

Business Indicators ♦ May 2006

Economy remains robust in 2005

British Columbia's economy chalked up another stellar performance in 2005, expanding 3.5%. However, the province faces a number of challenges, since recent economic growth has been primarily driven by consumer demand and business investment in residential construction. A growing trade deficit, a plunging saving rate and a persistent productivity gap pose challenges for the future.

Another stellar year for BC's economy

British Columbia's economy continued to make solid gains in 2005, with gross domestic product (GDP) expanding 3.5%¹ during the year. This was the fourth straight year in which the province outperformed the national average, and although the economy did not grow quite as fast as in 2004 (when it expanded 4.0%), 2005 was another stellar year for BC.

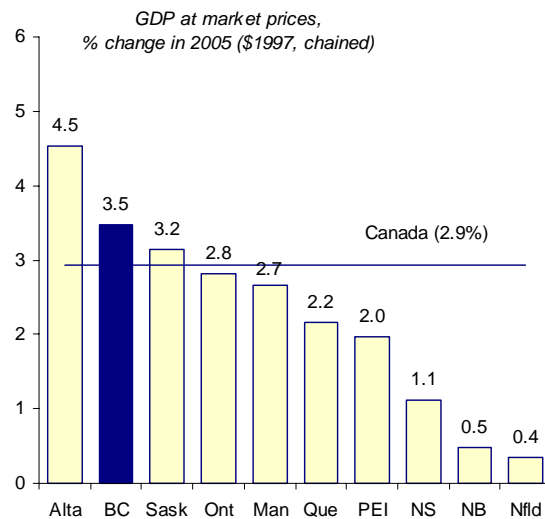
The province posted the second-highest growth rate in the country, well above the national average of 2.9%. Alberta led the way for the second year in a row² with a 4.5% gain.

Other economic indicators illustrate the fundamental strength of the BC economy. Employment increased 3.4%, and the jobless rate fell to 5.9% last year. It is currently at a thirty-year low. Housing starts, retail sales, mineral production and manufacturing shipments were all up in 2005, although

in most cases the increase was not as strong as in the previous year.

Economic growth was strongest in the west, with three of the four western provinces, plus Yukon (+3.4%), outperforming the national average. All regions except Nunavut posted gains during 2005. Newfoundland's economy, which had surged ahead when oil production from the Terra Nova offshore oilfield began earlier in the decade, recorded a marginal 0.4% increase after shrinking 1.4% in 2004.

Alberta was the only province to see faster growth than BC last year



Data Source: Statistics Canada

Together, BC and Alberta account for a quarter of total Canadian GDP, and although Ontario and Quebec have larger economies (comprising just over 60% of the Canadian total), both provinces recorded slower-than-average growth in 2005.

¹ Unless otherwise indicated, all of the figures quoted in this article are in chained 1997 dollars. The data comes from Statistics Canada, primarily from Catalogue 13-213-PPB, released April 26, 2006.

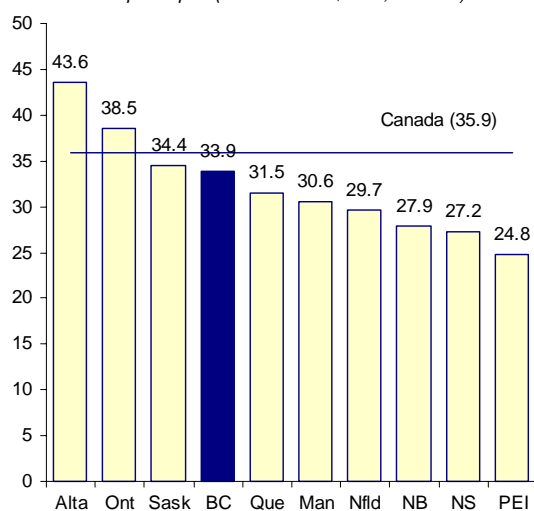
² Initial estimates for 2004 showed BC at the front of the pack, but revised figures released by Statistics Canada in November 2005 suggest that Alberta was actually the fastest-growing province in 2004.

Per capita GDP still below the national average

Despite strong GDP growth in recent years, per capita GDP remains well below the national average, and considerably lower than in both Ontario and Alberta. Real GDP per person was \$33,853 in 2005, compared to a national average of \$35,867. Real per capita GDP in Alberta was nearly \$10,000 higher, at \$43,598. In Ontario, per capita GDP was \$38,533.

Per capita GDP still below the national average

GDP per capita (thousands of \$1997, chained)

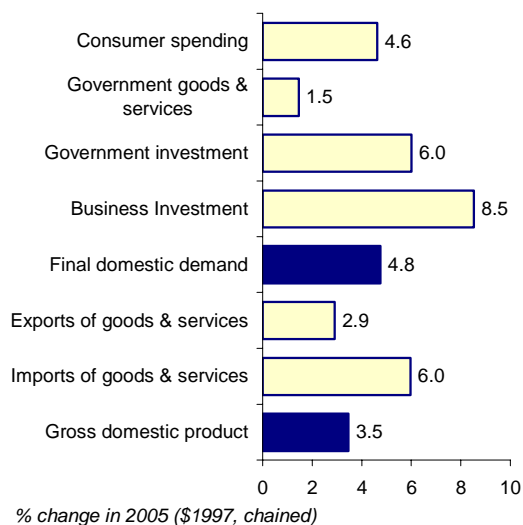


Data Source: Statistics Canada

Domestic demand continued to fuel the BC economy

Final domestic demand for goods and services (consumer, business and government spending on goods and services, plus investment in fixed capital) was again a primary cause of GDP growth last year. Domestic demand expanded 4.8%, which was well above the national average (+4.3%), but lower than in Alberta (+9.8%) and the three northern territories.

Business and government investment remained a primary source of economic growth



% change in 2005 (\$1997, chained)

GDP is equal to final domestic demand plus the change in the value of inventories, exports minus imports

Data Source: Statistics Canada

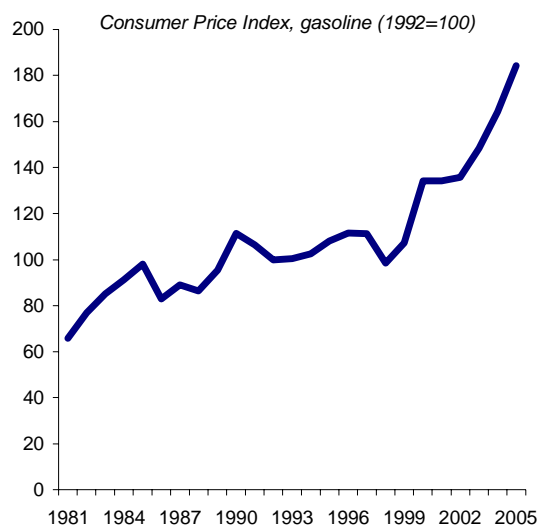
Consumers invested heavily in new durable goods but used less gasoline

Personal expenditures on goods and services rose 4.6% as consumers continued to make a lot of big-ticket purchases. Total spending on durable goods was up 5.5%, with smaller, but still significant increases in spending on other types of goods and services.

Although the frenetic pace of new residential construction slowed somewhat (housing starts rose only 5.3% following four straight years of gains that were twenty percent or higher), spending on household appliances and equipment continued unabated in 2005. Sales of refrigerators, freezers, washers, dryers, stoves and other appliances, as well as TV sets, cameras and electronic equipment all increased significantly. Lower prices for many of these products may have encouraged consumers other than those who were buying furnishings for a new home to invest in new household equipment.

The uncertain political situation in the Middle East, together with the effect of hurricanes Katrina and Rita on North American refinery capacity took a toll on consumers' pocket books. The average price of gasoline in 2005 was nearly 90% higher than in 1998. Consumers responded to rising prices by cutting back on their gasoline consumption. However, spending on heating fuel and electricity, which are less discretionary items, increased in 2005.

Up, up and away: prices at the pump have risen nearly 90% since 1998



Data Source: Statistics Canada

Purchases of new cars rose only marginally but used car sales were up and so were sales of trucks and vans, ending a two-year-long slump. This suggests that, although consumers may be making some changes in order to cope with persistently higher gas prices, they're not yet prepared to give up on their love affair with trucks and vans, which typically use more fuel than smaller vehicles.

Higher gas prices have pushed up the cost of many types of consumer goods and services. Although the all-items consumer price index increased just 2.0% last year, consumers paid significantly more for public transportation (+3.6%) and utilities (+3.4%) in 2005. This didn't keep them from

travelling. Even after removing the effects of inflation, spending on air, bus and rail transportation increased last year.

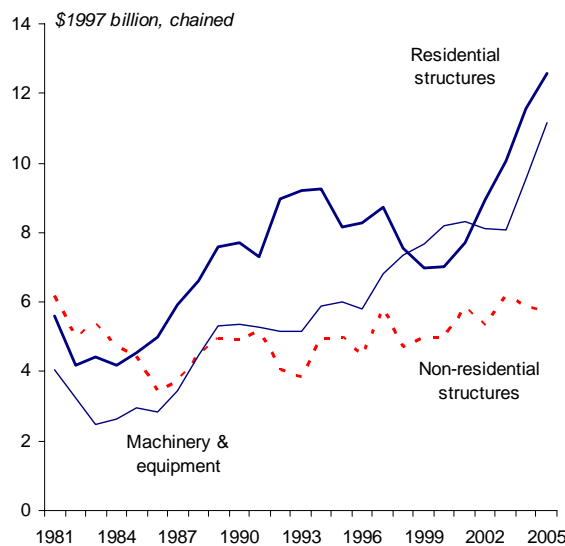
Governments held the line on current expenditures, but invested more in new capital

Federal, provincial and local government purchases of goods and services rose just 1.5%, about half the national increase. Investment in new machinery and equipment increased significantly after dropping off in the previous year, and spending on new structures was also up. Total investment in fixed capital rose 6.0%. Local and provincial governments, which together account for more than 90% of government investment in fixed capital, increased their spending, while the federal government cut back on capital expenditures in BC during 2005.

Business investment remained a significant source of growth

Business investment remained a big factor in overall GDP growth, increasing 8.5% during the year. While higher than the national average (+6.9%), this was only half the 17.0% advance seen in Alberta.

Spending on residential structures and machinery & equipment continued to rise



Data Source: Statistics Canada

Residential investment, long a mainstay of economic growth in the province, posted its smallest increase since 2000, rising 8.6%. Spending on real estate commissions and new residential structures had been growing at double-digit rates since 2002. The market for existing housing remained active, and real estate commissions continued to grow at double-digit rates, but spending on new construction or alterations rose at a more moderate pace.

The rise in the value of the dollar made imported machinery & equipment less costly for BC businesses, and this may have been a factor in their investment decisions. Spending on new machinery & equipment was up 16.7% in 2005, the second straight year of double-digit increases. However, the increased spending on machinery & equipment may have been seen as an alternative to investing in new non-residential structures: commercial and institutional buildings, as well as roads or other types of business infrastructure. Investment in these structures declined (-1.8%) for the third time in four years.

Another \$1.1 billion added to inventories

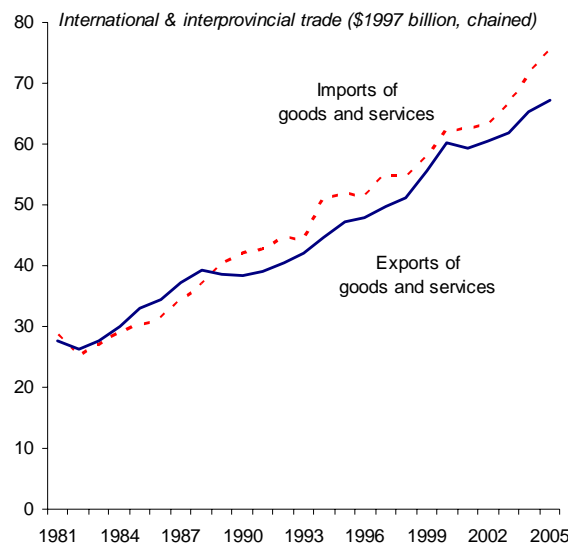
Business inventories increased by \$1.1 billion, marking the fourth straight year in which there has been an inventory build-up. Most producers saw the value of their inventories of finished goods increase, with particularly large gains recorded in the manufacturing and logging industries. Retailers and wholesalers also added to their inventories of finished goods. Businesses may stockpile finished goods in order to ensure that they can meet anticipated future demand, but inventory build-ups can also be an indication that supply is outpacing the demand for BC products. It is unlikely that the latter is a concern: eight out of ten BC manufacturers surveyed early in the second quarter of this year said they thought that inventory levels were “about right”, although the remaining 20% were

concerned that inventory levels were too high.

The external sector again put the brakes on economic growth as the province's trade deficit continued to grow

The weak link in BC's economy continues to be the external sector, which again put the brakes on economic growth in 2005 as the trade deficit continued to grow. The total value of exports advanced 2.9% in 2005, with particularly strong growth (+3.9%) in sales of goods and services to other provinces. International exports were up 2.4% during the year. However, total imports rose even more (+6.0%). This was largely due to a 9.2% increase in international imports, which were up significantly for the third year in a row, driven in part by the increased buying power of the loonie. Imports from other provinces increased 2.1%.

BC's trade deficit grew in 2005



Data Source: Statistics Canada

Consumer demand for many imported products is rising

Consumer spending has provided the impetus for much of the province's economic growth in recent years, and the demand for goods and services has been largely met by imported products. This is one of the main reasons for the province's large and grow-

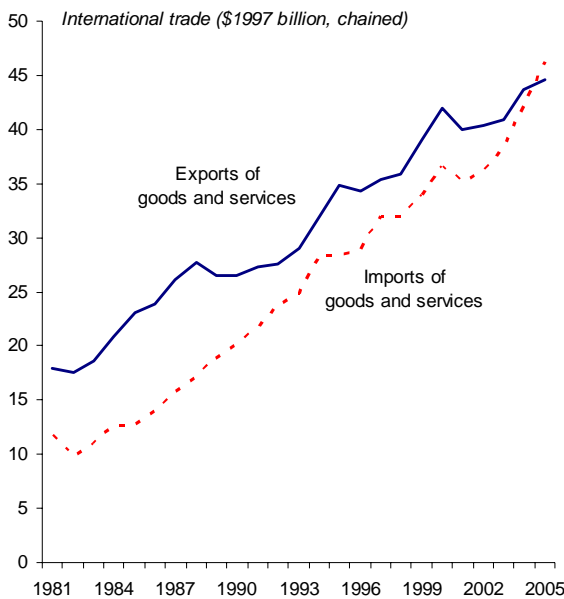
ing trade deficit. Although the province's exports have also been rising, external demand for BC goods and services isn't growing nearly fast enough to keep up with our hunger for more consumer goods.

At the same time, the increase in business investment that has occurred in recent years has been primarily concentrated in the residential sector or on imported goods such as machinery & equipment. This has also played a role in increasing the value of BC's total imports.

The province is a net importer of goods and services from other regions

BC is a net importer of goods and services from other regions. Many of the finished goods purchased by British Columbians are produced outside the province and are either imported into Canada or come from manufacturers in the east.

International imports of goods and services exceeded exports for the first time in 2005



Data Source: Statistics Canada

This means that, while consumer and business demand for durable goods such as appliances or vehicles can stimulate the economy (since wholesalers, retailers and

companies that ship these products benefit from increased activity), an increase in demand for these products usually benefits producers outside the province. Ontario appliance manufacturers do well when BC consumers buy more fridges, but the province's manufacturing sector doesn't necessarily see an increase in the demand for its products. On the other hand, BC is a major supplier of lumber and other raw materials used in housing construction, so we benefit when there is a building boom in other parts of the country, in the US and even overseas.

For the first time, BC imported more goods and services from other countries than it exported to them

Historically, BC has had an international trade surplus, but has been a net importer of goods and services from other provinces. This is no longer the case, and it appears that the situation is unlikely to change anytime soon. The province moved into a deficit situation in terms of its international trade last year. This was the first time³ that exports to other countries have not exceeded the value of imports. At the same time, while the trade deficit with other provinces is smaller than it was in the 1990s, it shows no sign of closing.

Goods comprise 80% of the province's international exports, and nearly 90% of its imports from other countries. There has been an international trade deficit in goods since 2002, and the surplus on the service side is shrinking as service imports from other countries have been growing a lot faster than exports to them.

The saving rate continued to plunge

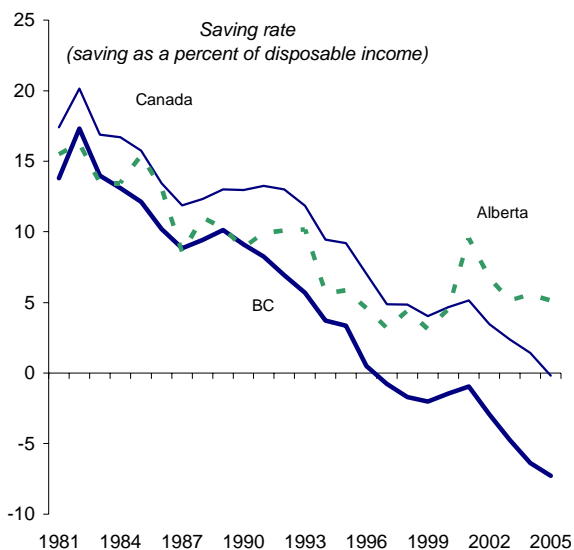
Real after tax income rose 2.5% to \$20,693 per person, but higher tax bills took a bigger bite out of personal income. With more people working and some moving up into higher tax brackets, after adjusting for infla-

³ 1961 is the first year for which these statistics are available.

tion the total revenue to government increased between 2004 and 2005. Personal income before taxes was up 3.0%.

BC's personal saving rate continued to plunge in 2005, falling to a new low of -7.3%. While this was by far the most negative saving rate in the country, BC was not the only province where personal spending exceeded after tax income. Saving rates were negative in eight of the provinces. The only exceptions were Ontario and Alberta. However, saving rates have been declining in Ontario and the rate was just 1.2% in 2005. Alberta, however, is bucking the national trend, and saving rates in that province have been relatively stable since the late 1990s. The rate there has remained in the five to six percent range since 2002.

BC's saving rate fell to a new low



Data Source: Statistics Canada

The saving rate is often seen as a measure of an economy's ability to fund new investment in capital equipment, and an ongoing downward trend in the saving rate is cause for concern. However, the saving rate does not give a complete picture of the availability of capital for investment, since some types of income or potential income are not necessarily included in this measure. For example, capital gains on the stock exchange or the value of assets (such as

housing) are not included, since they do not represent income that is actually earned in a given year. Similarly, dissaving could be occurring because larger numbers of older people, or new immigrants who have entered the province as entrepreneurs, are dipping into accumulated wealth to finance current expenditures. Personal income only measures the amount of money received in a given year, but it isn't necessary to pay for expenditures using current income. However, the money that is used to pay for current expenditures is not available to investors, and over the longer term, a persistently negative saving rate is unlikely to be sustainable.

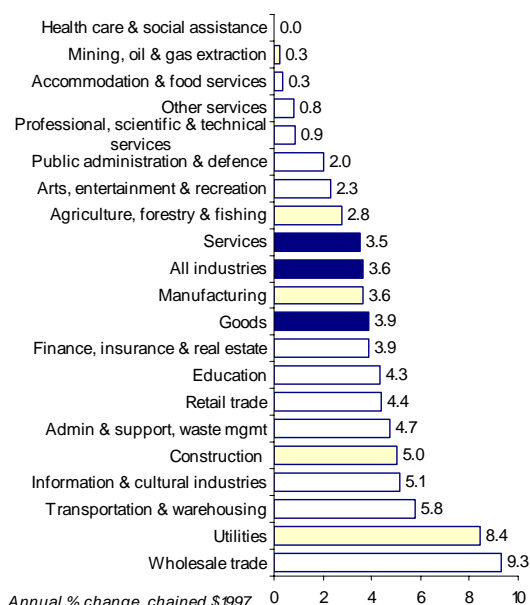
Solid growth in both goods and service industries

In recent years, GDP growth in the goods sector has been stronger than in the service producing industries, but in 2005, both sectors grew at similar rates. The goods industries advanced 3.9% during the year, and construction again played a big role in overall growth. At the same time, the utilities industry posted a solid gain following two years of decline.

Manufacturers in the province had another good year, with total GDP advancing 3.6%, even though the wood products industry posted only modest growth (+1.0%) and value added in the paper industry declined 2.5%. The computer and electronics industry posted a 3.9% decline. Offsetting this were strong gains in the food (+9.1%), non-metallic mineral (+12.1%) and fabricated metal (+13.4%) products industries, as well as other components of the manufacturing sector.

Crop and animal production bounced back from a lacklustre showing in 2004, when the effects of avian flu and the ongoing embargo on Canadian exports of beef to the US kept the lid on growth.

Wholesale trade, utilities and transportation & warehousing posted the strongest growth in 2005



Data Source: Statistics Canada

Output in the mining, oil & gas extraction industry inched ahead, but this was mainly due to exploration, development, and other service activities. Although prices for mineral products and fuels skyrocketed and investors in mining and related companies enjoyed the benefits of higher revenues, the volume of oil, gas and other minerals extracted by this industry fell slightly in 2005 and in real terms the value added by these activities declined.

Not surprisingly, given the strong demand for consumer goods and building supplies for new housing, retail and wholesale trade made strong gains during 2005. The transportation & warehousing industry also had a good year. Information and cultural industries, including activities such as telecommunications and filmmaking, grew 5.1%. However, the professional, scientific & technical services industry saw GDP increase only marginally during the year. Education and public administration increased their output, but the health and social services industry was unchanged from 2004.

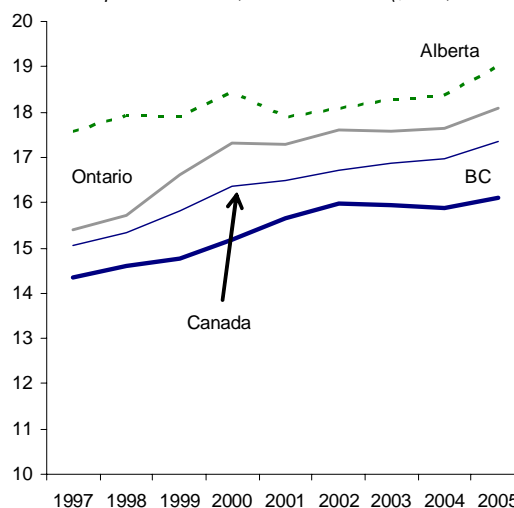
No progress on closing the productivity gap

Persistently low productivity⁴ levels remain a challenge for the province's economy. In 2005, the productivity gap between BC and Canada as a whole expanded for the third year in a row.

The productivity gap between the province and the rest of Canada has persisted despite strong gains in productivity during the last few years, and particularly during the period from 1997 to 2002. In fact, up to 2002, labour productivity in the province increased at about the same rate as in the country as a whole.

Labour productivity in the province remains below the national average

GDP per hour worked, business sector (\$1997, chained)



Data Source: BC Stats

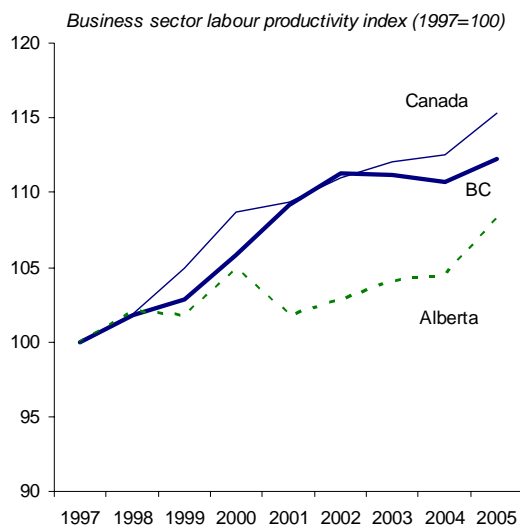
BC has lost ground relative the rest of the country in recent years, despite seeing GDP growth that is well above the national average. The fact that the productivity gap between BC and the country as a whole is

⁴ Labour productivity is calculated as the ratio of GDP (in chained 1997 dollars) to total hours worked in the business sector, which is defined here to include all industries except health & social assistance, education, public administration & defence, and the imputed rental income on owner-occupied housing. A more complete discussion of productivity measures can be found in the feature article "Probing the Productivity Puzzle", published in the September 2005 issue of this report.

expanding suggests that economic growth in this province has been due to more intensive use of labour inputs rather than technological improvements or more efficient use of capital, while in the rest of Canada, inputs other than labour have played a bigger role in economic growth. To a certain extent, this may be a reflection of the fact that much of BC's GDP growth in recent years has been in the service sector, which tends to be more labour-oriented than are the goods industries. This also explains part of the productivity gap between BC and Alberta, where capital equipment is used heavily in the extraction and processing of mineral fuels and other types of goods production.

Interestingly, labour productivity has risen a lot more in BC than in Alberta during the last few years. The problem for BC is that the overall productivity level here is so much lower than in the other have provinces, and this means that to catch up, BC will have to see faster-than-average productivity growth during the next few years.

Productivity growth in the province has lagged in recent years



Data Source: BC Stats

What's the outlook for BC?

BC's economy chalked up another strong-growth year in 2005, outpacing every other province except Alberta. However, the province faces a number of significant challenges. Real GDP per capita remains well below the national average, as does personal disposable income, and the size of the gap is not shrinking significantly. The saving rate continues to plunge, and shows no sign that a reversal in the long-run decline is pending. The province continues to have lower-than-average productivity levels, and the trade deficit is worsening.

On a more positive note, consumer demand for goods and services has remained robust, and continues to play a big role in stimulating economic growth. Employment gains in the last year have been significant and the jobless rate is currently at a thirty-year low. As long as consumer and business demand remains solid, BC's economy is likely to continue on an even upward keel. Whether or not the province will eventually be able to regain the ground lost during the slow-growth period of the 1990s remains to be seen.