BC ECONOMIC REVIEW AND OUTLOOK

Business Council of British Columbia
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BC ECONOMY STILL STRONG...BUT DOWNSHIFTS IN 2018

HIGHLIGHTS

- The outlook for economic growth in BC this year has again been revised upwards. Real GDP is now forecast to expand by more than 3% for the fourth consecutive year.
- By 2018, however, growth is expected to downshift to a more sustainable pace near 2.3% as consumer spending comes off the boil and export growth moderates.
- BC's job market has been on fire for the past two years. So far 2017 has seen another hefty increase in the number of people working. Total employment in BC is poised to grow by a very healthy 3.5% this year, although in recent months labour demand appears to have slowed.
- BC's export sector is benefitting from a sunnier global economic backdrop. International merchandise exports continue to make headway, in part due to stronger commodity prices. Coal and natural gas have seen the largest export gains.
- Robust consumer spending has made a big contribution to BC's impressive economic growth performance. Job growth, rising incomes, still low interest rates, a booming tourism sector, and high-levels of spending on housing-related goods and services have all contributed to strong gains in retail sales and in overall consumer outlays.
- Slightly higher interest rates and a tightening of mortgage lending requirements for banks will dampen housing activity in BC in 2018-19. We do not anticipate a major market correction, however, notwithstanding eye-watering housing prices in urban areas of the province.
- While we expect BC's growth trajectory to moderate in 2018-19, the momentum the BC economy has enjoyed over the past three years means there is some upside risk to the forecast. The key near-term downside risk is the future of NAFTA and rising American protectionism.

BUOYANT CONDITIONS PERSIST

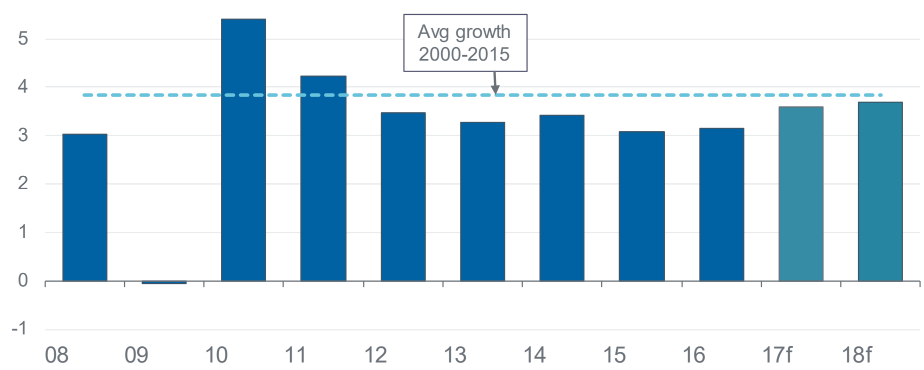
The British Columbia economy remains on a healthy growth track, supported by rising exports, substantial increases in consumer spending, and high levels of activity in the housing sector. A sunnier global economic backdrop has lifted the province's exports, while hefty employment gains have helped to underpin robust consumer spending. Most indicators point to continued strength, prompting us to revise our growth forecast for 2017 upwards for the second time this year. Looking to 2018, the province's economy is expected to downshift after four consecutive years of above average growth.

The Business Council forecasts that BC's economy will expand by 3.1% (after inflation) this year — an upgrade from the 2.7% figure we projected in July. Next year, growth should ease to a more sustainable 2.3% pace, as consumer spending comes off the boil and export growth moderates. Higher interest rates and the introduction of more stringent federal mortgage lending regulations will dampen housing-related activity, which has been a leading driver of economic growth in the province.

GLOBAL ECONOMY ACCELERATES

The global economy has strengthened. In its most recent World Economic Outlook report, the International Monetary Fund (IMF)

FIGURE 1: **GLOBAL GDP GROWTH (%)**



e = estimate f = forecast

Source: IMF World Economic Outlook, October 2017.

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

	2015	2016	2017f	2018f
World	3.4	3.2	3.6	3.7
US	2.9	1.5	2.2	2.3
Euro area*	2.0	1.8	2.1	1.9
Japan	1.1	1.0	1.5	0.7
China	6.9	6.7	6.8	6.5
Emerging market economies (all)	4.3	4.3	4.6	4.9

* 19 EU member states collectively f - forecast

Source: IMF, October 2017.

projects that global output will rise by 3.6% this year, measurably better than last year's 3.2% pace. With both emerging and advanced economies picking up speed, the IMF foresees world growth inching higher to 3.7% in 2018.

The US economy is in good shape overall. The number of jobs has been rising for more than 80 consecutive months and the unemployment rate is now below 5%. Equity markets are in record territory, and data point to high levels of consumer and business confidence amid still supportive financial conditions. The IMF expects the US economy will grow by 2.2% in 2017 and 2.3% in 2018. Some private sector forecasters anticipate faster growth, in part due to potential significant tax reductions. The third quarter estimate shows the US economy growing at 3.1% (annualized), essentially matching the second quarter's pace.

Commodity prices have generally trended higher over the last 12-18 months, in line with healthier global demand for energy, industrial raw materials and foodstuffs. Higher oil prices have been a key factor behind Canada's recent economic rebound (see below). For BC, higher lumber, coal and natural gas prices are all positive developments.

For Canada's business community and our major export-oriented industries, the prospect of the US withdrawing from NAFTA is a serious concern. At this stage, talks on re-tooling NAFTA are continuing, and the negotiating deadline has been extended to the end of the first quarter of 2018. However, the signals and tone coming out of the Trump Administration do not inspire confidence in a successful outcome. Indeed, there is mounting speculation that the US could announce its intention to end participation in the trade pact. In that event, it is unclear what would happen next – but the risk of NAFTA unravelling is likely to dampen business confidence and investment in Canada in the coming months.

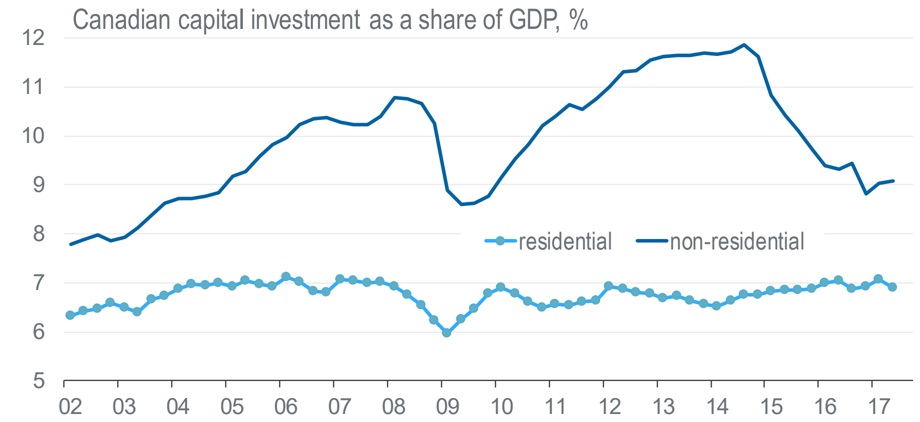
CANADA GETS A TEMPORARY ECONOMIC BOOST

The Canadian economy enjoyed a growth spurt over the first half of the year, with the first quarter registering an impressive 3.7% (annualized) expansion followed by even stronger 4.5% growth in Q2. Much of this rests on the consumer. Consumer spending in BC and most other provinces has been buoyed by the sturdiest labour market in years, a revamped and expanded Canada Child Benefit program, low interest rates, and the wealth effects from escalating home prices. However, economic conditions are poised to soften in 2018-19 as interest rates climb, the benefits of earlier currency depreciation wane, and business confidence is hit by NAFTA-related uncertainty. We see real GDP increasing by 2.1% in 2018, down from 3.1% in 2017.

Canada continues to face challenges on the business investment front – at least outside of the frothy real estate sector. As shown in the accompanying figure, non-residential capital spending declined by the equivalent of 3% of GDP between 2014 and 2016. While the energy sector saw the worst of the slump, the weakness in capital spending has not been limited to the oil and gas industry – many other traded goods industries (including advanced technology) have also been affected. This suggests that Canada's overall competitiveness has eroded across significant parts of the economy – notably energy, other natural resource sectors, and manufacturing. Dwindling private sector capital spending on machinery, plant, equipment, intellectual property products, and infrastructure assets indicates that policy-makers at all levels of government need to be paying more attention to the factors that influence where companies choose to invest and grow. Our concern is that Canada is losing ground in the global race to attract investment and high value business activity.

With the output gap (the difference between how fast the economy is growing and how quickly it can grow without overheating) closing faster than expected, the Bank of Canada decided to increase its overnight lending rate in both July and September. Governor Poloz recently indicated that the Bank will proceed cautiously with further rate hikes, noting that elevated household debt levels "amplify" the impact of the tightening that's already been introduced, while the stronger Canadian dollar "complicates" the inflation outlook. Private sector views on future rate hikes are mixed, but given the lack of evidence that inflation pressures are building we believe the central Bank will remain on hold through the end of the year and the first quarter of 2018.

FIGURE 2: **BUSINESS INVESTMENT WEAK**



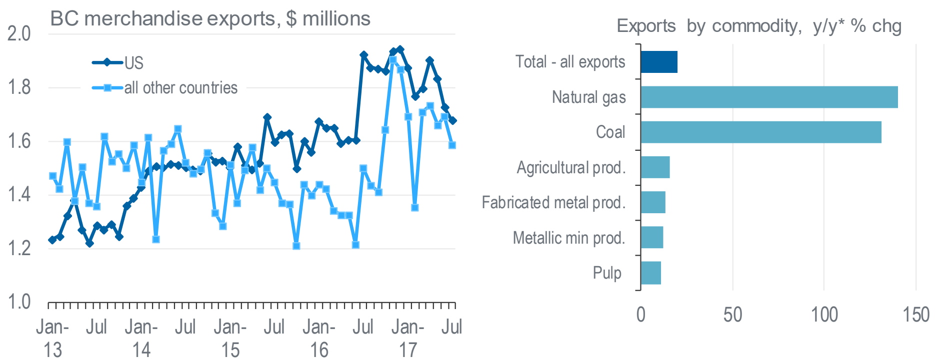
Source: Statistics Canada, CANSIM 380-0064. Seasonally adjusted annual rates.

BC EXPORTS POST SOLID GAINS

A brighter global economic picture has paved the way for a rebound in BC's international merchandise exports. A lower Canadian dollar since the 2014-16 oil price collapse has also contributed to better times for the export sector. The dollar has strengthened in 2017, but firmer commodity prices, particularly for coal and natural gas, and decent US economic growth have combined to offset some of the growth-inhibiting impact of a firmer Loonie. Year-to-date, BC's merchandise exports are up more than 15% over last year, with shipments to the US up 9%. A substantial portion of the gain is attributable to higher prices for coal, metals, lumber and natural gas.

Output in the BC lumber sector was hurt by the extreme forest fire season this past summer. The value of lumber and other wood product exports to the United States is down slightly so far in 2017. However, demand for lumber stateside remains brisk, which has pushed prices higher. The destruction and property loss from multiple US hurricanes points to a stronger pricing environment as the rebuilding process unfolds. Punitive US duties imposed on lumber imports from Canada have been a drag on the BC forest industry, of course. But we expect favourable pricing conditions to benefit Canadian lumber producers in the year ahead. The picture is more mixed for other BC export sectors that are mainly focused on markets south of the border.

FIGURE 3: **ENERGY HELPING BOOST BC EXPORTS**



Source: BC Stats. *January to September compared to same period previous year.

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

	2015	2016	2017f	2018f
Real GDP	3.3	3.7	3.1	2.3
Employment	1.2	3.1	3.5	2.2
Unemployment rate (%)	6.3	6.0	5.4	5.3
Housing Starts (000 units)	31.4	41.8	39.0	38.0
Retail sales	6.0	7.4	8.0	6.0
BC CPI	1.1	1.8	1.7	1.9

f - forecast

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

Meanwhile, BC's exports to China (up 14% so far this year) and other Asian markets (exports to South Korea are up 46%) have also made headway in 2017. The pick-up in exports to Asia is welcome after a number of years of muted gains in sales to offshore markets. Merchandise exports should continue to advance in 2018, but at a more subdued pace, due to some levelling off in commodity prices and the adjustment to a higher Canadian dollar since the spring.

The upswing in BC's service exports has been even stronger than that for goods. Tourism, a key export sector, is now one of the province's fastest growing industries. BC has seen a big jump in the number of American visitors as well as in travellers from Asia and Europe. We expect this trend to continue through 2018-19. Exports of services produced by BC's advanced technology industries have also been on the rise, supporting the continued growth of the technology sector — which now accounts for 8% of the province's GDP.

BC's busy film and television industry is basking in the best of times. A competitive exchange rate, a top-ranked pool of local talent, and the arrival of new productions have all added to levels of activity in the sector. Last year, the number of people working in film/t.v. production soared by 55%, the biggest increase of any industry in BC. And the outlook remains positive.

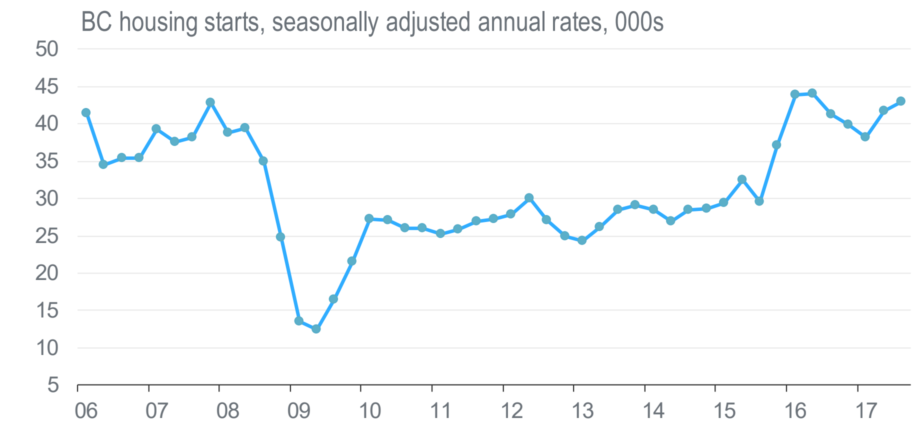
DOMESTIC ECONOMY CONTINUES TO ADVANCE

Housing sales, new home construction, and renovation activity have all been major economic engines in British Columbia. The residential "real estate complex" (which we define to include home building, home renovation, the offices of real estate agents and brokers, plus owner occupied imputed rent) grew by 7% last year, more than twice the 3.1% pace of the rest of the economy. This marks the fifth consecutive year the residential real estate complex has outrun economy-wide growth by similar magnitudes.

In addition to the spinoff benefits from employment and income growth in the sector, the "wealth effect" from surging property prices is also feeding into BC's sustained economic expansion. Although this dimension is difficult to quantify, rising home values and substantial increases in household net worth have bolstered consumer sentiment and encouraged greater spending by many homeowners. The wealth effect is also supporting high levels of renovation spending.

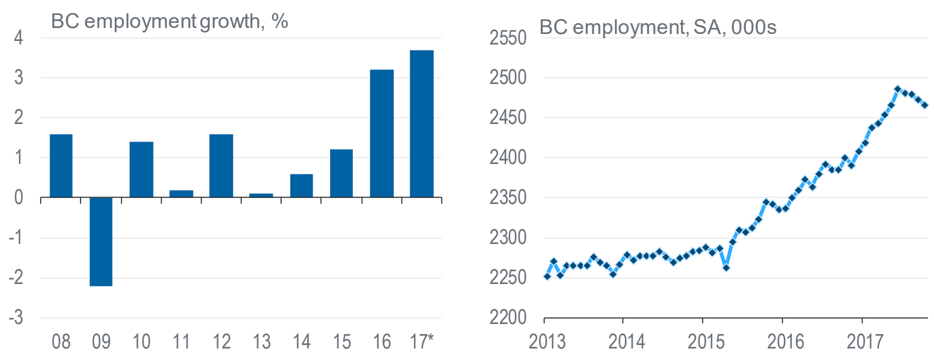
Recent home construction figures are off slightly from last year, but starts are still at elevated levels. Looking ahead, some moderation in

FIGURE 4: **BC HOUSING STARTS REMAIN ELEVATED**



Source: Statistics Canada.

FIGURE 5: **STRONG JOB GROWTH IN BC, BUT SOME WEAKENING RECENTLY**



Source: Statistics Canada. SA= seasonally adjusted. *Jan-Oct

the growth of the housing and real estate sector is expected. Population and job gains will continue to support housing demand. However, rising interest rates coupled with more stringent federal lending requirements (including requiring uninsured borrowers to pass "stress tests" to ensure they can afford monthly payments under higher interest rate scenarios) will erode affordability and cool housing sales, with the biggest impact likely to be felt by prospective first-time buyers. We also see a possibility of new measures by the BC government to discourage speculation in the housing market and tamp down further on non-resident demand. While we believe housing will continue to add to economic growth in BC, housing-related activity is likely to become a less predominant factor in the province's overall growth story.

JOB CREATION SURGES

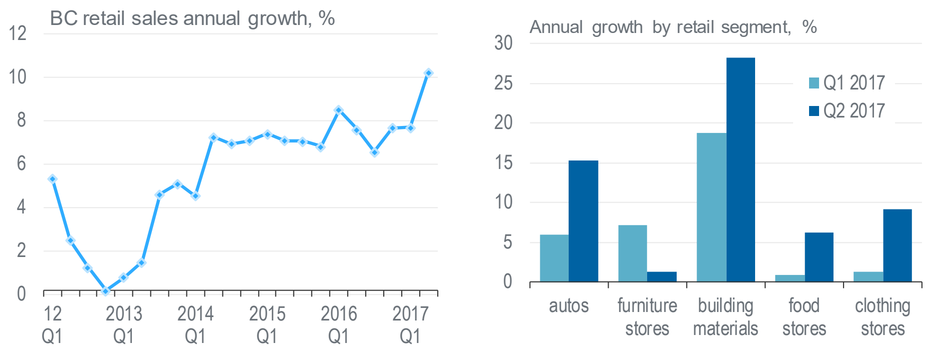
The labour market has been another area of strength in BC. Following a couple of years of well above average employment growth, the number of people working continued to climb in 2017 – up 3.6% year-to-date. Moreover, job growth is now more balanced and spread across most regions of the province. A string of impressive job gains pushed BC's unemployment rate below 5% by Q3. Labour markets across much of the province have tightened, with more employers facing hiring challenges.

While the rate of job creation has been impressive, the month-to-month pattern has shifted recently. In fact, BC has seen employment levels edge lower for four consecutive months. While the declines are very small, they may herald a moderation in the growth of labour demand. If so, this would not be surprising after the outsized job gains of the past two years. We expect employment will continue to rise in 2018, but not as strongly as in 2016-17.

CONSUMERS ON A SPENDING SPREE

Fueled by sustained job growth, continued in-migration, an expanding tourism industry, and the wealth effect from higher housing values, retail sales in BC have been on a tear. In the second quarter of 2017, total retail sales were running 10% above the prior year level. The impact of the housing sector is evident in the remarkable 28% increase in sales by building materials and garden supply stores. In the second quarter of 2017 auto sales also jumped by 15%. Looking ahead, retail spending is poised to downshift to a 5-6% growth rate in 2018 – still healthy by long-term standards.

FIGURE 6: **RETAIL SPENDING GROWTH REMAINS ELEVATED**



Source: Statistics Canada.

BUSINESS INVESTMENT AND CAPITAL SPENDING

Business investment is one area of the provincial economy that has been soft in the last half-decade or so. But even here, the past year has seen some revival. The value of non-residential building permits is up 13% year-to-date (through September). Much of the increase is attributable to a large jump in industrial permits. The value of commercial permits is up by 3%. Fiscal policy is supporting activity in the construction sector, with government and institutional permits running 25% above last year's level thanks to rising BC and federal government capital spending.

Some engineering projects not captured in the permits data are also contributing to growth. The most notable is the multi-billion-dollar Site C project. The future of this project is uncertain, however, as the government is reviewing whether to continue with it. The Site C project is large enough that if it is cancelled, we would trim our growth forecast for 2018-19. For this updated forecast, we are assuming that no large-scale LNG projects commence in 2017-18. The government's decision to cancel the Massey bridge project will reduce capital spending and construction jobs in the lower mainland. That said, the September 2017 Budget Update foresees total BC government capital spending rising by nearly $1 billion over the next three years.

CONCLUDING THOUGHTS

The economic lights in BC have been shining brightly for more than three years. We expect the positive momentum to carry forward into 2018. An improving global economy will keep BC's export sector in an expansion mode, albeit at a slower pace.

The domestic side of the economy is in good shape, supported by steady in-migration, robust job creation (notwithstanding the recent pull-back), high levels of consumer spending, and a resilient housing market. Most of the anticipated slowdown will be concentrated in the residential real estate complex and consumer spending, as moderately higher interest rates, tighter lending rules and increasing household debt all weigh on levels of activity.

For both Canada and BC, the most worrisome near-term downside risk is NAFTA. Failure to secure a favourable trade deal with the US that maintains Canada's access to the vital American market would have negative implications across the Canadian industrial economy, leading to job losses and diminished business investment. If NAFTA disappears entirely, the damage will be greater, with the impact extending beyond the current forecast horizon. Uncertainty about NAFTA's fate will weigh on business investment and confidence in Canada in the coming months. The other key downside risk to the BC outlook concerns the fate of large-scale capital projects, notably Site C.

However, there is also some upside risk to our forecast. The BC economy has outperformed expectations in the past two years. The elevated pace of domestic spending could persist for longer than most forecasters now anticipate. In addition, the province's economy is benefitting from greater industrial diversification as sectors like tourism, IT, the digital economy, clean tech, film/t.v. production, international education, and advanced manufacturing all continue to make welcome contributions to the growth of overall business revenues, employment and exports.

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