BC Economic Review and Outlook

Business Council of British Columbia

February 2016

# BC's Growth Story Remains Intact… Despite An Uninspiring Global Backdrop

## Highlights

- The outlook for the global economy has been trimmed for 2016, largely reflecting the tempering of activity in emerging markets. Softer growth in China is spilling over to other economies and contributing to a broadly-based slump in commodity prices.
- Even amid conflicting data, the US economy remains on a solid growth footing. But the US outlook has also been notched back due to weakness in manufacturing and the effects of a strong currency.
- Canada's economy has been hit hard by plunging oil (and other commodity) prices and is in the midst of a protracted adjustment process. The Bank of Canada projects that output (real GDP) will advance by a tepid 1.4% in 2016, little changed from last year.
- Notwithstanding slow global growth and a struggling Canadian economy, BC is holding up surprisingly well. Conditions in the province's export sector are mixed: commodities are weighing on growth, while service exports and non-resource merchandise shipments are benefitting from the low Canadian dollar and ongoing US expansion. A diversified industrial and export base is helping BC.
- The domestic side of the province's economy is healthy. Consumer spending is buoyant, aided by a decline in cross-border shopping and continued population growth.
- Housing and residential construction are adding to economic growth in BC, with "offshore" money playing a visible but hard-to-quantify role in supporting prices in some segments of the market.
- BC's economic growth rate should accelerate to 2.8% in 2016, boosted by consumer spending, housing activity, and a small pick-up in population growth. For 2017, we see growth reaching 3.0%. These projections assume one large LNG project moves forward in BC.

Against the backdrop of diverging growth prospects across the developed and emerging economies and substantial declines in the prices of many commodities, British Columbia is poised for another year of respectable economic performance in 2016. The province's economy is being held back by low prices for many commodities, but non-resource merchandise and service exports are kicking into gear, aided by the low Canadian dollar. The housing market remains active, supported by continued rock-bottom interest rates, stronger job creation and inflows of foreign money. The current economic downturn in Alberta means that BC will see a surge in interprovincial migration, which should further bolster housing markets and retail sales in the province.

### A Wobbly External Setting

The global economic setting has deteriorated over the past six months. Growth in emerging economies has slowed. Much attention is being focused on China, where the combination of slower growth, industrial overcapacity, and mounting debt has dampened demand for raw materials and depressed fixed investment.

Table 1
**Global Economic Forecast**
(annual % change in real GDP)

| | 2015 | 2016f | 2017f |
|---|---|---|---|
| World | 3.1 | 3.4 | 3.6 |
| US | 2.5 | 2.6 | 2.6 |
| Euro area* | 1.5 | 1.7 | 1.7 |
| Japan | 0.6 | 1.0 | 0.3 |
| China | 6.9 | 6.3 | 6.0 |
| Emerging market economies (all) | 4.0 | 4.3 | 4.7 |

*19 EU member states that use the euro currency
f – forecast
Source: IMF, January 2016.

The IMF now sees world output expanding by 3.4% in 2016, down from the 3.6% it foresaw last October. In the initial years of recovery from the 2008-09 Great Recession, the shortfall in global demand was attributed to a weaker-than-expected recovery in the advanced economies. Now, sluggishness in the emerging economies is the main culprit. Apart from softer growth in China, the IMF's downward adjustment reflects recessions In Brazil, Russia and South Africa, as well as a loss of momentum in many other emerging economies – including many that depend on oil and other commodity exports to sustain economic activity.

China's near-term outlook has dimmed, but the extent of the deceleration there is difficult to assess. The IMF notes that the slowdown in China's imports and exports has been faster than expected, in part owing to lower investment and a contraction in manufacturing output. Other analysts believe the decline in China's imports signals that underlying economic conditions are worse than the official data indicate.

Whatever the true picture, slower growth and concerns about China's future prospects are spilling over to other economies through trade channels and sliding commodity prices. The adjustments underway in China are weighing on global trade volumes. The IMF has marked down its forecasts for the growth of world trade by more than half of a percentage point for both 2016 and 2017. In an environment of weak demand, business investment remains muted across most national economies.

The United States is a minor factor in the IMF's scenario of slower global growth, as the pace of America's economic expansion is now expected to hold steady rather than gather momentum. Preliminary data show US real GDP rising at a disappointing 0.7% annualized pace in the last quarter of 2015. For the year as a whole, real GDP increased by a little over 2%, again under-shooting most forecasters' projections.

Despite the choppy data, we believe the fundamentals for the US are sound. The details of the GDP reports for the last half of 2015 suggest that the weakness was concentrated in areas of the economy directly exposed to oil and gas and the export sector. Job creation remains robust, and the US housing sector still has considerable upside potential. The outlook for the domestic US economy is mostly favorable, in our view. Real consumer spending rose by an annualized 2.2% in the fourth quarter, and will continue to be underpinned by healthy job creation and emerging wage gains. Financial conditions are also broadly supportive of continued economic growth.

Low oil prices are usually thought of as positive for the US, which is still a net energy importer. But the sharp decline in oil and gas prices is curtailing investment, which is subtracting from the gains accruing to US consumers and non-energy firms thanks to lower energy prices. The sturdy US dollar is also dampening growth as it cuts into manufacturing activity and exports. Most forecasters see the US economy expanding by 2.1-2.5% over 2016-17. The IMF is more optimistic, predicting that US real GDP will advance by 2.6% per annum over the next two years.

In the euro area, an uptick in private consumption -- supported by lower oil prices and easy financial conditions – is outweighing the negative impact of subdued exports. While economic conditions appear to be gradually improving, growth in much of Europe is still hindered by internal structural imbalances, poor demographics and political and policy uncertainty.

Economic activity in Japan is expected to firm slightly in 2016, on the back of fiscal support, lower oil prices, a weak yen, and accommodative financial conditions. In a recent surprise move, the Bank of Japan joined four other European central banks by instituting "negative" short-term policy rates. It plans to use negative interest rates in conjunction with continued quantitative and qualitative (QQE) easing policies to help achieve a (higher) inflation target of 2%. It is unclear whether this effort will be successful.

Oil prices have tumbled further since September, reflecting expectations of sustained production along with sluggish global demand. Futures markets predict only modest increases in oil prices in 2016-17. The prices of many other traded commodities, especially metals, have fallen as well.

**Canada Hit by the Oil Melt-Down**

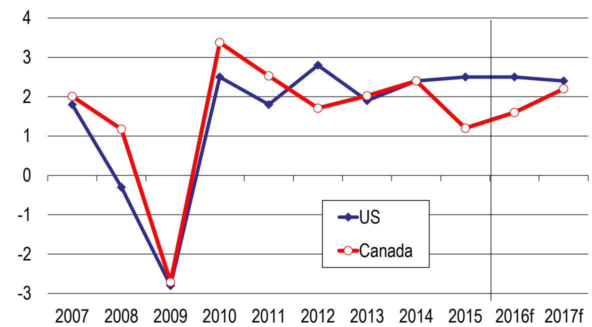
The collapse of oil prices has taken a big toll on the Canadian economy. The first half of 2015 saw two quarterly contractions in output. A rebound in the third quarter unfortunately gave way to a stall in the final months of the year. The net result is that real GDP growth for 2015 came in at 1.2%, the slowest pace since the 2008-09 recession and financial crisis.

As the Bank of Canada has documented, the plunge in commodity prices over the past two years has set off a complex, lengthy and painful adjustment process, one that will take time to unfold as capital and labour are reallocated from resource-based sectors and regions to other parts of the Canadian economy. The fall in oil prices alone is estimated to have reduced national income by more than $50 billion, equivalent to about $1,500 for every Canadian.[1]

Figure 1

**Canada and US Economic Growth**

per cent




Source: Statistics Canada for history, IMF "Global Economic Outlook" January 2016 for forecasts.

The labour adjustment process is already underway but has further to go. Net interprovincial migration to Alberta in the third quarter of 2015 was at its lowest level since 2010, with more Albertans now moving to British Columbia. At the same time, last year Ontario registered the largest net inflow of interprovincial migrants since 2002.

One positive macro-economic development is that Canadian exports snapped back in the second half of 2015, finally responding to the combination of a lower dollar and growth in US demand. Most forecasters believe that rising non-energy exports will help to keep the Canadian economy afloat in 2016.

The national employment picture has been surprisingly resilient, notwithstanding rising job losses in the resource sector. Coupled with rock bottom household borrowing costs, this is

[1] "Life After Liftoff," speech by Bank of Canada Governor Stephen S. Poloz, January 7, 2016.

supporting consumer spending even with the stiff headwinds emanating from diminished business investment and low commodity prices. Canadian consumers have been doing almost all of the heavy lifting in our economy for some time, and vulnerabilities in the household sector are growing as Canadians pile on more debt.

Table 2

**Canadian Economic Forecast**

(annual % change unless otherwise noted)

| | 2015 | 2016f | 2017f |
|---|---|---|---|
| Real GDP | 1.2 | 1.0 | 2.1 |
| Consumer spending* | 1.9 | 1.1 | 1.5 |
| Business investment+ | -7.3 | -6.0 | 1.6 |
| Employment | 0.9 | 0.5 | 0.8 |
| Housing starts (000 units) | 194 | 187 | 180 |
| CPI inflation | 1.1 | 1.6 | 1.9 |

*real dollars + real dollars, non-residential capital spending
Source: BMO Capital Markets Economics Jan. 29, 2016.

It will take time for rising capital spending and output and exports in non-resource sectors to take up the slack in the Canadian economy. Coupled with the poor outlook for commodities, this signals another sub-par year in 2016, with real GDP expected to increase by 1.0%-1.6%, according to recent projections from private sector forecasters (Table 2 summarizes the outlook of one of the most pessimistic sources). The Bank of Canada is also cautious, calling for growth of just 1.4% in 2016, up a bit from last year's 1.2% gain. The central bank points to the continued fallout from low oil and natural gas prices, including further declines in business capital spending, as the key factor behind its lacklustre Canadian forecast.

On the upside, the new Liberal government's promise to step up fiscal stimulus looks to be timely. A change in Ottawa's approach to fiscal policy should provide a small lift to Canadian economic growth in the second half of 2016 and through 2017.

In light of the underperforming economy and the fact that inflation remains below the Bank of Canada's target, there is speculation that interest rates could fall further. Arguably, the Loonie's dramatic decline over the past two years has already done enough to help the economy adjust and to bolster Canadian competitiveness. Additional interest rate cuts would encourage consumers to take on more debt and prompt more capital and other resources to flow into inflated and over-valued housing markets. We expect the Bank of Canada to hold its policy rate steady and allow fiscal stimulus and the adjustments stemming from the previous currency depreciation to deliver support to the struggling economy.

## BC Well Positioned for Growth

We do not want to be unduly sanguine about the challenging macroeconomic backdrop and downside risks, but the near-term macro outlook for the BC economy looks to be quite positive. Thanks to higher proportions of domestically sourced inputs in our major export industries and a large tourism sector, BC is benefitting more than most other provinces from the sagging Loonie. Stronger in-migration and strength in the residential real estate complex are also pluses. That BC has an increasingly diversified industrial and export base is also good news at a time of low commodity prices. The Business Council expects real GDP to climb by 2.8% this year, rising to 3.0% in 2017 -- which should be sufficient to put BC at the top of the provincial growth rankings. This forecast assumes one large LNG project moves forward by the last quarter of 2016.

### *Commodity Prices Weigh on Merchandise Exports*

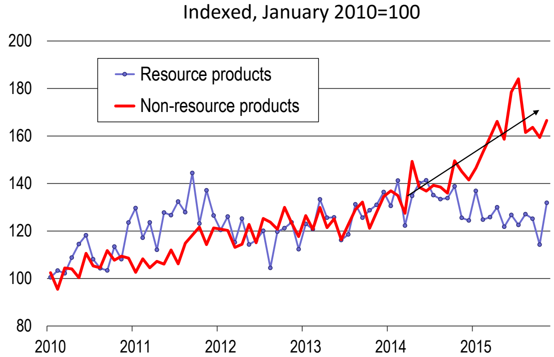
The story for BC's international merchandise exports is mixed. A weak dollar has made our exports more competitive and given some export categories a boost. The value of BC's agricultural exports was up by more than 20%

last year, with a similar gain for machinery and equipment exports. But falling commodity prices led to a decline in the value of some of the province's principal exports: metallic mineral products fell 3.5%, natural gas tumbled 40%, and coal exports dropped by 15% (on the heels of earlier declines). The net result is that the value of BC's total merchandise exports was basically flat in 2015.

Figure 2

**BC Merchandise Exports**

Indexed, January 2010=100




Source: BC Stats. Latest: November

Looking at different export markets, the boost from the faltering Loonie is evident, as the province's US-bound merchandise exports were up 4.5% last year. The slowdown in China, however, is clearly washing up on BC's shores: after more than two decades of solid growth, exports to China (now our second largest export market) slipped 6.4% last year. Exports to Japan fell 3%, while those destined for South Korea were down by 14%.

It must be noted that BC's export sector, broadly defined to include the services component, is still making a positive contribution to growth, in part because some key service segments are seeing healthy export gains. One of the most significant turnarounds is in tourism. After a decade of grappling with border delays and security issues, the Great Recession and a Canadian dollar that for a time was clearly "overvalued," tourism in BC is reaping dividends from the Loonie's slide along with lower gasoline prices and the rebound in American consumer spending. The number of Americans visiting BC (both overnight and longer stays) jumped by almost 10% in 2015. More visitors led to higher hotel occupancy rates as well as a 10% bump in average daily room rates. We are optimistic about the BC tourism sector's prospects over the next few years. An attractively priced Canadian dollar will boost the number of US visitors, while the still expanding middle class in China and other parts of Asia should be a source of additional gains for the industry. At the same time, the low Canadian dollar is discouraging out-of-country travel by Canadians. When British Columbians or other Canadians choose to travel within the country/province rather than venture south, this buoys the local tourism sector.

The film and television industry is also booming on Canada's west coast, in part thanks to the currency. Together with a highly skilled workforce, a number of top studios and a growing digital animation sector, the lower dollar makes BC an appealing place for US film and TV productions to be filmed.

The Gateway sector is another noteworthy advantage for the province. Collectively, BC's ports, related rail, trucking and other logistics industries, as well as Vancouver International Airport are an important economic engine for our economy. Although cargo tonnage through Port Metro Vancouver is increasing at a more modest clip than in the past, the Gateway sector as a whole is still adding to economic growth. High-end professional, businesses, scientific and technical services, BC's growing and diverse advanced technology industry, and the post-secondary education sector are also significant areas of economic strength.

In our estimation, tourism, film and television production, the Gateway sector, the growing high tech sector, an expanding array of tradable business and professional services, and strength in some categories of non-commodity based merchandise exports are among the reasons to be optimistic about British Columbia's economic prospects over the balance of the decade.

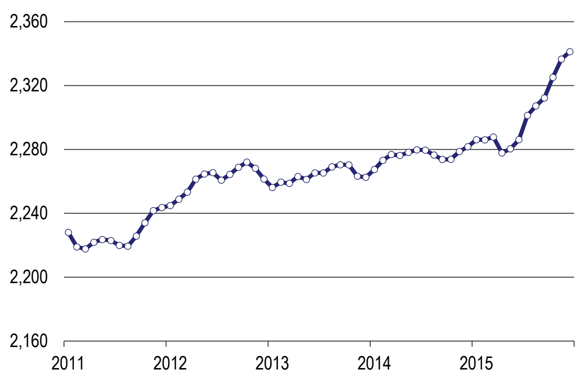
***Focus on the Domestic Economy***

On the domestic side of the economy ongoing population growth, higher consumer spending, a busy residential real estate sector, and a long-awaited upturn in employment are all feeding into a favourable outlook for BC.

Figure 3

**BC Employment**

000s




Source: Statistics Canada, Labour Force Survey, 3-month moving average, latest December 2015.

After a period of soft job numbers that often seemed out of sync with other economic indicators, employment in the province finally turned up last year. The average employment level in the first six months of 2015 was up just 0.4% versus the same period in 2014. But in the second half of the year, the pace of job growth accelerated to 2.2%. In our July 2015 outlook publication, we argued that the Labour force Survey (LFS) was likely underestimating job creation in 2014 and early 2015.[2] The impressive employment gains reported by the LFS over the past six months represent both a "payback" for earlier underestimates as well as a pick-up in underlying job creation. In 2015 average wage increases in BC (3.6%) were well ahead of inflation (1.1%), helping to sustain growth in household consumption.

The housing market, particularly in the lower mainland and the Fraser Valley, remains strong. The Greater Vancouver Real Estate Board reported a record number of sales in 2015, despite a relatively tight supply of listings. Sales surged by 28% over 2014 levels, and by December 2015 the average benchmark price for all residential properties in the Vancouver area was 19% higher than a year earlier. The Fraser Valley saw a 33% increase in home sales, just shy of 2005's record, with the benchmark price up 17%. In response to the brisk housing sales environment, new home construction is rising: the value of residential building permits reached a record high last year. That said, we expect housing starts to ease a bit in 2016 as some of the froth comes out of the real estate market.

Consumer spending is a bright spot in the BC economic landscape. Growth in retail spending is running at 5%-6% on an annualized basis, with all segments of retail seeing gains. The housing market is supporting retail spending through a couple of channels: directly, via purchases of building materials for renovations and new construction along with demand for furnishings and other housewares; and indirectly, through the positive wealth effect from escalating home values. Substantial increases in home prices have augmented the net worth of hundreds of thousands of BC homeowners. Some of them are accessing equity to finance spending, while others are selling (or thinking about selling) their properties and realizing (or contemplating) large capital gains. There is a risk that hot urban housing markets could lose steam or experience a non-trivial price correction, but we have not included such a scenario in our 2016-17 forecast.

Looking ahead, the momentum in retail spending is expected to continue over 2016-17,

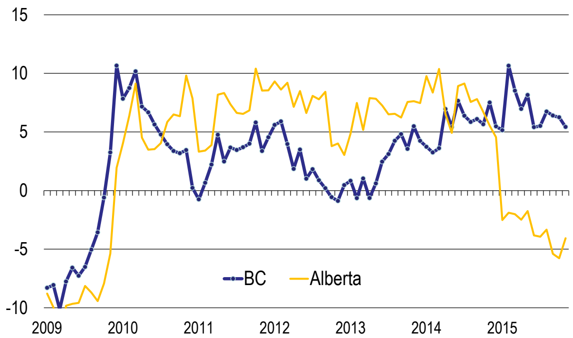
[2] Jock Finlayson and Ken Peacock, "Amid External Headwinds, BC's Economy Is Holding Up Well", BC Economic Review and Outlook, Business Council of BC, July, 2015; available at www.bcbc.com.

aided by decent job and income growth, the above noted wealth effect, and in-migration of people and capital from the rest of Canada and other countries.

Figure 4

**Retail Sales Growth**

annual % change




Source: Statistics Canada. Latest: November

### *Business Investment Still Lagging*

As with most other advanced economies, business investment has been relatively weak in BC. Non-residential building permits are off from their 2014 levels. And investment in machinery, equipment and advanced process technologies is too low to establish a foundation for the productivity gains needed to deliver rising real wages and an improved standard of living for residents in the future.

Capital investment in the province's mining and forestry sectors has dropped significantly. On the other hand, construction of the Site C project has commenced. By the second half of this year, the multi-billion dollar Site C project should be making a material contribution to economic activity in the province.

There also remains a possibility that one or more of the several proposed LNG projects could move to the construction phase over the next two years. In our baseline forecast, we assume that one large LNG project starts toward the end of the year and advances further in 2017. This adds two to three tenths of a percentage point to our forecast for real GDP growth in 2017. If all of the large proposed LNG projects remain stalled, we will revisit our growth forecasts for both 2017 and beyond.

Federal government fiscal stimulus is expected to provide a small economic boost for the province. The new Liberal government in Ottawa has pledged to increase spending on infrastructure (and perhaps on other programs as well). Because of delays in ramping up infrastructure construction, we have built in only a small positive impact from this source in 2016, but we anticipate a more significant lift in the following three years.

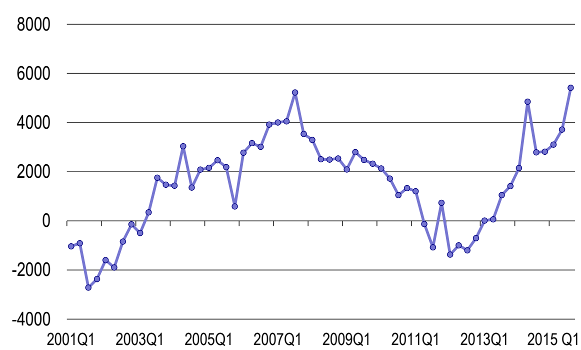
### *BC Population Growth and Migration*

Population growth should also be a plus for domestic demand in 2016-17. British Columbia is seeing an upturn in interprovincial migration, as fewer people are re-locating to Alberta and more residents of other regions of the country are moving to BC. In the third quarter of 2015, net interprovincial migration was nearly double the figure for the same period in 2014. Slightly faster population growth should translate into higher retail sales and a steady demand for housing in the next 12-24 months.

Figure 5

**BC Net Interprovincial Migration**

persons, seasonally adjusted




Source: BC Stats, BCBC for seasonal adjustment. Latest: Q3 2015

Table 3
**BC Economic Outlook**
(annual % change unless otherwise indicated)

| | 2014 | 2015f | 2016f | 2017 |
|---|---|---|---|---|
| Real GDP | 3.2 | 2.6e | 2.8 | 3.0 |
| Employment | 0.6 | 1.2 | 1.3 | 1.3 |
| Unemp. rate (%) | 6.1 | 6.2 | 5.8 | 5.7 |
| Housing starts – (000 units) | 28.4 | 31.4 | 30.2 | 30.0 |
| Retail sales | 5.5 | 6.5 | 6.0 | 5.0 |
| BC CPI | 1.2 | 1.1 | 1.5 | 1.6 |

f - forecast e – estimate
Sources: Statistics Canada and BC Stats; BCBC for forecasts.

On the international side, the immigration numbers have broadly held up. Here we need to be cautious in describing and assessing recent developments. Immigration in the third quarter of 2015 was up from 2014 and represented the largest Q3 inflow since 2010. However, when factoring in all the different elements of international migration, the picture is different. Following the tightening of rules for temporary foreign workers by the federal government, the number of non-permanent residents (which includes TFWs) fell sharply. In the third quarter of 2015, 3,600 non-permanent residents were added to BC's population; the comparable Q3 numbers in earlier years ranged between 9,000 and 13,000. Over the first three quarters of 2015, permanent immigration was down by about 1,000 persons compared to previous years, which is not enough to suggest a meaningful shift.

Thus, while the overall net international immigration numbers are lower than in the recent past, the drop is mostly attributable to temporary residents rather than a fall-off in permanent immigration. We expect total immigration (including non-permanent) to be lower than in recent years, by between 10,000 and 15,000 annually. Fewer temporary new-comers will affect population growth, but the economic impact is less than if there were a comparable drop in the ranks of permanent immigrants. We will continue to monitor the immigration data closely over the coming year.

## Concluding Thoughts

In spite of a generally uninspiring global backdrop, we expect British Columbia's economy (real GDP) to expand by 2.8% this year, rising to 3.0% in 2017. While momentum in the housing and consumer spending segments is likely to ease a bit by 2017, this should be more than offset by increased construction spending on Site C and at least one major LNG project, along with a slight firming in commodity markets by the second half of next year. In the event that no LNG projects proceed in British Columbia, the rate of economic growth in 2017 will be lower than we have assumed here.

In summary, our updated projections point to a small improvement in BC's economic growth profile over 2016-17. Given the challenging external environment and Canada's decidedly mediocre near-term economic prospects, this must be counted as a strong showing for British Columbia – one that is underpinned by the low Canadian dollar, rock bottom interest rates, and continued increases in population, employment and consumer spending.

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