AUSTRALIA - THE FUTURE FOR INVESTMENT?

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(This address was delivered by Mr. Wolfensohn, formerly of Sydney but now President of the J. Henry Schroder Banking Corporation in New York, on 26 August 1974. He was speaking at the Seminar held in Sydney on that day under the joint sponsorship of The Sydney Stock Exchange Limited and the Institute.)

The firm hand of the banker, as it has been earlier referred to, is a description that I feel does not really apply to me this morning. Mine is rather the nervous hand of a banker coming back to talk on a subject to a group of people who have lived with it for the seven years during which I have been away. In order to allevicte my fears and to regain some confidence in my knowledge, I have cast my mind back to the time when I knew something about the subject. I shall share with you my thought processes in trying to develop something for this Seminar, which will, I hope, be both relevant and based on personal experience.

I go back to the period of the early sixties in an attempt to compare what has happened in Australia in the intervening years to what has happened on the international scene in that same period. I will seek to draw from that comparison such conclusions as validly may be drawn in regard to the position in which Australia now finds itself within the international community to that which prevailed in the early sixties - a very different one than exists today.

Many of you will remember that the early sixties was a time when there was a rare ebullience about overseas investment in Australia. It was a time when Australia was just at the beginning of the process of sophistication of its financial market, when the term "Merchant Banker" was something that was not even as well understood as it is today! It was a time when the short-term money market had not yet developed and when a few of us visited the United States to examine the organization of the New York market and came back here to start the inter-company deposit market and the buy-back market. It was a time when "take or pay" contracts with the

Japanese were quite new and Australia's mining export expansion had not really come about. It was a time when, in terms of new overseas investment here, there was a welcome - indeed, a ready welcome - to foreign investors in equity and in debt securities, a time when we recognised that new skills and financial strength were required to find the wonderful resources which now have been proved in abundance.

It was a period when, in terms of local investment, the major corporations other than the traditional mining houses had not really yet ventured forth into mining investment. It was a time when we were trying to interest the life insurance companies in the financing of natural resource ventures. I remember very well visiting the life insurance companies and meeting with boards of directors to explain "pelleting of iron ore" and "take or pay" contracts. It was a time when we were talking about the strength of the Japanese economy and whether financing could be based on Japanese contracts. All this was only ten/twelve years ago, and yet how quickly it's all changed! Now we accept all of those things as axiomatic - a normal part of life, and with a great industrial Japan occupying such an important position in Australian trade. And, in most of the intervening period, Australia, within the world context, has given a ready welcome to foreign investment to become the darling of the international investment community.

So time has passed, with a lot of ups and downs in the stock market, including periods when we as individuals all became experts in the mining field and instantly wealthy, and then instantly poor again. During the last seven years I have lived overseas. I might tell you that when I reached London full of hope and full of knowledge, confident that I had solved the problem of making money (particularly in the mining market), I was brought down to earth rather sharply by a distinguished Lord, to whom I was seeking to give advice on some minor business matter. He said "Young man - you're an Australian. You think you know everything and you think that you've invented it there but I should tell you that, so far as Australia is concerned, it's all happened before."

I said - "What do you mean, Sir?" and he said - "Well, in 1917 there was a company called Great Australian Gold Miners which was listed on the London Stock Exchange. You think Poseidon is something new, but in those days the prospectors took a sample of the ore body and placed it in the Mappin & Webb jewellery store window across from the Bank of England. The sample of this ore body contained a wonderfully rich vein of gold and the shares rose from ten shillings to 23 pounds, fluctuating wildly. There wasn't a great deal of information about the company. The London Stock Exchange sent a series of cables to Australia and finally one which said - "You will be de-listed next Monday unless you send immediately a drilling report." The response came back - "Delighted to comply. Please send back the mine." So that brought me down to earth a little bit in relation to Australia's resources and its techniques in international financing although, happily, these have developed both in substance and in form since then.

Today, of course, when one returns to Australia, one finds a different political and national environment. An environment in which we see the further rapid development of the predicted and world-wide rise in Nationalism, in which Australia, along with many other countries, is flexing its muscles in terms of its national aspirations. There is an environment in which, in place of a completely open door to foreign investments, we now have the Companies (Foreign Takeovers) Act, the Trade Practices Act and the Inter-departmental Committees on Takeovers, and Petroleum and Mineral Authority Act, variable deposit requirements and A.I.D.C. So it is a different scene though not one peculiar to Australia among the asset-rich nations. It is a world-wide phenomenon that can be seen in Canada, in Venezuela, the Middle East as well as in many other places. These national developments have taken place against a background of frequent, abrupt and profound changes in the international financial system.

In the early sixties, there was stability in the international monetary scene. We were operating within a set of given scales. The Bretton Woods Agreement, negotiated in the forties, established a system based on fixed exchange rates, in accordance with which governments of the world, by and large, were prepared to submit themselves to the regulatory order of the International Monetary Fund, creating a cohesive international system. During that period under Bretton Woods trade and investment expanded rapidly and Australia could reasonably believe that it was operating within the context of a firm, stable international system. The international scene has changed dramatically and today, one must have concern for the stability of that system.

We Australians can no longer assume that the world monetary system is stable and world bankers and investors are there waiting for us. We cannot assume that Australia has the luxury of being apart from the world, making its own decisions in isolation. Australia, like other countries of the world, in order to secure its own future, must participate in a constructive way in making sure that the international financial system in which it operates is in fact going to survive in a stable form. It must be strong and resilient to provide a fruitful financial and economic climate in which Australia can itself flourish. While not wishing to be a Cassandra, I think I can point to a number of aspects of the international scene today which require not only comment but which suggest that Australia should take initiatives well beyond the limits of domestic concerns. Why?

First, may I remind you of some of the things that have happened in these last few years. During the period of Bretton Woods, we had a period of stability. In 1964 the United States had a balance of payments surplus of 6.7 billion dollars. Between the period 1964 to 1972, accompanied by danger signals such as the devaluation of the pound in 1967, that surplus swung round to a deficit of 7 billion dollars, and yet the whole system was built around the stability of the U.S. Dollar. Then came August '71! You will remember that after the burgeoning development of the Euro-currency market, the United States declared one night that the U.S. dollar was no longer convertible into gold. And this sent a shock wave through the system, because it signalled the end of the era of

Bretton Woods. It was the end of the stabilising force which had contributed so much to the international financial system.

We then saw a succession of individual events, all of which made headlines at the time - the Deutsche Mark changing its value 2 or 3 percent, the French Franc floating, the U.S. Dollar floating in February/March '73 cnd then, in September '73 a very significant meeting of the International Monetary Fund and the World Bank, as a result of which the "Committee of 20" was set up to examine and recommend how all this disorder in the international financial arena might be improved. Countries like Australia recognised that, if they were to make their own independent and individual naticnalistic decisions about how they would run their own countries, they had also to have regard to what was going on in the rest of the world, to see if something could be organised to ensure a degree of international financial stability and even the system's continuance. In setting up the Committee of 20, countries recognised that the balance of payments adjustment process should be improved with both surplus and deficit
countries, that adequate methods to ensure timely and effective adjustment would be assisted by improved international consultation, including the use of objective indications. The importance of domestic policies for the adjustment was underlined. And the inter-relationship of what decisions are made within a domestic economy and the impact of those decisions on the international scene was recognised generally. This latter point is something which is very difficult for practical politicians within a national environment to do, but something which in the cloistered halls of Washington, they were able to recognise as of extreme importance not only for the continuance of the international financial system but for the stability of nations themselves. This has great importance in terms of domestic policy but may not be a lively domestic political issue. And the charge to the Committee went on to talk about exchange rates, reserve deposits and the role of investment internationally.

Unfortunately, the Committee of 20 came out with something of a non-result. The non-result was that they could not solve the problem of organising a stable international system, and so, a further group of 20 Ministers was established to consider the matter further and on a continuing basis. I'm afraid that we are little further today than we were in the time when the original Committee was set up.

Why is this important in relation to a Seminar on investment in Australia? First, because Australia is highly dependent on the world market for capital. Based on Mr. Callaghan's figures, it has been taking an average \$800/\$900 million a year in foreign investment, averaged through the 1960's. Australia has been dependent until recent times on foreign funds for between 10% - 15% of gross investment. The coincidence of the rapid increase in our commodity prices and the growth of our exports which has increased our reserves from $1\frac{1}{2}$ billion to 4 billion dollars over recent years, has meant that recently we have been less dependent. Prospectively however, looking at the estimates that I have been able to get for the next months, it looks to me as though the foreign exchange reserves of Australia will be reduced substantially and we will be forced again to look at international market sources of finance for debt and equity capital. Secondly, all our national projections and our plans are formed on the basis that we have customers who themselves have stable political and economic systems and are therefore able to honour the contracts which have been made with Australia. So we can't opt out, we have to take an increased role just because we have developed, in less than fifteen years, from a country which has been reliant on overseas capital to one which has built up reserves and needs - increasingly needs - stable markets for its growing output. We must now act not as a country which has a colonial tradition, but as one which stands up as an independent and responsible member of the community of nations and also of the international economic scene. I truly hope that that will happen in the economic and financial arena as so much has been done in the area of foreign affairs in recent times.

But over and above this whole panorama of problems, there has now boomed on to the scene an even greater challenge and one which is causing an uncertainty in the system certainly greater than anything I've seen and certainly, as I judge it, greater than anything that any of my colleagues and friends, more senior than I, have seen either. This is the dislocation caused by the increase in fuel prices, not alone in the Persian Gulf but in all the producing centres, from $2 a barrel for mid-East crude in January to $3.68 a barrel in November 1973, to $7.61 a barrel in January 1974.

Perhaps it is worth just pausing a moment or two to reflect on just what all this means. Translated into the broadest dollar terms, this means that the world oil bill has gone up from $50 billion in October 1973 to $120 billion today. That is an increment of $70 billion. To put that into perspective, the free world's foreign exchange reserves at the moment are somewhere between $170 and $180 billion. So that in something under two and a half years, assuming that every country had exactly the foreign reserves needed in order to pay for the increment in oil bills - an assumption clearly not true - you would have the total of the free world's reserves transferred to the OPEC countries.

If there is to be any stability at all in the international system, we need a recycling mechanism which will ensure that these funds are channelled effectively back to the countries who need the money to pay for the oil, not only in the developed world, but in the Third world which is faced with a crisis now.

At the moment the increased oil prices operate pretty much as a tax by the OPEC countries on the rest of the world. Australia has fortunately not been as badly affected as many other countries - I think here the oil bill is something of the order of $500 million compared with total trade of 8.5 billion dollars. In other parts of the world the impact is greater and while inflating energy prices acts as a price inflator it also has deflationary consequences. It is deflationary because it takes that money out of the system and puts it into the hands of a foreign government. It would not be deflationary if it could be recycled back into the United States, or back into the United Kingdom, or back into Italy, except, of course, to the extent to which they would need to service the money which they would be borrowing.

What is currently happening in the international financial system is that the moneys representing the increased prices started flowing in the middle of this year from the oil consumers to the oil producing countries and, instead of there being an international mechanism, (whether it be Bretton Woods or "Committee of 20" or some altogether new system) which would enable it to be properly distributed, the money is flowing back into the private system, into the banks in the Euro-Dollar market, into the banks in the United States and partially into Government securities, mainly in the United States. Why? Because if you are a central banker of one of the OPEC countries and you have a billion dollars hitting you every two weeks or every four weeks and if, as is true in all these countries, you have limited management resources to cope with funds on such a scale, what do you do? You adopt the traditional method of recycling the limited funds which you always had as a central banker, which is to stay short and stay liquid in relation to the demands made upon you. You stay safe, because that is what you are paid to do.

But the OPEC countries are recycling, not through any comprehensive inter-governmental mechanism, but straight into the private sector (which Australia depends on in terms of its foreign borrowing) and it's going back in huge quantities, put there into the private sector at 90 and 180 days, and then is being transformed by these private banks into medium term loans to the countries that need the money to pay for the oil. In the first half of this year, $20 billion was recycled in this way.

The International Monetary Fund attempted to find a solution to this problem and, after a great deal of effort, succeeded in getting together 3½ billion dollars for a recycling procedure through government channels. A total of $3½ billion against an excess inflow to the oil producing countries of the order of $40 to $50 billion, in one year!

Incidentally, this represents a crucial difference between the situation that existed in the Bretton Woods era and today. Bretton Woods had to deal with the international effects of the traditional and largely predictable business cycles of the industrialized countries; today we have to deal with mammoth flows of funds and the real transfer of wealth and the process involves a politically much more divergent and larger group of nations.

So you will see that the western world's financial system simply has not come up with an answer to this problem and the strains in the international financial system are now getting horrendous. This morning in the Euro market, there is a feeling of indigestion. First of all, if you are a central banker and you have $300 million or $400 million with an individual bank on deposit, you begin to think that whatever the bank is, you may have too much with them. Conversely, if you are a member of the bank management, you begin to wonder (if the moneys are callable at 90 days' notice), "Should I accept more than $300 or $400 million from an individual depositor?" And, if you are a member of the same bank management and you are lending $500 million to an individual country, pretty soon you begin to wonder, "Is it my job to lend so much to that country, and, indeed, can they repay?" And there are individual limits - sometimes imposed by management, and sometimes by regulation of the central banking authorities. So this indigestion is now becoming apparent in the market place.

The other thing that we're finding is a break-down of the structure of the market itself. Where previously you could have orderly markets in foreign exchange - orderly markets in money, orderly markets in bonds - because of the wild fluctuations which have occurred in the last two or three years, we are now finding that the intermediaries have gone out of the market. And that's not unimportant, as I'm sure you, as a Stock Exchange group, will agree! Let me give you an example. The members of the New York Stock Exchange used to bid firm for parcels of bonds and securities and if someone wanted to sell, they would buy them, they would put them in portfolio and subsequently they would resell them.

And they were able to do this because they knew that the fluctuations would operate within tolerable ranges. Today, throughout the whole range of money securities in the foreign exchange and fixed interest markets, fluctuations which used to occur over a period of months, occur overnight. A year ago, a change of 2% in the value of the Deutsche Mark would have made headlines. Today it rates not even a footnote on an inside page. In this sort of environment, the people who make the markets run away. Now, if someone wants to sell, instead of there being a cushion of dealers and agents, the securities involved hit the market with a raw and undisciplined thump, and if circumstances are not exactly right the market gyrates and the fluctuations become progressively more extreme. These problems are further compounded in the international monetary scene because, for all the reasons I have mentioned, everybody's running scared, everybody runs for safety at the same time. So that if you have small and medium sized banks and institutions which make up the bulk of this system, you find that people are withdrawing money from them all to put money with the big names. Well, it is a self fulfilling thing, because if the money comes out of the smaller and medium sized banks to go to the big banks, it creates the very problem that the investors were worried about - only the big banks are able to get deposits and the small and medium size banks become weaker.

I don't wish to scare you, but this is the environment in which the world is operating at the moment and I have given you the background because I believe that when you think of investment in Australia you should be aware (and many of you, I know, are aware) that Australia is not operating against the static background of Bretton Woods. It is operating against a background with challenges within it which are far greater and far more dangerous than anything we've seen since the thirties.

That is the current situation, and within such an environment Australia, in considering what national policies will be adopted, must recognise the fact that there isn't necessarily a queue at the door. Australia cannot turn on the tap of overseas funds whenever it wants to. There is also, in my view, a further responsibility on Australia to get stuck into seeing what it can do about bearing its full responsibility for supporting the structure and assisting the reform of the international system. When it is making internal decisions, whether they be political or economic, a look should be had (as was suggested in the terms of reference for the "Committee of 20") at the likely effect of the proposed moves on the international system.

Finally, I should like to say that, when Australia does make up its mind on the ground rules for investment and the basis on which foreign participation can be accepted, it must make its position clear. There has been a period of time when, looking on from overseas, it has not always been possible to know whether the relationships between Australia and overseas nationals are productive of harmony or discontent. Nobody would question Australia's right to take a view on foreign investment based on whatever is the prevailing political philosophy. But what we must do in a world which is not standing still, and in which we will be competing for funds when we want them, what we must do, is to remember that when we do reach clarity in relation to the view that is taken on overseas investment, we must make it clear to the rest of the world what is wanted, what is desired. If this is done I would hope it will be fair, equitable and consistently applied after which I'm sure Australia will be able to share in full measure in the benefits which are available in the international financial scene.

I think the only other thing that I should like to say is that my message is not one of unabated pessimism in regard to the world economic situation. However, I think each one of us, in thinking of our own domestic, national and political interest, should have regard to the rest of the world. It has an enormous impact on domestic issues. This is a time when, I hope, not only will we think of what the world can do for us, but when we will also think of what we can do for the world.