Canada's Oil Sands: Misconceptions about Dutch Disease

G Cornelis van Kooten
Department of Economics, University of Victoria
(May 25, 2012)

Both the leader of the Green Party of Canada, Ms. Elizabeth May, and the newly elected leader of the NDP, Mr. Thomas Mulcair, pounced on a recent OECD report to tell citizens that Canada has Dutch Disease. And oil sands development is the culprit. Ontario Premier Dalton McGuinty has even gone so far as to blame Alberta for undermining the competitiveness of the Ontario economy. Clearly, politicians do not understand Dutch Disease or its cure.

Dutch disease refers to the phenomenon whereby a rise in the value of natural resource exports causes an appreciation of a country's real exchange rate. The higher exchange rate, in turn, makes it more difficult for the country to compete internationally, leading to unemployment in the manufacturing sector. This happened in the Netherlands as a result of a massive gas find in 1959 that led to energy exports, appreciation of the guilder and a less-competitive export sector. The subsequent rise in unemployment was not addressed through improved productivity or by keeping manufacturing wages in check, but with a welfare safety net that aimed to protect workers who lost their jobs. The safety net was paid for by gas royalties. Unfortunately, income transfers became so lucrative that those on welfare had no incentive to seek employment. The government had to import 'guest workers' from Turkey to take menial jobs the Dutch refused to take. The government also had to pass a series of laws to keep welfare payouts in check. One example was a 'front-door law' that reduced welfare benefits for singles if they co-habited with others receiving welfare.

It was only later that the Dutch recognized the error of their ways, sacked the socialist government, brought in industrial strategies to increase productivity, and implemented policies to keep wage increases and government outlays in check. Indeed, by the mid-1990s, the Dutch Central Planning Bureau came out with a report explaining why the Dutch model worked so well, with the economy out performing that of Germany on all measures. It would be the same as if the Greeks, who are currently in a situation equivalent to that of a high exchange rate, were to turn their economy around by significantly increasing productivity, working longer hours and reducing their wages.

Dutch Disease has been used in the 'resource curse' literature as a possible explanation of why countries with abundant natural resources have lower rates of economic growth. Note that the explanation applies equally to forestry, agriculture and minerals as well oil and gas. One could just as well blame these sectors for leading to an appreciation of the Canadian dollar and purported decline in the manufacturing sector. After all, a global commodity boom will increase primary product prices leading to a higher exchange rate – to Dutch Disease.

According to Statistics Canada, in 2011 agriculture, forestry and metals/minerals accounted for $80.9 billion of exports, while crude petroleum contributed only an additional $67.6 billion, much of which came from non-oil sands sources (e.g., coal is the most important exported product from British Columbia and is set to increase in the future as are exports of LNG from that province). Realistically, petroleum exports from oil sands contributed no more than $45 billion, or about 10%, of Canada's exports. Since oil sands development also led to increased imports of material for oil sands development, the impact of the oil sands on the exchange rate during the past several years has likely been small. If anything, the increase in global commodity prices is a bigger culprit in the stronger Canadian dollar than anything coming from the oil sands.

Should Canada react to the commodity boom by reducing exports of primary sector products to protect the exchange rate and manufacturing jobs? Do the Greens and NDP want western Canada to reduce its economic prospects to protect inefficient manufacturing jobs in central Canada?

Proponents of the Dutch Disease view also ignore the benefits of a higher exchange rate – it reduces import prices, including equipment that Canadian manufacturers purchase abroad. By relying on a falling exchange rate to prop up the manufacturing sector, inflation is aggravated. This leads to higher wage demands by unionized labor that undermines Canada's competitiveness, putting greater downward pressure on the exchange rate, and leading to a downward spiraling of living standards. Those on fixed incomes, such as pensioners, would be particularly vulnerable.

Statistical evidence to support the Dutch Disease phenomenon is not forthcoming. Rather exploitation of petroleum resources leads to rent seeking that fuels corruption, which, in turn, leads to diminished economic growth. The culprit is not the rise in exchange rates. If economic rents in the oil and gas sector are used wisely to incentivize productivity gains in manufacturing and address real environmental concerns, then all Canadians can benefit from resource exploitation. But if rents are squandered on government largesse, demands for higher wages that are unwarranted by productivity gains, and welfare programs, Canada's economic prospects could be greatly diminished.

In conclusion, exports from Canada's oil sands and other commodity sectors have the potential to greatly increase the wellbeing of Canadians. Huge economic rents are available because oil, gas and other resources can be exported to countries such as China, Japan, Europe and the U.S. These countries value these commodities by much more than it costs us to deliver them, even after environmental costs are appropriately taken into account. What we do with the rents is what matters! If we use them inappropriately, we can bring about Dutch Disease and regional strife, and harm the worst off in society. But we can also use them to make our economy more productive now and in the future, and increase employment. It is all about good governance!

References

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