Great Lakes-St. Lawrence Region

Driving North American Growth and Trade

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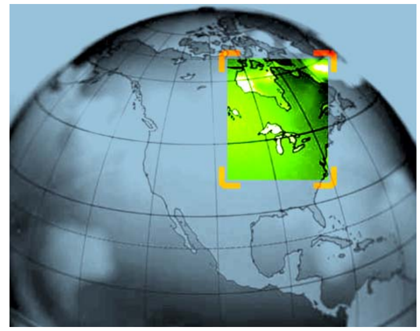


The Great Lakes-St. Lawrence region is a vital driver of North American economic output, employment and trade, accounting for nearly a third of combined Canadian and U.S. output, jobs and exports. Economic growth in the region is expected to accelerate in 2017 as Ontario and Quebec post another year of strong activity, while states in the region pick up alongside a broader increase in U.S. momentum. Overall, ongoing expansions in housing and consumer spending are supportive, with the currency impact adding a modest boost on the Canadian side of the border. 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. At the same time, uncertainty on the trade front is an area of concern given the deeply integrated nature of cross-border activity in the region, and its impact on the overall North American economy.

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 2016, 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 Improving

The Great Lakes-St. Lawrence economy is poised to accelerate in 2017, after posting sturdy growth in recent years. Real GDP in the region expanded at an expected 1.6% pace in 2016, roughly in-line with each of the prior two years. Growth in Ontario and Quebec has strengthened above 2%, while the U.S. states in the region have lagged—but the latter look to do some catching up this year.

The **U.S. economy** is expected to accelerate this year, growing at a 2.3% clip in 2017, up from a 1.6% pace last year. Canada is expected to outperform slightly after lagging in recent years, growing at 2.5% as Central Canada remains strong, while the oil-producing provinces emerge from recession. Ontario is seeing sturdy growth around the 2.6% mark, topping the national average on a sustained basis for the first time in more than a decade, while Quebec is piercing through the 2% threshold—both well above-potential economic growth.

Chart 1

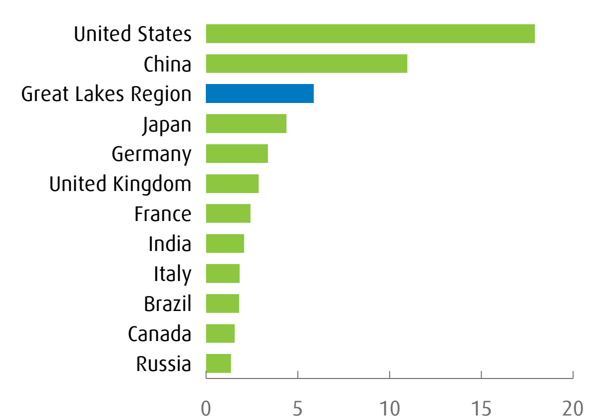
Facts and Figures

- **GDP of US$6 trillion (2016 est)**
- **Population: 107 million (2015)**
- **30% of Canadian/U.S. economic activity**
- **51 million jobs**
- **30% of Canadian/U.S. workforce**
- **More than half of Canada/U.S. cross-border trade**

Chart 2

Gross Domestic Product

2015 (US$ trlns)



North American **car and truck production** hit a 14-year high in 2016, while sales remain buoyant (especially in Canada), supporting activity through the supply chain. However, unlike on the Canadian side of the border, the strong U.S. dollar has been a headwind to U.S. **export activity**, and contributed to below-average GDP growth in the Great Lakes states in the three years through 2016. Some firms in the factory sector have also been clipped by **capital spending** retrenchments in energy and agriculture, but the tide appears to be turning modestly on both fronts.

The **housing market** continues to recover across the U.S. Midwest. Still-attractive 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 will continue to rise even as the Federal Reserve raises interest rates more aggressively this year and in 2018. Meantime, Toronto's market continues to set record price levels and conditions have strengthened across Southwestern Ontario and in areas such as Ottawa and Montreal.

For **consumers** in the region, the steep decline in oil prices has helped, while jobless rates fell in most jurisdictions in the Great Lakes region last year. Indeed, **hiring continues** across the region, led by sturdy gains in the service sector, while some states are seeing cyclical rebounds in construction and manufacturing—sectors that are still below peak levels.

Adding it all up, the Great Lakes region continues to churn out sturdy economic growth. While some headwinds have kept the pace of growth in check south of the border, most signs point to a stronger expansion in 2017.

A Diverse Employment Engine for North America

The region plays an extremely important role in the North American labour market, supporting roughly 51 million jobs in 2016. That is 30% of the combined Canadian and U.S. workforce. Employment growth was a healthy 0.8% last year, down slightly from 2015 as slowdowns in Illinois and New York weighed. Still, job gains overall pulled the regional jobless rate down to 5.0% in early 2017, a cycle low.

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 in the region 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.

Chart 3
Growth Outlook Improves

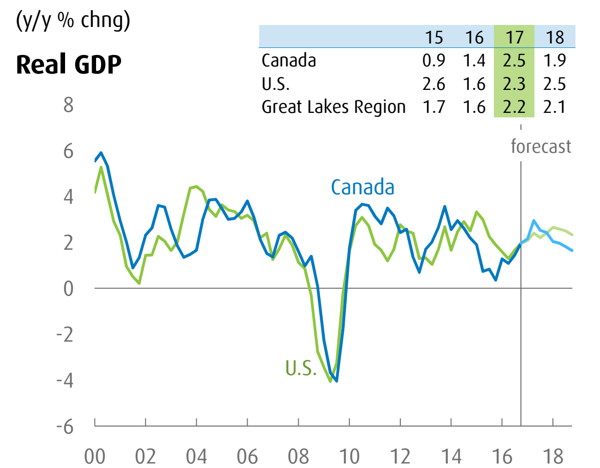


Chart 4
Service Sector Steadily Hiring

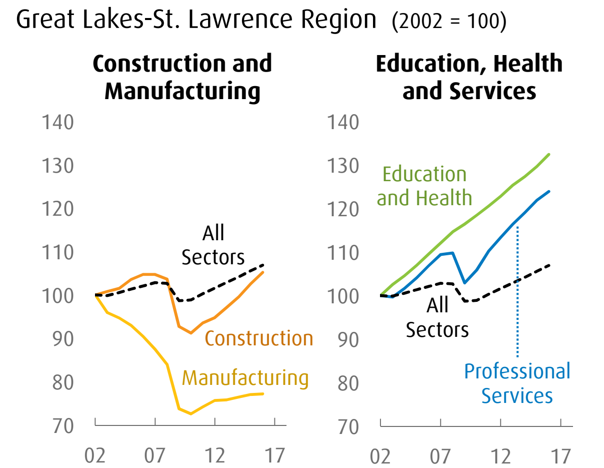
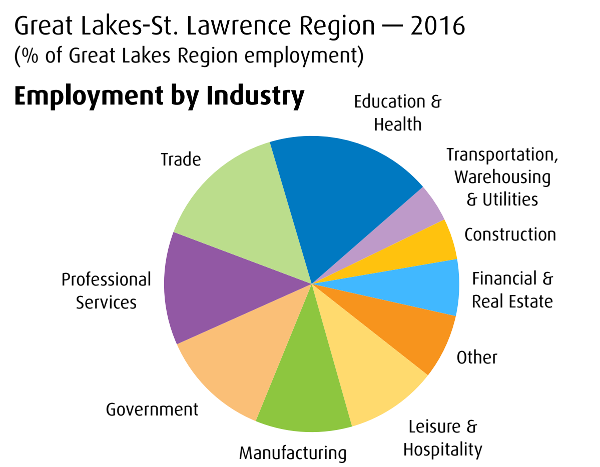


Chart 5
More than Manufacturing



While manufacturing employment is down 15% from pre-recession levels, education & healthcare (+21%) and professional services (+16%) have helped make up the shortfall. In fact, education, healthcare and professional services alone have added 2.5 million jobs over the last 10 years, dwarfing the near-1 million 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. Construction employment is still recovering after a deep U.S. recession.

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), while Canadian output is down 20% 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 Weigh on Potential Growth

Population growth continues to slow across the region for a number of reasons, including cyclical factors, relative economic performance and aging demographics. Overall population growth in the region is running at a 0.3% y/y pace, less than half the North American average. 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 continues to slow labour force growth in the region, with the 2016 growth rate just up from the weakest since 1986, dragging down potential economic growth with it. Notably, Ontario and Quebec have outpaced their Great Lakes state counterparts in recent years, spurred by strong international immigration trends and, recently, surging interprovincial migration into Ontario.

Meantime, the Great Lakes states have been grappling with net outward migration to other states. Illinois lost a net 114,000 people to other states in 2016, which contributed to a third-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 and Quebec should see provincial flows strengthen further this year as the oil price shock reverses the movement of migrants to oil-producing provinces seen for much of the past decade.

Chart 6
Manufacturing Heartland—Still

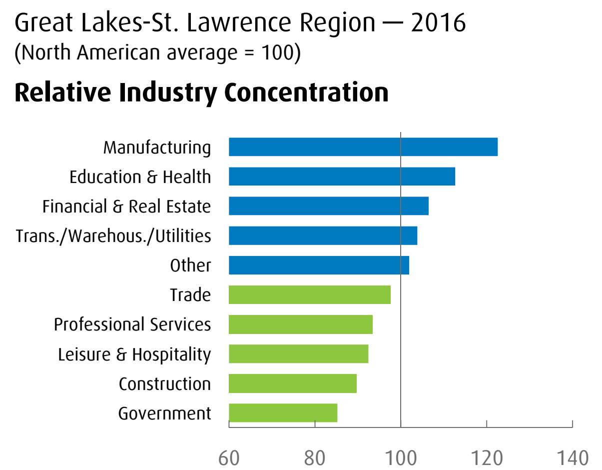


Chart 7
Demographic Drag for Many

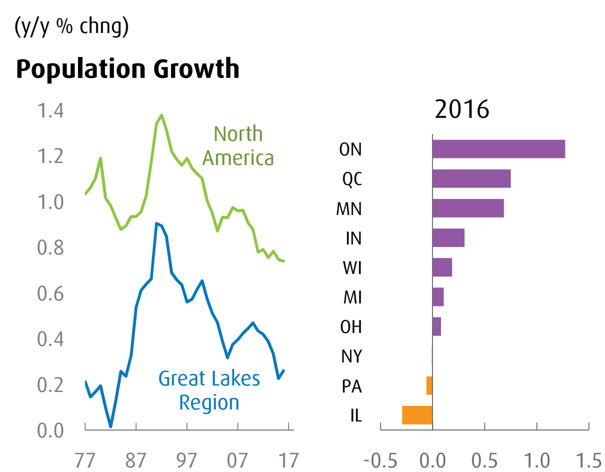
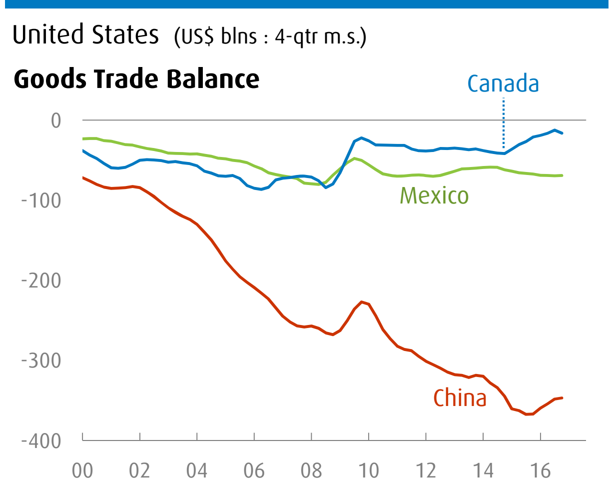


Chart 8
U.S. Trade Deficit: Not Made in Canada



A Critical Trade Relationship

Trade is a pressing issue given the policy priorities of the new U.S. Administration. Note that while the U.S. ran a near-$350 billion trade deficit with China in 2016, the gap was a much smaller $69 billion with Mexico, and a paltry $16.5 billion with Canada. On a wide scale, this 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 as well, 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.

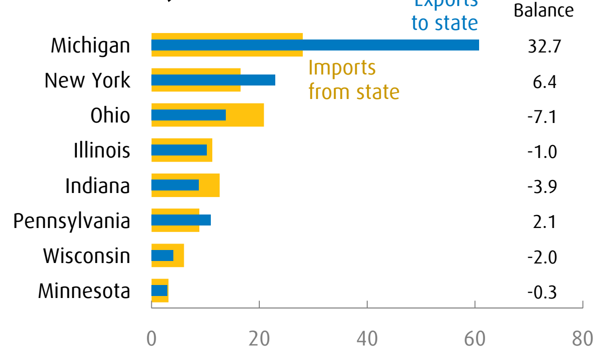
The Great Lakes-St. Lawrence region is also a **critically important North American trading hub**. The region's states were the origin of roughly a quarter of total U.S. merchandise exports in 2016, while Ontario and Quebec accounted for 60% of Canadian shipments (a decade high). Transportation equipment 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 $242 billion of total trade in 2016. That represents almost a third of total international trade among the two provinces. Also, it's notable that fully 33 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 is concerning given how integrated the supply chain has become.

Meantime, improving **border infrastructure** is encouraging. For example, construction of the Gordie Howe International Bridge between Windsor and Detroit continues to move closer to reality, though completion looks to be beyond 2020. This should help improve the flow of goods at what is currently the busiest commercial crossing on the U.S.-Canada border.

Finally, the **Great Lakes-St. Lawrence Seaway** is a critical avenue for North American trade. According to the Chamber of Marine Commerce, shipping in the region supports 227,000 jobs, produces $35 billion of business revenue, and adds nearly $5 billion per year to federal, state and provincial revenues.

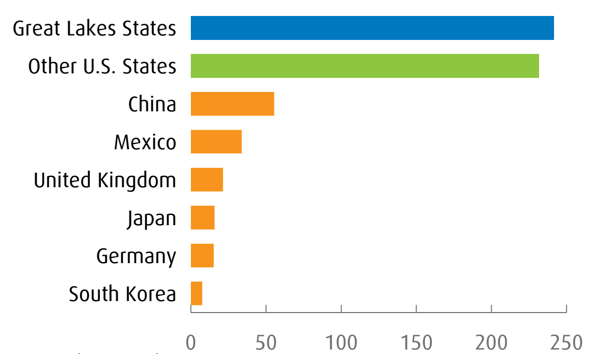
The Bottom Line: The Great Lakes-St. Lawrence region is a key contributor to North American economic output, employment and trade, and the current outlook remains positive for the region. Measures by policymakers to maintain the trade relationship and further facilitate the flow of goods in the region and beyond would be a clear positive for economies on both sides of the border.

Chart 9
Key Trading Partners
2016 (C$ blns)
Ontario and Quebec Trade



Source: Industry Canada

Chart 10
Strong Cross-Border Ties
2016 (total trade : C$ blns)
Ontario and Quebec's Trading Partners



Source: Industry Canada

Chart 11
Selling Mostly to Canada
United States — 2016 (Census basis)
Largest Export Trading Partner by State

Sources: BMO Economics, U.S. Department of Commerce

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$)													
2014	2.6	2.4	**1.7**	2.7	1.3	1.1	2.1	1.9	2.4	0.8	2.6	1.8	2.2
2015	0.9	2.6	**1.7**	2.5	1.2	1.8	1.4	1.6	1.9	0.9	1.8	2.8	1.1
2016e	1.4	1.6	**1.6**	2.6	2.0	1.5	1.9	1.6	0.5	1.6	1.2	1.2	1.4
Employment (% chng)													
2014	0.6	1.6	**1.1**	0.8	-0.1	1.3	2.9	2.1	0.9	0.5	1.4	0.6	1.4
2015	0.9	1.7	**1.1**	0.7	1.0	1.1	2.5	1.9	0.9	1.1	0.7	0.8	1.1
2016	0.7	1.7	**0.8**	1.1	0.9	0.4	2.0	2.0	0.7	0.3	0.2	0.5	1.1
Unemployment Rate (%) [1]													
2014	6.9	6.2	**6.2**	7.3	7.8	7.0	5.9	7.1	4.1	6.3	5.7	5.8	5.4
2015	6.9	5.3	**5.4**	6.7	7.7	5.9	4.8	5.4	3.8	5.3	4.9	5.3	4.5
2016	7.0	4.9	**5.2**	6.6	7.0	5.9	4.5	5.0	3.9	4.9	5.0	5.5	4.2
Population (% chng)													
2014	1.1	0.7	**0.3**	1.0	0.7	-0.1	0.4	0.2	0.6	0.2	0.2	0.1	0.3
2015	0.9	0.7	**0.2**	0.8	0.6	-0.2	0.3	0.0	0.5	0.1	0.1	0.0	0.2
2016	1.1	0.7	**0.3**	1.3	0.7	-0.3	0.3	0.1	0.7	0.0	0.1	-0.1	0.2
Exports (% chng, US$)													
2014	10.3	2.6	**7.8**	8.4	15.0	3.5	3.8	-4.6	3.1	2.4	3.1	-1.7	1.5
2015	-0.7	-7.5	**8.4**	10.7	7.5	-7.0	-5.1	-4.6	-6.5	-6.9	-2.8	-2.0	-4.2
2016	-0.7	-3.4	**1.2**	4.2	-2.1	-5.7	3.0	2.4	-3.9	-7.1	-3.1	-7.2	-6.4

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