

The Effect of Financial Crises on the Relationship between Debt and Economic Growth: Case of the 1997 Asian Financial Crisis

L'effet des crises financières sur la relation entre l'endettement et la croissance économique : Cas de la Crise Financière de 1997 en Asie

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Abstract

This scientific article undertakes an in-depth exploration of the complex impact caused by financial crises on the equally complex dynamics between debt and economic growth. The analysis primarily focuses on the emblematic example of the 1997 Asian Financial Crisis.

The study sheds detailed light on how financial crises can act as catalysts, thereby revealing vulnerabilities related to excessive indebtedness and structural imbalances within an economy.

When delving into the post-crisis repercussions, it becomes evident that the reforms and actions implemented after this crucial period have played a decisive role in restoring stability and fostering economic recovery. This research underscores the vital importance of enlightened debt management as well as the implementation of robust structural reforms. Such measures aim to mitigate the negative impacts stemming from financial crises and to enhance long-term economic resilience. In summary, this article convincingly demonstrates how financial crises, although disruptive, can also catalyze positive changes and stimulate a thorough reassessment of economic systems.

Keywords : Financial crises ; debt ; economic growth ; Asian Financial Crisis ; resilience.

Résumé

Cet article scientifique entreprend une exploration approfondie de l'impact complexe provoqué par les crises financières sur la dynamique tout aussi complexe entre la dette et la croissance économique. L'analyse se focalise principalement sur l'exemple emblématique de la Crise Financière asiatique de 1997.

L'étude met en lumière de manière détaillée comment les crises financières peuvent agir en tant que catalyseurs, révélant ainsi les vulnérabilités liées à l'endettement excessif et aux déséquilibres structurels au sein d'une économie.

Lorsqu'on se penche sur les répercussions post-crise, il devient manifeste que les réformes et les actions mises en place après cette période cruciale ont joué un rôle décisif pour rétablir la stabilité et encourager la reprise économique. Cette recherche souligne l'importance capitale d'une gestion de la dette éclairée ainsi que de la mise en œuvre de réformes structurelles solides. De telles mesures visent à atténuer les impacts négatifs issus des crises financières et à renforcer la résilience économique à long terme. En somme, cet article démontre de manière convaincante comment les crises financières, bien que perturbatrices, peuvent également catalyser des changements positifs et stimuler une réévaluation approfondie des systèmes économiques.

Mots clés : crises financières ; dette ; croissance économique ; Crise Financière en Asie ; résilience.

Introduction

The effect of financial crises on the relationship between debt and economic growth constitutes a crucial area of study within the context of the global economy. Financial crises are often associated with periods of deep economic instability, characterized by recessions, deteriorating financial conditions, and a contraction in investments. In this context, understanding how financial crises influence the dynamics between debt and economic growth, and how they can disrupt or alter this relationship, is paramount.

Financial crises are typically triggered by an excessive accumulation of debt, whether it be public, private, or even within financial institutions. When this debt reaches unsustainable levels, it creates financial fragility and exposes the economy to significant risks. Financial crises can emerge when speculative bubbles burst, defaults multiply, or external shocks destabilize financial markets.

Once financial crises unfold, they can have profound consequences on economic growth. The transmission channels from financial crises to the real economy are multiple and intricate. Financial crises can lead to a contraction in economic activity, decreased investment, reduced consumption, and deteriorating financial conditions. Additionally, they can trigger a crisis of confidence among economic actors, exacerbating the negative effects on growth.

It is also noteworthy that financial crises can alter the relationship between debt and economic growth. Prior to a crisis, debt may be perceived as a driver of economic growth, promoting investment and consumption. However, during and after a financial crisis, debt can become a burden, hindering economic recovery and limiting growth opportunities.

Understanding these dynamics is critical for formulating effective economic policies aimed at mitigating the negative effects of financial crises on the relationship between debt and economic growth. It is necessary to establish regulatory and surveillance mechanisms to prevent excessive debt accumulation and detect early signs of financial crises. Furthermore, appropriate macroeconomic policies and stabilization measures can help restore the confidence of economic actors and stimulate economic recovery after a financial crisis.

In this article, we will delve into the detailed analysis of the effect of financial crises on the relationship between debt and economic growth. We will examine the mechanisms through which financial crises alter this relationship, the consequences of financial crises on economic growth, the structural changes that may occur during and after crises, as well as the economic policies that can mitigate the impact of financial crises on this relationship. A comprehensive

understanding of these interactions is essential for crisis management and the promotion of sustainable economic growth, while analyzing the case of the 1997 Asian financial crisis.

The 1997 Asian Financial Crisis marked a pivotal economic turning point, illuminating the intricate interplay between debt and economic growth. How precisely did this crisis impact the nuanced dynamic between these two interconnected factors? What valuable lessons can be gleaned to enhance the future management of financial crises, thereby fortifying economies' resilience and recovery capacity in such circumstances?

To address the impact of financial crises on the intricate relationship between debt and economic growth, with a specific focus on the 1997 Asian Financial Crisis, this study will adopt a mixed-methods approach. The initial phase will involve an in-depth analysis of economic literature to establish a robust conceptual framework. Subsequently, quantitative data will be collected from official economic sources, enabling an examination of pre-, during, and post-crisis trends concerning debt, economic growth, and other relevant indicators. Concurrently, specific case studies will be conducted to understand how the 1997 Crisis influenced different Asian countries. This comprehensive approach will provide a holistic perspective on the impact of financial crises on the dynamics between debt and economic growth, offering crucial insights to guide future financial crisis management.

This study is divided into three segments to examine the impact of financial crises on the intricate relationship between debt and economic growth, spotlighting the 1997 Asian Financial Crisis as the central case study. The first segment, titled "Debt as a Catalyst for Financial Crises," will delve into how excessive debt accumulation can trigger financial turmoil. The second segment, "Financial Prudence as a Brake on Financial Crises," will explore how prudent debt management and financial reforms can mitigate crisis risks by curtailing excessive borrowing. Lastly, the third segment will conduct a "Comprehensive Analysis of the 1997 Asian Financial Crisis," scrutinizing its specific impacts on diverse Asian nations, underlying mechanisms, and responsive actions taken. This structural approach aims to furnish a comprehensive understanding of the dynamic interplay among debt, financial crises, and economic growth, thereby offering valuable insights to inform more effective future crisis management strategies.

1. Debt as a Catalyst for Financial Crises

1-1 Minsky's Financial Instability Theory

The theory of financial instability developed by Hyman Minsky underscores the role of debt in the genesis of financial crises. According to Minsky, periods of financial stability encourage economic agents to accumulate more debt, often for speculative investments. However, this excessive debt accumulation creates financial fragility as borrowers can become vulnerable to economic shocks or a reversal in financial conditions. When defaults occur and non-performing loans multiply, a financial crisis can erupt.¹

Minsky's theory outlines three phases in the economic cycle for financial systems:

- ❖ **Phase of financial stability:** In this phase, economic agents exercise caution in their borrowing and investment decisions. Borrowers can repay their debts without difficulty, resulting in a low probability of default. Interest rates are low, and optimism prevails in financial markets. (Minsky,1982)
- ❖ **Phase of financial euphoria:** Over time, as the economy expands and credit conditions remain favorable, economic agents become more optimistic. Borrowers start taking excessive risks, accumulating more debt, and investing in high-yield speculative projects. Creditors, in turn, become less cautious and extend loans to increasingly risky borrowers. This phase is characterized by an upward spiral in asset prices, fueling an overall sense of financial euphoria.
- ❖ **Phase of financial fragility:** As debt continues to mount, some borrowers might start facing difficulties in repaying their debts, especially if interest rates rise or expected incomes from speculative investment projects fail to materialize. Defaults begin to rise, leading to a decline in asset prices. This price decline can trigger forced asset sales and exacerbate financial fragility, thus creating a vicious cycle of economic and financial decline. (Minsky,1975)

1-2 Moral Hazard Theory

The theory of moral hazard, also known as the "Moral Hazard Theory," is a widely studied concept in economics and finance. It refers to the situation where a stakeholder, shielded against certain risks, may be incentivized to make imprudent or risky decisions because they know they

¹ Minsky, H. P. (1992). "The Financial Instability Hypothesis." Levy Economics Institute of Bard College, Working Paper No. 74.

will not bear all the negative consequences of their actions. This theory is often applied to the context of financial markets and financial institutions, where excessive risk-taking can be encouraged by the presence of guarantees or government bailouts. In the financial context, moral hazard occurs when entities or individuals (such as banks, investors, or financial institutions) take excessive risks because they know that in case of a major problem, they can rely on government intervention or public insurance to bail them out or protect them against losses. This perception of safety can encourage them to engage in risky activities or take speculative positions that, without this implicit insurance, would be deemed too risky.² In other words, moral hazard occurs when the risk of loss is largely transferred to another party who does not have direct control over the risky actions. This can create an imbalance and distortion of economic incentives, as actors may be inclined to take excessive risks without bearing the full financial responsibility. In the framework of financial regulation, the theory of moral hazard is often cited to justify the need for appropriate incentives and accountability mechanisms to deter imprudent behaviors. This can include stricter regulations, higher capital requirements for financial institutions, and incentives for stakeholders to bear the consequences of their actions. Tirole, J. (1999).

In summary, it is evident that debt can play a role as a catalyst in the emergence of financial crises. Excessive levels of debt can lead to economic fragility and amplify the repercussions of economic shocks. When borrowers are no longer able to honor their financial obligations due to unsustainable debt levels, it can trigger a series of defaults that spread through the financial system, eroding investor confidence and leading to economic contraction. To counter this potential catalyst effect, it is imperative to maintain rigorous monitoring of debt levels, both on an individual and systemic scale. Debt management policies must be implemented cautiously, considering the inherent risks of excessive debt accumulation. It is also crucial to promote financial transparency and encourage the implementation of risk mitigation measures, such as adequate financial reserves and robust credit regulations.

2. Financial Prudence as a Brake on Financial Crises

2.1. Theory of Excessive Debt Prevention

The Theory of Excessive Debt Prevention, largely developed by prominent economists Kenneth Rogoff and Carmen Reinhart, holds a significant place in the analysis of risks associated with

² Stiglitz, J. E., & Weiss, A. (1981). Credit rationing in markets with imperfect information. *The American Economic Review*, 71(3), 393-410.

disproportionate debt accumulation within national economies. Their influential work, "This Time Is Different: Eight Centuries of Financial Folly" (Rogoff & Reinhart, 2009), offers a comprehensive and engaging historical perspective on the economic and financial consequences of excessive debt levels. Based on meticulous analysis of data spanning centuries, their research highlights a concerning trend: when debt-to-GDP ratios cross critical thresholds, economies become highly vulnerable to economic disruptions and financial shocks. These thresholds vary across economies, but surpassing a certain limit generally exposes countries to an increased risk of financial crises. The central element of this theory is that excessive debt levels weaken economic resilience. Countries heavily borrowing to fund public or private expenditures risk compromising their ability to respond effectively to unforeseen crises such as global economic slowdowns, exchange rate fluctuations, or sectoral crises. Moreover, debt accumulation can potentially create a vicious cycle: growing debt necessitates higher interest payments, which can impede a government's ability to invest in crucial areas such as education, health, and infrastructure, contributing to persistent economic slowdown. (Rogoff, & Reinhart 2009).

Rogoff and Reinhart's work also highlights the significance of sovereign defaults and confidence crises that can stem from excessive debt. As creditors perceive an increasing likelihood of default, they may demand higher interest rates to offset the heightened risk, which in turn can exacerbate a country's financial woes. This underscores a crucial aspect of this theory: once market confidence is shaken due to excessive debt levels, restoring it quickly becomes challenging, even with budgetary and structural reforms.

2.2. Governance and Transparency Theory

The Governance and Transparency Theory offers a crucial perspective in the prevention of financial crises by emphasizing the central role of prudent management, ethics, and transparent communication in economic stability. This theory underscores that robust governance structures, featuring competent boards of directors, clear power distribution, and accountability to stakeholders, contribute to establishing stable foundations for businesses and financial institutions. Financial transparency, involving accurate and accessible disclosure of information to investors and regulators, plays a pivotal role in building trust. It helps minimize the risks of misleading or fraudulent financial behaviors, thus reducing the probabilities of crises triggered by concealed or manipulated information. One of the critical facets of this theory lies in the prevention of conflicts of interest. By promoting responsible governance and ethical decision-

making, companies and financial institutions can steer clear of decisions driven by personal interests rather than the common good. Indeed, independent governance bodies and a culture of integrity contribute to mitigating the risks of mismanagement and abuse of power, which could potentially precipitate crises. In conclusion, financial prudence emerges as a fundamental pillar in safeguarding economic stability and preventing financial crises. Informed financial decision-making, avoiding excessive indebtedness, implementing rigorous regulatory mechanisms, and adopting transparent practices hold paramount significance. Lessons from past crises remind us of the necessity to maintain adequate financial reserves, monitor systemic risks, and refrain from complacency in the face of warning signals. Furthermore, promoting responsible and ethical corporate governance, grounded in high standards of transparency and collective decision-making, plays a pivotal role in preventing financial abuses and mismanagement. Ultimately, financial prudence embodies a proactive approach aimed at ensuring the long-term health of economies and preserving investor confidence, thereby creating a more resilient environment in the face of economic challenges.

3- Comprehensive Analysis of the 1997 Asian Financial Crisis

The Asian Financial Crisis of 1997, also known as the "Asian Crisis," marked a pivotal juncture in the economic history of the region. It impacted several countries in Southeast Asia, including Thailand, Indonesia, Malaysia, and the Philippines, as well as more advanced economies like South Korea. This crisis, which erupted in late 1997 and persisted into 1998, caught global observers off-guard due to its swiftness and devastating impact. The roots of this crisis lie in factors such as overvalued national currencies, excessive debt, rapid financial liberalization, and vulnerability to capital movements.

3-1 Triggering Factors of the Crisis

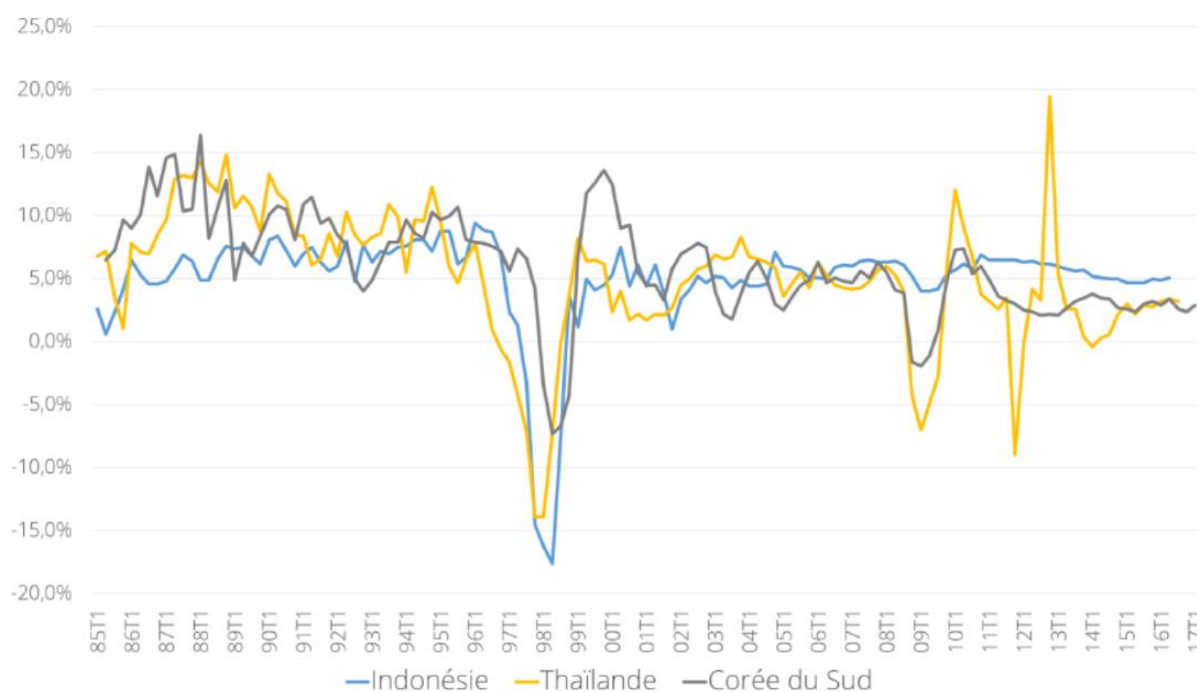
The triggering factors of the 1997 Asian Financial Crisis can be attributed to a complex interplay of economic and structural factors that created a conducive environment for the crisis. Among these factors, currency overvaluation, rapid financial liberalization, excessive debt, and vulnerability to capital movements played a significant role in the outbreak of the crisis.. Currency overvaluation stands as a primary source of imbalance. For instance, prior to the crisis, the Thai baht was overvalued by about 15% compared to its real exchange rate. In Indonesia, the rupiah was overvalued by approximately 30% to 40%, while the South Korean won was overvalued by around 15%. This overvaluation distorted trade balances and hindered



export competitiveness. Rapid financial liberalization also played a major role by opening up Asian economies to international capital flows. However, this swift opening created heightened vulnerability to sudden capital outflows during times of uncertainty. Prior to the crisis, capital flows into these countries had grown exponentially, with annual growth rates reaching 30% to 40%.

Excessive debt, both at the corporate and household levels, amplified risks. In South Korea, for example, corporate debt reached around 130% of GDP before the crisis, while Indonesia displayed similar levels. This high debt made economies susceptible to financial pressures, especially as interest rates began to rise. Lastly, vulnerability to capital movements was accentuated by the lack of effective management mechanisms. Asian economies were grappling with significant current account deficits, creating a constant need for external financing. For instance, the Philippines had a current account deficit equivalent to around 5% of their GDP in 1996. These statistics clearly illustrate the economic imbalances that fueled the Asian crisis. Currency overvaluation, rapid capital flows, excessive debt, and vulnerability to capital movements created a conducive environment for the eruption of the financial crisis in 1997. The analysis of quarterly GDP growth rates in Indonesia, Thailand, and South Korea from 1985 to 2017 reveals a dynamic economic trajectory. These countries experienced periods of robust growth in the 1980s and early 1990s but faced slowdowns and challenges after the 1997 Asian Financial Crisis. Post-crisis reforms contributed to a gradual recovery and more stable growth, underscoring the adaptability of these economies in the face of global economic fluctuations.

Figure 1: Quarterly GDP Growth Rates in Indonesia, Thailand, South Korea (1985-2017)



Source : <https://asialyst.com>

3-2 Responses, Reforms, and Lessons Learned from the Crisis

After the eruption of the 1997 Asian Financial Crisis, the affected nations embarked on a series of responses, reforms, and actions that marked a significant shift in their economic trajectories. Immediate measures to address the crisis were characterized by drastic monetary and budgetary adjustments. A notable example was Indonesia, which dramatically increased its interest rates, witnessing a staggering 32% rise in a single day to stabilize the value of the rupiah and control mounting inflation. International financial assistance also played a pivotal role in the crisis responses, with South Korea being a standout example. The country received substantial aid, totaling \$58 billion from the International Monetary Fund (IMF) and other sources to restore economic stability and market confidence. Structural reforms stood as another major pillar of the crisis response. These reforms were particularly visible in the banking sector, where measures like extensive recapitalization were adopted to eliminate non-performing loans and strengthen the soundness of the financial sector. For instance, Indonesia implemented a vast \$30 billion recapitalization program to restore the health of its banks. Corporate governance also came to the forefront in the context of post-crisis reforms. In Thailand, significant efforts

were made to enhance transparency and efficiency of corporations. This led to a substantial increase in the percentage of companies adopting governance codes, rising from 13% in 1997 to 70% in 2004. The lessons drawn from the crisis have had a lasting impact on future economic policies. One of the key takeaways was the need to restrict volatile capital flows to prevent massive outflows, as illustrated by the temporary controls implemented in South Korea to limit net capital outflows. Moreover, economic diversification became an essential priority. Malaysia pursued this goal successfully, increasing the share of the manufacturing sector in its GDP from 30% in 1998 to over 40% in 2004. In summary, the response to the 1997 Asian Financial Crisis was characterized by immediate measures, structural reforms, and lessons learned that left a lasting imprint on the region. These actions demonstrated how swift adaptation, targeted reforms, and consideration of past lessons can play a vital role in managing financial crises and reinforcing long-term economic stability.

Conclusion

The impact of the 1997 Asian crisis demonstrated that financial crises can trigger a vicious cycle, where mismanaged debt exacerbates economic decline, and economic contraction in turn hampers debt repayment. Nations affected by the crisis faced an extended period of economic slowdown, recession, and currency depreciation, resulting in an increase in both public and private debt.

However, the responses and reforms implemented after the crisis also highlighted economies' capacity to recover and learn from their mistakes. Structural adjustments, such as banking sector reforms and efforts in economic diversification, contributed to restoring investor confidence and stimulating economic recovery.

The lessons drawn from the Asian crisis also laid the foundation for improved financial management and heightened monitoring of excessive debt. The understanding that debt can potentially catalyze financial crises prompted many countries to adopt policies of financial prudence and reinforce regulatory and supervisory frameworks.

In summary, the experience of the 1997 Asian Financial Crisis underscores the critical importance of maintaining a prudent balance between debt and economic growth. Excessive debt can amplify the adverse effects of financial crises, but judicious management and appropriate reforms can help mitigate the consequences and prepare economies for a more robust recovery. This lesson remains relevant for contemporary economic challenges,

emphasizing that financial prudence and stability are essential cornerstones of long-term economic resilience.

From a scientific standpoint, this study highlights the complexity of interactions among debt, financial crises, and economic growth. It underscores the need for multidisciplinary approaches to fully comprehend these dynamics. Furthermore, the research's findings can guide policymakers and financial practitioners in their efforts to prevent and manage financial crises in the future.

The future perspectives in this research domain are promising. Technological developments, increasing economic globalization, and new financial regulations will continue to influence the dynamics between debt and economic growth. Exploring how these factors shape interactions in the modern era would be intriguing.

In conclusion, this study makes a significant contribution by shedding light on the intricate relationships between debt, financial crises, and economic growth. It underscores the importance of prudent management of public and private finances to avert potentially devastating imbalances. The lessons learned from the 1997 Asian Financial Crisis can serve as a compass for navigating the turbulent waters of the modern global economy, while ensuring sustainable and resilient growth.

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