Valuation effects and fiscal and external imbalances in the US
(joint with Serhiy Stepanchuk and Martin Wolf)

Recent fiscal stress in the United States has led some observers to question the long-run sustainability of US public liabilities. At the same time, much of US public debt is held abroad, such that US fiscal and external imbalances are fundamentally intertwined. In this paper, we study this interlinkage in a two-country model in which public debt may be held by foreign creditors. Furthermore, high public debt raises the risk of inflation. We find that inflation risk translates into positive valuation effects on the debtor country's external position. As the debtor country's external position is effectively relaxed, it attains a permanent increase in wealth at the expense of its foreign creditors.