



## Waiting for Better Days

### Highlights

Projections for the global economy have been scaled back since the outset of the year, mainly due to weaker growth in emerging markets.

The US economy experienced a significant but temporary setback in the first three months of 2014; it should regain lost momentum in the coming quarters. With job creation picking up, consumer spending gaining ground and fiscal drag fading, the American economy is on a path to more solid economic growth.

BC's export sector made some gains over the past year, with most of the improvement stemming from rising sales to the US. A setback in shipments to China is tempering BC's overall export performance.

The domestic side of the provincial economy is mixed. Job creation remains underwhelming and consumer spending, while improving, is far from robust. On the other hand, housing market activity has perked up in response to lower mortgage rates and non-residential construction spending is at a reasonably healthy level.

The timeline for LNG and other large capital projects in BC has been pushed back. Combined with the soft BC job market and a slightly weaker global economy, this has caused us to shave our growth forecasts for 2014-15. We now look for real GDP to expand by 2.2% this year and 2.9% in 2015.

Some of the optimism about the global economy evident in early 2014 has diminished in recent months, causing forecasters (including the Business Council) to revise down their growth projections. The change is not dramatic, but the tone has shifted in a more cautious direction. In its spring update, the International Monetary Fund (IMF) shaved its forecast for global GDP growth by one-tenth of a percentage point for both 2014 and 2015, pointing to softer conditions in emerging economies as the main reason.<sup>1</sup> The economics team at Scotiabank has also trimmed its

forecast and now looks for global growth of just 3.2% this year. The unexpected fall in Q1 real GDP in the United States (a 2.9% annualized decline) has helped to temper near-term expectations. The dismal US Q1 number will pull down average growth for the year as a whole. The deceleration in the Chinese economy is also an important factor in the evolving global picture.

Against this backdrop, the Business Council has scaled back our economic outlook for British Columbia. We now expect the province's real GDP to advance by 2.2% this year, down a notch from the 2.3% we predicted in January. The prospects for 2015 are better, albeit still

<sup>1</sup> IMF, World Economic Outlook, April 2014.

uncertain, as a stronger US and global economic footing should have materialized by then. However, we see more uncertainty around the magnitude and sequencing of major capital investment in the province, and this, coupled with modest export gains and financially stretched BC consumers, has prompted us to lower our real GDP growth forecast for 2015 by three-tenths of a percentage point, to 2.9%.

### **A Choppy External Setting**

We begin with United States, which will be the source of much of the upside for BC's exports over the projection horizon. Fundamentally, America's ongoing economic expansion remains intact and should build momentum over the next couple of years. One important positive indicator is employment. Job creation has accelerated, with the US economy adding more than 280,000 jobs in May – one of the biggest monthly jumps in several years. In addition, American households have paid down some of their past accumulated debts and are now in a better position to spend, as evidenced by strong automobile sales and continued decent retail sales figures. And public sector fiscal austerity has eased, lessening the impact of what had been a significant economic headwind.

Having said that, the first quarter drop in real GDP means that 2014's growth rate will be lower than anticipated. Although economic conditions should improve over the balance of the year, most forecasters predict a gradual recovery in US consumer spending rather than a sharp snapback. It should also be noted that US housing starts have lost a step, in part due to weather-related factors, but also because of a cautious approach to new projects by developers. Home sales weakened in the latter half of 2013 in response to rising mortgage rates and higher home prices.

Recent forecasts for the US suggest a sub-par performance this year, with output rising by perhaps 1.8%, similar to 2013 but below the

projections at the start of 2014. Real GDP growth should pick up to something closer to 3% in 2015.

| Table 1<br>World Economic Forecast<br>(per cent change in real GDP)                 |         |      |       |       |
|---|---------|------|-------|-------|
|   | 2000-12 | 2013 | 2014f | 2015f |
| US  | 1.9     | 1.9  | 1.8   | 3.0   |
| Canada  | 2.2     | 2.0  | 2.2   | 2.5   |
| Euro zone   | 1.3     | -0.4 | 1.0   | 1.4   |
| UK  | 1.7     | 1.7  | 2.8   | 2.5   |
| Japan   | 0.9     | 1.5  | 1.6   | 1.2   |
| China   | 9.3     | 7.7  | 7.3   | 7.0   |
| World   | 3.7     | 3.0  | 3.2   | 3.6   |
| Source: Scotiabank Economics, Global Forecast Update<br>(June 26 2014) f = forecast |         |      |       |       |

China's economy has cooled, with the IMF predicting that real GDP will increase by 7.3% this year and 7.0% next year. This constitutes a material downshifting from a long stretch of 10% plus annual growth rates. China's slowdown is weighing on a number of emerging economies; it has also affected markets for many globally-traded commodities. Measured on an annualized quarter-over-quarter basis, output growth in China recently slipped below the 6% mark, prompting the Chinese authorities to introduce new stimulus measures (cuts to required reserve ratios for rural banks, stepped-up spending on housing and infrastructure projects, business tax cuts, and a small engineered depreciation of the renminbi). One question mark hanging over China is the real estate market. If the current real estate downturn becomes more pronounced, it would have negative implications for the banking system and the wider economy. However, the most recent data signal that economic conditions appear to have stabilized. China "remains the global economy's most important growth engine."<sup>2</sup>

<sup>2</sup> Michael Spence, "Rebooting China," Project Syndicate, June 19, 2014.

With the 2011-13 recession behind it, the Eurozone managed to post positive economic growth in the first quarter (0.7% annualized), although this was actually down a bit from the final three months of 2013. Economic performance among the 28 EU member countries is very mixed, with the UK and Germany doing better than France, Italy and other southern European countries. Several EU member states continue to grapple with large sovereign debt burdens and/or malfunctioning banking systems that have reduced the availability of credit. In aggregate, it is fair to say that the 500 million consumers residing in the EU are not making a major contribution to global economic growth.

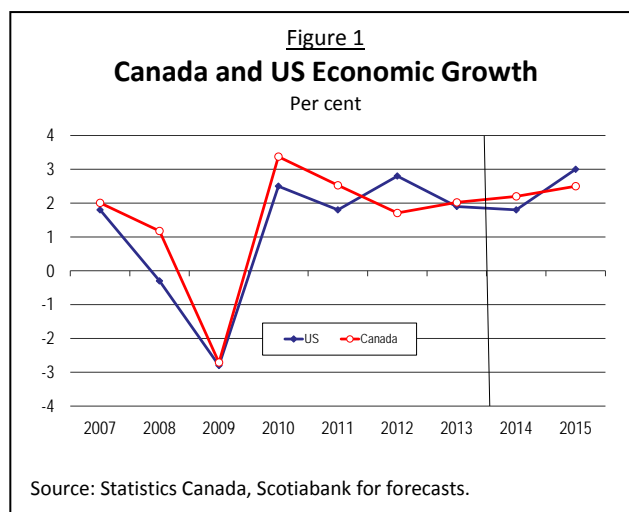
Monetary and fiscal stimulus policies in Japan are supporting a somewhat sunnier economic outlook and seem to be mitigating long-entrenched deflationary expectations. The recent three-point increase in the national consumption tax will dampen growth in the short term, but Japan's economy should eke out modest gains over 2014-15.

### **Canada Making Slow Progress**

Canada's economy is slowly strengthening, with real GDP growth in 2014 on track to surpass (albeit barely) last year's moderate 2.0% expansion. Canada should also outpace the US this year, thanks to the latter's poor Q1 showing. However, beyond 2014 we believe Canada will be lagging the United States in the growth of GDP, consumer spending, employment, household income, and residential investment over the medium term.

Canada was also dealt a weather-related blow in the first quarter. The labour market has deteriorated, with the pace of job growth slowing to less than 1% on an annualized basis. Housing market activity and residential investment have been stronger than forecasters

were expecting six months ago.<sup>3</sup> However, muted gains in real per capita income and a record high household debt burden will keep a lid on the growth of consumer outlays going forward.



One area where the Canadian economy has fallen short is exports. Almost six years after the global financial crisis and recession, the value of international merchandise exports still hovers below the 2007 peak. Exports should revive over 2014-16, however. Shipments to the US have already started to rebound, with higher oil and gas prices leading to a 10% jump in the value of energy exports so far this year. But non-energy exports continue to struggle, and Canada has lost ground in the American market in the past decade, particularly for manufactured products. Despite this, Canada's overall merchandise export sales should receive a boost as the US economy gathers speed. And our tourism industry should benefit as American consumers increase spending and travel at a time when the Canadian dollar is trading at a more competitive level.

<sup>3</sup> See BMO Financial Group Economics, "Housing Starts: Stampede in Alberta," EconoFacts, July 9, 2014.

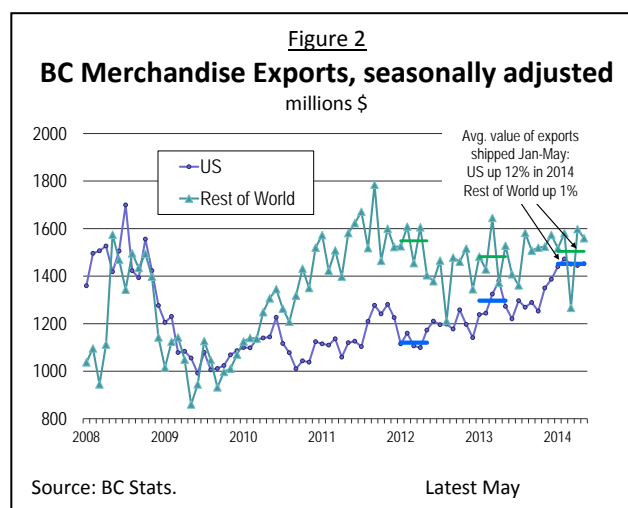
Although inflation in Canada recently ticked higher, GDP growth remains on the soft side with plenty of slack in the economy. Moreover, inflation expectations remain well anchored around the Bank of Canada's 2% target, allowing the central bank to maintain its accommodative monetary policy stance. Canadian forecasters believe short-term interest rates will not start to climb from today's rock-bottom levels until late 2015, at the earliest. The central bank is reluctant to embark on a monetary tightening cycle before the economy has moved to a more solid growth trajectory. Thus, the cost of money will remain low for credit-worthy borrowers. Many financial market analysts suspect that the Bank of Canada would be happy to see the Canadian dollar lose altitude from its recent level of 93-94 cents US. Indeed, the Loonie has been trading higher than analysts were predicting a few months ago. Even so, the dollar's fall from approximate parity with the US greenback 12-18 months ago has conferred a modest competitive benefit on many trade-exposed industry sectors in Canada. Most economists see the Canadian dollar weakening further over the next year or two.<sup>4</sup>

### **US Provides a Lift to BC's Export Sector**

Over the January to May period, BC's international merchandise exports rose 6% from the same period in 2013. The slowdown in emerging markets and the relative improvement in the US are showing up in the province's export numbers. In dollar terms, merchandise exports to the US are up 12% year-to-date, while shipments to the rest of the world have hardly budged (+ 1%). BC's exports to China are down almost 2% so far in 2014, which contrasts with a pattern of consistent, often double-digit increases over the previous

<sup>4</sup> For example, see TD Economics, "Canadian Outlook: Modest Growth at Home to Limit Economy's Acceleration," Quarterly Economic Forecast, June 23, 2014.

two decades. The value of exports to Japan is off by more than 10% year-to-date.

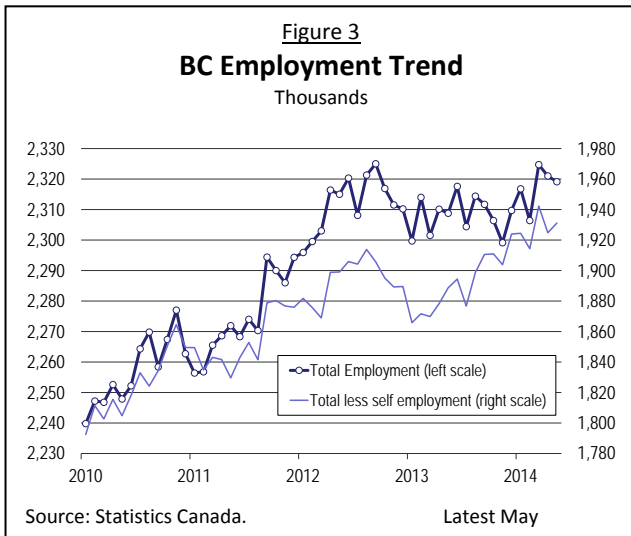


BC will be leaning more heavily on the US to kick-start exports over the next two years. Looking at the composition of economic growth south of the border, there are a few hopeful signs as well as some reasons for caution. The recent cooling in US home building is reflected in BC's wood product exports being down by 1% year-to-date. In addition, much of the overall increase in the province's southbound exports is due to a 60% surge in natural gas exports. While this is welcome, it is mostly the result of higher prices – and the long-term outlook for natural gas in the North American market remains poor given rising US domestic production. On the positive side, the 13% increase in BC's machinery and equipment sales to the US is indicative of a broadly-based if still gradual upswing in the American economy.

### **Waiting for the Domestic Economy to Strengthen**

The province's domestic economy is best described as mediocre, with few signs yet of stronger growth. Of particular concern is the job market. While we expect hiring to pick up in 2015, the pace of job creation has been disappointing. Following essentially zero net employment growth in 2013, total employment

is up 0.5% this year, shy of the national benchmark (0.7%) and weak compared to labour markets in the other western provinces.



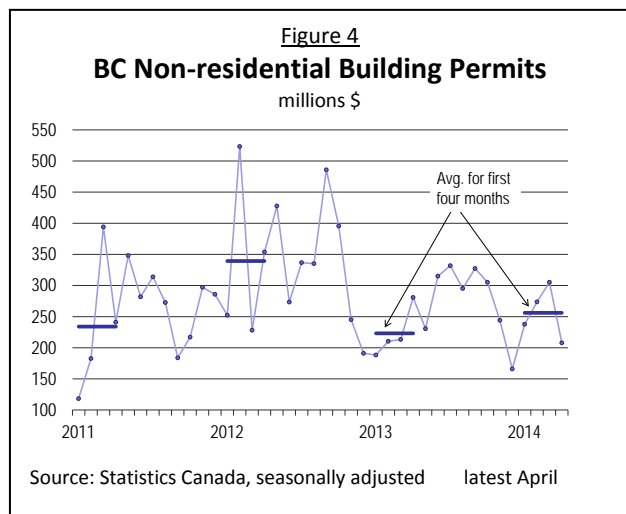
Consumer spending in BC has rebounded modestly, with Q1 retail sales climbing by 3.7% over the first quarter of 2013. This is good news, but a better economic environment for retail activity hinges on stronger job growth and a higher level of business capital outlays.

From our perspective, a healthier economic picture for BC requires a sizeable advance in large development projects and greater strength in private sector non-residential investment more generally. As summarized in Figure 4, non-residential building permits are up slightly from 2013 levels, but the permit data basically depict a sideways trend. Statistics Canada’s 2014 investment intentions survey pointed to relatively subdued capital spending in the near-term.<sup>5</sup>

It is true that there are many major engineering and other significant capital projects on the books in BC, as updated regularly in the provincial government’s Major Projects

<sup>5</sup> Statistics Canada, “Private and Public Investment in Canada, 2014, Survey.

Inventory.<sup>6</sup> In our January outlook, we were optimistic that a significant number of these would come to fruition and begin to make a contribution to growth this year and into 2015. Some have, particularly in the commercial sector (e.g., office towers and other new commercial development in Metro Vancouver). At the midpoint of 2014, however, we have decided to dial back some of our earlier optimism about major project activity. Large resource, infrastructure and industrial projects are complex and have proven difficult to advance in the BC context. In the mining sector, numerous projects are being postponed owing to unfavourable commodity and capital market conditions. In the energy transportation segment, proposed oil pipelines are meeting stiff opposition and face a host of regulatory and other challenges. The recent Supreme Court of Canada decision in the William case is apt to lead to further delays in proceeding with some economic development projects; we fear it may also contribute to a more generalized chill in capital spending in certain sectors.



Preliminary site preparations and upstream drilling related to proposed LNG projects have started, and we continue to anticipate the construction of 2-3 of these facilities in the next

<sup>6</sup> BC Stats, Major Project Inventory.

few years. Our original timeline saw LNG construction commencing in the second half of 2015, but prudence suggests a delayed timeline, resulting in more of the construction-related economic upside happening in 2016 and later years. This is one reason why we have scaled back our 2015 economic forecast. It is important to recognize that BC faces strong competition from other LNG supply jurisdictions, with the US in particular making faster progress in establishing the necessary infrastructure and supportive policy regimes. There is a limited window to move ahead with large-scale LNG projects in BC.<sup>7</sup>

On a positive note, in the lower mainland work is proceeding on several new office towers as well as retail and infrastructure projects such as the Evergreen Line and the large retail complex being developed by the Tsawwassen First Nation. The housing market has picked up in recent months, with new home construction and renovation spending now expected to provide a lift to GDP growth in 2014 (but less so in 2015).

Looking at the prospects for a number of key BC industries over the next 18 months, we see above average growth for the tourism sector; high technology; business, professional, scientific and technical services; and wood products manufacturing. Non-residential construction spending should remain quite elevated, although as noted above there is some concern around the pace of major project development. Considerable economic activity will continue to take place linked to the province's prospective LNG opportunity. Retail spending and residential investment are likely to grow roughly in line with nominal GDP. Fiscal restraint at the federal and provincial levels

<sup>7</sup> See M. Moore et al, Risky Business: The Issue of Timing, Entry and Performance in the Asia-Pacific LNG Market, School of Public Policy, University of Calgary, July 2014.

means that government spending will be contributing little to economic growth over 2014-15.

Faster population growth should help to create an environment that is more supportive of economic expansion. Over 2012 and part of 2013, BC recorded a net outflow of interprovincial migrants. Migration patterns have shifted, with the province again experiencing a net in-flow of interprovincial migrants. International immigration continues to run at 35,000-40,000 per year.

| <u>Table 2</u><br><b>BC Economic Outlook</b><br>(annual % change unless otherwise indicated)         |             |              |              |
|--|-------------|--------------|--------------|
|  | <b>2013</b> | <b>2014f</b> | <b>2015f</b> |
| Real GDP   | 2.0         | 2.2          | 2.9          |
| Employment   | -0.2        | 1.0          | 1.5          |
| Unemp. rate (%)  | 6.6         | 6.4          | 5.9          |
| Housing starts – (000 units)   | 27.1        | 27.0         | 27.5         |
| Retail sales   | 1.6         | 3.2          | 3.2          |
| BC CPI   | 0.0         | 1.0          | 1.5          |
| a – actual f – forecast e – estimate<br>Sources: Statistics Canada and BC Stats; BCBC for forecasts. |             |              |              |

In summary, our assessment is that British Columbia is in store for another year of modest and generally subpar economic and employment growth in 2014, followed by a better performance in 2015. By 2016, a more fulsome recovery in the United States and progress on more major investment projects within the province should be enough to push real GDP growth above the 3% mark.

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