Buena Vista Investment Management, LLC

Creative Investment Solutions

GREEK FINANCIAL CRISIS HAS THE WORLD'S ATTENTION

By Joel Sullivan, Partner Buena Vista Investment LLC

June 23, 2011

A lot of attention from the financial world has been focused on Greece recently. Specifically, investors are monitoring the possibility of default. Greece is unable to pay their current debt obligations without assistance form other European Nations and the International Monetary Fund (IMF). Both institutions have made additional aid contingent upon whether the current government has the backing of parliament and whether Greece can pass significant budget cuts. On Tuesday, Greek Prime Minister George Papandreou survived a critical vote of confidence by his parliament. In terms of budget cuts, Greece is being asked to slash $40 billion from their budget. Time is running out for Greece. Euro zone finance ministers meet July 3rd. Greece has E$12 billion coming due in the very near term. In addition to that, they need another E$100 billion to meet the 2012 budget.

The main focus of attention is on whether or not Greece defaults, meaning they can't pay on their debt. This situation could play out in several ways. Greece could actually default on their debt, or they could have what is referred to as a de facto default. De facto default is the term used to describe a situation whereby the borrower changes the terms of the loan. Lenders still may get most or all of the money owed to them, but typically over a longer time period or at different interest rates. This is what occurred with Latin American debt in the 1980's. This isn't as severe as an actual default, but many experts still feel that such an occurrence in Greece would be detrimental to confidence.

You may wonder whether this even matters to anyone investing in the US stock market. In situations such as this, it is helpful to put things in perspective. First, let's look at the size of the Greek economy relative to the world economy. Greece represents ½ % of world Gross Domestic Product (GDP). The GDP of Greece is about $310 billion. To put that in perspective, that puts Greece about midway between the economies of Wisconsin ($252 billion) and Michigan ($372 billion). So in absolute terms, Greece is not a major player in the world's economy. However, psychologically, Greece could have a much bigger impact. Financial markets trade not just on data, but on emotion as well. Overall levels of confidence and fear can have significant impacts on the market, especially in the short term. And, at this stage in the economic recovery the world stock markets seem especially vulnerable to shocks.

Secondly, it is important to understand that defaults by nations are not uncommon, especially for Greece. Economists Carmen Reinhart and Kenneth Rogoff documented in their research in 2008 that Greece has defaulted or rescheduled its debt 5 times since 1829. Argentina has defaulted 3 times since 1980. Mexico and Brazil defaulted in 1983 and nearly defaulted in the early 90's.

The reality is that Greece is a small country with a long history of financial crises. The real issue is a fear that these defaults could spread to other European countries and that European banks would be negatively affected. So actual default of even a restructuring of debt by Greece may have a short term negative affect on U.S. financial markets, but is unlikely to have a significant impact in the long run.