WIDESPREAD DEMAND-SUPPLY IMBALANCES AND RISING PRICES BUFFET THE ECONOMIC RECOVERY

B.C. ECONOMIC REVIEW AND OUTLOOK

December 2021

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HIGHLIGHTS

- Global GDP growth is projected to be 6.5% in 2021, 4.3% in 2022 and 3.4% in 2023. While the direct economic impact of the pandemic is fading, widespread demand-supply mismatches are unsettling the pace of the recovery and contributing to persistent inflation in many countries (including Canada). The period of ultra-loose fiscal and monetary policy is coming to an end.
- U.S. GDP growth is expected to be 5.6% in 2021, 3.9% in 2022 and 2.7% in 2023. The downward revisions for 2021 and 2022 are due to the global factors listed above, the ebbing effects of the Biden Administration's massive fiscal packages, and disruptions caused by the Delta variant wave. U.S. inflation is tracking well above 4% y/y, increasing the likelihood that the Federal Reserve will tighten monetary conditions sooner than previously expected.
- The outlook for **Canada's GDP growth** is modestly lower than assumed in our last report, at 5.1% in 2021, 4.3% in 2022 and 3.7% in 2023. Canada is grappling with widespread demand-supply mismatches and rising prices that are sapping some of the recovery's initial strength.
- Canada's unemployment rate is significantly higher than that of peer countries. Ultra-loose fiscal and monetary policy has been needed for longer to try to reduce labour market slack, but comes at a cost of exacerbating other economic imbalances such as the current credit boom causing higher established house prices.
- With CPI inflation trending close to 5% and proving to be "non-transitory", the Bank of Canada has with some reluctance shifted its tone and timeline for the winding down of monetary policy stimulus. As well, most federal emergency supports expired in October. As these policy interventions are unwound, Canada's recovery may be heading into choppy waters.
- B.C. real GDP growth is now forecast to be 5.0% in 2021 and 4.0% in 2022. The robust pace of growth is expected to ease in 2023 with the economy downshifting to a more average growth rate around 2.6%.
- Some moderation in current economic indicators and the provincial floods have prompted a downward revision to B.C.'s outlook.
- The full reopening of the economy will result in strong gains in consumer spending on services, even as spending in retail stores softens.
- The steady if somewhat sporadic recovery in international tourism is also a positive tailwind for the provincial economy.
- We expect private sector hiring to strengthen in 2022, with gains spreading to hard-hit sectors as well as ones where employment has recovered.
- Risks to the outlook are mostly on the downside stemming from the Omicron variant, sustained inflation and sooner-than-expected interest rate hikes.

GLOBAL ECONOMIC RECOVERY LOOKS INCREASINGLY CHOPPY AS INFLATION PRESSURES BUILD

Global GDP growth is expected to rebound from the brief 2020 slump to reach 6.5% in 2021 before easing to 4.3% and 3.4% in 2022 and 2023, respectively (**Table 1**). High rates of vaccinations are facilitating the reopening and recovery in advanced economies, while vaccination rates are lagging in emerging economies. The Bank of Canada assumes most public health restrictions will be eliminated globally by the end of 2022, and in Canada's case by the end of 2021.

The global recovery is exhibiting choppiness as rising demand for goods and services encounters widespread supply-side problems including: shortages and escalating costs of production materials (e.g. semiconductors); high shipping costs and long delays; increasing costs for carbon mitigation; and insufficient global energy supply (affecting Europe, China and the United Kingdom particularly).

With the pandemic fading, and inflation rising, many central banks (including Canada's) have signaled their intention to throttle back on monetary stimuli. Extraordinary monetary policy measures adopted since early 2020 have included ultra-low policy interest rates, forward guidance about the future path of policy interest rates, and quantitative easing (i.e. buying government and other bonds to artificially push down their yields). As was the case following the 2007-09 Global Financial Crisis (GFC), how economies adjust to the end of "cheap money" is an open question. The adjustment may be bumpy.

The **U.S. economy** is expected to grow by 5.6% in 2021, 3.9% in 2022 and 2.7% in 2023. The modestly lower U.S. outlook for 2021 and 2022 is due to some of the global factors listed above, the fading effects of the Biden Administration's massive fiscal packages, and disruptions caused by the Delta variant wave. The Federal Reserve's preferred inflation gauge, the personal consumption expenditure (PCE) price index, is running at 4.4% y/y. America's CPI is even higher at 5.4% y/y. High inflation, and the Fed's response to it over the next 2-3 years, will bear on Canada's recovery given the strong trade and financial linkages between the two countries. Risks to the U.S. outlook are weighted to the downside in our view. Some economists are even raising the prospect of a U.S. recession within two years as consumer and business confidence ebbs.

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

	2020f	2021f	2022f	2023f
World	-2.2	6.5	4.3	3.4
U.S.	-3.4	5.6	3.9	2.7
Euro area	-6.5	5.3	4.5	1.9
Japan	-4.7	2.5	3.0	0.1
China	2.3	7.9	5.3	5.9
Canada				
Potential GDP	0.8-2.0	0.8-2.2	0.4-2.2	1.0-3.0
Actual GDP	-5.3	5.1	4.3	3.7
CPI Inflation	0.7	3.4	3.4	2.3

f - forecast

Source: Bank of Canada.

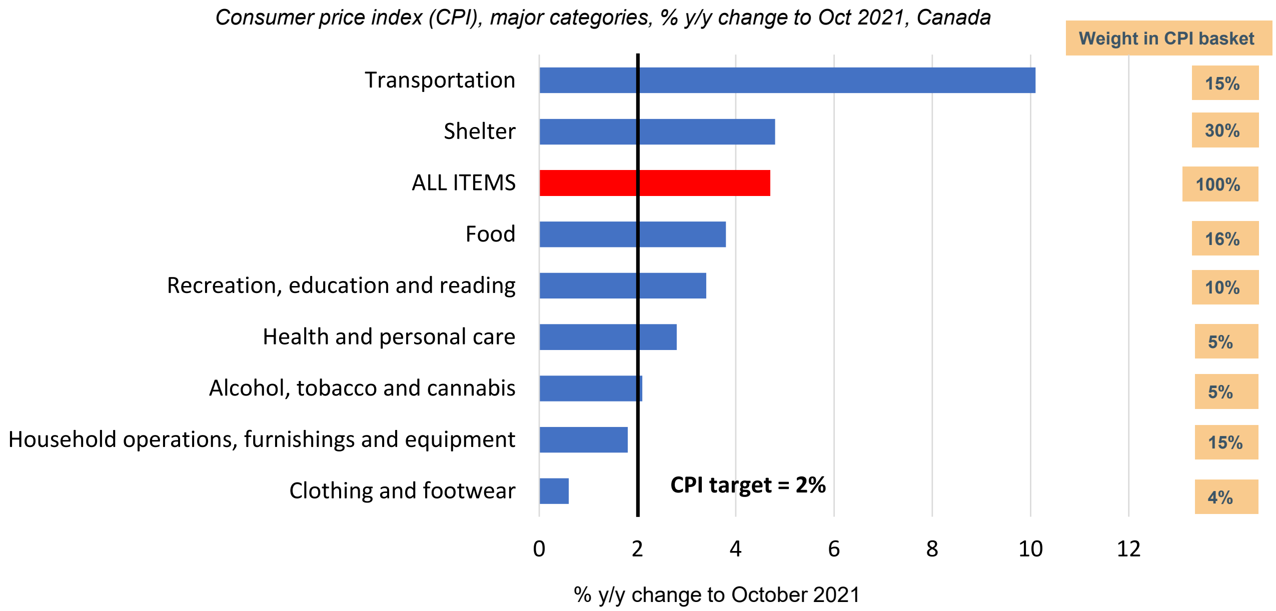
POLICY INTERVENTIONS, SUPPLY-DEMAND MISMATCHES AND RISING PRICES BUFFET CANADA'S RECOVERY

The outlook for **Canada's GDP growth** is modestly lower than in our previous BCERO report at 5.1% in 2021, 4.3% in 2022 and 3.7% in 2023 (**Table 1**). After a slow start, Canada's vaccination rate ramped up quickly during the middle of 2021, enabling a swifter-than-expected reopening of the economy. With 86% of the eligible (aged 12+) population vaccinated, Canada has one of the world's highest vaccination rates. Nonetheless, the economy is now grappling with the effects of numerous policy interventions, widespread demand-supply mismatches and rising prices that are sapping some of the recovery's initial strength.

In the labour market, as noted in our previous BCERO, the federal government in our view made a policy error by ramping up immigration targets at a time when labour demand was in recession and struggling to recover. At a stroke, the government moved the goalposts on closing the labour market gap. The federal government is stoking labour supply on the one hand, forcing the Bank of Canada to keep its extraordinarily loose monetary policy in place for longer to stoke labour demand on the other. The consequence of Canada's policy discoordination is that the labour market is in overall excess supply, even as there are widespread labour demand-supply mismatches.

Canada's unemployment rate was 6.7% in October, still considerably higher than many other advanced

FIGURE 1: **CANADA FACES BROAD-BASED CPI PRESSURES**



Source: Statistics Canada.

countries such as New Zealand, Australia and the United Kingdom that acted pragmatically to scale back immigration targets while labour demand was weak. We worry that hardship lies ahead for many jobseekers, especially newcomers, as federal emergency supports continue to be dialed back. At the same time, the extended period of ultra-cheap debt has come at the cost of exacerbating other longstanding imbalances around indebtedness and house price inflation. The potential for a disorderly unwinding of these imbalances is a key risk to Canada's medium-term economic prospects.

Similarly, inflation pressures are widespread across provinces and spending categories. Consumer price inflation (CPI) in Canada reached 4.7% y/y in October, well above the pace of nominal wage growth and the Bank of Canada's 1-3% per annum inflation control range (**Figure 1**).

Having initially dismissed high inflation as "transitory", the Bank has reluctantly had to shift its inflation outlook, communications tone, and policy stance. It has also announced the immediate end of quantitative easing. The Bank now expects monthly CPI to run at an annualized pace of just under 5% over the balance of 2021 and to ease towards its target of 2% by the end of 2022. Calendar year average forecasts for CPI are 3.4% for 2021, 3.4% for 2022, and 2.3% for 2023 (**Table 1**).

Overall, Canada's outlook features modestly downgraded forecasts for economic growth, higher-for-longer CPI inflation, and an earlier scaling back of ultra-loose monetary policy. Federal fiscal policy will also be tightened as emergency supports are scaled back. With the emergence of the omicron variant, risks to Canada's GDP outlook are weighted to the downside.

B.C. GROWTH OUTLOOK TRIMMED

Consistent with the Canadian outlook, B.C.'s growth prospects are scaled back, but the economy will continue growing at a solid pace. Demand-supply mismatches are proving more disruptive and pervasive and are impacting production and the shipment of goods in some sectors. The slowing in retail spending, downturn in building permits and softer gains in private sector employment also suggest growth is easing in the final quarter of the year.

The flooding that devastated B.C. communities in November, displacing families and businesses and severing critical transportation connections, has also necessitated a downward recalibration. While the full extent of the damage and how long it will take to repair key transportation infrastructure are uncertain, the impacts from the flooding disaster are localized but are also reverberating through the economy -- compounding supply chain issues. The flooding will likely shave another two or three tenths of a percentage point off of real GDP growth in 2021. Adding it up, we now expect real GDP growth to reach 5% for 2021, down from our previous 5.8% projection (**Table 2**).

The weaker-than-expected handoff going into next year is also prompting a downward revision for 2022, with B.C.'s real GDP now forecast to rise 4% (rather than 4.5%). Although repairs and rebuilding from the flooding will extend through much of 2022, transportation connections should be fully restored in a few weeks and have a limited impact on the annual top line growth number.

There is more uncertainty regarding 2023. By then, we assume that higher borrowing costs will dampen housing activity and weigh on consumer spending. Global growth will also moderate. The provincial economy is expected to downshift to its longer-term average growth rate of around 2.6%.

The heightened uncertainty over the new Omicron COVID variant, how quickly international travel might resume, escalating inflation, and policy missteps identified in the previous section make growth forecasts more of a moving target than usual. These factors also tilt most of the risks to our outlook to the downside.

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

	2020	2021f	2022f	2023f
Real GDP	-3.4	5.0	4.0	2.6
Employment	-6.5	7.2	3.2	2.2
Unemployment rate (%)	8.8	6.5	5.4	5.0
Housing Starts (000 units)	38.0	47.5	45.0	42.0
Retail sales	1.3	13.5	6.0	6.2
B.C. CPI	0.8	2.8	3.5	3.5

f - forecast

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

SPENDING ON SERVICES TO BOOST CONSUMER EXPENDITURES

We have trimmed B.C.'s outlook in part because spending in retail stores levelled off sooner than anticipated and is on track to post only modest gains in the first half of 2022. The pace of car purchases slowed after a large jump earlier in 2021 and the surge in spending at building supply stores is also ebbing. Substantially higher energy and food price are also headwinds for B.C. consumers.

As noted previously, the 2020 COVID downturn differed from other recessions because consumer spending on goods held up but spending on services tumbled. With the economy fully reopening, consumers spending on services will resume for activities that were curtailed or even non-existent over the past 20 months. A promising sign is that in the third quarter of this year, spending in full-service restaurants regained (and slightly surpassed) its pre pandemic level (**Figure 2**).

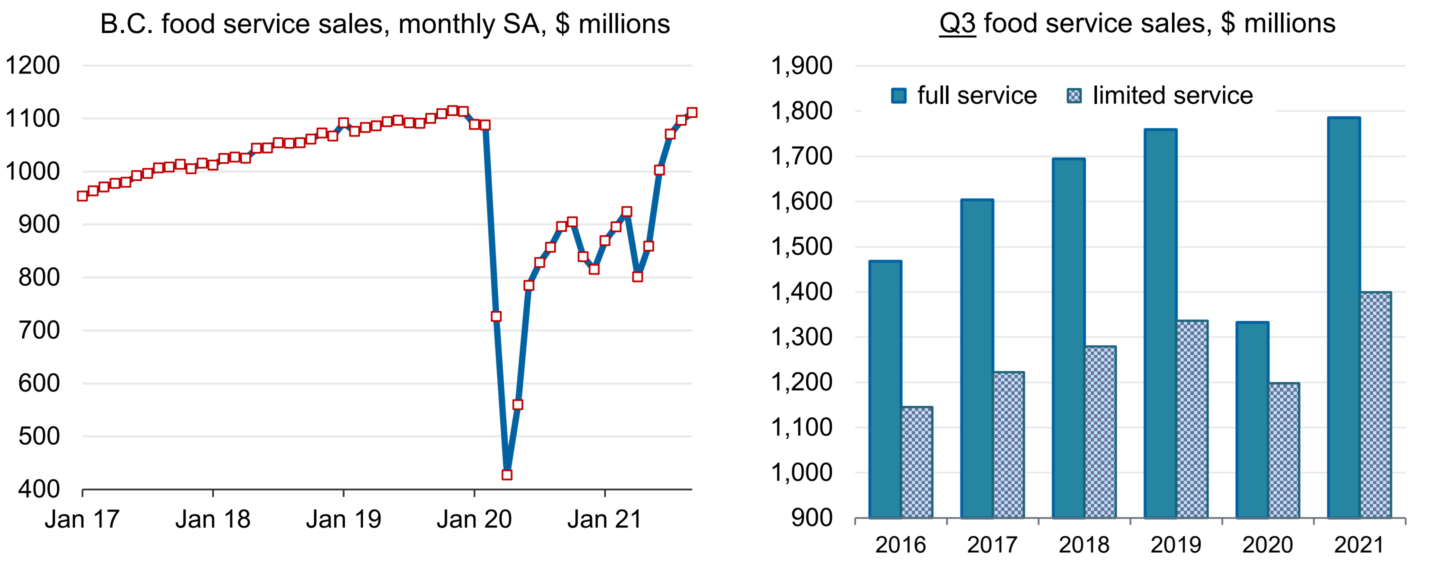
B.C. home re-sales surged to record highs in 2021. In response to strong demand for home purchases (and the pushing out of some of new housing projects from 2020 to 2021), housing starts are on track to reach a new annual high of nearly 48,000 units. In 2022, the number of starts will move back from this high mark, but the elevated level of construction activity will carry into 2022 and contribute to the province's above average economic expansion. Even modestly higher interest rates will significantly erode affordability and dampen housing activity in the second half of the year, leading to some pull-back in residential construction activity.

MORE UPSIDE FOR B.C. EXPORTS

Exports have supported B.C.'s recovery since mid-2020. Wood and energy products have posted the strongest gains, but all export product categories are up in 2021. Broadly-based gains and buoyant global commodity markets point to additional export growth, if at more moderate pace.

Wood product exports now account for 25% (one in every four dollars) of all provincial merchandise exports. The integrated pulp sector makes up another 8% of B.C.'s goods exports. Energy accounts for another 25% and mined metallic and mineral products for 13%. Combined, natural resource products that mostly come from the

FIGURE 2: **SALES AT FULL-SERVICE RESTAURANTS RECOVER**



Source: Statistics Canada, Table: 21-10-0019-01. Latest September 2021. SA=seasonally adjusted.

province's Crown land base make up nearly 75% of all provincial exports. This statistic underscores the reality that natural resources still dominate B.C.'s export mix, even though the overall economy has diversified significantly in the past 2-3 decades.

Further into the forecast horizon, we believe the forest sector's economic contribution will shrink. The pine beetle has already led to curtailments in harvestable timber. The province's recent announcement that it intends to defer logging in 2.6 million hectares of old growth forests will compound existing fibre shortages and result in the closure of another 10-15 sawmills and potentially 1-2 pulp mills. It will also prompt forest companies to accelerate the redirection of investment dollars to other jurisdictions. The large and widespread negative economic impacts flowing from the provincial government's policies regarding forestry as well as other land-based industry sectors is one reason why we expect the B.C. economy to downshift towards a more "average" growth performance over the medium term.

That said, an anticipated ongoing upswing in the value of service exports will help keep the near-term expansion on a solid footing. Tourism is normally one of the province's largest industries and a key source of export revenue. Our forecast builds in a modest but steady return of international travel. This assumption could prove too optimistic, as many countries are now implementing international travel bans and closing their borders as the Omicron variant spreads across the world. At this stage we still expect a gradual revival of international travel to contribute to B.C.'s economic growth in 2022. We will revisit this issue in our next quarterly update.

Rapidly growing demand for new streaming content is a plus for B.C.'s large and vibrant film and television production industry. We expect the transportation and logistics sector to run full out in the coming year as product shortages are addressed and supply chains repaired.

MORE PRIVATE SECTOR HIRING NEEDED

Over the course of the shut-down and re-opening, B.C.'s employment recovery has been comparatively strong. Employment levels, however, are still below pre-pandemic levels in nine of 16 broad industry categories. The aggregate job numbers have also been notably bolstered by frenzied public sector hiring while hiring in the private sector remains more modest.

Our 2022 growth forecast is predicated on a pick-up in private sector hiring and a more fulsome recovery in all industry sectors, especially the hard-hit consumer facing ones. An important potential headwind to faster private sector job creation, however, is rising payroll costs. The provincial government just announced a minimum of 5 days mandatory paid sick days for all employees. B.C. employers will have to either absorb or pass on the additional costs, which are on top of escalating payroll levies like the Employers' Health Tax, higher CPP contributions, and significant increases in the maximum pensionable and maximum insurable earnings thresholds under both the CPP and the Employment Insurance programs, respectively. For some employers hammered by COVID-related disruptions and extra workplace safety costs, the steep jump in government-determined payroll charges may be the final straw. We see a risk that job creation in the private sector could slow appreciably in the next couple of years.

Sharply higher payroll costs also come at a time when many employers are having more difficulty than usual finding employees. The job vacancy rate is the highest on record. B.C. today also has the highest vacancy rate of any province, with the worst shortages reported in the Thompson-Okanagan region and on Vancouver Island. As pandemic-related government supports are wound down, we expect more people to return to the workforce. But even a large bump in the pool of potential workers will not alleviate the high vacancy rates reported in some sectors.

The resumption of stronger population growth will also be a source of new workers and is another reason we expect GDP growth to stay elevated in 2022. In 2021, the number of immigrants moving to the province slumped by half. The processing of temporary workers and other non-permanent residents also tumbled, resulting in the previous net inflow of 25,000 temporary residents to switch to a net outflow of roughly the same magnitude. Rather than growing by the usual 1.6% - 1.8%, B.C.'s population grew by just 0.5% in the second half of 2021. The resumption of more normal immigration flows (and positive net interprovincial migration) should help to boost economic growth in 2022. It is also a reason growth eases in 2023: once immigration and population growth return to more normal patterns, the lift to GDP due to the rebound from abnormally low population gains will not be repeated.

NON-RESIDENTIAL INVESTMENT LIFT FADES OVER FORECAST HORIZON

In the year prior to and throughout the pandemic, construction of large capital projects has provided a very large boost to B.C.'s economy. Absent the Trans Mountain pipeline expansion, the building of the LNG facility in Kitimat, and the Site C Hydro project, economic growth would have been muted in 2019 and the downturn much larger in 2020. Ongoing construction of these massive capital projects will help sustain growth into 2022, but after that as these projects enter the final build stages the lift from construction will wane. The profile of non-residential building permits – spiking in 2019 and then returning to more normal levels in 2020 – also points to more moderate construction activity in the years ahead. The pull-back in non-residential building permits and timelines for the large capital projects means investment spending and related construction activity will become a drag on B.C.'s economic growth rather than a lift later in the forecast horizon

SUMMARY

This year the provincial economy benefited from buoyant commodity markets and a reviving global economy. The same dynamic generally will continue, with more of a lift coming from service exports. The full reopening of consumer-facing services will see consumer spending rotate back towards spending on services compared to goods.

In 2023, we expect the economy to downshift towards its long-term potential growth rate as higher interest rates weigh on the finances of heavily indebted households. Higher inflation will also erode purchasing power and dampen consumer spending.

The risks to the outlook are mostly on the downside. Higher inflation could prompt an earlier and more aggressive policy response by the Bank of Canada. There is also a risk that the new COVID variant could dampen the anticipated recovery of the global economy and deliver a further blow to the province's tourism, travel and hospitality sectors.

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