

ANNEX II

Economic Outlook

OVERVIEW

The province's economic growth is expected to be soft in the near term due to heightened global economic uncertainty. The Ministry of Finance is projecting Ontario real gross domestic product (GDP) growth of 0.1 per cent for 2008. The average private-sector forecast for Ontario real GDP growth, as of October 16, 2008, is 0.7 per cent in 2009.

Ontario Economic Outlook (Per Cent)	Table 1						
	2003	2004	2005	2006	2007	2008e	2009p
Real GDP Growth	1.4	2.5	2.7	2.5	2.2	0.1	0.7
Employment Growth	3.0	1.7	1.3	1.5	1.6	1.5	0.4
CPI Inflation	2.7	1.9	2.2	1.8	1.8	2.3	2.0

e = estimate; p = private-sector average (October 16, 2008).

Sources: Statistics Canada, Ontario Ministry of Finance and Ontario Ministry of Finance Survey of Forecasts.

This is a time of unusually heightened global economic uncertainty that is having an impact on many jurisdictions including Ontario. Private-sector forecasts for economic growth were changing rapidly during the writing of this document, reflecting the current environment. The Ministry of Finance will update its economic growth projections for planning purposes in the 2009 Budget.

FINANCIAL MARKET TURMOIL

Recent global financial market and economic turmoil poses a significant threat to economic growth. Virtually every economy has faced a decline in consumer and business confidence over the past year. There have been significant liquidity challenges in the investment and banking sectors. Equity markets worldwide have experienced sharp price declines. Central banks have acted to prevent credit markets from seizing up by injecting liquidity and lowering their policy interest rates. The fall in interest rates for central government debt, however, has not been fully matched by declines in interest rates for businesses, consumers and other levels of government. As well, financial market uncertainty has reduced credit availability and is dampening business and household spending, which is having an adverse impact on Ontario.

SOURCES OF CREDIT MARKET TURMOIL AND RISKS TO GROWTH

The global financial crisis began with a sharp rise in defaults in the subprime mortgage market in the United States. Many of these high-risk mortgages had been packaged as securities and sold to investors around the world. Rising default rates caused the value of these securities to plunge. Uncertainty regarding risk led to reduced lending and higher interest rates for businesses and consumers. Numerous well-known institutions have failed, been acquired by their governments or bought by stronger competitors at marked-down values.

The Canadian banking and financial systems are in much better shape than their counterparts south of the border. The subprime mortgage market in Canada is estimated to account for less than five per cent of the mortgages outstanding, compared to 22 per cent in the United States. Canadian banks, therefore, have faced much lower loan losses. Risk aversion in U.S. financial markets has spread to Canada, but to a lesser extent. The commercial paper market has frozen up, making it very difficult for businesses to raise money through the traditional capital-market channel. Canadian Treasury-bill yields have fallen as investors look for safer assets. Inter-bank lending rates have increased sharply in Canada, making it more costly and difficult for banks to do business.

The most serious risk going forward is the relationship between the financial system and the economy. Tighter liquidity conditions lead to restrictions in business and consumer lending, which contributes to weaker economic growth that in turn leads to further weakening in financial markets. Recently, central banks and governments worldwide have injected substantial additional liquidity and provided other important measures to safeguard the financial system.

ONGOING EXTERNAL ECONOMIC CHALLENGES

Ontario has been facing an increasingly challenging external economic environment. Until recently, oil prices have been increasing and the Canadian dollar has been strengthening. More recently, weakening U.S. demand and heightened global financial market turmoil have created additional challenges.

Key External Variables	Table 2						
	2002	2003	2004	2005	2006	2007	2008 ^y
Crude Oil (\$ US per Barrel)	26.1	31.1	41.4	56.5	66.1	72.3	113.3
Canadian Dollar (Cents US)	63.7	71.4	76.8	82.5	88.2	93.1	98.2
U.S. Real GDP Growth (Per Cent)	1.6	2.5	3.6	2.9	2.8	2.0	2.3
Three-Month Treasury Bill Rate	2.6	2.9	2.2	2.7	4.0	4.2	2.6
10-Year Government Bond Rate	5.3	4.8	4.6	4.1	4.2	4.3	3.7

y = year-to-date average (October 16, 2008).

Sources: Bank of Canada, New York Mercantile Exchange and U.S. Bureau of Economic Analysis.

The price of oil has soared from a low of \$18 US per barrel in January 2002 to a record high of more than \$147 US per barrel in mid-July 2008. Oil prices have averaged \$113 US per barrel so far this year, up \$87 US per barrel over the past six years — the largest increase on record. Higher oil prices are a challenge for Ontario because they increase costs for businesses, consumers and governments. In 2007, Ontario residents and industry spent an estimated \$30 billion on crude oil and oil products, natural gas and coal, equivalent to about five per cent of the province's GDP.

The Canadian dollar increased from a low of 61.8 cents US in January 2002 to a peak of 110.3 cents US in November 2007, marking the largest five-year increase on record. So far this year, the Canadian dollar has averaged 98.2 cents US. The stronger Canadian dollar is a challenge as it makes Ontario's exports more expensive and imports cheaper. As a result, Ontario businesses find it more difficult to compete with foreign producers, both in the Canadian market and abroad. On the other hand, the stronger Canadian dollar benefits Ontario consumers and businesses by lowering the cost of imported goods and materials, including productivity-enhancing machinery and equipment.

U.S. demand for Ontario-produced goods and services has been declining due to the stronger Canadian dollar, weakening U.S. economic growth and increasing competition from newly industrializing economies. The value of Ontario's merchandise exports over the last five years to the United States, its largest trading partner, has fallen by 12.2 per cent.

While newly industrializing economies are a competitive challenge for Ontario

businesses, they also present new opportunities. Ontario's international merchandise exports to countries other than the United States have more than doubled over the past five years.

As a result, Ontario's export base has significantly diversified. For instance, over the last five years, the value of merchandise exports to Russia has increased by 377 per cent; exports to India by 258 per cent; and exports to China by 95 per cent. Ontario has also increased its exports to other G7 countries.

Over the last five years, exports to the United Kingdom have risen by 280 per cent; exports to Germany by 36 per cent; exports to Japan by 30 per cent; and exports to Italy by 77 per cent.

ONTARIO'S ECONOMIC PROGRESS OVER THE PAST FIVE YEARS

Ontario's economic advantages include its proximity to large markets, a well-educated population, a highly skilled workforce, diversified industrial structure, competitive business costs, modern infrastructure and strong support for innovation. The Ontario Government's five-point economic plan, outlined in the *Foreword*, continues to enhance the foundation for long-term growth.

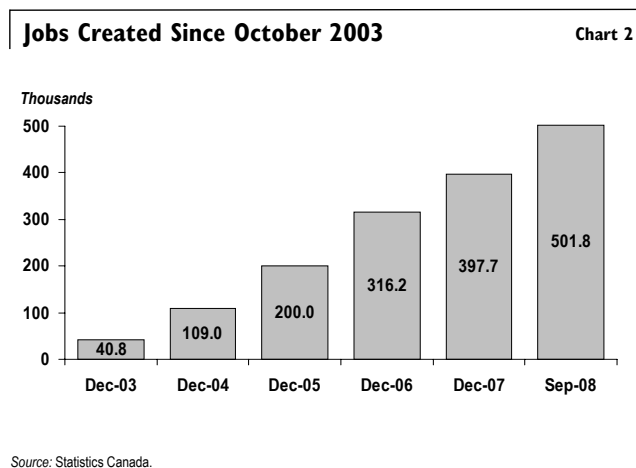
There has been continued economic growth in Ontario over the past five years, despite an increasingly challenging global environment:

- Ontario real GDP growth averaged 2.3 per cent over the 2003 to 2007 period.



- Inflation has been low and stable in recent years, with the consumer price index (CPI) inflation rate averaging close to two per cent over the 2003 to 2007 period.

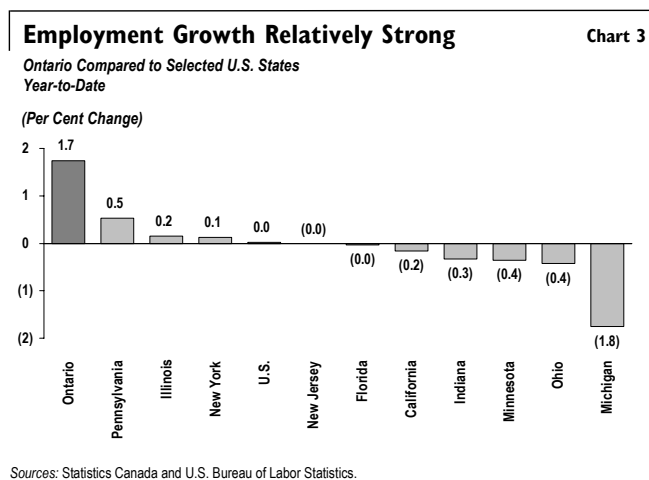
- More than a half million net new jobs have been created since October 2003. There has been strong employment growth in sectors paying above-average wages, including educational services (98,000); health care and social assistance (89,200); construction (73,500); professional, scientific and technical services (62,100); and finance, insurance, real estate and leasing (47,800).



- Solid wage and employment growth has led to strong income gains. Real personal disposable income per capita has grown at an average annual pace of 1.8 per cent over the past five years.
- Business investment has been robust. Real machinery and equipment investment, a key component of increasing productivity in the province, expanded by an average of 9.0 per cent annually between 2003 and 2007.
- Housing starts averaged 78,100 per year between 2003 and 2007. Unlike in other jurisdictions, there is little evidence of overbuilding in the Ontario housing market.

THE ONTARIO ECONOMY IN 2008

As reported in the 2008 second-quarter Ontario Economic Accounts, Ontario economic growth during the first half of 2008 was very modest. Real GDP increased 0.3 per cent in the second quarter, following a contraction of 0.4 per cent in the first quarter. The main drag on growth has been lower export volumes, which are down more than seven per cent over the first half of the year. Ontario is not alone in seeing modest growth during the first half of 2008. Canadian real GDP increased



0.1 per cent in the second quarter, following a contraction of 0.2 per cent in the first quarter.

All G7 economies are also facing significant economic challenges. Among them, Germany, France, Italy

and Japan have seen at least one quarterly decline in output so far. Despite avoiding a quarterly decline, there has been weakness in U.S. and U.K. employment, housing construction and financial markets.

Ontario has created 104,100 jobs so far this year. About 83 per cent of these have been in the private sector. Although Ontario has lost 16,200 manufacturing jobs, there have been strong job gains in other industries paying above-average wages including construction (37,500); health care and social assistance (26,800); and professional, scientific and technical services (19,400). This increase in employment has led to solid income gains. Labour income grew by 4.2 per cent over the first half of the year, supported by job gains and higher wages.

The side of the Ontario economy based on domestic demand has remained strong in 2008. Household spending continues to be firm, with real consumer spending up by a robust 4.6 per cent in the first half of the year. Residential construction spending has increased by 0.9 per cent in real terms. So far in 2008, housing starts averaged 77,600 units (on an annualized basis), up from 69,100 units for the same period in 2007. While housing starts have increased, home resales have weakened from a record-setting year in 2007.

Corporate profits are down 2.8 per cent over the first half of this year, reflecting the negative impact of record oil prices and the higher dollar. So far this year, Ontario real non-residential construction has grown by 2.1 per cent, and real machinery and equipment spending has risen 1.2 per cent.

Ontario's CPI inflation rate has averaged 2.2 per cent so far this year, up from 1.8 per cent in 2007. This was largely due to elevated gasoline prices and an increase in food inflation. Ontario's core inflation rate, which excludes food and energy, has averaged 1.1 per cent on a year-over-year basis and has remained below 2.0 per cent for 11 straight months. The dramatic decline in oil prices since mid-July 2008 will exert downward pressure on CPI inflation over the near term. Over the first seven months of 2008, annual wage settlements have averaged 2.4 per cent.

Ontario's trade balance has deteriorated significantly in 2008, largely because of a decline in automotive exports to the United States. Imports have declined, but at a slower pace than exports, largely due to reduced demand for automotive production inputs.

HEIGHTENED GLOBAL ECONOMIC UNCERTAINTY

The short-term Ontario economic outlook is heavily influenced by external factors such as oil prices, the Canadian dollar exchange rate, interest rates, U.S. economic growth and global financial market turmoil. In the current economic environment there is an unusually wide range of views on the outlook for each of these key factors as shown in the following table. The recent dramatic movements in asset prices, foreign exchange and commodity markets mean that relatively little confidence can be attached even to these wide private-sector forecast ranges in 2009.

External Variables

Table 3

Private-Sector Forecast

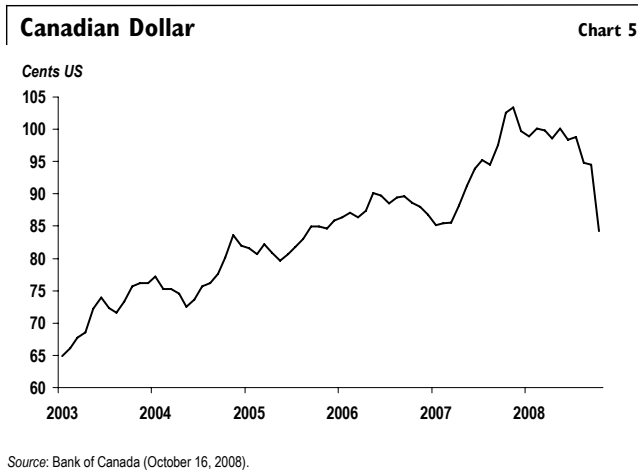
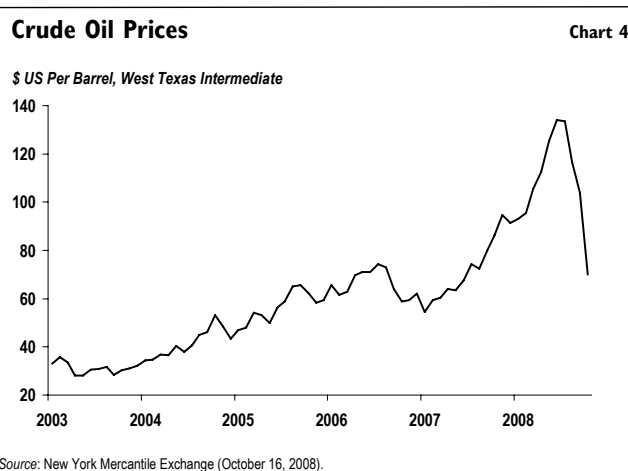
	2008			2009		
	Low	Avg.	High	Low	Avg.	High
Crude Oil (\$US per Barrel)	105.0	110.4	119.1	78.0	103.3	130.0
Canadian Dollar (Cents US)	93.7	95.7	97.7	85.3	92.2	95.7
U.S. Real GDP Growth (Per Cent)	1.2	1.5	1.8	(0.7)	0.5	1.9
Three-Month Treasury Bill Rate (Per Cent)	1.8	2.2	2.7	1.7	2.3	3.5
10-Year Government Bond Rate (Per Cent)	3.4	3.6	4.0	3.4	3.9	4.5

Sources: Bank of Canada, *Blue Chip Economic Indicators* (October 2008) and Ontario Ministry of Finance Survey of Forecasts (October 16, 2008).

Oil prices fell from a record intra-day high of \$147.27 US per barrel on July 11 to less than \$70 US per barrel in mid-October 2008. Weaker demand from Organization for Economic Cooperation and Development (OECD) countries is expected to continue to be more than offset by strong consumption in non-OECD countries. Limited global surplus capacity will likely keep oil markets relatively tight and oil prices vulnerable to major supply disruptions over the forecast horizon.

A significant amount of volatility still exists in oil markets, and analysts' projections for 2009 range from a high of \$130 US per barrel to a low of \$78 US.

After hovering around parity with the U.S. dollar for the first seven months of the year, the Canadian dollar depreciated significantly in October, reflecting the sharp decline in commodity prices and weakening outlook for the domestic economy. The value of the Canadian dollar could fluctuate a great deal in the future depending on commodity prices, financial flows and interest rates. There is a



significant divergence of views on the outlook for the Canadian dollar, with forecasts ranging from a low of 85.3 cents US to a high of 95.7 cents US in 2009.

Although overall U.S. economic growth has continued at a moderate pace, there has been a significant reduction in U.S. demand for Ontario-produced goods and services. For example, spending on autos has been particularly hard hit, with auto sales expected to slow to 13.8 million units in 2008 — the lowest level since 1992. There are considerable risks stemming from the U.S. economy, which continues to face imbalances and significant issues in its financial markets.

Interest rates affect consumer and business costs as well as the projected government expense for interest on the Province's debt. The Bank of Canada has cut its benchmark target for the overnight interest rate by 200 basis points since December 2007, including the 50 basis point cut on October 8, 2008, and has taken additional measures to support liquidity in financial markets. However, the turmoil in global financial markets has led to tighter credit conditions for businesses, and some are facing higher borrowing costs. How global financial markets evolve and how this impacts economic growth have important implications for interest rate projections.

The wide range of views on each of these key assumptions represents a significant risk to the forecast because a change in any of them can have a major impact on Ontario's economic growth outlook. The following table shows the typical range for the first- and second-year impacts of these external factors on Ontario real GDP growth. These estimates are based on historical relationships and illustrate the upper and lower limits for the average response. They show the implications of sustained changes in key assumptions in isolation from changes to other external factors. The combination of changing circumstances can also have a substantial bearing on the actual outcome.

Impacts of Changes in Key Assumptions on Ontario Real GDP Growth¹ (Percentage Point Increase)	Table 4	
	First Year	Second Year
Canadian Dollar Depreciates by Five Cents US	0.1 to 0.8	0.5 to 1.2
World Crude Oil Prices Decrease by \$10 US per Barrel	0.1 to 0.5	0.1 to 0.5
U.S. Real GDP Growth Increases by One Percentage Point	0.3 to 0.7	0.4 to 0.8
Canadian Interest Rates Decrease by One Percentage Point	0.1 to 0.5	0.2 to 0.6

¹ Impacts based on changes being sustained.

Source: Ontario Ministry of Finance.

PRIVATE-SECTOR ECONOMIC FORECASTS

The Ontario Economic Forecast Council was established as part of the *Fiscal Transparency and Accountability Act, 2004* to provide advice on macroeconomic forecasts and assumptions. The council members are Peter Dungan from the University of Toronto, Glen Hodgson from the Conference Board of Canada, Dale Orr from Global Insight and Ernie Stokes from the Centre for Spatial Economics. The Minister of Finance met

with council members and other private-sector forecasters in the process of preparing the *2008 Ontario Economic Outlook and Fiscal Review* and received their views on Ontario's economic outlook and other economic policy advice.

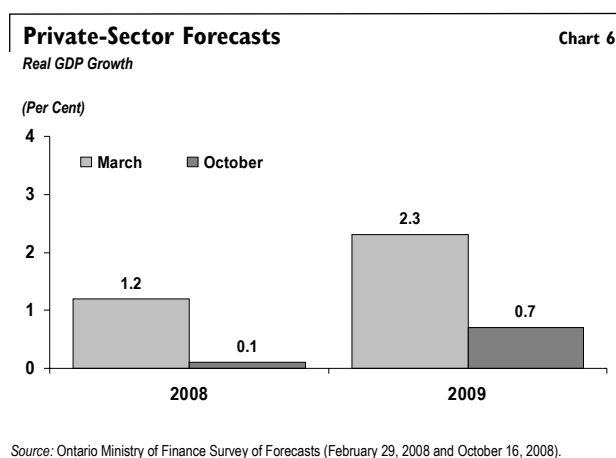
Private-Sector Forecasts for Ontario Real GDP Growth (Per Cent)	Table 5	
	2008	2009
Conference Board of Canada (October)	0.3	1.5
Global Insight (October)	0.3	0.5
Centre for Spatial Economics (June)	0.4	1.9
University of Toronto (October)	(0.4)	0.6
RBC Financial Group (October)	0.0	0.4
Scotiabank Group (October)	(0.1)	(0.9)
TD Bank Financial Group (October)	0.3	0.8
Desjardins Group (September)	(0.1)	0.9
BMO Capital Markets (October)	(0.1)	0.4
CIBC World Markets (October)	0.1	0.9
Private-Sector Survey Average	0.1	0.7

Source: Ontario Ministry of Finance Survey of Forecasts (October 16, 2008).

Private-sector forecasters are, on average, calling for modest Ontario real GDP growth of 0.9 per cent in 2009. This modest pace of growth is due to the view that the economic environment will remain challenging well into 2009. Views regarding the outlook for 2009 have changed rapidly, making it especially difficult for the government to determine appropriate planning projections.

COMPARISON TO THE 2008 ONTARIO BUDGET

The Ministry of Finance is lowering its projection for 2008 real GDP growth to 0.1 per cent from the 1.1 per cent released in the 2008 Budget last March. The average private-sector forecast at the time of the budget was 1.2 per cent. This adjustment largely reflects continued financial market turmoil and a more negative outlook for U.S. demand. Weaker Ontario real GDP growth in 2008 is largely reflected through weaker exports and profits. Exports are currently expected to decline by 6.0 per cent rather than remaining



flat as expected at the time of the Budget. Corporate profits are now expected to be weaker than forecast in March, falling by 5.0 per cent in 2008 instead of growing by 4.0 per cent.

Employment and wages, along with retail sales and housing starts, have performed well so far this year, with growth forecasts now higher than at the time of the Budget. Employment was forecast to grow by 1.0 per cent for 2008, but that forecast has been revised up to 1.5 per cent. Solid employment gains have contributed to stronger-than-expected income and spending growth. Personal income is forecast to rise by 4.2 per cent — 1.1 percentage points above the forecast at the time of the Budget. Retail sales for 2008 are now forecast to grow by 4.6 per cent, up from 3.4 per cent in the Budget, and there are expected to be 75,000 housing starts, up from a Budget forecast of 64,000.

The average private-sector forecast for Ontario real GDP growth is now 0.7 per cent in 2009, significantly weaker than the Ministry of Finance's 2008 Budget forecast of 2.1 per cent. This is primarily due to global financial market turbulence and a substantially weaker outlook for U.S. demand. The table below shows the changes in the projections for the key economic variables since the 2008 Budget.

Changes in Key Economic Forecast Assumptions, 2008 Fall Economic Statement Compared to 2008 Ontario Budget (Per Cent Change)				Table 6	
	2008		2009		
	2008 Budget	2008e Fall Update	2008 Budget	2008p Fall Update	
Real GDP	1.1	0.1	2.1	0.7	
Nominal GDP	2.8	2.1	3.9	2.2	
Retail Sales	3.4	4.6	3.7	3.6	
Housing Starts (000s)	64.0	75.0	63.0	64.9	
Personal Income	3.1	4.2	4.0	3.8	
Labour Income	3.4	4.3	3.9	3.9	
Corporate Profits	4.0	(5.0)	4.9	1.7	
Employment	1.0	1.5	1.1	0.4	
Job Creation (000s)	68	101	76	25	
Key External Variables					
Crude Oil (\$ US per Barrel)	85.0	108.0	80.0	103.3	
U.S. Real GDP	1.7	1.5	2.6	0.5	
Canadian Dollar (Cents US)	100.0	96.0	98.0	92.2	
Three-Month Treasury Bill Rate	3.3	2.3	3.8	2.3	
10-Year Government Bond Rate	3.9	3.6	4.5	3.9	

e = estimate; p = private-sector average.

Sources: *Blue Chip Economic Indicators* (October 2008), Ontario Ministry of Finance and Ontario Ministry of Finance Survey of Forecasts (October 16, 2008).

