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CONTEMPORARY THEORETICAL DEBATES ON ECONOMIC POLICY: LESSONS FOR THE POST-PANDEMIC PERIOD

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Abstract

Following the Global Financial Crisis of 2007, intense scrutiny on the validity of the mainstream macroeconomic model (New Consensus Macroeconomics) and its economic policy implications emerged in the academic community. The crisis revealed significant flaws in the traditional understanding of economic dynamics, especially regarding financial market regulation and systemic risk management. Additionally, the unprecedented impact of the COVID-19 pandemic on the global economy served as another test for the current macroeconomic paradigm. The pandemic-induced economic crisis exposed vulnerabilities in the global economic system, highlighting deep-rooted inequalities and structural weaknesses. Once again, doubts arose about the applicability of current macroeconomic models in addressing such complex challenges. This paper seeks to assess the ongoing theoretical debate surrounding the effectiveness of economic policies and discuss their implications for the post-pandemic period. It argues that the macroeconomic role of fiscal policy should be respected, not only when economic disorders occur but also in periods of economic stability. However, the risks associated with increased indebtedness in both advanced and emerging economies are linked to fiscal and financial dominance issues, which may escalate in the future. Therefore, this paper contends that economic policymakers should apply the proper economic-policy mix to address the current and future economic challenges.

Key words: economic policy, New Consensus Macroeconomics, fiscal dominance, COVID-19 pandemic.

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САВРЕМЕНЕ ТЕОРИЈСКЕ РАСПРАВЕ О ЕКОНОМСКОЈ ПОЛИТИЦИ: ПОУКЕ ЗА ПОСТПАНДЕМИЈСКИ ПЕРИОД

Апстракт

Након Глобалне финансијске кризе настале 2007. године, покренута је интензивна академска дебата о валидности доминантног макроекономског модела (Нови консензус у макроекономији) и његових импликација за економску политику. Криза је открила значајне недостатке у традиционалном схватању економске динамике, посебно у погледу регулисања финансијског тржишта и системског управљања ризицима. Поред тога, утицај пандемије COVID-19 на глобалну економију, који је био без преседана, представљао је још један тест за важећу макроекономску парадигму. Економска криза изазвана пандемијом разоткрила је рањивост глобалног економског система, наглашавајући дубоко укорењене неједнакости и структурне слабости. Сумње у примењивост постојећих макроекономских модела у решавању овако сложених изазова су поново присутне. Овај рад настоји да процени текућу теоријску дебату о ефикасности економске политике и размотри њихове импликације у периоду након пандемије. У раду се истиче да је потребно уважавати макроекономску улогу фискалне политике, не само у условима економских поремећаја, већ и у периодима економске стабилности. Међутим, ризици повезани са повећаном задуженошћу напредних и економија у развоју повезани су са проблемима фискалне и финансијске доминације, који могу ескалирати у будућности. Стога, у раду се тврди да креатори економске политике треба да примене одговарајућу комбинацију економске политике како би одговорили на садашње и будуће економске изазове.

Кључне речи: економска политика, Нови консензус у макроекономији, фискална доминација, пандемија COVID-19.

INTRODUCTION

The development of contemporary economic thought was characterised by many convergent and divergent streams, whereas establishing a broader consensus was relatively rare. The first such case was related to the famous Neoclassical synthesis, as a connection between neoclassical and Keynesian economic theories. The emergence of stagflation in the 1970s and the constraints in Keynesian economic policy measures both resulted in abandoning this synthesis. The second situation was during the 1990s, when the New Consensus Macroeconomics (hereafter: NCM) emerged. NCM amalgamated Monetarism, New Classical Macroeconomics, New Keynesianism, and Real Business Cycles theory (Mihajlović & Marjanović, 2020).

The dominant approaches to economic policy aimed to stabilise the economy were also changing during the development of contemporary macroeconomic theory. These changes were the corollary of the shifts in dominant macroeconomic paradigms, most commonly as a consequence of the economic crises. For instance, the domination of Keynesian economic policy was interrupted, *inter alia*, due to the economic crisis induced by the supply-side shocks in the 1970s.

In the 21st century, two global economic crises occurred: the Global Financial crisis (2007) and the economic crisis induced by the COVID-19 pandemic. The validity of the NCM paradigm was questioned in both crisis events. The stance on economic policy effectiveness was also under suspicion by the academic community and policymakers around the globe.

Accordingly, this paper aims to evaluate the theoretical controversies which followed the evolution of the economic policy approach to date, focusing on how the last two global economic crises shaped the dominant macroeconomic paradigm about economic policy effectiveness. It also seeks to enrich the ongoing discourse among scholars and policymakers regarding the strategies for conducting economic policy to attain macroeconomic stability in the aftermath of the pandemic, while also acknowledging the distinctions between advanced and emerging economies.

ECONOMIC POLICY DEBATES IN THE CONTEXT OF THE GLOBAL FINANCIAL CRISIS (2007)

Favourable macroeconomic conditions in developed economies, spanning from the mid-1980s until the onset of the Great Recession in 2008 (so-called Great Moderation), led the majority of mainstream economists to believe that significant economic disruptions were a thing of the past. It was widely held that both short-term and long-term macroeconomic objectives could be attained with adequate economic interventions, primarily through monetary policies. The NCM model, also known as the New Neoclassical Synthesis, was considered a good basis for the successful conducting of economic policy since the period from its establishment was characterised by macroeconomic stability.

However, the financial crisis in 2007, which a year later spilt over into the real sector, resulted in the Great Recession, as the most serious crisis after the Great Depression of the 1930s. The financial crisis arose in the mortgage market of the United States of America, with the 'bursting' of a speculative bubble, as a result of a sudden drop in real estate prices after a multi-year trend of growth. Combined with financial liberalisation, these processes enabled the introduction of a wide range of financial instruments intended for the so-called securitisation of deposits and multiplication of mortgage loans (Wray, 2008). The absence of effective financial regulation, coupled with an overly expansive monetary policy, led to a systemic financial crisis and severe recession.

The optimism of the NCM model proponents and the creators of economic policy suddenly subsided as the essential fragility of the financial and economic system was observed. It has been shown that the key flaw of NCM model lies in the incorrect treatment of the financial sector since it was assumed that restrictions on the financial market only increase the impact of disturbances originating from other sources (Mihajlović, 2023). Consequently, the valuable financial indicators, which could indicate the unsustainability of the situation that preceded the crisis, were omitted from the NCM model.

Since the interest rates in the majority of economies were low, the solution had to be found in the strong fiscal expansion. The real interest rates were also low or even negative due to relatively low inflation rates; these rates were at the so-called effective lower bound – the rate which ensures a kind of equilibrium but with excessive savings (r_L rate in Figure 1). For investments and savings to be equal the real interest rate should equals equilibrium interest rate (r_0^*). As it is apparent from Figure 1, r_L rate is still above r_0^* and the intersection between IS and LM curves lies below the potential output (Y^*) in point A. Expansionary monetary policy can only move LM curve to the right and the economy to point B where negative output gap still persisting. Accordingly, a massive fiscal expansion should be implemented to move the IS curve to the right and to establish the equilibrium at the potential output level (point E).

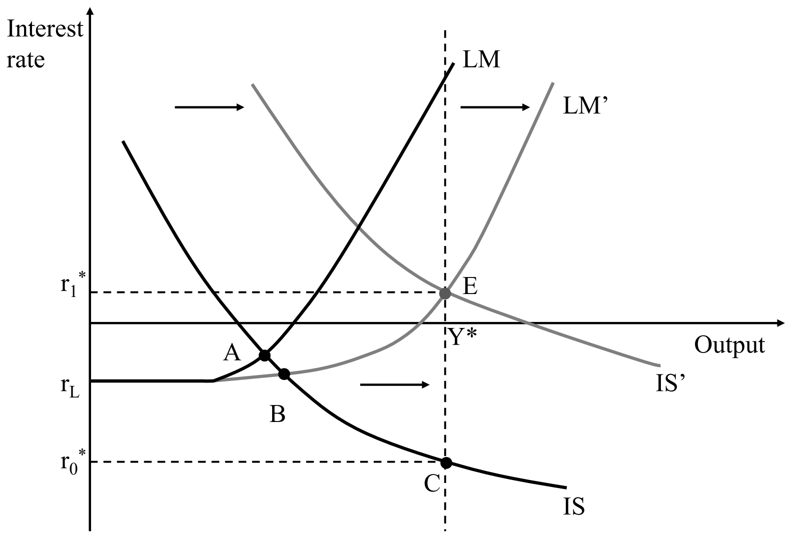

Figure 1. Effective Lower Bound and the combination of monetary and fiscal policy
Source: Buti and Papaconstantinou (2021), p. 5

The crisis emphasised the importance of monetary and financial policy coordination, with a focus on implementing measures to stabilise financial markets. This was encapsulated in the *macroprudential* policy framework, aiming to reduce risks and macroeconomic consequences of financial instability. Monitoring credit, liquidity, and capital levels at micro and macro levels became key instruments. Macroprudential policies offered quicker implementation than fiscal policies and could be tailored to specific financial sector risks, mitigating adverse effects on economic activity (Lim et al, 2011). In cases where conventional monetary policy had been ineffective, such as low inflation, macroprudential measures were more effective in stabilising the economy. Challenges with discretionary fiscal policy have led to a shift towards fiscal rules, mirroring monetary rules, aiming to ensure fiscal stability through efficient, rational, and transparent public expenditure reduction.

THE ECONOMIC CRISIS INDUCED BY COVID-19 PANDEMIC AND ECONOMIC POLICY CONTROVERSIES

Unlike the previous global economic crisis, the COVID-19 crisis resulted from the shock outside the economy (health crisis), but with serious economic consequences (economic downturn, rise in unemployment and inflation, deterioration in external and fiscal position). One of the significant corollaries of the pandemic was the enormous fall in aggregate demand due to social distancing measures and lockdowns. In addition, the aggregate supply was also dramatically reduced since a number of firms stopped business activity or provided only minimal levels of production.

The economic effects of the pandemic could be divided into short- and long-run effects. Some of the significant short-run effects were as follows:

- The reduction in the general level of spending due to distancing measures and the uncertainty about the future events connected with the pandemic. The enterprises faced a significant drop in sales and started to hoard the goods in inventories (Carlsson-Szlezak, 2020). Although there were cases of panic buying of some goods (Prentice, Chen, & Stantic, 2020), the net effect was a decrease in spending;
- The financial markets disorders which were transferred to the economy. One of the results of these disturbances was the reduction of households' wealth and, consequently, the fall in spending (Ullah, 2023);
- The supply chain disruptions, either by slowing or temporarily stopping the flow of raw materials and finished goods, thus inducing manufacturing disruption as well (Moosavi, Fathollahi-Fard, & Dulebenets, 2022). These changes were also connected with the labour demand decline and the rise of unemployment, with significant socio-economic consequences (Coibion, Gorodnichenko, & Weber, 2020).

On the side of the long-run economic effects of the pandemic, one can underline several important consequences, which Stiglitz (2021) referred to as a hysteresis effects. First of all, the widespread bankruptcies due to the aggregate demand decline resulted in the long-run loss of human, organisational and informational capital which cannot be restored in the short term. The pandemic also resulted in the investment decline with the long-lasting effects on the output dynamics. Finally, the increased uncertainty induced the rise in precautionary savings, which aggravate the chances for investment-savings balance in the long term.

The fiscal response to the pandemic in most economies was ample and has reached almost unprecedented levels (Figure 2). In the advanced economies, the general government debt levels reached their historical peaks during World War II. In emerging economies, the public debt exceeded 60 percent of the GDP which was the historically highest level. In addition, the monetary policy (especially in advanced economies) was highly accommodative, with the interest rates almost reaching the zero lower bound.

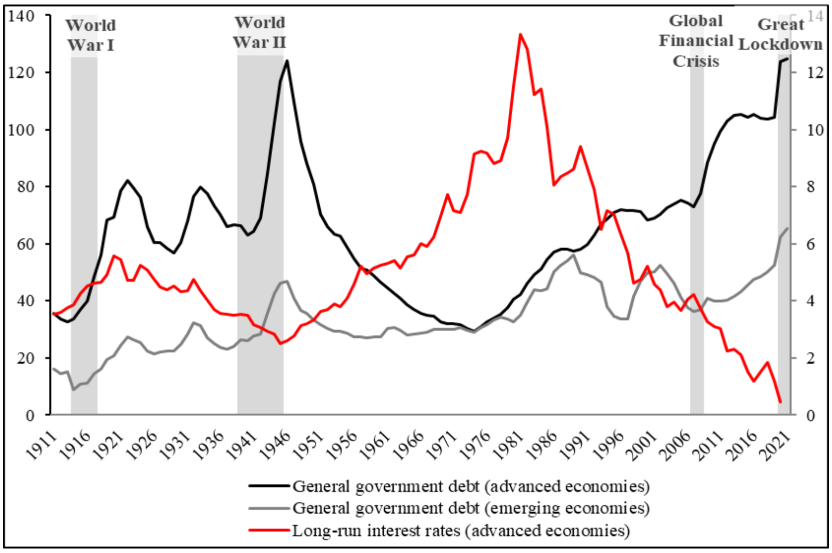

Figure 2. Historical patterns of general government debt (% of GDP, left scale) and interest rates (right scale)
Note: The aggregate public-debt-to-GDP series for advanced economies and emerging market economies is based on a constant sample of 25 and 27 countries, respectively, weighted by GDP in purchasing power parity terms.
Source: Author, based on the data from International Monetary Fund (https://www.imf.org/en/Publications/FM)

It was clear that deficit spending was unavoidable to stimulate aggregate demand and prevent the pandemic's economic consequences from being more severe. The classical approach to public debt management, based on sound finance and fiscal discipline, had to be temporarily abandoned. Policymakers around the globe resorted to Keynesian measures of fiscal expansion, hoping that the increases in public spending would have expected multiplier effects on economic activity (Mihajlović, 2023).

A more liberal approach to public debt management also contributed to the reaffirmation of some of the neglected theoretical concepts, such as the theory of functional finance and Modern Monetary Theory, both founded in the Post-Keynesian theory. The concept of functional finance (Lerner, 1943) predicts that the state should primarily take care of economic stability and that the balance of the state budget may be disturbed in the short and medium term. The government utilises fiscal tools such as taxation and spending to regulate economic activity and achieve desired outcomes. This approach suggests that deficits or surpluses should be used strategically to meet economic objectives, such as promoting growth, reducing unemployment, or controlling inflation. Short- and medium-run deviations from a balanced budget are only a *means* to achieve these fundamentally important goals in the long-run (Skott, 2016). Abba Lerner proposed several principles of functional finance that harmonise public spending and tax revenues to achieve the level of aggregate demand necessary to achieve full employment. As long as an economy has unused resources, such as unemployed labour or idle production capacity, the government can pursue deficit spending to stimulate demand and put these resources to work. Conversely, during periods of inflation or excessive demand, the government can implement fiscal measures to reduce spending and cool down the economy (Skott, Costa Santos, & Oreiro, 2022).

Modern monetary theory assumes that the state faces a different budget constraint than households. If the state has a monopoly on issuing its own currency (monetary sovereignty) there will be no financial restrictions for the implementation of fiscal policy (Tymoigne & Wray, 2015; Tymoigne, 2021). The only issue for the state is to create sufficient public debt necessary for accomplishing the macroeconomic goals – full employment and adequate investment level. The employed production capacity in the economy determines the capacity for money absorption, meaning that inflation will be relatively low as long as the economy is below its potential output (full employment level). MMT also argues that the interest rates will not increase with the rise in budget deficit since the money from public spending will be transferred to the private sector and finally to the banking system. If the economic subjects' investment decisions are impacted by the future economic outlooks rather than the price of borrowing money (interest rate), the changes in the interest rates will not significantly affect economic activity (Taylor, 2019).

As the pandemic led to a significant rise in unemployment, some other points of the MMT theory also became the subject of academic debate. One of them is related to the job guarantee system, as a form of countercyclical automatic stabiliser (Mitchell & Wray, 2004). The government should act as the employer of last resort and provide a job for everyone able and available to work and cannot find a job in the labour market. According to the MMT advocates, the government can provide full employment by following job guarantee schemes even in periods of low aggregate demand.

While financing public spending through money creation might seem advantageous during exceptional circumstances like the current pandemic, such actions can bring significant limitations. One prominent concern is the potential for inflation, especially when the money supply grows rapidly, possibly escalating into hyperinflation. The recent uptick in inflation across many economies has largely been attributed to temporary factors like surging energy prices, supply chain disruptions, and geopolitical tensions such as the Ukrainian crisis. These factors are not directly influenced by raising interest rates, which partly explains the delay in monetary authorities' response in that direction. However, regardless of the inflation's root cause, there is a genuine risk that it could fuel demands from labour unions for higher wages, thereby perpetuating further price increases and sparking an inflationary cycle.

The ongoing discourse surrounding the legitimacy of Modern Monetary Theory (MMT) is notably contentious. Within academia, there exist both advocates (for instance, Tymoigne, 2021; Kotilainen, 2022;) and critics (e.g. Prinz & Beck, 2021; Drumetz & Pfister, 2021). However, some academic economists argue that there still exist some fundamental assumptions shared by both mainstream macroeconomics and the concept of functional finance and MMT (Jayadev & Mason, 2018):

- Short-term output is determined by aggregate demand;
- In the short term, unemployment decreases as output increases, while inflation tends to rise;
- There exists an equilibrium level of output where both inflation and unemployment are at acceptable rates – potential output or full employment. Deviations below this level result in higher unemployment and deflation, while deviations above lead to lower unemployment but higher inflation, as described by the Phillips curve relationship;
- Aggregate demand is influenced by factors such as the interest rate and the budget position. Lower interest rates and larger fiscal deficits typically stimulate higher aggregate demand and output, and *vice versa*;
- Changes in the debt-to-GDP ratio over time are determined by the current fiscal position (primary balance), the interest rate on existing public debt, and the nominal GDP growth rate.

Hence, it seems that both models share the common objectives of macroeconomic policy: closing the output gap (where unemployment is low and the inflation rate is stable) and maintaining sustainable public debt (ensuring the debt-to-GDP ratio remains at or below its current level). However, the primary distinction lies in which policy—monetary or fiscal—should be employed to achieve these goals. In the mainstream perspective, monetary policy is seen as the tool for stabilising output, while fiscal policy is geared towards managing debt. Conversely, functional finance and MMT advocate for the opposite approach: fiscal policy should handle aggregate demand management, while monetary policy should focus on ensuring public debt sustainability (Jackson, Jackson & Lerven, 2022). This is particularly relevant in high-debt environments since the disinflation policy by increasing interest rates would necessitate cutting public spending to prevent further debt accumulation, which could exacerbate economic contraction. In such cases, fiscal contraction alone is often deemed the more prudent solution.

THE IMPLICATIONS OF THEORETICAL DEBATES FOR ECONOMIC POLICY IN A POST-PANDEMIC PERIOD

After the Global Recession, and especially during the pandemic crisis, policymakers viewed fiscal policy measures as the most powerful solution to alleviate severe economic contraction. Undoubtedly, extensive public expenditures across nearly all nations played a role in mitigating the adverse effects of the pandemic. Although the severity of the crisis justified a 'whatever it takes' approach, the effects of the implemented measures may have long-lasting effects and result in negative tendencies in the post-pandemic era.

One of the problems that could arise is related to the negative effects of applying increasingly popular approaches to economic policy, such as MMT, in developing countries. For instance, one of the main tenets of the MMT is that a government with control over its own currency cannot default in that currency. Although it can be accepted in principle, the government can still face default in foreign currency and may resort to austerity measures to rectify external imbalances, which especially holds for developing countries. To manage foreign-currency debt and prevent external crises that could necessitate domestic austerity, exports must outpace interest payments on foreign debt (Vernengo & Pérez Caldentey, 2020).

Another limitation of MMT is its applicability primarily to economies with monetary sovereignty, such as the USA, Great Britain, or Japan, where the government can issue and borrow in its own currency. The European Central Bank operates differently from the central banks of Japan or the USA, functioning as a supranational institution responsible for a unified monetary policy, while fiscal policy remains within the purview of national authorities in member states (Begg, 2021). Additionally, as the world's reserve currency, the U.S. dollar enjoys more advantages than the euro, resulting in different economic implications for public debt monetisation.

One of the most important implications of the MMT for economic policy in advanced economies is related to the public expenditure financing through substantial fiscal deficits and the accumulation of public debt. This concept can be challenged from mainstream macroeconomics point of view (Boone, Fels, Jorda, Schularick, & Taylor, 2022). For instance, the traditional Phillips curve theory (as well as the New Keynesian variant, embraced by NCM) provides an empirically founded explanation that fiscal stimulus can lead to overheating in both goods and labour markets, resulting in upward pressure on prices (Lastauskas & Stakėnas, 2020; Hooper, Mishkin & Sufi, 2020). This effect could be more pronounced in emerging economies due to lower market flexibility. The second problem of the MMT-based economic policy occurs when extensive debt levels constrain central banks from implementing tighter monetary policies to counter inflation, leading to higher risk of public debt monetisation and so-called *fiscal dominance*. As a consequence, monetary and fiscal expansions exacerbate cyclical pressures and inflationary expectations, thus driving up the actual inflation rate. The concept of fiscal dominance also leads to another perspective on debt-driven inflation, known as the fiscal theory of the price level (Woodford, 1994; Leeper & Zhou, 2021; Sakai, 2024), which proposes a direct correlation between government debt and inflation. According to this theory, whether increasing fiscal deficits lead to higher inflation hinges on whether the private sector believes the government will eventually balance its budget by running surpluses in the future.

In addition, central banks, notably in advanced economies, face pressure to hike interest rates to address inflation, leading to a conflict between their dual objectives of managing both inflation and financial stability. The private sector heavily relies on central bank liquidity, resulting in a situation where concerns about financial stability limit the effectiveness of monetary policy, a phenomenon termed *financial dominance*. This situation implies that tightening monetary policy could disrupt the financial sector and heighten the economy's vulnerability to minor disturbances (Benigno, Canofari, Di Bartolomeo, & Messori, 2021). The extent of this financial reliance depends on the adequacy of private banks' capitalisation and the efficiency of private bankruptcy proceedings, thereby complicating the task of central banks in reducing inflation without precipitating a recession and somewhat undermining their practical independence.

The recent experience indicates that fiscal policy is essential for macroeconomic stabilisation when interest rates are low. Yet, even if full employment is attainable with a certain fiscal approach, there is a risk that very low interest rates could lead to excessive borrowing and jeopardise financial stability. These perspectives mark a departure from orthodox viewpoints, suggesting that countries may have more flexibility in fiscal space as fiscal expansions can enhance sustainability by boosting GDP more than debt and interest payments.

CONCLUSION

The Global Recession and the COVID-19 pandemic have challenged conventional wisdom regarding economic policy advocating fiscal prudence and neutrality. The severity of these crises necessitated a paradigm shift, leading policymakers to embrace expansive fiscal measures as a means of mitigating economic downturns.

The pandemic highlighted the potency of fiscal policy in combating severe economic contractions. Governments worldwide deployed unprecedented levels of public spending to alleviate the adverse impacts of the crisis. Yet, while these measures were crucial at that moment, their long-term implications merit careful consideration.

The rise of alternative economic paradigms, such as Modern Monetary Theory (MMT), presents both opportunities and challenges for economic policymaking, especially in developing countries. MMT's applicability varies across economic systems, with its principles more readily adaptable to economies with monetary sovereignty. However, challenges arise in regions lacking such autonomy, where external factors and geopolitical dynamics play significant roles in shaping fiscal and monetary policy. Additionally, concerns persist regarding the potential inflationary consequences of extensive public expenditure financed through fiscal deficits and increased debt levels. Furthermore, the interplay between fiscal and monetary policy complicates efforts to address inflationary pressures without jeopardising financial stability. Central banks face a delicate balancing act in managing inflation while ensuring the resilience of the financial sector. The recent experience underscores the importance of fiscal policy in macroeconomic stabilisation, particularly in environments where traditional monetary tools may prove ineffective.

Looking ahead, confidence in government institutions will be paramount in navigating the economic challenges posed by mounting debt levels and inflationary pressures. Advanced economies with robust institutions and a history of low inflation may have more leeway to sustain deficits and invest in long-term growth-enhancing initiatives. However, maintaining fiscal discipline and addressing structural imbalances will remain critical to ensuring economic resilience and sustainability in the post-pandemic era. The evolving landscape of fiscal policy necessitates a nuanced approach that balances short-term stabilisation measures with long-term sustainability goals. While the COVID-19 pandemic has underscored the importance of fiscal intervention in times of crisis, a careful consideration of the broader economic implications is essential to fostering stable and resilient economies in the years to come.

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САВРЕМЕНЕ ТЕОРИЈСКЕ РАСПРАВЕ О ЕКОНОМСКОЈ ПОЛИТИЦИ: ПОУКЕ ЗА ПОСТПАНДЕМИЈСКИ ПЕРИОД

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Резиме

Економски поремећаји током 21. века у више наврата су доводили у питање валидност приступа економској политици у оквиру главног тока економске мисли. Глобална финансијска криза настала 2007. и, последично, Велика рецесија 2008., разкриле су недостатке доминантног макроекономског модела (Нови консензус у макроекономији) у погледу регулисања финансијског тржишта и системског управљања ризицима. У условима ниских каматних стопа, монетарна политика је испољила своје слабости, па се решење нашло у фискалној експанзији. Економска криза узрокована пандемијом COVID-19 поново је покренула академску дебату о исправности важеће макроекономске парадигме и на њој засноване економске политике. Снажна фискална експанзија довела је до раста јавног дуга у напредним економијама и у земљама у развоју, намећући додатне проблеме и отварајући нова питања.

Измена приступа економској политици као одговор на економску кризу услед пандемије довели су до афирмације неких од претходних теоријских приступа, као што су концепт функционалних финансија и Модерна монетарна теорија. Оба приступа заговарају интензивну фискалну експанзију и напуштање принципа „здравих“ финансија ради постизања макроекономске стабилизације. Међутим, ограниченост примене ових концепата у земљама у развоју, као и у већини развијених земаља које немају монетарни суверенитет, сужава могућност да ови приступи обликују начин вођења економске политике у савременим условима.

Сходно томе, у раду се евалуира приступ економској политици заснован на моделу Новог консензуса у макроекономији у контексту последње две глобалне економске кризе. Овај приступ, који се, у зависности од околности, кретао између кејнзијанског и неокласичог екстрема, претрпео је извесне модификације под утицајем економских поремећаја. Једна од најзначајнијих је реафирмација значаја фискалне политике, која представља ефикасно средство регулисања привредних токова, а не само решење које треба применити током кризе, када је дејство монетарне политике ограничено. У раду се разматрају и проблеми везани за примену експанзивне фискалне политике у циљу спречавања дубље рецеције услед пандемије, а који су везани за проблем раста јавног дуга и настанак фискалне доминације. Истиче се да овај проблем, између осталих, представља значајно ограничење за ефикасну регулацију инфлаторних притисака. На основу тога, износе се аргументи у прилог примени адекватне комбинације монетарне и фискалне политике која би превазишла све недостатке појединачних мера.