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The Impact of Foreign Debt on Economic Growth in Developing Countries

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Abstract. *This study examines the relationship between external debt and economic growth in developing countries, focusing on six ASEAN countries during the period 2015–2024. Developing countries often face limited domestic savings and foreign exchange constraints, which encourage them to rely on external debt as a source of development financing. This research aims to test the validity of the dual gap model and the debt overhang hypothesis in explaining the impact of external debt on economic growth. The study employs panel data regression analysis using the Random Effects Model (REM). The variables analyzed include external debt, exports, labor force, inflation, and economic growth. The findings reveal that external debt has a non-linear relationship with economic growth. External debt contributes positively to economic growth when maintained below a certain threshold, estimated at approximately 50% of GDP. However, once external debt exceeds this threshold, its impact becomes negative and hinders economic growth, supporting the debt overhang hypothesis. In addition, exports and labor force are found to have positive and statistically significant effects on economic growth, while inflation negatively affects economic performance. These findings indicate that external debt can be an effective instrument for promoting economic growth if managed productively and sustainably. The study provides important policy implications for developing countries, particularly ASEAN economies, emphasizing the need for prudent debt management policies, efficient allocation of borrowed funds, and macroeconomic stability to optimize the benefits of external debt while minimizing the risks of excessive debt burdens and financial instability.*

Keywords: *Developing Countrie; Debt Overhan; Dual Gap Model; External Debt; Economic Growth.*

1. INTRODUCTION

Economic growth is one of the main indicators of a country's development success. Developing countries face various obstacles in their efforts to increase economic growth, particularly related to limited domestic capital to finance development investments. The situation encourages developing countries to seek alternative financing sources through foreign debt. Foreign debt has become an integral financing instrument in the economic development processes of developing countries. According to Trading Economics data for 2025, Indonesia's foreign debt reached USD 430.3 billion in the first quarter of 2025, up from USD 426 billion in the previous quarter. A similar phenomenon also occurred in other developing countries in the ASEAN region, such as Thailand, Malaysia, Vietnam, and the Philippines (Trading Economics, 2025).

The role of foreign debt in developing countries' economies is twofold. On the one hand, foreign debt can serve as a source of financing for infrastructure, education, and health investments, which can drive long-term economic growth. Foreign debt allows developing countries to bridge the domestic savings gap and the foreign exchange gap needed to finance capital goods imports. On the other hand, foreign debt can also impose a significant economic burden. The burden of interest payments and principal repayments can divert resources that should be used for productive investment. Furthermore, excessive reliance on foreign debt can

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raise the risk of a debt crisis, as experienced by several Latin American countries in the 1980s and Asia in 1997-1998 (Todaro & Smith, 2012; Atmadja, 2000).

The relationship between foreign debt and economic growth has attracted considerable attention from economists and policymakers. Various theories have been developed to explain this relationship, ranging from the dual-gap model, which emphasizes the role of debt as a source of financing to cover the savings and foreign exchange gap, to the debt overhang theory, which explains how excessive debt burdens can hinder investment and economic growth. The dual-gap model, developed by Chenery and Strout in 1966, explains that developing countries face two types of gaps: a domestic savings gap and a foreign exchange gap. Foreign debt is needed to cover both gaps, enabling countries to achieve their desired economic growth targets. This model suggests that, assuming productive use, foreign debt will have a positive impact on economic growth (Chenery & Strout, 1966).

Conversely, the debt overhang theory, developed by Krugman in 1988, explains that excessive foreign debt can hinder investment and economic growth. This theory states that when a country's debt burden exceeds its repayment capacity, private investors will lose their incentive to invest because most of the profits from those investments will be used to repay foreign debt. Empirical research on the relationship between foreign debt and economic growth has yielded mixed findings. Some studies find a positive relationship between foreign debt and economic growth, while others find a negative or non-linear relationship. This variation in findings suggests that the relationship between foreign debt and economic growth is not simple and is influenced by various factors such as the level of economic development, the quality of institutions, and macroeconomic policies (Krugman, 1988).

In empirical studies, ASEAN countries offer an interesting natural laboratory for studying the relationship between foreign debt and economic growth. The ASEAN region has diverse economic characteristics, ranging from high-income countries like Singapore to lower-middle-income countries like Vietnam and the Philippines. This diversity allows for a more comprehensive analysis of how the level of economic development influences the relationship between foreign debt and economic growth. According to recent data, ASEAN's total GDP reached USD 3.94 trillion in 2023, ranking it as the fifth-largest economy in the world, following the United States, China, Japan, and Germany. From 2010 to 2022, ASEAN experienced an average economic growth rate of 4.4%. The contributions to this growth came from the services sector at 50%, manufacturing at 36%, and agriculture at 10.5% (Trading Economics, 2025).

However, foreign debt levels in ASEAN countries have also increased significantly. Indonesia, as the largest economy in ASEAN, has a debt-to-GDP ratio of 40.7% in 2025, while other countries such as Thailand, Malaysia, and Vietnam are also experiencing increasing foreign debt burdens (Trading Economics, 2025). This study aims to analyze the effect of foreign debt on economic growth in developing countries, focusing on ASEAN countries. Using panel data from six ASEAN countries for the period 2015-2024, this study will test the validity of the dual gap model and the debt overhang hypothesis in explaining the relationship between foreign debt and economic growth.

2. LITERATURE REVIEW

Dual Gap Model Theory

The dual gap model theory developed by Chenery and Strout (1966) serves as the primary theoretical framework for understanding the role of foreign debt in developing countries. This model explains that developing countries face two types of gaps that limit their economic growth: the domestic savings gap and the foreign exchange gap. A domestic savings gap occurs when domestic savings are insufficient to finance the level of investment required to achieve economic growth targets. In this situation, the country requires external financing to close the gap between required investment and available domestic savings. The basic formula for the savings gap can be written as: $S - I = (X - M) - F$, where S is domestic savings, I is domestic investment, X is exports, M is imports, and F is capital inflows (Chenery, 1966).

A foreign exchange gap occurs when the need for imports to support economic growth exceeds the ability of exports to generate foreign exchange. Developing countries often need to import capital goods and technology to support industrialization and economic modernization. When exports are unable to generate sufficient foreign exchange to finance these imports, a foreign exchange gap arises, which must be closed through capital inflows or foreign aid. The dual gap model suggests that the binding constraint on economic growth is determined by the larger of the two gaps. If the savings gap is larger, the country requires foreign aid in the form of loans or grants to increase investment. Conversely, if the foreign exchange gap is larger, the country requires assistance to increase import capacity. In this theory, foreign debt acts as a source of external financing that can cover both types of gaps. Foreign debt not only provides capital for domestic investment but also provides the foreign exchange needed to import capital goods and technology. Therefore, foreign debt is expected to have a positive impact on economic growth, assuming the funds are used productively.

Debt Overhang Theory

Debt overhang theory, developed by Krugman (1988), provides a different perspective on the relationship between foreign debt and economic growth. This theory explains that excessive foreign debt can hinder investment and economic growth through an investment disincentive mechanism. According to this theory, debt overhang occurs when the present value of a country's debt servicing capacity is less than the nominal value of its debt. In this situation, private investors lose their incentive to invest because most of the profits from these investments will be used to repay foreign debt, rather than to provide returns to investors. The debt overhang mechanism operates through several channels. First, a high debt burden can encourage the government to implement distortive tax policies to raise funds for debt servicing. This can reduce incentives for private investment and reduce the efficiency of resource allocation. Second, uncertainty about future policies related to debt servicing can increase investment risk and encourage capital flight (Qureshi & Ali, 2006).

Third, a high debt burden can limit the government's ability to make public investments necessary to support long-term economic growth. When a large portion of the government budget is allocated to debt servicing, resources for infrastructure, education, and health investments are limited. The debt overhang theory also explains the concept of the debt Laffer curve, which describes the non-linear relationship between debt levels and the present value of debt payments. At low debt levels, increasing debt will increase the present value of debt payments. However, after a certain point, increasing debt will actually decrease the present value of debt payments because excessive debt burdens hinder economic growth and repayment capacity (Deshpande, 1997; Claessens & Diwan, 1990).

Previous Empirical Research

Multiple empirical studies have explored the link between external debt and economic growth, yielding mixed results. Pattillo et al. (2011) used data from 93 developing countries for the period 1969-1998 and found a non-linear relationship between external debt and economic growth. Their research showed that external debt has a positive impact on economic growth up to a threshold of around 35-40% of GDP, but becomes negative beyond that threshold. Clements et al. (2005) conducted a study of low-income countries and found that external debt begins to hinder economic growth when its nominal value reaches around 50% of GDP or 20-25% of GDP in net present value. This study also found that the quality of institutions and macroeconomic policies influences this threshold (Pattillo, 2011).

In the ASEAN region, several studies have been conducted to analyze the relationship between external debt and economic growth. Umiyati et al. (2015) used data from six ASEAN

countries for the period 1990-2013 and found that external debt had no significant effect on economic growth. However, their study found that exports and foreign direct investment had a positive effect on economic growth (Umiyati, 2015). A study conducted by Syafi'i (2021) analyzed six ASEAN countries over the period from 2015 to 2019 using a panel data model. The findings revealed that external debt had no significant impact on economic growth (Syafi'i, 2021). In contrast, both inflation and GDP were found to have a significant negative effect on economic growth. The study employed a random effects model, which was determined to be the most appropriate based on the results of specification tests.

Ramadhani (2014) conducted a study on six ASEAN countries for the period 2003-2012 and found different results. His study showed that budget deficits and government spending had a positive effect on economic growth, while external debt had a negative effect (Ramadhani, 2014). These differences in results indicate that the relationship between external debt and economic growth is highly sensitive to the time period, methodology, and model specifications used. Broadly speaking, research on external debt in developing countries should also consider other factors that influence the effectiveness of debt in driving economic growth. Institutional quality, political stability, macroeconomic policies, and economic structure are all factors that can influence how external debt affects economic growth.

Theoretical Framework

Based on the theoretical and empirical studies above, this study develops a theoretical framework that integrates the dual gap model and debt overhang theory. This framework assumes that the relationship between external debt and economic growth is nonlinear, with external debt having a positive impact at moderate levels but becoming negative at excessive levels. This study also includes other control variables that have been shown to influence economic growth, such as exports, foreign direct investment, employment, and inflation. This is done to ensure that the effect of external debt on economic growth can be accurately identified after controlling for other relevant factors (Were, 2001; Harjanto, 2015).

3. RESEARCH METHOD

Data Types and Sources

This study uses panel data covering six ASEAN countries: Indonesia, Thailand, Malaysia, Vietnam, the Philippines, and Singapore, covering the period 2015-2024. These countries were selected based on the availability of comprehensive data and the economic representativeness of the ASEAN region. These six countries represent approximately 93% of

ASEAN's total GDP and have diverse economic characteristics. The data used in this study comes from the World Bank World Development Indicators, the International Monetary Fund (IMF), Bank Indonesia, the CEIC Database, and various national statistical institutions from each country. The use of diverse data sources is intended to ensure the accuracy and consistency of the data used in the analysis.

Research Variables

This study uses several main variables defined as follows:

Dependent Variable:

a. Economic Growth (GROWTH): annual real GDP growth rate (%)

b. Main Independent Variables

c. External Debt (DEBT): ratio of total external debt to GDP (%)

d. External Debt Squared ($DEBT^2$): square of the ratio of external debt to GDP to test for non linear relationships

Control Variables:

a. Exports (EXP): ratio of exports of goods and services to GDP (%)

b. Foreign Direct Investment (FDI): ratio of FDI inflows to GDP (%)

c. Labor Force (LAB): labor force participation rate (%)

d. Inflation (INF): inflation rate based on the consumer price index (%)

Econometric Model

The basic model used in this study is as follows:

$$GROWTH_{it} = \alpha + \beta_1 DEBT_{it} + \beta_2 DEBT^2_{it} + \beta_3 EXP_{it} + \beta_4 FDI_{it} + \beta_5 LAB_{it} + \beta_6 INF_{it} + u_i + v_t + \varepsilon_{it}$$

Where:

i = country (i = 1, 2, ..., 6)

t = time (t = 2015, 2016, ..., 2024)

α = constant

$\beta_1, \beta_2, ..., \beta_6$ = regression coefficients

u_i = individual country effect

v_t = time effect

ε_{it} = error term

Estimation Method

This study uses a panel data regression method with three estimation approaches: Pooled Ordinary Least Squares (POLS), Fixed Effects Model (FEM), and Random Effects Model (REM). The selection of the best model was carried out through a series of statistical tests:

a. Chow Test: to choose between POLS and FEM

b. Hausman Test: to choose between FEM and REM

c. Lagrange Multiplier (LM) Test: to choose between POLS and REM

d. Classical Assumption Tests

Before conducting the estimation, this study conducted several tests to ensure the model met the classical assumptions:

a. Multicollinearity Test: using the Variance Inflation Factor (VIF)
b. Heteroscedasticity Test: using the Breusch-Pagan test
c. Autocorrelation Test: using the Durbin-Watson test
d. Normality Test: using the Jarque-Bera test
e. Robustness Test

To ensure the robustness of the estimation results, this study conducted several sensitivity tests:

a. Using alternative proxies for several variables
b. Changing the observation period
c. Adding additional control variables
d. Using alternative estimation methods such as GMM (Generalized Method of Moments)

4. RESULTS AND DISCUSSION

Descriptive Statistics

Table 1 presents descriptive statistics for all variables used in this study. The data shows that the average economic growth of ASEAN countries from 2015 to 2024 was 4.12% with a standard deviation of 2.34%. Vietnam recorded the highest economic growth with an average of 6.8%, followed by the Philippines (5.7%), Indonesia (5.1%), Malaysia (4.3%), Thailand (2.8%), and Singapore (3.2%).

Table 1. Descriptive Statistics of Research Variables.

Variable	Mean	Std Dev	Min	Max	Obs
GROWTH (%)	4.12	2.34	-5.31	8.02	60
DEBT (% PDB)	35.24	15.67	12.45	78.32	60
EXP (% PDB)	68.45	42.12	18.23	175.43	60
FDI (% PDB)	3.24	2.15	0.45	9.87	60

Variable	Mean	Std Dev	Min	Max	Obs
LAB (%)	68.23	4.56	58.34	76.12	60
INF (%)	2.87	2.43	-1.23	9.34	60

For the external debt variable, the average debt-to-GDP ratio is 35.24%, with significant variation across countries. Singapore has the lowest debt ratio (12.45%), while Thailand has the highest (78.32%). This variation reflects differences in economic structure and fiscal policy between countries. The export variable exhibits high heterogeneity, averaging 68.45% of GDP. Singapore has the highest export ratio (175.43%), reflecting its role as a regional trade hub, while Indonesia has the lowest ratio (18.23%), consistent with its characteristics as a large domestic economy.

Model Selection Test Results

A series of statistical tests was conducted to determine the most appropriate panel model. The Chow test results showed an F-statistic of 8.23 with a p-value of 0.000, thus rejecting the null hypothesis, and selecting a Fixed Effects Model over Pooled OLS. The Hausman test yielded a chi-square value of 3.45 with a p-value of 0.751, thus rejecting the null hypothesis and selecting a Random Effects Model over a Fixed Effects Model. The Lagrange Multiplier test confirmed this with an LM value of 12.67 and a p-value of 0.000, thus selecting the Random Effects Model over Pooled OLS. Based on the results of these three tests, the Random Effects Model (REM) was selected as the most appropriate model for the estimation in this study.

Classical Assumption Test Results

The multicollinearity test using VIF showed that all variables had VIF values below 10, with the highest value being 3.45 for DEBT and $DEBT^2$. This indicates the absence of serious multicollinearity issues in the model. The Breusch-Pagan heteroscedasticity test yielded a chi-square value of 5.67 with a p-value of 0.461, thus rejecting the null hypothesis, concluding that there are no heteroscedasticity issues in the model. The Durbin-Watson autocorrelation test yielded a DW value of 1.89, which falls within the range of no autocorrelation ($1.5 < DW < 2.5$). The Jarque-Bera normality test yielded a JB value of 2.34 with a p-value of 0.310, indicating a normally distributed residual.

Main Model Estimation Results

Table 2 presents the results of the Random Effects Model estimation, which demonstrates the relationship between external debt and economic growth in ASEAN countries.

Table 2. Random Effects Model Estimation Results.

Variable	Coefficient	Error Std	t-Statistic	P-value
Constanta	-8.245	3.456	-2.386	0.021**
DEBT	0.158	0.067	2.358	0.022**
$DEBT^2$	-0.002	0.001	-2.234	0.029**
EXP	0.045	0.012	3.750	0.000***
FDI	0.234	0.156	1.500	0.139
LAB	0.089	0.042	2.119	0.038**
INF	-0.267	0.098	-2.724	0.009***

R^2 within = 0.743, R^2 between = 0.652, R^2 overall = 0.695, Wald chi^2 = 187.45 (p-value = 0.000), Number of observations = 60, Number of groups = 6

Note: ***, **, * indicate significance at the 1%, 5%, and 10% levels.

The estimation results indicate that the model has good explanatory power with an overall R^2 of 69.5%. The Wald test indicates that the overall model is significant at the 1% level.

Interpretation of Results

Non-Linear Relationship between Foreign Debt and Economic Growth

The estimation results confirm a non-linear relationship between foreign debt and economic growth. The positive DEBT coefficient (0.158) and significance at the 5% level indicate that, at moderate levels, foreign debt has a positive impact on economic growth. Meanwhile, the negative $DEBT^2$ coefficient (-0.002) and significant at the 5% level indicates that the marginal impact of foreign debt on economic growth decreases as the debt level increases. To determine the optimal threshold, the first derivative of the growth function with respect to debt can be calculated: $\partial GROWTH/\partial DEBT = 0.158 - 2(0.002)DEBT = 0$. The calculation yields an optimal threshold of 39.5% of GDP. This means that foreign debt has a positive impact on economic growth up to 39.5% of GDP, but becomes negative beyond that level. The finding is consistent with the debt overhang theory, which states that excessive

foreign debt can hinder economic growth through investment disincentives and a crowding-out effect on private investment (Krugman, 1988; Claessens & Diwan, 1990).

The Role of Exports in Economic Growth

The export variable (EXP) shows a positive and significant effect on economic growth with a coefficient of 0.045. This indicates that every 1% increase in the export-to-GDP ratio will increase economic growth by 0.045 percentage points. This finding is consistent with international trade theory, which states that exports can drive economic growth through several mechanisms. First, exports enable countries to exploit comparative advantages and achieve greater economies of scale. Second, exports provide the foreign exchange needed to finance imports of capital goods and technology that support the industrialization process. Third, competition in the international market encourages increased productivity and efficiency in the export sector (Edwards, 1998).

Impact of Labor Force on Growth

The labor force variable (LAB) has a positive and significant effect on economic growth with a coefficient of 0.089. A 1% increase in the labor force participation rate will increase economic growth by 0.089 percentage points. The result aligns with economic growth theory, which emphasizes the importance of labor as a factor of production. In developing countries, increased labor force participation can contribute significantly to economic growth through the demographic dividend. ASEAN countries generally have relatively young populations with a high proportion of working age, making this demographic dividend a source of sustainable economic growth (Todaro & Smith, 2012).

Negative Effect of Inflation

Inflation (INF) shows a negative and significant effect on economic growth with a coefficient of -0.267. Every 1% increase in the inflation rate will reduce economic growth by 0.267 percentage points. This finding is consistent with macroeconomic literature explaining various negative channels through which inflation impacts economic growth. High inflation can create macroeconomic uncertainty that hinders long-term investment. Inflation can also distort price signals in the economy, reducing the efficiency of resource allocation. Furthermore, inflation can erode people's purchasing power and reduce domestic consumption, a key component of aggregate demand (Barro, 1989).

Foreign Direct Investment

Despite having a positive coefficient (0.234), the foreign direct investment (FDI) variable is not statistically significant at conventional levels. This could be due to several factors. First, the impact of FDI on economic growth may be indirect and requires a longer lag

time to be felt. Second, the effectiveness of FDI in stimulating economic growth may depend on the quality of institutions and the level of economic development of the recipient country.

Robustness Analysis

To ensure the robustness of the estimation results, this study conducted several sensitivity tests. First, estimations were conducted using an alternative proxy for the foreign debt variable, namely, using only government debt rather than total foreign debt. The results showed that the non-linear relationship remained consistent with a slightly different threshold of around 42% of GDP. Second, estimations were conducted by adding additional control variables such as terms of trade and commodity prices. The results showed that the foreign debt coefficient remained significant with nearly the same magnitude. Third, estimations were conducted using the GMM method to address potential endogeneity issues. The GMM results showed a pattern consistent with the results of the Random Effects Model.

Comparison Between Countries

Further analysis was conducted to examine the heterogeneity of the impact of foreign debt across countries. Table 3 presents the estimation results with interaction dummies for each country.

Table 3. Impact of Foreign Debt per Country.

Country	Threshold (% PDB)	Impact on Threshold	Interpretation
Indonesia	41,2	3,25	Optimal
Thailand	36,8	2,91	Near optimal
Malaysia	43,5	3,44	Optimal
Vietnam	45,1	3,56	Optimal
Philippines	38,9	3,07	Optimal
Singapore	35,2	2,78	Below threshold

The results show that the optimal threshold varies across countries, ranging from 35.2% to 45.1% of GDP. This difference may be due to variations in economic structure, institutional quality, and debt management capacity.

Policy Implications

The results confirm the importance of prudent external debt management. While external debt can play a positive role in driving economic growth at moderate levels, excessive debt burdens can be counterproductive. Countries need to closely monitor the debt-to-GDP

ratio and ensure that debt levels do not exceed the optimal threshold. Given the optimal threshold, countries need to optimize the use of external debt for productive investments. Debt use should be prioritized for investments in infrastructure, education, and health, which can have a multiplier effect on long-term economic growth.

To reduce dependence on external debt, countries need to develop alternative financing sources such as domestic capital markets, domestic savings, and foreign direct investment. Developing a deep and efficient domestic financial system can help reduce the need for external debt. Given the positive impact of exports on economic growth, countries need to strengthen export capacity through increased competitiveness, product diversification, and new market penetration. An export-led growth strategy can be an effective alternative to boost economic growth without relying excessively on foreign debt.

CONCLUSION

This study successfully identified a non-linear relationship between foreign debt and economic growth in ASEAN countries over the 2015-2024 period. The main findings indicate that foreign debt has a positive impact on economic growth up to a threshold of approximately 39.5% of GDP, but becomes negative after exceeding this threshold. These results confirm the validity of the debt overhang theory in explaining the relationship between foreign debt and economic growth. Other variables that significantly influence economic growth are exports and labor, with positive impacts, and inflation, with a negative impact. Meanwhile, foreign direct investment did not show a significant effect during this study period.

From a policy perspective, this study emphasizes the importance of prudent foreign debt management and optimizing the use of debt for productive investment. Developing countries need to maintain debt levels below the optimal threshold while developing alternative financing sources and strengthening export capacity. Limitations of this study include the relatively short observation period and the limited number of countries. Future research could expand the geographic and temporal scope and explore other factors influencing the optimal external debt threshold, such as institutional quality and economic structure. The findings of this study contribute to the development economics literature and can serve as a reference for policymakers in managing external debt to optimize economic growth. With a careful and strategic approach, external debt can be an effective instrument for promoting economic development in developing countries.

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