Southern Capital Perspective

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Why Should We Care About Greece?

It is the year 2015 and the entire world is interconnected through the global economy. Although Greece is only a small part of the European Union [EU] (estimated to be around 2%), it could have a significant Impact on the EU and even upon the entire world if it defaults on its debt and is forced to leave the EU. On June 29th, the global stock markets suffered severe declines from 2% in the US to 5% in some other parts of the world and it was largely attributable to the pending default of the Greeks. The peril is not the amount of money that will actually be lost due to the unpaid interest and principal but the unknown aftereffects that cannot be foreseen. In 2008, when Lehman Brothers brokerage firm went under, the primary damage to the global financial system was not the direct economic loss from Lehman but rather the loss of confidence in all financial institutions and the resulting chaos in the economies of the world.

Why is Greece Defaulting on Its Debt?

Unfortunately, there is historical precedence for Greek sovereign debt defaults. Five times since the 1800's Greece has defaulted on its debt: 1826, 1843, 1860, 1894 and 1932. In 1981 Greece joined the EU and in 2002 the Euro replaced the Greek drachma as their national currency. In the 194 years that present-day Greece has been a country, 90 of those years has been as a country in default or in debt-restructuring. In more modern times the following dates are important *(from the Yahoo website):*

- 2004 The European commission issues a warning to Greece after discovering the country lied about budget deficit data prior to joining the Eurozone.
- 2009 Greece's credit rating is downgraded by all three major rating firms.
- 2010 Eurozone countries ap prove a $145 billion crisis pack age for Greece in return for more austerity measures. Trade unions strike once more.
- 2011 The EU offers Greece a $109 billion bailout and a write-off of 50% of coun try's debt for more austeri ty.
- 2011 All three major rating firms downgrade Greece's credit and say there is a substan tial risk of default.
- 2012 Greece accepts a $130 billion deal from the EU and manages to halve its debt load through a debt-swap deal.
- 2013 Greece raises taxes and cuts pensions. Youth un employment reaches near ly 60%.
- 2015 June: Greece announced that all banks are closed for 6 days and missed its $1.67 billion payment to the International Monetary Fund (IMF) on June 30.

It is evident that Greece has a very troubled economic past, but what has caused their continuing economic problems? According to the website of Oxford University Press:

"One reason for this is that the Greeks simply don't have much money. All of the southern European countries that are struggling to stay in the euro zone – Spain, Portugal and Italy as well as Greece – are relatively economically backward compared to their richer northern neighbors. In all of them poor quality Mediterranean soils prevented agricultural development and the emergence of the prosperous middle class that drove the Industrial Revolution in the rest of Europe. But Greece was the most extreme example. Cut off by the Carpathian Mountains it was far removed from the mainstream of European science and culture. For much of the last millennium it was dominated by the Byzantine Empire – not much known for its industrial prowess. Even after independence it struggled to earn a living for itself.

While much of Mediterranean Europe modernized rapidly in the postwar years, Greece barely caught up. Occupation by the Nazis followed by a civil war didn't help. During the late 1960s and early 1970s, when much of peripheral Europe was starting to industrialise for the first time, it was ruled by a buffoonish clique of colonels who resisted any form of modernity, either cultural or economic. In a number of ways Greece still remains a pre-industrial economy, dominated by the state, by cartels and by a handful of wealthy families. Few multinational companies have found it possible to do business there.

The interesting question is why anyone thought Greece could survive in a monetary union alongside countries such as Germany, Austria, Holland and France that have always been far richer?"

Greece's history and the inexplicable decision by the EU countries to extend an invitation for Greece to join along with the bloated government worker payrolls, the inability of the government to collect taxes and the unaffordable pension system was a

blueprint for failure. After becoming part of the EU and with billions of Euros extended to them, the Greeks became addicted to this financial lifeline but unfortunately they have no capability to ever repay these loans. A recent report stated that the Greeks would need another 67 billion euros in order to survive for the next three years. For the EU to extend more billions to Greece without radical economic reform fits Einstein's definition of insanity "doing the same thing over and over again and expecting different results."

What is "FINANCIAL CONTAGION" as it relates to Greece?

The financial contagion that is feared is a potential falling domino effect among the weaker members of the EU (Spain, Portugal and Italy). The northern EU members are concerned that if the austerity measures that they are requiring Greece to live under will cause Greece to exit the EU and then the other weak nations might decide that leaving is better than living under the rigid austerity requirements. If that happens the entire EU might collapse. There is no doubt that leaving the EU would be very painful for the departing members but they may feel that the alternative is equally or maybe even more painful. Also the northern members fear that if they give in to Greece's demands, then the other weak southern tier countries might start demanding more to remain in the EU.

What would be the financial impact of a Greek default?

The direct financial impact on the creditors and the financial markets of a Greek default would not likely be very significant. Most of the money that Greece owes is to EU member governments and to large European banks. They have the ability to absorb the losses and most likely do not really expect to recover the money that has been lent. The impact on the Greek people would be severe because the government could not borrow what it needs to continue the social programs.

The indirect affect causing a possible loss of confidence in the entire system could cause a global economic shock and adjustment but it is unlikely to be anywhere near as devastating as 2008.

What is the likely outcome of the Greek crisis and what is the probable market response?

In our opinion, there are three potential outcomes:

1. The "can gets kicked down the road," which means that there is no definitive resolution. The problem will still exist, but it will be put off by temporary measures because politicians and central bankers do not like to make hard choices. In other words, the EU, the IMF and the European Central Bank [ECB] will continue to advance money to Greece, and then Greece will pretend to make real reforms. The impact on the markets would be minimal because it would be business as usual.

2. Greece accepts the severe austerity measures required by the EU and then is supplied with the money that it needs. The theory sounds good, but the Greek people could not and would not accept it and then would be right back where they are now. The markets would not like the continued unsettled condition and would respond with volatility.

3. Greece defaults and is kicked out of the EU. If that were to happen, then the question becomes: How will the EU and its member countries be affected? The EU itself and the large banks of the EU will likely absorb the loss without much problem – the banks have been preparing for this and have built up large capital reserves with this possibility in mind and the EU itself is creating 60 billion eruros per month in new money under its QE program.

The weaker EU members (Spain, Portugal and Italy) are the more important consideration. If Greece leaves and switches its currency back to the Drachma and is not suffering, then one or more of the other three might choose to free themselves from the EU imposed austerity which would put the very continued existence of the EU in jeopardy. The market would not like this outcome.

Alternatively, if Greece leaves and is struggling, then the three weak members would remain in the EU. The danger is that China or Russia might court the Greeks which would be more of a geo-political problem than an economic one. Needless to say the market would not be thrilled with this type of outcome either.

Outlook

The first half of 2015 has been pretty much as expected, that is, slightly positive and yet with a significant amount of volatility. The overall positive economic elements are still present: a steady but slowly-growing US economy, money creation (QE programs) going on in major countries around the world, the FED on hold or at least moving very slowly on raising interest rates, and enormous amounts of cash (trillions of dollars) in corporations and individual accounts earning close to nothing.

The negative elements are also still there: slow-growth in Europe, China's economy is slowing, stocks are no longer at bargain prices, geo-political hotspots heating up worldwide, and continued uncertainty in Greece.

The most likely scenario for the second half of 2015 is more of the same: slightly positive with volatility. The crisis in Greece probably will not be resolved and the "can being kicked down the road" is to be expected. The geo-political hotspots will probably continue to simmer but not boil over. However, this outlook cannot be assured, so we are beginning to prepare for the possibility of more difficult outcomes like Greek contagion or a geo-political confrontation. We do not think these scenarios are likely, but they are not remote possibilities either. So we must prepare by being ready with a defensive strategy.