

The global economic crisis and beyond - prospects and opportunities.

Address to the Australia-Israel Chamber of Commerce

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Good afternoon and thank you for the warm welcome.

Let me also thank the Australia-Israel Chamber of Commerce for giving me the opportunity to talk to you today.

This is the second time I have had the privilege of speaking to the Chamber – the last, in Sydney, was put to me as a KGB Interrogation. Alan Kohler, Bob Gottlieb and Steve Batholomew made it a little more enjoyable than that but I am very pleased to be here today and have the opportunity to speak to you on my own terms.

What I want to do this afternoon is share my views on the current state of the global economy.

I'm also going to explore what this means for businesses who intend to not only survive, but to thrive in what is proving to be the most difficult set of economic conditions the world has faced since the 1930s.

Even before the current crisis when the world economy was going through a once in a generation boom, it's worth reflecting that Australian public companies like other listed companies around the world found the going difficult.

Every decade, an average of 12 companies disappeared from the list of the 20 largest companies in Australia. If this was the average in the good times, what are things going to look like in this decade?

One thing that strikes me in the Southern Hemisphere is how little understanding there is about the depth of the global recession. I think this is a serious problem because it does colour the debate in Australia and other countries like New Zealand.

If you haven't been to New York or London in the past year I think it is nearly impossible to understand exactly how difficult things are.

Warren Buffett summed up the global financial crisis nicely when he said the US was facing the equivalent of an 'economic Pearl Harbour'.

There, investment banking has been decimated, hedge funds and private equity groups are faltering, the car industry is in deep trouble, financial fraud is adding to investor woes and an estimated 8 million homes are worth less than the mortgage debts associated with them.

Despite the political rhetoric and other commentary we hear day-in and day-out though, I don't believe the reality has really hit us in Australia yet.

Let me give you something to think about.

- In the financial year that's about to end, the Australian economy grew by about $\frac{1}{4}$ %. In the coming financial year we think economic activity will contract by about $\frac{3}{4}$ %.
- Unemployment in Australia is forecast to rise to a peak of 8.3% in December 2010. That means between now and next December over 350,000 Australians will lose their jobs.
- For government, the dramatic effects were all too evident in the recent Federal Budget – the slowdown is hammering tax revenue while cost pressures are increasing. A \$20 billion surplus in 2007-08 is forecast to become a \$58 billion deficit next financial year.
- And finally in banking, provisions for loan losses by the major Australian banks were over \$6 billion last year.

This year, market expectations are for provisions among the major banks to exceed \$12 billion.

It's a sobering outlook, to say the least.

Even with those expected provisions, what we need to remember is Australian banks are in good shape relative to their international peers because in global banking, it's really been carnage.

Since January 2008, there have been close to US\$1.5 trillion in losses, at least 50 bank failures and over half a million jobs lost in financial services.

The IMF recently suggested that write-offs by financial institutions globally could reach US\$4 trillion. To give you some perspective on that, US\$4 trillion is only slightly less than the annual GDP of Japan or four times that of Australia.

Personally, I'm not as pessimistic as the IMF and I think we're now beginning to see some early positive signs that the global financial system is, at last, beginning to stabilise.

Nevertheless, global economic activity is expected to fall by 1.3% this year, its first fall in 60 years.

And despite the recent rally in global equity markets, the harsh reality is there's no evidence that the world economy has bottomed out.

So how do we respond as business people?

I was reminded by a recent Boston Consulting Group paper that many companies react to a recession much as bears do in winter – by hibernating.

And we are seeing that here in Australia. Many have been ultra reactive and have simply shrunk production capacity, reduced employee numbers and cut spending rather than anticipate the problems and prepare themselves for when the economy picks up again.

The new reality though is that things will never go back to the way they were over the last 5 to 10 years.

That's most obvious in global banking.

Investment banking as we came to know it on Wall Street since the early 90s - with bonus pools worth billions of dollars, taking risk rather than managing risk and ultra-thin capital levels – is over. Finished.

And the era in which money became the cheapest commodity in the world is also over.

Today, in the US financial system, the philosophy has become akin to the creed I saw on restaurant walls when I was young: 'In God we trust; all others pay cash.'

Even here in Australia, the cost of borrowing, even for AA-rated banks like ANZ, remains high and very different to the overnight cash rates set by the RBA.

At the same time, some of the world's largest banks – for example, the Royal Bank of Scotland, Lloyds Bank and Citibank – are now majority or part government-owned.

And of course this coincides with the philosophy of 'small government' being officially at an end – at least for the foreseeable future - with governments around the world now playing a much larger and much more directive role in the economy.

Economic stimulus packages put in place by governments in the last year now total US\$2.5 trillion and we are seeing the early signs of re-regulation and various forms of subtle protectionism.

While there is no question that these actions have been necessary to minimise the depth and extent of the downturn, we need to remember that fiscal stimulus on this scale globally has never been tried before.

Nobody knows with any real certainty when it will have an effect – let alone how much difference it will make or the knock-on effect to other players in the debt markets.

And ultimately, real recovery depends on government demand being replaced by a sustainable recovery in private spending.

In this new era of 'big government', we need to ensure governments don't choke off the recovery in private spending by pushing up tax rates.

Rather, they should think about raising retirement ages and encouraging other forms of workforce participation - as we have seen here in Australia; reining in health costs; and broadening the tax base.

I also need to sound a further note of caution here that while the inevitable aftermath of the recent failures in the financial system and in business is going to be greater regulation – the essential task right now is to recover from the recession we are in.

That requires a convincing restoration of business confidence. Policies which amplify uncertainty will only serve to slow recovery by making business freeze and hoard, rather than to venture and spend.

My view is that a resurgence of bank-bashing, a rush to greater regulation and irrational and uninformed debates about executive remuneration might speak to our 'inner populist', but they simply don't help.

The real challenge is finding how we create a balance between free markets which are the best tool we know for fostering innovation and generating wealth, and ensuring there is a watchful eye from regulators that can help markets avoid overshooting and spinning out of control.

In our new reality, I also believe consumer and investor behaviour will have been altered for at least a generation.

Tighter credit and falling asset prices have exposed high levels of indebtedness among consumers and businesses and it will see them saving more.

There's no question that the historically high levels of leverage that drove the economic bubble of the last 5 to 10 years are unlikely to be seen again in our life time.

Of course, in times like those, you didn't need much more than a pulse to make money.

Today, successful businesses need to play it long and try to avoid unnecessary tactical management or pandering to the short-termism of the market.

And reverting to management fads simply won't help. Many of you would remember with varying degrees of fondness.

Management by Objectives, Benchmarking, TQM, Quality Circles and of course, looking around the room, one that would resonate with many of us here today, Lean Management.

In the end, they were as long-lasting as hula hoops, mood rings, pet rocks, and platform shoes ... although I'm told they, at least, are back in.

To deliver real value actually requires a return to business basics like vision, consistency, discipline, experience and the skills to execute and to follow through.

Here, hibernating or inaction is not actually an option.

In order to survive and to thrive, we need a range of short-to-medium term responses to the current environment to drive sustainable performance. At the same time, we also need longer term responses so we emerge from the downturn competitively advantaged.

First, the next two years is about the survival of the fittest and taking the necessary and difficult decisions ahead of the game to ensure we come through this period stronger, and positioned to deliver growth.

At its most basic level, survival will come down to a few simple things like cash flow and margins. Again, what I think of as the basics.

So if you're a low margin company without sustainable cash flow or with too much leverage, the odds are - you simply won't make it in today's environment.

But in this part of the cycle, who succeeds and who fails is not going to be determined by cost cutting. Cutting costs is not strategy. A relentless drive for productivity is.

Secondly, given the new reality and all its uncertainties, we need to learn the lessons from the downturn in order to create greater resilience and flexibility in our companies.

Resilience – or the ability to anticipate and adapt to critical strategic shifts – will become a key driver of future competitive advantage.

Less well known I think are the organisational and cultural challenges of fostering resilience.

For many companies who systematically lost their resilience in 15 year of good times, rebuilding it will require significant cultural change and a focus on capability development and leadership.

Difficult times represent an opportunity for business to break ingrained structures and behaviours which undermine productivity and effectiveness in companies. Such moves aren't a short term response – they often take a year or more to pay dividends.

And when jobs do need to go, the cuts need to focus on removing unproductive bureaucracy and complexity and building transparency and accountability that supports future growth and expansion.

And at an individual level, resilience is about your personal strength, consistency and the integrity you demonstrate day-in and day-out as a leader.

That resilience is needed if you are going to really change a culture rather than indulge in what I often see as executive entertainment or by its more popular name 'change management'.

Now, having painted you a pretty gloomy picture, I need to take a moment to remind you that I am actually an optimist.

In particular, I'm an optimist about Australia and our future.

Why?

Apart from the relative strength of our financial system here in Australia, economic growth in our region – East Asia ex-Japan – led by China, is running at almost 4% and about 6½% in 2010.

This compares to the G7 economies which are expected to contract by 3¾% in 2009.

To bring this alive though, remember that in 10 years' time, China will have 15 cities each with more people than live in Australia, and a further 22 cities with more than 10 million people each.

This enormous growth has seen GDP grow at a compound annual growth rate of over 9 per cent for 30 years and it means that Chinese growth is driving world resources demand.

Although there is a slowdown occurring in China, particularly in areas such as the Pearl River Delta, I believe the Chinese Government has both the political will and the financial resources to manage its impact.

And so far, it's pleasing to see the Australian Government understands China's importance by seeking a balanced pathway to engagement.

This approach to engagement is clearly in the national interest and is the right approach now and for the future.

Australia, because of the good fortune of its geographic position, is part of Asia's growth. But we need to embrace Asia, and open engagement with the region if we wish to benefit from its growth and the prosperity that it brings.

That is why it is so critically important we position ourselves now as a nation, and as business people, to be able to capitalise on the opportunities in Asia - to deal with the challenges that have emerged after 15 years of uninterrupted economic growth, while also setting out the long-term architecture for the future.

For Australia to survive and thrive in the new economic reality we not only need our companies to avoid hibernating so that they emerge from the downturn stronger and more resilient, our nation has to continue to build its involvement and engagement with Asia.

I believe all of us in Australia are in a unique position.

There are always moments in history when the door opens to let the future in. This is such a moment for Australia. We must not let it slip past.

Many thanks for listening to me this afternoon and I'm happy to take some questions.