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ONTARIO

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1. SUMMARY

Ontario's strong 4.8 percent growth performance of 1985 should be followed in 1986 by growth in the range of 3.0 to 3.5 percent. The province's success has arisen from its concentration of economic activity in the Toronto-Highway 401 corridor and in the auto industry and its economic integration with the U.S. Great Lakes states. This state of affairs leaves Ontario vulnerable to external developments and places pressure on its adaptability. Ontario has shown considerable flexibility in its deployment of resources and in the markets it serves.

The overriding issue for Ontario is the potential for further liberalization of trade with the United States, achieved through bilateral and/or multilateral negotiations. Debate in Ontario has focused around, on the one side, doubts about adaptability, vulnerability, job and income losses and social impacts and, on the other side, the substantial benefits of closer integration which are harder to quantify, let alone articulate. The pivotal challenge is manufacturing, which faces a complex blend of opportunities and challenges.

The Ontario government's position of deep concern reflects the asymmetry of the debate: some known costs to be balanced against unknown, but anticipated, benefits. The policy challenge will be to establish the appropriate objectives and scope of the negotiations, to engage provincial participation in a helpful way and to develop measures of support for adjustment.

The quality of human resources Ontario is able to deploy will be an important determinant of the economy's success in responding to the new economic environment shaped by continuing technological change and trade liberalization. The existing matrix of institutions and measures for education and training may need to be refocused to offer special adjustment assistance to individuals particularly adversely affected by the process of adjustment to a new trade regime.

Institutional change and flexibility also will be required if individuals are to be supported in their adjustments. In particular, management and labour will have to negotiate toward a new understanding of the trade-offs among employment, remuneration, job security and cost reduction.

Ontario has the largest and most sophisticated capital market in Canada. Further development will see this market increasingly integrated into the world financial system. This, plus the changes in technology and techniques, is making the sector more flexible and responsive, but also is bringing higher risks. The key policy challenge will be to set framework policies in such a way that the right balance can be struck between innovation and security.

The auto industry, after three excellent years, faces a scenario of substantial excess capacity and downsizing. As Ontario accounts for the great bulk of Canadian auto production, it risks bearing the brunt of any reduction in output and employment. Only to a very limited extent will this be offset by the new capacity being installed in Ontario by non-North American producers. This downsizing outlook is independent of the trade negotiations, but the timing will be coincident. This likely will throw the industry's problems of adjustment into relief, lead to renewed calls for supportive measures and enhance doubts about the value of trade liberalization.

Mining and forestry, long the mainstays of Northern Ontario, are facing more competitive, softer markets. These conditions are forcing both industries to re-invest in cost-reducing technology to remain competitive. A major effect of this is to reduce Northern Ontario employment and incomes, undercutting the economic base of many single-industry towns. Tourism has the potential to grow and replace some of the losses in the other two resource industries, but this will require investment and development.

2. ECONOMIC OVERVIEW

i) Performance

The past year has been a good one for Ontario. In contrast to early predictions of a slump after the strong performance of 1984, the economy is now believed to have enjoyed broadly based growth of roughly 4.8 percent in 1985. Nonetheless, the unadjusted January 1986 unemployment rate was still 8.2 percent and Ontario had slightly more unemployed than Quebec. Sub-regional pockets of severe unemployment are centered around Sudbury, Thunder Bay and St. Catharines-Niagara Falls.

The forecast provincial growth for 1986 of 3.0 to 3.5 percent will be driven by stronger investment spending with weaker exports and consumer demand. This outlook could be altered by movements in the value of the Canadian dollar or the price of oil. There would appear to be little likelihood of the dollar rising to the point where Ontario's commodities or manufactured goods would become uncompetitive, but the need to sustain the dollar from further declines through higher interest rates might constrain Ontario's ability to invest for growth and competitiveness. The recent drop in oil prices will be of general benefit to Ontario as a consuming province and of particular benefit to the petrochemical industry. Of more importance for the province's competitive position will be the relationship between Ontario prices and those in the U.S.

ii) Structure

Ontario's economic structure is unique in that the province houses the industrial and commercial heartland of Canada: over 50 percent of Canadian secondary manufacturing and over 40 percent of Canadian business-related services. From this fact flow two crucial structural features: economic concentration in the Toronto and Highway 401 corridor sub-regions and economic integration with U.S. border states.

The economic heart of the province is Toronto with 41 percent of the Gross Provincial Product (GPP), complemented by the Highway 401 corridor with 28 percent. The two regions, dominant in most sectors, are pre-eminent in secondary manufacturing and business-related services. These two regions are what makes Ontario wealthy and dynamic; equally, their future prospects will determine the economic shape and health of the province.

The rest of the province has an economy typical of much of Canada. The dominant industries are resource-based: mining and mineral processing, forestry and wood processing, agriculture and tourism. Development in this part of the province tends to be slower, reliant on resource-exploitation projects and concentrated in single-industry communities. As the resource sectors generally face slow-growth prospects and declining employment, many northern communities will face painful adjustments as their economic and social fabric is unravelled.

Ontario's growing reliance on the U.S. is fundamental. Shipments to the U.S. have risen from 18 percent of Ontario output in 1976 to 33 percent in 1984, while the share of Ontario output consumed by all other markets (Ontario, rest of Canada, rest of world) has declined.

What is more significant is that the province is deeply integrated into a "Great Lakes economic region" made up of Ontario and the eight adjoining U.S. states. More than three-quarters of all Ontario's exports to the U.S. go to these states, while over half of Ontario's imports originate there. While these states have absorbed much of the increase in exports, they are expected to have below-average economic growth to the end of the century.

The great bulk of the trade in both directions is automotive-related, but there is evidence of complementarity and integration in other products as well. After motor vehicles and parts, six of the top eight exporting sectors are the same for Ontario and the U.S.: precious metals, industrial chemicals, office machinery and equipment, scientific and professional equipment, communications equipment and other machinery and equipment. Ontario enjoys a surplus in both the auto-related and non-auto sectors.

The effect of these key structural features is that Ontario's economy has become highly specialized both internally and externally. While this has brought considerable benefits, it leaves the province vulnerable to market changes in those areas of specialization and means that any costs, in the form of stress on the environment, economic infrastructure or social fabric, will be equally concentrated.

With the help of a depreciating Canadian dollar, Toronto and the Highway 401 corridor have developed into an auto-based, export-oriented economy closely tied to neighbouring states. Whether this role is sustainable is unclear. In terms of the fundamentals of competitiveness, Ontario has slipped behind its foreign competitors and, on some measures, its provincial competitors. While Canadian productivity grew more slowly than other countries in the past decade, Ontario's actually declined.

Other challenges to Ontario's success are the sustainability of the U.S. expansion, rising U.S. protectionism, tougher foreign competition and the economic structural problems of several of the Great Lakes states.

iii) Structural Adjustment

Ontario has accomplished its economic integration with the Great Lakes states as a result of extended structural change. It would appear, however, that this structural evolution will need to continue and even accelerate.

Ontario is now more than ever engaged in volatile, internationally competitive markets and successful Canada-U.S. trade liberalization may lead to further substantial changes in the market environment.

A review of the flexibility of Ontario's human and capital resources and the ability of the economy to adjust its product and market mix should give some idea of the assets and liabilities Ontario will have as it confronts the issues of change.

Ontario's human resources have shown a substantial degree of flexibility. Job tenure data for 1984 show that over half of all employees had been with their current employer for less than five years, about the same as for the rest of Canada and the U.S. Similarly, Ontarians have shown considerable geographic mobility in response to economic opportunity. The 1981 census showed that 17 percent of the labour force changed location within the province that year.

Interprovincially, the late 1970s saw a flow from Ontario to Western Canada reflecting increased economic activity there. But a turnaround began late in 1981 and gained momentum thereafter. In 1984 Ontario gained (net) 20 000 people from the West, and another 22 000 from Quebec and the Atlantic provinces.

The future flexibility of Ontario's human resources will be shaped, in part, by the ability of institutions -- management, labour unions and educational institutions -- to evolve new practices and relationships which facilitate change.

It is harder to measure capital flexibility. One indicator is the age of the capital stock, with a relatively younger stock indicating a more recent flow of resources and, probably, the incorporation of new technology or methods. A comparison of the age of capital stocks between Ontario and the U.S. for 1981 shows that the Ontario stocks in manufacturing, transportation and commmunications were slightly newer than those of the U.S., while those in agriculture, fisheries, forestry, mining and finance, insurance and real estate were somewhat older. The recession-induced slump in investment led to an overall aging of the Ontario capital stock in every sector except finance, insurance and real estate.

Ontario's growing orientation to the U.S. has been accompanied by a shift in products exported. This shift has been away from raw materials toward manufactured goods, and particularly towards goods embodying advanced technology. Over the period 1977 to 1984, the share of exports accounted for by resource-related industries dropped from 25 percent to 23 percent, while secondary manufacturing rose from 71 percent to 73 percent. The manufacturing sectors with greatest growth were rubber products, office machinery and equipment, and communications equipment and instruments and related products. Autos and parts as a share of exports declined very slightly from 49.5 percent to 49 percent.

3. ISSUES

Given the province's heavy dependence on Canada-U.S. trade, the fundamental challenge is to improve the competitive strength of all aspects of the economy. In this connection, the current trade negotiations with the U.S. hold centre stage as an issue. Two other issues will have major impacts on Ontario's competitiveness: the quality of its human resources and its capital markets.

In addition to these broad questions facing all of the economy, there are two industries facing major structural turning points. In southern Ontario it is motor vehicles; in Northern Ontario it is the resource-based industries.

i) Trade Liberalization

Ontario's markets are steadily becoming more international. Exports account for 36 percent of total output of goods and services and imports occupy at least 30 percent of apparent domestic market. The fast growth of both exports and imports suggests Ontario's best prospects for raising real incomes lie in greater specialized participation in international markets.

The current issue in this regard is the potential for liberalized trade with the U.S., either through a comprehensive bilateral agreement or through the next GATT round. Analysis now under way among governments and business groups will give better insight into the effects of freer trade, especially in certain sectors.

Previous experience with trade liberalization suggests the benefits outweigh the costs but are harder to identify at the outset, especially at greater levels of disaggregation. The debate in Ontario has been marked by this asymmetry. On the one side, it has been possible to give dimensions to the doubts about adaptability, vulnerability, job and income loss and social impacts. On the other side, the substantial benefits of closer economic integration with the U.S. have proven to be much harder to articulate, let alone identify in detail.

Improved access to the U.S. should prove to be beneficial to the mining and forestry sectors and their related processing industries. Many companies already are internationally competitive and export oriented and are well-positioned to take advantage of the market opportunities that open up. Tariffs are relatively unimportant to these industries, but U.S. contingency protection and border harassment do constitute significant trade barriers. The importance of resource-based activities in northern, central and eastern Ontario means that the traditionally slower-growth parts of the province should get a boost from more assured access to the U.S. Nonetheless, competitive pressures will continue to constrain employment and growth prospects for the resource-based industries and the towns dependent on them.

In the agri-food sectors, the major role played by government means negotiators will be faced with a need to balance farming, processing and consumer interests. The removal of government supply-management programs could enable processors to become more competitive in specialized markets in the U.S., but also could force a major restructuring in agriculture under import pressure. The retention of the programs could permit a more gradual agricultural restructuring, but could leave food processing uncompetitive against freely imported products.

The sector where trade liberalization is expected to bring about the greatest structural change is secondary manufacturing. This arises from the fact that it is already closely integrated with the secondary sector in the Great Lakes states and is the most susceptible to the "engineered" competitive advantages of technology, design, management excellence and product quality. The sector is heavily concentrated in Toronto and the Highway 401 corridor, so the burden of change and adjustment will fall heavily on these key sub-regions.

The response of the economic players here effectively will determine Ontario's performance under any trade deal. The behaviour of two groups of secondary manufacturing firms will be key to determining the response of the sector: the large U.S. subsidiary companies and the Canadian-controlled small and medium-sized firms.

Ontario government estimates suggest 65 percent of provincial output comes from U.S.-controlled subsidiaries. Many of these firms originally located in Ontario to surmount tariff barriers and serve the Canadian market. As tariffs have declined the firms have shown a clear willingness to rationalize production north-south in order to marry Canadian cost advantages to their U.S. marketing and distribution networks. It is difficult to categorize what their adjustment response will be to a comprehensive agreement. More so than small firms, these companies may be faced with pressures outside those of the market which shape their decisions: from state and provincial governments, unions, communities and public interest groups.

The response of smaller, Canadian-owned firms is key both because these firms have been such an important source of employment growth in recent years and because the high rate of company births and deaths makes the sector very responsive to new conditions.

Under trade liberalization these firms would face fewer constraints on their access to new markets but, in return, they would face tougher competition in their current ones. The major challenge such firms will face is building a distribution network that will enable them to access and service the U.S. market. These firms also are concentrated in Toronto and the Highway 401 corridor, reinforcing the importance of trade liberalization for these sub-regions.

Canadian and smaller businesses are also likely to suffer the most if trade is <u>not</u> liberalized. They are poorly equipped to fight U.S. protectionism, and impaired access to that market could force some of the most successful to move capacity and jobs south of the border.

Within the manufacturing sector, motor vehicles and parts already are traded under a system of managed free trade. Ontario enjoys a sizeable surplus in auto trade with the U.S. It is hard to see how this sector could substantially improve its performance under a less-structured trading relationship.

The vast bulk of the service sector's output is consumed locally and will be untouched by changes in the trading environment. For those services that are traded the field is beset with natural and created barriers, but so far it has been impossible even to identify all of them, let alone their impact. There is some question of the extent to which services can effectively be brought into the negotiations.

A major issue confronting decision-makers will be the complex and shifting patterns of public support for trade liberalization with the U.S. The business community, and especially the larger firms, are supportive of more open relations with the U.S., as they believe they could benefit from a greater integration with the U.S. industry. Nonetheless, many industries and firms have special advantages which they will be reluctant to give up. The concentration of business opinion-leaders in Toronto gives them a particularly strong role in shaping opinion.

As elsewhere, unions are a focal point for resistance to trade liberalization, citing their fears about job and income losses and Canadian sovereignty. The influence of this group is heightened, because so much of union membership is located in Toronto and the Highway 401 corridor, and in secondary manufacturing which is expected to experience the greatest structural change.

The general public, for all the discussion among interest groups, has yet to become seized with the issue. However, the generalized goodwill toward the notion of freer trade with the U.S. -- always weaker in Ontario -- has declined over time and is tempered by caution about the economic impact. Decima polls portray Ontarians as more doubtful than other Canadians about the benefits of trade liberalization for their province and Canada, and less confident in Canada's ability to negotiate a good deal.

As well, there are concerns about the potential loss of Canadian sovereignty and independence. This has long been an Ontario concern, focused around questions such as foreign investment and the impact of U.S. culture, and amplified by the strength of the Toronto-based print and electronic media.

The position of the Ontario government is very much in tune with the complex blend of challenges and concerns discussed above. The province considers trade enhancement with the U.S. as the priority issue, and the concerns it has raised -- the ability of Ontario manufacturing firms to respond to more vigorous competition, the vulnerability that grows with increased specialization and integration into foreign markets, the human cost in terms of job and income loss, social impacts in single-industry towns and cultural identity -- are core concerns for Ontario.

The provincial government also is concerned about the impact of trade liberalization on interprovincial trade. It has pressed for the early removal of provincial barriers in order to enable domestic firms to strengthen their positions before the advent of increased import competition.

These views have led Ontario to press vigorously for a central role in preparing for, and negotiating, any changes in the Canada-U.S. trade relationship and for extensive analysis and consultation before talks begin. The province also is aware that delay or dissension on the Canadian side will scupper the talks, and that if all ten provinces become active participants, the dialogue will become a cacaphony.

Federal policy makers will have to address and balance the substantive concerns of the many interests within Ontario and achieve a modus vivendi with the Ontario government prior to the commencement of negotiation if there is to be any hope of success.

This challenge encompasses these tasks: establishing the objective, scope and timing of the negotiations; resolving the extent and nature of provincial government participation; and developing measures of support for adjustment which strike a balance between providing security and promoting change.

ii) <u>**Investing in Human Capital**</u>

In the area of human resources, the challenge over the coming years can be broken into three issues, each of concern to governments:

* the difficulties faced by members of disadvantaged groups in securing and retaining good jobs;

* the short-term costs of loss of employment; and

* the need to upgrade continually the quality of the labour force to stay competitive.

The first is a problem common to all jurisdictions and is as much a problem of equity as development. Accordingly, it will not be discussed in this paper. The second issue, unemployment, has been a large one in recent years. At the peak of the recession in 1983, 10.3 percent of the labour force, 470 000 people, were unemployed. Today, after a recovery that in one 12-month period generated 175 000 new jobs, the unadjusted January unemployment rate was still 8.2 percent. Ultimately, alleviating this problem is best pursued through increasing the pace of growth.

Studies done for both the provincial and federal governments have pointed to increasing demand for workers in higher-skill trades and for people in certain specialized university disciplines. As many of the positions of this nature are in manufacturing and business-related services, Ontario's demand for such workers will be especially strong, and its economic prospects closely tied to the development and deployment of these people.

The lead time required to produce such workers means the education, training and retraining systems must be oriented to long-term results and sensitive to the needs of employers. The maturing of the baby boom in an era of technological change means the focus of effort will have to shift from educating young people to upgrading workers on a continuing basis.

The current level of industry activity is low. A recent study of a selected group of Ontario industries found close to half the industries expected to spend less than five percent of total labour costs on training to 1990 and 1995. This contrasts with levels of seven to nine percent in some more information-intensive industries. More encouragingly, the general trend was up from current levels and expenditures on training related to new technology are increasing.

Ontario has the largest number of university and community college places in Canada and the highest university participation rate. University funding has been constrained in recent years, but the current government has provided for an additional infusion of funds.

One objective of the Canadian Jobs Strategy is to take a longer-term perspective on training in order to link it more closely with the needs of the private sector. Publicly, the provincial government has supported this approach. In practice, it has slowed the shift of federal funds from direct purchases of institutional training from provincial community colleges to purchases of industrial training through various market-driven mechanisms.

The different elements of the strategy give governments the range of instruments needed to tackle the different facets of adjustment in the labour market. If a trade-liberalization agreement is accomplished, the strategy may need to be adjusted to give a higher profile to programs specifically linked to the adjustment process in order to address the crucially important area of individual confidence and security.

While Ontarians have shown themselves willing to respond to opportunity, the personal risks and costs involved -- loss of income, relocation costs and the risk of unemployment -- represent a very real impediment. To encourage individual adaptability, it may be necessary to offer assistance to those particularly adversely affected by the process of adjustment to a new trade regime. Indeed, worker and union concerns about the impact of trade liberalization are sufficiently strong that such a program will be a necessity. Confidence would be sustained better if the program were developed and announced in advance of the completion of negotiations than if it were produced in response to problems after they arise.

Companies, unions and professional associations represent a potentially powerful source of support for individuals as they adapt and build their human capital over a lifetime. But these institutions also may represent an impediment to investment in human capital unless they themselves can make major adjustments in their behaviour, objectives and relations with each other.

In particular, managers and union leaders will have to learn how to negotiate joint decisions about the delicate trade-offs among cost reduction, employment growth, worker incomes, job security, etc.

The management and labour members of an Ontario government task force on technology and employment showed a remarkable consensus on how to approach adjustment. Speaking specifically of technology, they agreed that "the external factors that shape organizations really offer little or no choice between adopting or not adopting: it has to be done ..." This willingness to be flexible and endure the costs of adjustment is an important economic asset in an era of change.

Given the primacy of provincial governments in the field of education, the issues faced by the federal government focus more on how effectively Ontario's human resources are developed and applied after formal schooling is completed. The sensitive issues would appear to include the quality and financing of post-secondary education, the forging of better links between the publicly-supported training systems and the private sector, and the development of an adjustment-assistance program for workers affected by free trade.

iii) <u>Capital Markets</u>

Investment decisions mark the point at which adjustment begins: through decisions to invest, the productive resources of labour and capital are allocated or redeployed. Analysis of provincial expenditures as shown in the National Accounts indicates that the portion of Ontario expenditures allocated to capital formation is 15.6 percent in the latest years available, 1983 and 1984. This portion is lower than the rest of Canada (21.3 percent) and below that of other industrialized countries, including the U.S., U.K., France, Germany and Japan. Given the severity of the downturn in Ontario, this situation is understandable and, indeed, capital spending forecasts suggest a resurgence has begun.

Ontario industry benefits from its proximity to Canada's largest and most sophisticated capital market and its financial intermediation sector. Toronto provides financial services for business throughout the country and accounts, in itself, for a fifth of all Canadian employment in the finance, insurance and real estate sector. The size and international scope of many of the firms in the sector mean that it is substantially integrated into international capital markets.

Currently, it is not clear to what extent and with what effect service industries will be included in the Canada-U.S. trade negotiations or in the next GATT round. The natural and created barriers are such that negotiating a fair reciprocal opening of domestic financial systems would be very difficult. Nonetheless, as the Toronto financial market grows, it gradually will be drawn further into the international system. This will offer new opportunities and challenges in the form of new capital sources and services and new markets for the domestic industry.

This sector is facing two revolutions: in technology and in technique. The advent of cheap, efficient information processing and communication equipment has altered fundamentally the products and standards of service the sector can offer. As well, there have been rapid advances in financing, insurance and other techniques.

While the Toronto centre still lags behind the technology and practices of the large American centres, it is evolving swiftly, and probably more quickly than in other provinces. At least part of the reason for this is its sheer size and concentration which has bred a competitive dynamism.

These trends toward greater competition, innovation and flexibility bring with them higher levels of risk both for companies in the sector and for their clients. The sector, its clients, governments and the public will have to assess the implied trade-offs and evolve a new balance. Nonetheless, the adaptability and sophistication of this sector is crucial to its own future health and to that of the other sectors which rely on its competitive strengths to build their own.

The regulatory and framework policies which shape this industry are of paramount importance to the future of capital investment in Ontario. The need to set the right investment climate suggests a number of sensitive issues: finding a new and more fluid balance between financial innovation and security, encouraging investment to respond positively to market signals and designing framework policies appropriate to a period of flux.

iv) Ontario's Automotive Sector

The motor vehicle industry has had three excellent years. Car sales in Canada soared at a 19 percent annual rate from 1983 to 1985. In the U.S. sales grew at a 12 percent average rate. Employment in the Canadian plants had recovered by 1984 to the peak levels set in 1979. The combined profits of the Big Four (GM, Ford, Chrysler and AMC Renault) hit an all-time high of $11 billion in 1984. Since 1982, Canada has enjoyed a large and rapidly growing surplus on the balance of trade in motor vehicles and parts and 1985 promises to be the best year yet.

Notwithstanding these good times, the industry appears to be heading for a painful crunch -- which may come as early as 1987-88 -- as a result of the appearance of substantial excess capacity in the plants of the Big Four.

This scenario is based on forecasts of slower overall demand growth coupled with rising market shares held by Japanese and other foreign automakers and accentuated by relatively faster demand growth in the small-car segment where these producers have a cost and quality advantage.

On the basis of existing information, the projection of excess capacity is about 1.3 million units, some 15 percent of the 1985 North American Big Four car production and approximately 130 000 jobs. Ontario, with 85 percent of Canadian activity and employment, could bear the brunt of any Canadian losses. (By way of comparison, the 1979-82 automotive downturn resulted in an output cutback of about 32 percent in Canada over four years and layoffs totalling 26 200.)

Some observers suggest this forecast is somewhat pessimistic because Ontario has a smaller portion of small-car production (25 percent vs. 40 percent in the U.S.), Ontario production costs are lower and Auto Pact safeguards may require plants to be kept open. As well, two Japanese producers -- Honda at Alliston and Toyota at Cambridge -- will start production over the forecast period. This new assembly capacity also will open growth opportunities for domestic part suppliers, especially if the new assemblers wish to take advantage of the Auto Pact.

This top-down perspective can be matched against a bottom-up view based on a plant-by-plant assessment. While only incomplete, preliminary work has been done, this approach suggests that among the Big Four some of Ford's capacity is vulnerable, as are the AMC/Renault plants. Affected communities could be Oakville, St. Thomas, Sarnia, Stratford and Brantford.

The independent parts industry, which employs 60 percent of the parts workforce, has not been assessed on a plant-by-plant basis. Most companies are poorly positioned to obtain out-sourcing opportunities from the Big Four, so their outlook could be worse than for the Big Four. However, they should have an opportunity to forge relationships with the new assemblers if they are able to upgrade their competitiveness.

This outlook is entirely independent of the outcome of trade negotiations, but the timing likely will be coincident and therefore linked in public perceptions. If the pact is included in the trade talks, it will represent a very contentious aspect of the negotiations, and the job losses due to excess capacity will be seen as the result of liberalization.

The Ontario government in particular may press hard for border measures, minimum Canadian content requirements, subsidies for modernization, product innovation and employee retraining, and for exchange rate or tax measures to maintain its number one industry sector.

In the absence of such assistance, Ontario's concerns about free trade with the U.S. could be greatly amplified and made quite specific and tangible in the public's mind. Its opposition to free trade could become highly focused around the plight of the motor vehicle and parts industry.

4. NORTHERN RESOURCES

Northern Ontario's dependence on its endowment of rocks and trees historically has meant a boom-and-bust economy concentrated in single-industry communities and marked by a growth rate below that of the rest of the province.

The recession of 1982-83 and the appreciation of the Canadian dollar against currencies other than the U.S. dollar hit the area very hard, and to this day its major industries have not recovered fully. There is reason to believe that boom times may never return, as the recession highlighted and exacerbated a number of structural trends which threaten the long-term health of the resource-based industries.

The minerals sector has long been a price-taker in international markets, relying on the quality of its resource base and its cost efficiency to remain competitive. The past decade has seen markets and prices for most of Northern Ontario's minerals except gold decline as alternative materials, general downsizing and slower world economic growth reduced world demand.

At the same time, downward pressure on price has occurred as a result of the entry of Third World countries as major suppliers. They threaten the total demise of the industry, as they not only have modern world-scale facilities, but persist in saturating market demand at, or below, cost to earn badly needed foreign exchange.

To stay in the game, the mining industry has been forced to innovate and apply new technology and techniques at an accelerated rate in all stages of the industry -- prospecting, mining and processing. These steps hold the promise of enabling the industry to maintain its position, but at a substantial socio-economic cost to the region, as well as financial cost to the industry.

The major effect of the new technologies is to displace labour, thereby worsening the unemployment rate, reducing incomes in the region and causing substantial economic and social problems for mining communities.

Environmental concerns about the impact of acid rain have placed increasing pressure on the nickel companies to reduce the SO_2 emission from their smelters. To some extent this pressure coincides with the need to modernize smelter operations in order to remain competitive and the federal and provincial governments are prepared to provide some financial assistance for this purpose. However, the emission-reduction targets recently announced by the province are seen by the industry as being too rigorous. Inco, in particular, has said the targets are unattainable at any cost. Layoffs and shutdowns are the lightly veiled alternatives the company is suggesting if the new limits are implemented.

The problems facing the foresty and forestry-related processing industries are similar: soft world prices, slow demand growth, excess capacity and fierce international competition. However, the most pressing problems relate to the fibre supply and the costs of processing.

This industry has lost any resource-base advantage it once had. Quality stands of wood fibre are increasingly distant from mills, making their cost higher, and the quality and availability of the resource is threathened by pests, fire and insufficient resource management. The advent of new pulping technologies has diminished the historic advantage of Ontario's quality, long-fibred northern softwoods. New thermo-mechanical and chemi-thermal-mechanical pulping processes have enabled fast-growing southern U.S.A. pine and the eucalyptus forests of the Third World to rival the Canadian product in terms of quality.

Unlike the mining industry, parts of the wood-processing industry have not kept cost-competitive with their foreign counterparts. In addition to the higher resource costs noted above, Ontario pulp and paper mills tend to be older, less efficient and more labour-intensive than best-practice mills elsewhere. To rectify this situation would require a massive modernization effort at a time of over-capacity and soft markets. Lumber producers have remained efficient and modern, but are constrained by labour costs higher than elsewhere in Canada and the U.S.

The effects of these trends and of any industry efforts to deal with them will again be painful for the region. Employment, as a major and variable cost, will be reduced as a result of either downsizing or modernizing. The health of single-industry towns will be affected and many individuals will have to seek work in other sectors outside the region, continuing the trend to emigration which has been evident for some time.

The advent of freer trade with the U.S. would give the industries some additional market opportunities which would aid in their survival. But, even this will not lead to a resource boom sufficient to increase employment.

The third northern resource-based industry, tourism, does have potential for growth and for employment creation. The industry currently produces significant income and employment for the region, but the resource is only lightly developed and potential demand is large and growing. As in other industries, product quality, capital investment and a skilled workforce will be needed to be successful.

5. CONCLUSIONS

Ontario enjoyed a good year in 1985 and the prospects for the current year suggest continued growth. Over the medium term, the economy will come under pressure as a result of Ontario's integration into international markets and the competitive, volatile nature of those markets.

Within this scenario, the dominant issue is the negotiations around more liberalized trade with the United States. Freer Canada-U.S. trade would have significant impacts, both positive and negative, on Ontario's economic structure and growth.

The quality of human resources Ontario is able to develop and deploy will be an important determinant of the economy's success in responding to new conditions. These resources will need to be supported by institutions which are flexible and contribute to improving the quality of the labour force. Another important factor influencing the adjustment response will be the flexibility and strength of capital markets.

In sectoral terms, the ability of two important industry groups to weather coming structural turning points will have a major influence on the overall response of regions in which they are situated.

In the industrialized south, the auto industry is expected to go through a major shake-out in the part of the industry centered around the Big Four, coupled with growth in the non-North American component of the industry.

In the north, mining and forestry will face tough competition. The challenge and the response threaten to weaken the socio-economic fabric of Northern Ontario. Tourism offers potential growth which might offset some of these impacts.

Governments will influence this perspective principally through the appropriateness of the broad "framework" policies they pursue -- trade liberalization, skills development and capital markets regulation -- and there also may be scope for policies and programs to address the particular requirements of the automotive and resource industries. In addition, of course, there will be demands from many other quarters for special programming to deal with other specific interests.

ANNEX A -- ONTARIO ECONOMIC STRUCTURE AND PERFORMANCE

i) Structure

Ontario constitutes 11 percent of the Canadian land mass and 36 percent of the nation's population. In terms of labour force, retail sales, output and income, Ontario's share of the national total is slightly greater than its population share. This situation is even more pronounced with respect to exports, with those originating from Ontario accounting for nearly half of the Canadian total.

Like the rest of Canada, Ontario has a large service sector within its economy, although it is smaller than in all other provinces. In terms of national share of services, the province particularly dominates the finance, insurance and real estate activity. Unlike other provinces, however, which rely largely on the resource and related processing industries to make up the difference in their economic activity, Ontario depends on secondary manufacturing which accounts for just over a fifth of provincial output.

Dominating such activity is the auto industry, which accounts for one-quarter of manufacturing production. The electrical-products and metal-fabricating industries are also significant, with the chemical and printing industries showing increased importance. In terms of resource-related activity, approximately 11 percent of economic activity is derived from these sources. Table 1 (page 20) provides more detail on the sectoral allocation of Ontario activity and employment.

Within the province, the Toronto-centred region is economically dominant. Constituting 37.2 percent of the provincial population, it plays a significant role in terms of the service-sector functions of transportation, communications, trade and finance. It also is a substantial manufacturing centre, characterized by low- and medium-tech industries. Cheap labour provides an attraction for many industries such as clothing, furniture, textiles and printing. Metal fabricating and electrical products are other leading industries.

Equally significant from an economic perspective is the Highway 401 corridor, which skewers the Toronto region on an east-west axis and contains 29 percent of the province's population. Like the Toronto region, the corridor has a disproportionately large share of manufacturing which is dominated by capital-intensive, frequently high-tech, heavy industry. Notable activities include primary metals, transportation equipment and machinery. Agricultural activity is heavily concentrated here, too; over one-half of farm cash receipts are earned in this area. Together, the Toronto-centred region and the corridor account for from 50 percent to 90 percent of all types of Ontario economic activity, with the exception of a few resource industries.

The rest of the province, containing over 90 percent of the land mass and a third of the population, has an economy very much like the rest of Canada. The dominant industries are extractive and processing operations related to resource endowments of minerals, agriculture and wood. Complementing this goods-producing activity is a service sector which is largely based on community and personal-service activities. Development in this part of the province tends to be slower, fragmented and tied to resource exploitation projects.

With respect to market orientation, Ontario consumes over one-half of everything it produces, while the residual is distributed on a three-to-one basis between offshore exports and those to the rest of Canada. Items produced predominantly for the international market include almost all types of services, construction and the manufacture of food, paper, motor vehicles and several other key metal products. Economic activity -- where demand from other provinces is important -- is largely goods-related and tends to involve heavy industry items or consumer durables. The exceptions are financial and transportation services.

Foreign exports are a particularly important source of demand for the province, with almost half of Canada's offshore trade originating in Ontario. Historically, four-fifths of the province's trade is with the U.S.A. and is overwhelmingly related to the auto sector, with Ontario accounting for 93 percent of all Canadian auto-related trade activity. Non-auto exports to the U.S. are slightly less than 40 percent of the national total and are primarily resource-related, although office, scientific and communications equipment also are extensively traded. Exports of services are relatively unimportant, with only 12 percent of trade earnings being attributed to this source. Such trade also is less concentrated in the U.S. market.

In contrast with other provinces, Ontario runs a trade deficit with foreign countries and a surplus in its interprovincial trade. The latter is larger, meaning Ontario produces more than it consumes. The province receives livestock, grain and hydrocarbons from Western Canada, a wide range of processed and manufactured products from Quebec and a significant amount of financial and transportation services from both regions.

Internationally, Ontario relies on the U.S.A. for more than 80 percent of its imports, notably fruit and vegetables, machinery, automotive products, scientific equipment, industrial chemicals, communications equipment and printing.

ii) Performance

After a very strong year in 1984, marked by real growth of seven percent, the Ontario economy grew by an estimated 4.8 percent in 1985. The demand components contributing to growth in 1985 were much more evenly distributed. The addition of the consumer spending and investment elements to that of the slower, but still substantial, performance of the export market provided a broader and more sustainable base for provincial development. Investment growth is particularly welcome because of its effects and its contribution to future growth and competitiveness.

On a sectoral basis, some of the strongest and most consistent performances have been derived from the service sectors, notably transportation and communications and the finance, insurance and real estate group. The increases in consumer spending, particularly on motor vehicles and clothing, during the first three quarters of 1985 also helped to retain the trade sector at a strong level of performance. On the goods-producing side, construction -- with improved investment activity for machinery and equipment -- showed a positive turnaround. Manufacturing activity, led by strong performances in all facets of the transportation equipment industry, as well as textiles, clothing and petroleum, matched the level of overall provincial performance after substantial advances during 1984. Struggling, after good performances in 1984, were utilities and the resource sector, along with the latter's related processing industries. Growth in the public administration sector continues to be stagnant.

Recent trends in the labour market indicate improvement (Table 2, page 21). Annual provincial unemployment dropped from 9.1 percent in 1984 to eight percent in 1985, due to a combination of increased employment and slower growth in the labour force. As of January 1986, approximately 392 000 people remained without jobs in Ontario, 30 percent of total Canadian unemployment. Pockets of the most severe unemployment are centered around Sudbury, Thunder Bay and St. Catharines-Niagara Falls.

In terms of earnings, real personal income grew by about three percent, down from 5.5. percent in 1984. While inflation has been relatively constant, this drop can be attributed to lower labour settlements and increased taxes. Investment returns, on the other hand, have been very strong since an exceptionally poor year in 1983. Personal savings, after being lower in 1983, also have again been moving upwards. Ontario corporate profits before taxes have had a fairly strong turnaround from their recession lows and debt/equity ratios have almost all been totally restored except in the resource-related area. Latest Provincial Accounts information shows profits advancing by 5.6 percent over the first half of the year. Nevertheless, for many industries corporate performance still remains below pre-recessionary levels. Real profits for the industrial goods, resource-related services, construction and real estate sectors all fall under this category.

Provincial growth for 1986 is estimated to be in the 3.0 to 3.5 percent range. This more modest expansion will result from a further moderation of growth in the area of net trade, as well as in consumer spending. The latter factor will be weakened by tax measures initiated in recent federal and provincial budgets, the impact of which will be most noticeable next year. This will be partially offset by lower energy prices. Investment spending, for its part, is largely committed and is expected to be one of the stronger areas of growth.

Table 1

1984 Ontario Economic Structure*

	Share of Provincial Output (%)	Share of Provincial Employment (%)	Share of Corresponding National Activity (%)
Total Resource and Related Processing	11.6	10.4	33.1
Agriculture - Includes Food and Beverage and Tobacco Manufacturing	4.9	5.2	36.9
Mining - Includes Primary Metals Mfg., Non-Metallic Minerals, Petroleum and Coal	4.4	3.2	33.8
Forestry - Includes Pulp and Paper and Wood Manufacturing	2.3	2.0	27.0
Total Secondary Manufacturing	20.8	17.1	62.1
Transport, Equipment	6.2	3.6	79.5
Other Secondary Manufacturing	14.6	13.5	58.0
Total Services	61.2	66.2	38.6
Community, Business and Personal Services	20.9	30.5	41.1
Finance, Insurance and Real Estate	14.7	6.4	44.0
Other Services	25.6	29.3	34.5

* Excludes construction and utilities sectors, fishing and trapping.

Table 2

1985 Economic Indicators

	Ontario	Canada	Ontario as a Percent of Canada
Population (thousands)	9 066	25 359	35.8
Gross Domestic Product (Current $ million)	157 213	422 308	37.2
Labour Force (thousands)	4 787	12 639	37.9
Employment (thousands)	4 402	11 311	38.9
Unemployment Rate	8.0%	10.5%	76.2
Participation Rate	68.0%	65.2%	104.3
Personal Income Per Capita ($)	16 905	15 386	109.9
Earned Labour Income Per Capita ($)	11 504	9 930	115.9
Exports as a proportion of GDP	36.6%	27.6%	132.6

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