Great Lakes-St. Lawrence Region

# Partners in Growth and Trade

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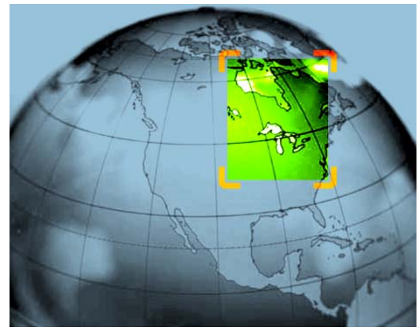


The Great Lakes-St. Lawrence region is a vital driver of North American economic output, employment and trade, accounting for nearly a third of combined Canadian and U.S. GDP, jobs and exports. Economic growth in the region is expected to accelerate for a second consecutive year in 2018, this time led by gains south of the border. While Ontario and Quebec should downshift after leading the region in 2017, most U.S. states are expected to pick up alongside cyclically-strong factory activity, stronger business investment and a heavy dose of fiscal stimulus. Still, some longer-term issues remain for the region's economy. Labour costs are in focus as the factory sector seeks to remain competitive, while demographic headwinds will be a persistent challenge. Meantime, uncertainty on the trade front is currently the biggest concern given deeply integrated cross-border activity in the region, and its impact on the North American economy.

Chart 1
**Facts and Figures**

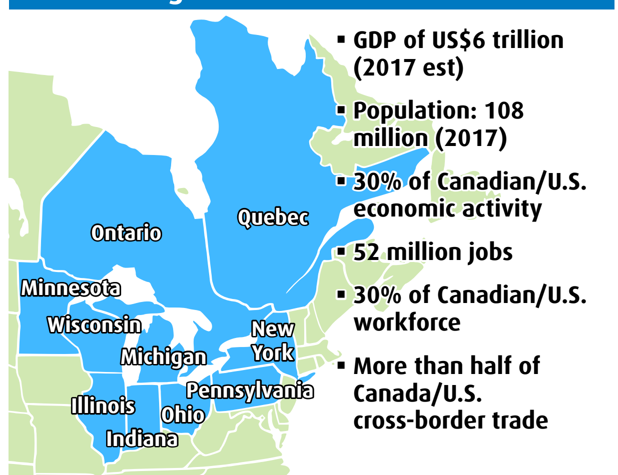
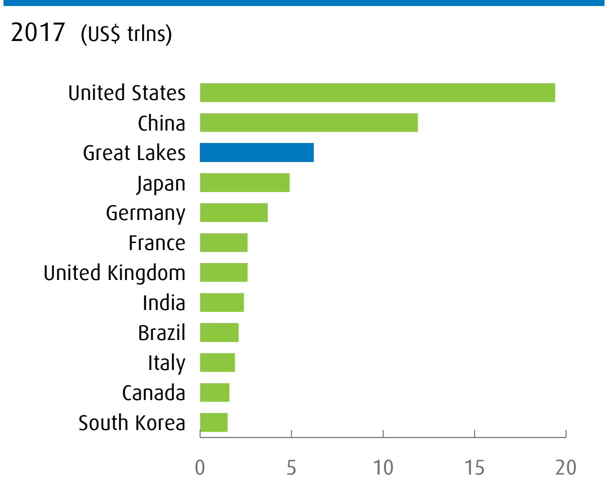



Chart 2
**Gross Domestic Product**




## Pulling the Weight of a Nation

The Great Lakes-St. Lawrence region boasts a massive geographic footprint, and is a major driver of the North American economy. With economic output estimated at US$6 trillion in 2017, the region accounts for 30% of combined Canadian and U.S. economic activity and employment. The region's output ranks ahead of Japan, Germany, the U.K. and France, and it would rank as the third largest economy in the world if it were a country, behind only the U.S. and China—notably, the region overtook Japan a few years ago. Quite simply, the economic importance of the region can't be overstated.

## Economic Update—Growth Remains Firm

The Great Lakes-St. Lawrence economy is poised to accelerate in 2018, building on the momentum seen last year. Real GDP expanded at an estimated 2.0% pace in 2017, up from 1.6% on average in the prior two years. Growth in Ontario and Quebec was a big driver, with each strengthening to around 3%, while most states in the region also picked up—look for the latter to do most of the lifting this year as the provinces cool.

The **U.S. economy** is expected to accelerate this year, growing at a 2.8% clip in 2018, up from 2.3% last year. In contrast, **Canada** looks to soften to 2.0% from 3.0% in 2017, as the economy settles back toward potential after a temporary surge. Ontario's latest three-year run of near-3% growth was the strongest in 15 years, while Quebec's (3.1%) was the strongest since 2000 last year—both are forecast to ease to the low-2% range this year. In contrast, most U.S. states in the region are expected to build on the momentum seen in 2017, which should help nudge up overall growth.

North American **car and truck production** edged down for the first time this cycle in 2017, while U.S. sales have levelled off (though remaining strong in Canada). This sector is largely running at capacity, thereby limiting growth, although the broader **factory sector** on the U.S. side of the region is enjoying cyclically-strong conditions. U.S. business **capital spending** has been a major contributor to stronger national growth, and the Great Lakes manufacturing base has benefitted. Notably, retrenchments in energy and agriculture spending have subsided, benefiting machinery and equipment producers in the region. Indeed, **business surveys** covering the Chicago, Milwaukee and New York regions entered 2018 at cycle (or longer) highs, with new orders strong.

Meantime, significant **fiscal stimulus** will hit the U.S. economy, with the largest tax cuts in three decades expected to add 0.4 ppts to national GDP growth this year. While some of this boost will be offset by more aggressive **Federal Reserve tightening** than we would likely otherwise see (expectations are for four rate hikes this year), the net impact is still positive. In Canada, stimulus continues to flow through the federal infrastructure program (though this year's budget pushed some spending out to 2019) and provincial spending, particularly in Ontario and Quebec. Monetary policy will likely remain cautious, albeit with a bias to tighten.

The **housing market** remains sturdy and stable across the U.S. Midwest. Still-decent affordability, healthy job growth and some easing in credit conditions should support continued gains in the sector. Importantly, U.S. housing affordability remains attractive enough that home prices should continue to rise even as the Federal Reserve continues to raise interest rates this year. Meantime, the Southern Ontario market is adjusting to a number of policy changes introduced over the past year—a 15% tax on non-resident buyers; stricter federal mortgage qualification rules; and Bank of Canada rate hikes. These changes have broken the speculative psychology that was beginning to run rampant through 2016 and early-2017. Markets in Ottawa and Montreal, however, have seen momentum improve in the past year.

**Labour market** fundamentals remain solid, with plunging jobless rates in Ontario and Quebec helping pull the average rate in the region below 5% last year. This is supporting **consumer confidence**, particularly on the U.S. side of the border.

## North America's Employment Engine

The region plays an extremely important role in the North American labour market, supporting roughly 55 million jobs in 2017. That is 30% of the combined Canadian and U.S. workforce. Employment growth

Chart 3
**Growth Outlook Improves**

(y/y % chng)

**Real GDP**

| | 16 | 17 | 18 | 19 |
|---|---|---|---|---|
| Canada | 1.4 | 3.0 | 2.0 | 1.8 |
| U.S. | 1.5 | 2.3 | 2.8 | 2.5 |
| Great Lakes Region | 1.3 | 2.0 | 2.2 | 1.9 |

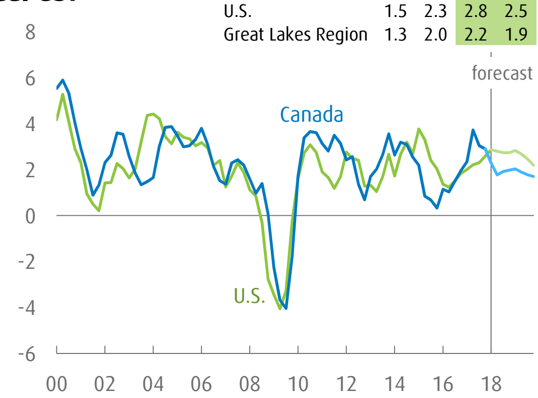



Chart 4
**Ontario Home Prices Correcting**

Ontario (C$ 000s)

**Average House Price**

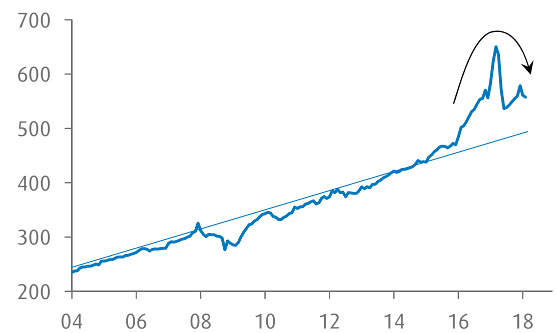
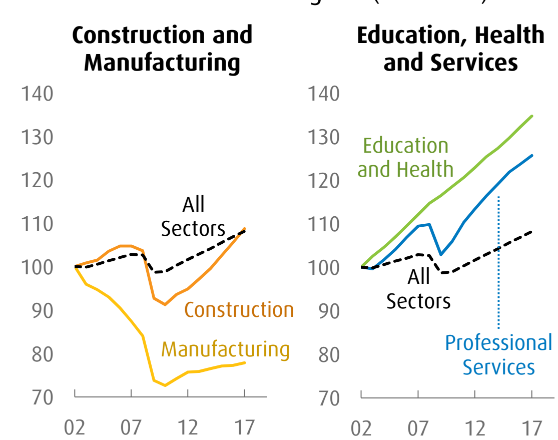



Chart 5
**Service Sector Job Driver**

Great Lakes-St. Lawrence Region (2002 = 100)



was a healthy 0.9% last year, down slightly from 2016 as strong growth in Ontario and Quebec was dampened by softness in Illinois and New York. Still, job gains overall pulled the average unemployment rate in the region down to 4.6% in 2017.

The region's highly diverse economy drives employment across a wide range of manufacturing and service industries. While traditionally considered the manufacturing heartland, factory-sector employment now makes up just over 10% of the region's workforce, down from about 15% a decade ago. Still, on a relative basis, manufacturing does carry a disproportionately high weight versus North America as a whole, where factory jobs account for less than 9% of the total. Part of the decreased reliance on manufacturing reflects capacity lost during the Great Recession, but also the gradual long-term diversification of the region's economy. While manufacturing employment is down more than 10% from pre-recession levels, education & healthcare (+20%) and professional services (+15%) have helped make up the shortfall. In fact, education, healthcare and professional services alone have added 2.4 million jobs over the last 10 years, outweighing the 675k manufacturing job losses.

Elsewhere, retail & wholesale trade, government and professional services also now carry double-digit employment shares within the region. Indeed, while manufacturing still boasts a comparatively high employment share, education & health and finance & real estate also outweigh the North American average. Notably, **construction employment has now recovered all the jobs lost during the financial crisis**.

Labour costs remain one challenge for the region, with an increasing share of new production, particularly in the auto sector, directed toward the Southeastern United States and Mexico. Indeed, while Mexican auto production has nearly doubled over the past decade, U.S. output is little-changed (through the cycle), and Canadian output is down 30% from the 1999 peak. Right-to-work laws in Indiana, Michigan and Wisconsin suggest that the push to control labour costs is moving north, but the broader challenge is to ensure that productivity growth remains in line with labour costs.

## Demographics a Long-Term Challenge

Population growth encouragingly improved in the region for a second straight year in 2017, but to a still-slow 0.4% pace, well below the North American average. While international and interprovincial inflows have supported Ontario—fastest population growth in 15 years at 1.6%—much of the region remains well below the 1% mark. Michigan, for example, was hard-hit by the recession in the auto sector, and saw net declines during the 2008-to-2011 period—that trend has since reversed. Meantime, broad-based aging

Chart 6
**Diverse Employment Base**

Great Lakes-St. Lawrence Region — 2017
(% of Great Lakes Region employment)

**Employment by Industry**

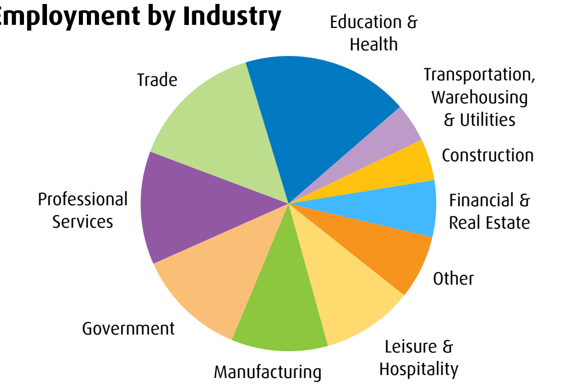



Chart 7
**Manufacturing Heartland—Still**

Great Lakes-St. Lawrence Region — 2017
(North American average = 100)

**Relative Industry Concentration**

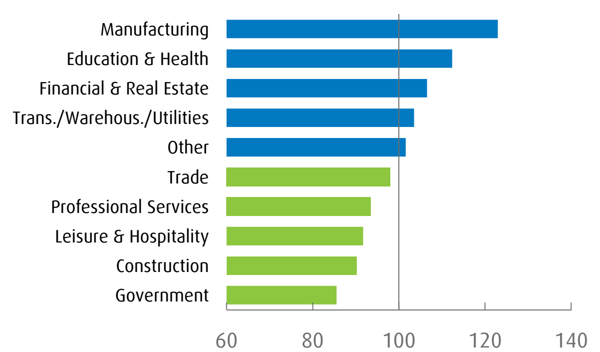
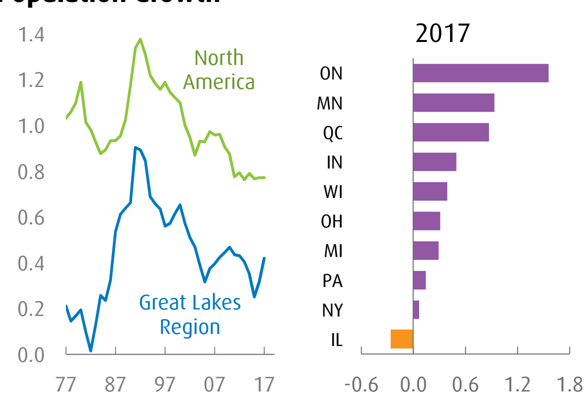



Chart 8
**Demographic Relief, For Now**

(y/y % chng)

**Population Growth**



continues to slow labour force growth in the region, with the 2017 growth rate still close to the weakest since 1986, in turn dragging down potential economic growth.

Meantime, the Great Lakes states have been grappling with net outward migration to other states. Illinois lost a net 115,000 people to other states in 2017 (a record), which contributed to a fourth-straight annual decline in that state's population—the first time since WWII. The broader region continues to see outflows to the South and West with stronger economic growth and employment prospects. Ontario should see net provincial flows strengthen further this year—and Quebec should see outflows lessen—as relative economic prospects remain strong versus the rest of Canada.

## Cross-Border Trade in Focus

Trade remains a pressing issue given the policy priorities of the new U.S. Administration. Note that while the U.S. ran a $376 billion goods trade deficit with China in 2017, the gap was a much smaller $76 billion with Mexico, and just $23 billion with Canada (and a surplus on goods and services). This strongly suggests that **the U.S. trade imbalance is not an issue best resolved at the Canadian border**. Meantime, trade within the Great Lakes region is relatively balanced, with Ontario and Quebec running a modest surplus with the U.S. states. The bulk of that surplus is with Michigan, while the provinces run small deficits with Illinois, Wisconsin, Indiana and Ohio.

The Great Lakes-St. Lawrence region is also a **critically important North American trading hub**. The region's states were the origin of roughly a quarter of total U.S. merchandise exports in 2017, while Ontario and Quebec accounted for 60% of Canadian shipments. Transportation equipment and machinery are the major drivers, but agricultural and food products, metals and chemicals contribute to a diverse range of exports. The region's cross-border trade linkages are also immensely important. For example, the Great Lakes-St. Lawrence states are Ontario and Quebec's largest trading partner, accounting for $216 billion of total trade in 2017. That represents roughly a third of total international trade among the two provinces. Also, it's notable that fully 36 U.S. states count Canada as their largest export market, including all in the Great Lakes-St. Lawrence region. The **North American Free Trade Agreement** has certainly helped to spur the trade relationship in the region, and recent policy rhetoric and the ongoing uncertainty surrounding NAFTA are concerning given how integrated the supply chain is.

## Assessing the NAFTA Impact[1]

A negative shock on the trade front, such as NAFTA breakup, wouldn't be absorbed equally among the provinces or states. To be

Chart 9
**U.S. Trade Deficit: Not Made in Canada**

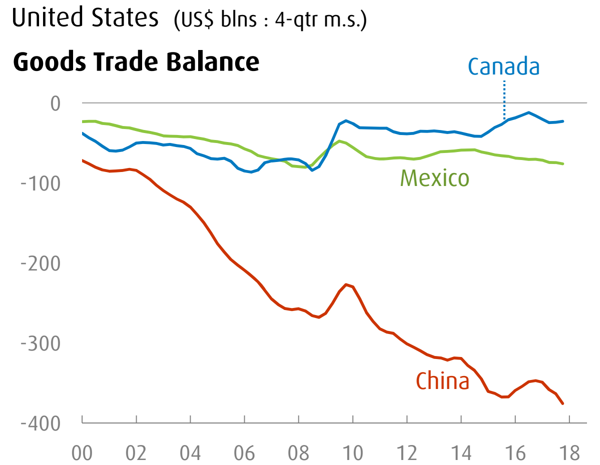
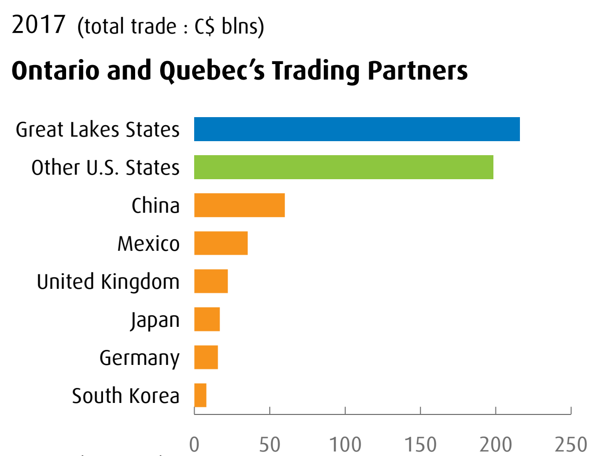
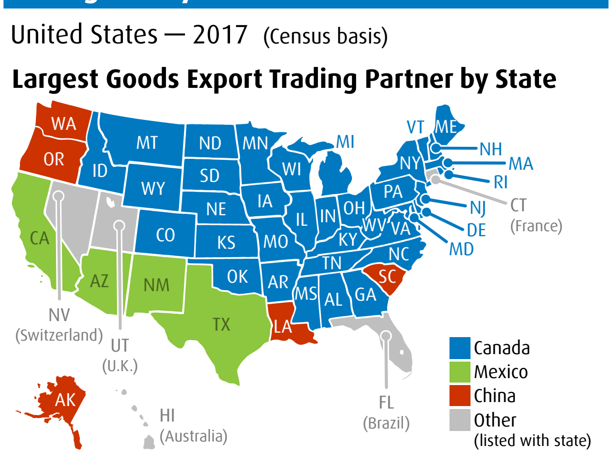



Chart 10
**Strong Cross-Border Ties**




Source: Industry Canada

Chart 11
**Selling Mostly to Canada**




Sources: BMO Economics, U.S. Department of Commerce sure, there are many moving parts when considering the impact (i.e., currency, price changes, trade substitution with other countries or interprovincially), but a rough assessment shows that the Great Lakes region would be relatively hard hit. From a **Canadian perspective**, the simplest way to assess the potential impact is to look at each province's reliance on, and exposure to, U.S. exports.

**Ontario** looks like the province most at risk from a disruption to NAFTA, since its economy is arguably the most integrated with the U.S. through well-established supply chains. Indeed, Ontario's export sector is one of the most highly-levered to the U.S., with nearly 83% of shipments going south of the border in 2016. Because the province is relatively export-intensive to begin with, that leaves 26% of GDP tied to U.S. exports. And, the bulk of those exports (80% of the U.S. total) are in industries that we deem vulnerable to trade negotiations, including a whopping $79 bln of transportation equipment exports. Indeed, the tightly-integrated auto sector is probably the key area of concern for the province, especially when considering activity in other areas that feed off the sector.

**Quebec** looks less vulnerable than Ontario. While roughly 76% of the province's U.S. exports are deemed high risk (similar to Ontario), that weighs in at only around 11% of GDP (around half of Ontario), largely because of a more diverse export base, to regions like Europe. That said, Quebec would certainly feel an impact. Aerospace and other non-auto transportation goods account for 15% of total exports, while Quebec boasts the largest number of dairy farms in Canada and $8.5 bln of food-product exports (also largest in Canada)—supply management is another area targeted by the U.S. Administration, but could be unaffected in a full NAFTA breakdown (since dairy exports are minimal).

The **U.S. regional impact** of a NAFTA termination would be spread across many states, but those near the borders, and with high exposure to industries with tightly-integrated supply chains, would face the biggest fallout—the Great Lakes states fit this description. That said, the overall impact in even the most exposed states remains much smaller than for the Canadian provinces, given Canada's status as the much smaller and more open economy. In fact, the province least exposed to NAFTA (British Columbia) carries an export share of GDP that is still larger than the most exposed U.S. state (Michigan).

Still, some states would certainly feel a significant impact from a trade disruption. **Michigan** looks the most at risk thanks to a tightly-integrated auto-sector supply chain. Exports to Canada and Mexico accounted for 7.3% of GDP in 2016, the highest in America. In fact, three other Great Lakes states—Indiana, Ohio and Illinois—rank in the top quartile of U.S. states by this measure, and only New York sits below the 50-state median, highlighting the importance of cross-border trade in the region.

**The Bottom Line:** The Great Lakes-St. Lawrence region is a key contributor to North American economic output, employment and trade, and the current economic environment remains positive for the region. That said, cross-border trade is clearly the key issue at the moment given how integrated these regional economies have become, and businesses are eagerly waiting an outcome on the NAFTA file.

[1] This section in mostly an excerpt from "The Day After NAFTA – Economic Impact Analysis", published by BMO Economics and available at https://economics.bmocapitalmarkets.com/.

## Regional Economic Indicators

| | Canada | U.S. | G. Lakes-St. Lawr. | Ontario | Quebec | Illinois | Indiana | Mich. | Minn. | N.Y. | Ohio | Penn. | Wisc. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP (% chng, US$) | | | | | | | | | | | | | |
| 2016 | 1.4 | 1.5 | **1.3** | 2.6 | 1.4 | 1.0 | 2.5 | 2.2 | 2.1 | 0.4 | 1.1 | 0.6 | 1.3 |
| 2017e | 3.0 | 2.3 | **2.0** | 2.8 | 3.1 | 1.1 | 2.0 | 3.2 | 2.6 | 1.0 | 2.2 | 1.8 | 1.7 |
| 2018f | 2.0 | 2.8 | **2.2** | 2.0 | 2.2 | 2.1 | 2.6 | 3.0 | 2.5 | 1.9 | 2.5 | 2.1 | 2.4 |
| Employment (% chng) | | | | | | | | | | | | | |
| 2015 | 0.9 | 1.7 | **1.3** | 0.7 | 1.0 | 1.2 | 2.5 | 1.9 | 1.4 | 1.7 | 0.9 | 1.0 | 1.3 |
| 2016 | 0.7 | 1.7 | **1.1** | 1.1 | 0.9 | 0.8 | 2.3 | 2.3 | 1.1 | 0.7 | 0.7 | 0.4 | 1.7 |
| 2017 | 1.9 | 1.3 | **0.9** | 1.8 | 2.2 | 0.0 | 0.7 | 1.3 | 1.3 | 0.6 | 0.7 | 0.1 | 1.4 |
| Unemployment Rate (%) [1] | | | | | | | | | | | | | |
| 2015 | 6.9 | 5.3 | **5.4** | 6.7 | 7.7 | 6.0 | 4.8 | 5.4 | 3.7 | 5.3 | 4.9 | 5.3 | 4.5 |
| 2016 | 7.0 | 4.9 | **5.2** | 6.6 | 7.0 | 5.8 | 4.4 | 5.0 | 3.9 | 4.9 | 5.1 | 5.4 | 4.0 |
| 2017 | 6.3 | 4.4 | **4.6** | 6.0 | 6.0 | 5.0 | 3.6 | 4.6 | 3.5 | 4.7 | 5.0 | 4.9 | 3.3 |
| Population (% chng) | | | | | | | | | | | | | |
| 2015 | 0.9 | 0.8 | **0.2** | 0.8 | 0.6 | -0.2 | 0.3 | 0.0 | 0.6 | 0.2 | 0.1 | 0.0 | 0.1 |
| 2016 | 1.1 | 0.7 | **0.3** | 1.3 | 0.7 | -0.2 | 0.4 | 0.2 | 0.8 | 0.1 | 0.1 | 0.0 | 0.2 |
| 2017 | 1.2 | 0.7 | **0.4** | 1.6 | 0.9 | -0.3 | 0.5 | 0.3 | 0.9 | 0.1 | 0.3 | 0.1 | 0.4 |
| Exports (% chng, US$) | | | | | | | | | | | | | |
| 2015 | -0.8 | -7.5 | **8.4** | 10.7 | 7.4 | -7.0 | -5.1 | -4.6 | -6.5 | -6.9 | -2.8 | -2.0 | -4.2 |
| 2016 | -0.7 | -3.6 | **1.2** | 4.3 | -1.9 | -5.7 | 3.0 | 2.4 | -3.9 | -7.1 | -3.1 | -7.2 | -6.4 |
| 2017 | 5.4 | 6.5 | **1.5** | -2.8 | 5.9 | 8.5 | 9.0 | 9.8 | 7.5 | 1.2 | 1.9 | 5.7 | 6.1 |

[1] Great Lakes-St. Lawrence = 10-region average  e = BMO Capital Markets estimate