Finance Committee and Falling Oil Prices

The recent drop in oil prices is a painful but perhaps useful reminder that the fortunes of this industry will always be cyclical. In fact, the downturn in this cycle has been less severe than previous declines in 1986, 1998 and 2009.

The 1998 experience is particularly instructive, as it coincided with the long-term shift in Canada's oil production from conventional sources to the oilsands. This development reflected both new technologies and the adoption of a new royalty regime in Alberta. These are reminders of how the evolution of this industry is driven by factors other than prices, such as technological innovation and tax policy, even if prices capture most of the public's attention.

Should Canada lower its dependence on oil or other resources because they are cyclical or because we are too dependent on them? To start, our overall dependence on oil should not be exaggerated. Oil extraction accounts for about 3% of Canada's GDP, while adding investment by the industry lifts the total share of oil-related activity to 6% (compared with 11.7% for manufacturing output and investment and 6.8% for housing). Employment in oil production is a smaller share of all jobs, because of its capital-intensive production processes. Of course, oil has a much greater significance for some sectors and regions, notably exports and Alberta.

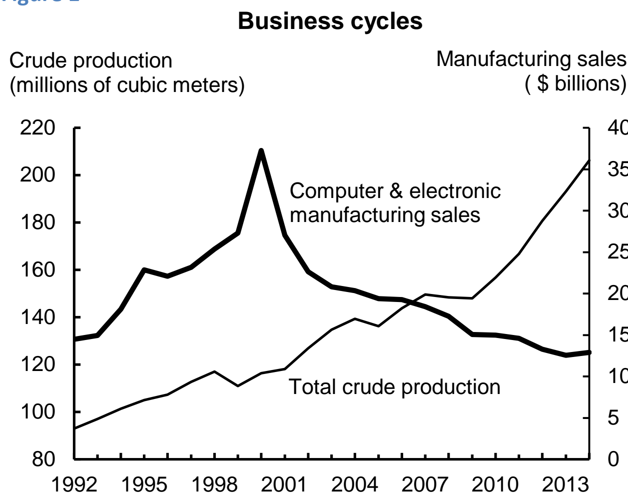
Many industries are much more cyclical than resources. The boom in resources after 2002 can be seen as a correction to Canada's under-investment in natural resources and over-reliance on manufacturing for growth in the 1990s, culminating in the ICT bubble in 2000 at companies such as Nortel and JDS Uniphase. Being responsible for Statcan's business cycle analysis at the time, whenever people asked me what was the business cycle, I would pull out the following graph for the Computer and Electronics Manufacturing industry. It shows years of monotonic increases, followed by years of unbroken decline, a textbook example of boom and bust (bust implying industry output returns to where it began, resulting in stagnation over the long term). Yet at the time, I never heard anyone decry our over-reliance on a cyclical industry like high tech manufacturing. Housing and the auto industry also follow a pattern of recurring growth and recession. Being cyclical is not a reason to discourage particular industries, especially those where long periods of growth far outweigh short periods of contraction.

What is the impact of lower oil prices on growth? There is no reason to argue with the Bank of Canada's estimate that the halving of oil prices will shave 0.3 percentage points off real GDP this year. Cyclical downturns in the resource sector are different than in autos or housing, where production bears the brunt of the drop, not prices. This is especially true for oil, where the impact is almost exclusively felt by prices and profits, not real output or employment. This is reflected in the leading indicator I compile, which fell 0.2% in the latest month; excluding commodity prices, the index rose 0.3%, showing that the effect has been largely confined to lower prices. The negative impact of lower oil prices will be concentrated in business investment, where oil and gas has become the largest industry at $90 billion in 2014.

While falling business investment in energy will slow the future growth of crude oil production, oil output does not decline rapidly during recessions like auto assemblies do. Once you have made the

investment in oil production, especially oil sands plants, you rarely turn them off. During the 2008-2009 recession, for example, total oil production fell only 1.1% in volume (Figure 1) and oil sands output actually grew by 12%. By comparison, auto assemblies plunged by 35% in 2008-2009 while capital spending was halved. The oil sector cuts investment more than output during its downturns.

Figure 1



It is possible the overall economy could even strengthen during 2015, since the cuts related to lower oil prices were implemented quickly and prices seem to have stabilized. Again, recall 1998, when oil prices fell in response to the Asian financial crisis and the subsequent Russian debt default. Despite this setback, the Canadian economy accelerated significantly to over 4% growth, pulled along by the tailwind of a pick-up in the US economy, which for Canada is several times more important than developments in the rest of the world.

One apparent difference is that the 1998 crash in oil prices reflected falling global economic demand outside of the US. The retreat this winter appears more related to increased supply than falling world demand. That external demand continues to expand is encouraging for our overall growth prospects outside of the oil sector. With the US economy poised to finally break through its recent ceiling of 2.5% growth buoys the outlook for Canada going forward in 2015. The latest monthly readings for output and jobs surprised on the upside. This contradicts polls which show a majority of Canadians feel the economy is declining, a sentiment driven more by the widely-publicized drop in prices for oil, the stock market and the Canadian dollar. Losses in the resource sector are concentrated more in prices and profits than output and employment, unlike most cyclical industries. The loss of income and wealth is compounded by a lower exchange rate. Put another way, the pain is going to be felt more on Bay St than on Main St.

Another positive outcome could result from the recent slump in oil prices. It appears to be leading Alberta’s government to a fundamental reassessment of its overall fiscal strategy, notably its over-reliance on volatile resource revenues and its reluctance to set aside some of these revenues for investment instead of current expenditure. Such a review is long overdue.