract

This study looks at how current balance deficit, GDP, and government spending affect foreign debt in eight countries in the Organization of Islamic Cooperation: Lebanon, Jordan, Egypt, Pakistan, Morocco, Bangladesh, Kazakhstan, and Algeria. This research uses a quantitative method with data from 2010 to 2020. It uses panel data to explain information between units and cross sections. The results showed that the current balance deficit had no significant effect on foreign debt, but GDP and government expenditure had a significant effect.

Keywords : Current Balance Deficit, GDP, Government Expenditure

1. INTRODUCTION

The state has a duty to maintain the economic stability of its country so that there needs to be strategies that must be carried out by the state to encourage positive economic growth. One of the efforts that can be made is with new sources of financing for development both from within the country and foreign debt. Foreign debt is a consequence of the costs that must be paid as a result of unbalanced economic management, coupled with an economic recovery process that is not comprehensive and consistent. During times of economic crisis, foreign debt becomes one of the instruments used by the government to maintain the country's economic stability. Thus, the state must add new foreign debt to pay the old foreign debt that has matured. The accumulated foreign debt and interest will be paid through the State Budget in installments in each fiscal year. Ineffective and inefficient use of debt will actually increase the burden on the state because it causes a reduction in the prosperity and welfare of the people in the future, so it will clearly burden the community, especially the taxpayers in the country.

According to (Arsyad, 2010), foreign debt is a source of financing the government budget and economic development. Foreign debt is used to finance public expenditure so that it can support economic activities, especially productive activities, which in turn will encourage economic growth. Debt is usually used to finance budget deficits. The growth created in turn contributes to job creation and poverty reduction. On the other hand, the current debate on foreign debt in developing countries revolves around its poor management, where most of the borrowed funds are spent on conspicuous consumption. This tendency is largely responsible for high foreign debt levels and the inability to service debt. This situation occurred in the 1980s, when massive defaults in debt payments in Sub-Saharan African countries led to them being frozen out of global financial markets. Latin American and Caribbean countries also defaulted and were frozen out of global financial markets.

The situation became so severe in the 1990s that it required International Monetary Fund atau World Bank intervention to facilitate the reduction of debt levels through debt relief programs. The intervention succeeded in bringing down debt burdens to sustainable levels, which allowed these countries to regain access to global financial markets in the mid-2000s. Since then, these countries have resumed accumulating foreign debt, while the foreign exchange reserves needed to service the debt remain inadequate. Over the years, the IMF/World Bank has continued to voice grave concerns about the consequences of allowing the ratio of foreign exchange reserves to foreign debt to remain low (International Monetary Fund, 2017). The theoretical support for foreign inflows and growth comes from the neo-classical and endogenous growth models which consider capital accumulation and technological progress as essential for economic growth and development (Ehigiamusoe & Lean, 2019). In the seminar paper, Chenery dan Strout (1966) highlighted the effect of foreign inflows on growth from a developing country perspective. They consider two different stages of economic development, the first before reaching the growth target and the second after reaching the growth target, where foreign inflows can affect economic growth through different channels. Developing countries generally lack capital and so their abundant labor force remains unemployed as growth-accelerating activities such as the production of goods and services for both domestic and international markets are negatively affected. Under such circumstances, the opportunity to grow in the long run disappears significantly.

The global economic conditions that are increasingly uncertain due to the trade wars of several superpowers make other countries must have a precise strategy in maintaining the economic stability of their country. One of the impacts of economic shocks outside the country is the swelling deficit in the State Revenue and Expenditure Budget. This deficit situation has spurred countries to increase their sources of income from debt, especially foreign debt. The foreign debt ratio of OIC countries varies widely, ranging from 3% to 139%. The difference in the level of debt ratio of each country depends on the economic conditions and government policies of each country. Through empirical studies and conceptually important reasons, the researcher examines the problem of foreign debt of several selected countries in this study and the factors that influence the foreign debt policy of each country. These factors include direct and indirect factors. So in this study look at the effect of Current balance deficit, GDP and Government Expenditure on Foreign Debt of OIC Countries.

2. LITERATURE REVIEW

2.1 Total Foreign Debt

In terms of theoretical studies, the problem of foreign debt can be explained through the national income approach. As one of the sources of development financing, foreign debt is needed to cover 3 (three) deficits, namely the investment savings gap, budget deficit and current balance deficit. According to Tambunan (2011:249) high foreign debt in a country is caused by three types of deficits, namely: (1) current balance deficit, where exports (X) are less than imports (M); (2) investment deficit or I-S gap, where the funds needed to finance investment (I) in the country are greater than national or domestic savings (S); and (3) budget deficit (fiscal) or G - T (fiscal gap).

Among these factors, the current balance deficit is often cited in the literature as the main cause of the ballooning foreign debt of many developing countries. The size of the TB deficit exceeding the capital account (CA) surplus (if the balance is positive) results in a balance of payments (BOP) deficit, which also means that the foreign exchange reserves (FER) are depleted. If the CA balance is negative every year, the FX reserves are automatically depleted if there are no other sources (e.g. foreign investment capital), as is the case in the poorest countries of the African continent. Foreign exchange is needed primarily to finance the import of capital goods and supplies for domestic production activities. From the above description, it can be seen that the continuous TB deficit makes many developing countries dependent on foreign debt (ULN), especially countries whose economic conditions do not attract foreign investors, making it difficult for these countries to replace ULN with investment, for example in the form of foreign investment (PMA).

2.2 Current Balance Deficit

According to (Bank Indonesia, 2008) the current account measures Indonesia's receipts and expenditures from transactions in goods and services, income, and current transfers with non-residents. The components of the current account are trade balance, services, income, and current transfers. The trade balance is the export and import transactions of goods (commodities). Meanwhile, exports and imports of services are included in the services balance. The services balance includes transactions in the provision of services by residents to non-residents (inflows) and by non-residents to residents (outflows). Services are transactions in the provision of services between residents and non-residents. There are 11 types of services listed in the Indonesian Balance of Payments (NPI), namely transportation services, travel, communication services, construction services, insurance services, financial services, computer and information services, royalties and license fees, personal, cultural, and recreational services, government services, and other business services. Income is the result arising from the provision of production factors of labor and financial capital. Income consists of compensation of employees and investment income. Compensation of employees comes from seasonal workers who work for less than one year. Investment income is divided into three: direct investment income, portfolio investment income, and other investment income. Current transfers record unilateral transactions that involve the transfer of resources without reciprocity (e.g. gifts or grants). The largest element of the current account is workers' remittances. These are transfers of Indonesian workers abroad.

2.3 Gross Domestic Product (GDP)

According to Peacock and Wiseman (Basri & Subri, 2003), if the gross domestic product increases, it will have an impact on increasing economic activity, especially the real sector and the business world in general. Increased economic activity will have an effect on increasing government revenue through taxation, because the economy is vibrant so that business activities increase and ultimately company profits increase as well. The increase in company activities and profits will certainly increase taxation both from income tax, value added tax and excise. Tax revenue is the main post in domestic revenue. With an increase in tax revenue, it is expected that it will result in the Indonesian budget becoming a surplus or in other words, if the budget is in deficit in the previous year, then an increase in tax revenue will result in a budget deficit that can decrease in the following year period, even expected to result in a surplus budget.

In theory, there is a relationship between foreign debt and economic growth. The classical school of thought argues that foreign debt hampers economic growth by reducing fiscal and budget discipline and the private sector's access to credit (Broner et al., 2022). Furthermore, it is argued that foreign debt servicing tends to constrain economic growth with domestic investment. On the other hand, the Keynesian school of thought argues that public spending financed by debt has a multiplier effect on national output, as public spending stimulates the economy more. This view suggests that government debt is important for stimulating growth, provided that it is not used for consumption. In this way, the impact of debt on growth can be optimized with moderate inflation (Driessen & Gravelle, 2019).

3. IMPLEMENTATION METHOD

3.1 Research Scope

This research is a study of the factors that affect the foreign debt of the Organization of Islamic Cooperation countries in the period 2005 to 2015. In the form of panel data, which is a combination of cross-section and time series data. Includes data from 8 countries with a composition of 3 countries with high foreign debt, 3 countries in the middle position and 4 countries with less debt. The factors that influence the foreign debt are analyzed: current balance deficit, GDP, government expenditure.

3.2 Type and Data Source

The data used in this paper is taken from http://www.sesric.org/ for analysis purposes, the data used is from 2005 to 2015. The sample countries are Lebanon, Jordan, Egypt, Pakistan, Morocco, Bangladesh, Kazakhstan and Algeria. The analytical tool used is descriptive macroeconomic analysis. Literature studies, both from textbooks and journals/magazines, are very important sources.

$$Y = a + \beta 1X1it + + \beta 2X2it + \beta 3X3it + \varepsilon i$$

X1 = Current Balance Defisit
X2 = GDP
X3 = Government Expenditure
β1-β3 = coefficient
i = cross section
t = time series
εi = errorterm

3.3 Data Analysis

The econometric analysis technique used in this study is the panel data model. Panel data is a combination of cross-sectional and time-series data (i.e., a number of variables are observed for a number of categories and collected over a period of time)(Rosadi, 2012). The estimation models in this panel data depend on assumptions about the intercept, slope coefficient, and the error term. There are several methods commonly used to estimate regression models with panel data, namely the common effect approach, fixed effect approach, random effect approach, random effect method.

The hypothesis in this test is that the intercepts are equal, or in other words, the correct model for panel data regression is common effect, so the alternative hypothesis is that the intercepts are not equal, or the correct model for panel data regression is fixed effect. The calculated F statistic value will follow the distribution of the F statistic with m degrees of freedom for the numerator and n - k for the denominator. If the calculated F value is greater than the critical F, the null hypothesis is rejected, which means that the correct model for the panel data regression is the fixed effects model. Conversely, if the calculated F-value is less than the critical F, the null hypothesis is accepted, which means that the correct model for panel data regression is the common effect model.

3. RESULTS AND DISCUSSION

Based on the results of panel data regression estimation using Pooled Ordinary Least Square (PLS), Fixed Effect Model (FEM), and Random Effect Model (REM) approaches, the Chow test and Hausman test are performed to select the best model among 3 approaches.

Table 1 chow's panel regression results

Effects Test	Statistic	d.f.	Prob.
Cross-section F	90.484149	(7,61)	0.0000
Cross-section Chi-square	182.411889	7	0.0000

Source: Data processed, 2024

Based on table 1 probability value.Cross-section F of 0.0000 <0.05, then H0 is rejected so that the selected model is fixed effect method. Furthermore, the Hausman test is seen in table 2:

Table 2. Panel Data Regression Estimation Results with Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	83.101335	6	0.0000

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Based on Table 2 prob value. Chi Square = 0.0000 <0.05, then H0 is rejected, so the selected model is the fixed effect model. Thus, it can be concluded from the Chow test and Hausman test that the best model is the Fixed Effect Model (FEM). The results of the panel data regression with the fixed effect model (FEM) are shown in Table 3:

Table 3 Fixed Effect Model Panel Data Regression Results

Dependent Variable: LN_Y
Method: Panel Least Squares
Sample: 2005 2015
Periods included: 11
Cross-sections included: 8
Total panel (unbalanced) observations: 75

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-21.76633	4.706287	-4.624948	0.0000
LN_X1	-2.37E-05	0.020557	-0.001155	0.9991
LN_X2	1.594906	0.229374	6.953308	0.0000
LN_X3	-0.024282	0.010413	-2.331845	0.0230
	Effects Specification			
Cross-section fixed (dummy variables)				
R-squared	0.960887	Mean dependent var		17.22507
Adjusted R-squared	0.952552	S.D. dependent var		0.738064
S.E. of regression	0.160769	Akaike info criterion		-0.650974
Sum squared resid	1.576653	Schwarz criterion		-0.218376
Log likelihood	38.41151	Hannan-Quinn criter.		-0.478242
F-statistic	115.2771	Durbin-Watson stat		1.184229
Prob(F-statistic)	0.000000			

Source: Data processed, 2024

Based on Table 1, the regression equation that shows the effect of the independent variables of current balance deficit, outward foreign investment, exchange rate, foreign exchange reserves, GDP and Government Expenditure on the dependent variable Total Foreign debt is:

$$\boldsymbol{Y = -21.76633 - 2.37E\text{-}05X1 + 1.594906X5 - 0.024282X6 + \varepsilon i}$$

The fixed effect model regression results for the X1 variable t test (Current balance deficit) have a sig. t of 0.9991 ≥ 0.01; so H0 is rejected, the Current balance deficit has no effect on Total Foreign debt. The X2 variable t test has a sig. t of 0.0000 ≤ 0.05; so H0 is accepted then GDP has a positive influence on Total Foreign debt. The X3 variable t test has a sig. t of 0.0230 ≤ 0.05; so H0 is accepted then Government Expenditure has a positive influence on Total Foreign debt 0.0230 ≤ 0.05. From the fixed effect model regression table for the F test, it can be seen that the F-statistic probability value is 0.000000 <0.05, then the independent variables affect the dependent variable which means that the current balance deficit, GDP and Government Expenditure simultaneously affect the performance of Islamic commercial banks. Simultaneously (Adjusted R-Squared) obtained a number of 0.960887. This means shows that 96.08%. Total Foreign debt can be explained by the GDP and Government Expenditure variables, while 3.92% can be explained by variables outside the study. The effect of the state revenue and expenditure budget deficit, foreign exchange reserves, net exports, and foreign debt in the previous year on foreign debt. Based on the results of the analysis, the state revenue and expenditure budget deficit has a positive but significant effect at the prob-0.1% level on Indonesia's foreign debt, these results are supported by the theory put forward by (Tambunan & Sikumbang, 2011) that foreign debt is influenced by the state revenue and expenditure budget deficit but the significant level is small with the assumption that an increase in the budget deficit tends to increase the flow of foreign debt, unless the government has access to international markets from other governments, and is clarified as an alternative to government financing trying to make budget deficits through state bonds or bonds. Based on the results of the analysis, foreign exchange reserves have a positive and significant effect on foreign debt if foreign exchange reserves increase, foreign debt will also increase because if the government has strong foreign exchange reserves, it will support foreign debt as state financing because another function of foreign exchange reserves is to pay for state financing These results are supported by research (Satrianto, 2016).

Based on the results of the analysis, net exports have a positive but insignificant effect on foreign debt, these results are supported (Satrianto, 2016), which means that the positive value in the data cannot be trusted because it is not significant. Based on the results of the previous year's foreign debt has a positive and significant effect on foreign debt, it can be explained because if the previous year's foreign debt rises, the current foreign debt will also rise because the government must pay off debts and interest and so is forced to make new debts supported by research. Based on the research results above, this study is in line with the same theory put forward by previous researchers, Satrianto. From previous research also reveals that all variables in this study have an effect, but in this study one of the variables is not significant. So it can be concluded that a significant variable in this study is that if the independent variable increases, foreign debt will also increase.

4. CONCLUSION

Foreign debt is very helpful in covering the lack of development costs in a country's budget, but the problem of paying installments and interest is a burden that must be carried continuously, especially since the exchange rate against the dollar tends to be unstable every year. Meanwhile, foreign capital inflows also play a role in covering the foreign exchange gap caused by the current balance deficit. Foreign debt is very helpful in the short term, but in the long term it turns out that foreign debt can cause several economic problems, because the loan is not given purely as assistance to other countries, but implies political interests in it. Therefore, the management of the state budget must be carried out as effectively and efficiently as possible, not only for consumption needs, but also for productive interests, so that the country does not continue to be trapped in foreign debt, which is increasing every year.

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