Amid External Headwinds, BC's Economy Is Holding Up Well

Highlights

- The outlook for the global economy has been trimmed since early 2015, due to a slow start for the US economy, weaker growth in China and softer conditions in many other emerging market economies.
- Because of the setback in the first part of the year, the US economy is now projected to grow by 2.5% (much slower than forecasts at the outset of the year).
- The Canadian economy has been hit by the oil price slump and is now expected to expand by a tepid 1.1% to 1.5% (in its just released Monetary Policy Report, the Bank of Canada's forecast was at the bottom end of that range).
- Against the backdrop of a slower global economy and subdued growth in Canada, economic activity here in BC is holding up reasonably well.
- In light of sluggish external conditions, we have downgraded our outlook for BC and now expect real GDP to climb by 2.4% this year (compared to our forecast of 2.6% in January).
- The depreciating Canadian dollar is helping to lift BC's exports to the US. Tourism is also a bright spot in the provincial economy.
- BC's economic growth rate should pick up to 3.1% in 2016, driven in part by early stage construction of at least one large LNG plant and an improving US economy.

Against the backdrop of a choppy and risk-prone global economy and decelerating growth here in Canada, British Columbia is holding its own. As a small trade-oriented jurisdiction, the province is certainly not impervious to the economic headwinds, whether they blow globally or from within Canada. Sluggish commodity prices and the oil-driven recession unfolding in Alberta and Newfoundland are affecting all regions of Canada and have prompted us to trim our growth BC outlook relative to expectations back in January. However, by Canadian standards British Columbia looks well-positioned for a decent economic performance over the next 18-24 months.

External Setting

The international economic picture has deteriorated since late last year.[1] The first quarter yielded disappointing results, particularly for the United States and China.[2] Forecasters have been downgrading their projections for world economic growth, with the International Monetary Fund's latest predictions summarized in Table 1. Weaker growth across

[1] As summarized in the July 2015 economic update from the International Monetary Fund at www.imf.org/external/pubs/ft/weo/2015/update/02/

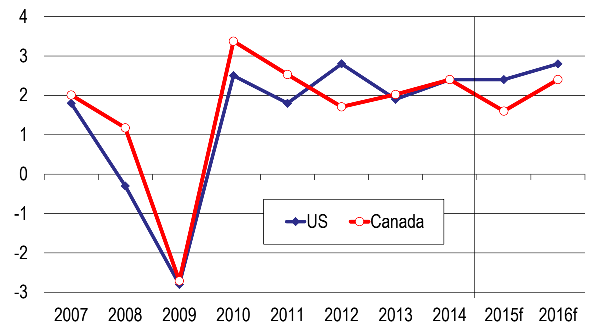
[2] Canada also had a poor Q1, with real GDP contracting by 0.6% annualized.

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

	2014	2015f	2016f
World	3.4	3.3	3.8
US	2.4	2.5	3.0
Euro area*	0.8	1.5	1.7
Japan	-0.1	0.8	1.2
China	7.4	6.8	6.3
Emerging market economies (all)	4.6	4.2	4.7

*19 EU member states collectively f - forecast
Source: IMF, July 2015 update

Figure 1
Canada and US Economic Growth
per cent



Source: Statistics Canada for history, forecasts are averages of forecasts from BMO, CIBC, RBC, Scotiabank and TD.

many of the emerging markets is an important factor behind the relatively subdued global outlook.

One piece of good news is the return to positive (albeit still tepid) economic growth in the Euro area, notwithstanding the never-ending Greek crisis and intractable high unemployment rates in a number of European countries. Aggressive monetary stimulus by the European Central Bank and a more competitive Euro exchange rate have diminished previous deflationary pressures. Better economic conditions in much of Europe and an upside growth surprise in Japan in Q1 are helping to offset the effects of slower growth in most of the emerging economies. Beyond the short-term, there is hope for some momentum to build in the world economy, with most forecasters anticipating that global output will expand by at least 3.5% in 2016.

Canada Hit by Oil Slump

The dramatic and protracted decline in oil prices and the associated slashing of energy-related capital investment are reverberating throughout the Canadian economy – an economy that became significantly more "energy-centric" in the decade up to 2014.[3] The soft start to 2015 in the United States has also been weighing on Canada. Accordingly, Canadian forecasters have been revising down their projections for real GDP growth in 2015, from 2% plus in January to something in the range of 1.0-1.5% in the past few weeks. In its July 2015 Monetary Policy Report, the Bank of Canada forecasts growth of just 1.1% for the year.[4]

Canada's economy should gain a bit of traction in the second half of 2015. The current economic weakness is not widespread – it is concentrated in oil-producing provinces, in energy related capital spending, and in non-agricultural commodity exports. Decent job numbers, some gains in retail spending, and continued high levels of activity in the housing sector suggest that Canada is not experiencing a true economic downturn, even though the economy may have slipped into a "technical recession[5]" over the first six months of 2015.

[3] By 2013, energy accounted for one-quarter of Canada's merchandise exports, with crude oil representing more than 75% of all energy-related exports. Two decades ago energy made up less than 10% of Canadian merchandise exports.

[4] Measured on an average annual basis.
[5] Defined as two consecutive quarters of declining real GDP.

Table 2
Canadian Economic Forecast
(annual % change unless otherwise indicated)

	2014	2015	2016
Real GDP	2.4	1.5	2.2
Consumer spending*	2.7	2.1	2.3
Business investment+	0.2	-6.2	2.4
Employment	0.6	0.8	1.0
Housing starts (000 units)	189	184	180
CPI inflation	1.8	2.3	2.1

*real dollars + real dollars, non-residential capital spending
Source: BMO Capital Markets Economics July 10, 2015

Looking to 2016, the Bank of Canada has clearly signalled its intention to maintain a near record-low short-term policy rate (now set at 0.5%) for some time. Coupled with the depreciating Canadian dollar and improving US economy, this should pave the way for a pick-up in Canadian growth later this year and into 2016. Table 2 provides a recent forecast from a major Canadian bank.

BC's Economy is Holding Up

In our January outlook we argued that the sharp drop in oil prices would give an overall boost to household and business spending in British Columbia. This was based on our view that tumbling oil prices would translate into tangible savings at the gas pump for grateful consumers. However, gas prices in BC have not fallen as much as we had assumed, and the savings accruing to consumers have been fairly meagre so far. Having said that, retail spending in the province has been buoyant, so perhaps even the modest energy-related savings recorded to date have bolstered consumer confidence and are helping to spur spending in other areas.

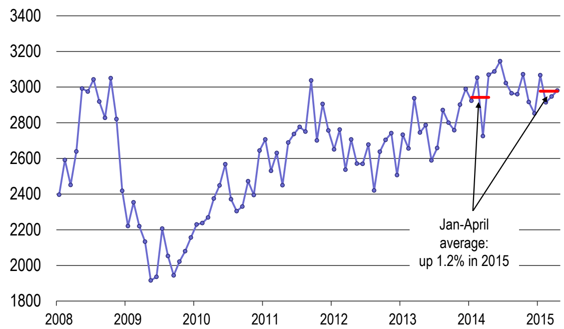
The plunge in oil prices since mid-2014 has pushed Alberta and Newfoundland into outright recessions and put a lid on growth in Saskatchewan. The oil-related downturn is not centred on BC, which produces little crude oil, but we are still feeling some of the effects. Several hundred BC companies sell goods and services into the oil sector, and tens of thousands of British Columbians work in Alberta's energy patch. Dramatic reductions in capital spending by oil producers and a steady drum-beat of layoffs in the energy sector are a negative for BC. Our province also exports significant quantities of natural gas to Alberta that is used in oil extraction and processing. To the extent that oil output in Alberta is scaled back (which hasn't happened yet), natural gas production in this province stands to take a hit.

Weak Energy Sector Dampens Exports

Some of BC's export-oriented industries are benefitting from the lower Canadian dollar and a healing US economy. However, dismal natural gas markets and low prices for coal and many base/precious metals are dampening the province's export performance, with the value of international merchandise exports up just 1.2% for the first four months of the year compared to the same period in 2014. Exports to the US are down slightly year-to-date in dollar terms. Exports to China are 2.8% higher, while those to Japan have risen by 5% -- one of the strongest gains among all of BC's export markets.

The small setback in exports to the US has been driven by falling natural gas shipments, which mainly reflects low North American prices for the commodity. Apart from natural gas and pulp, exports of all other commodity groups to the US have been growing this year. Wood product exports are up 20%, machinery and equipment shipments are up by a similar amount, and exports of metallic mineral products have advanced 24%. Natural gas exports to the US have tumbled by 50%, however, which has basically cancelled out the gains in other export categories. If natural gas is stripped out, the value of BC's merchandise exports to the US is nearly 11% higher than last year. More generally, the United States is re-asserting its traditional

Figure 2
BC Merchandise Exports
billions $



Source: BC Stats.

primacy in BC's export mix as the American economy revives and our exports to China have slowed. We expect this pattern to persist over 2015-16.

Although the total value of BC's mineral product exports is up so far in 2015 versus year-ago levels, this is mainly due to a rise in zinc export receipts. Exports in other segments of the mining industry have dwindled. Total mining-related exports are projected to slide further in 2015 compared to 2013-14, owing to low prices for coal and some base metals and a recent decision by BC's biggest mining company to scale back coal production.

On the other hand, BC's exports of non-resource manufactured products, wood products and agricultural goods should continue to rebound. In aggregate, the province's international merchandise exports are expected to increase modestly this year and again in 2016, supported by a lower Canadian dollar and a stepped up pace of economic activity in the US.

It is sometimes forgotten services have become a substantial part of BC's export base, although they are not captured by the data on merchandise exports referenced above. The Business Council sees exports of services as a key engine of growth for the province going forward. Here, the Gateway sector – BC's ports, the related rail, trucking and other logistics industries, as well as Vancouver International Airport – is a major contributor, along with tourism and an array of professional, business, technical and other high-end services.

Tourism stands out as a notable bright spot for British Columbia. With Americans benefitting from a 20% plus currency-induced discount when travelling in Canada, the number of US visitors to the province was up almost 10% through the first four months of 2015. Increases in visitor numbers from Asia (5%) and Europe (2%) are more modest, but nonetheless welcome. We are optimistic about the prospects for tourism in BC. Apart from more US visitors, an expanding middle class in emerging Asia should drive growth in the tourism sector. In addition, more Canadians will be holidaying at home thanks to the Loonie's waning international buying power.

Domestic Economy

Turning to the domestic side of the BC economy the story is generally positive, notwithstanding worries about consumer debt levels, somewhat sluggish job growth, and housing affordability issues in the lower mainland.

It has been challenging to make sense of the province's job market. The total number of people working has shown only muted growth over most of the past year, which is puzzling given other indicators pointing to a reasonably healthy economy. Statistics Canada's flagship Labour Force Survey indicates that total employment was up by less than 0.5% over the first half of 2015, although the pace of job creation did accelerate in May-June. The number of employees in the private sector rose in 2014 and is continuing to inch higher in 2015. Public sector jobs are down 1.9% so far this year. Self-employment is up 3.7%, following a sizable contraction in 2014. Swelling self-employment is sometimes viewed as a sign of underlying softness in the labour market.

There is reason to believe the job market is stronger than the LFS data have been suggesting. An alternative labour market survey of employers indeed points to sturdier job growth.[6] The Survey of Payrolls, Employment and Hours shows the number of payroll employees climbing by 1.8% over the first four months of 2015, compared to the same period last year. This paints a brighter picture of the labour market than the LFS data discussed earlier.

One of the strongest current economic indicators for BC is consumer spending. The value of retail sales has jumped, posting some of the biggest annualized gains in a decade. If the SEPH data are a more accurate reflection of the state of the job market, then it follows that moderate growth in payroll employment may be boosting retail activity. We believe pent-up demand for consumer goods is also helping to buoy retail sales, as is a significant drop in cross-border shopping (which implies that a portion of some BC households' budgets is being diverted back into the local retail marketplace).[7]

Auto sales have been a hot spot in the retail landscape. Sales at new and used auto dealerships across BC were up 13% in the first four months of 2015 compared to last year. Auto sales are a useful indicator to track as they account for one-fifth of all retail spending.

We expect the momentum in retail spending to continue in the coming year, aided by low interest rates, an uptick in population growth, and further declines in cross-border shopping.

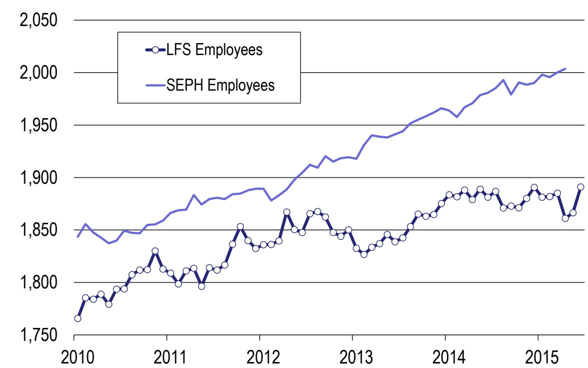
The BC housing market has strengthened in recent quarters and looks set for further gains as mortgage rates plumb new depths and demographic growth underpins housing demand. Thanks to brisk sales, new home construction in BC has risen. Housing starts are running at annualized rate of 30,000 units, which has caused us to revise our forecast for housing starts from 27,000 units in 2015 to 29,500, with a similar number projected for 2016.

A higher population growth rate will also assist in creating an environment that is supportive of domestic demand. British Columbia should continue to see international immigration of

Figure 3

BC Employment (two different surveys)

000s

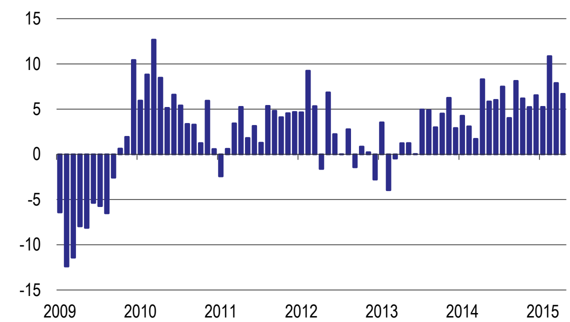


Source: Statistics Canada, Labour Force Survey and Survey of Employment, Payroll and Hours.

Figure 4

BC Retail Sales Growth

annual % change



Source: Statistics Canada. Latest: April

[6] Statistics Canada's widely cited Labour Force Survey is based on a household survey.

[7] Jock Finlayson and Ken Peacock, "Lower Canadian Dollar Dampens Cross-Border Shopping," Business Alert, Business Council of BC, June 23, 2015; available at www.bcbc.com

35,000-40,000 per year, but the more interesting story is interprovincial migration. In the first quarter of 2015, BC saw the biggest net inflow of people from other provinces in a decade. Faster population growth should translate into fairly robust retail sales and additional increases in new home construction in the next 12-18 months.

One area of economic weakness is non-residential investment. While the provincial government's Major Project Inventory features lengthy lists of current, planned and proposed capital projects, the real investment picture is more sobering. According to Statistics Canada's investment intentions survey, capital spending is slated to slip by 6.3% in 2015 – a steeper decline than the 4.9% drop expected at the national level. Much of the drop in planned investment is the oil and gas sector. Capital spending is projected to rise in a few industries (including wood products and wholesale/retail trade).

Looking beyond 2015, there remains the strong possibility that one or more of the several proposed multi-billion dollar LNG projects on the books in BC could advance to the construction phase. In our updated forecast (summarized in Table 3), we assume that one large LNG project commences by mid-2016.

BC Could Top the Provincial Growth Rankings

We have lowered our real GDP growth forecast for 2015 from 2.6% to 2.4%, largely because of the still sputtering global economy and weak commodity markets. That British Columbia can still achieve reasonable GDP gains in the midst of a "slow growth" world and generally low commodity prices testifies to the economy's underlying resilience. For 2016, we see real GDP increasing by just over 3%, as some work on LNG facilities and related pipeline construction begins later in the year. Tourism, wood products, non-resource manufacturing, and the advanced technology sector will also contributing to a stronger overall growth profile.

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

	2014	2015f	2016f
Real GDP	2.3e	2.4	3.1
Employment	0.9	0.6	1.1
Unemp. rate (%)	6.1	6.0	5.9
Housing starts – (000 units)	28.0	29.5	29.0
Retail sales	5.5	5.5	4.0
BC CPI	1.2	0.8	1.5

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

Canada's major oil producing provinces are clearly struggling, and the ongoing reductions in energy-related capital spending and employment are being felt right across the country. While the oil slump is affecting BC, our increasingly diverse industrial base and above-average population growth rate mean that the province should easily outperform Canada as a whole in both 2015 and the following year.

In summary, our updated analysis posits that BC will experience roughly the same rate of economic growth this year as in 2014. Considering the challenging external environment, this is a respectable showing – one that hinges on a reviving US economy, a more competitive exchange rate, and low interest rates. In 2016, the province can look forward to stronger growth as a handful of major investment projects move ahead.

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