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ASSURANCES

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by

D. H. FULLERTON

Over the summer, discussion about the economic outlook was increasingly focussed on the Government's approval in June of two wage settlements involving Montreal longshoremen and the Seaway workers. Both these settlements granted wage increases over a two-year period in excess of 30 percent, much greater than any possible rise in productivity. All current and subsequent labour negotiations were inevitably affected by the results of this Government intervention, and the 30 percent figure became established as the minimum objective of organized labour. One example of labour's new militancy was the fact that Canadian steel workers on August 22 rejected a wage increase that appeared to push their wages slightly above that of their American counterparts.

[1] Reproduit de "Canadian Banker", avec l'autorisation de l'auteur. A.

It was against this background that more than 100,000 members of various railway brotherhoods summarily rejected settlements proposed by conciliators of about 18% over the next two years, and went on strike on August 26th. The railways had estimated that the cost of meeting the unions demands for 30% plus would cost them $250 million over the two year period. Like many other unresolved labour negotiations, the railway issue became a problem for the

Government to settle, and Parliament was called into session on August 29th to deal with the strike and with basic problems facing the transportation industry. The Government is unlikely to accept union demands in full if only because it would confirm the fact that the earlier settlements had set us clearly on the road to inflation and to possible financial crisis and devaluation.

One can understand the current unrest in the union movement. Six years of economic expansion, a healthy corporate profits picture, the over-rising cost of living, and inter-union rivalry have not been calculated to inspire moderation in wage demands, and in this the members appear to be taking an even more militant approach than their leaders. However, unless wage increases are matched by gains in productivity, prices must inevitably rise, and the competitive position of Canadian goods at home and abroad will be adversely affected. It can be argued that these concerns do not take adequate account of developments in other countries. It appears likely, for example, that unit costs in the United States will rise next year when major American union contracts are renegotiated. Nevertheless, although the current wage guidelines of the U.S. administration have been stretched by the 5% increase granted in the settlement of the airlines strike, this is a long way from the 15% target of Canadian labour.

A further complicating factor seems to be the growing demand by Canadian labour for wage-parity with Americans. There is a superficial logic in fact that Canadians doing the same job as Americans should be paid the same wage. Unfortunately, it is not supported by the facts. Average productivity in Canada is 25% lower than in the U.S. for a host of reasons. Many of our manufacturing plants are not as productive as their U.S. competitors because our smaller markets have led to shorter production runs and to less specialization. Canadian machinery cost more because of the tariff and sales tax. Geography is against us and our transportation costs are higher. The average Canadian worker is neither as educated nor as well trained as the American worker; he also seems to lack some of the drives which help make American labor the most productive in the world.

Thus, when we talk of parity with the Americans we should be thinking of wages 25% lower than American wages, not equal to them. In the more productive industries in Canada, particularly the capital intensive ones, the wage and productivity differential will be much narrower than 25%, but the conclusions based on simple arithmetic are inescapable. For all those who narrow the 25% wage gap by the efficient nature of their business, their special skills, or their strong bargaining power, there will be others whose wages will be more than 25% below the American level. In essence, to achieve parity with American wages we must become as productive as the Americans. There have been very few signs in the last few decades that we have made much progress in this direction.

Stock Market — It is clear now that the May break in New York stock prices was an accurate indicator of the power of the bearish forces in the market. The major elements which had concerned the market for several months had

intensified in the summer : the bombing of North Vietnam, a projected increase in defence expenditures, the higher costs and scarcity of credit, and the increasing attractiveness of yields on fixed income securities. Toward the end of July the Dow Jones industrial index hit a so-called resistance level of 850 without attracting significant support, and late in August fell below 800. On August 26th the index was at a new low of 780, more than 20% below the February high.

The Canadian stock market moved more or less in sympathy with New York. At its August 25th level of 148.8, the Toronto Stock Exchange industrial index was at its lowest point in more than two years and was 15 percent below its 1966 peak. The implications of the current wage settlements for the future trend of corporate profits were not lost on the market, and added to this depressing element was the flow of funds out of Canada into American stocks. The D.B.S. figures show than in the first five months of this year Canadians were net buyers of $87 million of U.S. stocks, and also repurchased $40 million of outstanding Canadian equities from foreign holders. The repatriation of Canadian stocks has slackened considerably from the inflows of 1965, but the substantial outflow into the American stock market this year far exceeds that of 1965. Should this trend continue, Canadian stock prices could remain in the doldrums even if New York stages a recovery. Canadian investors find U.S. stocks increasingly appealing, in part because of the breadth of the U.S. market, the much wider choice of industries, and the more volatile price movement of U.S. industrial issues. New York is "where the action is".

It may be that the stock market has returned to its traditional role as a leading economic indicator. Since the May break in prices, evidence has been accumulating that the difficulty in finding available sources of credit is beginning

to have some effect in Canada. Housing starts dropped sharply in the second quarter and are now forecast at a total of only 140,000 units in 1966, a 14 percent drop over a year ago; retail sales fell reflecting reduced purchases not only of cars but a whole range of other consumer goods; industrial production was still rising but at a much more restrained pace than in the first quarter, and the output of durables recently turned down; inventories were building up faster than shipments and the ratio of stocks to shipments in May climbed to its highest level in almost three years.

In spite of these indications of slackening in the economic pace the Government was understandably disappointed with the mid-year survey of capital investments intentions. Although the budget attempted to curtail capital expenditures, the latest survey revealed that investment intentions were even stronger than the expenditure forecast drawn up last year. Capital costs and prices continue to climb, and it is difficult to assess how much of the increase in planned dollar outlays for capital goods reflects price inflation alone.

Any analysis of the Canadian position must take account of developments in the United States economy, where GNP in the second quarter rose at a slower rate than in the first three months. The U.S. authorities are still concerned about the balance of payments and about inflation, although they are apparently anxious to avoid introducing any new fiscal measures, at least until the November elections are over. It is perhaps premature to accept Fortune's bearish prediction that the U.S. economy has not only slowed its pace but has already changed direction, but both Canada and the U.S. appear at this stage to have come to some kind of an economic crossroads.

The Money Market — In both the Canadian and American capital markets the structure of interest rates which emerged

this summer was one of strong upward pressure on all maturities, but with the strongest pressure the short and middle range of the yield curve. Yields on short Canada bonds at the end of August were close to 6.00 percent, up about 75 basis points from mid-June; the 4¼'s of 1972 were trading on a 6.08 basis compared with 5.59 in June, whereas long Canadas moved up 30 basis points to the 6.00 percent level. Listed rates for prime finance and corporate paper were in excess of 6 percent, and more was paid for substantial offerings of cash.

Treasury Bill rates have been largely divorced from the upward thrust of the rest of the money market, remaining close to the 5.10 percent level to which they rose following the March increase in bank rate. Since the Bill market is limited almost entirely to the Bank of Canada, Government accounts and the chartered banks, which are in a sense captive markets, the rate cannot be regarded as a particularly significant indication of market conditions generally. However, some of the stability in the Bell market resulted from the increase in the chartered banks' holdings; a smaller than normal growth in loans in June and a seasonally adjusted increase of almost $400 million in money supply in July enabled the banks to increase their Bill portfolio by about $100 million. Following as it did two consecutive months of contraction, the increase in money supply suggested a significant shift in policy, but was probably intended more to moderate the extent of the upward interest rate adjustment until the Government refunding issue was out of the way than a permanent change in direction.

Two factors appeared to be behind the rapid rise in yields in other money market instruments. The initial impetus reflected developments in the United States where summer brought with it what was called "an interest rate war". Although still seemingly reluctant to raise the discount rate,

the Federal Reserve Board used virtually every other weapon in its arsenal to tighten the credit screws still further. At the end of June, the Board raised the reserve requirements against certain types of time deposits and brought short-term promissory notes under the regulations governing reserve requirements. This action was apparently the trigger behind a rise in the rate on prime loans at commercial banks, and the jump of 56 basis points in yields on 91-day Treasury Bills over the first three tenders in July. Seven weeks later a second round of increases was initiated when both the prime loan rate and the reserve requirements against time deposits were raised to 6 percent.

The second factor contributing to the upward adjustment in interest rates in Canada was the Government of Canada refunding issue. The growing conviction that the task of refunding the $450 million maturing September 1st issues posed a very difficult problem for Ottawa compounded the already gloomy attitude of investors. Notwithstanding the increase in money supply, the Bank of Canada was forced to step in and support a rapidly deteriorating market in the week prior to the announcement of the terms of the new issue. For the investment community, the dilemna facing the Government's debt managers centred on the limited supply of available funds in the hands of investors and on the likelihood that, unless substantial concessions were offered, the refunding operation would result in a high rate of attribution. Despite this unpromising climate virtually no price concessions were forthcoming, and moreover the Government attempted to raise $50 million in excess of the amount needed for the refunding. The new issues included a 4¼ percent thirteen-month maturity, priced at 98.60 to yield 5.60 percent, a 5¾% three year one-month bond priced at 99.625 to yield 5.88 percent, and a twenty-six year bond priced at 97.50 to yield 5.94 percent. A total of $425 million of the two short-

term issues were offered, of which the Bank of Canada was committed to take up a minimum of $150 million, and $75 million of the long-term bonds, of which the Bank would purchase at least $25 million.

On August 17th it was announced that the issue had been "oversubscribed" and that $175 million of the short maturity and $250 million of the three-year maturity had been

allotted. In fact, these two issues moved very slowly and when the restrictions on trading were lifted prices fell rapidly. The new October 1967's had dropped as low as a 6.13 percent basis when the Bank stepped in on August 24th to support the market, and on August 26th the October 1969's were trading on a 6.15 basis. Estimates of the amount of the two issues actually taken up by the Bank of Canada and Government accounts range between $200 million and $250 million, much more than had been intended. This bond issue will have to be regarded as the most unsuccessful Canada issue in recent years, and the market has undoubtedly been adversely affected by it.

Long-Term Bonds — Although the shorter-term issues have seen a sharper upward shift in yields, prices of Canadian long-term bonds weakened steadily in an unusually soft summer market. The declining trend accelerated prior to the new Canada issue partly on speculation that the Government would have to include a long maturity bond in its offering. The market was also affected by developments in the United States. The $250 million A.T. & T. issue in New York, brought out on August 3rd at a near-record yield, was little better than half sold two weeks later. This difficulty in placing a prime corporate issue encouraged the view that interest rates in the United States would go still higher, carrying yields in this country up with them.

The impact of these developments is best illustrated by the behaviour of several recent issues. The $50 million Ontario Hydro 6's of 1988 was brought out at par in mid-June and two months later had fallen to 97 to yield 6.25 percent. The Quebec Hydro 6's of 1990, issued at 6.22 percent were trading at 6.65 percent at the end of August. The 6 percent Alberta Government Telephone 25-year bonds, issued at par on July 7th had fallen to 6.27 percent, and the Bell Telephone issue of mid-June, originally offered at 6.15 percent, was quoted on a 6.45 percent basis. Prices of long Canadas were supported by the Bank of Canada at about 5.90 percent at the time of the new issue, but when the Bank withdrew its support the downward trend was resumed and at the end of August most long Canadas were selling at about 6.00%.

The limited supply of funds available from lenders will be a more important factor than the increasingly heavy costs of financing in determining whether corporate borrowers will be able to carry out their buoyant capital investment programmes. Certainly the deluge of corporate issues anticipated earlier in the year has not yet hit the market in Canada. There is now a very narrow differential between the costs borrowers must pay in the New York market and in Canada, and this may be expected to produce an abnormally sharp rise in corporate borrowing in Canada this fall.

The signs of weakness spreading through the economy may mean, however, that interest rates are close to their peak. It has been only common sense in the past to buy bonds when rates are at their historic highs, and when the economy may be topping out. Nevertheless, it is difficult for us to be optimistic about a reversal of recent trends. Long-term rates may not rise much more, but barring a major depression the chances of any appreciable decline appear remote. The proportion of institutional portfolio investment in bonds has been declining

for some years. Individuals as well as institutional investors are becoming more aware of the danger of inflation, and have been raising their holdings of equities. It is perhaps too pessimistic to suggest that the capital market may become one of the casualties of the current inflationary surge — as appears to have occurred in Germany in recent months — but investors do not seem as attracted to the current high levels of interest rates as they were to relatively lower rates a few years ago. Indeed it is not impossible that in the next year or two we may have to become accustomed to a much higher average level of interest rates than we have seen these past ten years. Whether or not this pessimistic forecast is borne out will depend on how resolutely the Government handles the railway crisis situation. Those who buy and sell long term will be watching with great interest.