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Central Canada gets much-needed break from oil price drop

Ontario and Quebec benefiting as manufacturing is boosted by lower energy costs and a depreciated loonie

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Oil prices have come down quite sharply since the summer, with every commodity (Brent, West Texas intermediate and Western Canada Select) falling by around $25 to $30 (U.S.) a barrel.

Most of this decline has been caused by increased supply, a strengthening U.S. dollar and softer-than-expected growth in China and the euro zone. But the most recent leg down appears more to be the impact of the Organization of Petroleum Exporting Countries looking like it wants to put its foot down and confront the U.S. shale oil boom head on.

Over all, the Bank of Canada's latest Monetary Policy Report tells us that lower oil prices should be a net negative for Canada. The impact on business investments should vary from one province to the next, with less capital spending in the oil and gas sector but, with the combined effect of the lower loonie, more investing in the manufacturing sector. As a whole, the bank even goes as far as claiming that Canada's gross domestic product growth could be lowered by a quarter percentage point in 2015, which, as Governor Poloz himself stated before the Senate banking committee last week, would be "sufficient for me to think about it and be concerned about it."

Canada being a net energy exporter, it might seem obvious that lower oil prices would be, as a whole, a net negative for the Canadian economy. After all, if the price of your main export product goes down, that's less money coming into the country from international trade. But Canada being a country characterized by large regional disparities, the impact will most likely differ from one province to the next. What is interesting is that commodity prices are also the main determinant of our exchange rate, whose movements affect Canadian provinces differently. Lower oil prices combined with a weaker loonie actually create a double positive for Central Canada.

The economics of oil's impact on the loonie are quite simple. Higher oil prices mean more foreign money coming into the country for a given quantity of exported oil, pushing the exchange rate up. But a stronger loonie is also a bane for Central Canada, which depends largely on exports from its manufacturing sector to the U.S. (and whose competitiveness suffers when the loonie trades at parity). All of these effects are reversed if oil prices are falling instead of rising.

Luckily, the Canadian model is held together by fiscal federalism. This is in contrast to the euro zone, which is comprised of heterogeneous countries that share a single currency but do not redistribute the wealth from those who benefit from this stronger currency (think of Germany as our Alberta) to those who are actually hurt by it (Spain as our Quebec). Thus, while the country's economy is quite different in the east than in the west, the benefits and the burdens resulting from outside shocks are to some extent spread across all provinces.

One area where the impact is a clear positive is for Canadian consumers. Lower oil prices are a timely benefit for households, especially in Ontario and Quebec, where already tax-burdened Canadians are facing the prospects of austerity. Not only do lower prices at the pump act like a tax break for all Canadian citizens, but they also cut costs for many businesses without them having to invest a single dollar.

Where the impact is more unclear is regarding most provinces' public finances. While in Alberta, Saskatchewan and Newfoundland, the impact is a clear negative (lower prices mean less revenue), the situation is more ambiguous in the rest of the country.

Taking Quebec as an example (the typical manufacturing, oil-importing province), a quick glance at trade data shows that the province imports roughly 300,000 barrels a day of crude oil and an additional 360,000 barrels a day of refined oil products. As a rule of thumb, an average fall of $15 in the price of Brent crude during a year means $1.9-billion less in imports. This is money that remains in the pockets of Quebec consumers and businesses and that can be spent or invested on other goods and services.

On the flip side, this gain would be countered by lower transfer payments, which for Quebec amounted to $9.3-billion in 2014. It is unclear by how much those transfer payments would be lowered as the oil-exporting provinces' revenues fall, but we can assume that the impact would not be as significant as the fall in imports, resulting in a net positive for the province's GDP.

Just like most aspects of the Canadian economy, regional disparities are always a large part of the equation. For the moment, at least, lower oil prices are giving Central Canada's consumers and businesses a much-needed break.

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