TD Bank Financial Group

TD Economics

Topic Paper

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AN UPDATE ON THE ECONOMY OF THE CALGARY-EDMONTON CORRIDOR: MORE ACTION NEEDED FOR THE TIGER TO ROAR

Introduction

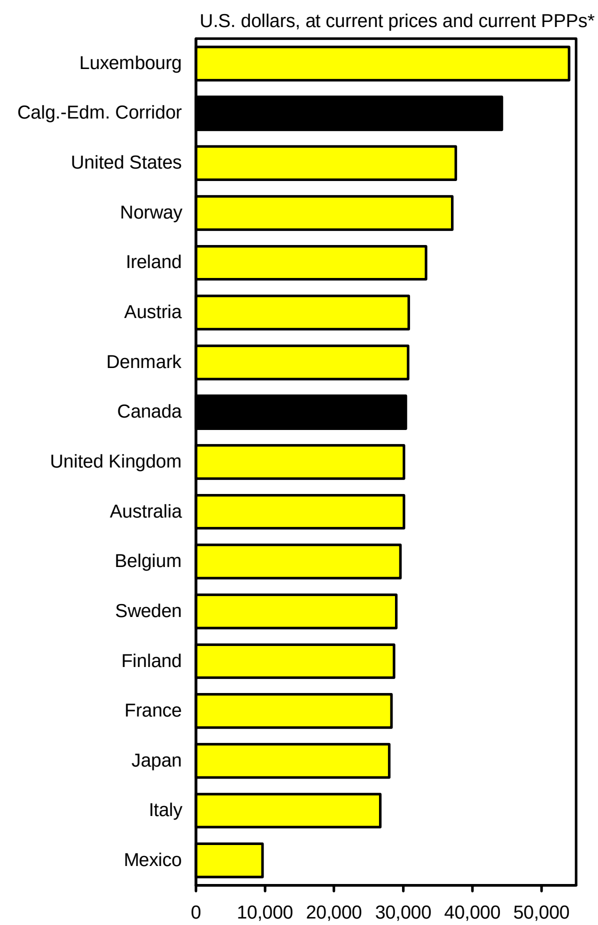
In April 2003, TD Economics released a special report entitled *The Calgary-Edmonton Corridor: Take Action Now to Ensure Tiger's Roar Doesn't Fade*. In that study, we highlighted the Corridor's enviable position as the only Canadian urban centre to blend U.S.-level wealth with Canadian-style quality of life. Furthermore, with its vast wealth of natural resources, a rapidly growing and youthful population and low business costs, we predicted the Corridor would widen its economic lead over the rest of Canada. Indeed, with energy prices running at higher-than-anticipated levels, the economic expansion in the Calgary-Edmonton Corridor has exceeded the expectations we formulated in our 2003 report.

In that report we also addressed a number of factors that could impede growth. These included the heavy reliance upon natural resources, a sizeable infrastructure gap, a low post-secondary education participation rate and growing labour shortages. The red-hot pace of growth over the past two years has amplified the importance of dealing with these impediments. Some positive steps have been taken by governments, but more action will be required to unleash the full economic potential of the Corridor.

The Corridor's lead is growing fast…

Real GDP growth averaged 3.7 per cent in the Corridor in 2003 and 2004 and is poised to be slightly stronger this year. While Calgary lagged growth in Edmonton and the rest of the Corridor (ROC) in 2003 and 2004, all three areas are now experiencing strong output gains. Nominal

GROSS DOMESTIC PRODUCT PER CAPITA IN 2003



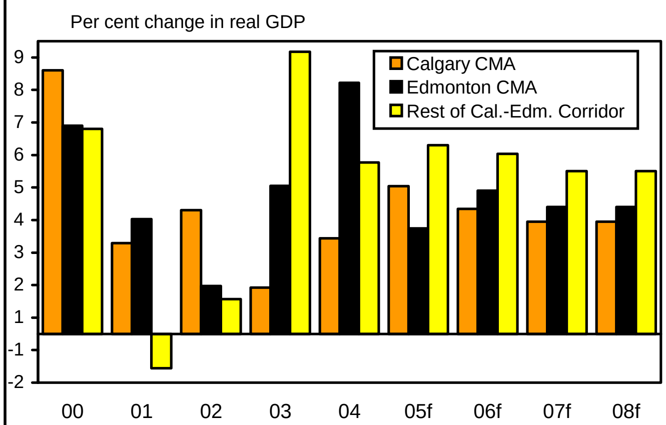
* Purchasing power parity exchange rates
Source: OECD as of Sept 2005, TD Economics

GDP per capita (a measure of standard of living) in the Corridor was US$44,000 in 2003, a whopping US$4,000 increase compared to the 2000 figure we featured in our earlier report and a gigantic US$14,000 or 47 per cent above the Canadian average. In fact, GDP per capita is $7,000 higher in the Corridor than the U.S. average.

The Corridor's positive economic momentum is likely to continue over the next few years. TD Economics expects real GDP growth in the Corridor to come in at 4.2 and 4.0 per cent in 2005 and 2006, respectively, compared to 4.0 and 3.8 per cent for Alberta and 2.9 and 3.0 per cent for Canada. Edmonton's service sector and labour market will rebound strongly next year, the ROC will benefit from the re-opening of the U.S. border to Canadian cattle shipments and growth in Calgary's commercial services industries should be even stronger than in the recent past. As we argued in a September 2005 special report: *Crude Oil Squeeze to Ease Next Year But Era of High Prices is Here to Stay*, crude oil prices are likely to remain above US$50 per barrel over the next five years, buoyed by demand from energy-hungry countries such as the U.S. and China and limited prospects for growth in global production. At the same time, natural gas prices will hold at levels above US$8 per MMBtu through 2010. These firm commodity prices will help the Corridor's economy sustain an expansion over the medium term in the 3.5 to 4.0 per cent range, continuing its outperformance relative to the rest of Canada.

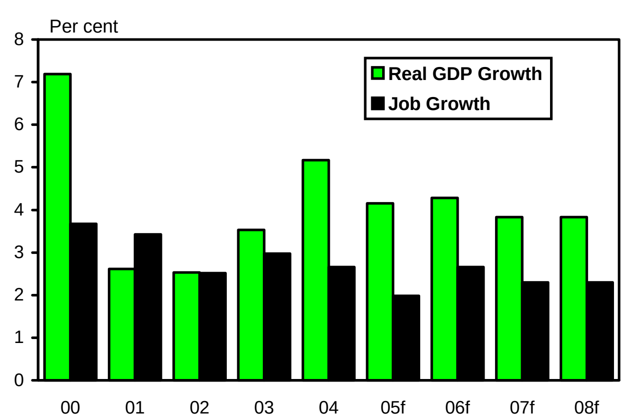
Some of the components of income suggest the Corridor's superior performance to the rest of Canada has been even starker. Calgary and Edmonton experienced the fastest growth of all urban centres in personal disposable income in 2004 at 7 and 5 per cent, respectively. Corporate profits grew 44 per cent in Alberta (no profit estimate is available for the Corridor) in 2003 and a further 19 per cent in 2004. This growth brings corporate profits to 22 per cent of Alberta's nominal GDP, roughly twice the share posted in the rest of Canada. The Alberta government has also shared in the income growth, recording a $5 billion surplus in fiscal year 2004-05. Before any extraordinary disbursements, the surplus this year will likely be in the $7-9 billion range. These surpluses have enabled the province to pay off its debt and build a massive $27 billion net asset position (14 per cent of nominal GDP). To a lesser extent, municipalities in the Corridor have experienced a lift in their finances, primarily through property tax gains from a buoyant housing market.

ECONOMIC GROWTH IN THE CALGARY-EDMONTON CORRIDOR



f: forecast by TD Economics as at Sept. 2005
Source: Statistics Canada, Conference Board of Canada

THE CALGARY-EDMONTON CORRIDOR



f: forecast by TD Economics as at Sept. 2005
Source: Statistics Canada, Conference Board of Canada

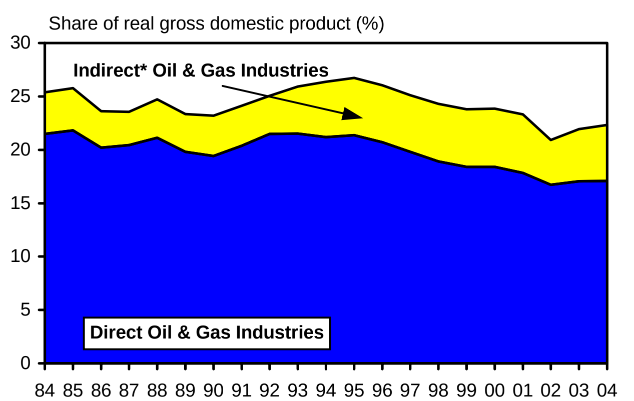
… but challenges are heating up too

If the Calgary-Edmonton Corridor is to sustain strong growth rates over the long haul it will need to address some potential roadblocks. The first challenge we highlighted in our 2003 paper was diversification around the natural resource base. The potential is certainly there in light of the high-quality labour force and low business costs in the region. However, if anything, the Corridor is becoming even more tied to the oil and gas sector over the past few years. While this increased energy reliance is not so much a statement about the weakness of the non-energy sectors as it is a testament to the booming energy component, it leaves the Corridor's economy vulnerable to the traditional commodity cycles. At the same time, however, the downside of future energy cycles should be much more muted than in the past (recall that the price of crude oil was sitting at US$12 at the end of 1998) because the balance between energy demand and supply should be reasonably tight for the foreseeable future. Still, the eventual development of alternative sources of transportation fuel and rising costs for labour, land, technology and environment protection related to oil sands production could cloud the future of the industry.

Secondly, labour shortages have worsened, not just in oil and gas, but across most industries. Interprovincial migration into the Wild Rose Country, which had been a huge source of population growth and skilled labour in the late 1990s, has slowed recently because of British Columbia's own rising economic fortunes. This has heightened the competition for capital and skilled labour. The tightness of the Western Canadian labour markets is evident in the jobless rate for the Corridor of around 4 per cent so far in 2005 and 6.4 per cent in British Columbia, the lowest rate there in 25 years. In the absence of action, labour shortages could have a growing influence in dampening economic gains. And, over the longer run, an aging population in the Corridor will complicate the challenge of skills shortages.

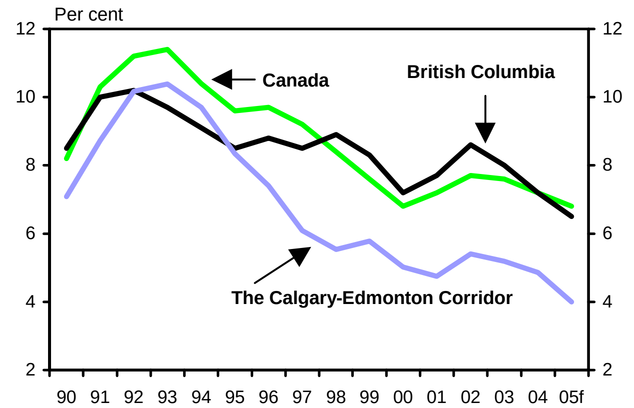
Moreover, the rapid economic and population growth in the Corridor has exacerbated the problems of urban sprawl. In particular, the gaps in physical and social infrastructure have grown. Back in 2003, the Canada West Foundation estimated the annual shortfall in infrastructure investments to be about $125 and $136 million respectively for Edmonton and Calgary. In 2005, the City of Edmonton forecast its own infrastructure gap – the difference between its capital needs and the funding available to address the infrastructure rehabilitation and growth requirements of the city – to average $400 million per year for the next 10 years.

ALBERTA'S RELIANCE ON OIL AND GAS



* Include oil& gas engineering construction, petrochemical manufacturing, mining machinery and pipeline transportation
Source: Statistics Canada

UNEMPLOYMENT RATES



f:Forecast by TD Economics as at Sept. 2005
Source: Statistics Canada

Finally, in the 2003 study we spoke of the growing gap between the "have" and "have-not" residents of the Corridor. In most urban centres, including Edmonton, the share of people with less than $20,000 of annual income has continued to decline. However, Calgary has recently bucked this trend, with 42 per cent of its residents now in this low-income category, up five percentage points in the past two years. In fact, the City of Calgary continues to have higher shares of earners at both ends of the income spectrum than other Canadian urban centres. Moreover, housing has become less affordable with average rents for a two-bedroom apartment jumping by 9 per cent in Calgary and 22 per cent in Edmonton since 2000 to reach $806 and $730 per month in 2004, respectively. As such, more residents find that they cannot afford housing, even if their wages have increased.

Some positive actions have been taken

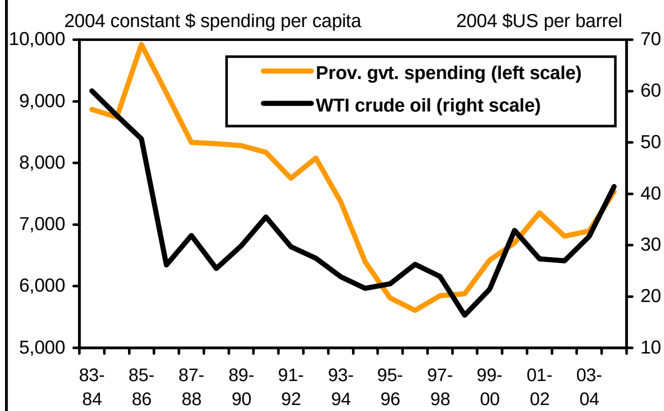
Alberta is well known for providing the lowest tax burden for higher-income individuals, having the lowest tax rate in Canada for large corporations (after Quebec) as well as the second lowest tax rate for small businesses (after New Brunswick). The provincial government has spoken of cutting the corporate tax rate from its current 11.5 to 8 per cent. Still, it has not addressed the role tax relief could play in narrowing income disparities between low and higher-income earners and in addressing problems such as unaffordable housing.

The Alberta Government has been sharply ramping up its spending. In fiscal 2004-05, it hiked outlays by 12 per cent and this year the increase is likely to be as sizeable. Part of this spending growth has been for the purpose of improving access to advanced education – an area we addressed in our 2003 report as a soft spot for the Corridor. Care must be taken in what is done with the burgeoning fiscal surpluses in the province. The Government must be mindful that the windfall from energy revenues may not be permanent and spending surges can drive up costs. Real program expenditure per capita is moving back to the levels reached in the early 1980s and of course that proved to be unsustainable as energy prices retreated.

In response to higher-than-expected energy prices, the Alberta Government announced in late August that it will give a $400 "prosperity" cheque to each citizen by the end of the year. The measure may be popular, but it simply fuels consumption in the short term while doing nothing to address structural growth impediments. We have encouraged consideration of Norway's promising model for dealing with commodity-related revenue booms. Established in 1990 to shield the economy from sharp movements in oil revenues, the Norway Petroleum Fund invests royalty revenues through external managers in foreign stocks and bonds. Application of this model to Alberta would facilitate saving part of the non-renewable resource revenues for less prosperous times and provide greater wealth for future generations. It would also reduce the inflationary risks associated with unsustainable spending increases and tax cuts and soften the calls in the rest of the country for revenue sharing.

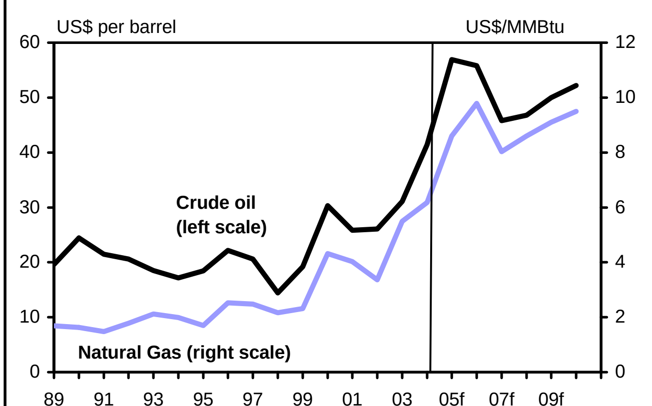
Other positive steps have been taken since 2003. The Alberta Government has teamed up with its counterpart in British Columbia to tackle the devastation from the mountain pine beetle, protect and share common water resources and expand export gateways to emerging countries of Asia.

ALBERTA GOVERNMENT REAL PROGRAM SPENDING PER CAPITA



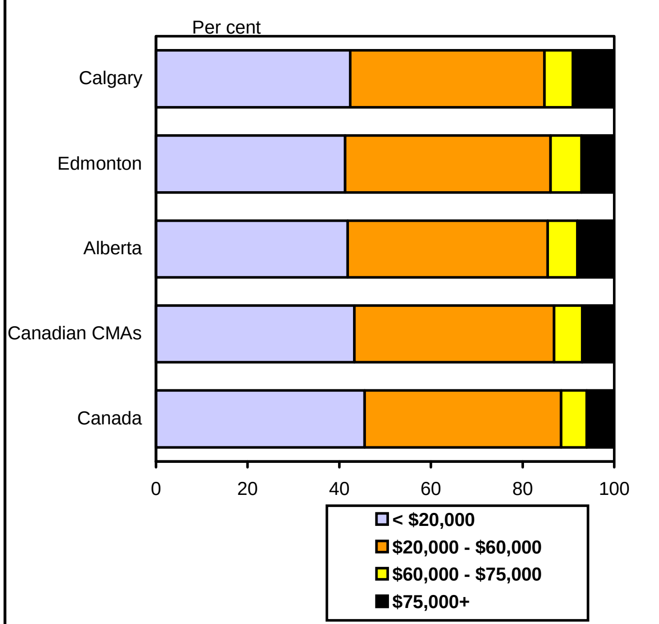
Source: Alberta Government, Statistics Canada

CRUDE OIL AND NATURAL GAS PRICES



Last actual plot: 2004 annual average price; Forecast by TD Economics as at September 2005; Source: Bloomberg News, The Globe and Mail

DISTRIBUTION OF TOTAL INCOME PER INDIVIDUAL IN SELECTED REGIONS FOR 2003



Source: Statistics Canada

The Cities of Edmonton and Calgary will benefit from the new federal-municipal gas revenue-sharing deal as well as now being exempt from the GST for their expenditures. Some possible major infrastructure projects are garnering attention, including the development of a high speed train link between Calgary and Edmonton, a project estimated to cost between $2 and 4 billion. Private-sector involvement in such infrastructure could be an important catalyst for action.

Most areas would wish to have the Corridor's problems

The Calgary-Edmonton Corridor is in a position that other areas of the country can only dream of. The likelihood that energy prices will remain high over the foreseeable future should help to keep the growth momentum strong and give the Corridor additional time to diversify into other high-value sectors. This all adds up to an even greater potential to be the most prosperous and best place to live in the world. But such heady growth raises challenges that must be addressed if the potential is to be realized. The good news is that governments, businesses and citizens appear to be cognizant of these challenges and the need to address them.

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