B.C. ECONOMIC REVIEW AND OUTLOOK

Business Council of British Columbia
Est. 1966

JUNE 2022

PUTTING THE INFLATION GENIE BACK IN THE BOTTLE

HIGHLIGHTS

- Global GDP growth is expected to slow from 6.1% in 2021 to 3.6% in 2022 and 2023. United States GDP will decelerate from growth of 5.7% in 2021 to 3.7% in 2022 and 2.3% in 2023.
- Across several advanced economies, including Canada, fiscal and monetary policies have been too loose for too long. Demand for goods and services is outstripping supply. Inflation rates in the United Kingdom (9% y/y), United States (8.3%), Euro area (7.4%), Canada (6.8%) and Australia (5.1%) are *several multiples* of central bank inflation targets.
- Central banks' challenge of "putting the inflation genie back in the bottle" is complicated by the ongoing looseness of fiscal policy and the economic and financial implications of Russia's invasion of Ukraine. Higher real interest rates are needed to cool overheating economies, but adjusting to higher borrowing costs will be a challenge for many economies, especially Canada.
- Canadian GDP growth is expected to moderate from 4.6% in 2021 to 3.9% in 2022 and 2.8% in 2023. CPI was 6.8% y/y in April and has been above the Bank of Canada's inflation control range of 1-3% for 13 consecutive months. Federal policies are supporting booming residential investment and goods consumption, while business investment and exports are yet to recover to pre-pandemic levels even though Canada's external terms of trade are at near-record levels. Policy settings continue to promote an unbalanced and uncompetitive economy.
- B.C.'s economy is forecast to grow at a brisk 3.8% in 2022 before retreating to a more typical 2.4% in 2023. B.C. is benefitting from strong global commodity markets. The positive backdrop for exports underpins our forecast for above average growth in 2022. In addition, ongoing construction of several large capital projects all continue to make sizable contributions over the forecast horizon.
- Domestic economic activity continues to recover with the more complete reopening of consumer services. However, growth in consumer spending is overshadowed by rising inflation and mounting debt servicing costs for households and firms in the province.
- Aggregate numbers suggest the labour market is overheated and there are large numbers of unfilled job openings in certain sectors. As the Bank of Canada throttles back on monetary stimulus to cool inflation, labour market pressures should start to ease in 2023.
- The unwinding of the extraordinary COVID-related government support for businesses and individuals, and sharp hikes in interest rates, will dampen household income growth and challenge the viability of some businesses going forward.

HIGHER REAL INTEREST RATES ARE NEEDED TO COOL OVERHEATED ADVANCED ECONOMIES

World GDP growth is expected to slow from 6.1% in 2021 to 3.6% in 2022 and 2023 (**Table 1**), while **United States GDP** will decelerate from growth of 5.7% in 2021 to 3.7% in 2022 and 2.3% in 2023. Across several advanced economies, including Canada, fiscal and monetary policies have been too loose for too long (**Figure 1**). Demand for goods and services is outstripping supply, and consequently inflation rates in the United Kingdom (9%), United States (8.3%), Euro area (7.4%), Canada (6.8%), and Australia (5.1%) are *several multiples* of central banks' official targets. Despite falling unemployment rates and rising inflation rates for more than 12 months, the Federal Reserve and other central banks reckoned that high inflation was "transitory" and would abate toward the end of their forecast horizon. However, that assessment misjudged both: (a) the persistence of pandemic-related supply chain disruptions; and (b) the stimulatory impacts of historic, sustained and unnecessary fiscal and monetary support for *demand* in the second half of 2021 and into 2022.

High inflation was already entrenched by February 2022 when Russia invaded Ukraine, but that calamity has further amplified inflationary pressures. High commodity prices cut real incomes for commodity-importing countries because there is less income left over for consumers and businesses after paying for commodity-intensive necessities and raw material business inputs. Overall, high commodity prices will inhibit global economic growth. At the same time, commodity-*exporting* countries like Canada are benefiting from an extraordinarily favourable shift in their terms of trade (the ratio of export prices relative to import prices) that will lift Canadians' real incomes and help offset the loss of purchasing power caused by higher inflation. In inflation-adjusted terms, Canadian dollar energy prices are near record levels (**Figure 2**). Fish, forestry, and metals prices are also elevated in inflation-adjusted terms.

TABLE 1: **GLOBAL ECONOMIC FORECAST**

Region	2021	2022f	2023f
Real GDP growth (%)			
World	6.1	3.6	3.6
Canada	4.6	3.9	2.8
United States	5.7	3.7	2.3
United Kingdom	7.4	3.7	1.2
Euro area	5.3	2.8	2.3
Japan	1.6	2.4	2.3
China	8.1	4.4	5.1
Central bank policy interest rate (% at end of year)			
Canada	0.25	2.50	3.00
United States	0.25	2.75	3.00

f - forecast

Source: IMF (GDP); Scotiabank Economics (policy rates).

Higher real policy interest rates over the next 12-18 months will be required to cool global demand and bring inflation to heel. This should be accompanied by actively or passively reducing central banks' still very large holdings of government bonds, known as "quantitative tightening." **Figure 3** shows the sharp jump in the yield curve for Canadian government bonds compared to May 2021. Nonetheless, policy interest rates in several advanced countries remain steeply *negative* in inflation-adjusted terms.

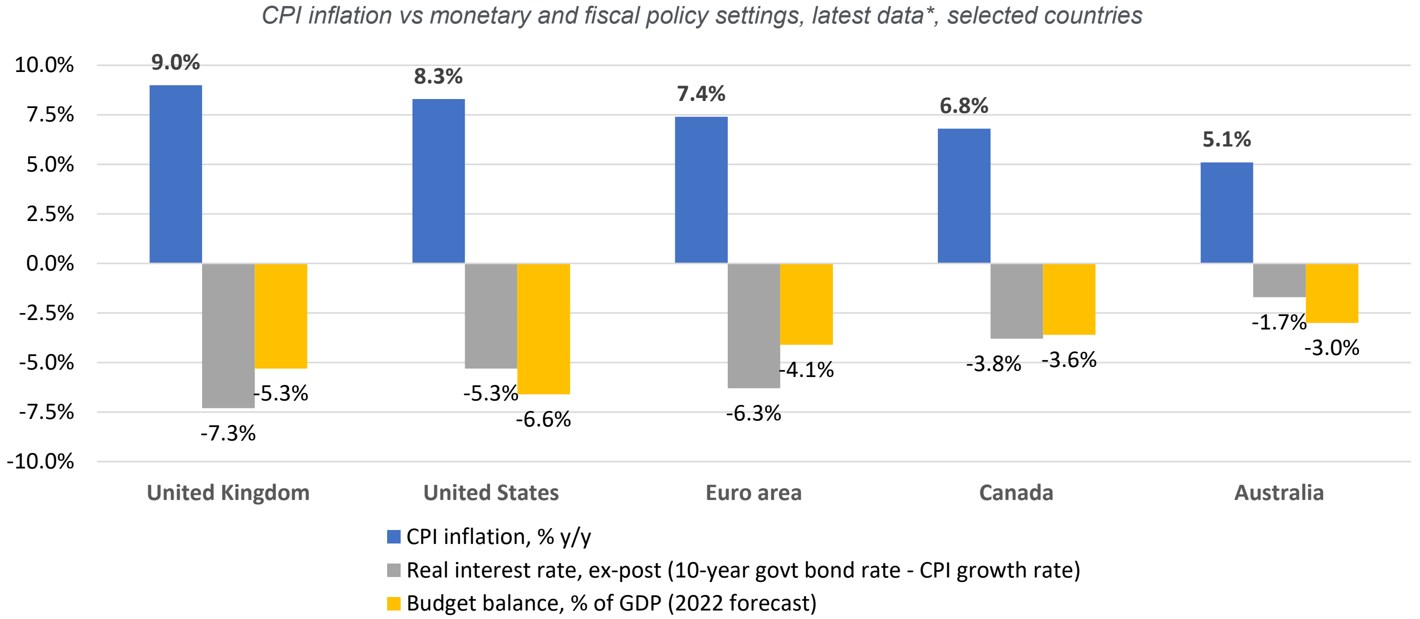
In our view, adjusting to higher *real* interest rates is the major challenge facing the global economy over the forecast horizon. Credit booms rarely end well. There are few instances in history where central banks have achieved an "immaculate disinflation," that is, reducing inflation without inducing a contraction in financial and economic conditions. Exacerbating the challenge is that fiscal policies remain loose in many countries. Thus, even if central banks can collectively take their feet off the accelerator pedal, fiscal policymakers are still pushing it toward the floor. It is rare to see monetary and fiscal policies as disconnected from the state of their economies and from each other. Overall, risks to the global outlook are weighted to the downside. The outlook for the Chinese economy is a key downside risk as the national government imposes strict lockdowns in some regions to stem outbreaks of COVID-19.

CANADA'S RECOVERY BOOSTED BY NEAR-RECORD EXTERNAL TERMS OF TRADE

Canadian GDP growth is expected to moderate from 4.6% in 2021 to 3.9% in 2022 and 2.8% in 2023. The latter year growth rates exceed the economy's potential growth rate. This implies that CPI inflation remains above the Bank of Canada's 2% target over the forecast horizon. CPI is currently more than thrice the Bank's target at 6.8% y/y in April – but it is really 7% or more if used car prices are properly measured in the CPI.[1] Inflation has exceeded the

[1] Used cars have a 6.2% weight in Canada's CPI basket. However, Statistics Canada has hitherto taken a shortcut by tracking new car prices only and inserting them as a proxy for used car prices in the CPI. This assumes new and used cars are identical and their prices move together (see here). Over the past two years, there has been renewed criticism of that approach as used car prices have significantly outpaced new car prices – causing CPI to be underestimated by at least 0.2 percentage points. From May 2022, Statistics Canada will prospectively include used car prices in the CPI. This will bring Canada into line with the approach of other advanced countries' statistical agencies with respect to passenger vehicle prices.

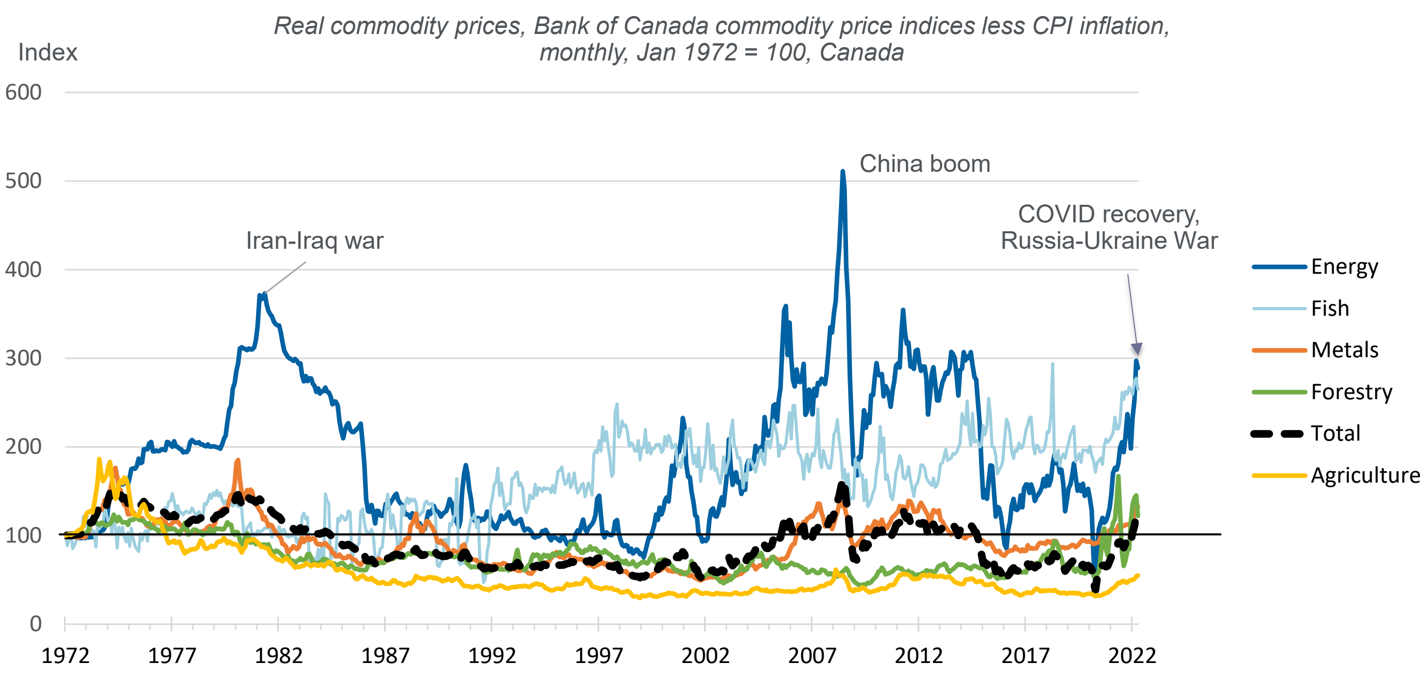
FIGURE 1: **MONETARY AND FISCAL POLICIES REMAIN (TOO) LOOSE IN MANY ADVANCED ECONOMIES**



Source: The Economist; BCBC.

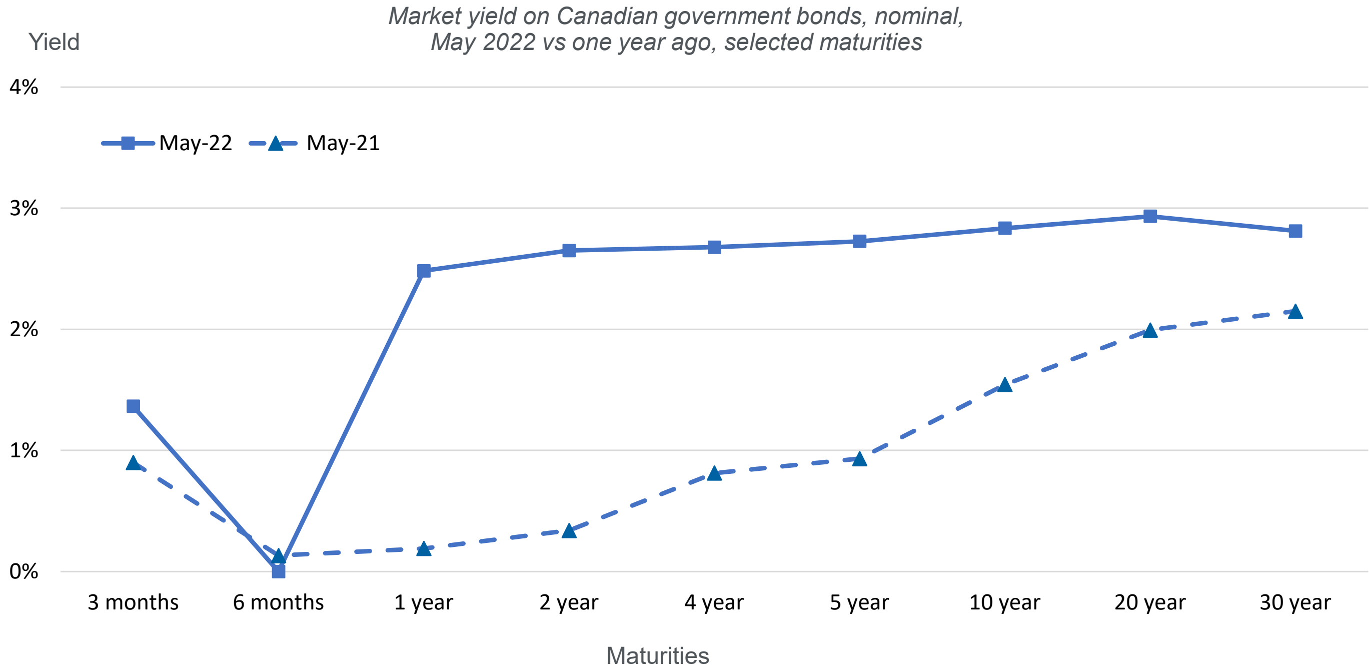
*As at April 2022 (Q1 2022 for Australia).

FIGURE 2: **REAL ENERGY PRICES ARE AT NEAR-RECORD LEVELS**



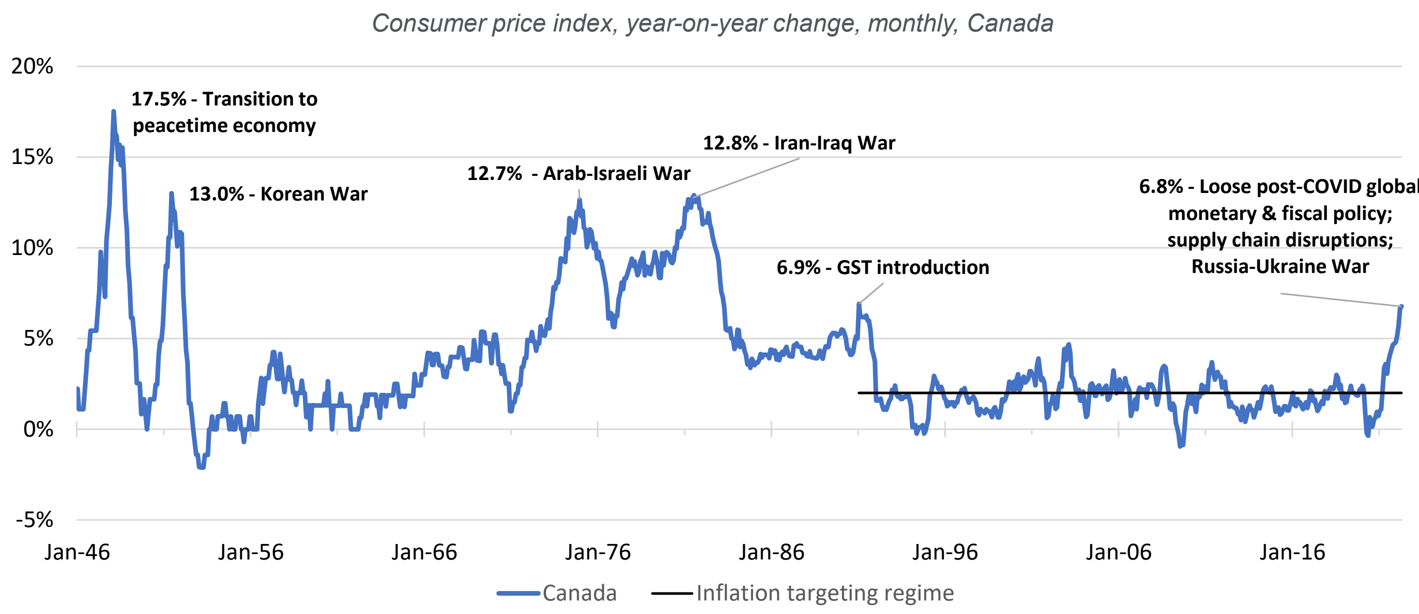
Source: Bank of Canada; Statistics Canada; BCBC.

FIGURE 3: **INTEREST RATES HAVE JUMPED OVER THE PAST YEAR**



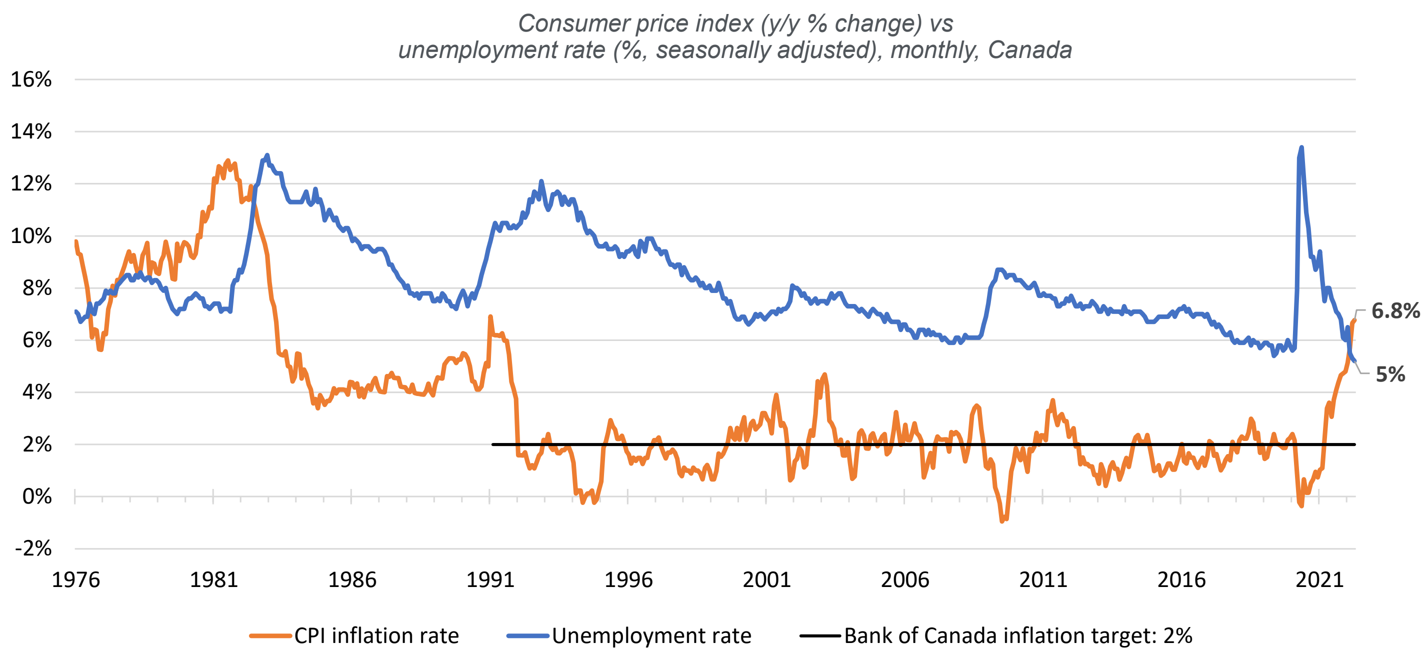
Source: Marketwatch.com.

FIGURE 4: **CANADA'S INFLATION IS THE HIGHEST SINCE 1983 (EXCLUDING ONE-OFF GST INTRODUCTION)**



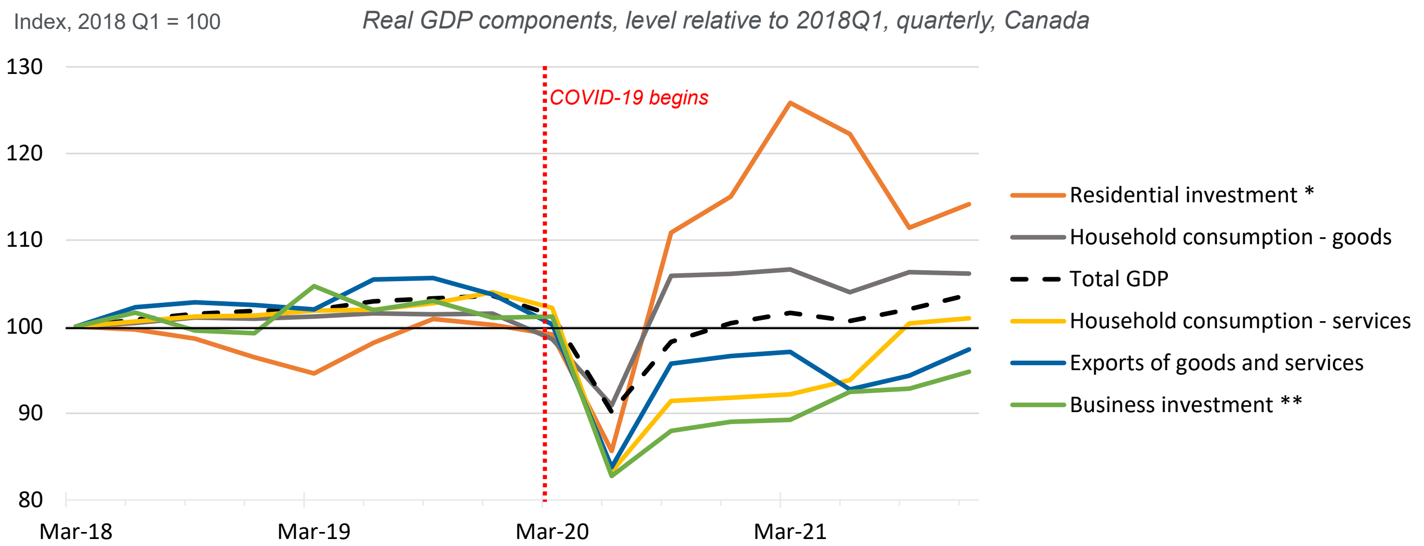
Source: Statistics Canada.

FIGURE 5: **CANADA'S CPI INFLATION RATE HAS NOT EXCEEDED THE UNEMPLOYMENT RATE SINCE 1977-1982**



Source: Statistics Canada; BCBC.

FIGURE 6: **FEDERAL POLICIES HAVE SUPERCHARGED DEMAND FOR RESIDENTIAL INVESTMENT AND GOODS CONSUMPTION, WHILE BUSINESS INVESTMENT AND EXPORTS LANGUISH**

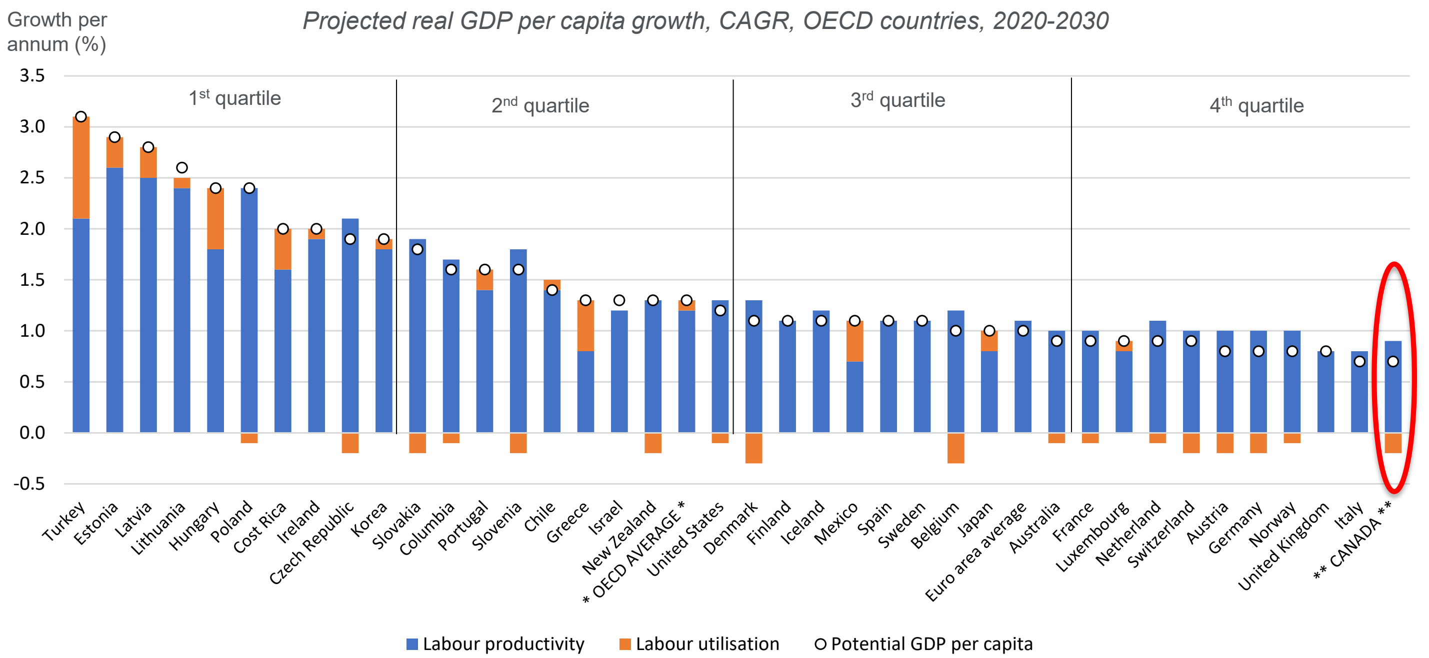


* Expenditure on new and renovation residential construction, and transferring real estate between owners.

** Expenditure on non-residential structures and machinery & equipment.

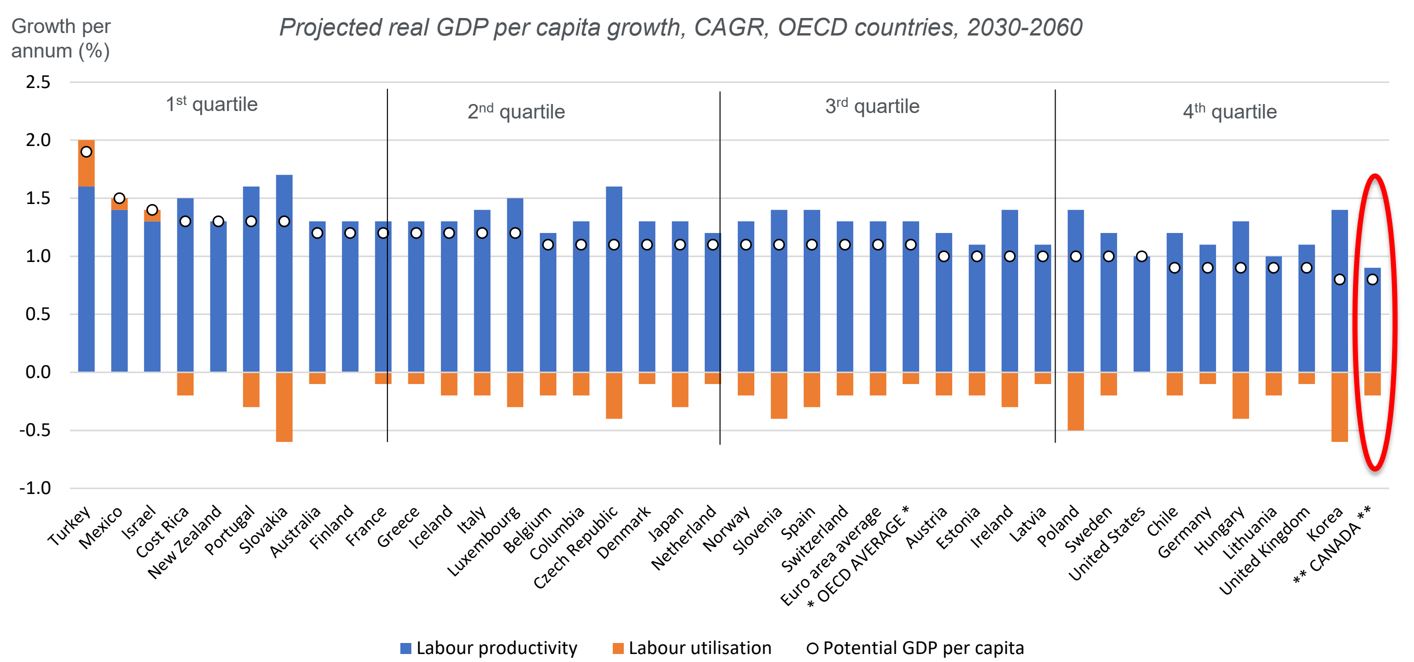
Source: Statistics Canada.

FIGURE 7: **OECD PREDICTS CANADA WLL BE THE WORST PERFORMING ADVANCED ECONOMY OVER 2020-2030**



Source: OECD (2021).

FIGURE 8: **OECD PREDICTS CANADA WILL ALSO BE THE WORST PERFORMING ADVANCED ECONOMY OVER 2030-2060**



Source: OECD (2021).

Bank of Canada's inflation control range of 1-3% for 13 consecutive months. Excluding the one-time introduction of the GST in 1991, CPI inflation has not been higher since 1971-83 (**Figure 4**). Also, Canada's CPI inflation rate has not exceeded the unemployment rate since 1977-82 (**Figure 5**).

Figure 6 shows the level of GDP by expenditure since 2018. Federal government policies have supercharged demand for residential investment (defined as expenditures on new and renovation residential construction, and on the transfer of real estate assets between owners) and household goods consumption. Meanwhile, exports and business investment languish and are yet to recover pre-pandemic levels.

As the world's 6th most indebted economy (see Williams 2021a), Canada will find the adjustment to higher global real interest rates particularly challenging. The subdued outlook for exports and non-residential investment, despite extraordinarily favourable export prices, should be a flashing red signal to policymakers in Ottawa and provincial capitals that Canada's economy is credit-dependent, unbalanced, and uncompetitive. The OECD projects that Canada will be the worst performing economy among 38 advanced countries over the next forty years (**Figure 7** and **Figure 8**), with the lowest growth in real GDP per capita (Williams 2021b). Overall, we believe the risks to the Canadian economy are weighted to the downside.

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

	2020	2021	2022f	2023f
Real GDP	-3.4	6.1	3.8	2.4
Employment	-6.5	6.6	3.3	2.0
Unemployment rate (%)	8.8	6.5	4.8	5.0
Housing Starts (000 units)	38.0	47.5	40.8	41.0
Retail sales	1.3	13.5	3.0	3.5
B.C. CPI	0.8	2.8	6.4	3.8

f - forecast

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

B.C. ECONOMIC OUTLOOK

The B.C. economy expanded by a robust 6.1% in 2021 as idled or furloughed capacity came back on-line. Several factors should keep B.C.'s economy growing by a brisk 3.8% in 2022 before retreating to a more typical 2.4% advance in 2023. Like Canada, the province is benefitting from strong global commodity markets and a significant terms-of-trade lift flowing from higher prices for energy, minerals, and forestry products. The positive backdrop for the foundational elements of B.C.'s export base supports our forecast for above average growth this year, although this fades in 2023. The reopening of travel and gradual revival of international tourism, together with the expansion of other services exports, should sustain overall export growth in 2022-23. Moreover, the ongoing construction of several large capital projects will underpin provincial growth through 2023.

Domestic economic activity rebounded sharply last year, as the steady reopening of consumer services resulted in a realignment of spending back towards services. The extent and pace of this recovery in services spending, however, is overshadowed by rising inflation and mounting debt servicing costs for households and firms in the province. B.C. households carry much higher debt loads than the average Canadian. The winding up of the extraordinary COVID-related government support for businesses and individuals, along with sharp interest rate hikes, will dampen household income growth and challenge the viability of some businesses going forward. Growth across different segments of the domestic services economy will be mixed and limited by slowing household income growth amid escalating consumer prices.

EXPORTS AND NON-RESIDENTIAL CONSTRUCTION SUPPORT B.C.'S RECOVERY AND EXPANSION

B.C.'s export sector has been instrumental in driving the current economic recovery and expansion (**Figure 9**). Much of the lift flows directly from higher energy, lumber and minerals prices as detailed in the first section. Last year, real GDP in the industries that comprise these key parts of the province's [export base] grew by more than 8%. High commodity and energy prices will continue to bolster B.C.'s expansion this year but diminish in 2023.

Service sector elements of [B.C.'s export base] are also on the upswing. Eliminating testing requirements and the reopening of international borders means the long-awaited tourism revival is now unfolding. Passenger volumes at YVR are rebounding (**Figure 10**). By the end of the Q1 2022, U.S. passengers through YVR had regained 50% of March 2019 volumes. Other international traveller volumes reached 43% of pre-COVID volumes. The once fully shuttered cruise ship sector has also resumed operations and is expecting a record year in 2022. A rapid revival in air travel alone will provide a significant boost considering that B.C.'s air transportation sector GDP tumbled by 75% in 2020 (the largest decline of any industry apart from the cruise ship sector) before falling a further 20% in 2021.[2]

Film and television production is another major service sector export. It has more than recovered since a brief COVID-induced slump and has resumed its strong expansion. This sector continues to grow its economic footprint within the provincial export landscape and is also a big source of employment.

LARGE CAPITAL CONSTRUCTION PROJECTS SUSTAIN GROWTH

The ongoing construction of LNG Canada's Kitimat facility, its associated pipelines, the Site C construction, and the twinning of the Transmountain Pipeline have all made sizable contributions to provincial economic activity in recent years. Real GDP in the engineering construction industry has been at least $2 billion above normal levels for at least two years. Activity will remain elevated in 2022-23, but further gains will be limited as these projects are past or near their peak levels of building activity. Planned increases in provincial government capital spending related to new hospitals and other infrastructure are also positive.

HOUSEHOLD BUDGETS STRAINED AS CONSUMER SERVICE SPENDING "NORMALIZES"

As the economy opens more fully, households should continue to redirect spending to services. Output in some consumer service industries has remained below pre-pandemic levels (notably sports, performing arts, theaters, personal services and business services). In 2021, real output (GDP) of all services was still below trend growth levels.

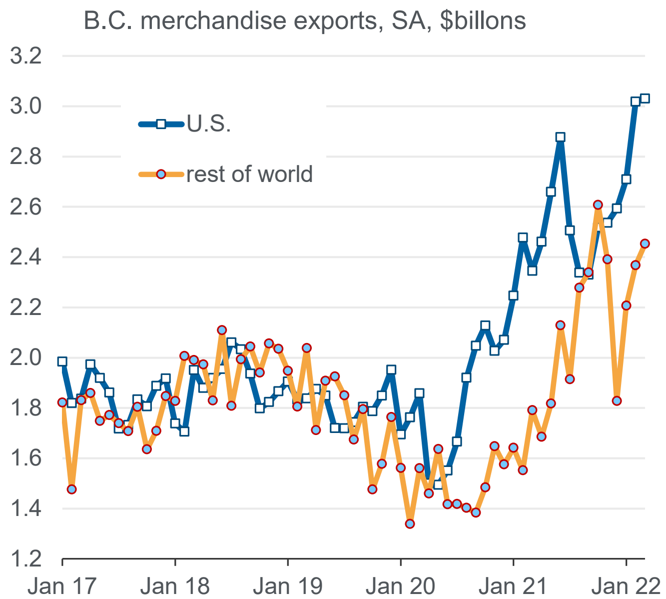
Rising prices and perhaps more spending on services are affecting the pattern and extent of retail spending, which has been flat for more than a year (**Figure 11**). Price changes, however, appear to be weighing on the mix of spending. Amid soaring prices, sales at gas stations rose 13% y/y in Q1 (in nominal terms). This is the largest increase of any retail segment. In the same quarter, consumers trimmed spending in other areas, notably motor vehicles and building materials.

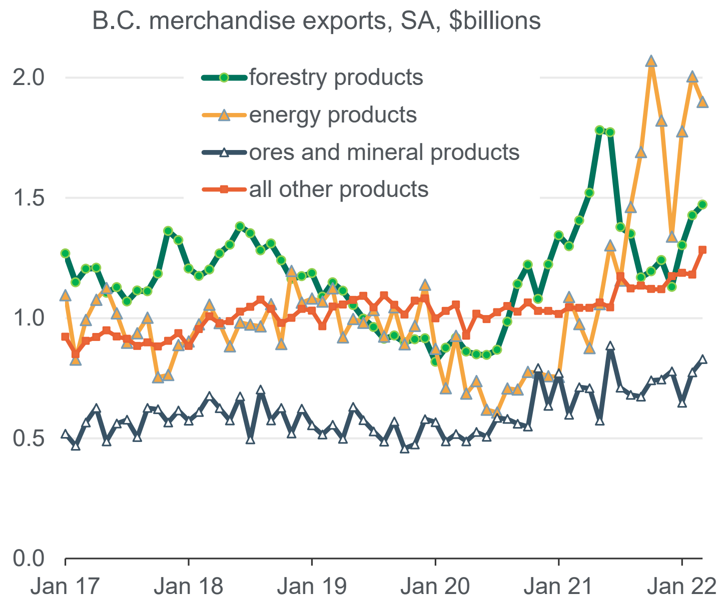
Higher interest rates are cooling turnover in B.C.'s supercharged real estate sector. In Greater Vancouver, resales of existing homes are down roughly one-third over the first four months of 2022 compared to the same period in 2021. Resale prices have also levelled off. In the Fraser Valley, resales of existing homes have dropped by a similar magnitude (32%) over the same period and resale prices have slipped month-to-month. The picture in other regions is mixed.

As turnover and prices for resale homes cool, and amid sharp rises in mortgage interest rates, new residential construction activity should moderate in the near term. Builders appear to be reassessing and scaling back speculative projects that might have only been manageable with rock-bottom interest rates. Housing starts have cooled and will likely dip this year because of higher interest rates. That said, they should recover soon as the federal government turbocharges demand for new housing in major cities through the highest levels of temporary and permanent immigration in a century. Overall, B.C.'s residential construction, mortgage financing, and real estate transaction "industrial complex", often a key engine of economic growth, will weigh on growth in 2022, with all three elements set to decline in the near term.

[2] Real GDP in the air transportation fell from around $2 billion in 2019 to just $350 million in 2021.

FIGURE 9: **B.C. EXPORTS SURGE AMID WIDESPREAD GAINS**

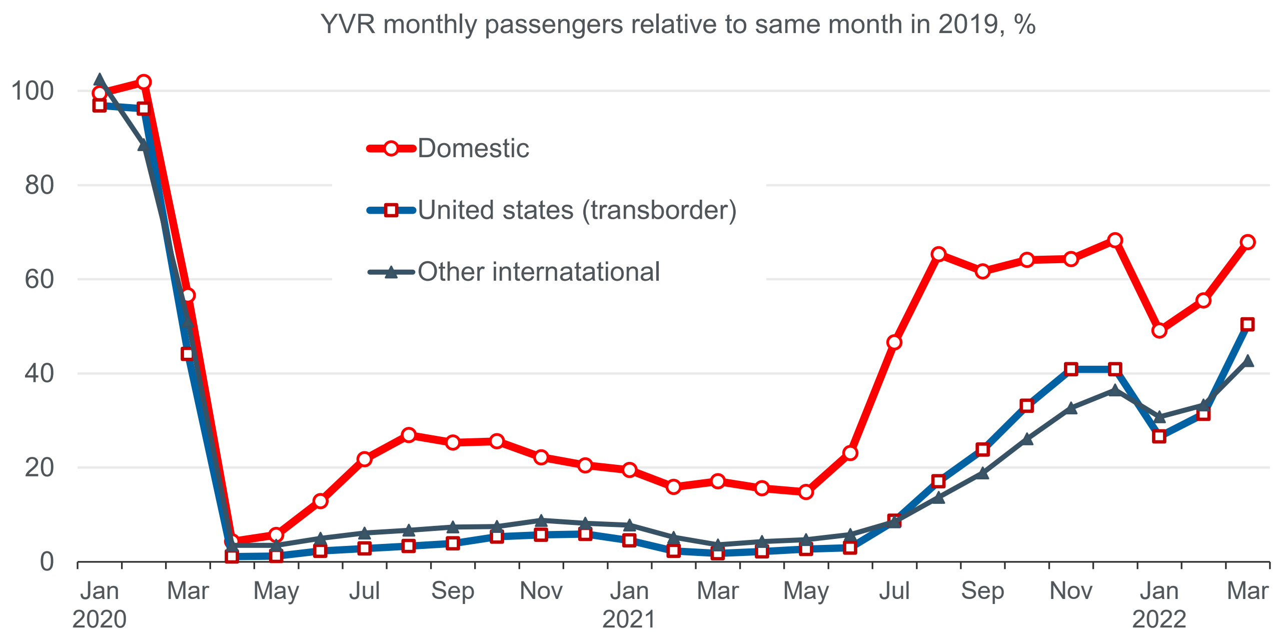




Source: B.C. Stats.

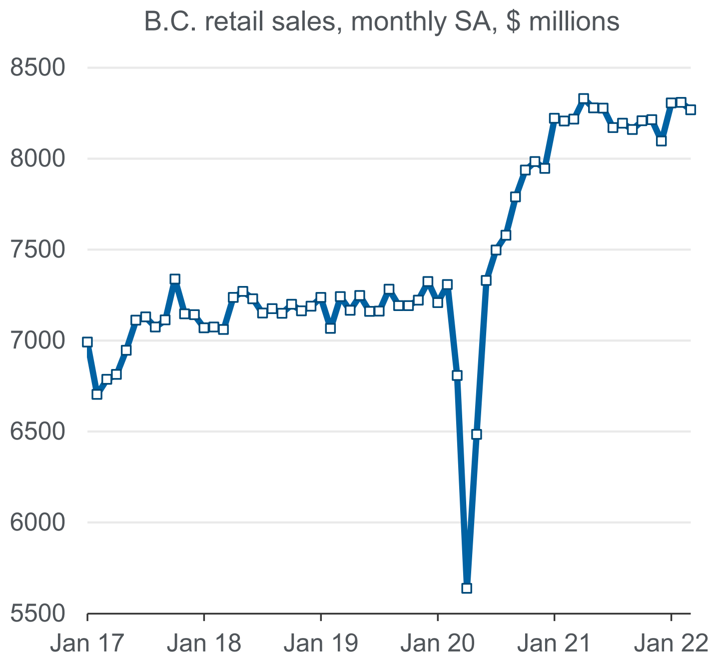
Latest data March 2022, SA = seasonally adjusted.

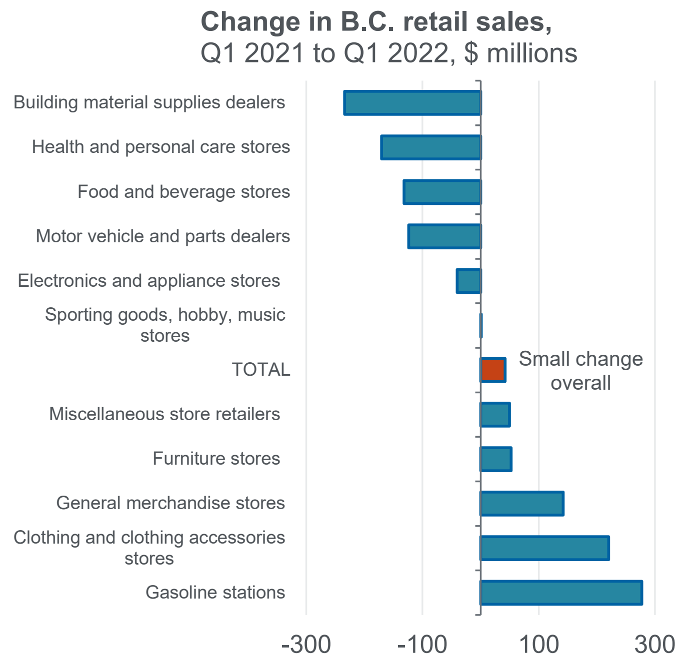
FIGURE 10: **AIR TRAVEL HALF-WAY BACK**



Source: YVR.

FIGURE 11: **RETAIL SALES FLAT OVERALL AS B.C. CONSUMERS SPEND MORE ON GAS**

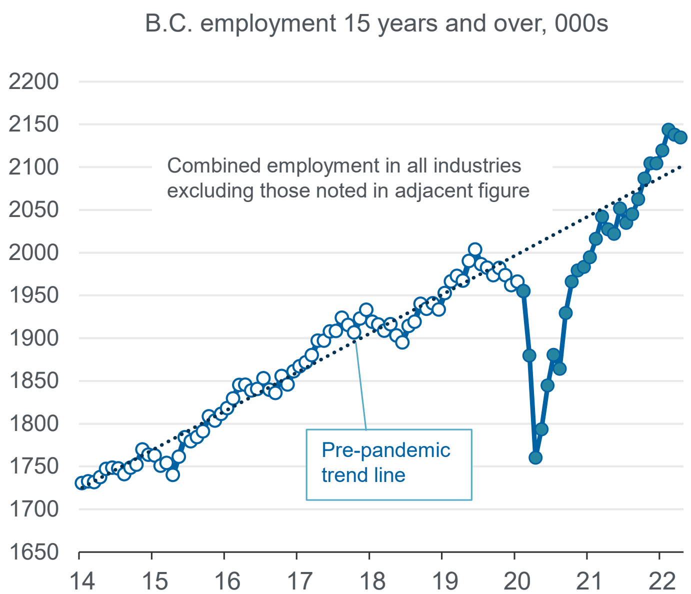


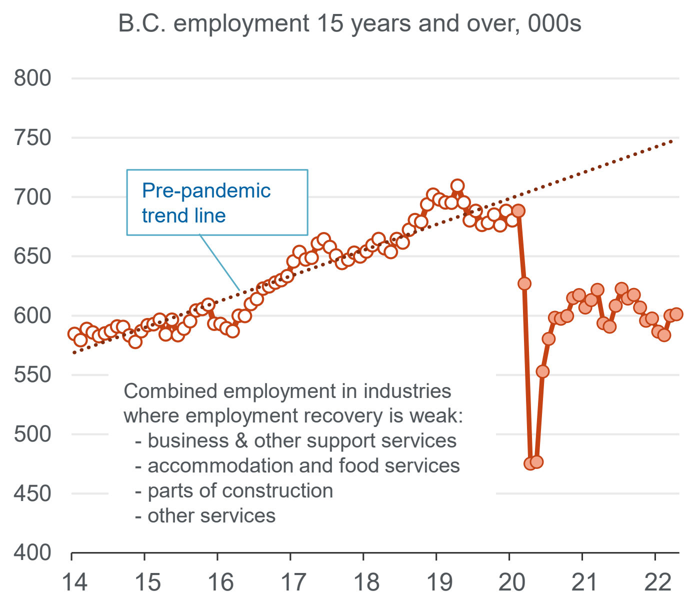


Source: Statistics Canada Table 20-10-0008-01.

Latest data March 2022, SA = seasonally adjusted.

FIGURE 12: **EMPLOYMENT RECOVERED IN MOST INDUSTRIES BUT REMAINS UNUSUALLY LOW IN HARDER HIT SECTORS**





Source: Statistics Canada, Labour Force Survey, Table 14-10-0355-01.

Latest data April 2022, seasonally adjusted.

THE LABOUR MARKET

The unemployment rate is close to record lows and, like the economy overall, the labour market is overheated. That said, employment in several sectors remains well below pre-pandemic levels (**Figure 12**) and provincial job creation has been skewed towards the public sector.

The uneven reopening and recovery across the economy mean there are large numbers of unfilled job openings in certain sectors. The largest number of openings and most acute hiring challenges are in accommodation and food services and other parts of the tourism and hospitality sectors. As higher interest rates start to cool the economy, and inflation, hiring challenges should start to ease in 2023.

SUMMARY THOUGHTS

Runaway inflation and higher interest rates will dampen growth in economic activity in 2023. B.C. should benefit from strong global commodity markets, large ongoing capital projects and increased public sector capital spending. Even though inflation is eroding purchasing power and real incomes, we expect spending on services to rise as consumers can undertake activities that previously were restricted.

Our forecasts for B.C.'s real GDP growth have not changed substantially from our previous update. The global backdrop and other pertinent factors have not changed much in recent months and were mostly reflected in our earlier outlook. We still expect provincial GDP growth to downshift significantly in 2023 as interest rate hikes bite, but slightly more so in this updated forecast. We have also increased the CPI inflation outlook to reflect recent inflation readings. The bigger shift is to the risks for next year's outlook. We now see a more elevated risk of a steeper slowdown or even recession, stemming from higher global and domestic interest rates and consequently weaker global GDP growth than expected a few months ago.

Policymakers should be concerned about B.C.'s growth prospects beyond the forecast horizon. Structural weaknesses evident for many years include low levels of investment in machinery and equipment, weak productivity growth and real wage growth, burdensome regulatory processes, and high and uncompetitive operating costs in many sectors. These weaknesses could become more evident for B.C. as the economic lifts subside from: the positive terms of trade shock and export gains; the capital investment associated with large capital projects; and the massive boom in mortgage borrowing, resale transactions, and new residential construction driven primarily by ultra-low interest rates during the pandemic.

CO-AUTHORED BY

Ken Peacock,
Chief Economist
& Senior Vice President

David Williams, DPhil,
Vice President of Policy