BC ECONOMIC REVIEW AND OUTLOOK

Business Council *of* British Columbia
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BC ECONOMY STILL HEALTHY ...BUT GROWTH WILL DOWNSHIFT IN 2017

HIGHLIGHTS

- Following three years in which BC topped the provincial growth charts, in 2017 our economy will lose a bit of momentum. Real gross domestic product (GDP) is forecast to expand at a slightly below average pace of 2.2%, with a similar performance in 2018.
- The slowdown in BC's real estate/housing complex, particularly in Metro Vancouver, is a key reason why overall economic growth is projected to slow this year and next.
- Despite an improved global economic backdrop, BC's export growth is expected to slow after a solid advance in 2016.
- The tourism, film and television industries, benefitting from the weak Canadian dollar, posted rising levels of activity over the past couple of years. Growth in these sectors is also set to moderate, in part because the recent pace of growth simply cannot be sustained.
- BC's labour market should remain quite healthy, with the unemployment rate continuing to edge lower over the forecast horizon. Job creation, however, will slow after 2016's outsized jump in employment.
- Consumer spending is forecast to remain solid, but it too will slow after two years of brisk gains.

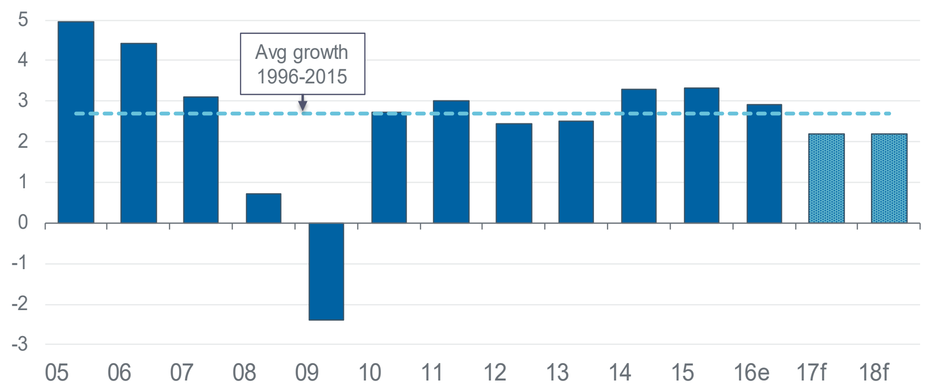
BC'S GROWTH OUTLOOK OVERVIEW

BC's real economic growth rate is poised to downshift in 2017, following three years of above average gains. Somewhat ironically, this occurs even though the global economic backdrop is improving. In part this reflects the fact that most of BC's merchandise exports are commodity based, and the cyclical upswing for many of BC's commodities took hold in 2016 – something that's not likely to be repeated this year. Also, the near-certain imposition of stiff US penalty duties on softwood lumber imports from BC will also weigh on the province's exports in 2017-18.

The biggest factor in our more restrained near-term growth outlook, however, is the slowdown in the residential real estate complex, notably in Metro Vancouver. A sharp drop in sales activity means fewer new homes will be built in the province this year. This, in turn, will ripple through the wider economy via less demand for related services (financing and legal), as well as a fall-off in spending in some segments of retail. Business investment also remains fairly sluggish in BC. And while we believe non-residential investment spending is likely to notch higher this year, the gain will not be enough to offset softer conditions in other sectors.

BC's economy remains resilient because of its diversity in both industrial structure and export markets. But slower growth, both on the export front and in most elements of domestic economic activity, mean that real GDP growth will dip to a below average rate of 2.2% over the next two years. A healthier global backdrop and improved commodity prices, however, will benefit other western Canadian provinces that have struggled in recent years. The result is a

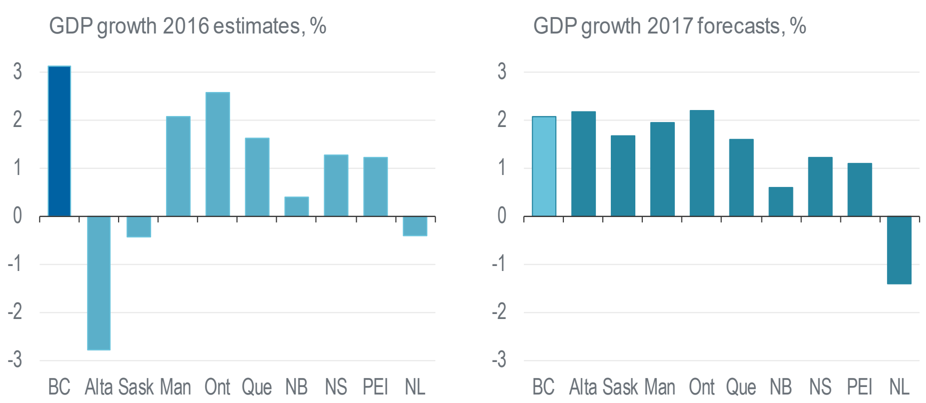
FIGURE 1: **BC REAL GDP GROWTH (%)**



e = estimate f = forecast

Source: Statistics Canada.

FIGURE 2: **REAL GDP GROWTH BY PROVINCE (%)**



Source: Averages of forecasts from BMO, CIBC, RBC, Scotiabank and TD.

convergence in provincial economic growth rates over 2017-18, such that BC goes from being clearly at the front of the class to finding itself clustered together with several other provinces (Figure 2).

A BRIGHTER GLOBAL ECONOMIC PICTURE

Following a lackluster 2016, global economic activity is slowly accelerating, pointing to a better economic backdrop for 2017 and 2018. Growth in the advanced economies is expected to edge higher in the next two years. But a bigger lift should come from the emerging markets, which have transitioned to a firmer growth path. Although baseline growth projections are more promising, most pundits see a wide range of potential outcomes stemming from the high degree of uncertainty surrounding the policy agenda (and leadership style) of the new Trump administration in the United States. In this regard, one of the biggest risks to a more upbeat global scenario in 2017-18 is the potential for escalating protectionism.

According to the IMF's recent outlook, collectively the advanced economies are expected to grow 1.9% in 2017, followed by 2.0% in 2018. These figures do not elicit high fives, but they are respectively 0.1 and 0.2 percentage points higher than the IMF was forecasting last October. The upgraded forecasts reflect unanticipated strengthening in the final months of 2016. Even smallish upward revisions provide some reason for cautious optimism.

For the US, which remains by far the most important economy for BC, growth is expected to pick up to 2.3% and then advance to 2.5% in 2018, notably stronger than 2015's anemic 1.6% pace. The US economy gained momentum in the final months of 2016 and the very early part of this year, and this is expected to carry on into 2018. Forthcoming infrastructure and defence spending boosts, combined with substantial tax cuts signalled by President Trump and backed by the Republican Congress, should provide a fillip to economic growth south of the border in the next 2-3 years. The US job market is hot, with impressive employment growth and recent moves to stronger wage increases. This is helping to pave the way for steady increases in consumer spending and ongoing improvements in the housing market. Economic growth projections for 2017 have also been revised upward for Germany, Japan, Spain, and the United Kingdom.

Also contributing to a better global outlook is a sturdier performance in many emerging market economies. Collectively, emerging and developing economies are expected to expand by 4.5% this year, with a further advance to 4.8% penciled in for 2018. If realized, these outcomes will be significantly better than last year's 4.1% expansion.

Brighter global growth prospects are contributing to better, but still mixed, pricing conditions for BC's major commodity exports. The price of lumber advanced in 2016 and ended the year at over US$320 per thousand board feet. Pulp prices also edged higher in 2016. Natural gas markets saw even more significant change. After falling to historic lows in the second quarter of 2016, prices snapped back. More recently, however, natural gas prices have retreated, casting a shadow over the outlook for the sector in 2017. Coal prices, too, moved smartly higher in 2016, but have since reversed course.

The Canadian economy began the year on a firmer footing, prompting forecasters to upgrade their growth projections to the 2.0-2.2% range for this year and slightly higher in 2018. Following two years of decidedly subpar performance, higher oil prices and healthy consumer spending helped the Canadian economy perk up in the third quarter of 2016. The momentum continued in the fourth quarter, and recent data continue to be promising, with strength in employment, housing starts and even business sentiment.

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

	2015	2016	2017f	2018f
World	3.2	3.1	3.4	3.6
US	2.6	1.6	2.3	2.5
Euro area*	2.0	1.7	1.6	1.6
Japan	1.2	0.9	0.8	0.5
China	6.9	6.7	6.5	6.0
Emerging market economies (all)	4.1	4.1	4.5	4.8

* 19 EU member states collectively f - forecast

Source: IMF, January 2017.

As long as the Bank of Canada believes there is excess capacity in the economy, it will not raise its short-term policy rate. For this reason, we believe the overall interest rate environment will remain broadly supportive of growth over the forecast horizon. Almost all observers expect the Bank of Canada to keep its trend setting lending rate at 0.5% through 2017, and possibly into mid-2018. With the central bank on hold, bond yields and in turn mortgage rates should remain relatively low. That said, rising US market interest rates can be expected to spill over into Canada to some extent in the next few quarters, pointing to some upward pressure on borrowing costs.

South of the border, the US Federal Reserve raised its lending rate at its March 15th meeting. Inflation stateside has moved to a five-year high, fanning expectations that the Fed will continue to notch its rate higher. The divergent Canada-US stances of monetary policy will put downward pressure on the Canadian dollar in the coming months. The price of oil, however, is also a critical factor in the Loonie's future trajectory. Oil prices did move higher in 2016, but recently they slipped below US$50 again. In today's rapidly changing energy world, stronger global oil prices quickly lead American shale oil producers to ramp up production, putting downward pressure on prices. This dynamic is expected to keep a lid on oil prices over the next 18 months. We have therefore built our forecasts for BC and Canada around a Canadian dollar that trades in the 73 to 76 US cents range this year.

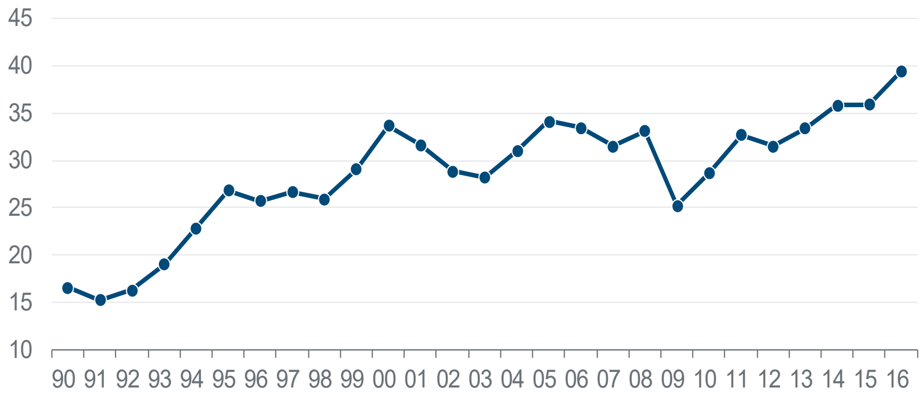
BC EXPORT SECTOR HELPS UNDERPIN GROWTH

The strengthening of the US and the global economy is reflected in BC's export performance. Following a few years when the value of merchandise exports was essentially flat, a surge in export shipments over the final two quarters of last year produced a strong showing for BC's exports in 2016. In fact, last year was a milestone for the province's exports. For the past 15 years, the total value of merchandise exports never rose above $35 billion. But in 2016, BC's merchandise exports climbed to almost $40 billion, solidly into record territory.

Having reached a new high, however, the outlook for BC's exports in 2017 is mixed. The improvement in some global commodity markets is good news, but most of the cyclical gains in key commodity markets have already been realized, pointing to at best very modest increases this year. And, as noted above, in a few areas such as natural gas and coal, prices have recently weakened.

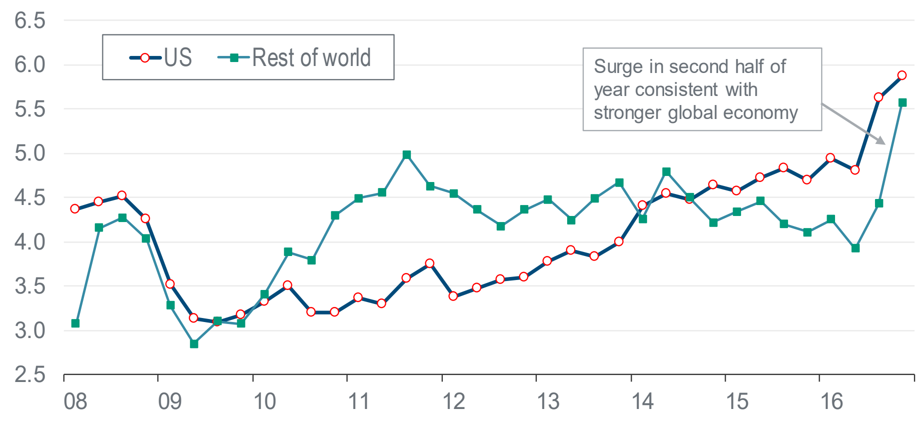
The sagging Canadian dollar has bolstered BC's export sector. Merchandise exports to the US advanced by an impressive 13% in 2016, extending an upward trend that has been in place for several years. The feeble Loonie has boosted tourism, film and television production, manufacturing, and many segments of the province's high technology sector. A competitive exchange rate has also supported BC's exports of tradable business services such as engineering, finance, and architectural and environmental services. All of BC's leading export industries will continue to benefit from a relatively weak loonie. But

FIGURE 3: **BC MERCHANDISE EXPORTS (BILLIONS $)**



Source: BC Stats.

FIGURE 4: **BC MERCHANDISE EXPORTS, QUARTERLY SEASONALLY ADJUSTED (BILLIONS $)**



Source: BC Stats.

the sizable gains in export sales seen over the past couple of years will not be matched again this year.

Although US housing starts continue to grind higher and lumber prices are at a healthy level, the outlook for BC wood product exports is clouded by the return of the Canada-US lumber trade dispute. Most observers believe the US will introduce punitive duties on all Canadian softwood products in the next few weeks. Under the Trump overtly protectionist administration, the fear is that these duties could be as high as 35% or even 40%. At the same time, the industry in BC is struggling with a reduced supply of available timber because of the vast tracks of forests killed by the pine beetle. With lumber alone accounting for 17% of all BC's merchandise exports in 2016, these negative developments in the

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lumber business will be a drag on BC's growth prospects over the next 12 months.

From the vantage point of the first quarter of 2017, there is scope for more upside in BC's merchandise exports shipped to China and other Asian economies. In the final months of last year, exports to Asia rebounded (reflecting both price and volume effects). The result was that, after two years of decreases, the value of BC's exports to China was up by 2.5%. Even exports to Japan rose slightly. We expect further small-scale increases in exports to Asia-Pacific markets in 2017-18.[1] One caveat to a more upbeat outlook in this area, however, is weaker coal prices.[2]

In sum, BC's export sector will contribute to economic growth this year, but not to the same extent as in 2016.

DOMESTIC ECONOMIC ACTIVITY MODERATES

The domestic side of the BC economy is poised to downshift this year. One key reason is the softening of the residential housing sector that is already unfolding in the Metro Vancouver area. Consumer spending is also set to lose a step, after a number of years of strong gains in retail spending and food service sales.

The slowdown in the housing sector is at the top of the list of factors leading to our more subdued economic outlook. In the wake of notably frothy conditions including a record setting pace of sales in early 2016, market conditions started to cool by late spring. The application of the government's 15% foreign buyer's tax in Metro Vancouver further dampened sales. The result was a marked drop in sales transactions. In Metro Vancouver, sales of single family homes have tumbled 60% compared to 2016, while sales of attached and apartment units are down by 30%. These are big declines, but it should be noted that sales activity in early 2016 was at an especially elevated level so some fall-off was to be expected. Sales in 2017 will continue to edge lower, reflecting tighter mortgage insurance rules, the foreign buyers' tax in Metro Vancouver, reduced speculation, and shifting sentiment about the outlook for residential real estate in the next few years.

In the face of fewer home sales, housing starts are also forecast to drop off in 2017. In 2016 BC recorded almost 42,000 starts, up sharply from about 31,500 in 2015 and the highest number since 1993. The construction of new homes is expected to decline to 35-36,000 units both this year and next. Home construction (new starts plus renovation) was a substantial economic driver for the province over the past 2-3 years. Factoring in the lift from residential construction, real estate and related legal and financial services and the knock-on boost to parts of the retail sector, we estimate that around 35% of economic growth

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

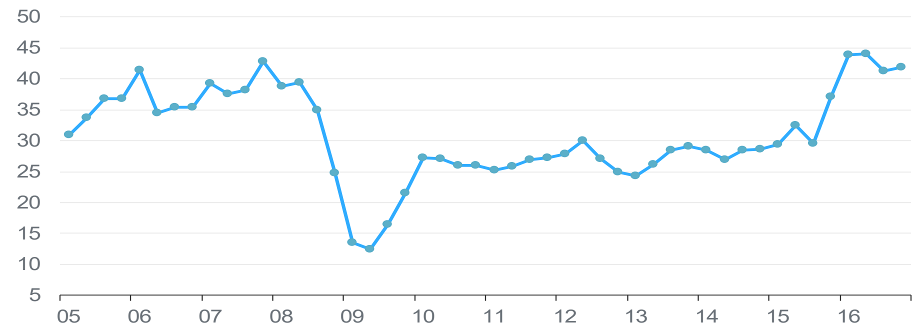
	2015	2016	2017f	2018f
Real GDP	3.3	2.9e	2.2	2.2
Employment	1.2	3.2	1.4	1.3
Unemployment rate (%)	6.2	6.0	5.8	5.7
Housing Starts (000 units)	31.4	41.8	36.5	35.0
Retail sales	6.4	6.0	4.5	4.5
BC CPI	1.1	1.8	2.0	1.8

f - forecast e - estimate

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

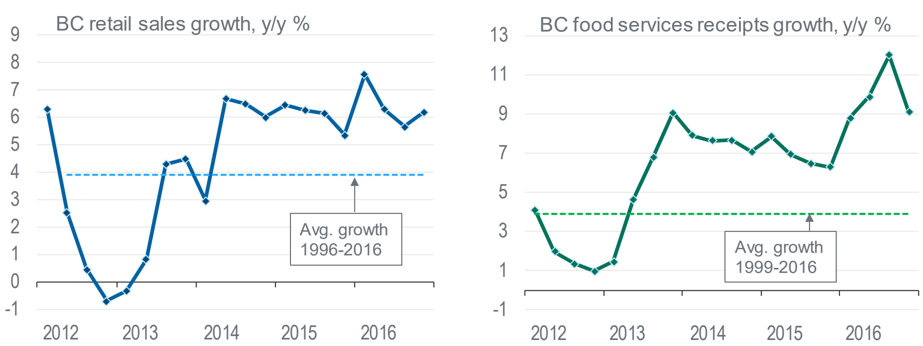
[1] Exports to South Korea climbed by 19% last year.
[2] Given the large role that coal plays in the overall BC export mix.

FIGURE 5: **BC HOUSING STARTS, QUARTERLY SAAR**



Source: Statistics Canada. Seasonally adjusted annual rates.

FIGURE 6: **CONSUMER SPENDING STRONG**



Source: Statistics Canada. Seasonally adjusted annual rates.

in BC in 2015 through the first half of 2016 was attributable to residential real estate activity. The moderate decline in sales and construction spending that we forecast for 2017-18 means residential real estate will not be contributing much if anything to overall GDP growth in BC in the next few quarters.

GROWTH IN CONSUMPTION STILL HEALTHY, BUT DOWNSHIFTS

Consumer spending has also been a key factor behind BC's healthy economic expansion, with retail sales rising by a robust 6.4% in 2016, following similar sized growth in the prior two years. The gains were spread across all sectors of retail, with sales of new and used automobiles being an important element of the overall increase in retail outlays. The largest annual increase was in the building supply stores sector, reflecting the high level of home building activity (underscoring why the slowdown in the residential real estate sector will have widespread growth dampening effects). Sales in the food and beverage service industry have also been brisk, with notable increases in tourism, additional business travel and positive consumer sentiment all contributing. Here too, our view is that growth in this segment of retail will moderate over the next two years.

EMPLOYMENT BOOM NOT SUSTAINED

The job market is still another area where we see slower growth ahead, in large part because labour market conditions are tightening and it will be difficult to repeat 2016's stellar pace of job creation. In fact, last year BC saw the strongest job growth since 1994, with total employment up by 73,000. Almost half of the new jobs were part-time, which detracted somewhat from the overall "quality" of the aggregate employment gain.

The impact of the province's booming real estate and related construction markets was evident in the labour market data, with 10,000 of these new jobs in the construction sector.

Employment in the motion picture sector rose by nearly 8,000, a staggering 54% rise from 2015 (which itself was up 36% from the previous year). Professional services employment expanded by 7,400 (nearly a 4% increase). A 6% increase in employment was recorded in the financial and real estate services sector (amounting to another 7,400 positions). The retail sector recorded the biggest absolute increase in employment, adding another 12,200 jobs last year. The impact of stronger commodity prices was felt in the labour market as employment in mining and related support activities grew by 4% and 5.5%, respectively, 2016. In short, many sectors contributed to BC's unusually robust job market in 2016.

As we have noted in previous publications, however, the job gains recorded in 2016 were unevenly distributed across the province, being heavily concentrated in the lower mainland, and to a lesser extent southern Vancouver Island. In all other regions of the province, employment levels fell last year, with the largest decreases in the Northeast and Kootenay areas.

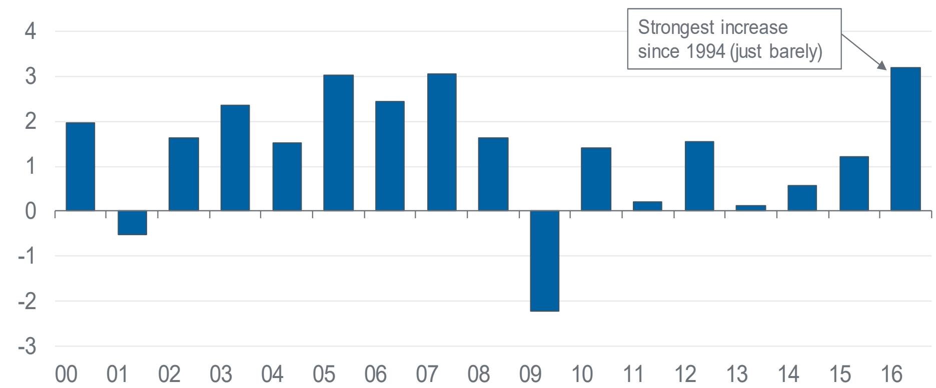
Turning to 2017, we expect employment growth to decelerate to less than half of last year's pace, as the lift from residential real estate and consumer spending fades and the forest sector suffers job losses linked to fibre supply constraints and trade issues with the United States.

LOOKING FOR MORE OUT OF NON-RESIDENTIAL CONSTRUCTION AND INVESTMENT

In contrast to residential investment (which as described has been a major source of economic growth), business investment has been relatively soft in BC. On the construction side, spending on structures slipped in both 2015 and 2016. According to Statistics Canada's latest survey of investment intentions, construction investment is slated to rise in 2017, but it will remain below peak levels seen a few years ago. One reason for sluggish overall business investment is a significant drop in capital spending in the mining and manufacturing sectors, according to Statistics Canada's projections.

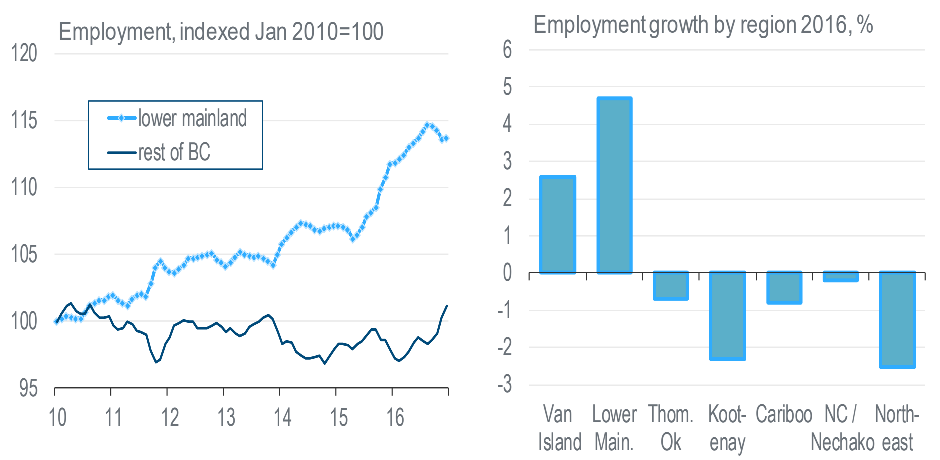
Investment in machinery and equipment picked up in 2016, but this came after a long period of subdued levels of M&E investment.

FIGURE 7: **BC EMPLOYMENT GROWTH (%)**



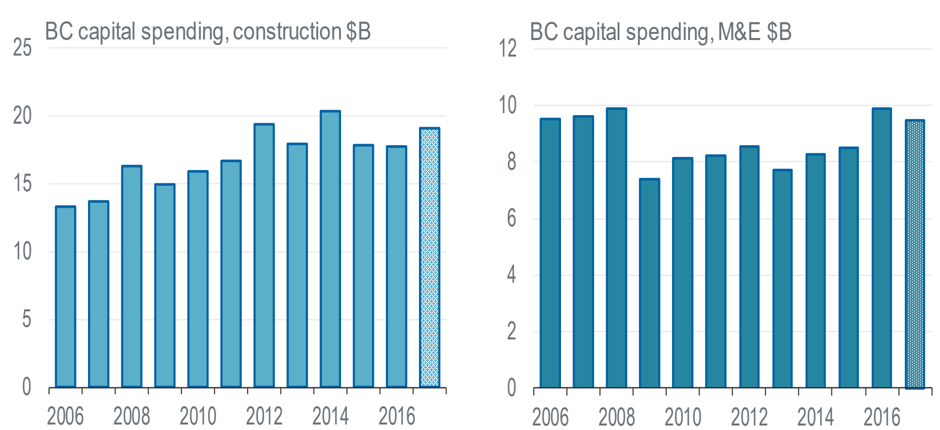
Source: Statistics Canada, Labour Force Survey.

FIGURE 8: **JOB GROWTH CONCENTRATED IN THE LOWER MAINLAND**



Source: Statistics Canada, Labour Force Survey.

FIGURE 9: **CAPITAL INVESTMENT IN CONSTRUCTION TO PICK UP IN 2017**



Source: Statistics Canada.

According to the Statistics Canada survey, investment in M&E should also increase moderately this year. In aggregate, business non-residential investment should make a small positive contribution to economic growth in the province in 2017. However, we see a risk that actual business investment in 2017 could come in below what Statistics Canada is projecting, due to Canadian companies' and investors' concerns over access to the US market and rising protectionism generally.

CONCLUDING THOUGHTS

Softer conditions across many sectors of the BC economy suggests that the province will shift from an above average pace of expansion to a slightly below average pace over the next couple of years. BC will also become more closely aligned with the growth trajectories expected in the other Western provinces. The benefits of economic growth, many of which flowed from a hot (and arguably overheated) urban residential real estate sector, have been heavily concentrated in the Metro Vancouver region. Even though growth is poised to moderate, an improved global backdrop should feed into a more balanced economic dynamic within the province. With the unemployment rate falling below 6% and two years of impressive job increases in Metro Vancouver, we expect hiring challenges and skill shortages to intensify in many industry sectors over the coming 18 months, even as the larger BC macro-economy loses a step.

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