



Eric Lascelles
Chief Economist
RBC Global Asset Management Inc.

HIGHLIGHTS

- › Europe remains stuck in a cycle of inadequate bailouts and spreading illiquidity.
- › Greek fiscal finances are still unsustainable despite the latest bailout.
- › Contrary to popular sentiment, Italy appears solvent.
- › Bank bailout plans are underwhelming, but may just suffice.
- › Europe is unlikely to unleash a global financial crisis, but its economy is set to drag.

DÉJÀ VU ALL OVER AGAIN FOR EUROPE

It's déjà vu all over again for Europe. Markets were temporarily besotted by yet another bailout, but the glossy veneer has begun to flake off, revealing flimsy details and an underwhelming size. Yet another nation – Italy – has been sucked into the gravitational pull of the crisis, and debate abounds as to whether it has passed the threshold of no return. Nor does this appear to be the final go-round. Additional countries are at risk of capsizing, and further measures are necessary from policymakers.

In this report, we revisit Europe's fiscal crisis in a question-and-answer format. In so doing, we reiterate our view that, even post-bailout, Greece remains unsustainable; that, in contrast, Italy should remain solvent despite its recent travails; that there is nonetheless the risk of the crisis infecting an even wider set of nations; that the plan to recapitalize the banking sector is undersized, but perhaps still workable; and that European leaders need to more clearly flesh out their bailout plans, and ideally upsize them as well. Market volatility should remain high throughout the episode, and European bad news may yet overshadow good news for a while longer. But global contagion on the scale of the fall of 2008 remains unlikely.

What are markets saying?

Markets are not unanimous in their voice. In particular, there has been a curious decoupling between stocks and bonds. Government bond yields in the troubled peripheral European nations have been rising, reflecting growing scepticism that policymakers are on the right path (Exhibit 1). Government bond yields elsewhere continue to bump along the floor, absorbing the safe-haven flows that this attitude has conjured.

Exhibit 1: Italian Bond Yield is the Canary in the Mineshaft



Source: Haver Analytics, RBC GAM

This is quite a contrast to equity markets, which have rebounded mightily since late September, recouping a large fraction of their summertime losses (Exhibit 2). This divergence is not entirely irrational. It embraces the improvement in the flow of economic data outside of Europe, and acknowledges the amazingly resilient performance of the corporate sector.

It is possible this disparate focus can persist, buoyed by businesses well fortified against a downturn and at odds with governments mired in debt. But it is more likely that some convergence between stocks and bonds will occur, and the risk is that stocks could be forced to acknowledge that Europe's autumnal decay is still the main storyline for global markets. Everything else is secondary.

Can Europe be fixed?

Yes, it is most definitely possible to fix Europe. This is what makes the past two years of half-measures so frustrating.

Collectively, European nations have sufficient resources to solve their own fiscal and banking problems. In fact, the Eurozone compares rather favourably to the U.S. across most debt metrics (Exhibit 3). The Eurozone has a smaller government debt load, smaller fiscal deficit, superior current-account balance and smaller private-sector debt burden. True, the Eurozone has inferior long-run growth prospects relative to the U.S., but at worst Europe comes out even in a test of debt sustainability versus the U.S.

Perhaps that line of reasoning is not entirely convincing. After all, the U.S. is hardly an example of pristine fiscal finances. But a different approach yields the same basic conclusion. The cost of absorbing the entirety of defaulting European sovereigns is unlikely to exceed around 5% of Eurozone GDP. If the rest of the world were to assist, the bill would come to just 1% of global GDP. The cost similarly represents no more than 1.5% of the world's stock-market capitalization, and yet the consequences of inaction have at times bled many times this amount from investment portfolios.

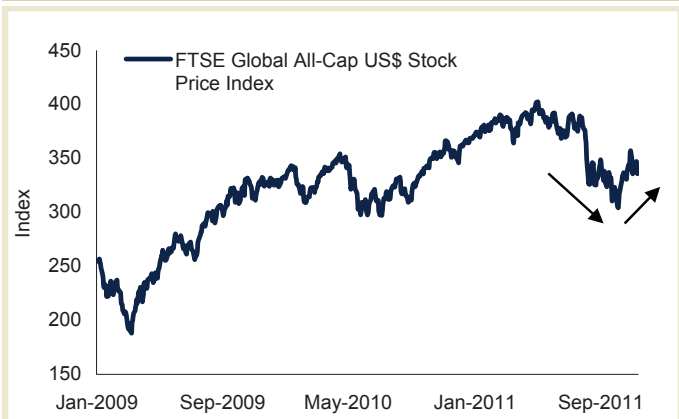
What's the hold up, then?

There are several complications. First, the sources of Europe's money and debts are poorly matched. Most of the economic might is in the north, while the heavier debt loads exist in the south.

Second, there is a major problem of political coordination. Eurozone decisions require political unanimity across the 17 member states. This is a high hurdle when the goal is to transfer hard-earned money to countries that frittered their finances away, and toward unpopular banks. Frankly, it is impressive how much has been accomplished given this constraint.

Third, there is such a wealth of possible saviours that no entity feels sufficiently compelled to unilaterally wrestle the problem to its knees. Potential actors include the imperilled countries themselves, their stronger Eurozone brethren, the European Central Bank (ECB), the International Monetary Fund (IMF), and a handful of flush developing nations. All would benefit from a resolution, but each drags its heels on taking action in the hope that the next will pick up the slack. Weaker European nations balk at the austerity that's required. Stronger European

Exhibit 2: Global Equities Have Partially Recovered



Source: FT, Haver Analytics, RBC GAM

Exhibit 3: Eurozone Is Not So Bad On The Aggregate
% of GDP (2011 est.)

	EUROZONE	U.S.
Government Debt	89	100
Fiscal Balance	-4.1	-9.6
Current Account Balance	0.1	-3.1
Private Debt (non-financial)	171	238

Source: IMF, RBS, RBC GAM

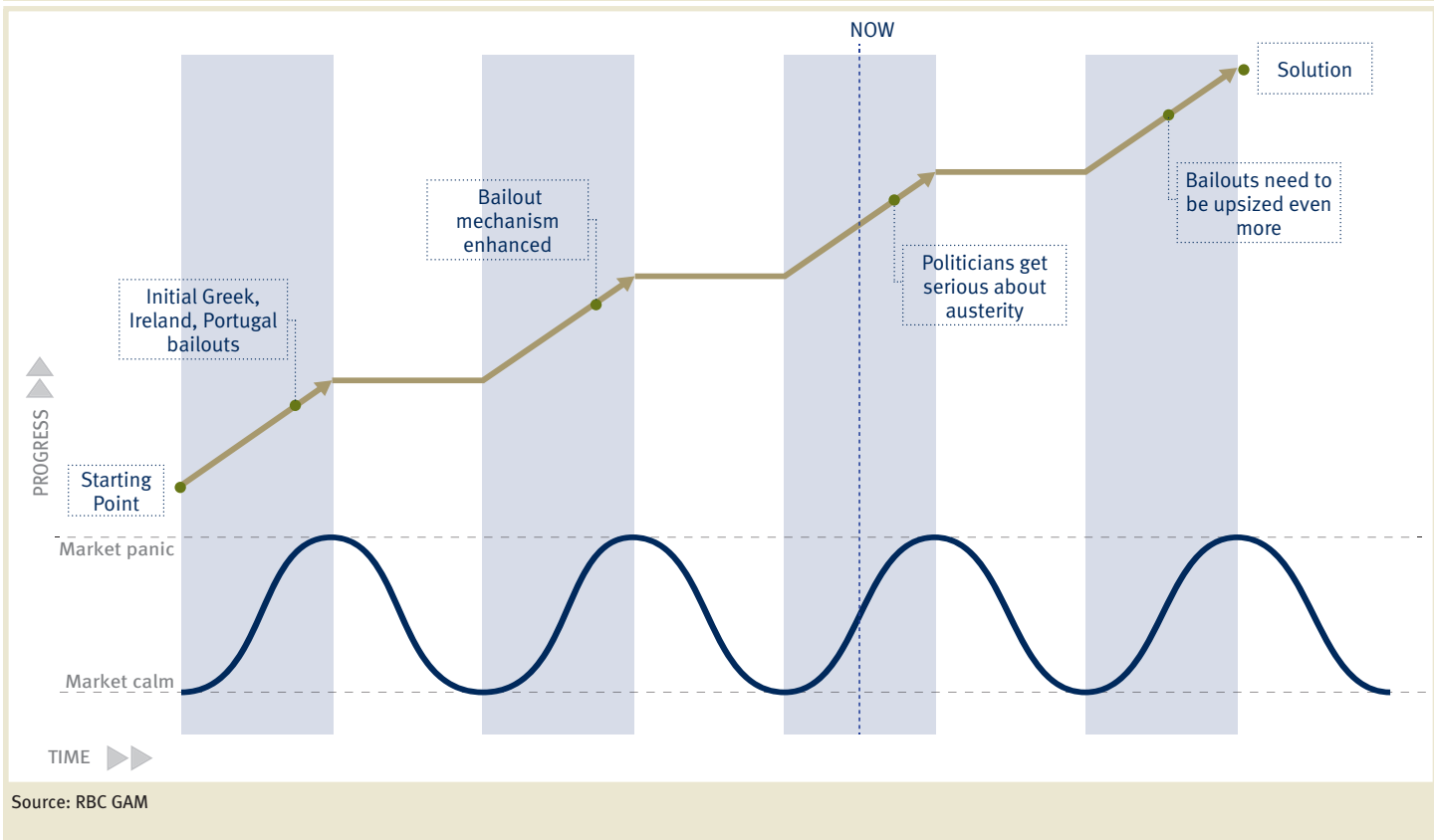
nations begrudge their dysfunctional neighbours. The ECB has the capacity to completely alter the dynamic, but is reluctant to compromise its principles or its balance sheet. The IMF appears willing to help, but not to the extent of absorbing a loss. Emerging-market nations have the necessary resources, but question the logic of bailing out countries far richer than themselves.

Why is the crisis spreading?

The three factors mentioned above have put policymakers firmly in reactive mode at a time when they need to be much more proactive. Perhaps this is unavoidable. In particular, nothing short of extreme market distress seems capable of providing the necessary political cover for European policymakers to advance an unpopular bailout agenda (Exhibit 4).

The crisis is spreading because politicians are acting too slowly and with insufficient force, allowing market psychology to race well ahead of the remedies. Ground zero for the current

Exhibit 4: Politicians Prodded Toward Solution by Market Panic



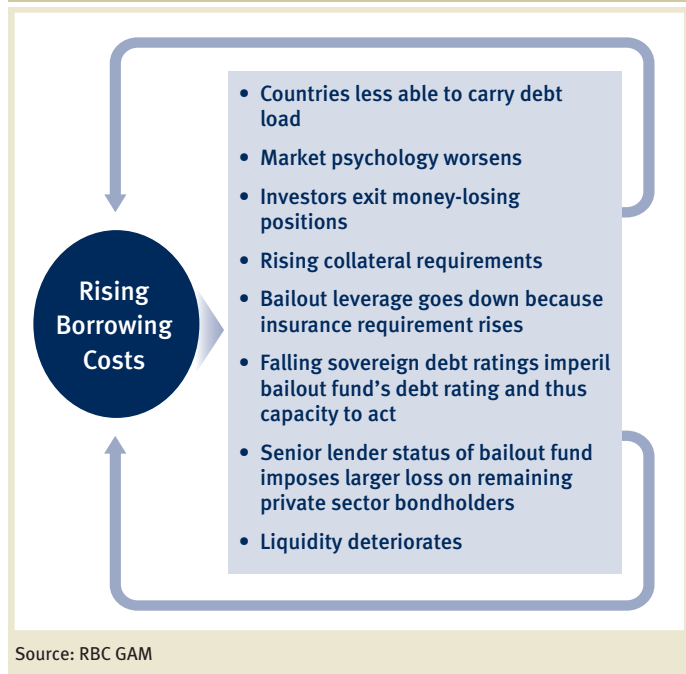
problems – Greece – is still without a credible final solution. The recapitalization plan for European banks is more tentative than it should be, and the unallocated remainder of the European Financial Stability Fund (EFSF) is relatively paltry (around €250 billion) when compared to the size of threatened sovereigns such as Italy.

Moreover, austerity measures have not been kindly received by indebted nations. In fact, the leader of every single threatened European nation has been swept out of office since the crisis began. First Ireland, then Portugal, Greece, Italy and – imminently – Spain. Leaders elsewhere in Europe are hardly more popular.

Meanwhile, well-intentioned regulators are imposing higher bank capital requirements at precisely the moment that asset valuations are falling. This is squeezing banks.

Markets are now under the influence of a vicious cycle (Exhibit 5). Primarily, rising interest rates render countries less able to afford their debt, prompting investors to push yields even higher. There are also a handful of other amplifying channels, such as deteriorating market psychology, worsening liquidity

Exhibit 5: Europe's Vicious Cycle



and rising collateral requirements. Meanwhile, the bailout fund itself is eyed with suspicion by investors due to its murky purpose and precarious AAA rating.

None of this fates Europe to failure, but it certainly makes for an uphill climb.

Does every distressed country suffer from the same basic problem?

On the surface, the answer is yes: each suffers from high debt, slow growth and sceptical markets.

Beneath the surface, however, the answer is no. For one thing, the provenance of their debt varies. In Greece, Portugal and Italy, it was good old-fashioned government profligacy, whereas in Ireland and Spain, housing bubbles caused economic and banking-sector problems that landed in the lap of the sovereign. But this is now ancient history.

The differences that matter today extend along the channels of liquidity, solvency and competitiveness (Exhibit 6). Liquidity is the capacity to easily and affordably borrow money over the short term. Solvency is the capacity to pay it back over the medium term. Competitiveness is the ability of a country to compete with the rest of the world over the long term, given its cost structure.¹

Greece wears the dubious triple mantle of being illiquid, insolvent and uncompetitive. Markets won't lend to the country, it has more debt than it can ever hope to pay back, and its wages run unsustainably ahead of the value of its output.

The remainder of the distressed nations suffer from some combination of these maladies, but not all of them. Ireland and Portugal are also illiquid, but the jury is out on whether they are insolvent. And while their competitiveness is imperfect, it is not all that bad. Meanwhile, Italy remains (imperfectly) liquid and, based on our calculations, is still solvent. But it is clearly uncompetitive and needs hard work over the long run to restore this. The same goes for Spain.

One of the central problems is that the troubled European nations continue to be treated primarily for the symptoms of illiquidity, when the issue of insolvency is just as pressing.

¹ As we define it, competitiveness is quite distinct from productivity. A country can be poor and relatively unproductive – China is a good example – and yet be enormously competitive so long as it pays wages that are proportionate to that level of productivity. The problem with uncompetitive countries is that they pay wages well in excess of their productivity level, making it difficult to compete with the rest of the world.

Exhibit 6: Parsing the Problem

COUNTRY	LIQUID	SOLVENT	COMPETITIVE
Greece	No	No	No
Portugal	No	So-So	So-So
Ireland	No	So-So	So-So
Italy	So-So	Yes	No
Spain	So-So	Yes	No
France	Yes	Yes	So-So
Germany	Yes	Yes	Yes

Note: **Liquid:** capacity to raise funds in bond market

Solvent: capacity to afford debt over medium to long term

Competitive: economic competitiveness versus rest of Eurozone

Source: RBC GAM

Illiquidity can be fixed by a low-interest-rate loan. Insolvency can only really be fixed by writing down the value of a country's debt.

With so many countries struggling, is Greece yesterday's news?

No. Greece is still the bellwether. It was the first country to run into trouble, its state of decay is more advanced than the rest, and some of the fixes being enacted for Greece will also solve the problems elsewhere in Europe.

After a brief flirtation with a referendum, Greece has mercifully pulled back from the precipice. It has now installed a temporary unity government headed by Lucas Papademos, a former Bank of Greece Governor and ECB Vice President. This should help Greece's austerity plan gain traction and free up the next bailout tranche before it runs out of cash in mid-December.

Yet Greece's fate still looks grim. The economy is hurting enormously, the public is unhappy² and the banking sector continues to experience a slow run on deposits to the tune of 10%-20% of deposits per year, as citizens yank their money to avoid losses from a bank failure or a return to the drachma.

Even more importantly, the latest bailout package is unlikely to return Greece to a sustainable trajectory. Greece's debt load will remain too high at 120% of GDP, even after the private-

² Alas, the unpopular austerity isn't optional. Greece could default today, writing off the entirety of its debt, and yet still require austerity both to restore a balanced budget and to become competitive again with the rest of Europe. The austerity has something to do with its debt load, but not everything.

sector haircut. That is simply unsustainable for a country slowed by austerity and tainted by the debt intolerance that plagues nations after they default on their debt (Exhibit 7).

Greece needs to default such that its debt load falls to 80% of GDP or below. This need not be disorderly, and it is unlikely to be. To be big enough, these losses cannot be restricted to the private sector as the current plan envisions. The loans extended by the bailout fund and the bonds held by the ECB will also need to pay the piper. The consequence of this will require some scrambling to accommodate.

What's wrong with Italy?

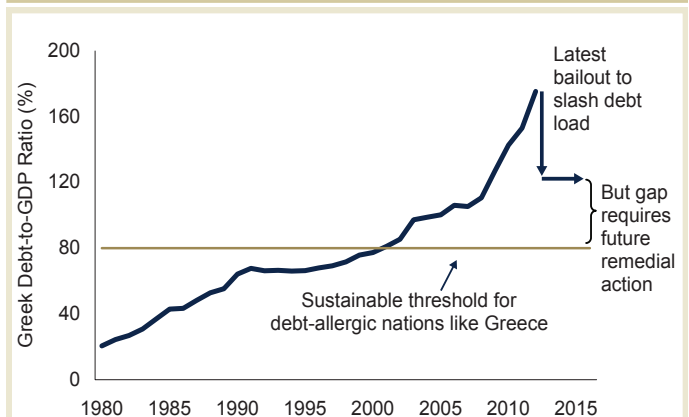
Italy is the latest country to be tarred and feathered by markets. Its borrowing costs have soared, reflecting concern it could be the next country to topple. This is no trivial matter, because Italy's large economy and debt render even moderately bad outcomes problematic. Italy has the third-largest economy in Europe and the third-largest government debt program in the world. It needs to roll over an astonishing €430 billion in bonds during the next year just to maintain an even keel.

There are equal doses of truth and misconceptions about Italy. It is true that Italy has a very high government debt-to-GDP ratio of around 120%. This is the main criticism against it, and it is a big one. Additionally, it has until recently lacked the political will to enact the necessary austerity programs, and its growth prospects look limited for the next few years. Acknowledging this, the Italian government recently asked the IMF to begin monitoring the country's pace of reform, and Italy may yet be granted access to an IMF credit-line program intended for countries with temporary vulnerabilities but solid fundamentals.

Misconceptions about Italy's situation deserve equal attention. Italy's 120% debt-to-GDP ratio may actually be sustainable for two reasons. First, our view that Greece cannot survive at a similar (post-bailout) debt level is in part due to the debt intolerance countries develop after defaulting. Italy is not in this position. Second, Italy has a smaller budget deficit than the other troubled nations, and is already on the cusp of a primary surplus.³ This means less hard work is needed to reach a sustainable position.

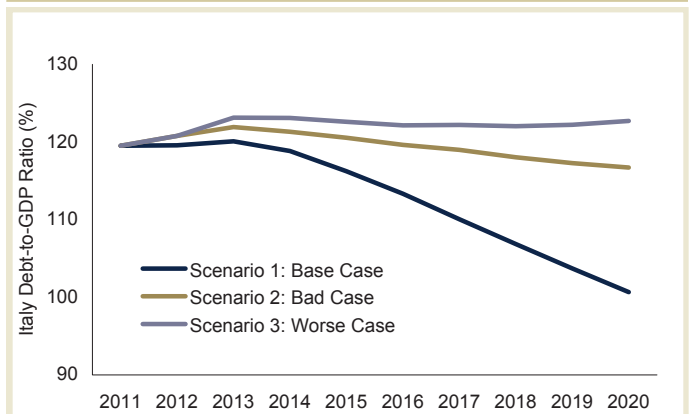
Italian debt is also disproportionately held domestically, rendering it less susceptible to speculative forces. Its debt has an unusually long average duration of seven years, meaning that

Exhibit 7: Greek Debt-to-GDP Ratio Remains Too High



Source: IMF, RBC GAM

Exhibit 8: Italian Debt-to-GDP Stabilizes Even Under Adverse Scenarios



Scenario 1: Base case – 6.5% interest rates, normal recession, middling austerity
 Scenario 2: Bad case – 8% interest rates, lengthy recession, mild austerity
 Scenario 3: Worse case – 10% interest rates, lengthy recession, mild austerity
 Source: RBC GAM stress testing

the majority will remain sheltered from rising borrowing costs for quite some time. Italy also holds around €100 billion in gold reserves. In contrast to their spendthrift government, Italians and Italian businesses have relatively little debt. Italy is hardly a poster child for prudent budget management, but neither is it on the scale of Greece or Portugal.

Despite these ameliorating factors, there is still a sense in the market that Italy is either insolvent or verging on insolvency. The main argument is that it has breached the 7% 10-year bond threshold that necessitated bailouts for Greece, Ireland and Portugal. But according to our calculations, Italy is probably different, and very likely still solvent (Exhibit 8).

³ A primary budget balance refers to government revenues less government expenditures, excluding debt-servicing costs.

In fact, by virtue of its small deficit, less austere economic outlook and long bond duration, Italy's debt load is surprisingly manageable compared to the rest. Under a realistic scenario incorporating a 6.5% 10-year yield, a moderate recession and modest austerity, Italy's debt-to-GDP ratio declines handily over the next decade. Not drastically, mind you, but cleanly and steadily downward. Even a more pessimistic scenario of a 10% 10-year yield and a lengthy recession would translate into a roughly steady debt-to-GDP ratio over the coming decade.

Framed differently, the cost of servicing Italian government debt is presently just 4.6% of GDP. This metric is the ultimate test of debt sustainability. It is both unusually light for Italy and nowhere near the danger zone of 10% (Exhibit 9). Even under a pessimistic scenario for the next decade, the cost of servicing Italian debt will be nowhere near its early 1990s peak or the danger zone.

This is all very good news, and confirms that Italy remains solvent. Italy's big risk, then, is not whether a 7% borrowing cost is fundamentally sustainable. It is. Instead, the question is whether markets believe this. Debt dynamics are exceedingly sensitive, with seemingly small shifts in sentiment having outsized consequences (Exhibit 10). Irrational fears can very quickly become rational if the borrowing cost is pushed high enough. This is the risk for Italy. Italy should remain solvent, but it could certainly use the help of the ECB to remain that way.

Italy's other challenge is to regain its competitiveness (Exhibit 11), a process that will be gradual and requires a great deal of economic and regulatory reform to modernize its labour market and economy. New Prime Minister, Mario Monti, should get this ball rolling.

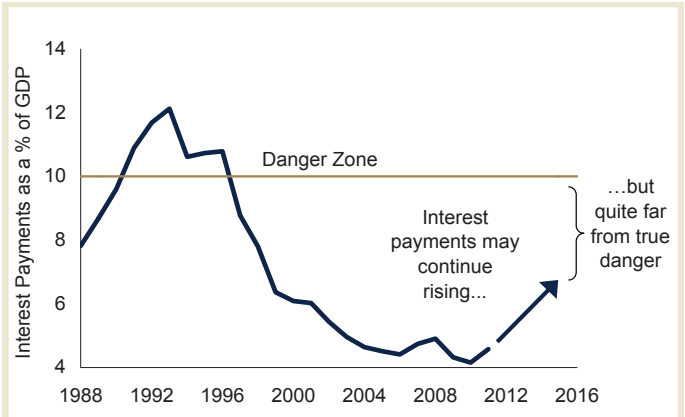
Why have Ireland and Portugal fallen off the map?

Little is said of Ireland and Portugal these days. This might seem odd, since the risk of Ireland or Portugal defaulting is, on paper, still much greater than Italy's.

However, markets are actually right to focus their attention elsewhere. The risk of Italian default may be quite low, but the reverberations would be huge. By contrast, the economies and absolute debts of Ireland and Portugal are tiny.

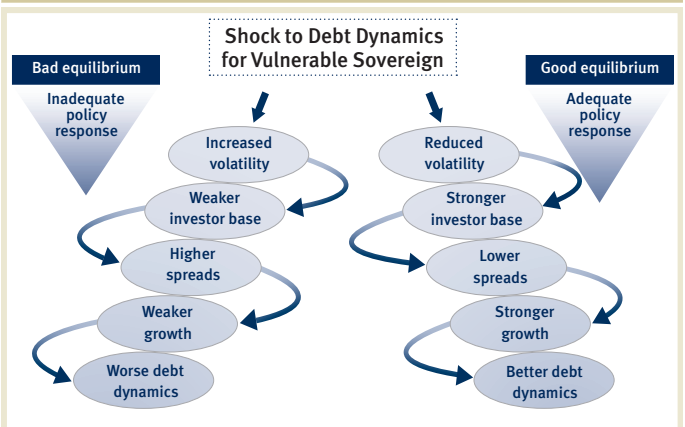
Also, Ireland and Portugal continue to possess a fighting chance of returning to sustainability thanks to existing bailout packages. Ireland, in particular, might just pull it off given

Exhibit 9: Italian Government Interest Payments Look To Remain Manageable



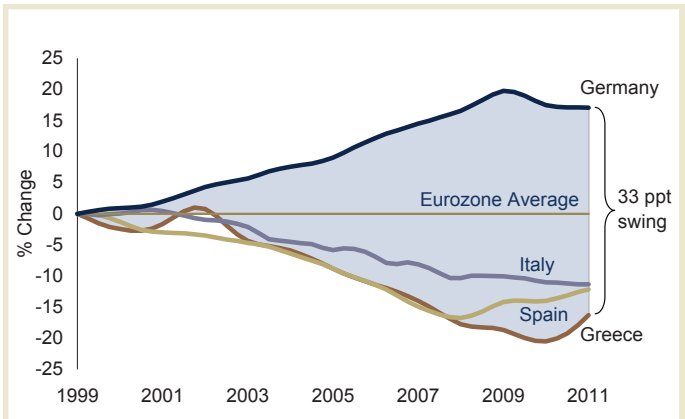
Source: IMF, Haver Analytics, RBC GAM

Exhibit 10: Debt Dynamics



Source: IMF

Exhibit 11: Eurozone Competitiveness Gap Requires Hard Work To Close



Note: Change in relative economic competitiveness since currency union in 1999
Source: Haver Analytics, RBC GAM

impressive gains in competitiveness and the prospect of at least modest economic growth. Both are managing a decent amount of austerity. Default remains a real possibility for both, but Greece is the bellwether on this front, and the sorts of solutions being proposed there provide a useful template for Ireland and Portugal, should further action be needed. The various fixes being implemented right now – bank recapitalization, for instance – address not just Greece but equally the risks for Ireland and Portugal.

Who is next to incur the market's wrath?

There has been a clear progression to Europe's downward spiral. First Greece, then Ireland, then Portugal, and now Italy. It would be naïve to guarantee the problems stop with Italy, however solvent Italy and the remainder may be. The market is looking for trouble, and this could theoretically be found in Spain, Cyprus, Belgium, Austria or France. Truthfully, Spain is just about the only country of the bunch that really deserves a closer look, by virtue of its large size, high unemployment rate, troubled banks and spend-happy regional governments. Indeed, sentiment is beginning to deteriorate in Spain as it has with Italy, and its yields have recently blown out to Italian levels. But as with Italy, Spain still looks to be solvent, it has a lower debt burden than France or Germany, and the election of a new and credible government should help matters.

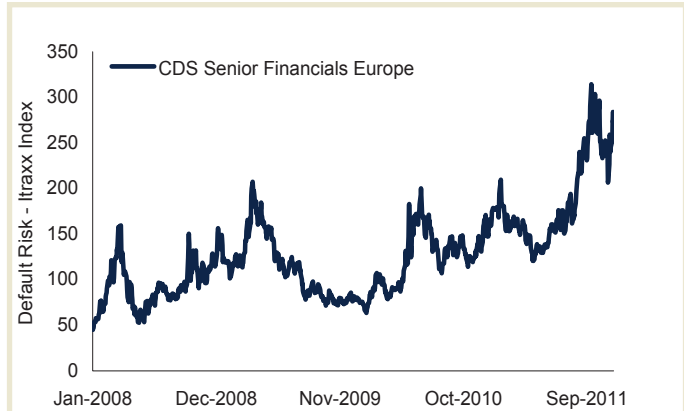
For the rest, they have neither the debt load of Italy nor the economic problems of Spain, and so despite moderately widening spreads, it is hard to envision them truly succumbing to the same market pressures. Outside of the Eurozone, Eastern Europe remains a key risk due to its deep linkages to the Eurozone via trade, banking and financial flows.

Why do we care about European banks?

We care about European banks for two reasons. First, because credit is the lifeblood of any economy, and an impaired credit channel would spell serious trouble for the European economy. Second, because global banking remains sufficiently intertwined that the failure of a systemically important European bank would shake the world's financial system to its core.

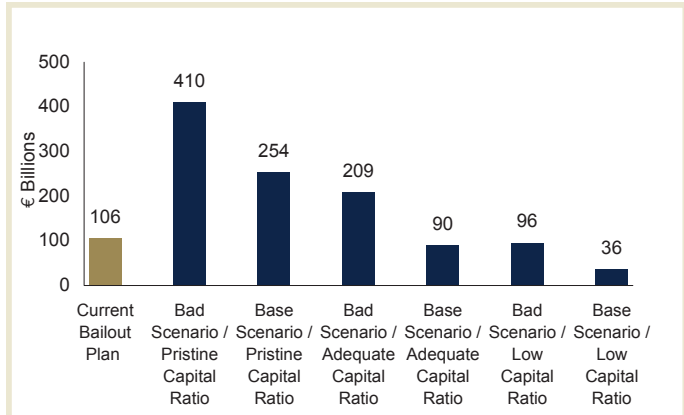
European banks hold a great deal of sovereign debt. This is the usual state of affairs: banks always hold a lot of their own country's debt because they are permitted to treat it as a risk-free asset. But now that the value of this sovereign debt is in question, problems are mounting (Exhibit 12).

Exhibit 12: Bank Distress Remains Elevated



Source: Bloomberg, RBC GAM

Exhibit 13: European Bank Recapitalization Needs



Capital Ratios refer to core Tier 1 capital ratio: Pristine=9%, Adequate=7%, Low=5%
Bad Scenario assumes the following sovereign writedowns: GR=75%, PT=50%, IE=50%, IT=30, ES=30%
Base Scenario assumes the following sovereign writedowns: GR=60%, PT=40%, IE=40%, IT=0%, ES=0%
 Source: Reuters, RBC GAM

Already, European funding markets are showing clear signs of distress, and capital markets are closed to many European banks. A central risk is that banks will be unable to roll their unsecured debt. Without the generous provision of unlimited liquidity to Eurozone banks by the ECB, Europe would have several Lehman Brothers on its hands.

Fortunately, 2008 is unlikely to be repeated in full. In addition to the ECB's heroics, European policymakers have repeatedly and credibly committed to ensuring that all systemically important European banks remain viable. Without the spark of a major failure, global shock waves should be limited.

Europe has mandated that banks raise €106 billion in capital to insulate them from the crisis. The idea is that even if Greece and various of its brethren fail, the banks would be able to absorb the losses and keep on ticking. We'd prefer to see more like €200 billion to €250 billion in capital raised (Exhibit 13) so as to be absolutely sure of having enough, especially given the risk of additional losses due to recessionary conditions. This overkill would be less costly to governments than it first looks, since banks must first endeavour to recapitalize via private means, and because the U.S. experience demonstrates that bank bailouts are often outright profitable in time.

Despite our qualms, the current plan may just suffice in the end. After all, banks can survive on less than a 9% core Tier 1 capital ratio, however undesirable that may be. We must hope that funding markets recognize this and become more amenable to bank funding needs.

What's in the hopper to fix Europe?

There is a kaleidoscope of potential actors and remedies for what ails Europe. To begin with, the enhanced EFSF bailout package now in place actually does a decent job of providing policymakers with a framework for a solution. In particular, Europe can now bail out additional nations or banks on a moment's notice. The problem with the package is that it is undersized, especially as Italy and Spain come under pressure. Efforts are underway to remedy this.

Most popular and most likely is an insurance scheme that would see the €250 billion or so of remaining bailout funds effectively multiplied by something like a factor of three or four, permitting close to a €1 trillion punch. This would be accomplished by promising to reimburse investors in Italian (and perhaps Spanish) bonds for their first 30% of losses. Any Italian default wouldn't be much in excess of a 30% writedown, rendering Italian bonds effectively risk-free. Italian borrowing costs should then normalize.

A less likely option is to leverage up the bailout fund, by turning it into what amounts to a bank. This "bank" would then be permitted to hold assets well in excess of its capital. The fund would buy sovereign bonds, lend them into an ECB liquidity facility in exchange for cash, use the cash to buy more sovereign bonds, and repeat the exercise until the fund had purchased

sovereign bonds amounting to several times its underlying capital.⁴

Of course, one of the main consequences of any insurance or leverage plan is that the risk of loss is magnified in direct proportion to the telescoping size of the fund. Some European nations continue to drag their heels on these proposals precisely because they have trouble stomaching the idea that a large chunk of their bailout contribution could be lost due to even a relatively small shift in sovereign-debt valuations.

Along other avenues, the IMF may yet step in with a few hundred billion euros, possibly sponsored by some of the larger emerging-market nations. Why would a country like China volunteer? They might view it as a way of shifting the world's balance of power away from Europe and the U.S. and toward themselves, and view the protection of the IMF's senior lender status as the lowest-risk way of doing so. They might also hope to procure favours from Europe, including an increased allotment of voting shares at the IMF, an understanding that China would cease to be criticized as a "currency manipulator," and an understanding that China would no longer be blocked from acquiring certain European companies.

There is also the possibility that the ECB begins purchasing European bonds on a far larger scale than it has to date. The ECB enjoys a technically unlimited capacity for action, which, if done credibly, would snuff out most of the speculative attack on Italy and other solvent but pressured European countries. So far, the ECB has been reluctant to take on this role, but the newly appointed president, Mario Draghi, may yet embrace it. Another rumour is that the ECB could opt to fund the IMF, lending a hand indirectly.

The notion of providing a joint European commitment for all Eurozone debt – a eurobond – remains intriguing. It would capitalize on the fact that the Eurozone's debt load is entirely manageable when paired with its full economic firepower, and would greatly reduce debt-servicing costs for heavily indebted nations. Eurobonds don't appear to be a near-term fix, however, since enacting them requires constitutional and treaty changes. One criticism is that they reduce incentives for fiscal responsibility, but the option should not be discounted altogether. In particular, the current piecemeal approach of bailouts and ECB buying amounts to an implicit fiscal transfer from northern Europe to southern Europe anyhow, and so it

⁴ It isn't clear that this is legal under the European Treaty, however, and so one variation would be to create a special investment vehicle, shift the bailout funds into that, and take subsequent actions there.

might be preferable to formalize the rules and introduce some proper incentives.

Which of these varied options is destined to emerge? Probably some combination. The insurance scheme seems most likely in the near term, along with some form of IMF contribution. But if the insurance and leverage schemes don't congeal, there is a fair chance the ECB will eventually break down and start buying government bonds on a large scale. Eurobonds remain reasonably likely over the long run, but won't be implemented quickly enough to play a major role in rescue efforts.

What's the endgame for Europe?

It is perhaps best to cut through this mess with some broad conclusions, regardless of the bailout vehicles employed (Exhibit 14). Greece remains insolvent, even after the latest raft of bailouts. The odds of a Greek default are conservatively 95%, and likely closer to 100%. After all, there is already an agreement in principle to write down the value of privately held Greek bonds by 50% – the very definition of default.⁵ Perhaps of greater relevance, we think there is a 75% chance that the Greek default will have to be greater than currently envisioned. As to the magnitude, a 60% writedown across all bond holders (not just the private sector) should suffice. The way things are going, this could yet grow.

For Ireland and Portugal, the odds of default are around 40% and 60%, respectively. The magnitude of any writedown would be around 40%.

In contrast, Italy still appears solvent, and so the main risk is the mounting toll of market pressure. We put the risk of default at around 10%, and believe the haircut would be around 30%, putting Italy's debt in line with Germany and France.

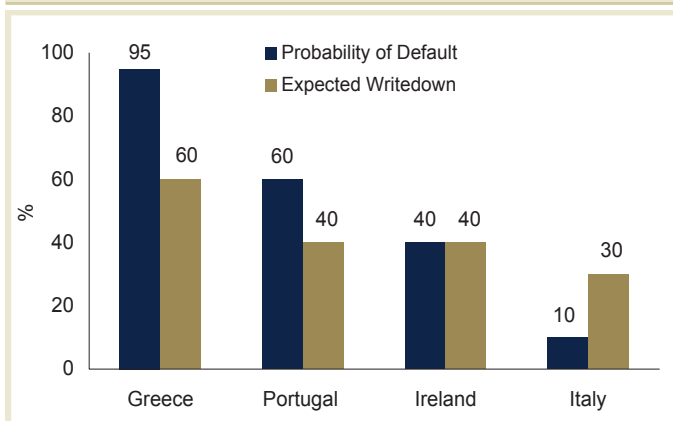
A spate of defaulting nations is fine, by the way, so long as the banking sector is properly recapitalized to handle the losses. And it looks like it should be. In turn, this morphs from being a market problem into an economic problem.

Could the Eurozone break apart?

It could, but it isn't very likely. Granted, the attraction for weak countries is clear: your new currency depreciates and you quickly regain your competitiveness. And while it is true that the

⁵ The ratings agencies acknowledge this as a default. However, ISDA may stubbornly insist this is not a default due to its "voluntary" nature, and so credit default swaps may not be triggered. That actually creates as many problems as it solves.

Exhibit 14: European Oddsmaking



Source: RBC GAM

possibility of Greece exiting the Eurozone was recently raised by European leaders, it seemed more of a bargaining tactic to ensure that any hypothetical Greek referendum was framed in the context of "Do you want to stay in the Eurozone?" (which Greeks desire), as opposed to "Do you like the latest bailout?" (which Greeks do not).

When properly tallied, there are far more negatives connected with leaving the Eurozone than positives. First, the euro was conceived as more than simply an economic tool. It is also a mechanism for binding the fates of European nations more tightly together in an effort to leave behind centuries of war and conflict. This is ironic given the squabbling currently on display over precisely this, but it still beats war.

Second, a Eurozone breakup would be costly to strong nations such as Germany and the Netherlands. Their currencies would soar, challenging their export-oriented economies.

Third, it would set an awful precedent if Greece left the Eurozone, and speculators would very quickly set to work pushing other countries out.

Fourth, the operation would be horribly bloody. Greeks would try to evade the spectre of a depreciating drachma, pre-emptively shifting their money into cash or foreign banks. This would precipitate a run on the banking sector and possibly banking failures. At best, there would be an extended bank holiday and a resulting cash crunch. Travel restrictions might also be necessary. Businesses with foreign liabilities would suddenly find those liabilities doubled, and crumble under the weight. Credibly, the Greek economy would initially shrink by half in response to this turmoil. That hardly constitutes an easy way out.

In fact, the opposite outcome is more likely. Instead of breaking apart, what we are witnessing is the Eurozone fusing itself more tightly together. The bailouts themselves constitute a crude first attempt at fiscal union, and the great gobs of money put into bailout funds demonstrates the resilience of the commitment. There are already a few small equalization programs at work that transfer funds to needy countries. These are the buds of a fuller fiscal union.

What's the worst-case scenario?

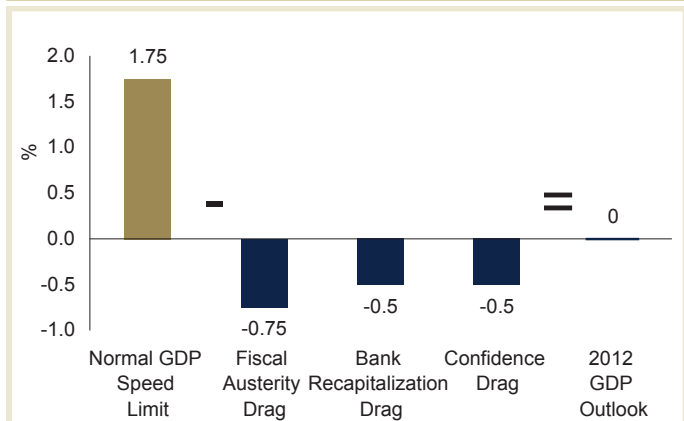
There are all sorts of negative scenarios that can be spun. All bets are off if a major European bank fails, if a country like Italy or Spain defaults, or if Greece exits the Eurozone. The magnitude of the consequences would be enormous, and possibly on par with the global financial collapse of 2008.

We don't expect any of these things to happen, but neither are they impossible. In particular, avoiding disastrous scenarios requires a great deal of political will. Remarkably, this seems to exist. But lurking beneath the surface is an evident lack of public will. The average citizen in Greece is angry, as is the average Dutch citizen. Austerity on the scale currently required tends to translate not just into protests, but sometimes into outright revolt. This is the path along which a worst-case scenario could find its way into being.

What does this mean for the global economy?

The Eurozone economy is already headed for a recession in 2012. We forecast flat output for the year, with several negative quarters along the way. This grim forecast is due to three things (Exhibit 15). First, fiscal austerity is painful and subtracts around 0.75 percentage points off GDP. Second, bank recapitalization (or worse, bank divestment of assets)

Exhibit 15: European 2012 GDP Math Has Deteriorated



Source: RBC GAM

should subtract another 0.5 percentage points, as banks scale back on lending. Third, consumer and investor confidence is at rock-bottom levels in Europe given persistent uncertainty, and this looks to subtract around 0.5 percentage points off growth as well. These effects shouldn't be quite so bad for 2013 and beyond, but growth will be depressed for several more years.

For the rest of the world, our best estimate is that Europe subtracts around 0.5 percentage points off growth in 2012 from most nations, including the U.S. and Canada. Unless the unthinkable happens and a big bank is allowed to fail, or Italy slips into oblivion, an outright global recession is unlikely on the back of European events alone.

In the meantime, it will remain déjà vu all over again for investors as market distress induces European bailouts that temporarily sate markets but ultimately fall short, producing yet more market distress and yet more bailouts. Forward progress is being made, but a lasting solution remains elusive.

This report has been provided by RBC Global Asset Management Inc. (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM. It is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. Due to the possibility of human and mechanical error as well as other factors, including but not limited to technical or other inaccuracies or typographical errors or omissions, RBC GAM is not responsible for any errors or omissions contained herein. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

Any investment and economic outlook information contained in this report has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

All opinions and estimates contained in this report constitute our judgment as of the indicated date of the information, are subject to change without notice and are provided in good faith but without legal responsibility. To the full extent permitted by law, neither RBC GAM nor any of its affiliates nor any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of the outlook information contained herein. Interest rates and market conditions are subject to change.

A NOTE ON FORWARD-LOOKING STATEMENTS

This report may contain forward-looking statements about future performance, strategies or prospects, and possible future action. The words “may,” “could,” “should,” “would,” “suspect,” “outlook,” “believe,” “plan,” “anticipate,” “estimate,” “expect,” “intend,” “forecast,” “objective” and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties about general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings and catastrophic events. The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

® Registered trademark of Royal Bank of Canada. RBC Global Asset Management is a registered trademark of Royal Bank of Canada. Used under licence. © RBC Global Asset Management Inc. 2011.



**RBC Global
Asset Management**