Montreal Economic Institute
Ideas for a More Prosperous Nation

ECONOMIC NOTE

December 2007

DOMESTIC PRICES AND THE APPRECIATION OF THE CANADIAN DOLLAR

Canadian consumers believe that they are not getting the full value at the check-out counter of the substantial appreciation in the Canadian dollar during the last five years (see Figure 1). An exchange rate appreciation makes exports more expensive and imports less expensive. While this creates a more competitive selling environment for the producers of exportables, at the same time it provides a more favorable environment for consumers and importers.

The Canadian dollar currently stands at a slight premium relative to the US dollar - a status not attained since the 1970s. While the Canadian dollar has fluctuated considerably compared to the US dollar in these three decades, the most recent surge has been particularly strong and concentrated in time - our dollar stood at 70¢US in Spring 2003. The subsequent appreciation has resulted primarily from the worldwide increase in the demand for our energy products - oil, natural gas and coal, and an interest rate occasionally higher in Canada than in the US – which has encouraged a capital inflow.

At the same time the Canadian dollar has appreciated by a smaller margin against the Euro – from 0.63€ in spring 2003 to about 0.70€ currently. The Euro economies as a group account for a much smaller percentage of our trade than the US however. So, on a trade-weighted basis, the Canadian dollar has indeed appreciated substantially.

Yet consumers have not seen much of the benefits of this appreciation, while at the same time many manufacturing jobs have been lost due to our inability to compete with lower-price producers in the world marketplace. According to Statistics Canada, the country has lost 12.8% of its manufacturing jobs, mainly in Ontario and Québec, between its peak of November 2002 and October 2007, that is, 298 200 jobs. Over the same period, Canada enjoyed a *net* increase of 1 480 800 new jobs, so the unemployment rate keeps decreasing too.[1]

So, why have Canadian prices not adjusted more rapidly to their level in the US, given the approximate parity of the two currencies? There is no one reason for the current state of price differentials between Canada and the US, and different sectors of the economy react very differently in the face of fluctuating exchange rates. Let us consider some of these reasons. One possibility is that an adjustment period is required; another is that it may be cheaper 'to do business' in the US; a third could be that Canada's 'welfare state' keeps our costs higher that in the US; it is also likely that competition is more intense in the US; finally, the cost of distribution may be significantly higher in Canada. Let us consider more reasons for price differentials.

1. Over the same period, Ontario lost 173 000 jobs in manufacturing (-15.5%) but gained 525 500 net new jobs overall (+8.6%) while Québec lost 133 500 jobs in manufacturing (-19.9%) but gained 275 200 net new jobs overall (+7.6%). See Statistics Canada, *Labour force survey estimates (LFS), employment by North American Industry Classification System (NAICS)*, CANSIM Table 282-0088.

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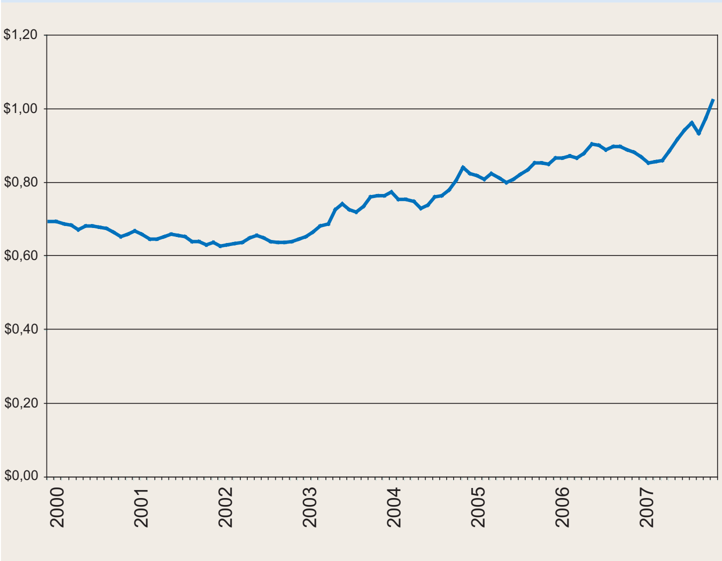
FIGURE 1

Canada–US exchange rate
(January 2001-October 2007)



Pyramid goods

Oil and gasoline are of great interest because the world price of energy is a major driver of the Canadian dollar. At the same time, goods such as gasoline are what we can call 'pyramid' goods, in the sense that the price of gasoline has crude oil as one component. While the price of a barrel of oil on world markets has risen from the thirty dollar range to the ninety dollar range since 2003, the price of gasoline that we use in our vehicles has only increased by about 40%.[2] The reason for this buffered response is that the price of gasoline has a very large tax component: they may account for up to 40% of the price of a litre depending on the province. In addition there are shipping, refining and distribution costs, and retailer margin. As a consequence, the variation in the price of gasoline is significantly dampened when the price of oil increases or oscillates on world markets, for the reason that crude oil accounts for significantly less than half of the finished product.[3]

Regulated prices – the agricultural sector

All of Canada's provinces practice supply management of one form or another in beef, pork, poultry, eggs and dairy products, with direct price controls in the last three products. So Canadians consume very few imported products in this group. While they may enjoy their French Brie or their Roquefort, they pay very high tariffs for the privilege of having a discriminating taste. The prices of poultry, eggs and milk are set considerably above the free market price. A consequence of this is the cost of milk quotas now run to almost $30,000 per cow.[4]

Exchange rate changes obviously have minimal impact in these sectors, particularly as they use few imported intermediate goods and their prices are controlled outside market pressures.

Goods with no foreign competition – services

As economies become more developed, a growing fraction of aggregate household expenditures is allocated to service transactions. These might be the cost of staying in a hotel while on business or vacation in Canada, fees to a babysitter or one's financial advisor, dental bills for one's children, a monthly transit pass or parking fees, third level education fees, payments to the physiotherapist, insurance for one's car or house and so forth. Such services cannot be imported easily and therefore are largely insulated from import competition and fluctuations in the exchange rate, unless they involve inputs of imported goods. But it is difficult to believe that the cost of new dental instruments, for example, form such a large part of a dentist's costs that a rising currency value could have a perceptible impact on their fee. While the internet is proving to be an ever more important source of information on prices, at the present time it facilitates trade in relatively few services.

Exchange rate changes have minimal impact on the price of goods produced by sectors protected from international competition, as their prices are controlled outside market pressures.

2. See Statistics Canada, CANSIM Table 326-0020.
3. See Department of Finance Canada, http://www.fin.gc.ca/toce/2005/gas_tax-e.html.
4. See as an example Nelson Zandbergen, *Dairy producer group plans quota assessment appeal*, December 2006, http://www.agrinewsinteractive.com/fullstory.htm?ArticleID=8036&ShowSection=News.

Particular cases of interest

The automobile sector

A free trade agreement should ensure that, adjusted for transportation and distribution costs, tradable goods sell at much the same price in member states. But at present we are witnessing differentials of 20% in car prices between the US and Canada.[5] Different demand conditions mean that a supplier will maximize profit by choosing a different price in each market, which is called price discrimination. However, competition between suppliers is supposed to eliminate such price disparities.

Yet Canadian car dealers do not appear to aggressively cut their prices to US levels, in an effort to increase their sales. Perhaps the unquestioning Canadian buyer is less likely to shop around for a better price, with the result that suppliers who recognize this can price discriminate more easily. Furthermore, Canadian buyers seeking to purchase in the US are frequently prevented from doing so by dealers refusing to sell to buyers without an American address, following their manufacturers' directives.

Contracts may fix ahead of time the price at which goods will be delivered for an extended period.

In addition to price discrimination, manufacturers may have a common interest in preserving the balance sheet of their leasing companies. Let us see how. Each year in Canada more than one half of all new vehicles going through dealers are leased rather than purchased. If, on average, cars loose one half of their value over a leasing period of say three years, then the buy-back on a $40,000 car will be $20,000 after three years. This $20,000 is an asset on the books of the leasing company. Now, if this $40,000 price were reduced in Canada to the US level of $32,000, then the buy-back value after three years should fall to $16,000. At an exchange rate of 80¢, the former $20,000 would have bought the same amount of US dollars as the $16,000 at parity. Hence, expressed in US$, the balance sheets of leasing companies would not change following this 20% drop in Canadian prices. But, absent an adjustment of Canadian prices to US levels, the leasing companies stand to gain billions.[6]

It is unclear how will this market evolve. Virtually no distributors are selling to Canadians in the US, even though this violates the intent of the *North American Free Trade Agreement*. A class action suit was filed in Ontario[7] against Canadian distributors recently, but there is no sign that the federal government is moving on this issue. The government obviously would not wish to be seen as undermining Canadian retailers by arguing in favor of freedom to purchase in the US.

The pharmaceuticals sector

Pharmaceuticals is another sector where successful cross-border price discrimination flourishes. The Patented Medicine Prices Review Board (PMPRB) is an independent quasi-judicial body whose role is to regulate prices charged by manufacturers for patented medicines.

Reports from the PMPRB show that, in 2005, drug prices[8] in the generic prescription drug market segment were higher in Canada than in all countries of comparison. But in the patented and non-patented branded prescription drug segments, only two countries had higher drug prices than Canada, Switzerland at +34% and the United States at +250%. Prices in this segment were lowest relative to Canada in Spain and New Zealand.

With respect to drug prices in the US in particular, the Canadian consumer appears to gain from lower prices in the patented and non-patented branded prescription drug segments (accounting for 84.4% of sales in 2005 with an annual growth rate of 12.6% since 2001) and to lose in the generic prescription drug market segment (15.6% of sales; annual growth rate of 20.8%).

However, given that big pharmaceutical companies have relentlessly expressed dissatisfaction with the relatively low prices (as regulated by the PMPRB) compared to the US, it is unlikely that they will be receptive to attempts by the Board to renegotiate prices following the appreciation of the Canadian dollar.

5. There is no definitive index on the price differential that we can locate. However, we have checked a substantial number of *manufacturers' suggested retail prices* on the internet, and the 20% number is conservative.
6. Between 2004 and 2006 Statistics Canada data indicate that about 1.5 million light vehicles (cars, SUVs and light trucks) were sold in Canada each year (see Francine Roy and Clérance Kimanyi, "Canada's changing auto industry", Statistics Canada, May 2007). If half of this three-year total is on lease, there are 2.25 million outstanding leases. If, in addition, each of these leases/assets were to be adjusted downward as a result of lower prices in Canada by on average $2,000 (assuming the average retail overpricing is $4,000) then such an adjustment would wipe almost five billion dollars off the balance sheets of leasing companies. Hence, without an adjustment in prices we have almost a five billion dollar gain on the balance sheets of leasing companies. Losing such a gain would not be good news for leasing companies.
7. Juroviesky & Ricci LLP filed the suit in the Ontario Superior Court on September 26, 2007.
8. Patented Medecine Prices Review Board, *Annual Report 2006*, Chapter 3.

Lagged adjustment and contracts

Another reason explaining why prices are frequently slow to respond is that contracts may fix ahead of time the price at which goods will be delivered for an extended period. Restricting the flexibility of prices at the signing of a contract serves to reduce the risk that both buyer and seller face during the course of the delivery agreement. Such limits are frequently placed on fruit and vegetable contracts that involve US suppliers to Canadian supermarkets. If the price limits are denominated in Canadian dollars, then a currency appreciation of unanticipated magnitude will not reduce prices proportionately. We may have to wait to the following contract cycle before prices fully reflect the currency change.

Consumers should realize that prices will never be exactly the same as those of other countries because of several factors and rigidities.

Likewise, book and magazine deliveries frequently have a price determined well ahead of the anticipated sale date. This may be why we still see that prices in the US for a given book are frequently lower by a considerable margin than the corresponding price in Canada.

Conclusion

Very different forces operate in the various sectors of the economy when it comes to setting prices. Relatively few sectors are characterized by unregulated prices, no price discrimination, ease of substitution and low transaction costs. While there remains a great unease about the present Canadian prices situation, consumers should realize that prices will never be exactly the same as those of other countries because of all the reasons discussed above. However, with some patience, the situation will probably improve in several sectors because of inescapable competitive pressures.

The federal Minister of Finance, Jim Flaherty, has recently been exhorting retailers in Canada to reduce their prices more rapidly to US levels. Nonetheless, the federal government has not indicated that it has requested the Competition Bureau to review particularly egregious cases of price discrimination. Nor does it appear willing to disturb the cozy relationship between government and the farming sector where supply management is concerned.

Thus, it is the consumer who can provide the incentives for price reductions - by searching more widely, using the Internet in their shopping, and putting pressure on retailers by making them aware of their alternatives.

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