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Global Fiscal Consolidation*

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The buildup in government debt in response to the "great recession," has raised a number of policy dilemmas for individual countries as well as the world as a whole. The recent need for a change of fiscal policy stance has fuelled debates about the impact of fiscal consolidation on domestic economies that are tightening, the flow-on effects to the world economy, and also about how much tightening there should be and how quickly it should happen. This paper explores these issues in a global framework focusing on the national and global consequences of coordinated fiscal consolidation. It explores the implications this fiscal adjustment might have on country risk premia and what happens if all countries coordinate their fiscal adjustment except the United States. A coordinated fiscal consolidation in the industrial world that is not accompanied by U.S. actions is likely to lead to a substantial worsening of trade imbalances globally as the release of capital in fiscally contracting economies flows into the U.S. economy, appreciates the U.S. dollar, and worsens the current account position of the United States. The scale of this change is likely to be sufficient to substantially increase the probability of a trade war between the United States and other economies. To avoid this outcome, a coordinated fiscal adjustment is clearly in the interest of the global economy.

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