

Perspectives on the Current State of the Market from a some-time British Banker

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Good afternoon to you all.

This really is a beautiful room. And it is very appropriate given today's topic, that we are so close to the gaming floor of one of the Southern Hemisphere's largest casinos. But more of that later.

It really is a pleasure to be here.

Of course one of the reasons that I am glad to be here is that ANZ is a sponsor of the Chamber. So, as a dyed in the wool banker, I'm glad to have the opportunity to check out first hand where our money is going.

Now as you can guess from my accent, I originally came from the United Kingdom.

But in reality, I have spent more of my life in Asia than in England and so I am going to give a much more global perspective in my talk today.

In many places across Asia, the 7th of February, marked the beginning of the Chinese New Year, a time of great celebration.

Today, the 7th of March, marks the beginning of Moomba, which I gather is the Melbourne equivalent of the Chinese New Year - without the dragons but with the fireworks. I'm looking forward to seeing the differences first hand.

Soon after I started at ANZ I spoke at a lunch in Sydney.

While I thought I made some pretty interesting remarks about the global economy, banking and the future of Asia, most of the newspapers seemed to focus on my comments on the supermodel Giselle.

Now Giselle is not just a pretty face. She is the highest-paid model in the world and also the sixteenth richest woman in the entertainment world, having earned about \$40 million last year.

In my speech I pointed out that not only was Giselle rich but she was a better judge of currency markets than many foreign exchange dealers.

When Giselle signed a contract in August last year to represent Pantene hair products in Brazil, it's reported she wanted payment in Brazilian Reals rather than US dollars.

While Giselle seems to have subsequently clarified she is happy to be paid in any currency, Giselle of course was right.

The Real is now at its highest level against the US Dollar in nine years thanks to Brazil's commodity rich export base. But not only was she right but the world's greatest investor Warren Buffet has been taking her advice.

Buffet's only "direct" currency investment last year was in the Real against the Greenback.

The reason, well one of the reasons, I like to tell this story is that in today's volatile markets investors would have done well to follow Giselle's advice.

Sub-prime and associated write downs by major banks are now around \$160 billion.

And, at the moment, write downs in the last year are more than the annual GDP of New Zealand.

As Wells Fargo chief executive John Stumpf said recently: "It's interesting that the industry has invented new ways to lose money, when the old ways seemed to work just fine".

Now the direct effects in the US and the impact on the global economy are becoming clearer.

The US economy is suffering a significant downturn and it is likely some other OECD countries will follow.

The Australian economy is in reasonably good shape but the ripple effects of the sub-prime crisis are now being felt here.

Liquidity has tightened in financial markets leading to higher interest rates for banks and, in turn, for business and retail borrowers.

In my five months back in Australia at ANZ, I have come to learn pretty quickly there is a lot of politics around banks.

The fact is turmoil in global credit markets means the cost of funds has gone up over and above the Reserve Bank's increase.

I don't recall too many people saying that bakers shouldn't put up the price of bread when the cost of flour rises.

So the debate around this issue is quite strange to me, as it would be to most people who want to run a sustainable business.

But I am getting to understand about Australian politics fast.

Certainly, I believe the increase we pass on will have to strike a balance between the additional increase in funding costs and what we pass on to customers and what we absorb ourselves.

Those pressures are however continuing to intensifying globally, and they will continue to put pressure on Australian households and businesses.

This is being played out in the share market where there is incredible volatility. The ASX 200 has fallen by around 15% over the last two months, a decline we have not seen since the last recession in the early 1990s.

From a short term perspective it's clear the twin economic challenges facing the Reserve Bank are containing and subduing inflation while not tightening so hard that it induces a severe downturn in domestic demand.

While headline inflation is running at 3 per cent a year, underlying inflation is now running well ahead of the Reserve Bank's two to three per cent target and there is a risk it will stay above that level for an extended period of time without a change in policies.

However, at the same time, the global economy is weakening, the global financial system is in turmoil and risk is being repriced upwards.

The bottom line is higher credit costs, a tightening of credit availability in Australia and an erosion of business confidence.

One of the many things I believe is missing in this debate is that if we can't properly reprice lending, there is a real risk banks will ultimately be limited in the amount we are able to lend customers to buy houses or to expand their businesses.

We saw this earlier this week when Macquarie became the first prime lender to say it would scale back its mortgage business as they no longer see it as having a balanced risk reward relationship.

These are factors that are bound to affect the level of activity in the economy.

The job of tackling inflation is more difficult in this environment, as the Reserve Bank has to consider the future dampening effects of the global economy, while all recent economic data tells them that the Australian economy is growing strongly.

I say this because we need to recognise that global liquidity issues are already exerting downward pressure on economic activity globally and Australia will not be immune from this.

So, on the one hand, the Government and Reserve Bank see Australian consumers spending at record levels. They see wages growing, personal income tax cuts with more to come and very low unemployment.

They also see Australian commodity export receipts rising significantly with resource companies looking to invest more capital to meet the demand from China and other Asian countries.

States like Western Australia and Queensland are booming.

But higher interest rates place a considerable burden on many Australian households with mortgages that are trying to manage a budget which is already stretched.

And so it also makes sense to ask whether other instruments of economic policy could also play a role in containing and reversing inflationary pressures.

The Federal Government's five point plan is therefore a welcome addition to monetary policy in cooling demand pressures and easing supply constraints.

What bankers see, particularly, following this week's rise in official interest rates is that wholesale funding costs are continuing well above official increases. ANZ for example, is now paying more than 50 basis points extra for wholesale funding compared to a year ago.

Investors now prefer short term liquidity. Peripheral financial intermediaries are finding it harder to obtain funding and global banks are retreating to their core markets.

This is placing an even more significant role on the major trading banks to provide finance to facilitate the running of the economy.

And as borrowers increasingly turn to banks to borrow, lending books expand there is a need for more expensive equity capital.

These global forces are inevitably flowing through to interest rates over and above changes that may be made by the Reserve Bank.

So there is not only a very difficult balance between what costs we absorb ourselves and what we need to pass on to customers, but there is already a very real impact on the economy from higher wholesale rates and reduced liquidity.

The inevitable outcomes are not popular.

The issue here is that policy makers often have nothing better than dated numbers to work on and this data may not be picking up the difficulties the economy is facing in 2008.

Driving forward, you need to be looking at the road ahead as well as checking the review mirror.

In the financial markets which are the life blood of the economy, this year's issue is liquidity and the impact of the ripple effects of the US sub-prime crisis on our own businesses.

While I can't speak for other banks, I feel sure that all of us would be enthusiastic about working more closely with policy makers to try to ensure the best outcome for Australia and particularly for Australians under stress.

This is a very challenging environment but as it stands today, we see growth rates of about 3 per cent for the next two years. These are the sort of growth rates many other countries could only wish for, but I believe the risks are significant.

At the same time there are other longer term economic challenges facing Australia. These include:

- education and skills formation against a backdrop of an aging population;
- improving and extending economic and social infrastructure;
- addressing environmental issues including the impact of climate change, water security, salinity and soil degradation; and
- fostering Australia's economic and social engagement with Asia which is now, undoubtedly, where Australia's future lies.

In this environment of global financial turmoil, tight liquidity and scarce financial capital, we are also coming to terms with the rise in importance of sovereign wealth funds.

Last month's nationalisation or to put it bluntly 'bail out' of Northern Rock by the British Government seems to reverse 20 odd years of diminishing government intervention in the major OECD economies.

But of course, in the US, it isn't only the government that's doing the doing the bailing – it's been sovereign wealth funds.

In November, the Abu Dhabi Investment Authority bought a \$8 billion stake in Citigroup, significantly easing liquidity concerns at the bank.

China Investment Corporation has also invested over \$5 billion in Morgan Stanley after a similar investment in Barclays Bank.

UBS in Switzerland will also receive a \$13 billion injection from the Government of Singapore Investment Corporation and a Middle Eastern investor.

And here in Australia, Singapore's Temasek disclosed last week that it had taken advantage of the fall in ABC Learning's shares to top up its stake to 14.7 per cent - just below the level that would trigger the involvement of the Foreign Investment Review Board.

Of course, the role of sovereign wealth funds is not limited to firms in difficulty. Standard Chartered recently highlighted that it was one bank, like ANZ, that has not forgotten how to make money.

We welcome strategic, long term investors like the sovereign funds.

Standard Chartered already boasts two of the more transparent sovereign wealth funds from Dubai and Singapore - as long-standing shareholders.

The obvious questions coming out of these transactions is: Why now? And should we be concerned?

The answer to 'why now?' can be found in the rapid growth in the size of sovereign wealth funds. In the Gulf this reflects high oil prices, and in Asia it arises from the sustained economic boom and savings habits of its people and their governments.

The potential cash flow from sovereign wealth funds is enormous and it's clear their significance is only going to grow.

The world's largest sovereign wealth fund is the Abu Dhabi Investment Authority which manages just under \$1 trillion, mostly coming from windfall oil profits in the United Arab Emirates. By contrast, Australia's Future Fund holds around \$60 billion.

However, concern among OECD governments about the motivations of investments by sovereign wealth funds is prompting some sovereign funds to rebalance holdings geographically, primarily towards the booming economies of southern Asia.

In mid-February, Dubai International Capital announced plans to invest over \$5 billion into China, India and Japan over the next three years, while other funds have stated that countries such as China are very welcoming to sovereign wealth funds and so they are looking to invest more there.

Western governments and regulatory authorities, including Australia, will need to weigh carefully their concerns about the impact of the sovereign funds against the risks of forfeiting the benefits that their infusions of capital can bring.

Australia needs to think carefully about this in considering its policy on sovereign funds and what is and isn't in the national interest....just as we need to think about the impact our four pillars policy is having on the growth of our major companies and the country.

But that discussion is for another day.

Our economy and our banking system are probably weathering the current turmoil better than just about any other Western financial system.

In Asia, I don't expect economies as a whole to be as seriously affected by the deepening slowdown in the US economy, as they would have been, say 10 years ago.

And while China is likely to experience its own modest slowing, Asia is in a much stronger macroeconomic position than it was a decade ago with healthier balance of payments and rising income levels which are lifting domestic demand.

Asian GDP, led by China, is forecast to remain 3 to 4 times higher than the G7 countries. The compound effect of recent strong growth is that Asia accounted for just 20 per cent of global GDP in 1980. Today, it is close to double that.

Of course, growth is not guaranteed to any country or any business. It takes leadership, training, skill and most importantly courage.

In today's business environment, companies cannot settle for incremental improvement; they must periodically undergo performance transformations to get, and stay, on top.

Looking at recent profit announcements it's clear that successful companies understand that the market no longer rewards just meeting expectations. It only rewards out performance.

So at ANZ, the next stage of our development is to step up our performance.

The transformation task we set ourselves in December was to become a 'super regional' bank over the next five years. This is an ambitious program which involves being a leading bank in the world, with a clear focus on this region.

What became clear to me when I looked at where ANZ is in the world, is that we are the world's only genuine Asia Pacific bank. So we have a great foundation to build on.

Thank you very much for listening to me today.