Euler Hermes Economic Research

Economic Insight

Low Energy Prices More of a Canadian Curse than Blessing

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Executive summary

- The previously resilient Canadian economy will be sharply impacted by the fall in oil prices with a net loss of half a point of GDP in 2015.
- Lower exports revenue and capital expenditures, fewer highly skilled jobs, and turbulence for housing and public spending in energy-dependent areas are among the negative consequences of the drop in energy prices.
- Lower energy prices also mean positives: a drop in fuel prices, a recovering chemical sector, a weaker Canadian Dollar, and an export boost to the U.S.
- In the short run, companies need to keep credit risk under scrutiny. Higher risk in the Machinery/Equipment sector and an increase in insolvencies (+4% in 2015) are expected.

Oil Prices to reduce 2015 GDP by 0.5pp

The sharp decline in oil prices has created a headwind for the Canadian economy whose prognosis had otherwise been generally healthy. Oil has an outsized impact on the Canadian economy and Euler Hermes expects that the fall in oil prices is likely to take -0.5 percentage points off of 2015 GDP bringing it from 2.4% under a 100$/barrel assumption to 1.9% with a 59$/barrel assumption. Insolvencies are likely to rise for the first time since 2001 by 4%.

Resilient economy now facing headwinds

Since the end of the recession, the Canadian economy has been more resilient than most other developed economies, including the U.S. Canada recovered all of the jobs lost in the recession in just 27 months (Figure 2), whereas it took the U.S. 75 months to achieve this milestone.

The resilience of the economy has been evident in the business sector: insolvencies fell at an average annual rate of -8% between 2000 and 2012 and continued to fall in 2013 and 2014 albeit at a much slower rate (-2%). The level of bankruptcies reached a historical low in 2014, with just two main sectors registering a sensitive level of risk according to Euler Hermes: Textile and Paper.

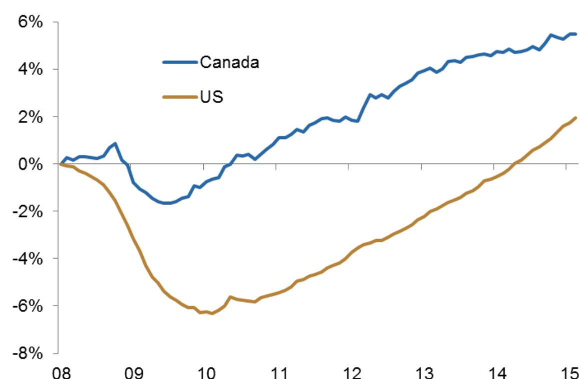
Figure 1: GDP Forecasts and Oil Price Assumptions

	2014 (A)	*2015 (PF)*	**2015 (F)**	**2016 (F)**
GDP growth	2.5	*2.4*	**1.9**	**2.1**
Oil price WTI (USD)	93	*100*	**59**	**71**
CAD	1.10	*1.15*	**1.30**	**1.27**

A=Actual F=Forecast PF=Prior Forecast

Sources: IHS, Euler Hermes

Figure 2: Percentage of Jobs Lost and Gained in Canada and U.S. Since Start of Recession (Jan-08)



Sources: IHS, Statistics Canada, BLS, Euler Hermes

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Currently depressed oil prices are likely to take a toll on the Canadian economy despite the fact that energy, and oil and gas extraction in particular, take up only 10% of GDP and employment. Yet as shown in Figure 3, there is firm evidence that oil prices are positively correlated with GDP growth. The relationship between the two is complex however since there are both positive and negative effects.

Negative Effects

Negative effects include falling petroleum exports, a drop in capital expenditures particularly impacting the machinery sector, and more localized effects to some provinces such as increased unemployment, deteriorating housing markets and damage to government finances. In particular, the province of Alberta is most exposed to the oil industry, and to a lesser extent the provinces of Saskatchewan and Labrador & Newfoundland are as well.

1. Petroleum exports down 38% but CAD weakness has offset some of this.

The Canadian trade balance, currently in surplus over the past 12 months, can be divided into two highly divergent sectors, energy and non-energy (Figure 4). As oil prices have declined over -50% since June of 2014, the energy trade surplus has shrunken -38%. Offsetting this decline however the ex-energy trade deficit has shrunk -13% since October, driven by the falling Canadian Dollar (CAD).

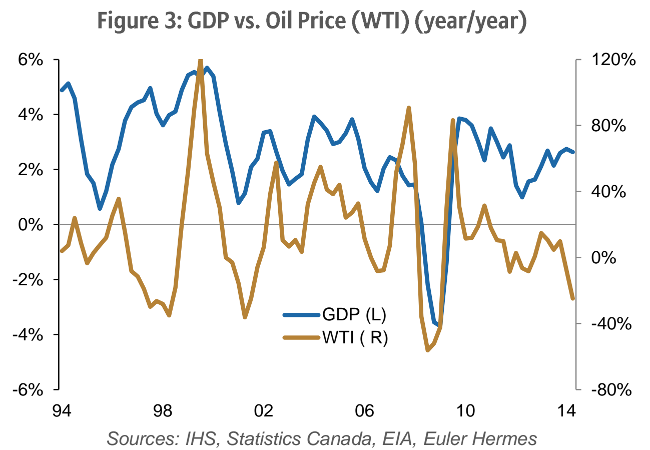
2. Falling Capital Expenditures will shave 0.3% from GDP

Over the past decade, capital expenditures (CAPEX) for construction in the oil and gas sector have comprised over a third of all capital expenditures for non-residential construction. Capital investment in Western Canada, including the oil sands, will add up to $46 billion in 2015, down from $69 billion invested in 2014. Regarding oil sands, capital investment is forecast at $25 billion in 2015, down from $33 billion last year. Moreover, capital spending in the conventional oil and gas portion of the Western Canada Sedimentary Basin is expected to decrease to $21 billion this year, from $36 billion invested in 2014. The total number of wells expected to be drilled in Western Canada this year is forecast to decline by 30% to 7,350. Clearly if those forecasts are confirmed, they will have a significant effect on the total economy: a 25% fall in oil CAPEX will trim 0.3% from real GDP in 2015.

3. Housing issues and fiscal contraction focused on energy-dependent areas

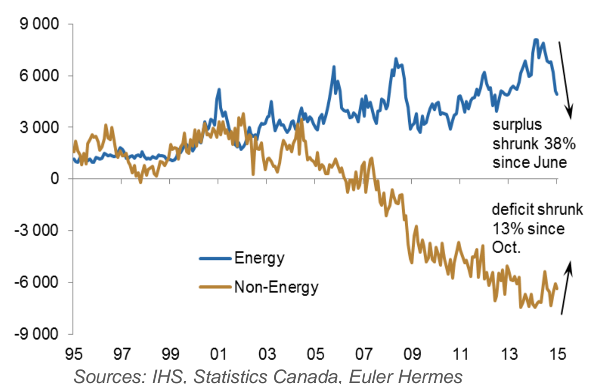
The housing market in the oil rich provinces is also likely to see downward pressure both in activity and prices. As shown in Figure 5, over the past three months ending in February, housing prices in 11 major cities fell at an annualized rate of -0.8% on average. But prices declined -6.2% in Calgary, Alberta and have fallen for four consecutive months. While Alberta has only 11% of Canada's population, it accounts for about 20% of the country's housing activity. If a firm increase in mortgage defaults occurs, housing activity could come under significant pressure.

Figure 3: GDP vs. Oil Price (WTI) (year/year)



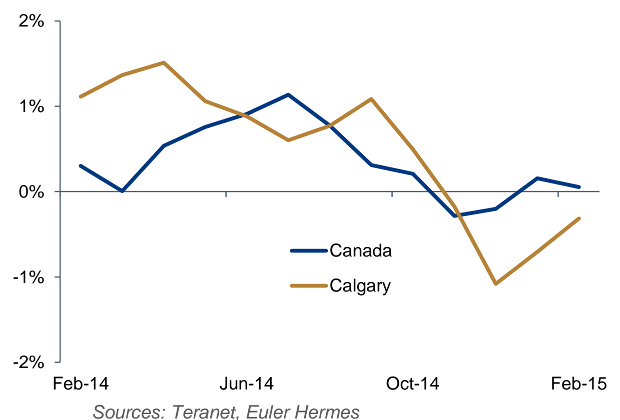
Sources: IHS, Statistics Canada, EIA, Euler Hermes

Figure 4: Trade Gap in Energy and Non-Energy Sectors



Sources: IHS, Statistics Canada, Euler Hermes

Figure 5: Housing Prices, m/m



Sources: Teranet, Euler Hermes

Provincial governments, especially Alberta, Saskatchewan, and Newfoundland and Labrador rely on royalties from oil and gas production as a major source of revenue. As a result, a 9% cut in spending has been proposed for next year's Alberta budget although there is considerable opposition to that proposal. Estimates for the federal government project as much as CAD5bn lost over the next two years, a total of -0.3% of GDP, possibly sending the budget into deficit and crimping any new spending plans.

Figure 6: Provincial Budgets and Oil Price Assumptions

FY 14/15 (f) Budget, CADbn	Alberta	Saskatchewan	Newfoundland & Labrador
Revenues	43,928	14,242	7,291
Expenses	40,760	14,167	7,829
Balance	3,168	75	(538)
Resource Revenue	9,821	2,805	2,398
Assumes WTI (US$/bbl)	96.69	99.89	105.00*

*FY 13/14 estimate

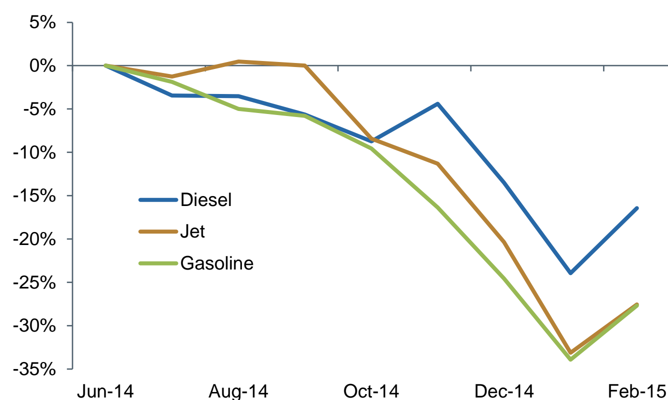
Sources: IHS, Bank of Montreal, Euler Hermes

4. Limited effect on jobs but concentrated on high paying positions

Oil companies are also announcing job cuts, and the Canadian Association of Oilwell Drilling Contractors forecasts that as many as 23,000 jobs will be cut in 2015. While this would amount to a dramatic -14% hit to the approximately 170,000 workers in the mining and oil and gas extraction sector across Canada, it would amount to only -0.1% of all of Canada's 17.9 million people currently employed. However, employees in that sector earn about three times as much, pushing the possible effect to -0.3% of aggregate wage income.

There are two factors that will help the damage from falling oil prices. First, Canadian oil sands projects can break even at prices as low as USD30-35/bbl. Even as some companies are cutting their capital spending, they are still projecting production increases of 6%-11% this year. The second mitigating factor is a weaker CAD which helps offset the drop in the price of oil denominated in USD.

Figure 7: Change in Fuel Prices Since June 2013



Sources: IHS, Statistics Canada, Euler Hermes

Positive Effects

The drop in fuel prices, a strong recovery in the chemical sector, a weaker Canadian Dollar (CAD), and a boost to U.S. economy could all support Canada's growth in 2015.

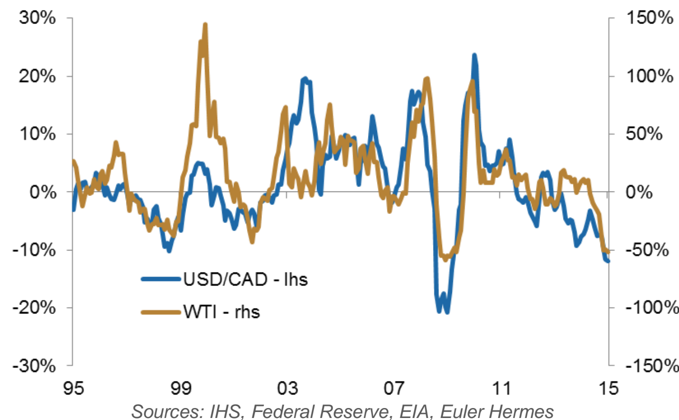
1. Lower gasoline prices drive consumer spending boost

In the 12 months before oil prices started to fall in June of 2014, Canadians spent CAD64bn on gasoline, an amount equivalent to 3.3% of GDP. As shown in Figure 7, Canadian gasoline prices have since fallen 28%, giving consumers a lift of 0.9% of GDP. In addition, over the past year diesel fuel has fallen 16% while jet fuel has dropped 28%, providing an extra benefit to consumers as well as trucking firms and airlines.

2. Strong recovery in the chemical sector due to lower input costs

After experiencing fluctuations in recent years, the chemicals market is expected to experience strong growth thanks to falling fuel prices and rising investments. As energy prices are expected to remain low going forward, production costs will remain moderate and allow chemical manufacturers to earn higher profits.

Figure 8: CAD vs. Oil Prices (y/y)



Sources: IHS, Federal Reserve, EIA, Euler Hermes

3. Weaker CAD boosting competitiveness

Lower oil prices tend to drive the value of the CAD lower against the USD as shown in Figure 8. In turn, a weakening CAD makes Canadian (non-energy) exports more competitive as shown in Figure 9, contributing to GDP growth.

4. An improving U.S. is a key support for the Canadian economy

As a result of the drop in gasoline prices, the U.S. consumer will experience an effective increase in disposable income equivalent to around +0.5% of GDP, or about USD1,000 per family per year. That extra spending power will provide a boost to Canada since about 20% of all Canadian economic activity is reliant upon exports to the U.S.

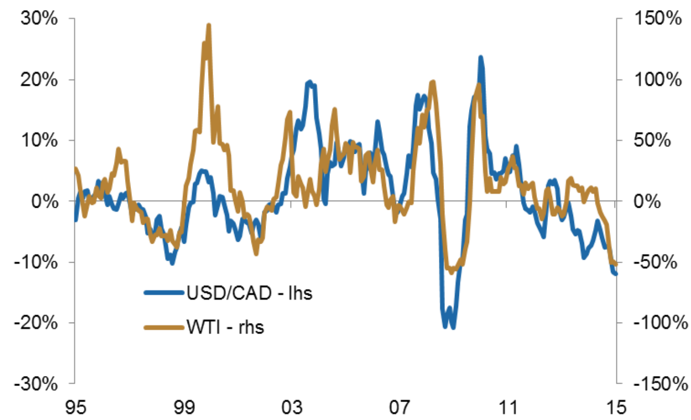
How resilient will the private sector be in the short-run?

The balance of the positive effects and negative effects is likely to have two main impacts on the private sector in the short-run:

- On the sector risk rating side: Chemical firms will be the main beneficiaries of lower energy prices. However the machinery & equipment sector is facing a downward trend due to falling investments from the oil and gas industry, suggesting a downgrade of its risk rating from Medium to Sensitive. All other sectors' grades will remain unchanged (Figure 10).
- Insolvencies will rise (+4%) for the first time since 2001 (Figure 11).

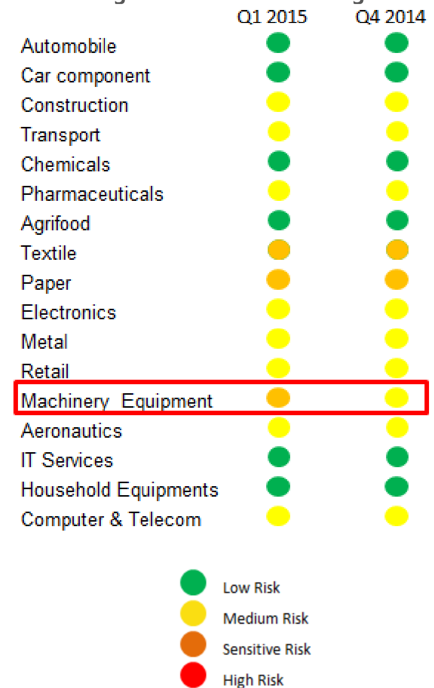
In response to this situation, companies exposed to the oil sector should closely monitor payment delays as well as the path of oil prices. Several significant Canadian energy businesses have already become insolvent with losses to creditors. Companies with exposure to businesses which depend on provincial spending are also at risk. Accounts receivable from oil producers throughout the value chain are currently at a heightened risk of late payment or default. Companies selling to these businesses may want to shorten payment terms, extend smaller credit lines, or purchase a trade credit insurance policy.

Figure 9: CAD (year/year) vs. Exports (CAD mn)



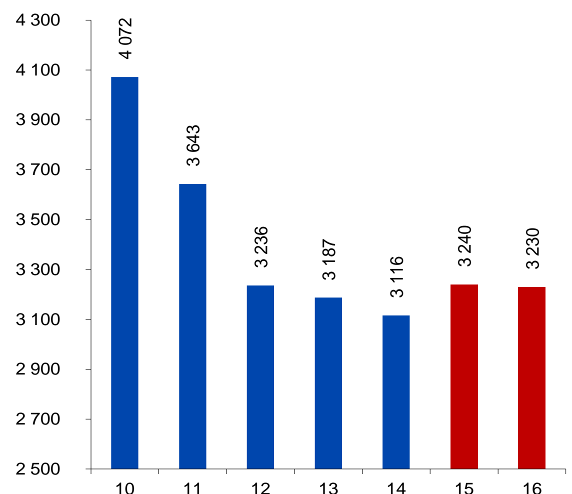
Source: IHS, Statistics Canada, Federal Reserve, Euler Hermes

Figure 10: Sector risk ratings



Source: Euler Hermes

Figure 11: Yearly insolvencies in Canada



Source: IHS, Statistics Canada, Euler Hermes

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