During the covid pandemic, governments undertook large fiscal interventions—initially to support households and firms during mandated shutdowns and then, as the need for social distancing abated, to revive economic activity. Beginning in early 2020, the U.S. government passed a sequence of bills to provide covid support, totaling some $5.8 trillion and increasing the federal debt to GDP ratio from 107 percent in 2019 to 136 percent in 2021. Governments in Europe similarly enacted an ambitious set of fiscal policies, including an expansion of social safety nets, loan guarantees to firms to protect workers and jobs, and expanded flexibility in national and local debt limits. Over the same 2019 to 2021 period, euro area government debt increased from 84 to 96 percent of GDP (imf.org). The debt figures for the euro area, as a whole, mask large differences across Europe, as the countries hardest hit by the pandemic (such as Spain and Italy) saw debt increases comparable to that of the United States. Relative to the United States, European governments tended to provide more above-line-support such as loan guarantees, while U.S. fiscal interventions relied more heavily on direct transfer payments to individuals.

The focus of Aggarwal et al. is the transmission of these unprecedented, covid-related fiscal expenditures across the set of advanced economies. The paper argues that debt-financed transfers during covid resulted in predictable changes in the current account that persist over time. Countries that made larger-than-average transfers tended to run current account surpluses, while those below the average ran deficits. In the model, fiscal deficits are initially funded by increases in private saving, but over time households begin to unwind the unexpected windfall of transfers. Depending on the magnitude of the fiscal transfer and preferences for home and foreign goods, this dissipation of savings generates a persistent shift in the current account.

The model in the paper is a many-country extension of Auclert et al. (2021) and Auclert et al. (2018). The baseline case is a small open economy, where the government can borrow on international markets at a fixed world interest rate. Because the economy is small, there is no impact on the global interest rate and the government can undertake a one-time rollover of debt and transfer purchasing power to households. The increase in borrowing effectively relaxes the national budget constraint, making it possible to consume more of both home and foreign goods. The paper briefly considers an extension to a global economy with asymmetric countries and examines the relative importance of pure covid shocks relative to covid-induced fiscal shocks.

**How well does this theory explain the data?**

The emphasis of the paper is the extension of their theoretical framework to the covid shock. The emphasis of my comments will be to ask, how well does theoretical framework help us understand the data? To make the discussion simple, I will focus on the United States and Europe, with Europe measured by the euro area.

Figure 1 shows the evolution of net private and government savings in the United States and Europe since 2000. The plots are both in $U.S. trillions and are on the same scale for ease of comparison. The bars in blue show household net saving, while the orange bars show government dissaving. The magnitude of the U.S. fiscal intervention starting in 2020Q2 is clear, roughly quadrupling in one quarter. As the paper suggests, dissaving by the government is nearly matched by saving on the part of the private sector. Private saving stays high and gradually decreases over time. Figure 1b shows that spending by euro area governments also increased, though less dramatically than in the United States. For Europe, private savings

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1 Note that the “twin deficits” phenomenon emphasized in the title—countries with high fiscal deficits also run current account deficits—can, by definition, only apply to some countries in the world. Virtually all countries experienced fiscal deficits during covid, but only a subset can run current account deficits.
jumps quite a bit more than the increase in government spending. One possibility, advanced by the paper, is that the difference in the magnitude of the fiscal shock will result in different saving and consumption behavior across countries. An alternative, one I will consider below, is that differences in the way that governments provided covid support generated differences in consumption as well as employment and output.

Figure 1: Net private and government savings

The second part of the paper’s story is the impact of fiscal expenditures on the current account. Figure 2 illustrates the current account for the United States and the euro area, again over the 2000 to 2021 period. Both current accounts are scaled by GDP, consistent with the paper’s emphasis on the dynamics of saving and consumption and not the direct impact of covid on economic activity. The connection between the dramatic fiscal interventions that occurred after 2020q1 and the current account is not at all clear. The U.S. current account deficit deteriorates a bit, but the drop is rather small, compared with the unprecedented, four-fold increase in government spending. The euro area current account improves a bit in the early stages of the pandemic, but again is in the range of 2 to 4 percent of GDP that is observed for the euro area since 2013. Overall, it is a stretch to see the covid period as a dramatic change from previous movements in the current account. It is also hard to see a dynamic “unwinding” of the covid shock – though perhaps with just eight quarters of data that is a lot to ask. The authors themselves concede that their model has only limited explanatory power for changes in the current account.

Is it a puzzle that we don’t see much action in the current account during covid? Neoclassical theory suggests no. Current accounts move in response to country-specific, asymmetric, transitory shocks. The covid pandemic was (still is?) a global shock that depressed output and disrupted markets worldwide. It certainly affected some countries more than others, and the timing was not exactly synchronous. But as shocks go, covid was a big, global shock. In the face of such a shock, governments effectively borrowed from the future by running deficits and issuing debt, but there was little scope for countries to borrow from each other.
Fiscal policy in the United States and Europe

This is not to suggest that there was no impact on the current accounts of the major countries of the world. The covid shock affected countries at different points in time, and governments responded with different types of economic policies, generating asymmetries in income, consumption and demand for home and foreign goods. The paper emphasizes the size of the fiscal shock and differing degrees of home bias, but there are likely other asymmetries that could also be important. As suggested above, fiscal policy in Europe tended to come in the form of loan guarantees and efforts to keep workers connected with firms, while much of the U.S. fiscal response tolerated higher unemployment along with direct transfers of income to households.

In a speech on the nascent recoveries of the United States and the euro area, OECD chief economist Laurence Boone highlights the asymmetric role of fiscal policy in the two regions. As Figure 3 shows, the decline in economic activity in the covid crisis was deeper in the euro area than in the United States. At the same time, euro area employment remained almost constant while it declined sharply in the United States. As Boone emphasizes, this is likely a consequence of the fiscal policies in Europe that kept idle workers in their jobs. Fiscal policy in the United States tended to support income, and this is evident Figure 4. While the contraction in overall consumption in the two regions is similar at 10 to 15 percent of the pre-covid level, household disposable income in the US increased during the covid pandemic, remaining flat in the euro area. Figure 4 indicates where that income went – U.S demand for both durables and nondurables surged while demand in the euro area remained flat. As durables and nondurables both contain a significant component of tradable inputs (or are directly importable as final goods) this surge in demand likely put strong downward pressure on the U.S. current account.
A generous interpretation of the paper would be that the fiscal shock, which was bigger in the U.S. and spread across more households, indeed resulted in more consumption spending and current account deficit. A less generous interpretation is that it is important to take into account the impact of fiscal policy on output, investment and employment to say something about the current account.
What about China?
While a paper cannot be expected to explain everything, a paper about U.S. and European current accounts probably should address China. China accounts for nearly 20 percent of U.S. imports and 12 percent of euro area imports. More importantly, the economic impact of covid hit China earlier than in the United States and Europe. Figure 5 illustrates industrial production in the United States, Germany, the United Kingdom and China all indexed to 2019.12 = 100. While the United Kingdom, Germany and the United States move almost in lockstep, China both contracts earlier and recovers earlier. Again, neoclassical theory would suggest that China, not Europe, is a more likely counterpart for U.S. trade imbalances.

![Figure 5: Industrial production: US, China, UK, Germany](source: FRED)

Conclusion
This contribution is part of a larger set of papers that have helped shed light on the dynamics of consumption and savings both within and across countries. In some ways, the theory is very simple and elegant. There are exogenous changes to government spending, there is no role for production or investment, and the theory yields a simple mechanism to deliver dynamic adjustments in consumption and the current account. In other ways, however, the model is quite complicated with heterogeneous agents, monetary policy, sticky wages, incomplete markets and dynamic asset positions. In the end, however, it isn’t clear that the details of the model are central for understanding the impact of the fiscal responses to the covid shock and the implications for international borrowing and lending.

References


