

2008 ECONOMIC OUTLOOK COMMENTARY

By Adam Legge,
Director – Research & Business Information

Highlights

- The global economy is expected to cool off slightly in 2008, as central banks around the world begin raising interest rates in an effort to stem inflation. The timing and magnitude of these rate hikes will in many instances be highly dependent upon the state of the U.S. economy however.
- Uncertainty regarding the credit crisis in the U.S. will create a slow year for the U.S. economy, and may further impact the Canadian economy depending on how much further the crisis extends. Canada's, and therefore to some degree Calgary's, economy will be impacted should interest rates rise and/or the Canadian dollar rise further.
- Calgary's economy should continue its slower growth trend off the peak in 2006, to a more sustainable level, a level of economic growth slower than 2007, yet one that is very healthy, and the envy and desire of any city around the world.
- Calgary's higher housing costs and limited rental housing should serve to curb in-migration and slow population growth, resulting in population growth for 2008 between 22,000 and 25,000.
- Continued high demand for labour, yet constrained supply should bring employment growth in at 2.5 to 3 per cent in 2008.
- Labour supply is expected to remain tight, resulting in a continued low unemployment rate of between 3 and 3.3 per cent over 2008.
- Inflation should moderate in 2008 to 3 to 3.5 per cent, with price escalation of the main contributor to our high inflation – housing – slowing to more reasonable levels.
- Housing market fundamentals remain healthy and in place, however slowing in-migration and the plethora of listings should bring housing starts in at 13,500 – 14,000 in 2008.
- Given the slowing trend of Calgary's economy, uncertainty around natural gas prices, and an unclear picture of how the U.S. economy will perform in 2008, Calgary's real GDP growth is forecast at 3.3 to 3.8 per cent in 2008.

Introduction

Yogi Berra once famously proclaimed, “the future just ain’t what it used to be.” This is especially true for economies. There are so many forces, drivers and conditions that exert influence on economies, making them such important yet interesting subjects.

And since the future isn’t what it used to be, Calgary Economic Development has prepared this 2008 Calgary Economic Outlook to provide insights into the local economy.

The information within can aid in business planning, budgeting and organizational forecasting. Our aim through this outlook is to increase awareness of local-based issues and developments, to better support the community in its ongoing success.

Context - Global and National Outlook

Prior to the credit crisis in the U.S., there was general consensus that the global economy would slow slightly in 2008, as central banks around the world raised interest rates to stem increasing inflation and overheated economies. While the long-term impact of the credit crisis in the U.S. is uncertain in terms of whether it will go deeper, it left the Bank of Canada holding rates steady, and the Federal Reserve dropping the federal funds rate by half a percent on September 18.

So 2008 is a bit uncertain in terms of the global economy, as much hinges on the state of the U.S. economy. Barring any further deepening of the crisis, the global economy should cool off slightly in 2008. U.S. housing markets are correcting, and consumer spending, the prop for the economy over the past many years, will be curtailed by tightening of consumer credit and reduction of the “wealth” of households, as they are unable to withdraw equity from their homes as easily.

Global energy demand should remain on an upward trajectory as populations in China and India urbanize and acquire more wealth, however slowing U.S. demand may curtail overall growth slightly. Modest increases in global supply should bring the oil market back towards some more balance, but there still remains little buffer for supply disruptions. Oil prices should therefore continue to remain elevated over previous years.

Natural gas prices on the other hand have been depressed for many months since a high in 2006, as inventories remain high. Gas well completion is down nearly 20 per cent year over year leading to underutilization of rigs and crews. This has negative implications for the viability of certain operations and employment in the sector. Natural gas prices remain a significant uncertainty for the 2008 forecast as many sources are mixed in their outlook for the price into 2008.

As the Canadian dollar now sits at parity with the U.S. dollar, there is potential for the loonie to create a further headwind for certain sectors. These include tourism, film, manufacturing, energy and other sectors that are trade dependent, or dependent upon currency valuations in those that are now becoming devalued against the Canadian dollar. Essentially, as Canadian product becomes more expensive, or the payment for Canadian goods comes from lower value currencies, it can create further challenges for those sectors.

In Canada, employment remains strong, unemployment levels are at near historic lows, and spending is healthy, particularly in the Western provinces. Barring any further meltdown in U.S. markets, it is therefore likely that the Bank of Canada will raise interest rates as the economy continues to spend and create price escalation. Therefore, interest rates are likely to rise over 2008. This action against a weak U.S. dollar would then likely see appreciation in the value of the Canadian dollar.

Calgary Overview

Calgary's economy was dancing on the ceiling in 2006, and expectations were that 2007 would shape up to be a return to a more sustainable level. In Calgary Economic Development's June State of the Economy, we estimated year-to-date economic growth to be in the mid 4 per cent range – down from the 7 per cent level that was experienced in 2006 – but higher than the 3.9 per cent forecast at this time last year. Calgary's economy just seems to have such momentum that it is not returning to more sustainable levels as quickly as thought.

Given the momentum, and what is happening around the world, what is 2008 looking like for Calgary's economy?

Calgary's economy is somewhat of a tricky one to forecast. First, it is prone to volatility as a result of its linkage with oil and gas prices. Secondly, it is demonstrating characteristics of both readiness to continue charging ahead – high oil prices, strong demand for talent, highly educated workforce and diverse sector base - and characteristics of needing to take a breather – inflation, labour shortages, and tight commercial real estate markets.

In the end, the theme for 2008 should be something akin to 2007 – slowing from a peak in 2006, coming off the ceiling, and returning to earth; a more sustainable level, a level of economic growth slower than 2007, yet one that is very healthy and the envy and desire of any city around the world.

Consider Calgary's economy as a high performance runner. It is in top shape, strong and healthy. Our economy ran flat out in 2006 to achieve a personal best. 2007 and 2008 are the wind-down jog bringing the heart rate back down to a normal level. We are performing well, but showing signs of stress and strain from over-exertion.

Not only is Calgary's economy full of momentum, it is essentially at capacity – labour is tapped out; real estate is essentially all spoken for; housing prices have escalated significantly and records have been set for residential sales and non-residential building permit values. Compounding the impact of our economy at capacity is that the Canadian economy overall is performing strongly as well, resulting in limited slack to be taken up elsewhere.

One has to consider that an economic growth rate of over seven per cent is just not sustainable – it creates too much burnout, too much overheated demand and too much price escalation. What is important to take away is that slower growth, down from unsustainable levels, is a highly desirable situation. Slower growth does not mean no growth. The economy, its workers and its infrastructure need a breather.

That sentiment is echoed in the 2007 Calgary Business Survey, which found that when asked if Calgary's growth is positive or a challenge, 59 per cent of respondents indicated that it is a challenge, an increase from 39 per cent in 2006. Calgarians need a break.

What would be the cause of slower growth in 2008? Necessity for one thing, as companies realize that they simply cannot repeat 2006, from a cost and human resource perspective. In addition, slowing in-migration, moderating employment growth, and a slower housing market will all act as a natural brake to the economy. Ultimately, the biggest factor driving our slower growth is the higher cost environment in which we find ourselves. And that higher cost environment is a result of shortages across labour and real estate that could not meet demand.

Additionally, macro factors described earlier are likely to have an impact locally, specifically lower natural gas prices and a slow U.S. economy.

Overall Economic Activity

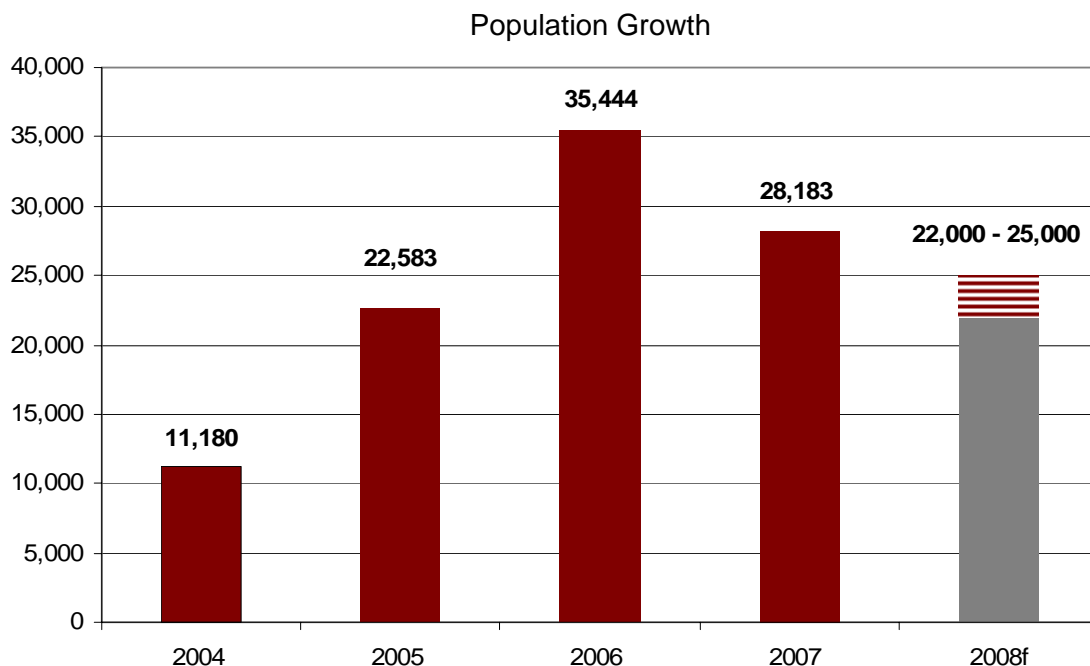
Population

2006 was a peak year for population growth, with 35,681 new residents according to the 2006 Civic Census. The 2007 Civic Census reported 28,183 new residents, down from 2006 but still above 10 year average.

Calgary's population growth should continue to remain healthy, as the youthfulness of Calgarians results in more babies – yes we are having our own little baby boom in Calgary - and the economic appeal of Calgary continues to draw more in-migrants.

However, expect Calgary's higher housing costs and limited rental housing to curb in-migration and slow population growth, particularly those coming from less expensive housing centres. Calgary's housing has just become too expensive for certain recruits, specifically those in entry level positions or on the lower end of the wage scale. And while slower population growth will aid in the infrastructure catch up, it further compounds the labour shortage, as there will likely be fewer people coming to Calgary to take up the much needed jobs.

Natural addition is forecast at 10,000 – 11,000, with net in-migration slowing to 12,000 – 14,000, resulting in a total population increase of 22,000 – 25,000 in 2008. To put that figure into perspective, that is like adding between two and two and a half High Rivers to the population of Calgary in one year.



Source: Calgary Civic Census, CED

Employment Growth

The labour situation is Calgary's biggest and most significant challenge – confirmed in the 2007 Calgary Business Survey as the number one issue impacting economic development in Calgary by 88 per cent of the respondents. The two key questions on the job creation front for 2008 are:

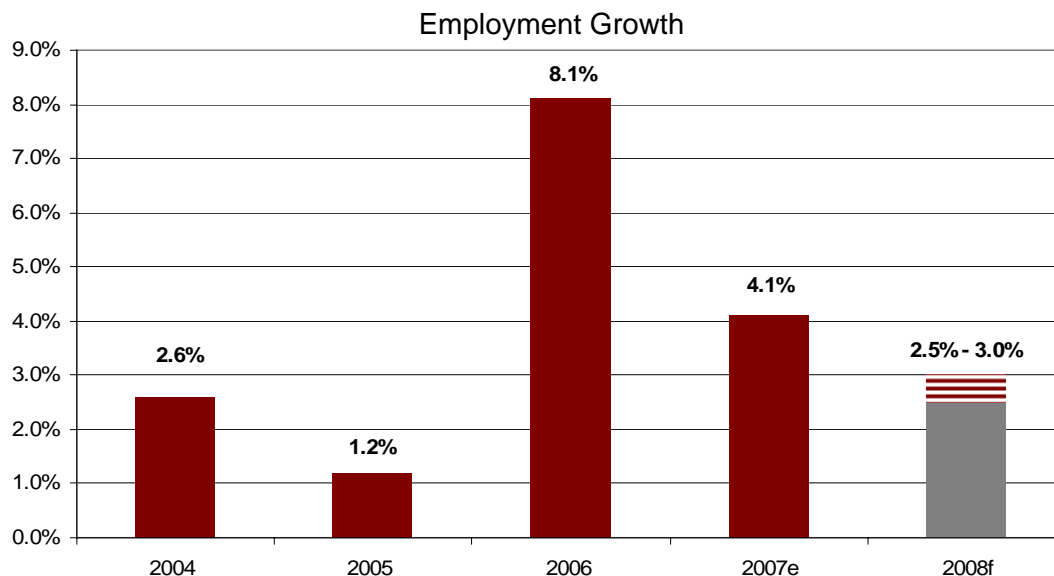
1. Will there be sufficient worker supply to meet demand?
2. How would continued depressed natural gas prices impact employment growth in Calgary?

Can workers be found? They can be, but not overnight to meet the immediate needs of employers. The labour shortage is here for a while – this is not a short-term condition as a result of a heated economy. That means that companies need to consider a variety of options to meet their needs – changing hiring practices to utilize existing populations already here but underemployed; increased focus on retention and development; technology and automation; and the use of foreign workers.

Calgary is in for the long haul and for a global competition for labour. Cities all around the world are competing for high quality, educated and skilled labour, and if we don't have a great city to attract them to, they will go to Barcelona, London, New York, or stay in India, China, Russia and Vietnam.

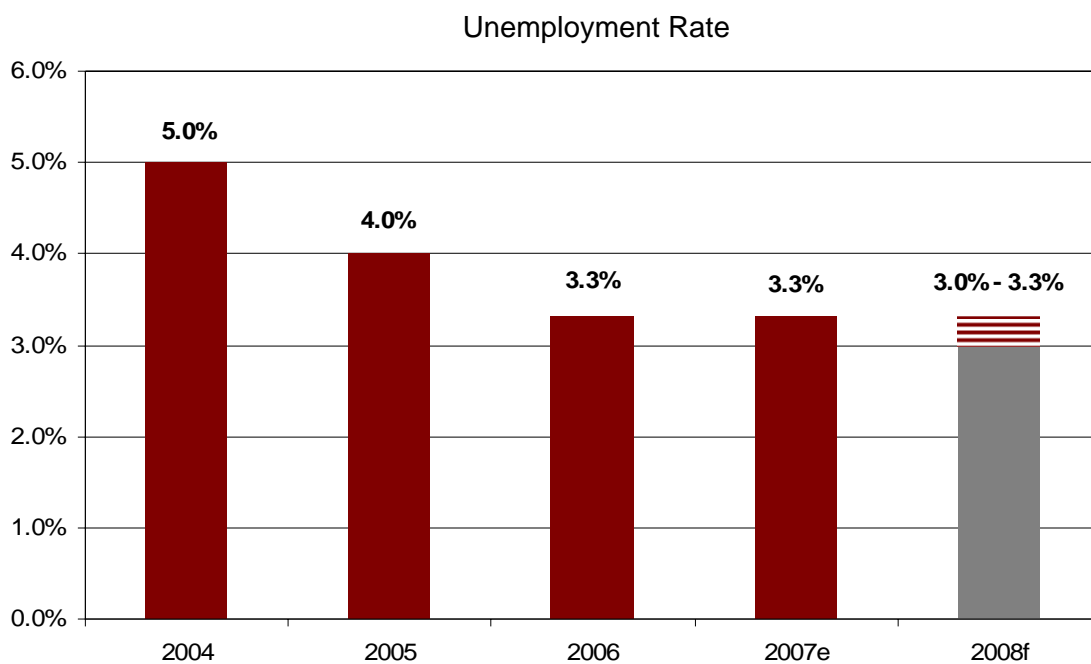
On the gas question, as natural gas represents anywhere from 60 to 80 per cent of Alberta's drilling activity, continued depressed gas prices could have a significant impact on employment in the gas companies, particularly service companies, and potentially business and financial service companies that have gas and gas service companies as clients. Forecasts are mixed but this outlook assumes that the gas prices will not get worse but may not rebound to previous highs within the outlook horizon.

Continued high demand for labour, yet uncertainty regarding labour supply and natural gas impacts, should bring employment growth in at 2.5 to 3 per cent in 2008.



Unemployment Rate

As mentioned above, labour supply is expected to remain tight, resulting in a continued low unemployment rate. Given slowing population growth, it is unlikely that the labour force will grow much more than employment unless there are significant job losses as a result of continued low natural gas prices. Therefore, the unemployment rate over 2008 is forecast at 3 to 3.3 per cent.



Source: Conference Board of Canada, CED

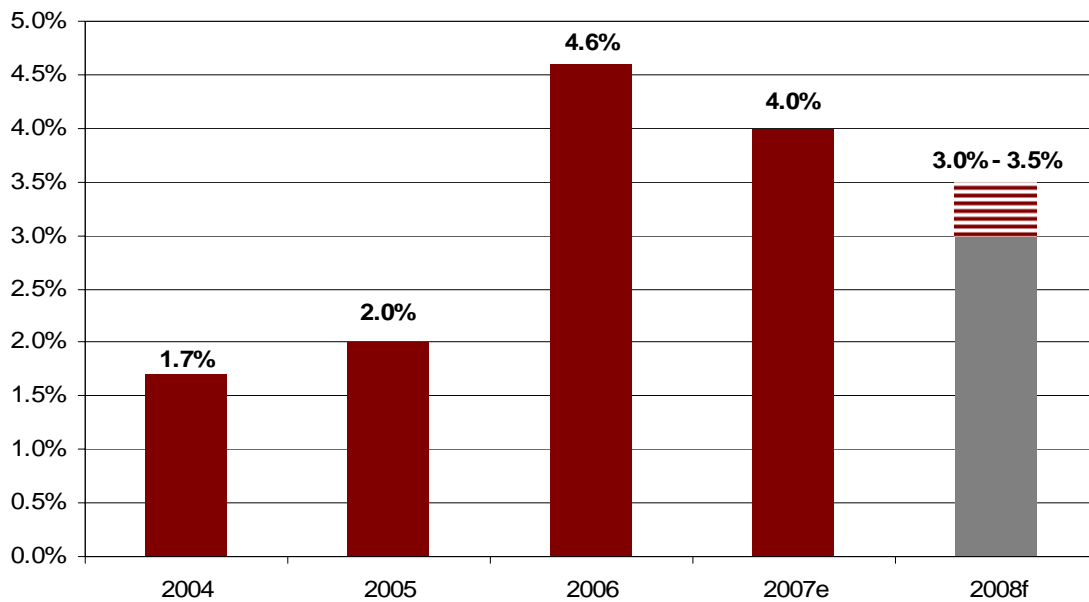
Inflation

Inflation has been a significant story in 2007, as prices grew tremendously over the 2006 and 2007 period. Calgary's year-over-year inflation rate as of July 2007 was 4.8 per cent, and 3.8 per cent year-to-date. This was a slow down from a high of 6.5 per cent year-over-year in March 2007, which was being driven by feverish activity in Calgary's housing market.

Inflation should moderate in 2008 as price escalation of the main contributor to our high inflation – housing – slows to more reasonable levels. However, Calgary's higher cost environment, particularly for housing, labour and real estate, will ultimately serve as a key dampening force on the economy over 2008.

Inflation is forecast at 3 to 3.5 per cent over 2008.

Calgary's Inflation Rate



Source: Conference Board of Canada, CED

Residential Real Estate

As a result of an overheated housing market in 2006, Calgary's housing market has been elevated to new highs in terms of prices and sales, but the intensity is cooling off and should result in a more balanced market over 2008.

All the fundamentals of a healthy housing market are in place in Calgary – continued employment growth; continued wage gains; continued net migration. Therefore demand should still exist at a respectable level. However, as of September 2007, there are a record number of listings available in Calgary.

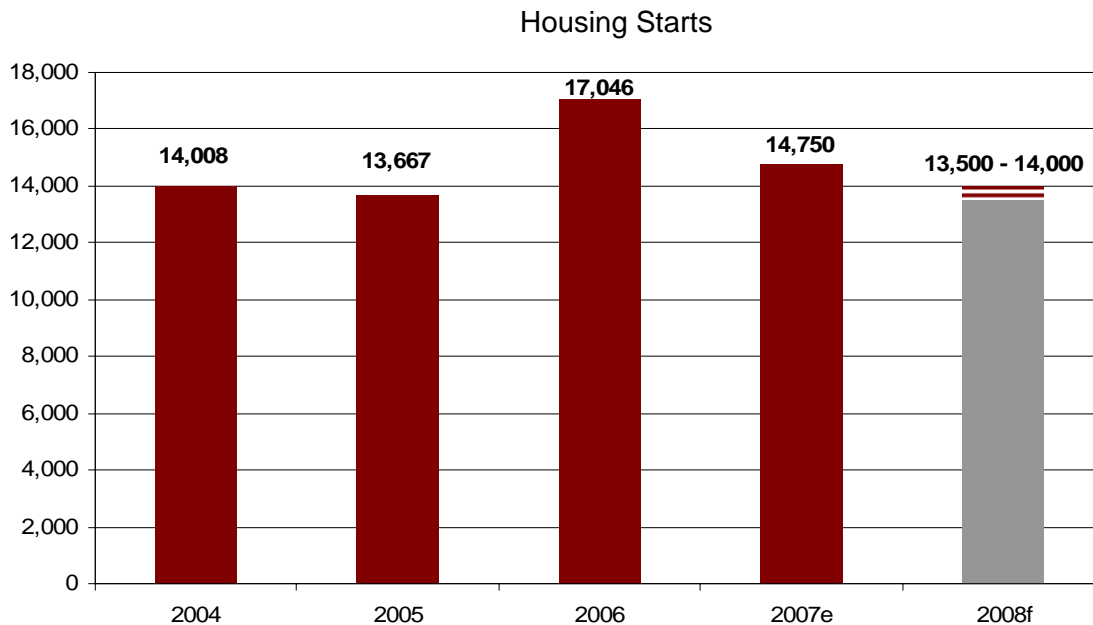
The rise in listings is expected to be one factor to put a brake on the rapid escalation in housing prices, as purchasers have more choice, with much available for immediate occupancy. This should also serve to reduce the number of housing starts for new product, as demand shifts to include the wide range of choice in the resale market.

Additionally, the rapid rise of housing prices is serving as a barrier to many households becoming homeowners. This also impacts Calgary's labour attraction activities as some recruits may find the cost of entry level housing more than they can afford, depending on where they are coming from and at what household income level they reside within.

Calgary now unfortunately boasts the second highest MLS median house price in Canada behind Vancouver. However, another ranking conducted by RBC Economics takes a more broad measure of affordability including utilities and property taxes. The RBC Affordability Index finds that a Calgary single-detached home remains more affordable than Vancouver, Toronto and Montreal, as a result of lower property taxes, utilities and higher incomes. Regardless, the cost of entry into the Calgary housing market is now at a very high level.

Compounding the affordability problem is uncertainty around mortgage rates in 2008, and whether there will be continued fall out from the U.S. credit markets. Both may have the downside risk of making borrowing costs much higher for homeowners making home purchases and home renovations less likely.

It is unlikely that year-over-year housing prices will drop over 2008, barring any significant economic impact, and reports of such in the media are unwarranted. Housing market fundamentals remain healthy and in place. Therefore, housing starts are forecast to be between 13,500 – 14,000 in 2008.



Source: Conference Board of Canada, CED

Calgary's rental housing market appears to have no relief in sight. With vacancy essentially at 0 per cent according to CMHC's Rental Market Statistics Spring 2007, choice and availability of rental housing are extremely tight. The tight supply and intense demand are driving rents up, with the average two-bedroom apartment renting for \$1,037 per month according to CMHC.

With escalating housing prices, compounded with a labour shortage, a balanced rental market is a necessity. Calgary's rental housing market is unable to meet this need. With continued condo conversion, the pool of more affordable rental product in Calgary continues to shrink. Calgary can ill-afford this trend at the present time.

Non-Residential Real Estate

Non-residential construction is highly active in Calgary as of August 2007. The total value of building permits for non-residential projects was over \$2 billion, \$700 million higher than the same time last year.

Major projects in Calgary include The Bow, Centennial Place, Jamieson Place, Bankers Court, the South Calgary Hospital, expansions at the Calgary International Airport, and numerous transportation infrastructure projects.

The Calgary office market is still currently very tight, with an overall vacancy rate of 3.2 per cent as of Q3 2007, the lowest in Canada, according to CBRE. Demand has slowed from its pinnacle in 2006, as some demand has been met with the 1.5 million square feet of space delivered in 2007 so far, combined with suburban migration and rising rental rates deterring acquisition of new space.

Downtown remains the hotspot of activity in Calgary's office market construction in terms of square feet under construction, at 5.2 million square feet and vacancy of 3.1 per cent. The suburban market has rallied under the tight conditions and is now a very attractive alternative for many companies looking for a more immediate response to their space needs, less expensive space and access to more plentiful parking. At 3.1 million square feet of space under construction and a vacancy rate of 3.6 per cent, the suburban market is very active.

2008 should represent the continuation of a gradual trend toward a more balanced market over the next three to five years. With 8.3 million square feet of office space under construction, 2009 looks to be the year when greater movement is made towards equilibrium. 2008 does not appear to bring too much relief with it for downtown, but new suburban product should become available.

Overall, Calgary is still far from a balanced market, as there is still demand for space as firms continue to grow. Core fundamentals are in place for continued demand, such as elevated oil prices. Calgary's growing dominance as a financial centre is bolstering demand for space. However, as already discussed, uncertainties exist which pose a risk to the office market demand, including continued soft natural gas prices which may result in space becoming available as gas companies and related entities rationalize their real estate needs, and potential for decreased activity should the royalty regime alter corporate plans.

To articulate the magnitude of the Calgary office market imbalance, if over two million square feet of office space were to come on stream immediately and remain vacant, Calgary's office market would still be considered balanced, at about eight per cent vacancy. That is about two Petro Canada West towers – the tall one – of space vacant.

Calgary's industrial market is also at its max. Vacancy for industrial product is one per cent as of Q3 2007, according to CBRE, with new product acquired as soon as it is complete. Observations are that numerous obsolete industrial facilities are being used in the absence of other new product.

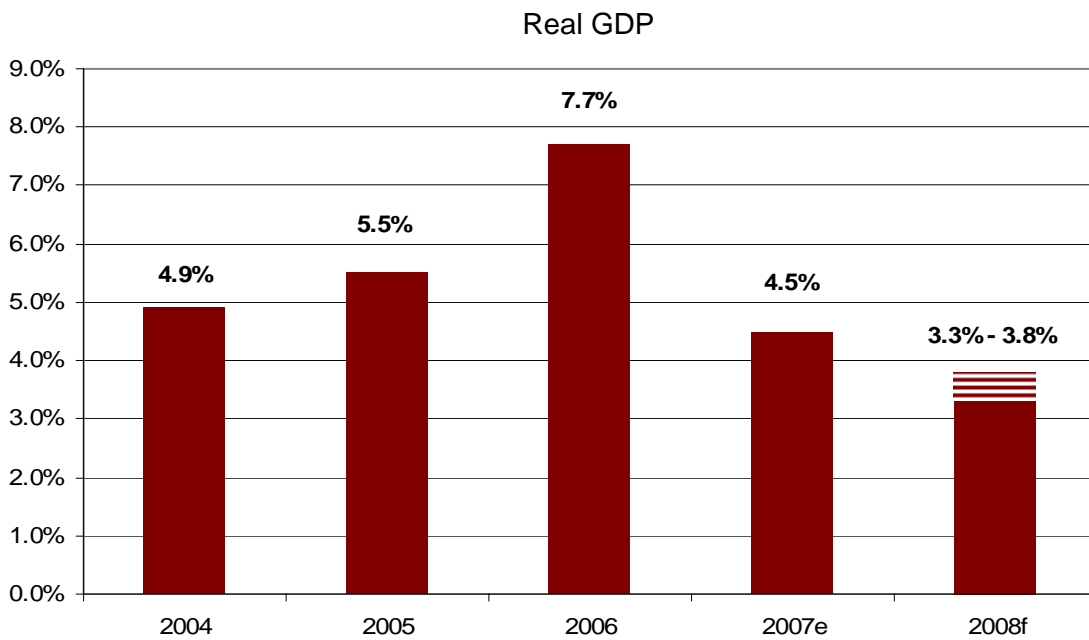
Demand for Calgary's industrial real estate is coming predominantly from distribution, warehousing, manufacturing and oil and gas services. Calgary continues to grow as a distribution centre, and niche manufacturing still performs in response to domestic and global demand, despite poor trade conditions. Current land pricing for industrial is also encouraging more innovative, dense and intensified uses that will serve to support additional sector activity in Calgary beyond current uses.

Real GDP

The picture for Calgary's 2008 overall economic activity isn't substantially different than that of this year: expect the Calgary economy to continue its slowing trend as a result of over-capacity (i.e., shortage) in key areas like labour and real estate.

The past 10 years have been so strong, slowly driving our growth to unsustainable levels, which peaked in 2006, it is only natural that we continue a downward trend off 2006 to levels that are more reflective of trend and capacity. Continued slower growth is a necessary and welcome respite from very high levels of activity that put strain on our resources, and inflated prices to levels which we are still dealing with today.

Given the slowing trend of Calgary's economy, uncertainty around natural gas prices, and an unclear picture of how the U.S. economy will perform in 2008, Calgary's real GDP growth is forecast at 3.3 to 3.8 per cent in 2008.



Source: Conference Board of Canada, CED

Sector Assessment

- Energy* – Continued high oil prices should provide a lift to the oil patch and support continued drilling and oil sands project investments over 2008. The oil side of the sector should remain strong for 2008, as a result of escalating prices, and would result in continued hiring and investments in new projects. Soft natural gas prices in 2007 and perhaps into 2008 create uncertainty as to how the gas side of the sector will perform in 2008. Gas well completion is down nearly 20 per cent over last year. Depending on their balance sheet, some gas companies may be able to weather the low prices, but service companies and employees of such are likely to be negatively impacted should prices remain depressed through 2008.
- Manufacturing* – A persistent high Canadian dollar, increasing wage costs, tight labour markets, and expensive and limited real estate are creating, unfortunately, a perfect storm for manufacturers. Some manufacturers already have or are looking to move some of their operations to lower cost jurisdictions. Continuation of the perfect storm may serve to hollow out some of the manufacturing activity in Calgary. However, Calgary is home to a core group of very niche manufacturers who are doing amazing things in the areas of furniture, metal fabrication, and food despite challenging conditions.
- Transportation and Logistics* – This sector has driven a significant amount of economic and land development activity in Calgary over the past few years. Calgary is an extremely attractive location for logistics and distribution, and is serviced by world class companies and infrastructure. The sector should continue to be active, however rising land costs for this land-intensive activity could pose a barrier to investment and expansion. As a result, expect some of this activity to happen outside of the core or traditional areas of distribution facilities, and into regional locations, or to result in intensified uses on site.
- Financial Services* – The diversity of financial activity that continues to grow in Calgary is highly reflective of our importance as a global financial centre. Capital flows to support the oil sands projects continue to be immense. There may be some impact to local financial markets if the U.S. conditions worsen, but so far the tightening of credit has not been significant. Capital investors and entrepreneurs eagerly await Minister Horner's response to the Value Added and Technology Commercialization Task Force's recommendations, as they have significant opportunities for broadening Calgary's investment milieu. Assuming stabilization in the U.S., Calgary's financial services sector should be on track for a strong performance in 2008.

- *Professional Services* – There probably isn't a professional service firm in Calgary that isn't short staffed and full to the brim with projects. Engineering, law, accounting and management consulting firms all appear to be at full steam. Employment and firm growth in this sector has led the economy on average for the past 10 years, and represents a solid component of Calgary's workforce. With a slightly slower economy in 2008, yet with tight labour markets, activity in the professional services sector should remain brisk. The work opportunities in Calgary are attracting the attention of international consulting firms looking to gain entry into the market, increasing the level of competition within the sector. The one downside risk to the sector is depressed gas prices, which if persistent, may cut back on some of the design and consulting work associated with drilling and exploration work.
- *Creative Industries* – Calgary continues to grow as a creative centre in a variety of perspectives. Traditional arts and culture are strong, and Calgary's new media and digital design work is growing in prominence. ACAD is launching *Stirring Culture 2*, which should continue to engage Calgarians in the spirit of culture, city vitality and creativity. Calgary's place as an international location for film is once again in the spotlight with the release of *The Assassination of Jesse James by the Coward Robert Ford*, which was filmed in Calgary and environs in 2005. Several of Calgary's film talent have recently been awarded Emmy's for their work on projects such as *Broken Trail* and *Bury My Heart At Wounded Knee*. However, a higher Canadian dollar does negatively impact film activity, so hopes in the industry are for moderation to the high dollar. Overall, the creative industry sector seems poised for continued growth in 2008 given some of the great work that is being done locally and globally.
- *Information and Communication Technology* – This sector is poised for growth. It is likely that the Province will enact some means of fostering more capital availability in Alberta. Add this to a city that is becoming increasingly a centre of innovation and creativity, design and research, and there are boundless opportunities. Calgary is ripe for strong growth in the areas of health and wellness, environmental technologies, as well as our proven strength in wireless and geomatics.

Calgary's Pressure Points

The 2007 Calgary Economic Forecast included three pressure points on the economy: *labour shortage*; *office space shortage*; and *affordable housing shortage*. The picture is essentially unchanged for the 2008 forecast, as these three pressure points are still going concerns with little significant movement or resolution over the past 12 months. They will continue to exert a brake on the economy, and continue to challenge Calgarians and Calgary businesses.

All of the pressure points add up to one outcome – inflation. The average Calgarian, and the average Calgary business, is struggling under a higher cost environment. Whether it be for a house, office space, or workers, it is all costing more. And while inflation is often a signal of intense economic activity, it is dangerous at high and prolonged levels. Calgary simply can't afford it – literally and figuratively.

We need to create some slack in the economy so pressure on price escalation eases significantly. We need that cool down jog off the record setting sprint.

The reality is that while the pace of price escalation may slow, we are in a higher cost environment, barring any significant economic impacts. This is one of the outcomes of a fast growing urban economy, and one that is gaining prominence on the global stage. There are more people and more exciting and diverse things to do, however prices rise. Companies will need to adjust to the new reality – higher costs for real estate and for talent. Calgary's days of competing on price are over.

If we are no longer competing on cost, we will need to do a host of things. First and foremost we need to ensure utilization of our labour force to its fullest potential. We need to have all our residents working in jobs they are trained to do. We need to be full of highly educated, creative, and productive talent. We will also need to ensure that we compete on creativity, innovation and value-add. To support that, Calgary will need to be a more vibrant, dynamic city that can compete with the likes of internationally renowned top tier cities. That is what will continue to attract the top talent. To do this will take detailed planning, visionaries, integration of living, learning, working and activity, but most importantly a high degree of collaboration, coordination, and partnerships. Calgary will not be successful if we do not collectively unite to make this happen.

The housing situation is more challenging. While is a core human need, many struggle in Calgary for adequate housing. Calgary cannot afford to have its citizens and its talent without adequate housing. It will be imperative that the collective response is measured and appropriate to ensure that there are sufficient housing options necessary to support Calgary's continued labour requirements, and the overall shelter needs of Calgarians.

Risks to the Outlook

Upside

- Better than expected natural gas prices
- Resilience in the U.S. economy resulting in less of a slowdown
- Containment of the U.S. credit crisis

Downside

- Lower than expected natural gas prices
- Rapid and/or significant rise in the Canadian dollar beyond current levels
- Drop in oil prices
- Continued high inflation
- Hard landing for U.S. economy as a result of the credit crisis
- Negative reaction implication for energy sector investment as a result of a potential new Provincial royalty regime

Sources

- City of Calgary Corporate Economics
- CBRE
- Bank of Canada
- TD Economics
- CMHC
- Canadian Association of Petroleum Producers
- Conference Board of Canada
- RBC Economics
- Statistics Canada
- GLJ Petroleum Consultants
- Energy Information Administration
- Alberta Employment, Immigration and Industry
- Nickle's Daily Oil Bulletin

Contact

Adam Legge

Director, Research and Business Information
Calgary Economic Development

P: 403-221-7892

E: adam@calgaryeconomicdevelopment.com

W: www.calgaryeconomicdevelopment.com

Disclaimer

Calgary Economic Development provides this information in good faith. The organization makes no representation, warranty or condition, statutory express or implied and takes no responsibility for any errors and omissions which may be contained herein and accept no liability for any loss arising from use or reliance on this outlook.