

The Newfoundland and Labrador Economy: A Reality Check

A Presentation to the Board of Trade's The Power of
Possibility: People, Passion, Persistence

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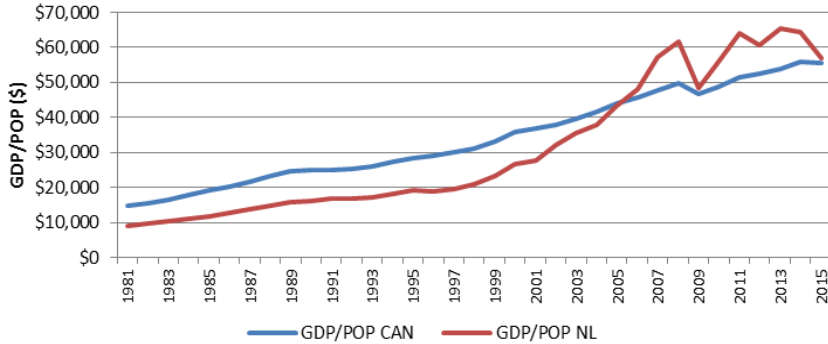
Thursday, February 9, 2017
St. John's Convention Centre

Challenges and Opportunities Faced by NL

- Demographic Challenges
- Economic and Employment Challenges
- Fiscal Challenges
- Debt and Borrowing Challenges
- Temporal Challenge – Is Waiting a Real Option?
- There is significant energy and non-renewable resource potential
- Business confidence appears to be high
- Short-term challenged, medium-term challenged and longer –term positive depending upon how we react in the short and medium terms

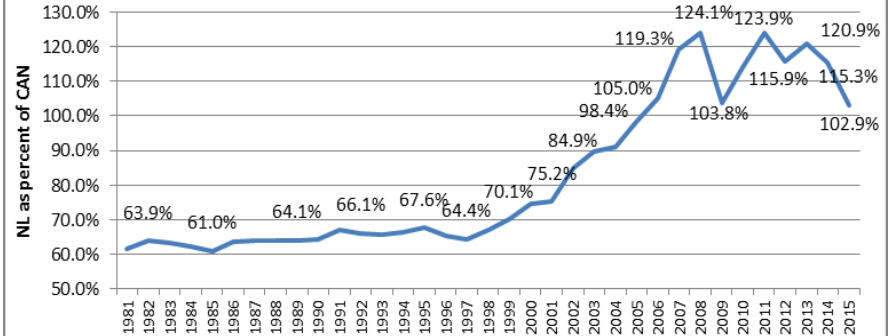
GDP per Capita

A Comparison of GDP per capita: Newfoundland and Labrador and Canada



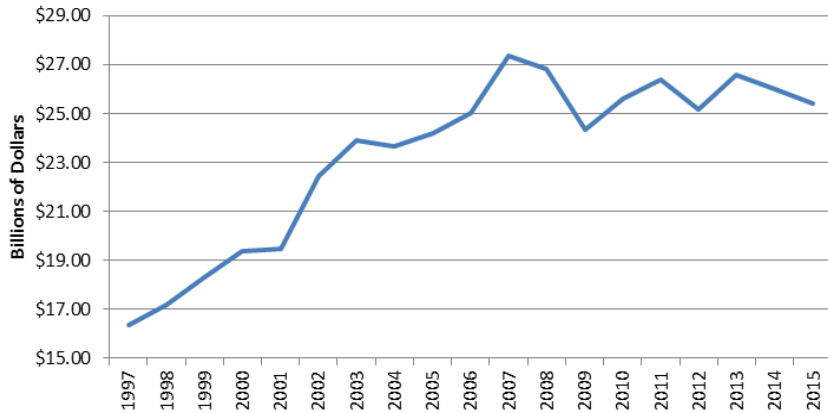
Data Source: Author's calculation based on Stats Can CANSIM Table 510001 and 3640038

Ratio of Nominal Newfoundland and Labrador GDP per capita to GDP per capita Canada-wide



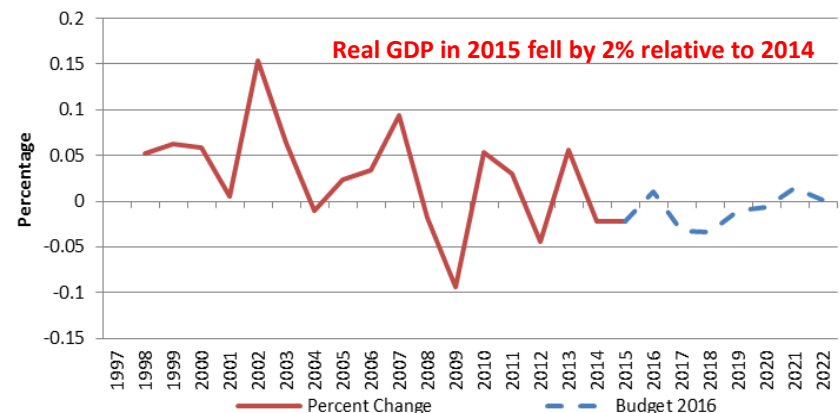
Data Source: Author's calculation based on Stats Can CANSIM Data Tables 510001 and 3840038

NL Real GDP (Chained 2007 Dollars): Levels



CANSIM Data Series V624519

NL Real GDP (Chained 2007 Dollars): Rates of Change



Calculated from CANSIM Data Series V624519 and Budget 2016

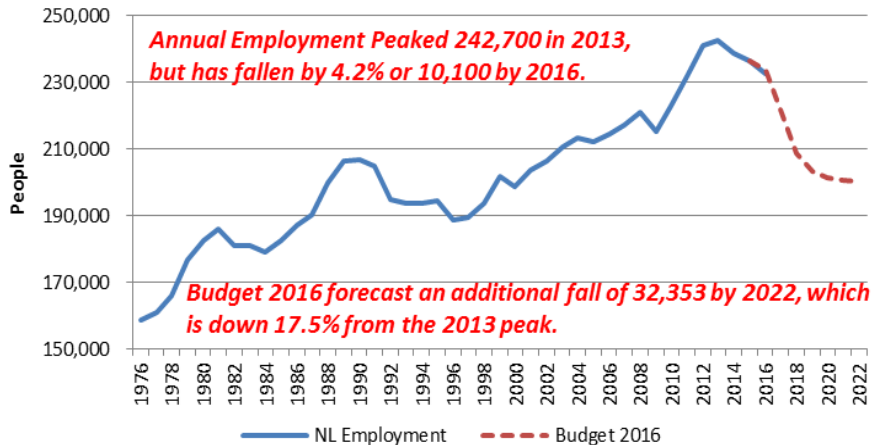
NL's absolute and relative position have improved over time, but they have been declining in recent years.

We are starting to see the impacts of lower oil prices with two years of real decline in GDP

The budget is forecasting several years of negative growth

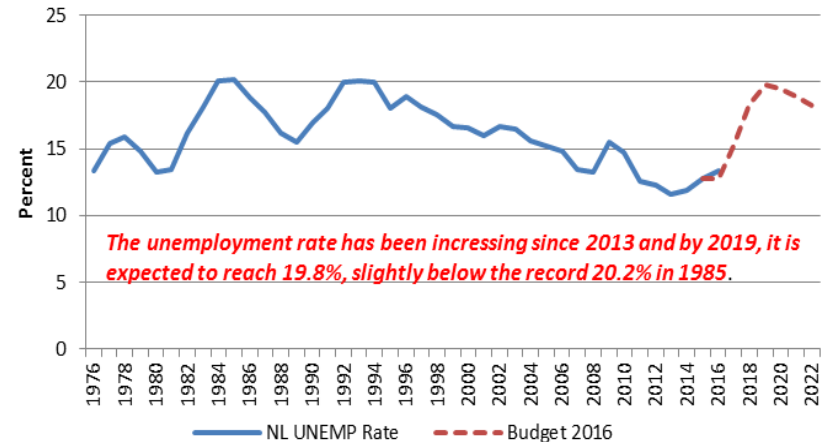
Employment (1)

NL Employment and Budget Forecast



CANSIM Data Table 2820002 and Budget 2016

NL Unemployment Rate and Budget Forecast



CANSIM Data Table 2820002 and Budget 2016

There is a noticeable decline in employment and a noticeable increase in the seasonally adjusted unemployment rate in the last three years, which pre-dates the fall in the price of oil.

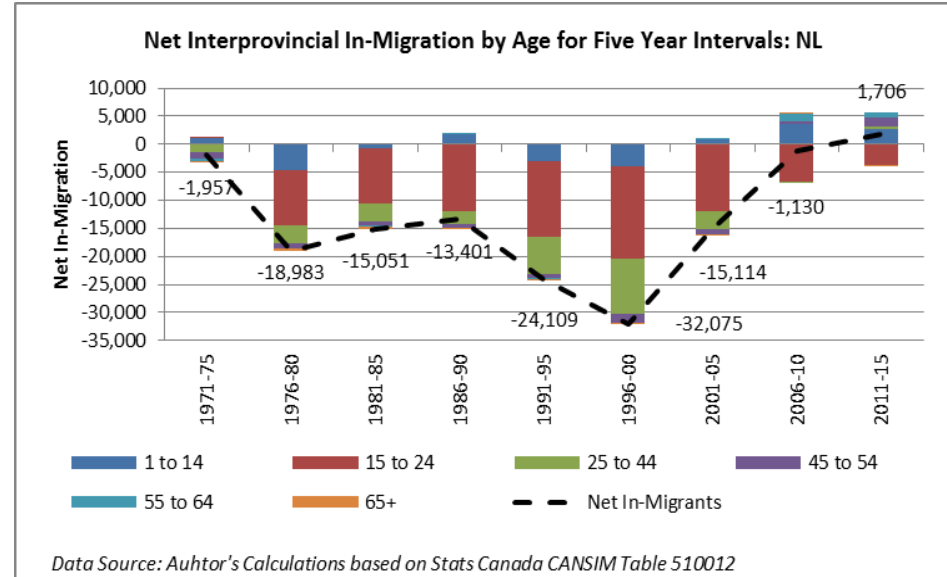
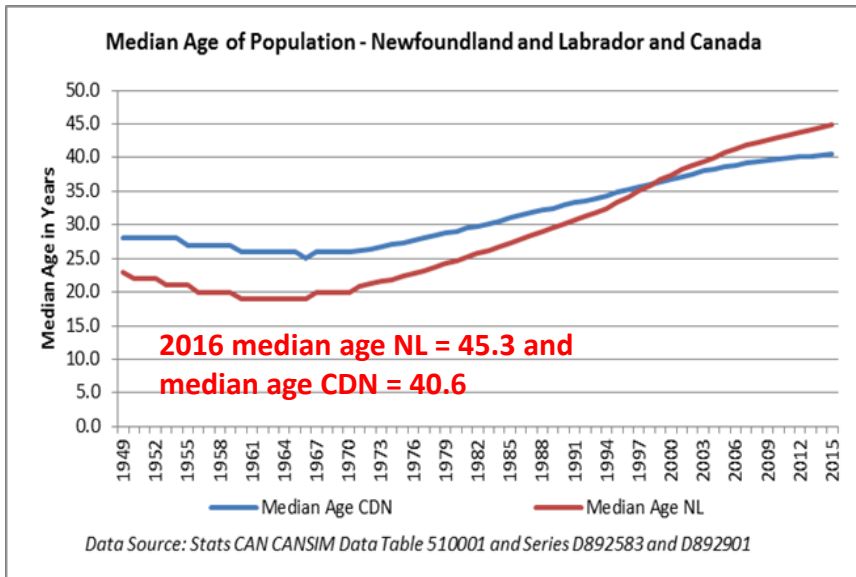
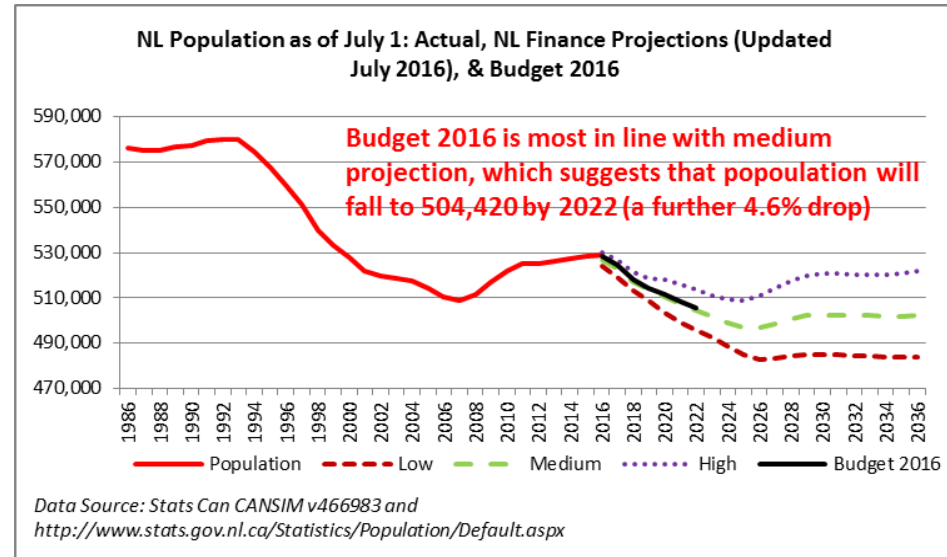
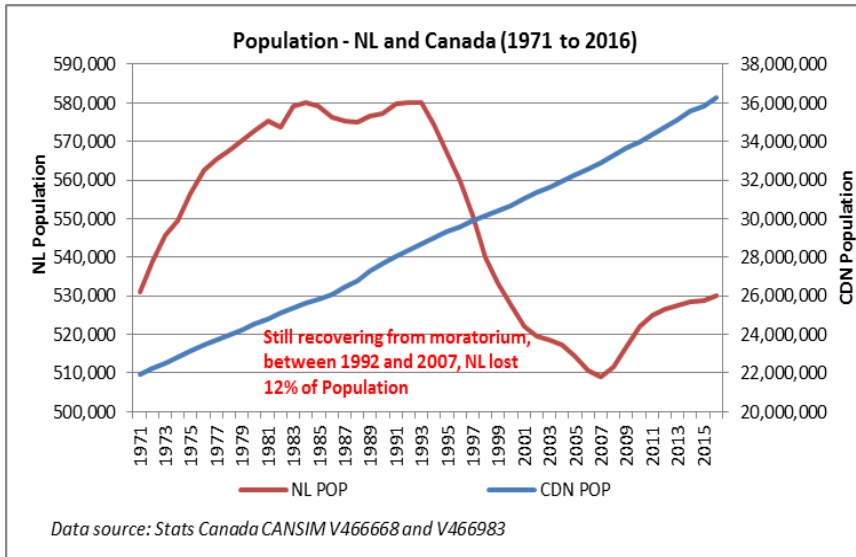
Employment levels expected to be 42,350 lower than they were in 2013, when annual and monthly employment peaked. This represents a 17.5% reduction in employment levels from 2013 to 2022.

To put this in perspective, in the last three years, employment fell by 4.2% from peak or there are 10,100 fewer people working in 2016 than in 2013

Unemployment rates have been increasing and by 2019, they are expected to increase to 19.8%, which is just below the 20.2% record in 1985

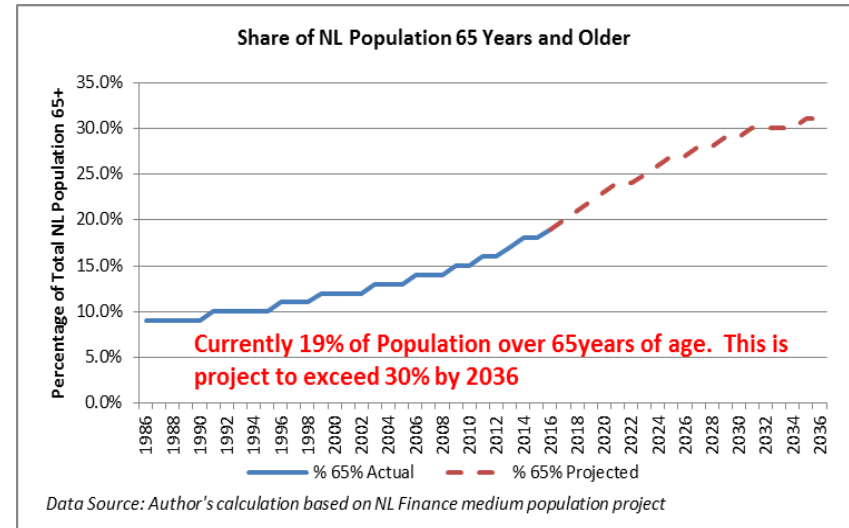
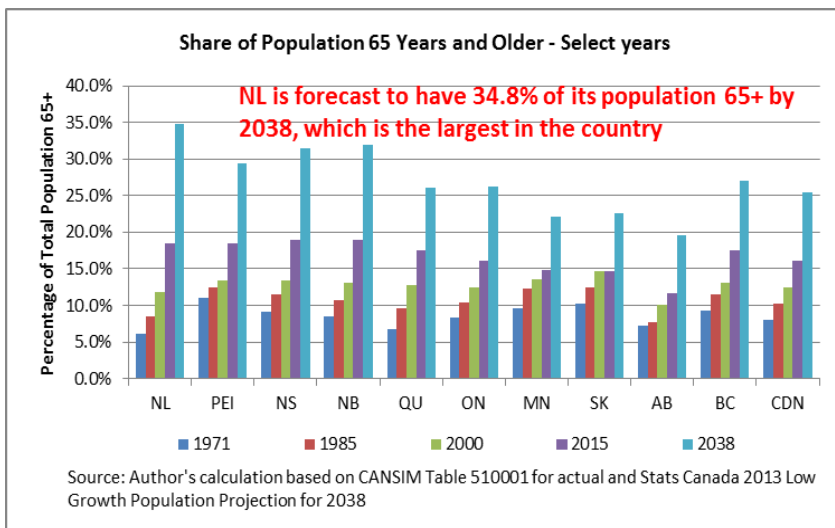
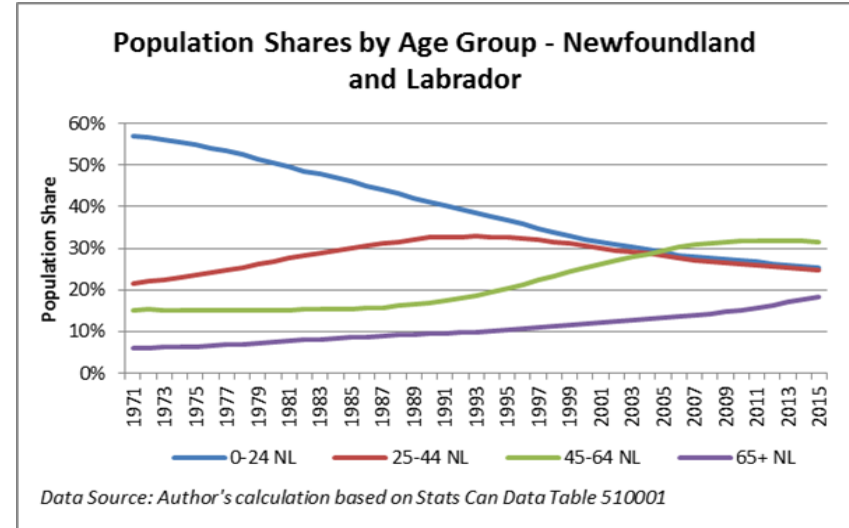
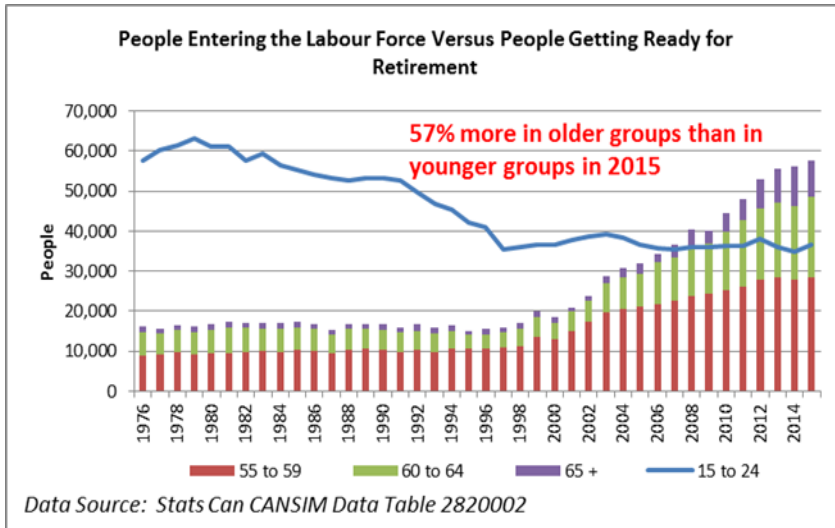
Hard to know how much of it is caused by oil price falls, but certainly some of the deterioration is due to a slow down in the oil economy

Demographic Time Bomb: Declining Population



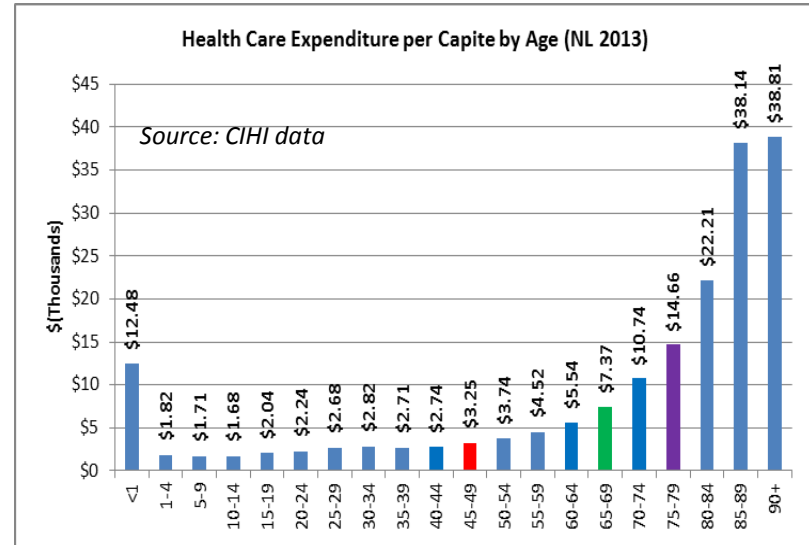
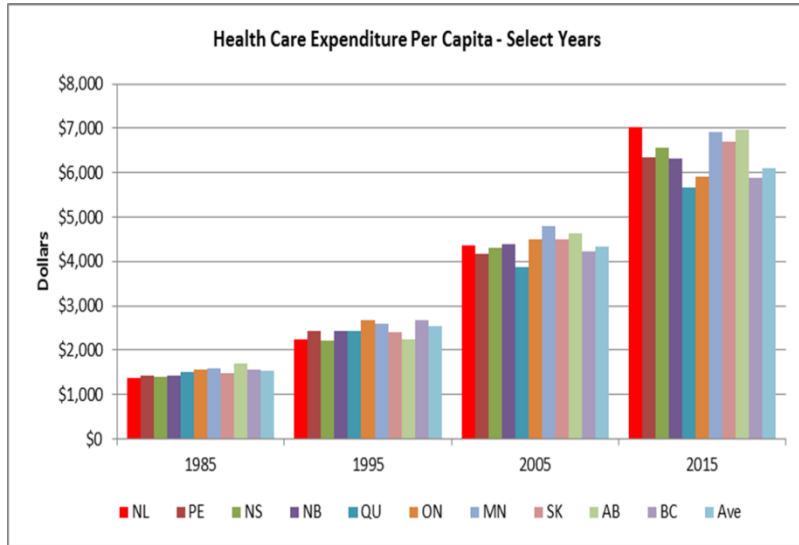
Between 1961 and 2016, 154,576 more people left NL than moved to NL from other provinces, which average 2,836 per year and between 2015 to 2038, population expected to fall by 8.5% with low, 5% with medium and 1.3% with high

Demographic Time Bomb: Declining and Aging Population



NL is getting older and quickly. By 2038, NL is expected to have 34.8% (31% utilizing NL projections) of population over 65 years of age, while Canada will have 25.4%. This will have implications for public services (health in particular), housing, labour markets and demand for various types of projects

Per Capita Expenditure on Health Care – NL (2013)



An aging population would normally be expected to put more pressure on health care costs

On average, it costs NL \$5,061 per capita for health care costs

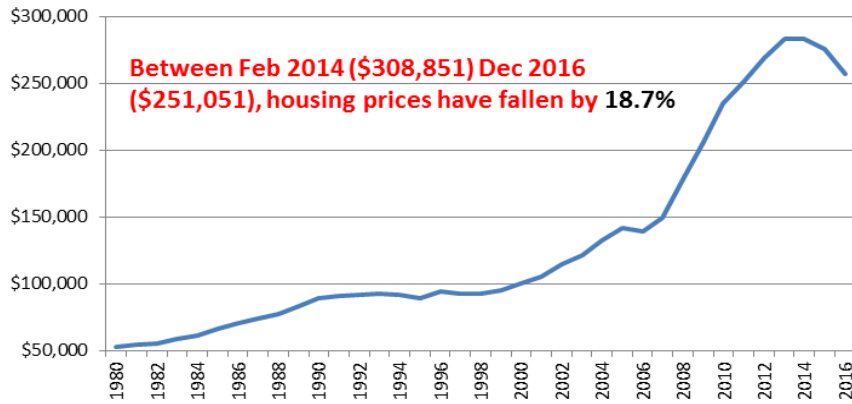
If no other cost drivers change (doctor's salaries, cost of band aids, etc.), then in 20 years the median age (currently 45 years) person's health cost will more than double and will nearly double yet again in another 10 years after that

Health care is so important to Newfoundlanders and Labradorians and is the biggest expenditure in the budget (36% of expenditure on the Health Care Sector)

It is one of the most significant cost drivers for the government and it may be time to have a Royal Commission to look at all aspects of health care (funding, delivery, infrastructure and what we want and can pay for) seems to make a lot of sense at this point in time.

NL Housing Market

Average MLS Housing Prices - NL (Annual)



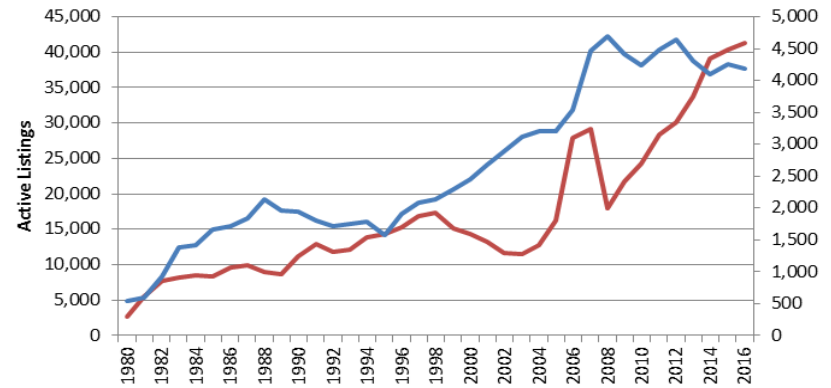
Data Source: NL Association of Realtors

Aging population, lower employment, higher taxes (including HST), lower expenditures and lower confidence do not bode well for the housing market

Provincial expenditure cuts in the range of \$240 to \$250 M would have a significant and negative impact on the housing market

At \$60,000 average wages and 50% of expenditure on wages, this could translate into in excess of 2,000 fewer people working directly for government

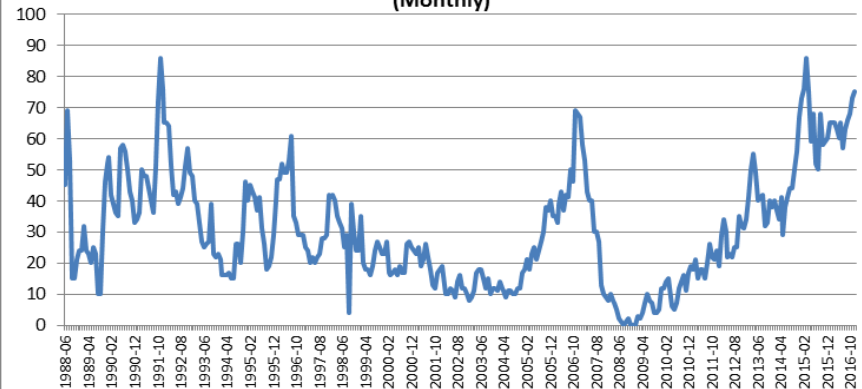
Average MLS Sales and Listings - NL (Annual)



NL Association of Realtors

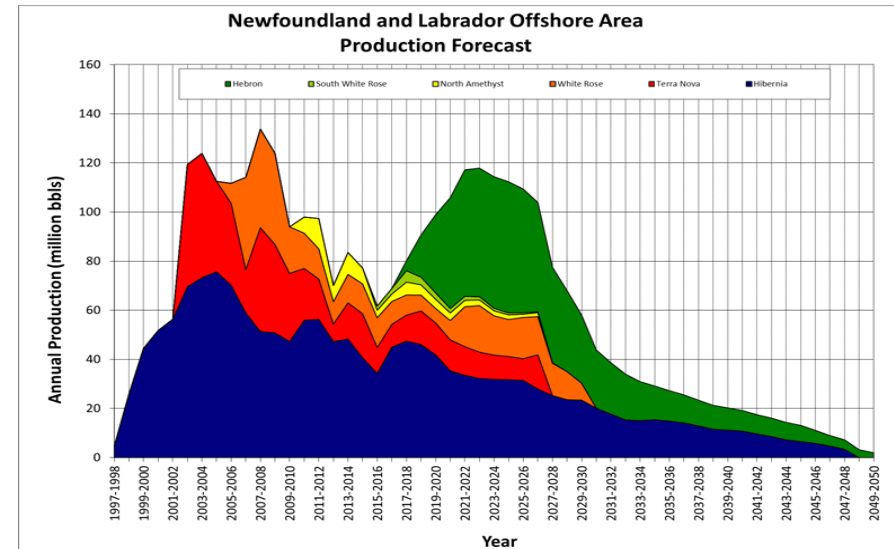
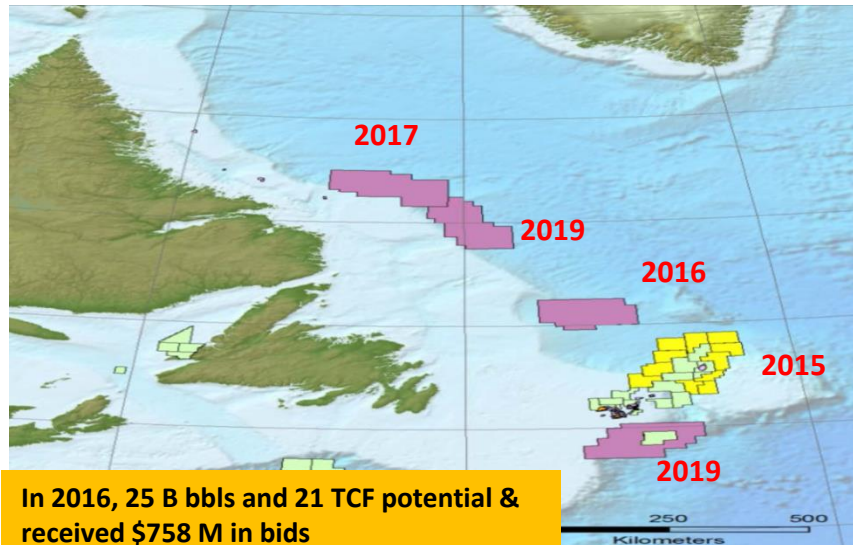
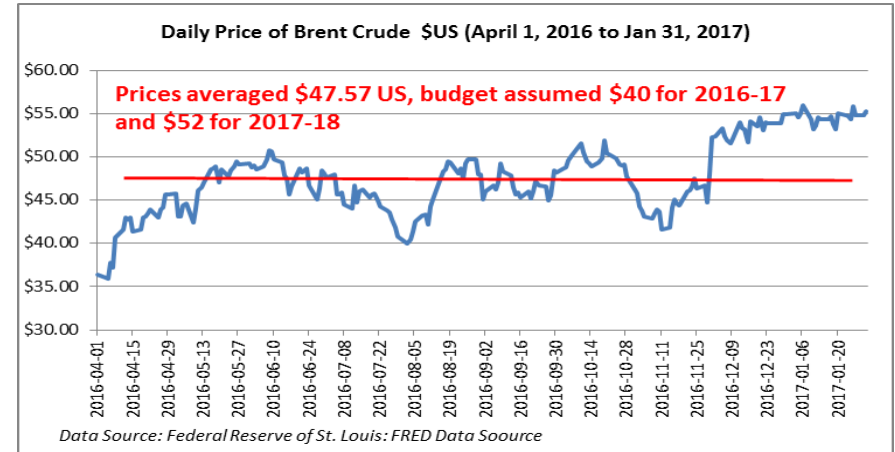
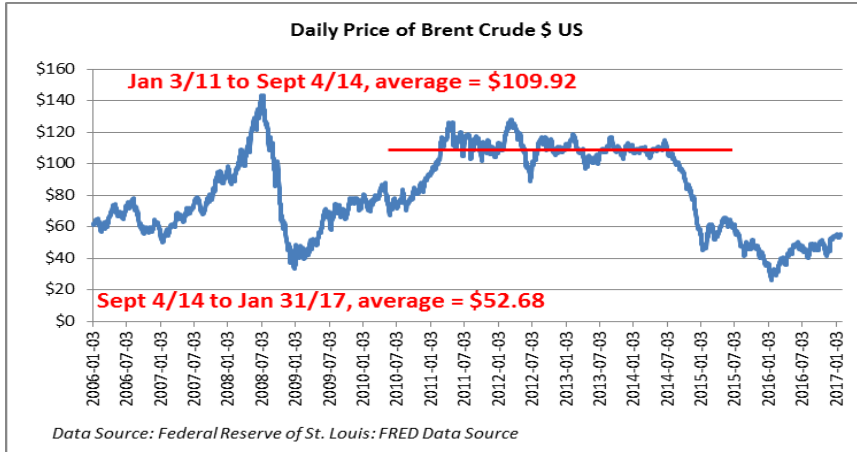
— Listing — Sales

Unabsorbed Inventory of Newly Complete Dwellings - St. John's (Monthly)



Stats Canada CANSIM 270038

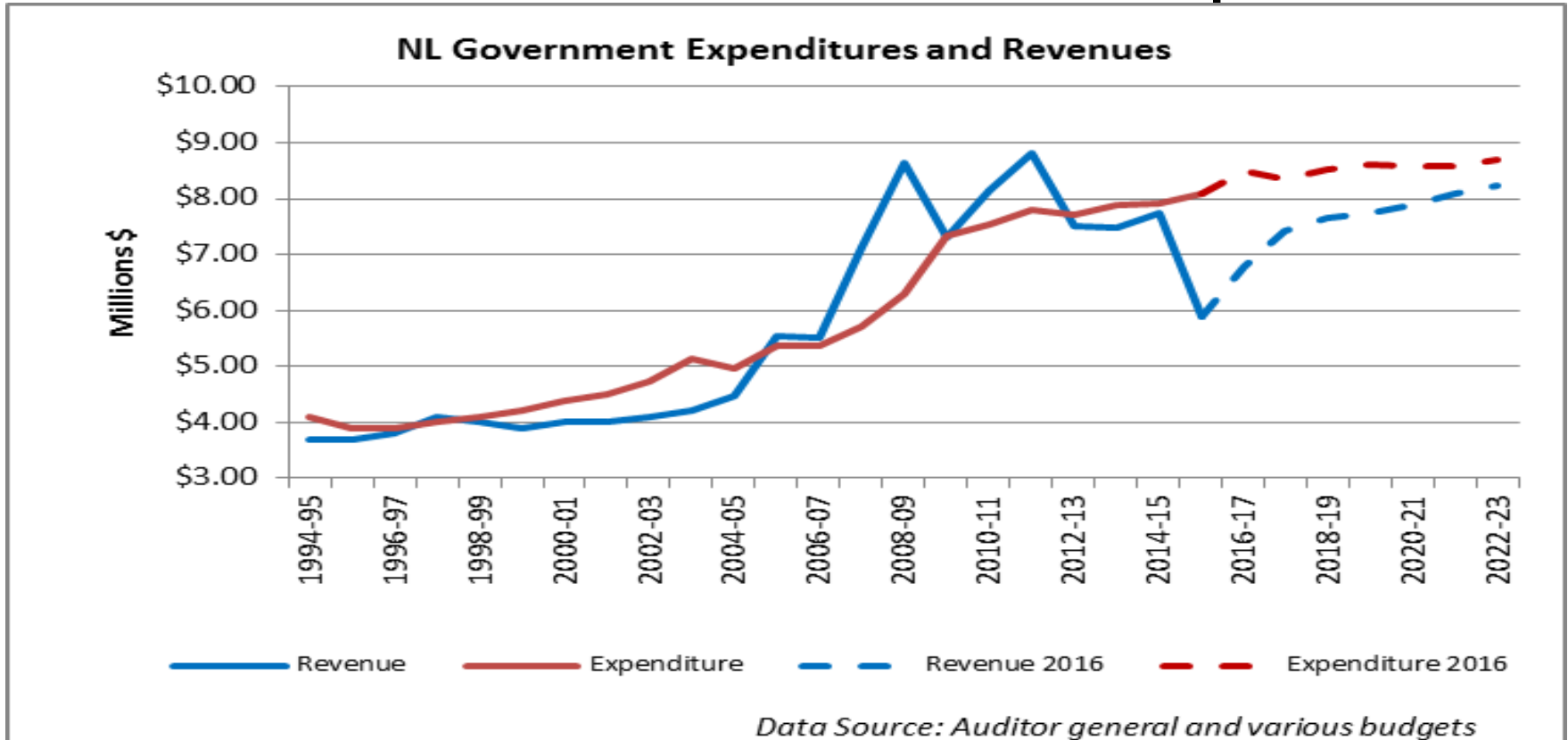
Oil and Gas



Statoil exploration plans for the Flemish Pass is indeed good news and will create some short term economic stimulus, but we are a long ways away from any significant contribution to the current fiscal situation faced by the province

In 2016, land sales for identified 25 B bbls & 21 TCF resulted in \$768 M in bids. In 2015, land sales for identified 12 B bbls & 113 TCF resulted in \$1.2 B in bids

Government Revenues and Expenditures



Between 2011/12 and 2015/16, royalties have fallen from 38.7% of provincial revenues to 10.5%

Between 2004-05 and 2014-15, revenues increased by 73% and expenditures increased by 59%.

Most of the heavy lifting in Budget 2016 was done through revenue increases, rather than expenditure cuts. However, if revenue is not sustained in the future, then we will be in the same spot as we are currently.

Implied Budgetary Changes to Meet Stated Targets

	Forecast Revenue Budget 2016	Forecast Program Expenditure Budget 2016	Forecast Debt Serving Expenditure Budget 2016	Revenue Risk Adjustment (Fudge Factor)	Revenue minus Expenditure or Implied Deficit	Target Deficit Budget 2016	Additional Adjustment Required to Meet Target Deficit (Either Reduced Expenditure or Enhanced Revenue)
2016-17	\$6,776.30	-\$7,499.00	-\$982.30	-\$125.00	-\$1,830.00	-\$1,830.00	\$0.00
2017-18	\$7,409.60	-\$7,307.30	-\$1,033.50	-\$125.00	-\$1,056.20	-\$800.00	-\$256.20
2018-19	\$7,659.20	-\$7,390.30	-\$1,125.20	-\$125.00	-\$981.30	-\$650.00	-\$331.30
2019-20	\$7,737.00	-\$7,432.50	-\$1,166.70	-\$125.00	-\$987.20	-\$500.00	-\$487.20
2020-21	\$7,871.80	-\$7,406.70	-\$1,181.80	-\$125.00	-\$841.70	-\$250.00	-\$591.70
2021-22	\$8,096.60	-\$7,362.90	-\$1,229.10	-\$125.00	-\$620.40	\$0.00	-\$620.40

Implied Annual Changes in Variables to Meet Target Deficit

	Forecast Revenue Budget 2016	Forecast Program Expenditure Budget 2016	Forecast Debt Serving Expenditure Budget 2016	Revenue Risk Adjustment (Fudge Factor)	Revenue minus Expenditure or Implied Deficit	Target Deficit Budget 2016	Additional Adjustment Required to Meet Target Deficit (Either Reduced Expenditure or Enhanced Revenue)
2016-17							
2017-18	\$633.30	-\$191.70	\$51.20	\$0.00	-\$773.80	-\$1,030.00	\$256.20
2018-19	\$249.60	\$83.00	\$91.70	\$0.00	-\$74.90	-\$150.00	\$75.10
2019-20	\$77.80	\$42.20	\$41.50	\$0.00	\$5.90	-\$150.00	\$155.90
2020-21	\$134.80	-\$25.80	\$15.10	\$0.00	-\$145.50	-\$250.00	\$104.50
2021-22	\$224.80	-\$43.80	\$47.30	\$0.00	-\$221.30	-\$250.00	\$28.70
Cum Total	\$1,320.30	-\$136.10	\$246.80	\$0.00	-\$1,209.60	-\$1,830.00	\$620.40

To get to balance, \$1.3 B (\$8.1 B - \$6.8 B) in extra revenue plus \$140 M (\$7.50 B - \$7.36 B) in indicated program reductions (1.8%) and another \$620 M in implied program expenditure cuts (8.3% reduction) for a total implied reduction on program expenditure of \$760 M (10.1% reduction) If the expenditure were made up by cutting labour costs, then, utilizing an average wage of \$60,000, this would imply a reduction of 1,667 full-time equivalent jobs for \$200 M reduction in program expenditure, assuming half comes from wages.

Fiscal Update and Way Forward

Summary of Fiscal Update - Relevant Parameters			
	Change Since Budget 2016		Change Since Budget 2016
oil revenues (royalties and CIT from higher prices)	\$120	Oil Prices	\$5
Government Business Enterprises	\$17	Oil Production (MM bbls)	\$4
Prior Year Base Adjustments (PIT and CIT)	\$80	Exchange Rate	?
Total Change in Revenue	\$217	Real GDP	-0.4%
Program Expenditures	-\$111	Household Income	-0.5%
Debt Servicing Expenses	\$132	Retail Sales	-0.7%
Total Change in Expenses	\$21	Housing Starts	-0.3%
Revised Change in Deficit	\$197	Capital Investment	-1.3%
Change in Accounting Assumption (reduce \$125M to \$75M)	-\$50	Employment	-0.3%
		Unemployment Rate	0.4%
Change in Adjusted Deficit	\$247	Participation Rate	-0.2%
		Population	0.3%
		HST Over Payment \$140 M (while \$89 M already included in estimates, there is still \$51 M that needs to be taken into account)	

Note: with the fiscal update, all the indicators appear to be going in the wrong direction. It does not bode well for hitting future budget targets. The 2016 AG report states: “Most economic indicators have deteriorated in the 6 months since the economic forecast released as part of Budget 2016 – this indicates there may be some risk for the revenue forecast for the remainder of 2016-17 and, also, future years.”

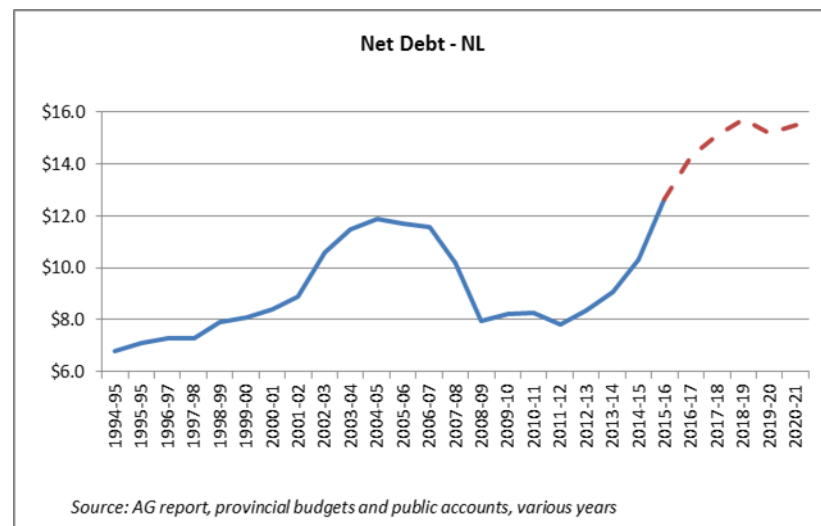
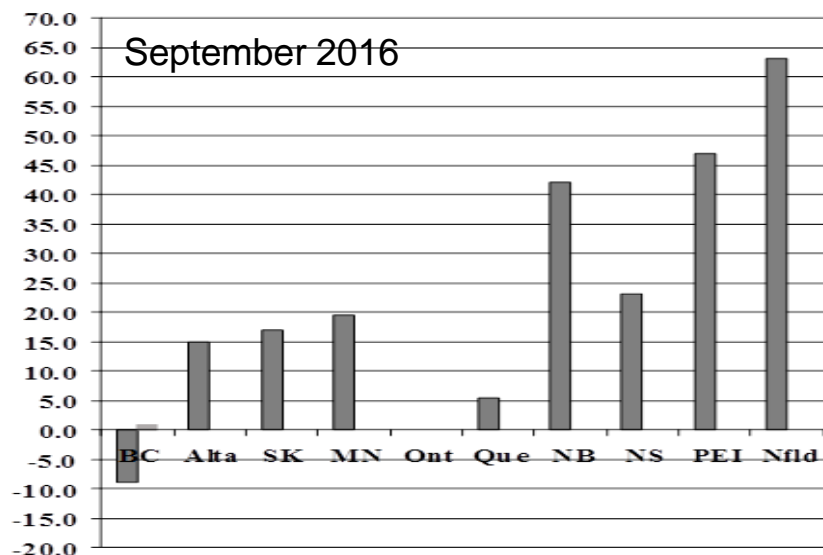
The Way Forward lays out a vision, but one that does not appear to be fully integrated with the economic and fiscal realities of the province. It is certainly not a roadmap. It appears to be more in line what the government hopes will transpire.

NL is Already Challenged in terms of Borrowing

Long Term Debt Credit Rating Systems				
Investment Quality	Moody's	Standard and Poor's	DBRS	Fitch
Highest Quality	Aaa	AAA	AAA	AAA
Substantial Payment Capacity	Aa1	AA+	AA(High)	AA+
	Aa2	AA	AA(Middle)	AA
	Aa3	AA-	AA(Low)	AA-
High Payment Capacity	A1	A+	A(High)	A+
	A2	A	A(Middle)	A
	A3	A-	A(Low)	A-
Adequate Payment Capacity	Baa1	BBB+	BBB(High)	BBB+
	Baa2	BBB	BBB(Middle)	BBB
	Baa3	BBB-	BBB(Low)	BBB-
Non-investment grade: BB, B, CCC, CC and C categories				
In Default	C	D	D	D

Canadian Provincial Ratings, December 31 st , 2016			
	DBRS	S&P	Moody's
British Columbia	AA(high)	AAA	Aaa
Alberta	AA(high)	AA (negative)	Aa1 (negative)
Saskatchewan	AA	AA+ (negative)	Aaa
Manitoba	A(high)	AA- (negative)	Aa2
Ontario	AA(low)	A+	Aa2
Quebec	A(high)	A+(positive)	Aa2
New Brunswick	A(high)	A+	Aa2
Nova Scotia	A(high)	A+	Aa2
Prince Edward Island	A(low)	A	Aa2
Newfoundland & Labrador	A(low)	A (negative)	Aa3 (negative)

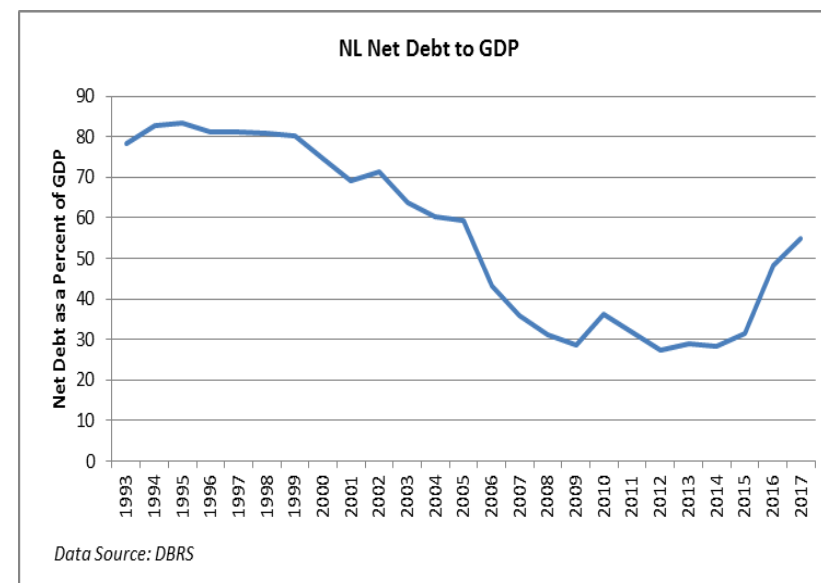
NL Borrowing Challenges: Another Risk



Risk associated with NL long term debt has increase relative to Ontario since 2015 (premium required to attract financing is higher by 65 basis points and about 50 basis points currently currently)

Net debt has come down in recent years, but with lower oil prices, deficits are higher and net debt is rising. If the 2016 budget targets are met, we will see a slowdown in debt accumulation; it will not result in debt being reduced. Net debt, if everything goes well, will set in about \$15 to \$16 B

Net debt as a percent of GDP is increasing which will enhance the likelihood of a credit downgrade (we are the lowest in the country currently)



Learning from the Past (1)

Janice MacKinnon, Minister of Finance for Saskatchewan in the early 1990s, Minding the Public Purse: The Fiscal Crisis, Political Trade-offs and Canada's Future page 99, describes how a failing US \$500 million debt issue (being marketed to investors, but no take-up) prompted the Province to take significant actions in the budget

As the vicious cycle of deficit/debt and interest worsened, further credit-rating downgrades led some investors to refuse to lend to provinces such as Saskatchewan, so the number of investors willing to buy government bonds shrank. The final threshold was the line between a very low A and a BBB credit rating.

In an ominous reference to Saskatchewan and Newfoundland, Canada's most indebted provinces, the prime minister would say, "Tomorrow I will begin emergency consultations with provincial premiers, including the premiers of two provinces where federal officials have essentially taken over control of fiscal planning under IMF instructions.'

Learning from the Past (2)

At our first cabinet meeting all ministers were presented with documents to be signed agreeing to a cut in our pay in the name of fiscal restraint. After that, the bad news just kept rolling in like tidal waves. Just as we had absorbed one dose of woe, another wave would roll in to sweep the feet out from under us again. Three days into our new government, we were told that the deficit for 1991-92 was going to be more than half a billion dollars higher than the very unreliable Conservatives' budget estimate.

Conclusion

- While one can **legitimately debate** what the appropriate **way is to deal** with the problems we are now facing, there ought to be **no debate** that we are facing **serious problems**.
- This includes the **economic and employment problem**, **fiscal problem**, an **aging and declining population** and **borrowing/debt problem**
- It may be difficult to meet the **deficit targets** but, as **ambitious** as they maybe, only get us to a point where debt stops accumulating. It does **not lower** NL's **indebtedness**.
- It is equally important to recognize that the **best way** to deal with an **expenditure problem** is to address your **expenditures directly**.
- It is easy to be **critical** of how any particular person deals with a problem, but it is **not helpful** if there are **no feasible alternatives** offered. The problem **belongs to all of us** and we all need to **share in the solution**! Furthermore, waiting to deal with the problem and hoping things get better may compound the problem
- Even though people seem recognize the current **fiscal and economic circumstances**, it seems to me that we, as a province, have **not fully appreciated** just how difficult the solution will have to be and that **waiting** may make the **adjustment costs more unmanageable**.
- There is **hope** with the offshore and that oil prices will rise, but these are medium to longer term and we do not know by how much they will rise and for how long. Yet, we do need to do something now and the **political will and social acceptability does not seem to be there**.
- This might be a good time for a Royal Commission on Health Care and any vision statement for the province needs to have a firm grounding in the economic and fiscal realities of the province.