Fiscal Dominance or Dominance of the Absurd?
A self-fulfilling prophecy

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Periods of greater economic distress have as its key factor the fragility of the moment in terms of vulnerability to the action by "free riders", who invariably take advantage of the situation to make prosper ideas which are not only crazy but, as a rule, much ideological. The cost of the imponderable may well be very high.

This is precisely the juncture we are living. In the past few weeks, every kind of alternatives to our tragic situation of economic shortage was unearthed. In the same time in which the debate and the discussion of ideas are absolutely healthy, the will of resolution might not be shaken, let alone flexible, while searching, in the presented purposes, alternative ways that refute reality, thus overshadowing good practices and burying the expectations of a definitive solution in the long run. In this context, the phenomenon of the Fiscal Dominance (an issue deeply studied by economists, and with no consensus so far) has been raised frequently by the press, and in economic workshops and debates.

Initially, it is important to highlight that the macroeconomic indicators of the Brazilian economy have been fast deteriorating in recent times, that is, the foundations are growing worse and expectations of improvement are lacking in the foreseeable horizon. Objectively, we are talking about the above-target inflation rate, dwindling economic activity, upward thrusting levels of unemployment and all of this amid a troubled social-politic scenario. This situation arises after years of erroneous economic policies, where the desirable fine tuning between Fiscal and Monetary Policies simply did not happen – due to unfettered spending of the government, and also because of the fragile, roundabout and condescending stance regarding the original mission of any Central Bank, namely: inflation control and its consequences for the rest of economy.

Thus, if the Brazilian Central Bank (BACEN) had acted in peremptory and disciplined fashion in its interest rates policy, we would have controlled credit expansion, making the country more attractive to the international resources and, lately, we would have anchored inflation by taming expectations. Obviously interest-rate therapy does not wrap up the problem, but if applied at the right time and warranted intensity, it does assist in the transition toward harmony with Fiscal Policy – resting on this latter the true long-term solution. Brazil has chosen otherwise. We have instead dropped interest rates, boosted the government spending… hence the counter-cyclical policies!

Well then, now we face the bill of the called New Macroeconomic Matrix, the mediocre "Keynesians" do not surrender (austerity is always and everywhere the greatest of evils!), and suggest that we been overridden by Fiscal Dominance. Worse yet, in face of an acute crisis, economists from different schools are "contaminated" and begin to see the same diagnostic, although with varying perspectives.

The reasoning is shallow as was, in the beginning of the "Plano Real", the idea of that the high interest rate causes inflation via increasing costs for companies and them passing on to the final prices of products, in an vicious cycle. Now it is somewhat more elaborated,

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namely: the stock and service of the Domestic Public Security debts values increase (at least in part) as a function of the rise of the SELIC, also because the increase of the interest rates affects the performance of economic activity and also the levels of employment. Consequently, the ratio of Gross Debt/GDP (solvency indicator of the country) deteriorates and investors start to doubt that the government will be able to honor its debts. The effects are immediate: the country risk increases, the price of the Dollar rises, the *status* of good payer is lost and, with it, the inflation increases. Hence the conclusion: interest rates cannot make the inflation decrease anymore, it does not affect the expectations anymore and also impairs the fiscal.

This is the landscape where brilliant minds say that we find ourselves in, the one with Fiscal Dominance. A phenomenon in which BACEN loses its main instrument of management and becomes absolutely impotent, limiting its actions and restricting its effects – a veritable spectator. Could we be really at this point, or could we be under the Dominance of the Absurd? As much as back in the days of the Real Plan in which it was not admitted to use interest rates as instrument of inflation control, we need to evaluate the problem in an broader manner and according to the dynamic of the economy. Therefore, we do not rule out the possibility of existence of the phenomenon, rather we wish to emphasize that the main motto to an increase of interest rates is the *wicksellian* principle whereby savings (S) have to be inter-temporally equal to investment (I) via a *natural interest rate*. More than equality, only this identity (S ≡ I) is able to restore real equilibrium to the other *accounts* of the country, with impacts on inflation, public debts, etc. However, the results do not happen in *t+0*, but in *t+1*, *t+2*… *t+n*.

In this sense, to believe that the Monetary Policy has low firepower against inflation means to accept, in the limit, that inflation is not essentially a monetary phenomenon (in other words, interest rate as price of the money and instrument of draining liquidity has its functions outstripped) and it is an absolute domain of the absurd. Has anybody any doubt? Forget for a minute the impossibility of barter economy and remove the currency of the economy. We cannot eschew the heart of the issue, which is to drastically cut government spending and leave the economy working freely and openly. It includes every kind of variable of adjustment, like effective floating exchange rate, unemployment, higher interest rates, if we are to restructure the debts profile, and implement actions to improve our competitiveness.

What is deeply disturbing in the debate, however, are two points underlying the idea of Fiscal Dominance at this time. The first has the character of a self-fulfilling prophecy, whereby the inexorable fact is that if we keep with current economic police we will be doomed to failure, because maintaining interest rates each time higher would undermine the credibility of BACEN. Second, and maybe more important, it might be the result of a position ideologically justified and opportunistically relevant: BACEN being inert or even slacker on its interest rate policy meets the concepts held by economists and politicians of the party in power and removes the sword off the head of the economic team and its fiscal adjustment. On these terms, the acceptance of Fiscal Dominance – conversely – will become a stimulus to the continuously unfettered fiscal spending.

Brazil will not withstand a retreat of such a magnitude.

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