THE TIGER THAT ROARED ACROSS ALBERTA

Executive Summary

In 2003, TD Economics issued a comprehensive report on the opportunities and challenges facing Canada's economic "tiger", the Calgary-Edmonton Corridor. In light of the large upward adjustment to expectations on crude oil prices and other dramatic developments over the past 4 ½ years, we felt that a reassessment of the region's prospects was warranted. As well, with the tiger's roar not just being heard along the Corridor, but across the province, we have expanded the coverage to include other centres in Alberta.

We thought we were bold when in 2003 we forecast growth in the Corridor of 4% per year over the 2002-06 period. Yet the actual figure was even more impressive, at 5% per year. Our underestimation boiled down to crude oil and, to a lesser extent. natural gas price forecasts that weren't heroic enough, even when the surging Canadian dollar is factored in. As such, the spotlight turned up even higher on the oil sands, where the grand total of investment projects over the next 10-15 years continued to climb – from $85 billion at the time of the 2003 report to more than $120 billion in 2007.

The combination of brimming cash flows and rising investment in the oil patch since 2003 has sprinkled substantial and wide-ranging benefits around the province. We calculate that every major region – Calgary, Edmonton, the rest of the Corridor (including Red Deer) and the rest of the province – racked up annual average real GDP gains of at least 4% per year in 2002-06. And while the bigger urban centres of Calgary and Edmonton remained the major economic workhorses, the last half decade has witnessed the rapid emergence of a number of medium sized markets. Indeed, among Canada's 15 fastest growing medium-sized markets, 7 were located either along the Corridor (Red Deer and Okotoks) or in the rest of Alberta (Wood Buffalo, Grande Prairie, Canmore, Medicine Hat and Lethbridge).

In 2003, we argued that the Corridor stood out as the only Canadian urban market to enjoy a U.S.-style standard of living along with a Canadian-style quality of life. Owing to the last 4 years of sizzling growth, the region's position has improved even more. For example, in 2000, the Corridor enjoyed a US$5,000 advantage in GDP per capita against the U.S. average. That edge has surged to more than US$15,000.

Cost pressures to drag down growth in 2008-09

As recent developments in the province clearly attest to, growth can be a double-edged sword. A fast rate of growth is desirable, but if an economy generates too much gusto – which has been the case in Alberta – labour, housing and materials shortages soon develop, rents and prices are bid up and enormous strains are placed on infrastructure. In this regard, the question could be raised as to whether the growth has been too much of a good thing. This dilemma plays out for governments in the region, where for the most part, particularly at the provincial level, they have accommodated the growth by strongly ramping up spending, thereby throwing further fuel on the fire.

Even on the national landscape, there have been concerns that a white-hot Alberta economy has been responsible for driving up national growth and inflation, domestic interest rates and the Canadian dollar. We argue that this criticism is off base, since it doesn't recognize the rewards generated by a prosperous Alberta, including providing energy security and financing federal surpluses which permit major redistribution within Canada and keep taxes down. We estimate that for each $1 increase in real GDP in Alberta, 20 cents in increased GDP flow to other provinces through higher demand for goods and services.

In our view, cost pressures will be the number-one culprit reining in economic growth in Alberta – to about 2.5-3% per year in 2008-09. Already, eroding affordability is beginning to lead to weaker housing activity in Calgary, and the Edmonton market is likely to follow suit. The sharp rise in prices in the province is likely a factor behind a recent slowdown in inter-provincial migration flows. Above all, cost pressures in the oil and gas industry is likely to exert a greater drag on activity going forward, especially in the natural gas industry, where prices have fallen back significantly. Still, with crude oil prices expected to average about US$70 per barrel over the next few years, we believe that the economy will avert a hard landing.

Addressing longer-term challenges

We remain upbeat about the growth prospects for the Alberta economy beyond 2010. The benefits of oil sands developments will continue to migrate from the north of the province to the Corridor, with the Edmonton Area alone poised to enjoy some $50 billion in oil sands related construction projects over the next decade.

In the 2003 study, we focused on a number of longer-term term vulnerabilities that if left unaddressed would create impediments for sustained improvements in prosperity and quality of life. These included: diversification, education and skills, infrastructure and social inequity/poverty. If anything, the developments over the past four years have further highlighted these challenges. Governments have sprung into action – although, as we argue, with mixed consequences.

In terms of diversification, the Alberta economy continued to experience robust strength in non-energy industries over the past half decade. In 2001, combined direct and indirect oil and gas activities accounted for 23% of real GDP. That share has declined to 19%. Looking ahead, it will be critical that any efforts to achieve further diversification occur around a thriving oil and gas sector. Yet, there are many hard policy decisions that, if poorly thought out, could have a detrimental impact on the oil and gas sector's long-term prospects, including the environment and changes to non-renewable royalty and tax regimes.

The environment is a challenge that has risen in profile since our 2003 report. Alberta and its oil patch in particular is a major contributor to Canada's greenhouse gas emissions. It is certainly possible that policy action will be taken that will sharply raise the price of carbon. Unless efficiencies are quickly gained on emissions, this could hurt prospects in Alberta's energy field, especially for upgrading and refining.

Adding to potential cost pressures in the oil patch is the report on the Royalty Review Panel. As argued by the Panel, Alberta's government share of revenues is low by international standards. Still, it must be recognized that the sector faces high discovery and development costs. The existing royalty payments were put in place when the oil sands were in their infancy and prices were much lower. It is likely that some increase in royalty rates will be imposed.

Governments in the province have been active on the diversification front since 2003 announcing programs to support industries such as nanotechnology, other high tech industries, petrochemicals, alternative energy, and tourism. But while these efforts can contribute to a more diversified economy, governments' success in picking winners has been spotty at best. The most powerful way to foster diversification is to continue with Alberta's past formula of creating a winning business climate. And given the fact that the province's cost advantage has been virtually eliminated on the back of a strengthening Canadian dollar, there needs to be renewed attention to improving personal and corporate tax competitiveness and building on recent efforts to boost inter-provincial trade. While Alberta's tax rates are the envy of most Canadians, they are not particularly low in the global arena.

Chipping away at other vulnerabilities

The challenge of skilled labour shortages is one that is unlikely to recede over the next decade, especially as baby boomers head into retirement. In 2003, we argued that the province's high rate of educational attainment was reliant on "importing" skilled workers from other provinces, given the province's relatively low of participation in post-secondary (PSE) education. Despite a substantial injection of new funding since 2003, PSE participation rates have actually fall back further, weighed down by the attractive draw from the hot labour market.

Over the past few years, there has been progress made in opening the doors to increased international migration. Earlier this year, the federal and Alberta governments signed a bilateral immigration agreement that should push up the number of newcomers to its population share (25,000 per year). Changes made to the federal immigration process for temporary workers and plans by Alberta to streamline and expand the provincial nominee program have also been welcome news. However, as the number of migrants from abroad increases, Alberta will need to carefully manage the integration of these individuals.

Five years ago, infrastructure had become the most pressing challenge outside of health care in Alberta. Since 2004, combined local-provincial public capital spending has increased by about 20% per year. Yet it is difficult to say how much of the infrastructure gap has been reduced, since the needs list appears to have grown just as rapidly. Moreover, rising construction costs have mitigated some of the benefits. The cost issue speaks of the critical need for governments to put considerable attention on setting priorities.

In 2003, we went at length to discuss the importance of a sustainable fiscal arrangement for cities. We have witnessed progress on this front, including the province's recent commitment to provide significant 10-year funding to municipalities, free of strings. As well, the province is currently mulling over a request by municipalities for new taxing powers.

As we highlighted five years ago, there is still scope for local governments in Alberta to make better use of their existing tools. Residential tax rates and debt levels are low on the whole and there remains a reticence to move down the path of full-cost pricing for services. Public-private-partnerships is another area where considerable opportunities lie. On the bright side, there have been efforts to increase regional cooperation – notably among the 24 municipalities that comprise the Greater Edmonton Area. That said, a major challenge remains the lack of any regional government structure empowered to make binding decisions on behalf of the region.

Among the various challenges facing the Corridor and the rest of the province, the growing gap between haves and have-nots stands out as the one where a significant step backwards has been recorded since 2003. While average incomes have been rising, the bulk of the gains have been enjoyed by the high-income end of the spectrum. A lack of affordable housing, which traditionally has been a big city problem, is a challenge even in smaller markets. Governments have been responding by allocating new funds to rental assistance and affordable housing programs, while the Province raised the minimum wage. One major impediment to helping low income individuals are the extremely high personal marginal income tax rates as social assistance benefits are taxed back.

Saving for a rainy day

Lastly, a successful long-term strategy will require that the province sets enough of the windfall from the oil and gas sector aside to fund public investments down the road. This is especially important in Alberta's context. If non-renewable revenues decline in the future – which is a real risk – an inadequate savings endowment would imply higher taxes, reduced public services and a lower standard of living.

On the plus side, the province's Heritage Fund is growing again, from $12 billion in 2003 to $17 billion in 2007. Yet savings have been carried out in an arbitrary way, while returns on the Fund have lagged behind other large institutional funds, including Ontario Teachers Pension Plan. Further, the size of Alberta's endowment is only a fraction of that of Norway, which currently boasts about US$200 billion in assets. In Norway, all of the country's resource revenue is deposited into its Petroleum Fund and returns are re-invested. (Withdrawals are sometimes made to cover anticipated non-oil budgetary deficits). As importantly, the management of the Fund has been turned over to an external manager (Norges Bank) which invests the proceeds outside the country.

The provincial government is currently looking at its options as it reviews its royalty structure. Recently, the Premier indicated a desire to grow the Heritage Fund to $40 billion over the next decade, which is certainly achievable. Part of the secret will be to improve the Fund's return performance. And, in that vein, we are also encouraged by the government's decision to move the Alberta Asset Management Corporation (AIMCO) from within Alberta Finance to a new corporation, to be chaired by former TD CEO Charles Baillie and George Gosbee of Tristone Capital. Moreover, the government has recently established a 5-member independent commission to determine the investment asset mix, led by tax expert and Chairman of the University of Calgary Jack Mintz.

Bottom Line

The tiger's roar is likely to soften in 2008 and 2009, as as cost pressures naturally apply the brakest to activity in key areas such as the oil sands and the housing market. Still, a substantial simmering down is what the doctor is ordering to ensure that expansion continues over the medium term. Looking out further down the road, we remain upbeat about both the path of crude oil prices and the province's overall growth prospects. But so much will depend on how successfully governments and the private sector tackle the vulnerabities that we have highlighted.

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