The Canadian Economy Is No Longer as Vulnerable to a Drop in Oil Prices

Earlier this week, we noted that a sudden deepening of the discount on Canadian oil had caused the price of Western Canadian Select (WCS) to drop to around US$ 20 per barrel. This significant drop in oil prices is a reminder of the one observed in 2014 (graph 1). Back then, the Bank of Canada (BoC) did not hesitate to react by lowering its key rates twice.

There are several reasons for thinking that the recent decline in oil prices will have a much smaller impact this time. In 2014, the oil industry was running full throttle and was one of the main drivers of Canada’s economic growth. Investments in oil and gas extraction had reached 28% of total non-residential capital spending in 2014. Oil production continued to go up after price collapsed, but the sudden drop in investments in this sector in 2015 had a major negative impact on the Canadian economy. The situation is completely different today, as investments in the extraction sector never really rebounded and now represent only 14% of total investment (graph 2). Business investment in other sectors is growing at a good pace, and the outlook appears strong, especially after the easing of trade tensions with the United States.

IMPLICATIONS

The drop in WCS prices is a bad news that may worsen the difficulties the oil sector is already experiencing and lead to a negative wealth effect for the Canadian economy. The consequences for the entire economy should, however, be limited, as the oil sector is no longer an important source of investment growth in Canada. As a result, the BoC is expected to continue to tighten its monetary policy at the meeting on October 24. Ongoing extremely low prices for Canadian oil could represent, nevertheless, one more reason for the BoC to continue to act with caution.

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