CURRENTS

WESTERN CANADA'S
ECONOMIC BULLETIN

GLOBAL OUTLOOK

China's swoon adds to the drama

CANADA WEST FOUNDATION ↗ AUGUST 2015

Diversification CHASING *the* HOLY GRAIL

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GLOBAL OUTLOOK

Oil prices, euro drama keep Canada on a roller-coaster

Events both around the globe and closer to home are influencing economic activity.

The World Bank revised its July forecast downwards, reflecting expectations for an economic slowdown globally for the remainder of 2015. Overall growth is expected to be 3.3%, followed by a slightly more buoyant growth rate of 3.8% in 2016.

Advanced economies are experiencing a slow-but-steady growth path, with 2.1% projected growth in 2015 and 2.4% in 2016. Winter storms in North America and port strikes on the west coast of the United States during the first quarter put a damper on growth this year. Emerging markets and developing markets are expected to experience another decline this year, from 4.6% in 2014 to 4.2% in 2015. An uptick is projected for 2016, with growth of 4.7%.

Expectations of further volatility in the financial markets increase the risk to growth in the short term. The financial crisis in Greece will likely continue as that country's prime minister finds himself in the middle of an explosive tug of war. It appears no one in the European Union wants to experiment with a Greek exit.

Such a move could start a run on the eurozone, as Spain and other financially troubled countries decide it is better to go it on their own. The risk of some type of financial contagion escaping Europe increases with disintegration.

In China, the stock market's losses have been heavy for Chinese investors, losing about one-third of its value in matter of two weeks.The Chinese government has stepped in with restrictive rules to stabilize the equity market, but further volatility can be expected. China is moving from an export-led economy to one that is service-based, and it will rely more on domestic consumers to stimulate economic growth. To the relief of commodity producers, Gross Domestic Product (GDP) growth in China is expected to stay within 7% over the coming year, ensuring ongoing demand for global commodities.

Events are equally rocky on the home front, led by gyrating oil prices. From May to June, oil prices hovered around the US$60 bbl/d mark until the beginning of July, when prices dropped to US$50 bbl/d. Whether prices will linger at or below the US$50 bbl/d mark no one knows. With the lifting of sanctions on Iran as early as December, that country could pour even more oil into a saturated market. Iran has the capability of producing one million barrels a day although analysts think 250,000 bbl/d is more likely. Many wells are said to be depleted and need new investment to increase production. This is in addition to the 30 million barrels of oil stored in barges. Word on the street is the current price of oil has the new supply from Iran already factored in.

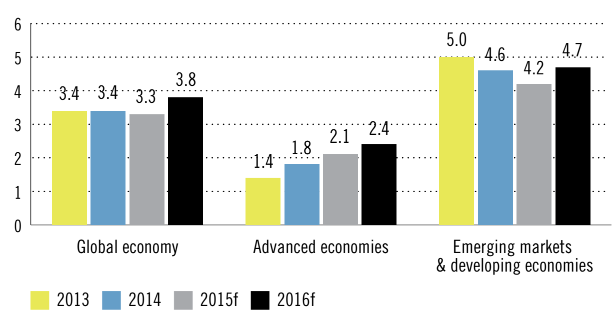
The U.S. economy is moving two steps forward and one step back, with mixed economic indicators. While the Federal Reserve (Fed) was happy with the number of jobs created over the second quarter, Chair Janet Yellen was less excited about the employment participation rate. The data suggest that although the unemployment rate dropped from 5.8% to 5.3%, fewer people are actually working. (The percentage shifted because some people have not returned to the workforce, and are not counted as unemployed.) Another troubling trend is that more part-time jobs than full-time jobs are being created.

The Fed is expected to increase interest rates as soon as Fall. It is closely watching the unemployment rate and, as it edges down closer to 5.0% (considered to be full employment), it will likely pull the trigger on a rate increase.

In Canada, interest rates are going the opposite direction. On July 15, Bank of Canada Governor Stephen Poloz lowered the overnight interest rate to 0.5% on reports of national GDP declining for the fourth consecutive month. While not yet in a technical recession, the country is certainly sliding that way. The rate decrease drove the loonie down to C$0.77 to the U.S. dollar. So, while consumers enjoy a windfall from lower oil prices, it is being offset by the deflated Canadian dollar as they pay more for imported goods. The national unemployment rate is holding steady at 6.8% with only a slight decline of 0.2% in the participation rate. Unlike the U.S., however, more full-time jobs were created in Canada than part-time jobs.

One of the worrisome consequences of low interest rates is that it encourages Canadians to take on more debt. In spite of a troubled economy, prices in residential real estate markets across Canada are mostly going up. Ever lower interest rates could reinforce this trend.

WORLD ANNUAL GROWTH RATES OUTLOOK (%)



Source: IMF World Economic Outlook, July 9, 2015

WESTERN COMMENTARY

Diversification dilemma vexes every province

We ask a lot of our politicians when it comes to managing the economy.

In a perfect world, the economy would be entirely rational and would react in predictable ways to prescribed actions. In reality, however, economies are complex and react in unpredictable ways to often competing forces. In our quest to diversify, we need to pay attention to what David Ricardo, a British political economist, identified as an economy's comparative advantage – and how western Canada's comparative advantages can be used to enhance wealth through trade. Wealth creation depends on each economy's structure. When we ignore how our economies are structured, we get into trouble with diversification strategies.

Governments have tried over the years to influence how economies are structured through the implementation of economic development policies. Unfortunately, many of these initiatives are short-term solutions and are not sustainable over the long haul.

A common economic diversification strategy is to pursue the latest economic development trend – think of pursuing call centres instead of traditional smoke-stack industry, dedicating public funds to develop large sport and entertainment complexes, and providing support for green and other research-intensive industries. In a few cases, these strategies have worked. But for most, the synergy needed to support industry growth does not exist and the effort fails.

Governments have also tried to buy industries through the use of subsidies – picking winners and losers. Canada's history is full of examples of how this has flopped. In the 1970s, for example, Alberta set aside a portion of revenues from the Heritage Savings Trust Fund to fund economic development projects. Over time, this program activity was cancelled because of poor returns. Ontario has pursued an aggressive strategy of attracting Canada's creative sector with the introduction of tax credits and financial support to artists. It is unclear, however, whether Ontario realizes enough revenue from this strategy to make it sustainable.

Another diversification strategy pursued by Canadian provinces is the creation of more open business climates. Competitive taxes, good infrastructure, a trained and skilled labour force, and a positive outlook on economic development are the components of this strategy. British Columbia has pursued this strategy going on 15 years and has held its own against Ontario and Quebec. Its West Coast location gives it easier access to Asia and California, where business relationships have been key to investments in the province.

Other western provinces have also followed this path. The Alberta Advantage, instituted by former premier Ralph Klein, is an example of an open business climate, in this case funded by non-renewable resource revenue. The challenge of maintaining an open business climate with a competitive tax environment, however, is to ensure balance between revenues and spending. This has become a problem for Alberta amid royalty revenue volatility.

Another way to diversify economically is to invest in what a jurisdiction does well. We've seen this in Saskatchewan's decision to eliminate its film employment tax credit. Instead, it redirected the $8 million annual revenue to meet spending targets elsewhere. Film is an attractive industry in North America but not all communities have the infrastructure and support services to sustain it.

Economic diversification is challenging and long term, but it must also be smart. As industry trends emerge and technology changes, so should an economy evolve. This is where comparative advantage plays its hand. Economic development strategies which encourage the evolution and growth based on natural advantages are more likely to succeed in the long run.

HEALTHY ECONOMIES

HAVE A RANGE OF INDUSTRIES

FROM THE EDITOR

We have all learned through harsh experience that having a one-horse economy can be a rocky ride. Whether you place all your bets on oil, agriculture or forestry, the one-industry game fates a province to a roller-coaster ride of good years and bad. Better to have a range of industries to even out the peaks and valleys.

The four provinces of western Canada all strive to diversify their economies, but the degree to which that ideal has been achieved varies. In this edition of Currents, we look at the economic structure and level of diversification for each of the four western provinces.

Our analyses indicate that the four western provinces sort into similar pairs. Alberta and Saskatchewan both have a concentration of goods-producing sectors making up almost half of total economic contributions. British Columbia and Manitoba both have more diversified economies, with a heavier weight on service-producing sectors.

To take a look at the structure of each provincial economy, we looked back over an 18-year period. The analysis shows that change is gradual, telling us that diversification strategies require patience. History has shown there are smart ways to diversify and strategies that have been a waste of time and money. Governments must choose their approaches with great care.

This is the last print edition of CURRENTS. Look for our new online edition this fall.

Comments are welcome at: **communication@cwf.ca**

BRITISH COLUMBIA

Real estate lifts service sector role

Even though British Columbia has a reputation for being heavily dependent on natural resources, it might come as a surprise to see how important service-producing goods are to the economy. Similar to Manitoba, the provincial economy is diversified and can weather economic events without the volatility experienced by Alberta or Saskatchewan.

The accompanying chart shows the goods-producing sector makes up one-quarter of the provincial economy, and the service-producing sector the remaining three-quarters. This relationship between goods and service-producing sectors creates more diversification than any other western province. Over time, the shift from the goods-producing sector to the service-producing sector has been driven in part by the increase in value of the provincial real estate market. The service sector, however, heavily supports the development, operation and logistics of the natural resources sector.

Over the past 18 years, the goods-producing sector declined by almost 2% as the forest products sector faced significant challenges. Offsetting this decline somewhat was the growth in the mining and oil and gas sector driven by growing global demand and higher commodity prices.

Provincial growth in the services sector reflects the concentration of professional and other support services provided to the natural resources sector. In addition, British Columbia's high technology sector continues to grow and compete in world markets. Significantly for the province, the real estate market overshadows other sectors in terms of economic contribution, increasing its share of GDP from 15% in 1997 to 17% in 2014.

At one time, the forestry sector dominated the provincial economy, but a series of events pushed the industry to restructure. These include the implementation of the softwood lumber agreement with the U.S. in 2003, increased global competition and the pine beetle epidemic. The changes made the industry smaller but more competitive. It has also expanded its export focus to Asian markets.

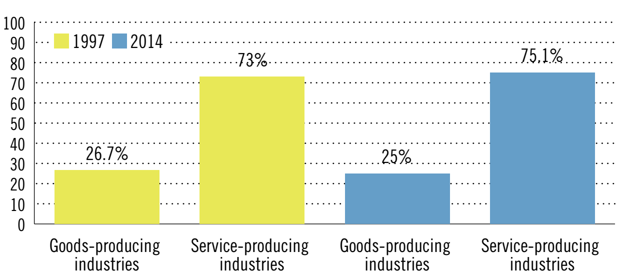
B.C. has also built up a credible and growing technology sector. Industry growth can be attributed to many factors: the development of communications technology that initially served the natural resources sector and then expanded out to radio, telephone, wireless and satellites; a concentration of university research and the ability to transfer knowledge to the private sector; and, proximity to complementary centres in Seattle and San Francisco with greater access to capital.

A variety of manufacturing and service industries make up the high-tech sector. In BC Stats' most recent update on the sector, the high-technology sector accounted for about 6.5% of the province's overall economic output in 2013.[1] In comparison to B.C.'s traditional industries, the high-technology industries now employ more people than the forestry and mining industries combined.[2] According to BC Stats, in 2013, B.C. ranked fourth among the provinces in terms of high-technology industries.[3] It contributed $13.9 billion to the $125-billion national total in 2013.

The challenge for B.C. is to find a way to encourage high-technology companies to build their businesses from start-up to mid- and larger-sized companies, instead of exiting early. Most recently, B.C.-based online dating site PlentyOfFish, sold for US$575 million to the New York-based Match Group.

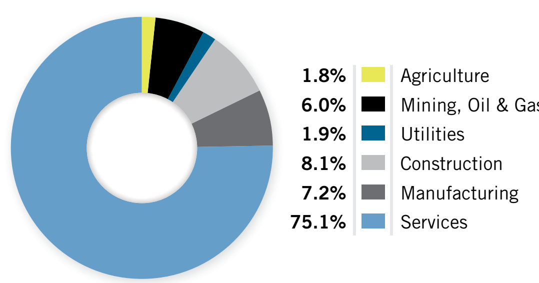
B.C.'s economy is expected to grow between 2.2% and 2.5% this year, and from 2.5% to 3.1% in 2016, joining Ontario in leading Canada's growth. The construction of the Site C dam in northeastern B.C. will provide ongoing stimulus while the province awaits development decisions on liquefied natural gas (LNG) export facilities, especially the Petronas-led Pacific Northwest LNG for the Port of Prince Rupert.

BC, GOODS AND SERVICE-PRODUCING INDUSTRIES AS A PERCENTAGE OF GDP, 1997 AND 2014



Source: Statistics Canada and Canada West Foundation

BC, MAJOR SECTORS AS A PERCENTAGE OF GDP, 2014



Source: Statistics Canada and Canada West Foundation

[1] Profile of the British Columbia high technology sector: 2014 edition, BC Stats, June 2015, [2] Ibid, [3] BC Stats, page 12

ALBERTA

Power of oil and gas makes shift difficult

OPEC first taught the world, and Alberta, a bitter lesson back in 1973 when it chose to restrict oil supply – the notorious Arab oil embargo that sent the world into turmoil. The lesson that Alberta learned is that diversification could help decrease the impact of actions by external forces on the provincial economy.

The government of Peter Lougheed identified diversification as a priority, and decided to invest 20% of the non-renewable resource revenue from the Heritage Savings Trust Fund into industries outside the oil and gas industry. Unfortunately, many of those investments were in one-off projects that lacked any integration with the rest of the economy. Over time, it became apparent that the diversification portfolio was not reaching its goals, and the program was dropped and the structure of the savings fund revised. Government policy focused on encouraging and growing the oil and gas industry, with only occasional policy gestures towards diversification.

The accompanying chart shows that the goods-producing sector makes up more than half of Alberta's economy. More than any other province, the relationship between goods-producing and service-producing industries has been consistent since 1997, moving by only 1% towards greater services in 2014.

While the economy has grown in terms of wealth, there has been a shift in the direct contribution from the mining and oil and gas sectors from 40% in 1997 to 27% in 2014. This shift can be explained in part by the increase in the share of the construction sector to total economic activity, increasing from 6.2% in 1997 to 10.8% in 2014. This shift reflects the capital investment that occurred in oil sands projects. Additional increases in retail trade (1.5%), real estate (1.5%), and professional, scientific and technical services (1.5%) also contributed to the shift in overall contributions to the economy.

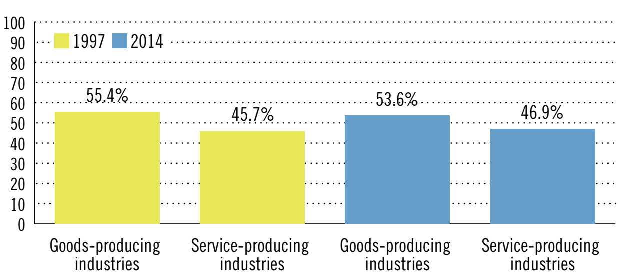
Although the economic development focus has been on the energy sector, Alberta is not a one-industry province. Agriculture is a key economic contributor, especially through export sales, even though this sector's share of economic activity is modest at 1.5%. Manufacturing also stands as out as an important contributor to the economy at 6%, although much of the manufacturing activity is tied to the energy sector.

The two largest urban centres, Calgary and Edmonton, play an important role in the diversification of the economy. Calgary is the headquarters for the oil and gas sector and Edmonton is the government centre. There are also innovative companies focused on developing energy sector technology. These products and services have the capability of being exported to other energy-focused markets. According to BC Stats, in 2013, Alberta ranked third among the provinces in terms of high technology industries, contributing $19.2 billion to the national economy.

As important as agriculture, manufacturing, technology and other sectors are to the economy, the wealth generated through their activity is overshadowed by the wealth generated by the mining and oil and gas sectors. This imbalance creates a dilemma when making choices about where to invest in the economy.

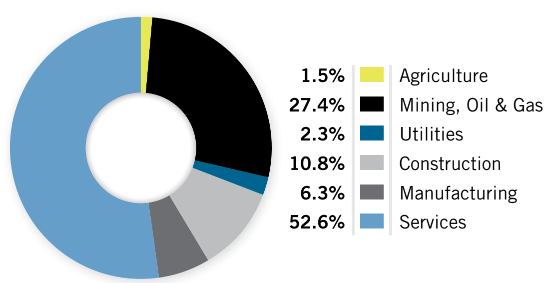
With the drop in oil prices, diversification is once again on the minds of many. In 2011, the government of the day commissioned the Premier's Council for Economic Strategy, a group of people to look into the question of diversification. The report, called *Shaping Alberta's Future*, looked exhaustively into how Alberta could diversify its economy. Many of the suggestions in the report are relevant today and can provide a starting point for new discussions on how to get off the roller coaster.[4]

AB, GOODS AND SERVICE-PRODUCING INDUSTRIES AS A PERCENTAGE OF GDP, 1997 AND 2014



Source: Statistics Canada and Canada West Foundation

AB, MAJOR SECTORS AS A PERCENTAGE OF GDP, 2014



Source: Statistics Canada and Canada West Foundation

[4] Shaping Alberta's future, report of the Premier's Council for Economic Strategy, May 2011

SASKATCHEWAN

Potash drives evolution from agricultural roots

Saskatchewan's economy was built on agriculture, but has grown into other commodity-based industries. Today, Saskatchewan's economy looks more like Alberta's, with a heavy dependence on oil and gas extraction and exploration.

The chart shows that there is an almost even split between the contribution from goods-producing industries, at about 51%, and service-producing industries, at 49%. Similar to other western provinces, the relationship between goods-producing and service-producing industries has been relatively consistent since 1997. Over time, goods-producing industries have decreased by around 7%, and service-producing industries have picked up the slack.

The strength of Saskatchewan's economy comes from the natural resources sector. Natural resources include potash and uranium mining, oil and gas extraction, and agriculture (wheat and pulses). The province also supports research and development in technologies related to these sectors and includes biotechnology, crop sciences and carbon capture storage. The natural resources sector makes up about 28% of the economy while manufacturing contributes another 7%. The mining and oil and gas sectors have decreased as a share of total economic activity from 1997 to 2014. In 1997, mining and oil and gas made up one-third of provincial GDP, while in 2014, that share had declined to less than one-quarter.

During that shift, the province became almost 50% wealthier overall, and some industries saw their share of overall gross domestic product (GDP) increase. For example, construction increased as a share of total GDP from 5.5% in 1997 to 7.9% in 2014 and wholesale trade increased from 3.5% to 6.3% in the same time period.

In recent years, significant foreign direct investment has helped develop the potash industry, and Saskatchewan is today one of the world's largest potash producers. Potash was discovered in 1942, but its potential wasn't recognized until 1946, when the government of the day was looking for industries to serve as alternatives to agriculture. Since the 1950s, the value of potash production has expanded to surpass wheat, formerly Saskatchewan's no.1 commodity.[5]

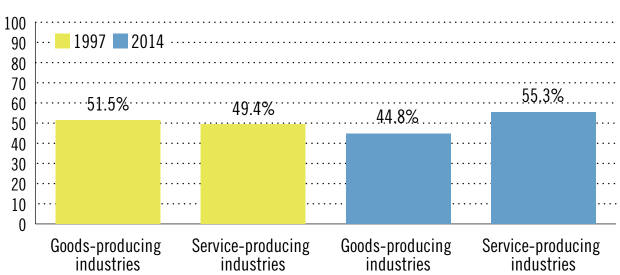
The rise of the oil and gas sector in the 1950s further diversified the economy, but also added volatility. Today, Saskatchewan produces about one-fifth of the oil in Canada, making it second to Alberta in production. With recent low oil prices, the rate of extraction and investment in exploration has slowed markedly, acting as a drag on the provincial economy. Forecasts suggest Saskatchewan will experience one of the lowest economic growths this year and in 2016, alongside fellow oil-producing provinces of Alberta and Newfoundland and Labrador.

Successive Saskatchewan governments have focused on making Saskatchewan a business-friendly province and tax competitive compared to other jurisdictions. Under the current government's growth plan, *Saskatchewan Plan for Growth: Vision 2020 and Beyond*, each year in its capital budget it has committed spending for infrastructure projects to support export growth. Of note is the investment in the Global Transportation Hub, Canada's only inland port authority.

Saskatchewan has put a small but dedicated focus on innovation and research. The Saskatchewan Research Institute, among other agencies, pursues research to support industry development. In addition, Saskatchewan is home to a small but growing high-technology sector. According to BC Stats, in 2013, Saskatchewan ranked fifth among the provinces in terms of high technology industries, contributing $3.1 billion to the national economy.[6]

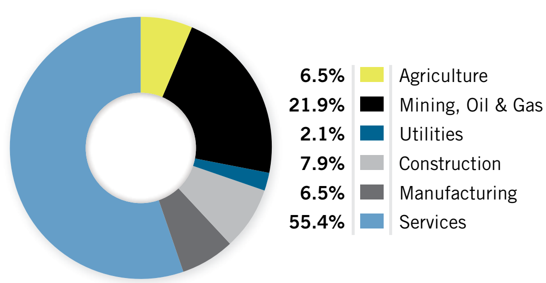
Similar to Manitoba, Saskatchewan has a population of just more than one million people. While plans are in place to increase the population, near-term investment in the province may be constrained by the smaller labour pool.

SK, GOODS AND SERVICE-PRODUCING INDUSTRIES AS A PERCENTAGE OF GDP, 1997 AND 2014



Source: Statistics Canada and Canada West Foundation

SK, MAJOR SECTORS AS A PERCENTAGE OF GDP, 2014



Source: Statistics Canada and Canada West Foundation

[5] Potash, an inside account of Saskatchewan's pink gold, John Burton, 2014, [6] BC Stats, page 12

MANITOBA

This economic pie has more slices

Right from the days of the fur traders, Manitoba has relied on a broad range of natural resources to generate much of its economic wealth. Much of the rest of its economic strength comes from manufacturing.

Unlike the other western provinces, the portion of each natural resources sector to the total economy is more evenly distributed, as the chart illustrates. It shows that goods-producing industries make up about 30% of the economy, while service-producing industries make up the rest. This relationship between goods-producing and service-producing industries has been fairly consistent from 1997 to 2014. Over time, there has been a slight decrease (1.8%) in the goods-producing industries, but the overall structure of the economy has not changed.

In addition to natural resources sectors, utilities, construction and manufacturing, Manitoba has strengths in tourism and technology industries. These include life sciences and other research and development that supports the agriculture and other natural resources sectors. A recent report published by BC Stats ranked Manitoba sixth among the provinces in terms of high technology industries in 2013. High-tech contributed $2.9 billion to the national economy[7] that year.

Diversification in Manitoba's economy acts as a hedge against unforeseen events. For example, while other provinces are hurting from low commodity prices and decreased demand, Manitoba's industries are benefiting from a falling dollar. Mining and oil and gas make up a much smaller portion of Manitoba's natural resources sector than the other provinces. Another resource industry, forestry, is in a position to increase sales into the recovering U.S. market as a result of the favourable dollar exchange rate. The Manitoba economy is avoiding the volatility common to Alberta and Saskatchewan when oil prices drop and non-renewable revenues decline.

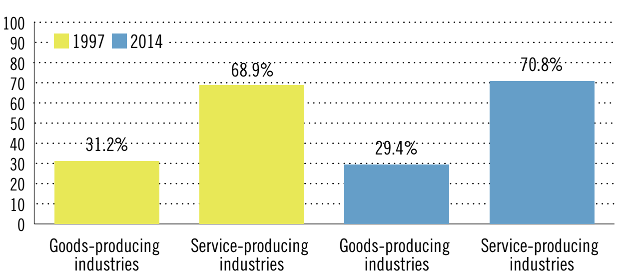
Even with this advantage, however, Manitoba industry faces challenges. Its companies are smaller in scale and have a less developed local supply chain than many competitors. Other jurisdictions with larger industries enjoy the synergy that occurs with greater industry concentration. Manitoba's industrial base is broad, but these industries are likely to have less capacity than their global competitors and fewer resources to draw on.

Manitoba is trying adjust for its small population base – just more than one million – by encouraging immigration.

It is also looking to create new product markets and diversify markets geographically. Historically, the U.S. has been Manitoba's primary trade partner because the north-south trade route has been cheap due to its proximity. Diversifying into other markets in either Asia or Europe at competitive costs is tough for a province located in the centre of Canada. The Government of Manitoba has invested in infrastructure projects to ease the export of goods to external markets.

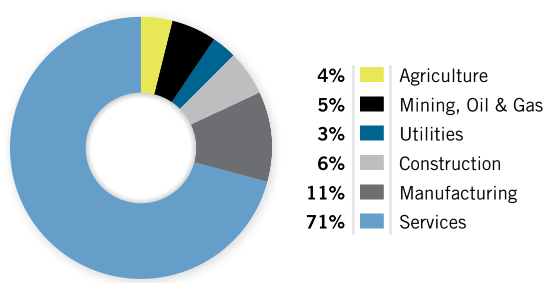
But Manitoba's economy is set to shine. A recent forecast from the Conference Board of Canada suggests Manitoba's economy could grow by 2.8% this year and again in 2016, joining Ontario and B.C. in leading Canada's growth. Public and private sector investments in infrastructure will underpin provincial growth. Key among these investments is the construction of new Manitoba Hydro projects. The massive construction will provide an immediate economic stimulus, while future hydro operations will ensure access to power for both domestic users and buyers outside the province's borders.[8]

MB, GOODS AND SERVICE-PRODUCING INDUSTRIES AS A PERCENTAGE OF GDP, 1997 AND 2014



Source: Statistics Canada and Canada West Foundation

MB, MAJOR SECTORS AS A PERCENTAGE OF GDP, 2014



Source: Statistics Canada and Canada West Foundation

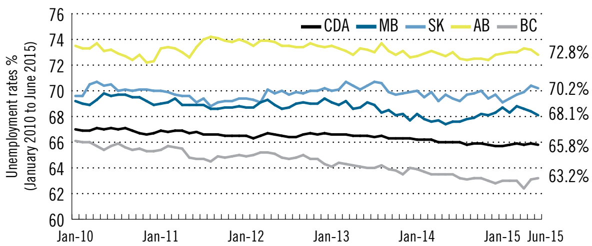
[7] 1 BC Stats, page 12, [8] Manitoba government news release, June 30, 2015

THE WEST'S ECONOMIC BAROMETER

EDITOR'S NOTE: Economy watchers pay close attention to employment indicators. Though these indicators are considered to be lagging, they provide important information on business and consumer confidence. Important trends regarding the labour force also show up in the employment numbers. In this issue of Currents, we look at two of those indicators.

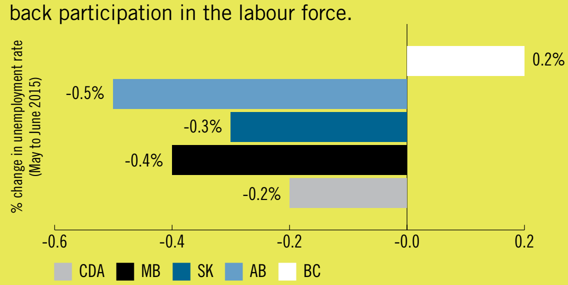
PARTICIPATION RATE

Participation in the labour force has been trending downwards over the past six months after a slight up-tick for western provinces early this year. The Canadian participation rate has been relatively flat over the last year, reflecting the changed fortunes in Alberta and Saskatchewan where growth has slowed. B.C. has the lowest participation rate; a reflection of fewer people in the labour pool as the workforce ages.



Source: Statistics Canada

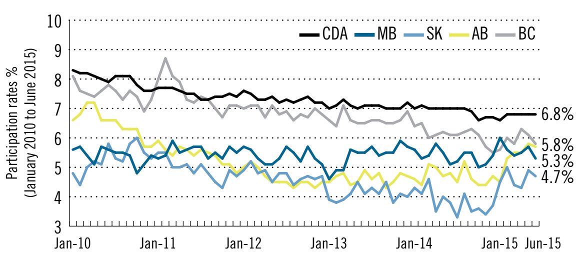
Alberta saw the greatest decrease in its participation rate on a month-over-month basis – down 0.5% from May to June. Both Saskatchewan and Manitoba saw decreases of 0.4% and 0.3% respectively. Only B.C. experienced an increase in its participation rate – up 0.2%. Company cutbacks from low oil prices and weaker-than-expected manufacturing sales appear to be holding back participation in the labour force.



Source: Statistics Canada

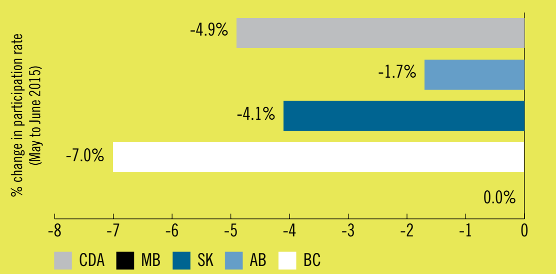
UNEMPLOYMENT RATE

The unemployment rate across Canada stayed at 6.8% in May, but decreased in June. While this can be seen as positive for the labour market, these rates are still higher than what was reported in January this year. Only Manitoba saw an unemployment rate decrease from January to June – from 6.0% to 5.3%.



Source: Statistics Canada

The unemployment rate decreased in all western provinces in June. The greatest decrease was in Manitoba, falling from 5.7% to 5.3%. Alberta had the smallest rate of decrease falling 1.7% from a May unemployment rate of 5.8%, suggesting the labour market is stabilizing.



Source: Statistics Canada

Except where noted otherwise, content for this edition of CURRENTS is written by Canada West Foundation Senior Economist Janice Plumstead.

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Watch for the new online CURRENTS coming this fall.

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