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The Impact of External Debt on Economic Growth in OIC Countries: A Panel Data Analysis

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Abstract: In recent decades, the OIC countries have experienced substantial variations in external debt levels, frequently driven by global economic trends and regional conflicts. These countries have traditionally financed their development projects through external debt, often facing difficulties in achieving long-term economic expansion. The increasing debt load has had a mixed influence on economic performance, with some nations benefiting from foreign investment, while others face rising debt repayment costs that constrain growth. This research examines the relationship between external debt obligations and economic growth across 34 OIC member countries, utilizing panel data methodology for 1999-2023. The findings indicate a substantial economic downturn associated with external debt, highlighting the importance of well-designed debt management plans. On the other hand, foreign direct investment (FDI) and exports have a significant positive impact, underscoring their crucial roles in driving economic performance. Lagged GDP per capita data indicate a significant positive correlation, suggesting that economic growth follows a long-term trajectory. In this context, unemployment and inflation do not have a significant effect on growth. The significance of policies aimed at decreasing debt loads, promoting investment, and boosting export competitiveness is underscored by these findings, highlighting their role in achieving sustainable development in OIC member countries.

Keywords: OIC, External debt, Panel data, Economic growth, FDI

JEL Classification: F43, C23, E60

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Introduction

The external debt burden is a widely recognized issue for developing countries, and it can be considered a typical trait of the fiscal sector in these economies. When the national saving rate is low, a country is likely to rely on external borrowing to support economic growth and stability. When the borrowed capital is invested in reliable and targeted projects it can lead to higher economic growth (Ashurov, Othman, Rosman, & Haron, 2020). For instance, a country can enhance its industrial output by investing in modern technology, expanding manufacturing plants, or upgrading workforce qualifications (Legass & Akkas, 2024). The education system can be strengthened by constructing more schools, employing more highly skilled teachers, and providing enhanced educational materials (Hakim, Ahman, & Kusnendi, 2023). A country can also improve its infrastructure by constructing new roads, bridges, and ports to facilitate the transportation of goods and individuals. The service sector also supports economic growth by creating employment opportunities and generating revenue (Shah, Younas, Junaid, & Iqbal, 2023).

Economic growth is a primary indicator of a country's development. Governments aim to achieve sustainable economic growth and reduce poverty. One of the primary determinants of economic growth is investment. Both external and domestic investment are main drivers of economic growth (Baral, 2023; Azam, 2016). However, most countries face considerable challenges in maintaining sustainable levels of domestic investment. This is partly due to the insufficient domestic savings—the primary source of investment—and issues related to governance and weak economic policies (Azam, 2016; Aurangzaib & Farooq, 2022). To cover the investment gap arising from insufficient domestic savings, countries rely on other forms of financing such as external borrowing. Another reason for borrowing is the trade deficit, which arises from lower exports and higher imports. Thus, countries borrow from external sources to close both the investment and trade deficits (Fatas, Ghosh, Panizza, & Presbitero, 2019).

External borrowing does not necessarily have adverse effects if returns exceed borrowing costs; however, it becomes problematic if not managed effectively. Borrowing externally can increase capacity and output growth, making the debt productive and justifiable (Doğan & Bilgili, 2014). In contrast, excessive debt can lead to fiscal imbalances and increased vulnerability to external shocks and crises. Fiscal policy effectiveness diminishes, and the monetary authority's capacity to raise interest rates is constrained, mainly due to impacts on budget deficits and debt (Dey & Tareque, 2020).

Although research on the negative impact of high debt levels on growth is challenging for the government and policymakers, studies on external debt and growth

in OIC countries are limited. This research examines the dynamic relationship between growth and external debt, bringing this issue to the forefront. This study is particularly significant for policymakers, as it offers valuable insights into how external debt affects economic growth in these 34 OIC countries. Policymakers can better understand the impact of external borrowing by examining its relationship to investment and debt accumulation. This knowledge enables governments to develop effective debt management strategies, improve resource allocation, and ensure that borrowed funds are directed to growth-promoting projects. In addition, the study underscores the potential for regional collaboration and the exchange of knowledge among OIC member states to tackle shared economic difficulties and foster sustainable growth.

The primary aim of this study is to investigate the influence of external debt on economic growth in 34 OIC member countries. This paper stands out from other studies by examining the connection between external debt and economic growth within a broader macroeconomic framework that incorporates the dynamic interaction between external debt and macroeconomic variables. The panel data model (random effects and dynamic) has been employed to demonstrate the dynamic consequences of external debt shocks on economic growth, as well as the influence of macroeconomic variable shocks on growth.

This paper is organized into six sections, beginning with the introduction. A review of existing empirical literature is done in Section 2. Section 3 provides details on external debt in OIC countries. Section 4 describes the econometric models and estimation methods. Section 5 discusses the results, and Section 6 presents the conclusions and policy recommendations.

Review of Literature

The relationship between external debt and economic growth has been widely studied, yet empirical findings remain mixed, varying across countries, time periods, and methodologies (Dey & Tareque, 2020; Baral, 2023). While some studies report a negative or insignificant impact, others identify context-dependent positive effects, suggesting that the debt-growth nexus is highly contingent on economic and institutional factors. Theoretical perspectives, such as Krugman's (1988) "debt overhang" hypothesis and Cohen's (1993) application of the Laffer Curve, argue that excessive debt discourages investment and growth by raising repayment risks. Reinhart and Rogoff's (2010) influential study supports this view, identifying a 90% debt-to-GDP threshold, beyond which growth declines in both developed and

developing economies.

However, subsequent research reveals significant variations in debt tolerance levels across regions. For instance, Pattillo et al. (2011) find that moderate debt levels (35–40% of GDP) reduce growth in average indebted economies, while concessional financing benefits Highly Indebted Poor Countries (HIPCs). Similarly, Jayaraman and Lau (2009) report a positive association between external debt and growth in Pacific Island nations, attributing this to trade openness, while budget deficits negatively influence economic performance.

Chen and Quang (2014) argue that as the debt burden increases, the government tends to increase the taxes on the private sector. As a result, this leads to an adverse impact on the private investment in the economy, thus resulting in a crowding-out effect. As a result, the economy is impacted adversely. Égert (2015) found that the negative relationship between debt and economic growth begins at lower debt levels, approximately between 20% and 60%. Thus, for OECD countries, debt levels above 20% adversely impact economic growth. The study recommends managing debt efficiently and keeping debt percentage below 20% in order not to be a negative determinant of economic growth. Makun (2021) argues that developing nations are highly dependent on external financing such as remittances, foreign investment, financial aid, and external borrowing due to lower revenue of government and lack of domestic sources. A total diversion of these resources towards growth-led policies might prove to be beneficial for long-term economic growth, however, such diversion can lead to the deterioration of other sectors such as environmental policies.

Beshenov and Rozmainsky (2015) in their study on Greece's debt crisis argue that fragile financial structures are a major factor behind the debt crisis. The study employed the financial instability hypothesis developed by Hyman Minsky. They used data from 36 Greek companies from 2001 to 2014, they found that during this period majority of these companies switched to a fragile financial structure, which increased the financial fragility, and thus, increased the proneness to the crisis.

In contrast, studies on African economies consistently highlight the adverse effects of external debt. Agyeman et al. (2022) and Ochieng et al. (2014) find that high debt levels hinder growth in sub-Saharan Africa and East Africa, with capital flight exacerbating the problem. Their findings show that external debt adversely impacts economic growth in EAC. This implies that higher reliance on external debt by EAC is detrimental to overall economic growth. The study recommends that the governments should reduce their reliance on external debt and utilize domestic alternatives, such as expanding the tax base, to promote long-term economic growth in the region.

Manasseh et al. (2022) further emphasize the role of governance, demonstrating that political stability and sound institutions mitigate debt-related growth constraints, whereas weak governance amplifies them. Meanwhile, Alhassan et al. (2024) suggest that bank loans and remittances, rather than foreign direct investment (FDI) or official development assistance (ODA), drive sustainable growth in sub-Saharan Africa, underscoring the importance of domestic financial sector development. Beyond Africa, Tran (2018), Ndoricimpa (2020), and Law et al. (2021) identify varying debt thresholds (40–69% of GDP) for emerging and developing economies, reinforcing the argument that optimal debt levels are context-specific.

Despite this extensive literature, few studies focus on OIC countries, where unique economic structures, reliance on Islamic finance, and shared institutional frameworks may shape the debt-growth relationship differently. Existing research predominantly examines regional blocs (e.g., sub-Saharan Africa, East Asia) or individual nations, leaving a gap in cross-country comparative analyses within the OIC. This study addresses this gap by (1) systematically comparing debt thresholds and growth effects across OIC member states, (2) incorporating governance and institutional quality as moderating factors, and (3) assessing the role of Islamic financial instruments in debt sustainability. By doing so, it contributes to the broader debate on debt and growth while providing policy insights tailored to the OIC's distinct socioeconomic landscape.

External Debt in OIC Countries

The Organization of Islamic Cooperation (OIC) is a multilateral body comprising 57 member states and is internationally recognized. As an institution of the Muslim world, the Organization of Islamic Cooperation is the second-largest world organization. The OIC includes 28 countries from Asia, 26 from Africa, two from South America, and one from Europe. Many of these countries have large Muslim populations (Susilowati et al., 2019). The OIC was founded in 1969 as the Organization of the Islamic Conference and underwent a name and logo change in 2011. The first Islamic Summit was held in Rabat, Morocco, convened by the government of Saudi Arabia. The primary goal of the Organization of Islamic Cooperation, as outlined in the OIC Charter, is to promote the interests of the global Muslim community. The global Muslim community is encouraged to unite to enhance solidarity and cooperation. The OIC promotes cooperation among Muslim countries in political, economic, and social spheres (Hassan, 2015).

The external debt history of the 34 OIC countries is shaped by economic and political developments in the post-colonial and globalized era. After gaining independence in the mid-20th century, many OIC countries in Asia and Africa faced substantial challenges in building infrastructure, developing industries, and providing essential ser-

vices (Aurangzaib & Farooq, 2022; SESRIC, 2023). Due to scarce domestic resources and underdeveloped financial systems, external borrowing became a key tool for financing nation-building. Pakistan, Indonesia, and Egypt were among the first to borrow from bilateral and multilateral sources to finance industrialization and modernization (Umam & Wardhana, 2021).

Significant shifts in the debt profiles of these countries occurred during the 1970s and 1980s, primarily as a result of global economic developments. The oil price shocks of the 1970s adversely affected oil-importing OIC countries such as Bangladesh, Türkiye, and Morocco, although oil-exporting nations benefited (Waheed & Abbas, 2021; SESRIC, 2023). Unfavorable trade balances, declining commodity prices, and rising energy costs prompted these nations to seek external financing. Many OIC countries obtained concessional loans from organizations such as the World Bank and regional development banks, as well as bilateral assistance from developed countries (Farooq et al., 2022).

Many OIC countries encounter significant economic structural issues, including restricted home revenue sources, high reliance on commodity exports, and political instability, all of which exacerbate reliance on foreign debt. Oil-exporting OIC nations often experience fluctuations in revenue due to volatile global oil prices, resulting in fiscal deficits that are addressed through external borrowing. In contrast, non-oil-producing countries within the OIC usually rely on external borrowing to offset trade deficits and fund fundamental infrastructure projects that their domestic savings cannot cover (Ulima, 2022).

Over the three decades following the 1980s, the debt burden of OIC countries increased significantly due to crises such as the 1973 oil embargo, the 1997 Asian financial crisis, and the 2008 financial crisis. According to the OIC Economic Outlook Report (2023), the public debt-to-GDP ratio of many OIC member countries has exceeded 70%. The total external debt stock increased by US$ 81 billion (4.1%) to US$ 2,064 billion in 2021, from US$ 1,983 billion in 2020. The use of IMF credit expanded by US$ 45.7 billion (60.7%) to US$ 120.9 billion, contributing most to this increase, although it remained the smallest component of total external debt (SESRIC, 2023). This underscores the urgent need for effective debt management and robust fiscal policies to contain debt and mitigate its adverse effects (Farooq et al., 2022).

Figure 1 below shows the external debt to GDP ratio for the 34 OIC member countries of this study.

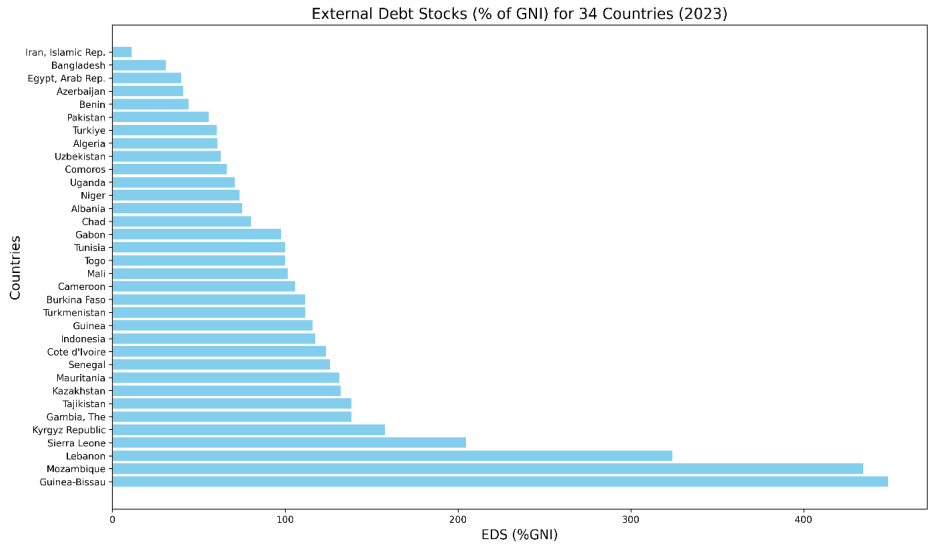

Figure 1. External Debt to GDP Ratio for 34 OIC Countries

Source: Author's own creation

Most economies have an external debt-to-GDP ratio ranging from 10% to 120%. However, Sierra Leone, Lebanon, Mozambique, and Guinea-Bissau have debt percentages greater than 200% as shown in Figure 1.

External debt levels in OIC countries significantly impact their economic growth trajectories. Historically, external borrowing has played a significant role in supporting development projects and maintaining economic stability, but a growing debt burden, particularly in countries that do not export oil, raises questions about long-term sustainability. Frequent debt repayment costs frequently redirect funds away from essential investments, thereby impacting long-term growth prospects. For economic stability, OIC member countries must implement prudent debt management, prioritize income generation, and encourage diversification to reduce reliance on external funding and promote sustainable growth.

Methodology and Estimation

The study is based on the two-gap theory popularized by Chenery and Strout (1966), which emphasizes domestic savings as central to economic growth. It argues that insufficient savings in the economy leads to insufficient capital for investment, which, in turn, leads economies to rely on external financing.

The national income identity for an open economy is:

$$Y = C + I + G + NX \quad (1)$$

Where Y is the GDP, C is consumption, I is investment, G is government spending, and NX represents the net exports which can be written as exports minus imports i.e., X-M.

From the equation, the investment identity can be written as:

$$I - S = M - X \quad (2)$$

In national income accounting, an excess of investment over domestic saving is equivalent to an excess surplus of import over export.

Income = consumption + imports + savings

Output = consumption + exports + investment

Income = output

Then, Investment – Saving = Imports – Exports

Equation two represents that in the case of inadequate savings, there is a gap between investment and saving, which is then financed by external sources equal to M–X, also known as the current account deficit. Thus, to cover the investment gap, and current account deficits, countries borrow from external sources.

This study uses a panel data modeling for the period of 1999-2023 across 34 OIC member countries obtained from the World development indicators. The study employs three distinct estimation techniques: panel fixed effects, random effects, and dynamic panel data models to investigate the impact of external debt on economic growth in these 34 countries. It employs the Levin et al. (2002) panel unit root test to ensure variable stationarity.

The estimation equation for this study is as follows:

$$y_{it} = \alpha \Gamma X_{it} + \varepsilon_{it} \quad \ldots\ldots (3)$$

Where y is the dependent variable, X represents independent variables, ε is the random error term, i denotes each country, and t represents the year (1999–2023). The extended form of the model is:

$$GDPPC_{it} = \alpha_{1i} + \alpha_2 ED_{it} + \alpha_3 FDI_{it} + \alpha_4 Inf_{it} + \alpha_5 Unemp_{it} + \alpha_{it} Exp_{it} + \nu_{it} \ldots (4)$$

For the dynamic panel data model, we include the lag of GDPPC. The model can be written as:

$$GDPPC_{it} = \alpha_{1i} + \alpha_2 ED_{it} + \alpha_3 FDI_{it} + \alpha_4 Inf_{it} + \alpha_5 Unemp_{it} + \alpha_6 Exp_{it} + \propto_7 GDPPC_{t-1} + \nu_{it}$$

..... (5)

Where $\nu_{it} = \varepsilon_i + \mu_{it}. \varepsilon_i$ represents the individual or cross-section error components, whereas μ_{it} represents the combined error component of time series and cross-section.

Equation 4 shows the relation between the dependent variable and independent variables. GDP per capita (GDPPC) is our dependent variable, and independent variables include external debt (ED), unemployment (Uenmp), foreign direct investment (FDI), inflation (Inf), and exports (Exp), and i and t indicate country and time respectively. Similarly, Equation 5 is the dynamic version, including lagged GDDPC as an independent variable.

To ensure an appropriate model we ran the Hausman specification test to choose between random and fixed effects model. The results are shown in Table 1. The test indicates that the random effects model is appropriate for our data set. However, we also employed a fixed effects model and a dynamic panel data model.

Table 1

Hausman Specification Test

	Fixed Effects	Random Effects
FDI	0.1514282	0.1515601
Unemp	0.0557673	0.0164109
ED	-0.8820045	-0.7479572
Inf	-0.0134514	-0.0094799
Exp	0.1062125	0.1077797
Chi-squared	8.65	
p-value	0.1236	

Table 2 shows the description of the variables where GDP per capita (GDPPC) is the dependent variable of the study and foreign direct investment (FDI), external debt (ED), inflation (INF), and exports (Ex) are the independent variables of the study.

Table 2

Description of Variables

Variable	Description	Source
GDPPC	Growth of Per Capita GDP in Percentage	WDI
FDI	Net Foreign Direct Investment as percentage of GDP	WDI
ED	External Debt Stocks as Percentage of GDP	WDI
INF	Consumer Price Index Annual Percentage	WDI
Ex	Total Exports as Percentage of GDP	WDI

Table 3

Levin-Lin-Chu Panel Unit roots

Variables	t-statistic	P-value	O.I
GDPPC	-17.2510	0.0000	*I(0)*
FDI	-13.2627	0.0000	*I(0)*
Unemp	-9.2293	0.0000	*I(0)*
LnED	-10.5110	0.0006	*I(0)*
INF	-18.9743	0.0000	*I(0)*
Exp	-22.3882	0.0000	*I(0)*

Table 3 shows the panel unit roots estimation for each variable. All the variables of the study are stationary at the level with the order of integration equal to zero. The variables being stationary at level implies that there is no need to test for co-integration.

Since our data ranges from 1999 to 2023 (25 years). This implies that there is no need for testing cross-sectional dependence, and serial correlation, which are problems in macro panels with long time series (30 years and above) (Torres-Reyna, 2007).

Table 4

Random Effects, Fixed Effects, and Dynamic Panel Data Estimates

	(1)	(2)	(3)
	GDPPC (RE)	GDPPC (FE)	GDPPC (Dynamic)
LnED	-0.748***	-0.882***	-0.458***
	(-4.13)	(-3.95)	(-3.44)
Unemp	0.0164	0.0558	0.00537
	(0.40)	(0.86)	(0.22)
Inf	-0.00948	-0.0135	0.00340
	(-1.01)	(-1.40)	(0.39)
FDI	0.152***	0.151***	0.113***
	(6.58)	(6.28)	(5.41)
Exp	0.108***	0.106***	0.0923***
	(15.68)	(15.31)	(13.07)
L.GDPPC			0.296***
			(10.27)
_cons	3.715***	3.993***	2.156***
	(5.11)	(4.98)	(4.05)
N	850	850	816

t statistics in parentheses

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Results and Discussion

The estimation results are reported in Table 4. The first column of the table shows the estimation for the random effects model, the second column shows the fixed effects model estimation, and the third column shows the estimation of the dynamic panel data model. The results indicate that external debt negatively and significantly affects economic growth in all models. Higher external debt is detrimental to growth in the 34 OIC countries. This implies that excessive debt reduces the ability to finance development, thereby hindering economic growth. The results are in line with the previous studies such as (Ochieng, Kiprop, Kalio, & Mose, 2014; Agyeman, Sakyi, & Oteng-Abayie, 2022; Reinhart & Rogoff, 2010)

Unemployment and inflation have no significant impact on economic growth across 34 OIC member countries across all econometric models, implying that inflation and unemployment are not significant determinants of economic growth for these countries. As expected foreign direct investment (FDI) and exports (Exp) have a positive and significant impact on GDP growth in all models. A one-unit increase in FDI increases economic growth by 0.152 percent, while a one-unit increase in exports increases growth by 0.108 percent. FDI plays a crucial role in driving economic growth by facilitating the flow of capital, introducing cutting-edge technologies, leveraging skilled management, and opening up global market opportunities. These contributions boost productivity, generate job opportunities, and spur domestic industries through their positive influence (Alnaa & Matey, 2023; Epaphra & Mesiet, 2021). The positive impact of exports on economic growth across all models supports the export-led growth (ELG) hypothesis (Petchko, 2018). The ELG hypothesis postulates that expanding exports promotes long-term growth; higher exports are associated with higher economic growth (Hilton, 2021).

In the dynamic model, the inclusion of lagged GDP per capita (L.GDPPC) has a positive and significant impact on GDP per capita growth. The results of the analysis show a clear and statistically significant positive correlation between current economic growth and the impact of lagged GDP per capita (L.GDPPC). Past economic performance continues to significantly impact current growth rates, likely due to the accumulation of investments, productivity improvements, and institutional stability over time. This implies that higher GDP growth in the previous period increases economic activity, which in turn impacts all other macroeconomic variables including employment, productivity, consumption, and domestic saving. This favorable impact on these variables, in turn, increases overall economic growth (Akram, 2011; Hilton, 2021). Higher previous GDP per capita signals a strong economic base with improved infrastructure, skilled labor, and technology, thereby driving long-term growth. The path to future economic progress relies heavily on past achievements, with historical economic developments creating momentum for continued advancement. It is essential to implement long-term policies that build on past successes to achieve consistent and sustained growth. This indicates that growth in the previous period has a spillover effect on current growth (Topal et al., 2018).

The overall findings emphasize the complex factors contributing to economic growth among OIC countries, specifically highlighting the importance of effective external debt management, foreign direct investment, and exportpromotion. External debt service is a major obstacle to economic growth, while foreign direct investment

and exports provide significant boosts to economic performance. Studies also show that economic growth persists, driven by the long-term effects of per-capita GDP. Collectively, these findings underscore the importance of balanced policies to reduce debt burdens, encourage investment, and promote trade for sustainable development.

Conclusion and Recommendations

The study investigates the impact of external debt and other macroeconomic variables on the economic performance of 34 OIC member countries for the period of 1999 to 2023. Using panel random effects as the primary model, along with fixed effects and dynamic panel data models, the study finds that external debt has a detrimental impact on economic growth in all models for the 34 OIC countries. This evidence supports the adverse impact of external debt on economic growth, as higher debt burdens deplete capital available for development, resulting in slower overall growth. The study also revealed a significant positive impact of FDI on economic growth, emphasizing the significance of foreign capital for long-term economic growth and development in these countries. Moreover, the results also indicate that exports are crucial for stable growth in these countries, as exports have a positive and significant impact economic growth. This also underscores the export-led-growth (ELG) hypothesis, which places exports at the center of long-term sustainable growth. Additionally, the positive and significant effect of lagged GDPPC indicates that past economic performance continues to impact current growth rates. A higher GDP per capita in the previous period typically signals a strong economic base, including improved infrastructure, enhanced human capital, and technological progress, all of which drive long-term economic expansion. The path to future economic progress relies heavily on past achievements, with historical economic developments creating momentum for continued advancement.

Based on these findings, the study recommends that policymakers in OIC countries prioritize sustainable debt management to mitigate the detrimental effects of external debt repayment on economic growth. Efforts should focus on increasing debt transparency, restructuring unsustainable debt, and utilizing borrowed funds to stimulate growth in productive sectors. Establishing stable governance framework, upgrading infrastructure, and implementing investor-friendly policies are crucial for attracting foreign direct investment. Furthermore, fostering export competitiveness by expanding markets, investing in high-value industries, and streamlining trade procedures can contribute to sustainable economic growth. In addition, OIC countries should enhance debt management through regional cooperation, including a shared surveillance framework and liquidity facilities to

address balance-of-payments crises. Expanding Islamic finance tools such as sukuk and risk-sharing mechanisms can reduce reliance on conventional debt while funding development projects. The Islamic Development Bank should facilitate knowledge sharing on debt sustainability and governance reforms. Strengthening intra-OIC trade through preferential agreements and local currency settlements would bolster foreign exchange reserves and reduce external borrowing needs. These coordinated efforts, combined with transparent debt thresholds tailored to OIC economies, would mitigate over-indebtedness and promote sustainable growth across member states.

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