

Dinner Speech
Hofburg Palace (Conference Center)
Herbert Stepic, CEO of Raiffeisen Bank International
Decembre 9, 2011

Dear Mr. Thierry de Montbrial,

Dear Excellencies,
Dear ladies & Gentlemen,

It is a great honour for me to speak today here in front of such a distinguished group of people.

Dear Monsieur de Montbrial, I have read your message on your website as a preparation for this event, in which you articulate your hope that this conference plays a modest but significant role in averting the misfortune of inter alia the break-up of the European Union, a collapse of the Euro-Atlantic couple, a fragmented world with (more or less) pure national interests resulting in wars, social unrest, etc.

You state that we have to find back to ways of global governance which end with "win-win" situations in opposition to "lose-lose" situations, which seem to be the prevailing risk nowadays.

I absolutely agree that we must find "win-win" situations. Especially in Europe, where a further acceleration of the crisis would have a major impact on the entire world.

Ladies & Gentlemen, as I am an European banker, I will concentrate on European governance and European macroeconomic issues, as they are strongly interrelated.

The future of the Euro

The future of the Euro is one of the major concerns we are currently confronted with when talking to clients, international investors, etc.

Most of the people know that I am a banker. When I am at home I am often asked by family and friends:

- Will the Euro last?
- What shall I do with my money?
- Do I have to invest into Gold?
- Should we buy land?

I usually end the conversation, as I cannot convince them about anything: look my friends, leave it on the saving account and wait for better times.

Undoubtedly there are major economic and political risks we are currently facing in the Eurozone, which lead to fear and great uncertainty in the markets.

This fear is fuelled by media reports and analysts glooming about the end of the EUR currency.

But what is really going on currently?

The current struggle is not about keeping or abandoning the Euro-project, but about avoiding the

painful economic fallout of sovereign bankruptcies.

While the question is how to avoid default of some weaker members, the Eurozone as a common currency area is in total even relatively strong:

- The Eurozone in aggregate has a comparatively low public debt level of (2011) 88% of GDP. This compares favourably to the USA (100%) or Japan (233.1%).
- The budget deficit is even more constructive, standing at 4.1 % (2011) of GDP in the Eurozone, vs. 9.3% in the US and 10.3% in Japan.
- Nor has the Eurozone a need for extensive external financing: The **current account** of the Eurozone (-0.8% of GDP in 2011) compares favourably with the sizable net external funding needs (current account deficits) prevailing in the UK (-2.5%) and the US (-3.1 %).

In average the fundamentals of the Euro are quite good, if I compare it with other currencies.

So when my friends ask me, will the Euro retain its value? I ask them against what? We have a very weak USD and I would also not like to invest into the JPY.

Unfortunately this average fundamental strength of the Eurozone in aggregate does not rule out financing problems of individual countries (and in the case of Greece even debt restructuring). Therefore the issue can be argued as follows:

1. A default of a Eurozone member does not automatically endanger the Euro per se or its value:

- a. Single countries cannot "print" their way out of the crisis and devalue the Euro
- b. Should a default of one or more Eurozone countries happen, something that I am convinced can and will be avoided, with the exception of Greece, the fall-out would affect the financial system (having to cope with substantial capital losses) and the real economy (suffering a deep and drawn-out recession), but not the price stability of the currency. In such a scenario the risk of deflation would be higher, like in Japan in the 90s.

2. A break up of the Eurozone is very unlikely as the costs of an exit are exorbitantly high

- a. Due to the export dependency of its members.
- b. And much more importantly: After 12 years of integrating financial markets, the break-up of the currency would lead to a massive devaluation of weak currencies, banking runs, recession and missing refinancing options. Most banks in these countries would need to be restructured, leading to enormous capital losses also in core Europe, in Germany and France. Many French and German banks would need to be nationalized, which would lead to a deep and protracted recession.

A break up of the Eurozone is a classic "lose-lose" situation and the financial and economic costs of a break-up, as well as the default of a major EUR country, are so high for EVERYBODY, that it will be avoided.

The means to avoid it, are difficult to agree on, as countries which are stability focused, are eager that a "safety net" for EUR countries does not set an incentive to continue piling up its high debt.

So, we need fundamental reforms. That is undisputed.

But what kind of reforms are needed? Reforms leading to more or less integration?

As explained before, less integration, namely the break up of the Euro is a very painful exercise and would send us most probably 20 years back in our development. Therefore we need more integration. This means a coordinated economic and fiscal policy, the elimination of tax heavens

and the implementation of certain mechanisms which may trigger the "shift of authorities" from local governments to Brussels. Otherwise a common currency cannot work.

However, there are a lot of different possibilities on how such a fiscal union can be structured (degree of centralisation, trigger mechanisms, trigger thresholds, members of fiscal Union → all EU members or all Eurozone members):

According to the results of the negotiations last night, the entire Eurozone will establish a "fiscal union", which will be based on contracts separate from the EU. All other EU members, except from the UK, are willing to join the fiscal union and will consult with their parliaments and will be involved in the negotiations.

That is not a perfect result, but for the Euro it is a good step into the right direction. The fiscal union is a precondition for the creation of Eurobonds, which most probably will be implemented at a later stage.

The separate contract shall be negotiated until March, which is a tight timeline, as the mechanisms of abandoning of "sovereignty rights" to a "ruling European institution" has to be agreed.

Equally controversial is the requested household consolidation. Simple and radical cost cutting is definitely also not the "cure to the disease" and answer to the current challenges. I will come back to this topic a little later again.

All this needs time! The contracts have to pass local governments at times where local governments have not held the European flag high. So we need time to change the system when financial markets do not allow for long change processes. They will continue to put indebted countries into the lime light of negative reporting and rating agencies will do the rest.

So we need time and interim measures!

3. Bond purchases of the ECB will remain a vital pillar to provide countries like Italy and Spain with the time to consolidate their budgets and undergo reforms

- a. I am absolutely confident, that all the countries besides Greece will be able to restructure in such a way that they will be able to come out of the crisis, as long as they can refinance themselves at acceptable rates.
- b. Money which is not coming out of the EFSF, will need to come from ECB

You will ask me then of course. Do these bond purchases endanger the purchasing power and the stability of the EUR. In theory yes. But what is happening at the moment?

- a. The European banking system is cutting back lending under the pressure of new regulation - I will come back to that a little later - and credit demand shrinks given the unfolding recession.
- b. Therefore less money than before is coming into the real economy and ECB bond purchases will help to fight deflation, which is a bigger risk than inflation at the moment.

Ladies & Gentlemen, let me shortly summarise on what I have said so far:

- a. A break up of the Eurozone or the bankruptcy of a large Eurozone member is extremely costly for everybody and therefore very unlikely.
- b. We have the means to fight the crisis, we just have to use them. Consequently I have little doubt that politicians will continue to go for a "win-win" situation of stronger integration and solidarity.

So far so good! BUT:

All reforms requested singularly concentrate on cost savings! But Europe needs both!

Europe needs budget consolidation, mainly via structural reforms, as well as growth .

We need to create jobs and provide future oriented programs, as social unrest is the biggest threat in case of rising unemployment and ever enlarging social differences.

This also means that any EU governance reform, such as the proposed fiscal union, has to take cyclicity into account and avoid procyclical measures.

And this is what I do not see so far.

EBA regulation in the context of growth

In the context of growth, I want to seriously oppose the new regulation of the European Banking Authority, which has been published on 27th of October, that all systemic relevant banks have to show a Core Tier 1 Capital Ratio of 9% by the 30th of June 2012, regardless whether they are exposed to peripheral countries, and consequently write offs, or not.

Do not understand me wrong. I am absolutely in favour of stabilizing the financial system and reduce the inherent risk to the global economy. But this needs to be a process over a certain period of time. That does not work from one day after the other.

Therefore, new "global" Banking regulations, namely Basel 3, have been developed after the Lehman crisis and they have foreseen a bundle of measures including a gradual step up of Core Tier 1 capital over a longer period.

According to the new EBA regulation banks have to fulfill Basel 3 targets of 2019, within a period of 8 months.

Ladies & Gentlemen, higher capital ratios in the middle of a debt crisis are absolutely counterproductive as banks will be finally forced to reduce lending.

And this is what will happen:

Morgan Stanley estimates that the European Banking Market will deleverage by EUR 1,5-2,5 trillion over the next 18 months.

This will have a serious long term effect on the economic development of Europe.

The crisis will not be solved by increased capital requirements on short notice, as the core of the problem is the mistrust of the markets in the solvency of public debt. And the key problem is liquidity and only second to that capital.

Central & Eastern Europe

As someone who is heavily engaged in CEE, let me make a few remarks about CEE.

In the context of this new EBA regulation, some international media commentators have written about deleveraging effects which will be especially negative for Central and Eastern Europe, which then will be a great risk for the stability of Austria due to the engagements of Austrian banks in CEE. Let me also try to clarify the issue here.

Of course, Eastern Europe, just like Western Europe will be also negatively affected by the crisis.

But: ladies & Gentlemen, Central & Eastern European countries are much better

Prepared for a crisis scenario than 2008/09:

They have used their time diligently and prolonged public debt maturities.

CEE is much less dependent on external financing, there is a reversed trend in external debt to

GDP and there is very high labour productivity. These countries are very competitive, and have a well educated workforce.

Central and Eastern European markets are less indebted with the exception of Hungary with less than 50% of the average indebtedness of EU countries. Looking at Central and Eastern Europe one sees the inherent conversion process of where Europe is heading.

If you are still living as a young man of 26 years with your parents and your grandparents in an apartment of 65 square meters you really want to have your own fiat. And this is the inherent motor of conversion. You want to have it.

You want to see it. You want to make it. And they have the brain to do it.

Therefore the "conversion-process" will continue:

CEE was and will remain the growth motor of Europe, as it is a market with more than 300 mn customers, who will fast catch up with Western Europe. The GDP per capita of the Eurozone (EUR 28,755) is more than 3,5x higher than of CEE (EUR 7,879). This difference shows the convergence potential between the two regions.

Due to this catching up process Eastern Europe will show a positive real GDP growth differential of approximately 2 percentage points on a sustainable basis to the Eurozone.

Ladies and Gentlemen, besides the very necessary consolidation process we need to focus on strategic growth programs. This will only be possible through solidarity. Otherwise we will have enormous social unrest. We are talking about a redistribution of wealth.

Pan-European solidarity and in a second step, increased European integration is the only way to avoid a "lose-lose" situation and I would even say to reach a "win-win" situation out of the current crisis for all involved parties.

Thank you!