“Rowing and Steering” Our Way Out of the Modern Staples Trap of Resource Capitalism

Daniel Drache, Professor Emeritus, York University, drache@yorku.ca

November, 29 2013

Comments Welcome

"Rowing and Steering" Our Way Out of the Modern Staples Trap of Resource Capitalism

Daniel Drache, Professor Emeritus, York University, drache@yorku.ca

The Pivot of Institutions and Economic Culture

Mainstream economists have long assumed that Canada and the United States operate from a shared rulebook because they are highly interdependent, liberal market economies. Yet studies by McCallum (1995), Banting and Simeon (1997), Helliwell (2002), Jackson (2002), and Drache (2004) have documented the divergent market patterns and practices between the North American neighbours. Other economists like Myrdal (1957), Hirshman (1958), Krugman (2008) and Stiglitz (2010) stressed the need to build linkages between the fast growing resource sector and the weaker and underdeveloped industrial side of the economy. Mel Watkins' restatement of the staples trap provided critical distancing from the foundational work of Innis (Watkins, 2007) and updated the theory of export-led growth in important ways. It supplied a modern analysis the rigidities of resource capitalism to sustain a balanced growth path.

The key features of the successful "Northern model of development" were the provision of mixed goods and social programs for working families and individuals, complemented by the general expectation that the government would play a large and significant role in the economy. Canadian public policy at its best was, in the vivid conceptual language of Peter A. Hall and David Soskice, a textbook example of a "coordinated market economy" – not a Hayekian liberal variant. The critical difference between the two archetypes was the large regulatory role of the state, "rowing and steering" the economy during resource commodity booms (Hall and Soskice, p. 8). Canada's unique model blended many elements: skilled human resources, a high-wage manufacturing sector, the dynamism of its powerful resource-based export sector, a modern public infrastructure, a robust financial sector, macro-economic stability, and a relatively unionized workforce. These were the critical elements that produced (until the turn of the century) a successful export-oriented growth strategy – driven by some of the best Canadian public policy practices.

Since 2000, however, the predominance of natural resources as well as neo-liberal cutbacks and the shrinking of redistributive policies and programs, have all favoured private wealth creation to an unprecedented degree. The proactive Canadian state had its wings clipped in dramatic fashion. Canada's policy space has been reoriented rapidly towards the Hayekian end of the spectrum. This bodes badly for Canada's ability to reign in the latest resource boom, and attain an economic trajectory that is more socially and environmentally sustainable.

The Innisian Insight

Innis' essential insight was that structural imbalances from external demand and the price distortions of commodity booms expose Canadian industries and communities to a highly volatile business cycle. Canada pays too high a price in terms of these externalities. It remains at the mercy of price spikes and the boom-bust demand cycle for Canada's rocks, logs, and energy staples. Each time the bubble bursts, Canada is left with a mega debt hangover due to the enormous fixed-cost investments required for export infrastructure.

The problem is visible once again in the current energy export boom. Today's pipelines are being built on the assumption that the world price for oil will stay well above $100 per barrel, but the unpredictability of global prices coupled with an oil glut in the US market has actually driven down prices. Mega-projects begun in the upside of the cycle prove to be unsustainable economically in the downside.

In the same way, at the end of the nineteenth century, the 'animal spirits of the wheat economy' led to a frenzy of unsustainable but lucrative railway building. Quickly, by the turn of the twentieth century, the three transcontinental lines were bailed out by the government and merged into two. It seems those lessons have been forgotten, as we repeat the same errors in overbuilding an expensive, unsustainable energy export infrastructure.

Innis rightly emphasized that Canada needed an altered trajectory to mobilize its resources in order to build strong industries, deepen its domestic market, and create new and better employment opportunities. Without a national strategy, investment follows the continental grooves of geography. The process is driven by a 'hot' energy sector sucking foreign direct investment into mining, oil and gas, and metals, lifting stock markets. Higher resource prices affect the exchange rate, with a disequilibrating impact on consumer and energy prices. An overvalued dollar knocks small- and medium-sized firms out of the competitive race, as they are forced to compete at a currency disadvantage too large to be offset by other factors.

Canadians needs to recognize that the current staples trap is reproducing once again the problems of structural imbalance, debt hangover, and the hollowing out of Canadian industry. Ottawa's approach has been to rebuff any notion of a viable energy policy, and instead let so-called market forces pick the winners. Canada's past policy successes required government to row and steer the economy – but Stephen Harper hardly sees this as his role.

The path to any substantive change in Canada requires us to examine the past and learn the historical dynamics. If the Canadian state can no longer "row and steer" the economy, it will be impossible to have national environmental policies and national resource strategies with realistic goals and realistic chances of success. The current resource boom is swamping any viable notion of an effective and comprehensive national energy and environmental policy.

All of these transformations are political with roots that stem from political power. Today's resource curse is more complex, multi-stranded and transnational than in Innis' day. It is rooted in more than commercial dependency on the US market. It has led to a variety of rigidities with crippling consequences for an economy burdened by debt and a shrinking industrial core. It has intensified the conflict between regional needs and local institutions – and the parallel conflict between local markets supporting indigenous developments and a compliant laissez-faire state. Regional specialization in resource exports has limited the role of central government, fragmenting policy space and weakening national regulatory capacity (including, crucially, the capacity to set environmental standards).

Six Elements of the Modern Staples Trap

Six identifiable elements of the modern staples trap create powerful negative externalities, requiring state intervention to overcome them. If there is no direct mechanism to take these factors into account in our analysis, nor any judicial order to reveal them, then the effects of these externalities will be concealed in the prices of the transactions between Canada and other transacting parties (Boutang, 2012). These externalities add up to a more dangerous staple trap than Michael Porter singled out in his 1992 major report on Canada's competitiveness for Business Council of National Issues (entitled *Canada at the Crossroads*). The six factors include:

- <u>'Dutch disease'</u>: Over-specialization in resources has significant adverse effects (experienced through the currency) on manufacturing competitiveness. In a 2013 study, the IRPP found that about a quarter of total manufacturing industries show a pronounced negative relationship between US exchange rate and manufacturing output. Hardest hit are labour-intensive and smaller firms such as textile and apparel, machinery, and consumer products.

- <u>De-industrialization</u>: The loss of manufacturing capacity results in the hollowing out of Canadian industry, with significant and long-term job loss. Branch plant firms are closed down as production is shifted to the US, Mexico or other low-wage production centres. Small- and medium-sized firms cannot compete with imported goods. After the 2008 financial crisis, about 400,000 jobs disappeared from the Canadian economy; less than 20 percent have returned (Drache 2013).

- <u>Policy drift</u>: A deliberate federal policy of "drift" has become a real barrier to the effective, balanced management of Canada's resource economy. Each firm, driven by global competitive pressures, sets its own expansion strategy independently, on a catch-as-catch-can footing. Each province is eager to exploit its resources for much-needed cash revenues. Technology transfer, skilling of the work force and access to capital are not co-ordinated between Ottawa and the provinces, but are industry driven. Laissez-faire ideology reinforces the dominant tendency in Ottawa to unilaterally abandon policy-making or regulatory capacity. Given the continuing volatility and uncertainty which mark this industry (such as the potential implications of the stunning increase in oil production in the US), this unilateral disarmament on the part of the central government is dangerous indeed.

- Policy capture: The extreme political influence of staples industries (in the modern setting represented especially by the powerful energy lobby) is not a new factor by any means, but business advocacy and insider lobbying by energy giants (and banks, too) have intensified. Their opposition to a sustainable national energy policy has for the time being succeeded in blocking a national environmental strategy, the litmus test of its power. Canada is now firmly in the U.S. Republican camp of trying to ignore global warming, and rejecting any national or international regulatory strategy to deal with it.

- Labour markets: Job-killing technology is another negative externality. The intense focus on efficiency gains and increased productivity in many industries means companies shed labour as they become more efficient. New hire rates are not adequate to restore employment to 2008 pre-crisis levels. Business benefits from the overall development of society and the educational attainment of its population, yet Canada continues to be a laggard with no fully developed employment strategy.

- Stewardship: Despite green shoots of supportive public opinion for a national energy strategy, Canada has a very weak notion of strategic stewardship. Ottawa does not have a sovereign wealth fund, like Norway, financed by energy royalties. Canada has not renegotiated a better deal from oil MNCs – as Brazil did when it forced energy corporations to pay a larger share of resource revenues from the discovery of deep ocean gas reserves off its coast. Alberta's wealth fund established in 1976 is still the size of a peanut: just $16 billion compared with Norway's (which was created in 1990, with a clear strategic vision) $800 billion. There are more than a hundred such sovereign funds globally, with $80 trillion in combined assets. Yet Canada, as the 7th largest oil producer and 3rd largest global gas producer, is 'lost in translation'. Ottawa does not believe in the need for a 'war chest' for uncertain times and national developmental goals.

Escaping the Staples Trap

The central challenge of the staples trap is to find a way out of deindustrialization, the dangerous debt overload from mega-resource projects, and the unprecedented job losses in core manufacturing industries resulting from an over-valued dollar. Some regions fare better from a resource boom, but even having multiple regions exporting Canada's wealth from the ground can only lead to more imbalances and twisting of markets. Winner-take-all regional economies do not want Ottawa to co-ordinate national goals and objectives; rather they hide behind a narrow regionalism that Innis was highly critical of. This leaves giant corporations like Enbridge and Vale in charge of Canada's resource future. Still, the public supports reducing greenhouse gas emissions and moving in a greener direction.

Innis was an institutionalist, not a determinist; he assigned primary importance to the policy environment and its regulatory institutions. If a government leads from the rear, the outcomes are suboptimal. An out-in-front government can set strategic goals and the appropriate means to achieve them. We need to look at how other jurisdictions unlocked the 'trap' of erroneous policies from the past (Drohan 2012). Deviations from orthodoxy or, more precisely, policy innovations ultimately stem from changes in power relations.

In Canada, we must build a very different policy environment to escape the modern staples trap and address the imbalances of fixed overhead costs, mountains of debt, and over-investment in unsustainable mega projects. Other countries have successfully climbed out of the staples trap, altering their economic trajectories. A survey of this experience suggests that seven conditions need to be met.

First, there must be a champion inside the political class to make it happen: such as a latter day Walter Gordon or Eric Kierans. Second, there must be a strategic purpose and moral compass for environmental and redistributive goals. Third, the country must possess a valuable commodity that gives the state the leverage to negotiate new resource revenue sharing with MNCs (revenues which in turn are recycled to support broader development goals). Fourth, the country needs a modern infrastructure. Fifth, public opinion must be on side to demand fundamental policy changes. Sixth, there need to be credible new ideas to transform the "resource curse" into a blessing. This requires a strategy to use resources as a driver of domestic growth and diversification, competitive industries, and strong job-creation. The final ingredient, of course, is luck. Here, timing is key: the optimal moment to introduce a national energy policy is during the upswing of a commodity boom, when the state has optimal leverage with banks and resource players.

No country ever has all these ducks lined up. But fresh ideas, strong leadership, and optimal timing are the key ingredients that could allow Canada to attain a more promising future than blindly riding the staples roller-coaster yet again.

References

Acemoglu, Daron and James A. Robinson (2012). *Why Nations Fail The Origins of Power, Prosperity and Poverty.* New York: Crown Business

Adams, Michael (2003). *Fire and Ice: The United States, Canada and the Myth of Inevitability* Toronto: Penguin, 2003.

Banting, Keith, George Hoberg and Richard Simeon eds. (1997). *Degrees of Freedom: Canada and the United States in a Changing World* Montreal: McGill-Queen's, 1997.

Barker, Alex and James Politi, (2013) "Brussels proposes €30bn 'Tobin tax'", *Financial Times*, February 14.

Canada Watch, Special Issue, Canada-US Relations Daniel Drache ed.8: 4–5, November–December 2002, available at www.robarts.yorku.ca

Drache, Daniel (2004). *Borders Matter: Homeland Security and the Search for North America*, Halifax: Fernwood.

Grant, Hugh and Wolfe, David eds. (2007) *Staples and Beyond – Selected Writings by Mel Watkins*, Montreal: McGill-Queen's U.P.

Helliwell, John F. (1998). *How Much Do Borders Matter?* Washington, D.C.: Brookings Institution.

Hirschman, Albert. (1958). *The Strategy of Economic Development.* New Haven, Conn.: Yale University Press.

Innis, Harold (1995). *Staples, Markets and Cultural Change: Selected Essays*, ed. by Daniel Drache Montreal: McGill-Queen's, UP.

Jackson, Andrew. (2002-2003) "Poverty and Income Inequality in the 1990s," *Economy* 13, no. 3 (Winter), CLC, Ottawa.

McCallum, John. (June 1995). "National Borders Matter: Canada-US Regional Trade Patterns," American Economic Review 85: p. 615–23;

Myrdal, Gunnar. (1957) *Economic Theory and Underdeveloped Regions*, London: Gerald Duckworth.

Porter, Michael (1992) *Canada at the Crossroads,* Ottawa: BCNI and Government of Canada, Industry and Commerce.

November 29, 2013