

# 1 Domestic or Foreign Debt ? A Choice of no Wrong Selection

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## 5 Abstract

6 This paper reviewed the matter of balance and trade-off between domestic debt and public  
7 debt. The study sought to underpin the general consensus on the issue of debt and how  
8 economic activities were impacted by the various forms of public debt. The paper gives an  
9 overview of different countries experience with regards to debt sourcing. Various authors  
10 express various views with regards to this question that do not necessarily bring about points  
11 of convergence in ideologies. The general point of agreement of specialists who have looked  
12 into this subject matter is established at the use of the debt acquired. If debt is acquired to  
13 facilitate development projects then there is no doubt that such debt will resultantly bring  
14 about economic growth and economic development. On the other hand there are some  
15 governments that do borrow for to finance recurrent expenditure however much that this  
16 increases consumption within the economy, the desired growth and development is hardly  
17 achieved. Worse still some of the funds acquired as a result of debt in some nations are  
18 squandered and pocketed by few individuals and this is very significant in the retrogressive  
19 states of many countries with weak systems that provide no serious check mechanisms as well  
20 as accountability and ownership of responsibility.

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22 **Index terms**— domestic debt, foreign debt, economic growth, debt overhang, crowding out.

## 23 1 Introduction

24 striking a balance between domestic debt and foreign debt presents a challenge as discussed in debt overhang  
25 theory. Albeit a sound equilibrating policy or guideline is required to ensure economic growth and development  
26 are met with utmost efficiency. Public debt refers to the total of the nation's debts which covers debts of local  
27 and national governments indicating how much public spending is financed by borrowing instead of taxation  
28 (Makau, 2008). According to (Paterno & Tan-Cruz, 2007), a public debt is a debt owed to both external and  
29 internal parties by a government of an independent country. This is an indication that nations have liberty to  
30 bridge their budgetary deficits within the local markets or international financial markets. (Mahara & Dhakal,  
31 2020) Found that fiscal deficit, trade openness, and foreign aid are major macroeconomic determinants of external  
32 debt in Nepal. From the obtained results, it is seen that an increase in foreign aid helps to significantly reduce  
33 external debt but trade openness and the budget deficit significantly leads to an increase in external debt both in  
34 the shortrun as well as in the long-run. The error correction term is found to be significant and negative, showing  
35 proof of a strong association between the selected variable and ensures the correction of short-term disequilibrium  
36 to a stable equilibrium at the rate of 37 percent per annum. The study concluded that foreign aid, budget deficit,  
37 and trade openness were the main determinants of external debt in Nepal in both the long-run and shortrun.  
38 Appropriate export-import or foreign trade policy, effective demand management policy, progressive tax system  
39 as well as monitoring tax evasion, effectual and productive utilization of available resources helped to reduce debt  
40 accumulation and saves the nation from the possible debt trap.

41 (Benli, 2020) investigated the long run dynamics of external debt burden -economic growth nexus as well as the  
42 nonlinearity in the debt-growth relationship in Turkey over the period 1970-2018. Using a multivariate model in  
43 which real output growth, external debt burden, domestic investment, exports and population growth are included  
44 as variables we employ Autoregressive Distributed Lags (ARDL) bounds testing approach to cointegration. The

## 8 B) STUDY AREA

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45 empirical findings indicated that the external debt burden harms economic growth in Turkey. The preliminary  
46 evidence presented here also does not appear to support the hypothesis of the debt Laffer curve in Turkey for  
47 the study period.

48 (N'Zue, 2020) sort to determine the impact of external debt on economic growth in the ECOWAS region.  
49 Panel data spanning from 1990 to 2016 was used and analyzed using panel CS-ARDL estimation approach. The  
50 results indicated cointegration among the variables. The study found that external debt has a positive impact  
51 on economic performance up to a threshold. In the short run, the threshold stood at 45% and in the long run,  
52 it stood at 42.52%. Beyond these points, additional external debt accumulation negatively affects the regional  
53 economic performance. Knowing that the level of the region's external debt-to-GDP ratio stood at 33.11% in  
54 2018 (below the threshold), it appears that external debt has not yet hampered economic performance in the  
55 ECOWAS region. The study however, noted a need for caution given the fast rate of increase (25% in six years)  
56 of external debt accumulation in the region.

## 57 2 II.

### 58 3 Statement of the Problem

59 It is largely documented that countries appetite for debt has continually increased pushing up individual countries  
60 debt to GDP ratio across board. The structure of these acquired debts range from domestic instruments to foreign  
61 instruments. With regards to how these two wide instruments affect economic growth and economic development  
62 is a constant point of divergence for researchers. This paper seeks to review insights drawn from African and  
63 Asian contexts so as to establish a concrete perspective on matter of debt instruments. generally attract higher  
64 interests this means that the financiers in the domestic markets make more while dealing with the government.  
65 This can spur growth since they will be making more, the levels of consumption is also expected to increase due  
66 to the increased incomes.

### 67 4 III. Theoretical Review: Debt Overhang

68 This theory was propounded by ??Myers, 1977). The debt overhang theory is based on the premise that if  
69 the total amount of debt exceeds the country's repayment ability in the future, then the expected debt service  
70 of that country will be an increasing function of its output level. This implies that part of the returns gained  
71 from investing in the domestic market is taken by the foreign creditors thus discouraging domestic investments  
72 (Claessens et al. 1996). In such a situation the indebted country is left with a small proportion of any increases  
73 in output and exports because part of the proceeds is used to service external debt.

74 The theory postulates that reducing debt obligation lead to a rise in investment and repayment capacity.  
75 When this happens, the outstanding debt is more likely to be repaid therefore reducing chances of debt default.  
76 Similarly when the effect is strong, the indebted country is said to be on the wrong side of the debt Laffer  
77 curve. Here debt Laffer describes the relationship between the level of debt and the country's repayment ability  
78 which implies that there is a maximum at which accumulation of debt promotes growth (Elbadawi et al. 1996).  
79 Therefore the debt overhang hypothesis predicts that if there is likelihood that in future, debt will be larger than  
80 the country's repayment ability, then the cost of servicing the debt will depress further domestic and foreign  
81 investment (Krugman, 1988), (Sachs, 1990), ??Karafat, 2002).

## 82 5 IV.

### 83 6 Conceptual Framework

### 84 7 Independent Variables Dependent Variable

85 Figure 1

86 a) Research Design So as to be able to capture and explain changes that occur overtime, longitudinal design  
87 was best suited for the study.

## 88 8 b) Study Area

89 This study utilized data collected over a period of two decades within reputable and verifiable statistics For the  
90 dependent variable E.G, the measures of central tendencies were as follows, the mean was (23.29, the median was  
91 established as ??23.65) The dispersion statistics were generated as follows: standard deviation was (0.85). The  
92 Kurtosis statistic was determined as (1.59) which is below the value (3) which illustrates presence of symmetry.  
93 The skewness coefficient was (-0.23) this bespeaks that the variable is moderately skewed. Minimum was noted  
94 as (21.98) while maximum connoted as (24.62).

95 For F.D, the mode was equivalently obscure while the mean was derived as (23.58) and median stood at  
96 ??23.33). The standard deviation was fixed at (0.63). Kurtosis statistic was specified as (2.56) denoting presence  
97 of symmetry. Skewness coefficient confirmed the same settling at (0.84). The minimum value was ??22.78) and  
98 the maximum value was (24.97).

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99 CBK\_Over drafts the fifth independent variable wanted the mean as ??22.12) and median stood at (22.02)  
100 the mode was analogously nebulous. The standard deviation was fixed at (0.31). Both Kurtosis statistics that  
101 was specified as ??5.60) The correlation analysis revealed that both foreign debt and domestic debt are positively  
102 correlated with economic growth as evidenced by their coefficients 0.17 and 0.53, respectively.

## 103 **9 e) Johansen Cointegration Trace Test**

104 From Johansen test, the time series variables were not cointegrated. Consequently, the best model to use in the  
105 study was Vector Autoregressive Model (VAR).

## 106 **10 Vector Autoregressive Model (Var)**

## 107 **11 Coefficient**

108 Std. Error t-Statistic Prob.

109 C The model is reliable for forecasting since Log Likelihood criteria {587.84>30} is an indication of the  
110 goodness of fit. With an R-Square of 64% the model is fit for prediction. This is interpreted that E.G can be  
111 explained by the variables in the model up to 64 % while the remaining 36% could be explained by other variables  
112 not in the current study.

113 The model therefore was stated as;E.G = -0.0001 + O.18E.G t-1 + 0.13E.G t -2 + 0.5200 D.D + 0.5524 F.D  
114 f) Domestic Debt (D).

## 115 **12 D) and Economic Growth (E.G)**

116 The fourth objective of the study was to establish the effect of CBK overdraft and economic growth. The null  
117 hypothesis was therefore stated as follows;

118 H 0 : Domestic Debt has no significant effect on Economic Growth.

119 The table indicates that the regression weight of D.D and E.G was 0.5200 ( $p = 0.000 < 0.05$ ) indicating  
120 existence of a positive and significant effect of D.D on E.G and hence the null hypothesis was rejected. This  
121 means that a unit increase in D.D causes E.G to expand by 0.5200. The amount borrowed should be matched  
122 with type of investment to ensure repayment is done on Volume XXI Issue IV Version I

## 123 **13 ( E )**

124 time thus avoiding delayed repayment ‘costs. This finding has a bearing on borrowing implementation policy  
125 that ought to match borrowed money and targeted investments required to reduce chances of penalties associated  
126 with delayed debt servicing. This will in turn enhance credit rating hence reduce cost of borrowing consequently  
127 narrowing the interest rate spread. (Muhammad, Muhammad & Tariq, 2010) in their study in Pakistan on  
128 impact of domestic debt on economic growth found that there exists a positive relationship between domestic  
129 debt and economic growth. (Putunoi & Mutuku, 2013) also found existence of a positive relationship between  
130 public debt and economic growth in their study of domestic debt in Kenya.

## 131 **14 g) Foreign Debt (F.D) and Economic Growth (E.G)**

132 The sixth objective of the study was to determine effect of bilateral debt on economic growth. The null hypothesis  
133 was therefore stated as follows;

134 H 0 : Foreign Debt has no significant effect on Economic Growth.

135 The analysis on Table ???.6b indicates that the regression weight of F.D on E.G was 0.55 ( $p = 0.000 < 0.05$ )  
136 indicating existence of a positive and significant effect of bilateral debt on economic growth and this therefore  
137 led to the rejection of the null hypothesis. This means that a unit increase in F.D enhances E.G by 0.55. This  
138 result could be attributed to economic discipline (management efficiency) in the application of debt as contained  
139 in the debt agreement between the parties hence improved debt rating. This in turn enables the government  
140 to access cheaper credit in future. This finding has a policy implication with respect to continue having a legal  
141 limit on size/volume of bilateral debt to avoid situation of excess debt repayment installments (Principal, interest  
142 and associated penalties) that consequently reduces savings necessary to catalyze economic development. These  
143 findings affirm use of Debt Overhang Theory. These findings contradicts the study by (Pattillo, Poirson, & Ricci,  
144 2004) who looked at the channels through which external debt affects growth. They found out that there exists a  
145 strong negative relationship between external debt and economic growth. In their study that looked at the impact  
146 of external debt and debt servicing on poverty reduction in Nigeria, (Oloruntoba, Apollos & Emerah, 2013) also  
147 contradicts the findings of this current study since they indicated that there exists an inverse relationship between  
148 external debt and economic growth.

**149 15 VI.**

**150 16 Conclusion a) Domestic Debt (D.D) and Economic Growth  
151 (E.G)**

**152** The first objective of the study was to establish the effect of D.D on E.G. The null hypothesis was therefore  
**153** stated as follows; H 0 : Domestic Debt has no significant effect on Economic Growth.

**154** The findings show existence of a positive and significant effect of D.D on E.G and hence the null hypothesis  
**155** was rejected. D.D is seen to stimulate economic growth as evidence by the positive correlation as well as positive  
**156** coefficient in the estimated model. This variable defies the expectations from the neoclassical theory since it  
**157** shows that debt can be a tool to invoke economic growth.

**158 17 b) Foreign Debt (F.D) and Economic Growth (E.G)**

**159** The second objective of the study was to determine effect of Foreign Debt on Economic Growth. The null  
**160** hypothesis was therefore stated as follows; H 0 : Foreign Debt has no significant effect on Economic Growth.

**161** The analysis indicates existence of a positive and significant effect of bilateral debt on economic growth and  
**162** this therefore led to the rejection of the null hypothesis. Bilateral debt was not in agreement with the neoclassical  
**163** postulations since it indicated a positive interaction with economic growth.

**164 18 VII.**

**165 19 Recommendation**

**166** Key establishments have it that as a country secures loans, feasibility has to be factored in to see the position in  
**167** terms of debt repayment. Still to be considered is the function of the acquired debt and this should largely revolve  
**168** around development projects to ensure sustainability of growth and development. Further if the development  
**169** projects could also be income generating the better for the country since this will relieve undue and unnecessary  
**170** pressures within the economy in search for funds to help off-set the loans. These consideration factors are a clear  
**171** indication that frugality in cost-benefit analysis needs to occur and this could possibly tame the global outtake  
**172** of debt appetite. The market from where the debt is drawn is of importance to the individual governments'  
**173** consideration since the outcomes have significant effects to both the market players and the countries at large.  
**174** Domestic debts. <sup>1</sup> <sup>2</sup>

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