

Bezhoska, Anita Angelovska; Mitreska, Ana; Bojceva-Terzijan, Sultanija

Research Report

The fiscal consolidation process in CESEE countries

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Anita Angelovska Bezhoska, Vice Governor

Ana Mitreska, Director of MPRD¹

Sultanija Bojceva - Terzijan, Deputy Director of MPRD

The fiscal consolidation process in CESEE countries²

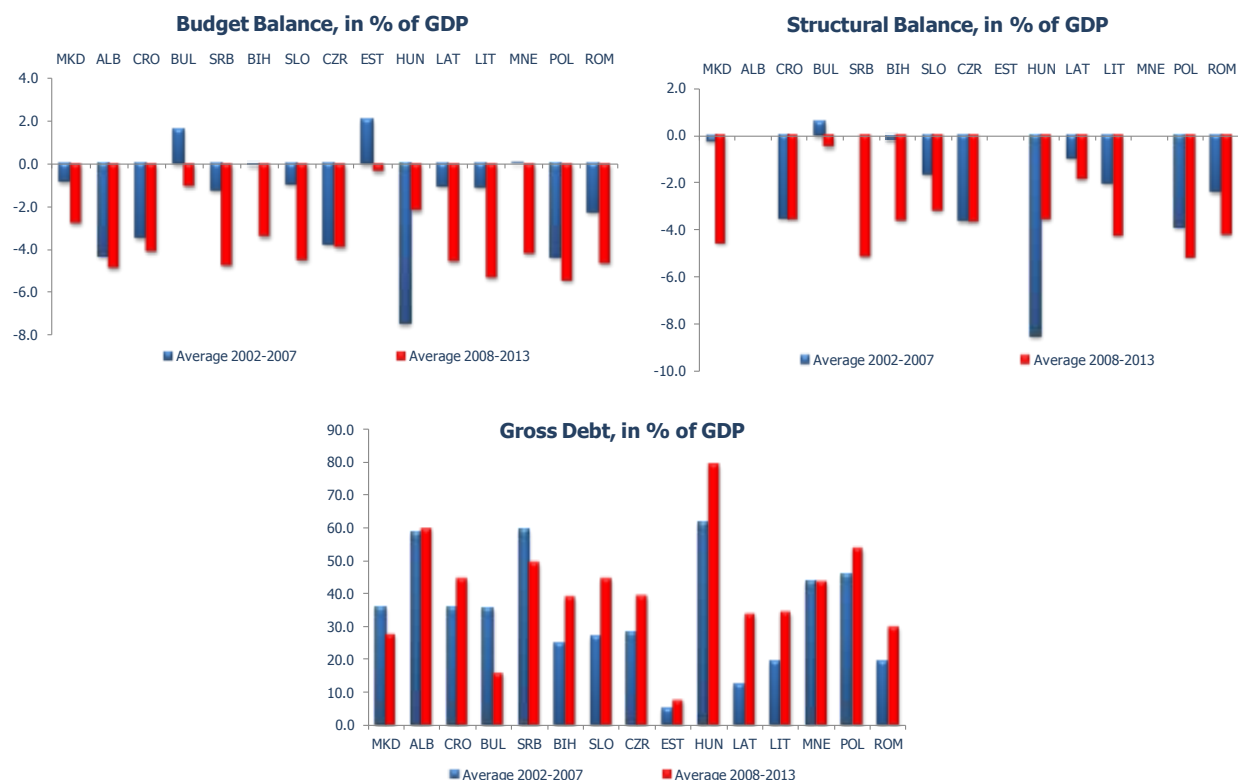
The aim of the note is to provide a snapshot on the current fiscal position of the CESEE group of countries, as well as a view at a glance on the envisaged medium-term fiscal path. Scrutinizing the fiscal stance is of importance, as it can provide "hints" on the challenges in multiple areas of interest. It can provide a general notion on the sustainability of public finances, the room for quantitative and qualitative adjustments in the fiscal area, whether the fiscal consolidation process adheres to the "conventional wisdom", and it can flag possible challenges for other policies. An understanding on what the current fiscal stance is, and whether it should be neutral, expansionary or not in the future, provides a general view on the room which monetary policy has or will have. Fiscal consolidation might alleviate the imbalances, and provide room for a looser monetary policy. However, at the same time, the monetary loosening must not yield significantly lower cost of financing on the domestic market, thus being a temptation for the fiscal authorities to put the adjustment on hold. "Monetary policy can powerfully facilitate the repair of public sector balance sheets over time in a number of ways. The temptation to overburden monetary policy is great, as is the risk of eventual fiscal dominance" (Orphanides, 2013).

The emergence of the global crisis expectably took its toll on the fiscal positions of the countries in the region. The headline fiscal balances deteriorated sharply, partly reflecting the impact of the automatic stabilizers. But, deterioration was visible in the structural balances as well, as governments were undertaking discretionary fiscal stimulus measures to support the economy. The public debt went on a rising track, and albeit being lower compared to the advanced world, given the lower threshold of tolerance, it worsened the risk profile of many of the countries within the group.

¹ Monetary Policy and Research Department.

² The note was prepared as a platform for discussion for the BIS Meeting of the Working Party on Monetary Policy in Central and Eastern Europe, Ljubljana, Slovenia on 27-28 March 2014. Special thanks to Mite Miteski and Jasna Petrova (MPRD) for collecting and organizing the data used in this note.

Chart 1: Headline deficit, structural deficit and public debt in the group of CESEE countries



Source: IMF, WEO database, October 2013.

In most of the countries, the need for fiscal consolidation was acknowledged quite soon after the onset of the crisis, and some of the countries started the consolidation process already in the 2010-2011 period. At that juncture, many of the countries were aware of their limited initial fiscal space before the crisis, and the concerns which the elevated level of fiscal deficits can raise in terms of the fiscal and the overall vulnerability of the economy. Without the ignition of the fiscal consolidation, debt ratios could have risen at a much rapid pace. This would have meant running into risk of financial markets not being willing to finance the large and non-declining financing needs. In general, the fiscal consolidation was pursued through adjustments in public spending, i.e., to a large extent it was expenditures-based. Albeit, some of the countries introduced tax changes, the

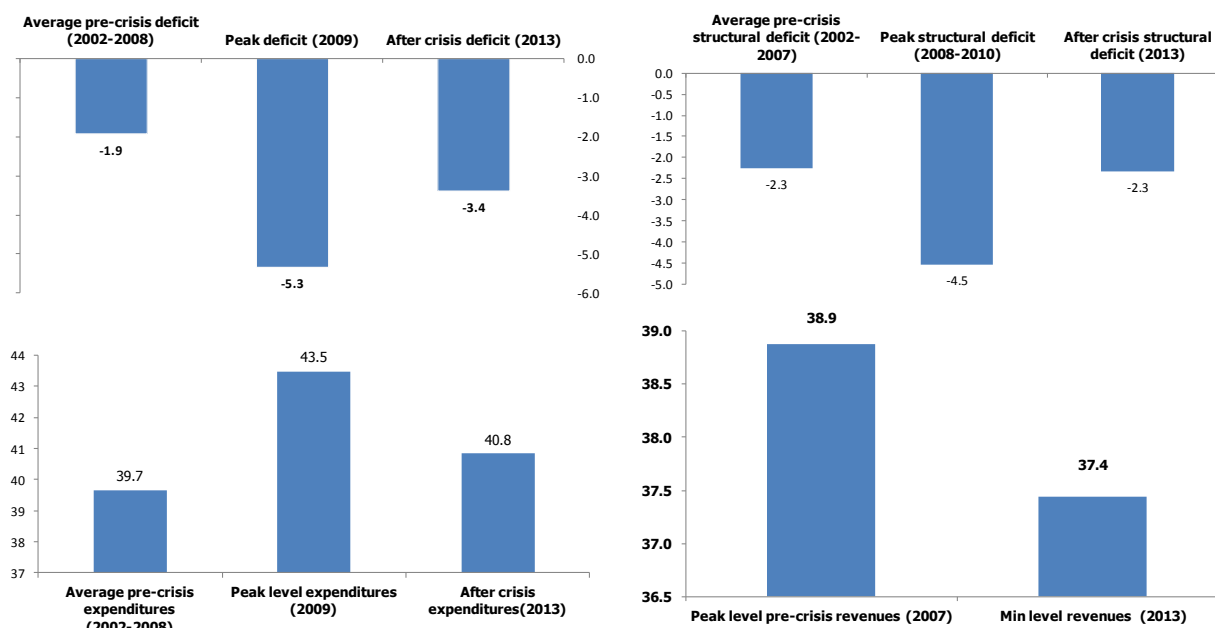
relative share of revenues in GDP, on average for the group has slightly declined.³ Exceptions are few countries, for instance Estonia, Hungary⁴, where there has been an increase of the share of the budget revenues.

Table 1: Tax Measures in Selected Countries from the CESEE region, 2010-13

Country	Personal Income Taxation		Corporate Income Taxation		Value-Added Tax		Social Security Contributions		Excises		Property	
	Rate	Base	Rate	Base	Rate	Base	Rate	Base	Rate	Base	Rate	Base
Czech Republic	↑	↑		↑	↑		↓ -1	↓ -1	↑			
Slovenia	↑		↓ -1						↑			
Bulgaria					↑	↑	↑		↑			
Estonia									↑		↑	
Hungary	↓ -1	↓ -1	↓ -1		↑		↑		↑			
Latvia	↓ -1	↓ -1		↓ -1	↑	↑	↑		↑		↑	↑
Lithuania	↓ -1		↓ -1	↓ -1		↓ -1		↑	↑		↑	↑
Poland					↑	↑	↑		↑			
Romania					↑				↑			

Source: IMF, Fiscal Monitor, October 2013.

Chart 2: Overall and structural budget balance (change in p.p.), revenues and expenditures, as % of GDP



Source: IMF WEO, October 2013 database, author's own calculations.

³ *Serbia* increased the VAT rate, the CIT rate, with elimination of certain tax incentives, PIT on dividends and interest income and the excise duties on cigarettes and petroleum. *Croatia* increased the basic VAT rate as well as the tax base, while the health insurance contribution rate was decreased. The CIT on reinvested earnings was repealed, large number of reliefs in the income tax system was eliminated and excise duties were raised. *Albania* eliminated certain VAT incentives and increased the excise taxes. *Montenegro* increased the basic VAT rate, PIT rate (for higher-income population) and excise taxes on cigarettes. *Bosnia and Herzegovina* introduced several reforms in the tax system, tax incentives for domestic companies and foreign investors, as well as changes in SSC in respect to certain categories of SSC payers. Also, the excise taxes were increased.

⁴ The sharp increase of the government revenues in Hungary, to a certain extent was driven by the diversion of the second pillar private pension contribution to the budget. The asset transfer from the second to the first pillar was estimated by the IMF to reach 10.1% of GDP in 2011.

Despite the ongoing fiscal consolidation in the region and the notable adjustment in the headline budget deficit, deficits have remained elevated and, for some of the countries, well above the pre-crisis average. For most of the countries, budget deficits are higher compared to the pre-crisis average (2002-2008) with highest deviation observed for Serbia and Slovenia. In many countries in the region, overall deficit remains high, while in some of them (Croatia, Serbia, Slovenia), the estimated deficit for 2013 exceeds the 2009 level. The data indicates that for some of the countries the consolidation has not started yet, in some of them the consolidation is more gradual, or it reversed at a certain point in time. Of course, the differences in the fiscal adjustment process reflect the diversity in the initial fiscal position, the difference in the degree of structural rigidities in the structure of the government expenditures, the political and economic space for revenue adjustments, as well as the cyclical position of the economy.

Chart 3: Speed and size of fiscal adjustment*

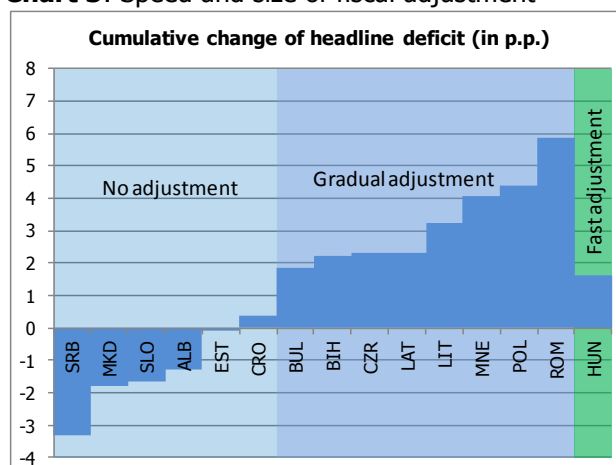
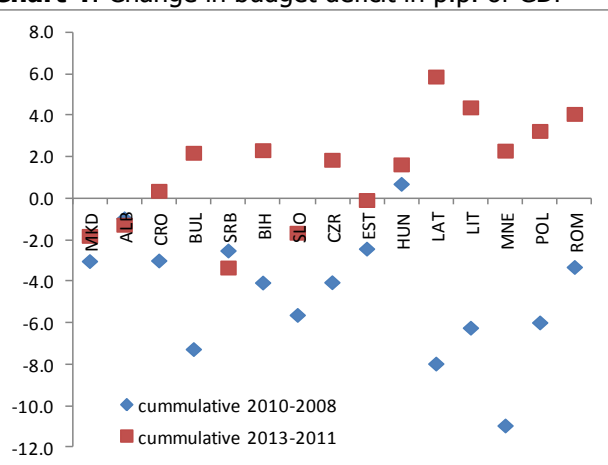


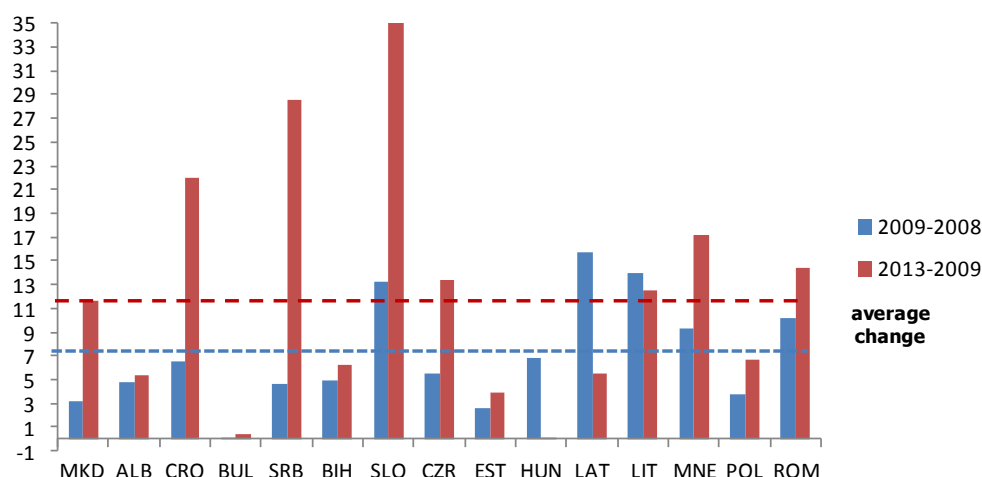
Chart 4: Change in budget deficit in p.p. of GDP



*Speed: no consolidation; consolidation distributed within three years ; concentrated adjustment in one year. The consolidation refers to the 2011-2013 period.

Given the persistent budget deficits, after the sharp increase in the "acute" phase of the crisis, the level of public debt stayed on a rising track in the aftermath of the first wave of the crisis. In 2009, the level of public debt, on average for the region, rose by 7 pp in only one year, with notable differences among countries. The debt of a group of countries (Slovenia, Latvia, Lithuania, Montenegro and Romania) increased above the average. Yet, with the exception of Bulgaria and Estonia, the upward shift of public debt of the other countries was not negligible at all. Afterwards, the public debt of all countries within this pool continued to rise, with an average increase of around 12 pp in the 2013-2009 period (Bulgaria and Hungary being the exceptions). The biggest increase of the public debt is observed for Slovenia, Serbia and Croatia.

Chart 5: Change in the public debt, in percentage points of GDP



The rising public debt and the vulnerabilities it implies, suggest a need for further fiscal adjustment.

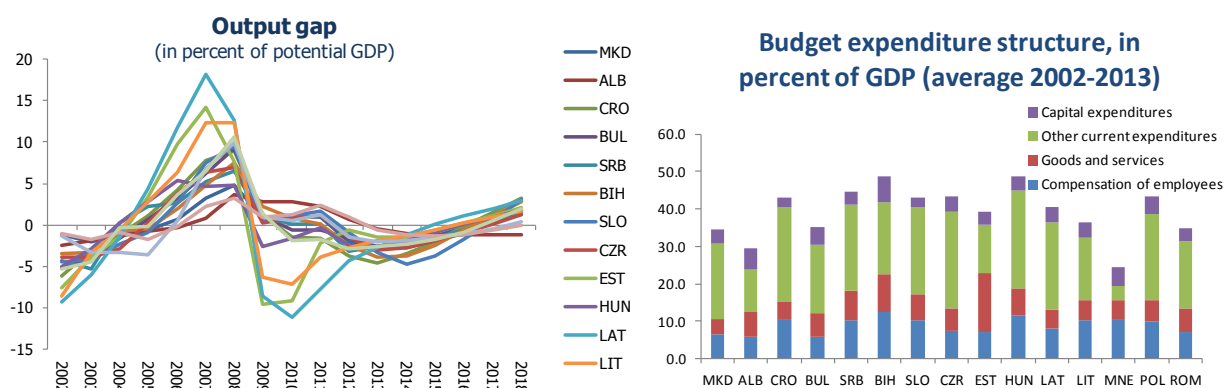
The latest available IMF country reports (where the public finances are scrutinized in depth), confirm the hypothesis. For many of the countries in the region, the policy advice pinpoints the need for further consolidation, while for those where the public finances are "in order", the role of fiscal policy in cushioning potential shocks is limited to temporary and targeted measures. For a group of countries, in which Serbia, Hungary, BIH, Croatia, Albania, Macedonia, Slovenia, Montenegro, Lithuania can be pinned down, the policy advice emphasizes the need for further fiscal consolidation. In general, the proposed model aims towards gradual and steady fiscal consolidation, which can be combined revenue- and expenditure-based, but anyway inevitable for the purpose of reaching a manageable public debt level, preventing deterioration in the sovereign and corporate pricing and maintaining the external market access. Other countries, like Poland, Bulgaria, Latvia, Estonia and the Czech Republic are praised, but still a neutral fiscal policy stance is required and some of the medium fiscal challenges are required to be addressed (the aging population and the impact on the sustainability of pension finances for example).

Consequently, the current debates and general dilemmas pertaining to fiscal consolidation are of a high priority, when the public finances of CESEE countries are discussed. The scope of consolidation, the speed of adjustment and whether the consolidation should be revenue- or expenditure-based are the main issues to be tackled. The main goal is to design a fiscal consolidation path, which would reflect the commitment of the governments to debt sustainability and at the same time would be least harmful for the economic prospects of the region. The general notion is that it is difficult to strike the appropriate balance. A small in size and very slow fiscal consolidation could destroy the confidence of financial markets, but if consolidating fast and in a large size, the recovery might be undermined. Hence, despite the consolidation of public finances, the public debt might rise further, posing the questions on its sustainability and tempting the confidence of international investors. The recent empirical research yielded, or in fact, confirmed certain "guidelines" in this regards. Pennings

and Ruiz (2013) for example, explore whether the consolidation should be front-loaded or should run at a steadier pace. Their findings support more gradual consolidation, of course given a market access and credible consolidation plan. Alesina et al., (2012) find that "adjustments based upon spending cuts are much less costly in terms of output losses than tax-based ones. The difference cannot be explained by accompanying policies and it is mainly due to the different response of business confidence and private investment." A very recent assessment by the European Commission of the impact of 2010-2013 fiscal consolidation in Europe, among others, concludes that "the crucial issue is the appropriate pace for consolidations. On the one hand one could argue that for as long as crisis conditions prevail, a slower pace, i.e. back loading some of the required adjustment to later years... However, a more gradual adjustment would require a credible long term consolidation strategy designed to avoid adverse financial market reactions to a slower pace of consolidation". In fact the evidence proves that time is needed for the markets to acknowledge effects of fiscal consolidation. Market confidence is heavily dependent on fiscal fundamentals. Apparently, despite the "conventional wisdom" which the empirical research can yield, there are many preconditions and probably important country specifics, which are crucial for the success of a fiscal consolidation plan.

As noted, it is perceived that fiscal adjustment is likely to have a larger adverse impact on economic activity when implemented while output gaps are negative rather than positive. Most of the CESEE are currently faced with negative output gaps and a need for fiscal consolidation. The general recommendation is to pursue a gradual fiscal consolidation when a large slack in the economy is present. Hence, for the CESEE, despite the limited fiscal space, the probability for a better off economy is higher with a well-sequenced fiscal consolidation, than if a "shock" therapy is implemented. *The evidence shows that the expenditure-based consolidation proves to be more efficient compared to the revenue-based one.* But, this model of consolidation might be quite challenging for some of the CESEE countries. The expenditures' structure proves to be more rigid, and therefore, difficult to be downsized in a short time span. Hence, for these emerging countries, amidst unfavorable economic prospects, the gradual fiscal consolidation might be not only recommendable, but also unavoidable.

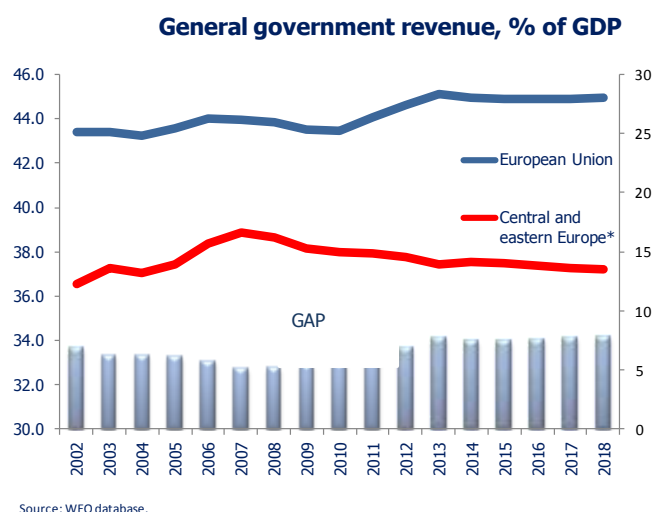
Chart 6



Source: WEO database and various IMF country reports.

If one screens the magnitude of budget revenues, a permanent and relatively constant gap, compared to the average of the EU can be noticed, which indicates the scope for part of the consolidation to proceed through tax measures. Indeed, as mentioned before some of the countries undertook changes in the tax rates, for a sole purpose of increasing revenues, amidst rigid expenditures structure and unavoidable fiscal adjustment. But, it appears that there is still a room for maneuver. Some of the measures, which the advanced countries introduced in the aftermath of the Great Recession brought to the fore a discussion on the possible consensus on the optimal taxation changes that can be considered by other countries when devising the modifications in the tax systems with a view of minimizing distortions and increasing efficiency. Consensus has been centered around pursuing a fiscal devaluation (shifting tax burden from direct to indirect taxes), widening the tax base by eliminating unnecessary exemption before raising tax rates, taxing externalities and strengthening tax compliance. The choice in the practice has been mixed. For the purpose of providing "quick fix" of revenues, many countries from the CESEE increased the rates on indirect taxes (VAT, excises), most of the countries decreased the rates on direct taxes, though some have increased them (Czech Republic and Slovenia), some of the countries increased social contributions, property tax has been increased in the Baltic states. At the same time, efforts were made in some of the countries to broaden the tax base and to strengthen tax enforcement. Some of the countries, such as Macedonia decreased the tax burden by lowering the tax rates. For the pool of CESEE countries the recommendations are rather mixed given the country specifics and current level of taxation, which ranges from 23,1% of GDP in Albania to 47,6 % of GDP in Hungary. In general, they accentuate the possibility to proceed with fiscal devaluation, broaden the tax base and enforce collection.

Chart 7: Comparison of general government revenues (gap -difference EU versus CESEE revenues)



How are the countries going to pursue with their fiscal policy based on the IMF's DSA frameworks and to what extent are they going to follow the general "policy guidelines"?⁵

First, most of the countries have opted for the more gradual adjustment of their fiscal position, although there are still countries (roughly 40% of the sample) which will expand their public debt, with some facing serious fiscal sustainability problems. The most successful in resolving the medium-term fiscal position is the group of so called "fast debt adjusters" such as Latvia, Poland and Bosnia and Herzegovina with the expected average decline in the medium-term debt in the 2013-2018 period of 10 p.p. These countries will also have relatively low level of debt measured by the distance to the Maastricht criteria of public debt at the level of 60% of GDP, with Poland being the closest to this level. The second group of countries (Romania, Lithuania, Macedonia, Hungary and Albania) is the "gradual debt adjusters", with the average decline of debt of 1 p.p. for the analyzed period. Among them Albania and especially Hungary have already crossed the 60% benchmark. The next group of countries (Bulgaria, Montenegro, Czech Republic and Croatia) is characterized by a slight public debt rise in the following period of 2.5 p.p., on average. With the exception of Bulgaria, which despite the slight increase is expected to maintain its solid fiscal position (lowest debt in the analyzed group of countries), the rest of the countries will close the "gap" to the Maastricht benchmark of 60% of GDP public debt level. Finally, the last group consists of Slovenia and Serbia - countries facing serious concerns about the sustainability of fiscal position. The conclusion pertains to the fact that on average the debt will increase by 21 p.p., although more

⁵ The DSA data are taken from various IMF country reports, where short-term projections are based on officially announced budgets, adjusted for differences between the national authorities and the IMF staff regarding macroeconomic assumptions. The medium-term fiscal projections incorporate policy measures that are judged by the IMF staff as likely to be implemented. For countries supported by an IMF arrangement, the medium-term projections are those under the arrangement.

notably in Serbia. Also, as shown in the chart, these two countries are expected to reach very high level of public debt of around 90%, level that according to empirical research (Rainchart & Rogoff) could potentially start harming growth.

Chart 8: Debt change and distance from the Maastricht

Criteria 60% of GDP ("-" is above "+" is below the benchmark)

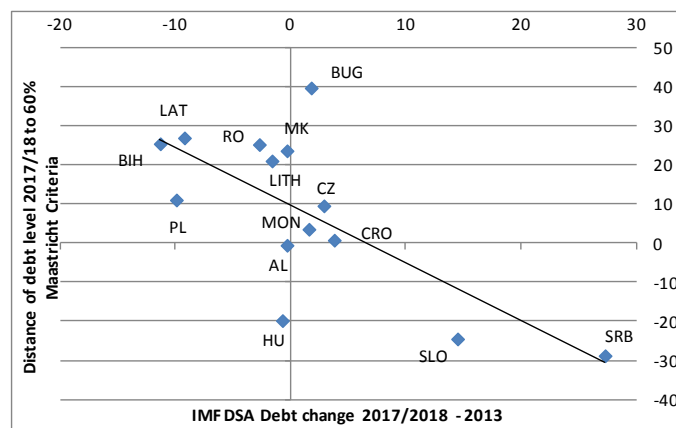
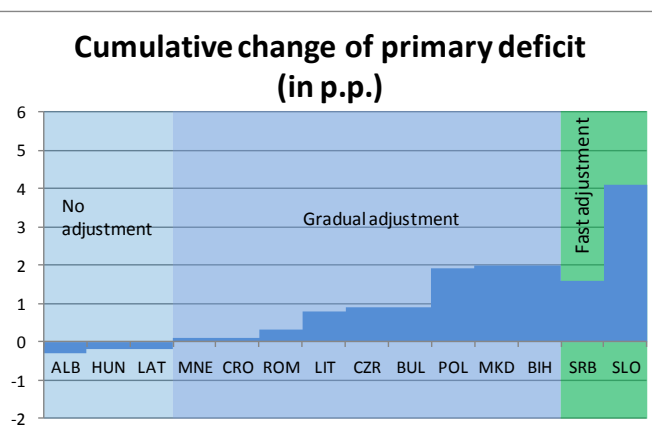


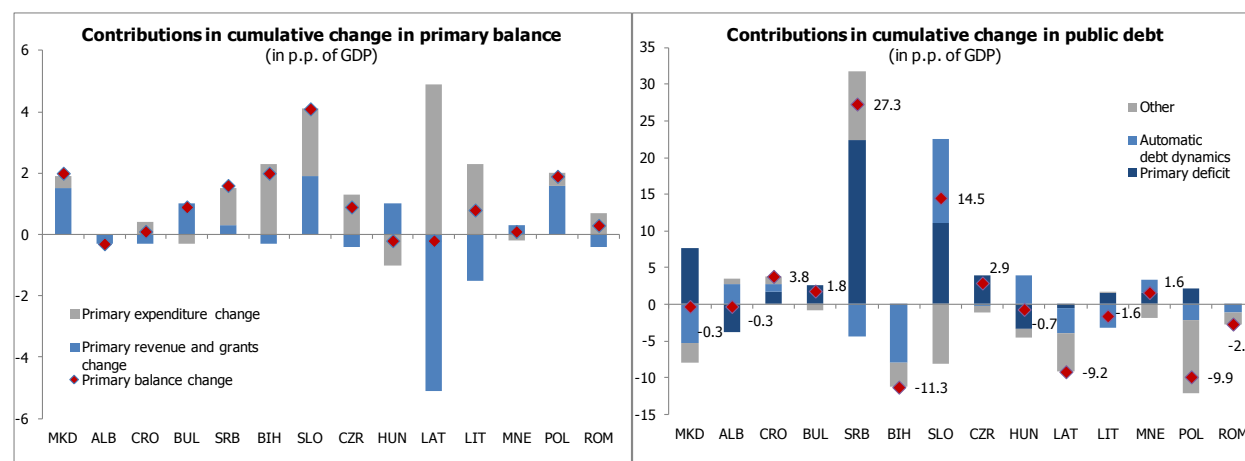
Chart 9: Speed and size of adjustment*



*Speed: 0.5 - no adjustment; 1 - gradual or adjustment distributed within three years ; 2 - fast or adjustment concentrated in one year.

Second, the DSA frameworks point to a consolidation that will take place mainly by expenditure cuts, even though some tax changes are also envisaged. As shown in the chart below, 10 out of 14 countries are going to undertake further expenditure based fiscal measures, while only 6 of them will pursue also tax measures to improve their fiscal position.

Chart 10: Snapshot of IMF, DSA Framework for the CESEE group of countries



*Positive change in primary balance - consolidation.

Apparently, most of the countries do envisage some sort of fiscal consolidation in the period to come. The implementation of the consolidation plan seems inevitable. Even more, the debt dynamics signals that the needed

fiscal adjustment is by far larger compared to what the medium-term plans are envisaging. Hence, demonstrating that the planned fiscal adjustment (if any) will be delivered is of crucial importance for retaining the market confidence and assurance that the fiscal adjustment will proceed further beyond the medium-term framework.

In this regard, what is of a vital importance is the institutional strength, which can shape the fiscal outcome to a large extent. Empirical literature points to a positive relationship between the quality of fiscal institutions and fiscal performance⁶. Although the quality of the fiscal institutions cannot be a substitute for a political commitment to pursue a prudent fiscal policy, yet stronger institutions and systems provide a better platform and incentives to implement more optimal fiscal policy. Stronger institutions can lead to better-informed policy decision-making based on a realistic medium-term macroeconomic and budgetary framework with awareness of the contingent liabilities and overall risks surrounding the projections; better quality in managing the public finance due to higher public scrutiny and accountability for the fiscal policy; efficient use of the scarce public resources by tilting them towards strategic priorities of the economy, including expenditures that can have a long-term implications for the potential of the economy; and strengthened fiscal discipline by making sure that budget deficit and public debt targets are met and over-committing of the budget is avoided.

Olden et al. (2012) provide a comprehensive screening of the institutional setting in the SEE⁷ group of countries. They identify three stages of the fiscal consolidation process: 1) understanding the scale and scope of the fiscal challenge (requiring comprehensive, timely and credible fiscal reporting; adequate macro and fiscal forecasting and disclosure of fiscal risks); 2) developing a credible consolidation strategy (requiring medium-term fiscal objectives and frameworks, independent fiscal agencies and performance-oriented budgeting), and 3) implementing the strategy through the budget process (requiring top-down approach to budget preparation, discipline in budget execution). The evaluation of the institutional strength for SEE yielded in several conclusions, which at the current juncture are probably relevant for the pool of the most of the countries, discussed in this note.

General picture is that the strength of the budget institutions across analyzed countries of SEE is similar, with most of the countries having an overall score of C (moderately strong), from a range of A to F. However, the assessment pinpoints many deficiencies in the budget planning and execution procedures. The weakest points, where the focus on improvements should be placed are: macro-fiscal forecasting, analysis and disclosure of fiscal risks, parliamentary scrutiny, and independent fiscal institutions (fiscal councils). Additionally, it should be stressed that the evaluation is based on an assessment by the fiscal authorities, which may imply biased answers. For example, the score for fiscal reporting for all countries is B (strong) or C (moderately strong), but in practice it appears that the fiscal reporting in most cases is not fully comprehensive. In some of the countries, the general government data on budget and debt are not available on a regular basis. Also, often fiscal reports lack data on the so called "special revenues and expenditures" (which by their nature are budgetary revenues), on the

⁶ See, for example von Hagen and Harden (1996), de Haan et al.(1999), Hallenberg et al. (2009)

⁷Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia FYR, Moldova, Montenegro, Romania, and Serbia.

spending financed through international loans thus effectively underestimating the fiscal deficit, and on the spending of some public enterprises, which by their nature are budgetary institutions (usually public enterprises in charge of construction of roads). Additionally, there are cases where spending is treated as financing transaction thus underestimating the aggregate spending and deficits. Improvement in the breadth, depth and timelines in fiscal reporting and more systematic risk analysis could be employed to have a better picture on the scale and the scope of the fiscal consolidation and allow better and timely monitoring and implementation.

Table Summary of Institutional Evaluation

Budget Institutions	SEE Avg.	South East European Countries									
		Alb	BiH	Bul	Cro	Kos	Mac	Mol	Mon	Rom	Ser
A. Understanding the Fiscal Challenge		C	C	C	C	C	C	D	D	C	D
1 Fiscal Reporting		C	B	B	C	B	B	C	C	C	C
2 Macro-Fiscal Forecasting		C	C	D	C	C	D	C	C	B	C
3 Fiscal Risk Management		D	D	C	C	D	D	C	D	C	D
B. Developing a Consolidation Plan		C	C	D	C	B	C	D	C	D	C
4 Medium-term Fiscal Objectives		C	C	E	B	C	B	C	C	D	B
6 Medium-term Budget Framework		C	B	B	B	B	B	C	B	E	B
5 Independent Fiscal Agency		E	F	E	F	C	F	F	F	F	C
7 Performance Orientation		C	B	D	B	A	C	C	C	C	C
C. Implementing the Strategy		C	D	D	C	C	C	C	C	D	B
8 Top-Down Budgeting		C	C	B	B	A	C	C	B	D	B
9 Parliamentary Approval		D	D	F	C	D	E	B	D	D	A
10 Budget Execution		C	C	C	C	C	B	C	B	C	C
OVERALL SCORE		C	C	D	C	C	C	C	C	D	C

Source: "Fiscal Consolidation in Southeastern European Countries: The Role of Budget Institutions", Olden et al., IMF WP 12/113

What are the implications of the state of the fiscal finances for the monetary policy in CESEE countries and to what extent can the monetary policy help in the process of repair of public finances without endangering its credibility? To mitigate the negative effects from the crisis, central banks have been loosening the stance by relying on standard instruments, as well as non-standard monetary and macro prudential measures. Key interest rates have been substantially reduced from the pre-crisis levels and liquidity was increased by changes in the required reserves and other measures. Low interest rates amidst liquidity buffers, coupled with still high uncertainty about the economic prospects created rather favourable conditions for government borrowing on domestic markets. Thus, in some of the countries the share of domestic debt increased. The countries with the IMF arrangements were also able to borrow under favourable conditions. In this context, a couple of challenges for the monetary policy deserve being highlighted. First, on the one hand prevalent policy of low interest rates may discourage the governments to consolidate the fiscal finances at the planned pace and therefore may have negative long-term implications. On the other hand, rising of interest rates may complicate the process of stabilization of the public debt through the interest rate and economic growth channels. The same point refers to the central bank measures that are aimed at providing more liquidity in the banking system. Second, rising debt has substantially increased refinancing needs, which in part of the countries in the group are assessed to be higher than the standard thresholds. This may negatively affect investors' perceptions for the "health" of public finances, result in higher risk premiums and complicate the process of consolidation. Difficulties in refinancing external debt may especially

complicate the conduct of monetary policy in the countries with some form of fixed exchange rate regime, potentially implying a significant drain on the foreign reserves. Third, it should be noted that external debt has risen from the pre-crisis levels thus making the economies less resilient to unfavourable developments at international financial markets. In most of the countries the share of external debt in the total debt has risen. The external financial markets proved to be very volatile with huge implications for the economies dependent on them. Strains on the financial markets may also lead to high fluctuations in the exchange rates with significant impact on the economies that are net debtors endangering their consolidation path. This risk of high external exposure should be especially factored in by the central banks pursuing some form of fixed exchange rate regime.

The current state of the fiscal finances calls for further fiscal consolidation and good coordination between the fiscal and monetary policy makers. Even for the countries with more advanced consolidation efforts, the general advice is towards maintaining neutral fiscal position, creating additional fiscal buffers and making qualitative changes in the fiscal area. The screening of the most recent medium-term fiscal adjustment plans pinpoints in general, gradual and expenditures based consolidation, but with maintaining the debt ratios on an elevated level for a longer period of time. However, with the medium-term debt forecast in mind, it is more than obvious that the envisaged fiscal consolidation must not be compromised and probably should proceed after the end of the time horizon is being considered. Fiscal adjustment must continue, if public finances are to be prudent and sound. Fiscal consolidation will lower the vulnerabilities and pave a way for more accommodative monetary policy yielding lower interest rates. This is even more accentuated in countries which are in some way targeting the exchange rate, which by definition limits the room for monetary policy and asks for a sound fiscal policy. The fiscal consolidation will be more successful if fiscal actions are well coordinated with the monetary policy. Reforms aimed at strengthening the budget institutions will facilitate the consolidation process and increase its credibility.

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