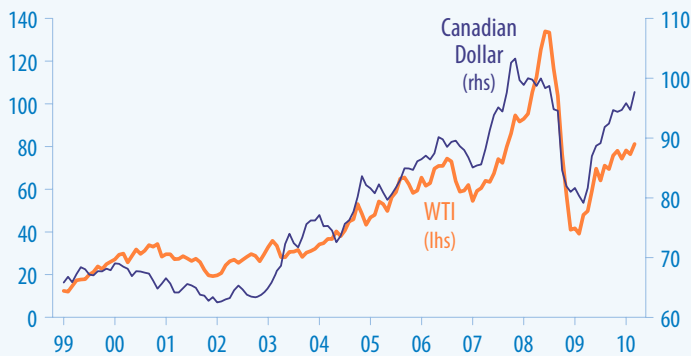


## Is Oil Fuelling the Loonie's Rise?

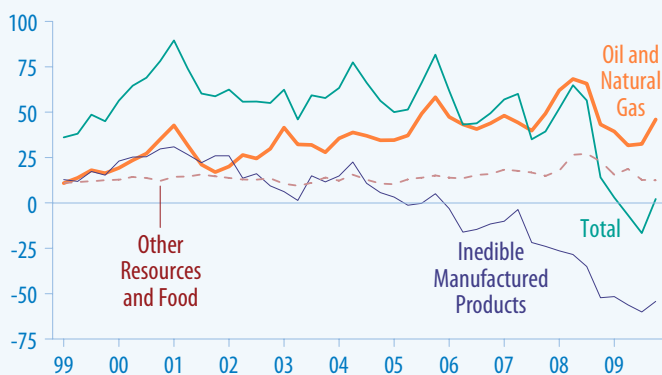
Earl Sweet, Senior Economist

**CHART 1**  
THE LOONIE AND OIL PRICES



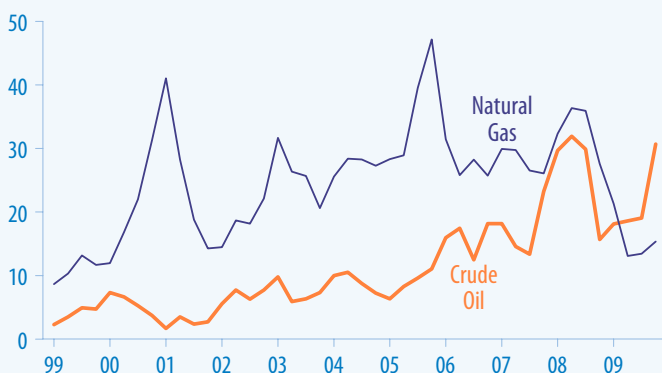
WTI = (US\$/bbl) Canadian Dollar = (US¢)  
Sources: Wall Street Journal, Bank of Canada

**CHART 2**  
CANADA'S MERCHANDISE TRADE BALANCE  
(C\$ blns : s.a.a.r.)



Source: Statistics Canada

**CHART 3**  
CRUDE OIL & NATURAL GAS TRADE BALANCES  
(C\$ blns : s.a.a.r.)



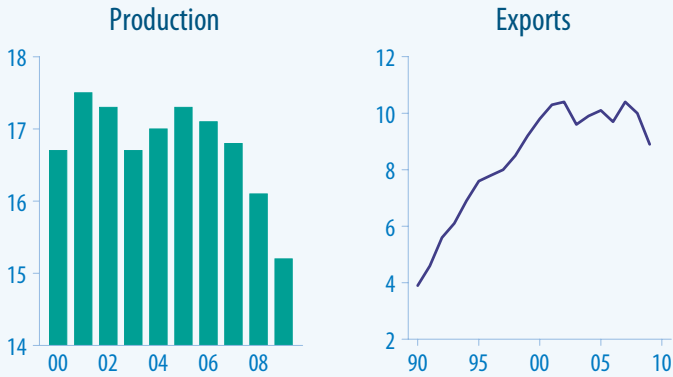
Source: Statistics Canada

The loonie is sometimes referred to as a 'petro-currency', but how important are oil prices to Canada? Over the past ten years, the Canadian dollar and oil have closely tracked each other (*Chart 1*). During the speculative commodity frenzy in the first half of 2008, oil temporarily sped ahead of the loonie. Now, the roles are reversed, with the loonie outperforming, supported by relatively strong economic fundamentals. Although the current disconnect between the two is likely to show some staying power, oil is becoming an increasingly important factor for the economy and the currency.

Canada's crude oil and natural gas trade surplus has trended upward since 2000 (*Chart 2*), with a particularly sharp increase in 2008 due to the commodity price surge. This, along with a steady surplus in other resources and food processing, offset a rapidly growing deficit in inedible manufactured products, reflecting the sharply rising loonie. Although declining petro-fuel export volumes and prices during the recession caused the oil & gas surplus to diminish and overall trade balance to fall into deficit, that trend is now reversing, with the exception of falling natural gas exports.

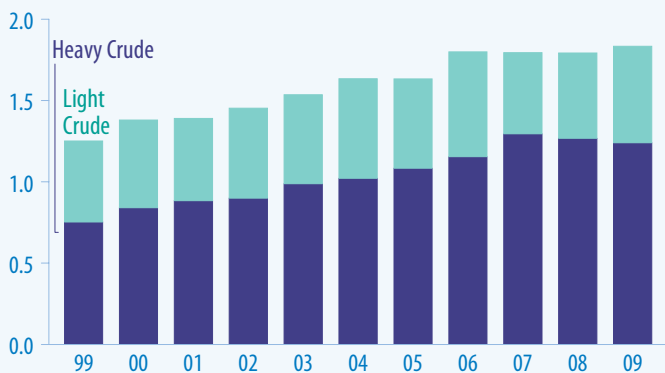
During most of the past decade, natural gas played a considerably larger role in Canada's energy surplus than crude oil (*Chart 3*), although that relationship is now shifting. Natural gas production in Canada, so far largely concentrated in conventional fields as opposed to resource plays such as shale, has been sliding since its peak in 2001 (*Chart 4*), as the productivity of those fields is in significant decline. This contributed to a topping out of export volumes to the United States early in the 2000s and notable declines during the past couple of years. This was exacerbated by a recession-induced sharp drop in U.S. demand and a steep rise in U.S. production of gas from shale formations. Although there are very promising shale resources throughout Canada, particularly in northern British Columbia, these are not likely to add significantly to production during the next couple of years. Additionally, more of Canada's natural gas will be diverted to domestic uses as natgas-intensive oil sands operations increase.

**CHART 4**  
**CANADIAN NATURAL GAS**  
(billion cubic feet per day)



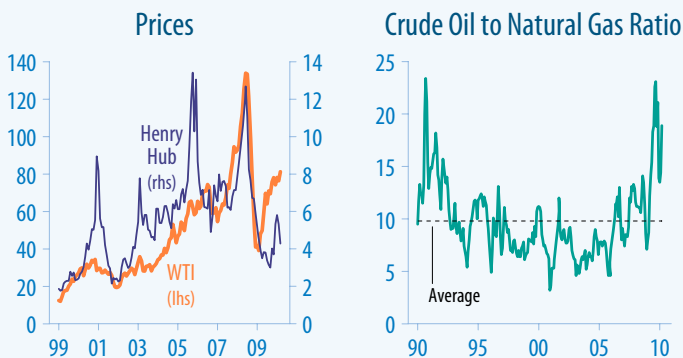
Source: National Energy Board

**CHART 5**  
**CANADIAN CRUDE OIL EXPORTS**  
(million barrels per day)



Source: National Energy Board

**CHART 6**  
**CRUDE OIL AND NATURAL GAS PRICES**



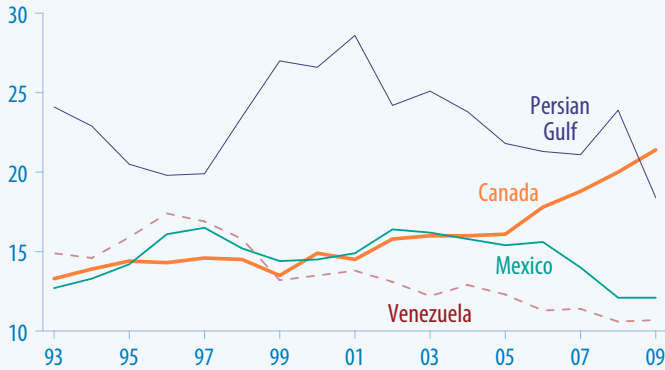
WTI = (US\$/bbl) Henry Hub = (US\$/mmbtu)  
Sources: Wall Street Journal, Natural Gas Week

Meanwhile, crude oil exports are on a rising trend, reaching 1.8 million barrels/day in 2009 (*Chart 5*). Although conventional, light-crude fields are facing the same stresses as natural gas, these have been more than offset by rising shipments of heavy oil, supported by growth in the oil sands. While exports during the past couple of years have levelled out, reflecting some production problems in the oil sands and recession-diminished demand, they are likely to soon resume their upward trend. First, there are signs that the demand for oil products is beginning to strengthen in the United States. Second, TransCanada's new Keystone pipeline, currently being filled, will soon be in operation. In its initial phase, it will provide close to 450,000 barrels/day additional crude oil export capacity to refineries in Illinois. A second phase, likely to start up by next year, will transport oil to the storage and distribution hub at Cushing Oklahoma and raise the pipeline's daily export capacity to approximately 590,000 barrels. And, a third phase, scheduled to be in operation by the end of 2012, would expand the pipeline and extend it to oil refineries on the Gulf coast, raising its total capacity to about 1.1 million barrels/day.

Another factor bringing crude oil to the fore in energy exports is the change in relative prices (*Chart 6*, showing U.S. benchmarks WTI for oil and Henry Hub for natural gas). Crude oil, a globally traded commodity, is receiving support from rapid growth in emerging markets such as China. However, natural gas, still largely a continental market, has been suppressed by deeply depressed, if improving, industrial demand and sharp increases in U.S. supply during the past two years. Since 1990, the price of a barrel of oil has averaged about 10 times that of a million British thermal units (approximately equivalent to the energy in 1000 cubic feet) of natural gas. During the past couple of years, the ratio has shot up to more than twice that level and will likely remain well above normal during the next few years.

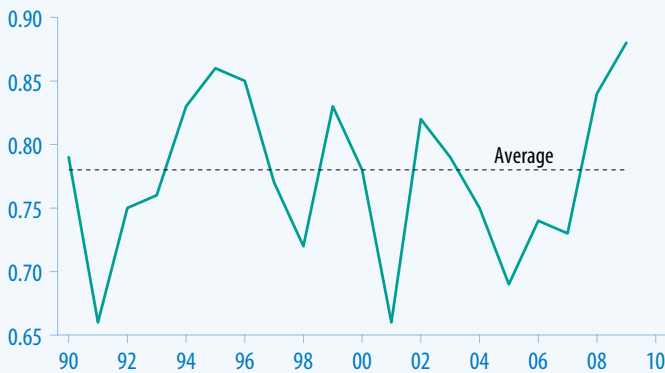
Further, there is strong demand for Canadian heavy oil by U.S. refineries, which have increased their capacity to refine the commodity. U.S. imports of heavy oil from Mexico and Venezuela have been on declining trends during the past several years (*Chart 7*), partly reflecting poor resource management in those countries. And, oil from Canada—now the number-1 supplier to the U.S.

**CHART 7**  
**U.S. IMPORTS OF CRUDE OIL**  
 (% share)



Source: EIA

**CHART 8**  
**HEAVY-LIGHT OIL PRICE RATIO**  
 For Canadian Exports



Source: National Energy Board

market—has also been replacing imports from the Persian Gulf. As heavy oil is more expensive to refine, it trades at a discount to light, sweet (low sulphur) oils such as West Texas Intermediate (WTI). Since 1990, the heavy-light price ratio has averaged 0.78 (Chart 8). During the past couple of years, however, the price gap has significantly narrowed due to restricted supplies of heavier crude, with the ratio now running close to 0.90. This has helped support the value of Canadian crude oil exports and the balance sheets of producers of the commodity. The price differential is likely to remain relatively narrow during the next year, although as pipeline export capacity expands and heavy oil becomes more readily available in the United States, the gap will likely widen again.

**Bottom line:** Crude oil has surpassed natural gas as a driver of Canada’s economy and trade surplus, reflecting significant shifts in market fundamentals for the two commodities. These forces are likely to continue for the next couple of years, although there are promising opportunities for renewed production and export growth for natural gas further out. The demand for Canadian crude oil from the United States and elsewhere will continue to grow and pricing is likely to remain favourable. Huge investments in the oil sands and increased pipeline export capacity will ensure that rising foreign demand will be met, with positive implications for Canada’s trade surplus. This will help support the loonie at, or moderately above, current levels for the next few years.

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