Oil and the Economy in Nine Charts

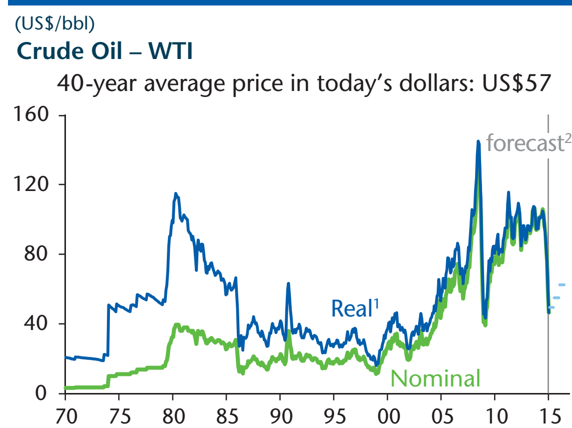
Douglas Porter and Robert Kavcic

As Finance Minister Joe Oliver discovered while trying to formulate his first budget at the confluence of early election spending and an unforeseen oil crash, economics and politics don't always reconcile. To the extent that economic factors can be foreseen, BMO's Douglas Porter and Robert Kavcic are among the nation's leading forecasters. Here's their latest read on the impact of oil on the economy; invaluable intelligence in an election year.

The Canadian economy's reliance on oil was certainly no secret before November, 2014. But the OPEC meeting in Vienna at which the organization declined to cut its output, sending oil prices crashing, exposed in brutal short order the degree to which the national economy as well as those of oil producing provinces—Alberta's in particular—are vulnerable to market fluctuations. Amid the uncertainty, there are facts we can marshal, along with some well-informed assumptions.

- The plunge in oil prices of more than 55 per cent in just over six months is the third deepest correction in such a short period of time in the past 45 years.
- Our economic forecast now assumes that prices will remain on the defensive through the first half of this year and average just $52 (WTI) in 2015. While we see a partial rebound next year, our working assumption has been trimmed to $65 for 2016.
- These levels compare with an average price of $57 over the past 40 years, measured in today's dollars.

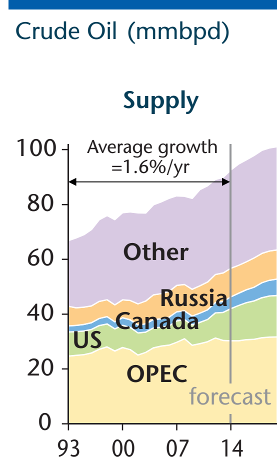
Chart 1:
Crude Prices Collapse



¹ January 2015 US$ ² [nominal] half-year averages

- While a variety of factors have conspired to undercut prices, including a roaring US dollar, the dominant factor has been on the supply side.
- Global supply rose by 2.0 per cent last year, above the long-run average growth rate of 1.6 percent.
- Notable gains have come from the US (again the world's largest producer), Canada (now the fourth largest) and Iraq (reaching record levels of 4 million bpd by December).
- Fully 8 of the top 10 producers are now reporting output well above their own 20-year trend. Only Iran and Mexico have seen production declines.

Chart 2:
Global Oil Production: Gathering Speed



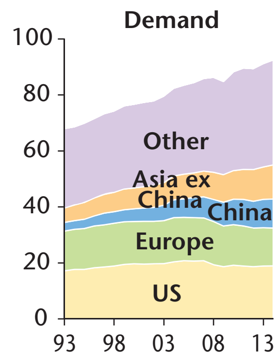
Top Producers	2014	1993-2013 Average
US	11.7	8.1
Russia	10.4	8.2
Saudi Arabia	9.7	7.8
Canada	**4.3**	**3.0**
China	4.1	3.5
Iraq	3.3	1.8
Iran	2.8	3.3
UAE	2.8	2.1
Kuwait	2.8	2.1
Mexico	2.8	3.3
Global 2014	**93.2**	**+2.0%**

¹Includes products Source: International Energy Agency

- Softer-than-expected global growth has also played a role in oil's weakness. Even with global GDP growth of just over 3 per cent in 2014 (similar to what is expected in 2015), oil demand only rose 0.8 per cent.
- That divergence between 2 per cent supply growth and 0.8 per cent demand growth swung the overall oil market from a balanced (or even tight) market a year ago, to an over-supplied market of more than 1 per cent (i.e., more than 1 million BPD).
- What caught the market completely off-guard, and thus the steep plunge in prices, was the fact that OPEC (i.e., Saudi Arabia) refused to step in to balance the market. Recall that prices were still around $75 prior to the late-November OPEC meeting.

Chart 3:
Global Oil Demand: Losing Momentum

Crude Oil (mmbpd)



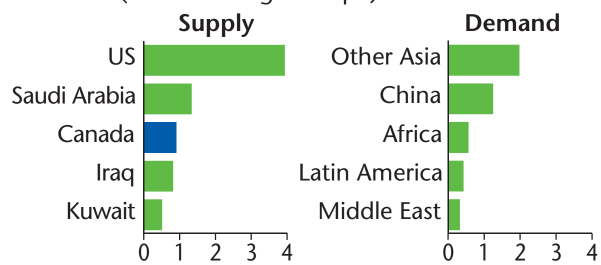
Top Consumer	2014	1993-2013 Average
US	19.0	19.2
Europe	13.5	14.9
Other Asia	12.2	8.3
China	10.3	6.1
Middle East	8.1	5.8
Latin America	6.8	5.2
Russia[1]	4.8	4.1
Africa	4.0	2.8
Global 2014	**92.5**	**+0.8%**

[1]Former Soviet Union Source: International Energy Agency

- Zeroing in on just the past four years reveals the crux of the issue for the oil market, and the mismatch between supply and demand.
- US production has seen an amazing turnaround, with output surging nearly 4 million bpd, taking it back to levels not seen since the early 1970s and reversing more than three decades of declining production.
- Meantime, Canada has been quietly churning out solid gains as well, which in fact have been underway since the early 1980s.
- On the flip side, demand growth remains muted and confined to the emerging markets. Note that oil consumption is now lower in the industrial world than it was 20 years ago.

Chart 4:
What Has Changed?

Crude Oil (2010-14 chng: mmbpd)



Source: International Energy Agency

- The net effect on the global economy of the deep dive in oil prices is still a matter of debate. While we would agree that it is, on balance, a positive for global growth, the benefits may be a bit more tempered this cycle because: 1) most major central banks don't have room to cut interest rates meaningfully (which normally provides the positive second-round effects); and, 2) a number of oil producers will face immediate strains.
- The most obvious strain will be on Russia, which is facing a very serious recession in 2015.
- On the flip side, almost all of the industrialized world will benefit from the oil price slide, especially the big importers in Japan, India and China. Canada and Norway are the outliers on this front.

Chart 5:
Winners and Losers of Low Oil?

Net Trade in Oil & Products – 2014 est. (% of GDP)

Winners: Net Importers		Losers: Net Exporters	
Turkey	6.2	Saudi Arabia	42.9
Japan	5.1	Venezuela	36.4
India	5.1	Russia	13.5
Eurozone	3.0	Iran	13.1
China	2.8	Norway	9.8
United States	1.2	**Canada**	**3.5**
United Kingdom	0.6	Mexico	1.0

- The decline in oil prices is a net negative for the Canadian economy, likely cutting 0.5 per cent from real GDP growth in 2015.
- Oil & gas extraction directly accounts for just over 6 per cent of GDP, and roughly 2 per cent of total employment. But, the true footprint is larger after accounting for support activities and spinoffs to other related sectors (manufacturing, transportation, etc.)
- Capital spending in the oil patch will feel the most direct hit, with many 2015 budgets slashed by 20 per cent-to-30 per cent. This accounts for a third of all private non-housing related capex.
- Lower oil prices mean lower incomes and corporate profits, which will cut Ottawa's tax revenues by about $5 billion.

Chart 6:
Oil Industry – How Big?

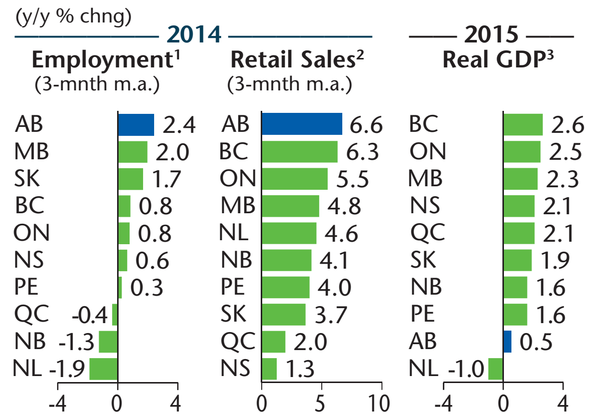
Share of Total – 2014 estimates (percent)

Oil & Gas Extraction	GDP	Employment[1]	Capital Spending[2]	Est. Net GDP Impact[3]
Canada	6.2	2.2	34	-0.5
Alberta	24	7.4	64	-3.0
Saskatchewan	15	5.0	30	-1.0
Nfld. & Labrador	22	7.1	23	-2.0
United States	1.7	0.7	8	+0.5

[1]Natural resources sector [2]Private non-res. business investment
[3]Impact over the next year

- The most dramatic impact may well be the reshaping of the regional economic growth landscape.
- Oil & gas directly accounts for 24 per cent of GDP in Alberta, 22 per cent in Newfoundland & Labrador and 15 per cent in Saskatchewan.
- Growth in Alberta is expected to stall (0.5 per cent in 2015) after a strong outperformance in recent years. Interprovincial migration flows to the province are likely to be cut by about two thirds from recent levels, while Calgary's housing market is already in the grips of a correction.
- The fiscal impact in these provinces is likely in the $8 billion range.
- Most other provinces benefit from lower oil prices and the associated weakness in the Canadian dollar. Ontario GDP growth should top the national average for only the second time in 13 years.

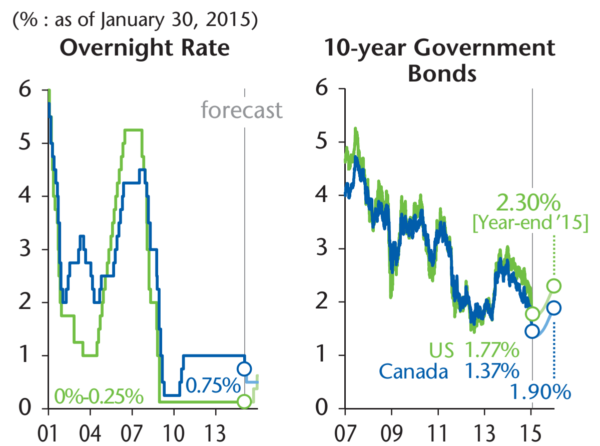
Chart 7:
Regional Outlook: The Changing of the Guard



[1]Dec. 2014 [2]Nov. 2014 [3]BMO forecast

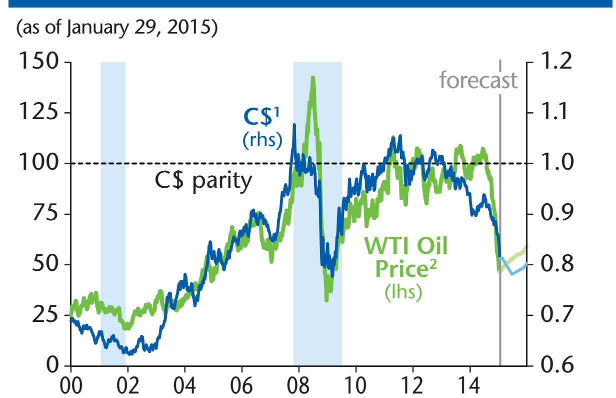
- After cutting interest rates 25 basis points to a Bank rate of 0.75 per cent, Governor Stephen Poloz said that, "The drop in oil prices is unambiguously negative for the Canadian economy".
- The cut was sold as an "insurance" move, should the expected offsetting positives (consumer spending, exports, business confidence) take longer to develop, or develop with less vigour.
- The Bank assumed $60 oil in the accompanying outlook, but sub-$50 oil could trim another quarter point from growth in the first half of 2015, further delaying the closing of the output gap, which is now pegged at the end of 2016.
- Barring a quick rebound in oil prices or clear evidence that strong US demand is lifting other sectors of the Canadian economy, another rate cut is possible in March. The last one was a surprise. Another one wouldn't be.

Chart 8:
Bank of Canada: Another Rate Cut Possible



- The loonie is arguably the biggest loser from the slide in oil prices, now moving above the $1.27/USD (79 US cents) mark for the first time since the financial crisis.
- A $10 move in oil prices typically swings the loonie by about 3-5 cents.
- Barring a sudden rebound in oil, we look for the currency to weaken further to around $1.30/USD (77 US cents) by mid-year.
- Diverging monetary policy prospects for the Bank of Canada (easing) and Federal Reserve (preparing to tighten) will also apply pressure. **P**

Chart 9:
Oil's Impact on the Loonie



[1](US$/C$) [2](US$/bbl) Vertical bands represent US recessions
Actuals: weekly averages Forecast: monthly averages

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