Economic Viewpoint

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The energy sector continues to struggle

Should monetary and fiscal policy be even more stimulating in Canada?

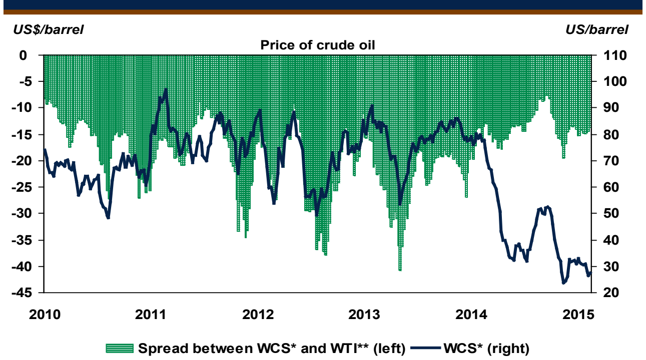
Although Canada's economic growth picked up speed in the third quarter, for the energy sector, the conditions remain tough, fuelling uncertainty. We cannot completely rule out the possibility that low oil prices could persist longer than anticipated, or that oil prices could come down further in the international markets. Such an alternate scenario could have major consequences for Canada's monetary and fiscal policy.

Energy prices plummeted as of mid-2014 in the international markets, disrupting the Canadian economy substantially, and even led to a technical recession in the first two quarters of 2015 due, among other things, to a substantial drop in private energy sector investment. However, the third quarter was back in positive territory with real GDP up by 2.3% on a big rebound by exports (+9.4%).

Despite the improvement, conditions remain arduous for the energy sector. The price of Canadian oil (based on Western Canada Select), is oscillating under US$30 a barrel, which is just above its historic low (graph 1). At first glance, the weakness of Canadian oil prices does not seem to be exacerbated by national problems, as the spread between Canadian and U.S. oil prices is not very wide. However, this data has to be looked at in terms of proportion: a spread of US$14 has a very different effect when Canadian oil is close to US$30 than when it is oscillating around US$80. In terms of percentage, the price gap is now close to 55%, which is well above the historic average (28%). This could be due to a shortage of access for Canadian petroleum products due, among other things, to the substantial development of non-traditional oil production in the United States, the technical innovations developed in this industry, and the shelving of the Keystone XL pipeline project.

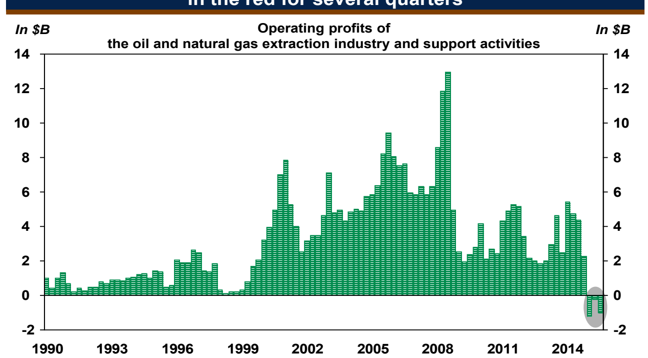
The myriad problems are impacting the profitability of energy businesses, where operations generated a $1B loss in the third quarter (graph 2). They have lost a total of $2.4B since the start of 2015. Because of the heavy fixed costs, the erosion of profitability has not had too big of an impact on the volume of oil and natural gas produced, so far. However,

Graph 1 – Canadian oil prices are still very low



* Western Canada Select; ** West Texas Intermediate.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 2 – The oil and natural gas sector have been operating in the red for several quarters



Sources: Statistics Canada and Desjardins, Economic Studies

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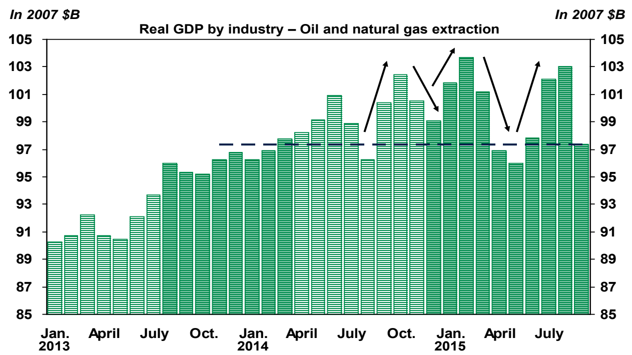
our projections indicate that oil prices could stay very low for several more quarters, meaning that the negative impacts on Canadian oil and natural gas production could intensify in the months to come. September's data on real GDP by industry included a 5.5% pullback by oil and natural gas extraction (graph 3). Some one-off factors intensified the decline, but it will be interesting to see what happens next.

We can also expect non-residential investment in the energy sector to keep dropping over the near term. Some stabilization is likely in 2016, when much of the correction will be behind us. On the other hand, it will no doubt take several years before a noteworthy increase materializes.

Graph 3 – Oil and natural gas production has been at a standstill since spring 2014



Sources: Statistics Canada and Desjardins, Economic Studies

Implications: The energy sector should keep the brakes on the country's economic growth in the coming quarters. According to our **base scenario**, non-energy exports will, however, support real GDP growth, which could hold at a fairly good pace in 2016. However, there are many uncertainties. For example, oil prices could slide further, or the current weakness could persist longer than anticipated. This could exacerbate the problems in the energy sector and seriously hamper Canadian economic growth. In this **alternate scenario**, the Bank of Canada might have to step in again, cutting key interest rates again and, in the end, deploying non-conventional measures. In the **alternate scenario**, fiscal policy could be even more stimulating, while the Canadian dollar could slide below the ¢70 mark; wich would eventually facilitate the Canadian economy's adjustment.

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