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Oil Prices, Economic Growth and Monetary Policy

Discussion by the C.D. Howe Institute Monetary Policy Council

On January 21st, the Bank of Canada surprised many by announcing that it was lowering its target overnight lending rate by one-quarter of a percentage point, "in response to the recent sharp drop in oil prices," according to the Bank's statement. The C.D. Howe Institute subsequently canvassed members of the Institute's Monetary Policy Council to gauge their views of the effect of the oil price drops, and what Canadian governments and the Bank of Canada should do in response.

Council members who participated agreed that the fall in oil prices will slow down the Canadian economy, particularly in the short-term. The downsides of low prices are apparent – steep falls in energy-related investment, lower consumer spending in previously booming resource economies, and potential housing market troubles in parts of Western Canada that risk exacerbating the immediate pain. By contrast, the positive effects of low oil prices on manufacturing and consumer spending are uncertain in size, and may be slow to emerge.

Council members also agreed that the federal government should not embark on major fiscal policy changes because of the drop in oil prices. However, the outlook for resource-dependent provinces is less certain. Some Council members argued that some provinces should raise taxes, while other members suggested provincial governments should run deficits. Another observation from some on the Council was that the Bank of Canada, which surprised markets with the recent rate cut, should disclose more clearly the underlying reasons for cutting rates. Some members felt that the Bank's argument that the rate cut was an insurance move was problematic. Members were not unanimous on this point; many felt that the Bank of Canada's sudden interest rate drop could have an effect on inflation expectations.

Oil Prices and the Canadian Economy

The C.D. Howe Institute Monetary Policy Council is comprised of 12 of Canada's most distinguished financial-market and monetary economists. Chaired by the Institute's President and Chief Executive Officer William B.P. Robson, it provides the Bank of Canada, financial-market participants and economic policy commentators with a regular independent assessment of the appropriate stance of Canadian monetary policy as the Bank of Canada pursues its 2 percent inflation target.

The majority of Council members answered the following questions:

- What do you expect the world price of oil to do over the next three years?
- Given your (stated or implicit) expectations about the world price of oil, do you expect the net impact of the change from recent highs on the Canadian economy over the next three years to be negative or neutral or positive, and why?
- What is your view about the relative timing of negative or positive effects – in particular, do you expect the negative impacts to predominate through that period, or do you expect the positive effects to largely or completely offset them before the end of the period?
- What does your view on the effect of oil prices on the Canadian economy mean for policy, both for the Bank of Canada and Canadian governments more generally?

The View on Oil Prices and the Economy

Looking at the supply and demand dynamics of the world oil market, those members who provided a price forecast felt that a supply glut, along with slow global growth, would keep prices below $60 a barrel of West Texas Intermediate oil for 2015. Looking to 2016 and 2017, the group's range of forecasted oil prices was between $60 and $77 per barrel with none expecting a return, in that period, to triple-digit oil prices. Some in the group felt that such prices would allow the energy sector to return to growth, albeit at a slower pace than in the past.

There was some disagreement on the extent of the negative effects. Some Council members felt that the fall in oil prices would be neutral. Many others, however, thought the effect would be slightly or severely negative for the Canadian economy, and that the effects will be especially severe in the next 18 months. Looking beyond that, however, there are potential positives that may emerge. No member of the Council explicitly stated an expectation that Canada would enter a recession, and one member argued that it is important to keep in mind what counterfactual growth would have been. No matter the price of oil, the US was going to be growing strongly, which Canada would have benefited from anyway. The effect of low oil prices will dampen growth, particularly in resource-dependent regions, but many argued the net effect of low oil prices will be to dampen Canadian economic growth, not halt it.

The Immediate Negative Effects of Falling Oil Prices

The clear consensus among the participants was that the negative effects on the economy will be largely front-loaded. One Council member noted that "…the impact on investment, which traditionally takes time to materialize, is happening quite quickly this time around. In other words, the negative impact may be faster than traditional models would predict because companies are quickly adjusting their capital plans."

Some members on the Council were also concerned about other factors that may exacerbate the near-term negative effects. The oil price drop is also likely to reduce consumer and government spending. A correction in house prices in resource-rich regions will have a negative wealth effect that will further drive down private consumption. One member argued that "the biggest impact of lower oil prices will be on gross domestic income as Canada's terms of trade have experienced a massive negative shock. This means that we will receive less income for what we produce and export and pay more for what we consume and import."

The Unclear Positive Effects of Falling Oil Price

What about the potential positive effects of lower oil, especially outside of resource-rich regions? One positive effect Council members pointed to is the boost lower gasoline prices will give to consumer spending on other goods and services. There was some disagreement on the scale and speed of the potential positive benefits.

Several members of the Council felt that a lower exchange rate and lower oil prices would be a clear positive for manufacturing. However, some members argued that positive effect of a lower exchange rate on manufacturing could take

several years to occur. Others felt even that was too optimistic and expressed doubt that a temporary cut from already low interest rates would make a tremendous difference in that respect.

Policy Recommendations

What, if anything, should the federal government and provinces do in response to the fall in oil prices? Of those with a view on spending, Council members agreed that resource-rich provinces and the federal government should not overreact and adopt strict spending cuts. One member argued that "at the federal level, the year-to-date numbers are running well ahead of plan which, combined with explicit and implicit fiscal cushions built into the projections, leaves the plan to return to surplus achievable."

However, there were varying views on what else provincial governments should do in response. Some members thought that the situation calls for Alberta to adopt a harmonized sales tax to replace lost revenues and to refocus its fiscal strategy altogether, while others thought that now is not the time to raise taxes. Others felt that resource-rich provinces – Alberta, Saskatchewan and Newfoundland and Labrador – can ride out the fiscal deterioration without having to tighten fiscal policy significantly. Some members suggested the provinces combine current deficits with credible medium-term plans for a return to balance. In the rest of Canada, some Council members suggested provinces with high debt levels should resist the temptation to raise energy consumption taxes.

The advice that Council members gave the Bank of Canada reflects the important role it has in setting signals for the market and inflation expectations. By way of background, at the January 15th meeting of the Council, two members had stressed the possibility that lower gasoline prices or temporarily low readings for the consumer price index might cause households to expect inflation below 2 percent. One explicitly recommended that the Bank lower its policy rate if that drop in expectations occurred, and a couple of others thought the Bank of Canada could stress that such a drop in expectations could trigger a rate cut.

Some members of the Council believed that the Bank of Canada's move in January may inadvertently lower future expectations of inflation, leading to further rate cuts. One member was concerned that "we are moving towards an undesirable equilibrium where low inflation expectations become entrenched by low and falling interest rates." Another believed that the "sensitivity of inflation expectations to the fall in oil prices is likely to be further magnified by the Bank's actions."

Some on the Council believed that Bank of Canada's rate cut may reflect a desire to support the adjustment of the Canadian economy away from resources and into more manufacturing. On that view, the Bank's action of lowering rates sends a signal to the economy that it views Canada's manufacturing sector as the buffer of the Canadian economy.

Some thought the Bank should explain more carefully its reasoning on how lowered interest rates improve financial stability. Those members challenged the Bank's view that the cut in interest rates increases financial stability or acts as insurance. In their opinion, the cut simply shifts such concerns into the future, where the potential costs would outweigh the marginal short-term benefits. Many Council members felt that lower rates would have little positive effect on homebuyers in Alberta, who are already facing large financial risks because of the oil price drop. However, many felt the rate cut would likely encourage more housing risk elsewhere in the country.[1]

One Council member recommended that the Bank clarify whether it attributes the recent fall in oil prices to supply effects or to demand effects. A drop in price that is principally demand related would be a sign of slowing growth. In

1 At its subsequent meeting on Feb. 26, the MPC recommended that the Bank of Canada keep its target for the overnight rate at 0.75 percent at its next announcement on March 4, 2015. Looking ahead, the Council called for the Bank to hold the target at 0.75 percent through to September, and called for a target of 1.25 a year from now.

turn, this would affect the degree to which the demand for Canadian non-petroleum exports could take up the slack from the reduced income from petroleum exports. A drop in prices that is brought on primarily by increased supply from past infrastructure investments coming on line is much more positive for the world economy, and therefore other Canadian exports.

That member recommended that the Bank of Canada should discuss the detailed results of the macroeconomic model, ToTEM, it uses to assess the impact of an oil price shock. This would go a long way in explaining the Bank's monetary policy choices in response to world oil price shocks. Others felt, however, the Bank of Canada should get due credit for the transparency it exhibited in explaining why it felt the need for an overnight rate cut, and that the Bank's Monetary Policy Report did discuss both the supply and demand factors that led to the sharp drop in the oil price.

Conclusion

The fall in oil prices will be a net negative for the Canadian economy, according to the median view of the members of the C.D. Howe Institute Monetary Policy Council. The economic pains are evident and will be front-loaded. The positive effects of low oil prices will be apparent only in future, and are uncertain. As the Bank of Canada prepares for its much anticipated March 4th meeting, it should have these potential effects front of mind.

For more information on the Monetary Policy Council go to: http://www.cdhowe.org/monetary-policy-council-2