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Bennett Jones Winter 2015 Economic Outlook

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Oil prices have fallen sharply since the release of our *Fall 2014 Economic Outlook*. While this shock should have relatively little effect on our outlook for global growth, in part because of other offsetting developments in the short run, it will entail a major redistribution of income from oil-exporting countries to oil-importing countries. Most notably, it will depress overall growth in Canada as a result of a marked slowdown in the growth rates of oil-producing provinces. This *Winter 2015 Update* provides revised projections of the global and Canadian economies along with a brief discussion of the policies that need to be pursued by governments in Canada in this new context.

Recent World Economy Dynamics

Recent data releases reveal a growing divergence in growth rates among large economies, reflecting a buoyant expansion in the U.S., falling output in Japan, weakening (but still strong) growth in China, and continued near-stagnation in the Euro area. This growth divergence is at the root of the recent marked appreciation of the U.S. dollar against other currencies, including the euro, the yen, the Australian dollar and the Canadian dollar.

While the improved outlook for the U.S. has reinforced expectations of incipient rises in U.S. policy interest rates by mid-year, risks of stagnation and deflation have prompted a number of central banks to take action to stimulate their economies and raise inflation expectations. The ECB has announced a substantive program of quantitative easing while Japanese authorities have boosted their own quantitative easing program and delayed a second increase in the consumption tax rate. But despite economic weakness, governments in many countries have perversely tightened fiscal policy.

The key shock to the world economy is that the U.S. price of WTI oil has fallen by over 40 percent since last fall, from $85/bbl last October to about $50/bbl in early February. Our Fall 2014 Economic outlook (based on oil futures price in early November) assumed an average price of $75/bbl for the next couple of years. Some of the price decline since last Fall stemmed from unexpected demand weakness (also reflected in declining metals prices), but most originated from increased supply, notably the decision by OPEC not to reduce production in the face of steadily rising "tight oil" production in the United States. With demand for and supply of oil both fairly unresponsive to prices in the near term, recent perceptions of a positive shift in supply and a negative shift in demand have generated the relatively large downward adjustment of oil prices witnessed in recent months. In economist's jargon, both supply and demand are price inelastic in the short term.

Global Dynamics: 2015-2016

Despite the dramatic decline in oil prices, the dynamics of global growth over 2015-2016 remain essentially the same in this Update as in our Fall 2014 Economic Outlook. We still expect a modest strengthening of global growth over the next two years relative to 2013 and 2014, largely originating from improved performance of the advanced economies, and the U.S. in particular. Growth rates in the emerging economies as a whole will increase somewhat in 2015 and 2016 relative to 2014, but progress will be constrained by a slowing of the projected growth rate in China. Lower oil prices and the unexpectedly strong momentum of the U.S. economy would have led to a more robust strengthening of global growth than currently projected were it not for persistent impediments to growth in Japan and the Euro area and for policy efforts at rebalancing growth and containing credit expansion in China.

There is a great deal of uncertainty surrounding any projection of oil prices. Our working assumption is that the WTI oil price will gradually rise from US$45-55/bbl in the first half of 2015 to US$60-70 in 2016 and US$75-100 in 2017-2020, compared to an average price of US$93 in 2014. In effect, the assumed trajectory of oil prices this time is more U-shaped and less V-shaped than in 2008-2009. This measured increase fundamentally stems from expected gradual responses of supply and, to a lesser extent, demand to the recent shock in the short term. On

the supply side, some current production risks being shut-in since breakeven costs may be above a very low short-term expected oil price. More importantly, companies will slow or defer work on ongoing or planned projects to conserve cash, resulting in delayed completion and reduced future supply. On the demand side, expectations of eventually higher prices in light of deep cuts in investment spending by the oil industry may further induce increased short-term demand for oil inventory. Lower oil prices would incent the consumers of oil products to acquire less fuel-efficient cars, trucks and other pieces of equipment; eventually this would boost demand for oil. This being said, there is much uncertainty about the speed and magnitude of the responses of supply and demand to the current oil price shock. Moreover, there is some probability that supply disruptions will occur in the future for technical or geopolitical reasons.

There are thus both upside and downside risks to the above projection of oil price trends. One new feature of the oil market relative to earlier episodes of substantial price adjustment is that the important new supply of oil from the shale basins in the U.S. appears to be more responsive to price movements than most other existing sources of supply. New shale production can be turned off and on relatively quickly and has become as important a source of swing production as is Saudi Arabia. Thus, the oil price over 2017-2020 period may be near the lower end of the $75-100/bbl range on which we had based our medium-term outlook last Fall.

Global Growth Outlook 2015-2016

Global growth should average close to 3.5 percent in both 2015 and 2016. In the **United States** the expansion likely reaches high gear in 2015, even more so than projected in the Fall, and slows to an above-potential rate of slightly less than 3 percent in 2016. An improved labour market, higher business and consumer confidence and lower oil prices contribute to a strong momentum in domestic spending. However, the marked appreciation of the U.S. dollar will tend to depress net exports. An expected modest rise in U.S. interest rates starting around mid-2015 will contribute to the slower output growth projected for 2016. In the **Euro** area and **Japan**, the (quantitative) easing of monetary policy, the depreciation of the currency and lower oil prices should help to raise growth, but to still fairly modest levels by 2016. Growth in **China** is expected to continue to decelerate in 2015 and 2016 in response to excess capacity and slower credit growth. Some emerging countries which are oil importers (such as India) should see their growth prospects improve. Commodity exporters (such as Russia and Brazil) face greater head winds.

Canadian Outlook

TIn Canada, the strong momentum of the economy experienced in mid-2014 is projected to disappear in 2015, as the price of oil falls to a projected $45-55/bbl in the first half of the year. Real GDP growth falls to 2.1 percent in 2015 from 2.4 percent in 2014, before rebounding to 2.4 percent in 2016. Weakening growth in 2015 arises from the oil price shock which leads to a cut in the level of total business fixed investment, concentrated in the oil and gas sector.

Short-term Prospects for Output Growth (%*)

	2013	2014	2015	2016
Canada	2 (2.0)	2.4 (2.3)	2.1 (2.4)	2.4 (2.3)
United States	2.2 (2.2)	2.4 (2.3)	3.6 (3.1)	2.8 (2.7)
Euro area	-0.4 (-0.4)	0.8 (0.8)	0.9 (1.0)	1.2 (1.2)
Japan	1.6 (1.5)	0.1 (0.8)	0.6 (0.7)	1.6 (0.8)
China	7.7 (7.7)	7.4 (7.4)	7.1 (7.1)	6.7 (6.7)
World	3 (3.1)	3.1 (3.2)	3.4 (3.5)	3.5 (3.4)

*Figures in brackets are from the Bennett Jones Fall 2014 Economic Outlook.

Reduced inflow of foreign investment in the oil and gas sector and the lower price of commodity exports weighs on the value of the Canadian dollar. Our projection for the 2015 value of the Canadian dollar declines from the 83-90 cent range in our Fall Outlook to the 76-84 cents range now. Our projection for the value of the Canadian dollar from 2017-2020 remains centred on 83 to 85 cents U.S. as it was in our Fall 2014 Economic Outlook.

The decline in the terms of trade and associated loss in the real income of Canadians that results from lower oil prices at least partly counteract the expected positive response of domestic spending to lower oil product prices, the latter acting in effect like a sales tax cut. At the same time, we expect the response of Canadian manufacturing exports to the weaker Canadian dollar and stronger U.S. activity to be somewhat constrained by a lack of production capacity. The lack of capacity is a result of earlier downsizing of the manufacturing sector in response to the loss of global cost competitiveness. In Southern Ontario, this has been accentuated by a shift in the locus of U.S. manufacturing activity from the Great Lakes states to the southern states and Mexico.

Canadian growth should strengthen to 2.4 percent in 2016 as business investment outside the oil and gas industry picks up steam, and exports of manufactured goods and services improve even as the U.S. expansion slows somewhat. Household demand also continues to improve, although the improvement is mitigated to some extent by higher prices of fuel and imported goods and by a likely higher household savings rate, especially in oil producing regions. Interest rates are also expected to begin to rise modestly toward the end of 2016.

While the net impact of lower oil prices is negative on the overall Canadian economy over the 2015-2016 period, the impact differs substantially across regions depending on the relative importance of their oil sector versus the sectors that are sensitive to exchange rate movements and to U.S. growth, notably manufacturing. This is because lower oil prices stimulate U.S. growth and induce a weaker Canadian dollar, both of which have a positive effect on Canadian manufacturing production. The projected lower oil prices will sharply depress growth in oil-producing provinces, particularly Alberta and Newfoundland and Labrador, and will have negative spillovers on the rest of the country through inter-provincial trade links and lower labour demand. On balance, however, lower energy costs and the weaker Canadian dollar will tend to support output growth in Ontario and Quebec.

The shock to oil prices will have significant effects on the budgetary positions of governments in Canada in 2015, 2016 and beyond. The fall in the oil price in 2015 to around US$50 from its 2014 average of US$93 will likely erode the federal fiscal balance in 2015 by about $5 billion. This is due to slower growth in income and spending in Canada and their effect on government revenues and automatic stabilizing expenditures (*e.g.*, EI). **Alberta** faces a sharp drop in government revenues that would bring its operational budget into considerable deficit in 2015 and 2016 barring any major budgetary adjustment. The fall in government revenues arises both from a drop in non-renewable resource revenues, largely royalties which accounted for 15 percent of total revenues in 2013-14, and much slower growth in income and spending in the province. Very rough calculations suggest that with WTI at US$50 and the Canadian dollar at US$0.80 in 2015, total government revenues in that year could fall by between $7 billion and $9 billion relative to a case in which the price of WTI would continue at its 2014 average of US$93/bbl and the Canadian dollar at its 2014 average of US$0.905. **Ontario**, on the other hand, could experience somewhat stronger growth in income and spending as a result of faster U.S. growth and the weaker Canadian dollar. This, on balance, would tend to increase growth in government revenues and reduce the budget deficit.

What Should Governments Do?

In the first instance, given the prospective slowdown in the Canadian economy, the federal government and those provinces with a low or moderate debt/GDP ratio should let automatic stabilizers work. That is, they should not try to offset the immediate impacts of the slowdown on their revenues and expenditures.

In the second place, the federal government and the provinces should consider accelerated investment in needed infrastructure to take advantage of the reduced wage and cost pressures resulting from the decline of private investment in the resource industries. This might take the form of federal support for provincial or municipal investment along the lines of the special federal-provincial infrastructure program introduced in 2009. The federal government could also increase needed infrastructure investment in its own jurisdiction. However, over the medium term, the federal and provincial governments need to pay greater attention to the proper pricing of services provided by publicly financed infrastructure. This could be done through the greater use of user fees and charges.

Increased net spending would support aggregate demand at a time when economic slack is rising or declining more slowly because of weaker demand growth. Even more important than the short term stimulus effects, infrastructure investment, if properly targeted, would enhance economic efficiency and raise potential output and real income per capita in the longer run. An increase in infrastructure expenditure at this time would also be consistent with both the IMF's call for greater such investment in its Fall 2014 World Economic Outlook and the G20 Global Infrastructure Initiative put forward at Brisbane in November 2014. Moreover, now is the time to invest given that long-term interest rates are low.

The federal government and the provinces should also consider increasing their existing excise taxes and carbon taxes to offset some of the decline in fuel prices. This would send an offsetting price signal to consumers for environmental reasons. More importantly, it would help to fund infrastructure investment and to achieve fiscal balance.

In the case of Alberta, the government should not waste the opportunity provided by the current drop in revenues to correct a serious long-term structural budget problem associated with high per capita program expenditures relative to other provinces, insufficient non-resource tax revenues to cover operating expenses and volatile direct resource revenues. This may require a three-pronged approach: (1) reducing current operating expenditures, including restraint on wages and salaries, while boosting investment in critical infrastructure while private investment is weak; (2) broadening income tax and consumption tax bases, and raising user charges; and (3) establishing a policy framework for the future use of direct resource revenues. Such a framewo rk might provide for future revenues from royalties and land sales to be deposited in a special non-budgetary fund which could be comprised of: a sovereign wealth component (*i.e.*, a true heritage fund à la Norway), and a development component (for capital expenditure to support the future development of the Alberta industry).

The fall in oil prices has brought a substantial depreciation of the Canadian dollar that should facilitate adjustment of the economy to the significant loss in the terms of trade consequent to the oil price retreat. This adjustment implies increased net real Canadian exports in response to the improved cost competitiveness of Canadian producers of goods and services resulting from the weaker Canadian dollar. Manufacturing exports from Central Canada and net exports of travel and tourism services should be prime beneficiaries of the gain in Canadian competitiveness. Better prospects for net sales abroad in turn would encourage more business investment to increase capacity and raise productivity, which has fallen increasingly short of U.S. level in recent decades. For these adjustments to fully materialize, however, it is imperative that Canadian wages and costs in Canadian dollars are kept under control (*i.e.*, do not increase faster than Canadian productivity) so that the initial gain in competitiveness is not significantly eroded subsequently. This is relevant not only for Central Canada but also for the rest of the country, including Alberta where costs have escalated in recent years.

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