



Publication

MID-YEAR ECONOMIC UPDATE

July 2010

ECONOMIC RECOVERY DOWNSHIFTS

With the province's economy having bounced back from the Great Recession of 2008-09, the key question now concerns the strength and durability of the upswing. The latter part of 2009 and the first few months of 2010 saw a solid expansion, bolstered by additional economic activity linked to hosting of the Winter Olympics. Over the first half of 2010, we estimate that inflation-adjusted gross domestic product (GDP) in BC grew slightly faster than the 5% annualized rate posted by Canada over that period. And as our political leaders often proclaim, Canada as a whole stands out as one of the best-performing advanced economies.

That said, approximately a year into the recovery phase of the current business cycle, the global outlook is being scaled back. In the United States, the UK and a number of continental European countries, a process of de-leveraging has now begun, after a dramatic build-up of debt over the preceding decade.¹ This de-leveraging – involving households, but also the financial sector and to some extent governments – promises to dampen economic growth in the affected nations in the years ahead. Even Canada, for all its advantages, is likely to experience a modest degree of de-leveraging, particularly by households (which are carrying a record high level of debt relative to income). For both Canada and British Columbia, the implication is that economic growth is expected to slow over the second half of 2010 and into next year.

Although most forecasters believe that the global economy remains on a recovery track, there will be more twists, turns and bumps than normal. An imminent European sovereign debt crisis has been fended off, but unsettled conditions in several EU countries will keep financial markets on edge. Many European countries are moving to slash unsustainable budget deficits, which will subtract from economic growth in the short-term. At the same time, the risk of a “double dip” recession in the United States has risen, with top Federal Reserve Board officials openly worrying that the economy is losing momentum. While it should avoid a technical “double dip,” the US economy is poised to disappoint over the next 12 months. For now, the main source of strength in the world economy will be China, India and other emerging markets.

¹ A useful discussion of the debt built-up can be found in the following McKinsey Global Institute report: [Debt and deleveraging: The global credit bubble and its economic consequences](#) (January 2010).



External Setting

On the global stage, the most significant concerns are the subdued economic outlook for Europe and unusually weak private sector spending in the United States. Together, the US and Europe represent more than two-fifths of world output.

Forecasts for Europe have been downgraded since the start of the year. In its July 2010 update, the International Monetary Fund shaved 0.2 percentage points off its projection for the Euro area, pegging real GDP growth at a meagre 1.3% in 2011. Canada's trade exposure to Europe is slight, so the direct impact of faltering European growth is limited. However, stagnation in Europe will have knock-on effects for the wider global economy.

World Economic Forecast (per cent change in real GDP)				
	2008	2009	2010	2011
US	0.4	-2.4	3.3	2.9
Euro area	0.6	-4.1	1.0	1.3
Japan	-1.2	-5.2	2.4	1.8
China	9.6	9.1	10.5	9.6
World*	3.0	-0.6	4.6	4.3
* PPP basis Source: IMF, World Economic Outlook, July 2010 Update.				

Despite a decent performance over the first half of this year, supported by large gains in exports and a fiscally-driven pick-up in consumption, economic projections for Japan have also been lowered. Robust expansion in other parts of Asia should benefit Japan's export sector, but growth will decelerate because much of the necessary inventory restocking has already taken place. As with many advanced countries, the impact of large-scale government fiscal stimulus will begin to fade next year, crimping consumer spending. Japan's economy is projected to grow by 2.4% this year, slipping to 1.8% in 2011.

The outlook for emerging Asia is more positive, although the growth retrenchment theme carries through to some economies in the region. Massive fiscal stimulus and rebounding global trade have kept China's economy running at full tilt. The IMF forecasts that China's real GDP will increase by 10.5% this year but it has pruned next year's forecast to 9.6%. In its recent global forecast, TD Bank puts growth in China at 9% for 2011. A number of Asian economies are presently growing above trend and are therefore at risk of spikes in inflation, adding another element of uncertainty to the near-term picture.

Of greatest relevance for British Columbia is the US economy, where prospects have dimmed in the past few months. Meaningful growth in the first quarter of 2010 (3.7% annualized) fed optimism, but a spate of weaker economic data is prompting questions about the expansion. Preliminary figures show real GDP growth decelerating to a tepid 2.4% annualized rate in the second quarter. As noted above, a "double dip" is unlikely, but ongoing fiscal retrenchment at the state and local government level, a still desperately troubled housing sector, and an anaemic job market all point to a sub-par growth scenario for the US over the coming 12 months.

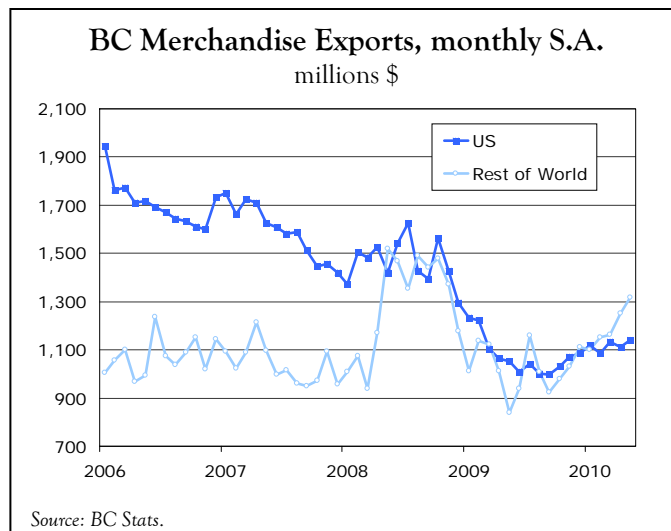


Many economists are characterizing the vaunted US jobs machine as broken, and it is difficult to quibble with this view: the official unemployment rate remains near 10% and the median duration of unemployment has soared to record highs. At this stage of the recovery, job creation is usually well underway, but this time around employment has barely budged. More alarmingly, the absolute number of payroll jobs in America is back to the level set a decade ago, even though the country's population has surged by more than 35 million since 2000. Looking further ahead, the need to unwind fiscal stimulus and address the ballooning federal debt will require a hand-off to the private sector to drive economic expansion, as governments begin a lengthy period of fiscal consolidation. Unfortunately, a rapid rebound in private sector spending is by no means assured.

Canada's economy came through the global downturn in better shape than most others. Real GDP roared ahead by more than 6% (annualized) in the first quarter of the year, on the heels of a 5% advance in Q4 2009. This is 4-5 times faster than the pace of growth seen in Europe and twice as fast as in the US. The Bank of Canada was the first G7 central bank to raise its overnight lending rate on June 1, with another 25 basis point increase announced on July 20. Canada's economic rebound is unfolding largely as expected, although the Bank did note that the recovery is expected to be more gradual than it envisioned a few months ago. In its most recent update, the Bank of Canada foresees the nation's economy growing by 3.5% this year, dropping to 2.9% in 2011.² Like other forecasters, we expect interest rates to edge higher over the next 18 months. But this likely won't take the form of steady rate hikes. The subdued US recovery and the risk of additional negative shocks in financial markets will cause the central bank to proceed cautiously as it seeks to normalize interest rates after almost two years of "emergency" low rates.

BC's Export Sector

The value of BC's international merchandise exports was up nearly 8% through May compared to the same period in 2009. This follows a precipitous decline last year (and in 2008), with total exports still well below pre-recession levels. In the first half of 2010, lumber prices climbed to their highest level in four years. A seasonal blip in US home-building and stronger demand in China were positive factors, but most of the movement was attributable to



supply curtailments rather than improved fundamentals in US home-building. With lumber producers stepping up supply in response, prices have since fallen again.

² Bank of Canada, Monetary Policy Report (July 2010).

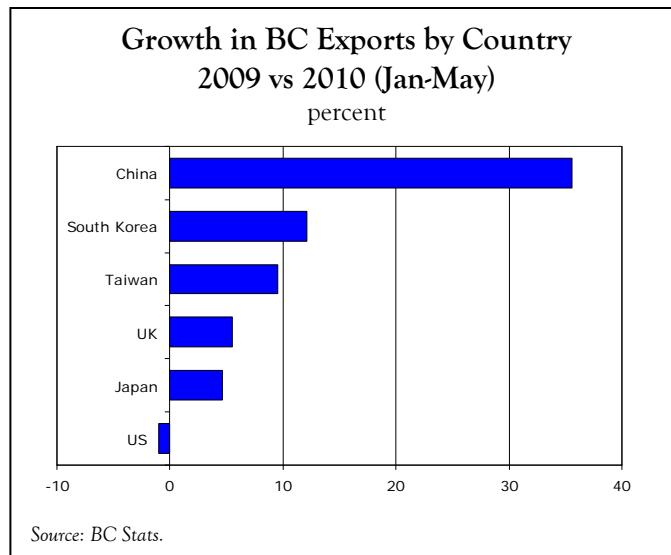


China is now purchasing BC lumber in growing volumes. In the first four months of the year BC producers shipped \$132 million worth of lumber to China, a 63% increase from the same period in 2009. China is on track to surpass Japan, which has long been BC's second largest export market for wood products.

We expect overall export growth to moderate as many of BC's export-oriented industries face headwinds in the second leg of recovery. Prices for lumber, natural gas and several other commodities of interest to BC are not expected to increase appreciably in 2011.³

At the same time, the Canadian dollar has gained value vis-à-vis the US greenback over the past year and looks to be settling in around the US 95-97 cents mark. A year ago the loonie was trading below US 90 cents; in the early spring of 2009 it was at 80 cents. Another factor impinging on BC's near-term export prospects is a further delay in any recovery in US home-building. Sales of existing US homes have slowed for a number of months. By the first quarter of 2010 more than 11 million American homeowners were in a negative equity position (they owe more on the mortgage than their home is worth), which adds up to fully one-quarter of all residential properties with mortgages.⁴ Estimates suggest there are four million "surplus" homes in the US. Some analysts believe it may take five years to work through the foreclosures and excess supply of homes, a scenario that does not augur a quick snap-back in home-building activity.

Offsetting the weakness in the United States, BC is benefiting from its increasing orientation to the Asia Pacific. Prior to the Great Recession, the province shipped two-thirds of its merchandise exports to the US. Owing mainly to the deep American recession, BC's total exports fell sharply over 2008-2009. Exports to Japan, China and other Asian markets also slipped, but not to the same extent, and they have revived more quickly than sales to the US. As a result the United States now accounts for less than half of all BC exports. While this proportion is unusually low and America's appetite for BC goods will eventually rebound, the recent trend points to a longer-term shift in BC's export orientation away from North America and towards Asia and other emerging market economies.



³ Scotiabank Commodity Price Index (July 21, 2010).

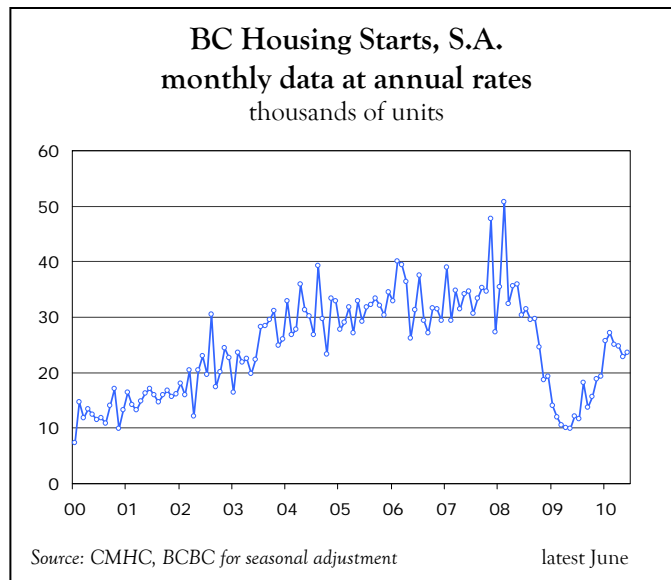
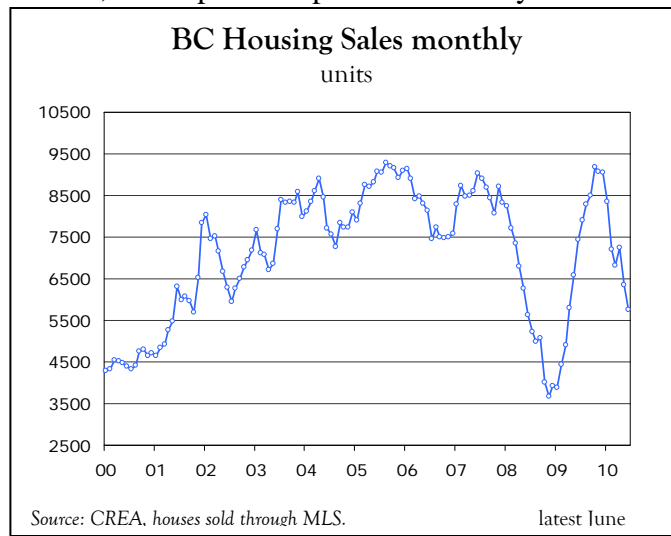
⁴ CoreLogic, 2010 Q1 Negative Equity Report.



Domestic Economy

The province’s domestic economy has fared relatively well over the past year, boosted by a hefty dose of fiscal stimulus and record low interest rates that spurred a surprising rebound in home sales and home-building. Indeed, BC’s domestic economy has been quite resilient in the face of the world-wide downturn. Still, we expect the pace of recovery to slow as monetary and fiscal stimulus are gradually reduced and the province’s heavily indebted consumers struggle to manage household budgets in an environment of rising borrowing costs. There are also questions about the strength of private sector hiring at a time when public sector payrolls will be under downward pressure.

Home construction typically fuels the early stages of economic recoveries, and this time was no exception in BC. In response to the surge in sales activity, new home construction increased steadily from a seasonally adjusted annual rate of 10,000 units in May 2008 to a peak of 27,000 units by February of this year. More recently, starts have slipped and indications are that home-building will continue to ease in the second half of the year and into 2011. Some of the increase in starts over the past year likely reflects an effort to complete sales prior to the implementation of the new Harmonized Sales Tax. In addition, many home buyers have been anxious to get into the market before interest rates move higher.



At this stage during a “normal” economic recovery, non-residential construction would start to come to life as companies gear up investment spending. But given lingering uncertainties about the US and global economies, we expect BC businesses to proceed cautiously. Consistent with a wait and see approach, over the first four months of the year building permits for commercial and industrial structures were both down about 15% from the same period in 2009.

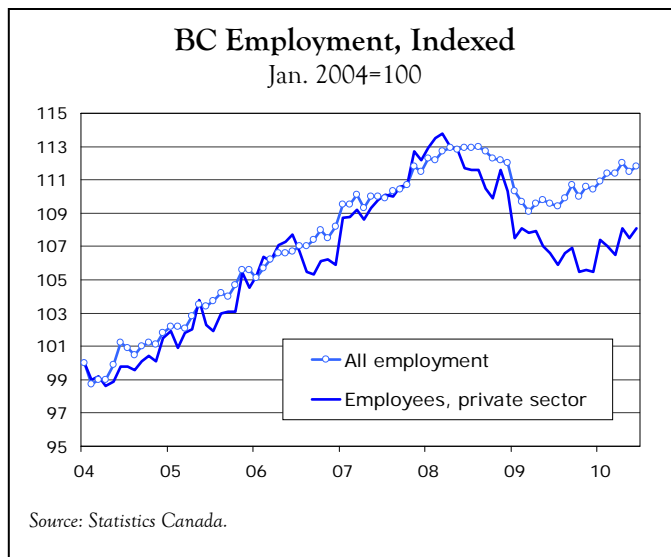


Following a significant decline in consumer spending in 2009 (when retail sales fell by 4.4%), spending in stores has bounced back but is still below pre-recession trends. Data over the past few months suggest some of the momentum in consumer spending has subsided, in part reflecting softer retail outlays on items relating to home purchases. But the retail marketplace is certainly in better shape today than it was in 2009.



Focus on the Job Market

The economic outlook hinges in large part on employment growth. More people working fuels spending, home sales and construction. In BC, employment has increased at a slightly below average pace over the past year. In spite of the gains made, the total number of jobs is still below the pre-recession peak. Continued slack in the labour market is evidenced by an unemployment rate not far shy of 8% (versus about 4% in 2007 and early 2008).



As with so many elements of this recovery process, there are concerns about the underlying strength of the labour market. While the job market in Canada and BC is much healthier than in the US, the rise in overall employment masks the fact that private sector hiring has been weak. The number of employees in BC's private sector is still 5% below the level reached in the first quarter of 2008. Looking at year-over-year growth reveals some stark differences across labour market segments. The number of private sector employees in the first half of this year is unchanged from the same period in 2009, whereas the number of public sector employees is up 6.5%. Self-employment has increased by 2.7%. We believe private sector job gains will pick up in 2011, but at a comparatively slow pace. And public sector hiring is expected to downshift in the next couple of years as governments address their budget deficits.



Concluding Thoughts

Just as the province’s economy could not avoid being dragged down by the global slump, BC will feel the effects of financial market gyrations and weak economic growth in the US and Europe in the next year. The province is benefiting from its increased exposure to China and other emerging Asian economies, but growth in these markets is not enough to offset the impact of a sub-par economic expansion across almost all of the advanced countries.

As 2011 approaches we forecast a moderation in economic growth for British Columbia (and for Canada). The handoff from government-engineered fiscal and monetary stimulus to private sector-led growth will not be complete, as business investment is slow to pick up and the “new normal” for consumer spending turns out to be more subdued than during the free-wheeling 2004-2007 era. Softer housing markets may translate into lower housing prices, which could weigh on consumer sentiment in BC’s housing and real estate-centric economy. And while new jobs will be created in many sectors, employment growth won’t be strong enough to produce a rapid fall in the unemployment rate in 2011.

In terms of the province’s fiscal position, it should be noted that our revised forecast for real GDP growth in 2010 (3.5%) is stronger than the 2.2% figure assumed in the 2010 provincial budget. Our current forecast of 2.6% real growth for 2011, however, is similar to the 2.3% figure used in the budget. In a relatively slow growth environment featuring a number of (largely external) downside risks, good fiscal management will be key to the BC government’s ability to meet its budget targets.

As always, it is important to keep relative economic performance in mind. British Columbia is certainly in better shape than the US and most of Europe, and the province is likely to match and perhaps slightly exceed the national average growth rate over 2010-11. Compared to the boom years preceding the Great Recession, however, economic conditions will seem quite tame in 2011.

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BC Near-Term Economic Outlook (annual per cent change unless otherwise indicated)			
	2009a	2010f	2011f
Real GDP	-2.3	3.5	2.6
Employment	-2.4	1.8	2.1
Unemployment rate (%)	7.6	7.5	6.6
Housing starts (000 units)	16.1	23.8	22.0
Retail sales	-4.4	5.5	5.0
BC CPI	0.0	1.2	1.6
A – actual f – forecast Sources: Statistics Canada, BC Stats and Business Council for forecasts.			