BC More Than Holding Its Own Amid Global Economic Turbulence

At a time of pronounced uncertainty, BC's economy continues to grow and to outperform most other North American provinces and states. Conditions, however, are mixed across different industry sectors and regions of the province. A decelerating global economy and a softening domestic housing market will weigh on BC's growth over the next two years. At the same time, a high level of major project activity, an expanding mining industry, and continued growth in tradable services and advanced technology should provide a lift. The provincial labour market is also in decent shape, which should help to support consumer spending going forward.

Although there are significant downside risks, BC's economy remains surprisingly resilient. With a rapidly shrinking deficit and a credible plan to return to a balanced budget, BC's fiscal position is sound. The export sector is becoming more diversified, both in terms of products and markets, with BC's gateway role and multiplying linkages to Asian markets among the key positive factors. Immigration, although down, continues to underpin steady population growth.

Back in January, we expected that financial turmoil in Europe would continue, that global growth would ease, and that the US recovery would remain sluggish. These assumptions, which were built into our January projections, have been confirmed by subsequent developments. Global economic forecasts have been trimmed over the past few months, prompting us to lower expectations for the province's export performance over 2012-13. The domestic side of the economy, however, has been perkier than we anticipated six months ago. The net result is that we are sticking with our earlier forecast that BC will post real GDP growth of 2.0% this year. But with a wobbly external backdrop and a slowdown in the local housing sector, we are lowering our growth forecast for 2013 from 2.6% to 2.2%.

An Unsettled and Risky World

Forecasts for the global economy are being pared back across the board. With more than half of the year behind us, the world economy is battling several headwinds that promise to dampen growth this year and next. In its most recent outlook, the International Monetary Fund observes that "an already sluggish global recovery shows signs of further weakness, mainly because of continuing financial problems in Europe and slower-than-expected growth in emerging economies."[1] The IMF foresees the global economy expanding by 3.5% this year, down from its previous projections (but still higher than some private sector forecasts). This represents a material weakening in global growth compared to 2010-2011. For 2013 the IMF looks for slightly stronger growth of 3.9%, but this is also down from the Fund's official projections at the start of this year.

In its July 2012 Monetary Policy Report,[2] the Bank of Canada broadly concurs with the IMF's assessment of the international picture, pointing to continued disappointing growth in the United States, the ongoing financial and sovereign debt crisis in the Eurozone, and a sharper-than-anticipated slowdown in many emerging economies. Although Europe may be slipping into recession, Canada's prospects are more closely aligned to the United States, which still absorbs 73% of Canadian merchandise exports, compared to just 10% destined for Europe.

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[1] International Monetary Fund, World Economic Update (July 2012).

[2] Bank of Canada, Monetary Policy Report (July 2012).

Table 1
World Economic Forecast
(per cent change in real GDP)

	2010	2011	2012f	2013f
US	5.3	1.7	2.0	2.3
Euro area	1.9	1.5	-0.3	0.7
Germany	3.6	3.1	1.0	1.4
France	1.7	1.7	0.3	0.8
Italy	1.5	0.4	-1.5	-0.6
Spain	-0.1	0.7	-1.7	-0.3
UK	2.1	0.7	0.2	1.4
Japan	4.4	-0.7	2.4	1.5
China	10.4	9.2	8.0	8.5
World	5.3	3.9	3.5	3.9

Source: IMF, World Economic Update (July 2012).
f = forecast

The base-case scenario for the Bank of Canada – one shared by most other prognosticators – sees European policy-makers taking sufficient action to avoid a full blown financial collapse and unravelling of the Eurozone arrangements.[3] That said, Europe is the main risk to the economic outlook. While the results of the June 2012 Greek election signaled a desire to remain in the Eurozone, such an outcome is far from certain. Greece is insolvent, with a collapsing economy and public sector debt amounting to 160% of GDP. The country is being kept afloat, barely, thanks to financial aid packages overseen by EU authorities and the IMF. Most economists share the view of German Vice Chancellor Philipp Roesler, who recently opined that he is "very skeptical" that European leaders will be able to rescue Greece, and that the prospect of the country's exit from the euro no longer inspires "terror."[4]

Economic, fiscal and banking system challenges in Spain are also mounting. The country is in the midst of a painful multi-year recession. The government's tough austerity programs mean that no economic rebound is imminent. Unemployment stands at 24% (among youth, it is 50%). Spanish bond yields have reached record highs (10-year government bond yields in excess of 7.5%), some regional governments are pleading for assistance from Madrid, and the stock market is down 30% so far this year. If Spain is no longer able to tap the markets to finance its public sector deficits and roll over its sovereign debts (and to fund its banks), EU leaders are likely to face a full-scale crisis. A €100 billion bailout for Spain's banks has been agreed to, but it may not be enough.

In the Eurozone, the "peripheral" countries – Spain, Greece, Ireland, and Portugal – have been the primary focus of concern, although there are also worries about Italy's borrowing costs and access to the bond markets. But current economic indicators in Germany show that it is also losing steam and could even be tipping into recession, as exports are hit by the turmoil in Europe and slower growth in the emerging economies that are key markets for Germany's hyper-competitive exporters. Manufacturing activity across Europe as a whole has slumped to its lowest level since mid-2009, and the data for new orders point to worsening conditions over the balance of the year.

Turning to the United States, most forecasters expect growth to trundle along at a muted 2% trajectory for some time. Since the recession ended in mid-2009, America has experienced the weakest economic recovery in half a century. Disappointing Q2 growth of 1.5% (annualized) followed a decidedly modest 2.0% gain in Q1. There is little reason to expect a faster economic expansion over the rest of 2012 or the first half of 2013, although the markets seem convinced the Federal Reserve

[3] The Eurozone is made up of 17 out of 27 European Union countries that have adopted a single currency and operate with one central bank, the European Central Bank. The Eurozone members together account for about 17% of the world economy, while the bigger EU 27 group produces close to one-quarter of global GDP.
[4] Bloomberg, http://www.bloomberg.com/news/2012-07-22/germany-s-roesler-says-very-skeptical-greece-can-be-rescued.html

will soon launch another round of "quantitative easing" in a bid to stimulate confidence and spending and trim interest rates that are already setting record lows. Employment is rising, but an average monthly increase of 150,000 so far this year is not enough to lower the unemployment rate.

The winding up of the Bush tax cuts and other fiscal stimulus measures launched over 2008-10 will also work to dampen growth. There is uncertainty as to how the administration and Congress will manage this issue and the related debt ceiling debate. From a medium-term perspective, it is not clear whether the fractious and polarized US political system will be capable of defining and then implementing the fiscal policy reforms required to put Washington's finances on a sustainable footing.

American consumers represent 70% of economy-wide spending. Remarkably, over the past 18 quarters real consumer demand has advanced at a paltry average annual pace of 0.7%, compared to a 3.6% growth trend in the decade before the 2008 crisis.[5] Even with some growth in investment and net exports, it will be difficult for the giant US economy to gain much traction unless household spending kicks into higher gear. Unfortunately, median household net worth in the US plummeted by 39% from 2007 to 2011, which suggests a sharp revival in consumer spending is unlikely – although a pattern of slow improvement is feasible now that household de-leveraging is well advanced and the job market is showing signs of life.

Of significant concern to resource exporting nations is the near-term outlook for emerging markets, above all China – the world's most voracious consumer of a wide range of industrial commodities. The IMF expects China's real GDP growth to ease to a still robust 8% this year, although many other forecasters predict an outcome in the range of 7%-7.5%. Some pundits are questioning the validity of "official" Chinese GDP estimates because other measures, such as electricity consumption, suggest economic activity is slowing more significantly. Meanwhile, India's economy is visibly faltering amidst stalled reform efforts, political dysfunction and widespread and debilitating infrastructure bottlenecks. And Brazil's formerly hot economy appears to have stalled. The vaunted BRICS have lost a bit of their shine.

Canadian Outlook

For 2012-13, Canada's economic performance will be capped by sluggish US growth and some pullback in emerging markets. Financial instability in Europe will be felt via weaker exports and some spillover into domestic financial markets. The Bank of Canada projects that the economy will expand by 2.1% (after inflation) this year, rising to 2.3% in 2013. This compares to its April forecast of 2.4% growth for both years. Inflation should remain tame, although the ongoing drought across parts of North America will push up food prices. While the Bank continues to warn Canadians that interest rates will eventually climb from today's rock-bottom levels, most forecasters believe rate hikes will be pushed off until late 2013 or 2014.

On the upside, Canada's economy will benefit from continued exceptionally accommodative monetary policy, a well-functioning banking system, relatively healthy public finances, and the large capital investments that are flowing into resource and infrastructure development. Consumption and business non-residential investment are expected to be the principal drivers of growth in 2012-13. A shift to fiscal restraint as governments tackle budget deficits means the Canadian public sector won't be contributing much to top-line economic growth in the next couple of years.

[5] Stephen Roach, "America's Other 30%," Project Syndicate (July 31, 2012).

The strong Canadian dollar is working to temper export gains while exerting downward pressure on imported inflation. Now trading near parity with the US dollar, the Loonie is likely to remain near there for some time. For BC, our increasing trade and commercial orientation toward Asia has somewhat lessened the macroeconomic effects of a higher dollar compared to the situation 10 or 20 years ago.

A Mixed Industry-by-Industry Outlook for BC

Export-focused sectors will continue to have a significant influence on BC's economic performance over 2012-13. Unfortunately, slower global growth is already crimping exports, with the value of BC merchandise exports trending lower in the past six months. With the exception of China, exports to the province's major foreign markets are set to decline this year. And in the case of China, surging coal shipments are the only reason exports to the Middle Kingdom are expected to be higher on a year-over-year basis.[6] In contrast, lumber and pulp shipments to China have lost altitude year-to-date.

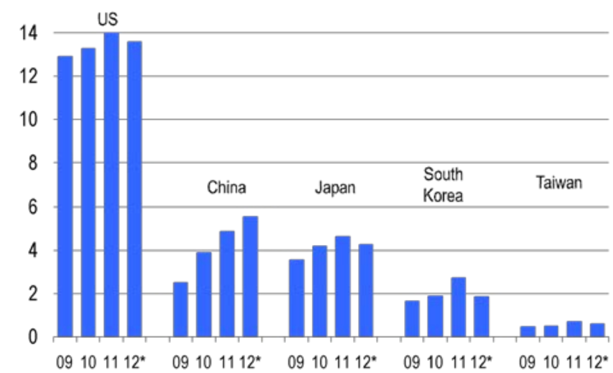
The US housing market has bottomed and a gradual recovery in homebuilding activity should continue. This has translated into a better pricing environment for BC lumber producers; so far this year there has been a roughly 10% increase in US-bound lumber exports. Most analysts believe the lumber market will see only modest additional gains over the next two years, as US housing starts slowly accelerate.

BC's machinery and equipment sales to the US are also up, as are exports of agricultural products and a number of smaller commodity groups. On the downside, natural gas exports are off, reflecting abysmally low prices as well as increased US domestic production and expanding supplies. Given the abundance of shale gas across North America and advances in drilling and production technologies, most analysts see prices remaining low. Thus, BC gas exports to the US may decline further – a prospect that underscores the need for the province to capitalize on growing Asian demand for natural gas. Thankfully, the government is pressing ahead on this front, with an aggressive strategy to develop the liquefied natural gas sector. But the economic benefits of this endeavour will come in the post-2013 period.

Figure 1

BC Merchandise Exports

billions $



Source: BC Stats. * projections based on Jan-May data

Mining continues to be one of BC's bright spots. In the next two years, activity in the sector should be boosted by a still generally positive price environment, the opening of new mines, and investments to expand/refurbish several existing ones. According to the Major Projects Inventory, there are eight new or expansion mining projects under way in BC. Mount Milligan, a copper-gold project northwest of Prince George, is the largest, with an estimated construction cost of $1.3 billion. Altogether, mining projects worth more than $3 billion are currently under way across the province.

[6] Over the first five months of 2012, BC's exports of coal to China soared by 327% on a value basis.

BC's forestry and wood products sector should continue to benefit from Chinese demand coupled with a recovery in US home-building. Lumber prices are poised to creep higher over the projection horizon. Pulp, another important BC export, has seen some slippage in selling prices.

Tourism is a significant part of the province's export base. Unfortunately, the industry is battling a number of headwinds, including the strong dollar, a muted US recovery, and mounting competition from other jurisdictions that are investing to build their own tourism sectors. The number of visitor entries from offshore countries has dwindled. Business volumes have dropped at the Vancouver Trade and Convention Centre.[7] Over time, there is scope to attract more tourists from China, Brazil, Mexico, and other up-and-coming emerging economies, but so far gains in these markets have not been enough to offset decreases in bigger and more established tourism markets.

Transportation and logistics in BC should continue to benefit from Asia's global rise and is expected to be a growth engine for the province over the rest of the decade. Sizable investments are taking place in the sector. A $200 million expansion of the Ridley coal terminal that began last August 2011 is nearing completion. The expansion of the Fairview Container Terminal in Prince Rupert has now commenced, at an estimated construction cost of $820 million. When completed, it will increase the Port of Prince Rupert's capacity from 500,000 TEUs to 2,000,000. Port Metro Vancouver plans to step up investment with its Delta Port Terminal, Road, and Rail Improvement Project. Vancouver International Airport is also investing to expand capacity and improve services.

Table 2

BC Economic Outlook

(annual per cent change unless otherwise indicated)

	2011a	2012f	2013f
Real GDP	2.9	2.0	2.2
Employment	0.8	2.0	1.9
Unemployment rate (%)	7.5	6.9	6.6
Housing starts – all areas (000 units)	26.4	27.0	25.8
Retail sales	3.1	4.3	4.5
BC CPI	2.4	1.9	2.1

a – actual f – forecast e – estimate

Sources: Statistics Canada and BC Stats; Business Council for forecasts.

BC's advanced technology industry is sometimes overlooked by economic analysts, but with 80,000 direct jobs the sector is an important part of the province's economic base, particularly in the lower mainland. A new report by KPMG estimates that the broadly defined high technology sector accounts for 6% of the province's GDP and has grown at an above-average annual rate of 5.7% over the past decade.[8] Growth may slow a bit over the next two years, but the province should continue to benefit from a diverse mix of technology sub-sectors and an abundance of entrepreneurial and technical talent in the sector. The film and television industry faces competitive challenges from the high valued Loonie, the pending elimination of the Harmonized Sales Tax, and enriched tax credits in some other North American jurisdictions. It will be fortunate to hold its own in the next couple of years.

Spurred by a growing list of major projects, BC's construction industry should see decent growth over the next few years. Performance will be uneven across the broad construction sector,

[7] This is seen as a temporary situation given the long-lead times for convention bookings.

[8] KPMG, British Columbia Technology Report Card 2012. Available at www.kpmg.ca

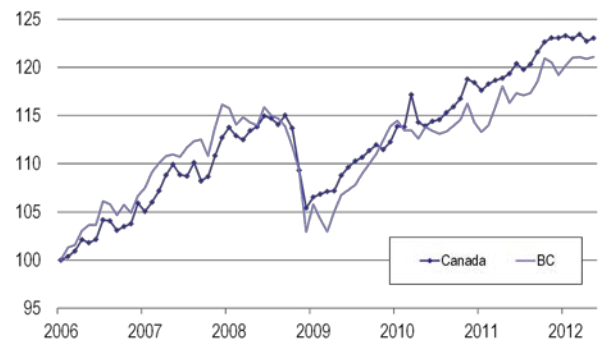
however. To date in 2012, non-residential building permits are lower compared to last year. And as discussed below, we expect new home construction to be flat or perhaps to fall slightly in 2013.

Consumers and the Job Market

Nationally, forecasters expect consumer spending to rise at a pace below the long-term average.[9] A similar scenario is anticipated here in BC. Consumer outlays are up over last year, but have been mainly flat in recent months. Still, year-to-date retail sales are 4.6% higher than in 2011, which has prompted us to nudge our retail spending forecast upwards (to 4.3% for 2012).[10] Looking forward, high household debt loads in BC are likely to weigh on consumer spending in the coming years; they could also pose a downside risk to the wider economy if interest rates rise more quickly than markets currently anticipate.

One reason BC has seen an uptick in consumption is because job growth has firmed. At the mid-point of 2012, employment was up 1.9% compared to the same period in 2011. The labour market has strengthened from last year, when job growth was an anemic 0.8%. Job creation has been better than we projected in January. That the number of employees in the private sector is up 2.6% year-to-date is particularly welcome. During much of the post-2008 period, job creation was mainly driven by public sector hiring. This is no longer the case: new jobs are emerging in both the public and private sectors. The number of self-employed is down, which is a positive sign since some of the self-employed are in that situation because they can't find paid work. It is also encouraging that full-time employment in BC has risen by 3% year-to-date, with part-time employment down 1.9%. This dynamic is associated with a strengthening of the underlying job market, and heralds better labour market conditions over the next year.

Figure 2
BC Retail Sales
Indexed 2006=100



Source: Statistics Canada. Latest: May 2012

Figure 3
BC Employment, monthly
thousands; seasonally adjusted

Source: Statistics Canada. Latest: June

[9] See, for example, the Bank of Canada's July 2012 Monetary Policy Report, and TD Economics, "A Little Less Growth for all Provinces" (July 9, 2012).
[10] This is higher than the most recent retail sales forecasts of some bank economics departments.

Figure 4

BC Housing Starts, monthly

units; seasonally adjusted

Source: CMHC, BCBC for seasonal adjustment. Latest: May 2012

We don't see the housing market adding to economic growth this year and it may detract from top-line growth in 2013. A steeper than expected decline in sales since January is one of the reasons we have pruned our housing outlook for 2013. Sales in the frothy Vancouver-area market recently fell to their lowest levels since 2000; in many other regions, home sales have slowed to the point where market conditions now favour buyers. Some economists argue that the Metro Vancouver housing market is "overvalued" by 10-15%,[11] suggesting a non-trivial possibility that the region could experience a few years of flat to falling prices, at least in certain sub-markets.

Notwithstanding a brighter employment outlook and very low interest rates, sales activity is projected to be weaker in 2013 than in 2012, which should translate into softer prices. In turn, this probably will cause developers to become more cautious and lead to a slightly lower number of housing starts next year. Figure 4 indicates that provincial housing starts may have settled into a demographically-driven range around 25,000 per year. Note that elimination of the HST and the planned return to the PST in April 2013 should not have much of an impact on home construction because the provincial government introduced measures to ease the transition and previously increased the HST threshold on new homes.

New Projects a Positive Factor

A number of large resource-related and infrastructure projects under way or imminent are expected to provide a boost to the economy over the next two years. But we shouldn't overstate the near-term impact, as many of these won't commence until after 2014.

Some significant projects that have already started and thus should add to GDP and employment over the forecast horizon include Rio Tinto Alcan's $3.3 billion upgrade of its aluminium smelter in Kitimat; the Northwest Transmission power line; the mining projects noted earlier; and several highway and other transportation-related projects and major investments.

Many other projects worth tens of billions of dollars are likely to proceed later in the decade. The most noteworthy are large liquefied natural gas (LNG) plants and associated pipeline infrastructure. We are optimistic that at least three LNG plants will be constructed to ship BC-produced gas to markets in Asia. These facilities and the related pipelines to carry the gas to the coast represent large investments that promise many years of construction activity.

Fiscal Policy

In our January outlook we noted that both the federal and provincial governments are restraining spending as they seek to move back to balanced budgets. Nothing has changed on this front. Restraint will temper overall economic growth, as both levels of government

[11] TD Economics, "Toronto and Vancouver: The Housing Markets that Have All Eyes Watching" (June 11, 2012).

transition from providing fiscal stimulus to a period of leaner increases in budgetary outlays. The province's 2012 budget outlined a plan to limit annual program expenditure increases to 2% over the coming three fiscal years – about half of the pace of the period preceding the recession. Consistent with the provincial government's overall fiscal policy stance, capital spending on schools, hospitals, roads, and other infrastructure is also slated to ease.

At the federal level, the government is holding program spending increases to 1% in 2012-13 and 1.4% the following year. To put this in context, recall that federal program spending rose on average by 6% annually in the years prior to 2009, before jumping by almost 18% in 2009-10 as Ottawa responded to the economic downturn.

While spending restraint will act as a drag on growth in the near-term, it is important to recognize that BC's prudent management of expenditures puts it in excellent fiscal shape and will deliver benefits in the future. The province ended fiscal year 2011-12 with a deficit of $1.84 billion, but this included a one-time repayment of $1.6 billion of HST transitional funding owed to Ottawa. Excluding this, BC would have posted a slim operating deficit of $241 million. The government should easily meet its target of balancing the budget in 2013-14. From a competitive vantage point, BC is well positioned in its fiscal position: it has reasonable taxes, a top-notch credit rating and a soon-to-be-balanced budget. The biggest competitiveness problem for the province lies in the extra business costs and added complexities that will come with the restoration of the PST next spring.

Concluding Thoughts

Our baseline projection for 2012 shows BC's economy expanding by 2.0% after inflation. We have not changed our forecast for this year because the softer external environment and export sector should be offset by firmer domestic conditions than we anticipated in our January forecast. For 2013, however, we have trimmed our growth outlook. It should be emphasized that the risks to our baseline forecast for BC are heavily tilted towards the downside, primarily because of the continued financial and sovereign debt crisis in the Eurozone – a crisis for which no resolution is presently in sight.

Although the risks and the near-term global outlook are worrisome, we are struck by the recent resilience of BC's economy and the province's comparatively good performance. Over the 2010-2011 period, real GDP growth in British Columbia averaged 3.0% (the 4th strongest in Canada, and among the best in North America). Although growth is expected to ease over the next 18 months or so, this underlying resilience should keep BC in a relatively strong economic position – even in the face of weaker external conditions.

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