

# R<sub>x</sub> for Canada? Oil off the Boil

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*"The benefits of the current commodity boom can be felt across Canada—not just in the resource-heavy sectors and regions. Above all, rising commodity prices have made Canada wealthier as a nation."*

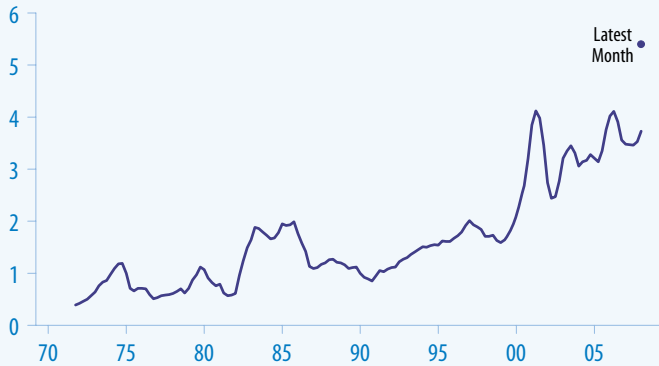
—Bank of Canada Governor Mark Carney, June 19, 2008

The received wisdom in recent years is that the Canadian economy benefits on net from higher oil prices, given the country's status as a significant (and growing) net energy exporter. That wisdom is in serious need of review. While the TSX may beg to differ, a pullback in energy prices would be good news for the economy. The traditional view on oil prices is based on the impact of moderate changes, not the disruptive, game-changing doubling we have witnessed in the past year. There is a strong case to be made that the energy price surge crossed the tipping point this spring from providing some economic ballast for the domestic economy to acting as a heavy anchor. So, even at a time when the trade surplus on energy goods has reached an all-time high of 5% of GDP (*Chart 1*), the negative hit on the prospects of Canada's major trading partners and consumers looms much larger. Here are three channels through which higher energy prices became too, too much of a good thing for the Canadian economy:

1) **Industry:** The surge in energy costs is first and foremost a problem for domestic industry, since it raises costs across the board and hammers growth prospects in the industrialized world. Notably, even the oil and gas sector has been unable to make much of a contribution to real output growth in recent years. Its share of GDP has actually dropped significantly from its peak in the mid-90s amid fading production of conventional oil & gas and despite rising oil sands output (*Chart 2*). Faced with soaring costs and a razor-tight labour market, even Alberta can not fully benefit from this year's spike in energy prices.

Meantime, the latest charge in gasoline prices has taken direct aim at U.S. auto sales, slicing them to their

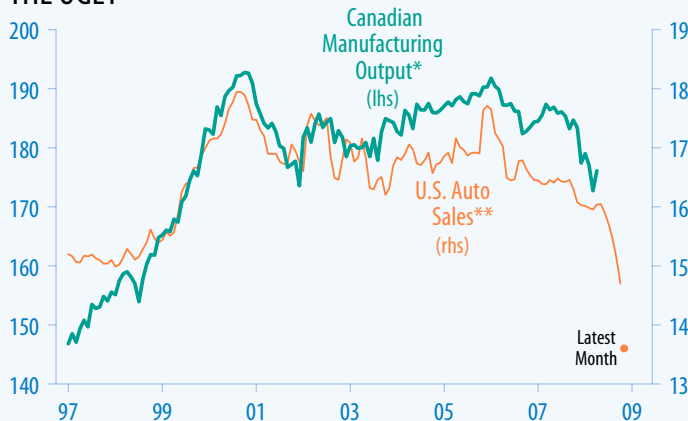
**CHART 1  
THE GOOD**  
Canada (% of GDP : 4-qtr m.a.)  
Energy Trade Surplus



**CHART 2  
THE BAD**  
Canada (% of Real GDP)  
Oil and Gas Output

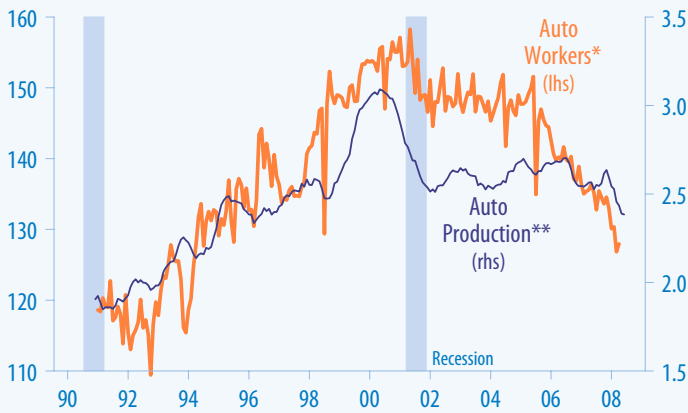


**CHART 3  
THE UGLY**



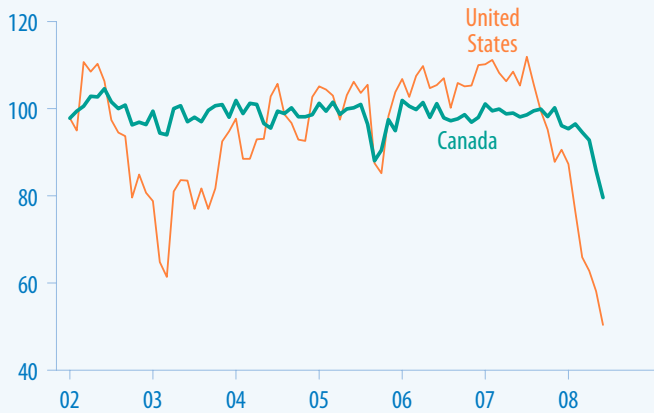
\* (2002 C\$ blns) \*\* (mlns units : 6-mnth m.a. : advanced 4 mnths)

**CHART 4**  
**CANADIAN AUTO INDUSTRY JOBS HIT HARD**

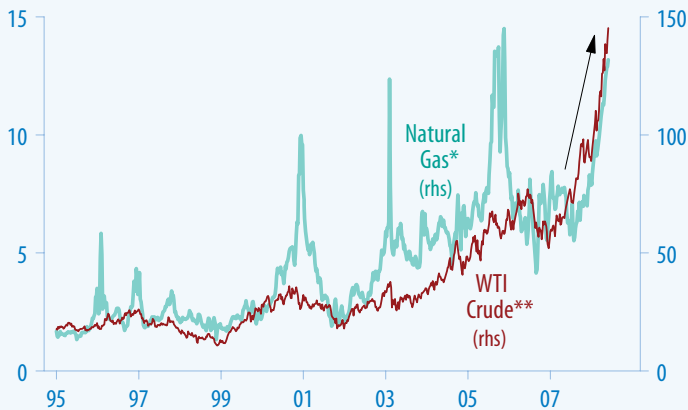


\* (000s) \*\* (mlns units : 12-mnth m.s.)

**CHART 5**  
**CONFIDENCE TAKES THE HIT**  
**Consumer Confidence**



**CHART 6**  
**NATURAL GAS BUBBLES HIGHER TOO**



\* (US\$/mmbtu) \*\* (US\$/bbl)

lowest level since the early 1990s. Since the Canadian economy is twice as sensitive to auto production as the U.S. economy (producing more than twice as many vehicles per capita), this sales downturn has hit Canadian industry hard, despite the fact that domestic sales are currently on track for a record year. If the U.S. sales slide in June is sustained, then an even deeper drop in Canadian manufacturing output could occur in the months ahead (*Chart 3*). Total auto sector employment in Canada is already down roughly 20% from the peak (a loss of 30,000 jobs) and looks poised to slide further as production ratchets lower (*Chart 4*).

- 2) **Consumer:** The energy price spike has also landed a direct hit on Canadian consumer sentiment and wallets. The consumer had no problem looking past the U.S. housing/subprime woes, but confidence really began to slide in May as oil hit record after record, taking gasoline prices with it (*Chart 5*). While sentiment is still somewhat healthier than in the U.S., thanks to solid real wage gains and a much stronger job market in Canada, the sag in domestic confidence has also put a chill into the housing market.

Plus, while raging gasoline prices have been hogging the headlines, natural gas has been quietly rising every bit as fast as crude oil in the past year (doubling in that period), and this will wallop household heating bills this winter (*Chart 6*). With many of the energy input costs for hydro companies on the march, it is only a matter of time before electricity prices also lurch higher in many provinces. Accordingly, total spending by Canadian households on energy (gasoline, natural gas, fuel oil and electricity) likely hit an all-time high as a share of disposable income in Q2 of about 7% and looks poised to continue heading higher (*Chart 7*).

- 3) **Inflation:** The dramatic sprint in energy costs is also finally making an important impact on Canadian headline inflation. After largely sheltering Canadians from global inflation forces for years, the loonie has singularly refused to budge since the start of 2008 even in the face of roaring commodities (*Chart 8*). To this point, firms had held the line on passing along cost increases, but the latest Bank of Canada Business

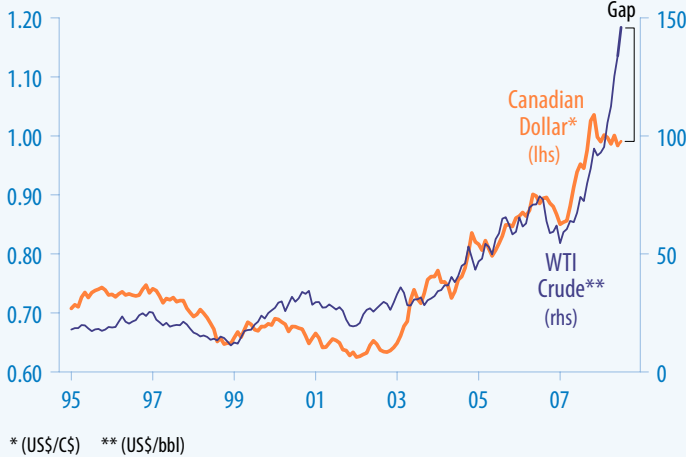
**CHART 7**  
**CANADIAN HOUSEHOLDS PAY THE PRICE**

Canada (% of disposable income : 4-qtr m.a.)

Spending on Energy



**CHART 8**  
**OIL AND LOONIE NO LONGER JOINED AT THE HIP**



Outlook Survey revealed that companies are now preparing to ramp up prices, and many expect inflation to stay above target. The CPI report for June (due July 23) could hit the 3% barrier, and threatens to push above that top end of the Bank of Canada's comfort range in the next few months. And keep in mind that these figures are still flattered by the 1-point GST cut at the start of the year—the underlying inflation rate will be closer to 3½%.

Still, this is better than in almost all of the rest of the world, where headline inflation is threatening to hit 5% in the U.S. and is already 7% or higher in 16 of the 40 largest global economies. Even so, Canadian inflation at or near the top of the Bank's target range and the possibility that inflation expectations may be grinding higher could prompt the central bank to begin hiking interest rates even as the economy is struggling in the months ahead.

**The Bottom Line:** Always be careful what you wish for, but some sustained moderation in oil and gas prices would be the most positive near-term development possible for the greater good of the Canadian economy at this stage. While it would no doubt be painful for the previously resilient TSX and Canada's merchandise trade surplus, lower energy costs would remove a tremendous burden from the U.S. and global economy and would take some of the pressure off simmering inflation pressures. How do you spell relief from mounting stagflation concerns? L-O-W-E-R-O-I-L-P-R-I-C-E-S.

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