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BC OUTLOOK

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DETERIORATING GLOBAL BACKDROP LEADS TO DOWNGRADING OF BC ECONOMIC OUTLOOK

Following a solid rebound in 2010, BC's economy is on course for fairly subdued growth this year and into 2012. Some of last year's expansion was attributable to a post-recession rebound in consumer spending, home construction and exports, with the extra spending associated with the 2010 Winter Olympics providing an added one-time boost. Apart from the export sector, the pace of expansion in most segments of the BC economy has moderated over the past two or three quarters, after climbing out of previous deep cyclical low points. Increases in consumer spending have been tepid, and the residential real estate industry is weak, casting a shadow over the prospects for housing investment. Business capital spending is improving, but at a slower pace than is typical at this stage of the economic cycle. The wrapping up of government stimulus and a renewed focus on moving to fiscal balance will also act as a drag on growth over the next 18 months.

We expect the provincial job market to perform better in the second half of the year than it has in the first half, but it remains a soft spot in the macro picture. Although BC is working off a decent economic foundation, the overall expansion is being held back by a soft labour market and decelerating growth in the US and global economies. For the near-term, BC's prospects are tied to the export sector, and here it is mainly about China and other emerging economies buying resource-related goods, coupled with increasing two-way trade flows through the Vancouver and Prince Rupert/Prince George gateways. In short, against a backdrop of slowing global growth and a flagging US economy, we believe BC is looking at a mixed and uneven economic performance over 2011-12.

External Picture

As a small open economy, the external setting is always critical for British Columbia. Today it is arguably more important than ever, as the province will be relying on the export sector (and export-linked capital spending) to sustain growth. Although the global economic picture is varied and unsettled, brisk growth in many emerging markets has proved sufficient to support broadly-based gains for the province's export sector. Whether that will continue over the rest of 2011 and into next year is uncertain. Global equity markets are in the midst of a brutal sell-off, and many forecasters are downgrading their outlook for the world economy on the back of disappointing US data, a temporary recession in Japan, severe financial stress in the Euro zone, and somewhat weaker growth in China. Table 1 provides a recent global forecast from one Canadian source.

Table 1
World Economic Forecast
(per cent change in real GDP)

	2000-2009*	2010a	2011f	2012f
US	1.7	3.0	1.8	2.5
Euro area	1.1	1.7	1.7	1.5
Japan	0.6	4.0	0.3	3.5
China	9.4	10.4	9.3	9.5
UK	1.7	1.4	1.2	1.5
Germany	0.9	3.5	3.3	2.1
World	3.6	5.1	4.0	4.3

* Annual average. a – actual f – forecast
Source: ScotiaBank Economics, August 5, 2011.

Economic activity across most of the advanced countries remains tepid, especially considering the depths of the 2008-09 recession. Significantly for BC, the United States continues to fall short of expectations based on previous recovery cycles. The latest American labour market report, which showed 174,000 jobs created over the two-month period of June-July, has failed to allay concerns about the dismal jobs situation market standing in the way of a more self-sustaining expansion. The sickly US housing sector is another powerful economic headwind. Unfortunately for BC, a meaningful upturn in US homebuilding activity is still more than a year away.

While several transitory factors have weighed on US growth (e.g., higher oil prices, bad winter weather, and Japan's earthquake/tsunami and related supply disruptions), it is becoming increasingly apparent that America's recovery in the aftermath of 2008-09 financial crisis/housing implosion is going to involve many years of sub-par growth, as households rebuild balance sheets, real estate markets slowly normalize, and the public sector moves to put its tattered finances in order.

So far in 2011, economic conditions have been stronger than expected in some parts of the euro area, where real GDP growth rebounded to a surprising – and not to be repeated – 3.4% (annualized) in the first quarter. Germany's unemployment rate is at a post-unification low, and it is the only advanced economy where growth is forecast to exceed 3% this year. In contrast, the peripheral EU economies continue to face huge challenges, especially Greece and Ireland, which are slashing government spending to make the fiscal adjustments necessary to secure financial aid from the IMF and the European Union. Economic activity is also weak in Spain, Portugal, Italy and the UK, all of which have embarked on fiscal austerity programs of their own. Near-term economic retrenchment in Europe is inevitable. Recent indicators point to sluggish growth over the rest of 2011, which is likely to carry over into 2012.

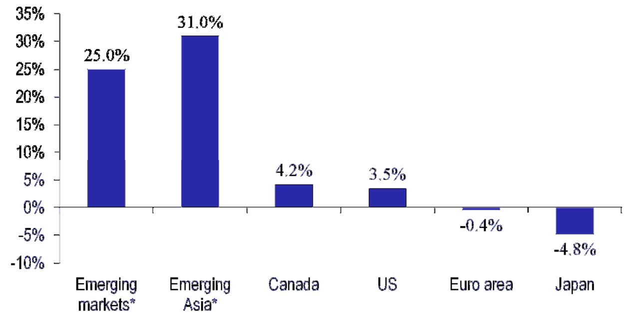
Japan has started to rebound from the earthquake and tsunami disasters that struck in March, although growth will remain below previous expectations through the end of the year. Output is likely to stay flat for 2011 on an annual average basis, followed by a decent recovery in 2012.

In contrast to the advanced economies, growth in the emerging markets has been brisk. China's economy is poised to slow a bit, with real GDP increasing by 9.0-9.5% this year as the authorities tighten monetary policy and take other steps to dampen rising inflation and frothy property markets. Growth of 8% or more should be enough to sustain China's demand for Canadian resource goods, although the BC forest sector expects the pace of lumber sales to China to slow after a dramatic surge in shipments to China over the past few years.

Figure 1

Emerging Markets Driving Global Growth

Change in level of real GDP, Q1 2007 to Q1 2011



Source: Bank of Canada and IMF.

Canada's economy grew at a robust 3.9% pace in the first quarter of the year, but it then lost momentum from April to June. Consumers and housing markets have powered the Canadian recovery over the past two years, but these growth engines are visibly down-shifting under the weight of high household debt, the exhaustion of pent-up demand for housing and big-ticket durable goods, and the winding down of government stimulus spending. National housing markets have turned down, with sales and listings softening in many regions.

A strong Canadian dollar is another factor that will temper growth in the coming months. The Loonie has been trading above parity with the US dollar and is likely to remain there for some time. If the Bank of Canada begins to raise interest rates ahead of the US Federal Reserve, as most forecasters anticipate, this could put additional upward pressure on the Canadian dollar. On the other hand, if global oil prices continue to weaken the Loonie may falter against both the US dollar and the euro.

At this point, we project that Canada will post real GDP growth of 2.5% or so this year, with a broadly similar performance in 2012. The composition of growth will shift, however, with exports and non-residential investment playing bigger roles as consumer spending and housing-related activity cool.

BC Economy: Focus on the Export Sector

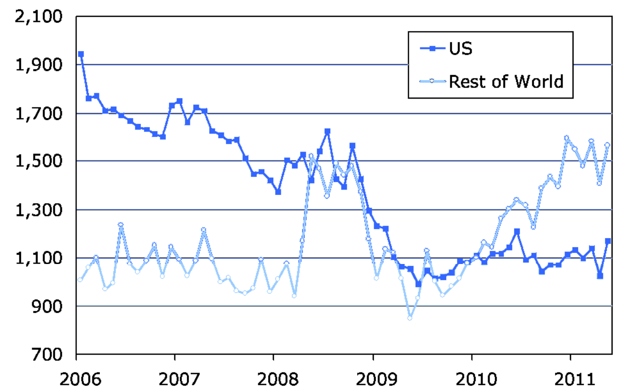
Turning to the situation here in BC, let's start with some good news: the value of the province's international merchandise exports is up nearly 14% this year (through May) compared to the same period in 2010. This follows a slightly stronger increase the previous year. Of interest, this upswing has occurred with almost no help from the United States, as exports headed south have essentially been flat over the past two years.

In contrast, BC's merchandise exports to emerging economies have soared. Sales to China, in particular, were up more than 60% last year, and are on course for a further 50% jump in 2011. China is close to eclipsing Japan as BC's second largest export market. Exports to

Germany have also risen sharply, but this has little impact as Germany represents just 1% of total provincial exports, whereas China now accounts for 15%.

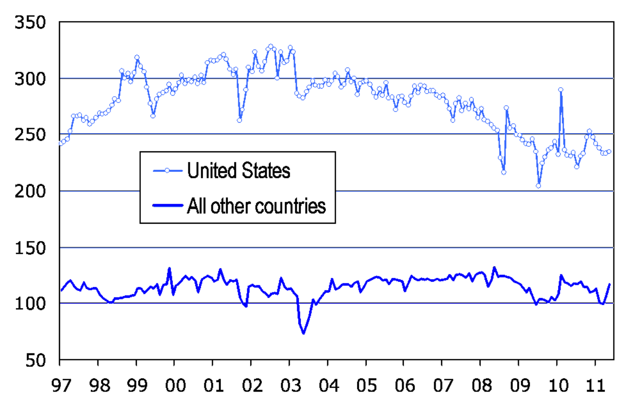
Through the second half of 2011, BC's export sector will be key to whatever economic growth the province manages to achieve. Note, too, that this includes the province's Gateway industries, which are closely tied to the health of trans-Pacific trade. With the increasing volume of goods moving between North America and Asia, the transportation and logistics sector is one of the most important contributors to the provincial economy. On the other hand, we don't expect much lift from the US in the near-term, as the American economy flirts with a possible double dip recession, homebuilding stays in the dumps, and prices for lumber and natural gas – two key BC exports to the US – remain low. Fortunately, BC's more diversified export base means the higher Loonie will not have as negative an impact on export sales as would have been the case five or ten years ago.

Figure 2
BC Merchandise Exports, monthly
millions $; seasonally adjusted



Source: BC Stats. Latest May

Figure 3
Tourists* Entering BC, monthly
thousands; seasonally adjusted



Source: Statistics Canada. *overnight stays latest May

In terms of risks, the knock-on effects from market reactions to sovereign debt worries and weak banks in Europe are a concern for Canada (and BC), but arguably a greater worry is a potential marked slowdown in the Chinese economy. Our operating premise in this forecast update is that China's economy will continue to grow in the range of 8-9% over the next few years. But if China downshifts appreciably, BC will feel the pinch through diminished exports, lower commodity prices generally, and reduced business volumes at the Vancouver and Prince Rupert/Prince George gateways.

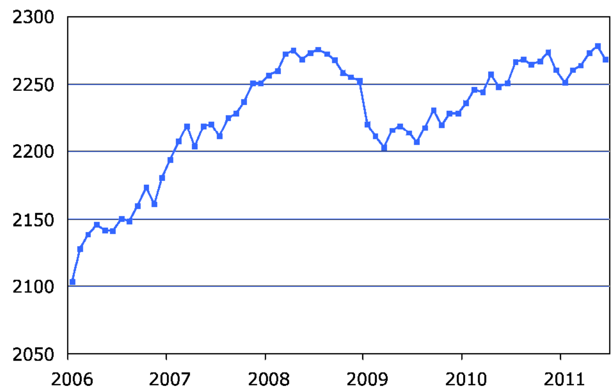
With US households anxious about jobs and focused on rebuilding their balance sheets and Canada's currency trading at lofty levels, BC's international tourism industry continues to operate in a difficult business climate. The number of tourists coming from the US has trended down for a decade, and this pattern is unlikely to reverse anytime soon. Last year did see an increase in American tourists (owing mainly to the Olympics), but over the past six months the numbers have again ebbed. Tourists arriving from other countries have increased recently, but in a longer-term context the Asian and European markets are still quite weak. The Vancouver business convention market is one notable bright spot for the tourism sector.

BC's Domestic Economy

Many BC consumers are under financial stress and hesitant (or unable) to spend. Companies, on the other hand, have seen profits rebound in most industrial sectors. And while it has yet to show up in the employment figures, some firms at least are starting to invest.

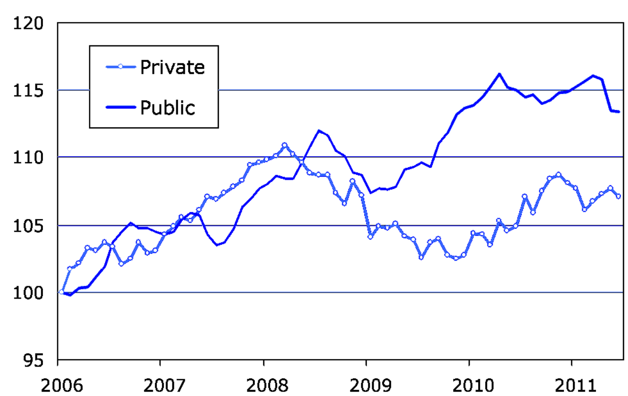
The uneven performance on the domestic side of the province's economy is reflected in the job numbers. As shown in Figure 4, total employment is just now returning to its 2008 pre-recession peak. Although the upward trend appears to be intact, the sizable dip recorded in late 2010 means the province hasn't made much headway on the jobs front over the past three quarters.

Figure 4
BC Employment, monthly
thousands; seasonally adjusted



Source: Statistics Canada. latest June

Figure 5
BC Employees, Public and Private Sectors
(monthly, indexed 2006=100; seasonally adjusted)



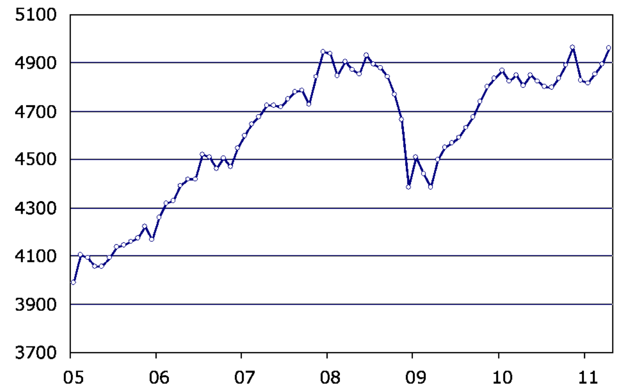
Source: Statistics Canada. . latest June

Digging deeper into some of the employment segments reveals further underlying weakness. Private sector hiring has yet to gain much traction. Figure 5 confirms that private sector employment is still below its pre-recession peak. Much of the job growth since 2009 has been driven by the public sector (which includes health care and education), plus an expansion in the self-employment category.

With governments now shifting to fiscal restraint, public sector hiring has slowed, and job creation in the broad government sector is apt to be weak (or even negative) for some time. This underlines the need for stronger job growth in the private sector. We do expect BC firms to step up hiring activity, but it may be slow to materialize given lingering uncertainties about the US and global economies.

Retail spending is a soft spot in the provincial economy (Figure 6). Many consumers appear to be cautious, which is not surprising in light of the generally disappointing job numbers and record high household debt levels. The value of total retail sales has made little headway over the past ten months. Factoring in population growth and inflation, in real per capita terms retail sales have contracted.

Figure 6
BC Retail Sales
thousands $; seasonally adjusted

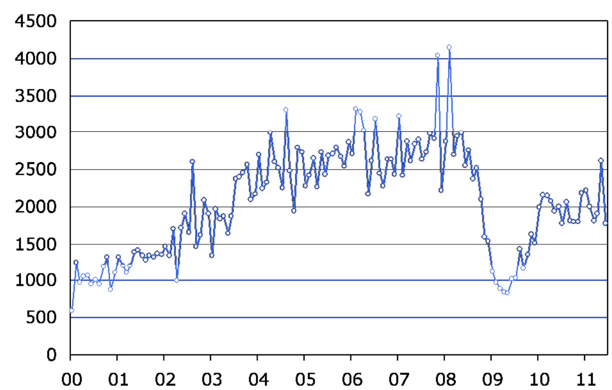


Source: Statistics Canada.

Home construction typically fuels the early stages of an economic recovery and this time, both for Canada and for BC, was no exception. But there are indications the housing market is losing steam. BC home sales have slipped since early in the year, and most analysts expect further declines followed by some price reductions in the next 6-18 months. Within Canada, Metro Vancouver stands out as a market that is overvalued according to all of the usual metrics. The main reasons for the recent downturn in housing sales are punishing consumer debt loads, steep home prices, below-par job growth, and (perhaps) the anticipation of rising interest rates over the next few years.

Meanwhile, homebuilding has been in a bit of a holding pattern. Although the number of starts has jumped around, the overall trend has been sideways since early 2010. A slowdown in sales activity means new home construction is set for a modest dip this year, and we predict a flat performance in 2012. In a growth accounting sense, home construction will not provide much of a lift to BC's economic expansion over the forecast period.

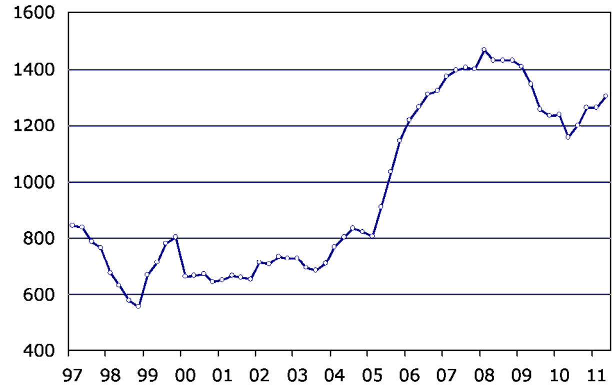
Figure 7
BC Housing Starts, monthly
units; seasonally adjusted



Source: Statistics Canada.

At this stage during a normal economic recovery non-residential construction typically starts to come to life, as companies gear up capital spending. Spending on non-residential buildings did turn the corner about a year ago. With the value of non-residential permits up almost 30% year-to-date compared to 2010, non-residential investment is serving as a positive growth engine this year and this should persist into 2012. Gains are evident across all segments, including

Figure 8
BC Non-residential Construction Investment. Quarterly
millions $; seasonally adjusted



Source: Statistics Canada.

industrial permits, which is consistent with export growth and reports of companies making (or planning) investments to meet rising demand from Asian markets

The resource industries are also expanding. In fact, there are so many projects underway or slated to begin in the next few years that, in contrast to the past two decades, economic conditions in the northern regions of the province will be more robust than in the lower mainland and other larger population centres. In addition to strong fundamentals boosting existing operations, BC should see a number of new mines open in the coming years. Mount Milligan, a copper-gold project located 155 km northwest of Prince George, is under construction and should be operating by 2013. Several additional mine sites are in the final permitting phase. Mine development and mineral exploration – encompassing base metals, precious metals, and coal – will be a significant source of growth for BC throughout this decade. Vast natural gas reserves and well established infrastructure make the natural gas sector another bright spot.

Forestry is in the (very) early stages of what, hopefully, will prove to be a multi-year revival, thanks to greater demand from China, an expected recovery in US homebuilding, and diversification into bioenergy and pellet production. However, the benefits of a recovery in lumber prices and demand will be more evident in the out-years than in the next 12-18 months. Steady growth in throughput at the Port of Prince Rupert is another source of prosperity for the north. Both container and bulk facilities at Prince Rupert are near capacity and will need to be expanded. Final approval for the construction of an electric transmission line along Highway 37 in northwest BC means this project will soon be underway. And Rio Tinto Alcan is progressing step-by-step with a multi-billion dollar upgrade of its big aluminum smelter operation in Kitimat.

Perhaps the greatest challenge for the north will be finding enough workers to complete all the projects being developed or proposed. The Cariboo labour market region has already gone from having the highest unemployment rate in the province (12.1% in 2009) to being below the lower mainland's rate and second only to the northeast (it now sits around 7.4%).

Concluding Thoughts

Our revised 2011-12 forecast for the BC economy is summarized in Table 2. We expect BC to post modest real GDP growth of just 2.2% in 2011, down from 4% last year. Some pick-up is likely in 2012, predicated on sustained export gains and higher levels of non-residential capital spending. High debt loads and muted job growth are weighing on BC households, and managing a record household debt burden will become a bigger challenge as interest rates normalize. As such, we believe consumer spending will play only a minor role in BC's economic expansion over the next 12-18 months. The same is true for housing.

Table 2
BC Economic Outlook
(annual per cent change unless otherwise indicated)

	2010a	2011f	2012f
Real GDP	4.0e	2.2	2.8
Employment	2.1	1.4	2.0
Unemployment rate (%)	7.6	7.5	6.6
Housing starts (000 units)	27.0	24.0	25.0
Retail sales	6.0	2.5	3.5
BC CPI	0.0	1.2	1.6

a – actual f – forecast e – estimate
Sources: Statistics Canada, BC Stats and Business Council for forecasts.

China and Asia generally are looming larger for BC and can be credited with sustaining much of the province's recovery and reshaping regional economic fortunes. With a number of big projects beginning or planned over the next few years, growth in the northern half of BC should outpace that in other parts of the province.

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