Does economic sovereignty still exist?
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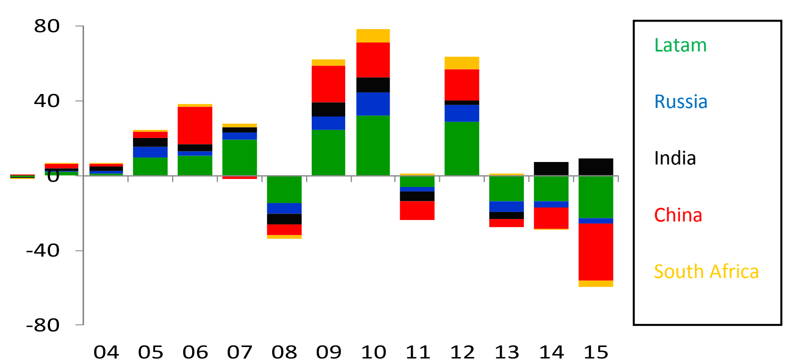
Economic sovereignty may capture many dimensions of economic management –tax policy, economic regulation, competition, labour markets, finance. Still, this panel is focused on macroeconomic policy, or the ability to stabilize the economy through fiscal and monetary policies. The organizers provocatively argue that such policies, delivered at the national level, have become unable to deal with crises that are systemic and global.

Of course this assessment takes place against the background of the extended slowdown/recession that started in 2007. This has been an extraordinary period with three crises following each other: (a) the US financial crisis of 2007-2009; (b) the eurozone recession of 2010-2014, and the EME slowdown of 2014 onwards. During this time, world growth has halved compared to the previous ten years, volatility has increased significantly, unemployment in the advanced economies has soared, and deflation has become a real, multi-country concern. The financial sector has been particularly vulnerable and some of its recent wounds are feared to reopen with new shocks.

Indeed, finance is the common thread across these three episodes and what makes them truly global. When we speak of systemic and global crises, finance is usually at the core of it. Finance flows and operations don´t recognize borders and national policies can do little about them. Even the re-regulatory zeal prompted by the 2008 crisis has died out, especially in Europe, where major global banks still cannot completely clean their portfolios, despite all the help from governments and regional institutions. As for EMEs, capital flows tend to be very volatile and subject to the changes in risk apetite from investors, independently of national fundamentals prompting major swings in currencies (Figure 1).

Figure 1. Capital Flows to EM (annual, USD billions)



Source: IMF and EPFR

Still, it should be noted that not all economic shocks and crises are systemic and global. There are a number of current developments with a strong idiosyncratic origin. These include the recessions in Brazil, Russia and South Africa; the origins of the Greek crisis, and the Chinese rebalancing – even if it involves only a slowdown. The recent past also includes critical economic episodes in South East Asia, the dot-com sector in the US, Sweden and Denmark, to name only a few. Brexit is indeed a national-based phenomenon, no matter the justifications given by its promoters. Since many of these episodes had substantial spillovers on other countries one may wonder if an extra dose of globality –reflected in greater responsibility towards the resto of the World—could have help prevent or mitigate them.

Still, the question remains: how much can national policies do to limit the domestic impact of such global events?

In my view, there are four factors that are crucial in facing external shocks and minimize their impact, even if no one is fully immune to them:

1. Financial buffers and shock absorbers, that help withstand market turbulence

2. Price flexibility, to speed up national responses

3. A deep and well capitalized financial sector that can absorb part of the costs and limit the spread of malaise to other sectors of the economy

4. A social protection system that can limit social costs and the multiplier effects of shocks into consumption

This list should make it clear that if countries cannot prevent an external shock, surely there is still a lot they could do to isolate it and prevent contagion to critical areas of the domestic economy. Moreover, I would argue that many of the recent crisis spread out because of the absence of one or more of the factors listed above.

For example, when we speak of the ineffectiveness of fiscal policy, it is frequently due to having a highly indebted public sector from the very start (Italy) with limited tolerance for additional debt, or by governments being fiscally overwhelmed by the bail-out of failing private financial institutions (Ireland, Portugal, Spain) or by the interest bill growing rapidly as the cost of new debt escalates (all the above). Reducing gross debt buildup through more conservative fiscal policies, building Chinese walls between governments and banks and minimizing refinancing or liquidity risks, are very simple strategies to secure a fully operative fiscal policy.

Take now monetary policy. Everybody acknowledges that central banks saved the world from a disastrous depression some seven years ago by providing liquidity at a time it was being sucked by financial turmoil and uncertainty. To do so, monetary authorities walked into uncharted territory to support the economy in the face of challenging conditions, like the reduction of money multipliers by banks withholding funds in the light of heightened risk perceptions, uncertainty over the quality of their portfolios or capitalization needs. Monetary policy has also helped gain competitiveness through its effects on exchange rates, even if such gains have proved short-lived due to competing moves elsewhere. As we know, the main challenge in advanced countries today is to avoid deflation, in a context of weak investment, trade and manufacturing growth.

There are many countries in the world that manage their economies on the basis of national fiscal and monetary policies. Certainly some of the BRICs mentioned, many EMEs, but also advanced countries that are not attached to any bloc, like Canada, Australia, New Zealand, Corea or Sweden. This last group of countries has something very important in common: they all faced economic crises of their own in the 10-15 years prior to 2007. So it looks that they learned something from it. Their fiscal response to the crisis in 2008-2010 is very telling in this regard (Table 1).

Table 1. Fiscal Behaviour of OECD countries 2007-2013
(Percentajes of GDP)

Country groups	2007-09			2009-13e		
	Change in underlying balance[2]	Change in primary spending[3]	Change in gross debt[4]	Change in underlying balance[2]	Change in primary spending[3]	Change in gross debt[4]
Group 1	-4.08	4.17	7.78	2.37	-3.52	1.71
Group 2	-4.55	5.60	19.07	7.95	-5.14	13.41
Group 3	-1.91	5.05	14.21	2.85	-2.29	12.16
Group 4	-5.22	6.07	22.7	2.75	-2.87	24.21
Total	-4.33	5.64	18.70	3.32	-3.16	17.66

1. Group averages are weighted and refer to general government.
2. Underlying balances are adjusted for the cycle and for one-offs.
3. Primary spending refers to total disbursements, excluding net interest payments.
4. Gross debt data are not always comparable across countries due to different definitions or treatment of debt components. For more details, see *OECD Economic Outlook Sources and Methods* (*www.oecd.org/eco/sources-and-methods*). Group 1 countries include: Australia, Canada, Finland, Korea, New Zealand and Sweden. Group 2 countries include: Greece, Hungary, Iceland, Ireland, Italy, Portugal and Spain. Group 3 countries include: Austria, Belgium, Estonia, France, Germany, Luxembourg, the Netherlands, the Slovak Republic and Slovenia. Group 4 countries include: Japan, Switzerland, the United Kingdom and the United States.

Source: Marcel (2013)

Prior to the crisis, the US and the Eurozone thrived on the illusion of being protected from internal or external shocks. Regulators were too slow in responding to the challenges posed by new financial products and risk mismanagement and even misinformation. Eurozone countries borrowed at euro spreads under the (lenders´) assumption that they were backed by the stronger economies of the bloc and violated fiscal rules even in good times. EMEs suffered from a similar veil that prevented countries from recognizing their own weaknesses even during the first stages of the long recession. The prolongued commodity boom created the illusion that many of these countries had finally matured to a point where they could afford countercyclical policies, for the first time in their modern economic history. Once they were unable to unwind their expansionary policies after the emergency and the downside of the cycle caught them with high debt and growing inflation, many have had to return to the old procyclical response of cutting spending and raising interest rates.

In my view, this illusion of protection is what explains the severity of the economic crisis and what may lead to blame the "system" for the current state of affairs.

A major question in this regard is whether markets suffer from a similar level of myopia that obscures the true vulnerabilities of domestic economies in the face of a thriving economy, regional risk pooling or booming commodity prices. Figures 2a and 2b present the CDS Spreads series from before the financial crisis for Eurozone and LAC countries. It should be evident that up to mid-2009, spreads for Eurozone countries were almost identical, with the exception of Ireland, where a financial and housing bubble exploded at a similar time than in the US. In the case of LAC distinctions have been more marked, with countries differentiating significantly from each other at various stages, partly due to the fact that commodities do not follow identical cycles anyway.

Figure 2a: CDS Spreads in Eurozone countries 2007-2015
(basis points)

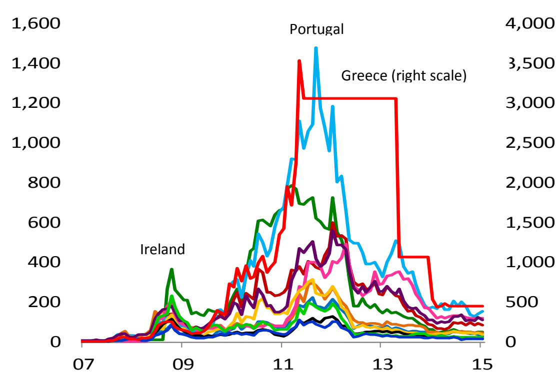
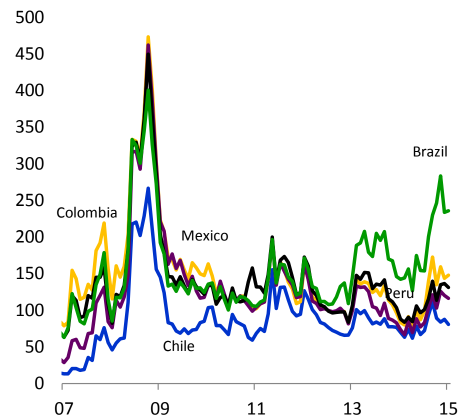


Figure 2b: CDS Spreads in LAC countries 2007-2015
(basis points)



Source: Bloomberg

So if effective national macro policies are feasible, what are regional economic blocs for? While regional integration offers a number of benefits on the real economy side, macro policy essentially benefits from the pooling of risks and liquidity. This involves a smaller effort in terms of the factors 1-4 listed above. In other words, regional integration lowers the cost of macro management in mild business cycles. But this involves two risks: first, this lowers the pressure to buildup macro defense mechanisms in good times; second, this may create a deep divide among countries in the same regional bloc in the case of substantial opposing balances. In the case of the Eurozone, for example, it suffered from the division between surplus and deficit, creditor and debtor countries throughout the crisis. Without exchange rates to differentiate each other, this left “internal devaluation”, that is, the change in relative prices and salaries through deflation, as the only adjustment mechanism.

The former illustrates the point that regionalism is not a free lunch, since it should come with substantial requirements on collective action. Regionalism could be used to build policy coherence. This relates not only to institutions (like financial regulation or deposit insurance), but also to limit internal imbalances. The current discourse against British opportunism after Brexit should be extended to many members that profit from benefits while paying little costs for EU membership.

In sum, globalization has not necessarily made national macro policies ineffectual, as testified by the reality of many countries in recent years. Price flexibility, fiscal prudency, strong reserves, access to liquidity and a solid financial sector can do a lot to limit, isolate and compensate the impact of external shocks, as demonstrated by the experience of many countries that learned from past crises. Alternatively, countries can take shelter in broader alliances, pooling their risks and resources for more efficient protection. However, regional systems also need to prepare and be ready to react to crises, which, in turn requires effective collective action mechanisms. As usual, there are no free lunches here.