BC ECONOMIC REVIEW AND OUTLOOK

Business Council of British Columbia
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IS IT THE BEST OF TIMES OR THE WORST OF TIMES?

HIGHLIGHTS

- Global economic growth looks broad-based and strong. The critical question is whether the world is at last ready to be weaned off monetary policy stimulus, or will the process be waylaid, or derailed, by the United States' escalating trade disputes with China, Canada, Mexico and the EU.
- After a stellar 2017, the Canadian economy is expected to grow at or slightly above potential over the next two years. Capacity pressures and labour shortages are pervasive outside of oil-producing regions and are putting upward pressure on wages and inflation. However, global trade tensions could undermine Canada's medium-term prospects.
- The British Columbia economy is operating above its capacity. Labour scarcity is holding back job growth. BC has the highest job vacancy rate in Canada, and growth in average hourly wages is nearly three times the rate of inflation.
- The apparent end of the real estate boom is likely to see a downshift in BC's economic growth rate after a blistering 2017. Going forward, the improving global economy and firm commodity prices will support BC's growth, albeit with greater uncertainty due to US trade policies. The weaker Canadian dollar will also provide some support.
- Two multi-billion-dollar capital projects (LNG Canada and the Trans Mountain pipeline) present upside risks to the BC outlook. Given the economy's sensitivity to trade and real estate, the main downside risks are disorder in global trade and turbulence in domestic real estate and credit markets in the context of tightening global monetary conditions.

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way—in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only. - Charles Dickens, A Tale of Two Cities, 1859, Chapter 1

SUMMARY

The opening lines from Charles Dickens' *A Tale of Two Cities* aptly describe the bizarre second quarter of 2018. For much of the quarter, it seemed the best of times. Global economic growth was accelerating to approach the fastest pace since the Global Financial Crisis and looked broad-based and sustainable. Yields on US ten-year Treasury notes reached a 7-year high of 3.1%. Key central banks were reducing monetary policy support for their economies. However, by the end of June, the outlook had darkened. The US set off tariff wars with Canada, the European Union, Mexico and China, who then retaliated with their own tariffs on some US goods. As of early July the situation is fluid, and the full extent and effect of these protectionist measures is difficult to assess.

The Canadian economy is growing at or above its potential rate of growth.[1] Weighing against this momentum in the medium term will be a raft of trade-related issues: the ongoing Canada-US softwood lumber dispute; new punitive US tariffs on steel and

[1] A country's potential output growth is the rate at which its economy can sustainably grow while keeping inflation unchanged. It is composed of long-run growth trends in labour productivity (GDP per hour worked) and labour inputs (total hours worked by the country's population). In the short run, when actual GDP grows faster than potential GDP, economists expect inflation to rise. For a primer on these concepts, see Schembri 2018.

aluminum; the cost to Canadian consumers and businesses from Canada's own retaliatory trade measures; the potential for tariffs on US imports of automobiles and parts from Canada and other foreign suppliers; the overall impact of escalating US protectionism and tit-for-tat responses by US trading partners on the world economy; and uncertainty over the fate of the North American Free Trade Agreement (NAFTA).

Despite the turbulent global backdrop, the BC economy is in decent shape. Labour scarcity and other capacity pressures are holding back GDP and employment growth, while wage growth has reached the highest rate in decades. The protectionist turn in US trade policy will create challenges but should not be enough to derail BC's growth prospects. The nascent slowdown in real estate dependent sectors of the economy is likely to be a bigger factor for BC.

STRONGEST GLOBAL GROWTH SINCE THE FINANCIAL CRISIS… WILL IT CONTINUE?

Global growth has looked synchronized and solid across the advanced and emerging economies, reflected in strengthening merchandise trade and business investment (Table 1). Global output is projected to expand by almost 4% in 2018 and 2019 (Table 1). If realized, aside from the post-recession bounce in 2010, this will be the fastest pace in a decade. Against this backdrop, some central banks are looking to gingerly withdraw monetary policy stimulus by raising rates from ultra-low levels

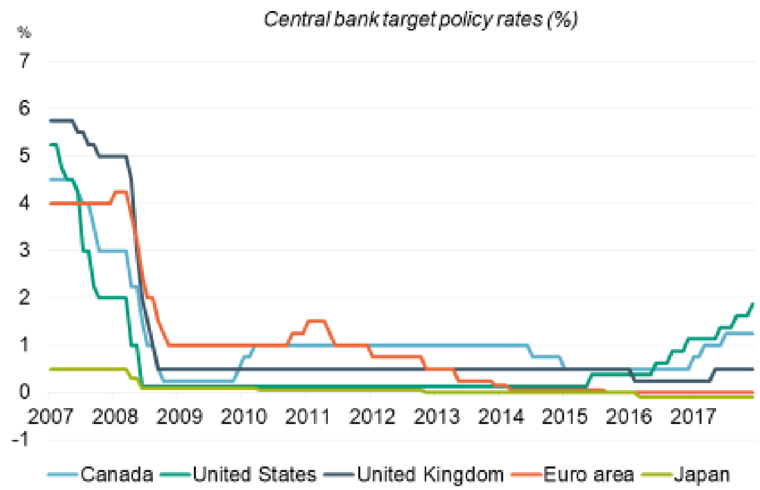
TABLE 1: **GLOBAL ECONOMIC FORECASTS (ANNUAL % CHANGE IN REAL GDP)**

	2017	2018f	2019f
World	3.7	3.8	3.7
Canada	3.0	2.0	1.8
US	2.3	3.0	2.8
Euro zone	2.6	2.1	1.7
Japan	1.7	1.0	1.3
China	6.9	6.5	6.2

f - forecast

Source: TD Economics, June 19, 2018.

FIGURE 1: **CAN THE GLOBAL ECONOMY BE WEANED OFF ULTRA-LOW INTEREST RATES?**



Source: BIS Statistics; data as at 15 June.

TABLE 2: **CAN THE GLOBAL ECONOMY BE WEANED OFF CENTRAL BANKS' ASSET PURCHASES?**

	Central Bank Assets *converted to USD Trillion*	% of GDP
Bank of England	0.8	26.6
European Central Bank	5.3	37.1
US Federal Reserve	4.3	21.0
Bank of Japan	5.0	94.8

Source: Thomson Reuters. Latest data: May 2018.

or tapering asset purchases. The critical question is whether the global economy is at last ready to be weaned off years of central banks' monetary policy stimuli, or will the process be waylaid, or derailed, by the United States' escalating trade disputes with the rest of the world.

The **United States** economy is in full swing. An economy that was already operating at potential will be further stimulated in the coming years by corporate and personal income tax cuts, full expensing of most types of capital investment, and additional government spending. On June 13, the Federal Reserve raised the federal funds rate target, having also done so in March (Figure 1). The Fed cited strong job gains, declining unemployment, stronger household spending and rising business investment as supporting inflation near its 2% target over the medium term. Still, the current stance of monetary policy in the US remains "accommodative." The Fed expects to raise rates twice more in 2018 and thrice in 2019. Meanwhile, it continues to withdraw liquidity through gradual quantitative tightening. The Fed is gently shrinking its balance sheet at rate of a little over $100 billion per annum. Nevertheless, its balance sheet remains sizable, at USD 4.3 trillion or 21% of GDP (Table 2).

Growth in the **euro-zone** is solid and increasingly broadly-based. On June 14, the ECB announced plans to reduce its asset purchases from €30 billion to €15 billion per month until the end of September, and cease purchases entirely by the end of December. The ECB's balance sheet is 37% of GDP as at May 2018. Even so, the ECB expects to keep interest rates at current, ultra-low levels until

TABLE 3: **THE UNITED STATES' WAR ON TRADE**

2018	
March 1	US President Trump tweets "trade wars are good" in advance of the US announcing tariffs of 25% on steel imports and 10% on aluminum imports on "national security" grounds, effective March 23.
March 22	US announces temporary exemptions for Canada, Mexico, the European Union (EU), Australia, South Korea, Brazil, and Argentina until June 1, 2018.
March 23	US steel and aluminum tariffs take effect. Mr. Trump confirms additional sanctions against China are being prepared for the alleged theft of US technology.
March 28	US permanently exempts South Korea, but Korea accepts steel quota which cuts its shipments by 20% from 2017 levels.
April 2	China announces retaliatory tariffs on US products worth USD 2.4 billion, including 15% duty on 120 American products.
April 3	US Trade Representative recommends tariffs of 25% on 1,300 Chinese goods.
April 4	Beijing adds tariffs on $50 billion worth of US products, including aircraft, cars and soybeans.
April 5	Trump threatens another wave of tariffs on Chinese goods worth $100 billion.
April 30	Trump administration extends steel and aluminum tariff exemptions provided to the EU, Canada and Mexico until June 1.
May 1	US extends permanent exemptions to Australia, Brazil and Argentina.
May 11	US President indicates the possibility of imposing duties of 20-25% on imports of automobiles and auto-parts from the EU.
May 19	China and the US announce they have reached a ceasefire and that China will "significantly increase" purchases of US goods and services. Both sides agree not to impose any new tariffs while talks continue.
May 23	US Commerce Department launches national security review of duties on imported automobiles and auto-parts, with a report due in February 2019.
May 29	In a surprise move, the White House says it will move ahead with the 25% tariffs on USD 50 billion worth of Chinese goods.
May 30	US rescinds exemption for Canada, Mexico and the EU on steel and aluminum tariffs.
May 31	Canada announces tariffs on up to CAD 16.6 billion on imports of US steel, aluminum and other products, effective 1 July 2018; Mexico announces tariffs of a range of products imported from the US including steel, pork, apples, grapes, cranberries, cheeses and bourbon.
June 1	US steel and aluminum tariffs take effect on imports from Canada, Mexico and the EU.
June 15	US announces 25% tariffs on 1,102 products imported from China worth USD 34 billion, effective July 6. Another 284 products worth USD 14 billion are identified as potentially becoming subject to the tariff at an unspecified date.
June 18	US President directs the US Trade Representative to identify a further USD 200 billion in Chinese imports that could potentially become subject to a 10% tariff. The President indicated another USD 200 billion in Chinese imports could be added if China responds with counter-measures. Taken together, if realized, US tariffs would apply to USD 450 billion of Chinese imports. This represents the bulk of inbound merchandise trade with China (the US imported USD 460 worth of goods from China in 2016).
June 20	EU announces its intention to impose tariffs on up to USD 3.2 billion imports of US products, effective June 22. Products include steel and aluminum, farm produce, bourbon, jeans and motorcycles.
June 22	EU counter-measures take effect.
June 27	Alliance of Automobile Manufacturers estimates that 25% tariffs on cars imported to the US would add USD 5,800 to the price of vehicles and collectively cost US consumers USD 45 billion per year.
June 29	Canadian government announces $2 billion package to support steel, aluminum and manufacturing industries affected by US trade policies.
July 1	Canadian counter-measures take effect.
July 6	US tariffs on Chinese imports take effect.

Data as at June 29, 2018.

mid-2019. The principal reason is that projected euro-zone growth is associated with still muted inflation. Inflation in the zone is expected to average just under 2% over the medium term.

In **Japan**, the central bank is less sanguine. While the Japanese economy is expanding moderately, assisted by firmer global growth, inflation remains weak. The Bank of Japan is concerned about the impact of US economic policies and Brexit on the global outlook. It expects to continue with a short-term policy rate of -0.1%, and a very large program of asset purchases aimed at keeping the 10-year government bond rate around 0%. The Bank's balance sheet is now USD 5.0 trillion or 95% of GDP.

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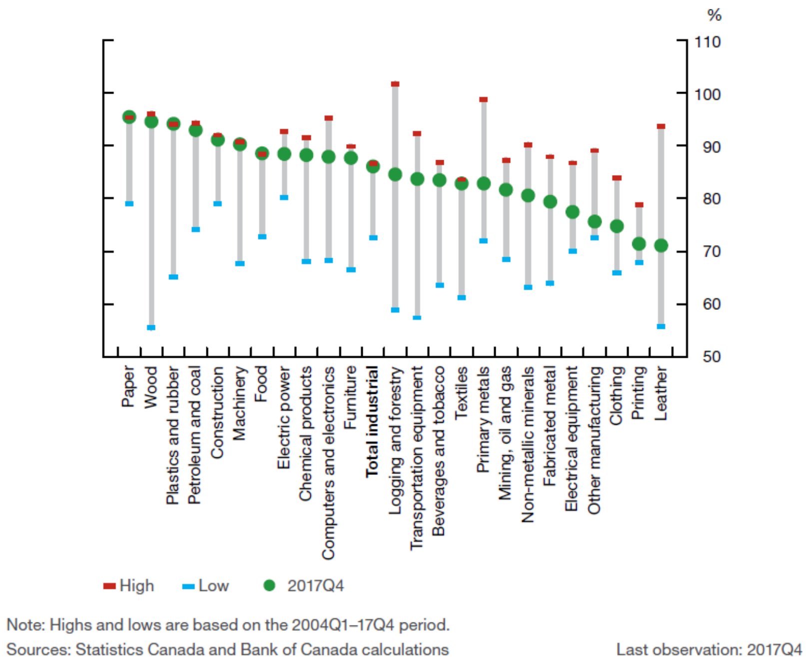
THE UNITED STATES' TRADE WAR ESCALATES

During May and June, the US President's protectionist rhetoric crystalized into policy action. The US imposed punitive tariffs on steel and aluminum imports from key trading partners, with threats of more to come. Table 3 inventories the sequence of trade announcements. Given the highly-integrated, global nature of supply chains for goods production, particularly in North America, US trade policies portend some disorder for world trade flows and business investment – together with mounting risks for Canada.

CANADIAN ECONOMY IS RUNNING NEAR POTENTIAL

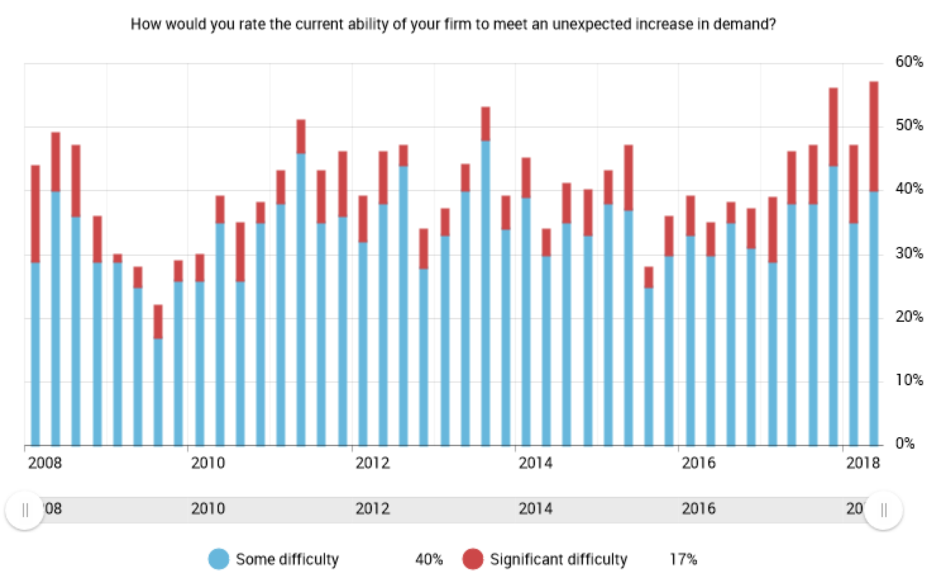
Canadian GDP growth, which was surprisingly strong in 2017, should moderate to be in line with potential output growth over the next two

FIGURE 2: **RATES OF CAPACITY UTILIZATION IN MANY GOODS-PRODUCING INDUSTRIES ARE NEAR POST-2003 HIGHS**



Source: Bank of Canada Monetary Policy Report, April 2018,Chart 8.

FIGURE 3: **MORE THAN HALF OF CANADIAN FIRMS FACE SOME OR SIGNIFICANT CAPACITY PRESSURES**



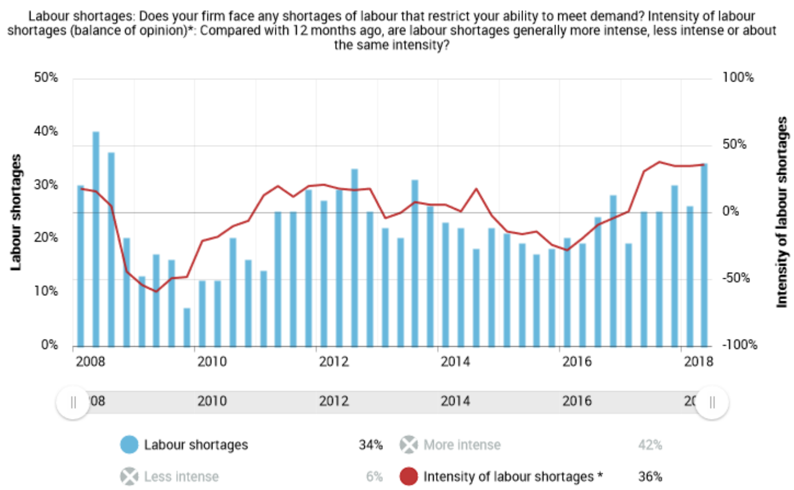
Source: Bank of Canada Business Outlook Survey, Summer 2018, Chart 5.

years. In April, the Bank of Canada (BOC) revised up its estimates for potential output growth. The BOC now estimates potential output growth of 1.5-2.1% in 2018 and 1.4-2.2% in 2019. Actual economic growth is expected to come in near the upper end of those bounds (Table 1). As a result, inflation is likely to peek its nose above the BOC's target (i.e. 2%) to 2.3% in 2018 and 2.1% in 2019.

Some rotation in the sources of growth is anticipated: a little less dependence on consumption and real estate-related activities, and slightly bigger contributions from business investment and exports. Higher interest rates and borrowing costs, tighter mortgage credit availability and a lower Canadian dollar should encourage the transition. Such a growth rotation, if it materializes, will be welcome, as Canada has become too dependent on the positive feedback loops between rising house prices, rising residentially-secured indebtedness and real estate-related activities stimulated by that dynamic.

Business investment is imperative to alleviate capacity pressures and also to establish the foundation for future productivity gains. Utilization rates

FIGURE 4: **ONE-THIRD OF CANADIAN FIRMS FACE A BINDING LABOUR SHORTAGE**



Source: Bank of Canada [Business Outlook Survey](), Summer 2018, Chart 6.

of physical capacity are near post-2003 highs in many goods-producing industries (Figure 2). In the BOC's Summer *Business Outlook Survey*, more than half of firms surveyed said they would face "some or significant difficulty" meeting an unanticipated increase in demand (Figure 3). This judgement is most common among firms in BC, Quebec and Ontario. Labour markets are also very tight. There is a widespread view among firms that labour shortages have intensified over the past year. In fact, one-third of firms said they faced binding labour shortages that restrict their ability to meet demand (Figure 4). Meanwhile, Canada has posted the lowest unemployment rate since 1976 for four consecutive months, at 5.8%.

The above developments should give the BOC ample reason to raise rates in July and once more over the balance of 2018. However, concerns about global trade tensions, and some softness in Canadian monthly economic data during Q2, could yet prompt the Bank to stay its hand. And, if Canadian economic data weakens, or more damaging US trade policies are announced, it is not inconceivable that the Bank would put a rate cut on the table.

BC ECONOMY: CHOPPY WATERS AHEAD

British Columbia's **merchandise exports** (by value) remain elevated but the overall growth eased to 2.5% year-on-year (y/y) in April (Figure 5). Export values for energy and solid wood products fell, while export values for pulp and paper, agriculture, fish, and fabricated metal products rose. By destination, exports to the major markets of the US, Japan and South Korea moved lower but were mostly offset by gains in a range of other markets (e.g. China, India, Taiwan, Hong Kong and the United Kingdom). There is likely to

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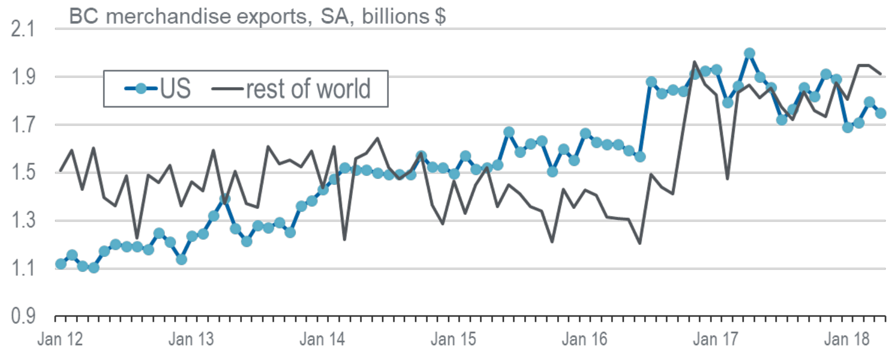
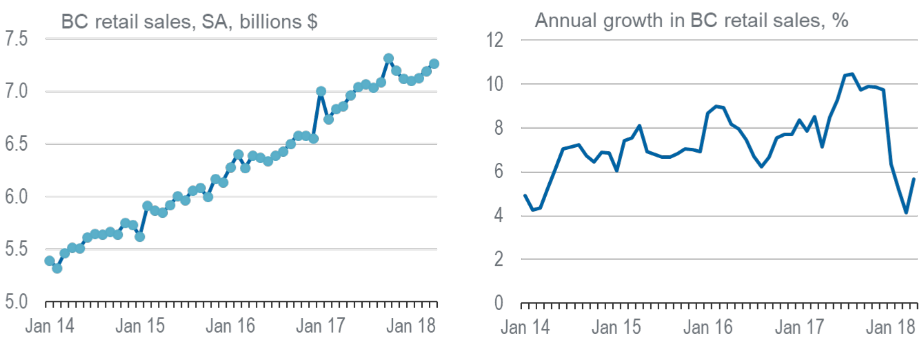
FIGURE 5: **BC MERCHANDISE EXPORTS REMAIN ELEVATED**



Source: BC Stats. Latest: April 2018.

FIGURE 6: **GROWTH IN CONSUMER SPENDING SLOWS**



Source: Statistics Canada. Growth rates calculated from 3-month moving averages, latest April 2018.

be some disruption in trade flows as the US-led global tariff war unfolds. The renewed depreciation in the Canadian dollar, which began 2018 at almost 80 US cents but has since slipped to 75-76 US cents, should provide some cushion.

The 5-6% year-to-date depreciation in the CAD will also support **tourism**, a large sector in BC that has been running hot for several years. International visitor entries were up 7.2% (y/y) in March due to strong demand from the US and Asia. Hotel occupancy rates averaged 62.5% in 2018 Q1 for the province, compared to 61.3% for the same period in 2017.

Consumer spending has played a vital role in BC's economic expansion over the past few years, though there are some signs that the pace of growth is softening. Retail spending is still being supported by high levels of employment and consumer confidence and wage/salary gains (Figure 6). On the other hand, the drop in resale activity (i.e. turnover of established properties) will dampen demand for furniture and appliances, carpets, garden equipment and other household items that home-buyers frequently replace or upgrade when moving.

WHAT'S NEXT FOR THE REAL ESTATE ECONOMY?

The BC economy is heavily reliant on the reselling, financing, leasing and building of real estate assets. Over the past five years, the residential construction, finance and real estate sectors in combination have amounted to 28% of provincial GDP, compared to its usual average of around 24% of GDP. In our last update, we noted that activities tied to real estate have driven more than one-third of all economic growth in BC over the past four years.

Much of this activity has been stimulated by the surge in established house prices in the province's major cities. The acceleration in established house prices is attributable to an era of ultra-low interest rates, strong growth in uninsured mortgage debt (notably home equity lines of credit), and unprecedented flows of savings and loan capital from China into the real estate markets of "gateway" cities and their satellites (especially in the Pacific Rim). In response to these powerful price signals, residential construction activity has trended above historical averages as a share of GDP, and also in relation to population growth. BC's real estate boom has also stimulated strong employment and income growth for several years.

Figure 7 highlights the surge in demand for established housing assets. Greater Vancouver established house prices (all types, composite) have typically traded at a premium of 1.4-1.5 times the

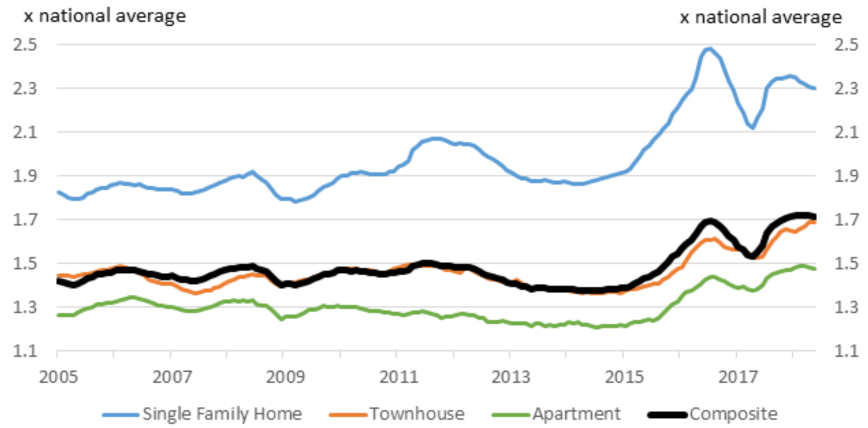
Canadian average. After 2015, that premium jumped to 1.7. Single family homes traded at a peak of 2.5 times the Canadian average in July 2016. Unlike the 2010-2012 surge, which mostly affected single family homes, the post-2015 price boom encompassed all types of housing. Prices for single family homes, townhouses and apartments are now, respectively, 2.3, 1.7 and 1.5 times the national average. Similarly, abrupt increases in house prices have occurred in other gateway cities around the Pacific Rim in recent years.

The outlook for the real estate sector appears precarious, as several factors point to the end of the long boom: higher domestic and global interest rates; tighter mortgage credit availability; numerous housing tax and other demand-dampening measures in the 2018 BC budget; a renewed government focus on anti-money laundering and real-estate related tax evasion; and aggressive steps by the Chinese government to rein in its credit and housing boom and to stem capital outflows. Taken together, these developments could play out in a number of ways: declining resales (and therefore commissions on ownership transfers); flat then falling inflation-adjusted house prices; and softer renovation activity and home-related household consumption.

New residential construction is expected to ease but remain at elevated levels given the persistence of high prices to date as well as demographic growth in BC's key urban markets. New housing starts in the province are around 40,000-45,000 units, still around their highest levels since the mid-2000s

FIGURE 7: **VANCOUVER'S HOUSE PRICE "PREMIUM" SURGED ABRUPTLY FROM 2015**

RATIO OF GREATER VANCOUVER TO CANADIAN HOUSE PRICES



Source: Canadian Real Estate Association MLS Benchmark House Price.

FIGURE 8: **BC HOUSING STARTS STILL ELEVATED**

SAAR = seasonally adjusted annual rates, Q2 2018 estimate based on April & May data.

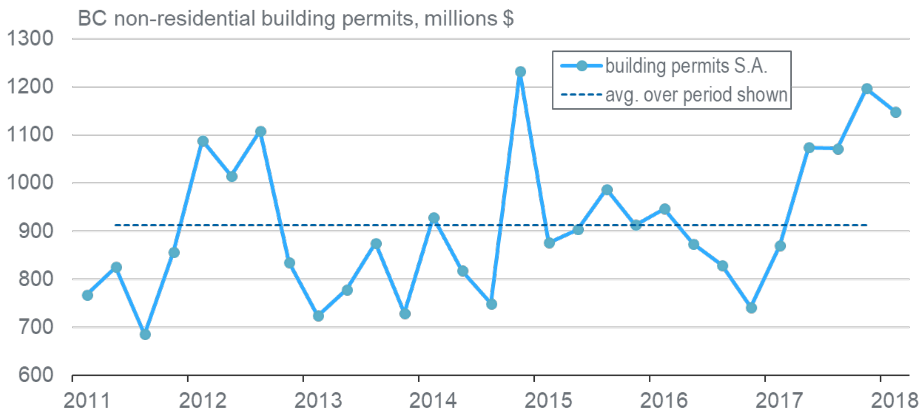
Source: Statistics Canada.

(Figure 8). The federal government's ambitious plan to ramp up Canada's immigration intake from 300,000 per year in 2017 to 340,000 by 2020 will also support residential construction in the gateway cities of Vancouver and Toronto.

A MIXED PICTURE FOR BUSINESS INVESTMENT

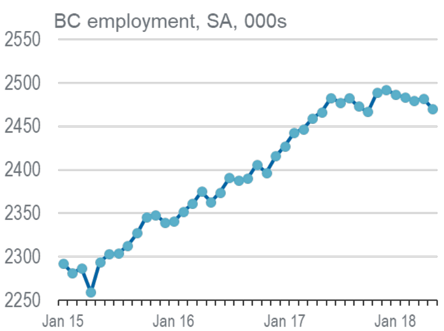
The value of building permits in BC climbed throughout 2017. The industrial, commercial, government sectors all contributed to the rise. The value of building permits is currently running about 26% above

FIGURE 9: **BC NON-RESIDENTIAL CONSTRUCTION BOOSTING GROWTH**



Source: Statistics Canada.

FIGURE 10: **BC JOB GROWTH HAS LEVELLED OFF**



SA = seasonally adjusted, latest May 2018.

Source: Statistics Canada, Labour Force Survey.

FIGURE 11: **RISING JOB VACANCY RATE IN BC**

Source: Statistics Canada, Job Vacancy and Wage Survey.

the average level recorded since 2011 (Figure 9). Machinery and equipment investment intentions are also positive.

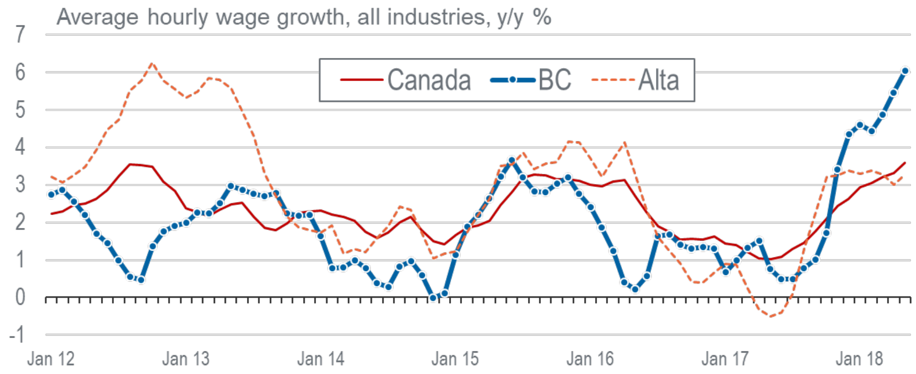
Having said that, escalating trade wars, uncertainty over NAFTA's future, recent US tax cuts, and more onerous regulatory and permitting processes all cloud the private sector investment climate in BC. Here, the downside risks are especially acute for BC's merchandise export sector, much of which relies on land-based business operations and large, capital-intensive facilities. Stronger global growth has pushed commodity prices higher, including record high lumber prices. Most Canadian forecasters assume a relatively muted pickup in business investment in 2018-19, despite capacity pressures and favourable commodity prices. A particular concern for the Business Council is the increasingly complex and costly domestic regulatory and tax climate coupled with the risk of a "worst of times" external backdrop – circumstances that are likely to prompt many BC businesses to postpone or scale back capital investment.

JOB MARKET MAXED OUT IN BC

Following three years of brisk growth, provincial employment has remained essentially unchanged over the past year (Figure 10). The flattening mostly reflects the reality that there are not enough people to hire rather than any easing in labour demand. With the unemployment rate below 5%, the lowest among provinces, many businesses continue to report difficulty finding and hiring new workers. The overall job vacancy rate is 4.0%, the highest in the country, with some industry sectors having vacancy rates close to 1 in 10 (Figure 11).

The tight labour market is now showing up in accelerating wages over the past six months. Average hourly wages in BC are up 6% over the past year, an increase that is nearly double the national benchmark and the fastest pace seen in BC in at least three decades (Figure 12). This provides clear evidence of a labour market operating beyond full capacity.

FIGURE 12: **WAGE PRESSURES ARE SURGING (FINALLY)**



Source: Statistics Canada.

TABLE 4: **BC ECONOMIC FORECAST (ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)**

	2017	2018f	2019f
Real GDP	3.9	2.3	2.3
Employment	3.7	1.2	1.4
Unemployment rate (%)	5.1	4.6	4.4
Housing Starts (000 units)	40.1	39.0	37.0
Retail sales	9.0	5.9	5.3
BC CPI	1.7	2.1	2.0

f - forecast

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

SUMMARY AND RISKS

BC remains on a reasonably solid growth footing. On the positive side of the ledger, the global economy is in the best shape since the Great Recession, and commodity prices are supportive of continued growth in BC and Western Canada more generally. The province benefits from diversification in industrial structure as well as market diversification. BC's role as a gateway and the related contributions of the transportation and logistics industry will also underpin growth.

The economy does, however, face headwinds. The number and impact of items on the negative side of the ledger is a concern. New tariffs and escalating trade wars are clear negatives for Canada and BC. Because of its oversized role over the past few years, the expected end of the real estate boom is a key reason why we believe real GDP growth in the province will downshift to 2.3% this year, from the blistering 3.9% pace set in 2017.

Policy changes and government-created policy risks have also emerged as factors weighing on the broader business investment outlook. The tax burden for business and highly-skilled earners in BC (and Canada) has increased, at a time when the United States has reduced taxes (especially for businesses) and taken steps to lighten and streamline regulatory burdens. As the economy shifts away from real estate-driven activity, we see a risk that business investment will fall short of the upswing typically expected at this stage in the economic cycle – not only in BC, but in Canada as a whole.

However, there are upside risks to the outlook. If the LNG Canada project proceeds, it would provide an almost $40 billion boost to the BC economy in future years. Another upside risk is the Trans Mountain pipeline project. With the federal government effectively nationalizing the project in May, the $7 billion plus capital project looks more likely to advance. Finally, there is a possibility that global monetary policy could remain very accommodative for longer than most forecasters currently expect.

On the downside, external risks for BC/Canada include further escalation of the United States' global trade war and uncertainty over NAFTA. The key domestic risk is that the extensive imbalances in Canada's real estate and credit markets could unwind in a disorderly manner, as lessons from financial history and from the experience of other countries suggest could happen. This risk could become more acute if global monetary conditions tighten faster than anticipated.

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