

## Chapter 5

# Keynesian-flavoured Notes on Trade and Economic Structure

Trade and economic growth are tied together for both empirical and theoretical reasons. “Export-led growth” has become a catch phrase in economic literature for good reason. Economic growth is strongly correlated with export growth, particularly for those nations which have emerged from resource-based economies to developed status. This begs the question of causality. Do exports increase because of strong domestic growth or is export-led growth an accurate description?

Causality almost certainly flows in both directions. Exports increase because the domestic economy has grown to the point where local firms are competitive; on the other side of the equation, domestic economic growth is spurred by the stimulus of export growth and the constant need to improve products and productivity to keep up with the international competition. (Reverse the clauses, and the sentence still holds.) From this point of view, the adverse effects of regional subsidies on exports produces great damage to the region’s economy.

Trade is critical to economic growth according to both neo-classical and Keynesian analysis. From a Keynesian point of view, exports provide a key or, with some writers, the key source of demand stimulus, through a variation of the Keynesian multiplier effect. As McCombie and Thirlwall (1994, pg. 233) wrote, “the rate of growth of exports divided by the income elasticity of demand for imports gives such a good approximation to the actual growth experience of major developed countries since 1950 that a new economic rule, or ‘stylized fact’... might almost be formulated.” From a neo-classical perspective, trade helps liberate the dynamism of the market. Competing in external markets sharpens the entrepreneurial ability of local firms; they must market against the best, keep pace with productivity enhancements and push them further, and develop products the world wants. Equally important is the competition of external products in the home market in sharpening entrepreneurial skills. Most empirically-minded analysts of economic development stress the impetus provided by competition in the home market.

If this view of trade is correct, it emphasizes the need to remove distortions in the Atlantic economy which inhibit exports and implies that this is a vital step towards establishing a more dynamic economy in the region. The efficiency advantages of selling to a large market — rather than a small indiscriminating local market, supported by a unusual structure of regional subsidies — are obvious.

Another way to look at the trade disadvantages documented in Chapter 2 is through the perspective of the Verdoorn law, a staggeringly international effort. Writing in Italian, Dutch economist P. J. Verdoorn first proposed the law in an obscure Italian journal *L’Industria* in 1949. It did not receive widespread attention until Lord Kaldor discussed it in

his 1966 inaugural address at Cambridge University and named it Verdoorn's law. Verdoorn isolated the close relationship between the growth of productivity and the growth of output in industry (defined as manufacturing, public utilities and construction). No, or little, relationship between output and productivity growth is evident in other sectors of the economy. This implies industry is primarily responsible for economic growth. The specification and magnitude of the Verdoorn Law is controversial, but few doubt the relationship posited by Verdoorn is an empirical reality.

The Verdoorn Law is often interpreted with a Keynesian twist. Excess labour exists in agriculture. Demand constraints mean this excess labour can be absorbed only slowly by the industrial sector. Nonetheless, high growth results in the decades during which this excess labour is transferring to industry. When the excess labour is absorbed, growth slows. More broadly, as McCombie and Thirlwall note, excess labour can be said to exist in sectors which continue to be operated with a high labour input and a weak link between productivity and employment. In Atlantic Canada, this would include the fisheries and perhaps even industries which have been long supported by government. Here, employment is not based on productivity, but rather on government making up the difference between product and wages, breaking the link between the two.

In Atlantic Canada, government policies deliberately stalled, and sometimes reversed, the flow of excess labour out of traditional industries. This is most evident in the fishing industry where new technology was (and is) often highly regulated, and where seasonal work, and therefore low year-round productivity, was encouraged, and where employment actually grew as government shuffled capital and human resources into the industry through a complex series of subsidy programs, breaking all linkages between productivity and employment. Increasing fisheries employment, which had been on a long-term decline with relatively easy adjustment for individuals, went beyond any rational social goal. As Bickerton (1990, pg. 299) notes:

*[T]he fishery departs from the norm when employment trends are considered. In agriculture, forestry, and mining, rationalization and mechanization had steadily reduced the size of the labour force. But in the fishery employment has fluctuated, depending on the state of the industry. Between 1974 and 1981, the number of licensed fishermen in the Atlantic fishery increased by some 45 per cent (to 53,000) and the number of processing facilities by 35 per cent (to 700). Both labour and capital were subject to seasonal variables, however, with labour underemployed and capital underutilized in the off-peak season.*

It is as if Ontario, at the turn of the century or after the Second World War, decided to promote economic development by increasing farm employment.<sup>18</sup>

Under such circumstances, imagine the current state of Ontario's agriculturally-dominated, industry-weak economy. Iron, coal, heavy water and other government-supported sectors would normally be counted as industry for the purpose of calculating Verdoorn's law, but here, too, government action in Atlantic Canada broke the link between productivity and employment and impeded the adjustment of labour markets. This would be a worthwhile

area of further research. A more complete investigation would try to isolate the areas where government broke the link between productivity and employment, fit this into a McCombie-type model (McCombie 1986 and 1991), and test to see if it is consistent with the data in Atlantic Canada.

Trade is also part of the picture when considering Verdoorn's Law. Atlantic Canada is too small a market for most parts of the industrial sector. To the extent that government policies suppress the region's trade — by increasing costs as discussed in Chapter 2 and through the micro distortions described in Chapter 4 — Atlantic Canada loses the beneficial affects of the Verdoorn Law.