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economic LETTER

MARCH 2012

EXPLAINING PRICE VARIANCES BETWEEN CANADA AND THE UNITED STATES

With an exchange rate at par with the U.S. dollar, it's easy for Canadian consumers to compare prices for similar goods in Canada and the United States. In doing so, they could have noticed that prices are generally higher on this side of the border. In April 2011, the Bank of Montreal's economic research unit estimated that a basket of comparable goods in both countries was 20% more expensive in Canada.[1] The Bank of Canada undertook a similar exercise that revealed much the same results, noting that the variance had nevertheless narrowed to 11% a few months later, in September 2011.[2]

Several factors can explain why prices are not identical in both countries, even if we take the exchange rate into account:

> Fiercer competition in the U.S. retail sector than in Canada puts downward pressure on prices: in Canada, the four largest retailers share a much larger market share than in the United States, or 28% vs. 12%.

> Overall, the retail sector in the United States is much more efficient than in Canada, which enables retailers in the U.S. to set their prices lower while generating the same profit margins. In fact, for an equal number of hours worked, the value of retail sales is higher in the U.S. This better performance could be due to differences in the underlying structures of this sector in both countries, among other reasons. Stores that are part of a chain, a higher ratio in the U.S. than in Canada, had better productivity gains than independent stores, and this was achieved via significant investments in technology throughout the 1990s.

> The U.S. market is 10 times the size of the Canadian market, meaning that U.S. importers are far more likely to benefit from substantial economies of scale.

> Given Canada's weak population density, freight costs are higher in Canada than in the United States. And because it is taxed more, gas is more expensive in Canada, which also translates into higher freight costs

We can expect the price differences to continue to narrow for goods that Canadian consumers can purchase easily and at a low cost in the United States. This ▼

1 BMO Economic Research, "Raging Loonie: What It Can and Can Not Do," Focus, April 2011.
2 Bank of Canada, Opening Statement by Mark Carney, Governor of the Bank of Canada, to the Senate National Finance Committee on November 2, 2011, Ottawa, Ontario, page 2.

BDC's Monthly Economic Letter is produced by the Strategy and Corporate Development department and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to March 10. Reliance on and use of this information is the reader's responsibility.

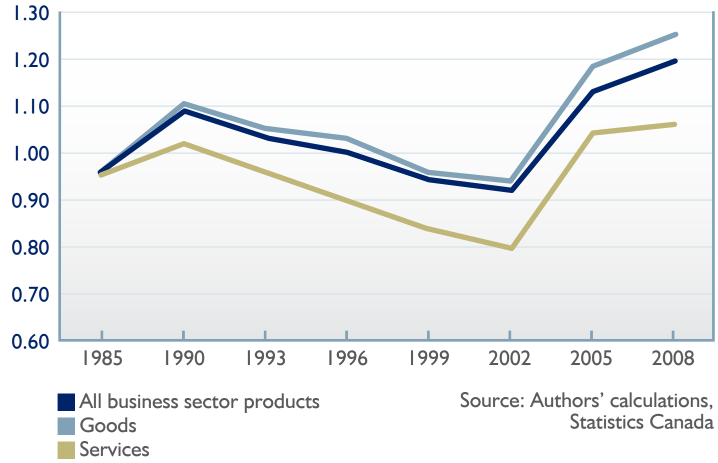
is the case for several standard products that are available online and that are not subject to customs charges, like books. This is probably why the price variance has narrowed over time, as noted by the Bank of Canada.

With the exception of some prices that react quickly to exchange rate fluctuations, like fruit and vegetables, for example, the vast majority of prices are not overly influenced by these variances, at least in the short term. The Bank of Canada has estimated that a 10% increase in the value of the Canadian dollar would push the consumer price index down by only 0.4%, and it would take several months for the impact to be felt.[3]

This variance is unfavourable for Canadians at the moment. However, in the past when the loonie was worth less than the greenback, prices in Canada were lower than in the U.S., once adjusted to take the exchange rate into account. Based on the calculations made by Statistics Canada, and on the price levels compared, this was the case in 2002 and in 2009, when the exchange rate was US$0.67 and US$0.64, respectively, as shown in the graph.[4]

In closing, we have to expect that the prices for goods that are easily exchanged and at a low cost between both will converge at some point, but significant pricing differences will continue to exist between the U.S. and Canada, regardless of the exchange rates of both currencies.

Median comparative price levels (CPLs), goods and services, selected years, 1985 to 2008
(Comparative price levels, U.S.=1.0)



CANADA

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The most recent indicators are sending mixed signals. On the one hand, real GDP growth slowed in the last quarter of the year and employment has been flat for several months now. On the other, exports to the United States are up, the residential construction sector remains strong and the outlook for corporate profits is getting brighter. The labour market's situation is raising concerns, but firming economic growth south of the border should help Canada's economy gain traction.

Real GDP growth has slowed

Real GDP growth, which rebounded from -0.6% to 4.2% from the second to the third quarter of 2011, settled at 1.8% in the fourth quarter (keep in mind that output in Q2 was disrupted by the effects of the tsunami in Japan last spring). The production advance in the fourth quarter can be attributed to consumption and exports, and to a lesser extent, corporate investment, while public spending contributed close to zero. All told, the real GDP reached 2.5% in 2011 compared with 3.2% in 2010. Corporate investments in plants and equipment contributed the most to growth in 2011.

Investments in equipment posted growth in excess of 10% in the past two years, enabling companies to exceed their pre-recession levels, which is not the case for investments in non-residential construction (graph).

Annual Change in Real Investment in Non Residential Construction and in Machinery and Equipment

3 Ibid., page 4.
4 Statistics Canada, "New Evidence on Exchange-rate-adjusted Prices in Canada," Economic Insights, No. 2, January 2012. The comparative price level (CPL) is determined by setting the sale price in the United States at 1.0. If the CPL is 1.2, this means that the Canadian price is 20% above the U.S. price level.

Employment continues to stagnate

Employment declined by 2,800 in February, as the part-time jobs lost was partially offset by gains in full-time jobs. Most of the job losses occurred in the wholesale and retail sector, while the finance, insurance and real estate sector posted the biggest gains. Employment had the best showing from the end of the recession until mid-2011, but has stagnated ever since. The unemployment rate, which rose between July 2011 and January 2012, declined in February, from 7.6% to 7.4%, due to a decrease in the labour force. Few changes were observed in February on a regional level, except in New Brunswick where labour pulled back sharply. Quebec did not recoup the steep losses, all in part-time jobs, sustained in the last quarter of 2011.

Employment and Unemployment Rate

Source: Statistics Canada

Trade surplus falls

A steeper -2.3% decline in exports combined with a -0.6% drop in imports in January moved the trade surplus from $2.9B in December 2011 to $2.1B in January 2012. Exports to the United States were up, especially for crude oil, but this increase was more than offset by a decline in exports to Japan and the European Union. January's decrease in exports occurred after several months of advances and is not a concern. We can expect exports to resume their upward trend as the U.S. economy strengthens.

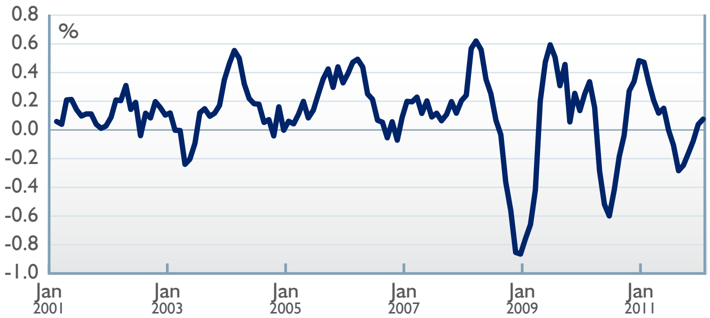
Housing starts increase

After falling in January, the number of housing starts increased in February, from 198,100 units to 201,100. In urban centres, housing starts for single-family homes were up 3.5% while multiple unit construction was up 3.3%. The increase in multiple-unit construction was especially strong in Quebec, with activity up 50% in February, but this immediately followed a similarly steep drop one month earlier, signalling a return to more normal conditions. Overall, the residential construction market is in good shape. The CMHC estimates that the number of housing starts in 2012 will fall slightly below the level reached in 2011 (meaning an average of 190,000 vs. 193,500) due in most part to demographic shifts in Canada.

Outlook brightens for corporate profits

After five straight monthly declines from July to November 2011, the Conference Board's Leading Indicator of Industry Profitability (LIIP) rose in January for the second consecutive month. The indicator declined in only 17 of the 49 sectors covered. With growth of 0.07% in January, this indicator still has a way to go before it points to a solid profit outlook, but the trend's recent reversal leaves room for some optimism.

Leading Indicator of Industry Profitability
(monthly change)



Source: Conference Board of Canada

Real GDP growth accelerated in each quarter of 2011, the job market is increasingly improving and consumer confidence is up. Even the housing market is experiencing somewhat of a recovery, if not a solid upswing. These results lead us to believe that, as expected, growth will accelerate in 2012 compared with 2011.

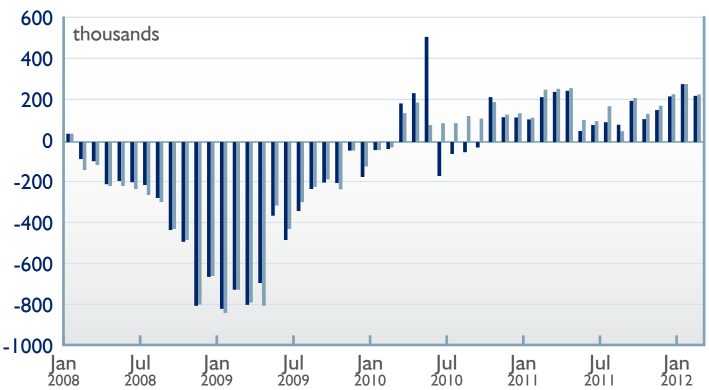
Real GDP growth accelerates

Real GDP growth gradually ramped up in 2011, reaching 3.0% in the fourth quarter, according to the second estimate of the U.S. Bureau of Economic Analysis. This result pushed annual growth to 1.7% in 2011, a decline vs. the 3.0% recorded in 2010. The slowdown in output growth compared with 2010 is mainly due to the private sector's investments in inventory and to federal public expenditures, which fell in 2011 after posting increases the previous year. Consumption growth was slightly better in 2011 than in 2010 (2.2% vs. 2.0%).

Employment continues to climb

Non-farm employment increased by a total of 227,000 jobs in February and 233,000 jobs were created in the private sector, which by now has recovered about 44% of the jobs lost during the recession. It is encouraging to note that the pace of growth has accelerated in recent months, as shown in the graph below. This acceleration has pushed the unemployment rate down significantly in the past few months, from 9.1% in August 2011 to 8.3% in January 2012. The rate remained stable in February.

Monthly Change in Non-Farm Employment

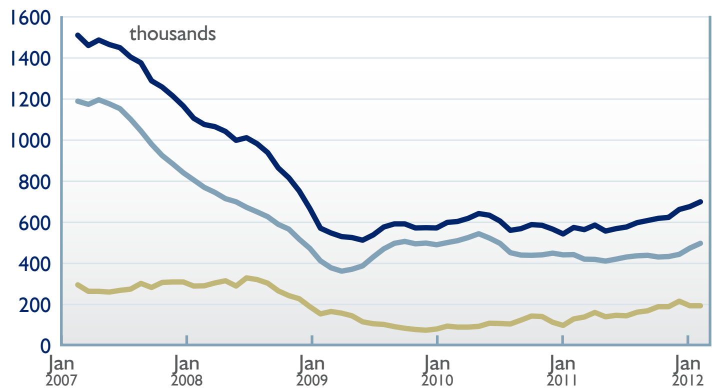


Source: US Bureau of Labour Statistics

Housing market recovers gradually

Housing starts were up 1.5% in January compared with one month earlier. This increase is entirely attributable to advances in multiple-unit construction (14.4%), since the starts for single-family homes declined by 1.0%. Recovery in housing starts is slow; however an upward trend appears to emerge, as shown in the graph below. Furthermore, sales of existing homes, which had pulled back 0.5% in January, rebounded in February, advancing by 4.3%. The inventory of homes continues to trend downward: at this pace, it would take 6.1 months to liquidate the current inventory, compared with 6.4 months one month before.

Housing Starts
(3-month moving average)



Source: U.S. Census Bureau

Consumers regain confidence

The Conference Board's consumer confidence index rebounded between January and February, shifting from 61.5 to 70.8, its highest level in almost a year (it reached 72.0 in February 2011). Consumers are less pessimistic than they were the previous month about the business climate and state of the labour market, and their optimism about the outlook for the U.S. economy, jobs and their own financial position is getting brighter.

INTEREST RATES

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Key interest rate should not increase for several months

On March 8, the Bank of Canada (BoC) decided to leave its key interest rate unchanged at the level it has been since September 2010, i.e. 1.0%. The statement announcing this decision was more positive than before, however. In fact, the central bank believes that the risk related to Europe's sovereign debt has decreased since January and the outlook for Canada's economy has recently improved. Despite the BoC's more upbeat tone, forecasters expect that the key interest rate will remain unchanged for several more months.■

OIL AND THE LOONIE

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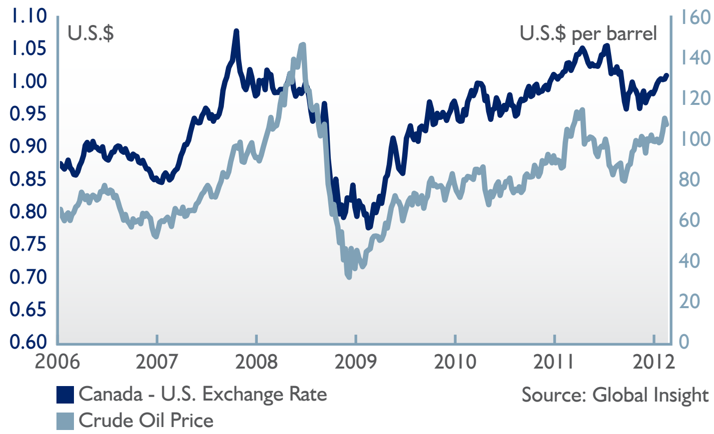
Oil prices and the loonie both up

Prices for crude oil have increased due to the aggravation of the crisis in Iran and the instability that has gripped Libya. Israel threatened to resort to military intervention to prevent Iran from following through on its nuclear ambitions, and the United States, which has affirmed its preference for the diplomatic route and sanctions, has not eliminated the possibility of military action. This positioning has exacerbated tensions with Iran, pushing crude prices higher. In addition, internal divisions that are rife in Libya are threatening the region's oil development, which would also push oil prices upward. Canada's currency appreciated in response to the increase in crude prices.■

Crude Oil Price and Canada-U.S. Exchange Rate



Source: Global Insight

SME CONFIDENCE

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SME confidence keeps improving

The CFIB's Business Barometer Index was up for the sixth consecutive month, shifting from 65.2 in January to 66.0 in February. It is slowly approaching the peak of 68.3 reached in July 2011, before it dropped sharply in August due to the sovereign debt crisis in Europe. Confidence is still stronger in the Prairies, but it nevertheless made a marked improvement in February in Ontario, New Brunswick and Nova Scotia. Despite the month's substantial declines in manufacturing and wholesale trade, all sectors had readings above the 60-mark and the CFIB noted that, for the first time since this index was created, agriculture is among the top three most confident sectors. Lastly, the short-term outlooks for SMEs showed a significant improvement for the second straight month, which is a very good sign.■

CFIB Business Barometer and Real GDP Growth
(Index of 50 = equal balance of stronger and weaker business expectations)

Source: Canadian Federation of Independant Business

BUSINESS CREDIT CONDITIONS

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Banks' business credit accelerated

The growth of business credit granted by the chartered banks ramped up in January, bringing the 3-month percentage of change to 8.6% in January vs. 2.7% in December 2011. In addition, the effective business interest rate, calculated by the Bank of Canada (a weighted average of bank and market interest rates for new lending to non-financial businesses) is still weak: it was 3.4% in January. ■

Effectif Business Interest Rate

Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2011				Latest		Forecasts	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2012	2013
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.7	-0.6	4.2	1.8	Dec	0.4	2.0	2.3
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.5	30.2	-11.8	2.7			5.5	6.4
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	20.7	-5.1	18.3	21.4			4.7	6.5
Industrial Production (% growth)	-0.5	-3.1	-9.5	4.9	6.6	-4.1	7.7	2.1	Dec	0.9	2.4	3.3
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	5.4	0.2	0.7	Jan	0.3	2.2	2.7
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	15.9	0.9	17.4					
Housing Starts (' 000 units)	229	212	148	191	177	192	205	199	Feb	201	180	179
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	0.6	2.0	1.8	2.9			1.8	2.1
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.3	3.4	1.0	2.9	Jan	0.4	1.9	2.0
Employment (% growth)	2.4	1.7	-1.6	1.4	2.2	1.6	1.2	-0.3	Feb	0.0		
Unemployment Rate (%)	6.0	6.1	8.3	8.0	7.7	7.5	7.3	7.5	Feb	7.4	7.4	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0	64.2	64.1	Feb	66.0		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0	63.5	61.8	Feb	61.7		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.