INFLATION AND COSTS SPIRAL AS ECONOMIC RECOVERY CONTINUES

B.C. ECONOMIC REVIEW AND OUTLOOK

March 2022

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Business Council of
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HIGHLIGHTS

- Global GDP growth is expected to be 4.1% in 2022 and 3.7% in 2023. Key challenges facing advanced economies are runaway inflation, high indebtedness, ongoing supply chain disruptions, raw material shortages, fall-out from Russia's invasion of Ukraine, and the possibility of future disruptions from new COVID-19 variants.
- Policymakers across major countries, including Canada, are beginning the overdue process of winding back emergency-levels of monetary and fiscal support for demand. Red-hot inflation – 7.9% y/y in the U.S. (40-year high) and 5.7% y/y in Canada (30-year high) – is clear evidence that demand is outstripping supply. Policymakers have been too slow to scale back demand-side stimulus as economic conditions improved over the past year.
- Canada's GDP growth is expected to be 3.7% in 2022 and 2.7 % in 2023. The economy is operating at or beyond full capacity. High global commodity prices are providing much-needed nourishment for real incomes and public finances, with Canada's external terms of trade approaching record levels.
- B.C.'s economy is forecast to grow by 3.8% in 2022. This represents a slight downward reduction from our previous forecast owing to global turmoil and rising inflation.
- Next year real GDP growth is projected to downshift to a more typical 2.6% expansion.
- Very high global commodity prices are boosting the value of B.C.'s merchandise exports. In 2021 exports surged to record levels. This momentum is expected to continue well into 2022.
- The construction of several large capital projects will continue to make a substantial contribution to growth over the forecast horizon.
- Unemployment is comparatively low and B.C.'s labour market is tight. Higher inflation and labour scarcity will put upward pressure on wages, especially in the second half of the year.

POST-PANDEMIC RECOVERY CONTINUES AMID RAMPANT INFLATION AND THE FOG OF WAR

Global GDP growth is expected to dip to 4.1% in 2022 and 3.7% in 2023, following a robust 6.2% in 2021. (**Table 1**). The Omicron variant will shave a few tenths of a percentage point off global growth in 2022. Russia's invasion of Ukraine is likely to see that forecast further trimmed in coming months as trade and financial sanctions on Russia, and high energy prices, drag on global activity (albeit soaring prices will benefit energy-exporting countries like Canada). The war has shaken financial and commodity markets, delivered a blow to business confidence, and prompted a complete rethink of European and British energy policies (see here, here, here, here, and here).

A major challenge facing many advanced countries is runaway inflation. Growth in demand for goods and services (especially goods) is outstripping growth in supply. Many advanced economies are operating with "excess demand" – at or beyond their full capacity – resulting in the highest rates of inflation in several decades. Contributing to rising prices from the supply side are shipping delays, supply-chain bottlenecks and shortages of key materials, indicators of which remain high albeit lower than their 2021 extremes.

However, policy settings are far from neutral and are also contributing to inflation from the demand side. **In our view, the extraordinarily loose monetary and fiscal policies used to stimulate demand during the depths**

of the COVID-19 recession of 2020 are well past being appropriate for economic conditions in the second half of 2021 and now in 2022 (Figure 1).

The **U.S. economy** is expected to expand by 4.3% in 2022 and 3.2% in 2023, following robust growth of 5.7% in 2021. Labour force participation – the percentage of the population employed or actively looking for work – is yet to fully recover and was 62.3% in February versus 63.5% before the pandemic. Within the labour force, the unemployment rate is very low at 3.8% in February and is roughly back to 2019 levels. **U.S. CPI inflation was a rip-roaring 7.9% y/y in February, the highest rate of inflation since 1982**. Taken together, the U.S. economy appears to be operating well beyond full capacity. The Federal Reserve will likely begin to raise policy interest rates this month.

Risks to the global and U.S. outlooks are weighted to the downside, especially because of the uncertain implications of Russia's attack on Ukraine. The unwinding of monetary and fiscal policy support for demand is overdue but will need to be balanced against the war's impact on the world economic outlook. Economies will be sensitive to interest rate increases because of very high levels of private and public indebtedness (especially in Canada).

TABLE 1: **GLOBAL ECONOMIC FORECAST**

	2021f	2022f	2023f
Real GDP growth (%)			
World	6.2	4.1	3.7
Canada	4.6	4.3	3.2
United States	5.7	3.9	3.3
United Kingdom	7.5	3.1	1.2
Euro area	5.6	3.1	2.2
Japan	1.9	2.4	1.8
China	8.1	5.1	5.3
CPI inflation (%)			
Canada	4.7	5.8*	2.1*
United States	6.7	6.8*	3.2*
Central bank policy interest rate (% at end of year)			
Canada	0.25	2.50	3.00
United States	0.25	2.25	2.50

* Likely to be revised up in coming months.

Source: Scotiabank Economics.

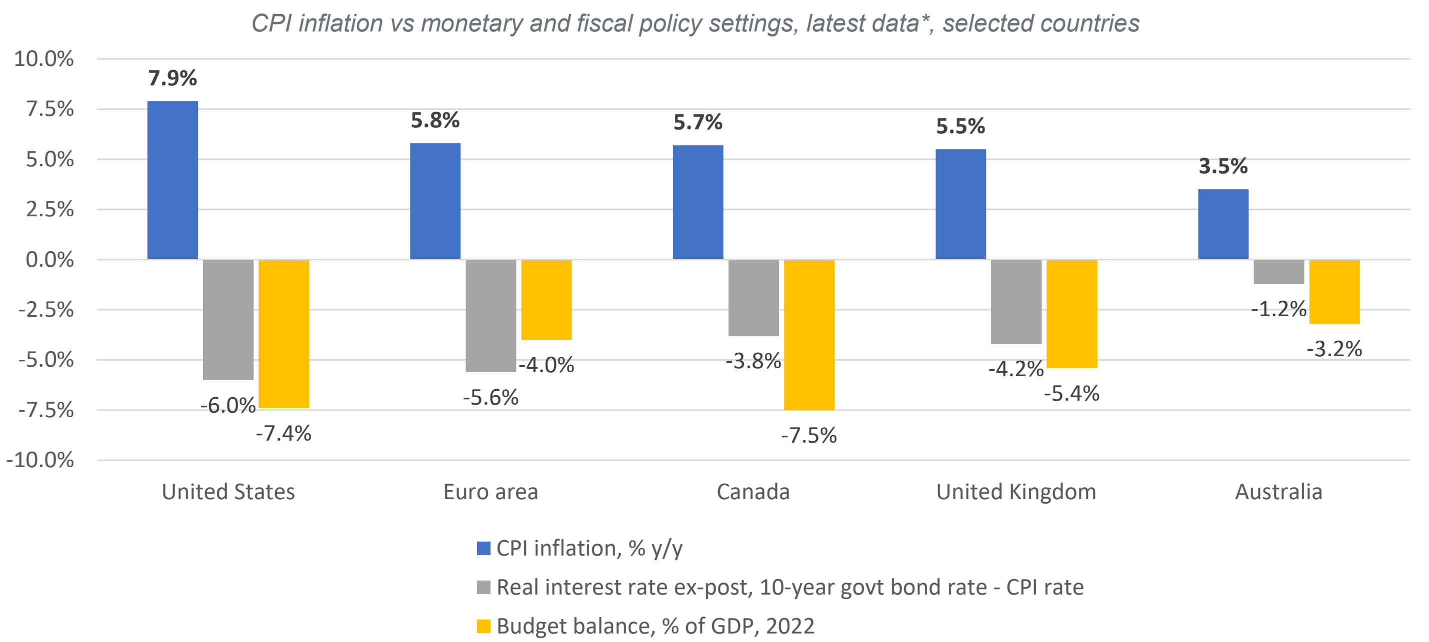
CANADA'S RECOVERY BOOSTED BY SURGING TERMS OF TRADE

Canadian GDP growth is expected to be 4.3% in 2022 and 3.2 % in 2023, following a robust post-recession recovery of 4.6% in 2021 (**Table 1**). **CPI inflation is red hot at 5.7% y/y for February, the 11th consecutive month that annual inflation has exceeded the Bank of Canada's 1-3% inflation control range. It is the fastest pace since 1991**; ironically, that was the year that the inflation-targeting approach for monetary policy was introduced. Inflation is broad-based with seven out of eight major components exceeding 2% y/y, and six components exceeding 3% y/y. Core measures of inflation, which attempt to look through temporary influences, accelerated to 4.3% y/y.

In January, the Bank of Canada assessed that excess supply in the economy had now been fully absorbed. Yet real interest rates (i.e., ex-inflation) are *negative*, wildly stimulatory for demand and in our view wholly inappropriate for current economic conditions (**Figure 1**). BCBC expressed its concerns about policy overstimulating demand and contributing to inflation (*in addition* to supply-side forces) in our blogs of September 2021 and December 2021. Troublingly, an analysis released by Scotiabank this week shows inflation expectations have been completely de-anchored from the Bank's 2% target since late-2021 as, seeing the Bank's inaction, households and businesses have increasingly looked to their experience of *actual inflation* to guide their expectations about future inflation.

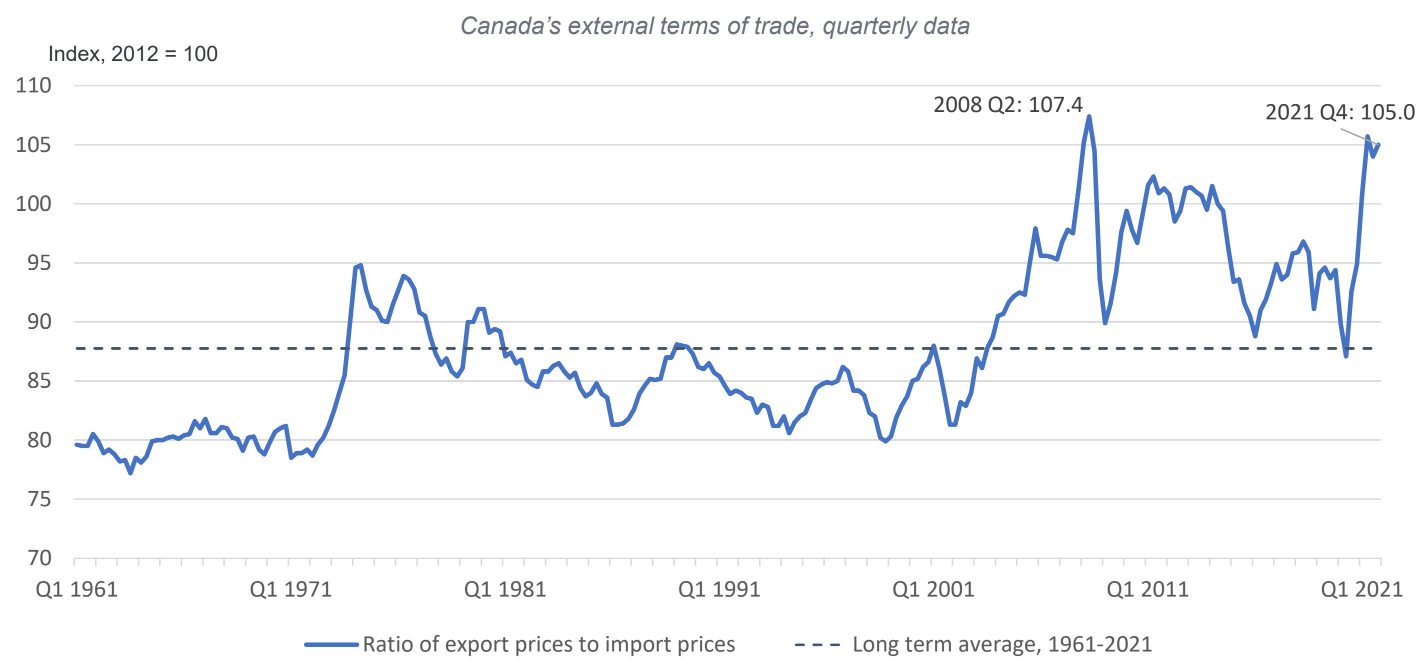
In March, the Bank increased its policy interest rate (i.e. the target for the interest rate on overnight loans between banks) by 25 basis

FIGURE 1: **LOOSE MONETARY AND FISCAL POLICY HAS CONTRIBUTED TO RUNAWAY INFLATION**



Source: The Economist, Country statistical agencies; BCBC. *Australia: Q4 2021; Others: Feb 2022.

FIGURE 2: **CANADA'S TERMS OF TRADE SOARS...BUT WILL EXPORT *VOLUMES* RISE TO GRASP THE OPPORTUNITY?**



Source: Statistics Canada.

point (bp) for the first time since 2018. Some market economists are expecting six *additional* rate increases in 2022, plus two more in 2023 (**Table 1**). This would return the nominal policy rate to roughly a "neutral" range – estimated to be around 1.75% to 2.75% – where it is neither stimulating nor dragging on demand. It remains to be seen whether simply *restoring* the policy rate to around the neutral range will be sufficient to bring sharply rising inflation to heel, or whether the Bank will need to *actively tighten* monetary policy so that the policy rate is materially *above* neutral for a period of time.

Near-term indicators of consumption (especially of durable goods) and housing demand remain superheated, while indicators of exports and investment are improving from weak levels. Global commodity prices have surged due to: Russia's invasion of Ukraine; the imposition of sanctions on Russia's commodity exports; the shake-up in European and British energy policies; and a general shortage of global energy and mineral reserves available to bring into production because of a dearth of resource exploration and new development over recent years. Developments in energy markets are a reminder that the transition to a low-carbon future will be longer, more costly, and much bumpier than many governments and most environmental activists – including in Canada – assume.

With natural resource products making up about half of Canada's merchandise exports, high commodity prices are providing much-needed nourishment for real incomes and public finances.

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

	2020	2021	2022f	2023f
Real GDP	-3.4	5.3e	3.8	2.6
Employment	-6.5	7.2	2.9	2.2
Unemployment rate (%)	8.8	6.5	4.7	4.8
Housing Starts (000 units)	38.0	47.5	45.0	42.0
Retail sales	1.3	13.5	6.0	6.2
B.C. CPI	0.8	2.8	5.0	4.2

e - estimate f - forecast

Source: Statistics Canada and B.C. Stats; Business Council of B.C. forecasts.

Canada's terms of trade – the ratio of prices of products Canada exports to the prices of products Canada imports – have surged to near-record levels (**Figure 2**). **A key question is whether Canada's exporters can increase production to meet global demand and grasp this opportunity of extraordinarily favourable prices**.

Prospects do not look good, however. Canada and B.C. have retreated from international trade over the past two decades as evidenced by exports declining as a share of GDP. In contrast, most other OECD countries have shown *increasing* openness to international trade over the past 20 years (see BCBC's report here). Notwithstanding favourable export price signals, the Canadian business climate for energy and other natural resource industries has become more uncertain and less competitive in the last several years. These trends are expected to hinder new investment in our export-focused sectors going forward. Overall, near-term risks to the Canadian outlook are balanced.

B.C. REMAINS ON SOLID GROWTH FOOTING IN 2022, DESPITE GLOBAL TURBULENCE

In British Columbia, several factors are expected to support a healthy 3.8% real GDP expansion in 2022 before the economy downshifts to a more "normal" 2.6% pace in 2023 (**Table 2**). Mirroring the Canadian situation, B.C. has been benefitting from the strong global economy and a massive terms-of-trade improvement driven by higher commodity prices. Ongoing construction of several large capital projects will also help to keep growth in the province elevated in 2022. The lifting of COVID-related restrictions and resumption of international travel mean the beleaguered tourism industry will finally enjoy a long-awaited recovery. The still-significant level of government policy stimulus and a high level of public sector capital spending also provide a growth-supporting backdrop.

With inflation surging ahead and the Bank of Canada in "catch-up" mode, and with the Russia-Ukraine war unsettling energy markets and cutting into global growth, we have trimmed our 2022 outlook for the provincial economy. For now, we have shaved two-tenths of a percentage point off our earlier forecast of 4% GDP growth in 2022. For 2023 we have not made any revisions.

EXPORT BOOM FOR B.C.

Last year, provincial exports surged to a record ~$54 billion, crushing the previous high mark of $46 billion several years back. Much of the growth flowed directly from high commodity prices, especially for energy and lumber but also extending to minerals/metals and pulp (**Figure 3**). Lumber prices have retreated from stratospheric levels seen in 2022, however, which has recently reduced provincial export revenues. This shift is one of reasons we have adjusted down our 2022 growth outlook.

The revival in international tourism is expected to provide a welcome economic boost this year. The cruise ship sector is expecting a record year in 2022 with more than 300 sailings scheduled to arrive at Canada Place in the Port of Vancouver this season. There are also 350 ships scheduled for the Victoria Cruise Terminal over the seven-month season. The upturn in air travel also points to a robust rebound. After climbing steadily through the year, YVR handled 220,000 international travellers in December 2021. While this is just one-third the number in December 2019, it is instructive to compare this recent figure to the 50,000 passengers that YVR processed in December 2020, when more pervasive travel restrictions were in place.

NON-RESIDENTIAL INVESTMENT AND CONSTRUCTION SPENDING CONTINUE TO UNDERPIN GROWTH

The ongoing construction of LNG Canada's Kitimat facility, the associated pipelines, Site C and the twinning of the Transmountain Pipeline all continue to make large contributions to provincial growth, as they have done in recent years (see here).

Total capital spending in the province is slated to climb to a record $48.7 billion this year, a further 7% increase over 2021's record level (**Figure 4**), according to Statistics Canada's most recent investment intentions survey.[1] Public sector investment in schools and hospitals is also elevated. In the private sector more generally, there are signs B.C. businesses are stepping up capital plans albeit from weak levels. Absent the handful of very large capital projects, we estimate capital investment in B.C. would be closer to $37 billion. The sheer size of these projects means that as they wind down in 2024-25, tens of billions of dollars of construction spending will no longer be occurring – putting a significant drag on growth and jobs in the second half of the decade.

CONSUMER AND HOUSEHOLD SPENDING RISE AS RESTRICTIONS ARE LIFTED

The full reopening of the B.C. economy means spending patterns should continue to "normalize". We expect consumer spending on previously constrained or unavailable services and entertainment to climb sharply and boost domestic economic activity. Retailers should enjoy decent gains in sales, but inflation and surging energy prices will bite into household budgets and weigh heavily on growth in retail spending measured in inflation-adjusted dollars.

Fuelled by record low interest rates, home resales in B.C. (i.e. turnover of *existing* dwellings) soared to a record high of 115,000 units last year, an increase of 60% over 2021's already heady sales level. Rising interest rates will soon start to weight on resale market turnover and established house price growth. Meanwhile, in the new home market, century-high levels of temporary and permanent international immigration will continue to support demand for new home building activity. Housing starts in B.C. jumped to a new high of 47,000 units in 2021, a one-third increase over 2020. In summary, the resale market will start to cool as interest rates normalize; but record federal immigration targets will keep "stoking the fires" for new home construction.

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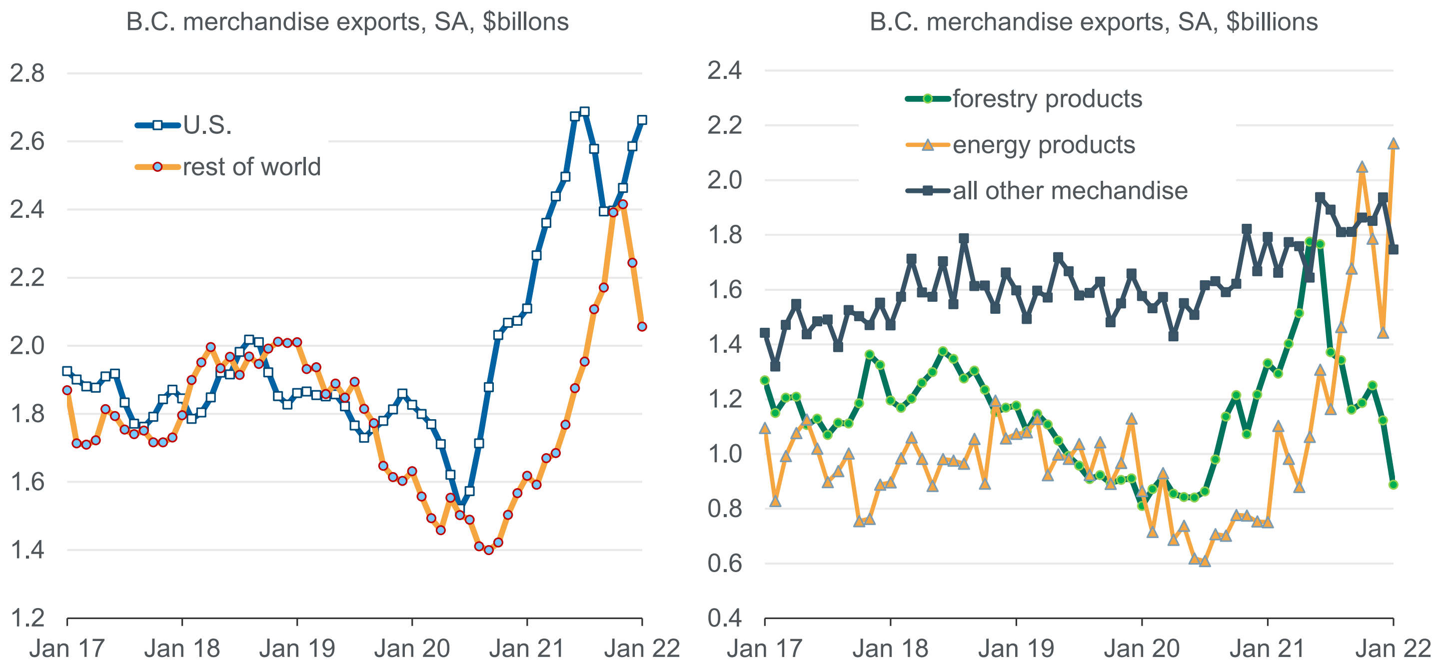
UNEMPLOYMENT FALLS TO NEAR RECORD LOWS, EMPLOYERS FACE HIRING CHALLENGES

Two years after the economy was shuttered, total employment in the province has mostly recovered. The top-line number, however, masks quite different profiles across industries. The number of public sector employees (found in public administration, health care and extent education) is up sharply. But in the private sector only a few industries – notably professional services, manufacturing, and the resource sector – have seen employment fully recover and grow. Employment in many industries, especially food services and accommodation,

[1] The survey was completed last fall so the forecast may be somewhat dated given the rapidly shifting global geopolitical backdrop and the Bank of Canada's determination to scale back monetary policy stimulus.

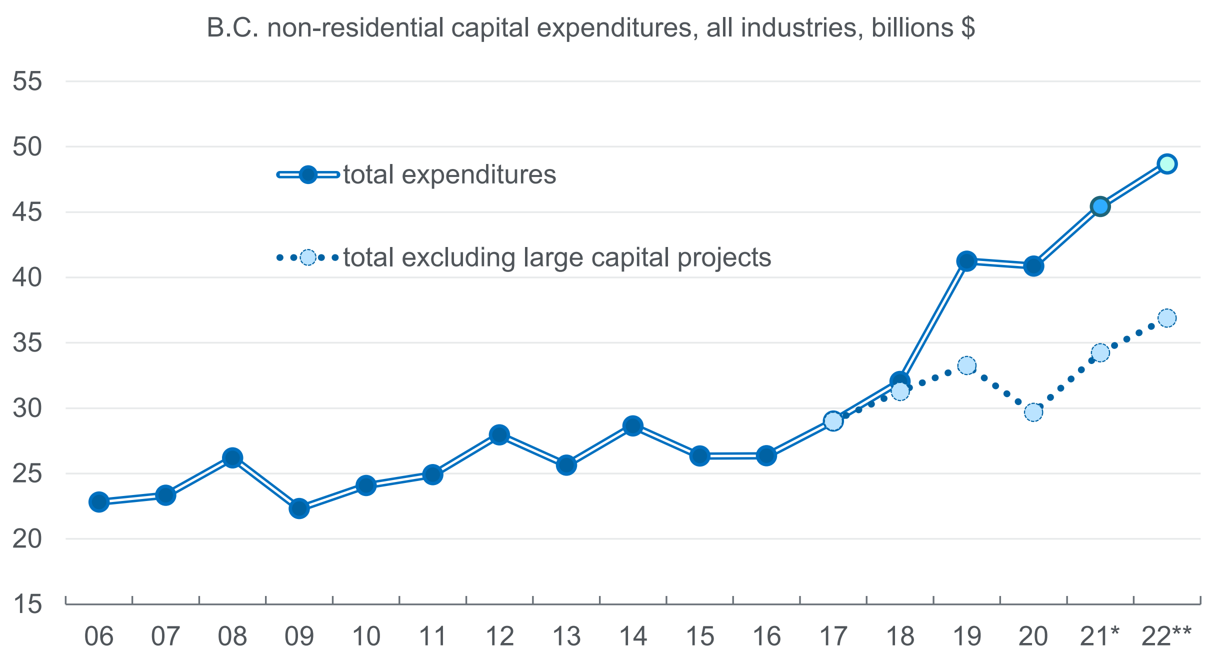
FIGURE 3: **EXPORTS TO U.S. BOOSTED BY FOREST PRODUCTS**



Source: B.C. Stats.

Latest data January 2022, SA = seasonally adjusted.

FIGURE 4: **B.C. CAPITAL INVESTMENT AT RECORD HIGHS**



Source: Statistics Canada, Table: 34-10-0035-01.

*estimated **planned

personal services, and business services, remains well below of pre-pandemic levels.

Somewhat oddly, a more fulsome recovery in the job market will be hampered by a shortage of workers. The provincial unemployment rate fell to 4.9% in February 2022, lower than prior to the pandemic. This means there are approximately 140,000 unemployed people in the province. There are currently approximately 155,000 job openings. Because of population aging, labour markets have been steadily tightening. Several years ago, the ratio of unemployed persons to job openings in B.C. was approximately 2 to 1. Just ahead of the pandemic it had dipped to about 1:5 to 1. Now the ratio is I slightly below 1 to 1, even as employment remains short or pre-pandemic levels in many sectors. Matching skills and talent with job opportunities in this environment is much more difficult. Tight labour market conditions and high inflation are likely to put upward pressure on wages in most sectors over the course of 2022-23.

SUMMARY THOUGHTS

Amid the heightened uncertainty caused by Russia's war on Ukraine, disruptions in global energy markets, high and surging inflation, B.C. remains well-positioned for another year of solid growth in 2022 before the economy downshifts in 2023. Thanks to large capital projects and strong global commodity markets, much of this growth is baked into B.C.'s 2022 expansion. As we move through the year, however, growth should moderate as domestic activity slows as emergency-levels of monetary and fiscal stimuli for demand are belatedly scaled back.

Our forecast is for B.C.'s real GDP growth to downshift significantly in 2023. As with the Canadian situation, the risks to next year's outlook are balanced. The benefits to Canada flowing from hot global commodity markets could keep B.C. on a stronger growth path. Alternatively, more muted global commodity markets, broad-based and still rising inflation, and higher borrowing costs would weigh on growth prospects.

The bigger concern for policy makers is B.C.'s growth prospects by the mid-2020s. Structural weaknesses evident for many years – low levels of investment per worker across asset types, weak productivity growth and real wage growth, costly and burdensome regulatory processes affecting both business operating costs and confidence to make long-term investments in the province – will become more evident as the massive lift from several large capital projects subsides.

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