BC ECONOMIC REVIEW AND OUTLOOK

Business Council of British Columbia
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BC'S EXPANSION SET TO CONTINUE THROUGH 2019

HIGHLIGHTS

- The global economic backdrop has strengthened, with higher commodity prices providing a boost to BC's export sector.
- Following a strong showing in 2017, growth in the Canadian economy is expected to ease. Still the national economy remains on a solid footing.
- With a rate hike early in the year, the Bank of Canada has resumed its tightening cycle. Additional rate increases are expected.
- The BC economy is poised to downshift in 2018, following another above potential expansion in 2017. Real GDP growth is forecast to rise 2.3% this year, following a 3.1% expansion in 2017.
- Modest interest rate increases and a tightening of mortgage lending standards will act as headwinds for residential real estate activity. Real estate has been a substantial growth driver for the province in recent years so the anticipated downshift will spill over to retail sales and other segments linked to real estate sales and construction.
- BC's job market remains healthy, although there is some early indication that the pace of job growth is moderating. Some slowing is inevitable as the unusually strong gains earlier in 2017 were not sustainable.
- With both the export sector and domestic activity still expanding, BC's economy is in good shape. While there are risks to the outlook, there is nothing on the horizon to derail BC's expansion.

BALANCED EXPANSION

Amid an improving external backdrop, BC's economic expansion remains on a healthy course with little on the horizon to suggest this will change over the next couple of years. Both the export sector and domestic economic activity are contributing to growth. The province's export base has become more diversified, which is translating into more resilient and more balanced growth. Having said that, we do expect the economy to cool. Growth has been running above capacity and the housing market, which has provided a powerful boost for several years, is set to encounter policy headwinds in 2018. There is already some indication that the robust economic growth recorded in 2017 will not be repeated in the year to come. Some external risks are also evident, notably the prospect of NAFTA being cancelled and various geopolitical tensions. But for BC, we judge the upside risks to be roughly equivalent. Barring a sharp correction in housing markets, an extended upswing in commodity prices and stronger-than expected US growth could translate into another year of above average expansion for British Columbia.

GLOBAL BACKDROP STRENGTHENS

The global economy continues to gather momentum. In both the second and third quarters of 2017 growth accelerated to an above-trend pace of 4% (annualized). This strength carried through the final quarter of 2017, putting growth for the full year on track to reach 3.7%.[1] With a solid handoff for this

[1] Scotiabank Economics, "Global Outlook," January 12, 2018.

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

	2016	2017	2018f	2019f
World	3.2	3.7	3.8	3.6
Canada	1.4	2.9	2.3	1.7
US	1.5	2.3	2.5	1.8
Euro zone	1.8	2.4	2.7	2.5
Japan	0.9	1.8	1.4	0.9
China	6.7	6.8	6.5	6.2

f - forecast

Source: Scotiabank Economics, January 2018.

year and growth becoming more synchronized, the outlook is for global economic activity to increase further in 2018, with growth hitting 3.8% before edging down to 3.6% in 2019. Some of the additional strength has materialized in the advanced economies, with notable improvements in the Euro zone and some other G7 countries. The Chinese economy is also contributing to a more synchronized and self-sustaining global expansion. In many countries, economic activity continues to benefit from highly accommodative monetary policy, and more recently, supportive fiscal policies.

With global growth at a cyclical peak, there is finally some indication that wage and inflation pressures are building. The patterns across countries, however, are divergent. In Canada and the United States, early signs of wages and inflation edging higher point to the further withdrawal of monetary stimulus in the year ahead. But in Europe and Japan, inflation remains stubbornly low.

Building on a strong finish to 2017, US economic momentum is expected to carry forward into 2018. Consumers have shouldered much of the heavy lifting in the US, but a broadening in industrial activity and stepped-up business investment should lead to a more balanced economic profile over the forecast horizon. The recently-approved package of tax cuts and tax reforms will give a lift to business investment and consumer optimism. However, the tax package is expected to boost growth only slightly in the short-term because America's economy is already operating at or close to capacity: labour markets are tight with the unemployment rate well below 5%, and household consumption is strong. Further, the US personal income tax reductions are tilted towards higher income earners, who are less likely to spend their new tax savings.

For BC, the fact that the American housing market is showing signs of renewed vigour is positive, notwithstanding the negative impact of penalty US tariffs on lumber imports from Canada. Home sales have accelerated, after showing signs of stalling in the first half of 2017. And builders are responding. By the end of 2017 both single family starts and total housing starts were running 13% higher than at the end of 2016. The number of US housing starts is forecast to climb to 1.28 million units in 2018[2], with a further increase in 2019 as starts approach 1.4 million — the number estimated to meet underlying demographic demand.

After a strong first half, Canada's economy downshifted somewhat in the second half of 2017. Still, most forecasters peg Canada's growth at around 3.0% for the year, a significant gain following two lacklustre years in 2015 and 2016. As 2018 unfolds, Canadian growth should gradually decelerate, as tighter mortgage qualification standards and higher interest rates weigh on real estate markets. As shown in the accompanying table, real GDP growth is projected ease to 2.3% in 2018 and then fall closer to potential, which is estimated at between 1.5% and 1.7%.

Following three straight years of above potential economic growth, which has essentially closed the output gap, inflationary pressures are expected to materialize over the next two years. After nearly a decade of near record low interest rates, the Bank of Canada is now in tightening mode, as seen with the latest hike in its policy rate on January 17/18. We expect two additional interest rate hikes this year, followed by 2-3 more in 2019. The era of rock bottom borrowing costs in Canada is ending. However, Bank of Canada policy-makers have signalled that they intend to move cautiously, in

[2] TD Economics, "Quarterly Economic Forecast," December 2017.

part because of concerns related to high levels of household debt and uncertainty about the fate of NAFTA. A booming job market is fueling confidence and consumer spending across the country. The strongest pace of employment growth in a decade and a half has pushed Canada's unemployment rate to 5.7%, the lowest level in more than four decades.

In recent years, a weaker Canadian dollar helped to support exports and provided a cushion when global oil markets collapsed. However, lately the Canadian dollar has risen in relation to the US greenback. While this diminishes some of the competitive advantage conferred by a cheap currency, we expect the Canadian dollar to trade at a level — 77 to 80 cents — that keeps BC's exports broadly competitive in the North American marketplace. However, if the Americans decide to withdraw from NAFTA, the loonie could take a hit.

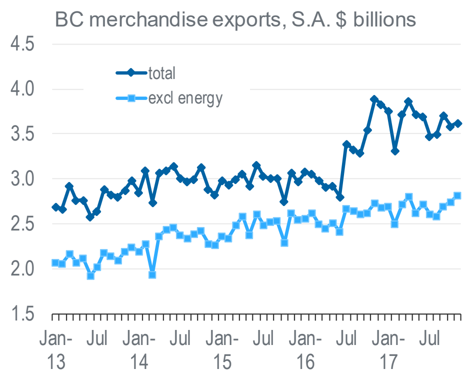
TABLE 2: **BC ECONOMIC OUTLOOK (ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)**

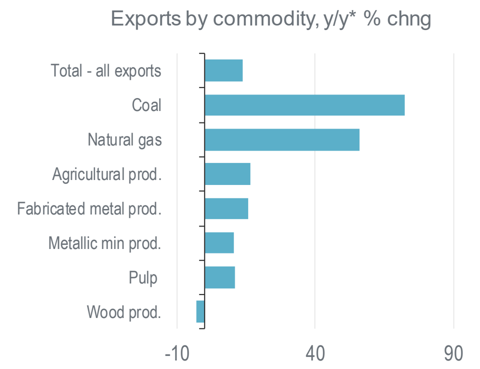
	2016	2017	2018f	2019f
Real GDP	3.7	3.1	2.3	2.4
Employment	3.2	3.7	2.2	2.0
Unemployment rate (%)	6.0	5.1	5.0	4.9
Housing Starts (000 units)	41.8	40.1	39.0	38.0
Retail sales	7.4	9.0	6.5	5.5
BC CPI	1.8	1.7	1.9	1.9

f - forecast

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

FIGURE 1: **BROAD GAINS LIFT EXPORTS TO NEW HIGHS**





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

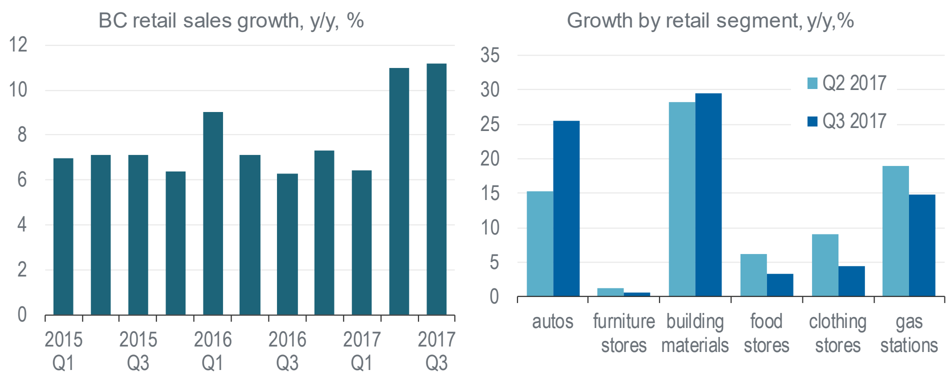
BC EXPORTS ON THE RISE

A healthier international economic backdrop, which includes generally higher commodity prices, has benefitted BC's exports. The value of the province's international merchandise exports is on track to surpass $43.5 billion for 2017, well into record territory. Sizable gains in the energy segment (mostly natural gas and metallurgical coal used in steel making) helped to push exports higher, but even if energy is excluded from the total, the value of BC's exports still reached new highs in 2017.

The uncertain future for NAFTA clouds the outlook for Canada's export industries. More immediately, the anti-dumping and countervailing duties that the US has imposed on BC's lumber shipments are taking a toll on the local industry. Fortunately, North American lumber prices are buoyant amid robust demand stateside. The destruction of property from multiple US hurricanes is contributing to a stronger pricing environment for lumber and other construction materials as rebuilding gets under way.

The impact of a US withdrawal from NAFTA is uncertain. Opting out requires six months notice, so at a minimum the deal is set to remain intact for most of this calendar year. After that, legal opinions are mixed as to whether the 1987 Canada-US Free Trade Agreement would spring back to life in the event that NAFTA unravels. If not, then trade between Canada and the US would be governed by World Trade Organization (WTO) rules, meaning

FIGURE 2: **RETAIL SPENDING GROWTH REMAINS ELEVATED**



Source: Statistics Canada.

low tariffs (generally in the range of 2% to 4%) on most goods traded between the two countries. A key concern for Canada is the potential loss of NAFTA's dispute settlement mechanism. We also believe that under a no-NAFTA scenario, business investment will further tilt away from Canada toward the United States across broad swathes of the manufacturing and technology sectors, as well as in the energy industry.

BC's international service exports continue to increase at a healthy clip, with growth outpacing that for goods exports over the 2014-2017 period.[3] Tourism is booming, with the upswing expected to persist for the next two years. Conditions in the film and television industry are also very positive, with the industry expanding at an unprecedented rate in the last few years. The number of people working in the film and t.v. sector jumped by 20% in 2017, an impressive gain considering that employment surged by 50% the previous year. Exports of services produced by BC's advanced technology industries have also been climbing, fueling the continued growth of the technology sector which currently accounts for 8% of the province's GDP and some 100,000 direct jobs.

BC CONSUMERS DOING MORE THAN THEIR SHARE

Upbeat consumer sentiment and rising levels of household spending are bolstering economic activity in most regions of the province. Housing and housing-related consumption are notable economic drivers, but most dimensions of retail and other segments of consumer spending are also doing well. Total retail spending in BC is up nearly 10% in 2017.[4] As discussed in previous BCBC publications, the positive impact of residential housing is evident in the retail sales data. Sales at building material stores were up nearly 30% in the second and third quarters of 2017. And sales at automobile retailers posted an annualized gain of more than 25% in Q3. Here, the steady inflow of foreign money and wealthy immigrants are factors, but so is the broader wealth effect from soaring real estate values as more BC homeowners tap into their home equity to help finance renovations and other large purchases. A strong 7.4% increase in food service and drinking places across the province also reflects upbeat consumer sentiment. The 2017 gain in sales in BC's drinking and dining establishments was the strongest among all provinces. We expect the pace of retail spending to soften somewhat in 2018, as interest rates edge higher and job growth eases, but the wealth effect is likely to remain evident in some parts of the consumer marketplace.

CONSTRUCTION ALSO A GROWTH ENGINE

The construction industry has also been a vital economic engine for British Columbia. On the residential side, strong employment growth, inflows of migrants, and still low borrowing costs are propelling the demand for housing. In the final quarter of 2017, housing starts surged to a record 52,500 units (annualized). The late-in-the-year lift was enough to keep starts for the year near record levels.

Given the favourable conditions underpinning housing demand, starts are projected to remain at elevated levels in 2018. However, we expect tighter mortgage lending requirements and higher

[3] BCBC estimate.
[4] Compared to the January-October 2016 period.

interest rates to slightly dampen demand. Capacity constraints will also begin to crimp the potential to further ramp up homebuilding, as the number of homes currently under construction is running at new highs. The unemployment rate in the construction sector averaged just 4.6%, the lowest of any province and the lowest rate for the industry since 2007/08 when there were widespread reports of labour shortages.

In the lower mainland, escalating affordability challenges — for both new homebuyers and renters — are prompting people to move further away from the core and shifting demand towards apartments and condos. Prices are also rising in other BC cities such as Victoria, Nanaimo, Abbotsford and Kelowna, as a growing number of residents from Metro Vancouver relocate to areas where housing is more affordable.

Looking to non-residential construction, there are signs that investment is picking up. Commercial building permits advanced 11% in 2017 and are running at their highest level since 2008. Permits for industrial projects are up nearly 50% and are at their highest level since 2012. Also worth noting is that 2017 saw more than a 50% increase in the number of people working in the non-residential construction business. Government and institutional permits jumped 42% in 2017. All in all, non-residential construction appears to have decent forward momentum.

JOB GROWTH WILL DOWNSHIFT

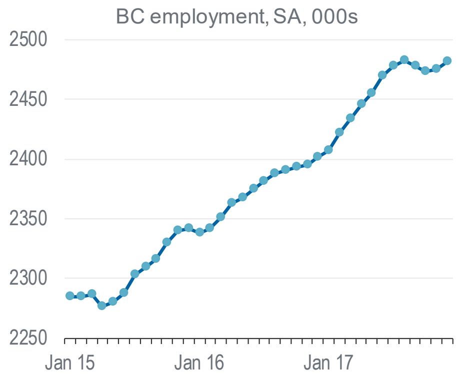
Strong economic growth has translated into a very healthy pace of job creation in BC over the past couple of years. Economic expansion across a broad array of industries and the aging workforce have fostered widespread hiring. And in turn, the employment upswing has boosted both consumer spending and the residential real estate market. In 2018-19, we anticipate some easing in job growth, as the overall economy loses a step and employers adjust to tighter labour market conditions.

With a glance at high frequency monthly data, a shift in the underlying trend in employment growth over the latter months of 2017 is evident. We expect job growth to continue, but at a somewhat more subdued pace.

FIGURE 3: **BC HOUSING STARTS CLIMB TO RECORD HIGH**

Source: Statistics Canada.

FIGURE 4: **STRONG JOB GROWTH IN 2017...**



Source: Statistics Canada, LFS.

Monthly data seasonally adjusted, 3 month moving average.

CONCLUDING THOUGHTS

BC's has been number one or two among the provinces in economic and job growth for several years. Over the next couple of years, however, economic conditions across the country should converge, as growth in other provinces picks up and BC's economy moderates, in part due to policy changes intended to take some of the steam out of residential real estate markets.

For both Canada and BC, the main near-term downside risk is NAFTA. Failure to secure a favourable agreement with the US that maintains Canada's access to the American market would have negative implications across the Canadian industrial economy, leading to job losses, diminished investment and possibly even the re-location of some production activity. If NAFTA disappears entirely, the damage will be greater, with the impact extending well past 2018. Our biggest worry is how uncertainty about Canada-US trade relations and the possible thickening of the border may weigh on business sentiment and capital spending in Canada over the medium term.

The domestic side of the BC economy looks to be in good shape, notwithstanding high levels of household debt and legitimate concerns over housing affordability in urban areas. The Bank of Canada's shift to a tightening stance and an expected gentle rise in interest rates suggest that the prospects for the residential real estate sector present some potential downside risk to the outlook. Real estate and related spinoff activity have been such important economic engines in BC that rising borrowing costs and further housing market interventions could have a material effect on economic growth in the province over the next two years.

Finally, looking further into the future, BC continues to face challenges around productivity, business growth and overall competitiveness. Out of 400,000 registered businesses, only 7,900 firms operating in the province have 50 or more employees. Too few large companies, along with too few fast-growing firms, contributes to sluggish productivity growth and, ultimately, insufficient numbers of high-paying jobs. BC policy-makers should be focused on creating an economic environment that encourages firms to grow, instead of reinforcing the incentives to stay small. They also need to be attentive to the shifting competitive landscape, both in North America and globally, as other jurisdictions move to overhaul their tax systems, streamline regulations, and aggressively seek to attract job-creating capital investment in the manufacturing, energy, mining, communications, and advanced technology industries.

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