

## Greek burdens ensure some Pigs won't fly

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Financial markets have coined a new term to sum up troubled eurozone states: the 'Pigs'. Portugal, Ireland, Greece and Spain have found their bonds moving together, with Greece and its troubles a bellwether for the entire group. These countries all had a long boom based on cheap credit, which ended in a bust in which their public finances deteriorated spectacularly – raising concerns as to whether they will be able to service their debt.

However, this acronym is misleading, as is the exclusive concentration on fiscal policy.

In determining the sustainability of public debt one should not look only, perhaps not even mainly, at today's fiscal accounts, but at the resource balance for the entire country. On this account clear differences emerge. The Pigs consist of two quite different groups, with Greece and Portugal in the weakest position because of their lack of domestic savings.

The gross national savings rates of these two countries – private and state combined – are at record lows: Greece a mere 7.2% of gross domestic product, Portugal 10.2%. By contrast, the average for the euro area is about 20%. Ireland and Spain, at 17 and 19%, are much closer to the euro area average than to Greece and Portugal. This implies that Spain and Ireland will be able to finance government deficits from their national savings now that housing investment has crashed and no longer absorbs such a large chunk of savings. Greece and Portugal are unique in their reliance on foreign capital to such a large extent.

Gross savings show the domestic resources (cash flows) available to finance domestic investment and consumption (wear and tear) of capital. With such low gross savings it is not surprising to find that neither Greece nor Portugal have been able to finance even a minimum level of net investment from domestic sources. Greece is unique in the eurozone in that its net national savings have been negative for almost a decade, reaching minus 5.1% of GDP in 2008 (only Portugal did worse). By contrast, the euro area average is (plus) 6% of GDP. Even the Baltic states, which relied on foreign capital to finance a construction binge, are in a better position with net savings safely in positive territory.

Such low levels of domestic savings have two implications: A fiscal adjustment alone does not solve the problem, and a bail-out would be costly.

A fiscal adjustment that is not reflected in an increase in the national savings rate would simply transfer the problem from the government to the private sector. A cut in the fiscal deficit would simply result in more private debt. Banks would see non-performing loans accumulate, and in the end they would have to be bailed out by the government. Adjustment requires belt tightening by the entire economy. To set Greece and

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Portugal on a sustainable economic path requires an increase in savings; put simply, it needs a cut in consumption of about 10% of GDP.

The lack of domestic savings combined with a high net external debt is also the reason why a bail-out could be rather costly. For purposes of illustration, let us draw an analogy between a country and a company. The gross national savings rate represents the cash flow generated by all sectors of the economy and the net savings rates shows the evolution of shareholders' equity.

It is one thing to provide financing to a country or a company that is generating strong internal cash flows and got into trouble only because of excessive investment (the case of Ireland and Spain). It is quite a different proposition to prop up one whose equity is being eroded because internal cash flow is not even sufficient to maintain the capital stock (the case of Greece and Portugal).

When taking over a company in distress one does not consider only the views of management. Similarly, a bail-out of a country makes sense only if all stakeholders contribute. Saving a country that is consuming too much makes sense only if the entire body politic accepts that more than a fiscal adjustment is required. Deep cuts in private sector wages and consumption are needed before any outsider should even consider stepping forward.

Europe's Stability Pact is flawed because it concentrates only on one sector (government) rather than on the entire country's resource balance, which is what counts in the long run. Preventing a repeat of the problems of the weakest of the Pigs requires concentrating surveillance on this aspect.