

British Columbia Economic Review and Outlook

September 1998

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BRITISH COLUMBIA ECONOMIC REVIEW AND OUTLOOK

Overview¹

The crisis in Japan and Asia, which has had a greater economic impact in those regions than initially forecast, is now being felt in North America. This is partly behind the slowing growth in the Canadian and United States economies. U.S. real GDP growth fell from an annual rate of 5.5 per cent in the first calendar quarter of 1998 to 1.6 per cent in the second quarter, and Canada's second quarter GDP mirrored this trend, with growth slowing to 1.8 per cent in the second quarter from 3.4 per cent in the first quarter.

British Columbia's economic growth paused in the first half of 1998, due to declining activity in the fourth quarter of 1997 and the first quarter of this year. Despite the downturn of a number of key indicators and the difficulties in the export and resource sectors, an encouraging development is the monthly growth in employment this year.

The Asian downturn has primarily effected British Columbia's exports and resource sector. Although there are indications that Japan's economy has bottomed, other countries in the region are only now beginning to feel the most serious effects of the downturn. As a result, it is unclear how long it will take for an Asian and Japanese recovery to begin.

British Columbia real GDP growth is expected to range from +0.5 to -0.8 per cent in 1998. This range reflects year-to-date developments, volatility in financial markets and uncertainty about the timing of an Asian recovery.

1998 Year-to-Date Developments

■ *The Canadian Economy*

In Canada, growth slowed to 1.8 per cent in the second quarter from 3.4 per cent in the first quarter. Residential investment was weak due to labour disputes in Ontario's construction industry, although consumer spending and machinery and equipment investment rebounded from the first quarter.

Employment was 2.8 per cent higher in the first seven months (equal to 390,000 jobs) compared to a year earlier. The national unemployment rate averaged 8.5 per cent in the January-July period, down from 9.5 per cent a year ago.

¹ The cutoff date for data used in this report was August 31, 1998. Readers with questions or comments can contact Chris Lawless, manager, economic analysis at (250) 387-9021 or at Internet address: Chris.Lawless@gems8.gov.bc.ca

Retail sales were up about 6 per cent in the first half of the year. The chilling effect of the January ice storm, a construction trades strike in Ontario and weakness in British Columbia have reduced national housing starts by 2 per cent to date this year.

Inflation has been subdued despite the relatively strong economy. Year-over-year increases in the consumer price index have remained in the 1-per-cent range in recent months, although some argue that the falling Canadian dollar will soon show up in higher import prices and the overall inflation rate. Wage settlements nationally were in the 1.5 per cent range so far this year.

■ **Foreign Economies**

U.S. real GDP grew at a 1.6 per cent annual rate in the second quarter, following a revised 5.5 per cent annual rate in the first quarter of 1998. Strong consumer and investment spending offset the negative effect of the labour dispute at General Motors Corporation, a scaling back of inventories and lower exports due to continued weakness in the Asian economies. The consensus forecast for U.S. economic growth is now 3.4 per cent in 1998, above the 2.0 per cent that was assumed in the March 1998 economic forecast.

Continuing strength in economic activity, together with tight labour markets, had raised fears early in the year that the U.S. Federal Reserve would tighten monetary policy. Federal Reserve officials themselves expressed concern about the sharp rise in U.S. stock prices in the first half of the year. However, these concerns have been tempered by the recent pullback in the stock market and continuing evidence of subdued inflation; the GDP price deflator, a broad measure of price movements, increased only 0.9 per cent in the second quarter, the smallest increase since 1964.

The U.S. housing market, which represents a major source of demand for British Columbia forest products, remains very strong fuelled by high levels of consumer confidence and relatively low mortgage interest rates. In July, housing starts were at their highest level since 1987. Existing home sales fell in June after reaching a record high in May. However, this strength has failed to translate into higher lumber prices due to ample wood supplies.

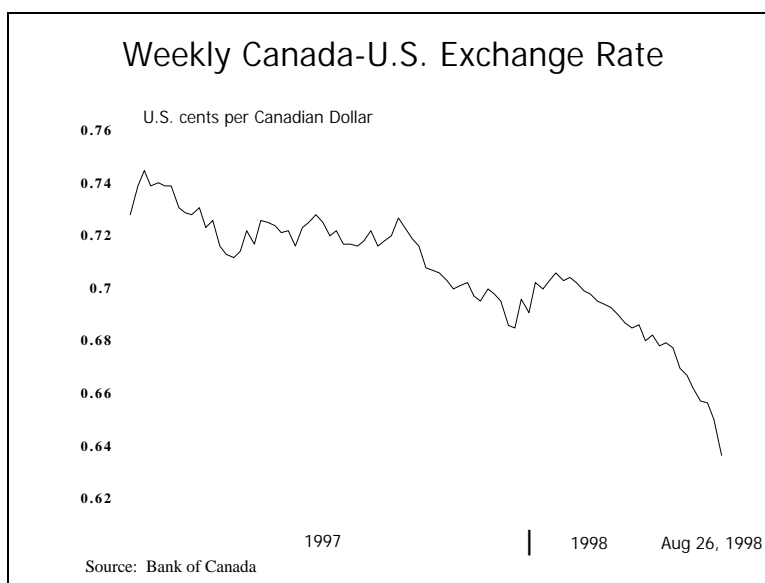
The Japanese economy contracted at an annual rate of 5.3 per cent in the first quarter of 1998 with the banking sector problems and the Asian crisis dampening demand. The unemployment was 4.1 per cent in July and is expected to climb further. The *Consensus Economics* average of forecasters is projecting a 1.5 per cent contraction in the Japanese economy in 1998 followed by growth of 0.5 per cent in 1999.

In an effort to stem the economy's decline, the Japanese government unveiled an economic stimulus package that contains 10 billion yen in tax cuts. However, the turnover of political leadership in Japan has delayed implementation of the tax package.

In Europe, growth momentum is shifting from the U.K. to the Continent. The United Kingdom's economy slowed in the first half with preliminary real GDP increasing at a 2.2 per cent annual rate. Germany's economy continued to accelerate with real GDP increasing at about a 2.5 per cent annual rate in the first half of 1998. The French and Italian economies have also improved considerably from a year ago (although Italy's economy shrank slightly in the first quarter because a temporary sales tax cut on autos came to an end). The main European economic problem remains high unemployment rates on the Continent (double-digit unemployment rates compared to under 5 per cent in the United Kingdom).

■ **Financial Markets**

The Canadian dollar has been declining steadily in recent months after rebounding to slightly above 71 cents U.S. in late March. By the end of August, the dollar was trading just below 64 cents U.S. Downward pressure on the dollar is due to ongoing troubles in Asia and declining commodity export prices. As well, the weakness of the Canadian dollar reflects the attractiveness of the U.S. dollar as a safe haven in times of global economic uncertainty. While a lower dollar provides some added revenue for firms selling products abroad, it boosts the costs of imports and reduces Canadian s' global purchasing power.



The Bank of Canada's May *Monetary Policy Report* suggested interest rates would remain at their current level for the remainder of 1998. However, the Bank of Canada responded to the downward pressure on the Canadian dollar by raising the Bank rate a full percentage point on August 27. By the end of August, the currency had strengthened slightly and was trading just below 64 cents U.S.

■ **Commodity Prices**

Prices for commodity products such as pulp, lumber and copper are a key factor in the performance of British Columbia's resource industries.

The bellwether Spruce-Pine-Fir (SPF) 2x4 lumber price has been soft this year, averaging \$282 U.S. per thousand board feet in July. SPF prices appear to have bottomed at \$255 in early June. The price was \$300 on August 28th, still below prices of \$350 a year ago. Prices for hemlock baby squares, the main product for the Japanese housing market and coastal sawmills, are currently around \$510 U.S. This drop from prices in the \$900 range seen early in 1997, is due to the slump in Japanese housing activity.

The Asian downturn, the recently-concluded Fletcher Challenge strike and the ongoing strike at 11 Abitibi-Consolidated mills in eastern Canada have had conflicting impacts on pulp and paper prices. Newsprint prices had been moving up in recent months, with prices slightly higher than in 1997 but recent indications are that prices will be flat or even soften under pressure from lower-cost Asian mills.

Most Canadian and U.S. producers tried to boost pulp prices to \$600 U.S. per tonne at the beginning of June, but were largely unsuccessful and prices remain below \$600. British Columbia pulp and paper exports should recover in coming months due to the end of the Fletcher Challenge labour dispute.

Metals prices have also been hurt by the Asian downturn. Copper prices, for example, have fallen back to the mid-70 U.S. cent range in recent months as the second wave of Asian upheaval hit following Indonesia's political explosion in May and June. Price declines have caused several British Columbia mining operations, including the Mount Polley and Gibraltar mines, to announce shutdowns.

World oil prices have been very weak, falling as low as \$13 U.S. per barrel. However, natural gas export prices have been fairly strong recently due to strong economic growth in the United States. With the addition of new pipeline capacity, natural gas exports should increase and British Columbia export prices should rise to levels in the rest of North America.

■ **The British Columbia Economy: Recent Performance**

In May, Statistics Canada released real GDP figures that showed the British Columbia economy grew 2.2 per cent in 1997, following growth of 1.1 per cent in 1996. The new real GDP data have been rebased to 1992 dollars (budget real GDP figures were based in 1986 dollars).

This year in British Columbia, those sectors of the economy dependent on resource exports have been most heavily affected by the Asian downturn, with commodity

exports to Japan down 35 per cent. Partially offsetting the resource sector decline, areas in secondary manufacturing, high technology and the service industries are performing strongly while tourism has weathered the impact of reduced Asian visits. Employment growth has resumed following a decline at the turn of the year. Most other economic indicators so far in 1998 were below levels recorded a year earlier.

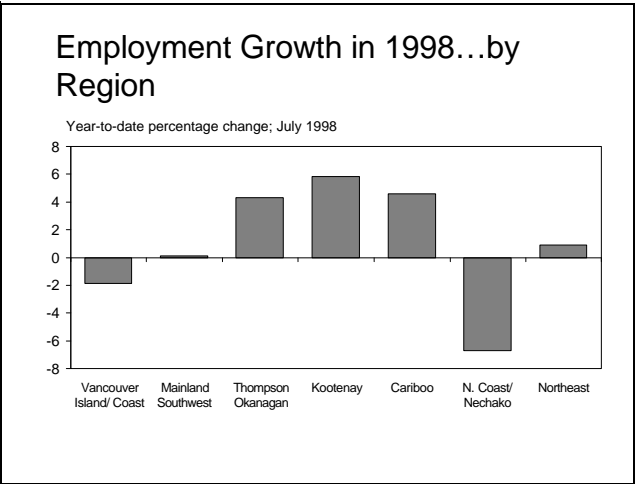
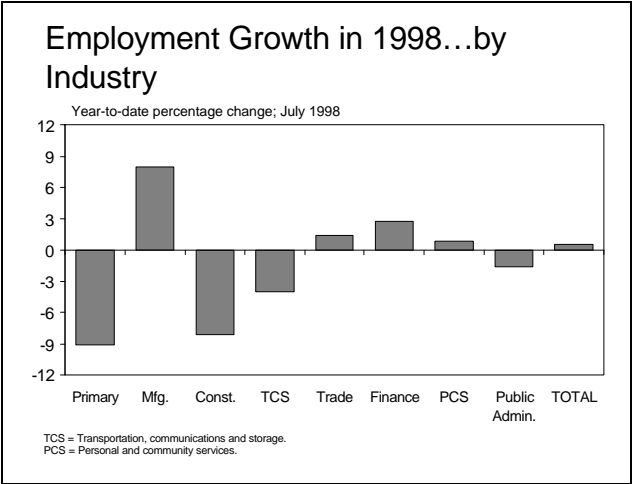
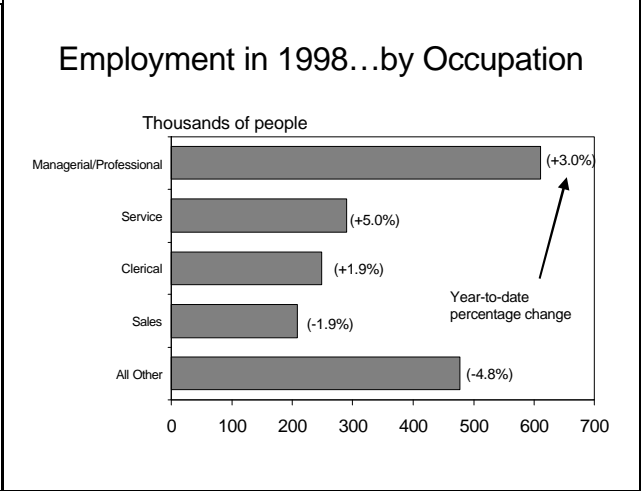
The Labour Market

Seasonally-adjusted employment fell in the fourth calendar quarter of 1997 and the first quarter of 1998 (mainly due to the large decline in January). However, employment grew 1.1 per cent in the second calendar quarter. Since January, employment has risen by 2.0 per cent or 36,000 jobs up to July. The level of employment has now reached its August 1997 peak. For the first seven months of 1998, employment was up 0.5 per cent from the same period in 1997.

The unemployment rate was 9.1 per cent in July. During the first seven months of the year, the unemployment rate averaged 9.5 per cent, up from 8.6 per cent during the same period in 1997.

The charts below show employment growth in British Columbia to date in 1998 by occupation, by industry and by region. The charts depict a diverse labour market across the province:

- Manufacturing employment grew 8.0 per cent in the first seven months of the year, even though nearly half of the jobs in this sector are resource related. This reflects the strong performance of non-resource manufacturing.
- Financial services employment also grew strongly.
- Employment in managerial and service occupations has grown rapidly this year, though employment in construction, resource processing and transportation occupations has declined.
- The downturn in the resource sector appears to have hit hardest in the Vancouver Island/Coast and North Coast/Nechako regions. In the Northeast, employment rose slightly in the first seven months of the year, and the region's unemployment rate remained very low, averaging 3.3 per cent in the January to July period. Employment growth has been relatively strong in the province's Interior.



In-migration slowed in the first quarter of 1998 but remained positive with international net in-migration more than offsetting a decline in interprovincial net in-migration. Total net in-migration fell from 12,900 persons in the first quarter of 1997 to 4,000 in the first quarter of 1998. Interprovincial in-migration went from a net *inflow* of 1,150 to a net *outflow* of 3,560, while international net in-migration fell from 10,700 to 7,500. Indications are that interprovincial out-migration continued in the second quarter of 1998.

The Consumer Sector

Retail sales fell sharply in the first quarter of 1998, but were up marginally in the second quarter. On a year-to-date basis, sales were down only 0.2 per cent. The major reason for the slight year-to-date decline is the sharp fall in motor vehicle sales – down nearly 9 per cent in the January to June period, after having increased 14.4 per cent in 1997. Auto sales incentives and rebates at the end of last year, left sales weak early in 1998. A survey by the Conference Board of Canada indicates that British Columbia consumer confidence declined in the first and second quarters of 1998.

While retail sales have been weak, some areas of the service sector have shown strength. For example, estimates for restaurant caterer and tavern receipts for the second quarter were up 8.9 per cent from the first quarter.

Tourism has been an important contributor to the province's service sector in the last few years. Conditions appear positive this year, with increased numbers of American and European visitors offsetting a decline in the number of Asian visitors. Year-to-date foreign visitor entries to British Columbia were up 6.1 per cent from 1997 levels. In the first six months of 1998, the number of international passengers traveling through Vancouver International Airport was up 7.2 per cent from the same period last year. The decline in the value of the Canadian dollar has made Canada an attractively-priced destination for many visitors.

Lower consumer confidence and lower levels of in-migration have combined to weaken the province's housing sector. Housing starts declined 20.9 per cent on a year-to-date basis through July and the value of residential building permits, a leading indicator, was down 21.5 per cent during the first half of the year. Over the January-to-July period, sales of existing homes fell 25 per cent from a year ago, continuing a downward trend that started at the end of 1996. Prices of new and existing homes are down between 3 and 5 per cent.

Inflation remains low in British Columbia with a year-to-date increase of 0.2 per cent in the consumer price index through July. The province's low inflation reflects falling housing costs and lower gasoline prices.

Business and Industrial Activity

The dollar value of British Columbia's exports and manufacturing shipments declined during the first half of the year. The main factor underlying the decline was the general weakness in prices for forest products and metals accompanying the downturn in Asia. These declines have been larger than had been expected at the time of the budget, when it had been anticipated that exports to Asia would drop from \$10.5 billion to between \$9.5 and \$10 billion, or about 10 per cent.

The value of British Columbia merchandise exports fell 12.2 per cent on a year-to-date basis through June. Exports to Japan are down about 35 per cent while those to the rest of Asia are down 25 per cent. The Fletcher Challenge strike, lower prices and lower volumes shipped in the wake of the Asian crisis contributed to the decline in exports.

Manufacturing shipments were down 7.1 per cent on a year-to-date basis through June. However, manufacturing employment is up some 8 per cent to date in 1998, reflecting considerable strength in non-resource manufacturing.



The decline in manufacturing shipments was due to lower commodity prices as well as lower volumes shipped. The Ministry of Finance and Corporate Relations export commodity price index (ECPI) shows that Canadian dollar prices for the province's key exports were down 8.4 per cent in the first half of 1998 compared to the first half of 1997.

Forest products, which account for 45 per cent of total manufacturing shipments, have fallen 15.6 per cent to date as a result of lower prices and volumes shipped. Forest product shipments should recover in coming months as the three Fletcher Challenge mills resume production (they account for 20-25 per cent of British Columbia pulp and paper production capacity).

Non-resource sectors have performed strongly in 1998. Manufacturers of machinery, transportation equipment and electronics have increased shipments 7.0 per cent on a year-to-date basis. The value of clothing and plastics shipments is up 9.1 and 7.4 per cent, respectively.

Statistics Canada's private and public investment intentions July survey showed planned investment in British Columbia is expected to increase 2.1 per cent in 1998, up from the initial 1.3 per cent reported in February. Business non-residential investment is planned to decrease 1.0 per cent from 1997 levels, while residential investment is expected to increase 0.7 per cent in 1998.

The Vancouver office market was quite strong early in 1998 with a vacancy rate around 6 per cent. However, the vacancy rate has risen and developers who were optimistic at

the beginning of the year appear to be taking a wait-and-see attitude to new office construction.

The province-wide value of non-residential building permits, a leading indicator of future construction activity, was up 13.6 per cent in the first six months of 1998 compared to the same period in 1997. Areas enjoying strong construction activity include Burnaby, where a number of office and retail projects are underway, and Richmond, where investors plan to develop a \$500-million high technology industrial park. A \$180-million entertainment complex has also recently been approved in Richmond. The Vancouver International Airport is planning a \$250-million expansion to accommodate cross-border flights. The provincial government has recently taken steps to accelerate planned capital projects, including transit, schools and the Vancouver Trade and Convention Centre, in part to offset the slowdown in other areas of the economy.

The British Columbia Economy: Revised 1998 Outlook

The March economic forecast projected British Columbia growth of 0.9 per cent in 1998. Heightened volatility in financial and commodity markets, and the rapidly-changing Asian situation have made it difficult to forecast overall economic growth with certainty. Economic growth in British Columbia should be in the +0.5 to -0.8 range in 1998.

There are three main reasons for the downward revision to the forecast:

- The Asian crisis has had a greater economic impact than initially forecast
- Weaker commodity prices and weaker-than-expected export volumes, notably to Japan; and
- Reduced migration to British Columbia, lower housing starts and lower consumer spending.

■ *Changes to the External Outlook*

The Asian crisis has resulted in a sharp downward revision in Japan's growth prospects. Overall, commodity prices are likely to decline much as had been anticipated earlier. Partly offsetting these factors are stronger North American growth and a lower Canadian-U.S. exchange rate. (see Table 1).

TABLE 1
BRITISH COLUMBIA ECONOMIC OUTLOOK: KEY ASSUMPTIONS

| | Actual | 1998 | |
|--|--------|------------------------------|-------------------|
| | 1997 | Budget Forecast March '98 | Likely Outcome |
| Percentage change unless otherwise specified | | | |
| Economic Growth (per cent) | | | |
| - Canada | 3.8 | 3.0 | 3.1 |
| - United States | 3.8 | 2.0 | 3.4 |
| - Japan | 0.9 | 0.3 | -1.4 |
| - Europe | 2.5 | 2.5 | 2.8 |
| Canadian Interest Rates (per cent; annual average) | | | |
| - 3-month Treasury Bills | 3.2 | 4.7 | 4.7 |
| - 10-year and over Government of Canada bonds | 6.4 | 6.0 | 6.0 |
| U.S. cents/Canadian dollar | 72.1 | 70.2 | 68.0 |
| British Columbia Goods and Services | | | |
| Export Prices | | | |
| - in Canadian dollars | 0.3 | -1.3 | 0.0 |
| - in U.S. dollars | -1.3 | -4.0 | -5.8 |

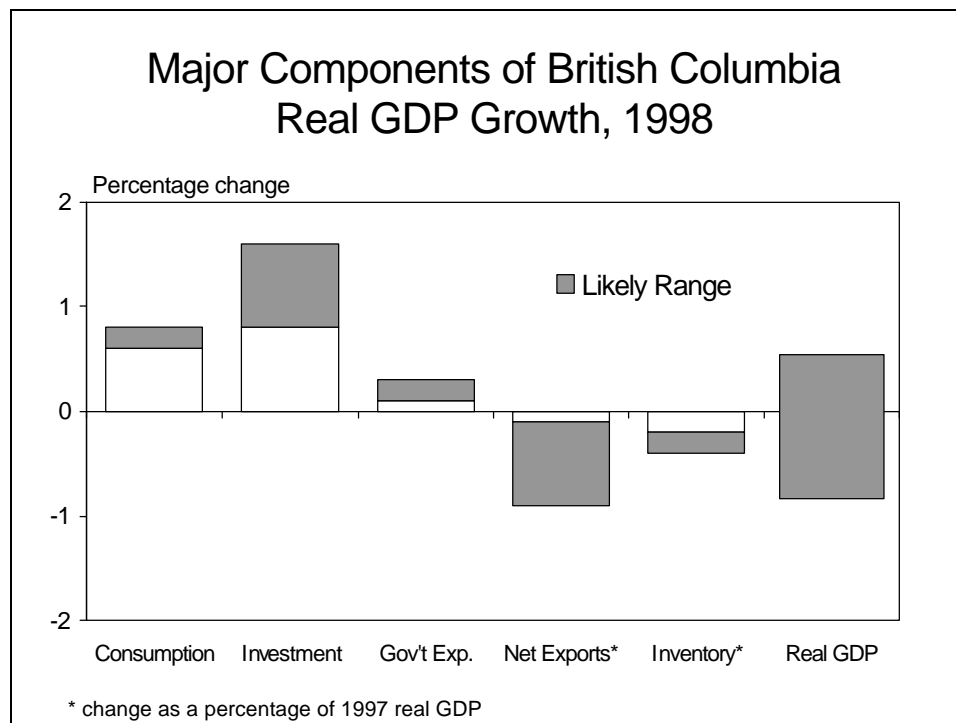
■ **British Columbia Final Domestic Demand**

Final domestic demand, which consists of consumer spending on goods and services, capital investment and government expenditures, is expected to grow more slowly than projected in the March 1998 forecast. Much of this has to do with reduced in-migration and housing demand.

Real consumer spending, the largest component of final domestic demand is expected to rise more slowly than projected in the budget forecast (see Table 2 for forecast ranges). The slower growth in spending is mainly due to lower spending on goods, notably automobiles, and reduced housing activity (which reduces demand for furniture and appliances).

Overall capital investment is now expected to grow more slowly with a decline in residential investment being partly offset by accelerated public capital spending. Business non-residential investment is expected to decline slightly. This is due in part to lower investment in the forestry and mining sectors which have been hit by falling commodity prices. Due to reduced levels of in-migration, housing starts are now expected to be lower than the 27,900 starts projected in March.

The provincial government has recently taken steps to accelerate planned capital projects, including transit, schools and the Vancouver Trade and Convention Centre, in order to help stimulate economic activity. Operating spending of the three levels of government is expected to remain at about the same level as in the previous forecast.



■ **Exports and Imports**

During the first half of the year, both the value and volume of exports fell at a greater pace than expected in the March forecast. Part of the decline was due to lower volumes shipped as a result of the prolonged Fletcher Challenge strike; with these mills back in production, pulp and paper exports will experience some recovery. The other key factors in the first-half decline were lower copper and lumber exports. Looking ahead, economic weakness in Asia will likely continue through the year end but will be partially offset by the weaker-than-expected Canadian dollar. The volume of exports of goods and services is now expected to fall in 1998, compared to the 1.0 per cent increase projected in March. Due to slower growth in domestic demand, import volumes should grow more slowly than previously forecast. As a result, the change in net exports is now expected to reduce real GDP by between 0.1 and 0.9 per cent in 1998. This range encompasses the 0.6 per cent projected earlier.

■ **Inventory Accumulation**

In 1997, the province experienced a large inventory build-up which accounted for a large portion of last year's economic growth. This highly-volatile component of GDP could subtract up to 0.4 percentage points from growth in 1998.

■ ***Real and Nominal GDP Growth***

As a result of the weak first-half performance, volatility in financial markets and uncertainty about the timing of a recovery in Asia, economic growth in British Columbia this year should be in the range of +0.5 to -0.8 per cent. The downturns in the resource and construction sectors should be roughly offset by continued growth in other sectors.

Nominal GDP growth is expected to range from +1.0 to -0.8 per cent in 1998, compared to the 1.1 per cent increase forecast in March. This reflects the year-to-date performance of the largest component of income-side GDP, labour income, as well as likely ranges for corporation pre-tax profits.

■ ***Labour Market and Population***

Employment is expected to increase 0.4 to 0.7 per cent in 1998. This is similar to the forecast in the March budget. Employment in non-resource manufacturing performed better than expected during the first half of the year. With the labour force expected to grow between 1.4 and 1.7 per cent, the unemployment rate will likely average between 9.3 and 9.8 per cent.

The British Columbia population is expected to grow slightly slower than the 1.7 per cent forecast in March. The main factor is that total net in-migration will be lower. Net international in-migration is expected to be slightly lower than forecast in the March budget. Inter-provincially, a net *outflow* is expected in 1998, compared with the budget projection of a 3,000-person *inflow*. As a result, total net in-migration for 1998 will likely be between 18,000 and 22,000 people.

■ ***Incomes, Profits and Prices***

Total personal income is projected to be slightly less than forecast in the March 1998 budget. While wage, salary and supplementary labour income is expected to rise, weaker growth is expected in other major components of personal income, notably interest, dividends and miscellaneous investment income and unincorporated business income. Average weekly earnings have grown slightly slower than the 0.8 per cent forecast in March.

Similar to the March forecast, corporate profits are expected to decline after growing 10.1 per cent in 1997. The Asian economic crisis has eroded profits in the resource sectors.

Inflation in British Columbia has been virtually non-existent to date, averaging 0.2 per cent in the first half of the year. The province's inflation rate is now expected to average around 0.3 per cent in 1998, down from the 0.7 per cent in the March forecast. The forecast for the broadly-based GDP price deflator has also been revised down, reflecting lower export prices.

TABLE 2
BRITISH COLUMBIA ECONOMIC OUTLOOK SUMMARY

| | Actual | 1998 | |
|---|--------|------------------------------|---------------|
| | 1997 | Budget Forecast March '98 | Likely Range |
| Percentage change unless otherwise specified | | | |
| Gross Domestic Product (current dollars) | 3.3 | 1.1 | -0.8 — +1.0 |
| Real Gross Domestic Product (1992 dollars) | 2.2 | 0.9 | -0.8 — +0.5 |
| - Consumer Expenditure | 4.3 | 1.5 | 0.6 — 0.8 |
| - Government Expenditure | 0.8 | 0.2 | 0.1 — 0.3 |
| - Capital Investment | 4.4 | 1.4 | 0.8 — 1.6 |
| - Exports of Goods and Services | 4.6 | 1.0 | -2.0 — 0.0 |
| - Imports of Goods and Services | 10.2 | 1.6 | 0.1 — 0.4 |
| - Inventory Investment (change in billions of 1992 dollars) | 1.2 | 0.1 | -0.4 — -0.2 |
| Population | 2.0 | 1.7 | 1.4 — 1.5 |
| Net In-migration (thousands) | 47.3 | 40.7 | 18.0 — 22.0 |
| Labour Force | 1.6 | 1.6 | 1.4 — 1.7 |
| Employment | 1.8 | 0.5 | 0.4 — 0.7 |
| Unemployment Rate (%;annual average) | 8.7 | 9.6 | 9.3 — 9.8 |
| Retail Sales | 5.0 | 2.0 | -1.0 — -0.5 |
| Labour Income ¹ | 3.3 | 1.5 | 1.3 — 1.8 |
| Corporate Pre-tax Profits | 10.1 | -20.0 | -15.0 — -5.0 |
| Housing Starts | 6.2 | -4.9 | -27.0 — -20.0 |
| Consumer Price Index | 0.7 | 0.7 | 0.2 — 0.3 |

¹ Wages, salaries and supplementary labour income

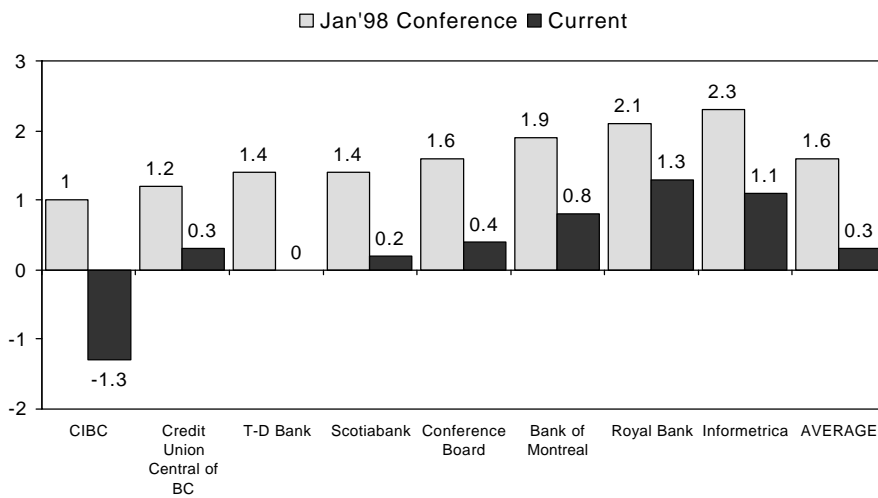
■ Other Forecasts

The budget economic forecast projected 0.9 per cent growth in 1998. This forecast and those made by other organizations at the Minister of Finance's January 1998 economic conference are shown in the chart at the top of page 14.

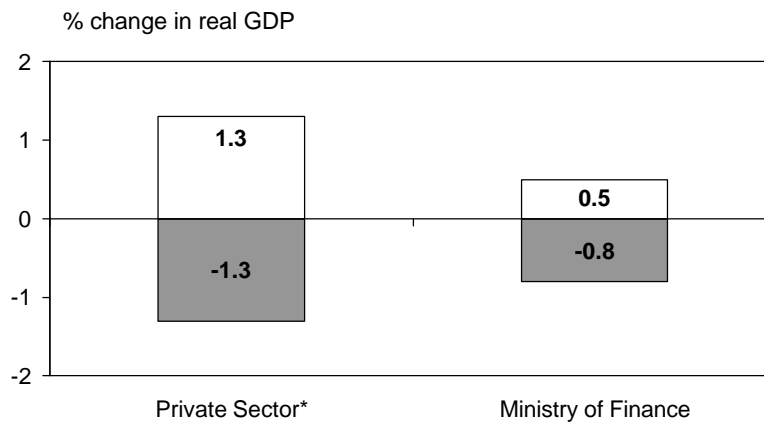
Other organizations' forecast have also been revised down since January. As of the end of August, these forecasts ranged from +1.3 to -1.3 per cent (see chart at top of page 14).

The Ministry of Finance forecast range of +0.5 to -0.8 per cent economic growth is below the budget forecast of 0.9 per cent growth, but encompasses the 0.3 per cent growth assumed for the budget revenue forecast. This assumption provided a revenue reserve of \$130 million against the possibility of lower-than-expected economic growth.

Recent Forecasts of B.C. Economic Growth, 1998



B.C. Economic Forecast Ranges, 1998



* as of August 31

Risks to the Outlook

The forecast range is based on assumptions regarding the external conditions that influence the province's economy. As mentioned throughout this report, there are several external and domestic developments that could affect the outlook. To recap:

- The Asian outlook is uncertain. The Asian downturn could last longer than currently anticipated but, because of the depth of the slowdown and the extent of financial restructuring, the eventual recovery could be stronger than expected.
- The United States and Canadian economies are slowing from rapid rates of growth. Growth of 2 to 2.5 per cent is widely expected. However, a more significant slowdown could further depress demand and prices for British Columbia exports.
- On the upside, interprovincial migration flows could stabilize if expected economic conditions cool in Alberta and other parts of Canada.
- Canadian interest rates may fall if the Federal Reserve lowers interest rates in the United States.