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Markets Falter as Worry Rises in Greek Crisis

By Graham Bowley

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Greece's financial and political crisis, compounded by new fears about the pace of the United States economic recovery, sent financial markets reeling on Wednesday.

Thousands took to the streets in Athens to protest austerity measures, and Prime Minister George Papandreou said he would reshuffle his cabinet and request a vote of confidence in Parliament. At stake is the prospect of a new bailout plan for the debt-ridden country.

Anxious investors feared the situation could spin out of control, igniting a series of crises in other heavily indebted euro zone countries, like Portugal, Ireland and Spain. That, in turn, could threaten Europe's banks and even reach into the United States financial system.

"We are pretty much giving back everything we got yesterday and more," said Lawrence R. Creatura, a portfolio manager at Federated Investors, noting the rise in the main American indexes of more than 1 percent Tuesday. "Today the market just can't escape the undertow of deteriorating economic data and political events."

After having lost more than 200 points earlier Wednesday, the Dow Jones industrial average closed down 178.84 points, or 1.5 percent, to 11,897.27. The markets rallied earlier this year on confidence about the economic recovery, and at one point the Dow was poised to break through the 13,000 mark. But stocks have been falling week after week on a drumbeat of dismal economic news from soft job creation to falling housing prices.

The market has surrendered almost all of its gains for this year, falling 7 percent since its peak at the end of April. It may be nearing what is known as a market correction, a sort of miniature bear market characterized by a 10 percent decline in a short period of time.

Greece needs to pass a new round of austerity measures by the end of the month in return for new loans from the International Monetary Fund and the European Union.

In Athens, thousands joined a nationwide strike as Parliament prepared to debate a second round of sharp cuts in government spending. The measures are unpopular with Greeks, who have already suffered deep salary and pension cuts.

Although many analysts expect that a default by Greece on its debts will eventually be averted, the political uncertainty in Greece is providing an unsettling backdrop for investors. In addition, they are fretting because the United States this summer faces its own fractious negotiations over raising the federal debt ceiling.

The European Central Bank said on Wednesday in a report on financial risk that it would be a big mistake for Greece to be allowed to miss its debt payments, either by delaying payments to a later date, or by paying back less than the full amount. Germany, the biggest economy in the 17-member euro zone, is proposing that private sector bondholders accept some form of a loss on their Greek bonds.

This could prove damaging to Greek banks, requiring them to mark down the value of their holdings of government debt at a time when they are struggling with bad loans in their home market. And it could have similar dire repercussions for other European banks that hold Greek debt.

“The concern is that a default by Greece would not only hurt European banks but could also spread to U.S. banks,” said **Bernard Baumohl**, an economist at the Economic Outlook Group in Princeton, N.J. “Should there be a default, it can only have a delaying effect on the recovery, hurting American exports and the banks’ ability to lend.”

Pointing to a slowing United States economy, a Federal Reserve regional report for New York State showed a decline in both manufacturing activity and optimism for June. Also Wednesday, a government report showed consumer prices crept up again, though they were held in check by a decline in energy prices.

The recent economic data has prompted economists to steadily downgrade their forecasts for economic growth in the second quarter of this year. Macroeconomic Advisors, a prominent forecasting firm, on Wednesday lowered its annualized second-quarter gross domestic product forecast to 1.9 percent, compared with the 3.5 percent growth it was expecting when the quarter began.

“There is enough negative data that came out of the U.S. and the situation in Europe to warrant a conservative tone in the markets,” said Quincy Krosby, a market strategist for Prudential Financial. “The data underscores a soft patch, and the Greek issue has deteriorated.”

The fear that a default by Greece could lead to broader European problems were fanned by Moody’s Investors Service, which on Wednesday put the credit ratings of three of France’s largest banks on review for a possible downgrade because of their exposure to Greek debt.

Moody’s cited concerns about the exposure of the three banks, BNP Paribas, Société Générale and Crédit Agricole to the Greek economy, either through holdings of government bonds or loans to the private sector there, directly or through subsidiaries operating in Greece.

According to data from the Bank for International Settlements, French banks could potentially lose more from a collapse of Greek banks and a sovereign default than other countries, including Germany, the United States and Britain.

Moody’s stressed that there were “potential mitigants” to the concerns about Greece, including the French banks’ strong overall financial profiles, substantial scale and earnings diversification.

The Standard & Poor’s 500-stock index fell sharply on Wednesday. It lost 22.45 points, or 1.74 percent, to close at 1,265.42. The Nasdaq composite index average fell 47.26 points, or 1.76 percent, to 2,631.46.

The euro, oil prices and Treasury yields also fell on Wednesday.

The stock market sell-off is a sign to some analysts that investors are entering a phase when they will flee riskier assets like stocks, commodities and richer-yielding bonds.

According to the Investment Company Institute, United States equity funds experienced outflows for at least six successive weeks. Investors redeemed about $15 billion from American stock funds since the beginning of May, even as they shifted billions into less risky bond funds.

On Wednesday, the yield on the Treasury’s benchmark 10-year note fell to 2.98 percent from 3.10 percent, suggesting to analysts a continuing strong flow of investment funds from risky assets into safer investments like Treasuries

Marc Harris, an economist at RBC Capital Markets, said interest rates in short-term money markets — where banks and companies borrow funds to keep their businesses going — were “spiking in a troubling way” mainly in Europe.

All of the sectors of the market were down by 1.24 percent or more, with financials and materials recording the heaviest declines at more than 2.3 percent.

Crude oil took a tumble, falling $4.56, to $94.81 a barrel for July delivery, on the New York Mercantile Exchange.

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