B.C. ECONOMIC REVIEW AND OUTLOOK

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THE ECONOMY IS GETTING BIGGER, BUT NOT MUCH BETTER

HIGHLIGHTS

- Global GDP growth is expected to be a little over 3% across 2020-21, the slowest pace since the Global Financial Crisis (GFC) of 2008-09. Among the advanced economies (especially Canada), longstanding structural problems that engender low productivity growth remain unaddressed. Nonetheless, recent progress on several trade issues should ease uncertainty and foreshadow a modest turnaround in global trade, investment and industrial production.

- Canada's economy is expected to limp along with growth of 1.6% in 2020 and 2.0% in 2021. This is about as good as it gets. Potential output growth – the economy's natural speed limit – is estimated to be only 1.2-2.4% in 2020, mainly because of generationally-low contributions from productivity. Three quarters of the country's recent GDP growth simply reflects population growth. Recent growth in GDP *per capita* has shriveled to around 0.5% per annum, as has growth in real wages.

- In an age of digitalization and automation, Canada is pursuing a *labour*-intensive economic growth strategy. Business investment per capita is *lower* than at the peak of the last business cycle 11 years ago. Instead, Canada is betting its chips on super-charged immigration and record population growth. Neither makes any difference to productivity, which drives long-term growth in real wages, or GDP per capita, which determines the country's standard of living. To our minds, Canada has embraced a "prosperity-free" economic growth strategy.

- B.C.'s economy is expected to grow by 2% in 2020, a modest downgrade from our earlier forecast of 2.2% growth. Several economic indicators are weakening and collectively point to a softer outlook for near-term growth.

- Still, B.C.'s economic expansion is not likely to fall below 2% and will be good enough to outpace most other provinces, supported by large increases in the population and non-residential construction activity.

- B.C.'s diversified economy also helps, with tourism, film and television, transportation services and other service exports continuing to expand at a healthy clip.

SLOWEST WORLD ECONOMIC GROWTH SINCE THE GFC

After decelerating to 2.9% in 2019, **global GDP growth** is expected to improve slightly to around 3.1% in 2020 and 3.3% in 2021 (**Table 1**). These are the slowest growth rates since the GFC of 2008-09. Persistently poor productivity growth is the Achilles' Heel of most advanced economies (especially Canada, see below). This issue *pre-dates* trade tensions and uncertainty that escalated over late-2018 and 2019 and chilled global trade, industrial production and capital

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

Region	2018	2019f	2020f	2021f
World	3.7	2.9	3.1	3.3
U.S.	2.9	2.3	1.9	1.9
Euro area	1.9	1.2	1.0	1.3
Japan	0.3	1.1	0.6	1.2
China	6.7	6.1	5.9	5.8
CANADA				
Potential (range)	1.5 - 2.1	1.5 - 2.1	1.3 - 2.1	1.2 - 2.4
Actual	2.0	1.6	1.6	2.0

f - forecast

Source: Bank of Canada.

investment. Nonetheless, a Phase One agreement has now been announced between the U.S. and China, Brexit is underway, and the United States has ratified the USMCA – the successor trade agreement to NAFTA. Monetary policy in most advanced economies has also become looser in the last year or so. These developments should support a modest turnaround in trade and investment flows, but may be offset by uncertainty about the impact of the coronavirus outbreak in China. Risks to the global outlook are weighted to the downside.

The **U.S. economy** should be amongst the strongest of the advanced economies in 2020 and is expected to expand in line with its potential of around 2%. Households remain a source of strength: American household balance sheets are in good order, the unemployment rate is at 3.5%, and nominal wages are increasing at around 3-4% per annum. Inflation below 2% gave the Federal Reserve room to cut its policy rate by 0.75 basis points last year, which is expected to buttress growth in consumption and, after a period of weakness, home building in 2020 and beyond. It should also support business investment, which decelerated sharply last year. Assuming tentative progress on the trade front continues (and does not unravel), a modest pick-up in U.S. business investment is expected in 2020-21.

POOR PRODUCTIVITY GROWTH IS THE CANADIAN ECONOMY'S ACHILLES' HEEL

Canadian GDP growth is expected to limp along at a little under its potential in 2020 and around its potential by 2021 (1.6% and 2.0%, respectively). Inflation is on target around 2% and the unemployment rate remains near historic lows at 5.6%. There appears to be only a modest degree of spare capacity in the economy, concentrated in energy-producing regions.

The principal constraint on Canada's economy is home-grown. Potential GDP growth – the top speed the economy can sustain without generating above-target inflation – is estimated to be very low at 1.3-2.1% in 2020 and 1.2-2.4% in 2021 (**Table 1**). Risks to Canada's near-term outlook are evenly weighted, but over the medium term, this is about as good as it gets.

GDP growth is made up of growth in (1) labour productivity (GDP per hour worked) and (2) total hours worked. The main culprit for Canada's disappointing economic performance is productivity, which is advancing at its weakest pace since the 1980s (**Figure 1**). Productivity growth has made up only around one-quarter of overall GDP growth over the past 5 years, while growth in hours worked has made up three-quarters (**Figure 2**). Canada has not seen a situation like this in a generation.

Capital intensity is a key contributor to productivity growth. Quite simply, workers can produce more output per unit of effort when they have more and better tools and equipment at their disposal. However, on a per capita basis, real business investment in Canada is now $841 *lower* than at the peak of the last business cycle in early 2008 (**Figure 3**). And it is lower across most asset types.[1] Falling capital intensity is the opposite of what one would expect – and be striving for – in an era of digitalization and automation.

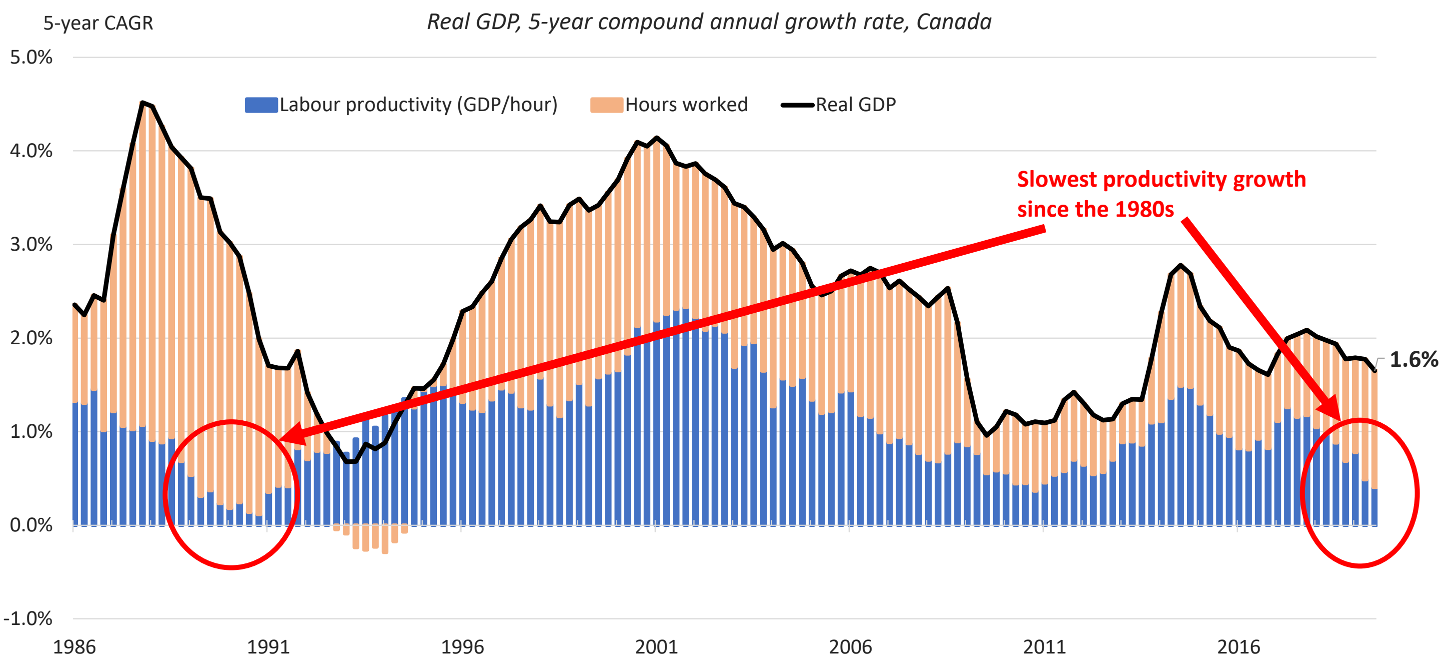
The Canadian government appears to be betting its chips on a labour-intensive strategy of super-charged immigration and record population growth to increase the absolute size of the economy.

Instead, the Canadian government appears to be betting its chips on a *labour*-intensive strategy of super-charged immigration and record population growth to increase the absolute size of the economy. Canada's population jumped by a staggering 560,000 in 2019 – a record since 1971. Permanent immigration has reached 335,000 per annum and is expected to further increase in 2020-21, while net temporary immigration (student and work visas etc.) is at an unprecedented 177,000 per annum (**Figure 4**). Given the geographical concentration of immigration-driven population growth, land scarcity and inevitable lags in time to build, we expect to see strains on housing, transport and other infrastructure in Canada's gateway cities in coming years.

Fully three-quarters of Canada's recent GDP growth (i.e. over 1% per annum) is attributable to growth in hours worked, which largely reflects turbo-charged immigration. Record population growth means that it is virtually certain that the economy will get bigger over time. Arithmetically, this makes a technical recession (i.e. an outright fall in GDP over six months) highly unlikely.

[1] These figures are for gross investment. They would be *even lower* net of depreciation costs, which are becoming more important as asset lives shorten.

FIGURE 1: **CANADA'S "BACK TO THE FUTURE" ECONOMY**



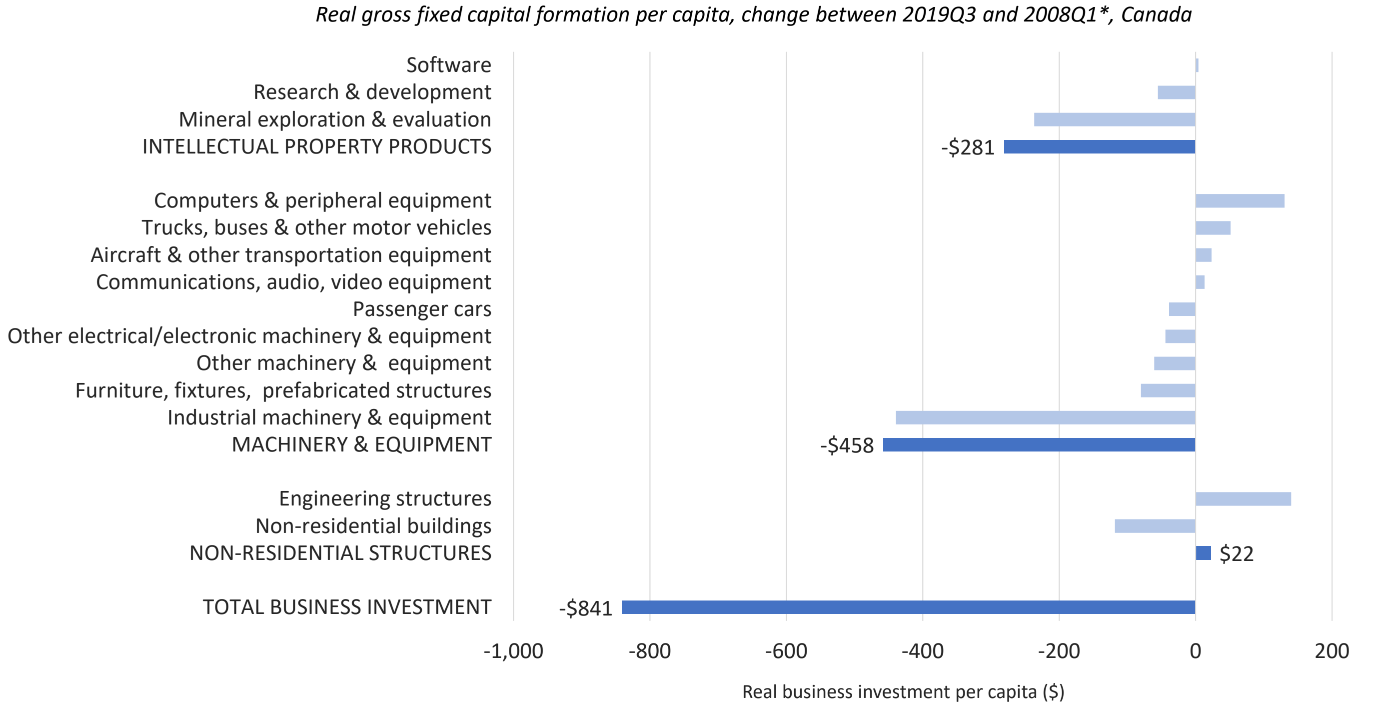
Source: Statistics Canada.

FIGURE 2: **PRODUCTIVITY GROWTH MAKES UP ONLY A QUARTER OF GDP GROWTH — ONLY THE 1980S WERE WORSE**

Source: Statistics Canada.

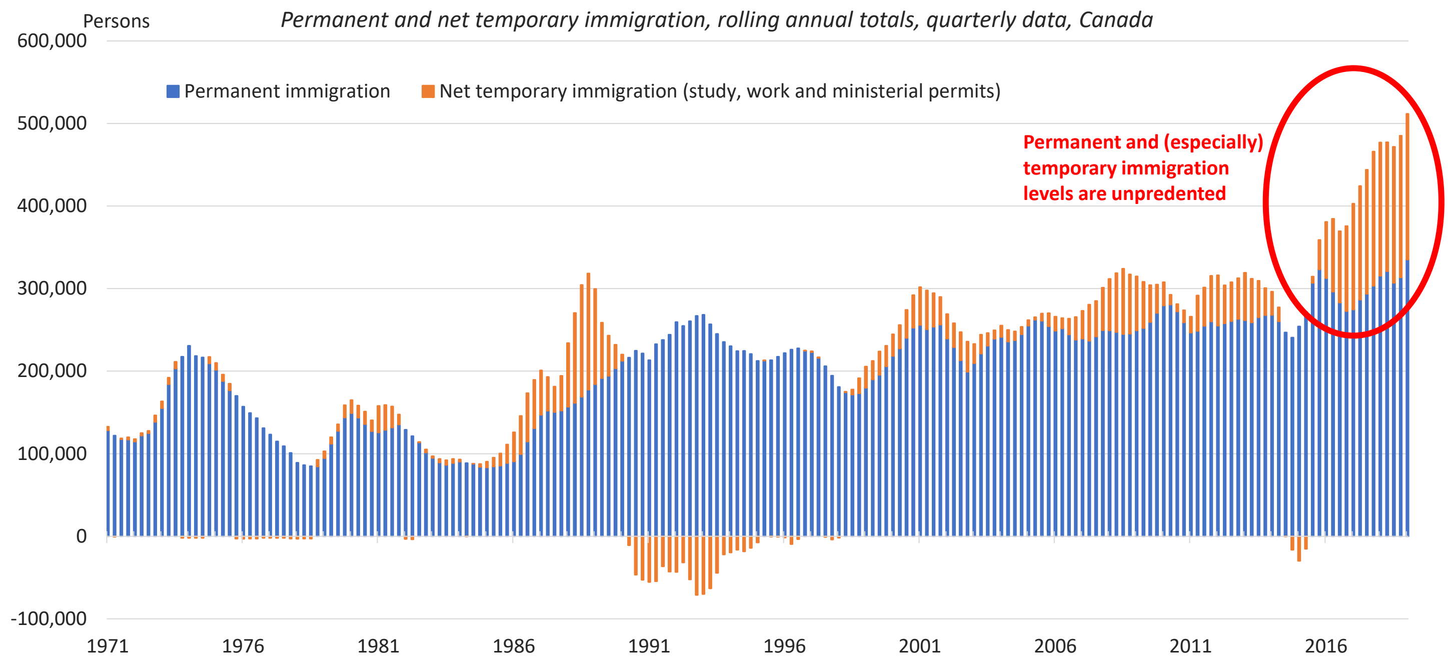
*GDP growth is the sum of growth in labour productivity and total hours worked.

FIGURE 3: **ACROSS MOST ASSET TYPES, BUSINESS INVESTMENT PER CAPITA IS LOWER THAN AT THE PEAK OF THE LAST BUSINESS CYCLE**



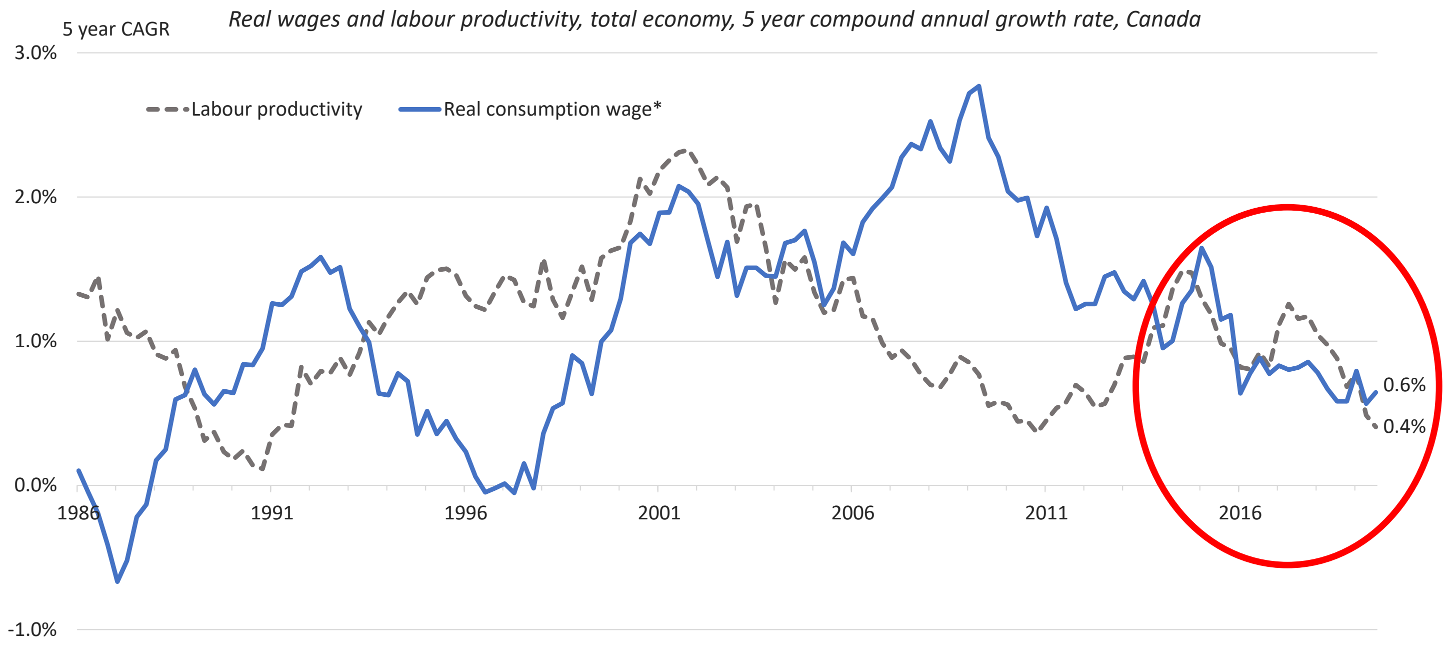
Source: Statistics Canada. Note: Figures are for gross investment and would be *lower* net of depreciation. * Change in 4-quarter average levels.

FIGURE 4: **SUPER-CHARGED IMMIGRATION IS CENTRAL TO THE GOVERNMENT'S ECONOMIC GROWTH STRATEGY**



Source: Statistics Canada.

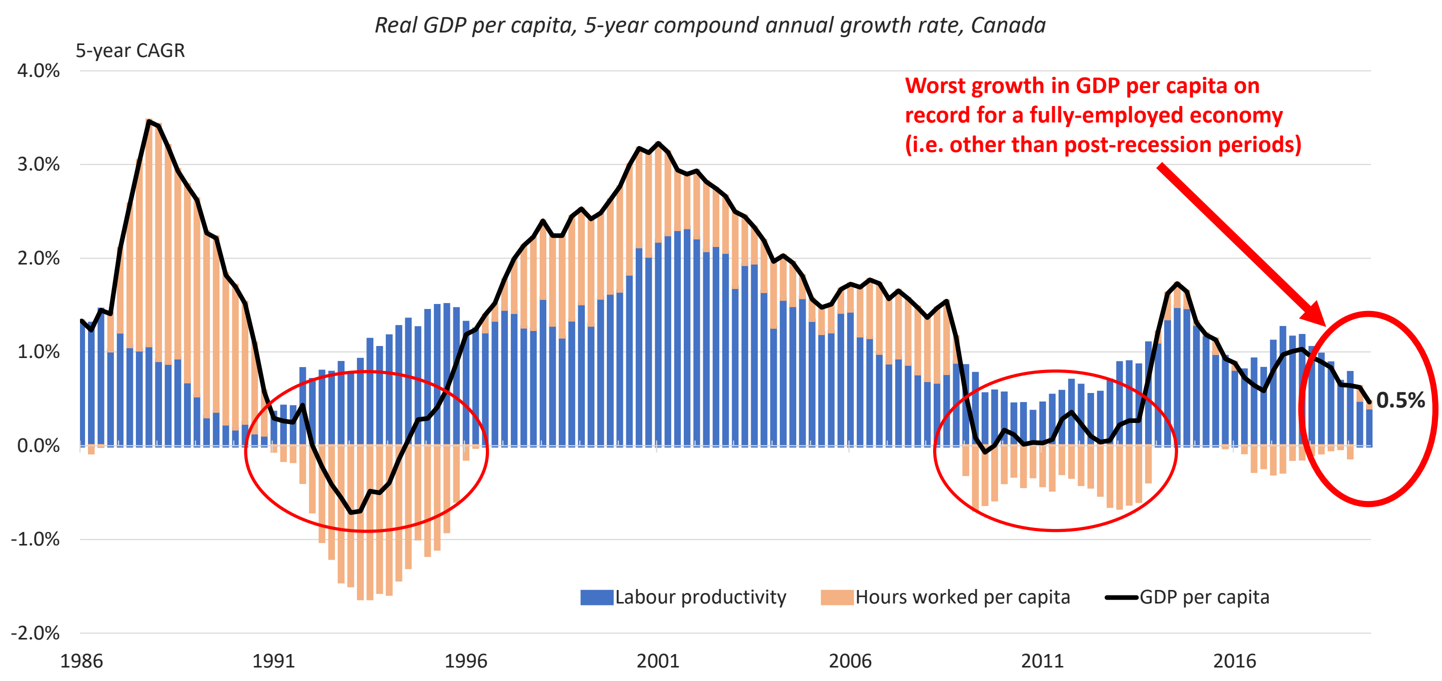
FIGURE 5: **GROWTH IN REAL WAGES AND PRODUCTIVITY HAS SLOWED TO A CRAWL**



Source: Statistics Canada.

* Total hourly compensation deflated by household consumption deflator.

FIGURE 6: **CANADA'S PROSPERITY-FREE ECONOMIC GROWTH STRATEGY**



Source: Statistics Canada.

However, increases in immigration and in the size of the population have no impact on productivity, which drives long-term growth in real wages, or GDP per capita, which determines a country's overall standard of living. Indeed, recent growth in labour productivity and real wages has collapsed to just 0.4% and 0.6% per annum, respectively (**Figure 5**). Growth of GDP *per person* has fallen to a paltry 0.5% per annum (**Figure 6**). This is Canada's worst performance on record, outside of recessionary periods. In our view, the evidence suggests that Canada has embraced a "prosperity-free" economic growth strategy, one that will do little to raise living standards for most households over time.

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

	2018	2019	2020f	2021f
Real GDP	2.4	1.8e	2.0	2.3
Employment	1.1	2.6	1.9	1.8
Unemployment rate (%)	4.7	4.7	4.9	5.0
Housing Starts (000 units)	41.0	43.0	39.0	41.0
Retail sales	2.0	1.8	0.7	3.0
B.C. CPI	2.7	2.3	2.1	2.0

f - forecast e - estimate

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

B.C.'S OUTLOOK DOWNGRADED...AGAIN

Against an uninspiring Canadian economic backdrop, British Columbia's economy should put in a comparatively respectable performance over the next two years. B.C. looks set to outpace most other provinces over 2020-21. But only in a *relative* sense can the province's outlook be described as bright. Indeed, output or real GDP measured on a *per person* basis will scarcely budge in 2020 and 2021.

The Business Council estimates the provincial economy slowed significantly in 2019, with a real growth rate of just 1.8%. Growth should continue at a similar pace this year, although the ramping up of a number of large capital construction projects together with ongoing population gains should ensure a small growth uptick from 2019 levels.

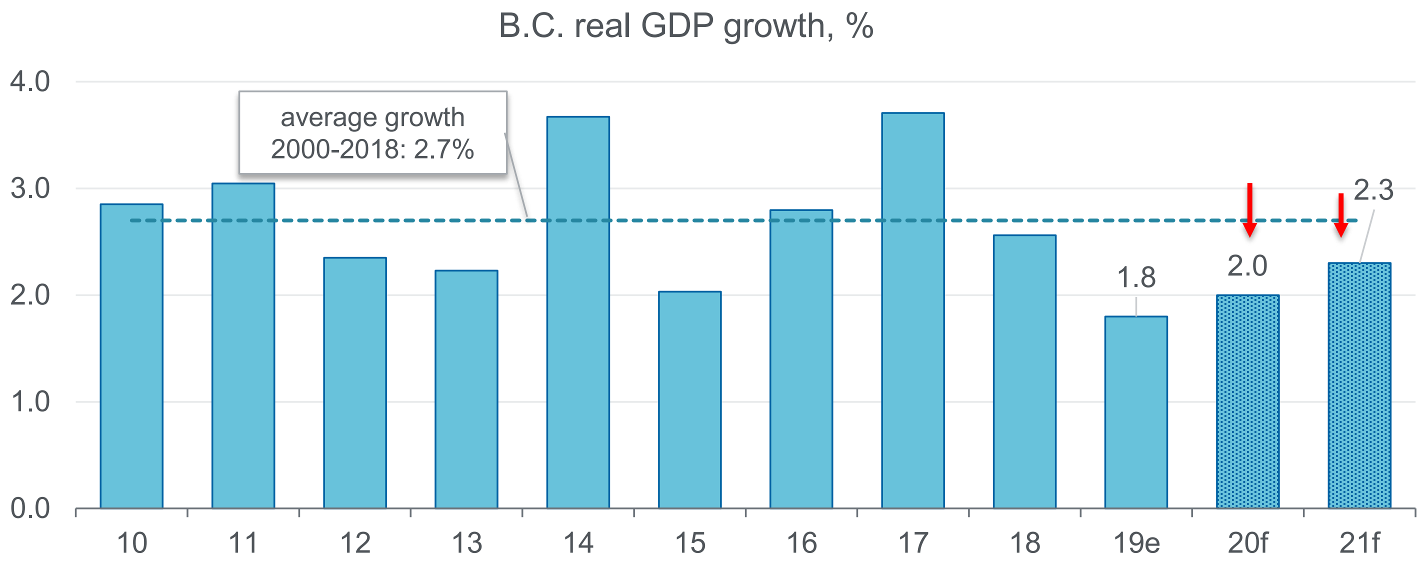
In our view, the near-term prospects for the B.C. economy have dimmed and we have again downgraded our projections for 2020. In our previous report, we expected the provincial economy to expand by 2.2% in 2020. We now believe growth will be closer to 2.0%. For 2021, we have marginally trimmed the growth forecast from 2.4% to 2.3% (**Figure 7**).

In spite of the downgrades, we judge the B.C. economy to be resilient. Population growth, the stabilization of the residential real estate market after two years of turbulence and price drops, buoyant non-residential construction, a list of sizable engineering projects, the fall in mortgage interest rates – given these factors, it is hard to imagine real GDP growth falling much below 2%, short of a major slump. The B.C. economy could even surprise on the upside, especially in 2021. That said, the widespread and concomitant deterioration in many current indicators points to a further softening of the near-term outlook.

The reason for our downgrade is summarized in **Figure 8**. In both panels, the indicators are indexed, setting January of 2014 equal to 100. Indexing rebases each indicator to 100, allowing them to be plotted on the same graph, while also showing the growth path of each indicator. From the left panel, it is evident that international merchandise exports and manufacturing sales have been falling for 18 months or so. Retail sales have flatlined for more than two years. And more recently, employment has also slipped. The provincial job market has been strong for a few years, but since mid-2019 the number of people working has declined. With the downturn in exports and the severe economic challenges facing forestry – B.C.'s leading export industry – there has been an even steeper downturn in employment in the goods sector.

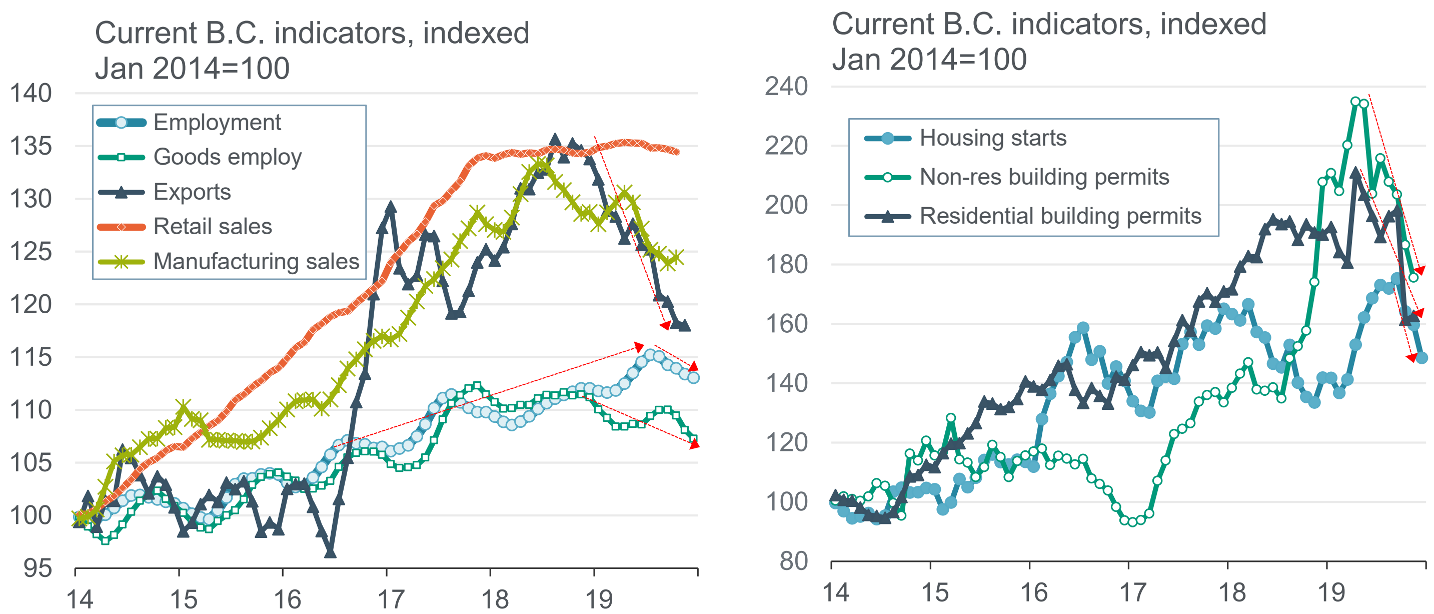
The right-hand panel in **Figure 8** depicts construction-related indicators. Here, the key point is that the three series have all dropped sharply and suddenly. Housing starts have fluctuated over the past couple

FIGURE 7: **A PERIOD OF SUB-PAR ECONOMIC GROWTH FOR B.C.**



Source: Statistics Canada, BCBC for forecasts.

FIGURE 8: **MOST CURRENT INDICATORS HAVE TURNED DOWN**



Source: Statistics Canada.

We believe the B.C. economy should grow by at least 2% this year, notwithstanding the headwinds confronting export-oriented industries like forestry, mining, and manufacturing.

of years and on the whole have been stronger than anticipated. But over the past five months, starts have moved noticeably lower, suggesting some softening in activity. The decline in the value of residential building permits supports the view that home building will retreat at some point in 2020. A significant drop in non-residential building permits is also evident in the data.

Taken together, these indicators signal weaker economic growth. Non-residential construction, however, remains at elevated levels, helping to underpin the province's economy. It should also be noted that most large engineering projects (bridges, pipelines, etc.) do not get captured in the non-residential permit data.

Some other parts of the B.C. economy also remain healthy. Tourism is still doing well. Scientific, technical and professional services (including service exports) continue to thrive. Population growth is strong. These elements of the overall picture, especially population growth, are why we believe the economy should grow by at least 2% this year, notwithstanding the headwinds confronting export-oriented industries like forestry, mining, and manufacturing.

REASONS FOR THE DOWNGRADE

The reasons we are a little more pessimistic about the near-term outlook than we were a few months back are summarized above. What follows is some additional context behind the downgrade.

Recent deterioration in the job market

Based on the annual average over the 12 calendar months, B.C. recorded well above average job growth in 2019. The average unemployment rate for the year was 4.7%, equivalent to 2018 and one of the lowest unemployment rates on record. The annual figure, however, masks the significant deterioration in the labour market that unfolded during 2019. Looking at the monthly data (seasonally adjusted) shows employment peaking in July and trending lower since then. In the second half of 2019, year-over-year job growth markedly slowed. By the end of the year, the gain in employment compared to December 2018 was a meagre 0.3%. As a result of job losses, labour market conditions are not as tight as in 2017-18. The unemployment rate has moved up a half percentage point from its late 2018 low. And the job vacancy rate also declined over the past year, providing additional evidence that the demand for labour has shifted down (**Figure 9**).

Another consideration when assessing labour market conditions is that employment is now declining in both the goods and services sectors. Amid a longer-term downward trend, the loss of jobs in the goods sector accelerated in 2019. Meanwhile, the number of people working in the broad services sector has also been decreasing for six months.

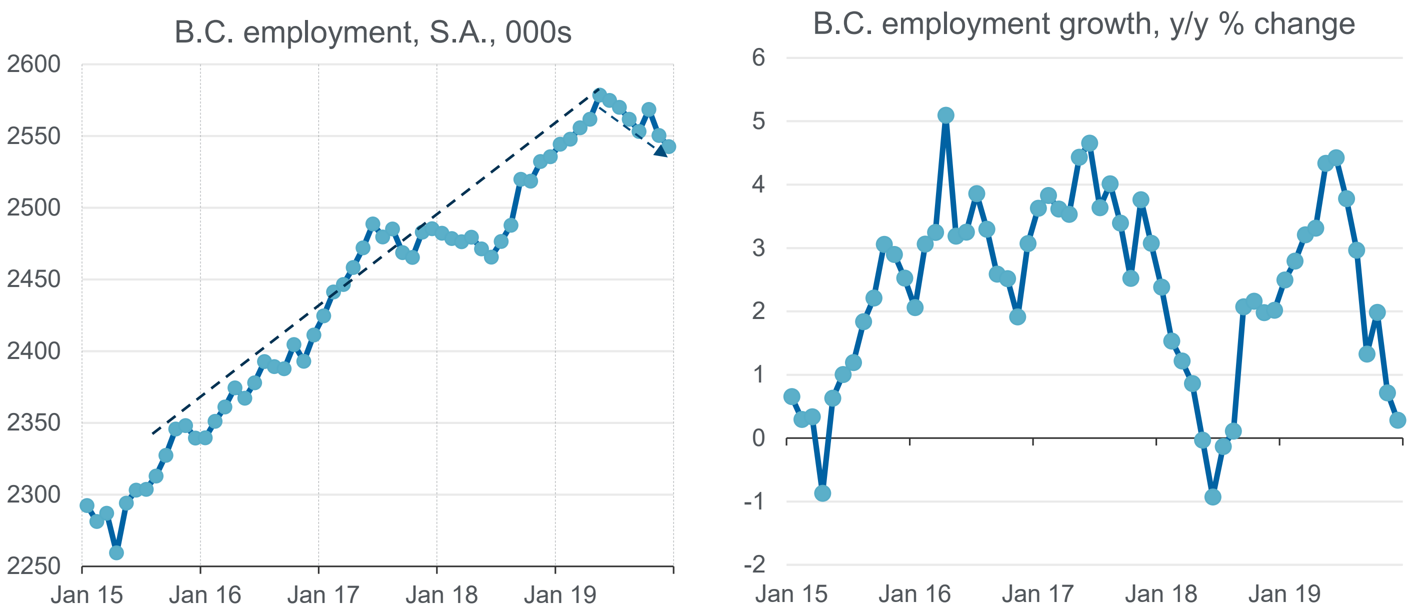
Exports continue to slide

Another worrisome indicator is the drop in B.C.'s merchandise exports (**Figure 10**). Exports to other countries have been sliding for more than a year. Through the first 11 months of 2019, the value of international merchandise exports was down 6.7%. The downturn is fairly widespread. The value of exports is off in all the province's major export markets except India. Most commodity categories have also experienced retrenchment. The most pronounced declines have occurred in wood products and pulp and paper, each off by ~20%. Exports of metallic mineral products are down by 10%. On the brighter side, agriculture continues to do well, with exports up 10% in 2019. And machinery and equipment exports advanced 6% last year.

The simultaneous downturn in B.C. manufacturing sales partly reflects the erosion in export markets. Many manufactured items, however, are consumed domestically. That manufacturing sales have fallen for nearly two years underscores both the weakness in exports and B.C.'s structural deterioration in competitiveness across most goods-producing industries.

While the partial resolution of the U.S.-China trade conflict is positive for global trade and for Canada, it is not likely to have much impact on B.C. exporters in the near-term. The sluggish global economy, mixed commodity market conditions, waning industrial competitiveness, and the crisis in the province's forestry sector are likely to have a bigger role in shaping B.C.'s export performance in 2020.

FIGURE 9: **B.C. EMPLOYMENT TURNS DOWN**

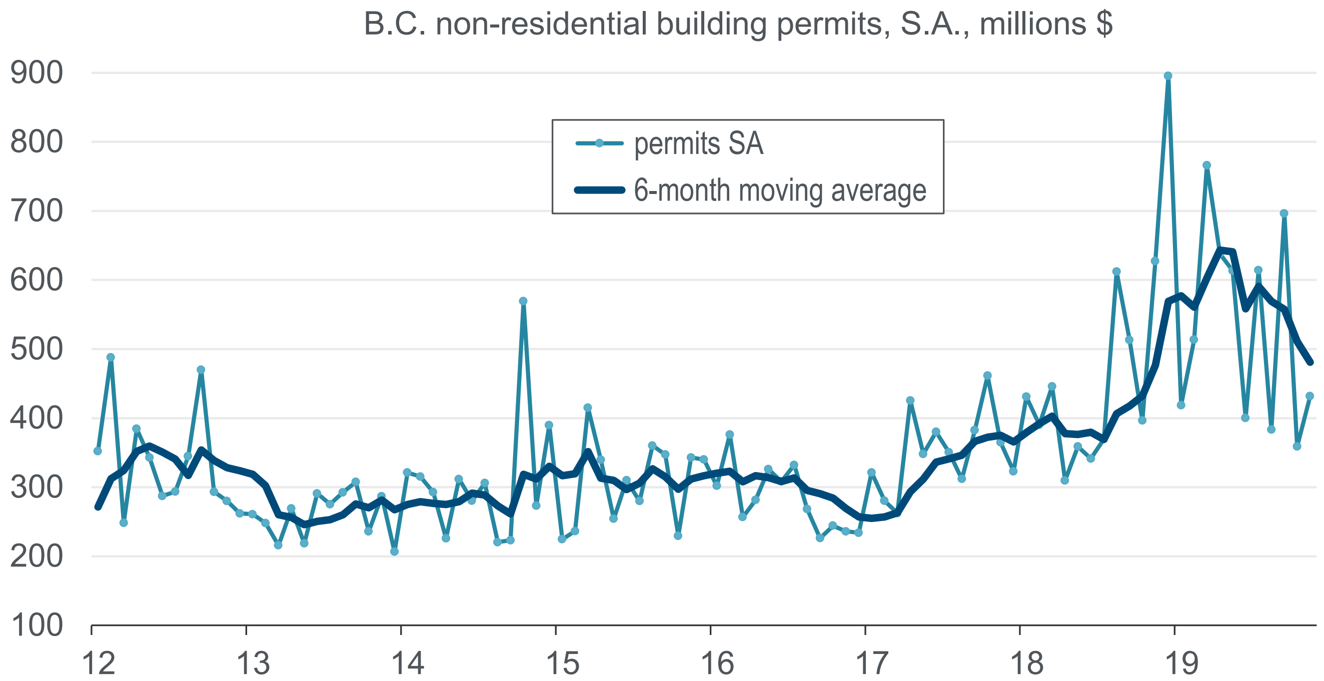


Source: Statistics Canada, Labour Force Survey. S.A. = seasonally adjusted.

FIGURE 10: **MERCHANDISE EXPORTS STILL FALLING**

Source: BC Stats. Latest: November 2019. S.A. = seasonally adjusted. 3-month moving average.

FIGURE 11: **NON-RESIDENTIAL CONSTRUCTION WILL EASE SLIGHTLY IN 2020 AS BUILDING PERMITS GEAR DOWN**



Source: Statistics Canada, Table 34-10-0066-01. Latest: November 2019. S.A.= seasonally adjusted.

FIGURE 12: **NON-RESIDENTIAL PERMITS HAVE HELD UP IN METRO AREAS**

Source: Statistics Canada, Table 34-10-0066-01. 6-month moving averages.

*metro areas include Vancouver, Victoria, Abbostford and Kelowna.

Building permits down in second half of 2019

The reason we have underscored non-residential construction as a growth engine for B.C. for some time now is apparent in **Figure 11**. Between 2012 and 2016, the monthly value of non-residential permits fluctuated between $250 million and $300 million. Then, in 2017, non-residential permits started to rise. The gains were especially strong in latter 2018, and by mid-2019 the monthly value of non-residential permits had more than doubled from their earlier trend level.

But as is also clear in the figure, permit values then moved lower over most of 2019. The sum of non-residential permit values in the second half of 2019 was 14% lower than in the first half of the year. Non-residential construction activity remains at elevated levels in absolute terms, and the timing and pace of how building activity unfolds is uncertain. But the recent drop in permit values likely presages a moderation in the growth of non-residential investment spending and construction activity later this year.

Figure 12 breaks down non-residential permits into two regions: the province's four large census metro areas combined (Vancouver, Victoria, Abbotsford and Kelowna), and the sum of permits in the "rest of the province." In both of these aggregate "regions," total non-residential permits have doubled in value over the past couple of years. The more recent downturn, however, is concentrated in the non-metro "rest of province" region, suggesting the shift to slower growth in non-residential construction will be tilted towards the non-metro parts of the province.

New residential building permits have also slipped

New residential building permits are also at a high level, thanks to multi-year gains in the multiple family segment. But the value of residential permits in the second half of 2019 was down 17%, compared to the first half of the year, mirroring the second half drop in non-residential permit values (**Figure 13**). With immigration targets driving record population growth, we doubt that home building will fall much. But in the context of the outlook for 2020, the easing in residential permits supports the case for downgrading B.C.'s growth forecast.

Housing starts in B.C. are also at elevated levels. But in concert with building permits, the numbers fell significantly (-11%) between the first half of 2019 and the second half. Another notably lackluster indicator is retail sales. As referenced earlier, retail spending has been essentially flat in B.C. for more than two years as households grapple with record high debt loads and debt servicing costs. Factoring in inflation and population growth, the real of value retail spending on a per capita basis has been trending lower. The malaise in retail sales has occurred during a period of solid job growth and provides no reason to be optimistic about the outlook for consumer spending in 2020.

BUT GROWTH WON'T FALL BELOW 2%

Despite our decision to trim the B.C. growth forecast, we believe real GDP growth will not slip below 2% in 2019 and will pick up slightly in 2021. Three factors underlie this expectation.

The first is non-residential construction

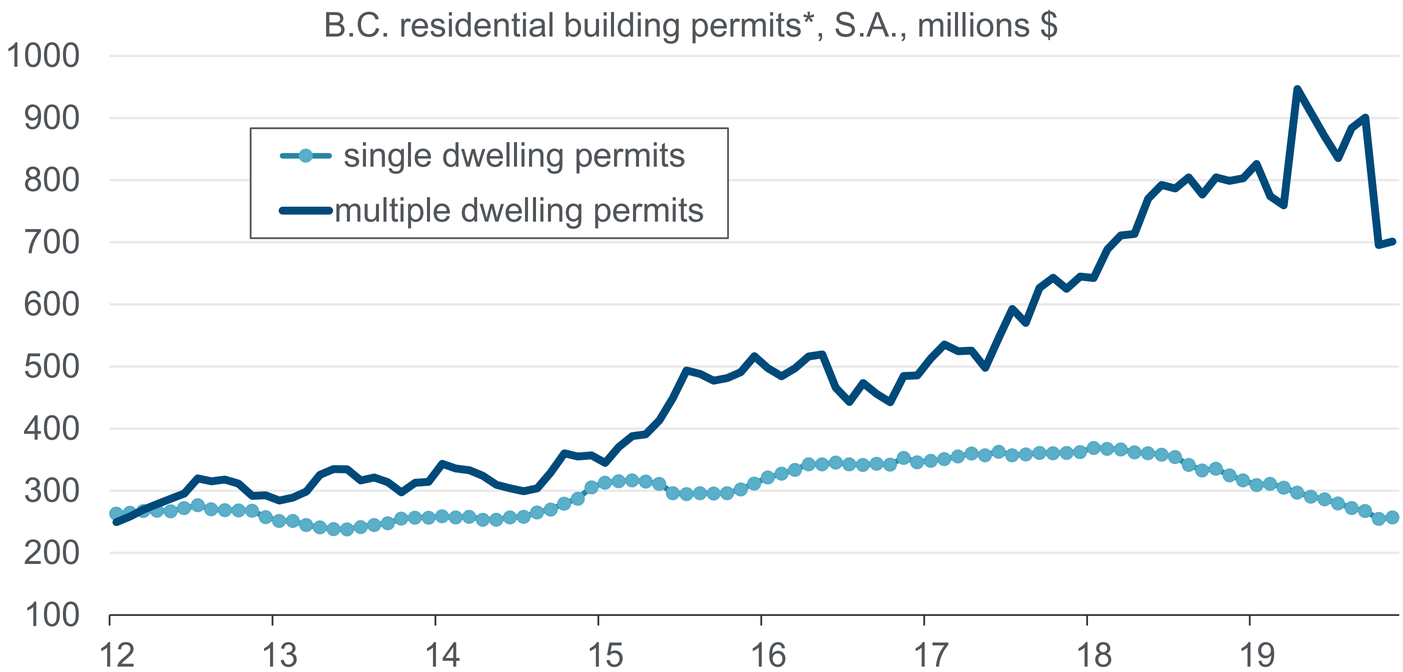
Notwithstanding the recent moderation, non-residential permit values are still at high levels. There are also large engineering projects across B.C. which are not captured by the building structure permit data, such as pipelines, bridges, roads and highways. Pipeline construction will boost growth in the years ahead as new lines are developed to transport natural gas to LNG Canada's Kitimat facility. The recent Supreme Court of Canada decision suggests the Trans Mountain pipeline expansion will move ahead. Work on B.C. Hydro's Site C project continues. Last spring, the government announced that the Pattullo Bridge replacement had received environmental approval so this project should proceed in 2020. Major capital spending is also underway at the Vancouver Fraser Port and Vancouver International Airport.

The second factor is population growth

Net in-migration to the province has risen in recent years. In particular, B.C. has seen a huge jump in the number of net non-permanent residents. This category consists largely of students and temporary workers. The increase in this segment is shown in **Figure 14**, where net non-permanent residents are depicted by the green bars.

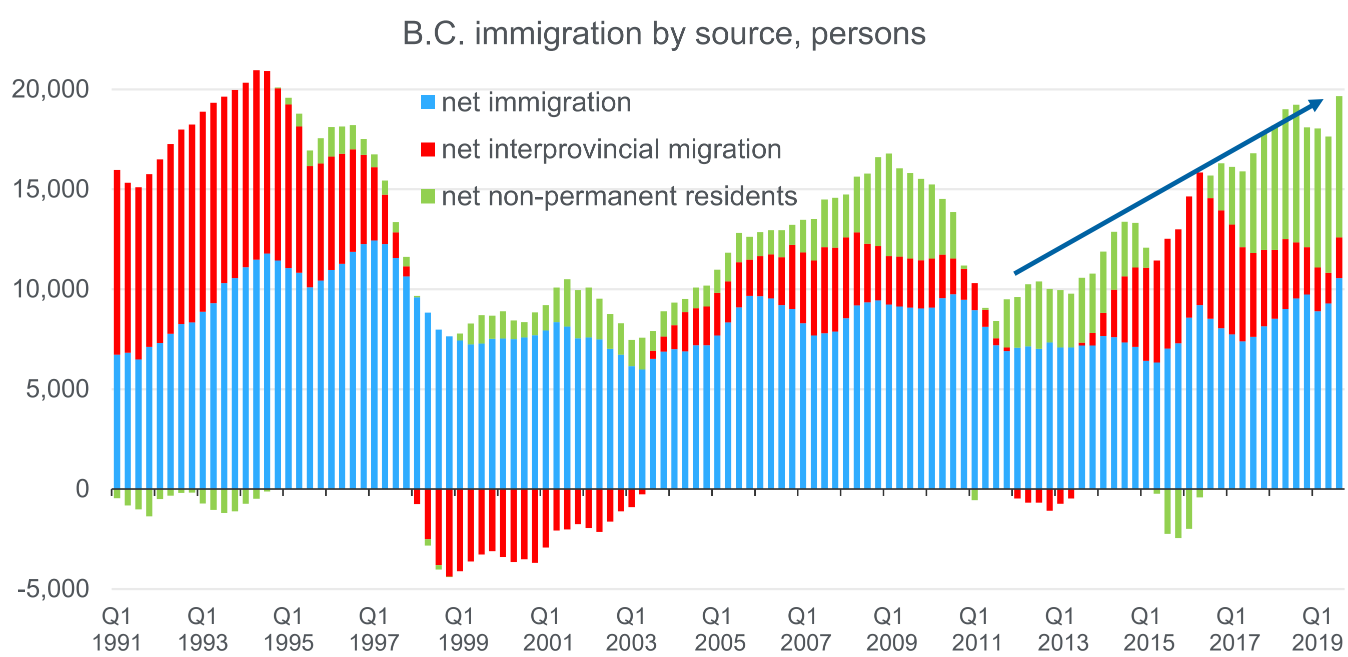
In-migration has soared over the past seven or eight years (**Figure 15**). Recently, record numbers of non-permanent residents have been a key reason. Fully three-quarters (1.5%) of GDP growth in the province is attributable to population growth, leaving only muted gains in GDP per person (**Figure 16**).

FIGURE 13: **RESIDENTIAL BUILDING PERMITS ALSO LOWER IN SECOND HALF OF 2019**



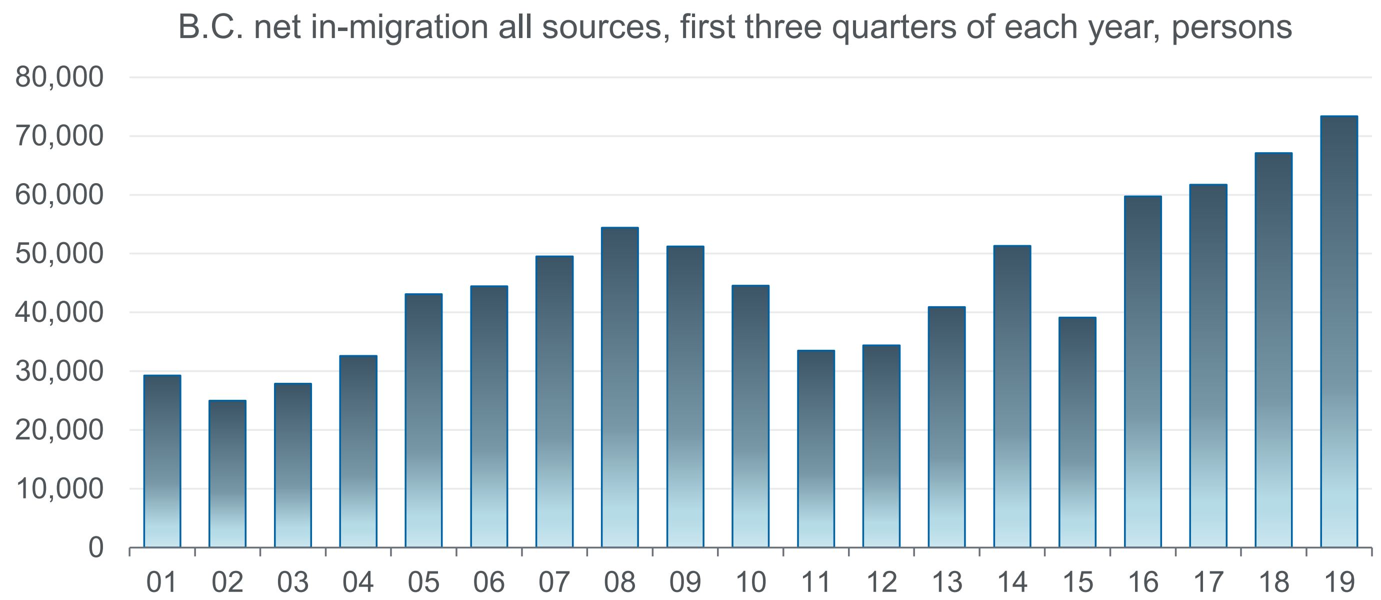
Source: Statistics Canada, Table 34-10-0066-01. Latest: November 2019. S.A.= seasonally adjusted. *6-month moving average.

FIGURE 14: **INFLOW OF NON-PERMANENT RESIDENTS LIFTING POPULATION GROWTH**



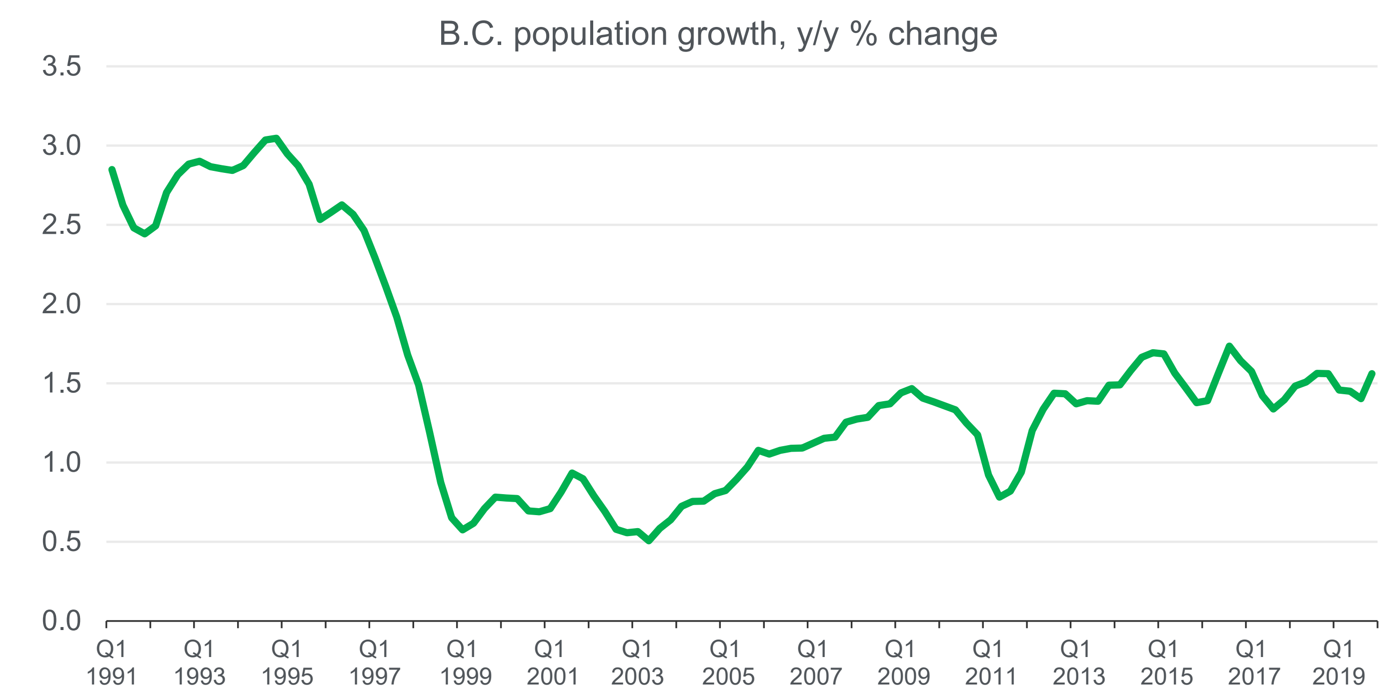
Source: Statistics Canada. Latest: Q3 2019.

FIGURE 15: **MIGRATION FROM ALL SOURCES IS LIFTING POPULATION GROWTH**



Source: Statistics Canada.

FIGURE 16: **THREE QUARTERS OF RECENT GDP GROWTH SIMPLY REFLECTS POPULATION GROWTH**



Source: Statistics Canada. Latest: Q3 2019.

The third reason is B.C.'s diversified economy

B.C.'s export sector (and the province's economic base) continues to diversify. The film and television industry has expanded at a head-spinning clip in recent years, with the industry's GDP growing at an average annual rate of 27% between 2015 and 2018. The tourism industry is performing well. Growth in the accommodation services sector has been especially strong in recent years.

High technology in the province is also showing strength overall. The arrival of a number of U.S. tech giants means a new driver for output and employment growth in the B.C. tech sector. Professional, scientific and technical services represent a large and expanding part of the economy and job market. Within this space, the computer system and design industry has grown nearly three times as fast as the overall economy. Much of what is produced in this sector is for domestic use, but the value of B.C.'s knowledge-intensive service exports is also rising steadily. While the slowdown in forestry and mining will have negative spinoff effects on B.C. firms selling professional, scientific and technical services, we believe the sector will continue to expand at an above average rate.

The transportation and warehousing industry, anchored by airports, international ports, and the rail network, is another important growth engine, helping to boost the broader B.C. economy.

CONCLUDING THOUGHTS

As with the Canadian outlook, many of the ingredients in the B.C. outlook for the next couple of years are already baked-in. Increases in the population and overall construction, along with continued strength in segments of the economy that have been growing briskly, all but ensure that the province's economy will avoid a serious downturn and likely grow by at least 2% in 2020 and 2021.

While this looks positive on the surface, it is not a stellar performance judged by historical standards or when measured on a *per person* basis. Last year, real GDP in B.C. rose at the slowest rate since the 2009 recession, so a small uptick in 2020 is nothing to get excited about. Moreover, as with Canada, real GDP *per person* is likely only to inch ahead in 2020-21 meaning that living standards for British Columbians will barely change. This marks a shift in B.C.'s growth dynamics. Over the middle part of the decade through to 2018, stronger economic growth with population growth rates similar to today meant that B.C. recorded solid increases in real per capita GDP. But if our outlook for 2020 and 2021 is close to what materializes, the province will have experienced three consecutive years of substandard GDP growth and very skinny gains on a per capita basis.

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