BC ECONOMIC REVIEW AND OUTLOOK

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CREAKY SHIPS NAVIGATE CHOPPY WATERS

HIGHLIGHTS

- Global GDP growth is expected to slip to around 3% in 2019 and 3¼% across 2020-21 as the "creaky ships" of the world's major economies, including Canada, navigate the rough waters induced by trade disputes and uncertainty. Risks are weighted to the downside.
- Canada's economy remains lacklustre with growth driven mainly by the fastest population growth in 30 years. GDP growth is expected to be 1.3%, below potential, before growing around potential at close to 2% over 2020-21. These are low rates of economic growth by historical standards. Abstracting from population growth, GDP per capita has stalled and has not risen since mid-2017.
- The growth outlook for B.C. has been downgraded to 2% for 2019 (from 2.2% in our previous update).
- The provincial job market remains healthy overall, but employment levels are falling in some resource-dependent regions.
- Consumer spending in B.C. remains weak. Retail sales are barely advancing, weighed down by a contraction in auto sales and a sharp slowing in activity related to housing sales and remodelling.
- The once-stellar boom in sectors tied to real estate and residentially-secured credit continues to unwind, aided by changes in federal, provincial and Chinese government policies. In the new home construction sector specifically, Canada's rapid population growth should support demand over the longer term. However, there are likely to be some soft years ahead as falling house prices cool interest in pre-sales for new development.
- Non-residential construction is a bright spot in the B.C. economy.
- Conditions in the province's export sector are mixed, but most segments, including tourism, are slowing.

GLOBAL OUTLOOK

Global GDP growth is expected to slip to around 3% this year and inch higher to 3¼% over 2020-21. The "creaky ships" of the world's major economies are navigating choppy waters. Structural problems abound. Productivity growth has been stubbornly low in most major economies since 2007, including in Canada, and yet there appears little appetite or imagination among political leaders to tackle much-needed structural reforms. Ultra-loose monetary policy has kept these ships afloat over the past decade, albeit at a cost of higher global indebtedness.[1] Over the past two years, key central banks have attempted to wean their economies off monetary support. However, as their economies have started to founder in roughening waters, these plans have been suspended for the foreseeable future.

Exacerbating these issues, many countries can now expect less near-term support from external demand as global trade flows weaken. Trade tensions have escalated between the two countries responsible for the lion's share of global economic growth over the past decade, China and the U.S. China's trade flows have been particularly hard hit (**Figure 1**). In May, the U.S. raised tariffs from 10% to 25% on USD 200 billion worth of Chinese imports. China retaliated with tariffs on USD 60 billion worth of U.S. goods. The U.S. has threatened further tariffs on an additional $300 billion worth of Chinese imports. Against a backdrop of structural policy indifference, low productivity growth, the end of ultra-

[1] The IMF estimates that global debt is at an all-time high of USD 86,000 per person, or 2.5 times average income per person.

loose monetary policy, and ongoing trade disputes and uncertainty, global trade growth has stalled (**Figure 1**) and business investment has retreated (**Figure 2**).

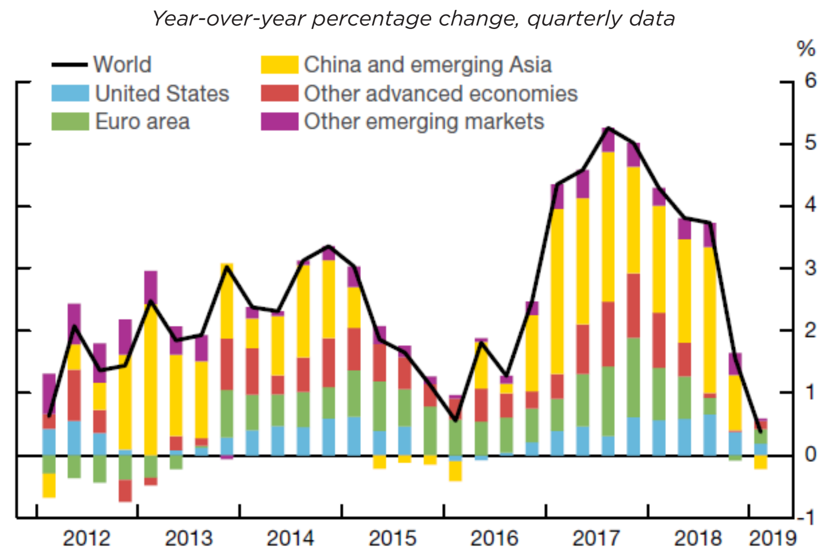
U.S. economic prospects and its trade policies weigh heavily on the global outlook. Following a strong 2018, U.S. GDP growth is expected to ease to 2.5% in 2019 and to less than 2% over 2020-21. The U.S. labour market so far remains strong, providing support to income growth, while household balance sheets are in good shape (much better shape than in Canada). The unemployment rate is 3.6%, the lowest since 1969.

Nevertheless, nine Federal Reserve policy rate hikes since 2015 and trade disputes have cooled economic momentum. U.S. 10-year Treasury bond yields have plummeted from a seven-year high of 3.2% last November to around 2% today. Consequently, the yield curve – the gap between long- and short-term interest rates on debt of the same credit quality – has turned negative. A negative yield curve tends to be harbinger of a technical recession (i.e. two quarters of negative GDP growth) lying 12 months ahead. However, that signal may need to be interpreted with some caution, given central banks' unprecedented involvement in long-term bond markets during the post-Crisis era.

Risks to the global growth outlook are weighted to the downside. While a swift resolution of trade disputes would likely engender a turnaround in trade and investment activity, it seems more likely that tensions and related uncertainties will persist or perhaps worsen.

FIGURE 1: **GLOBAL TRADE HAS STALLED**

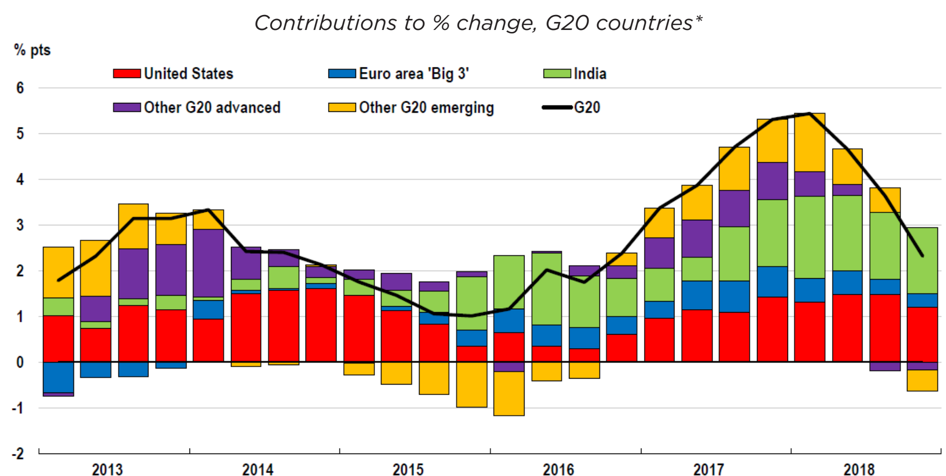
Year-over-year percentage change, quarterly data



Source: Bank of Canada *Monetary Policy Report*, Chart 1, July 2019.

FIGURE 2: **G20 FIXED INVESTMENT HAS SLOWED**

*Contributions to % change, G20 countries**



*Excludes China and Saudi Arabia due to lack of quarterly national accounts; Euro area 'Big 3' are Germany, France and Italy.

Source: OECD.

CANADA'S ECONOMY GROWING CLOSE TO ITS (MEAGRE) POTENTIAL

The Canadian economy is expected to grow at 1.3% in 2019 and around 2% across 2020-21. This is a little below estimates of potential GDP growth in 2019 and broadly in line with potential growth in 2020 and 2021. Global trade tensions and uncertainty are dampening exports and investment and remain the "wild card" in Canada's economic outlook, according to the Bank of Canada. Risks to the outlook are weighted to the downside.

Canada's trade fortunes continue to evolve. U.S. tariffs on Canadian steel and aluminum exports have been lifted, as have Canada's countermeasures. However, China has imposed restrictions on imports of Canadian canola, beef and pork.[2] The Bank of Canada estimates that weaker global growth and commodity prices, trade disputes and economic uncertainty will combine to reduce the level of Canada's real GDP by up to 2% by 2021. A further headwind is the higher Canadian dollar. It is trading near USD 0.76, up 2 cents from June and 3 cents since January.[3]

The "base case" assumption is that these negative influences abate across 2020-21. However, even then, Canada can only sustain GDP growth of around 2% per annum without generating above-target inflation. By historical standards, that is meagre.

From a supply-side perspective, GDP is composed of productivity (GDP per hour worked) and total hours worked. Arguably, Canada's current economic strategy is focused almost solely on achieving economic growth via the latter. The federal government is aggressively raising immigration levels to among the highest in the past century. In 2018, Canada's population increased by 1.4% (double the U.S. pace), whereas it typically grows by 1% per annum. Canada has not tried to expand its population this fast for thirty years.

Rapid population growth is contributing to higher total hours worked (**Figure 3**), as employment growth is partly offset by decreased working hours per worker. For the

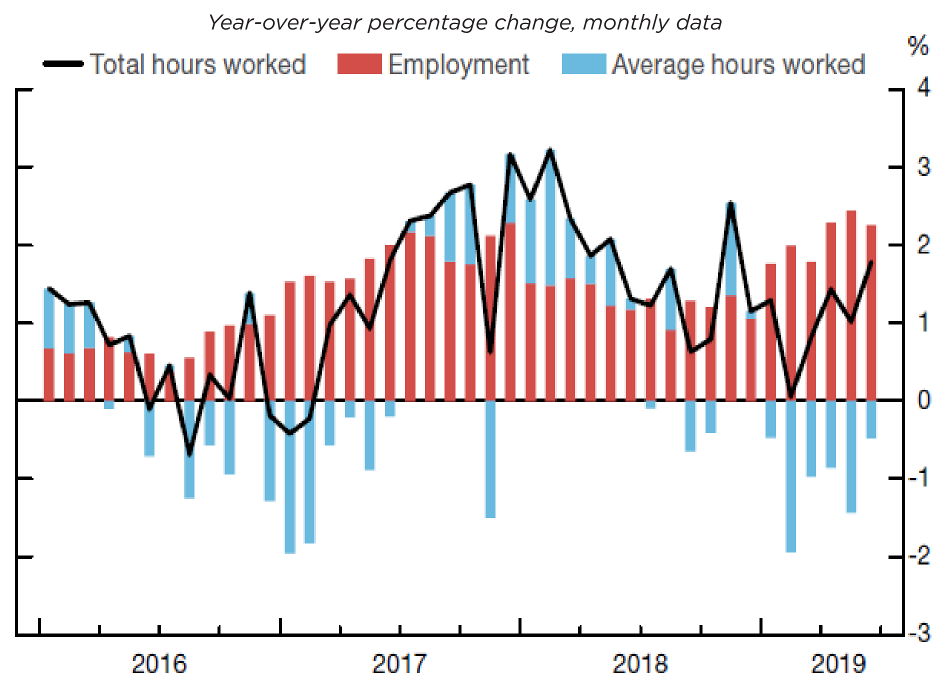
TABLE 1: **GLOBAL ECONOMIC FORECAST (ANNUAL % CHANGE IN REAL GDP)**

	2018	2019f	2020f	2021f
World	3.7	3.0	3.2	3.3
U.S.	2.9	2.5	1.7	1.6
Euro area	1.9	1.2	1.4	1.6
Japan	0.8	0.6	0.2	0.7
China	6.5	6.1	5.9	5.8
CANADA				
Potential	1.5-2.1	1.5-2.1	1.3-2.1	1.2-2.4
Actual	1.9	1.3	1.9	2.0

f - forecast

Source: Bank of Canada *Monetary Policy Report,* July 2019.

FIGURE 3: **TOTAL HOURS WORKED HAS INCREASED...**



Source: Bank of Canada *Monetary Policy Report*, July 2019.

[2] China is a major market for Canadian canola exports (40% of total), worth $2.7 billion last year. However, China is a second-tier market for Canadian beef and pork exports. In 2018, Canada exported around $500 million of beef and $100 million of pork to China. By comparison, exports to the U.S. were $3.1 billion of beef and $1.6 billion of pork; and exports to Japan were $200 million of beef and $1.2 billion of pork.

[3] The appreciation may reflect expectations that the Bank will leave rates unchanged in 2019 whilst other central banks contemplate rate cuts.

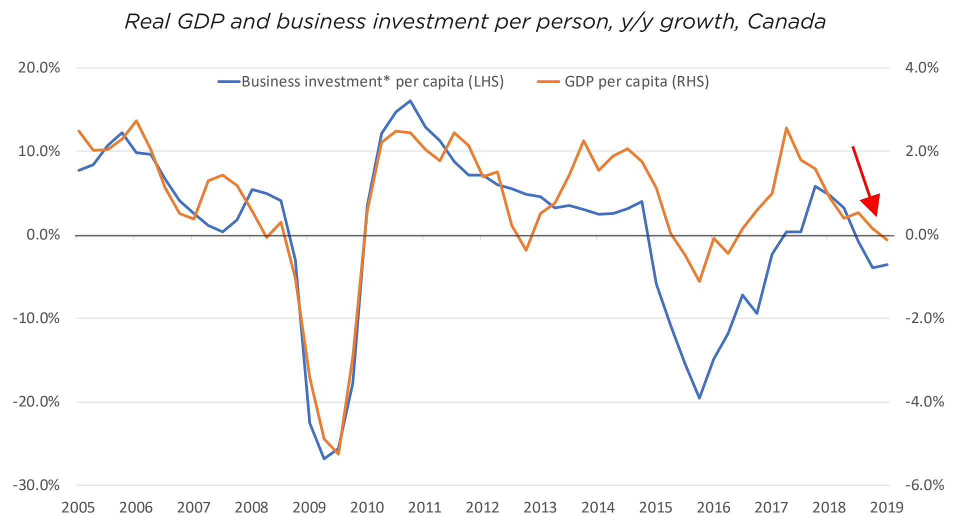
purposes of raising living standards though, a policy of expanding the population is "fool's gold." **A bigger population raises total GDP, but *not* GDP per person.** Growth in Canada's real GDP per person is currently close to zero (**Figure 4**). Since 2008, it has grown only 0.6% per annum, compared to 1.0% for the U.S. and for the OECD average.

Canadian productivity growth was a dismal -0.2% in 2018 and has averaged 0.9% per annum since 2008. Business investment contributes to productivity by raising the economy's capital intensity (i.e. capital per unit of labour). Yet the outlook for investment remains subdued. Adjusting for population, growth in business investment per capita has been mostly negative since 2015 (**Figure 4**). In fact, all forms of business investment – including machinery and equipment, non-residential structures and intellectual property products – are below 2008 (pre-recession) levels in per capita terms.

Overall, the data indicates that growth in Canadian GDP per capita has stalled and the economy is becoming more labour-intensive (i.e. more workers, but less capital per worker). This seems at odds with the predicted impacts of technological change related to digitalization, which are supposed to engender *higher* living standards and a more *capital*-intensive economy. The analysis underscores the need for structural reforms to invigorate Canada's productivity performance. To improve prosperity for Canadians, the economy needs to become better in per capita terms, not merely bigger in absolute terms.

FIGURE 4: **... HOWEVER, ON A PER CAPITA BASIS, CANADIAN GDP AND BUSINESS INVESTMENT ARE DECLINING**

Real GDP and business investment per person, y/y growth, Canada



*Includes: machinery and equipment; non-residential structures; intellectual property products.

Source: Statistics Canada.

OUTLOOK FOR B.C. DOWNGRADED

Consistent with the slowing at the national level, we expect B.C.'s economy to gear down further. The anticipated retrenchment follows a significant slowing that unfolded in 2018, due to a pull-back in household spending coupled with a steep downturn in the residential real estate sector. We now expect the provincial economy to grow at an uninspiring 2% pace this year, which represents a downward revision from the 2.2% pace we expected a few months back. A similar pace, of around 2.3%, is projected for 2020. Absent the boom in housing transactions and consumer spending which fuelled much of the province's robust mid-decade expansion, B.C. is poised to record three consecutive years of below average growth.

As consumers take a step back, non-residential construction has become a bright spot. Here, government fiscal stimulus via stepped-up capital spending is a positive factor. But private sector construction of commercial buildings and a number of large projects in the resource and infrastructure space are more significant developments.

We expect growth in B.C.'s international merchandise exports to subside (and possibly turn negative). Considering the deteriorating external backdrop, sagging commodity markets and trade policy concerns, the risk for exports is clearly on the downside. However, some segments of service exports, such as technology and professional services and film and television production, will continue to show strength in 2019-20.

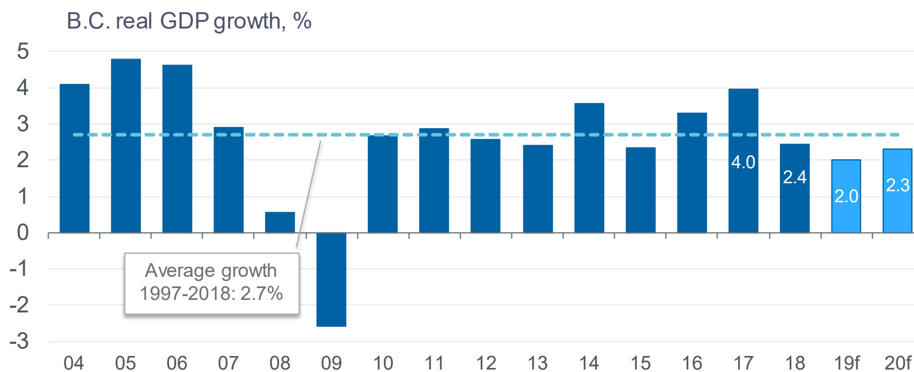
TABLE 2: **B.C. ECONOMIC OUTLOOK (ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)**

	2017	2018	2019f	2020f
Real GDP	4.0	2.4	2.0	2.3
Employment	3.7	1.1	2.0	1.2
Unemployment rate (%)	5.1	4.7	4.4	4.6
Housing Starts (000 units)	41.2	38.4	42.9	35.1
Retail sales	9.3	2.0	3.0	3.5
B.C. CPI	2.1	2.7	2.4	2.2

f - forecast

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

FIGURE 5: **B.C.'S GROWTH OUTLOOK FOR 2019 DOWNGRADED**



Source: Statistics Canada, Table 36-10-0401-01; BCBC forecasts for 2019-20.

Within the context of the Canadian economy, B.C. will still manage to register a decent growth rate as the construction of LNG Canada's Kitimat export facility and related pipeline gets underway. This year, we expect the early stages of that project to lift economic growth by 4 tenths of a percentage point and then by 5 to 7 tenths of a point in 2020. The timeline for proceeding with Kinder Morgan's Trans Mountain expansion project is more uncertain, but we expect it too will provide a meaningful economic boost in 2020. Absent these massive capital projects, B.C.'s growth profile would be considerably less impressive.

In our previous outlook, we indicated that the growth dynamic within the province would shift to some extent, with the slowdown in residential real estate and consumer spending weighing disproportionately on the lower mainland while the northern regions of province benefit more from major capital projects. While these factors will still shape regional economic activity, the hit to the province's resource sectors – particularly forestry – has become a bigger negative factor than we envisaged, resulting in a more subdued near-term economic outlook for many regions in the province.

LABOUR MARKET REMAINS POSITIVE, WITH A COUPLE OF CAVEATS

Even as the economy cools, the job market in B.C. is healthy. So far this year (through June), the average employment level is up 3.4%. The unemployment rate is hovering near record lows – averaging 4.5% so far this year, down from 4.8% over the same period in 2018.

Looking at different dimensions of the labour market confirms that hiring on the whole continues to be robust. The number of employees in the private sector is up 4.4% year-to-date. The number of public sector employees is essentially flat, while self-employment is up 2.3%. There is some regional disparity emerging, however. Employment in Greater Victoria (and Vancouver Island more generally) is down so far this year. And the impact of the pronounced weakness in the forestry sector is evident in the Cariboo region, where employment is down 3.1%. The North Coast/Nechako region and the Northeast have also registered job losses this year.

In our previous quarterly outlook, we expected job growth in the North to stay reasonably strong, aided by the construction of LNG Canada's multi-billion-dollar project in Kitimat. But the negative impact of several lumber mill closures and a broader deterioration in the province's resource sector is now chipping away at the employment figures.

Wage growth in B.C. has recently moderated and is negative in real terms. The increase in the average hourly wage is currently running around 1%, which is *below* inflation, and well shy of the 4-5% gains seen over the first half of 2018. We still view the B.C. job market as positive, given overall job gains, low unemployment and a high job vacancy rate. But the emerging regional variation warrants close attention, as does the lack of real wage growth.

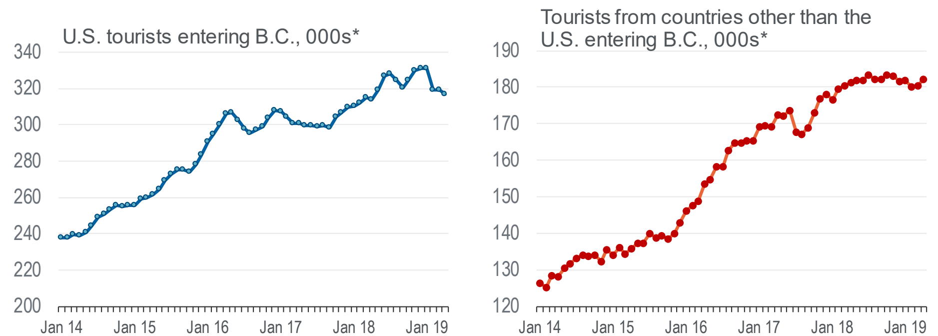
MIXED CONDITIONS IN THE EXPORT SECTOR

Apart from a bump in May, B.C.'s international merchandise exports have trended lower for the better part of a year. Through May, goods exports are down slightly (1.3%) compared to the same five-month period last year, with most of the weakness attributable to resource-related sectors. Wood products have experienced the biggest export decline (down 12%). Metallic mineral products are off 7.5% and pulp and paper products are down by a similar amount. The value of coal shipments is also down modestly. Bucking the trend, a firmer pricing environment has resulted in a 30% increase in the value of natural gas exports.

The impact of a less positive external setting is evident across most of B.C.'s major export markets. Exports to the U.S. are down slightly, while shipments to Japan and South Korea are off 12% and 8%, respectively. The one exception among B.C.'s major export markets is India. Following a number of years of rapid growth, India is now B.C.'s fifth largest international market. Exports to India are up 36% so far this year.

Other parts of B.C.'s export base are stronger. Notwithstanding some recent appreciation, the loonie is supporting gains in tourism as well as film and television production and in those parts of the B.C. technology sector that produce and export services rather than goods. In the case of tourism, after several years of impressive growth the trend in the number of tourists coming from other countries has leveled off. Consistent with an easing in demand, the cost of accommodation services in B.C. is also slipping. While tourism activity will continue to expand, these indicators suggest it will make a smaller contribution to economic growth in B.C. this year (and likely in 2020 as well). The downshift in tourism is another factor in our decision to trim our 2019 GDP growth projection. Transportation services, technology services and an array of business services are segments of the broader export base that we expect will continue to contribute to B.C.'s economic expansion in 2019-20.

FIGURE 6: **TOURISM ACTIVITY LEVELS OFF**



* 3-month moving averages.

Source: Statistics Canada, Table 24-10-10043-01 seasonally adjusted.

FIGURE 7: **COST OF TRAVELLER ACCOMMODATION SERVICES FALLING**

* Leisure travellers, calculated from 3-month moving averages. Latest: March 2019.

Source: Statistics Canada, Table 18-10-0249-01.

HOUSING BOOM CONTINUES TO UNWIND

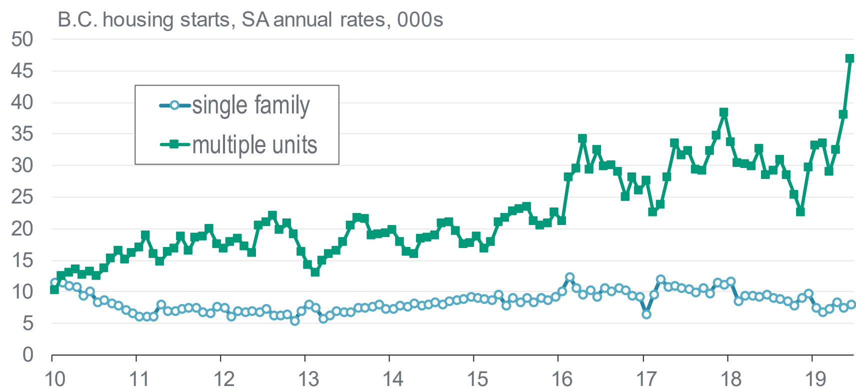
The resale housing market remains very sluggish. Although the labour market and the economy are in decent shape, housing resales (i.e. the rate of turnover or churn in the resale market of existing properties) are low. Resales in June 2019 were the lowest since 2000.

Much of the decline in the residential real estate sector is policy-induced, both in Canada and in China, and most acutely affects investor-buyers. The Bank of Canada has raised its policy rate five times since 2017. The federal mortgage stress tests (especially its 2018 extension to uninsured mortgages, which constitute more than 80% of the GVA market) and several provincial measures largely targeting foreign buyers, speculative demand, and affluent property owners are all dampening the rate of churn in the established property market.

Meanwhile, China's tightening of capital outflow restrictions has contributed to a significant cooling of non-resident buyer demand in several Asia-Pacific real estate markets. In Australia, for example, non-resident demand for newly constructed residential real estate quadrupled across 2014-2016 (concentrated in Sydney and Melbourne), and then collapsed to pre-boom levels across 2017-2018.[4] Australia's Reserve Bank Governor describes these shifts in foreign demand as having "broadly coincided with – and reinforced – the shifts in domestic demand."

These forces are now putting *downward* pressure on established home prices. In June, the average price of established B.C. homes was down seven per cent year-over-year. Prices have been trending lower for more than a year and we expect further falls.

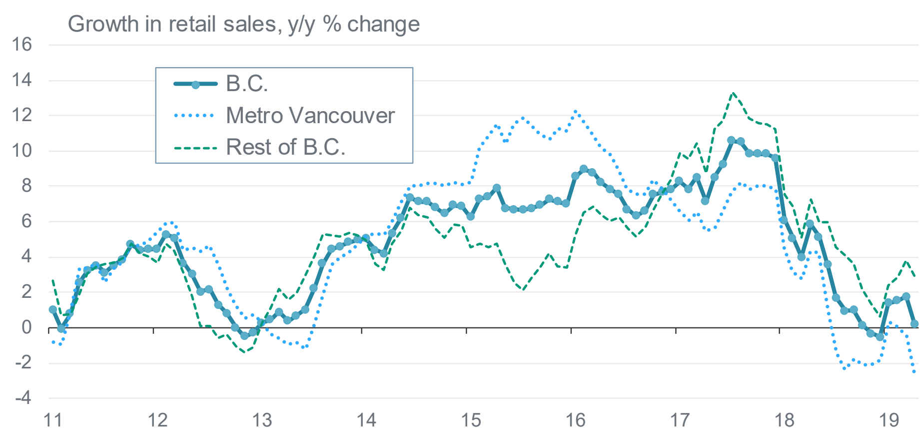
FIGURE 8: **SHARP INCREASE IN MULTI-UNIT HOUSING STARTS**



* 3-month moving average. Latest: June 2019. Seasonally adjusted annual rates.

Source: Statistics Canada.

FIGURE 9: **B.C. CONSUMERS TIGHTEN THEIR BELTS**



Source: Statistics Canada.

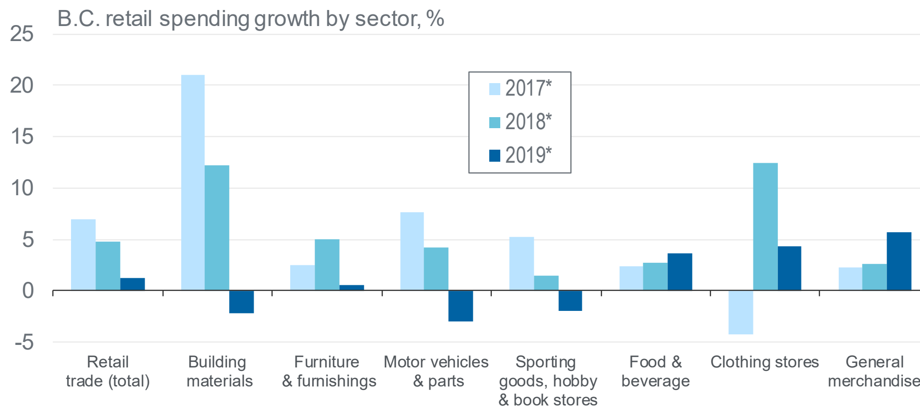
In the new housing sector, multi-family housing starts have surged in recent months. The surge is likely to be temporary as pre-sold projects that have long been in development reach the construction phase. Going forward, starts are expected to cool in line with weaker demand from domestic and offshore buyers from China. Even so, the federal government's population growth policies are expected to support the longer term outlook for new housing construction.

B.C. CONSUMERS TAPPED OUT

Spending in retail stores in B.C. has slowed significantly over the past 18 months as the tailwind from rising

[4] See Chart https://www.rba.gov.au/speeches/2019/sp-gov-2019-03-06.html.

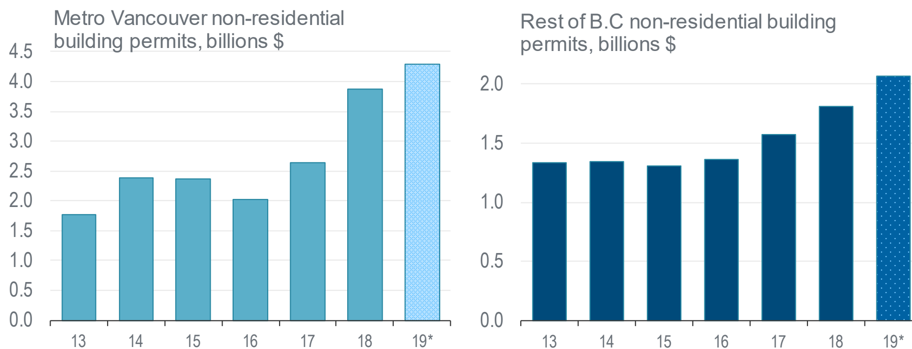
FIGURE 10: **RETAIL SALES WEIGHED DOWN BY HOUSING SENSITIVE SEGMENTS AND AUTOS**



* year-to-date Jan to April.

Source: Statistics Canada.

FIGURE 11: **NON-RESIDENTIAL CONSTRUCTION STRONG ACROSS THE PROVINCE**



* 2019 projected based on January to May data.

Source: Statistics Canada, CANSIM table: 34-10-0066-01. .

home prices and housing collateral has disappeared. Growth in total retail outlays has been below 2% for nearly a year, which means that in inflation-adjusted terms spending has been roughly flat.

Retail spending has slowed more in Metro Vancouver than in other regions of the province. The latest figures show retail sales contracting by more than 2% in B.C.'s biggest urban area. In contrast, the rest of the province collectively has seen retail spending expand by roughly 3%.

As has been apparent for some time, segments of retail linked to the real estate boom have seen a sharp decline in business. Spending at stores selling building materials and related goods is down 2.2% over the first four months of the year compared to the same period in 2018. Sales growth at home furnishing stores has slowed to a crawl. The 3% decline in auto sales (and parts) is also weighing on overall retail sales and is part of the reason retail activity is weaker in Metro Vancouver.

On the other hand, retail spending at food and beverage stores has perked up somewhat. While this is a positive for operators in this space, the 3.7% increase is modest considering inflation is running close to 2% and B.C.'s population is increasing by 1.5%. In other words, after taking inflation and population growth into account, even the gain in sales at food and beverage stores is meagre. Looking ahead, we expect retail spending to strengthen, but only modestly. Sales in retail segments linked to housing, re-remodelling and auto sales will remain soft.

NON-RESIDENTIAL CONSTRUCTION A BRIGHT SPOT

Non-residential building is running at elevated levels in the province. After impressive gains over the past two years, further increases in non-residential building permits issued so far this year point to additional growth in spending.

Across B.C., the value of industrial building permits issued between January and May is up 67% over the same period last year. Commercial building permits, which account for two thirds of all non-residential permits, are up 69% so far this year and are responsible for much of the overall increase in non-residential permits. But government spending is also a significant factor in the non-residential building sector. The value

of institutional and governmental permits is double what it was last year – reflecting the fact the province has ramped up capital spending on schools and hospitals.

Another feature of B.C.'s busy non-residential construction sector is that there is strength across most regions of province. Overall permit values are up almost 70% in Metro Vancouver, 66% in the Kelowna area, and nearly 24% in Greater Victoria. Abbotsford has experienced a drop in permit values, but this follows a doubling in permits in both 2017 and 2018. Outside of the four large Metro areas, the rest of the province has seen a 136% jump in the value of non-residential building permits.

The early stage impact of the LNG plant in Kitimat is one factor in the big increase in permit values outside of B.C.'s major metro areas. In Kitimat, the value of industrial permits surged from $2.3 million in 2017 to $18 million in 2018. So far this year, industrial permits in the northern coastal community are on track for a further increase. Other industrial projects have resulted in similar gains in Prince Rupert. The net result is the North Coast is benefitting significantly from the construction of a number of sizable capital projects: industrial building permits in the region went from close to $3 million in 2017 to $127 million in 2018. Permit data for the first four months of this year point to similar advances this year.

SUMMARY

Growth in the provincial economy continues to moderate. For more than a year, the rate of turnover of established properties and consumer spending have stood out as key soft spots. However, the slowdown now seems to be broadening. The external environment has also become less supportive for B.C. This trend is dampening activity in the export sector, as the value of B.C.'s merchandise exports sags. Tourism has also downshifted from a being a growth leader to eking out at best very small gains this year.

Rapid population growth through immigration is central to the employment gains being recorded both in Canada and B.C. In the coming months, we will be monitoring regional labour markets to see to what extent resource dependent communities across B.C. are facing divergence in labour markets. We will also be watching the performance of the giant American economy as the U.S. enters the 11th year of an unusually lengthy expansion amid signs that a significant downturn could materialize within the next 12 months. In that event, we would need to reassess the growth forecasts for B.C. and Canada.

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