The Impact of the Oil Price Plunge on Canadian Manufacturing

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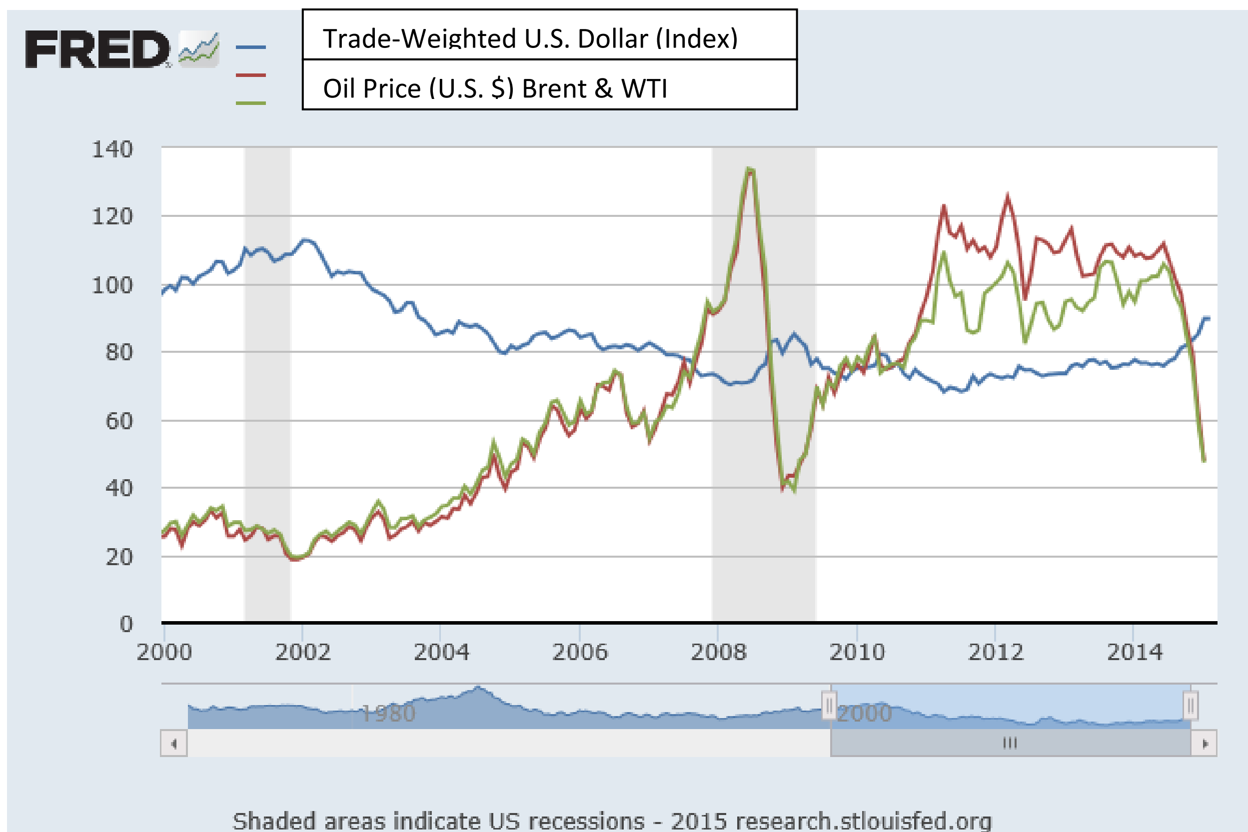
The Oil Price, the Dollar, & the Global Economy

- The price of oil is closely correlated with the trade-weighted value of the U.S. dollar.
  - Because the price of oil is denominated in U.S. dollars, movements in the U.S. dollar exchange rate will affect oil prices even if supply and demand conditions do not change. A stronger U.S. dollar (usually associated with a weaker Canadian dollar) will result in lower oil prices, and vice versa.
  - A stronger U.S. dollar is an indication of higher and safer rates of return on investments in U.S. dollar denominated assets – and is usually a signal that the U.S. economy is strengthening while other major economies are weakening. This is also a sign that global demand for oil is falling, putting additional downward pressure on oil prices (if supply is left unchanged).



- The impact of lower oil prices on Canadian manufacturing and the Canadian economy has to be considered in conjunction with the impact that changing international demand conditions and a lower Canadian dollar exchange rate have on Canadian exports.

- Diagnosis of Dutch disease and treatment of the Canadian dollar as a petro-currency are gross oversimplifications of the relationship between oil prices and currency exchange rates. Higher oil prices have a relatively small impact on the exchange value of the Canadian dollar. More generally, the price of oil and the Canadian dollar will tend to move together, both reflecting the strength or weakness of the U.S. dollar.

Positive Impacts on Manufacturing

- Lower oil prices will result in a small reduction in energy costs. Oil as an energy source accounts for less than 0.3% of total production costs for Canadian manufacturers.
- Input costs will fall for those sectors where petroleum is an important feedstock – especially for petroleum products, petrochemicals, resins, and plastics.
- If sustained for 12 months or longer, lower oil prices will result in lower freight (rail, trucking, air) rates. To date, however, there is little indication that these costs are coming down.
- Lower gasoline prices will leave more money in the pockets of Canadian consumers, but their spending power will be partially if not wholly offset by higher import costs.
- The most important positive benefit of lower oil prices for Canadian manufacturers will be to boost personal disposable incomes in the United States. That will in turn strengthen the U.S. economic recovery and, along with a lower Canadian dollar, increase demand for Canadian exports.

Negative Impacts on Manufacturing

- The downturn in oil exploration and production activity has already cut orders for manufacturers supplying the petroleum industry. In the oil sands sector, supplies for maintenance and operating activities, which account for about $25 billion per year, have not been affected (oil sands facilities are manufacturing operations that continue to function). On the other hand, new and proposed project activity has declined – leading to an estimated $12 billion reduction in demand for manufactured goods in 2015 (primarily among suppliers of heavy equipment and parts, structural steel, metal fabricating, tubes, pumps, valves, and pressure vessel industries). In addition, there are now strong pressures being exerted by oil and engineering and procurement companies on manufacturers to reduce their prices. On the positive side, this is focusing more attention on the need for productivity improvement and innovation. However, sudden reductions in customer orders coupled with demands for lower prices are significantly reducing the operating cash that manufacturers require to invest in the improvements they need to maintain customer orders.
- The rapid depreciation of the Canadian dollar has increased the cost of imported materials, parts, and equipment for manufacturers across Canada. While, over time, the net impact of a lower dollar will be cash flow positive for Canadian manufacturers, in the short-term many companies are caught with higher input costs without offsetting revenue benefits.
- The devaluation of energy-related financial assets erodes personal and corporate savings, generally makes businesses more conservative with respect to their investment intentions, and could

potentially constrain the availability of financing, particularly for smaller manufacturers as well as for companies closely tied to the petroleum supply chain.
- More generally, plunging oil prices are a signal that all is not well in the global economy. It is a reflection of uncertainty, and uncertainty is not good for investment.

Net Impact on Manufacturing

- Canadian manufacturing production grew by 5.4% over the course of 2014, almost twice as fast as the economy as a whole.
- 76% of manufacturers across Canada are optimistic that lower oil prices, coupled with stronger U.S. market demand and a lower Canadian dollar will boost sales, profits, and employment in 2015.
- Driven by higher export demand, Canadian manufacturing production is likely to grow by more than 5% again in 2015.

The Challenge of Long-Term Competitiveness

- Lower oil prices, a low dollar, and the resurgence in U.S. market demand are not sufficient in themselves to guarantee short-term business success or long-term growth for Canadian manufacturers.
- Canadian manufacturers need to continue to invest in new product development, new technologies, improved processes, and upgrading employee skills in order to take advantage of these more positive business conditions in today's era of intense global competition.
- Measures like accelerated depreciation, tax credits and direct support for technology adoption and commercialization, and a low tax environment for manufacturers are more important than ever – even when low oil prices and a low dollar are taken into account.