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See table of contents

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Financial panorama: spring 1968 [1]

by

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On New Year's Day President Johnson delivered a balance of payments policy statement to the American people, and at the beginning of March financial markets were still suffering from ensuing events which at times threatened to disrupt completely international monetary mechanisms. The President proposed the conversion of the guidelines on direct investment abroad by American corporations, formerly on a voluntary basis, into a mandatory programme, and in addition tightened the requirements for repatriating earnings. This message was designed to avert the possibility of further gold speculation which had plagued international markets following the devaluation of sterling and which threatened to increase with the release of a report revealing a sharp deterioration in the U.S. fourth quarter balance of payments. In Ottawa the new proposals were greeted with the same guarded optimism the government has used in responding to all such U.S. moves since the Interest Equalization Tax was announced in 1963.

However, by January 19th the Canadian dollar was weakening rapidly in the exchange market under the weight of a substantial shift of funds out of the country. This movement subsided only after the Bank of Canada raised Bank Rate by a full one percentage point to 7 percent, effective January 22nd, and requested the chartered banks to refuse

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[1] Reproduit de "Canadian Bankers", avec l'autorisation de la revue et des auteurs.

any abnormal demands for credit from American subsidiaries. Simultaneously, the U.S. Treasury Department (no doubt having been made aware of the worsening Canadian situation) issued the following clarification:

"The new U.S. balance of payment programme does not call for and is not intended to have the effect of causing abnormal transfers of earnings or withdrawals of capital by U.S. companies having investments in Canada. Moreover, the U.S. government had already made it clear, and now repeats, that Canadian subsidiaries of U.S. corporations are expected to act as good corporate citizens of Canada."

The initial reaction in the exchange markets offered the hope that these measures had indeed stopped the rot. The price of the Canadian dollar in U.S. funds, which had fallen so precipitously to its unofficial floor of 91.74 on January 19th from its late October peak of close to 93¼, strengthened immediately to 92¼. However, erosion set in again with the announcement of the official reserve position at the end of January. The combined total of the Exchange Fund's holdings of gold and U.S. dollars and Canada's net creditor position at the International Monetary Fund at the end of January was U.S. $97.7 million below the end of 1967, despite the inclusion of U.S. $250 million borrowed from the Federal Reserve Board under the reciprocal currency arrangement with the Bank of Canada. On February 26th Finance Minister Sharp was forced to confirm the Paris rumour that Canada had drawn U.S. $426 million from the International Monetary Fund, equivalent to the gold tranche plus our net creditor position with the Fund. On March 1st the Minister announced the end-February reserve position which revealed a further loss of $113 million. On March 4th, the chartered banks were requested to refrain for the time being from extending swap deposit facilities to new customers and to disallow renewals

on existing contracts. Although the forward rate, which widened further following this move, is likely to remain weak for some time to come, the slow unwinding of the almost $900 million in swap deposits will help to bolster the spot rate. As this article went to press, the spot rate on the dollar was fluctuating between 91.95 and 92.05, the lower figure apparently being the point at which the Bank of Canada was prepared to provide support. The discount on the forward dollar provided an annual yield pickup ranging from 240 basis points on a 30 day investment to 175 basis points for a term of one year.

What has happened to produce such a swift fall in the price of the Canadian dollar ? Certainly President Johnson's mandatory programme following so soon after sterling devaluation played the major role. The new measures would require American multi-national corporations to reduce direct investment, including retained earnings, in a group of countries comprising Canada, Japan, Britain, Australia, New Zealand and the oil producing countries, to 65 percent of the 1965-66 base. Admittedly this was a more fortunate treatment than that accorded Europe where an absolute moratorium was imposed. Finance Minister Sharp's assurance that the new restrictions would not have much effect on Canada was based on the fact that capital flows last year had already been cut back to approximately this level. However, the 65 percent target applied not only to the aggregate group of countries but to the activities of each multi-national corporation. In the reassessment of foreign investment opportunities which undoubtedly followed the President's message, American parent companies must have downgraded the profit potential of their Canadian operations.

Certainly the anticipated spotty economic performance in this country in 1968 and the increasingly aired possibility

that the substantial wage increases granted in 1965 and 1966 and an unimpressive rate of increase in productivity would inevitably result in devaluation in two or three years' time did not encourage an increasing flow of investment capital to Canada. The devaluation of sterling appears to have created a general distrust of foreign currencies, leading international speculators to cast about for the next likely candidates. If the Canadian dollar was indeed judged to be a strong contender, it would only be simple prudence for American corporations to hedge this possibility by repatriating capital and replacing it with funds raised in Canada.

The greatest external danger to Canada's export potential lies in the determined effort now being made in the United States to achieve equilibrium in its balance of payments. Each facet of international trade is being explored by Washington in meticulous detail with a view to strengthening the dollar — from export promotion and a tightening of restrictions on capital outflows to ways and means of improving the deficit on travel account. This latter area offers an illustration of the depth to which the American government is prepared to plumb the workings of the economy in order to improve its international competitive position. Not only is a travel tax to be imposed in order to discourage Americans from travelling outside North America, but a special "Travel Task Force" has been set up by President Johnson to look into such questions as the shortage of medium priced hotels in key American cities, the difficulties foreigners face in buying, renting and insuring automobiles, and space-available plane travel for all foreign tourists in the United States, to list only a few.

Despite the American government's preoccupation with its own balance of payments problems, the Administration is also determined, in the interests of the United States and of

international monetary stability, to counteract speculative attempts to devalue the Canadian dollar. How long this determination lasts, however, rests in the long run not only on the curbing of gold speculation but on Canada's ability to put its own house in order.

The Stock Market

In both New York and Toronto prices of industrial common stocks slid steadily downhill following a brief year-end rally. By March 4th the Dow-Jones industrial average had dropped to 830.6, 78 points, or 9 percent below its early January peak. The Toronto Stock Exchange index stood at 148.8, down 10 percent from its January 18th high. Investors became increasingly cautious about market prospects and were reportedly accumulating a growing level of cash reserves. A factor in the bearishness was the disappointing GNP performance in the United States in the fourth quarter, where the 2 percent growth was attributable entirely to inventory buildup and price increases. Much more important was the continuing bad news from Vietnam, creating fears of new military costs and higher taxes, and adding to the general feeling of depression. The first economic indicators emerging in 1967 did not show the fast pickup in the economy which had been anticipated, and optimists are now pinning their hopes on a strong second half. There are few who anticipate any robust recovery in the stock market over the next few months.

There were two developments which were not fully reflected in the movement of the broad industrial averages. The late January announcement by Litton Industries that profits for the current quarter would fail to match expectations resulted in an 18 point drop in the price of Litton shares and provided a blow to the sustained rise in the popular high-multiple "concept" and conglomerate stocks. In Toronto the

spreading lack of confidence in the future value of money, which has been characteristic of the period since the devaluation of sterling, contributed to a rapid escalation in the price of gold shares; the gold index at the beginning of March was up 62 percent from its level only four months earlier. The demand for gold and gold shares was also fanned by French attempts to induce an increase in its price.

Money Market

The surprising development in the Canadian money market in the first two months of the New Year was not the upward adjustment of some 50 to 100 basis points in the level of short-term yields, but the length of time it took to achieve the new levels. The increase in bank rate had an immediate impact only on Canada treasury bills and on bankers acceptances. Yields on 91-day bills rose 39 basis points at the tender of January 25th and have since risen a further 61 points to the current level of 6.80 percent. At the time of the change in bank rate commercial borrowers were comfortably liquid, having taken advantage of the usual January increase in the supply of funds, and were in no hurry to raise their cost of money. Although the chartered bank reserve position had tightened significantly, the banks were still bound by the gentlemen's agreement concluded last October to keep rates on term deposits below 6¼ percent. By early February the forward discount on the Canadian dollar had failed to narrow, lengthening expectations about the life of the 7 percent bank rate, and the unofficial ceiling on term deposits was raised to 6¾%. This quickly became the level around which all short-term rates fluctuated.

Well before the development of any exchange problems, the Bank of Canada had tightened its grip on the banking system and monetary policy became much more restrictive. Money supply, which had expanded at a seasonally adjusted

annual rate of 22 percent in the third quarter, rose at an annual rate of only 5 percent over the five months ending in February. Currency and bank deposits held by the general public actually fell by about $200 million since November. In order to satisfy the continued demand for loans, the banks maintained their liquid asset holdings within a fairly narrow range and the ratio of liquid to total assets fell from a relatively easy level of 32½ percent at the end of September to 30 percent at the end of November. In the following three months the liquid asset ratio averaged close to 30.5 percent.

The more restrictive monetary policy did not enhance the reception of new federal financing. On December 27th, the government announced its plans to refund the $400 million in outstanding bonds maturing January 15th. Market conditions once again forced the authorities to design an issue which could be sold to the banks, but the terms proved unattractive and the banks did not replace over $100 million of the maturing issues. That the Federal Reserve announced the same day an increase in reserve requirements against time deposits effective in January was an unfortunate coincidence. Two new issues were offered; $500 million was sought but subject to the now usual escape clause of plus or minus 10 percent. The shorter issue was a 6 percent bond due February 15, 1970 priced at 99.60 to yield 6.20 percent, the other a 6 percent issue due December 15, 1971 at a price of 98½ to yield 6.44 percent. The Bank of Canada agreed to purchase at least $100 million of the new issues and to buy from primary distributors the new 1970s against a maximum of $50 million of its holdings of the outstanding 6's of April/71 and to exchange a similar amount of its holdings of 6¼'s of 1973 and $25 million of the 1992's against sales of the new 1971's. When the books were closed, the amount sold was set at the low end of the range of the total offered, with $250 million of

the 1970s being allotted and $200 million of the 1971s. The removal of trading restrictions resulted in an immediate drop in price and by the beginning of March the 1970's were trading at 98.85, a yield of 6.65 percent, while the 6's of 1971 had fallen 2 points below issue to yield almost 7 percent.

The decline in Exchange Fund holdings eliminated the need for new Government financing in the winter months, since the sale of exchange provides Canadian dollar balances. The market is now anticipating the announcement of plans to refund the $175 million maturing April 1st, at which time it is more than likely that the government will also try to raise new money. Even more crucial is the awaited statement by the Minister of Finance as to the steps to be taken to replace the revenues lost with the defeat of the tax bill. Regardless of what may be in store in the fiscal area, it is difficult to see any early relaxation of current high short-term rates.

Long Term Bonds

While yields in the short-term area rose 50 to 100 basis points in the first two months of the New Year, long term interest rates moved upwards by only 25 to 50 basis points on the average. The Canada 4½'s of 1983 at the beginning of March were trading on a 7.00 basis and the 5¾'s of 1992 were priced at a yield of 6.75 percent. The Province of Ontario at the end of January sold a $50 million 20 year issue on a 7.05 basis, which went to a small premium but at the end of February a $50 million Ontario Hydro issue was offered on a 7.09 basis into a troubled market and quickly fell to a 7.20 percent level. Helping to restrain an even more substantial drop in long term bond prices were the already depressed condition of the market, a relative shortage of new issues and the traditional — although wanting — New Year's infusion of institutional buying power.

But even the most optimistic of bond traders could see little reason for hoping for an early turn around in the market, and those who have been arguing for some time that the long term bond is a dying investment instrument found their views reinforced.

Postscript : March 18

In the last two weeks events have moved with startling rapidity and at times an international monetary crisis appeared unavoidable. This caused speculation against the Canadian dollar, but this was eased following the announcement on March 7 that Canada had been given a complete exemption from the 65 percent ceiling on direct investment by American corporations. In return Finance Minister Sharp agreed that the Exchange Fund's holdings of U.S. dollars would be invested in U.S. non-market securities which do not constitute a liquid claim on the United States. At the same time Canadian standby credit facilities with the Export-Import Bank and foreign central banks were increased by a total of $900 million.

Meanwhile gold speculation mounted sharply, as the feeling grew that some increase in price could no longer be put off. This led to a further run on sterling and the U.S. dollar. Threatened by a collapse in the world's monetary system, the suppliers to the gold pool were forced to act on March 14th. The London gold market, British banks and the London stock exchange remained closed the following day; a meeting of countries participating in the London gold pool was scheduled for the weekend; the Federal Reserve raised its discount rate by ½ percent to 5 percent, followed by a similar move to 7½ percent by the Bank of Canada; the Senate passed the bill removing the 25 percent gold cover requirement against Federal Reserve notes, thereby freeing

$10 billion in U.S. gold stocks. Faced with this uncertain climate, the Government of Canada delayed the announcement of plans to refund the April 1 maturing issue.

The weekend meeting of the seven countries participating in the London gold pool resulted in the return to a two-price gold market after a seven year attempt at a unified pool arrangement supplying official and private buyers at one price. Under the new system the price of U.S. $35 an ounce would be maintained but only for transactions between central banks and international monetary authorities. The participating countries agreed that their existing gold stocks were sufficient, in view of the proposed new drawing rights scheme, and that they no longer felt it necessary to buy gold from the market. Non-official transactions in gold would be restricted to a private market where the price would be free to fluctuate, but the gold pool members agreed not to sell to countries who in turn were selling gold in the private market.

If there was agreement that the new system could not be sustained indefinitely, it at least served to buy time in which to implement the new special drawing rights as a supplement to international liquidity. In financial markets the initial reaction to the weekend developments was distinctly favourable. North American bond and stock markets strengthened and the price of gold in Paris on Monday morning was quoted at about $40 an ounce, well below the peak of $44.36 reached in hectic trading the previous Friday. The international financial community now awaits the introduction of the British budget and the passage of the U.S. tax proposals, but the crisis appears to have passed and the patient is breathing more easily.