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The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

Editor

Olivér Kovács okovacs@icegec.hu

About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

Contact information

ICEG European Center, 5/B Kiralyhago Street Budapest, 1126 Hungary. Phone: (+36) 1 248 1160. Fax: (+36) 1 319 0628 E-mail: office@icegec.hu. Webpage: www.icegec.org

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A Brief Introduction of the Moldovan Socio-economic Development[1]

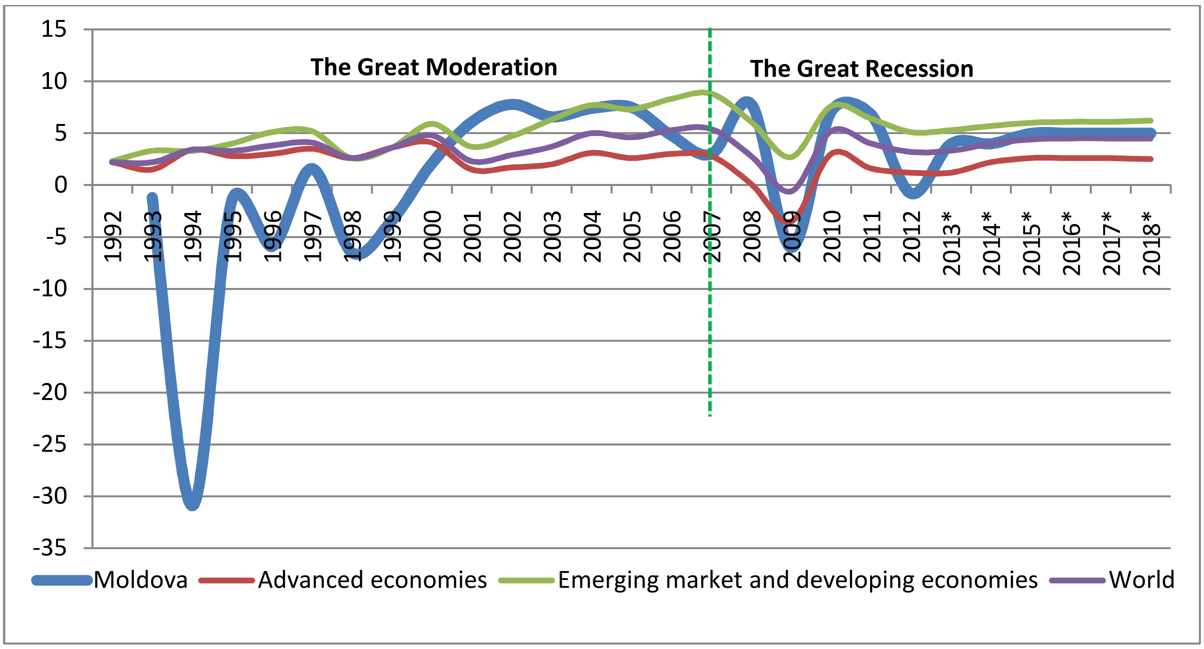
Olivér Kovács

In November 2013, the Third Eastern Partnership Summit will be held in Vilnius, Lithuania. With the Eastern partnership initiative, the European Union is to strengthen bilateral and multilateral collaboration with the six Eastern European partners: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine, to trigger structural reforms in these countries by bridging the gap between them and the EU.

If we take a mere glimpse into the development of real GDP growth path in various country groups, it becomes obvious that the flame of the era of Great Moderation, coined by Stock – Watson (2003), between 1992-2007 has seemingly gone out with the eruption of the 2008 financial and economic turbulence. The Great Recession was in the cards (Coibon – Gorodnichenko, 2010).

With globalisation, economic processes all over the world have become asymmetrical interdependent by leaving merely limited role of one national government to fend off the dramatic consequences of the global crisis. A country's recovery is getting more and more influenced by growth prospects of another relevant country or a group of countries. It is also reflected in the growth trajectory of Moldova.

Chart 1. Economic growth in selected group of countries (%)



Source: World Bank, National Accounts

[1] This research was realized in the frames of TÁMOP 4.2.4. A/2-11-1-2012-0001 „National Excellence Program – Elaborating and operating an inland student and researcher personal support system". The project was subsidized by the European Union and co-financed by the European Social Fund.

There are at least six points to be reckoned with when it comes to judging the socio-economic development of the Republic of Moldova. Let us note that the relationship with Transnistria (a country, which is not widely recognised and legitimated) is not in our focus.

First, the takeoff started significantly later than in other Continental European countries (i.e. protracted growth strengthening was an ubiquitous phenomena in CIS countries during the 1990s).

Second, up until the midst of the 2000s, Moldovan economy converged to the emerging markets and developing economies (between 2000 and 2008, the average annual real GDP per capita growth rate was 6 per cent), but after 2005, the growth prospect became much more gloomy.

Third, the 2008 financial and economic crisis, which infiltrated into the European continent, had substantial repercussions in CIS countries as well being dependent on countries from where remittances are coming back (Ghencea – Gudumac, 2004) and the main energy resources are imported. In Moldova, on average, the recession was even deeper than in advanced economies, and even in the world (GDP collapsed by 6%).

Chart 2. Evolution of selected macroeconomic indicators, 2010-2015

	2010	**2011**	**2012**	**2013***	**2014***	**2015***
Nominal GDP (USD mn)	5,813	7,003	7,589	8,216	8,969	9,776
Real GDP growth (%)	7.1	6.8	-0.8	3.0	4.0	5.0
Total investments (% of GDP)	23.52	24.49	24.72	25.49	25.91	26.12
Gross national savings (% of GDP)	15.21	13.88	14.98	15.57	16.71	17.80
Budget balance / GDP (%)	-2.5	-2.4	-2.1	-2.0	-1.5	-1.2
Public debt / GDP (%)	23.2	21.7	24.3	24.6	24.4	23.5
Export growth (% change)	13.7	27.4	2.3	2.8	4.8	5.2
Import growth (% change)	14.3	19.7	2.5	3.2	4.5	6.1
Current account balance / GDP (%)	-7.7	-11.3	-7.0	-7.4	-7.9	-8.9
Remittances (% change, USD)	12.6	18.2	10.8	7.0	4.0	4.0
Gross foreign debt / GDP (%)	82.3	77.6	84.5	83.3	81.9	81.7
CPI inflation (%, annual average)	7.4	7.6	4.6	4.9	5.0	4.8
Unemployment rate (%)	7.4	6.7	6.6	6.4	6.0	5.5

Note: data with asterisks are projections.
Source: Moldovan authorities, World Bank, IMF (2013).

As always, reasons behind the slippage of 2006-2009 are to be found partly in the previous prosperity. The relatively surpassing growth rate of the early 2000s was mainly nourished by the internal consumption whose ammunition stemmed from the enormous amount of remittances from abroad. As a corollary, with the economic crisis, the internal consumption declined by more than 8 per cent (UNDP, 2009) when the European Union was also severely hit lowering the amount of remittances (e.g. remittances account to one-third of the Moldovan € 4 billion GDP and its annual amount decreased by 34% in the first half of 2009). Additionally, the pre-crisis development of the Moldovan economy was also suffering from the FDI exposure (from 2008 to 2009, the inflow FDI fell by more than 83%, see: EBRD, 2010). While FDI as a percentage of grossed fixed capital formation was 30.9 in 2005-2007, its rate diminished substantially to 9.5 by 2012.

Fourth, although mainly expenditure-based fiscal adjustment was implemented to meet deficit and debt targets being accompanied with structural reforms to boost export, the regenerating growth performance of 2010-2011 was disposed into the air as the European economic potential weakened further. It has at least one implication for economics: expenditure based fiscal adjustment may not have negative effect on real GDP growth, but the sustainability of the achievement relies heavily on whether the consolidation is constructed along a strategy (i.e. focusing on specific fields like innovation and R&D that potentially will have long-lived positive impetus on the economic performance) or the consolidation is just imagined as a mechanistic stabilisation of deficit and debt targets through reducing various expenditures like wages, salaries etc.

Fifth, during an economic turmoil, fiscal consolidation should be considered not only as a short-term economic policy engineering mechanism to cool down the fiscal challenges mechanistically, rather a developing function should be carefully integrated into that which considers longer term strategic vision (inclusive growth, innovation-based knowledge economy etc.).

And last but not least, beyond this fact, the volatility-prone Moldovan growth path conveys us the message that the socio-economic learning, the institutional quality and the growth context of the country still has a lot room for improvement. Its exposure to the economic situation that of its regional trading partners (including the European Union) with regard to remittances, capital inflows and exports can be considered as one of the highest ones among CIS countries.

Since socio-economic learning is one of the most fundamental prerequisites of development that can be manifested in comprehensive and visionary strategies and action plans, all time governments should envision that the exposure of Moldova to the economic situation that of its regional trading partners (including the European Union) with regard to remittances, capital inflows and exports should be addressed in a more dedicated way.

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Message in a Battle – Austerity in Europe and Lessons for Central and Eastern European Member States[2]

Olivér Kovács

Background

With the benefit of hindsight, some economic professionals have the opportunity to ponder on earlier findings by reviewing, refining and elaborating them further. This holds in case of the myth of expansionary austerity which, by its very nature, supports, rather than undermines growth (Giavazzi – Pagano, 1990, 1996; Alesina – Perotti, 1995, 1996; Alesina – Ardagna, 2010, 2013; Perotti, 2013). Since recent financial and economic crisis has had a juggernaut effect on economic performance and economic policy alike by engendering the Great Recession, researchers have an intention to analyse whether austerity was a dangerous idea or not in tackling unsustainable public finances.

This type of inquisitiveness was a key leitmotif behind writing a book on the history and ideology of austerity, which was authored by Mark Blyth and was published in the second part of April 2013.[3] The book demonstrates the crumbling fundamentals of the austerity approach through a deep literature review. He argues that "by the middle of 2011, empirical and theoretical support for expansionary austerity was slipping away" (Blyth, 2013:213).

For the year 2012, real GDP growth data for Central and Eastern European Member States have been published in March 2013 by showing for instance the salient performance of Latvia (5.6%). The achievement of the Latvian austeritarian policy seems not to be in accordance with what the Nobel-laureate Paul Krugman stressed in 2008, namely that Latvia will be the new Argentina.[4] While austeritarian policies in western and southern Europe seem to have growth-degrading effects, such policy appears to be featured with pro-growth character for instance in Latvia.

In this article we purport to illustrate why differential diagnosis is inevitable when it comes to fighting against the tide to gain control over indebtedness and dampen sovereign risk in European countries. To this end, we first look at the crisis management of old European Union member states and then outline succinctly the importance of interdependence between old and new member states

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[2] This research was realized in the frames of TÁMOP 4.2.4. A/2-11-1-2012-0001 „National Excellence Program – Elaborating and operating an inland student and researcher personal support system". The project was subsidized by the European Union and co-financed by the European Social Fund.

[3] See: Blyth, M. (2013).

[4] As Åslund and Dombrovskis (2011) sensitively illustrated, the Latvian situation was entirely different from the Argentinean case. While the Argentinean crisis was mainly due to large public debt overhang, this was not the case in Latvia where the economy was overheated. In a similar vein, Argentina had relatively rigid labour market limiting the successful occurance of internal devaluation, while Latvia had more flexible one. What is more, Latvia was committed to joining the eurozone, which required that the peg is maintained resolutely over time.

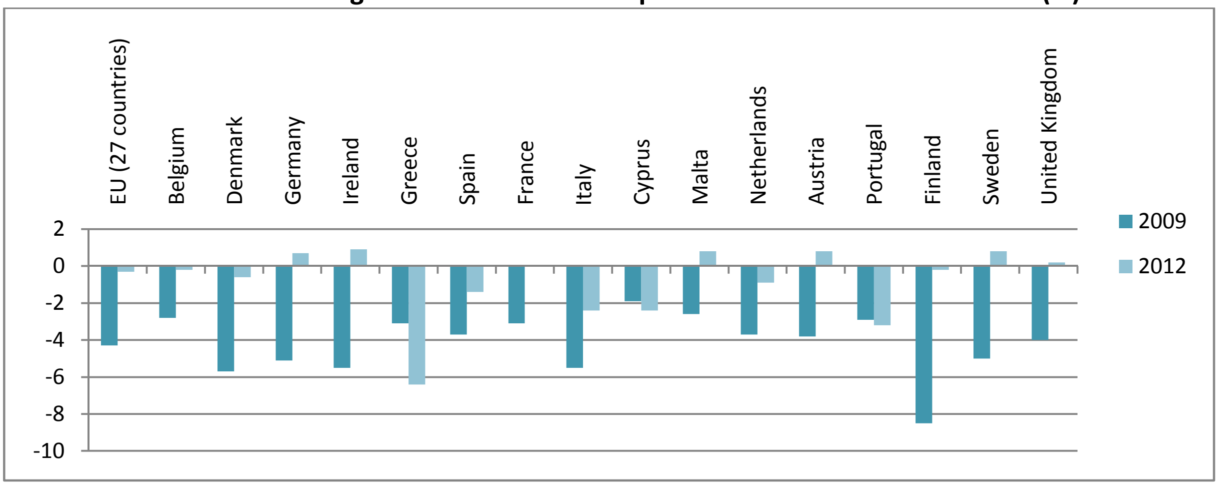
(EU-10). The latter has implications for the present and the future crisis management alike. We argue that policymakers and scholars working on how to stabilise public finances without overly jeopardising the economic recovery of Europe should remember to Anthony Giddens' holistic view who stressed that the intensification of worldwide social relations link distant localities together in such a way that local happenings are shaped by events occurring many miles away and vice versa (Giddens, 1990:64). It implies that austerity at national level has cross-border spill over effects.

Crisis management in old member states

In the early stage of crisis management, interspersed with uncertainty over the scientific fundamentals of the economic profession[5], policymakers in the United States and Europe tried to boost economies through coordinated monetary stimulus. With the evolving web of commitment to underpin aggregate demand in a Keynesian way, governments in Europe were imposing fiscal measures as well to dampen the negative impetus of the financial and economic crisis. The logical repercussion of the Keynesian renaissance was the accumulation of deficit and debt-to-GDP ratios across Europe and even in the US. Since the European crisis management has been pervaded by the sentiment of the German prudent fiscal governance, the more and more increasing threat over the sustainability of sovereign debts established a solid claim about some sort of paradigm shift in crisis management, i.e. a shift to austerity instead of bolstering demand through stimuli that previously proved to be a futile undertaking.

A lesson learned from the current crisis management is that eschewing public debt can be as harmful as letting debt-to-GDP ratio to grow since austerity could not pervasively resurrect investors' confidence in certain countries due to the GDP declines (*Chart 1*) leading to increase in public debts.

Chart 1. Real GDP growth in selected European countries in 2009 and 2012 (%)



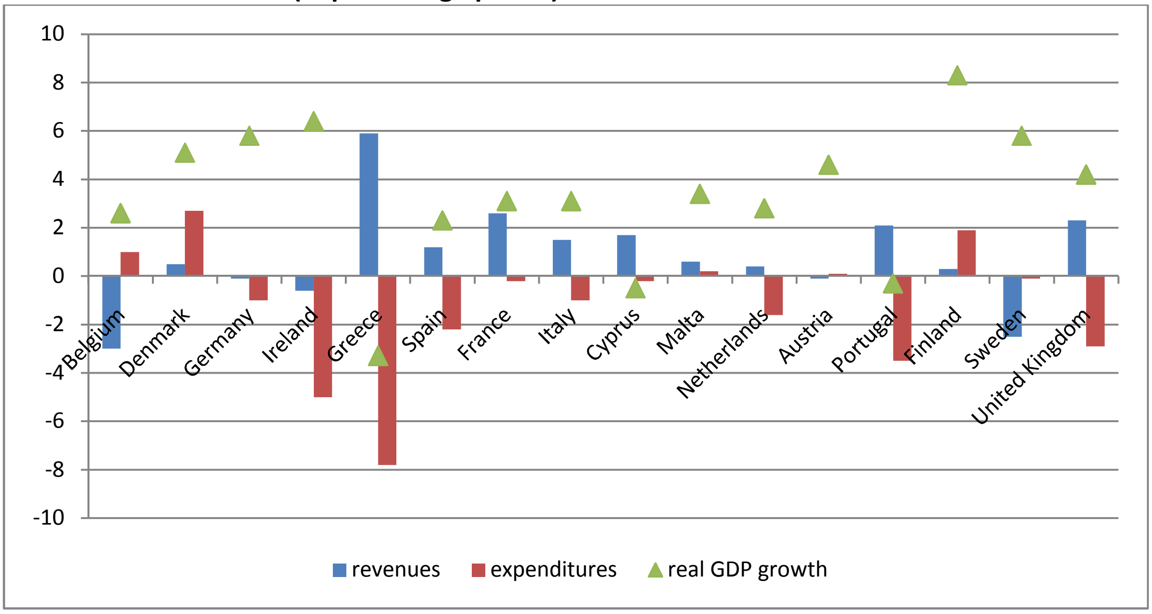
Source: Eurostat

[5] At the London School of Economics, Queen Elisabeth rightly raised the well-cited question regarding to the credit crunch being serious but recognised by nobody in time: „It's awful - Why did nobody see it coming?"

Hardly had the fiscal policy started to serve as the main conductor of crisis management because of the limited capability of monetary policy with near-to-zero rates (Almunia at el. 2009), when the issue of how should the burdens of consolidations be shared in the society raised intensively. It is therefore essential to consider that fiscal consolidations (i.e. budgetary austerities through tax hikes and expenditure cuts) affected income inequalities as well.

Plethora of authoritative studies pointed out that income inequality had been rising and it has been affected even more negatively by the crisis. Poorer people became indebted, so the growing income inequality was one of the most pivotal leitmotifs behind the extensive willingness to borrow and thus accumulate private debts[6]. Although trajectories in income inequalities have been long discussed among scholars, crisis management-related analyses have not incorporated the existence of a secular deteriorating capacity of households in recuperating the consumption-behaviour to boost aggregate demand. In this light, one can get a better understanding why the monetary and fiscal stimulus led to a *soupçon* of preventive effect (i.e. individuals and households or even firms had become more likely to arrange their debts rather than spending more on additional consumption or investments due to the stimulus). The concomitant weakening of economic growth in the era of austerity has also become much clearer (e.g. despite the Finnish and Belgian fiscal stimuli, the economic growth stagnated, merely) (*Chart 2*).

Chart 2. Changes in cyclically adjusted revenues and expenditures and real GDP growth (in percentage points) between 2009 and 2012



Source: European Commission, AMECO; Eurostat

[6] As Skidelsky (2013) stated: "Median incomes have been stagnant or even falling for the last 30 years, even as per capita GDP has grown.". Consequently, the well-known "*keep up with the Joneses*" phenomenon came into the forefront. See more: Bordo and Meissner (2012).

Experience has shown that fiscal adjustments concentrating primarily on the revenue side led to temporary improvement relative to the large and expenditure-side adjustments that proved to be more likely to have durable consolidation effects (Alesina et al. 2012; Devries et al. 2011). *Chart 2* portrays that at least three types of fiscal adjustments can be deciphered between 2009 and 2012.

(i) *Heavy-weight austerity* (i.e. realised considerable increases in tax revenues and substantial expenditure cuts) which occurred primarily in Greece, Spain, Portugal and the United Kingdom. Although the outcome effect of this type of consolidation cannot be estimated in a scientifically sound way due to the great uncertainty about the mid-term effect of fiscal multiplier, still, one can conclude that a more austeritarian fiscal policy – higher than 3 percentage points decrease in cyclically adjusted expenditures – tended to be accompanied with deteriorating real GDP growth (e.g. Greece and Portugal have been facing further decline in economic growth).

(ii) *Moderated but dominantly expenditure-side adjustments* were invoked to curb the debt accumulation and partly to signal credibility more resolutely (e.g. Germany, Ireland, and the Netherlands). All of these countries could reach an ameliorating trend in their real GDP growth rates in the respective period.

(iii) *Moderated but dominantly revenue-side fiscal adjustments* were pursued in France, Italy, Malta and Cyprus. The picture is mixed insofar the French, Italian as well as Maltese real GDP growth rates improved significantly, while that of Cyprus did not fared quite well and the country seems to smuggle back the 'financial and banking crisis' character of the European juncture.

Additionally, one may reasonably claim that two more types of fiscal policy behaviour can be unravelled. On the one hand, there is a fiscal policy behaviour manifesting governmental intentions to stimulate growth and demand between 2009 and 2012. In so doing Belgium, Denmark and Finland increased their deficit spending by reaching improving real GDP growth trajectories in the respected period. On the other hand, there were countries that did not require solid and conspicuous fiscal consolidation measures owing to their relative good fiscal governance (i.e. showing surplus or balanced budgetary conditions) such as Austria and Sweden. Let us add immediately that their growth rates were not untouched by the European-wide fiscal austerity either. Numerous of factors are relevant to mention in this regard but with the recognition that in a globalised and heavily interconnected economic arena, external fiscal austerities trigger cross-country spill over effects, hence may create less favourable demand for the exported goods and services of the given countries at their main trading partners.[7]

[7] For instance, the largest European countries of destinations of the Swedish export of goods are as follows: United Kingdom, Denmark and Germany of which imports from Sweden has been showing a pent up dynamics since the shift to austerity. See: http://www.scb.se/Pages/TableAndChart____124062.aspx Accessed on: 26.03.2013

It is important to emphasise that peripheral countries with heavy-weight fiscal adjustments – which led to blatant decline in their domestic demand – engendered negative external shocks for northern European countries as well as the core countries through decreasing export (Vihriälä, 2013) coupled with deceleration in internal consumption and private investments.

By grouping countries into three consolidation-type and differentiating between two further fiscal policy behaviours we can lead to the conclusion that 'this time is different'[8] in the sense that neither the classical view of consolidation (heavy-weight adjustment invoked to stabilise budgets in numerical terms in the short term) nor the large and expenditure based adjustments[9] seem to be an instructive way forward in the current circumstances. It holds especially because even the European core countries (e.g. Germany, France) also face growth problems and the European panorama became highly integrated with cross-country spill overs occurring in a more vigorous way.

This rudimentary analysis calls for *differential diagnosis* pervaded by the view that persistent and large consolidations should be constituted by considering carefully the initial conditions of the given country. Nevertheless, if we also take into account that this given country is being embedded into a broader regional, or even Europe-wide economic fate where the growth performance is dispiriting due to the deteriorating secular trend in productivity,[10] one may profess that *moderate and dominantly expenditure-side adjustments seem to be more preferable over the large and heavy-weight fiscal sobering in those countries – possessing large internal market and thus being export markets for small and open Central and Eastern European Member States – in the interest of minimising the negative spill over effects of fiscal consolidations*.[11]

Tackling the crisis in EU-10 countries

Concerning Central and Eastern European Member States (CEE), the return of positive growth appears to be faster (*Chart 3*) relative to that of western or peripheral Europe, but these countries are predominantly small and export-oriented economies, hence their exposure to regional and European-wide fiscal policy shocks may be even bigger.

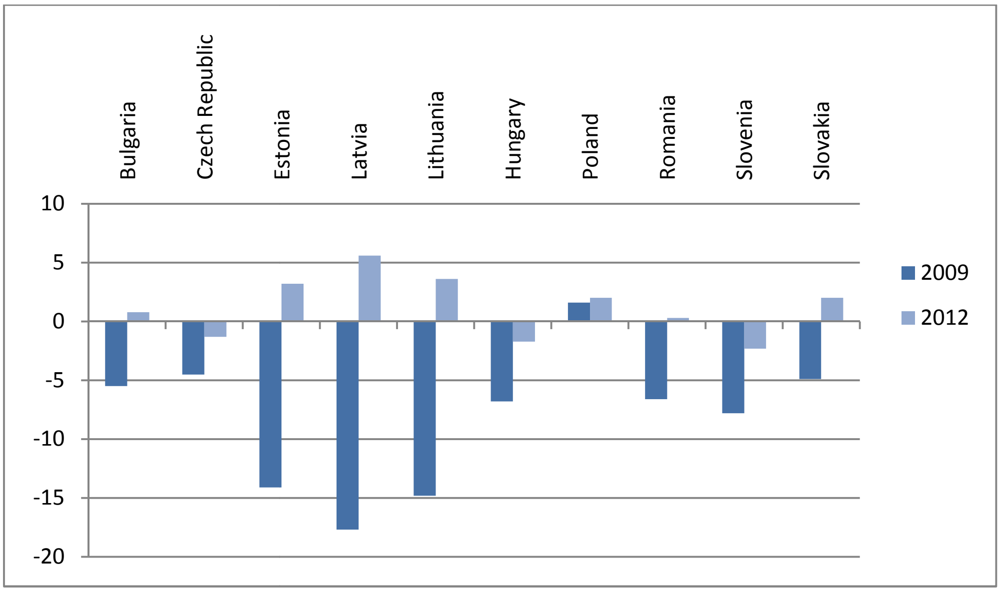
[8] This phrase was famiously used in a comprehensive book written by Carmen Reinhart and Kenneth Rogoff in 2011. See: Reinhart and Rogoff (2011).

[9] Whose crucial role was accentuated by Alesina and Ardagna (2010) because of its greater potential to signal more credible commitment to fiscal prudency (i.e. reducing risk premia).

[10] See: Gordon (2012) who pinpointed the worsening productivity trend in the US, and it is well-known that Europe has been falling behind the productivity level of the US since 1995. Furthermore see van Ark et al. (2008) on the productivity gap between the United States and Europe and also see Boone et al. (2013) who dedicates special attention to the effect of the recent crisis on productivity.

[11] The spill over effect arises in a non-linear way, policymakers therefore have not got the scientific backing to estimate *ex ante* the fiscal multiplier of a fiscal adjustment adequately. The multiplier was admittedly underestimated when it came to assessing the impact of austerity. See for instance Blanchard and Leigh (2013).

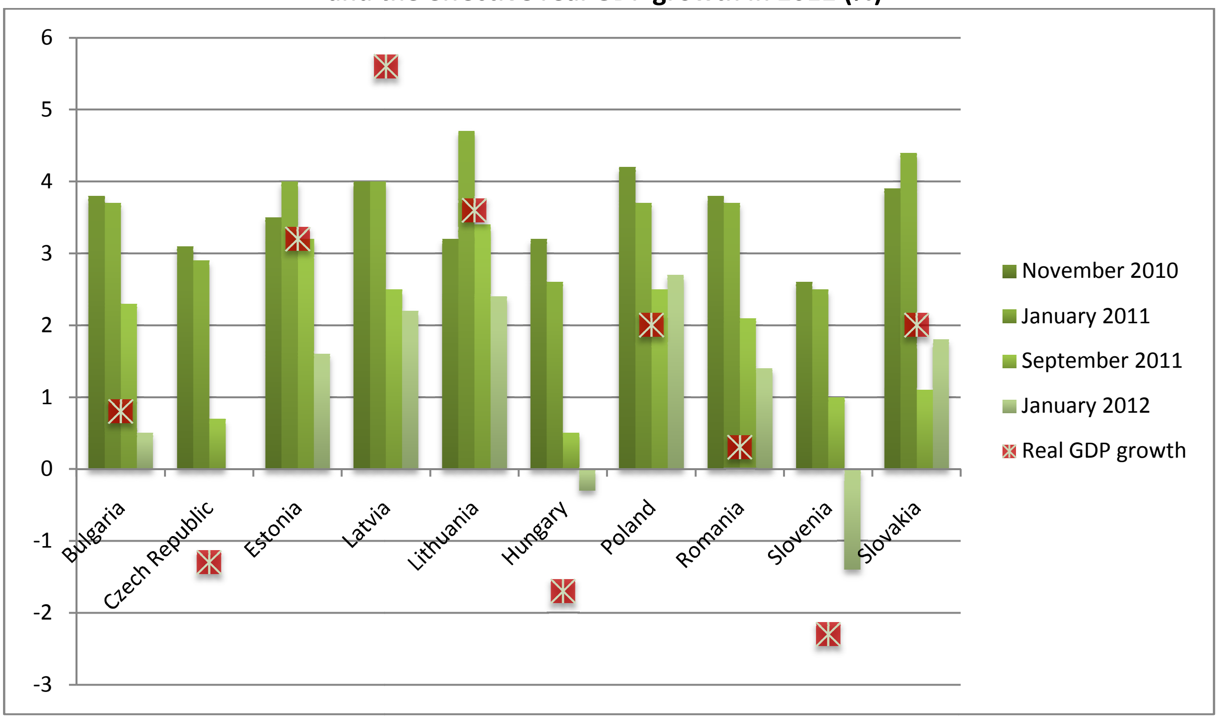
Chart 3. Real GDP growth in Central and Eastern European Member States in 2009 and 2012



Source: Eurostat

One telling illustration for the underestimated role of spill over effects might be the fact that official European Commission's forecasts did not envision negative growth rates for 2012 up until September 2011 (*Chart 4*). To put it another way, officials and policymakers were more or less inclined to think that fiscal consolidations throughout Europe are growth-compatible in a continent-wide context. With the time passing by this belief proved to be a Hayekian fatal conceit, however.

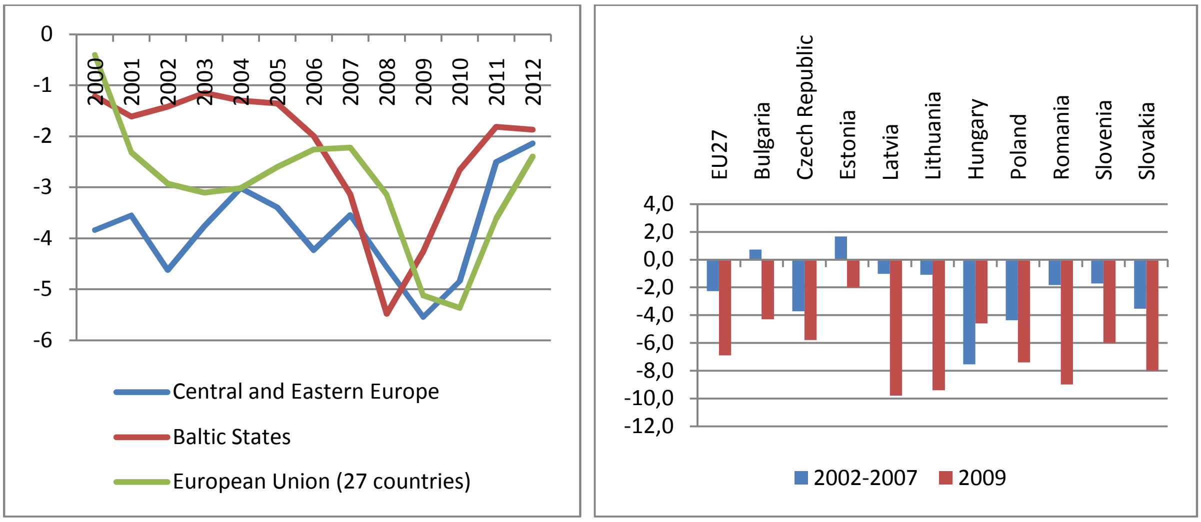
Chart 4. The development of real GDP growth forecasts for 2012 and the effective real GDP growth in 2012 (%)



Source: European Commission, European Economic Forecasts

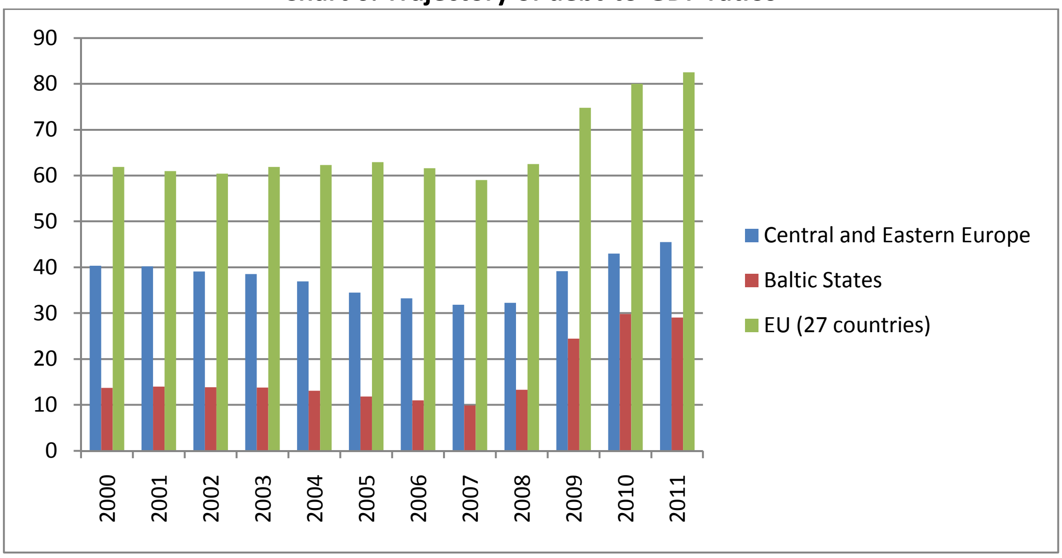
There is no gainsaying the fact that the described mutual interdependence and thus the spill over channel played a key role complemented with other explanatory factors reflecting in fiscal conditions. CEE countries have not been armed with prudence fiscal governance. Their deficits were above the 3% threshold stipulated in the Maastricht Treaty and preferred by the Stability and Growth Pact (*Chart 5)*. Fiscally more impaired governance occurred as a result of the recent crisis (*Chart 6*).

Chart 5. Trajectory of cyclically adjusted budgetary balance (% of GDP)



Note: the right chart contains average deficits in the period 2002-2007.
Source: AMECO

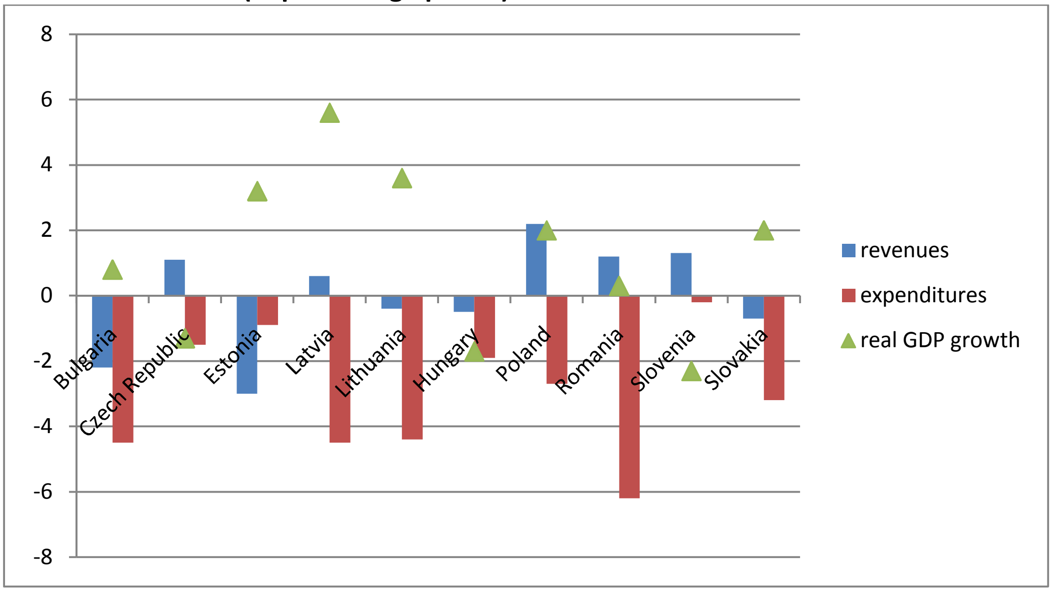
Chart 6. Trajectory of debt-to-GDP ratios



Source: Eurostat

As a consequence of the panic over the peripheral countries and with the fear of a contagion effect, not only the peripheral countries were forced by financial markets to implement enormous fiscal austerity (De Grauwe – Ji, 2012), but CEE countries to a large extent were also incentivised to implement large fiscal adjustments (*Chart 7*) in an effort to signal robustly the commitment to a more disciplinarian budgetary management and to lowering sovereign risks. As we indicated earlier, large fiscal adjustments were more or less doomed to fail because the more intense the austerity, the larger is the decline in GDP, hence in the debt-to-GDP ratios. Yet, these adjustments were mainly accompanied with recuperating economic growth by 2012 except countries that implemented moderated fiscal adjustments such as the Czech Republic, Hungary and Slovenia.

Chart 7. Changes in cyclically adjusted revenues and expenditures and real GDP growth (in percentage points) between 2009 and 2012



Source: Eurostat

The relatively rapid regeneration of GDP was mainly driven by export. In this regard it should be noted that the main trading partners of CEE countries such as Germany, Italy and France based their fiscal policy on moderated adjustments that not appear to have perceivable negative effect on these mostly small and export oriented economies. The relative improvement in terms of economic growth between 2009 and 2012 was higher in those countries which had higher average real GDP growth rates in the pre-crisis period 2003-2007, for instance in Estonia (8.12%), Latvia (9.48%), Lithuania (8.82%) and Slovakia (7.08%) (Eurostat, 2013). In countries of which average pre-crisis growth rates were relatively low like that of the Hungarian (3.34%) and Slovenian (4.82%) ones, the real GDP declined in the respected period. In the latter countries, problems are to a great degree linked to internal factors like anaemic domestic demand (private and public consumption, investment and change in inventories) that could not and cannot be fully overcompensated by exports.

Let us underscore that countries like Romania, Estonia, Bulgaria, Latvia and Lithuania carried out austerity measures (e.g. double-digit public sector wage-cuts, other expenditure cuts in fields such as social protection etc.) regained growth relatively quickly, however, their socio-economic paths to the crisis should be examined with meticulous care.

It would be naïveté to think that the country-specific features did not exert influence on the opportunities for austerity. Importantly, in case of Latvia, maintaining the peg required solid claim for structural reforms, austerity measures in an overheated – foreign capital flow-based economy, just like in Estonia and Lithuania. In case of Romania and Bulgaria, foreign capital-dependent growth model proved to be an unsustainable undertaking because as external shock occurs, banking crisis may easily arise where foreign owned banks are dominating and liquidity starts to dry up (Blyth, 2013: 222). This *per se* calls for differential diagnoses when it comes both to theoretising over economic ideas and empirically testing them.

Conclusion

Since Europe and the global economy is deeply integrated and serving as a fertile ground for non-linear effects of governmental policies (e.g. stimulus and austerity), national governments remain the main conductor of fiscal retrenchments in favouring more sustainable budgetary management. It seems that there is no universal and general yardstick for each country in Europe to tackle the crisis in a more effective way; however, fiscal policies can be geared towards minimising negative spill over effects of fiscal adjustments by building upon differential diagnoses.

Apart from the fact that domestic conditions should be improved through the gargantuan task of structural reforms, CEE countries' recovery relies heavily on the conditions of their main trading partners like Germany. Since Germany complemented with the highly competitive northern European economies have the necessary capacity to spark growth and thus serve as main engines for the European growth, southern austerity with a slower pace coupled with stimulus in the core and northern countries ought to be pursued parallelly. Consequently, CEE countries' fiscal challenges cannot be understood in isolation, a more systemic understanding is therefore needed in the European crisis management.

This would *per se* require financial markets to make perceptible shift in their mindset from being engaged in forcing countries superstitiously to conduct austerity to meet deficit and debt targets to the view tuned towards reinvigorating Europe's growth potential as a whole. It also implies that the view of simply dismantling the Hobbesian Leviathan states through fiscal adjustments that are targeting numerical objectives should also be replaced by a more nuanced one that enshrines the idea of making public sector itself to be more effective and innovative to increase societal welfare[12].

[12] See: European Commission (2012)

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