

economic LETTER

NOVEMBER 2011



THE PRICE OF OIL AND PRICES AT THE PUMP: WHY THE DIFFERENCE?

Since the end of April the price of crude oil based on the West Texas Intermediate (WTI) benchmark has dropped nearly 20%. Over the same period the price of regular gasoline went down by about 9% on average in Canada. Why did the price of gas not decline as much as the price of crude? Many consumers and entrepreneurs are asking the same question.

One of the reasons is that, although the price of crude is the main factor in the price of gas, it only makes up part of the price. According to estimates from Natural Resources Canada, the price of crude accounted for an average of 47% of the price of a litre of regular gasoline in 2010 (see chart). Costs and margins of refiners and retailers made up about 21% of the total price while the rest, i.e. 32%, consisted of taxes (federal, provincial and harmonized).

There are also regional differences: in Calgary—where the price of regular gas was the lowest among big cities in Canada in 2010—the price of crude oil made up 52% of the total price while in Vancouver—where the price was the highest—37% of the total price consisted of taxes.

Another factor that is having an impact right now also explains why the price of gas did not change in conjunction with the price of crude: the drop in the WTI price was not followed by a drop in Brent, which is the main benchmark for crude oil outside of North America. Refineries in Canada use roughly equal proportions of crude oil priced off WTI and Brent.¹

The reason for the drop in the price of WTI is excess supply at the delivery point for WTI oil contracts. Inventories have accumulated at the terminal in Cushing, Oklahoma, where many pipelines converge, especially since pipelines carrying oil from the Alberta tar sands joined the network. Inventory buildup is also the result of declining demand, primarily due to weakness in the U.S. economy. Demand for Brent, on the other hand, is still strong because this is the main type of oil that meets the needs of emerging economies.

When demand picks up again and new pipelines carry WTI to markets where oil is traded at higher prices, the price should increase. However, judging by oil price futures on the WTI and Brent, for which the price gap does not close until 2016, this will not happen for several years. ▼

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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 November 5. Reliance on and use of this information is the reader's responsibility.

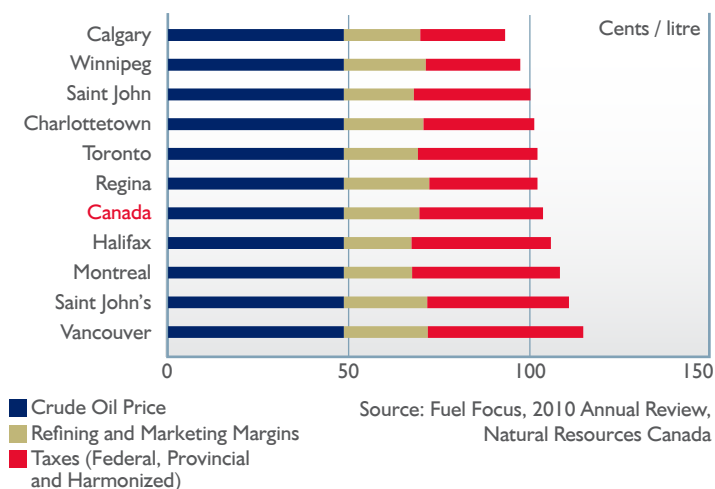
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¹ See Bank of Canada Monetary Policy Report October 2011, Technical Box 3, pages 22-23.

As mentioned above, refiners' and retailers' margins also affect the price of gas. Since they are very volatile and can change from week to week, it is more meaningful to use a four-week average to analyze changes. When we do that, we see that the refining margin contributed to the gap between the price of crude and the price of gas, since it rose about 8 cents per litre since the spring. Relatively speaking, the retailers' margin barely changed over the same period.

We have seen that various factors come into play in determining the price of gas. We should therefore not expect a drop in the price of crude oil to be followed by a parallel decline in prices at the pump, since that does not always happen. ■

Regular Gasoline Prices, Annual Average for 2010



CANADA

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The most recent figures suggest that the decline in real GDP in the second quarter will turn out to be temporary, reflecting disruptions in the production chain rather than a reduction in demand. The job losses in October, however, start off the last quarter of 2011 on the wrong foot, although a one-month decline in this indicator should not be considered too significant.

Real GDP continues to grow

After growing 0.4% in July, real gross domestic product rose a further 0.3% in August. Most of this growth is attributable to the energy sector: if it were excluded, real GDP would have stayed the same. Production was up in sectors mainly related to domestic demand, such as finance and insurance, retail trade and construction, and down in sectors more dependent on foreign trade, such as wholesale trade, manufacturing and some tourism-related industries. With these July and August results, it is virtually certain that real GDP growth will be positive in the third quarter. The dip in the second quarter will prove to be a temporary blip, the result of events that disrupted the production chain, such as bad weather in Canada, the tsunami in Japan and plant closures for maintenance work.

Job creation down

The labour market lost 54,000 jobs in October, wiping out most of the previous month's gains (60,900). All of the losses were in full-time employment (71,700) while part-time work expanded slightly (+17,700). The biggest losses were in the manufacturing sector, followed by construction. The unemployment rate edged up from 7.1% in September to 7.3% in October. Despite the decline in October, full-time employment (which accounts for 80% of total employment) grew 1.6% over twelve months. While the job losses in October are certainly not good news, a single month of substantial decline in nearly

two years is not a great cause for concern, especially since most of the losses were in manufacturing, a sector where employment is very variable (see chart).

Year-over-Year Change in Employment, Monthly Data



Housing starts up

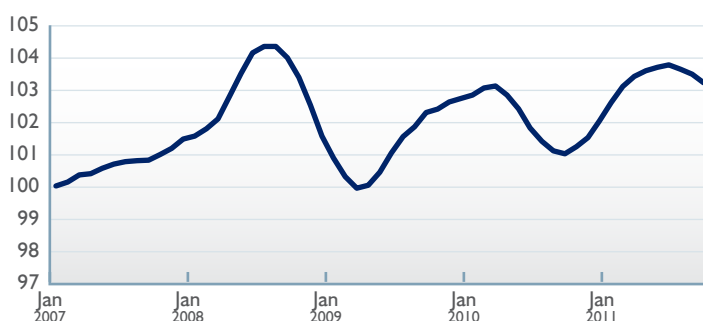
The number of housing starts increased from 191,900 in August to 205,900 in September. Multiple-unit housing starts in urban areas jumped 14.2%, while single family home starts were down 1.5%. The biggest increases in multiple housing starts occurred in British Columbia, Quebec and the Atlantic provinces. Canada Mortgage and Housing Corporation expects multiple-unit housing starts to fall in the near future, back to levels more in line with demographic changes in Canada.

Corporate profits could decline in three to six months

The Conference Board's Leading Indicator of Industry Profitability (LIIP) posted its third consecutive monthly decline in September. More than half of the industries covered, i.e. ▼

28 of 49, were down. The Indicator points to a decline in corporate profits in three to six months. The deteriorating outlook for the global economy has had a negative impact on export sectors and on the oil and mining sectors as commodity prices fell in response to the worsening outlook. In addition, financial market volatility has undermined consumer and business confidence, which in turn dampened expectations of profitability in many other sectors. ■

Leading Indicator of Industry Profitability (Index; January 2007 = 100)



Source: The Conference Board of Canada

★ UNITED STATES

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The most recent figures indicate that the recovery is continuing—real GDP growth is picking up speed and employment continues to grow—but that it is fragile: consumer and business confidence are both down and the housing sector remains depressed. Unlike what happened after previous recessions, the economy is not rebounding strongly. It is starting to grow again but at a slower, more sustainable, pace.

Real GDP growth picking up speed

Real GDP growth picked up speed, from 1.3% in the second quarter to 2.5% in the third. This acceleration was mainly driven by consumer spending, especially on durable goods. Part of this growth was undoubtedly due to catching up with purchases in the automotive industry, since the availability of some vehicles was limited in the second quarter due to production chain disruptions caused by the tsunami that hit Japan in March. There was also stronger growth in non-residential private investment, while the growth in government spending and in the export and import sectors remained relatively stable compared to the previous quarter. Investment in residential construction slowed. Lastly, there was much less

inventory buildup in the third quarter than in the second. This alone cut 1.1 percentage points from the total growth in real GDP and augurs well for production growth in the fourth quarter.

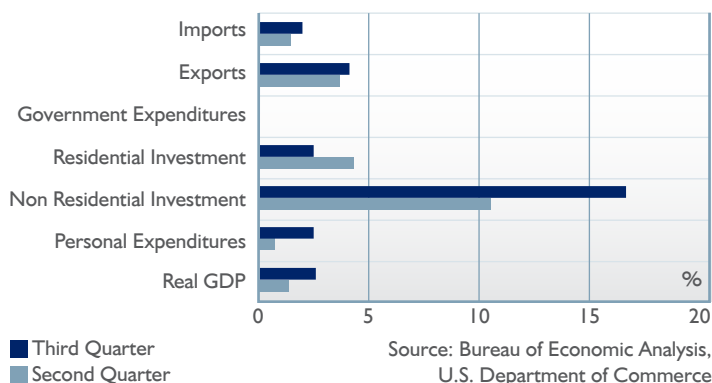
Employment still growing

The labour market gained 80,000 jobs in October after adding 158,000 in September. This is the 13th consecutive increase in employment. In the private sector 104,000 jobs were gained in October. An average of 151,000 jobs per month have been created in this sector in the past twelve months. The labour market is recovering but very slowly: so far only one quarter of the jobs that disappeared during the recession have come back and the unemployment rate, although it has declined gradually since the end of the recession, remains high at 9.0%.

Housing market up and down

Housing starts soared 15.0% in September from the previous month. This was largely due to a huge 53.4% increase in multiple-unit housing starts, since single family home starts only grew 1.7%. By contrast, the value of building permits was down 5.0% in September, which suggests that the resurgence in housing starts will not last. Also, sales of existing homes declined 3.0% in September. At the current pace of sales, the inventory ▼

Quarterly Growth of Real GDP and its Components



Existing Home Sales Inventory: Month's Supply Units



Source: US National Associations of Realtors

of unsold homes remains high at 8.5 months. In normal times this should be closer to 5 months (see chart), which is indicative of how much oversupply there still is on the real estate market.

Business and consumer confidence both down

The U.S. Conference Board's Consumer Confidence Index, which had risen slightly in September, dipped again in October from 46.4 to 39.8, a level close to those seen during the 2008-2009 recession. Consumers are expressing concern about employment prospects, employment income and the business climate. The

Institute for Supply Management (ISM) Purchasing Managers Index, which reflects the level of confidence of companies in the manufacturing sector, fell 0.8 percentage points to 50.8% in October. This level suggests that the manufacturing sector is still growing, but it will not take much more for the ISM Index to slide into negative growth territory. That being said, as long as it remains above 42.5%, the Index points to an expansion in the economy overall, and it is still well above that critical level. ■

INTEREST RATES

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Increase in the key interest rate pushed back to 2013, according to forecasters

On October 25 the Bank of Canada decided to leave the key interest rate unchanged at 1.0%, where it has been since September 8 2010. The central bank is now forecasting a mild recession in Europe, a slowdown in economic growth in the United States and continuing robust but more moderate growth

than previously predicted in the emerging economies. It has also made a downward revision of its growth forecasts for real GDP in Canada since July, from 2.8% to 2.1% for 2011 and from 2.6% to 1.9% for 2012. As a result, the increase in the key interest rate—which forecasters had predicted in 2012—has been pushed back to 2013. ■

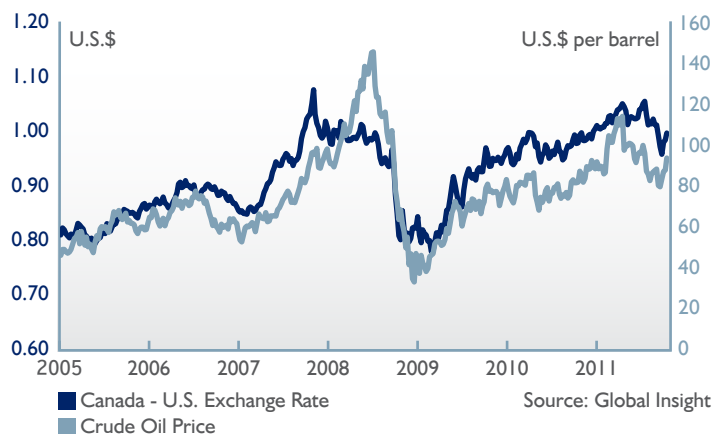
OIL AND THE LOONIE

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Price of oil and Canadian dollar both very volatile

Developments surrounding the sovereign debt crisis in Europe are fueling the volatility in oil prices: following the announcement of the European bailout plan the price of oil rose, only to fall when the Greek prime minister announced that he would be holding a referendum on the austerity plan; it then rebounded when the referendum was cancelled. The price of oil is likely to remain volatile until a sustainable solution for the European problem can be found. The Canadian dollar exchange rate fluctuated in tandem with the price of oil in recent weeks. ■

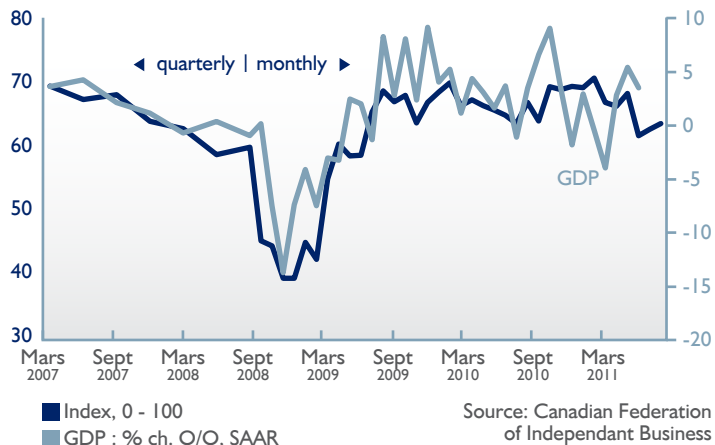
Crude Oil Price and Canada-U.S. Exchange Rate



Business confidence continues to improve

The CFIB Business Barometer Index rose for the second consecutive month, from 62.7 in September to 63.6 in October. It remains below the average posted in the first six months of the year (68.5) but is still well above the levels seen during the recession. The percentage of small business leaders stating that their company's performance improved in the previous 3 or 4 months continued its upward trend, while the percentage of those who expect it to improve in the next 3 or 4 months declined, reflecting fears that the current, relatively favourable, situation will deteriorate in the near future. The CFIB also reported that 76% of small businesses consider their credit requirements to be met (51% consider them fully met and 25% mostly met). Since this is a new indicator, it does not tell us anything about changes in the satisfaction of small business credit needs over time, but we will monitor developments in the indicator closely. ■

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



BUSINESS CREDIT CONDITIONS

Business credit conditions continue to ease

The Bank of Canada's Senior Loan Officer Survey indicates that non-financial business credit conditions eased again in the third quarter of 2011, but there was less of a consensus about this among the firms surveyed than in the previous quarter. The results related to credit conditions from the central bank's Business Outlook Survey corroborate this finding. ■

Business Credit Conditions (% tightening - % easing)





KEY INDICATORS — CANADA

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Key indicators – Canada	Historical				2011				Latest	Forecasts		
	2007	2008	2009	2010	Q1	Q2	Q3	Q4		2011	2012	
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.6	-0.4			Aug	0.3	2.3	2.0
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.2	31.0					16.4	7.9
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	19.7	-8.4					12.0	5.2
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.6	6.9	-4.0			Aug	1.2	3.0	2.5
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	5.3	-0.3		Sep	0.4	4.2	2.5
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	10.7	2.0						
Housing Starts (' 000 units)	229	212	149	192	178	192	205		Sep	208	181	176
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	-0.1	1.6					1.9	2.2
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.6	3.1	1.0		Sep	0.2	2.8	2.0
Employment (% growth)	2.4	1.7	-1.6	1.4	2.4	2.0	1.2		Oct	-0.3		
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	7.8	7.5	7.2		Oct	7.3	7.4	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0	64.2		Oct	63.6		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0	63.5		Oct	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.