E for effort, earnings, efficiency

Banks, along with other businesses and the economy as a whole, have seen tough times. ***Don Argus*** *predicts more pain before gain but says banks will be sounder for the discipline.*

A healthy Australian economy needs a strong and efficient financial system. Banks will continue to play a key role in the system — not least as the providers of a safe haven for funds, a stable payments system and an efficient means of delivering financial services to facilitate the development of Australia's productive potential.

Of course, banks, like all other corporations and households, will also be significantly affected by the environment in which they operate. In the near term, our judgment is that the domestic economy is likely to continue to recover — albeit at a relatively slow pace — with inflation remaining low.

That has implications for likely growth in bank balance sheets. Indeed, it seems that, together with further unwinding of corporate debt positions built up in the late 1980s, banks will face slower demand for credit.

The 1990s are also likely to see banks facing a higher cost of funding. If nothing else, proposed changes to superannuation arrangements are likely to work in that direction.

All this means that banks will need to be increasingly efficient providers of financial services to survive, let alone prosper. Of course, that is all to the good as far as the medium-term growth potential of the economy is concerned.

However, the challenge to become more efficient in the 1990s is not just a message for banks. Let there be no mistake: Australia now operates in an increasingly integrated and competitive world.

To prosper, all sectors of the economy — business, consumers and governments, need to improve their performance. One needs only to look across the Tasman, as I have recently been doing, to note that the rebuilding of a competitive economy can involve considerable pain in the short term. Not to do so, however, involves even more longer-term economic pain.

Many commentators have emphasised the need for businesses to improve their performance and benchmark themselves against international best practice. That applies equally to government — there is a need for government to establish the right incentives for productive investment, for savings and for productive effort.

Near-term economic outlook

Over the past year, there have been signs of economic recovery getting under way. However, it remains modest and patchy across regions. It is also clear that until recovery is more broadly based, we will be likely to see setbacks from time to time.

Increases in activity in the dwelling

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sector, public demand and further growth in private consumption are all expected over the coming year. However, other factors are providing considerable "lead in the saddle-bags".

At least three factors mean that the recovery is likely to be weak by historical standards.

First, there has been a substantial fall in property values since their peak in 1989, with values in central business district office markets now down by 50 per cent from their peak. A second wave of property-related problems — with further implications for corporate balance sheets and general levels of business confidence — cannot be totally ruled out.

Indeed, it is worth reminding ourselves that the current surplus of commercial property is more acute than that of the mid-1970s and is expected to get worse. Vacancy rates in Melbourne are expected to approach 30 per cent by 1993, while Sydney's will approach 25 per cent. This compares with the 1970s peak of 18 per cent for Melbourne and 13 per cent for Sydney.

I know I am likely to be branded a pessimist by some when I raise the commercial property issue, but a banker needs to be pragmatic about these things.

Second, the prospects of a weak domestic recovery and continued high levels of unemployment, and the related effects on confidence, will act to restrain growth. Business, faced with subdued growth and low inflation, will rightly continue to restructure and seek improvements in labour productivity.

Our best assessment is that employment will struggle to increase by more than 1 per cent in the next 12 months and, as a result, unemployment will remain around the 10.5 per cent level.

Third, developments in international economies are placing important constraints on how quickly Australia can grow.

Recovery in the United States appears to be proceeding but at a slower pace than many — including the US authorities — expected.

The Japanese economy has slowed significantly and a turnaround is not likely in the near term. Indeed, it seems to me that we are still holding our breath on Japan. The hope is that expected fiscal and monetary policy measures will be more successful than they have proved in other countries in turning around an economy that is absorbing a sizeable reduction in asset prices.

In the face of tight German monetary policy directed at inflationary pressures, demand continues to weaken in Germany and constrain the European outlook. The UK, for example, seems very much to be struggling to lift out of recession.

At best, global recovery in 1992/93 will be relatively moderate. My own view is that forecasts of recovery in world output in that period of around 32 per cent are optimistic.

As is probably evident, I belong to the school that sees further economic pain ahead for Australia.

In the near term there are limits to what the government can responsibly do. Here I very much have in mind the need not to set in place short-term palliatives which ultimately detract from our medium-term growth prospects.

Given these limitations, it strikes me as regrettable that the government has not gone further in considering an option which I have previously advocated: that is, we need to do more to revitalise the small and medium business sector.

Banks can, in my opinion, play a role here in contributing to the equity position of fundamentally sound firms which have had their equity base temporarily eroded in the recession.

I am not, of course, suggesting that banks be involved in running companies. Involvement by banks for a limited time in equity positions would allow for careful after-management of the position of the firm, which is one of the keys to success and long-term viability.

Having promoted this initiative, let me also point out that while greater availability of equity funding will help, it will not be fully effective unless the costs of doing business are brought down. Payroll tax, training levies and the compulsory superannuation levy are further burdens on productive enterprises which reduce their ability to compete.

There are also costs associated with tax compliance, which some have estimated as being as high as 2 per cent of turnover for a small business. All these costs present a real problem for small and medium sized business.

Medium-term challenges

I mentioned earlier the idea of all sectors benchmarking themselves against world best practice.

If we were to set up such a benchmark for government it would include — high on my list — reducing government-related costs of doing business. Beyond that, my list would also include setting policies which promote:

- the right incentives for productive investment;
- the right incentives for savings;
- the right incentives for productive effort.

Australia has made some progress on all these points over the past decade but is still lagging behind in relation to trends overseas and our own needs.

When I look at the past federal budget I wonder what, if anything, has it done to further promote incentives to invest and save. And what has it done to further reduce the government-related costs of doing business?

The answer, I am afraid, is not much — although, to give credit where it is due, misguided calls for increased protection (and/or delays in reducing the still high levels of protection in some sectors) have been avoided.

While one can understand a government's wish to "do something" to help alleviate high levels of unemployment, the medium-term outlook for the Australian economy means that if the deficit is to be unwound as recovery proceeds, we are unlikely to be able to afford a tax cut of the order promised in One Nation.

A further concern is the uncertainty that vague references to a list of, as yet, not fully articulated tax increases, worth up to $3 billion, could generate. This can only be a negative for business and consumer confidence.

I might add that part of those tax increases would act to increase government-related costs for banks in doing business — currently estimated for the National Australia Bank at

After the recession

This is an extract of a further address by ***Don Argus*** *to an Australian investment conference on 13 November 1992.*

There is no doubt in my mind that all sections of the Australian economy — business, employees and government — need to improve their performance and ensure that world best practice is the norm rather than the exception in Australia.

How successful we are here will bear importantly on the degree to which we can take advantage of an increasingly integrated world economy and, in particular, the fastest-growing region in the world — the Asia-Pacific region . . .

In part, our exports are sheltered from the full ramifications of the slowing in the major economies, due to the faster growth rates of our Asian trading partners.

For example, growth in our non-Japanese Asian exports has averaged about 30 per cent per annum since the late 1980s. Indeed, exports into these regions now account for about 30 per cent of our total exports — much the same as to Japan. This compares with the situation in the late 1980s when non-Japanese Asian exports accounted for about 20 per cent of our total exports.

Slower growth in the major economies, however, does have important ramifications for our terms of trade and, equally, important, for investor confidence.

The immediate outlook for Australia is for a modest recovery in activity with relatively subdued inflation and, at best, a gradual decline in unemployment. The challenge is to convert a struggling recovery into sustained growth. That ultimately requires higher private-sector confidence and renewed growth in investment.

While government policies can help soften the impact of recession, they do not provide the basis for sustained growth. Indeed, excessive attempts to stimulate the economy could cause reassessments of the sustainability of policies.

To stabilise our net external debt and liabilities ratios we need to maintain a surplus in our trade balance. In bankers' terms, we need to stabilise the "principal" component of our external debt, not just the "interest". This inevitably involves improving our competitiveness and productivity performance.

That is also the only way we will be able to grow faster than our trading partners and hence make relatively faster inroads into our unsatisfactory labour market situation.

This poses a challenge for all sections of the Australian community. Australian business will need to continue to eliminate inefficient methods of operation and actively seek innovative ways to successfully compete on world markets. Work practices must be improved and wage outcomes better aligned with productivity.

As many Australian businesses are discovering, benchmarking themselves against international best practice can help improve productivity and competitiveness.

Government, however, also has a vital role in establishing the right incentive structures encouraging sustained growth in private-sector activity. Such a framework must include setting up:

- the right incentives for productive investment;
- the right incentives for savings;
- the right incentives for productive effort;
- reduced government-imposed costs of doing business.

While some progress has been made in most of these areas, when benchmarked against international "government best practice" much still clearly needs to be achieved, especially in the labour market, taxation policy, transport and public trading enterprise performance.

These challenges must be fulfilled if Australia, with its political and social stability and considerable natural resources is to achieve its undoubted potential — both as a place to invest and as a place to live. ■

around $8 million a year.

Returning to the question of better incentives for private-sector activity, there are some interesting points to be made by looking at our near neighbour across the Tasman.

In looking to the New Zealand experience, I think the lessons relate more to what policy changes have done to New Zealand's perceived future competitiveness and growth potential. That is not necessarily the same thing as advocating the transposition of their policies directly into Australia.

It should not be forgotten that the recent economic cycles in Australia and New Zealand have been very different. Also, they have come from very different micro-economic starting points. Indeed, the New Zealand experience provides a graphic illustration of the longer-run sustainability of the highly regulated and protectionist policies adopted in New Zealand in the 1960s and 1970s.

New Zealand has probably done more than almost any other country in the area of micro-economic reform. Important reforms have included tax policy reform, a radical scaling-back of protection, and financial and labour-market deregulation. The government has moved to improve the efficiency of the public sector through increased privatisation and the greater use of market-based procedures.

The government's fiscal accounts — New Zealand is one of the few countries to report on an accruals basis — provide a more meaningful assessment than most of the changes for future generations being built up by current policies. The New Zealand government has also set in place institutional procedures to give greater credibility to its central bank's anti-inflationary objectives.

While these measures have been associated with large dislocation costs — in turn related to the long distance New Zealand has had to travel on the reform road — they may now be start-

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will be encountered in defining a "proper purpose" for the purposes of the section and that the subjective element inherent in the definition will give rise to potential delays and abuse by companies and to inevitable disputes and litigation.

In some cases the true purpose of the applicant may not be able to be disclosed for commercial reasons, such as where information is required for a proposed takeover.

Restricted use of information

An alternative method of revising s.210 would be to allow unlimited access to inspect and copy the register but to limit the uses to which the information could be applied, for example, by prohibiting its use in direct mailing campaigns.

Such a restriction would give rise to similar problems of definition and interpretation as those already mentioned. Further, the difficulties of policing the provision and detecting infringements would render the restriction of little benefit.

In our view, such a restriction warrants consideration in the context of legislation other than the Corporations Law.

Conclusion

The Institute's submission concluded:

Any restriction which is proposed will inevitably give rise to uncertainty, expense, litigation and delays in procuring copies of registers of members where they are legitimately required for commercial dealings.

We consider that any problems which would arise from any possible amendment of s.210 would be potentially more serious than the problems which are claimed to have arisen from the present provisions and that any problems associated with unsolicited mail should be addressed in a review of legislation relating to privacy and postal communications.

We do not consider that any concern with accessibility to members by companies' competitors (purely from the point of view of competition) warrants an amendment to s.210 of the Corporations Law. ■

What you say about JASSA

The Securities Institute would like to thank the many hundreds of members who responded to the *JASSA* questionnaire circulated with the September issue of the journal. The questionnaire sought opinions about the content and format of *JASSA*. The responses are being analysed and a report will be published in the March issue.

Banks: E for effort

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ing to bear fruit. Among the guideposts to which I would draw your attention are:

- the sharp increases expected by international organisations such as the OECD in rates of return on investment in business capital (around 15 per cent per annum);
- The dramatic increase in New Zealand's international ranking on future competitiveness. Indeed, the 1992 World Competitiveness Report shows government policies as contributing to New Zealand's elevation to first position on the future competitiveness scale.

Australia regrettably still languishes near the bottom of these packs.

Challenges for banks

As always, successful banking will require both anticipating and responding to the economic, regulatory and legal forces overlaying the environment.

It is important to respond to these challenges in a disciplined way to achieve best service to customers and returns to shareholders. Successful banks must have a vision integrated into their day-to-day operations and avoid becoming victims of the ebbs and flows of fashion in the financial services industry.

Overall, meeting the challenges of the 1990s will involve adapting to, at least initially, a subdued-growth, lower-inflation environment in which asset prices are likely to remain weak.

Credit growth and hence balance-sheet growth for banks will be slower. For banks, success will require growing quality earnings and maintaining a quality balance sheet. The keys to success are likely to be:

- improving productivity through disciplined resource use;
- ensuring the profitability of core activities;
- enhancing customer service and developing a distribution network appropriate to the needs of the 1990s;
- squeezing maximum benefit from existing technology;
- managing risk to improve asset quality and to ensure appropriate pricing; and
- maintaining a strong capital structure.

For banks with sufficient capital and other resources, offshore expansion also provides opportunities for profitable growth. In our case, we have made acquisitions in the UK and Australasia, and we may in time look to expansion in the US market.

Already, we have a long-standing presence in Asia. We were the first bank to open an office in Japan after the Second World War, and we have a well-spread network elsewhere in the region.

It is clear that the 1990s provides a very different environment for banks than the 1980s. Credit growth, and balance-sheet growth, will be slower and some banks will still be needing to repair their balance sheets during the early years of the decade.

Success in this environment will require more disciplined business strategies than those which prevailed in the 1980s, when strong growth in both the economy and in bank balance sheets disguised a number of weaknesses. The 1990s will require growing quality earnings and maintaining a quality balance sheet.

And, once broad ground-rules consistent with these objectives have ben established, the government should leave business to get on with it. ■