BC ECONOMIC REVIEW AND OUTLOOK

Business Council of British Columbia
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Q4 2018 (JANUARY)

A SHIFTING PROVINCIAL ECONOMIC LANDSCAPE

HIGHLIGHTS

- Global GDP growth is expected to cool to around 3½% in 2019 and 2020. The downgrade reflects the effects of tightening financial conditions and trade tensions. These developments, coupled with the U.S.-China trade war and political chaos in Washington, D.C., have rattled financial markets. Over the past quarter, valuations contracted in global equities. In addition, the U.S. corporate debt market shows signs of a nascent credit crunch, and the U.S. yield curve has flattened. Risks to the global outlook are slightly weighted to the downside.

- Canada's economy should continue to grow around 2% per annum, close to its potential but a meagre pace by historical standards. Growth will dip lower in 2019, as heavy price discounts on western Canadian oil and Alberta's decision to cut oil production to cope with them reduces output.[1]

- With little spare capacity in the rest of the economy and core measures of inflation close to 2%, the Bank of Canada intends to remove monetary policy stimulus over time to keep inflation at its target. Outside of oil-producing regions, labour markets are tight and wage growth is solid. Risks to the Canadian outlook are slightly weighted to the downside, on balance.

- B.C.'s economy slowed in 2018 due to a sharp downturn in consumption and activities tied to real estate. Still, labour market conditions remain tight and wage growth is well above historic norms.

- B.C. GDP growth is projected to ease slightly over the next two years, to around 2.2% to 2.4%. The $40 billion LNG Canada project gets underway later this year and will provide a substantial lift. Without this project, provincial growth would slip below 2% as the real estate boom unwinds.

- The composition of economic growth is expected to shift toward northern B.C., driven by LNG and related upstream drilling activity and pipeline construction, and greater reliance on business investment and exports more generally. Economic conditions will be softer in the lower mainland as the real estate boom deflates. A key downside risk is whether this rotation in provincial growth drivers can be achieved smoothly.

WORLD ECONOMY BRACES FOR TIGHTENING FINANCIAL CONDITIONS AND TRADE TENSIONS

Global GDP growth is expected to moderate from around 3¾% in 2017 and 2018 to 3½% or perhaps a bit less in 2019 and 2020. While this still counts as solid growth, it is a mark-down from early last year when growth was expected to accelerate to around 4%. The downgrade reflects headwinds from tightening financial conditions and uncertainty about trade relations (including their implications for the huge and opaque Chinese economy). Forward-looking indicators of global manufacturing activity are positive, but much less so compared to a year ago. These developments, along with an unusually turbulent political environment in the United States, have rattled financial markets over the past quarter. Valuations contracted in global equities, the U.S. corporate debt market shows signs of a nascent credit crunch (see our recent blog), and the U.S. yield curve has flattened.[2]

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[1] TD Economics.
[2] The slope of the yield curve is the difference between long-term and short-term yields for bonds of the same credit quality. The slope summarizes much information about the future state of the economy, inflation expectations and risk premia into a single indicator. Historically, an inverted slope (long-term yields less than short-term yields) tends to predict economic downturns within about a year. However, the slope can shift for several reasons, so its predictive ability has to be interpreted with caution (see Benzoni et al. 2018).

The **United States** economy has been operating above capacity for the last year or so. The unemployment rate is at a 50-year low of 3.7%. Median wage growth is around 4%, the fastest pace since before 2008. GDP growth is expected to cool and converge to potential GDP growth, as the effects of tighter monetary policy are felt and the effects of the November 2017 tax package fade out.[3]

On December 19, the U.S. Federal Reserve raised its policy rate to 2.25-2.5%. The Fed highlighted strong labour markets and robust household spending, with some moderation in business investment. Although there have been nine rate hikes since 2015, the real (inflation-adjusted) policy rate has only now reached zero. This is highly unusual given the strength of the American economy and the long expansion that began in mid-2009. To keep inflation close to 2%, the Fed expects two further rate hikes in 2019 and at least another one in 2020. It anticipates that monetary policy will be more "neutral" in its impact on the economy by 2020.[4]

Risks to the global outlook are slightly weighted to the downside. On the upside, improving labour markets in some advanced economies, resolution of trade disputes and a more gradual pace of monetary tightening by central banks could provide positive surprises for global growth. On the downside, the main risks are a disorderly unwinding of global financial imbalances (see our blog and previous BCERO) and/or a sustained disruption in trade and investment due to an escalation of the U.S.-China trade dispute.

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

	2017	2018e	2019f	2020f
World	3.8	3.7	3.4	3.5
Canada	3.0	2.1	1.8	2.0
U.S.	2.2	3.0	2.3	2.0
Euro area	2.5	1.9	1.5	1.5
Japan	1.9	0.7	1.0	0.3
China	6.8	6.6	6.2	6.0

f - forecast e - estimate

Source: TD Economics, Federal Reserve Board (for U.S.).

CANADA'S TWO ECONOMIES: ENERGY VS THE REST

Momentum ebbed in the Canadian economy in the second half of 2018. TD Economics estimates that the extraordinary price discount on western Canadian oil, and the oil production cuts by Alberta to cope with them, will subtract about 0.15 percentage points from Canada's GDP growth in 2019. This output loss is worth about CAD$3 billion.

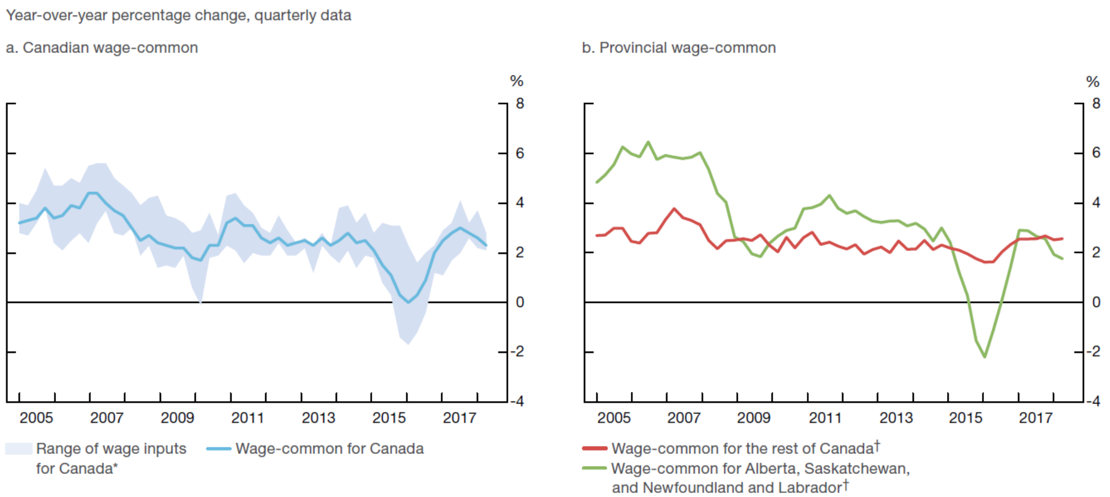
Outside of the Prairies, labour markets are tight. Canada's unemployment rate sat at a four-decade low of 5.6% in December and wage pressures and labour constraints are evident in many areas. The Bank of Canada's preferred wage growth measure shows that wages grew at 1.8% y/y in 2018Q3 in oil-producing provinces but at 2.6% y/y in the rest of Canada (**Figure 1**). Core measures of inflation are hovering around 2% per annum.

The Bank of Canada's winter *Business Outlook Survey* (BOS) indicates there is little idle capacity in the economy outside of oil-producing regions.[5] Canadian firms have seen faster sales growth over the past year and expect that pace to be sustained over the next 12 months. A sub-set of firms – those exposed to western Canadian oil prices and to housing in some regions – anticipate subdued or slowing sales growth.

In the winter BOS, a post-crisis record proportion (60%) of firms say they would face "some" or "significant" difficulty meeting an unanticipated increase in sales (**Figure 2**). Almost two-in-five firms reported a binding labour shortage that restricts their ability to meet demand. Most firms report that

[3] Potential GDP is the product of labour productivity (output per hour worked) and total hours worked. Growth in potential GDP is the natural "speed limit" on actual GDP growth. When actual GDP growth is above (below) potential GDP growth, it tends to lead to higher (lower) inflation. To stabilize inflation around a target, monetary policy tries to minimize the gap between actual and potential GDP growth.
[4] A neutral interest rate is the interest rate considered necessary to keep inflation stable and on target with an economy at full employment. At this point (or range), monetary policy has neither an expansionary nor contractionary influence on the economy.
[5] The *Business Outlook Survey* summarizes interviews conducted by the Bank's regional offices with the senior management of about 100 firms, selected in accordance with the composition of the gross domestic product of Canada's business sector. The winter survey was conducted from November 5-28, 2018.

FIGURE 1: **WAGE GROWTH REMAINS SOLID (EXCEPT IN OIL PRODUCING REGIONS)**



Wage growth 2018Q3 (y/y):

AB, SK and NL	1.8%
Rest of Canada	2.6%

Note: For details, see D. Brouillette, J. Lachaine and B. Vincent, "Wages: Measurement and Key Drivers," Bank of Canada Staff Analytical Note No. 2018-2 (January 2018), and J. Lachaine, "Applying the Wage-Common to Canadian Provinces," Bank of Canada Staff Analytical Note No. 2018-16 (May 2018).

* Wage data for the Canadian measure are from the Labour Force Survey; the Survey of Employment, Payrolls and Hours; the National Accounts; and the Productivity Accounts.

† Provincial wage data are from the Labour Force Survey; the Survey of Employment, Payrolls and Hours; and the National Accounts. Given the different information set, the provincial wage-common measures are not directly comparable with the Canadian wage-common measure. The provincial wage-common measures are weighted using Labour Force Survey employment shares to calculate regional aggregate measures.

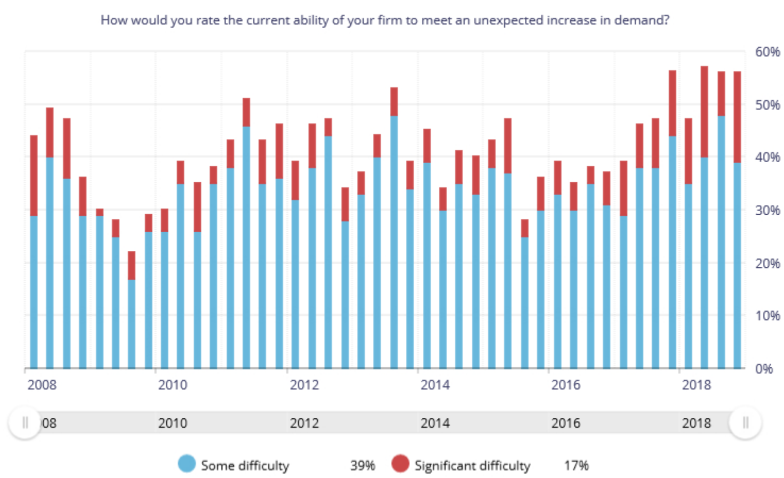
Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2018Q3

Source: Bank of Canada, Monetary Policy Report.

labour shortages are more intense than a year ago, except in the Prairies. Plans to increase investment and hiring over the next 12 months are quite widespread. Firms expect that these and other actions should alleviate and prevent further intensification of capacity pressures in the year ahead. Firms in Canada generally expect inflation to be in the upper half of the Bank's control range over the next two years (i.e. 2-3%).

FIGURE 2: **CAPACITY PRESSURES ARE WIDESPREAD AMONG CANADIAN FIRMS (EXCEPT IN THE PRAIRIES)**



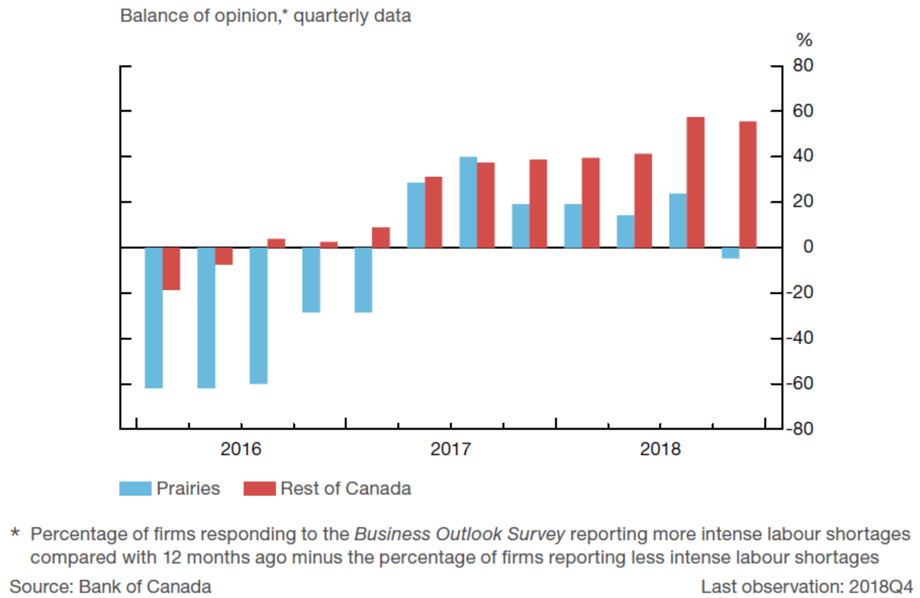
Source: Bank of Canada, *Business Outlook Survey*.

The Bank of Canada's policy interest rate is currently set at 1.75%, after five rate increases since July 2017. This is about zero after inflation: unusually low for an economy operating close to its potential. With little spare capacity in the economy (outside oil-producing regions), the Bank expects that, over time, it will need to move rates to a "neutral" nominal range of around 2.5-3.5% to achieve its inflation target. We expect rates to reach the bottom or mid-part of this range in 2020, including 1-2 rate hikes in 2019.

Risks to the Canadian outlook are slightly weighted to the downside. On the upside, external demand could yet provide greater than expected support, for example, due to a quick resolution of trade tensions or a slower pace of withdrawal of global monetary policy stimuli. On the downside, further escalation of trade tensions and faster tightening global financial conditions could dampen global growth. There is also concern over the impact of a chaotic BREXIT scenario in the U.K. Closer to home, as the Bank of Canada tries to wean the economy off many years of ultra-low interest rates, there could be a greater-than-anticipated slowdown or contraction in sectors that have been dependent on cheap and easily available credit.

The more fundamental, long-term challenge facing Canada is that potential GDP growth – the pace at which the economy can sustainably grow without generating above-target inflation – is only 2% (or less) per annum. This is paltry by historical standards. Canada's low growth "speed limit" reflects its faltering productivity growth over the decades (see Finlayson and Williams, 2018).

FIGURE 3: **LABOUR SHORTAGES ARE MORE INTENSE THAN A YEAR AGO (EXCEPT IN THE PRAIRIES)**



Source: Bank of Canada, *Business Outlook Survey*.

B.C. ECONOMY COOLS AS REAL ESTATE BOOM UNWINDS, BUT BUOYED BY LNG

Consistent with the slowing at the national level, B.C.'s economy will gear down slightly in 2019 followed by an acceleration to 2.4% real growth in 2020. The slowing in 2019, a continuation from 2018, mainly reflects a sharp downturn in consumer and real estate-related activities in the Lower Mainland and southern Vancouver Island. Without the boost from LNG, B.C.'s economy would be staring at several consecutive years of well below average growth as the real estate boom unwinds.

The LNG Canada project will help keep B.C. near the top of the provincial growth rankings in the next 2-3 years, as construction of LNG Canada's Kitimat export facility and the related pipeline gets underway. In 2019, we expect the early stages of the project will lift economic growth by 4 tenths of a percentage point, and by 5 to 7 tenths of a percentage point in 2020. Absent this massive capital project, B.C.'s growth profile would be more closely aligned with the national economy.

Beyond LNG, business investment is likely to be mixed, but with rising capital outlays in many sectors due to labour supply constraints and pressures stemming from automation and technological change. We expect growth in B.C.'s international merchandise exports to advance at a more modest pace, although there is downside risk due to wobbly commodity markets and potential escalation of trade wars. Key segments of service exports will help underpin the province's still respectable economic expansion: tourism, international transportation services, film and television production, and an array of other business services will all continue to grow at a solid clip.

The composition of provincial growth will shift away from credit and real estate-driven activity, concentrated in Metro Vancouver, and toward more reliance on business investment and exports. The northern regions will benefit disproportionally from LNG construction, related pipeline builds, more drilling activity in the gas patch, and the ongoing construction of the Site C dam. A key downside risk is whether this shift in composition of provincial GDP growth can be achieved smoothly.

LABOUR MARKET REMAINS TIGHT

Although the rate of job creation in B.C. slowed to 1.1% in 2018, about one-third of the pace registered over the previous two years, the labour market remains healthy. The slowdown in domestic consumer activity weighed on employment growth, but tight labour market conditions and hiring challenges also served to dampen employment growth. Notably, the unemployment rate dropped to near-record lows last year and is now the lowest among all provinces. B.C. also has the highest job vacancy rate in the country, another indicator of excess demand for labour.

Tight labour market conditions are showing up in faster wage growth. The all-industry average hourly wage rate rose by more than 4% in 2018, one of the biggest increases on record and nearly matching the gain registered in 2008. B.C.'s 2018 wage growth is also well above the national average and nearly twice the pace seen in Alberta. Another sign of tight labour market conditions is that firmer wage growth is broadly based, with gains of more than 4% in both the goods and services sectors.

Within the province, Metro Vancouver has seen the strongest job growth. Since the outset of 2015, employment in this urban region is up 13%. The number of people employed in Victoria is up 12% over the same period, although the Capital Region experienced employment losses for several years prior to 2015. Since 2015, Abbotsford and Kelowna have both seen employment rise by around 10%. Total employment in the remaining parts of the province (all areas outside of the four large Metro regions) is up a more modest 4.6%.

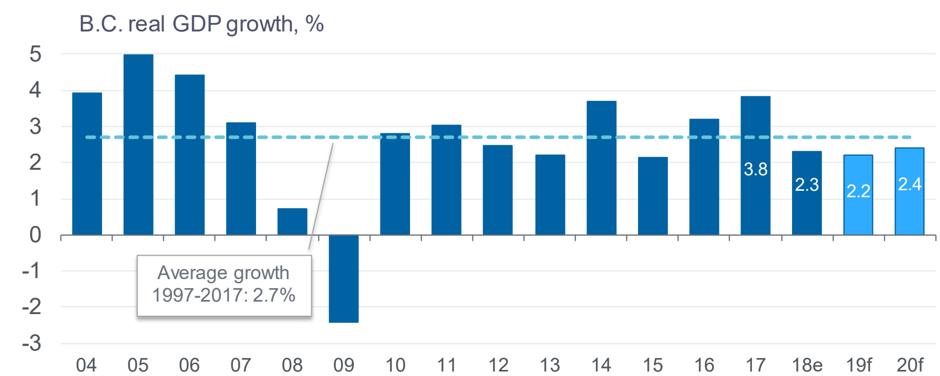
TABLE 2: **B.C. ECONOMIC OUTLOOK (ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)**

	2017	2018	2019f	2020f
Real GDP	3.8	2.3e	2.2	2.4
Employment	3.7	1.1	1.2	1.0
Unemployment rate (%)	5.1	4.7	4.4	4.6
Housing Starts (000 units)	40.1	41.0	36.0	37.0
Retail sales	9.0	2.4	4.0	3.9
B.C. CPI	1.7	2.7	2.3	2.2

f - forecast e - estimate

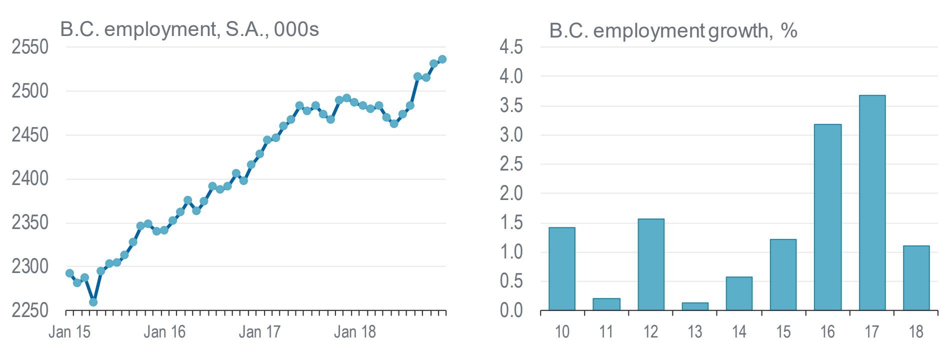
Source: Statistics Canada and BC Stats; BCBC for forecasts.

FIGURE 4: **DOWNSHIFT EXPECTED IN B.C. FOLLOWING A PERIOD OF STRONG ECONOMIC GROWTH**



Source: Statistics Canada, Table 36-10-0222-01, BCBC for forecasts.

FIGURE 5: **JOB GROWTH DOWNSHIFTS IN 2018**



Source: Statistics Canada, Labour Force Survey. Monthly data are seasonally adjusted.

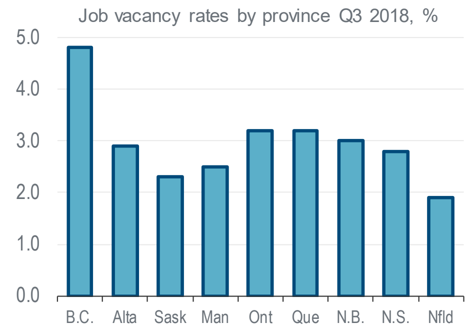
In 2019, tight labour market conditions and upward pressure on wages will persist. We expect job growth in the "non-metro" parts of the province to pick up but to ease in Metro Vancouver. Over the next few years, job growth may become tilted to areas outside of Metro Vancouver, particularly the North. This call goes against a multi-decade trend of job growth being concentrated – at times almost exclusively – in the Lower Mainland. The LNG Canada project in particular will generate thousands of jobs in relatively small northern job markets.

THE URBAN REAL ESTATE BOOM UNWINDS

The turnover of existing homes (i.e. resales) in the Greater Vancouver Real Estate Board fell nearly 32% in 2018. The Fraser Valley Real Estate Board saw a similar decline. In other parts of B.C., the slowdown in resales was not as steep, but rising interest rates and more limited credit access are still dampening turnover in most areas. Also, as demand for established housing ebbs, average or benchmark home prices have fallen between 5% and 10% in major urban centres across B.C., with more declines likely in store in 2019 (especially in inflation-adjusted terms).

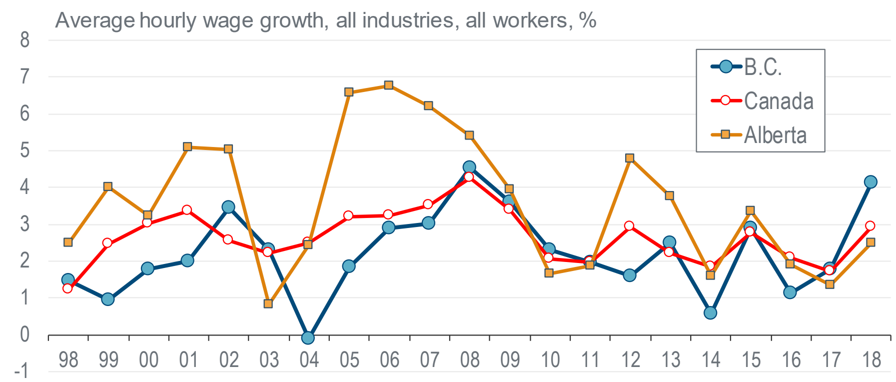
New residential construction, which for several years has been running around a record share of GDP, will also ease in 2019. The longer-term outlook for construction remains solid, however. Housing construction will be supported by record immigration levels and government plans to build more public housing.

FIGURE 6: **RISING JOB VACANCY RATE IN B.C.**



Source: Statistics Canada, Job Vacancy and Wage Survey.

FIGURE 7: **B.C. WAGE GROWTH JUMPS IN 2018**



Source: Statistics Canada, Labour Force Survey.

FIGURE 8: **HOUSING STARTS SLOW**

Latest: November 2018. SAAR = seasonally adjusted annual rates, 3-month moving averages.

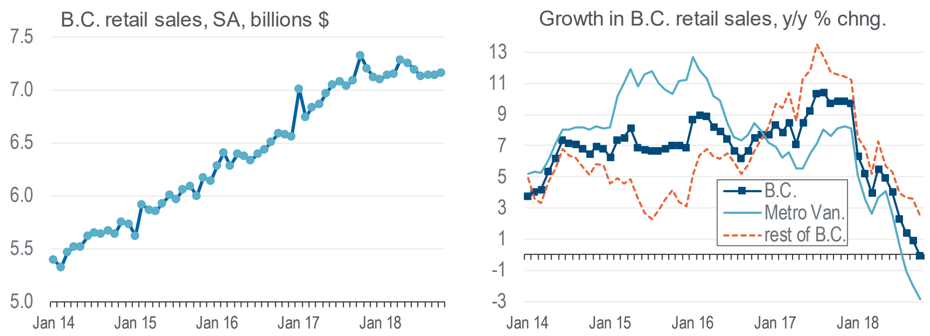
Source: Statistics Canada.

B.C.'S TWO CONSUMERS: METRO VANCOUVER VS THE REST

Retail sales in B.C. have flatlined for a year, following brisk growth for several years. Record household indebtedness along with higher interest rates have cooled spending enthusiasm, especially in Metro Vancouver (see below). Provincial consumer spending has fallen sharply for discretionary, big-ticket items: spending on autos and related products is down 7% y/y. The slowdown in resales (i.e. turnover of existing homes) has contributed to the 4% pull back in furniture and household furnishings sales and the 2% drop in electronics and appliance store sales. Building material retailers are also feeling the impact of reduced enthusiasm for renovation activity, with sales off by 2% y/y.

The pull-back in retail spending is most significant in Metro Vancouver, where the real estate boom was concentrated and is now visibly unwinding. Metro Vancouver retail sales are down almost 3% y/y. Spending on autos and parts is down 13% y/y, spending at building material and supplies stores is down 8% y/y, and spending at furniture and home furnishing stores in the Metro region is down 9%. However, in the rest of the province, the picture is more positive. Retail spending is growing above 2% y/y outside of Metro Vancouver. Spending on autos and parts is up 1% y/y, spending at building material and supplies stores is up 5% y/y, also up slightly is spending at furniture and home furnishing stores.

FIGURE 9: **GROWTH IN RETAIL SPENDING FLATLINES**



Growth rates calculated from 3-month moving averages.

Source: Statistics Canada.

GROWTH ROTATION TO BUSINESS INVESTMENT AND EXPORTS UNDERWAY

As noted above, we expect business investment to pick up and make a more meaningful contribution to economic growth in B.C. in the years ahead. Some support for this contention comes from the fact that non-residential building permits in the province advanced 20% in 2018. This increase was largely driven by Metro Vancouver, in particular a 46% jump in commercial building permits in the region. However, the value of non-residential permits in the rest of the province rose almost 7% last year. This comes on the heels of a 15% jump in 2017.

Early stage impacts of the LNG plant in Kitimat are evident in the building permit data. Outside of Metro Vancouver, the value of Industrial building permits grew 20% in 2018. And in the North Coast, industrial permits have already soared nearly 800%. Interestingly, industrial permits also increased by 300% in the Cariboo and by 20% in the Northeast. Commercial building permits are up 12% province-wide.

On the trade front, B.C.'s international merchandise exports trended higher throughout 2018, leaving exports 7% above where they stood in 2017 (based on 11 months of data through November). The upswing was widespread. Apart from wood products and energy products, all commodity categories recorded double-digit gains in 2018, notwithstanding softer global commodity markets. The value of wood products exports was roughly even with the previous year, but this follows seven to eight years of surging growth in this segment. Lumber exports have weakened amid stagnant U.S. housing construction and lower lumber prices over the past several months, however. The value of exports of energy products was up a modest 2.5% in 2018, as a decline in natural gas shipments (reflecting lower prices) pulled down the sector.

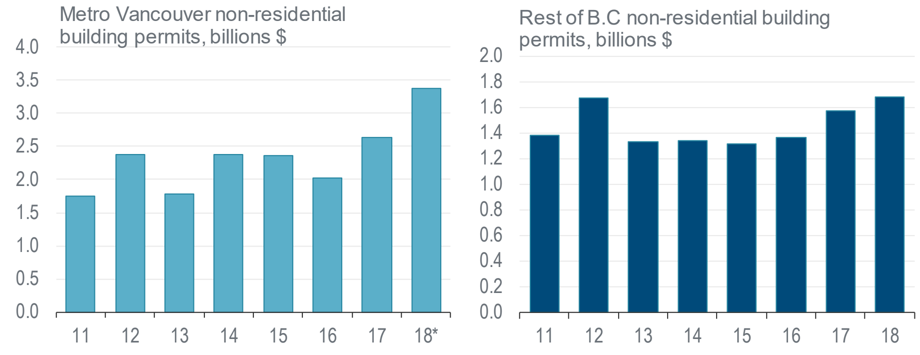
Exports to most of B.C.'s major markets were up in 2018. Sales to the U.S. advanced 2.7%. Exports to China and Japan were up 5% and 15%, respectively. The biggest increase of any market was India, which saw a 53% jump in exports. India is now B.C.'s fifth largest export market, with exports reaching $1.5 billion in 2018.

We are optimistic about service exports and some other elements of the province's export sector. The low Canadian dollar will support exports of engineering, environmental, architectural and other business services that have become a more substantial part of the province's export base. Film and television production should continue to do well, although outsized growth in this sector has left the industry capacity-constrained. Tourism is expected to remain a key growth industry, supported by rising middle class populations in Asia as well as more Americans attracted to B.C. by the lower Canadian currency.

POPULATION GROWTH AND INTERPROVINCIAL MIGRATION

The net inflow of people into B.C. from other provinces has steadily slowed over the past six quarters and recently dipped into negative territory (more people left B.C. than came here). Considering B.C. has had the strongest job market in the country and been a growth leader within Canada, the net outflow is unusual and does not fit with normal historic patterns. We speculate that painfully high housing costs in urban areas of B.C. are a "push" factor, deterring some young adults from relocating to B.C. and prompting some British Columbians to pursue their careers in other provinces.

FIGURE 10: **HIGHER PERMIT VALUES POINT TO MORE CONSTRUCTION ACTIVITY**



* 2018 estimated based on January to November data.

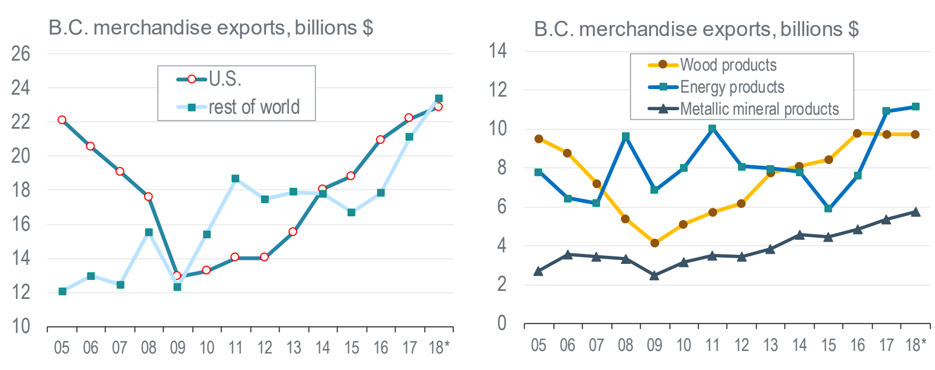
Source: Statistics Canada, Table 34-10-0066-01.

FIGURE 11: **MERCHANDISE EXPORTS TRENDING HIGHER**

Latest: November 2018. S.A. = seasonally adjusted.

Source: B.C. Stats.

FIGURE 12: **BROADLY BASED GAINS FOR MERCHANDISE EXPORTS**

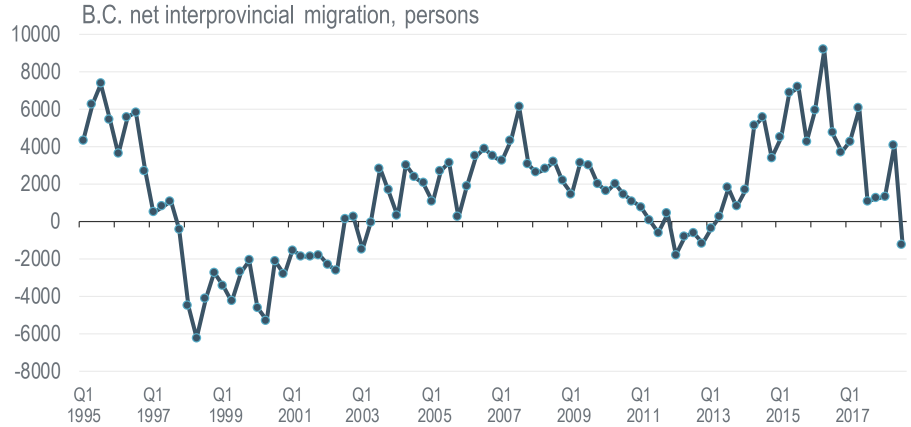


* 2018 data estimated based on January to November exports.

Source: B.C. Stats.

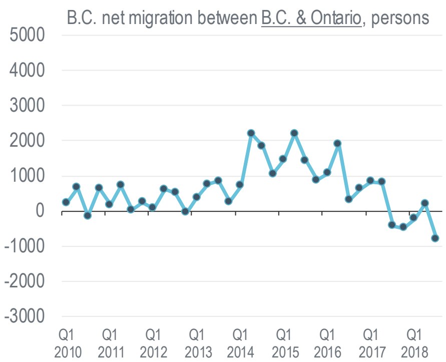
The majority of B.C.'s interprovincial migration occurs with Alberta and Ontario. In both cases, net migration with B.C. is now negative. B.C.'s overall population, however, is still growing by about 1.4% annually, due mostly to high levels of international immigration. In contrast to the interprovincial flows, B.C. continues to attract significant numbers of immigrants, with international migration bringing about 40,000 plus permanent residents to the province every year. There are also large numbers of non-permanent foreigners in the province (students, temporary foreign workers, etc.).

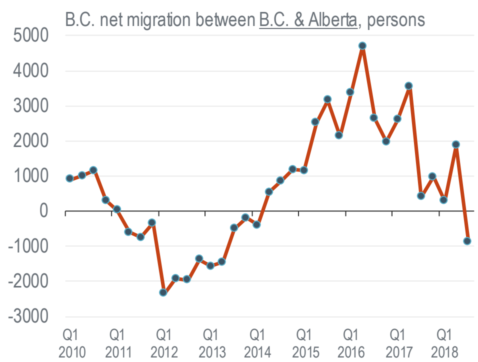
FIGURE 13: **MORE PEOPLE MOVING OUT OF B.C.**



Source: Statistics Canada. Table: 17-10-0020-01. Latest Q3 2018.

FIGURE 14: **...AS BOTH ALBERTA AND ONTARIO ATTRACT B.C. RESIDENTS**





Source: Statistics Canada. Table: 17-10-0045-01. Latest Q3 2018.

CONCLUSION

As we enter 2019, the economic setting and outlook for the province are reasonably positive, despite some external headwinds and domestic challenges. The global economy is slowing but should continue to grow at a moderate pace. The same is true for the United States – and for Canada as a whole. Market forecasters expect interest rates and borrowing costs in North America to rise, but not by much following the sequence of rate hikes already seen over the last two years. A Canadian dollar trading in the range of 74-77 cents U.S. will continue to supply a competitive edge to many exporters operating in B.C. and other provinces.

Looking more specifically at B.C., the industrial and regional dynamics of growth are changing. The multi-year real estate boom is unwinding and affected sectors are likely to detract from overall GDP growth in 2019 -- and perhaps 2020. Consumer spending has also cooled amid slumping real estate markets, higher interest rates and tighter access to residentially-secured credit. The province has recorded solid growth in both merchandise and service exports, although we anticipate more muted gains over the next two years. Business investment should pick up, as the massive LNG Canada project gets under way and more companies step up capital spending in the face of intense competitive pressure, digital disruption, and cyclically tight labour markets. This year, the Business Council forecasts real GDP growth of 2.2%, down slightly from 2018. In 2020, we see somewhat stronger growth, 2.4%, as the LNG Canada project advances. Regionally, the lower mainland is set for softer economic conditions as the real estate and retail sectors take a step back. In contrast, parts of the north will do better as large energy and infrastructure projects move ahead.

The perspective underlying the 2019-20 forecast is necessarily short-term in nature. However, it is important to consider medium- and longer-term trends that will affect future growth and prosperity in British Columbia. Many business leaders are concerned about the erosion of Canada's –

including B.C.'s – competitive position at a time of rapid technological change, mounting protectionism, and significant shifts in American tax, regulatory and energy policies. In the last two years, Canada has suffered large capital outflows, as companies keen to invest increasingly choose other locations. The business tax advantages that Canada long had vis-à-vis the United States have completely disappeared. The corporate head office sector is shrinking – nationally, and in B.C. as well.

Canada, including B.C., has acquired a reputation as a jurisdiction where regulatory and legal regimes are increasingly hostile to industrial and infrastructure development – and where the costs of doing business are rising across-the-board, as evidenced by B.C.'s new Employer Health Tax which comes into effect this year, as well as escalating energy taxes. So far, governments have done little to acknowledge, let alone address, the taxation, regulatory and other competitiveness challenges that are holding back business growth and new investment. This must change if national and B.C. policymakers aspire to build a more productive and prosperous economy in the decades ahead.

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