



## BC Poised for Decent Growth in A Turbulent World

### Highlights

- The outlook for the world economy has been downgraded due to weakness in Asia and an uneven and generally stagnant performance across the Eurozone.
- Lower oil prices will work to BC's economic advantage, as households reap significant savings at the gas pump. BC produces little crude oil, with imports providing most of the refined petroleum consumed here, so lower prices are an economic plus.
- The US economy, fortunately, is shifting to a stronger growth trajectory and looks positioned for the biggest gains in GDP and employment in more than a decade.
- Despite a subdued global economic backdrop and a number of downside risks, BC's exports of goods and services should keep rising, thanks to a rebounding US and a sagging Loonie.
- The BC job market is finally gaining momentum.
- Consumers in BC will do their part to support the economy, spending a bit more freely than they did in the first half of the decade. Housing starts are expected to remain stable.
- British Columbia's real GDP should increase by 2.6% in 2015, up slightly from 2014.
- The turmoil in global energy markets likely means further delays for LNG, although an expanded labour supply linked to faltering growth in Alberta may be positive for these proposed BC projects by easing cost pressures. If one or more large LNG projects commence in 2016, BC's real GDP growth should accelerate to about 3%. Over 2015-16, BC is expected to be near the top of the economic growth rankings among the provinces.

The global growth outlook has dimmed in recent months, with the world economy now projected to grow by 3.5% (after-inflation) in 2015, according to the latest forecast from the International Monetary Fund.<sup>1</sup> Last summer the outlook was brighter, but slower growth in China and other emerging markets, sluggish economic conditions across Europe and production and capital spending cuts in some oil producing countries are weighing on international growth prospects. Fiscal restraint is also dampening activity in a number of advanced economies, including Canada.

Collapsing crude oil prices have markets fearful that the decline is not simply a result of additional supply, but also reflects softer world-wide demand. Stock markets have been wobbly and government bond yields in many countries are plumbing all-time lows, a sign of investors' concern over the underlying health of the global economy. Greater volatility in financial markets may hinder any move to a stronger and more stable global economic footing.

There are some offsetting trends, however, that should keep the world economy expanding at a

<sup>1</sup> IMF, "Global Growth Revised Down, Despite Cheaper Oil, Fast US Growth," *IMF Survey*, January 20, 2015. Available at: [www.imf.org](http://www.imf.org)

modest clip. Plummeting oil prices have left consumers with more cash, which will boost spending in other sectors and spur economic growth in net energy-importing jurisdictions – a group that includes the US, China, Japan, India, and the EU. Lower oil prices mean reduced business costs and lower inflation, which is likely to prompt many central banks to further delay the planned “normalization” of current, record-low interest rates. The Bank of Canada’s January 21 announcement of a 25 basis point cut to its overnight lending rate is an example.<sup>2</sup>

Oil prices should edge higher over time, but for now downside risks persist. Moderate growth in global demand has been overwhelmed by a sizable jump in US (and Canadian) crude supply, as well as additional supply from several other producing nations. Saudi Arabia’s determination to maintain its output levels and market share is further underpinning the story of ample global crude oil supplies.

Looking at the overall macro-economic picture, the key message is that a broadly-based, synchronized global upturn remains elusive. Geopolitical tensions, the slowdown in emerging markets, and underperforming economies across much of the OECD continue to stand in the way of a healthy global upcycle.

Within the international mix, the US economy is a bright spot. American real GDP is forecast to advance by 3.6% in 2015<sup>3</sup>, the strongest growth in a decade. Low oil prices will reinforce the move to a firmer growth trajectory, with US consumers expected to reap annual energy-related cost savings of at least \$1,000 per household.<sup>4</sup> The Bank of Canada estimates that a drop in oil prices from \$110 to \$60 per barrel, if maintained, would raise the level of real GDP in the United States by

1% by the end of next year.<sup>5</sup> America’s job market has improved markedly, with non-farm payroll employment rising for 58 consecutive months and the economy adding almost 3 million net new jobs last year.

Table 1 World Economic Forecast (per cent change in real GDP)				
	2013	2014	2015f	2016f
US	2.2	2.4	3.6	3.3
Canada	2.0	2.4	2.3	2.1
Euro zone	-0.5	0.8	1.2	1.4
UK	1.7	2.6	2.7	2.4
Japan	1.6	0.1	0.6	0.8
China	7.8	7.4	6.8	6.3
World	3.3	3.3	3.5	3.7

Source: IMF World Economic Outlook Update (January 20, 2015) f = forecast

Both the Eurozone and Japan are likely to remain chronic underperformers, as much needed economic, labour market and social policy reforms and – in some EU countries -- increased fiscal stimulus are slow to materialize. Last week’s Greek election underscores the political uncertainties that characterize the Eurozone – a region that represents almost one-fifth of the world economy. The tail risk of an unravelling of the Eurozone would be a significant negative shock for the world economy, but the impact of such an event may be limited by the progress made since 2011 in strengthening the Eurozone banking union and financial system and the steps taken by the European Central Bank to bolster economic activity.<sup>6</sup>

Economic growth in China continues to ebb, with real GDP expanding by 7.4% in 2014. Chinese policymakers have implemented interest rate

<sup>2</sup> Bank of Canada, Monetary Policy Report, January 2015.

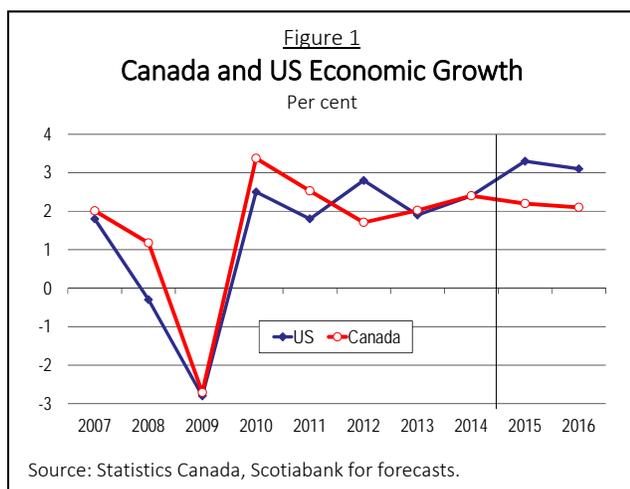
<sup>3</sup> By the IMF.

<sup>4</sup> The amount saved varies across US regions depending on the energy mix – including the sources of electricity and whether households rely on oil for home heating, as many in the northeast of the country do.

<sup>5</sup> Monetary Policy Report, January 2015, p. 6.

<sup>6</sup> Nicolas Vernou, “The Reshaping of Europe’s Financial System,” Peterson Institute for International Economics, January 2015.

cuts and hiked spending to forestall a sharper deceleration. Economic growth this year may slip below 7%, with a further drop possible in 2016. The slowing Chinese economy is a principal factor behind lower global commodity prices – a reflection of China’s vast appetite for natural resource products and industrial raw materials.



### **Canada’s Economy Loses a Step**

In contrast to the US, forecasts for the Canadian economy have been pared back. A diversified economy should help to keep Canada on a positive growth path, despite plunging oil prices and a financially overstretched household sector.

As noted by the Bank of Canada, lower oil prices will take a bite out of real GDP growth – in the range of half of one percent in 2015 – based on diminishing energy sector revenues, reduced investment in the oil patch, and a deterioration in Canada’s terms of trade.<sup>7</sup> But the most visible impact will be a redistribution of economic growth across Canada. Alberta and Newfoundland are sure to be hardest hit, followed by Saskatchewan. With oil royalties shrivelling and capital investment in the energy sector being slashed, the Alberta government is looking at an operating deficit of more than \$7

<sup>7</sup> Monetary Policy Report, pp. 9-10. A country’s terms of trade measure the value of it exports relative to the value of what it imports.

billion in 2015-16. Dwindling activity in the oil patch will spill into other parts of the province’s economy and lead to slower job growth and reduced investment in other sectors.

On the other hand, net oil importing provinces such as BC and Ontario will cheer cheaper energy.<sup>8</sup> Manufacturing will get a lift from reduced energy costs; the manufacturing sector will also benefit from a stronger US economy and the improvement in Canadian cost competitiveness stemming from the sinking Loonie. So for Canada as a whole, some of the negative impact from lower oil prices will be offset by slightly stronger growth in non-oil producing provinces. However, as emphasized by the Bank of Canada, the net result is still weaker economic growth for the country. Nominal GDP, business investment and government revenues – at both the federal level and in oil-producing provinces – will be dampened by sagging oil markets. Domestic demand will continue to get some support from rock-bottom borrowing costs and an anticipated uptick in investment in non-energy sectors.

The next two years should see a widening economic performance gap between Canada and the United States. A healthier American economy means the Federal Reserve will be in a position to start increasing its overnight policy rate in the second half of 2015. The Bank of Canada has adopted a more cautious stance, signalling that interest rate hikes here are unlikely until 2016 or later. Canada’s central bank is unwilling to embark on monetary tightening until the economy shows some positive momentum; at present, the national economy is losing steam. As falling energy prices filter through to the wider economy and depress key measures of inflation, the Bank of Canada will have even more reason to postpone any increases in its policy interest rate. Taken together, the above factors spell

<sup>8</sup> Conference Board of Canada, Regional Shakeup: The Impact of Lower Oil Prices on Canada’s Economy, January 20, 2015.

further weakness for the Canadian dollar, which we predict will drift below 80 cents US in the next few months. Last year the Loonie lost almost 10% of its value against the American greenback.

**BC Benefits from Tumbling Oil Prices**

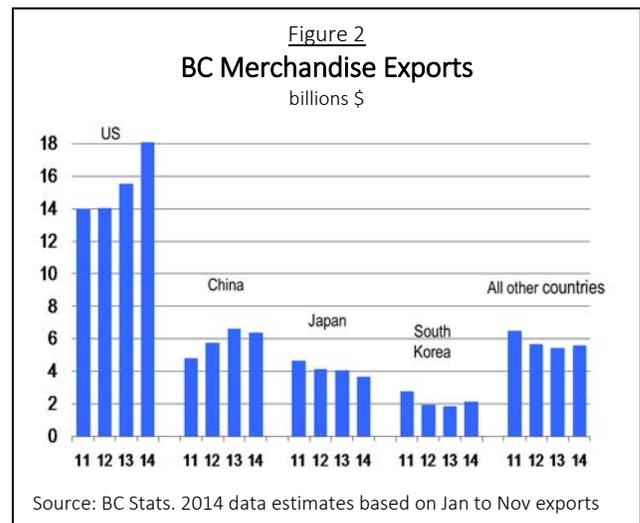
The downtrend in oil prices is a plus for British Columbia’s economy, adding perhaps two tenths of a percentage point to real GDP growth this year and next.<sup>9</sup> As with the national economy, the greatest and most direct benefit comes from the savings that accrue to consumers. With the sizable drop in gas prices that has occurred, the average BC household will save more than \$500 annually (assuming fuel prices remain at a similar level for the year). On an economy-wide basis, this translates into more than \$1 billion in consumer savings, most of which will be spent on other goods and services.<sup>10</sup> BC exporters will also applaud a lower Canadian dollar and the additional boost to US economic growth that should come from less costly energy.

British Columbia produces only small amounts of crude oil, so will see few direct negative consequences from the commodity’s epic price slide. Still, some spillover impacts will be felt. We estimate that 30,000-35,000 resident British Columbians “commute” to Alberta for work.<sup>11</sup> Such BC households could be at risk as a number of these Alberta jobs disappear. There are companies in BC which sell products and services into the oil patch and thus will be hurt by the announced and upcoming reductions in energy-related capital investment in Alberta. Overall, however, the gains for BC consumers, and the lift to the province’s export sector from a lower Canadian dollar, will outweigh the negative effects of the downturn in Alberta and slower

economic growth in other oil producing provinces.

**Export Picture Mixed**

As Figure 2 shows, the US economic revival is already being reflected in BC’s trade statistics. The province’s southbound exports have risen steeply in the past two years: in 2014, merchandise exports to the US jumped by nearly 17% in dollar terms. At the same time, the economic softening in other countries has offset some of the gains from the recovery of the US. The value of BC goods sold to China and Japan decreased by 3% and 7%, respectively, last year. Exports to South Korea registered a 23% increase, but that country accounts for a relatively small share (less than 6%) of BC’s international merchandise exports (versus a share of almost 50% for the US). Exports to all remaining foreign countries collectively were essentially flat last year (up by just 1%). The net result is that BC’s merchandise exports grew by almost 8% in 2014, mainly on the back of the improving American economy.



<sup>9</sup> Ibid.

<sup>10</sup> A portion of the energy cost saving accruing to BC residents will be used to reduce debt or augment household savings.

<sup>11</sup> This does not include the much larger number of working-age British Columbians who have moved to

Alberta in the past decade and are now classified as full-time Alberta residents. Some of these individuals could return to BC if Alberta’s job market sours for a protracted period.

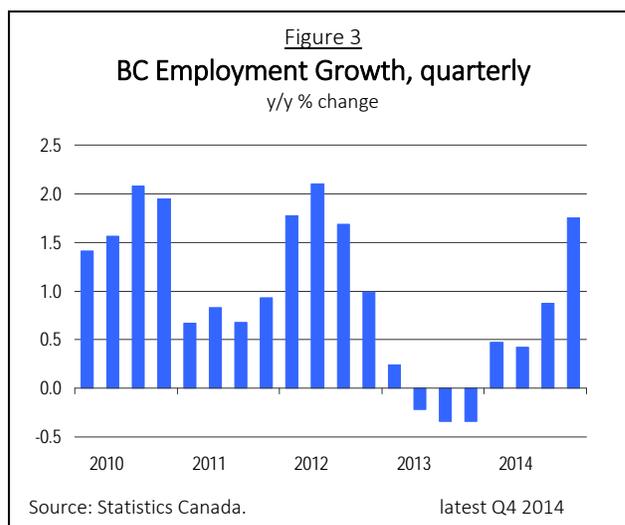
Looking ahead, BC will be relying heavily on the US to further boost exports over the next two years. Notwithstanding some recent cooling in US home building, shipments of wood products increased by more than 10% in 2014. We anticipate positive growth for most of the province's merchandise export categories over 2015-16. The primary exception is natural gas, where exports may decline further because of low prices and the continued expansion of US production. Unfortunately, slower economic growth in Asia and sluggish global markets for coal and metals/minerals will continue to offset some of the US-related gains, keeping BC's overall export growth below 10% in 2015.

Tourism is another vital BC export sector that is poised for better days.<sup>12</sup> We project solid gains for the tourism sector in 2015-16, with the US being the major impetus behind the upswing. As Americans' confidence grows and their appetite for spending rises, the weaker Canadian dollar and lower fuel costs will make travel to Canada an increasingly attractive prospect. The number of American visitors to BC was up by 2-3% in 2014; we predict further growth over 2015-16. And despite softer economic conditions in Asia, the number of travellers from that part of the world actually increased by more than 10% last year. In part, this speaks to the dramatic expansion of "middle class" populations in emerging Asia.

### **Domestic Economy on the Mend**

The province's domestic economy is also showing some positive signs, albeit the picture remains mixed. Of particular importance is a pick-up in job creation. As we predicted, job growth strengthened in the second half of 2014. Supported by a reviving export sector, we expect this trend to extend into 2015-16. However, a cautionary note is warranted – total employment in BC inched ahead by just 0.9% in 2014, after a

very disappointing performance in 2013. In other words, employment has not exactly come roaring back. The underlying health of the province's labour market will require close scrutiny as 2015 unfolds.

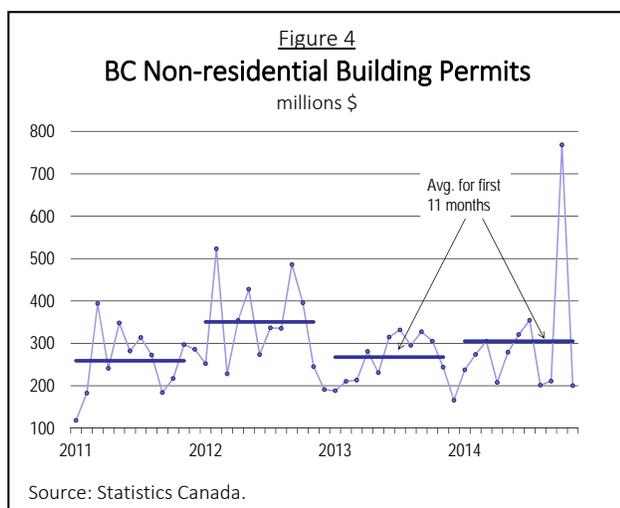


Consumer spending rebounded in BC in 2014. Better job numbers were a factor, but pent-up demand for certain retail categories likely played a bigger role, as suggested by surging auto sales. The slightly better economic environment that we expect in 2015 should help to sustain respectable growth in retail spending. Lower gasoline prices will have a dampening effect on the nominal value of aggregate retail sales, but as noted above much of the savings at the pump will be re-spent. The falling Canadian dollar will work to re-direct some portion of consumer spending back into the domestic marketplace as the ranks of BC cross-border shoppers dwindle.

### ***Outlook for Capital Spending and Housing***

As we observed in our 2014 mid-year economic forecast, a healthier medium-term economic scenario for British Columbia requires a steady advance in large development projects, along with an increase in private sector non-residential

<sup>12</sup> Export related revenues derived from spending by international visitors to BC are not captured in the merchandise trade statistics.



investment more generally. In this regard, recent non-residential building permit data give little indication of a strong upturn in capital investment, instead pointing to a sideways pattern (Figure 4). A review of major capital projects finds a record inventory of projects on the books, but only a small fraction of these will proceed over 2015-16.<sup>13</sup> Investment in the mining sector will be held back by unfavourable commodity and capital market conditions. In the energy transportation segment, proposed oil pipelines face stiff opposition along with complex regulatory and other challenges. BC forest companies are investing in their US operations and seem to be paying less attention to their BC facilities. Our assessment is that last year's Supreme Court of Canada decision in the William case will contribute to further delays affecting greenfield economic development projects in land-based sectors of the economy. Manufacturing-investment is weak in BC. On the other hand, commercial construction has been strong, and the province is benefitting from healthy levels of project-related investment spending in the electricity and port sectors and in some parts of the public sector.

<sup>13</sup> Jock Finlayson and Ken Peacock, "BC's Tourism Industry: Poised for Growth," Policy Perspectives, Business Council of BC, August 2014.

Although we still expect 2-3 LNG facilities to be developed in BC, the timing of these projects is likely to be pushed back in light of the turmoil in world energy markets. Many energy companies are grappling with declining cash flows and are taking steps to slash costs and prune capital outlays. It is difficult to imagine that this global context will have no effect on the decision-making of companies considering LNG in British Columbia. A scaling-back of investment in Alberta's oil industry may translate into a larger pool of skilled labour available for the construction and other industries elsewhere in western Canada, which may improve the business case for LNG in British Columbia by creating a less overheated labour market for skilled trades workers. At this juncture, our BC economic forecast assumes that preliminary work for a small number of LNG projects continues over 2015, with construction timelines pushed back. Our 2016 forecast assumes that one large and one smaller LNG project reach positive investment decisions and begin construction during that year.

Turning to the "urban economy," a significant amount of project activity is underway. In the lower mainland, work is proceeding on several new office towers as well as retail and infrastructure projects, including the Evergreen Line and large retail complexes near Tsawwassen First Nation land and adjacent to Vancouver International Airport. The economic climate for commercial development in BC remains favourable.

The province's housing market looks set to shift to more of a holding pattern. We do not expect residential investment to drive much additional economic growth in 2015-16. Under the weight of high prices and eroding affordability, sales activity may ease slightly, prompting builders to take a more cautious approach to developing new product. Housing prices in Metro Vancouver

have reached the point where many first-time buyers have been priced out of the market – even with rock bottom mortgage rates. If Canadian interest rates eventually rise, the lower mainland’s affordability problem will get worse – unless prices adjust. But at this stage we don’t anticipate much change in BC housing market conditions over 2015-16.

Slightly faster population growth should assist in creating an environment supportive of economic growth, with benefits for the retail and housing sectors. British Columbia will continue to see international immigration running at 35,000-40,000 per year, but this will be supplemented by modest net inflows of interprovincial migrants linked to the downturn of the Alberta economy.

#### **Diverse Economy Contributes to Stable Growth**

Overall, we project that real GDP in BC will increase by 2.6% in 2015. If oil prices stay low throughout the year, there may be an upside risk to this baseline forecast. British Columbia looks well positioned to emerge as one of the Canadian growth leaders in 2015-16, as oil producing provinces are knocked out of the top spots in the growth rankings.

Most of BC’s export-oriented industries can look forward to future growth, including tourism, high technology, and a range of business, scientific/technical, and professional services. The forest sector will gain from the expansion of US home building as well as a weaker Canadian dollar. The transportation and logistics sector will continue to be a source of economic growth for BC.

Domestic activity will help round out a respectable macroeconomic performance. Retail spending should see decent gains over 2015-16, while the hospitality industry will benefit from consumer savings at the gas pump (and from rising numbers

of tourists). The tourism and film industries, among others, will welcome the lower Canadian dollar.

For 2016, we see real GDP climbing by around 3.0% if, as anticipated, some work on LNG projects and related pipeline construction begins during the year. Absent this activity, we would trim our forecast for 2016.

<u>Table 2</u> <b>BC Economic Outlook</b> (annual % change unless otherwise indicated)			
	<b>2014</b>	<b>2015f</b>	<b>2016f</b>
Real GDP	2.3e	2.6	3.1
Employment	0.9	1.2	1.6
Unemp. rate (%)	6.1	6.0	5.9
Housing starts – (000 units)	28.0	27.0	27.0
Retail sales	5.5	5.0	4.0
BC CPI	1.2	0.8	1.5
f – forecast e – estimate Sources: Statistics Canada and BC Stats; BCBC for forecasts.			

Current fiscal restraint policies at the federal level and in BC suggest that governments will be adding very little to GDP growth over 2015-16. The BC government’s current plan to reduce real per capita public sector capital outlays at a time of historically low borrowing costs requires a re-thinking, in our view.

In summary, our assessment is that BC will enjoy slightly faster economic growth this year than in 2014, underpinned by the rebounding US, a weaker dollar, low oil prices and continued low interest rates. By 2016, the province should get a further economic lift with the commencement of a few major investment projects, notably LNG-related, which will add to what may by then be an increasingly broadly-based economic expansion.

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