Fall Update 2014-15

The Honourable Ross Wiseman
Minister of Finance and President of Treasury Board

Newfoundland Labrador

Current Global Economic Environment

The global economy continues to struggle with achieving consistent and sustainable growth across major regions. In October 2014 the International Monetary Fund (IMF) revised its global economic projections downward for this year. World GDP growth is now expected to average 3.3% in 2014 versus the view of 3.7% at the outset of the year. Europe, Japan and China have been struggling to strike the right balance between inflation and economic growth. Deflationary pressures, both on consumer and producer prices, are a concern for many monetary authorities. The only large economies showing near term accelerating growth prospects are the United States, United Kingdom and India.

China, one of the largest economies in the world and one of the key drivers of commodity prices, has been experiencing a slowdown in economic growth in recent quarters due to tightening credit and weaker export demand. The Euro area has been unable to shrug off the lingering effects of the 2008/2009 recession despite several years of extremely low interest rates. Japan has experienced a number of serious economic difficulties over the past two decades and these problems show no sign of abating in the near term—Japanese government policies designed to stimulate economic recovery did produce some positive results in 2013 but GDP growth faltered in the fourth quarter of 2013 and is estimated to have declined in the second and third quarters of this year.

Amid these economic challenges, prices for many commodities have been falling. Oil, in particular, has been declining since mid-June. Prices for Brent crude oil in early December were down over 30% from the beginning of this year and iron ore prices were down about 45% since January. International commodity markets will likely remain volatile until readjustment occurs. Oil demand growth is weaker than anticipated as economic growth in China has slowed and Japan and Europe struggle to regain sustained economic expansions. In addition, shale oil production from the U.S. has grown at unprecedented rates and traditional OPEC producers like Libya are increasing their oil production. As a result, world oil supply is outstripping demand and creating a surplus, and consequently, prices have decreased. Lower prices should have the dual effect of decreasing supply and encouraging more demand. In the short-term, however, the result has been a significant negative price swing. Oil price forecasts vary considerably and there is no clear consensus on when and at what level oil prices will stabilize.

For Canada, the drop in oil prices and fall in Canada's exchange rate should help economic performance in manufacturing intensive provinces. However, for oil exporters, commodity price declines are cause for concern. The latest forecasts from Canadian banks have real GDP in Canada growing by an average of 2.3% in 2014.

Newfoundland and Labrador

Economic conditions in Newfoundland and Labrador softened in 2014. Growth in the domestic side of the economy was constrained by lower investment spending in real terms and deteriorating global commodity market conditions, particularly for oil and iron ore, weighed heavily on the export sector. Real GDP is now expected to be down by 2.0% (see table of economic indicators), primarily due to lower exports, in particular oil and iron ore.

Economic Indicators Forecast (Calendar Year)
2014, Budget vs Fall and Latest 2015 Forecast
(per cent change unless otherwise indicated)

	2014 Budget	2014 Fall	Change Budget vs Fall	2015 Fall
Real GDP	0.5	-2.0	-2.5 ppt.	1.7
Household Income	3.4	4.7	+1.3 ppt.	2.6
Retail Sales	3.6	3.9	+0.3 ppt.	1.5
Housing Starts	2,843	2,287	-556 units	2,173
Capital Investment	2.4	0.6	-1.8 ppt.	9.2
Employment	0.3	-2.0	-2.3 ppt.	1.0
Unemployment Rate (%)	11.4	12.3	+0.9 ppt.	12.1
Population	0.0	-0.2	-0.2 ppt.	0.1

Capital investment in the province is estimated to have remained at very high levels in 2014. Investment is expected to total $12.4 billion this year, up 0.6% from the record level recorded in 2013. Lower spending on Vale's nickel processing facility in Long Harbour was offset by higher spending on the Hebron and White Rose projects and on the Muskrat Falls development.

Employment, as measured by Statistics Canada's Labour Force Survey, has fallen in 2014. Newfoundland and Labrador was one of four provinces to record negative or no employment growth year-over-year during the first 11 months of 2014. Lower development activity at Vale's nickel processing site in Long Harbour and the closure of Wabush Mines were contributing factors to the drop in employment this year.

On the positive side, indicators of income growth were solid. Average weekly earnings rose by 4.4% in the first nine months of 2014 and at $985 were the second highest among provinces after Alberta. The increase in wages resulted in a 5.2% gain in total employee compensation for the first nine months of 2014. Gains in income led to a 3.3% increase in the value of retail sales during the first nine months of 2014 compared to the same period of 2013.

Outlook

The economic outlook is brighter for Newfoundland and Labrador in 2015. The Department of Finance is expecting real GDP to increase as higher mineral and oil production will boost exports. As well, capital investment is expected to increase by about 9% primarily due to increased investment in White Rose and Muskrat Falls. Employment is expected to increase as the dampening effects of the winding down of Long Harbour development dissipate. This, combined with higher wages, should lead to a rise in incomes and retail sales. This positive outlook for the province is shared with other leading forecasters. The Conference Board of Canada has indicated that Newfoundland and Labrador should post one of the strongest real GDP growth rates among provinces in 2015.

Longer term, the enormous potential of the province's offshore resources is reason for optimism about the economic future of Newfoundland and Labrador. This optimism is supported by recent land sale results in the Newfoundland and Labrador offshore. Successful bids were received for three of six parcels and the bid on one parcel by ExxonMobil Canada Ltd., Suncor Energy Inc. and ConocoPhillips Canada Resources Corp. was $559 million, the highest bid ever on a land parcel in the Newfoundland and Labrador offshore area.

Additionally, the start of production from Hebron, Muskrat Falls and the White Rose Extension, development of Statoil's Bay du Nord discovery, and construction of the underground mine at Voisey's Bay will provide a boost to the province's economy.

Fiscal Update

2014-15 Update

Budget 2014, delivered on March 27, forecast a deficit for this year of $537.9 million. Since that time principally two events have had a material impact on the deficit forecast. A decline in oil prices over recent months have had a negative impact while the reform of the public sector pension plan and post-employment group health and insurance benefits has had a positive effect. This results in a net increase in the deficit of $378.2 million, now forecast for the year to be $916.1 million.

Statement of Operations 2014-15

$ Million	2014-15 Budget	2014-15 Fall Update	Variance
Revenue	6,902.1	6,240.0	(662.1)
Net Income of GBEs	388.7	372.1	(16.6)
Total Revenue	**7,290.8**	**6,612.1**	**(678.7)**
Net Expenses:			
Program Expenses	6,954.7	6,763.0	191.7
Debt Servicing Expenses	874.0	765.2	108.8
Total Net Expenses	**7,828.7**	**7,528.2**	**300.5**
(Deficit)	**(537.9)**	**(916.1)**	**(378.2)**

Revenue

The greatest single impact on our revenues is the price of oil, which, along with the volume of oil production and the US-Canadian dollar exchange rate, determines our offshore royalties.

Our oil price assumption at Budget of an average price of $105US a barrel for this fiscal year initially proved sound, as that price was mostly exceeded until the end of July, reaching as high as $115US in mid-June. After that, the price drifted lower, but stayed mostly above $100US until the end of August.

It has been conventional wisdom that Brent crude at a minimum of $100US a barrel is a benchmark price used as the basis for the budgets of many major oil producing countries around the world, and that these oil producers, notably OPEC, would take steps to support the price in the $100US range should it test that level. Until recently, except for a brief period in mid-2012, Brent oil has exceeded $100US a barrel since February 2011.

However, in the past few months, the view of commodity markets internationally is that world oil supplies are exceeding demand, and with little indication supply is being curtailed, prices have drifted lower. On November 27 OPEC indicated its members would not lower their production levels and this is contributing to weaker prices. We are presently in a period when the future direction of oil prices is not clear. We remain optimistic the interest so many oil producing countries have in a minimum price in the $100US range will see action taken to support higher prices in the future.

In the shorter term, however, we have to be prudent and adjust our oil price forecast for the remainder of this fiscal year. Whereas the price we received averaged $106.46US for the first half of the year from April to September, and averaged $100.50US from April to November, we are expecting the price to average $63.00US for the remaining four months from December to March 2015. Together with production being about 9 percent lower than forecast at Budget, but the exchange rate being more favourable, we are forecasting oil royalties to be $791.7 million lower than Budget for the year.

Lower oil royalties are offset somewhat by improvements in other revenues, notably personal income tax, but also other natural resource revenues, HST and corporate income tax. Revenues, other than offshore royalties, are $113.0 million higher than Budget, led by an $85.3 million improvement in personal income tax, reflecting the underlying strength of our economy.

Expenses

On the expense side, it has been an objective of this government to place public sector pension plans on a sustainable basis. In cooperation with our public sector unions we have made significant progress in achieving this. As announced last week, the Government of Newfoundland and Labrador and the five largest public sector unions finalized a joint sponsorship agreement and legislation will implement contribution rate increases and changes to the pension plan design effective January 1, 2015. On this basis, we are recognizing savings related to pension and other post-retirement benefits this year amounting to $157.7 million.

We are forecasting all other net expenses to be $52.8 million lower than Budget.

Premier Davis announced on November 27 that we are adding a new layer of approval to scrutinize all hiring for government departments and agencies, and that discretionary spending is being ceased effective immediately. These measures are anticipated to save $90 million.

Fiscal Outlook

Our fiscal plan projected a return to surplus next year. However, as we do every year, we will have to evaluate our plan over the coming months as we prepare Budget 2015. What the future holds for oil prices will continue to evolve and it is still some months before we will determine our price forecast for next year and beyond.

Despite the current fiscal challenges, Government shares with the people of the province the view that there is every reason to be optimistic. The economic prosperity we have enjoyed since 2003 will continue well into the future. As government prepares next year's Budget difficult choices will need to be made as adjustments take place to reflect the reality of much lower oil revenues.