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South Korea's Response to the Euro Zone Crisis

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Interviewee

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The euro zone crisis has emerged as a major challenge for South Korea's future economic growth. At the same time, the crisis provides an opportunity for Seoul to become involved in discussions on the future of global economic governance. To understand more about the crisis and how South Korea should respond, the EAI invited Professor Yong Wook Lee of Korea University to speak more on these issues. The following is a summary of the main policy recommendations from this interview.

Q1: What are the causes of the euro zone crisis?

A1: "The European debt crisis was triggered by rapid financial liberalization without proper institutional foundation."

- In analyzing the Euro zone crisis, it is important to distinguish between two different causes – those that have triggered the crisis and those that have prolonged the crisis. Crucially, these two kinds of causes are not necessarily mutually exclusive.

- Looking at what triggered the euro zone crisis, recent studies have identified four factors as potential causes: 1)the absence of banking regulations in the euro zone and the subsequent expansion of excessive loans and insolvency of European banks; 2) the increase in trade imbalances among EU countries and related financial weakening of the smaller EU economies, such as those of Greece, Portugal, and Spain; 3) the emergence of financial bubbles due to prolonged levels of low interest rates, and the fact that foreign capital inflows to the smaller EU countries ended up as investments in real estate and spending on consumables; and 4) the rapid spread of the crisis due to strong financial ties among EU countries.

- Despite these factors, the fundamental trigger of the euro zone crisis appears to be the fact that rapid financial liberalization occurred without proper institutional foundation. It is interesting to note that this is actually not too different from what caused the 1997-98 Asian financial crisis. The arrival of the euro during a wave of neoliberal deregulation led to rapid financial liberalization, which, in turn, significantly contributed to the aforementioned increase in excessive loans by and insolvency of the banks, the emergence of financial bubbles, and the deepening of strong financial ties – and consequently, increased susceptibility and vulnerability – across the euro zone countries. Furthermore, while the introduction of the euro has brought about Europe's integration into a single economic bloc, the resulting absence of currency barriers and foreign exchange risk has also led to a decrease in the national competitiveness of the smaller EU economies. These countries have therefore become financially vulnerable, largely due to the repetition of stimulus economic policies.

- The lack of leadership and disagreements within the euro zone countries over the causes and appropriate responses to the crisis have been highlighted as reasons why the crisis persists. In particular, the two largest EU member states, France and Germany, have been at odds with each other over the issue, further contributing to the absence of a unified leadership. While they share a similar vision in their policies, EU countries often disagree over which specific policies should be prioritized, and thus have a difficult time devising a Pan-European solution to the crisis.

Q2: How well have the European countries responded to the crisis? What is the outlook for the crisis?

A2: "The issues related to liquidity and financial reform will remain unsolved due to the lack of leadership in the region."

- The response of EU member states to the euro zone crisis can be divided into two different policy approaches. The first is efforts to solve liquidity problems, while the second is focused on financial reform. The former has been advocated by France and other southern European countries, while the latter approach has been strongly favored by Germany. The problem is that the two policy approaches have not been pursued in a complementary fashion but rather in a competitive manner. As a result, there have been insufficient efforts to provide liquidity, while the attempts at financial reform have only added to the economic difficulties in the financially weaker countries.

- At the European Council meeting on 28-29 June, 2012, EU leaders agreed to the following five measures to solve the current crisis: 1) EU member states will pursue a "Compact for Growth and Jobs" to enhance the competitiveness of Europe; 2) a banking union with central supervision will be established; 3) the European Financial Stability Facility (EFSF) will provide aid to insolvent banks, until the new European Stability Mechanism (ESM) takes over the job; 4) EFSF/ESM will be allowed to buy bonds in primary markets; and 5) ESM will give up its senior creditor status. The first measure was pushed by France, the second by Germany, and the others by Spain and Italy. Although this compromise appears to have contributed to the EU's attempt to solve the crisis, there is still disagreement over which policies should be prioritized in terms of implementation.

- As the crisis persists, some commentators have started to worry about the possibility for the breakup of the Euro zone itself. Despite these concerns, it is important to consider the foundational background of the euro. The fact is that the euro was established for political rather than economic reasons. That is, the euro was created to compete with the dollar and therefore gain autonomy from the dollar. Hence, the future of the euro zone depends largely on political factors, instead of economic ones. Of course, if the crisis persists, the euro zone could collapse in the midst of growing distrust among European countries. However, as of now, such a prospect is still far off.

Q3: How should South Korea respond to the euro zone crisis?

A3: "South Korea should offer innovative policy ideas in the midst of a changing global financial order."

- At the national level, South Korea should undertake efforts to secure its industrial competitiveness. As mentioned before, countries that are suffering greatly from the euro zone crisis tend to have weak industrial competitiveness. This has then led to an insolvency of their financial institutions. By contrast, the South Korean government was able to rapidly recover from the Asian financial crisis by regaining its industrial competitiveness, which then led to an expansion of its exports. Clearly, countries with high levels of industrial competitiveness can recover quickly from a financial crisis, which is why the South Korean government should first and foremost focus on enhancing its industrial competitiveness as a response to the ongoing euro zone crisis. South Korea should also work to develop an alternative market in order to offset the negative effects of the long drawn-out economic recession in Europe and the United States. It should not only develop its own domestic market, but also engage the emerging markets of Northeast Asia and Brazil, Russia, India, and China or the BRIC countries.

- At the regional level, South Korea should actively participate in the development of a regional financial market, especially with respect to establishing and funding a financial safety net. By doing so, it can help to secure a stable supply of investment funds and strengthen its own financial stability. Examples in this regard include the Chiang Mai Initiative Multilateralization and the Asia Bond Market Initiative.

- Lastly, at the global level, South Korea should seize the opportunity in the ongoing debate about restructuring the global economic order to become a country that connects advanced and developing economies. Such an effort will help Seoul to have its policy preferences reflected in the global economic governance. With the changing global economic order, South Korea must seek to offer innovative policy ideas as such ideas could be more influential than a country's national power. Given this opportunity, South Korea needs to consider how it can advance from a country that simply abides by the given rules to one that sets and changes the rules.

About the Interviewee

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Professor Yong Wook Lee received his PhD from the University of Southern California, and is currently serving as an associate professor in the Department of Political Science at Korea University.

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