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Antonio Fatás, Lawrence H. Summers

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The Permanent Effects of Fiscal Consolidations

Antonio Fatás* and Lawrence H. Summers**

Abstract: The global financial crisis has permanently lowered the path of GDP in all advanced economies. At the same time, and in response to rising government debt levels, many of these countries have been engaging in fiscal consolidations that have had a negative impact on growth rates. We empirically explore the connections between these two facts by extending to longer horizons the methodology of Blanchard and Leigh (2013) regarding fiscal policy multipliers. Our results provide support for the presence of strong hysteresis effects of fiscal policy. The large size of the effects points in the direction of self-defeating fiscal consolidations as suggested by DeLong and Summers (2012). Attempts to reduce debt via fiscal consolidations have very likely resulted in a higher debt to GDP ratio through their long-term negative impact on output.

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