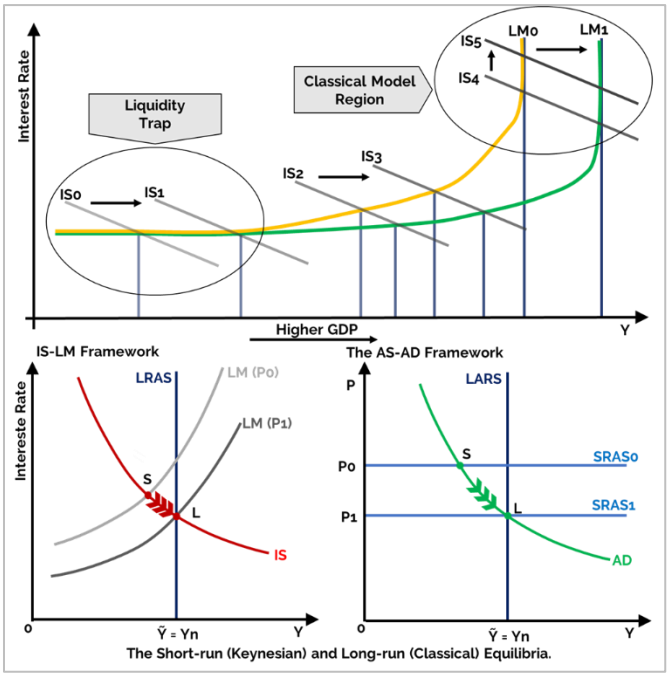
Macroeconomics Infected

A Crisis is a Terrible Thing to Waste – Paul Romer – American Economist

Mario Cezar Silva Serpa[1]

Science should be immune to infection by money, arrogance or politics, but the dismal science has suffered a lot, especially in macroeconomics. Not to say that its evolution was not important, but we are far from an appeasing solution that will assist us in unconventional situations. However, history shows us that in extreme circumstances, such as the one we now face, we evolved on the back of ideas, innovations and advances, seeing alternatives and proposals, sometimes counterintuitive, but with great practical effects. This is a time when the (macro) economy needs to evolve.

Among the various existing models, the ones that always come to the fore are the Hicks-Hansen Model (or IS-LM Keynesian Model) and the Classical Model which, albeit old, present various positions as to its premises and serve as parameters for our argument. On the one hand, the Keynesian, in need of state intervention and, on the other, the Classics, assuming the fundamental assumption that if the idle factors of production are left to adjust, they will always produce the best results. The graphs on the side are intended to summarize the following discussion in the context we are experiencing.



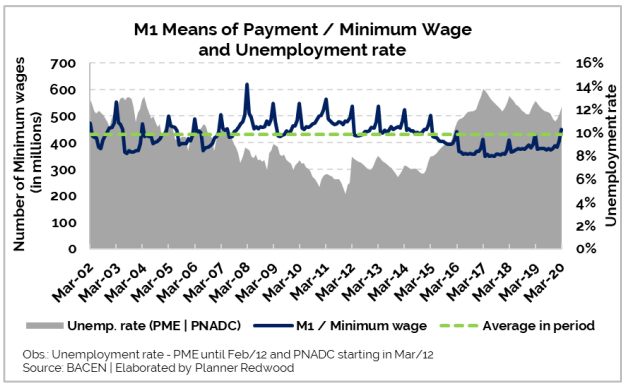
The shocks observed in the economy so far leave no doubt as to its destructive potential; and, possibly, we will not be able to *exclusively* use the available tools (fiscal and monetary policies) or even an enhanced application of them. However, the starting point cannot be different from the diagnosis of the problem. It seems important to highlight that the economic world is indeed governed by natural laws in any part of the planet, even if adjusted to factors and traits specific to a region/country, and thus misallocations are avoided in a free-choice situation, optimizing total productivity of factors. This is not the case. In fact, the State, by imposing quarantine and/or lockdowns (although epidemiologically defensible), inhibits the efficient allocation of resources and brings with it the responsibility of helping the population and the "duty" of meddling in the economy (Paper: Brazil on the brink?).

When cast under this light, and taking into account the country's situation, it remains to be seen how far this "meddling" should go, as well how long it would take and which mechanisms could make both monetary and fiscal policies fully potent. Initial observations suggest interest rates, inflation, economic activity and our fiscal situation. Not to infer any causality at this moment, but we have the lowest historical interest level, extremely low inflation, activity in strong retraction and a Gross Public Debt/GDP ratio towards 100%. Additionally, with aggregate demand even more depressed, it would not be absurd to assume that we are near a Liquidity Trap (low effectiveness of monetary policy), in line with its deleterious effects verified in the GDP. Policies that shift the IS curve to the right (increased spending and/or reduced taxes) appear to be of an imposing nature, but caution is needed to the side effects on our public finances, especially due to the country's solvency expectations. Likewise, even if the BACEN acts believing in the endogeneity of money (reduces the SELIC and the

[1]Mario Serpa is an Economist and Partner at Planner Redwood Asset Management.

monetary base adjusts), further interest rate cuts would not promote, as a first order factor, an increase in output. It is possible, sequentially, that the increase in the monetary base may promote some inflation and reduce real wages, feeding some competitiveness and improvements into the labor market. A way to "preserve" our entrepreneurs and their businesses is essential to our economy.

But, as it stands, we are talking about more of the same (although useful analysis), insufficient for the moment and gravity of the situation. We are not under ideal conditions, as if all structural reforms were approved. And, even if we implement the policies suggested by the models, overcoming our timid and belated reaction to the crisis, these would still fall short of keeping up with the epidemic reality that Covid-19 has established. The laudable efforts implemented by the Ministry of Economy and the Central Bank go in the right direction, but they fail in execution and effectiveness, sometimes due to the novelty of the situation, sometimes to incompetence. Therefore, although some positive and relieving results may come from fine-tuning the measures, the economic policy to be followed may have irreversible consequences.



However, despite the variables addressed here and their "use", even within the models presented, the velocity of money has an important role, especially in the short term. Seen as almost constant for Classics and variable for Keynes (and less important - a consequence - in other approaches), it could be better studied. In the equation of the Classics MV = Py = (nominal GDP), with the currency (M) constant throughout the LM and the activity in retraction, it is deduced that the velocity of money (V) fell, and, as it is stressed, quite strongly in the short term! Thus, the proportion of the fall in the velocity of money compared to the reduction in GDP is a proxy for the quantity of (demand for) money. In other words, the simple expansion of the monetary base (either by reducing the Selic rate and the endogenous adjustment of the quantity of money) without the effective transmission mechanism for banks to actually make loans and make money circulate, we will not have the desired effect of boosting activity.

This money circulation needs to occur and increase (speed!), not as a pure and simple consequence, but in an induced way - we want to treat V as an exogenous and not an endogenous variable. Here are the restrictions of macroeconomics, in view of the instruments we have. All things constant, if we knew other variables impacting V, especially in the short term, perhaps due to a new dynamic of exchange mechanisms, we could, at least, return to the pre-crisis situation. Trust is still the known and reasonably consensual variable, but it does not mean that there aren't others affecting V directly or indirectly.

At this crossroads, macroeconomics does not offer us a less controversial, costly and short-term alternative, so we must use political and healthcare solutions to recover credibility. Since a vaccine will not be available in the very short term, we need a logical and orderly plan for reopening the economy, massively and constantly testing the population, so that the most vulnerable individuals are kept away and protected, and confidence is offered so that the others can return to activities (properly "equipped").

It is important to note that unavailability of a short-term economic solution is a given, i.e., a rapid recovery is unlikely under current conditions. It is not about the economy or saving lives, but about the economy and saving lives ... we will have to learn to live in another existential dimension. The government's credit and liquidity facilities today are still stalled, and are expected to adjust in the medium term. Possibly too late. Macroeconomics is not dismal, it is useful, but it is failing to be a good protagonist.

[1]Mario Serpa is an Economist and Partner at Planner Redwood Asset Management.