BOOMS AND BUSTS: WESTERN CANADA ON THE RECESSIONARY LANDSCAPE

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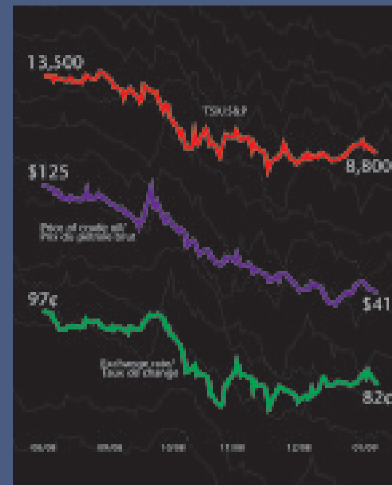


Nowhere has the collapse of oil prices and the crash on the stock market been more acutely felt than in western Canada, home of Canada's oil patch. Only last July, oil peaked at $148 a barrel, before plummeting to its December low of US$33. Energy stocks and income trusts, which drove the TSX to record high levels last year, have led its historic retreat since last September. The implications for the oil patch, and particularly the oil sands of Alberta, are obvious. We asked the authors, from the Canada West Foundation, to share their perspectives on the current situation and their outlook for recovery.

Nulle part ailleurs que dans l'Ouest canadien, le champ de pétrole du pays, n'a-t-on ressenti plus durement la chute du prix du pétrole et l'effondrement du marché boursier. Tout juste en juillet dernier, ce prix avait atteint 148 dollars le baril avant de plonger à 33 dollars en décembre. Les actions et les fiducies de revenu énergétiques, qui avaient l'an dernier propulsé le TSX à des sommets record, ont amorcé en septembre un repli historique. Les répercussions sur les champs de pétrole, et notamment sur les sables bitumineux, sont flagrantes. Nous avons demandé à trois membres de la Canada West Foundation de faire le point sur la situation et les perspectives de rétablissement.

The past few years have witnessed a great deal of discussion about the westward shift of the Canadian economy, a shift that reflects the dynamic growth that has taken place across the four western provinces while the manufacturing economy based in Ontario has struggled with a high Canadian dollar and intensifying global competition. No matter what the indicator might be — housing starts and prices, GDP growth, employment, in-migration — the western Canadian provinces have led the national field and have collectively positioned themselves as the "engine" of the Canadian economy. Although growth was evident across all four western provinces, with Saskatchewan and Manitoba overtaking Alberta in early forecasts for 2009, Alberta has been front and centre in these discussions about the restructuring of the Canadian economy, discussions that were brought into bold relief last summer when the price of oil approached $150 a barrel and the Alberta government forecast a 2008/09 budget surplus of $8-$12 billion.

Well, that was then and this is now, as a recession sweeps across the country. The recession's battering impact raises interesting and important questions. Will the current economic downturn derail the westward shift of the national economy? As the resource boom withers in western Canada, will we look back on the past decade as a temporary, if long, blip in the evolution of the national economy? Or might the recession itself be a brief interruption in a regional restructuring of the national economy that will continue to reinforce the West's leading role? Perhaps of greatest importance, will the regional restructuring of the Canadian economy prompt or hinder essential transformations within the resource-based western Canadian economy?

Now, to pose these questions may seem foolhardy, given the tremendous uncertainty that surrounds the Canadian and global economies. The brutal reality is that we have very little idea how deep or long the recession will be, and therefore to speculate on the nature of the postrecession Canadian economy is to peer into an extremely clouded if not opaque crystal ball. Nonetheless, the questions are important as governments wrestle with measures to combat the current economic malaise. If we don't know where the economy might be once we begin to crawl out of the downturn, we may make the wrong policy choices in the meantime, directing our stimulus firepower at yesterday's economy rather than at where the economy might be tomorrow. It is useful to contemplate the evolution of the national economy and its regional parts if we are to follow the metaphorical advice of Wayne Gretzky and skate to where the puck is going to be rather than to where it is.

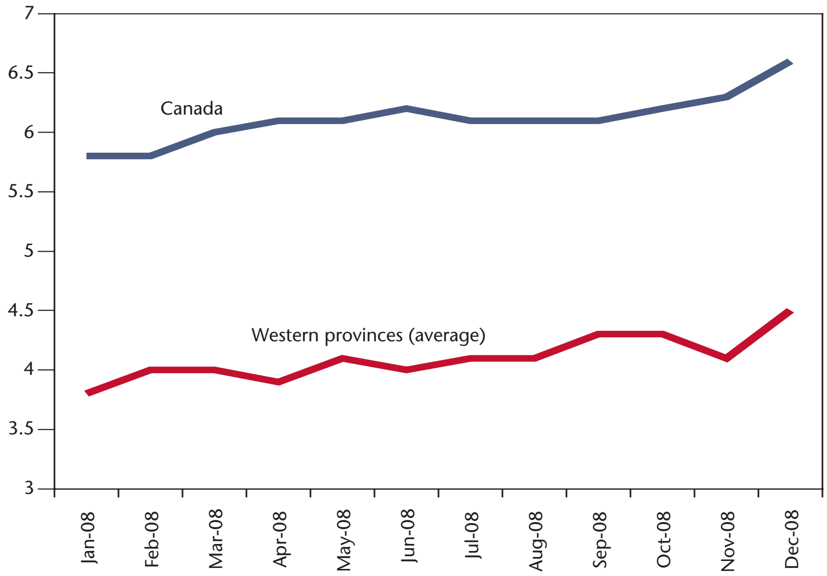
While data about economic conditions at the end of 2008 are fragmentary and impressionistic at best, there is no evidence to date that western Canada has escaped the economic downturn, nor is there any reason to expect that it will do so in the near future. Just as Canadians at large have abandoned hope that Canada will avoid the global storm, so too have western Canadians abandoned hope that their trade-dependent regional economy will be untouched. If anything, the precipitous drop in commodity prices and the concomitant drop in equity values across the resource sector have given the downturn a sharper edge in western Canada.

This edge can be illustrated by the region's bellwether province, Alberta, keeping in mind that Alberta is not the West, and that recessionary times will not play out evenly across the four western provinces. Nonetheless, more than any other western province over the past decade Alberta has been emblematic of the transformation taking place in the Canadian economy, and it has most often been the lens through which Canadians have viewed that transformation.

There is no denying that the Alberta economy is sputtering. The price of oil has fallen by almost 70 percent since this past summer's peak, and bitumen prices approaching US$20 a barrel combined with the credit crunch have brought oilsands development to a near stop; projects for which the ground has not already been broken have been scaled down, put on hold, and even cancelled. Conventional oil and gas exploration is down sharply, real estate prices are beginning to slide although by no means plummet, in-migration is slowing, and the provincial government is looking at the very real possibility of a deficit, if not for the current fiscal year then certainly for the next one. There are several large holes in the ground in Calgary's inner city where cranes once stood ready to throw up another condo tower. Just as Alberta led the country's economic growth for most of the past decade, it could end up leading the recessionary decline.

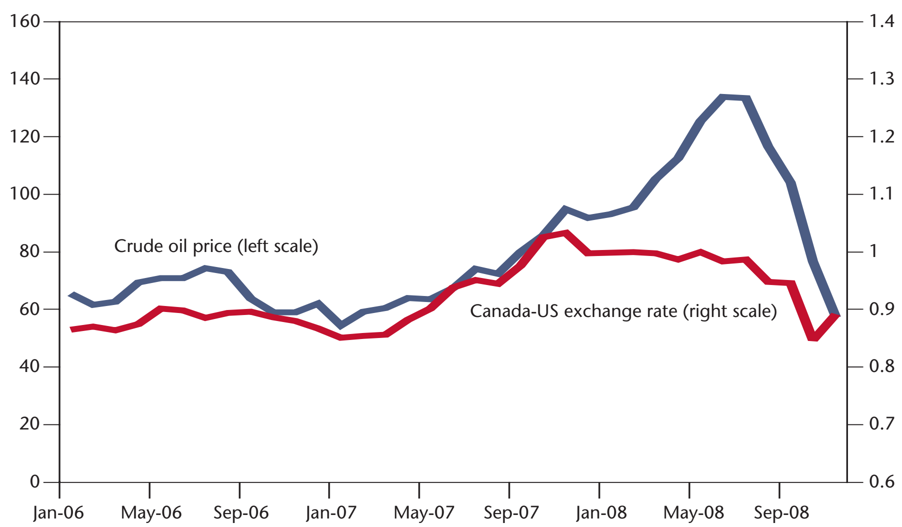
The current scene in Alberta shows that volatility in commodity markets dwarfs the currency volatility that bedevils the manufacturing sector. Although we have seen important swings in the value of the Canadian dollar over the past three years, they have been more progressive than the volatility observed over the course of 2008 in most commodity markets. Those markets declined systematically from January onward, with the notable exception of oil and gas, which peaked in the summer before dropping

FIGURE 1: UNEMPLOYMENT RATES IN CANADA AND THE WEST, 2008



Source: Statistics Canada.

FIGURE 2: CRUDE OIL PRICES AND THE CANADA-US EXCHANGE RATE, JANUARY 2006-DECEMBER 2008



Sources: US Energy Information Administration and Bank of Canada.

and closing the year well below their level 12 months earlier. Over 2008 the value of the Canadian dollar dropped by just under 20 percent, while natural gas fell by 25 percent, crude oil by 60 percent, and uranium by 40 percent.

Of course, swings in commodity prices are not exactly new in Alberta or western Canada more broadly considered. However, what may be new is that the regional resource base has been diversified to include not only oil and gas, agriculture, minerals and forestry but also coal, potash and uranium, and with diversification comes greater stability. Only rarely, although admittedly this may one of those rare times, will commodity prices fluctuate in unison. What is also new is an important structural change in the energy sector. Past swings in oil and gas prices were met by a relatively flexible energy sector — drilling could be postponed and production could be locked in until market conditions improved. Now, we have massive capital investments in the oilsands that can only be sustained (or new projects approved) at a minimum price. Conventional oil and gas production can slow down or speed up, but it is nearly impossible to fine-tune the capital expenditures associated with the oilsands. Although any decision to proceed with such developments rests on an assessment of potential energy prices over the project's 40-50-year lifespan, the current price of oil plays a significant role in those decisions.

At the same time, it is important not to focus too narrowly on energy prices as the indicator of the strength of the western Canadian economy, as analysts both inside and outside the region are prone to do. Growing anxiety in the West has not yet been matched by sustained economic decline, especially with respect to labour markets. Declines in residential real estate values outside the lower mainland of British Columbia have been modest, and Regina and Saskatoon have continued to show growth. Public finances across the region are in good shape, and although provincial governments are heading into deficit territory (as are governments across the country and around the world), established reserves should cushion the blow for at least a year. (Here the debt-free Alberta government is particularly well positioned with its $7.5 billion sustainability fund.) The regional economy has been running on overdrive, and now the inflationary cost pressures and labour shortages that have plagued it should abate somewhat, although they will not disappear. In this sense, the recession will provide welcome relief and the opportunity to plan for when the economy picks up again.

It also should be stressed that the regional economy as a whole is not nearly as volatile as swings in commodity prices might suggest. Most wage earners are not employed in the resource sector, just as most wage earners in Ontario are not employed in the auto sector. In the West as elsewhere in Canada, the service sector dominates the labour market with approximately 75 percent of paid employment. Robust western urban economies, which began a period of sustained growth during the late 1990s when commodity prices were generally depressed, have proven to be relatively insulated from the irregular boom and bust cycles in those prices. Thus while the provincial economies are shaken when resource markets go pear-shaped, they are not broken by irregular changes in commodity prices. The regional economy is now far more resilient than it was in the past, and urban centres like Vancouver can bubble along quite nicely even when the resource-based economy of BC's interior is struggling.

In short, to focus on the price of oil, or on the price of any particular commodity, is to miss the western Canadian forest for the tree. That larger forest, with the unfortunate exception of the forestry industry itself, is more resilient and stable than commodity prices would suggest.

As the resource boom withers in western Canada, will we look back on the past decade as a temporary, if long, blip in the evolution of the national economy? Or might the recession itself be a brief interruption in a regional restructuring of the national economy that will continue to reinforce the West's leading role?

What, then, can be said about the longer-term future of the regional economy, and the longer-term place of this economy within the broader Canadian economy? What lessons might we draw from both the resource boom of recent years and the economic collapse of recent months? Will the westward shift continue, stop, or even be reversed?

Any assessment of the impact of the economic downturn requires a rough *comparative* assessment of the long-term prognosis for both the regional economy in the West and the manufacturing economy in central Canada. In the long-term, and hopefully not in the very long-term, continental and global demand for western Canadian resources will certainly rebound. Declining prices today will lead to declining investment in the development of future supply, which in turn will push prices back up as supply and demand return to equilibrium. And, in this context, it is important to note the recent discovery of major oil and particularly reserves in southwest Saskatchewan and northeast BC; the region is not running dry.

Nothing in the current recession will change the fact that the world's population will increase by almost two billion people in the next 20 years. Moreover, we would argue that the global recession will slow but not end the rapid pace of economic growth in developing countries. And, when it comes to potential Asian markets and investment, BC remains perched on the Asia-Pacific rim. In the simplest possible terms, the West produces food and energy, and the global demand for both will return and expand. While none of this guarantees a smooth ride for the western Canadian economy, it does provide grounds for optimism about the future.

However, while the inevitable resumption of global commodity demand will be good news for the West, it will play out quite differently in other parts of the national economy. An increase in global demand and the concomitant increase in prices will mean more revenue for the West but higher input costs for other parts of the Canadian economy (including parts of the western Canadian economy, particularly the agricultural sector). In addition, global competition in the manufacturing economy will only increase in the years to come; Chinese and Indian manufacturers are more likely to threaten the Canadian auto sector than to threaten Canadian production of coal, natural gas, oil, potash and uranium. In short, what might be good for the West in terms of the global economy could be much more problematic for Canada's manufacturing heartland. Thus, the westward shift of the national economy could well resume, in part because of an economic rebound in the West and in part because of ongoing challenges elsewhere. The resource sector will always face market volatility, but not a long-term decline in demand, whereas the manufacturing sector may be facing just that.

Of course, any discussion of global demand and global competition masks the reality that for many Canadian producers, this is synonymous with American demand and American competition. Here we confront a very large unknown with respect to how the Canadian-American economic relationship will play out in the years to come. How quickly will the American economy rebound? Will Congress cater to protectionist impulses in the United States, ones that may threaten manufacturing jobs in Ontario but also the forestry industry in BC? How will an American shift to a green economy play out for Alberta and the West? Will the oilsands be an integral part of the American quest for energy security, or will the "dirty oil" label gain traction in the Obama administration? Will security concerns increase even more and lead to a further thickening of the Canadian-American border and, if so, will that have a greater impact on Canadian exports of manufactured products than on the export of oil, gas, electricity and lumber?

In other words, the Canadian economy remains very vulnerable to economic and political conditions in the United States. While we might argue that this vulnerability is somewhat moderated in western Canada, any such regional difference is highly speculative.

There is no question that the current downturn has at least temporarily curtailed the westward shift of the national economy; the resource sectors based in the West have been hit, and hit hard. At the same time, there is also little question that continental and global demand for what the West has in abundance will return, just as it is certain that the competition faced by Canada's manufacturing sector will only intensify. Thus at a time when any economic projection seems unwise in the extreme, the odds look good that two, five or ten years down the road the westward shift will resume. Yes, booms go bust, but so too do busts eventually boom. The western Canadian hewers of wood and drawers of water should come out of this in good shape, although we wouldn't bet even a sub-prime mortgage when this will happen.

This is a region with great educational institutions, leaders in research and development, strong connections to the growing economies of China and India, and cities that have the potential to be hubs in a knowledge-based economy.

This, however, should not be seen as a prescription for complacency. Low productivity is far too common a feature of resource-extraction industries, and international competition for unprocessed raw materials will intensify. Moreover, when demand picks up again, as it will, the demand will not be for the same products produced in the same way. With luck, therefore, the recession will provide an opportunity to address productivity issues, to move western Canadian production up the value chain, and to develop further opportunities for not only the export of natural resources but also for the accumulation and commercialization of expertise that has grown up around resource industries.

The recession may jar the West out of its resource dependency and help prepare the region for a long-term future in which the economic importance of resources will inevitably recede. This is a region with great educational institutions, leaders in research and development, strong connections to the growing economies of China and India, and cities that have the potential to be hubs in a knowledge-based economy. With luck, the recession will serve as a wake-up call, and the resumption of strong commodity markets will give western Canadians some breathing space to address the ongoing challenges to both the West and Canada that go well beyond the current recession. As we move to do so, we should also remember that today's rough patch shows that Canadians are all in this together, that there are no regional sanctuaries.

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