BANK OF CANADA
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House of Commons Standing Committee on Finance
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Good morning Mr. Chairman and Honourable Members. On behalf of the Bank of Canada, I thank you for this opportunity to share our analysis of the impact of lower oil prices on the Canadian economy, in general, and on the manufacturing sector, in particular.

Our analysis is at the level of Canada's economy as a whole.

The rapid fall in oil prices will have both positive and negative effects on different sectors of the Canadian economy. To assess the overall impact, we used a modelling tool that we built to take account of the various channels and spillovers. We also drew on surveys and numerous meetings with firms and business associations.

The bottom line is that the sizable decline in the price of oil since June 2014 is unambiguously negative for the Canadian economy. As outlined in our January *Monetary Policy Report*, most of the negative effects will appear in the first half of 2015.[1]

The energy price decline will reduce aggregate income. Indeed, even though real GDP grew by 2.4 per cent in the fourth quarter of 2014, the real incomes of Canadians contracted. This occurred because the world price of an important export product declined. And that means a loss of purchasing power for Canadians.

In addition to this negative terms-of-trade effect, business fixed investment is expected to be weaker. Business investment in the oil and gas sector is anticipated to fall by about a third in 2015, and investment in this sector is roughly one-third of total business investment.

The effects of the oil-price shock will be felt across the country. The main transmission channels are the aggregate income effect, which works through lost purchasing power, and supply-chain effects, since nearly one-third of the goods and services purchased by the Alberta oil sands industry are drawn from other provinces.

There are some positive, but partial, offsets. While Canadians are worse off in the aggregate, cheaper oil means more money in the pockets of individual consumers. They can either spend the additional disposable income or save it. Their decisions will matter for economic growth. In addition, lower production

[1] *Monetary Policy Report*, Bank of Canada, January 2015.

costs for firms that use oil as an input may lead to a rise in profits, output and investment in the non-oil-related sectors of the economy.

Let’s keep in mind that today’s lower oil prices are mainly the result of abundant global supply, as my colleague Deputy Governor Tim Lane pointed out in a recent speech.[2] The supply-driven decline in oil prices is stimulating economic activity in the United States, Canada’s main trading partner. This will be good for Canadian exports if our export sector responds in line with historical experience.

Lower oil prices will have an impact on Canada through another channel. Because we are net oil exporters, the value of the Canadian dollar tends to move with the price of oil.[3] From 2002 to 2008, oil prices and the dollar were both on a general upward trend. You may recall that, in 2008, when oil was trading at well over $100 per barrel, the Canadian dollar was almost at parity with the U.S. dollar. Today, oil prices are much lower, and our dollar is about 80 cents against the U.S. dollar.

The lower dollar is improving the competitiveness of production in Canada, which should further boost exports and, eventually, investment.

Altogether, as we noted in the January *Monetary Policy Report*, the manufacturing sector is expected to benefit from stronger U.S. demand, lower shipping costs and the weaker Canadian dollar.

As we assess the ability of Canada’s manufacturing sector to benefit from cheaper oil and the lower dollar, we have to recall where we are coming from. In Canada, competitiveness challenges, and the prolonged period of weak U.S. demand, forced many non-energy exporters to discard unneeded capital and eliminate jobs—or to close their doors for good. Rebuilding the lost productive capacity won’t happen overnight.

The Bank has long been saying that, in order for us to return to sustainable growth, we need a rotation of demand toward exports and business investment. Growth in our non-energy exports is showing more momentum in recent quarters, suggesting that the rotation is happening.

Our most recent *Business Outlook Survey* indicated that hiring intentions and investment plans were robust for manufacturers. A majority of firms reported that they were planning investment projects aimed at increasing production. Overall, these are positive signs that the rebuilding process is under way.

Thank you.

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[2] T. Lane, “Drilling Down - Understanding Oil Prices and Their Economic Impact” (speech to the Madison International Trade Association, Madison, Wisconsin, 13 January 2015).

[3] S. S. Poloz, “Float of the Loonie” (speech to Société de développement économique de Drummondville, Drummondville, Quebec, 16 September 2014).