Pre-COVID economics post-COVID: 
teaching post-Keynesian theory in the aftermath of a pandemic

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This paper focuses on economics education after the COVID pandemic, since this crisis showed the importance of rethinking economics on both theoretical and policy-oriented grounds. The first section summarizes mainstream economics as taught in closely all the economics faculties around the globe. The second section explains the major flaws and shortcomings of pre-COVID economic theory and policy. The third section reveals that “fiscal consolidation” is a political constraint since, in fact, there is no budget constraint for the public sector. The fourth section explains that monetary policy has also a variety of distributional consequences that central bankers cannot ignore. The last section offers a conclusion for both the economics profession and policy makers all over the world.

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Introduction

This paper focuses on economics education after the COVID pandemic, since this crisis showed the importance of rethinking economics on both theoretical and policy-oriented grounds. As a matter of fact, such a pandemic clearly showed that economic activities in any countries around the world need somehow the support of the public sector, which is a major player within the economic system. Free markets, indeed, are subject to several shocks that can disrupt their orderly working, with a series of negative consequences for all market participants, be they households, firms or financial institutions.

In spite of this empirical evidence, mainstream economics still considers that the public sector’s intervention within the economic system must aim at two policy goals only: on one hand, it has to balance its own budget (over the business cycle, if not yearly), which means in practice cutting down public expenditures to make sure the latter can be financed only with tax receipts; on the other hand, the central bank has to guarantee price stability on the markets for produced goods and services, as this is considered instrumental for supporting economic growth.

In fact, this policy stance of both fiscal and monetary authorities is problematic for several reasons, as we will argue in this paper.
While there is much to discuss with respect to pre-COVID economics post-COVID, in this paper we will focus closely on only fiscal and monetary policies. We believe that in doing so, we take on two of the most important arguments of post-COVID economics. Combined, they deal a serious blow to the legitimacy of neoclassical economics.

The next section summarizes mainstream economics as taught in closely all economics faculties around the world. The third section explains the major flaws of pre-COVID economic policies. The fourth section reveals that “fiscal consolidation” is a political constraint because, in fact, there is no budget constraint for the public sector. The fifth section explains that monetary policy has also a variety of distributional consequences that central bankers cannot ignore. The last section offers a critical conclusion for both the economics profession and policy makers all over the world.

Mainstream economics in the twenty-first century

It is no exaggeration to claim that to date mainstream economics is pre-Keynesian, as it relies on a theoretical conception that goes back to the neoclassical school of economics (namely, the Walrasian general equilibrium theory). According to such an approach, any economic system is governed by market forces (notably, supply and demand), which are affected by the famous Say’s law (that is, “supply creates its own demand”), so that the public sector’s interventions should focus on the supply side and not on the demand side – contrary to Keynes’s (1936) concept of “effective demand” and the related proposal to have a countercyclical economic policy affecting aggregate demand – to achieve full employment as well as price stability on the product market.
Assuming that supply creates its own demand, mainstream economics induces policymakers to liberalize and deregulate any kinds of markets (namely, the labour, financial, and product markets), so that the supply side of them (firms and financial institutions) will increase production and employment levels up to their full capacity, provided the State balances its own budget over the medium run (if not yearly) – without burdening taxpayers, who are deemed rational and subject to a “Ricardian equivalence” theorem: any fiscal deficits give rise to public debt that sooner or later will be paid through some increase in taxes that taxpayers are therefore in a position to expect, thereby reducing their own expenditures and affecting economic growth negatively.

By contrast, if fiscal policy provides for a balanced budget, there will be no increase in public debt, so that a free-market economy can provide for full employment and price stability because every economic agent can maximize either their utility (as consumers) or profits (as firms), in an economic framework where agents are rational and can anticipate the future path of the economic system. Along these lines, mainstream economics suggests that a number of areas where the public sector intervenes (like healthcare, transports, and education) should be privatized, to make sure that there is an efficient allocation of resources and that the taxpayers’ burden is minimized to avoid tax evasion and corruption of State officials. In this regard, tax competition is meant to achieve this goal, through making sure the public sector uses all its own resources efficiently, as the latter are reduced over time by an interjurisdictional competition that lowers the tax rate as time goes by – to avoid that the wealthy taxpayers “vote with their feet” and thus move in a jurisdiction where the tax burden is lower (see Hirschman, 1970; Barro, 1979).
As regards monetary policy, central banks must be independent of governments, so that the latter cannot ask the former to “monetize” the public sector’s debt – that is, the idea of the “printing press” paying for public deficits and thereby increasing the inflationary pressure across the economic system. Central bank independence must then be granted with the mandatory goal for monetary authorities to guarantee price stability, which the latter authorities have been considering with regard to the product market only – that is, ignoring financial markets and the related issue of financial (in)stability. Policy rates of interest have been therefore decided in light of inflation (forecast) targeting strategies – a slightly updated version of monetary targeting strategies inspired by monetarism (see Rochon and Rossi, 2021; Rossi, 2022a). Central banks should not try to increase the level of employment because, if they do so, they create an inflationary pressure giving rise to an upward price–wage spiral that eventually affects all the economic system negatively.

This conventional policy stance has been providing financial instability and crises, as well as involuntary unemployment – a series of problems that have been noticed since the global financial crisis burst in 2008, but which largely existed even before. Let us expand on this in the next section, to point out the major flaws of mainstream economic thinking and policy making.

**Major flaws of pre-COVID economics**

Mainstream economics is fundamentally affected by a number of conceptual, theoretical, methodological and empirical flaws, which cannot be solved within such an approach to economic problems – that are largely the result of its own mistakes (see Cencini and Rossi, 2015).
As regards macroeconomic analysis, indeed, the mainstream view based on so-called microfoundations is flawed, because of Samuelson’s fallacy of composition: “[w]hat is true for each is not necessarily true for all; and conversely, what is true for all may be quite false for each individual” (quoted in Hartley, 1997, p. 174; see also King, 2021). This amounts to saying that in economic analysis “[t]he whole is different from the sum of the parts. There is such a thing as society” (Ormerod, 1994, p. 91; see also Verdon, 1996, pp. 13–14). As a matter of fact, an essentially atomistic approach as followed by mainstream economists cannot appraise the working of the economic system as a whole. In this regard, Laidler (1993, p. 28) noticed that “[i]n the process of acquiring market-theoretic micro-foundations, macroeconomics thus lost its separate identity”.

To be sure, as already noted by Schlicht (1985, p. 101), “[m]icroeconomic questions require microeconomic theories although macro considerations might contribute to solve them. On the other hand, macroeconomic questions cannot typically be analyzed fruitfully in microeconomic terms”. This amounts to saying that analogies between micro- and macroeconomic “laws” could prove to be seriously misleading, if not entirely wrong (Schlicht, 1985, pp. 63–4; Caballero, 1992, p. 1291; see also Lavoie, 2014).

Among a variety of so-called “paradoxes” – such as the famous paradox of thrift already pointed out by Keynes (1936) – there is the paradox of public deficits: “a budget deficit […] permits profits to increase above the level determined by private investment and capitalist consumption” (Kalecki, 1933/1991, p. 245). This is because public spending enters into the economic circuit and increases aggregate demand directly or indirectly, that is, through households’ or firms’ expenditures, thus supporting economic growth.
and thereby enhancing firms’ sales and profits eventually (see Scott, 2022). This is so much so in a crisis period – be it due to endogenous or exogenous reasons such as the bursting of a financial bubble or a pandemic like COVID. If firms do not invest in light of the current situation and their expectations, but cut down their labour demand, the only economic agent that can enhance and support economic growth is the public sector, as logically speaking the State does not need to collect taxes to finance public spending: by accessing a credit line (be it with the central bank or some commercial banks), the public sector can finance its own expenditures, which increase produced output (as measured by the gross domestic product), and thereby national income – a fraction of which the State may obtain by collecting taxes that allow it to repay public debt eventually. The so-called “golden rule” of public finance requires indeed that all current expenditures by the public sector are financed by taxes to be paid by the current generation of taxpayers, while public investment should be financed through borrowing (that is, issuing government bonds), in order for the future generations of taxpayers to contribute to financing this investment, since they will also benefit from it. As a matter of fact, and as the COVID pandemic has shown undeniably, when the public sector builds for instance a new hospital (that is, a public investment in healthcare), the current as well as the future generations of taxpayers benefit from it. It would thus be wrong to finance this public investment with only the current taxpayers’ income, as also future taxpayers will benefit from such an investment in healthcare, and therefore should also contribute to its financing through their taxation up to an amount that corresponds to the amortization costs of such an investment – according to the “pay as you use” principle (see Buchanan, 1958).

As regards monetary policy, the pre-COVID strategy that all major central banks have been putting into practice is not up to the task of guaranteeing financial stability, and is
also flawed on conceptual grounds, as it is based on a wrong conception of money and banking. With regard to money, mainstream economics imagines that it is an exogenous magnitude that central banks can control – either directly (with the “printing press”) or indirectly (through the “money multiplier”) (see, for instance, Friedman, 1969). In fact, money is endogenous, since it is issued by any kinds of banks every time the latter grant a credit line to any kinds of borrowers (including the public sector, which usually banks with the central bank, even though these agents cannot be considered like “husband and wife within the [same] household” as imagined by Wray (2003, p. 92)). As a matter of fact, the central bank (like any bank) simply provides the means of final payment for a payment order to be carried out properly (see Rossi, 2007, pp. 79–88). This occurs also every time the State needs to pay any kinds of bills: if this occurs through the country’s central bank, the latter issues the number of money units necessary to carry out such a transaction but is neither the buyer nor the seller of anything. As Hicks (1967, p. 11) clearly noticed, “[e]very transaction involves three parties, buyer, seller, and banker.” Indeed, the central bank merely acts as a monetary and financial intermediary when a public sector expenditure occurs. It opens a credit line to the public sector in order for the latter to pay finally its bills on any kind of markets (the factor market or the goods market usually). Owing to money endogeneity, bank loans give rise to bank deposits, as Schumpeter (1954, pp. 1110–17) recognized. The causality runs indeed from the assets side to the liabilities side of banks’ bookkeeping logically: there can be no deposits in the banking sector if no bank is willing to provide a loan to any kind of borrowers, who need it to pay finally their counterparty across the marketplace. A final payment, indeed, occurs only when “a seller of a good, or service, or another asset, receives something of equal value from the purchaser, which leaves the seller with no further claim on the buyer” (Goodhart, 1989, p. 26). To be sure, as Graziani (2003, p. 60) explained, “[i]f a simple promise of payment could perform the role of final payment, buyers would be
endowed with a seigniorage privilege, namely with a right of withdrawing goods from the market without giving anything in exchange”. In fact, neither the State nor any other economic agent can finally pay by surrendering their promise to pay, which is merely an acknowledgment of debt (IOU); a means of final payment is required to this effect. This is the essential reason why banks are special and cannot be considered at the same level as non-bank financial institutions (such as pension funds): for the latter, deposits make loans, while for the former loans make deposits, as cogently explained by endogenous money theorists (see, for instance, Rochon, 1999, Rossi, 2007, and the literature cited therein).

With regard to monetary policy strategies, the latter have been inspired by monetarism, and therefore consider that central banks can manage the money supply and should do it in order to achieve price stability on the market for produced goods and services (which is measured with the consumer price index or the core inflation index, that is, an index established considering a basket of goods and services that excludes those items whose price is more volatile than others; see Rossi (2001, pp. 14–26) for elaboration on that). Since the late 1980s all major central banks have been focusing on price stability only – moreover, measured on the market for produced goods and services, thereby ignoring both real and financial assets – because of the mainstream conception of inflation being the result of too much money chasing too few goods. This induced a series of asset price bubbles (also known as credit bubbles), since central banks have been considering that their policy goal was achieved once price stability on the product market is observed as measured by the relevant price index. In fact, central banks have been inflating several financial bubbles, as a result of their policy rates of interest being too low for a too long period in order to make sure that financial stability is preserved in light of banks’ credit granting for “non-GDP-based transactions” (Werner, 2012, p. 29).
As a matter of fact, generally speaking, the transmission mechanism of policy rates of interest does not operate as central bankers (and mainstream economists) imagine. The rate of interest that any bank applies when it decides to open a credit line to any kind of borrowers depends on the creditworthiness of the latter, much more than on the policy rates of interest decided by the central bank (see Rochon, 1999). This is even more so in a crisis period, when banks decide to increase their lending rates of interest in light of a (potential) banking crisis, even though the central bank may reduce its own policy rates of interest in an attempt at reducing the risks of such a crisis. For instance, when the so-called subprime bubble burst in 2006 across the United States, the US Federal Reserve much reduced (and rapidly so) the policy rate of interest, but the interbank market rate of interest showed a mushroom growth since banks became reluctant in lending across such a market (which indeed was completely frozen in light of the precarious situation of several banks across the United States and beyond them).

In this regard, an open issue that remains to be addressed concerns the proper definition of financial stability. As a matter of fact, a large consensus exists in the central banks’ community (and in the mainstream of the economics profession) that price stability on the market for produced goods and services corresponds to an increase in the relevant price index close to (but below) 2 per cent. By contrast, there is no consensus yet about the measurement of financial stability, as regards neither the proper index to be used nor the numerical value of it considered to be appropriate for such a policy goal that central banks have been forced to include in their policy strategy after the global financial crisis burst in 2008. In this regard, as we explain below, central bankers should also consider that their policy rates of interest have important distributional consequences across the economic system with respect to both national income and wealth. Contrary to what the
mainstream of the economics profession believes, monetary policy decisions are never neutral as regards so-called “real” variables, such as income and wealth distribution as well as employment levels and the corresponding rate of unemployment. Let us turn to these issues in the remainder of this paper.

**Teaching macroeconomics post-COVID**

The above discussion has highlighted some of the flaws within neoclassical theory as well as its policy prescriptions. Both are necessarily related, as theory infuses policy at all institutional levels. To be sure, economists must be able to propose relevant policies to address and solve real economic problems. In this sense, economic theory is only as relevant as the policies it can provide in times of crises. As Galbraith (2021, p. 67) explains, “economics is a policy discipline.” As such, the flaws in neoclassical economics are both theoretical and in the realm of policy. In this sense, as a profession, we must ask ourselves how relevant neoclassical theory is to the real world.

To be sure, heterodox economists have been criticizing neoclassical theory for several decades, arguing that it does not explain the real world and, by excluding the possibility of a crisis, cannot offer any relevant policies to mitigate its consequences. This stands in contrast to the mainstream’s claim that, as a result of their theories and subsequent policies, the “central problem of depression-prevention has been solved” (Lucas, 2003, p. 1), pointing to the Great Moderation as proof. The global financial crisis, however, quickly disproved this claim. Yet, as Lavoie (2018) points out, mainstream economists do not lay blame at the feet of their theories. This is evident in the following quote by Blanchard: “the crisis was not triggered primarily by macroeconomic policy. But it has exposed flaws in the precrisis policy framework, forced policymakers to explore new
policies during the crisis, and forces us to think about the architecture of postcrisis macroeconomic policy. In many ways, the general policy framework should remain the same” (Blanchard et al., 2010, p. 16). In other words, the theory is fine: if something went wrong, we should blame the real world for disobeying the “laws of economics”.

Of course, this is reminiscent of Keynes’s observation that (neo)classical economists conduct themselves like Euclidean geometers in a non-Euclidean world, and blame parallel lines for touching, without examining the soundness of their theories. They “rebuke the lines for not keeping straight” rather than “throw over the axiom of parallels.”

Now, for obvious reasons, we disagree with Blanchard’s assessment of theoretical absolution. Moreover, if the global financial crisis revealed the fact that the neoclassical emperor has no clothes, then the COVID crisis has done much worse: it laid bare a theory that at best could only offer austerity as the appropriate fiscal policy to crises. Yet, we know empirically that austerity does more harm than good, and that austerity has “been oversold” (Ostry et al., 2016).

In this section, we will show important policy changes that resulted from the events of COVID that invalidate the foundations of neoclassical policies. We will focus on fiscal and monetary policies, respectively, and argue that the COVID policies were largely inspired in many regards by heterodox economics, and as such proved largely sufficient, and dare we say, instrumental, in managing a health-cum-economic world crisis, the likes of which remain unmatched. The consequences of the swift policy actions held a financial and banking system together, while unemployment soared, and production collapsed.
An immediate conclusion is that among the pantheon of economists, Keynes and Kalecki come immediately to mind. Despite having developed theories of aggregate demand close to nine decades ago, their insights remain the most relevant today. In this sense, it was far more than the “return of the Masters” – to paraphrase the title of Skidelsky’s 2009 book about Keynes – but a reminder that we should never stray too far from the Masters.

Heterodox economics and policies revealed themselves more than capable in addressing not only times of recessions, but also desperate times of crises. In this sense, while mainstream economics has proven to be irrelevant to analysing and prescribing policies, heterodox economics has remained fairly intact after COVID. Indeed, we will argue that in the real world such a post-Keynesian approach to policies is able to tackle crises and beyond that addresses some of the more pressing social and ecological challenges of our time. In the greater picture, what has emerged from the COVID crisis is how fiscal and monetary policies must be understood within the greater societal context.

**COVID and the monetary response**

Let us begin by discussing the role played by central banks and monetary policy. Here, we will draw six important lessons from the conduct of monetary policy during the COVID crisis, but also during the financial crisis. These lessons are well-known to post-Keynesians, but they have been made obvious or rather more evident during the crises.

The COVID and financial crises have shown how central banks adopted some dramatic policies, resulting in important post-COVID lessons, albeit these ideas have been long recognized by post-Keynesians. As Lavoie (2010, p. 4) has remarked, “[t]he subprime
financial crisis that started in August 2007 and was later called the global financial crisis, has forced several central banks to take extraordinary measures and to modify some of their operational procedures. These changes have made the deficiencies and lack of realism of mainstream monetary theory even clearer, as can be seen in undergraduate textbooks as well as in most macroeconomic models.” The same could be argued with regard to the COVID crisis.

Conventional monetary policy relies on the assumption that lower interest rates will spur economic activity. This is the traditional IS-type assumption. In times of economic slowdown, central banks are quick to lower interest rates. During the financial crisis, as well as at the beginning of COVID, central banks around the world followed this policy unsurprisingly, and pushed interest rates (close) to their lower bound.

A first observation is the ease with which central banks were able to push interest rates near zero; central banks were able to have the rate of interest of their choice. The true exogeneity of the rate of interest was thus made obvious. This stands in contrast to more mainstream models such as the New Consensus model, where the short-term interest rate is indeed set by the central bank and is thus exogenous, but this can at best only be a short-term situation as ultimately, in the long run, this rate must move to equate the natural rate of interest, which acts as the ultimate centre of gravitation in these models.

But COVID as shown that central banks can have any interest rate they want, and leave it there indefinitely. In the United States, for instance, the Federal Funds rate of interest remained at its lower bound for (roughly) eight years. So, there should be no doubt that central banks are able to keep interest rates at low levels for a prolonged period of time. Hence, from a pedagogical perspective, this is the first post-COVID lesson.
This first lesson shatters conventional theories, still portrayed in some textbooks, that
central banks control the money supply. In fact, central banks have very little control, if
any at all, over the growth of the money supply. In its stead, central banks have a
commanding level of control over interest rates. As Lavoie (2014, p. 189) expressed,
“[a] central bank is able to set the base rate [of interest] at the level of its choice.” This
is reminiscent of Keynes’s (1980a, p. 149) argument that “the whole management of the
domestic economy depends upon being free to have the appropriate rate of interest
without reference to the rates prevailing elsewhere in the world”. Keynes (1980c, p.
232) later argued that “monetary authorities can have any rate of interest they like.”

The above argument does not mean that there will not be any consequences to those
choices. For instance, keeping interest rates at the lower bound when all other central
banks have begun raising theirs may lead to some important exchange rate problems, as
is, at the time of writing this article, the case of the euro. But this is a separate question
from the one above: interest rates are truly exogenous. Nothing prevents central banks,
in a control sense, to have the interest rate of their choosing.

Moreover, the financial crisis and the COVID crisis have seen central banks adopt
unconventional policies, such as Quantitative Easing (QE), that is, the direct purchase of
longer-term securities on the open market. This was done essentially to show how
central banks can remain relevant despite pushing interest rates near the lower bound.
QE answered the question of “what more can central banks do?”
There is much to say about QE, in particular over its theoretical emphasis on the money multiplier model. But while the intended purpose was to lower long-run rates of interest, the unambiguous result of such a monetary policy was to lead to important income and wealth distributive consequences. In turn, this spawned an increase in both academic and central bank research on the question, and is the second lesson we learned from this crisis:

**Lesson two: monetary policy has important income and wealth distributive effects.**

Indeed, the large-scale purchase of financial assets by central banks raised the prices of these assets and thus benefited their holders. This consequence is now widely accepted. For instance, according to Saiki and Frost (2014, p. 11):

UMP [unconventional monetary policies] widened income inequality, especially after 2008 when quantitative easing became more aggressive. This is largely due to the portfolio channel. […] The mechanism is straightforward: an increase of the monetary base (through purchases of both safe and risky assets) tends to increase overall asset prices. Higher asset prices benefit primarily upper incomes, who hold a larger amount and share of overall savings in equities, and thus benefit from greater capital income.

The income distributive impact of monetary policy also applies to conventional policies. Indeed, according to Draghi (2016, internet), “[o]ver the medium-term, it is unambiguous that [expansionary] monetary policy has positive distributional effects through macroeconomic channels. Most importantly, it reduces unemployment, which benefits poorer households the most. And a faster return to full employment should, in turn, contribute to lower future inequality, since we know that if unemployment lasts too long it can lead to permanent income losses through labour market scarring.”
This now forms a central component of post-Keynesian economics going back to Moore (1989), Niggle (1989), and Lavoie and Seccareccia (1998, 1999) (see Kappes, 2022, for a survey of the mainstream contribution to this topic). Rochon (2022a) and Rochon and Seccareccia (2022) have explicitly looked at this argument in detail and likened monetary policy to a long-run incomes policy: “monetary policy has acted as an incomes policy that protected rentiers, except over the last decade where the focus has been on preventing the collapse of asset prices in the financial markets, for instance, through unsterilized asset purchases by central banks, dubbed quantitative easing, that kept central bank rates to their historical minimum.”

Another lesson learned from QE during the COVID crisis is the following:

**Lesson three: the decoupling of the money supply growth from central bank reserves growth.**

In mainstream models, the supply of money is linked, through the money multiplier, to the quantity of reserves in the system. In fact, the growth of the money supply is said to be a multiple of the increase in the supply of reserves. Yet, during the financial crisis, “increases in the official definitions of the money supply, however measured, seem to be much smaller than increases in bank reserves” (Lavoie, 2014, p. 228). Indeed, we have seen the growth in reserves, as a result of QE, far outpacing the growth of the money supply. This is due to the fact that banks have been reluctant in increasing the volume of credit lines granted to either firms or households, in light of the negative economic outlook concerning real GDP growth.
Finally, an important implication of the conduct of monetary policy during the COVID pandemic was to show how, on its own, monetary policy is simply unable to encourage economic growth. In mainstream theory, low interest rates lead to higher economic activity, by encouraging both consumption and investment. Yet, with interest rates at their lower bounds, and with long-run rates of interest at low levels because of QE, economic activity was non-responsive. As the old adage says, you can lead a horse to water, but you simply cannot make it drink.

**Lesson four: monetary policy on its own is incapable of encouraging economic activity.**

At this stage, two arguments can be introduced. First, consumption and investment may simply be non-responsive to changes in interest rates. On this front, there is some empirical evidence. For instance, Cynamon et al. (2013, p. 13) summarized this view nicely: “The transmission mechanism from monetary policy to aggregate spending in new consensus models relies on the interest sensitivity of consumption. It is difficult, however, to find empirical evidence that households do indeed raise or lower consumption by a significant amount when interest rates change. Some authors have generalized the link to include business investments (see Fazzari, Ferri, and Greenberg, 2010 and the references provided therein) but a robust interest elasticity of investment has also been difficult to demonstrate empirically.”

Second, post-Keynesians would argue that investment depends on uncertainty, or what Keynes called “animal spirits” (see Rochon, 2022b). The global financial crisis and the COVID crisis were certainly evidence of this: despite record low interest rates, investment was not responding, simply because the level of uncertainty about the
growth of aggregate demand in the future was too acute. Investment implies increased capacity to produce that must eventually be sold. But during a crisis, firms are reluctant (or refuse) to make this commitment in light of high degrees of uncertainty.

There is also a fifth lesson.

*Lesson five: inflation is unrelated to monetary policy.*

This lesson is certainly an important one, as it goes against one of the most sacrosanct assumptions of mainstream economic theory, namely, that inflation is the result of excess demand related to loose monetary policy (and expansionary fiscal policy). In other words, mainstream economists have never given up on the Friedmanian idea that inflation was a “monetary [policy] phenomenon”. Yet, during the COVID pandemic, two key mainstream arguments used in explaining inflation were present: record-low interest rates and ballooning public deficits and debt. Yet, despite these fundamental arguments, inflation remained rather tame. Indeed, in the decade between the crises, the greatest fear was deflation, not inflation.

This said, at the moment of writing this article (June 2022), inflation has once again roared back to life. The mainstream quickly points to low interest rates and public deficits as the main culprits, and as a result central banks are rushing to (predictably) raise interest rates.

On this front, however, two counter arguments can be presented. First, if inflation is really the result of excessive fiscal deficits and a low interest rate policy, then they must explain why it took inflation so long to increase. After all, interest rates have been low...
for a decade. Second, this analysis seems to ignore the supply-side factors that have contributed to the current inflation crisis: supply-chain constraints, oil shortages, corporate greed, and more. As a result, it seems that current inflation is seeing much less demand-side factors than what they believe. As a result, this raises the question of how effective monetary policy can be in taming inflationary pressures (Rochon, 2022a).

Finally, one last lesson learned from the conduct of monetary policy is the following:

*Lesson six: central banks may claim to be independent in theory, but they are not in practice.*

Central bank independence is considered another one of these sacrosanct assumptions of mainstream economic theory. It is argued that central banks must remain independent from political manipulation of interest rates. Here, two counterarguments must be introduced. First, in discussing independence, we must ask “independent from who?” It is clear that, in theory, central banks must be independent from possible interference by activist governments, but we would argue that central banks are still dependent on two important groups. Indeed, Epstein (2015, pp. 105–106) has argued that “central bank policy is determined by a struggle between industrial capital, financial capital, and labour. […] Where central banks are ‘independent’ of the executive branch of government, they tend to be dependent on the financial sector for political support, and therefore tend to make policy with ‘finance coloured’ glasses.”

This argument has been further elaborated upon by Rossi (2022b), who argues that no central bank is independent of banks, since the latter cannot go bankrupt when a major financial crisis occurs. Banks know that, as a group, they are too big to fail, so that their
business strategies are based on “privatizing profits and socializing costs”: they thereby inflate credit bubbles as much as possible, knowing that if those bubbles burst and can create a global financial crisis, central banks will intervene to “mop up” the mess – as Greenspan (2002) famously declared.

_**COVID and the fiscal policy response**_

Having discussed above six important lessons from the conduct of monetary policy during the COVID crisis, we now turn our attention to the use of fiscal policy, and the lessons we have learned from government spending policies during COVID. In this regard, we will end this article by pointing to two important, yet far reaching, lessons we learned.

There has been perhaps no better time to witness the amazing transformative ability of the State to counter a world pandemic. Indeed, the COVID crisis has shown the degree to which the State can harness its fiscal policy to accomplish great things. In some countries, we have seen, as a result, public deficits and debts soar to historical levels, and in some countries large subsidies to workers and firms.

Through all this, one key observation is the following: do not governments have budget constraints? After all, we have been told for many decades now that “we cannot afford this or that”, implying some sort of limit on the ability of governments to spend. Moreover, traditional analyses of the State reduce it to a household: like households, the State “must live within its means.”
Yet, the inevitable conclusion of fiscal policy during COVID is that there do not seem to be any constraints on government expenditures. As Tooze (2021a, internet) remarked, “[b]udget constraints don’t seem to exist”. Indeed, in several countries, governments increased spending 10-fold (and more in other countries). Public deficits exploded to heights rarely seen before; public debt also expanded enormously. In a way, this fiscal response simply mirrored what was happening in the private sector: as the private sector collapsed, the public sector expanded as a consequence. To be sure, the inconsistencies in neoclassical theory on this subject echo some of the arguments above: enormous public debts and deficits were accompanied by falling interest rates. According to Tooze (2021a, internet), “[g]overnments around the world issued debt as not seen since World War II, and yet interest rates plunged. As the private sector shut down, the public sector expanded. As government deficits grew, the monetary system responded elastically. Government spending made up for the loss of private incomes and spending.”

This leads to our next lesson:

**Lesson seven: government budget constraints do not exist.**

If this lesson is true, it has far-reaching implications. In particular, it leads to the conclusion that governments are able to adopt whatever programmes they desire. The only constraint is their willingness to do so, or rather a political constraint. So, rather than argue that “we cannot afford a better health care system”, for instance, we should read, “we do not want to spend the money to have a better health system.”

There is some antecedent for this thinking. Indeed, Keynes gave a series of radio interviews, in 1942, to the BBC, in which he says “anything we can actually do, we can
In the long run almost anything is possible [...]. We can do almost anything we like, given time. [...] In good time we can do it all. But we must work to a long-term programme” (quoted in Tooze, 2021b, internet). This is a remarkable statement to make, and Marshall and Rochon (2022, p. 340) have linked this to Keynes’s (1936) notion of “full investment” (as opposed to full employment), which suggests a massive involvement of the State in impacting an economy’s physical infrastructure. For Marshall and Rochon (2022, p. 344), “full investment can only be understood under the telos of human need and advancement, and would be a step beyond full employment: the full realization of human potential.” The guiding principle is human advancement and enlightenment. Yet, in the following seldom-mentioned quote from The General Theory, Keynes warns us “that a state of full investment in the strict sense has never yet occurred, even momentarily” (Keynes, 1936, p. 324).

However, COVID has shown that if willing, governments could pursue policies of full investment – if not full employment – and that the finance required is not a constraint.

Finally, the above discussion points to the important role of the State. It shows the formidable and core role played by the State in times of crises. We argue, as many post-Keynesians before us, that this role need not be limited to times of crises, that the State can quasi-nationalize wages and industries, so it can certainly enact less far-reaching policies. This is the fundamental lessons learned from Keynes and Kalecki:

Lesson eight: fiscal policy can be truly transformative

Conclusion
Economic systems are complex, not prone to stability or convergence to tranquillity. Rather, they are subject to forces of instability and fragility. COVID was the proof: prices or other such mechanisms did not bring the economy back to stable positions of so-called equilibrium: the State did that and prevented the further erosion of our economic systems.

COVID was also the perfect petri dish and allowed us to see that all constraints, both in terms of monetary and fiscal policy, are artificial in the sense that they are not imposed by markets, but rather by political decisions. This article allowed us to see through the political veil the realities behind it.

References


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