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Background Notes
Major Economic Forces from a Corporate Perspective

Trends/Opportunities/Pressures/Problems

1. Identification of such economic forces has several dimensions.
 - a) Degree of likelihood - Is it likely to occur (probability greater than 0.6); possible (around 0.5); not likely (less than 0.4)?
 - b) Degree of impact on corporation - Sudden (with little advanced warning) and large at one extreme to a "tendency" that will identify itself through slow changes with time to react at the other extreme.
 - c) Degree of policy sensitivity - Can the force be modified by government policy; is it a result of policy; or is it likely to come through regardless of feasible policy responses?
 - d) Degree of specificity - Does the force affect all corporations or is it specific to the industry or even the company?

Of most concern would be a force that was likely, sudden, and specific to the company. In this case there would be little likelihood for policy amelioration.

2. The kinds of economic forces can be grouped in many ways. For convenience we will consider the following broad categories.
 - a) World-wide
 - b) Canadian demographics
 - c) Canadian labour markets and labour policy
 - d) Canadian financial markets and monetary policy
 - e) Canadian energy policy
 - f) Canadian fiscal policy and policy formulation
 - g) Specific to the Industry or Corporation.
3. The format for treating each force will be a "positive" statement with no qualifications, a brief reason for adopting this view, and a "so what" for the corporation. For most "forces" there are "counter forces" and reasons why they may not occur. No attempt is made to be balanced; rather a judgement with the information base available today of those forces most likely to occur has been made.

World-Wide

- o World oil prices will continue to decline in real terms and perhaps absolutely until the late 1980s.

Why? Continued Excess supplies from OPEC are expected to continue until the economic growth of the world has picked up substantially and current oil conservation moves have run their course.

So What? The relative price of energy-intensive goods will also decline, including goods with a significant transportation element. This decline in real OPEC prices will sustain the world economic recovery and reduce inflationary tendencies. Corporate strategic planning should respond to a less inflationary, more rapid growth scenario. A large number of energy mega-projects is not likely.

- o The battle between protectionism and freer trade will continue, with an intensity reflected by relative exchange rates.

Why? Today protectionist sentiment is high in the U.S. and to some degree in Canada, reflecting an overvalued U.S.\$\$. A devaluation of the U.S. dollar will switch the protectionism to Europe and Japan.

So What? Today's battles for foreign market access (or domestic protection) may be reversed tomorrow. Is there a consistent corporate position on trade?

- o The U.S. dollar will devalue with respect to most European currencies and the Japanese Yen.

Why? The combination of a large current account deficit, declining real interest rates (see below), and a desire to prolong the economic recovery in the U.S. will lead to some devaluation. But estimates of 20% or more are too high. As a U.S. devaluation begins other countries will try to contain their revaluation through lower interest rates and fiscal stimulus.

So What? Exports from North American production bases will become more competitive in Europe and Japan. Emphasis should be placed on minimizing the adverse effect of the devaluation on domestic costs. Imported materials from Europe and Japan will rise in price, helping relative competitiveness against imports, but raising the costs of imported material inputs.

- o Real interest rates will decline in the U.S., eventually.

Why? The implication of maintaining real interest rates in excess of real economic growth is a growing proportion of income accruing to debt-holders. There are two ways out of this position - repudiate the debt or lower real rates. Experience with debt repudiation in the thirties and current fears of this occurring among major debtor countries with a financial crisis suggest that the easier road will be to lower real interest rates - either by lowering nominal interest rates or by stabilizing nominal rates with higher inflation.

So What? The timing is uncertain, but the adjustment could be rapid. The implication is that financing should be done with short-term or variable rate instruments. Rates will be moved downwards in other countries as well. Foreign financing (non U.S.) carries the double threat of lower rates and revaluation of the foreign currency requiring larger repayments in domestic currency.

The volume of investment should respond to these lower rates, improving the market for construction and machinery.

Canadian Demographics

- o Population growth, labour force growth, and household growth will be slower in the next ten years than the last ten years.

Why? Birth rates remain low, and a sudden reversal would only affect labour force and household growth after a long lag (15-20 years). Net immigration could affect labour force and household growth more rapidly, but current and continuing slack in labour markets should keep net immigration low.

So What? Markets tied to demographic growth will be expanding less rapidly. New housing starts at an annual rate of 160,000 is sufficient to provide for household growth.

- o The age distribution will continue to shift with fewer people under 19 and more 65 and over.

Why? Again this is tied to a declining birth rate since the early 1960s, rising survival rates for most age categories, and reduced immigration (which favours the young).

So What? For the next twenty years the number of dependents (young and old and not in the labour force) per person in the labour force will be declining. It is a propitious time to redirect resources from education and health to other areas and to develop retirement income systems. Discretionary income growth will be aided by the demographics. Fewer new entrants to the labour force as youth may require adjustments to hiring practices.

Canadian labour markets and labour policy

- o Unemployment rates will remain at historically high levels during most of the next decade.

Why? Economic growth of at least 3% is required to maintain the unemployment rate stable at any level. (Labour force growth averaging 1.5% per year, and productivity growing at 1.5% per year or more, yields the potential growth rate of 3+% per year). To reduce the unemployment rate to 6% from the current level above 11% would require about 10% additional growth, or an average 4+% per year for the next decade.

So What? Political pressure will be high to reduce the unemployment rate, particularly for groups and regions with above average unemployment rates. This will affect macroeconomic policy (see below) and labour market policies. In particular, there will be an emphasis on directed youth employment programs, hiring of women, training programs at company level. Funding for such activities may utilize the UI system or an independent grant-levy system. Differential UI premiums for employers based on experience may become a new feature of the program.

- o Pension improvement will become a reality in the 1980s.

Why? After much discussion and with a growing constituency Federal and provincial legislation will be enacted improving the vesting and portability of private pensions. The Canada Pension Plan and Quebec Pension Plan contribution rates will be increased in the mid-1980s, both for actuarial reasons and to provide a captive source of financing for governments. Indexing of private pensions will be introduced, but perhaps with a cap or on the basis of the actual earnings of the fund.

So What? Another element of labour costs will increase. There may be room to trade-off pension improvements for other compensation to some degree. Active participation in the policy debate is likely to be the most fruitful area for limiting indexing or the "generosity" of the reform.

- o Schemes for gain-sharing and wage flexibility will not disappear.

Why? There is agreement that one area of difficulty for the Canadian economy is a lack of wage flexibility that leads to more inflation and difficulty in adjusting to relative price shocks. One way to achieve more flexibility is for a larger

part of compensation of workers to be tied to the performance of the company through gain-sharing. The opposition from labour is usually in the form of their inability to affect profits or to be part of corporate decision-making.

So What? Corporations should continue to pursue experiments with such programs and try to find a way that is satisfactory to both management and labour.

- o The emphasis on productivity improvement will continue.

Why? Canada will continue to be an open economy, exporting about 30% of its production and importing about 30% of its needs. The keys to maintenance of its competitive position are the exchange rate and productivity growth.

So What? Focus on continuous reduction in unit costs (labour, material, and capital). Success here will ensure real income growth and less inflation.

Canadian Financial Markets and Monetary Policy

- o Canadian real interest rates will move downward with U.S. real rates, and perhaps, earlier if exchange rate pressures vis-a-vis the U.S. dollar can be contained.

Why? With continuing high unemployment, large direct costs of interest payments on Federal debt, and a desire to increase investment there is a pressing need for lower real interest rates.

So What? The cost of investment funds should decline; in the meantime long-term commitments should be minimized. The cost of carrying inventories will be reduced and product demand should expand. If exchange rate pressures conflict it is likely that some further devaluation will be tolerated, improving competitiveness vis-a-vis the U.S.

- o The Canadian government will issue indexed bonds in some form.

Why? Long-term commitments at today's high nominal rates represent a potentially costly form of finance. At the same time, it is not desirable that all of the government debt be refinanced every year or two. A long-term instrument with a real coupon of 4% plus inflation represents a way out of the dilemma. (Both the real and inflationary component are likely to be taxable).

So What? This innovation should be examined for corporate financing as well. One variant would be to index to product prices rather than to a broad measure like the CPI.

Canadian Energy Policy

- o A new energy policy will be put in place before 1986, with oil priced at world market prices. Natural gas will continue to be priced below a BTU-equivalent price, given excess supply and the desire to reduce oil dependency.

Why? The sorting out of producer - consumer - owner interests will be a difficult one. But the relative shift in political power to the West should result in a world price; particularly if it continues to decline in real terms.

So What? There will be some increase in domestic oil prices, although the current gap is small. Resolution of the uncertainty and some improvement in cash flow to the industry should improve the investment outlook for this sector.

- o Electricity pricing will remain a provincial matter, but revenues from exports may not be used to subsidize domestic electricity prices to the same degree as in the past.

Why? With relative prices of other forms of energy increasing, there will be room for increases in electricity prices. Lower interest costs will help to contain these increases. But provincial governments will want to capture the profits from export sales for general revenue.

So What? Purchased electricity prices will rise but not as rapidly as other forms of energy. The value of water rights will increase and provincial governments will try to capture this value.

Canadian fiscal policy and policy formulation

- o The priority of the Federal government will shift from controlling inflation to economic growth.

Why? Inflation has abated world-wide, unemployment remains high. The prospect for strong economic growth without policy intervention is not reflected in current forecasts. But large deficits and a strong desire not to repeat the inflation of the 1970s will limit the amount and form of fiscal stimulus.

So What? Look for tax cuts and expenditure increases to maintain final demand. But incomes that are not being spent, persons with higher incomes and corporations not investing, may be subject to higher taxes.

- o Federal Policy formulation will increasingly stress consultation and consensus with the provinces and major groups (business, labour, consumers, etc.).

Why? The legacy of confrontation has not proven to be an effective process. The pressures of individual groups can be muted by a consensus process. As well, this consensus may substitute for more formal incomes policies.

So What? Most business groups are ill-prepared for this form of social negotiation. Corporations and business organizations should identify their objectives and define what they are prepared to give up in the negotiations. Corporations will be asked for commitments by their representative associations.

- o Structural policies including deregulation will continue to be developed and implemented.

Why? The importance of market-related prices and enhanced competition has been a driving force behind moves in the U.S. and elsewhere. Improvements in resource allocation and the desire to have relative price adjustments instead of production cutbacks will keep the pressure on in Canada.

So What? Air transportation, trucking, and telecommunications will continue to be deregulated both as regards prices and competition. This should lower net costs for their competitive offerings, but raise prices for other parts. (e.g. local phone service up, long distance down). Foreign investment review will be softened. Financial institutions will become more competitive.