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Petroleum Plunge: Crude Calculations for Canada

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Amid the many fast-moving parts in financial markets, perhaps the single most important development for the Canadian economy is the deep drop in oil prices since the summer. From a June peak of more than US$107, WTI has promptly plunged 23% in four months, while Brent has tanked by about 25%. While we believe that current prices in the low-$80s range are below fundamental value (i.e. the marginal cost of production is closer to $90-to-$95), and won't be sustained for long, there is clearly a risk that low prices could persist for at least a few quarters given the supply glut and softer global outlook. Here are some of the key implications for the Canadian economy and financial markets from a sustained drop in oil prices to around $80.

1. Overall economic growth: As a major net exporter of crude and bitumen, lower oil prices are widely seen as a significant negative for Canadian GDP growth. However, the evidence is a bit more nuanced. Our research, and a recent Bank of Canada study *(Baumeister, Peersman & Van Robays, 2011)*, find that, depending on the nature of the shock, a 10% rise in oil prices would lift Canadian GDP by roughly 0.1 percentage points. While reversing the signs for the recent episode would seem reasonable, the authors note that production is not overly sensitive to a (moderate) price drop, given the heavy up-front capital investments in oilsands projects. The energy sector alone accounts for 22% of all non-housing capital spending in Canada, and capex in the sector is the main downside risk to growth. On the flip side, consumers benefit from lower prices (which act as an instantaneous tax cut), and non-oil exporters may benefit from the growth boost in other industrial economies as well as a potentially lower Canadian dollar. While these indirect positive effects are outweighed by the direct negative hit to the energy sector (and its many suppliers), we suspect the latest move, if sustained, would trim 2015 Canadian GDP by less than 0.2 percentage points. We have already shaved our 2015 GDP forecast a tick to 2.4%.

2. Regional growth trends: Perhaps the most significant effect of sliding oil prices in Canada would be a re-ordering of the regional growth ladder. While Alberta remains atop the pack, momentum has faded somewhat in recent months alongside the slide in oil prices. With some projects delayed due to rising costs, and the labour market outperformance much less staggering than earlier in the year, real GDP growth is expected to cool to 3.5% this year and 2.9% in 2015. That will still leave Alberta as the only province near the 3% mark, but the

growth gap with the rest of Canada is narrowing. Indeed, while weaker oil prices are a negative out West, it's good news for Central Canada, especially with weakness attached to a lower Canadian dollar. Also, with at least part of the softness prompted by supply-side developments, and negative news on the demand side largely coming from Europe and China (rather than in our major trading partner, the U.S.), we would judge the recent decline to be a net positive for Central Canada.

3. Fiscal impact: The most direct hit, not surprisingly, will be on provincial finances in the oil-producing regions. Alberta, Saskatchewan and Newfoundland & Labrador are currently basing FY14/15 budget plans on oil prices in the $97 (WTI)-to-$105 (Brent) range, so there's considerable downside risk if prices stay at or below recent levels for the remainder of the fiscal year. Longer-term plans (mostly in the $95 range) would also be at risk if these prices stick. Helping somewhat will be an offsetting revenue boost from the weaker Canadian dollar; and, in Alberta's case, a well-behaved WCS spread. At the federal level, the impact is less direct, with lower oil prices dragging on corporate income taxes, and (very indirectly) through personal incomes. We estimate that the recent move in oil prices will cut the GDP deflator by roughly 1 percentage point, which Ottawa estimates will cost it $2.1 billion. Combined with the small net impact on real GDP, we estimate that the slide in oil would boost Ottawa's deficit by just over $3 billion—right in line with the contingency cushion currently built in to budget forecasts.

4. Canadian Dollar: Perhaps the most clear-cut loser from weaker oil prices on the domestic front is the Canadian dollar. We have long maintained that for every $10 move in oil prices, the loonie makes a parallel move of about 3-to-5 cents. And, indeed, the currency has sagged almost 6 cents since June as oil prices have dropped more than $20. We believe that the C$ is now close to fair value based on today's commodity prices, but further weakness in crude would drag the loonie along for the ride. Note that the parallel drop in the currency softens the blow from lower oil prices for both real growth (as it supports non-oil exports) and government finances (as revenues are driven by energy prices in C$ terms).

5. Canadian equities: Sliding oil prices are a clear negative for the TSX, in absolute terms and relative to its S&P 500 counterpart. This is mainly a composition story, with the energy sector weighing in at nearly 25% of the index versus less than 10% south of the border. In fact, since equities peaked in early September, sector performances have not been all that different in the two markets (energy down nearly 20% in each), but the composition has weighed much more in Canada. This phenomenon is not new, nor will it change anytime soon.

6. Inflation: The sudden slide in oil prices has begun cutting into already low inflation rates in much of the world; but, here again, Canada is a bit of an outlier. With a sliding currency acting as a counterweight, inflation dipped only slightly in

September to 2% (even as inflation is dropping below that level in many other major economies). And, while gasoline prices have careened lower in October, they also took a 5% fall last October, so even then the drop in headline inflation may not be noteworthy. Still, if the energy price weakness persists, it will chip away at other underlying costs and put some serious downside risks to the consensus inflation outlook for 2015 (now at 2%). The upside to this is that lower headline inflation will suddenly drive recent 2% wage gains above CPI trends, giving consumers more buying power.

7. Interest Rates: While there are many factors buffeting the outlook for domestic interest rates, lower oil prices by themselves would tend to even further delay possible Bank of Canada rate hikes. Our view, even before the recent financial market volatility, was that the Bank would wait until late 2015 before beginning to hike rates. While there's plenty of water to go under the bridge by then, a sustained decline in oil prices would threaten to even further delay potential rate hikes. The plunge in long-term bond yields—10-year GoCs have dropped to a 17-month low below 2%—is a loud signal in that direction.

8. Small business: In general, small businesses will tend to benefit from lower energy costs (except those who supply the sector, directly or indirectly). Some of the benefits include: lower fuel and lubricant costs to run machinery and vehicles, lower bills for heating oil and other energy, and less for packaging costs. As well, retailers that rely on customers by car may see firmer volumes, while businesses that rely on discretionary spending, such as travel destinations, could see more visitors.