Vladimir Mihajlović*
E-mail: vmihajlovic@kg.ac.rs

MACROECONOMIC POLICY RESPONSE TO PANDEMIC: A PARADIGM SHIFT IN SIGHT?

Abstract: Economic disturbances are always an opportunity to check the validity of an economic theory or paradigm. In the case of the COVID-19 pandemic, an interesting question arises: whether monetary and fiscal policy responses were aligned with a dominant macroeconomic paradigm (New Consensus Macroeconomics) or we are witnessing a paradigm shift to some extent? The analysis in this paper aims to address this question by showing how the abandoning of the sound finance principle due to pandemics opened a room for reaffirmation of the functional finance approach and Modern Monetary Theory. Deficit financing of the aggregate demand was a necessity concerning economic disorder induced by pandemic and the evident inability of monetary policy to address this problem alone due to the liquidity trap. It confirms the rule that, as in all recent economic crises, Keynesian-type economic measures were implemented. Therefore, at least a slight change in the mainstream macroeconomic model regarding the treatment of the fiscal policy and the role of public debt management is suggested. The main conclusion is that the approach to economic policy and the coordination of the monetary and fiscal measures should be upgraded to provide more flexible mechanisms to respond to economic disturbances. Their role would be to ensure a more prompt reaction without previous considerations through the lens of fiscal discipline. Furthermore, the role of fiscal policy should be broadened from traditional public debt management to aggregate demand management, whereas monetary policy could be also used for a temporary reduction of debt burden.

KEYWORDS: MACROECONOMIC POLICY, COVID-19 PANDEMIC, FUNCTIONAL FINANCE, PUBLIC DEBT MANAGEMENT

JEL CLASSIFICATION: B22, E12, E63, H63

* University of Kragujevac, Faculty of Economics, Republic of Serbia

1. INTRODUCTION

The history of economic thought witnessed a number of economic disturbances and crises that serves as a good indicator of the validity of ongoing theory or paradigm. For instance, Great Depression questioned the importance of classical economic theory founded on Say's law and liberalism thus opening the room for Keynes' economic ideas. Stagflation in the 1970ies led to the abandoning of the Neoclassical Synthesis model and opened a scene for neoclassical counterrevolution. The period of significant economic stability, called Great Moderation, marked the time span from the 1980ies to the Great Recession of 2008, and the New Consensus Macroeconomics paradigm become the mainstream. Finally, about a decade after this crisis, a new economic recession emerged, generated by the COVID-19 pandemic, raising the question about the validity of the ongoing paradigm.

This relatively long period of macroeconomics development can be observed as relatively discontinuous since it has been interrupted by several theoretic revolutions/counterrevolutions, mainly induced by economic disturbances. In that way, these events served as indicators of the validity of a particular theoretic paradigm and economic policy approach based on it.

The ongoing pandemic resulted in one of the most severe economic recessions, producing significant changes in economic policy worldwide. The fiscal discipline principle which was paramount till the Great Recession and after, in the form of fiscal consolidation, turns to be too rigid to current conditions. The enormous reduction in aggregate demand, coupled with the interruptions in aggregate supply chains, demanded an aggressive economic policy response. Since the room for monetary policy changes was narrowed due to unprecedentedly low interest rates, the solution was found in expansionary fiscal policy, mainly in the form of large government spending. In some other conditions, these measures probably would not be implemented on that scale, but the ongoing crisis exhibited the necessity for financing different programs of aggregate demand stimulation in order to prevent a dramatic fall in economic activity. As a corollary, huge fiscal deficits emerged. However, the condemnation of the economics profession was mainly absent, indicating that some shifts in the macroeconomic paradigm are maybe in sight.

This paper tries to enlighten how macroeconomic orthodoxy looks at these recent events and to respond to whether there are some indications about the potential shift in macroeconomic theory. Since the reaffirmation of some previous economic concepts, such as functional finance and Modern Monetary Theory are more and more present in economic discourse, the analysis in the paper strives to critically

evaluate their potential to become a part of the dominant macroeconomic paradigm. Finally, some implications of economic policy response to pandemic and the changes in economic theory on the macroeconomic paradigm were analyzed in order to come to valid conclusions.

2. STATE OF THE MACROECONOMIC THEORY PRIOR TO PANDEMIC

The period of prolonged economic stability in developed economies since the mid 1980ies (so-called Great Moderation) resulted in the convergence of different macroeconomic schools of thought, leading to the establishment of the New Consensus Macroeconomics in the 1990ies. It became a dominant macroeconomic paradigm based on several principles:

- in the macroeconomic model, output and employment fluctuate around the potential level as a result of unexpected aggregate demand and supply shocks. The system reacts to these shocks by changing the output and employment in the short term;
- real effects occur due to price rigidity, as a result of the goods and labour market imperfections and the resistance of economic subjects to price changes;
- a change in the money supply has real effects in the short term, and the non-neutrality of money is due to a slower price adjustment compared to changes in monetary policy instruments (most often nominal interest rates);
- in the long run, monetary and fiscal policy measures cannot permanently affect potential output and the natural unemployment rate, but only price growth. After short- and medium-term adjustments, the system returns to long-term equilibrium. This balance may be the same as before the shock, or a new long-term equilibrium may be established;
- economic policy should be based on rules. In the case of more permanent fluctuations in economic activity, the intervention of economic policymakers is necessary and should be directed to both the demand and supply sides. In such a way, it is possible to minimize the deviations around the potential output and the targeted inflation rate.

Fiscal policy in the NCM model should be conducted by respecting the intertemporal budget constraint, which requires that the present discounted value of current and future government spending be equal to the present discounted value of all current and future tax revenues. This is a condition that should be achieved in the long term, while short-term deviations are allowed depending on the circumstances in the economy. Therefore, it is necessary that future surpluses in the budget be at least

equal to the net public debt. It is based on the assumption that the government faces similar budget constraints as other economic entities. In other words, it is considered that the government's ability to finance spending does not differ fundamentally from those available to households and businesses.

In the dominant macroeconomic paradigm, priority is given to monetary rather than fiscal policy. It is a result of the recognised benefits of applying the inflation targeting regime, in the form of achieving price stability and mitigating the time inconsistency problem. The framework of the monetary policy includes relations that represent the monetary rule, that is, the way the central bank adjusts the interest rate, reacting to the deviations of the target variants from the target values.[1]

The period prior to the Great Recession of 2008, however, witnessed unprecedentedly low interest rates which made a room for monetary policy intervention extremely narrow. The expansionary fiscal policy measures were conducted in order to prevent a more serious recession. Although the fiscal policy role in the period of the crisis was different compared to its position in the NCM model, in the post-crisis period the status of fiscal policy, especially discretionary one, was unchanged. On the other hand, the issues related to the treatment of the financial system in economic disturbances were brought to the surface, due to the fact that it could be an initiator of the crisis, not only to amplify the effects of disorders which came from other sources. Accordingly, the period of more than a decade between the Great Recession and the COVID-19 pandemic was marked by necessary modifications of the dominant macroeconomic model and economic policy based on it.

3. ECONOMIC POLICY RESPONSE TO PANDEMIC

The COVID-19 pandemic represents a significant exogenous shock to global economic activity. The unexpected duration of the pandemic led to severe economic consequences. The fall in output, rise in unemployment, aggravation of external and fiscal position, and inflation in almost all economies are only some of these corollaries.

The crisis due to pandemics is different from the previous ones. For instance, the Great Recession of 2008 was initiated in the financial system, more precisely in the mortgage market, and these disturbances overflowed into the economy resulting in

[1] King (2002), p. 162.

the economic recession. In the case of an ongoing pandemic, the social distancing measures and the lockdown in many economies resulted in a dramatic decrease in aggregate demand. At the same time, the aggregate supply side has also been affected since a number of economic subjects reduced or completely stopped their economic activity. The pandemic didn't affect all economic sectors equally and sectors more dependent on personal contact were particularly hit. Hence, the pandemic provoked shocks on both the demand and supply sides.

The negative effect of a pandemic on the economy was exhibited through three channels[2]. The first is the direct impact related to the reduction of spending on goods and services. This impact was aggravated by social distancing measures and the consumers' pessimism regarding future prospects. The second channel refers to the indirect impact, contained in the disturbances in financial markets which were transferred to the economy. Some of these disturbances are connected with the reduction of households' wealth and the decrease in spending. The third channel is manifested through supply-side disorders in the form of supply chain interruptions, a fall in labour demand and, consequently, the rise of unemployment. As these changes in the labour market have significant socio-economic corollaries by affecting working time and employment, this channel was a subject of the numerous empirical research[3].

All these effects can be observed in the short run. However, the pandemic also induced some long-lasting consequences, usually referred to by economists as a hysteresis effects. For instance, Stiglitz distinguishes three kinds of these phenomena. First, the hysteresis resulted from widespread bankruptcies, which has set of corollaries, such as a huge loss of human, organizational and informational capital. The long-lasting effects occur as the significant amount of time is necessary to restore these features once the pandemic is over. Second, the pandemic led to changes in corporate balance sheets that resulted in diminished willingness to invest and even produce, in some cases. Finally, the significant reduction of the households' spending on durables, as a consequence of decreases in income and wealth, led to the fall in aggregate demand and rise in precautionary savings[4]. All these effects make the post-pandemic recovery process more long-lasting and call for adequate economic policy response.

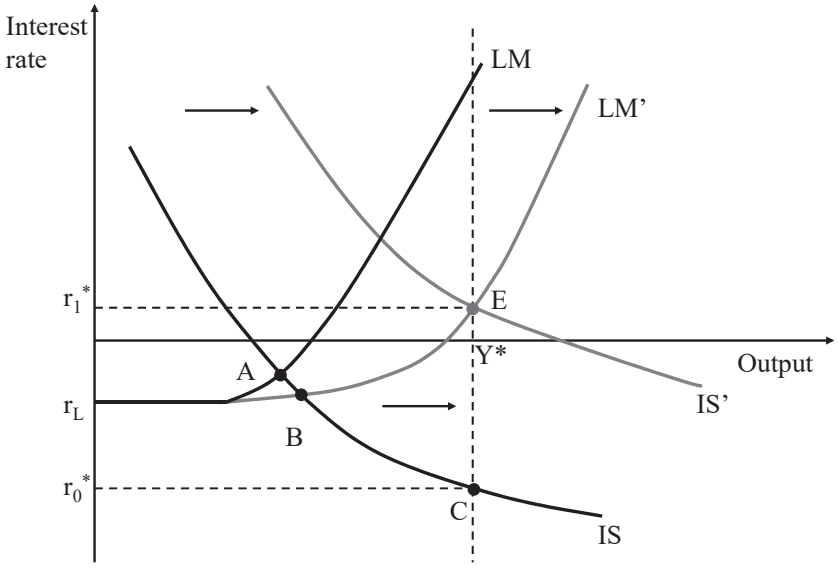
[2] Carlsson-Szlezak (2020).

[3] For instance, the following studies can be mentioned: Adams-Prassl et al. (2020, April 23); Coibion et al. (2020); Kahn et al. (2020); Rojas et al. (2020).

[4] Stiglitz (2021), p. 4.

The response to a pandemic in the conditions characterized by low interest rates, which was the case in the majority of economies, had to be based on strong fiscal expansion. Namely, when the inflation rate is low (as in the first year and a half of the current pandemic), the real interest rate can also be low or negative in the case when the nominal interest rate is near zero. In a number of economies, actually, the real interest rate was at the level of effective lower bound (r_L), which ensures a kind of equilibrium which is, however, characterized by excessive savings[5]. In other words, the effective lower bound rate, although it can be negative, is still above the so-called equilibrium real interest rate (r_0*). It means that the point of intersection between IS and LM curves will be below the potential output, Y*, in point A (Figure 1). In these conditions, the monetary expansion would move the LM curve to the right and point B will be the new equilibrium. However, this point still reflects the negative output gap which cannot be solved only by monetary policy measures. Therefore, by a massive fiscal expansion which would move the IS curve to the right, it will be possible to establish the equilibrium at the potential output level, although it would probably increase the real interest rate. Having in mind the recent increase in the inflation rate, it is clear that the net effect on the real interest rate will be uncertain and it will determine the investment and saving dynamics in the medium term.

Figure 1 *Policy mix at the Effective Lower Bound*



Source: Buti and Papaconstantinou (2021), p. 5

[5] Buti and Papaconstantinou (2021), p. 5.

Table 1 *Fiscal response to pandemic in selected economies in the period January 2020 – October 2021.*

Country	Billions USD	% GDP	Economic growth in 2020.	Economic growth in 2021.
USA	5328	25.5	-3.4	5.6
Great Britain	522	19.3	-9.7	6.9
Australia	250	18.4	-2.5	3.8
Greece	33.1	17.5	-9.0	8.3
Japan	844	16.7	-4.6	1.8
Germany	589	15.3	-4.6	2.9
Austria	65.7	15.2	-6.7	4.5
Serbia	6.4	12.2	-0.9	7.4
Hungary	17.8	11.5	-4.7	7.1
Italy	205	10.9	-9.0	6.6
Slovenia	5.2	9.4	-4.2	8.1
Czech Republic	22.6	9.2	-5.8	3.3
Brazil	133	9.2	-4.4	5.0
Poland	38.5	6.5	-2.5	5.7
Slovakia	6.3	5.9	-4.4	3.0
Bulgaria	3.7	5.3	-4.4	4.2
Russia	74	5.0	-2.9	4.3
China	711	4.8	2.3	8.2
Croatia	2.6	4.6	-8.1	10.4
European Union	488	3.8	-5.9	5.3
Denmark	12.2	3.4	-2.1	4.1
Romania	8.5	3.4	-3.7	5.9
WORLD	10.793	10.2	-3.4	5.6

Source: Fiscal Monitor 2021, Eurostat Database, OECD Database.

Note: According to the IMF classification, the fiscal response covers an additional increase in public spending and the tax revenue reduction directed to the health and non-health sectors. The EU data do not refer to the sum of particular spending of the member states but the spending of the EU as a supranational entity.

When observing the real data about the extent of the fiscal response to the pandemic, one can conclude that it was unprecedented in the majority of countries. For instance, in the period of about a year and a half more than a quarter of the GDP in the USA has been spent on the support of public spending programs. A similar

situation is in the case of other countries with monetary sovereignty, such as Great Britain, Australia, and Japan. In the selected eurozone countries, such as Greece, Germany, and Austria, the fiscal response was also significant, spanning between 15 and 17.5 per cent of the GDP. On the other hand, the rest of the countries, except Serbia, Hungary, and Italy, spent less than 10 per cent of GDP on these measures. If one observes the fourth column of Table 1, it is evident that the most severe economic fall was in the case of G. Britain, Italy, Croatia, Austria, and the Czech Republic. The rest of the observed countries faced a GDP reduction of less than 5 per cent. The GDP reduction in Serbia was the lowest among observed countries, while the economy of China succeeded to achieve positive economic growth in 2020. In the next year, the recession was formally ended as all observed countries exhibit positive growth rates.

Large fiscal responses around the globe launched a question about fiscal deficit financing. The mainstream macroeconomics stance says that the increase of the share of public debt in the GDP above a certain threshold will probably negatively affect economic growth in the long run. However, in the case of a pandemic, the "whatever it takes" approach was implemented in order to prevent losses of lives in the first place, and then a deep recession and unemployment increase. The corollary of these economic policy actions was that the debates about necessary shifts in the dominant macroeconomic paradigm were much more frequent.

4. IMPLICATIONS OF THE PANDEMIC FOR MACROECONOMIC THEORY AND POLICY

Ample fiscal response to the pandemic in the majority of economies has induced the debate among economists about public finance stability and the potential ways excessive public debts can affect economic conditions. In economic theory, two general approaches to public debt management can be distinguished: classical and Keynesian. The classical approach insists on fiscal discipline as the impact of fiscal policy is limited. In addition, high levels of public debt can slow down economic growth. In other words, this approach gives an advantage to the so-called neutral or sound finance. Fiscal policy is limited due to the crowding-out effect and the Ricardian equivalence theorem. Crowding out can emerge when the emission of state bonds increase the competition in financial markets, thus reducing their price and increasing the interest rate. This imposes higher borrowing costs for the private sector and results in the reduction of private investments. In that way, the rise in public spending crowds out private investments. However, in contemporary conditions, this situation is not so likely, since the short-run interest rate is controlled

by the central bank. The Ricardian equivalence reflects the case when a private sector increases its savings as a reaction to public debt growth since it assumes that the debt will be paid by increasing the tax rates. Although this principle has become a part of modern macroeconomic modelling based on the Dynamic Stochastic General Equilibrium (DSGE) models, its influence is rather limited as a number of preconditions should be fulfilled.[6]

The classical approach to public finance also presumes that public debt should be kept at a "safe" level in the medium term. There is no alternative to fiscal discipline since it improves the credibility of fiscal policy and allows the creation of sufficient fiscal space, i.e. the capacity of the state to borrow in the case of economic disorders. In addition, this approach distinguishes monetary and fiscal policy functions: monetary policy is directed to aggregate demand management in order to achieve economic stability, whereas fiscal policy is used for public debt management.[7]

Keynesian approach to public finance stems from the stance that economic recessions are primarily the consequence of insufficient aggregate demand. It should be stimulated by the increase in public spending which has a multiplier effect on economic activity, thus generating higher tax revenues. Therefore, the Keynesians support deficit aggregate demand financing when it is necessary as it can prevent economic downturns and unemployment which are much more serious problems than the deficit itself.

Having in mind the economic consequences of the pandemic, deficit spending is seen as an unavoidable way to increase aggregate demand. This approach also promoted the reaffirmation of some previous theoretical concepts developed within the Keynesian and Post-Keynesian frameworks, such as functional finance and Modern Monetary Theory (MMT). The functional finance concept was developed by Abba Lerner (1903-1982) who believed that the state should primarily be concerned about economic stability and employment, which might be achieved at a cost of losing public finance stability in the short run. Full employment, price stability and a decent standard of living represent the fundamental macroeconomic goals and the state is the one which should promote its achievement. Accordingly, the efficiency of economic policy should be evaluated based on its success in accomplishing these goals, while some temporary deviations from the balanced budget should not be observed as so significant. In other words, the principles of

[6] Jackson et al. (2022), p. 5.
[7] Jackson et al. (2022), p. 20.

sound finance should not be followed all the time.[8] Instead, Lerner proposed the so-called functional finance principle, which states that the government should align public spending and tax revenues in a way that the aggregate demand is enough to ensure the total output is realised at full employment and current prices. Budget deficit and monetary expansion are the *means* for accomplishing the main goals, full employment and price stability.

The MMT approach emerged mainly within the functional finance concept and Post-Keynesian theory. It presumes that the budget constraint of the state is quite different from the households' budget constraint. More precisely, there is no financial constraint in the implementation of fiscal policy as the state has a monopoly in issuing its currency (in other words, the state can borrow in its own currency). Accordingly, the main goals of the economic policy – the economic and price stability can be achieved by creating sufficient public debt. The economy's capacity for the absorption of money is determined by the employed production capacity and the risk of inflation is low as far as the economy is below full employment level. In addition, MMT presumes an increasing budget deficit, *ceteris paribus*, will not induce the growth of interest rates. Namely, the rise of public spending creates more money in the private sector which will finally find its place in the banking system. The adjustment of the interest rates will not significantly affect economic activity as economic actors make their investment decision based on future prospects rather than on the price of borrowing money.[9]

MMT also insist on the countercyclical role of the automatic stabilisers, especially on the job guarantee system.[10] The government should become the employer of last resort and provide full employment regardless of the aggregate demand level.[11] Among other automatic stabilisers, the MMT proponents prefer the automatic adjustment of the tax rates in order to regulate the quantity of money in the economy, especially if it approaches full employment. In contrast to conventional understanding, MMT assumes that public spending is financed by issuing money and taxes should be used to withdraw the excess liquidity to prevent inflationary pressures.

Although in exceptional circumstances, such as the current pandemic, it may seem that financing public spending by money creation is a good solution, such measures

[8] Lerner (1943), p. 354
[9] Taylor (2019), p. 7.
[10] Chohan (2020), p. 9.
[11] Mitchel and Wray (2004), pp. 2-3.

can be accompanied by significant limitations. The most visible of them is manifested in the inflation rate, which in conditions of high growth rates of the money supply can turn into hyperinflation. The ongoing inflation rise in most economies was generally assessed as temporary, resulting from increased energy prices and interruptions and re-establishments of supply chains, but also geopolitical tensions (the Ukrainian crisis). None of the mentioned causes can be directly influenced by increasing interest rates, which to some extent explains the delay in the reaction of the monetary authorities in this direction. However, regardless of the cause of inflation, one must keep in mind the real possibility that the rise in prices will eventually be incorporated into the demands of labour unions for increased wages, which may consequently increase prices further and lead to the emergence of an inflationary spiral.

In this sense, MMT's proposals regarding the financing of public spending through the creation of high fiscal deficits and the accumulation of public debt can be challenged by mainstream macroeconomics from at least three aspects. The first relates to the traditional concept of the Phillips curve, which emphasizes the importance of fiscal stimulus for overheating goods and labour markets, thus creating upward pressure on prices. The second emphasizes the importance of monetary factors combined with the dynamics of government borrowing. The stronger the link between monetary and fiscal authorities, the greater the likelihood of monetization of public debt and the risk of fiscal dominance, since high levels of debt may limit the ability or willingness of central banks to implement a more restrictive monetary policy against inflation. According to this understanding, monetary and fiscal expansion lead to the intensification of cyclical pressures and the rise of inflationary expectations, which together increase the real inflation rate. The third explanation is based on the fiscal theory of the general price level and more directly emphasizes the link between unsustainable fiscal policy and inflation. If the private sector loses confidence in the government's ability or willingness to cover current deficits by generating surpluses in the future, private consumption may increase as the population no longer expects future tax rate increases. This creates cyclical pressure and also increases inflationary expectations as inflation is seen as the only way to make debt sustainable.[12]

[12] Boone et al. (2022), pp. 78-79.

It is evident that the current debate about the validity of MMT is very heated. There are academic proponents and opponents[13]. However, there are also academic economists stating that there are no so much differences between the orthodox model and MMT. Indeed, there is a set of key assumptions that are in common to both mainstream macroeconomic and functional finance (MMT) concept: 1) short-run output is determined by the level of aggregate demand; 2) In the short run, unemployment is a decreasing (whereas inflation is an increasing) function of the output level; 3) The output can be at a certain level which assumes that both inflation and unemployment have admissible rates. It is a case when the output is at potential (full employment) and prices are stable. The deviation below this level of output is connected with higher unemployment and deflation whereas the deviation above this level implies lower unemployment but higher inflation (Phillips curve relationship); 4) The level of aggregate demand depends on, inter alia, the interest rate as an instrument of monetary policy and the budget position as the instrument of fiscal policy. Lower interest rates and larger fiscal deficits are likely to produce higher aggregate demand and output and another way around; 5) The changes in the debt-to-GDP ratio over time are a function of the current fiscal position (the primary balance), the interest rate on existing public debt and the nominal GDP growth rate.[14]

Therefore, it appears that the two models are focused on the same goals of the macroeconomic policy – zero output gap (at which the unemployment is low and the inflation rate is low and stable) and sustainable public debt (meaning that the debt-to-GDP ratio remains at or below its current level). In contrast, the main difference remains regarding the question of which goal should be achieved by monetary and which by fiscal policy. As stated above, the classical view insists on monetary policy as a means of output stabilisation whereas the fiscal policy is directed at debt management. However, functional finance and MMT presume quite the opposite – fiscal policy should be devoted to aggregate demand management and monetary policy should be used in achieving public debt sustainability. It is especially true in the environment of high public debt. For instance, when the increased aggregate demand creates inflationary pressures, disinflation can be achieved by monetary or by fiscal contraction. In the case when the public and/or private debts are low, the increase in interest rates could be treated as a good solution. However, if the public and/or private debts are relatively high, interest rates increase will require a cut in public spending in order to prevent public debt to grow further, provoking

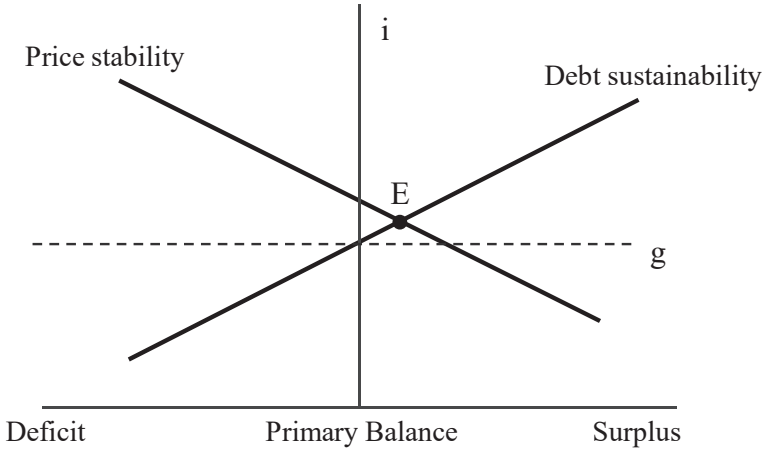
[13] For instance, the MMT is supported in following studies: Kotilainen (2022); Tymoigne (2021); Summa (2022). On the other hand, the criticisms of the concept can be found in: Leeper, (2022); Prinz and Beck (2021); Drumetz and Pfister (2021); Bossone (2020).

[14] Jayadev and Mason (2018).

additional contraction of economic activity. In that case, the better solution is to use fiscal contraction only.[15]

The relationship between the goals of economic policy and the instruments to accomplish them is presented in Figure 2. The "price stability" curve represents the combinations of interest rate and fiscal balance that satisfy the condition the output gap is zero, i.e. the inflation is stable and equal to the expected rate. The "debt stability" curve shows the combinations of interest rate and fiscal balance for which the change in the debt-GDP ratio is equal to zero. The points above and to the right of the price stability curve represent the cases when unemployment is high; the points below and to the left of this curve refer to cases when inflation is high. Likewise, at points below and to the right of the debt sustainability curve, the debt-GDP ratio is falling and vice versa at the points above and to the left of this curve. "g" stands for the real output growth rate.

Figure 2. *Goals and instruments of monetary and fiscal policy*



Source: Jayadev and Mason (2018).

Therefore, there are two policy goals (output gap and public debt change) and two policy instruments (interest rate and primary balance). The point of intersection of the two curves (point E) denotes the only combination of interest rate and primary balance position when both goals are accomplished. In other words, no matter what goal is assigned to which instrument, the final outcome of economic policy will be

[15] Jackson et al. (2022), p. 24.

the same in orthodox and MMT model. Accordingly, the differences between the two macroeconomic policy approaches can be diminished.

However, in order to induce the shift in the dominant macroeconomic paradigm, the MMT should provide a policy framework which can be implemented in various economic systems. One of the drawbacks of this concept lies in the fact it is feasible in economies with monetary sovereignty. These economies, such as the USA, Great Britain or Japan, may issue and borrow in their own currency. On the other hand, the countries which are in currency union don't have their own central bank. For instance, European Central Bank is organised in a different way than central banks in Japan or USA, since it represents a supranational institution focused on conducting common monetary policy, whereas the fiscal policy is under the jurisdiction of national authorities in member states.[16] Furthermore, as a world reserve currency, the U.S. dollar enjoys more privileges than the euro, for instance. It indicates different economic implications in the case of public debt monetisation. Accordingly, the postulates of the MMT have somewhat limited application in most economies, leading one to conclude that the potential to become a vital part of a New Consensus Macroeconomics is still under question.

5. CONCLUSION

The neoliberal tendencies in economic theory and policy resulted in glorifying fiscal discipline and sound finance principles, thus suppressing the ideas of functional finance. However, the severity of economic recession due to the pandemic requested the implementation of exactly such kind of principles, in order to prevent further fall in aggregate demand and deeper crisis.

The current circumstances, which forced even conservative fiscal policymakers to create high budget deficits and increase public debt in order to preserve economic stability, opened space for the reaffirmation of theoretical concepts such as functional finance and the MMT. Consequently, the paper evaluated the validity of the application of the mentioned framework of economic policy in countries with different levels of monetary sovereignty in order to show whether these concepts can become a part of the dominant macroeconomic paradigm.

As shown, the set of options available to fiscal policymakers varies significantly from country to country. In economies that can freely issue their currency and borrow in

[16] Begg (2021).

it, such as the USA, Great Britain, Japan, etc., there is much more room to finance extensive public spending to support the economy and the population. In accordance with the postulates of functional finance and the MMT, high deficits and the increase in public debt were assessed as second-order problems compared with the losses in production and employment. Consequently, the paper shows that such theoretical approaches can be applied in the mentioned countries, primarily in the USA. Moreover, taking into account the privileged position of the U.S. dollar in relation to other currencies, it is often pointed out that the MMT principles are actually already being applied. However, with such an assessment, possible negative effects must be taken into account, among which inflation is especially important, which in most developed countries has already recorded the highest values in the last few decades.

Having in mind the potential negative effects of their implementation, as well as the fact their usage in the majority of economies around the globe is rather limited, the functional finance concept and MMT still do have not enough potential to become a part of the dominant macroeconomic paradigm. Although the circumstances stemming from the ongoing pandemic induced a different approach to economic policy, it is not radically different from the current model and it appears to be unsustainable in the long run. Accordingly, there is still room for some modifications and improvements in the dominant macro paradigm, primarily tied to the relaxation of traditional roles of monetary and fiscal policies. As shown in the paper, depending on the ongoing conditions (the share of public debt, interest rates dynamics and so on), the policymakers should decide whether to use fiscal or monetary policy measures for aggregate demand and public debt management. In other words, the functions of monetary and fiscal policies should be more interrelated in order to achieve short- and long-run macroeconomic goals. In addition to these functions, the government should adequately respond to market imperfections by regulating externalities, promoting robust competition, guarding against exploitation, limiting market power, and providing social protection, which appears to be highly important in the pandemic era.

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