



## Market Analysis, Research & Education

A unit of Fidelity Management & Research Company

# Why Greece's Debt Drama Is Driving Market Volatility

## *Small Country a Potential Catalyst for Big Problems*

By Dirk Hofschire, CFA®

Despite the announcement of a \$146 billion aid package by the Euro-region governments and the International Monetary Fund for Greece on May 2, global markets have continued to trade violently. The following are some of the key reasons why recent Euro-zone efforts have failed to quell investor uncertainty:

- ① There is concern that even if the package is fully approved that Greece will be unable to achieve the right combination of deficit reduction and economic growth to regain investor confidence and place itself squarely on a path to fiscal sustainability. The structural changes to the Greek economy would be massive and, even if Greek political will holds firm, it is unclear whether the economy would grow quickly enough to stabilize at a manageable level.
- ② For the rest of the world: Even if the agreement and its implementation do ultimately stabilize Greece's financial situation, there is no guarantee in the meantime that it will prevent financial contagion, thus affecting other countries in Europe and becoming an even larger source of instability for global financial markets.

### **Why financial contagion is a concern**

Financial contagion may be the hardest issue for many investors to grasp, considering the relatively small space the Greek economy commands on the

global stage. Greece's financial crisis is potentially a bigger problem than it might first appear for the Euro-zone, not only because of the common currency union and the negative impact it could have on the Euro currency, but also due to the interconnectedness of government debt holdings and European banks. Roughly three-quarters of Greek government debt is held by foreigners, mostly by European banks and other financial institutions, with the biggest shares held by France and Germany. A Greek sovereign debt default would therefore impose significant costs on the still-struggling banking systems in the larger European economies.

These problems would still be relatively minor if they were confined to Greece alone. The broader issue for the Euro-zone is to what extent other members with severe fiscal challenges—including Portugal and Spain, as well as Italy and Ireland—may follow Greece into a sovereign debt crisis (see Exhibit 1, page 2). A large proportion of the outstanding debt of these countries is also owned by banks and other investors in the larger economies such as France and Germany, as well as by some of the other heavily indebted countries themselves.<sup>i</sup> While Greece has less than \$300 billion of debt held by Europeans, the prospects of bailing out several countries that collectively have nearly \$4 trillion of outstanding public debt could be catastrophic for Europe.<sup>ii</sup>

Perhaps still in the back of the minds of investors is the possibility that falling sovereign dominoes in a financial contagion could lead to a broader panic beyond the Euro-zone. Some of the largest economies in the world also face daunting fiscal challenges, including the U.K., Japan and the United States.

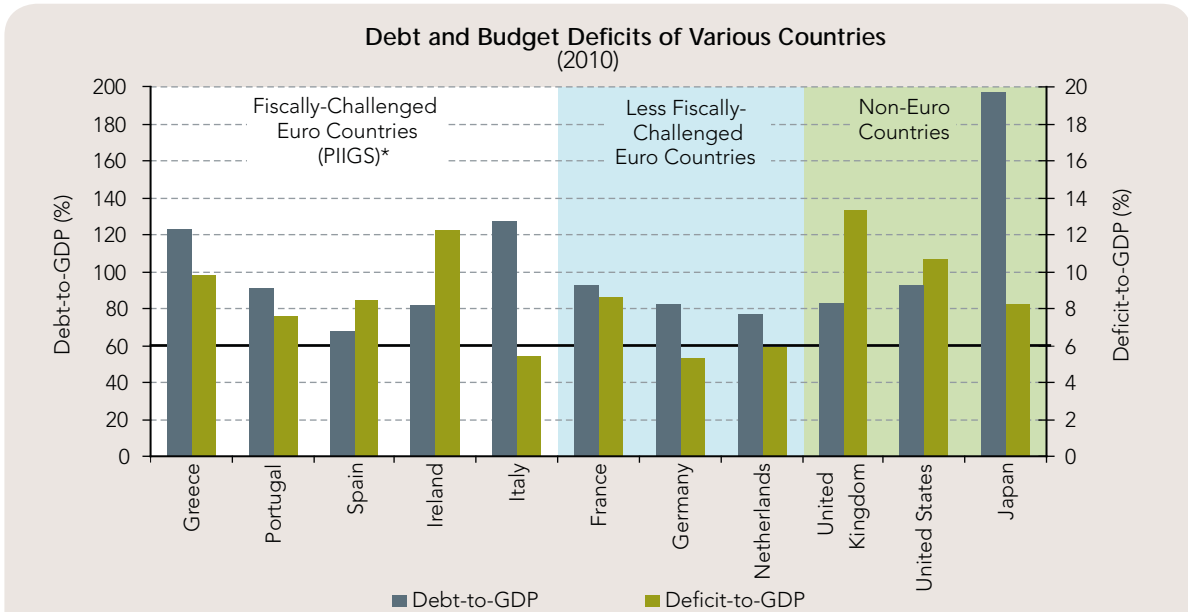
### **Divergence in debt markets: Flight to quality**

The good news so far is that investor jitters have been confined to the heavily indebted, generally smaller economies of the Euro-zone. Portugal and Spain have seen their credit ratings downgraded in recent days,

## KEY TAKEAWAYS

- Concerns about the potential for the Greek debt crisis to evolve into global financial contagion have rattled financial markets around the world.
- To this point, debt jitters have not spread to large economies outside Europe and have yet to derail the global economic recovery, but with no easy solution sovereign debt woes may remain a source of continued market volatility for some time.

**EXHIBIT 1:**  
Smaller Euro-zone countries with large government deficits and debt are facing the most urgent fiscal challenges.



\* Portugal, Ireland, Italy, Greece, and Spain (PIIGS). The dark line at 60% is the debt-to-GDP ratio required by the Maastricht Treaty for Euro members. Source: Organization for Economic Co-operation and Development (OECD), Haver Analytics, FMRCo. (MARE) as of 5/5/2010.

and their borrowing costs (2-year government-bond yields) have risen significantly. Ireland and Italy also have experienced smaller increases in borrowing costs. However, bond yields have moved down for the larger economies in Europe (Germany and France), as well as for the U.K. and the United States (see Exhibit 2). At least to this point, investors are treating the larger economies as relatively stable places to move money, differentiating their sovereign debt problems from those with more urgent fiscal challenges, such as Portugal, Ireland, Italy, Greece and Spain. (PIIGS).

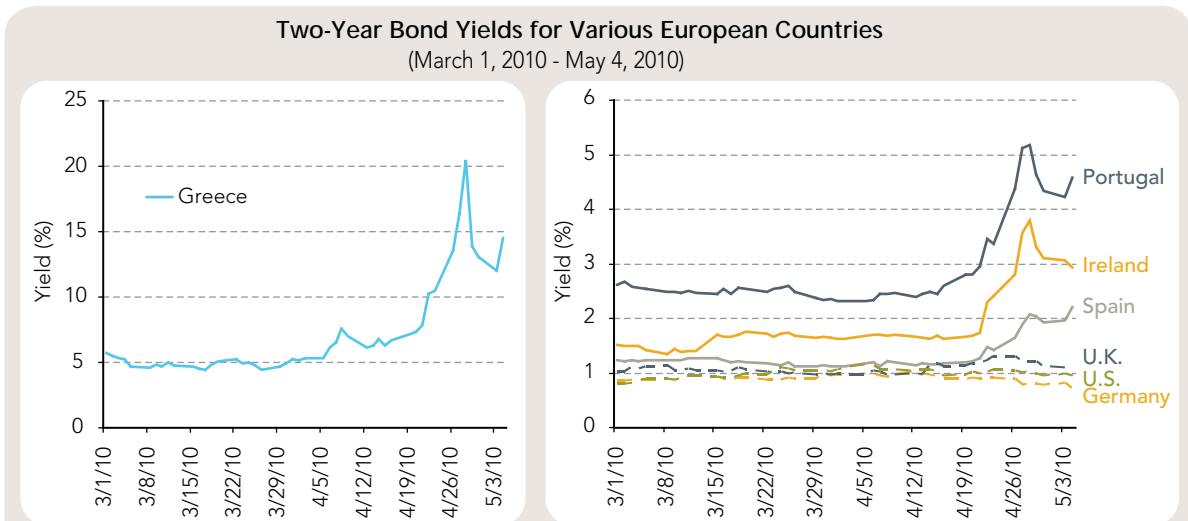
The bad news, however, is that there are no easy solutions to the sovereign debt problems, both near-term in Europe and longer-term in other larger economies. For Europe in the near-term, drawing the line at Greece and stopping the financial contagion

is probably desirable, but the details of the rescue so far have been insufficient to quell market concerns. For Greece and others facing rising borrowing costs, even a bailout package will still require painful fiscal adjustments over a period of years. In other words, the sovereign debt problem facing many developed economies is unlikely to disappear any time soon.

#### Investment implications

The Greek sovereign debt crisis, which first surfaced as a source of volatility in the second half of 2009, has yet to upset the general trend of global economic improvement that has continued to gain steam in 2010. However, regardless of the near-term resolution of a support package for Greece, European sovereign debt jitters may be a source of higher market volatility for some time to come. ■

**EXHIBIT 2:**  
Greek bond yields have soared (left) and other heavily indebted Euro-zone countries, such as Portugal, have also seen a sharp rise in borrowing costs (right). In contrast, the bond yields of larger economies, such as Germany and the U.S., have declined (right).



Source: Reuters, Haver Analytics, FMRCo. (MARE) as of 5/3/10.

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**Past performance is no guarantee of future results.**

[i] Banks in France and Germany held \$79 billion and \$45 billion, respectively, of Greek debt. Source: New York Times, International Monetary Fund, Bank for International Settlements, Haver Analytics, FMRCo. (MARE) as of 4/30/10.

[ii] Source: Organization for Economic Co-operation and Development (OECD), FMRCo. (MARE) as of 4/30/10.

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