

Some thoughts on the New Reality

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It's always a pleasure to be back here in Auckland.

Although I have to say as someone who is here by way of Hong Kong, having spent most of my life in Asia, and now is headquartered in Melbourne, things do get a bit confusing.

On top of that Graham Hodges tells me we are doing our part to support the long history of Trans-Tasman rivalry. ANZ is the major sponsor of the Black Caps in cricket. I am a bit hesitant to raise this, but we also support the ANZ Netball Championship where the Sydney Swifts beat Waikato Magic recently.

But I hope you'll forgive us given our sponsorship of what could be the deciding game in the Bledisloe Cup in Hong Kong in November. At least for the time being anyway.

As an outsider I don't completely understand the New Zealand-Australia rivalry but there is a competition that is even more important.

That's the race for global competitiveness. Here the news is not so good for both countries.

Over five years New Zealand has slipped from the tenth most competitive to the twenty fourth. Australia from being the fifth most competitive country in the world to the nineteenth.

The more competitive an economy is, the faster it will grow in the medium and long term and real incomes will rise. The only way to make an economy or an organisation more competitive is to raise productivity.

When you think about the difference between growth rates in developing and OECD economies; when you look closer to home at the weak economy in New Zealand and the softening economy in Australia, my own view is that reversing this dramatic decline in productivity has never been more critical.

First, that's going to involve some difficult decisions to expose our economies to more competition. This involves resisting the temptation to introduce protectionism and allowing anti-competitive forces to develop during the difficult times we are now in.

Instead, we need to foster forces that ensure we get better at the things we can do well and get out of things we don't do well. In short, we need to encourage resources in the economy to shift from industries and businesses where they aren't used productively to industries and businesses where they can be.

Second, it's going to require greater investment in human capital through education and skills development and in infrastructure including ports, transport and communications infrastructure.

Let me turn to the very different circumstances we are now facing in 2008 – what I call our new reality.

Soon after I arrived in Australia to join ANZ last year, I made some comments on how volatile things looked in the US and UK markets. I recall telling analysts in February, that when you looked at the US and the UK, it was a 'blood-bath out there'.

Not surprisingly, even six months ago, some thought I was scaremongering.

Now, there are those that are wondering if I was guilty of understatement.

Eleven months ago sub-prime and associated write downs by major banks were nearly \$50 billion.

At that time, those losses were then close to the annual Gross Domestic Product of Kuwait.

Three months later, I spoke in at a gathering like this in Melbourne and sub-prime losses had risen to \$160 billion - more than the annual GDP of New Zealand.

Today, total write downs are close to \$500 billion, with 100,000 jobs lost in financial services globally. Just to put this in perspective, \$500 billion is more than the annual GDP of Indonesia.

Goldman Sachs have estimated total US credit losses at \$1.3 trillion with some observers saying the debt related losses could total closer to two trillion.

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

Having said that, I do want to reflect on the strength of the Australian and New Zealand banking system. We should remember that our banking system is probably weathering the current turmoil better than just about any other western economic and financial system.

Australia's four major banks are among the top 50 banks in the world by market capitalisation. And we are among just 18 double-A rated banks in the world.

While I know Australian banks aren't always popular, and from time to time the issue is part of public debate in New Zealand, I believe it's a huge plus for both Australia and New Zealand that our major financial institutions are so well positioned, that they are profitable and well capitalised.

Nevertheless, the effects of the turmoil in financial markets are now playing out in the real economy and the impacts are becoming clearer.

The US, UK and Japanese economies are suffering a significant downturn and other OECD countries are following.

And of course the ripple effects of the global turmoil are now being felt here in New Zealand where the economy is in a down turn with GDP growth down from around 3.5 percent in the last quarter of 2007 to less than 2 percent.

Tightening liquidity and declining asset prices – particularly housing – are going to limit the opportunity for any short term turn around.

Of course, another sign of the strain is the gap between money market rates which determine bank funding costs, and cash rates set by central banks. The reason this is so significant at present is that customer deposits only account for around 50% of bank funding.

The gap between the cash rate and money market rates is much wider than the historical average and is not showing any sign of easing. The new reality is that movements in cash rates set by central banks are no longer a reasonable guide to the cost of bank funding.

Indeed, as older, less expensive funding is maturing and being replaced with new, more expensive funding, the average cost of funds – the money that banks have borrowed on domestic and international markets to lend their customers - is increasing.

To be explicit, the *average* cost of funds is still rising, even though the *marginal* cost of funds appears to have stabilized over the past month.

And so if 2007's theme was turmoil on Wall Street, then 2008 is the year when these financial stresses go on to impact Main Street.

This is being played out in the share market where there is incredible volatility. The ASX 200 has fallen by around 21% since the start of the year. Similarly, the NZX 50 Index has fallen by around 20% since the start of the year. These are declines we have not seen since the last recession in the early 1990s.

The same volatility can be seen in commodity prices with the one closest to our hearts and pockets, oil, moving up and down over a breathtaking range and currently around \$120 a barrel.

Some environmentalists are welcoming higher prices as a way of limiting greenhouse emissions.

Cars - particularly old ones - are one of my passions and so I have to say that I'm less philosophical when I am filling up at the petrol bowser.

What's interesting to observe however is the oil shocks of the 70s eliminated oil from power generation. Today's oil shock may have the long term effect of freeing transport from oil's century long monopoly.

Whether that's realistic or not, higher oil prices are a reality and the shift to a low carbon economy is already underway and business must get ready for it, especially in energy, transport and heavy industry.

Together, these are factors that are bound to affect the level of activity in the economy.

In Asia – our region - 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. Although I do expect asset prices to ease.

Of course, for the majority of the last 20 centuries, China has been the largest economy in the world.

In 1890 – over a century ago – a quarter of the globe was ruled from London.

Then we moved from the European century to the American century.

Today, we are at another turning point. One in which by 2020, China will once again be the world's largest economy.

Over the last two decades we have watched the industrialization and urbanization of China. Over that time around 700 million people have moved from rural areas into the cities. This is the biggest movement of people in the history of the world.

In 15 years, China will have 15 cities with more than 25 million people each and a further 22 cities with more than 10 million.

This enormous growth that has seen GDP grow at a compound annual growth rate of almost 10 per cent year on year for 30 years means that Chinese growth is driving world material demand. The Chinese steel industry is now four times the size of the US steel industry.

Let's put this another way: over 60 per cent of the world's population lives in Asia.

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

This century is the Asian century. One only has to look at the Beijing Olympics and Friday's stunning opening ceremony to see how real this is.

So where does New Zealand and Australia fit in all this?

First of all we are part of Asia and much of our wealth and economic growth is already coming from the region. For Australia, that's most obvious with the success of the resources industry but for both New Zealand and Australia there are huge opportunities in services and in agriculture.

Now as nations and as businesses, we can make a decision to sit back and see others in the region succeed and passively accept the indirect benefits; or we can decide to be part of Asia, part of the opportunity and share in creating the region's success.

To help us decide whether this is our new reality or just a fad, let me give you two facts and ask you a question.

Today, China represents 21 per cent of world population and 15 per cent of world GDP.

Do you believe these proportions will remain constant?

If you want some help, the Board of BHP Billiton have already answered that question in making the proposal to Rio Tinto to create a \$400 billion resources giant.

Chinese banks and increasingly Chinese companies are also answering the question. They are using their size to look at strategic opportunities outside China.

To help us think about this, it is worth remembering that the largest bank in the world by market capitalisation is not Citibank; it's not Bank of America; and it's not HSBC.

In fact it is a Chinese bank - ICBC with a market capitalisation of \$240 billion and over 18,000 outlets including more than 100 overseas branches.

Today, in fact the top three banks in the world by market capitalisation are Chinese.

In Australia and New Zealand, I believe it is the banks from Asia that will form the next wave of competition.

So in this environment, this new reality, how are our banks placed?

One aspect I haven't discussed today is how, in every industry, power has moved to the customer. The music industry is a great example of this. How technology has allowed consumers to buy music where they want to, when they want to and how they want to.

Banks, including mine, have recognised this but been slow to act.

Our customers want to deal with us on their terms and they want us to have 'one view' of their business dealings with us.

We have been slow to adopt new technologies to allow this to happen with many banks still battling legacy systems.

Our organisational structures are geared to a different era. Many banks business models reflect a response to the product-focused competitive environment of the past, when 'specialists' like home loan originators and brokers were the dominant competitive threat to our business.

Today, with consolidation taking place in the banking industry, the specialists are increasingly disappearing and the game has shifted to one of becoming customer-centric.

That's a challenge in traditional organisations like ours, and maybe even some of you face the same issue. Our organisation is complex with up to 11 layers of staff between me and our customers in some places creating unnecessary bureaucracy and slow and siloed decisions and processes.

In the good economic times productivity did not need to be a primary focus.

Today we have to both walk and chew gum.

We have to both drive revenue up and at the same time drive down costs.

But we, and I think all companies in Australia and New Zealand, have to deal with an added challenge.

While there are significant financial and economic problems in the US and the UK, a re-emerging Russia and the emergence of China and India and other economic powers like Brazil and the countries of the Middle East is going to shift global economics and politics radically. The world is going to be more balanced in the future, rather than relying on one engine, which has been the US.

There are big issues ahead: How do you integrate the 2.2 billion Chinese and Indian consumers into the global economy? Can the world's environment cope with the legitimate aspiration of those 2.2 billion people to our standard of living? There will be transitional costs and there will be displacement of workers, both blue-collar and white, in the advanced economies.

My contention is that in this new reality every company, every country has to make fundamental decisions.

We're coming off the back of over 15 years of a robust global economy which is unprecedented in recent history, and we are moving into another unprecedented time in world economic history.

As companies and as countries we have a duty to reset the way we operate. It's a time to put ourselves and our businesses into the best possible shape to take advantage of the new reality.

There is no reason that a well-run business shouldn't continue to thrive in this environment.

To my mind, it's a time to take stock and to look at what you want to come out of the other end of the tunnel as.

It's a time to focus our resources on our best businesses, on our growth businesses and to reshape our underperforming businesses.

At a national level, with the same approach, there is no reason New Zealand and Australia can't move back up the ladder of international competitiveness.

What is important is that rather than just battenning down the hatches in this turbulent period, we need to manage our businesses tightly but also take a very clear view of where we want to be when the storm is over and position ourselves to achieve that.

At ANZ we have taken the decision that it is time to change and set ourselves up to become a super regional bank in Asia.

Our approach will focus on making things simple and productive.

We will reduce complexity by becoming simpler, leaner and more agile. To do that we will make accountability clearer and give our people the confidence to 'go for it' rather than having to deal with layers of bureaucracy. We'll bring our people closer to our customers and build a single 'One ANZ' brand to reinforce that.

The bottom line is; economic and social growth is not guaranteed to any country or any company.

Now is the time for both New Zealand and Australia and our companies to make the decision about whether we want to be real players on the world stage.

In my view, to be a truly successful in the 21st century, we need to create industries and companies which are regionally, if not globally relevant. And we need to accelerate our engagement with Asia.

But we must do this quickly. The world will not wait for us.

Thank you very much for listening to me today.