The New Economic Engine

British Columbia's Economic Profile and Forecast

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Canada West Foundation

This report is part of the ongoing work of the Canada West Foundation on the economy of western Canada. The next province-specific report will be on the economy of Manitoba, and will be published in October 2005, followed by reports on Saskatchewan in January 2006 and Alberta in April 2006. For more information, please contact Canada West Foundation Chief Economist Todd Hirsch (Hirsch@cwf.ca).

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INTRODUCTION

In the summer of 2004, the Canada West Foundation entitled its BC profile and forecast *Out of the Ashes* – a tribute to an economy that had suffered a few years of economic malaise. Devastating forest fires, a steep drop in tourism, SARS, slumping commodity prices, a rising Canadian dollar, and a fierce softwood lumber trade dispute all contributed to very weak growth. But British Columbia's economy came roaring back to life in 2004 with real GDP growth of 3.9% – the strongest growth in the country.

Credit for the solid expansion in 2004 is due largely to a return of strong prices for natural resource commodities, particularly natural gas, base metals, lumber, and coal. As well, recent changes to the regulatory environment have certainly helped boost private sector investment and production in the mining sector. Construction activity also led to the recovery.

This summer's Canada West Foundation economic update for British Columbia is entitled *The New Economic Engine,* as BC's economy continues to gain traction in 2005.

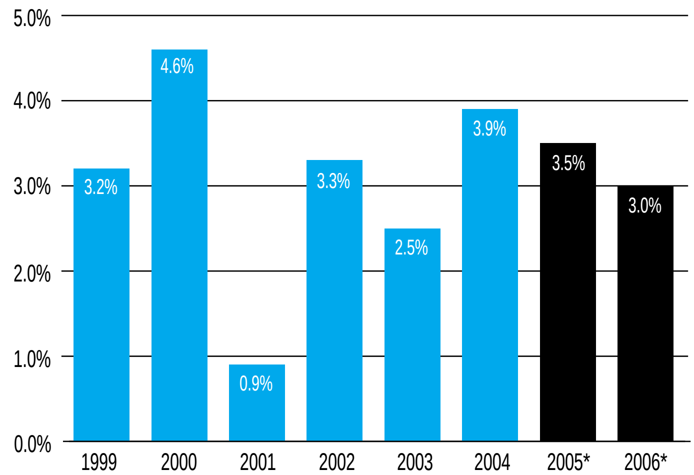
Growth in employment is outpacing the national average, and is even well ahead of Alberta's robust economy. As of May 2005, employment stands 4.1% above the level of jobs in May 2004. Growth nationally was only 1.3%. As a result of the strong employment picture, interprovincial in-migration has reversed the outflow that characterized the province in the early part of this decade. British Columbia is once again a net recipient of interprovincial migrants.

The economy should continue to perform very well in 2005 and 2006. Continued strong commodity prices, red-hot non-residential construction activity, robust gains in employment and in-migration, and a burgeoning transportation sector will propel the economy ahead.

Areas of concern for the province of British Columbia include the mountain pine beetle infestation (which will initially boost the volume of timber harvested, but lead to sharp curtailment in the long-run). The province is also facing a strike among truckers in the lower mainland that may cause major economic disruptions if it lasts into the summer. As well, there is some concern about a looming shortage of skilled labour in the province, particularly in the construction trades. While there is no evidence of wide-spread shortages or rising wages yet, it could become a problem in the long term as projects related to the 2010 Winter Olympics get underway.

Overall, British Columbia's economy is likely to post growth of 3.5% in 2005 and 3.0% in 2006 *(Figure 1)*. GDP growth will continue to outperform the national average and may even surpass the rate of expansion in neighboring Alberta.

FIGURE 1: British Columbia's Gross Domestic Product
(At Market Prices in Billions of Chained 1997 Dollars)



SOURCE: Statistics Canada, *The Daily,* April 27, 2005. *2005 and *2006 are CWF forecasts.

Economic Bright Spots

- Commodity prices should remain steady, with perhaps some decline in base metal prices.
- Non-residential construction will boost growth, particularly projects related to transportation and the 2010 Winter Olympics.
- Interprovincial in-migration will boost retail spending and housing demand.
- Rail and port facility expansion will strengthen BC's role as a transportation hub in North America.

Areas of Concern

- Mountain pine beetle infestation, which will lead initially to rising timber output levels but cause major disruptions to supply in the future.
- Transportation disruptions likely if the truckers' strike is prolonged.

FORESTRY

Despite an on-going trade dispute with the US on softwood lumber exports and a much stronger Canadian dollar, many producers in BC's forestry sector have been doing quite well. Producers in the Interior are very cost-competitive, having rationalized much of their older and less efficient mills over the past several years. Coastal producers, however, are not as competitive and many are facing severe difficulties. As a whole, forest products experienced their best performance in years with annual improvements of more than 15% in 2004 for both forestry and sawmill production.

Lower volume supply to the US and strong housing activity on both sides of the border have kept lumber prices steady. Exporters have been gaining in terms of higher value, rather than greater volume, of lumber exports. The value of lumber exports had fallen every year since 2000 to a low of $5.4 billion in 2003. However, the total value of exports shot up dramatically in 2004 to nearly $7 billion *(Figure 3)*.

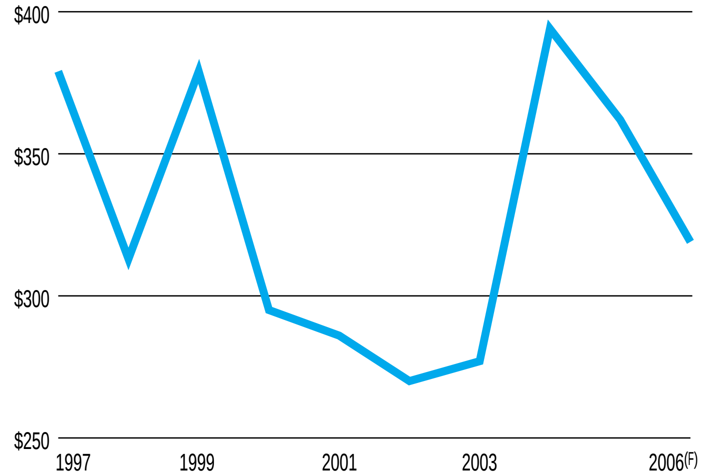
It appears that the value of lumber exports is continuing to increase in 2005. During the first four months of 2005, BC's lumber exports to international markets increased by 6.8% over the same time period in 2004. Exports of lumber to the US alone increased in value by 16.8%.

A major issue for BC's lumber producers is the infestation of the mountain pine beetle, which kills standing pine by laying eggs under the bark. The interior of British Columbia has experienced several consecutive mild winters and drought-like summers. Beetle populations in many parts of the Interior – especially to the southwest of Prince George – have increased to epidemic levels as a result.

The revised projection of the total volume of timber that will be lost due to the mountain pine beetle is now at 90 million cubic metres. This compares with the annual allowable province-wide timber harvest in a typical year of around 70 million cubic metres.

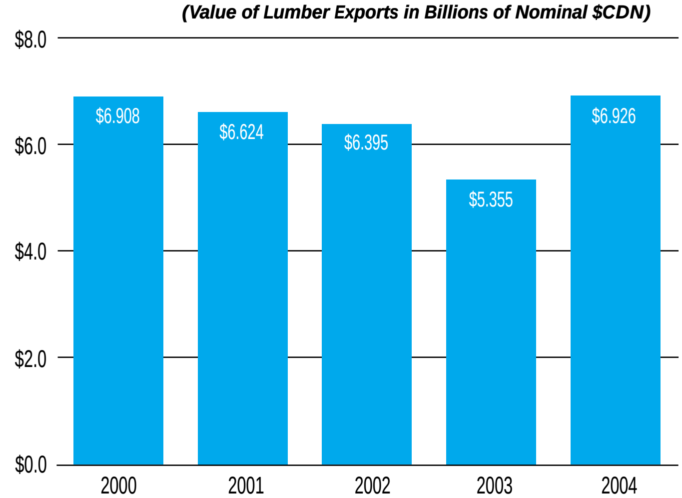
To counteract the infestation and as a means of recovering the greatest value of the affected timber, the provincial government has increased the allowable harvest in heavily affected areas.

FIGURE 2: Forestry Product Prices and Forecasts
($US per Thousand Board Feet, SPF, 2X4)



SOURCE: *TD Economics Commodity Price Report*, June 15, 2005.

FIGURE 3: British Columbia's Exports of Lumber
(Value of Lumber Exports in Billions of Nominal $CDN)



SOURCE: Statistics Canada.

These temporary increases have resulted in a surge in harvesting activity and timber supply. However, significant reductions to allowable annual cuts are inevitable as timber supplies decline and the beetle infestation completes its cycle. In the short-term, production and supply of BC timber will increase, followed by a sharp curtailment over the next five to ten years.

TOURISM

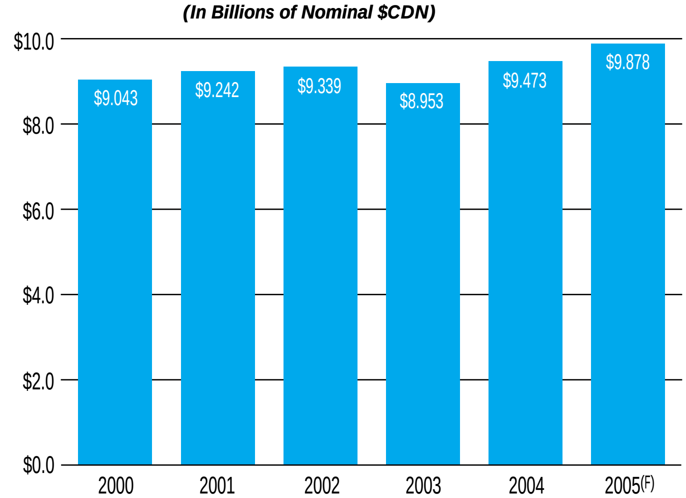
Tourism accounts for more than 117,500 direct jobs in British Columbia and 266,000 indirect jobs – one out of every eight jobs in the province is related to tourism. BC's tourism industry generated $9.5 billion in revenues in 2004, making tourism one of the largest industries in the province.

Recent data from *Statistics Canada* indicate that tourism spending in Canada is regaining traction. Total tourism spending (i.e., transportation, accommodation, food and beverage) grew 1.1% in the first quarter of 2005 primarily on the strength of outlays by domestic travelers. With this increase, spending (adjusted for inflation) has now finally recovered from setbacks to tourism in the past few years. A downturn in the economy along with the effects of September 11, 2001 and the SARS outbreak in 2003 had caused tourism expenditures in Canada to tumble. British Columbia was especially hard-hit by these setbacks. Seven consecutive quarters of growth, generating an 11% increase in tourism spending nationally, has helped bring about the recovery in tourism.

According to *Tourism British Columbia,* overnight visitor revenue in the province is forecast to increase by 4.3% in 2005 to $9.878 billion *(Figure 4)*. This comes after an annual increase of 5.3% in 2004. The 2005 outlook is based on assumptions of a stable Canadian currency, continued economic growth within British Columbia itself, somewhat lower fuel prices, and no recurrence of major geo-political or other travel-impeding events.

However, since the time of this forecast (February 2005), gasoline prices have in fact increased, not decreased. As a result, some industry observers are now less optimistic about a strong resurgence in tourism revenue in the short term, forecasting rates somewhat weaker than the 4.3% growth suggested by *Tourism British Columbia.*

FIGURE 4: Overnight Visitor Tourism Revenue
(In Billions of Nominal $CDN)



SOURCE: Tourism British Columbia.

ENERGY AND MINING

Natural gas drilling and production in the northeast corner of British Columbia has grown tremendously over the past decade, buoyed largely by high commodity prices *(Figure 5).* According to the provincial *Ministry of Energy, Mines and Petroleum Resources,* industry investment in oil and gas has increased 151% since 2000, from $1.8 billion in 2000 to an estimated $4.5 billion in 2004. This increase in activity is reflected in the drilling data – the number of wells drilled in BC has increased by 65% from 2000 to 2004 (777 to 1,279).

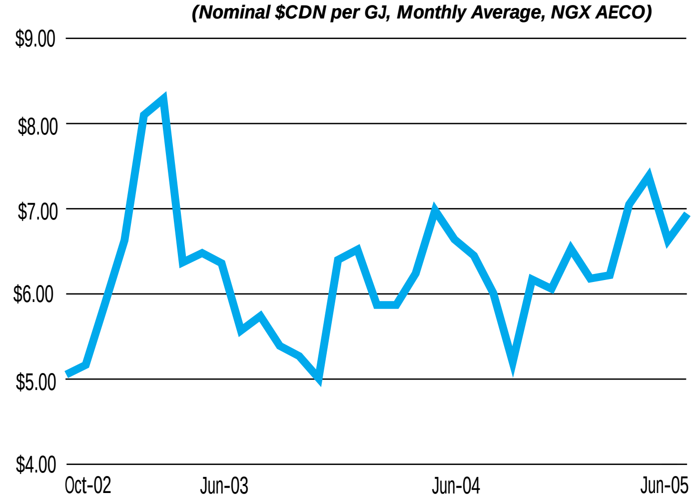
Natural gas prices, as measured by the Alberta reference price (the NGX AECO next day value), have been steady around the $6.00 to $7.00 ($CDN) range for the past year. This strength in price is partially due to the high price of crude oil, for which natural gas acts as a substitute. Weather conditions (i.e., cold winters, hot summers) also have a strong influence on the continental price of natural gas.

Given normal summertime demand and sustained global demand for crude oil, the continental price for natural gas is expected to remain stable throughout the rest of the year. This will continue to bolster exploration and production in British Columbia's natural gas sector in 2005, and likely into 2006.

Base metals have also enjoyed strong prices, particularly for copper and zinc – commodities important to the BC interior's mining sector *(Figure 6).* Copper demand continues to be driven by strong industrial and consumer demand in China. As well, the provincial government's positive approach towards exploration and development has resulted in a less burdensome regulatory environment. Both of these factors have helped raise base metal exploration, production and exports from BC over the past few years.

Some base metal price forecasters are predicting that we are now at the peak of the demand cycle and will see global industrial demand falling over the short to medium-term. *TD Economics* is predicting a reduction in base metal prices of about 20% over the next 18 months. Even with this reduction, however, metal prices should still remain well above their five and ten year averages. Thus, we can expect fairly strong activity to continue in BC's base metal mining sector for the 2005-06 period.

FIGURE 5: Natural Gas Prices
(Nominal $CDN per GJ, Monthly Average, NGX AECO)



SOURCE: Natural Gas Exchange (NGX) Inc.

RECENT DEVELOPMENTS IN BRITISH COLUMBIA'S OIL AND GAS INDUSTRY

- The June 22, 2005 sale of oil and gas rights in northeast BC brought $100.5 million in bonus bids – the third highest in the history of the province. The average bid price was $1,682 per hectare, which is the second highest ever.
- BC's raw natural gas production increased by 1.6 per cent in 2004 and over 50 per cent in the last 10 years.
- BC's Summer Drilling Royalty Program will provide up to $100,000 in royalty credits to wells drilled between April 1 and November 30, 2005.
- BC is providing $50.3 million over two years as part of the Heartlands Oil and Gas Road Rehabilitation Strategy to improve public roads and allow industry to operate in areas that may have been restricted due to seasonal road bans.
- BC is investing $6 million into a new Centre of Excellence in Oil and Gas Training in Fort St. John. EnCana Corp. also provided $3 million, and an additional $3 million is anticipated from oil and gas industry donations.
- The BC government partnered with industry to commit $1 million to create the B.C. Oil and Gas Education and Training Consortium, which will help meet the demand for skilled workers.

Source: *BC Ministry of Energy, Mines and Petroleum Resources*

Coal mining in BC has enjoyed a resurgence lately. Strong demand by Asian steel makers for metallurgical coal, mined extensively in the southeast corner of the province, has kept prices and shipments steady. Output in coal mining in British Columbia rose 15% in 2004, with much of the coal destined for export.

EXPORTS

International exports from British Columbia are dominated by forest products, particularly lumber, pulp, paper and construction materials. However, the total value of exports from the province has fallen from a peak in 2000 of $35.5 billion to a recent low of $29.6 billion in 2003 *(Figure 7)*. Exports recovered somewhat in 2004 to $32.3 billion.

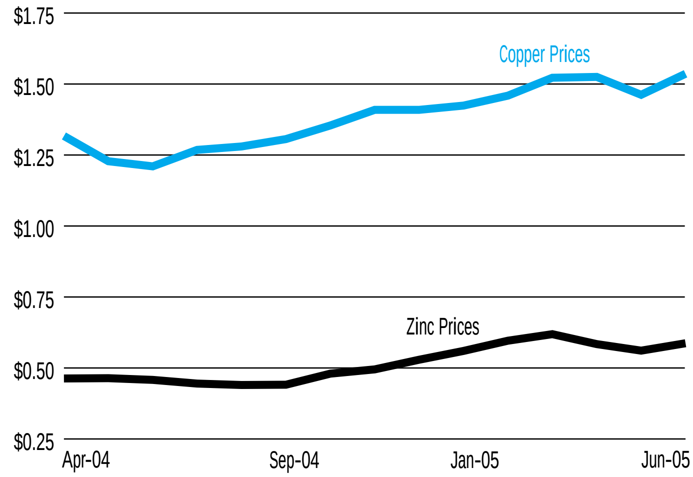
The strong appreciation of the Canadian dollar vis-à-vis the flagging US dollar over this time period is largely responsible for the downward trend in total exports. As well, a small recession in the US immediately following 9/11 reduced demand from and exports to the US.

In 2005, however, there is evidence that exports are continuing to recover strongly. During the period January to April 2005, exports from BC totaled $10.7 billion – up 8.2% from the same period in 2004. This comes despite continued strength in the value of the Canadian dollar. Driving this increase is a stronger US economy where consumer spending and housing starts have lifted demand for a variety of BC exports.

So far in 2005, the major export products showing the strongest increase over the same period last year are copper (+64.8%), coal (+60.5%), and natural gas (19.4%).

The burgeoning Chinese economy is a small but growing export market for British Columbia. Between 2000 and 2004, total exports grew in value by over 41% to nearly $2.2 billion *(Figure 8)*. Exports to the Chinese economic area (the CEA, which includes China, Taiwan, Hong Kong and Mongolia) accounts for about 6.8% of total international exports from British Columbia. The most important commodities exported to the CEA are pulp, coal and lumber.

FIGURE 6: Copper and Zinc Prices
(Monthy Average, Nominal US¢ per Pound, LME Cash)



SOURCE: TD Economics. Cash prices in US¢ per pound, London Metal Exchange.

FIGURE 7: British Columbia's International Exports
(Annual Value of Exports in Millions of Nominal $CDN, 2000-2004)

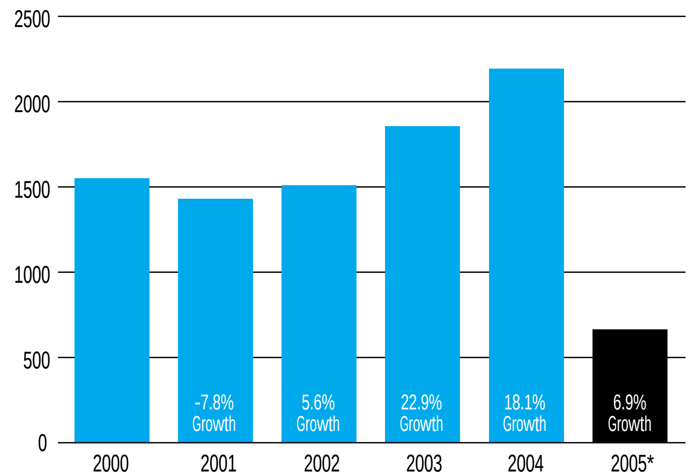
	2000	2001	2002	2003	2004
Lumber	$ 6,908	$ 6,624	$ 6,395	$ 5,355	$ 6,926
Woodpulp (Chemical)	3,888	2,677	2,385	2,330	2,618
Natural Gas	2,610	2,745	1,903	2,851	2,512
Coal	1,332	1,431	1,372	1,450	1,577
Particle Board	446	401	408	637	736
Newsprint	911	889	680	584	609
Aluminum	623	491	452	473	599
Copper Ores	540	458	349	422	583
Uncoated Paper	504	583	628	557	563
Shingles, Shakes, Building Wood	612	626	586	497	535
Wood in the Rough	393	418	567	502	470
Zinc	453	236	311	320	376
Kraft Paper	390	383	386	329	364
Molybdenum	42	46	87	128	331
Plywood	260	279	282	272	322
Fresh or Chilled Fish	318	353	409	359	313
Electronic Circuits	878	280	189	241	309
Woodpulp (Semi-Chemical)	354	259	293	322	306
Hydroelectric Energy	1,987	2,085	288	382	290
Plywood and Veneer	144	179	196	186	251
Coated Paper	408	355	331	249	235
Printing Machinery	279	223	152	180	212
Pre-fabricated Buildings	164	201	210	196	201
Motor Vehicle Parts	164	164	188	192	199
Frozen Fish	106	105	115	126	186
Other	10,768	10,430	11,095	10,447	10,682
TOTAL (ALL PRODUCTS)	$ 35,484	$ 32,923	$ 30,256	$ 29,586	$ 32,303

SOURCE: Statistics Canada.

Exports from BC to the CEA in 2005 have slowed from the large year-over-year percentage gains posted in 2003 and 2004. In the period January to April, exports are up only 6.9% – a rate slower than the rate of increase of BC's total international exports. While the Chinese economy continues to expand, it could be that growth has slowed somewhat, leading to a moderation in demand for BC's exports.

Merchandise exports to the CEA are still a small portion of total BC exports (6.8%). Despite the slower pace of export growth to the CEA this year, it is still expected that China will continue to grow in importance for BC in the coming years.

FIGURE 8: BC Exports to the Chinese Economic Area
(In Billions of Nominal $CDN, 2000-2005)



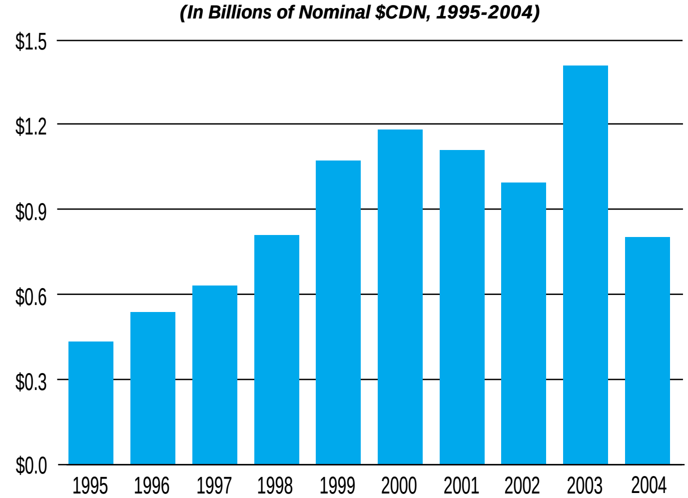
SOURCE: Statistics Canada. *2005 growth rate is compared to Jan-Apr 2004.

FILM AND TV PRODUCTION

British Columbia is the third-largest production centre in North America after New York and Los Angeles. An estimated 30,000 jobs in the province are related to film and TV production.

After a record $1.4 billion in production spending in 2003, the industry sank hard in 2004 with the value of production falling to a seven-year low of $801 million *(Figure 9).* Fewer foreign productions were the result of a higher-valued Canadian dollar, along with measures taken in California to stem "run away" productions out of the US into Canada.

FIGURE 9: Spending on TV and Film Productions in BC
(In Billions of Nominal $CDN, 1995-2004)



SOURCE: BC Film Commission. Includes foreign and domestic productions.

As well, the generous tax credits that the provincial government offers to film and TV productions in BC have been met or exceeded by other provinces wanting to develop their own industries. This has created a much more competitive environment within Canada in attracting foreign (i.e., American) productions.

Legislation was introduced in spring 2005 to raise BC's foreign film tax credit rate to 18% from 11% and BC's domestic film tax credit rate to 30% from 20%. According to the *British Columbia Film Commission,* this announcement triggered an additional $350 million in planned film and TV production spending in 2005. But in spite of these more generous tax credits, the film and TV production industry is not seen as a major area of growth for the BC economy. Growth is likely to be limited by the other negative factors (i.e., the higher Canadian dollar, more competition from other provinces). Total revenues may recover somewhat in 2005 but will probably remain flat or even decline in the medium-term.

TRANSPORTATION

BC is the major transportation corridor between out-going exports from Canada (especially natural resources from the prairie provinces) and imports from China and Asia. The railways throughout the province, and the ports, are integral parts of this transportation corridor, and both are undergoing a period of expansion.

In June 2005, *Canadian Pacific Railway (CPR)* announced the completion of the first of twenty-five projects under a $160 million program to increase train capacity on the railway's network between the Prairies and the Port of Vancouver.

An 8,500-foot-long track has also been built at *CPR's* Coquitlam yard near Vancouver for trains of Canadian bulk commodities destined for ocean-going ships departing from Vancouver. CPR is also increasing its capacity to accommodate the growing volume of imported finished goods, shipped in containers arriving from Asia.

When the twenty-five projects are complete in the fourth quarter of 2005, CPR will be able to run an additional four trains daily – or more than 400 freight cars a day – between the Prairies and the Port of Vancouver (a 12% increase in capacity). These projects will not only solidify BC's role as a transportation corridor in North America, they will directly contribute to British Columbia's rising level of industrial and commercial construction in 2005 and 2006.

Canada's largest railway company – *CN Rail* – is also investing in BC's transportation capacity. In April, the company announced its intention to contribute $30 million to the expansion of the Port of Prince Rupert. The federal and BC provincial governments, along with *Maher Terminals of Canada Corporation* and the *Prince Rupert Port Authority,* will partner with *CN* in these projects scheduled for completion by spring 2007. The investment will greatly expand Prince Rupert's capacity to handle intermodal and container traffic from Asia.

The transportation sector is not without its challenges, however. In late June, an estimated 1,000 truckers parked their vehicles at the *Port of Vancouver* and *Fraser Port,* effectively blocking the flow of industrial goods to the Lower Mainland of the province. The blockade affects both the export of BC-based commodities as well as imported container traffic destined for BC.

At issue is the truckers' dissatisfaction with wages paid by contractors. Since deregulation of the trucking industry in 1999, truckers' wages have plummeted to as little as $50 a day (after expenses). Deregulation increased competition, putting more trucks on the road and driving down wages. The increased fuel prices have also seriously squeezed truckers' margins.

The blockage is estimated to affect $30 million daily in goods imported and exported by BC businesses. If the strike is prolonged, the damage to the provincial economy over the summer could be quite serious.

EMPLOYMENT AND INTERPROVINCIAL MIGRATION

Job growth in British Columbia has led the country over the past few years. This follows several very weak years in the early part of this decade when the general economy and employment conditions were very weak.

In May 2005, seasonally adjusted employment in BC stood at 2,132,000 *(Figure 10).* This is an increase of 4.1% over May 2004, far exceeding the national rate of job growth (+1.3%), and even Alberta's rate (+1.8%). In May alone, 18,000 jobs were added in the province, with most of these positions in public administration and transportation. British Columbia's unemployment rate fell to 5.7%, the second lowest on record.

With the strong expansion in employment has come interprovincial in-migration. The steady outflow of people leaving BC for other parts of the country reversed in 2003. In that year, the province recorded the first positive gain of net interprovincial migrants in six years with a total gain of 3,747 people. In 2004, BC posted a net increase of 7,080 people moving from other provinces, the highest net interprovincial migration in almost a decade.

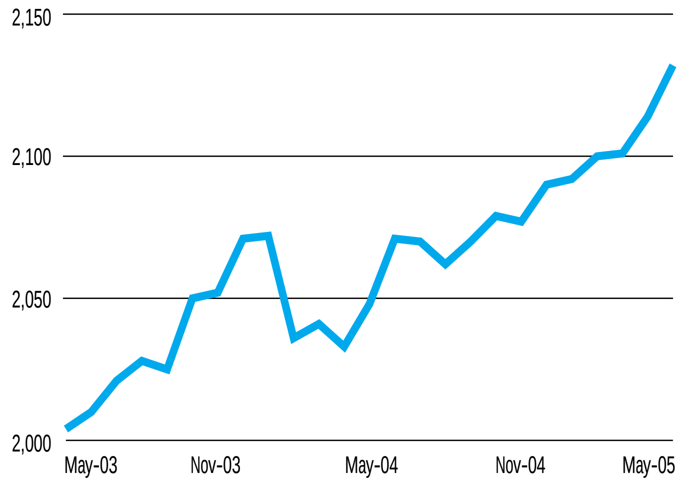
It appears that 2005 is on-track to exceed 2004's gain. According to *Statistics Canada,* British Columbia was a net recipient of 1,073 people who moved interprovincially during the first quarter of 2005, typically the slowest quarter of the year for migration. This compares very favourably with the first quarter of 2004 when there was a net decrease of 250 people.

CONSTRUCTION

Residential construction in British Columbia was among the strongest in the country last year. Housing starts in urban areas of the province grew from 24,700 in 2003 to 30,900 in 2004 (+25.1%). Housing starts have remained steady in 2005, averaging 29,100 over the first three months of the year (at annual rates). Strong in-migration into the province, solid job growth, and a continued low interest rate environment all contributed to the strength in the housing market in 2004. Starts in 2005 are likely to come down from last year's brisk pace, although total activity will still remain at a relatively high level.

Several major infrastructure projects – including a rapid transit line (RAV) to the Vancouver Airport, highway construction throughout the province, and projects related to port expansion – will result in healthy growth in non-residential construction investment this year. As well, preparations for the 2010 Winter Olympics will give an additional boost to new non-residential construction.

FIGURE 10: Total Employment in BC
(In 000's, May 2003 to May 2005)



SOURCE: Statistics Canada.

PUBLIC FINANCE

In fiscal year 2004/05, stronger economic conditions in BC and an increased level of transfers from the federal government lifted total provincial revenue to $33.2 billion, a $4.2 billion increase over the previous year. Spending by the provincial government totaled $30.7 billion, an increase of $323 million over the previous year. The result is a $2.6 billion surplus. This compares very favourably with the $1.3 billion deficit posted in 2003/04.

With the 2004/05 surplus, the province has been able to make some progress in debt repayment. Total provincial debt fell to $35.8 billion at the end of 2004/05, a record decline of $1.9 billion. The taxpayer-supported debt-to-GDP ratio, a key measure of debt affordability, has declined to 18.3 per cent. This was its lowest level in 12 years.

Despite the larger-than-anticipated surplus posted in 2004/05, the provincial government's overall fiscal picture remains challenging. Potentially smaller federal government transfers, spiraling health care costs, modest tax relief for low and medium-income families, and higher provincial employee wages (when the current wage freeze expires in 2006) will keep future surpluses small. As a result, the government's forecast surplus for 2005/06 is only $220 million and $200 million in both 2006/07 and 2007/08.

SUMMARY

Having risen out of the ashes in 2004, BC's economy will continue to gain momentum in 2005 and 2006. It will be the new economic engine of the country.

Leading this growth will be strong performances in the natural resource sectors, particularly natural gas and coal. Lumber producers in the Interior will continue to profit from high commodity prices. Construction activity and business and personal services will benefit from projects related to the 2010 Olympics. The transportation sector should also perform very well. Retail sales and housing markets will benefit from continued strength in interprovincial in-migration in 2005 and 2006.

The American economy – the largest market for BC's exports and foreign tourism – grew at an annual rate of 3.8% in the first quarter of 2005, exceeding initial estimates. If growth in the US can continue at this pace, exporters and tourism operators in BC will benefit. Natural resources prices (such as lumber and base metals) will also be lifted by a strong US economy.

Coastal lumber producers, the film and TV industry, and residential construction activity will all experience weakness or declines in 2005. As well, the mountain pine beetle infestation in the interior poses a very serious threat to lumber output in the longer term. Also, a truckers' strike this summer raises the possibility of transportation disruptions.

Overall, however, British Columbia's economy is in very good shape in the middle of 2005. It is likely to post real GDP growth of close to 3.5% this year and 3.0% in 2006 – somewhat slower than the rapid rate of expansion it experienced in 2004, but still above the national average. ■

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