Impact of Lower Oil Prices on the Canadian Economic Outlook?

Oil prices fell steadily, and sharply, through the summer and fall of 2014. WTI prices are currently sitting around $83/bbl, down sharply from an average $106/bbl in June. The drop in prices has not been specific to North America, with Brent prices also down sharply to around $85/bbl recently from an average of $111/bbl in June. RBC’s energy team attributes the surprising weakness to a combination of factors including a slowing global demand backdrop, strong supply growth in the United States, the recovery of production in Libya, and the appreciating U.S. dollar. These factors are not expected to fade significantly in the near-term prompting a marking down of RBC’s forecasts for WTI and Brent prices to an average $86.5/bbl and $94/bbl, respectively, in 2015 from $96/bbl and $105/bbl previously. Prices in 2016 have been lowered as well to $85.0/bbl and $97/bbl, for WTI and Brent respectively, from $89.25/bbl and $102/bbl previously. Longer-term price estimates were left unchanged at $95.0/bbl and $102/bbl, respectively.

Impact on the Canadian economic outlook

Although there are significant regional and fiscal implications, changes of the above magnitude are not likely to have a material impact on overall Canadian GDP growth. The approximately 10% downgrade in our oil price forecast next year if sustained would have a negative impact on activity in the oil industry over time; however, as the Bank of Canada has highlighted repeatedly, the net impact on overall Canadian GDP depends on the potential impact of the price shock itself on foreign demand. The most recent drop in oil prices has been driven by a combination of supply factors and non-U.S. global demand factors suggesting that the decline is likely a net positive for the U.S., which remains (for now) a net importer of petroleum products, and by extension Canada’s non-energy exports. Our own working assumption is that every sustained 10% decline (increase) in oil prices raises (lowers) U.S. GDP growth by 0.1% to 0.2%. Thus, in the face of the downward revision to oil prices we expect the attendant increase in external demand to more-than-offset weakness in the domestic energy sector resulting in a very modest (less than 0.1%) but positive impact on Canadian GDP. This impact is likely to be even smaller given the initial downward revision to oil prices is eventually unwound through the longer term. This estimate is similar to the results of Baumeister et al. (2010) that found an essentially neutral impact on Canadian GDP growth from a supply-driven 10% oil price shock, once accounting for the impact of the shock on foreign demand.
Similar to GDP, net levels of employment as well as the national unemployment rate are unlikely to be significantly impacted by the oil price change, although the lack of impact on national activity will likely hide more significant offsetting regional and industry impacts.

Although the impact of the recent decline in oil prices will not necessarily be reflected in weaker real production growth, the impact on national real income growth is unambiguously negative via the hit to Canada’s terms-of-trade. Lower oil prices reduce the ratio of export prices to import prices (the terms-of-trade) thereby reducing the volume of imports that can be purchased with a given volume of exports. This reduces the net purchasing power of domestic production which lowers real incomes as measured by real Gross Domestic Income (GDI). Our own initial estimates suggest that incorporating new oil price assumptions into our forecast would lower the Canadian terms-of-trade by approximately 0.4% in 2015 relative to previous assumptions which in turn lowers real GDI growth by approximately 0.1ppts in the year. Our most recent forecast implied about a 2.3% increase in real GDI growth in 2015, slightly below our forecast for a 2.7% increase in real GDP in the year.

Lower oil prices also mean lower gasoline prices and headline CPI growth. Our initial estimates suggest that the approximately 10% reduction in our assumed oil price next year will lower our headline CPI growth forecast in 2015, currently at 1.6%, by approximately 0.2/0.3 ppt assuming core CPI growth unchanged at 1.9%. Government revenues will also likely be impacted significantly, although again regional differences mean that lower oil royalties collected in oil producing provinces like Alberta, Newfoundland & Labrador, and Saskatchewan, and lower corporate tax revenues (provincially and federally), could be offset at least partially by stronger balances in provinces where economic activity is typically boosted by stronger U.S. demand, like Ontario.

The deterioration in the terms-of-trade also adds approximately $2 billion to the Canadian current account deficit in 2015, which equates to about 0.1 ppt as a ratio to GDP.

References:
