

**Address to CEDA
CEO Vision Series**

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Mike Smith, Speaking Notes

Good afternoon and thank you for the warm welcome.

Let me also thank CEDA for giving me the opportunity to talk to you today.

Although I'm a traditional banker and I've recently remarked that banking should be boring – not the racy, risk taking profession that it had become on Wall St in the lead up to the financial crisis - I was a little taken a-back last week when Tony Boyd from the Australian Financial Review compared me to Geoff Boycott, the cricketer.

Now, my idea today is not to become known to you for my ability to occupy the crease but to play a little more in the style of Botham - to make a quick hundred, take a few wickets and perhaps to serve up a little controversy.

The formal title of my address is 'Growing regionally – New opportunities in a post GFC world'.

But what I really want to do in my address this afternoon is share my perspective on the global economic recovery and give you my views on what it means for our region.

Having set the scene, I also want to leave plenty of time for questions afterwards because I think that's the real benefit of these sorts of lunches.

Well, the good news is that we've avoided the Armageddon scenario that was feared after the collapse of Lehman Brothers some 18 months ago.

The world economy is recovering and global economic growth is expected to be about 4% this year, while in the most advanced economies, it's expected to be around 2% - the weakest level of growth of the modern era.

The recovery remains fragile however, having been largely driven by Government stimulus packages which now total almost US\$2 trillion; and by central bankers who have had monetary policy on emergency settings.

What we are seeing is an increasingly multi-speed recovery around the world. We have, in a way, moved from a highly synchronised global downturn to a much more differentiated global recovery.

First, there are a group of countries emerging from the recovery in first gear with the engine spluttering.

This group is mainly made up of major advanced economies like the United States where the recovery is underway but growth remains sluggish.

In the US for example after a recession in 2009, economic growth is expected to be just over 2% in 2010.

And despite the fact we've had a financial crisis that was 'Made in America', there's another group of countries that are now paying for past excesses and struggling to get out of reverse gear.

In this group, I have in mind the European countries now unflatteringly described as PIIGS – Portugal, Ireland, Italy, Greece and Spain.

These countries will have at least another year of no growth or negative growth. And the European Union's tardy response to the issues in Greece is only serving to exacerbate matters.

Now if you think about the US, some argue that in the seven years that followed the dot com crash until the global financial crisis, American consumers and businesses had the benefit of tax cuts, expanding credit, low interest rates, low inflation and massive government spending.

There's now evidence in the US and in other countries that a deleveraging process is getting underway that's going to exert a significant drag on economic growth for many years.

So while these two groups may have avoided Armageddon, the biblical standard for booms and busts is that seven fat years are followed by seven lean years.

This may very well be the case now for the US and Europe.

Finally in our multi-speed recovery, there are the major emerging market countries that have quickly shifted gears and are growing strongly again.

This includes most of Asia - notably China and India - which are expected to achieve high growth rates, broadly in line with their potential.

While economic growth among this group of countries was kick started by large fiscal stimulus packages and credit easing, the prospects for growth in private demand appear good.

Here, despite recent steps to temper growth in China, Asia is expected to remain the world's best performing region with growth of almost 8% excluding Japan – more than twice the global average.

In this group there are other economies, such as Australia, that have strong trade links with China and are directly benefiting from its growth.

In last years market rally, the performance of countries and markets was almost directly correlated with their exposure to China; for example countries in Asia that export goods to China or commodity exporters such as Australia.

However, a note of caution.

Because US interest rates are effectively at zero – economies that have started the upward rate adjustment are effectively becoming a carry trade and will therefore attract hot money, which as implied, is never stable.

With the recovery looking like it will be sustained however, there's a gradual tightening of monetary and fiscal policy beginning.

And of course, the concern here is whether China can gently exit stimulus driven growth without taking action too early - which would result in stalling the economy - or too late which could result in inflation.

Already we have seen China begin slowly put on the brakes with technical measures such as adjusting the reserves that banks are required to hold and my sense is the government is preparing to let the currency appreciate a little, although this will depend on the behaviour of the US Congress.

While Asia's resilience came as a surprise to some observers who over-estimated the importance of exports to Asia's largest economies and didn't appreciate the reforms undertaken by governments following the crisis of the late 90s, it's been less of a surprise to those of us in Australia who know Asia well.

Although there is still much to do to realise the aspiration of the Asian Century, with the significance of problems in the US and Europe, the importance of China and the rest of Asia, is now well understood.

Indeed, simply by securing its economic needs in resources and in agriculture, China is shifting the balance of power to Asia.

And it's resulting in what I think of as a fundamental shift in the world's economic and political tectonic plates.

By this I mean that the status of Asia - particularly China and India – has been permanently elevated by the events of the past two years and the region is now going to be the engine for global growth for many years to come.

Still, this isn't new.

For hundreds of years prior to the Industrial Revolution, China and India together accounted for about half the world's economic activity.

Then, as Western economies industrialised, China and India fell behind – representing only 8% of total economic activity in 1970.

This trend began to reverse about 30 years ago and today, China and India alone account for approximately 18% of global economic activity.

In many ways though, this is also hardly a surprise - China represents 25% of world population and over 10% of world GDP. It's completely obvious that these proportions aren't going to remain constant.

But I want to emphasise that the Asia story is not just a China story - over time the emerging nations of Vietnam and Indonesia are going to play an important role in the region's economic growth.

At the same time, Australia's linkages with its major trading partners in the region are deepening – particularly in Korea, in Japan and in India.

And as for Australia - because of its linkages to Asia and the size of its resources and agricultural sectors; because of the prompt action by the Government and Reserve Bank to stimulate the economy; and because of the strength of the Australian banking sector - the downturn has also been shorter than originally anticipated with growth of almost 3.5% expected in 2010.

Much of this growth is being fuelled by Australia's "rocks and crops" exports to Asia.

This linkage between Australia and Asia is actually one of the reason's I left Hong Kong two and a half years ago, because I saw a unique opportunity at ANZ to build on its history in Asia and create what I call a super regional bank focussed on Australia, New Zealand and Asia Pacific.

The logic here is obvious.

- Growth in trade and capital flows between Asia and Australia is tracking at over 20% per annum.

- There is approximately \$60 billion in direct foreign investment into Australia from the Asian region.
- More than 50% of our domestic Corporate and Institutional banking clients depend on Asia for more than 25% of their business and 80% have some connection with the region.

And as one of the few banks in the world to have come out of the financial crisis stronger than when we went in, we are perfectly positioned to take advantage of this opportunity.

Of course ANZ's super regional strategy is a reflection of our optimism about our region – Asia – because I believe this century is going to be Asia's century.

But I'm also a realist and it's not my style as a banker to be exuberant – and right now there are also good reasons for caution about the outlook and for being careful and deliberate in management.

My own view is that, having experienced what I think of as a major financial earthquake triggered by the collapse of Lehman Brothers and the bailout of AIG, we are going to see further aftershocks – or volatility – this year as the global financial crisis works its way through the system.

For example, we've already seen how nervous markets are about the very significant amounts of debt that are outstanding with implicit or explicit sovereign guarantees.

That includes the recent problems with Dubai World's default, the Greek fiscal crisis, the crisis in Iceland and the uncertainties surrounding countries like Spain.

Today, it's not an issue of who guarantees the banks – it's who guarantees sovereigns. And the danger is a re-emergence of paranoia and of faltering confidence in debt and equity markets.

In global banking too, where we have seen chaos, blood-letting and destruction since late 2007, some fundamentals like the role that banks play in supporting their customers have not changed, but the aftershocks of the crisis seem set to fundamentally change the environment in which banks operate and compete.

The question here is: will there be further regulation in response to the crisis. The answer is yes.

But my concern is that we're going to end up with an over-reaction driven by populism in the US and Europe.

And while as I've said, the financial crisis was "Made in the USA", here in Australia and in Asia, banks put in a strong performance which was due to good strategies, to good regulation and, more importantly, due to good supervision.

Unless we get regulatory reform right, there is the risk that the type of proposals we are now seeing emanate from the US will restrict the flow of credit to the economy, put up barriers to future economic growth and result in higher costs for consumers.

And the bottom line is that none of us – banks, customers or the wider economy - can afford the costs of unnecessary or bad regulation.

The Federal Treasurer's perspective on the G20 – in particular his rejection of a one size fits all approach and the scepticism about the global bank assets tax, I think represents a welcome note of balance in the debate around the world.

In this regard, I'll close by making just a few topical comments about the Federal Government's response this weekend to the Henry Tax Review – focusing particularly on financial services.

First, thinking about our topic today – Asia – people there save now to spend later, whereas here in the western world we tend to borrow now to spend now.

I believe measures which encourage savings are both necessary and good for all Australians.

In particular, the proposed increase in the Superannuation Guarantee and the measures to increase superannuation savings for people on low incomes will provide a much needed boost in retirement savings and will reduce reliance on the pension as the population ages.

However, let's also not forget that it isn't a free ride and some of the changes are coming at a cost for business Australia.

Looking ahead, there's the opportunity to extend these changes to superannuation and to widen incentives to save and to help lessen Australia's dependence on offshore borrowing.

In particular, we support Henry's recommendation to provide tax concessions for interest earned on bank deposits and remove interest withholding tax for deposits raised overseas.

We hope the government will implement this in the near future.

The reduction in the corporate tax rate from 30% to 28% from 2013-2014 is also welcome as it'll position Australia more competitively and help ensure Australia remains attractive for business expansion and for investment.

However, I would also add that two of the key attributes to attract inward investment are transparency and certainty. Constantly changing regulation makes investors nervous and makes planning for long term capital projects difficult.

Many thanks for the opportunity to speak to you today – and I hope there'll be some time now for questions.