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Financial Panorama

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Financial Panorama [1]

by

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Rising prices and balance of payments problems, more than fears of any softening of the current boom, promise to be the chief source of concern in 1966. The Canadian GNP rose more than 9 per cent in 1965, or 6½ per cent in real terms, and in the coming year a further gain of about 5 per cent in real terms is expected. In the United States, President Johnson forecast the growth in real GNP at about 5 per cent, compared with 5½ per cent last year. The longest-lived economic expansion in the history of both countries is now in its sixth year, but the view is nearly unanimous that it will continue.

With the economy operating at close to full capacity and unemployment down to its lowest level in many years, a high priority must clearly be given to containing wage and price increases and to stimulating improvements in productivity. Both the new Minister of Finance and the Governor of the Bank of Canada have stressed these objectives in recent public statements. Mr. Sharp, in calling for "restraint in price and wage increases in 1966", did not go quite so far as the O.E.C.D. report on Canada, which pointed out the potential usefulness of price-wage guidelines such as have been used with some success in the United States. Mr. Rasminsky expressed concern over the increase in prices and costs recorded last year, and stated that if these warning signs are brushed aside the expansion will be brought to a premature end, and

[1] Reproduit de "Canadian Banker" avec l'autorisation de la Revue et de l'auteur.

balance of payments problems may develop. These concerns will no doubt be emphasized in his forthcoming Annual Report.

The second annual review of the Economic Council of Canada appeared somewhat less concerned over general inflationary dangers, attributing most of the 3 per cent increase in the consumer price index in 1965 to a series of special factors. The Council reviewed the performance of the Canadian economy over the last two years in relation to the goals for potential growth to 1970 set out in its first report, and found us slightly ahead of target. Nevertheless, the Council warned that although unemployment is down close to the objective of 3 per cent of the labour force, productivity gains in 1965 were below the rate of advance of recent years, and unless output per worker increases, future growth in GNP will fall short of expectation. A number of broad policies to improve productivity were put forward, with emphasis on education at all levels and the retraining of the work force. Other specific proposals included more active manpower and labour mobility policies, expanded research and development incentives, lower international trade barriers, a programme to assist industries and workers affected by reductions in Canadian tariffs, and further aid to developing countries. The recent announcements by the Federal Government of aid to universities and the establishment of a Department of Manpower represent the first steps taken to implement the Council's proposals.

Implicit in the growing concern about productivity is the fear that if we do not reverse the current trend and prevent costs per unit of output from rising, then our competitive position in international markets will deteriorate, and our reliance on foreign capital to finance the widening current deficit will increase. The actions taken by the U.S. government over the last two and a half years to improve its balance of payments have added to this concern. Although Canada has had a substantial degree of exemption from these programs, this has been contingent on the understanding that Canada would not raise its official exchange reserves above the mid-1963 level through borrowings in New York, thus posing added problems for Canadian authorities in managing reserves and domestic credit policy. A worsening fourth quar-

ter position, and the rise in Canada's reserves, led the U.S. government to review with Canadian officials the rate of Canadian borrowings in New York. One result was that Canadian borrowers in November and December were requested to defer delivery until January.

Against this background, the small decline in the combined total of our official reserve holdings and our net IMF position in January, from \$2,880 million to \$2,838 million, is understandable. Proceeds from sale of new bond issues, augmented by the deferred deliveries of earlier borrowings, may have amounted to as much as \$300 million. In addition U.S. drawings from the Fund led to an increase in our net IMF creditor position of \$60 million. On the other side of the ledger was the special purchase of \$40 million of long-term Canada bonds from U.S. holders, supplementing the seasonally large outflows of foreign exchange to balance the deficit in merchandise trade and to take care of payments on interest and dividends. Canada's reserves are obviously some distance above the upper limit of \$2,600 million which was the reserve target set in our agreement with the United States, and on the basis of which we received an exemption from the Interest Equalization Tax, and from the new guidelines to financial institutions limiting their foreign long-term loans and investments. One can almost hear the prayers of the Canadian authorities that reserve losses will be recorded in the next few months, and their wishes will almost certainly be granted if our current deficit builds up at the expected rate, and if, as suggested below, it proves increasingly difficult to sell our bonds to American investors.

The Stock Market

Stock prices in Canada finally broke out of the narrow range in which they have fluctuated since last summer and advanced in January. For the first time in months the Canadian market outpaced the advance in American stock prices
— the Toronto industrial index at the end of January was 3½ per cent above December, while the Dow-Jones index rose only 1½ per cent. However, the strength in Canadian prices was not sustained in February, except in the oils; the Dow-Jones average, after coming very close to breaking through the 1,000 level, declined to 975 on February 17th. At time of writing, the American market outlook appeared increasingly uncertain. In Canada the less buoyant profits picture and the continued repatriation of Canadian stocks held by foreign investors still act as a damper on the possibility of any prolonged advance, in spite of expectations of continuing prosperity.

The Money Market

The increase in Bank Rate on December 6th to 4¾ per cent from 4¼ per cent (following a rise in the Federal Reserve Board rate from 4 to 4½ per cent) led to a sharp upward move in short-term interest rates, although long rates initially remained almost unchanged. At the first tender following the announcement of the increase in Bank Rate, the average yield on 91-day Government of Canada treasury bills moved up 30 basis points and has since risen a further 23 points to about 4.70 per cent. U.S. treasury bills are about 60 points above the level in effect before the discount rate increase. The rate on chartered bank loans to prime borrowers was raised to the 6 per cent ceiling in mid-December, and the banks are rumoured to be resorting to the use of compensating balances, in some instances, to realize an effective yield above the 6 per cent level.

Despite these higher charges the banks are likely to face an unusually sharp spurt in demand for loans in the next few months. The deterioration in the bond market is expected to increase corporate efforts to obtain bank accommodation in lieu of alternative sources of financing. To comply with the guidelines, American subsidiaries will also be looking for bank funds, but Mr. Rasminsky has told the chartered banks that the needs of Canadian borrowers must come first.

To refund the $330 million maturing February 1st, the Government of Canada offered three new issues, of which only the shortest maturity attracted much interest. The issues included $170 million 4 per cent fourteen-month bonds priced to yield 5.16 per cent, $50 million 5 per cent bonds of 1970 on a 5.38 per cent basis, and $80 million 5½ per cent bonds of 1980 to yield 5.50 per cent. The Bank of Canada also offered to sell from its own portfolio up to $25 million of the 5 per cent issue of October, 1973, and $25 million of the 5¼ per cent issue of May 1990 in exchange for the new issues. This offering from the Bank's portfolio was an experiment apparently designed to satisfy investor demand and enable dealers to cover short positions without disturbing existing rate structures.

Tightness in the Long-Term Market

The prospect is for a continuation of the extreme tightness in the bond market which has appeared in recent weeks. At the time of writing, interest rates on long-term Canada bonds are close to a 5.75 per cent basis. Yields on long Canadas had held around a 5.50 basis between mid-November, when the Bank of Canada stepped in to support the market, and the end of January. The December increase in Bank Rate had little effect on long-term rates once the central bank indicated it was again prepared to support the market, and in fact prices showed some slight improvement. With U.S. bond levels declining after the rise in the discount rate, however, the differential between long-term Governments in both countries by the end of the year had fallen to about .95 per cent from the 1.10 to 1.15 spread of early last fall. Early in February the Bank withdrew its support when bond prices in New York continued to slide, and the Canadian market slid with them. By mid-February the Canada 4½'s of 1983 were quoted below 87, down more than 7 points from a year ago. The Canada-U.S. spread remained not far from the one per cent level.

The weakness in the United States long market is attributable to a variety of factors — Vietnam, the glut of corporate issues on the calendar, the build-up of inflationary pressures, and Secretary of the Treasury Fowler's announcement that he will seek authority to lift the 4¼ per cent coupon ceiling on new issues of Government long-term bonds. Added to this is the widespread skepticism that President Johnson's budget forecast — a substantial reduction in the administrative budget deficit in the fiscal year beginning July 1 — can be sustained. Short of peace in Asia, the costs of the war appear bound to exceed the forecast of $10 billion and the U.S. Government will be forced either to resort to deficit financing or to raise taxes.

Not only is the U.S. market trending downward, but there has been some lack of enthusiasm in that market for Canadian issues, perhaps the result of the oversupply combined with the psychological impact of the guidelines program. However, the current demand for bonds in Canada is so weak that Canadian borrowers continue to be very dependent on access to the United States Market. Institutional buyers in Canada have become extremely selective, and during the past year have diverted a greater share than before of their new money to stocks, real estate and mortgages. The increase in the N.H.A. rate on January 10 to 6¾ per cent may cut further into the meagre supply of funds available for new bond issues. The demand for Canadian issues has also been weak-

ened during the early months of 1966 by the sale in Canada of Euro dollar issues brought out by American companies to finance their foreign subsidiaries. These "offshore" issues, many of which are convertible into stock of the American parent, have been priced attractively, particularly in comparison to bonds of Canadian corporations of comparable quality. About the only encouraging sign on the horizon is the accretion to the provinces of the money from the new Canada and Quebec pension plans, but most of this may well be sopped up by rising provincial government expenditures. Recent expenditure estimates of the federal and some provincial governments confirm that government spending in 1966 will continue to have inflationary implications.

The U.S. Guidelines

On December 5th Mr. Sharp announced that, following discussions between the Governments of Canada and the United States, Canadian borrowers would continue to have unlimited access to the United States new issue market for long-term securities, and that United States investors are free to buy such securities on the basis of market considerations and free of the Interest Equalization Tax. There were two other aspects of the agreement which were not explicitly mentioned but which were an integral part of it. The first was that the United States guidelines to non-bank financial institutions (insurance companies, pension funds, etc.), which limited their holdings of long-term foreign investments to a proportion of a base period, would not apply to Canadian securities. The second implicit element of the agreement, however, and the one which has since led to a considerable amount of public discussion in Canada, was that the new U.S. guidelines, specifically governing the international operations of corporations with foreign subsidiaries, would be applied to Canada. Prior to that date their Canadian operations had not been included.

The application of the guideline approach to the international operations of U.S. corporations provoked the Honourable Eric Kierans of the Quebec Cabinet to write his now famous letter to the U.S. Secretary of Commerce protesting against the American action. Mr. Kierans subsequently elaborated on his position in speeches in Toronto and Montreal. The recent controversies have intensified Canadian interest in the economic and social consequences of foreign ownership and control, and the appropriate capital policy for Ottawa.

One may take issue with Mr. Kierans' views, and indeed a number of people have suggested that he has been overly pessimistic about possible developments. However, as this writer noted in an article in the Financial Times of February 14th, we have very little data on which to base an informed opinion about the validity of Mr. Kierans' charges. No one really knows much about the corporate relationships between American parents and their Canadian subsidiaries, the competitiveness of the prices paid by the subsidiary for parts or material, the appropriateness, or otherwise, of the charges made by the parent for patents, royalties and other services, and the effect of the guidelines on dividend policy and methods of financing. This gap in our information clearly demonstrates a need for the Government in Ottawa to build up

a much greater knowledge of the operations and policies of the subsidiary companies than has been available to date. This may well require a direct company-to-company approach. Under the U.S. guidelines approach the parent companies are required to furnish quarterly data to the American Government, covering in some detail all their transactions with foreign subsidiaries. As a minimum requirement the equivalent information should be sought from Canadian affiliated
42 companies. It may also be that the rules about secrecy of corporate earnings and balance sheet data should be substantially modified, and all foreign subsidiaries or affiliates, whether incorporated or not, should be required to publish full and detailed statements of their activities.