BC ECONOMIC REVIEW AND OUTLOOK

Business Council of British Columbia
Est. 1966

Q1 2018 (MARCH)

BC ECONOMY DOWNSHIFTS IN 2018, BUT SOLID GROWTH LIKELY TO CONTINUE

HIGHLIGHTS

- The global economic backdrop has improved, which should help to sustain BC's economic expansion over the next couple of years.
- However, the underlying pace of economic and job growth in the province will slow in 2018-19.
- A number of indicators already point to some moderation in economic activity.
- The robust expansion in recent years means the economy is operating close to full capacity, with the limited availability of workers curtailing employment gains.
- Higher interest rates and the suite of new government tax and regulatory measures affecting housing and mortgage financing are dampening home sales in urban markets.
- There are heightened risks to the outlook, particularly for capital formation. A deteriorating policy environment and escalating intergovernmental conflict over the Trans Mountain pipeline expansion project are clouding the investment environment.

In our previous quarterly outlook, we projected that BC's economy would grow 2.3% (after-inflation) this year. This represented a sizable downshifting from 2017's estimated 3.1% output gain. At the time, we acknowledged that growth in BC could surprise to the upside. With the US and global economies moving to a firmer growth footing, BC's economy appeared to have substantial forward momentum. Now, however, with the province running into some policy headwinds and bumping up against capacity constraints, we are comfortable keeping our growth forecast at 2.3%. Moreover, we see more risk of a downward adjustment to this projection in our next quarterly outlook.

Several current economic indicators have already softened, providing support for the growth moderation scenario we believe is unfolding. The pace of job creation, for example, has levelled off following a few years of near-record increases. The province's economy has been expanding above its estimated long-run potential speed limit since 2014, and employers have mopped up most of the pool of available workers. The ongoing pull-back in residential real estate activity suggests this sector will not boost economic growth in the way seen over the past four years. Finally, BC consumers, who have been on a spending tear lately, are also poised to scale back.

A robust economy increases profits for businesses, allowing companies to invest more in business operations and also to expand production. So, at this point in the cycle, we would expect business investment in BC to accelerate and to contribute more to economic growth. A concern today, however, is that growing policy uncertainty and the cumulative impact of recent and proposed government tax and regulatory measures may dampen capital expenditures and discourage business expansion in some of the industries that occupy an important place in the province's economy.

TABLE 1: **GLOBAL ECONOMIC FORECAST (ANNUAL % CHANGE IN REAL GDP)**

	2016	2017	2018f	2019f
World	3.2	3.7	3.8	3.7
Canada	1.4	3.0	2.2	2.1
US	1.5	2.3	2.6	2.4
Euro zone	1.8	2.5	2.5	2.3
Japan	0.9	1.7	1.3	0.9
China	6.7	6.9	6.5	6.2

f - forecast

Source: Scotiabank Economics, April 2018.

EXTERNAL BACKDROP IMPROVING

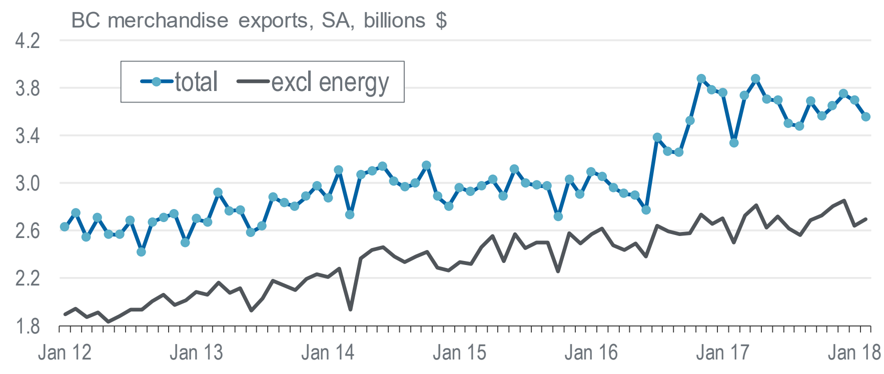
The global economy is in a sweet spot. Growth is now more or less synchronized across the advanced and emerging economies. This broadly-based expansion is helping to underpin rising levels of trade, with the volume of international trade now growing about three times faster than a few years back (1.5% in the latter part of 2015 and more than 4.5% last year). Higher levels of business investment in the US, Europe and some other markets are also supporting global growth.

In the **United States**, economic conditions continue to brighten. The labour market has been strong, adding an average of 200,000 plus new jobs each month over the last half year. Sizable fiscal stimulus, delivered through tax cuts and additional government spending, will bolster growth in the near term, even though it also aggravates America's long-term fiscal challenges. Some estimates suggest that the fiscally-related lift to US economic growth may be as much as half a percentage point this year and next.[1] Notwithstanding a sluggish start for consumer spending this year, US consumer confidence remains high. The industrial and service sectors are both growing at the fastest pace in a decade. Business investment has been climbing and will receive a further boost from sharply lower corporate income tax rates and other tax changes that permit full expensing of most types of capital investment.

Many of the **Euro-zone** economies should also post another year of above-potential growth after a solid performance in 2017. The UK is expected to gear down as Brexit-related concerns weigh on that country's growth prospects.

The **Canadian economy** is projected to slow from last year's surprisingly brisk advance. According to Scotiabank Economics, real GDP growth will slip from 3.0% in 2017 to 2.2% in 2018. In its latest Monetary Policy Report, the Bank of Canada has a similar forecast, albeit it sees a more pronounced slowing in 2018.[2] Canada stands to benefit from ongoing US growth, a healthy global economy, and rising oil prices. But business investment in Canada is being depressed by uncertainty over the future of NAFTA, escalating US-China trade tensions, the loss of Canada's previous business tax advantages vis-à-vis the United States, and changes in housing policies and mortgage lending standards.

FIGURE 1: **BC MERCHANDISE EXPORTS CLIMB TO NEW HIGH**



Source: BC Stats.

[1] "Scotiabank's Global Outlook," Scotiabank Economics, April 12, 2018, p.2.
[2] Bank of Canada, Monetary Policy Report, April 2018.

In its [April 2018 Monetary Policy Report], the Bank of Canada notes that capacity pressures are widespread: the share of industries operating with capacity utilization rates above their long-run average is at its highest level in a dozen years. Moreover, capacity pressures are expected to increase since order backlogs are rising, the national unemployment rate is hovering at a 43-year low, and labour shortages are spreading. The overall industrial rate of capacity utilization is now close to its historical peak, with some sectors at or near their post-2003 highs. With still accommodative monetary policy and financial conditions, all of this should trigger a surge in business capital spending. However, in many Canadian industries, investment remains muted as large and mid-sized companies re-assess their plans and prospects against the backdrop of a dynamic and increasingly uncertain business and public policy environment.

With the national economy operating near capacity and inflation running close to 2%, one might well have expected the Bank of Canada to hike its overnight lending rate in April. Instead, citing trade worries, high levels of household debt, waning Canadian competitiveness, and some moderation in consumption, the Bank chose to remain on hold. While the future path of monetary policy will continue to be "data-driven", we expect at least two, and possibly three, quarter-point rate increases by the end of 2018. Businesses, consumers and borrowers in Canada need to prepare for a period of rising interest rates.

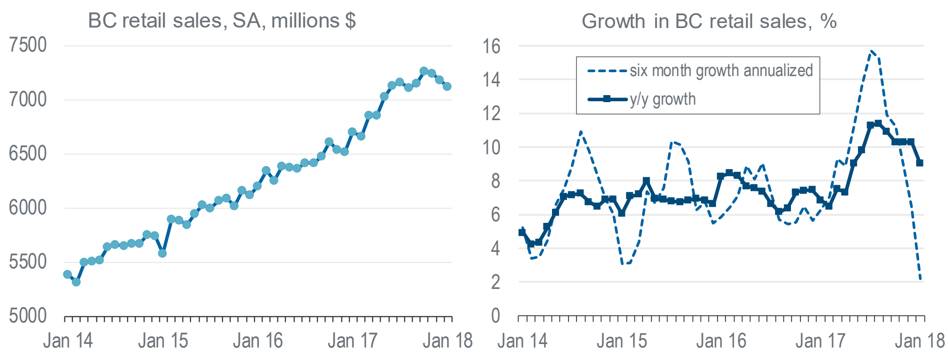
TABLE 2: **BC ECONOMIC OUTLOOK (ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)**

	2016	2017	2018f	2019f
Real GDP	3.7	3.1	2.3	2.4
Employment	3.2	3.7	1.2	1.6
Unemployment rate (%)	6.0	5.1	4.6	4.4
Housing Starts (000 units)	41.8	40.1	38.0	38.0
Retail sales	7.4	9.0	6.0	5.5
BC CPI	1.8	1.7	2.1	1.9

f - forecast

Source: Statistics Canada and BC Stats; BCBC for forecasts.

FIGURE 2: **GROWTH IN CONSUMER SPENDING SLOWS**



Source: Statistics Canada, CANSIM 080-0020. Growth rates calculated from 3-month moving averages.

BC ECONOMY: SOME DECELERATION ALREADY EVIDENT

The improving external economic picture will help sustain growth in **BC's export sector** in 2018. Most export-oriented industries enjoyed solid gains in 2017, with coal exports being especially buoyant, rising from $4.2 billion to $6.6 billion. The healthier global economy fed into rising exports to all of BC's main export markets last year. Aided by a relatively low Canadian dollar and the favourable global backdrop, the province's exports should remain elevated throughout 2018 and 2019, but growth will not match the 13% advance recorded in 2017.

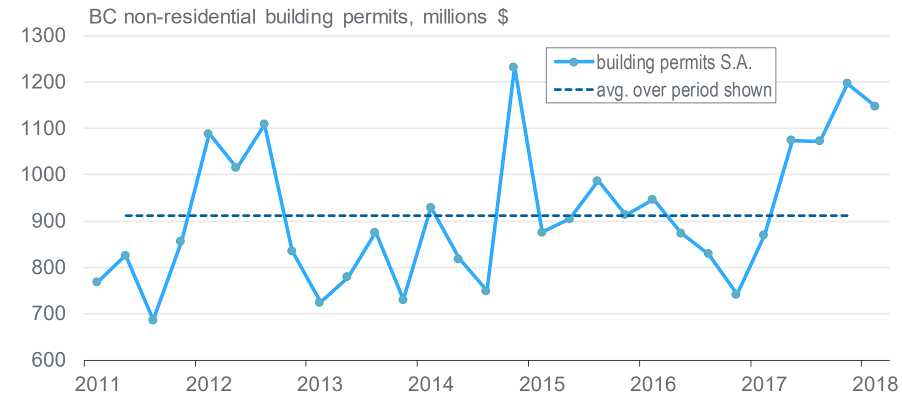
Tourism is another export sector that is a source of significant economic activity in BC.[3] However, as with other elements of the province's export economy, the biggest increases in tourism-related spending are probably behind us, at least for the near-term. In 2017, total traveler entries were up 3.6%, well

[3] The value of tourism exports is not captured in the statistics on merchandise exports discussed above.

FIGURE 3: **BC HOUSING STARTS STILL ELEVATED**

Source: Statistics Canada, CANSIM table 051-0017. SAAR = seasonally adjusted annual rates.

FIGURE 4: **BC NON-RESIDENTIAL CONSTRUCTION BOOSTING GROWTH**



Source: Statistics Canada, CANSIM 026-0021.

shy of the 11% increase in 2016. Still, the BC tourism industry had an excellent year, as more international visitors coupled with higher levels of domestic tourism lifted the average hotel occupancy rate in 2017 to a record high.

Consumers have played the dominant role in BC's economic expansion over the past few years. Growth in **retail sales** has been especially brisk, but here too there are signs that the spending spree is tapering off. Annual growth in sales in retail outlets across the province is currently running near 9%. This is a very strong gain, but it doesn't match the 11%+ annual increase recorded a few months back. Moreover, looking at the month-to-month changes points to some further softening ahead.

The **housing and real estate sector** has been a powerful growth engine for the province. We estimate that housing sales and related services, residential construction (including renovation spending), and retail spending flowing from furnishings, appliances and building materials collectively accounted for about one-third of all economic growth in BC over the past four years.

The outlook for housing is mixed. Housing demand will continue to be supported by population growth and rising incomes. However, there is uncertainty about the near-term path for the market. The BC government's suite of unprecedented housing-related tax measures, including the so-called speculation tax but also higher property transfer, school, and foreign buyers' taxes, seems to be having the (intended) effect of dampening sales and cooling the market. In the early months of this year, sales are off roughly 25% from last year. Sales activity has slowed across most regions, with the steepest declines in the Lower Mainland, Kamloops, and the Kelowna area. In the Greater Vancouver Real Estate Board region, detached home sales in March were down 37% from the same month last year. Sales of attached homes and apartments were off by 24% and 27%, respectively. In the Fraser Valley Real Estate Board region, total sales were 25% below the level in 2017, with each of the segments recording similar-sized decreases.

The slowing in sales activity is a headwind for **residential construction**. Population growth will still underpin the demand for housing units, but new taxes, tougher mortgage lending standards, and eroding affordability have curtailed demand. We expect that this will prompt builders to be more cautious and delay some development projects. In our previous quarterly outlook, we had housing starts at

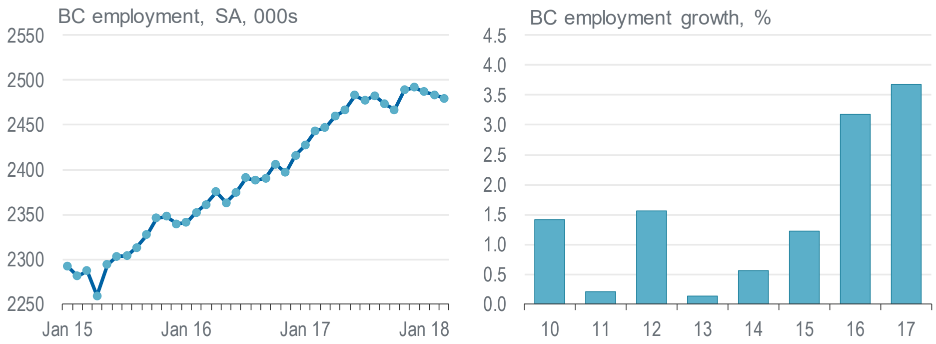
39,000 units in 2018. With more recent data, we are slightly trimming our forecast to 38,000 starts. But we realize that may be too high. Of interest, the provincial government itself anticipates a more dramatic slowing. In its February budget, the government projects that housing starts will fall by almost 27% in 2018, down to 32,000 units.[4]

At this stage of the economic cycle, the provincial economy should be shifting away from consumer-led growth towards investment and export-led growth. To some extent that is happening. Consistent with this rotation, the value of **non-residential building permits** climbed steadily through 2017, with the three main segments (industrial, commercial, government) all contributing to the rise. As a result, 2018 started off at elevated permit levels. With the value of non-residential building permits running about 25% above the average level since 2011, non-residential construction activity will help to bolster overall economic growth this year.

We are concerned, however, about developments affecting the broader investment climate.

Some of the downside risks to the BC outlook stem from external sources and include the potential for escalating global trade wars and uncertainty around the fate of NAFTA. Domestically, the housing sector also represents some near-term downside risk.

FIGURE 5: **STRONG BC JOB GROWTH IN 2016 AND 2017**



Source: Statistics Canada, Labour Force Survey. Monthly data seasonally adjusted, latest March 2018.

Capital investment in **machinery and equipment** has been slow to recover. Only in 2017 did private sector spending on machinery and equipment regain the level seen back in 2006. While Statistics Canada's survey of investment intentions points to a small gain in M&E spending this year, we believe both the local investment climate and the larger Canadian competitive landscape have soured since the survey was completed over the latter part of 2017. The United States has become a more attractive location for business investment, relative to both BC and Canada as a whole, as Canada's previous business tax advantages vis-à-vis the US have evaporated. In BC, taxes on carbon emissions are higher than in other North American jurisdictions, handicapping some of our export industries and raising energy costs across much of the economy. The regulatory, project review, and permitting burdens in BC (and Canada) continue to grow, making it increasingly difficult for companies in the natural resource, infrastructure and manufacturing sectors to justify putting incremental capital in our jurisdiction. Finally, the political and intergovernmental dispute over the Kinder Morgan expansion project is sending chills throughout the capital markets and into many corporate boardrooms, threatening to deliver a blow to our reputation as a safe and predictable place to invest.

On a positive note, in the last two years BC's strong job market has done wonders for consumer spending, housing sales, and economic growth generally. Job growth, however, has slowed markedly. Last year, the number of people working in BC rose by 3.7%, one of the strongest increases recorded over the past three decades. This annual figure, however, masks the month-to-month evolution of employment and the fact that employment levelled off during the year and has essentially moved sideways in the last several months. In March 2018, total employment was slightly below the level nine months earlier -- in June 2017. Given the pull-back in job creation, we have scaled back our BC employment growth forecasts for 2018 and 2019.

[4] BC Budget 2018, p. 102.

Why has job creation decelerated so markedly? One reason is that the pace of economic growth has moderated in recent months, as reflected in the retail sales figures, developments in the residential real estate sector, and even BC's exports to some degree. But the extent of the slowdown in job growth is hard to explain from just these factors. With the unemployment rate plumbing record lows, it appears an insufficient supply of available workers is also weighing on job growth. Indeed, the number of job vacancies jumped by 21% over the past year, giving BC the highest job vacancy rate in the country. (Currently, 4% of all positions are vacant.) Of 470,000 job vacancies across Canada, 88,000 are in BC. Stated differently, BC has 19% of all job openings in the country, but only accounts for 13% of all payroll employment in Canada.

MORE RISKS

We see some upside risk to the BC outlook, mainly related to two large projects – neither of which is included in the forecasts summarized here. If the LNG Canada project proceeds, the almost $40 billion plus investment would provide a significant boost to provincial growth. The timing is uncertain, but if the consortium makes a positive final investment decision, meaningful additional expenditures should be visible by 2019. The other upside risk is the Trans Mountain Pipeline project. As with LNG Canada, this $7.4 billion capital project is not incorporated into our current outlook, in part due to timing uncertainties.

Some of the downside risks to the BC outlook stem from external sources and include the potential for escalating global trade wars and uncertainty around the fate of NAFTA. Domestically, the housing sector also represents some near-term downside risk. The combined effects of new government-imposed housing taxes, tighter lending standards and higher interest rates could have a bigger negative impact on sales activity, prices and residential investment spending than policy makers (and most economic forecasters) expect. Finally, if the political battle over the Trans Mountain Pipeline project escalates and Alberta and Saskatchewan end up restricting shipments of oil and refined petroleum products to BC, this would have negative implications for the local economy. Fuel prices would surge, taking a bite out of consumers' pockets and raising operating and shipping costs for many BC companies. Business and consumer confidence would both take a hit. We hope the conflict over the pipeline project is successfully managed to avoid such an outcome.

CONCLUDING THOUGHTS

All in all, BC's economy looks to be in decent shape, after four years of above-potential growth. But the headwinds are increasing. Rising job vacancies and the fact that labour shortages are now constraining business growth in some sectors indicate that the province's economy is running near capacity, even with high levels of household debt and concerns over housing affordability. A brighter global economic picture continues to augur well for the province's export-oriented industries, even though we expect weaker growth in the value of BC's exports in 2018-19.

British Columbia's economic dynamic is gently pivoting away from reliance on consumer-led growth. Business investment should advance and play a bigger role in the growth story over the next two years, but increasingly we are hearing talk of companies delaying projects, re-assessing capital spending plans, or looking at different jurisdictions in which to deploy capital. Policy changes and government-created policy risks have emerged as factors weighing on the investment outlook. The tax burden for business and highly-skilled earners in BC (and Canada) has increased, at the same time as the United States has reduced taxes (especially for businesses) and taken steps to lighten and streamline regulatory burdens. In the international arena, a failure to renegotiate NAFTA would further discourage business investment in Canada and raise doubts about the ability of many of our export industries to grow. Adding to the uncertainty is the battle over the Trans Mountain Pipeline project – a conflict that is casting a shadow over BC's investment landscape.

CO-AUTHORED BY

Jock Finlayson
Executive Vice President
and Chief Policy Officer

Ken Peacock
Chief Economist
and Vice President