Zagreb International Review of Economics & Business, Vol. 15, No. 2, pp. 45-60, 2012

ISSN 1331-5609; UDC: 33+65

Fiscal Policy in Crisis: Rethinking Austerity

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Abstract: Many macroeconomists and politicans claim that fiscal austerity – getting the budget deficit down immediately – would be good for employment and growth. We think that fiscal stimulus is expansionary, and fiscal contraction is contractionary. There is a large and growing body of literature that shows that fiscal expansion can help economy to grow and reduce unemployment in near term; that certain types of fiscal stimulus are very effective and that fiscal contractions tend to lower output and employment in the short run. Fiscal austerity may be desirable for the long-term solvency and health of the economy. But it lowers growth and raises unemployment in the near term. A policy mix between new monetary strategy (nominal GDP targeting) and fiscal stimulus would be especially effective.

Keywords: austerity, stimulus, NGDP targeting, fiscal multiplier, full employment

JEL Classification: B22, E62, H6, P43

Introduction

If we want to talk about austerity measures we have to go back to the theoretical background of economics of monetary union and open economy macroeconomics (De Grauwe, 2007.; Lapavitsas, 2012).

Optimum Currency Areas Theory

Countries can use national monetary policies, including exchange rate changes, to make balance-of-payments adjustments in case of demand shocks (reduced output and higher unemployment). Members of monetary union have different mechanisms, bacuse they don't have national monetary policy: wage flexilibility (and mobility of labour). This will require country-member of monetary union to follow deflationary

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policies, which in turn will constrain the growth process. Thus, a monetary union has a cost for the growing country.

It will find more advantageous to keep its national currency, so as to have the option of depreciatiang its currency when it finds itself constrained by unfavourable developments in its trade account.

Fiscal policies are implemented at national levels, but monetary policies are centralized (ECB and Target-2 payment system) and therefore cease to be a source of asymmetric shocks. But, although monetary and economic integration can weaken the occurrence of asymmetric shocks, the existence of nation-states, i.e. the level of political integration, with their own specific will be contiuned source of asymmetric disturbances in a monetary union.

In the analysis of Mundell, who pioneered „theory of optimum currency area" in his celebrated article 1961, a depreciation is a flexible instrument that can be used frequently in balance-of-payments adjustments, which could influence output and employment. The absence of national monetary and exchange rate policies to assist in the adjustment process will be felt as a macroeconomic cost of the monetary union. This is very important conclusion for Croatia, as a new EU member. As we can see, the hard core of the OCA analysis still stands. Although exchange rate volatility can be an independent source of asymmetric shocks, it is still true that large shocks can occur which can more easily be dealt with when the exchange rate can be allowed to adjust.

Open Economy Macroeconomics

Let us suppose a simple model of balance-of-payments policy. A country is a two-sector economy: tradables and non-tradables. National economy has a current account deficit. By fiscal contraction (austerity measures) absorption/domestic demand will be reduced. The role of monetary policy would be to manage exchange rate.

To simplify, fiscal policy could be targeted on absorption (real spending cuts, so-called „disabsorption"), and monetary policy on the exchange rate, in order to achieve the so-called „internal and external balance". This is a „two-targets two-instruments" strategy. Essentially, appropriate disabsorption (budget cuts, austerity) and relative price change/switching, like a devaluation are likely to be needed.

To simplify, it follows that when the spending cuts/austerity measures are associated with the right switching policy/devaluation, the budget cuts need not be as great as when the whole balance-of-payments adjustment process has to be brought about by an absorption reduction on its own.

But, members of the eurozone are not able to have a switching policy, and austerity measures are considered as the main policy instrument for adjustment process, which is politically very painful. This is so-called „internal devaluation", essentially an attempt to reduce real wages in order to regain international competitiveness.

Some flexibility in eurozone could be found in unconventional monetary policy of the ECB (Quantitative Easing - QE), that ECB/ESCB started to follow by the end of last year introducing new refinancing facilities (Emergency Liquidity Assistance - ELA and Long – Term Refinancing Operations - LTRO). Expansionary monetary policy and weakening of the euro (against dollar) could bring positive effects as any other switching policy and to some extent could ease political pressure on fiscal policy.

The Issue

This is not the place to review in detail the large literature on the effect of fiscal policy on economy. We think that fiscal stimulus is expansionary, and fiscal contraction is contractionary. There is a large and growing body of literature that shows that fiscal expansion help economy to grow and reduce unemployment in near term; that certain types of fiscal stimulus are very effective and that fiscal contractions tend to lower output and employment in the short run. Fiscal austerity may be desirable for the long-run solvency and health of the economy. But it lowers growth and raises unemployment in the near term.

Many conservative politicians and neoliberal economists claim that fiscal austerity – getting the budget deficit down immediately – would be good for employment and growth.

Expansionary Fiscal Contractions?

Estimating effects of fiscal policy is very hard. Giavazzi and Pagano (1990) were among first to raise possibility of expansionary fiscal contractions. They analyzed Denmark and Ireland and found evidence that spending cuts in late 1980s were folowed by strong growth in the private sector. In both cases, fiscal consolidation was acompanied by a shift in the balance of political power and by complementary monetary and exchange rates policies. Both countries experienced a large initial devaluation and then they pegged their currencies to the German mark, inducing sharp disinflationary process and liberalized capital flows. Essentially, the final outcome of fiscal conslidations was determined by the complementary policies and expectations of future policy they induced. But, it is important to emphasize, as Gavazzi and Pagano note, these two cases were the exceptions, not the norm! The estimated effect on output is indeed positive, although statistically not significant. In addition, two countries had experienced a rapid deterioration in their sovereign debt rating, after expansionary fiscal contractions. The results also suggest that these two cases are not representative of the normal output response, even among countries with a relatively poor initial credit rating (IMF, 2010).

Later, a very influental paper by Alberto Alesina and Silvia Ardagna (2010) found that fiscal austerity was generally espansionary. European (and our) policymakers also belive this strongly. German policy makers are firm believers in expansionary fiscal contraction, which heavily influences EU policy response to economic crisis in the eurozone. But this is not conclusive. What Alesina and Ardagna did was to get budget data for a large number of advanced countries for past 35 years. They identified large fiscal consolidations and found that output tended to rise on average after these consolidations, particularly those focused on government spending cuts. But, we have to take into consideration a problem called by economists: „omitted variable bias“[1]. Essentially, any time looking at the relationship between two variables, you need to worry that a third variable is influencing both of them. We have learned that omitted variable bias is the central problem in this area and in the most empirical research in economics. Failing to take account of this omitted variable leads to a biased estimate of the relationship of interest. Unfortunately, there turns out that there was a lot of omitted variable bias in Alesina and Ardagna's empirical analysis. This omitted variable bias made it look as though deficit reduction was expansionary, when in reality it was not (Romer, 2011).

The proponents of radical austerity policy, usually take as a role model of successfull fiscal adjustments in Baltic countries. But, it is a false hope. Kattel and Raudla (2012) published a paper on Baltic Austerity and their main findings are that the Baltics essentially „outsourced“ their recovery, through massive use of EU fiscal funds (there is high level of uncertainty, because EU funds run out by 2015), deep economic integration with Scandinavia and Poland and due to uniquely elevated levels of emigration, the pace of which has increased since the crisis broke, decreasing high unemployment in the Baltics. Lithuania and Latvia experienced particularly large depopulation process in 2011. These unique circumstances account for a great deal of the modes growth enjoyed by the Baltic economies – but they have little to do with domestic policies.

In the United Kingdom experts urge George Osborne to make U-turn on austerity. To simplify, he has been urged to abandon austerity plans and boost infrastructure spending to rescue the economy by the group of 20 top economists who backed his deficit cutting plans just two years ago (Eaton, 2012). The revolt by the same experts whose support for the Tory economic strategy was a pivotal moment in the pre-election debate in 2010 will be embarassing for the Chancelor. He is already facing calls from IMF and employers body the CBI to take action on growth in the wake of double-dip recession.

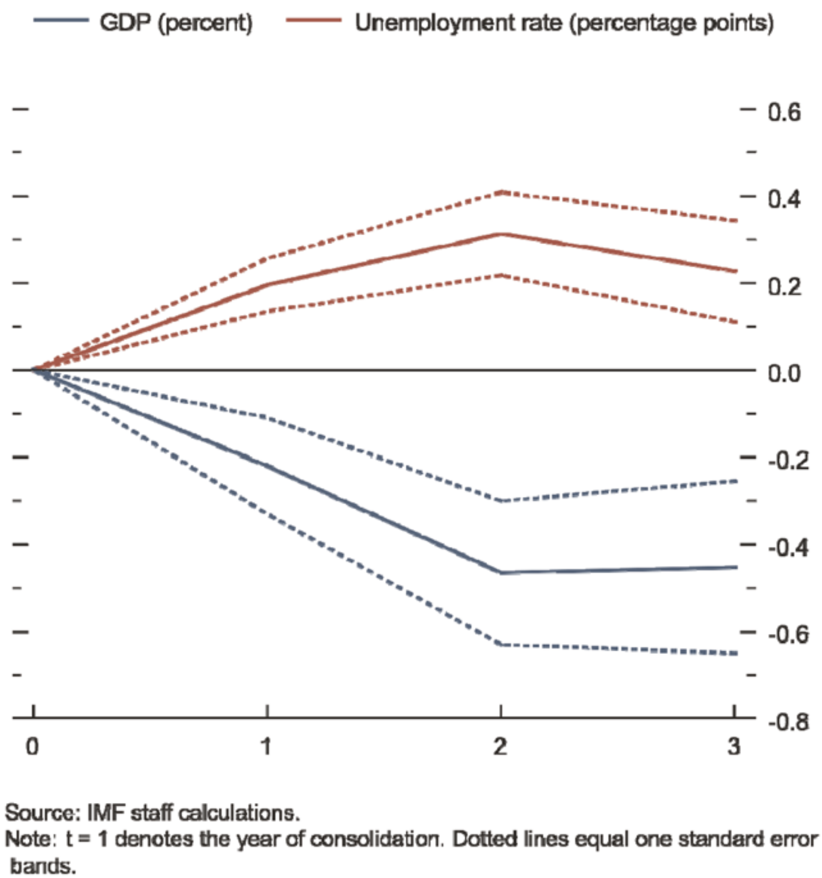
Greece says that it needs „breathing room“ to pay debt. The austerity-based fiscal adjustment program shows catastrophic effects (Polychroniou, 2012). Greece's governing coalition, grappling with the fifth year of recession and youth unemployment of about 50 percent, has said it favors an extension of its fiscal adjustment program by two years to 2016.

Rethinking Austerity

There are much more careful studies at the IMF (2010), and papers published by Robert Skidelsky (2010), Robert Parentau (2010), Christina Romer (2011), Paul Krugman (2012), Brad De Long (2012), Giancarlo Corsetti (2012), Carlo Cottarelli (2012), Costas Lapavitsas (2012) and many other researchers.

For instance, an IMF paper (2010) shows that unemployment and output fell following austerity programs. They identified deliberate consolidation moves in 15 advanced countries over the last 30 years using narrative analysis. They dealt with omitted variable bias. Fiscal contraction in normally contractionary. A fiscal consolidation equal to 1 percent of GDP tipically reduces real GDP by about 0,5 percent and raises the unemployment rate by about 0,3 percentage points. IMF's findings are consistent with our views that fiscal austerity is pro-cyclical and unemployment has risen dramatically after austerity programs. Figure 1 offers a striking image of fiscal consolidation episodes and their outcome on GDP growth and unemployment.

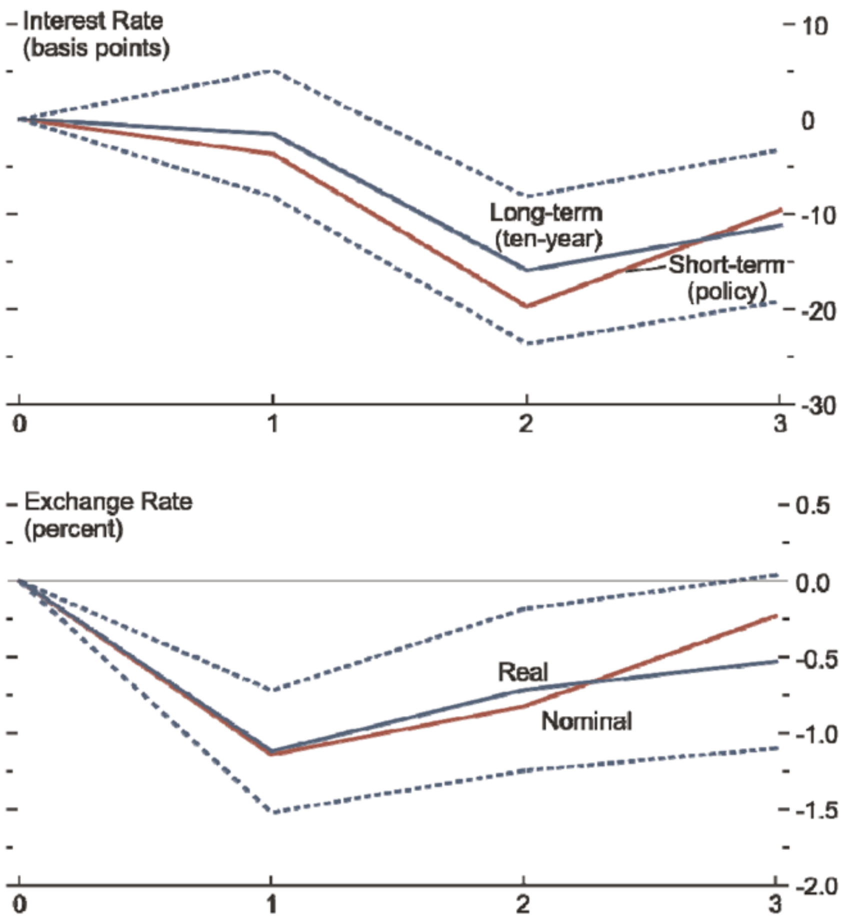
Figure 1. Impact of a 1 Percent of GDP Fiscal Consolidation on GDP and Unemployment



Source: International Monetary Fund (2010)

Other main findings of the IMF are the following: reductions in interest rates usually support output during fiscal consolidation programs (Figure 2); devaluation of domestic currency typically plays an important cushioning role by inducing net exports (Figure 2), fiscal consolidation results expand net export, thus changing GDP components (Figure 3); and, model simulations suggest that over the long term, reducing debt is likely to be beneficial.

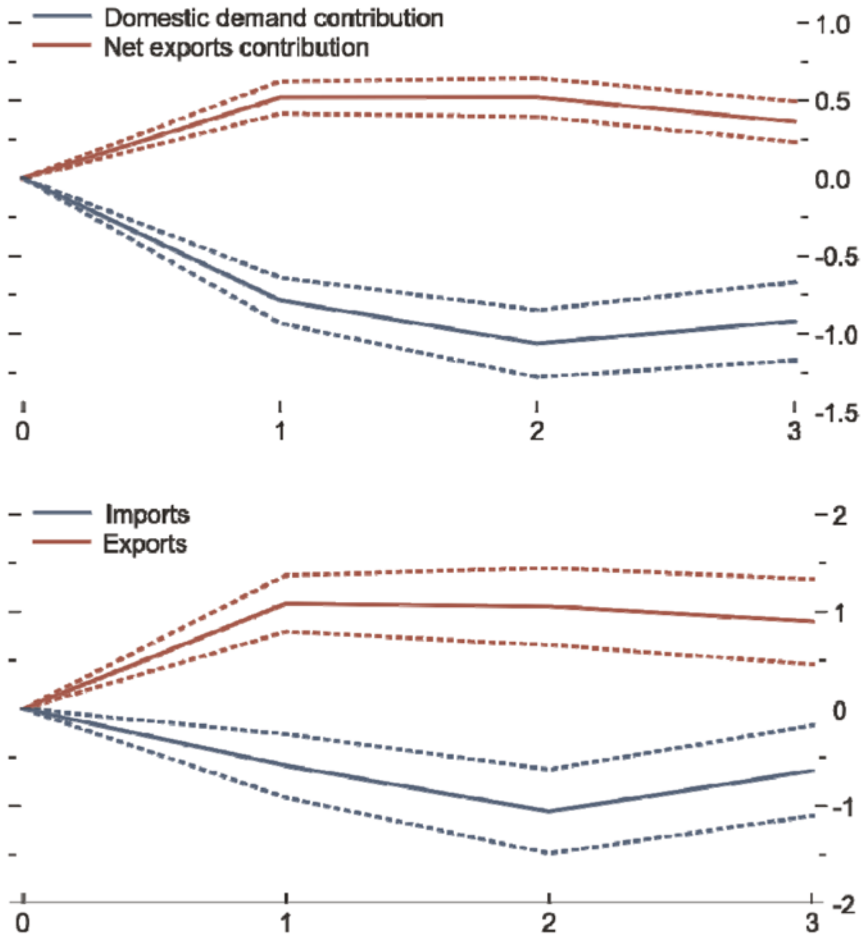
Figure 2. Response of Monetary Conditions to a 1 Percent of GDP Fiscal Consolidation



Source: IMF staff calculations.
Note: t = 1 denotes the year of consolidation. Dotted lines equal one standard error bands.

Source: International Monetary Fund (2010)

Figure 3. Impact of a 1 Percent of GDP Fiscal Consolidation on GDP Components (Percent)

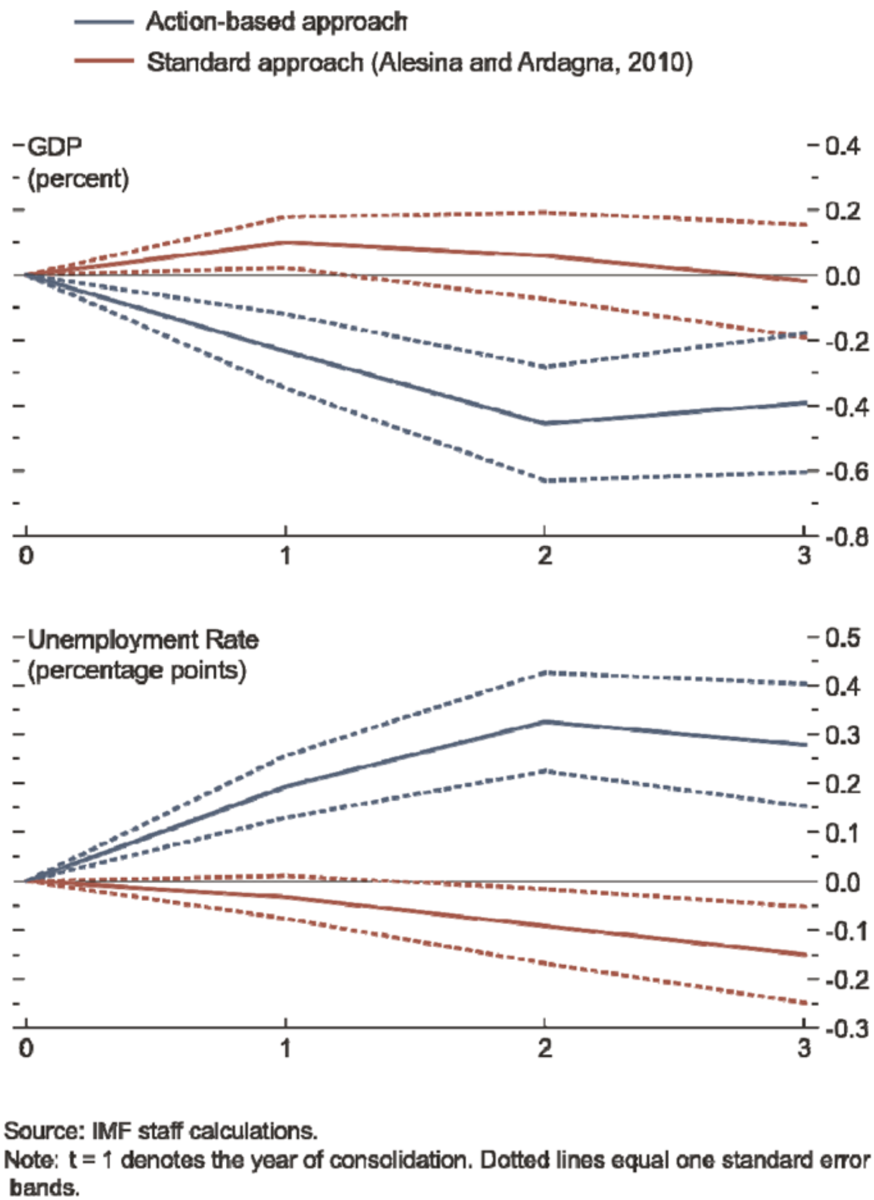


Source: IMF staff calculations.
Note: t = 1 denotes the year of consolidation. Dotted lines equal one standard error bands.

Source: International Monetary Fund (2010)

A comparison of standard approach (Alesina and Ardagna, 2010) and action-based approach (IMF, 2010), identified significant differences (Figure 4.). Large fiscal consolidations - according to the action-based approach - impact on GDP is negative and unemployment rises.

Figure 4. Impact of Large Fiscal Consolidation on GDP and Unemployment: Action-Based Approach versus Standard Approach (Impact of each additional 1 percent of GDP fiscal consolidation)



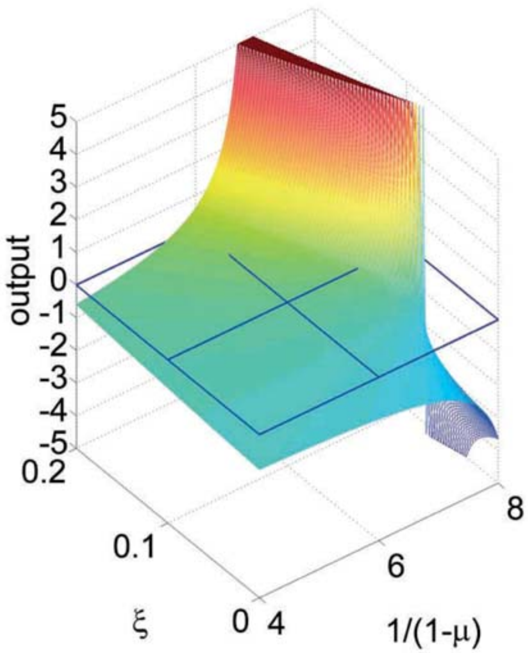
Source: International Monetary Fund (2010)

The experience of a number of countries currently undergoing fiscal austerity is consistent with IMF findings (Greece, Portugal, Ireland, Spain, the United Kingdom, Italy, Serbia, Slovenia, Croatia, etc.).

Brad De Long and Larry Summers (2012) published a paper on the efficiency of discretionary fiscal policy concluding that in severely depressed economies in which interest rates are constrained by the zero lower bound discretionary fiscal policy is a crucial instrument. Essentially, the analysis suggests that under plausible conditions temporary fiscal expansions may actually be self-financing. Even if expansionary policies do raise long-term debt levels, the analysis suggests that they may well be desirable in certain circumstances. A most important conclusion is that policies of deficit reduction in the presence of substantial output shortfalls will have adverse impacts in both the short and long run, and may even exacerbate creditworthiness problems. They suggested that temporary fiscal stimulus are consistent with a perception of long run fiscal consolidation. There is positive experience with temporary fiscal expansions and also with phased-in-long-run deficit reductions.

Finally, Giancarlo Corsetti et al. (2012) published a paper, which has views of leading economists on austerity. The issue has many dimensions. This issue can be illustrated by means of figures that I borrowed from Corsetti (2012).

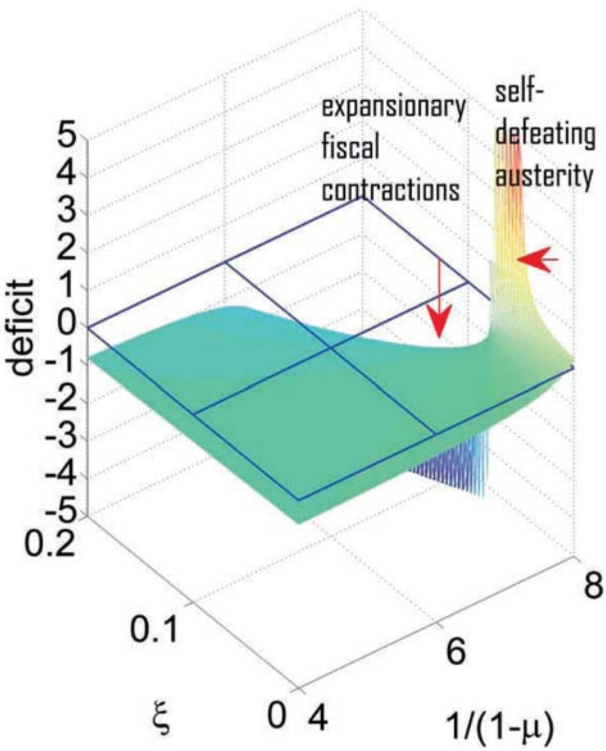
Figure 5. Short term recession, austerity expansionary



Source: Corsetti (2012)

The figure conveys a key message. If a recession is not expected to last very long (below four quarters), upfront spending cuts cause a moderate fall in output, and end up reducing the deficit. The contractionary impact of the Keynesian multiplier is attenuated by the positive effects of the cut on the interest rate on sovereign debt, reflected by private borrrowing costs. However, when the anticipated duration of recession is longer – between one and two years – the results are radically different. With a low sensitivity of the sovereign risk premium to future deficits, the multiplier effect dominates and becomes quite large. Because of a large multiplier, upfront cuts are self-defeating: the deficit-to-GDP ratio actually rises.

Figure 6. Long term recession, austerity self-defeating



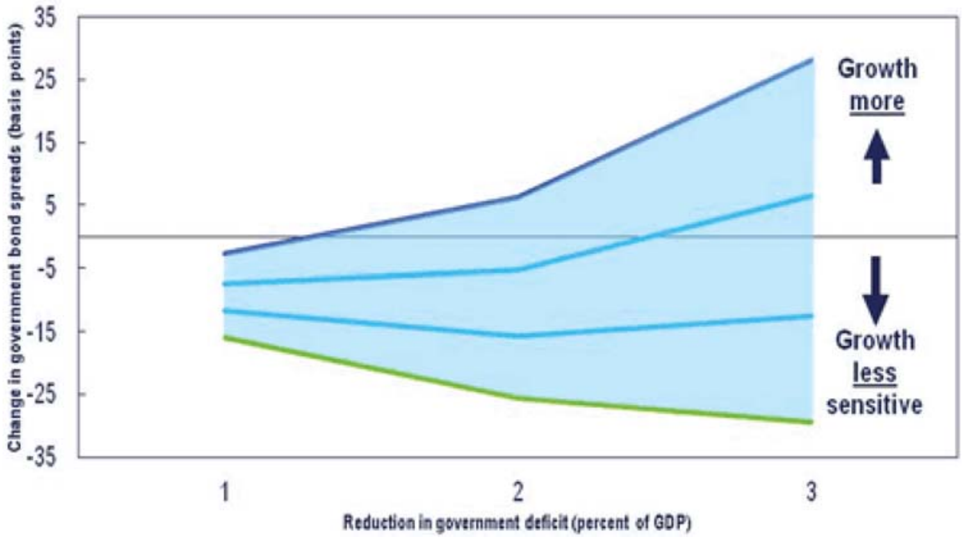
Source: Corsetti (2012)

Essentially, there is a fine line between self-defeating and expansionary contractions are quite thin: small differences in expectations and market attitude make a large difference on the outcome. In addition, with longer anticipation of duration of recession, the economy becomes highly vulnerable to self-fulfilling crises.

Cottarelli (2012) analysed correlation between fiscal austerity and market behaviour. It shows that lower debt ratios and deficits lead to lower interest rates on sovereign debt, but so does faster short-term growth. So, when countries implement fiscal austerity and the economy slows, some of the gains from better fiscal fundamentals will be lost through lower growth and long-term fiscal prospects. There is nonlinear relationship between growth and sovereign debt spreads (CDS). As Cottarelli mentioned in his work, spreads are more likely to increase when growth is already low and the fiscal adjustment is large (see Figure 7, that was borrowed from Cottarelli, 2012). Essentially, if growth falls as a result of austerity measures, interest rates could actually rise as the deficit falls.

Figure 7. Fiscal adjustment: Double-edged sword?

Fiscal adjustment can help lower spreads on government bonds where the impact on growth is limited. But the more fiscal tightening hurts growth, the more it will also cause spreads on government bonds to rise.



Source: Cottarelli, (2012)

To simplify, self-defeating austerity in a depressed economy is the most likely outcome of radical fiscal adjustment. Paul Krugman (2012) published a book „End This Depression Now“. His policy point of view is that „it really doesn't matter whether austerity in a depressed economy literally hurts a country's fiscal position or merely does very little to help that position. All that we need to know is that the payoff to fiscal cuts in times like these is small, possibly nonexistent, while the costs are large“.

Political Implications of Austerity Measures

Radical austerity policies are losing credibility in the Eurozone. Citizens don't feel that they are succesfull. They don't think that sacrifices deliver promised results. With Europe in a double-dip recession, voters rewarded those who opposed austerity measures. There is a growing dissatisfaction of the electorate with the European Monetary Union and the current setting of the European institutions. The political developments in Europe raise an important consistency issue for the current setting of European policies.

Essentially, can respresentative democracy and the fiscal austerity stay together? Radical fiscal austerity, as deflationary policy, increases unemployment, thus lowering democratic legitimacy of the mainstream political parties and incites political polarization.

Negative political aspects of austerity measures have deep rationale. We might add an insight from Michal Kalecki (1943), who wrote an essay „Political Aspects of Full Employment". Basically, Kalecki found that business leaders are opponents of public investment policy aimed at restoring full employment. Bussines lobbies are focused on private investments and have a veto power over government actions. Essentially, deflationary policies are supported by the bussines lobbies that are more rent-seeking and they want to restore „bussines confidence" with conservative fiscal policy, some kind of radical fiscal adjustment and restrictive monetary policies. In his concept of the political business cycle, Kalecki focused atention on a different viewpoint of business lobby and the masses of the achivement and maintainance of full employment. He analysed the actual mechanism of transmission of economic interests of two classes within the institutional framework of parliamentary democracy. Kalecki's diagnosis was that fiscal austerity and private investment - led growth are in best interests of the business community and explains the causes of capitalist's opposition to a permanent full employment. This theory could also explain radical austerity strategy applied as a EU response to the eurozone debt crisis. EU response to the crisis offers an example of the policies aimed to protect the interests of large financial and industrial capital (Lapavitsas, 2012). To simplify, radical austerity leads to political instability and unstable democratic institutions.

In Greece, two mainstream political parties were barely able to form a unstable coalition government, while leftist movement Syriza became the second largest political party. Voters judged the two big parties to be guilty of providing parliamentary support to the radical austerity measures. In Italy, technocratic Government lead by Mario Monti is losing ground, as a consequence of radical austerity program. Italy has large public debt, although their governments are able to run primary budget surpluses since the early 1980s. Debts that are big are crippling growth rates, and Italy's economy has been stagnant for more than a decade. The Five-Star Movement won local elections and together with leftist Democratic Party could win parliamentary majority on next general elections. French Socialist Party won the Presidential elections, while neo-communist Mellenchon achived notable electoral success. The winner Hollande repeatedly made promises that austerity shall not be implemented in France. In Germany, The Pirate Party has gathered more than 8 % of the vote in Schleswig-Holstein, while CDU and SPD are constantly losing public support and the Liberal democrats are fighting for survival[2]. Much the same applies, or will soon apply to Portugal, Spain, Slovenia, Serbia, Croatia, Netherlands and other European countries. The spectre of anti-austerity movements haunts Europe. As in every Eurozone country in crisis austerity policy was meant to reassure the markets, but it had the exact opposite effect. The more governments tighten, the more likely they are to fall in bad equilibrium. Essentially, dynamic growth is what matters the most and strenghtens the credibility of the country's fiscal and economic policy.

Concluding Remarks and Policy Recommendations

What does all of this evidence mean for policymakers? What is to be done? I don't want to get into detailed policy advice. But there are some broad implications that I think are very important.

A most important conclusion is that policies of deficit reduction in the presence of substantial output shortfalls will have adverse impacts in both the short and long run, and may even exacerbate creditworthiness problems. Radical austerity measures are self-defeating, effects of radical fiscal reduction are lower growth process and higher unemployment. The resulting unemployment makes the budget deficit problem even worse. Essentially, fiscal austerity leads to higher unemployment which leads to higher deficits and more austerity. The result is bad equilibrium of the economy. Recession than turns into economic depression.

Austerity as economic doctrine and political ideology rationalizes social injustice. Radical fiscal adjustment has large redistributional effects[3], that serve interests of the few (banking industry). Policy makers have to change focus from deficits and low inflation to job creation and growth. Mass unemployment is a terrible problem. It is imperative to get this unemployment down quickly. Specific types of fiscal stimulus are very effective. The empirical evidence is that fiscal stimulus does raise output and employment significantly.

Policy makers have to come up with a new policy mix, in which non conventional monetary policy should be combined with counter - cyclical fiscal policy. Woodford (2012) says that fiscal stimulus, such as tax cuts or spending increases, pairing with NGDP targeting (because inflation targeting is not an effective monetary regime in deflationary crisis) would be especially effective as policy intended to boost growth, as it would prevent any „crowding out" of private sector activities or inflation that could result from increased government spending. Fiscal stimulus should be accompanied with a serious plan in order to reduce the fiscal deficit over time[4].

NOTES

[1] The usual approach to fiscal adjustment cases has been focused on swings in the cyclically adjusted primary balance (CAPB). But, there are some important methodological problems: standard cyclical –adjustment methods fail to remove effects of asset prices or that it ignores the motivation behind fiscal actions. Therefore, IMF analysis, rather then focusing on CAPB, look at policy actions. This so-called „action-based approach“ is closely related to the „narrative approach“ (IMF, 2010; Romer 2011). To sum up, the main importance of IMF analysis is that it reduced these bias problems and therefore allowed for a better estimation of the casual impact on output of fiscal consolidation (read more at: Appendix 3.3.: Identifying Periods of Fiscal Consolidation: The Standard versus the Action-Based Approach in IMF, 2010).

[2] Fiscal policy stance by the German political parties has been highly influenced by the economic ortodoxy that has the historical and ideological foundations of German economic thinking in the so-called „Ordoliberalism“ (read more at: Dullien and Guerot, 2012). German economic ortodoxy differs from mainstream international discourse. It is centered on austerity and low inflation stabilization policy at the expence of economic growth.

[3] Deploying Parentau's analysis of Sector Financial Balances (Parentau, 2010) allows important conclusions on the efficacy of austerity meaures. Namely, if foreign financial balance does not change radically, then changes in the fiscal balance must be matched by an equal and opposite adjustment of the private sector's financial balance (because, essentially, Parenatau's accounting identity is: Domestic Private Sector Financial Balance+Fiscal Balance+Foreign Financial Balance=0). If we rearrange the financial balance identity as follows, we have:*Domestic* Private Sector Financial Balance = Current Account Balance – Fiscal Balance. If a nation wishes to run a persistent fiscal surplus and thereby pay down government debt, it needs to run an even larger trade surplus, or else the domestic private sector will be left stuck in a persistent deficit spending mode. When sustained over time, this negative cash flow position for the domestic private sector will eventually increase the financial fragility of the economy, if not insure the proliferation of household and business bankruptcies. It follows that austerity policies aimed at reducing public deficits must be matched by increased private spending. Fiscal austerity focused on wage cuts or wage freezes, rising unemployment and uncertainty, will decrease private investment and consumption. As a result, austerity strategy will then most likely lead to contraction of GDP, rising unemployment and wage deflation. Austerity strategy will thus become self-defeating (read more at: Parentau, 2010).

[4] EU Council has compiled a new Fiscal Compact Treaty on 9 December 2011. Many economists think that Fiscal Compact in fact contain budgetary constraints enshrining 'pro-cyclical fiscal policies' and even outlaw Keynesianism. But, is seems that the Treaty permits a Eurozone member hit by an earthquake, natural disaster, or a severe economic blow to undertake temporary fiscal stimulus. Also, if a Eurozone has a large output gap, it can implement a fiscal stimulus to reduce it. Current mainstream economic thinking suggest that sound fiscal policy has to be based on two main elements: First, it should guide an economy towards a moderate and sustainable level of public debt. Second, it should keep public debt fluctuating around this moderate level in a countercyclical fashion. In relation to the first element, the compact emphasises the need for an explicit trajectory whereby countries can return towards a 60% debt-to-GDP ratio. Far less positive, however, is the so-called golden rule setting a

legally binding maximum structural deficit of a 0.5% of GDP when a country has a debt ratio above 60% and a maximum of 1% when a country has a debt ratio lower than 60%. Simple analytics shows that in relation to long-run debt levels, the so-called „golden rule“ will led, over time, to debt ratios well bellow those considered sustainable (Whelan, 2012).

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