

CONNECTING ACROSS BORDERS

A Special Report on the Great Lakes and St. Lawrence Regional Economy

By **Robert Kavcic**, Senior Economist - BMO Capital Markets



CONFERENCE OF GREAT LAKES AND
ST. LAWRENCE GOVERNORS AND PREMIERS

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In 2015, I joined with my colleagues to create the Conference of Great Lakes and St. Lawrence Governors and Premiers. This action formalized our long-standing partnership to protect our world-class environment and grow our \$5 trillion regional economy. It also reflects the deeply integrated nature of our region's infrastructure, industries and trade patterns.

In an increasingly globalized economy, connections within our region and with the world are keys to future prosperity. By working together toward shared goals, we can more effectively grow our State and Provincial economies while enhancing our region's competitiveness. It is therefore critical that we understand our regional economy as a whole so that we can leverage our strengths and seize new opportunities for growth. Ongoing, strategic collaboration will benefit the people, businesses and institutions in each of our ten States and Provinces.

This report is the first of its kind for the Great Lakes-St. Lawrence region which includes the eight U.S. States of Illinois, Indiana, Michigan, Minnesota, New York, Ohio, Pennsylvania and Wisconsin and the two Canadian Provinces of Ontario and Québec. This report looks at the region holistically and will enable us to begin planning and working as the integrated region that, in many ways, we already are.



We are delighted to partner with BMO Capital Markets on this report. In coming years, we plan to expand it to look more deeply at regional economic performance and the factors effecting competitiveness. By regularly producing reports, we will track progress over time using consistent data and methods. These reports will help inform our regional work to facilitate trade flows, support productivity growth and compete more effectively in the global economy.

We look forward to our continued work together.

Rick Snyder
Governor of Michigan
Chair, Conference of Great Lakes and
St. Lawrence Governors and Premiers



Economic Challenges and Opportunities

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. The region's expansion is expected to continue in 2016 as manufacturing and exports in Ontario and Québec get a boost from a weaker currency and firm U.S. demand, while U.S. states in the region see an ongoing housing and consumer expansion tempered somewhat by the strong U.S. dollar. Additionally, a lower-for-longer oil price environment should reduce costs through the manufacturing supply chain. Still, some longer-term issues remain for the region's economy. Labor costs are in focus as the factory sector seeks to remain competitive, while productivity growth has slowed; demographic headwinds are blowing; and policymakers are working to keep finances in order, as well as facilitating cross-border trade flows.

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\$5.8 trillion in 2015, the region accounts for 30% of combined Canadian and U.S. economic activity and 31% of employment. The region's output ranks ahead of Germany, France, Brazil and the U.K., 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 in 2013. Quite simply, the economic importance of the region can't be overstated.

Robert Kavcic, Senior Economist

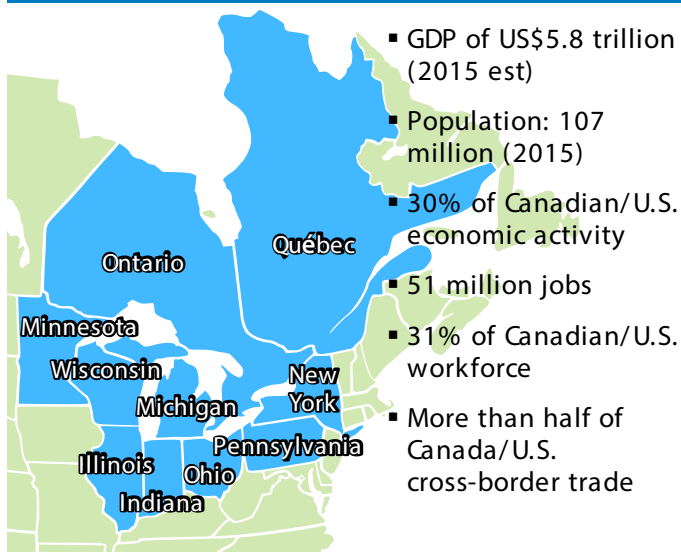
Robert Kavcic is Vice President and Senior Economist with BMO Capital



Markets. He plays a key role in analyzing regional economic and fiscal trends in Canada and the United States, and is

the author of the *Provincial Monitor* and creator/author of *State Monitor*. Robert regularly contributes to *AM Notes*, *Focus* and *econoFacts*, and monitors equity markets from a macroeconomic perspective through the *Global Equity Weekly* publication. Robert is a regular commentator on economic and financial trends to the media. Before joining BMO, Robert worked in the research department at the Bank of Canada.

Chart 1
Facts and Figures



ECONOMIC UPDATE – STURDY GROWTH AHEAD

The Great Lakes-St. Lawrence economy has recovered from the Great Recession, a period that hit the region relatively hard. Real GDP now tops 2007 levels in almost all of the region's states and provinces. Real GDP in the region expanded at an expected 2.1% pace in 2015, marking a second straight year of accelerating growth, though still trailing the U.S. average slightly.

The U.S. economy is expected to continue its expansion in the year ahead, growing at a 1.8% clip in 2016, down from a 2.4% pace last year. While Canada is expected to lag slightly with 1.6% growth, after reporting the widest growth gap in twenty years last year, the weakness north of the border is almost entirely concentrated in energy-producing provinces outside the Great Lakes-St. Lawrence region. Against that backdrop, the economic

outlook on Canada's side of the Great Lakes-St. Lawrence region has improved, even as growth nationally has downshifted. Ontario is seeing sturdy 2%-to-2.5% growth, topping the national average for the first time in more than a decade.

North American **car and truck production** held near 15-year highs in 2015, and record sales should support activity through the supply chain. However, unlike on the Canadian side of the border, the strong U.S. dollar is a headwind on U.S. export activity, and kept GDP growth in the Great Lakes states running below the national average in 2015. Some firms in the factory sector have also been clipped by capital spending retrenchments in energy and agriculture.

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 this sector. Importantly, U.S. housing affordability remains attractive enough that home prices will continue to rise even as the Federal Reserve raises interest rates. Meantime, Toronto's market continues to set record price levels and conditions in Southwestern Ontario have firmed, supporting healthy new construction activity.

For **consumers** across the region, the steep decline in oil prices is a clear positive, while jobless rates are below year-ago levels in most jurisdictions in the Great Lakes-St. Lawrence region. 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 well below peak levels.

Adding it all up, the Great Lakes-St. Lawrence 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 continued expansion in 2016.

NORTH AMERICA'S EMPLOYMENT ENGINE

The region plays an extremely important role in the North American labor market, supporting more than 50 million jobs in 2015. That is more than 30% of the combined Canadian and U.S. workforce. Employment growth was a solid 1.2% last year, pulling the average jobless rate down to 5.4%, down 2 ppts from two years prior.

Chart 2
Gross Domestic Product

2014 (US\$ trlns)

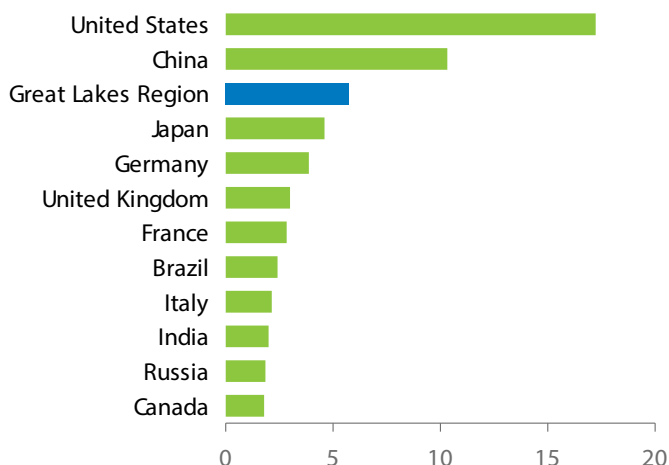


Chart 3
U.S. Economy to Lead

(y/y % chng)

Real GDP

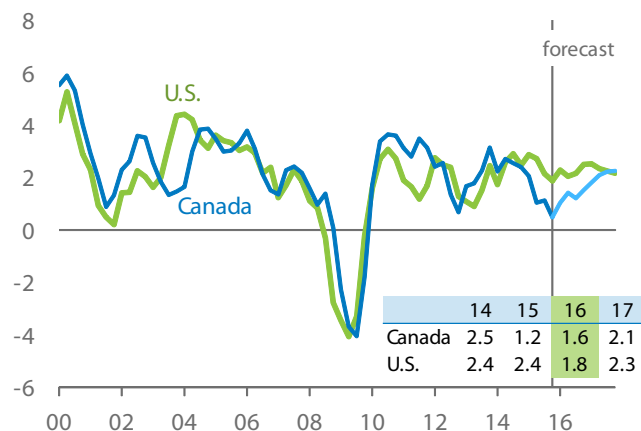
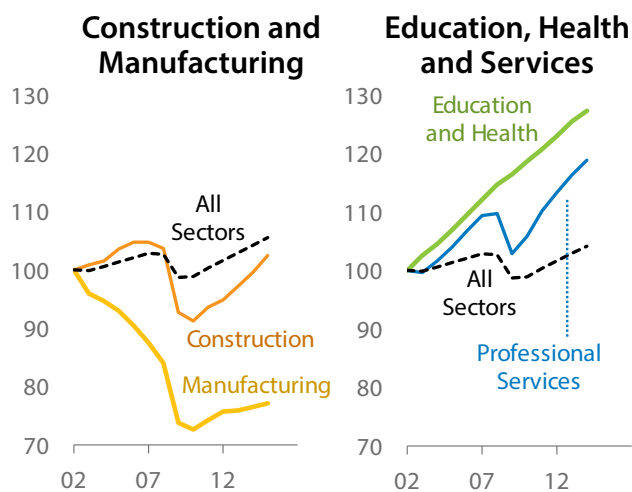


Chart 4 Service Sector Steadily Hiring

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



The region’s highly diverse economy also 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. While manufacturing employment is down 17% from a decade ago, education & healthcare (+21%) and professional services (+17%) have helped make up the shortfall. In fact, education & healthcare alone have added 1.6 million jobs over the last 10 years, more than offsetting the 1.1 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.

Labor 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 (despite swings through cycle), while Canadian output is down more than 20%. Recently-enacted right-to-work laws in Indiana, Michigan and Wisconsin suggest that the push to control labor costs is moving north, but the broader challenge is to ensure that productivity growth remains in line with labor costs.

Chart 5 Diverse Labor Market

Great Lakes-St. Lawrence Region —2015
(% of regional employment)

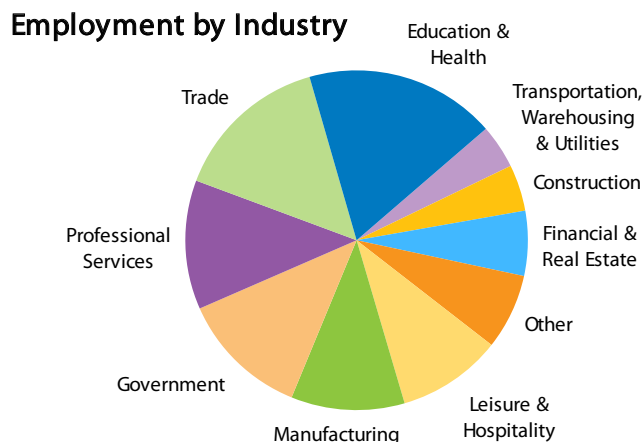
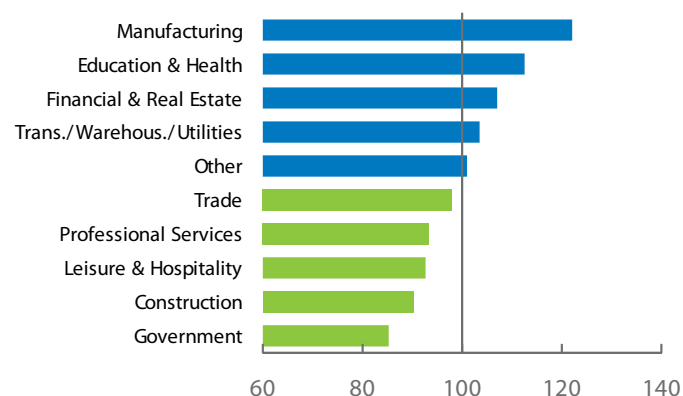


Chart 6 Manufacturing Heartland — Still

Great Lakes-St. Lawrence Region —2015
(North American average = 100)

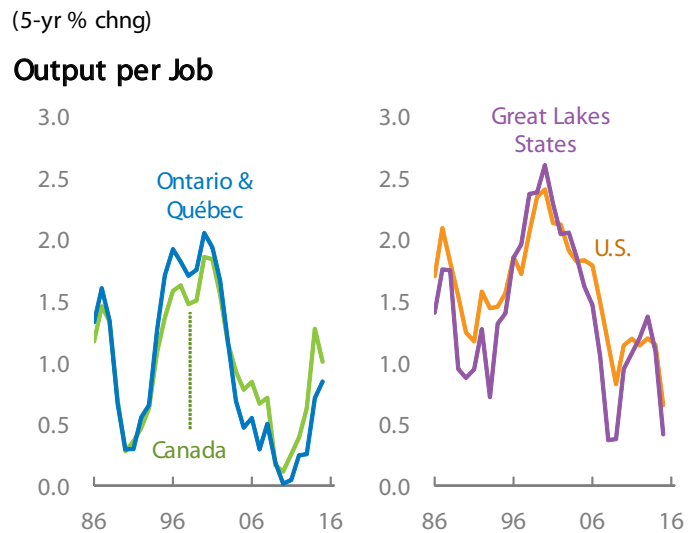
Relative Industry Concentration



PRODUCTIVITY GROWTH MIXED

Labor productivity across the region has slowed over the past two decades, especially among the Great Lakes states. Over the past five years, output-per-job has expanded at a muted 0.7% annualized clip among the states, tracking U.S. productivity growth lower. This is a stark turnaround from the 1990s and 2000s, when productivity growth was running at a 1.5%-to-2% clip. Meantime, productivity growth in Ontario and Québec slowed through the mid-2000s, but has picked up since the Great Recession—exports and factory output have experienced a cyclical rebound, but much of the pickup has simply filled existing capacity, and has not led to net new hiring or major capital investment in the sector. As the region’s economic base gradually transitions away from traditional manufacturing and more into the service sector, we could continue to see downward pull on productivity simply due to share effects (i.e., higher-productivity industries now carry less weight than in the past).

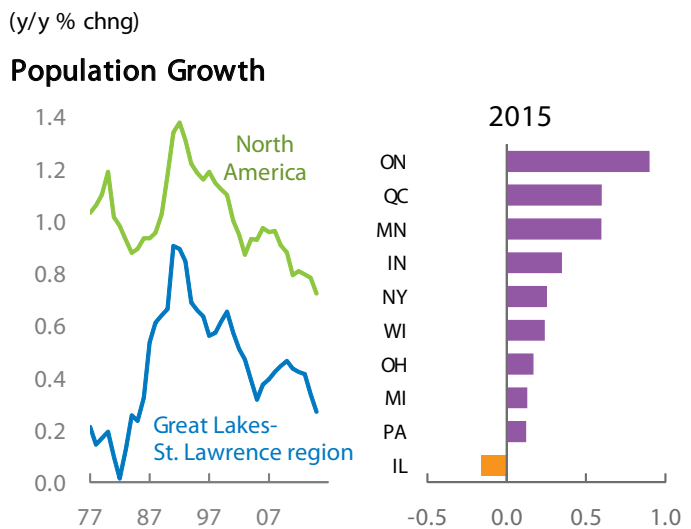
Chart 7
Productivity: Room to Improve



DEMOGRAPHIC CHALLENGES PERSIST

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 now running at a 0.3% y/y pace, roughly 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 population and labor force growth in the region, with the 2015 growth rate the weakest since 1986, dragging down potential economic growth with it. Notably, Ontario and Québec have outperformed their Great Lakes state counterparts in recent years, spurred by strong international immigration trends. That said, all jurisdictions have been grappling with net outward migration to other states/provinces. Illinois lost a net 105,000 people to other states in 2015, which contributed to a second-straight decline in that state’s population—that hasn’t happened since the mid-1980s. The broader region continues to see outflows to the South and West with stronger economic growth and employment prospects. Ontario and Québec are poised to see outflows subside this year as the oil price shock reverses the flow of migrants to oil-producing provinces.

Chart 8
Demographic Headwinds Blowing



INTEGRATED TRADING HUB

The Great Lakes-St. Lawrence region is 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 2015, while Ontario and Québec accounted for more than 60% of Canadian shipments. Transportation equipment and machinery are the major drivers, but agricultural and food products, metals and chemicals are also important exports. The region's cross-border trade linkages are also immensely important. For example, the Great Lakes-St. Lawrence states are Ontario and Québec's largest trading partner, accounting for \$235 billion of total trade in 2015. That represents almost a third of total international trade among the two provinces.

The North American Free Trade Agreement has certainly helped to grease the trade relationship in the region, but more can still be done to enable the efficient movement of goods, especially given how integrated the supply chain has become. Improved border infrastructure is one priority area. For example, construction of an additional bridge between Windsor and Detroit continues to move closer to reality, with Canada now agreeing to fund construction of a customs plaza on the U.S. side—a long-time hurdle for the project. The Ambassador Bridge is among North America's busiest border crossings, carrying more than 25% of merchandise trade between Canada and the U.S.

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. Infrastructure spending in the region's shipping network continues to move ahead, with \$1.1 billion committed by 2018 through a combination of public- and private-sector investments.

Chart 9
Domestic Migration Rate

(2015: per 1,000 persons)

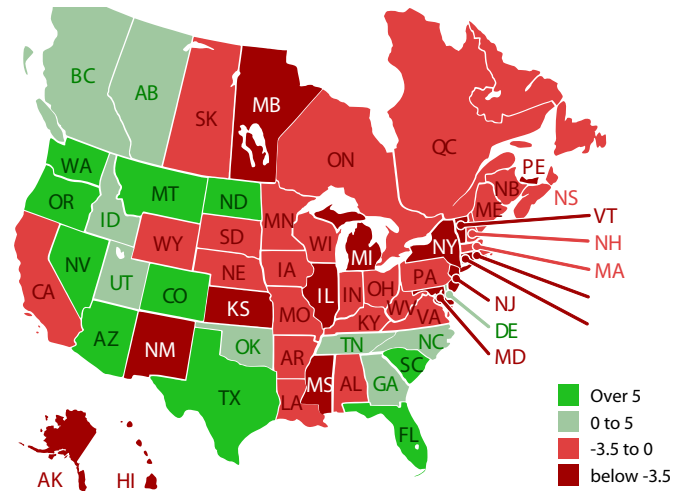
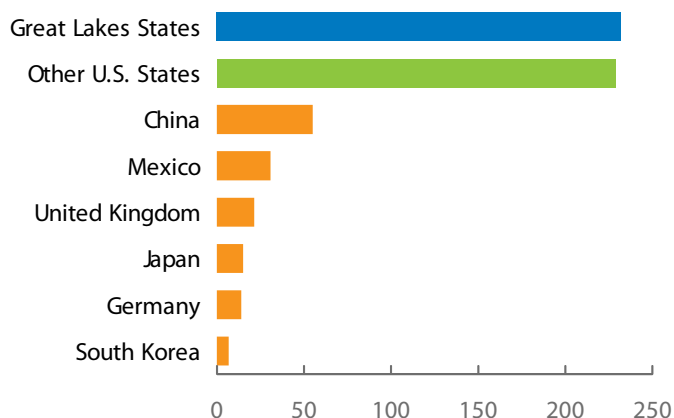


Chart 10
Strong Cross-Border Ties

2015 (Total trade, C\$ blns)

Ontario and Québec's Trading Partners



The Bottom Line: The Great Lakes-St. Lawrence region remains a key contributor to North American economic output, employment and trade, and the current outlook remains positive for the region. Measures by policymakers to facilitate trade flows, support productivity growth and contain business costs are key for the long-term health of the region and broader North American economy.

REGIONAL ECONOMIC INDICATORS

	Canada	U.S.	G.Lakes- St. Lawr.	Ontario	Québec	Illinois	Indiana	Mich.	Minn.	N.Y.	Ohio	Penn.	Wisc.
Real GDP (% chng, US\$)													
2013	2.2	1.5	0.6	1.3	1.2	-1.0	1.5	2.5	2.2	-0.5	0.5	0.7	0.9
2014	2.5	2.4	1.8	2.7	1.5	1.0	1.2	1.6	1.8	2.7	1.4	1.5	1.2
2015e	1.2	2.4	2.1	2.5	1.1	1.4	2.4	2.2	2.0	2.2	2.2	2.2	1.9
Employment (% chng)													
2013	1.4	1.0	1.0	1.8	1.2	-0.3	1.6	1.8	1.3	1.3	0.4	0.3	0.9
2014	0.6	1.6	1.2	0.8	-0.1	1.4	2.9	2.1	1.2	1.0	1.4	0.8	1.4
2015	0.9	1.7	1.2	0.7	1.0	1.1	2.2	1.7	1.2	1.7	0.7	1.1	1.0
Unemployment Rate (%) ¹													
2013	7.1	7.4	7.4	7.6	7.6	8.9	7.5	8.5	4.8	7.5	7.3	7.1	6.6
2014	6.9	6.2	6.2	7.2	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	6.8	7.7	5.9	4.8	5.4	3.6	5.3	4.8	5.0	4.6
Population (% chng)													
2013	1.2	0.7	0.4	1.1	0.9	0.1	0.5	0.1	0.7	0.4	0.2	0.1	0.3
2014	1.1	0.8	0.4	1.0	0.8	-0.1	0.4	0.2	0.7	0.3	0.2	0.1	0.3
2015	0.9	0.8	0.3	0.9	0.6	-0.2	0.3	0.1	0.6	0.2	0.1	0.1	0.2
Exports (% chng, US\$)													
2013	4.1	1.9	3.2	0.9	3.6	-3.2	-0.7	2.7	0.8	6.1	4.1	5.3	-0.1
2014	10.1	2.5	7.6	8.0	14.6	3.5	3.8	-4.6	3.1	2.4	3.1	-1.7	1.5
2015	-0.9	-7.3	8.3	11.1	7.8	-7.0	-5.1	-4.6	-6.5	-6.9	-2.8	-2.0	-4.2

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

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As this report illustrates, the economy of the Great Lakes-St. Lawrence region continues to grow and evolve. In coming years, the Conference of Great Lakes and St. Lawrence Governors and Premiers plans to release more reports that can help the region better understand this dynamism, and inform regional policy. This work will necessarily include many partners and support will be needed from organizations that can help develop regional data, information and trends for:

- Quality of life
- Capacity utilization
- Infrastructure
- Capital markets and access to capital
- Innovation and entrepreneurship
- Trade flows among the States and Provinces, and intra-regional barriers
- Clusters

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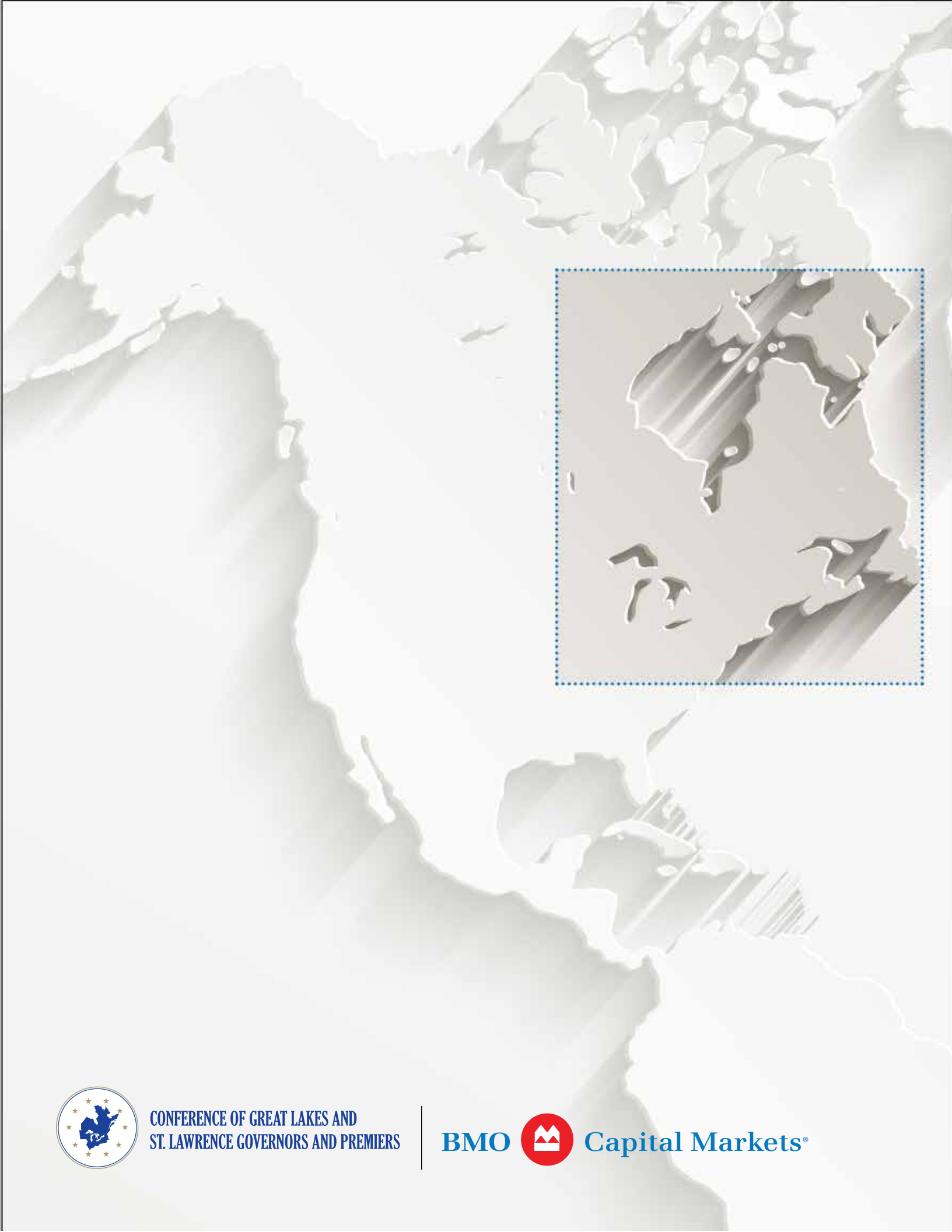
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For more information visit <http://www.cglslgp.org/>

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