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BC ECONOMIC GROWTH TILTED TOWARDS CONSUMPTION

British Columbia has enjoyed a number of years of unusually strong economic growth. In inflation adjusted terms, the provincial economy grew 3.1% in 2007 and by an average of 3.4% over the past five years. This pace is well above the 2.7% average recorded over the preceding decade. It is also above the province's long run potential, especially against the backdrop of slowing labour force growth. What follows is a review of BC's economic performance, with a particular focus on 2007. While the analysis is largely backward looking, identifying recent trends and growth drivers provides a baseline to assess near-term economic prospects.

Highlights of the review are as follows:

1. The BC economy remained healthy in 2007, but among the provinces it went from a lead to a middling performance on many key economic metrics.
2. Consumers played an unusually large role in the province's expansion in 2007.
3. The construction industry's role as an economic growth engine diminished in 2007.
4. The province's export sector was once again a significant drag on growth last year.
5. Government made its largest contribution to growth in many years.
6. The uneven nature of the economic expansion and the potential for further softening in the construction industry points to slower growth over the 2008-2009 period.

BC's Economic Performance

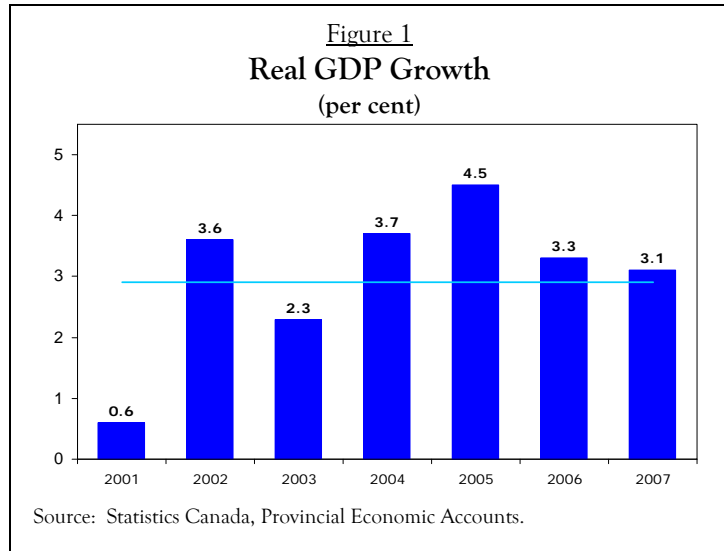
According to Statistics Canada, BC's economy grew (in inflation adjusted terms) by 3.1% in 2007. Although down slightly from 2006's 3.3% pace, this was still a strong showing. Notably, BC has now outpaced Canada's GDP growth consistently since 2001. A pick up in economic activity in the other western provinces as well as Newfoundland, however, meant that BC slipped to fourth place in the provincial growth rankings last year, down from second place in 2005 and being tied for second in 2006.

Still, on a five-year average basis, the current economic upswing remains impressive. BC's 3.4% average growth over that period exceeds all provinces except for Alberta (4.7%).

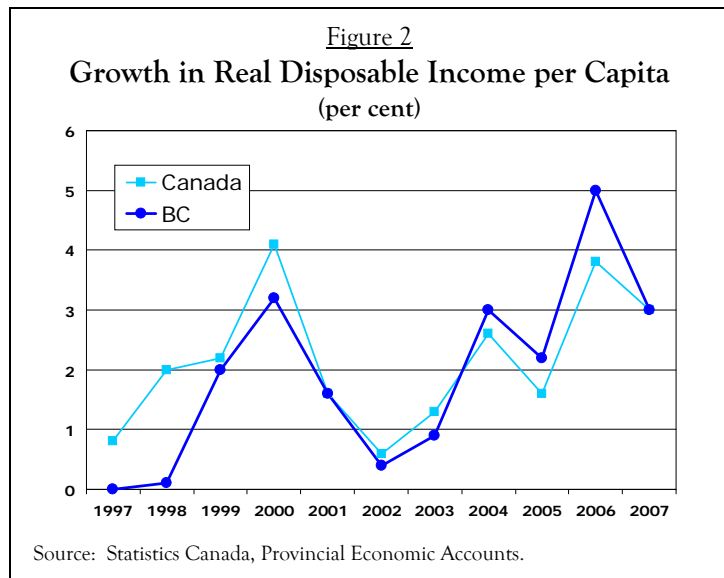
In tandem with the robust economic expansion, BC's job market continued to be vibrant in 2007, which was one of the key factors fuelling consumer spending. Employment jumped 3.2%, marking the third straight year job growth has topped 3%. The abundance of new jobs pushed the unemployment rate down to an unprecedented 4.2% by the end of 2007.



While these top line figures are quite impressive, digging a bit deeper reveals some softening in BC's economic performance. Metrics that better reflect prosperity eased considerably in 2007. After peaking at 3.1% in 2005, growth in real GDP per capita slowed to a more typical 1.7% last year, a performance in line with the Canada-wide showing. Over the 2004-06 period BC posted bigger gains in per capita GDP than most other provinces.



Growth in real personal disposable income per capita, another widely used gauge of living standards, also downshifted. On its own, 2007's 3.0% increase is very respectable, but it is well off of the 5% surge seen in 2006. More significantly, in a comparative context it puts BC back on par with the national increase, following three years during which the province comfortably beat the Canada-wide gain.



What Fuelled Last Year's Expansion?

Although BC's economy was still healthy in 2007, a reversion towards a more average performance is to be expected following a number of years of above-capacity growth. In terms of sustaining a strong economy, there are grounds to be concerned about the somewhat unbalanced nature of the province's economic expansion in recent years, but especially in 2007.

Jobs, rising incomes and many years of escalating house prices all helped fuel consumer spending. Personal consumption on goods and services surged 5.6% in 2007, on the heels of a 5.5% advance in 2006. The last time consumption grew at this pace was back in the late 1980s. While strong growth in consumer outlays reflects the province's economic upswing, these data suggest that BC's economy has become heavily tilted towards personal



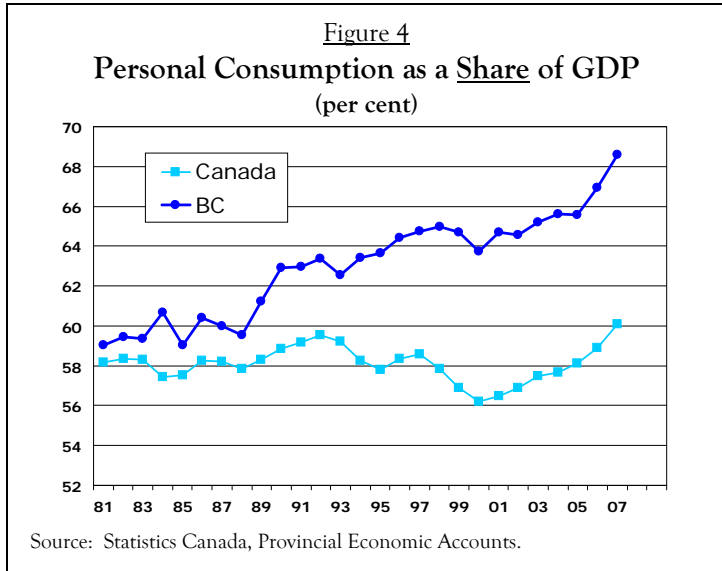
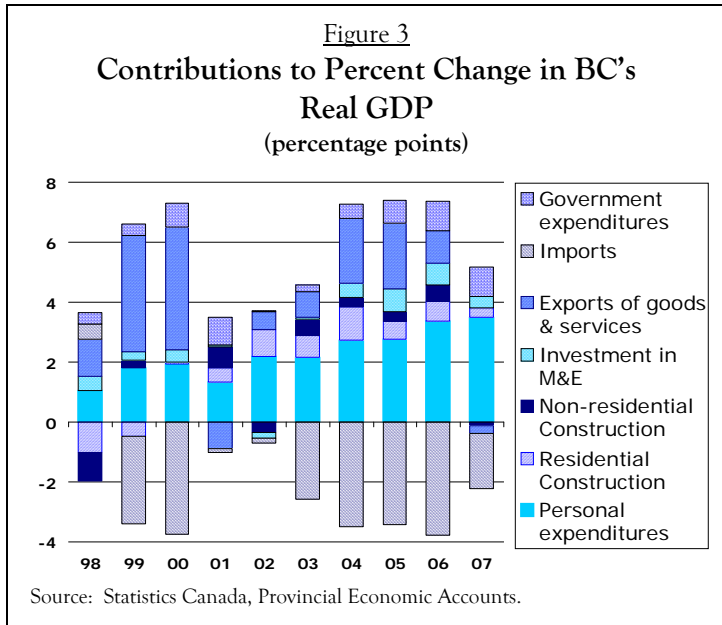
consumption, with exports and even construction investment shrinking in importance. In fact, personal consumption accounted for nearly all of BC's economic growth in 2007.

Moreover, the outsized importance of consumption appears to have become a structural feature of BC's economy. Personal consumption on goods and services now accounts for an astounding 68.6% of the province's GDP. For Canada, the comparable share is 60%; for Ontario, it stands at 59%. And even though Albertans have acquired a reputation as prolific spenders (thanks to the high value of oil exports), consumption there only amounts to 50.3% of total economic activity.

The next largest contribution to growth in BC last year was government. All together, municipal, provincial and federal government spending advanced 4.4% in 2007. Adding current expenditures and capital investment together, the public sector contributed nearly one full

percentage point to growth in both 2006 and 2007. This is the largest contribution to growth since the 1991 economic downturn. While there is nothing wrong with fiscal stimulus, the fact that government was a leading driver of growth during a period of relative economic strength speaks to some of the underlying structural weaknesses in the BC economy - such as a fragile and underdeveloped export base.

In the context of BC's five-year upswing, construction activity has been at the forefront. In 2007, however, construction wasn't much of a growth driver. On the residential side, investment in new residential structures was up only 3.5%, half the pace of the two previous years and well below the 15% surge in 2004. In the non-residential segment, construction spending (in inflation adjusted dollars) actually fell 2.2%, meaning non-residential





construction (structures as well as engineering projects) was actually a drag on growth last year. Combining the two segments together, construction activity still lifted growth, but only by two-tenths of a percentage point, which is about one sixth of the sector's growth contribution in 2006.

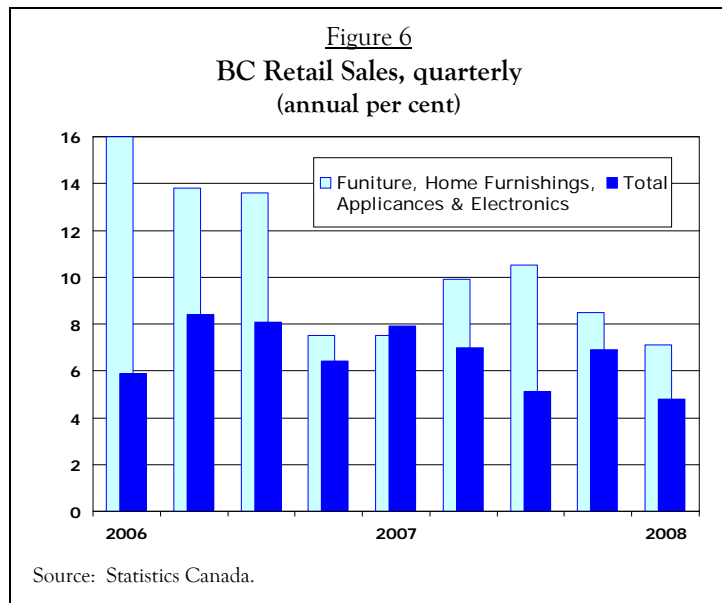
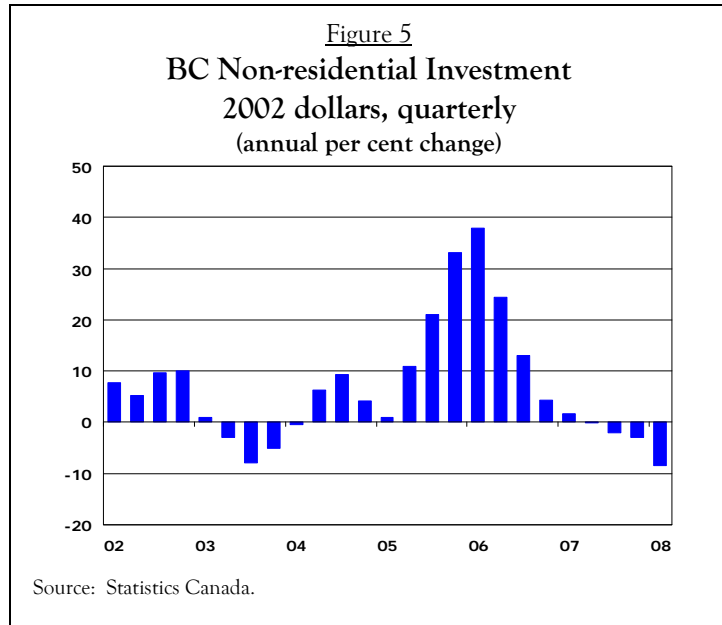
The largest drag on the economy came from the export sector. The total value of all goods and services exported from BC fell 0.6% in 2007, the first decline since 2001. With US housing in free fall and the Loonie soaring to new highs, it is not surprising that international goods exports fell. More surprising is that the value of BC goods exported to other provinces registered an even steeper drop in 2007 and was also the largest drag on growth, even though for BC, interprovincial goods exports amount to just one-third the value of international exports.

Looking Ahead

Against the backdrop of a reasonably strong but largely consumer-led expansion in 2007, we turn to our revised outlook for 2008/09.

For BC to reach even an average economic performance in 2008, a better showing by exports and construction investment will be required. Unfortunately, current indicators in both of these areas are weakening rather than improving.

In the first quarter of 2008, the value of international merchandise exports was down 12.5% compared to the first quarter of 2007. This decline is twice as large as 2007's fall, meaning that the international goods component of BC's export sector is off to a rather poor start. International services are also likely to slip this year in the face of the strong dollar and a weakening American economy. Exports to other provinces are more difficult to





gauge because there are no current indicators that track this activity, but the fact that the Alberta and Ontario economies are slowing points to a modest gain at best, and possibly a small decline, in the value of BC's exports to the rest of Canada.

With so much building underway in the province, construction activity will remain at elevated levels, but again will not provide much of a lift to measured economic growth in 2008. In the non-residential segment, the value of building permits has dropped sharply from a peak of \$1.2 billion in the second quarter of 2007, to just over \$600 million in the first quarter of this year (seasonally adjusted). This retreat is already showing up in the data, as the value of investment in non-residential structures (in inflation adjusted dollars), fell 8.5% in the first quarter of 2008.

Fortunately, residential construction will again be a growth engine. Housing starts are up so far this year and should provide an overall economic boost as these homes are built through the remainder of the year. In addition, renovation activity is up sharply (28% year-over-year). So even if the number of housing starts slows in the second half of the year, the recent pick up in starts combined with more renovation spending will translate into another rise in residential investment.

With the unbalanced nature of the expansion set to continue in 2008, the broader economic outlook hinges on consumption. BC consumers will continue to do most of the heavy lifting, although there are some signs that spending growth may moderate slightly. Growth in retail sales has eased in the first four months of 2008.

There are, in addition, a number of downside risks. For one thing, concerns about the faltering US economy and the rapid deterioration in the housing market south of the border could weigh on consumer sentiment. The slowdown in BC housing sales may also dampen growth in outlays for durable goods such as furniture and appliance. And perhaps the biggest wild card is the potential for higher energy prices to take a significantly bigger bite out of household budgets.

Conclusion

The bottom line is that the near term prospects for the BC economy are largely in the hands of consumers. In contrast to a few years back, construction will probably make only a small positive contribution, while the importance of government spending and investment will be greater in 2008. Activity in the export sector is poised to decline again in 2008. Adding it all up suggests that it will be hard for BC to grow by more than 2.0-2.2% this year, with the risks squarely on the downside. Looking out to 2009, we expect the province's economy to strengthen modestly as the US downturn ends. Still, the stronger currency and ongoing difficulties in the US housing market will work against a bigger upturn in BC's exports and hinder any move towards a balanced economic expansion.