

Weaker currency and lower oil prices: the winning provinces

The sudden drop in oil prices in the last few weeks has raised its share of concerns, especially for the economies of provinces out west. These fears stem from the fact that oil prices have dropped below the profitability level for some new projects, a situation that could compromise future investments. Overall, however, we must not delve into excess pessimism, as other regions could benefit greatly from lower oil prices, if they stay low. In this *Economic Viewpoint*, we examine the weight of industries that are heavy consumers of oil in each province, in order to identify regions that could be affected most by lower prices. We then conduct a similar exercise for the currency depreciation and its effect on exports, by province. Our analysis reveals that Quebec, Manitoba, Ontario and British Columbia stand to benefit the most if the situation continues.

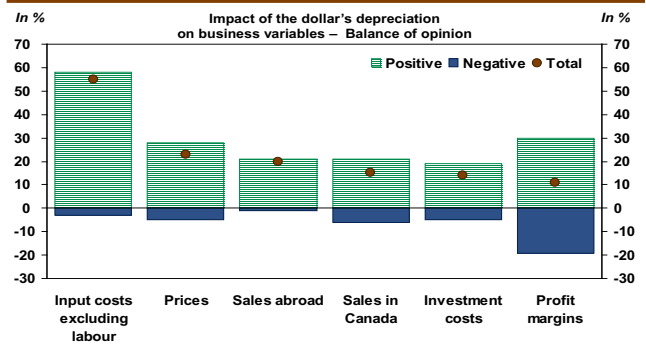
There is little doubt that if oil prices stay weak, profits and revenue in western Canada will suffer. All the same, we must recognize the silver lining in this event. Lower oil prices act indeed as an important profitability boost for most Canadian businesses, most especially those that consume a lot of oil.

Remember, for example, that in early 2014, the currency's depreciation put upside price pressure on imported goods, while elevated geopolitical tensions kept oil prices relatively high. Judging from the answers businesses provided in a survey conducted by the Bank of Canada last spring, the positive effects of a weaker currency on profitability were mitigated by higher oil prices (graph 1). This could explain why businesses were ambivalent about the impact of the Canadian dollar's depreciation on their profit margins. From this perspective, many will salute the recent about-face in oil prices.

A WELCOME TURN OF EVENTS FOR MAJOR CONSUMERS

For the purposes of this *Economic Viewpoint*, we will define oil-intensive industries (OII) as sectors in the top quartile for the percentage of their input costs represented by oil. OIIs include mining, manufacturing and transportation, which are the three largest consumers of oil (in proportion of their input costs). Added to these are some industries in the agricultural sector, as well as utilities (table 1 on page 2).

Graph 1 – Input costs did not go unnoticed at the start of the year



Sources: Bank of Canada, *Business Outlook Survey, Spring 2014* and Desjardins, *Economic Studies*

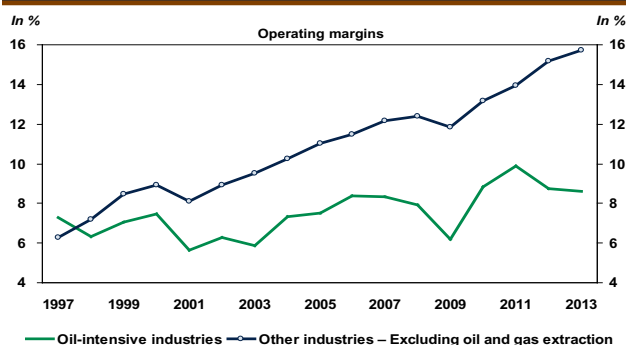
In terms of performance, most OIIs have struggled since the turn of the millennium. First, competition from emerging countries has been ferocious, and OIIs, which also tend to be exporters, have suffered as a result. Then, the price of oil rose from US\$25 in 2000 to fluctuate around US\$92 from 2010 onwards. The Canadian dollar had also appreciated over this period. These three factors combined have eroded the competitiveness of many companies that are heavily dependent on oil. Note that OIIs' operating margins have grown very little since the late 1990s, in marked contrast with most other industries (graph 2 on page 2).

Table 1
Consumption of petroleum products by industry

Rank*	Industries**	Average for 2007–2011		High consumption
		\$B	Proportion*** (%)	
1	Mining	67.3	36.5	x
2	Manufacturing	68.7	11.4	x
3	Transportation and warehousing	14.1	11.1	x
4	Activities to support agriculture and forestry	0.3	10.1	x
5	Fishing	0.2	7.7	x
6	Forestry and logging	0.6	6.3	x
7	Utilities	2.4	5.0	x
8	Crops and livestock	2.0	3.9	x
9	Engineering	3.5	3.9	
10	Construction (repairs)	1.0	3.1	
11	Other services (except public admin.)	0.9	2.4	
12	Residential construction	1.7	2.1	
13	Wholesale trade	2.7	2.0	
14	Other municipal public admin. services	1.3	2.0	
15	Advertising	1.0	1.7	
16	Non-profit institutions serving households	0.6	1.6	
17	Repairs	1.1	1.6	
18	Teaching	0.1	1.4	
19	Non-residential construction	0.5	1.3	
20	Healthcare and social assistance	0.6	1.2	
21	Finance	3.6	1.2	
22	Government education services	1.1	1.1	
23	Retail trade	1.4	1.1	
24	Administrative services	0.6	1.0	
25	Other First Nations public admin. services	0.0	0.5	
26	Accommodation and food services	0.3	0.5	
27	Other federal public admin. services	0.3	0.4	
28	Arts	0.1	0.4	
29	Information and cultural industries	0.3	0.4	
30	Professional services	0.4	0.3	
31	Government healthcare services	0.2	0.3	
32	Other prov. and terr. public admin. services	0.2	0.2	
	All industries combined	179.3	5.1	

* Among the 32 industries; ** According to the classification of input-output industries; *** Total inputs.
Source: Desjardins, Economic Studies

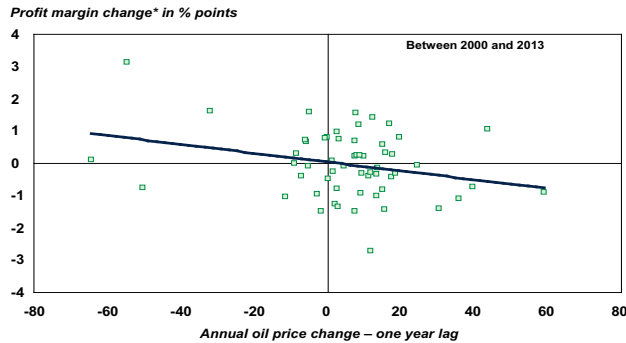
Graph 2 – Recent years have been difficult for oil-intensive industries



Sources: Statistics Canada and Desjardins, Economic Studies

The more cyclical nature of OIIs is reflected by their steeper decline in profitability during the Great Recession, compared with the experiences of other industries. After bouncing back somewhat during the first years of the recovery, the last two years have seen profit margins fall for OIIs. Though many factors played a role, the negative relationship between oil price shocks and heavy consumers' profit margins (graph 3 on page 3) indicates that the price situation of recent years has been one of the impediments on these industries' prosperity. The recent turnaround in both oil prices and the Canadian dollar could therefore be a welcome breath of fresh air.

Graph 3 – Profitability for major consumers tends to drop after oil prices rise

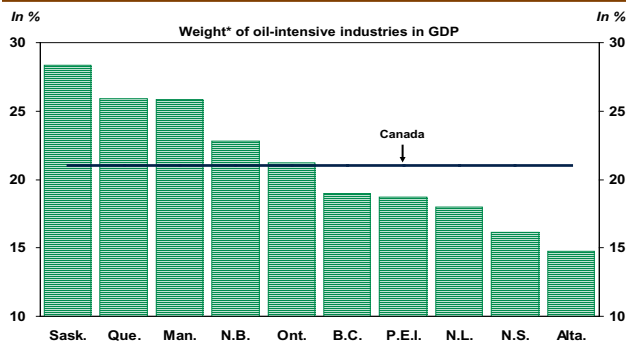


* Oil-intensive industries.
Sources: Statistics Canada and Desjardins, Economic Studies

IMPLICATIONS FOR THE GEOGRAPHIC REBALANCING OF GROWTH

In percentage of GDP, oil-intensive industries take a significant position in the economies of Quebec, Manitoba and Saskatchewan (graph 4). For Quebec and Manitoba, this largely reflects the importance of manufacturing, which represents 15% and 11% of these provinces’ GDPs respectively. Saskatchewan is the province most reliant on OIIs, mainly due to its mining sector, which accounts for 11% of GDP, as well as agriculture (8%) and manufacturing (5%). In Ontario’s economy, the weight of OIIs is slightly above the Canadian average because of its large mining sector. However, OIIs have a slightly lower weight in Ontario than in Quebec, Manitoba or Saskatchewan, as the agricultural and transportation sectors play a relatively smaller economic role in the province.

Graph 4 – Heavy consumers of oil make up a large share of economies in central Canada

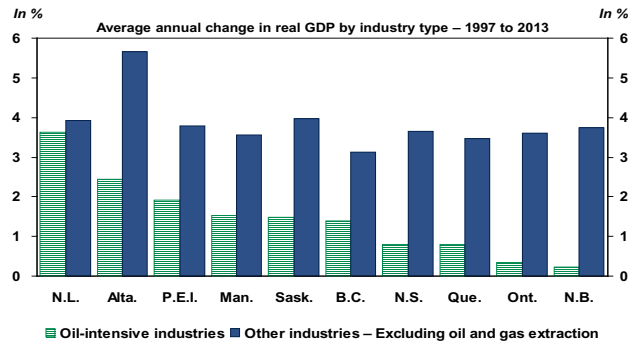


* In percentage of nominal GDP, 2007 to 2011 average.
Sources: Statistics Canada and Desjardins, Economic Studies

Due to their industrial makeup, provinces in the centre of the country seem better poised to capitalize on falling oil prices. In Quebec and Ontario, this could help real GDP

growth for OIIs catch up to the other industries somewhat (graph 5). Note also that in recent years, real GDP growth for OIIs in Ontario and Quebec has been far below what was enjoyed by OIIs located in the Prairies, or even the Atlantic Provinces.

Graph 5 – Oil-intensive industries have experienced more difficulties, especially in Quebec and Ontario



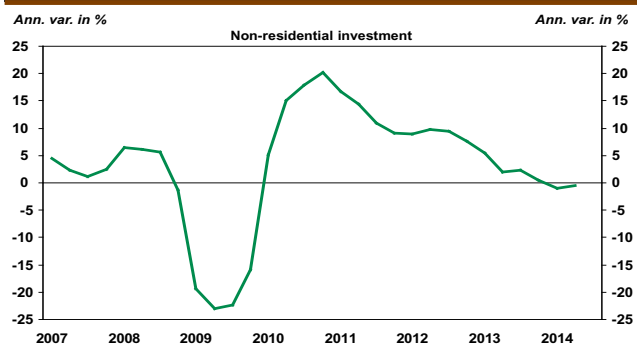
Sources: Statistics Canada and Desjardins, Economic Studies

In these regions, the indirect effects of the commodity boom seem to have made up for the negative impacts of higher oil prices and a stronger currency these last few years. The slide in oil prices could therefore harm OII growth in these provinces. As it turns out, the geographical rebalancing of Canadian growth may well begin to materialize in industries that consume large quantities of oil.

... AND SURGE IN INVESTMENT

New momentum for OII growth could also have positive repercussions for capital spending. Remember that hopes for sustainable Canadian growth now rest largely on a revival of business investment, which has slowed almost constantly since 2010; its annual change is currently close to zero (graph 6).

Graph 6 – Canadian businesses are still hesitant to invest



Sources: Statistics Canada and Desjardins, Economic Studies

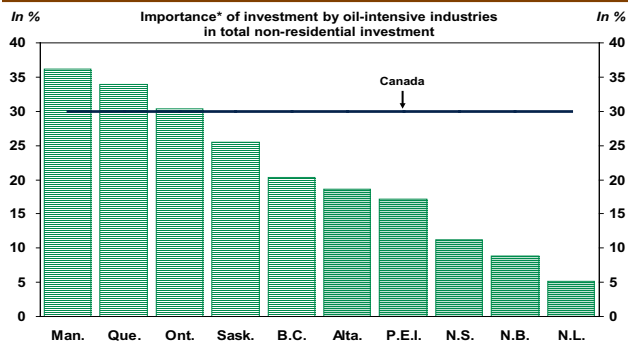
OIIs account for a relatively large share of non-residential investment in Manitoba, Quebec and Ontario (graph 7), meaning that we can contemplate a scenario in which these provinces' profitability and investment will be boosted by input prices that remain weak and revitalization of the U.S. economy. Hence, a reasonably sustained drop in oil prices could definitely play an important role in Canada's

move toward more balanced growth, either from a geographic perspective or from a final-demand component perspective.

DON'T FORGET THE CURRENCY EFFECT

Central provinces are major exporters of non-energy goods and the currency's depreciation seems to have already had some benefits for shipments of these goods abroad. In a recent study, the Bank of Canada¹ examined 31 subcategories of non-energy exports. It identified those that have historically been sensitive to the currency's value, as well as those that were most likely to lead to a recovery in total non-energy exports. The evaluation was performed on such criteria as the relationship between the performance of these export categories and the components of U.S. domestic demand (table 2). Below, we refer to exports that are both

Graph 7 – Oil-intensive industries play an important role in investment



* In percentage of nominal investment, average for 1997 to 2013.
Sources: Statistics Canada and Desjardins, Economic Studies

¹ André Binette et al., "Canadian Non-Energy Exports: Past Performance and Future Prospects", *Research – Discussion Paper*, Bank of Canada, April 2014, 15 p., www.banqueducanada.ca/wp-content/uploads/2014/04/dp2014-1.pdf.

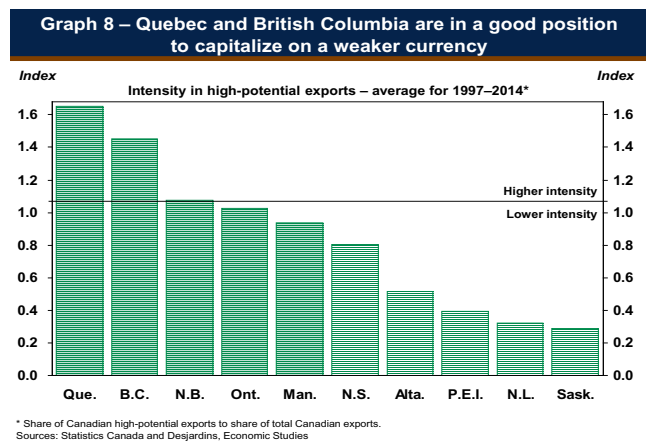
Table 2
Exports according to sensitivity to the exchange rate and growth outlooks

	<i>Sensitive to the exchange rate</i>	<i>Should drive recovery</i>	<i>High potential</i>
Categories of non-energy exports (services excluded)			
Passenger cars and light trucks			
Intermediate metal products		X	
Building and packaging materials	X	X	X
Aircraft, aircraft engines and aircraft parts	X	X	X
Plastic and rubber products	X	X	X
Pharmaceutical and medicinal products		X	
Logs, pulpwood and other forestry products	X	X	X
Industrial machinery, equipment and parts	X	X	X
Basic/industrial chemical products			
Tires, motor vehicle engines and parts	X		
Other electronic and electrical machinery, equipment and parts	X	X	X
Pulp and paper stock			
Metal ores and concentrates			
Non-metallic minerals			
Food and tobacco intermediate products			
Communication and audio and video equipment	X	X	X
Recyclable waste and scrap			
Furniture and fixtures	X		
Clothing, footwear and textile products	X		
Fabricated metal products	X		
Paper and published products	X	X	X
Medium and heavy trucks, buses and other motor vehicles	X		
Other transportation equipment and parts	X		
Computers and computer peripheral equipment		X	
Non-metallic mineral products	X	X	X

Sources: Bank of Canada and Desjardins, Economic Studies

sensitive to currency levels and likely to lead the recovery as “high-potential” exports.

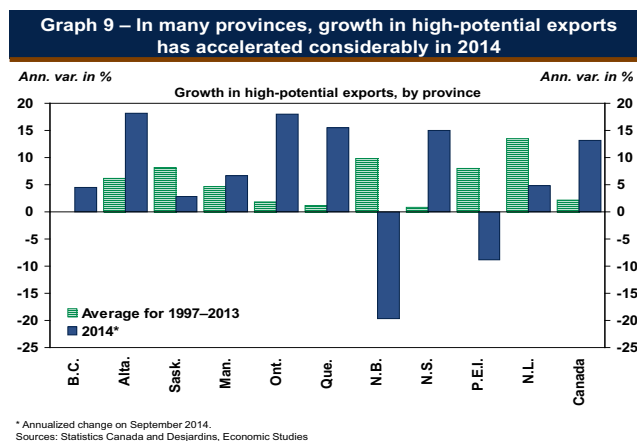
By taking the provincial distribution of Canada’s high-potential exports, and adjusting it to account for the weight of each province in total Canadian exports, we can calculate an export intensity metric for each province (graph 8).



Quebec and British Columbia stand out as the top-ranking provinces according to this metric. Ontario lags somewhat, largely due to the weight of its auto-sector exports, which are not identified as high-potential. However, Ontario is still a key player, as it is the source of 40% of Canada’s high-potential exports. Together, Ontario, Quebec and British Columbia account for over 75% of the country’s high-potential exports. These are provinces that we can expect to be the most stimulated by the lower currency.

The first signs have already been felt in some high-potential export categories, thanks to the strong U.S. economy, with an especially positive influence in Ontario and Quebec. For example, Ontario exports more than 56% of Canada’s metals and non-metallic minerals, and Quebec exports 30%. In September 2014, exports of this type of good were up more than 27% in Ontario and more than 9% in Quebec, on a year-over-year basis. Forestry products are another encouraging example. Nearly 32% of these exports come from British Columbia, while Quebec and Ontario account respectively for 27% and 22% of Canada’s exports. After several difficult years, the forestry sector is now picking up: in September, exports were up 8% year-over-year in each of British Columbia and Ontario, and grew more than 13% in Quebec.

Broadly speaking, growth of high-potential exports has accelerated in many provinces, compared to average growth in previous years (graph 9). For Canada as a whole, while



**Table 3
Provincial ranking by variable**

	Oil-intensive industries		Intensity in high-potential exports	Average ranking
	% of GDP	% in non-residential investment		
Quebec	2	2	1	1.7
Manitoba	3	1	5	3.0
Ontario	5	3	4	4.0
British Columbia	6	5	2	4.3
Saskatchewan	1	4	10	5.0
New Brunswick	4	9	3	5.3
Prince Edward Island	7	7	8	7.3
Nova Scotia	9	8	6	7.7
Alberta	10	6	7	7.7
Newfoundland and Labrador	8	10	10	9.0

Source: Desjardins, Economic Studies



average growth was of just 2.1% between 1997 and 2013, it now stands at 13.1%. Ontario and Quebec are clearly front and centre in this recovery.

CONCLUSION

By synthesizing provincial rankings for the exposure to lower oil prices and the currency's depreciation (table 3 on page 5), we see that Quebec, Manitoba, British Columbia and Ontario will be the major beneficiaries, should the situation persist. These provinces' domestic economies could get a supplementary boost if energy costs loosen their grip on household finances. This comes in very timely, especially since the savings rate in some provinces is quite low (e.g. 2.7% in Quebec and 0.9% in Manitoba in 2013, compared with the national average of 5.2%).

However, we must stress the sustainability condition. Crucially, solid growth must be observed for several quarters in the United States before it will inspire enough confidence in exporting businesses and kick off a return to prosperity, which could in turn generate investment and jobs. If, as we predict, the U.S. economy posts its best growth in 10 years next year, we can be optimistic.

Jimmy Jean
Senior Economist