

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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FREE TRADE: EFFICIENCY V ACCESS

The Australian government is talking about a free trade pact with the USA as though it was an easy exit from a deteriorating national export performance. Australia needs a vibrant export culture to support higher rates of profit growth. There should be more emphasis on business efficiency and international market development efforts for a sustainable improvement in overseas market penetration.

Australia's trade minister, Mr Mark Vaile, was reported in the past week as saying that the negotiation of a free trade agreement with the USA was critical if Australia was to be able to boost its export performance.

The USA is already a substantial market for Australian goods. It was the largest single national export destination after Japan, accounting for 10% of Australia's exports, in 2002. Since Japan's position is boosted by its raw material imports, the statistics understate the importance of the USA as a destination for higher value added goods.

Looking ahead, the USA is likely to have a relatively fast growing economy because, among the industrialized nations, it is likely to suffer least from a slowdown in population growth. The United Nations has projected US population growth in the first half of this century of around 0.7% a year compared with a contracting population base in Europe and Japan.

While Asia (excluding Japan), as a region, should be growing faster than the USA, it will lack the USA's political and economic cohesion. For cultural reasons, too, many Australian exporters will continue to regard the USA as a relatively attractive market.

Is it preferable, however, to enter a bilateral arrangement with the USA rather than succeed in fostering a multilateral international approach to freer trade?

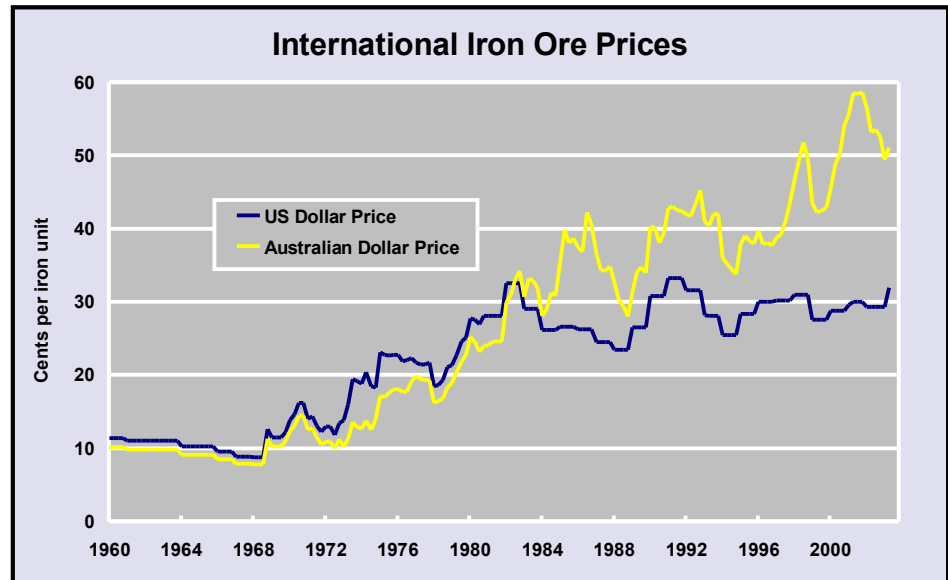
This is the subject of some debate but there is little doubt that global free trade would be preferable to bilateral agreements if the former could be achieved. Bilateral agreements tend to exclude those most in need. They are trade distorting - otherwise they would not be pursued - diverting trade to those markets where the barriers are least solid rather than where underlying comparative advantage might say it should occur. They also take the pressure off those countries, such as Europe with its damaging agricultural trade policies, as negotiating energies are directed elsewhere.

The officials charged with negotiating an agreement between Australia and the USA are working towards a December 2003 deadline agreed by the two heads of government. The commitment to a rapid conclusion was no doubt motivated by Australia's support for the USA in its attack on Iraq. With different leaders and less enthusiasm for the US foreign policy cause, the offer to proceed might not have been forthcoming so readily. Taking advantage of this fortuitous window of opportunity will make Australia the only developed country after Canada with which the USA will have a free trade agreement. But for other world events, the queue might be a long one.

"Since the end of 2000, there has been no growth in the volume of Australian exports. Weaker economic growth internationally has taken its toll but the motivation to do better seems to have diminished from the top down."

(Continued on page 3)

THE WEEKLY CHART SPOT



Source: International Monetary Fund & World Bank

“The stronger Australian dollar ... potentially erodes some of the US dollar denominated price gains which have been agreed. However, ...there has been an average annual rate of price rise of 13% since the end of 1988.”

Iron ore producers in Brazil and Australia have obtained price increases of around 9%. Negotiations which began in December have been unusually prolonged. The higher prices for sales to Japan will apply for the year commencing April 2003. The increases are consistent with the outcomes negotiated with the European steel mills by Brazilian producers.

This relatively strong increase might appear inconsistent at first blush with global economic conditions and the state of the Japanese and European economies. However, strong demand from China is reducing the available supplies of iron ore to such an extent that both European and Japanese buyers are having to pay the higher prices to ensure the supplies which they require.

The principal iron ore producers such as Rio and BHP-Billiton in Australia and CVRD in Brazil have also argued that the higher prices are required to fund the necessary investment to maintain and expand operations.

The stronger Australian dollar - currently 15% higher than a year ago - potentially erodes some of the US dollar denominated price gains which have been agreed. However, the chart illustrates well how the prior weakness in the Australian dollar actually boosted prices being received by Australian producers.

While the Australian dollar iron ore price is now some 13% below its peak values attained in the second half of 2001, there has been an average annual rate of price rise of 13% since the end of 1988. This compares over the same period with a 6½% annual rate of price increase measured in US dollar terms.

FREE TRADE: EFFICIENCY V ACCESS CONT'D

(Continued from page 3)

business and investors alike.

- The pressure on Australian companies to be competitive forces them to adopt world's best practice in operations and management.
- Competitive export oriented companies will force other Australian companies to adopt the same standards and the ripple effects will permeate the economic structure.

- Overseas investors will be more likely to provide capital to fund Australian businesses or use Australia as a base for their own activities.

This is the self-reinforcing model for Australian business and the ideal toward which it should be heading. It would actually be a worry if Australia was dependent on negotiating a free trade agreement as a primary means of improving its export performance.

FREE TRADE: EFFICIENCY V ACCESS CONT'D

(Continued from page 1)

The language from the officials negotiating the agreement at a press conference on 23 May suggested that the deadline might be optimistic. They were reluctant to admit to any stumbling blocks in part because they had not progressed far enough for them to be identified. Asked about the position on continuation of the Australian Pharmaceutical Benefits Scheme and local content in Australian television, the US side simply referred to the talks as information gathering to achieve greater understanding of what was in place.

In any event, meeting a negotiating deadline might be meaningless politically. Access to US markets for Australian farmers, for example, can be blocked by US farm interests lobbying members of congress. Many US legislators will have less reason than the President to be acting out of gratitude to Australia for its political support and more reason to be concerned about the outcome of the 2004 electoral cycle.

Australian ministers have said publicly that there will be no agreement which is contrary to the interests of Australian industry. This could be construed as a typically ambiguous political statement which would allow movement in any direction.

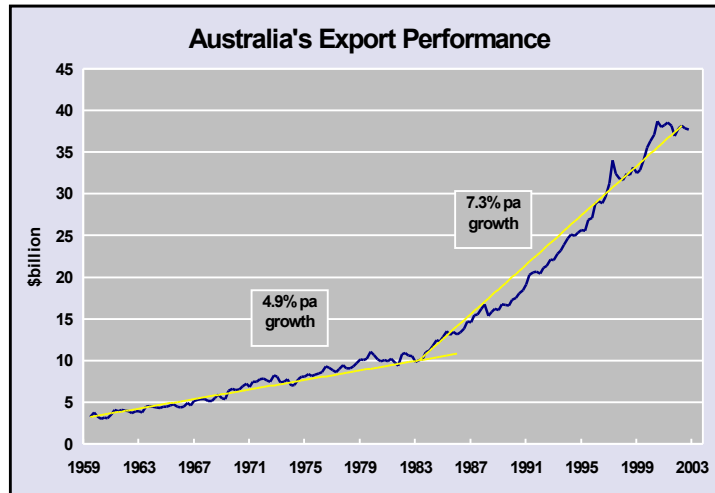
However, it would be an unrealistic proposition if they meant that no short term disadvantage would be incurred by individual industry sectors. After all, progress toward a meaningful reduction in trade restrictions can only occur if both sides can compromise by conceding access where there are already impediments to trade (or industry support measures, depending on one's perspective).

But government can do more to assist the national export performance.

More recently, there has been a smugness among Australian ministers built around Australia's relatively strong economic growth. Much of this superior performance has been due to the institutional and policy changes which occurred when growth was not so robust and more

had to be done to actively shore up longer term economic prospects.

The focus on international politics seems to have displaced at least some of the en-



"It would actually be a worry if Australia was dependent on negotiating a free trade agreement as a primary means of improving its export performance."

ergies which might have otherwise been directed to this important continuing task.

For some 15 years from the mid 1980s Australia's export performance was boosted by a newfound competitiveness among Australian companies. A weaker currency provided some fillip but there was an attitudinal shift and more flexible markets generally assisted in honing the export skills.

Knowing that government would no longer cosset uncompetitive industries at the expense of others was a strong motivating factor. The need for improved export performance through enhanced competitiveness and improved efficiency was maintained on the national agenda by various political leaders.

Since the end of 2000, there has been no growth in the volume of Australian exports. Weaker economic growth internationally has taken its toll but the motivation to do better seems to have diminished from the top down.

Australia is likely to be a small player in many markets rather than a dominant participant in any. The ideal is that the export culture takes hold across all sectors of the economy and that attention is not confined to single markets.

As well as the direct income benefits from exploiting overseas market opportunities, other benefits deliver recurrent value for

(Continued on page 2)

ST GEORGE: HOW TO SLAY A DRAGON?

With a long trail of corporate strategy failures among Australian listed companies, it lifts the spirit occasionally to see a positive example to highlight how business can be conducted. St George Bank is proving that the best form of takeover defence is the rarely seen determination to make the company too expensive for a predator.

In earlier editions, *thebigpicture* has been critical of two aspects of the Australian business environment which have been disadvantaging shareholders:

- the over-readiness to restructure as a quick fix; and,
- the promotion of takeovers as something investors should be happy to support.

The pressures to restructure are pervasive.

- External advisers earn fees from companies deciding to restructure their businesses by merging, divesting or acquiring.
- Boards are increasingly composed of professional advisers or people without direct operational exposure within the industries in which the company operates.
- Directors are biased in favour of today's one-off value increment even if it comes at the expense of the recurrent opportunities which are driven internally over a longer period.
- External commentators tend to take more notice when there are company transforming events on which they can report.
- Investors, often hard-pressed to see where the value is going to grow, can usually be persuaded that a single event can be the source of significant value.

So, when in doubt, restructure! Given the balance of forces, there seems little reason to expect anything else.

The widely held view in this environment was that St George Bank was nothing more than a takeover target. It was sup-

posed to be a plaything for restructuring companies. One or other of the major banks would use it to expand its business once ownership restrictions in its articles had lapsed.

And, yet, it is showing that a well executed business plan can add value and that the best outcome for a shareholder is not for the company to be taken over but for it to perform consistently in a way which makes shareholders wealthier.

Perhaps the possibility that it might remain independent also reflects the learning curve of the major banks which have all discovered in their own ways that acquisitions frequently fail to deliver their promised returns and that organic growth options might contribute more value in the longer term.

Business continuity delivers a double benefit. Not only does a shareholder receive the capital appreciation or income which comes from an investment but he is also saved from having to find alternative investments when the one he has chosen initially is no longer available.

This choice is fraught with two kinds of danger. Having invested in a company whose prospects seemed likely to deliver superior returns, choosing something else pushes one into a lower return alternative. Also, being pushed to buy predators through takeovers opens up additional risks, including the risk that its acquisitions will not achieve the benefits which were identified.

There is scarcely a larger company on the Australian market which does not show the scars of having taken a step beyond its own level of competence. Names like Brambles, Lend Lease, AMP, National Australia Bank and Southcorp loom large today but, in earlier cycles, Westpac, Foster's, Coles Myer, BHP and WMC are among the raft of others which would have featured. And, then, there are those many others which have simply not survived to tell the tale of their unfortunate strategic initiatives.

The short life cycle of Australian companies is one of the great continuing dangers afflicting the Australian investor.

"The short life cycle of Australian companies is one of the great dangers afflicting the Australian investor."