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Reforms in Economic Governance of Eurozone after the Debt Crisis and Lessons for Korean Economy

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The Causes of the Debt crisis in the Eurozone

This study analyzes the causes of the European debt crisis and reviews reforms the eurozone has pushed for in order to solve the crisis. It also focuses on the future prospect of economic governance of the eurozone. European debt crisis has spread over the entire eurozone despite the bail out of Southern European countries. Greece, Ireland, and Portugal were bailed out and since the second semester of 2011, Italy and Spain have been under the pressure of a potential debt crisis due to their soaring bond yield rate. During the early period of the crisis, the eurozone focused on providing liquidities to Greece. However as the crisis affected other countries one after another, eurozone's responses have become more comprehensive, recognizing that the crisis is related to insolvency beyond liquidity crisis.

The causes of the debt crisis can be analyzed in two parts: the macroeconomic factors of individual countries and the structural default of the European Monetary Union (EMU). The fiscal stimulus measures used during the global financial crisis caused serious damage to fiscal sustainability of the individual eurozone countries. In this sense the European crisis is a direct consequence of the crash of 2008 in the global economy. There are common causes of the crisis found in the crisis-affected countries, such as Greece, Portugal, Ireland, and Italy. A failure in economic governance (Greece) and a distorted growth strategy based on asset bubbles (Spain and Ireland) provided a cause for the crisis. Country-specific causes of the crisis can be summarized as follows in Table 1.

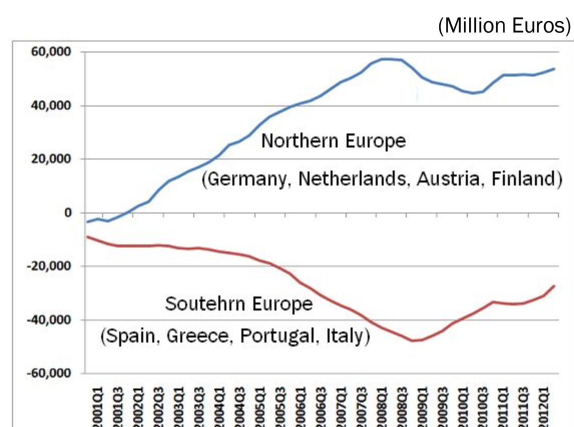
Table 1. Country-specific Causes of the European Debt Crisis

Greece	Portugal
- High level of tax evasion - Excessive public spending in pension / large public sector - Industrial structure vulnerable to economic shock (too high level of service—tourism, low level of manufacturing) - Statistical fraud/loss of confidence	- Persistent current account deficit - Weak industrial base - Prolonged low economic growth (2002–06: 0.7% yr.) - Inflexible labor market - Political turmoil (weak government)
Spain	**Ireland**
- Burst of property market bubble - Unbalanced industrial structure (concentrated in construction and tourism) - Sharp upturn of unemployment rate: Increasing trade account deficit) - Persistent current account deficit	- Drop in FDI since 2004 (labor cost↑, investment diversion) - End of property boom-driven growth (subprime crisis from the U.S.) - Banks' near-collapse - Increase in public deficit due to bail out of banks - Unemployment soared

The EU did not have a bail out mechanism in terms of public finance crisis and so had to invent a mechanism to respond the crisis. The early efforts of the EU were often termed as "patchwork" because their early responses to the crisis were not coherent. Since the debt crisis, the financial market has been increasingly doubtful of the integrity of the eurozone as a monetary union and this lack of confidence has turned up as diverging yield rates of government bonds. With regard to the structural problems of the eurozone, the member states adopted the single currency without serious budget disciplines and coordination mechanisms for fiscal policies. In addition to the lack of budget discipline, there has been no consideration on internal imbalance in the eurozone. Germany pursues export-driven growth model, while Spain has consumption and investment-driven growth model. Export performances of eurozone members are very different, which causes current account imbalances among the members. However, eurozone has maintained current account balance as a whole, which secured euro's value. As a result, it was easy for a country to lose its sensitivity to macroeconomic imbalances and a country is prone to be overindebted over its economic fundamentals.

Figure 1. Current Account Imbalances Between Northern and Southern Europe

(Million Euros)



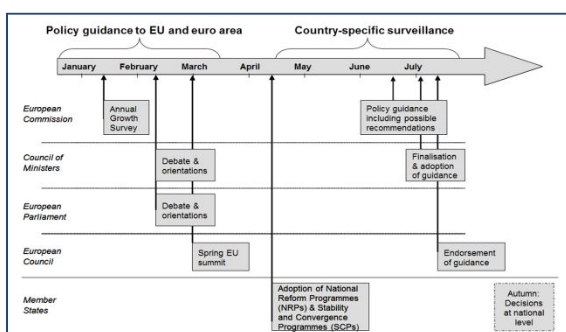
Source: Eurostat.

The ambiguous role of the European Central Bank (ECB) as a "lender of last resort" is also pointed as the reason the crisis has spread. Political factors acted strongly from the early stage of the debt crisis and the latter has an aspect of a political crisis about the European integration. Major actions were slow and ill-coordinated due to lack of leadership at the EU level. Germany and France did not share views in tackling the crisis from the beginning.

Strengthening of Fiscal Discipline

In order to tackle the debt crisis and reform economic governance, the eurozone has advanced various measures in strengthening the fiscal discipline. First, the European Commission initiated economic governance and proposed surveillance structures. It successfully introduced the European Semester, which intends to exert peer pressure for relevant budget control for each member. The Stability and Growth Pact (SGP) was strengthened; contrary to previous cases, procedure for sanction can be applied not only for excessive fiscal deficit, but also for excessive government debt. Besides, the reverse qualified majority voting was introduced in order to make it difficult an exemption of a financial sanction.

Figure 2. Timeline of European Semester



Source: European Commission.

In addition, 25 members of the EU signed the new fiscal pact that sets up a debt brake in each member's legal system and strengthens sanction in case of violation. Germany has been particularly insistent in this regard and has led other countries to agree on the fiscal compact.

Table 2. New Fiscal Pact

	Contents
Debt brake	- General government budgets shall be balanced or in surplus. - The annual structural deficit must not exceed 0.5% of the GDP. - Such a rule will be introduced in member states' national legal systems as part of constitution or equivalent. - Member states whose government debt exceeds the 60% reference level shall reduce it at an average rate of 1/20 per year as a benchmark. - The rule will contain an automatic correction mechanism that shall be triggered in the event of deviation.
Sanction	- European Court of Justice can fine a country that does not adopt a standardized balanced budget rule with a penalty equivalent to up to 0.1% of the GDP. - The money goes either to the ESM (if an EU country is fined) or to the general EU budget (in case of fines imposed on non-eurozone signatories).

Source: Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union

Correction of Macroeconomic Imbalances

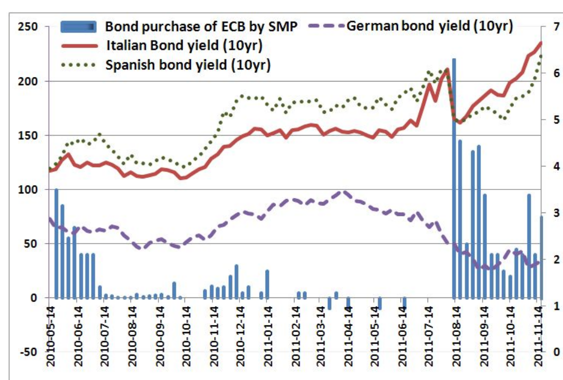
The EU adopted a new measure to monitor and correct macroeconomic imbalances based on an early warning system. In fact, it is not easy to develop policy tool to curb current account deficit. Instead of developing direct policy measures, European countries agreed to develop various indicators to check macroeconomic imbalances of each country. When one member of the EU tends to diverge too much from an average of the EU, the European Commission can give a warning, "Excessive Imbalance Procedure (EIP)." After failure to correct the imbalance, a penalty (up to 0.1% of

the GDP) may be imposed. However, it is doubtful that this measure can be effective because the latter concerns mainly the private sector and the result from either growth model of each country or lack of competitiveness in industries.

Further Role of the European Central Bank

The ECB's responses have been increasingly active. In order to keep financial markets stable, the ECB has intervened in three ways. First, it lowered the base interest rate three times from 1.50% to 0.75%, which is record-low level since the introduction of the euro. Second, the ECB purchased sovereign bonds from secondary market by operating Security Market Program (SMP). It intervened intensively from August 2011, as shown in Figure 3. The SMP was policy option under constraint that ECB cannot purchase sovereign bond of its member countries directly from primary market. Meanwhile, the ECB had been under increasing pressure and criticism because of its reluctance to increase the amount of sovereign bond purchased by the SMP.

Figure 3. ECB's SMP and Sovereign Yield Rate of Italy and Spain



Source: European Central Bank, Bloomberg.

Third, the ECB provided massive low-interest loans (Long Term Refinancing Operation, LTRO) to European commercial banks in late 2011 and early 2012. Two LTROs suggest that the ECB tend to act as *de facto* lender of last resort in case of a crisis but in a different way. This operation was termed as Backdoor QE or silent bazooka. Finally, in October 2012, its president announced the ECB would purchase sovereign bonds of short maturity without limit, if the crisis spreads further. This announcement has been interpreted as a willingness of the ECB as a lender of last resort.

Closer Coordination in Economic Policy

There is a consensus that the eurozone needs strong reforms in order for the euro to survive in the future. First, it will be inevitable to push for a certain level of fiscal integration to sort out the current crisis. However, this will require a high level of political compromise, as well as efforts of debt-ridden countries for structural reforms and budgetary discipline. Progress toward fiscal integration will depend highly on political agreements among eurozone member states.

Second, correcting macroeconomic imbalance among members will be a key issue in the medium and long terms because the debt crisis is regarded as a consequence of diverging competitiveness among members. Third, it will be increasingly necessary to develop a close coordination mechanism of economic policies among members. This mechanism will have to address not only the budgetary behavior of member states, but also the comprehensive economic policies, including labor market reforms and industrial policies.

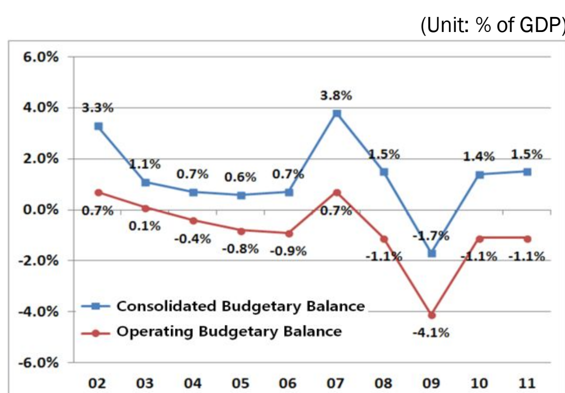
European Debt Crisis from Korean Perspective

South Korean economy had also been affected by the European debt crisis and Korean media has covered this issue with much interest. Regarding the European debt crisis and its development in governance, we can suggest the following points in order to strengthen Korean policy to cope in various fields.

First, social security system should be carefully planned based on the fiscal status. In Korea, the aging population will soon become a more salient issue than any other OECD member countries. Statistics show that budget expansion in Korea resulted by aging society is expected to expand by 13.4% from 2005 to 2050, while Germany, France, UK, and the USA will show a 3.0%, 3.5%, 3.4%, and 2.9% respective increase.[1] In order to maintain a sound financial condition, in-depth study on both current fiscal status and future fiscal demand in Korea should be premised before planning, while inevitable tax increase supports for balanced government revenue and expenditure.

Figure 4. Budgetary Balance Ratio in South Korea

(Unit: % of GDP)

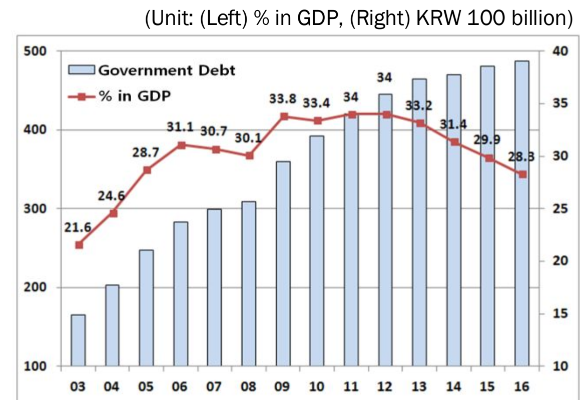


Source: Ministry of Strategy and Finance

[1] OECD, European Commission.

Figure 5. Government Debt in South Korea

(Unit: (Left) % in GDP, (Right) KRW 100 billion)



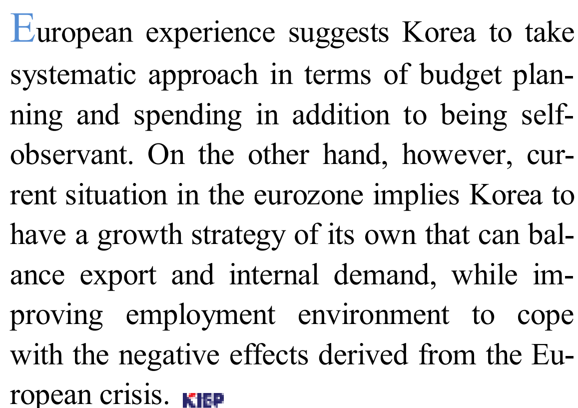
Footnote: Projected data from 2012.
Source: Ministry of Strategy and Finance

Second, for an unerring fiscal management, it will be crucial to attain confidence for market stabilization of which accurate statistics would be the starting point to achieve such. As we can see from the Greek example, rise in fiscal deficit was derived somewhat from activities by shadow economy and tax evasion. Therefore, it would be necessary to secure further efficiency in the taxation system and to improve transparency to prevent growing fiscal deficit before a tax boost.

Third, it is necessary to monitor development of household debt. Increased private debt can exert indirect impact on credibility of fiscal sustainability. The current economic situation in Europe, in some aspects, can be interpreted as households' debt crisis converted into public debt crisis. Korea, with KRW 472 trillion worth of credit to households in 2003 had exceeded KRW 911 trillion in the first quarter of 2012. According to the OECD data, Korean household debt to GDP ratio has scored 81%, while OECD average was only 73%. High-debt ratio in households can make both the private sector and the whole economy vulnerable to market change. Especially, the Korean economy should be aware of the collapse of the bubbles in the real estate market, which

can accompany extreme recession and end up with heavy deficit.

Fourth, it is vital to maintain industrial competitiveness while developing domestic demand. Korea is an export-oriented economy based on manufacturing. High value-added and technology-intensive features will put Korea in an advantageous position when competing with emerging countries. However, such export-oriented economies can be sensitive to external environment, such as volatile exchange rate, particularly, when its domestic consumption is weak. In the Korean case, the services sector is less competitive compared to the manufacturing sector. Therefore, with the aim of developing domestic demand, it would be important for Korea to nurture the services sector for sustainable economic growth.



European experience suggests Korea to take systematic approach in terms of budget planning and spending in addition to being self-observant. On the other hand, however, current situation in the eurozone implies Korea to have a growth strategy of its own that can balance export and internal demand, while improving employment environment to cope with the negative effects derived from the European crisis. KIEP