Labour Economic Monitor

December 2008

Introduction

The May 2007 issue of *Labour Economic Monitor* compared a booming economy to a party, where some of the guests have a bit too much to drink and get carried away. Well, the party is over, and it's time to clean up the mess. The crash of financial markets in 2008 pushed the whole global economy into recession, and no one knows how deep or how long this downturn will be.

Alan Greenspan, former head of the Federal Reserve (the central bank in the U.S.) told an audience in Toronto last month "That we are in a recession, very severe, there's no question." He went on to say "We know we are going down and there's very little we can do about that." Greenspan should know, since his actions as Federal Reserve Chair helped lay the foundations for the current disaster.

World Bank economist Justin Lin suggests that "the financial crisis now is likely to be the worst since the 1930s," and the Bank's report on the crisis predicts that world trade will actually contract by 2.1% in 2009, the worst performance in a half century.

So how did we get here? In the mainstream media, the meltdown has been blamed on the growth and failure of the market in "sub-prime mortgages," with the implication that all would be well if we just hadn't tried to extend home ownership to those pesky poor people. It's true that some mortgage brokers went over the top, offering so-called "ninja loans" (no income, no job, no assets). But really, that's only part of the story. More important was the interaction between a deregulated financial market and a speculative bubble in housing prices.

As an example, let's look at how the financial market dealt with mortgages, including sub-prime mortgages. Lenders parceled up batches of these loans and sold them off as financial derivatives called a Collateralized Debt Obligation (CDO) or a Collateralized Mortgage-backed Obligation (CMO).

Herein lies the first part of the problem: because the mortgage lender was immediately selling off the mortgage to a third party, they had no pressing interest in doing due diligence to make sure that the borrower would be able to repay the loan. Instead, they had an interest in making as many loans as possible and offloading the financial risk by selling the resulting derivatives off as fast as possible. That kind of separation of risk and reward is a classic recipe for disaster in a financial system.

As these derivatives were passed from bank to bank, and from investment house to hedge fund, two things happened:

1. Ever higher levels of debt were piled on top of one another, as the CDOs and CMOs were used as collateral for further borrowing; and
2. The financial risk was shuffled and reshuffled until nobody – not the banks' shareholders, not the financial regulators, and not even the banks themselves – knew who was left holding the financial risk.

The value of any financial derivative depends on the value of the financial asset underpinning it. When the U.S. housing price bubble burst, the value of the mortgages underpinning the CDOs and CMOs also collapsed, creating doubt as to which banks had huge losses hidden in off-balance-sheet derivative investments. As a result, banks became more hesitant to lend to each other, and to other large financial institutions, and the global financial system ground to a halt.

When the dust cleared (and it may not have entirely cleared yet), the five largest investment banks in New York had ceased to function as investment banks. Three of them (Bear Stearns, Lehman Brothers and Merrill Lynch) had been taken over by other banks at bargain basement prices, and the other two (Goldman Sachs and Morgan Stanley) had to convert from investment banks to holding banks, a legal change that meant they could ask for financial help from the U.S. Federal Reserve in return for increased oversight and regulation from government.

It wasn't as if the collapse of housing prices came as a big surprise to anyone – prices had been going up for most of the last two decades and any rational adult (a group that surely includes merchant bankers) knows that nothing goes up forever. The problem was that the bonuses paid to these "masters of the universe" were earned by selling derivatives, not by carefully assessing risk. When Lehman Brothers went into Chapter 11 bankruptcy (the largest bankruptcy in the history of the world), its staff were owed $2.5 billion in bonuses. In the last two years of its existence, its staff were paid bonuses totaling $8.2 billion.

So the fundamental causes of the financial meltdown were fourfold:

1. Excessive leverage (borrowing) based on shaky assets;

2. A lack of transparency, as debt and risk were repackaged and resold over and over again;

3. Improper compensation systems that disconnected rewards from responsibility and risk; and

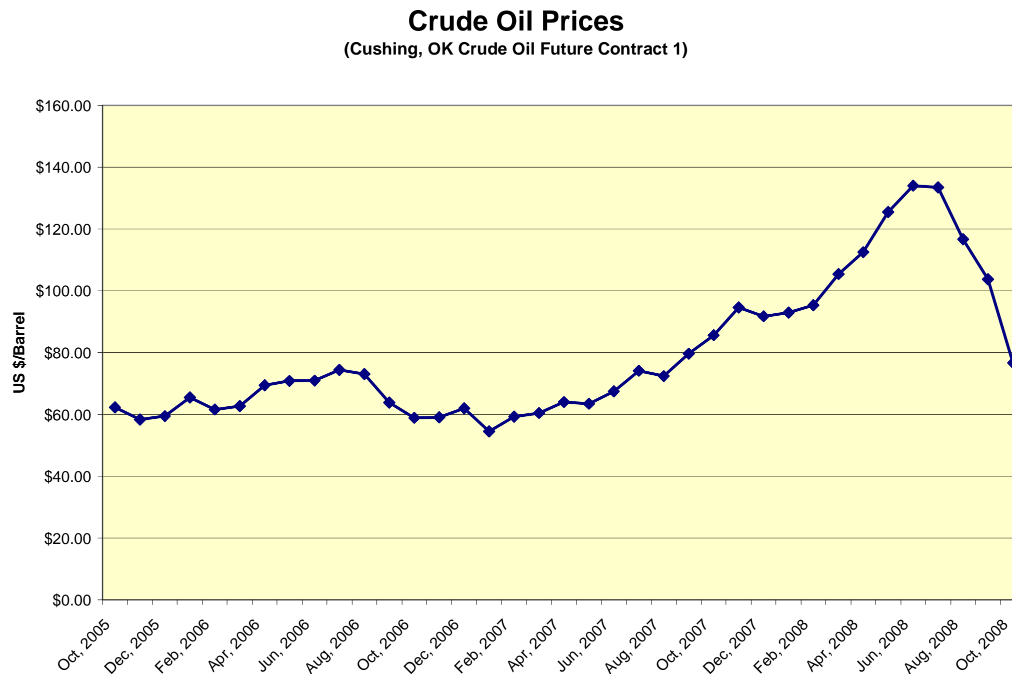
4. A deregulated financial system that allowed the whole farce to be played out.

Nobody knows if the financial crisis is over yet. Banks aren't jumping at the opportunity to lend money, and mortgages weren't the only kind of questionable debt in the marketplace – there are record levels of consumer debt (credit card debt, care loans, etc.) out there still and if the recession proves to be long and deep, a lot of that debt is likely to be in default.

Alberta has been partially insulated from swings in the business cycle by its oil wealth, but a serious and prolonged recession might keep the energy prices depressed for a long time. If that happens, we'll see what happens to an economy that is almost totally reliant on a single industry. It might not be a pretty sight.

Energy Prices

The oil-price bubble has burst, and the provincial mood is turning glum, as oil-sands construction projects shut down one after another. After peaking briefly at over $140 in July, the price of a barrel of oil slid to $50 dollar in the last week of November, and into the $40 dollar range in early December. The price spike was actually quite brief which isn't all the surprising. It was, after all, a "double bubble" price: a speculative run-up in oil prices on top of a larger economic bubble based on inflated housing prices and questionable credit expansion in deregulated financial markets.

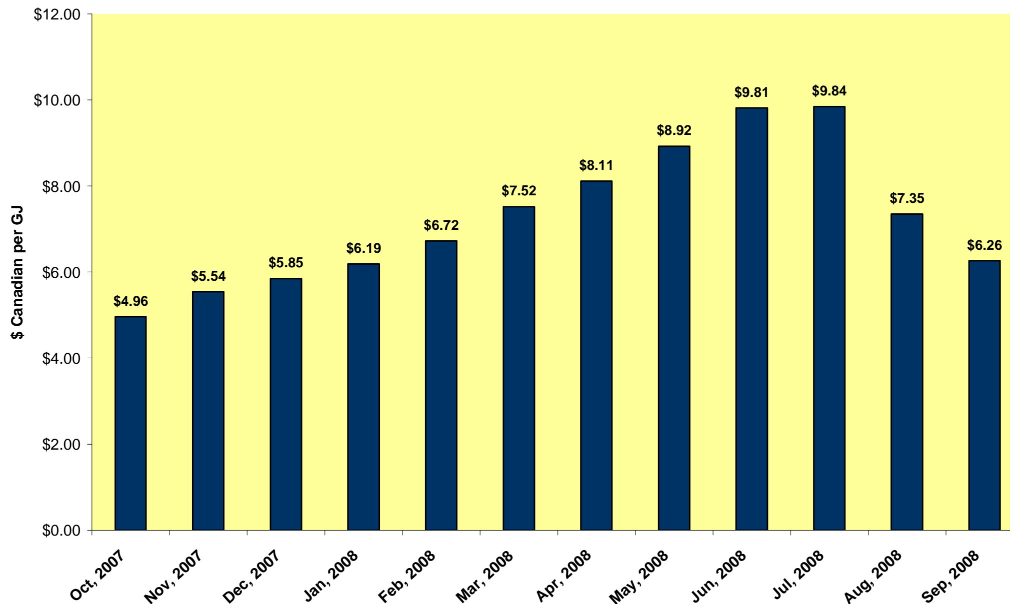


As a result, oil-sands construction has slowed radically, although it's hard to tell how much of this is based on low oil prices, and how much on the scarcity of credit to finance construction. The Canadian Association of Petroleum Producers has reduced its spending forecast for next year by 20% and many oil-sands projects planned for the next five years have been put on hold or cancelled. All this is happening at a time when the environmental consequences of oil sands production are subject to increased scrutiny, and the industry is being tarred as a source of "dirty oil".

In its 2008 budget, the Stelmach government assumed an average oil price for the fiscal year 2008/09 of $78 per barrel (bbl) for benchmark West Texas Intermediate crude oil. For the first seven months (through October), the actual average price was $114/bbl, but the prospects for the rest of the year are grim. Merrill Lynch has cut its oil price forecast for 2009 to just $50/bbl.

Natural gas prices have also begun to fall, after peaking at just under $10 per gigajoule (GJ) in July. The provincial budget assumed an average price of $6.75/GJ, and for the first half of 2008/09 the actual price averaged $8.38/GJ.

For each 10 cents natural gas prices rise above the budget assumption, provincial royalty revenues rise by $114 million. For each dollar the price of oil rises above its forecast, revenues rise by $130 million.



The high prices of the last two quarters, combined with the positive budgetary effects of the declining Canadian dollar, should allow the Alberta government to enjoy a significant surplus this year, but the outlook over the medium run is poor. As mentioned above, economic forecasters are predicting relatively low oil prices over the next year or so.

More importantly for Albertans, the long-term economic prospects are limited by the refusal of successive governments to interfere with “free markets” (except when the interference involves a subsidy to oil companies). Production and reserves of natural gas and conventional crude oil continue to decline and this trend will continue into the future. The government has announced new royalty breaks for energy exploration companies (before the new royalty regime approved last year even comes into effect!), but there just aren’t any large new reserves to be discovered and any modest new reserves brought on line will suffer higher production costs.

When it comes to oil-sands development, it’s important to get past the massive hype this industry has generated. The government has never had a well-thought-out policy for the sector and so far the main economic benefit has been construction jobs. Indeed, it’s now a

truism that, in Alberta, the boom now coming to an end was a construction boom as much as or more than an oil boom.

The question has always been: what kind of jobs will be generated after the construction phase is completed? The greatest economic benefit from a resource like the oils sands lies in the secondary processing – upgrading and refining of the resource. The Stelmach government has never made any serious effort to require that the bitumen coming out of Fort McMurray be upgraded or refined in this province, while American politicians and corporate leaders have made it clear they want this industry to be situated in the U.S. While the construction of upgraders and refineries in Alberta is cancelled or put on hold, similar facilities in the U.S. are being built and old ones are being refurbished.

When all is said and done, Alberta will probably reap only a fraction of the potential economic benefits of the development of the oil sands. On the other hand, when oil prices go back up, energy revenues will rise and the government can go back to running surpluses. One ongoing problem with energy policy in this province is that the government has never grasped the difference between the fiscal and economic dimensions of the industry. You can have (and we may well have in the future) an energy industry that generates revenues for government, without providing spin-off jobs and industries that create real economic value.

Meanwhile, in the short run we can expect low energy prices, a contraction in the industry, and yet another round of government "fiscal restraint." We all know what that means: over the last fifteen years, the Klein and Stelmach governments have used resource revenues to underwrite tax cuts, eroding the tax base and leaving the government even more dependent on income from royalties. That means that when energy markets turn down, the province gets a rough ride.

Apology

Back in the October, 2006 edition of *Labour Economic Monitor*, we said:

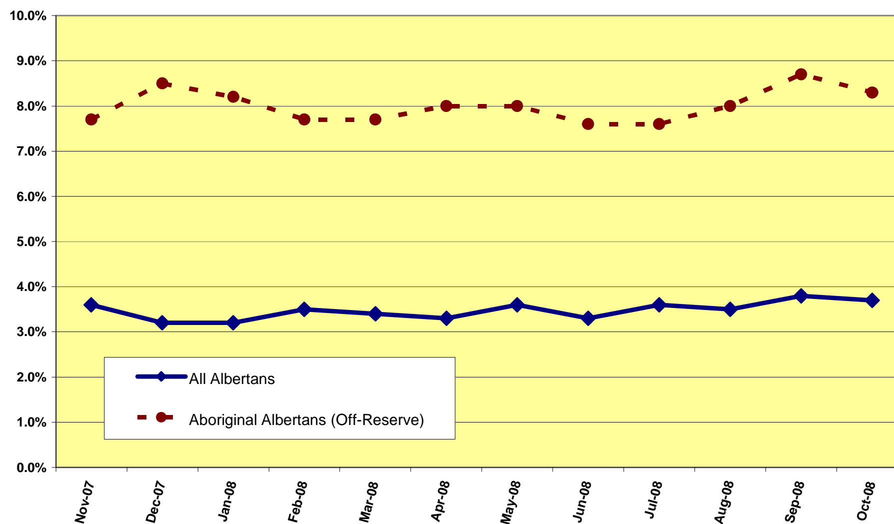
> ”*Sometimes it seems as though the Klein government's energy policy consists of just two ideas:*
>
> 1. *Give the oil companies whatever they want (including an endless succession of royalty breaks),*
>
> 2. *Sacrifice some chickens, and pray for $90-a-barrel oil."*

Those remarks were incorrect and unwarranted, and *LEM* wants to correct the record: everybody knows that when hard times hit Alberta, it's the poor who get sacrificed.

Unemployment

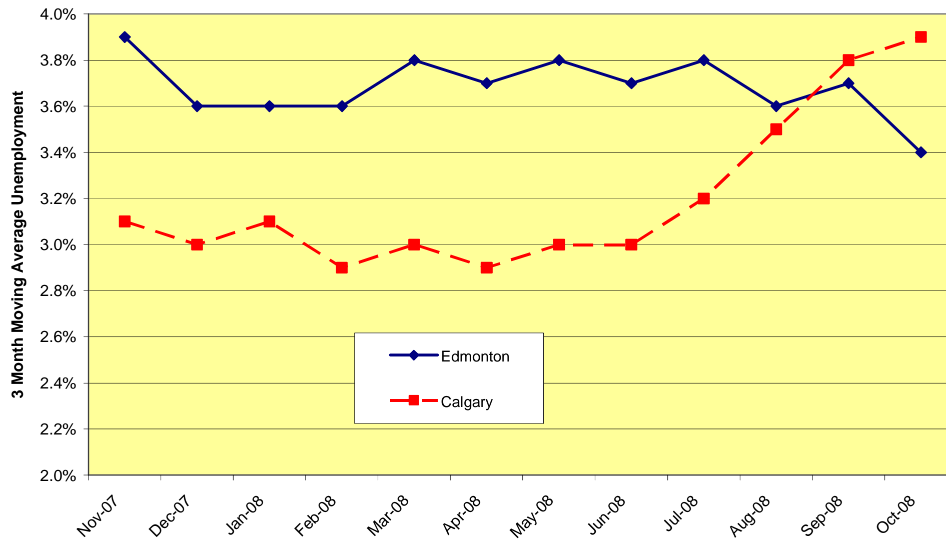
The effects of the financial market collapse haven't yet worked their way into the Alberta labour market. Overall unemployment remains low – the rate for October was 3.7%, as opposed to 6.2% for Canada as a whole. The number of Albertans employed is up over October 2007 by 63,000 jobs.

Surprisingly, the majority of these new jobs are in the goods-producing sector, with construction and manufacturing adding 22,000 and 13,000 jobs respectively. Equally surprising, in the context of last year's boom was the fact that important parts of the public sector actually saw job losses: employment fell by almost 12,000 in the health care and social assistance sector, and 6,000 in public administration.



Unemployment was lowest in the east and southeast of the province, with the Camrose/Drumheller region at 2.6%, and the Lethbridge/Medicine Hat region at 3.1%. Meanwhile, unemployment among Aboriginal Albertans living off-reserve continued to be almost three times that of the rest of the province (8.3% in October).

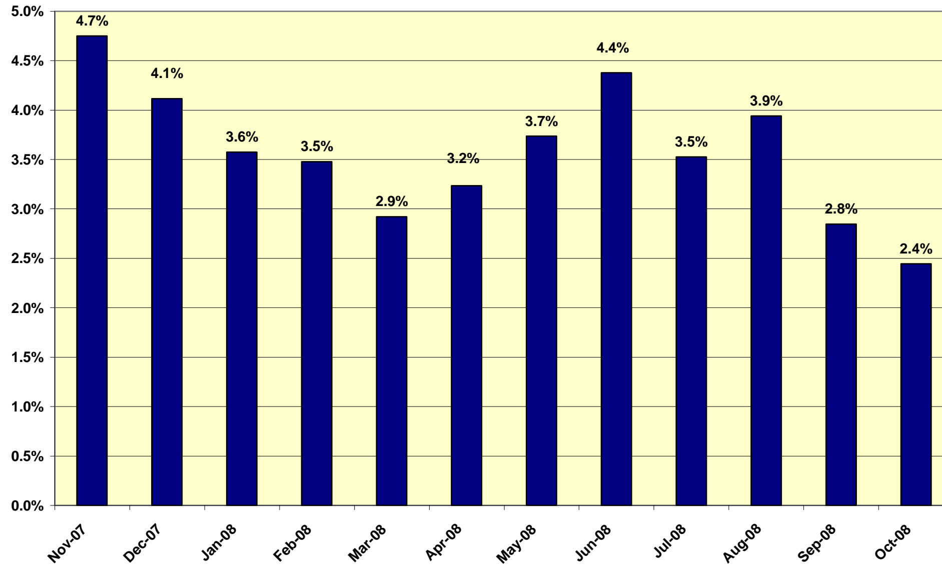
In Calgary, the jobless rate has been rising (albeit slowly) since April, rising to 3.9% in October, while in Edmonton the rate has been more or less stable over the same period, falling slightly to 3.4% in the latest data.



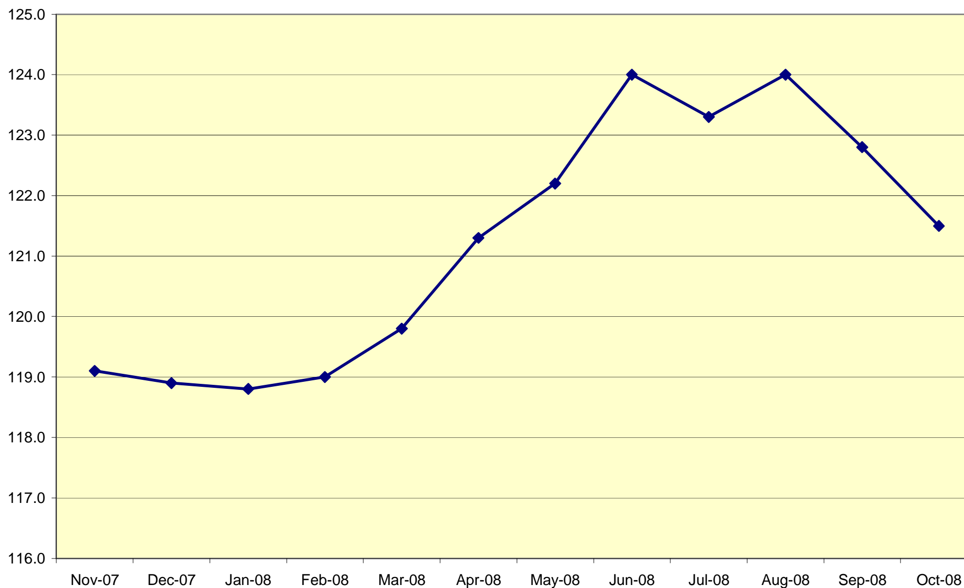
Once the recession really starts to bite, we'll see much higher unemployment figures, but one group of workers won't show up in the numbers. Temporary foreign workers have no way to access EI or other benefits and their ability to stay in the country is tied directly to their employment. When they get laid off, they'll get sent home and their job losses will be invisible. Of course, it will be the higher-paid jobs that will go first; in the "hospitality industry," employers will fight to keep low-paid employees who have few enforceable legal rights. Some of those workers facing job loss will try to avoid being sent back to their country of origin: instead they'll go underground and enter the "grey" labour market. That's how the temporary foreign worker program helps to create an underclass in Canada.

Inflation

First it was inflation we had to worry about, then "stagflation, and now the economic threat-of-the-week is deflation. For years now, Alberta has faced inflation rates far higher than the rest of the country – sometimes as much as double the national rate. That created a problem in maintaining or improving real wages, especially for unions negotiating nation-wide agreements which generally would reflect national, rather than local, inflationary pressures. In October, however, inflation in Alberta stood at just 2.4%, less than the national rate of 2.6%.



In point of fact, the value of the Consumer Price Index for Alberta peaked in August, and has declined for the last two months running. Bear in mind that we calculate inflation by comparing the CPI for one month with the same index twelve months earlier. This means we can have a positive rate of price inflation (using this measurement) while the month-to-month trend in actual prices (as reflected in the CPI) is downward.



However, two months don’t make a trend and it would be premature to conclude that we are already in a deflationary situation. That’s a good thing because serious and prolonged deflation would mean a very serious and prolonged recession, or even a depression.

Analysts in the business press try to argue that a deflationary spiral is caused (at least in part) by consumers holding off on purchases because they believe that the price of the items they want will be lower in the future. A recent article in the Wall Street Journal, for example, says: “What the Federal Reserve has to avoid is the kind of chain reaction that ensues when consumers and businesses expect prices to keep falling, leading to a downward spiral of lower spending and job cuts.”

That kind of analysis is completely out of touch with the realities faced by most working people. It assumes that consumers behave like commodity traders on the Chicago Mercantile Exchange, constantly surveying asset prices and placing bets on which way they’ll move. In fact, that’s just not the way most of us make our spending decisions.

In the first place, most consumer spending isn’t really discretionary: we don’t decide to hold off on buying groceries for the week or getting news shoes for the kids because we think prices might be half-a-per-cent lower in six months. For most North Americans, the bulk of our paycheque is spent as soon as it comes in, and it’s spent on day-to-day necessities.

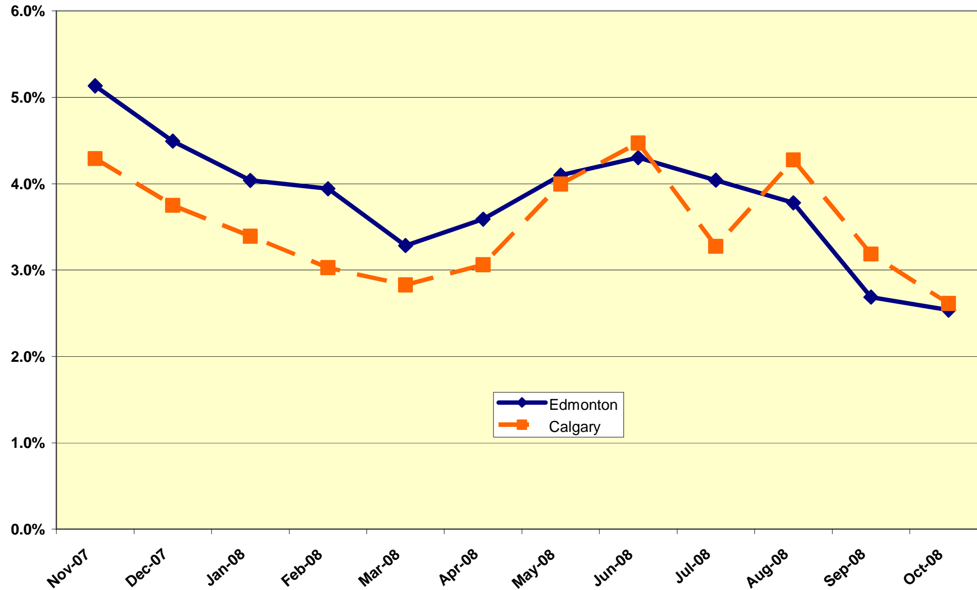
In the second place, while consumers do react to price differences, these reactions tend to take the form of comparison shopping – people will seek out merchants who offer better prices for their goods and services. In general, however, price-seeking by consumers doesn’t take the form of comparing prices through time. Except in the case of special events like Boxing Day sales, consumers don’t make purchasing decisions based on expectations of future prices. Only when it comes to large-cost consumer items (a new car, a new washer, even a new house), do we pay close attention to these trends and those kinds of purchases don’t happen every day. When we do make those decisions, we’re more likely do so based on our confidence that we’ll still have a job in a year, rather than what the price will be in six months.

Expectations of future price trends aren’t what drive a deflationary spiral – job security and wage expectations are much more important in that regard. So when employers cut back operations, lay off workers and reduce compensation (as the Big Three automakers are being asked to do) that contributes to even more deflationary pressure.

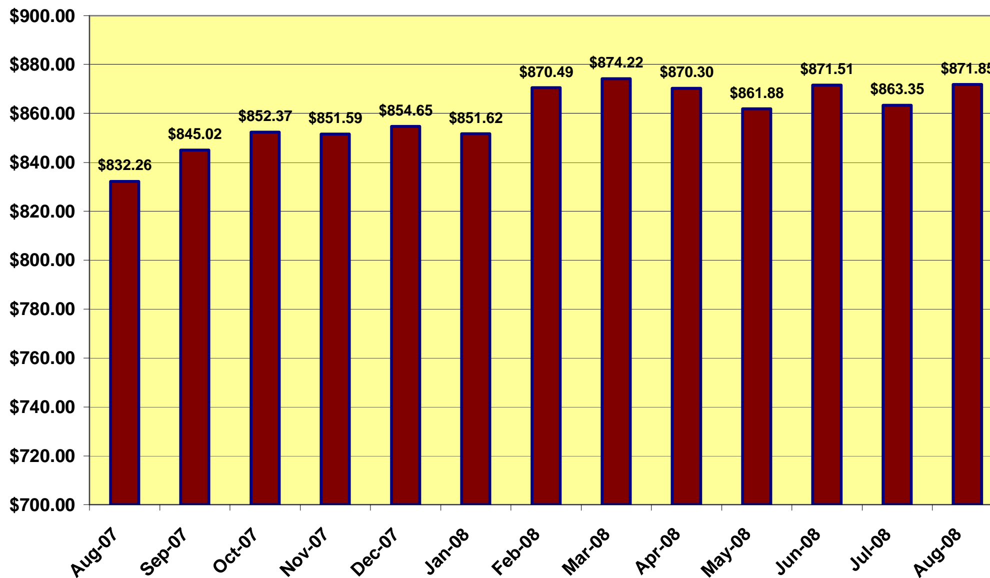
Meanwhile: the monthly Consumer Price Index for Alberta fell 1.1% between September and October. The reason for this decline was energy prices, which fell by 10.2%. In fact, the CPI for all items <u>excluding</u> energy showed no change at all.

Inflation in Edmonton and Calgary pretty much tracked overall provincial trends. In October monthly year-over-year inflation was 2.5% in Edmonton and 2.6% in Calgary. In each city, the CPI has been falling over the last few months.

The fact that prices are falling in Alberta faster than elsewhere in Canada points to the instability of an economy based on hydrocarbons and vulnerable to the sudden and massive price swings the world oil market generates.

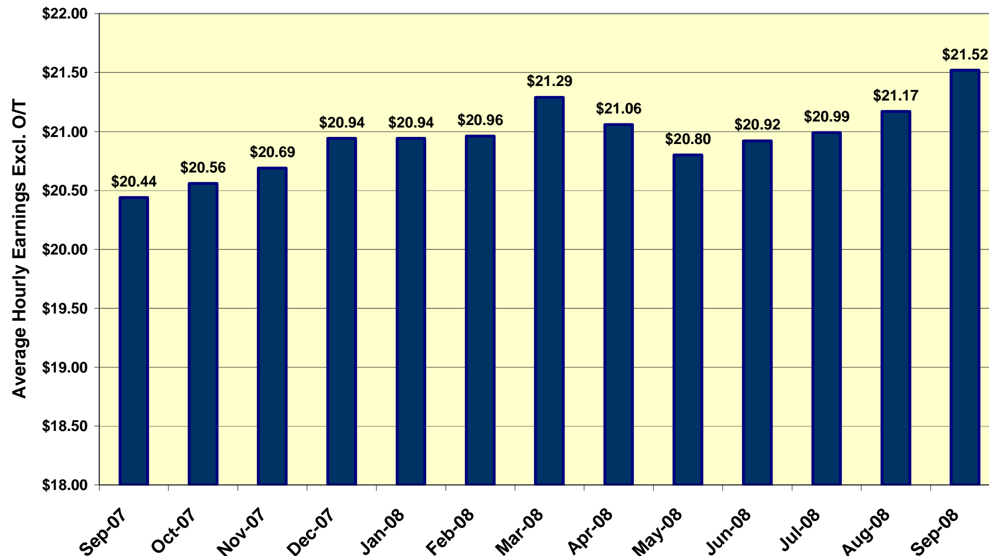


Wages



With low unemployment rates persisting, it's not surprising that Alberta's labour market continues to support wage growth. For the 12-month period ending last August, weekly earnings in the province averaged 4.8 % higher than the previous year.

Hourly wage trends are similar, with average wages in the most recent 12 month period 4.5% higher than in the previous year.



Since inflation has averaged less than four per cent over the same period, this means workers in Alberta are making significant gains in real wages for the first time in years.

We have to be cautious in interpreting trends in average wage figures. For example: if average hourly wages are rising, does this mean that:

1. Employment and job opportunities are shifting from lower-paid occupations to higher-paid ones, owing (for example) to changes in technology or production methods; or

2. Industries that pay higher wages (heavy construction, for example) are growing faster than other sectors of the economy; or

3. People are actually getting a raise; i.e., they are being paid more for doing the same work they were doing before.

Without going into too much detail, we can identify some current patterns in wages in Alberta:

- Wage increases in the goods-producing sector (4.3%) and the service sector (4.7%) are both fairly close to the overall (industrial aggregate) average of 4.5%. However, during the last two months for which data are available, wages in the goods-producing sector seemed to spike sharply (up 8.4% in August, and 7% in September). This may be just a temporary anomaly caused by seasonal or other variations in particular industries. Whatever the case, the current economic climate means that the trend is unlikely to persist.

- Wage growth in the finance sector is quite dramatic, about 14% above levels a year previously. On the other hand, wage trends in this sector in 2007 were actually negative. It's hard to know what to make of this, it may reflect changing employment patterns, combined with a prevalence of non-standard (e.g., performance-based) pay in this industry. At any rate, given the current state of financial markets, it's hard to believe that this sector will see big pay increases in the near future.

- One occupational group *Labour Economic Monitor* follows closely is something called "Limited-service eating places." These are the "McJobs," the lowest paid part of the labour market. The good news is that wages in this sector have actually been rising – by about 12% to 15% over the last couple of years. Apparently the Alberta labour market has been so tight that employers couldn't find people willing to flip burgers for the lousy wages they were offering, so those wages had to rise (of course, at $11. 56 per hour they still aren't great wages).

Wages, Recessions, and Union Bashing

Wages trends tend to lag slightly behind other economic indicators. It takes time for an upturn or recession in the economy to affect the labour market, and for this effect to be reflected in wages. Over the last few decades, employers have become adept at exploiting this lag. When the economy enters a growth cycle, employers (both union and non-union) fight to hold compensation rates in check until an inability to attract and retain employees forces them to boost wages. When a recession occurs, employers jump onto the wage-concessions bandwagon almost immediately.

The current downturn has brought a classic example of this tactic: before the ink was dry on the trillion dollar bailout for investment banks, the U.S. and Canadian media were lining up to snipe at a similar (although much, much cheaper) bailout for the auto industry. The target: union wages. CNN and Fox News in the U.S., and the CBC and Globe and Mail in Canada all insist that any bailout of the auto industry must be preceded by major wage concessions from the unions.

The centerpiece of this argument is the claim that compensation for employees of the Big Three is $73 per hour, as opposed to about $45 per hour for non-union plants operated by Honda, Toyota and Nissan. That astonishing figure is the pretext under which UAW in

the States and CAW in Canada are being bashed by ill-informed media pundits who have swallowed without question self-serving numbers put forward by employers.

Not surprisingly, reports like this make the average Canadian see red and stir right-wing media commentators into spluttering denunciations of “bloated union contracts.” The problem is that these numbers are deeply misleading, some would argue consciously distorted. U.S. Senator Bob Casey, for example, said last week: “It’s a total lie. I think some people have perpetrated that deliberately, in a calculated way, to mislead the American people about what we’re doing here.”

The details of this distortion aren’t especially relevant; they have to do with a) what is counted as part of “total compensation,” and b) the relative ages of the workforces in the Big Three automakers versus the Japanese-owned manufacturers. (Readers who are interested can contact *Labour Economic Monitor* and we will try to provide at least a partial breakdown of these costs.) The important thing is that these distorted figures provide a way to attack UAW, CAW and, by extension, all unions. When a recession hits, the blame isn’t directed at the bizarre practices of the merchant bankers (the “masters of the universe”) who created the mess, nor at the corporate executives who have criminally mismanaged industry. As usual, it’s the unions that are the target.

Wage Settlements

2007 was a big year for bargaining, with unions negotiating collective agreements covering 70,000 workers, and achieving an average settlement rate of 5.2% per year over the life of these agreements. That’s higher than the rate of inflation for 2007 which means our members are gaining in real, after-inflation earnings. Further, since the rate of inflation is dropping, workers covered by these contracts will probably see their real wages increase over the life of the agreement.
So far, at least, 2008 is also going well, with settlements averaging 4.5%. With the economy heading into a recession, we can expect these rates to drop over the balance of the year, and probably well into 2009. So much, in collective bargaining, depends on timing.

Year	# CAs	# E'ees	Rate
2006	194	37,919	**3.7%**
2007	222	70,008	**5.2%**
2008	95	30,755	**4.5%**

Public sector settlements are averaging 5.2% so far this year, with private sector rates just slightly behind at 4.3%, still well above current inflation rates.

For more detailed information on sectoral settlement rates, contact *Labour Economic Monitor* at the AFL or check out the Alberta Employment ant Immigration data at:

http://employment.alberta.ca/cps/rde/xchg/hre/hs.xsl/3240.html