BC ECONOMIC REVIEW AND OUTLOOK

Business Council *of* British Columbia
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KEEP CALM AND CARRY ON

HIGHLIGHTS

- Global GDP growth is expected to slow to around 3% in 2019-20 due to the cumulative effects of trade conflicts, investment uncertainty and feeble productivity gains in most advanced economies (including Canada).
- U.S. GDP growth is expected to cool to 1.7% in 2020, down from 2.5% this year and almost 3% in 2018.
- Canada's economy is expected to limp along at 1.5-1.6% growth in 2019-20. This is close to the economy's full speed as there is little spare capacity or unemployment. The main source of growth is century-high immigration. However, in per capita terms, the economy is barely growing at all, real wage growth is anemic and investment per worker is falling.
- B.C.'s economy is also slowing. We have downgraded our outlook again and now project that GDP will increase by 1.8% in 2019. The outlook for 2020 has also been trimmed slightly from our previous forecast to a 2.2% rate of growth.
- The main reason for the downgrade is the deteriorating external setting. B.C.'s merchandise exports are already sliding and will probably continue to fall into 2020.
- Consumer spending in the province also remains weak. And there are some signs that the job market is softening, consistent with the steep downturn in the forestry sector and sluggish retail sales.
- Residential investment is poised to decline in 2020. Although resale activity is picking up, helped by lower mortgage rates, housing starts are cooling.
- Currently, the main drivers of the B.C. economy are rapid population growth and buoyant non-residential construction spending.

TEPID GLOBAL GROWTH OUTLOOK

Global growth is expected to slow from 3.6% in 2018 to around 3% over 2019-21, the slowest pace since the 2008-09 financial crisis (**Table 1**). Advanced economies are beset with structural weaknesses reflected in persistently low productivity growth over the past decade or more (**Figure 1**). Exacerbating these problems, the escalation of trade tensions and the rise in uncertainty over the past year has chilled international trade, industrial production and capital investment (**Figure 2**). The downturn in investment will further undermine productivity growth and lead to lower medium-term potential GDP

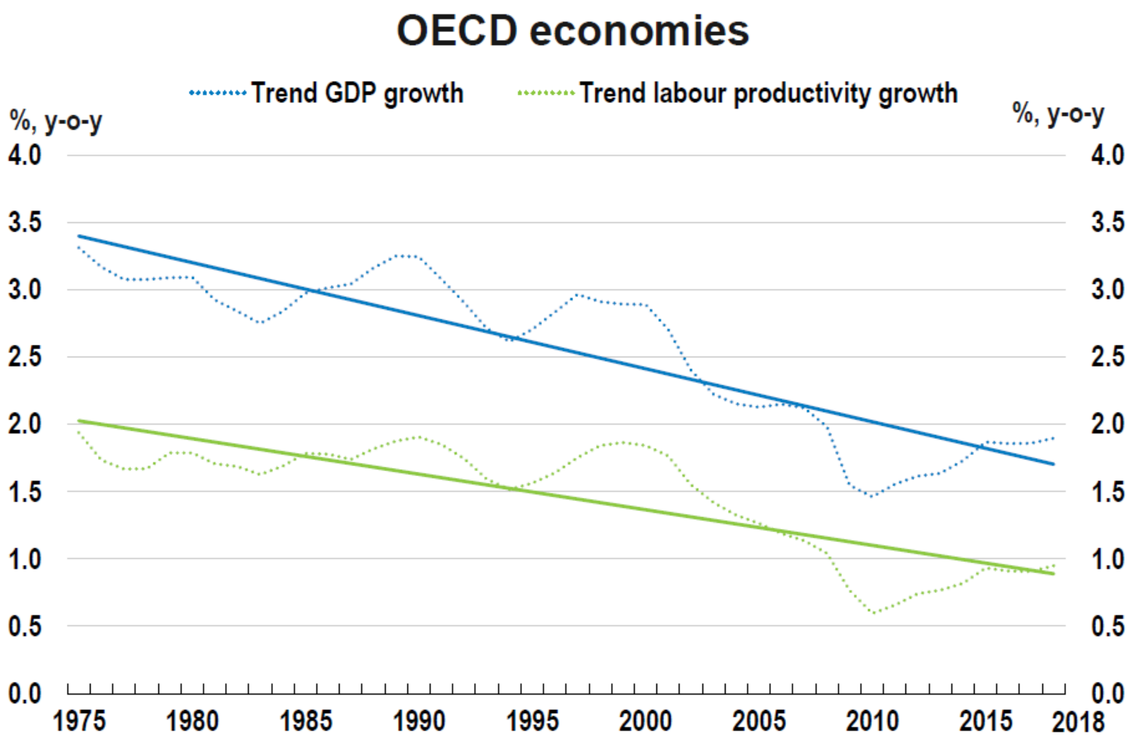
TABLE 1: **GLOBAL ECONOMIC FORECAST (ANNUAL % CHANGE IN REAL GDP)**

Region	2018	2019f	2020f	2021f
World	3.6	2.9	3.2	3.4
U.S.	2.9	2.3	1.7	1.8
Euro area	1.9	1.1	1.0	1.3
Japan	0.8	1.1	0.2	0.8
China	6.5	6.3	6.0	5.7
CANADA				
Potential	1.5 - 2.1	1.5 - 2.1	1.3 - 2.1	1.2 - 2.4
Actual	1.9	1.5	1.6	1.7

f - forecast

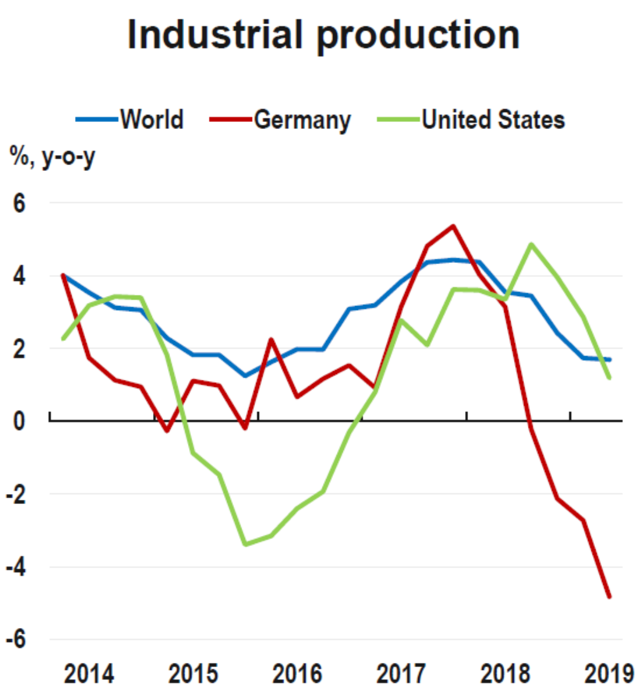
Source: TD Economics, Bank of Canada (potential GDP).

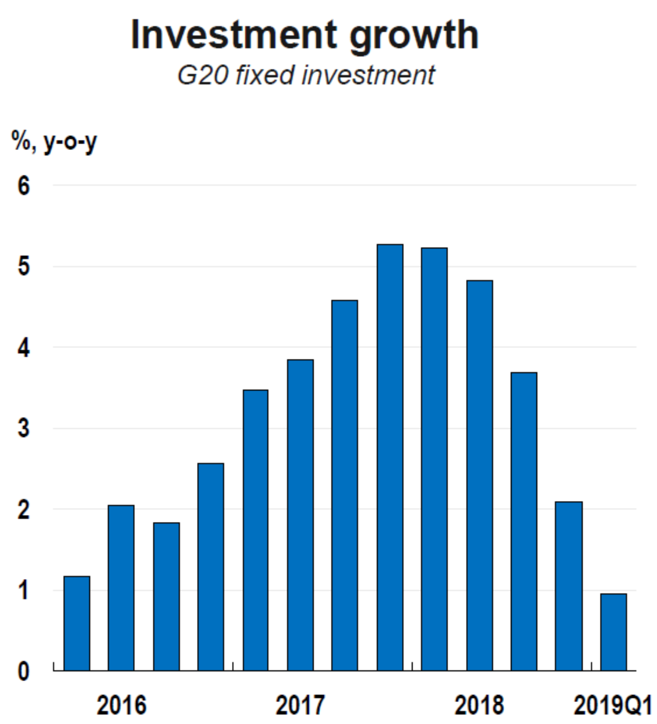
FIGURE 1: **LONG-TERM DECLINE IN PRODUCTIVITY & GDP GROWTH**



Source: OECD.

FIGURE 2: **UNCERTAINTY DAMPENS MANUFACTURING & INVESTMENT**





Source: OECD.

growth. Demographic trends in many advanced economies are also exacerbating this secular decline in growth.

The U.S. economy is on track to moderate due to cooling business investment and exports. The American consumer should provide some support for the otherwise wilting economy, given that household balance sheets are in good shape (unlike in Canada). Still, U.S. growth will likely outpace most other advanced countries across the forecast horizon. The Federal Reserve (and some other global central banks) has loosened monetary policy to offset near-term weakness in aggregate demand. However, loose monetary policy can play only a limited role: getting economies back to their full potential. It *cannot* address the problem of fundamentally weak growth in potential GDP caused by anemic productivity growth. Only structured reforms can address productivity problems. Risks to the global outlook are weighted to the downside.

CANADA'S ECONOMY: WHEN DID "GROWTH BELOW 2%" BECOME "STRONG"?

Some commentators — misleadingly in our view — characterize the Canadian economy as "strong." This is only true in the sense that the economy is expected to grow broadly within the range of estimates for potential GDP growth (**Table 1**). Potential GDP growth — a function of growth in labour productivity and labour inputs (total hours worked) — acts as a natural "speed limit" that the economy can attain without generating above-target inflation. Current estimates for potential growth for Canada are 1½ - 2% over 2019-21, meagre by historical standards.

Canada's principal economic strategy rests on 30-year high population growth. Permanent immigration is approaching the highest intake since 1911-13 and, when temporary residents are added, Canada is experiencing the highest immigration intake since Confederation. The federal government's population expansion strategy is buttressing GDP growth by raising employment numbers and total hours worked.

However, the strategy is having no impact whatsoever on the variables that determine Canadian living standards – productivity, GDP per capita and real wages. GDP growth has averaged 1.7% per annum over the past 3 years, with fully 1.1% of this attributable to population growth. In per capita terms, GDP growth has averaged just 0.6% per annum. Real wage growth is trending around the same rate. The immutable rules of humble arithmetic thus help to explain the disconnect between our supposedly "strong" economy and the fact many Canadians feel they are not getting ahead. In per capita terms, most people are not seeing any material rise in living standards.

Productivity growth — the key determinant of growth in potential GDP — has averaged just 0.3% per annum over the past 3 years. Capital intensity — the amount of invested capital per dollar of production or per employee — is declining. Real business investment per worker fell 4% y/y in 2019Q2. Across almost all types of capital equipment, investment per worker is lower than at the peak of the last business cycle 11 years ago (**Figure 4**). In total, Canadians are working with $1,500 less capital per worker than they were in 2007Q2-2008Q1. Declining capital intensity is an ominous signal about future productivity and potential GDP growth.

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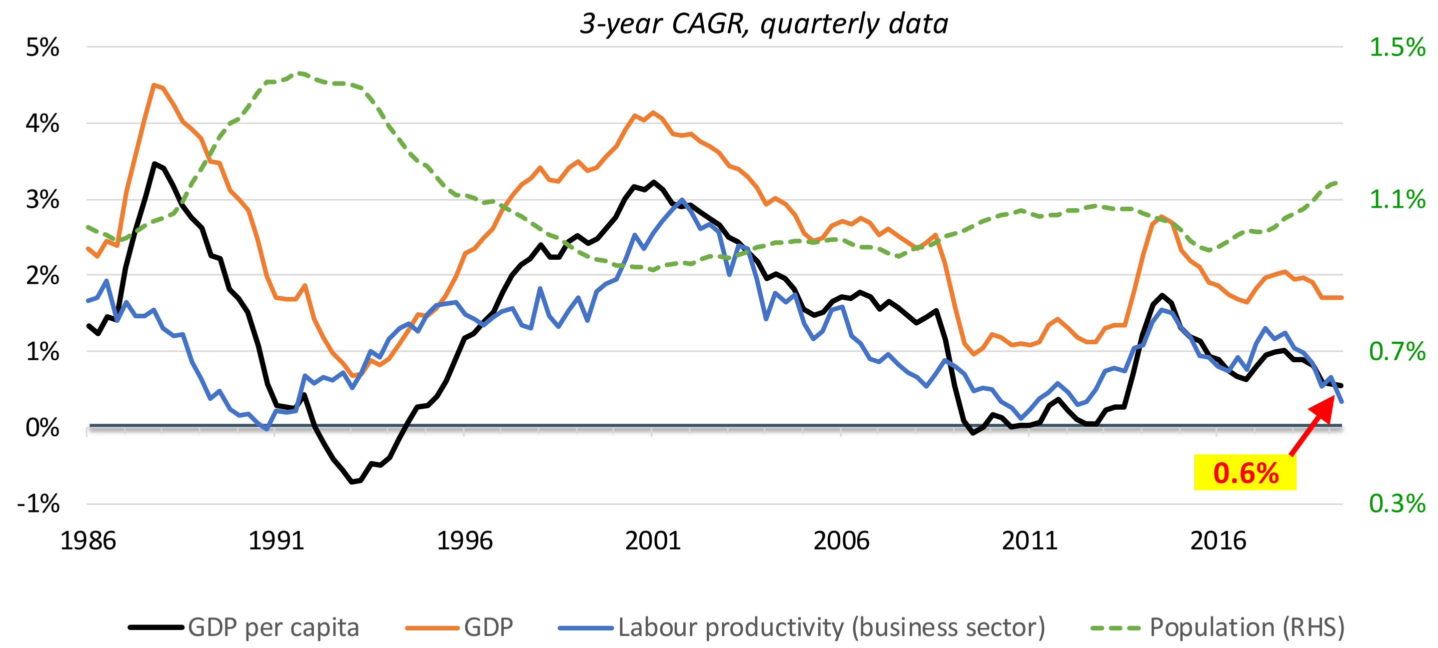
Overall, risks to the Canadian economy are mostly weighted to the downside. The biggest upside risk is the prospect of a quick resolution to the U.S.-China trade conflict which continues to roil global markets and erode business confidence. On the downside, Canada's national indebtedness is now the 8th highest globally and the economy is yet to seriously begin deleveraging.

GLOBAL SLOWDOWN WASHING UP ON B.C.'S SHORES

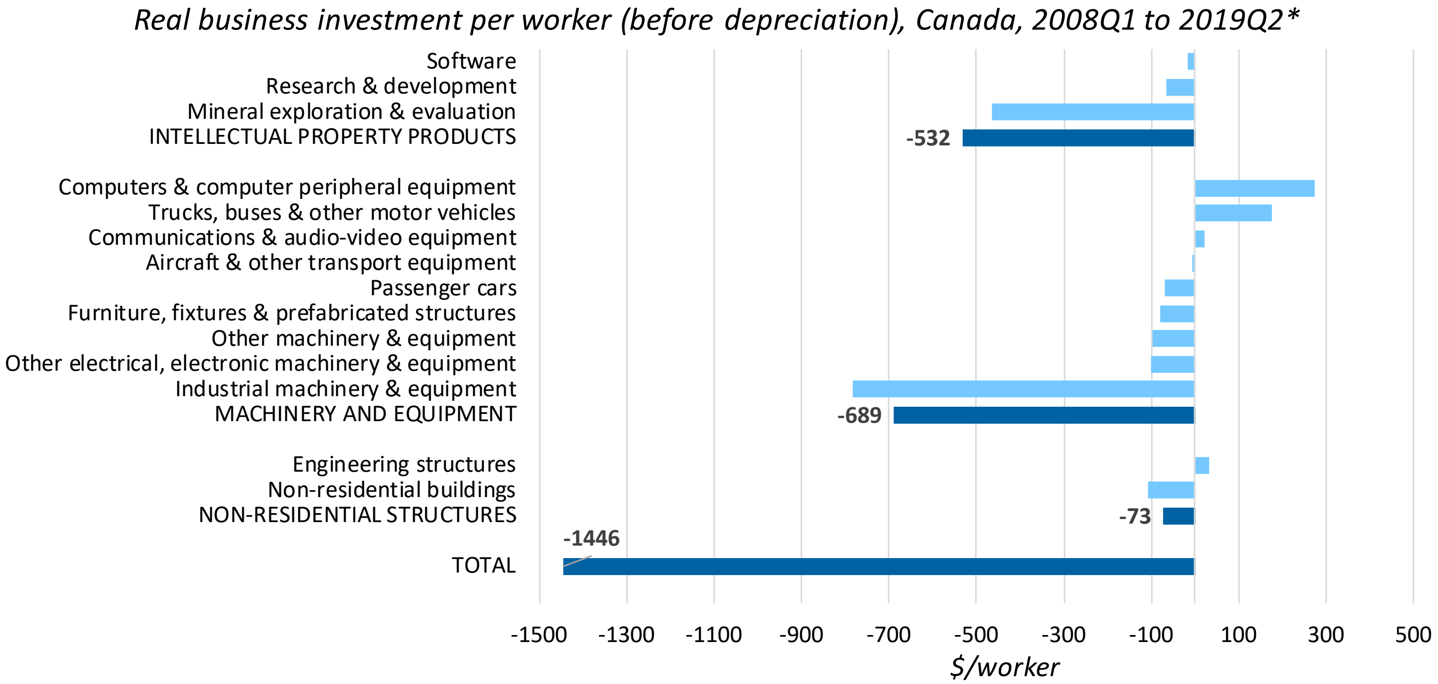
The B.C. economy is in reasonably good shape, but the headwinds from weaker growth south of the border and an unsettled global trade environment are weighing on B.C.'s prospects. In our previous quarterly outlook publication, we noted that growth in B.C.'s international merchandise exports was likely to turn negative. It turns out that this has now occurred. Considering the deterioration in the external backdrop, we see further downside for B.C.'s merchandise exports. On the domestic side of the economy,

FIGURE 3: **30-YR HIGH POPULATION GROWTH IS LIFTING GDP, BUT NOT PRODUCTIVITY & GDP PER CAPITA**



Source: Statistics Canada.

FIGURE 4: **CAPITAL INTENSITY IS BELOW PRE-RECESSION LEVELS**



Source: Statistics Canada.

* 4 quarter average, 2012 chained dollars

consumer spending growth remains unusually muted. The worsening outlook for exports and B.C.'s increasingly cautious consumers have prompted us to trim our forecast for the second time this year.

We now expect the B.C. economy to grow by just 1.8% this year. In our second quarterly outlook we projected growth of 2.0% and at the start of the year we anticipated a slightly above average performance of 2.5%. Next year, bolstered by high levels of non-residential construction, including progress on LNG Canada's massive Kitimat project and continued work on Site C, we see the economy strengthening modestly to grow by 2.2%.

The 2020 outlook, however, is uncertain. If the global economy continues to soften and the trade dispute between the U.S. and China escalates further, both Canada and B.C. will be dragged down. Under such conditions, economic growth in B.C. would probably slow to a crawl.

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

	2017	2018	2019f	2020f
Real GDP	4.0	2.4	1.8	2.2
Employment	3.7	1.1	2.5	1.2
Unemployment rate (%)	5.1	4.7	4.7	4.9
Housing Starts (000 units)	40.1	41.0	40.0	34.5
Retail sales	9.3	2.0	1.8	3.0
B.C. CPI	1.7	2.7	2.3	2.1

f - forecast

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

JOB MARKET HOLDING UP, BUT CRACKS ARE EMERGING

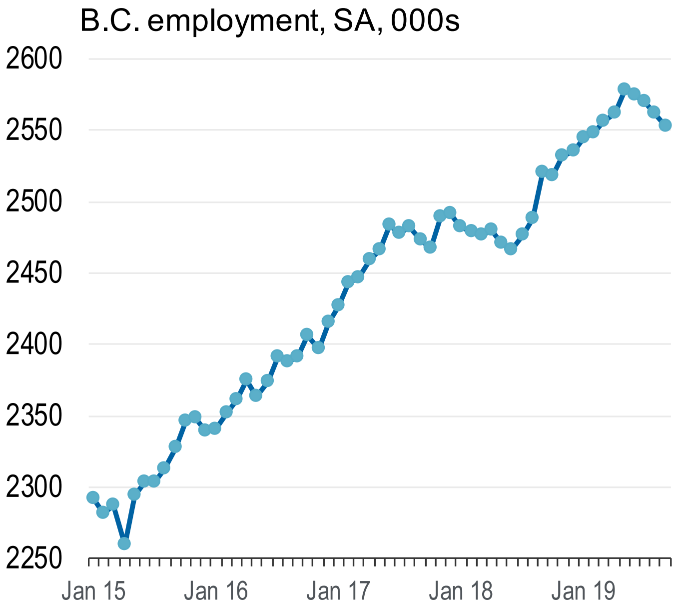
The provincial labour market remains healthy, especially with a 3.4% increase in the average employment level this year compared to the same period in 2018. The year-over-year comparison, which captures the early months of 2019, masks some emerging cracks in the province's job market, however. Recent data tracking month-to-month changes shows total employment edging lower for the past few months. The unemployment rate has also crept up to 4.8%, whereas it hovered around 4.2% a year ago. Normally, these changes would not garner much attention, because employment data can be volatile, particularly when looking at changes over a month or two. However, the worsening global economic backdrop and the crisis-like conditions in forestry all point to a less buoyant job market.

A particular concern is the retrenchment in private sector hiring. The number of employees working in the B.C. private sector has slumped by almost 47,000 over the past several months. This sizable decline has been partly offset by a 15,000 bump in public sector employment, tempering the drop in the overall job numbers. The erosion in private sector hiring, however, bears close monitoring, as it often heralds a period of slowing economic activity.

B.C. CONSUMERS INCREASINGLY TAPPED OUT, ESPECIALLY FOR LARGE TICKET ITEMS

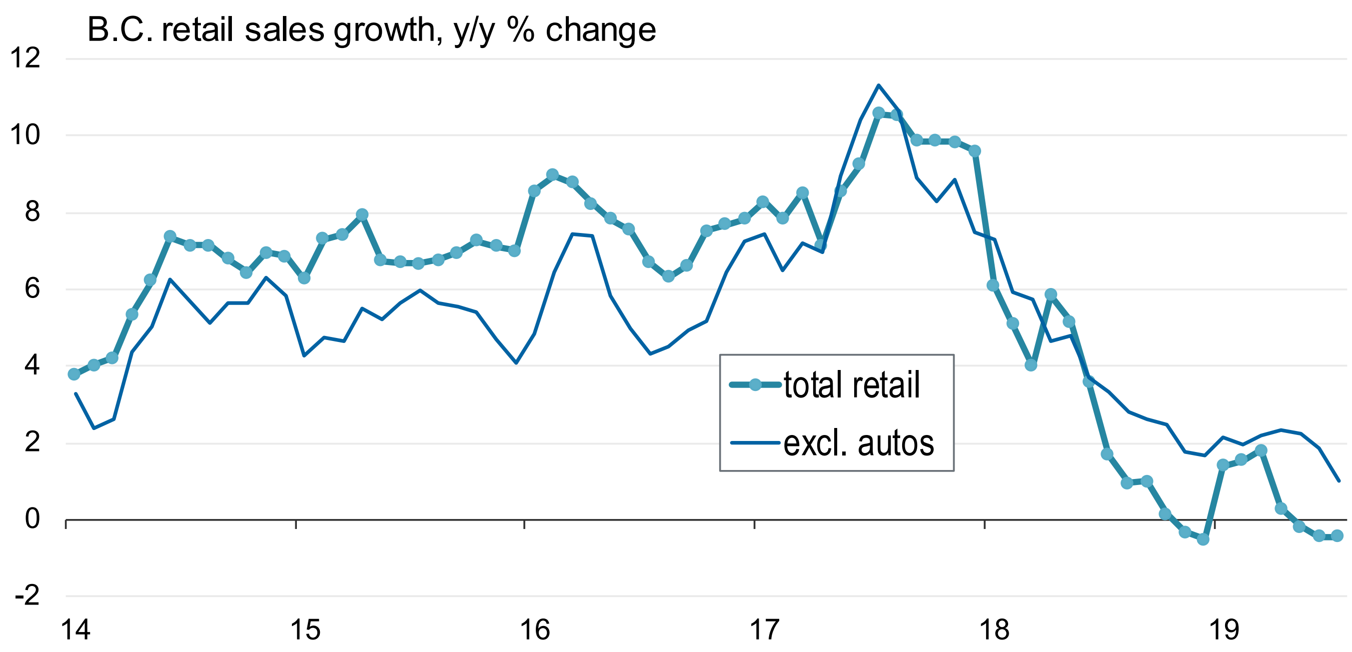
Consumer spending is a critical indicator of general macro economic conditions. Total retail spending in the province grew at a very robust pace for many years. But roughly 18 months ago, the retail sector began to lose momentum and by the end of 2018 retail sales were falling. Most recently, retail sales are down in nominal terms from year ago levels. Much of the weakness is due to a sharp pull-back in auto sales. If autos are excluded, the remaining total for retail sales is still growing, but at a very anemic 1–2% pace. Considering that inflation is running at more than 2% and B.C.'s population is increasing by 1.5% annually, adjusting for inflation and population growth confirms that retail spending is exceptionally weak. Sales of new automobiles are telling. The number of new vehicles sold in B.C. has been trending lower for 18 months now, with the pace of decline reaching close to 10% annually. Retail spending is clearly a soft spot in the B.C. economic setting. We do not foresee a sharp rebound in the near future. Record high household debt levels don't help.

FIGURE 5: **EMPLOYMENT GROWTH SLOWING?**



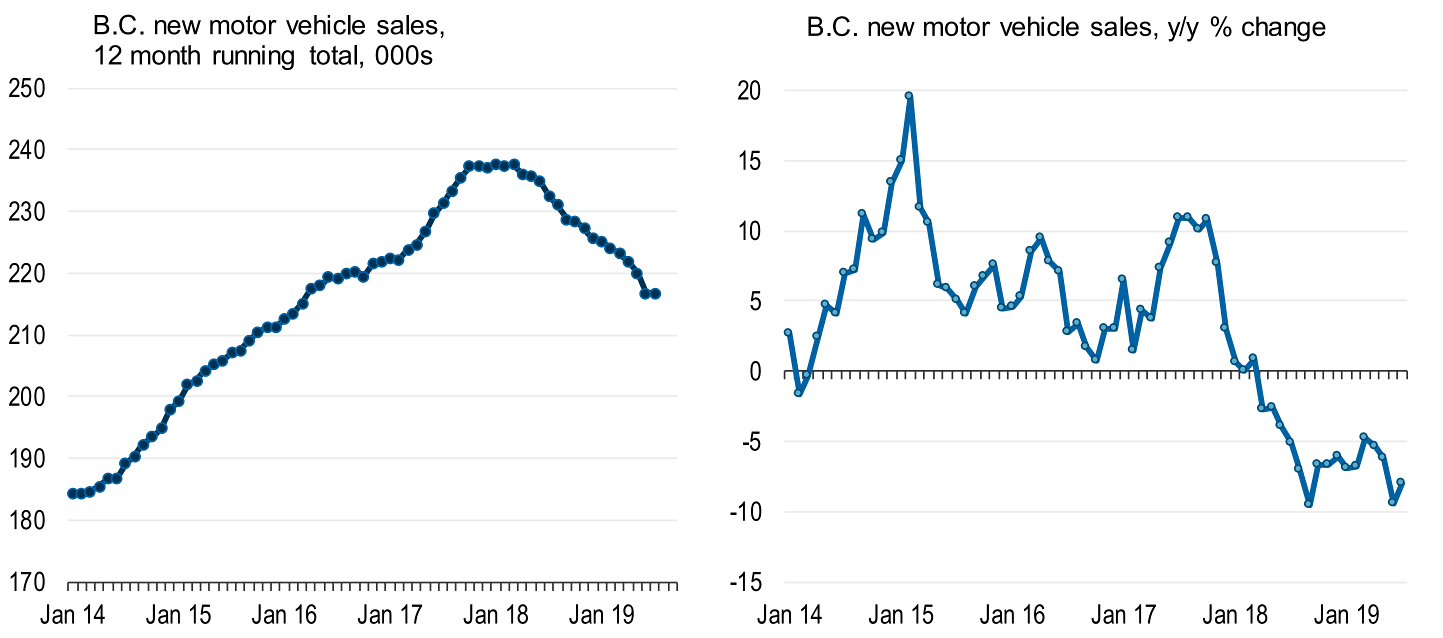
Source: Statistics Canada, Labour Force Survey. Monthly data are seasonally adjusted. *year-to-date (Jan-Sept)

FIGURE 6: **CONSUMERS TIGHTEN THEIR BELTS**



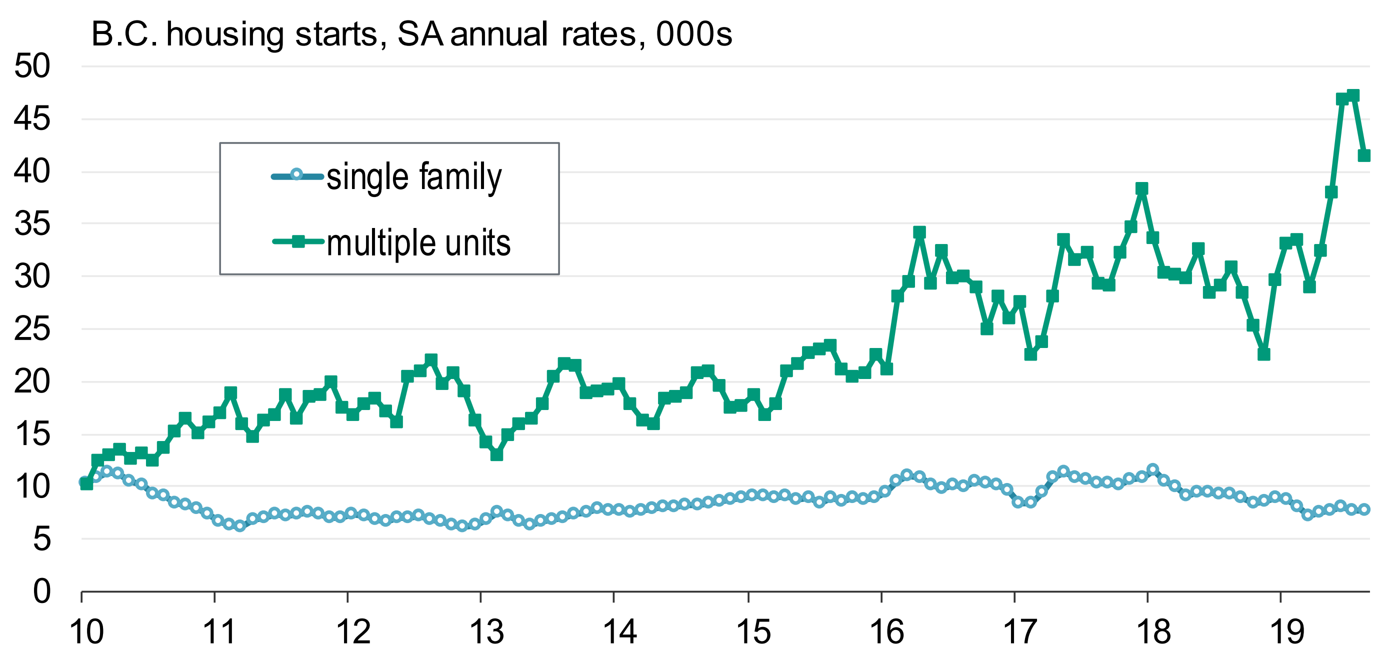
Source: Statistics Canada, Table 20-10-0008-01. Based on 3-month moving averages.

FIGURE 7: **NEW MOTOR VEHICLE SALES TUMBLE**



Source: Statistics Canada, Table 20-10-0001-01. % change calculated from 3-month moving averages.

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



Source: Statistics Canada. Latest: August 2019. Seasonally adjusted annual rates, 3-month moving average.

Consistent with the drop in global trade and the gloomier external economic environment, B.C.'s international merchandise exports are declining. The forest products sector has been especially hard hit.

HOME RESALES HAVE PICKED UP, BUT REAL ESTATE SECTOR STILL A SOFT SPOT

The residential real estate sector remains sluggish with resales of existing homes still hovering below long-term averages. However, there are some positive developments in the sector. Affordability is improving and sales activity has recently perked up. The improved sales environment suggests that residential real estate activity is no longer a drag on economic growth, certainly not to the degree it was over the past couple of years.

Lower mortgage rates, especially for 3-year terms, coupled with some price decreases — particularly in the lower mainland — have eased affordability pressures slightly. Provincial home resales continued their upward trend in August, which produced the fifth monthly gain (on a seasonally adjusted basis) in the past six months. The upswing was sufficient to push resales 8% above the tally recorded in August of 2018. The pick-up in sales was especially strong in the Greater Vancouver Real Estate Board region, where September's sales jumped 46% compared to the same month in 2018. Despite the big gain, September's resales remained slightly below (1.7%) the 10-year average for that month. In the Fraser Valley Real Estate Board region, year-over-year resales rose 12%. For the second month in a row, home resales in the Fraser Valley surpassed 2018 levels, but are still below the ten-year average.

EXPORTS ARE BECOMING A DRAG ON GROWTH

Consistent with the drop in global trade and the gloomier external economic environment, B.C.'s international merchandise exports are declining. So far (through August) this year, merchandise exports are down more than 5%. Looking ahead, the near-term trend for B.C. exports is negative. The weakening is quite widespread, with exports to nearly all of the province's major trading partners falling. The one notable exception is India, where exports are up 33% year-to-date, extending a period of very strong sales to this market.

The forest products sector has been especially hard hit. B.C. wood product exports are down 19% so far this year. The downturn in forestry is underscored by the steep drop in manufacturing sales. On a year-to-date basis, manufactured wood product sales are down 22%. Pulp and paper exports are down 15%.

There are still a few bright spots. The value of B.C.'s agricultural exports is up nearly 20% so far this year, which continues a positive trend for this sector. And energy exports have made a bit of headway due to firmer natural gas prices. Still, the overall story is that most segments of B.C.'s goods exports are struggling and are likely to face further headwinds in the coming year.

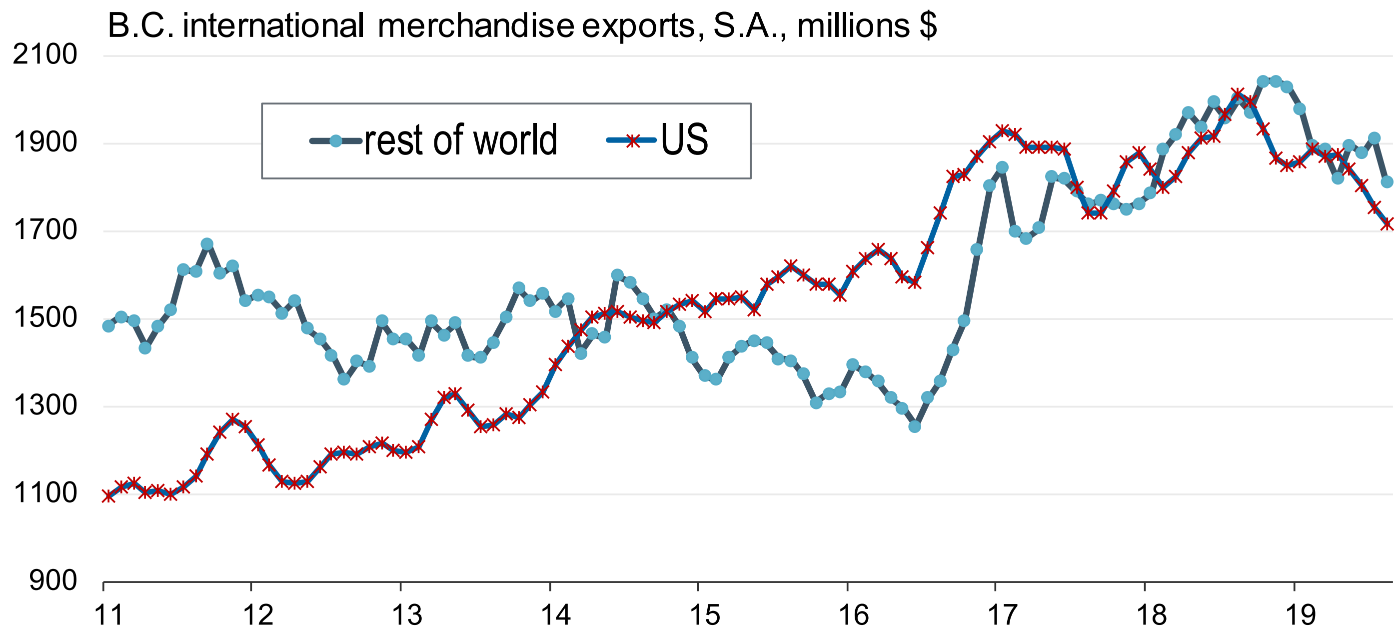
NON-RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING STAND OUT AS THE BRIGHT SPOT

The construction of major engineering projects, infrastructure, public sector buildings and commercial structures is an area of the provincial economy that stands out as a current growth star. Investment and building across all of these segments is at elevated levels and still climbing. In fact, the non-residential construction industry is operating at capacity or beyond capacity, as the reported shortages of qualified workers suggest.

The value of non-residential building permits in B.C. over the first half of the year totalled $3.2 billion. Over the same six-month period in 2018, non-residential permits were just over $2 billion, meaning permit values have surged 57% so far in 2019. This impressive gain comes amid a longer upward trend in non-residential construction activity that has been evident for several years. Since 2014, the value of non-residential building permits in B.C. has doubled in nominal terms. This, together with population growth, is what now underpins the province's continued modest economic expansion.

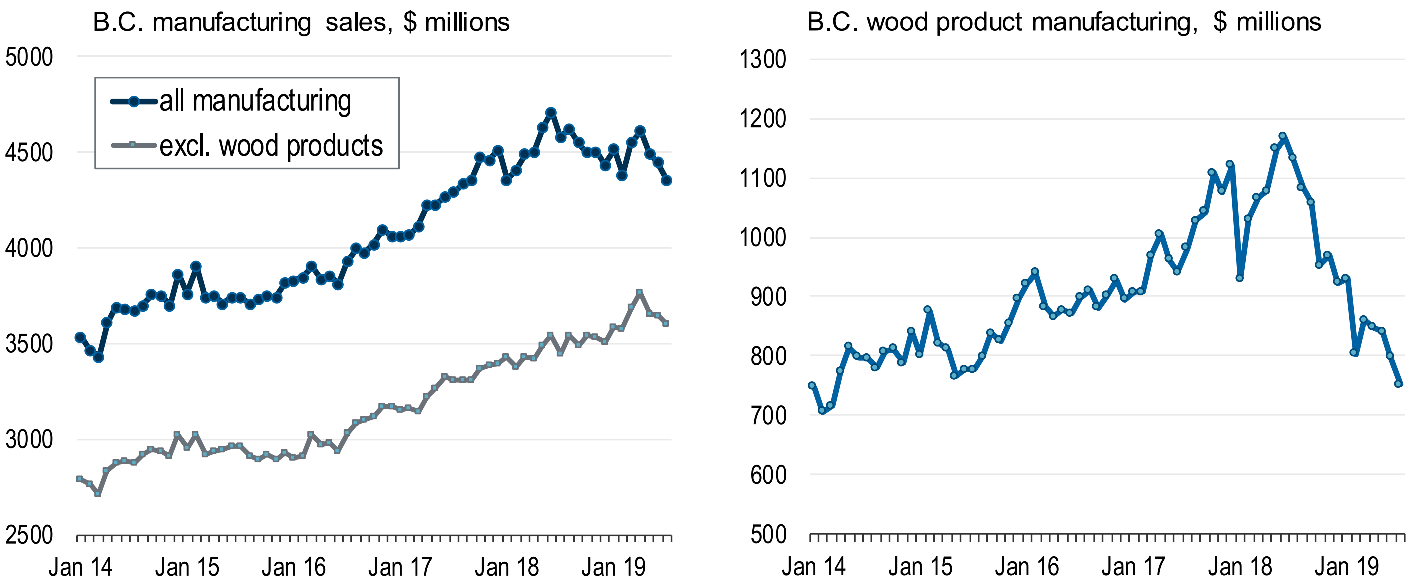
Commercial building permits account for two-thirds of all non-residential building permits. Activity in the commercial segment has been robust. Across B.C., commercial permits are up 53% over the previous year; in Metro Vancouver, they are up 37%. If Metro Vancouver is excluded from the provincial total, in the "rest of B.C." commercial permits have nearly doubled in value. This outsized jump is in large part due to a dramatic surge in commercial permits in

FIGURE 9: **MERCHANDISE EXPORTS SLOWING**



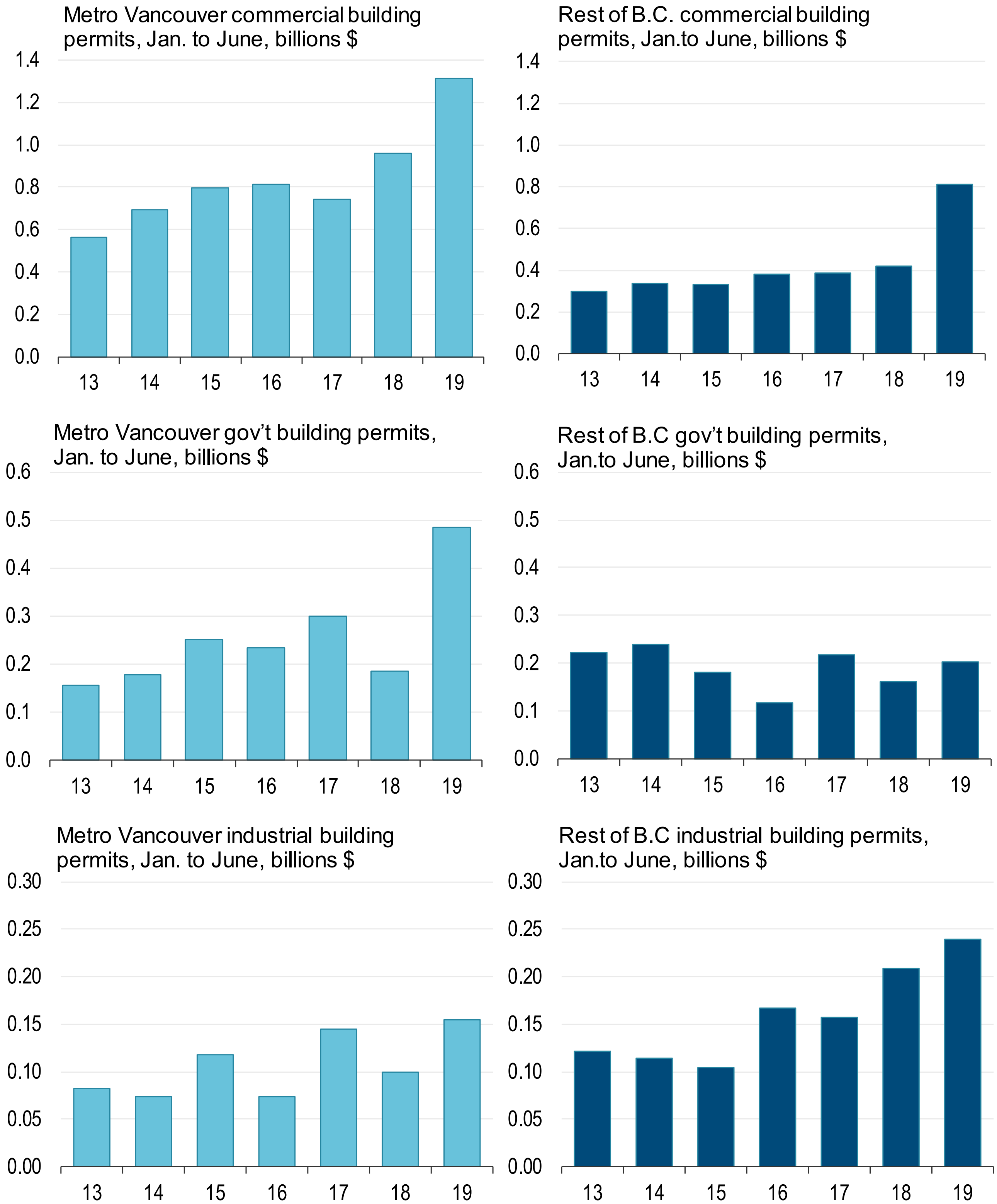
Source: B.C. Stats. Latest: August 2019. S.A.= "seasonally adjusted'. 3-month moving average.

FIGURE 10: **MANUFACTURING ACTIVITY TURNS DOWN**



Source: Statistics Canada, Table 16-10-0048-01. Seasonally adjusted. 3-month moving averages.

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



Source: Statistics Canada, CANSIM Table 34-10-0066-01 and B.C. Stats.

and around Kitimat. If Kitimat is excluded from the "rest of B.C.", then the increase in permit values is a more modest 36% (in line with the gain seen in Metro Vancouver). Government and institutional permits are up strongly in Metro Vancouver, while industrial building permits have grown in the "rest of B.C."

In addition to the increase in non-residential building construction, there are a number of engineering projects underway or about to begin that are also part of the economic growth story. In the private sector, LNG Canada's Kitimat facility and the related pipelines ($40 billion) is under construction, work on the Trans Mountain pipeline expansion ($7.4 billion) has resumed, and Woodfibre LNG's project ($1.8 billion) also looks to be going ahead.

Government has also stepped up investment activity, with public sector capital spending rising from $8.9 billion in fiscal 2018/19 to $10.6 billion in 2019/2020. Some of the larger and more notable public sector projects underway or imminent include the Pattullo Bridge replacement ($1.4 billion), the Broadway subway line ($2.8 billion), Kicking Horse Canyon phase 4 ($450 million), the new St Paul's hospital ($1.9 billion), expansion of Royal Columbian Hospital 2&3 ($1.1 billion), the new tower at Royal Inland Hospital ($400 million) and ongoing work on Site C ($10.7 billion).

SUMMARY

Overall, the B.C. economy is losing some steam. The export sector is a major weak spot that will weigh on the province's economy over the next 12-18 months. The deterioration in global growth and the ongoing trade disputes make the current economic environment an unusual one for a small trade-oriented jurisdiction like B.C. (or indeed Canada).

The recent upturn in residential home resales is a positive development for the sector, although we expect further gains to be modest. The building of new homes provides a much larger economic lift, but unfortunately housing starts in the province are poised to slip in 2020. With the export sector faltering and many consumers still restraining their spending, B.C. is set for another year of below average growth of 1.8%.

As the economy downshifts, we are concerned about the province's waning competitiveness, especially in the natural resource, infrastructure, manufacturing and transportation sectors – the backbone of B.C.'s export economy. The tax burden on business has increased significantly in recent years, and provincial and federal legislative and regulatory developments are adding costs and heightening uncertainty for companies in many industry sectors that underpin B.C.'s prosperity. Looking ahead, we believe the time has come for policy-makers to focus more attention on the challenge of building a more productive, innovative and competitive British Columbian economy.

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