

## COMMENTARY

# A New Generation of Trade and Industrial Policy

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*Debates about free trade and industrial policy are back. The Trump Administration announced the creation of a new White House Trade Council, specifically to move on trade and industrial policy. As the global trade and investment agendas struggle with slower growth, rising protectionism and job anxiety, new thinking is needed within a rule-based regime to support a new generation of domestic industrial policy.*

Thirty-two years ago, the MacDonald Royal Commission Report challenged Canadians to take a “leap of faith” by embracing a comprehensive free trade agreement with the United States. The federal election of 1988 was won by the proponents of what became the Canada–U.S. Free Trade Agreement (FTA).

Before that leap, Canada’s trade with the United States comprised a series of sector-specific agreements, notably in automobiles. The shift to a comprehensive free trade agreement was therefore historic: it not only entrenched the Canadian focus on U.S. markets, but laid the groundwork for a new generation of regional trade agreements, including the North American Free Trade Agreement (NAFTA).

However, the free trade option prompted an intense public policy debate. As an article of faith, economists view free trade as a central plank of economic growth. The economics of free trade are based on a few, exceptionally potent notions, such as comparative advantage, specialization and scale, each of which is amenable to mathematical modelling (Clapp, 2014).

Yet some economists have always questioned whether trade liberalization inevitably enables countries, industries and communities to prosper. In the midst of the free trade debate of the 1980s, Canadian economist Mel Watkins—following the pioneering work of Harold Innes—doubted that free trade was capable of delivering cumulative benefits between countries. He argued, for example (anticipating the recent income inequality analyses of Thomas Piketty and others), that trade tends to magnify inequality within and between countries. While dismissed by most mainstream economic and business specialists, Watkins cautioned that Canada was especially vulnerable to free trade due to the country’s reliance on exporting natural resources such as minerals and forest products.

The knee jerk reaction then—as now—was to label those who questioned gains from trade as being anti-trade. Yet Watkins’ alternative route of economic development through industrial policy certainly included trade: however, it also envisioned job generation through



creating backward and forward linkages in resource-intensive sectors that would in turn diversify the Canadian economy, creating more higher-value-added segments than trade alone.<sup>1</sup>

It's useful to dust off these 30-year-old arguments for three reasons.

First, in many western economies there has been a growing public backlash against the trading system. While global trade has contributed to lifting hundreds of millions out of extreme poverty in developing countries, it has also unleashed fury in many industrialized economies, as job security and wages have stalled. Questions about the social license of trade are challenging when the trade agenda itself has increasingly moved beyond simply reducing tariffs to shaping the ability of countries to regulate their domestic activities. This has been most pointed in investor–state arbitration, first seen in NAFTA, which has led to legitimate discontent about the rights of domestic parliaments and courts to set and change domestic laws and regulations.

No one knows exactly what the Trump administration will do beyond killing the Transpacific Partnership Agreement, though it's likely NAFTA will be reopened.

Second, these changes are happening at a pivotal moment for global trade itself. From 1990 to 2007, global trade was a powerful and reliable economic engine, growing at roughly twice the rate of global output (Krugman, 2016; Mallaby, 2016). Since 2008, growth in global trade has (except for two years) been outpaced by growth in global output for the first time in decades.

Part of the slowdown in trade is due to China, which had a current account surplus in 2007 of approximately 10 per cent of its economy: in 2015 that shrank to 3 per cent. So, as the United States seems ready to turn its back on brokering global, regional and bilateral trade rules, many countries are looking to China to shape a new generation of trade agreements. In the last few weeks, China has reiterated its commitment to multilateralism through the World Trade Organization. At the same time, interest in the dozen regional trade agreements China has adopted, as well as ongoing negotiations for the Regional Comprehensive Economic Partnership, has intensified.<sup>2</sup>

The third reason to reexamine the role of trade and industrial policy is climate change. Canada and another 165 subnational jurisdictions including Quebec, Ontario and the Northwest Territories have set out a clear, ambitious goal over the next 30 years: reduce dependence on fossil fuels by 80 per cent.<sup>3</sup> Since the 2015 Paris climate agreement, innovative companies and countries are pushing a new generation of low-carbon jobs, services and innovations. In late 2016, Google committed to making all its operations 100 per cent reliable on renewable energy by 2017. Germany has promised to be 100 per cent renewable by mid-century.

Facing the convergence of these three challenges, many countries—including the United States—are looking at industrial policy as a tool to provide what free trade alone cannot deliver. Canada and other resource-dependent countries may repeat the leap of faith that free trade alone can address these challenges. How likely one judges this to be depends on how one views the country's record of economic growth over the past 30 years.

The current standard account of economic growth by country unit is GDP, and, according to the Organisation for Economic Co-operation and Development (OECD), Canada's rate of GDP growth from 1980 has increased steadily.

However, GDP data does little to alleviate fears about what the next decade may look like, as well as the uneven distribution of economic gains within a country or community. In late 2016, IISD published a [new report](#) that measured Canada's comprehensive wealth<sup>4</sup> over the past 33 years. This report compiled thousands of data and national statistics sets—from household data to forests and mining reserves—drawn primarily from Statistics Canada.

The [key findings](#) of the report are troubling. In the past 30 years—the period of analysis—Canada's wealth has grown by less than 0.2 per cent per year, taking into account inflation and population growth—the weakest growth rate of any G7 country. In unpacking this aggregate number, the report found that for human capital—which comprises 80 per cent of industrialized country wealth—there has been virtually no increase in the past 30 years, in marked contrast to our G7 partners.

<sup>1</sup> I am grateful to Brendan Haley for sharing his 2015 PhD thesis from the University of Ottawa, in setting up this juxtaposition between industrial policy and free trade. See also Haley (2014). As well thanks to Howard Mann and Aaron Cosby for their comments.

<sup>2</sup> See Whalley & Li (2014).

<sup>3</sup> Visit [Under2Mou.org](http://Under2Mou.org) for more information.

<sup>4</sup> Comprehensive wealth has emerged as a rigorous complement to more standard GDP indicators, and thus provides a mirror of the main structural features that together comprise our national wealth.



GDP growth neither anticipated nor explains the anger seething within many western democracies around job and wage insecurity. Our report shows that despite more Canadians investing in university degrees, diplomas and specialized skills, the average lifetime earnings of a Canadian worker today are exactly the same as three decades ago.

Two other empirical findings shed light on this wage stagnation. First, the value of Canada's natural capital—that is, mines, forestry and oil and gas—has declined by a staggering 25 per cent in the past 30 years. This drop is explained by two factors: some minerals, such as zinc and silver, have been physically exhausted, while the volatility of global commodity prices has created a roller-coaster effect, with Canada's wealth currently in a trough. For example, in 2015 the Canadian oil sands were valued at \$535 billion. According to Statistics Canada's most recent data, that value has dropped to \$50 billion—one-tenth of its earlier value.

Second, the strongest growth indicator over the past 30 years has been produced capital, increasing by roughly 1.6 per cent per year. However, the majority of that growth—almost 70 per cent—has gone into just two economic sectors: housing, and oil and gas. While the first is prone to instability (including bubbles), the latter is prone both to cyclic volatility, as well as to the longer-term scientific reality of a carbon-constrained economy moving forward. Both point to the lack of diversity in the Canadian economy.

The past three decades have largely been shaped by the faith that trade, as a centrepiece of Canadian economic policy, will steadily increase Canadian wealth. IISD's report on Canadian comprehensive wealth is not intended to explain the multiple causes behind three decades of lacklustre growth. Instead, it provides perhaps the most robust mirror of the underlying structures that together shape our wealth. Blaming Canada's lack of growth on trade is therefore simplistic, and we do not have a counterfactual mirror of what could have happened had Canada rejected the free trade option of the 1980s and embraced the vision of Innes, Watkins and others.

However, their warnings of a staples trap resonate in light of the overall drop in Canada's natural capital, coupled with the dramatic plunge in the asset value of the Canadian oil sands. Moreover, their warnings about the lack of backward and forward linkages within a staples

economy are reflected in the stunning lack of diversity in produced capital.

Yet the most compelling reason to reexamine these 30-year old debates lies not only in what our past performance has delivered. Instead, it lies in an alternative economic model to trade, envisioned and discarded in the 1980s, that is reemerging today.

Industrial policy is undergoing a renaissance. Governments are looking at how best to align and provide an urgent, coherent focus to innovation and competitiveness. Rapid changes in information technology have been dubbed the “fourth industrial revolution” by the World Economic Forum at Davos (Schwab, 2016). While these changes accelerate, Canada and other countries are eyeing how government policy can help innovation create jobs, markets and exports because of the transition to a low-carbon economy.

Despite the easily made criticism of industrial policy—i.e., that governments are lousy at picking winners—it is equally true that governments are poor at sustaining focused, coherent and clear goals to amplify innovation and productivity gains beyond fiscal policy incentives. Many of the key instruments of industrial policy—local content, specifying joint ventures, shielding infant industries, aligning government-led research and development with capital to bring to scale—have been used routinely in the past. Yet the policy space of these measures associated with industrial policy has been constrained by trade and investment rules.

This constraint too is now being questioned, and the debates raised 30 years ago by Watkins and others are back in play. More countries have embraced aspects of industrial policy, to the extent that it has been called a “renaissance” in industrial policy, whereby job skill upgrading is being aligned with public finance in research and development (Salazar, 2014).

Harvard economist Dani Rodrik, who has been (among many others) a strong voice warning of the limits of trade, globalization and the now-discarded Washington Consensus, has argued that industrial policy is best when it organizes different policy objectives—like fiscal treatment, infrastructure spending, research and development, job skill upgrading and other areas—around key goals.



Of course, there are in reality very few “either-or” crossroad public policy pathways. In adopting the best parts of industrial policy, Canada cannot turn its back on trade. Yet the policy space that the World Trade Organization allows for domestic space to focus and accelerate ambitious industrial policies remains open to debate.<sup>5</sup>

But what is clear from our report on comprehensive wealth is that Canada simply cannot repeat the same recipe of economic growth for the next 30 years. Now is the time to have a real debate about the road ahead.

<sup>5</sup> For example, Harsha Singh in Industrial Policy and the Rules of the WTO, International Center for Trade and Sustainable Development argues that the WTO leaves enough space for industrial policy, including infant industry protection. In contrast, Aaron Cosbey in Trade and Investment Law and Green Industrial Policy, UNEP (in press) argues that since a large proportion of industrial policy favour national industries, it runs afoul of core trade law principles of national treatment and non-discrimination.

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