BC Economic Review and Outlook

Business Council of British Columbia

January 2014

BC Economy and Job Market to Gain Momentum Over 2014-15

Highlights

Expected improvements in the global economy, including a stronger US performance and a return to (slight) positive growth in the Eurozone, provide a more favourable backdrop for the BC economy as 2014 begins.

BC's real (inflation-adjusted) gross domestic product is projected to increase by 2.3 % this year, up from an estimated 1.4% in 2013. In 2015, real GDP is predicted to rise by at least 3%.

The stronger growth trend over 2014-15 reflects modest gains across many different segments of the provincial economy. Higher exports, an acceleration of major project construction, increased Gateway activity, a pick up in tourism, and some growth in consumer spending should all contribute to a more robust economic expansion.

Although the evidence is still preliminary, we believe the job market is finally on the mend after a disappointing 2013, with employment likely to increase by 1.4% this year.

By 2015, construction of LNG facilities and related pipelines and upstream natural gas development should give the provincial economy an additional boost.

Against a more balanced and somewhat stronger global growth setting, BC's economy should make progress in 2014, on the heels of a rather disappointing 2013. We expect the province's real GDP to advance by 2.3% this year – solid, but not spectacular. By 2015, further improvements in the global economy and a substantial jump in capital spending in BC should push GDP growth above the 3% mark.

The marked decline in the Canadian dollar is helping to set the stage for an export rebound and may even present an upside risk to the BC outlook. When the Loonie was at or near parity, many Canadian companies cut costs and took other steps to bolster competitiveness. As the dollar moves into the low 90 cents range, BC exporters who were successful when the dollar was stronger will benefit from an effective price reduction of around 10% on their products and services sold south of the border (or sold in offshore markets but priced in US dollars). The BC tourism industry also stands to gain from a weaker Loonie.

A Brighter External Economic Picture

An improving global economic environment is now starting to materialize, with the most important developments occurring in the United States. Notwithstanding December's lacklustre jobs report, the US economy is generating jobs at a respectable rate (more than 2 million last year), households have paid down some past accumulated debt, the housing market continues to recover, consumer spending is strengthening, and the corporate sector is in excellent financial shape. Most forecasters see the US economy growing in the vicinity of 2.7% in 2014, up from last year's 1.8% expansion. Importantly, housing starts stateside are on track to exceed 1 million this year, for the first time since 2007. The BC lumber industry will continue to benefit as US housing starts gradually climb back to an equilibrium level of approximately 1.5 million per year.

Table 1

World Economic Forecast

(per cent change in real GDP)

	2000-12	2013	2014f	2015f
US	1.9	1.8	2.7	3.0
Canada	2.2	1.8	2.4	2.5
Euro area	1.3	-0.5	0.8	1.3
Germany	1.3	0.5	1.6	1.8
France	1.3	0.2	0.6	1.0
Italy	0.4	-1.9	0.2	0.7
Spain	1.9	-1.3	0.4	0.9
UK	1.7	1.9	2.5	1.7
Japan	0.9	1.8	1.8	1.2
China	9.3	7.7	7.3	7.0
World	3.7	2.9	3.5	3.6

Source: Scotiabank Economics, Global Forecast Update (Jan. 2014)
f = forecast

Economic growth in China, which now accounts for 20% of BC's merchandise exports, is projected to slip to 7.3% this year followed by 7% in 2015. While this represents a slowing from a long stretch of 10% plus growth rates, it must be remembered that the Chinese economy is now much bigger than it was 5 or ten years ago, so even a reduced growth rate still represents a large absolute increase in economic output and spending. BC's exports to China have risen at a double-digit pace over the past decade. Last year, with China's real GDP increasing by 7.7%, BC's exports destined for China surged by almost 18%. Demand for BC's resources in China will likely be sustained, so we expect steady growth in exports to China over the next several years. Japan, BC's third largest export market, is poised for another year of near 2% growth, as the government in Tokyo continues to focus on reflating and reforming the world's third biggest national economy. Economic fundamentals in Japan are improving after many years of sluggish output growth and deflationary conditions.

Turning to Europe, the recession which gripped the Eurozone[1] for almost 2 years ended in the third quarter of 2013, and most forecasters now expect real GDP growth in the 1% range for 2014. Within the wider EU region, the UK and Germany will do better than France or Italy, while some of the struggling "peripheral" Eurozone countries should finally see a return to positive growth in 2014-15. That said, there remains a risk of further financial turbulence in Europe, as a number of EU nations grapple with punishing public sector debt burdens and the banking sector across much of the region continues to cut back on lending activity.

While most market analysts are looking for relatively soft global commodity prices going forward, the prospects for some of BC's major export commodities are brighter. Rising US demand for lumber (and other building materials) will push prices higher over the medium-term, pulp prices are also projected to advance, and natural gas prices seem to be climbing (albeit from very depressed levels). In line with most other metal and mineral commodities, copper may ease slightly this year, but prices should remain high enough to sustain exploration and development.

At the national level, Canada's economy is slowly improving but will lag behind the US in 2014-15. Real GDP growth in Canada accelerated over the past year, and with the US upswing now gaining traction, Canada's export sector should rebound sufficiently to support economic growth in the 2.2% to 2.4% range in 2014. Inflationary pressures remain both subdued and weaker than forecasters anticipated. The Bank of Canada has softened

[1] The Eurozone is comprised of 18 EU member states that share a common currency and central bank. Ten other EU member states are outside of the Eurozone scheme, including the UK.

its language around the need for and timing of future interest rate hikes – suggesting that rates are set to stay “lower for longer.”

In mid 2013, in anticipation of central banks eventually hiking their policy rates and – in the case of the US Federal Reserve – moving away from “quantitative easing” policies, long-term bond yields jumped. More recently, bond yields have retreated as markets come to believe the Fed and the Bank of Canada will hold their trend setting short-term rates steady well into 2015. Low interest rates will provide support to Canada’s economy in 2014, extending into 2015. This is particularly helpful for BC since our households shoulder the highest debt burdens in the country.

Add it all up, and the external setting for BC – stronger US growth, the end of recession in the Eurozone, some growth in Japan, a lower Canadian dollar, and interest rates still on hold – arguably looks better than it has in the past several years.

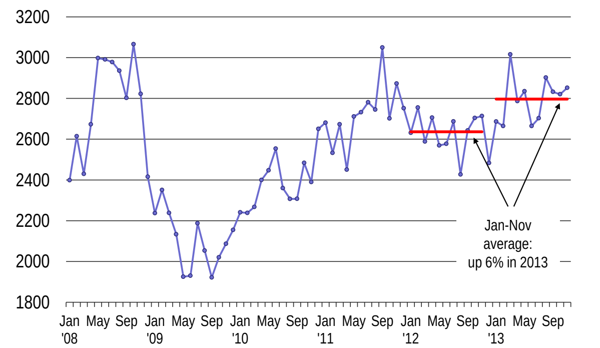
Domestic Economic Conditions

On the domestic side of the BC economy, we also see the picture brightening. Last year consumer spending was sluggish, home building moved sideways, and the job market stalled (with the average employment level for the year actually falling a bit according to the Labour Force Survey). But in the final quarter of 2013, signs of more robust spending activity emerged, and this momentum should continue. After a couple years of restraint, British Columbians are ready to spend a little more freely. Apart from a healthier export sector, stronger job and income growth should pave the way for higher consumer spending. The sagging Canadian dollar will help to dampen cross-border shopping – which has soared since 2009 – and keep more consumer dollars circulating within the domestic economy, benefitting the retail sector.

Figure 1

BC Merchandise Exports, seasonally adjusted

millions $

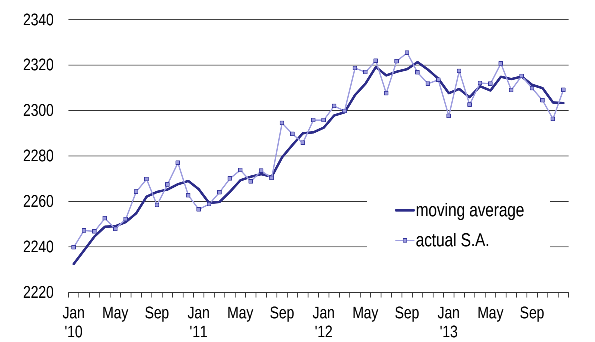


Source: BC Stats. Latest November

Figure 2

BC Employment

thousands



Source: Statistics Canada. latest December

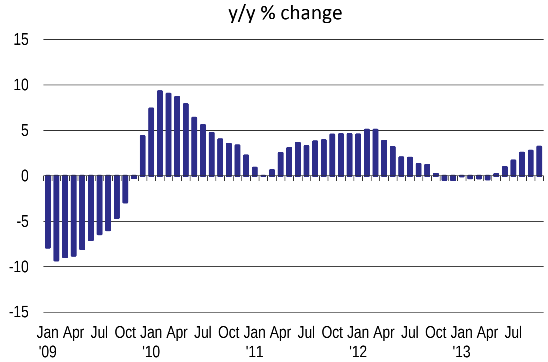
Following essentially no net employment growth in 2013, we see the BC job market recovering in the coming year. Growing exports, higher non-residential construction outlays and some increase in consumer spending will translate into a greater demand for workers and more hiring by BC businesses. And while government fiscal restraint (federally and in BC) continues to weigh on the economy, a more buoyant private sector should offset any fiscal drag emanating from the public sector.

From our perspective, the improving economic outlook rests heavily on a projected upturn in fixed investment and construction. Permit values for non-residential structures slipped early in 2013 but recently regained some of the lost ground, suggesting this sector will generate additional economic activity in the first half of 2014. Major engineering projects should begin to make a larger contribution to growth this year and provide a bigger lift in 2015. A review of major projects now underway or scheduled to commence in the near future suggests points to an extra $3-4 billion in construction spending in 2014. Seaspan's multi-billion, multi-year combat vessel contract will also get underway this year. Rio Tinto Alcan's $3.3 billion upgrade to its Kitimat smelter continues. In Metro Vancouver, work is proceeding on a number of new office towers and other large building projects.

Figure 3

BC Retail Sales

y/y % change

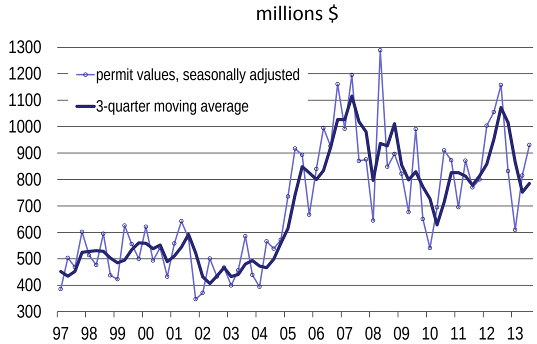


Source: Statistics Canada. latest October

Figure 4

BC Non-residential Building Permits

millions $



Source: Statistics Canada, seasonally adjusted latest Q3

Some preliminary site preparations and upstream drilling related to LNG development are likely to materialize this year. But the more significant investment dollars linked to LNG should start to flow in 2015 and beyond. At this stage, we assume that the construction of two LNG facilities will commence in 2015. Combined with associated pipelines and a number of other major projects, this could lift overall capital spending in the province by $5-10 billion in 2015. A surge in project-driven capital spending will also lead to thousands of new jobs.

Homebuilding typically contributes to BC's economic expansion, but this year new home construction is likely to move sideways, as housing starts fall back from 2013. However, renovation spending, which was at elevated levels in 2013, should advance again amid continued low borrowing costs and slightly higher home prices.

One important area to keep a close eye on is population growth, which has normally played a significant role in BC's economic growth story. Over 2012 and part of 2013 BC saw lower net in-migration (interprovincial and international). Consistent with our theme of modest but broadly-based improvements in the BC economy, the outflow of interprovincial migrants (mostly to Alberta) slowed in the latter part of 2013, and the number of international migrants coming to the province picked up. The net result was that total net migration into BC exceeded 20,000 in the third quarter of 2013, compared to just over 11,000 in the same quarter of the previous year. Slightly stronger population growth should continue this year and will help to impart a firmer tone to consumer spending.

Fiscal policy is impinging on near-term economic conditions, as both the federal and BC governments concentrate on eliminating their budget deficits (in BC's case, keeping the operating budget balanced). Government spending is rising in nominal terms, but it is decreasing measured on a *real per person* basis; in addition, taxes have recently risen in BC. Thus, public sector fiscal drag is likely to dampen economic growth in 2014-15. But a commitment to sound budgetary policy should enable the BC government to keep tax rates relatively low and position the province favourably from a longer-term perspective.

Table 2
BC Economic Outlook
(annual per cent change unless otherwise indicated)

	2013	**2014f**	**2015f**
Real GDP	1.4e	2.3	3.2
Employment	-0.2	1.4	1.7
Unemployment rate (%)	6.6	6.4	5.9
Housing starts – all areas (000 units)	26.4	23.5	23.5
Retail sales	1.6	3.0	3.0
BC CPI	0.0	1.0	1.5

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

A risk to the medium-term BC outlook is the high level of consumer debt. Because of high housing costs and big mortgages, the average British Columbian homeowner pays more in interest relative to disposable income than his/her counterparts in other provinces. Since interest rates are not expected to move much this year, debt loads for most households should remain manageable. High household debt, however, does pose an economic risk over the medium term, especially if house prices slip or interest rates rise faster than forecasters now project.

Another concern for the economic outlook is potential shortages of skilled workers, especially tradespeople needed to build major projects in the north of the province. Securing enough qualified workers is a formidable challenge for BC, in part due to stiff competition from other western provinces. There is a risk that wages could escalate in a way that results in cost over-runs and even the cancellation (or postponement) of some projects. While the provincial government is working on strategies to educate, train and attract sufficient numbers of appropriately qualified workers to support the economic development goals embodied in the BC Jobs Plan, so far it appears that little has been done to ramp up training capacity.

In summary, our economic assessment for BC in 2014 signals a return to average growth, with an additional growth spurt the following year. This marks a welcome improvement over last year's listless performance. Our forecast for a near-term economic upturn is based upon modest gains in several areas, including export growth, more tourism-related spending, higher non-residential investment, a healthier job market, and some growth in consumer spending. The weaker dollar and continued low interest rates will also help to underpin a stronger BC economy in 2014-15.

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