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Loonie's Leap: Mind the (Price) Gap

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The Canadian dollar has rocketed ahead by 20% in the space of less than five months, its strongest such run on record. Besides posing yet another heavy-duty challenge to besieged manufacturers and the tourism industry, the resurgent loonie also threatens to make life miserable for domestic retailers. In theory, retailers could actually benefit from a stronger currency, as margins widen on falling costs. In reality though, as the loonie gets within sight of par, cross-border price comparisons become Canada's second favourite national pastime, and relentless pressure mounts on top-line prices. Given the dramatic swings in the currency over the past two years, and the broader view that the global economy will heal, a return to parity certainly appears to be a reality that firms may be dealing with sooner than most would have believed possible just six months ago.

TABLE 1
PRICE GAP
2009

Item	Cdn. Price (C$)	U.S. Price (US$)	U.S. Price* (C$-terms)	Gap (%)
Books (sample 7)				
regular price	$28.49	$23.69	$25.70	11
sale price	15.23	14.08	15.28	0
Magazines (sample 5)	6.07	4.89	5.31	14
Cars (sample 8)	31,353	28,601	31,032	1
Sony Blu-ray Player	299.99	249.99	271.24	11
Dell Inspiron Netbook	439.99	349.00	378.67	16
MacBook Air 1.86GHz	1,749	1,499	1,626	8
Garmin Nuvi GPS (1350)	329.99	299.00	324.42	2
32G iTouch	399.99	399.99	433.99	-8
Essential Michael Jackson (2 CDs)	17.99	13.99	15.18	19
Wii Console	279.99	249.99	271.24	3
Cameras (sample 5)	339.99	308.49	334.71	2
Drills (sample 3)	199.33	179.32	194.57	2
Chain saws (sample 4)	199.25	146.75	159.22	25
BBQs (sample 3)	539.99	362.99	393.84	37
Crate & Barrel – Mandarin sideboard	1,099	999	1,084	1
Pottery Barn for Kids – Activity table	419.00	349.00	378.67	11
Starbucks tall nonfat latte	3.00	2.80	3.04	-1
Cold Stone Creamery ice cream	4.99	5.99	6.50	-23
AVERAGE				**6.8**

* using $1.09 exchange rate

The issue of Canada/U.S. price differentials pretty much went into hibernation last fall, when the Canadian dollar tumbled 20% in the space of a month to less than 80 cents. That, and earlier price rollbacks on many items by domestic retailers, actually left Canadian prices well below their U.S. alternatives and all but dried up the swamp of cross-border shopping for a time. However, with the loonie rapidly homing in on parity again, the issue could quickly re-emerge, presenting a new and unwelcome challenge for shopkeepers just as Canadian consumers are gradually mounting a modest recovery.

So, how do Canadian retail prices stack up against U.S. alternatives? In fact, we found they now compare surprisingly well, even with the recent dramatic sprint in the loonie (*Table 1*). Our basket of goods (which is admittedly quite arbitrary) is less than 7% more expensive in Canada than in the U.S. (before taxes), adjusted for the current exchange rate. We believe that using today's exchange rate of roughly 92 cents is a relatively fair metric, since that also just so happens to be the average level for the currency over the past two years (*Chart 1*). The 6.8% gap is significantly nar-

CHART 1

THE LOONIE'S WILD RIDE

(US cents)

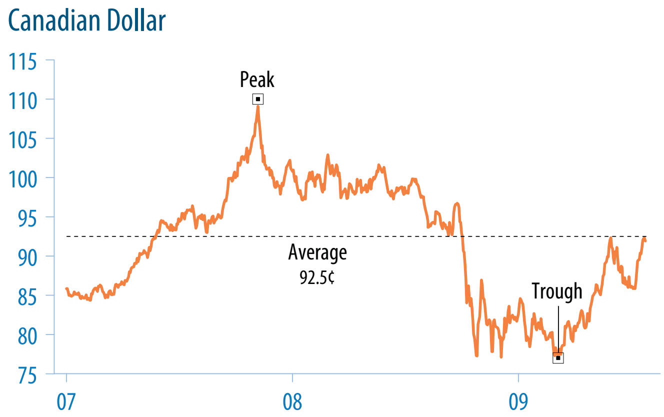


CHART 2

DEFLATION

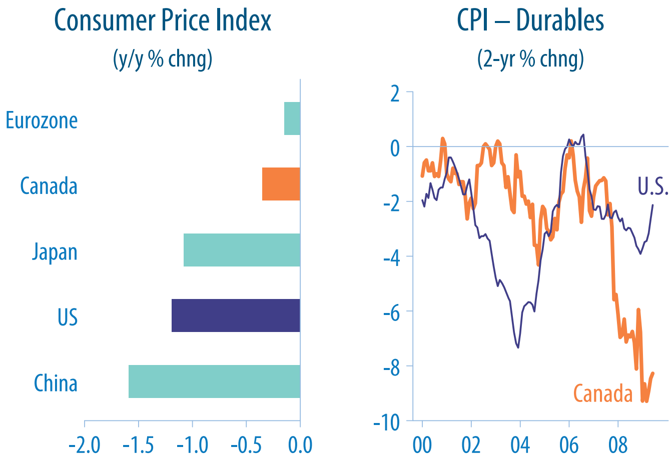
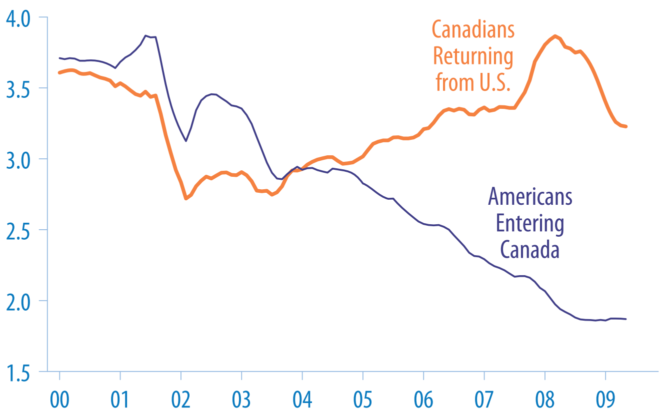


CHART 3

ONE-WAY TRIPS

(mlns : 6-mnth m.a.)



rower than we have found in the past. When we last took a close look at this topic in June 2008, the Canada/U.S. price spread was a bit above 18%. Much of the narrowing is simply due to the drop in the Canadian dollar since that point (when it was effectively parity), but there has also clearly been some underlying price chopping going on in the past year in Canada, which has carved into the spread. In light of the extreme moves in the loonie—a 43% swing in under two years—firms have done an admirable job bringing prices closer in line.

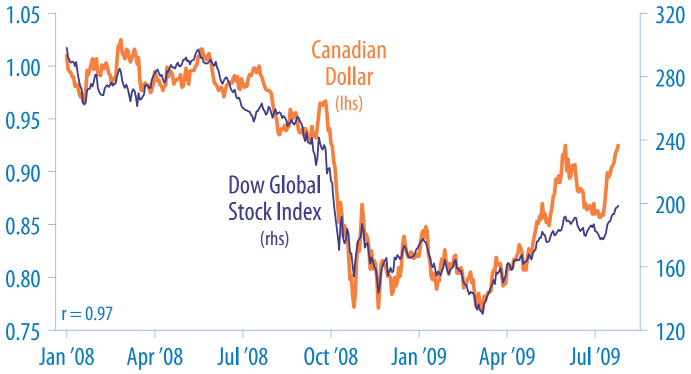
While there are still some items where significant gaps remain, there are other areas where previously wide differentials have been all but eliminated. It is no coincidence that the two most high profile and easily comparable goods—cars and books—have seen the most dramatic narrowing. We found that Canadians are now paying not measurably more than Americans for either item on average, when typical discounting is taken into account. Little more than a year ago, the spread was as much as 20% on both broad categories. Again, the exchange rate has played a part, but there has also been significant movement in prices on both fronts (especially after accounting for discounts).

If retailers have been cutting prices so aggressively, a fair question is: why is that not showing up in an even deeper drop in Canada's inflation rate? While Canada posted its first negative inflation reading in June since the early 1990s, the U.S. and other countries have seen even deeper declines in prices in the past year. The answer is that the drop in the loonie from its lofty perch a year ago has put upward pressure on food costs in particular, but has also kept energy prices from falling as deeply as seen stateside. Excluding food and energy, Canadian inflation *has* been lower than U.S. trends. And, the price of durable goods alone has fallen much more deeply in Canada relative to the U.S. over the past two years (*Chart 2*). With the currency heading north again, look for renewed downward pressure on both headline and core CPI inflation even as the economy recovers.

CHART 4

THE DOLLAR'S DRIVER... FOR NOW

(as of July 27, 2009)



Dow Global Stock Index: (December 31, 1991 = 100) Canadian Dollar = (US$/C$)

Unfortunately, the substantial price cuts to-date do not mean that domestic retailers can completely relax. If the Canadian dollar indeed takes a run to parity, Canada/U.S. price differentials would naturally widen (we estimate to an average of around 15%), which could ramp up cross-border traffic again (*Chart 3*)—at a time when underlying sales are struggling to recover from the deep downdraft of late last year. Assuming global markets continue to heal, a stronger loonie will be a natural by-product, and parity is certainly within reach. As we have previously pointed out, the link between global equity markets and the Canadian dollar has been uncannily tight, especially since the crisis broke wide open last year (*Chart 4*).

Endnote: *The exercise of price comparisons across borders is not straightforward: Many published materials no longer openly show both Canadian and U.S. prices, while a number of products have slight differences in specifications between the U.S. and Canada. Wherever possible, we compared apples to apples, all from similar retail outlets. Thanks to the team of intrepid shoppers – Carl Campus, Jennifer Lee, and Benjamin Reitzes.*