Economic Trends

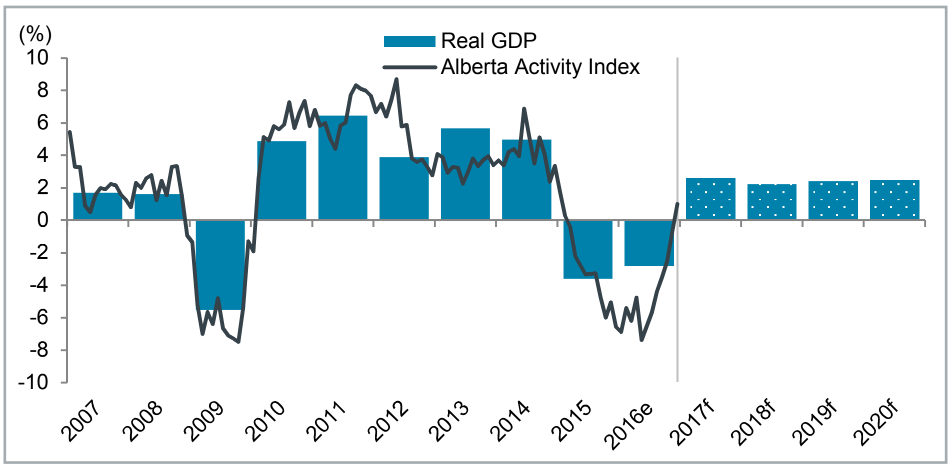
This month's Economic Trends is taken from the Economic Outlook chapter of Budget 2017: Working to Make Life Better, released on March 16, 2017.

The Road to Recovery

Alberta's economy will expand in 2017, with real GDP forecast to rise 2.6%. Activity is picking up in the province and many economic indicators are now rising (Chart 1), more than two years after oil prices began their descent. However, the recovery is expected to be moderate. The unprecedented decline in incomes during the downturn, particularly corporate profits, will continue to weigh on business investment and consumer spending. With oil prices rising gradually, but not expected to return to pre-recession levels, real GDP is forecast to remain below 2014 levels until 2019.

Chart 1: Alberta beginning to recover

Year-Over-Year Change in the Alberta Activity Index (AAX)* and Real GDP

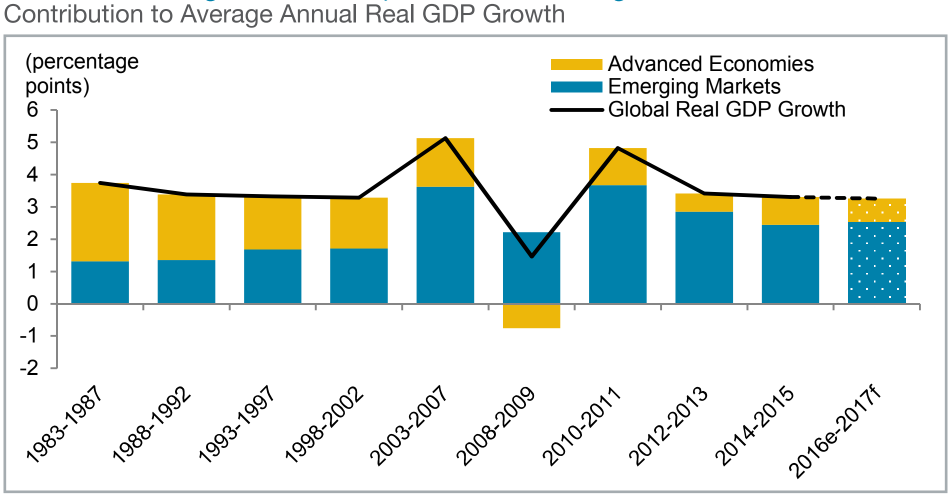


Source: Statistics Canada, Alberta Treasury Board and Finance, e-estimate, f-forecast

* Developed by Alberta Treasury Board and Finance, the AAX tracks economic activity closely. It is a weighted average of nine monthly indicators (employment, average weekly earnings, retail trade, wholesale trade, manufacturing, new truck sales, housing starts, rigs drilling, oil production).

Chart 2: Global growth unlikely to reach recent highs

Contribution to Average Annual Real GDP Growth



Sources: International Monetary Fund and Alberta Treasury Board and Finance calculations, e-estimate, f-forecast

Exports will drive the return to growth this year. Completed oil sands projects in 2016 and 2017 will see production grow markedly and expanding manufacturing output and government capital spending will also contribute to growth. Rebuilding in Fort McMurray and the bounce back in oil production following last year's wildfire-related disruptions are expected to add around 1% to real GDP growth this year.

As the economy transitions to the lower oil price environment, several factors will help smooth the adjustment. Business costs have moderated and a lower Canadian dollar will continue to support exports. A return to employment growth and slower labour force expansion are expected to facilitate a steady decline in the unemployment rate. Increased infrastructure spending is expected to boost activity and improve productivity. Alberta's population growth, while slowing, is forecast to expand faster than the Canadian average and incomes and investment are expected to remain higher than in other provinces.

Global Economy

After a shaky start to 2016, the world economy improved in the second half of the year. Momentum is expected to carry forward into 2017 and beyond, with real GDP growth forecast to be around 3.5%. Despite being hit by a number of disruptive shocks over the past five years, global real GDP growth has been remarkably stable between 3.0 and 3.5% (Chart 2). This trend is forecast to continue with steady expansion in the US and China and a retreat from recession for Russia and some Latin American economies as oil prices improve. While 3.0-3.5% growth is weak compared to the 2003-

07 period, a slowing China and the effects of population aging in the West make it unrealistic to expect growth to return to those levels. This is important for Alberta, since it reduces the probability of another demand-fueled commodity price boom.

US reaches full employment

For the first time in almost a decade, the US economy is operating at capacity and is projected to expand at its long-run growth rate of around 2.5%. Low unemployment and accelerating wage growth will help fuel growth in household consumption and ensure continued expansion in the housing sector. Business investment disappointed in 2015 and 2016, due to a larger than expected drag from the oil and gas industry, but going forward should pick up in line with the broader improvement in economic activity and oil prices. Improving labour market conditions have enabled the US Federal Reserve to begin tightening monetary policy. However, the central bank is likely to proceed cautiously with further tightening.

Emerging markets key for oil demand

Emerging market economies (EME) are the main source of growth in demand for commodities, making them particularly important for Alberta. EME growth is expected to rise in 2017, mostly because higher commodity prices will enable Brazil and Russia to exit recession. Although China remains a driver for the global economy, Chinese growth is expected to continue to ease as the pace of investment transitions to more stable levels. Growth in India is expected to outpace China, as it did for most of 2016, notwithstanding any additional impacts from last year's currency reforms.

Oil market rebalancing

The global oil market is expected to return to balance by the middle of 2017. US oil production fell by over 1 million barrels per day (bpd) between April 2015 and September 2016. In addition, OPEC pledged to cut 1.2 million bpd of production in the first half of 2017. Early signs in 2017 suggest compliance by OPEC members will be high; however, it remains to be seen whether these countries, many of whom are under substantial fiscal pressure, can maintain their commitments.

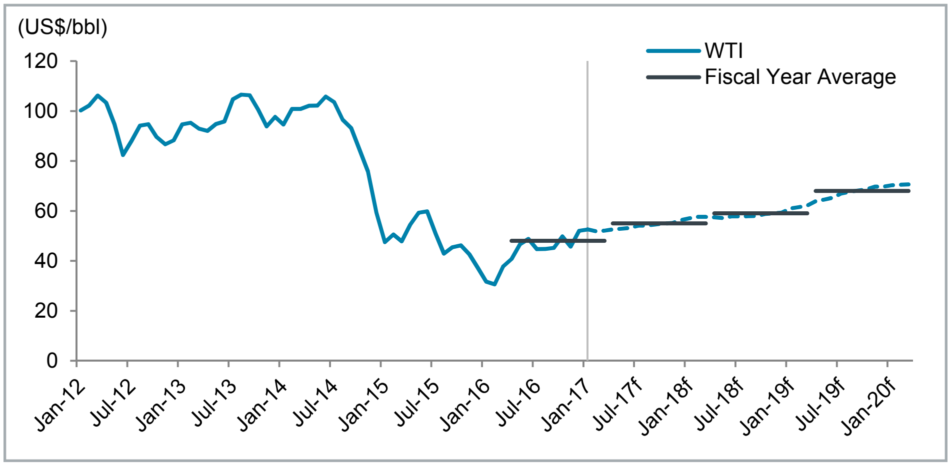
A key determinant of the oil price outlook is the supply reaction of US producers to higher prices. Improvements in drilling techniques and technology have lowered breakeven prices for US producers. This is expected to keep prices contained as elevated global inventories gradually unwind. West Texas Intermediate (WTI), the North American benchmark oil price, is forecast to average $US55/bbl in 2017-18 (Chart 3). Over the medium term, it is expected that additional production from other more expensive sources will be required to meet demand. WTI is forecast to rise to US$68/bbl by 2019-20 to keep pace, but will remain well below price levels seen in recent years.

Canadian Economy

Economic growth in Canada is expected to improve from weak to modest, rising from 1.4% in 2016 to 2.0% in 2017. This improvement is mostly due to diminishing headwinds from the oil and gas sector as energy investment stabilizes. Over the medium term, the Canadian economy is expected to expand close to 2.0%. With

Chart 3: Oil prices to gradually improve

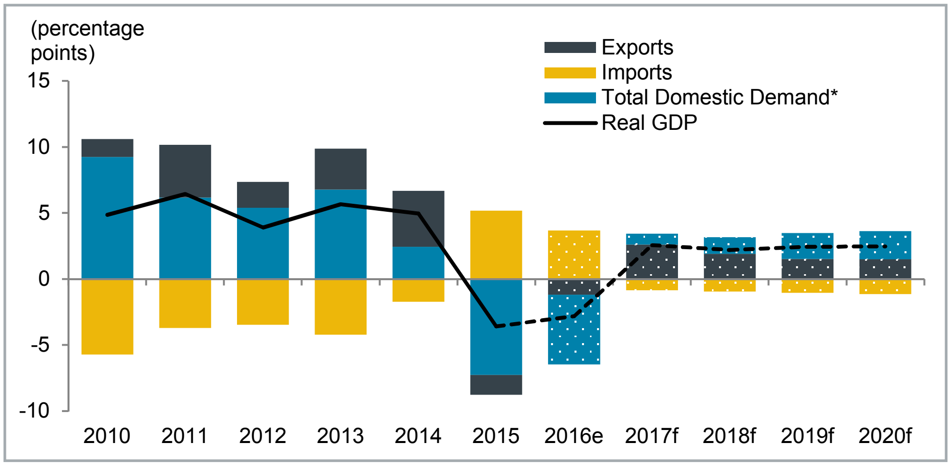
West Texas Intermediate



Source: Wall Street Journal and Alberta Energy, f-forecast

Chart 4: Demand recovering

Contribution to Change in Alberta Real GDP by Expenditure



Source: Statistics Canada and Alberta Treasury Board and Finance, e-estimate, f-forecast

* Includes total household, business and government spending

investment taking a back seat, growth will be largely driven by household consumption. Energy exports will also be an important source of growth as oil production in Alberta continues to expand. Non-energy exports should improve after growth stalled at the end of 2016, due in part to the substantial appreciation of the Loonie against most of Canada's major trading partners over the course of 2016. Some exporters will likely proceed cautiously with new investment, though, due to uncertainty around US trade policy. The Canadian dollar is expected to appreciate gradually along with oil prices, from US¢76.0/Cdn$ in 2017-18 to US¢78.0/Cdn$ in 2019-20.

Alberta Economy

After a two-year recession, the Alberta economy will begin to expand in 2017, growing 2.6%. Growth will be driven by rising exports, along with reconstruction efforts in Fort McMurray and public sector capital spending. However, with the steep decline in economic activity and incomes in the province over the past two years and the weak outlook for oil prices, the recovery will be longer than in past recessions. Real GDP is not forecast to return to its previous peak until 2019.

Box 1: Importance of Pipeline Access

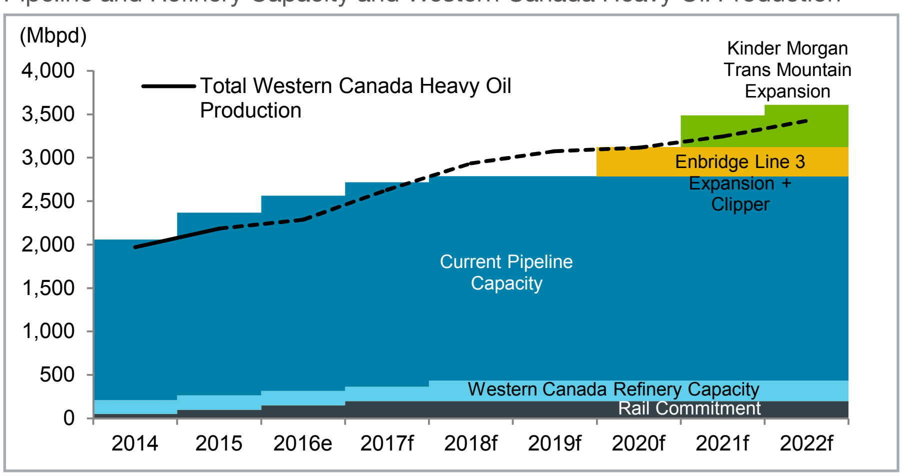
Alberta bitumen is priced at a discount to WTI because of the lower quality of heavy oil and the cost of transporting it to market. This discount is measured through the light-heavy (L/H) differential. Without sufficient pipeline access, oil sands producers incur higher transportation costs shipping their crude by rail, which is an estimated US$2-7/bbl more expensive than by pipeline, widening the L/H differential and reducing the returns Alberta producers receive.

Given the production profile of the oil sands, without additional pipeline access, it is expected that there will not be enough pipeline capacity to accommodate Alberta's oil sands production by early 2018 (Chart 5). The increased use of higher cost rail is forecast to widen the L/H differential from US$16.00/bbl in 2017-18 to around US$18.00/bbl in 2018-19. In addition, access to more lucrative heavy oil markets on the US Gulf Coast and in Asia is necessary for Alberta producers to maximize revenue and increase investment.

The approval of the Line 3 replacement and the Trans Mountain Expansion is a critical step in improving market access. Line 3 is expected to come online in 2020 and the Trans Mountain Expansion in 2021. Between 2017 and 2022, this will add an additional $10 billion to oil investment, which would result in a 150,000 bpd increase to production capacity by 2022, add around 1.5% to real GDP, lift average annual employment by 12,000 and boost royalty payments by $3-9 billion. Keystone XL would further enhance access to markets beyond 2022.

Chart 5: Pipeline access needed for oil sands production

Pipeline and Refinery Capacity and Western Canada Heavy Oil Production



Source: Alberta Energy, e-estimate, f-forecast

Exports drive economic recovery

Alberta's economic recovery will be spearheaded by exports and supported by production growth in several sectors, rising oil prices and a lower Canadian dollar. Real exports are expected to expand 4.6% in 2017 while imports remain muted due to weak domestic demand. As a result, trade is expected to add 1.8 percentage points to real GDP growth in 2017 (Chart 4). The contribution of trade will diminish over the medium term as export growth slows and household and business spending pick up.

A surge in oil sands output will drive exports. Two major mining projects are expected to come online this year. Along with the completion of several other projects, production is set to expand by more than 600,000 bpd over the next two years. Growth in 2017 will also be buoyed by a return of production that was deferred because of the Wood Buffalo wildfires. Production growth is forecast to slow starting in 2019 as the last of the projects initiated prior to the downturn are completed, with an additional 150,000 bpd of production capacity added by 2020. The ramp up in oil production over the next three years reinforces the need to expand pipeline infrastructure. The Enbridge Line 3 and Kinder Morgan Trans Mountain Expansion projects, recently approved by the Federal Government, will play a critical role in easing pipeline constraints and supporting industry growth and royalties (Box 1).

Machinery and equipment manufacturing and Alberta's engineering and technical expertise will benefit from increased activity in the global energy sector. The Sturgeon Refinery completion and the Joffre polyethylene plant expansion will increase chemical and refining product manufacturing, while food manufacturing is forecast to continue expanding. The province should receive an additional boost from tourism in 2017, as free national park entry in celebration of Canada's 150th anniversary is expected to attract record visitors to the province.

Conventional investment rebounds

Drilling for oil and higher margin natural gas liquids (NGL), along with innovation-driven well productivity gains, are expected to propel conventional oil and gas activity in the province. Conventional investment is forecast to grow by over 20% in 2017. With natural gas prices expected to remain low, averaging just below C$3/GJ over the next few years, drillers are expected to continue targeting NGL. Natural gas and NGL demand in Alberta will be bolstered by the oil sands sector and growth in petrochemical production and power generation.

The increase in conventional oil and gas drilling in 2017 is expected to lift overall energy investment by 4.9% in 2017 (Chart 6), before slowing to an average of 3.3% growth over the forecast period.

Slowing oil sands investment

Oil sands investment is expected to remain weak this year before stabilizing in 2018 and then ramping up gradually as oil prices and pipeline access improve. The last of the major oil sands construction projects that broke ground prior to 2015 will be completed by the end of 2018, while the plunge in oil prices over the past two years has curbed new investment. In addition, cost reductions mean that the amount of capital required to sustain current production and for new projects has declined. Investment in the oil sands is expected to grow in 2019 and beyond as oil prices and pipeline access improve. Even with the modest growth, non-conventional investment in 2020 is expected to be less than half of what it was in 2014, reflecting a leveling off of capital spending that had more than tripled during the 2010-14 period.

Muted outlook for construction

Outside the energy sector, investment continues to be hampered by declining private sector construction spending. Industrial and commercial construction fell in 2016, with declines accelerating in the second half of the year. A number of major projects were completed or are near completion and building permits have fallen significantly since the end of 2015. This suggests there will be fewer projects breaking ground in 2017. Private investment outside of oil and gas is expected to decline 5.8% in 2017.

Non-energy business investment is expected to return to growth in 2018 as the economic recovery takes root and business confidence increases. It is expected to grow 1.1% in 2018 and climb to over 6% by 2020. Investment will be boosted by the Petrochemicals Diversification Program and increased provincial government infrastructure spending.

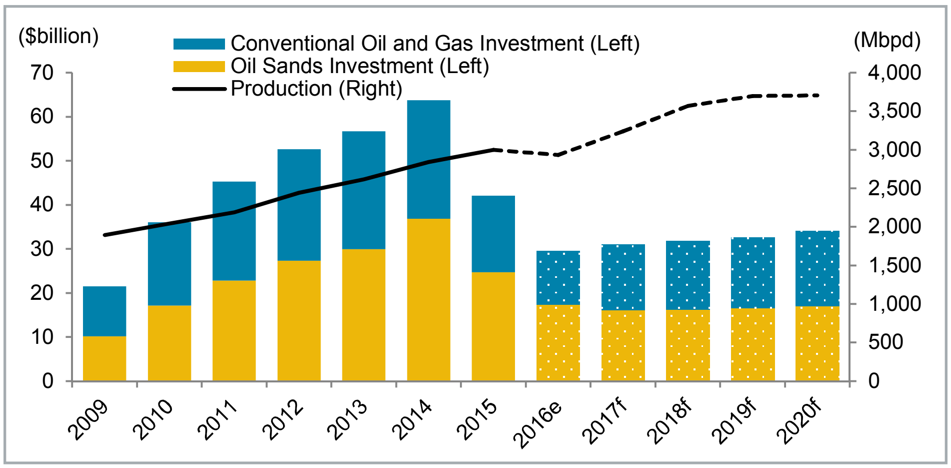
Labour market to recover gradually

Employment in the province is expected to improve in 2017 (Chart 7), carrying momentum from the second half of 2016. With conventional oil and gas and manufacturing activity increasing this year, and Fort McMurray reconstruction efforts and government infrastructure spending supporting construction, the goods sector is expected to drive the jobs recovery. However, lower oil sands and private sector investment will limit gains. Employment is expected to advance 0.9% in 2017 and grow by 1.4% in 2018, when it will surpass its previous peak.

Even as employment declined in 2016, people continued to join the labour force in Alberta. This caused the unemployment rate to rise to average 8.1%. In 2017, the labour force and employment will rise at almost the same pace, keeping the unemployment rate elevated at 8.0%. Beyond 2018, growth in employment is forecast to surpass

Chart 6: Energy investment stabilizing

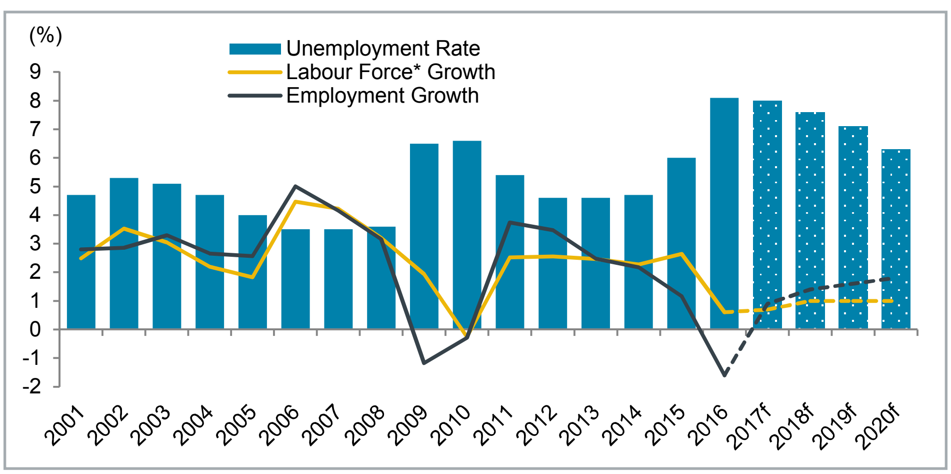
Alberta Energy Investment and Oil Production



Source: Statistics Canada and Treasury Board and Finance, e-estimate, f-forecast

Chart 7: Unemployment rate to ease

Alberta Labour Market Indicators



Sources: Statistics Canada and Alberta Treasury Board and Finance, f-forecast

* The number of people working or looking for work

labour force growth. As the participation rate declines towards a 35-year low due to population aging, the unemployment rate will fall steadily to 6.3% by 2020.

Income growth returns

With oil prices strengthening and producers sustaining cost reductions, corporate profits and labour earnings are expected to improve. Net corporate operating surplus, a measure of corporate profits and driver of corporate income tax revenues, is anticipated to grow over 60% in 2017 after an unprecedented decline over the past two years. This will boost nominal GDP, a broad measure of incomes, by over 5% this year (Chart 8). Over the medium term, continued economic expansion, higher oil prices and efficiency measures implemented during the downturn will allow for continued profit growth. Nevertheless, net operating surplus is not anticipated to return to pre-recession levels during the forecast period as oil prices remain below US$70/bbl through 2019-20.

A return to growth in high-paying goods sector jobs will have a positive impact on earnings in 2017. After falling for the second consecutive year, average weekly earnings (AWE) will grow 1.4% in 2017 before gradually accelerating to 3.0% by 2020. While this will keep Alberta's wages above the national average, and likely highest among provinces, it will take until 2018 before AWE returns to its 2014 peak. Similarly, after declining 3.5% in 2016, primary household income, a key driver of personal income taxes, will grow a modest 1.8% in 2017 before improving over the medium term.

Population growth continues

Population dynamics in Alberta are shifting due to the slowdown in Alberta's labour market. Although population growth remains above the national average, the pace of growth is slowing due to weaker migration. The number of Albertans leaving for opportunities in other provinces accelerated through 2016. This trend is expected to continue into 2017, with the net outflow of interprovincial migrants forecast to reach 11,000. However, natural increase and elevated international migration are expected to more than offset the outflow to other provinces and drive population growth of 1.3% in 2017. Over the medium term, population growth is forecast to pick up to 1.4% by 2020. Slower economic growth relative to the pre-recession period will reduce the contribution of net interprovincial migration, but immigration above 35,000 annually through 2020 and natural increase will provide a solid base for expansion.

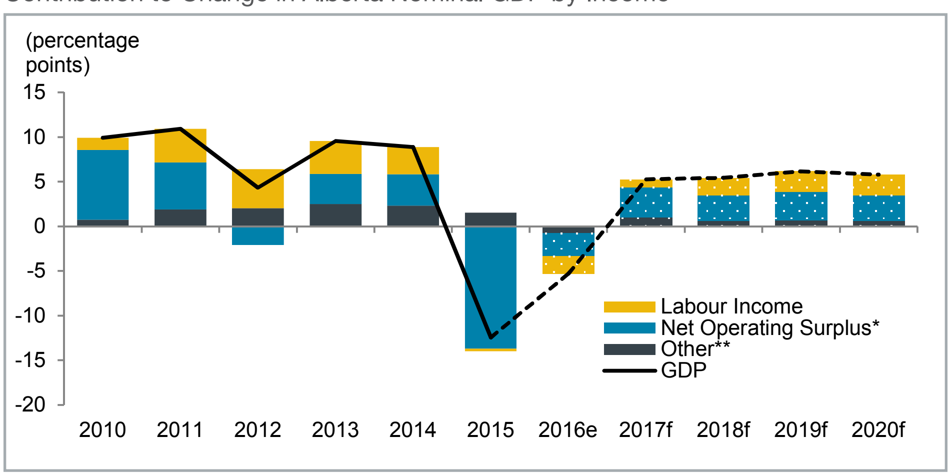
Households continue to adjust

Slower population growth and muted employment gains are expected to limit growth in consumer spending this year. Household expenditures are forecast to grow a modest 2.8%, or 0.9% in real terms (adjusted for inflation). Housing starts will be virtually unchanged from 2016 at 24,500. Despite rebuilding efforts in Fort McMurray, housing starts will be impacted by the completion of projects started prior to the downturn, which has led to record inventories of multi-unit builds in Calgary and Edmonton.

Over the medium term, an expanding population, relatively low interest rates and Alberta's high per capita income are expected to support housing and consumer spending. However, given the slower pace of the recovery, consumer spending growth will average 3.5%, about 1.5 percentage points less than the average over the previous 20 years. Housing starts are forecast to barely surpass 30,000 by 2020.

Chart 8: Incomes to improve

Contribution to Change in Alberta Nominal GDP by Income



Sources: Statistics Canada and Alberta Treasury Board and Finance, e-estimate, f-forecast

* Includes net operating surplus of corporations and net mixed income

** Includes consumption of fixed capital and taxes less subsidies

Risks to the Economic Outlook

- A reversal (continuance) of OPEC's policy to cut production, increased (decreased) non-OPEC production (e.g. from US shale producers) and/or lower (higher) demand growth could put downward (upward) pressure on oil prices and weaken (strengthen) Alberta's economic outlook.
- A US move towards more protectionist trade policies could trigger tariffs on Canadian goods and services, impacting Alberta's terms of trade and negatively affecting the outlook.
- Slower population growth due to higher-than-expected out-migration would weigh on consumer spending and housing.
- If interest rates rise more rapidly than anticipated, rising debt-servicing costs could have a negative impact on consumption and overall growth.
- Should pipeline expansion projects be delayed or cancelled, transportation costs for the oil industry would remain elevated and the light-heavy differential could widen, impacting profits and investment.

Contact

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